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Serbia and Montenegro: 2005 Article IV Consultation—Staff Report; Fifth Review Under the Extended Arrangement, Financing Assurances Review, and Request for Waiver of Nonobservance of Performance Criteria and Rephasing of Purchases—Staff Report; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Serbia and Montenegro

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2005 Article IV consultation with Serbia and Montenegro and the fifth review under the Extended Arrangement, financing assurances review, request for a waiver of nonobservance of performance criteria, and rephasing of purchases, the following documents have been released and are included in this package:

- the staff reports for the 2005 Article IV consultation and fifth review under the Extended Arrangement, financing assurance review, and request for waiver of nonobservance of performance criteria and rephasing of purchases, prepared by a staff team of the IMF, following discussions that ended on February 2, 2005 for the Article IV and May 12, 2005 for the fifth review, with the officials of Serbia and Montenegro on economic developments and policies. Based on information available at the time of these discussions, the staff reports were completed on June 13, 2005. The views expressed in the staff reports are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) and Press Release summarizing the views of the Executive Board as expressed during its June 29, 2005 discussion of the staff report that concluded the Article IV consultation and the IMF arrangement, respectively.

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

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

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

*May also be included in the Staff Report.

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

SERBIA AND MONTENEGRO

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the
2005 Consultation with Serbia and Montenegro

Approved by Reza Moghadam and Donal Donovan

June 13, 2005

- **Article IV consultation discussions.** During January 19–February 2 the staff team met with the President, Prime Minister, and Deputy Prime Minister of Serbia; the ministers of finance, economy, international economic relations, and energy, and the Governor of the National Bank of Serbia; the Prime Minister and Deputy Prime Minister of Montenegro; the minister of finance and the chairman of the Central Bank of Montenegro; other key officials in Serbia, Montenegro, and the Union of SCG; and representatives of public enterprises, trade unions, the private sector, and think tanks. The mission held a seminar with key stake-holders to listen to their views on Serbia's economic challenges.

- **Staff.** The mission comprised Mr. Thomsen, Ms. Sorsa (head), Messrs. Gorbanyov, Mottu, Westphal (all EUR), Chua (FAD), Sdralevich (PDR), and Hirschhofer (resident representative). Messrs. Zurbrügg and Antić (OED) attended most policy meetings.

- **This report covers Article IV issues.** A discussion of policies related to the Extended Arrangement (Appendix I) is contained in a separate staff report for the Fifth Review.

- **2002 Article IV consultation.** At its conclusion, Directors emphasized that prudence and vigilance in policy implementation are required to safeguard the inflation and external objectives and noted the importance of strict wage policy in this regard. They also considered that achieving fiscal sustainability will require improving tax administration and streamlining expenditures by containing current spending. Directors stressed that enterprise and bank reform, as well as an improved business environment, will be critical to foster private sector-led growth (Box 1).

- **Exchange system.** SM has accepted the obligations of Article VIII, Sections 2, 3, and 4, and it maintains a system free of restrictions on payments and transfers for current international transactions.

- **Data.** Despite significant improvements, SM's statistical base is not yet fully adequate for effective surveillance. In particular, the absence of quarterly GDP data and the insufficient coverage and consolidation of fiscal data complicate timely assessments of economic trends (Appendix II).

- **Publication.** The authorities have not yet decided on the publication of this staff report. Previous reports were all published. The mission's concluding statement was released to the public.

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Executive Summary

Macroeconomic imbalances have widened in 2004 putting at risk some of the earlier achievements. Aggregate demand has surpassed supply and spilled over to imports, as slow structural reforms have kept too much labor and capital in uncompetitive activities. As a result, exports have remained at a third of imports, inflation picked up, and the external deficit widened. External vulnerability has increased with the recent build-up of new external debt, although private, to finance imports.

The attempts to deal intermittently with the rising inflation or the external balance with exchange rate policy have failed to reduce the imbalances due to persistent structural rigidities. The use of exchange rate depreciation to lower the external balance led to surging inflation, given the high euro-indexation of prices and the small share of competitive supply. Similarly, fixing the exchange rate to bear down on inflation worsened the external balance, as a rigid spending structure limited fiscal tightening and loose wage policy boosted demand.

The main challenge to policies is to reduce these trade-offs by faster structural reform, while maintaining macroeconomic stability with tighter fiscal, monetary, and incomes policies. While policy implementation in a fragile political environment will not be easy, the recent advances towards EU accession help "draw the road map" to sustainability. The authorities have recently chosen to use again the exchange rate to reduce inflation. To succeed, this would require:

- **Fiscal policy.** To reduce risks for the current account of slower depreciation and increase public savings, fiscal policy needs to be tightened substantially, and its flexibility increased by reducing the large share of non-discretionary spending. This leaves no room for tax cuts in the near term, and calls for reforms in pensions and subsidies to defunct enterprises.

- **Monetary policy**. The high level of euroization, partly a reflection of the frequent shifts in exchange rate policy, complicates monetary management. Nevertheless, monetary policy needs to be tightened to slow the credit boom and foreign borrowing by increasing reserve requirements and repo operations, and continuing the use of prudential measures.

- **Banking reform.** The successful bank privatization should continue, with the entry of new banks boosting competition. Bank supervision is to be strengthened to deal with increased foreign currency risk and credit activity.

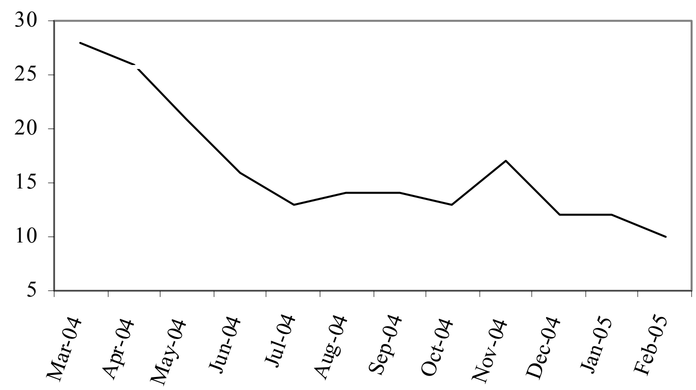
- **Structural reform**. Finalizing the privatization and liquidation of socially owned companies, restructuring state enterprises, and strengthening financial discipline are key to allocating resources for growth and stability given the external financing constraints from high debt levels.

I. INTRODUCTION

1. **The 2005 Article IV consultation takes place at an opportune time.** First, with rising inflation and persistently high current account deficits, SM is at a critical juncture to preempt a further increase in macroeconomic vulnerabilities. Second, the current Extended Arrangement (EA) is drawing to an end in 2005, and the authorities need to decide whether to request a successor arrangement. Third, recent successes towards European Union (EU) accession may consolidate policy reform. Against this background, the Article IV consultation offers an opportunity to take stock of achievements in creating a sustainable basis for growth, and to determine reform priorities.

2. **The political situation is fragile, complicating consistent implementation of economic reforms.** Political tensions in 2003 halted economic reforms initiated in 2002 for almost a year. After general elections in December 2003, the minority government that took office in March 2004 has revitalized policies to stabilize the economy and advance structural reforms. However, the policy agenda remains shadowed by the constant threat of early elections, uncertainties about the future of Kosovo, and calls for ending the SM union. In Montenegro, the ruling coalition retains a majority, facilitating policy implementation.

The government has lost support in polls as reforms have progressed (percent of polled).



II. MACROECONOMIC PERFORMANCE SINCE 2002 HAS BEEN MIXED[1]

3. **Macroeconomic imbalances have widened in 2004, putting at risk some of the earlier achievements (Tables 1–2, Figures 1–2):**

- **GDP growth in recent years has been driven mainly by domestic demand.** Despite a steady 5 percent growth in non-agriculture since 2002, output is barely over half of its pre-transition level, as slow structural reforms have kept competitive supply and exports low.[2] At the same time, a solid growth in remittances and large real wage hikes, peaking at 35 percent in 2002–03, have fuelled domestic demand.

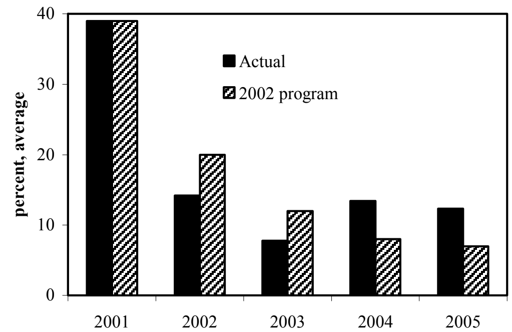
[1] Stabilization in SM has been supported by a three-year Fund arrangement approved in 2002 (Box 1).

[2] Close to 20 percent of labor is still employed in largely unrestructured state and socially-owned enterprises.

Box 1. Performance Under the EA and Implementation of Fund Advice Has Been Mixed

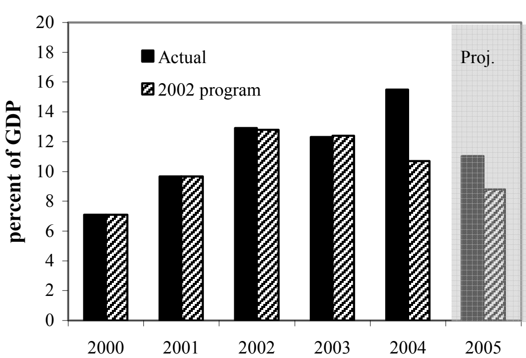
Since the last Article IV discussion, the implementation of Fund advice has been weakest in wage and structural policies. In 2002 Executive Directors emphasized that vigilance in policy implementation was required to safeguard the inflation and external objectives. They noted the importance of strict wage policy in this regard, and stressed that enterprise and bank reform, as well as an improved business environment, would be critical to foster private sector-led growth. In the event, enterprise reform was slow, and wage policy weak. This undermined stabilization and kept the private sector share in the economy at a low 50 percent. The resulting low level of exports and high demand pressures contributed to the large structural trade deficit and made disinflation more difficult.

After initial over performance, inflation has recently been higher than programmed ...

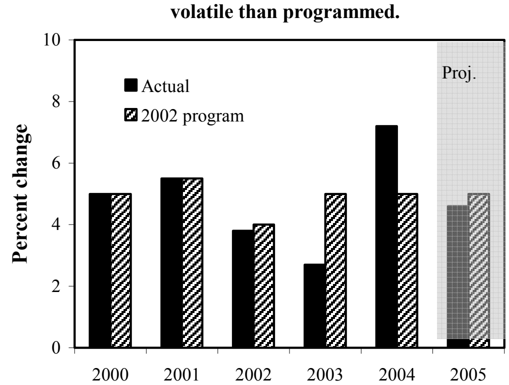


While the EA-supported-program helped stabilize the economy and sustain growth, the current account deficit and inflation have not declined as envisaged. Despite declining, and lower-than-programmed fiscal deficits, demand outpaced supply and boosted imports resulting in a larger current account deficit. Weak incomes policies were unable to arrest large real wage increases that fed demand, along with remittances. A further impetus came from strong credit growth as bank privatization brought in new foreign banks, and greater confidence increased deposits. As the slow restructuring of the enterprise sector kept competitive supply limited, excess demand boosted imports. Disinflation was complicated by the shifts in exchange rate policy between fixing the dinar and generating real depreciations, as pass-through from exchange rate changes was reflected in prices. Structural reform was accelerated in 2004, which together with the tightening of macroeconomic policies is projected to bring down the current account deficit and inflation.

The current account deficit has not declined as envisaged...



...and growth has been moderate but more volatile than programmed.



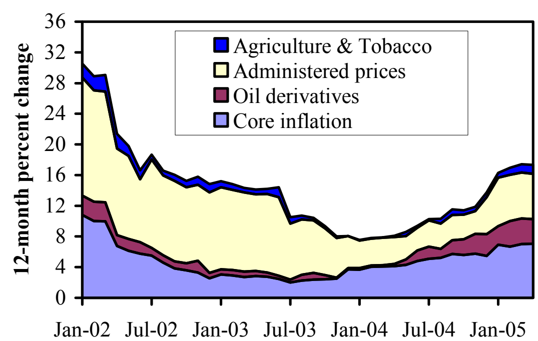
Sources: Serbia and Montenegro authorities; and Fund staff estimates and projections.

Demand was particularly strong in 2004, as a boom in credit from newly established foreign banks and access to foreign loans by recently privatized companies reduced savings needs, and unleashed pent-up consumption and, increasingly, investment. With the limited domestic growth potential, the increased demand spilled over to imports, widening the current account deficit, and boosted inflation. Since mid-2004, there are signs of an incipient recovery in exports from recently privatized companies, but it is too early to draw firm conclusions of a new trend.

- **The resulting large structural current account deficit has become unsustainable with the surge in debt-financing.** The lack of competitive supply has made the trade deficit highly sensitive to demand pressures. As a result, imports have increased to about half of GDP, while exports have remained at about 17 percent of GDP. Despite attempts in 2003–04 to accelerate the real depreciation of the dinar to boost competitiveness, the current account deficit has remained high at 12-15 perc`ent of GDP, reflecting the structural nature of the imbalance.[3] The recent surge in debt-financing of the deficit makes it unsustainable, and increases the country's vulnerability to shocks via the exchange rate.[4] The high debt level also limits future reliance on foreign savings to boost growth. The large inflows of capital increased gross international reserves to US$4.3 billion by end-2004, close to 4 months of projected imports.

- **Inflation in Serbia resurged in 2004 undermining earlier gains, influenced by faster dinar depreciation and demand pressures**. The widespread euro-indexation of prices in Serbia, a legacy of hyperinflation and instability in the 1990's, and the large share of imports in the economy have made prices sensitive to exchange rate movements. In 2002, the exchange rate-based stabilization stopped hyper-inflation. Subsequently, when exchange rate policy shifted towards faster depreciation to deal with the widening external deficit, inflation resurged as the pass-through from the exchange rate to prices accelerated, and demand pressures continued. Inflation dynamics have also been

Core inflation doubled in 2004 as the dinar depreciation accelerated.



Sources: National authorities; and IMF staff calculations.

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[3] Some of the large current account deficit in 2004 (about 1.7 percent of GDP) is explained by a temporal shift of imports between 2004 and 2005 in anticipation of the introduction of the VAT in January 2005.

[4] The 8 percent of GDP increase in net debt in 2004 has kept the debt-to-GDP ratio at 62 percent despite substantial debt relief (7 percent of GDP). The underlying debt remained at 69 percent of GDP.

influenced by lagged effects of a weak incomes policy in 2002–03, as administrative prices are only gradually adjusted for wage increases.[5] Much of the decline in inflation to single digits in 2003, despite wage and exchange rate pressures, likely reflected a pre-election freeze in administrative prices. These pressures were partly unleashed towards end-2004 with large hikes in administered prices.[6] Inflation in 2004 was also influenced by higher fuel prices and strong wage growth until mid-year. While monthly inflation has started to decline in early 2005 in response to the slower dinar depreciation and policy tightening, continued strong demand and delayed administrative price adjustments are likely to keep price pressures strong.

4. **Due to important structural rigidities and timid enterprise reforms, the broadly prudent fiscal and monetary policies failed to reduce the imbalances:**

- **An increasingly tight fiscal stance has supported demand restraint, but a rigid public expenditure structure limits policy flexibility** (Tables 3–5, Figure 3). The deficit (excluding grants) declined from over 5 percent of GDP in 2002 to a projected surplus in 2005. However, the bulk of the adjustment, especially in 2004, was due to an endogenous increase in revenues given the strong economy, while cuts in the rigid, politically sensitive current spending have been more limited. The slow pace of enterprise and pension reforms has led to the share of non-discretionary spending (wages, subsidies, and transfers) remaining high at over 70 percent of total expenditures. As a result, the tax burden and the size of government, with expenditures at 45 percent of GDP, continue to be the highest in the region, reducing the flexibility of fiscal policy in demand management.

Fiscal policy has been continuously tightened.

(General Government, in percent of GDP)

	2002	2003	2004 Est.	2005 Proj.
Total revenue	42.8	42.7	45.2	44.8
Total expenditure	47.3	46.0	45.5	43.7
Overall cash balance	**-4.5**	**-3.3**	**-0.3**	**1.2**
Memorandum items:				
Overall cash balance before grants of:				
Serbian general government	-4.2	-2.9	0.0	1.4
Montenegrin general government	-3.8	-4.9	-3.6	-2.7

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

[5] These still account for 40 percent of the RPI basket.

[6] Estimates in a selected issues paper on inflation indicate that the pass-through from dinar depreciation to prices increased to 0.7. The spike in inflation in early 2005 was also influenced by the introduction of the VAT.

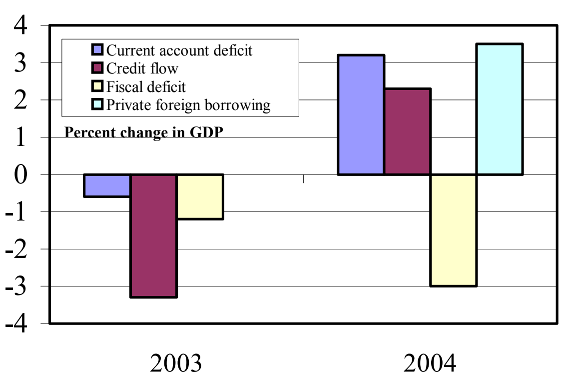
- **Weak incomes policy contributed to demand pressures until mid-2004.** Large real wage increases in the public sector, especially in 2002–03, undermined the exchange rate-based stabilization and attempts at containing demand with fiscal policy. Since mid-2004 a tight wage policy in public enterprises and harder budget constraints in socially owned enterprises have contained wage growth.

Real wage growth has decelerated since mid-2004.

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

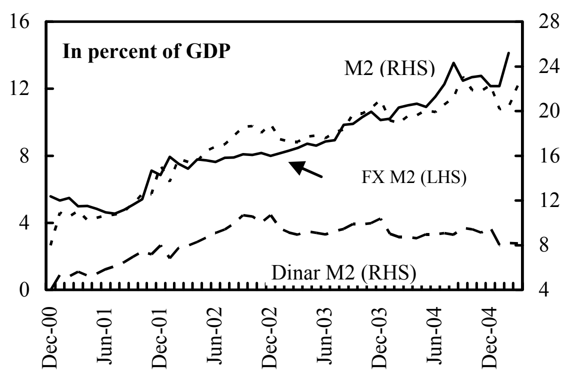
- **Monetary policy, weakened by increasing euroization, has been accommodating (Table 6).** The shifts in exchange rate policy in Serbia to deal intermittently with rising inflation or the external deficit have reduced confidence in the dinar and led to increasing currency substitution.[7] The latter was compounded by the negative real interest rates on dinar-denominated deposits. Rising euroization has reduced monetary policy effectiveness and contributed to the increased pass-through from the exchange rate to prices. At the same time, successful bank restructuring and privatization, and the attendant remonetization coupled with the quest for market share by newly established foreign banks with access to foreign borrowing, contributed to a credit boom in 2004, which exacerbated demand pressures. As the monetary policy tightening in mid-2004 was

Strong credit growth and foreign borrowing may have undermined the impact of tight fiscal policy on the current account.



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

Since 2003 euroization of deposits accelerated.



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

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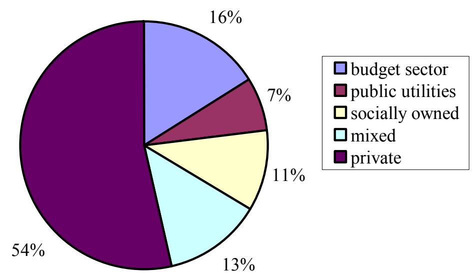
[7] Euroization is discussed in a selected issues paper, which shows that euro deposits have increased to about 70 percent of total deposits, and 70 percent of all loans are either in euro or indexed to the euro.

insufficient to contain the credit boom, the NBS in late-2004 complemented this by tighter prudential measures. While these have halted the growth of consumer loans, other credits continued to expand in 2005. The entry of new banks with the expected advances in privatization in 2005 will increase these pressures further. In Montenegro, which adopted the D-mark in 1999, later replaced by the euro, inflation has stabilized at 3–4 percent (Box 2).

- **The slow structural reform is at the core of the macroeconomic imbalances and rigidities (Figure 4).** As the public sector still produces about half of GDP, competitive supply is small, and too much capital and labor are trapped in overstaffed and unreformed public and socially owned enterprises.[8] The weak financial discipline in many of these enterprises, reflected in subsidies and arrears to the budget and public utilities, has reduced public savings and partially undermined the tight fiscal policy pursued at the central government level.[9] Given the external financing constraint, productivity gains will depend on reallocating resources within the economy through enterprise restructuring. The slow progress in improving the business environment[10] has also weighed on productivity, discouraged investment, including FDI, and increased costs of doing business.

Socially owned and state enterprises still employed about a fifth of the labor force in 2004



Sources: National authorities; and IMF staff calculations.

III. Short and Medium-Term Macroeconomic Outlook and Risks

5. **The outlook for growth in 2005 and beyond is favorable under prudent policies (Table 7–8, Figure 5).** Gradually increasing annual growth to over 5 percent over the medium term should be feasible, given the output gap relative to its level 15 years ago. This will require an increasing investment-to-GDP ratio from the current 18 percent, in particular by a reallocation of resources within the economy from the inefficient state and socially

[8] SM scored lowest in the region in the EBRD transition index in 2004, 8-9 years behind Bulgaria and Romania.

[9] These issues are discussed in more detail in Selected Issues papers on fiscal policy and quasi-fiscal activities.

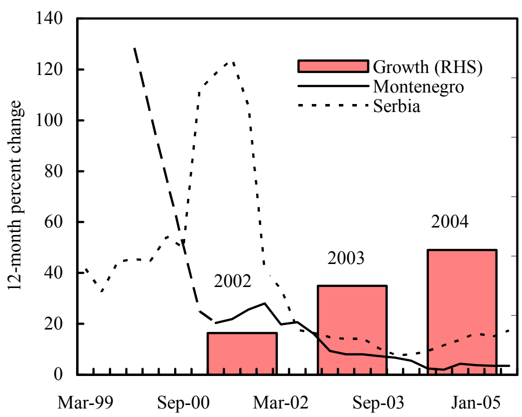
[10] SM ranks mixed in the region in various surveys on competitiveness, corruption, and business environment.

Box 2. Recent Developments in Montenegro under Euroization

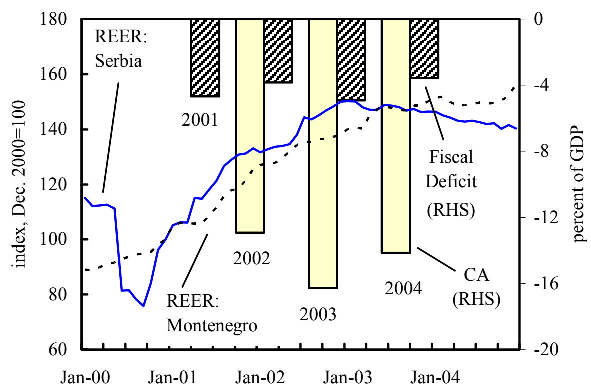
Adoption in 1999 of the D-mark, subsequently the euro, as legal tender has lowered inflation to low single digits. Widespread use of the D-mark in transactions and prices, and a desire to shield the economy from high inflation rates in Serbia were main factors contributing to the decision of full official euroization. This coincided with a rapidly stabilizing inflation, which dropped from over 100 percent to 3-4 percent in two years.

However, failure to contain demand pressures and slow structural reform have kept growth modest and the external deficit large. A relatively loose fiscal stance, rapid credit growth, and availability of external credit led to a rising domestic demand, which was largely met by imports. The slow structural reforms have kept exports at low levels and dependent on a few volatile commodities and tourism. Wage and demand pressures have also appreciated the real exchange rate, eroding the competitiveness of the tradable sectors. Much of the import demand has been satisfied by foreign borrowing, increasing external vulnerability to sudden changes in market conditions.

Inflation decreased sharply but growth remains subdued.



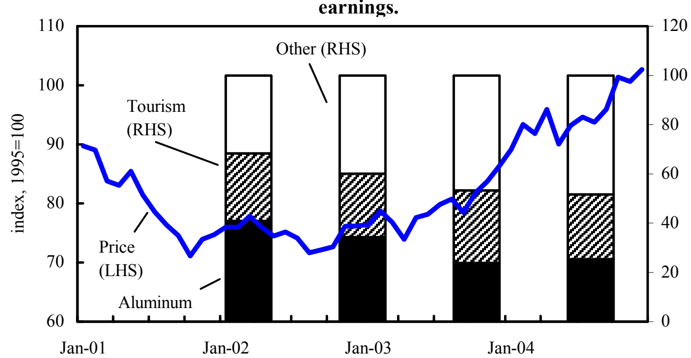
Current account and fiscal deficits are large and the real exchange rate is appreciating.



Source: Montenegro Central Bank; and IMF staff calculations.

Speedier structural reform and stronger demand management would boost growth and external sustainability. The fiscal stance needs to remain cautious to contain demand for imports. The high dependency on aluminum and tourism for export earnings requires a capacity to accommodate sudden shifts in external demand. A sound underlying fiscal position, including low levels of public debt, would enhance the ability to mitigate the impact of shocks. In this context, privatization receipts in 2005 (about 10 percent of GDP) could be used to reduce public sector debt, and to build a fiscal reserve to serve as a buffer for future adjustment needs.

Aluminum price (LHS) is volatile and dominates, with tourism, export earnings.



Sources: World Economic Outlook, and Montenegro Central Bank.

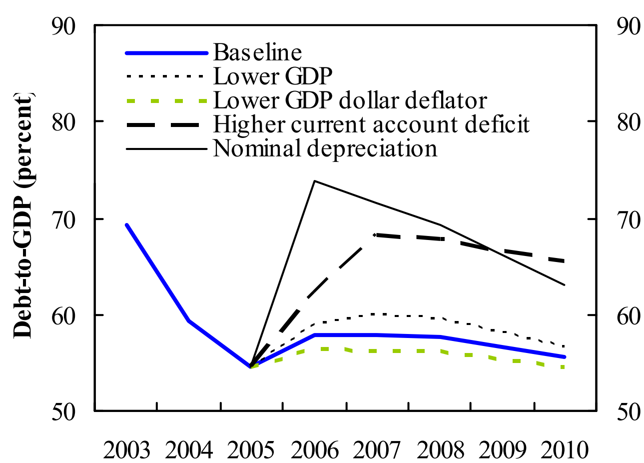
owned enterprises to achieve continued growth in productivity and exports. There was broad agreement that faster structural reforms are key to achieving this.

6. **The current account deficit is unsustainable at present levels and must be reduced steadily.** Continued demand and price pressures make lowering the deficit to 11 percent of GDP in 2005 a challenge. The large investment needs, and pent-up consumer and investment demands, are likely to put pressure on foreign savings. Rapid restructuring and prudent demand policies would help increase investment, exports, and FDI and lower the current account deficit towards 10 percent of GDP over time, with debt-financing declining in line with higher FDI. But even with a prudent policy scenario, the debt-to-GDP ratio would at best stabilize at its current level of 54–55 percent, highlighting external vulnerabilities.

7. **Inflation pressures remain strong**. The authorities expect that a more stable exchange rate and the recent policy tightening would lower inflationary expectations and bring inflation towards single digits by end-2005, admitting, however, that the risks are on the upside. In their view, the recently adopted tougher policies should help achieve this. The staff noted that this is likely to be a challenge, even if demand is reduced further, as inflation in the first five months already reached 7.1 percent. Furthermore, pressures from higher international energy prices and suppressed administered prices make a single digit inflation hard to reach even in the coming years.

8. **The debt-build-up has increased vulnerability to external shocks (Tables 9–11, Appendix III-IV)**. The DSA shows particular vulnerability to changes in external sector conditions such as the exchange rate or current account deficit. The outlook is also vulnerable to policy failures either in containing domestic demand and addressing the still vast structural reform agenda. A "slow reform" scenario (see Figure 5) with a reversal of the fiscal consolidation effort and tepid structural reforms would include lower FDI and slower GDP growth. While this would slightly lower import growth, exports would be significantly less, leading to an exploding debt path, unless foreign reserves are drawn down. Thus the down-side risks of slow reform are high.

The DSA is most sensitive to external shocks...

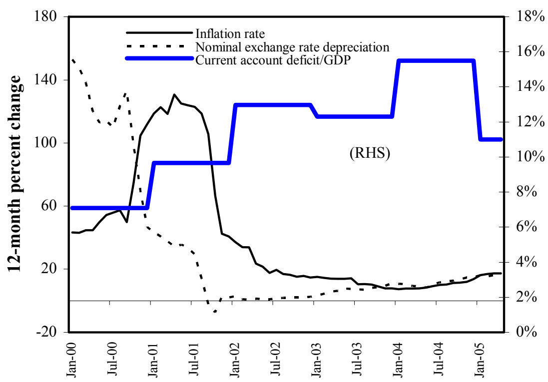


Sources: National authorities; and IMF staff projections

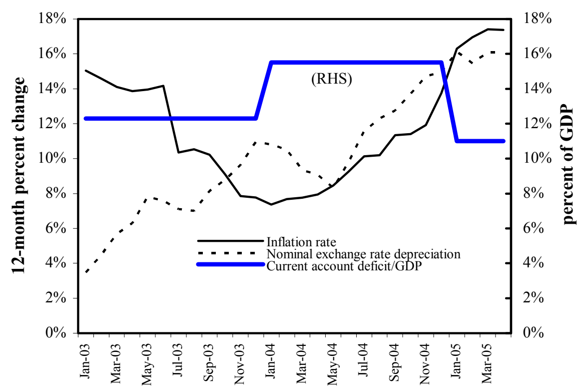
IV. Policy Discussions

A. The Overall Policy Mix

The fixing of the dinar tamed inflation in 2002 at the expense of the current account...



...the shift to faster real depreciation in 2003 fuelled inflation, and failed to lower the current account deficit.



Sources: National authorities, and Fund staff estimates.

9. **Much of the discussions focused on the difficult trade-off between inflation and current account objectives, in an environment of persistent structural rigidities.** There was agreement on the diagnosis that the intermittent use of the exchange rate since 2002 to either lower inflation or the external deficit has led to widening macroeconomic imbalances, despite broadly prudent fiscal and monetary policies, and to a reduced confidence in the dinar as evidenced by increasing euroization. To a large extent this reflects a failure to deal with the underlying structural rigidities in the economy, and weak incomes policy until mid-2004. The increasing euroization and euro-indexation of prices has reduced monetary policy effectiveness and made inflation increasingly sensitive to exchange rate movements. The rigid structure of public spending, stemming from a large share of non-discretionary expenditure, in particular transfers, has limited fiscal policy flexibility in demand management. Failure to privatize and restructure a large part of the enterprise sector with weak financial discipline has kept competitive supply below potential and fuelled large wage increases. The resulting excess demand has spilled to imports and inflation, leading to the macroeconomic imbalances.

10. **There was broad agreement that structural problems and reform are the main cause of and cure for the macroeconomic imbalances, but that these will take time to take effect.** Even with extraordinary efforts, the full impact of reforms in the state and socially owned enterprises on potential growth and the current account deficit will only be felt in the medium term. Fiscal and monetary policies will need to remain tight until then.

11. **Exchange rate policy and the accompanying policy mix were at the core of the discussions.** The authorities insisted on shifting the focus of exchange rate policy to reversing the inflation trend by a slower depreciation of the dinar, to be accompanied by prudent macroeconomic policies, including incomes policy. The staff pointed to the high

risks of this option, as it would require a further tightening of demand through fiscal, incomes, and monetary policies to safeguard the current account objective and to arrest a further build-up of external debt. It could also increase the balance sheet risks of banks, if foreign exchange risk is underestimated. Therefore, this option may not be sustainable against the background of past inability to increase fiscal policy flexibility by addressing the rigid structure of public spending, and the limited effectiveness of monetary policy. Reliance on incomes policy in demand management can also be risky in a politically fragile environment, and it indeed often failed in the past, resulting in large real wage rises. Furthermore, the recent surge in new external debt has increased external vulnerability, including to shocks relating to exchange rate changes. The authorities noted that because the bulk of the increase in debt was by the private sector to finance investment, it was of lesser concern, as it would eventually enhance growth. On the other hand, failure to reverse the upward inflation trend in the coming months could unravel incomes policy and reduce confidence, posing a large risk to stability. In particular, a further surge in inflation could exacerbate exchange rate risks by causing foreign banks to reassess macroeconomic stability, possibly cutting credit lines. While welcoming the authorities' willingness to commit to substantial additional fiscal and monetary tightening to support their choice for exchange rate policy, staff continued to emphasize the risks of this option.

B. Fiscal Policy

12. **There was broad agreement that the fiscal stance in 2005 needs to be tighter than in the budget to increase savings, with further consolidation needed in the medium term**. The fiscal stance in 2005 in Serbia is to be tightened further to generate a surplus. To reduce the current account deficit over time, the staff recommended that a primary surplus of about 2–2½ percent of GDP would be needed. While the authorities agreed to primary surpluses in principle, they noted that specific targets would need to be linked to macroeconomic developments. This will be a challenge in view of the need to increase capital spending[11] and reduce the tax burden over time. In Montenegro, there was agreement that modest deficits need to be maintained in 2005 and beyond to contain the external deficit despite pressures to spend the large privatization revenues.

13. **Given the high tax burden, fiscal consolidation needs to rely mainly on curtailing expenditures and reorienting spending priorities towards supporting growth.** This would also increase flexibility of fiscal policy over time. Savings should focus on reducing the high levels of non-discretionary spending, while increasing capital spending over time. In this context, further reforms are necessary, in particular to reduce the size of the wage bill and restore the financial viability of the pension fund. These will be achieved by a civil service reform in 2005, major changes in the pension law for 2006 in Serbia, as well as government employment reduction in the health sector through outsourcing of non-

[11] The authorities are considering public-private-partnerships to address some infrastructure needs.

medical services.[12] There was broad agreement that accelerated restructuring and privatization would also help reduce subsidies. The authorities were reluctant, however, to commit to more specific medium-term plans for reducing budgetary sector employment and noted that additional budgetary resources will be required to mitigate the social impact of structural reforms, particularly for severance payments. In Montenegro, the repeated failure to implement envisaged employment cuts is reducing the flexibility of fiscal policy. These reforms should be implemented without delay to create room for the needed capital spending.

14. **The need for further fiscal consolidation limits the scope for tax cuts in the near term, while reductions in labor taxes remain a medium-term goal.** The increased shift towards indirect taxes with the VAT is welcome and should enhance efficiency of the tax system. The authorities emphasized that a further reduction in the tax burden by lowering direct taxes was important to improve the efficiency of the system, and to raise compliance. In particular, they noted that reducing labor taxes was important to render SM more competitive and help create jobs. Staff noted that while a lower tax burden over time is welcome, it should be consistent with further fiscal consolidation. In particular, a reduction in labor taxes will need to go hand in hand with pension reform. With respect to 2005, there seems to be no room for tax cuts and any reduction in specific excise taxes to mitigate the impact of high international fuel prices should be resisted.

15. **Enforcing fiscal discipline in municipalities is a key medium-term priority.** There was agreement that local budgets have at times undermined the fiscal stance of the central government. Problems were arising, in particular, from foreign debt financing of infrastructure projects (about 0.4 percent of GDP in 2005), and the use of surpluses accumulated in previous years (0.3 percent of GDP in 2004). Against this background, the authorities were determined to review the legal framework for municipal budgets to reduce the local authorities' scope for undermining the central government's fiscal stance.

16. **Further structural reforms in revenue administration and expenditure management are key for reducing fiscal risks.[13]** Building on recent achievements in tax administration reform, tax compliance needs to be improved further, particularly with respect to socially owned enterprises.[14] Implementing performance-oriented program budgeting, as well as prioritizing foreign-financed public investment projects and

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[12] The envisaged pension reform would increase the pension age by 2 years, and shift from quarterly to annual and to inflation-based indexation. Civil service reform in the army envisages cuts in civilian and army personnel, and a decompression and employment rationalization in the republican government in 2005. Reform in the education and health sectors will be undertaken in the medium-term with the World Bank support,

[13] For a detailed discussion of the fiscal structural reform agenda, see Selected Issues Paper "Creating Fiscal Space– A Reform Agenda for the Fiscal Sector in Serbia".

[14] Many of these are not audited for tax purposes, making it hard to collect arrears.

incorporating them into the regular budget will be key to increasing the efficiency and transparency of public expenditure management. While expected privatization revenues and past fiscal consolidation will reduce overall financing needs in the near term, the development of a strategy for debt management, including arrears clearance, can help address future risks given the high share of external public debt.

C. Monetary, Exchange Rate and Financial Sector Policies

17. **Further monetary tightening will rely on both prudential and monetary policy measures given the high level of euroization.** There was broad agreement that a further tightening of monetary conditions is needed to support exchange rate policy and reduce inflation. This will be achieved primarily by increasing the reserve requirements on foreign currency deposits of enterprises and foreign borrowing of banks, and stepping up the volume of repo operations. It will need to be complemented by the continued use of prudential measures, which besides striving to avoid a deterioration in the quality of the loan portfolio, are also expected to contribute to a slowdown in credit growth.

18. **Discussions on exchange rate policy focused on the trade-offs between inflation and current account targets.** To reduce the risks for competitiveness of the authorities' preference for slower depreciation of the dinar in 2005, the staff pointed to the fact that the burden of achieving external equilibrium now with this option may well fall largely on fiscal policy. The rigid structure of public expenditures limits fiscal adjustment in Serbia, and points to the need for a more flexible exchange rate policy to lower the high current account deficit. With continued wage pressures despite restructuring, and the political difficulties associated with large public expenditure cuts, it could be risky to use the exchange rate to significantly bear down on inflation. Although competitiveness seems currently adequate[15], and risks for the external balance are mitigated by the envisaged large fiscal tightening and faster structural reform, the staff, while concurring to the slower depreciation of the dinar in 2005, pointed to the large risks with this option for the current account. The options for exchange rate policy will be kept under review in light of the degree of success of the current strategy in lowering inflation and the current account deficit, and range from a continued stable dinar policy to more flexibility within an inflation targeting framework.[16]

19. **Restructuring of the banking sector is speeding up.** Most of the remaining state-controlled banks will be offered for sale by end-2005, which should lower state ownership

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[15] The recent strong export performance suggests price competitiveness may have been improved by the real depreciation of the REER since 2003, while wage data are mixed. Wages in SM are high by regional standards, but the recent slowdown in wage growth below productivity may be improving competitiveness. A selected issues paper elaborates on various competitiveness indicators.

[16] Official euroization before joining the ERMII can render EU accession more difficult.

of assets to an estimated fifth of total. This should also spur competition, possibly lowering the still high spreads in the sector. In Montenegro, bank privatization should also be accelerated.

20. **There was broad agreement on the need to continue to enhance financial supervision, in particular given the increased vulnerabilities from rapid credit growth.** The growth of euro-indexed loans has increased currency risk of unhedged borrowers, which is exacerbated by the small share of exporters in the economy. To address these risks, supervision needs to be enhanced with better monitoring and management of risks, and further efforts made to strengthen on-site and off-site supervision and eliminate regulatory forbearance. The authorities emphasized that they are in the process of improving the quality of supervision, including with respect to the linkages between bank and non-bank financial sectors to address the risks from connected party lending, large single borrower exposures, and cross holdings between banks and insurers. A forthcoming FSAP report will further elaborate on financial sector issues (Box 3 in the accompanying staff report on the Fifth Review of the EA).

D. Incomes Policy

21. **A tight incomes policy will remain key for supporting demand management and restructuring of state-owned enterprises.** While the authorities' efforts at containing wage growth in the public sector have recently been successful, and are likely to have produced some demonstration effect as well, staff pointed to high risks of putting too much emphasis on incomes policy in achieving disinflation. Wage bill ceilings are difficult to enforce, and can be circumvented, incomes policy has been difficult to enforce in the past, and the monitored public enterprises cover only a small share of employment. Notwithstanding these concerns, incomes policy will remain a key instrument for reducing losses in state-owned enterprises and containing public expenditure growth.

E. Enterprise Restructuring and Privatization

22. **Bold acceleration of privatization is undoubtedly the overriding economic policy challenge.** Given the constraints on the current account, growth has to rely on improved total factor productivity with a better allocation of existing resources. There was broad agreement on the strategy and actions: restructuring of the state-owned enterprises; privatizing or liquidating all socially-owned enterprises; and increasing financial discipline.

- **While agreeing on the need to restructure the large public companies, the authorities noted that this can take up to five years**. Business and strategic plans have been prepared for eight large companies in Serbia that include divestiture of key non-core activities in 2005, trimming of excess labor, and rationalization of operations, and their implementation is expected to reduce public employment by about 10 000 workers this year. More restructuring is envisaged in the coming years.

- **All socially-owned enterprises will be offered for sale by end-2006.** This will be a formidable task considering the resistance from vested interests, in particular, in the 65 large, debt-ridden, and overstaffed conglomerates under restructuring. Selling the large number of small and medium-sized enterprises with less debt and excess labor should be easier, as many of them are potentially viable with limited additional investments by new owners. Unsellable companies will be declared bankrupt to ensure that all resources are reallocated. In Montenegro, the envisaged sales of hotels and various utilities are an important step in boosting private sector growth.

- **To speed up restructuring and reduce moral hazard, financial discipline in publicly owned enterprises needs to be hardened**. Measures have been taken to speed up arrears collection by the energy companies and the budget in Serbia. As a result, the implied deficits in the state and socially owned companies have started to improve in 2004,[17] with further progress expected in 2005. Direct subsidies will also be gradually reduced in the large and politically sensitive mining and automobile sectors.

23. **The investment climate will also need to be improved to attract more local and foreign investment and reduce inefficiency costs in enterprises.** There was agreement on the need to further streamline administrative regulations and formalities related to the establishment and functioning of enterprises. Refraining from tariff increases is also important to increase competition in the economy.

V. Staff Appraisal

24. **Macroeconomic imbalances have widened in 2004, putting at risk some of the earlier achievements.** The exchange rate-based stabilization in 2002 helped bring the hyperinflation down to single digits by late-2003, and started to create a basis for growth. However, macroeconomic policies have failed to contain aggregate demand. It continues to surpass supply and spill over to imports, as slow structural reforms have kept too much labor and capital in uncompetitive activities. As a result, exports have remained at a third of imports, inflation picked up, and the external deficit widened. External vulnerability has increased with the recent build-up of new external debt, although private, to finance imports.

25. **The reduction of the macroeconomic imbalances requires carefully balanced policies given the persistent structural rigidities in the economy and the increasingly stark trade-off between inflation and the current account.** The recent policy corrections, consisting of the use of an exchange rate anchor, demand tightening, and acceleration of structural reforms, are expected to start reversing inflation and the external deficit. The main burden will fall on fiscal policy to avoid putting at risk the recovery in investments through

[17] See the selected issues paper estimating these deficits.

excessively tight monetary policy, and considering the problems in enforcing incomes policy. However, the widespread euro-indexation of prices, the rigid structure of public spending, and the still small share of a competitive private sector in GDP reduce policy effectiveness and raise risks significantly.

26. **Despite supporting this approach for now, the staff is concerned about a prolonged use of the exchange rate to anchor inflation in Serbia, given the risks for the current account deficit.** The staff concurs to limiting the pace of dinar depreciation to reduce inflation conditioned on the envisaged strong fiscal adjustment and the reinvigoration of structural reforms. Due to the widespread euroization, this policy could prove effective in anchoring inflationary expectations and securing a reduction in inflation. However, the attendant real dinar appreciation requires an even larger fiscal tightening than under a flexible exchange rate policy to prevent a further rise in the current account deficit and in external debt, which should be avoided. As the record of sustainable fiscal adjustment and incomes policy implementation in Serbia is rather poor, and structural reforms can be politically difficult to implement, this strategy carries substantial risks for the external balance. It may also exacerbate the negative impact of demand management on economic growth, which may become politically unsustainable over time. In Montenegro, euroization has successfully contributed to disinflation, but containing the current account deficit requires tight demand management and faster structural reforms.

27. **Given the high tax burden, further fiscal tightening should come from expenditure savings.** Tax cuts in Serbia should be postponed until the macroeconomic situation has stabilized. Expenditure savings can be found in subsidies, social transfers, and the general government wage bill. The envisaged pension reform is welcome in this regard. While cutting total expenditures, additional resources will be required to support reforms, notably for redundancy payments, and to modernize infrastructure. Further fiscal adjustment may be needed if the external deficit fails to improve, including revenue measures if the envisaged, difficult expenditure cuts are delayed. In Montenegro, plans for tax cuts should likewise be postponed until the external deficit has been reduced to a sustainable level. The large expected privatization revenues in 2005 should be saved or used to pay back debt.

28. **Monetary conditions should be tightened in Serbia.** Although the deepening of financial intermediation and the attendant credit boom are welcome for growth and investment, the pace is unsustainable due to the resulting pressure on the current account and external debt. In environments of high euroization, monetary policy needs to continue to rely on both monetary and prudential measures, including reserve requirements on foreign borrowing by banks, to contain credit growth and reduce excess liquidity.

29. **Recent progress with bank privatization is commendable, but banking regulation and supervision must be further strengthened.** The privatization of all state-controlled banks, including two large and systemically important banks, should be completed as soon as possible to reduce prudential risks and increase efficiency in the sector. The sharp increase in mostly euro-linked credits makes it imperative to strengthen banking supervision and enforce sound prudential standards more rigorously. In

Montenegro, further progress with bank privatization is needed to consolidate the progress to date, and the brisk credit growth also calls for continued vigilance in bank supervision.

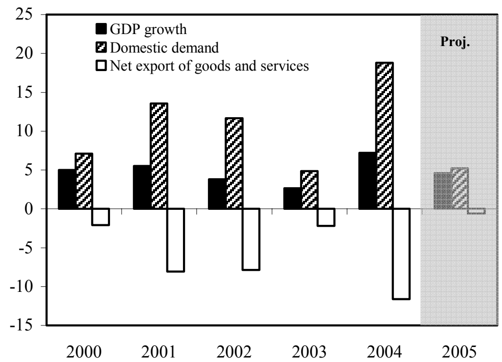
30. **The imposition of a limit on the wage bill in large state-owned enterprises is welcomed considering their weak financial discipline.** However, as these enterprises account for only 8 percent of non-agricultural employment, further means for enforcing financial discipline are needed. In particular, state-owned utilities must cut service to delinquent customers, and bankruptcy procedures should be initiated in case of prolonged arrears.

31. **Boldly accelerating privatization and restructuring remains the main economic challenge.** This is key to overcoming the financial indiscipline that underlies many of the longstanding macroeconomic problems. As the large structural current account deficit leaves little scope for increasing the low share of investments in GDP, sustained economic growth will require redeploying labor and existing capital to more productive uses. The ambitious plan to offer all socially owned enterprises for privatization by end-2006 is welcome. Moving boldly on privatizing these enterprises, while still pressing ahead with restructuring and privatization of large state-owned enterprises, offers a realistic way of ensuring the urgently needed export-driven growth. To meet their ambitious goal for privatization, the authorities should not hesitate to initiate bankruptcy procedures in the case of financially troubled enterprises that do not attract investors. In state enterprises, given significant overstaffing and depleted capital, accelerating labor retrenchment and restructuring is key to improving financial performance. Early privatization and spin-off of non-core activities could possibly attract significant new investments and generate employment.

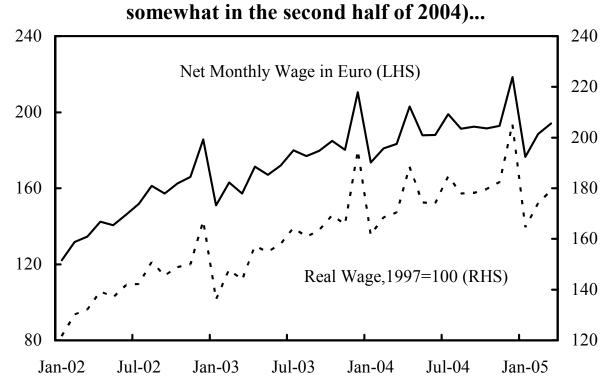
32. Serbia and Montenegro is to remain on the 24-month consultation cycle.

Figure 1. Serbia and Montenegro: Indicators of Economic Activity, 2000-05
(year-on-year growth rates, unless otherwise noted)

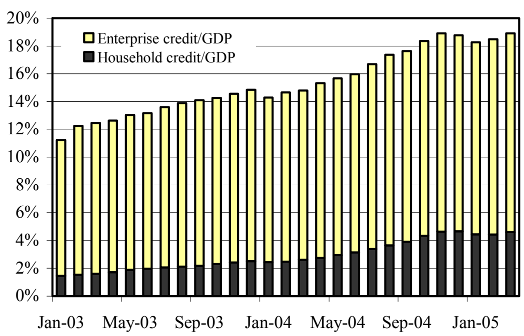
GDP growth has been led by domestic demand...



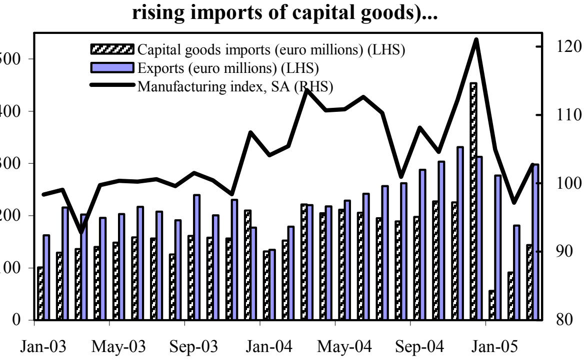
...boosted by real wage increases (albeit moderating somewhat in the second half of 2004)...



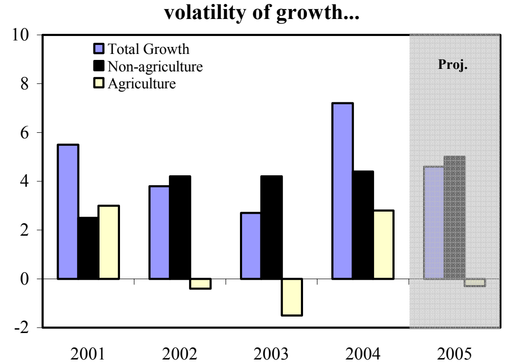
...and a surge in domestic credit.



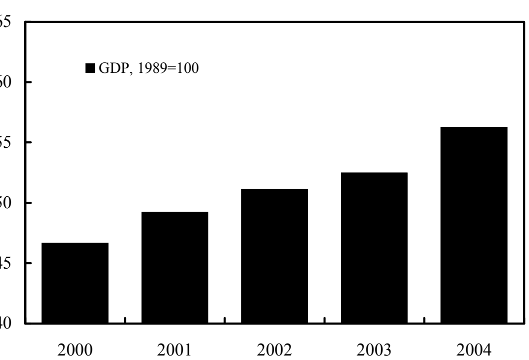
There are signs of stronger manufacturing activity helped by growing exports and investment demand (as indicated by rising imports of capital goods)...



...but large swings in agriculture increased the volatility of growth...



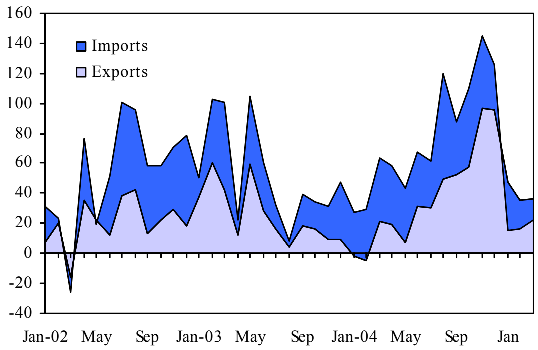
...and output is still well below past levels.



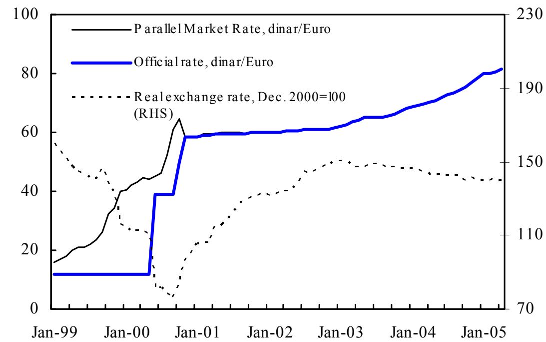
Sources: Serbian Office of Statistics: National Bank of Serbia; and IMF staff estimates.

Figure 2. Serbia and Montenegro: External Sector Developments, 2001–05
(year-on-year growth rates, unless noted otherwise)

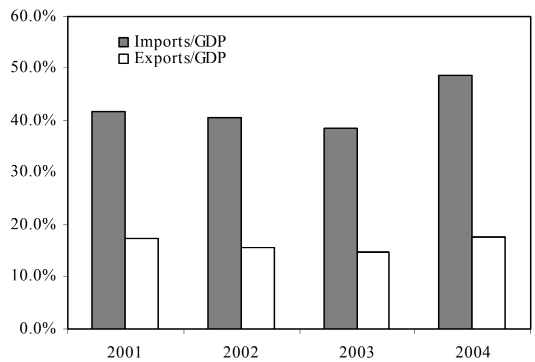
Export and import growth rates accelerated in 2004.



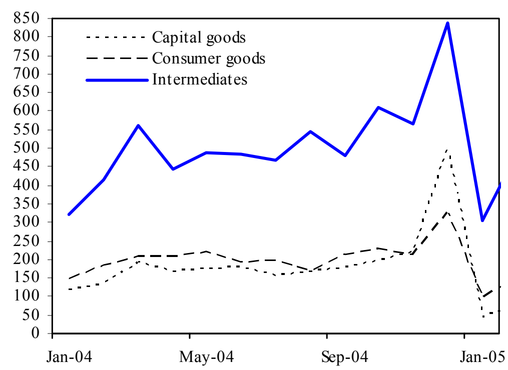
The REER depreciation since 2003 may have helped exports...



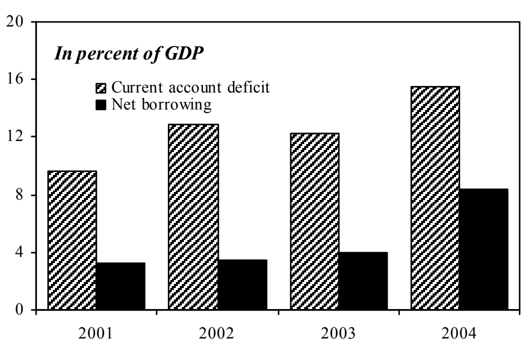
...but imports continue to be much larger than exports.



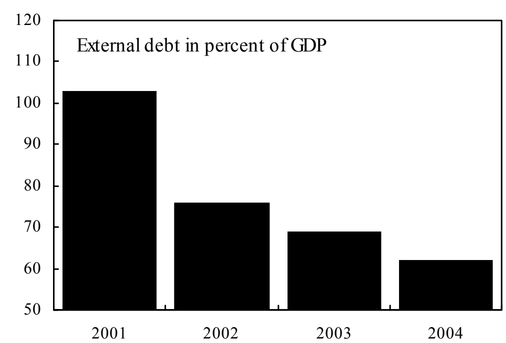
However, some of the large increase in imports at end 2004 is likely to reflect temporary factors.



The increase in debt financing of the current account is of concern and...

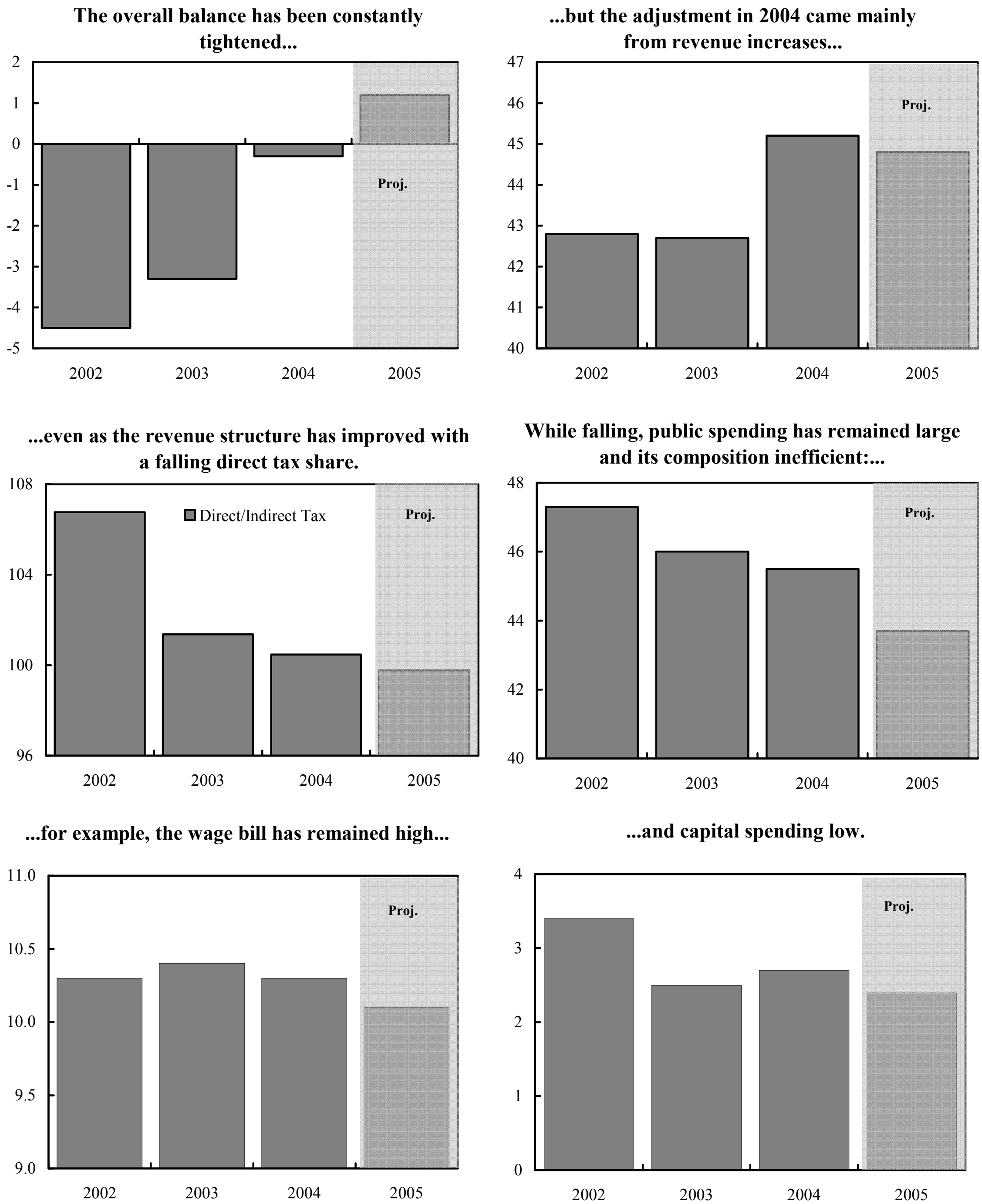


...may undermine the favorable debt development since 2002.



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

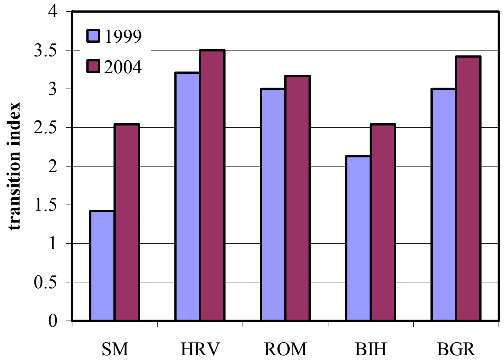
Figure 3. Serbia and Montenegro: Fiscal performance, 2002-05
(In percent of GDP)



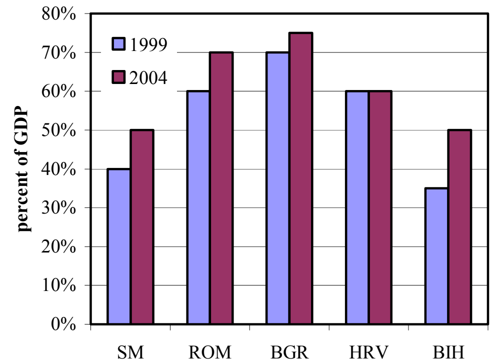
Source: National authorities; and IMF staff estimates and projections.

Figure 4. Serbia and Montenegro: Structural Reform Indicators

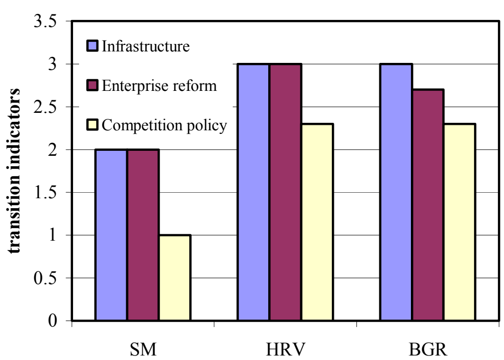
Transition reforms in SM have advanced, but are still 8-9 years behind peer in the region...



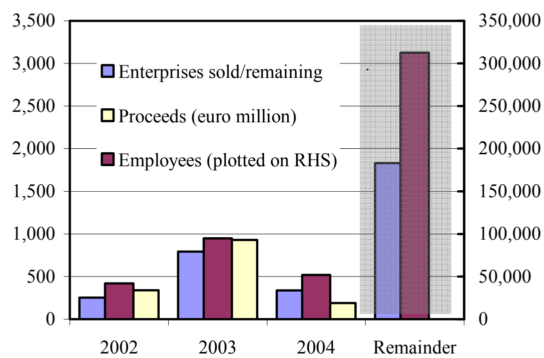
..., and the share of the private sector at 50 % of GDP is among lowest in the region.



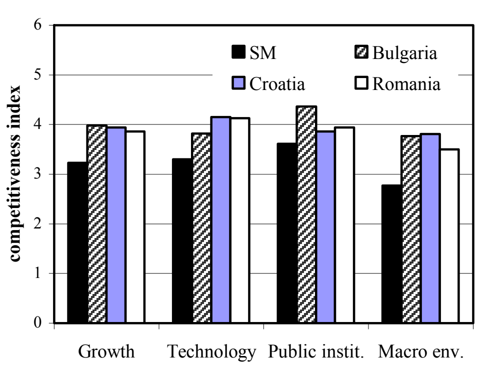
SM is most behind in restructuring-related reforms...



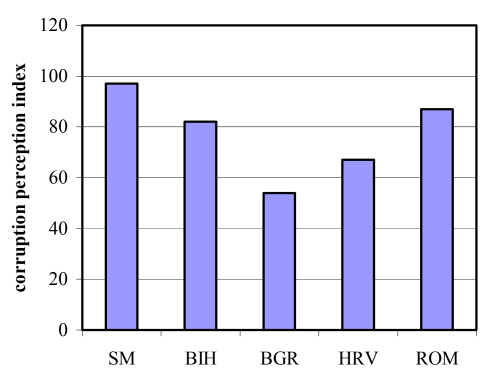
...as, for example, only half of the socially owned enterprises have been sold.



SMs could boost competitiveness by improving the business environment...



...and lower the high perceived corruption.

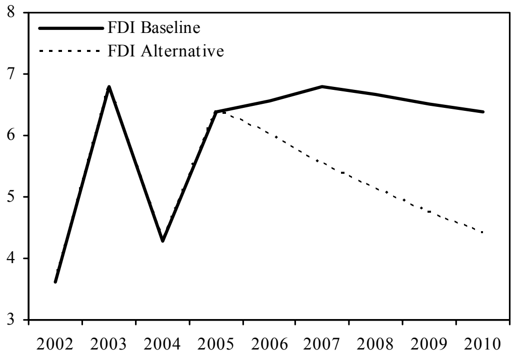


Sources: National authorities; Transparency International; European Bank for Reconstruction and Development; and IMF staff estimates.

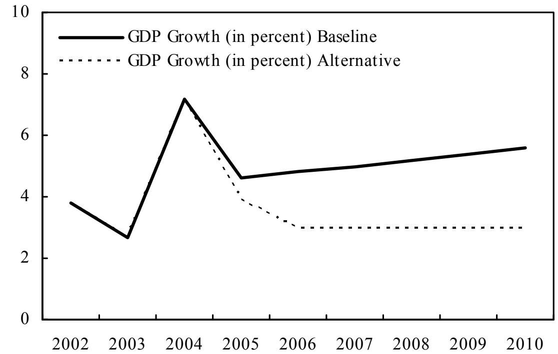
Figure 5. Serbia and Montenegro: Alternative Scenarios, 2002-2010

(In percent of GDP, unless otherwise indicated)

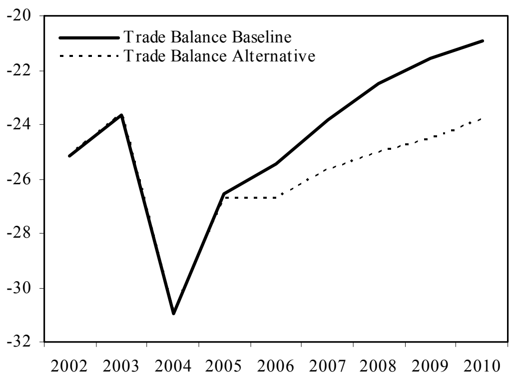
Slower structural reforms accompanied by lower FDI...



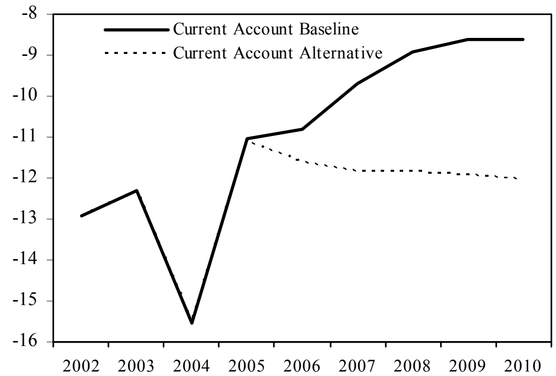
... would lead to lower GDP and export growth,...



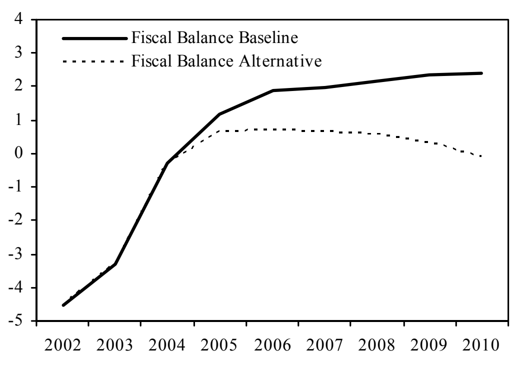
...which in turn would slow down the projected improvements in the trade balance,...



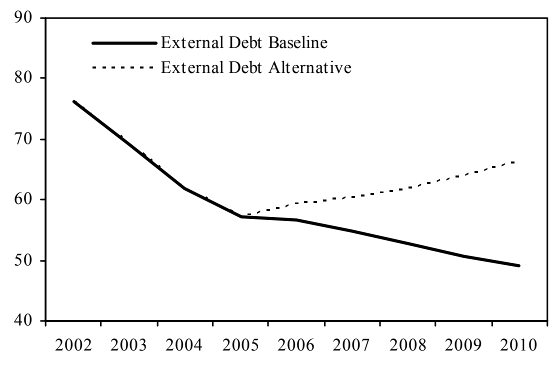
..., the external current account,...



...and the fiscal position.



As a result, external debt would be put on an upward path, unless foreign reserves are drawn down significantly.



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

Table 1. Serbia and Montenegro: Selected Economic and Financial Indicators, 2001–05 1/

	2001	2002	2003	2004 Est.	2005 Proj.
	(Percent change, unless otherwise indicated)				
Real economy					
Real GDP	5.5	3.8	2.7	7.2	4.6
Nominal GDP (in billions of dinars)	772	998	1,189	1,401	1,700
Gross industrial production	0.0	1.7	-2.7	7.5	5.0
Retail prices (period average)	91.1	21.2	11.3	9.5	15.4
Retail prices (end of period, 12-month)	39.0	14.2	7.6	13.4	12.3
Net real wage (period average)	11.3	24.0	12.3	11.9	…
Average net wage (in euros per month)	102	149	175	192	…
Unemployment rate (in percent) 2/ 3/	12.2	13.3	14.6	18.5	…
	(In percent of GDP)				
General government finances 4/					
Revenue	38.9	42.8	42.7	45.2	44.8
Expenditure	40.3	47.3	46.0	45.5	43.7
Overall balance (cash basis)	-1.4	-4.5	-3.3	-0.3	1.2
Foreign grants	0.7	1.1	0.2	0.1	0.2
Foreign loans (net)	0.0	1.8	1.2	1.0	0.9
Privatization receipts	0.0	2.2	4.3	0.6	3.1
Domestic financing (net)	0.7	-0.5	-2.4	-1.4	-5.4
Gross debt 2/ 5/	123.2	85.4	79.2	60.2	53.1
of which: Forex-denominated (in percent of total)	92.0	91.9	90.3	87.9	95.1
	(12-month percent change)				
Money supply (end-of-period) 2/					
Money (M1) 6/	125.2	79.8	10.9	8.0	6.9
Broad money (M2) 6/	104.9	52.7	27.5	30.3	22.4
Credit to non-government 7/	7.6	49.6	25.1	48.1	27.0
	(In percent)				
Interest rates (weighted average, end-of-period)					
Lending rate	32.5	19.2	14.8	14.6	…
Deposit rate	4.1	2.6	2.7	3.6	…
	(In billions of U.S. dollars, unless otherwise indicated)				
Balance of payments					
Current account balance, before grants	-1.1	-2.0	-2.5	-3.7	-2.9
(In percent of GDP)	-9.7	-12.9	-12.3	-15.5	-11.0
Underlying current account balance (percent of GDP) 8/	…	…	…	-13.7	-12.6
Exports of goods (f.o.b.)	2.0	2.4	3.1	4.2	5.5
Imports of goods (c.i.f.)	-4.8	-6.3	-7.9	-11.7	-12.6
Trade balance	-2.8	-3.9	-4.9	-7.4	-7.1
(In percent of GDP)	-24.5	-25.2	-23.6	-31.0	-26.6
Current account balance, after grants	-0.5	-1.4	-1.5	-3.1	-2.5
(In percent of GDP)	-4.6	-8.9	-7.3	-13.1	-9.5
External debt (end of period) 5/	11.9	11.8	14.3	14.9	15.2
(In percent of GDP)	103.2	76.2	69.2	62.0	57.1
Gross official reserves	1.2	2.3	3.6	4.3	5.6
(In months of prospective imports of GNFS)	2.4	3.1	3.3	3.7	4.3
Exchange rate (Dinar/euro, period average)	59.7	60.7	65.1	72.6	…
REER (annual average change, in percent; − indicates depreciation) 2/	23.8	17.1	5.5	-3.5	…

Sources: Statistical Offices of SM, Serbia, and Montenegro; National Bank of Serbia; State Ministries of Finance; and IMF staff estimates.

1/ Excluding Kosovo (with the exception of foreign debt).
2/ Excluding Montenegro.
3/ Break in series in 2004, when it becomes consistent with Eurostat/ILO definition.
4/ Fiscal operations of all levels of government, except for Montenegro where it excludes local governments.
Frozen Foreign Currency Bond payments are recorded below the line.
2004 data include previously off-budget fiscal operations in Montenegro amounting to 0.2 percent of GDP.
5/ Including the first phase of the Paris Club debt reduction in 2002 and of the London Club agreement in 2005.
6/ At current exchange rates.
7/ At constant exchange rates.
8/ Corrected for the surge in imports at end-2004 ahead of the introduction of the VAT in January 2005.

Table 2. Serbia and Montenegro: Balance of Payments, 2001–10
(In millions of U.S. dollars, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
				Est.			Proj.			
Trade balance	**-2,834**	**-3,908**	**-4,886**	**-7,434**	**-7,064**	**-7,204**	**-7,270**	**-7,356**	**-7,561**	**-7,915**
(In percent of GDP)	-24.5	-25.2	-23.6	-31.0	-26.6	-25.4	-23.8	-22.5	-21.5	-21.0
Exports f.o.b.	2,003	2,412	3,054	4,219	5,503	6,705	7,944	9,290	10,670	11,723
(In percent growth)	4.2	20.4	26.6	38.1	30.4	21.8	18.5	16.9	14.8	9.9
(In percent growth in euro)	7.5	14.2	5.8	25.8	23.6	29.1	18.3	16.8	14.7	9.9
Imports c.i.f.	-4,837	-6,320	-7,941	-11,653	-12,568	-13,909	-15,215	-16,646	-18,231	-19,638
(In percent growth)	30.4	30.7	25.6	46.8	7.8	10.7	9.4	9.4	9.5	7.7
(In percent growth in euro)	34.5	23.9	5.0	33.6	2.2	17.3	9.3	9.3	9.4	7.7
Services (non-factor services, net)	**417**	**292**	**336**	**486**	**771**	**681**	**706**	**682**	**615**	**590**
Receipts	740	829	1,130	1,678	2,178	2,399	2,516	2,590	2,625	2,776
Expenditure	-323	-537	-795	-1192	-1407	-1719	-1811	-1908	-2011	-2186
Net factor income	**-26**	**-111**	**-231**	**-293**	**-535**	**-632**	**-693**	**-767**	**-823**	**-916**
Of which: Net interest	-26	-111	-222	-274	-514	-632	-693	-767	-823	-916
Earnings	48	62	70	81	79	113	122	130	138	146
Payments 1/	-74	-173	-291	-354	-593	-745	-815	-897	-961	-1,062
Unrequited private and official transfers, net	**1,915**	**2,343**	**2,777**	**4,092**	**3,891**	**4,097**	**4,303**	**4,519**	**4,746**	**4,985**
Private remittances, net	**1,324**	**1,719**	**2,239**	**3,510**	**3,891**	**4,097**	**4,303**	**4,519**	**4,746**	**4,985**
Inflows	1,698	2,089	2,661	4,129	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Outflows	-374	-370	-422	-620	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Current account balance, before grants	**-1,119**	**-2,007**	**-2,543**	**-3,731**	**-2,937**	**-3,059**	**-2,955**	**-2,921**	**-3,023**	**-3,256**
(In percent of GDP)	-9.7	-12.9	-12.3	-15.5	-11.0	-10.8	-9.7	-8.9	-8.6	-8.6
Official grants 2/	591	624	538	583	0	0	0	0	0	0
Foreign direct investment, net	165	562	1,405	1,028	1,698	1,856	2,074	2,180	2,291	2,407
Foreign loans, net	374	537	822	2,011	1,707	958	656	846	988	1,066
Medium and long term, net	299	379	756	1,588	1,474	758	456	646	788	866
Disbursements	332	421	974	2,119	2,179	1,750	2,000	2,500	2,900	3,200
Of which: Official creditors 2/	205	343	460	537	617	650	700	800	800	800
Amortization	-33	-43	-218	-530	-705	-992	-1,544	-1,854	-2,112	-2,334
Short term, net	75	158	66	423	234	200	200	200	200	200
Other capital inflows	629	892	281	296	254	308	309	309	310	310
Commercial banks, net	-274	-144	31	26	20	0	0	0	0	0
Capital account balance	**894**	**1,846**	**2,539**	**3,362**	**3,679**	**3,124**	**3,041**	**3,338**	**3,593**	**3,789**
Errors and omissions	239	320	409	432	0	0	0	0	0	0
Overall balance	**605**	**784**	**943**	**646**	**742**	**65**	**86**	**416**	**569**	**533**
Financing	**-5,981**	**-855**	**-1,001**	**-3,905**	**-3,012**	**-499**	**-514**	**-728**	**-897**	**-820**
Net foreign assets (increase, -)	-395	-816	-1,001	-711	-1,240	-499	-514	-728	-897	-820
Central Bank, net	-395	-816	-1,001	-711	-1,240	-499	-514	-728	-897	-820
Gross foreign reserves (increase, -)	-523	-1,111	-1,277	-719	-1,301	-457	-400	-400	-400	-400
Of which: IMF purchases	128	295	276	243	276	0	0	0	0	0
Gross foreign liabilities (increase +)	128	295	276	8	60	-42	-114	-328	-497	-420
IMF repayment	0	0	0	-235	-215	-42	-114	-328	-497	-420
Arrears (reduction, -) 3/	-5,587	-39	0	-3,194	-1,772	0	0	0	0	0
Financing expected / to be secured	n.a.	0	n.a.	n.a.	443	293	234	234	234	234
Official grants 2/	n.a.	0	n.a.	n.a.	410	293	234	234	234	234
Official borrowing (excluding IMF) 2/	n.a.	0	n.a.	n.a.	33	0	0	0	0	0
Residual gap	5,377	71	59	3,259	1,827	142	194	78	93	53
Arrears settlement with creditors 3/	5,377	39	0	3,194	1,772	0	0	0	0	0
Debt relief from creditors	0	32	59	65	55	0	0	0	0	0
Memorandum items:										
Current account balance, after grants	-528	-1,383	-1,513	-3,148	-2527	-2,767	-2,721	-2,687	-2,789	-3,022
(In percent of GDP)	-4.6	-8.9	-7.3	-13.1	-9.5	-9.8	-8.9	-8.2	-7.9	-8.0
Gross international reserves, US$ mn (end period)	1,169	2,280	3,557	4,302	5,602	6,059	6,459	6,859	7,259	7,659
in months of prospective imports of goods & services	2.4	3.1	3.3	3.7	4.3	4.3	4.2	4.1	4.0	3.9
Debt service, cash	107	183	451	972	1,732	1,779	2,473	3,079	3,569	3,816
(in percent of GDP)	0.9	1.2	2.2	4.1	6.5	6.3	8.1	9.4	10.2	10.1
Principal	33	43	218	675	1,076	1,034	1,658	2,182	2,609	2,754
Interest	74	141	233	297	656	745	815	897	961	1,062
External Debt 4/	11,948	11,839	14,303	14,876	15,173	16,075	16,700	17,260	17,787	18,599
(In percent of GDP)	103.2	76.2	69.2	62.0	57.1	56.8	54.8	52.8	50.7	49.2
Underlying external debt 5/	n/a	n/a	n/a	16,652	18,367	19,269	19,894	20,454	20,982	21,793
(In percent of GDP)	n/a	n/a	n/a	69.4	69.1	68.0	65.3	62.6	59.8	57.7
Net external debt (debt minus gross reserves)	10,140	8,776	9,860	9,714	8,731	9,176	9,401	10,401	10,528	10,940
(In percent of GDP)	87.6	56.5	47.6	40.5	32.8	32.4	30.8	31.8	30.0	29.0

Sources: SM authorities; and IMF staff estimates.

1/ Debt service due after the debt reduction granted by bilateral and commercial creditors, but before the capitalization of moratorium interest (in "debt relief from creditors").

2/ Official grants and loans recorded above-the-line are amounts based on conservative assumptions; further possible amounts are shown below-the-line.

3/ Negotiations are on-going to clear all remaining external arrears.

4/ Including July 2004 debt reduction from London Club, and assuming completion of Paris Club debt relief operation and comparable debt relief by non-Paris Club and commercial creditors (from June 2004 onwards).

5/ Excluding all debt relief concluded or assumed after end-June 2004.

Table 3. Serbia and Montenegro: General Government Fiscal Operations, 2001–05 1/
(In percent of GDP) 2/

	Consolidated General Government: Serbia					Consolidated General Government: Serbia and Montenegro				
	2001	**2002**	**2003**	**2004** Est.	**2005** Proj.	**2001**	**2002**	**2003**	**2004** Est.	**2005** Proj.
Total revenue	**35.9**	**40.0**	**39.9**	**42.3**	**41.9**	**38.9**	**42.8**	**42.7**	**45.2**	**44.8**
Current revenue	35.9	40.0	39.5	41.9	41.5	38.9	42.8	42.3	44.7	44.4
Tax revenue	32.9	37.0	36.2	38.4	37.9	35.5	39.6	38.8	41.1	40.7
Personal income tax	4.3	5.3	5.9	5.5	5.2	4.7	5.7	6.2	5.8	5.5
Social security contributions	9.9	9.8	9.7	11.0	10.5	11.1	10.7	10.6	11.9	11.3
Corporate income tax	0.4	0.4	0.5	0.5	0.5	0.4	0.5	0.6	0.6	0.6
Retail sales tax/VAT	9.3	11.0	10.6	11.4	12.3	9.8	11.7	11.4	12.2	13.1
Excises	3.4	4.5	4.9	5.2	4.8	3.7	4.8	5.2	5.6	5.1
Taxes on international trade	1.9	2.4	2.4	2.4	2.3	2.1	2.7	2.6	2.6	2.5
Other taxes	3.6	3.5	2.1	2.4	2.4	3.7	3.6	2.1	2.5	2.5
Nontax revenue	3.0	3.0	3.4	3.5	3.6	3.5	3.2	3.5	3.6	3.8
Capital revenue	0.0	0.0	0.4	0.4	0.4	0.0	0.0	0.4	0.5	0.4
Total expenditure and net lending	**36.8**	**44.2**	**43.0**	**42.3**	**40.6**	**40.2**	**47.3**	**46.0**	**45.5**	**43.7**
Current expenditure	34.6	40.5	40.1	39.6	37.9	37.6	43.3	42.8	42.5	40.7
Expenditure on goods and services	16.0	17.1	17.0	17.0	16.7	17.4	18.3	18.2	18.1	17.9
Wages and salaries	8.5	9.5	9.5	9.5	9.2	9.5	10.3	10.4	10.3	10.1
Of which: severance payments	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.1
Goods and services	7.5	7.7	7.4	7.5	7.5	8.0	8.0	7.8	7.8	7.8
Other current spending	0.0	0.0	0.5	0.7	0.0	0.0	0.0	0.5	0.9	0.2
Interest payment	0.7	0.9	0.9	1.3	1.2	0.7	1.0	1.0	1.4	1.3
Subsidies and other current transfers	17.8	22.5	21.6	20.7	20.0	19.5	24.0	23.0	22.1	21.3
Subsidies	3.0	4.2	3.4	3.1	2.5	3.1	4.4	3.5	3.1	2.5
Transfers to households 3/	14.8	18.3	18.2	17.7	17.5	16.4	19.6	19.5	19.0	18.8
Capital expenditure	1.4	3.3	2.4	2.6	2.2	1.6	3.4	2.5	2.7	2.4
Of which: financed by project loans	0.0	0.7	0.5	0.6	0.5	0.0	0.8	0.5	0.7	0.6
General reserves	0.0	0.2	0.0	0.0	0.1	0.1	0.3	0.0	0.1	0.2
Lending minus repayment	0.8	0.1	0.6	0.1	0.3	0.9	0.1	0.7	0.2	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
Net transfer from Montenegro	0.0	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gap/Statistical discrepancy	0.1	0.2	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.0
Overall balance	**-1.0**	**-4.2**	**-2.9**	**0.0**	**1.4**	**-1.3**	**-4.5**	**-3.3**	**-0.3**	**1.2**
Excluding project loans	-1.0	-3.5	-2.5	0.6	1.9	-1.3	-3.7	-2.8	0.4	1.8
Foreign grants	0.4	1.0	0.2	0.1	0.2	0.7	1.1	0.2	0.1	0.2
Overall balance including grants	-0.5	-3.3	-2.8	0.0	1.6	-0.6	-3.4	-3.1	-0.2	1.4
Financing	0.5	3.3	2.8	0.0	-1.6	0.7	3.4	3.1	0.2	-1.4
Domestic financing	0.5	-0.2	-2.5	-1.4	-4.6	0.7	-0.5	-2.4	-1.4	-5.4
Foreign Financing	0.0	1.7	1.1	0.9	0.8	0.0	1.8	1.2	1.0	0.9
Privatization receipts	0.0	1.8	4.1	0.5	2.3	0.0	2.2	4.3	0.6	3.1

Sources: Ministries of Finance of the Republic of Serbia and the Republic of Montenegro; and IMF staff estimates.
1/ Includes the federal, the republican, and the local governments (except for Montenegro), the social security funds, and the extrabudgetary programs.
2/ GDP of Serbia and Montenegro, excluding Kosovo.
3/ Excluding foreign currency deposit payments to households, reclassified below the line.

Table 4. Serbia: Republican Government Fiscal Operations, 2001-05
(In percent of GDP) 1/

	2001	2002	2003	2004 Est.	2005 Proj.
A Total revenue and grants (1+2+3)	**16.2**	**25.6**	**24.6**	**25.1**	**26.5**
1. Total revenue (1.1+1.2)	15.8	24.7	24.2	25.0	26.3
1.1 Current revenue (1.1.1+1.1.2)	15.8	24.7	24.2	25.0	26.3
1.1.1 Tax revenue (1.1.1.1+...+1.1.1.6)	14.8	22.8	21.6	22.7	23.9
1.1.1.1 Personal income tax	4.1	4.4	4.4	3.9	3.1
1.1.1.2 Corporate income tax	0.4	0.4	0.4	0.5	0.5
1.1.1.3 Turnover tax 2/	4.9	9.4	9.1	9.6	12.3
1.1.1.4 Taxes on international trade	0.0	2.4	2.4	2.4	2.3
1.1.1.5 Excises	3.2	4.5	4.9	5.2	4.8
1.1.1.6 Property taxes	1.3	1.0	0.3	1.1	1.0
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	2.6	2.3	2.4
1.2 Capital revenue	0.0	0.0	0.0	0.0	0.0
2. Transfer from Montenegro	0.0	0.0	0.0	0.0	0.0
3. Grants	0.4	1.0	0.2	0.1	0.2
B. Total expenditure and net lending (1+...+6)	**17.0**	**29.1**	**27.2**	**25.9**	**25.2**
1. Total expenditure (2+3+4)	16.2	29.0	26.6	25.9	24.9
2. Current expenditure (2.1+2.2+2.3)	15.7	27.1	24.5	23.6	23.3
2.1. Expenditure on goods and services (2.1.1+...+2.1.4)	6.7	5.9	7.4	6.9	6.7
2.1.1 Wages and salaries	3.5	3.5	4.6	4.2	4.0
2.1.2 Employer contribution	0.7	0.8	0.9	0.8	0.8
2.1.3 Severance payments	0.0	0.0	0.0	0.0	0.1
2.1.4 Other purchases of goods and services	2.4	1.5	1.7	1.7	1.4
2.2. Interest payment	0.1	0.7	0.9	1.0	1.2
2.3. Subsidies and other current transfers	8.9	20.6	16.2	15.6	15.4
2.3.1 Subsidies	2.8	3.4	2.6	2.5	1.8
2.3.2 Transfers to households 3/	2.8	3.2	3.1	2.3	2.5
2.3.3 Current transfers to other levels of government	3.4	14.0	10.4	10.8	11.2
Federal budget	0.0	6.9	2.7	3.3	2.9
Local Budgets	0.1	1.3	1.2	1.0	2.1
Pension Funds	2.8	4.9	5.4	5.0	4.9
Health Fund	0.3	0.4	0.3	0.2	0.2
Labor Market Fund	0.1	0.3	0.4	0.6	0.5
3. Capital expenditure	0.5	1.9	1.8	2.2	1.5
Of which: Budget for recovery and reconstruction	0.0	0.7	0.5	0.6	0.5
4. General reserves	0.0	0.0	0.0	0.0	0.1
5. New Serbia expenditure	0.0	0.0	0.0	0.0	0.0
6. Lending minus repayment	0.8	0.1	0.6	0.1	0.3
Overall budget balance including grants (A-B)	**-0.8**	**-3.5**	**-2.6**	**-0.8**	**1.2**
Overall budget balance excluding grants and project loans	-1.2	-3.7	-2.3	-0.3	1.6
Financing (1+2+3)	0.8	3.5	2.6	0.8	-1.2
1. Domestic financing (net)	0.8	0.0	-2.6	-0.6	-4.3
2. Foreign financing (net)	0.0	1.7	1.1	0.9	0.8
3. Privatization receipts 4/	0.0	1.8	4.1	0.5	2.3

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

1/ GDP of Serbia and Montenegro, excluding Kosovo. Data for 2000 and 2001 exclude the Union budget.
2/ Retail sales tax up to 2004. VAT from 2005 onward.
3/ Excluding frozen foreign currency deposit payments to households, reclassified below the line.
4/ Total privatization revenue accruing to the republican government.

Table 5. Montenegro: Consolidated Fiscal Operations, 2001–05
(In percent of GDP)

	2001	2002	2003	2004 Est.	2005 Proj.
Total revenue	**38.0**	**35.1**	**34.8**	**36.5**	**36.3**
Current revenue	38.0	35.1	34.8	36.2	36.3
Tax revenue	32.9	32.8	32.6	34.5	34.7
Personal income tax	5.4	4.4	4.4	4.2	4.2
Social security contributions	10.8	11.5	10.6	11.2	10.3
Corporate income tax	0.6	1.0	0.9	1.1	1.4
VAT (Retail sales tax until March 2003 1/)	7.1	8.3	9.7	10.3	10.7
Excises	4.4	4.3	4.0	4.0	4.2
Taxes on international trade	4.3	3.0	2.7	2.4	2.6
Other taxes 2/	0.4	0.4	0.2	1.3	1.3
Extrabudgetary taxes	0.0	0.0	0.0	0.0	0.0
Nontax revenue	5.1	2.3	2.2	1.7	1.5
Capital revenue	0.0	0.0	0.1	0.2	0.0
Total expenditure and net lending	**42.3**	**38.6**	**37.6**	**37.7**	**36.4**
Current expenditure	38.6	35.5	34.0	34.0	32.4
Net wages, salaries and allowances	9.9	10.0	8.9	9.5	9.1
Payroll tax	1.6	1.1	1.5	1.7	1.4
Purchases of goods and services	5.9	3.7	4.2	3.5	3.4
Interest payment	0.1	1.0	1.0	1.6	0.9
Subsidies and other current transfers	20.7	19.0	17.9	16.9	17.2
Subsidies to enterprises	1.2	1.9	1.0	0.6	0.4
Transfers to households 3/	19.5	17.1	16.9	16.4	16.8
Other non-interest current expenditure	0.5	0.6	0.5	0.7	0.4
Capital expenditure	2.0	1.5	1.6	2.0	2.8
Of which : foreign financed project spending	0.0	0.6	0.6	1.2	1.1
General reserves	0.6	1.0	0.6	0.7	0.7
Net lending	1.1	0.7	1.4	1.0	0.5
Transfer to the Union Budget	**0.0**	**0.0**	**2.2**	**2.3**	**2.6**
Discrepancy	0.4	0.3	-0.1	0.0	0.0
Overall balance before grants	**-4.7**	**-3.8**	**-4.9**	**-3.6**	**-2.7**
Overall balance before grants and foreign-financed project loans	**-4.7**	**-3.3**	**-4.4**	**-2.4**	**-1.6**
Foreign grants	3.1	2.1	0.9	0.5	0.2
Overall balance including grants	**-1.6**	**-1.8**	**-4.0**	**-3.1**	**-2.4**
Financing	**1.6**	**1.8**	**4.0**	**3.1**	**2.4**
Domestic financing	**1.6**	**-3.7**	**1.7**	**0.6**	**-9.5**
Bank financing	0.8	-3.4	1.1	-0.8	-9.0
Nonbank financing	0.8	-0.3	0.6	1.4	-0.5
Of which: repayment of FFCDs 3/	0.0	-0.3	0.0	-0.3	-0.5
Foreign financing (net)	**0.0**	**0.6**	**1.3**	**2.0**	**1.9**
Program	0.0	0.0	0.8	0.9	0.9
Project	0.0	0.6	0.6	1.2	1.1
Amortisation	0.0	0.0	0.0	-0.1	-0.1
Privatization receipts	**0.0**	**4.9**	**1.0**	**0.5**	**10.0**
Memorandum item:					
Montenegro GDP (Euro million)	1,049	1,302	1,441	1,531	1,639

Sources: Montenegrin Ministry of Finance; and Fund staff projections.

1/ From 2002 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/ Foreign currency deposit payments to households, formerly classifed as above the line, were reclassified as below the line.

Table 6. Monetary Survey of Serbia, December 2001–December 2005
(In millions of SRD; end of period) 1/

	2001	2002	2003	2004	2005			
					Mar.	Jun.	Sep.	Dec.
					Act.	Proj.	Proj.	Proj.
Net Foreign Assets 2/	93,179	136,996	172,685	198,589	202,392	204,199	225,833	252,046
(NFA in millions of euro)	1,561	2,227	2,528	2,517	2,566	2,589	2,863	3,195
Assets	122,375	180,694	242,371	298,180	304,837	305,904	329,314	363,206
NBS	79,100	134,491	193,962	245,936	258,450	261,600	281,076	312,113
Commercial banks	43,275	46,203	48,409	52,244	46,387	44,304	48,238	51,093
Liabilities (-)	-29,196	-43,697	-69,686	-99,592	-102,445	-101,706	-103,480	-111,160
NBS	-25,173	-39,333	-59,740	-66,162	-62,599	-70,281	-67,279	-70,463
Commercial banks	-4,023	-4,365	-9,946	-33,429	-39,847	-31,424	-36,201	-40,697
Net Domestic Assets	19,101	49,709	64,249	110,136	102,551	113,617	114,497	104,126
Domestic credit	97,006	144,168	153,356	248,341	254,862	…	…	…
Net credit to government	1,258	-12,595	-23,586	-21,560	-42,119	-35,289	-50,529	-78,146
Credit	16,429	24,377	23,250	30,402	30,856	…	…	…
Dinar credit	16,154	23,497	23,130	30,255	30,409	…	…	…
NBS	13,085	20,720	19,051	21,427	21,235	…	…	…
Commercial banks	3,069	2,777	4,079	8,828	9,174	…	…	…
Foreign currency credits	275	880	120	147	447	…	…	…
NBS	0	0	0	0	0	…	…	…
Commercial banks	275	880	120	147	447	…	…	…
Liabilities	-15,171	-36,972	-46,836	-51,962	-72,975	…	…	…
Dinar liabilities	-11,052	-21,079	-25,677	-38,762	-52,005	…	…	…
NBS	-3,734	-5,101	-14,305	-28,064	-40,592	…	…	…
Commercial banks	-7,318	-15,978	-11,372	-10,698	-11,413	…	…	…
Foreign currency deposits	-4,119	-15,893	-21,159	-13,200	-20,970	…	…	…
NBS	-3,783	-6,159	-18,108	-9,801	-17,528	…	…	…
Commercial banks	-336	-9,734	-3,051	-3,399	-3,442	…	…	…
Short-term government credits to banks	-768	-191	-239	-363	-450	…	…	…
Purchased bonds for repaying frozen deposits	...	1,384	4,897	8,240	10,187	10,000	11,500	12,500
Credit to the non-government sector	96,515	155,570	172,284	262,024	287,244	294,712	312,907	332,811
Households	4,377	16,021	28,643	64,441	69,844	…	…	…
Non-profit and other sectors	2,658	4,553	3,815	2,397	2,205	…	…	…
Non-profit and other sector in dinar	2,022	4,140	3,379	2,081	1,929	…	…	…
Non-profit and other sector in foreign currency	636	413	436	316	275	…	…	…
Enterprises in dinar	40,416	71,507	88,911	138,382	157,584	…	…	…
Enterprises in foreign currency	49,064	63,489	50,915	56,804	57,612	…	…	…
(in millions of euros)	836	1,063	745	720	843	…	…	…
Other items, net.	-77,905	-94,459	-89,107	-138,204	-152,311	-155,806	-159,381	-163,039
Broad Money (M2)	112,280	186,706	236,934	308,725	304,944	317,816	340,331	356,172
Dinar-denominated M2	64,368	105,328.7	117,040	132,249	124,129	128,479	135,408	141,238
M1	49,269	88,579	98,223	106,112	99,676	104,436	108,910	113,404
Currency outside banks	25,324	43,719	42,979	45,165	39,368	41,416	43,087	46,972
Demand deposits	23,945	44,860	55,244	60,947	60,308	63,019	65,823	66,432
Time and savings deposits	7,697	16,750	18,817	26,137	24,453	24,043	26,497	27,834
Foreign currency deposits (Non-frozen)	47,912	81,377	119,894	176,476	180,815	189,337	204,923	214,934
(In millions of euros)	802	1,323	1,755	2,237	2,647	2,400	2,598	2,725
Memorandum items:								
Broad money at current exchange rates (in billions of SRD)	104.9	187.0	240.4	308.7	338.7	327.6	356.0	377.8
Foreign currency deposits (current exchange rates, in billions of SRD)	40.5	81.6	123.4	176.5	214.5	199.1	220.6	236.6
12-month growth rates (in percent)								
Broad Money (M2)	104.9	52.7	27.5	30.3	42.6	31.3	26.0	22.4
Dinar-denominated M2	143.2	63.6	11.1	13.0	17.6	14.1	11.7	6.8
M1	125.2	79.8	10.9	8.0	12.6	10.9	9.0	6.9
Currency outside banks	131.6	72.6	-1.7	5.1	3.6	2.7	1.5	4.0
Foreign currency deposits	...	101.5	51.1	43.0	62.7	45.5	36.8	34.1
Velocity (M1)	16.3	11.1	11.6	13.0	15.2	14.9	14.7	14.4
Multiplier (Dinar M2/Reserve money)	1.6	1.7	1.7	1.7	1.8	1.9	1.9	2.0
Currency/Dinar deposits (In percent)	73.2	71.0	58.0	51.9	48.4	47.6	46.7	49.8
Required reserve ratio (Effective, in percent)	0.0	29.5	24.5	24.1	23.1	24.1	24.1	24.1
Excess reserves/Dinar deposits (In percent)	22.7	12.6	15.3	12.5	9.5	6.2	6.2	7.1
Foreign exchange deposits/Broad money	38.6	43.7	51.3	57.2	63.3	60.8	62.0	62.6
Dinar-denominated M2/ annualized monthly GDP	8.0	10.7	10.3	9.6	8.2	8.3	8.5	8.6

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

1/ For 2001-2004, valued at current exchange rates; for 2005, valued at end-2004 exchange rates.
2/ Excluding undivided assets and liabilities of the SFRY and, from 2002 onwards, liabilities to banks in liquidation.

Table 7. Serbia and Montenegro: Macroeconomic Framework, 2001–10

	2001	2002	2003	2004 Est.	2005 Proj.	2006	2007	2008	2009	2010
Nominal GDP (billions of dinars)	772	998	1,189	1,401	1,700	1,952	2,200	2,426	2,658	2,918
					(Percent change)					
Real GDP	5.5	3.8	2.7	7.2	4.6	4.8	5.0	5.2	5.4	5.6
Retail prices (end-period)	39.0	14.2	7.6	13.4	12.3	9.0	6.0	4.0	4.0	4.0
					(In percent of GDP)					
Gross domestic savings	-7.2	-7.3	-5.9	-11.3	-5.3	-3.2	-0.4	1.2	2.4	3.3
Non-government	-7.8	-5.6	-5.9	-14.3	-9.8	-10.0	-7.6	-6.4	-5.6	-4.5
Government	0.6	-1.7	0.0	3.0	4.5	6.7	7.3	7.6	8.0	7.8
Net factor receipts and transfers from abroad	16.3	14.4	12.1	15.8	12.6	13.3	12.6	12.2	11.8	11.4
Non-government	15.6	13.3	12.6	16.6	13.3	14.2	13.6	13.3	12.9	12.5
Government	0.7	1.1	-0.5	-0.7	-0.7	-1.0	-1.0	-1.1	-1.1	-1.1
Gross national savings	9.1	7.1	6.3	4.5	7.3	10.1	12.3	13.4	14.2	14.7
Non-government	7.8	7.6	6.7	2.2	3.6	4.3	6.0	6.8	7.3	8.0
Government	1.3	-0.6	-0.5	2.2	3.7	5.8	6.3	6.5	6.9	6.7
Gross domestic investment 1/	13.6	16.0	16.1	17.6	18.4	19.8	21.2	21.6	22.2	22.7
Non-government	11.7	12.3	13.3	14.6	15.6	15.7	16.6	17.0	17.4	17.7
Government	1.6	3.4	2.5	2.7	2.4	3.8	4.2	4.3	4.5	4.6
Savings-investment balance 1/	-4.6	-8.9	-9.9	-13.1	-11.0	-9.8	-8.9	-8.2	-7.9	-8.0
Non-government	-3.9	-4.7	-6.6	-12.3	-12.0	-11.4	-10.6	-10.1	-10.0	-9.8
Government	-0.3	-4.0	-2.9	-0.5	1.3	2.0	2.1	2.2	2.4	2.1
Foreign savings	4.6	8.9	9.9	13.1	11.0	9.8	8.9	8.2	7.9	8.0
Foreign savings including official grants	9.7	12.9	12.3	15.5	11.0	10.8	9.7	8.9	8.6	8.6
Net exports of goods and services	-20.9	-23.3	-22.0	-29.0	-23.7	-23.0	-21.5	-20.4	-19.8	-19.4
Memorandum item:										
Current account balance (before grants)	-9.7	-12.9	-12.3	-15.5	-11.0	-10.8	-9.7	-8.9	-8.6	-8.6

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

1/ Components may not always add up to the total as a result of rounding and inventory changes.

Table 8. Serbia and Montenegro: Medium-Term Baseline and Alternative Scenario, 2002-2010
(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
			Est.			Proj.			
					Baseline				
Real GDP growth (In percent)	3.8	2.7	7.2	4.6	4.8	5.0	5.2	5.4	5.6
GDP deflator (In percent)	24.6	16.0	9.9	16.1	9.5	7.2	4.9	3.9	3.9
General government fiscal balance 1/	-4.5	-3.3	-0.3	1.2	1.9	2.0	2.2	2.3	2.4
General government debt (Gross) 1/	-0.5	79.2	60.2	53.1	46.7	43.1	41.3	39.2	36.8
Trade balance	-25.2	-23.6	-31.0	-26.6	-25.4	-23.8	-22.5	-21.5	-21.0
Current account balance (Before grants)	-12.9	-12.3	-15.5	-11.0	-10.8	-9.7	-8.9	-8.6	-8.6
Foreign direct investment	3.6	6.8	4.3	6.4	6.6	6.8	6.7	6.5	6.4
External debt (End of period)	76.2	69.2	62.0	57.1	56.8	54.8	52.8	50.7	49.2
Gross official reserves (In billions of U.S. dollars)	2.3	3.6	4.3	5.6	6.1	6.5	6.9	7.3	7.7
					Alternative Scenario ("slow reform")				
Real GDP growth (In percent)	3.8	2.7	7.2	3.9	3.0	3.0	3.0	3.0	3.0
GDP deflator (In percent)	24.6	16.0	9.9	16.2	9.7	7.3	4.9	4.0	4.0
General government fiscal balance 1/	-4.5	-3.3	-0.3	0.7	0.7	0.7	0.6	0.3	-0.1
General government debt (Gross) 1/	-0.5	79.2	60.2	53.5	48.8	47.4	47.3	46.8	45.9
Trade balance	-25.2	-23.6	-31.0	-26.7	-26.7	-25.7	-25.0	-24.5	-23.8
Current account balance	-12.9	-12.3	-15.5	-11.1	-11.6	-11.8	-11.8	-11.9	-12.0
Foreign direct investment	3.6	6.8	4.3	6.4	6.0	5.5	5.1	4.8	4.4
External debt (End of period)	76.2	69.2	62.0	57.2	59.2	60.2	61.8	63.9	66.4
Gross official reserves (In billions of U.S. dollars)	2.3	3.6	4.3	5.6	5.6	5.6	5.5	5.4	5.3

Sources: National authorities; and staff estimates and projections.

1/ Coverage as in Table 1.

Table 9. Serbia and Montenegro: Indicators of External Vulnerability, 2000–04 1/
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004
Financial indicators					
Public sector debt	119.1	123.2	85.4	79.2	60.2
Broad money (percent change, 12-month basis)	61.4	104.9	52.7	27.5	30.3
Private sector credit (percent change, 12-month basis)	68.6	7.6	49.6	25.1	48.1
Weighted deposit interest rates (percent per month, December) 2/	6.8	0.3	0.2	0.2	0.3
Retail prices (percent change per annum, end of period)	113.5	39.0	14.2	7.6	13.4
External Indicators					
Exports (recorded exports, percent change, 12-month basis in US$)	14.7	10.4	19.5	29.9	33.7
Imports (percent change, 12-month basis in US$)	14.4	30.4	30.7	25.6	46.8
Current account balance, before grants	-7.1	-9.7	-12.9	-12.3	-15.5
Current account balance after grants and FDI	-3.6	-3.1	-5.3	-0.5	-8.8
Errors and omissions	3.1	2.1	2.1	2.0	1.8
Gross official reserves (in US$ million)	516	1,169	2,280	3,557	4,302
(in months of imports GS of the following year)	1.2	2.4	3.1	3.3	3.7
Central Bank short-term foreign liabilities (in US$ million) 3/	0	0	100	100	100
Gross reserves of the banking system (in US$ million)	882	1,809	3,063	4,443	5,162
(in months of imports GS of the following year)	2.1	3.2	4.2	4.2	4.4
Short term foreign liabilities of the commercial banks (In US$ million)	349	59	74	136	136
Foreign currency liabilities of the commercial banks (In US$ million)	871	775	1,483	2,651	4,354
Official reserves/Broad money (M2) (In percent)	50	0	74	79	74
Official reserves/reserve money (In percent)	164	0	199	262	290
Short term external debt by original maturity (In US$ million) 4/	1,153	1,026	1,020	1,056	999
Short term external debt by remaining maturity (In US$ million) 4/	1,186	1,069	1,224	1,731	2,075
Short term external debt to reserves by original maturity (In percent)	223.4	87.7	44.7	29.7	23.2
Short term external debt to reserves by remaining maturity (In percent)	229.8	91.4	53.7	48.7	48.2
Share of short term external debt to total debt by original maturity (In percent)	10.1	8.6	8.6	7.4	6.7
Share of short term external debt to total debts by remaining maturity (In percent)	10.4	8.9	10.3	12.1	13.9
Total external debt (In US$ millions)	11,403	11,948	11,839	14,303	14,876
Of which : Public and publicly guaranteed debt 5/	10,250	10,922	10,919	13,348	13,977
Total external debt (In percent of exports of G&S)	448	436	365	342	252
External interest payments, cash basis (In percent of exports of G&S)	1.6	2.7	4.3	5.6	5.0
External amortization payments, cash basis (In percent of exports of G&S)	0.0	1.2	1.3	5.2	11.5
Exchange rate, official (Per euro, end of period)	58.7	60.6	61.5	68.3	78.9
REER (Annual average, 1995= 100) 6/	50.2	65.2	73.2	77.2	74.5
Sovereign long-term credit rating, Standard & Poor's	n.a.	n.a.	n.a.	n.a.	B+
Fitch	n.a.	n.a.	n.a.	n.a.	BB-

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 10. Serbia and Montenegro: External Financing Requirements and Sources, 2001–07

(In millions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007
				Est.		Proj.	
1. Gross financing requirements	**-7,261**	**-3,200**	**-4,039**	**-8,409**	**-6,931**	**-4,550**	**-5,013**
External current account deficit (excl. official transfers)	-1,119	-2,007	-2,543	-3,731	-2,937	-3,059	-2,955
Debt amortization	-33	-43	-218	-530	-705	-992	-1,544
Medium- and long-term debt	-33	-43	-190	-481	-444	-992	-1,544
Short-term debt 1/	0	0	-28	-50	-262	0	0
Repayment of arrears	-5,587	-39	0	-3,194	-1,772	0	0
Gross reserve accumulation	-523	-1,111	-1,277	-719	-1,301	-457	-400
IMF repurchases and repayments	0	0	0	-235	-215	-42	-114
2. Financing	**7,261**	**3,200**	**4,039**	**8,409**	**4,660**	**4,115**	**4,584**
Official grants 2/	591	624	538	583	0	0	0
Foreign direct investment (net)	165	562	1,405	1,028	1,698	1,856	2,074
Disbursement from private creditors	202	236	580	2,005	1,796	1,300	1,500
Medium and long-term financing	127	78	514	1,582	1,562	1,100	1,300
Short-term financing and other capital inflows	75	158	66	423	234	200	200
Disbursement from official creditors 2/	205	343	460	537	617	650	700
Multilateral 3/	205	285	341	507	584	650	700
Other	0	58	119	30	33	0	0
IMF disbursement	128	295	276	243	276	0	0
Accumulation of arrears (exceptional)	0	0	0	0	0	0	0
Debt Relief	5,377	71	59	3,259	0	0	0
Other flows 4/	594	1,069	721	755	274	309	310
3. Financing Gap	**0**	**0**	**0**	**0**	**2,270**	**434**	**429**
Expected disbursements of grants from donors 2/	0	0	0	0	410	293	234
EU	0	0	0	0	59	0	0
Others (mostly official bilateral creditors)	0	0	0	0	351	293	234
Expected disbursement of loans from donors 2/	0	0	0	0	33	0	0
World Bank	0	0	0	0	0	0	0
IMF	0	0	0	0	0	0	0
EBRD	0	0	0	0	0	0	0
EIB	0	0	0	0	0	0	0
EU	0	0	0	0	33	0	0
Others (mostly official bilateral creditors)	0	0	0	0	0	0	0
Debt relief	0	0	0	0	1,827	0	0
4. Residual Financing Gap	**0**	**0**	**0**	**0**	**0**	**142**	**194**

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. In particular, part of expected EU grant and loan assistance had not yet been approved at the time of preparation of the staff report.

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 11. Serbia and Montenegro: Stock of External Debt at December 31, 2004 1/
(In millions of U.S. dollars)

Creditor	Total Debt	*Of which:* Arrears 2/ Principal	Interest	Late Interest	Total Arrears
Total debt	14,876	1,593	347	465	2,405
Of which:					
Serbia	14,099	1,543	332	428	2,303
Montenegro	777	51	15	37	103
Multilateral institutions	5,554	10	5	9	24
IMF	962	0	0	0	0
IBRD	2,839	0	0	0	0
IDA	462	0	0	0	0
EUROFIMA	170	0	0	0	0
IFC	134	10	5	9	24
EIB	313	0	0	0	0
European Community	361	0	0	0	0
EUROFOND - CEB	33	0	0	0	0
EBRD	280	0	0	0	0
Official bilateral creditors	3,923	288	177	102	567
Paris Club	3,227	0	1	0	2
Other official bilateral creditors	697	288	176	102	565
Commercial creditors	4,400	652	164	355	1,170
London Club	1,164	27	31	11	69
Other commercial creditors: convertible currencies 3/	3,052	466	108	344	917
Other commercial creditors: nonconvertible currencies 3/	184	159	26	0	184
Short-term debt 3/	999	644	0	0	644
Trade credits on oil & gas imports 4/	240	240	0	0	240
Other short-term debt	759	404	0	0	404

Sources: SM authorities, and IMF staff estimates.

1/ Debt figures reflect the Paris Club debt rescheduling agreement (November 2001) and London Club restructuring (signed in July 2004).
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.

Table 12. Serbia and Montenegro: Millennium 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)	...	1.6	1.9	...	...
2. Population below minimum level of dietary energy consumption (%)	...	5.0	9.0	...	...
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 of relevant age group)	69.4	...	74.9	...	...
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 and secondary education (%)	102.7	102.9	100.7	...	...
2. Proportion of seats held by women in national Parliament	...	3.0	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)	30.0	23.0	20.0	19.0	...
2. Infant mortality rate (per 1,000 births)	25.0	20.0	17.0	16.0	...
3. Immunization, measles (% o children under 12 months)	83.0	86.0	90.0	92.0	...
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 (percent of total)	...	92.6	98.9	...	...
2. Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	11.0	...	...
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 tuberculosis (per 100,000 people)	...	...	44.8	37.8	...
2. Tuberculosis cases detected under DOTS (%)	...	...	...	22.4	...
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)	165.6	191.5	415.9	489.1	...
2. Personal computers (per 1,000 people)	...	14.2	23.4	27.1	...

Source: World Bank.

SERBIA AND MONTENEGRO: FUND RELATIONS
As of April 30, 2005

I. **Membership Status:** Joined December 14, 1992 (succeeding to membership of the former SFR Yugoslavia); accepted Article VIII on May 13, 2002.

II. **General Resources Account**	SDR Million	%Quota
Quota	467.70	100.00
Fund Holdings of Currency	1,042.81	222.97

III. **SDR Department**	SDR Million	%Allocation
Net cumulative allocation	56.66	100.00
Holdings	13.61	24.02

IV. **Outstanding Purchases and Loans**	SDR Million	%Quota
Extended arrangement	462.50	98.89
Stand-by arrangements	68.75	14.70

V. **Latest Financial Arrangements**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
EFF	5/14/02	12/31/05	650.00	462.50
Stand-by	6/11/01	5/31/02	200.00	200.00

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

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	43.85	54.17	43.75	58.33	77.08
Charges/Interest	16.13	20.32	18.03	16.40	14.09
Total	59.98	74.49	61.78	74.73	91.15

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

[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.

Arrangement approved on May 13, 2002, which is scheduled to expire on December 31, 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 Country Report No. 02/105. The proposed remedies by the mission are being implemented.

VIII. **Exchange Arrangement**

Serbia and Montenegro 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. **FSAP Participation**

Serbia participated in the Financial Sector Assessment Program during 2005, and the Financial System Stability Assessment report will be discussed in relation with the sixth review, expected for December 2005.

XI. **Technical Assistance to Serbia and Montenegro during the Past 12 Months**

Department	**Timing**	**Purpose**
MFD	Sep. 2004	Monetary operations, insurance supervision, and banking issues
	Nov. 2004	Diagnostic TA in Banking Supervision, Foreign Exchange Operations, Research (Montenegro)
FAD	Jun. 2004	Public Expenditure Management (Serbia)
STA	May 2004	Monetary and Financial Statistics
	Jun.–Jul. 2004	Balance of Payments Statistics (Montenegro)
	Sep. 2004	National Accounts Statistics

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 missions reviewed the progress in modernizing tax administration and establishing treasury system, and recommended (i) more clearly delineating the tax policy role of different revenue agencies, (ii) improving taxpayer services and compliance programs based on segmenting the tax base, (iii) strengthening the Treasury's organization and developing its core operations as wells as debt management functions, (iv) reforming the payroll system and strengthening the quality of personnel records in budget institutions to eliminate "ghost employment." The MFD recommendations were key to (i) developing market-based instruments for monetary operations, (ii) improving public sector debt management, (iii) providing a clear focus to future work on enhancing banking supervision practices and (iv) outlining positive directions for NBS reorganization. The STA missions provided an action plan to improve existing statistics by (i) developing comprehensive data sources for national accounts, (ii) applying statistical concepts to organize information on government revenues and expenditures to develop sound government finance statistics, (iii) strengthening the coverage of balance of payments transactions in Montenegro, and assisting with the adoption of compilation methodologies consistent with the recommendations of the fifth edition of the Balance of Payments Manual (BPM5), and (iv) introducing sound classifications in compiling monetary and financial statistics.

XII. **Resident Representative**

Mr. Harald Hirschhofer took up his position as Resident Representative in September 2004.

SERBIA AND MONTENEGRO: STATISTICAL ISSUES

1. In recent years, Serbia and Montenegro (SM) has been successfully upgrading its statistical system with the assistance of the IMF and other bilateral and multilateral institutions, but international standards are not yet fully met. Official data for all sectors are, nonetheless, sufficiently good to support key economic analysis. In many areas, including monetary and fiscal sectors, internationally accepted reporting standards have been introduced. However, SM still makes extensive use of definitions that were developed to accommodate national characteristics and were not updated during the decade when the country was isolated from international developments. A major impediment to the compilation and reporting of economic data is the fragmentation of statistical activity between the two Republics and the State Union, hampering coordination. Except for monetary statistics for Serbia compiled by the National Bank of Serbia (NBS), SM does not report data to IMF's Statistical Department (STA) and does not have a page in *International Financial Statistics (IFS).*

2. In response to the authorities' requests, the Fund dispatched a series of technical assistance missions to improve the quality of macroeconomic statistics that would support policy analysis. In 2001–2003, STA conducted four TA missions: two on monetary and financial statistics in 2001 and 2002, a multisector statistics mission in 2002, and a balance of payments mission to Serbia in 2003. In 2004, there was a monetary and financial statistics mission during April 28–May 14, national accounts mission during September 9–23, and a balance of payments mission (to Montenegro only) during June 23–July 6. These missions found that there was a critical need for SM to improve existing statistics by (1) developing comprehensive data sources for national accounts, (2) applying statistical concepts to organize information on government revenues and expenditures to develop sound government finance statistics, (3) strengthening the coverage of balance of payments transactions, and (4) further improving the classification of bank accounts by economic sector and by financial instrument in compiling monetary and financial statistics.

A. Real Sector

3. The primary responsibility for compiling real sector data for the republics is assigned to the Republic of Serbia Statistical Office (RSSO), and the Republic of Montenegro Statistical Office (RMSO), while the Serbia and Montenegro Statistical Office (SMSO) is responsible for compiling real sector data for the union. The SMSO has been compiling national accounts statistics first for the FRY and subsequently for Serbia and Montenegro since 1997. Annual current price estimates of GDP by activity or by expenditure are available for Serbia, for 1997–2003 and for Montenegro for 1997–2002. No quarterly data are yet disseminated, but the RSSO are compiling on an experimental basis constant price estimates of GDP by the production approach. The agencies have made commendable efforts to adopt 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. Overall, the quality of the source data is poor, and the national

accounts data sources are in serious need of improvement. The statistical techniques used for the national accounts compilation also need further improvement, and the statistical agencies are aware it. These issues are being addressed in a master plan for the improvement of economic statistics, which was developed with the assistance of EUROSTAT.

4. One of the major problems of the official statistics is the lack of estimates for the informal activities, producing up to one half of the value added in the economy. In an attempt to improve the industrial output index, the statistical office has broadened the coverage of the index in 2004 to include several hundred small and medium enterprises, but with the drawback of a reduced reliability of the index and its limited comparability with the data for previous years. The coverage of labor force statistics is similarly impaired by incomplete sampling of informal sector activities, resulting in an implausibly high official unemployment rate of about 30 percent.

5. The SMSO and the RSSO compile and disseminate, respectively for the union and Serbia, retail price indices (RPI), consumer price indices (CPI), producer price indices (PPI), and unit-value price indices for imports and exports. In Montenegro, the RMSO compiles a RPI and a CPI, 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

6. 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. Forthcoming legislation is expected to expand the responsibilities of the NBS, by charging it with the recording of leasing transactions and leasing-related debt. While the data compilation procedures appear appropriate, some components of the balance of payments payments (e.g. remittances) suffer from substantial underrecording owing to the large proportion of foreign exchange transactions occurring outside official channels. Since 2001, the NBS has expended commendable efforts to improve its estimation of actual flows. The NBS could further improve coverage, valuation and classification by adjusting trade data for transactions not explicitly declared (e.g., repairs, shuttle trade and grants in kind), and removing exchange-rate changes from certain financial transactions, including arrears below the line. In Montenegro, the CBM has recently transferred responsibility for external debt recording to the Ministry of Finance

7. At present, the union's balance of payments statement strives to cover both constituent states, notably with regard to trade in goods and services, but the compilation of various items may still suffer from missing or poor information and inconsistent estimates

from state sources, notably with regard to the estimation of trade in goods and services between Serbia and Montenegro. As a consequence, the statement continues to show significant net errors and omissions. The NBS compiles a balance of payments statement for Serbia using existing national sources, and the CBM has also begun compiling balance of payments statistics for Montenegro. However, the coordination of technical work at the state level needs to be improved in order to lay the basis for accurate union-level statistics, including with regard to external debt. A balance of payments technical assistance mission to the CBM in June/July 2004 assisted with adoption of compilation methodologies consistent with the fifth edition of the *Balance of Payments Manual (BPM5)* and provided recommendations to improve international trade and external debt statistics, as well as Montenegro's international transaction reporting system (ITRS). Close coordination between the NBS and the CBM will be needed to compile balance of payments data on a BPM5 basis for the Union.

C. Government Finance

8. 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 republican treasuries and the budget execution reports of the spending ministries and first-level budget units. For Serbia, revenue data are more timely and reliable than expenditure data, and the information on detailed government operations is available with substantial delays. Montenegro now reports the republican budget implementation data on monthly basis.

9. While data on the general government are now compiled, they are not fully compliant with the *Government Finance Statistics Manual (GFSM 2001)*. Since 2001, the government of Serbia has made efforts to bring the existing budget reporting system in line with GFS methodology. But full compliance is still to be achieved as full implementation of the new chart of accounts, generally consistent with the classifications of the *GFSM 2001*, has not been completed.

10. Fiscal data for the central government of Montenegro are based on the new GFS classification. However, data for the social security funds, reported directly by the funds with significant delays, are not compiled on a GFS basis. A new chart of accounts was introduced in Montenegro in 2001, but still needs to be fully implemented at the local level. SM began reporting data on general government—including local government—in the 2003 edition of the *Government Finance Statistics Yearbook.*

D. Monetary Accounts

11. Monetary and financial statistics are compiled by the NBS and the CBM, broadly following the methodology set forth in the *Monetary and Financial Statistics Manual.* After a break of over a decade, the NBS began reporting to STA monetary statistics for Serbia in November 2002. 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

according to the recommendations of 2001–02 STA missions on monetary and financial statistics. In July 2003, the NBS reported annual data going back to 1995. After a hiatus between December 2003 and July 2004, the NBS resumed its reporting of data to STA in August 2004. The NBS reported data as of November 2004 in its recent submission. Since October 2003 the NBS has also begun publishing detailed monetary statistics in a new monthly *Statistical Bulletin*, which includes tables on monetary statistics, balance sheets and surveys for the NBS and the commercial banks. At present, both the NBS and the CBM meet GDDS recommendations with respect to the periodicity and timeliness of financial sector data.

12. The Republic of Serbia introduced new charts of accounts for the NBS and the commercial banks in December 2003. The Republic of Montenegro also introduced new charts of accounts for the CBM (January 2004) and for the commercial banks (December 2003). Both republics are now compiling monetary statistics from data collected based on the new charts of accounts. Despite significant progress, there is still plenty of room for further improvements. The monetary and financial statistics mission in 2004 made recommendations to the NBS on methodological issues concerning (1) classification of loan-loss provisions and treatment of nonoperating banks, (2) uniform treatment of residents/nonresidents and various domestic sectors (including the government sector); and (3) uniform treatment of residents of Montenegro as nonresidents across all macroeconomic statistics for the Republic of Serbia. The mission also made detailed recommendations to the CBM for improving (1) the classification of financial instruments, including loan-loss provisions and depreciation, (2) sectorization of government units and funds, and (3) mapping between the charts of accounts of the CBM and other depository corporations with the respective sectoral balance sheets. The mission also developed a prototype Depository Corporations Survey for the CBM to use in reporting data to the IMF.

13. The Fund is in the process of resuming the publication of a country page in *International Financial Statistics (IFS)* for SM. The proposed country page will have a section for each republic. To facilitate the process, the 2004 monetary and financial statistics mission reiterated the recommendations of the 2002 multisector statistics mission to nominate the *IFS* correspondents and establish a track record of timely and regular reporting of macroeconomic statistics to STA.

TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

[AS OF MAY 20, 2005]

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	May 20, 2005	May 20, 2005	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 20, 2005	May 20, 2005	D	W	M
Reserve/Base Money	May 20, 2005	May 20 , 2005	D	W	M
Broad Money	Mar. 2005	Apr. 25, 2005	M	M	M
Central Bank Balance Sheet	Mar. 2005	Apr. 25, 2005	M	M	M
Consolidated Balance Sheet of the Banking System	Mar. 2005	Apr. 25, 2005	M	M	M
Interest Rates[2]	Mar. 2005	Apr. 25, 2005	M	M	M
Consumer Price Index	Apr. 2005	Apr. 29, 2005	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Mar. 2005	Apr. 30, 2005	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Mar. 2005	Apr. 15, 2005	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar. 2005	Apr. 28, 2005	M	M	M
External Current Account Balance	Jan.– Mar. 2005	Apr. 28 2005	Q	Q	Q
Exports and Imports of Goods and Services	Jan.– Mar. 2005	Apr. 28, 2005	M	M	M
GDP/GNP	2003	Sep. 2004	A	A	A
Gross External Debt	Jan.– Mar. 2004	Apr. 28, 2005	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic non-bank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. General government reporting is incomplete; local government expenditure data are available only after a 6 month lag.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Semi-annually (SA), Annually (A), Irregular (I); Not Available (NA).

Serbia and Montenegro: External Debt Sustainability Analysis

This note updates the debt sustainability analysis in Country Report No. 05/13.

Medium-term balance of payments projections

1. The baseline scenario assumes that: (a) exports will grow at an annual average of 24 percent in the first three years (starting with 2005) and 14 percent in the following four years in dollar terms (growth rates in euro terms are similar); (b) imports will grow at about 9 percent in the first years (due to high pent-up demand) but then decline, even though they remain higher than nominal GDP[1]; (c) FDI related to the privatization process continues to flow in during 2005 and 2006, but is gradually replaced by other types of FDI, including "greenfield" investment, equity investment, and reinvestment in existing companies, building on the success in privatization and improving the 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) gross international reserves will remain at around 4 months of prospective imports of goods and services.

2. Under the baseline scenario, the debt-to-GDP ratio improves over the next 10 years, averaging around 56 percent in the first 3 years and around 51 percent in the next five years. Debt service ratios, on the other hand, increase over the time horizon, partly reflecting the increased debt service after the end of the grace period offered by the Paris Club and other bilateral creditors, and stabilize at around 10 percent of GDP and 26 percent of exports. The rise of debt service ratios argues for the maintenance of adequate official reserves 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, differ from the results in Country Report No. 05/13 due to the revision of nominal GDP figures, and to higher-than-previously-expected commercial borrowings by newly privatized companies and foreign-owned banks, mostly from their parent companies abroad.

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[1] The assumptions on export and import growth rates take into consideration the experience of other transitional economies and the performance of exports and imports of SM since 2000. The rapid growth of imports partly reflects the large needs for basic investment and consumption goods following the economic isolation of the country, and is supported by increasing availability of financing. Exports are expected to show sustained growth in the projection period, reflecting the recovery of the domestic demand of SM's main trading partners, as well as the impact of the structural reforms, the domestic and substantial foreign investments in recent years, and the increasing trade integration with the rest of the world.

Stress testing applying the standardized sustainability framework

3. The standard framework for the debt sustainability analysis has been adapted to the particular case of Serbia and Montenegro to take into account the limited availability of data and the exceptional factors that have affected economic performance, as well as data quality, in the course of the 1990s. The historical averages for most key variables are based on the outturns of 2000–2004; deflators are based on 2001–2004 to exclude the inflationary episode following the Kosovo war. Notwithstanding these specificities, this DSA relies exclusively on country data for the first time for stress testing.[2] Results are therefore only partially comparable with previous DSAs.

4. If the key variables (real GDP growth, dollar deflator, nominal interest rate, export and import growth rates, non-interest current account, and non-debt inflows) are set as the historical averages, as defined above, the external debt ratios would decline faster than in the baseline case after the first year, owing to the much higher historical GDP deflator related to to dollar depreciation, and the lower nominal interest rate partly associated with the delayed start of debt service to the Paris Club creditors.

5. Sensitivity analysis allows to compare the debt-to-GDP ratios under different scenarios..The largest increases in the debt-to-GDP ratio are brought about by shocks to the current account (partly due to the exceptionally high 2004 outcome) and by large one-time nominal depreciation in 2005 (due to the significant drop in GDP in dollar terms). Shocks to real growth increase the debt ratio in the medium term, but in the long run the ratio converges to the baseline. On the other hand, shocks to the interest rate from the historical average have a positive impact, reflecting the low interest rates in 2002–03. Similarly, as the dollar deflator in 2000–04 was relatively high, the scenario with shocks to the deflator from its historical average generates a slightly improved debt ratio relative to the baseline. The combination of smaller shocks of all the above variables would yield slightly lower debt ratios than the baseline due to the prevalence of the GDP deflators and interest rate effects.

6. The DSA also analyzes the impact on debt dynamics of the alternative slow reform scenario discussed in the main report. Such scenario envisages slower structural reform, with lower GDP growth, exports, and, to a lesser degree, imports, despite assuming acceptable macroeconomic policies. FDI would be negatively affected, and financing the higher current account would increasingly rely on external commercial borrowing. Under this scenario the debt would follow an explosive path and would be increasingly higher over time.

[2] As explained in Country Report No. 03/151, previous DSAs used data from four countries in the region (Albania, Bulgaria, Croatia, and Romania) to derive standard deviation; moreover, the historical averages were based on the outturns of 2002 and 2003.

Table 1. Serbia-Montenegro: External Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual 2000	2001	2002	2003	2004	5-Year Historical Average 8/	5-Year Standard Deviation 8/	Projections 2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						**Debt-stabilizing non-interest current account 7/**
1 **External debt**	132.5	103.2	76.2	69.2	62.0			**57.1**	**56.8**	**54.8**	**52.8**	**50.7**	**49.2**	**-6.6**
2 Change in external debt	26.8	-29.3	-27.0	-7.0	-7.2			-4.9	-0.3	-2.0	-2.0	-2.1	-1.4	
3 Identified external debt-creating flows (4+8+9)	31.8	-30.9	-21.1	-18.6	0.9			0.6	0.7	-0.5	-1.0	-1.1	-0.7	
4 Current account deficit, excluding interest payments	3.4	3.9	8.0	6.2	11.9			7.0	7.1	6.3	5.5	5.2	5.2	
5 Deficit in balance of goods and services	16.9	20.9	23.3	22.0	29.0			23.7	23.0	21.5	20.4	19.8	19.4	
6 Exports	29.6	23.7	20.9	20.2	24.6			28.9	32.1	34.3	36.4	37.9	38.4	
7 Imports	46.5	44.6	44.2	42.3	53.5			52.6	55.2	55.8	56.8	57.7	57.8	
8 Net non-debt creating capital inflows (negative)	-0.3	-1.4	-3.6	-6.8	-4.3			-6.4	-6.6	-6.8	-6.7	-6.5	-6.4	
9 Automatic debt dynamics 1/	28.6	-33.4	-25.5	-18.0	-6.7			0.0	0.2	0.0	0.2	0.3	0.4	
10 Contribution from nominal interest rate	0.5	0.6	0.9	1.1	1.3			2.5	2.7	2.7	2.7	2.7	2.8	
11 Contribution from real GDP growth	-6.7	-5.4	-3.1	-1.7	-2.7			-2.5	-2.5	-2.7	-2.6	-2.5	-2.4	
12 Contribution from price and exchange rate changes 2/	34.8	-28.6	-23.3	-17.4	-5.3			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	-5.0	1.6	-5.9	11.6	-8.1			-5.6	-1.0	-1.5	-1.0	-1.1	-0.7	
External debt-to-exports ratio (in percent)	447.7	435.6	365.3	341.8	252.3			197.5	176.6	159.6	145.3	133.8	128.3	
Gross external financing need (in billions of US dollars) 4/	1353.1	1747.0	2494.7	2956.3	5586.9			5678.5	5804.4	4379.0	7898.1	9150.5	9970.2	
in percent of GDP	15.7	15.1	16.1	14.3	23.3			21.5	21.0	14.7	24.8	26.9	27.5	
Key Macroeconomic Assumptions														Projected Average
Real GDP growth (in percent)	5.0	5.5	4.0	3.0	4.4	4.4	1.0	4.5	4.6	5.0	5.0	5.0	5.0	4.9
GDP deflator in US dollars (change in percent)	-24.7	27.5	29.2	29.7	8.3	23.7	10.3	5.2	0.2	2.4	1.9	1.9	1.3	2.2
Nominal external interest rate (in percent)	0.4	0.6	1.2	2.0	2.1	1.3	0.8	4.4	4.9	5.1	5.4	5.6	6.0	5.2
Growth of exports (US dollar terms, in percent)	18.6	7.7	18.2	29.1	40.9	22.9	12.6	30.3	18.5	14.9	13.6	11.9	9.1	16.4
Growth of imports (US dollar terms, in percent)	13.2	28.9	32.9	27.4	47.1	29.9	12.2	8.8	11.8	8.9	9.0	9.1	7.8	9.2
Current account balance, excluding interest payments	-3.4	-3.9	-8.0	-6.2	-11.9	-6.7	3.4	-7.0	-7.1	-6.3	-5.5	-5.2	-5.2	-6.1
Net non-debt creating capital inflows	0.3	1.4	3.6	6.8	4.3	3.3	2.5	6.4	6.6	6.8	6.7	6.5	6.4	6.6
								II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 7/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 5/								**57.1**	**47.4**	**40.5**	**35.2**	**31.0**	**27.7**	**-9.3**
A2. Alternative (slow reform) scenario 6/								**57.1**	**59.2**	**60.2**	**61.8**	**63.9**	**66.4**	**-5.4**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**57.1**	**55.6**	**52.5**	**50.5**	**48.4**	**47.0**	**-6.6**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**57.1**	**57.6**	**56.5**	**54.0**	**51.4**	**49.3**	**-7.2**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**57.1**	**55.2**	**52.9**	**51.1**	**49.0**	**47.5**	**-6.6**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**57.1**	**63.2**	**68.4**	**66.2**	**63.8**	**62.4**	**-6.6**
B5. Combination of B1-B4 using one standard deviation shocks								**57.1**	**52.9**	**50.3**	**48.6**	**46.7**	**45.5**	**-5.6**
B6. One time 30 percent nominal depreciation in 2005								**57.1**	**72.8**	**67.9**	**63.3**	**58.6**	**54.7**	**-9.0**

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ 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, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ The change in key variables under this scenario is discussed in the text.
7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.
8/ Due to exceptional factors, including the Kosovo war, data from 2000-2004 are used (2001-2004 for GDP deflators). Stress test results are different from DSAs in previous staff reports which relied on 1996-2001 data from a set of comparable countries.

Table 2. Serbia and Montenegro: Medium-Term External Sustainability, 2000-2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average 2005-07	Average 2008-10	Average 2000-2010
	(In millions of U.S. dollars, unless indicated otherwise)													
Export growth (US$ terms, in percent)	14.7	4.2	20.4	26.6	38.1	30.4	21.8	18.5	16.9	14.8	9.9	23.6	13.9	19.7
Export growth (euro terms, in percent)	32.5	7.5	14.2	5.8	25.8	23.6	29.1	18.3	16.8	14.7	9.9	23.7	13.8	18.0
Import growth (US$ terms, in percent)	12.6	30.4	30.7	25.6	46.8	7.8	10.7	9.4	9.4	9.5	7.7	9.3	8.9	18.2
Import growth (euro terms, in percent)	30.0	34.5	23.9	5.0	33.6	2.2	17.3	9.3	9.3	9.4	7.7	9.6	8.8	16.6
Current account balance, before grants	-610	-1,119	-2,007	-2,543	-3,731	-2,937	-3,059	-2,955	-2,921	-3,023	-3,256	…	…	…
in percent of GDP	-7.1	-9.7	-12.9	-12.3	-15.5	-11.0	-10.8	-9.7	-8.9	-8.6	-8.6	-10.5	-8.7	-10.5
Current account balance, after grants	-339	-528	-1,383	-1,513	-3,148	-2,527	-2,767	-2,721	-2,687	-2,789	-3,022	…	…	…
in percent of GDP	-3.9	-4.6	-8.9	-7.3	-13.1	-9.5	-9.8	-8.9	-8.2	-7.9	-8.0	-9.4	-8.1	-8.2
Gross official reserves	516	1,169	2,280	3,557	4,302	5,602	6,059	6,459	6,859	7,259	7,659	…	…	…
in months of prospective imports of GNFS	1.2	2.4	3.1	3.3	3.7	4.3	4.3	4.2	4.1	4.0	3.9	4.3	4.0	3.5
External debt 1/	11,403	11,948	11,839	14,303	14,876	15,173	16,075	16,700	17,260	17,787	18,599	…	…	…
In percent of exports of goods and services	448	436	365	342	252	198	177	160	145	134	128	177.9	135.8	253.1
In percent of GDP	133	103	76	69	62	57	57	55	53	51	49	56.2	50.9	69.5
In percent of government revenue	361	265	178	162	142	135	137	135	131	126	122	135.7	126.0	172.2
External debt service 2/ 3/	56	107	183	436	972	1,732	1,779	2,473	3,079	3,569	3,816	…	…	…
In percent of exports of goods and services	2.2	3.9	5.7	10.4	16.5	22.5	19.5	23.6	25.9	26.8	26.3	21.9	26.4	16.7
In percent of GDP	0.6	0.9	1.2	2.1	4.1	6.5	6.3	8.1	9.4	10.2	10.1	7.0	9.9	5.4
In percent of government revenue	1.8	2.4	2.8	5.0	9.3	15.4	15.2	20.0	23.3	25.2	24.9	16.9	24.5	13.2

Sources: SM authorities, and IMF staff estimates.

1/ Incorporates the phased 66 percent debt reduction offered by the Paris Club, the debt reduction at comparable terms agreed with the London Club in July 2004, and other 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.
3/ Cash payments.

SERBIA AND MONTENEGRO: PUBLIC SECTOR DEBT SUSTAINABILITY ANALYSIS

1. This appendix updates the public sector DSA in Country Report No. 05/13. Under the baseline scenario, SM's debt-to-GDP ratio would decline steadily from 60.2 percent of GDP in 2004 to 39.2 percent of GDP in 2009 (Table 1). The debt-to-revenue ratio would decline by 41.9 percentage points over the same period, from 133 percent in 2004. The result of the baseline scenario is similar to the one presented in Country Report No. 05/13, with the debt-to-GDP ratio falling more rapidly after 2005 due to higher GDP growth in 2004 and valuation effect. The DSA reflects the London Club debt rescheduling following successful negotiations in mid-2004. Following a sizeable fiscal improvement in 2004 and 2005, the baseline assumes a more gradual fiscal adjustment from 2006 onwards. Current primary spending would gradually fall as a share of GDP, but would increase in real terms over time, even in 2005 where cuts in current spending are large. This medium-term decline reflects savings from budget sector reform. Notwithstanding some delay in laying off government workers in 2005, wage bill and employment reform will continue to form an important component of the medium-term expenditure improvement plan. In addition, measures will be taken to reduce subsidies to the public enterprises while a high priority pension reform, to be started later in the year, will help alleviate the burden on the budget. In particular, significant budgetary savings are expected after the law on pensions is amended to delink pension benefits from wages and replace quarterly with annual indexation. Capital spending, which is expected to remain weak in 2005, should pick up in 2006 and thereafter. The primary surplus is projected to improve steadily from 1.2 percent of GDP in 2004 to 3.8 percent of GDP by 2008 and 2009—this is because the primary spending is projected to decline faster than the revenue ratio. Privatization receipts are expected to fall, and be relatively modest, in the coming years (especially when compared to 2003 and 2004).

2. Using the standardized methodology set out in Assessing Sustainability, May 28, 2002 (http://www.imf.org/external/np/pdr/sus/2002/eng/052802.htm), but with modifications due to data constraints, stress tests were conducted. Historical averages for SM were incomplete prior to 2000. As a result, the 2003–04 outturns were used to replace historical averages, and the 1997–2001 data for 4 countries in the region Albania, Bulgaria, Croatia and Romania, were used to derive the standard deviation.

3. The first stress test keeps real GDP growth rate, real interest rate, and the primary balance at the 2004 level. This results in somewhat slower reduction in the debt ratio in the outer years relative to the baseline, but the decline will eventually catch up by 2009, leading to a net reduction of 20.9 percentage points of GDP from 2004–2009. Other stress tests, including (i) higher real interest rates, (ii) lower GDP growth, (iii) lower primary balance; (iv) combination of (i)–(iii); and (v) a 10 percent increase in debt-creating flows would lead broadly to similar results—a decline in the debt-to-GDP ratio from its 2004 level into the medium term, but at a generally slower pace compared to the baseline scenario.

4. The stress test with a real depreciation of 30 percent in 2005 would, however, increase the 2005 debt ratio by a significant amount; it would decline thereafter in the medium term, gradually returning to near its starting level at the end of the projection period.

Table 1. Serbia and Montenegro: Public Sector Debt Sustainability Framework, 2003-2009
(In percent of GDP, unless otherwise indicated)

	2003	2004	Projections 2005	2006	2007	2008	2009
I. Baseline Medium-Term Projections							
1 Public sector debt 1/	**79.2**	**60.2**	**53.1**	**46.7**	**43.1**	**41.3**	**39.2**
o/w foreign-currency denominated	71.5	52.9	49.6	46.0	42.6	40.8	38.7
2 Change in public sector debt	-6.2	-19.0	-7.1	-6.5	-3.5	-1.9	-2.1
3 Identified debt-creating flows (4+7+12)	-16.5	-9.1	-6.1	-6.2	-6.6	-5.6	-5.6
4 Primary deficit	2.1	-1.2	-2.5	-3.5	-3.6	-3.8	-3.8
5 Revenue and grants	42.9	45.3	44.9	44.7	43.4	43.1	43.0
6 Primary (noninterest) expenditure	45.0	44.1	42.4	41.2	39.8	39.4	39.2
7 Automatic debt dynamics 2/	-14.3	-7.4	-1.2	-2.0	-2.5	-1.5	-1.5
8 Contribution from interest rate/growth differential 3/	-12.9	-10.6	-8.6	-4.8	-3.9	-2.7	-2.0
9 Of which contribution from real interest rate	-11.0	-5.7	-6.3	-2.6	-1.8	-0.6	0.1
10 Of which contribution from real GDP growth	-1.9	-4.8	-2.3	-2.3	-2.1	-2.0	-2.1
11 Contribution from exchange rate depreciation 4/	-1.4	3.2	7.4	2.8	1.4	1.2	0.5
12 Other identified debt-creating flows	-4.3	-0.6	-2.3	-0.7	-0.5	-0.3	-0.2
13 Privatization receipts (negative)	-4.3	-0.6	-2.3	-0.7	-0.5	-0.3	-0.2
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)	10.3	-9.9	-1.0	-0.3	3.0	3.8	3.5
Public sector debt-to-revenue ratio 1/	184.4	133.0	118.2	104.5	99.5	95.7	91.1
Gross financing need 5/	3.2	0.7	-0.8	-1.5	-1.4	-1.7	-1.8
in billions of U.S. dollars	0.7	0.2	-0.2	-0.4	-0.4	-0.5	-0.6
Key Macroeconomic and Fiscal Assumptions							
Real GDP growth (in percent)	2.7	7.2	4.6	4.8	5.0	5.2	5.4
Average nominal interest rate on public debt (in percent) 6/	1.4	2.1	2.5	2.8	3.2	3.4	3.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-14.9	-7.8	-11.9	-5.1	-4.0	-1.4	0.3
Inflation rate (GDP deflator, in percent)	16.3	9.9	14.4	7.9	7.2	4.8	3.1
Growth of real primary spending (deflated by GDP deflator, in percent)	-1.3	5.0	2.1	3.3	1.6	4.2	5.7
II. Stress Tests for Public Debt Ratio							
1. Real GDP growth, real interest rate, and primary balance are at 2004 preliminary in 2005-2009		**60.2**	**55.4**	**48.6**	**44.8**	**42.1**	**38.9**
2. Real interest rate is at historical average plus two standard deviations in 2004 and 2005		**60.2**	**59.9**	**53.1**	**49.1**	**46.9**	**44.4**
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005		**60.2**	**51.8**	**45.3**	**41.9**	**40.0**	**37.9**
4. Primary balance is at historical average minus two standard deviations in 2004 and 2005		**60.2**	**54.5**	**47.8**	**44.1**	**42.1**	**39.8**
5. Combination of 2-4 using one standard deviation shocks		**60.2**	**55.4**	**48.7**	**44.8**	**42.7**	**40.0**
6. One time 30 percent real depreciation in 2005 7/		**60.2**	**81.8**	**74.1**	**69.0**	**66.1**	**62.9**
7. 10 percent of GDP increase in other debt-creating flows in 2005		**60.2**	**63.1**	**56.2**	**52.2**	**50.0**	**47.6**

Variables used for stress tests	Standard Deviation 8/	2004 Prel.	Average 2005-09
Primary deficit	1.8	-1.2	-3.4
Real GDP growth (in percent)	4.4	7.2	5.0
Nominal interest rate (in percent) 6/	11.1	3.1 9/	3.1
Real interest rate (in percent)	7.9	-6.8 9/	-4.4
Inflation rate (GDP deflator, in percent)	6.7	9.9	7.5
Revenue to GDP ratio	2.6	45.3	43.8

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 $r - \pi (1+g)$ 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 using debt written off and domestic arrears stock.

SERBIA AND MONTENEGRO: IMF/WORLD BANK RELATIONS

Partnership with 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 was reviewed 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, is described more fully below.

World Bank Group Strategy

4. 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 were approved under the TFFRY. 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.

5. 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.

6. [1] The TSS contained a three-year IDA envelope of up to US$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 Update, discussed by the Bank's Board on August 8, 2002, confirmed the overall approach (including the focus on policy-based lending), and laid out the Bank's program for FY03. A second TSS Update, covering FY04, was endorsed by the Bank's Board on March 16, 2004.

7. A Joint World Bank-IFC Country Assistance Strategy covering FY05–07 was endorsed by the Bank's Board of Directors on December 16, 2004. The CAS has three goals: (i) creating a smaller, more sustainable and more efficient public sector; (ii) creating a larger, more dynamic private sector; and (iii) reducing poverty levels and improving social protection and access to public services.

8. 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 the republic level. To date, seven 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), supported further reforms in pensions, health and labor, while enhancing the focus on social assistance and poverty monitoring. Two Private and Financial Sector Adjustment Credits (PFSAC I and II, approved May 2002 and June 2003 respectively) 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., A second (single tranche) multisectoral SAC for Serbia was approved in December 2004. It's focus centers on improving the business environment, further rehabilitating the energy sector, enhancing social protection and fostering stronger public administration. In Montenegro, the first multi-sectoral Structural Adjustment Credit, approved in August 2002 supported reforms critical to fiscal sustainability as well as economic growth in the areas of public expenditure management, pensions, energy, labor markets, and the business environment. A second (two tranche) multi-sectoral SAC for Montenegro was approved by the Board on September 14, 2004. It

[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.

focuses on enhancing growth potential, including reforms to the financial, energy, pension, health and public administration sectors.

9. 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 which covered both republics—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 supports an ongoing program 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 recently finalized an Economic Memorandum for Serbia focusing on the agenda for sustained growth and employment creation. An Economic Memorandum for Montenegro has been initiated for delivery this fiscal year.

10. 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, in Serbia IDA is supporting an Education project, an Enterprise and Bank Restructuring Technical Assistance operation, an Energy Efficiency project , a Health Reform operation, an Employment Promotion Learning and Innovation project, a Transport Rehabilitation project, and a Real Property Registration and Cadastre project. In Montenegro, an education reform project was recently approved on March 31, 2005. The Bank also supports an Environmental Improvement project an Energy Learning and Innovation Credit, a Pension System Administration and Improvement Project and a Health Reform project. As of end-April 2005, 21 IDA credits totaling US$ 590 million had been approved for SM, with adjustment support comprising the majority

IFC

11. SM is a major IFC priority in South East Europe. During FY02–03 IFC committed about US$43 million in 5 projects, three in financial markets and two in manufacturing. Donor supported technical assistance (TA) has been an important component of the IFC strategy to develop a pipeline of potential investments in SM. During the last two years IFC has mobilized about US$4 million of trust fund resources for technical assistance conducting

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

more than twenty assignments on institutional strengthening in the financial sector and on project preparation in the real sector.

12. IFC has contributed to strong foreign strategic investor interest in the ***financial sector*** and to establishing viable financial institutions. IFC supported the first Microfinance Bank and the establishment of RaiffeisenBank in the country. In Montenegro, IFC approved an investment in Opportunity Bank Montenegro for a line of credit of up to Euro4 million to fund micro-enterprise and SME lending. IFC is supporting the restructuring and privatization of Udruzena Vojvodjanska Bank (UVB) successor banks. Also, the recent agreement between IFC and the Government of Montenegro on the restructuring of IFC's claims on Montenegrin enterprises and banks, should pave the way for additional IFC restructuring and privatization support in the financial sector. IFC's Southeast Europe Enterprise Development facility (SEED) has provided extensive assistance to the institutional development of leasing market and to overall SME sector development. IFC has provided extensive due diligence to the Serbian Insurance Supervisor and has conducted a preliminary due diligence on the restructuring and privatization of Dunav Insurance Company.

13. In the ***corporate sector***, IFC has achieved good results investing Euro20 million in Tigar Michelin Holding, a leading regional producer of high quality car tires. The financing was accompanied by extensive technical assistance to the company and its suppliers, supported by SEED linkages program, resulting in high development impact. IFC is providing an innovative technical assistance program to Elektronska Industrija, a Serbian manufacturer of consumer electronic products and home appliances, to help the company with pre-privatization restructuring and to facilitate the joint ventures and/or direct sales to foreign investors.

14. In tandem with the Bank's program of support, IFC is committed to supporting the restructuring and preparation for privatization of the ***infrastructure sector***, as well as facilitating private sector participation in the sector. Through its Balkans Infrastructure Development Facility (BIDFacility), IFC will help public sector entities in the South East Europe region, including Serbia and Montenegro, to attract private sector participation and investments in infrastructure, primarily in the energy, transport and water and sanitation sectors. IFC focus will be to explore, facilitate, and support public-private partnership (PPP) opportunities, particularly in solid waste and water management services (city of Belgrade), oil and gas transport and distribution, and the power cogeneration sector. In the area of information and communication technology, IFC will explore investment opportunities in the sector. In the energy sector, IFC has been active supporting an advisory assignment to prepare a restructuring and privatization strategy of the Serbian oil company Naftna Industrija Srbije (NIS), as well as launching a Power Cogeneration study to survey the market potential and identify opportunities for private sector participation and PPP.

15. Though foreign investors' country risk appetite remains modest, opportunities for new IFC investment projects are being actively pursued in both the financial and manufacturing sectors. IFC's program development, however, depends on further implementation of the Governments reform agenda, the creation of a favorable business

climate, and the acceleration of the privatization process. While in the short term IFC will continue to expand its activities in general manufacturing and the financial sectors, in the longer term IFC will look for opportunities to support Serbia and Montenegro with investments in the energy and telecommunication sectors, as well as in the infrastructure sector.

MIGA

16. As of November 30, 2004, MIGA’s outstanding guarantee portfolio in SM consisted of 15 guarantee contracts: 13 in the financial sector, one in the services sector, and one in the manufacturing sector, with a total gross exposure of US$344.2 million and a total net exposure of US$170.6 million. At 6.3 percent of MIGA's total gross exposure, SM is now MIGA's fourth largest host country. MIGA also provides TA (institutional development and capacity building) on investment promotion to both Serbia and Montenegro. An initial project benefiting the Serbia Investment and Export Promotion Agency (SIEPA) is nearing completion. A comprehensive follow-on project with a two- to three-year time horizon is expected to be launched in early 2005; this project will be implemented by MIGA on behalf of the EAR. In Montenegro, also with financial support from the EAR, MIGA is currently implementing an initial capacity building project in support of the new Montenegrin Investment Promotion Agency. MIGA’s TA activities in SM are feeding into a new, regional FDI outreach and marketing initiative for the Western Balkans which MIGA launched in summer 2004 (that is, the European Investor Outreach Program for the Western Balkans).

Joint Staff Assessment (JSA) of the Poverty Reduction Strategies

17. Bank and Fund staff produced 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, notably the focus on harmonization to common EU standards, continuing privatization, an improved business environment, and policies to raise employment. However, 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. Staff agreed that the envisioned market-oriented reforms, if implemented in the context of continuing macroeconomic stability, will foster a considerable reduction in poverty.

Bank-Fund Collaboration in Specific Areas

18. 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:

19. **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, requiring 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.

20. **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 credits/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 provides continuing support to the sector in Serbia with an Energy Efficiency Credit and complementary Global Environmental Fund grant, now under preparation. The already approved Montenegro Energy Sector Learning and Innovation Credit will introduce automated billing and demand management, facilitate the eventual privatization of distribution services and lay the basis for institutional strengthening.

21. **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 supported 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 Administration Improvement Project was approved for Montenegro and work has commenced on a pension reform technical assistance operation for Serbia for this fiscal year delivery.

22. Serbia's SAC also included initial reforms of the health care system 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 deepened this reform agenda. The Bank's involvement in the health care sector in Montenegro has focused on analytical work, most recently under the PEIR and a health sector reform project was approved in June 2004.

23. 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 were completed and deepened under the SOSAC. The SAC for Montenegro also supported the enactment of a Law on Labor and Law on Employment.

24. **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 rapid 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 is continued under the Privatization and Restructuring of Banks and Enterprises Technical Assistance Project. The

Bank has increased its involvement in these areas in Montenegro under the recently approved second SAC for Montenegro.

25. **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 supported 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, bankruptcy, business registration, and on Agency for Business Services. 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 extended to the Government of Serbia supports the improvements in Serbia's court administration and the development of a National Judicial Reform Strategy.

Prepared by World Bank staff. Questions may be addressed to Ilker Domac at 458-1138 or Carolyn Jungr at +381-11-3023700.

INTERNATIONAL MONETARY FUND

SERBIA AND MONTENEGRO

Fifth Review Under the Extended Arrangement, Financing Assurances Review, Request for Waiver of Nonobservance of Performance Criteria, and Rephasing of Purchases

Prepared by the European Department
(in consultation with other departments)

Approved by Reza Moghadam and Donal Donovan

June 13, 2005

- **Extended Arrangement (EA).** The fourth review of the three-year EA with Serbia and Montenegro (SM) approved in May 2002 (SDR 650 million, or 139 percent of quota) was completed on December 15, 2004, with a total of SDR 462.5 million disbursed (Appendix I, IMF Country Report No. 05/13). A further SDR 125 million (26.7 percent of quota) would be made available upon completion of this review. The EA, which originally was scheduled to expire on May 13, 2005, was extended at the request of the authorities until December 31, 2005 to allow for the completion of this and the sixth review.

- **Discussions.** These took place in Belgrade and Podgorica during January 19–February 2 and May 6–12, and in Washington during April 14–18. The missions met with the President, Prime Minister, and Deputy Prime Minister of Serbia; the ministers of finance, economy, capital investments, international economic relations, energy, and labor and social policy, and the governor of the National Bank of Serbia; the Prime Minister and Deputy Prime Minister of Montenegro; the minister of finance and the chairman of the Central Bank of Montenegro; other key officials in Serbia, in Montenegro, and in the Union of SM; and representatives of public enterprises, trade unions, the private sector, and think tanks. It coordinated its work with World Bank staff (Appendix II).

- **Staff.** The missions comprised Ms. Sorsa (head), Messrs. Alvesson, Gorbanyov, Mottu, Westphal (all EUR), Chua, Simone (FAD), Sdralevich (PDR), and Hirschhofer (resident representative). Messrs. Zurbrügg and Antić (OED) attended policy meetings.

- **Letter of Intent (LoI).** The attached LoI and Memorandum of Economic and Financial Policies (MEFP, Appendix III) describe the authorities' program for the rest of 2005.

- **Publication.** The authorities have not yet decided on the publication of this staff report. Previous reports were all published. A press statement by the IMF Resident Representative in SM was released at the conclusion of the May mission.

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I. Introduction

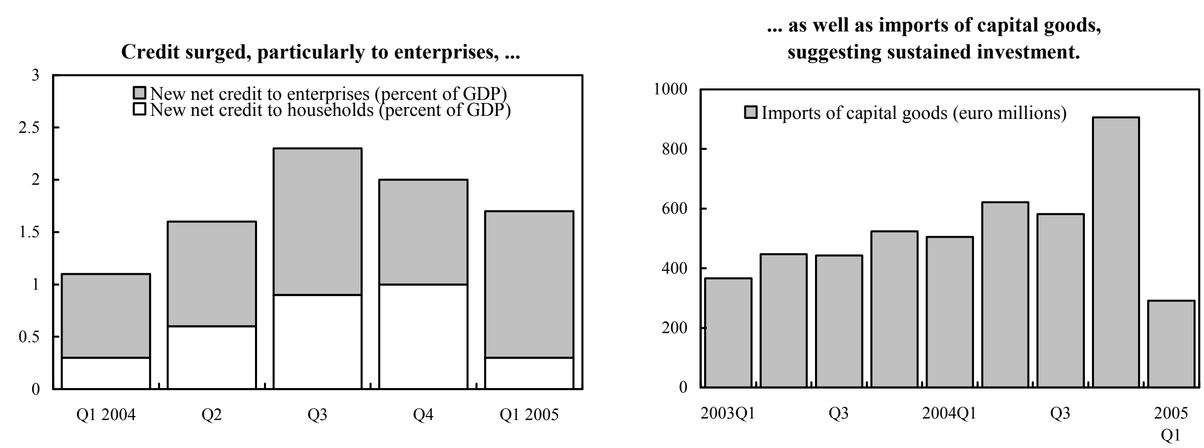
1. **This report focuses on the fifth review under the EA.** The Article IV consultation discussions are the subject of a separate report.

2. **Program implementation has been mixed (Appendix III, Annexes A–B).** While all but one end-March quantitative PCs were met, important structural performance criteria related to downsizing of the army and restructuring in the energy sector were missed. Several benchmarks were also met with some delay, but program implementation has overall improved from the last review. The discussions on the fifth review took longer than expected because of differing views on the amount of fiscal and monetary policy tightening needed to deal with the rising inflation and external imbalance.

3. **The political situation remains fragile implying large policy implementation risks, although recent advances with EU accession have strengthened the reform momentum.** In Serbia, while the minority government's position was recently boosted by a positive Feasibility Study—a first step towards EU accession—the political agenda continues to predominate over economic issues. Uncertainties regarding Kosovo and the union between Serbia and Montenegro remain, although prospects for international cooperation were enhanced by improved collaboration with the International Criminal Tribunal in The Hague. In Montenegro, pro-independence sentiment may result in a referendum in early 2006 on the separation of the two republics.

II. Recent Developments

4. **Macroeconomic risks in early 2005 continue to be high.** Although recent data point to a potential leveling of the rising inflation and current account trends, their reversal remains uncertain, and the external debt remains high (Tables 1–2, Figures 1–2).

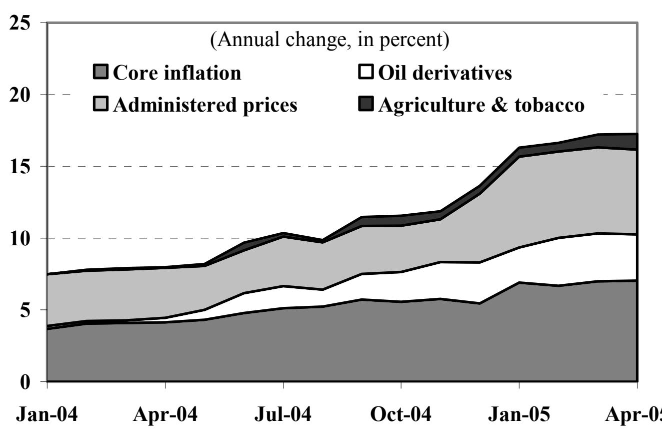


Sources: Serbian Office of Statistics: National Bank of Serbia; and IMF staff estimates.

- **Although growth has slowed from last year's record pace, it continues to be led by strong domestic demand.** Despite a marked deceleration in real wage growth since mid-2004, demand has been sustained by a continuing credit boom and solid inflows of remittances. It continues to exceed the still limited competitive domestic supply, contributing to the large macroeconomic imbalances. There are signs of a shift from consumption to investment demand towards end-2004, as indicated by the surge in capital goods' imports and increase in the share of credit to enterprises (Box 1). Output dropped slightly in early 2005 due to stockpiling at end-2004, but is expected to pick up with continued export growth and investment in privatized companies. The VAT introduction in January complicates the analysis because of a one-off shift of imports, external borrowing, and output from 2005 to end-2004 (Box 2).

- **Inflation in early 2005 surged beyond program targets, reflecting continued demand pressures and hikes in administered prices.** Annual inflation exceeded 17 percent in May, boosted by oil and municipal price increases, the VAT introduction, and dinar depreciation. The widespread euro-indexation of prices has contributed to the increased pass-through from the exchange rate to prices (Figure 3).[1] This, coupled with persistent demand pressures, led to a doubling of core inflation during 2004. The slower depreciation of the dinar since January and tighter demand management policies may explain the recent deceleration of monthly inflation. However, inflationary pressures remain strong, as many administrative price increases are being delayed, and cost pressures from past wage increases remain.

Inflation in early 2005 has stabilized.



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

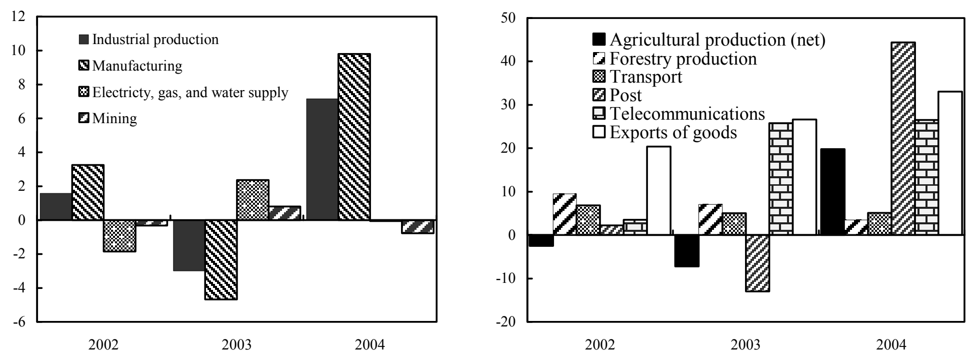
- **The excess demand widened the current account deficit to 15½ percent of GDP in 2004—an unsustainable level despite some improvement in early 2005.** Imports rose by 7 percent of GDP in 2004, reaching half of GDP, while exports, despite an increasing trend since mid-2004, remained at a third of that level—reflecting the still small share of a competitive private sector in the economy. While the VAT effect

[1] A selected issues paper for the accompanying Article IV consultation report has estimated that the pass-through from the exchange rate to prices has increased to 0.4-0.7 in 2004.

Box 1. Indicators of Growth in Serbia

After a disappointing performance in 2002-03, real GDP growth picked up strongly in 2004, and various indicators suggest that competitive supply may be gradually increasing. This is evidenced, for example, by robust growth of *industrial production* (7.2 percent), especially in *manufacturing*; and soaring *exports* of goods and of services. There may also be a shift from consumption to investment, as production of *capital goods* and *intermediate goods* was particularly strong in 2004.

Serbia: Domestic Production Indicators, 2002-04
(Annual change, in percent)



Sources: Serbia authorities; and Fund staff estimates.

However, much of the growth is still explained by strong domestic demand. Real consumption grew by 14 percent while investment soared by 20 percent in 2004. On the consumption side, *retail sales*, *sales of agricultural, forestry, and fishing products*, and *consumer goods imports* all grew strongly in real terms. This was sustained mostly by a boom in consumer credit, which grew by 71 percent in real terms, as *real wage* growth slowed to 10.1 percent on average over the year. On the investment side, *imports of capital goods* and *credit to enterprises* soared, but *construction* activity remained subdued, albeit on the upside.

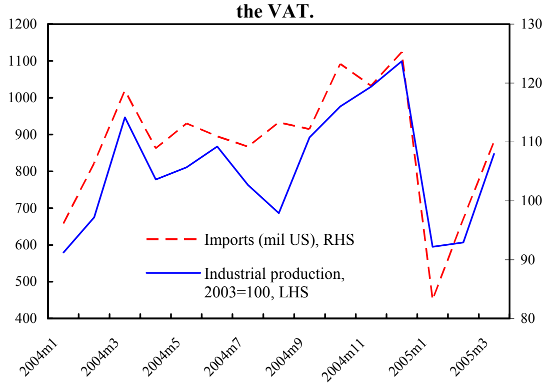
Box 2: Macroeconomic Impact of the Introduction of the VAT in Serbia

The value-added tax (VAT) was introduced in January 2005 in Serbia with a normal rate of 18 percent and a reduced rate of 8 percent. It replaced a 20 percent retail sales tax on goods and services that excluded many agriculture, food, and health products, and computers. Thus, the taxable VAT base is broader than the retail sales tax; moreover, as with most VATs, capital goods are taxed but can be deducted along with other taxed inputs, although with a lag.

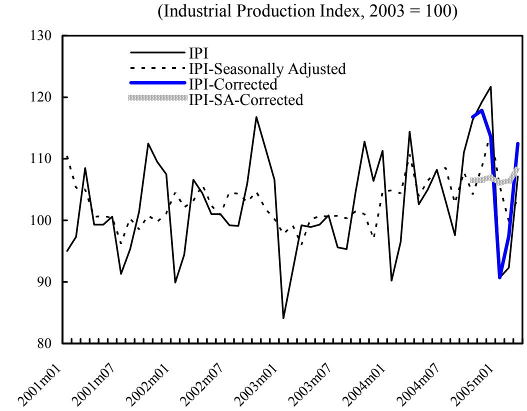
The VAT had a significant macroeconomic impact on economic activity during the last quarter of 2004 and the first quarter of 2005, as firms and households brought forward their consumption and investment plans in anticipation of the VAT. The available data suggest that purchases of final consumption goods, intermediate goods, and capital goods becoming taxed under the VAT accelerated significantly during Q4 of 2004. This, in turn, led to an acceleration in both imports and domestic production, a rise in inventories, and additional domestic and external borrowing. This may have been compounded by the belief that the overall price level would increase with the VAT. Subsequently, demand dropped in the first quarter of 2005, resulting in low imports and a drop in domestic industrial production and inventories. Correcting for this VAT effect, industrial production would have remained steady in 2005 (see Text Figures).

The staff estimated the size of the VAT effect on the current account at about 1¾ percent of GDP in 2004 and 2005. Specifically, about $700 million in imports and $300 million in remittances were brought forward into 2004, increasing the current account deficit that year and lowering it in 2005. External debt may also have been affected by an increase in borrowing needed to finance the exceptionally high imports, even though the net effect is difficult to estimate.

Imports and industrial production shot up in Q4 2004, before dropping in Q1 2005, largely due to the VAT.



Corrected for the VAT effect, industrial production remained flat in Q4 2004 - Q1 2005
(Industrial Production Index, 2003 = 100)



Sources: Serbian Statistics Office; Economics Institute, Belgrade; and IMF staff estimates.

The VAT also had a one-off effect on prices in January-February, contributing some percentage points to the RPI. Price increases for newly-taxed goods and services were, to some extent, offset by price reductions for electricity and oil derivatives, which saw their tax rates decline from 20 percent to 18 percent. The indirect effects, for example incorporated in some municipal price increases, are more difficult to quantify.

explains some of the worsening of the trade balance in 2004 and its improvement in early 2005, the adjusted current account deficit at 13.7 percent of GDP in 2004 is unsustainable, as the increased share of debt financing (over 50 percent) is adding to the already high debt burden.

Serbia: Financing of the 2004 current account deficit
(before grants, in percent of total)

Financing	100
1. Debt-creating flows	55
Of which	
Medium- to long-term borrowing, net	43
(by borrower)	
Public sector	7
Private sector	36
Banks	15
Corporate sector	21
Short term debt, net	12
2. Non-debt creating flows	65
Of which	
Grants	15
Foreign direct investment	28
3. Change in Central Bank NFA	-20
(– = increase in net assets)	

- **The boom in foreign borrowing has increased vulnerability to exchange rate shocks (Tables 3–5).** Although the bulk of the rise in net foreign debt (by 8 percent of GDP in 2004) is by private banks and corporations and of medium-term maturities, the worsening of the external debt dynamics is of concern.[2] As a result, total external debt at end-2004 at US$14 billion (62 percent of GDP) was unchanged despite the debt reduction by the London Club and other creditors.[3] The vulnerability is exacerbated by the prevalence of euro-indexed lending that transfers exchange rate risk to often unhedged borrowers. The large capital inflows boosted gross foreign reserves of the National Bank of Serbia (NBS) to $4.3 billion at end-December 2004 (3.7 months of projected imports), and the trend has continued in early 2005 with a strong inflow of FDI.

5. **The tightening of macroeconomic policies since mid-2004 has been insufficient to reduce the imbalances in the face of a lending boom and widespread euro-indexation of prices:**

- **The fiscal deficit was well below its target in 2004 as the strong economy and improved collections boosted revenues (Tables 6–8).** The overall fiscal position improved by 3 percent of GDP from the previous year, resulting in a nearly balanced

[2] Although the bulk of the borrowing by commercial banks has medium-term maturities, these loans could be withdrawn at short notice, if the macroeconomic situation worsens.

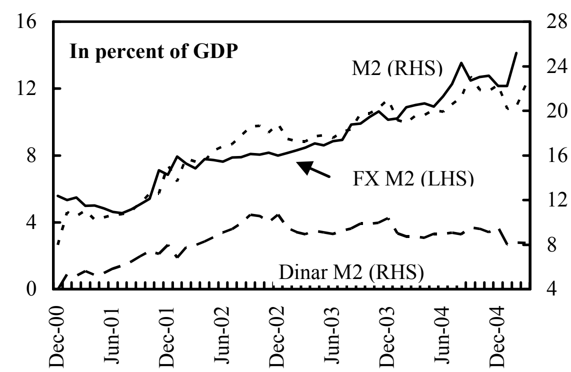
[3] The London Club agreement of July 2004 implies a reduction of the debt owed to commercial banks by 62 percent, reducing SM's overall debt burden by 7 percent of GDP in 2004. The debt swap began in April 2005.

budget in 2004. Despite tax cuts in both Serbia and Montenegro,[4] revenues exceeded projections (by 2 percent of GDP) as collection improved and growth was stronger than expected. Expenditures were kept in line with the revised budget. In Montenegro, the fiscal deficit declined by about 1½ percent of its GDP, slightly better than programmed, as expenditure was compressed to compensate for larger-than-expected revenue losses following the recent tax cuts.

- **The strict incomes policy in the public sector helped contain wage growth and facilitated downsizing.** This may even have helped to limit wage demands more broadly, as the public sector has for a long time been considered a trend setter in wage policy. In Serbia, employment in the 8 monitored state enterprises[5] was reduced by several thousand people in early 2005, thereby helping to keep the wage bill growth in line with the 7 percent annual program target. In Montenegro, public employment was reduced by 3.8 percent as of March 2005, about a third of the bi-annual target.

- **However, monetary policy was unable to contain the credit boom that fuelled the excess demand (Table 9).** The improved access to credit by households and enterprises reduced the need to save, and unleashed strong pent-up demand as newly established foreign banks competed for market share. Much of it was spent on imports putting pressure on the current account. Despite the measures introduced at end-2004 to contain foreign borrowing by banks and consumer lending, credit from banks to enterprises continued to grow rapidly in early 2005. The measures to slow the pace of domestic lending may also have encouraged enterprises to borrow directly from abroad—foreign-financed leasing activity and direct loans to enterprises increased substantially towards end-2004, reaching over 6½ percent of GDP. The introduction of repo operations in

Since 2003 euroization of deposits accelerated.



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

[4] In Serbia, the corporate tax rate was cut from 14 percent to 10 percent in 2004; and the wage bill tax was eliminated. In Montenegro, the corporate tax was halved to 9 percent as of 2006, and personal income and social contribution taxes were reduced from 47 to 42 percent in two steps.

[5] The 8 enterprises comprise the electricity, petroleum, railway, post, telecommunication, airline, airport, and forestry companies.

January has so far had a modest impact on monetary conditions in an environment of high and increasing euroization, e.g. euro-liabilities reached 70 percent of total deposits in 2004, the highest share ever in transition countries.[6]

- **The impact of exchange rate policy, used over time intermittently to lower inflation or the external deficit, continues to be weakened by the severe structural rigidities in the economy (Figure 4).** The faster depreciation of the dinar in 2004, aimed at lowering the current account deficit, contributed to higher inflation, influenced by the widespread euro-indexation of prices and euroization of assets and liabilities. While the faster depreciation may have helped export competitiveness in 2004, it was insufficient to improve the current account given the strong demand pressures and the still limited competitive supply stemming from delayed structural reforms. Against this background, and with the history of hyperinflation, the authorities considered inflation as the main short-term risk for stability, and insisted in January on using the exchange rate to anchor expectations. The slower depreciation of the dinar since in early 2005 seems to have contributed to disinflation, and the continued growth of exports suggests that competitiveness is adequate, which points to the structural nature of the external imbalance.[7] However, the risks for the current account have increased, putting a higher burden on fiscal and incomes policies in containing demand.

Foreign financing of credit increased.
(Net flows in percent of GDP; at current exchange rates)

	2004					2005
	Q1	Q2	Q3	Q4	annual	Q1
Credit to nongovernment	1.1	1.6	2.2	2.0	7.0	1.8
o/w: credit to households	0.3	0.6	0.9	1.0	2.8	0.3
credit to enterprises	0.8	1.0	1.4	1.0	4.3	1.4
Memo. Items:						
Deposits	0.4	0.8	2.4	1.8	5.4	0.5
Foreign borrowing by commercial banks	0.3	0.7	0.7	1.7	3.5	0.4
Direct corporate borrowing	0.5	0.5	1.0	2.4	4.4	0.5
Leasing	...	...	...	...	2.1	...

- **Although structural reforms have picked up recently, excessive resources are still locked in uncompetitive activities, putting too much burden on demand management to lower the external imbalance.** The slow structural change has left SM lagging behind its neighbors in transition (it scored a regional low on the EBRD transition index), and in the share of labor (20 percent of labor) still employed in inefficient public and socially owned companies. Nevertheless, reforms have recently accelerated. Institutional changes required for faster privatization and restructuring advanced towards end-2004 in Serbia. Regulations for bankruptcy were adopted, tenders and auctions of socially owned enterprises accelerated since October 2004 with close to 300 companies offered for sale, of which about 40 percent found buyers, and

[6] A selected issues paper for the accompanying Article IV consultation report discusses euroization in Serbia.

[7] A selected issues paper for the accompanying Article IV consultation discusses competitiveness.

bank privatization advanced on schedule. In Montenegro, privatization picked up with the recent sale of the telecommunications company and other entities.

III. Policy Discussions

6. **Discussions focused on measures needed to reverse inflation, and the persistently large, and increasingly debt-financed, current account deficit.** The three-year program has so far failed to achieve its key macroeconomic targets (Figure 5). Its extension until end-year provides an opportunity to restore macroeconomic stability with a strong policy package.

- **The program will be based on an exchange rate anchor, as the authorities saw inflation as the main threat to confidence in the near term.** At the same time, they considered the current account deficit, while large, to be more of a medium-term risk, as financing continues to be available from private and multilateral banks, FDI is rising, short-term debt remains low, and international reserves continue to increase. Furthermore, in their view, using the exchange rate to improve the external balance would only lead to a depreciation-inflation spiral, because of the widespread euroization, and the structural nature of the current account deficit.

- **Staff underlined that to reduce the risks of this strategy for the external balance, a further tightening of fiscal and monetary policies is needed.** This is risky given the rigid structure of public spending and past reliance on revenues in deficit reduction, and the limits set to monetary policy by euroization. To ensure that the fiscal stance is put on a more sustainable footing, it is essential to include more sustainable expenditure cuts in the 2006 budget. A more stable exchange rate may also increase balance sheet risks, if borrowers underestimate foreign exchange risk. This calls for tighter supervision and prudential rules. Structural reforms also need to be accelerated to reduce medium-term current account risks by improving the supply response of the domestic economy.

- **Against this background, understandings were reached to complement the slower dinar depreciation favored by the authorities, with** (i) tighter-than-previously-programmed fiscal policies in 2005; (ii) further monetary tightening to contain credit growth; and (iii) the acceleration of the structural reform agenda, including the reduction of quasi-fiscal losses in public enterprises. These are supported by substantially strengthened program conditionality including four prior actions for the completion of the review, eight new structural PCs, two new quantitative indicative targets, and 17 structural benchmarks (for details see paragraph 21, and Annex C in Appendix III).

A. Macroeconomic Framework

7. **Macroeconomic performance is expected to improve, as agreed policies aimed at reducing domestic demand take effect, but risks remain (¶12).**[8] Reducing inflation and containing the current account deficit while supporting sustainable growth are the key economic objectives for 2005 and beyond (Table 10, Figure 6):

- **Growth is projected to recede to 4½–5 percent in 2005, reflecting decelerating demand growth and weaker agricultural output after last year's bumper crop.** Growth in industry and services in 2005 is expected to remain robust, fueled by strong, albeit moderating consumption and investment demand. Growth is projected to reach 5 percent on average in subsequent years as privatization and enterprise restructuring continue and FDI inflows increase.

- **Inflation in Serbia is expected to decline to about 13 percent by end-2005, as demand pressures subside, exchange rate expectations adapt, and tight incomes policies in the public sector take hold.** However, the authorities project a 10 percent end-year inflation in Serbia, as they expect a stronger impact on prices from the tightening of policies. Pressures from oil and administrative prices are a major risk for the target. In Montenegro, inflation is expected to remain at 3½ percent by end-year.

- **The current account deficit is projected to drop to about 11 percent of GDP in 2005 as demand pressures subside and export growth continues.** The underlying deficit (corrected for the VAT effect) should be reduced from 13.7 percent to 12.6 percent of GDP, broadly in line with the program. The current account deficit is projected to decline in the medium term, as structural reforms elicit a supply response and prudent policies strengthen competitiveness. The external debt/GDP ratio is expected to move gradually towards 52-54 percent of GDP in the medium-term. The capacity to repay the Fund is expected to remain comfortable (Table 11). However, the scenario and the debt dynamics are subject to large risks from policy slippages or external shocks.[9]

8. **The program targets are subject to large downside risks, despite the strengthened policies.** These stem mainly from (i) the high uncertainty of the impact of monetary measures on credit growth as an increasing number of new foreign banks compete to gain market share; (ii) continued growth in direct foreign borrowing; (iii) developments in international oil prices, in addition to the underlying pressure to align energy tariffs to cover current and investment costs; (iv) the still fragile political situation, which carries high implementation risks, in

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[8] ¶ refers to the relevant paragraph number in the MEFP (Appendix III).

[9] The accompanying Article IV consultation report includes a debt sustainability analysis and an alternative, slow-reform scenario.

particular, for policies in the fiscal and structural areas affecting employment or incomes under the program. The authorities stated their readiness to take appropriate measures, should key macroeconomic indicators show signs of deterioration.

B. Fiscal and Incomes Policy

9. **The fiscal stance in 2005 will be tightened beyond program targets, although the quality of the additional adjustment remains weak (¶14–24).**[10] The consolidated general government is projected to achieve a surplus of 1.2 percent of GDP against a programmed deficit of 0.8 percent of GDP—a 1.5 percent of GDP improvement relative to the 2004 outcome. This is to be achieved by (i) expenditure cuts already incorporated in the 2005 budget;[11] (ii) stronger-than-expected revenue collection (on account of good VAT performance) and improvements in tax collection;[12] and (iii) additional reductions in various expenditure outlays. While this would result in a decline of both revenues and expenditures relative to GDP compared to the 2004 outcome, only part of the changes are permanent cuts in spending, which reduces the quality and sustainability of the proposed adjustment. The high share of non-discretionary outlays in the budget reduces the scope for more permanent cuts in programs in the short run.

Fiscal Policy needs to be tightened
(General Government, in percent of GDP) 1/

	2003	2004		2005	
		4th Review	Prel.	4th Review	Proj.
Total revenue	42.7	43.3	45.2	42.8	44.8
Total expenditure	46.0	45.3	45.5	43.6	43.7
Overall cash balance	**-3.3**	**-2.0**	**-0.3**	**-0.8**	**1.2**
Memorandum items:					
Serbian general government	-2.9	-1.7	0.0	-0.6	1.4
Montenegrin general government	-4.9	-4.0	-3.6	-2.8	-2.7

Sources: National authorities, and IMF staff estimates.
1/ Includes the Union, republican and local governments, social security funds and the extrabudgetary programs, except local governments in Montenegro.

Factors behind the fiscal improvement in 2005
(In percent of GDP)

Overall fiscal improvement	**1.5**
Revenue	**-0.4**
VAT bouyancy	0.3
Higher arrears collection	0.7
Increase in dividends/administrative fees	0.2
Revenue loss from mid-2004 tax reform	-1.0
Excise (including delayed indexation)	-0.3
Others	-0.3
Expenditure	**-1.9**
Lower wages/salaries	-0.3
Reduced spending on goods/services	-0.6
Cut in subsidies/transfers	-0.8
Cut in capital spending	-0.3
Increase in net lending	0.2
Others	-0.1

[10] The fiscal stance for the 2006 budget will be discussed in September 2005 and will take into account macroeconomic developments.

[11] These largely relate to subsidies, in line with the policy of steadily reducing budget support to inefficient enterprises and agricultural support, and goods and services such as travel, office supplies, and rent.

[12] This is supported by various tax administrative measures initiated in 2004 including the confiscation of bank accounts of delinquent tax payers, and use of a cash registry that have a more permanent impact on collection rates.

10. **The quality of adjustment will be improved in 2006, as various expenditure reforms take hold.** Cuts in permanent spending amounting to about 1 percent of GDP will be achieved mostly through pension reform and lower subsidies as enterprises restructuring advances (¶16).

11. **The continued strong economy and successful introduction of the VAT are expected to keep revenues strong in 2005, well above budget targets (¶15).** Despite projected revenue losses from cuts in direct taxes in line with the 2005 budget,[13] the carry-over from the strong economy last year and the successful introduction of the VAT in January have contributed to buoyant revenues through May this year. Coupled with improved collection, this is expected to maintain revenues at 44.8 percent of GDP this year. However, the projections carry down-side risks, which the authorities agreed to address by a set of contingency measures (¶19). The staff also advised against further tax cuts and tax exemptions this year, emphasizing the importance of predictability in tax policy.

12. **Expenditures would be cut more than budgeted to support the envisaged tightening and deal with policy slippages in civil service reform.** As a result, the share of expenditures in GDP would remain in line with the previous 2005 program. Spending will be curtailed in various categories involving current and capital outlays, beyond the cuts in subsidies and the wage bill already included in the budget. To compensate for the slower-than-envisaged civil service reform (¶17), and for the higher-than-projected transfers to the social funds from unexpected hikes in inflation, the authorities agreed to speed up health sector reform by outsourcing some non-medical services with the aim of generating savings by reducing total health sector employment. Over the longer term, this would create space for some wage decompression for highly qualified medical staff. The Belgrade municipality also agreed to curtail spending, to be cemented by a supplementary budget. Some of these cuts carry notable implementation risks as they are tied to politically sensitive lay-offs. To reduce the social cost of adjustment from public sector downsizing, the budget includes outlays for redundancy payments and active labor market policies (¶20).

13. **The programmed fiscal tightening in Serbia in 2005/06 will be supported by the following policies/reforms:**

- **Local governments (¶18).** To improve fiscal coordination, the central government will make wage and price increases in local utilities subject to approval by the central government. In addition, the city of Belgrade has agreed to amend its budget to scale back expenditure by 0.2 percent of GDP in 2005.

- **Tax arrears (¶19).** Bankruptcy procedures against non-payers will be stepped up by active recourse to the new procedures to improve both tax collection and financial

[13] Overall revenue will decline on account of the elimination of the financial transactions tax in January 2005, and the tax cuts implemented in the second half of 2004.

discipline. On this basis, the stock of tax arrears will be reduced by 0.7 percent of GDP in 2005.

- **Pension reform (¶21).** The various pension funds for employees, farmers, and self-employed, whose deficit, covered by budgetary transfers, has reached 6 percent of GDP will be reformed. Specifically, a phased reform over four years will (i) increase the retirement age by 2 years; (ii) base the pension indexation formula solely on inflation; and (iii) replace quarterly with annual pensions indexation at end-2005. These measures are expected to result in annual savings of about 0.6 percent of GDP in 2006.

- **Public expenditure management (¶23–24).** The action plan to reorganize and improve treasury operations was issued in March, requiring that the accounts of indirect budget users be closed and incorporated into the budget. Budget control will also be improved by incorporating all spending programs, including foreign-financed projects, into a unified budgetary framework in 2006. The authorities have requested technical assistance from the Fund to assess fiscal risks arising from potential public-private-partnerships and their macroeconomic effects.

14. **To improve public sector financial discipline in Serbia, arrears collection will be improved in the energy companies, and tight incomes policy will continue.** The oil company (NIS) and the electricity company (EPS) have set quarterly collection targets of bills and arrears, to be enforced by a stricter disconnection policy. To reduce quasi-fiscal losses, the staff also recommended pricing of utilities at cost-recovery levels—provided appropriate restructuring is implemented—independently of its possible impact on headline inflation. Similarly, the pricing formula linking domestic to world prices should be used more consistently to ensure adjustment to higher world energy prices. The authorities agreed in principle, but indicated that this may require lowering excise taxes to mitigate the impact on inflation. The strict incomes policy in the public sector agreed under the program will continue (¶37).

15. **In Montenegro, the fiscal deficit will be reduced by about 1 percent of GDP to reach 2.7 percent of GDP in 2005 to contain demand and the external balance.** To achieve this target, transfers and other outlays will be cut relative to the budget, reduction of public employment will be stepped up, and no further tax cuts will be granted. The large expected privatization proceeds (10 percent of Montenegrin GDP) will be used mainly to retire domestic debt. Staff urged the authorities to resist spending pressures and to postpone the large planned infrastructure projects to avoid destabilizing macroeconomic balances. Instead, the authorities should strengthen revenue collection, accelerate civil service reform, and improve debt and asset management to create room for additional investment (¶26–27**).**

C. Monetary and Exchange Rate Policies

16. **Monetary policy will be tightened further in Serbia in 2005 to help contain domestic demand and inflationary pressures, with an increasing reliance on indirect instruments (¶29–30).** As the prudential measures undertaken in early 2005 have not slowed

down overall credit growth, further tightening of policies was needed. The NBS will step up repo operations to reduce liquidity with substantial frontloading by end-June. This will be complemented by increasing the reserve requirement on enterprise foreign exchange deposits and banks' foreign borrowing by 5 percentage point to 26 percent. At the same time, the reserve requirements on dinar deposits will be lowered from 21 to 20 percent to help develop dinar markets. To level-off the playing field, leasing activities will be brought under prudential controls.

17. **A slower rate of dinar depreciation[14] is expected to help disinflation (¶31).** While this carries considerable risks for the external balance through potential real appreciation, these concerns will be mitigated by the tighter-than-previously- programmed fiscal and monetary policy. Furthermore, given the structural nature of the external imbalance following a decade of economic isolation, the acceleration of structural reform should lower the current account risks in the medium term.

D. Financial Sector Reform

18. **The restructuring of the banking sector and the strengthening of financial sector regulation and supervision will continue in line with FSAP recommendations (¶32–35).[15]** In Serbia, privatization of 5 state-owned banks is underway and legislation is being prepared to strengthen the financial infrastructure, in particular in the areas of deposit insurance, bank liquidation, and the Bank Rehabilitation Agency. Moreover, to address prudential risks resulting from strong credit expansion, the NBS is committed to reform the legal framework for bank regulation and supervision in line with the recommendations of the recent FSAP mission (Box 3), while continuing to step up on-site and off-site supervision. A new banking law will be enacted in November to align the regulatory framework with Basel Core Principles, including by strengthening governance and the framework for risk management, internal control, and audits. In the insurance sector, the two largest socially owned insurance companies will be prepared for privatization and restructuring. The development of the non-bank financial sector will also benefit from new laws on securities, investment funds and pension funds. In Montenegro, privatization of 3 banks with a majority state-ownership is also well advanced and is expected to be completed this year (¶36).

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[14] The authorities have announced a targeted depreciation of 10 percent for the euro-/dinar rate during 2005. To achieve this target, the NBS intervenes regularly during the fixing sessions with commercial banks. In the first five months of 2005, foreign currency inflows have increased gross reserves by US$177 million (or US$451 million at constant end-2004 exchange rates) to counter the appreciation pressure.

[15] See Box 3 for a summary of the findings of the April 2005 FSAP mission.

Box 3: Key Findings of the 2005 Serbia FSAP Mission

The rapid move from a limited state-controlled to a dynamic market-driven financial sector is creating new and difficult policy challenges. The rapid credit expansion, largely fueled by foreign banks, whose share in total banking system assets rose to 52 percent, is contributing to the long-term economic recovery of Serbia. At the same time, however, rapid credit growth brings with it new risks, especially in the context of the unsustainable current account deficit and stubbornly high inflation.

While the financial system is broadly stable, there are two main systemic risks that could come to the fore if the rapid pace of credit growth continues. *First*, credit risks are arising from the 47 percent growth in bank loans during 2004 and the increase in non-performing loans, which amount to nearly one-fourth of loans. Moreover, as virtually all new lending is indexed to the euro, credit risk resulting from borrowers' exposure to exchange-rate risk has risen significantly, as the low share of exports in GDP implies that many borrowers are unhedged. *Second*, the state-owned banks, especially the two largest, could pose systemic risks prior to their privatization owing to their weak financial performance and governance.

These risks are exacerbated by weaknesses in banking regulation and supervision. While banking supervision has improved over the last few years, gaps in the banking law and regulations, nonfinancial ownership of some banks, the absence of consolidated supervision, and weak enforcement reduce its effectiveness.

To mitigate the risks, the legal framework for banking regulation and supervision should be brought in line with Basel Core Principles. In particular, the new banking law, scheduled to be adopted by parliament by mid-November, should require accurate and timely asset classifications, introduce consolidated banking supervision, establish explicit statutory protection for NBS staff, strengthen "fit-and-proper" criteria, and require banks' boards of directors to accept responsibility for establishing and overseeing integrated risk management systems.

Changes in the legal environment need to be accompanied with vigorous efforts to end regulatory forbearance. In particular, it is imperative to step up the resolute enforcement of the results of supervisory examinations, and to improve systems of internal controls, risk management, governance, and data reporting. To contain risks emanating from the two systemically important state-owned banks, vigorous efforts to accelerate their privatization, combined with immediate improvements in governance, are key.

In addition, financial development in Serbia is highly unbalanced. While lending by foreign banks is surging and leasing growing sharply, nonbank financial markets are either small or nonexistent. The uneven development largely reflects key gaps in the legal and regulatory framework. In this context, it is important to remove impediments to the healthy growth of the insurance sector, in particular by restructuring and privatizing the two large socially-owned insurance companies. For the development of the nascent capital markets, the creation of a supporting legal framework is the key issue at this stage. The securities regulator suffers from insufficient legal authority and weak institutional capacity. Investment funds in Serbia remain unregulated and pose a risk for future private pension funds. Reforms should focus on revising legislation, strengthening the regulatory agencies, and enforcing high standards of accountability and transparency.

E. Enterprise Reform

19. **Enterprise restructuring and privatization will be further accelerated to enhance growth and medium-term external sustainability (¶38–43).** This will build on the efforts already intensified since late-2004:

- **Privatization of socially owned enterprises through tenders, auctions, and sales of government minority-shares will continue, with a view to offering at least 350 companies through auctions, and 14 through tenders by end-year**. The remaining 1500 will be offered for sale in 2006. Privatization will be facilitated by debt workouts under the new framework facilitating a write-off of debt to state creditors and public utilities, which was approved in May. Reallocation of resources should be speeded up with the intensified use of bankruptcy for unsellable companies envisaged this year. The plans to reduce subsidies to a mining complex and car factory by stepping up their restructuring are a major step in signaling an end to passive subsidies to unprofitable activities despite political sensitivities.

- **Restructuring of public enterprises will accelerate including with the sale of some core and most non-core assets.** The electricity company was unbundled with a view to improving the efficiency of its operations and reducing core employment. The petroleum company will be split into four units in July, and a tender launched to prepare for a majority privatization of the refineries in early 2006. About 104 non-core entities will be transferred to the privatization agency from the 8 monitored public enterprises in various steps. As these include attractive assets like hotels and catering, their privatization should contribute to growth and job creation over time.

- **In Montenegro, several large public enterprises will be offered for sale in 2005,** including the tobacco and the lottery companies, and hotels, while others will be prepared for privatization (¶44).

IV. Review Issues and Financing Assurances

20. **The staff supports the authorities' request for waivers for the missed performance criteria, as corrective actions were undertaken to ensure that the implementation of the underlying policy measures remain broadly on track.** Both the continuous and the end-March performance criteria on the ceiling of outstanding external arrears in Montenegro were breached by a small margin, but they were cleared in May. The end-December structural performance criterion on changing the laws on the Yugoslav army and union-level civil employees was only partially met with delays, but the envisaged downsizing will be achieved with other measures. The end-February 2005 structural performance criterion on the legal registration of the new electricity transmission and dispatch company was delayed to July due to more time needed to formally separate the companies, while their restructuring is on schedule. Given the strengthened conditionality, staff supports the authorities' request to maintain the combined purchase for the fifth review, and to rephase the eleventh and final

purchase to become available upon the completion of the sixth review, which would cover July–November 2005 test dates.

21. **Program conditionality has been strengthened to address the mounting macroeconomic risks and to support the authorities' reform efforts** (Appendix III, Annexes A and C).

- The **prior actions** for the completion of the fifth review reflect a frontloading of important structural measures in Serbia regarding pensions, privatization of socially owned enterprises, and spin-off of non-core companies of state-owned enterprises, as well as tighter monetary policy.

- The **quantitative performance criteria** will be set for end-June and end-September 2005 and reflect the tighter fiscal and monetary stances.

- The **structural performance criteria and benchmarks** support faster structural reform in the financial and enterprise sectors, and important fiscal reforms. Structural performance criteria relate to critical reforms in Serbia in the state-owned electricity and oil sectors; passage of supplementary budgets by Serbia and the city of Belgrade to implement the envisaged fiscal stance; passage of the 2006 budget, the pension reform and the new banking law; and further spinning off of non-core companies of public enterprises.

22. **Negotiations on settling pending external arrears have progressed, and the external financing outlook remains adequate.** The debt swap envisaged under the July 2004 agreement with the London Club was implemented in April with the issuance of a 20-year bond in April.[16] The Paris Club agreement has been implemented with all but one creditor; past debt with China and Russia is close to being settled; and negotiations with other bilateral and commercial creditors are progressing. Arrears with Russia emerged in Montenegro, but were settled. The remaining 15 percent of the Paris Club debt reduction is pending until completion of the EA, in line with the Agreed Minutes of the 2001 agreement. External grants and loans, FDI, and other capital inflows are expected to allow an increase in gross external reserves to about $5.6 billion by end-2005 (4⅓ months of prospective imports).

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[16] Under the agreement with the London Club, SM's debt is reduced by about 62 percent in NPV terms, which the Paris Club accepted as broadly comparable with its own debt relief. The 20-year US$1.08 billion bond with a 5-year grace period carries a 3.75 percent coupon for the first 5 years and a 6.75 percent coupon for the next 15 years. The London Club agreement does not cover around US$70 million of arrears on some bonds, the holders of which did not participate in the 1988 debt rescheduling. The authorities are preparing for negotiations to obtain a rescheduling from these creditors on the same terms as the July 2004 agreement.

V. Staff Appraisal

23. **The recent surge in demand, while supporting strong growth, has increased inflation, the external deficit, and overall risks, despite a tightening of macroeconomic policies.** Demand has continued to outpace supply, reflecting dissaving by the private sector with increased access to credit, and failure to reallocate resources from unprofitable and overstaffed state and socially-owned enterprises. The situation has been complicated by a surge in direct foreign borrowing by privatized companies at end-2004. Although the macroeconomic picture is distorted by the VAT introduction that led to a one-off boost to inflation and a shift of imports, external borrowing, and output from 2005 to end-2004, the underlying current account deficit and core inflation remain too high. Furthermore, the surge in foreign debt towards end-2004 has increased external vulnerability to sudden stops in funding.

24. **The authorities have responded to these challenges with a strong package of substantially tighter macroeconomic policies, faster structural reform, and an exchange rate anchor.** This package is expected to reverse inflation, thereby reducing short-term risks for macroeconomic stability, while both the current account deficit and inflation would be lowered by reining in demand with tighter fiscal, incomes, and monetary policies. At the same time, the faster structural reforms would improve the prospects for sustainable growth.

25. **The substantial further tightening of the fiscal stance is welcome, but the quality of the adjustment needs to be improved to ensure its sustainability.** The VAT introduction has been successful in contributing to strong revenues, which were also supported by robust demand and improved tax administration. Nevertheless, reliance on improved tax collection or endogenous increases in revenues, has large downside risks. Therefore, the authorities should stand ready to implement the identified contingency measures, if revenues underperform, and resist any further reductions in taxes this year. On expenditures, the agreed spending cuts in the 2005 budget are being implemented, including subsidies. The backtracking on civil service reform is regrettable, and it should be avoided in other areas to reduce risks for achieving the fiscal targets this year. Long-overdue reforms to address the pension fund deficit are necessary and should improve the sustainability of the fiscal stance by enabling permanent reductions in spending from 2006 onwards.

26. **The agreed further monetary tightening should support fiscal and incomes policies in containing domestic demand.** The impact of monetary policy on credit growth remains uncertain, however, owing to the high degree of euroization in the economy and intensified competition by foreign banks for market share. For this reason, monetary instruments should continue to be complemented by a strengthened application of prudential rules to promote financial stability and contain credit growth. Over time, the focus of policies should shift increasingly from reserve requirements to repo operations.

27. **Vigorous efforts to complete the privatization of state-controlled banks need to continue, while the increase in foreign currency-indexed credit calls for enhanced supervision.** Rapid privatization of the two largest state-owned banks would reduce systemic

risks. The new banking law should be fully in line with Basel Core Principles as recommended by the recent FSAP mission. Moreover, the new prudential rules to improve the monitoring and management of credit risk resulting from borrowers' exposure to exchange rate risk should be vigorously implemented. The recent measures to enhance leasing and insurance supervision are welcome.

28. **The exchange rate policy in Serbia carries risks**. While a more stable exchange rate regime should support disinflation, it is bound to put pressure on the already large current account deficit and increase balance sheet risks through potential underestimation of foreign exchange risk. The tightening of macroeconomic policies in this context should restrain demand, while the speedier structural reform should, over time, increase competitive supply and reduce medium-term risks associated with the external balance. Strengthened prudential rules on foreign currency borrowing should address some of the potential moral hazard associated with the exchange rate. Exchange rate policy should be kept under review in light of inflation and current account developments.

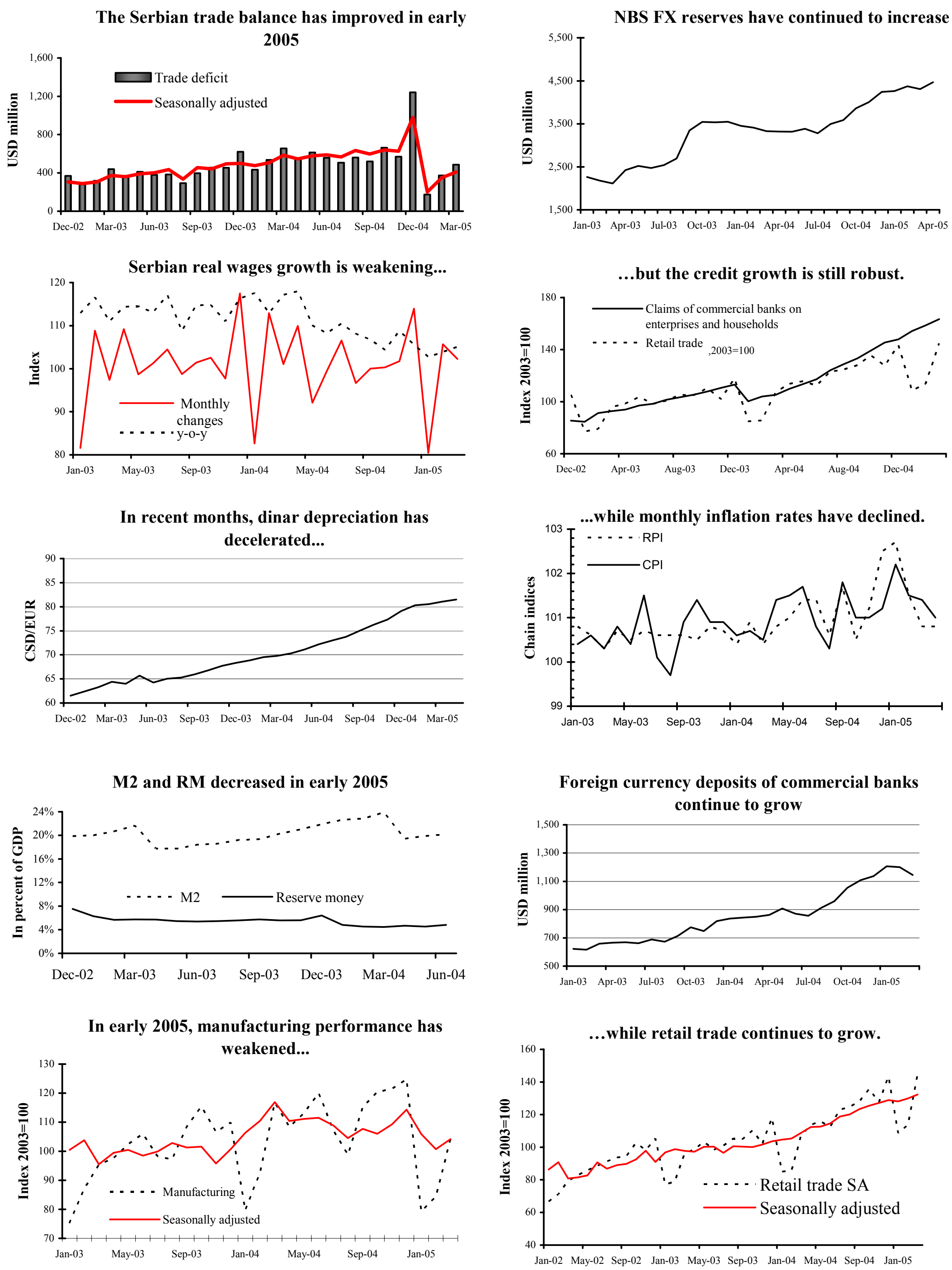
29. **Incomes policies continue to be critical in containing domestic demand and inflationary pressures, and improving competitiveness.** Government employees and public enterprises have a leading role in the labor market, and the authorities' efforts to contain wage increases are commendable. The risk for slippages in state-owned enterprises and in local government remains high, however, due to weak institutional arrangements and absence of effective state control. The fragile political situation further diminishes the government's ability to strictly implement its income policy.

30. **The acceleration of structural reforms is crucial for reducing the macroeconomic imbalances over time and should be implemented without delay despite potential resistance from vested interests.** While bankruptcies and downsizing will affect employment in the near term, the privatization of non-core assets and socially owned enterprises is likely to create new and more secure jobs over time. The envisaged redundancy payments should mitigate social costs.

31. **The risks to the program are considerable, both politically and economically.** The fragile coalition will be tested by the implementation of many difficult measures, especially in the structural area. The uncertain impact of the macroeconomic tightening on credit growth and foreign borrowing, the main causes of excess demand in 2004, and suppressed administrative price increases, carry risks for inflation and the external balance. This is compounded by the limited effectiveness of monetary policy owing to high euroization, and potential difficulties in implementing the agreed permanent expenditure cuts.

32. **The staff supports the authorities' request to complete the fifth review under the EA, including the financing assurance review.** The staff also supports the requests for waivers for the missed performance criteria, since the targeted measures were adopted with short delays, or corrective measures were implemented. While overall program implementation and inflation and current account performance have been disappointing, the policies outlined in the authorities' MEFP provide an appropriate response to the key risks and challenges ahead.

Figure 1. Serbia: Selected Economic Indicators, 2002-05



Sources: National Bank of Serbia, and Fund staff estimates.

Figure 2. Montenegro: Selected Economic Indicators, 2001–05

	2001	2002	2003	2004 Est.	2005 Proj.
Real economy					
Nominal GDP (EUR millions)	1,049	1,302	1,441	1,531	1,639
Average net wage (in euros per month)	...	...	174.0	195.3	...
			(Percent change)		
Real GDP	...	1.7	2.5	3.1	3.3
Retail prices (period average)	...	19.7	7.5	3.1	3.6
Retail prices (end of period, 12-month)	28.0	9.4	6.7	4.3	3.5
			(In percent of GDP)		
General government finances 1/					
Revenue	38.0	35.1	34.8	36.5	36.3
Expenditure	42.3	38.6	39.8	40.0	38.9
Cash balance (before grants)	-4.7	-3.8	-4.9	-3.6	-2.7
Domestic financing (net) 2/	1.6	-3.7	1.7	0.6	-9.9
Privatization receipts	0.0	4.9	1.0	0.5	10.0
Public debt (end of period, stock) 3/	...	85.0	48.4	47.7	...
Externa debt	...	68.7	32.8	32.8	...
Domestic debt	...	16.4	15.6	14.9	...
External debt (end of period, stock) 3/	64.3	69.4	35.4	39.3	...
Public	64.3	68.7	32.8	32.8	...
Private	...	0.7	2.6	6.5	...
			(In millions of U.S. dollars)		
Balance of payments - IMF 4/					
Exports of goods (f.o.b.)	...	...	263.5	423.1	493.2
Imports of goods (c.i.f.)	...	...	-762.7	-1,002.8	-1,145.3
Current account balance, before grants	...	...	-264.7	-280.2	-282.1
(In percent of GDP)	...	...	-16.2	-14.7	-13.1

Sources: Ministry of Finance; Central Bank of Montenegro; Statistical Office of Montenegro; and Fund staff estimates.

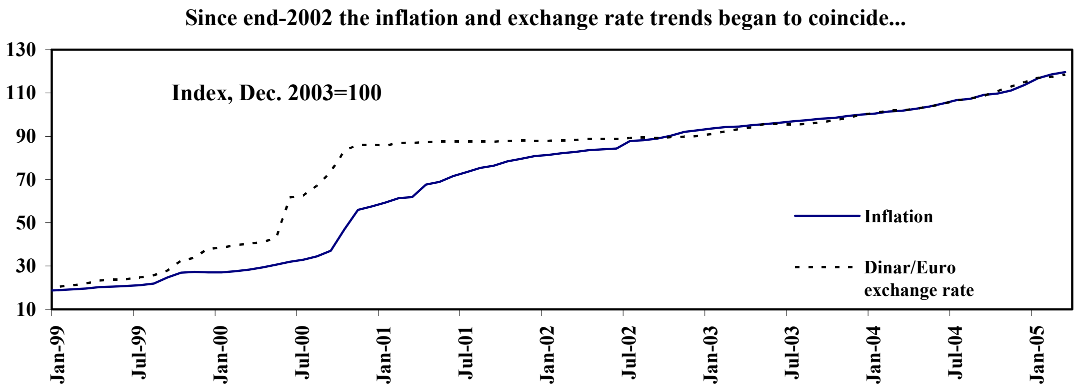
1/ Excludes local governments.

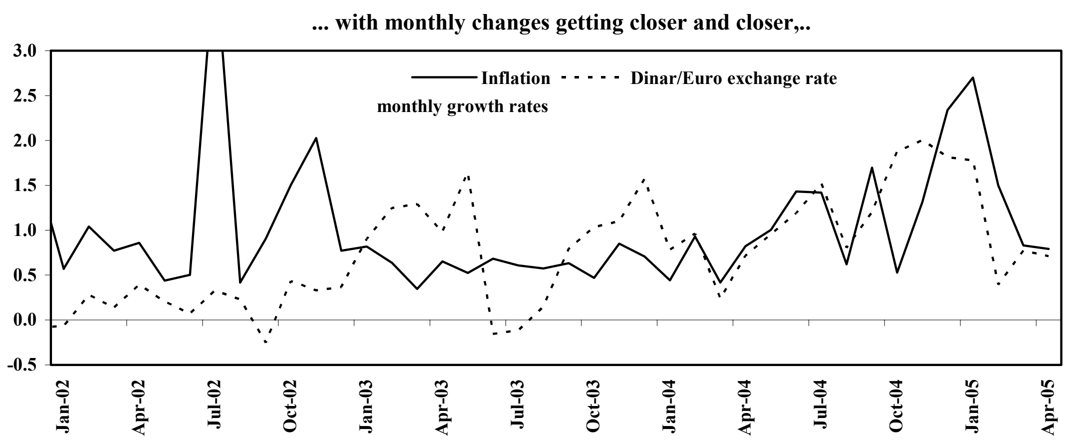
2/ Includes FFCD repayments.

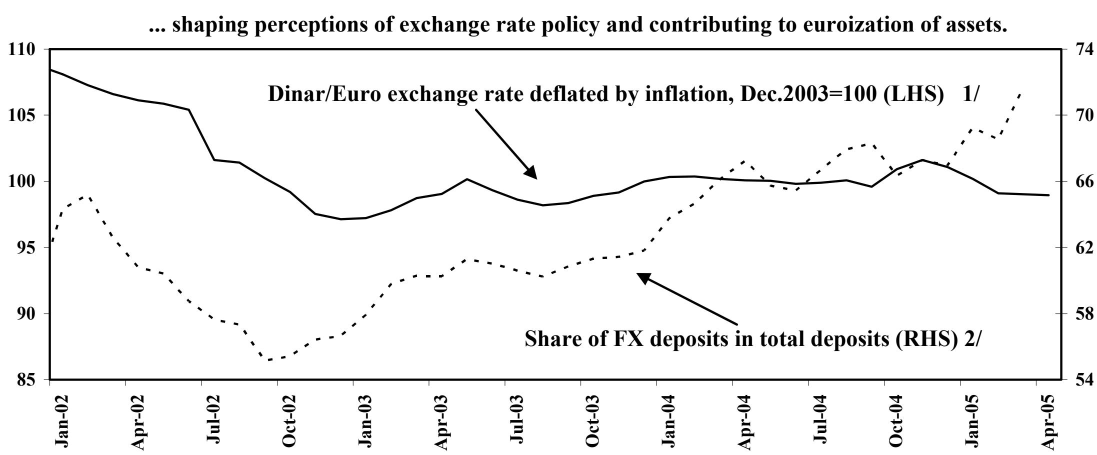
3/ Data on public and foreign debt is highly preliminary.

4/ Balance of Payments data are highly preliminary. In particular, information regarding the inter-trade between Serbia and Montenegro remains disputed. If data sourced from Montenegro were taken into account, the level of the current account deficit would be lower while the trend would remain the same.

Figure 3. Serbia: Pass-Through From the Exchange Rate to Inflation







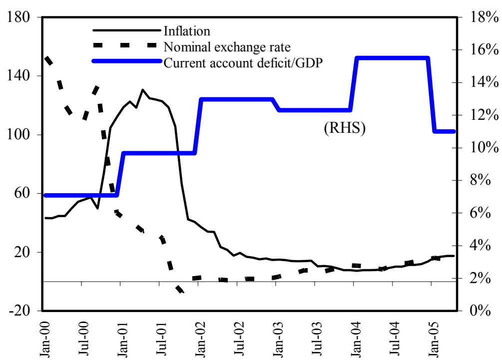
Sources: The National Bank of Serbia; Republican Statistical Office; and Fund staff estimates.

1/ Ratio of indices of Dinar/Euro exchange and domestic inflation in Serbia.
2/ In constant program exchange rate.

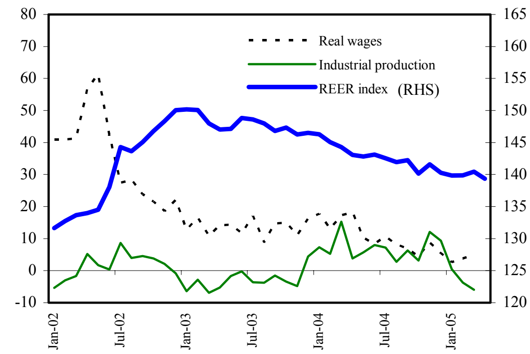
Figure 4. Serbia and Montenegro: Exchange Rate Policy and Tensions Between Inflation and the External Balance.

(12-month growth rates unless noted otherwise)

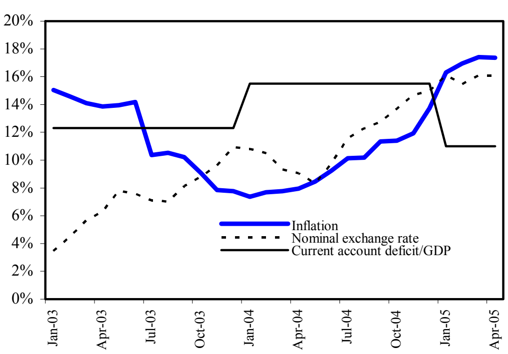
The fixing of the dinar tamed inflation in 2002 at the expense of the current account...



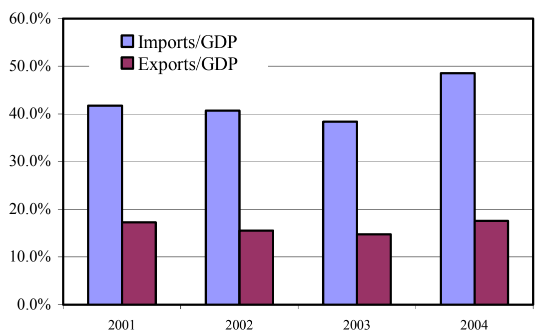
...but strong wage growth appreciated the real exchange rate and worsened the current account, forcing another regime change.



The shift to faster real depreciation in 2003 fuelled inflation, and failed to lower the current account deficit.

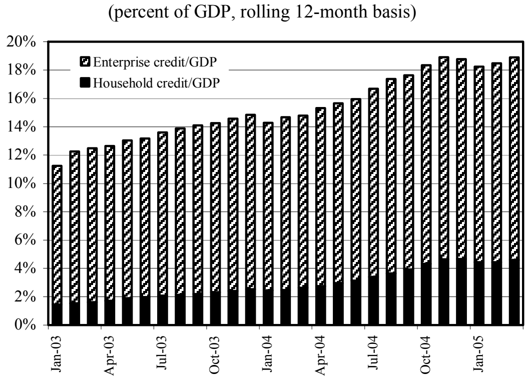


This reflected the structural imbalance between exports and imports with slow structural reforms...

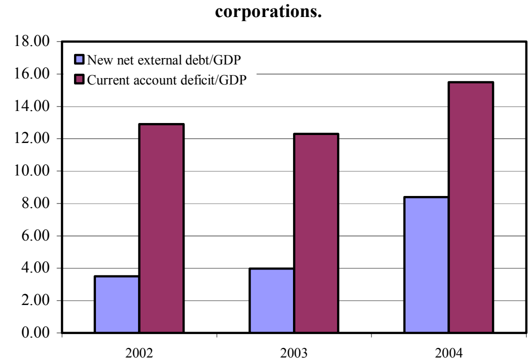


...but also pressure on demand from credit growth...

(percent of GDP, rolling 12-month basis)

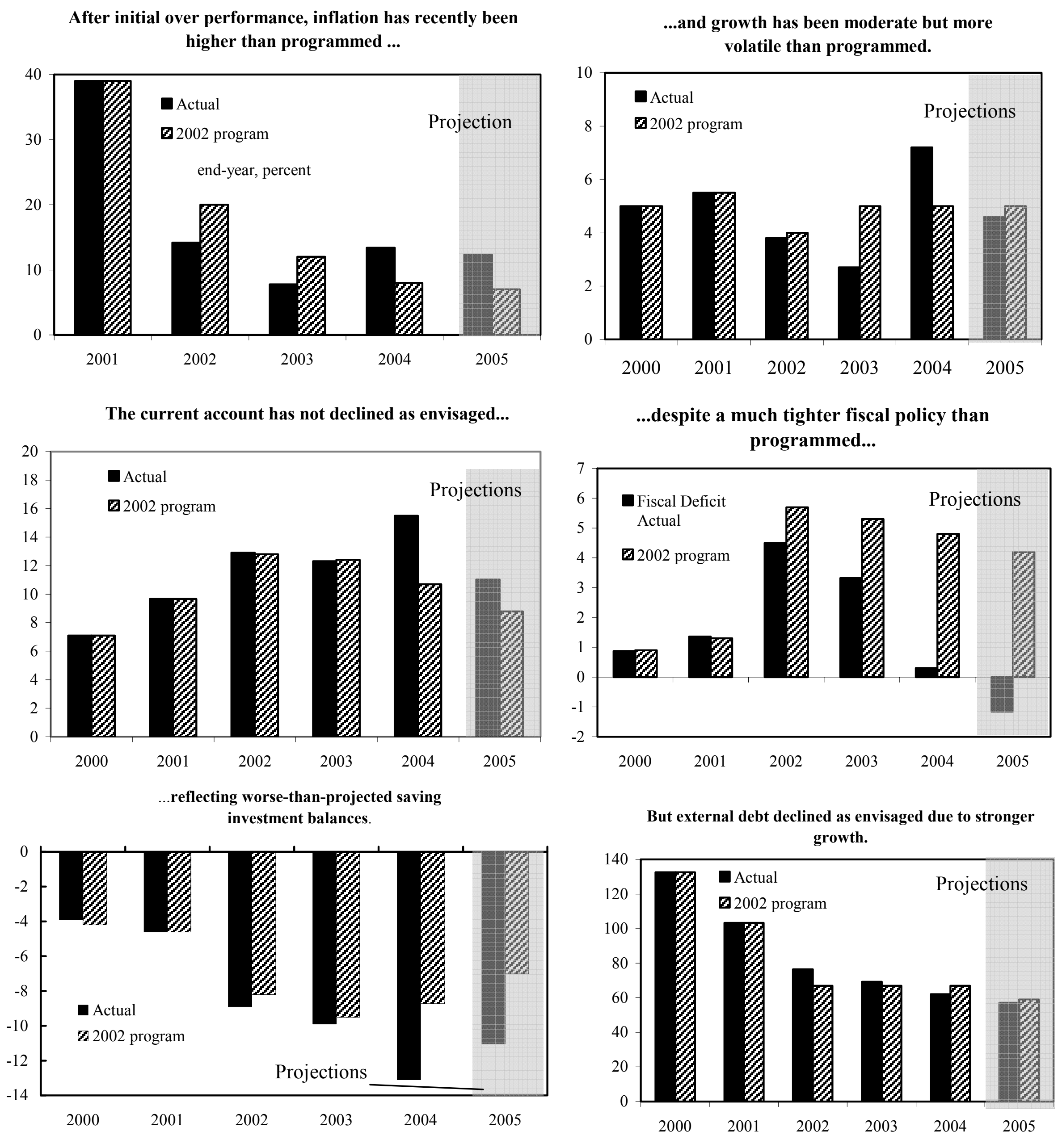


...and from a surge in foreign borrowing by banks and corporations.



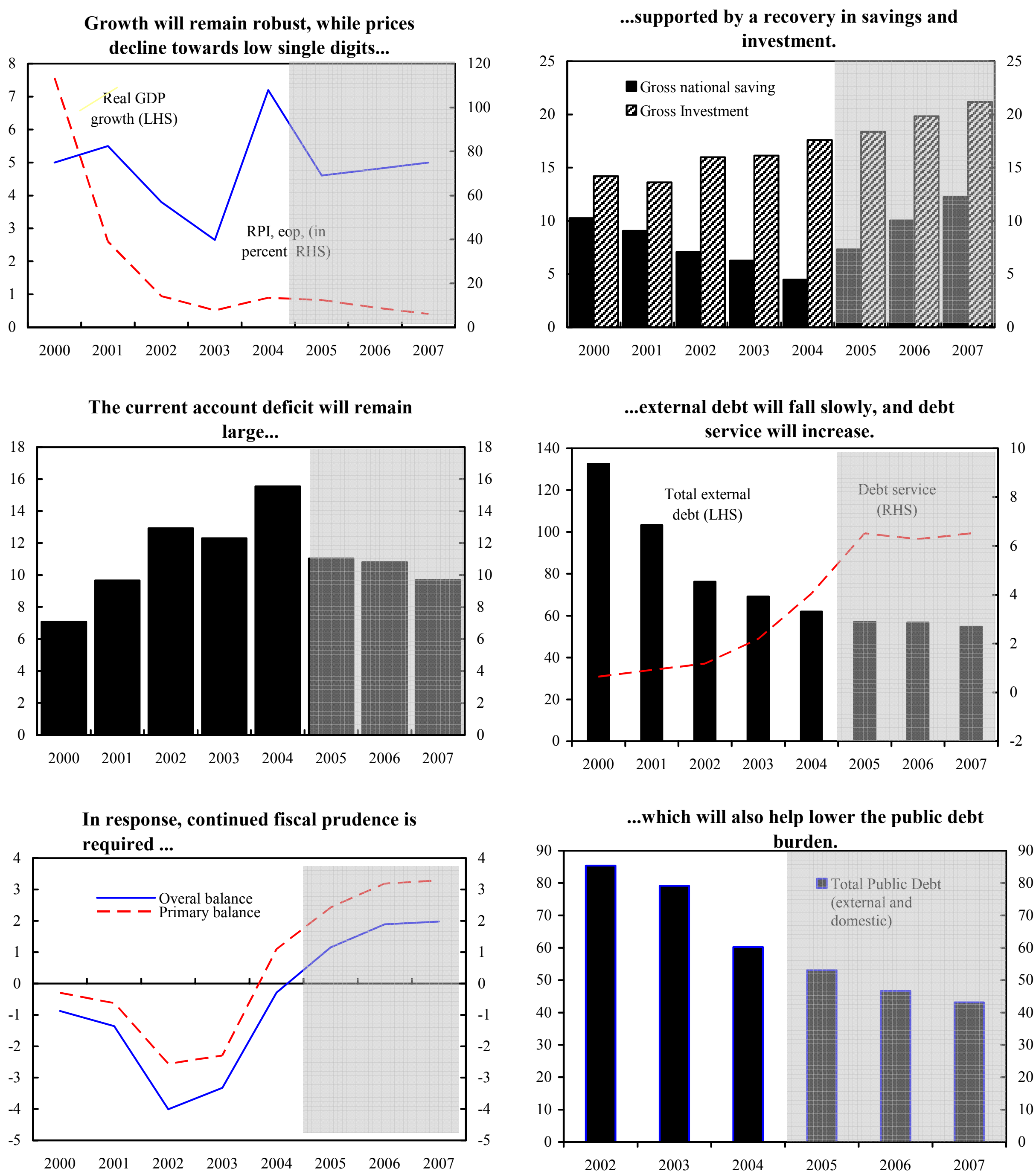
Sources: National authorities, and Fund staff estimates.

Figure 5. Serbia and Montenegro: Performance under the EA, 2002–2005
(in percent of GDP unless noted otherwise)



Sources: Serbia and Montenegro authorities; and Fund staff estimates and projections.

Figure 6. Serbia and Montenegro: Baseline Medium-Term Projections, 2000–07 1/
(In percent of GDP, unless otherwise noted)



Sources: Serbia and Montenegro authorities; and Fund staff estimates and projections.

1/ 2005 onward: program projections.

Table 1. Serbia and Montenegro: Selected Economic and Financial Indicators, 2001–05 1/

	2001	2002	2003	2004		2005	
				4th Review	Est.	4th Review	Proj.
	(Percent change, unless otherwise indicated)						
Real economy							
Real GDP	5.5	3.8	2.7	6.0	7.2	4.6	4.6
Nominal GDP (in billions of dinars)	772	998	1,189	1,371	1,401	1,604	1,700
Gross industrial production	0.0	1.7	-2.7	…	7.5	…	5.0
Retail prices (period average)	91.1	21.2	11.3	9½	9.5	12½	15.4
Retail prices (end of period, 12-month)	39.0	14.2	7.6	12 – 13	13.4	9 - 10	12.3
Serbia	40.7	14.8	7.8	…	13.7	…	13.0
Montenegro	28.0	9.4	6.7	…	4.3	…	3.5
Net real wage (period average)	11.3	24.0	12.3	…	11.9	…	…
Average net wage (in euros per month)	102	149	175	…	192	…	…
Unemployment rate (in percent) 2/ 3/	12.2	13.3	14.6	…	18.5	…	…
	(In percent of GDP)						
General government finances 4/							
Revenue	38.9	42.8	42.7	43.3	45.2	42.8	44.8
Expenditure	40.3	47.3	46.0	45.3	45.5	43.6	43.7
Overall balance (cash basis)	-1.4	-4.5	-3.3	-2.0	-0.3	-0.8	1.2
Foreign grants	0.7	1.1	0.2	0.1	0.1	0.0	0.2
Foreign loans (net)	0.0	1.8	1.2	0.9	1.0	1.1	0.9
Privatization receipts	0.0	2.2	4.3	0.4	0.6	1.6	3.1
Domestic financing (net)	0.7	-0.5	-2.4	0.7	-1.4	-1.9	-5.4
Gross debt 2/ 5/	123.2	85.4	79.2	63.3	60.2	55.1	53.1
of which: Forex-denominated (in percent of total)	92.0	91.9	90.3	…	87.9	…	95.1
	(12-month percent change)						
Money supply (end-of-period) 2/							
Money (M1) 6/	125.2	79.8	10.9	10.4	8.0	10.1	6.9
Broad money (M2) 6/	104.9	52.7	27.5	32.5	30.3	29.1	22.4
Credit to non-government 7/	7.6	49.6	25.1	42.0	48.1	45.5	27.0
	(In percent)						
Interest rates (weighted average, end-of-period)							
Lending rate	32.5	19.2	14.8	…	14.6	…	…
Deposit rate	4.1	2.6	2.7	…	3.6	…	…
	(In billions of U.S. dollars, unless otherwise indicated)						
Balance of payments							
Current account balance, before grants	-1.1	-2.0	-2.5	-3.0	-3.7	-2.8	-2.9
(In percent of GDP)	-9.7	-12.9	-12.3	-13.0	-15.5	-12.0	-11.0
Underlying current account balance (percent of GDP) 8/	…	…	…	-13.0	-13.7	-12.0	-12.6
Exports of goods (f.o.b.)	2.0	2.4	3.1	4.0	4.2	4.6	5.5
Imports of goods (c.i.f.)	-4.8	-6.3	-7.9	-10.5	-11.7	-11.2	-12.6
Trade balance	-2.8	-3.9	-4.9	-6.5	-7.4	-6.5	-7.1
(In percent of GDP)	-24.5	-25.2	-23.6	-28.0	-31.0	-28.2	-26.6
Current account balance, after grants	-0.5	-1.4	-1.5	-2.5	-3.1	-2.4	-2.5
(In percent of GDP)	-4.6	-8.9	-7.3	-10.8	-13.1	-10.3	-9.5
External debt (end of period) 5/	11.9	11.8	14.3	13.5	14.9	13.3	15.2
(In percent of GDP)	103.2	76.2	69.2	58.4	62.0	57.4	57.1
Gross official reserves	1.2	2.3	3.6	3.7	4.3	4.2	5.6
(In months of prospective imports of GNFS)	2.4	3.1	3.3	3.7	3.7	3.9	4.3
REER (annual average change, in percent; – indicates depreciation) 2/	23.8	17.1	5.5	…	-3.5	…	…

Sources: Statistical Offices of SM, Serbia, and Montenegro; National Bank of Serbia; State Ministries of Finance; and IMF staff estimates.

1/ Excluding Kosovo (with the exception of foreign debt).
2/ Excluding Montenegro.
3/ Break in series in 2004, when it becomes consistent with Eurostat/ILO definition.
4/ Fiscal operations of all levels of government, except for Montenegro where it excludes local governments.
Frozen Foreign Currency Bond payments are recorded below the line.
2004 data include previously off-budget fiscal operations in Montenegro amounting to 0.2 percent of GDP.
5/ Including the first phase of the Paris Club debt reduction in 2002 and implementation in 2005 of the London Club agreement.
6/ At current exchange rates.
7/ At constant exchange rates.
8/ Corrected for the surge in imports and remittances at end-2004 ahead of the introduction of the VAT in January 2005.

Table 2. Serbia and Montenegro: Balance of Payments, 2001–08
(In millions of U.S. dollars, unless otherwise indicated)

	2001	2002	2003	2004		2005		2006	2007	2008
				4th Review	Est.	4th Review	Proj.		Proj.	
Trade balance	**-2,834**	**-3,908**	**-4,886**	**-6,492**	**-7,434**	**-6,540**	**-7,064**	**-7,204**	**-7,270**	**-7,356**
(In percent of GDP)	-24.5	-25.2	-23.6	-28.0	-31.0	-28.2	-26.6	-25.4	-23.8	-22.5
Exports f.o.b.	2,003	2,412	3,054	4,030	4,219	4,613	5,503	6,705	7,944	9,290
(percent growth)	4.2	20.4	26.6	33.7	38.1	14.5	30.4	21.8	18.5	16.9
(percent growth in euro)	7.5	14.2	5.8	21.7	25.8	13.0	23.6	29.1	18.3	16.8
Imports c.i.f.	-4,837	-6,320	-7,941	-10,522	-11,653	-11,153	-12,568	-13,909	-15,215	-16,646
(percent growth)	30.4	30.7	25.6	32.2	46.8	6.0	7.8	10.7	9.4	9.4
(percent growth in euro)	34.5	23.9	5.0	20.4	33.6	4.5	2.2	17.3	9.3	9.3
Services (non-factor services, net)	**417**	**292**	**336**	**641**	**486**	**720**	**771**	**681**	**706**	**682**
Receipts	740	829	1,130	1,548	1,678	1,672	2,178	2,399	2,516	2,590
Expenditure	-323	-537	-795	-907	-1192	-952	-1407	-1719	-1811	-1908
Net factor income	**-26**	**-111**	**-231**	**-397**	**-293**	**-530**	**-535**	**-632**	**-693**	**-767**
Of which: Net interest	-26	-111	-222	-397	-274	-530	-514	-632	-693	-767
Earnings	48	62	70	69	81	138	79	113	122	130
Payments 1/	-74	-173	-291	-466	-354	-668	-593	-745	-815	-897
Unrequited private and official transfers, net	**1,915**	**2,343**	**2,777**	**3,745**	**4,092**	**3,570**	**3,891**	**4,097**	**4,303**	**4,519**
Private remittances, net	**1,324**	**1,719**	**2,239**	**3,231**	**3,510**	**3,570**	**3,891**	**4,097**	**4,303**	**4,519**
Inflows	1,698	2,089	2,661	3,631	4,129	3,970	n.a.	n.a.	n.a.	n.a.
Outflows	-374	-370	-422	-400	-620	-400	n.a.	n.a.	n.a.	n.a.
Current account balance, before grants	**-1,119**	**-2,007**	**-2,543**	**-3,017**	**-3,731**	**-2,780**	**-2,937**	**-3,059**	**-2,955**	**-2,921**
(In percent of GDP)	-9.7	-12.9	-12.3	-13.0	-15.5	-12.0	-11.0	-10.8	-9.7	-8.9
Official grants 2/	591	624	538	514	583	0	0	0	0	0
Foreign direct investment, net	165	562	1,405	966	1,028	1,181	1,698	1,856	2,074	2,180
Foreign loans, net	374	537	822	1,123	2,011	565	1,707	958	656	846
Medium and long term, net	299	379	756	996	1,588	445	1,474	758	456	646
Disbursements	332	421	974	1,410	2,119	1,067	2,179	1,750	2,000	2,500
Of which : Official creditors 2/	205	343	460	339	537	0	617	650	700	800
Amortization	-33	-43	-218	-413	-530	-622	-705	-992	-1,544	-1,854
Short term, net	75	158	66	126	423	120	234	200	200	200
Other capital inflows	629	892	281	135	296	195	254	308	309	309
Commercial banks, net	-274	-144	31	138	26	0	20	0	0	0
Capital account balance	**894**	**1,846**	**2,539**	**2,361**	**3,362**	**1,941**	**3,679**	**3,124**	**3,041**	**3,338**
(Capital account in euro terms)	998	1,954	2,245	1,917	2,704	1,552	2,808	2,526	2,062	2,262
Errors and omissions	239	320	409	237	432	200	0	0	0	0
Overall balance	**605**	**784**	**943**	**95**	**646**	**-639**	**742**	**65**	**86**	**416**
Financing	**-5,981**	**-855**	**-1,001**	**-3,355**	**-3,905**	**-2,343**	**-3,012**	**-499**	**-514**	**-728**
Net foreign assets (increase, -)	-395	-816	-1,001	-161	-711	-404	-1,240	-499	-514	-728
Central Bank, net	-395	-816	-1,001	-161	-711	-404	-1,240	-499	-514	-728
Gross foreign reserves (increase, -)	-523	-1,111	-1,277	-165	-719	-474	-1,301	-457	-400	-400
Of which: IMF purchases	128	295	276	239	243	276	276	0	0	0
Gross foreign liabilities (increase +)	128	295	276	4	8	70	60	-42	-114	-328
IMF repayment	0	0	0	-233	-235	-205	-215	-42	-114	-328
Arrears (reduction, -) 3/	-5,587	-39	0	-3,194	-3,194	-1,939	-1,772	0	0	0
Financing expected / to be secured	n.a.	0	n.a.	n.a.	n.a.	782	443	293	234	234
Official grants 2/	n.a.	0	n.a.	n.a.	n.a.	400	410	293	234	234
Official borrowing (excluding IMF) 2/	n.a.	0	n.a.	n.a.	n.a.	382	33	0	0	0
Residual gap	5,377	71	59	3,259	3,259	2,200	1,827	142	194	78
Arrears settlement with creditors 3/	5,377	39	0	3,194	3,194	1939	1,772	0	0	0
Debt relief from creditors	0	32	59	65	65	112	55	0	0	0
Memorandum items:										
Current account balance, after grants	-528	-1,383	-1,513	-2,503	-3,148	-2380	-2527	-2,767	-2,721	-2,687
(In percent of GDP)	-4.6	-8.9	-7.3	-10.8	-13.1	-10.3	-9.5	-9.8	-8.9	-8.2
Gross international reserves, USD mn (end period)	1,169	2,280	3,557	3,715	4,302	4,189	5,602	6,059	6,459	6,859
in months of prospective imports of goods & services	2.4	3.1	3.3	3.7	3.7	3.9	4.3	4.3	4.2	4.1
Debt service, cash	107	183	451	1,047	972	1,384	1,732	1,779	2,473	3,079
(In percent of GDP)	0.9	1.2	2.2	4.5	4.1	6.0	6.5	6.3	8.1	9.4
Principal	33	43	218	646	675	827	1,076	1,034	1,658	2,182
Interest	74	141	233	401	297	556	656	745	815	897
External Debt 4/	11,948	11,839	14,303	13,547	14,876	13,303	15,173	16,075	16,700	17,260
(in percent of GDP)	103	76	69	58.4	62.0	57.4	57.1	56.8	54.8	52.8
Underlying external debt 5/	n.a.	n.a.	n.a.	15,316	16,652	16,578	18,367	19,269	19,894	20,454
(in percent of GDP)	n.a.	n.a.	n.a.	66.0	69.4	71.5	69.1	68.0	65.3	62.6
Net external debt (debt minus gross reserves)	10,140	8,776	9,860	9,084	9,714	8,366	8,731	9,176	9,401	10,401
(in percent of GDP)	87.6	56.5	47.6	39.1	40.5	36.1	32.8	32.4	30.8	31.8

Sources: SM authorities; and IMF staff estimates.

1/ Debt service due after debt reduction granted by bilateral and commercial creditors, but before capitalization of moratorium interest (in "debt relief").

2/ Official grants and loans recorded above-the-line are amounts based on conservative assumptions; further possible amounts are shown below-the-line.

3/ Negotiations are on-going to clear all remaining external arrears.

4/ Including July 2004 debt reduction from London Club, and assuming completion of Paris Club debt relief operation and comparable debt relief by non-Paris Club and commercial creditors (from June 2004 onwards).

5/ Excluding all debt relief concluded or assumed after end-June 2004.

Table 3. Serbia and Montenegro: External Financing Requirements and Sources, 2001–07

(In millions of U.S. dollars)

	2001	2002	2003	2004	2005	2006	2007
				Est.		Proj.	
1. Gross financing requirements	**-7,261**	**-3,200**	**-4,039**	**-8,409**	**-6,931**	**-4,550**	**-5,013**
External current account deficit (excl. official transfers)	-1,119	-2,007	-2,543	-3,731	-2,937	-3,059	-2,955
Debt amortization	-33	-43	-218	-530	-705	-992	-1,544
Medium- and long-term debt	-33	-43	-190	-481	-444	-992	-1,544
Short-term debt 1/	0	0	-28	-50	-262	0	0
Repayment of arrears	-5,587	-39	0	-3,194	-1,772	0	0
Gross reserve accumulation	-523	-1,111	-1,277	-719	-1,301	-457	-400
IMF repurchases and repayments	0	0	0	-235	-215	-42	-114
2. Financing	**7,261**	**3,200**	**4,039**	**8,409**	**4,660**	**4,115**	**4,584**
Official grants 2/	591	624	538	583	0	0	0
Foreign direct investment (net)	165	562	1,405	1,028	1,698	1,856	2,074
Disbursement from private creditors	202	236	580	2,005	1,796	1,300	1,500
Medium and long-term financing	127	78	514	1,582	1,562	1,100	1,300
Short-term financing and other capital inflows	75	158	66	423	234	200	200
Disbursement from official creditors 2/	205	343	460	537	617	650	700
Multilateral 3/	205	285	341	507	584	650	700
Other	0	58	119	30	33	0	0
IMF disbursement	128	295	276	243	276	0	0
Accumulation of arrears (exceptional)	0	0	0	0	0	0	0
Debt Relief	5,377	71	59	3,259	0	0	0
Other flows 4/	594	1,069	721	755	274	309	310
3. Financing Gap	**0**	**0**	**0**	**0**	**2,270**	**434**	**429**
Expected disbursements of grants from donors 2/	0	0	0	0	410	293	234
EU	0	0	0	0	59	0	0
Others (mostly official bilateral creditors)	0	0	0	0	351	293	234
Expected disbursement of loans from donors 2/	0	0	0	0	33	0	0
World Bank	0	0	0	0	0	0	0
IMF	0	0	0	0	0	0	0
EBRD	0	0	0	0	0	0	0
EIB	0	0	0	0	0	0	0
EU	0	0	0	0	33	0	0
Others (mostly official bilateral creditors)	0	0	0	0	0	0	0
Debt relief	0	0	0	0	1,827	0	0
4. Residual Financing Gap	**0**	**0**	**0**	**0**	**0**	**142**	**194**

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. In particular, part of expected EU grant and loan assistance had not yet been approved at the time of preparation of the staff report.

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. Serbia and Montenegro: Indicators of External Vulnerability, 2000–04 1/
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004
Financial indicators					
Public sector debt	119.1	123.2	85.4	79.2	60.2
Broad money (percent change, 12-month basis)	61.4	104.9	52.7	27.5	30.3
Private sector credit (percent change, 12-month basis)	68.6	7.6	49.6	25.1	48.1
Weighted deposit interest rates (percent per month, December) 2/	6.8	0.3	0.2	0.2	0.3
Retail prices (percent change per annum, end of period)	113.5	39.0	14.2	7.6	13.4
External Indicators					
Exports (recorded exports, percent change, 12-month basis in US$)	14.7	10.4	19.5	29.9	33.7
Imports (percent change, 12-month basis in US$)	14.4	30.4	30.7	25.6	46.8
Current account balance, before grants	-7.1	-9.7	-12.9	-12.3	-15.5
Current account balance after grants and FDI	-3.6	-3.1	-5.3	-0.5	-8.8
Errors and omissions	3.1	2.1	2.1	2.0	1.8
Gross official reserves (in US$ million)	516	1,169	2,280	3,557	4,302
(in months of imports GS of the following year)	1.2	2.4	3.1	3.3	3.7
Central Bank short-term foreign liabilities (in US$ million) 3/	0	0	100	100	100
Gross reserves of the banking system (in US$ million)	882	1,809	3,063	4,443	5,162
(in months of imports GS of the following year)	2.1	3.2	4.2	4.2	4.4
Short term foreign liabilities of the commercial banks (in US$ million)	349	59	74	136	136
Foreign currency liabilities of the commercial banks (in US$ million)	871	775	1,483	2,651	4,354
Official reserves/Broad money (M2) (percent)	50	0	74	79	74
Official reserves/reserve money (percent)	164	0	199	262	290
Short term external debt by original maturity (in US$ million) 4/	1,153	1,026	1,020	1,056	999
Short term external debt by remaining maturity (in US$ million) 4/	1,186	1,069	1,224	1,731	2,075
Short term external debt to reserves by original maturity (in percent)	223.4	87.7	44.7	29.7	23.2
Short term external debt to reserves by remaining maturity (in percent)	229.8	91.4	53.7	48.7	48.2
Share of short term external debt to total debt by original maturity (in percent)	10.1	8.6	8.6	7.4	6.7
Share of short term external debt to total debts by remaining maturity (in percent)	10.4	8.9	10.3	12.1	13.9
Total external debt (in US$ millions)	11,403	11,948	11,839	14,303	14,876
Of which : Public and publicly guaranteed debt 5/	10,250	10,922	10,919	13,348	13,977
Total external debt (in percent of exports of G&S)	448	436	365	342	252
External interest payments, cash basis (in percent of exports of G&S)	1.6	2.7	4.3	5.6	5.0
External amortization payments, cash basis (in percent of exports of G&S)	0.0	1.2	1.3	5.2	11.5
Exchange rate, official (per euro, end of period)	58.7	60.6	61.5	68.3	78.9
REER (annual average, 1995= 100) 6/	50.2	65.2	73.2	77.2	74.5
Sovereign long-term credit rating, Standard & Poor's	n.a.	n.a.	n.a.	n.a.	B+
Fitch	n.a.	n.a.	n.a.	n.a.	BB-

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 5. Serbia and Montenegro: Stock of External Debt at December 31, 2004 1/
(In millions of U.S. dollars)

Creditor	Total Debt	*Of which:* Arrears 2/ Principal	Interest	Late Interest	Total Arrears
Total debt	14,876	1,593	347	465	2,405
Of which:					
Serbia	14,099	1,543	332	428	2,303
Montenegro	777	51	15	37	103
Multilateral institutions	5,554	10	5	9	24
IMF	962	0	0	0	0
IBRD	2,839	0	0	0	0
IDA	462	0	0	0	0
EUROFIMA	170	0	0	0	0
IFC	134	10	5	9	24
EIB	313	0	0	0	0
European Community	361	0	0	0	0
EUROFOND - CEB	33	0	0	0	0
EBRD	280	0	0	0	0
Official bilateral creditors	3,923	288	177	102	567
Paris Club	3,227	0	1	0	2
Other official bilateral creditors	697	288	176	102	565
Commercial creditors	4,400	652	164	355	1,170
London Club	1,164	27	31	11	69
Other commercial creditors: convertible currencies 3/	3,052	466	108	344	917
Other commercial creditors: nonconvertible currencies 3/	184	159	26	0	184
Short-term debt 3/	999	644	0	0	644
Trade credits on oil & gas imports 4/	240	240	0	0	240
Other short-term debt	759	404	0	0	404

Sources: SM authorities, and IMF staff estimates.

1/ Debt figures reflect the Paris Club debt rescheduling agreement (November 2001) and London Club restructuring (signed in July 2004).
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.

Table 6. Serbia and Montenegro General Government Fiscal Operations in 2003–05 1/

	Consolidated General government: Serbia								Consolidated General Government: Serbia and Montenegro							
	2003	**2004**	**2005**	**2003**	**2004**		**2005**		**2003**	**2004**	**2005**	**2003**	**2004**		**2005**	
		Est.	Proj.		4th Review	Est.	4th Review	Proj.		Est.	Proj.		4th Review	Est.	4th Review	Proj.
	(Billions of dinars)			(Percent of GDP) 2/					(Billions of dinars)			(Percent of GDP) 2/				
Total revenue	**474.9**	**592.7**	**713.0**	**39.9**	**40.3**	**42.3**	**39.5**	**41.9**	**507.9**	**633.0**	**762.3**	**42.7**	**43.3**	**45.2**	**42.8**	**44.8**
Current revenue	470.1	586.6	706.0	39.5	40.3	41.9	39.5	41.5	503.0	626.7	755.3	42.3	43.3	44.7	42.8	44.4
Tax revenue	430.1	538.1	644.0	36.2	37.2	38.4	35.9	37.9	460.9	576.3	691.3	38.8	40.0	41.1	38.9	40.7
Personal income tax	70.1	76.9	88.3	5.9	5.5	5.5	5.1	5.2	74.3	81.4	93.9	6.2	5.9	5.8	5.5	5.5
Social security contributions	115.8	153.5	178.6	9.7	10.2	11.0	10.1	10.5	126.0	166.0	192.7	10.6	11.1	11.9	11.0	11.3
Corporate income tax	5.9	6.9	8.2	0.5	0.5	0.5	0.5	0.5	6.8	8.1	10.1	0.6	0.6	0.6	0.6	0.6
Retail sales tax/VAT	126.3	159.1	208.9	10.6	11.1	11.4	11.2	12.3	135.3	170.6	223.5	11.4	12.0	12.2	12.1	13.1
Excises	58.3	73.4	80.9	4.9	5.3	5.2	5.2	4.8	62.1	77.8	86.6	5.2	5.6	5.6	5.5	5.1
Taxes on international trade	28.9	34.3	39.2	2.4	2.4	2.4	2.4	2.3	31.4	36.9	42.7	2.6	2.6	2.6	2.7	2.5
Other taxes	24.7	34.0	40.0	2.1	2.1	2.4	1.4	2.4	24.9	35.5	41.8	2.1	2.2	2.5	1.5	2.5
Nontax revenue	40.0	48.5	62.0	3.4	3.1	3.5	3.7	3.6	42.1	50.4	64.0	3.5	3.2	3.6	3.8	3.8
Capital revenue	4.8	6.1	7.0	0.4	0.0	0.4	0.0	0.4	4.9	6.3	7.0	0.4	0.0	0.5	0.0	0.4
Total expenditure and net lending	**511.9**	**593.0**	**689.7**	**43.0**	**42.0**	**42.3**	**40.1**	**40.6**	**547.4**	**637.1**	**742.6**	**46.0**	**45.3**	**45.5**	**43.6**	**43.7**
Current expenditure	476.5	555.1	644.1	40.1	39.5	39.6	37.7	37.9	508.8	595.3	691.8	42.8	42.5	42.5	40.8	40.7
Expenditure on goods and services	201.7	237.6	284.7	17.0	16.9	17.0	16.4	16.7	216.3	254.0	304.2	18.2	18.1	18.1	17.7	17.9
Wages and salaries	113.2	132.9	157.1	9.5	9.7	9.5	9.3	9.2	123.3	144.6	171.3	10.4	10.6	10.3	10.2	10.1
o/w: severance payments	0.0	0.0	1.4	0.0	0.0	0.0	0.4	0.1	0.0	0.0	8.0	0.0	0.0	0.0	0.4	0.1
Goods and services	88.6	104.6	127.6	7.4	7.2	7.5	7.1	7.5	93.0	109.3	132.9	7.8	7.5	7.8	7.5	7.8
Other current spending	6.3	9.4	0.0	0.5	0.4	0.7	0.0	0.0	6.3	12.0	3.5	0.5	0.6	0.9	0.2	0.2
Interest payment	11.3	17.7	20.2	0.9	1.1	1.3	1.4	1.2	12.2	19.5	21.5	1.0	1.2	1.4	1.5	1.3
Subsidies and other current transfers	257.2	290.5	339.2	21.6	21.1	20.7	19.9	20.0	274.0	309.9	362.6	23.0	22.6	22.1	21.4	21.3
Subsidies	40.9	43.1	41.7	3.4	3.2	3.1	2.7	2.5	41.8	43.7	42.2	3.5	3.3	3.1	2.7	2.5
Transfers to households 3/	216.3	247.4	297.5	18.2	17.8	17.7	17.2	17.5	232.1	266.2	320.4	19.5	19.3	19.0	18.7	18.8
Capital expenditure	27.9	36.0	37.7	2.4	2.4	2.6	2.1	2.2	29.3	38.1	41.5	2.5	2.6	2.7	2.3	2.4
of which: financed by project loans	5.6	8.3	8.9	0.5	0.6	0.6	0.6	0.5	6.1	9.5	10.6	0.5	0.7	0.7	0.7	0.6
General reserves	0.0	0.0	2.1	0.0	0.0	0.0	0.1	0.1	0.6	0.8	3.0	0.0	0.1	0.1	0.2	0.2
Lending minus repayment	7.4	1.8	5.7	0.6	0.1	0.1	0.2	0.3	8.7	2.9	6.4	0.7	0.2	0.2	0.2	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	0.0	0.0	0.0	0.0
Net transfer from Montenegro	2.0	0.0	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	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	0.0	-0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	**-34.9**	**-0.3**	**23.3**	**-2.9**	**-1.7**	**0.0**	**-0.6**	**1.4**	**-39.5**	**-4.1**	**19.7**	**-3.3**	**-2.0**	**-0.3**	**-0.8**	**1.2**
Excluding project loans	-29.3	8.0	32.3	-2.5	-1.2	0.6	0.1	1.9	-33.4	5.4	30.3	-2.8	-1.3	0.4	-0.1	1.8
Foreign grants	1.9	0.9	3.4	0.2	0.1	0.1	0.0	0.2	2.7	1.4	4.0	0.2	0.1	0.1	0.0	0.2
Overall balance including grants	-33.0	0.5	26.7	-2.8	-1.7	0.0	-0.6	1.6	-36.8	-2.7	23.7	-3.1	-1.9	-0.2	-0.7	1.4
Financing	33.0	-0.5	-26.7	2.8	1.7	0.0	0.6	-1.6	36.7	2.8	-23.7	3.1	1.9	0.2	0.7	-1.4
Domestic financing	-29.2	-20.1	-78.0	-2.5	0.6	-1.4	-2.0	-4.6	-28.4	-19.4	-91.5	-2.4	0.7	-1.4	-1.9	-5.4
Foreign Financing	12.9	12.3	12.8	1.1	0.7	0.9	0.9	0.8	14.2	14.4	15.6	1.2	0.9	1.0	1.1	0.9
Privatization receipts	49.3	7.2	38.5	4.1	0.3	0.5	1.6	2.3	50.9	7.7	52.1	4.3	0.4	0.6	1.6	3.1

Sources: Ministries of Finance of the Republic of Serbia and the Republic of Montenegro; and IMF staff estimates.

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

2/ GDP of Serbia and Montenegro, excluding Kosovo.

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

Table 7. Serbia: Republican Government Fiscal Operations, 2001-05
(In percent of GDP) 1/

	2001	2002	2003	2004		2005	
				4th Review	Est.	4th Review	Proj.
A Total revenue and grants (1+2+3)	**16.2**	**25.6**	**24.6**	**25.7**	**25.1**	**25.6**	**26.5**
1 Total revenue (1.1+1.2)	15.8	24.7	24.2	25.3	25.0	25.6	26.3
1.1 Current revenue (1.1.1+1.1.2)	15.8	24.7	24.2	25.2	25.0	25.6	26.3
1.1.1 Tax revenue (1.1.1.1+...+1.1.1.6)	14.8	22.8	21.6	22.0	22.7	22.6	23.9
1.1.1.1 Personal income tax	4.1	4.4	4.4	4.0	3.9	3.1	3.1
1.1.1.2 Corporate income tax	0.4	0.4	0.4	0.5	0.5	0.4	0.5
1.1.1.3 Turnover tax 2/	4.9	9.4	9.1	9.2	9.6	11.2	12.3
1.1.1.4 Taxes on international trade	0.0	2.4	2.4	2.4	2.4	2.4	2.3
1.1.1.5 Excises	3.2	4.5	4.9	5.6	5.2	5.2	4.8
1.1.1.6 Property taxes	1.3	1.0	0.3	0.3	1.1	0.3	1.0
1.1.1.7 Other taxes	0.9	0.6	0.0	0.0	0.0	0.0	0.0
1.1.2 Nontax revenue	1.0	1.9	2.6	3.2	2.3	3.0	2.4
1.2 Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2 Transfer from Montenegro	0.0	0.0	0.0	0.2	0.0	0.0	0.0
3 Grants	0.4	1.0	0.2	0.2	0.1	0.0	0.2
B. Total expenditure and net lending (1+...+6)	**17.0**	**29.1**	**27.2**	**27.4**	**25.9**	**26.1**	**25.2**
1. Total expenditure (2+3+4)	16.2	29.0	26.6	27.0	25.9	25.9	24.9
2. Current expenditure (2.1+2.2+2.3)	15.7	27.1	24.5	24.3	23.6	24.1	23.3
2.1. Expenditure on goods and services (2.1.1+...+2.1.4)	6.7	5.9	7.4	6.9	6.9	7.1	6.7
2.1.1 Wages and salaries	3.5	3.5	4.6	4.3	4.2	4.1	4.0
2.1.2 Employer contribution	0.7	0.8	0.9	0.9	0.8	0.9	0.8
2.1.3 Severance payments	0.0	0.0	0.0	0.0	0.0	0.3	0.1
2.1.4 Other purchases of goods and services	2.4	1.5	1.7	1.4	1.7	1.6	1.4
2.2. Interest payment	0.1	0.7	0.9	1.0	1.0	1.4	1.2
2.3. Subsidies and other current transfers	8.9	20.6	16.2	17.7	15.6	15.6	15.4
2.3.1 Subsidies	2.8	3.4	2.6	2.6	2.5	2.0	1.8
2.3.2 Transfers to households 3/	2.8	3.2	3.1	2.4	2.3	2.6	2.5
2.3.3 Current transfers to other levels of government	3.4	14.0	10.4	11.4	10.8	10.9	11.2
Federal budget	0.0	6.9	2.7	3.9	3.3	3.1	2.9
Local Budgets	0.1	1.3	1.2	1.1	1.0	2.3	2.1
Pension Funds	2.8	4.9	5.4	5.2	5.0	4.4	4.9
Health Fund	0.3	0.4	0.3	0.2	0.2	0.2	0.2
Labor Market Fund	0.1	0.3	0.4	0.5	0.6	0.5	0.5
3. Capital expenditure	0.5	1.9	1.8	2.1	2.2	1.7	1.5
Of which: Budget for recovery and reconstruction	0.0	0.7	0.5	0.8	0.6	0.6	0.5
4. General reserves	0.0	0.0	0.0	0.3	0.0	0.1	0.1
5. New Serbia expenditure	0.0	0.0	0.0	0.2	0.0	0.0	0.0
6. Lending minus repayment	0.8	0.1	0.6	0.4	0.1	0.2	0.3
Overall budget balance including grants (A-B)	**-0.8**	**-3.5**	**-2.6**	**-1.7**	**-0.8**	**-0.6**	**1.2**
Overall budget balance excluding grants and project loans	-1.2	-3.7	-2.3	-1.1	-0.3	0.1	1.6
Financing (1+2+3)	0.8	3.5	2.6	1.7	0.8	0.6	-1.2
1 Domestic financing (net)	0.8	0.0	-2.6	-0.4	-0.6	-2.0	-4.3
2 Foreign financing (net)	0.0	1.7	1.1	1.4	0.9	0.9	0.8
3 Privatization receipts 4/	0.0	1.8	4.1	0.6	0.5	1.6	2.3

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

1/ GDP of Serbia and Montenegro, excluding Kosovo. Data for 2000 and 2001 exclude the Union budget.
2/ Retail sales tax up to 2004. VAT from 2005 onward.
3/ Excluding frozen foreign currency deposit payments to households, reclassified below the line.
4/ Total privatization revenue accruing to the republican government.

Table 8. Montenegro: Consolidated Fiscal Operations, 2001–05
(In percent of GDP)

	2001	2002	2003	2004		2005	
				4th Review	Est.	4th Review	Proj.
Total revenue	**38.0**	**35.1**	**34.8**	**38.5**	**36.5**	**38.2**	**36.3**
Current revenue	38.0	35.1	34.8	38.1	36.2	37.8	36.3
Tax revenue	32.9	32.8	32.6	36.3	34.5	35.9	34.7
Personal income tax	5.4	4.4	4.4	4.6	4.2	4.6	4.2
Social security contributions	10.8	11.5	10.6	11.0	11.2	10.5	10.3
Corporate income tax	0.6	1.0	0.9	1.1	1.1	1.1	1.4
VAT (Retail sales tax until March 2003 1/)	7.1	8.3	9.7	11.2	10.3	11.2	10.7
Excises	4.4	4.3	4.0	4.2	4.0	4.2	4.2
Taxes on international trade	4.3	3.0	2.7	2.6	2.4	2.8	2.6
Other taxes 2/	0.4	0.4	0.2	1.6	1.3	1.6	1.3
Extrabudgetary taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nontax revenue	5.1	2.3	2.2	1.8	1.7	1.9	1.5
Capital revenue	0.0	0.0	0.1	0.4	0.2	0.4	0.0
Total expenditure and net lending	**42.3**	**38.6**	**37.6**	**39.9**	**37.7**	**38.3**	**36.4**
Current expenditure	38.6	35.5	34.0	35.7	34.0	34.0	32.4
Net wages, salaries and allowances	9.9	10.0	8.9	9.6	9.5	9.1	9.1
Payroll tax	1.6	1.1	1.5	1.7	1.7	1.6	1.4
Purchases of goods and services	5.9	3.7	4.2	4.0	3.5	4.1	3.4
Interest payment	0.1	1.0	1.0	1.2	1.6	1.2	0.9
Subsidies and other current transfers	20.7	19.0	17.9	19.1	16.9	17.8	17.2
Subsidies to enterprises	1.2	1.9	1.0	0.6	0.6	0.3	0.4
Transfers to households 3/	19.5	17.1	16.9	18.5	16.4	17.6	16.8
Other non-interest current expenditure	0.5	0.6	0.5	0.2	0.7	0.2	0.4
Capital expenditure	2.0	1.5	1.6	2.5	2.0	2.8	2.8
of which : foreign financed project spending	0.0	0.6	0.6	1.6	1.2	1.1	1.3
General reserves	0.6	1.0	0.6	1.1	0.7	1.2	0.7
Net lending	1.1	0.7	1.4	0.7	1.0	0.2	0.5
Transfer to the Union Budget	**0.0**	**0.0**	**2.2**	**2.6**	**2.3**	**2.7**	**2.6**
Discrepancy	0.4	0.3	-0.1	0.0	0.0	0.0	0.0
Overall balance before grants	**-4.7**	**-3.8**	**-4.9**	**-4.0**	**-3.6**	**-2.8**	**-2.7**
Overall balance before grants and foreign-financed project loans	**-4.7**	**-3.3**	**-4.4**	**-2.4**	**-2.4**	**-1.6**	**-1.4**
Foreign grants	3.1	2.1	0.9	0.5	0.5	0.5	0.5
Overall balance including grants	**-1.6**	**-1.8**	**-4.0**	**-3.5**	**-3.1**	**-2.3**	**-2.2**
Financing	**1.6**	**1.8**	**4.0**	**3.5**	**3.1**	**2.3**	**2.2**
Domestic financing	**1.6**	**-3.7**	**1.7**	**0.5**	**0.6**	**0.1**	**-9.9**
Bank financing	0.8	-3.4	1.1	0.8	-0.8	0.7	-9.4
Nonbank financing	0.8	-0.3	0.6	-0.3	1.4	-0.5	-0.5
of which: Repayment of FFCDs 3/	0.0	-0.3	0.0	-0.3	-0.3	-0.5	-0.5
Foreign financing (net)	**0.0**	**0.6**	**1.3**	**2.6**	**2.0**	**1.8**	**2.1**
Program	0.0	0.0	0.8	1.1	0.9	0.6	0.9
Project	0.0	0.6	0.6	1.6	1.2	1.1	1.3
Amortisation	0.0	0.0	0.0	0.0	-0.1	0.0	-0.1
Privatization receipts	**0.0**	**4.9**	**1.0**	**0.4**	**0.5**	**0.4**	**10.0**
Memorandum item							
Montenegro GDP (Euro million)	1,049	1,302	1,441	1,475	1,531	1,580	1,639

Sources: Montenegrin Ministry of Finance; and Fund staff projections.

1/ From 2002 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/ Foreign currency deposit payments to households, formerly classifed above the line, were reclassified below the line.

Table 9. Monetary Survey of Serbia, December 2003–December 2005
(In millions of SRD; end of period) 1/

	2003	2004			2005					
	Dec.	Dec.			Mar.			Jun.	Sep.	Dec.
	Act.	Prog. 6/	Act.		Prog.	Act.		Prog.	Prog.	Prog.
	7/	7/	7/	8/	7/	7/	8/	8/	8/	8/
Net Foreign Assets 2/	172,685	172,591	175,022	198,589	172,345	178,668	202,392	204,199	225,833	252,046
(NFA in euro m.)	2,528	2,526	2,562	2,517	2,523	2,615	2,566	2,589	2,862.8	3,195
Assets	242,371	240,610	264,379	298,180	259,348	270,482	304,837	305,904	329,314	363,206
NBS	193,962	197,217	218,440	245,936	214,114	229,624	258,450	261,600	281,076	312,113
Commercial banks	48,409	43,392	45,939	52,244	45,234	40,858	46,387	44,304	48,238	51,093
Liabilities (-)	-69,686	-68,019	-89,356	-99,592	-87,003	-91,813	-102,445	-101,706	-103,480	-111,160
NBS	-59,740	-60,573	-60,046	-66,162	-67,589	-56,853	-62,599	-70,281	-67,279	-70,463
Commercial banks	-9,946	-7,446	-29,310	-33,429	-19,414	-34,960	-39,847	-31,424	-36,201	-40,697
Net Domestic Assets 3/	64,249	94,134	111,956	110,136	124,601	104,102	102,551	113,617	114,497	104,126
Domestic credit	153,356	…	241,979	248,341	…	249,239	254,862	…	…	…
Net credit to government 3/	-23,586	-12,469	-19,924	-21,560	-11,992	-39,477	-42,119	-35,289	-50,529	-78,146
Credit	23,250	…	30,384	30,402	…	30,803	30,856	…	…	…
Dinar credit	23,130	…	30,255	30,255	…	30,409	30,409	…	…	…
NBS	19,051	…	21,427	21,427	…	21,235	21,235	…	…	…
Commercial banks	4,079	…	8,828	8,828	…	9,174	9,174	…	…	…
Foreign currency credits	120	…	129	147	…	394	447	…	…	…
NBS	0	…	0	0	…	0	0	…	…	…
Commercial banks	120	…	129	147	…	394	447	…	…	…
Liabilities	-46,836	…	-50,308	-51,962	…	-70,280	-72,975	…	…	…
Dinar liabilities	-25,677	…	-38,762	-38,762	…	-52,005	-52,005	…	…	…
NBS	-14,305	…	-28,064	-28,064	…	-40,592	-40,592	…	…	…
Commercial banks	-11,372	…	-10,698	-10,698	…	-11,413	-11,413	…	…	…
Foreign currency deposits	-21,159	…	-11,546	-13,200	…	-18,275	-20,970	…	…	…
NBS	-18,108	…	-8,566	-9,801	…	-15,255	-17,528	…	…	…
Commercial banks	-3,051	…	-2,980	-3,399	…	-3,020	-3,442	…	…	…
Short-term government credits to banks	-239	…	-363	-363	…	-450	-450	…	…	…
Purchased bonds for repaying frozen deposits	4,897	…	7,136	8,240	…	8,822	10,187	10,000	11,500	12,500
Credit to the non-government sector	172,284	201,333	255,130	262,024	253,771	280,344	287,244	294,712	312,907	332,811
Households	28,643	…	64,441	64,441	…	69,844	69,844	…	…	…
Non-profit and other sectors	3,815	…	2,358	2,397	…	2,172	2,205	…	…	…
Non-profit and other sector in dinar	3,379	…	2,081	2,081	…	1,929	1,929	…	…	…
Non-profit and other sector in foreign currency	436	…	278	316	…	243	275	…	…	…
Enterprises in dinar	88,911	…	138,382	138,382	…	157,584	157,584	…	…	…
Enterprises in foreign currency	50,915	…	49,949	56,804	…	50,745	57,612	…	…	…
Enterprises in foreign currency (euro million)	745	…	731	720	…	743	843	…	…	…
Other items, net.	-89,107	-94,729	-130,024	-138,204	-117,178	-145,137	-152,311	-155,806	-159,381	-163,039
Broad Money (M2)	236,934	266,725	286,978	308,725	296,945	282,771	304,944	317,816	340,331	356,172
Dinar-denominated M2	117,040	132,300	132,249	132,249	134,745	124,129	124,129	128,479	135,408	141,238
M1	98,223	110,698	106,112	106,112	101,468	99,676	99,676	104,436	108,910	113,404
Currency outside banks	42,979	47,277	45,165	45,165	41,749	39,368	39,368	41,416	43,087	46,972
Demand deposits	55,244	63,421	60,947	60,947	59,719	60,308	60,308	63,019	65,823	66,432
Time and savings deposits	18,817	21,602	26,137	26,137	33,278	24,453	24,453	24,043	26,497	27,834
Foreign currency deposits (non-frozen)	119,894	134,426	154,729	176,476	162,200	158,642	180,815	189,337	204,923	214,934
Foreign currency deposits (non-frozen; euro million)	1,755	1,968	2,265	2,237	2,374	2,322	2,647	2,400	2,598	2,725
Memorandum items: 4/										
Broad money at current exchange rates (SRD billion)	240.4	284.8	308.7	308.7	327.2	312.4	338.7	327.6	356.0	377.8
Foreign currency deposits at current exchange rates (SRI	123.4	152.5	176.5	176.5	192.4	188.2	214.5	199.1	220.6	236.6
12-month growth rates (in percent)										
Broad Money (M2)	27.5	20.2	30.3	30.3	37.8	31.6	42.6	31.3	26.0	22.4
Dinar-denominated M2	11.1	13.0	13.0	13.0	27.7	17.6	17.6	14.1	11.7	6.8
M1	10.9	12.7	8.0	8.0	14.6	12.6	12.6	10.9	9.0	6.9
Currency outside banks	-1.7	10.0	5.1	5.1	9.9	3.6	3.6	2.7	1.5	4.0
Foreign currency deposits	51.1	23.6	43.0	43.0	45.9	42.7	62.7	45.5	36.8	34.1
Velocity (M1)	11.6	12.7	13.0	13.0	15.0	15.2	15.2	14.9	14.7	14.4
Multiplier (Dinar M2/Reserve money)	1.7	2.0	1.7	1.7	2.1	1.8	1.8	1.9	1.9	2.0
Currency/Dinar deposits (in percent)	58.0	55.6	51.9	51.9	44.9	48.4	48.4	47.6	46.7	49.8
Required reserve ratio (effective, in percent)	24.5	23.9	24.1	24.1	24.1	23.1	23.1	24.1	24.1	24.1
Excess reserves/Dinar deposits (in percent)	15.3	7.9	12.5	12.5	6.2	9.5	9.5	6.2	6.2	7.1
Foreign exchange deposits/Broad money	51.3	53.5	57.2	57.2	58.8	60.3	63.3	60.8	62.0	62.6
Dinar-denominated M2/ annualized monthly GDP	10.3	9.4	9.6	9.6	8.9	8.2	8.2	8.3	8.5	8.6

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.
6/ Revised to reflect revisions to end-2003 data.
7/ Valued at end-2003 exchange rates.
8/ Valued at end-2004 exchange rates.

Table 10. Serbia and Montenegro: Macroeconomic Framework, 2001–10

	2001	2002	2003	2004		2005	2006	2007	2008	2009	2010
				4th Review	Est.			Proj.			
Nominal GDP (billions of dinars)	772	998	1,189	1,371	1,401	1,700	1,952	2,200	2,426	2,658	2,918
					(Percent change)						
Real GDP	5.5	3.8	2.7	6.0	7.2	4.6	4.8	5.0	5.2	5.4	5.6
Retail prices (end-period)	39.0	14.2	7.6	12.5	13.4	12.3	9.0	6.0	4.0	4.0	4.0
					(In percent of GDP)						
Gross domestic savings	-7.2	-7.3	-5.9	-8.7	-11.3	-5.3	-3.2	-0.4	1.2	2.4	3.3
Non-government	-7.8	-5.6	-5.9	-11.1	-14.3	-9.8	-10.0	-7.6	-6.4	-5.6	-4.5
Government	0.6	-1.7	0.0	2.4	3.0	4.5	6.7	7.3	7.6	8.0	7.8
Net factor receipts and transfers from abroad	16.3	14.4	12.1	14.4	15.8	12.6	13.3	12.6	12.2	11.8	11.4
Non-government	15.6	13.3	12.6	16.0	16.6	13.3	14.2	13.6	13.3	12.9	12.5
Government	0.7	1.1	-0.5	-1.6	-0.7	-0.7	-1.0	-1.0	-1.1	-1.1	-1.1
Gross national savings	9.1	7.1	6.3	5.7	4.5	7.3	10.1	12.3	13.4	14.2	14.7
Non-government	7.8	7.6	6.7	5.0	2.2	3.6	4.3	6.0	6.8	7.3	8.0
Government	1.3	-0.6	-0.5	0.8	2.2	3.7	5.8	6.3	6.5	6.9	6.7
Gross domestic investment 1/	13.6	16.0	16.1	16.5	17.6	18.4	19.8	21.2	21.6	22.2	22.7
Non-government	11.7	12.3	13.3	13.6	14.6	15.6	15.7	16.6	17.0	17.4	17.7
Government	1.6	3.4	2.5	2.6	2.7	2.4	3.8	4.2	4.3	4.5	4.6
Savings-investment balance 1/	-4.6	-8.9	-9.9	-10.8	-13.1	-11.0	-9.8	-8.9	-8.2	-7.9	-8.0
Non-government	-3.9	-4.7	-6.6	-8.7	-12.3	-12.0	-11.4	-10.6	-10.1	-10.0	-9.8
Government	-0.3	-4.0	-2.9	-1.8	-0.5	1.3	2.0	2.1	2.2	2.4	2.1
Foreign savings	4.6	8.9	9.9	10.8	13.1	11.0	9.8	8.9	8.2	7.9	8.0
Foreign savings including official grants	9.7	12.9	12.3	13.0	15.5	11.0	10.8	9.7	8.9	8.6	8.6
Net exports of goods and services	-20.9	-23.3	-22.0	-25.2	-29.0	-23.7	-23.0	-21.5	-20.4	-19.8	-19.4
Memorandum item:											
Current account balance (before grants)	-9.7	-12.9	-12.3	-13.0	-15.5	-11.0	-10.8	-9.7	-8.9	-8.6	-8.6

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

1/ Components may not always add up to the total as a result of rounding and inventory changes.

Table 11. 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	174.5	162.7	52.4	74.3	138.2	183.6	177.6	105.7
In millions of U.S. dollars	…	10.2	13.3	17.1	256.7	239.1	77.1	109.6	204.0	270.9	262.0	156.0
In percent of exports of goods and NFS	…	0.4	0.4	0.4	4.4	3.1	0.8	1.0	1.7	2.0	1.8	1.0
In percent of debt service	…	9.6	7.3	3.9	26.4	13.8	4.3	4.4	6.6	7.6	6.9	3.9
In percent of quota	…	1.7	2.2	2.6	37.3	34.8	11.2	15.9	29.6	39.2	38.0	22.6
In percent of gross official reserves	…	0.9	0.6	0.5	6.0	4.3	1.3	1.7	3.0	3.7	3.4	1.9
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	308.3	141.7	41.7
In millions of U.S. dollars	154.2	280.2	539.9	862.6	913.5	983.0	945.2	872.7	700.9	455.0	209.0	61.5
In percent of quota	25.0	46.4	89.1	131.9	132.8	143.0	137.2	126.5	101.6	65.9	30.3	8.9
In percent of GDP	1.8	2.4	3.5	4.2	3.8	3.7	3.3	2.9	2.1	1.3	0.6	0.2
In percent of gross official reserves	29.9	24.0	23.7	24.2	21.2	17.5	15.6	13.5	10.2	6.3	2.7	0.8
Memorandum items:												
Exports of goods and NFS (millions of US$)	2,547	2,743	3,241	4,184	5,897	7,681	9,104	10,461	11,880	13,295	14,499	15,835
Debt service, after debt relief (millions of US$)	56	107	183	436	972	1,732	1,779	2,473	3,079	3,569	3,816	4,041
Quota (millions of SDRs)	468	468	468	468	468	468	468	468	468	468	468	468
Quota (millions of US$)	617	604	606	654	688	687	689	690	690	690	690	690
Gross official reserves (millions of US$)	516	1,169	2,280	3,557	4,302	5,602	6,059	6,459	6,859	7,259	7,659	8,059
U.S. dollar per SDR	1.32	1.29	1.29	1.40	1.47	1.47	1.47	1.47	1.48	1.48	1.48	1.48

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 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	Purchased.
8.	February 15, 2004	50.0	10.7	Purchased.
9.	August 15, 2004	62.5	13.4	Purchased.
10.	February 15, 2005	125.0	26.7	Observance of end-March 2005 performance criteria and completion of the fifth semi-annual review (including financing assurances review). 2/
11.	November 15, 2005	62.5	13.4	Observance of the relevant July-November 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.
2/ Previously conditional on the observance of end-December 2004 performance criteria.

SERBIA AND MONTENEGRO: FUND RELATIONS

As of April 30, 2005

I. **Membership Status:** Joined December 14, 1992 (succeeding to membership of the former SFR Yugoslavia); accepted Article VIII on May 13, 2002.

II. **General Resources Account**	SDR Million	%Quota
Quota	467.70	100.00
Fund Holdings of Currency	1,042.81	222.97

III. **SDR Department**	SDR Million	%Allocation
Net cumulative allocation	56.66	100.00
Holdings	13.61	24.02

IV. **Outstanding Purchases and Loans**	SDR Million	%Quota
Extended arrangement	462.50	98.89
Stand-by arrangements	68.75	14.70

V. **Latest Financial Arrangements**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
EFF	5/14/02	12/31/05	650.00	462.50
Stand-by	6/11/01	5/31/02	200.00	200.00

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

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	43.85	54.17	43.75	58.33	77.08
Charges/Interest	16.13	20.32	18.03	16.40	14.09
Total	59.98	74.49	61.78	74.73	91.15

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 May 13, 2002, which is scheduled to expire on December

[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.

31, 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 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. **FSAP Participation**

Serbia participated in the Financial Sector Assessment Program during 2005, and the Financial System Stability Assessment report will be discussed in relation with the sixth review, expected for December 2005.

XI. **Technical Assistance to Serbia and Montenegro during the Past 12 Months**

Department	**Timing**	**Purpose**
MFD	Sep. 2004	Monetary operations, insurance supervision, and banking issues
	Nov. 2004	Diagnostic TA in Banking Supervision, Foreign Exchange Operations, Research (Montenegro)
FAD	Jun. 2004	Public Expenditure Management (Serbia)
STA	May 2004	Monetary and Financial Statistics
	Jun.–Jul. 2004	Balance of Payments Statistics (Montenegro)
	Sep. 2004	National Accounts Statistics

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 missions reviewed the progress in modernizing tax administration and establishing treasury system, and recommended (i) more clearly delineating the tax policy role of different revenue agencies, (ii) improving taxpayer services and compliance programs based on segmenting the tax base, (iii) strengthening the Treasury's organization and developing its core operations as wells as debt management functions, (iv) reforming the payroll system and strengthening the quality of personnel records in budget institutions to eliminate "ghost employment." The MFD recommendations were key to (i) developing market-based instruments for monetary operations, (ii) improving public sector debt management, (iii) providing a clear focus to future work on enhancing banking supervision practices and (iv) outlining positive directions for NBS reorganization. The STA missions provided an action plan to improve existing statistics by (i) developing comprehensive data sources for national accounts, (ii) applying statistical concepts to organize information on government revenues and expenditures to develop sound government finance statistics, (iii) strengthening the coverage of balance of payments transactions in Montenegro, and assisting with the adoption of compilation methodologies consistent with the recommendations of the fifth edition of the Balance of Payments Manual (BPM5), and (iv) introducing sound classifications in compiling monetary and financial statistics.

XII. **Resident Representative**

Mr. Harald Hirschhofer took up his position as Resident Representative in September 2004.

SERBIA AND MONTENEGRO: IMF-WORLD BANK RELATIONS

Partnership with 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 was reviewed 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, is described more fully below.

World Bank Group Strategy

4. 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 were approved under the TFFRY. 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.

5. 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 US$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 Update, discussed by the Bank's Board on August 8, 2002, confirmed the overall approach (including the focus on policy-based lending), and laid out the Bank's program for FY03. A second TSS Update, covering FY04, was endorsed by the Bank's Board on March 16, 2004.

6. A Joint World Bank-IFC Country Assistance Strategy covering FY05-07 was endorsed by the Bank’s Board of Directors on December 16, 2004. The CAS has three goals: (i) creating a smaller, more sustainable and more efficient public sector; (ii) creating a larger, more dynamic private sector; and (iii) reducing poverty levels and improving social protection and access to public services.

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 the republic level. To date, seven 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), supported further reforms in pensions, health and labor, while enhancing the focus on social assistance and poverty monitoring. Two Private and Financial Sector Adjustment Credits (PFSAC I and II, approved May 2002 and June 2003 respectively) 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., A second (single tranche) multisectoral SAC for Serbia was approved in December 2004. It’s focus centers on improving the business environment, further rehabilitating the energy sector, enhancing social protection and fostering stronger public administration. In Montenegro, the first multi-sectoral Structural Adjustment Credit, approved in August 2002 supported reforms critical to fiscal sustainability as well as economic growth in the areas of public expenditure management, pensions, energy, labor markets, and the business environment. A second (two tranche) multi-sectoral SAC for Montenegro was approved by the Board on September 14, 2004. It focuses on enhancing growth potential, including reforms to the financial, energy, pension, health and public administration sectors.

[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.

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 which covered both republics—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 supports an ongoing program 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 recently finalized an Economic Memorandum for Serbia focusing on the agenda for sustained growth and employment creation. An Economic Memorandum for Montenegro has been initiated for delivery this fiscal year.

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, in Serbia IDA is supporting an Education project, an Enterprise and Bank Restructuring Technical Assistance operation, an Energy Efficiency project , a Health Reform operation, an Employment Promotion Learning and Innovation project, a Transport Rehabilitation project, and a Real Property Registration and Cadastre project. In Montenegro, an education reform project was recently approved on March 31, 2005. The Bank also supports an Environmental Improvement project an Energy Learning and Innovation Credit, a Pension System Administration and Improvement Project and a Health Reform project. As of end-April 2005, 21 IDA credits totaling US$ 590 million had been approved for SM, with adjustment support comprising the majority

IFC

10. SM is a major IFC priority in South East Europe. During FY02-03 IFC committed about US$43 million in 5 projects, three in financial markets and two in manufacturing. Donor supported technical assistance (TA) has been an important component of the IFC strategy to develop a pipeline of potential investments in SM. During the last two years IFC has mobilized about US$4 million of trust fund resources for technical assistance conducting more than twenty assignments on institutional strengthening in the financial sector and on project preparation in the real sector.

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

11. IFC has contributed to strong foreign strategic investor interest in the ***financial sector*** and to establishing viable financial institutions. IFC supported the first Microfinance Bank and the establishment of RaiffeisenBank in the country. In Montenegro, IFC approved an investment in Opportunity Bank Montenegro for a line of credit of up to Euro4 million to fund micro-enterprise and SME lending. IFC is supporting the restructuring and privatization of Udruzena Vojvodjanska Bank (UVB) successor banks. Also, the recent agreement between IFC and the Government of Montenegro on the restructuring of IFC's claims on Montenegrin enterprises and banks, should pave the way for additional IFC restructuring and privatization support in the financial sector. IFC's Southeast Europe Enterprise Development facility (SEED) has provided extensive assistance to the institutional development of leasing market and to overall SME sector development. IFC has provided extensive due diligence to the Serbian Insurance Supervisor and has conducted a preliminary due diligence on the restructuring and privatization of Dunav Insurance Company.

12. In the ***corporate sector***, IFC has achieved good results investing Euro20 million in Tigar Michelin Holding, a leading regional producer of high quality car tires. The financing was accompanied by extensive technical assistance to the company and its suppliers, supported by SEED linkages program, resulting in high development impact. IFC is providing an innovative technical assistance program to Elektronska Industrija, a Serbian manufacturer of consumer electronic products and home appliances, to help the company with pre-privatization restructuring and to facilitate the joint ventures and/or direct sales to foreign investors.

13. In tandem with the Bank's program of support, IFC is committed to supporting the restructuring and preparation for privatization of the ***infrastructure sector***, as well as facilitating private sector participation in the sector. Through its Balkans Infrastructure Development Facility (BIDFacility), IFC will help public sector entities in the South East Europe region, including Serbia and Montenegro, to attract private sector participation and investments in infrastructure, primarily in the energy, transport and water and sanitation sectors. IFC focus will be to explore, facilitate, and support public-private partnership (PPP) opportunities, particularly in solid waste and water management services (city of Belgrade), oil and gas transport and distribution, and the power cogeneration sector. In the area of information and communication technology, IFC will explore investment opportunities in the sector. In the energy sector, IFC has been active supporting an advisory assignment to prepare a restructuring and privatization strategy of the Serbian oil company Naftna Industrija Srbije (NIS), as well as launching a Power Cogeneration study to survey the market potential and identify opportunities for private sector participation and PPP.

14. Though foreign investors' country risk appetite remains modest, opportunities for new IFC investment projects are being actively pursued in both the financial and manufacturing sectors. IFC's program development, however, depends on further implementation of the Governments reform agenda, the creation of a favorable business climate, and the acceleration of the privatization process. While in the short term IFC will continue to expand its activities in general manufacturing and the financial sectors, in the longer term IFC will look for opportunities to support Serbia and Montenegro with

investments in the energy and telecommunication sectors, as well as in the infrastructure sector.

MIGA

15. As of November 30, 2004, MIGA's outstanding guarantee portfolio in SM consisted of 15 guarantee contracts: 13 in the financial sector, one in the services sector, and one in the manufacturing sector, with a total gross exposure of US$344.2 million and a total net exposure of US$170.6 million. At 6.3 percent of MIGA's total gross exposure, SM is now MIGA's fourth largest host country. MIGA also provides TA (institutional development and capacity building) on investment promotion to both Serbia and Montenegro. An initial project benefiting the Serbia Investment and Export Promotion Agency (SIEPA) is nearing completion. A comprehensive follow-on project with a two- to three-year time horizon is expected to be launched in early 2005; this project will be implemented by MIGA on behalf of the EAR. In Montenegro, also with financial support from the EAR, MIGA is currently implementing an initial capacity building project in support of the new Montenegrin Investment Promotion Agency. MIGA's TA activities in SM are feeding into a new, regional FDI outreach and marketing initiative for the Western Balkans which MIGA launched in summer 2004 (that is, the European Investor Outreach Program for the Western Balkans).

Joint Staff Assessment (JSA) of the Poverty Reduction Strategies

16. Bank and Fund staff produced 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, notably the focus on harmonization to common EU standards, continuing privatization, an improved business environment, and policies to raise employment. However, 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. Staff agreed that the envisioned market-oriented reforms, if implemented in the context of continuing macroeconomic stability, will foster a considerable reduction in poverty.

Bank-Fund Collaboration in Specific Areas

17. 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:

18. **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, requiring 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.

19. **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 credits/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 provides continuing support to the sector in Serbia with an Energy Efficiency Credit and complementary Global Environmental Fund grant, now under preparation. The already approved Montenegro Energy Sector Learning and Innovation Credit will introduce automated billing and demand management, facilitate the eventual privatization of distribution services and lay the basis for institutional strengthening.

20. **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 supported 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 Administration

Improvement Project was approved for Montenegro and work has commenced on a pension reform technical assistance operation for Serbia for this fiscal year delivery.

21. Serbia's SAC also included initial reforms of the health care system 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 deepened this reform agenda. The Bank's involvement in the health care sector in Montenegro has focused on analytical work, most recently under the PEIR and a health sector reform project was approved in June 2004.

22. 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 were completed and deepened under the SOSAC. The SAC for Montenegro also supported the enactment of a Law on Labor and Law on Employment.

23. **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 rapid 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 is continued under the Privatization and Restructuring of Banks and Enterprises Technical Assistance Project. The Bank has increased its involvement in these areas in Montenegro under the recently approved second SAC for Montenegro.

24. **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 supported 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, bankruptcy, business registration, and on Agency for Business Services. 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 extended to the Government of Serbia supports the improvements in Serbia's court administration and the development of a National Judicial Reform Strategy.

Prepared by World Bank staff. Questions may be addressed to Ilker Domac at 458-1138 or Carolyn Jungr at +381-11-3023700.

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington DC 20431

June 8, 2005

Dear Mr. de Rato:

Renewed commitment to our medium-term economic program supported by the Fund under the Extended Arrangement (EA), extended to end-December 2005, will achieve necessary progress in stabilization and reform. To ensure continued progress and address new challenges, we have updated our economic and policy targets for 2005, as described in detail in the attached Memorandum on Economic and Financial Policies.

On this basis, we request: (a) completion of the fifth review under the EA; (b) waivers for the non-observance of an end-December 2004 performance criterion (the enactment of amendments to the law on the Yugoslav army and Union-level civil employees); an end-February 2005 performance criterion (the legal registration of the new electricity transmission and dispatch company); a March 2005 performance criterion (the non-accumulation of external arrears); and a continuous performance criterion (on the same issue); (c) the purchase of SDR 125.0 million following the completion of the fifth review; and (d) a rephasing of the eleventh and final purchase to become available upon completion of the sixth review, which would be postponed to cover July-November 2005 test dates. The non-observance of structural performance criteria has been rectified with delays. We are taking measures to improve policy implementation in these areas.

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 Fund staff, as necessary, to keep the program on track. We will remain in close consultation with the Fund staff 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 Board discussions for the final review expected in December 2005. The next review will focus on the implementation of strong fiscal, monetary, and incomes policies and on progress in structural reforms (including pension reform, budgetary employment reduction, and enterprise restructuring and privatization)

Yours sincerely,

/s/
Miroljub Labus
Deputy Prime Minister
Republic of Serbia

/s/
Miroslav Ivanišević
Deputy Prime Minister
Republic of Montenegro

/s/
Mladjan Dinkić
Minister of Finance
Republic of Serbia

/s/
Radovan Jelašić
Governor
National Bank of Serbia

/s/
Igor Lukšić
Minister of Finance
Republic of Montenegro

/s/
Ljubisa Krgović
Chairman
Central Bank of Montenegro

SERBIA AND MONTENEGRO

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

June 8, 2005

I. Introduction

1. This memorandum updates and supplements the Memorandum of Economic and Financial Policies (MEFP) attached to the Letter of Intent of November 29, 2004. 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 2005.[1]

2. **The performance under the program, supported by the Extended Arrangement with the Fund, has been mixed (Annex A and B).** All but two of the 11 end-December 2004 quantitative performance criteria (PCs) were observed. The ceiling on the wage bill of the 7 monitored public utilities in Serbia was missed by a small margin due to lump-sum payments to airline employees, and external arrears were accumulated in Montenegro. All but one of the 11 end-March 2005 quantitative PCs were met, as the external arrears accumulated by Montenegro were only settled in May. This also caused a breach of the continuous PC on non-accumulation of external arrears. The end-December 2004 structural PC for enacting the amendment to the law on the Privatization Agency was met, but the PC for enacting the amendments to the laws on the Yugoslav Army and Union-level Civil Employees was missed. The amendments to the Army law were eventually enacted in February, although the dismissal notice time was not reduced from three months to thirty days. The end-February 2005 PC on the unbundling of EPS into two separate companies was missed, as the two new companies were not legally registered, but the process to enable them to function as separate companies is on track. In Serbia, four out of five end-November and end-December 2004 structural benchmarks were met on time. The tender for the privatization of Niška Banka was launched with some delay on January 31, 2005. The end-February 2005 structural benchmark on establishing a supervisory body to license, supervise, and regulate bankruptcy trustees was met with a slight delay in March, but the end-March 2005 structural benchmark on the adoption of new laws on deposit insurance, bank liquidation, and the bank rehabilitation agency was missed. In Montenegro, the end-December 2004 structural benchmark on the sale of nonfinancial assets carved-out from the banking system was met, but those on the transfer of republican government deposits at commercial banks to the treasury single account and on the issuance of a tender for a majority stake in Podgoricka Bank were missed.

[1] Annex A, attached to this memorandum, contains the quantitative performance criteria and indicative targets, while Annexes B and C list the structural performance criteria and benchmarks as well as prior actions. Annex D (Technical Memorandum of Understanding, TMU) defines the performance criteria and indicative targets and describes the reporting arrangements.

3. **Strong growth in 2004 has been accompanied by accelerating inflation and increasing external imbalances.**

- **Real growth was stronger than expected in 2004.** GDP growth is estimated to have reached 7.5 percent in Serbia (7.2 percent in SM), led by a bumper crop in agriculture and solid industrial growth supported by output gains in recently privatized enterprises. Demand was boosted by an increase in consumption and investment fed by rapid credit growth; an estimated 10.2 percent average increase in real wages in Serbia (decelerating somewhat in the second half of the year); and an increase in remittances in both republics. In Montenegro, GDP grew 3-4 percent in 2004, supported by increasing activity in industry, tourism, and agriculture.

- **Inflation in SM accelerated in the second half of 2004 and in 2005.** Twelve-month inflation in Serbia rose to 17.5 percent in May 2005 (against 8 percent a year before and 13.7 percent in December 2004), driven by buoyant domestic demand, increases in administered prices, the rising cost of fuel imports, and the one-off effect of the VAT introduced in January. Inflation in Montenegro rose in 2004 to 4.3 percent in December.

- **The SM current account deficit increased further in 2004, reaching 15½ percent of GDP.** Imports rose by 47 percent year-on-year in dollar terms. While export growth at 38 percent lagged behind, exports accelerated in the second half of 2004, partially as an effect of past privatizations. While energy imports remained constant as a share of total imports, the increase in world prices implied a lower growth rate for imported volumes. Imports at end-year were boosted by a one-off large increase in anticipation of the introduction of the VAT in Serbia in January 2005. Private remittances continued to be high at 15 percent of GDP in 2004, but FDI fell to 4 percent of GDP, reflecting a slowdown in privatization in the first half of the year. Gross foreign reserves rose to US$4¼ billion (3.7 months of projected 2005 imports) at end-December 2004. In Montenegro, the current account balance showed signs of improvement in 2004, with FDI inflows of US$60 million consisting mainly of investment in the tourism sector. However, private sector foreign debt continued to increase at a high rate.

- **The debt dynamics in SM benefited from the completion of negotiations with London Club creditors, but the increase in the debt financing of the current account deficit raises concern.** The London Club agreement implies a 62 percent reduction of the debt to commercial banks, reducing the country's overall debt burden by 7 percent of GDP, down from 69 percent at end-2003. However, an increasing share of the external deficit is financed by debt (about 54 percent) making the country more vulnerable to external shocks. The increase in mostly private foreign borrowing by 8 percent of GDP kept the external debt-to-GDP ratio at 62 percent at end-2004.

4. **Developments so far in 2005 were mixed.** In Serbia, in the first quarter of 2005, the trade balance improved, with exports up by 41 percent and imports down by 14 percent

relative to the previous year. Cumulative inflation reached 7.1 percent in the first five months. Industrial production declined by 3.4 percent in the first quarter relative to the same period last year, although exporting sectors remained strong. In Montenegro, the trade balance improved further in the first quarter and inflation declined to 3.6 percent.

5. **The buoyancy of budgetary revenues resulted in a lower-than-programmed budget deficit in Serbia in 2004.** Reflecting strong domestic demand and improved tax enforcement efforts, the revenue performance of the republican and local budgets exceeded expectations by significant margins. In particular, customs and excise revenues, boosted by the advancement of imports ahead of the VAT introduction in January, were buoyant, while improved collections of fees and licenses contributed to an increase in nontax revenue. Expenditures were generally under tight control.

6. **In Montenegro, fiscal policy contributed to maintaining macroeconomic stability.** The consolidated fiscal deficit declined in 2004 in line with the program. However, revenues fell somewhat short of the program target, reflecting a stronger-than-expected negative revenue impact of the 2004 tax reform. Consequently, cash expenditures were reduced to meet the deficit target. Employment financed from the budget was reduced by 2.4 percent. Despite the expenditure cuts, spending arrears of the consolidated budget did not increase during 2004. In the first quarter of 2005, the fiscal execution was broadly as programmed. Privatization receipts, substantially higher than expected, were used to initiate the repayment of domestic debt and increase government reserves.

7. **Increasing confidence in the banking system in Serbia was accompanied by growing euroization and rapid credit growth.** Reflecting increasing confidence in the banking sector in line with progress in bank restructuring, remonetization continued, with broad money relative to GDP increasing from 19.2 percent at end-March 2004 to 22.3 percent at end-March 2005. This was primarily the result of strong growth in foreign-currency deposits, while the demand for dinar-denominated deposits has stagnated. Euroization—measured as the share of foreign-currency deposits in total deposits—surged by 5.6 percentage points in one year, reaching 71.7 percent at end-March. Buoyant economic activity, pent-up demand for durable consumer goods, and a surge in foreign borrowing by commercial banks and the corporate sector resulted in a lending boom. As a result, the share of credit in GDP rose from 15 percent at end-March 2004 to 19 percent at end-March 2005. Lending to households rose from 2.6 percent to 4.6 percent of GDP.

8. **The NBS implemented prudential measures to reduce macroeconomic and prudential risks:**

- The NBS issued a new guideline on consumer credits, effective December 1, 2004, recommending (i) limiting the monthly payment to net income ratio to 30 percent; and (ii) requiring a downpayment of at least 20 percent of the purchase price of acquired goods. It is closely monitoring compliance with these ratios and stands ready to further tighten the regulations on consumer lending, should the achieved slowdown turn out not to be sustained.

- Since January 1, 2005 the stock of commercial banks' foreign borrowing of maturities of up to 4 years and all new foreign borrowings by commercial banks independent of maturities are subject to a minimum reserve requirement of 21 percent, thereby reducing the bias in favor of foreign-sourced funding. Effective April 11, 2005, all short-term deposits of foreign banks with banks operating in Serbia are equally subject to the 21 percent reserve requirement.

- Moreover, to reduce prudential risks, the NBS increased the capital adequacy ratio from 8 percent to 10 percent, effective March 31, 2005.

- The NBS moved decisively on enforcing prudential regulations in the insurance sector through the withdrawal of 18 insurance company licenses in December 2004 and January 2005.

9. **Structural reforms in Serbia gained momentum.** In 2004, 456 socially owned enterprises were offered for sale, of which 336 with 52,000 employees were sold. The privatization effort was especially strong in the fourth quarter of 2004 and the first quarter of 2005—exceeding the commitments in the previous MEFP. In the fourth quarter of 2004, 184 socially owned companies were offered for sale through auctions with a success rate of 51 percent. During the same period, 13 large socially owned enterprises were offered for sale through tenders, of which three from the list of companies under restructuring. In the first quarter of 2005, 78 companies were offered for sale through auctions with a success rate of 35 percent, and 7 companies were offered through tenders, of which 3 under restructuring. About 1,830 companies remain to be privatized.

10. **Substantial progress was also made in consolidating the banking system, with marked changes in patterns of bank ownership.** Most importantly, the sale of Jubanka was successfully completed in January 2005 at a price of €150 million, the second-highest proceeds for any privatization deal in Serbia so far. Five other state-owned banks are currently passing through the bank privatization program managed by the Bank Restructuring Agency (BRA). Owing to progress in bank privatization and the acquisition of private domestic banks by foreign banks, the share of the latter in total bank assets rose to 52 percent at end-April 2005.

11. **Privatization in Montenegro was accelerated.** In mid-2004 the largest steel producer Niksicka Steelworks was privatized, and in 2005, the local telecommunication monopoly Telekom Montenegro was sold. An international financial advisor for the privatization of Podgorička Banka, the largest state-owned bank, was selected in February and the invitation to express interest was launched in May. The authorities have prepared a time-bound strategy for the privatization of majority and minority-owned equity stakes in the remaining state-owned banks. Besides, hotels and other minor assets are being privatized.

II. Economic Objectives and Policies

12. **The key economic objectives for 2005 and beyond are to reduce inflation and lower the current account deficit, while supporting sustainable growth** (Table):

- **Real GDP growth** in SM is projected to reach 4½–5 percent in 2005, owing to the lower contribution of agriculture, while economic activity in the industrial and service sectors is expected to remain robust, fueled by buoyant investment and strong, albeit moderating consumption demand. Growth is projected to average 5 percent in subsequent years, as restructuring-related output losses subside, privatization and enterprise restructuring continue, and FDI inflows reach higher levels.

- End-period **inflation** in Serbia is targeted to decline to 10 percent by end-2005, reflecting gradually receding domestic demand pressures and lower increases in administrative prices and municipal tariffs and fees, and despite the one-off effect of the VAT introduction in January 2005. There are clear risks to this target, but the government is committed to take the necessary corrective measures to achieve it, in particular as regards demand management and fiscal discipline. In Montenegro, inflation is expected to remain at 3½ percent by end-2005.

- The external **current account deficit** (before grants) is projected to decline to about 11 percent in 2005, as policies initiated last year to contain domestic demand are taking effect with a longer-than-expected lag, and additional measures are being taken. The current account deficit is projected to continue to decline in the medium term—reflecting the recovery of exports as structural reforms elicit a supply response and prudent policies strengthen competitiveness—, thereby contributing to external sustainability and consistency with expected financing. As structural reforms accelerate and the business climate improves over the medium term, FDI inflows could play an increasing role in financing the current account deficit. However, foreign assistance and loans will remain an important source of financing.

- The import coverage of **foreign reserves at end-2005** will increase to 4 months of prospective imports, with a view to guarding against possible risks and preparing for the projected rise in external debt service in the medium-term following the expiry of grace periods under debt restructuring agreements.

13. **The PRSP process will continue to guide the development agenda and social policies.** The PRSPs adopted by the Serbian and by the Montenegrin governments in late 2003 outline the key reforms. 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.

Serbia and Montenegro: Macroeconomic framework, 2003-05

	2003	2004		2005	
	Actual	4th Review	Est.	4th Review	Proj.
	(Percentage change)				
Real GDP Growth	2.7	6.0	7.2	4½ - 5	4½ - 5
Inflation (end period)	7.8	12 - 13	13.4	9 - 10	9 - 10
	(Percent of GDP)				
Domestic investment	16.1	16.5	17.6	17.8	18.4
Domestic savings	-5.9	-8.7	-11.3	-7.3	-5.3
Current account deficit (before grants)	12.3	13.0	15.5	12.0	11.0
Gross official reserves (US$ billion)	3.6	3.7	4.3	4.2	5.6
In months of projected imports	3.3	3.7	3.7	3.9	4.3
Total external debt	69.2	58.4	62.0	57.4	57.1
Net external debt	47.7	39.1	40.5	36.1	32.8
Underlying net external debt 1/	47.7	46.8	47.9	50.2	44.8
Fiscal balance	-3.3	-2.0	-0.3	-0.8	1.2

Source: SM authorities.

1/ Excludes the impact of write-offs in London Club and other commercial and official bilateral debt.

A. Fiscal Policy

14. **Fiscal policy in 2005 will continue to anchor the stabilization effort and improve medium-term sustainability**. The fiscal balance will improve by 1.5 percentage points of GDP over 2004 to achieve a surplus of 1.2 percent of GDP in 2005, largely through savings of revenue exceeding the projections in the budget and targeted expenditure cuts. Reflecting the tightened fiscal stance, assumed privatization proceeds (3.1 percent of GDP), and foreign disbursements (0.9 percent of GDP), the fiscal program for 2005 envisages negative domestic financing equivalent to 5.4 percent of GDP. Privatization proceeds beyond program targets will be used to reduce net government indebtedness.

Serbia

15. **The fiscal stance in 2005 will be tightened compared to the program.** In light of the rekindling of inflationary pressures and the higher-than-programmed current account deficit, the fiscal stance for this year needs to be more restrictive than originally expected. This must be achieved despite significant higher social fund spending, which was not envisaged at the time of the passage of the 2005 budget. Given this additional expenditure pressure, the government will scale back spending on current and capital programs already approved in Republican and City of Belgrade budgets for 2005 by about 0.7 percent of GDP (the ceiling on expenditure of the Republican budget is *a quantitative indicative target*), and will save all revenues exceeding the 2005 budget projections that may arise from the carry over of strong domestic demand, unless otherwise noted. It will, in consultation with Fund staff, submit a draft supplementary budget to Parliament—the approval of which will be *a*

structural PC for end-July 2005. The government will also step up tax collection efforts, including the enforced collection of tax arrears.

16. **The fiscal stance will be reassessed during the sixth review when the effectiveness of the measures taken so far to rein in domestic demand becomes clearer.** Further fiscal consolidation will be targeted if needed. Moreover, to reduce vulnerability to external shocks over the medium term, the government is committed to cut permanent expenditure in 2006 by at least 1 percent of GDP. This will be supported by changes to the pension law, reform of the health sector, cuts in transfers to municipal governments, and reductions in subsidies. Submission to Parliament of the 2006 budget consistent with these parameters, after consultation with Fund staff, will be *a structural PC for November 1, 2005*. In the meantime, the government will strengthen control over expenditure commitments of all direct and indirect budget users to ensure no build-up of expenditure arrears. To help attain the macroeconomic objectives, no further tax cuts beyond those agreed will be implemented.

17. **The government will ensure that obstacles hindering the successful implementation of employment policy are removed.** To compensate for the increase in the wage bill at the union level stemming from the delay in the passage of the army law, compensating cuts in nonwage expenditure will be carried out. To bring about the planned reduction in the union-level employment, monthly transfers to the union budget will be conditional on achieving the targeted monthly reduction in union-level employment. This will compensate for the Union Parliament not succeeding in amending the law on Union-level civil employees to reduce the dismissal notice from 3 months to 1 month, which will not be resubmitted. The government will ensure that employment in the central government will be reduced in June, as agreed earlier under the program. However, the proposed reduction in employment in the general government will be postponed until a strategy for the education sector is developed. To partly compensate for this delay, the government will accelerate the reform of the health sector, which will include a reduction in employment. A strategy for modernizing this sector is at an advanced stage of preparation, and concrete measures will be developed by end-July under a European Agency for Reconstruction project (*structural benchmark*). We expect this project to make recommendations that would improve the efficiency of the health network by reducing the burden on the public health budget through streamlining of operations, outsourcing of non-medical services, and spin-off of non-healthcare assets. In addition, co-payments for health services, which are at a low level, will be increased in July 2005, with due consideration for vulnerable groups.

18. **To support its broad policy objectives, the government will ensure that local budgets are in balance or stronger in 2005.** Large-scale wage increases for budgetary sector employees and municipal utility workers—announced by some local authorities—would undermine the overall fiscal stance and put at risk the effectiveness of the government's incomes policy. It is therefore imperative that the local governments stay within the announced fiscal and incomes policy framework. To this end, the city of Belgrade has agreed to cut from its planned budgetary spending by 0.2 percent of GDP, primarily in low priority programs. The approval by the City Council of Belgrade of a revised budget will

be *a structural PC for end-July 2005*. More generally, the central government will also ensure that wage increases and prices at all local utilities are fully consistent with the law on public utilities.

19. **To strengthen collection performance of budgetary revenues and harden budget constraints of socially owned and private enterprises, the government will implement an ambitious plan to reduce tax arrears.** For this purpose, the government established targets for reducing the stock of tax arrears (including interest and penalties) by SRD 5 billion by end-June 2005 compared to the end-December 2004 stock (*structural benchmark*). In each of the remaining six months of 2005, the stock of these arrears will be reduced by another SRD 1 billion. These targets will be achieved by stepping up forced execution (including the confiscation of bank accounts), initiating bankruptcy procedures against non-payers, or by conditional write-offs for companies undergoing privatization. In view of the revenue risk associated with these measures, the Ministry of Finance has drawn up contingency expenditure measures (in goods and services, subsidies, and transfers to the Road Fund) equivalent to 0.6 percent of GDP, which can be quickly implemented in the event that revenue performance turns out to be weaker than expected.

20. **The government will carefully reassess the adequacy of budgetary resources for the restructuring of state- and socially owned enterprises.** If necessary, within the overall expenditure ceiling in the 2005 budget, the government will consider redirecting additional budgetary resources for restructuring, including to finance layoffs in public enterprises on a temporary basis (these loans would need to be repaid to the budget by year-end from the enterprises' own resources). However, to ensure that funds are effectively used, as indicated in the previous MEFP, no payments from the Serbian Development Fund will be made to any enterprise that (i) raised its wage bill by more than projected inflation, and (ii) failed to abide by its restructuring program.

21. **The government will move decisively to ensure the long-term sustainability of the pension system.** The government has formed an inter-ministerial task force to guide the work on reforming the pay-as-you-go pension systems for employees, farmers, and self-employed. To improve the financial position of the pension system over the medium term, the task force has examined ways to further improve pension legislation, including through de-linking pensions from wages, accelerating the increase in the retirement age, and equalizing the retirement age for men and women. As a result, to reduce the structural deficit of the pension system over time, the government will, before end-June, make a formal decision (*a prior action for completion of the fifth review*) to (i) increase the retirement age by 2 years (to 65 years for men and 60 years for women), phased-in in four years; (ii) phase in inflation-based indexation for post-retirement pension benefits (instead of 50 percent wage and 50 percent inflation) in four years (in four equal annual increases in the inflation coefficient); (iii) replace quarterly with annual indexation of pensions; and (iv) keep the current indexation system for pre-entitlement pension calculations. It will also review the current supplemental entitlement system (bonus) for specific professions, with a view to ensuring its fairness. Enactment by parliament of the revised legislation, after consultation with Fund and World Bank staff, will be *a structural PC for end-October 2005*.

Concurrently, the government will benefit from World Bank assistance to strengthen pension administration. As agreed earlier, plans for the clearance of one-half month of the Employee Pension Fund arrears in 2005 will be made conditional on the overall budgetary revenue performance and, if needed, will be delayed by one year. In any case, this payment will not be made before Q4 2005.

22. **To support the fiscal consolidation into the medium term, the government will broaden its expenditure reform beyond the civil service and pension.** In particular, spending on social programs will need to be better targeted to those who are most in need. In this connection, it will request technical assistance from the World Bank and the Fund to assess the effectiveness of current social programs with a view to identifying cost savings and eliminating duplicative services, which it will seek to incorporate in the 2006 budget.

23. **Further improvements in public expenditure management are essential to the goal of fiscal consolidation.** To improve budget management, the government will place all spending programs under a unified budgetary framework starting in 2006. To this end, it will set up an inter-ministerial group to coordinate all capital investment budgets that are financed by foreign loans. Beginning with the 2006 budget, these investment programs would be fully integrated in the budget planning process. To evaluate the fiscal risks associated with public-private partnerships (PPP) in investment and their potential macroeconomic impact, the government has requested technical assistance from the Fund. As agreed, the government remains committed to closing off accounts of the indirect budget users and incorporating the spending programs currently financed from such accounts into the budget. As a first concrete step towards achieving this goal, the government will submit appropriate amendments to the Law on Budget System and the Law on Foreign Exchange by end-June 2005. In early-May 2005, the accounts of the Ministry of Defense were incorporated into the treasury single account (TSA); the last remaining budget user (Ministry of International Affairs) will be brought under the TSA by December 2005.

24. **The government will make better use of the capabilities and services of Public Payment Agency (PPA) to improve fiscal management.** The action plan to incorporate the PPA into the Treasury was issued in March, in line with the program commitment. With its technical capabilities and as the main agency servicing local budgets, the PPA is suitably placed to develop a software module for recording local budget expenditures on a GFS-consistent basis in order to shorten the reporting lag of local budget statistics. Such a program will be developed for implementation by June 2005 for the four largest local municipalities and will eventually be extended to all local government budgets. As part of a broader effort to improve the public expenditure management, the Ministry of Finance will seek Fund assistance to assess the adequacy of fiscal management in Serbia by requesting participation in the fiscal Report on the Observance of Standards and Codes (ROSC).

25. **Public debt management functions will be further strengthened.** The debt management function will be retained in the Treasury. While the Treasury develops its expertise, debt registration and servicing functions should continue to remain in the NBS, which will integrate its domestic and external debt registration in a single database to allow

for consolidated reporting on the debt portfolio. The Treasury should move rapidly toward full integration of cash and debt management, which will be particularly timely given the expected large inflows of privatization proceeds in the coming months. In addition, the development of the T-bill market will be fully coordinated with the NBS. The government has submitted to Parliament a draft law on Public Debt; however, it will not issue foreign currency debt this year.

Montenegro

26. **In 2005, the government will reduce the deficit of the consolidated general government to 2.7 percent of Montenegrin GDP to further strengthen macroeconomic stability.** To secure the deficit target, and reflecting improved collection of contributions to the social funds, the government will reduce its transfers to the Pension Fund and increase reserves by €5 million. It will withdraw all deposits with commercial banks that do not serve as collateral for loan programs (similarly, the privatization proceeds allocated to the Restitution Fund will be transferred to an account at the central bank) by end-June 2005 (*structural benchmark*). Remaining deposits will be transferred to the Treasury as the respective loans mature with a view to eliminating all government commercial banks deposits by end-2005. Civil service reform efforts will be stepped up to reach the original expenditure reduction target for budget-financed employment of 4,200 for the fiscal years 2004 and 2005. By end-June 2005 the government will prepare an inventory of spending arrears of the consolidated budget and adopt a schedule for arrears clearance (*structural benchmark*). To strengthen control over the fiscal position of the consolidated public sector, the government will issue a decree by end-June to unify the charts of accounts of the central government, municipalities, and extrabudgetary funds.

27. **Higher-than-budgeted privatization receipts will be used mainly to reduce debt and build up reserves.** The government currently expects proceeds of €164 million in 2005, which will be used to reduce the domestic debt by about €50 million by retiring the debt to domestic banks and amortizing T-bills falling due in 2005. The remainder and any additional privatization proceeds will be deposited in the central bank to increase reserves. The government will consider additional investment spending only after preparing a medium-term public investment program and updating debt and asset management strategies, in consultation with Fund staff. The government has requested technical assistance to this end. The increase in investment spending will be discussed in the context of sixth program review and will be conditioned on strong macroeconomic performance, continued progress in structural reforms and privatization, cuts in current spending, and a satisfactory revenue performance and no new tax cuts.

B. Monetary and Exchange Rate Policies

28. **The monetary program for 2005 envisages a tightening of monetary conditions to help contain domestic demand and inflationary pressures.** For 2005, the revised monetary program provides for an increase in end-period NFA by US$768 million, with monthly average NDA declining to SRD -82.9 billion, and a real decline in reserve money by

8.2 percent. Broad money is projected to rise by 22.4 percent. The NBS will stand ready to sterilize higher-than-programmed foreign exchange inflows as needed to contain credit expansion.

29. **The reliance on indirect monetary instruments will increase.** The NBS will assess by mid-June 2005, in close cooperation with Fund staff, the feasibility of establishing an interest rate corridor, which would link the interest rates on the NBS deposit facility and on the three lending facilities to market conditions. In this context, the NBS will also consider streamlining the three NBS lending facilities with a view to creating a lender-of-last resort facility in line with international practices. In addition, the NBS is preparing for two-way repo operations to allow the NBS to inject liquidity into the market if necessary, including through very short term repos. The monthly average volume of repo transactions operations will increase from a stock of SRD 2,584 million in March 2005 to at least SRD 6.5 billion in June, SRD 7.5 billion in September, and SRD 8.0 billion in November 2005. Moreover, the NBS envisages outright sales of government bonds, with an amount of SRD 1 billion being offered in the third quarter and another SRD 1 billion in the fourth quarter to reduce structural excess liquidity in the money market and help establish a secondary market for these securities.

30. **The use of prudential measures to contain macroeconomic and prudential risks resulting from rapid credit growth will continue:**

- Effective June 10, 2005, statutory reserve requirements (SRR) on enterprises' foreign-currency deposits and on commercial banks' foreign borrowing will be increased from 21 percent to 26 percent (*a prior action for completion of the fifth review*). At the same time, SRR on dinar deposits will be reduced from 21 percent to 20 percent to help contain euroization by increasing the wedge between SRR on dinar-denominated and foreign currency-denominated deposits.

- The NBS will issue by end-May 2005 a decision requiring the Board of Directors of commercial banks to approve specific risk monitoring and risk management policies with respect to credit risk resulting from borrowers' exposure to exchange-rate risk by, *inter alia*, assessing borrowers' ability to service loans—most of which are indexed to the euro—in the event of exchange rate changes and by considering the results of these assessments in determining the appropriate loan classification.

- By end-July 2005, the Law on Leasing and the Law on the NBS will be amended with a view to grant the authority for regulating and supervising leasing companies to the NBS (*structural benchmark*). On this basis, the NBS will issue by-laws (a) introducing a minimum value of leasing contracts; and (b) applying the same ratios already applied to consumer loans also to leasing contracts (20 percent minimum downpayment and 30 percent maximum monthly payment-to-net income ratio).

- The NBS and the government will support the private credit bureau established in 2004 in charge of monitoring individual's credit risk exposure and payment history. They will also strengthen the legal framework, in accordance with EU Directives, to ensure that the privacy of borrowers' personal data is protected. By end-May 2005, the credit bureau's data base will be extended to comprise data on leasing activities, tax arrears and arrears to utilities, and lending to enterprises.

31. **Exchange rate policy will continue to balance the objectives of reducing inflation and containing the current account deficit.** Against the background of the recent surge in inflation, exchange rate policy will aim at strengthening confidence in the dinar by contributing to reducing inflation, while at the same time striving to ensure external competitiveness. Exchange rate policy will be assessed frequently in light of current account, wage, and inflation developments.

C. Bank Reform and Financial Sector Supervision

32. **A new banking law in Serbia will substantially strengthen the regulatory and supervisory environment.** Parliamentary approval of the new banking law in line with the recommendations of the recent FSAP mission is expected by mid-November 2005 (*a structural PC*). The new law will:

- Ensure that accurate and timely asset classifications are applied and reported to the NBS.
- Authorize the NBS to supervise banks on a consolidated basis.
- Establish explicit statutory protection for NBS staff when performing their duties in good faith in accordance with the law.
- Reduce the significant ownership level criterion for prior approval by the NBS from 15 percent of bank capital to 5 percent.
- Set limits for banks' aggregate exposures to related parties at the level of at most 20 percent of bank capital in line with EU directives.
- Strengthen the "fit-and-proper" criteria for the members of the banks' boards of directors and supervisory boards and for significant shareholders.
- Revise the criteria for loan loss provisions to minimize the number of exceptional reductions in required provisions.
- Require banks' boards of directors to accept responsibility for establishing and overseeing integrated risk management systems. In this context, the NBS will be empowered to apply remedial actions in the event of financial misreporting.

33. **The NBS will further strengthen on-site and off-site supervision.** The NBS is committed to withdraw the license of banks failing to meet the minimum capital requirement. As part of its Supervisory Development Plan, the NBS will also adopt a time bound corrective action plan to address Basel Core Principle deficiencies identified by the recent

FSAP mission. In addition, the NBS will act decisively to eliminate regulatory forbearance in other areas, *inter alia* with respect to protracted breaches of the limits for banks' credit exposures to shareholders and their associates. With a view to increase the quality of on-site inspections, the NBS will hire new staff and step up internal and external training. The NBS will conduct regular full-scope examinations of the two systemically important state-controlled banks and—as for all banks examined—ensure the timely adoption of the resulting recommendations. To further improve the off-site inspection capacity, the NBS data gathering capabilities will be strengthened, including through reporting requirements on all foreign currency-denominated and foreign currency-indexed assets and liabilities. To improve financial sector transparency and market discipline, all banks will publish the full audited IAS/IFRS compliant end-2004 audit reports, supporting documents, and auditor's opinions by mid-July 2005.

34. **Insurance supervision will also be strengthened.** The NBS will require comprehensive year-end audits, with management letters provided to the NBS for all insurance companies. In this context, the NBS will ensure that IAS/IFRS and NBS accounting rules are fully applied to fixed assets and accounts receivable. To facilitate the reduction of state influence in the insurance sector and improve financial discipline, the government has submitted to Parliament amendments to the BRA law and the insurance law assigning responsibility for the privatization and bankruptcy of insurance companies to the BRA. As a major contribution to the restructuring of the insurance sector, upon passage of the respective legislative amendments, the government will launch by end-July 2005 a transparent international tender for the appointment of a financial advisor for the privatization of the second-largest socially-owned insurance company DDOR (*structural benchmark*). By end-May 2005, the NBS will initiate its on-site examination of DDOR. Moreover, for the largest socially owned insurance company Dunav, the BRA will, upon passage of the amendments to the BRA law, launch a tender by end-July 2005 for an independent diagnostic report. Based on the findings of this report, the government will adopt a time-bound corrective action plan by end-November 2005 (*structural benchmark*). In the second half of 2005, the NBS will also commence an on-site inspection of Dunav.

35. **The momentum in bank privatization will be maintained.** For Vojvođanska Banka, an invitation for the submission of expression of interest will be launched by end-September 2005 (*structural benchmark*). Binding bids were due on May 16 for Novosadska Banka and Continental Banka, and end-July for Niska Banka. Moreover, the government is committed to offering by end-December 2005 its stakes in all majority-state-owned banks (Panonska Banka and Credy Banka) that were comprised in the BRA portfolio as of end-2004, with the exception of Privredna Banka Pancevo, for which the privatization tender will be launched in 2006. Concurrently, with bilateral assistance, the BRA will further strengthen its reporting requirements, control mechanisms, and governance in other banks equity holdings to preserve their value prior to resolution. After significant delays, the BRA will publish by mid-May a schedule for the sale of unimpaired nonperforming loans and equities with range-of-value estimates. The first sale of such assets will be launched by end-May. Finally, the deposit insurance, bank liquidation, and Bank Rehabilitation Agency laws will be enacted by Parliament by end-July 2005 (*structural benchmark*).

36. **In Montenegro, strong efforts will be made to increase efficiency in the banking industry.** A tender for a majority stake in Podgoricka Banka will be issued by end-June 2005 (*structural benchmark*). The government aims at combining the direct and indirect state-holdings in another two banks (in Plevaljska by end-June, and in Nikšićka by end-September 2005) to be able to offer majority packages to strategic investors. A new insurance law, which will open up the commercial insurance business to international competition, was passed by Parliament in end-April 2005.

D. Enterprise Sector

37. **In Serbia, the wage bill in state enterprises will continue to be controlled to contain inflation pressures and encourage restructuring.** To help ensure that the state enterprise wage bill remains under control, the government passed in November 2004 a decree requiring ex ante approval by the Ministries of Labor and Finance for wage increases in the eight monitored public enterprises.[2] In 2005, the aggregate wage bill in these enterprises will be allowed to grow only by 7 percent on an annual average basis (the wage bill ceilings for *end-June and end-September 2005 are PCs*; in the event of spin-offs as a result of restructuring, the wage bill envelope will be adjusted downward for the wage bills of the spun-off units). The government approved detailed business plans in April 2005, which include plans for reducing employment. Redundancy payments for the laid-off workers will be paid from the non-wage enterprise budgets, the Transition Fund, or the budgetary reserve.

38. **Privatizing and restructuring socially owned enterprises—key to improving export performance, strengthening growth, and offering solid employment opportunities—will continue.** The Serbian government's objective is to offer all remaining socially owned enterprises for sale at least once by end-2006. Specifically:

- Between January 1-June 30, 2005, at least 130 companies will be offered for sale through auctions (*structural benchmark*), with a success rate of at least 40 percent. Between January 1-September 30, at least 230 companies will be offered through that channel (*structural benchmark*), with a similar success rate. For the year 2005 as a whole, the Privatization Agency (PA) plans to offer at least 320 companies for sale through auctions, and the government will provide it with an additional €5 million as needed to achieve this objective.

- The PA will offer for sale 7 socially owned enterprises, of which 4 from the list of companies under restructuring, through tenders during the second quarter of 2005 (*structural benchmark*). It will offer for sale another 7 companies, of which 4 from the list of companies under restructuring, through tenders between July 1–October 30, 2005 (*structural benchmark*).

[2] These are the electricity, petroleum, railway, postal, telecommunication, airline, airport, and forestry companies.

- To accelerate sales of residual state-owned shares in socially owned enterprises from the Share Fund (through public offers or sales via the stock exchange), amendments to the Share Fund law were passed in May. Moreover, to increase the depth of the market, it will also submit to parliament new laws on securities, investment funds, and voluntary pensions by end-June 2005. In the meantime, 45 such transactions were conducted in the first quarter of 2005, and another 90 are expected in the period covering the second and third quarters, with a view to achieving 200 offerings by the end of the year.

- To ensure fiscal transparency, all privatization proceeds will be treated as budgetary financing (below the line).

39. **To accelerate privatization, the Serbian government envisages debt workouts for large socially owned enterprises.** The framework for such agreements will be strengthened through amendments to the Privatization Law, which were approved by Parliament in late May (*a prior action for completion of the fifth review*), enshrining the principle of write-offs of enterprise debt to state creditors and public utilities, conditional upon privatization. Immediately after its passage by parliament, the government will enact the necessary ordinances to implement the law. The new framework will significantly accelerate the process of preparing companies under restructuring for sale, and will allow the reoffering of companies that were offered unsuccessfully. After passage of the law, the government will follow a policy of initiating bankruptcy procedures within three months against those socially owned enterprises that failed twice to be sold through auctions or tenders.

40. **The government is moving ahead with setting up an effective bankruptcy process and will use it with determination to strengthen financial discipline.** The bankruptcy process will become fully operational by end-June 2005, following the adoption of bylaws to the Bankruptcy Law and the establishment of (a) a Supervisory Body to license, supervise, and regulate bankruptcy trustees; and (b) a specialized unit within the PA to act as bankruptcy trustee for state- and socially owned enterprises. The new Supervisory Body will start licensing trustees in July 2005. To give credibility to the new bankruptcy legislation and improve financial discipline by creating a strong precedent, the government initiated in April bankruptcy procedures under the new regulations against 3 heavily indebted, loss-making socially owned companies from the list of companies under restructuring. Creditors initiated procedures against 15 other companies under the new framework (in addition to the 17 companies in bankruptcy already under administration of the PA under the previous legislation). The government will continue this policy by initiating bankruptcy procedures against at least another 5 large socially owned enterprises between June-September 2005 (*structural benchmark*).

41. **The Serbian government is firmly committed to improving the financial performance of the railway company (ZTP) by accelerating restructuring and downsizing employment.** Delays in restructuring, and excessive employment, have created large losses and imposed a substantial budgetary burden through annual subsidies (½ of one percent of GDP in 2005). Against this background, the Ministry of Capital Investment

has prepared both a one-year business plan and a restructuring plan for the period 2005-09 drawing on the plan elaborated by a consulting company. The one-year business plan, which was approved by the government and already implemented in part, provides detailed plans for 2005 for (a) reducing employment; (b) undertaking preparatory activities to allow for the spinning off of all non-core activities by offering them for sale to private investors (one spun-off unit that primarily employs handicapped persons is not slated for privatization); and (c) potentially withdrawing service and/or closing loss-making railway lines, if service-specific Public Service Contracts that fully compensate ZTP for the losses incurred in providing the services are not agreed. The company has made good progress in all three areas, and will reduce employment by 1,900 by end-September. The restructuring plan provides the detailed timetable for the continuation of these activities during 2005-09, and will be approved by the government by end-June 2005. Moreover, parliament approved in February 2005 a transportation law prepared by the government in consultation with the World Bank that provides for the unbundling of ZTP into separate infrastructure, freight transport, passenger transport, and rolling stock maintenance companies.

42. **The Serbian government will continue restructuring public utilities and other state-owned companies based on strategic plans.**

- Following the enactment of the energy law in 2004, an independent energy regulator was established, which will become fully operational by end-May 2005. As a first step, it will issue tariff methodologies by end-October 2005.

- The government will effectively unbundle the electricity company Elektroprivreda Srbije (EPS) into two separate companies, one for power generation, distribution, and distribution system management, and one for transmission and dispatch by legally registering the new transmission and dispatch company before July 15, 2005 (*a structural PC*), and by ensuring that the two companies function as independent enterprises by January 1, 2006. In addition, EPS will (i) complete the spin-off of all non-core activities; (ii) reduce its core employment by 2,750 (relative to end-December 2004), in line with the company's strategic plan; (iii) service all its debt to the government in full except for Kosovo-related debt; and (iv) not receive any budgetary subsidy in 2005.

- Legislation supporting the unbundling of the oil and gas company Naftna Industrija Srbije (NIS) into four separate companies (dealing with gas; oil exploration and research; oil refining and distribution; and non-core activities) will be passed by Parliament by end-July 2005 (*a structural PC*). The government will request by end-May 2005 technical assistance from the World Bank for assessing the appropriate sequencing of steps to privatize the four companies, including a schedule for removing the protection for the refineries (in particular by abolishing the NIS monopoly for importing oil derivatives and by liberalizing end-consumer prices). Based on these findings, it will launch by end-July 2005 (*structural benchmark*) an international tender to hire an advisor for the privatization of NIS, including advice on selling a majority stake in the two refineries in early 2006. Before issuing the tender, the terms of reference of the advisor will be reviewed by Fund and World Bank staff.

- By June 22, 2005, 33 companies, non-core assets, and hotels and recreational establishments of the 8 monitored state-owned enterprises will be spun off, registered as separate companies, and transferred to the PA for privatization (the TMU, Section K, lists 8 non-core companies of EPS and 25 others under the first group of companies) (*a prior action for completion of the fifth review*). By end-September 2005, 65 companies, non-core assets, and hotels and recreational establishments of the 8 monitored state-owned enterprises (the TMU, Section K, lists 30 hotels and recreational establishments of EPS, 11 companies or non-core assets of EPS, and 24 companies or non-core assets of the other state-owned enterprises under the second group of companies) will be spun-off, registered as separate companies, and transferred to the PA (*a structural PC*). Finally, all the remaining companies, non-core assets, and hotels and recreational establishments of the 8 monitored state-owned enterprises (the TMU, Section K, lists 6 companies and non-core assets of EPS under the third group of companies) will be spun-off, registered as separate companies, and transferred to the PA by end-October 2005 (*a structural PC*).

- The government will, after close consultation with World Bank staff, adopt by end-June 2005 a restructuring plan for the mining company RTB Bor (*structural benchmark*). This plan will include time-bound actions with respect to resolution of all constituent parts, including core and non-core businesses, labor reductions, privatization, and environmental remediation.

- To raise transparency in the sector, all monitored public utilities will publish by end-June 2005 an auditor's report on their 2004 accounts in line with IAS prepared by a reputable international auditing firm engaging a review partner with relevant industry experience from outside the local office.

43. **To enhance collection and harden budget constraints of state- and socially owned enterprises, public utilities will enforce penalties on late payments and cut off supplies to commercial users that are not honoring their payment obligations for more than two months.** If the government considers that continuation of delivery to these enterprises is imperative for strategic or social reasons, the utility bills will be paid from the budget. In 2005, the two largest primary energy suppliers EPS and NIS, both state-owned companies, will make strong efforts to improve collections of current bills and arrears. In particular, the collection rate on current deliveries of EPS (including collection of arrears) will increase from 89.5 percent on average in 2004 to at least 92.3 percent in 2005, with intermediate targets set for June, September, and December 2005 (*indicative targets*). For NIS, the same collection rate will increase during the year to 100.3 percent on average, with intermediate targets set for June, September, and December 2005 (*indicative targets*).

44. **Privatization in Montenegro will be further accelerated to attract international investment and management expertise.** The government will offer for sale in 2005 through

transparent public tenders the tobacco industry, a lottery company, and three large hotels. Furthermore, the privatization strategies for EPCG (electricity company), the port of Bar, the railroad, and Plantaže (winery) will be finalized by end-2005.

E. Foreign Trade System

45. **Serbia and Montenegro largely conduct their foreign trade systems and customs operations separately, in line with the "twin track" approach recently adopted by the EU.** In Serbia, the government is preparing a foreign trade law which sets the framework for international trade consistently with WTO and EU regulations, and on a custom tariffs law, which will harmonize tariff lines according to HS 2000/2002 standards and the EU combined nomenclature. The latter law will also revisit some tariff rates to bring them more in line with the structure of the economy. Largely as a result of the increase in tariff lines, the simple average tariff will increase by slightly more than 1 percent, to 8.7 percent, but the weighted average tariff will remain at 6.3 percent. A foreign trade law, compliant with international standards, has been implemented in Montenegro since April 2004. The resolution of the outstanding issues with the EC relating to sugar trade has allowed the resumption of sugar exports to the EU, even though, starting July 2005, tariff quotas are expected to be applied in the context of the new EU regulation of the sugar market. Furthermore, Serbia has signed a trade agreement to liberalize trade in textiles with the EU.

46. **Discussions on bilateral Free Trade Agreements with neighboring countries within the initiative of the Stability Pact—aimed at facilitating trade through harmonized rules and standards and simplified customs procedures—have progressed well.** Free Trade agreements with Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Moldova, and Romania have been ratified and implemented, while work is underway to review the trade agreement with Macedonia. In this regard, the government is committed to work towards a resolution of the ongoing trade dispute with Bosnia-Herzegovina regarding Serbian agricultural exports. In February 2005, the World Trade Organization approved the separate accession of the two republics, and distinct Working Parties are expected to meet in the coming months. In this context, Serbia plans to improve its administrative capacity to implement WTO-related measures. Customs operations are expected to be further strengthened. To avoid backtracking on reforms and maintain a competitive market environment, both member states will refrain from introducing or intensifying import restrictions. Serbia and Montenegro agree to improve the comparability of respective external sector data, and provide foreign debt data on a periodic basis.

III. Program Monitoring

47. **Macroeconomic policy performance will continue to be monitored through quarterly quantitative performance criteria and indicative targets (Annex A)**. Quarterly PCs are set for end-June and end-September 2005, as specified in Annex A. Progress in structural reform will be monitored through structural PCs and benchmarks on key policy measures, listed in Annex C along with prior actions for completion of the fifth review.

Table 1. Serbia and Montenegro: Quantitative Performance Criteria and Indicative Targets for end-2004 and 2005
Under the 2002–05 Extended Arrangement 1/
(SRD million, unless otherwise noted; end of period)

	2004			2005					
	Dec.			Mar.			Jun.	Sep.	Dec.
	Program 15/	Program w/adjustor	Act.	Program	Program w/adjustor	Act.	Program	Program	Program
A. Quantitative performance criteria									
Floor on the net foreign assets of the NBS 2/ 3/	1,594	1,523	1,841	1,608	1,568	2,060	2,051	2,326	2,734
Ceiling on net domestic assets of the NBS 2/ 4/	-16,001	-13,501	-28,485	-22,197	-32,190	-44,935	-52,349	-62,075	-82,938
Ceiling on net credit of the banking system to the consolidated general government 2/ 5/ 6/ 7/	-11,280	-6,106	-19,106	-10,590	-31,277	-46,702	-43,632	-61,633	-90,060
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 8/	500		348	100		43	200	300	400
Multilateral creditors (EBRD, EIB, EU, IBRD, and IFC)	500		348	100		43	200	300	400
Serbia	460		286	92		40	184	276	368
Montenegro	62 16/		62	8		3	16	24	32
Other creditors	0		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 9/	0		0	0		0	0	0	0
Ceiling on new guarantees and the assumption of bank or enterprise debt by the public sector 10/	0		... 17/	0		... 17/	0	0	0
Ceiling on outstanding external debt service arrears 3/ 11/	0		1.7 20/	0		0.8 20/	0	0	0
Ceiling on the wage bill of the monitored public enterprises 12/	29,725 18/		30,257	8,030		7,813	15,941	24,180	32,700
B. Indicative targets									
Ceiling on net credit of the banking system to									
consolidated general government of Serbia 2/ 5/ 6/ 13/	-12,469		-19,924	-11,992		-39,477	-35,289	-50,529	-78,146
consolidated general government of Montenegro 2/ 5/ 13/	1,189		818	1,402		-7,225	-8,343	-11,104	-11,914
Ceiling on net domestic assets of the banking system in Serbia 2/ 14/	94,134		111,956	124,601		104,102	113,617	114,497	104,126
Ceiling on Serbian central government dinar deposits in commercial banks	0		0	0		0	0	0	0
Ceiling on change in the arrears of									
the Union government	0		1,516	0		525	0	0	0
the consolidated general government in Serbia	0		-974	0		2,207	0	0	0
the consolidated general government in Montenegro	0		18	0		667	0	0	0
Expenditure ceiling for the Serbian Republican budget 21/	...		...	...		89,917	190,846	297,513	406,399
Floor on the collection rate of EPS in percent 19/	...		89.5	...		90.7	90.6	91.5	92.3
Floor on the collection rate of NIS in percent 19/	...		96.6	...		93.1	100.0	99.0	100.3

1/ Quantitative performance criteria and indicative targets are defined in Annex E and evaluated—for program purposes—at end-December 2003 exchange rates for December 2004 and March 2005, and at end-December 2004 exchange rates for June and September 2005. In 2005, figures in section A. are performance criteria for March, June, and September and indicative targets for December.

2/ The end-2004 performance criteria were adjusted by the amount that actual data differed from the estimates for December 2003.

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 7/.

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 adjustors for shortfalls in (i) nonbank domestic financing; and (ii) severance payments apply, as defined in sections II.D, and II.J of the TMU, respectively.

7/ 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 as defined in the TMU.

8/ 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.

9/ Excludes normal import-related credits.

10/ Quantitative performance criteria for December 2004 and March 2005; indicative targets for the remainder of 2005. Excludes assumption of debt of socially-owned enterprises at the moment of ownership transfer on the basis of the amendment to the privatizaation law adopted by Parliament on May 23, 2005; also excludes indebtedness arising from the fulfillment of existing government guarantees.

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

12/ In 2004, the 7 monitored enterprises were 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. For 2005, JP Aerodrom Beograd was added to this list. In the case of spin-offs of activities from these companies through the creation of new companies the wage bill target will be adjusted downwards for the wage bill of the spun-off units. Targets are cumulative since the beginning of the respective year.

13/ Consolidated Montenegrin government includes all entities in Montenegro defined under 7/; the rest of entities under 7/ is included in the consolidated Serbian government.

14/ Foreign currency-denominated loans and deposits at program exchange rates, i.e. end-2003 exchange rates for December 2004 and March 2005 and end-2004 exchange rates for the remainder of 2005.

15/ Reflects, as appropriate, revisions to the NBS' foreign exchange liabilities, credit to government by the banking system, and broad money at end-2003, and adjustments stemming from raising of the reserve requirement ratio on SRD-denominated deposits from 18 to 21 percent effective August 11, 2004.

16/ The original PC for end-December 2004 of US$ 40 million was revised by the Executive Board on December 15, 2004.

17/ Data have not been provided by the authorities.

18/ On December 15, 2005, the Executive Board increased the origional end-December 2004 indicative target by 1.7 percent and converted it into a quantitative performance criterion.

19/ Cumulative since the beginning of the respective year.

20/ The performance criterion has been breached on the account of arrears of Montenegro vis-à-vis Russia.

21/ The cumulative expenditure ceiling for the Serbian Republican budget excludes foreign-financed project expenditures, amortization payments (including all FFCDs), and all own-resource financed expenditures of budgetary units.

Table 2. Serbia and Montenegro: Extended Arrangement, May 2002–December 2005
Prior Actions, Structural Performance Criteria, and Structural Benchmarks, September 2004–March 2005

	Target Date	Implementation
I. Prior Actions for Board Consideration of the Fourth Review		
1. Serbia: Parliamentary approval of the revised budget for 2004 in line with the MEFP.		Adopted October 20, 2004.
2. Serbia: Submission to Parliament of the draft 2005 budget in line with the MEFP.		Adopted November 20, 2004.
3. Montenegro: Government approval and publication of the revised budgetary objectives for 2004 in line with the MEFP.		Done.
4. Montenegro: Submission to Parliament of the draft 2005 budget in line with the MEFP.		Done.
5. Serbia: Issue tender for 3 large socially-owned enterprises		Done.
6. Serbia and Montenegro: Submit to federal parliament amendments to the laws on (i) the Yugoslav Army and (ii) Union-level Civil Employees, reducing the redundancy payment from 24 to 12 months' wages and the dismissal notice time from 3 months to 30 days.		Done.
II. Structural Performance Criteria		
1. Serbia: Enact amendment to the Law on the Privatization Agency enabling the Privatization Agency to act as the bankruptcy trustee agency for state- and socially-owned enterprises.	end-December 2004	Enacted on December 21, 2004.
2. Serbia: Enact the amendments to the law on (i) the Yugoslav Army and (ii) Union-level Civil Employees, reducing the redundancy payment from 24 to 12 months' wages and the dismissal notice time from 3 months to 30 days.	end-December 2004	(i) Partially enacted with delay on February 17, 2005; the dismissal notice remains unchanged; (ii) Not done.
3. Serbia: The government will (i) legally register the new transmission and dispatch company, which will be owned separately from EPS; and (ii) adopt a time bound action plan for implementation of EPS restructuring covering accounting separation, introduction of transfer prices, labor restructuring, debt restructuring, asset transfer, and other steps necessary to enable the separated companies to function as independent enterprises from July 1, 2005.	end-February 2005	(i) Not done, rescheduled for mid-July 2005; (ii) Action plan adopted with delay in March 2005.
III. Structural Benchmarks		
A. Fiscal Sector		
1. Serbia: Agree with World Bank on key elements of civil service reform consistent with restraining the 2005 budgetary wage bill in line with the MEFP.	end-November 2004	Done.
2. Montenegro: Withdraw all central government deposits from commercial banks to the Treasury Single Account in the Central Bank of Montenegro (for the bank in the process of privatization, the deposits would decline by €2 million by end-2004, with the remainder to be withdrawn by end-June 2005).	end-December 2004	Not done. Rescheduled for end-June 2005, for deposits that do not serve as collateral for loan programs.
3. Serbia: Prepare a plan to reduce tax arrears to the budget.	end-November 2004	Done.
4. Serbia: Adopt Law on Civil Service	end-March 2005	Not done. Pending World Bank project.
B. Financial Sector		
1. 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	Done.
2. Serbia: Submit to Parliament a draft law to convert existing government debt to the NBS into tradable securities.	end-November 2004	Done.
3. Serbia: Close banks that do not meet the minimum capital requirement, unless reputable investors recapitalize them, or they are undergoing merger to help them meet this requirement.	end-December 2004	Done.
4. Serbia: Launch the privatization tender for Niška Banka.	end-December 2004	Done with delay in January 2005.
5. Serbia: Adopt the laws on deposit insurance, bank liquidation, and the Bank Rehabilitation Agency in consultation with the World Bank and the Fund.	end-March 2005	Not done. Rescheduled for end-July.
6. Montenegro: Launch the sale of nonfinancial assets carved-out from the banking system.	end-December 2004	Done.
7. Montenegro: Launch a transparent international tender to sell the state's holdings in Podgoricka Banka to maximize cash privatization proceeds.	end-April 2005	Not done. Rescheduled for end-June.
C. Enterprise restructuring and privatization		
1. Serbia: Establish a Supervisory Body to license, supervise, and regulate bankruptcy trustees.	end-February 2005	Done with delay in March.

Table 3. Serbia and Montenegro: Extended Arrangement, May 2002–December 2005 (continued) 1/
Prior Actions, Structural Performance Criteria, and Structural Benchmarks, January-December 2005

	Target Date
I. Prior Actions for Completion of the Fifth Review	
1. Serbia: Government to adopt a formal decision on a pension system reform that will increase the retirement age by 2 years for men and women over a period of at most 4 years; shift to inflation-based indexation of benefits over a period of at most 4 years; and replace quarterly with annual indexation.	
2. Serbia: NBS to increase statutory reserve requirements on enterprises' foreign-currency deposits and on commercial banks' foreign borrowing to 26 percent.	
3. Serbia: Parliament to adopt the law amending the privatization law to facilitate debt workouts for socially owned enterprises, conditional upon privatization.	
4. Serbia: Government to spin off, register, and transfer to the Privatization Agency 33 companies, non-core assets, and hotels of the 8 monitored state-owned enterprises.	
II. Structural Performance Criteria	
1. Serbia: Government to legally register the new electricity transmission and dispatch company, which will be owned separately from EPS, to allow for the implementation of the EPS	July 15, 2005
2. Serbia: Parliament to adopt a supplementary budget yielding a surplus of 18.9 billion dinars (including FLIPs, excluding amortization) to support the fiscal stance defined in the MEFP.	end-July 2005
3. Serbia: Council of the City of Belgrade to adopt a revised 2005 budget that will reduce spending by 3.5 billion dinars to support the fiscal stance defined in the MEFP.	end-July 2005
4. Serbia: Parliament to adopt legislation abolishing the current law on NIS and allowing for the unbundling of the oil and gas company NIS into four separate companies.	end-July 2005
5. Serbia: Government to spin off, register, and transfer to the Privatization Agency 65 companies, non-core assets, and hotels from the 8 monitored state-owned enterprises between July-September 2005.	end-September 2005
6. Serbia: Parliament to enact a pension system reform increasing the retirement age by 2 years for men and women over a period of at most 4 years; shift to inflation-based indexation of benefits over a period of at most 4 years; and replace quarterly with annual indexation.	end-October 2005
7. Serbia: Government to spin off, register, and transfer to the Privatization Agency all the remaining companies, non-core assets, and hotels from the 8 monitored state-owned enterprises.	end-October 2005
8. Serbia: Government to submit a 2006 budget to Parliament, after consultation with Fund staff, consistent with the parameters defined in the MEFP and envisaging cuts in permanent expenditure of at least 1 percent of GDP.	November 1, 2005
9. Serbia: Parliament to enact a new banking law, as indicated in paragraph 32.	November 15, 2005
III. Structural Benchmarks	
A. Fiscal Sector	
1. Serbia: Reduce the stock of tax arrears to the budget by 5 billion dinars by end-June 2005 relative to end-December 2004.	end-June 2005
2. Serbia: Government to prepare an action plan for restructuring employment in the health sector.	end-September 2005
3. Montenegro: Withdraw all central government deposits with commercial banks that do not serve as collateral for loan programs.	end-June 2005
4. Montenegro: Government to prepare an inventory of spending arrears of the consolidated budget and to adopt a schedule for their clearance.	end-June 2005
B. Financial Sector	
1. Serbia: Parliament to adopt new laws on deposit insurance, bank liquidation, and the Bank Rehabilitation Agency.	end-July 2005
2. Serbia: Parliament to adopt amendments to the leasing law and the NBS law granting the authority for regulating and supervising leasing companies to the NBS.	end-July 2005
3. Serbia: Government to launch an international tender for appointing a financial advisor for the privatization of the largest socially owned insurance company DDOR.	end-July 2005
4. Serbia: Launch an invitation for the submission of expressions of interest for Vojvodanska Banka.	end-September 2005
5. Serbia: Government to adopt a time-bound corrective action plan for Dunav, the second-largest socially owned insurance company.	end-November 2005
6. Montenegro: Launch a tender to sell a majority stake in Podgoricka Banka.	end-June 2005

Table 3. Serbia and Montenegro: Extended Arrangement, May 2002–December 2005 (concluded) 1/
Prior Actions, Structural Performance Criteria, and Structural Benchmarks, January-December 2005

	Target Date
C. Enterprise restructuring and privatization	
1. Serbia: Government to adopt, after close consultation with World Bank staff, a restructuring plan for the mining company RTB Bor.	end-June 2005
2. Serbia: Launch privatization auctions for at least 130 socially owned enterprises between January and end-June 2005.	end-June 2005
3. Serbia: Launch privatization tenders for at least 7 socially-owned enterprises, of which 4 from the list of companies under restructuring, between April and end-June 2005.	end-June 2005
4. Serbia: Government to launch an international tender for hiring an advisor for the privatization of NIS, including advice on selling a majority stake in the oil refineries.	end-July 2005
5. Serbia: Launch privatization auctions for at least 230 socially owned enterprises between d d b	end-September 2005
6. Serbia: Government to initiate bankruptcy procedures against 5 large socially owned companies under the new bankruptcy law between June-September 2005.	end-September 2005
7. Serbia: Launch privatization tenders for at least 7 socially-owned enterprises, of which 4 from the list of companies under restructuring, between July and end-October 2005.	end-October 2005

1/ The relevant paragraphs of the MEFP and the TMU are binding.

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 November 29, 2004. 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 2005 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 and Montenegrin special budgetary programs), the National Bank of Serbia (NBS), and the Central Bank of Montenegro (CBM). For consistency with previous years, the Serbian state government will be defined to include the Road Directorate, even after it is corporatized, which is envisaged for mid-2005. 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 and for the period January 1, 2005-March 31, 2005, the program exchange rates are those that prevailed on December 31, 2003. In particular, US$1 = SRD 54.6372, €1 = SRD 68.3129, and SDR1 = US$ 1.4806. For the remainder of 2005, the program exchange rates are those that prevailed on December 31, 2004; in particular, US$1 = SRD 57.9355, €1 = SRD 78.8850, and SDR1 = US$ 1.55301. Monetary gold shall be valued at an accounting price of US$ 416.85 per ounce. On December 31, 2004, the NBS's foreign reserve assets as defined above amounted to US$3,998.0 million, including gold valued at US$148.8 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, 2004, the NBS's foreign reserve liabilities, as defined above, to nonresidents were US$1,099 million and to residents were US$1,058 million.

- For 2004 and for the period January 1, 2005-March 31, 2005, 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. For the remainder of 2005, the conversion will be based on the respective exchange rates against the U.S. dollar prevailing on December 31, 2004. 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, 2004, 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 Agency for Deposit Insurance, Rehabilitation, Bankruptcy, and Liquidation of Banks (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, 2004 (US$18.4 million through end-June 2005, US$97.7 million through end-September 2005, and US$140.9 million through end-December 2005) with a maximum adjustment of US$100 million. The net foreign assets floor will also be adjusted by the amount that the end-December 2004 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 F) 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 2005, 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, 2004, NDA of the NBS so defined were valued at SRD -28,485 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 SRD 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 F), 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 2004, net credit of the banking system in Montenegro to the consolidated general government in Montenegro amounted to €11.97 million (equivalent to SRD 818 million). At end-December 2004, net credit of the banking system to the consolidated general government so defined was SRD -19,106 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, 2004, and upward for any decrease. These performance criteria will be adjusted by the amount that the end-December 2004 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 SRD 6 billion for Serbia's and €11 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, and from asset sales by the public sector and by state-owned or socially-owned enterprises. 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 the year specified) with the actual inflows evaluated at the average exchange rates of the month when funds are received:

Serbia (2005, in SRD billion)

	Jun	Sep	Dec
External Financing	0.9	5.6	8.1
Privatization proceeds	22.6	28.3	38.5

Montenegro (2005, in € million)

	Jun	Sep	Dec
External Financing	5.1	10.1	18.2
Privatization proceeds	115.6	150.6	164.4

D. Nonbank Domestic Financing

13. **Definition.** Nonbank domestic financing to the consolidated general government is defined as any form of resident financing for the consolidated budget deficit other than (i) from the NBS, (ii) from commercial banks, and (iii) privatization proceeds. This will include domestic financing from nonbank financial institutions, nonfinancial enterprises, households, and all other domestic financing not elsewhere classified. Nonbank domestic financing covers any net change in the consolidated general government liabilities to any of these institutions, representing either direct loans or advances to the consolidated general government or holdings of securities of the consolidated general government, including promissory notes or other contractual obligations. FFCD payments are treated below the line as negative domestic nonbank financing.

14. **Adjustor.** If quarterly net nonbank domestic financing deviates from the projected quarterly cumulative path (coinciding with projected cumulative FFCD payments) provided below in billions of dinars, the excess (shortfall) will trigger an equal downward (upward) adjustment in (i) net banking system credit to the consolidated general government (performance criterion) and in (ii) net banking system credit to the consolidated general government in Serbia (indicative target).

	2005			
	Mar.	Jun.	Sep.	Dec
Projected Nonbank Domestic Financing	0.0	17.4	20.9	22.5

E. Ceiling on Change in Domestic Arrears

15. 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.

16. **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.

- Euro-denominated claims on government will be converted at the program exchange rate; claims denominated in currencies other than the euro will first be converted at their respective program exchange rates against the euro. 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 2004.

17. **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.

F. Definition of Reserve Money

18. **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, 2004, the required reserve ratio was at 21 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 (SRD 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.

19. 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, 2004, currency in circulation amounted to SRD 45,165 million, while required reserves amounted to SRD 20,808 million, and excess reserves to SRD 7,938 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.

20. **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, 2004, 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.

G. Ceiling on External Debt-Service Arrears

21. **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.

22. **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.

H. Ceilings on External Debt

23. **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 I 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, in 2005 cumulative from December 31, 2004, 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$100 million by end-March 2005, US$200 million by end-June 2005, US$300 million by end-September 2005, and US$400 million by end-December 2005 (Annex A defines the separate ceilings applicable for Serbia and for Montenegro). For new debt to budgetary users, the day the debt is contracted will be the relevant date for program purposes. For new debt to non-budgetary users, the day the first guarantee (whether by the Union, Serbia, or Montenegro) is signed will be the relevant date. Contracting or guaranteeing of new debt will be converted into US dollar 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.

24. **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, separately by Serbia and Montenegro, within four weeks of the end of each quarter.

I. Ceiling on the Wage Bill of Serbian Public Enterprises

25. **Definition.** For 2005, the performance criterion is set on a quarterly basis on the cumulative monthly wage bill of eight large public enterprises, namely JP Elektroprivreda Srbije, JP Naftna Industrija Srbije, JP Zeleznicko Transportno Preduzece Srbije, JP PTT Srbije, JP Srbija Sume, JP JAT Airways, JP Telekom Srbija, and JP Aerodrom Beograd. Wages are accounted on an accrual basis, excluding taxes and social security contributions, and include overtime payments and bonuses.

26. **Adjustors.** In the case of spin-offs of activities from these companies (defined as the spinning off of a unit or its transfer to another entity or temporary/permanent transfers of employees) after end-December 2004, the wage bill target will be adjusted downwards for the wage bills of spun-off units. In the case of EPS, the successor companies (according to MEFP paragraph 35, bullet two) will all be included in the wage ceiling.

27. **Reporting.** The wage bills of the eight monitored state-owned companies will be reported monthly to the European Department of the Fund and the Office of the IMF Resident Representative by the Ministry of Finance (Public Utility Restructuring Unit) with a lag of less than four weeks. Monthly data for JP Aerodrom Beograd will also be provided for the period January through December 2004.

Serbia (In SRD millions)

	2005		
	Jun	Sep	Dec
Wage Bill ceiling	15,941	24,180	32,700

J. Adjustor for Lower-Than-Targeted Severance Payments

28. Within the overall expenditure envelope of the 2005 budgets for the central government in Serbia, the Union level government, and the Serbian Transition Fund a total amount of SRD 8.2 billion is envisaged for severance payments, out of which
(a) SRD 5.0 billion related to employment reduction in the Serbian central government;
(b) SRD 2.0 billion related to employment reduction on the Union level; and
(c) SRD 1.2 billion included in the funds for the Transition Fund related to employment reduction in the eight monitored state-owned enterprises listed in paragraph 24 of the TMU. While the expenditures under (a) and (b) will be financed through general budgetary revenue, expenditures under (c) will financed through privatization receipts. To ensure that these budgetary resources can be spent only for the intended severance payments, the ceiling on net credit of the banking system to the consolidated general government (performance criterion) and on net credit of the banking system to the Serbian consolidated general government (indicative target) will be adjusted downwards for the total shortfall of the respective severance expenditures in categories (a), (b), and (c).

Serbia: Projected Cumulative Path of Redundancy Payments in 2005
in billions of SRD

	March	June	September	December
Category a	0.0	0.0	5.0	5.0
Category b	2.0	2.0	2.0	2.0
Category c	1.0	1.2	1.2	1.2
Total	3.0	3.2	8.2	8.2

K. Companies and Assets Spun-Off from State-Owned Enterprises

29. **Definition.** The companies, non-core assets, and hotels and recreational establishments of the 8 monitored state-owned enterprises referred to in the MEFP as being spun-off, registered as separate companies, and transferred to the Privatization Agency (PA) for privatization are listed in three separate groups in Attachment II. These lists are indicative, as companies from one list may be substituted for companies from the other lists. In the case of assets that do not need to be registered as separate companies for the PA to privatize them, their registration is not a condition.

30. **Reporting.** The Ministry of Economy and the Privatization Agency will report to the European Department of the Fund and the Office of the IMF Resident Representative on the progress of the actions described in the MEFP with a lag of less than one week.

L. Collection Rate Targets for EPS and NIS

31. **Definition.** The quantitative indicative targets are floors for the collection rates on current deliveries and the collection of arrears for (i) Elektroprivreda Srbije (EPS); and (ii) Naftna Industrija Srbije (NIS). Both collection rates are defined as the ratio of total cash and off-sets collection during the respective period (cumulative from the beginning of the year) from households, enterprises, and public sector entities (including collection of arrears) over the total billed amounts during the same period.

32. **Reporting.** EPS and NIS will report on a monthly basis to the European Department of the Fund and the Office of the IMF Resident Representative with a lag of less than four weeks. EPS and NIS will submit (i) total billed amounts, (ii) total cash collections, (iii) total offsets for the five groups of customers (households, companies undergoing restructuring, republican budget users, local government budget users, and other customers).

III. Other Reporting Requirements for Program Monitoring

A. Macroeconomic Monitoring Committee

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

34. The authorities will notify the European Department of the Fund of **developments on structural performance criteria and benchmarks** as soon as they occur. The authorities will provide the documentation, according to the dates in Annex 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

35. Any revision to relevant macroeconomic data will be transmitted within three weeks of the date of the revision.

Public finance

36. 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.. Privatization receipts will be reported with a breakdown according to domestic-currency proceeds and foreign-currency proceeds, as well as according to proceeds from tenders, auctions, and share fund sales.

- 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

37. 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) nonresidents, (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.

- Weekly report on NBS repo operations.

38. The balance sheet of the NBS and the consolidated balance sheets of Serbian commercial banks, as well as the balance sheet of the Central Bank of Montenegro and the consolidated balance sheets of commercial banks in Montenegro, will be transmitted on a monthly basis within three weeks after the end of each month. The stocks of government and NBS securities held by banks and by nonbanks, 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 after the end of each month. Credit to government by the banking system is provided with detailed breakdowns on the union, state, and local governments.

39. 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.

- Data on foreign borrowing by commercial banks with a breakdown according to maturities.

- Individuals' foreign exchange savings in top ten banks.

- Grants and loans disbursement as well as debt amortization and interest payments.

External data

40. 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;

- External borrowing data, with breakdown by type of creditor (corporate/banks) and debtor (official/private sector), will be provided on a monthly basis within four weeks of the end of the month;

- Detailed monthly data on the volume and prices of exports and imports, separating out imported petroleum products; and

- External debt data and debt service schedules separately for Serbia and for Montenegro, with breakdown by creditor.

- The CBM will provide quarterly updates of the Montenegro balance of payments, including projections for the current and subsequent year, while the Montenegro Ministry of Finance will provide the external debt and debt service information described above.

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.

List of Companies and Assets to be Spun-Off from State-Owned Enterprises

First Group

EPS
"Betonjerka" Aleksinac
"Izgradnja" Bajina Basta
"24. Septembar" Uzice
"Ugostiteljstvo" Lazarevac
"Sava" TENT Obrenovac
"Standard" Kostolac
"Usluge" Derdap Kladovo
"Energosoft" Novi Sad

NIS
Refinery Belgrade-lubricants line
FAM Krusevac-lubricants line
Share in FIM Kanjiza
FAM Farm

ZTP
FASO
Fersped
CIP
Business space
Storehouse space
Railway ground
Ground on total rails
Holiday houses Makarska
Holiday house Omis
Hotel in Bolu on Bracu.

JAT
Hotel Slavija
Apartments in Kopaonik
Catering company
Charter and leasing company

Airport
Airport catering
Department for sales and marketing
Parking
Cargo Department

And 3 other companies from the second or third groups

Second Group

EPS
Hotel Park-Budva
Vile hotela Park-Budva
Vila Obrenovac-Budva
Vila Morava-Budva
Vila EDB-Budva
Vikend kuca ED Kikinda-Budva
Odmaraliste TE Kolubara-Divcibare
Hotel Jezero Perucac-B. Basta
Dom odmora radnika-fruska gora,
Vila elekrodisribucija-Bulajrica
Odmaraliste Elekrodistribucija-Becici
Odmaraliste Vlasinske HE-Becici
Odmaraliste Elekrodistribucija-Donja Lastra
Odmaraliste Elekrodistribucija-Meljine
Odmaraliste Elekrodistribucija-Ulcinj
Odmaraliste ED-Vranje
Odmaraliste Elekrosrbija-Kopaonik
Vila Elekroistok-Kopaonik
Vila Zlatar-Nova Varos
Odmaraliste Zlatibor ED Uzice-Zlatibor
Odmaraliste Elekrosrbija-Vrnjacka Banja
Odmaraliste TE Morava-Kopaonik
Odmaraliste Vlasina
Odmaraliste Vila Karadzic-Arandjelovac
Vila Elektroistok-Vrnjacka Banja
Hotel Sumadija-Becici
Hotel Biserna obala-Canj
Olga Dedijer-Kopaonik
TH Borjak-Vrnjacka banja
Srebrno jezero-Veliko Gradiste
Prim
Autotransport
RIO
Security company
Georad
Univerzal
Gradevinar
Kolubara usiuge
JP Elektrosrbija-Elektromontaza
Odrzavanje
Betonjerka

NIS
Naftagas-hotels and restaurants
Energogas-hotels in Montenegro
Refinery Novi Sad-motel and restaurants
Jugopetrol-hotels on Zlatibor and Crni Vrh and restaurants
Naftagas-motels

ZTP
Fire workshop
Security Department
Building maintenance
Proinvest
Zelturist
Truck maintenance
Beogradturis
Zelnid
ZIT
Zelkomerc
Belgrade railway tie
Zelvoz
Health protection

PTT
Posturs
Ugostiteljstvo
Holiday house Petko Maljevic
Land

Forestry company
Catering
Srbijasumepromet

JAT
Aircraft maintenance

Telekom
Building maintenance
Security Department

Three of these companies will have already been spun-off as of end-June

Third Group

EPS
Metal
Juzna Backa
Javna rasveta
Izgradnja
Elektroistok-Projekt- Izgradnja
JP EPS-RU Kovin

SERBIA AND MONTENEGRO: TENTATIVE WORK PROGRAM

Staff Visit	July 2005
Sixth Review under Extended Arrangement, Mission	September 2005
Sixth Review under Extended Arrangement, Board Meeting	December 2005

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/84
FOR IMMEDIATE RELEASE
July 5, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with Serbia and Montenegro

On June 29, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Serbia and Montenegro.[1]

Background

Macroeconomic imbalances in Serbia and Montenegro have widened in 2004 putting at risk some of the impressive earlier achievements. Growth, around 5 percent in non-agriculture since 2002, has been fueled by a surge in domestic demand. Lack of competitive domestic production has led to increased imports and a widening current account deficit. Annual inflation returned to double-digit levels reflecting demand pressures and faster dinar depreciation coupled with widespread euro-indexation. The current account deficit reached 15 percent of GDP in 2004; the increase only partly explained by the value added tax (VAT) induced shift of imports in late 2004. In Montenegro, the adoption of the euro has stabilized inflation at 3–4 percent. However, a large current account deficit, financed by foreign borrowing and, in 2005 by privatization receipts, risks eroding domestic competitiveness.

The attempts to use exchange rate policy to address rising inflation or deteriorating external balances have failed due to important structural rigidities. Exchange rate depreciation led to surging inflation given the high euro-indexation of prices, and small share of competitive

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

supply, and fixing the exchange rate worsened the external balances, as a rigid spending structure limited fiscal tightening and loose wage policy boosted demand.

The fiscal stance has increasingly been tightened to strengthen demand management. The deficit declined from over 5 percent of GDP in 2002 to a projected surplus in 2005. However, the bulk of the adjustment was due to an increase in revenues, while cuts in current spending have been more limited. As a result, the revenue burden and the size of government, with expenditures at 45 percent of GDP, remain the highest in the region. Monetary policy has been accommodating, weakened by increasing euroization and complicated by a credit boom.

The slow structural reform is at the core of the macroeconomic imbalances and rigidities. With the private sector at barely half of the GDP, the competitive supply remains limited. The weak financial discipline in many of the public enterprises has reduced public savings and undermined the tight fiscal policy pursued at the central government level. Given the external financing constraint to investment, enterprise restructuring is increasingly important for growth and for the efficient reallocating resources within the economy.

The main policy challenge is to maintain macroeconomic stability while accelerating structural reform. Fiscal policy needs to be tightened substantially, and its flexibility increased by reducing the large share of non-discretionary spending. A tighter monetary policy, despite the high level of euroization, is necessary to slow down the credit boom and foreign borrowing fuelling imports. Structural reforms should be deepened through the privatization and liquidation of socially owned companies, restructuring of the state enterprises, and hardening financial discipline. The successful bank privatization should continue, with the entry of new banks boosting competition. Bank supervision is to be strengthened to deal with increased foreign currency risk and credit activity.

Executive Board Assessment

Executive Directors commended the authorities of Serbia and Montenegro for the tightening of the fiscal stance over recent years, and the decrease in inflation from triple-digits that helped create a basis for stronger GDP growth. However, Directors expressed concern over the recent widening of the macroeconomic imbalances. Despite tight fiscal policy, domestic demand has remained strong, putting pressure on inflation and the current account, as the slow pace of structural reforms continued to suppress competitive domestic supply and exports. The increased recourse to foreign debt to finance imports has heightened external vulnerabilities.

Directors stressed that structural rigidities are at the core of the macroeconomic imbalances and difficult policy dilemmas which the authorities are facing. Slow progress in addressing these rigidities has hampered productivity growth, discouraged investments, including foreign direct investment, and increased the cost of doing business. Weak financial discipline in many state- and socially-owned enterprises, together with a rigid public expenditure structure and high euroization, complicate macroeconomic management. Against the backdrop of the current imbalances, Directors stressed that using the exchange rate to bear down on inflation would need to be accompanied by a tightening of macroeconomic policies along with an acceleration of structural reforms. They were encouraged by the authorities' recent policy adjustments and commitments in this regard.

Directors welcomed the envisaged reduction in the fiscal deficit. While immediate fiscal consolidation relies on a combination of higher revenues and expenditure cuts, the challenge now is to improve the quality of fiscal adjustment. Given the high tax burden, this will need to be achieved through strong and sustained efforts to identify permanent expenditure savings and reorient spending priorities towards supporting growth. Savings should focus on reducing the high levels of nondiscretionary spending, in particular by cutting the wage bill and restoring the financial viability of the pension fund. On the revenue side, Directors encouraged further improvements in tax administration.

Directors emphasized that a further tightening of monetary policy will be needed to contain demand, in particular to curb the strong growth in credit. They welcomed the increase in the reserve requirement on foreign currency deposits of enterprises and commercial banks' foreign borrowing, and the recent significant increase in the level of repo operations to mop up dinar liquidity. Acknowledging that high and rising euroization has reduced the effectiveness of monetary policy in Serbia, Directors underlined the need to complement monetary policy tools with the continued use of prudential measures to slow credit growth and safeguard the quality of the banks' credit portfolio.

Directors highlighted the risks of using the exchange rate to anchor inflation, while, more generally, the use of the exchange rate to pursue different objectives over time was seen as weakening the credibility of economic policy. Directors noted that previous attempts to use exchange rate depreciation to reduce the external imbalances had contributed to higher inflation due to the widespread euro-indexation of prices in Serbia. While the authorities' decision to use the exchange rate to bear down on inflation is understandable, this policy has in the past also contributed to a worsening of the current account deficit. Accordingly, Directors stressed that the preference for slower depreciation would necessitate tighter fiscal, monetary, and income policies, while simultaneously accelerating structural reforms in the publicly controlled enterprise sector.

Directors welcomed the increased pace of banking sector reforms, and the authorities' commitment to follow through on the recommendations of the recent Financial Sector Assessment Program (FSAP) review. Completing the sale of the remaining state-controlled banks is a priority, and should spur competition in the sector and reduce the high spread between borrowing and lending rates. Directors emphasized the need to further strengthen banking regulation and supervision to bring them in line with international best practices. Enhancing risk management and supervisory practices will be particularly important for addressing the increasing risks and vulnerability emanating from rapid credit growth and the growing share of euro-indexed loans to unhedged borrowers.

Directors urged the authorities to continue to push ahead with the privatization and liquidation of socially-owned enterprises and with the restructuring of state-owned enterprises. In this regard, they highlighted the importance of proper legal frameworks, and supported the provision of appropriate safety nets. To strengthen financial discipline and allocate resources for increased growth, Directors stressed the need to step up the use of bankruptcy procedures against unviable socially-owned enterprises and to end the forbearance of arrears to the main utility companies, while pressing ahead with their restructuring to recover operational costs. The importance of further streamlining administrative regulations to improve the business and investment climate was also highlighted. Going forward, Directors pointed to further integration with the European Union as providing support and direction to future reform efforts.

Directors were encouraged by the recent macroeconomic developments in Montenegro, where inflation has dropped to low single digits following the adoption of the euro. However, the subdued rate of economic growth and high current account deficit remain a source of concern, and Directors urged the Montenegrin authorities to continue to press forward with structural reforms and the rationalization of public spending. The authorities should also resist pressures to use the large proceeds from privatization expected for 2005 for fiscal spending.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Serbia and Montenegro: Selected Economic and Financial Indicators, 2001–05 1/

	2001	2002	2003	2004 Est.	2005 Proj.
Real economy					
Real GDP (percent change)	5.5	3.8	2.7	7.2	4.6
Retail prices (percent, period average)	91.1	21.2	11.3	9.5	15.4
	(In percent of GDP)				
General government finances 2/					
Revenue	38.9	42.8	42.7	45.2	44.8
Expenditure	40.3	47.3	46.0	45.5	43.7
Overall balance (cash basis)	-1.4	-4.5	-3.3	-0.3	1.2
Gross debt 3/ 4/	123.2	85.4	79.2	60.2	53.1
Of which: Forex-denominated (in percent of total)	92.0	91.9	90.3	87.9	95.1
	(12-month percent change)				
Money supply (end-of-period) 3/					
Money (M1) 5/	125.2	79.8	10.9	8.0	6.9
Broad money (M2) 5/	104.9	52.7	27.5	30.3	22.4
Credit to non-government 6/	7.6	49.6	25.1	48.1	27.0
	(In percent)				
Interest rates (weighted average, end-of-period)					
Lending rate	32.5	19.2	14.8	14.6	…
Deposit rate	4.1	2.6	2.7	3.6	…
	(In billions of U.S. dollars, unless otherwise indicated)				
Balance of payments					
Current account balance, before grants	-1.1	-2.0	-2.5	-3.7	-2.9
(In percent of GDP)	-9.7	-12.9	-12.3	-15.5	-11.0
Underlying current account balance (percent of GDP) 7/	…	…	…	-13.7	-12.6
Exports of goods (f.o.b.)	2.0	2.4	3.1	4.2	5.5
Imports of goods (c.i.f.)	-4.8	-6.3	-7.9	-11.7	-12.6
Current account balance, after grants	-0.5	-1.4	-1.5	-3.1	-2.5
(In percent of GDP)	-4.6	-8.9	-7.3	-13.1	-9.5
External debt (end of period) 4/	11.9	11.8	14.3	14.9	15.2
(In percent of GDP)	103.2	76.2	69.2	62.0	57.1
Gross official reserves	1.2	2.3	3.6	4.3	5.6
(In months of prospective imports of GNFS)	2.4	3.1	3.3	3.7	4.3
Exchange rate (dinar/euro, period average)	59.7	60.7	65.1	72.6	…
REER (annual average change, in percent; – indicates depreciation) 3/	23.8	17.1	5.5	-3.5	…

Sources: Statistical Offices of Serbia and Montenegro; National Bank of Serbia; State Ministries of Finance; and IMF staff estimates and projections.

1/ Excluding Kosovo (with the exception of foreign debt).

2/ Fiscal operations of all levels of government, except for Montenegro where it excludes local governments. Frozen Foreign Currency Bond payments are recorded below the line. Data for 2004 include previously off-budget fiscal operations in Montenegro, amounting to 0.2 percent of GDP.

3/ Excluding Montenegro.

4/ Including the first phase of the Paris Club debt reduction in 2002 and implementation in 2005 of the London Club agreement.

5/ At current exchange rates.

6/ At constant exchange rates.

7/ Corrected for the surge in imports and remittances at end-2004 ahead of the introduction of the VAT in January 2005.

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fifth Review Under An Extended Arrangement With Serbia and Montenegro and Approves US$182.9 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the fifth review of Serbia and Montenegro's economic performance under an Extended Arrangement. The completion of the review enables the release of an amount equivalent to SDR 125 million (about US$182.9 million), which would bring the total disbursement under the program to SDR 587.5 million (about $US859.7 million).

The Executive Board also granted waivers for the non-observance of the continuous performance criterion on non-accumulation of new external arrears; the end-March performance criterion on outstanding external arrears; the end-December 2004 structural performance criterion concerning the Yugoslav army and union-level civil employees; and the end-February 2004 structural performance criterion on the legal registration of the new electricity transmission and dispatch company. In addition, the Board completed a Financing Assurances Review and approved a request to rephase the eleventh and final disbursement, which would become available upon the completion of the sixth review.

The Extended Arrangement was approved in May 2002 for a total amount equivalent to SDR 650 million (about US$951.1 million) to support Serbia and Montenegro's 2002-2005 economic program (see Press Release No. 02/25).

Following the Executive Board's discussion on Serbia and Montenegro, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:

"Following a mixed program implementation during the third year of their Extended Arrangement with the Fund, the authorities of Serbia and Montenegro have agreed on an appropriate set of corrective actions to deal with the growing macroeconomic imbalances. While economic growth has been commendably strong, the continued strength of domestic demand, sustained by a credit boom and inflows of remittances, as well as the constraints stemming from the high euroization and structural rigidities have contributed to a resurgence in inflation and a persistently large current account deficit. The authorities' policies of further fiscal and monetary tightening and accelerated structural reforms should help reverse the imbalances.

"The tighter fiscal stance is welcome. Following the heavy reliance in the short run on higher revenues, it will now be important to implement the cuts in permanent spending, mostly through pension reform and lower subsidies, that will help achieve a sustainable reduction in the size of the public sector.

"The envisaged monetary tightening should help contain demand and inflationary pressures. The strong pressure from recently established foreign banks competing for market shares to increase credit calls for heightened vigilance, and the authorities should stand ready to take further measures to tighten monetary conditions if needed. The privatization of the two largest state-owned banks in Serbia will be a key priority for the period ahead.

"The use of the exchange rate to bear down on inflationary pressures is understandable given those pressures and the extent of euroization. However, the approach is sustainable only in the measure in which the tightening of macroeconomic policies offsets the impact of this policy on the current account. More fundamentally, structural reforms, in particular, privatization and restructuring of publicly controlled enterprises, need to be accelerated to stimulate export growth, and enhance medium-term external sustainability. Strict enforcement of bankruptcy procedures is also needed to reallocate resources within the economy.

"In Montenegro, the implementation of the agreed reduction in the fiscal deficit of about one percent of GDP will help contain demand and the external deficit in line with the program. The large privatization revenues should be used mainly to retire domestic debt. The development of a debt and asset management strategy, strengthened revenue collection and acceleration of civil service reform will be essential to create room for additional public investment.

"Strong implementation of the envisaged policy package will be key to lowering macroeconomic imbalances, containing program risks, and boosting growth in the medium term. This will also be key to ensuring the international community's continued support for Serbia and Montenegro's adjustment and reform efforts," Mr. Kato said.

Statement by Fritz Zurbrügg, Executive Director for Serbia and Montenegro and Srboljub Antic, Senior Advisor to Executive Director June 29, 2005

We thank staff for the comprehensive set of documents that present a well-balanced picture of the economic situation in Serbia and Montenegro. The reports also spell out very clearly the important challenges the authorities continue to face. Let us state from the outset that the authorities share the staff's views in terms of the main economic problems and the basic orientation of the policy response. This is still a very delicate period in Serbia and Montenegro's transition to a full-fledged market economy. Our authorities are convinced that the macroeconomic policies contained in the Memorandum of Economic and Financial Policies (MEFP) are ambitious enough to tackle the increased vulnerabilities. The benchmark for this review has been set at a high level, including a number of prior actions and significantly strengthened structural conditionality.

It cannot be denied that there are considerable risks surrounding the current program. Our authorities are fully aware of these risks and are committed to fully implement the economic program supported by the Fund. It is important to note that the reform momentum from the second part of 2004 has remained strong in 2005. This is reflected in a decreasing current account deficit, a further strengthening of fiscal adjustment, and ongoing utility sector restructuring.

This reform momentum has received a further boost from the political side, namely through the completion of the EU's feasibility study. This signals enhanced prospects for EU accession, which establishes a clear framework for moving ahead with the reforms. The recently signed trade arrangements with the EU are another positive element, which will provide important support for the real economy. Furthermore, discussions on bilateral free trade agreements in the region are progressing well, with many of them ratified and implemented.

Recent developments

Real growth in 2004 surpassed expectations and is estimated at 7.2 percent. Agriculture and the privatized part of the industry also recorded high growth rates. The growth rate for 2005 is projected at 4.5-5 percent, simply because it will be difficult to achieve a similar bumper crop like in 2004. The weakening of the industrial production in the first quarter of 2005 remains a puzzle, since other indicators, such as exports and investment, are very positive.

The further acceleration of inflation in Serbia in 2005 is a source of concern for the authorities. While the one-off effect of the VAT introduction in January 2005 played an important role in pushing up inflation in 2004, curbing the main factor, namely high domestic demand, will be the key policy answer to curb inflation in 2005. Together with controlled increases in administrative prices, the slowing down of domestic demand should help in reaching the targeted end-2005 inflation in Serbia of 10 percent. The authorities are aware of the risks that this target could be exceeded and are ready to take the necessary corrective actions to achieve it.

After reaching its peak of 15.5 percent of GDP in 2004, the current account deficit is projected to decline to about 11 percent in 2005. Foreign trade statistics for the first four months of 2005 show a significant improvement, with exports rising at a rate of 42.6 percent, while imports declined by 11.4 percent. These foreign trade developments bode well for the staff's current account projections. In the medium term, the current account deficit is projected to continue to decline, thus contributing to external sustainability.

Fiscal policy

Fiscal adjustment in Serbia and Montenegro has been strong over the last three years, with a fiscal deficit of 3.3 percent in 2003 moving to a surplus of 1.2 percent of GDP in 2005. The authorities continue to see sound fiscal policies as a key element of their stabilization efforts. Fiscal policy will be the most important part of the policy mix that addresses inflationary pressures and the higher-than-programmed current account deficit.

In Serbia, the fiscal stance in 2005 will be further tightened. Instead of having a small fiscal deficit in 2005, as envisaged under the previous projections, the authorities will aim at a surplus of 1.2 percent of GDP. Capital and current expenditures approved in the 2005 budget will be scaled back by 0.7 percent of GDP and all revenues exceeding projections will be saved. A draft supplementary budget that will incorporate lower expenditures will be submitted to the parliament in July 2005. In the medium term, the government is committed to cut permanent expenditures further. At least 1 percent of GDP expenditure cuts will be incorporated in the 2006 budget.

The government is aware that decisive moves are needed to ensure long-term sustainability of the pension system. An inter-ministerial task force was formed to work on pension legislation with the objective to reduce the structural deficit of the pension fund over time. The task force will cover all important issues, including de-linking pensions from wages, accelerating the increase in the retirement age, and indexation frequency.

In Montenegro, further deficit reduction should strengthen the macroeconomic stability. On the expenditure side, the efforts on the civil service reform will be stepped up to reach the agreed government employment reduction. If expectations of higher than projected privatization revenues materialize, the government will reduce debt and build up reserves.

Monetary policy

The National Bank of Serbia (NBS) has been tightening monetary policy in order to contain domestic demand and inflationary pressures. The revised monetary program for 2005 projects further rising of foreign exchange reserves, which will grow to US$5.6 billion and will cover 4.3 months of imports at the end of 2005. As described in detail in the MEFP, the NBS will significantly increase the volume of repo operations to better manage market liquidity.

In order to slow down further credit growth and borrowing from abroad by banks and the private sector, the NBS increased reserve requirements from 21 to 26 percent on foreign currency deposits. To curb rising euroization, reserve requirements on dinar deposits were slightly lowered.

The role of the exchange rate policy has been constrained by the high and recently growing euroization, which has strengthened the pass-through effect. As in the past, the authorities will continue to use the exchange rate policy to balance the objectives of reducing inflation and curbing the current account deficit. Against the background of a recent inflation surge, the exchange rate policy will be used to increase confidence in the dinar. The authorities will frequently assess the exchange rate policy in light of developments in inflation, current account, and wages.

Structural policies

The acceleration of structural reforms is a key element in the authorities' efforts to reduce the macroeconomic imbalances. After gaining momentum in the second half of 2004, privatization and restructuring of the so-called socially owned enterprises continues in 2005. The authorities' intention is to offer all socially owned companies for sale until the end of 2006 through auctions, tenders or share sale on the stock exchange. A debt workout scheme, that will make write-offs of debt conditional upon privatization, is being introduced to help privatize large enterprises. The authorities are also moving ahead with an effective bankruptcy procedure that will strengthen financial discipline. The bankruptcy process will become fully operational in the beginning of the third quarter 2005. In April, the government initiated the bankruptcy procedure under the new regulation against three large and heavily indebted loss makers to give credibility to the new bankruptcy legislation. Other creditors followed this approach and have initiated many bankruptcy proceedings.

As outlined in paragraphs 42-43 of the MEFP, the restructuring of public utilities will continue through combined measures that introduce competition and improve efficiency by imposing hard budget constraints through subsidy cuts and strict wage controls. An independent energy regulator started to operate at the end of May 2005. The unbundling process of the electric power company will be started with the creation of two companies (generation and distribution company, and grid company) and is covered under the program with a structural performance criterion. As regards the unbundling of the oil and gas company, the authorities expect the enabling legislation to be passed by parliament in July 2005 (also a structural performance criterion). Furthermore, an international tender will be launched for hiring an advisor for the privatization of the oil and gas company.

Conclusion

The authorities of Serbia and Montenegro are fully aware of the difficult challenges they currently face. Responding to the slower-than-expected reaction of macroeconomic indicators to the measures taken in the second half of 2004, they have further tightened economic policies and strengthened the structural reform program. They are committed to this program and are grateful for the Fund's support. The authorities also remain fully committed to transparency in the relations with the Fund and consent to the publication of all staff documents.