January 2009
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Republic of Serbia: Request for Stand-By Arrangement—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Serbia

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

- The staff report for the Request for Stand-By Arrangement prepared by a staff team of the IMF, following discussions that ended on November 14, 2008, with the officials of the Republic of Serbia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 30, 2008. 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 Press Release summarizing the views of the Executive Board as expressed during its January 16, 2009 discussion of the staff report that approved the arrangement.
- A statement by the Executive Director for the Republic of Serbia.

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

Letter of Intent sent to the IMF by the authorities of the Repulbic of Serbia*
Memorandum of Economic and Financial Policies by the authorities of the Republic of Serbia*
Technical Memorandum of Understanding*
*Also included in the staff report

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF SERBIA

Request for Stand-By Arrangement

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

Approved by Poul M. Thomsen and Thanos Arvanitis

December 30, 2008

Stand-By Arrangement. In the attached letter, the Serbian authorities request a 15-month, SDR 350.8 million (75 percent of quota), Stand-By Arrangement (SBA). An initial purchase of SDR 233.9 million (50 percent of quota) would become available on approval of this request. The authorities do not intend to draw on Fund resources unless the need arises. Given the abrupt deterioration in global financial sentiment toward the region, the key objective of the authorities' economic program is to safeguard macroeconomic and financial stability. While Serbia's large financial buffers should prove a solid first line of defense against financial crisis spillovers, implementation of much stronger policies than in the past will be needed to maintain market confidence. The authorities' program focuses on: upfront fiscal restraint, with the 2009 deficit limited to 1¾ percent of GDP; containing inflation, while maintaining a managed float to facilitate external adjustment; strengthening crisis preparedness; and reforms to boost the economy's supply side.

Discussions. During October 28–November 14, 2008, with Prime Minister Cvetković, First Deputy Prime Minister Dačić, Deputy Prime Ministers Djelić, Dinkić, and Krkobabić, Minister of Finance Dragutinović, National Bank of Serbia (NBS) Governor Jelasić, other senior officials, representatives of International Financial Institutions (IFIs), the European Union (EU), and private sector representatives.

Mission team. Messrs. Jaeger (head), Mottu, Mirzoev (all EUR), Dodzin (SPR), and Ms. Eble (FAD). Ms. Nestorović, from the local IMF office, assisted the mission. Mr. Antić (OED) attended all policy meetings. The mission coordinated closely with World Bank staff on structural issues.

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Attachment

I. Background

1. **With global financial turmoil increasingly spilling over to Serbia, the authorities requested a 15-month SBA, which they intend to treat as precautionary.** An earlier Extended Arrangement expired in February 2006, and Serbia has since fully repaid the Fund. While the authorities pondered requesting an SBA already before the recent marked worsening of global financial tensions, Serbia's external and financial vulnerabilities, as well as fears of regional contagion, added urgency to the request. Looking ahead, should adverse spillovers to Serbia prove significantly graver than presently projected, the SBA could serve as a launch pad for a higher-access arrangement.

2. **The new coalition government is firmly EU-oriented, and Serbia's turbulent politics could lose some of its distractive sway over economic policymaking.** In recent years, policymaking was roiled by frequent elections, a constitutional referendum, Montenegro's independence, and Kosovo's declaration of independence. The new coalition government is keen on exercising Serbia's EU integration option, and the recent Stabilization and Association Agreement (SAA), although not yet ratified by the EU, could help achieve EU candidate status in 2009. But the new coalition government also includes seven parties with wide-ranging ideologies and vested interests, and it relies on a wafer-thin majority in parliament. At the same time, the main opposition party has split into pro- and anti-EU camps.

A. Recent Economic Developments

3. **As for the region as a whole, global financial turmoil has begun to spill over to Serbia.** The stock market has plummeted; sovereign spreads have soared; and, amid high volatility and frequent NBS interventions to maintain foreign exchange (FX) market liquidity, the dinar has depreciated substantially vis-à-vis the euro (Figure 1). Households, in part responding to alarmist media reports, but also mindful of their 1990s experiences of deposit freezes and financial collapse, have withdrawn some of their deposits. Although banks' large liquidity buffers have so far easily accommodated deposit withdrawals, the tensions have cast a pall over the banking system, reflected in widening interbank market spreads and in banks' hoarding of FX liquidity.

4. **Serbia's recent fast-paced growth, which was strongly tilted toward nontradables, seems to be losing momentum.** Real GDP excluding agriculture expanded by almost 9 percent in 2007 (Table 1), and it remained robust through the first half of 2008. Remarkably, nontradable sectors—trade, transport and communication, and financial services—accounted for practically all growth, while industry contributed little (Table 2). Recent monthly indicators on retail trade and industrial production suggest that the economy is slowing, likely reflecting tighter credit and deteriorating external demand conditions.

5. **Region-wide food and energy price shocks have pushed headline inflation into double digits, but underlying inflation remained moderate.** Reflecting this year's good harvest and declining international energy prices, headline inflation pressures began to ease somewhat in the summer (Figure 2). Nevertheless, headline retail price inflation (RPI) remained in double digits, while inflation excluding regulated and agricultural prices—the NBS's "core inflation target"—reached 10¾ percent in October, well above the end-2008 target range of 3–6 percent. While Serbia's labor market data need to be interpreted with caution, wage settlements in recent years well exceeded inflation plus labor productivity growth, putting pressure on underlying inflation. Given still high unemployment rates, these wage pressures seem to reflect not so much capacity pressures, but high reservation wages underpinned by strong bargaining power of unions, particularly in the large public sector, and high social transfers. With trading partner inflation rates significantly below Serbian levels and no persistent depreciation pressures since 2006, lower import price inflation has contributed to containing inflation. By contrast, monetary sources of underlying inflation are difficult to pinpoint. In fact, monetary aggregates appear largely disconnected from inflation trends, likely reflecting instability in money demand in a highly euroized economy where FX cash holdings are not captured by official money measures.

6. **While recent growth and inflation outcomes have been broadly consistent with internal balance, they have been accompanied by the build-up of an increasingly unbalanced external position.** Since 2005, the current account deficit has more than doubled and, in 2008, could reach 18 percent of GDP (Table 3). But the widening external deficit was easily financed by capital inflows, as also reflected by rising international reserves (Table 4). Nevertheless, external stability risks have increased substantially in the present financial crisis environment: this reflects an unsustainably large external deficit; the private sector's high external indebtedness; high euroization, and indications of weak export competitiveness (Box 1). Moreover, unlike in the region's other high external deficit countries, the run-up in Serbia's external deficit has not primarily financed an investment boom, but, with national savings declining, instead supported high consumption relative to income levels (Table 6, Figure 3).

7. **Financial stability risks have also increased, but the banking sector's liquidity and capital buffers are large.** At least from a regional perspective, Serbia's domestic bank credit expansion was subdued and fully financed by deposits (Figure 4). But, with banks aggressively competing for market share, the pace of domestic credit growth, particularly for household credit, has been rapid (Table 7). As the authorities stepped up prudential efforts to slow domestic credit growth, banks engaged in regulatory arbitrage by providing cross-border loans to Serbian companies. Credit risk is compounded by high euroization of loans extended to insufficiently hedged borrowers, raising concerns over credit quality during the downturn. In addition, foreign banks, representing about 80 percent of banking sector assets, face risks from guarantees extended for cross-border borrowing by companies (Box 2). Nevertheless, reflecting tight prudential provisions imposed in response to booming bank

credit, capital and overall liquidity buffers in the banking system are very high, although availability of FX liquidity could prove a bottleneck (Tables 8–9).

Box 1: Serbia. External Stability Risks

The combination of an overvalued exchange rate, high external debt, large external financing needs, high balance sheet euroization, and low export-GDP ratio signal considerable external stability risks.

Exchange rate risks: Serbia's real effective exchange rate still seems overvalued by some margin, despite the substantial recent dinar depreciation. The external sustainability approach points to a current account norm in the range of 8–10 percent of GDP, compared with a projected 2008 external deficit of 18 percent of GDP. While the underlying current account deficit is likely smaller given a positive output gap and temporarily high energy import prices, overvaluation could still be in the 10–20 percent range. However, overvaluation estimates based on current account measures are surrounded by significant measurement uncertainties, including a likely underestimated level of GDP owing to the exclusion of informal economic activities.

External balance sheet risks: External private-sector debt has soared in recent years, contributing to a projected external financing requirement of about 25 percent of GDP in 2009 (Tables 2 and 5). Although short-term external debt is limited and well covered by FX reserves, overall amortization payments are much more substantial.

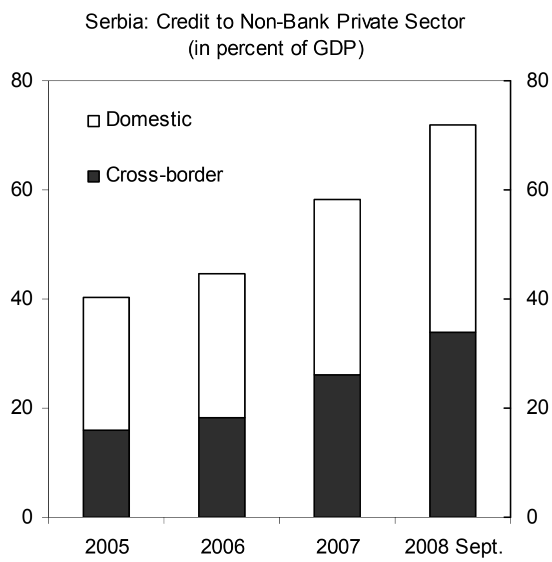
Capital account liberalization: At least on the outflow side, Serbia's capital account is still relatively closed, mitigating somewhat concerns about external stability risks in the present global financial crisis environment, and controls are supported by comprehensive reporting requirements.

Export competitiveness: Goods exports are growing rapidly, but starting from a low base (22 percent of GDP), are natural-resource intensive, and have little low-skilled-labor content. While Serbia's euro wage levels relative to labor productivity are in line with most transition peers, they significantly exceed those of key regional competitors, including Bulgaria and Slovakia.

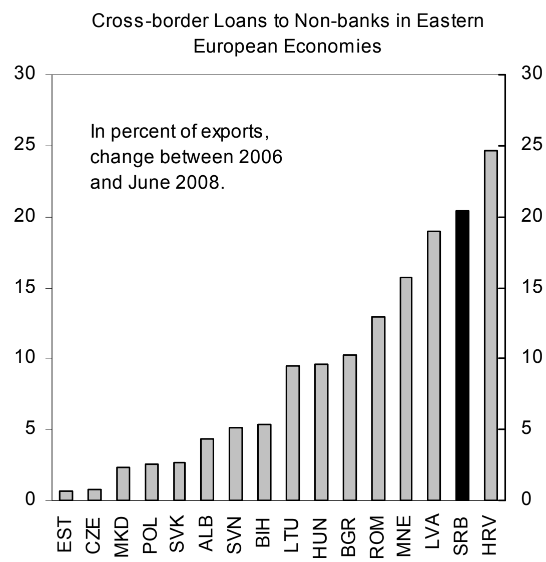
Euroization: Domestic bank loan euroization is high (70 percent), and high direct cross-border borrowing by corporates is likely to have added to unhedged FX positions.

Box 2. Serbia: Risks From Cross-Border Lending

Relative to export capacity, Serbia has been one of the largest recipient of cross-border loans in the region. These loans were mostly directed to nontradable sectors, notably telecom, financial leasing, and real estate. About one half of cross-border debt originates from the ten largest foreign lenders, another significant portion represents intercompany loans, and over one third is guaranteed by domestic banks. These guarantees—usually booked as off-balance sheet items—are subject to provisioning requirements. But they are generally not counted toward banks' open FX positions and, at over 10 percent of assets, represent a sizeable contingent liability.



Source: National Bank of Serbia.

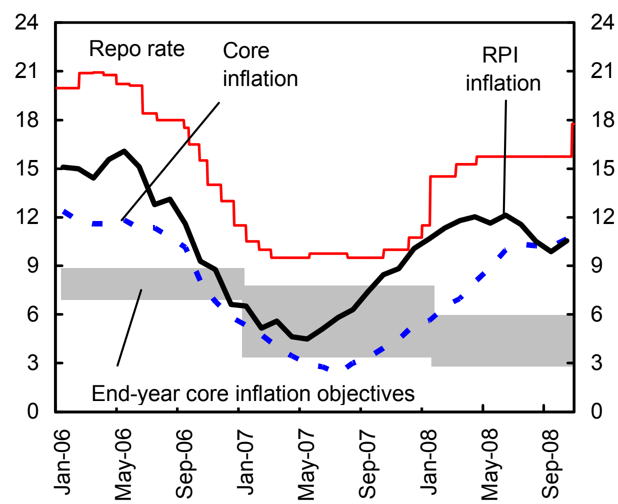


Source: BIS.

B. Recent Policy Developments

8. **Since adopting numerical inflation objectives in August 2006, the NBS has used its policy tools proactively to maintain low inflation.** In particular, in an effort to contain second-round effects from supply shocks, and more recently, from exchange rate depreciation, the NBS has hiked its policy interest rate repeatedly since the beginning of the year, by a cumulative 775 basis points, to 17¾ percent. The NBS has also used changes in reserve requirements and prudential measures to curb domestic credit growth. Nevertheless, with its "core inflation" concept running well above target, the NBS has signaled an upward short-term policy bias, expressing especially concern about continued depreciation pressures. The NBS has also repeatedly intervened in FX markets to maintain liquidity, while noting that its monetary framework is not compatible with leaning against exchange rate trends. Reflecting recent nominal depreciation of the dinar, earlier concerns regarding the need to recapitalize the NBS have receded (Table 10).

Monetary Policy Reactions



Source: NBS.

9. **To safeguard financial stability, the authorities have implemented several measures.** Responding to household withdrawals of FX deposits, the NBS acted to boost banks' FX liquidity: by eliminating reserve requirements for new external borrowing; raising the share of required reserves on FX liabilities to be held in dinars from 10 to 40 percent; lowering the net open FX position limit from 20 to 10 percent; and allowing banks to use the most recent deposit data to calculate required reserves. A small bank that experienced liquidity problems was promptly put under receivership. The deposit insurance coverage was hiked from €3,000 to €50,000, which is high relative to Serbia's per capita GDP of about €4,500, but this action was partly forced by neighboring countries enacting similar increases. To help mitigate private sector balance sheet pressures, the four leading banks are offering borrowers the option to extend loan repayment terms and to convert FX loans into dinar loans.

10. **Aggravating underlying macroeconomic tensions, fiscal policy in 2008 remained in procyclical mode.** After recording a fiscal surplus in 2005, public finances shifted into deficit. The procyclical policy shift was facilitated by large privatization receipts (Table 11). While actual fiscal deficits remained close to 2 percent of GDP during 2006–08, staff estimates that the structural fiscal deficit during that period rose to about 4½ percent of GDP,

reflecting mainly the revenue-boosting effects of unsustainably high domestic demand relative to the level consistent with external balance. At the same time, public debt dropped sharply during 2005–08, from 56 to 34 percent of GDP.

Serbia: General Government Operations, 2005-08
(In percent of GDP)

	2005	2006	2007	2008		
				Original Budget	Revised Budget	Prog.
Revenue	42.8	43.6	43.0	42.3	43.3	42.8
Expenditure	42.0	45.2	44.9	44.2	46.0	45.2
Fiscal balance	0.8	-1.6	-1.9	-1.9	-2.7	-2.3
Structural balance 1/	0.6	-1.9	-3.6	-4.0	-4.8	-4.4

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

1/ Actual fiscal balance adjusted for the effects of both the output and the external absorption gaps. See IMF Country Report No. 07/390, Chapter III, for details.

11. **Structural reforms are lagging.** Serbia's privatization agenda is still long and unfinished. For transition economies, cross-country evidence suggests that a large private sector is not only instrumental for increasing a country's capacity to produce, save, and export, but also to create a virtuous circle where privatization creates a stronger constituency that in turn pushes for structural reforms (Figure 5). Serbia also continues to trail best-performing transition peers on key investment climate scores, particularly licensing, registering property, paying taxes, and enforcing contracts (Table 12). High levels of corruption, weak competition policies, and large infrastructure gaps add to an overall picture of lagging structural reforms stifling the economy's supply side.

12. **In sum, Serbia will have to face the suddenly emerged financial headwinds from a vulnerable position.** The combination of several factors accounts for the apparent dissonance between recent internal and external balance developments:

- Serbia's undersized private sector remains one of the smallest in the region, putting an effective constraint on domestic saving, export capacity, and productivity growth, while keeping the potential constituency lobbying for structural reforms small.

- Serbia's oversized public sector has been tuned toward consuming and redistributing resources instead of investing in the country's future, further weakening the economy's supply side.

- High social transfers and excessive wage growth have supported domestic demand, but undermined incentives to work and external competitiveness.

- Nevertheless, at least so far, foreigners have been willing to bridge the rapidly widening gap between Serbia's domestic demand and national disposable income through capital inflows.

The net outcome of these forces has been a low-productivity, low-savings, low-exports economy, which has nevertheless managed to achieve robust catch-up growth with low underlying inflation, but only at the cost of accumulating external and financial vulnerabilities.

II. The SBA-Supported Program

A. Program Objectives

13. **The authorities' SBA-supported program responds to the abrupt deterioration in global financial sentiments.** In the new adverse economic environment, Serbia's short-term economic outlook has worsened drastically: trading partner growth and prices of key Serbian exports, particularly metals, are projected to slow sharply in 2009; and formerly plentiful capital inflows can no longer be taken for granted, likely further constraining both domestic and cross-border credit growth (Figure 6). While Serbia's large financial buffers may provide an adequate first line of defense, the authorities are convinced that an SBA-supported policy package is needed to underpin an orderly rebalancing of the economy. The financial crisis spillovers, while holding serious downside risks, also offer an opportunity: if the Serbian economy manages to emerge from the downswing in a more balanced and reformed condition, it would be in a much stronger position to relaunch sustainable real convergence growth toward EU income levels.

14. **Safeguarding macroeconomic and financial stability are the primary objectives of the program, and the authorities recognize that policies will need to be strengthened across the board.** The program's policy package has the following main features: tightening of the fiscal stance during 2009–10, with the 2009 general government deficit limited to 1¾ percent of GDP, followed by further fiscal consolidation in 2010; maintaining the managed float under a strengthened inflation targeting framework; making good use of the accumulated financial sector buffers, while enhancing financial crisis preparedness; and implementing structural policies to address the roots of the economy's low capacity to produce, save, and export.

B. Macroeconomic Framework

15. **The program's macroeconomic framework assumes a decline of foreign inflows and domestic credit, which should lead to a slowdown in domestic demand, output growth, and inflation, and a narrowing of external imbalances.** Real GDP growth is projected to decelerate to 3½ percent in 2009 but should, in line with global and regional growth assumptions, rebound in 2010 (Table 13). With the inflation-reducing effects of

commodity price declines and slowing activity being counteracted by pressures on the exchange rate, inflation is projected to slow only gradually to 8 percent by end-2009, and further to 6½ percent in 2010. The external deficit is projected to decline to about 16 percent of GDP in 2009, from 18 percent in 2008, with sharply slowing import demand and lower energy import prices partly offset by declines in export prices and the drag on export volumes exerted by slumping trading partner growth (Table 3).

16. **Beyond the program period, a strengthened policy framework, also in line with Serbia's EU integration ambitions, provides the basis for a resumption of strong GDP and export growth** (Table 13). This assumes that the structural reforms in the enterprise sector and the business environment implemented so far and planned for 2009—accompanied by tight fiscal and wage policies—start bearing fruit in the form of improved competitiveness and higher corporate savings. With rising FDI supporting export growth and an increasingly responsive domestic output, the current account deficit would normalize gradually over the medium term and external debt would start declining.

17. **With financing requirements remaining sizable under the program scenario, external stability risks are expected to diminish but not dissipate.** Given the modest narrowing of the current account deficit during 2009–10, gross external financing requirements would remain large at 25–30 percent of GDP—about equally split between the projected current account deficit and external debt amortization, which are projected to increase sizably after years of heavy borrowing (Table 5). The program assumes continuation of FDI inflows and corporate access to external financing sufficient to cover the current account deficit, and the roll-over of cross-border loan amortization and short-term debt. As a result, external private-sector obligations—although in large part FDI-related—will continue to ratchet upward. External sustainability will remain subject to substantial risks, stemming from vulnerability to exchange rate shocks, rising rollover requirements, and uncertainty regarding the size of FDI inflows (Appendix I).

18. **Risks to the program scenario are multifaceted and clearly weighted to the downside.** Downside risks to growth relate both to the depth and duration of the slowdown—largely reflecting uncertainty about international developments. Moreover, in the current difficult financial environment, a sharp contraction in available external financing cannot be ruled out. This could trigger the risks mentioned above and precipitate a financial crisis. Finally, given Serbia's history of banking crises, doubts about banks' solvency or the security of deposits could result in financial tensions through accelerated deposit withdrawals. Should these risks materialize, the precautionary SBA could provide a springboard for moving to a higher-access SBA arrangement with policies focused on dealing with the new challenges as they arise.

C. Fiscal Policy

19. **The authorities are committed to contain the 2008 general government deficit.** Although the adopted revised budget is consistent with a deficit of 2¾ percent of GDP, and tax collections are now projected to underperform relative to budget, there is considerable scope to underexecute or contain spending relative to budget, thereby limiting the deficit to about 2¼ percent of GDP (MEFP ¶8).

20. **Going forward, fiscal restraint will be a cornerstone of the authorities' program.** Limiting the fiscal deficit to at most 1¾ percent in 2009 and 1 percent of GDP in 2010, respectively, will help maintain macroeconomic stability after years of procyclical expansion. Moreover, the fiscal stance in 2009 is tightly constrained by available financing but, given Serbia's history of fiscal dominance, restraint is also needed to reassure investors and the Serbian public that policies remain on a sound footing. Finally, carryover effects and precommitments related to the extraordinary 10 percent pension increase in November 2008, customs revenue losses under the SAA agreement, and the budgetary cost of joint ventures to promote FDI will weigh on the 2009 budget (MEFP ¶9).

Serbia: General Government Operations, 2007-10
(In percent of GDP)

	2007	2008		2009	2010
		Rev. Budget	Prog.	Prog.	Prog.
Revenue	43.0	43.3	42.8	42.0	41.2
Expenditure	44.9	46.0	45.2	43.8	42.2
Current	39.6	40.8	40.4	39.0	37.2
Capital	5.3	5.1	4.7	4.8	5.0
Fiscal balance	-1.9	-2.7	-2.3	-1.8	-1.1
Structural balance 1/	-3.6	-4.8	-4.4	-2.9	-1.9

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

1/ Actual fiscal balance adjusted for the effects of both the output and the external absorption gaps. See IMF Country Report No. 07/390, Chapter III.

21. **Tighter and more balanced incomes and pension policies—the major budgetary outlays—are needed to achieve the fiscal deficit target (MEFP ¶12).** The authorities considered several options to limit the growth of pensions and government wages in 2009, including staff's preferred option to convert the recent extraordinary 10 percent pension hike into a one-off payment. In the end, the government chose not to renege on past political commitments and, instead, to suspend pension indexation in 2009, although average pensions would still increase by 13¼ percent. In the medium term, designing a more sustainable pension system will be a reform priority. Public sector wages will only be adjusted for projected inflation, with non-essential hiring suspended. Public enterprises and local

governments will be expected to follow similar wage policies. Other measures to achieve the fiscal target include raising excise taxes closer to regional averages, restoring dividend transfers from profitable public enterprises, and streamlining spending on goods and services and subsidies. The budget preserves allocations for capital spending, enterprise restructuring, and subsidized lending to small- and medium-sized enterprises.

Serbia: Nominal Growth in Average Pensions and Wages, 2005-10
(In percent)

	2005	2006	2007	2008 Prog.	2009 Prog.	2010 Prog.
Pensions 1/	24.2	22.3	9.8	24.3	13.3	3.2
Gross wages	24.3	24.4	21.9	15.6	9.7	11.0
of which:						
General government	20.3	21.4	24.7	17.0	9.3	9.2
Public enterprises	16.8	23.7	23.6	14.0	9.3	9.2
Private sector	21.5	30.0	14.1	11.0	...	...

Sources: Statistical Office; and Fund staff estimates and projections.

1/ Average paid out pension, including payment of securitized arrears. Assumes nominal freeze in 2009 and inflation indexation in 2010.

22. **Given the uncertain outlook, the authorities are prepared to take contingency measures to preserve the program's fiscal objectives.** Risks to the 2009 fiscal target include weaker tax collections and dividend transfers from public enterprises, unexpected financial sector liabilities, and shortfalls in privatization proceeds (related particularly to ongoing and planned privatization transactions in the oil and gas and telecom sectors) and IFI financing. Should downside risks materialize, the authorities stand ready to reduce discretionary spending further and—as a last resort—to increase the VAT rate. The fiscal program does not include provisioning for the potential cost of financial sector bailouts; should bailouts become necessary, the associated costs would not count against the program's fiscal targets.

23. **The medium-term fiscal framework is anchored by a structural deficit target of about 1 percent of GDP.** This target should be achieved through continued reduction in recurrent spending in 2010–11, while space is being created for capital outlays. This would allow the debt-to-GDP ratio to drop to 22 percent by 2013, containing public debt sustainability risks. However, should contingent fiscal liabilities from the banking and public enterprise sectors materialize, or the restitution process resume, additional adjustment effort may be needed (Appendix II).

D. Monetary and Exchange Rate Policy

24. **The program supports strengthening the focus on inflation targets as the economy's nominal anchor.** The new monetary framework introduced in August 2006

contributed to reducing inflation, initially, and to limiting second-round effects of the 2007-08 commodity price shocks, subsequently. Challenges remain, however. In particular, to improve communication of inflation objectives, the practice of targeting "core inflation" (retail prices excluding regulated prices and agriculture) will be replaced by targeting headline CPI inflation, which covers a broader range of goods and services and would serve as a stronger anchor for expectations and indexation. This will require closer coordination between the NBS and the government regarding adjustments in regulated prices, to be formalized through a memorandum of understanding (MEFP ¶16). Trends in monetary and credit aggregates, particularly the central bank's net domestic assets, will be monitored as a cross-check to the standard inflation analysis, but the NBS believes that the information value of monetary aggregates in Serbia is limited by their high volatility and low correlation with inflation.

25. **The authorities will maintain the managed floating exchange rate regime.** Exchange rate flexibility helps absorb increasingly volatile shocks, while the ability to intervene limits the balance sheet effects of such fluctuations. Going forward, the NBS will continue to limit interventions to those aimed at maintaining orderly FX market conditions. Moreover, during the program period, the authorities will update the central bank's legal framework in line with best EU practices, including by prohibiting lending to the public sector, clarifying procedures for recapitalization, and enhancing central bank independence.

E. Financial Sector Policies

26. **Financial sector stability policies will focus on preventive measures to strengthen monitoring of risks and maintain confidence.** Although bank liquidity and capital buffers are high, bank supervisors will monitor closely liquidity and non-performing loans in individual banks and be ready to react, if needed, to financial stability risks (MEFP ¶20–21).

27. **The authorities will strengthen the financial crisis management framework.** A key measure will be to formalize understandings between the government, the NBS, and the Deposit Insurance Agency on their respective responsibilities in maintaining financial sector stability (MEFP ¶22). Detailed procedural plans will be specified, notably for the event of increased demand for lender of last resort funds, including provision of appropriate guarantees, expansion of the range of acceptable collateral, and coordination with foreign banks' parent offices and their supervisors.

28. **Developing local currency bond markets and phasing out state ownership in banks and insurance remain medium-term priorities.** The authorities plan to develop a public debt management strategy before starting to issue government bills and bonds, tentatively in 2010 assuming normalization of market conditions. Meanwhile, the financial transfer tax will be eliminated as part of the 2009 budget. The authorities intend to consolidate the four remaining majority-owned banks to prepare them, along with the state-owned insurance company, for eventual privatization (MEFP ¶24).

F. Structural Policies

29. **Structural reforms remain key to boosting the economy's output capacity in the medium term.** In line with the country's ambitions for EU integration, the authorities are determined to push ahead with privatization and enterprise restructuring plans, notwithstanding the difficult economic environment (MEFP ¶25). A review of business regulations, aimed at streamlining the regulatory framework, has started. While the lengthy program of privatization of socially owned enterprises is close to completion, further steps to prepare selected state-owned enterprises for private sector participation are envisaged. Meanwhile, wage policies in public enterprises will be strictly controlled to avoid adverse wage dynamics and encourage rationalization (MEFP ¶28).

III. Program Modalities

30. **The SBA-supported program will anchor a shift to stronger policies, while signaling that Serbia is not an "emergency case."** By being considered under regular, not exceptional, procedures and access limits, the arrangement distinguishes Serbia from other recent regional SBA cases. The large financial buffers should be adequate to maintain stability under the program scenario, justifying consideration of the SBA as precautionary. The authorities hope that the SBA will signal strong policies, complementing their efforts to attract infrastructure financing from IFIs as well as private FDI to jumpstart export-led development. They also hope that the SBA will discipline fiscal policy, including by forcing trade-off decisions between competing budgetary demands—importantly between infrastructure, pensions, and public wages.

31. **These considerations are reflected in the SBA's design.** The relatively short duration (15 months) with relatively high, but not exceptional access (75 percent of quota, about US$541 million) allows to anchor strong policies over the coming year, while providing flexibility if circumstances change. Access is justified by the risks of a potentially significant shortfall of financing in light of high potential liquidity drains in the current global environment. While the authorities intend to treat the arrangement as precautionary, the proposed access provides sufficient potential resources to underpin market confidence, enhance financial stability by raising potential buffers, and reduce crisis risks. Consistent with this approach and given the front-loaded conditionality, the arrangement makes 50 percent of quota available upfront, and the rest evenly spread over the period of the arrangement (Table 14). Should financial tensions intensify, staff and the authorities agreed to review the program and consider requesting higher access.

32. **Conditionality is streamlined.** The inflation consultation clause follows the model used in other IT countries by comprising a central target point with bands.[1] As a cross-check,

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[1] Breaching the announced ±2 percent band would prompt consultations with staff, while breaching this band by more than 1 percent would prompt consultations with the Fund.

monetary aggregates will be monitored closely. Standard quarterly quantitative performance criteria are set on: (i) net foreign assets of the NBS; (ii) the consolidated general government overall deficit; (iii) contracting or guaranteeing medium-term external public debt from non-IFI creditors; (iv) contracting or guaranteeing short-term external public debt; and (v) non-accumulation of government external payment arrears. An indicative target is set on budgetary government recurrent spending. The SBA will have semi-annual reviews, and quarterly financing assurances reviews as long as official arrears to private creditors persist. An updated safeguards assessment of the NBS is underway.

33. **The authorities will implement several prior actions to support their request for an arrangement** (Table 15). To safeguard fiscal adjustment, the authorities will submit to Parliament a 2009 budget consistent with the program. The two structural benchmarks complement this prior action by ensuring full coverage of the general government budget, consistency of wage and employment policies in public enterprises, and enforcement of dividend transfers to the budget. As regards the 2010 budget, conditionality will be set by the next reviews. In the monetary area, the NBS and the government will sign, as a prior action, a memorandum of understanding on inflation targeting. Similarly, they will sign a memorandum of understanding on their respective roles and responsibilities in maintaining financial stability. Additional financial sector conditionality could be set after an FSAP Update, planned for mid-2009.

34. **The program is subject to significant macroeconomic and policy-related risks, which could require its recalibration.** Downside risks related to trade and capital flows are high: slower demand for Serbian exports or a sudden stop in capital inflows could lead to lower growth, a full-fledged credit crunch, and further pressure on the currency. A deterioration in financial conditions of corporates and households, especially those with unhedged FX positions, could test the bank sector's large capital buffers. Moreover, a credit-crunch driven slump in domestic demand could lead to a sharp drop in budget revenues and require scaling back nominal spending further given tight financing constraints. On the policy side, the governing coalition's commitments could potentially be tested by continuing pressures to hike pensions and wages. And, although the currently tight financing constraints will help ensure fiscal discipline, improved economic prospects in 2010 may prompt calls for early relaxation and a return to expansionary policies. By seeking to reduce external and financial vulnerabilities and enhance buffers, including through tight fiscal and monetary policies, the program seeks to reduce crisis risks. The authorities are, however, prepared to respond to a deteriorating financing outlook by taking additional measures and, if necessary, to request higher access.

35. **Should Serbia make purchases under the arrangement, staff is confident that it could meet its financial obligations to the Fund.** Under the proposed purchase schedule, Fund credit outstanding would peak at 4.6 percent of gross official reserves in 2009, while debt service to the Fund would not exceed 1.2 percent of exports of goods and nonfactor services during the repayment period (Table 16).

36. **Negotiations on settling remaining official external arrears are ongoing.** External arrears mostly relate to debt of the former Socialist Federal Republic of Yugoslavia (SFRY) (Table 17). Restructuring agreements were concluded with Paris and London Club creditors in 2001 and 2004, respectively, and are being implemented. Negotiations with non-participants in the London Club settlement, as well as with other official and private creditors are progressing, albeit at a relatively slow pace given succession issues related to the SFRY and some of the creditor states.

37. **Other IFIs and the EU are engaging with Serbia.** They are stepping up their financing operations, notably to support infrastructure investment and structural reforms.

IV. STAFF APPRAISAL

38. **Over the last few years, Serbia enjoyed robust GDP growth and moderate underlying inflation, but the economy became increasingly unbalanced on the external side.** Strong GDP growth allowed significant catch-up with EU income levels, albeit from a low initial base. However, and mainly reflecting lagging structural reforms, growth was overwhelmingly driven by nontradable sectors, raising concerns about the competitiveness of tradable sectors. With the NBS focused on containing inflation, food and energy price shocks pushed headline inflation back into double digits, but underlying inflation excluding these shocks remained moderate. Serbia's relatively favorable growth and inflation outcomes were, however, underwritten by increasingly larger capital inflows to sustain high levels of domestic demand and to compensate for declining national savings. Moreover, in part reflecting Serbia's volatile politics, fiscal policy has been procyclical since 2006, adding unhelpful expansionary impulses to domestic demand. The strong dissonance between internal and external balance developments is reflected in the build-up of significant external and financial stability risks. The 2008 current account deficit is projected at 18 percent of GDP, one of the highest deficits in the region, and FX exposures in private sector balance sheets are large and only partially hedged.

39. **Starting from this vulnerable economic position, the authorities' program—supported by the proposed SBA—seeks to safeguard macroeconomic and financial stability through a comprehensive policy package.** With global financial turmoil increasingly spilling over to Serbia, a rebalancing of the economy through a sharp slowing of credit and domestic demand seems unavoidable and, in fact, welcome if it can be achieved in an orderly fashion. But to succeed in maintaining stability, policies will need to be much stronger than in the recent past. In particular, fiscal policy will need to be considerably tightened, a step also dictated by limited available financing. Monetary policy should continue to focus on inflation, while maintaining a managed float. Financial stability policies need to be strengthened further, including through improving financial crisis preparedness. Privatization and enterprise restructuring needs to be speeded up, and Serbia can do much to match better-performing peers in lowering the costs of doing business.

40. **There are clear risks to the program, however.** Importantly, the external financing assumptions could prove optimistic if adverse spillovers from global financial turmoil to the region turn out to be significantly stronger and more protracted than presently projected. The authorities' political will and administrative capacity to implement agreed measures could also disappoint.

41. **In order to achieve the tight 2009 deficit target, fiscal policy will need to take strong measures in several areas.** Reflecting the procyclical fiscal stance since 2006 and limited budgetary financing options, there is no scope now for countercyclical fiscal loosening. Anything less than a tight fiscal stance could also jeopardize the credibility of the program in the eyes of foreign investors and the Serbian public. While the need to slow excessive nominal pension growth is widely accepted, fiscal policy will in addition need to put a tight constraint on nominal wage growth in government sectors and public enterprises, which should also help to slow wage growth in the private sector via demonstration effects. The program includes ambitious but commendable undertakings to slash subsidies, while most spending on goods and services will be frozen in nominal terms. Implementing these policies will require strong coordination across different levels of government, and the authorities needs to stand ready to take compensatory measures without delay if revenue collections disappoint relative to program targets. Moreover, fiscal adjustment in 2009 should not be seen as a one-off effort, but as a stepping stone toward a stronger fiscal framework anchored by a low medium-term deficit target.

42. **While further strengthening the monetary framework, the NBS will need to adjust its stance flexibly given the uncertain economic environment.** Focusing monetary policy on targeting inflation has worked reasonably well, but anchoring inflation expectations at targeted levels, particularly for wage setters, has clearly been a challenge. The NBS's determined policy responses to contain second-round effects from supply shocks was appropriate within its framework. Looking ahead, the NBS may again have to quickly adjust its stance as required by rapidly changing circumstances. With incomes policies well anchored under the program, the NBS should continue to limit FX interventions to maintaining orderly market conditions. The envisaged switch from core retail price to CPI inflation targets brings the framework in line with best practices elsewhere, but will also require more coordination with the government given the still significant role of regulated prices.

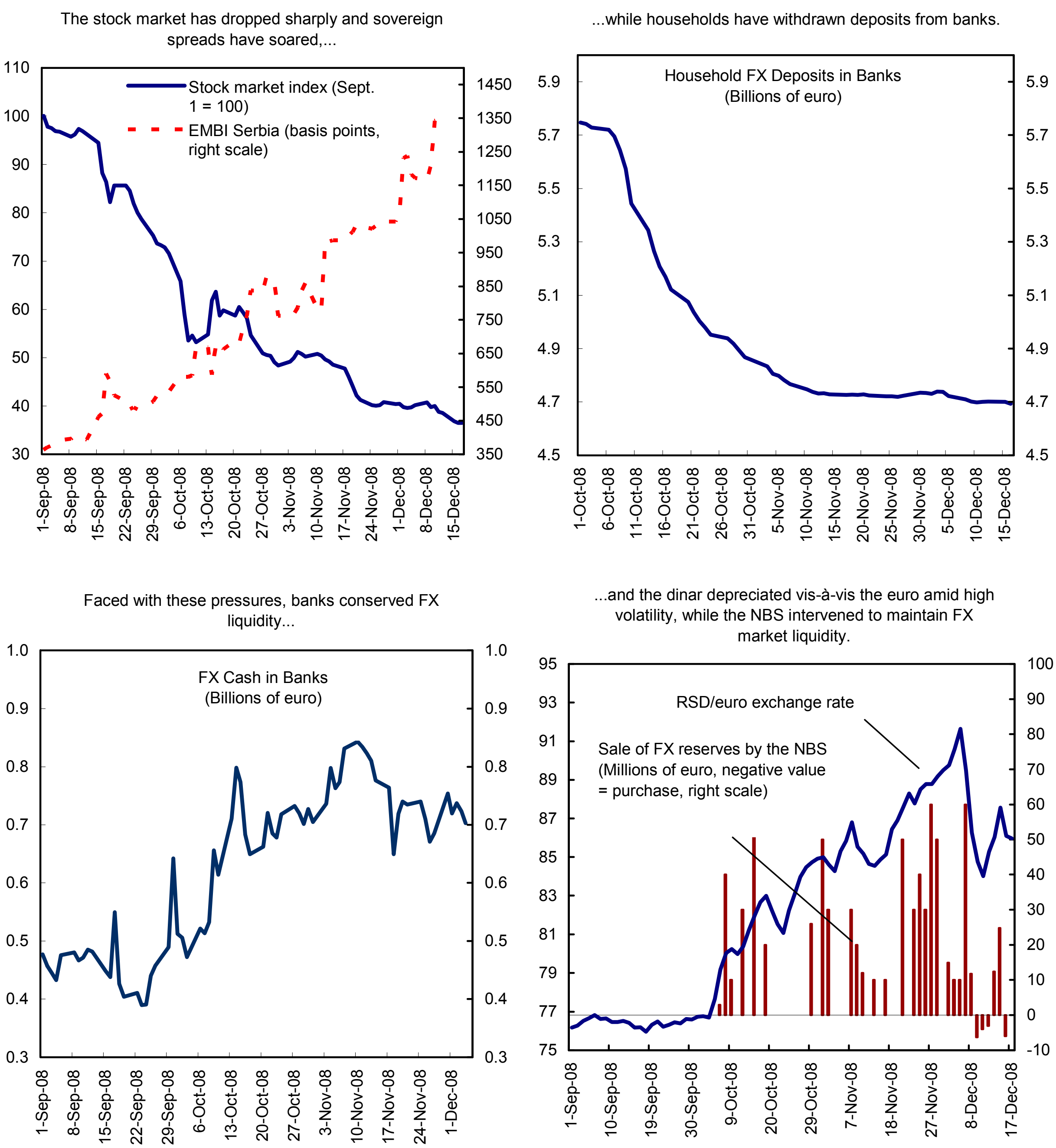
43. **Past tight prudential policies are now paying off in providing a strong first line of defense against financial crisis spillovers, but there is a need to improve the monitoring of risks and to prepare crisis contingency plans.** Tight prudential policies succeeded in building large liquidity and capital buffers in the banking system, although they may also have encouraged risky cross-border borrowing practices. These buffers should now be used wisely, allowing banks to adjust to a much more difficult economic environment characterized by higher funding costs and the likely emergence of credit quality problems. The authorities will also need to move fast to put in place comprehensive crisis contingency

plans that clearly specify policies and responsibilities of different players if tensions in the banking system intensify. An FSAP Update, scheduled for mid-2009, should provide an opportunity to comprehensively review financial stability risks and policy responses.

44. **Without addressing Serbia's weak supply side over the next few years, there is little hope that the economy will eventually be able to deliver sustainable catch-up growth toward EU income levels.** The recent pace of structural reforms was exceedingly slow, and the economy's low capacity to produce, export, and save is at the root of Serbia's struggle to achieve balanced growth. The program calls for a strong focus on privatizing, restructuring, or liquidating a wide range of state- and socially owned enterprises to help expand Serbia's still undersized private sector. Serbia also still lags best-performing transition peers in reducing the cost of doing business, and there is considerable scope to eliminate, clarify, or reconcile rules and regulations that undermine the predictability of the business environment.

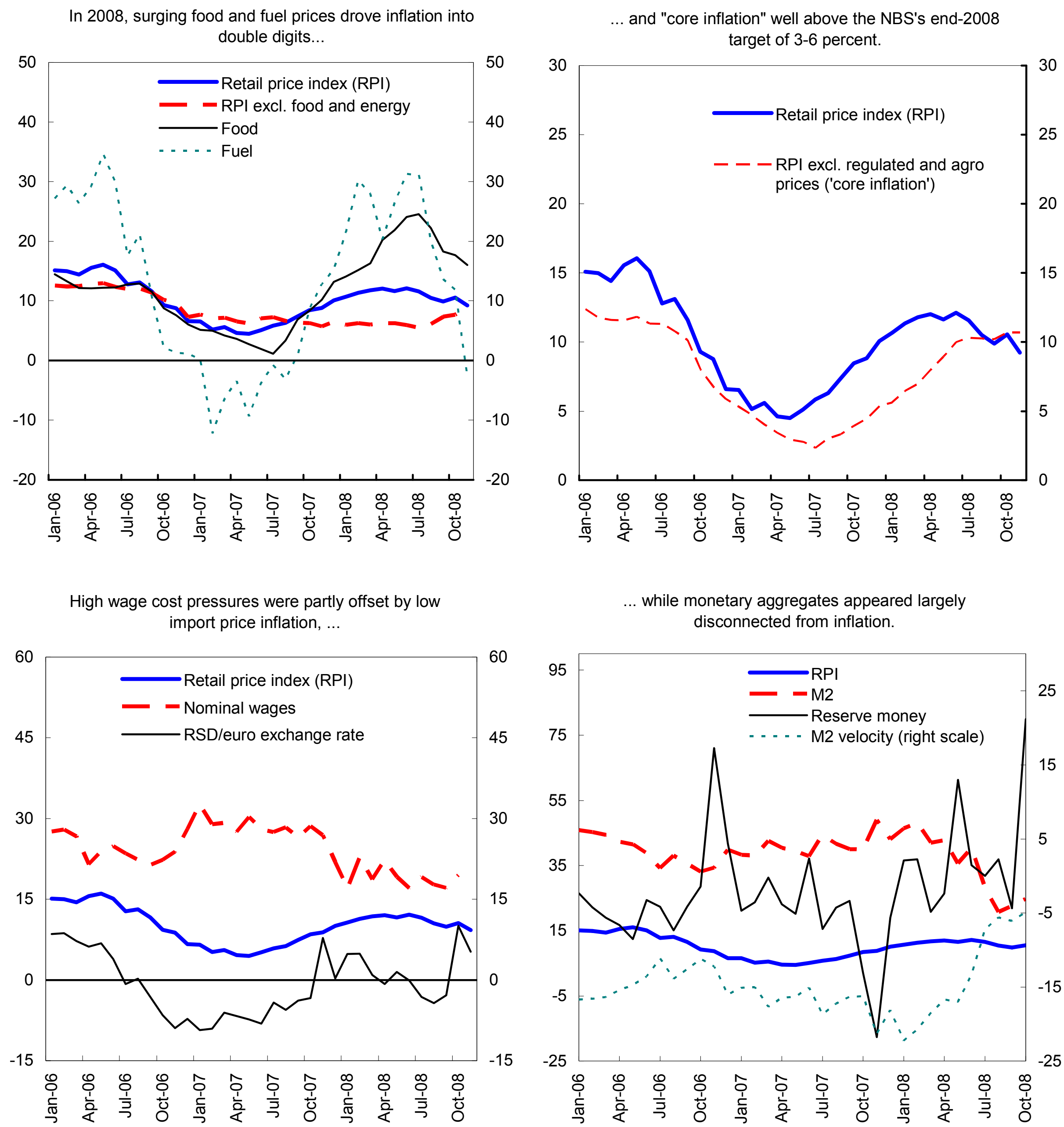
45. **If the authorities implement their program steadfastly while being ready to respond to new adverse developments, staff expects that the Serbian economy will succeed in overcoming the present difficulties.** Therefore, staff supports the authorities' request for a 15-month SBA.

Figure 1. Serbia: Spillovers from Global Financial Market Turmoil, September-December 2008



Sources: National Bank of Serbia; Bloomberg; and Belgrade Stock Exchange.

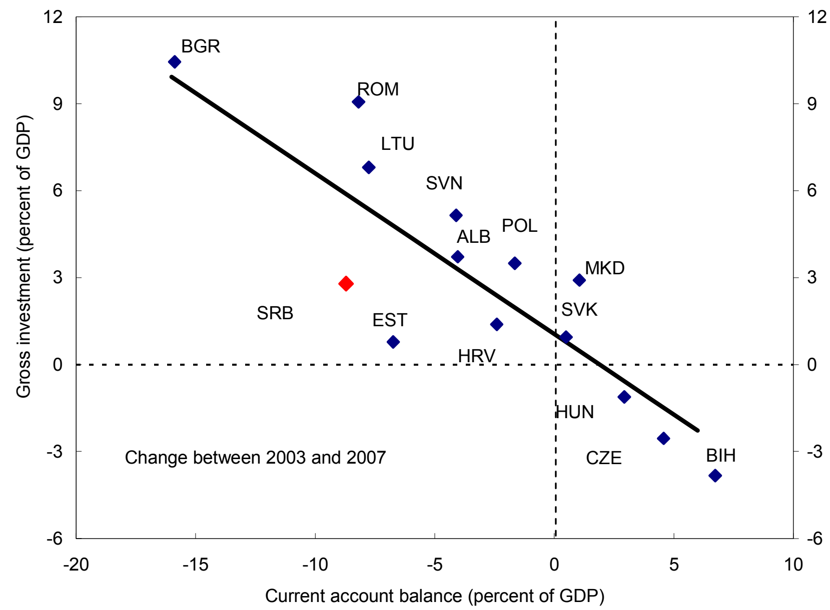
Figure 2. Serbia: Inflation Developments, 2006-08
(Twelve-month growth, percent)



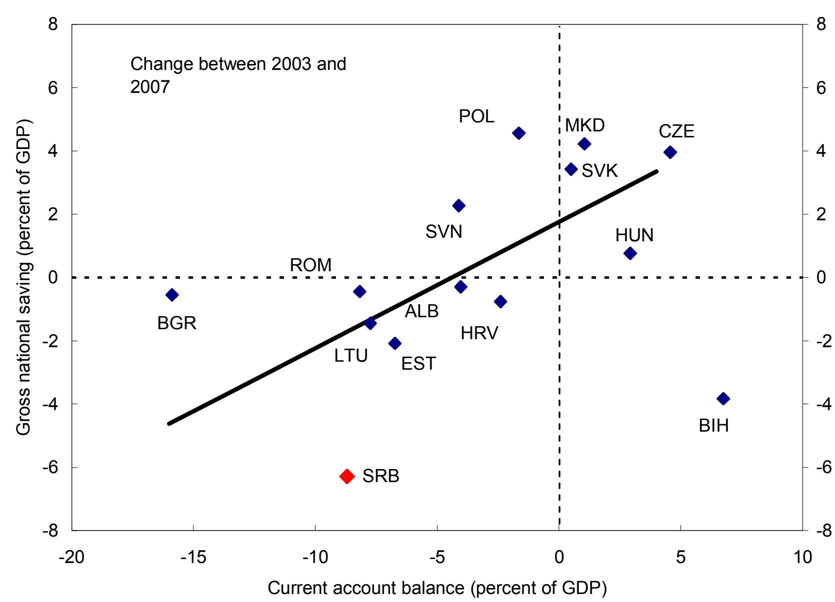
Sources: National Bank of Serbia; and Serbian Statistics Office.

Figure 3. Eastern European Countries: Changes in Current Account Deficits, Investment, and Savings, 2003-07 1/

Serbia's surging external deficit is not unique in the region, but it financed a much smaller increase in investment, ...



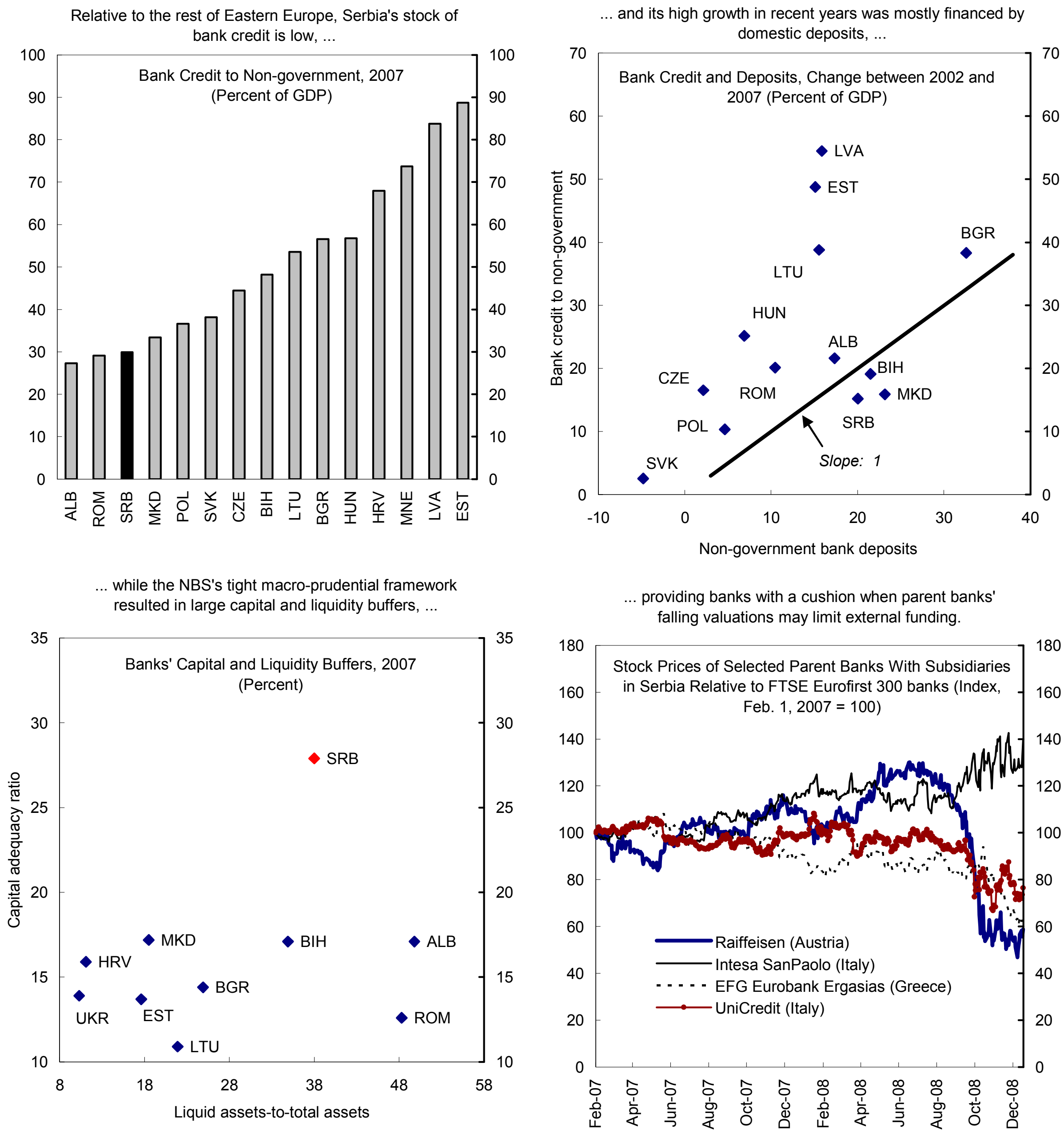
... while compensating for a marked decline in national saving.



Source: WEO.

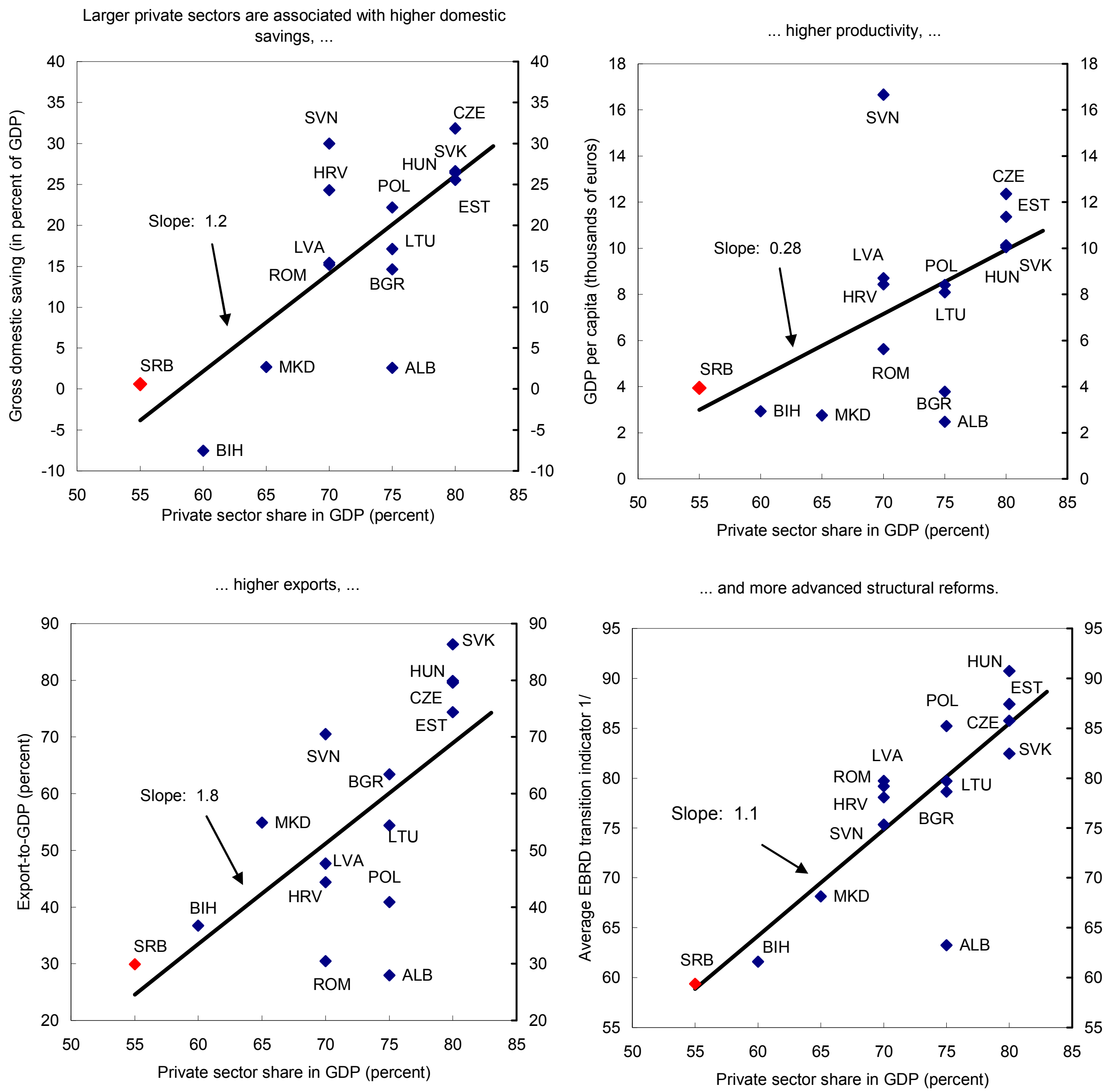
1/ ALB = Albania; BGR = Bulgaria; BIH = Bosnia & Herzegovina; CZE = Czech Republic; EST = Estonia; HRV = Croatia; HUN = Hungary; LTU = Lithuania; LVA = Latvia; MKD = Macedonia, FYR; POL = Poland; ROM = Romania; SRB = Serbia; SVK = Slovak Republic; SVN = Slovenia.

Figure 4. Serbia: Banking Sector Developments in a Regional Context



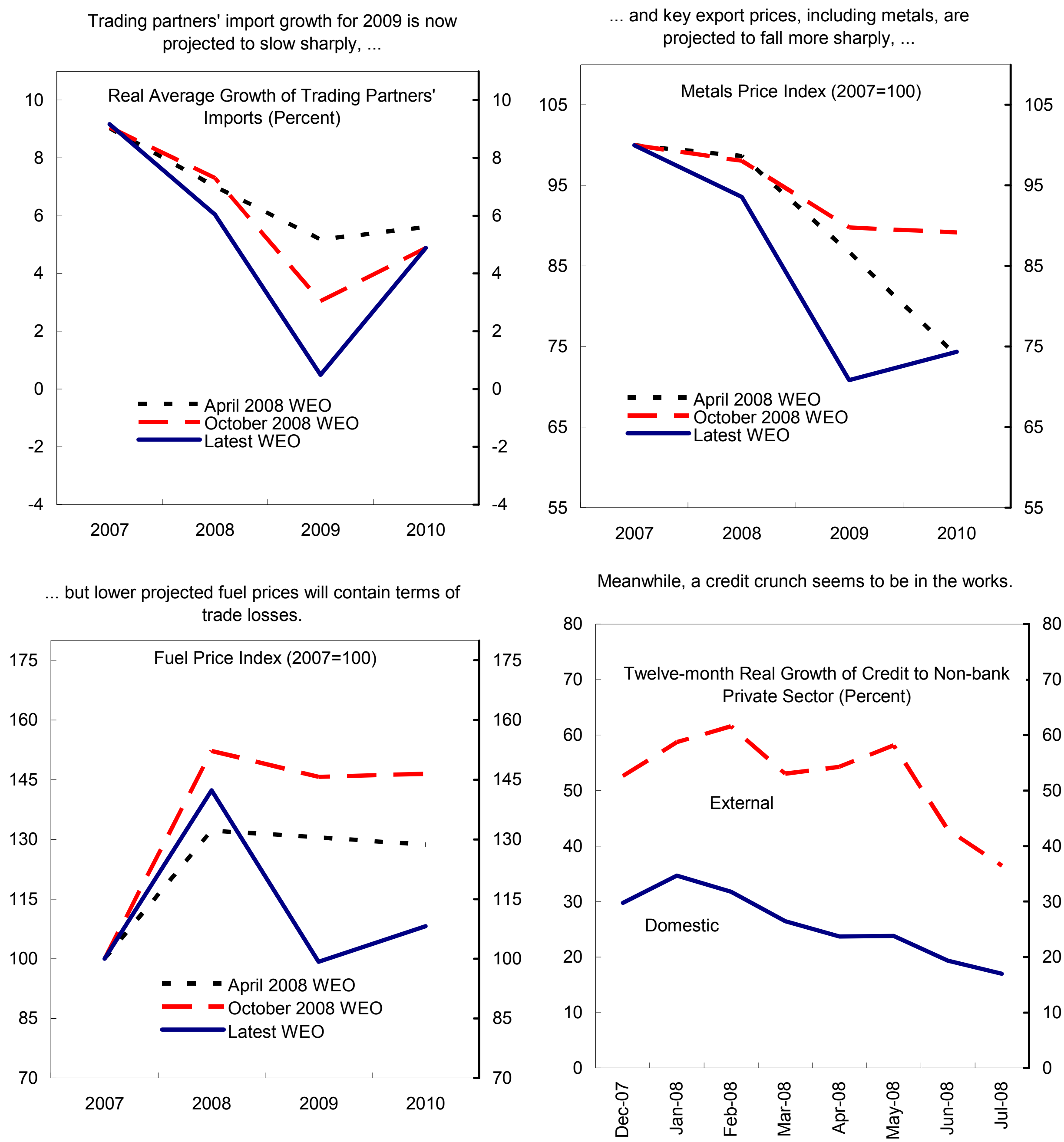
Sources: IFS; Bloomberg; National authorities; and IMF staff estimates.

Figure 5. Eastern European Countries: Structural Reforms, Private Sector Development, and Supply Side Performance, 2007



Sources: WEO; EBRD; World Bank; and IMF staff estimates.
1/ EBRD transition indicators were normalized to range from 100 (best) to 0 (lowest).

Figure 6. Serbia: Recent Revisions in Short-Term Economic Outlook



Sources: WEO; and National Bank of Serbia.

Table 1. Serbia: Selected Economic and Social Indicators, 2004–10 1/

	2004	2005	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.
	(Change in percent, unless otherwise indicated)						
Output, prices, and labor market							
Real GDP	8.2	6.0	5.6	7.1	6.0	3.5	4.5
Real GDP excluding agricultural sector	6.7	7.6	6.3	8.9	5.9	3.9	5.0
Real domestic demand (absorption)	13.5	-3.4	6.5	11.8	6.3	2.6	2.2
Consumer prices (average) 2/	10.1	17.3	12.7	6.8	11.0	7.9	7.2
Consumer prices (end of period) 2/	13.7	17.7	6.6	10.1	9.5	8.0	6.5
Core retail prices (average) 2/	7.7	14.8	10.2	3.8	9.1	...	...
Core retail prices (end of period) 2/	11.0	14.5	5.9	5.4	10.5	...	...
Nominal gross wage	23.7	24.3	24.4	21.9	15.6	9.7	11.0
Real net wage	10.6	6.5	11.0	19.9	4.2	1.6	3.6
Net wage in euro	10.0	8.3	23.3	33.9	…	…	…
Unemployment rate (in percent)	19.5	21.8	21.6	18.8	…	…	…
	(In percent of GDP)						
General government finances							
Revenue	42.8	42.8	43.6	43.0	42.8	42.0	41.2
Expenditure	42.7	42.0	45.2	44.9	45.2	43.8	42.2
Fiscal balance (cash basis)	0.0	0.8	-1.6	-1.9	-2.3	-1.8	-1.0
Structural fiscal balance 3/	...	0.6	-1.9	-3.6	-4.4	-2.9	-1.8
Gross debt	65.0	56.0	42.5	34.2	33.8	30.9	28.3
	(End of period 12-month change, in percent)						
Monetary sector							
Money (M1)	8.3	31.0	37.1	25.3	-8.2	18.2	8.7
Broad money (M2) 4/	30.4	43.1	38.4	44.5	7.9	5.2	13.5
Domestic credit to non-government	44.6	51.2	17.1	36.9	29.6	6.1	12.3
	(End of period, in percent)						
Interest rates (dinar)							
NBS repo rate	16.3	19.2	14.0	10.0	17.8	…	…
Deposit rate	3.6	3.7	5.1	4.1	6.4	…	…
	(In percent of GDP, unless otherwise indicated)						
Balance of payments							
Current account balance	-12.1	-8.7	-10.0	-15.9	-17.9	-16.0	-15.4
Exports of goods	17.2	19.6	21.7	22.0	22.3	20.5	21.7
Imports of goods	44.4	40.5	42.8	44.9	46.1	42.3	41.6
Trade of goods balance	-27.2	-20.9	-21.1	-22.9	-23.8	-21.8	-19.8
Remittances, net	13.3	12.2	11.8	9.3	7.9	8.6	8.5
FDI, portfolio investment, and capital transfers (net)	4.1	6.1	18.8	7.6	6.1	5.7	6.4
External borrowing, net	8.4	10.4	12.3	12.1	6.3	7.0	10.1
External debt (end of period; billions of euro)	10.4	13.1	14.9	17.8	22.4	24.7	28.4
(In percent of GDP)	54.1	64.0	63.0	61.1	66.6	71.6	75.8
of which: Private external debt	...	26.2	35.8	40.0	46.0	50.8	56.0
Gross official reserves (in billions of euro)	3.1	4.9	9.0	9.6	9.0	8.1	8.7
(In months of prospective imports of GNFS)	4.3	4.6	6.7	6.3	6.2	5.1	5.3
Exchange rate (dinar/euro, period average)	72.6	82.9	84.2	80.0	81.5	…	…
REER (annual average change, in percent; + indicates appreciation)	-3.6	-3.1	6.6	7.2	5.0	-4.3	1.3
Social indicators							
Per capita GDP (2008): US$6,685. Population (2007): 7.4 million. Poverty rate (poverty line is US$5 per day, 2007): 6.6 percent.							

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

1/ Excluding Kosovo (with the exception of external debt).
2/ Retail prices until 2008. Monitoring of core retail price indices to be discontinued in 2009.
3/ Fiscal balance adjusted for the automatic effects of both the output gap and the external absorption gap on the fiscal position; see IMF Country Report No. 07/390 for details.
4/ Excluding frozen foreign currency deposits.

Table 2. Serbia: Real GDP Growth Components, 2004-10
(In percent)

	2004	2005	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.
	(Real growth rate by expenditure category)						
Gross Domestic Product (GDP)	8.2	6.0	5.6	7.1	6.0	3.5	4.5
Domestic demand (absorption)	13.5	-3.4	6.5	11.8	6.3	2.6	2.2
Non-government	17.2	-3.1	5.8	9.7	7.1	3.3	1.8
Government	-0.6	-4.5	9.4	21.0	3.2	-0.2	3.8
Consumption	3.5	0.8	7.0	11.5	6.6	3.3	1.5
Non-government	5.3	2.6	8.2	9.7	6.8	4.4	1.3
Government	-2.6	-5.9	2.1	19.5	5.9	-0.7	2.1
Investment	62.8	-16.4	4.5	12.8	5.2	0.0	4.8
Gross fixed capital formation	27.8	2.7	14.5	13.0	5.1	-0.5	5.9
Non-government	29.6	2.1	7.3	9.4	8.7	-1.1	4.5
Government	17.2	6.4	58.8	27.6	-7.5	2.0	11.5
Change in inventories 1/	8.0	-5.5	-1.7	0.3	0.2	0.1	-0.1
Net exports of goods and services 1/	-7.8	10.2	-1.8	-6.5	-1.6	0.3	1.9
Exports of goods and services	5.7	14.4	4.9	14.9	11.7	2.0	12.1
Imports of goods and services	21.0	-13.6	7.8	25.2	10.2	0.6	3.3
	(Contribution to real growth by expenditure category)						
Gross Domestic Product (GDP)	8.2	6.0	5.6	7.1	6.0	3.5	4.5
Domestic demand (absorption)	16.1	-4.2	7.4	13.6	7.6	3.2	2.6
Non-government	16.2	-3.2	5.4	9.1	6.8	3.2	1.7
Government	-0.2	-1.0	2.0	4.5	0.8	0.0	0.9
Consumption	3.4	0.7	6.3	10.5	6.3	3.2	1.4
Non-government	4.0	2.0	5.9	7.1	5.2	3.3	1.0
Government	-0.6	-1.2	0.4	3.4	1.1	-0.1	0.4
Investment	12.6	-5.0	1.1	3.0	1.3	0.0	1.2
Gross fixed capital formation	4.6	0.5	2.8	2.7	1.1	-0.1	1.2
Non-government	4.2	0.4	1.2	1.6	1.5	-0.2	0.8
Government	0.4	0.2	1.6	1.1	-0.4	0.1	0.5
Change in inventories	8.0	-5.5	-1.7	0.3	0.2	0.1	-0.1
Net exports of goods and services	-7.8	10.2	-1.8	-6.5	-1.6	0.3	1.9
Exports of goods and services	1.4	3.5	1.3	3.9	3.3	0.6	3.5
Imports of goods and services	9.3	-6.7	3.1	10.4	4.9	0.3	1.6
	(Contribution to real GDP growth by production category)						
Gross Domestic Product (GDP)	8.2	6.0	5.6	7.1	6.0	3.5	4.5
Gross Value-Added	7.1	4.7	5.8	5.8	5.2	3.1	3.9
Agriculture	2.3	-0.6	0.0	-0.9	0.7	0.0	0.0
Industry	1.3	0.2	0.9	0.7	0.4	-0.2	0.2
Services	4.6	6.5	4.7	7.2	5.0	3.7	4.3
Wholesale and retail trade	1.3	1.8	1.0	2.0	0.9	-0.1	0.2
Construction	0.1	0.1	0.2	0.3	0.2	0.2	0.2
Transport and communications	1.2	1.9	2.8	2.2	2.1	2.1	2.3
Financial services	0.5	0.8	0.9	1.1	0.8	0.7	0.7
Other	0.5	0.5	0.1	0.4	0.3	0.4	0.2
Taxes minus subsidies	1.5	1.6	0.0	1.5	1.0	0.6	0.7
Memorandum items:							
Non-agriculture GDP	5.9	6.6	5.6	8.0	5.3	3.5	4.5
Non-agriculture value added	4.9	5.3	5.9	6.7	4.5	3.1	3.9

Sources: Serbian Statistical Office; and IMF staff estimates and projections.

1/ Contributions to GDP growth.

Table 3. Serbia: Balance of Payments, 2005-13 1/

	2005	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.
				(In billions of euro)					
Current account balance	-1.8	-2.4	-4.6	-6.0	-5.5	-5.7	-5.1	-4.8	-4.4
Trade of goods balance	-4.3	-5.0	-6.7	-8.0	-7.5	-7.4	-6.9	-6.7	-6.6
Exports of goods	4.0	5.1	6.4	7.5	7.1	8.1	9.3	10.6	12.2
Imports of goods	-8.3	-10.1	-13.1	-15.5	-14.6	-15.5	-16.2	-17.4	-18.8
Services balance	0.0	0.0	-0.3	-0.2	0.0	-0.2	-0.3	-0.3	-0.3
Exports of nonfactor services	1.3	1.8	2.3	2.7	2.7	3.0	3.3	3.7	4.1
Imports of nonfactor services	-1.3	-1.9	-2.6	-2.9	-2.7	-3.2	-3.5	-3.9	-4.4
Income balance	-0.3	-0.3	-0.6	-0.7	-1.2	-1.5	-1.8	-2.0	-2.2
Net interest	-0.3	-0.3	-0.2	-0.1	-0.5	-0.7	-0.8	-0.9	-0.9
Others, including reinvested earnings 1/	0.0	0.0	-0.5	-0.5	-0.7	-0.8	-1.0	-1.1	-1.3
Current transfer balance	2.8	3.0	2.9	2.9	3.2	3.4	3.8	4.2	4.7
Official grants	0.3	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3
Others, including private remittances	2.5	2.8	2.7	2.7	3.0	3.2	3.5	3.9	4.4
Capital and financial account balance	3.8	7.5	5.4	5.2	4.6	6.4	6.4	6.5	5.1
Capital transfer balance	...	0.7	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment balance	1.2	3.4	1.8	2.0	1.9	2.3	3.2	3.5	3.7
Portfolio investment balance	...	0.4	0.7	0.0	0.1	0.1	0.1	0.2	0.3
Other investment balance	2.5	3.0	3.2	3.2	2.7	4.0	3.1	2.8	1.1
General governement	0.2	-0.2	0.1	0.1	0.3	0.3	0.3	0.3	0.3
Domestic banks	1.1	1.6	-0.5	0.2	-0.1	-0.3	-0.5	-0.8	-1.1
Other private sector	1.2	1.6	3.6	2.9	2.4	4.0	3.3	3.2	1.8
Errors and omissions	-0.4	-0.3	0.2	-0.4	0.0	0.0	0.0	0.0	0.0
Overall balance	1.7	4.8	0.9	-1.1	-0.9	0.7	1.3	1.7	0.7
Financing	-1.7	-4.8	-0.9	1.1	0.9	-0.7	-1.3	-1.7	-0.7
Gross international reserves (increase, -)	-1.5	-4.2	-0.7	1.1	0.9	-0.7	-1.3	-1.7	-0.7
					(In percent of GDP)				
Current account balance	-8.7	-10.0	-15.9	-17.9	-16.0	-15.4	-12.3	-10.5	-8.5
Trade of goods balance	-20.9	-21.1	-22.9	-23.8	-21.8	-19.8	-16.6	-14.6	-12.8
Exports of goods	19.6	21.7	22.0	22.3	20.5	21.7	22.6	23.2	23.7
Imports of goods	-40.5	-42.8	-44.9	-46.1	-42.3	-41.6	-39.2	-37.8	-36.5
Services balance	0.0	-0.2	-0.9	-0.6	0.0	-0.6	-0.6	-0.6	-0.6
Income balance	-1.3	-1.4	-2.1	-2.0	-3.5	-4.1	-4.3	-4.5	-4.3
Current transfer balance	13.5	12.6	10.0	8.6	9.3	9.2	9.2	9.2	9.2
Official grants	1.3	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Others, including private remittances	12.2	11.8	9.3	7.9	8.6	8.5	8.5	8.5	8.5
Capital and financial account balance	18.6	31.6	18.5	15.6	13.4	17.2	15.5	14.2	9.8
Capital transfers balance	...	2.9	-1.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment balance	6.1	14.4	6.3	6.0	5.5	6.1	7.7	7.7	7.2
Portfolio investment balance	...	1.5	2.3	0.0	0.2	0.3	0.4	0.4	0.5
Other investment balance	12.5	12.9	10.8	9.5	7.7	10.8	7.4	6.0	2.1
General governement	0.9	-0.9	0.2	0.4	0.9	0.7	0.7	0.7	0.6
Domestic banks	5.4	6.9	-1.6	0.5	-0.2	-0.7	-1.3	-1.7	-2.1
Other private sector	6.1	6.9	12.2	8.7	6.9	10.8	8.0	7.1	3.6
Errors and omissions	-1.8	-1.1	0.6	-1.1	0.0	0.0	0.0	0.0	0.0
Overall balance	8.1	20.5	3.2	-3.4	-2.6	1.9	3.2	3.7	1.4
Memorandum items:			(In billions of euro unless otherwise specified)						
Export growth (percent)	21.8	28.0	25.0	17.0	-5.8	15.2	14.5	14.4	14.5
Import growth (percent)	-2.7	22.3	29.4	18.6	-6.0	6.6	4.0	7.5	8.0
Export volume growth (percent)	14.4	4.9	14.9	11.7	2.0	12.1	12.2	12.5	12.5
Import volume growth (percent)	-13.6	7.8	25.2	10.2	0.6	3.3	2.1	6.2	8.5
Export prices growth (percent)	6.4	22.0	8.8	4.7	-7.6	2.8	2.0	1.7	1.7
Import prices growth (percent)	12.6	13.5	3.3	7.6	-6.5	3.2	1.9	1.3	-0.5
Change in terms of trade change (percent)	-5.5	7.5	5.3	-2.7	-1.2	-0.4	0.1	0.5	2.2
Gross external financing requirement (bn euros)	...	9.4	8.7	8.4	8.9	11.0	12.6	14.5	14.6
(percent of GDP)	...	39.9	29.8	24.8	25.9	29.5	30.6	31.6	28.5
o/w Debt amortization		1.9	2.9	3.3	4.1	4.3	6.0	7.7	9.2
(percent of GDP)		8.0	10.1	9.7	11.9	11.6	14.5	16.8	18.0
Medium and long term		1.1	2.1	2.3	2.9	3.2	4.5	6.0	7.4
Short term		0.8	0.8	0.9	1.2	1.2	1.5	1.7	1.9

Sources: NBS; and IMF staff estimates and projections.

1/ Some estimates, in particular, for private remittances and reinvested earnings are subject to significant uncertainty. In addition, intercompany loan transactions are not identified and are recorded as debt flows rather than FDI flows.

Table 4. Serbia: External Balance Sheet, 2005-13 1/

	2005	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.
				(In billions of euros)					
International investment position 2/	-15.1	-16.0	-18.7	-28.4	-33.8	-39.4	-44.3	-48.9	-53.0
Public sector 3/	-3.2	2.7	3.8	2.5	1.3	1.7	2.7	4.1	4.5
Private sector 3/	-11.9	-18.8	-22.6	-30.9	-35.1	-41.1	-47.0	-53.0	-57.5
FDI and portfolio investment (net) 4/	-4.7	-8.4	-9.6	-12.8	-14.7	-17.0	-20.3	-23.9	-27.8
External debt (net) 4/	-12.6	-14.4	-17.4	-21.9	-24.3	-27.9	-30.5	-32.8	-33.3
Gross external debt	-13.1	-14.9	-17.8	-22.4	-24.7	-28.4	-31.0	-33.2	-33.8
General government	-7.7	-6.4	-6.1	-6.9	-7.2	-7.4	-7.7	-8.0	-8.2
Private sector	-5.3	-8.5	-11.7	-15.5	-17.5	-20.9	-23.3	-25.3	-25.5
Banks	-2.2	-3.9	-4.0	-3.8	-3.9	-3.7	-3.3	-2.6	-1.7
Other private sector	-3.6	-5.0	-8.1	-11.7	-13.6	-17.2	-20.0	-22.6	-23.8
Gross external assets	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Other, net (inc. commercial banks foreign assets)	-1.9	-1.9	-1.3	-2.6	-2.9	-3.1	-3.4	-3.8	-4.2
Central bank gross international reserves	4.0	8.7	9.5	9.0	8.1	8.7	10.0	11.6	12.3
o/w central bank free net reserves	2.3	5.5	6.1	6.1	5.8	6.2	7.2	8.5	8.8
o/w commercial banks required reserves and other residents deposits held with NBS	1.7	3.2	3.4	2.9	2.3	2.5	2.8	3.1	3.5
				(In percent of GDP)					
International investment position 2/	-74.0	-67.9	-64.1	-84.5	-98.1	-105.3	-107.3	-106.4	-103.1
Public sector 3/	-15.6	11.5	13.1	7.5	3.8	4.7	6.6	9.0	8.7
Private sector 3/	-58.4	-79.5	-77.5	-92.0	-101.8	-110.0	-113.9	-115.4	-111.8
FDI and portfolio investment (net) 4/	-22.9	-35.7	-32.9	-38.1	-42.7	-45.6	-49.2	-52.1	-54.1
External debt (net) 4/	-61.5	-61.2	-59.7	-65.3	-70.4	-74.7	-74.0	-71.5	-64.8
Gross external debt	-64.0	-63.0	-61.1	-66.6	-71.6	-75.8	-75.1	-72.4	-65.7
General government	-37.8	-27.2	-21.0	-20.5	-20.9	-19.9	-18.6	-17.3	-16.0
Private sector	-26.2	-35.8	-40.0	-46.0	-50.8	-56.0	-56.4	-55.1	-49.7
Banks	-10.7	-16.4	-13.6	-11.3	-11.2	-10.0	-8.0	-5.8	-3.3
Other private sector	-17.8	-21.3	-27.7	-34.7	-39.5	-46.0	-48.4	-49.3	-46.4
Gross external assets	2.4	1.9	1.4	1.3	1.3	1.2	1.1	0.9	0.8
Other, net (inc. commercial banks reserves)	-9.3	-7.9	-4.6	-7.9	-8.4	-8.4	-8.3	-8.2	-8.1
Central bank gross international reserves	19.7	36.8	32.7	26.8	23.4	23.3	24.2	25.3	23.9
o/w central bank free net reserves	11.3	23.3	21.0	18.1	16.7	16.6	17.5	18.6	17.2
o/w commercial banks required FX reserves and other residents' FX deposits held with NBS	8.5	13.6	11.7	8.6	6.7	6.7	6.7	6.7	6.7
Memorandum items:									
				(in billions of euros, unless otherwise specified)					
Central bank international reserves									
Gross reserves (in months of next year's imports)	4.0	6.7	6.2	6.2	5.2	5.3	5.6	6.0	6.1
Free net reserves (in months of next year's imports)	2.3	4.2	4.0	4.2	3.7	3.8	4.1	4.4	4.4
Short term external debt by original maturity	0.8	0.8	0.9	1.2	1.2	1.5	1.7	1.9	2.0
(in percent of central bank net reserves)	20.0	9.6	9.9	13.0	14.4	16.7	17.0	16.1	16.0
(in percent of total debt)	6.2	5.6	5.3	5.2	4.7	5.1	5.5	5.6	5.8
(in percent of GDP)	3.9	3.5	3.2	3.5	3.4	3.9	4.1	4.1	3.8
Short term external debt by remaining maturity	2.0	3.1	3.3	4.1	4.3	6.0	7.7	9.3	...
(in percent of central bank net reserves)	49.9	35.1	34.1	45.5	53.7	68.7	77.3	79.6	...
(in percent of total debt)	15.4	20.5	18.3	18.3	17.5	21.1	24.9	27.8	...
(in percent of GDP)	9.9	12.9	11.2	12.2	12.6	16.0	18.7	20.2	…

Sources: NBS; and IMF staff estimates and projections.

1/ NBS estimates for gross external debt and international reserves. Stock data for other items are staff estimates based on flows since the beginning of transition. Household holdings of FX cash are currently not included due to difficulties in identification.

2/ + denotes a net asset position, - a net liability.

3/ Staff estimates (available data on gross external debt assets and other items is not sufficient to accurately estimate the breakdown public/private).

4/ Currently intercompany loans cannot be identified and are included in external debt rather than in FDI position.

Table 5. Serbia: External Financing Requirements and Sources, 2006-13
(In billions of euros)

	2006	2007	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.
1. Gross financing requirements	**9.4**	**8.7**	**8.4**	**8.9**	**11.0**	**12.6**	**14.5**	**14.6**
External current account deficit excl. official transfers	2.6	4.8	6.2	5.8	6.0	5.4	5.1	4.7
Debt amortization	1.9	2.9	3.3	4.1	4.3	6.0	7.7	9.2
Medium and long term debt	1.1	2.1	2.3	2.9	3.2	4.5	6.0	7.4
Public sector 1/	0.1	0.1	0.1	0.1	0.2	0.2	0.3	0.4
Commercial banks	0.3	0.9	0.7	0.1	0.3	0.6	0.9	1.2
Corporate private sector	0.7	1.2	1.6	2.7	2.6	3.7	4.8	5.8
Short-term debt 2/	0.8	0.8	0.9	1.2	1.2	1.5	1.7	1.9
Repayment of arrears	...	...	...	...	...	...	...	...
Gross reserves accumulation	4.4	0.7	-1.1	-0.9	0.7	1.3	1.7	0.7
IMF repurchases and repayments 3/	0.6	0.2	0.0	0.0	0.0	0.0	0.0	0.0
2. Available financing	**9.4**	**8.7**	**8.4**	**8.9**	**11.0**	**12.6**	**14.5**	**14.6**
Capital transfers	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)	3.4	1.8	2.0	1.9	2.3	3.2	3.5	3.7
Portfolio investment (net)	0.4	0.7	0.0	0.1	0.1	0.1	0.2	0.3
Debt financing from private creditors	4.8	6.0	5.0	6.0	7.3	8.3	9.3	9.1
Medium- and long-term financing	4.0	5.2	4.1	4.9	6.1	6.5	7.6	7.3
To public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
To commercial banks	1.8	0.7	0.1	0.2	0.2	0.2	0.3	0.3
To corporate private sector	2.2	4.4	4.0	4.7	5.9	6.3	7.4	7.0
Short-term financing	0.8	0.8	0.9	1.2	1.2	1.8	1.7	1.9
Official creditors 4/	0.4	0.5	0.5	0.7	0.7	0.8	0.9	1.0
To public sector	0.4	0.5	0.5	0.7	0.7	0.8	0.9	1.0
To private sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IMF 3/	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Accumulation of arrears (exceptional)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other flows 5/	-0.5	-0.2	0.8	0.2	0.6	0.2	0.6	0.5
Memorandum items:								
Debt service	2.4	3.6	4.0	5.2	5.7	7.5	9.4	11.0
o/w interest	0.5	0.7	0.7	1.1	1.4	1.6	1.7	1.8
o/w amortization	1.9	2.9	3.3	4.1	4.3	6.0	7.7	9.2

Sources: NBS; and IMF staff estimates and projections.

1/ Excluding the IMF.
2/ Original maturity of less than 1 year. Stock at the end of the previous period.
3/ Assumes that the proposed Stand-By Arrangement remains precautionary.
4/ Includes both loans and grants.
5/ Includes all other net financial flows, and errors and omissions.

Table 6. Serbia: Savings-Investment Balances, 2005–13 1/
(In percent of GDP)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
				Projection					
Domestic demand	120.9	121.3	123.8	124.5	121.8	120.4	117.2	115.3	113.4
Consumption	97.2	97.6	99.4	100.3	98.4	97.0	93.0	90.4	88.2
Non-government	79.4	80.2	80.4	81.3	80.2	79.2	75.6	73.1	70.8
Government	17.8	17.5	19.0	19.0	18.2	17.8	17.4	17.4	17.4
Gross domestic savings	2.8	2.4	0.6	-0.3	1.6	3.0	7.0	9.6	11.8
Non-government	-1.3	-0.8	-2.8	-2.5	-2.2	-1.5	1.7	4.0	6.3
Government	4.1	3.2	3.4	2.2	3.7	4.5	5.3	5.6	5.5
Net factor receipts and transfers from abroad	12.2	11.2	7.9	6.6	5.8	5.1	4.9	4.8	4.9
Non-government	13.0	12.0	8.4	7.1	6.6	5.7	5.3	5.1	5.3
Government	-0.8	-0.8	-0.5	-0.5	-0.8	-0.6	-0.4	-0.4	-0.4
Gross national savings	15.0	13.6	8.5	6.3	7.4	8.1	11.9	14.3	16.7
Non-government	11.7	11.2	5.6	4.6	4.4	4.2	7.0	9.1	11.6
Government	3.3	2.4	2.9	1.8	2.9	3.9	4.9	5.2	5.2
Gross domestic investment 1/	23.6	23.6	24.4	24.2	23.4	23.5	24.3	24.8	25.2
Non-government	21.0	19.6	19.7	20.1	19.3	19.1	19.2	19.3	19.4
Gross fixed capital formation	16.2	16.7	16.7	17.1	16.3	16.3	16.6	16.9	17.2
Change in inventories	4.7	2.9	3.0	3.0	3.0	2.8	2.6	2.4	2.2
Government	2.7	4.0	4.7	4.1	4.0	4.3	5.0	5.5	5.8
Overall savings-investment balance	-8.7	-10.0	-15.9	-17.9	-16.0	-15.4	-12.3	-10.5	-8.5
Non-government	-9.3	-8.4	-14.0	-15.5	-14.9	-15.0	-12.2	-10.2	-7.9
Government	0.6	-1.6	-1.9	-2.3	-1.1	-0.4	-0.1	-0.3	-0.6
Foreign savings	8.7	10.0	15.9	17.9	16.0	15.4	12.3	10.5	8.5
Foreign savings excluding official grants	9.9	10.8	16.6	18.5	16.7	16.0	13.0	11.2	9.1
Memorandum items:									
Net exports of goods and services 2/	-20.9	-21.3	-23.8	-24.5	-21.8	-20.4	-17.2	-15.3	-13.4
Current account balance (incl. grants)	-8.7	-10.0	-15.9	-17.9	-16.0	-15.4	-12.3	-10.5	-8.5
General government fiscal balance	0.8	-1.6	-1.9	-2.3	-1.8	-1.0	-0.7	-0.8	-1.0

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

1/ Including changes in inventories.

2/ Equal to the absoption gap (GDP minus domestic demand).

Table 7. Serbia: Monetary Survey, 2004-10.
(In RSD billions, unless indicated otherwise; end of period) 1/

	2004	2005	2006	2007	2008 Sept.	2008 Oct.	2008 Proj.	2009 Proj.	2010 Proj.
Net foreign assets 2/	161	219	408	563	536	517	533	444	493
in billions of euro	2.0	2.6	5.2	7.1	7.0	6.1	6.1	4.9	5.3
Foreign assets	313	492	771	877	828	889	881	812	857
NBS	248	425	715	766	745	798	783	730	810
Commercial banks	65	67	56	111	83	91	98	82	46
Foreign liabilities (-)	-152	-273	-363	-314	-292	-372	-349	-368	-364
NBS	-69	-82	-56	-14	-13	-17	-17	-18	-18
Commercial banks	-83	-191	-308	-300	-279	-356	-332	-350	-346
Net domestic assets	148	223	203	320	412	423	420	558	644
Domestic credit	334	473	481	701	887	977	993	1,118	1,242
Government, net	6	-28	-104	-112	-94	-98	-55	-1	-20
NBS	-11	-43	-107	-100	-85	-91	-60	-8	-36
Banks	17	15	2	-12	-9	-7	5	8	17
Local governments, net	-13	-15	-19	-14	-28	-25	-24	-19	-15
Non-government sector	341	516	604	827	1,010	1,101	1,072	1,138	1,277
Households	67	132	204	306	334	372	380	383	417
Enterprises	264	371	381	508	652	706	670	725	826
Other	10	13	19	13	23	23	23	29	35
Other assets	64	70	70	78	43	47	41	35	35
Capital and reserves (-)	-143	-182	-242	-356	-414	-488	-499	-485	-510
NBS	-34	-41	-7	-7	12	-56	-69	-60	-55
Banks	-109	-140	-235	-350	-426	-432	-430	-425	-455
Provisions (-)	-107	-139	-106	-104	-105	-113	-115	-110	-124
Broad money (M2)	309	441	611	883	948	940	953	1,002	1,137
Dinar-denominated M2	132	175	255	370	344	349	361	414	486
M1	106	139	191	239	206	206	219	259	282
Currency in circulation	45	54	68	77	72	77	80	90	88
Demand deposits	61	85	122	162	135	129	139	169	194
Time and saving deposits	26	36	65	131	137	143	142	154	204
Foreign currency deposits	177	267	355	513	604	591	591	588	651
in billions of euro	2.2	3.1	4.5	6.5	7.9	7.0	6.8	6.5	7.0
Memorandum items:									
Twelve-month growth:									
M1	8.3	31.0	37.1	25.3	4.8	6.3	-8.2	18.2	8.7
M2	30.4	43.1	38.4	44.5	25.6	24.1	7.9	5.2	13.5
Total credit to non-government	...	54.7	23.1	48.6	40.6	...	45.2	13.6	21.2
Domestic	44.6	51.2	17.1	36.9	29.3	39.0	29.6	6.1	12.3
Households	125.2	98.7	54.1	50.3	16.9	28.7	24.1	1.0	8.7
Enterprises	34.0	40.2	2.9	33.2	37.4	46.3	31.8	8.4	13.8
External	...	61.8	34.6	68.0	57.4	...	66.5	21.6	29.5
Total real credit to non-government	...	31.5	15.5	35.0	28.0	...	32.6	5.3	13.8
Domestic	27.1	28.5	9.8	24.4	17.7	25.8	18.3	-1.7	5.4
Households	98.0	68.9	44.5	36.5	6.4	16.4	13.3	-6.5	2.1
Enterprises	17.9	19.1	-3.5	21.0	25.0	32.3	20.3	0.4	6.9
External	...	37.6	26.3	52.6	43.3	...	52.1	12.6	21.6
Velocity (M1)	13.1	12.2	10.4	9.8	12.7	12.9	12.5	11.8	12.2
Velocity (M2)	4.5	3.8	3.3	2.6	2.8	2.8	2.9	3.1	3.0
Deposit euroization 3/	67	69	66	64	69	68	68	65	62
Credit euroization 4/	68	77	80	74	67	69	68	62	65

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

1/ Foreign exchange denominated items are converted at contemporaneous exchange rates.

2/ Excluding undivided assets and liabilities of the FSRY and liabilities to banks in liquidation.

3/ Share of non-government foreign currency deposits in total non-government deposits at commercial banks.

4/ Share of net (excl. provisions) fx-indexed and fx-denominated bank credit in total bank credit to non-government.

Table 8. Serbia: Balance Sheet of Commercial Banks, 2004-08 1/
(In RSD billions, unless indicated otherwise)

	2004	2005	2006	2007	2008 September	October 2008			2008 Proj.
							in bn. of euro	in percent of GDP	
Assets	615	914	1,274	1,678	1,838	1,906	22.4	71.5	1,889
Foreign exchange	65	67	56	111	83	91	1.1	3.4	98
Claims on NBS	99	206	468	569	579	551	6.5	20.7	564
Dinar cash and reserves	32	40	63	80	77	117	1.4	4.4	146
Foreign exchange reserves	65	148	254	270	255	244	2.9	9.2	243
NBS bills and other claims	2	17	152	219	246	190	2.2	7.1	175
Claims on government	22	24	18	8	8	8	0.1	0.3	8
Claims on other sectors	335	509	594	827	1,011	1,103	13.0	41.4	1,072
Households	66	132	203	305	334	372	4.4	13.9	380
Enterprises	264	370	380	507	651	705	8.3	26.4	670
Other institutions	4	7	11	15	26	26	0.3	1.0	23
Fixed assets	42	56	66	75	84	85	1.0	3.2	79
Other assets	52	53	71	88	73	68	0.8	2.5	68
Liabilities	615	914	1,274	1,678	1,838	1,906	22.4	71.5	1,889
Foreign liabilities	83	191	308	300	279	356	4.2	13.3	332
Dinar deposits	97	135	213	319	305	300	3.5	11.2	300
Demand deposits	61	85	122	162	135	130	1.5	4.9	140
Time and saving deposits	35	47	79	142	158	160	1.9	6.0	160
Government deposits	2	3	12	16	12	10	0.1	0.4	0
Foreign currency deposits	179	271	359	517	605	594	7.0	22.3	592
Enterprises	62	69	84	116	137	145	1.7	5.5	...
Households	111	190	261	382	431	406	4.8	15.2	...
Government	4	6	4	4	5	6	0.1	0.2	3
Other institutions	3	6	10	15	32	37	0.4	1.4	...
Other deposits	1	3	2	3	2	2	0.0	0.1	2
Liabilities to NBS	2	1	0	2	0	4	0.0	0.1	4
Other liabilities	49	49	70	95	125	124	1.5	4.7	125
Provisions	94	124	87	93	95	95	1.1	3.6	104
Capital and reserves	109	140	235	350	426	432	5.1	16.2	430
Memorandum items:									
Provisions against credit losses:									
Enterprises	67.2	86.6	54.8	57.9	65.5	70.7	0.8	2.6	77.4
in percent of credit	108.6	125.3	65.0	49.7	47.9	48.6	...	...	...
Households	2.1	7.2	7.5	10.8	15.1	16.1	0.2	0.6	...
in percent of credit	1.9	3.8	2.9	2.8	3.5	4.0	...	...	...
Off-balance sheet items 2/	511	726	1,163	1,580	2,053	...	26.8	78.0	...
External debt (bn. of euros)	0.8	1.7	3.4	3.5	3.1	3.5	...	9.8	3.8
medium- and long-term	0.6	1.1	2.8	2.6	2.2	2.3	...	7.1	2.5
short-term	0.2	0.6	0.6	0.9	0.8	1.2	...	2.7	1.3

Source: National Bank of Serbia.

1/ Numbers are on a gross basis; credit numbers include provisions.

2/ As of September 2008, about 18 percent of off-balance sheet items represented various guarantees, mostly on cross-border loans. Other off-balance sheet items include collateral against loans and repo contracts, undrawn credit lines, and derivative contracts. Figures in euros and in percent of GDP correspond to the latest available observation.

Table 9. Serbia: Banking Sector Financial Soundness Indicators, 2004-08
(End-of-period, in percent)

	2004	2005	2006	2007	2008 June
Capital Adequacy					
Regulatory capital to risk-weighted assets 1/	27.9	26.0	24.7	27.9	28.1
Tier 1 capital to risk-weighted assets	25.6	22.2	24.2	28.5	29.5
Total regulatory capital to total assets	18.8	16.0	15.6	17.1	18.6
Liquidity					
Liquid assets to total assets	21.0	28.8	41.4	38.0	35.7
Asset Quality					
Nonperforming loans to total loans 2/	...	...	11.7	...	...
Nonperforming loans to total loans (net of provisions) 2/	...	...	4.11	3.81	4.94
Share of risky loans to total loans 3/	22.2	23.8	23.1	24.7	29.5
FX denominated and FX indexed loans to total loans	69.9	88.1	83.5	77.2	71.0
Earnings and Profitability					
Net income to average assets (ROA)	-1.2	1.1	1.7	1.7	2.6
Net income to average capital (ROE)	-5.3	6.7	10.0	10.2	14.1
Net interest income to average total assets	6.4	6.3	6.6	6.9	8.7
Noninterest expense to gross income 4/	132.9	117.6	104.9	98.6	97.1
Personnel expense to gross income 4/	9.3	9.0	6.5	4.8	4.0
Interest income to gross income 4/	22.6	24.1	19.4	17.8	17.3
Noninterest income to gross income 4/	77.4	75.9	80.6	82.2	82.7
Personnel expenses to noninterest expenses	7.0	7.6	6.2	4.9	4.2
Customer deposits to total loans	97.5	99.4	109.2	113.6	101.8

Source: National Bank of Serbia.

1/ Regulatory capital excludes, among other things, investments in other banks in excess of 10 percent of total capital.
2/ Based on 9 largest banks in Serbia – loans past due more than 90 days.
3/ Assets (net of provisions) classified by the NBS as receivables in C, D, and E risk categories with provisioning requirements of 25 percent, 50 percent, and 100 percent, respectively.
4/ Gross income excludes income from indirect write-offs.

Table 10. Serbia: Balance Sheet of the NBS, 2004-10
(In RSD billions, unless indicated otherwise; end of period) 1/

	2004	2005	2006	2007	2008 Sept.	2008 Oct.	2008 Proj	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Proj.
Net foreign assets 2/	114	196	406	482	476	536	530	518	509	506	506	556
in billions of euro	1.3	2.2	5.1	6.1	6.2	6.3	6.1	5.9	5.7	5.6	5.6	6.0
Gross foreign reserves	248	425	715	766	745	798	783	757	735	730	730	810
Gross reserve liabilities (-)	-135	-229	-309	-284	-269	-262	-253	-238	-227	-224	-224	-254
Net domestic assets	-36	-101	-272	-323	-327	-343	-304	-267	-237	-229	-229	-298
Net domestic credit	-3	-60	-264	-316	-340	-287	-236	-202	-176	-169	-169	-243
Government	-11	-43	-107	-100	-85	-91	-60	-34	-13	-8	-8	-36
Claims	22	17	16	11	11	11	11	10	9	9	9	9
RSD	22	16	16	11	11	11	11	10	9	9	9	9
foreign currency	0	0	0	0	0	0	0	0	0	0	0	0
Liabilities (-)	-33	-60	-123	-111	-96	-102	-70	-44	-22	-17	-17	-45
RSD	-23	-41	-20	-29	-61	-63	-31	-18	-8	-5	-5	-15
foreign currency	-10	-19	-103	-82	-35	-39	-40	-26	-15	-12	-12	-30
Other public sector	-6	-7	-10	-11	-20	-19	-18	-20	-22	-22	-22	-26
Banks	0	-16	-151	-218	-246	-186	-171	-167	-163	-162	-162	-194
Claims	2	1	0	1	1	3	4	6	8	8	8	6
Liabilities (-)	-2	-17	-152	-219	-246	-189	-175	-173	-171	-170	-170	-200
Other sectors	14	6	4	13	11	9	13	18	22	23	23	13
Capital accounts (-)	-34	-41	-7	-7	12	-56	-69	-64	-61	-60	-60	-55
Reserve money	77	94	134	159	149	193	226	252	272	277	277	258
Currency in circulation	45	54	68	77	72	77	80	85	89	90	90	88
Commercial bank reserves	32	41	65	82	77	116	146	167	183	187	187	170
Required reserves	21	26	34	30	65	96	109	118	125	127	127	140
Excess reserves	5	5	22	45	5	2	20	28	34	35	35	15
Vault cash and giro accounts	6	10	9	7	7	17	17	21	24	25	25	15

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

1/ Foreign exchange denominated items are converted at contemporaneous exchange rates.

2/ Excluding undivided assets and liabilities of the FSRY and liabilities to banks in liquidation.

Table 11a. Serbia: General Government Fiscal Operations, 2005–10 1/
(In billions of RSD)

	2005	2006	2007	2008 Revised Budget	2008 Prog.	2009 Q1 Prog.	2009 Q2 Prog.	2009 Q3 Prog.	2009 Q4 Prog.	2009 Prog.	2010 Prog.
Revenue	**725**	**867**	**1001**	**1185**	**1173**	**295**	**312**	**318**	**360**	**1,284**	**1411**
Taxes	640	756	870	1035	1031	257	270	274	314	1,115	1236
Personal income tax	94	119	116	140	140	31	36	35	45	147	163
Social security contributions	185	231	270	321	323	78	86	89	105	358	399
Taxes on profits	10	18	30	41	42	18	10	9	13	50	56
Value-added taxes	216	225	265	315	308	80	85	84	90	339	371
Excises	71	87	99	111	111	28	31	35	37	130	158
Taxes on international trade	39	45	57	70	70	12	12	13	14	51	45
Other taxes	24	30	33	36	36	9	10	10	11	40	45
Non-tax revenue	75	99	119	133	125	38	42	43	45	168	174
Capital revenue	8	10	12	17	17	0	0	0	0	0	0
Grants	1	2	1	0	1	0	0	0	0	1	1
Expenditure	**711**	**898**	**1045**	**1259**	**1237**	**304**	**321**	**330**	**385**	**1,339**	**1445**
Current expenditure	660	807	922	1119	1107	276	288	297	332	1,193	1275
Wages and salaries	171	204	238	283	281	71	78	77	83	309	337
Other goods and services	126	157	193	232	225	46	55	60	74	235	258
Interest	25	30	18	21	22	8	4	7	9	28	30
Subsidies	55	56	64	82	83	13	14	15	24	66	67
Transfers	284	361	409	500	496	138	137	138	142	556	584
Pensions	190	228	260	336	332	97	97	97	97	389	398
Other transfers 2/	94	132	150	164	164	41	40	40	45	167	187
Capital expenditure	45	80	110	118	112	17	26	30	50	124	148
National investment plan	0	9	39	29	20	...	...	...	...	...	...
Other	45	71	70	88	92	...	...	...	...	...	...
Net lending	5	11	13	23	18	11	7	3	2	22	22
Fiscal balance (cash basis)	**14**	**-31**	**-44**	**-74**	**-64**	**-9**	**-9**	**-12**	**-25**	**-55**	**-35**
Financing	**-14**	**31**	**44**	**74**	**64**	**9**	**9**	**12**	**25**	**55**	**35**
Privatization proceeds	42	143	65	...	20	18	18	18	17	70	25
Domestic	-68	-123	-44	...	31	-6	-14	-4	0	-25	-18
Bank	-40	-99	5	...	10	0	0	0	0	0	0
Non-bank	-28	-34	-49	...	21	-6	-14	-4	0	-25	-18
External	13	11	23	...	12	-2	5	-1	8	10	27
Memorandum item:											
Gross debt	948	844	796	938	927	...	...	...	...	944	972

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

1/ Includes the republican budget, local governments, social security funds, and the Road Company.
2/ Excluding foreign currency deposit payments to households, reclassified below the line.

Table 11b. Serbia: General Government Fiscal Operations, 2005–10 1/
(In percent of GDP)

	2005	2006	2007	2008 Revised Budget	2008 Prog.	2009 Q1 Prog.	2009 Q2 Prog.	2009 Q3 Prog.	2009 Q4 Prog.	2009 Prog.	2010 Prog.
Revenue	**42.8**	**43.6**	**43.0**	**43.3**	**42.8**	**44.8**	**42.3**	**39.6**	**41.7**	**42.0**	**41.2**
Taxes	37.8	38.0	37.4	37.8	37.6	39.0	36.7	34.1	36.4	36.4	36.1
Personal income tax	5.6	6.0	5.0	5.1	5.1	4.7	4.9	4.4	5.2	4.8	4.7
Social security contributions	11.0	11.6	11.6	11.7	11.8	11.9	11.7	11.0	12.2	11.7	11.6
Taxes on profits	0.6	0.9	1.3	1.5	1.5	2.7	1.3	1.1	1.6	1.6	1.6
Value-added taxes	12.8	11.3	11.4	11.5	11.2	12.2	11.5	10.5	10.4	11.1	10.8
Excises	4.2	4.4	4.2	4.1	4.1	4.2	4.2	4.3	4.3	4.3	4.6
Taxes on international trade	2.3	2.3	2.5	2.6	2.6	1.8	1.7	1.6	1.6	1.7	1.3
Other taxes	1.4	1.5	1.4	1.3	1.3	1.4	1.4	1.2	1.3	1.3	1.3
Non-tax revenue	4.4	5.0	5.1	4.9	4.6	5.8	5.7	5.4	5.2	5.5	5.1
Capital revenue	0.5	0.5	0.5	0.6	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Grants	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	**42.0**	**45.2**	**44.9**	**46.0**	**45.2**	**46.1**	**43.6**	**41.1**	**44.5**	**43.8**	**42.2**
Current expenditure	39.0	40.6	39.6	40.8	40.4	41.9	39.2	37.0	38.4	39.0	37.2
Wages and salaries	10.1	10.3	10.2	10.3	10.3	10.7	10.6	9.6	9.6	10.1	9.8
Other goods and services	7.4	7.9	8.3	8.5	8.2	6.9	7.5	7.5	8.5	7.7	7.5
Interest	1.5	1.5	0.8	0.8	0.8	1.2	0.5	0.9	1.1	0.9	0.9
Subsidies	3.2	2.8	2.7	3.0	3.0	2.0	1.9	1.9	2.7	2.1	1.9
Transfers	16.8	18.1	17.6	18.2	18.1	21.0	18.7	17.2	16.5	18.2	17.0
Pensions	11.2	11.5	11.2	12.2	12.1	14.8	13.2	12.1	11.3	12.7	11.6
Other transfers 2/	5.5	6.7	6.4	6.0	6.0	6.2	5.4	5.0	5.2	5.4	5.4
Capital expenditure	2.7	4.0	4.7	4.3	4.1	2.6	3.5	3.8	5.8	4.0	4.3
National investment plan	0.0	0.5	1.7	1.1	0.7	...	...	...	...	...	...
Other	2.7	3.6	3.0	3.2	3.4	...	...	...	...	...	...
Net lending	0.3	0.5	0.6	0.8	0.6	1.6	0.9	0.3	0.3	0.7	0.6
Fiscal balance (cash basis)	**0.8**	**-1.6**	**-1.9**	**-2.7**	**-2.3**	**-1.4**	**-1.3**	**-1.5**	**-2.9**	**-1.8**	**-1.0**
Financing	-0.8	1.6	1.9	2.7	2.3	1.4	1.3	1.5	2.9	1.8	1.0
Privatization proceeds	2.5	7.2	2.8	...	0.7	2.7	2.4	2.2	1.9	2.3	0.7
Domestic	-4.0	-6.2	-1.9	...	1.1	-1.0	-1.9	-0.5	0.0	-0.8	-0.5
Bank	-2.4	-5.0	0.2	...	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Non-bank	-1.6	-1.7	-2.1	...	0.8	-1.0	-1.9	-0.5	0.0	-0.8	-0.5
External	0.8	0.5	1.0	...	0.5	-0.4	0.7	-0.1	1.0	0.3	0.8
Memorandum item:											
Structural fiscal balance 3/	0.6	-1.9	-3.6	-4.8	-4.4	...	...	...	...	-2.9	-1.8
Output gap 4/	0.7	0.3	1.4	1.2	1.2	...	...	...	...	-0.5	-1.2
Absorption gap 5/	0.2	1.6	7.6	9.7	9.7	...	...	...	...	7.5	6.5
Gross debt	56.0	42.5	34.2	34.2	33.8	...	...	...	...	30.9	28.3
Nominal GDP (in billions of dinars)	1,692	1,988	2,329	2,740	2,740	658	736	803	863	3,060	3,428

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

1/ Includes the republican budget, local governments, social security funds, and the Road fund.
2/ Excluding foreign currency deposit payments to households, reclassified below the line.
3/ Actual fiscal balance adjusted for the automatic effects of both the output gap and the external absorption gap on the fiscal position; see IMF Country Report No. 07/390 for details.
4/ Percentage deviation of actual from potential GDP.
5/ Percentage deviation between actual absorption and the level consistent with external balance.

Table 12. Serbia: Rankings of Selected Competitiveness and Structural Indicators 1/

	Serbia		Best performers 2/				Distance 3/	
	2007	2008	Country	2007	Country	2008	2007	2008
World Bank Doing Business survey 4/	52	48	Estonia	90	Estonia	88	-39	-40
Starting a business	49	41	Estonia	89	Macedonia	93	-39	-52
Dealing with licenses	16	6	Estonia	92	Estonia	90	-76	-84
Employing workers	38	50	Czech Rep.	69	Bulgaria	67	-31	-18
Registering property	35	46	Lithuania	98	Lithuania	98	-62	-51
Getting credit	93	85	Slovak Rep.	96	Bulgaria	97	-3	-13
Protecting investors	64	61	Slovenia	89	Albania	92	-25	-31
Paying taxes	32	30	Latvia	89	Macedonia	85	-57	-55
Trading across borders	67	66	Estonia	96	Estonia	97	-29	-31
Enforcing contracts	43	47	Latvia	98	Latvia	98	-55	-51
Closing a business	42	45	Lithuania	83	Lithuania	81	-40	-36
Transparency International								
Corruption Perception Index	34	34	Slovenia	66	Slovenia	67	-32	-33
EBRD transition indicators	77	77		92		92	-15	-15
Large scale privatization	62	62		92		92	-31	-31
Small scale privatization	85	85		100		100	-15	-15
Enterprise restructuring	54	54		85		85	-31	-31
Price liberalization	92	92		100		100	-8	-8
Trade and foreign exchange system	77	85		100		100	-23	-15
Competition policy	46	46		85		85	-39	-39
Banking reform	62	69		92		92	-31	-23
Non-bank financial institutions	46	46		92		92	-46	-46
Overall infrastructure reform	46	54		85		85	-39	-31

Sources: EBRD; Transparency International; World Bank; World Economic Forum; and IMF staff calculations.

1/ For comparability, all indices normalized so that they range from 0 (lowest) to 100 (best).

2/ Country name and index of best performers among: Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, FYR Macedonia, Montenegro, Poland, Romania, Serbia, Slovak Republic, and Slovenia. Country names are not shown for EBRD transition indicators due to the presence of multiple entries.

3/ Distance of Serbia from best performer for each index.

4/ As pointed out in an independent evaluation of the Doing Business survey (see www.worldbank.org/ieg/doingbusiness), care should be exercised when interpreting these indicators given subjective interpretation, limited coverage of business constraints, and a small number of informants which tend to overstate the indicators' coverage and explanatory power.

Table 13. Serbia: Medium-Term Program Scenario, 2005–13 1/

	2005	2006	2007	2008	2009	2010	2011	2012	2013
				Program					
GDP and prices (annual percent change)									
GDP growth (real)	6.0	5.6	7.1	6.0	3.5	4.5	6.0	6.5	7.0
Domestic demand growth (real)	-3.4	6.5	11.8	6.3	2.6	2.2	2.7	4.6	5.9
Retail price inflation (end of period)	17.7	6.6	10.1	9.5	8.0	6.5	6.0	5.6	5.0
Savings and investment (in percent of GDP)									
Savings - investment balance	-8.7	-10.0	-15.9	-17.9	-16.0	-15.4	-12.3	-10.5	-8.5
Non-government	-9.3	-8.4	-14.0	-15.5	-14.9	-15.0	-12.2	-10.2	-7.9
Government	0.6	-1.6	-1.9	-2.3	-1.1	-0.4	-0.1	-0.3	-0.6
General government (in percent of GDP)									
Overall fiscal balance	0.8	-1.6	-1.9	-2.3	-1.8	-1.0	-0.7	-0.8	-1.0
Revenue	42.8	43.6	43.0	42.8	42.0	41.2	40.9	40.7	40.5
Expenditure	42.0	45.2	44.9	45.2	43.8	42.2	41.6	41.5	41.5
Current	39.0	40.6	39.6	40.4	39.0	37.2	36.0	35.5	35.2
Capital and net lending	3.0	4.6	5.3	4.7	4.8	5.0	5.6	6.0	6.2
Structural fiscal balance	0.6	-1.9	-3.6	-4.4	-2.9	-1.8	-1.0	-1.0	-1.0
Output gap	0.7	0.3	1.4	1.2	-0.5	-1.2	-0.9	-0.2	0.0
Absorption gap	0.2	1.6	7.6	9.7	7.5	6.5	3.3	1.5	0.0
Gross debt	56.0	42.5	34.2	33.8	30.9	28.3	25.8	23.7	22.0
Balance of payments (in percent of GDP)									
Current account	-8.7	-10.0	-15.9	-17.9	-16.0	-15.4	-12.3	-10.5	-8.5
of which: Trade balance	-20.9	-21.1	-22.9	-23.8	-21.8	-19.8	-16.6	-14.6	-12.8
of which: Remittances, net	12.2	11.8	9.3	7.9	8.6	8.5	8.5	8.5	8.5
Capital and financial account	18.6	31.6	18.5	15.6	13.4	17.2	15.5	14.2	9.8
of which: FDI and portfolio investment	6.1	18.8	7.6	6.1	5.7	6.4	8.0	8.1	7.7
External debt (end of period)	64.0	63.0	61.1	66.6	71.6	75.8	75.1	72.4	65.7
of which: Private external debt	26.2	35.8	40.0	46.0	50.8	56.0	56.4	55.1	49.7
Gross official reserves (in billions of euro)	4.9	9.0	9.6	9.0	8.1	8.7	10.0	11.6	12.3
REER (ann. av. change; + = appreciation)	-3.1	6.6	7.2	5.0	-4.3	1.3	1.9	2.3	2.4

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

1/ Definitions and coverage as in previous tables.

Table 14. Serbia: Proposed Schedule of Purchases
Under the Stand-By Arrangement

	Available on or after	Amount of Purchase: In millions of SDRs	Amount of Purchase: In percent of quota 1/	Conditions
1.	January 16, 2009	233.850	50.0	Board approval of arrangement.
2.	March 15, 2009	23.385	5.0	Observance of end-December performance criteria and completion of financing assurances review.
3.	June 15, 2009	23.385	5.0	Observance of end-March performance criteria and completion of the first semi-annual review (including financing assurances review).
4.	September 15, 2009	23.385	5.0	Observance of end-June performance criteria and completion of financing assurances review.
5.	December 15, 2009	23.385	5.0	Observance of end-September performance criteria and completion of the second semi-annual review (including financing assurances review).
6.	March 15, 2010	23.385	5.0	Observance of end-December performance criteria and completion of financing assurances review.
	Total	350.775	75.0	

1/ The quota is SDR 467.7 million.

Table 15. Serbia: Structural Conditionality, 2008–09

Action	Timing	Rationale for Criticality
Prior actions		
1. Government to submit to Parliament the Republican and social security fund budgets for 2009 consistent with the program, including legal provisions that ensure a nominal freeze of pensions throughout 2009.	Before Board meeting	Fiscal policy is a cornerstone of the policy package to restore macroeconomic stability. Conditionality is needed to safeguard the envisaged fiscal adjustment. Pensions are one of the largest single government spending item. Following years of wage indexation and an exceptional 10 percent increase at end-2008, more moderate pension increases are a cornerstone of the fiscal adjustment.
2. NBS and government to sign a Memorandum of Understanding on respective responsibilities in achieving the inflation objectives (¶16 of the MEFP).	Before Board meeting	Critical for the success of the inflation targeting regime and the switch to headline CPI targeting, given the large share of regulated prices in the CPI basket (33 percent).
3. Government and NBS to sign a Memorandum of Understanding regarding the respective roles and responsibilities of different players, including in particular the Deposit Insurance Agency (DIA), in maintaining financial stability (¶22 of the MEFP).	Before Board meeting	Critical for establishing an effective crisis management framework.
Structural benchmarks		
4. Government to adopt the business plan of the Road Company of Serbia consistent with the program.	End-January 2009	Complements prior action No. 1 by ensuring full coverage of the general government .
5. Government to adopt state enterprises' business plans that conform to general government wage and employment policy in 2009 and ensure profit transfers to the state.	End-January 2009	Complements prior action No. 1 by ensuring consistent wage and employment policies throughout the public sector, and profit transfers to the government budget.

Table 16. Serbia: Indicators of Capacity to Repay the Fund, 2009-13 1/

	2009	2010	2011	2012	2013
Fund repurchases and charges					
In millions of SDRs	7	8	8	113	177
In millions of US$	10	12	12	172	271
In percent of exports of goods and NFS	0.1	0.1	0.1	0.9	1.2
In percent of GDP	0.0	0.0	0.0	0.3	0.4
In percent of quota	1.4	1.7	1.7	24.1	37.8
In percent of total external debt service	0.2	0.2	0.1	1.6	2.1
In percent of gross international reserves	0.1	0.1	0.1	1.1	1.6
Fund credit outstanding (end-period)					
In millions of SDRs	327	351	351	246	73
In millions of US$	497	534	535	376	112
In percent of exports of goods and NFS	3.8	3.6	3.1	1.9	0.5
In percent of GDP	1.1	1.1	1.0	0.6	0.2
In percent of quota	70.0	75.0	75.0	52.5	15.6
In percent of total external debt	1.5	1.4	1.3	0.8	0.2
In percent of gross international reserves	4.6	4.5	4.0	2.4	0.7
Memorandum items:	(in millions of U.S. dollars, unless otherwise indicated)				
Exports of goods and NFS	13,129	14,949	17,026	19,434	22,220
Quota (in millions of SDRs)	468	468	468	468	468
Total external debt service	5,446	6,134	8,233	10,513	12,492
Public sector external debt (end-period)	9,405	9,750	10,153	10,566	10,996
Total external debt stock (end-period)	32,909	38,005	41,703	44,796	45,410
Gross international reserves	10,778	11,765	13,522	15,829	16,783

1/ Assuming actual purchase of projected available amounts.

Table 17. Serbia: External Debt, September 30, 2008

(In millions of euros)

Creditor	Outstanding debt	Principal arrears	Interest arrears	Late interest	Total
Total debt	19,700	1,647	416	414	20,530
Public sector borrowing	5,953	295	152	176	6,282
Medium- and long-term debt	5,919	295	152	176	6,247
International financial organizations	3,164	-	-	-	3,164
IBRD	1,588	-	-	-	1,588
IDA	446	-	-	-	446
European Community	273	-	-	-	273
EIB	465	-	-	-	465
CEB	24	-	-	-	24
EBRD	260	-	-	-	260
EUROFIMA	108	-	-	-	108
Governments - Paris Club	1,603	-	-	-	1,603
Other governments	286	252	131	166	582
London Club	771	22	22	10	803
Other creditors	74	-	-	-	74
Debt in nonconvertible currency	21	21	-	-	21
Short-term debt	35	-	-	-	35
Private sector borrowing	13,747	1,351	263	238	14,248
Medium- and long-term debt	11,870	964	258	238	12,366
Banks	2,271	50	41	44	2,357
International fianancial organizations	362	11	5	6	374
Governments - Permanent Paris Club members	110	-	-	-	110
Other creditors	1,799	39	36	38	1,873
Enterprisies	9,599	914	217	193	10,009
International fianancial organizations	189	15	6	0	195
Governments - Permanent Paris Club members	25	3	1	0	26
Other governments	12	12	3	5	20
Other creditors	9,329	841	198	189	9,716
Debt in nonconvertible currency	43	43	9	0	52
Short-term debt	1,877	387	5	0	1,882
Banks	1,118	277	0	0	1,118
Enterprisies	760	110	5	0	764

Source: National Bank of Serbia.

Appendix I. Serbia: External Debt Sustainability

1. **Serbia's external debt has been rising since 2004 despite rescheduling operations and early repayments to some multilateral creditors, including the Fund** (Table A1).[1] External debt reached €20.5 billion (US$29.5 billion) in September 2008. The rise was due to private debt, which tripled since early 2006. In particular, nonbank private debt has been rising sharply, as prudential regulation on bank activity became tighter and non-financial companies switched to direct foreign borrowings, often with domestic commercial banks acting as intermediaries. As a result, debt is now two-third private (half corporate), a sharp reversal from less than two years ago.

Serbia: Structure of External Debt, 2005-08
(Percent of total debt)

	End-05	End-06	Dec. 07	Sep. 08
Public	59	43	34	31
Private	41	57	66	69
Banks	17	26	22	17
Other private	24	31	43	52
Total	100	100	100	100

Sources: NBS; and Fund staff estimates.

2. **The associated vulnerabilities are considerable, especially in the context of the present global financial turmoil:**

- The ability of domestic borrowers to service their debt is vulnerable to ***exchange rate depreciation***.

- The impact of the depreciation shock would be compounded by large ***unhedged foreign exchange indebtedness*** in the domestic banking system—the consequence of widespread financial euroization. Household and corporate indebtedness could rise sharply, with negative consequences for banking sector soundness. It should be noted, though, that the banking system has significant capital and liquidity buffers to mitigate such risk, as described in this report.

- The debt is subject to ***rollover risks*** as recent years of heavy borrowing translate into rising due maturities and annual payments.

3. **There are significant uncertainties in the medium term.** Under the baseline scenario, forced, but orderly external adjustment and sound policies would help contain the growth of financing requirements and put a halt to the increase in external debt. However, in the current difficult financial environment, a sharper reduction in available financing cannot be ruled out. While the latter would further reduce the debt-to-GDP ratio, it could also trigger the risks mentioned above and precipitate a financial crisis.

[1] See the related discussion in the 2006 Article IV report (IMF Country Report No. 06/384, Appendix III).

4. **Standard tests illustrate some of these risks.** Standard bound tests show the sensitivity of the debt path to the current account position and the exchange rate (Figure A1). A larger deterioration of the current account would rapidly contribute to further build-up of external debt, and a 30 percent nominal depreciation of the dinar would push the debt-to-GDP ratio close to 100 percent of GDP. In contrast, a scenario assuming key variables at their historical averages shows a return to a sustainable path of external debt, but this is simply because the build up of external imbalances and deterioration of Serbia's external position is recent. The tests also show relatively low sensitivity to interest rate and growth rate shocks.

Table A1. Serbia: External Debt Sustainability Framework, 2003-13
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing non-interest current account 6/**
1 **Baseline: External debt**	62.1	54.1	64.0	63.0	61.1	**66.6**	**71.6**	**75.8**	**75.1**	**72.4**	**65.7**	**-12.7**
2 Change in external debt	-4.3	-8.0	9.8	-0.9	-2.0	5.5	5.1	4.2	-0.8	-2.7	-6.7	
3 Identified external debt-creating flows (4+8+9)	2.4	6.7	5.3	-0.1	-4.8	7.6	7.0	4.9	-0.9	-3.1	-4.8	
4 Current account deficit, excluding interest payments	6.2	10.8	7.0	8.0	13.6	15.7	12.8	11.6	8.5	6.7	5.0	
5 Deficit in balance of goods and services	19.3	26.5	20.9	21.3	23.8	24.5	21.8	20.4	17.2	15.3	13.4	
6 Exports	22.1	23.4	26.0	29.5	29.9	30.2	28.4	29.7	30.5	31.2	31.7	
7 Imports	41.4	49.8	46.9	50.8	53.7	54.7	50.3	50.2	47.8	46.4	45.1	
8 Net non-debt creating capital inflows (negative)	0.0	0.0	0.0	-1.5	-8.7	-7.1	-6.8	-7.5	-9.1	-9.2	-8.8	
9 Automatic debt dynamics 1/	-3.8	-4.1	-1.7	-6.6	-9.6	-1.0	0.9	0.7	-0.4	-0.6	-1.1	
10 Contribution from nominal interest rate	1.0	1.2	1.7	2.1	2.3	2.2	3.2	3.7	3.8	3.8	3.5	
11 Contribution from real GDP growth	-1.8	-4.7	-3.0	-3.1	-3.6	-3.2	-2.3	-3.0	-4.1	-4.4	-4.5	
12 Contribution from price and exchange rate changes 2/	-3.1	-0.7	-0.3	-5.6	-8.3	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	-6.7	-14.7	4.6	-0.8	2.8	-2.1	-1.9	-0.7	0.1	0.4	-1.9	
External debt-to-exports ratio (in percent)	281.4	231.6	245.6	213.8	204.2	220.3	252.0	255.2	245.9	232.2	207.1	
Gross external financing need (in billions of euros) 4/	1.6	3.3	2.6	4.3	7.6	9.3	9.6	10.1	11.1	12.5	13.6	
in percent of GDP	9.2	17.2	12.8	18.3	26.1	27.6	27.9	26.9	26.8	27.3	26.5	
Scenario with key variables at their historical averages 5/						**66.6**	**60.0**	**58.0**	**57.1**	**56.4**	**54.4**	**-10.3**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	2.8	8.2	6.0	5.6	7.1	6.0	3.5	4.5	6.0	6.5	7.0	
GDP deflator in euros (change in percent)	4.8	1.1	0.6	9.6	15.2	8.9	-1.0	3.8	4.1	4.5	4.6	
Nominal external interest rate (in percent)	1.7	2.2	3.3	3.7	4.5	4.2	4.9	5.6	5.5	5.6	5.4	
Growth of exports (euro terms, in percent)	22.7	15.9	18.9	31.0	25.2	16.6	-3.6	13.4	13.4	13.6	13.9	
Growth of imports (euro terms, in percent)	12.5	31.7	0.4	25.2	30.5	17.6	-5.8	8.2	5.1	8.2	8.7	
Current account balance, excluding interest payments	-6.2	-10.8	-7.0	-8.0	-13.6	-15.7	-12.8	-11.6	-8.5	-6.7	-5.0	
Net non-debt creating capital inflows	0.0	0.0	0.0	1.5	8.7	7.1	6.8	7.5	9.1	9.2	8.8	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in euro terms, g = real GDP growth rate, e = nominal appreciation (increase in euro value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

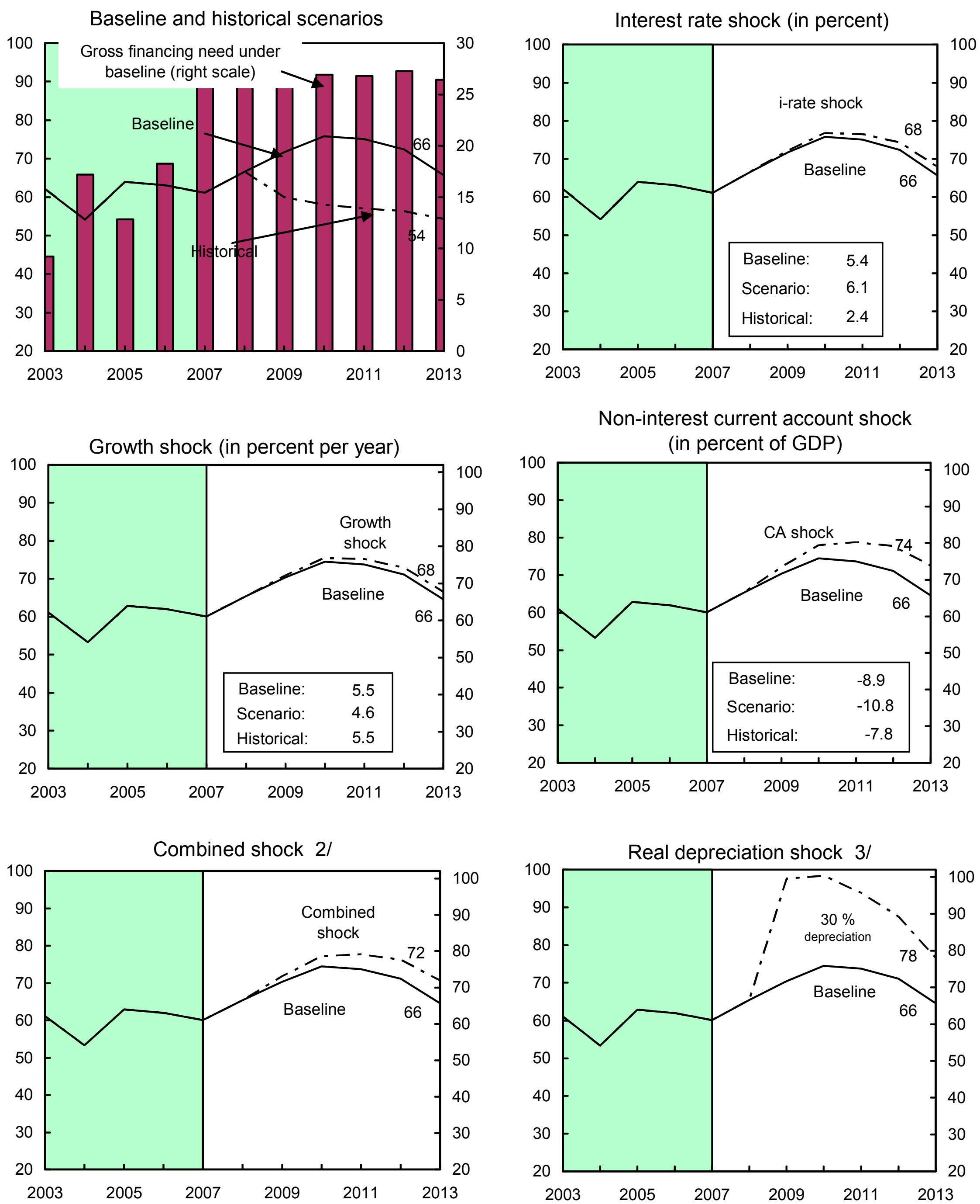
3/ For projection, line includes the impact of price and exchange rate changes.

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

5/ The key variables include real GDP growth; nominal interest rate; euro 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, euro deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure A1. Serbia: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
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. Seven-year historical average for the variable is also shown.
2/ Permanent 1/2 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2009.

Appendix II. Serbia: Public Debt Sustainability

General government debt in Serbia is sustainable under the program scenario, which envisages continued fiscal consolidation against the backdrop of a temporary slowdown in GDP growth. However, while the overall level of public debt and rollover risks are low compared to other emerging market economies, its sensitivity to shocks—exchange rate and growth shocks in particular—highlights potential vulnerabilities. Further, sustainability is less assured if contingent costs from financial sector vulnerabilities, linked to large exposures to exchange rate risk and off-balance sheet transactions, are taken into consideration. Contingent liabilities from state-owned and socially-owned enterprises could pose additional downside risks.

1. **Under the program scenario, Serbia's gross debt-to-GDP ratio would decline from 34 percent of GDP in 2007 to 22 percent of GDP in 2013** (Table A1).[1] This assumes stabilization of the fiscal deficit at around 1 percent of GDP (balanced primary position) in the medium term. Thus, the decline in the debt-to-GDP ratio is due to projected real GDP growth, fiscal deficits declining to well-below the debt stabilizing target of 1½ percent of GDP), and the favorable terms on the current debt stock (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.

2. **However, in the unchanged current policies scenario, the public debt-to-GDP ratio would increase to 40 percent of GDP in 2013.** This assumes that spending-to-GDP remains at the 2008 level, including the full year impact of the 2008 pension increases, while revenue grows as in the baseline. In contrast, assuming key variables at their historical averages, public debt-to GDP would decline to 14 percent of GDP, reflecting a history of strong fiscal surpluses in earlier years, robust growth in the catch up phase of transition, and low real interest rates.

3. **Standardized bound tests show that Serbia's debt is vulnerable to several shocks, but particularly exposed to exchange rate shocks (Figure A1)**. A 30 percent real depreciation of the exchange rate would increase the debt-to-GDP ratio to 33 percent of GDP by 2013 (1½ times the level of the baseline), given that 90 percent of the debt is denominated in foreign currency (comprising mainly frozen currency deposits and debt to multilaterals and Paris Club creditors). Also, assuming half a standard-deviation shocks to growth, the public debt stock would increase to 29 percent of GDP. However, a similar shock to the primary balance and interest rates would leave the public debt-to-GDP ratio at 26 and 23 percent by 2013, respectively.

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[1] 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.

4. **Further risks to the debt outlook come from contingent liabilities**. These relate to:

- **Financial sector**. In the context of the current international financial crisis, there are large contingent liabilities to the public sector from potential financial sector distress, which could come from injecting fresh capital into viable, but undercapitalized financial institutions; purchasing or swapping illiquid or nonperforming assets; nationalizing banks; funding deposit insurance schemes, as needed; and covering potential losses of the National Mortgage Company.

- **Public enterprises**. With state-owned and socially owned enterprises receiving explicit or implicit subsidies (through lower taxes and utility tariffs) and most public enterprise debt included in the general government debt stock (since they require state guarantees), their losses are implicitly included in the debt projections. However, risks remain that this still sizable part of the economy could become a drain on the budget in case of adverse macroeconomic developments.

- **Restitution**. The government's 2007 plan to provide restitution for confiscated assets after World War II, with a contemplated ceiling at the time of €4 billion (over 10 percent of GDP) would significantly increase the public debt stock. Moreover, should compensation be granted in foreign currency bonds, the foreign exchange exposure of the government would increase.

Table A1. Serbia: Public Sector Debt Sustainability Framework, 2005-2013
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	5-Year Historical Average	5-Year Standard Deviation	2008	2009	2010	2011	2012	2013	Debt-stabilizing primary balance 10/
1 **Baseline: Public sector debt 1/**	56.0	42.5	34.2			**33.8**	**30.9**	**28.3**	**25.8**	**23.7**	**22.0**	**-1.6**
o/w foreign-currency denominated	48.0	38.6	30.5			30.3	26.6	24.5	21.8	20.0	18.3	
2 Change in public sector debt	-9.0	-13.5	-8.3			-0.3	-3.0	-2.5	-2.6	-2.1	-1.6	
3 Identified debt-creating flows (4+7+12)	-11.1	-17.5	-7.0			-3.5	-4.0	-3.0	-2.9	-2.3	-1.6	
4 Primary deficit	-2.3	0.0	1.1			1.5	0.9	0.2	-0.3	0.0	0.2	
5 Revenue and grants	42.8	43.6	43.0			42.8	42.0	41.2	40.9	40.7	40.5	
6 Primary (noninterest) expenditure	40.5	43.7	44.1			44.4	42.8	41.3	40.7	40.6	40.7	
7 Automatic debt dynamics 2/	-6.4	-9.9	-5.4			-4.3	-2.6	-2.4	-2.2	-2.0	-1.8	
8 Contribution from interest rate/growth differential 3/	-10.2	-6.8	-5.5			-4.3	-2.6	-2.4	-2.2	-2.0	-1.8	
9 Of which contribution from real interest rate	-7.0	-4.2	-2.9			-2.6	-1.6	-1.2	-0.7	-0.5	-0.3	
10 Of which contribution from real GDP growth	-3.2	-2.6	-2.6			-1.7	-1.1	-1.2	-1.5	-1.5	-1.5	
11 Contribution from exchange rate depreciation 4/	3.8	-3.0	0.1			...	...	...	...	...	...	
12 Other identified debt-creating flows	-2.5	-7.7	-2.8			-0.7	-2.3	-0.7	-0.4	-0.2	0.0	
13 Privatization receipts (negative)	-2.5	-7.7	-2.8			-0.7	-2.3	-0.7	-0.4	-0.2	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/	2.1	4.0	-1.2			3.2	1.0	0.5	0.3	0.1	0.0	
Public sector debt-to-revenue ratio 1/	130.8	97.3	79.5			79.0	73.5	68.9	63.0	58.1	54.4	
Gross financing need 6/	1.1	3.3	3.8			3.7	3.4	3.0	2.1	2.2	2.4	
in billions of euros	0.2	0.8	1.1			1.2	1.2	1.1	0.9	1.0	1.2	
Scenario with key variables at their historical averages 7/						**33.8**	**27.6**	**23.2**	**19.6**	**16.5**	**13.9**	**-2.0**
Scenario with no policy change (constant primary balance) in 2009-2013 8/						**33.8**	**33.6**	**33.8**	**35.6**	**37.6**	**39.6**	**-3.0**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline				5-Year Historical Average	5-Year Standard Deviation							
Real GDP growth (in percent)	6.0	5.6	7.1	5.9	2.0	6.0	3.5	4.5	6.0	6.5	7.0	
Average nominal interest rate on public debt (in percent) 9/	2.8	3.2	2.1	2.3	0.7	2.7	3.0	3.2	3.8	3.9	4.0	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-12.2	-8.1	-7.3	-9.9	2.1	-8.2	-4.9	-4.0	-2.5	-1.9	-1.2	
Nominal appreciation (increase in euro value of local currency, in percent)	-7.4	7.8	-0.3	-4.6	8.5	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	15.0	11.3	9.4	12.2	2.0	11.0	7.9	7.2	6.3	5.8	5.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.7	13.7	8.1	5.9	5.1	6.6	-0.1	0.9	4.2	6.5	7.1	
Primary deficit	-2.3	0.0	1.1	-0.1	1.7	1.5	0.9	0.2	-0.3	0.0	0.2	

1/ Includes general government and guaranteed debts (gross).

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

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

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

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

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector 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/ Based on baseline revenue projections and keeping 2008 expenditure of constant as a share of GDP 2008 plus full year impact of the November 2008 pension increase.

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.

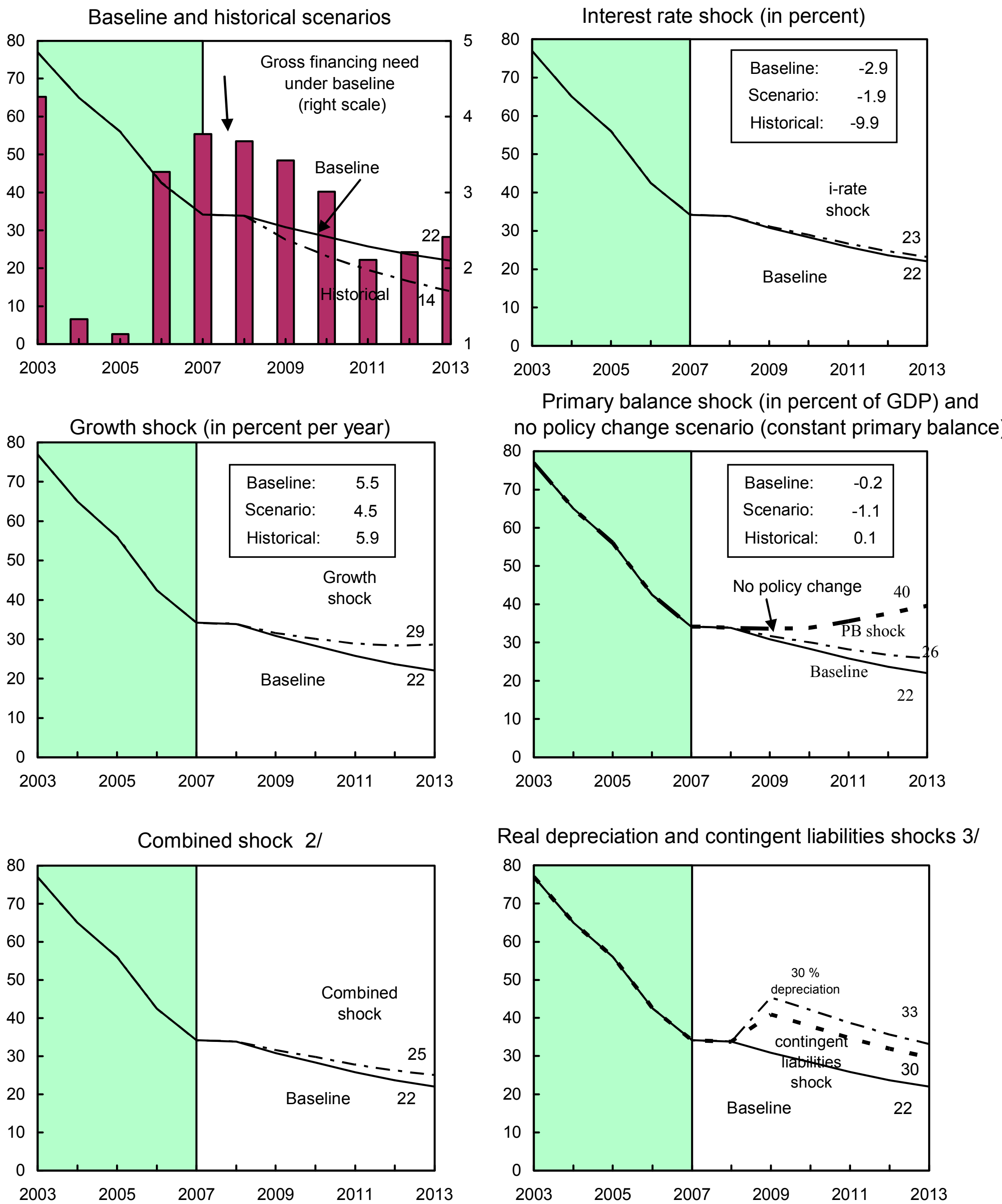
Table A2. Serbia: Government and Government-Guaranteed Debt, 2000–08
(End-period stock by creditor, in percent of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008 Sept.
Gross debt (excluding IMF)	**240.0**	**113.5**	**80.3**	**77.0**	**65.0**	**56.0**	**42.5**	**34.2**	**28.4**
Domestic	**80.0**	**39.1**	**32.9**	**33.0**	**30.5**	**22.8**	**17.5**	**14.2**	**11.3**
Foreign currency-denominated	61.8	29.8	24.1	23.5	21.2	17.6	13.0	10.5	8.2
Frozen Foreign Currency Deposits	61.8	29.8	24.1	23.5	21.0	17.4	12.9	10.5	8.2
Other	0.0	0.0	0.0	0.0	0.2	0.2	0.1	0.0	0.0
Local currency-denominated	18.2	9.3	8.9	9.5	9.3	5.1	4.5	3.6	3.1
T-bills	0.0	0.0	0.0	0.2	0.5	0.3	0.3	0.2	0.1
Long-term loans	0.5	0.3	1.9	1.8	1.5	1.2	0.9	0.5	0.4
Credit from the banking system (net	4.0	2.1	2.5	2.0	2.2	1.4	1.1	0.7	0.7
Domestic arrears	13.8	6.9	4.5	5.5	5.2	2.3	2.3	2.3	1.9
External	**159.9**	**74.4**	**47.4**	**44.0**	**34.6**	**33.3**	**24.1**	**20.0**	**17.1**
Multilateral (excluding IMF)	31.7	15.9	14.4	14.8	15.1	14.3	11.3	10.0	8.4
IBRD	27.5	14.1	11.4	10.9	10.3	9.1	6.4	5.5	4.4
IDA	0.0	0.0	1.0	1.3	1.8	2.0	1.7	1.4	1.2
EIB	0.0	0.0	0.6	0.8	1.1	1.3	1.4	1.5	1.3
EBRD	0.0	0.0	0.0	0.2	0.5	0.6	0.7	0.7	0.6
EU+CEB	4.2	1.7	1.4	1.6	1.5	1.4	1.2	1.0	0.8
Official Bilateral	82.6	38.3	18.3	16.3	14.9	14.4	9.6	7.5	6.6
Paris Club	74.9	33.2	14.4	12.9	11.7	11.0	7.0	5.7	5.0
Other bilateral	0.2	0.1	0.3	0.4	0.5	0.5	0.4	0.4	0.3
Debt under negotiation 1/	7.4	4.9	3.5	3.0	2.7	2.9	2.2	1.4	1.3
Commercial	45.7	20.2	14.6	12.9	4.5	4.6	3.2	2.5	2.1
London Club	45.7	20.2	14.6	12.9	4.5	4.6	3.2	2.5	2.1
Memorandum items:									
Debt to IMF	2.5	2.4	3.4	4.4	4.0	3.7	0.7	0.0	0.0
Government deposits	2.4	2.0	3.8	4.1	3.8	5.0	8.0	6.5	5.5
Net debt (excl. IMF)	237.5	111.6	76.5	72.8	61.3	51.0	33.7	27.6	22.9
Kosovo debt	17.7	9.2	6.0	5.8	4.8	4.3	3.6	2.9	2.9
Guaranteed debt	0.0	0.0	0.9	2.7	2.0	3.3	3.1	2.9	2.4
Share in total gross debt of:									
Foreign currency-denominated debt	92.4	91.8	88.9	87.7	85.7	90.8	89.3	89.4	89.1
Short-term debt (original maturity)	0.0	0.0	0.0	0.2	0.7	0.5	0.6	0.5	0.2
Debt at variable interest rates	44.4	43.3	36.2	36.6	42.4	46.0	44.7	46.9	47.8
Debt to official creditors	47.6	47.7	40.7	40.4	46.2	51.2	50.1	51.3	52.7

Source: Ministry of Finance; and Fund staff estimates.

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

Figure A1. Serbia: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

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 primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in euro value of local currency) minus domestic inflation (based on GDP deflator).

ATTACHMENT I. SERBIA: LETTER OF INTENT

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington DC

Belgrade, December 25, 2008

Dear Mr. Strauss-Kahn:

The attached Memorandum of Economic and Financial Policies (MEFP) outlines the economic policies that the Government of the Republic of Serbia and the National Bank of Serbia intend to implement during the remainder of 2008 and in 2009 to safeguard Serbia's macroeconomic and financial stability in an increasingly difficult global and regional economic environment. We will adopt tight budgets for 2009 and 2010, following three years of procyclical fiscal expansion; implement structural reforms to boost the economy's low capacity to produce, save, and export; and will continue to conduct our monetary and financial sector policies in a prudent way to contain inflation and avoid financial instability.

We are in particular determined to constrain recurrent spending growth at all levels of government, including by freezing pensions in nominal terms from now on throughout 2009, and by implementing significant nominal cuts in subsidies.

In support of these policies and to signal our commitment to strong macroeconomic policies, we request that the Fund support our program through a Stand-By Arrangement (SBA) for a period of 15 months in the amount of SDR 350.775 million (75 percent of quota). In view of Serbia's comfortable international reserves position and continued access to external financing, we intend to treat the arrangement as precautionary. Therefore, we do not intend to make the purchases under the requested arrangement when they become available upon its approval and after observance of its performance criteria and completion of its reviews.

The implementation of our program will be monitored through quantitative performance criteria, structural benchmarks, and an inflation consultation clause, as described in the attached MEFP and Technical Memorandum of Understanding. There will be two reviews of the arrangement by the Fund, to be completed by no later than mid-June 2009 and mid-December 2009, to assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve its objectives. Moreover, each potential purchase under the arrangement will be subject to financing assurances reviews.

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

Sincerely,

Mirko Cvetković
Prime Minister

Diana Dragutinović
Minister of Finance

Radovan Jelašić
Governor of the National Bank of Serbia

ATTACHMENT II

REPUBLIC OF SERBIA

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

December 25, 2008

I. ECONOMIC AND POLICY DEVELOPMENTS

1. **The global financial turmoil has begun to spill over to Serbia.** As elsewhere in the region, Serbia's stock market has plummeted, the cost of foreign financing are rising, and the exchange rate vis-à-vis the euro has come under depreciation pressure. Households have withdrawn some of their bank deposits. And credit growth, both from domestic banks and cross-border sources, seems already to be slowing appreciably, while credit quality is likely to start deteriorating over the coming months.

2. **Large financial buffers are Serbia's first line of defense against these spillovers.** The National Bank of Serbia's (NBS) past prudential and supervisory measures, many of them heavily criticized when they were implemented, have created large liquidity and capital buffers in the banking system, including a high aggregate liquidity-asset ratio as well as one of the region's highest capital adequacy ratios. At the same time, the NBS's net international reserves stand at about 4 months of imports, and they more than fully cover the country's short-term external debt as well as next year's expected medium- and long-term debt amortization service.

3. **The financial crisis spillovers are hitting the Serbian economy after a prolonged stretch of robust growth and with underlying inflation at moderate levels.** Real GDP expanded by an average of 7 percent during 2004–07, while inflation excluding energy and food prices has been reduced to single digits. Externally, growth was supported by a booming global economy and buoyant capital inflows. Growth also benefited from continued structural reform efforts, which, however, were undercut by volatile politics. With domestic demand already strong, fiscal policy has added expansionary impulses since 2006, mainly by hiking spending on capital and pensions. Wage growth, particularly in nontradable sectors, exceeded productivity growth, fuelled demand pressures, and undermined external competitiveness. In this challenging setting, the NBS's new inflation-target based monetary framework has started to anchor inflation expectations.

4. **But Serbia will have to face up to financial headwinds with an imbalanced external position.** With Serbia's demand for goods and service expanding much faster than Serbia's ability to generate incomes, the external current account deficit has soared over recent years. The external deficit could exceed 18 percent of GDP in 2008, one of the region's highest deficits. Nevertheless, at least until recently, favorable global financial conditions allowed to finance the current account deficit smoothly by drawing on foreign

savings. But, at the same time, the private sector's external financial obligations have also soared, leaving the economy vulnerable to sudden stops in capital inflows.

II. ECONOMIC OBJECTIVES AND OUTLOOK

5. **Given the abrupt deterioration in the global financial and economic environment, the main objective of the program is to safeguard macroeconomic and financial stability.** While our expansionary fiscal policies and lagging structural reforms may have contributed to the build-up of external and financial imbalances, these imbalances were mainly fuelled by imprudent private-sector borrowing and lending practices based on seemingly overoptimistic assumptions about risk-return tradeoffs. The abrupt shift in global financial sentiments, slowing trading partner demand for Serbian exports, and declines in prices of key Serbian export commodities are likely to force significant real and financial adjustments. In this difficult setting, the program seeks to put in place policies that will lead to orderly adjustments of production, demand, credit, and external financing flows. These policies should enable the economy to emerge more balanced and ready to resume sustainable real convergence growth toward EU income levels, which is Serbia's ultimate economic objective.

6. **The program's macroeconomic framework reflects the short-term economic and financial adjustments that are likely to occur during the program period:**

- **Real GDP growth** is projected to decelerate to only 3½ percent in 2009, but should, in line with global and regional growth assumptions, rebound in 2010. With credit constraints expected to tighten considerably, nontradable activities, including financial services and trade, which were the main engines behind recent GDP growth, are projected to slow particularly sharply. This growth projection is subject to downside risks, regarding both the depth and duration of the slowdown, largely reflecting uncertainty about international developments.

- **Inflation**, as measured by the Consumer Price Index (CPI), is projected to gradually decline to 8 percent by end-2009, from 10.9 percent in September 2008, and decline further to 6½ percent in 2010. The inflation path reflects this year's good harvest, declines in international energy prices, and slowing credit and demand growth. But these disinflationary forces will be counteracted by pass-through effects from the recent nominal exchange rate depreciation, as well as only slow deceleration of excessive nominal growth momentum in pensions and wages.

- The **external deficit** is projected to decline to about 16 percent of GDP in 2009. The narrowing in the large external imbalance results from slowing domestic demand and declining international energy prices, although projected declines in metals prices and the global slowdown will also lower Serbian export receipts. Export growth is expected to pick up again in 2010, with the external deficit projected to normalize to about 8 percent of GDP over the medium term.

III. Economic Policies

7. To achieve our program objectives, we will use all available fiscal, structural, monetary, and financial sector policies:

- **Fiscal restraint during 2009–10 will have to be the cornerstone of our program.** Significant fiscal adjustments, consistent with fiscal deficits of 1¾ and 1 percent of GDP for 2009 and 2010, respectively, are needed for three reasons: owing to the procyclical policies during 2006–08, there is now no scope for countercyclical loosening; the fiscal deficit is subject to tight financing constraints; and, to reassure investors and the Serbian public, public finances need to be put on a sounder footing.

- **On monetary policy, we see a need to strengthen the role of inflation targets as the economy's nominal anchor.** Using inflation targets since 2006 as the focus of monetary policy has served Serbia adequately, but many challenges remain. In particular, to improve communication of inflation targets, the practice of targeting core retail inflation will be replaced by targeting headline CPI inflation.

- **Financial stability policies will need to preempt, and, if necessary, be ready to react to financial stability threats.** While present bank liquidity and capital buffers are indeed reassuring, bank supervisors will need to monitor closely liquidity and non-performing loans at individual banks. The NBS and the government will further strengthen and clarify the key elements of Serbia's financial crisis management framework.

- **Structural reforms that boost the economy's low capacity to produce, save, and export will remain critical for the medium-term success of the Serbian economy.** In part due to a late start, Serbia's transition to a more efficient, private-sector-dominated economy is lagging considerably behind peers. Thus, and in line with Serbia's EU integration ambitions, we will push ahead with privatization and enterprise restructuring plans, notwithstanding the difficult economic environment. Moreover, competition will be promoted, while administrative red tape will be cut.

A. Fiscal Policy

8. **We will keep the 2008 general government deficit significantly below budgeted amounts.** The adopted rebalanced budget is consistent with a deficit of 2¾ percent of GDP. However, owing to announced customs tariff cuts under the Stabilization and Association Agreement (SAA) with the EU at the beginning of 2009, tax collections could underperform relative to budget. At the same time, there is scope to limit spending on goods and services, net lending operations, and wage bonuses. Moreover, the capital budget is likely to be

underexecuted by a significant margin, especially in the National Investment Plan (NIP). In sum, and in line with very tight budgetary financing constraints, we expect to contain the 2008 general government deficit to about 2¼ percent of GDP.

9. **The general government deficit in 2009 will be limited to at most 1¾ percent of GDP, and the government will seek to achieve additional savings of about ¼ percent of GDP through tight execution of budgeted spending.** To achieve this, however, a strong adjustment effort will be needed given the carryover effects from pension increases and fiscal precommitments. In particular, (i) the exceptional 10 percent pension increase in November 2008 will have large carry-over costs for the 2009 budget (1¼ percent of GDP); (ii) the phasing in of customs tariff reductions under the SAA could reduce revenue by ¾ percent of GDP in 2009, although losses could be temporarily less if some imports are shifted to 2009; and (iii) already agreed spending related to the joint venture project with Fiat and the Zastava car company will cost the 2009 budget ½ percent of GDP. Our fiscal adjustment strategy for 2009 will be to target revenue increases that broadly compensate for the cost of the SAA agreement, to secure capital spending roughly constant as a share of GDP, and to constrain nominal recurrent spending growth in line with the 1¾ percent deficit target. As regards financing, we estimate that privatization proceeds of 2¼ percent of GDP and external borrowing of ¾ percent of GDP from international financial organizations will be sufficient to cover amortization and the targeted deficit, obviating the need for additional, likely expensive, domestic or foreign borrowing. The government will submit to Parliament the Republican and social security budgets for 2009 consistent with the program, including legal provisions that ensure the freeze of nominal pensions throughout 2009 (prior action).

10. **Higher excise taxes and dividend transfers will offset the cost of the SAA.** The 2009 budget will raise the specific excise taxes on diesel and gasoline which, combined with higher excises on tobacco, will yield ¼ percent of GDP in additional revenue. Moreover, profitable public enterprises (mainly Telecom, NIS oil company, and Belgrade Airport) will be required to transfer 50 percent of 2008 net profits to the budget, yielding an estimated ½ percent of GDP. The financial transfer tax of 0.3 percent will be abolished. Apart from temporarily suspending the tax on capital gains and the withholding tax on interest income in 2009 to keep deposits in banks, no other new tax exemptions or reductions will be introduced: in particular, the present income tax exemption threshold will be maintained.

11. **The capital budget for 2009 will focus spending on high priority, high social-return infrastructure projects, while infrastructure planning and execution will be upgraded.** A key priority is the Corridor 10 road project, for which financing has already been secured from the EBRD, EIB, World Bank, and Greece. The NIP will focus on this project; other capital spending will be pruned to respect the overall capital budget envelope. Regarding the Road Company, the government will by March 2009 hire a consultant with international experience to audit and review the company's financial performance and arrears.

12. **Recurrent spending growth will be tightly constrained across all levels of government:**

- Nominal increases of **government sector wages** will be limited to indexation to projected inflation. Moreover, there will be no bonus payments, and hiring will be limited to refilling essential positions only. Collective agreement provisions that would increase government sector wages, including hot meal and holiday allowances, will not be implemented. These measures should be sufficient to constrain the growth rate of the wage bill to less than 6 percent in 2009. Wage and employment policies in selected public enterprises (see ¶28 of this memorandum) will be based on the same rules.

- **Subsidies** and **goods and services** will be streamlined**.** In particular, to reduce subsidies, tariffs in the transportation and utilities sectors will be brought closer to cost recovery levels. Agricultural subsidies will also be reduced, including by abolishing the per hectare land entitlement of legal entities. Goods and services in the Republican budget and local governments will be frozen in nominal terms. These measures will yield total 2009 budget savings of 1¼ percent of GDP.

- **A nominal freeze of pensions will be needed to slow their rapid growth rate.** Reflecting the November 2008 exceptional 10 percent increase in pensions, the average pension in 2009 will still increase by 13½ percent relative to the average in 2008. A comprehensive pension reform that balances the interests of pensioners, pension contributors, and tax payers consistent with putting the pension system on a more stable and financially viable footing will be a government priority in 2009, and will be discussed during the first program review.

- The government will ensure that the province of **Vojvodina and the local governments,** including Belgrade and Novi Sad, present balanced 2009 budgets and adopt wage policies in line with the above-mentioned principles, while the **health fund** will plan for a surplus of about RSD 6 billion. The government will also adopt the business plan of the Road Company consistent with the program (structural benchmark).

13. **There are several risks to the 2009 budget, and the government stands ready to take compensatory measures.** Key downside risks include (i) lower revenue and higher social transfers on account of further downward revisions of growth prospects; (ii) additional fiscal liabilities on account of financial sector tensions; and (iii) shortfalls in privatization proceeds and dividend transfers from public enterprises, as well as delays in IFI financing. The government will compensate the NBS for losses arising from fulfilling its mandate as liquidity provider of last resort (see ¶22). The government stands ready to take measures to preserve program objectives, including cutting discretionary spending and increasing, as a last resort, the rate of VAT. The government will also take adequate measures to prevent the

accumulation of spending arrears. Moreover, any revisions of the 2009 budget, including for wages, pensions, and transfers, will only be considered in agreement with the Fund.

14. **For 2010, we plan to reduce the general government deficit further to 1 percent of GDP.** This deficit target should help restore external and domestic macroeconomic stability and preserve public debt sustainability, while providing space for the much-needed infrastructure investment. Assuming a rebound in growth in 2010, we expect that the tight policies in 2009 will open up some fiscal space for raising capital spending, as well as some relaxation of tight 2009 controls of recurrent spending. The draft 2010 budget will be discussed at the time of the second review of the program.

B. Monetary and Exchange Rate Policies

15. **Monetary policy will remain focused on achieving low and stable inflation.** On balance, we are persuaded by experience that targeting inflation provides a better nominal anchor for Serbia's economy than the two main alternatives—targeting the exchange rate or a monetary aggregate. Low and stable inflation combined with a flexible exchange rate should facilitate real and nominal convergence to EU income levels. Nevertheless, targeting inflation faces distinct challenges in Serbia's economic and political context, and the NBS and the government will strive toward strengthening the effectiveness of this framework.

16. **Starting in 2009, and with government support, the NBS will use CPI inflation to communicate its inflation outlook and policy intentions.** The presently used inflation concept—retail core inflation—will be replaced by CPI headline inflation, which covers a much broader range of goods and services. To communicate a clear government commitment to creating a low-inflation environment, and given the significant share of 33 percent of regulated prices in the CPI basket, a *Memorandum of Understanding* will be signed between the government and the NBS, providing a clear division of responsibilities between the NBS and the government in achieving the inflation objectives (prior action). The government will support the NBS in achieving the agreed headline CPI inflation objectives, which will be 8 ±2 percent in 2009, and will respect the NBS's operational independence. The higher numerical targets and wider bands relative to the previously announced retail core inflation objectives do not imply a monetary relaxation. Rather, they are needed to allow for convergence of non-traded goods prices and volatility of commodity prices which are not part of the retail core inflation.

17. **During the program period, the NBS will seek to maintain a monetary policy stance consistent with the announced inflation targets.** The NBS will stand ready to adjust monetary policy, using its policy interest rate, as needed to achieve the inflation objectives. Developments in monetary and credit aggregates, including net domestic assets of the central bank, will be monitored as a cross-check of the NBS's standard inflation analysis. In line with standard EU practices, the NBS will not extend credit to the public sector, either directly or through primary market purchases of government debt obligations, except for potential

operations to be agreed under the financial stability framework (see ¶22). Under the program, inflation developments will be monitored using a standard consultation clause (see Technical Memorandum of Understanding (TMU)).

18. **In line with this framework, we will maintain the present managed float exchange rate regime.** Allowing moderate exchange rate fluctuations in 2007–08 with limited intervention helped to absorb domestic and external shocks while containing the private-sector balance sheet vulnerabilities. Going forward, the NBS will continue to limit interventions to those aimed at smoothing shocks and preserving financial stability. Recognizing the importance of maintaining an adequate level of international reserves as a buffer against external and financial sector vulnerabilities, the NBS will not allow its net foreign assets, evaluated at program exchange rates, to fall below €5.1 billion throughout 2009.

19. **We will continue to strengthen the monetary policy framework during the program period.** With the government's support and consistent with EU *acquis* requirements, the NBS will propose amendments to the Law on the NBS by end-2009 to prohibit NBS lending to the public sector, clarify procedures for the recapitalization of the central bank, and, more generally, enhance the independence of the NBS. Other measures will include strengthening the NBS's policy decision making capacity, including by upgrading the inflation modeling and forecasting framework.

C. Financial Sector Policies

20. **We have stepped up our financial sector monitoring efforts and taken preventive steps to reduce financial stability risks.** We have intensified daily monitoring of liquidity, deposits, and foreign exchange buffers of banks, and use early warning indicators to identify potential pressure points. The NBS has also strengthened collection and exchange of information on financial conditions of foreign banks' parent companies, and is monitoring the financial accounts of domestic systemic banks on a daily basis. Preventive measures taken so far aim at boosting the confidence in and liquidity of the banking system: in particular, and broadly in line with other countries in the region, the deposit insurance limit will be raised from €3,000 to €50,000; and the foreign exchange reserve requirements on new foreign borrowing by banks was eliminated.

21. **We will intensify our preventive efforts in the coming months to maintain financial stability.** The new chart of accounts introduced by the NBS allows regular collection of data on non-performing loans, using standard definitions, and provides more details—with breakdown by maturity and currency composition—on financial institutions' positions. We will use this data to enhance our monitoring of banking sector risks. We also recognize the need to step up further coordination with regulators and supervisors of foreign parent banks, and we hope that all our counterparts will be fully cooperative given regional contagion risks across national banking systems.

22. **We also recognize that elements of our financial crisis management framework need, as a matter of urgency, to be strengthened.** We will put in place a crisis contingency plan that outlines the policies and actions needed to prevent, manage, and resolve potential tensions in the banking system. In particular, we will streamline and clarify the lender-of-last-resort framework with a view to providing solvent banks with adequate access to liquidity financing from the NBS at non-subsidized rates against appropriate collateral. Potential NBS losses from these operations will be covered by a government guarantee. At the same time, the NBS will not finance, and the government will not guarantee, bank loans to non-financial enterprises in addition to those listed in the draft 2009 budget. The government and the NBS will sign, a *Memorandum of Understanding* regarding the respective roles and responsibilities of different players, including in particular the Deposit Insurance Agency (DIA), in maintaining financial stability (prior action).

23. **Developing the dinar bond market remains a key medium-term priority.** The planned elimination of the 0.3 percent financial transfer tax in the 2009 budget will remove a key bottleneck. However, high interest rates and the need for fiscal adjustment will constrain bond issuance needed to establish a reference dinar yield curve. Nevertheless, by mid-2009, we will develop an effective and operational public debt management strategy, and we will also develop the necessary market infrastructure to begin regular issuance of government bonds in 2010.

24. **State ownership in banks and the remaining insurance company will be phased out as soon as market conditions permit.** By March 2009, the government will adopt an action plan for all remaining banks with state participation, with consolidation of the four majority-owned state banks into a single bank before privatization as a key option. To facilitate our overall privatization plans, as well as to promote stock market development, by end-2009, the government will also submit to Parliament a new *Securities Law* conforming with EU regulations.

D. Structural Policies

25. **We will continue to reduce state influence in directly operating enterprises and improve the investment climate.** In particular, we will take measures to: (i) privatize, restructure, or liquidate a wide range of public enterprises, utilities, and socially owned enterprises; and (ii) eliminate, clarify, or reconcile rules and regulations that undermine the predictability of the business environment or significantly raise the cost of doing business relative to best-performing transition peers. While we may have to postpone actual sales of state-owned enterprises if market conditions are too unfavorable, we will continue to prepare enterprises for eventual privatization. We have started a regulatory review aimed at streamlining business regulations. Importantly, we will also strive to resolve the still pending, but politically very difficult, issues of land ownership and restitution. To improve the bankruptcy framework and help liquidate loss-making enterprises, we will also amend the bankruptcy law.

26. **Our goal is to modernize public enterprises and utilities by opening them to private sector participation.**

- **State enterprises.** Based on case-by-case studies, we will move ahead with corporatization (when necessary) followed by full or partial privatization, Initial Public Offerings (IPOs), joint ventures, or a private management contract. We will also address the issue of ownership of public enterprise assets before end-June 2009. In the short term, we intend to finalize the sale of a majority share of NIS (oil company); restructure the airline company following the failed tender; launch tenders or IPOs for the pharmaceutical company and the telecom company (in 2009) and the airport company (in 2010); and find a minority partner for the electricity company (in 2011). We will accelerate the restructuring of the railway company. To increase transparency, we will publish annual financial statements of state enterprises.

- **Local enterprises.** The government will launch, in collaboration with municipalities, a comprehensive review of the business and financial conditions of all locally owned companies and utilities, with a view to reducing losses and budget transfers, while improving service delivery and preparing for private sector participation.

27. **We plan to complete the privatization program of socially owned enterprises.** The Ministry of Economy aims at finalizing the privatization of socially owned enterprises in 2009. About 480 such enterprises (out of about 800 as of end-October 2008) will be offered for sale, or will have liquidation or bankruptcy procedures initiated before end-2008. Regarding the remaining large socially owned enterprises, we are setting up a joint venture between the car manufacturer Zastava and Fiat, and will try a similar approach for RTB Bor (copper mining company), which failed twice to be sold through tender.

28. **We will ensure the same wage discipline in selected public enterprises as in the general government.** To avoid adverse wage dynamics and encourage rationalization, the government will adopt state enterprises' business plans that conform to general government wage and employment policies by end-January 2009 (structural benchmark), and will subsequently closely monitor wage bill developments in these enterprises.

IV. Program Monitoring

29. Progress in the implementation of the policies under this program will be monitored through quarterly quantitative performance criteria (PCs) and indicative targets, structural benchmarks, and an inflation consultation clause. These are detailed in Tables 1 and 2. The attached TMU contains definitions. Quantitative targets up to June 2009 are PCs. September and December 2009 targets are indicative and will be converted into PCs at the time of the first review.

Table 1. Serbia: Quantitative Conditionality Under the SBA, 2008–09 1/

	2008 2/	2009 2/			
	Dec. Program Targets	March Program Targets	June Program Targets	Sept. Indicative Targets	Dec. Indicative Targets
Quantitative Performance Criteria					
Floor on net foreign assets of the NBS (in billions of euro)	5.0	5.1	5.2	5.2	5.3
Ceiling on consolidated general government overall deficit (in billions of dinars)	64	15	20	30	55
Ceiling on contracting or guaranteeing by the public sector of new short-term external debt (up to and including one year, in millions of euro)	0	0	0	0	0
Ceiling on contracting or guaranteeing by the public sector of new nonconcessional external debt (over one year, in millions of euro) 3/	50	200	250	300	300
Ceiling on accumulation of government external payment arrears (continuous, in millions of euro)	0	0	0	0	0
Inflation Consultation Bands					
Central point	10.0	9.2	8.6	8.5	8.0
Band, upper limit	12.0	11.2	10.6	10.5	10.0
Band, lower limit	8.0	7.2	6.6	6.5	6.0
Indicative Target					
Ceiling on current expenditure of the Serbian Republican budget (in billions of dinars)	635	190	360	535	708

1/ As defined in the Letter of Intent, the Memorandum on Economic and Financial Policies, and the Technical Memorandum of Understanding.

2/ Cumulative from January 1.

3/ Excluding loans from the IMF, EBRD, EIB, EU, IBRD, KfW, Eurofima, CEB, IFC, and bilateral government creditors, as well as debt contracted in the context of restructuring agreements.

Table 2. Serbia: Structural Conditionality, 2008–09

Action	Timing
Prior actions	
1. Government to submit to Parliament the Republican and social security fund budgets for 2009 consistent with the program, including legal provisions that ensure a nominal freeze of pensions throughout 2009.	Before Board meeting
2. NBS and government to sign a Memorandum of Understanding on respective responsibilities in achieving the inflation objectives (¶16 of the MEFP).	Before Board meeting
3. Government and NBS to sign a Memorandum of Understanding regarding the respective roles and responsibilities of different players, including in particular the Deposit Insurance Agency (DIA), in maintaining financial stability (¶22 of the MEFP).	Before Board meeting
Structural benchmarks	
4. Government to adopt the business plan of the Road Company of Serbia consistent with the program.	End-January 2009
5. Government to adopt state enterprises' business plans that conform to general government wage and employment policy in 2009 and ensure profit transfers to the state.	End-January 2009

Attachment III. Serbia: Technical Memorandum of Understanding

30. This memorandum sets out the understandings regarding the definitions of indicators used to monitor developments under the program. To that effect, the authorities will provide the necessary data to the European Department of the Fund as soon as they are available. As a general principle, all indicators will be monitored on the basis of the methodologies and classifications of monetary, financial, and fiscal data in place on October 1, 2008, except as noted below.

A. Floor for Net Foreign Assets of the NBS

31. **Net foreign assets** (NFA) of the NBS consist of foreign reserve assets minus foreign reserve liabilities.

32. For purposes of the program, **foreign reserve assets** shall be defined as monetary gold, holdings of SDRs, the reserve position in the IMF, and NBS holdings of foreign exchange in convertible currencies. Any such assets shall only be included as foreign reserve assets if they are under the effective control of, and readily available to, the NBS. In particular, excluded from foreign reserve assets are: undivided assets of the former Socialist Federal Republic of Yugoslavia (SFRY), long-term assets, NBS' claims on resident banks and nonbanks, as well as subsidiaries or branches of Serbian commercial banks located abroad, any assets in nonconvertible currencies, encumbered reserve assets (e.g., pledged as collateral for foreign loans or through forward contracts), and precious metals other than monetary gold.

33. For purposes of the program, all foreign currency-related assets will be evaluated in euros at **program exchange rates** as specified below. For 2008 and 2009, the program exchange rates are those that prevailed on October 8, 2008. Monetary gold will be valued at the average London fixing market price that prevailed on October 8, 2008.

Cross Exchange Rates and Gold Price for Program Purposes 1/

	Valued in				
	RSD	euro	USD	SDR	GBP
Currency:					
RSD	1.0000	0.0125	0.0170	0.0112	0.0097
euro	80.0352	1.0000	1.3632	0.8961	0.7772
USD	58.7113	0.7336	1.0000	0.6574	0.5702
SDR	89.3113	1.1159	1.5212	1.0000	0.8673
GBP	102.9723	1.2866	1.7539	1.1530	1.0000
Gold	53,324.54	666.26	908.25	597.06	517.85

34. For purposes of the program, **foreign reserve liabilities** are defined as any foreign-currency-denominated short-term loan or deposit (with a maturity of up to and including one year); NBS liabilities to residents and nonresidents associated with swaps (including any

portion of the NBS gold that is collateralized) and forward contracts; IMF purchases; and loans contracted by the NBS from international capital markets, banks or other financial institutions located abroad, and foreign governments, irrespective of their maturity. Undivided foreign exchange liabilities of SFRY are excluded.

35. On October 23, 2008, the NBS's net foreign assets, evaluated at program exchange rates, were euro 6,404 million; foreign reserve assets amounted to euro 9,411 million, and foreign reserve liabilities amounted to euro 3,006 million.

36. **Adjustors.** For program purposes, NFA will be adjusted upward *pari passu* to the extent that: (i) after October 23, 2008, the NBS has recovered frozen assets of the FRY, assets of the SFRY, long-term assets, and foreign-exchange-denominated claims on resident banks and nonbanks, as well as Serbian commercial banks abroad; and (ii) the restructuring of the banking sector by the Deposit Insurance Agency involves a write-off of NBS foreign exchange-denominated liabilities to resident banks. The NFA floor will also be adjusted upward by the excess of privatization revenue in foreign exchange relative to the following assumed path:

Privatization Receipts
(in millions of euro, end of period)

December 31, 2008	175
March 31, 2009	400
June 30, 2009	-
September 30, 2009	-
December 31, 2009	-

37. Privatization receipts are defined in this context as the proceeds from sale or lease of all or portions of entities and properties held by the public sector that are deposited in foreign exchange at the NBS, either directly, or through Treasury.

B. Inflation Consultation Mechanism

38. The quarterly consultation bands in 2008–09 are defined for the 12-month end-of-period consumer price (CPI) inflation as measured by the Serbian Statistics Office.

39. Breaching the inflation target bands would trigger a consultation with Fund staff. A deviation of more than 1 percentage point from either the upper or the lower band specified in Table 1 would trigger a consultation with the Fund's Executive Board on the proposed policy response before further purchases could be requested under the stand-by arrangement.

C. Ceiling on External Debt Service Arrears

40. **Definition.** External debt-service arrears are defined as overdue debt service arising in respect of obligations incurred directly or guaranteed by the public sector, except on debt

subject to rescheduling or restructuring. The program requires that no new external arrears be accumulated at any time under the arrangement on public sector or public sector-guaranteed debts. The authorities are committed to continuing negotiations with creditors to settle all remaining official external debt-service arrears.

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

D. Ceilings on External Debt

42. **Definitions.** The ceilings on contracting or guaranteeing of new nonconcessional external debt by the public sector with original maturity of more than one year and short term external debt (with maturities up to one year) applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000 (Decision No. 12274-(00/85)) but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are normal short-term import credits.

43. Excluded from the ceilings are loans from the IMF, EBRD, EIB, EU, IBRD, KfW, CEB, Eurofima, IFC, and bilateral government creditors, as well as debt contracted in the context of restructuring agreements. The public sector comprises the consolidated general government.

44. For new debt to budgetary users, the day the debt is contracted will be the relevant date for program purposes. For new debt to non-budgetary users, the day the first guarantee is signed will be the relevant date. Contracting or guaranteeing of new debt will be converted into euros for program purposes at the program cross exchange rates described in this TMU. Concessionality will be based on a currency-specific discount rate based on the ten-year average of the OECD's commercial interest reference rate (CIRR) for loans or leases with maturities greater than 15 years and on the six-month average CIRR for loans and leases maturing in less than 15 years. Under this definition of concessionality, only debt with a grant element equivalent to 35 percent or more will be excluded from the debt limit.

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

E. Fiscal Conditionality

46. **The general government fiscal balance,** on a cash basis, is defined as the difference between total general government revenue (including grants) and total general government

expenditure (irrespective of the source of financing) as presented in the "GFS classification table" and including expenditure financed from foreign project loans. For program purposes, the consolidated general government comprises the Serbian Republican budget (on-budget and own revenue), local governments, the pension fund (employees, self-employed, and farmers), the health fund, the National Agency for Employment, and the Road Company (JP Putevi Srbije). Any new extrabudgetary fund established over the duration of the program would be consolidated into the general government.

47. **Adjusters.** The deficit ceiling will be adjusted upward for the additional expenditure that may be needed for potential lender-of-last-resort operations under the financial stability framework (MEFP, ¶22), following consultation with Fund staff. It will be increased (respectively reduced) in 2009 by the amount of project loans disbursed by foreign institutions listed in ¶14 above to the general government in excess of (respectively, lower than) the program projections indicated in the table below, in consultation with Fund staff, on the basis of actual disbursements as jointly reported by the Ministry of Finance and the NBS. This adjustment does not apply to program loans and general budget support.

Disbursements of project loans by foreign institutions

From January 1, 2009 to:	Program projections (billions of dinars)
March 31, 2009	1.7
June 30, 2009	4.2
September 30, 2009	7.1
December 31, 2009	12.0

48. **Government current expenditure of the Republican budget** (excluding expenditure financed by own sources) includes wages, subsidies, goods and services, interest payments, transfers to local governments and social security funds, social benefits from the budget, other current expenditure, and net lending. It does not include capital spending. The ceiling will be adjusted for the additional expenditure that may be needed for potential lender-of-last-resort operations under the financial stability framework (MEFP, ¶22).

49. The **public enterprises** monitored under the program include the following eleven enterprises or their successors: JP Elektroprivreda Srbije (EPS), JP Elektromreza Srbije (EMS), JP Naftna Industrija Srbije (NIS), JP Transnafta, JP Srbijagas, JP PTT Srbije, JP Jugoslovenski Aerotransport, JP Zeleznice Srbije, JP Srbijasume, JP Aerodrom Nikola Tesla Beograd, JVP Srbijavode. This list excludes JP Putevi Srbije (the Road company), which is considered part of general government, and JP Srbija Telekom, which competes with other telecommunication providers.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SERBIA

Request for Stand-By Arrangement

Informational Annex

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

December 30, 2008

Contents Page

Appendix I. Serbia: Fund Relations
(As of October 31, 2008)

I. **Membership Status:** Joined December 14, 1992 (succeeding to membership of the former Socialist Federal Republic of Yugoslavia); accepted Article VIII on May 15, 2002. Serbia continues the membership in the Fund of the former state union of Serbia and Montenegro—previously the Federal Republic of Yugoslavia—since July 2006.

II. **General Resources Account:**

	SDR Million	%Quota
Quota	467.70	100.00
Fund Holdings of Currency	467.70	100.00
Reserve Position	0.00	0.00

III. **SDR Department:**

	SDR Million	%Allocation
Net cumulative allocation	56.66	100.00
Holdings	1.27	2.24

IV. **Outstanding Purchases and Loans:** None.

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** (In millions of SDR):

	Forthcoming				
	2008	2009	2010	2011	2012
Principal					
Charges/Interest	0.37	1.06	1.06	1.06	1.06
Total	0.37	1.06	1.06	1.06	1.06

VII. **Implementation of HIPC Initiative:** Not Applicable.

VIII. **Implementation of Multilateral Debt Relief Initiative (MDRI):** Not Applicable.

IX. **Safeguards Assessment:**

Under the Fund's safeguards assessment policy, the National Bank of Serbia (NBS) is subject to an update assessment in conjunction with an upcoming Stand-By Arrangement. The update assessment is underway. The initial assessment of the NBS, completed December 4, 2001, identified substantial risks in the financial reporting framework, internal audit mechanism, and system of internal controls. Staff recommendations proposed under program conditionality and other recommendations were reported in IMF Country Report No. 02/105. Periodic monitoring of the bank's safeguards identified that the NBS had introduced measures to significantly strengthen its financial reporting and internal audit mechanisms and its internal control systems.

X. **Exchange Arrangement:** Serbia accepted the obligations under Article VIII, Sections 2, 3, and 4, on May 15, 2002, and maintains a system free of restrictions on payments and transfers for current international transactions, except with respect to blocked pre-1991 foreign currency savings deposits (IMF Country Report No. 02/105). The exchange rate arrangement (de jure and de facto) is a managed floating system since January 1, 2001.

XI. **Last Article IV Consultation:** Concluded on January 28, 2008 (IMF Country Report No. 08/54).

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

2006 Consultation:

- Capital Formation and External Deficits
- Employment
- Banking System
- Economic Structure and the Choice of Exchange Rate Regime
- Foreign Exchange and Monetary Operations
- Exchange rate pass-through
- Inflation targeting in emerging markets

2007 Consultation:

- Overview of Vulnerabilities
- Financial Conditions in the Corporate Sector
- Household Credit
- CGER-Type Assessments of the Real Effective Exchange Rate
- Twin Deficits in Serbia
- Forecasting and Monetary Policy Analysis Modeling
- Fiscal Impact of Privatization

XIII. **FSAP Participation:** Serbia participated in the Financial Sector Assessment Program in 2005, and the Executive Board discussed the Financial System Stability Assessment in February 2006 (IMF Country Report No. 06/96).

XIV. **Technical Assistance in the Past 12 Months:**

Department	**Timing**	**Purpose**
MCM	May 2006–08	Resident advisor for monetary policy
MCM	Nov. 2007	Foreign Exchange Operations

MCM	Dec. 2007	Liquidity management
MCM	July, Oct. 2008	Modeling and forecasting
MCM	Oct. 2008	Foreign Exchange Operations
MCM	November 2008	Financial stability / Capital account liberalization
STA	April 2008	Balance of Payments Statistics
FAD	Sep.–Oct. 2008	Public Financial Management

XV. **Resident Representative:**

The Resident Representative position was closed in May 2008 in the context of the downsizing of the Fund. However, the IMF maintains a locally staffed office at the National Bank of Serbia, and plans to reopen the Resident Representative position shortly.

Appendix II. Serbia: World Bank Group Relations

Partnership with Serbia's Development Strategy

1. The World Bank has been discussing the policy reform agenda with successive governments, notably since the formation of the coalition government in July 2008. Support for the government's 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, while the Bank takes the lead on structural policy. In areas of direct interest to the Fund, the Bank leads the policy dialogue in: (i) macroeconomically important sectoral reforms (e.g., in the energy sector); (ii) pension, health, education, and social assistance reform; (iii) restructuring and privatization of enterprises; (iv) legal reforms with a bearing on the business environment, including labor markets; and (v) decentralization and local government operations. The Bank and the Fund have jointly led the policy dialogue in the financial sector, including on the restructuring and privatization of banks, in public expenditure management, and in foreign trade.

The World Bank

3. As of September 2008, total IDA credits and grants committed to Serbia by the Bank since 2001 amount to approximately \$740 million, with an additional \$190 million in IBRD commitments. The Bank has assisted Serbia to make progress against key objectives set out in the Country Assistance Strategy (CAS) for FY05–07: (i) streamlining the public sector (the overall fiscal adjustment has been limited with early gains being reversed, but there has been a trend toward higher capital expenditure); (ii) encouraging private sector growth (annual growth averaging 6 percent, with Serbia the lead reformer in *Doing Business* 2006); and (iii) reducing poverty (which fell from 12.7 percent in 2002 to 8.8 percent in 2006). Serbia has now graduated from IDA status and will borrow on IBRD terms in the future.

4. A new Country Partnership Strategy (CPS) was discussed by the World Bank Board of Executive Directors on December 13, 2007. The CPS envisages base case IBRD lending of \$600 million over the period FY08–11. The CPS' three main pillars are to (i) encourage dynamic private sector-led growth to ensure that incomes continue to converge with European levels; (ii) provide opportunities and broaden participation in growth; and (iii) manage emerging environmental and disaster risks. To increase flexibility and responsiveness, the Bank will deploy of a range of financial instruments beyond traditional lending, and will also explore the use of innovative financial products. The CPS outlines a set of agreed investments and analytical support for FY08 and FY09—decisions on interventions in the second half of the CPS period will be made as part of a mid-term review process anticipated for late CY2009.

5. The Bank's current portfolio consists of 11 projects under implementation, with a total commitment value of \$444.3 million (including IDA, IBRD and GEF). Out of these, ten

are from the previous CAS and one loan (US$ 46.4 million) was approved under the new CPS. Investments support: (i) transport and energy infrastructure aimed at rehabilitating the road network and encouraging regional integration; (ii) agricultural, environment and irrigation investments to improve production and help Serbia meet EU standards; (iii) pension and health sector reform to strengthen the quality of service and improve financial sustainability and social services; (iv) strengthened land administration; (v) energy efficiency, (vi) regional development activities in the depressed former mining region of Bor; (vii) improved delivery of local social services; and (viii) reducing pollution of waters connected to Danube River from selected Serbian enterprises.

6. Recent analytical work by the Bank includes a set of Policy Notes for the government in July 2007, and reports on decentralization, poverty, labor markets, public expenditure and financial management, and road management. A public investment and expenditure management review, a strategy for privatization of municipal enterprises, and capital markets development notes are under preparation.

International Finance Corporation (IFC)

7. The IFC has a significant investment portfolio in Serbia, which has contributed to supporting private sector-led economic growth. As of August 30, 2008, IFC had 11 projects in its Serbia portfolio, with total commitment of $361 million.

8. In the ***financial sector***, IFC has supported development of microfinance institutions, the introduction and expansion of new financial products, including mortgage financing, consumer finance, energy efficiency financing, and SME finance. IFC contributed to the cleaning-up, rehabilitation and privatization of the banking sector through restructuring its claims to a few Serbian banks. IFC's largest single investment has been made with Banca Intesa, one of Italy's largest commercial banks. Financing has enabled the bank to strengthen its capital base and significantly increase its lending and financial service activities, particularly to SMEs, retail clients, and residential mortgages. Other investments have included Raiffeisen Bank, Continental Bank, HVB Serbia, and Pro-Credit Bank. Investments have particularly encouraged the expansion of long-term lending, particularly to SMEs, mortgage operations, and lending relating to commercial and residential real estate development, and the development of energy efficiency products. IFC has also invested $37 million in the European Fund for Southeast Europe (EFSE), $7.4 million of which is for Serbia. This collective debt investment will channel long-term resources for on-lending to SMEs through banks, specialized microfinance institutions, and viable microfinance non-profit organizations in the Southeast European region, including in Serbia.

9. In the ***real sector,*** IFC supported the growth and strategic development of Tigar, a leading regional producer of car tires. Also, IFC supported Mercator, a Slovenian company, to establish a new hypermarket store in Serbia. This investment is expected to stimulate competition in the sector and improve the variety, price, quality, and delivery of consumer

goods. In addition, through its investments in regional Private Equity Funds, IFC has supported 3 other companies in the manufacturing sector. During the last fiscal year, IFC invested US$281 million in a number of other regional projects in the infrastructure, commercial property, and SME sectors. Through its regional projects, IFC hopes to help attract more FDI in Serbia, invest in SME sector, and facilitate Serbia to strengthen economic cooperation and integration with neighboring countries.

10. ***Advisory Services***. In June 2005, IFC started the Private Enterprise Partnership Southeast Europe (PEP-SE) facility focused on SMEs and linkages, business enabling environment, access to finance, and infrastructure advisory operations. Through this facility, IFC has also supported judicial reform, particularly alternative dispute resolution mechanisms. Three mediation centers in Serbia, supported by PEP-SE, have helped to resolve over 1,600 cases. Under the recycling linkage program, IFC is commercializing the small street collectors, who in Serbia are significantly comprised of the Roma population. PEP-SE Infrastructure (PEP-SE I) was appointed lead advisor in the restructuring of Serbia's national carrier, JAT Airways. Also, IFC has been helping the City of Belgrade with the privatization (concession) of the Belgrade solid waste disposal services.

11. Through the Foreign Investment Advisory Service (FIAS), analytical and advisory support has also been provided to assist the Serbian authorities in their successful efforts to improve the investment climate. With support from the European Agency for Reconstruction, IFC has been engaged in assisting the Serbian Investment and Export Promotion Agency, as well as in following up on Doing Business reports to analyze investment constraints in Serbia, especially at the sub-national level. This fiscal year, IFC expects to bring to completion the regulatory guillotine project which will result in major simplification of business regulations, thus giving new momentum to Serbia's reform process. Also, under the Sub-national Competitiveness Project, IFC has completed the first stage of the pilot project in 4 municipalities.

MIGA

12. As of December 2007, MIGA's outstanding portfolio in Serbia consists of 8 contracts of guarantee with total gross exposure of $82 million. MIGA guarantees have primarily supported the expansion of foreign financial institutions in the Serbian banking sector, with some activity also in the manufacturing sector.

Prepared by World Bank staff. Questions may be addressed to Ronald Hood or Simon Gray.

Appendix III. Serbia: Statistical Issues

1. Data provision has some shortcomings, but is broadly adequate for surveillance. The statistical system has been successfully upgraded in recent years with the assistance of the IMF[1] and other bilateral and multilateral institutions. 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, balance of payments, and real sectors, internationally accepted reporting standards have been introduced. A page for the Republic of Serbia was introduced in the October 2006 issue of the *International Financial Statistics (IFS)*.

2. On October 1, 2008 the Serbian authorities informed STA of their interest in participating in the Fund's General Data Dissemination System (GDDS) and nominated a GDDS country coordinator. STA is working with the authorities to facilitate GDDS participation in the near future.

A. Real Sector Statistics

3. Real sector data are compiled by the Republic of Serbia Statistical Office (RSSO). Annual current and constant price estimates of GDP by activity and current price GDP by expenditure are available for 1997–2007. In June 2005, the RSSO started publishing quarterly constant price estimates of GDP using the production approach. Data are available from 1999 onward and are disseminated with a lag of three months after the reference quarter. The RSSO has made commendable efforts to adopt the *System of National Accounts (1993 SNA),* but there are still problems with the consistency of the annual GDP estimates from the production and expenditure sides, and estimates of fixed capital formation and changes in inventories. Data sources are still in need of improvement. Official statistics do not incorporate estimates of informal activities, which the RSSO estimated at 16–18 percent of GDP in 2003–05.

4. The RSSO compiles and disseminates monthly indices for retail and consumer prices, producer prices, industrial production, as well as unit-value indices for imports and exports. The CPI, introduced in 2007, appears broadly in line with international standards as do the producer price and the industrial production indices.

B. Balance of Payments Statistics

5. Balance of payments statistics are compiled by the National Bank of Serbia (NBS). While the data compilation procedures appear appropriate, the NBS could further improve coverage of current account reporting for workers remittances, and adjust trade and services

[1] Since 2001, STA conducted four technical assistance missions on monetary and financial statistics, three missions on national accounts, one multi-sector mission, and one balance of payments mission.

data for transactions not explicitly declared (repairs, shuttle trade, grants in kind, and tourism). Estimates of reinvested earnings also need to be improved. In reporting on financial account transactions, the NBS should improve the measurement of FDI and remove exchange-rate effects from the estimation of certain financial transactions, including reserves and arrears. It should upgrade its data collection and management processes to identify inter-company loans. Currently inter-company loans associated with FDI are not identified, and are included in external debt flows and stocks, not in FDI flows and stocks. Serbia has begun reporting balance of payments statistics to STA in preparation for publication in the *IFS* and the *Balance of Payments Statistics Yearbook*. NBS is also has been working towards compiling IIP.

C. Government Finance Statistics

6. Government finance statistics are compiled by the Ministry of Finance and reported on a monthly basis. Principal data sources are the Republican Treasury and budgetary 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. 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. The classification of all expenditure of the "National Investment Plan" as capital is not in line with international standards. While the data on the clearance of arrears are available on a monthly basis, information on the accumulation of new arrears is not available. The reconciliation of fiscal and monetary data is not conducted on a regular basis.

D. Monetary and Financial Statistics

8. Monetary and financial statistics are compiled by the NBS, broadly following the methodology set forth in the *Monetary and Financial Statistics Manual, 2000* (*MFSM*), and meeting the GDDS recommendations with respect to periodicity and timeliness for financial sector data. Monetary data are reported to the Fund using Standardized Report Forms.

9. Some improvements could still be made. The NBS only began collecting data on nonperforming loans in September 2007 from a limited number of banks and introduced a new chart of accounts allowing systematic collection of NPL data from all banks in July 2008. The coverage of monetary statistics excludes (i) banks in liquidation (as their data are not available on a timely or comparable, International Accounting Standard-specified, basis) and (ii) a group of relatively small deposit-taking institutions that the authorities designate as *Other Financial Institutions (OFIs)*.

Serbia: Table of Common Indicators Required for Surveillance

(As of November 30, 2008)

	Date of Latest Observation	Date Received	Frequency of Data[4]	Frequency of Reporting[4]	Frequency of Publication[4]
Exchange rates	Nov. 28, 2008	Nov. 28, 2008	D and M	D and M	D and M
International reserve assets and reserve liabilities of the monetary authorities[1]	Nov. 28, 2008	Nov. 28, 2008	D	D	M
Reserve/base money	Nov. 27, 2008	Nov. 28, 2008	D and M	W and M	W and M
Broad money	Oct. 2008	Nov. 24 2008	M	M	M
Central bank balance sheet	Oct. 2008	Nov. 24, 2008	M	M	M
Consolidated balance sheet of the banking system	Oct. 2008	Nov. 24 2008	M	M	M
Interest rates[2]	Oct. 2008	Nov. 24, 2008	M	M	M
Consumer price index	Nov. 2008	Nov. 28, 2008	M	M	M
Revenue, expenditure, balance and composition of financing – general government	Aug. 2008	Nov. 2008	M	M	M
Revenue, expenditure, balance and composition of financing– central government	Sep. 2008	Nov. 2008	M	M	M
Stocks of central government and central government-guaranteed debt[3]	Sep. 2008	Nov. 2008	M	M	M
External current account balance	Sep. 2008	Nov. 2008	M	M	M
Exports and imports of goods and services	Oct. 2008	Nov. 28, 2008	M	M	M
GDP/GNP	Q2 2008	Sept. 30, 2008	Q	Q	Q
Gross external debt	Sep. 2008	Nov. 2008	M	M	M
International Investment Position[5]	N.A	N.A	N.A	N.A	N.A

[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] Including currency and maturity composition.
[4] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Semi-annually (SA), Annually (A), Irregular (I); or Not Available (NA).
[5] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

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FOR IMMEDIATE RELEASE
January 16, 2009

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves €402.5 million Stand-By Arrangement for Serbia

The Executive Board of the International Monetary Fund (IMF) today approved a 15-month SDR 350.8 million Stand-By Arrangement (about €402.5 million or US$530.3) to support the authorities' program aimed at maintaining macroeconomic and financial stability. The approval makes SDR 233.9 million (about €268.4 million or US$353.3) immediately available. However, the Serbian authorities intend to treat the arrangement as precautionary, and not to draw on Fund resources unless the need arises.

The authorities' program aims at safeguarding macroeconomic and financial stability, in view of the global financial turmoil. It focuses on measures aimed at maintaining market confidence, complementing the large buffers in the financial system. Policies include upfront fiscal restraint, with the 2009 deficit limited to 1¾ percent of GDP; containing inflation, while maintaining a managed float to facilitate external adjustment; strengthening crisis preparedness; and reforms to boost the economy's supply side.

Following the Executive Board discussion, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, issued the following statement:

"Serbia's recent stretch of robust growth and moderate underlying inflation—underpinned by large capital inflows—has been accompanied by the build-up of sizable external imbalances and vulnerabilities. With the global financial turmoil spilling over to Serbia, a rebalancing of the economy through a sharp slowing of credit and domestic demand seems necessary.

"The authorities' program—supported by the SBA—is an appropriate response to the current challenges, and seeks to safeguard macroeconomic and financial stability through a comprehensive policy package. Determined implementation of this program should poise the Serbian economy to resume more balanced and sustained real income growth.

"Strong fiscal measures are being taken to achieve the tighter 2009 deficit target. Because of the procyclical fiscal policy stance since 2006, limited budgetary financing options, and the need to ensure the credibility of the program, there is no scope now for countercyclical fiscal loosening. The slowdown in public wage and pension growth, as well as other savings measures, preserve fiscal space for much-needed infrastructure investment.

"Monetary policy will continue to focus on inflation within a strengthened framework, supported by a managed float with foreign exchange interventions limited to ensuring orderly market conditions. Given the uncertain economic environment, the monetary stance will need to be adjusted flexibly.

"Past prudential policies are now paying off in providing a strong first line of defense against spillovers from the financial turmoil. These policies have succeeded in building large liquidity and capital buffers in the banking system, although they may also have encouraged risky cross-border borrowing. The authorities need to strengthen the financial stability framework, mainly by improving the monitoring of risks and setting up comprehensive contingency plans.

"Structural policies need to address the economy's weak supply side, with a view to delivering balanced and sustainable catch-up growth toward EU income levels. The program calls for privatizing, restructuring, or liquidating a wide range of state- and socially owned-enterprises, as well as lowering the cost of doing business, to help expand the undersized private sector.

"The authorities have started to implement their program steadfastly. This gives confidence that the Serbian economy, with the support of the international community, will succeed in overcoming the present difficulties," Mr. Portugal said.

Annex

Recent Economic Developments

The global financial turmoil began to spill over to Serbia in the fourth quarter of 2008, as for the region as a whole. The stock market plummeted; sovereign spreads soared; households withdrew some of their deposits; and, amid high volatility and frequent NBS interventions to maintain foreign exchange market liquidity, the dinar depreciated. Growth, which so far was strong, seemed to be losing momentum. At the same time, the reversal of the region-wide food and energy price shocks eased headline inflation pressures. These outcomes were accompanied by the build-up of an increasingly unbalanced external position. The current account deficit could reach 18 percent of GDP in 2008, although it has so far been easily financed by capital inflows, resulting in rising international reserves.

Consequently, external stability risks have increased substantially in the current international environment. These reflect Serbia's unsustainably large external deficit; the private sector's high external indebtedness; high euroization; and indications of weak export competitiveness. Financial stability risks have also increased, but the banking sector's liquidity and capital buffers are comforting.

Program Summary

The authorities' program, supported by the SBA, responds to the abrupt deterioration in the short-term outlook: trading partner growth and prices of key Serbian exports, particularly metals, are projected to slow sharply in 2009; and formerly plentiful capital inflows can no longer be taken for granted, further constraining domestic and cross-border credit growth.

The program's objective is to safeguard macroeconomic and financial stability through strengthened policies, designed to underpin an orderly rebalancing of the economy. The **policy package** focuses on four main features:

- **Tightening of the fiscal stance** in 2009–10, with the 2009 general government deficit limited to 1¾ percent of GDP, followed by further fiscal consolidation in 2010. This involves strict incomes policies for containing public sector wage and pension growth and a streamlining of non-priority recurrent spending, which helps create fiscal space to expand infrastructure investment.

- **Strengthening the inflation targeting framework** while maintaining a managed floating exchange rate regime.

- **Making good use of the accumulated financial sector buffers**, while enhancing financial crisis preparedness.

- **Implementing structural policies** to address the roots of the economy's low capacity to produce, save, and export. The main elements of the fiscal package include

The program's macroeconomic framework assumes a decline of foreign inflows and domestic credit, which should lead to a slowdown in domestic demand, output growth, and inflation, and a narrowing of external imbalances. Real GDP growth is projected to decelerate to 3½ percent in 2009 but should rebound in 2010. With the inflation-reducing effects of commodity price declines and slowing activity being counteracted by pressures on the exchange rate, inflation is projected to slow only gradually to 8 percent by end-2009.

Serbia joined the IMF on December 14, 1992; its quota is SDR 467.7 million (about €541 million or US$707 million) and it has no outstanding use of IMF credit. Its latest arrangement with the IMF was an Extended Fund Facility, completed on February 28, 2006.

Serbia: Selected Economic and Social Indicators, 2006–10 1/

	2006	2007	2008 Est.	2009 Proj.	2010 Proj.
	(Change in percent, unless otherwise indicated)				
Output, prices, and labor market					
Real GDP	5.6	7.1	6.0	3.5	4.5
Real GDP excluding agricultural sector	6.3	8.9	5.9	3.9	5.0
Real domestic demand (absorption)	6.5	11.8	6.3	2.6	2.2
Consumer prices (end of period) 2/	6.6	10.1	9.5	8.0	6.5
Core retail prices (end of period) 2/	5.9	5.4	10.5	...	...
	(In percent of GDP)				
General government finances					
Revenue	43.6	43.0	42.8	42.0	41.2
Expenditure	45.2	44.9	45.2	43.8	42.2
Fiscal balance	-1.6	-1.9	-2.3	-1.8	-1.0
Gross debt	42.5	34.2	33.8	30.9	28.3
	(End of period 12-month change, in percent)				
Monetary sector					
Money (M1)	37.1	25.3	-8.2	18.2	8.7
Broad money (M2)	38.4	44.5	7.9	5.2	13.5
Domestic credit to non-government	17.1	36.9	29.6	6.1	12.3
	(In percent of GDP, unless otherwise indicated)				
Balance of payments					
Current account balance	-10.0	-15.9	-17.9	-16.0	-15.4
Exports of goods	21.7	22.0	22.3	20.5	21.7
Imports of goods	42.8	44.9	46.1	42.3	41.6
Trade of goods balance	-21.1	-22.9	-23.8	-21.8	-19.8
External debt (end of period)	63.0	61.1	66.6	71.6	75.8
of which: Private external debt	35.8	40.0	46.0	50.8	56.0
Gross official reserves (in billions of euro)	9.0	9.6	9.0	8.1	8.7
(In months of prospective imports of GNFS)	6.7	6.3	6.2	5.1	5.3
Exchange rate (dinar/euro, period average)	84.2	80.0	81.5	…	…
Real effective exchange rate (annual average change, in percent; + indicates appreciation)	6.6	7.2	5.0	…	…

Social indicators

Per capita GDP (2008): US$6,685. Poverty rate (poverty line is US$5 per day, 2007): 6.6 percent.
Unemployment rate (2008): 14 percent.

Sources: Serbian authorities; and IMF staff estimates and projections.
1/ Excluding Kosovo (with the exception of external debt).
2/ Retail prices until 2008. Monitoring of core retail price indices to be discontinued in 2009.

Statement by Thomas Moser, Executive Director for the Republic of Serbia, and Srboljub Antic, Senior Advisor to the Executive Director
January 16, 2009

1. Our Serbian authorities would like to thank staff for the constructive policy dialogue and a well-written document, which provides a realistic assessment of the Serbian economy. The report highlights important vulnerabilities in the context of the current highly uncertain global financial and economic environment, and it accurately describes the numerous risks and challenges that the Serbian policymakers face. Our authorities share the staff's assessment of their policy options and policy constraints.

2. Serbia is approaching the end of a very challenging political period during which some long standing issues had to be tackled. Over the last two and a half years, Serbia had three elections, and some delicate issues were resolved or are in the process of being resolved. A positive achievement of the Serbian government was the signing of the Stabilization and Association Agreement with the EU, even though ratification by the EU is still pending.

3. The Fund arrangement that the Serbian authorities ask the Board to support is neither an emergency nor an exceptional access arrangement. Rather, Serbia requests a standard, relatively low-access Stand-By Arrangement, which the authorities intend to treat as precautionary. This reflects the authorities' recognition that the situation primarily requires adjustment rather than financing. Should the economic outlook deteriorate further and downside risks materialize, however, the Serbian authorities are confident that the agreed program framework could provide a springboard for moving to a higher-access arrangement.

4. Thanks to past prudential and supervisory measures, Serbia's banking system has large liquidity and capital buffers, and the National Bank of Serbia's (NBS) net international reserves significantly exceed the country's short-term external debt. However, to help preserve macroeconomic and financial stability, the requested program deals with a number of outstanding problems of structural nature, fiscal issues, and vulnerabilities arising from the high current account deficit. Our authorities believe that strong fiscal adjustment, a

continuation of prudent monetary policy, and advancement in structural reforms will be adequate to achieve the objectives of the program. In the case of significant changes to the main program assumptions, the authorities are ready, in consultations with the IMF, to take additional measures to protect the objectives of the program.

5. The effects of the global economic slowdown have begun to affect Serbia. Although GDP growth is expected to have reached 6 percent in 2008, a slowdown of economic activity is clearly visible in Q4 2008. Industrial production showed signs of weakness in October and November, being lower than in the same months of 2007. Core inflation is still in the double digits but headline inflation has started to decline significantly since November. In October, Serbia also experienced the first effects of the global financial crisis, when households started to withdraw foreign exchange deposits from the banking sector. The National Bank of Serbia (NBS) reacted promptly by providing foreign exchange liquidity to the system. However, foreign exchange deposits are still declining, and the exchange rate has become more volatile.

6. The authorities started to tighten fiscal policy in the last quarter of 2008. Following strong fiscal expansion over the last years, the rebalanced 2008 budget was underexecuted. The authorities have adopted a tight budget for 2009, with the intention to lower the fiscal deficit by another 0.5 percent of GDP, with a plan to underexecute spending an additional 0.25 percent of GDP. Risks to the 2009 budget are significant, but the authorities stand ready to implement compensatory measures if necessary.

7. After large increases in the last two years, recurrent spending will be constrained at all government levels. The authorities are introducing a nominal freeze of pensions throughout 2009, and a freeze of government sector wages in real terms. Expenditures on goods and services are also being frozen in nominal terms, while subsidies will be cut nominally. In the case that budget revenues are lower than projected, the authorities will cut discretionary spending. In order to continue the improvement of the country's infrastructure, capital expenditure will be kept at the level of the two previous years (4 percent of GDP).

8. Monetary policy will continue to use inflation targeting to achieve low and stable inflation as its main objective, but the current concept of retail core inflation will be replaced by headline CPI inflation, which will be easier to communicate to the public. The wider band and higher numerical targets compared with the previous year do not imply a monetary relaxation, but reflect the volatility of the commodity prices and convergence of the non-traded goods prices that were not part of the retail core inflation concept.

9. The NBS continues to be committed to the managed floating exchange rate regime for the dinar. Exchange rate fluctuations helped in absorbing domestic and external shocks. Recent interventions of the NBS in the foreign exchange market aimed at smoothing shocks and preserving financial stability.

10. A set of measures was introduced to reduce risks to financial stability. Monitoring of liquidity, deposits and foreign exchange exposure of banks has been intensified. To boost the confidence in, and liquidity of, the banking system, the deposit insurance limit has been raised to Euro 50,000 and foreign exchange reserve requirements on new foreign borrowing by banks were eliminated. A crisis contingency plan to prevent, manage and resolve potential problems in the banking sector was recently adopted. One of the measures will be to streamline the lender-of-last-resort framework.

11. Although market conditions have not been conducive to privatization, the selling of state and socially owned companies continues. The state-owned oil company was recently sold to a foreign investor, while other segments of utilities will also be open to private sector participation. The process of privatization of socially-owned enterprises is close to completion. All eligible companies will be offered for sale or put under liquidation or bankruptcy procedure. For some of the remaining large socially-owned enterprises, the authorities intend to set up joint ventures with foreign investors. To facilitate the overall privatization plans, as well as to promote development of the stock market, the government will also submit to the parliament a new Securities Law conforming with EU regulations.