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# Republic of Serbia: 2006 Article IV Consultation and Post-Program Monitoring Discussions—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Serbia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation and post-program monitoring discussion with the Republic of Serbia, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 27, 2006, with the officials of Serbia and Montenegro on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 10, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff supplement of October 13, 2006 updating information on recent developments;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 18, 2006 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Executive Director for the Republic of Serbia.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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REPUBLIC OF SERBIA

# Staff Report for the 2006 Article IV Consultation and Post-Program Monitoring Discussions

Prepared by the Staff Representatives for the 2006 Consultation with Serbia

Approved by Juha Kähkönen and Michael Hadjimichael

August 10, 2006

- **Discussions** took place in Belgrade June 14–27, 2006. The mission met with the Deputy Prime Minister, the ministers of economy, finance, labor, energy, and agriculture, the governor of the National Bank of Serbia (NBS), other key government and NBS officials, and representatives of the private sector, public enterprises, trade unions, and think tanks.
- The **staff team** comprised Messrs. Doyle (head), Mottu, Westphal, Mirzoev (all EUR), Sdralevich (PDR), Hayward (consultant, MFD), and Ms. Ivanova (FAD), and was assisted by Mr. Hirschhofer (Resident Representative) and Mr. Guzijan and Ms. Nestorović from the resident office. Mr. Antić (OED) attended most policy meetings. The mission coordinated closely with World Bank staff (Appendix IV) and held a press conference.
- **Serbia continues the membership in the Fund of the state union of Serbia and Montenegro.** Following Montenegrin independence, Serbia was determined to be the continuing state of the former union of Serbia and Montenegro. The economic consequences for Serbia are minimal.
- **Fund relations.** The last Article IV consultation was concluded on June 29, 2005. The sixth and final review of the 2002–06 Extended Arrangement (EA) was completed on February 6, 2006, with Serbia and Montenegro having drawn SDR 650 million (139 percent of quota). In June, Serbia repurchased SDR 162.5 million, reducing Fund credit to SDR 487.5 million, or 104 percent of quota. Serbia is subject to post-program monitoring (PPM) since the completion of the EA (Appendix I).
- **2005 Article IV consultation.** Directors' views may be found at http://www.imf.org/external/ np/sec/pn/2005/pn0584.htm.
- **Article VIII.** Serbia has accepted the obligations of Article VIII and maintains a system free of restrictions on payments and transfers for current international transactions. The exchange rate regime is a managed float.
- **Statistics.** Serbia's economic data are broadly adequate for surveillance purposes (Appendix V).

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## Executive Summary

**After two decades of decline, post 2000 reforms have turned Serbia around.** But the difficult legacies of earlier policies remain, reflected in poor employment, inflation, and external performance—and associated considerable vulnerabilities. Nevertheless, capital inflows have been and remain strong, overwhelming a strong—notably fiscal—policy response. Thus, the current account deficit, over 10 percent of GDP, has barely budged in four years despite fiscal consolidation of 5½ percentage points of GDP, multiple macro-prudential measures, and fx-intervention to contain appreciation. Large external deficits have also unsettled the focus of monetary and exchange rate policies—which has alternated between disinflation and external objectives.

**Failed corporate structures lie at the heart of Serbia's economic difficulties.** Weak governance—most notably in socially owned and state-owned enterprises—are reflected in sizeable corporate losses of the non-financial sector. By draining domestic savings, they are at the core of Serbia's external deficits while also curbing investment and employment growth.

**But the authorities emphasized instead the need for public investment and labor tax cuts.** Seeing imbalances as normal transition strains rather than binding constraints on performance, they plan an immediate sizeable fiscal relaxation—with key details still being prepared—along with labor tax cuts. Corporate reforms beyond those already in process and early reductions in inflation and the current account deficit are further down the priority list.

**This complicates welcome steps recently taken by the central bank to increase exchange rate flexibility.** Prior arrangements had struck an unsatisfactory balance between internal and external goals, ultimately securing neither. And given high pass-through rates and effective repo operations, monetary policy can be effective against inflation through the exchange rate, despite extensive financial euroization. But a major weakening of fiscal policy could call external sustainability and pursuit of ambitious disinflation into question.

**In this context, staff suggested**: (i) renewed efforts on privatization and bankruptcies, to invigorate corporate activity; (ii) initiatives to strengthen banking supervision and reduce excess returns in banking to help curb credit excesses; (iii) pending reflection of reinvigorated corporate reforms in the external balance, continued fiscal restraint; and (iv) in this context, purposeful disinflation and elaboration of recent exchange regime reforms anticipating eventual fully fledged inflation targeting. But if fiscal support is not forthcoming, then immediate disinflation ambitions may be beyond reach.

# I. Background

1. **Serbia is growing.** After two decades of stagnation and decline at the end of the last century, output is up 40 percent from 2000. Furthermore, some 60 percent of non-budget non-agricultural employment is now in the private sector, almost double the share five years ago (Text Table 1). A tough and extensive reform agenda—including stabilization after 2000, banking sector restructuring, introduction of VAT in 2005, and privatization of hundreds of firms—has reversed a long decline.

Text Table 1. Serbia: Employment by Ownership

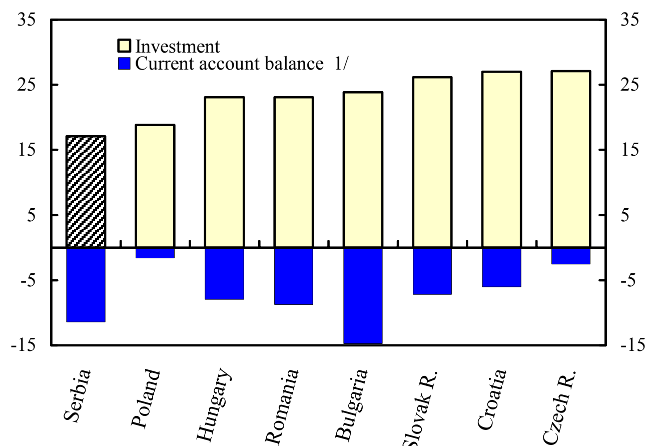
| | 2001 (Sept.) | 2006 (April) |
|---|---|---|
| (In percent of total) | | |
| General government | 12 | 12 |
| Private sector | 45 | 60 |
| Others 1/ | 43 | 28 |
| (In percent of non-agriculture non-general government) | | |
| Private (non-agriculture) sector | 32 | 57 |

Source: Statistics Office.

1/ State, socially, and mixed-owned enterprises.

2. **The legacy of two decades of decline is not readily reversed, however.** Since 2000, official data report consistent declines in employment, unemployment is close to 21 percent and still rising, headline inflation has only briefly dipped below the mid-teens, and almost half the CPI remains subject to official controls. And fixed investment remains below 20 percent of GDP, well under transition country norms (Text Figure 1, Text Table 2). But even so, the external current account deficit has remained in double digits, keeping external debt above 60 percent of GDP despite Paris and London club debt write downs. And widespread financial euroization—the euro denomination or indexation of over ¾ of bank credit and almost all household deposits—is symptomatic of persistent skepticism about inflationary and broader economic prospects, giving rise to large corporate and household forex exposures (Figures 1–3, Tables 1–4).

Text Figure 1. Investment and External Deficits, 2005
(In percent of GDP)




Source: IMF Staff Reports.
1/ Including grants. VAT-adjusted for Serbia.

Text Table 2. Serbia
Savings-Investment Balances
(In percent of GDP)

| | 2005 |
|---|---|
| Investment | 18.2 |
| Foreign savings | 9.8 |
| National savings | 8.4 |
| General government | 3.5 |
| Non-government | 4.9 |
| *Of which:* domestic | -9.1 |

Sources: Serbian authorities; and Fund staff estimates.

3. **Corporate reforms are the key challenge remaining from the pre-2000 period.** Weak governance—including social ownership, under which the workers manage and retain all profits from firms, but the state has sole rights to sell the firms—is reflected in corporate losses reportedly exceeding profits by 2 percent of GDP in 2005 for the non-financial sectors of the economy (Table 5, Text Table 3). Though this represents an improvement from 2004,

Text Table 3. Serbia: Profit and Losses of Non-Financial Enterprises, 2004-05

| | Profit-making Enterprises | | Loss-making Enterprises | | Net | |
|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2004 | 2005 | 2004 | 2005 |
| | (In percent of GDP) | | | | | |
| Private | 4.9 | 8.1 | -2.4 | -4.8 | 2.5 | 3.2 |
| Non-private | 3.5 | 3.1 | -10.6 | -8.4 | -7.1 | -5.3 |
| State-owned | 0.7 | 1.7 | -2.4 | -2.5 | -1.6 | -0.8 |
| Socially owned | 0.4 | 0.3 | -3.7 | -2.3 | -3.3 | -2.0 |
| Mixed ownership | 2.3 | 1.0 | -4.5 | -3.4 | -2.2 | -2.4 |
| Other | 0.1 | 0.1 | -0.1 | -0.2 | 0.0 | -0.1 |
| Total | 8.5 | 11.1 | -13.0 | -13.2 | -4.6 | -2.1 |

Source: Solvency Center.

the state, socially owned, and mixed enterprises continue to report dire results, and even private sector loss-makers show a sizeable deterioration in 2005. These losses, which partly reflect the extensive remaining official controls on output prices, are largely financed by depreciation and debt service and wage arrears—some 10–15 percent of accrued non-budget wages are unpaid in a typical month. By draining domestic savings, they are at the core of Serbia's external deficits, while also curbing investment and jobs. And they cast a shadow over competitiveness (Box 1).

4. **But capital inflows have been strong, these difficulties notwithstanding.** They reflected a mix of privatization receipts, external borrowing by private corporates, reintermediation—including of mattress cash—following the entry of foreign banks, and parent bank funding for subsidiaries to take advantage of high banking spreads. In this context, though intermediation remains low by regional standards, bank credit has risen over 12 percentage points of GDP in three years (Figure 2). This boom compounded the pressures on the external current account emanating from corporate weaknesses and low household savings rates.

**Box 1. Competitiveness**

**Since 2001, exports have grown strongly from a low base and gained market share (Text Table).**

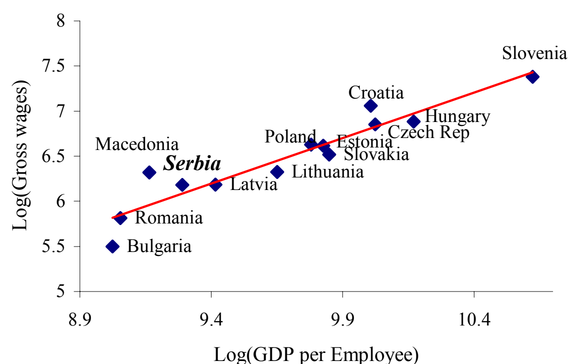
Merchandise Exports

| | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|
| Share of Serbia's exports in total world imports (2001=100) | 100 | 121 | 160 | 205 | 265 |
| Share of Serbia's exports in total EU imports (2001=100) | 100 | 112 | 115 | 155 | 184 |
| Share of exports in GDP (in percent) | 16.2 | 14.5 | 14.5 | 15.7 | 18.6 |

Source: National Authorities and IMF *Direction of Trade.*

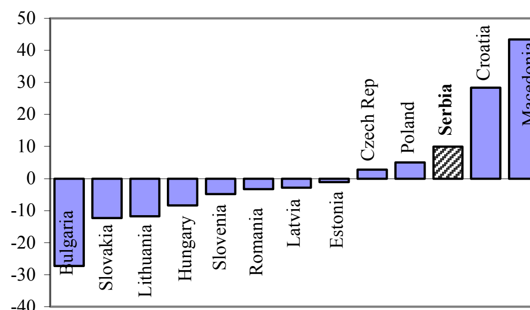
**But exports remain low relative to GDP and their growth reflects activity in just a few sectors and the rebound from the 1999 crisis, with competitiveness problems preventing much broader realization of potential.** With enterprises reporting heavy aggregate losses, competitiveness is in doubt. Furthermore, total labor costs (including employers' contributions) are as much as 10 percent higher than regional productivity-adjusted norms (Text Figures). And those norms are themselves doubtful—with high persistent unemployment and external deficits alongside lackluster investment ratios possibly suggestive of region-wide competitiveness difficulties.

Text Figure: Gross Monthly Wages and GDP per Employee, 2004




Source: Staff estimates.

Text Figure. Deviation of Actual Observation from Fitted Line in Previous Figure, 2004 (in percent)




**Manufacturing ULC data suggest that Serbian traded sector profitability deteriorated further in 2005 and early 2006, even if economy-wide profitabality improved.** Despite labor shedding, weak manufacturing growth and large wage rises boosted unit and relative unit labor costs (Text Tables). In this context, a further compression of manufacturing profitability—reflected in producer prices falling relative to ULCs—was the quid pro quo for a modest strengthening of competitiveness in goods markets, as signaled by the CPI-based REER, in 2004–05—which was subsequently reversed in early 2006 (Figure 4).

Components of Unit Labor Cost in Manufacturing, 2001=100

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006m4 |
|---|---|---|---|---|---|---|
| PPI | 100 | 111 | 117 | 128 | 145 | 159 |
| Production | 100 | 101 | 98 | 105 | 106 | 101 |
| Wages (net) | 100 | 150 | 176 | 216 | 273 | 310 |
| Employment | 100 | 92 | 85 | 78 | 74 | 70 |
| PPI/ULC | 100 | 81 | 77 | 80 | 76 | 73 |

Sources: Statistics Office; and Fund staff estimates.

Real Effective Exchange Rate (2001=100)

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006m4 |
|---|---|---|---|---|---|---|
| REER (CPI-based) | 100 | 117 | 124 | 120 | 120 | 122 |
| REER (ULC-based) | 100 | 133 | 142 | 136 | 141 | ... |

Sources: Serbian authorities; and Fund staff estimates.

5. **The inflows overwhelmed a strong—notably fiscal—response.** Given domestic supply rigidities, demand quickly spilled into imports, with, more recently, international oil prices compounding these effects (Text Table 4). Thus, the VAT-adjusted current account[1] has barely budged in four years despite strong exports, fiscal consolidation of 5½ percentage points of GDP, a string of macro-prudential monetary measures, and heavy central bank intervention taking import cover to about 6½ months (Box 2). Though the latter allowed early repurchase of outstanding Fund resources—a quarter completed in June 2006 with a further quarter penciled in for the fall—external objectives remained compromised (Tables 6–13).

Text Table 4. Serbia: Macroeconomic Indicators, 2001-05
Adjusted for the VAT Introduction in January 2005 1/

| | 2001 | 2002 | 2003 | 2004 | 2005 Prel. |
|---|---|---|---|---|---|
| Real GDP growth (in percent) | 5.1 | 4.5 | 2.4 | 8.9 | 6.9 |
| Current account balance (in percent of GDP) | ... | -13.0 | -11.8 | -13.0 | -12.8 |
| RPI Inflation (end of period, in percent) | 40.7 | 14.8 | 7.6 | 13.7 | 16.1 |
| Fiscal balance (in percent of GDP) | -1.0 | -4.6 | -3.2 | -0.2 | 1.0 |

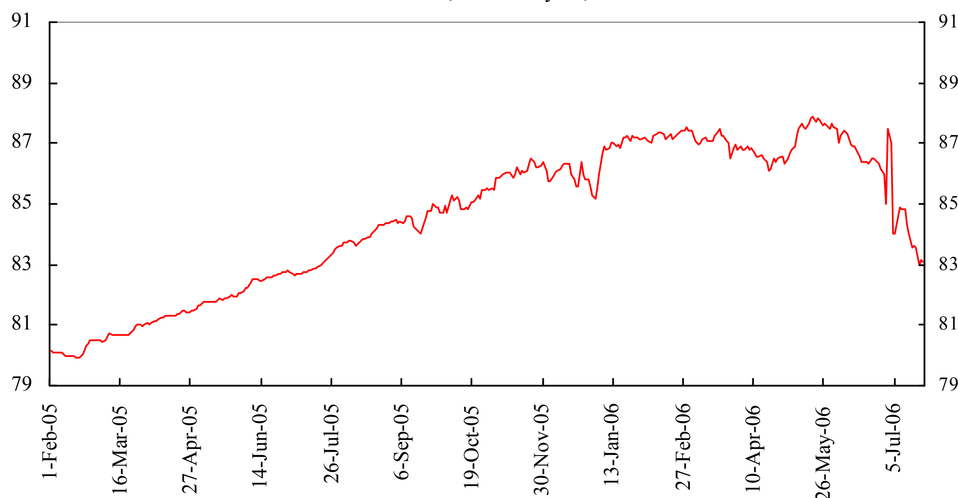
Sources: Serbian authorities; and Fund staff estimates.

6. **This unsettled the focus of monetary and exchange rate policy.** Despite fiscal support and rapid exchange rate pass through—up to 0.9 within a year for core inflation—efforts to secure disinflation via the exchange rate anchor after 2001 typically ran into external current account and debt concerns.[2] Thus, the announced fixed band to the euro which anchored the 2001–02 stabilization shifted into a regime accommodating steady depreciation with minimal volatility—albeit interrupted by political uncertainties during 2003—with the rate of depreciation sometimes leading and at other times lagging inflation outturns. Subsequently around February 2006, faced with increasing sterilization costs, the NBS announced and accommodated greater volatility in the exchange rate, in which context the dinar appreciated (Text Figure 2).

[1] This reports the current account balance corrected for imports and activity brought forward to Q4 2004 in anticipation of VAT introduction in January 2005. Other macro variables are similarly corrected.

[2] IMF Country Report 05/232, Chapter IV.

Text Figure 2. Serbia: Exchange Rate Dinar/Euro
Feb 01, 2005 - July 21, 2006




7. **The authorities aimed for external consolidation in 2006.** To this end, in the sixth review of the EA, they anticipated significant fiscal consolidation to a surplus, on IMF definitions, of 2¾ percent of GDP, to be secured by employment rationalization and reduced subsidies, allowing for a modest increase in public investment (Text Table 5). Given continued credit growth, this was projected to support a reduction in the VAT-adjusted current account deficit of about 2 percentage points of GDP, and help lower headline inflation to 9–11 percent by end-2006. Additional support would be provided by increased reserve requirements and modest regulated price rises (Box 2).

Text Table 5. Serbia: PPM Framework, 2005–06

| | 2005 Actual | 2006 PPM 1/ |
|---|---|---|
| | (In percent of GDP) | |
| General government fiscal balance | 0.8 | 2.7 |
| Current account balance (underlying) 2/ | -12.8 | -10.8 |
| | (Annual change in percent) | |
| Real GDP | 6.3 | 5.0 |
| Retail price inflation (end of period) | 17.7 | 11.5 |
| *Of which:* Core inflation | 12.7 | 9.5 |
| Credit to non-government (end of period) | 57.0 | 33.7 |

Sources: National authorities; and Fund staff estimates.

1/ Announced during the final review of the EA in Feb. 2006.
2/ Corrected for the impact of the VAT introduction in 2005. Excluding grants.

### Box 2. Response to IMF Advice

**After the 2000-01 hyperinflation, the Extended Arrangement (EA) anticipated disinflation, growth, and reduced external deficits.** The program initially aimed at disinflation through a quasi-peg, and increased public investment and privatization. But partly reflecting unexpectedly strong capital inflows, the initial inflation and external targets were missed, despite multiple policy adjustments (Text Table).

Performance under the EA, 2002–05 1/
(In percent of GDP, unless otherwise indicated)

| | 2002 | 2005 | Change |
|---|---|---|---|
| Inflation (in percent) | | | |
| 2002 Program | 20.7 | 7.3 | -13.4 |
| Outcome | 14.8 | 17.7 | 2.9 |
| Growth (in percent) | | | Average |
| 2002 Program | 4.0 | 5.0 | 4.8 |
| Outcome | 4.5 | 6.3 | 5.6 |
| Capital account | | | Cumulative |
| 2002 Program | 6.1 | 4.7 | 19.3 |
| Outcome | 11.9 | 19.8 | 58.1 |
| Current account (excl. VAT impact) | | | |
| 2002 Program | -12.8 | -8.8 | 4.0 |
| Outcome | -13.0 | -12.8 | 0.2 |
| Fiscal balance | | | |
| 2002 Program | -5.7 | -4.2 | 1.5 |
| Outcome | -4.6 | 0.8 | 5.4 |
| Gross official reserves (US$ billion) | | | |
| 2002 Program | 1.6 | 2.9 | 1.3 |
| Outcome | 2.3 | 5.8 | 3.6 |

Sources: Fund Staff Reports; and staff estimates.

1/ Figures for Serbia underlying the S&M program targets.

**Response to Fund advice in the 2005 Article IV consultation was mixed.** Some fiscal consolidation was achieved (0.8 percent of GDP) in 2005, although somewhat less than targeted, through permanent cuts in subsidies and transfers, and despite an increase in the wage bill as a share in GDP. Further fiscal effort was planned for 2006. With capital inflows a continuing challenge, the brisk growth of credit continued despite many prudential measures and a sizeable increase in the repo rate in early 2006. The call to reconsider the exchange rate regime was heeded with the regime shift initiated in Q1 2006 anticipating more exchange rate flexibility.

**Banking regulation was strengthened.** The new banking law brought legislation in line with Basel Core Principles, but effective implementation remains an issue. Five state-controlled banks were sold since end-2004 and two further sales are expected by end-2006.

**Structural reforms have lagged.** Privatization of socially owned enterprises has advanced, but the most difficult cases—including utilities—remain. While the 2004 bankruptcy law provides a sound legal basis, it remains little used, including by official creditors.

8. **Demand growth has remained strong so far this year.** Though interrupted gas imports followed by flooding dented activity in the early part of the year, exports, credit growth, and imports remained buoyant—the latter reflected in external debt rising to 61½ percent of GDP in May (Text Table 6). Headline inflation was boosted by energy—due to international price developments—and other administered price hikes to over 16 percent, while core inflation, at around 10 percent, has slowed modestly, partly in response to the strength of the dinar relative to its earlier trend since February. Meanwhile, activity was reflected in strong non-tax and income tax collections, which kept the general government fiscal balance broadly on track with PPM objectives in H1, despite some weaknesses in VAT and overruns in central government and pension fund expenditure. Spreads on Serbia widened since the spring, somewhat more than was the case for other emerging markets.

Text Table 6. Serbia: Selected Economic Indicators, 2005-06
(change over the previous quarter, seasonally adjusted, in percent)

| | 2005 | | | | 2006 | |
|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q to May |
| Retail sales (at constant prices) | 11.4 | 11.3 | -0.1 | 5.3 | -1.6 | -0.3 |
| Imports (in euro) 1/ | -7.1 | 5.5 | 7.4 | -0.7 | 1.1 | 6.7 |
| Gross domestic product (GDP) | -1.9 | 2.1 | 2.7 | 2.9 | -1.3 | ... |
| Industrial production | -4.6 | 1.6 | 4.4 | 2.1 | -2.9 | 0.9 |
| Retail price inflation 1/ | 4.6 | 3.4 | 3.4 | 4.0 | 3.3 | 4.0 2/ |
| *of which:* core inflation 1/ | 4.4 | 3.0 | 1.8 | 2.7 | 2.8 | 2.7 2/ |
| Average wages, net (nominal) | 6.2 | 8.7 | 4.4 | 4.2 | 7.7 | 4.9 |
| Credit to non-government | 12.6 | 10.1 | 9.3 | 14.8 | 13.8 | 11.6 |

Sources: Statistics Office, NBS; and Fund staff estimates.

1/ Adjusted for the impact of the VAT introduction in January 2005.
2/ Quarter to June.

9. **Political pressures are high.** Although Montenegro's independence passed without incident, challenging economic reforms, cooperation with the Hague tribunal, and the Kosovo status talks are on the immediate agenda. The opposition parties and—according to opinion polls—much of the general public strongly oppose all three. With the multi-party coalition itself divided on these matters and already lacking a parliamentary majority, it may have difficulty serving out its term to elections due in the fall of 2007.

## II. Report on the Discussions

10. **Since 2000, economic growth has been high but unbalanced.** Growth rates averaging 5½ percent have been accompanied by low investment, employment, and exports relative to activity, while inflation, financial euroization, credit and external deficits and debt have been high. Staff noted that these immediate vulnerabilities, and the associated shifting focus for monetary and exchange rate policy, call into question prospects for maintaining stability and sustaining growth.

11. **The authorities were nevertheless confident of prospects.** In their view, past reforms would continue to support exports and yield sustained job-rich growth rising to 7 percent. And though mindful of the imbalances, the authorities saw these as reflecting the pre-2000 legacy and normal transition strains, rather than as binding constraints on growth. Of greater concern were infrastructural bottlenecks—reflecting inadequate public investment over the past 20 years—and the burden of taxation on labor. Thus, the authorities saw need and scope—given large one-off privatization and other receipts—for immediate relaxation of the fiscal stance to allow public investment and labor tax cuts. These initiatives took precedence in their policy agenda over corporate reforms beyond those already planned and early reductions in core inflation and the external current account deficit.

12. **In this light—and to focus the consultation—discussions concentrated on sustainability and sequencing.** In particular, four inter-related issues were central**:**

- Have corporate, labor, and trade reforms gone far enough?
- How should capital inflows and associated financial sector vulnerabilities be managed?
- What should anchor fiscal policy?
- How can the competing objectives for monetary and exchange rate policy be reconciled?

### A. Corporate, Labor, and Trade Policies

13. **The authorities regard privatization as well on the way to completion**. With over 30 tenders outstanding, a record in Serbia, and multiple auctions underway, all remaining socially owned enterprises will be offered for sale by mid-2007. Alongside, state holdings in "mixed"—part state, part private—firms will be sold, including on the stock exchange. And on corporate restructuring more broadly, the adoption of a strong bankruptcy law in 2004—which emphasizes creditor rights and procedural deadlines—has laid the basis for effective bankruptcy procedures. Staff agreed that progress in these areas has been reflected in strong growth.

14. **But the critical cases have been left till last.** Staff noted that relatively healthy firms were offered for sale first, implying that past ownership restructuring was to some extent of form rather than of substance. Thus, large state-owned enterprises remain, despite some restructuring, with—apart from oil—no firm plans for sales at this stage. Further, the authorities agreed that notwithstanding data quality issues highlighted in the draft accounting and auditing ROSC, remaining state- and socially owned firms continue to make heavy losses—reflected in the external current account deficit. With the business environment continuing to discourage investors, staff observed that increased incidence of failed tenders was likely (Text Table 7). In this context, the deep reluctance to initiate bankruptcies—reflected in the low number of bankruptcy cases initiated by official creditors—would become a key impediment to further corporate restructuring, a view endorsed by the IBRD. And if so, associated aspirations to raise investment and employment, liberalize a greater share of consumer prices, and secure external sustainability would be compromised.[3]

Text Table 7. Serbia: Business and Competitiveness Indicators, 2005 Rankings

| World Bank Doing Business | | WEF Growth Competitiveness | | WEF Business Competitveness | | ICRG Institutional Quality | |
|---|---|---|---|---|---|---|---|
| Slovak Republic | 37 | Slovenia | 32 | Czech Republic | 27 | Slovenia | 36 |
| Czech Republic | 41 | Czech Republic | 38 | Slovenia | 32 | Czech Republic | 39 |
| Hungary | 52 | Hungary | 39 | Hungary | 34 | Poland | 49 |
| Poland | 54 | Slovak Republic | 41 | Slovak Republic | 39 | Hungary | 56 |
| Bulgaria | 62 | Poland | 51 | Poland | 42 | Croatia | 57 |
| Slovenia | 63 | Bulgaria | 58 | Croatia | 63 | Slovak Republic | 57 |
| Romania | 78 | Croatia | 62 | Romania | 67 | Bulgaria | 68 |
| Macedonia, FYR | 81 | Romania | 67 | Bulgaria | 78 | Romania | 73 |
| Bosnia and Herzegovina | 87 | **Serbia and Montenegro** | **80** | Macedonia, FYR | 83 | **Serbia and Montenegro** | **130** |
| **Serbia and Montenegro** | **92** | Macedonia, FYR | 85 | **Serbia and Montenegro** | **86** | Macedonia, FYR | - |
| Croatia | 118 | Bosnia and Herzegovina | 95 | Bosnia and Herzegovina | 94 | Bosnia and Herzegovina | - |
| | | | | | | | |
| FYR Countries Average | 88.2 | | 64.8 | | 71.6 | | 74.3 |
| EU Average | 32 | | 25 | | 23 | | 25.8 |

Sources: *Doing Business* database, World Bank 2005, *Global Competitiveness Report 2005-2006*, World Economic Forum (WEF), *Monthly International Country Risk Guide* (ICRG), April 2006.

15. **This poses difficult dilemmas.** The authorities emphasized, on the one hand, that if failed tenders lead to bankruptcies, then the consequent further loss of jobs would exacerbate unemployment—which is already high and rising. On the other hand, they accepted that if many firms continue as is, despite the fundamental inefficiencies revealed by tender failures, the associated macroeconomic imbalances would persist. Consequently, plans focus on reinforcing sale attempts. Write-offs of debts to the budget, utilities, and social security funds will be offered contingent on successful sales. And healthy parts of firms will be "spun off" for sale free of debts to domestic official creditors. In addition, a "two strike" approach—whereby a firm is automatically put into bankruptcy after two failed tenders—has been

[3] This draws on analysis in Selected Issues Chapter II, which sets Serbia's investment patterns in a broader transition area context.

considered. But it has not been adopted in light of concerns with employment and administrative delays in the courts. It is therefore unclear what the fate of such firms will be.

16. **The oil sector illustrates the trade offs.** A longstanding ban on imports of processed fuels has been reflected in refinery and distribution inefficiencies. This compounded the burden on the economy of high international oil prices—which by virtue of the administrative formula controlling domestic fuel prices are regularly passed on to consumers to preserve high refinery margins. But to shield refining jobs and boost prospective proceeds from oil privatization, the import ban had recently been extended to 2010. And sale of a minority stake—with management control—in the refineries, integrated with their distribution network, was anticipated for the fall. In light of concerns, echoed by staff, that creation of a private monopoly would compromise efficiency gains from privatization, the authorities recently announced conversion of the import ban into a declining tariff schedule to 2012, consistent with EU and WTO principles. But, against staff suggestions, further steps in this direction—to sell the refineries separately from their distribution network, to sell majority stakes in both, to shorten the tariff horizon, all of which would lower refinery margins and remove need to administer fuel prices—have been ruled out by the authorities: the first, because it compromises privatization prospects unduly; the second, because it boosts them too much; and the third, because competitive pressures would be too strong for the domestic refineries.

17. **Labor institutions may complicate the challenges.** The 2005 Labor Law raised severance payments, non-wage benefits, experience pay, added further steps to lay-off procedures, and set a 12-month non-renewable limit on fixed-term appointments. The authorities considered that these steps had reflected EU guidelines, and that inefficient corporate structures and excess labor taxation rather than labor institutions explained disappointing employment performance. Nevertheless, in view of the latter, redeployment services are being strengthened, including to secure better skill matches. Staff welcomed the latter steps and the implicit recognition of need for further corporate restructuring. But in that light, and given considerable inherited wage setting rigidities, they suggested that the flexibility of labor market institutions warranted further review.[4]

18. **Oil and agriculture aside, the trade regime is broadly appropriate.** The top tariff and weighted average rates are 30 and 7 percent respectively, tariff structures are relatively stable, and quotas are absent—so that world and domestic relative prices for tradable goods are largely aligned. But 22 lines (including metals) are subject to export duties, licenses are applied on sensitive products, refined oil imports have until now been banned, and agriculture is significantly protected. Access to the EU and to regional neighbors is on a preferential basis. Staff welcomed intentions to phase out export duties and encouraged

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[4] Options to stimulate employment are discussed in Selected Issues Chapter III.

further liberalization including in the context of negotiations for a new trading relationship with Montenegro, a Western Balkan Free Trade Agreement, and steps to WTO membership—anticipated for 2007.

## B. Capital Flows and the Financial Sector

19. **Despite political and reform uncertainties, capital inflows have been strong.** The capital account surplus averaged 15 percentage points of GDP between 2002–05. Greenfield FDI and portfolio flows have been negligible, however, the former primarily reflecting business environment concerns, and the latter the limited development of capital markets (Text Table 8). The authorities noted that the low post-2000 economic base, the ability of creditors (of all kinds) to hedge against inflation risk through acquisition of real assets and euro indexation, and the considerable cumulative—if sometimes interrupted—reform efforts had provided sufficient prospective returns to draw many investors in, despite political and other uncertainties.

Text Table 8. Serbia: Composition of the capital account, 2004–06
(In percent of GDP)

| | 2004 | 2005 | 2006 Q1 |
|---|---|---|---|
| **Capital account balance** | 13.7 | 19.8 | 4.7 |
| **1. Debt creating flows** | 8.9 | 11.1 | 2.5 |
| *Of which:* | | | |
| **Medium- to long-term borrowing, net** | 6.9 | 9.3 | 1.6 |
| *(By borrower)* | | | |
| Public sector | 1.3 | 1.0 | 0.3 |
| Private sector | 5.6 | 8.3 | 1.3 |
| Banks | 2.4 | 3.6 | 0.6 |
| Corporate sector | 3.3 | 4.7 | 0.7 |
| **Short term debt, net** | 2.0 | 1.8 | 0.9 |
| **2. Non-debt creating flows** | 4.7 | 8.7 | 2.2 |
| Foreign direct investment | 4.3 | 6.5 | 0.8 |

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

20. **The outlook was more qualified, however.** In the near future, Kosovo and electoral issues risk inducing a significant loss of confidence and a reversal of capital inflows. But even if this was avoided, the flow of high net worth privatization assets was slowing, with the large telecom license receipt due in 2006 also non-recurring. And absent a further reform effort, greenfield FDI would continue to disappoint. Furthermore, Serbia had been affected, even somewhat disproportionately, by international capital market reassessments of emerging market risk since the spring, and the authorities agreed that the trend in private external debt—up 6 percentage points of GDP since 2002—would, if continued, dampen creditor appetite for Serbia risk at some point, possibly even suddenly. If so, the shock could be sharp given forex exposures and the large gross financing requirements.

21. **And there may be need to slow banking inflows in light of consumer protection and macro concerns.** In this regard, the authorities emphasized that despite the recent establishment of a credit bureau, pledge registry, and legislation enhancing creditor rights over collateral, effective arbitrage by borrowers between banks remains blunted. In particular, the complexity of fee structures and foreign currency clauses in loans—and the consequent obscurity to all but the most sophisticated borrowers of the associated forex exposures—impeded effective side-by-side comparisons of loan offers by banks. Reducing these transactions costs and related information asymmetries between banks and borrowers via strengthened consumer protection would better discipline borrowing decisions. This, in

turn, would slow credit and support the external balance. Staff agreed, adding that interbank competition would be further stimulated if banking licenses were again to be made available to greenfield banking investors (subject to appropriate "fit and proper" requirements) and that were banks to overcome their reluctance to press claims on past due debts in the courts, borrowing decisions would be disciplined further.

22. **Prudential indicators underscore the case for caution.** Staff noted the high share of non-performing loans in total lending, and that they were rising steeply among the foreign banks that had spearheaded the credit boom in recent years (Text Table 9).

Text Table 9. Serbia: NPL Ratios 1/

| | NPL Ratios | | | NPLs minus Provisions to Capital | | | Share in Credit |
|---|---|---|---|---|---|---|---|
| | Dec. 04 | Dec. 05 | Mar. 06 | Dec. 04 | Dec. 05 | Mar. 06 | Mar. 06 |
| State-controlled banks | 41.2 | 37.7 | 25.0 | 41.8 | 39.8 | 35.3 | 20.7 |
| Domestic private banks | 46.6 | 51.8 | 49.7 | 42.4 | 53.6 | 58.9 | 8.3 |
| Foreign banks | 10.0 | 16.0 | 16.1 | 25.8 | 46.4 | 48.7 | 71.0 |
| Total | 22.2 | 23.8 | 20.7 | 33.7 | 46.2 | 47.4 | 100.0 |

1/ Ownership structure as of March 2006; NPLs comprise loans in categories C, D, and E, with provisioning requirements amounting to 25 percent, 50 percent, and 100 percent, respectively.

Though some of this increase reflected a strengthening of classification procedures, the authorities recognized that credit risks were rising, while also underscoring that the prudential framework had been strengthened by adoption of the 2005 banking law (Box 3). Staff welcomed the latter and the authorities' intention to introduce risk-weights for unhedged borrowing from end-September. But in view of the associated increased implementation challenges, efforts to ensure a high quality cadre of supervisors would need to continue, including via a review of their conditions of employment. However, banks queried prudential and macro concerns with credit growth. They suggested instead that competition along with increased reserve requirements and their non-remuneration has excessively squeezed margins, notwithstanding generous reported returns on equity in private banks to end-2005 and continued rapid credit growth in 2006 (Text Table 10).

Text Table 10. Serbia: Indicators of Profitability in the Banking System 1/

| | Return on Assets 1/ | | | Return on Equity 1/ | | |
|---|---|---|---|---|---|---|
| | Dec. 04 | Dec. 05 | Dec. 05 adj. 2/ | Dec. 04 | Dec. 05 | Dec. 05 adj. 2/ |
| State-controlled banks | -4.8 | 0.2 | -2.6 | -27.6 | 1.2 | -15.5 |
| Domestic private banks | 6.1 | 6.9 | 9.0 | 14.4 | 18.6 | 24.2 |
| Foreign banks | -0.3 | 0.4 | 2.3 | -2.2 | 3.4 | 17.3 |
| total | -1.0 | 0.9 | 1.7 | -5.2 | 5.9 | 10.6 |

1/ Ownership structure as of March 2006.
2/ Calculated based on earnings before increase in provisioning during 2005.

**Box 3: Status of Implementation of FSAP Recommendations**[5]

**With 80 percent of all loans either forex-denominated or indexed, the main concerns highlighted in the FSSA were indirect credit risk and shortfalls relative to Basel Core Principles (BCPs)** (IMF Country Report No. 06/96).

**The banking law in November 2005** aligned key regulatory matters with the BCPs, including by introducing consolidated banking supervision and rendering banks' boards responsible for applying integrated risk management systems. One key state-owned bank is about to be sold, and the EBRD recently acquired a controlling minority stake in the other.

**Implementation and the transition to risk-based supervision remains ahead, however:**

- Regulations on indirect credit risk require borrowers forex exposure to be reflected in loan classification, but compliance often appears to be pro forma;
- Regulators cannot adequately monitor forex hedging by borrowers;
- A NBS decision in respect of consolidated supervision remains outstanding;
- The shift from compliance- to risk-based supervision requires establishment of clear guidance for supervisors about how to measure adherence; and
- Despite progress, regulatory forbearance remains an issue.

## C. Fiscal Policy

23. **The authorities regarded a balanced budget as appropriate for Serbia.** In particular, notwithstanding external imbalances and other uncertainties, the "common sense" in this goal would underpin public confidence in budgets—and hence the broader macro framework. In this light, they felt that the surpluses originally anticipated in the 2006 budget (2¾ percent of GDP) and projected for 2007 and beyond in the Extended Arrangement unduly constrained fiscal options and were "unrealistic." Thus, proposing to account one-off mobile phone license receipts of 1.6 percent of GDP in 2006 as revenue, they saw scope to raise spending compared to the adopted 2006 budget by 2½ percentage points of GDP (Text Table 11). They emphasized that given its funding by license receipts, this additional fiscal activity in 2006 would not be debt creating and that, on their definitions, the budget outturn would still be in significant surplus. On staff fiscal definitions for general government (which place the license receipts below the line), the proposals implied a fiscal deficit for 2006 of ½ of one percent of GDP, weaker by some 3 percentage points of GDP than anticipated, and representing a relaxation of 1½ percentage points of GDP from 2005.

[5] Selected Issues Chapter IV discusses recent financial sector developments and the implementation of policy recommendations of the 2005 FSAP.

Text Table 11. Serbia: General Government Operations, 2005–06
(In percent of GDP)

| | 2005 | 2006 | | |
|---|---|---|---|---|
| | Actual | PPM/Budget | Authorities' policies | |
| | | 1/ | 1/ | 2/ |
| Revenue | 45.2 | 45.1 | 44.3 | 45.8 |
| *Of Which:* telecom license | 0 | 0 | 0 | 1.5 |
| Expenditure | 44.4 | 42.5 | 44.9 | 44.9 |
| *Of Which:* investment program | 0 | 0 | 1.7 | 1.7 |
| **Overall Balance** | **0.8** | **2.7** | **-0.6** | **1.0** |
| *Of Which:* financed by license | 0 | 0 | 1.5 | 0 |

Sources: Ministry of Finance; Fund staff estimates.

1/ IMF staff accounting standards.
2/ Authorities' accounting standards.

24. **This would pave the way for additional public investment and labor tax cuts.** A five year public investment envelope, summing to at least 4½ percent of 2006 GDP, had been announced, to commence disbursements in the latter part of 2006, and the general public had been invited to suggest projects to absorb the resources. Amongst a great many proposals, priority would be given to a ring-road for Belgrade, computers for schools, and hospital construction. In addition, and outside this investment envelope and budget parameters, a highway connected to the pan-European network—Corridor 10 which the authorities hoped would be associated with a further Paris Club debt write-down—would be built, with various private-public partnerships (PPP) on other infrastructural projects also envisaged. And with the labor tax-and-contribution wedge at over 40 percent of gross remuneration, the personal income tax rate would be lowered from January 2007 from 14 to 12 percent and a basic exemption introduced—implying a permanent revenue loss of at least 1½ percentage points of GDP. Alongside, relief from personal income tax and employer social security payments will be provided for up to three years for recently unemployed recruits (the disabled, and those below 30 and above 45 years old).

25. **Staff urged caution.** The aversion to raising the tax burden in general, and the aim to shift towards indirect taxation, were both appropriate given overall tax ratios approaching 45 percent of GDP, the labor tax wedge, and the adverse tax compliance environment. But concerns remained, including with fiscal sustainability, even with the earlier envisaged path for the fiscal balance (Appendix II). Although those fiscal surpluses implied continued declines in public debt ratios, the authorities' fiscal accounting practices overlooked quasi-fiscal losses in the corporate sector, overstating the strength of fiscal balances considerably. Furthermore, enumeration of the potentially large fiscal costs arising from the decision to fill gaps in pension contribution histories since the early 1990s—caused by employer non-payment—remained outstanding. Determination of the use of one-off privatization and license receipts would be premature ahead of that information. And new spending of a

recurring nature—such as wages, where increases in one period also impact subsequent periods—would complicate fiscal options once the anticipated one-off receipts funding it are exhausted. But even aside from all these concerns, given ample scope for efficiencies in public spending—notably in transfers, the public wage bill, and enterprise subsidies, accounting for 17, 11, and 3 percent of GDP respectively—there appeared little need to fund public investment by weakening budget balances in the manner envisaged.

26. **Furthermore, external vulnerabilities could be aggravated.** Troubling external debt prospects, notably in the face of shocks, could be compounded by the envisaged fiscal relaxation (Appendix III). First, only part of the envisaged investment projects would be non-debt financed, with other parts funded by official creditors and, indirectly, via the PPP arrangements. Second, given the focus of the new spending on the non-traded sector (construction), its envisaged front-loading could drive up non-traded prices—thereby compromising competitiveness and therefore external debt objectives—and reduce project real returns. And, more immediately, a significant reversal of the direction of fiscal policy could, given weakening sentiment towards emerging markets and Kosovo challenges ahead, undermine confidence markedly. While acknowledging fatigue with persistent fiscal frugality and the evident need for public investment, staff emphasized that the underlying constraint lay in untapped current spending efficiencies and the broader challenge of low domestic savings—the fruit of weak corporate structures and the patterns of capital inflows. Until these matters were resolved, options for public investment and the fiscal balance would remain constrained by need to boost domestic savings. And only once they were addressed would it be prudent to re-anchor fiscal policy to fiscal rather than external sustainability concerns—thereby accommodating a fiscal relaxation. In view of these fiscal and external risks, staff suggested that the originally agreed PPM fiscal surplus of 2¾ percent of GDP remained the best balance between the various concerns. The authorities were not persuaded to change their plans.

### D. The Monetary and Exchange Rate Framework

27. **The central bank has moved towards greater exchange rate flexibility.** Finding, in the face of strong capital inflows, that their attempt to tighten monetary conditions from late 2005 with a 500bp increase in repo rates was exacting excessive sterilization costs, the monetary authorities opted in early 2006 to shift towards greater flexibility, anticipating an eventual float. This action also recognized, more fundamentally, that earlier exchange rate arrangements had struck an unsatisfactory balance between internal and external goals, ultimately securing neither. This left skepticism about inflationary prospects and the associated preference for financial euroization—the legacy of two bouts of hyperinflation in recent memory—unaddressed. The appreciation of the dinar, subsequent to the policy change, signaled a positive market response with, even by June, the first dividends evident in some moderation in monthly core and PPI inflation.

28. **This shift, on balance, has merit.** Certainly, fixity would seem warranted given high rates of euroization, exchange rate pass-through, trade openness, trade focus on the euro area, and the prevalence of monetary over real shocks. But the high share of primary commodities in exports, the volume of capital flows, fiscal rigidities, and prospects—including continued strong credit growth, corporate restructuring, and shocks from a troubled neighborhood—all point the other way.[6] And though either kind of regime can in principle operate effectively with appropriately supportive policies, a float is less costly when policy support is inadequate—particularly if financial regulators and borrowers manage forex exposures with appropriate diligence. The fiscal authorities had been inclined to endorse a shift towards flexibility only once the corporate reform agenda had been completed by end 2007. But they were persuaded that with political uncertainties high in the immediate future and—given unfettered financial euroization—the capital accounts de facto open, the early shift had appropriately diminished risk of an attack on the dinar.

29. **Repo operations provide the necessary instrument.** The impact of the hike in repo rates on the dinar from Q4 2005—albeit boosted in March when bank equity was declared ineligible to meet bank forex exposure regulations, and offset by continued official forex intervention—herald the potency of this tool. Accordingly, staff welcomed measures supportive of the repo already underway. These include scaling back forex intervention further—by progressively reducing the preferential rates offered by the NBS to the foreign exchange bureaus, anticipating transition to a "leaning against the wind" role for intervention—and encouraging competition between banks so as to strengthen further the role of the repo in influencing dinar banking interest rates.[7] With the repo thus shifting to center stage in dinar markets, reserve requirements on forex liabilities would continue to play a supportive role to contain overall—including euro indexed and denominated—credit developments and the external balance, supporting fiscal efforts to these ends.

30. **A new nominal anchor was needed—anticipating eventual inflation targeting.** The high share of administered in overall consumer prices and some uncertainties about inflation determinants counseled against premature adoption of formal "targets" for inflation. This would risk target misses due to developments outside NBS control, putting its credibility—and that of the new framework—in jeopardy. Instead, staff suggested that the NBS could adopt "objectives" defined on core inflation, expressed as a range, initially for 2006–07, but with the projection horizon extended every six months or so. Alongside, the Ministry of Finance could issue projections for administered prices, coordinated with the

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[6] This draws on Selected Issues Chapter V, which provides a fuller assessment of the implications of the structure of the Serbian economy for the choice of the exchange rate regime.

[7] Selected Issues Chapter VI discusses the implications of the shift in monetary arrangements for money market and intervention mechanisms.

NBS. With efforts underway to strengthen research capacity, the inflation range could be redefined into formal "targets," once experience is gained with the new framework. Other elements of a full-fledged inflation targeting framework—formal forecasting models, transparency, decision making procedures within the central bank, final determination of institutional responsibility to set the inflation target, and better data—could be developed over time. And as prices are increasingly liberalized in the process of corporate restructuring, the NBS would progressively become responsible for a greater share of overall inflation developments.[8] The authorities welcomed these suggestions.

31. **The ambition for early disinflation should, however, be carefully weighed.** Staff underscored that inflation in Serbia, which is regionally high, hinders efforts to raise investment and employment because it is a prominent signal of macroeconomic disorder. Thus, it is a significant concern. Furthermore, worries that disinflation achieved through appreciation could compromise competitiveness are attenuated by the high pass-through rates to core inflation. But staff acknowledged that even those modest and temporary competitiveness losses might be inappropriate if fiscal policies are unduly expansionary—given the combined effects of both policies on external deficits. In this light, the NBS would best carefully weigh fiscal prospects when determining its ambitions for the pace of disinflation. Subject to that qualification, and with core inflation running at monthly annualized rates of 7–9 percent, staff suggested that the NBS could announce an inflation "objective" range of 7–10 percent for 2006, declining to 4–7 percent for 2007. And staff emphasized that administered price increases should not be delayed by concerns with headline inflation targets lest the consequent additional corporate losses aggravate external imbalances further.

## E. Outlook for 2006–07

32. **A current account deterioration is likely in 2006–07 if the authorities proceed with their current fiscal plans.** While they have yet to determine the pace at which the multiyear investment program will be implemented, significant spending is anticipated in Q4 2006 and is likely to impact the current account deficit rapidly—raising it towards 14 percent of GDP depending on the pace of budget disbursements. With the authorities' plans yet to be determined, Text Table 12 presents an illustrative scenario reflecting the general flavor of their intentions, including the prospective PIT reforms. In the main, even assuming no loss of confidence from the envisaged fiscal relaxation, staff estimates the direct beneficial impact on growth to be small, given offsets from the expected real appreciation. The planned PPP projects for 2007, not reflected in the illustrative scenario, would take the budget—and hence the current account—further into deficit unless all these fiscal initiatives are offset by reductions in other expenditure.

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[8] Selected Issues Chapter VII outlines lessons for Serbia from other emerging market inflation targeters, discusses the composition of the CPI, and surveys the literature on the exchange rate pass-through for Serbia.

Text Table 12. Serbia: Illustrative Scenario, 2005–07

| | 2005 | 2006 | 2007 |
|---|---|---|---|
| | (In percent of GDP) | | |
| General government fiscal balance | 0.8 | -0.6 | -2.1 |
| Current account balance (underlying) 1/ | -12.8 | -14.0 | -15.4 |
| | (Annual change in percent) | | |
| Real GDP | 6.3 | 5.7 | 5.5 |
| Retail price inflation (end of period) | 17.7 | 12.0 | 8.1 |
| *Of which:* Core inflation | 12.7 | 8.0 | 5.5 |
| Credit to non-government (end of period) | 57.0 | 44.2 | ... |

Source: Fund staff estimates and projections.

1/ Corrected for the impact of the VAT introduction in 2005.

Excluding grants.

33. **This implies that PPM objectives for 2006 would be missed.** Policies envisaged at the time of the final review of the EA have been observed so far, and the associated macroeconomic objectives met (¶7, Text Table 5). Rationalization in the army and health sectors is proceeding as scheduled, and subsidies have been reduced as expected. But the investment program and other adjustments, which are planned to be incorporated in the supplementary budget in the fall, will set budget parameters adrift from earlier objectives.

34. **In addition, the costs of disinflation could be raised.** Notwithstanding non-debt financing and the recent strength of the dinar, to the extent that the fiscal initiatives permanently raise budget spending or non-tradeable prices, they further weaken medium-term external sustainability. This could put goals for core inflation, such as those in Text Table 12, beyond reach. In this light, the determination of specific core inflation goals for the next 18 months should be made in light of a detailed assessment of the fiscal authorities' plans for 2006-07.

35. **Strong structural and fiscal policies would provide a more secure platform for medium-term performance.** In staff's view, given past corporate restructuring, some strengthening in non-government savings is likely in the medium-term, and will be available to finance some increases in fixed capital formation, with associated rapid export growth. But given that the most difficult corporate restructuring challenges remain, this scenario would require maintenance of strong fiscal balances—surpluses of some 3 percent of GDP—if external deficits are to moderate (Tables 2 & 3). This framework would also support sustained disinflation. And with the boost to growth from sustained policy stability offsetting the drag as the post-2000 rebound draws to a close, growth would remain around 5 percent. But much better still would be a policy scenario based on decisive resolution of the remaining corporate restructuring challenges. This would set the stage for medium-term growth to approach the authorities' aspirations of 7 percent. And by stimulating domestic savings strongly, it would allow moderation in the external deficit alongside higher private investment and a less stringent fiscal stance.

## III. Staff Appraisal

36. **After two decades of decline to 2000, GDP has risen strongly.** This reflects the natural rebound following the 2001 stabilization, and a significant—if sometimes interrupted—cumulative fiscal and structural reform effort. Much is going well.

37. **But the legacies of earlier policies still weigh heavily—with failed corporate structures the most troublesome.** Just as these structures—compounded by earlier conflict and policy instability—drained domestic savings and economic vitality for two decades, so, completion of the post-2000 privatization and other corporate reform programs—and policy stability—remain essential to boost savings and restore economic health. And while weak corporate structures remain, competitiveness is in significant doubt.

38. **Difficult measures—notably bankruptcies—need to be taken.** Though many tough tasks have been largely completed, including bank restructuring, the more healthy firms were privatized first. The substantial remaining socially and state–owned firms incur heavy losses, absorb considerable subsidies, and accrue wage arrears. There is little option but to put them up for sale, with bankruptcy a swift consequence if buyers prove elusive. Until the taboo on bankruptcy is broken, these firms threaten the sustainability of growth. Broader business climate, labor, and trade arrangements—including for oil—should support restructuring, with aspirations for employment emphasizing job creation over job preservation.

39. **Capital inflows pose additional challenges.** With bank intermediation still regionally low, persistent further deposit and credit expansion is likely, with attendant risks to credit quality and the external deficit. Banks' continued appetite to lend suggests that total anticipated returns remain attractive, notwithstanding their concerns with unremunerated reserve requirements. Policy actions already taken to strengthen competitive forces on banks including establishment of the credit registry could be complemented by recommencing issuance of licenses to greenfield banks. By securing efficient spreads, such steps may encourage greater attentiveness by banks to macroeconomic and indirect credit risks. Alongside, supervision should continue to strengthen, notably via ensuring capacity of regulators to implement the improved regulatory framework effectively.

40. **External concerns leave little room for fiscal maneuver.** External debt is high, its private component is growing fast, and patterns of financial euroization imply significant forex exposures. Only once corporate reforms and credit deceleration are reflected in the current account balance may scope be created to allow the fiscal stance to be re-anchored from external to fiscal sustainability—thereby accommodating some fiscal relaxation. Until then, pending corporate and credit reform, sizeable budget surpluses remain a recommendation of last resort, with external vulnerabilities and immediate political uncertainties underscoring the limited scope for fiscal risks. In that light, the budget parameters anticipated under the EA—a surplus of 2½ percent of GDP (on IMF fiscal definitions)—remain appropriate.

41. **This puts the focus on public expenditure reform.** Ambitions to raise real public spending within fiscal balance targets would best be secured by economic growth—and growth of tax revenues—via corporate and other reforms, not by raising tax ratios. Until then, there is ample scope to curb current spending, including transfers. These actions would create room within appropriate fiscal balance targets for long overdue increases in public investment, including on roads and the social infrastructure.

42. **Alongside, a renewed assault on inflation would support restructuring.** By signaling strengthened policies, disinflation would encourage investment, thereby supporting job creation. And given high pass-through rates, the nominal exchange rate cannot play a sustained role in addressing Serbia's real effective exchange rate overvaluation and broader competitiveness difficulties. But if the fiscal stance goes badly awry, progress on disinflation could be put beyond reach.

43. **Recent changes in monetary arrangements are appropriate.** The repo has proven its effectiveness as a monetary policy instrument and greater exchange rate flexibility has been announced and realized. If forex intervention is scaled back further, the repo will become more potent still. Given high pass-through rates, monetary policy can be effective in combating inflation via its effect on the exchange rate, notwithstanding persistent financial euroization.

44. **These steps would best be taken further—towards inflation targeting.** The central bank could publicly adopt "objectives" for core inflation in the form of a range, extending this projection horizon every six months or so, with the Ministry of Finance engaging in similar exercises with respect to administered prices. Once experience is gained and research capacity built, the inflation range "objectives" could be reformulated as formal "targets" alongside other steps completing the process towards full-fledged inflation targeting. And as corporate restructuring reduces the share of administered prices in the CPI, the central bank will progressively become responsible for a greater share of CPI developments. And in support of these initiatives, fiscal and data transparency are priority areas for standards assessments. Though these exchange and monetary regime initiatives by themselves are no panacea, they will facilitate economic management.

45. **However, the envisaged fiscal relaxation calls much of this into question.** A fiscal balance outturn for 2006 as much as 3 percentage points adrift of recommendations is in prospect. And if the personal tax reforms and investment projects proceed in 2007 without offsetting spending cuts, then further fiscal slippage will occur. Though the proposed additional investment spending is only partly debt financed, it will, if implemented fully, significantly impact the current account deficit. Its unintended side effects will include loss of competitiveness via the impact on non-tradable prices, waste, delays to disinflation and the associated job creating effects, and risks to general investor confidence—the latter a particular concern given balance sheet fragilities. And PPM undertakings—on track so far—

would not be observed. Instead, critical public investment should proceed, carefully phased, funded in large part by efficiencies in public spending.

46. **After two decades of disappointment, Serbia has made significant progress in recent years.** The triple challenge ahead—on the economy, on cooperation with the Hague tribunal, and on Kosovo—would test the mettle of the boldest administration. That said, were the authorities to baulk now in the face of testing economic challenges and let up on the fiscal side, much of Serbia's hard won economic progress would be put in jeopardy.

47. Should the further early repurchase of outstanding Fund credit, which would reduce use below 100 percent of quota, go ahead as planned, continuation of PPM for a year—though not required—would be recommended in view of Serbia's external vulnerabilities. It is also recommended that the next Article IV consultation be held on the standard 12-month cycle

Table 1. Serbia: Selected Economic and Financial Indicators, 2003–07 1/

| | 2003 | 2004 | 2005 | | 2006 | | 2007 |
|---|---|---|---|---|---|---|---|
| | | | 6th Review | Est. | Proposed | Alternative | Proj. |
| | (Change in percent, unless otherwise indicated) | | | | | | |
| Real economy | | | | | | | |
| Real GDP | 2.4 | 9.3 | 4.8 | 6.3 | 5.5 | 5.7 | 5.0 |
| *Of which:* Non-agriculture | 4.0 | 7.9 | 6.8 | 8.2 | 6.6 | 6.8 | 5.9 |
| Industrial production (period average) | -3.0 | 7.1 | 0.0 | 0.8 | 2.0 | 2.0 | 2.0 |
| Retail prices (period average) | 11.7 | 10.1 | 17.3 | 17.3 | 14.3 | 14.3 | 9.7 |
| (end of period) | 7.6 | 13.7 | 17.7 | 17.7 | 12.0 | 12.0 | 8.1 |
| Real wage (period average) | 13.7 | 10.5 | 4.4 | 6.5 | … | … | … |
| Average net wage (in euros per month) | 177 | 194 | 207 | 210 | … | … | … |
| Unemployment rate (in percent) 2/ | 14.6 | 18.5 | … | 20.8 | … | … | … |
| GDP per capita (U.S. dollars) | 2,525 | 2,973 | 3,140 | 3,171 | 3,642 | … | 4,079 |
| | (In percent of GDP) | | | | | | |
| General government finances | | | | | | | |
| Revenue | 43.5 | 45.2 | 44.8 | 45.2 | 44.3 | 44.3 | 44.3 |
| Expenditure | 46.7 | 45.3 | 43.6 | 44.4 | 41.6 | 44.9 | 41.3 |
| Overall balance (cash basis) | -3.2 | 0.0 | 1.2 | 0.8 | 2.6 | -0.6 | 3.0 |
| Financing | 3.2 | 0.0 | -1.2 | -0.8 | -2.6 | 0.6 | -3.0 |
| Foreign grants | 0.2 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Foreign loans (net) | 1.2 | 0.9 | 0.7 | 0.8 | 0.3 | 0.5 | 0.0 |
| Privatization receipts | 4.5 | 0.6 | 3.2 | 2.6 | 6.8 | 6.8 | 1.0 |
| Domestic financing (net, incl. discrepancy) | -2.7 | -1.5 | -5.1 | -4.2 | -9.7 | -6.7 | -4.1 |
| Gross debt | 79.9 | 68.9 | 52.1 | 61.2 | 47.9 | 51.0 | 39.9 |
| *Of which:* Forex-denominated (in percent of total) | 87.7 | 85.7 | 87.7 | 87.9 | 87.0 | 87.2 | 90.1 |
| | (12-month change, in percent) | | | | | | |
| Monetary sector (end-of-period) | | | | | | | |
| Money (M1) | 10.9 | 8.0 | 23.7 | 30.9 | 20.4 | 20.4 | … |
| Broad money (M2) 3/ | 27.5 | 30.3 | 38.9 | 43.5 | 32.8 | 32.8 | … |
| Credit to non-government | 25.1 | 47.9 | 62.6 | 57.0 | 44.2 | 44.2 | … |
| | (In percent) | | | | | | |
| Interest rates (weighted average, end of period) | | | | | | | |
| NBS bills / Repo rate | 10.6 | 16.3 | 15.9 4/ | 19.2 | … | … | … |
| Deposit rate | 2.7 | 3.7 | 3.8 4/ | 3.7 | … | … | … |
| | (In percent of GDP, unless otherwise indicated) | | | | | | |
| Balance of payments | | | | | | | |
| Current account balance, before grants | -11.8 | -14.8 | -10.0 | -11.2 | -11.0 | -14.0 | -10.6 |
| Underlying current account balance 5/ | … | -13.0 | -11.6 | -12.8 | -11.0 | -14.0 | … |
| Exports of goods (f.o.b.) | 16.6 | 18.2 | 21.1 | 20.7 | 21.4 | 21.0 | 22.7 |
| (Percent change in volume) | 14.3 | 18.3 | 22.4 | 18.9 | 21.5 | 19.4 | 17.9 |
| Imports of goods (c.i.f.) | 39.7 | 48.5 | 45.1 | 44.1 | 43.0 | 45.0 | 43.3 |
| (Percent change in volume) | 24.2 | 32.0 | -2.4 | -5.3 | 14.3 | 19.9 | 12.2 |
| Underlying imports of goods (c.i.f.) 5/ | … | 45.4 | 48.0 | 47.1 | 43.0 | 45.0 | … |
| (Percent change in volume) | … | 23.3 | 11.3 | 8.3 | 7.1 | 12.4 | … |
| Trade balance | -23.1 | -30.3 | -23.9 | -23.4 | -21.6 | -24.0 | -20.7 |
| Remittances, net | 11.3 | 14.7 | 14.8 | 13.5 | 12.1 | 12.0 | 11.4 |
| Current account balance, after grants | -9.3 | -12.6 | -8.6 | -9.8 | -10.0 | -13.0 | -9.9 |
| Foreign direct investment | 7.2 | 4.3 | 7.4 | 6.5 | 9.3 | 8.6 | 6.2 |
| Foreign loans, net | 4.1 | 8.9 | 7.9 | 11.1 | 11.2 | 13.2 | 3.9 |
| External debt (end of period; billions of U.S. dollars) | 13.6 | 14.1 | 15.5 | 15.5 | 17.3 | 17.8 | 18.4 |
| (In percent of GDP) | 71.4 | 62.8 | 64.0 | 64.4 | 62.6 | 64.5 | 59.4 |
| Gross official reserves (in billions of U.S. dollars) | 3.6 | 4.2 | 5.7 | 5.8 | 9.7 | 9.3 | 10.0 |
| (In months of prospective imports of GNFS) | 3.6 | 4.2 | 4.9 | 5.2 | 7.7 | 7.4 | 7.3 |
| Exchange rate (dinar/euro, period average) | 65.1 | 72.6 | … | 82.9 | … | … | … |
| REER (annual average change, in percent; – indicates depreciation) | 5.4 | -3.5 | -2.7 | -2.6 | … | … | … |

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

1/ Excluding Kosovo (with the exception of external debt).
2/ Break in series in 2004, when it becomes consistent with Eurostat/ILO definition.
3/ Excluding frozen foreign currency deposits.
4/ November 2005.
5/ Corrected for the surge in imports and remittances at end-2004 ahead of the introduction of the VAT in January 2005.

Table 2. Serbia: Balance of Payments, 2003–11

(In millions of U.S. dollars, unless otherwise indicated)

| | 2003 | 2004 | 2005 | 2006 | | | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Est. | 6th Review 1/ | Proposed | Alternative | | | Proj. | | |
| **Trade balance** | **-4,391** | **-6,801** | **-5,625** | **-6,098** | **-5,959** | **-6,630** | **-6,407** | **-6,508** | **-6,572** | **-6,481** | **-6,406** |
| *(In percent of GDP)* | -23.1 | -30.3 | -23.4 | -24.6 | -21.6 | -24.0 | -20.7 | -19.5 | -18.3 | -16.8 | -15.4 |
| Trade balance, corrected for VAT effect 2/ | n.a. | -6,101 | -6,325 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| (In percent of GDP) | n.a. | -27.2 | -26.4 | n.a. | n.a. | n.a. | ... | ... | ... | ... | ... |
| Exports f.o.b. | 3,150 | 4,082 | 4,970 | 6,123 | 5,915 | 5,815 | 7,032 | 8,321 | 9,503 | 10,848 | 12,274 |
| (Percent growth) | 30.1 | 29.6 | 21.7 | 19.8 | 19.0 | 17.0 | 18.9 | 18.3 | 14.2 | 14.1 | 13.1 |
| (Percent growth in euro) | 15.1 | 18.0 | 20.7 | 23.3 | 24.6 | 22.5 | 20.2 | 18.0 | 14.0 | 14.0 | 13.0 |
| Imports c.i.f. | -7,541 | -10,883 | -10,594 | -12,221 | -11,874 | -12,446 | -13,439 | -14,829 | -16,075 | -17,329 | -18,681 |
| (Percent growth) | 32.4 | 44.3 | -2.7 | 12.2 | 12.1 | 17.5 | 13.2 | 10.3 | 8.4 | 7.8 | 7.8 |
| (Percent growth in euro) | 24.8 | 31.4 | -3.5 | 15.7 | 17.4 | 23.0 | 14.5 | 10.0 | 8.2 | 7.8 | 7.8 |
| Imports corrected for VAT effect 2/ | n.a. | -10,183 | -11,294 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| (Percent growth) | n.a. | 35.0 | 10.9 | 8.2 | 5.1 | 10.2 | ... | ... | ... | ... | ... |
| (Percent growth in euro) | n.a. | 22.8 | 10.1 | 13.3 | 10.1 | 15.4 | ... | ... | ... | ... | ... |
| **Services (non-factor services, net)** | **209** | **424** | **117** | **320** | **246** | **152** | **313** | **370** | **369** | **416** | **476** |
| Receipts | 1,022 | 1,471 | 1,639 | 1,977 | 1,819 | 1,770 | 1,995 | 2,095 | 2,106 | 2,306 | 2,513 |
| Expenditure | -813 | -1,047 | -1,522 | -1,656 | -1,573 | -1,618 | -1,683 | -1,725 | -1,737 | -1,890 | -2,037 |
| **Net factor income** | **-209** | **-241** | **-408** | **-616** | **-681** | **-691** | **-706** | **-821** | **-954** | **-1,093** | **-1,145** |
| *Of which:* Net interest | -209 | -241 | -408 | **-616** | -681 | -691 | -706 | -821 | -954 | -1,093 | -1,145 |
| Earnings | 69 | 80 | 98 | 124 | 133 | 133 | 203 | 203 | 215 | 221 | 227 |
| Payments 3/ | -278 | -321 | -506 | -740 | -813 | -824 | -909 | -1,024 | -1,169 | -1,315 | -1,373 |
| **Unrequited private and official transfers, net** | **2,628** | **3,794** | **3,564** | 3,711 | **3,399** | **3,351** | **3,523** | **3,699** | **3,810** | **3,848** | **3,887** |
| **Private remittances, net** | **2,152** | **3,290** | 3,234 | **3,711** | **3,355** | **3,307** | **3,523** | **3,699** | **3,810** | **3,848** | **3,887** |
| Inflows | 2,560 | 3,863 | ... | ... | 4,252 | ... | ... | | | | |
| Outflows | -408 | -573 | ... | ... | -978 | ... | ... | | | | |
| **Current account balance, before grants** | **-2,238** | **-3,329** | **-2,681** | **-2,683** | **-3,038** | **-3,863** | **-3,278** | **-3,259** | **-3,347** | **-3,310** | **-3,189** |
| (In percent of GDP) | -11.8 | -14.8 | -11.2 | **-10.8** | -11.0 | -14.0 | -10.6 | -9.8 | -9.3 | -8.6 | -7.7 |
| **C.A. balance, b. grants, corrected for VAT effect** | ... | -2,929 | -3,081 | ... | ... | ... | ... | ... | ... | ... | ... |
| (In percent of GDP) | ... | -13.0 | -12.8 | ... | ... | ... | ... | ... | ... | ... | ... |
| Official grants 4/ | 476 | 504 | 330 | 0 | 44 | 44 | 0 | 0 | 0 | 0 | 0 |
| Foreign direct investment, net | 1,360 | 966 | 1,550 | 1,711 | 2,869 | 2,683 | 1,914 | 2,067 | 2,212 | 2,322 | 2,439 |
| Capital transfers | | 0 | 0 | 0 | 411 | 411 | 0 | 0 | 0 | 0 | 0 |
| Foreign loans, net | 780 | 2,005 | 2,660 | 1,461 | 3,112 | 3,666 | 1,214 | 1,156 | 1,173 | 1,005 | 716 |
| Medium and long term, net | 714 | 1,556 | 2,221 | 1,261 | 2,717 | 3,071 | 1,014 | 956 | 973 | 805 | 516 |
| Disbursements | 918 | 1,933 | 2,763 | 2,352 | 3,755 | 4,109 | 3,010 | 3,400 | 4,800 | 5,220 | 5,280 |
| Of *which* : Official creditors 4/ | 328 | 468 | 481 | 482 | 515 | 815 | 300 | 200 | 200 | 200 | 200 |
| Amortization | -204 | -377 | -542 | -1,091 | -1,038 | -1,038 | -1,996 | -2,444 | -3,827 | -4,415 | -4,764 |
| Short term, net | 66 | 449 | 439 | 200 | 395 | 595 | 200 | 200 | 200 | 200 | 200 |
| Other capital inflows | 280 | 51 | 423 | 250 | 393 | 443 | 250 | 200 | 200 | 200 | 200 |
| Commercial banks, net | -9 | 46 | 126 | 0 | 324 | 324 | 0 | 0 | 0 | 0 | 0 |
| **Capital account balance** | **2,411** | **3,068** | **4,759** | **3,423** | **7,109** | **7,527** | **3,378** | **3,423** | **3,585** | **3,527** | **3,355** |
| Errors and omissions 5/ | 286 | 378 | -868 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **Overall balance** | **935** | **621** | **1,540** | **741** | **4,115** | **3,708** | **100** | **164** | **238** | **217** | **165** |
| **Financing** | **-994** | **-3,880** | **-1,624** | **-2,730** | **-6,122** | **-5,711** | **-372** | **-468** | **-540** | **-525** | **-468** |
| Net foreign assets (increase, -) | -994 | -686 | -1,624 | -960 | -4,352 | -3,941 | -372 | -468 | -540 | -525 | -469 |
| Central Bank, net | -994 | -686 | -1,624 | -960 | -4,352 | -3,941 | -372 | -468 | -540 | -525 | -469 |
| Gross foreign reserves (increase, -) | -1,270 | -695 | -1,599 | -1,010 | -4,176 | -3,765 | -300 | -300 | -300 | -300 | -300 |
| *Of which:* IMF purchases | 276 | 243 | 183 | 89 | 90 | 90 | 0 | 0 | 0 | 0 | 0 |
| Gross foreign liabilities (increase +) | 276 | 8 | -25 | 50 | -176 | -176 | -72 | -168 | -240 | -225 | -169 |
| IMF repayment | 0 | -235 | -208 | -39 | -266 | -266 | -72 | -168 | -240 | -225 | -169 |
| Arrears (reduction, -) 6/ | 0 | -3,194 | 0 | -1,770 | -1,770 | -1,770 | 0 | 0 | 0 | 0 | 1 |
| Financing expected / to be secured | ... | ... | 0 | 301 | 225 | 225 | 215 | 215 | 215 | 215 | 215 |
| Official grants 3/ | ... | ... | ... | 301 | 225 | 225 | 215.3 | 215 | 215 | 215 | 215 |
| Official borrowing (excluding IMF) 4/ | ... | ... | ... | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Residual gap | 59 | 3,259 | 84 | 1,688 | 1,782 | 1,778 | 56 | 88 | 86 | 92 | 87 |
| Arrears settlement with creditors 6/ | 0 | 3,194 | 0 | 1,770 | 1,770 | 1,770 | 0 | 0 | 0 | 0 | 0 |
| Debt relief from creditors | 59 | 65 | 84 | 12 | 12 | 12 | 12 | 12 | 0 | 0 | 0 |
| **Memorandum items:** | | | | | | | | | | | |
| Current account balance, after grants | -1,762 | -2,825 | -2,351 | -2,329 | -2,769 | -3,594 | -3,062 | -3,044 | -3,132 | -3,095 | -2,974 |
| (In percent of GDP) | -9.3 | -12.6 | -9.8 | -9.4 | -10.0 | -13.0 | -9.9 | -9.1 | -8.7 | -8.0 | -7.2 |
| Gross international reserves, US$ million (end period) | 3,550 | 4,245 | 5,843 | 6,682 | 10,019 | 9,608 | 10,319 | 10,619 | 10,919 | 11,219 | 11,519 |
| (In months of prospective imports of goods & services) | 3.6 | 4.2 | 5.2 | 5.3 | 8.0 | 7.6 | 7.5 | 7.2 | 6.8 | 6.5 | 6.2 |
| Debt service, cash | 436 | 959 | 1,197 | 1,971 | 2,184 | 2,227 | 3,115 | 3,752 | 5,358 | 6,091 | 6,598 |
| (In percent of GDP) | 2.3 | 4.3 | 5.0 | 7.9 | 7.9 | 8.1 | 10.0 | 11.2 | 14.9 | 15.8 | 15.9 |
| Principal | 204 | 675 | 790 | 1,181 | 1,415 | 1,415 | 2,105 | 2,611 | 4,066 | 4,640 | 5,089 |
| Interest | 232 | 284 | 407 | 790 | 769 | 812 | 1,011 | 1,140 | 1,291 | 1,452 | 1,510 |
| External Debt 7/ | 13,575 | 14,099 | 15,467 | 15,503 | 17,303 | 17,853 | 18,453 | 19,518 | 20,460 | 21,333 | 21,811 |
| ( In percent of GDP) | 71.4 | 62.8 | 64.4 | 57.7 | 62.6 | 64.5 | 59.5 | 58.5 | 57.0 | 55.2 | 52.5 |
| Underlying external debt 8/ | n.a. | 15,875 | 17,254 | 19,615 | 20,540 | 21,090 | 21,689 | 22,755 | 23,697 | 24,569 | 25,048 |
| ( In percent of GDP) | n.a. | 70.7 | 71.9 | 79.1 | 74.4 | 76.2 | 69.9 | 68.1 | 66.0 | 63.6 | 60.3 |
| Net external debt (debt minus gross reserves) | 9,139 | 9,057 | 8,952 | 9,004 | 6,613 | 7,574 | 7,463 | 8,899 | 9,541 | 10,114 | 10,292 |
| ( In percent of GDP) | 48.1 | 40.4 | 37.3 | 36.3 | 23.9 | 27.4 | 24.1 | 26.7 | 26.6 | 26.2 | 24.8 |

Sources: Serbian authorities; and IMF staff estimates.

1/ Refers to staff projections for Serbia underlying the Serbia-Montenegro balance of payments in the 6th review.
2/ Adjusted for the surge in imports and remittances at end-2004 ahead of the introduction of the VAT in January 2005.
3/ Debt service recorded above the line is after the debt reduction granted by bilateral and commercial creditors, but before the capitalization of moratorium interest (recorded as debt relief).
4/ Official grants and loans above the line are based on secured commitments; amounts expected from new pledges are shown below the line.
5/ Due to a large extent to the incomplete netting out of economic relations with Montenegro.
6/ Negotiations are on-going to clear all remaining external arrears.
7/ Including debt reduction operations from the London Club and Paris Club, and assuming comparable debt relief by other creditors.
8/ Excluding all debt relief concluded or assumed after end-June 2004.

Table 3. Serbia: Macroeconomic Framework, 2003–11

| | 2003 | 2004 | 2005 | 2006 | | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | Est. | Proposed | Alternative | | | Proj. | | |
| | (Annual change, in percent) | | | | | | | | | |
| Real GDP | 2.4 | 9.3 | 6.3 | 5.5 | 5.7 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 |
| Retail prices (end-period) | 7.6 | 13.7 | 17.7 | 12.0 | 12.0 | 8.1 | 7.5 | 6.5 | 5.5 | 5.0 |
| | (In percent of GDP) | | | | | | | | | |
| Gross domestic savings | -3.2 | -5.8 | -4.8 | -1.3 | -2.1 | 0.6 | 3.1 | 4.6 | 6.7 | 8.9 |
| Non-government | -3.2 | -9.0 | -9.1 | -8.0 | -7.6 | -6.1 | -4.1 | -2.5 | -0.5 | 1.4 |
| Government | 0.0 | 3.2 | 4.3 | 6.7 | 5.5 | 6.8 | 7.2 | 7.1 | 7.1 | 7.4 |
| Net factor receipts and transfers from abroad | 12.7 | 15.8 | 13.2 | 10.7 | 10.4 | 9.8 | 9.3 | 8.5 | 7.7 | 7.1 |
| Non-government | 13.3 | 16.7 | 14.0 | 11.8 | 11.6 | 10.7 | 10.1 | 9.3 | 8.4 | 7.8 |
| Government | -0.6 | -0.8 | -0.9 | -1.1 | -1.1 | -0.9 | -0.8 | -0.7 | -0.7 | -0.7 |
| Gross national savings | 9.5 | 10.1 | 8.4 | 9.3 | 8.3 | 10.4 | 12.4 | 13.1 | 14.3 | 16.0 |
| Non-government | 10.1 | 7.7 | 4.9 | 3.8 | 3.9 | 4.5 | 6.0 | 6.8 | 7.9 | 9.2 |
| Government | -0.6 | 2.4 | 3.5 | 5.5 | 4.4 | 5.9 | 6.4 | 6.3 | 6.4 | 6.8 |
| Gross domestic investment 1/ | 18.8 | 22.7 | 18.2 | 19.3 | 21.3 | 20.3 | 21.5 | 21.9 | 22.4 | 23.1 |
| *Of which:* Gross fixed capital formation | 18.1 | 19.3 | 17.1 | 18.5 | 20.4 | 19.5 | 20.8 | 21.3 | 21.8 | 22.6 |
| Non-government | 16.2 | 19.9 | 15.4 | 16.1 | 16.1 | 17.1 | 17.7 | 18.1 | 18.5 | 18.9 |
| Gross fixed capital formation | 15.6 | 16.6 | 14.3 | 15.2 | 15.2 | 16.3 | 17.0 | 17.5 | 17.9 | 18.4 |
| Change in inventories | 0.7 | 3.3 | 1.1 | 0.9 | 0.9 | 0.8 | 0.7 | 0.6 | 0.5 | 0.5 |
| Government | 2.6 | 2.8 | 2.8 | 3.2 | 5.2 | 3.2 | 3.8 | 3.8 | 3.9 | 4.2 |
| Savings-investment balance | -9.3 | -12.6 | -9.8 | -10.0 | -13.0 | -9.9 | -9.1 | -8.7 | -8.0 | -7.2 |
| Non-government | -6.1 | -12.2 | -10.4 | -12.3 | -12.2 | -12.5 | -11.7 | -11.3 | -10.5 | -9.7 |
| Government | -3.1 | -0.4 | 0.6 | 2.3 | -0.8 | 2.7 | 2.6 | 2.5 | 2.5 | 2.5 |
| Foreign savings | 9.3 | 12.6 | 9.8 | 10.0 | 13.0 | 9.9 | 9.1 | 8.7 | 8.0 | 7.2 |
| Foreign savings excluding official grants | 11.8 | 14.8 | 11.2 | 11.0 | 14.0 | 10.6 | 9.8 | 9.3 | 8.6 | 7.7 |
| Memorandum items: | | | | | | | | | | |
| Net exports of goods and services | -22.0 | -28.4 | -23.0 | -20.7 | -23.4 | -19.7 | -18.4 | -17.3 | -15.7 | -14.3 |
| Current account balance (before grants) | -11.8 | -14.8 | -11.2 | -11.0 | -14.0 | -10.6 | -9.8 | -9.3 | -8.6 | -7.7 |
| General government fiscal balance | -3.2 | 0.0 | 0.8 | 2.6 | -0.6 | 3.0 | 3.0 | 3.0 | 3.0 | 3.0 |

Sources: Statistics Office, National Bank of Serbia, Ministry of Finance; and Fund staff estimates and projections.

1/ Including changes in inventories.

Table 4. Serbia: Employment by Ownership, 2001-2006

| | Sept. 2001 | Sept. 2002 | Sept. 2003 | Sept. 2004 | Sept. 2005 | Apr. 2006 | Diff. 06/01 |
|---|---|---|---|---|---|---|---|
| Total employment | 2,787,858 | 2,736,087 | 2,710,161 | 2,678,509 | 2,654,136 | 2,600,776 | -187,082 |
| General government | 321,616 | 321,379 | 324,013 | 327,469 | 325,147 | 316,483 | -5,133 |
| State-owned enterprises | 187,290 | 183,623 | 182,779 | 181,195 | 173,691 | 164,640 | -22,650 |
| National | 134,938 | 130,317 | 127,284 | 123,992 | 112,303 | 104,250 | -30,688 |
| Local | 52,352 | 53,306 | 55,495 | 57,203 | 61,388 | 60,390 | 8,038 |
| Socially owned enterprises | 643,709 | 579,767 | 417,205 | 324,316 | 258,217 | 245,980 | -397,729 |
| Mixed ownership | 377,035 | 333,981 | 391,620 | 398,863 | 357,524 | 323,048 | -53,987 |
| Private sector | 1,258,208 | 1,317,337 | 1,394,544 | 1,446,666 | 1,539,557 | 1,550,625 | 292,417 |
| *Of which:* Non-farmers | 566,479 | 629,502 | 720,673 | 804,946 | 952,849 | 963,917 | 397,438 |
| Companies | 208,546 | 228,107 | 279,581 | 327,735 | 421,490 | 428,384 | 219,838 |
| Entrepreneurs and their employees | 357,933 | 401,395 | 441,092 | 477,211 | 531,359 | 535,534 | 177,601 |
| Farmers | 691,729 | 687,835 | 673,871 | 641,720 | 586,708 | 586,708 | -105,021 |
| Memorandum items: | | | | | | | |
| Non-agriculture non-gen. government | 1,774,513 | 1,726,873 | 1,712,277 | 1,709,320 | 1,742,281 | 1,697,585 | -76,928 |
| State, socially, and mixed-owned enterprises | 1,208,034 | 1,097,371 | 991,604 | 904,374 | 789,432 | 733,668 | -474,366 |
| | | | (In percent of total) | | | | |
| Total employment | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 0.0 |
| General government | 11.5 | 11.7 | 12.0 | 12.2 | 12.3 | 12.2 | 0.6 |
| State-owned enterprises | 6.7 | 6.7 | 6.7 | 6.8 | 6.5 | 6.3 | -0.4 |
| National | 4.8 | 4.8 | 4.7 | 4.6 | 4.2 | 4.0 | -0.8 |
| Local | 1.9 | 1.9 | 2.0 | 2.1 | 2.3 | 2.3 | 0.4 |
| Socially owned enterprises | 23.1 | 21.2 | 15.4 | 12.1 | 9.7 | 9.5 | -13.6 |
| Mixed ownership | 13.5 | 12.2 | 14.5 | 14.9 | 13.5 | 12.4 | -1.1 |
| Private sector | 45.1 | 48.1 | 51.5 | 54.0 | 58.0 | 59.6 | 14.5 |
| *Of which:* Non-farmers | 20.3 | 23.0 | 26.6 | 30.1 | 35.9 | 37.1 | 16.7 |
| Companies | 7.5 | 8.3 | 10.3 | 12.2 | 15.9 | 16.5 | 9.0 |
| Entrepreneurs and their employees | 12.8 | 14.7 | 16.3 | 17.8 | 20.0 | 20.6 | 7.8 |
| Farmers | 24.8 | 25.1 | 24.9 | 24.0 | 22.1 | 22.6 | -2.3 |
| Memorandum items: | | | | | | | |
| Non-agriculture non-gen. government | 63.7 | 63.1 | 63.2 | 63.8 | 65.6 | 65.3 | 1.6 |
| Private (non-farm) in non-agr. non-gen. gov. | 31.9 | 36.5 | 42.1 | 47.1 | 54.7 | 56.8 | 24.9 |
| State, social, mixed in non-agr. non-gen. gov. | 68.1 | 63.5 | 57.9 | 52.9 | 45.3 | 43.2 | -24.9 |

Source: Statistics Office.

Table 5. Serbia: Profit and Losses of Non-Financial Enterprises, 2004-05

| | Profit-making enterprises | | Loss-making enterprises | | Net | |
|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2004 | 2005 | 2004 | 2005 |
| **1. Net result** | | | | | | |
| | | | (In billions of dinars) | | | |
| Private | 64.6 | 128.9 | -31.7 | -77.2 | 32.9 | 51.7 |
| Non-private | 46.5 | 48.9 | -139.1 | -133.7 | -92.6 | -84.8 |
| State-owned | 9.7 | 27.5 | -30.8 | -40.4 | -21.1 | -13.0 |
| Socially owned | 5.8 | 4.2 | -48.4 | -36.5 | -42.6 | -32.3 |
| Mixed ownership | 30.2 | 16.4 | -58.4 | -54.0 | -28.2 | -37.6 |
| Other | 0.8 | 0.8 | -1.5 | -2.7 | -0.6 | -1.9 |
| Total | 111.1 | 177.8 | -170.8 | -211.0 | -59.7 | -33.1 |
| | | | (In percent of GDP) | | | |
| Private | 4.9 | 8.1 | -2.4 | -4.8 | 2.5 | 3.2 |
| Non-private | 3.5 | 3.1 | -10.6 | -8.4 | -7.1 | -5.3 |
| State-owned | 0.7 | 1.7 | -2.4 | -2.5 | -1.6 | -0.8 |
| Socially owned | 0.4 | 0.3 | -3.7 | -2.3 | -3.3 | -2.0 |
| Mixed ownership | 2.3 | 1.0 | -4.5 | -3.4 | -2.2 | -2.4 |
| Other | 0.1 | 0.1 | -0.1 | -0.2 | 0.0 | -0.1 |
| Total | 8.5 | 11.1 | -13.0 | -13.2 | -4.6 | -2.1 |
| **2. Depreciation and provisions** | | | | | | |
| | | | (In billions of dinars) | | | |
| Private | 24.1 | 45.5 | 7.2 | 17.8 | 31.3 | 63.3 |
| Non-private | 47.0 | 42.4 | 57.9 | 42.6 | 104.9 | 85.0 |
| State-owned | 7.7 | 20.3 | 31.0 | 27.0 | 38.6 | 47.3 |
| Socially owned | 10.3 | 3.7 | 11.6 | 7.8 | 21.8 | 11.5 |
| Mixed ownership | 28.5 | 17.6 | 15.0 | 7.6 | 43.5 | 25.2 |
| Other | 0.5 | 0.8 | 0.4 | 0.2 | 0.9 | 1.0 |
| Total | 71.1 | 87.9 | 65.2 | 60.5 | 136.3 | 148.4 |
| | | | (In percent of GDP) | | | |
| Private | 1.8 | 2.8 | 0.6 | 1.1 | 2.4 | 4.0 |
| Non-private | 3.6 | 2.6 | 4.4 | 2.7 | 8.0 | 5.3 |
| State-owned | 0.6 | 1.3 | 2.4 | 1.7 | 2.9 | 3.0 |
| Socially owned | 0.8 | 0.2 | 0.9 | 0.5 | 1.7 | 0.7 |
| Mixed ownership | 2.2 | 1.1 | 1.1 | 0.5 | 3.3 | 1.6 |
| Other | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 |
| Total | 5.4 | 5.5 | 5.0 | 3.8 | 10.4 | 9.3 |
| **3. Net result before non-cash expenditure** | | | | | | |
| | | | (In billions of dinars) | | | |
| Private | 88.7 | 174.4 | -24.5 | -59.4 | 64.2 | 115.0 |
| Non-private | 93.5 | 91.3 | -81.1 | -91.1 | 12.3 | 0.2 |
| State-owned | 17.4 | 47.8 | 0.2 | -13.4 | 17.6 | 34.4 |
| Socially owned | 16.0 | 7.9 | -36.8 | -28.7 | -20.8 | -20.8 |
| Mixed ownership | 58.7 | 34.0 | -43.4 | -46.4 | 15.3 | -12.4 |
| Other | 1.4 | 1.6 | -1.1 | -2.5 | 0.3 | -0.9 |
| Total | 182.2 | 265.7 | -105.6 | -150.5 | 76.6 | 115.2 |
| | | | (In percent of GDP) | | | |
| Private | 6.8 | 10.9 | -1.9 | -3.7 | 4.9 | 7.2 |
| Non-private | 7.1 | 5.7 | -6.2 | -5.7 | 0.9 | 0.0 |
| State-owned | 1.3 | 3.0 | 0.0 | -0.8 | 1.3 | 2.1 |
| Socially owned | 1.2 | 0.5 | -2.8 | -1.8 | -1.6 | -1.3 |
| Mixed ownership | 4.5 | 2.1 | -3.3 | -2.9 | 1.2 | -0.8 |
| Other | 0.1 | 0.1 | -0.1 | -0.2 | 0.0 | -0.1 |
| Total | 13.9 | 16.6 | -8.1 | -9.4 | 5.8 | 7.2 |

Source: Solvency Center.

Table 6. Serbia: General Government Fiscal Operations, 2003–07 1/

| | 2003 | 2004 | 2005 | 2006 | | | 2007 | 2003 | 2004 | 2005 | 2006 | | | 2007 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Prelim. | 6th Review | Proposed | Altern. | Proposed | | | Prelim. | 6th Review | Proposed | Altern. | Proposed |
| | (In billions of dinars) | | | | | | | (In percent of GDP) | | | | | | |
| **Total revenue** | **474.9** | **592.7** | **723.5** | **862.5** | **854.5** | **856.2** | **984.3** | **43.4** | **45.2** | **45.2** | **45.1** | **44.3** | **44.3** | **44.3** |
| Current revenue | 470.1 | 586.6 | 715.6 | 853.6 | 843.9 | 845.6 | 972.1 | 42.9 | 44.8 | 44.7 | 44.7 | 43.7 | 43.7 | 43.7 |
| Tax revenue (excl. other taxes) | 405.4 | 504.1 | 619.5 | 740.9 | 729.1 | 730.6 | 839.9 | 37.0 | 38.5 | 38.7 | 38.8 | 37.8 | 37.8 | 37.8 |
| Personal income tax | 70.1 | 76.9 | 94.3 | 113.3 | 116.1 | 116.1 | 133.8 | 6.4 | 5.9 | 5.9 | 5.9 | 6.0 | 6.0 | 6.0 |
| Social security contributions | 115.8 | 153.5 | 188.7 | 223.6 | 222.3 | 222.7 | 256.1 | 10.6 | 11.7 | 11.8 | 11.7 | 11.5 | 11.5 | 11.5 |
| Corporate income tax | 5.9 | 6.9 | 10.3 | 12.0 | 16.5 | 16.5 | 19.0 | 0.5 | 0.5 | 0.6 | 0.6 | 0.9 | 0.9 | 0.9 |
| Retail sales tax / VAT | 126.3 | 159.1 | 216.0 | 253.6 | 237.2 | 238.2 | 273.3 | 11.5 | 12.1 | 13.5 | 13.3 | 12.3 | 12.3 | 12.3 |
| Excises | 58.3 | 73.4 | 71.3 | 89.4 | 87.8 | 87.9 | 101.2 | 5.3 | 5.6 | 4.5 | 4.7 | 4.5 | 4.5 | 4.5 |
| Taxes on international trade | 28.9 | 34.3 | 39.0 | 49.0 | 49.2 | 49.2 | 56.6 | 2.6 | 2.6 | 2.4 | 2.6 | 2.5 | 2.5 | 2.5 |
| Nontax revenue and other taxes | 64.7 | 82.5 | 96.1 | 112.6 | 114.8 | 115.0 | 132.3 | 5.9 | 6.3 | 6.0 | 5.9 | 5.9 | 5.9 | 5.9 |
| Capital revenue | 4.8 | 6.1 | 7.9 | 9.0 | 10.6 | 10.6 | 12.2 | 0.4 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 |
| **Total expenditure and net lending** | **511.9** | **593.0** | **710.7** | **811.2** | **803.6** | **868.1** | **917.6** | **46.7** | **45.3** | **44.4** | **42.5** | **41.6** | **44.9** | **41.3** |
| Current expenditure | 476.5 | 555.1 | 660.3 | 742.7 | 737.2 | 761.2 | 841.3 | 43.5 | 42.4 | 41.2 | 38.9 | 38.2 | 39.3 | 37.8 |
| Wages and salaries | 113.2 | 132.9 | 171.3 | 185.7 | 185.7 | 191.0 | 210.8 | 10.3 | 10.1 | 10.7 | 9.7 | 9.6 | 9.9 | 9.5 |
| *o/w: severance payments* | 0.0 | 0.0 | 5.3 | 4.1 | 4.1 | 4.1 | 1.0 | 0.0 | 0.0 | 0.3 | 0.2 | 0.2 | 0.2 | 0.0 |
| Goods, services, and other current | 94.9 | 114.0 | 125.5 | 141.0 | 135.5 | 140.3 | 155.3 | 8.7 | 8.7 | 7.8 | 7.4 | 7.0 | 7.3 | 7.0 |
| Interest payment | 11.3 | 17.7 | 24.9 | 31.4 | 27.2 | 27.2 | 36.1 | 1.0 | 1.4 | 1.6 | 1.6 | 1.4 | 1.4 | 1.6 |
| Subsidies and other current transfers 2/ | 257.2 | 290.5 | 338.5 | 384.6 | 388.7 | 402.7 | 439.0 | 23.5 | 22.2 | 21.1 | 20.1 | 20.1 | 20.8 | 19.7 |
| Capital expenditure | 27.9 | 36.1 | 45.0 | 62.2 | 62.2 | 100.7 | 71.7 | 2.6 | 2.8 | 2.8 | 3.3 | 3.2 | 5.2 | 3.2 |
| Net transfer from Montenegro | 2.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Overall balance (cash basis)** | **-34.9** | **-0.3** | **12.8** | **51.4** | **50.9** | **-11.8** | **66.8** | **-3.2** | **0.0** | **0.8** | **2.7** | **2.6** | **-0.6** | **3.0** |
| Foreign grants | 1.9 | 0.9 | 0.5 | 1.6 | 0.6 | 0.6 | 0.6 | 0.2 | 0.1 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 |
| Overall balance including grants (cash basis) | -33.0 | 0.5 | 13.3 | 53.0 | 51.4 | -11.3 | 67.4 | -3.0 | 0.0 | 0.8 | 2.8 | 2.7 | -0.6 | 3.0 |
| Overall balance including grants (modified cash 3/) | -50.9 | -9.1 | 15.0 | ... | 57.4 | -5.3 | 76.3 | -4.6 | -0.7 | 0.9 | ... | 3.0 | -0.3 | 3.4 |
| Statistical Discrepancy | 0.0 | 0.0 | 2.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Financing** | **50.9** | **9.1** | **-12.9** | **-53.0** | **-57.4** | **5.3** | **-76.3** | **4.6** | **0.7** | **-0.8** | **-2.8** | **-3.0** | **0.3** | **-3.4** |
| Domestic financing | -29.2 | -20.1 | -65.5 | -107.8 | -207.5 | -149.6 | -90.4 | -2.7 | -1.5 | -4.1 | -5.6 | -10.7 | -7.7 | -4.1 |
| Bank | -17.5 | 0.0 | -40.4 | -85.3 | -184.9 | -127.0 | -47.4 | -1.6 | 0.0 | -2.5 | -4.5 | -9.6 | -6.6 | -2.1 |
| Non-bank | -11.7 | -20.1 | -25.1 | -22.4 | -22.6 | -22.6 | -43.0 | -1.1 | -1.5 | -1.6 | -1.2 | -1.2 | -1.2 | -1.9 |
| Foreign Financing | 12.9 | 12.3 | 12.9 | 14.2 | 5.7 | 10.5 | 1.0 | 1.2 | 0.9 | 0.8 | 0.7 | 0.3 | 0.5 | 0.0 |
| Privatization receipts | 49.3 | 7.2 | 41.5 | 40.5 | 150.3 | 150.3 | 22.0 | 4.5 | 0.6 | 2.6 | 2.1 | 7.8 | 7.8 | 1.0 |
| Change in arrears | 17.8 | 9.6 | -1.7 | ... | -6.0 | -6.0 | -8.9 | 1.6 | 0.7 | -0.1 | ... | -0.3 | -0.3 | -0.4 |

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

1/ Includes the union, republican, and local governments, social security funds, and extrabudgetary programs in Serbia.
2/ Excluding foreign currency deposit payments to households, reclassified below the line.
3/ Cash balance minus change in arrears.

Table 7. Serbia: Republican Government Fiscal Operations, 2003-07
(In percent of GDP) 1/

| | 2003 | 2004 | 2005 | 2006 | | | 2007 |
|---|---|---|---|---|---|---|---|
| | | | Prelim. | 6th Review | Proposed | Altern. | Proposed |
| **A. Total revenue and grants (1+2+3)** | **26.7** | **27.0** | **27.8** | **28.0** | **27.1** | **27.2** | **27.1** |
| **1. Total revenue** | **26.3** | **26.7** | **27.7** | **27.9** | **27.1** | **27.2** | **27.1** |
| 1.1. Current revenue | 26.3 | 26.7 | 27.7 | 27.9 | 27.1 | 27.2 | 27.1 |
| 1.1.1 Tax revenue, excl. other taxes | 23.0 | 23.1 | 24.1 | 24.4 | 23.4 | 23.4 | 23.4 |
| 1.1.1.1 Personal income tax | 4.7 | 4.2 | 3.2 | 3.3 | 3.2 | 3.2 | 3.2 |
| 1.1.1.2 Corporate income tax | 0.5 | 0.5 | 0.6 | 0.6 | 0.8 | 0.8 | 0.8 |
| 1.1.1.3 Turnover tax 2/ | 9.9 | 10.2 | 13.5 | 13.3 | 12.3 | 12.3 | 12.3 |
| 1.1.1.4 Taxes on international trade | 2.6 | 2.6 | 2.4 | 2.6 | 2.5 | 2.5 | 2.5 |
| 1.1.1.5 Excises | 5.3 | 5.6 | 4.5 | 4.7 | 4.5 | 4.5 | 4.5 |
| 1.1.2 Non-tax revenue and other taxes | 3.2 | 3.6 | 3.6 | 3.5 | 3.8 | 3.8 | 3.8 |
| 1.2. Capital revenue | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 2. Transfer from Montenegro | 0.2 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 3. Grants | 0.2 | 0.1 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 |
| **B. Total expenditure and net lending (1+5)** | **29.5** | **27.9** | **27.2** | **25.8** | **25.1** | **28.1** | **24.4** |
| 1. Total expenditure (2+3+4) | 28.8 | 27.7 | 26.9 | 25.5 | 24.9 | 27.7 | 24.2 |
| 2. Current expenditure | 26.6 | 25.2 | 25.1 | 23.5 | 22.9 | 23.8 | 22.2 |
| 2.1. Expenditure on goods and services | 8.1 | 7.4 | 8.0 | 7.7 | 7.5 | 7.9 | 7.7 |
| 2.1.1 Wages and salaries | 5.0 | 4.5 | 4.6 | 4.2 | 4.2 | 4.4 | 4.3 |
| 2.1.2 Employer contribution | 0.9 | 0.9 | 0.9 | 0.8 | 0.8 | 0.9 | 0.8 |
| 2.1.3 Severance payments | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| 2.1.4 Other purchases of goods and services | 1.9 | 1.8 | 2.1 | 2.0 | 1.9 | 2.1 | 2.1 |
| 2.2. Interest payment | 1.0 | 1.1 | 1.1 | 1.2 | 1.3 | 1.3 | 1.2 |
| 2.3. Subsidies and other current transfers | 17.6 | 16.7 | 16.1 | 14.6 | 14.1 | 14.7 | 13.3 |
| 2.3.1 Subsidies | 2.9 | 2.7 | 1.8 | 1.5 | 1.3 | 1.5 | 1.1 |
| 2.3.2 Transfers to households 3/ | 3.4 | 2.5 | 2.7 | 2.7 | 2.6 | 2.7 | 2.5 |
| 2.3.3 Current transfers to other levels of government | 11.3 | 11.5 | 11.6 | 10.3 | 10.2 | 10.5 | 9.7 |
| Federal budget | 2.9 | 3.6 | 3.1 | 2.9 | 2.9 | 2.9 | 2.7 |
| Local Budgets | 1.3 | 1.1 | 1.9 | 1.6 | 1.6 | 1.8 | 1.5 |
| Pension Funds | 5.9 | 5.4 | 5.2 | 4.4 | 4.4 | 4.5 | 4.1 |
| Health Fund | 0.4 | 0.2 | 0.2 | 0.0 | 0.0 | 0.0 | 0.0 |
| Labor Market Fund | 0.5 | 0.7 | 0.5 | 0.6 | 0.6 | 0.6 | 0.5 |
| 3. Capital expenditure | 2.0 | 2.3 | 1.7 | 2.0 | 2.0 | 3.9 | 2.0 |
| 4. General reserves | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| 5. Lending minus repayment | 0.7 | 0.1 | 0.3 | 0.3 | 0.2 | 0.3 | 0.2 |
| **Overall budget balance excluding grants** | **-3.0** | **-0.9** | **0.6** | **2.1** | **2.0** | **-0.9** | **2.8** |
| Overall budget balance including grants | -2.9 | -0.9 | 0.6 | 2.2 | 2.0 | -0.9 | 2.8 |

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

1/ GDP of Serbia, excluding Kosovo.

2/ Retail sales tax up to 2004. VAT from 2005 onward.

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

Table 8. Serbia: Government and Government-Guaranteed Debt, 2000–06
(End-period stock by creditor, in percent of GDP)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 May |
|---|---|---|---|---|---|---|---|
| **Gross debt (excluding IMF)** | **261.4** | **123.2** | **85.9** | **79.9** | **68.9** | **61.2** | **48.7** |
| **Domestic** | **87.2** | **42.5** | **35.3** | **34.2** | **32.3** | **26.0** | **21.5** |
| Foreign currency-denominated | 67.3 | 32.3 | 25.7 | 24.4 | 22.4 | 18.6 | 15.6 |
| Frozen Foreign Currency Deposits | 67.3 | 32.3 | 25.7 | 24.4 | 22.2 | 18.4 | 15.4 |
| Other | 0.0 | 0.0 | 0.0 | 0.0 | 0.2 | 0.2 | 0.2 |
| Local currency-denominated | 19.9 | 10.1 | 9.5 | 9.9 | 9.8 | 7.4 | 5.9 |
| T-bills | 0.0 | 0.0 | 0.0 | 0.2 | 0.5 | 0.3 | 0.3 |
| Long-term loans | 0.6 | 0.3 | 2.0 | 1.9 | 1.6 | 1.3 | 1.0 |
| Credit from the banking system | 4.3 | 2.3 | 2.7 | 2.1 | 2.3 | 1.4 | 1.0 |
| Domestic arrears | 15.0 | 7.5 | 4.8 | 5.7 | 5.5 | 4.4 | 3.6 |
| **External** | **174.2** | **80.7** | **50.7** | **45.7** | **36.6** | **35.1** | **27.2** |
| Multilateral (excluding IMF) | 34.6 | 17.2 | 15.4 | 15.3 | 16.0 | 15.1 | 13.1 |
| IBRD | 30.0 | 15.3 | 12.1 | 11.3 | 10.9 | 9.6 | 8.1 |
| IDA | 0.0 | 0.0 | 1.1 | 1.4 | 1.9 | 2.1 | 1.8 |
| EIB | 0.0 | 0.0 | 0.7 | 0.8 | 1.1 | 1.3 | 1.3 |
| EBRD | 0.0 | 0.0 | 0.0 | 0.2 | 0.5 | 0.6 | 0.6 |
| EU+CEB | 4.6 | 1.9 | 1.5 | 1.6 | 1.6 | 1.5 | 1.3 |
| Official Bilateral | 89.9 | 41.6 | 19.6 | 16.9 | 15.8 | 15.2 | 10.3 |
| Paris Club | 81.6 | 36.1 | 15.4 | 13.4 | 12.4 | 11.6 | 7.3 |
| Other bilateral | 0.3 | 0.1 | 0.4 | 0.5 | 0.5 | 0.5 | 0.5 |
| Debt under negotiation 1/ | 8.1 | 5.3 | 3.8 | 3.1 | 2.9 | 3.1 | 2.5 |
| Commercial | 49.7 | 22.0 | 15.7 | 13.4 | 4.8 | 4.8 | 3.8 |
| London Club | 49.7 | 22.0 | 15.7 | 13.4 | 4.8 | 4.8 | 3.8 |
| Memorandum items: | | | | | | | |
| Debt to IMF | 2.7 | 2.6 | 3.6 | 4.6 | 4.3 | 3.9 | 3.3 |
| Government deposits | 2.7 | 2.1 | 4.0 | 4.3 | 4.0 | 5.3 | 5.3 |
| Net debt (excl. IMF) | 258.8 | 121.0 | 81.9 | 75.7 | 64.9 | 55.8 | 43.4 |
| Kosovo debt | 19.2 | 9.9 | 6.4 | 6.0 | 5.1 | 4.6 | 3.6 |
| Share in total gross debt of: | | | | | | | |
| Foreign currency-denominated debt | 92.4 | 91.8 | 88.9 | 87.7 | 85.7 | 87.9 | 87.8 |
| Short-term debt | 0.0 | 0.0 | 0.0 | 0.2 | 0.7 | 0.5 | 0.5 |
| Debt at variable interest rates | 33.0 | 30.8 | 19.7 | 18.8 | 20.3 | 21.3 | 17.7 |
| Debt to official creditors | 47.6 | 47.7 | 40.7 | 40.4 | 46.2 | 49.6 | 48.1 |

Source: Ministry of Finance; and Fund staff estimates.

1/ Bilateral credits concluded before 2000; non-regulated London Club debt; and debt in non-convertible currencies.

## Table 9. Serbia: Monetary Survey, 2004–06

(In billions of SRD; end of period) 1/

| | 2004 | 2005 | | | | 2006 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Dec. | Jun. | Sep. | Dec. | | Mar. | | May | Jun. | | Sep. | | Dec. | |
| | Act. 4/ | Act. | Act. | Act. | Act. 5/ | Proj. 6/ | Act. | Act. | Proj. 6/ | Act. | Proj. 6/ | Rev. Proj. | Proj. 6/ | Rev. Proj. |
| **Net Foreign Assets** 2/ | 196.6 | 221.4 | 245.5 | 277.7 | 321.7 | 330.1 | 320.7 | 381.9 | 330.0 | 437.8 | 358.6 | 454.7 | 369.5 | 608.3 |
| (NFA in euro billion) | 2.5 | 2.8 | 3.1 | 3.5 | 3.7 | 3.8 | 3.7 | 4.4 | 3.8 | 5.1 | 4.1 | 5.3 | 4.3 | 7.0 |
| Assets | 298.2 | 326.4 | 363.3 | 412.8 | 476.0 | 496.4 | 499.5 | 574.4 | 497.6 | 592.0 | 528.4 | 609.6 | 544.0 | 767.5 |
| NBS | 245.9 | 276.0 | 315.6 | 367.0 | 424.9 | 447.8 | 461.2 | 539.3 | 449.8 | 554.4 | 481.4 | 571.1 | 499.0 | 731.3 |
| Commercial banks | 52.2 | 50.4 | 47.7 | 45.8 | 51.1 | 48.6 | 38.3 | 35.1 | 47.7 | 37.7 | 47.0 | 38.4 | 45.1 | 36.2 |
| Liabilities (-) | -101.5 | -105.0 | -117.8 | -135.1 | -154.3 | -166.3 | -178.9 | -192.5 | -167.6 | -154.2 | -169.8 | -154.9 | -174.5 | -159.2 |
| NBS | -67.8 | -60.4 | -68.5 | -66.6 | -78.9 | -83.4 | -83.6 | -83.2 | -82.1 | -66.5 | -81.4 | -65.7 | -79.9 | -64.6 |
| Commercial banks | -33.7 | -44.5 | -49.2 | -68.5 | -75.4 | -82.9 | -95.3 | -109.3 | -85.4 | -87.7 | -88.4 | -89.1 | -94.6 | -94.6 |
| **Net Domestic Assets** 3/ | 112.1 | 117.2 | 134.2 | 140.0 | 125.7 | 97.5 | 128.5 | 96.8 | 129.8 | 55.0 | 136.8 | 66.5 | 144.8 | -49.6 |
| Domestic credit | 248.1 | 282.2 | 310.7 | 356.9 | 362.4 | … | 396.9 | 421.5 | … | 429.0 | … | … | … | … |
| Net credit to government 3/ | -21.8 | -37.7 | -51.4 | -60.5 | -62.3 | -80.5 | -75.3 | -81.8 | -93.2 | -82.1 | -125.7 | -96.0 | -147.6 | -239.6 |
| Credit | 30.4 | 25.8 | 24.4 | 22.5 | 23.1 | … | 20.8 | 19.8 | … | 19.2 | … | … | … | … |
| Dinar credit | 30.3 | 25.5 | 23.8 | 21.7 | 22.2 | … | 19.7 | 18.7 | … | 18.0 | … | … | … | … |
| NBS | 21.4 | 16.6 | 16.0 | 14.7 | 15.2 | … | 13.7 | 13.7 | … | 13.4 | … | … | … | … |
| Commercial banks | 8.8 | 8.9 | 7.8 | 7.0 | 7.0 | … | 6.0 | 5.0 | … | 4.6 | … | … | … | … |
| Foreign currency credits | 0.1 | 0.3 | 0.6 | 0.8 | 0.9 | … | 1.1 | 1.1 | … | 1.1 | … | … | … | … |
| NBS | 0.0 | 0.0 | 0.0 | 0.2 | 0.2 | … | 0.2 | 0.2 | … | 0.2 | … | … | … | … |
| Commercial banks | 0.1 | 0.3 | 0.6 | 0.6 | 0.7 | … | 0.9 | 0.9 | … | 0.9 | … | … | … | … |
| Liabilities | -52.2 | -63.5 | -75.8 | -83.0 | -85.4 | … | -96.1 | -101.5 | … | -101.2 | … | … | … | … |
| Dinar liabilities | -38.8 | -51.3 | -58.4 | -60.9 | -60.9 | … | -68.7 | -82.7 | … | -84.2 | … | … | … | … |
| NBS | -28.1 | -36.5 | -42.8 | -46.7 | -46.6 | … | -51.4 | -66.7 | … | -61.0 | … | … | … | … |
| Commercial banks | -10.7 | -14.8 | -15.6 | -14.2 | -14.2 | … | -17.3 | -15.9 | … | -23.1 | … | … | … | … |
| Foreign currency deposits | -13.4 | -12.2 | -17.4 | -22.1 | -24.5 | … | -27.4 | -18.9 | … | -17.1 | … | … | … | … |
| NBS | -10.0 | -6.1 | -13.3 | -17.2 | -19.1 | … | -21.4 | -12.7 | … | -10.8 | … | … | … | … |
| Commercial banks | -3.4 | -6.1 | -4.1 | -4.9 | -5.4 | … | -6.0 | -6.2 | … | -6.3 | … | … | … | … |
| Short-term government credits to banks | -0.4 | -0.4 | -0.5 | -0.5 | -0.5 | -0.5 | -0.5 | -0.5 | -0.5 | -0.4 | -0.5 | -0.5 | -0.5 | -0.5 |
| Purchased FFCD bonds | 8.2 | 9.7 | 12.7 | 11.1 | 12.1 | 12.5 | 14.8 | 13.2 | 14.0 | 14.6 | 14.0 | 14.0 | 14.0 | 14.0 |
| Credit to the non-government sector | 262.0 | 310.5 | 349.9 | 406.7 | 413.0 | 429.6 | 457.9 | 490.5 | 476.1 | 497.0 | 517.6 | 541.3 | 548.1 | 583.6 |
| Households | 64.4 | 82.6 | 102.7 | 124.9 | 124.9 | … | 141.4 | 157.3 | … | 162.0 | … | … | … | … |
| Non-profit and other sectors | 2.4 | 2.4 | 3.4 | 4.1 | 4.2 | … | 4.6 | 4.8 | … | 4.8 | … | … | … | … |
| Non-profit and other sector in dinar | 2.1 | 2.0 | 3.1 | 3.6 | 3.7 | … | 4.0 | 4.1 | … | 4.0 | … | … | … | … |
| Non-profit and other sector in fx | 0.3 | 0.3 | 0.3 | 0.5 | 0.5 | … | 0.6 | 0.7 | … | 0.7 | … | … | … | … |
| Enterprises in dinar | 138.4 | 169.2 | 188.9 | 225.0 | 225.0 | … | 247.7 | 263.4 | … | 265.9 | … | … | … | … |
| Enterprises in foreign currency | 56.8 | 56.4 | 54.9 | 52.7 | 58.8 | … | 64.3 | 65.0 | … | 64.3 | … | … | … | … |
| Enterprises in fx (euro billion) | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 | … | 0.7 | 0.8 | … | 0.7 | … | … | … | … |
| Other items, net. | -136.1 | -165.0 | -176.5 | -216.9 | -236.6 | -263.6 | -268.4 | -324.7 | -266.6 | -374.0 | -268.6 | -392.3 | -269.3 | -407.1 |
| **Broad Money (M2)** | 308.7 | 338.5 | 379.7 | 417.7 | 447.4 | 427.6 | 449.2 | 478.7 | 459.8 | 492.8 | 495.4 | 521.2 | 514.4 | 558.6 |
| Dinar-denominated M2 | 132.2 | 139.3 | 156.5 | 175.3 | 175.4 | 157.6 | 166.0 | 179.3 | 170.9 | 180.9 | 183.7 | 201.0 | 190.1 | 231.3 |
| M1 | 106.1 | 112.1 | 124.4 | 138.9 | 138.9 | 125.4 | 125.7 | 134.8 | 134.2 | 137.4 | 143.5 | 151.9 | 146.5 | 167.3 |
| Currency outside banks | 45.2 | 42.3 | 47.3 | 53.6 | 53.7 | 42.7 | 45.8 | 46.4 | 46.5 | 48.9 | 49.9 | 54.5 | 51.4 | 59.8 |
| Demand deposits | 60.9 | 69.8 | 77.2 | 85.3 | 85.3 | 82.6 | 79.9 | 88.4 | 87.7 | 88.4 | 93.6 | 97.3 | 95.1 | 107.5 |
| Time and savings deposits | 26.1 | 27.1 | 32.1 | 36.3 | 36.4 | 32.2 | 40.2 | 44.5 | 36.7 | 43.5 | 40.2 | 49.1 | 43.6 | 64.0 |
| Fx-deposits (non-frozen) | 176.5 | 199.3 | 223.2 | 242.5 | 272.1 | 270.0 | 283.2 | 299.4 | 288.9 | 311.9 | 311.7 | 320.3 | 324.3 | 327.3 |
| Fx-deposits (non-frozen; euro billion) | 2.2 | 2.5 | 2.8 | 3.1 | 3.1 | 3.1 | 3.3 | 3.5 | 3.3 | 3.6 | 3.6 | 3.7 | 3.7 | 3.8 |
| Memorandum items: 4/ | | | | | | | | | | | | | | |
| Broad money at curr. exchange rates (SRD billion) | 308.7 | 352.8 | 396.1 | 437.2 | 443.0 | 428.5 | 450.2 | 479.7 | 466.1 | 493.9 | 512.8 | 539.1 | 543.9 | 588.5 |
| Fx-deposits at curr. exchange rates (SRD billion) | 176.5 | 213.5 | 239.6 | 261.9 | 267.7 | 271.0 | 284.2 | 300.5 | 295.2 | 313.0 | 329.1 | 338.2 | 353.8 | 357.2 |
| 12-month growth rates (in percent) | | | | | | | | | | | | | | |
| Broad Money (M2) | 30.3 | 41.4 | 40.2 | 41.6 | 43.5 | 37.7 | 44.6 | 41.3 | 32.1 | 40.0 | 29.4 | 36.1 | 26.8 | 32.8 |
| Dinar-denominated M2 | 13.0 | 23.7 | 29.1 | 32.5 | 32.6 | 26.9 | 33.7 | 32.2 | 22.7 | 29.9 | 17.3 | 28.4 | 15.0 | 31.9 |
| M1 | 8.0 | 19.1 | 24.6 | 30.9 | 30.9 | 25.8 | 26.1 | 22.8 | 19.7 | 22.5 | 15.3 | 22.0 | 11.6 | 20.4 |
| Currency outside banks | 5.1 | 4.9 | 11.4 | 18.8 | 18.8 | 8.6 | 16.4 | 12.5 | 9.9 | 15.6 | 5.5 | 15.4 | 9.5 | 11.5 |
| Fx-deposits | 43.0 | 54.1 | 48.5 | 48.4 | 51.7 | 44.8 | 51.9 | 47.5 | 38.2 | 46.6 | 37.4 | 41.1 | 34.2 | 33.5 |
| Velocity (M1) | 13.2 | 14.1 | 13.2 | 12.4 | 12.4 | 14.8 | 14.8 | 14.1 | 14.3 | 14.0 | 13.8 | 13.0 | 14.0 | 12.3 |
| Multiplier (Dinar M2/Reserve money) | 1.7 | 1.9 | 2.0 | 1.9 | 1.9 | 2.1 | 2.1 | 2.2 | 2.2 | 2.0 | 2.2 | 2.1 | 2.2 | 2.4 |
| Currency/Dinar deposits (in percent) | 51.9 | 43.6 | 43.3 | 44.1 | 44.1 | 37.2 | 38.1 | 34.9 | 37.4 | 37.1 | 37.3 | 37.3 | 37.1 | 34.9 |
| Required reserve ratio (effective, in percent) | 24.1 | 22.5 | 22.6 | 21.4 | 21.4 | 21.8 | 22.0 | 21.3 | 21.8 | 25.3 | 21.8 | 24.9 | 21.8 | 21.7 |
| Excess reserves/Dinar deposits (in percent) | 9.1 | 8.7 | 8.4 | 10.7 | 10.6 | 6.2 | 8.7 | 8.9 | 5.7 | 8.8 | 5.3 | 6.6 | 5.1 | 6.0 |
| Fx-deposits/Broad money | 57.2 | 60.5 | 60.5 | 59.9 | 60.4 | 63.2 | 63.1 | 62.6 | 63.3 | 63.4 | 64.2 | 62.7 | 65.0 | 60.7 |
| SRD-denominated M2/ annualized monthly GDP | 9.4 | 8.8 | 9.6 | 10.2 | 10.2 | 8.5 | 8.9 | 9.4 | 8.9 | 9.4 | 9.3 | 10.2 | 9.3 | 11.3 |

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

1/ Unless otherwise specified, foreign exchange denominated items are converted at constant exchange rates, using for each year actual exchange rates as of December 31 of the previous year. However, for 2006 the constant exchange rates used are US$1 = SRD 73.3898, €1 = SRD 86.6000, and SDR1 = US$ 1.42647. Monetary gold shall be valued at an accounting price of US$416.85 per ounce.
2/ Excluding undivided assets and liabilities of the SFRY and, from 2002 onwards, liabilities to banks in liquidation.
3/ Figures for NDA and net credit to government in the "projection" columns for March, June, September, and December 2006 are ceilings under the Post-Program Monitoring (PPM).
4/ Foreign exchange denominated items are valued at current exchange rates.
5/ Foreign exchange denominated items are converted at constant exchange rates specified in footnote 1, second sentence.
6/ Quarterly projections are adjusted for the difference between the projection for end-2005 and the actual end-2005 outcome.

Table 10. Serbia: Indicators of External Vulnerability, 2003–05 1/
(In percent of GDP, unless otherwise indicated)

| | 2003 | 2004 | 2005 |
|---|---|---|---|
| **Financial indicators** | | | |
| Public sector debt | 79.9 | 68.9 | 61.2 |
| Broad money (percent change, 12-month basis) | 27.5 | 30.3 | 43.2 |
| Private sector credit (percent change, 12-month basis) | 25.1 | 47.9 | 57.0 |
| Weighted interest rate on dinar deposits (percent p.a., December) 2/ | 2.8 | 3.7 | 3.8 |
| Retail prices (percent change per annum, end of period) | 7.8 | 13.7 | 17.7 |
| **External Indicators** | | | |
| Exports (recorded exports, percent change, 12-month basis in US$) | 32.8 | 27.8 | 27.1 |
| Imports (recorded imports, percent change, 12-month basis in US$) | 33.2 | 43.8 | -2.7 |
| Current account balance, before grants | -11.8 | -14.8 | -11.2 |
| Current account balance after grants and FDI | -2.1 | -8.3 | -3.3 |
| Errors and omissions | 1.5 | 1.7 | -3.6 |
| Gross official reserves (in US$ million) | 3,550 | 4,245 | 5,843 |
| (in months of imports GS of the following year) | 3.6 | 4.2 | 5.2 |
| Central Bank short-term foreign liabilities (in US$ million) 3/ | 180 | 204 | 204 |
| Gross reserves of the banking system (in US$ million) | 4,436 | 5,147 | 6,541 |
| (in months of imports GS of the following year) | 4.5 | 5.1 | 5.8 |
| Short term foreign liabilities of the commercial banks (in US$ million) | 182 | 577 | 1,039 |
| Foreign currency liabilities of the commercial banks (in US$ million) | 2,651 | 4,493 | 6,278 |
| Official reserves/Broad money (M2) (in percent) | 82 | 80 | 95 |
| Official reserves/reserve money (in percent) | 277 | 320 | 448 |
| Short term external debt by original maturity (in US$ million) 4/ | 1,056 | 999 | 1,514 |
| Short term external debt by remaining maturity (in US$ million) 4/ | 1,433 | 1,541 | 2,552 |
| Short term external debt by original maturity (in percent of reserves) | 29.7 | 23.5 | 25.9 |
| Short term external debt by remaining maturity (in percent of reserves) | 40.4 | 36.3 | 43.7 |
| Short term external debt by original maturity (in percent of total debt) | 7.8 | 7.1 | 9.8 |
| Short term external debt by remaining maturity (in percent of total debt) | 10.6 | 10.9 | 16.5 |
| Total external debt (In US$ millions) | 13,575 | 14,099 | 15,467 |
| *Of which* : Public and publicly guaranteed debt 5/ | 9,161 | 8,280 | 7,823 |
| Total external debt (in percent of exports of G&S) | 220 | 149 | 118 |
| External interest payments, cash basis (in percent of exports of G&S) | 5.5 | 5.1 | 6.2 |
| External amortization payments, cash basis (in percent of exports of G& | 4.9 | 12.2 | 12.0 |
| Exchange rate, official (per euro, end of period) | 68.3 | 78.9 | 85.2 |
| Real effective exchange rate (annual average, 1995= 100) 6/ | 77.2 | 74.5 | 72.6 |
| Sovereign long-term credit rating. Standard & Poor's | n.a. | B+ | B+ |
| Fitch | n.a. | BB- | BB- |

Sources: Serbia authorities; and Fund 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 11. Serbia: Stock of External Debt at March 31, 2006 1/
(In millions of U.S. dollars)

| Creditor | Total Debt | *Of which:* Arrears 2/ | | | |
|---|---|---|---|---|---|
| | | Principal | Interest | Late Interest | Total Arrears |
| Total debt | 16,093 | 1,553 | 333 | 488 | 2,374 |
| Multilateral institutions | 4,929 | 10 | 5 | 8 | 21 |
| IMF | 944 | 0 | 0 | 0 | 0 |
| IBRD | 2,163 | 0 | 0 | 0 | 0 |
| IDA | 488 | 0 | 0 | 0 | 0 |
| EUROFIMA | 156 | 0 | 0 | 0 | 0 |
| IFC | 70 | 9 | 5 | 8 | 21 |
| EIB | 365 | 0 | 0 | 0 | 0 |
| European Union | 330 | 0 | 0 | 0 | 0 |
| EUROFOND - CEB | 27 | 0 | 0 | 0 | 0 |
| EBRD | 385 | 1 | 0 | 0 | 0 |
| Official bilateral creditors | 2,981 | 333 | 186 | 130 | 650 |
| Paris Club | 2,232 | 0 | 0 | 0 | 0 |
| Other official bilateral creditors | 750 | 333 | 186 | 130 | 649 |
| Commercial creditors | 6,411 | 560 | 141 | 350 | 1,051 |
| London Club | 1,167 | 32 | 35 | 14 | 80 |
| Other commercial creditors: convertible currencies 3/ | 5,139 | 435 | 93 | 336 | 864 |
| Other commercial creditors: nonconvertible currencies 3/ | 106 | 93 | 13 | 0 | 106 |
| Short-term debt 3/ | 1,771 | 650 | 1 | 0 | 651 |
| Trade credits on oil & gas imports 4/ | 231 | 231 | 0 | 0 | 231 |
| Other short-term debt | 926 | 419 | 1 | 0 | 420 |

Sources: Serbia authorities, and Fund 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: External Financing Requirements and Sources, 2003–08

(In millions of U.S. dollars)

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| | | | Est. | | Proj. | |
| **1. Gross financing requirements** | **-3,740** | **-7,879** | **-5,093** | **-10,369** | **-5,682** | **-6,171** |
| External current account deficit (excl. official transfers) | -2,238 | -3,329 | -2,681 | -3,038 | -3,278 | -3,259 |
| Debt amortization | -232 | -427 | -605 | -1,119 | -2,033 | -2,444 |
| Medium- and long-term debt | -204 | -377 | -542 | -1,038 | -1,996 | -2,444 |
| Short-term debt 1/ | -28 | -50 | -63 | -81 | -37 | 0 |
| Repayment of arrears | 0 | -3,194 | 0 | -1,770 | 0 | 0 |
| Gross reserve accumulation | -1,270 | -695 | -1,599 | -4,176 | -300 | -300 |
| IMF repurchases and repayments | 0 | -235 | -208 | -266 | -72 | -168 |
| **2. Financing** | **3,740** | **7,879** | **5,093** | **10,144** | **5,422** | **5,879** |
| Official grants 2/ | 476 | 504 | 330 | 44 | 0 | 0 |
| Foreign direct investment (net) | 1,360 | 966 | 1,550 | 2,869 | 1,914 | 2,067 |
| Disbursement from private creditors | 685 | 1,963 | 2,784 | 3,716 | 2,947 | 3,400 |
| Medium and long-term financing | 591 | 1,465 | 2,282 | 3,241 | 2,710 | 3,200 |
| Short-term financing and other capital inflows | 94 | 499 | 502 | 476 | 237 | 200 |
| Disbursement from official creditors 2/ | 326 | 468 | 481 | 515 | 300 | 200 |
| Multilateral 3/ | 242 | 376 | 360 | 410 | 300 | 200 |
| Other | 84 | 92 | 121 | 104 | 0 | 0 |
| IMF disbursement | 277 | 243 | 183 | 90 | 0 | 0 |
| Accumulation of arrears (exceptional) | 0 | 0 | 0 | 0 | 0 | 0 |
| Debt Relief | 59 | 3,259 | 84 | 1,782 | 12 | 12 |
| Other flows 4/ | 557 | 475 | -319 | 1,128 | 250 | 200 |
| **3. Financing Gap** | **0** | **0** | **0** | **225** | **260** | **292** |
| Expected disbursements of grants from donors 2/ | 0 | 0 | 0 | 225 | 215 | 215 |
| EU | 0 | 0 | 0 | 0 | 0 | 0 |
| Others (mostly official bilateral creditors) | 0 | 0 | 0 | 225 | 215 | 215 |
| Expected disbursement of loans from donors 2/ | 0 | 0 | 0 | 0 | 0 | 0 |
| World Bank | 0 | 0 | 0 | 0 | 0 | 0 |
| IMF | 0 | 0 | 0 | 0 | 0 | 0 |
| EBRD | 0 | 0 | 0 | 0 | 0 | 0 |
| EIB | 0 | 0 | 0 | 0 | 0 | 0 |
| EU | 0 | 0 | 0 | 0 | 0 | 0 |
| Others (mostly official bilateral creditors) | 0 | 0 | 0 | 0 | 0 | 0 |
| Debt relief | 0 | 0 | 0 | 0 | 0 | 0 |
| **4. Residual Financing Gap** | **0** | **0** | **0** | **0** | **45** | **77** |

Sources: Serbia authorities; and Fund staff estimates.

1/ Original maturity of less than 1 year.

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

3/ Not including amortization of the debt to IMF.

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

Table 13. Serbia: Indicators of Capacity to Repay the Fund, 2003–11

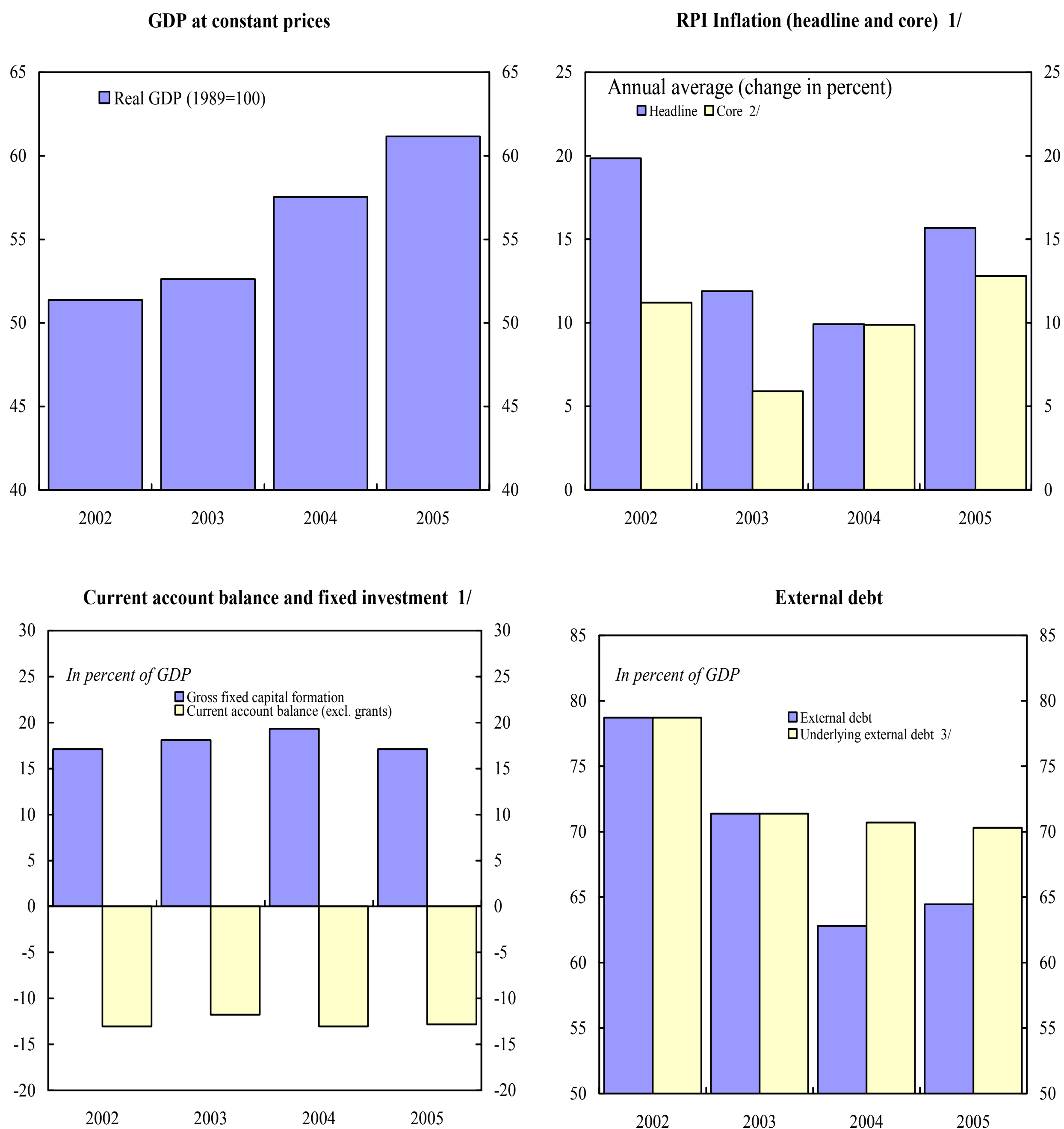
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|
| | | | Est. | Projections | | | | | |
| Fund repurchases and charges 1/ 2/ | | | | | | | | | |
| In millions of SDRs | 12.2 | 171.9 | 161.7 | 218.0 | 74.6 | 137.5 | 139.7 | 117.2 | 63.0 |
| In millions of U.S. dollars | 17.1 | 252.8 | 239.0 | 313.5 | 107.5 | 198.7 | 202.2 | 170.0 | 91.4 |
| In percent of exports of goods and NFS | 0.4 | 4.6 | 3.6 | 4.1 | 1.2 | 1.9 | 1.7 | 1.3 | 0.6 |
| In percent of debt service | 3.9 | 26.4 | 20.0 | 14.4 | 3.5 | 5.3 | 3.8 | 2.8 | 1.4 |
| In percent of quota | 2.6 | 36.7 | 34.6 | 46.6 | 16.0 | 29.4 | 29.9 | 25.1 | 13.5 |
| In percent of gross official reserves | 0.5 | 6.0 | 4.1 | 3.1 | 1.0 | 1.9 | 1.9 | 1.5 | 0.8 |
| Fund credit outstanding | | | | | | | | | |
| In millions of SDRs | 616.9 | 621.0 | 606.3 | 479.2 | 429.2 | 312.5 | 187.5 | 79.2 | 20.8 |
| In millions of U.S. dollars | 862.6 | 913.5 | 895.9 | 688.9 | 618.4 | 451.6 | 271.5 | 114.8 | 30.2 |
| In percent of quota | 131.9 | 132.8 | 129.6 | 102.5 | 91.8 | 66.8 | 40.1 | 16.9 | 4.5 |
| In percent of GDP | 3.2 | 2.8 | 2.5 | 1.7 | 1.4 | 0.9 | 0.5 | 0.2 | 0.1 |
| In percent of gross official reserves | 24.3 | 21.5 | 15.3 | 6.9 | 6.0 | 4.3 | 2.5 | 1.0 | 0.3 |
| Memorandum items: | | | | | | | | | |
| Exports of goods and NFS (millions of US$) | 4,172 | 5,553 | 6,608 | 7,734 | 9,027 | 10,417 | 11,609 | 13,154 | 14,788 |
| Debt service, after debt relief (millions of US$) | 436 | 959 | 1,197 | 2,184 | 3,115 | 3,752 | 5,358 | 6,091 | 6,598 |
| Quota (millions of SDRs) | 468 | 468 | 468 | 468 | 468 | 468 | 468 | 468 | 468 |
| Quota (millions of US$) | 654 | 688 | 691 | 672 | 674 | 676 | 677 | 678 | 679 |
| Gross official reserves (millions of US$) | 3,550 | 4,245 | 5,843 | 10,019 | 10,319 | 10,619 | 10,919 | 11,219 | 11,519 |
| U.S. dollar per SDR | 1.40 | 1.47 | 1.48 | 1.44 | 1.44 | 1.45 | 1.45 | 1.45 | 1.45 |

Sources: Serbia authorities; and Fund staff estimates.

1/ Arrears to the Fund of SDR 101 million were cleared on December 20, 2000. The projections are based on repurchase expectations.

2/ Figures reflect early repurchase of SDR 162.5 million on June 30, 2006.

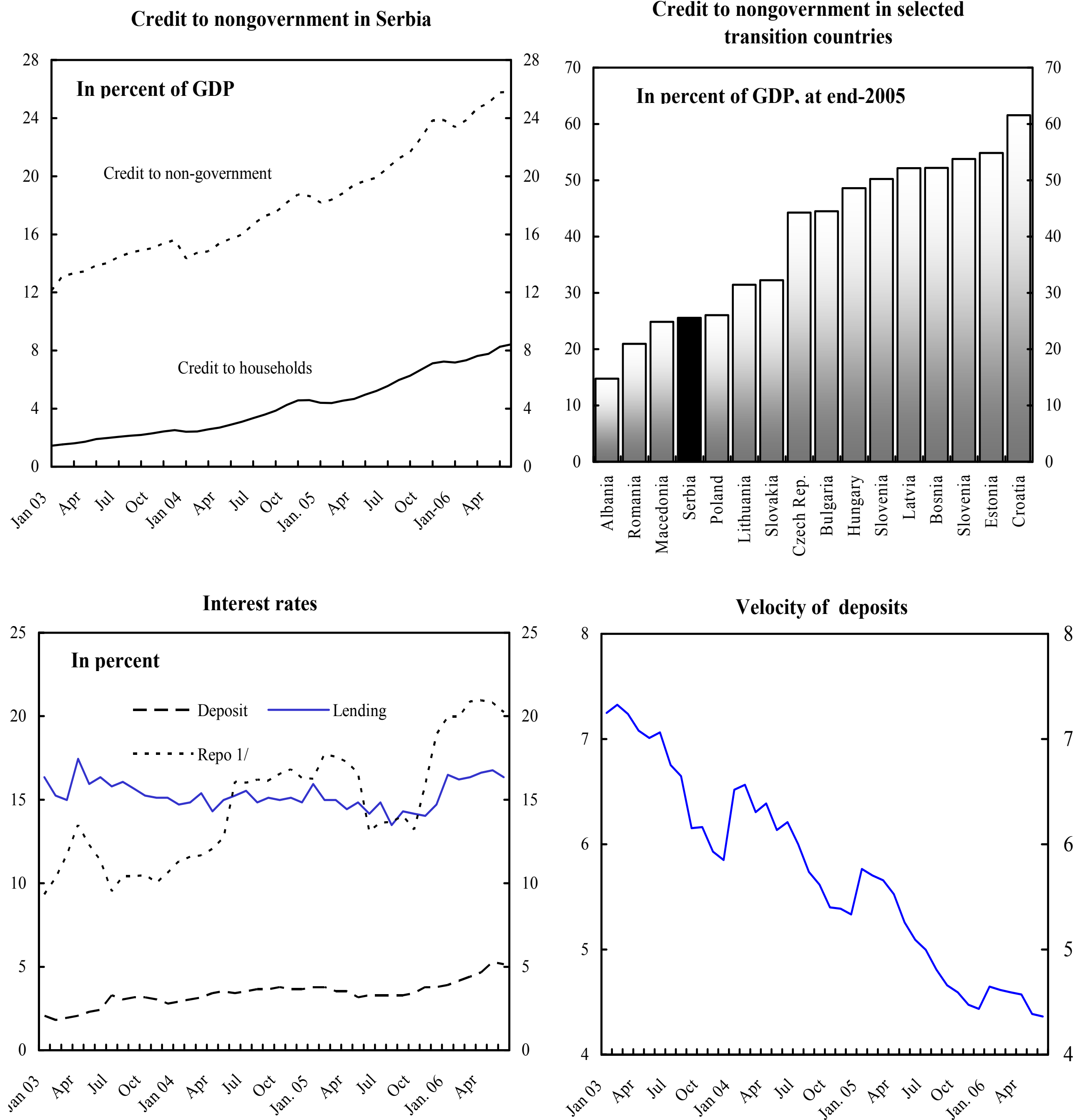
Figure 1. Serbia: Selected Economic Indicators, 2002-05




Source: National authorities; and Fund staff estimates.

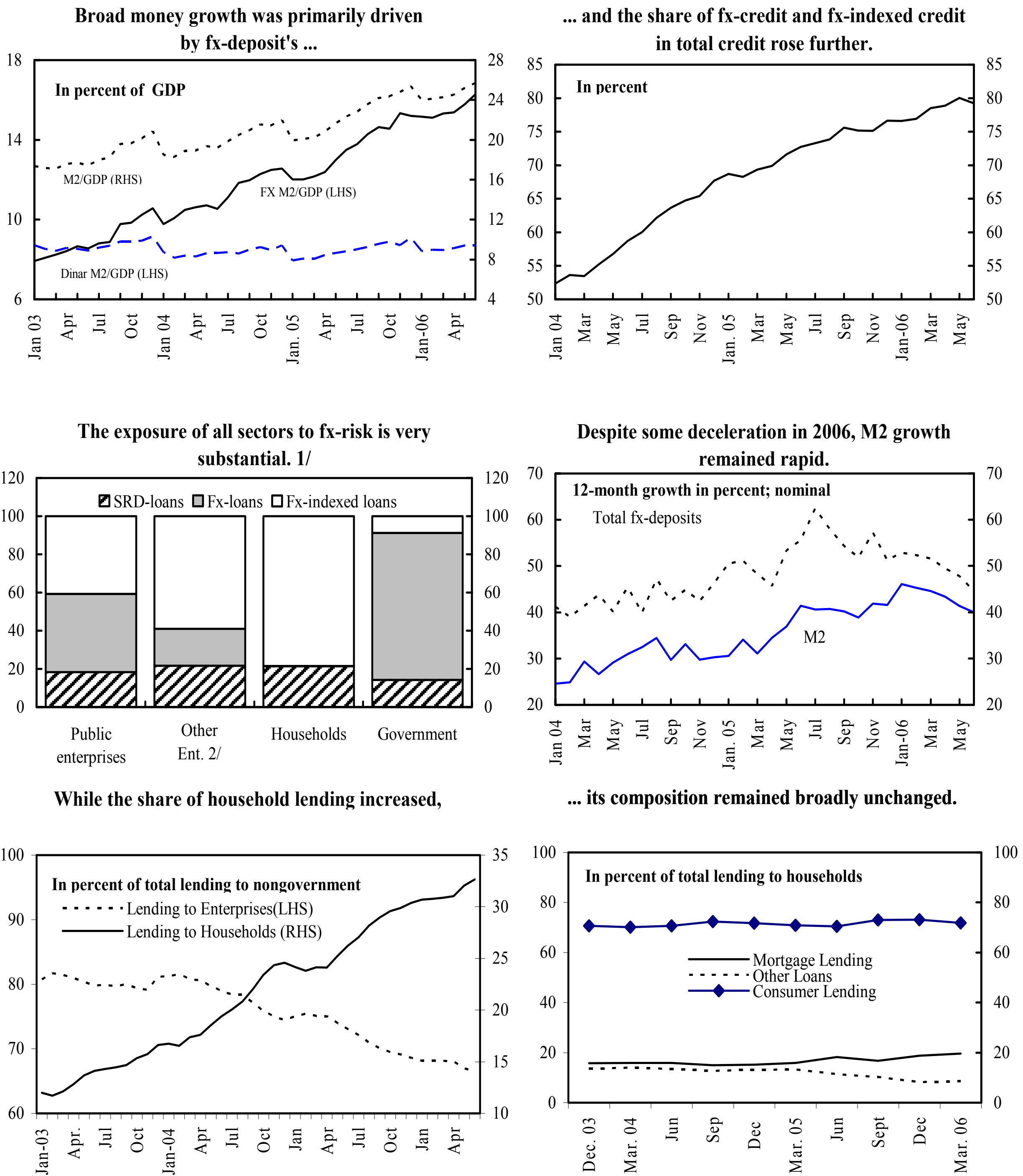
1/ Adjusted in 2004-05 for the impact of the VAT introduction.
2/ Excluding administered and food prices.
3/ Excluding Paris and London Club write-offs after 2003.

Figure 2. Serbia: Monetary Developments I, 2004-2006




Sources: NBS and staff calculations.
1/ Since February 2005 interest rate on 14-day repo operations; up to January 2005, interest rate on NBS-bills.

Figure 3. Serbia: Monetary Developments II, 2004–2006

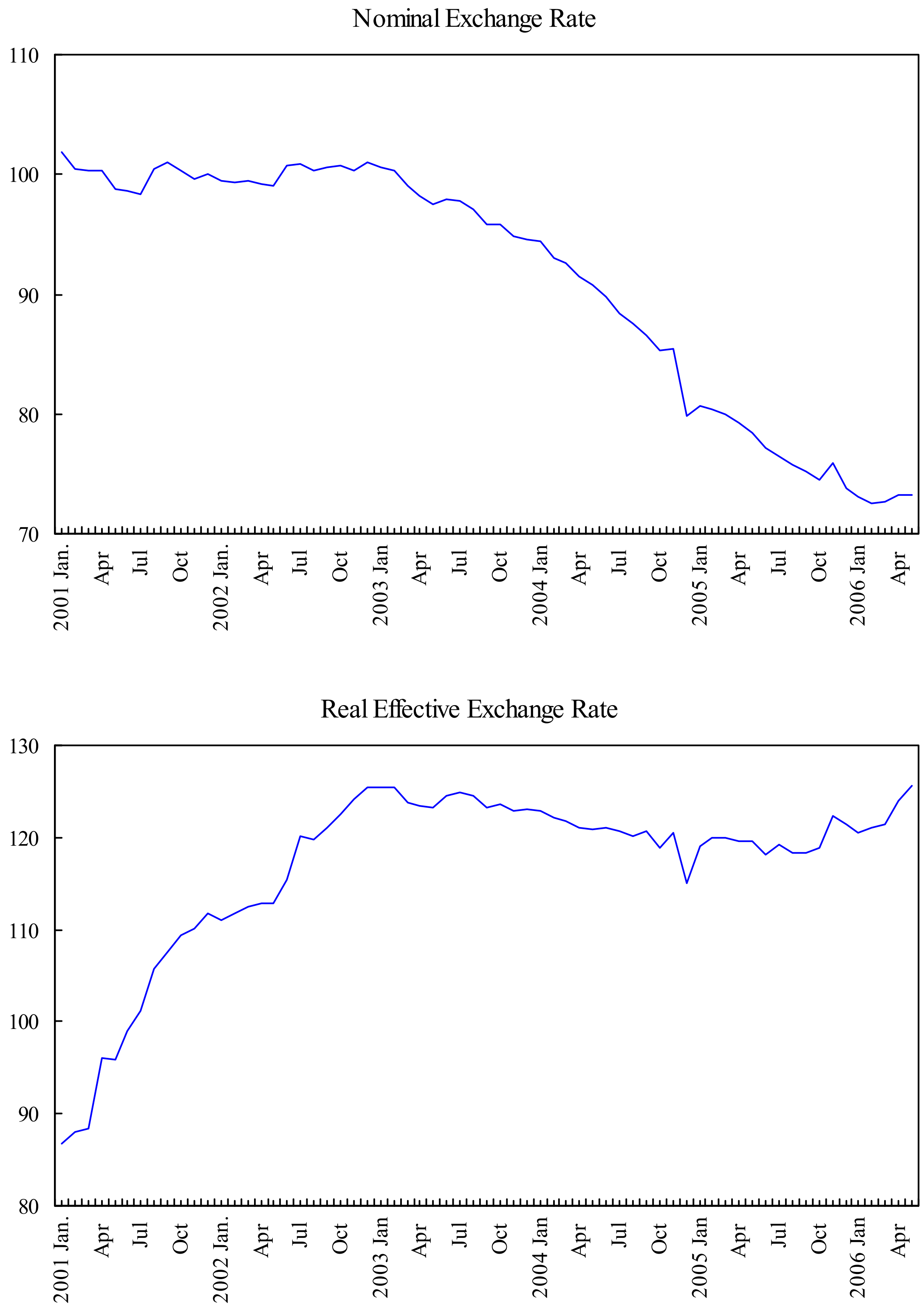



Sources: Serbian Office of Statistics; National Bank of Serbia; and Fund staff calculations.

1/ Loans to respective sector according to currency denomination in percent of total loans to the sector as of end-March 2006.

2/ Private enterprises and socially owned enterprises.

Figure 4. Serbia: Nominal and Real Effective Exchange Rates, 2001-06
(2001=100)




Source: IMF Information Notice System.

## Appendix I: Fund Relations

As of June 30, 2006

I. **Membership Status:** Joined December 14, 1992 (succeeding to membership of the former SFR Yugoslavia); accepted Article VIII on May 13, 2002. Following Montenegro's declaration of independence in June 2006 and secession as a newly independent state, Serbia continues the membership in the Fund of the state union of Serbia and Montenegro.

| II. **General Resources Account:** | SDR Million | Percent Quota |
|---|---|---|
| Quota | 467.70 | 100.00 |
| Fund Holdings of Currency | 955.21 | 204.24 |

| III. **SDR Department:** | SDR Million | Percent Allocation |
|---|---|---|
| Net cumulative allocation | 56.66 | 100.00 |
| Holdings | 27.69 | 48.86 |

| IV. **Outstanding Purchases and Loans:** | SDR Million | Percent Quota |
|---|---|---|
| Extended Arrangement | 487.50 | 104.23 |

V. **Latest Financial Arrangements:**

| Type | Approval Date | Expiration Date | Amount Approved (SDR Million) | Amount Drawn (SDR Million) |
|---|---|---|---|---|
| EFF | May 14, 2002 | Feb. 28, 2006 | 650.00 | 650.00 |
| Stand-by | June 11, 2001 | May 31, 2002 | 200.00 | 200.00 |

VI. **Projected Obligations to Fund:**
Under the Repurchase Expectations Assumptions[9] (In millions of SDR)

| | Forthcoming | | | | |
|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | 2009 | 2010 |
| Principal | 8.33 | 50.00 | 116.67 | 125.00 | 108.33 |
| Charges/Interest | 14.13 | 24.60 | 20.82 | 14.67 | 8.90 |
| Total | 22.47 | 74.60 | 137.48 | 139.67 | 117.24 |

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

VII. **Safeguards Assessments:**

Under the Fund's safeguards assessment policy, the National Bank of Yugoslavia (now the National Bank of Serbia) was subject to a safeguards assessment with respect to the Extended Arrangement approved on May 13, 2002. 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 accepted the obligations under Article VIII, Sections 2, 3, and 4, on May 13, 2002, and maintains a system free of restrictions on payments and transfers for current international transactions. The currency of Serbia is the Serbian dinar. On January 1, 2001, Serbia adopted a managed floating system.

IX. **Last Article IV Consultation:**

The last Article IV consultation was concluded on June 29, 2005 (Country Report No. 05/232).

X. **Analytical Work Undertaken in Past Consultations:**

2002 Consultation:
- Fiscal adjustment, tax reform, and social spending
- Monetary policy and developments
- Progress in restructuring the banking sector
- External debt restructuring and prospects for external sustainability
- Private sector development

2005 Consultation:
- Reform agenda for the fiscal sector
- Pension system: issues and reform options
- Deficits of state and socially owned enterprises
- Inflation determinants
- Euroization: macroeconomic, prudential, and policy implications
- Export performance and external competitiveness

## XI. FSAP Participation:

Serbia participated in the Financial Sector Assessment Program in 2005, and the Executive Board discussed the Financial System Stability Assessment in relation with the Sixth Review under the Extended Arrangement on February 6, 2006 (Country Report No. 06/96).

## XII. Technical Assistance to Serbia and Montenegro during the Past 12 Months:

| Department | Timing | Purpose |
|---|---|---|
| MFD/FAD | July 2005 | Management of Proceeds of Privatization and Review of PFM (Montenegro) |
| FAD | July 2005 | Public-Private Partnership (Serbia) |
| MFD | Oct. 2005 | Monetary Policy (Serbia) |
| STA | Nov. 2005 | National Accounts Statistics (Serbia) |
| MFD | Nov. 2005 | Monitoring and managing risks emanating from foreign exchange indexed borrowing (Serbia) |
| | Since Jun. 2006 | Resident advisor at the NBS for monetary policy (Serbia) |
| STA | April 2006 | Monetary statistics |
| LEG | May 2006 | Anti-money laundering and combating the financing of terrorism (AML/CFT) |

Technical assistance missions during the past 12 months from FAD, LEG, MFD, and STA have contributed significantly to strengthening public debt management (in Montenegro); identifying the risks associated with PPPs (in Serbia); strengthening AML/CFT efforts (in Serbia); creating a market-based financial system (in Serbia); and improving statistical data provision (in Serbia).

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 directions for NBS reorganization.

## XIII. Resident Representative:

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

## Appendix II: Public Debt Sustainability Analysis

*General government debt in Serbia is sustainable under the assumptions of continued prudent fiscal policies, as proposed by the staff, and robust GDP growth. Its sensitivity to exchange rate shocks, however, highlights potential vulnerabilities. Sustainability is less assured if fiscal policy is loosened significantly, if quasi-fiscal losses of state-owned and socially owned enterprises are taken into account, or if the NPV of unfunded pension liabilities prove to be large.*

1. Under the baseline scenario, Serbia's debt-to-GDP ratio would decline steadily from 61 percent of GDP in 2005 to 19 percent of GDP in 2011 (Table 1).[10] Sharp reduction in debt in 2006 reflects significant Paris Club debt relief (USD$ 600 mln.), which lowered debt-to-GDP ratio to 49 percent by end-May. Following a sizeable fiscal consolidation in 2004–05, the baseline assumes further fiscal tightening in 2006, with the overall cash balance stabilizing at 3 percent of GDP in the medium term. The debt-to-GDP ratio would fall rapidly due to the high projected primary surpluses and real GDP growth, and the favorable terms on the current debt stock over the next few years (most of public external debt is on concessional terms). Real interest rates are assumed to increase over time, however, as borrowing is contracted at market rates. The scenario assumes no effect from privatization receipts, to highlight the underlying debt path in the absence of these one-off receipts.

2. In the stress test using historical averages, however, the debt-to-GDP ratio would slightly increase in the medium-term due to a smaller historical primary surplus than assumed under the baseline.[11] In the no-policy-change scenario, assuming a constant primary balance, debt-to-GDP ratio is projected to decline to 22 percent of GDP. Other tests also result in a continuous, albeit slower, decline in the debt ratio (Figure 1). However, a one-time real depreciation of 30 percent results in a significant increase in the debt ratio, demonstrating the sensitivity of the debt dynamics to the exchange rate, as 87 percent of public debt is foreign currency-denominated.

3. To evaluate the implications of quasi-fiscal losses incurred by state-owned and socially owned enterprises, put by the Solvency Center at significant levels, a modified

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[10] The debt stock includes gross general government and government-guaranteed debt of the Republic of Serbia, including debt to non-Paris Club official creditors under negotiation and in non-convertible currencies.

[11] Stress tests were conducted using the standardized methodology but with modifications due to data constraints. Historical data for Serbia are incomplete prior to 2000 and those available thereafter are affected by debt restructuring operations. Hence, four-year averages (2002–05) were used to replace historical averages for all variables but the interest rate. The real interest rate was assumed at zero for the stress tests and the 1997—2001 data for 4 countries in the region (Albania, Bulgaria, Croatia, and Romania) were used to derive its standard deviation.

scenario takes into account these enterprises' deficit, estimated for illustrative purposes at 5 percent of GDP annually (Table 2). Under this scenario, the debt-to-GDP ratio would decline only slightly (to 45 percent of GDP), and the debt path would be much more sensitive to shocks. Under most standard stress tests, the debt ratio would increase. The scenario also serves to illustrate that a significant fiscal loosening would endanger sustainability and make Serbia more susceptible to public debt distress. This may materialize if the large investment program proceeds as announced, labor tax cuts are not compensated for, or the fiscal cost of bridging the social contributions gap—yet unquantified by the authorities—turns out to be substantial.

4. As yet unquantified fiscal costs may arise from a September 2005 law bridging gaps in payment of social contributions from the 1990s. To mitigate the social impact of the economic crisis of the 1990s and to facilitate restructuring and privatization of public and socially owned enterprises, the law provides for government-funded bridging of employer contribution gaps accrued between 1991-2003. Although the benefits for the period of missing contributions will be paid at the lowest applicable base, the full fiscal impact of this law remains unclear, and has not yet been quantified by the authorities. An estimated 183,000 employees have a gap in their pensionable service (12 percent of current contributors), its average length is not known. The authorities are currently processing applications with a view to providing fiscal estimates for the 2007 budget. Temporary measures are already in place to allow pensioners with missing years of contributions to claim partial benefits for those years.

Table 1. Serbia: Government Debt Sustainability Framework, 2003-2011
(In percent of GDP, unless otherwise indicated)

| | | Actual | | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | **Debt-stabilizing primary balance 9/** |
| 1 **Baseline: General government debt 1/** | **79.9** | **68.9** | **61.2** | **47.9** | **39.9** | **33.5** | **27.7** | **22.9** | **18.6** | **-0.7** |
| *Of which* foreign-currency denominated | 70.1 | 59.0 | 53.8 | 41.7 | 36.0 | 31.1 | 26.5 | 22.3 | 18.3 | |
| 2 Change in general government debt | -6.0 | -11.1 | -7.7 | -13.3 | -8.0 | -6.4 | -5.8 | -4.8 | -4.3 | |
| 3 Identified debt-creating flows (4+7+12) | -18.3 | -9.3 | -4.1 | -13.4 | -9.7 | -8.3 | -7.3 | -6.1 | -5.3 | |
| 4 Primary deficit | 3.8 | -0.6 | -2.5 | -4.4 | -5.0 | -4.8 | -4.7 | -4.2 | -3.9 | |
| 5 Revenue and grants | 43.5 | 45.2 | 45.2 | 44.3 | 44.3 | 43.9 | 43.1 | 42.7 | 42.3 | |
| 6 Primary (noninterest) expenditure | 47.3 | 44.6 | 42.7 | 39.9 | 39.2 | 39.1 | 38.5 | 38.5 | 38.4 | |
| 7 Automatic debt dynamics 2/ | -17.6 | -8.2 | 0.9 | -9.0 | -4.7 | -3.5 | -2.7 | -1.9 | -1.4 | |
| 8 Contribution from interest rate/growth differential 3/ | -12.8 | -11.8 | -10.9 | -9.0 | -4.7 | -3.5 | -2.7 | -1.9 | -1.4 | |
| 9 *Of which* contribution from real interest rate | -11.0 | -5.5 | -7.4 | -6.3 | -2.6 | -1.8 | -1.2 | -0.6 | -0.4 | |
| 10 *Of which* contribution from real GDP growth | -1.8 | -6.2 | -3.5 | -2.8 | -2.1 | -1.8 | -1.5 | -1.2 | -1.0 | |
| 11 Contribution from exchange rate depreciation 4/ | -4.8 | 3.6 | 11.9 | ... | ... | ... | ... | ... | ... | |
| 12 Other identified debt-creating flows | -4.5 | -0.6 | -2.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 13 Privatization receipts (negative) | -4.5 | -0.6 | -2.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 14 Recognition of implicit or contingent liabilities | 0.0 | 0.0 | 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 | 0.0 | 0.0 | |
| 16 Residual, including asset changes (2-3) 5/ | 12.3 | -1.7 | -3.6 | 0.1 | 1.7 | 1.9 | 1.5 | 1.3 | 1.0 | |
| General government debt-to-revenue ratio 1/ | 183.6 | 152.3 | 135.3 | 108.2 | 90.2 | 76.4 | 64.3 | 53.6 | 43.9 | |
| **Gross financing need 6/** | 4.5 | 1.4 | 1.1 | -0.7 | -0.7 | -1.2 | -1.5 | -1.1 | -1.7 | |
| in billions of U.S. dollars | 0.9 | 0.3 | 0.3 | -0.2 | -0.2 | -0.4 | -0.5 | -0.4 | -0.7 | |
| **Scenario with key variables at their historical averages 7/** | | | | **47.9** | **48.0** | **48.5** | **48.9** | **49.0** | **48.9** | **-1.4** |
| **Scenario with no policy change (constant primary balance) in 2006-2011** | | | | **47.9** | **43.3** | **37.4** | **31.9** | **26.9** | **22.0** | **-0.8** |
| **Key Macroeconomic and Fiscal Assumptions Underlying Baseline** | | | | | | | | | | |
| Real GDP growth (in percent) | 2.4 | 9.3 | 6.3 | 5.5 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | |
| Average nominal interest rate on public debt (in percent) 8/ | 1.4 | 2.0 | 2.8 | 2.8 | 3.9 | 3.6 | 3.4 | 3.7 | 3.6 | |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | -14.9 | -7.4 | -12.2 | -11.5 | -5.8 | -4.6 | -3.5 | -2.3 | -1.6 | |
| Nominal appreciation (increase in US dollar value of local currency, in percent) | 8.0 | -5.7 | -19.4 | ... | ... | ... | ... | ... | ... | |
| Inflation rate (GDP deflator, in percent) | 16.3 | 9.4 | 14.9 | 14.3 | 9.7 | 8.2 | 7.0 | 6.0 | 5.2 | |
| Growth of real primary spending (deflated by GDP deflator, in percent) | 4.2 | 3.1 | 1.7 | -1.5 | 3.2 | 4.6 | 3.3 | 5.2 | 4.7 | |
| Primary deficit | 3.8 | -0.6 | -2.5 | -4.4 | -5.0 | -4.8 | -4.7 | -4.2 | -3.9 | |

1/ General government and government-guaranteed gross 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; $\pi$ = growth rate of GDP deflator; g = real GDP growth rate; $\alpha$ = share of foreign-currency denominated debt; and $\varepsilon$ = 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/ For projections, this line includes exchange rate changes.

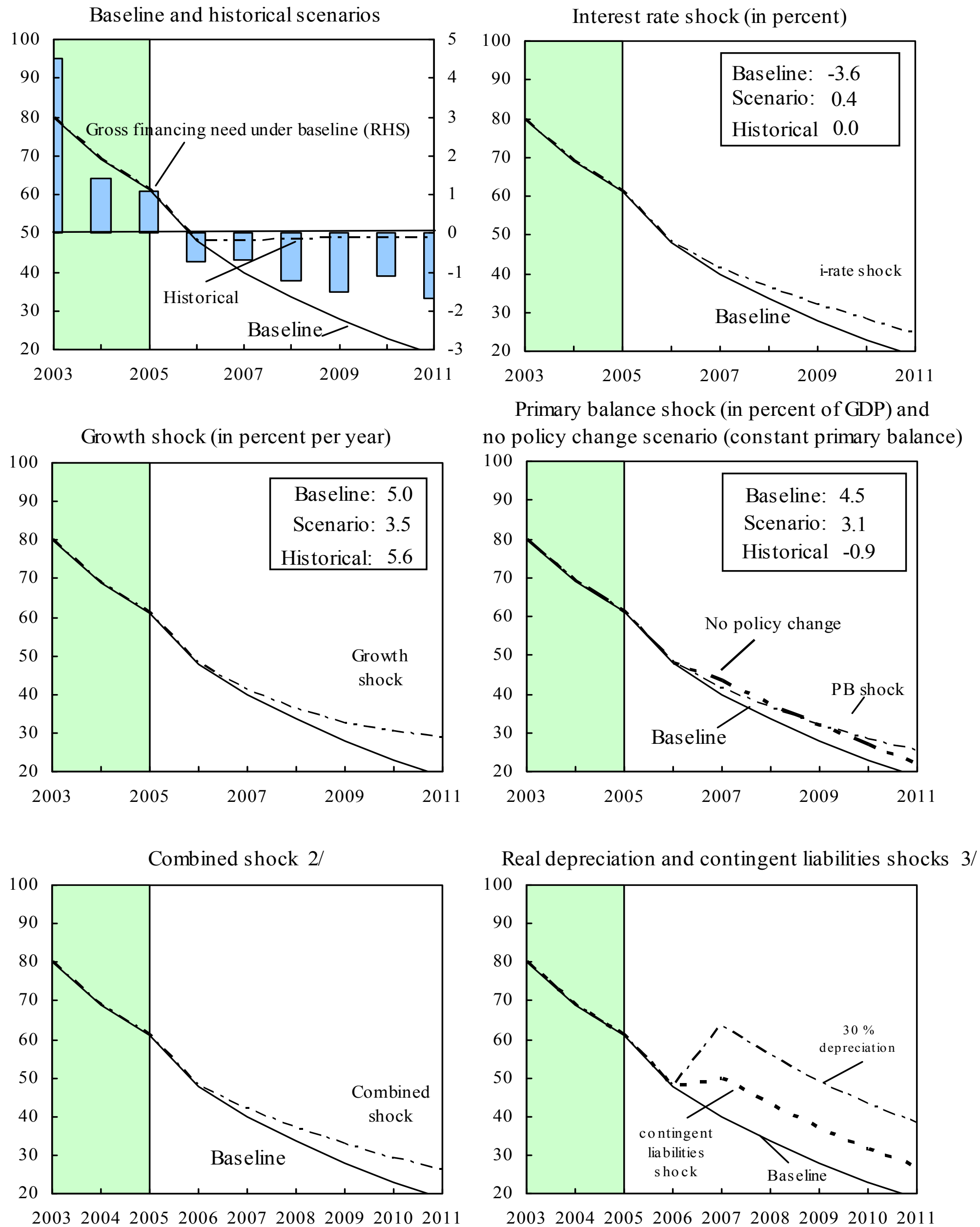
6/ Defined as general government deficit, plus amortization of medium and long-term government debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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

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

Figure 1. Serbia: Government Debt Sustainability: Bound Tests, 2003-2011 1/
(In percent of GDP)




Sources: Serbian authorities; and staff estimates and projections.

1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Four-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 2. Serbia: Government Debt Sustainability Framework, 2003-2011 (Modified Scenario 1/)
(In percent of GDP, unless otherwise indicated)

| | Actual | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | Debt-stabilizing primary balance 10/ |
| 1 **Baseline: General government debt 2/** | **79.9** | **68.9** | **61.2** | **52.9** | **49.5** | **47.7** | **46.3** | **45.6** | **45.1** | **-2.1** |
| *Of which* foreign-currency denominated | 70.1 | 59.0 | 53.8 | 46.7 | 45.5 | 45.4 | 45.2 | 45.0 | 44.8 | |
| 2 Change in general government debt | -6.0 | -11.1 | -7.7 | -8.3 | -3.4 | -1.7 | -1.4 | -0.7 | -0.5 | |
| 3 Identified debt-creating flows (4+7+12) | -18.3 | -9.3 | -4.1 | -8.4 | -5.3 | -4.1 | -3.5 | -2.6 | -2.2 | |
| 4 Primary deficit | 3.8 | -0.6 | -2.5 | 0.6 | 0.0 | 0.2 | 0.3 | 0.8 | 1.1 | |
| 5 Revenue and grants | 43.5 | 45.2 | 45.2 | 44.3 | 44.3 | 43.9 | 43.1 | 42.7 | 42.3 | |
| 6 Primary (noninterest) expenditure | 47.3 | 44.6 | 42.7 | 44.9 | 44.2 | 44.1 | 43.5 | 43.5 | 43.4 | |
| 7 Automatic debt dynamics 3/ | -17.6 | -8.2 | 0.9 | -9.0 | -5.3 | -4.3 | -3.9 | -3.4 | -3.2 | |
| 8 Contribution from interest rate/growth differential 4/ | -12.8 | -11.8 | -10.9 | -9.0 | -5.3 | -4.3 | -3.9 | -3.4 | -3.2 | |
| 9 *Of which* contribution from real interest rate | -11.0 | -5.5 | -7.4 | -6.3 | -3.0 | -2.2 | -1.7 | -1.3 | -1.2 | |
| 10 *Of which* contribution from real GDP growth | -1.8 | -6.2 | -3.5 | -2.8 | -2.3 | -2.2 | -2.1 | -2.1 | -2.1 | |
| 11 Contribution from exchange rate depreciation 5/ | -4.8 | 3.6 | 11.9 | ... | ... | ... | ... | ... | ... | |
| 12 Other identified debt-creating flows | -4.5 | -0.6 | -2.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 13 Privatization receipts (negative) | -4.5 | -0.6 | -2.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 14 Recognition of implicit or contingent liabilities | 0.0 | 0.0 | 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 | 0.0 | 0.0 | |
| 16 Residual, including asset changes (2-3) 6/ | 12.3 | -1.7 | -3.6 | 0.1 | 1.9 | 2.4 | 2.1 | 1.9 | 1.7 | |
| General government debt-to-revenue ratio 2/ | 183.6 | 152.3 | 135.3 | 119.5 | 111.8 | 108.8 | 107.5 | 106.8 | 106.6 | |
| **Gross financing need 7/** | 4.5 | 1.4 | 1.1 | 4.3 | 4.4 | 4.1 | 3.8 | 4.2 | 3.7 | |
| In billions of U.S. dollars | 0.9 | 0.3 | 0.3 | 1.2 | 1.4 | 1.4 | 1.4 | 1.6 | 1.5 | |
| **Scenario with key variables at their historical averages 8/** | | | | **52.9** | **52.9** | **53.5** | **53.9** | **54.0** | **53.9** | **-1.6** |
| **Scenario with no policy change (constant primary balance) in 2006-2011** | | | | **52.9** | **52.9** | **51.7** | **50.6** | **49.7** | **48.7** | **-2.2** |
| **Key Macroeconomic and Fiscal Assumptions Underlying Baseline** | | | | | | | | | | |
| Real GDP growth (in percent) | 2.4 | 9.3 | 6.3 | 5.5 | 5.0 | 5.0 | 5.0 | 5.0 | 5.0 | |
| Average nominal interest rate on public debt (in percent) 9/ | 1.4 | 2.0 | 2.8 | 2.8 | 3.6 | 3.6 | 3.2 | 3.0 | 2.6 | |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | -14.9 | -7.4 | -12.2 | -11.5 | -6.1 | -4.5 | -3.8 | -2.9 | -2.6 | |
| Nominal appreciation (increase in US dollar value of local currency, in percent) | 8.0 | -5.7 | -19.4 | ... | ... | ... | ... | ... | ... | |
| Inflation rate (GDP deflator, in percent) | 16.3 | 9.4 | 14.9 | 14.3 | 9.7 | 8.2 | 7.0 | 6.0 | 5.2 | |
| Growth of real primary spending (deflated by GDP deflator, in percent) | 4.2 | 3.1 | 1.7 | 10.9 | 3.4 | 4.7 | 3.5 | 5.1 | 4.8 | |
| Primary deficit | 3.8 | -0.6 | -2.5 | 0.6 | 0.0 | 0.2 | 0.3 | 0.8 | 1.1 | |

1/ Assumes a fiscal deficit higher by 5 percent of GDP compared to the main scenario, to account for estimated quasi-fiscal losses of state-owned and socially owned enterprises.

2/ General government and government-guaranteed gross debt.

3/ 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; $\pi$ = growth rate of GDP deflator; g = real GDP growth rate; $\alpha$ = share of foreign-currency denominated debt; and $\varepsilon$ = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

4/ 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.

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

6/ For projections, this line includes exchange rate changes.

7/ Defined as general government deficit, plus amortization of medium and long-term government debt, plus short-term debt at end of previous period.

8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

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

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

## Appendix III: External Debt Sustainability Analysis

*Under the assumption of strong policies leading to improving current account balances, external debt ratios are stabilized in the medium term well below 60 percent of GDP, and set on a declining path. However, the stress tests qualify this scenario. In particular, external debt ratios could be worsened by a large depreciation that could, for example, follow a confidence crisis. But even other less dramatic scenarios would keep debt ratios at higher levels than under the baseline. This is the first DSA conducted for Serbia only.*

### Medium-term balance of payments projections

1. Under the baseline scenario, the debt-to-GDP ratio remains relatively flat in the medium term and then improves over the long run, albeit at a relatively slow pace, averaging around 60 percent in the next three years and around 55 percent in the next five years (Table 1). The impact of the last tranche of the Paris Club debt rescheduling agreement following the completion of the Extended Arrangement in February 2006 is expected to be offset by greatly increased external borrowing by the private sector. Debt service ratios increase over the time horizon, reflecting both higher debt service after the end of the grace period offered by the Paris Club and other bilateral creditors, and, more importantly, the shift to external borrowing by the private sector away from the public sector, and stabilize at around 15 percent of GDP and 53 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.

2. The baseline scenario is grounded on the expected implementation of strong policies by the authorities in the coming years, and assumes that: (i) exports will grow at an annual average of 19 percent and 21 percent respectively in dollar and euro terms in the first three years (starting with 2006) and 14 percent in the following four years; (ii) imports will grow at about 12 percent and 14 respectively in dollar and euro terms in 2006-08 and then around 8 percent in the following four years (Table 2). However, average growth rates for 2006-07 are distorted by the effect of the VAT introduction in January 2005, so that the corrected average in this period would be slightly lower;[12] (ii) FDI related to the privatization process continues to flow in during 2006 and 2007, but is gradually replaced by other types of FDI,

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[12] 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 Serbia 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 strong domestic demand of Serbia'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.

including "greenfield" investment, equity investment, and reinvestment in existing companies, building on the success in privatization and improving the business environment; (iv) commercial borrowing will increase steadily as the business environment improves; (v) official borrowing will overall decline, particularly in program support being offset by project support; (vi) there will be no IMF financial support following the recently completed arrangement; and (vii) gross international reserves will remain at around 8 months of prospective imports of goods and services in 2006-07, reflecting the impact of the large-scale sterilization in the first quarter of 2006, and will then gradually decline to around 6 months as intervention is discontinued.

**Stress testing applying the standardized sustainability framework[13]**

3. With key variables set at their historical averages,[14] the external debt ratios would decline much faster than in the baseline after the first year. This owes to the higher historical GDP deflator related to dollar depreciation, and the past lower nominal interest rate partly associated with the delayed start of debt service to the Paris Club creditors.

4. While the external debt ratios are high but declining under the baseline, the sensitivity analysis exercises underline the significant vulnerabilities that underlie this relatively benign scenario. In particular, as shown by the bound test charts (Figure 1), a large one-time nominal depreciation in 2007, for example triggered by a crisis of confidence in the government's economic policy, would bring about a dramatic increase in the debt-to-GDP ratio. In this scenario, although the debt ratio declines after the initial peak, it remains well above its current level over the projection period. A shock to the current account, for example due to insufficient restructuring in the enterprise sector and poor export performance, would also negatively affect the debt dynamics, though to a lesser degree. Shocks to interest rates and to real growth rates increase the debt ratio, but it converges back to the baseline in the medium term. The combination of smaller shocks of all the above variables would yield higher debt ratios than the baseline mainly due to the current account shock component.

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[13] Due to the limited availability of data and the exceptional factors that have affected economic performance, the standard framework for debt sustainability analysis was adapted. Historical averages for most key variables are based on the outturns of 2003–05 for Serbia, complemented by 2001–03 data for Serbia and Montenegro where needed.

[14] These variables are real GDP growth, dollar deflator, nominal interest rate, export and import growth rates, non-interest current account, and non-debt creating inflows.

Table 1. Serbia: External Debt Sustainability Framework, 2003-2011
(In percent of GDP, unless otherwise indicated)

| | | Actual | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | **Debt-stabilizing non-interest current account 6/** |
| 1 | **Baseline: External debt** | **71.4** | **62.8** | **64.4** | **62.6** | **59.5** | **58.4** | **56.9** | **55.2** | **52.5** | **-6.4** |
| 2 | Change in external debt | -7.3 | -8.6 | 1.6 | -1.8 | -3.1 | -1.1 | -1.5 | -1.7 | -2.7 | |
| 3 | Identified external debt-creating flows (4+8+9) | -17.6 | -2.6 | -1.9 | -3.9 | 0.6 | 0.1 | -0.2 | -0.6 | -1.3 | |
| 4 | Current account deficit, excluding interest payments | 7.8 | 11.2 | 7.7 | 7.1 | 6.9 | 6.0 | 5.5 | 4.6 | 3.9 | |
| 5 | Deficit in balance of goods and services | 23.1 | 30.3 | 23.4 | 21.6 | 20.7 | 19.5 | 18.3 | 16.8 | 15.4 | |
| 6 | Exports | 16.6 | 18.2 | 20.7 | 21.4 | 22.7 | 24.9 | 26.5 | 28.1 | 29.5 | |
| 7 | Imports | 39.7 | 48.5 | 44.1 | 43.0 | 43.3 | 44.4 | 44.8 | 44.9 | 45.0 | |
| 8 | Net non-debt creating capital inflows (negative) | -7.2 | -4.3 | -6.5 | -10.4 | -6.2 | -6.2 | -6.2 | -6.0 | -5.9 | |
| 9 | Automatic debt dynamics 1/ | -18.2 | -9.5 | -3.2 | -0.6 | -0.1 | 0.3 | 0.5 | 0.8 | 0.7 | |
| 10 | Contribution from nominal interest rate | 1.5 | 1.4 | 2.1 | 2.9 | 2.9 | 3.1 | 3.3 | 3.4 | 3.3 | |
| 11 | Contribution from real GDP growth | -1.4 | -5.6 | -3.6 | -3.5 | -3.0 | -2.8 | -2.7 | -2.6 | -2.6 | |
| 12 | Contribution from price and exchange rate changes 2/ | -18.2 | -5.3 | -1.6 | ... | ... | ... | ... | ... | ... | |
| 13 | Residual, incl. change in gross foreign assets (2-3) 3/ | 10.2 | -5.9 | 3.6 | 2.1 | -3.8 | -1.2 | -1.3 | -1.1 | -1.4 | |
| | External debt-to-exports ratio (in percent) | 431.0 | 345.4 | 311.2 | 292.5 | 262.4 | 234.5 | 215.2 | 196.6 | 177.6 | |
| | **Gross external financing need (in billions of US dollars) 4/** | 2.0 | 4.5 | 4.0 | 5.6 | 7.0 | 7.7 | 9.4 | 10.2 | 10.5 | |
| | In percent of GDP | 10.3 | 20.0 | 16.7 | 20.1 | 22.0 | 22.4 | 25.6 | 25.7 | 24.7 | |
| | **Scenario with key variables at their historical averages 5/** | | | | **62.6** | **54.6** | **47.5** | **41.6** | **36.9** | **32.9** | **-10.9** |
| | **Key Macroeconomic Assumptions Underlying Baseline** | | | | | | | | | | |
| | Real GDP growth (in percent) | 2.4 | 9.3 | 6.3 | 6.3 | 5.5 | 5.0 | 5.0 | 5.0 | 5.0 | |
| | GDP deflator in US dollars (change in percent) | 30.1 | 7.9 | 2.6 | 9.2 | 8.1 | 2.6 | 2.4 | 2.4 | 2.4 | |
| | Nominal external interest rate (in percent) | 2.5 | 2.4 | 3.6 | 5.3 | 5.3 | 5.6 | 6.0 | 6.4 | 6.4 | |
| | Growth of exports (US dollar terms, in percent) | 30.1 | 29.6 | 21.7 | 19.0 | 18.9 | 18.3 | 14.2 | 14.1 | 13.1 | |
| | Growth of imports (US dollar terms, in percent) | 24.8 | 44.3 | -2.7 | 12.1 | 13.2 | 10.3 | 8.4 | 7.8 | 7.8 | |
| | Current account balance, excluding interest payments | -7.8 | -11.2 | -7.7 | -7.1 | -6.9 | -6.0 | -5.5 | -4.6 | -3.9 | |
| | Net non-debt creating capital inflows | 7.2 | 4.3 | 6.5 | 10.4 | 6.2 | 6.2 | 6.2 | 6.0 | 5.9 | |

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; $\rho$ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, $\varepsilon$ = nominal appreciation (increase in dollar value of domestic currency), and $\alpha$ = 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. $\rho$ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

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

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

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 2. Serbia: Medium-Term External Sustainability, 2002-2011

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | Average 2006-08 | Average 2009-11 | Average 2002-2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | (In millions of U.S. dollars, unless indicated otherwise) | | | | | | | | | | | | |
| Export growth (US$ terms, in percent) | 21.4 | 30.1 | 29.6 | 21.7 | 19.0 | 18.9 | 18.3 | 14.2 | 14.1 | 13.1 | 18.7 | 13.8 | 20.1 |
| Export growth (euro terms, in percent) | 32.0 | 15.1 | 18.0 | 20.7 | 24.6 | 20.2 | 18.0 | 14.0 | 14.0 | 13.0 | 20.9 | 13.7 | 19.0 |
| Import growth (US$ terms, in percent) | 31.7 | 32.4 | 44.3 | -2.7 | 12.1 | 13.2 | 10.3 | 8.4 | 7.8 | 7.8 | 11.9 | 8.0 | 16.5 |
| Import growth (euro terms, in percent) | -8.9 | 24.8 | 31.4 | -3.5 | 17.4 | 14.5 | 10.0 | 8.2 | 7.8 | 7.8 | 14.0 | 7.9 | 11.0 |
| Current account balance, before grants | -1,863 | -2,238 | -3,329 | -2,681 | -3,038 | -3,278 | -3,259 | -3,347 | -3,310 | -3,189 | … | … | … |
| In percent of GDP | -13.1 | -11.8 | -14.8 | -11.2 | -11.0 | -10.6 | -9.8 | -9.3 | -8.6 | -7.7 | -10.4 | -8.5 | -10.8 |
| Current account balance, after grants | -2,144 | -1,762 | -2,825 | -2,351 | -2,769 | -3,062 | -3,044 | -3,132 | -3,095 | -2,974 | … | … | … |
| In percent of GDP | -15.0 | -9.3 | -12.6 | -9.8 | -10.0 | -9.9 | -9.1 | -8.7 | -8.0 | -7.2 | -9.7 | -8.0 | -10.0 |
| Gross official reserves | 2,280 | 3,550 | 4,245 | 5,843 | 10,019 | 10,319 | 10,619 | 10,919 | 11,219 | 11,519 | … | … | … |
| In months of prospective imports of GNFS | 3.3 | 3.6 | 4.2 | 5.2 | 8.0 | 7.5 | 7.2 | 6.8 | 6.5 | 6.2 | 7.5 | 6.5 | 5.8 |
| External debt 1/ | 11,230 | 13,575 | 14,099 | 15,467 | 17,303 | 18,453 | 19,518 | 20,460 | 21,333 | 21,811 | … | … | … |
| In percent of exports of goods and services | 464 | 404 | 313 | 304 | 281 | 251 | 225 | 207 | 189 | 171 | 252.2 | 189.2 | 280.9 |
| In percent of GDP | 79 | 71 | 63 | 64 | 63 | 60 | 58 | 57 | 55 | 53 | 60.2 | 54.9 | 62.3 |
| In percent of government revenue | 165 | 151 | 130 | 133 | 144 | 147 | 148 | 148 | 147 | 141 | 146.5 | 145.4 | 145.5 |
| External debt service 2/ 3/ | 183 | 423 | 633 | 964 | 2,184 | 3,115 | 3,752 | 5,358 | 6,091 | 6,598 | … | … | … |
| In percent of exports of goods and services | 7.6 | 12.6 | 14.0 | 19.0 | 35.4 | 42.4 | 43.2 | 54.3 | 54.1 | 51.7 | 40.3 | 53.4 | 33.4 |
| In percent of GDP | 1.3 | 2.2 | 2.8 | 4.0 | 7.9 | 10.0 | 11.2 | 14.9 | 15.8 | 15.9 | 9.7 | 15.5 | 8.6 |
| In percent of government revenue | 2.7 | 4.7 | 5.8 | 8.3 | 18.2 | 24.8 | 28.5 | 38.8 | 42.1 | 42.6 | 23.8 | 41.2 | 21.7 |

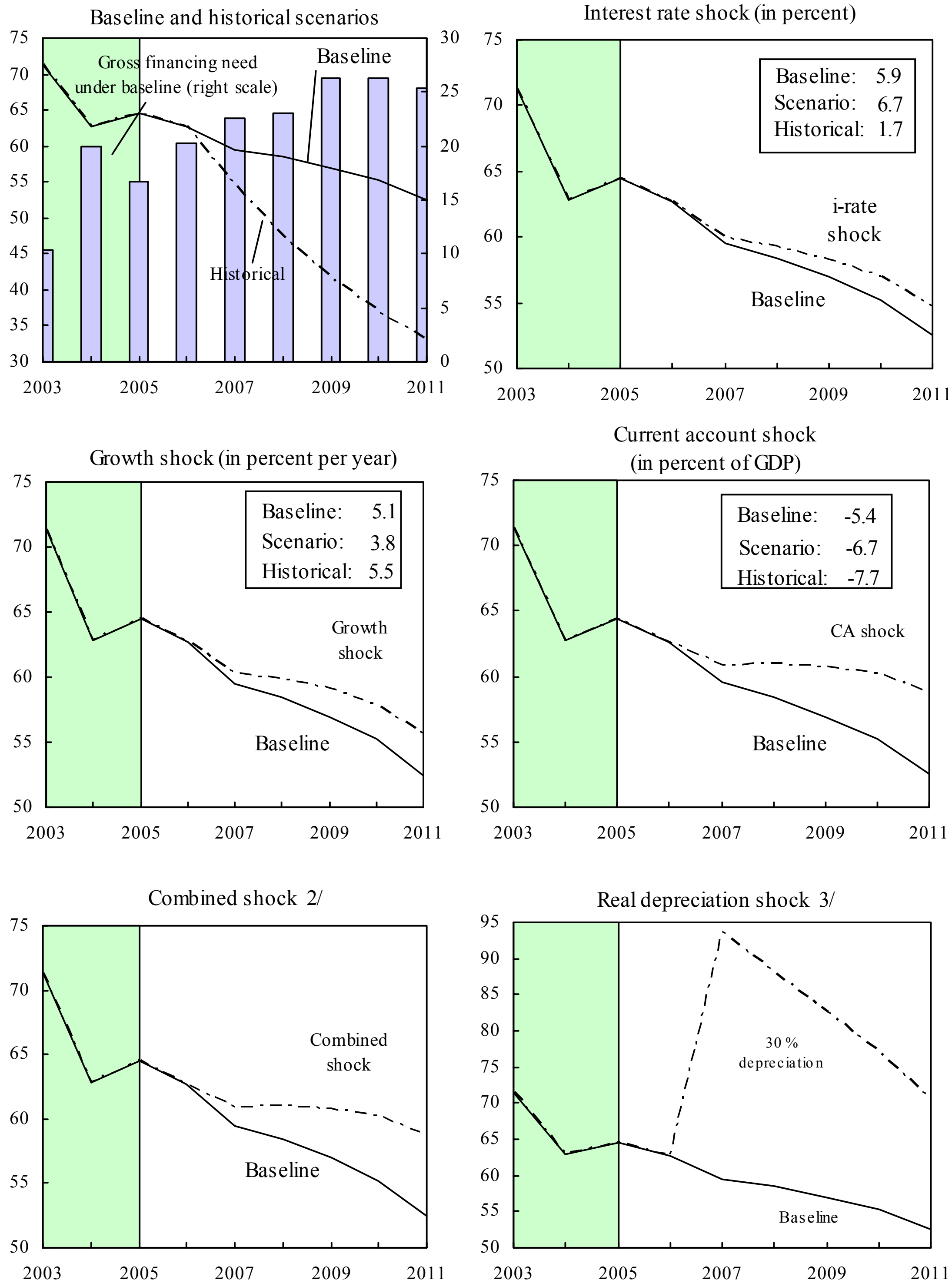
Sources: SCG authorities, and Fund staff estimates.

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.

Figure 1. Serbia: External Debt Sustainability: Bound Tests, 2003-2011 1/
(External debt in percent of GDP)




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

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2007.

## Appendix IV: IMF-World Bank Relations

### Partnership with Serbia's development strategy

1. In 2004, the two republics of Serbia and Montenegro highlighted progress in structural reform and stabilization, and outlined their medium-term development strategies in their respective Poverty Reduction Strategy Papers (PRSP). PRSP Progress reports and a Joint Staff Advisory Note (JSAN) were prepared in 2005 and reviewed by the IMF and World Bank Executive Boards in February 2006. Support for the governments' development strategy from the World Bank and the IMF follow the agreed upon division of responsibilities between the two institutions.

2. The Fund takes the lead on macroeconomic policies (fiscal, monetary, and exchange rate) aimed at facilitating sustainable growth. 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) 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.

### World Bank group strategy

3. A Joint World Bank-IFC Country Assistance Strategy for Serbia and Montenegro covering FY05-07 was endorsed by the Bank's Board 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. As outlined in the FY05-07 Country Assistance Strategy, the Bank's policy-based lending assistance in Serbia will have a series of up to four Programmatic Development Policy Lending (DPL) operations, in two parallel streams: (i) the development of a robust private sector through the Programmatic Private and Financial DPLs, the first of which was approved in December 2005; and (ii) the development of a smaller and more efficient public sector through the Programmatic Public Sector DPLs, the first of which will be sent for Board consideration in the second half of 2006.

4. The Bank's program of adjustment lending has been underpinned by analytical studies. For Serbia, the Bank recently finalized an Economic Memorandum, a Public Expenditure and Institutional Review, and an FSAP (jointly with the Fund). In addition, an Accounting and Auditing ROSC, and reports on agriculture, social protection, decentralization, and on poverty and labor markets are currently under preparation.

5. A program of selective investment lending has been designed to assist the authorities in tackling critical impediments to effective public sector management and private sector development, improving social policy, and underpinning reforms initiated under the Bank-supported adjustment programs. Investment projects support trade facilitation, education, enterprise restructuring, energy, health, and transport. As of end-April 2006, 16 IDA credits totaling $636 million had been approved for Serbia, with adjustment support comprising the majority.

**IFC**

6. As of June 2006, IFC has committed about $318 million in Serbia and Montenegro. During FY06, IFC committed about $169 million in 5 projects in the financial markets. Donor supported technical assistance has been an important component of the IFC's operations in the country.

7. In the *financial sector*, IFC's support has been focused in catalyzing foreign strategic investors' interest and establishing viable financial institutions such as ProCredit Bank and HVB Serbia. IFC has supported development of microfinance institutions by investing in Opportunity Bank Montenegro, in ProCredit Serbia and in ProCredit Kosovo. IFC supported the introduction and expansion of financial services including mortgage financing, consumer finance, leasing and SME finance. IFC helped the government with leasing regulation and invested in a leasing company (Raiffeisen leasing). Also, IFC contributed to the cleaning-up, rehabilitation and privatization of the banking sector through restructuring of IFC's claims on Serbian and Montenegrin banks.

8. In the *corporate sector*, IFC has provided a loan of US$19.5 million and an equity investment of US$8.5 million to Tigar Rubber Company, a leading regional producer of high quality car tires. The financing was accompanied by extensive technical assistance to the company and its SME suppliers implementing "Supply Chain Management" scheme which resulted in a high development impact.

9. Through SEED (now PEPSE) IFC has delivered programs supporting *SME*s. In June 2005, IFC started new programs through Private Enterprise Partnership South Europe (PEP-SE) with a focus in 4 business lines: SMEs support and linkages, business enabling environment, access to finance, and infrastructure advisory operations. IFC PEP SE is supporting three Mediation Centers in Serbia. So far 1515 cases were resolved through mediation and the amount resolved is EUR 4.6 million.

10. In *infrastructure,* through its PEP-SE Infrastructure, IFC is engaged in advising the city of Belgrade on structuring concessions for the rehabilitation and expansion of solid waste disposal facilities and for water and waste water services. In addition, IFC is advising the Government and the JAT Airways in a restructuring plan aimed at the participation of the private sector at a later stage.

11. While IFC will continue to expand its activities in the real and financial sectors in the short term, it will look for opportunities to support Serbia with investments in the energy, telecommunication, and transportation sectors in the long term.

**MIGA**

12. As of June 2006, MIGA's outstanding portfolio in Serbia and Montenegro consisted of 16 contracts of guarantee with a total gross and net exposure of $393 million and $172 million, respectively. All contracts of guarantee have been issued for project enterprises incorporated in Serbia. MIGA is also providing technical assistance for capacity building on investment promotion. It is currently implementing, jointly with the European Agency for Reconstruction, a follow-on project to strengthen the investment promotion capacity of the Serbian Investment and Export Promotion Agency (SIEPA).

**Joint staff advisory note (JSAN) of the PRSP and progress reports**

13. Bank and Fund staff prepared a joint assessment of the Serbian and Montenegrin poverty reduction strategies in 2004 and a JSAN on the Serbian and Montenegrin PRSP Progress Reports in 2005. In both instances, 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 latest JSAN commends the governments for their efforts to address the recommendations made in the first JSA, but notes that implementation of the poverty reduction strategies has been limited so far, and major challenges remain.

**Bank-Fund collaboration in specific areas**

14. *Public expenditure management*. 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.

15. *Energy sector reform*. 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 also motivated conditionality in successive Fund arrangements. The Bank program has combined support for policy reforms through its policy-based lending with investment credits/grants for critical capital needs.

16. *Pension, health and social assistance reform*. 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 the financial situation and sustainability of the pension systems. This created a synergy between Bank and Fund programs. The Bank has taken the lead on pension reforms through both policy-based and investment operations in both

republics. Technical assistance has also been provided through grants. The Fund has included related conditionality in its successive arrangements with SCG and provided supporting fiscal analysis. The Bank's policy-based loans have supported reforms of the health care system to begin restoring financial balance in that sector, as a basis for improving its functioning and ability to provide basic health care services for all citizens.

17. *Restructuring and privatization of enterprises and banks*. Reforms in the enterprise and financial sector began in late 2000. 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 policy-based credits with parallel projects to provide technical assistance.

18. *Legal reforms with a bearing on the business environment*. The Bank has taken the lead on business environment and general private sector development. The policy-based lending program supported enactment of laws on foreign direct investment, an SME agency, amendments to federal and republican enterprise laws, the preparation of a law on secured transactions, the enactment of laws on concessions, leasing, bankruptcy, business registration, and on the Agency for Business Services. In addition, the policy loans emphasized reforms of the legal framework for the labor market, promoting employment creation through greater flexibility, and ensuring the financial sustainability and effectiveness of unemployment benefit programs. This complemented Fund conditionality related to securities and accounting legislation, and rationalizing employment clauses in social programs associated with privatization and enterprise restructuring.

Prepared by World Bank staff.

## Appendix V: Statistical Issues

1. In recent years, Serbia has been successfully upgrading its statistical system with the assistance of the IMF and other bilateral and multilateral institutions, and although international standards are not yet fully met, official data for all sectors are sufficiently good to support key economic analysis and surveillance. In many areas, including monetary and balance of payments sectors, internationally accepted reporting standards have been introduced. However, Serbia 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 page on Serbia in the IMF's *International Financial Statistics (IFS)* is expected to be available sometime later this year.

2. In response to the authorities' requests, the Fund provided a series of technical assistance missions to improve the quality of macroeconomic statistics and support policy analysis. In 2001–03, STA conducted four missions, two on monetary and financial statistics, a multisector statistics mission, and a balance of payments mission. In 2004, there were two missions, on monetary and financial statistics and national accounts. These missions found that there was a critical need 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; and (iv) further improving the classification of bank accounts by economic sector and by financial instrument in compiling monetary and financial statistics. A follow-up mission on national accounts took place in late 2005. A follow-up mission in monetary and financial statistics took place in March-April 2006, which agreed with NBS officials on the establishment of a system for regular reporting of data that will lead to the introduction of an IFS page for Serbia.

### A. Real Sector

3. Real sector data are compiled by the Republic of Serbia Statistical Office (RSSO). Annual current price estimates of GDP by activity and by expenditure are available for Serbia for 1997–2003. In June 2005, the RSSO started publishing quarterly constant price estimates of GDP using the production approach, covering 1999–2005. The agency has made commendable efforts to adopt the *System of National Accounts (1993 SNA),* but there are still problems with the scope of the accounts and the basis for recording, which are not entirely consistent with international standards. Moreover, the quality of the source data is uneven, and data sources are in need of improvement. Official statistics do not incorporate estimates of informal activities, which the RSSO estimated at about 14 percent of GDP in 2003.

4. The RSSO compiles and disseminate retail price indices (RPI), consumer price indices (CPI), producer price indices (PPI), and unit-value price indices for imports and exports. It plans to introduce a new CPI index in 2006, in line with international standards.

While the frequency and methodology of observation appear adequate, weighting, data storage, and dissemination could be improved.

### B. Balance of Payments

5. Balance of payments statistics are compiled by the National Bank of Serbia (NBS). While the data compilation procedures appear appropriate, some components of the balance of payments (e.g., remittances) suffer from substantial underrecording owing to the large proportion of foreign exchange transactions occurring outside official channels. The NBS has made commendable efforts to improve its estimation of actual flows. In current account reporting, the NBS could further improve coverage, valuation and classification by adjusting trade and services data for transactions not explicitly declared (e.g., repairs, shuttle trade, grants in kind, and tourism). In reporting on capital account and financing, the NBS could improve FDI statistics and remove exchange-rate effects from the estimation of certain financial transactions, including reserves and arrears below the line.

### C. Government Finance

6. Fiscal statistics are compiled by the Serbian Ministry of Finance and reported on a monthly basis. Principal data sources are the Republican Treasury and the budget execution reports of the spending ministries and first-level budget units.

7. Since 2001, Serbia has made efforts to bring the existing budget reporting system in line with the *Government Finance Statistics Manual 2001 (GFSM 2001)* methodology. But full compliance has yet to be achieved as implementation of the new chart of accounts, generally consistent with the classifications of the *GFSM 2001*, has not been completed. Fiscal data reporting suffers from frequent re-classifications, especially at the level of local governments and social funds. While the data on government payment arrears are available on quarterly basis, information on accrual of arrears is not available. The authorities have requested a fiscal ROSC mission, which is tentatively scheduled for September 2006.

### D. Monetary Accounts

8. Monetary and financial statistics are compiled by the NBS, broadly following the methodology set forth in the *Monetary and Financial Statistics Manual*, and meet GDDS recommendations with respect to the periodicity and timeliness of financial sector data. Some improvements could still be made. Depository corporations' claims on clients in the NBS *Statistical Bulletin* are on a net-of-provisions basis, while those reported to STA for the development of the *IFS* page are on a gross basis. The coverage of monetary data excludes: (i) some still relatively small deposit-taking savings and credit institutions; and (ii) since January 2002, banks in liquidation (as their data are not available on a timely or comparable, *IAS*-specified, basis). Regarding the former, the March-April 2006 mission recommended that these activities be monitored and should they become analytically significant, these institutions should be included in the coverage of the depository corporations' survey. The

mission also recommended that the banks' claims on enterprises published in the NBS bulletin be disaggregated into claims on public and private enterprises. The NBS has began reporting monetary data in the Standardized Report Forms.

## SERBIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

*AS OF JULY 31, 2006*

| | Date of Latest Observation | Date Received | Frequency of Data[6] | Frequency of Reporting[6] | Frequency of Publication[6] |
|---|---|---|---|---|---|
| Exchange rates | July 28, 2006 | July 31, 2006 | D and M | D and M | D and M |
| International reserve assets and reserve liabilities of the monetary authorities[1] | July 28, 2006 | July 31, 2006 | D | D | M |
| Reserve/base money | July 28, 2006 | July 31, 2006 | D and M | W and M | W and M |
| Broad money | June 2006 | July 25, 2006 | M | M | M |
| Central bank balance sheet | June 2006 | July 25, 2006 | M | M | M |
| Consolidated balance sheet of the banking system | June 2006 | July 25, 2006 | M | M | M |
| Interest rates[2] | June 2006 | July 25, 2006 | M | M | M |
| Consumer price index | July 2006 | July 31, 2006 | M | M | M |
| Revenue, expenditure, balance and composition of financing[3] – general government[4] | June 2006 | July 21, 2006 | M | M | NA |
| Revenue, expenditure, balance and composition of financing[3]– central government | June 2006 | July 21, 2006 | M | M | M/NA 7/ |
| Stocks of central government and central government-guaranteed debt[5] | June 2006 | July 21, 2006 | M | M | M |
| External current account balance | May 2006 | July 20, 2006 | M | M | M |
| Exports and imports of goods and services | June 2006 | July 28, 2006 | M | M | M |
| GDP/GNP | Q1 2006 | June 30, 2006 | Q | Q | Q |
| Gross external debt | June 2006 | July 18, 2006 | M | M | M |

[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 six-month lag.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Semi-annually (SA), Annually (A), Irregular (I); or Not Available (NA).
[7]Only republican budget data are published.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SERBIA

# Staff Report for the 2006 Article IV Consultation and Post-Program Monitoring Discussions—Supplementary Information

Prepared by the Staff Representatives for the 2006 Consultation with the Republic of Serbia

Approved by Juha Kähkönen and Michael T. Hadjimichael

October 13, 2006

1. This supplement provides information on economic and policy developments since the staff report was issued. A proposed decision on the continuation of post-program monitoring (PPM) is also attached. The thrust of the staff appraisal remains unchanged.

## I. Recent Economic Developments

2. **Economic activity has exceeded expectations and inflation has declined, but external imbalances have widened.** Strong demand—fueled by continued capital inflows and credit growth—has buoyed activity and imports. This has set the current account on track for a deficit of 12 percent of GDP in 2006—even before a planned weakening of the fiscal stance later this year—and has raised external private debt by 7 percentage points of GDP since end-2005, with total external debt back to 65 percent of GDP in August despite the recent Paris Club write-off. With privatization receipts reflected in gross official reserves, the latter soared to $10 billion at end-September (over 8 months of imports of goods and services). This allowed a second early repurchase of SDR 162.5 million in September, reducing Fund credit to SDR 325 million, or 69.5 percent of quota, as of end-September. Reduced central bank intervention in the face of non privatization-related capital inflows led to nominal dinar appreciation in Q3 of some 4 percent relative to H1. However, the strong dinar, combined with favorable international oil price developments and a slowdown in other administered price increases, helped reduce inflation in September to 11.6 percent and core inflation to 10 percent year on year. Recent annualized monthly growth rates for core inflation are in the range of 5–7 percent.

## II. Recent Policy Developments

3. **The National Bank of Serbia (NBS) announced a new monetary policy framework in August.** It includes greater exchange rate flexibility and is anchored by the announcement of objectives for core inflation (7–9 percent at end-2006 and 4–8 percent at

end-2007), with the Ministry of Finance implicitly responsible for administered price projections (non-core inflation). The framework anticipates eventual transition to a full-fledged inflation targeting regime. The two-week repo rate will constitute the main monetary policy instrument. Market reaction to these changes has been favorable. Reflecting the decline in core inflation, the NBS gradually lowered the repo rate from 20 percent in June to 18 percent in September.

4. **Two large privatization operations were completed, and others are forthcoming.** In August, a mobile phone company and mobile operator license were sold for the equivalent of over 6½ percent of GDP (with the government receiving some 5 percent of GDP and the minority shareholder the remainder). In September, a state-owned bank was sold for over 1½ percent of GDP. The authorities are proceeding with the sale of a third mobile phone license. They also anticipate the sale of a minority stake in the state-owned oil and gas company.

5. **The authorities plan a considerable fiscal relaxation relative to their commitment at the time of the final review of the Extended Arrangement (EA) in February 2006.** In particular, the supplementary budget adopted in September involves spending increases by some 3½ percent of GDP in 2006 relative to the EA objectives, funded by part of this year's privatization and license proceeds. Part of the increase consists of additional current spending, in particular wages, while the rest will be executed under the rubric of a "National Investment Plan" (NIP) including transportation, health, education, and infrastructure. This implies, on IMF definitions, a general government deficit in 2006 of about 1.4 percent of GDP, compared to the EA objective of a surplus of 2.7 percent of GDP. Constraints on implementation capacity, however, are likely to prevent full execution of these plans in the envisaged time frame. Accordingly, staff projects a 2006 fiscal deficit of 0.6 percent of GDP. While the authorities expect a slightly lower deficit, their estimate is based on more optimistic revenue projections and the assumption that NIP budget appropriations are fully executed (Text Table 1). The authorities have not yet announced their budget plans for 2007. But taking account of the remaining NIP appropriations, continued implementation capacity constraints, and the already adopted tax cuts, the fiscal deficit outturn could be over 3½ percent of GDP in 2007—and up to 6½ percent of GDP if NIP appropriations were fully spent. This compares with a staff recommended surplus of 3 percent of GDP.

Text Table 1. Serbia: General Government Operations, 2005–06
(In percent of GDP)

| | 2005 | 2006 | | | |
|---|---|---|---|---|---|
| | Actual | Original Budget | Supplem. Budget | | Latest Staff Projection |
| | | | Staff | Authorities 1/ | |
| Revenue | 45.0 | 45.1 | 44.6 | 45.6 | 44.6 |
| Expenditure | 44.2 | 42.5 | 46.0 | 46.0 | 45.2 |
| *Of Which:* NIP | 0.0 | 0.0 | 1.8 | 1.8 | 1.0 |
| **Overall Balance** | **0.8** | **2.7** | **-1.4** | **-0.4** | **-0.6** |

Sources: Ministry of Finance; Fund staff estimates.

1/ Treating pro-rated license proceeds as revenue—in line with the authorities' accounting standards—would imply an overall balance of -0.3 percent of GDP.

6. **Political uncertainties are high.** With talks on the EU Stabilization and Association Agreement still suspended, a party, led by the Minister of Finance, has recently withdrawn from the minority government coalition. If, as now expected, early elections follow, they are likely to be held under a new constitution, the draft of which was recently approved by parliament and will be subject to a referendum in late October.

7. **Thus far, market confidence has not been affected.** This appears to reflect that these policy and political developments were anticipated, that implementation of the fiscal plans is expected to be only partial, and that high interest rates compensate for the risks.

## III. Staff Assessment

8. **The reforms to the monetary framework are welcome, but the envisaged relaxation of fiscal policy reinforces the concerns regarding trends in domestic demand, external imbalances, and vulnerabilities.** The envisaged redirection of fiscal policy—notwithstanding uncertainties about its timing and scale—will compound current account pressures, increase external vulnerabilities, complicate disinflation, and compromise competitiveness and medium-term growth. And if market sentiment turns, growth in the short term could also be hurt. Moreover, an increase in spending on the scale and pace sought by the authorities is virtually certain to be associated with large inefficiencies. The staff's advice remains unchanged—including continued fiscal consolidation, and an appropriate phasing of NIP initiatives funded largely through efficiencies in current public expenditure (Text Table 2). This would reduce external vulnerabilities, support disinflation and the new monetary framework, and along with further structural measures, set the stage for sustained medium-term growth.

Text Table 2. Serbia: Macroeconomic Framework, 2005–07

| | 2005 | 2006 | | 2007 | |
|---|---|---|---|---|---|
| | | PPM 1/ | Staff Proj. 2/ | Proposed 3/ | Illustrative 2/ |
| | (In percent of GDP) | | | | |
| General government fiscal balance | 0.8 | 2.7 | -0.6 | 3.0 | -3.8 |
| Current account balance (underlying) 4/ | -12.8 | -10.8 | 13½ | 10½ | 16 |
| | (Annual change in percent) | | | | |
| Real GDP | 6.8 | 5.0 | 6 | 5½ | 6 |
| Retail price inflation (end of period) | 17.7 | 11.5 | 10 | 8 | 9½ |
| O*f which:* Core inflation | 14.5 | 9.5 | 7½ | 5½ | 7 |

Source: Fund staff estimates and projections.

1/ Authorities' objectives at the time of the final review of the EA in Feb. 2006.
2/ Fund staff projection premised on staff's assessment of the likely NIP execution, given limited implementation capacity.
3/ Fund staff recommendation.
4/ Corrected for the impact of the VAT introduction in 2005. Excluding grants.

9. **Accordingly, continuation of post-program monitoring is proposed for another year.** As indicated in the staff appraisal (¶47), the external vulnerabilities and policy uncertainties warrant continued close monitoring, despite early repurchases reducing outstanding Fund credit below 100 percent of quota.

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# IMF Executive Board Concludes 2006 Article IV Consultation with Republic of Serbia

On October 18, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Serbia—the first Article IV consultation for Serbia alone following the dissolution of the former state union of "Serbia and Montenegro" in June.[15]

## Background

After two decades of stagnation and decline at the end of the last century, Serbia has made significant progress in recent years. Output is up 40 percent from 2000, and GDP growth reached 6.8 percent in 2005. This reflects progress in macroeconomic stabilization, banking sector restructuring, and privatization. Concomitantly, some 60 percent of non-budget non-agricultural employment is now in the private sector, almost double the share five years ago.

However, the legacies of earlier policies continue to weigh on economic performance. Employment has trended down—despite buoyant GDP growth—, headline inflation has only briefly dipped below the mid-teens, and fixed investment stagnated below 20 percent of GDP, falling well short of the level in comparable transition countries. Reflecting the low level of national savings, the current account deficit has remained in

[15] 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.

double digits, resulting in an increase in external debt to 65 percent of GDP by August 2006 despite Paris and London Club debt write-offs. Sizeable corporate losses of the non-financial sector—largely reflecting weak governance and soft budget constraints in socially owned and state-owned enterprises—are at the core of Serbia's external deficits, while also curbing investment and employment growth.

The strong—notably fiscal—policy response has been overwhelmed by surging capital inflows. Privatization-related FDI and direct corporate borrowing have been increasingly complemented by parent bank funding for subsidiaries to take advantage of high banking spreads. This, together with remonetization, has caused a credit boom, compounding external imbalances. As a result, the current account deficit has barely changed in four years despite fiscal consolidation of 5½ percentage points of GDP, macro-prudential measures, and foreign exchange intervention to contain appreciation.

Since 2002, the exchange rate regime has tried to balance internal and external objectives, ultimately securing neither. In early 2006, the National Bank of Serbia announced a transition to exchange rate flexibility and accommodated a considerably stronger dinar accordingly. At end-August, the NBS adopted a new monetary policy framework using the two-week repo rate as the main monetary policy instrument to achieve core inflation objectives (7-9 percent at end-2006, and 4–8 percent at end-2007). The new framework anticipates eventual transition to full-fledged inflation targeting. In the same vein, the NBS is scaling back foreign exchange intervention to a "leaning against the wind" role.

Reduced foreign exchange intervention in the face of continued strong capital inflows led to nominal dinar appreciation in the course of 2006. The strong dinar, combined with favorable international oil price developments and a slowdown in other administered price increases, helped reduce headline inflation to 11.6 percent and core inflation to 10 percent year-on-year in September.

Looking ahead, however, the envisaged fiscal expansion will exacerbate domestic demand pressures and complicate disinflation. The recently adopted supplementary budget provides for an increase in expenditures by 4 percent of GDP in 2006 relative to the original budget, funded by large privatization and license proceeds. This increase consists of additional current spending and expenditures under the National Investment Plan that provides for spending in the amount of €1.7 billion (7½ percent of GDP) in 2006–07. Fully implemented, this would imply a general government deficit in 2006 of up to 1.4 percent of GDP (0.3 percent of GDP according to the authorities' more optimistic revenue projections and accounting standards—which treat license proceeds as revenue—implying a surplus of 0.6 percent of GDP for the Republican budget). This general government deficit on staff definitions, however, compares to a surplus of 2.7 percent of GDP envisaged under the former Extended Arrangement with the IMF. However, capacity constraints are likely to prevent full execution of these spending plans. The authorities have not yet finalized their budget plans for 2007.

**Executive Board Assessment**

Executive Directors commended the authorities for Serbia's strong economic growth in recent years, the fruit of macroeconomic stabilization and structural reform. However, Directors underscored that large macroeconomic imbalances—including external deficits and debt, inflation, and unemployment—persist, with associated vulnerabilities, and that widespread financial euroization implies significant foreign currency exposures. In that light, they urged further policy effort, cautioning strongly that the proposed fiscal loosening carried risks of renewed macroeconomic instability.

Directors noted that sizeable surpluses for the consolidated general government remain appropriate. Though public debt is on a downward trajectory, fiscal surpluses are needed to contain external imbalances and vulnerabilities, support disinflation, and—in anticipation of reinvigorated structural reform efforts—create the basis for sustained medium-term growth. In this context, critical public investments should be funded by efficiencies in current spending, rather than fiscal relaxation. Directors also cautioned against relying on one-off privatization receipts to finance recurrent expenditure, such as wages. While recognizing the challenge of this approach in the current electoral context, Directors were of the view that the recently approved fiscal expansion, if fully implemented, would put at risk hard-won macroeconomic stabilization gains. They also noted that it would be inconsistent with key understandings under the post-program monitoring framework which were reached in February. In their view, re-anchoring fiscal policy from external to fiscal sustainability would be appropriate only once structural reforms—including corporate restructuring and credit deceleration—are reflected in a strengthened current account balance.

Directors considered that the remaining economic imbalances were symptomatic of weak corporate structures, which continue to drain domestic savings. In this light, an acceleration of corporate restructuring and completion of the privatization of socially-owned and state-owned companies are the central response to the imbalances and associated vulnerabilities. Thus, the divestiture of the remaining portfolio of socially-owned enterprises will require swift and consistent initiation of bankruptcy procedures should the tenders or auctions for these companies fail. To address employment concerns, Directors recommended increased flexibility of labor market institutions, including through a review of labor laws. They also recommended improvements in the business climate, including by strengthening the effectiveness of the judicial processes.

Directors noted that strong capital inflows pose additional challenges, including by spurring rapid credit growth and exacerbating current account strains. In this context, and given evidence of high non-performing loan ratios, they welcomed the new banking law, which has aligned the legal framework with Basel Core Principles. But further measures to strengthen banking supervision are necessary, including in regard to the exposure of unhedged borrowers to exchange rate risk. Moreover, additional measures to strengthen competition in the banking sector could, by securing efficient spreads, encourage greater attentiveness by banks to macroeconomic and indirect credit risks and, thereby, help contain credit growth. In this context, they encouraged the authorities to consider recommencing the issuance of licenses to greenfield banks.

Directors welcomed the new monetary policy framework as an important step towards eventual full-fledged inflation targeting. In this context, they supported the authorities' intention to scale back foreign currency interventions to a "leaning against the wind" role, in line with the goal of increased exchange rate flexibility. The new regime would support disinflation, which, in turn, would encourage economic growth. Directors underscored the importance of supportive fiscal policy for the credibility of the new regime and that, absent this, disinflation objectives could be compromised.

In view of Serbia's substantial external imbalances and vulnerabilities, Directors approved the continuation of post-program monitoring for another year, despite early repurchases that have reduced outstanding Fund credit to below 100 percent of quota.

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Serbia: Selected Economic and Financial Indicators, 2003–06 1/

| | 2003 | 2004 | 2005<br>Est. | 2006<br>Proj. |
|---|---|---|---|---|
| | (Change in percent) | | | |
| Real economy | | | | |
| Real GDP | 2.4 | 9.3 | 6.8 | 6.0 |
| Retail prices (end of period) | 7.6 | 13.7 | 17.7 | 10.0 |
| Core retail prices (end of period) | 6.2 | 11.0 | 14.5 | 7.6 |
| | (In percent of GDP) | | | |
| General government finances | | | | |
| Revenue | 43.5 | 45.2 | 45.0 | 44.6 |
| Expenditure | 46.7 | 45.3 | 44.2 | 45.2 |
| Overall balance (cash basis) | -3.2 | 0.0 | 0.8 | -0.5 |
| Gross debt | 79.9 | 68.9 | 60.9 | 50.2 |
| *Of which:* Forex-denominated (in percent of total) | 87.7 | 85.7 | 87.9 | 86.9 |
| | (12-month change, in percent) | | | |
| Monetary sector (end of period) | | | | |
| Money (M1) | 10.9 | 8.0 | 30.9 | 20.4 |
| Broad money (M2) 2/ | 27.5 | 30.3 | 43.5 | 32.8 |
| Credit to non-government | 25.1 | 47.9 | 57.0 | 44.2 |
| | (In percent) | | | |
| Interest rates (weighted average, end of period) | | | | |
| NBS bills / Repo rate | 10.6 | 16.3 | 19.2 | … |
| Deposit rate | 2.7 | 3.7 | 3.7 | … |
| | (In percent of GDP, unless otherwise indicated) | | | |
| Balance of payments | | | | |
| Current account balance, before grants | -11.8 | -14.8 | -11.2 | -13.5 |
| Underlying current account balance 3/ | … | -13.0 | -12.8 | -13.5 |
| Exports of goods (f.o.b.) | 16.6 | 18.2 | 20.6 | 21.4 |
| Imports of goods (c.i.f.) | 39.7 | 48.5 | 43.9 | 45.2 |
| Current account balance, after grants | -9.3 | -12.6 | -9.8 | -12.8 |
| External debt | 71.4 | 62.8 | 64.4 | 67.9 |
| Gross official reserves (in billions of U.S. dollars) | 3.6 | 4.2 | 5.8 | 9.7 |
| (In months of prospective imports of GNFS) | 3.6 | 4.2 | 4.8 | 7.3 |
| Exchange rate (dinar/euro, period average) | 65.1 | 72.6 | 82.9 | … |
| Real effective exchange rate (average change, in percent) | 5.4 | -3.5 | -2.6 | … |

Sources: Serbian authorities; and IMF staff estimates and projections.
1/ Excluding Kosovo (with the exception of external debt).
2/ Excluding frozen foreign currency deposits.
3/ Corrected for the surge in imports at end-2004 ahead of the introduction of the VAT in January 2005.

**Statement by Thomas Moser, Executive Director for Republic of Serbia and Srboljub Antic, Senior Advisor to Executive Director**
**October 18, 2006**

1. We would like to thank the staff for the comprehensive set of documents, which give a realistic account of the Serbian economy. The staff report very clearly presents the important achievements of the reform process since 2000 but also rightly points at the significant remaining challenges. Our Serbian authorities share the staff's views about the main economic problems and challenges, and they would like to thank the staff for the constructive policy discussions and the valuable recommendations.

2. Serbia is currently undergoing a very demanding period during which some long-standing and delicate political issues will have to be resolved, or at least tackled. The process for the adoption of a new constitution has started and the referendum will be held at the end of October 2006. There is a broad political consensus that early elections will be held shortly after the referendum, probably as soon as mid-December 2006.

3. Over the last six years, Serbia has implemented its macroeconomic policies under three successive Fund-supported programs, and the Fund's involvement has continued in the form of a Post Program Monitoring (PPM). During this period, real output has increased by more than 30 percent, inflation has decelerated and is on course for a single digit at the end of the year, and external debt has declined from over 130 percent to 65 percent of GDP. This outcome was mainly the result of prudent fiscal and monetary policies, but substantial progress has also been achieved in reforming both the banking and the real sector. The reform momentum has received a boost from the political side through the completion of the EU's feasibility study in 2005 and the start of negotiations on association. Although these negotiations are temporarily blocked, prospects for EU accession provide a clear framework for reforms.

4. Although these achievements are encouraging, the authorities are fully aware that much remains to be done and a challenging reform agenda is still ahead of them. While growth has been strong, the economy is still below its level of 1990, inflation continues to be relatively high, not to mention the high current account deficit and the array of remaining structural reforms.

5. One of the issues highlighted in the staff report and to a large extent discussed during the staff mission is the fiscal policy stance. Over the last years, Serbia has achieved significant fiscal consolidation with a change from high deficits to surpluses over the last two years. This demonstrated the authorities' willingness and ability to carry out a sizeable fiscal adjustment. At the current juncture, the Serbian authorities regard a relaxation of the demonstrated fiscal austerity as appropriate. While the elections looming at the end of 2006 undeniably provide part of the reason, the authorities also consider that higher revenue,

including from a third mobile license receipts, has created the necessary fiscal space to improve the country's infrastructure. After years of disinvestment in the 1990s and a very low level of public investment after 2000 (about 3 percent of GDP), Serbia's infrastructure is in a dire state and it is becoming a serious bottleneck for investors. The authorities consider an increase in public investment therefore as important. Size, scope, pace and financing, however, are issues to be discussed in the context of development of the budget for 2007.

6. Monetary policy is currently undergoing the significant change from an exchange-rate anchor as the main instrument for controlling inflation toward an inflation targeting framework. The first results – as reflected in declining inflation and inflation expectations and an appreciating exchange rate – are positive. The main instrument in the new monetary framework is the two-week repo rate, and there are initial but clear signs that the repo rate is becoming the key interest rate in markets. To strengthen its monetary signals, the National Bank of Serbia improved the money market operation design and introduced a new practice of publicly communicating the results of Monetary Board meetings. The National Bank of Serbia will continue to move out of the foreign exchange market, thus making the exchange rate more flexible. As the result of the introduction of the new monetary framework the exchange rate has been appreciating.

7. As in other transition countries, credit to the private sector in Serbia is growing rapidly, supported by foreign borrowing of foreign owned banks. Credit to private sector has more than doubled in last two years, despite high reserve requirements on foreign borrowing. Banking privatization has continued in 2006 with the selling of one of two largest state owned bank. The largest bank in Serbia was recapitalized by the EBRD, which also bought shares in one smaller private bank. A couple of other state owned and domestically owned private banks were also sold to foreign owners.

8. As the staff notes, slow reforms in the real sector have contributed substantially to external imbalances by lowering domestic savings. The authorities plan to reinvigorate privatization by putting up for sale all companies from the portfolio of the Privatization agency by mid-2007. The plan for the state owned Share Fund is to sell all shares in its portfolio through the stock exchange in 2007. All companies that cannot find buyers twice on auctions or tenders will be put into bankruptcy. The staff rightly notes that the bankruptcy procedures enacted in 2005 have remained little used up to now, but the number of bankruptcy cases is clearly rising.

9. Telecommunication and the oil sector are undergoing significant changes. After selling one of two majority state owned mobile companies for 1.5 billion Euros, the government launched the tender for a third mobile operating license. The entering of a third mobile operator will provide more competition and have positive effects on the business climate. The tender for selling minority shares in the oil company will be announced with the new government in office. The restructuring of other utilities continues through measures

that introduce competition and improve efficiency by imposing hard budget constraints through subsidy cuts and strict wage control.

10. The authorities decided to start early repurchase of outstanding Fund resources. Two repurchases were completed in June and September 2006, respectively, bringing outstanding Fund credit below the 100 percent of quota which requires a post-program monitoring. However, the Serbian authorities are fully aware that the country would still benefit from close monitoring, given the significant macroeconomic imbalances and the number of structural reforms that still need to be addressed. Therefore, our authorities would very much welcome the continuation of PPM.

11. Our Serbian authorities consider transparency in their relations with the Fund as important. Since regaining Fund membership in 2000, all staff reports on Serbia were published, and this policy will continue in the future. Accordingly, the Serbian authorities consent to the publication of the staff report.