April 2010
IMF Country Report No. 10/93

Republic of Serbia: Staff Report for the 2010 Article IV Consultation, Third Review Under the Stand-By Arrangement, and Financing Assurances Review

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on March 31, 2010 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 March 18, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement
- A Public Information Notice (PIN)
- A Press Release
- A statement by the Executive Director for the Republic of Serbia

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

Letter of Intent sent to the IMF by the authorities of the Republic of Serbia *
Technical Memorandum of Understanding*

*Also included in Staff Report

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SERBIA

Staff Report for the 2010 Article IV Consultation, Third Review Under the Stand-By Arrangement, and Financing Assurances Review

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

Approved by Poul M. Thomsen and Michele Shannon

March 18, 2010

Discussions. A staff team visited Belgrade during February 9–23 to conduct the 2010 Article IV Consultation and Third Review of the Stand-By Arrangement (SBA). The mission met with Prime Minister Cvetković, Deputy Prime Ministers Dinkić, Djelić, and Krkobabić, Minister of Finance Dragutinović, National Bank of Serbia (NBS) Governor Jelašić, other senior officials, representatives of international financial institutions (IFIs), the European Union (EU), and the private sector. Staff liaised with an EBRD mission exploring options to foster domestic-currency lending. Some team members took part in a Bank Coordination Initiative meeting in Vienna on February 26 to review foreign parent banks' commitments to Serbia. The staff team comprised Messrs. Jaeger, Floerkemeier, Hajdenberg (all EUR), Mr. Arnason (SPR), Mr. Chailloux (MCM), and Ms. Eble (FAD). Mr. Lissovolik (Resident Representative), Ms. Nestorović, and Mr. Kokotović (local IMF office) assisted the mission. Mr. Antić (OED) attended most of the policy meetings.

Stand-By Arrangement (SBA). The SBA, approved by the Executive Board on January 16, 2009, was extended to 27 months and augmented to the amount of SDR 2.6 billion (560 percent of quota) on May 15, 2009 (EBS/09/63). The third tranche, subject to the completion of this review, amounts to SDR 319.6 million.

Program status. All end-December 2009 performance criteria were met. Progress was also made on the program's structural reform benchmarks, albeit with delays.

Response to Fund advice. Before 2009, Fund advice noted that Serbia's unbalanced mix of weak structural, expansionary fiscal, and tight monetary policies undermined competitiveness and macro stability. With the SBA, the authorities' policies have been broadly consistent with Fund advice, although, as regards fiscal strategy, the authorities strongly preferred to put the full adjustment burden on current spending, while staff would have preferred a mix between current spending restraint and VAT increases.

Exchange system. Serbia has accepted the obligations of Article VIII and maintains a floating exchange rate system free of restrictions on current international payments and transfers, except with respect to blocked pre-1991 foreign currency savings accounts.

Statistics. Statistical data are adequate for surveillance purposes. Since May 2009, Serbia participates in the General Data Dissemination System (GDDS).

Contents Page

Appendices

Attachments

Executive Summary

Background

Before the global financial crisis hit in late-2008, Serbia grew rapidly, but only at the cost of rising external imbalances and financial stability risks. Serbia has so far weathered the crisis shocks relatively well. While the output slump was contained, domestic demand dropped significantly, resulting in rapid external adjustment. Moreover, capital inflows surprised on the upside, and external financing pressures have abated. However, the pickup in growth will likely be moderate in the short term, reflecting slow trading partner recoveries, corporate protracted deleveraging, and lagging labor market adjustment.

Policy discussions

The authorities' macroeconomic policy response to the economic downturn has been appropriate. Looking ahead, Serbia's prospects to achieve sustained medium-term growth will foremost depend on the authorities' ability to implement stronger structural and fiscal policies, but foreign banks and main trading partners will also need to support the shift to a new growth paradigm. As the recovery takes hold, policies should foster more balanced growth in the tradable and nontradable sectors, raise domestic savings, contain risks from unhedged foreign-exchange (FX) lending, and lock in lower and more stable inflation.

On structural reforms, the authorities are committed to increase the role of the private sector, improve the business climate, address public infrastructure bottlenecks, and seek to expand trading opportunities through closer integration with the EU and through WTO accession.

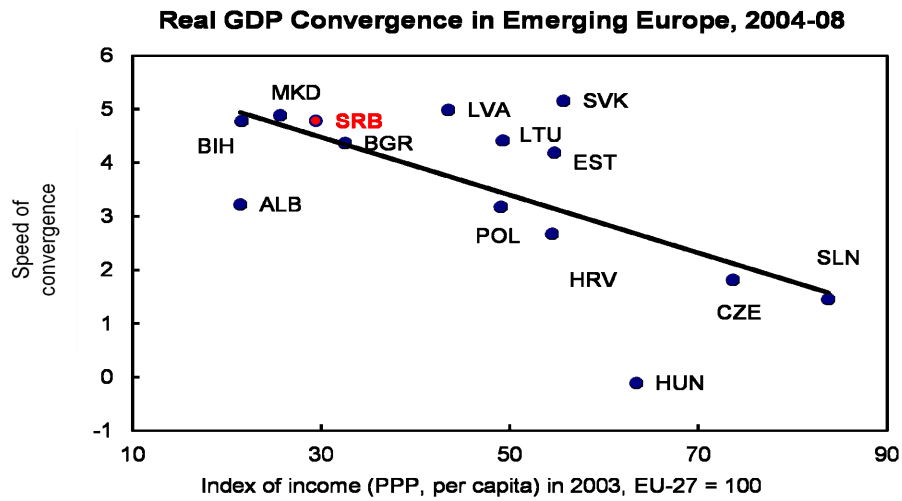
Restoring fiscal sustainability within the authorities' self-imposed constraints of a spending-based adjustment strategy could build much-needed policy credibility. Bold steps are needed to replace the nominal freezes of public wages and pensions and other ad hoc measures by structurally sound spending reforms. However, reforms streamlining public consumption and non-targeted social transfers have barely begun. And, with the recovery gaining hold and the 2012 elections approaching, political pressures for relaxing fiscal adjustment will be mounting. Against this backdrop, the authorities' fiscal strategy is subject to significant implementation risks, and hence fiscal responsibility legislation is being developed to ensure spending discipline.

The inflation targeting framework has served Serbia well and should prove effective in locking in a new regime of lower and more stable inflation. As also confirmed by the FSAP assessment, the financial sector has weathered the financial crisis spillovers well, but continues to face challenges. In particular, adverse spillovers from problems at key foreign parent banks represent a tangible short-term risk that requires careful monitoring.

I. Background

A. Pre-Crisis Macro Diagnostics

1. **Before the global financial crisis hit in late-2008, Serbia enjoyed fast-paced GDP growth.** Starting from a low base, GDP growth during 2004-08 accelerated to 6¼ percent, reflected in rapid convergence to EU income levels.



Sources: World Bank; and IMF staff calculations.
1/ Speed of convergence measured as the average annual percent change in the index of PPP per capita income.

2. **But Serbia's growth acceleration was accompanied by four troubling symptoms** (Figure 1):

- ***Lagging tradable sector growth:*** Growth was strongly tilted toward nontradables, in particular transport and communications, retail trade, and financial services (Table 4).

- ***Low domestic savings:*** With domestic savings close to nil, the economy's investment level was effectively constrained by remittances from abroad—which were trending downward—and the availability of foreign savings (Table 5).

- ***Extensive foreign-exchange (FX) lending:*** High loan euroization, even if direct cross-border FX loans to Serbian corporates are excluded, in an economy dominated by nontradable producers led to the buildup of large unhedged FX positions.

- ***High inflation:*** Average inflation during 2004-08 was the highest in the region.

3. **These symptoms were rooted in four unfavorable fundamentals of Serbia's economy** (Figure 2)**.** First, the economy's supply side was hampered by slow and inconsistent efforts at privatization, reflected in a relatively small private sector, and a difficult business climate, particularly for export-oriented firms that need to operate in the formal sector.

Second, the large government sector invested little in the country's future, as indicated by high untargeted spending on social transfers and a high public wage bill relative to public investment. Third, notwithstanding high unemployment, public-sector-led wage settlements often far exceeded targeted inflation and labor productivity growth, undermining the economy's cost competitiveness. And fourth, reflecting the severe monetary instabilities of the 1990s, inflation expectations remained stubbornly high relative to actual inflation.

4. **A policy response sufficient to rebalance the economy did not emerge.** The authorities undertook efforts, until 2006 under the aegis of IMF-supported programs, to foster more balanced growth: some public investment programs were launched to address infrastructure gaps, but implementation was slow; inflation targeting was adopted to better anchor inflation, but inflation expectations remained stubbornly above actual inflation; and prudential and supervisory rules were tightened to increase capital and liquidity buffers in the banking system, but foreign banks used direct cross-border loans to circumvent these rules. In a setting of volatile politics, the authorities' responses remained too fragmented to ensure a more sustainable growth acceleration.

B. Financial Crisis Spillovers and Policy Responses

5. **By 2008, a massive absorption gap had opened up, with excess domestic spending mainly reflected in a ballooning external imbalance.** Absorption (domestic demand) growth before the crisis far outpaced the rate consistent with internal and external balance, reflected mainly in a surge of imports and a widening external imbalance. However, a tide of capital inflows, intermediated by the largely foreign-owned banking system, smoothly financed the rapidly widening current account gap.

Serbia: Internal and External Imbalances, 2005-08
(Percent of potential GDP)

	Absorption Gap 1/ (Excess Domestic Demand)	=	Output Gap (Internal Imbalance)	+	Current Account Gap 2/ (External Imbalance)
2005	2.7		0.5		2.3
2006	4.1		-0.5		4.6
2007	9.5		0.1		9.4
2008	11.3		0.8		10.5

Source: IMF staff estimates.

1/ Absorption gap defined as actual minus sustainable level of absorption.
2/ Current account gap defined as actual minus estimated equilibrium current account deficit.

6. **In late-2008, the global financial crisis rapidly spilled over to Serbia through both finance and trade channels** (Figure 3). Country risk indicators soared, capital inflows stopped suddenly, households withdrew a sizeable share of their deposits, and both exports and imports plunged.

7. **Faced with a large projected external financing gap, the authorities adopted a three-pronged approach, embedded in an IMF-supported SBA**:

- ***Fiscal adjustment*** to facilitate external rebalancing, buttress market and public confidence, observe tight financing constraints, and restore fiscal sustainability.

- ***Private sector involvement*** as part of an innovative Financial Sector Support Program (FSSP), including assurances from foreign parent banks to at least maintain their external exposures to Serbia, while keeping their subsidiaries capitalized and liquid.

- ***External financing*** from IFIs and the EU to close the remaining gap.

8. **Fiscal adjustment in 2009 was in line with plans** (Table 6). The economy's abrupt downturn unmasked a weak underlying fiscal position—the structural fiscal deficit in 2008 is estimated at 4½ percent of GDP. The revenue-GDP ratio dropped sharply in line with the contracting absorption gap, while spending was restrained through nominal freezes of public wages and pensions but also cuts in capital spending.

Serbia: General Government Finances, 2007-09
(Percent of GDP)

	2007	2008	2009		
			1st Rev.	2nd. Rev.	Actual
Revenue	42.4	41.4	39.5	38.3	39.6
Expenditure	44.2	44.0	42.5	42.8	43.7
Current spending and net lending	39.6	40.3	39.1	39.7	40.6
Capital	4.6	3.8	3.4	3.1	3.2
Fiscal balance	-1.9	-2.6	-3.0	-4.5	-4.2
Structural balance 1/	-3.6	-4.6	-3.9	-4.0	-3.5
Public debt	34.3	33.1	34.8	31.5	36.4

Sources: Ministry of Finance; and IMF staff estimates and projections.
1/ Actual fiscal balance adjusted for the effects of both the output and the current account gap.

9. **Foreign parent banks kept their exposure commitments.** Their end-2008 external exposure is estimated at 8.7 billion euros (25 percent of GDP), mostly consisting of direct cross-border loans to Serbian corporations. Overall, the foreign parent banks honored their commitments, but, facing a lack of "bankable clients," many banks shifted part of their exposure to short-term instruments (T-bills, NBS repos), and some banks put excess liquidity into FX float accounts with their parents (0.6 billion euros).

Serbia: Exposures of Foreign Parent Banks 1/
(Billions of euros)

	Dec. 2008	Dec. 2009	Change	Percent change
Total exposure	8.7	9.5	0.7	8.4
Long-term exposure	8.0	7.7	-0.4	-4.4
Short-term exposure	0.7	1.8	1.1	153.5

Source: National Bank of Serbia.
1/ Includes balances in FX float accounts.

10. **The three-pronged SBA approach mitigated the fallout from the global financial crisis on output and helped rebalance the economy, but job losses were severe and corporate payment problems soared.** The 2009 output slump was limited relative to regional comparators, in part reflecting mattress money smoothing private consumption and government efforts to support bank lending through interest subsidies and loan guarantees. At the same time, the decline in domestic demand was large, particularly in investment, and reflected in rapid external adjustment. Unemployment—already high before the downturn—surged to about 17½ percent, and employment, particularly in the manufacturing and construction sectors, contracted sharply (Table 3). Corporate payment problems became endemic, as also reflected in rising non-performing loans (NPLs) (Table 7).

11. **The dinar exchange rate has depreciated markedly since the onset of the crisis** (Figure 4). After an initial sharp drop, the dinar-euro exchange rate remained stable without

FX interventions throughout most of 2009. However, in December 2009, depreciation pressures re-emerged, in part reflecting seasonal pressures in a shallow FX market. In line with its stated FX intervention strategy, the NBS intervened to smooth exchange rate volatility, but also allowed some further nominal depreciation.

12. **Balance-of-payments developments in 2009 were much more favorable than expected** (Tables 8-10). Not only did external financing requirements turn out to be lower than had been anticipated, but capital inflows were also substantially higher. As a result, FX reserve accumulation was significantly higher than targeted, while SBA disbursements were rephased given less pressing external financing pressures.

Serbia: External Financing in 2009 (billions of euros)

	1st Rev. 1/	Est.	Change
Financing requirement	9.0	6.0	-3.0
Current account deficit	4.0	1.7	-2.3
Amortization	5.0	4.3	-0.7
Available financing	6.6	4.8	-1.8
Capital inflows	6.0	7.2	1.2
Use of FX reserves (-=increase)	0.6	-2.4	-3.0
Financing gap	2.4	1.2	-1.2

Source: NBS; and IMF staff estimates and projections.

1/ May 2009.

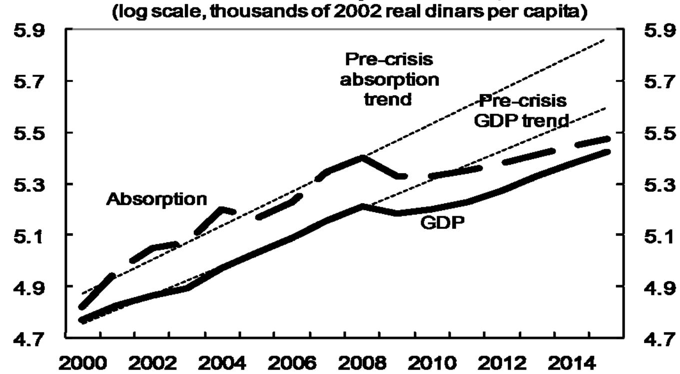
13. **Progress on structural reforms was limited.** Serbia has continued to trail best-performing transition peers across most key business climate scores (Table 11). Moreover, reflecting adverse market conditions, the privatization agenda has stalled since the onset of the crisis. The structural benchmark on large state enterprises' business plans was partially met, but the original deadlines for the benchmarks related to pension, fiscal responsibility, and debt restructuring legislation will need to be extended, owing in part to additional time needed to build political consensus but also to the complexity of the planned reforms (Table 2, LOI ¶1).

14. **Serbia has taken several landmark steps toward closer integration with the EU.** With internal political opposition to EU integration waning, in late-2009, visa liberalization for Serbian citizens took effect, the EU interim trade accord was unfrozen, and Serbia submitted its EU membership application

C. Outlook

15. **The recovery from the crisis will likely be gradual, also reflected in hefty medium- term output and absorption losses relative to pre-crisis trends** (Table 12). The program framework is based on 2 percent real GDP growth in 2010, with a gradual return to robust GDP growth only in 2012-13. Absorption is expected to remain flat in 2010, reflecting the combined impacts of declining real incomes and employment, drawn-out corporate deleveraging, and tight credit conditions. Maintaining external stability requires that medium-term absorption growth, especially consumption, remains

Serbia: GDP and Absorption Trends, 2000-15
(log scale, thousands of 2002 real dinars per capita)



Sources: Statistical Office of the Republic of Serbia; and IMF staff estimates and projections.

subdued (Box 1). This growth scenario is predicated on strong fiscal adjustment efforts and structural reforms underpinning a more sustainable growth model, with the tradable sectors emerging as a viable growth engine. Nevertheless, in line with sluggish projected demand in main trading partners, export growth is projected to regain strength only in 2011.

Box 1. External Stability Risks

The sharp external adjustment has considerably reduced immediate external stability risks, but external debt and balance sheet euroization remain uncomfortably high, and growth will need to become more balanced to avoid a resurgence of external stability risks.

Exchange rate risks: Serbia's real effective exchange rate now seems fairly valued, based both on the macroeconomic balance and external sustainability approaches, which indicated undervaluation of 2½ percent and ¾ percent, respectively. The two approaches point to a current account deficit norm of about 6 percent of GDP, compared with underlying current account deficits of also around 6 percent of GDP during 2009-15. However, this scenario assumes a shift to balanced growth over the medium term, a significant departure from Serbia's absorption-driven pre-crisis growth model. In the alternative scenario with the economy resuming absorption-led growth, the underlying current account deficit could rise to about 16 percent of GDP, well above the current account deficit norm, resulting in an estimated exchange rate overvaluation of about 17 percent.

External balance sheet risks: In the program scenario, external debt would decline substantially (Appendix I), but the negative international investment position would remain elevated and stabilize at about 100 percent of GDP (Table 12); in the alternative scenario, by contrast, external debt would remain high over the medium term against the backdrop of an overvalued exchange rate, reflected in unsustainable external balance sheet dynamics. Although short-term external debt remains covered by net free FX reserves in the program scenario, high balance sheet euroization means that risks remain significant.

Export competitiveness: Before the crisis, goods exports were growing rapidly, but starting from a low base (15 percent of GDP). While Serbia's euro wage levels relative to labor productivity seem in line with most transition peers, they significantly exceed those of key regional competitors, including Bulgaria and Slovakia.

16. **Disinflation is expected to continue, with inflation stabilizing around 4 percent, supported by prudent monetary and fiscal policies.** Headline inflation will likely undershoot point targets throughout the first half of 2010, but end the year close to the target of 6 percent (±2 percent). Inflation expectations have begun to moderate, but still have not responded fully to lower actual inflation. A credible inflation targeting framework, supported

by restrained nominal wage growth and a tight fiscal stance, will be key for locking in recent disinflation gains.

17. **To underscore the risks of a return to the pre-crisis growth paradigm, the mission presented an alternative absorption-led growth scenario, which would lead to the re-emergence of high external stability risks** (Table 13). While the alternative scenario features a similar growth acceleration as the program scenario, the pre-crisis symptoms of unbalanced growth would re-emerge: lagging tradable sector growth; low domestic savings; extensive FX lending; and a high inflation rate, mainly driven by high nominal wage growth. As a consequence, external imbalances would again balloon, resulting in high external stability risks. At the same time, as in the pre-crisis period, the headline fiscal position would be flattered by a rising tax-GDP ratio, owing to a widening external gap, while the structural fiscal deficit would remain elevated.

18. **While risks to the short-term outlook may appear broadly balanced, potential spillover risks from Greece, while considered a small-probability event, were on everybody's mind.** A stronger global economic recovery, especially in the EU, would further improve prospects for a pickup in external demand and private capital inflows. On the downside, a delayed global recovery could result in weaker-than-projected output and renewed exchange rate pressures. At the same time, contagion events in Eastern and Southern Europe, possibly related to adverse spillovers from escalating problems in Greece cannot be excluded. Serbia's direct trade links with Greece are small, with only about 2 percent of exports going to Greece. But, with Greek bank subsidiaries accounting for about 15 percent of Serbia's banking assets, problems originating from Greek parent banks could have more serious repercussions.

II. Policy Discussions

A. Fiscal Policy

19. **The program scenario is anchored by a medium-term general government deficit of 1 percent of GDP**. This anchor assures fiscal sustainability, even if fiscal risks related to government loan guarantees or restitution claims materialize (Appendix II). Moreover, the medium-term deficit target, combined with stepped up public investment, provides room for increased public savings (Table 6).

Serbia: General Government Finances under Program Policies, 2008-15
(Percent of GDP)

	2008	2009	2010 Prog.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
Revenue	41.4	39.6	38.4	38.0	37.6	37.6	37.8	38.1
Expenditure	44.0	43.7	42.5	41.0	40.1	39.6	39.3	39.0
Current spending and net lending	40.3	40.6	39.0	36.9	35.2	34.3	33.6	33.1
Capital	3.8	3.2	3.5	4.1	4.9	5.3	5.7	6.0
Fiscal balance	-2.6	-4.2	-4.1	-3.0	-2.5	-2.0	-1.5	-1.0
Structural balance 1/	-4.6	-3.5	-4.4	-3.5	-2.9	-2.3	-1.7	-1.1
Public debt	33.1	36.4	36.0	36.5	35.0	32.7	30.3	28.8

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

1/ Actual fiscal balance adjusted for the effects of both the output and the current account gap.

20. **The authorities are committed to a fiscal adjustment strategy supporting more balanced growth** (LOI ¶9-10). Given the currently high structural fiscal deficit and projected further declines in the revenue-GDP ratio as the economy rebalances over the medium term, further fiscal adjustment efforts are needed. Moreover, the authorities plan to keep the main tax parameters broadly unchanged, while addressing infrastructure bottlenecks that require significant increases in public investment. Given these constraints and priorities, there was agreement that the main burden of medium-term fiscal adjustment will have to fall on public wages and pensions:

- Restrained wage increases and reforms of the public administration, health, and education sectors are expected to reduce the public wage bill to about 8 percent of GDP by 2015 (from 10¼ percent in 2009).

- Parallel efforts to contain pension increases and implement parametric pension reforms should allow for a reduction in net pension spending to about 10 percent of GDP by 2015 (from 13¼ percent of GDP in 2009).

21. **Designing a fiscally affordable, economically efficient, and socially acceptable pension system has been a longstanding policy conundrum.** Serbia's population is aging rapidly, social expectations for what amounts to a fair pension are high, the pension contribution base, i.e. formal employment, is low, and pensioners have a strong political voice. Moreover, Serbia's statutory pension indexation mechanism is prone to produce unstable pension replacement rates over time (Box 2). The government has agreed on a package of parametric pension reforms that should help reduce medium-term pension costs, while raising the employment rate (LOI ¶14). In staff's view, additional rounds of parametric reforms will have to be considered, especially in view of the likely adverse demographic and migration trends over the next few years. At the same time, setting up a funded second-pillar pension system to relieve pressures on the first pillar is widely viewed as incompatible with fiscal sustainability considerations.

While the authorities' fiscal adjustment strategy is commendable in view of shared medium-term diagnostics, there are high implementation risks:

- Achieving an orderly exit from nominal wage and pension freezes: While the 2010 budget is in line with the adjustment strategy (LOI ¶11), the authorities noted rising pressures against the agreed nominal freezes of public wages and pensions, but nonetheless pledged to maintain this freeze for the time being (LOI ¶13-15). Some of the authorities stressed the need to design early a realistic exit strategy that balances macro stability, budgetary consolidation, and political economy considerations. Staff noted that the nominal freezes were a stopgap measure that would need to be replaced by structurally sounder reforms.

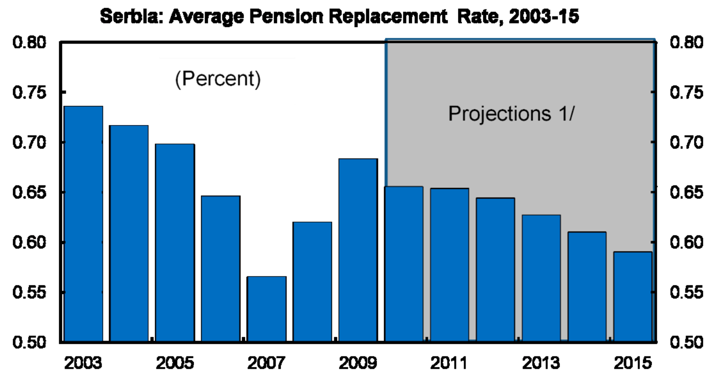
- Political fragmentation paired with weak institutional fiscal restraints: With the 2012 elections approaching, it will become more difficult to maintain spending discipline. To address this risk, the authorities are committed to drafting fiscal responsibility legislation that could include binding ceilings on public wages and pensions during 2010-12 (LOI ¶15).

- **Weaknesses in administrative capacity:** The authorities stressed the need to improve the Ministry of Finance's administrative capacity, also a condition for additional EU budget support (LOI ¶26).

Box 2. Serbia's Unstable Pension Indexation Mechanism

In 2005, to lower an unaffordably high average pension replacement rate, Serbia indexed the pension rights of new pensioners as well as pensions in payment to the CPI. With wages growing rapidly, by 2007, Serbia's unorthodox across-the-board CPI indexation mechanism had caused a sharp, and politically unsustainable, drop in the average pension replacement rate.

As a result of two exceptional across-the-board hikes in pensions during 2008, partly reflected the emergence of a politically powerful pensioner party, the average pension replacement rate surged back close to its 2003 level.



Sources: Pension fund; and IMF staff projections.
1/ After pension freeze in 2010, CPI indexation plus growth bonus.

Starting in 2009, pensions (and public wages) were frozen at their end-2009 level, and are scheduled to remain frozen through April 2011. The present agreement is that pensions after April 2011 would be re-linked to the CPI but augmented with a growth bonus if the previous year's GDP growth rate exceeds 4 percent. As an alternative, which could be politically more palatable as a burden sharing arrangement between public wage earners and pensioners, the government suggested during the review discussions to consider indexing—for an 18-month period starting in April 2011—pensions to public wages, and then to switch to CPI indexation. However, this alternative indexation option raises several technical issues regarding measuring public wages, and it is also fraught with fiscal risks if public wage growth cannot be contained.

Whatever the exact indexation arrangements over the next few years, there is agreement that, over the medium term, pension replacement rates will have to be lowered sufficiently to bring net pension spending to about 10 percent of GDP. However, to ensure more stable pension replacement rates beyond 2015, a reform of Serbia's across-the-board CPI indexation mechanism will likely be unavoidable.

B. Monetary and Exchange Rate Policies

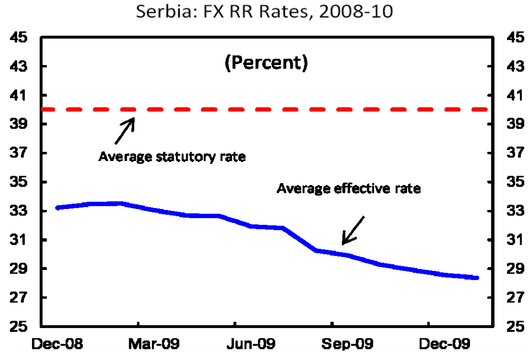
22. **With disinflation on track, the NBS's gradual monetary easing remains appropriate.** Given a significant output gap, public nominal wage and pension freezes, and a still high domestic real interest rate, it should be possible to lock in recent disinflation gains. Nevertheless, inflation expectations have yet to respond fully to recent disinflation, and there are both upside (higher energy prices, more exchange rate depreciation) and downside (more protracted recovery) risks to inflation. Going forward, some policy easing is expected from the announced gradual lowering of the high effective rate of reserve requirements (LOI ¶18). There was agreement that the high reserve requirements served as a valuable liquidity buffer during the crisis. At the same time, the NBS has also announced a plan to streamline the overly complex and distortionary reserve requirement regime (Box 3).

Box 3. The Case for Reforming Reserve Requirements

Prior to the announced reforms, Serbia's reserve requirement (RR) system was highly complex: First, it had three statutory rates on FX liabilities (45 percent on borrowing and deposits; 40 percent on household deposits; and 20 percent on subordinated debt); and two rates on dinar liabilities (a 10 percent general rate, and a 5 percent rate on longer-term deposits). Second, there were numerous deductions from the RR base, including for guaranteed mortgages, FX borrowing from abroad since October 2008, and loans under a government subsidy program. And third, banks had discretion to decide to which FX liability category the available deductions would be applied.

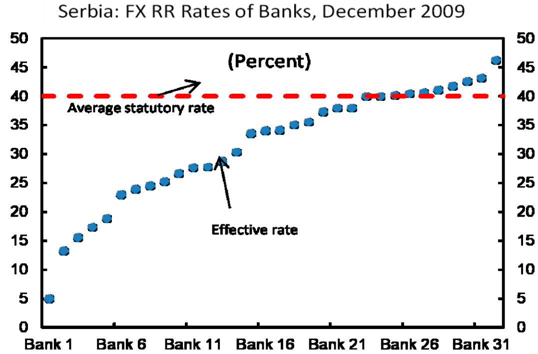
This complex RR system heavily distorted banks' decision making. In particular, it diverted banks' resources to targeting bank balance sheets that minimized their effective RR rates. For example, while the average statutory RR rate for FX liabilities in December 2009 was about 40 percent, the average effective RR was only about 29 percent. Moreover, the effective RR had declined significantly since the onset of the crisis as banks took increasingly advantage of deductions, and there was a wide dispersion of effective RRs across banks.

Serbia: FX RR Rates, 2008-10



Source: National Bank of Serbia.

Serbia: FX RR Rates of Banks, December 2009



C. Financial Sector Policies

23. **The recent FSAP Update noted that the banking sector has weathered the crisis spillovers well, but still faces a number of challenges** (Table 16). The authorities have already addressed some of these recommendations, including reducing the number of weekly repo auctions and reforming reserve requirements.

24. **Serbia's level of euroization is high, even by regional standards, and to the extent that FX exposures are unhedged, imposes significant financial stability risks.** Moreover, the impact of changes in the monetary policy rate on the economy will remain limited under the present euro dominance, while fear of floating because of unhedged household and firm balance sheets constrains the shock absorption capacity of the nominal exchange rate.

25. **The macroeconomic outlook provides a rare window of opportunity to launch a coordinated strategy to gradually lower unhedged FX risks and euroization**. There are deep-rooted historical reasons why the public favors the euro over the dinar (Box 4). However, the fallout from the crisis has re-alerted foreign banks, their home supervisors, the Serbian authorities, and the public to the risks of FX lending. At the same time, the macroeconomic outlook envisages a break with the past: lower and more stable inflation; lower external imbalances and remittances; and higher domestic savings. If this scenario materializes, it could chip away at the public's lack of trust in the dinar. In the meantime, shifting the composition of government debt toward the local currency will be key to signal the government's commitment to low inflation and to start building a benchmark yield curve that allows pricing of dinar financial instruments (LOI ¶20). A coordinated strategy exploiting this window of opportunity would need to consist of two elements:

- ***Short-term containment of risks from new FX lending to unhedged borrowers:*** Prudential and supervisory measures should continue to be used to discourage banks from extending new unhedged FX loans, including direct cross-border FX loans to unhedged borrowers in the nontradable sectors. This domestic response could be complemented by home supervisors leaning on their parent banks to avoid risky lending practices, including lending in Swiss francs.

- ***Medium-term development of savings vehicles in local currency:*** Building on the growing T-bills market, domestic market development measures, including corporate bond issuance, could jumpstart a market for local currency saving instruments.

Box 4. Reasons for Euro Dominance in Serbia

The roots of high euroization and unhedged FX risks reach back to the early years of the breakup of Yugoslavia. They include: (i) a long history of high and volatile inflation; (ii) past policy choices that have excessively favored the euro, including repaying frozen FX deposits but not dinar deposits; (iii) lack of trust in the fiscal authorities' commitment to low inflation given often sharp reversals on earlier promises of fiscal rectitude; (iv) a dearth of FX hedging solutions; and (v) underdeveloped local currency markets.

26. **Notwithstanding the crisis spillovers, the banking system remains well capitalized**. The NBS has recently completed diagnostic studies and stress tests for all 31 banks. The results show that even under the most severe, and by now quite unrealistic scenario for 2009-10, substantial increases in NPLs would not have resulted in significant undercapitalization.

Serbia: Onsite Diagnostic Studies and Stress Tests 1/
(Capital adequacy ratios (CAR), percent)

	2009	2010
Initial CAR position, end-March	21.0	
After onsite diagnostic study	17.8	
After subsequent capital increases 2/	19.8	
After stress test using downside scenario:	18.9	17.2
Memorandum items:		
Downside scenario assumptions:		
Real GDP growth (percent)	-6.0	-3.5
Output gap (percent of potential output)	-5.8	-8.5
Nominal depreciation (percent)	12.0	10.0
Bank profits (percent of 2008 profits)	60	60

Source: National Bank of Serbia.
1/ Aggregates 31 banks.
2/ Primarily reflects capitalization of the 2008 profits.

27. **Nevertheless, with Greek bank subsidiaries accounting for a significant share of the banking system, the authorities are prepared for adverse spillover scenarios.** The four Greek subsidiaries operating in Serbia account for about 15 percent of banking assets, but their parent banks were also engaged in extensive direct cross-border lending to Serbian corporates. Based on the recent stress tests, all Greek subsidiaries appear to be well capitalized and highly liquid, and should therefore be able to absorb even large shocks. At the same time, the authorities have significantly strengthened their crisis management framework, which already underwent a severe test in late-2008. The authorities believe that they have the necessary crisis tools to deal with different adverse scenarios, including a deposit run or the bankruptcy of a parent bank. They are also awaiting a decision by the Austrian authorities of how they plan to restructure the recently nationalized Hypo Alpe Adria Group, which has a significant presence in Serbia.

28. **The authorities are strengthening the debt collection and restructuring framework.** Serbia's collateral enforcement and bankruptcy procedures are costly, unpredictable, and lengthy. Blocking a delinquent debtor's accounts is the preferred mechanism of debt collection. However, with corporate debt distress rising sharply, this preference has led to a rush to block corporate accounts, sometimes shutting down viable companies. Voluntary debt restructuring is still at an early and experimental stage. Thus, reforms have focused on the following: First, the blocked account mechanism should be made more transparent to mitigate the rush-to-block incentives. Second, the new bankruptcy law that took effect in early 2010 should accelerate proceedings and allow for prepackaged

plans that would help expedite debt restructuring and reduce the burden on courts and insolvency administrators. Third, the authorities are developing an out-of-court corporate loan workout mechanism as a quicker and lower-cost option (LOI ¶22).

29. **A review meeting of the Bank Coordination Initiative agreed on gradually phasing out banks' exposure commitments.** It was agreed to lower the exposure limit from 100 percent to 80 percent of the end-2008 level, effective April. This relaxation reflects subsiding external financing pressures and sets the stage for a gradual exit from the exposure commitments. It will also allow banks to rebalance their portfolios in line with their strategic priorities. While some banks are expected to deleverage and undo positions accumulated in government securities and FX deposits with their parents, others are expected to continue expanding their operations in Serbia.

D. Structural Policies

30. **Structural reforms will have to provide the main underpinnings for the envisaged shift to a new growth model.** First, cross-country evidence suggests that a larger private sector is instrumental for increasing a country's capacity to produce, save, and export, while also creating a virtuous circle where privatization creates a stronger constituency for more structural reforms (Figure 5). The authorities are committed to increase the role of the private sector in the economy (LOI ¶25). Second, strengthening exports will require a much better business climate, as illustrated by the experience of successful peers in the region (Box 5). In this regard, the authorities plan to implement several specific measures in 2010 ((LOI ¶24). Third, in line with the authorities' fiscal strategy, the public sector envisages a significant reduction in the amount of resources devoted to consumption and non-targeted social transfers, while raising public investment to address urgent infrastructure bottlenecks. And fourth, expanding exports will require increased trade through closer integration with the EU, but likely also with some of Serbia's former Yugoslavia trading partners. In this context, Serbia is close to concluding its negotiations for WTO membership.

III. Program Issues

31. **Program modalities.** The Fund arrangement remains adequate to meet Serbia's balance of payment needs through end-2010, alongside financing commitments from the EU and the World Bank. While projected external financing needs for 2010 are somewhat lower than originally envisaged, the fragility of the stabilization process warrants continued precautionary FX reserve accumulation. In fact, free FX reserves are significantly lower than gross FX reserves as well as the high level of short-term external debt. The authorities intend to draw the amount available at the completion of the review (SDR 319.6 million).

32. **Capacity to repay and safeguards assessment:** Serbia's capacity to repay the Fund is expected to remain adequate (Table 17). The NBS has further strengthened their financial safeguards, including by appointing an external auditor for a multi-year term.

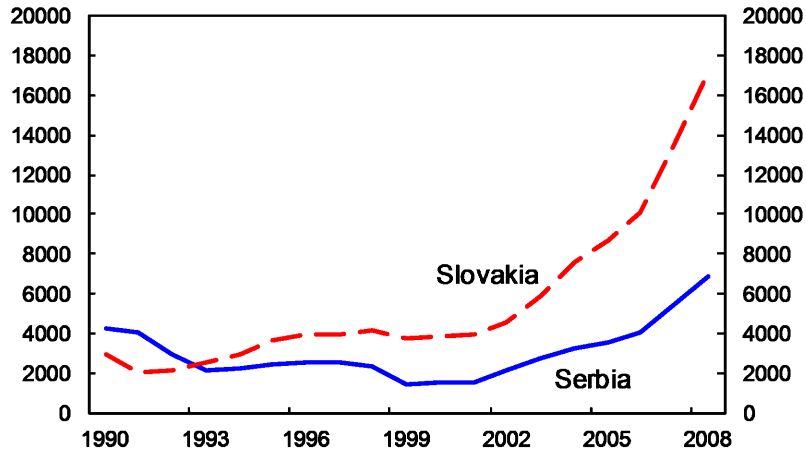
33. **New structural conditionality under the program.** To limit risks for revenue collections, especially with respect to VAT and social security contributions, new structural

conditionality was agreed to strengthen tax administration. Specifically, the tax administration agency's newly-established risk management unit will develop and establish an integrated taxpayer compliance strategy that will enable the agency to better allocate its resources toward improving taxpayer compliance (structural benchmark, July 2010).

Box 5. What Can Serbia Learn from Slovakia's Growth Model?

Among Serbia's Eastern European peers, Slovakia offers an example of a sustained growth acceleration, which catapulted Slovakia's per capita income significantly above Serbia's, notwithstanding a lower starting level in the early-1990s.

Serbia and Slovakia: Incomes per Capita 1/
1900-2008



Source: UN Statistics.
1/ Gross National Income Per Capita in current US dollars.

Slovakia's growth model differs from Serbia's along several dimensions: (i) Slovakia relied heavily on tradable sector growth, mostly by attracting FDI inflows to export sectors; (ii) it generated high domestic savings, allowing investment rates to consistently exceed 30 percent of GDP without accumulating persistent external imbalances; (iii) the share of FX lending was low; and (iv) inflation was low and stable.

Slovakia's growth model was underpinned by the following key reforms:

- **Privatization** was accorded high priority, including via the sale of stakes in the telecommunications, gas, and power companies. The private sector share in the economy is now about 80 percent, compared with 60 percent in Serbia.
- The **business climate** was revamped, including the bankruptcy law, corporate governance, and favorable conditions for FDI. For example, Slovakia ranks 42nd in the World Bank "Doing Business" indicators, compared to 88th for Serbia.
- The **structure of public spending** was managed to free room for **public investment**. For example, the ratio of spending on public wages and social transfers to public investment averaged 3½ in Slovakia during 1995-2002, compared to about 7½ in Serbia during 2005-08.

IV. Financing Assurances Review

34. **Progress has been made toward settling remaining official external debt issues—including external arrears**. Regarding the renegotiation of restructuring agreements with Paris Club members following the breakup of the Union of Serbia and Montenegro in 2006, the authorities estimate that in excess of 80 percent of the outstanding Paris Club debt has been reconciled. Agreement has been reached with non-participants in the London Club settlement and with other official non-Paris Club creditors. Remaining official external arrears mostly relate to debts of the former Yugoslavia.

35. **Expected disbursements from IFIs and other multilateral institutions**—such as the World Bank and the EU—to support structural reforms provide assurances that the program is fully financed in 2010.

V. Staff Appraisal

36. **During the years preceding the global financial crisis, Serbia enjoyed fast-paced GDP growth, but at the cost of growing external and financial stability risks.** On the economy's supply side, with structural reforms proceeding slowly and foreign banks providing FX loans freely to unhedged corporates, growth was mostly driven by the production of nontradables. On the economy's demand side, sustained high private and public consumption growth left little room for investing in the economy's supply capacity. As a consequence, Serbia's relatively moderate investment-GDP ratios could only be financed by running large current account deficits. On the eve of the global financial crisis, the economy was seriously unbalanced on the external side, while the private sector's unhedged FX exposures signaled high financial stability risks.

37. **The authorities' policy responses to the spillovers from the global financial crisis have been appropriate, limiting the fallout of the global crisis on Serbia.** The policy package focused on fiscal tightening, maintaining the managed float to support external adjustment, while enhancing financial crisis preparedness. At the same time, the authorities obtained assurances from foreign parent banks under the Bank Coordination Initiative to maintain their exposures vis-à-vis Serbia and keep their subsidiaries well capitalized, while the IFIs provided substantial external financing.

38. **As the economy recovers, policies should shift the economy toward a more sustainable growth paradigm.** To achieve more balanced growth, Serbia will also have to upgrade its deteriorated domestic infrastructure and catch up with other transition economy peers on key structural reforms that promote private sector development and an improved business climate. Tight fiscal policies based on current spending restraint should ensure fiscal sustainability and higher public savings, while measures to reduce euroization and unhedged FX lending should help reduce financial stability risks. More balanced growth will also require higher private savings to reduce the dependence on foreign savings. However, with many countries in the region urged or poised to strengthen exports, Serbia may face stiff competition in its export markets.

39. **Reducing the public sector's high claim on economic resources through fiscal consolidation will be key to boost domestic savings and private investments into tradable sectors.** Bringing spending to more sustainable levels while keeping the tax burden unchanged will require continued restraints on both pensions and public wages. This should free up resources for essential public infrastructure investment, with well-targeted social spending being protected. But maintaining nominal public wage and pension freezes through April 2011 could be a challenging, and developing a fiscally sound and politically credible exit strategy from the nominal freezes should be a priority of the next review.

40. **With the disinflationary trend persisting, the gradual monetary easing pursued by the NBS is appropriate.** The planned streamlining and gradual lowering of reserve requirements are welcome in this regard. But the NBS will have to continue to monitor inflation developments carefully to detect early any shift in the balance of risks. Planned efforts to curtail the high level of euroization could also help to strengthen the scope for more effective monetary policies.

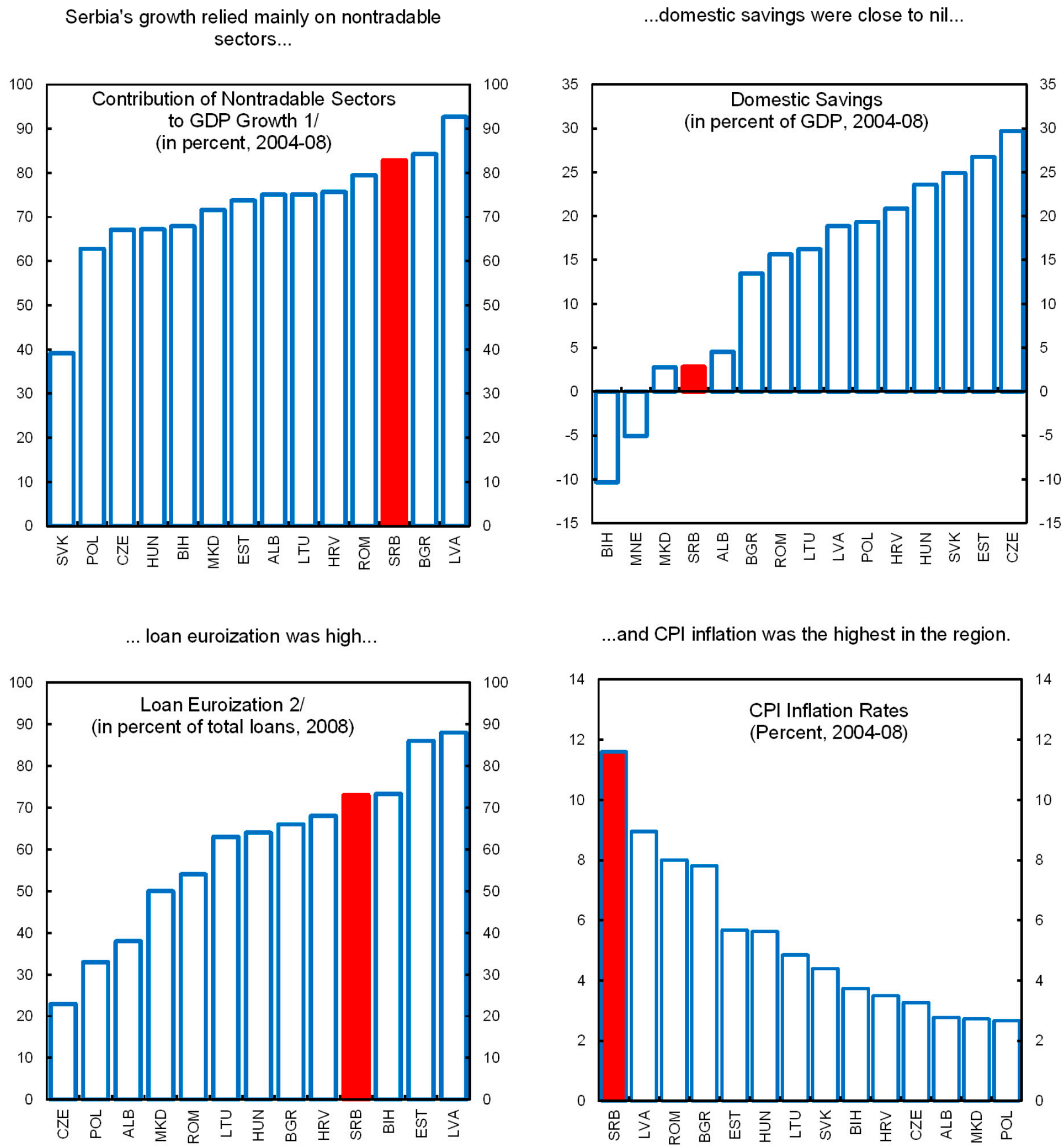
41. **The Financial Sector Support Program has helped the banking system to safely steer through the global financial storm, and systemic risks have largely abated.** But risks of regional spillovers, cannot be ruled out, as Greek parent banks of Serbian subsidiaries in particular could face funding pressures in their domestic markets or may have to undergo restructuring. Still rising corporate debt repayment problems are a key concern, calling for improvements in the framework for debt collection and restructuring, including putting in place a framework for voluntary loan workouts.

42. **Decisive progress on structural reform implementation is needed to tap Serbia's growth potential**. Public enterprise restructuring and privatization efforts have stalled during the economic downturn. But the authorities are committed to relaunch their privatization and corporatization agenda once market conditions permit. Recent progress in the authorities' regulatory guillotine project to streamline business laws and regulations is encouraging.

43. **On the basis of Serbia's good performance under the SBA, staff supports the authorities' request for completing the third review and the financing assurances review**. Staff also recommends establishing quantitative conditionality for end-June 2010, as specified in the Letter of Intent (LOI Table 1).

44. **It is proposed that the next Article IV consultations be held on the 24-month cycle**.

Figure 1. Eastern Europe: Symptoms of Unsustainable Growth Accelerations, 2004-08

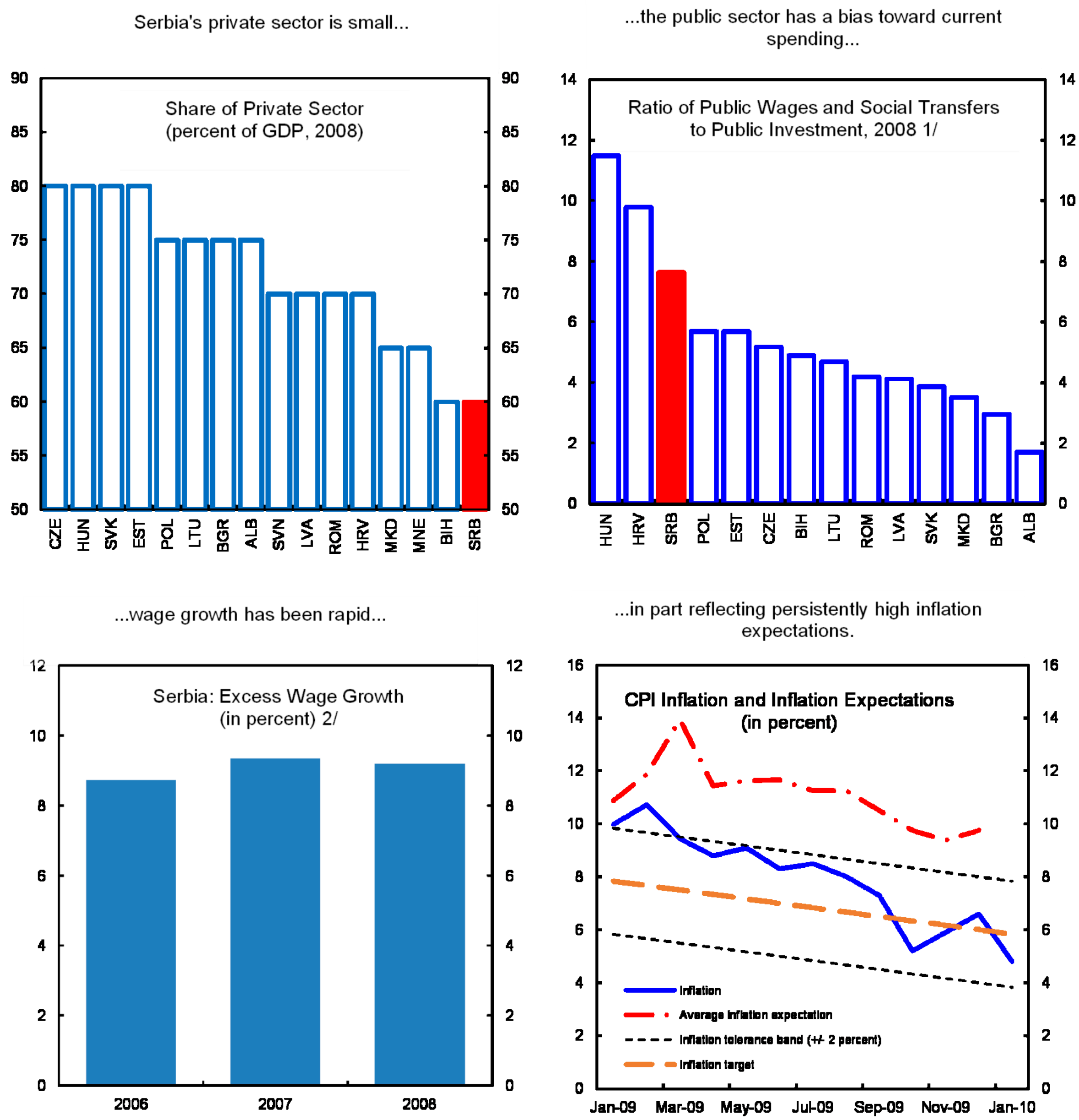


Source: WEO.

1/ Tradable sectors defined as agriculture, mining, manufacturing, and tourism. Nontradable sectors defined as including all other services, utilities, and construction.

2/ Excluding cross-border loans to Serbian corporates; including cross-border loans, loan euroization would amount to about 83 percent.

Figure 2. Eastern Europe: Adverse Fundamentals Underlying Unbalanced Growth, 2008-10

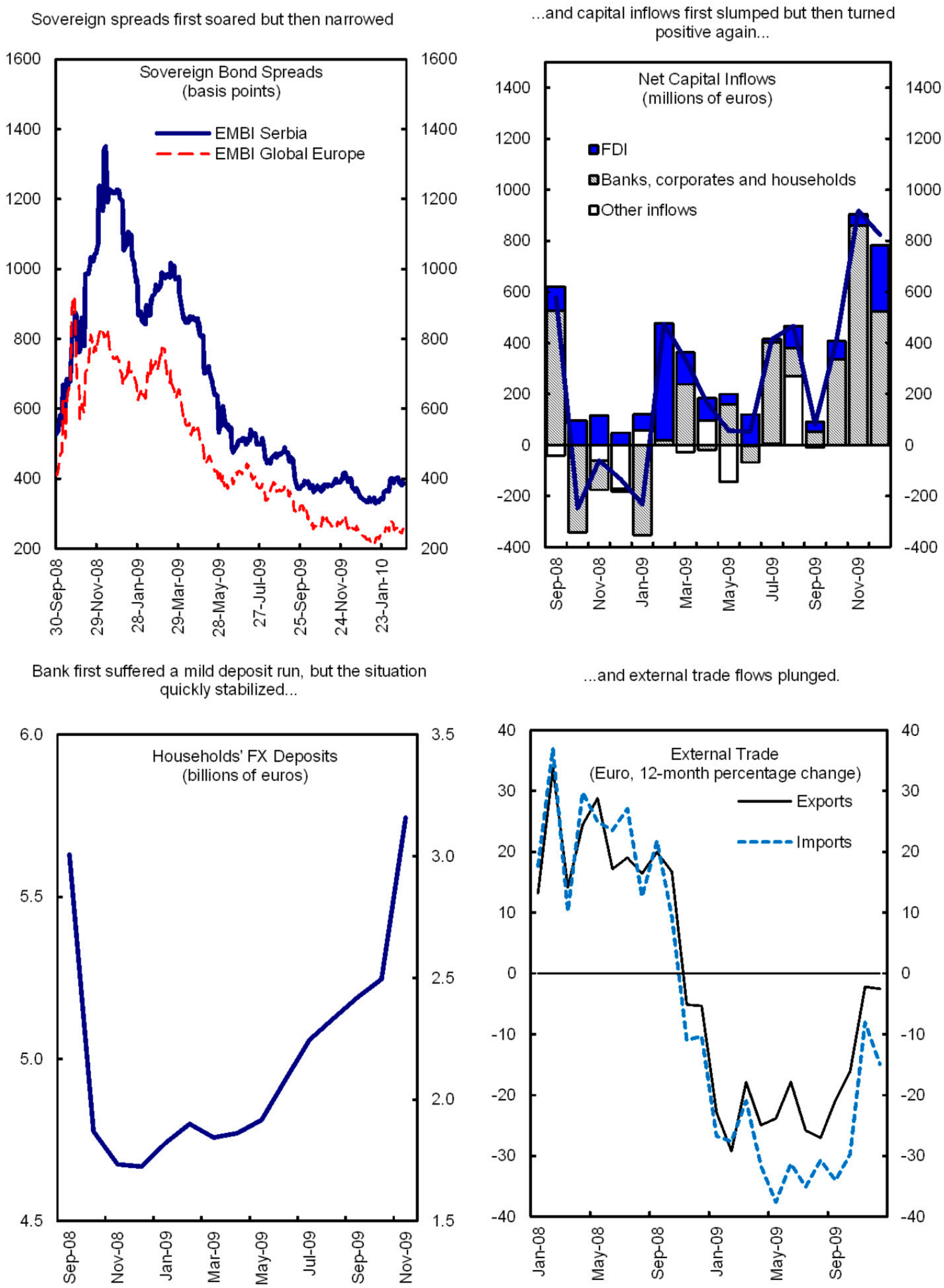


Sources: EBRD; National Bank of Serbia; Agency Strategic Marketing; and IMF staff calculations.

1/ Public investment may be understated in countries making significant use of public-private partnerships.

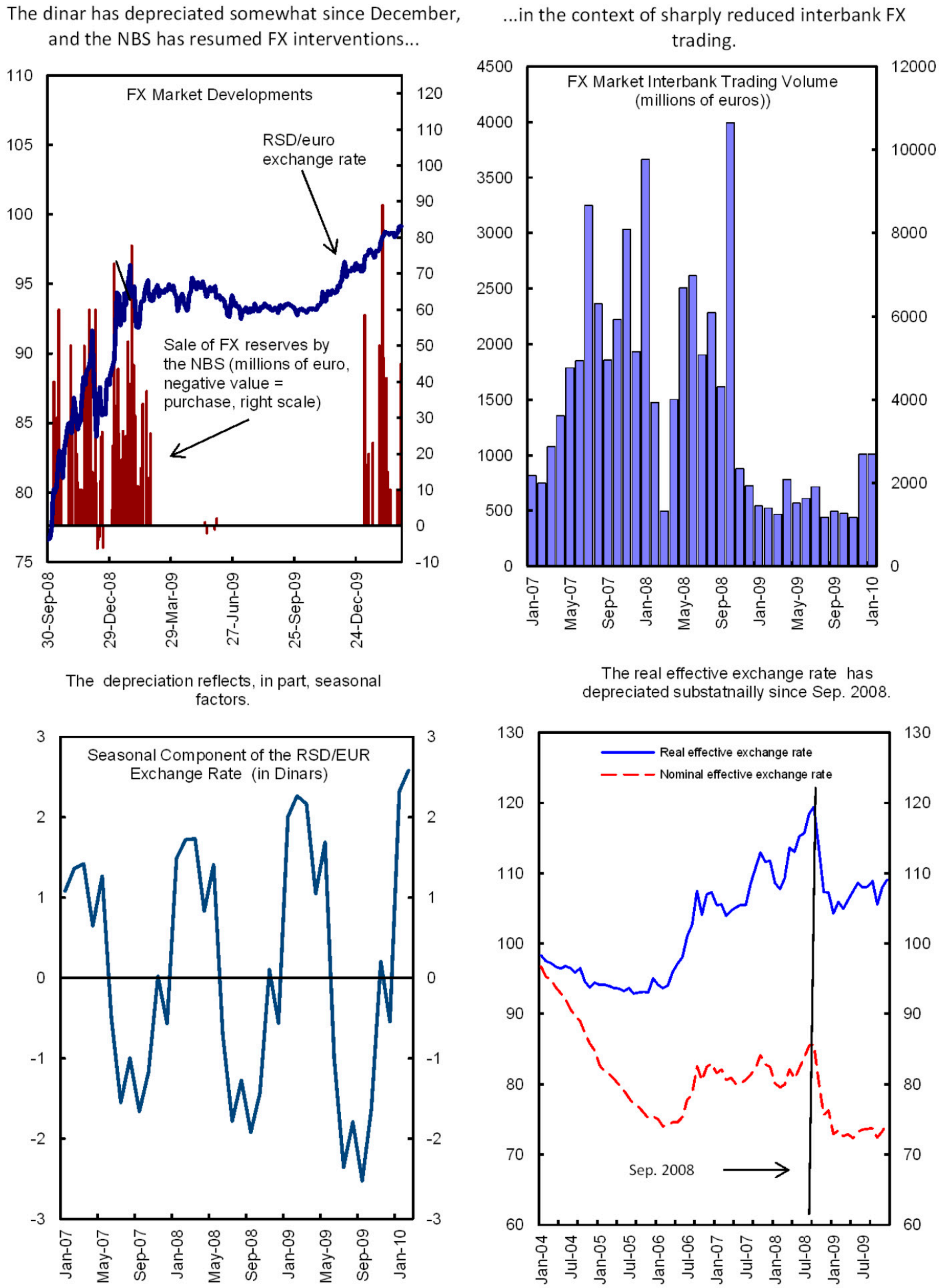
2/ Nominal wage growth minus targeted inflation rate minus productivity growth.

Figure 3. Serbia: Global Financial Crisis Spillovers 2008-10



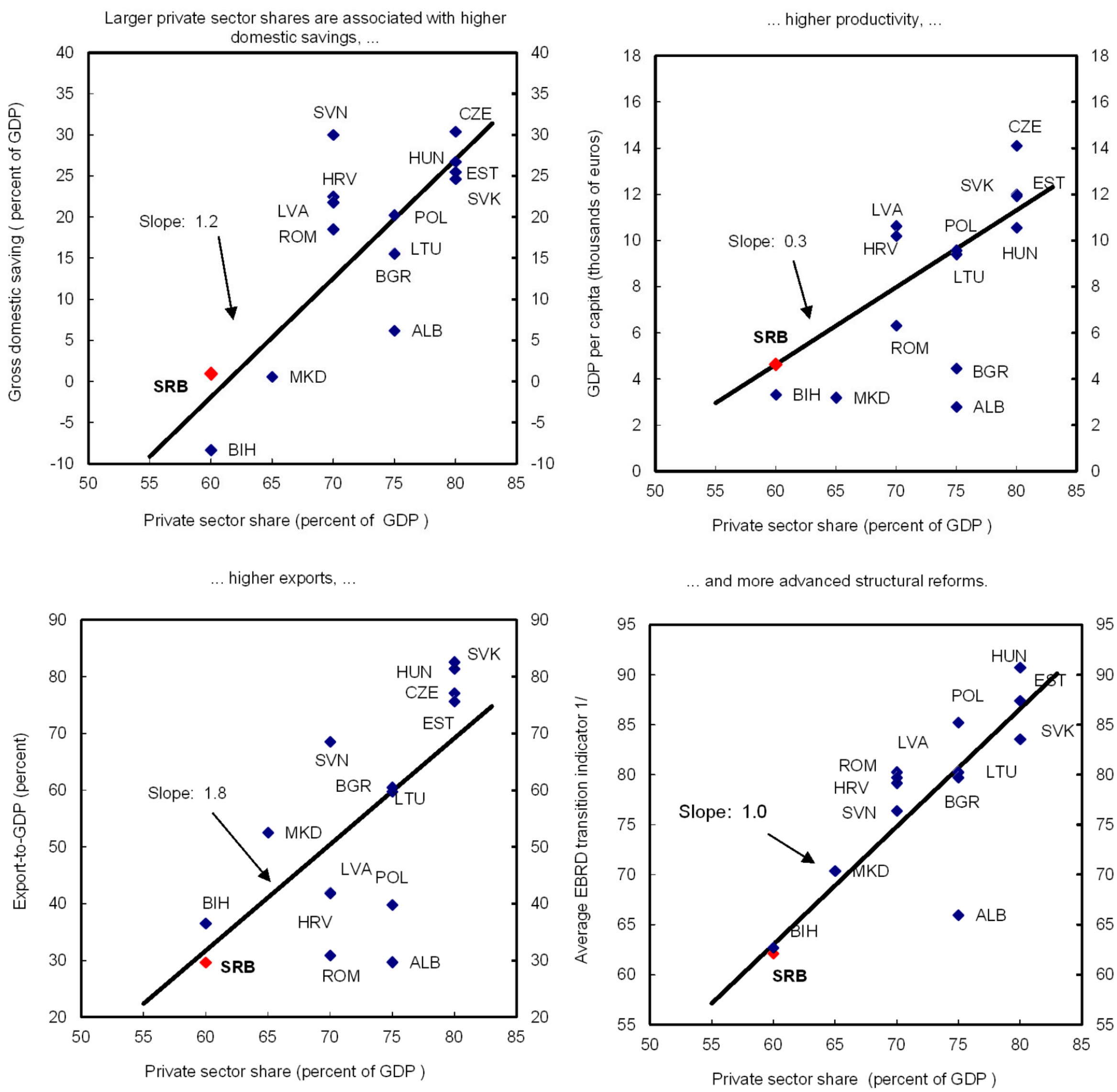
Sources: National Bank of Serbia; and Bloomberg.

Figure 4. Serbia: Exchange Rate Developments, 2004-10



Sources: National Bank of Serbia and the IMF's Information Notice System.

Figure 5. Eastern Europe: Private Sector Shares, Domestic Savings, Exports, and Structural Reforms, 2008



Sources: WEO; EBRD; World Bank; and IMF staff estimates.
1/ EBRD Transition Report 2009. Transition indicator scale was normalized to a range from 100 (highest) to 0 (lowest).

Table 1. Serbia: Quantitative Conditionality Under the SBA, 2008–10 1/

	2008		2009								2010		
	Dec.		March		June		Sept.		Dec.		March	June	Dec.
	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Prog.	Proj.
Quantitative Performance Criteria													
Floor on net foreign assets of the NBS (in billions of euro)	5.0	6.1	5.1	6.0	4.4	5.9	3.6	6.5	4.3	6.6	4.0	4.7	4.6
Ceiling on consolidated general government overall deficit (in billions of dinars) 2/	64	72	15	12	34	55	58	79	134	121	23	63	129
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) 2/	0	0	0	0	10	0	10	2	10	2	20	20	20
Ceiling on contracting or guaranteeing by the public sector of new nonconcessional external debt (over one year, in millions of euro) 2/ 3/	50	0	200	0	550	100	550	100	550	100	200	550	600
Ceiling on accumulation of government external payment arrears (continuous, in millions of euro)	0	0	0	0	0	0	0	0	0	0	0	0	0
Inflation Consultation Bands (in percent)													
Central point	10.0	8.6	9.2	9.4	8.0	8.3	9.5	7.3	7.5	6.6	5.4	4.0	6.0
Band, upper limit	12.0	n.a.	11.2	n.a.	10.0	n.a.	11.5	n.a.	9.5	n.a.	7.4	6.0	8.0
Band, lower limit	8.0	n.a.	7.2	n.a.	6.0	n.a.	7.5	n.a.	5.5	n.a.	3.4	2.0	4.0
Indicative Targets													
Ceiling on current expenditure of the Serbian Republican budget (in billions of dinars) 2/	635	633	190	152	335	331	520	506	695	689	182	370	729
Ceiling on gross accumulation of domestic guarantees by the Republican budget, the Guarantee Fund, and the Development Fund and domestic borrowing by the Guarantee and Development funds (in billions of dinars) 2/	n.a.	n.a.	n.a.	n.a.	50	7	50	15	50	15	13	25	50

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: Performance for Third Review

Measure	Target Date	Comment
Quantitative performance criteria		
1. Floor on net foreign assets of the NBS	December 2009	Observed
2. Ceiling on consolidated general government overall deficit	December 2009	Observed
3. Ceiling on contracting or guaranteeing by the public sector of new short-term external debt	December 2009	Observed
4. Ceiling on accumulation of government external payment arrears	December 2009	Observed
Indicative targets		
1. Ceiling on current expenditures of the Serbian Republican budget	December 2009	Observed
2. Ceiling on gross accumulation of domestic guarantees by the Republican budget, the Guarantee Fund, and the Development Fund and domestic borrowing by the Guarantee and Development Funds	December 2009	Observed
Inflation consultation clause	December 2009	Observed
Structural benchmarks		
1. Government to submit to parliament a draft pension reform law including measures as specified in TMU (¶20).	February 2010	Postponed to May 2010
2. Government to submit to parliament a draft Budget System and Responsibility Law, including supporting legislation (TMU ¶21).	April 2010	Postponed to May 2010
3. Authorities to adopt amendments to relevant credit enforcement laws and regulations strengthening the corporate debt restructuring framework (TMU ¶24).	March 2010	Postponed to September 2010
4. Authorities to adopt large state enterprises' business plans that conform to general government wage and employment policy in 2010 and ensure profit transfers to the state (TMU ¶19).	February 2010	Partially observed
Proposed new conditionality		
1. Risk management unit at tax administration to establish an integrated taxpayer compliance strategy (TMU ¶22).	July 2010	

Table 3. Serbia: Selected Economic and Social Indicators, 2006–11

	2006	2007	2008	2009		2010		2011
				2nd Rev.	Est.	2nd Rev.	Prog.	Proj.
	(Percent change, unless otherwise indicated)							
Output, prices, and labor market								
Real GDP	5.2	6.9	5.5	-3.0	-2.9	1.5	2.0	3.0
Real GDP excluding agricultural sector	6.0	8.8	5.2	-3.6	-3.4	1.4	2.0	3.1
Real domestic demand (absorption)	6.2	11.5	6.3	-8.0	-7.4	0.5	0.4	2.3
Consumer prices (average)	12.7	6.5	12.4	9.0	8.1	5.1	4.8	4.8
Consumer prices (end of period)	6.6	11.0	8.6	7.5	6.6	6.5	6.0	4.5
Nominal gross wage	24.4	21.9	17.8	5.0	4.1	5.7	4.8	6.7
Real net wage	10.6	19.9	4.9	-3.7	-3.7	0.6	0.0	1.8
Average net wage (in euros per month)	260	348	402	…	372	…	…	…
Net wage in euro	23.3	33.9	15.8	…	-7.7	…	…	…
Registered employment	-1.4	0.1	2.3	…	-4.6	…	-1.2	-0.4
Unemployment rate (in percent)	21.6	18.8	14.7	…	17.4	…	…	…
Nominal GDP (in billions of dinars)	1,980	2,363	2,751	2,974	2,899	3,230	3,139	3,388
	(Percent of GDP)							
General government finances								
Revenue	43.8	42.4	41.4	38.3	39.6	37.4	38.4	38.0
Expenditure	45.4	44.2	44.0	42.8	43.7	41.4	42.5	41.0
Current	40.8	39.0	39.6	39.1	39.8	37.0	38.2	36.5
Capital and net lending	4.6	5.2	4.5	3.7	3.9	4.4	4.3	4.5
Fiscal balance (cash basis)	-1.6	-1.9	-2.6	-4.5	-4.2	-4.0	-4.1	-3.0
Structural fiscal balance 1/	-2.3	-3.6	-4.6	-4.1	-3.5	-4.3	-4.4	-3.5
Gross debt	42.6	34.3	33.1	31.4	36.4	32.9	36.0	36.5
	(End of period 12-month change, percent)							
Monetary sector								
Money (M1)	37.1	25.3	-3.8	-9.7	8.7	11.7	14.5	14.1
Broad money (M2)	38.4	44.5	9.6	7.2	21.8	9.8	10.7	13.6
Domestic credit to non-government	17.1	36.9	35.0	10.0	15.9	11.9	16.0	23.2
	(End of period, percent)							
Interest rates (dinar)								
NBS repo rate	14.0	10.0	17.8	…	9.5	…	…	…
Deposit rate	5.1	4.1	6.4	…	5.1	…	…	…
	(Percent of GDP, unless otherwise indicated)							
Balance of payments								
Current account balance	-10.1	-15.5	-17.1	-7.2	-5.7	-9.3	-8.5	-9.1
Exports of goods	21.8	21.6	22.0	18.7	19.4	18.3	19.8	21.9
Imports of goods	42.9	44.1	44.6	33.4	34.9	32.8	34.5	36.9
Trade of goods balance	-21.2	-22.5	-22.3	-14.7	-15.5	-14.5	-14.7	-15.0
Capital and financial account balance	31.7	17.9	12.4	5.7	11.7	6.1	4.2	4.4
External debt	63.3	60.2	63.6	22.5	76.0	25.1	79.5	77.1
of which: Private external debt	36.0	39.5	45.0	45.8	51.7	44.2	48.5	45.6
Gross official reserves (in billions of euro)	8.7	9.5	8.2	9.0	10.6	9.8	11.3	10.2
(In months of prospective imports of GNFS)	6.6	6.3	7.7	7.3	9.6	8.1	9.2	7.4
(Percent of short-term debt)	294.5	268.4	438.3	188.7	207.7	190.1	217.9	190.0
Exchange rate (dinar/euro, period average)	84.2	80.0	81.5	…	93.9	…	…	…
REER (annual average change, in percent; + indicates appreciation)	6.6	7.2	6.4	-5.9	-7.1	2.6	-0.3	1.8
Social indicators								
Per capita GDP (2008): US$6,685. Population (2008): 7.4 million. Poverty rate (national poverty estimate, 2008): 6.1 percent.								

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

1/ Fiscal balance adjusted for the automatic effects of both the output gap and the current account gap.

Table 4. Serbia: Real GDP Growth Components, 2004–11
(Percent)

	2004	2005	2006	2007	2008	2009 Est.	2010 Proj.	2011 Proj.
	(Real growth rate by expenditure category)							
Gross Domestic Product (GDP)	8.3	5.6	5.2	6.9	5.5	-2.9	2.0	3.0
Domestic demand (absorption)	13.6	-3.8	6.2	11.5	6.3	-7.4	0.4	2.3
Non-government	17.4	-4.5	5.1	9.3	6.0	-7.5	1.1	3.1
Government	-0.6	-0.6	11.0	20.0	7.5	-6.8	-2.1	-0.8
Consumption	2.0	0.2	6.6	5.6	12.9	-2.7	-1.2	-0.3
Non-government	3.3	0.7	7.3	2.3	12.9	-2.0	-0.3	0.9
Government	-2.6	-1.5	4.2	18.3	13.1	-5.0	-4.2	-4.6
Investment	76.0	-16.3	4.6	33.8	-13.6	-25.8	8.6	14.3
Gross fixed capital formation	27.8	2.7	14.5	25.6	-8.3	-27.4	9.7	16.1
Non-government	29.6	2.1	7.3	25.1	-6.4	-29.7	9.2	14.8
Government	17.2	6.4	58.8	28.0	-16.2	-17.3	11.9	20.8
Change in inventories 1/	9.6	-5.5	-1.7	2.7	-2.0	-0.4	0.1	0.1
Net exports of goods and services 1/	-8.0	10.4	-1.9	-6.3	-2.0	6.1	1.5	0.4
Exports of goods and services	5.7	14.4	4.9	17.2	8.9	-11.0	6.5	14.1
Imports of goods and services	21.0	-13.6	7.8	26.0	9.4	-18.3	0.6	8.5
	(Contribution to real growth by expenditure category)							
Gross Domestic Product (GDP)	8.3	5.6	5.2	6.9	5.5	-2.9	2.0	3.0
Domestic demand (absorption)	16.3	-4.7	7.1	13.2	7.6	-8.9	0.4	2.6
Non-government	16.4	-4.6	4.7	8.6	5.6	-7.1	1.0	2.8
Government	-0.2	-0.1	2.4	4.6	2.0	-1.8	-0.5	-0.2
Consumption	2.0	0.2	6.0	5.1	11.7	-2.6	-1.2	-0.3
Non-government	2.6	0.6	5.2	1.6	8.9	-1.4	-0.2	0.6
Government	-0.6	-0.3	0.8	3.5	2.8	-1.1	-0.9	-1.0
Investment	14.3	-5.0	1.1	8.1	-4.1	-6.4	1.6	2.9
Gross fixed capital formation	4.7	0.5	2.8	5.4	-2.1	-5.9	1.6	2.8
Non-government	4.3	0.4	1.2	4.3	-1.3	-5.2	1.2	2.0
Government	0.4	0.2	1.6	1.2	-0.8	-0.7	0.4	0.8
Change in inventories	9.6	-5.5	-1.7	2.7	-2.0	-0.4	0.1	0.1
Net exports of goods and services	-8.0	10.4	-1.9	-6.3	-2.0	6.1	1.5	0.4
Exports of goods and services	1.4	3.6	1.3	4.6	2.6	-3.3	1.8	4.1
Imports of goods and services	9.4	-6.8	3.2	10.9	4.6	-9.4	0.3	3.6
	(Contribution to real GDP growth by production category)							
Gross Domestic Product (GDP)	8.3	5.6	5.2	6.9	5.5	-2.9	2.0	3.0
Gross Value-Added	7.0	4.3	5.4	5.6	5.2	-1.8	1.4	2.6
Agriculture	2.3	-0.7	0.0	-0.9	0.8	0.3	0.0	0.2
Industry	1.3	0.2	0.9	0.8	0.3	-2.0	0.5	0.5
Services	4.7	6.1	4.3	7.0	4.4	-1.1	1.5	2.3
Wholesale and retail trade	1.3	1.9	1.0	2.0	0.8	-1.0	-0.1	0.4
Construction	0.1	0.1	0.2	0.3	0.1	-0.5	0.1	0.1
Transport and communications	1.2	1.9	2.8	2.4	1.7	0.8	0.6	0.5
Financial services	0.2	0.4	0.4	0.6	0.5	0.2	0.1	0.1
Other	0.5	0.5	0.1	0.4	1.0	0.4	0.2	0.8
Taxes minus subsidies	1.5	1.7	0.0	1.5	0.6	-0.8	0.4	0.5
Memorandum items:								
Tradables GDP	4.2	0.1	0.9	0.4	1.3	-2.0	0.6	0.8
Non-tradables GDP	4.1	5.5	4.3	6.5	4.2	-0.9	1.4	2.2

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

1/ Contributions to GDP growth.

Table 5. Serbia: Savings-Investment Balances, 2004–15
(Percent of GDP)

	2004	2005	2006	2007	2008	2009 Est.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
Domestic demand	126.6	120.9	121.4	123.3	123.1	115.5	114.7	114.9	114.0	113.3	112.1	111.3
Consumption	96.8	97.2	97.6	94.7	99.4	97.4	95.5	93.5	91.1	89.5	88.1	87.0
Non-government	77.1	78.5	78.9	74.9	77.8	76.3	75.7	75.0	73.5	72.2	70.9	69.7
Government	19.8	18.7	18.7	19.8	21.6	21.1	19.7	18.4	17.6	17.3	17.3	17.3
Gross domestic savings	3.2	2.8	2.4	5.3	0.6	2.6	4.5	6.5	8.9	10.5	11.9	13.0
Non-government	0.1	-1.3	-0.8	2.0	-1.6	2.9	3.9	4.2	5.5	6.3	6.8	7.3
Government	3.1	4.1	3.2	3.3	2.2	-0.2	0.6	2.3	3.4	4.2	5.1	5.7
Net factor receipts and transfers	14.4	12.3	11.3	7.7	5.7	9.8	6.1	5.8	5.8	5.9	4.8	4.1
Non-government	15.2	13.1	12.0	8.2	6.2	10.1	6.8	6.7	6.6	6.7	5.6	4.7
Government	-0.8	-0.8	-0.8	-0.5	-0.4	-0.3	-0.7	-0.8	-0.8	-0.8	-0.7	-0.7
Gross national savings	17.6	15.0	13.6	13.0	6.3	12.4	10.7	12.4	14.7	16.5	16.7	17.1
Non-government	15.3	11.7	11.2	10.2	4.6	13.0	10.8	10.9	12.1	13.0	12.4	12.0
Government	2.3	3.3	2.4	2.8	1.8	-0.5	-0.1	1.4	2.6	3.4	4.4	5.0
Gross domestic investment	29.7	23.7	23.7	28.6	23.7	18.1	19.2	21.5	22.9	23.8	23.9	24.3
Non-government	27.1	21.0	19.7	24.0	20.0	14.9	15.7	17.3	18.0	18.5	18.2	18.5
Gross fixed capital formation	16.6	16.3	16.8	18.7	16.9	12.2	13.0	14.7	15.3	15.9	15.6	15.8
Change in inventories	10.5	4.7	2.9	5.2	3.0	2.7	2.7	2.7	2.7	2.7	2.7	2.7
# Government	2.6	2.7	4.1	4.6	3.8	3.2	3.5	4.1	4.9	5.3	5.7	5.8
Overall savings-investment balance	-12.1	-8.7	-10.1	-15.6	-17.4	-5.7	-8.5	-9.1	-8.2	-7.3	-7.2	-7.2
Non-government	-11.8	-9.3	-8.4	-13.8	-15.4	-1.9	-5.0	-6.4	-5.8	-5.5	-5.9	-6.5
Government	-0.3	0.6	-1.6	-1.8	-2.0	-3.7	-3.5	-2.7	-2.3	-1.8	-1.3	-0.8
Foreign savings	12.1	8.7	10.1	15.6	17.4	5.7	8.5	9.1	8.2	7.3	7.2	7.2
Memorandum items:												
Net exports of goods and services 1/	-26.6	-20.9	-21.4	-23.3	-23.1	-15.5	-14.7	-14.9	-14.0	-13.3	-12.1	-11.3
Current account balance	-12.1	-8.7	-10.1	-15.5	-17.1	-5.7	-8.5	-9.1	-8.2	-7.3	-7.2	-7.2
General government fiscal balance	0.0	0.8	-1.6	-1.9	-2.6	-4.2	-4.1	-3.0	-2.5	-2.0	-1.5	-0.9

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

1/ Equal to GDP minus domestic demand.

Table 6a. Serbia: General Government Fiscal Operations, 2008–2012 1/
(Billions of RSD)

	2008	2009		2010			2011	2012
		2nd Rev.	Act.	2nd Rev.	Budget	Rev. Prog.	Proj.	Proj.
Revenue	1,139	1,140	1,147	1,208	1,208	1,205	1,288	1,393
Taxes	999	999	1,000	1,060	1,061	1,053	1,135	1226
Personal income tax	136	134	133	141	142	138	148	159
Social security contributions	312	321	319	335	336	327	353	379
Taxes on profits	39	31	31	23	24	23	22	29
Value-added taxes	302	297	297	326	325	326	353	379
Excises	110	132	135	147	148	151	169	188
Taxes on international trade	65	47	48	44	44	45	44	42
Other taxes	36	37	37	44	43	43	47	51
Non-tax revenue	138	139	140	144	145	145	151	165
Capital revenue	0	0	0	0	0	0	0	0
Grants	1	2	6	5	2	6	2	2
Expenditure and net lending	1,211	1,274	1,268	1,337	1,344	1,334	1,389	1,487
Current expenditure	1,089	1,162	1,155	1,196	1,206	1,201	1,237	1295
Wages and salaries	293	306	302	301	313	308	313	327
Other goods and services	207	199	212	202	213	212	212	221
Interest	17	25	22	39	39	39	51	58
Subsidies	78	68	63	73	69	69	69	72
Transfers	493	564	556	580	572	572	591	618
Pensions	331	389	387	396	396	396	410	433
Other transfers 2/	162	174	168	184	176	176	181	185
Capital expenditure	103	92	92	111	111	109	140	183
Net lending	19	19	20	31	26	24	12	9
Fiscal balance (cash basis)	-72	-134	-121.3	-129	-136	-129	-102	-93
Financing	71	134	121	129	...	129	102	93
Privatization proceeds	33	62	59	0	...	4	0	0
Domestic	61	11	22	72	...	70	87	82
Banks	55	-39	-60	64	...	13	71	68
Central bank	...	-55	-60	45	...	-6	0	0
Commerical banks	...	16	0	19	...	19	71	68
Non-bank	6	50	82	8	...	57	16	14
External	-23	60	40	57	...	54	15	11
Program	...	62	42	67	...	64	22	22
Project	...	12	11	17	...	17	18	20
Amortization	...	14	13	26	...	27	25	31
Memorandum item:								
Augmented fiscal balance 3/		-154	-142	-131	…	-131	-103	-95
Nominal GDP (billions of dinars)	2,751	2,974	2,899	3,230	3,230	3,139	3,388	3,710

Sources: Ministry of Finance; and IMF 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.
3/ Including clearance of arrears of the Road Company.

Table 6b. Serbia: General Government Fiscal Operations, 2008–2012 1/
(Percent of GDP)

	2008	2009		2010			2011	2012
		2nd Rev.	Act.	2nd Rev.	Budget	Rev. Prog.	Proj.	Proj.
Revenue	**41.4**	**38.3**	**39.6**	**37.4**	**38.5**	**38.4**	**38.0**	**37.6**
Taxes	36.3	33.6	34.5	32.8	33.8	33.6	33.5	33.1
Personal income tax	5.0	4.5	4.6	4.4	4.5	4.4	4.4	4.3
Social security contributions	11.3	10.8	11.0	10.4	10.7	10.4	10.4	10.2
Taxes on profits	1.4	1.0	1.1	0.7	0.7	0.7	0.6	0.8
Value-added taxes	11.0	10.0	10.2	10.1	10.4	10.4	10.4	10.2
Excises	4.0	4.4	4.6	4.6	4.7	4.8	5.0	5.1
Taxes on international trade	2.4	1.6	1.7	1.4	1.4	1.4	1.3	1.1
Other taxes	1.3	1.3	1.3	1.4	1.4	1.4	1.4	1.4
Non-tax revenue	5.0	4.7	4.8	4.4	4.6	4.6	4.5	4.5
Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants	0.1	0.1	0.2	0.1	0.1	0.2	0.0	0.0
Expenditure	**44.0**	**42.8**	**43.7**	**41.4**	**42.8**	**42.5**	**41.0**	**40.1**
Current expenditure	39.6	39.1	39.8	37.0	38.4	38.2	36.5	34.9
Wages and salaries	10.7	10.3	10.4	9.3	10.0	9.8	9.2	8.8
Other goods and services	7.5	6.7	7.3	6.3	6.8	6.8	6.3	6.0
Interest	0.6	0.8	0.8	1.2	1.2	1.2	1.5	1.6
Subsidies	2.8	2.3	2.2	2.3	2.2	2.2	2.0	1.9
Transfers	17.9	18.9	19.2	18.0	18.2	18.2	17.5	16.6
Pensions	12.0	13.1	13.4	12.3	12.6	12.6	12.1	11.7
Other transfers 2/	5.9	5.9	5.8	5.7	5.6	5.6	5.3	5.0
Capital expenditure	3.8	3.1	3.2	3.4	3.5	3.5	4.1	4.9
Net lending	0.7	0.6	0.7	1.0	0.8	0.8	0.4	0.2
Fiscal balance (cash basis)	**-2.6**	**-4.5**	**-4.2**	**-4.0**	**-4.3**	**-4.1**	**-3.0**	**-2.5**
Financing	**2.6**	**4.5**	...	**4.0**	...	**4.1**	**3.0**	**2.5**
Privatization proceeds	1.2	2.1	...	0.0	...	0.1	0.0	0.0
Domestic	2.2	0.4	...	2.2	...	2.2	2.6	2.2
Banks	2.0	-1.3	...	2.0	...	0.4	2.1	1.8
Central bank	...	-1.9	...	1.4	...	-0.2	0.0	0.0
Commerical banks	...	0.5	...	0.6	...	0.6	2.1	1.8
Non-bank	0.2	1.7	...	0.2	...	1.8	0.5	0.4
External	-0.8	2.0	...	1.8	...	1.7	0.4	0.3
Program	...	2.1	...	2.1	...	2.0	0.6	0.6
Project	...	0.4	...	0.5	...	0.5	0.5	0.5
Amortization	...	0.5	...	0.8	...	0.9	0.7	0.8
Memorandum items:								
Structural fiscal balance 3/	-4.6	-4.0	-3.5	-4.2	…	-4.4	-3.5	-2.9
Absorption gap 4/	11.3	1.0	-0.5	3.2	…	2.5	3.1	2.2
Output gap 5/	0.8	-2.6	-2.5	-1.1	…	-0.5	0.0	0.0
External gap	10.5	3.6	2.0	4.3	…	3.0	3.1	2.2
Augmented fiscal balance 6/	...	-5.2	-4.9	-4.0	…	-4.2	-3.0	-2.6
Gross debt	33.1	31.5	36.4	32.9	…	36.0	36.5	35.0
Nominal GDP (billions of dinars)	2,751	2,974	2,899	3,230	3,230	3,139	3,388	3,710

Sources: Ministry of Finance; and IMF 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 (internal imbalance) and the current account gap (external imbalance) on the fiscal position.
4/ Percentage deviation between actual absorption and the level consistent with internal and external balance.
5/ Percentage deviation of actual from potential GDP.
6/ Including clearance of arrears of the Road Company.

Serbia 6c: Intergovernmental Fiscal Operations, 2010 Program
(Billions of dinars)

	Gen. Gov.	Republican budget	Own budgets	Local govs. 1/	Road company	Social security Funds	Pension fund	Health fund	Labor fund	Netting Operations
Revenue	1,205	662	32	146	33	388	244	128	16	-56
Current revenue	1,199	657	31	146	33	388	244	128	16	-56
Tax revenue	1,053	613		97	16	383	242	126	15	-56
Personal income tax	138	74		64						
Social security contributions	327			0		383	242	126	15	-56
Corporate income tax	23	22		1						
VAT	326	326								
Excises	151	135			16					
Taxes on international trade	45	45								
Other taxes	43	11		32						
Nontax revenue	145	44	31	49	17	5	3	2	0	
Capital revenue	0	0	0	0	0	0	0	0	0	
Grants	6	5	1	0	0	0	0			
Expenditure and net lending	1,390	465	32	223	36	635	422	184	29	-56
Current expenditure	1,257	406	26	171	21	633	421	183	29	-56
Wages and salaries	308	152	8	56	1	91	3	86	2	
Employer contribution	0	28	2	10	0	16	1	15	0	-56
Goods and services	212	48	14	53	18	80	3	76	1	
Interest payment	39	35	0	2	2	0	0	0	0	
Subsidies and transfers	493	43	2	24		424	396	6	22	
Transfers to households	148	100	0	26		22	18	1	4	
Capital expenditure	109	37	6	50	15	2	1	1	0	
Own resource	90	28	6	44	10	2	0	1	0	
Foreign financed	19	9		6	5					
Net lending	24	22		2		0	0	0	0	
Fiscal balance (before transfers)	-185	196	0	-77	-2	-247	-178	-56	-13	0
Transfers from other levels of government	365	0	0	57	0	307	227	54	26	0
Republican budget	301			57	0	244	218	0	26	
Local governments and Vojvodina	0	0	0	0	0	0				
Social security funds	64					64				
Transfers to other levels of government	365	301	0	0	0	64	50	1	13	0
Republican budget	0					0		0		
Local governments and Vojvodina	57	57				0				
Social security funds	307	244	0	0	0	64				
Net transfer to other levels of government	0	-301	0	57	0	244	178	53	13	0
Fiscal balance	-129	-104	0	-19	-2	-3	0	-3	0	0

Source: Ministry of Finance; and IMF staff estimates.
1/ Including Vojvodina.

Table 7. Serbia: Banking Sector Financial Soundness Indicators, 2005-09

	2005	2006	2007	2008	2009	
					June	December
Capital Adequacy						
Regulatory capital to risk-weighted assets	26.0	24.7	27.9	21.9	21.2	21.3
Regulatory tier I capital to risk-weighted assets	22.2	24.2	28.5	22.8	23.7	24.2
Capital to assets	16.2	18.5	21.0	23.6	23.3	21.0
Asset Composition and Quality						
Sectoral distribution of loans to total loans	...	...	100.0	100.0	100.0	100.0
Agriculture	...	...	...	3.0	2.9	2.7
Industry	...	...	...	17.2	18.0	17.9
Trade	...	...	...	17.2	18.5	18.3
Construction	...	...	...	5.9	5.9	5.9
Other			...	8.5	10.6	10.8
Households	...	...	35.1	32.7	33.4	32.7
Of which: Mortgage loans	...	...	10.4	15.0	15.6	15.6
Other	...	...	64.9	15.3	10.6	11.7
Gross non performing loans to total loans	...	...	...	11.3	16.5	15.5
Specific provisions to gross non-performing loans	...	...	...	56.9	46.6	49.5
Non performing loans net of provisions to tier I capital	...	...	...	14.8	27.1	25.5
Loans to shareholders and parent companies to total loans	...	...	2.1	2.2	2.2	...
Large exposures to tier I capital	82.5	49.6	46.1	36.6	40.7	...
Specific provisions to gross loans	10.3	11.0	8.4	7.1	9.4	9.2
Profitability						
Return on average assets (ROAA)	1.1	1.7	1.7	2.1	1.0	1.3
Return on average equity (ROAE)	6.5	9.7	8.5	9.3	4.1	5.7
Net interest margin to gross operating income 1/	…	…	…	…	61.8	62.6
Non-interest expenses to gross operating income 2/	…	…	…	…	88.9	84.5
Non-interest expenses to average assets	…	…	…	…	7.7	6.9
Personnel expenses to non-interest expenses	…	…	…	…	27.7	28.7
Liquidity						
Core liquid assets to total assets 3/	30.5	40.7	37.3	30.3	30.3	31.9
Core liquid assets to short-term liabilities	47.1	69.0	58.9	48.0	47.9	49.0
Liquid assets to total assets 4/	19.8	22.9	46.7	43.3	41.8	40.7
Liquid assets to short term liabilities	30.6	38.8	73.7	68.6	66.0	62.6
FX-denominated loans and FX-indexed loans to total loans	...	...	...	78.0	80.7	84.1
FX- deposits to total deposits	70.7	65.9	64.2	69.0	70.1	75.5
FX- liabilities to total liabilities	74.7	72.4	67.8	72.1	82.0	75.9
Deposits to assets	62.5	57.0	61.4	57.7	59.2	60.0
Loans to deposits	94.9	86.7	89.3	104.3	100.3	92.5
FX- loans to FX-deposits (including indexed)	…	…	…	113.3	110.7	103.1
Sensitivity to Market Risk						
Net open FX position (overall) as percent of tier I capital	18.6	21.7	14.5	7.4	4.4	3.2
Off-balance sheet operations as percent of assets 5/	26.4	41.0	49.2	56.2	49.1	45.9

Source: National Bank of Serbia.

1/ Gross operating income in this ratio excludes FX gains due to their volatility and distortionary impact.

2/ Non-interest expenses in the calculation of this ratio abstracts from FX losses.

3/ Cash, repos, t-bills, and mandatory reserves.

4/ Sum of first- and second-degree liquid receivables of the bank.

5/ Includes only risk-classified off-balance sheet items.

Table 8. Serbia: Balance of Payments, 2008-15 1/

	2008	2009 2nd Rev.	2009 Est.	2010 2nd Rev.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
					(Billions of euros)					
Current account balance	-5.9	-2.3	-1.7	-3.1	-2.7	-3.1	-3.0	-2.9	-3.2	-3.5
Trade of goods balance	-7.6	-4.6	-4.8	-4.9	-4.7	-5.1	-5.1	-5.3	-5.3	-5.4
Exports of goods	7.4	5.9	6.0	6.2	6.3	7.4	8.9	10.8	13.0	15.1
Imports of goods	-15.0	-10.6	-10.8	-11.1	-11.0	-12.5	-14.0	-16.1	-18.3	-20.5
Services balance	-0.2	-0.1	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Income balance	-0.9	-0.8	-0.5	-1.0	-0.9	-0.9	-0.8	-0.8	-1.2	-1.5
Current transfer balance	2.9	3.3	3.5	2.9	2.9	2.9	2.9	3.2	3.3	3.4
Capital and financial account balance	4.2	1.8	3.6	2.1	1.3	1.5	2.4	5.1	5.9	5.5
Capital transfer balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment balance	1.8	1.2	1.4	1.2	1.4	1.4	1.5	2.6	3.4	3.6
Portfolio investment balance	-0.1	-0.1	-0.1	-0.1	-0.1	-0.3	-0.2	-0.2	-0.1	-0.1
Other investment balance	2.5	0.7	2.3	1.0	0.0	0.4	1.1	2.7	2.5	1.9
General governement	0.1	0.6	0.7	0.3	0.3	0.3	0.3	0.3	0.3	0.4
Domestic banks	0.5	0.8	2.0	0.2	0.0	-0.1	0.4	0.2	0.4	0.2
Other private sector	2.0	-0.7	-0.4	0.6	-0.3	0.2	0.5	2.2	1.8	1.4
Errors and omissions	0.0	0.0	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-1.6	-0.5	1.9	-1.1	-1.4	-1.6	-0.6	2.2	2.7	2.0
Financing	1.8	0.5	-1.2	1.1	1.4	1.6	0.6	-2.2	-2.7	-2.0
Gross international reserves (increase, -)	1.8	-0.9	-2.4	-0.8	-0.7	1.2	0.8	-1.3	-1.4	-1.4
Prospective drawings	…	1.3	1.1	1.9	2.1	0.4	…	…	…	…
EU	…	0.1	0.0	0.3	0.2	…	…	…	…	…
World Bank	…	0.1	0.0	0.1	0.3	…	…	…	…	…
IMF	…	1.1	1.1	1.6	1.6	0.4	0.0	0.0	0.0	
Prospective repayments (IMF)	…	…	…	…	…	…	-0.2	-0.9	-1.3	-0.6
					(Percent of GDP)					
Current account balance	-17.1	-7.2	-5.7	-9.3	-8.5	-9.1	-8.2	-7.3	-7.2	-7.2
Trade of goods balance	-22.3	-14.7	-15.5	-14.5	-14.7	-15.0	-14.0	-13.3	-12.1	-11.3
Exports of goods	21.6	18.7	19.4	18.3	19.8	21.9	24.4	26.9	29.5	31.4
Imports of goods	-43.9	-33.4	-34.9	-32.8	-34.5	-36.9	-38.4	-40.2	-41.6	-42.6
Services balance	-0.5	-0.4	0.1	-0.6	0.0	0.0	0.0	0.0	0.0	0.0
Income balance	-2.7	-2.5	-1.6	-2.8	-3.0	-2.8	-2.2	-2.1	-2.7	-3.0
Current transfer balance	8.3	10.4	11.4	8.6	9.1	8.6	8.0	8.0	7.5	7.1
Capital and financial account balance	12.4	5.7	11.7	6.1	4.2	4.4	6.6	12.8	13.4	11.3
Capital transfers balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment balance	5.3	3.7	4.4	3.4	4.4	4.1	4.1	6.5	7.7	7.5
Portfolio investment balance	-0.3	-0.2	-0.2	-0.4	-0.3	-0.8	-0.7	-0.5	-0.1	-0.1
Other investment balance	7.3	2.3	7.5	3.1	0.1	1.1	3.1	6.8	5.8	4.0
Errors and omissions	0.0	0.0	-2.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-4.8	-1.4	6.1	-3.2	-4.3	-4.7	-1.6	5.4	6.1	4.2
					(Percent, unless otherwise indicated)					
Memorandum items:										
Export volume growth	8.9	-11.6	-11.0	3.8	6.5	14.1	19.2	20.4	19.9	15.8
Import volume growth	9.4	-19.9	-18.3	0.4	0.6	8.5	10.2	13.4	12.1	11.3
Export prices growth	6.7	-9.6	-9.4	0.7	-0.3	2.4	0.6	0.5	0.6	0.4
Import prices growth	5.7	-12.2	-12.5	4.6	2.0	4.1	1.8	1.4	1.5	0.8
Change in terms of trade	1.0	3.0	3.5	-3.7	-2.2	-1.7	-1.1	-0.8	-0.9	-0.3
GDP (billiions of euros)	34.3	31.7	30.8	33.9	32.0	33.8	36.4	40.0	43.9	48.1

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.

2/ Includes SDR allocations.

Table 9. Serbia: External Financing Requirements and Sources, 2008-15

(Billions of euros, unless otherwise indicated)

	2008	2009 2nd Rev.	2009 Est.	2010 2nd Rev.	2010 Prog.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
1. Gross financing requirements	9.49	7.94	8.36	8.73	8.54	7.11	7.74	11.09	12.58	13.22
Current account deficit	5.88	2.27	1.74	3.15	2.72	3.08	2.97	2.94	3.18	3.45
Debt amortization	3.62	4.79	4.25	4.79	5.12	5.20	5.35	5.98	6.70	7.76
Medium- and long-term debt	2.67	2.78	2.65	3.03	3.51	3.60	3.74	4.37	5.09	6.15
Public sector 1/	0.12	0.15	0.14	0.26	0.25	0.29	0.30	0.36	0.37	0.39
Commercial banks	0.54	0.12	0.12	0.20	0.21	0.35	0.37	0.67	0.69	1.01
Corporate sector	2.01	2.51	2.39	2.56	3.06	2.96	3.07	3.34	4.03	4.75
Short-term debt 2/	0.94	2.01	1.61	1.76	1.61	1.61	1.61	1.61	1.61	1.61
Commercial banks	…	1.32	1.17	1.32	1.17	1.17	1.17	1.17	1.17	1.17
Corporate sector	…	0.69	0.44	0.44	0.44	0.44	0.44	0.44	0.44	0.44
Accumulation of gross reserves	0.00	0.88	2.36	0.80	0.70	-1.18	-0.78	1.32	1.45	1.36
Repayment of prospective IMF credits	...	...	...	...	...	...	0.20	0.85	1.25	0.64
2. Available financing	9.49	6.61	7.15	6.85	6.44	6.70	7.74	11.09	12.58	13.22
Capital transfers	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Foreign direct investment (net)	1.81	1.16	1.37	1.16	1.40	1.39	1.49	2.60	3.40	3.60
Portfolio investment (net)	-0.09	-0.06	-0.06	-0.12	-0.11	-0.26	-0.25	-0.20	-0.06	-0.06
Debt financing	5.53	4.14	4.75	5.52	5.05	5.45	6.36	8.55	9.10	9.53
Medium- and long-term debt	4.86	2.38	3.14	3.76	3.44	3.84	4.75	6.94	7.49	7.92
Public sector 1/	0.18	0.33	0.39	0.55	0.60	0.60	0.61	0.68	0.68	0.75
Commercial banks	0.23	0.08	0.90	0.20	0.17	0.24	0.74	0.90	1.10	1.20
Corporate sector	4.46	1.97	1.85	3.00	2.67	3.00	3.40	5.36	5.71	5.97
Short-term debt 2/	0.67	1.76	1.61	1.76	1.61	1.61	1.61	1.61	1.61	1.61
Commercial banks	…	1.32	1.17	1.32	1.17	1.17	1.17	1.17	1.17	1.17
Corporate sector	…	0.44	0.44	0.44	0.44	0.44	0.44	0.44	0.44	0.44
Drawdown of gross reserves	1.61		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Other flows 3/	0.62	1.37	1.09	0.30	0.10	0.13	0.13	0.14	0.14	0.14
3. Financing gap	0.00	1.33	1.21	1.88	2.10	0.41	0.00	0.00	0.00	0.00
European Union (prospective)	…	0.05	0.05	0.25	0.20	…	…	…	…	…
World Bank (prospective)	…	0.15	0.04	0.07	0.30	…	…	…	…	…
IMF	…	1.14	1.12	1.56	1.60	0.41	…	…	…	…
Memorandum items:										
Debt service	4.35	5.58	4.89	5.79	6.19	6.31	6.40	7.04	7.81	8.93
Interest	0.73	0.78	0.64	1.01	1.07	1.11	1.05	1.07	1.11	1.17
Amortization	3.62	4.79	4.25	4.79	5.12	5.20	5.35	5.98	6.70	7.76

Sources: NBS; and Fund staff estimates and projections.

1/ Excluding IMF.
2/ Original maturity of less than 1 year. Stock at the end of the previous period.
3/ Includes all other net financial flows, SDR allocations, and errors and omissions.

Table 10. Serbia: External Balance Sheet, 2007-15 1/

	2008	2009 Est.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
				(Bllions of euros)				
International investment position 2/	**-25.8**	**-28.3**	**-31.0**	**-34.1**	**-37.1**	**-40.0**	**-43.2**	**-46.7**
Public sector 3/	1.4	2.8	1.0	-0.9	-1.8	0.1	2.5	4.1
Private sector 3/	-27.2	-31.1	-32.1	-33.3	-35.3	-40.1	-45.7	-50.8
FDI and portfolio investment (net) 4/	-12.4	-13.7	-15.0	-16.1	-17.3	-19.7	-23.1	-26.6
External debt (net) 4/	-22.2	-23.8	-25.8	-26.5	-27.3	-29.0	-30.1	-31.3
Gross external debt	**-21.8**	**-23.4**	**-25.4**	**-26.1**	**-26.9**	**-28.6**	**-29.7**	**-30.9**
General government	-6.4	-6.3	-6.6	-6.9	-7.2	-7.6	-7.9	-8.2
Private sector	-15.4	-15.9	-15.5	-15.4	-16.1	-18.4	-20.5	-21.9
Banks	-3.9	-5.2	-5.1	-5.0	-5.4	-5.6	-6.0	-6.2
Other private sector	-11.5	-10.8	-10.4	-10.4	-10.7	-12.8	-14.5	-15.7
Liabilities from prospective drawings from IFIs and the EU		-1.2	-3.3	-3.7	-3.5	-2.7	-1.4	-0.8
Gross external assets	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Other, net (inc. commercial banks foreign assets)	0.6	-1.5	-1.6	-1.7	-1.9	-2.0	-2.1	-2.3
Central bank gross international reserves	8.2	10.6	11.3	10.2	9.4	10.7	12.1	13.5
				(Percent of GDP)				
International investment position 2/	**-75.3**	**-91.8**	**-97.1**	**-100.8**	**-101.8**	**-100.0**	**-98.3**	**-97.0**
Public sector 3/	4.1	9.1	3.2	-2.5	-4.8	0.2	5.7	8.6
Private sector 3/	-79.4	-100.9	-100.3	-98.3	-97.0	-100.2	-104.0	-105.6
FDI and portfolio investment (net) 4/	-36.1	-44.4	-46.8	-47.5	-47.6	-49.3	-52.5	-55.3
External debt (net) 4/	-64.8	-77.2	-80.7	-78.2	-74.8	-72.4	-68.6	-65.0
Gross external debt	**-63.6**	**-76.0**	**-79.5**	**-77.1**	**-73.8**	**-71.4**	**-67.7**	**-64.2**
General government	-18.6	-20.3	-20.7	-20.5	-19.8	-18.9	-17.9	-17.1
Private sector	-45.0	-51.7	-48.5	-45.6	-44.3	-45.9	-46.6	-45.5
Banks	-11.4	-16.8	-16.0	-14.8	-14.8	-14.0	-13.7	-12.9
Other private sector	-33.6	-34.9	-32.4	-30.8	-29.5	-31.9	-32.9	-32.6
Liabilities from prospective drawings from IFIs and the EU		-3.9	-10.4	-11.0	-9.7	-6.7	-3.2	-1.6
Gross external assets	-1.1	-1.2	-1.2	-1.1	-1.1	-1.0	-0.9	-0.8
Other, net (inc. commercial banks reserves)	1.7	-4.8	-5.0	-5.1	-5.1	-5.0	-4.9	-4.8
Central bank gross international reserves	23.8	34.6	35.5	30.0	25.7	26.7	27.6	28.1
Memorandum items:								
				(Billions of euros, unless otherwise indicated)				
Central bank international reserves								
Gross reserves (months of next year's imports)	7.7	9.6	9.2	7.4	6.0	6.0	6.0	6.0
Free net reserves (months of next year's imports)	5.5	5.3	3.9	2.6	1.8	2.3	2.8	3.1
Short term external debt by original maturity due	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
(in percent of central bank gross reserves)	19.7	15.1	14.2	15.8	17.2	15.0	13.3	11.9
(percent of total debt)	7.4	6.9	6.3	6.2	6.0	5.6	5.4	5.2
(percent of GDP)	4.7	5.2	5.0	4.8	4.4	4.0	3.7	3.3
Short term external debt by remaining maturity	1.9	5.1	5.2	5.3	6.0	6.7	7.8	8.9
(percent of central bank gross reserves)	22.8	48.1	45.9	52.6	63.7	62.6	63.9	65.7
(percent of central bank free net reserves)	31.9	87.9	108.6	148.1	211.2	161.6	138.8	127.7
(percent of total debt)	8.5	21.9	20.5	20.5	22.2	23.4	26.1	28.8
(percent of GDP)	5.4	16.6	16.3	15.8	16.4	16.7	17.7	18.5
GDP	34.3	30.8	32.0	33.8	36.4	40.0	43.9	48.1

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

Table 11. Serbia: Rankings of Selected Competitiveness and Structural Indicators 1/

	Serbia		Best performers 2/				Distance 3/	
EBRD transition indicators	66	67		92		92	-27	-26
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	85	92		100		100	-15	-8
Competition policy	46	46		85		85	-39	-39
Banking reform	69	69		92		92	-23	-23
Non-bank financial institutions	46	46		92		92	-46	-46
Overall infrastructure reform	54	54		85		85	-31	-31
Transparency International								
Corruption Perception Index	34	35	Slovenia	67	Slovenia	66	-33	-31
World Bank Doing Business survey 4/	48	52	Estonia	88	Estonia	87	-40	-35
Starting a business	41	60	Macedonia	93	Macedonia	97	-52	-37
Dealing with licenses	6	5	Estonia	90	Estonia	89	-84	-84
Employing workers	50	49	Bulgaria	67	Czech Rep.	86	-18	-38
Registering property	46	43	Lithuania	98	Lithuania	98	-51	-55
Getting credit	85	98	Bulgaria	97	Serbia	98	-13	0
Protecting investors	61	60	Albania	92	Albania	92	-31	-32
Paying taxes	30	25	Macedonia	85	Macedonia	86	-55	-61
Trading across borders	66	62	Estonia	97	Estonia	98	-31	-36
Enforcing contracts	47	47	Latvia	98	Hungary	92	-51	-45
Closing a business	45	44	Lithuania	81	Lithuania	80	-36	-36

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 12. Serbia: Program and Alternative Scenarios, 2008–15

Program Macroframework (Balanced Growth)

	2008	2009 Prel.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
				(Percent)				
Real GDP	5.5	-2.9	2.0	3.0	5.0	5.5	5.5	5.0
Contribution of domestic demand	7.6	-8.9	0.4	2.6	3.4	4.4	3.4	3.6
Contribution of net exports	-2.0	6.1	1.5	0.4	1.6	1.1	2.1	1.4
Domestic demand	6.3	-7.4	0.4	2.3	3.0	4.0	3.1	3.4
Export volume	8.9	-11.0	6.5	14.1	19.2	20.4	19.9	15.8
Import volume	9.4	-18.3	0.6	8.5	10.2	13.4	12.1	11.3
CPI	12.4	8.1	4.8	4.8	4.3	4.3	4.0	4.0
REER (Index 2008 = 100)	100.0	92.9	92.6	94.3	95.7	98.3	100.7	103.0
Absorption gap	11.3	-0.5	2.5	3.1	2.2	1.3	1.0	0.6
Output gap	0.8	-2.5	-0.5	0.0	0.0	0.0	0.0	0.0
External gap	10.5	2.0	3.0	3.1	2.2	1.3	1.0	0.6
				(Percent of GDP)				
General government								
Overall balance	-2.6	-4.2	-4.1	-3.0	-2.5	-2.0	-1.5	-0.9
Revenues	41.4	39.6	38.4	38.0	37.6	37.6	37.8	38.1
Expenditures	44.0	43.7	42.5	41.0	40.1	39.6	39.3	39.1
Structural balance	-4.6	-3.5	-4.4	-3.5	-2.9	-2.3	-1.7	-1.1
Gross debt	33.1	36.4	36.0	36.5	35.0	32.7	30.3	28.8
Gross domestic investment	23.7	18.1	19.2	21.5	22.9	23.8	23.9	24.3
Gross domestic savings	0.6	2.6	4.5	6.5	8.9	10.5	11.9	13.0
Current account	-17.1	-5.7	-8.5	-9.1	-8.2	-7.3	-7.2	-7.2
Trade balance	-22.3	-15.5	-14.7	-15.0	-14.0	-13.3	-12.1	-11.3
External debt	63.6	76.0	79.5	77.1	73.8	71.4	67.7	64.2
Gross international reserves	24.2	34.6	35.5	30.0	25.7	26.7	27.6	28.1
(in months of next year's imports)	7.7	9.6	9.2	7.4	6.0	6.0	6.0	6.0
Net international investment position	-75.3	-91.8	-97.1	-100.8	-101.8	-100.0	-98.3	-97.0
Nominal wage growth (percent)	…	4.1	4.8	6.7	7.3	9.0	8.7	9.2
Wage bill (percent of GDP)	28.3	27.4	26.0	25.8	25.2	25.2	25.5	26.1
Average net wage (euros)	357	320	316	316	326	350	378	412

Alternative Macroframework (Absorption-Led Growth)

	2008	2009 Prel.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
				(Percent)				
Real GDP	5.5	-2.9	2.0	3.0	5.0	5.5	5.5	5.0
Contribution of domestic demand	7.6	-9.0	0.5	3.7	7.6	9.2	9.6	10.5
Contribution of net exports	-2.0	6.1	1.5	-0.7	-2.6	-3.7	-4.1	-5.5
Domestic demand	6.3	-7.4	0.4	3.2	6.6	7.9	8.1	8.7
Export volume	8.9	-11.0	6.5	9.3	10.6	11.2	11.1	8.8
Import volume	9.4	-18.3	0.6	7.9	13.1	15.1	15.1	15.2
CPI	12.4	8.1	4.8	7.0	9.0	10.0	10.0	10.0
REER (Index 2008 = 100)	100.0	92.9	92.6	96.3	100.8	106.8	113.2	120.5
Absorption gap	11.3	-0.5	2.5	3.5	4.7	6.8	9.4	11.9
Output gap	0.8	-2.5	-0.5	0.8	1.3	2.3	3.3	3.8
External gap	10.5	2.0	3.0	2.7	3.4	4.5	6.1	8.1
				(Percent of GDP)				
General government								
Overall balance	-2.6	-4.2	-3.8	-2.6	-1.6	-0.9	-0.5	0.3
Revenues	41.4	39.6	38.7	38.5	38.8	39.2	39.7	40.3
Expenditures	44.0	43.8	42.5	41.1	40.5	40.1	40.2	40.0
Structural balance	-4.6	-3.5	-4.1	-3.4	-2.7	-2.5	-2.8	-2.8
Gross debt	32.1	36.4	35.4	34.9	31.7	27.8	24.0	20.7
Gross domestic investment	23.7	18.1	18.4	18.9	19.8	20.2	20.3	21.0
Gross domestic savings	0.6	2.6	3.8	3.6	3.2	2.3	1.1	0.2
Current account	-17.1	-5.7	-8.5	-9.4	-10.6	-12.5	-15.2	-17.8
Trade balance	-22.3	-15.5	-14.7	-15.4	-16.6	-17.9	-19.2	-20.7
External debt	63.6	76.0	79.5	75.8	72.7	74.8	78.2	83.0
Gross international reserves	24.2	34.6	35.5	29.4	24.4	25.8	27.2	27.2
(in months of next year's imports)	7.7	9.6	9.2	7.2	5.8	6.0	6.0	6.0
Net international investment position	-75.3	-91.8	-97.1	-99.2	-99.6	-100.1	-103.1	-108.1
Nominal wage growth (percent)	…	4.2	5.5	9.5	14.0	16.1	16.1	15.5
Wage bill (percent of GDP)	30.8	29.8	28.5	28.4	28.8	29.2	29.8	30.6
Average net wage (euros)	357	320	319	331	364	414	475	547

Sources: IMF staff estimates and projections.

Tabie 13. Serbia: Monetary Survey, 2006–11
(Billions of dinars, unless otherwise indicated; end of period) 1/

	2006	2007	2008	2009 2nd Rev.	2009	2010 Q1 Proj.	2010 Q2 Proj.	2010 Q3 Proj.	2010 Q4 Proj.	2011 Proj.
Net foreign assets 2/	408	563	484	490	571	530	524	518	513	435
in billions of euro	5.2	7.1	5.5	5.2	5.9	5.4	5.3	5.3	5.2	4.3
Foreign assets	771	877	847	960	1,185	1,207	1,228	1,249	1,270	1,236
NBS	715	766	725	852	1,023	1,045	1,066	1,088	1,110	1,073
Commercial banks	56	111	123	108	163	162	161	161	160	163
Foreign liabilities (-)	-363	-314	-364	-470	-615	-677	-704	-730	-757	-801
NBS	-56	-14	-14	-88	-115	-178	-207	-235	-263	-297
Commercial banks	-308	-300	-350	-382	-500	-499	-497	-495	-493	-504
Net domestic assets	203	320	484	548	608	681	718	755	792	1,047
Domestic credit	481	701	1,048	1,193	1,276	1,351	1,445	1,477	1,551	1,820
Government, net	-104	-112	-53	-11	-4	-7	44	35	68	-14
NBS	-107	-100	-50	-107	-101	-115	-90	-111	-89	-89
Banks	2	-12	-4	95	97	108	134	146	157	75
Local governments, net	-19	-14	-16	-25	-14	-15	-15	-16	-18	-17
Non-government sector	604	827	1,117	1,229	1,295	1,373	1,416	1,459	1,502	1,850
Households	204	306	382	395	419	436	442	447	453	542
Enterprises	381	508	711	803	851	910	945	981	1,016	1,267
Other	19	13	23	31	25	27	29	31	33	41
Other assets	70	78	56	61	111	112	114	116	117	145
Capital and reserves (-)	-242	-356	-505	-556	-633	-625	-671	-656	-681	-672
NBS	-7	-7	-63	-111	-166	-148	-184	-159	-175	-158
Banks	-235	-350	-442	-445	-467	-477	-487	-497	-507	-514
Provisions (-)	-106	-104	-115	-150	-146	-158	-170	-182	-195	-245
Broad money (M2)	611	883	968	1,038	1,179	1,210	1,242	1,273	1,305	1,482
Dinar-denominated M2	255	370	371	367	412	427	443	459	475	549
M1	191	239	230	207	250	259	268	277	286	326
Currency in circulation	68	77	90	76	96	98	99	101	103	115
Demand deposits	122	162	140	131	154	161	169	176	182	211
Time and saving deposits	65	131	141	159	162	169	175	181	189	223
Foreign currency deposits	355	513	597	671	767	783	799	815	831	933
in billions of euro	4.5	6.5	6.7	7.6	8.1	8.1	8.2	8.3	8.5	9.2
Memorandum items:										
Twelve-month growth:										
M1	37.1	25.3	-3.8	-13.2	8.7	33.2	28.1	25.8	14.5	14.1
M2	38.4	44.5	9.6	17.6	21.8	24.1	21.5	20.9	10.7	13.6
Total credit to non-government	23.1	48.6	48.7	4.4	8.9	7.0	2.6	6.7	8.5	15.5
Domestic	17.1	36.9	35.0	10.0	15.9	10.0	11.2	12.7	16.0	23.2
Households	54.1	50.3	25.0	3.4	9.5	7.9	7.5	6.8	8.1	19.6
Enterprises	2.9	33.2	40.0	12.9	19.6	10.8	12.7	15.2	19.3	24.8
External	34.6	68.0	67.2	-1.7	1.2	3.3	-8.2	-0.8	-0.9	4.2
Total real credit to non-government	15.5	33.8	36.9	-2.9	2.2	1.6	-1.6	1.8	2.5	10.6
Domestic	9.8	23.3	24.3	2.3	8.8	4.5	6.7	7.5	9.6	17.9
Households	44.5	35.3	15.1	-3.8	2.8	2.5	3.1	1.9	7.2	14.4
Enterprises	-3.5	20.0	28.9	5.0	12.2	5.2	8.1	10.0	12.8	19.4
External	26.3	51.3	54.0	-8.6	-5.0	-1.9	-11.9	-5.4	-6.3	-0.3
Velocity (M1)	10.4	9.4	12.0	13.3	11.6	11.4	11.2	11.1	11.0	10.4
Velocity (M2)	3.3	2.5	2.8	2.7	2.5	2.4	2.4	2.4	2.4	2.3

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

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 14. Serbia: Balance Sheet of the NBS, 2006–11

(Billions of dinars, unless otherwise indicated; end of period) 1/

	2006	2007	2008	2009	2010				2011
					Q1	Q2	Q3	Q4	
					Proj.	Proj.	Proj.	Proj.	Proj.
Net foreign assets 2/	406	482	517	628	595	589	583	576	515
in billions of euro	5.1	6.1	5.8	6.6	7.5	6.6	6.1	5.9	5.1
Gross foreign reserves	715	766	725	1023	1045	1066	1088	1110	1073
Gross reserve liabilities (-)	-309	-284	-208	-394	-449	-477	-505	-533	-558
Net domestic assets	-272	-323	-208	-382	-365	-373	-381	-358	-310
Net domestic credit	-264	-316	-145	-216	-217	-189	-222	-184	-152
Government	-107	-100	-50	-101	-115	-90	-111	-89	-89
Claims	16	11	11	11	11	11	11	11	11
RSD	16	11	11	11	11	11	11	11	11
foreign currency	0	0	0	0	0	0	0	0	0
Liabilities (-)	-123	-111	-60	-112	-126	-102	-122	-100	-100
RSD	-20	-29	-20	-63	-63	-63	-63	-63	-63
foreign currency	-103	-82	-41	-49	-63	-39	-59	-37	-37
Other public sector	-10	-11	-15	-12	-13	-12	-12	-13	-11
Banks	-151	-218	-88	-151	-119	-126	-134	-149	-148
Claims	0	1	2	1	1	1	2	2	3
Liabilities (-)	-152	-219	-90	-152	-120	-128	-136	-152	-152
Other sectors	4	13	7	48	29	40	35	67	96
Capital accounts (-)	-7	-7	-63	-166	-148	-184	-159	-175	-158
Reserve money	134	159	309	247	230	216	201	218	205
Currency in circulation	68	77	90	96	98	99	101	103	115
Commercial bank reserves	65	82	219	151	132	117	100	114	90
Required reserves	34	30	165	112	115	100	86	71	40
Excess reserves	22	45	5	7	7	6	4	5	5
Vault cash and giro accounts	9	7	48	32	10	10	10	39	44

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

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 15. Serbia: Balance Sheet of Commercial Banks, 2006-09 1/
(Billions of dinars, unless otherwise indicated)

	2006	2007	2008		2009 Q4		
			Q3	Q4		Billions of euros	Percent of GDP
Assets	1,274	1,678	1,838	1,925	2,342	24.4	80.8
Foreign exchange	56	111	83	123	163	1.7	5.6
Claims on NBS	468	569	579	508	583	6.1	20.1
Dinar cash and reserves	63	80	77	219	151	1.6	5.2
Foreign exchange reserves	254	270	255	194	279	2.9	9.6
NBS bills and other claims	152	219	246	95	153	1.6	5.3
Claims on government	18	8	8	9	108	1.1	3.7
Claims on other sectors	594	827	1,011	1,118	1,299	13.5	44.8
Households	203	305	334	382	418	4.4	14.4
Enterprises	380	507	651	710	849	8.9	29.3
Other institutions	11	15	26	27	31	0.3	1.1
Fixed assets	66	75	84	88	99	1.0	3.4
Other assets	71	88	73	78	90	0.9	3.1
Liabilities	1,274	1,678	1,838	1,925	2,342	24.4	80.8
Foreign liabilities	308	300	279	350	500	5.2	17.3
Dinar deposits	213	319	305	301	338	3.5	11.7
Demand deposits	122	162	135	140	155	1.6	5.4
Time and saving deposits	79	142	158	154	178	1.9	6.2
Government deposits	12	16	12	7	5	0.0	0.2
Foreign currency deposits	359	517	605	599	770	8.0	26.6
Enterprises	84	116	137	140	145	1.5	5.0
Households	261	382	431	414	565	5.9	19.5
Government	4	4	5	6	7	0.1	0.2
Other institutions	10	15	32	40	53	0.5	1.8
Other deposits	2	3	2	1	2	0.0	0.1
Liabilities to NBS	0	2	0	6	1	0.0	0.0
Other liabilities	70	95	125	122	128	1.3	4.4
Provisions	87	93	95	103	135	1.4	4.6
Capital and reserves	235	350	426	442	467	4.9	16.1
Memorandum items:							
Provisions against credit losses	...	75.8	89.6	98.8	129.4	1.3	4.5
in percent of credit	...	9.2	8.9	8.8	10.0	10.0	...
Enterprises	54.8	58.8	66.3	72.5	96.1	1.0	3.3
in percent of credit	14.4	11.6	10.2	10.2	11.3	...	...
Households	7.5	10.8	15.1	17.2	23.4	0.2	0.8
in percent of credit	3.7	3.5	4.5	4.5	5.6	...	...
Off-balance sheet items 2/	1,163	1,580	2,053	2,157	2333	24.3	80.5
External debt (billions of euros)	3.9	4.0	3.5	3.9	4.7	...	15.2
medium- and long-term	2.9	2.8	2.4	2.3	2.7	...	8.7
short-term	0.9	1.2	1.1	1.6	2.0	...	6.5

Source: National Bank of Serbia.

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

2/ As of December 2009, about 16 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 16. Serbia: Key 2009 FSAP Update Recommendations

Recommendations	Timing
Monetary Policy Framework	
Streamline the reserve requirement regulations and reassess its level, although any changes Should be gradual	Done
Reduce the number of repo auctions to one per week	Done
Prepare alternative liquidity draining channels to allow a scaling down of the NBS repo auctions	Medium term
Corporate and Household Debt	
Establish corporate workout guidelines to facilitate restructuring of NPLs and address corporate distress	Structural benchmark for September 2010
Introduce mandatory registration of bills of exchange in a centralized registry	Structural benchmark for September 2010
Amend pledge law to clarify priority and protection of cash collateral (exempt from blocked accounts process)	Short term
Banking Regulation and Supervision	
Set more precise loan classification criteria and required provisioning rather than broad ranges subject to interpretation	Immediate
Monitor rescheduled and restructured loans	Immediate
Relax provisioning and asset classification requirements related to FX loans and the reclassification of restructured loans	Immediate
Ensure adequate staffing in the BSD through competitive salary structures, training opportunities, and career prospects	Short term
Bank Resolution	
Introduce broader problem bank restructuring options under the NBS for an open bank	Short term
Issue NBS regulations to separate problem bank resolution functions from supervisory functions, including setting up an independent problem bank restructuring unit when needed, reporting directly to the governor	Short term
Consider putting in place mechanisms for emergency government financial assistance for bank restructuring costs	Short term
Crisis Management Framework	
Introduce a comprehensive crisis management framework by obtaining approval of the necessary legal amendments	Immediate
Develop crisis memoranda of understanding with relevant home countries	Medium Term
Deposit Insurance Scheme	
Enhance the operational capacity of the DIA to ensure timely payout of insured deposits	Short-Term
Put in place contingent financing mechanisms between the Ministry of Finance (MOF) and the DIA for emergency drawdown needs	Short-Term
Evaluate the insured deposit coverage when the crisis is over and the system is stable	Medium Term
Prepare a comprehensive strategy for the DIA, including role, responsibilities, and funding	Medium Term
Insurance Sector	
Separate life and non-life insurance companies in all aspects	Short term
Adopt comprehensive measures to promote the insurance sector	Short term
Liberalize the local reinsurance market	Short term

Table 17. Serbia: Indicators of Capacity to Repay the Fund, 2009–15 1/

	2009	2010	2011	2012	2013	2014	2015
Fund repurchases and charges							
In millions of SDRs	10	38	58	234	967	1,151	395
In millions of euro	11	43	65	263	1,087	1,297	445
In percent of exports of goods and NFS	0.1	0.5	0.7	2.3	8.0	8.1	2.4
In percent of GDP	0.0	0.1	0.2	0.7	2.7	3.0	0.9
In percent of quota	2.1	8.1	12.5	50.0	206.7	246.0	84.4
In percent of total external debt service	0.3	0.9	1.4	5.2	16.7	17.3	5.7
In percent of gross international reserves	0.1	0.4	0.6	2.8	10.2	10.7	3.3
Fund credit outstanding (end-period)							
In millions of SDRs	1,021	2,300	2,619	2,444	1,693	599	40
In millions of euro	1,154	2,598	2,933	2,744	1,903	675	45
In percent of exports of goods and NFS	13.6	30.1	30.0	23.9	14.0	4.2	0.2
In percent of GDP	3.7	8.1	8.7	7.5	4.8	1.5	0.1
In percent of quota	218.3	491.7	560.0	522.5	362.1	128.1	8.5
In percent of total external debt	4.9	10.2	11.2	10.2	6.7	2.3	0.1
In percent of gross international reserves	10.8	22.9	28.9	29.3	17.8	5.6	0.3
Memorandum items:	(Millions of euros, unless otherwise indicated)						
Exports of goods and NFS	8,473	8,644	9,791	11,483	13,599	16,093	18,896
Quota (in millions of SDRs)	468	468	468	468	468	468	468
Total external debt service	3,600	4,628	4,766	5,056	6,520	7,501	7,769
Public sector external debt (end-period)	7,471	9,923	10,641	10,751	10,216	9,268	8,989
Total external debt stock (end-period)	23,396	25,425	26,075	26,884	28,600	29,746	30,877
Gross international reserves	10,644	11,344	10,164	9,382	10,699	12,147	13,506

Source: Fund staff estimates.

1/ Assuming actual purchase of projected available amounts.

Table 18. Serbia: Proposed Schedule of Purchases
Under the Stand-By Arrangement, 2009-11

	Available on or after	Amount of Purchase: In millions of SDR	Amount of Purchase: In percent of quota 1/	Conditions
1.	Purchased	233.850	50.0	Board approval of the arrangement.
2.	Purchased	23.385	5.0	Observance of end-December 2008 performance criteria and completion of financing assurances review.
3.	Purchased	444.315	95.0	Board approval of augmentation of the arrangement, observance of end-March performance criteria, and completion of the first program review (including financing assurances review).
4.	Purchased	319.595	68.3	Observance of end-September 2009 performance criteria and completion of the quarterly program review (including financing assurances review).
5.	February 25, 2010	319.595	68.3	Observance of end-December 2009 performance criteria and completion of the quarterly program review (including financing assurances review).
6.	May 25, 2010	319.595	68.3	Observance of end-March 2010 performance criteria and completion of the quarterly program review (including financing assurances review).
7.	August 25, 2010	319.595	68.3	Observance of end-June 2010 performance criteria and completion of the quarterly program review (including financing assurances review).
8.	November 25, 2010	319.595	68.3	Observance of end-September 2010 performance criteria and completion of the quarterly program review (including financing assurances review).
9.	February 25, 2011	319.595	68.3	Observance of end-December 2010 performance criteria and completion of the quarterly program review (including financing assurances review).
	Total	2,619.120	560.0	

1/ The quota is SDR 467.7 million.

Appendix I. Serbia: External Debt Sustainability

Improved prospects for GDP growth and a faster narrowing of the current account deficit led to some improvement of the external debt dynamics compared to the previous analysis. On current baseline projections, total external debt is expected to peak in 2010 (at 80 percent of GDP).On the assumption that growth will gradually accelerate and the current account deficit will stabilize in nominal terms, debt ratios would start to decline in 2011 and return to the level of 2008 (64 percent of GDP) in 2015. Standard tests yield similar results, except for the exchange rate shock, which raises the external debt-to-GDP ratio sharply. Moreover, under the alternative scenario, the debt dynamics are, of course, much less favorable, pointing to substantial risks.

1. **Serbia's external debt has been rising since 2004, resulting in increased vulnerabilities.** Following persistently large external imbalances—and despite rescheduling operations and early repayments to some multilateral creditors, including the Fund—external debt reached 21.8 billion euros in December 2008. The rise was due to private debt, which tripled since early 2006. In particular, nonbank private debt rose sharply, as prudential regulation on bank activity became tighter and companies switched to direct foreign borrowing, often with domestic commercial banks acting as intermediaries. This trend was interrupted toward the end of 2008, when private sector debt started. to decline. Nevertheless, external debt remained high at about 23.4 billion euros at end-2009 (Tables A1, A2).

Serbia: Structure of External Debt, 2005-09
(Percent of total debt)

	2005	2006	2007	2008	2009
Public	59	43	34	29	32
Private	41	57	66	71	68
Banks	17	26	22	18	22
Other private	24	31	43	53	46
Total	100	100	100	100	100

Sources: NBS and IMF staff estimates.

2. **Better prospects for GDP growth and faster adjustment of the current account balance have led to some improvement of the external debt dynamics compared to the previous analysis.** In particular, the debt-to-GDP ratio (including prospective liabilities to the Fund) is expected to peak in 2010 at about 80 percent of GDP percent before returning to a declining path.

3. **With global and domestic conditions beginning to improve gradually in 2010, external debt ratios are expected to start declining already in 2011 under the baseline scenario.** GDP growth is expected to recover gradually, the current account to stabilize in nominal terms, and FDI inflows to resume. As a result, the debt-to-GDP ratio is projected to decline to about 64 percent of GDP in 2015.

4. **Standard stress tests point to some risks.** With a real depreciation of 30 percent, the external debt-to-GDP ratio would initially rise to 116 percent, but decline thereafter. Under the other standard shocks, external debt would rise to close to 80 percent of GDP before returning to a declining path. However, such dynamics crucially depend on the assumptions of gradually rising growth and current account adjustment in the medium term.

5. **However, the alternative scenario, based on absorption-led growth, would entail significantly higher risks for debt sustainability.** Under this scenario, the external debt-to-GDP ratio would initially stabilize but would then begin to rise, reaching 83 percent of GDP in 2015. Moreover, underlying vulnerabilities are masked by the progressively more overvalued exchange rate. This underscores the need for strong policy action, close monitoring, and readiness to implement further measures, if needed, should the outcomes be worse than projected.

Table A1. Serbia: External Debt Sustainability Framework, 2005-2015
(Percent of GDP, unless otherwise indicated)

	Actual				Projections						
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	63.3	60.2	63.6	76.0	**79.5**	**77.1**	**73.8**	**71.4**	**67.7**	**64.2**	**-10.6**
Change in external debt	-0.8	-3.1	3.4	12.3	3.6	-2.5	-3.3	-2.3	-3.7	-3.5	
Identified external debt-creating flows (4+8+9)	-3.4	-5.8	3.8	8.5	3.0	3.5	1.2	-2.3	-4.0	-3.3	
Current account deficit, excluding interest payments	8.0	13.2	14.6	3.5	5.2	5.8	5.3	4.7	4.7	4.7	
Deficit in balance of goods and services	21.4	23.3	22.8	15.5	14.7	14.9	14.0	13.3	12.1	11.2	
Exports	29.6	29.4	29.6	27.5	27.0	28.9	31.5	34.0	36.6	39.3	
Imports	51.0	52.7	52.4	43.0	41.7	43.9	45.5	47.2	48.7	50.5	
Net non-debt creating capital inflows (negative)	-4.8	-8.5	-5.0	-4.3	-4.0	-3.3	-3.4	-6.0	-7.6	-7.4	
Automatic debt dynamics 1/	-6.6	-10.6	-5.8	9.3	1.9	1.0	-0.7	-1.0	-1.0	-0.7	
Contribution from nominal interest rate	2.1	2.3	2.5	2.2	3.3	3.3	2.9	2.7	2.5	2.4	
Contribution from real GDP growth	-2.9	-3.5	-2.9	2.0	-1.4	-2.3	-3.6	-3.7	-3.6	-3.1	
Contribution from price and exchange rate changes 2/	-5.7	-9.4	-5.4	5.1	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	2.5	2.8	-0.4	3.8	0.5	-6.0	-4.4	0.0	0.2	-0.2	
External debt-to-exports ratio (in percent)	213.8	204.8	214.7	276.1	294.1	266.3	234.1	210.3	184.8	163.4	
Gross external financing need (in billions of US dollars) 4/	4.3	7.5	9.5	6.4	7.8	8.3	8.3	8.9	9.9	11.2	
in percent of GDP	18.3	25.3	27.7	20.8	24.5	24.5	22.8	22.3	22.5	23.3	
Scenario with key variables at their historical averages 5/					**79.5**	**75.2**	**72.6**	**74.5**	**76.4**	**77.6**	**-8.9**
Key Macroeconomic Assumptions Underlying Baseline											
Real GDP growth (in percent)	5.2	6.9	5.5	-2.9	2.0	3.0	5.0	5.5	5.5	5.0	
GDP deflator in US dollars (change in percent)	9.8	17.5	9.9	-7.4	1.8	2.7	2.6	4.2	4.0	4.2	
Nominal external interest rate (in percent)	3.7	4.7	4.9	3.1	4.6	4.3	4.0	4.0	3.9	3.9	
Growth of exports (US dollar terms, in percent)	31.0	24.8	16.9	-16.5	2.0	13.3	17.3	18.4	18.3	17.4	
Growth of imports (US dollar terms, in percent)	25.2	30.0	15.3	-26.3	0.7	11.4	11.6	14.1	13.1	13.5	
Current account balance, excluding interest payments	-8.0	-13.2	-14.6	-3.5	-5.2	-5.8	-5.3	-4.7	-4.7	-4.7	
Net non-debt creating capital inflows	4.8	8.5	5.0	4.3	4.0	3.3	3.4	6.0	7.6	7.4	

Source: Ministry of Finance and IMF staff estimates.

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

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

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

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

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

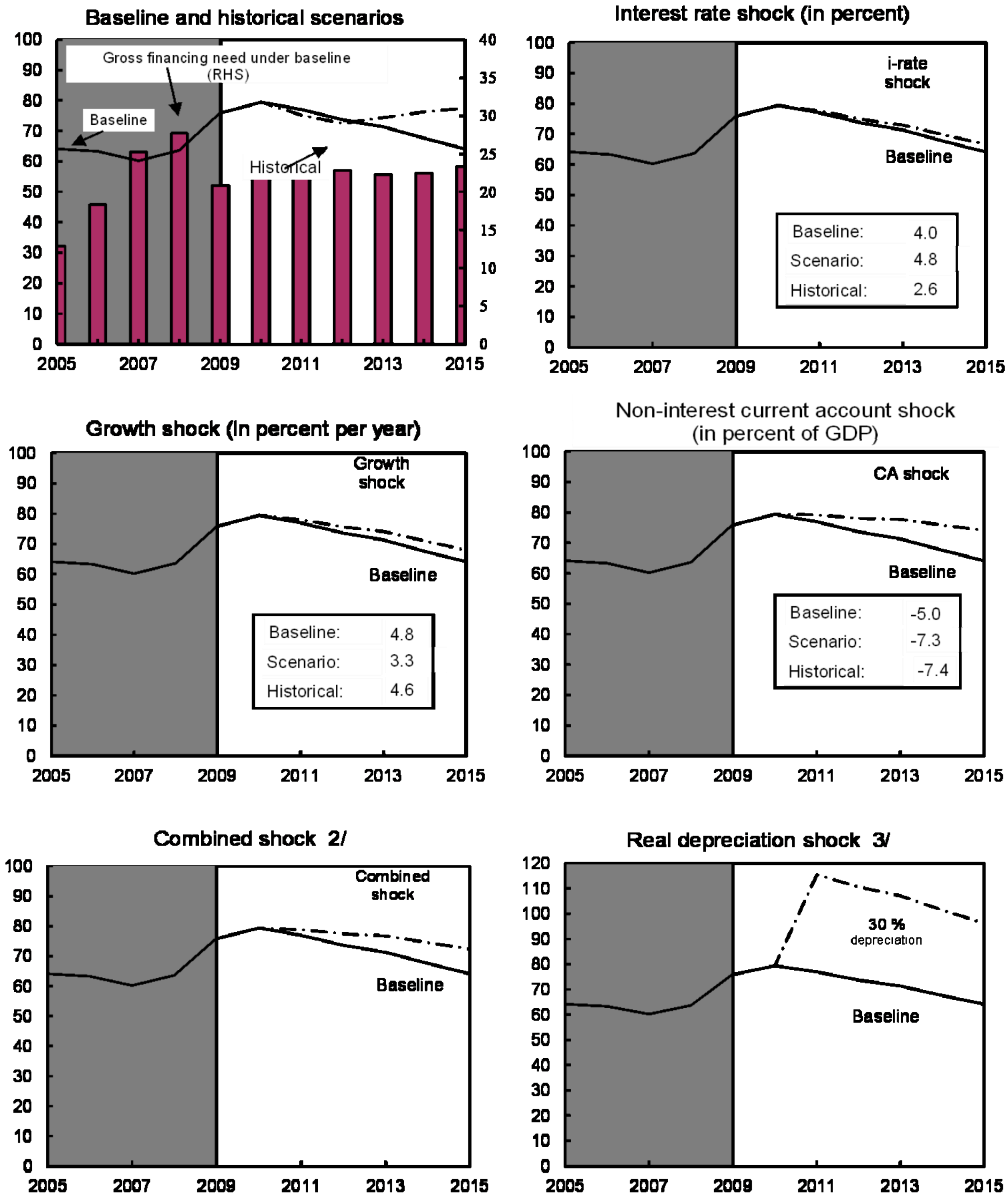
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table A2. Serbia: External Debt, December 31, 2009
(Millions of euros)

	Outstanding debt 1/	Principal arrears	Interest arrears	Late interest	Total
Total external debt	22,846	1,758	292	250	23,387
Public sector debt	7,794	80	23	14	7,831
Medium and long-term	7,793	80	23	14	7,830
IMF	1,710	0	0	0	1,710
IBRD	1,238	0	0	0	1,238
IDA	469	0	0	0	469
EC	273	0	0	0	273
EIB	613	0	0	0	613
EUROFOND-CEB	35	0	0	0	35
EBRD	365	0	0	0	365
EUROFIMA	101	0	0	0	101
Governments-Paris Club	1,561	0	0	0	1,561
Other Governments	494	36	0	0	494
London Club	771	23	23	14	808
Other creditors	143	0	0	0	143
Debt in non convertible currency	21	21	0	0	21
Short term debt	1	0	0	0	1
Private sector debt	15,051	1,679	268	236	15,556
Medium and long-term debt	12,779	1,275	260	236	13,275
Banks	2,636	47	12	47	2,694
International financial institutions	405	8	4	6	415
Governments - Permanent Paris Club Members	168	0	0	0	168
Other credtiors	2,064	40	7	40	2,111
Enterprises	10,143	1,227	248	189	10,580
International financial institutions	354	8	5	0	359
Governments - Permanent Paris Club Members	37	0	0	0	37
Other governments	20	5	1	0	21
Other creditors	9,689	1,171	233	189	10,111
Debt in non-convertible currency	43	43	9	0	52
Short-term debt	2,272	404	9	0	2,281
Banks	1,991	277	0	0	1,991
Enterprises	282	127	9	0	290

Source: National Bank of Serbia.
1/ Including principal arrears.

Figure 1. 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. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2010.

Appendix II. Serbia: Public Debt Sustainability

1. **General government debt in Serbia remains sustainable**. However, rollover risks will rise as the stock of domestic-currency T-bills is expected to increase from 3 percent of GDP in 2009 to about 11 percent during 2010-14. At the same time, the large FX share of public debt implies significant vulnerability to a depreciation of the currency. Additional fiscal risks derive from contingent liabilities associated to off-balance sheet transactions, from quasi-fiscal losses of state- and socially owned enterprises, from government support to the private sector, and the eventual payment of restitution debt.

2. **Gross general government debt increased to 36½ percent of GDP in 2009, from 32 percent of GDP in 2008, but is projected to decline to 30 percent of GDP in 2014** (Table A1).[1] At the time of the last review (see country report EBS/09/201), it was projected that the debt ratio in 2009 would reach 31½ percent of GDP in 2009. The significant upward revision of the 2009 level reflects the following factors: (i) the accumulation of large deposits at the central bank (1½ percent of GDP); (ii) more-than-projected exchange rate depreciation (½ percent of GDP); (iii) the carry-over effects from a downward revision in historical GDP data (½ percent of GDP); (iv) the inclusion of local government debt in the estimates (1 percent of GDP); and (v) the issuance of guaranteed debt by the public enterprises (1½ percent of GDP). This has been partly offset by a lower fiscal deficit (0.3 percent of GDP).

3. **However, in an unchanged policies scenario, the public debt-to-GDP ratio would increase to 50 percent of GDP in 2014**. This is mainly because this scenario ignores the expected expenditure-based adjustment. By contrast, under the assumption that key variables remain at their historical averages, the public debt-to GDP ratio would decline to 13 percent, reflecting very high growth during the absorption boom coupled with low real interest rates.

4. **Standardized bound tests show that Serbia's debt is particularly sensitive to exchange rate shocks (Figure A1)**. Given that 90 percent of the debt is denominated in foreign currency (comprising mainly frozen currency deposit bonds and debt to multilaterals and Paris Club creditors); a 30 percent real depreciation of the dinar would put the debt-to-GDP ratio at 45 percent in 2014. Imposing half a standard-deviation shocks to GDP growth and the primary fiscal balance, increases the public debt stock to 34 percent of GDP in 2014. However, a similar shock to interest rates would leave debt-to-GDP at 32 percent.

---

[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. It excludes any borrowing from the Fund by the NBS.

5. **Further risks to the debt outlook come from large contingent liabilities, in particular those related to public enterprises.** The main sources of risk are the following:

- **Public enterprises**. Some state-owned and socially owned enterprises are running large quasi-fiscal deficits, mainly because of overly high wages and pricing below cost. With most public enterprise debt included in the general government debt stock (since they carry government guarantees), and with enterprises receiving explicit or implicit subsidies through lower taxes and utility tariffs to cover their operations, their past and regular losses are implicitly covered. However, there are risks from delays in utility price adjustments, large investment plans and needs, and provision of new loan guarantees to nonviable enterprises.

- **Financial sector stability.** Financial sector distress could lead to the need for public sector support of the financial system.

- **Government support to the economy.** The domestic credit support program launched in February of 2009, and continued in 2010, could add up to 2 percent of GDP to public debt. Risks derive from state-guaranteed IFI loans to small and medium-sized enterprises (1½ percent of GDP), and loans granted through the National Development Fund and commercial banks (½ percent of GDP).

- **Restitution.** A plan formulated by the government in 2007 to provide compensation for assets confiscated by the communist government after World War could increase debt by up to about 16 percent of 2010 GDP. Moreover, the sensitivity of public debt to the exchange rate would be adversely affected if the restitution bonds were to be denominated in foreign currency.

Table A1. Serbia: Public Sector Debt Sustainability Framework, 2006-2014
(Percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2006	2007	2008			2009	2010	2011	2012	2013	2014	Debt-stabilizing primary balance 10/
Baseline: Public sector debt 1/	42.6	34.3	33.1			**36.4**	**36.0**	**36.5**	**35.0**	**32.7**	**30.3**	**-1.6**
o/w foreign-currency denominated	38.7	30.7	29.0			31.9	28.9	28.7	25.7	22.3	19.4	
Change in public sector debt	-13.5	-8.3	-1.3			3.4	-0.4	0.5	-1.5	-2.3	-2.4	
Identified debt-creating flows (4+7+12)	-17.5	-7.7	-0.3			0.5	1.3	0.4	-0.7	-1.2	-1.6	
Primary deficit	0.0	1.1	2.0			3.4	2.9	1.5	1.0	0.5	0.0	
Revenue and grants	43.8	42.4	41.4			39.6	38.4	38.0	37.6	37.6	37.8	
Primary (noninterest) expenditure	43.8	43.5	43.4			43.0	41.3	39.5	38.5	38.0	37.8	
Automatic debt dynamics 2/	-9.8	-6.0	-1.0			-0.9	-1.6	-1.1	-1.6	-1.6	-1.4	
Contribution from interest rate/growth differential 3/	-6.8	-6.1	-4.2			-0.9	-1.6	-1.1	-1.6	-1.6	-1.4	
Of which contribution from real interest rate	-4.3	-3.7	-2.6			-1.9	-1.1	-0.1	0.0	0.1	0.2	
Of which contribution from real GDP growth	-2.5	-2.5	-1.6			0.9	-0.5	-1.0	-1.7	-1.8	-1.6	
Contribution from exchange rate depreciation 4/	-3.0	0.1	3.2			...	...	...	...	...	...	
Other identified debt-creating flows	-7.8	-2.8	-1.2			-2.0	0.0	0.0	0.0	0.0	-0.3	
Privatization receipts (negative)	-7.8	-2.8	-1.2			-2.0	0.0	0.0	0.0	0.0	-0.3	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	4.0	-0.6	-1.0			2.9	-1.8	0.1	-0.8	-1.1	-0.7	
Public sector debt-to-revenue ratio 1/	97.3	81.0	79.8			92.1	93.8	96.0	93.2	87.1	80.4	
Gross financingneed 6/	3.3	3.3	5.0			3.9	9.8	11.0	11.4	11.4	10.9	
in billions of euro	0.8	1.0	1.7			1.2	3.1	3.7	4.1	4.6	4.8	
Scenario with key variables at their historical averages 7/						**36.4**	**29.3**	**24.7**	**20.2**	**16.0**	**12.7**	**-2.1**
Scenario with no policy change in 2010-2014 8/						**36.4**	**39.5**	**42.8**	**46.0**	**48.1**	**50.6**	**-1.9**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline				5-Year Historical Average	5-Year Standard Deviation							
Real GDP growth (in percent)	5.2	6.9	5.5	6.3	1.3	-3.0	1.5	3.0	5.0	5.5	5.5	
Average nominal interest rate on public debt (in percent) 9/	3.2	2.1	2.1	2.4	0.5	2.5	3.7	4.5	4.7	4.9	5.0	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-8.3	-9.5	-8.2	-9.9	1.9	-6.2	-3.0	-0.2	0.4	0.6	1.0	
Nominal appreciation (increase in euro value of local currency, in percent)	7.8	-0.3	-10.6	-4.8	8.6	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	11.5	11.6	10.3	12.3	1.9	8.6	6.7	4.8	4.3	4.3	4.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	13.5	6.0	5.4	6.0	4.5	-4.0	-2.5	-1.4	2.4	4.2	4.8	
Primary deficit	0.0	1.1	2.0	-0.1	1.7	3.4	2.9	1.5	1.0	0.5	0.0	

Source: Ministry of Finance and IMF staff estimates.

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 euro).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r -? (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.

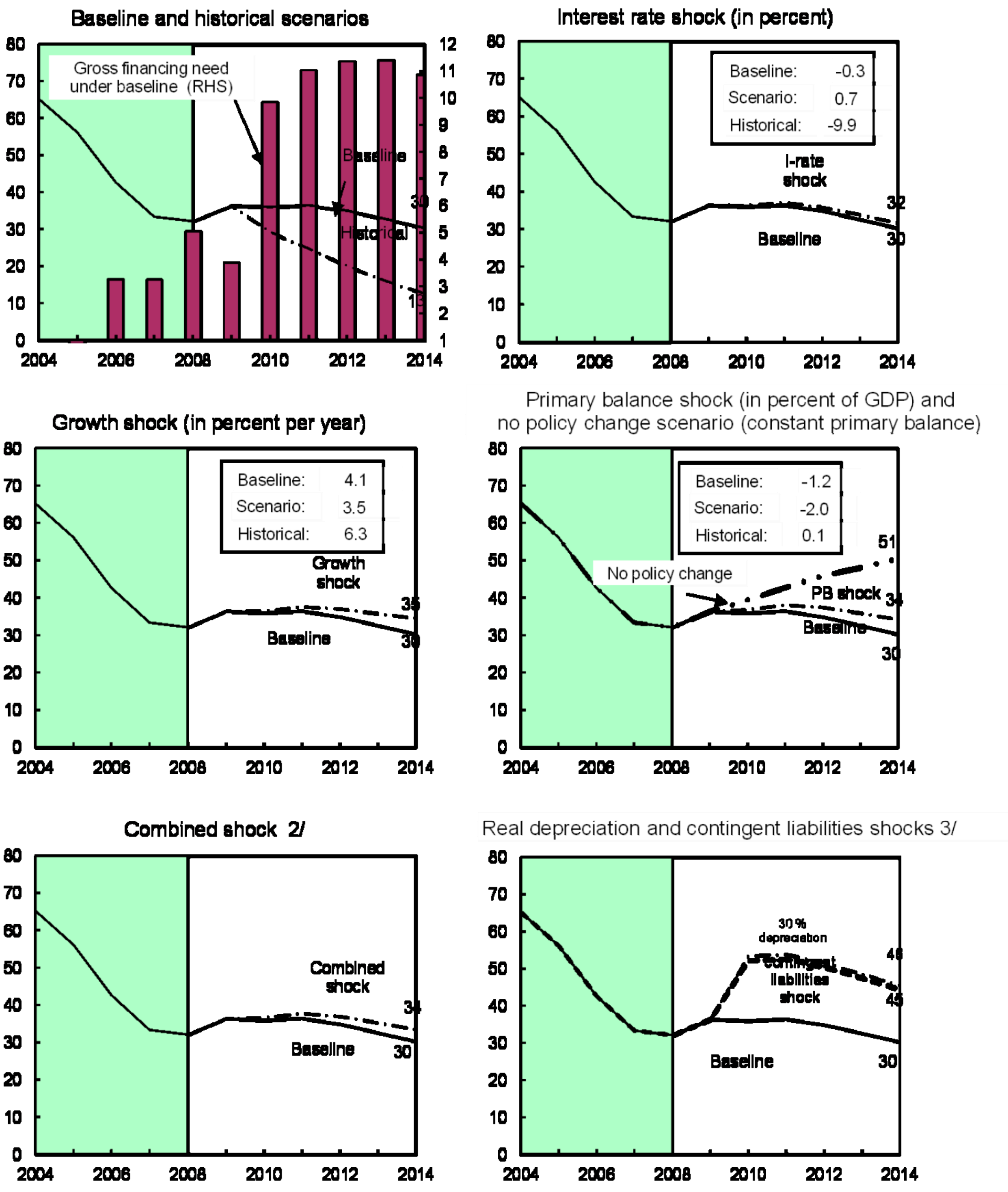
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Based on the unchanged policy scenarios under the program.

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.

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).

Table A2. Serbia: Government and Government-Guaranteed Debt, 2000–09
(End-period stock by creditor, in percent of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Gross debt (excluding IMF)	**241.7**	**114.5**	**81.2**	**77.3**	**65.2**	**56.1**	**42.6**	**34.3**	**33.1**	**36.4**
Domestic	**80.6**	**39.5**	**33.3**	**33.1**	**30.5**	**22.8**	**17.6**	**13.6**	**12.6**	**15.4**
Foreign currency-denominated	62.2	30.1	24.3	23.6	21.2	17.7	13.0	10.4	9.4	9.4
Frozen Foreign Currency Deposits	62.2	30.1	24.3	23.6	21.0	17.5	12.9	10.3	9.4	8.9
Other	0.0	0.0	0.0	0.0	0.2	0.2	0.1	0.0	0.0	0.0
Local currency-denominated	18.4	9.4	9.0	9.5	9.3	5.1	4.6	3.2	3.1	6.1
T-bills	0.0	0.0	0.0	0.2	0.5	0.3	0.3	0.2	0.1	3.5
Long-term loans	0.5	0.3	1.9	1.8	1.5	1.2	0.9	0.5	0.4	0.4
Credit from the banking system	4.0	2.2	2.5	2.1	2.2	1.4	1.1	0.7	0.8	1.3
Domestic arrears	13.9	7.0	4.6	5.5	5.2	2.3	2.3	1.9	1.9	0.9
External	**161.1**	**75.0**	**47.9**	**44.2**	**34.7**	**33.3**	**24.2**	**19.7**	**19.5**	**19.9**
Multilateral (excluding IMF)	31.9	16.0	14.6	14.8	15.2	14.3	11.3	9.9	9.8	10.0
IBRD	27.7	14.2	11.5	10.9	10.3	9.1	6.4	5.4	5.1	4.1
IDA	0.0	0.0	1.0	1.3	1.8	2.0	1.7	1.4	1.5	1.6
EIB	0.0	0.0	0.7	0.8	1.1	1.3	1.4	1.5	1.5	2.0
EBRD	0.0	0.0	0.0	0.2	0.5	0.6	0.7	0.7	0.8	1.0
EU+CEB	4.2	1.8	1.4	1.6	1.5	1.4	1.2	1.0	0.9	1.0
Official Bilateral	83.1	38.6	18.5	16.4	15.0	14.4	9.6	7.4	7.3	7.1
Paris Club	75.4	33.5	14.6	12.9	11.7	11.0	7.0	5.6	5.4	5.3
Other bilateral	0.2	0.1	0.3	0.4	0.5	0.5	0.4	0.3	0.4	0.6
Debt under negotiation 1/	7.5	5.0	3.6	3.0	2.7	2.9	2.2	1.4	1.5	1.2
Commercial	46.0	20.4	14.8	13.0	4.5	4.6	3.3	2.4	2.5	2.8
Local government debt	...	...	...	...	...	...	0.8	1.0	0.9	1.1
Memorandum items:										
Debt to IMF	2.5	2.4	3.4	4.4	4.0	3.7	0.8	0.0	0.0	3.7
Government deposits	2.5	2.0	3.8	4.1	3.8	5.1	8.2	6.4	3.6	5.1
Net debt (excl. IMF)	239.2	112.5	77.4	73.1	61.4	51.1	33.6	26.9	28.6	30.2
Kosovo debt	17.8	9.2	6.1	5.8	4.8	4.3	3.6	2.9	2.7	1.4
Share in total gross debt of:										
Foreign currency-denominated debt	92.4	91.8	88.9	87.7	85.7	90.8	89.3	90.7	90.5	82.1
Short-term debt	0.0	0.0	0.0	0.2	0.7	0.5	0.6	0.5	0.2	9.8
Debt at variable interest rates	44.4	43.3	36.2	36.6	42.4	46.0	44.7	47.5	48.0	52.5
Debt to official creditors	47.6	47.7	40.7	40.4	46.2	51.2	50.1	51.9	53.2	48.4

Source: Ministry of Finance; and Fund staff estimates.

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

Attachment I. Letter of Intent (LOI)

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Belgrade, March 18, 2010

Dear Mr. Strauss-Kahn:

1. Our program has continued to perform well. All end-December 2009 quantitative performance criteria were observed, most of them with a considerable margin, including the ceiling on the general government deficit (Table 1). We have also made progress on our structural reform agenda, including the highly sensitive reform of the pension system, the design of new fiscal responsibility legislation, and the complex revision of the corporate debt collection and restructuring framework. But most importantly, supported by the tailwinds of a global recovery and the strong commitment of foreign banks to Serbia, the economy is on the mend: output has started to recover following a precipitous decline through mid-2009; capital inflows have recently surprised on the upside; and disinflation is on track, with inflation expectations receding.

2. While the program is on track, clearly not all is well in our economy. The global financial crisis hit hard, and the need to correct the economy's external and fiscal imbalances now acts as a brake on the recovery. Corporate insolvencies and payment problems are still on the rise. Job opportunities, particularly for low-paid workers, have become scarce, reflected in increasing poverty. As a result, firms and households have cut back spending sharply relative to their incomes. This is also reflected in moderate credit demand and the sharp import contraction. Coming on the heels of an unsustainable private-sector boom, lower spending has led to a welcome rebalancing of the external account; the 2009 current account deficit was likely limited to only 5½ percent of GDP. But rapid private-sector adjustment has also unmasked a weak underlying fiscal position; with nominal tax revenues stagnant at their 2008 level, the fiscal deficit rose to 4¼ percent of GDP in 2009, notwithstanding across-the-board nominal freezes of most current spending and cuts in subsidies and capital spending.

3. In consideration of our strong implementation record and our continued commitment to the program's objectives, we request the completion of the third review of the SBA and the disbursement of SDR 319.6 million. The fourth program review, assessing performance relative to end-March performance criteria and benchmarks, and financing assurances review are envisaged for June 2010. The fifth program review assessing end-June performance criteria and financing assurances review are envisaged for September 2010.

4. We believe that the policies and measures set forth in this memorandum are adequate to achieve the objectives of the program, and stand ready to take any additional measures that may be appropriate for this purpose. The Government of the Republic of Serbia will consult with the IMF in advance on the adoption of such additional measures in accordance with the IMF's policies on such consultations.

Revised Macroeconomic Framework for 2010-11

5. We continue to expect a gradual recovery of economic activity, with real GDP projected to grow at 2 percent in 2010 and 3 percent in 2011. Investment and exports are expected to be the main engines of growth, while consumption is likely to lag. The moderate pace of recovery, along with the rebalancing of the economy away from absorption-led growth and the delays in matching unemployed workers with new jobs, will continue to put strains on the fiscal position, mainly through subdued tax revenues.

6. Inflation is expected to continue to decline, providing the National Bank of Serbia (NBS) with a window of opportunity to lock in a new regime of lower and more stable inflation rates. A sizeable output gap, decelerating nominal wage growth, and favorable food price trends have substantially moderated inflationary pressures, which in turn has allowed a substantial easing of the monetary policy stance. Inflation could undershoot the NBS's target band during the first half of 2010, but we expect it to end the year close to the target of 6 percent (±2 percent). In 2011, inflation is expected to decline further to around 4½ percent.

7. External current account adjustment is expected to pause in 2010, with the continued decline in the trade imbalance more than offset by projected higher external income payments and lower remittances. Following a contraction in 2009, export volume growth is expected to regain double-digit strength only in 2011. We are now projecting a current account deficit of 8 percent of GDP in 2010, followed by a gradual improvement over the medium term.

8. The external financing situation is projected to remain favorable in 2010 and beyond, but there are significant risks. Foreign parent banks are expected to broadly maintain their exposure to Serbia, notwithstanding a relaxation of exposure floors under the Bank Coordination Initiative. Other private inflows, along with financing from the IMF, other international financial institutions, and the EU, should be more than sufficient to meet all external financing needs in 2010. We expect a further increase in international reserves, albeit at a more modest pace than in 2009. These projections are, however, subject to downside risks, in part because some parent banks of local subsidiaries could face domestic funding pressures or restructuring needs.

Fiscal Policy

9. A decisive break with Serbia's pre-crisis pattern of growth driven by production of nontradables and high consumption to one led more by exports calls for improving external competitiveness and raising investment. While other economic policies will have to make their contribution as well, a paradigm shift in fiscal policy will be key to achieving this transformation of the economy. We are committed to implementing the painful and difficult measures in the public sector that are required.

10. Our fiscal strategy will continue to be based on four main principles: (i) the presently high structural fiscal deficits will be gradually reduced over the next few years; (ii) the economy's overall tax burden will be kept roughly unchanged; (iii) balanced and coordinated spending restraints will continue to be imposed on public wages and pensions; and (iv), the fiscal space freed up by spending restraints will be utilized to raise public investment. To succeed with this fiscal strategy, we will also have to enforce financial discipline in the still large public enterprise sector, especially by containing wage increases.

11. Consistent with this fiscal strategy, we will contain the general government deficit in 2010 to 4 percent of GDP, and plan to reduce the deficit to 3 percent of GDP in 2011. As in 2008 and 2009, we will execute spending cautiously to stay within the agreed general government spending envelope of about 1,340 billion dinars. Should the recovery in economic activity turn out to be somewhat stronger than presently expected, we will save any revenue overperformance during the first half of the year. The 2010 gross financing needs of about 2 billion euros will be covered by loans from international financial institutions and the EU, and, to a significant extent, through borrowing from the domestic T-bills market, where we intend to increasingly tap longer maturities to reduce rollover risk and foster local financial market development.

12. As regards revenue policies, we plan to keep any further changes to the tax system at least revenue neutral, while taking measures to strengthen tax administration. At this point, we have submitted to parliament limited amendments to simplify and broaden corporate and personal income taxes. To increase tax compliance, we will adopt an integrated taxpayer compliance strategy by end-July (structural benchmark).

13. We remain committed to reducing the wage bill of the general government to about 8 percent of GDP by 2015. To achieve this medium-term objective, we plan to implement the following specific policies during 2010-12:

- The level of wages of government employees will remain nominally frozen; the case for any wage increases will only be reviewed during the second half of 2010, and only provided revenue trends during the first half of 2010 are more favorable than presently expected. We will also ensure a wage bill freeze at the level of local government utilities, and we have approved 2010 business plans for ten large state enterprises monitored under the program that are consistent with a nominal freeze of their respective wage bills.

- The announced cuts in public administration staff at central and local government levels by about 10 percent will be implemented by April 2010, and a strict hiring freeze across all levels of government, including for temporary workers, implemented.

- During 2011-12, public sector wage increases will be limited to what is consistent with our medium-term objective of bringing the wage bill to 8 percent of GDP by 2015.

- To rationalize public employment further, we will finalize reform plans in the health care and education sectors, along the lines of recent World Bank recommendations, with the objective of starting their implementation in the context of the 2011 budget.

14. To ensure fair burden sharing between public sector employees and pensioners, we also remain committed to reducing the net spending by pension funds to about 10 percent of GDP by 2015. Our specific policies during 2010-12 are as follows:

- In line with the agreements presented in the last Letter of Intent, we have agreed on a comprehensive package of parametric pension reforms that will be submitted to parliament by end-May (structural benchmark). These reforms include an increase in the minimum retirement age for old-age pensions from 53 to 58 years for men and women, longer effective contribution periods for women, a cut in service credits for the military and police, and a tightening of survivor pension entitlements. To address the hardship of the poorest pensioners, we will increase minimum and farmers' pensions, while putting a tighter cap on maximum pensions.

- In line with the freeze of public wages, nominal pensions will remain frozen until April 2011.

- We believe strongly that continued but also balanced restraints on both public pensions and wages will be required during 2011-12. As an alternative to the CPI indexation plus GDP growth premium rule, we have proposed during the third review a link between pension and public wage growth during the 18-month period starting in April 2011. We recognize that IMF support for any indexation rule linking pensions and public wages will require assurances in May that public wage growth and fiscal targets during 2010-12 will remain credibly anchored in line with the agreed economic program, including through fiscal responsibility legislation. After the indexation adjustment of April 2012, we will shift to a CPI indexation rule. The new indexation arrangement will be consistent with bringing pension spending to about 10 percent of GDP by 2015.

15. We recognize that jointly anchoring public wage and pension growth during 2010-12 in line with these undertakings will be a difficult task. We will establish binding nominal ceilings on the general government wage and pension bills for the period 2010-12 in the framework of the planned fiscal responsibility legislation to be submitted to parliament by end-May (structural benchmark).

16. Finally, we will review the recently adopted public debt provisions relaxing restraints on local government borrowing and guarantees to ensure that local governments do not engage in fiscal activities that could ultimately require financial bailouts by the central government.

Monetary and Exchange Rate Policy

17. Monetary policy will remain focused on keeping inflation close to the pre-announced 6 percent (±2 percent) target for 2010. The NBS expects to continue easing its monetary stance, albeit cautiously given the risks associated with still high, though receding, inflation expectations, the possibility of faster-than-expected recovery of aggregate demand, further increases in energy prices, and the planned upward adjustments of regulated prices. Under the program, inflation developments will continue to be monitored using a standard consultation clause. In line with our inflation targeting framework, we will maintain the existing managed float exchange rate regime.

18. We plan to streamline and lower reserve requirements. The present reserve requirement regime is overly complex, with a large number of exemptions and multiple statutory rates. In response, many banks have targeted asset and liability structures to lower their effective reserve requirement rates. Under the new regime, almost all exemptions will be phased out, and there will be only two statutory rates, one for foreign exchange liabilities, and a lower one for dinar liabilities. This reform seeks to achieve several goals: (i) enhance transparency; (ii) promote more efficient operations of the banks; (iii) encourage de-euroization; and (iv) reclaim for the NBS the ability to use reserve requirements as an effective policy tool. At the same time, the new effective rate will be lower than the current one, complementing the monetary policy easing achieved through the lowering of the policy interest rate. The new regime will be phased in gradually and should be fully in place by March 2011. This much-needed reform is at the same time a complex policy change, and we will have to continuously monitor monetary conditions to achieve our inflation targets and prevent excessive volatility of the exchange rate.

19. We will also continue to strengthen our inflation targeting framework. In December 2009, to improve the functioning of the money market, we reduced the number of repo auctions from two to one per week; and we are assessing the case for further simplifying the auction system. We have also taken steps to improve coordination between the government and the NBS regarding plans for regulated price adjustments. To this effect, we have recently

set up a working group comprising technical experts from the NBS, Ministry of Finance, and other relevant ministries and agencies.

Financial Sector Policies

20. Serbia's level of euroization is high, even by regional standards, and it constrains the effectiveness of monetary policy while imposing financial stability risks. A precondition for any successful de-euroization strategy will be to achieve a lower and more stable inflation rate. Moreover, we will continue to use our prudential and supervisory framework to discourage unhedged currency risks. In addition, we will focus on market-based measures that would work through incentives, instead of coercive measures that could result in serious market distortions and increased costs of doing business. Specifically, we plan to: (i) introduce benchmark dinar securities, which may in part be issued by international financial institutions; (ii) foster a secondary market for T-bills; and (iii) encourage the development of hedging instruments.

21. The Financial Sector Support Program (FSSP) has proved a vital and innovative tool for safeguarding financial stability. As planned, we finished in December 2009 the onsite diagnostic studies and stress tests for all 31 banks. This comprehensive exercise confirmed that, following the recapitalization of one large domestic bank, our banking system is liquid and well capitalized, even after the most extreme scenario employed in the exercise. Given the easing of financial sector tensions since the peak of the crisis in early-2009, we have also agreed with participants in the Bank Coordination Imitative during a review meeting on February 26, 2010, to lower the exposure floor vis-à-vis Serbia of foreign parent banks from 100 to 80 percent, effective April 2010. Furthermore, we have amended our strict asset classification rules, and we are studying the scope for narrowing the provisioning ranges. Our cooperation with foreign home supervisors has strengthened appreciably, including through our participation in supervisory colleges, and we hope to finalize bilateral memoranda of understandings with Austria, France, and Germany in due course.

22. We have made progress on the framework for debt collection and restructuring. In December 2009, parliament approved the revised Bankruptcy Law. The new law stipulates the automatic initiation of bankruptcy procedures for companies whose accounts have been blocked for more than three years, and supports accelerated reorganizations using prepackaged plans. To address excessive blockages of bank accounts on the basis of promissory notes, the NBS has prepared draft amendments to the Law on Payment Transactions, including registration of all promissory notes in a single database—to increase transparency and reduce their excessive issuance—and modifications to the payout procedure from blocked accounts—to alleviate the rush-to-block problem. In response to feedback from market participants and government agencies, further changes are needed to facilitate the recording of promissory notes and to retain the high efficiency of the present blockage

procedure. Drawing on technical assistance, we have also started to explore options to introduce an out-of-court corporate loan workout framework.

23. Looking ahead, we plan to further improve the corporate debt restructuring framework. However, due to the legal complexities of this undertaking and resource constraints, we have to extend the deadline for submitting new legislation to parliament to end-September 2010 (structural benchmark). In this regard, we believe that blocked accounts and out-of-court restructuring mechanisms should be addressed in a coordinated and comprehensive manner, and incentives for restructuring should be tailored to facilitate consensual outcomes between creditors and borrowers.

Structural Policies

24. The following measures should help improve the business climate:

- Cutting red tape: A regulatory reform council is reviewing an estimated 7,500 laws, bylaws, and regulations, about 3,000 of which impact business. The ‘regulatory guillotine’ project, scheduled to be completed by June 2010, is estimated to cut Serbian companies’ costs by some 20 billion dinars annually.

- Adopting new legislation: With technical assistance from the international financial institutions, we will draft a new Company Law to strengthen corporate governance and eliminate all unnecessary requirements for the establishment and operation of entrepreneurs and companies.

- Ensuring property rights: We will strive to resolve, in line with our scarce fiscal resources, the still pending issues of land ownership and restitution of property seized from citizens and institutions after World War II. With regard to the latter, we have opted for compensation mainly in government bonds to avoid complications connected to restitution in kind, which has been limited by the adoption of the Law on Urban Development in 2009.

- Fighting corruption: A new anti-corruption agency with new expanded powers and responsibilities became operational as of January 1, 2010.

25. The following measures should increase the role of the private sector in the economy:

- Privatization: 169 companies are slated for privatization in 2010; additional sales of assets via forced liquidation and/or bankruptcy will be implemented in 201 existing cases, and new bankruptcy proceedings will be initiated for 336 nonviable state-owned companies. We hope to privatize the pharmaceutical company Galenika through a tender offer in 2010. We have recently agreed on the partial privatization of

Credy Bank. The new investor acquired more than half of the bank's stock and the government expects to divest its remaining shares within the next three years.

- Corporatization: All large state enterprises will be corporatized by end-2010**.** In several cases, this will be followed by either full or partial privatization, or the creation of joint ventures and private management contracts.

- Corporate restructuring: We have embarked on restructuring the airline company JAT. The overhaul of the state-owned railway company will also be accelerated with a view to reducing the need for large-scale subsidies over the medium term.

26. Following several recent important steps toward closer integration with the EU, and in line with the national plan for integration into the EU and the conditionality of EU budget support, we are committed to maintain and develop crucial administrative capacity. In particular, the Ministry of Finance will create conditions for the decentralized implementation system necessary to access EU structural funds.

/s/
Mirko Cvetković
Prime Minister

/s/
Radovan Jelašić
Governor of the National Bank of Serbia

/s/
Diana Dragutinović
Minister of Finance

Attachment

Table 1. Serbia: Quantitative Conditionality Under the SBA, 2008–10 1/

	2008		2009								2010		
	Dec.		March		June		Sept.		Dec.		March	June	Dec.
	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Prog.	Proj.
Quantitative Performance Criteria													
Floor on net foreign assets of the NBS (in billions of euro)	5.0	6.1	5.1	6.0	4.4	5.9	3.6	6.5	4.3	6.6	4.0	4.7	4.6
Ceiling on consolidated general government overall deficit (in billions of dinars) 2/	64	72	15	12	34	55	58	79	134	121	23	63	129
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) 2/	0	0	0	0	10	0	10	2	10	2	20	20	20
Ceiling on contracting or guaranteeing by the public sector of new nonconcessional external debt (over one year, in millions of euro) 2/ 3/	50	0	200	0	550	100	550	100	550	100	200	550	600
Ceiling on accumulation of government external payment arrears (continuous, in millions of euro)	0	0	0	0	0	0	0	0	0	0	0	0	0
Inflation Consultation Bands (in percent)													
Central point	10.0	8.6	9.2	9.4	8.0	8.3	9.5	7.3	7.5	6.6	5.4	4.0	6.0
Band, upper limit	12.0	n.a.	11.2	n.a.	10.0	n.a.	11.5	n.a.	9.5	n.a.	7.4	6.0	8.0
Band, lower limit	8.0	n.a.	7.2	n.a.	6.0	n.a.	7.5	n.a.	5.5	n.a.	3.4	2.0	4.0
Indicative Targets													
Ceiling on current expenditure of the Serbian Republican budget (in billions of dinars) 2/	635	633	190	152	335	331	520	506	695	689	182	370	729
Ceiling on gross accumulation of domestic guarantees by the Republican budget, the Guarantee Fund, and the Development Fund and domestic borrowing by the Guarantee and Development funds (in billions of dinars) 2/	n.a.	n.a.	n.a.	n.a.	50	7	50	15	50	15	13	25	50

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: Proposed Structural Conditionality for 4th and 5th SBA Reviews

Measure	Target Date	Comment
1. Authorities to adopt or submit to parliament amendments to relevant laws and regulations strengthening the corporate debt collection and restructuring framework (TMU ¶25).	September 2010	To address the issue of account blockages and foster out-of-court loan workouts to minimize unnecessary and costly bankruptcies and enhance banks' ability to deal with rising NPLs.
2. Government to submit to parliament a draft Budget System and Responsibility Law, including supporting legislation (TMU ¶21).	May 2010	To anchor authorities' medium-term fiscal adjustment plans and commitments to safeguard fiscal sustainability.
3. Government to submit to parliament a comprehensive pension law, incorporating both parametric reforms and a revised indexation formula, effective April 2011 (TMU ¶20).	May 2010	To support the medium-term fiscal consolidation strategy.
4. Risk management unit at tax administration to establish an integrated taxpayer compliance strategy (TMU ¶22).	July 2010	To address tax noncompliance and improve voluntary compliance.

Attachment II. Technical Memorandum of Understanding

REPUBLIC OF SERBIA

Technical Memorandum of Understanding

1. This memorandum sets out the understandings regarding the definition 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 IMF 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

2. **Net foreign assets** (NFA) of the NBS consist of foreign reserve assets minus foreign reserve liabilities, measured at the end of the quarter.

3. 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.

4. For purposes of the program, all foreign currency-related assets will be evaluated in Euros at **program exchange rates** as specified below. For the remainder of 2010, the program exchange rates are those that prevailed on March 11, 2009. Monetary gold will be valued at the average London fixing market price that prevailed on March 11, 2009.

Cross Exchange Rates and Gold Price for Program Purposes 1/

	Valued in			
	RSD	euro	USD	SDR
Currency:				
RSD	1.0000	0.0106	0.0134	0.0093
euro	94.0972	1.0000	1.2647	0.8715
USD	74.4028	0.7907	1.0000	0.6891
SDR	107.9718	1.1475	1.4512	1.0000
Gold		727.35	919.875	633.88

1/ March 11, 2009.

5. 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 the SFRY are excluded. Also excluded are the amounts received under any SDR allocations received after August 20, 2009.

6. On December 31, 2009 the NBS's net foreign assets, evaluated at program exchange rates, were €6,597 million; foreign reserve assets amounted to €10,792 million, and foreign reserve liabilities amounted to €4,196 million.

7. **Adjustors.** For program purposes, the NFA target will be adjusted upward *pari passu* to the extent that: (i) after December 31, 2009, 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 any privatization revenue in foreign exchange received after December 31, 2009. 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 the Treasury.

B. Inflation Consultation Mechanism

8. Inflation is defined as the change over 12 months of the end-of-period consumer price index (CPI), as measured and published by the Serbian Statistics Office.

9. Breaching the inflation consultation band limits at the end of a quarter would trigger discussions with IMF staff on the reasons for the deviation and the proposed policy response. 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 IMF's Executive Board on the reasons for the deviation and the proposed policy response before further purchases could be requested under the SBA.

C. Ceiling on External Debt Service Arrears

10. **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.

11. **Reporting.** The accounting of non-reschedulable 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 can be rescheduled, will be provided separately.

D. Ceilings on External Debt

12. **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.

13. 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. For the purpose of this performance criterion, the public sector comprises the consolidated general government, the Export Credit and Insurance Agency (AOFI), the Development Fund, and the Guarantee Fund.

14. 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.

15. **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

16. **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) and any of its subsidiaries. Any new extrabudgetary fund or subsidiary established over the duration of the program would be consolidated into the general government. Revenues of the Republican budget exclude profit transfers from the NBS. Expenditures exclude the clearance of arrears of the Road Company accumulated up to end-2008.

17. **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, following consultation with IMF staff. It will be increased (respectively reduced) in 2010 by the amount of project loans disbursed by foreign creditors listed in TMU ¶13 above to the general government in excess of (respectively, lower than) the program projections indicated in the table below, in consultation with IMF 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 creditors

From January 1, 2010 to:	Program projections (billions of dinars)
March 31, 2010	4.3
June 30, 2010	8.5
September 30, 2010	12.8
December 31, 2010	17.0

18. **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.

19. The **large public enterprises** monitored under the program include the following 10 enterprises or their successors: JP Elektroprivreda Srbije (EPS), JP Elektromreza Srbije

(EMS), 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, JP Naftna Industrija Srbije (NIS), which is in majority private ownership, and JP Srbija Telekom, which competes with other telecommunication service providers. Going forward, the program will include monitoring of the aggregate wage bill of local utilities.

20. **Pension law**. The new pension draft law should be submitted to Parliament by end-May 2010. This draft law should tighten early retirement rules, including by (i) gradually increasing the minimum early retirement age from currently 53 years to 58 years for both men and women by 2020, (ii) restricting retirement before the minimum early retirement age to only a limited number of occupations; (iii) increasing the minimum service requirement for retirement for women from 35 to 38 years and gradually phasing out more than a half extra service credit for women; and (iv) raising the eligibility age for survivor's pensions to 58 years for men and to 53 for women. Further, the draft law will impose strict limits on extra service credits to a limited number of eligible professions. Contribution collection efficiency would also be strengthened, including by registering of all social security payers in a single central registry. The draft law will also contain a revised pension indexation rule, to take effect in April 2011. Any revised rule will be in line with the medium-term objective of reducing net spending of pension funds to about 10 percent of GDP by 2015. Two alternatives are under consideration. Under one, the current semi-annual CPI-based indexation formula would be augmented to include a growth premium if the previous year's GDP growth rate exceeded a threshold of 4 percent. The growth premium will be calculated as the difference between the actual growth rate in the previous year and the 4 percent threshold. Under the second, pensions would be temporarily—during the 18-month period starting in April 2011—linked to public wages. Thereafter, pensions would be indexed to the CPI (end-May 2010).

21. **Fiscal responsibility legislation**. The present Budget System Law (BSL) will be amended to further strengthen fiscal discipline. Amendments should be adopted by the government and submitted to parliament that: (i) establish a simple and transparent rule that strengthens control over the medium-term fiscal framework; (ii) strengthen fiscal procedures of the current BSL; and (iii) establish effective fiscal monitoring and enforcement mechanisms, potentially including by setting up an independent fiscal council. Further, binding ceilings on pension and general government wage spending for 2010-12 should be included in the fiscal responsibility framework (end-May 2010).

22. **Tax administration reform**. The risk management unit at the tax administration agency should adopt a fully integrated taxpayer compliance strategy that is based on the identification of the major risks to revenue and appropriate resource allocation to ensure the highest impact on collections. The strategy should focus on improving voluntary compliance and reducing noncompliance (end-July 2010).

23. **Ceiling on the accumulation of domestic loan guarantees (gross) extended by the Republican budget, the Guarantee Fund, and the Development Fund.** The ceiling also includes the contracting of any domestic loans by the Development and the Guarantee Funds. It excludes any guarantees extended under the financial stability framework, unless such loans or guarantees are extended to entities other than financial sector institutions.

24. **Reporting.** General government revenue data and the Treasury cash situation table will be submitted weekly on Wednesday; updated cash flow projections for the Republican budget for the remainder of the year five days after the end of each month; and the stock of spending arrears of the Republican budget, the Road company, and the social security funds 15 days after the end of each month. General government comprehensive fiscal data (including social security funds) would be submitted by the 25th of each month. The large state-owned enterprises listed in paragraph 19 will submit quarterly accounts and the wage bill data 45 days after the end of the quarter.

F. Financial Sector Conditionality

25. Improvements to the framework for debt collection and restructuring will focus on two areas: account blockages based on promissory notes and out-of-court loan workouts. As regards the first area, the NBS, in consultation with the government, will finalize amending the law on payments transactions to introduce registration of promissory notes using a uniform format—containing essential loan details and blockage conditions—in a single registry. The Ministry of Economy, together with the NBS, will explore alternatives to the first-mover advantage in account blockages. As regards out-of-court loan workouts, the Ministry of Economy and the NBS, in consultation with the Ministry of Finance and banks, shall (i) establish an out-of-court restructuring mechanism working group comprising representatives of the Ministries of Finance and Economy, NBS, tax authorities and selective bank representatives by mid-March, 2010; (ii) draft a corporate debt restructuring strategy note proposing the main features of an out-of-court restructuring mechanism (such as the form of the framework, coverage of debtors, and role of the NBS) and identify the legal changes needed to support such a mechanism by end-April 2010; (iii) submit draft legislative changes for government approval by end-June 2010; and (iv) submit the package of the legislative changes to Parliament by end-September 2010 (structural benchmark).

Data Reporting for Quantitative Performance Criteria

Reporting Agency	Type of Data	Timing
NBS	Net foreign assets of the NBS (including adjustors)	Within one week of the end of the month
Ministry of Finance	Consolidated government overall deficit	Within 25 days of the end of the month
NBS and Ministry of Finance	New short-term external debt contracted or guaranteed by the public sector	Within four weeks of the end of the quarter
NBS and Ministry of Finance	New nonconcessional external debt contracted or guaranteed by the public sector	Within four weeks of the end of the quarter
Ministry of Finance	Government external payment arrears	Within two weeks of the end of the month
NBS	CPI inflation	Within four weeks of the end of the month
Ministry of Finance	Current expenditure of the Serbian Republican budget	Within 25 days of the end of the month
Ministry of Finance	Gross accumulation of domestic guarantees by the Republican budget, the Guarantee Fund, and the Development Fund and domestic borrowing by the Guarantee and Development Funds	Within eight weeks of the end of the month

INTERNATIONAL MONETARY FUND

REPUBLIC OF SERBIA

Staff Report for the 2010 Article IV Consultation, Third Review Under the Stand-By Arrangement, and Financing Assurances Review—Informational Annex

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

March 18, 2010

Contents | Page

Annex I. Serbia: Fund Relations
(As of January 31, 2010)

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	1,488.86	318.34
Reserve Position	0.00	0.00

III. **SDR Department:**

	SDR Million	%Allocation
Net cumulative allocation	445.04	100.00
Holdings	9.95	2.24

IV. **Outstanding Purchases and Loans:**

	SDR Million	%Allocation
Stand-by arrangement	1,021,15	218.33

V. **Latest Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Jan 16, 2009	Apr15, 2011	2,319.12	1,021.15
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				
	2010	2011	2012	2013	2014
Principal			175.39	510.57	335.19
Charges/Interest	12.83	13.55	13.33	9.46	3.49
Total	12.83	13.55	188.72	520.04	338.67

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) was subject to an update assessment in March 2009. The update found that the safeguards framework at the NBS was strengthened since the 2001 safeguards assessment. The application of international standards resulted in noticeable improvement in the quality of the audited financial statements and internal audit practices. Staff recommended that further enhancements should focus on the establishment of an audit committee to provide independent oversight of NBS operations, and on amending the NBS Law to ensure operational and financial independence.

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 de jure exchange rate arrangement is a floating system since January 1, 2001. According to the 2009 Monetary Policy Program, the National Bank of Serbia (NBS) implements a managed floating exchange rate regime.

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). An update under the Financial Sector Assessment Program was conducted in 2009 and the Executive Board discussed the Financial System Stability Assessment in [March 2010 (IMF Country Report No. 10/x].

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

Department	**Timing**	**Purpose**
FAD	Mar. 2009–Ongoing	Resident Advisor for Public Financial Management
FAD	June-July 2009	Expenditure Policy
FAD	Nov. 2009	Revenue Administration
FAD	Dec. 2009	Fiscal Responsibility Legislation
FAD	Jan.-Feb. 2010	Tax Policy
LEG	Jan. Feb. 2010	Corporate Debt Restructuring
MCM	March 2009	Crisis Management
MCM	March 2009	FX Market and Operations
MCM	June 2009	Stress Testing
STA	Jan.-Feb. 2010	Multi-Topic

XV. **Resident Representative:**

Mr. Bogdan Lissovolik took his position as Resident Representative in April 2009.

Annex 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 aimed at medium to long-term adjustment. In areas of direct interest to the Fund, the Bank leads the policy dialogue in: (i) public expenditure management; (ii) pension, health, and education; (iii) social safety net reform and the monitoring of the impact of the crisis on the poor; and (iv) legal reforms with a bearing on the business environment, including labor markets. The Bank and the Fund have jointly led the policy dialogue in the financial sector.

The World Bank

3. Total IDA credits and grants committed to the Republic of Serbia (Serbia) by the Bank since 2001 amount to approximately $740 million, with an additional $746,5 million in IBRD commitments (as of March 2010). The Bank has assisted Serbia to make progress against key objectives set out in the Country Partnership Strategy (CPS) for FY08–11: (i) *encouraging private sector led growth and EU convergence*; (ii) *providing opportunities and broadening participation in growth*; and (iii) *managing environmental and disaster risks*. The Government has advanced on the first two priorities with the support of World Bank financial and analytical products, though progress has been less substantial on the third priority owing to electoral and economic developments.

4. The 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. A Country Partnership Strategy Progress Report (CPS-PR) assessing progress in implementing the FY08-FY11 CPS for Serbia, was presented to the Board on November 19, 2009. At the request of the Government, the original CPS allocation has been increased by an additional US$300 million. This additional lending will initially be allocated to development policy lending (to support reform of public expenditures as well as private and financial sector development), which will help to meet Serbia's short to medium term financing needs and complement support under a coordinated assistance package comprising EU and IMF assistance under the SBA. Moreover nearly two-thirds (US$388 million) of the original CPS envelope has been reallocated to help complete Corridor X, the major north-south transport corridor.

5. As of March 2010, Serbia has a portfolio of 12 Bank-supported projects under implementation with a total commitment value of $845.8 million (including IDA, IBRD and

GEF). Investment support focuses on (i) transport and energy infrastructure aimed at encouraging regional integration and spurring economic growth; (ii) agricultural, environment, and irrigation investments to improve production and help Serbia meet EU standards; (iii) pension, education and health sector reform to strengthen the quality of service and improve financial sustainability; (iv) strengthened land administration; (v) energy efficiency; and (vi) regional development in the economically depressed former mining region of Bor.

6. The Bank's flagship analytical work in FY09 was a Public Expenditure Review (PER), following a request from the Minister of Finance in September 2008 for advice on where costs could be cut in the budget. The PER has been central to the DPL series and will be followed-up by FY10 just-in-time assistance to identify structural savings in the public sector wage bill. Other FY10 just-in-time assistance include work to identify measures that would: allow the pension system to become financially sustainable while ensuring adequate benefits into the future. With an eye to the longer-term competiveness agenda the Bank is providing FY10 TA for Education Reform strengthening Research and Innovation (key obstacle to successful completion of transition) and to improve efficiency in Municipal Enterprises. The Bank is coordinating support for better governance in the justice sector through a multi-donor trust fund. Broader academic and public dialogue is assured through a series of roundtables and policy notes.

IFC

7. As of March 2010, the IFC's committed portfolio in Serbia was US$285 million in eleven projects, of which 16% consists of equity investments. The financial and food sectors represent the largest sector exposures on IFC's own account. In addition, in December 2009 IFC made a Euro 40 million preferred share investment in a large bank of systemic importance through the recently established IFC Bank Capitalization Fund. IFC's investment portfolio also includes substantial indirect exposure to Serbia through either regional private equity funds or regional players in the micro-finance and retail sectors.

8. In the financial sector, since the inception of the global financial crisis IFC injected liquidity into the Serbian banking system by disbursing existing commitments as well as new commitments in the total amount of approximately US$90 million to banks. Under the Joint IFI Action Plan, IFC plans to provide an additional US$200 million in the form of equity and debt financing to systemic banks that are looking to play a counter-cyclical role by increasing their SME and corporate portfolio during the current market downturn.

9. Advisory Services. IFC completed the first phase of the regulatory guillotine review at sub-national level to improve the business environment and sub-national competitiveness in four municipalities. In addition, IFC is providing advisory services to several companies through its corporate governance and international standard programs. IFC has also

successfully completed the implementation of the Alternative Dispute Resolution (ADR) program.

FIAS

10. FIAS, a multi-donor service of the World Bank Group administrated by IFC, advises member countries on improving their investment climate and on methods to attract FDI. Under a joint World Bank project, FIAS is providing assistance to the government in improving the quality of regulations affecting the cost and risk of doing business in Serbia by developing and implementing tools for reviewing the flow of regulation. FIAS is also implementing several multi-year technical assistance investment generation programs to support Serbia in its efforts to attract FDI.

MIGA

11. As of December 2010, MIGA's outstanding portfolio in Serbia consisted of 6 contracts of guarantee with total gross exposure of $216 million. MIGA guarantees have primarily supported the expansion of Serbia's banking and leasing sectors.

Prepared by World Bank staff. Questions may be addressed to Anthony Gaeta at (202) 473-1798 or Marina Wes at + 381 11 3023 706.

Annex III. Serbia: Statistical Issues

1. Economic statistics in Serbia have faced many challenges in recent years but data provision 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. Serbia participates in the General Data Dissemination System (GDDS) and its metadata were posted on the IMF Data Dissemination Bulletin Board on May 1, 2009. The metadata identify plans for improvement, which are being used to guide further progress.

A. Real Sector Statistics

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 1997–2008. In June 2005, the RSSO started publishing quarterly constant price estimates of GDP using the production approach. Data are available from 1997 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. The new estimates of changes in inventories that comply with international recommendations have not yet been incorporated in the published data. 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.

3. 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

4. Balance of payments statistics are compiled by the National Bank of Serbia (NBS). The compilation procedures are generally appropriate; however, the source data for

---

[1] Since 2001, STA conducted four technical assistance missions on monetary and financial statistics, four missions on national accounts, two multi-sector mission, and two balance of payments mission. In addition, the STA GFS regional resident statistical advisor based in Slovenia visited Belgrade on three occasions and provided remote assistance.

compiling various current account transactions could be further improved. In particular, additional programs should be developed to collect data to estimate unrecorded trade, travel, and private transfers (workers' remittances).

5. The NBS has improved the source data for estimating transactions relating to direct investment by conducting direct surveys of direct investment enterprises. However, there is a backlog of data to be processed and direct investment transactions in the balance of payments statistics have not been adjusted based on the survey data.

6. The staff levels are not commensurate with the statistical program and the NBS may face some difficulty in conducting all the requisite data collection exercises and implementing the majority of the recommendations if staffing is not increased.

7. Serbia reports balance of payments statistics to STA for publication in the *IFS* and the *Balance of Payments Statistics Yearbook*. The NBS has made steady progress towards compiling international investment position statistics, which will be published for the first time in March.

C. Government Finance Statistics

8. 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.

9. 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

10. 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.

11. Some improvements could still be made. 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 small deposit-taking institutions that the authorities designate as *Other Financial Institutions (OFIs)*.

Serbia: Table of Common Indicators Required for Surveillance
(As of February 28, 2010)

	Date of Latest Observation	Date Received	Frequency of Data[4]	Frequency of Reporting[4]	Frequency of Publication[4]
Exchange rates	Feb. 25, 2010	Feb 26, 2010	D and M	D and M	D and M
International reserve assets and reserve liabilities of the monetary authorities[1]	Feb. 25, 2010	Feb. 26, 2010	D	D	M
Reserve/base money	Feb. 25, 2010	Feb. 26, 2010	D and M	W and M	W and M
Broad money	Jan. 2010	Feb. 24, 2010	M	M	M
Central bank balance sheet	Dec. 2009	Jan. 28, 2010	M	M	M
Consolidated balance sheet of the banking system	Dec. 2009	Jan. 28, 2010	M	M	M
Interest rates[2]	Feb 25, 2010	Feb. 26, 2010	D	D	D
Consumer price index	Jan. 2010	Feb. 23, 2010	M	M	M
Revenue, expenditure, balance and composition of financing – general government	Jan. 2010	Feb... 2010	M	M	M
Revenue, expenditure, balance and composition of financing– central government	Jan. 2010	Feb. 2010	M	M	M
Stocks of central government and central government-guaranteed debt[3]	Dec 2009	Feb 2010	M	M	M
External current account balance	Dec. 2009	Feb. 2010	M	M	M
Exports and imports of goods and services	Jan. 2010	Feb. 26, 2010	M	M	M
GDP/GNP	Q3 2009	Jan. 4, 2010	Q	Q	Q
Gross external debt	Dec.. 2009	Feb. 2010	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.

Statement by the Staff Representative on Republic of Serbia
March 31, 2010

1. This statement summarizes economic developments and policy actions in Serbia since the issuance of the staff report. The additional information does not change the thrust of the staff appraisal.

2. On March 23, the NBS lowered its policy interest rate by 50 basis points to 9 percent, against a backdrop of monthly CPI inflation rates (3.9 percent, y-o-y, in February) below the NBS's tolerance band, while one-year ahead inflation expectations of financial market participants have continued to trend downward.

3. National Bank of Serbia (NBS) Governor Jelašić has announced his resignation for personal reasons. The Parliament's finance committee is expected to formalize the decision in the next few weeks, and nominate the successor. Mr. Jelašić will continue to exercise his functions until the new Governor takes office.

4. The government adopted a new small program of subsidized consumer cash loans in dinars to support domestic demand. The budget cost of the additional interest subsidies could amount to up to 0.5 billion dinars, to be financed through existing budget allocations, while the take-up of the subsidized loans could reach up to 0.3 percent of GDP. In addition, the government decided that all other subsidized consumer loans will also only be extended in dinars.

5. The authorities announced a decision to sell a 40 percent stake in Telekom later this year through an international tender. The preliminary plan is to channel the potentially significant proceeds to a special fund, which would finance infrastructure investment.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/47
FOR IMMEDIATE RELEASE
April 7, 2010

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

IMF Executive Board Concludes 2001 Article IV Consultation with Serbia

On [March, 31, 2010], the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Serbia.[1]

Background

The Serbian economy enjoyed fast-paced GDP growth during the five years leading up to the global economic downturn, buoyed by strong domestic demand and an externally funded credit boom. But the economic expansion was strongly tilted towards non-tradable sectors. An increasingly procyclical fiscal policy added further expansionary impulses to domestic demand, while structural reforms proceeded only slowly. As a result, external stability risks increased, reflected in high external deficits, rising private sector external indebtedness, high euroization, and weak export competitiveness.

The global economic and financial crisis quickly spilled over to Serbia. The squeeze in external financing led to a sharp contraction of investment, followed by a significant drop in consumption. The fiscal deficit surged, reflecting higher social spending needs and tax revenues shortfalls on account of lower trade, incomes, and spending.

The authorities responded to the downturn with a comprehensive policy package to safeguard macroeconomic and financial stability. The policy response focused on fiscal adjustment;

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

implementation of a Financial Sector Support Program, including financing assurances from foreign parent banks; and substantial external financing from IMF, World Bank, and the EU. A structural policy reform program was designed to address the roots of the economy's low capacity to produce, save, and export.

The authorities' adjustment program—supported by the SBA—has contributed to limiting the fallout of the global crisis on Serbia. While the output slump has been limited relative to regional peers, the decline in domestic demand has been significant, resulting in a strong external adjustment. Real GDP contracted by less than 3 percent, and domestic demand by 7½ percent. With the economy's overall spending shrinking faster than income, the external current account deficit is estimated at 5¾ percent of GDP, down from 17 percent in 2008. Capital inflows have remained low but stable over the last few months; as a consequence, external financing pressures have abated.

The outlook for 2010 points to a slow but balanced recovery. The pick-up in growth will likely be moderate (2 percent), reflecting slow trading partner recovery, protracted corporate deleveraging, nominal freezes in public wages and pensions, and lagging labor market adjustment. The NBS inflation targets for 2010 should be met, but recent disinflation notwithstanding, inflation expectations remain elevated. The program targets a 2010 deficit of 4 percent of GDP and fiscal consolidation over the medium term. After the sharp external adjustment in 2009, the current account deficit is expected to widen slightly reflecting a drop in remittances relative to 2009.

Executive Board Assessment

Executive Directors noted that the Serbian economy has weathered the global financial crisis relatively well. The decline in output has been contained, while falling domestic demand has resulted in significant external adjustment. Going forward, Directors agreed that policies should shift the economy toward more sustainable growth, with resolute reduction of external and fiscal imbalances. Against this background, they welcomed the authorities' focus on strengthened structural and fiscal policies aimed at raising productivity, exports, and saving.

Directors supported the authorities' ambitious spending-based adjustment strategy, which aims at reducing high structural fiscal deficits mainly by restraining the growth of public wages and pensions, while increasing public investment to address long-standing infrastructure bottlenecks. They underscored, however, that bold steps are needed to replace these nominal freezes and other ad hoc fiscal measures by structurally sound spending reforms. Directors therefore welcomed the agreed package of parametric pension reforms and looked forward to its early approval by Parliament, while encouraging adoption of an indexation mechanism for pensions consistent with the authorities' medium-term target for pension outlays. The authorities should also speed up additional spending reforms in the education, health, and administration sectors, while maintaining a well-targeted social safety net. Directors observed that the credibility of the authorities' fiscal adjustment strategy hinges on early and determined implementation of these reforms. Fiscal consolidation efforts would also benefit from improvements in tax administration.

Directors stressed the importance of maintaining fiscal discipline, particularly in light of pressures for new spending. In this context, Directors welcomed the authorities' plans to draft fiscal responsibility legislation that could include ceilings on public wages and pensions during 2010-12. Some Directors considered that the authorities should stand ready to take additional fiscal measures or contingency actions as needed.

Directors supported the authorities' prudent conduct of monetary policy, as reflected in continued disinflation. They agreed that further easing should be pursued cautiously in view of the still elevated inflation expectations. Directors supported the authorities' plans to streamline and lower reserve requirements, as well as plans to curtail the high level of euroization, both of which could help improve the effectiveness of monetary policy.

Directors welcomed the positive assessment reached in the recent Financial Sector Assessment Program Update. They agreed that adverse spillovers from the global crisis on the Serbian banking system have been contained. However, supervisory challenges remain, including streamlining prudential rules and formalizing memoranda of understanding with key home supervisors. Prudential and supervisory measures should continue to be used to discourage banks from extending new unhedged foreign exchange loans. Directors welcomed foreign parent banks' re-affirmed commitments under the European Bank Coordination Initiative to keep their subsidiaries liquid and well capitalized. Careful monitoring of possible regional financial spillovers will be important.

Directors stressed that further progress on structural reform is needed to lift Serbia's growth potential and promote the tradable goods sector. They were encouraged by the recent efforts to streamline business laws and regulations. The authorities need to press ahead with public enterprise reform and privatization as market conditions permit.

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

Serbia: Selected Economic and Social Indicators, 2006–11

	2006	2007	2008	2009 Est.	2010 Proj.	2011 Proj.
	(Percent change, unless otherwise indicated)					
Output, prices, and labor market						
Real GDP	5.2	6.9	5.5	-2.9	2.0	3.0
Real domestic demand (absorption)	6.2	11.5	6.3	-7.4	0.4	2.3
Consumer prices (average)	12.7	6.5	12.4	8.1	4.8	4.8
Consumer prices (end of period)	6.6	11.0	8.6	6.6	6.0	4.5
Nominal gross wage	24.4	21.9	17.8	4.1	4.8	6.7
Real net wage	10.6	19.9	4.9	-3.7	0.0	1.8
Average net wage (in euros per month)	260	348	402	372	…	…
Net wage in euro	23.3	33.9	15.8	-7.7	…	…
Registered employment	-1.4	0.1	2.3	-4.6	-1.2	-0.4
Unemployment rate (in percent)	21.6	18.8	14.7	17.4	…	…
Nominal GDP (in billions of dinars)	1,980	2,363	2,751	2,899	3,139	3,388
	(Percent of GDP)					
General government finances						
Revenue	43.8	42.4	41.4	39.6	38.4	38.0
Expenditure	45.4	44.2	44.0	43.7	42.5	41.0
Current	40.8	39.0	39.6	39.8	38.2	36.5
Capital and net lending	4.6	5.2	4.5	3.9	4.3	4.5
Fiscal balance (cash basis)	-1.6	-1.9	-2.6	-4.2	-4.1	-3.0
Structural fiscal balance 1/	-2.3	-3.6	-4.6	-3.5	-4.4	-3.5
Gross debt	42.6	34.3	33.1	36.4	36.0	36.5
	(End of period 12-month change, percent)					
Monetary sector						
Money (M1)	37.1	25.3	-3.8	8.7	14.5	14.1
Broad money (M2)	38.4	44.5	9.6	21.8	10.7	13.6
Domestic credit to non-government	17.1	36.9	35.0	15.9	16.0	23.2
Interest rates (dinar)						
NBS repo rate	14.0	10.0	17.8	9.5	…	…
Deposit rate	5.1	4.1	6.4	5.1	…	…
	(Percent of GDP, unless otherwise indicated)					
Balance of payments						
Current account balance	-10.1	-15.5	-17.1	-5.7	-8.5	-9.1
Exports of goods	21.8	21.6	22.0	19.4	19.8	21.9
Imports of goods	42.9	44.1	44.6	34.9	34.5	36.9
Trade of goods balance	-21.2	-22.5	-22.3	-15.5	-14.7	-15.0
Capital and financial account balance	31.7	17.9	12.4	11.7	4.2	4.4
External debt	63.3	60.2	63.6	76.0	79.5	77.1
of which: Private external debt	36.0	39.5	45.0	51.7	48.5	45.6
Gross official reserves (in billions of euro)	8.7	9.5	8.2	10.6	11.3	10.2
(In months of prospective imports of GNFS)	6.6	6.3	7.7	9.6	9.2	7.4
(Percent of short-term debt)	294.5	268.4	438.3	207.7	217.9	190.0
Exchange rate (dinar/euro, period average)	84.2	80.0	81.5	93.9	…	…
REER (annual average change, in percent; + indicates appreciation)	6.6	7.2	6.4	-7.1	-0.3	1.8
Social indicators (2008)						
Per capita GDP: US$6,685. Population: 7.4 million. Poverty rate (national poverty estimate): 6.1 percent.						

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

1/ Fiscal balance adjusted for the automatic effects of both the output gap and the current account gap.

Press Release No. 10/131
FOR IMMEDIATE RELEASE
March 31, 2010

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Third Review Under Stand-By Arrangement with Serbia and Approves €360 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the third review of Serbia's economic performance under a program supported by a Stand-By Arrangement (SBA). The completion of the review enables the immediate release of SDR 319.6 million (about €360 million, or US$485.23 million). The Serbian authorities have indicated that they will draw only 50 percent of the purchase available under this review. This would bring total disbursements under the program to SDR 1.2 billion (about €1.3billion, or US$1.8 billion). The Board also completed the financing assurances review.

Serbia's initial 15-month SBA was approved on January 16, 2009, for SDR 350.8 million (about €395.13 million, or US$532.6 million). The arrangement was extended by one year and augmented to SDR 2.6 billion (about €2.9 billion, or US$4 billion on May 15, 2009 (see Press Release No. 09/169) to support the government's economic program amid a sharper than expected impact from the global financial crisis.

The Executive Board also concluded the 2010 Article IV consultation with Serbia. A Public Information Notice and the staff report will be published in due course.

Following the Executive Board's discussion on Serbia, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, said:

"Serbia continues to perform well under its economic program supported by the Fund's Stand-By arrangement. The authorities' policy response to the global financial crisis has helped contain its adverse effects on the Serbian economy: the output decline has been limited, while falling domestic demand has resulted in significant external adjustment.

"Fast-paced GDP growth in Serbia before the crisis came at the cost of growing external and financial stability risks. As the economy recovers, policies should be geared toward promoting more balanced medium-term growth. There is a need for stronger structural and fiscal policies to raise productivity, exports, and savings.

“The authorities’ spending-based adjustment strategy aims at reducing high structural fiscal deficits mainly by restraining the growth of public wages and pensions, while public investments will be increased to address long-standing infrastructure bottlenecks. Fiscal adjustment in 2009 was in line with the program, but was largely based on ad hoc measures that will need to be replaced by more durable spending reforms, such as the planned pension reform, and structurally sound reforms in the education, health, and administration sectors, while maintaining a well-targeted social safety net. The adoption of fiscal responsibility legislation should help maintain spending discipline.

“The Financial Sector Assessment Program Update concluded that the banking sector is well capitalized and highly liquid, and has successfully weathered the global financial crisis. However, supervisory challenges remain, including streamlining prudential rules and formalizing memoranda of understanding with key home supervisors. Foreign parent banks’ commitments under the European Bank Coordination Initiative are welcome, and the recent agreement to gradually phase out commitments is appropriate against the backdrop of a considerable easing of external financing pressures.

“To increase Serbia’s growth potential, structural reforms should be implemented, notably in the areas of public enterprise reform and privatization. Recent efforts to streamline business laws and regulations are welcome.”

Statement by Mr. Weber and Mr. Antic on Republic of Serbia
March 31, 2010

1. We thank staff for a comprehensive set of documents, which present an accurate picture of the economic situation in Serbia. The report candidly delineates the delicate policy challenges that the authorities are facing in this turbulent period. There are positive signs that the economy has reached the turning point to a lasting recovery, but the authorities are aware that this recovery needs to be underpinned by further fiscal and structural reforms. On behalf of our Serbian authorities, we would like to thank staff for very constructive policy discussions and valuable advice. As in the past, the authorities will not object the publication of the current reports, nor request any modification of the documents.

2. The Stand-By Arrangement with Serbia is on track and all end-December quantitative performance criteria and indicative targets were met, most with a considerable margin. The structural reform agenda remains politically difficult, but notable progress was made on the sensitive and complex reform of the pension system, in designing fiscal responsibility rules, and in facilitating corporate debt collection. Despite some delays, the authorities remain committed to implementing all the benchmarks agreed with the Fund.

3. Economic indicators are currently sending mixed signals. The global recovery is supporting a tentative upturn in industrial output, exports and capital inflows are higher than expected, and confidence in the banking system has been restored. On the other hand, corporate insolvency and payment problems are still on the rise and unemployment remains stubbornly high. Shrinking domestic demand caused a sharp reduction in the current account deficit, but the decline in imports resulted in a loss of fiscal revenues which, at least in part, will be permanent. The continued need to adjust external and fiscal imbalances might hold back the recovery and hamper the economy’s growth potential. The authorities are nevertheless confident that the gradual economic recovery projected for this year will materialize.

4. The authorities’ fiscal strategy is based on expenditure cuts with the exception of pro-poor spending and public investment in infrastructure, without an increase in the overall tax burden. A nominal freeze on wages of government employees and public pensions is in effect until end-2010, while other expenditure categories are being scrutinized for savings. The fiscal space thus created in the budget will be used for infrastructure investment. With this approach, fiscal deficits will be gradually reduced over the medium-term. The authorities

believe that the achievements on the fiscal front should be preserved and they will submit fiscal sustainability legislation to parliament by end-May.

5. Regarding public sector wages, the authorities intend to lower the ratio of general government wages to GDP to 8 percent by 2015. In addition to the wage freeze, the workforce in the central and local administrations is to be reduced by 10 percent, together with the imposition of a strict hiring freeze across all levels of government. Public employment will be further rationalized through reforms in health and education sectors.

6. A complex pension reform is under way with the aim to lower net spending by pension funds to 10 percent of GDP by 2015. With the pensions freeze being a temporary measure, sustainable longer-term savings are envisaged with parametric adjustments (increase of minimum retirement age, reduction in service credits for the military and police, tightening of survivor entitlements, longer contribution period for women). This package of reforms will be submitted to parliament by end-May. Most importantly from the point of view of fiscal sustainability, the authorities propose a new but temporary indexation formula after the freeze on pensions expires. They have proposed to establish a temporary link between pensions and public wages for 18 months starting in April 2011, with the idea that the burden of fiscal adjustment during 2011-12 should be equally shared between public wages and pensions. After the indexation adjustment in April 2012, there will be a shift to CPI indexation. This indexation agreement will be consistent with the ultimate goal of reducing pension spending to 10 percent of GDP in 2015.

7. The authorities expected that inflation will end the year within the target range of the National Bank of Serbia (NBS) of 4 to 8 percent. The NBS will remain focused on achieving stable inflation within this target range. In a situation where inflation is currently low and inflation expectation are declining, although from an elevated level, the NBS continues with an easing of its monetary stance. The policy rate was recently lowered to 9 percent. Reserve requirements will be simplified by phasing out most exemptions and only two statutory rates will be introduced. The new regime will be phased in gradually and should be fully in place by March 2011.

8. The NBS will continue with the managed float as the exchange rate regime for the dinar. Although the exchange rate helped in absorbing external shocks, Serbia's shallow foreign-exchange market is prone to excessive volatility. Recent NBS interventions are geared towards the objective of smoothing such volatility and preserve financial stability.

9. The Serbian banking system is well capitalized and liquid, as confirmed by the updated Financial System Stability Assessment. While the banking sector is resilient, the risks of a loss of confidence in banks due to regional contagion and of unhedged foreign exchange exposures persist. The authorities agreed with the participants of the Bank Coordination Initiative (Vienna Initiative) on a gradual exit strategy from the exposure commitments, with the exposure floor for Serbia reduced to 80 percent of the end-2008 exposure.

10. Although market conditions are not ideal for privatization, the selling of state and socially owned companies continues. All companies under the Privatization Agency will be

offered for sale or will be put under liquidation or bankruptcy procedure. One large social-owned enterprise has recently entered into a joint venture with a foreign investor, which is the strategy that the authorities intend to pursue with other large state companies. The utility sector will be corporatized this year and full or partial privatization should follow.

11. Our Serbian authorities believe that the design of the program has adequately addressed the economic challenges of the country. They are open to revisiting aspects of the arrangement, given that its objective is shifting from preserving financial and external stability to fiscal and structural reforms.