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February 2015

2014 ARTICLE IV CONSULTATION AND REQUEST FOR STAND-BY ARRANGEMENT—STAFF REPORT; PRESS RELEASES; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF SERBIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV Consultation and Request for Stand-By Arrangement, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 23, 2015, following discussions that ended on November 20, 2014, with the officials of Serbia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 6, 2015.
- An **Informational Annex** prepared by the IMF.
- A **Staff Statement** of February 23, 2015 updating information on recent developments.
- **Press Releases** including a statement by the Chair of the Executive Board, and summarizing the views of the Executive Board as expressed during its February 23, 2015 consideration of the staff report on issues related to the Article IV Consultation and the IMF arrangement.
- A **Statement by the Executive Director** for the Republic of Serbia.

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

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF SERBIA

February 6, 2015

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND REQUEST FOR STAND-BY ARRANGEMENT

EXECUTIVE SUMMARY

Context. Serbia is facing a weak economy, serious fiscal imbalances, and protracted structural challenges. The new government appointed in 2014 has a window of opportunity to address these issues, with support from a new Fund program.

Fiscal policy. Strong fiscal consolidation over the program period—largely based on curbing mandatory spending and reducing state aid to state-owned enterprises (SOEs)—is needed to put public debt on a downward path. These measures will be supported by strengthening public financial management (PFM).

Monetary and exchange rate policy. The inflation targeting framework is appropriate and the flexible exchange rate should remain an important shock absorber. Fiscal consolidation creates room for gradually easing monetary policy.

Financial sector policy. The financial sector has remained broadly resilient, but special diagnostic studies are necessary to gauge potential capital shortfalls and establish a consistent baseline for financial sector policies under the program. The high level of non-performing loans (NPLs) is a major challenge requiring a comprehensive strategy.

Structural reforms. Broad-based structural reforms, notably to improve the business environment and resolve loss-making SOEs, should foster Serbia's medium-term growth potential and reduce fiscal risks.

Program modalities. The proposed program supports the authorities' medium-term policy goals to restore fiscal sustainability, bolster growth, and boost financial sector resilience. The authorities request a precautionary 36-month Stand-By Arrangement (SBA) with access of SDR 935.4 million (200 percent of quota, or about €1,122 million). Staff support the request and believe that this program will underpin Serbia's resilience against adverse shocks that could give rise to a balance of payments need.

Approved By
European Department
Aasim M. Husain and
Athanasios Arvanitis

Discussions were held in Belgrade on November 4–20, 2014. The staff team comprised Zuzana Murgasova (head), Chuling Chen, Dmitriy Kovtun, Eugen Tereanu (all EUR), Santiago Acosta-Ormaechea (FAD), Constant Verkoren (MCM), Manrique Saenz (SPR), Daehaeng Kim (resident representative), Desanka Nestorović and Marko Paunović (Belgrade office). Aasim Husain (EUR) joined some of the policy discussions. HQ support was provided by Christine Richmond (FAD), Dustin Smith, and Patricia Mendoza (EUR).

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CONTEXT

1. **The Serbian economy has been facing protracted structural challenges.** Prior to the 2008 global financial crisis, strong growth was achieved at the expense of accumulating internal and external imbalances (Figure 1). At the same time, the unfinished structural reform agenda led to mounting competitiveness problems, poor labor market outcomes, large current account deficits, high and volatile inflation, and periodic exchange rate pressures (Figures 2 and 3). Weak public institutions and large fiscal imbalances in recent years have led to a rapid buildup of public debt (Figure 4). In addition, Serbia was hit by exogenous shocks, such as an extreme winter and drought in 2012, and devastating floods in 2014. As a result, Serbia's GDP is still below its pre-crisis level.

2. **Serbia now has a window of opportunity to break from past policies and embark on stabilization and reform.** The new coalition government, appointed in April 2014 and commanding a parliamentary majority, reaffirmed Serbia's path of EU accession and committed to implementing reforms needed to restore macroeconomic stability and achieve sustainable growth. This commitment has already been underscored by the launch of important structural reforms and strong steps toward fiscal consolidation (Box 1). To support their reform program, the authorities have requested a three-year precautionary SBA.

Box 1. Implementation of Past Fund Advice

The implementation of past Article IV recommendations accelerated in 2014. While the authorities agreed with many of the Fund's recommendations in past years, policy implementation had been incomplete. In 2014, important structural reforms were introduced in the summer and fiscal consolidation started in the fall.

In the **fiscal area,** the Fund's past advice focused on: (i) regaining fiscal sustainability through a reduction of mandatory spending; (ii) improving public financial management; and (iii) raising the efficiency of tax administration. A fiscal rule and a public debt ceiling (45 percent of GDP) introduced in 2011 to strengthen fiscal discipline were not followed and the fiscal situation deteriorated subsequently. Despite measures implemented in the past two years (i.e., VAT and CIT tax rate increases in 2012, lower wage and pension indexation in 2012–13, and a solidarity tax on high public wages with an attrition rule in the civil service in early 2014), the consolidation efforts were piecemeal and the size of the adjustment was limited. However, important fiscal consolidation measures have been introduced since mid-2014, including a parametric pension reform in line with the Fund's advice, a 10 percent public sector wage cut, and a progressive reduction of pensions (MEFP ¶¶6–7). While there have been modest improvements in the PFM area, notably in arrears monitoring and control, tax administration reform has yet to start.

In the area of **monetary and financial sector policies,** the National Bank of Serbia (NBS) maintained a tight monetary policy stance in the presence of loose fiscal policy and uncertain capital flows, in line with the Fund's previous advice. However, the NBS tightly managed the exchange rate through foreign exchange market interventions till mid-2014. Furthermore, the gap between the key policy rate and the average reverse repo rate, which sends an uncertain signal about the monetary policy stance, has remained. While weaknesses in several public banks eventually prompted resolutions at the expense of taxpayers, strong prudential policies were maintained, in line with the Fund's recommendations. Notable progress has been

Box 1. Implementation of Past Fund Advice (Concluded)

made in the area of strengthening the bank resolution framework, in collaboration with the Fund, the World Bank, and the EBRD.

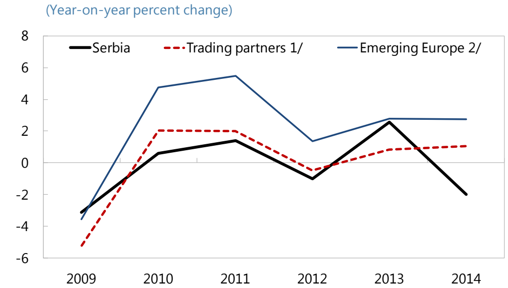
The related legislative changes have been finalized in early February 2015.

In **structural areas**, the Fund had previously advised: (i) labor market reforms to foster private sector job creation and tackle persistently high unemployment; (ii) regulatory reforms to improve Serbia's rigid business environment; and (iii) public enterprise reforms to reduce excessive state intervention in public enterprises. While these reforms had largely stalled in the past years, important legislative reforms were introduced since mid-2014 in line with the Fund's advice. Comprehensive amendments to the Labor Law have provided a legal basis for more efficient labor market functioning, and amendments to the Urban Planning and Construction Law cleared the way for more timely issuance of construction permits, removing a key bottleneck for investment. Recent changes to the Bankruptcy Law and a new Privatization Law have created more effective tools needed to resolve non-viable state and socially-owned enterprises. The authorities have also offered more than 500 socially-owned enterprises for sale in 2014.

RECENT ECONOMIC DEVELOPMENTS

3. **In 2014, the Serbian economy fell into recession for the third time in six years.** After a recovery in 2013, the economy contracted by an estimated 2 percent in 2014, as devastating floods in May took a heavy toll on industrial production and the energy sector, and weaknesses in economic activity in the trading partners reduced demand for Serbia's exports (Figure 5).[1] Formal employment has continued to fall, indicating persistent weaknesses in the labor market, and real net earnings remained flat. Credit to the economy continued to contract due to the challenging economic environment and NPL overhang.

Real Gross Domestic Product
(Year-on-year percent change)



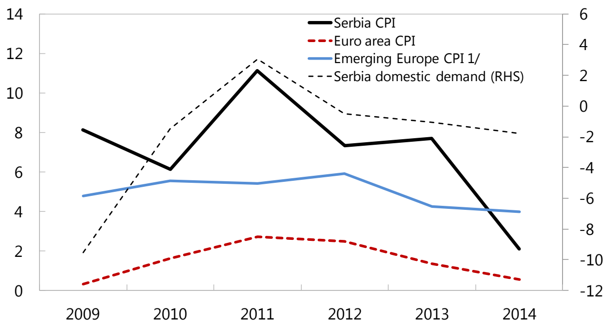
Sources: SORS; WEO; Direction of Trade Database; and IMF staff estimates.
1/ 10 largest trading partners by export value.
2/ ALB, BIH, BFR, HRV, HUN, UVK, LTU, MKD, MNE, POL, ROU, SRB, and TUR.

4. **Inflation fell to record low levels due to contracting domestic demand and low imported inflation.** Headline inflation has been below the inflation tolerance (IT) band due to a decline in food prices since late 2013 (Figure 6). Core inflation fell subsequently as well, suggesting broad-based disinflation pressures, similar to trends observed in the region. In response, the National Bank of Serbia (NBS) reduced the key policy rate by 50 basis points to

[1] In late 2014, the GDP time series were revised in line with 2010 SNA methodology, and nominal GDP was revised upward by an average of about 7 percent. This reduces all ratios as a share of GDP compared to previously reported statistics.

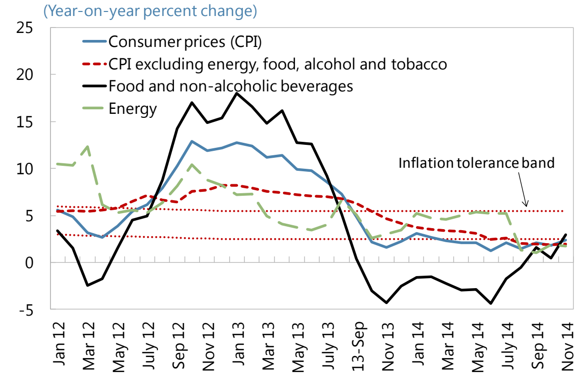
8 percent, and lowered reserve requirements on banks' foreign exchange liabilities by 3 percentage points to stimulate lending.[2] Despite the reduction, the key policy rate remained relatively high in real terms due to low inflation.

Consumer Price Index and Domestic Demand
(Year-on-year percent change)



Sources: SORS; WEO; and IMF staff estimates.
1/ ALB, BIH, BFR, HRV, HUN, UVK, LTU, MKD, MNE, POL, ROU, SRB, and TUR.

Inflation
(Year-on-year percent change)



Source: The NBS.

5. The gradual adjustment of the current account was interrupted by the floods and weak external demand. The improvement in the current account deficit in 2013, mainly due to expanding automobile exports, halted in 2014 on account of flood-related net electricity imports and a slower European market for automobiles, though lower oil prices in the second half of 2014 partly compensated for the expansion of imports (Figure 7).

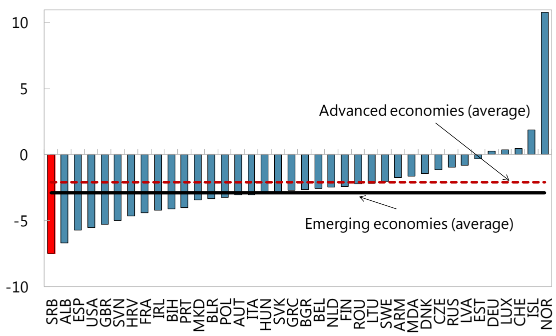
6. International reserves remained at comfortable levels despite capital outflows. The dinar came under pressure in the second half of 2014, as the widening current account deficit compounded the effects of continued net outflows from the banking sector and debt service by the public sector. This was further amplified by a weakening of market sentiment toward Serbia due to delayed fiscal adjustment and uncertainty regarding the policy course. In response, the NBS increased exchange rate flexibility after almost a year-long period of tight management, though foreign exchange market interventions continued (Figure 8). Despite a reduction by €1.3 billion over 12 months, gross international reserves stood at 6¾ months of imports (or at 205 percent of the Fund reserves metric, well above the 100–150 recommended range) at end-2014.

7. While the 2014 budget took steps toward fiscal adjustment, the headline deficit worsened, largely as a result of the floods. The legislated consolidation measures included a new solidarity tax on public wages and a tax on farmer income, introduction of a 5:1 attrition rule in public administration, and an increase in the lower VAT rate from 8 to 10 percent. Nevertheless, the flood-induced recession and the ensuing recovery spending led to the approval of a supplementary budget in October 2014. As a result, the general government deficit

[2] Required reserves ratios were reduced from 29 to 26 percent for maturities of less than two years and from 22 to 19 percent for maturities of two years or more. This was accompanied by a reduction in the share payable in foreign exchange by 6 percentage points.

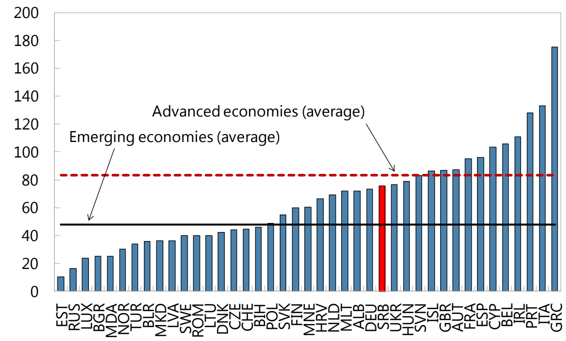
increased to an estimated 7½ percent of GDP in 2014, public debt reached about 70 percent of GDP, and gross financing needs rose sharply (Figure 4). Yields on domestic debt continued to fall in line with developments in emerging markets.

General Government Fiscal Balance, 2014
(Percent of GDP)



Source: WEO.

Public Debt, 2014
(Percent of GDP)



Source: WEO

OUTLOOK AND RISKS

8. **The authorities and staff agreed that the policies of the past are not sustainable.** Failure to address the problems in public finances and delays in structural reforms would result in persistently high fiscal deficits and rising public debt ratios, with adverse implications for borrowing costs, market access, and growth.

9. **Macroeconomic stability and balanced growth can be achieved with a rebalanced macro-policy mix and broad-based structural reforms.** The program scenario envisages the following outcomes:[3]

- GDP would continue to contract in 2015 due to the sizeable, but necessary, fiscal consolidation, and return to moderate growth in 2016–17. The recovery would strengthen over the medium term on account of a virtuous circle of positive confidence effects, falling interest rates, improved competitiveness, and higher foreign direct investment (FDI), supported by monetary easing and structural reforms (Figures 9, 10, and Tables 1–7). The authorities pointed out that the growth outlook has upside potential arising from prospective large foreign-financed investment projects if they materialize, and from faster-than-expected improvement in confidence.

[3] The program scenario and targets agreed with the authorities are based on the IMF's oil price assumptions as of November 2014 (the time of the negotiations). Oil price projections have since declined further. This would reduce the current account deficit in the absence of offsetting volume increases, provide stimulus for economic activity, and restrain inflation. The macro framework will be updated as needed at the time of the first review in line with the most recent forecast for commodity prices.

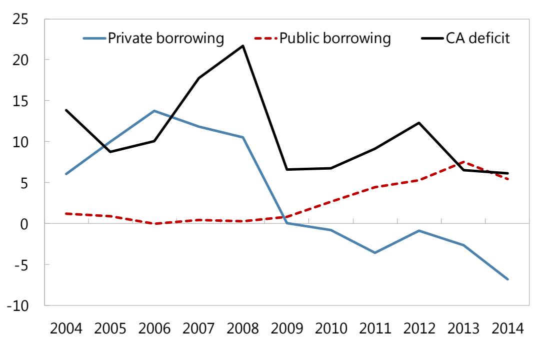
- The currently very low inflation is expected to return to the center of the NBS tolerance band (4±1½ percent) by end-2015 due to regulated price increases, recovery of agricultural prices, past depreciation, and loosening of monetary policy, which will cushion the contraction in domestic demand.

- The current account deficit is projected to narrow to 4¾ percent of GDP in 2015 despite continued flood-related imports, and to adjust further over the medium term to 3¾ percent of GDP (Tables 3a and 3b). The exchange rate is seen as broadly in line with fundamentals (Box 2).

Box 2. External Sustainability Assessment

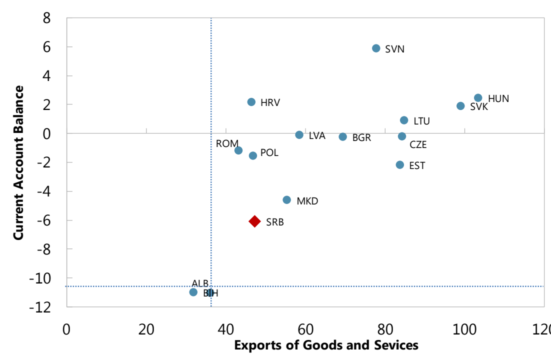
Serbia's large current account deficit has partially adjusted since the onset of the global crisis. Yet at end-2014, the current account deficit was still among the highest in the region with a significant portion financed through debt. Serbia's export base is narrow, owing to deep-rooted competitiveness problems, structural rigidities, and a weak business environment, which have led to a low share of FDI (particularly greenfield) in tradable sectors. Floods that affected Serbia in 2014 and slow growth in external demand from the EU have been recently reflected in a significant export slowdown.

Current Account and Net Foreign Disbursements
(Percent of GDP)



Source: Serbian authorities.

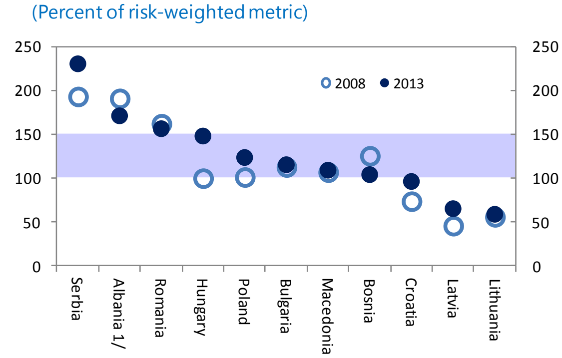
Current Account and Exports of Goods and Services, 2014
(Percent of GDP)



Source: World Economic Outlook Database.

Serbia's ample international reserves somewhat mitigate the large external vulnerabilities. The reserves are adequate, exceeding all standard indicators of reserve coverage. They surpass the recommended bounds of the IMF reserve adequacy metric, recording the highest reserve coverage in the region.[1]

International Reserves
(Percent of risk-weighted metric)



Source: IMF staff calculations.
1/ 2012 reserve data was used.

Going forward, a fundamental change in policies is needed to reduce external vulnerabilities and ensure future external sustainability.

Total external debt, estimated to reach almost 84 percent of GDP in 2014, is a clear sign of vulnerabilities of the Serbian economy. Setting it firmly on a downward path will require a significant adjustment in the current account deficit.

Under the proposed program, sustained policy efforts would help restore external sustainability, preserve

Box 2. External Sustainability Assessment (Concluded)

adequate reserve buffers, and reduce Serbia's net indebtedness to the rest of the world. Policies oriented toward reducing the weight of public expenditure in GDP should contribute significantly to this adjustment, aided by broad-based structural reforms that would improve competitiveness of Serbia's economy, and boost its growth potential. In this scenario, the current account deficit is expected to decrease from about 6 percent of GDP in 2014 to 3¾ percent of GDP in 2020. Macro balance and external sustainability approaches—based on the IMF's Consultative Group on Exchange Rate Issues (CGER) methodology—suggest that the exchange rate is broadly in line with fundamentals under the program scenario.

In staff's view, the exchange rate is broadly aligned with fundamentals after the programmed policy adjustment is implemented. Serbia's net foreign assets (NFA), currently at -94 percent of GDP (calculated as international reserves less FDI and external debt) are much lower than the average for countries in the region, and this constitutes a significant vulnerability for Serbia. Therefore, the external sustainability approach applied here uses the average (NFA) of countries in the region (-68 percent of GDP), rather than Serbia's existing NFA, to estimate the current account norm of 4 percent of GDP. With the current account deficit projected to decrease to 3¾ percent of GDP after the programmed policy adjustment, this implies an exchange rate undervaluation of 1¼ percent, which is well within the error margin.

Estimtes of Current Account Norm and Exchange Rate Misalignment

	Approach	
	CGER Macroeconomic balance 1/	External sustainability 2/
Projection of current account deficit in 2020	3.7	3.7
Current account deficit norm	5.6	4.0
Exchange rate misalignment (unadjusted)	-6.4	-1.2

1/ Based on IMF CGER methodology extension in Vitek, 2012 (Vitek, Francis, "Exchange Rate Assessment Tools for Advanced, Emerging, and Developing Countries" mimeo 2012.

2/ Assumes long-run net foreign assets of -68 percent of GDP in line with the average projected for Eastern European countries.

The macro balance approach estimates Serbia's current account norm at 5½ percent of GDP, and an exchange rate undervaluation of 6½ percent. Serbia's NFA at -94 percent of GDP is an input into this calculation which partly explains this high current account norm. Staff's view is that a current norm of 5½ percent of GDP is likely to be overestimated, as Serbia should lower its debt-related external vulnerabilities in the medium term, given a conservative outlook for FDI.

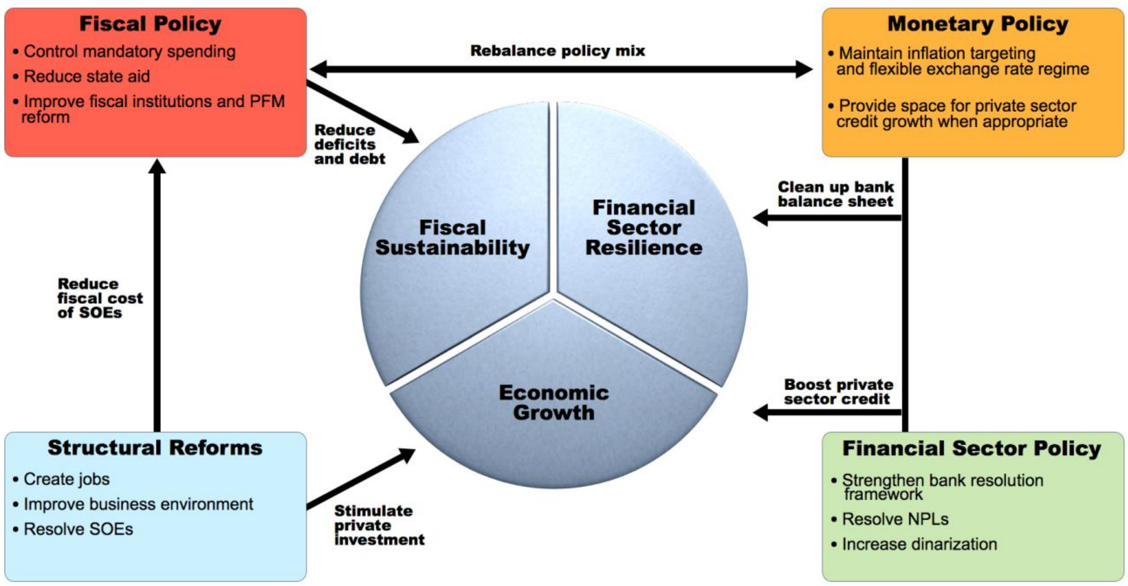
____

1/ The suggested appropriate range is 100–150 percent. See IMF, "Assessing Reserve Adequacy," 2011.

10. The outlook is subject to significant downside risks (Table 8). On the external side, a protracted period of slow growth among trading partners may reduce Serbia's growth. Possible spillovers from evolving regional geopolitical tensions and any related disruptions to Serbia's natural gas supply could hurt the economy. Serbia's financing needs are large and susceptible to changes in global market sentiment. On the domestic side, the impact of sustained fiscal consolidation on the already anemic domestic demand could be stronger than expected. The resolution of large SOEs could add unanticipated pressures on public finances. Finally, comprehensive reforms—especially fiscal adjustment and SOE restructuring—may face resistance. The realization of these risks would both compromise medium- to long-term growth prospects and exacerbate underlying debt sustainability concerns.

POLICY DISCUSSIONS: ACHIEVING MACROECONOMIC STABILITY AND SUSTAINED GROWTH

Discussions focused on policies over the program period of 2015–17 and beyond aimed at reducing the fiscal deficits and restoring public debt sustainability, strengthening competitiveness and growth, and boosting financial sector resilience.



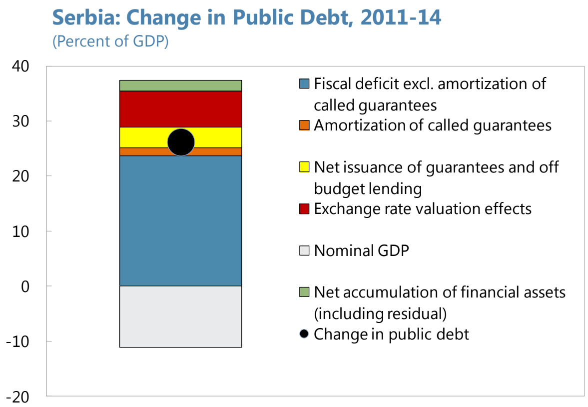
A. Fiscal Policy: Restoring Public Debt Sustainability

Background

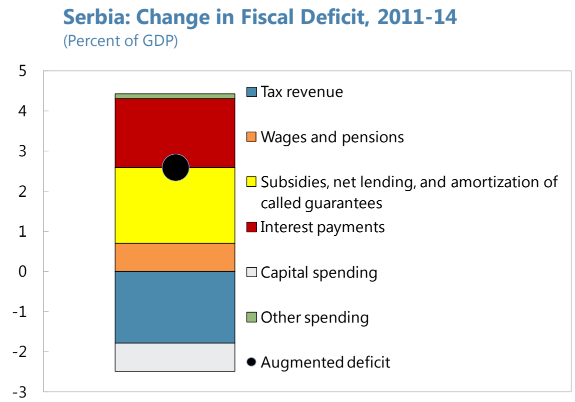
11. Public finances deteriorated in the past several years. The core problems arose from: (i) declining revenues despite tax rate hikes, (ii) continued rise of already unsustainably high mandatory spending, especially public wage and pension bills, (iii) expanding state aid to ailing SOEs, usually in the form of direct subsidies and guarantees for borrowing which often were called, and (iv) cost of resolving ailing public banks (Figure 4).[4] This was partially offset by the compression of capital spending, in part arising from the inability to execute budgeted projects. While most of the external public debt is owed to multilateral and bilateral creditors, which has

[4] State aid to SOEs includes direct subsidies, net lending through the budget, assumption of SOEs' debt, and the service of guaranteed debt called by creditors.

helped keep the average nominal interest rate low, the rising share of market debt in recent years has pushed up the interest bill substantially.

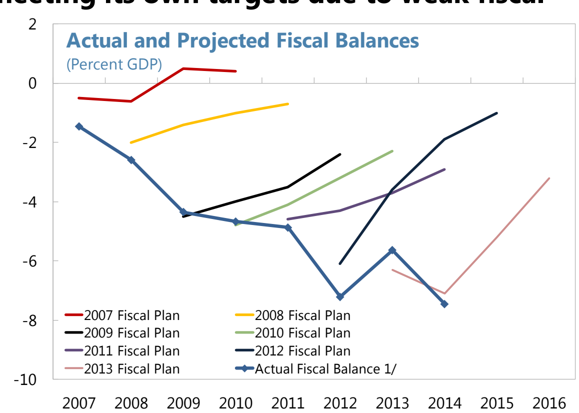


Sources: Ministry of Finance; and Fund staff estimations.



Sources: Ministry of Finance; and Fund staff estimations.

12. Serbia has had a poor track record of meeting its own targets due to weak fiscal framework. The main problems in public financial management included a fragmented budget process across time and the various parts of the general government, and the absence of effective multi-year orientation of spending policies. Incomplete transparency of fiscal operations, insufficient external and internal audit procedures, and recourse to quasi-fiscal operations also played a role.



1/ Actual fiscal balance series are calculated using revised nominal GDP.

Policy discussions

13. The authorities and staff agreed that a strong adjustment program is needed to stabilize public debt by 2017 and put it firmly on a downward path thereafter. This requires a reduction of the structural primary fiscal balance by about 3½ percent of GDP during 2015–17. The authorities viewed frontloading of measures as feasible in view of the political momentum that has been built, and as appropriate to enhance the credibility of reforms. The 2015 budget and supportive legislation approved by the National Assembly in December 2014 reflect these efforts. Over the medium term, the authorities considered the EU's Stability and Growth Pact (SGP) as a relevant fiscal anchor and concurred with staff that SGP criteria should be reached by the time of EU accession.

14. Despite the large fiscal adjustment, the projected decline in public debt is susceptible to a number of shocks (Annex I). In particular, the debt sustainability analysis suggests that a standard shock to real GDP growth would considerably increase the peak level of the public debt. In addition, the high share of foreign currency debt, which has been exacerbated by the issuance of eurobonds since 2011, gives rise to a significant vulnerability to currency depreciations. Furthermore, staff simulations indicate that debt sustainability could be jeopardized if only half of the envisaged fiscal adjustment is implemented over the program period (Figure 9). However, the authorities agreed to use potential proceeds from forthcoming privatizations to reduce the stock of public debt, while also creating room for high-return investment projects (MEFP ¶30).

15. To achieve the required consolidation, the authorities will rely primarily on durable expenditure measures. The package of fiscal consolidation measures, many of which have already been introduced in late 2014, is expected to yield gross nominal savings of 4¾ percent of GDP compared to unchanged policies and generate the targeted structural adjustment. The measures aim to address primarily unsustainable mandatory spending and reduce state aid (Table 6). In addition, the fiscal frameworks will be strengthened by improving fiscal institutions and implementing PFM reforms. Given that various tax rates have already been raised in the past two years, staff emphasized that future efforts should focus primarily on improving the efficiency of tax collections and broadening the tax base in line with the Fund's recent technical assistance, but advised against assuming associated fiscal gains in the macro framework. The authorities supported this approach and agreed to use any unanticipated revenue gains to reduce public debt in 2015, and thereafter to split them between reducing debt and supporting high-priority investments (MEFP ¶10). Contingency measures, such as raising the VAT and gasoline excise taxes, would be considered in the event of revenue shortfalls (MEFP ¶10).

Fiscal Measures, 2015–17

(percent of GDP)

	2015	2016	2017	Cumulative 2015-17
Total fiscal measures	2.7	1.0	1.0	4.7
mandatory spending 1/	1.6	0.6	1.0	3.2
state aid 1/	0.8	0.0	0.0	0.8
other measures 2/	0.3	0.4	0.0	0.7

1/ Netting out the cancellation of the solidarity tax.
2/ Revenue effects of electricity price increases, amendments of local government financing law, reduction of the markup on domestic goods and services and an excise on non-alcoholic drinks.

Tackling unsustainable mandatory spending

16. The authorities recognized that curbing the sizeable spending on public wages and pensions is critical for a durable fiscal adjustment. Thus, the program envisages a reduction of the wage and pension bills to more sustainable levels of 7 and 11 percent of GDP, respectively, supported by the following measures:

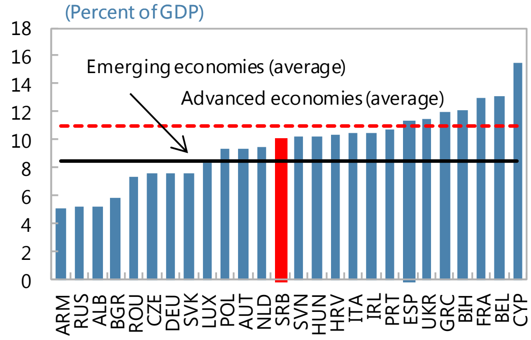
- ***Public wage reduction*** was the first step taken toward curbing mandatory expenditure (MEFP ¶6). An across-the-board 10 percent nominal wage cut (while protecting the minimum monthly wage of 25,000 dinars) was legislated with the 2014 supplementary budget and became effective as of November 2014. The cut applies to the broader public sector, including SOEs, which will help reduce the reliance of some SOEs on subsidies. In addition, legislation adopted in December 2014 suspends nominal indexation of wages until the wage bill (excluding severance payments) reaches the target level by the end of the program period (MEFP ¶8).

- ***A comprehensive general government wage system reform*** will follow the wage cuts, with the aim to simplify it and make it more manageable and equitable across various general government entities. It will include aligning base wages, unifying pay grades across comparable jobs, streamlining the wage coefficients, and integrating other elements of pay into the wage base. As the reform requires substantial preparation, staff concurred with the authorities that the transition period to the new system will be determined in the course of 2015 (MEFP ¶8).

- ***Rightsizing general government employment.*** The authorities have committed to a two-stage process. General government employment will be reduced by 5 percent through the continued application of the attrition rule and targeted separations by mid-2015 (MEFP ¶8). Subsequently, there will be additional rightsizing based on deeper reform of the general government employment through organizational and functional restructuring in 2016–17 (MEFP ¶9).

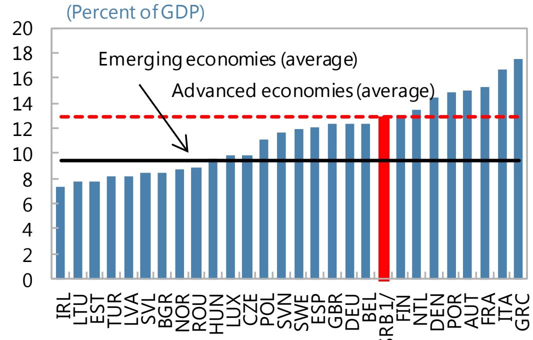
- ***Pension bill reduction***. A progressive cut in nominal pensions (22 percent for pensions between 25,000 and 40,000 dinars and 25 percent for higher pensions) was legislated from November 2014 to yield an effective 5 percent reduction of the pension bill. The parametric pension system changes implemented in mid-2014 (a higher statutory retirement age for women, increased minimum retirement age, and introduction of actuarial penalties for early retirement) will help maintain the sustainability of the pension system in the longer term (MEFP ¶7).

Government Wage Bill, 2013
(Percent of GDP)



Source: WEO

Pension Expenditure, 2012
(Percent of GDP)



Sources: Eurostat; and the Ministry of Finance .
1/ Serbia data as of 2013.

Reducing state aid

17. The authorities aim to reduce subsidies and have launched a reform of inefficient and loss-making SOEs to curb the need for state aid. The program focuses on the reduction of subsidies and elimination of liquidity support to the largest SOEs which have been the main recipients of budget support in past years, particularly in the transportation and energy sectors (MEFP ¶8). Moreover, the authorities concurred that a comprehensive reform of the largest SOEs is needed to strengthen their financial positions and contain fiscal risks over time (MEFP ¶31). These reforms are being designed in cooperation with other international financial institutions (IFIs) and the EU. In addition, subsidies to agriculture have been reduced from 2015.

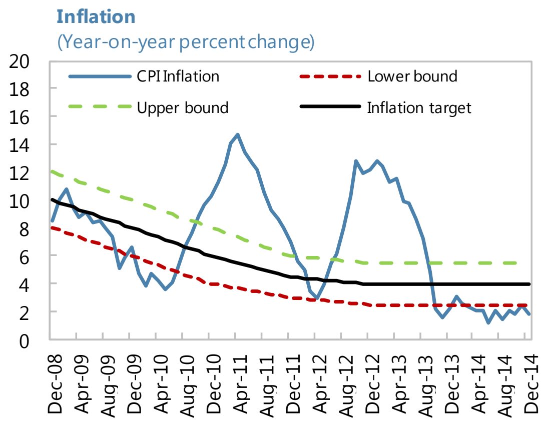
Improving fiscal institutions and PFM reform

18. The authorities are committed to improving the PFM framework. They agreed with staff that limiting fiscal risks and strengthening institutions will support fiscal consolidation. Specific measures, in line with IMF technical assistance recommendations, will aim to bolster fiscal planning by introducing three-year expenditure ceilings, and strengthen the Ministry of Finance's capacity to monitor and control fiscal risks. Staff recommended that the authorities perform fiscal impact analysis of all new legislative initiatives, ensure full assessment of all proposed public-private partnerships (PPPs), increase fiscal transparency, and reinforce expenditure control (MEFP ¶11).

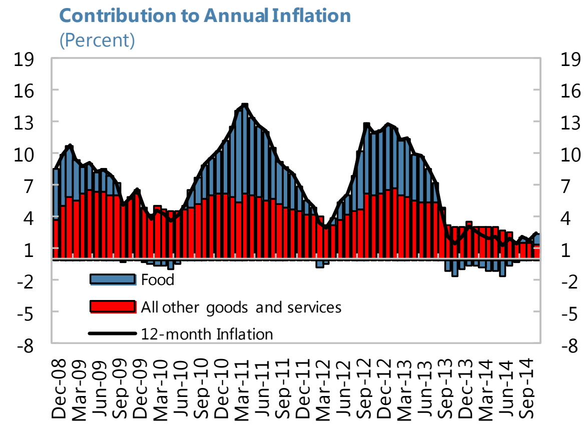
B. Monetary and Exchange Rate Policy: Keeping Inflation under Control

Background

19. Controlling inflation has been a challenge for Serbia's inflation targeting (IT) regime. Inflation has been frequently outside the tolerance band since the inception of the full-fledged IT framework in 2009. The factors contributing to the high inflation volatility were: (i) sizeable food price shocks that stemmed partly from protection of agricultural markets and relatively low food imports, (ii) large pass-through from periodic bouts of depreciation, (iii) weak monetary policy transmission mechanism due to exceptionally high euroization, and (iv) unpredictable changes in regulated prices.

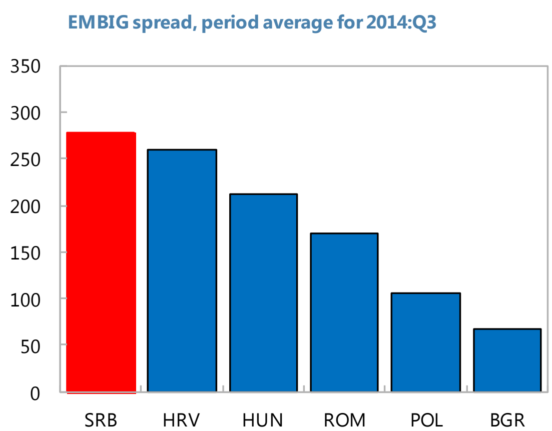


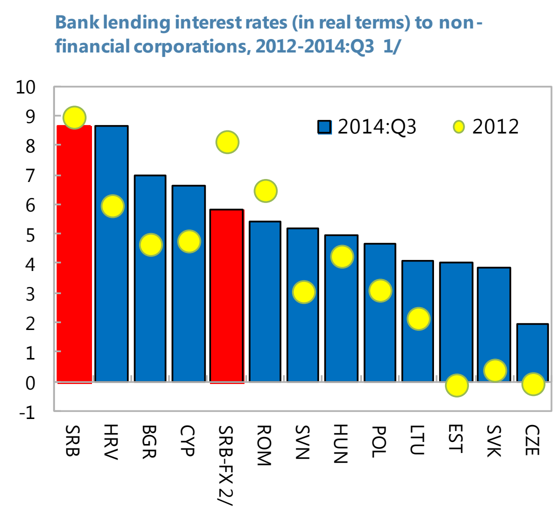
Source: National Bank of Serbia



Source: National Bank of Serbia

20. Tight monetary policy had to compensate for the overly loose fiscal policy. Serbia's mounting fiscal imbalances and public debt kept the risk premium (measured by the EMBIG spread) generally higher than in peer countries. This imposed constraints on monetary policy, requiring relatively high policy interest rates to ward off exchange rate pressures, led to elevated interest rates on bank lending, and dampened credit growth.





Source: Bloomberg, NBS and Fund staff calculations.
1/ Nominal interest rates on loans in local currency adjusted for CPI inflation.
2/ Interest rate on FX-linked loans to non-financial corporations.

Policy discussions

21. The NBS reaffirmed its commitment to inflation targeting and the flexible exchange rate regime. Staff agreed that the inflation targeting system remains appropriate for Serbia, despite the challenges in its implementation, as it helps anchor inflation expectations. In view of the exchange rate's important role as shock absorber, especially given widespread price and wage rigidities, staff supported the increasing exchange rate flexibility observed in the second half of 2014 and cautioned against large-scale or sustained foreign exchange market interventions. The authorities reaffirmed that interventions are used only for smoothing excessive volatility (MEFP ¶15). Staff also emphasized the need for better liquidity management and coordination, and the authorities agreed to reestablish the Liquidity Management Committee (MEFP ¶11).

22. **The NBS and staff agreed that the fiscal consolidation now underway creates room for further gradual monetary policy easing.** The fiscal adjustment initiated in late 2014—against a background of declining domestic credit—creates space for the loosening of monetary policy (MEFP ¶14). This rebalancing of the policy mix will help to reduce real interest rates and foster credit growth to the economy. However, staff emphasized that the pace of easing should be cautious and reflect external financing conditions, inflation expectations, and the progress in fiscal consolidation. Staff therefore recommended that future key policy rate reductions should take place only in the absence of balance of payments pressures. Staff also supported the recent reductions in the reserve requirements, which were set at high levels to stem large capital inflows during the pre-crisis years. There was also agreement that the capital account liberalization required in the context of EU accession should be gradual, particularly in removing restrictions on inflows to short-term securities and the ability of residents to open deposits abroad (MEFP ¶16).

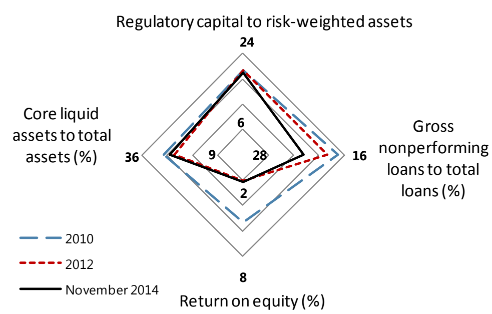
C. Financial Sector: Preserving Stability and Reviving Credit Growth

The program aims to support financial sector stability and resilience, while improving financial intermediation. The financial sector agenda is built around diagnostics of banks' balance sheets, an overhaul of the bank resolution framework, and the development of a comprehensive strategy to address high levels of distressed debt.

Background

23. **The mostly foreign-owned banking sector has remained resilient in the face of increasingly difficult economic conditions.**[5] Overall capitalization appears strong, as regulatory capital—largely consisting of Tier 1 instruments—amounted to almost 20 percent of risk-weighted assets in November 2014. The banking sector remains highly liquid and is increasingly reliant on deposits as a funding source. This stems from a combination of moderate but steady deposit growth and continued decline in parent funding of the

Financial Soundness Indicators, 2010-14



Source: National Bank of Serbia

[5] Foreign-owned subsidiaries, the majority of which are from the EU, account for about 75 percent of total assets, whereas local banks are mostly state owned.

Serbian subsidiaries of foreign banks, arising from low credit demand. As a result, the system's loan-to-deposit ratio has improved to about 95 percent. However, the profitability of the Serbian banking sector has been below the regional average, in part due to the difficult macroeconomic environment and reduced business volumes (Figure 11 and Table 9).

24. Nonperforming loans pose a significant challenge for Serbian banks. Since 2008, the NPL ratio has more than doubled, exceeding those of most regional peers (Figure 11). Corporate NPLs are particularly high (almost 30 percent of corporate loans in 2014:Q3) and constitute the bulk of the overall distressed debt. At the same time, high regulatory loan-loss reserves, which exceed provisioning on the basis of International Financial Reporting Standards (IFRS) accounting standards, provide a capital cushion against credit losses, and thus help underpin financial sector stability. However, such regulatory requirements do not result in losses being recognized in banks' financial statements.

25. Mounting vulnerabilities in some state-owned banks led to their failures. Four of these banks fell into distress and had to be resolved at a significant fiscal cost of 1¾ percent of GDP over 2012–14. Their resolution also revealed challenges in the application of the existing bank resolution framework. As a result, the government developed a comprehensive strategy for state-owned banks in 2014 to enhance their resilience (MEFP ¶23), which is being implemented. In particular, it aims to bolster institutions that fulfill a strategic function in the Serbian banking system, while selling or winding down in an orderly fashion other state-owned institutions, including via asset and liability transfers. The authorities are also committed to strengthening banks' corporate governance and risk control frameworks, in accordance with international best practices.

26. Credit to the economy has contracted since 2013, putting a drag on the economic recovery. The authorities believe that this is due to both demand and supply-side constraints, as weak economic prospects lead to low demand for credit. At the same time, high corporate indebtedness and perceived credit risk prompt banks to tighten lending standards and reduce their willingness to extend credit, thereby weakening financial intermediation.

Policy discussions

27. The authorities and staff agreed that a thorough assessment of the banks' balance sheets is necessary to anchor the financial sector policy agenda. These diagnostic studies, similar to asset quality reviews conducted in EU countries, will help verify the health of the banking system, dispel uncertainty about banks' asset quality, and guide regulatory and supervisory policies (MEFP ¶20). They will shed light on banks' collateral valuation practices, assess the adequacy of provisioning, and provide better information for combating vulnerabilities. In parallel, the authorities will further enhance the supervisory and regulatory frameworks by leveraging standards and requirements contained in the EU's Single Rule Book, international best practices, and the insights drawn from the diagnostic studies (MEFP ¶19).

28. The authorities, in collaboration with IFIs, are committed to designing and implementing a comprehensive strategy for dealing with NPLs. There was broad agreement that, if left unchecked, high NPLs can adversely affect financial stability, as credit losses sap bank profitability. The strategy should thus aim to: (i) assess, and—where necessary—enhance banks' capacity for dealing with NPLs; (ii) promote out-of-court restructuring; (iii) improve in-court corporate debt-resolution mechanisms; and (iv) remove impediments obstructing the development of a market for distressed debt (MEFP ¶22). Given the multidimensional nature of the debt overhang, the implementation of the strategy will require strong commitment and the collaboration of all stakeholders.

29. The authorities have taken steps to significantly strengthen the bank resolution framework, with technical assistance from the Fund. The reform establishes a robust framework that will facilitate timely resolution of banks while minimizing fiscal risks (MEFP ¶21). The new framework reflects international best practices and draws, as appropriate for Serbia's specific conditions, on the EU's Bank Resolution and Recovery Directive. The framework is based on the principle of loss allocation to private sector participants in line with creditor hierarchy. It expands the menu of resolution powers and tools to allow early and decisive intervention. It also improves transparency and predictability through legal and procedural clarity and advance preparation for orderly resolution. Moreover, resolution powers will be centralized at the NBS, with safeguards to duly separate resolution and supervision functions. In parallel, the governance and operational capacity of the Deposit Insurance Agency is being strengthened with technical assistance from the World Bank and the European Bank of Reconstruction and Development (EBRD).

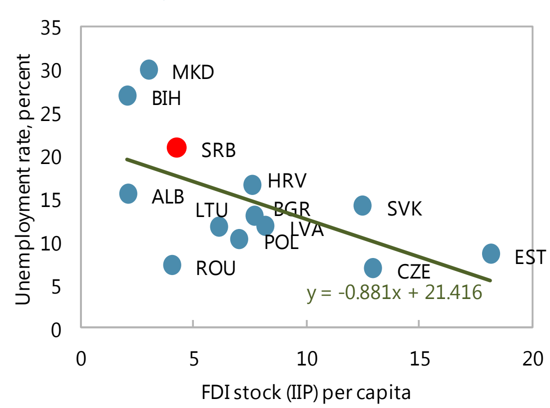
30. The authorities will continue to implement measures aimed at increasing dinarization of the financial system to strengthen the monetary transmission mechanism. Staff agreed that maintaining macroeconomic stability and keeping inflation within the target range will help improve confidence and promote demand for dinar-denominated assets. Staff also supported efforts to lengthen the maturity of dinar-denominated government securities in the local market and to promote hedging instruments (MEFP ¶24).

D. Structural Reforms: Strengthening Competitiveness and Growth

Background

31. The Serbian economy suffers from protracted structural weaknesses. Significant bottlenecks to private sector activity stem from delayed transition to a market economy. Serbia lags behind its peers in many aspects of the business climate, such as issuance of construction permits, licensing, and paying taxes (Table 10). The challenging business

Unemployment rates vs. FDI, 2013



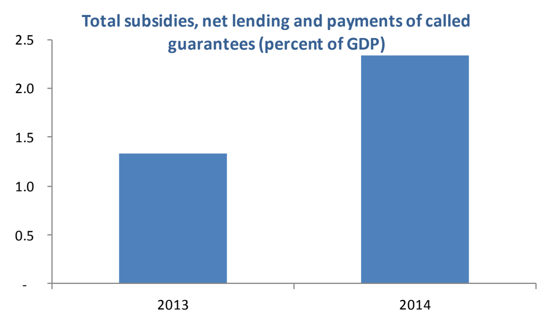
Sources: IFS; and WEO.

environment reduces incentives for investment—the stock of FDI per capita is significantly lower compared with the New Member States of the EU. This, in turn, hampers private sector growth and competitiveness, and leads to a narrow export base and wide current account deficits. The structural and labor market rigidities have also contributed to persistently high unemployment (particularly among young people), low labor force participation rate, and relatively high reliance on remittances from abroad (Figures 3 and 7). This poses a key social concern. In addition, significant resources are trapped in inefficient public enterprises (Box 3).

Box 3. Public Enterprises in Serbia

Public enterprises represent an important share of the Serbian economy. As of end-2014, more than 1,400 public enterprises had over 250,000 employees, accounting for 15–20 percent of total formal employment. This comprised mainly *state and local public enterprises* (almost 800), as well as a large number of *socially-owned enterprises* (more than 600), of which 512 are in restructuring and privatization processes in the Privatization Agency (PA) portfolio. In addition, there are also several *joint-stock or limited liability companies* operating in competitive industries (such as Telekom). Public enterprises include some of the largest employers in the country, such as Elektroprivreda Srbije (EPS-electricity generation) and Zeleznice Srbije (Serbia Railways), which employed around 38,000 and 18,000 workers, respectively, as of end-2014.

The fiscal costs associated with the public enterprises have been rising rapidly in recent years. *Direct fiscal costs* include subsidies, net lending, and payments of called guarantees. These amounted to more than 2 percent of GDP in 2014, and were concentrated in 7 companies, largely in the transportation and energy sectors. These costs have risen rapidly in the past few years, mainly due to the worsening performance of the SOEs, and could rise further if the underlying problems are not addressed. Additional direct fiscal costs arise from tax and social contribution arrears mainly among socially-owned enterprises. Furthermore, public enterprises give rise to *indirect fiscal costs*, which include implicit subsidies on borrowing costs due to issuance of state guarantees, and arrears to other public enterprises. Comprehensive data on the size of these costs are in not available, but they are expected to be very significant as well.



Sources: Ministry of Finance, and IMF staff calculations.

Policy discussion

32. The authorities and staff agreed that structural reforms are essential to boost Serbia's growth potential. There are three broad priorities to be implemented over the medium term: (i) job creation, (ii) improving the business environment and competitiveness, and (iii) resolution and reform of SOEs:

- **Job creation.** The authorities took a key step in adopting amendments to the Labor Law in mid-2014 aimed at removing disincentives for hiring and making wage bargaining and employment procedures more flexible. Specifically, the reform limits severance payments by linking them to service with the current employer rather than life-time employment, extends the maximum length of temporary contracts from one year to two years, clarifies and simplifies separation rules, and tightens the rules for extensions of collective agreements to all firms in the sector. Staff welcomed these changes and advised that steadfast implementation of the law is key for labor market efficiency (MEFP ¶27). The authorities underscored that job creation is a central element of their economic policies. They also committed to implementing their National Employment Strategy for 2011–20 and the National Employment Action Plan for 2015, which envisage specific job-supporting programs. These comprise job matching services, career counseling and training for both pre-redundancy workers and the unemployed, employer subsidies targeting disadvantaged job seekers, and self-employment support. Staff also emphasized the importance of evenhanded application of severance payments across the public sector, in light of the forthcoming rightsizing of the public administration and resolution of SOEs.

- **Improving the business environment.** The authorities committed to a number of short- and medium-term measures, aimed at removing obstacles to private sector development, attracting new investments, and fostering job creation (MEFP ¶32). These include, among others, (i) implementation of the regulatory framework for establishing one-stop shops for issuing construction permits, and for conversion of land-usage rights into ownership rights, (ii) adoption and implementation of a new Investment Law to enable efficient coordination of investment-related permits, and (iii) implementation of a strategy for improving the business environment for the small and medium enterprises (SMEs) for 2015–20.

- **Resolution and reform of SOEs.** The authorities are committed to wide-ranging SOE reforms in order to improve their operational viability and limit fiscal risks (MEFP ¶28–31). In this regard, staff welcomed the recent amendments to the Bankruptcy Law and the new Privatization Law, which were pre-requisites for a successful implementation of this reform. Going forward, a significant reduction of state aid to SOEs is a key priority of the program, to be achieved by: (i) curtailing direct and indirect subsidies, (ii) limiting issuance of new guarantees, and (iii) enhancing accountability, transparency, and monitoring of these enterprises. The program includes strategies for two broad categories of state-owned enterprises. The first group includes over 500 companies in the portfolio of the Privatization Agency, of which almost 200 have been slated for immediate bankruptcy, over 200 will be privatized, and resolution for the remainder was put on hold until technical and legal issues are resolved. The second group comprises large SOEs including the electricity, gas, railways and road companies, where corporate and financial restructuring plans need to be developed in the course of 2015 and implemented in the coming years (MEFP ¶31). These plans will determine specific future steps for improving collections, increasing efficiency and cost savings, and tariff increases: (i) the electricity generation company (EPS) will underpin its sustainability by financial restructuring, which will include raising regulated electricity prices and thereby moving household tariffs closer to cost-recovery levels, (ii) Srbijagas will reduce its reliance on subsidies after an increase in natural gas network fees and resolution of its biggest debtors, (iii) Railways of Serbia will cut costs in the context of a comprehensive organizational and financial restructuring, and (iv) the road companies will be merged and their efficiency boosted by corporate and financial restructuring. The SOE reforms are drawing on expertise of other IFIs.

PROGRAM MODALITIES AND RISKS

33. A 36-month precautionary SBA with access of SDR 935.4 million (200 percent of quota, or about €1,122 million) is proposed. Such long-term engagement is appropriate in light of the comprehensive medium-term fiscal and structural agenda, and in line with the last ex-post evaluation (EPE/EPA). Staff expect the public debt-to-GDP ratio to be stabilized and the growth prospects to improve by the end of the program, thus putting debt firmly on a downward trajectory thereafter.

34. The arrangement is expected to be precautionary. The potential balance of payments need would arise from adverse trade and financial spillovers, such as a delay in the recovery of euro area economic activity and tighter global liquidity conditions. The high level of foreign exchange reserves provides the first line of defense against a moderate deterioration of external conditions. Against this backdrop, staff believe that access of 200 percent of quota (935.4 million SDRs) should provide adequate insurance against external shocks that could be triggered by the above-mentioned "normal-sized" risks (Table 11). The phasing of purchases reflects the front-loaded fiscal and structural conditionality, and elevated external risks emanating from a potential abrupt surge in global financial market volatility (Table 12). However, realization of tail risks could require higher access and possibly more adjustment.

35. The proposed Fund-supported program will be monitored through quarterly reviews. Given that the key role of the SBA is to act as a commitment device in support of a comprehensive fiscal and structural reform agenda, the program will be monitored on a quarterly basis. The proposed quarterly performance criteria and indicative targets, as well as prior actions for the approval of the arrangement and structural benchmarks under the SBA, are summarized in Tables 1 and 2 in the MEFP. The prior actions include: (i) parliamentary approval of the 2015 budget and the accompanying legislation, (ii) parliamentary approval of legislative changes of the bank resolution framework, (iii) parliamentary approval of amendments to the Law on the Development Fund, and (iv) elimination of state aid—including budget subsidies, government guarantees, lending from the budget, or any other forms of public support—to steel producer Zelezara Smederevo and preventing accumulation of arrears by this company.

36. In the program scenario, Serbia's capacity to repay the Fund is projected to remain strong, although high public and external debt are important risks. On the basis of outstanding credit, Serbia's annual repayments to the Fund will be below 2 percent of gross reserves in 2015 and will decline to 0.1 percent of gross reserves by 2017. Even if the downside external risks discussed above were to materialize, and full drawings of 200 percent of quota were made under the new SBA, repayments to the Fund after the end of the proposed SBA would remain at or below 6½ percent of gross reserves (Table 13). Public sector and external debt stocks are expected to remain high during the program period, reaching 78 and 87 percent of GDP, respectively, in 2016. Program implementation would place both of them on a firm downward path thereafter. An update of the 2011 safeguards assessment of the NBS has been initiated and is envisaged to be completed by the first review.

37. Risks to the program are significant. Resistance to deep structural reforms and fiscal adjustment could undermine program implementation, which is key to reducing the public debt ratio in the medium term. Delays in SOE resolution and weaknesses in selected public banks could add unanticipated pressures on public finances. Moreover, sustained anemic domestic demand in the context of large fiscal consolidation could weaken growth prospects, particularly given an uncertain regional outlook, including from possible spillovers from evolving geopolitical tensions. Finally, an uncertain and volatile global outlook could complicate access to financing. The realization of these risks could compromise the envisaged debt reduction strategy. Thus there is little room for slippage if public debt is to stabilize by 2017, which highlights the appropriateness of front-loaded and legislated measures under the program.

STAFF APPRAISAL

38. The Serbian economy faces serious challenges. Persistent fiscal imbalances led to sharp accumulation of public debt. Chronic delays of key structural reforms eroded Serbia's competitiveness and medium-term growth potential, and contributed to feeble job creation and very high unemployment. Structural rigidities and the weak economy led to the accumulation of high NPLs, hampering financial intermediation. Moreover, there are significant risks as the external environment remains unsettled.

39. Serbia is now poised to break from past policies and embark on a reform path. Status quo economic policies are not sustainable. The authorities' program, supported by the proposed precautionary SBA, aims to: (i) restore public debt sustainability by rebalancing the policy mix toward tighter fiscal and easier monetary policy, (ii) enhance financial sector resilience, and (iii) improve competitiveness and medium-term growth potential. The program is expected to underpin a robust recovery over the medium term.

40. Significant fiscal consolidation is needed to regain control of the public sector debt. A structural fiscal adjustment of 3½ percent of GDP over the program period is needed to reach the objective of placing public debt firmly on a downward path by 2017. The frontloaded adjustment package will help stabilize public debt sooner, taking advantage of the reform momentum that has been built, and signaling credibility of the reforms. The projected decline in public debt is susceptible to shocks, although potential privatization receipts could mitigate the risks.

41. Fiscal adjustment should rely primarily on containing expenditures. Mandatory spending should be reduced through wage and pension cuts, suspended indexation, rightsizing of public administration, and the effects of the parametric pension reform. Furthermore, reforms of SOEs are needed to reduce state aid and fiscal risks. Improvements in tax administration are essential to provide an upside revenue potential for the fiscal program.

42. Strengthening the public financial management framework is needed to support fiscal consolidation. Better fiscal planning with a medium-term focus, strengthened capacity to monitor and control fiscal risks, increased fiscal transparency, and reinforced expenditure control are critical to reduce fiscal vulnerabilities.

43. The inflation targeting system remains appropriate for Serbia, and should be underpinned by consistent implementation of monetary and exchange rate policies. To preserve exchange rate flexibility, interventions should be used only for smoothing excessive volatility. The rebalancing of the policy mix will allow a gradual lowering of the key policy rate while meeting the inflation target. This, in turn, will help support credit growth and cushion the effect of the fiscal adjustment on domestic demand.

44. Financial sector policies should aim to strengthen financial system resilience and maintain stability. The special diagnostic studies of banks should guide policies to address financial sector vulnerabilities and strengthen Serbia's regulatory and supervisory frameworks. Strong implementation of the recently revamped bank resolution framework is essential for more effective resolutions of banks while containing costs. A comprehensive strategy is needed to resolve the high NPLs and promote private sector lending.

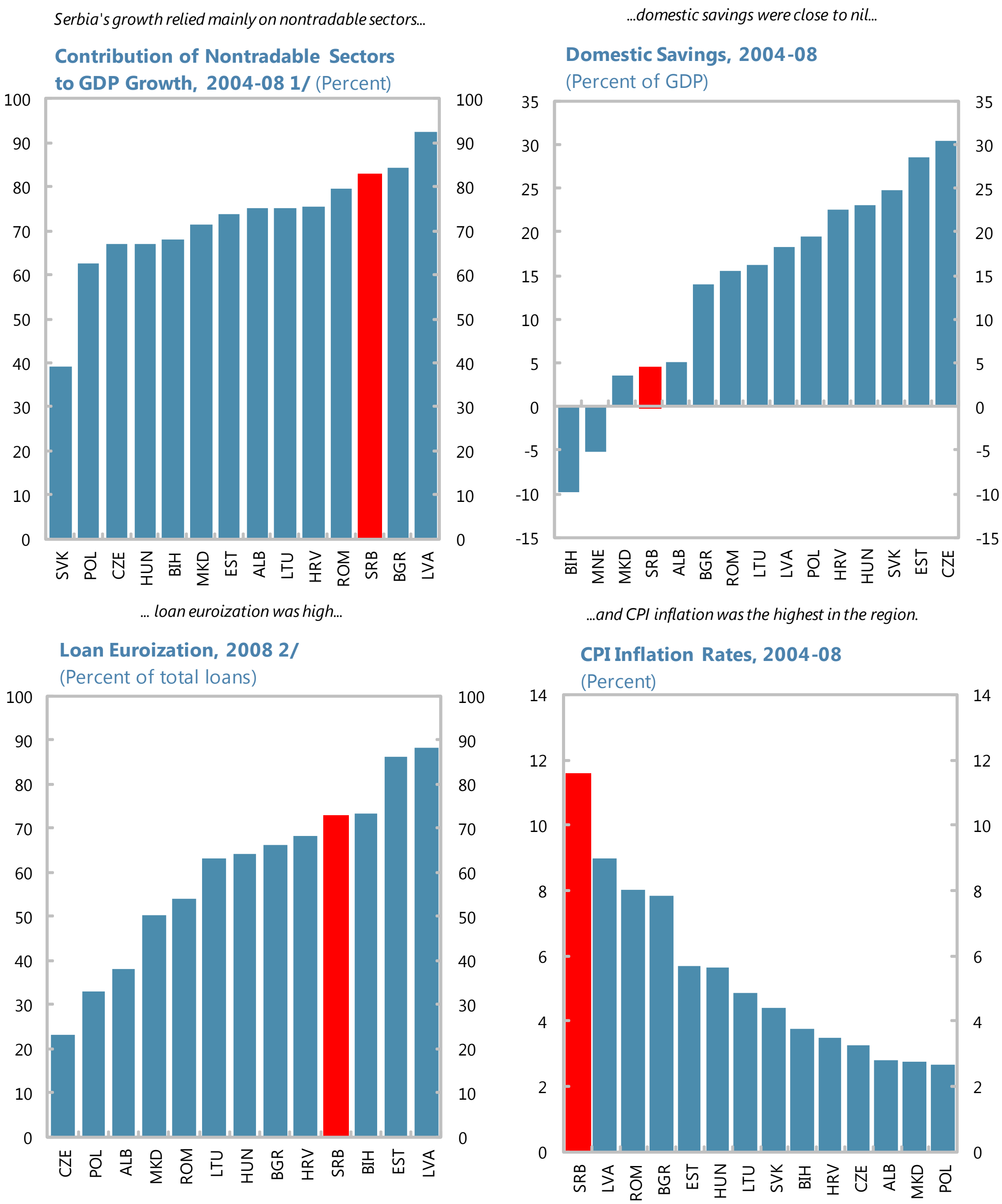
45. The medium-term growth potential critically depends on the implementation of comprehensive structural reforms. The recent amendments of the Labor Law, parametric pension reform, streamlining construction permits, and the launch of resolution procedures for socially-owned enterprises have been important steps which demonstrate the authorities' commitment to change the status quo. Vigorous implementation of these reforms will be essential for restoring competitiveness of the economy, stimulating investment, and supporting growth recovery over the medium term. To the same end, further efforts will also be necessary to improve the business climate, execute the national anti-corruption strategy, and reform large SOEs.

46. Risks to the program are significant, but are mitigated by the authorities' commitment to frontloaded fiscal adjustment and structural reforms. Given the size of the fiscal adjustment and the breadth and depth of the proposed reforms, their implementation could face resistance. Fiscal slippages or delays in reforming SOEs would jeopardize the key objective of restoring debt sustainability. Furthermore, the external environment could prove to be worse than expected, making fiscal adjustment and reform more challenging. These risks are mitigated by the authorities' commitment to frontloaded fiscal measures and broad-based structural reforms. Consistent implementation of reform policies is crucial for achieving the program's objectives.

47. Staff support the authorities' request for a Stand-By Arrangement. In view of the policy measures already taken and the authorities' commitment to implement the reforms, staff support the request for a Stand-By Arrangement in the amount of SDR 935.4 million (200 percent of quota).

48. It is recommended that the next Article IV consultation will be held in accordance with Decision No. 14747-(10/96), adopted September 28, 2010, as amended.

Figure 1. Serbia: Symptoms of Unsustainable Growth Accelerations, 2004–08

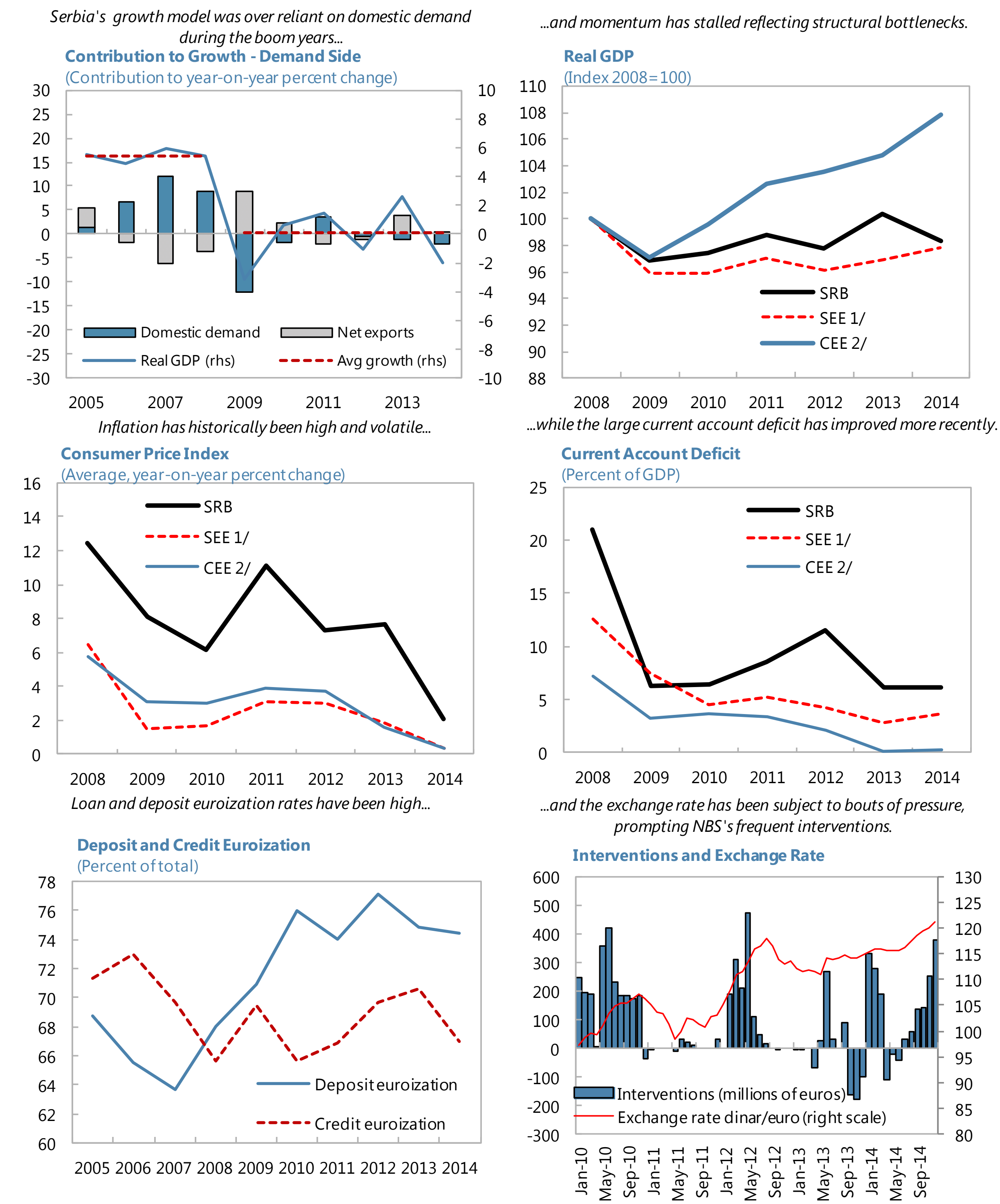


Source: WEO.

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. Serbia: Policy Challenges, 2005–14

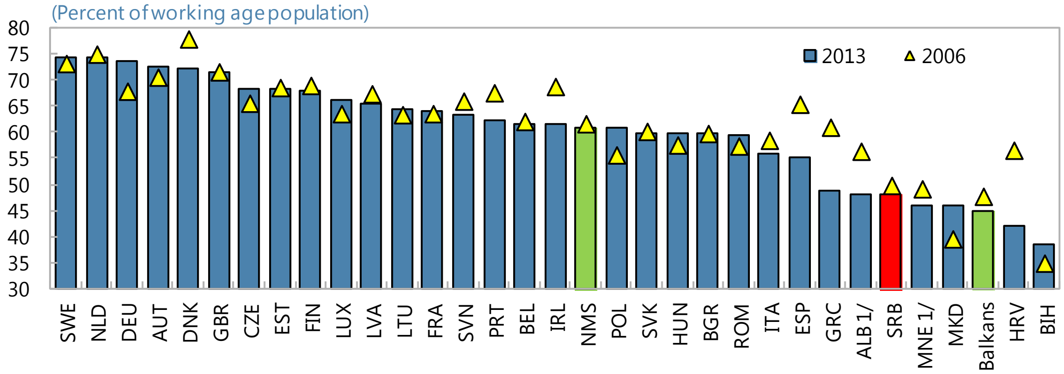


Source: Serbian Statistical Office (SORS); National Bank of Serbia; WEO; and IMF staff estimates.
1/ SEE includes: ALB, BIH, HRV, UVK, MKD, and MNE.
2/ CEE includes: BGR, CZE, HUN, POL, ROU, SVK, and SVN.

Figure 3. Serbia: Selected Labor Market Indicators, 2006–13

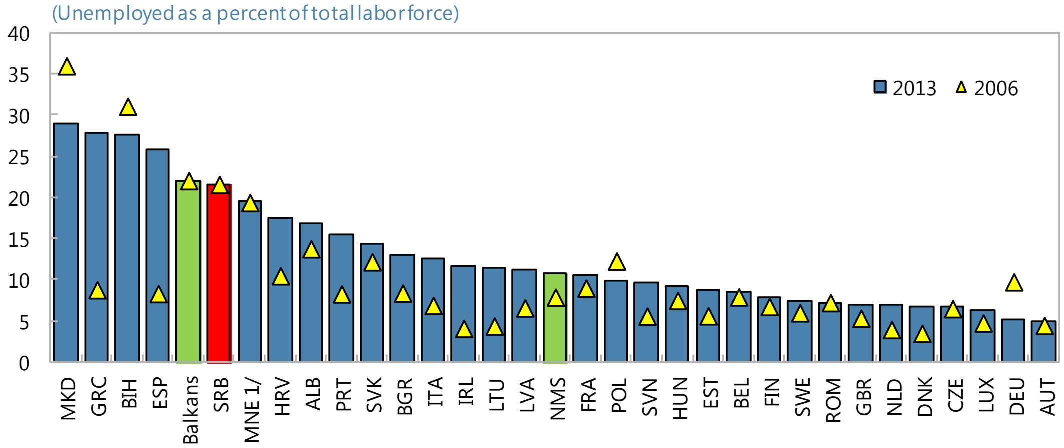
The employment rate in Serbia is one of the lowest in Europe…

Working Age Employment
(Percent of working age population)



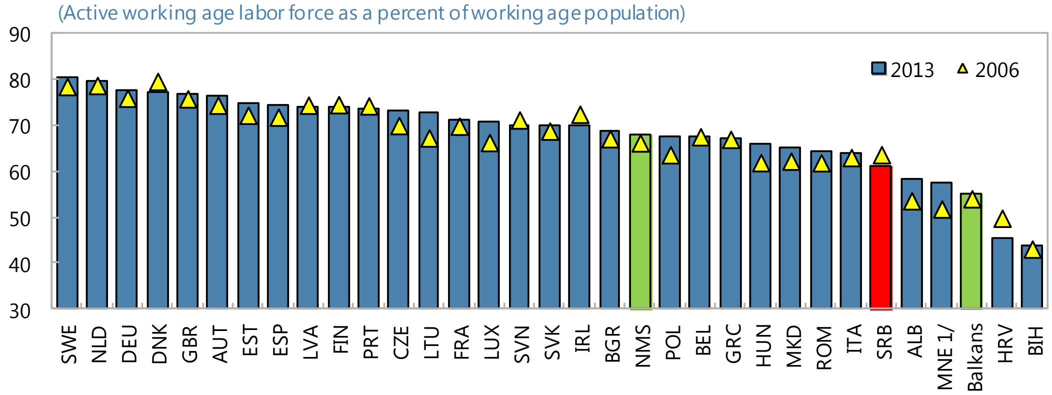
…on account of a very high unemployment rate…

Unemployment Rate
(Unemployed as a percent of total labor force)



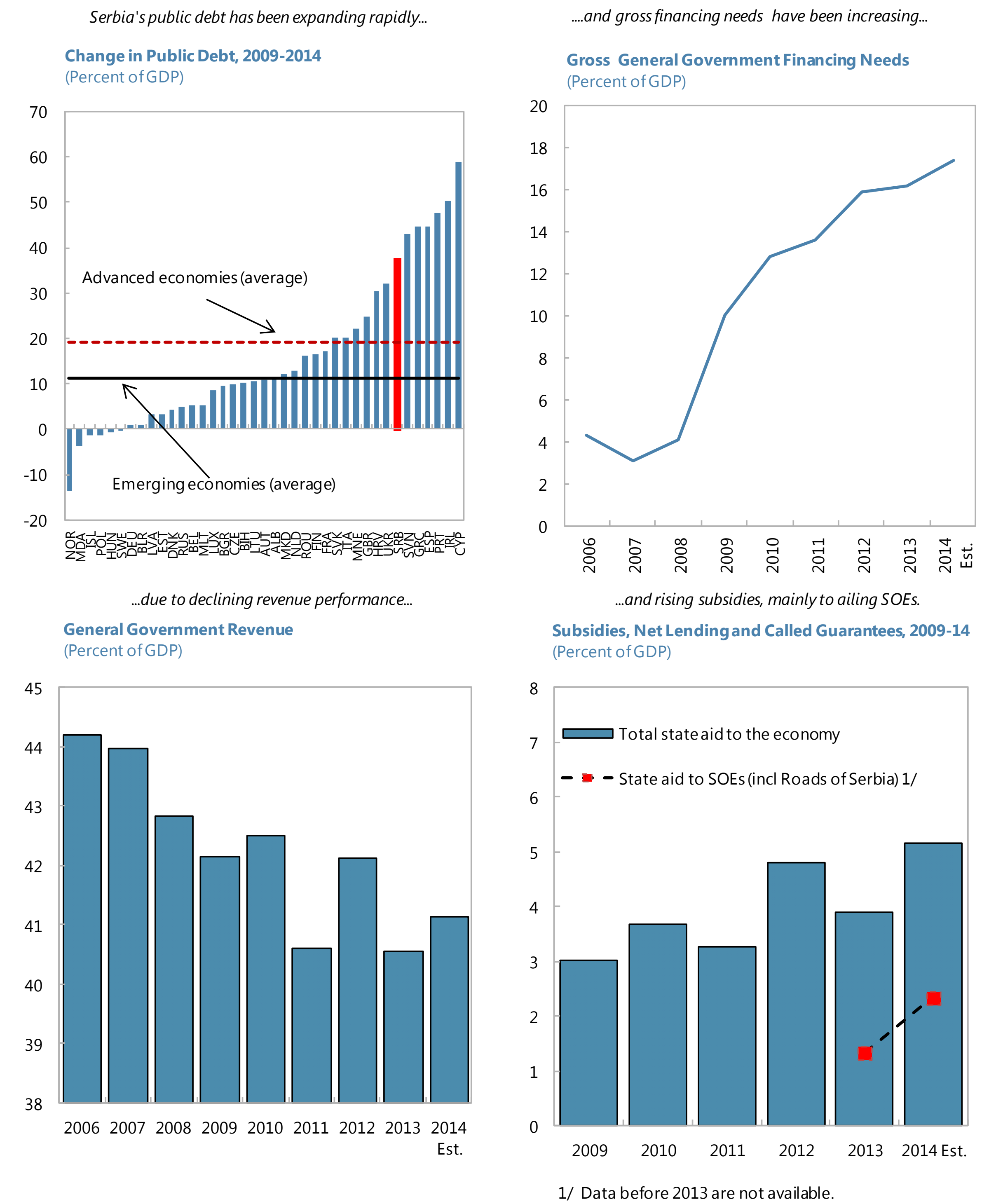
…and low labor force participation.

Activity Rate
(Active working age labor force as a percent of working age population)



Sources: Country authorities; OECD; Haver; Eurostat; and IMF staff calculations.
Note: NMS refers to the New Member States of the European Union.
1/ 2007 data used in place of 2006 data.

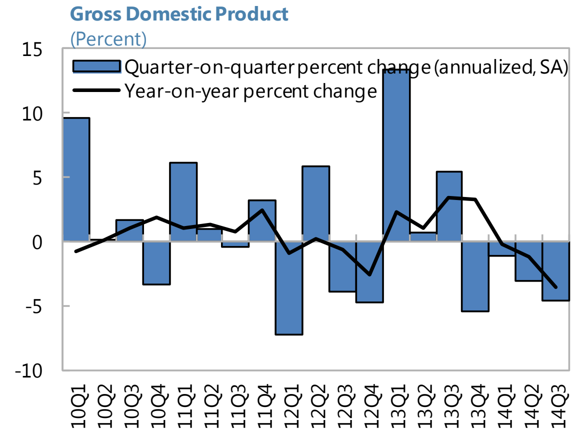
Figure 4. Serbia: Fiscal Challenges, 2006–14



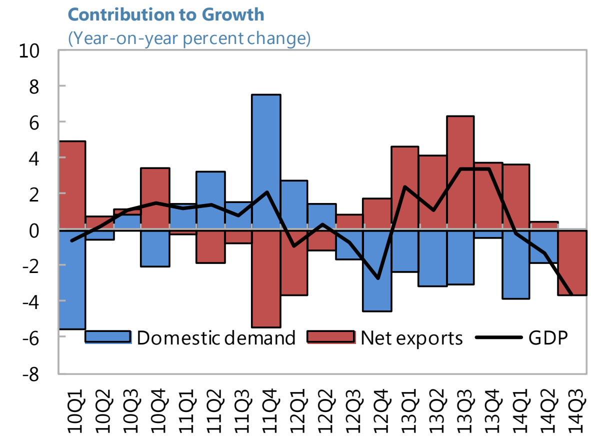
Sources: National Authorities, WEO, and IMF staff estimates.

Figure 5. Serbia: Real Sector Developments, 2010–14

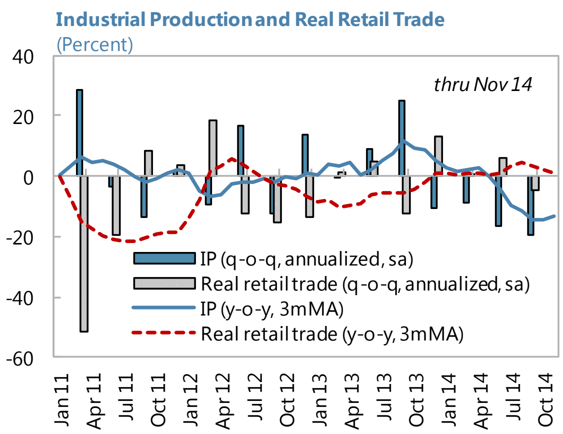
After a recovery in 2013, the economy fell into another recession...



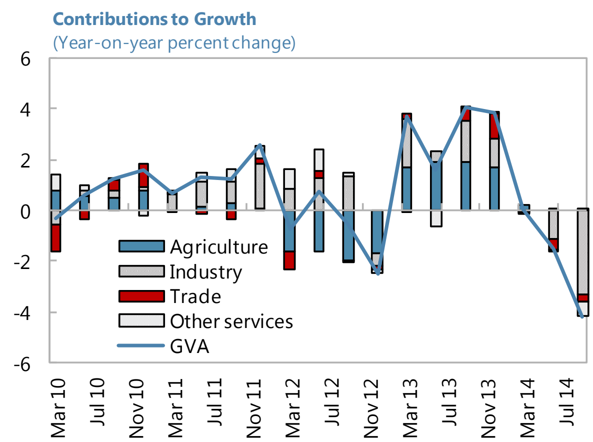
...with decline in both domestic demand and net exports.



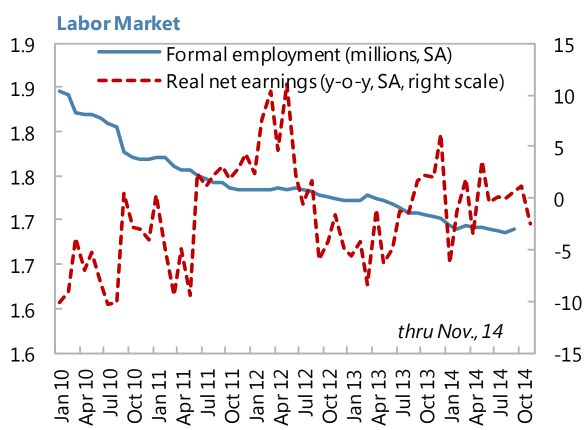
The floods disrupted industrial production...



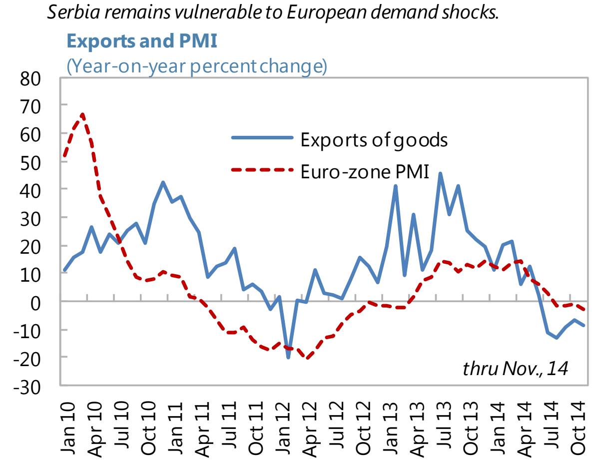
...and contributed to the economic decline.



Employment has continued to decline.

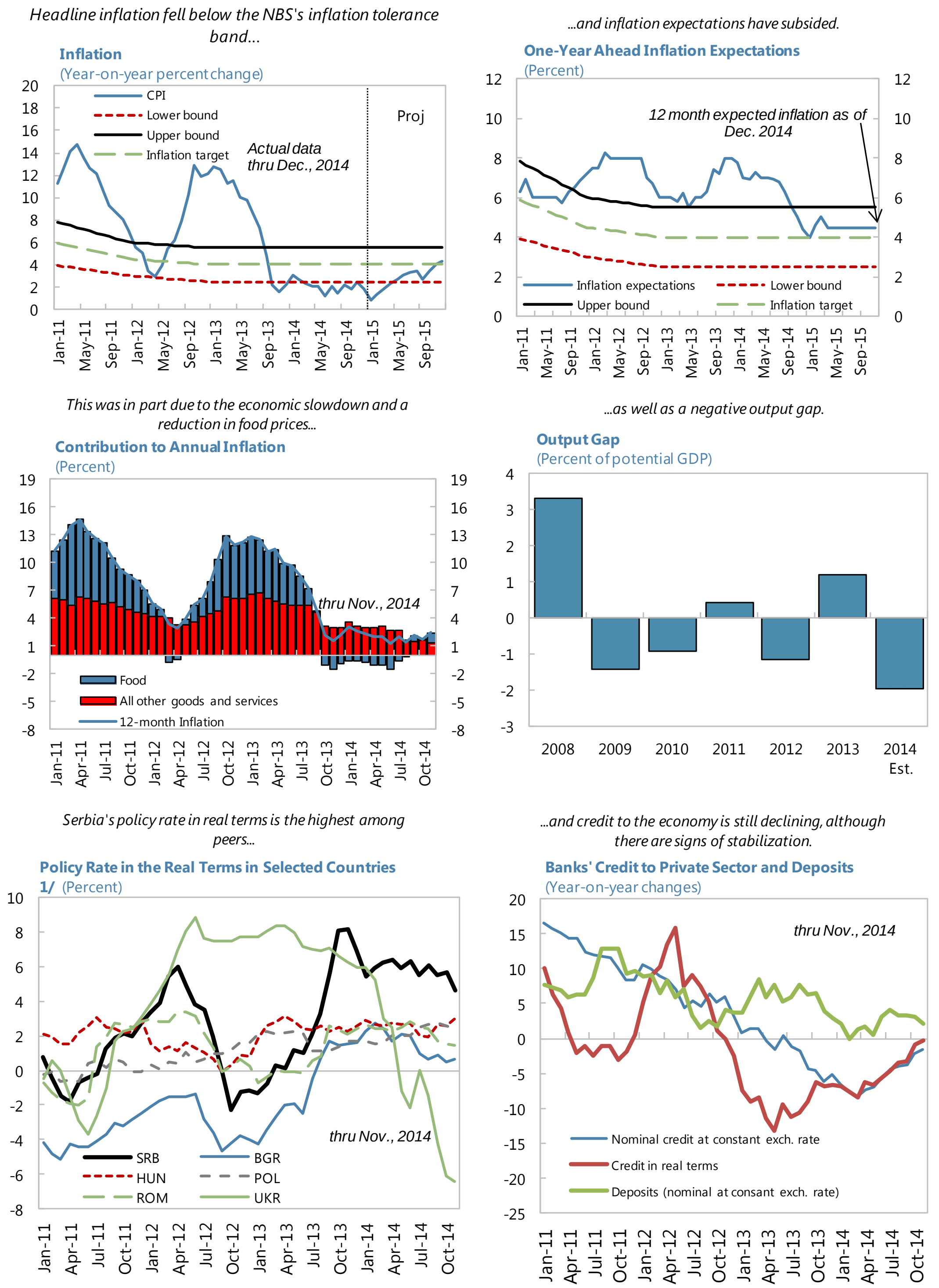


Serbia remains vulnerable to European demand shocks.



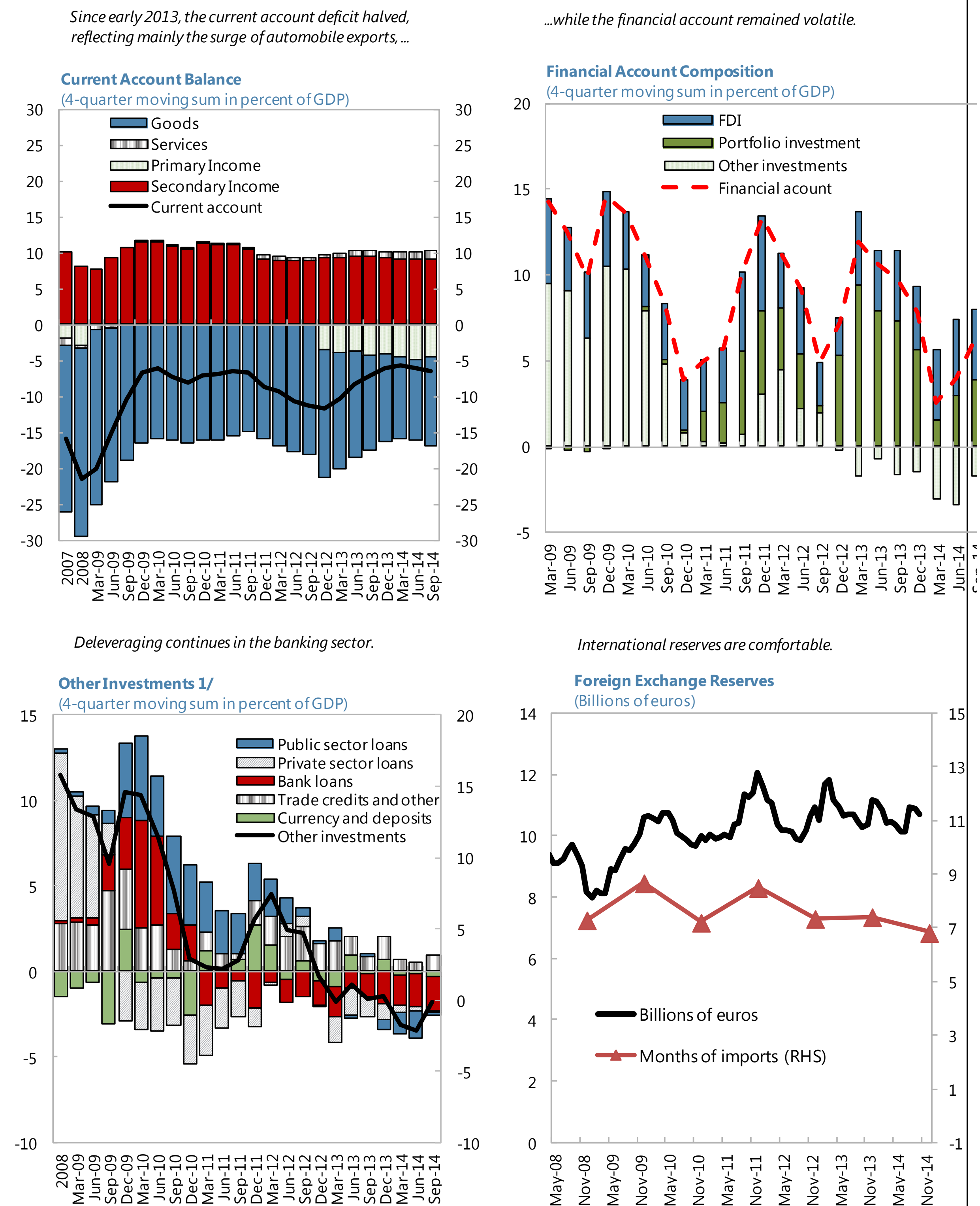
Sources: Haver, SORS and IMF staff calculations.

Figure 6. Serbia: Inflation and Monetary Policy, 2008–15



Sources: Haver; Bloomberg; National Bank of Serbia (NBS); SORS; and IMF staff estimates and projections.
1/ Nominal policy rate adjusted by inflation over the past 12 months.

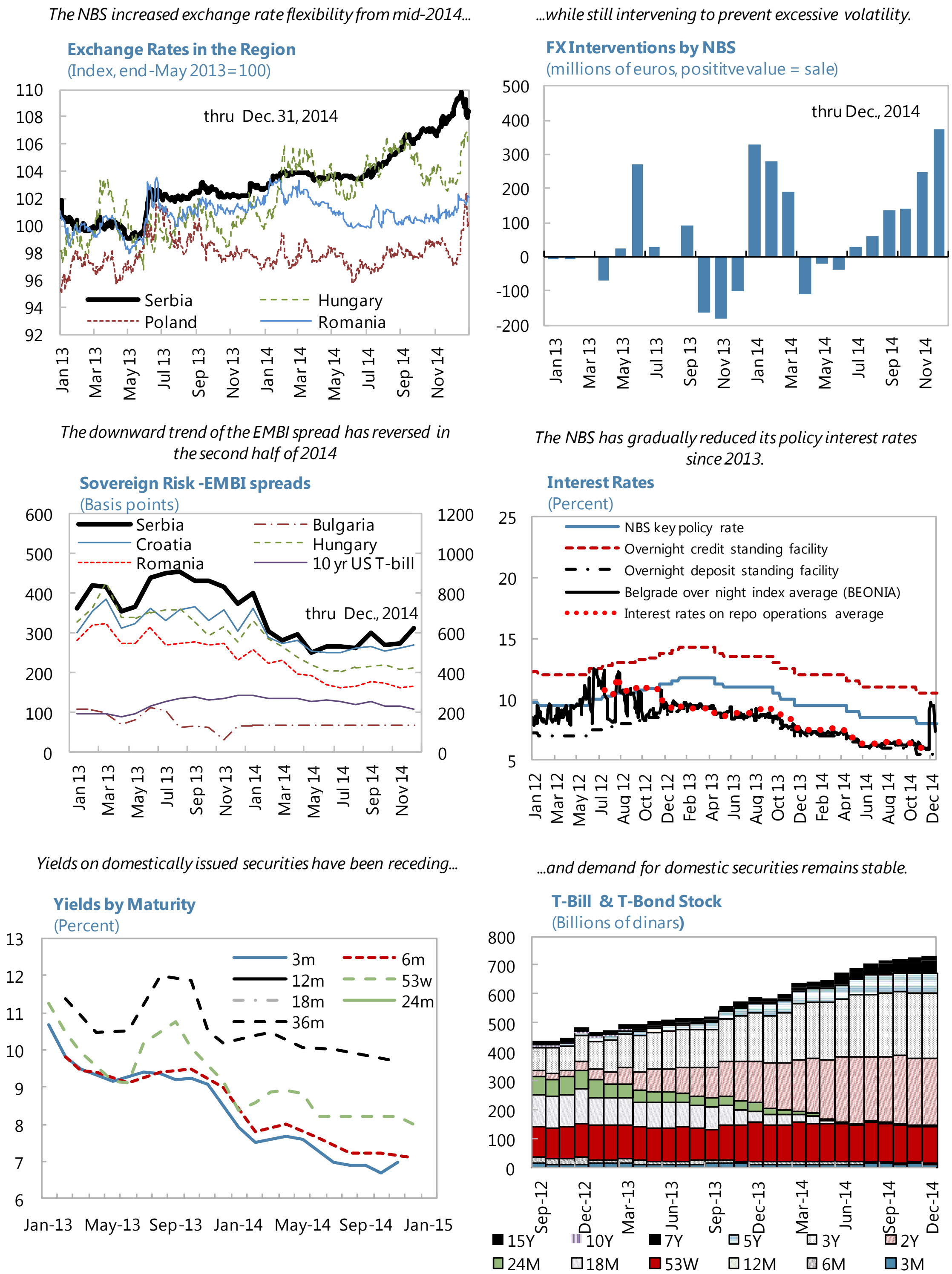
Figure 7. Serbia: Balance of Payments, 2007–14



Sources: Haver; and IMF staff calculations.

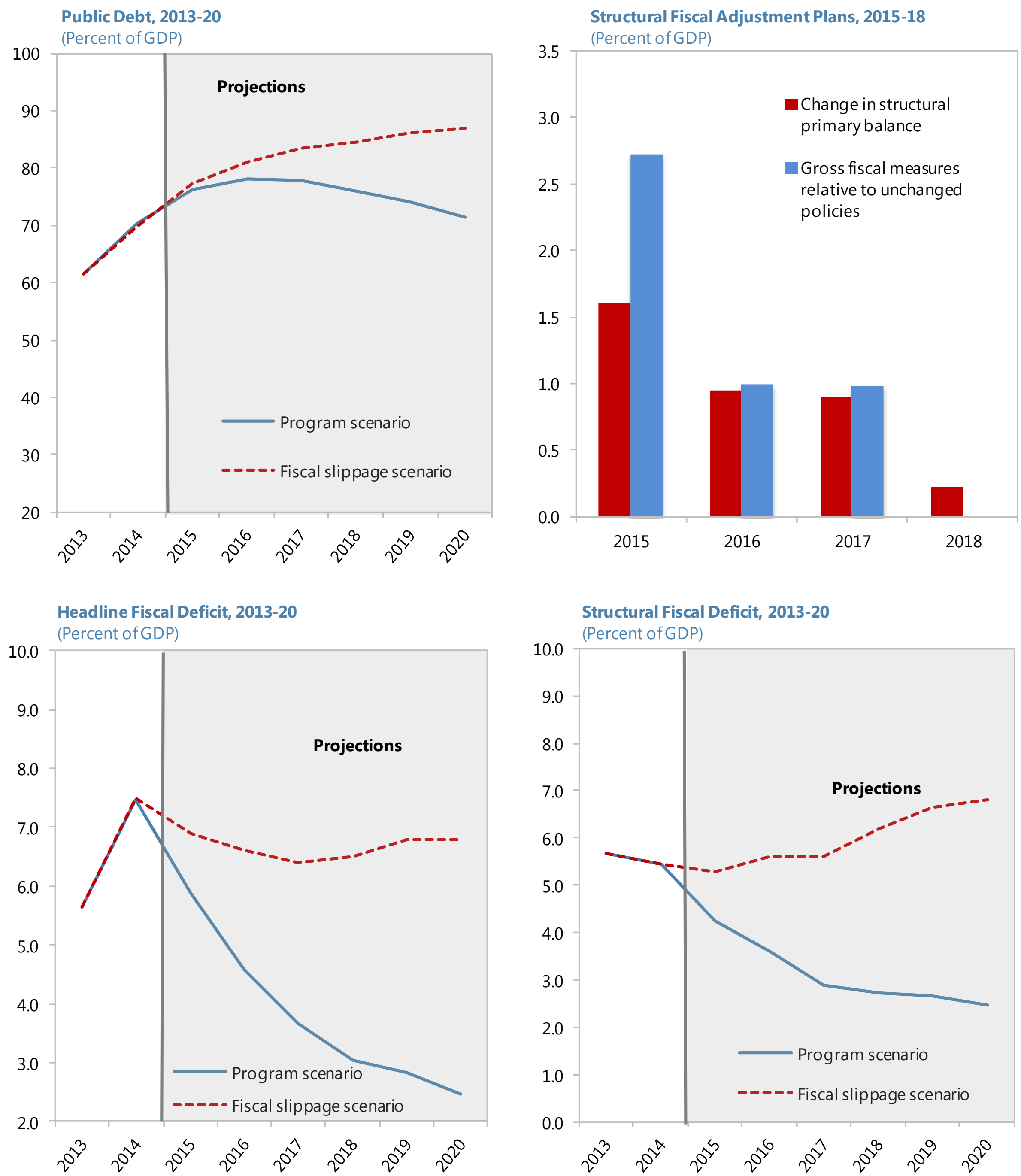
1/ BPM5 data spliced with BPM6 going forward starting March 2013.

Figure 8. Serbia: Recent Financial and Exchange Rate Developments, 2012–14



Sources: Serbian Authorities; Bloomberg; and Haver.

Figure 9. Serbia: Fiscal Outlook Under Alternative Scenarios, 2013–20 1/



Sources: National authorities, and IMF staff estimates.
1/ The fiscal slippage scenario assumes that only a half of envisaged fiscal adjustment is implemented over the program period.

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Figure 10. Serbia: Structural Reform Agenda

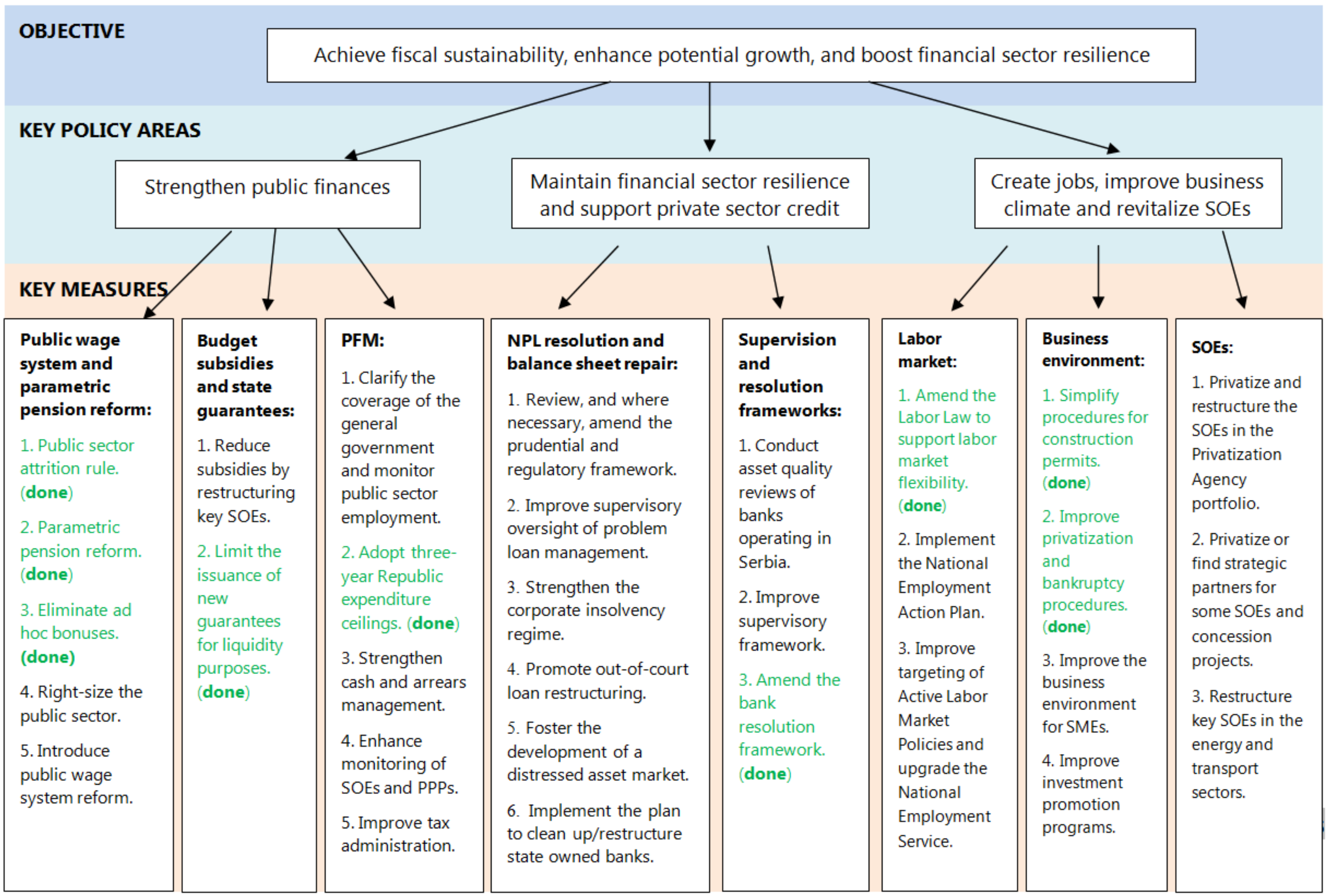
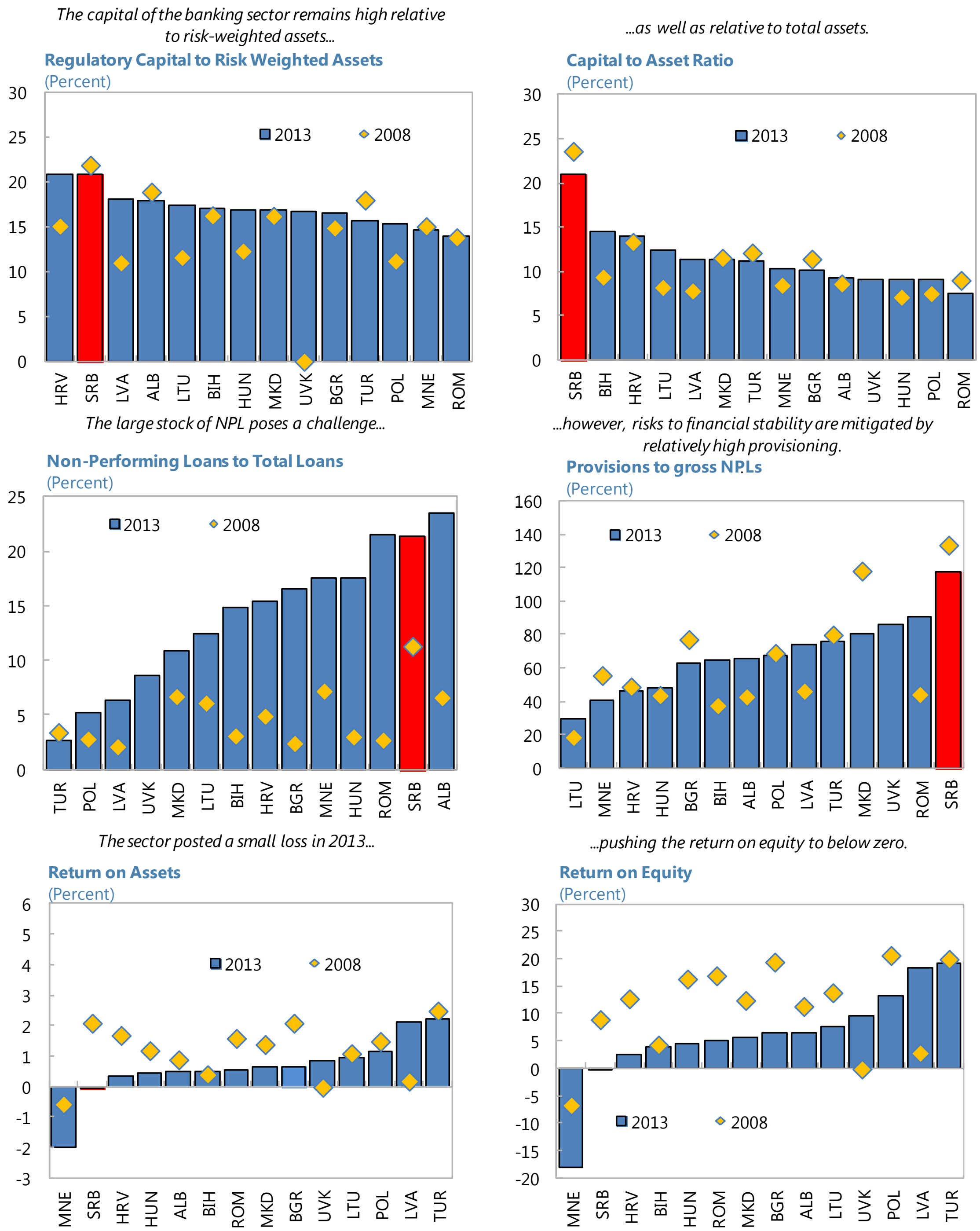


Figure 11. Serbia: Financial Soundness Indicators, 2008 and 2013 1/



Source: NBS and IMF Financial Soundness Indicators.

1/ All values for 2013 are the latest available with the exception of Bulgaria and Montenegro which are December 2012. Values for Serbia are as of December 2013.

Table 1. Serbia: Selected Economic and Social Indicators (Program Scenario), 2010–15

	2010	2011	2012	2013	2014 Est.	2015 Proj. 1/
	(Percent change, unless otherwise indicated)					
Real sector						
Real GDP	0.6	1.4	-1.0	2.6	-2.0	-0.5
Real domestic demand (absorption)	-1.5	3.1	-0.5	-1.1	-1.8	-2.4
Consumer prices (average)	6.1	11.1	7.3	7.7	2.1	2.7
GDP deflator	5.9	9.6	6.3	5.4	2.2	2.7
Unemployment rate (in percent) 2/	20.0	23.6	24.6	23.0	19.7	…
Nominal GDP (in billions of dinars) 3/	3,067	3,408	3,584	3,876	3,881	3,967
	(Percent of GDP)					
General government finances						
Revenue	39.9	38.2	39.4	37.9	39.4	38.7
Expenditure	44.6	43.1	46.6	43.5	46.8	44.6
Current	40.0	38.9	42.5	40.8	43.0	40.6
Capital and net lending	4.4	4.1	3.8	2.5	3.0	3.2
Amortization of called guarantees	0.2	0.2	0.3	0.2	0.8	0.8
Fiscal balance (cash basis)	-4.5	-4.7	-6.9	-5.4	-6.6	-5.1
Augmented fiscal balance 4/	-4.7	-4.9	-7.2	-5.6	-7.5	-5.9
Primary fiscal balance (cash basis)	-3.6	-3.6	-5.3	-3.2	-4.4	-2.4
Gross debt	43.7	46.6	58.3	61.4	69.9	76.4
	(End of period 12-month change, percent)					
Monetary sector						
Money (M1)	-2.2	16.8	3.8	23.7	10.9	6.9
Broad money (M2)	13.7	10.4	9.2	4.2	7.5	4.0
Domestic credit to non-government 5/	17.5	8.3	3.3	-5.2	0.0	-0.1
	(Period average, percent)					
Interest rates (dinar)						
NBS key policy rate 6/	9.1	11.6	10.1	11.1	9.0	…
Interest rate on new FX and FX-indexed loans 6/	8.6	8.2	8.0	7.3	6.2	…
Interest rate on new dinar deposits 6/	10.5	10.8	9.9	9.3	7.3	…
	(Percent of GDP, unless otherwise indicated)					
Balance of payments						
Current account balance	-6.4	-8.6	-11.5	-6.1	-6.1	-4.7
Exports of goods	25.0	25.3	26.5	30.8	32.5	33.9
Imports of goods	-40.4	-41.2	-44.2	-42.9	-45.1	-45.0
Trade of goods balance	-15.5	-15.9	-17.8	-12.1	-12.6	-11.1
Capital and financial account balance	1.8	13.3	7.9	9.4	2.3	7.3
External debt (percent of GDP)	80.3	74.5	84.3	79.3	83.8	88.2
of which: Private external debt	49.6	40.0	42.7	36.8	36.4	34.1
Gross official reserves (in billions of euro)	10.0	12.1	10.9	11.2	9.9	10.6
(in months of prospective imports)	7.2	8.5	7.4	7.4	6.7	7.0
(percent of short-term debt)	195.7	322.2	207.5	262.3	278.2	372.4
(percent of broad money, M2)	78.6	85.2	76.8	76.2	66.5	67.4
(percent of risk-weighted metric)	…	…	…	228.3	204.6	218.0
Exchange rate (dinar/euro, period average)	103.5	102.0	113.0	113.1	117.2	…
REER (annual average change, in percent; + indicates appreciation)	-7.9	9.3	-7.4	7.8	-2.1	-2.2
Social indicators						
Per capita GDP (in US$)	5,354	6,404	5,664	6,324	6,116	5,649
Population (in million)	7.3	7.3	7.2	7.2	7.2	7.2

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

1/ Projections for 2015 reflect the program scenario.
2/ Unemployment rate for working age population (15-64).
3/ The GDP series were revised in October 2014 based on ESA 2010 methodology and resulted in an increase of average 7 percent.
4/ Includes amortization of called guarantees.
5/ At constant exchange rates.
6/ Period average for the actual available data.

Table 2. Serbia: Medium-Term Framework (Program Scenario), 2012–20

	2012	2013	2014	2015	2016	2017	2018	2019	2020
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
				(percent change)					
Real sector									
GDP growth	-1.0	2.6	-2.0	-0.5	1.5	2.0	3.5	3.5	4.0
Domestic demand (contribution)	-0.6	-1.3	-2.0	-2.7	0.9	1.6	3.7	3.8	4.6
Net exports (contribution)	-0.4	3.8	0.0	2.2	0.6	0.4	-0.2	-0.3	-0.6
Consumer price inflation (average)	7.3	7.7	2.1	2.7	4.0	4.0	4.0	4.0	4.0
Consumer price inflation (end of period)	12.2	2.2	1.8	4.2	4.0	4.0	4.0	4.0	4.0
Output gap (in percent of potential)	-0.8	1.8	-2.0	-2.6	-2.0	-1.5	-1.0	-0.5	0.0
Domestic credit to non-gov. (constant exchange rate) 1/	3.3	-5.2	0.0	-0.1	0.0	4.3	6.5	4.6	7.3
				(percent of GDP, unless otherwise indicated)					
General government									
Revenue	39.4	37.9	39.4	38.7	37.7	36.9	36.8	36.7	36.6
Expenditure	46.6	43.5	46.8	44.6	42.4	40.7	40.1	39.8	39.3
Current	42.5	40.8	43.0	40.6	38.5	37.1	36.5	36.3	35.8
of which: Wages and salaries	10.5	10.1	10.1	9.1	8.2	7.4	7.3	7.3	7.2
of which: Pensions	13.2	12.8	13.1	12.4	11.8	11.3	11.0	10.7	10.3
of which: Goods and services	8.0	7.2	7.8	7.6	7.4	7.4	7.4	7.4	7.4
Capital and net lending	3.8	2.5	3.0	3.2	3.2	3.1	3.1	3.1	3.1
Amortization of called guarantees	0.3	0.2	0.8	0.8	0.7	0.5	0.5	0.5	0.4
Augmented fiscal balance 2/	-7.2	-5.6	-7.5	-5.9	-4.7	-3.8	-3.3	-3.1	-2.7
change (+ = consolidation)	*-2.3*	*1.6*	*-1.8*	*1.6*	*1.2*	*0.9*	*0.5*	*0.1*	*0.4*
Augmented primary fiscal balance	-5.3	-3.2	-4.4	-2.4	-0.8	0.3	1.0	1.2	1.6
change (+ = consolidation)	*-1.8*	*2.1*	*-1.2*	*2.0*	*1.6*	*1.1*	*0.7*	*0.3*	*0.3*
Structural primary balance	-4.1	-3.2	-2.4	-0.7	0.2	1.1	1.3	1.4	1.6
change (+ = consolidation)	*-0.5*	*0.8*	*0.8*	*1.7*	*0.9*	*0.9*	*0.2*	*0.1*	*0.2*
Gross debt	58.3	61.4	69.9	76.4	78.4	78.0	76.2	74.6	72.2
Effective interest rate on government borrowing (percent)	3.8	4.3	5.0	5.1	5.3	5.5	5.8	6.2	6.1
Domestic borrowing (including FX)	4.9	5.6	7.1	6.8	7.2	7.5	8.2	8.6	8.7
External borrowing	2.9	3.3	3.5	3.8	4.2	4.4	4.7	4.9	5.0
				(percent of GDP, unless otherwise indicated)					
Balance of payments									
Current account	-11.5	-6.1	-6.1	-4.7	-4.7	-4.4	-4.3	-3.9	-3.7
of which: Trade balance	-17.8	-12.1	-12.6	-11.1	-10.3	-9.6	-9.3	-9.1	-9.0
of which: Current transfers, net (excl. grants)	9.0	9.1	8.8	9.3	8.7	8.2	7.8	8.1	8.1
Capital and financial account	7.9	9.4	2.3	7.3	7.6	5.0	3.2	3.7	4.1
of which: Foreign direct investment	2.1	3.6	3.8	4.0	3.8	4.0	4.2	4.2	4.2
External debt (end of period)	84.3	79.3	83.8	88.2	87.1	84.0	77.7	72.3	67.4
of which: Private external debt	42.7	36.8	36.4	34.1	31.3	28.9	26.5	24.2	22.0
Gross official reserves									
(in billions of euros)	10.9	11.2	9.9	10.6	11.6	11.8	11.4	11.3	11.5
(in percent of short-term external debt)	207.5	262.3	278.2	372.4	283.1	279.3	291.6	215.0	218.7
REER (ann. av. change; + = appreciation)	-7.4	7.8	-2.1	-2.2	2.8	1.4	1.6	1.6	1.6

Sources: NBS, MoF, SORS and IMF staff estimates and projections.

1/ Using the September 2014 dinar/euro exchange rate as the base for converting FX and FX-indexed loans to dinars (assuming that all FX loans are in euros).

2/ Includes amortization of called guarantees.

Table 3a. Serbia: Balance of Payments (Program Scenario), 2012–20 1/

(In billions of euros)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
					(Billions of euros)				
Current account balance	-3.6	-2.1	-2.0	-1.5	-1.6	-1.6	-1.7	-1.6	-1.6
Trade of goods balance	-5.6	-4.2	-4.2	-3.6	-3.5	-3.5	-3.6	-3.7	-4.0
Exports of goods	8.4	10.5	10.8	11.0	11.6	12.4	13.4	14.5	15.6
Imports of goods	-14.0	-14.7	-14.9	-14.6	-15.1	-15.8	-17.0	-18.2	-19.6
Services balance	0.1	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1.0
Exports of nonfactor services	3.1	3.4	3.5	3.6	3.8	4.1	4.4	4.8	5.1
Imports of nonfactor services	-3.0	-3.1	-3.2	-3.1	-3.2	-3.3	-3.6	-3.9	-4.1
Income balance	-1.1	-1.4	-1.5	-1.6	-1.8	-2.0	-2.0	-2.1	-2.2
Net interest	-0.8	-0.9	-0.8	-0.9	-1.1	-1.2	-1.3	-1.3	-1.3
Current transfer balance	2.9	3.2	3.3	3.2	3.2	3.1	3.1	3.3	3.6
Others, including private remittances	2.9	3.1	2.9	3.0	3.0	3.0	3.0	3.3	3.6
Capital and financial account balance 2/	2.5	3.2	0.8	2.4	2.6	1.8	1.2	1.5	1.8
Foreign direct investment balance	0.7	1.2	1.3	1.3	1.3	1.4	1.6	1.7	1.9
Portfolio investment balance	1.7	1.9	0.5	1.7	1.2	0.7	-0.2	0.0	0.2
of which: debt liabilities	1.7	2.0	0.5	1.7	1.2	0.7	-0.2	0.0	0.2
Other investment balance	0.2	0.1	-0.9	-0.6	0.1	-0.3	-0.1	-0.2	-0.2
Public sector 2/ 3/	0.5	0.4	0.6	0.3	0.4	0.0	0.1	0.1	0.0
Domestic banks	-0.4	-0.5	-1.6	-0.7	-0.2	-0.1	0.0	0.0	0.0
Other private sector 4/	0.1	0.1	0.1	-0.3	-0.1	-0.2	-0.2	-0.3	-0.2
Errors and omissions	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-0.9	1.3	-1.2	0.8	1.0	0.2	-0.4	-0.1	0.2
Financing	0.9	-1.3	1.2	-0.8	-1.0	-0.2	0.4	0.1	-0.2
Gross international reserves (increase, -)	1.1	-0.7	1.8	-0.7	-1.0	-0.2	0.4	0.1	-0.2
Use of Fund credit, net	-0.2	-0.6	-0.6	-0.1	-0.01	0.0	0.0	0.0	0.0
Purchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-0.2	-0.6	-0.6	-0.1	-0.01	0.0	0.0	0.0	0.0

Sources: NBS; and IMF staff estimates and projections.

1/ Some estimates, in particular for private remittances and reinvested earnings, are subject to significant uncertainty.
2/ Excluding net use of IMF resources.
3/ Includes SDR allocations in 2009.
4/ Includes trade credits (net).

Table 3b. Serbia: Balance of Payments (Program Scenario), 2012–20 1/

(Percent of GDP)

	2012	2013	2014 Est.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.
				(Percent of GDP)					
Current account balance	-11.5	-6.1	-6.1	-4.7	-4.7	-4.4	-4.3	-3.9	-3.7
Trade of goods balance	-17.8	-12.1	-12.6	-11.1	-10.3	-9.6	-9.3	-9.1	-9.0
Exports of goods	26.5	30.8	32.5	33.9	33.6	34.3	34.8	35.3	35.4
Imports of goods	-44.2	-42.9	-45.1	-45.0	-43.9	-43.9	-44.1	-44.4	-44.4
Services balance	0.4	0.9	1.1	1.6	1.8	2.0	2.1	2.2	2.2
Income balance	-3.4	-4.1	-4.6	-5.0	-5.3	-5.4	-5.3	-5.2	-5.0
Current transfer balance	9.3	9.2	9.9	9.8	9.2	8.6	8.1	8.1	8.1
Capital and financial account balance 2/	7.9	9.4	2.3	7.3	7.6	5.0	3.2	3.7	4.1
Foreign direct investment balance	2.1	3.6	3.8	4.0	3.8	4.0	4.2	4.2	4.2
Portfolio investment balance	5.3	5.6	1.4	5.2	3.5	1.9	-0.6	-0.1	0.5
Other investment balance	0.5	0.3	-2.8	-1.9	0.3	-0.9	-0.4	-0.4	-0.5
Public sector 2/ 3/	1.5	1.2	1.8	1.0	1.2	0.0	0.2	0.2	0.0
Domestic banks	-1.3	-1.3	-5.0	-2.1	-0.6	-0.3	0.0	0.0	0.0
Other private sector 4/	0.4	0.4	0.3	-0.8	-0.3	-0.6	-0.5	-0.6	-0.5
Errors and omissions	0.6	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-2.9	3.9	-3.8	2.5	2.9	0.6	-1.1	-0.2	0.4
				(Percent, unless otherwise indicated)					
Memorandum items:									
Export growth	-0.5	25.6	2.1	2.3	5.0	7.0	8.3	8.4	7.6
Import growth	2.0	4.7	1.5	-2.0	3.2	4.9	7.3	7.5	7.4
Export volume growth	-0.8	21.9	3.4	3.1	5.0	6.6	7.7	7.9	7.6
Import volume growth	0.8	2.7	2.8	-1.5	3.0	4.6	6.8	7.1	7.4
Trading partner import growth	-0.2	1.0	4.5	4.6	5.3	5.3	5.1	4.6	4.6
Export prices growth	0.3	3.0	-1.3	-0.8	0.0	0.4	0.5	0.4	0.0
Import prices growth	1.2	2.0	-1.2	-0.5	0.2	0.3	0.4	0.3	0.0
Change in terms of trade	-0.9	1.0	-0.1	-0.3	-0.2	0.1	0.1	0.1	0.0
Gross official reserves (in billions of euro)	10.9	11.2	9.9	10.6	11.6	11.8	11.4	11.3	11.5
(In months of prospective imports of GNFS)	7.4	7.4	6.7	7.0	7.2	6.9	6.2	5.7	5.4
(in percent of short-term debt)	207.5	262.3	278.2	372.4	283.1	279.3	291.6	215.0	218.7
(in percent of broad money, M2)	76.8	76.2	66.5	67.4	70.1	67.5	60.8	56.6	53.6
(in percent of risk-weighted metric)	...	228.3	204.6	218.0	217.9	215.3	206.5	191.4	194.6

Sources: NBS; and IMF staff estimates and projections.

1/ Some estimates, in particular for private remittances and reinvested earnings, are subject to significant uncertainty.

2/ Excluding net use of IMF resources.

3/ Includes SDR allocations in 2009.

4/ Includes trade credits (net).

Table 4. Serbia: External Financing Requirements (Program Scenario), 2012–20

	2012	2013	2014 Est.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.
			(percent of GDP)						
1. Gross financing requirements	19.7	23.5	13.6	17.8	15.8	16.4	14.2	13.2	16.0
Current account deficit	11.5	6.1	6.1	4.7	4.7	4.4	4.3	3.9	3.7
Debt amortization	11.8	15.3	12.9	11.0	8.3	11.3	11.0	9.5	11.9
Medium and long-term debt	9.8	13.9	12.3	10.7	8.0	11.1	10.7	9.2	11.7
Public sector	2.2	7.0	7.3	5.5	3.9	6.2	6.6	4.4	7.4
Of which: IMF	0.7	1.8	1.7	0.4	0.0	0.0	0.0	0.0	0.0
Of which: Eurobonds	0.0	0.0	0.0	0.1	0.1	1.6	1.9	0.1	2.5
Of which: Domestic bonds (non-residents)	n.a.	2.6	3.5	2.5	1.7	1.9	1.8	1.7	1.6
Commercial banks	1.8	3.2	2.6	2.4	2.2	1.7	1.5	1.6	1.5
Corporate sector	5.7	3.7	2.3	2.8	1.8	3.1	2.6	3.2	2.7
Short-term debt	2.0	1.4	0.6	0.3	0.3	0.3	0.3	0.2	0.2
Public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	1.8	1.2	0.5	0.2	0.2	0.2	0.2	0.2	0.2
Corporate sector	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Change in gross reserves (increase=+)	-3.6	2.0	-5.4	2.1	2.9	0.6	-1.1	-0.2	0.4
2. Available financing	19.7	23.5	13.6	17.8	15.8	16.4	14.2	13.2	16.0
Capital transfers	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)	2.1	3.6	3.8	4.0	3.8	4.0	4.2	4.2	4.2
Portfolio investment (net) 1/	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt financing	15.2	17.9	11.6	14.2	12.0	12.4	10.0	9.0	11.8
Medium and long-term debt	13.6	17.4	11.3	13.9	11.7	12.1	9.7	8.8	11.6
Public sector 2/	6.5	12.2	8.9	11.3	8.6	8.2	6.1	4.6	7.9
Of which: Eurobonds	4.4	5.6	0.0	4.6	3.6	3.5	1.3	0.0	3.0
Of which: Domestic bonds (non-residents)	n.a.	3.9	4.9	3.2	1.7	1.9	1.8	1.7	1.6
Commercial banks	1.0	1.7	0.5	0.6	1.7	1.4	1.5	1.6	1.5
Corporate sector	6.1	3.5	1.9	2.0	1.5	2.5	2.1	2.6	2.2
Short-term debt	1.6	0.6	0.3	0.3	0.3	0.3	0.3	0.2	0.2
Public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	1.3	0.5	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Corporate sector	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other net capital inflows 3/	2.4	2.1	-1.9	-0.3	0.0	0.0	0.0	0.0	0.0
o/w currency and deposits and trade credit	1.1	2.0	0.5	0.0	0.0	0.0	0.0	0.0	0.0
3. Total financing needs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Debt service	14.5	18.1	15.3	13.8	11.0	14.2	13.8	12.3	14.5
Interest	2.7	2.7	2.4	2.8	2.8	2.8	2.9	2.8	2.6
Amortization	11.8	15.3	12.9	11.0	8.3	11.3	11.0	9.5	11.9

Sources: NBS; and Fund staff estimates and projections.

1/ Only includes equity securities and financial derivatives.
2/ Excluding IMF.
3/ Includes all other net financial flows and errors and omissions.

Table 5a. Serbia: General Government Fiscal Operations (Program Scenario), 2012–20 1/

(In billions of RSD)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
					(Billions of RSD)				
Revenue	1,411	1,468	1,527	1,535	1,580	1,643	1,762	1,891	2,041
Taxes	1,226	1,296	1,358	1,348	1,391	1,445	1,557	1,678	1,819
Personal income tax	165	156	143	141	144	149	159	170	182
Social security contributions	379	418	435	421	426	443	483	526	575
Taxes on profits	55	61	74	76	79	85	92	100	108
Value-added taxes	367	381	405	399	410	429	462	497	540
Excises	181	205	215	227	244	249	266	283	303
Taxes on international trade	36	33	32	29	30	29	30	32	35
Other taxes	43	43	54	54	57	61	65	70	76
Non-tax revenue	180	163	161	178	181	188	196	204	212
Capital revenue	1	5	0	0	0	0	0	0	0
Grants	3	3	9	9	9	9	10	10	10
Expenditure	1,669	1,686	1,817	1,767	1,776	1,810	1,919	2,054	2,193
Current expenditure	1,523	1,582	1,670	1,611	1,614	1,651	1,749	1,872	1,999
Wages and salaries 2/	375	393	391	360	345	328	351	375	404
Goods and services	287	278	304	303	310	328	354	381	412
Interest	68	95	118	137	162	180	203	225	239
Subsidies	145	130	155	104	98	105	113	122	132
Transfers	647	687	702	706	699	710	728	769	812
Pensions 3/	474	498	508	491	496	501	526	551	577
Other transfers 4/	174	189	194	214	202	209	202	218	235
Capital expenditure	119	83	102	123	130	134	144	155	168
Net lending	16	13	12	3	3	3	3	3	4
Amortization of activated guarantees	11	9	32	31	30	23	23	23	23
Fiscal balance (cash basis)	-248	-210	-257	-201	-166	-144	-134	-139	-128
Augmented fiscal balance (incl. amortization of called guarantees)	-259	-218	-290	-232	-196	-167	-157	-162	-152
Financing	259	218	290	232	196	167	157	162	152
Privatization proceeds	22	3	0	0	0	0	0	0	0
Equity investment	-39	-18	0	0	0	0	0	0	0
Domestic	116	42	207	-14	5	20	96	161	-2
Banks	130	33	170	0	16	30	85	124	3
Government deposits ((-) means accumulation)	-30	-100	46	-22	-12	1	-6	-13	-12
Securities held by banks (net)	98	56	125	22	28	29	92	138	16
Other domestic bank financing	63	76	-1	-1	-1	-1	-1	-1	-1
Non-banks (incl. non-residents)	-14	8	37	-14	-11	-10	11	37	-5
Securities held by non-banks (non-residents, net)	34	56	85	20	26	10	31	47	5
Others (incl. amortization)	-48	-48	-48	-35	-37	-20	-20	-10	-10
External	160	192	82	247	191	147	61	1	153
Program	0	0	0	0	0	0	0	0	0
Project	43	36	44	52	55	57	61	66	71
Bonds and loans	159	234	96	243	222	211	135	71	267
Amortization	-41	-78	-57	-48	-86	-120	-135	-136	-185
Memorandum items:									
Arrears accumulation (domestic)	9	-5	0	0	0	0	0	0	0
Quasi-fiscal support to SOEs (gross new issuance of guarantees)	134	112	18	14	30	23	23	23	23
Gross public debt	2090	2381	2712	3030	3285	3472	3652	3849	4024
Gross public debt (including restitution)	2090	2381	2990	3308	3563	3750	3930	4127	4302
Nominal GDP (billions of dinars)	3584	3876	3881	3967	4191	4450	4790	5156	5577

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

1/ Includes the republican budget, local governments, social security funds, and the Road Company, but excludes indirect budget beneficiaries (IBBs) that are reporting only on an annual basis.

2/ Including severence payments.

3/ Excluding military pension payments from the Republican budget.

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

Table 5b. Serbia: General Government Fiscal Operations (Program Scenario), 2012–20 1/

(Percent of GDP)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
					(percent of GDP)				
Revenue	39.4	37.9	39.4	38.7	37.7	36.9	36.8	36.7	36.6
Taxes	34.2	33.4	35.0	34.0	33.2	32.5	32.5	32.5	32.6
Personal income tax	4.6	4.0	3.7	3.6	3.4	3.4	3.3	3.3	3.3
Social security contributions	10.6	10.8	11.2	10.6	10.2	10.0	10.1	10.2	10.3
Taxes on profits	1.5	1.6	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Value-added taxes	10.3	9.8	10.4	10.1	9.8	9.6	9.6	9.6	9.7
Excises	5.1	5.3	5.5	5.7	5.8	5.6	5.6	5.5	5.4
Taxes on international trade	1.0	0.8	0.8	0.7	0.7	0.7	0.6	0.6	0.6
Other taxes	1.2	1.1	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Non-tax revenue	5.0	4.2	4.1	4.5	4.3	4.2	4.1	4.0	3.8
Capital revenue	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Expenditure	46.6	43.5	46.8	44.6	42.4	40.7	40.1	39.8	39.3
Current expenditure	42.5	40.8	43.0	40.6	38.5	37.1	36.5	36.3	35.8
Wages and salaries 2/	10.5	10.1	10.1	9.1	8.2	7.4	7.3	7.3	7.2
Goods and services	8.0	7.2	7.8	7.6	7.4	7.4	7.4	7.4	7.4
Interest	1.9	2.4	3.0	3.5	3.9	4.0	4.2	4.4	4.3
Subsidies	4.1	3.3	4.0	2.6	2.3	2.4	2.4	2.4	2.4
Transfers	18.1	17.7	18.1	17.8	16.7	16.0	15.2	14.9	14.6
Pensions 3/	13.2	12.8	13.1	12.4	11.8	11.3	11.0	10.7	10.3
Other transfers 4/	4.8	4.9	5.0	5.4	4.8	4.7	4.2	4.2	4.2
Capital expenditure	3.3	2.1	2.6	3.1	3.1	3.0	3.0	3.0	3.0
Net lending	0.5	0.3	0.3	0.1	0.1	0.1	0.1	0.1	0.1
Amortization of activated guarantees	0.3	0.2	0.8	0.8	0.7	0.5	0.5	0.5	0.4
Fiscal balance (cash basis)	-6.9	-5.4	-6.6	-5.1	-4.0	-3.2	-2.8	-2.7	-2.3
Augmented fiscal balance (incl. amortization of called guarantees)	-7.2	-5.6	-7.5	-5.9	-4.7	-3.8	-3.3	-3.1	-2.7
Financing	7.2	5.6	7.5	5.9	4.7	3.8	3.3	3.1	2.7
Privatization proceeds	0.6	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Equity investment	-1.1	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic	3.2	1.1	5.3	-0.4	0.1	0.4	2.0	3.1	0.0
Banks	3.6	0.9	4.4	0.0	0.4	0.7	1.8	2.4	0.1
Government deposits ((-) means accumulation)	-0.8	-2.6	1.2	-0.5	-0.3	0.0	-0.1	-0.2	-0.2
Securities held by banks (net)	2.7	1.5	3.2	0.6	0.7	0.7	1.9	2.7	0.3
Other domestic bank financing	1.8	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non-banks (incl. non-residents)	-0.4	0.2	1.0	-0.4	-0.3	-0.2	0.2	0.7	-0.1
Securities held by non-banks (non-residents, net)	0.9	1.4	2.2	0.5	0.6	0.2	0.7	0.9	0.1
Others (incl. amortization)	-1.3	-1.2	-1.2	-0.9	-0.9	-0.4	-0.4	-0.2	-0.2
External	4.5	5.0	2.1	6.2	4.6	3.3	1.3	0.0	2.7
Program	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Project	1.2	0.9	1.1	1.3	1.3	1.3	1.3	1.3	1.3
Bonds and loans	4.4	6.0	2.5	6.1	5.3	4.7	2.8	1.4	4.8
Amortization	-1.2	-2.0	-1.5	-1.2	-2.1	-2.7	-2.8	-2.6	-3.3
Memorandum items:									
Arrears accumulation (domestic)	0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Quasi-fiscal support to SOEs (gross new issuance guarantees)	3.7	2.9	0.5	0.4	0.7	0.5	0.5	0.5	0.4
Gross financing need	15.9	16.2	17.4	16.9	16.7	19.1	19.2	17.7	20.8
Gross public debt	58.3	61.4	69.9	76.4	78.4	78.0	76.2	74.6	72.2
Gross public debt (including restitution)	58.3	61.4	77.1	83.4	85.0	84.3	82.0	80.0	77.1
Nominal GDP (billions of dinars)	3,584	3,876	3,881	3,967	4,191	4,450	4,790	5,156	5,577

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

1/ Includes the republican budget, local governments, social security funds, and the Road Company, but excludes indirect budget beneficiaries (IBBs) that are reporting only on an annual basis.

2/ Including severence payments.

3/ Excluding military pension payments from the Republican budget.

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

Table 6. Fiscal Policy Measures (Program Scenario), 2015–17 1/
(Percent of GDP)

	2015	2016	2017	Cumulative 2015-17
Reducing pensions and public sector wages	1.62	...	...	1.62
Wages: general government	0.63	...	...	0.63
Gross savings	0.81	...	...	0.81
Cancellation of the solidarity tax	-0.18	...	...	-0.18
Wages: public enterprizes	0.36	...	...	0.36
Gross savings	0.45	...	...	0.45
Cancellation of the solidarity tax	-0.09	...	...	-0.09
Pensions	0.63	...	...	0.63
Freezing wages and pensions in 2015-17	0.08	0.15	0.49	0.72
Wages	0.03	0.05	0.17	0.25
Pensions	0.05	0.10	0.32	0.47
Rightsizing the public sector	0.26	0.50	0.47	1.23
Gross savings from attrition	0.13	0.19	0.12	0.43
Gross savings from targeted separations	0.13	0.31	0.35	0.79
Reduction of subsidies	0.42	0.00	0.03	0.45
Eliminating of agricultural subsidies (for land over 20 hectars)	0.15	0.00	0.00	0.15
Reducing subsidy to Srbijagas (network fees to pay for called guarantees)	0.18	0.04	0.03	0.25
Removing subsity to RTS/RTV in 2015 (by one year faster)	0.05	-0.04	0.00	0.00
Reducing subsidy for Serbia railways	0.05	...	...	0.05
Other measures	0.35	0.35	...	0.70
Reducing mark-up on domestic goods and services	0.06	...	...	0.06
Amending the local government financing law	...	0.19	...	0.19
Imposing excises on nonalchoholic drinks	...	0.02	...	0.02
Revenue effects of electricity price increases	0.28	0.14	...	0.42
Total headline consolidation measures	2.73	1.00	0.99	4.72

Source: Ministry of Finance and Fund staff estimates.

1/ The column for 2015 includes measures implemented in late 2014 (wage and pension cuts).

Table 7a. Serbia: Monetary Survey (Program Scenario), 2012–20

	2012	2013	2014			2015	2016	2017	2018	2019	2020
			Oct	Nov	Dec						
			Prel.	Prel.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Billions of dinars, unless otherwise indicated; end of period) 1/										
Net foreign assets 2/	673	847	1029	1038	1025	1079	1241	1292	1248	1248	1282
in billions of euro	5.9	7.4	8.6	8.6	8.5	8.9	10.1	10.4	10.0	9.9	10.1
Foreign assets	1420	1427	1492	1505	1452	1535	1681	1728	1696	1710	1759
NBS	1250	1291	1285	1247	1207	1291	1430	1469	1427	1428	1464
Commercial banks	169	136	207	257	245	244	251	258	269	281	295
Foreign liabilities (-)	-747	-580	-463	-467	-427	-456	-440	-436	-448	-461	-476
NBS	-166	-87	-36	-36	-25	-9	-7	-7	-7	-7	-7
Commercial banks	-581	-493	-428	-431	-402	-447	-433	-429	-441	-454	-469
Net domestic assets	943	836	747	745	785	804	769	852	1,031	1,218	1,346
Domestic credit	2,027	1,886	1,935	1,943	2,042	2,041	2,073	2,197	2,421	2,654	2,832
Government, net	95	49	84	87	134	134	149	177	261	385	388
NBS	-160	-236	-310	-298	-255	-277	-292	-293	-301	-316	-330
Claims on government	1	1	1	1	1	1	1	1	1	1	1
Liabilities (deposits)	161	237	311	299	256	278	293	294	302	317	331
Banks	255	285	394	385	389	411	440	470	562	701	719
Claims on government	290	336	448	447	448	469	499	530	622	762	780
Liabilities (deposits)	36	51	54	63	58	58	59	60	60	61	61
Local governments, net	6	1	-8	-12	1	1	1	1	1	1	1
Non-government sector	1,926	1,837	1,859	1,868	1,907	1,906	1,924	2,019	2,158	2,268	2,444
Households	654	675	721	726	725	754	776	814	871	915	986
Enterprises	1,226	1,111	1,098	1,101	1,129	1,099	1,095	1,148	1,228	1,290	1,390
Other	47	51	40	41	53	53	53	56	60	63	67
Other assets, net	-1,084	-1,050	-1,188	-1,198	-1,257	-1,236	-1,304	-1,345	-1,389	-1,436	-1,486
Capital accounts (-)	-876	-830	-877	-892	-904	-903	-955	-974	-995	-1,018	-1,043
NBS	-264	-217	-271	-285	-285	-284	-301	-319	-340	-363	-387
Banks	-611	-613	-606	-607	-619	-619	-654	-654	-655	-655	-656
Provisions (-)	-237	-257	-289	-287	-304	-313	-328	-349	-370	-392	-415
Other assets	28	37	-22	-19	-50	-20	-21	-22	-24	-26	-28
Broad money (M2)	1616	1683	1777	1783	1810	1883	2011	2144	2280	2466	2629
Dinar-denominated M2	455	515	551	546	571	610	665	742	826	921	1033
M1	296	366	376	375	406	434	473	528	588	655	735
Currency in circulation	111	122	123	125	136	145	158	176	196	219	246
Demand deposits	186	244	253	250	270	289	315	351	391	436	489
Time and saving deposits	159	149	175	171	165	176	192	214	238	266	298
Foreign currency deposits	1161	1169	1226	1237	1239	1273	1345	1402	1454	1545	1596
in billions of euro	10.2	10.2	10.3	10.3	10.2	10.5	11.0	11.3	11.7	12.3	12.6
Memorandum items:	(year-on-year change unless indicated otherwise)										
M1	3.8	23.7	13.3	12.5	10.9	6.9	9.0	11.5	11.4	11.5	12.2
M2	9.2	4.2	7.0	6.9	7.5	4.0	6.8	6.6	6.3	8.2	6.6
Velocity (Dinar part of money supply)	7.9	7.5	7.0	7.1	6.8	6.5	6.3	6.0	5.8	5.6	5.4
Velocity (M2)	2.2	2.3	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Deposits at program exchange rate	3.6	2.9	3.2	2.2	3.0	3.8	5.5	5.6	5.4	7.3	5.6
Credit to non-gov. (program exchange rate) 3/	0.8	-3.8	0.5	...	1.3	-1.6	-0.5	1.9	3.5	2.1	4.2
Domestic	3.3	-5.2	-2.2	-1.7	0.0	-0.1	0.0	4.3	6.5	4.6	7.3
Households	0.1	2.4	2.2	2.1	2.2	3.9	1.6	4.0	6.2	4.2	6.9
Enterprises	3.9	-9.8	-5.4	-4.8	-2.5	-2.7	-1.5	4.2	6.3	4.3	7.1
External	-3.9	-1.1	5.5	...	3.7	-4.3	-1.5	-2.8	-2.6	-3.4	-3.2
Credit to non-gov. (real terms)	-4.1	-5.3	2.3	...	4.0	-5.6	-3.3	-1.4	0.0	-1.3	0.7
Domestic credit to non-gov. (real terms)	-2.6	-6.7	-0.9	-0.2	2.1	-4.1	-2.9	0.9	2.8	1.0	3.6
Households	-3.3	1.0	4.7	5.0	5.7	-0.3	-1.0	0.9	2.8	1.0	3.6
Enterprises	-2.1	-11.3	-3.9	-3.1	-0.1	-6.6	-4.3	0.9	2.8	1.0	3.6
External	-6.9	-2.4	8.2	...	7.5	-8.1	-3.9	-5.6	-5.6	-6.3	-6.1
Deposit euroization (percent of total) 4/	77.1	74.9	74.1	74.6	74.0	73.2	72.6	71.3	69.8	68.8	67.0
Credit euroization (percent of total) 4/	69.7	70.6	67.2	67.3	67.0	66.0	65.0	64.0	63.0	62.0	61.0

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

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

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

3/ Using program dinar/euro exchange rate as the base for converting FX and FX-indexed loans to dinars (assuming that all FX loans are in euros).

4/ Using current exchange rates.

Table 7b. Serbia: NBS Balance Sheet (Program Scenario), 2012–20

	2012	2013	2014		2015	2016	2017	2018	2019	2020
			Nov	Dec						
			Prel.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Billions of dinars, unless otherwise indicated; end of period) 1/									
Net foreign assets	1085	1204	1211	1182	1282	1423	1462	1420	1421	1457
(In billions of euro)	9.5	10.5	10.0	9.8	10.6	11.6	11.8	11.4	11.3	11.5
Gross foreign reserves	1250	1291	1247	1207	1291	1430	1469	1427	1428	1464
Gross reserve liabilities (-)	-166	-87	-36	-25	-9	-7	-7	-7	-7	-7
Net domestic assets	-470	-584	-607	-589	-678	-799	-807	-732	-691	-685
Net domestic credit	-206	-368	-322	-304	-393	-498	-487	-391	-328	-298
Net credit to government	-160	-236	-298	-255	-277	-292	-293	-301	-316	-330
Claims on government	1	1	1	1	1	1	1	1	1	1
Liabilities to government (-)	-161	-237	-299	-256	-278	-293	-294	-302	-317	-331
Liabilities to government (-): local currency	-55	-89	-125	-44	-39	-39	-39	-39	-39	-39
Liabilities to government (-): foreign currency	-106	-148	-174	-212	-239	-254	-255	-263	-278	-292
Net credit to local governmens	-18	-31	-45	-34	-34	-34	-34	-34	-34	-34
Net claims on banks	-39	-110	-14	-26	-93	-183	-171	-67	12	56
Capital accounts (-)	-264	-217	-285	-285	-284	-301	-319	-340	-363	-387
Reserve money	614	620	581	593	604	624	656	688	731	771
Currency in circulation	111	122	125	136	145	158	176	196	219	246
Commercial bank reserves	186	200	186	204	218	211	214	216	219	224
Required reserves	140	145	153	181	194	188	190	192	195	199
Excess reserves	45	55	33	23	24	24	24	24	24	25
FX deposits by banks, billions of euros	2.8	2.6	2.2	2.1	2.0	2.1	2.1	2.2	2.3	2.4

Sources: National Bank of Serbia; and IMF staff estimates and projections.
1/ Foreign exchange denominated items are converted at current exchange rates.

Table 8. Serbia: Risk Assessment Matrix[1]

Source of Main Threats	Relative Likelihood of Threat and Transmission Channels	Expected Impact if Threat is Realized	Policy Response
External Risks			
1. An abrupt surge in global financial market volatility	**High** Prices of risky assets could drop abruptly, prompting investors to reassess underlying risk.	**High** Serbia is highly dependent on external financing. A surge in the risk premium would increase fiscal and BOP pressures.	Implement fiscal adjustment to reassure investors about commitment to restore fiscal sustainability.
2. Protracted period of slower growth in advanced and emerging economies	**High** Lower-than-anticipated potential growth and persistently low inflation due to a failure to fully address legacies of the financial crisis lead to secular stagnation in advanced and emerging economies.	**High** Due to significant trade linkages with the region and the EU, Serbia's growth would weaken. Weaker growth would jeopardize the process of achieving debt sustainability as social acceptance of adjustment measures would erode further. Weaker growth would increase NPLs and reduce profitability of Serbian banks, although high capitalization is a mitigating factor.	Accelerate the pace of structural reforms to boost attractiveness of FDI and investment in Serbia. Rebalance policy mix towards tighter fiscal and looser monetary policy, to support sustainable economic growth.
3. Heightened geopolitical tensions surrounding Russia/Ukraine conflict	**Medium** Depressed business confidence and heightened risk aversion, amid disturbances in global financial, trade and commodity markets.	**Medium** Direct trade and financial linkages with Russia/Ukraine are moderate, but natural gas supply disruptions would adversely affect Serbia's economy.	Accelerate the pace of structural reform. In case of a long-lasting shock, allow the exchange rate to adjust without jeopardizing financial stability.

[1] The RAM shows events that could materially alter the baseline path.

Table 8. Serbia: Risk Assessment Matrix (Concluded)			
Domestic Risks			
4. Insufficient fiscal consolidation	**High** Sustained implementation of the large fiscal adjustment required may be a challenge.	**High** Fiscal slippages and mounting debt would result in: • higher cost of public and private sector financing. • possible BOP pressures.	Legislate fiscal consolidation measures. Pursue structural reform to foster private sector job creation.
5. Partial implementation of structural reforms	**Medium** Absence of broad-based political and social support may derail implementation of structural reforms.	**High** Insufficient structural reforms would constrain investment and potential growth in Serbia.	Increase social dialogue on the key reforms.

Table 9. Serbia: Banking Sector Financial Soundness Indicators, 2010–14

	2010	2011	2012	2013	2014 Nov.
Capital adequacy					
Regulatory capital to risk-weighted assets	19.9	19.1	19.9	20.9	19.4
Regulatory Tier 1 capital to risk-weighted assets	15.9	18.1	19.0	19.3	16.7
Nonperforming loans net of provisions to capital	29.0	30.8	31.0	32.7	33.1
Capital to assets	19.7	20.6	20.5	20.9	20.9
Large exposures to capital	39.6	65.0	61.9	90.4	105.4
Regulatory capital to total assets	16.1	12.2	12.2	12.2	10.7
Asset quality					
Nonperforming loans to total gross loans	16.9	19.0	18.6	21.4	22.5
Sectoral distribution of loans (percent of total loans)					
Deposit takers	0.1	0.1	0.3	0.3	0.7
Central bank	3.1	7.2	2.3	5.8	0.8
General government	3.7	3.8	3.2	2.3	2.0
Other financial corporations	1.2	1.6	1.6	1.6	1.2
Nonfinancial corporations	55.6	52.5	56.5	54.1	54.9
Agriculture	2.8	2.0	2.9	2.7	3.3
Industry	18.8	17.1	18.0	18.4	18.4
Construction	7.1	6.2	5.5	4.6	4.3
Trade	16.3	14.8	15.2	13.5	14.0
Other loans to nonfinancial corporations	10.6	12.3	14.8	14.9	15.0
Households and NPISH	34.2	33.1	34.1	34.8	38.1
Households and NPISH of which: mortgage loans to total loans	16.4	16.1	17.3	16.8	18.1
Foreign sector	2.0	1.7	2.0	1.1	2.3
Specific provision for NPLs to gross NPLs	47.2	51.0	50.0	50.9	52.9
Specific and general provisions for NPLs to gross NPLs	112.2	111.7	111.1	105.5	109.5
Specific and general provisions for balance sheet losses to NPLs	133.6	121.4	120.7	113.8	115.9
Specific and general provisions to NPLs	149.4	129.2	126.5	117.9	119.3
Specific provision of total loans to total gross loans	9.1	10.8	10.2	11.9	12.7
Earnings and Profitability					
Return on assets	1.1	0.0	0.4	-0.1	0.5
Return on equity	5.3	0.2	2.0	-0.4	2.1
Interest margin to gross income	65.7	69.0	65.6	69.2	68.0
Noninterest expenses to gross income	67.1	65.9	69.8	69.4	68.3
Personnel expenses to noninterest expenses	37.4	37.6	34.4	35.3	33.1
Liquidity					
Liquid assets (core) to total assets	27.2	25.4	23.9	26.1	25.5
Liquid assets (core) to short-term liabilities	58.4	60.4	57.2	63.2	66.9
Customer deposits to total (noninterbank) loans	86.7	91.8	93.2	103.4	108.2
Foreign-currency-denominated loans to total loans	76.8	69.8	74.1	71.6	70.5
Average monthy liquidity ratio	2.0	2.2	2.1	2.4	2.0
Average monthy narrow liquidity ratio	1.3	1.5	1.6	1.8	1.6
Sensitivity to Market Risk					
Net open position in foreign exchange to capital	1.3	2.5	2.7	3.3	1.8
Foreign-currency-denominated liabilities to total liabilities	81.8	79.0	80.1	76.7	75.7
Total off-balance sheet items to total assets	97.7	110.5	103.5	111.0	112.6
Classified off-balance sheet items to classified balance sheet assets	33.9	32.0	26.1	28.7	27.3

Source: National Bank of Serbia.

Table 10. Serbia: Rankings of Selected Competitiveness and Structural Indicators 1/

	Serbia		Best performers 2/				Distance 3/	
	2008	2013		2008		2013	2008	2013
EBRD transition indicators	71	73		92		94	-22	-21
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	54		77		85	-31	-31
Transparency International								
Corruption Perception Index	34	42	Slovenia	67	Estonia	68	-33	-26
World Bank Doing Business survey 4/	48	54	Estonia	88	Estonia	89	-40	-35
Starting a business	41	80	FYR Macedonia	93	FYR Macedonia	97	-52	-17
Dealing with licenses	6	4	Estonia	90	Estonia	80	-84	-76
Registering property	46	78	Lithuania	98	Lithuania	97	-51	-19
Getting credit	85	79	Bulgaria	97	Latvia	98	-13	-20
Protecting investors	61	58	Albania	92	Slovenia	93	-31	-35
Paying taxes	30	17	FYR Macedonia	85	FYR Macedonia	87	-55	-70
Trading across borders	66	46	Estonia	97	Estonia	96	-31	-50
Enforcing contracts	47	47	Latvia	98	Hungary	92	-51	-45
Closing a business	45	45	Lithuania	81	Czech Republic	81	-36	-37

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, 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 11. Serbia: Balance of Payments (Precautionary SBA Shock Scenario), 2010–20 1/

	2010	2011	2012	2013	2014 Est.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.
					(Billions of euros)						
Current account balance	-1.9	-2.9	-3.6	-2.1	-2.0	-2.1	-2.3	-2.2	-2.1	-1.9	-1.6
Trade of goods balance	-4.6	-5.3	-5.6	-4.2	-4.2	-4.2	-4.3	-4.1	-4.0	-4.0	-4.0
Exports of goods	7.4	8.4	8.4	10.5	10.8	10.4	10.8	11.8	12.9	14.3	15.6
Imports of goods	-12.0	-13.8	-14.0	-14.7	-14.9	-14.6	-15.1	-15.8	-17.0	-18.2	-19.6
Services balance	0.0	0.2	0.1	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1.0
Exports of nonfactor services	2.7	3.0	3.1	3.4	3.5	3.6	3.8	4.1	4.4	4.8	5.1
Imports of nonfactor services	-2.7	-2.9	-3.0	-3.1	-3.2	-3.1	-3.2	-3.3	-3.6	-3.9	-4.1
Income balance	-0.7	-0.8	-1.1	-1.4	-1.5	-1.6	-1.8	-2.0	-2.0	-2.1	-2.2
Net interest	-0.6	-0.7	-0.8	-0.9	-0.8	-0.9	-1.1	-1.2	-1.3	-1.3	-1.3
Others, including reinvested earnings	0.0	0.0	-0.3	-0.5	-0.7	-0.7	-0.7	-0.8	-0.7	-0.8	-0.9
Current transfer balance	3.4	3.0	2.9	3.2	3.3	3.2	3.2	3.1	3.1	3.3	3.6
Official grants	0.2	0.2	0.1	0.0	0.4	0.2	0.2	0.2	0.2	0.0	0.0
Others, including private remittances	3.2	2.8	2.9	3.1	2.9	3.0	3.0	3.0	3.0	3.3	3.6
Capital and financial account balance 2/	0.5	4.4	2.5	3.2	0.8	0.5	1.3	1.8	1.2	1.5	1.8
Capital transfer balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment balance	0.9	1.8	0.7	1.2	1.3	1.3	1.3	1.4	1.6	1.7	1.9
Portfolio investment balance	0.0	1.6	1.7	1.9	0.5	1.0	0.6	0.7	-0.2	0.0	0.2
of which: debt liabilities	0.0	1.5	1.7	2.0	0.5	1.0	0.6	0.7	-0.2	0.0	0.2
Other investment balance	-0.4	1.0	0.2	0.1	-0.9	-1.7	-0.6	-0.3	-0.1	-0.2	-0.2
Public sector 2/ 3/	0.7	0.7	0.5	0.4	0.6	0.3	0.4	0.0	0.1	0.1	0.0
Domestic banks	-0.1	0.2	-0.4	-0.5	-1.6	-1.5	-0.7	-0.1	0.0	0.0	0.0
Other private sector 4/	-1.0	0.1	0.1	0.1	0.1	-0.6	-0.3	-0.2	-0.2	-0.3	-0.2
Errors and omissions	0.1	0.2	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-1.3	1.7	-0.9	1.3	-1.2	-1.6	-1.1	-0.4	-0.9	-0.3	0.2
Financing	1.3	-1.7	0.9	-1.3	1.2	1.6	1.1	0.4	0.9	0.3	-0.2
Gross international reserves (increase, -)	0.9	-1.8	1.1	-0.7	1.8	1.2	0.8	0.2	1.0	0.7	0.1
Use of Fund credit, net	0.3	0.1	-0.2	-0.6	-0.6	0.5	0.2	0.2	-0.1	-0.3	-0.3
Purchases	0.3	0.1	0.0	0.0	0.0	0.6	0.3	0.2	0.1	0.0	0.0
Repurchases	0.0	0.0	-0.2	-0.6	-0.6	-0.1	0.0	0.0	-0.1	-0.3	-0.3
					(Percent of GDP)						
Current account balance	-6.4	-8.6	-11.5	-6.1	-6.1	-6.6	-6.8	-6.1	-5.5	-4.6	-3.7
Trade of goods balance	-15.5	-15.9	-17.8	-12.1	-12.6	-13.0	-12.4	-11.3	-10.5	-9.7	-9.0
Exports of goods	25.0	25.3	26.5	30.8	32.5	32.0	31.5	32.6	33.6	34.7	35.4
Imports of goods	-40.4	-41.2	-44.2	-42.9	-45.1	-45.0	-43.9	-43.9	-44.1	-44.4	-44.4
Services balance	0.0	0.5	0.4	0.9	1.1	1.6	1.8	2.0	2.1	2.2	2.2
Income balance	-2.3	-2.3	-3.4	-4.1	-4.6	-5.0	-5.3	-5.4	-5.3	-5.2	-5.0
Current transfer balance	11.3	9.1	9.3	9.2	9.9	9.8	9.2	8.6	8.1	8.1	8.1
Official grants	0.7	0.6	0.3	0.1	1.1	0.5	0.4	0.4	0.4	0.0	0.0
Others, including private remittances	10.7	8.5	9.0	9.1	8.8	9.3	8.7	8.2	7.8	8.1	8.1
Capital and financial account balance 2/	1.8	13.3	7.9	9.4	2.3	1.6	3.7	5.0	3.2	3.7	4.1
Capital transfers balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment balance	2.9	5.5	2.1	3.6	3.8	4.0	3.8	4.0	4.2	4.2	4.2
Portfolio investment balance	0.1	4.8	5.3	5.6	1.4	3.0	1.7	1.9	-0.6	-0.1	0.5
Other investment balance	-1.2	3.0	0.5	0.3	-2.8	-5.3	-1.8	-0.9	-0.4	-0.4	-0.5
Public sector 2/ 3/	2.5	2.0	1.5	1.2	1.8	1.0	1.2	0.0	0.2	0.2	0.0
Domestic banks	-0.4	0.7	-1.3	-1.3	-5.0	-4.5	-2.0	-0.3	0.0	0.0	0.0
Other private sector 4/	-3.2	0.2	0.4	0.4	0.3	-1.8	-0.9	-0.6	-0.5	-0.6	-0.5
Errors and omissions	0.2	0.5	0.6	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-4.3	5.2	-2.9	3.9	-3.8	-5.0	-3.1	-1.1	-2.3	-0.8	0.4
Memorandum items:					(percent change unless indicated otherwise)						
Export growth	23.8	14.0	-0.5	25.6	2.1	-3.3	4.0	8.6	10.1	10.2	9.6
Import growth	9.7	14.8	2.0	4.7	1.5	-2.0	3.2	4.9	7.3	7.5	7.4
Export volume growth	16.8	3.6	-0.8	21.9	3.4	-2.6	4.0	8.2	9.5	9.7	9.6
Import volume growth	2.9	8.0	0.8	2.7	2.8	-1.5	3.0	4.6	6.8	7.1	7.4
Trading partner import growth	10.7	6.8	-0.2	1.0	2.0	4.0	5.3	5.3	5.1	4.6	4.6
Export prices growth	6.0	10.0	0.3	3.0	-1.3	-0.8	0.0	0.4	0.5	0.4	0.0
Import prices growth	6.6	6.3	1.2	2.0	-1.2	-0.5	0.2	0.3	0.4	0.3	0.0
Change in terms of trade	-0.6	3.5	-0.9	1.0	-0.1	-0.3	-0.2	0.1	0.1	0.1	0.0
Gross official reserves (in billions of euro)	10.0	12.1	10.9	11.2	9.9	8.7	7.9	7.7	6.8	6.1	6.0
(In months of prospective imports of GNFS)	7.2	8.5	7.4	7.4	6.7	5.7	5.0	4.5	3.7	3.1	3.0
(in percent of short-term debt)	195.7	322.2	207.5	262.3	278.2	307.3	193.8	183.5	174.0	116.3	113.9
(in percent of broad money, M2)	78.6	85.2	76.8	76.2	66.5	55.6	48.0	44.3	36.3	30.6	27.9
(in percent of IMF risk-weighted metric)	224.6	273.1	224.6	228.3	204.6	193.4	161.3	146.8	125.8	104.8	102.6
GDP (billions of euros)	29.6	33.4	31.7	34.3	33.1	32.5	34.4	36.1	38.5	41.1	44.1

Sources: NBS; and IMF staff estimates and projections.

1/ Some estimates, in particular for private remittances and reinvested earnings, are subject to significant uncertainty.
2/ Excluding net use of IMF resources.
3/ Includes SDR allocations in 2009.
4/ Includes trade credits (net).

Table 12. Serbia: Proposed Schedule of Purchases under the Stand-By Arrangement

	Available on or after	Amount of Purchase			Cumulative	Conditions
		In millions of SDR	In millions of euros 1/	In percent of quota 2/	In percent of quota 2/	
1	2/23/2015	187.080	224.6	40	40	Board approval of arrangement.
2	6/7/2015	116.925	140.5	25	65	Observance of continuous and end-March 2015 performance criteria, and completion of the review.
3	9/7/2015	116.925	140.5	25	90	Observance of continuous and end-June 2015 performance criteria, and completion of the review.
4	12/7/2015	70.155	84.2	15	105	Observance of continuous and end-September 2015 performance criteria, and completion of the review.
5	3/7/2016	70.155	84.2	15	120	Observance of continuous and end-December 2015 performance criteria, and completion of the review.
6	6/7/2016	46.770	56.1	10	130	Observance of continuous and end-March 2016 performance criteria, and completion of the review.
7	9/7/2016	46.770	56.1	10	140	Observance of continuous and end-June 2016 performance criteria, and completion of the review.
8	12/7/2016	46.770	56.0	10	150	Observance of continuous and end-September 2016 performance criteria, and completion of the review.
9	3/7/2017	46.770	56.0	10	160	Observance of continuous and end-December 2016 performance criteria, and completion of the review.
10	6/7/2017	46.770	55.9	10	170	Observance of continuous and end-March 2017 performance criteria, and completion of the review.
11	9/7/2017	46.770	55.9	10	180	Observance of continuous and end-June 2017 performance criteria, and completion of the review.
12	12/7/2017	46.770	55.8	10	190	Observance of continuous and end-September 2017 performance criteria, and completion of the review.
13	2/15/2018	46.770	55.7	10	200	Observance of continuous and end-December 2017 performance criteria, and completion of the review.
	Total	935.400	1,121.5	200	200	

Source: FIN, WEO.
1/ At projected WEO exchange rates.
2/ Serbia's quota is SDR 467.7 million.

Table 13. Serbia: Indicators of Capacity to Repay the Fund, 2013–20

	2013	2014	2015	2016	2017	2018	2019	2020
Fund repurchases and charges								
In millions of SDRs	579	502	121	19	9	124	297	277
In millions of euro	663	574	143	22	10	144	345	321
In percent of exports of goods and NFS	4.7	4.0	1.0	0.2	0.1	0.8	1.8	1.5
In percent of GDP	1.9	1.7	0.4	0.1	0.0	0.4	0.8	0.7
In percent of quota	123.9	107.3	25.9	4.0	1.9	26.5	63.6	59.1
In percent of total external debt service	10.7	11.3	3.2	0.6	0.2	2.7	6.8	5.0
In percent of gross international reserves	5.9	5.8	1.6	0.3	0.1	2.1	5.7	5.4
Fund credit outstanding (end-period)								
In millions of SDRs	624	128	503	702	889	821	532	260
In millions of euro	701	150	590	821	1035	954	616	301
In percent of exports of goods and NFS	5.0	1.0	4.2	5.6	6.6	5.5	3.2	1.5
In percent of GDP	2.0	0.5	1.8	2.4	2.9	2.5	1.5	0.7
In percent of quota	133.5	27.3	107.5	150	190	176	114	56
In percent of total external debt	2.6	0.5	2.2	3.0	3.7	3.4	2.3	1.1
In percent of gross international reserves	6.3	1.5	6.7	10.3	13.4	14.1	10.1	5.0
Memorandum items:								
Exports of goods and NFS	13,963	14,290	14,011	14,611	15,807	17,328	19,021	20,747
Quota (in millions of SDRs)	468	468	468	468	468	468	468	468
GDP	34,277	33,097	32,513	34,390	36,093	38,529	41,131	44,112
Total external debt service	6,194	5,069	4,474	3,796	5,109	5,321	5,042	6,401
Public sector external debt	14,596	15,685	17,433	18,677	19,604	19,354	19,095	19,001
Total external debt	27,194	27,733	27,428	27,645	28,236	27,777	27,248	26,913
Total external debt stock excluding IMF	26,497	27,515	26,756	26,803	27,170	26,522	25,658	25,008
Gross international reserves	11,189	9,907	8,744	7,929	7,747	6,780	6,095	5,969

Source: Fund staff estimates.

Appendix I. Letter of Intent

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Belgrade, February 6, 2015

Dear Ms. Lagarde:

In the past few years, Serbia has accumulated internal and external economic imbalances. The government appointed in April 2014 has recognized the challenges associated with these imbalances and is strongly committed to address them. While the global financial crisis seems to have abated, downside risks to our exports and external funding sources, particularly with regard to EU countries, remain elevated. To insure against such risks and better anchor our policy framework, we request that the Fund support our new economic program through a precautionary Stand-By Arrangement (SBA) for a period of 36 months in the amount of SDR 935.4 million (200 percent of quota).

The attached Memorandum of Economic and Financial Policies (MEFP) outlines the economic policies that the Government of the Republic of Serbia and the National Bank of Serbia (NBS) intend to implement under the new SBA. Our program has the full support of all coalition partners in the present government. In view of Serbia's comfortable international reserve position and continued access to external financing, we aim to treat the arrangement as precautionary. Therefore, we do not intend to make the purchases under the requested arrangement when they become available upon its approval and after observance of its performance criteria and completion of its reviews.

The implementation of our program will be monitored through prior actions, quantitative performance criteria, indicative targets, structural benchmarks, and an inflation consultation clause, as described in the attached MEFP and Technical Memorandum of Understanding (TMU). There will be twelve reviews of the arrangement by the Fund, scheduled to be completed on a quarterly basis to assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve its objectives.

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

We wish to make this letter available to the public, along with the attached MEFP and TMU, as well as the IMF staff report on the 2014 Article IV consultation and the request for a three-year SBA. We therefore authorize their publication and posting on the IMF website, subject to Executive Board approval. These documents will also be posted on the official website of the Serbian government.

Sincerely,

/s/
Aleksandar Vučić
Prime Minister

/s/
Jorgovanka Tabaković
Governor of the National Bank of Serbia

/s/
Dušan Vujović
Minister of Finance

Attachments: Memorandum on Economic and Financial Policies
Technical Memorandum of Understanding

Attachment I. Memorandum of Economic and Financial Policies

1. This memorandum sets out our economic program for 2015–2017 that will address short-term as well as medium-term economic challenges that Serbia is facing. The economic program has three main objectives:

- First, address macroeconomic imbalances and vulnerabilities, most notably by placing public sector debt on a sustainable path.
- Second, bolster resilience of the financial sector and improve its intermediation function necessary to support economic growth.
- Third, improve competitiveness and reduce key growth bottlenecks through vigorous implementation of comprehensive structural and SOE reforms.

These goals are compatible with our aspirations to become an EU member after having started the accession process in January 2014. Implementing this program would allow Serbia to realize the significant potential for convergence towards EU income levels.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

2. We recognize that Serbia's economy is facing a number of challenges. In 2014, the economy fell into recession for the third time in six years, partially due to the devastating floods in May, 2014. Unemployment in excess of 18 percent of working age labor force poses a major social concern. A combination of falling domestic demand, a good agricultural outcome in 2013 and 2014, and low growth of regulated prices in 2014 have pushed inflation below target. Public debt has risen sharply and is estimated to have reached about 70 percent of GDP in 2014, while the fiscal deficit in 2014 was close to 7½ percent of GDP. A scenario without comprehensive policy changes is untenable, with likely economic stagnation and unsustainable public debt dynamics.

3. We will consistently implement policy actions and reforms envisaged under this economic program. We expect that this will give rise to a virtuous cycle of boosting confidence, improving growth and private sector vibrancy. We envisage the following macroeconomic scenario under the program:

- **Real GDP** is expected to contract by ½ percent in 2015 due to sizeable fiscal consolidation. Growth will gradually accelerate over the medium term on account of smaller fiscal adjustment, recovering market confidence and credit growth, and positive effects of structural reforms.

- **Headline CPI inflation** is projected to return close to the inflation target of 4 percent by the end of 2015 and stay within the inflation tolerance band (4 percent±1.5 percent), supported by the inflation targeting regime.
- **The current account deficit** is expected to adjust to about 4¾ percent of GDP this year and decrease to close to 3¾ percent of GDP over the medium term. External financing will rely mostly on FDI, eurobond issuance, and project loans.

4. **The program scenario is subject to downside exogenous risks, but the Serbian economy has considerable buffers to withstand them.** In light of the close trade and financial links with the EU, a protracted period of slow growth in trading partners would have a negative impact on Serbia. Continued deleveraging by foreign bank subsidiaries, which dominate our financial sector, could pose challenges. However, as the first line of defense we have large foreign exchange reserves and a well-capitalized and liquid banking system. The Fund arrangement would provide an additional buffer to help us cope with negative shocks, and we are prepared to further adjust policies as necessary.

ECONOMIC POLICIES

A. Fiscal Policies

5. **We are committed to implementing a set of fiscal consolidation policies that will reverse the rise in public debt by 2017 and put it firmly on a downward path thereafter.** We believe that a credible three-year adjustment requires significant front-loading. To this end, we identified gross fiscal measures amounting to 4¾ percent of GDP during 2015–17, of which over half has already been implemented or will be implemented this year. The measures focus primarily on containing public expenditures, namely on scaling down public sector wage and pension bills and reducing state aid to state-owned enterprises (SOEs).

6. **We have already initiated fiscal consolidation with the introduction of expenditure measures in 2014.** In order to contain the growth of the public wage bill, the original 2014 budget imposed a solidarity tax on wages higher than 60,000 dinars in the public sector (general government and SOEs) and introduced a 5:1 attrition rule for general government employment. The supplementary 2014 budget approved in October 2014 created additional net savings by replacing the solidarity tax with an across-the-board 10 percent nominal wage cut, protecting wages below 25,000 dinars per month and introducing a progressive cut in nominal pensions (22 percent for pensions between 25,000 and 40,000 dinars per month and 25 percent for higher pensions).

7. **In order to put the public pension system on a more sustainable footing, we have introduced a comprehensive parametric pension reform in July 2014**. We have legislated a new Pension Law which includes the following changes: (i) increasing the statutory retirement age for women from 60 to 65 years by 2032 (6 months per year by 2020, and 2 months per year

afterwards); (ii) increasing the minimum retirement age from 58 to 60 years by 2024, and (iii) introducing actuarial penalties of 4 percent per year for early retirement.

8. We will continue with fiscal consolidation in 2015. As a prior action, we have adopted the 2015 budget with the accompanying legislation as indicated below. This introduces additional fiscal measures that will reduce the augmented deficit of the general government to about 6 percent of GDP this year (performance criterion):

- We will reduce general government employment by 5 percent, through the continued application of the attrition rule and targeted separations in mid-2015, by preparing wage bill envelopes for individual public institutions in the 2015 budget. Severance payments will be determined in line with the current legislation. To support this, we extended the attrition rule through 2015 by amending the Budget System Law in December 2014.

- We will suspend the indexation of public sector wages in years in which the share of general government salaries (excluding severance payments) is expected to exceed 7 percent of GDP. We will suspend indexation of pensions in years in which the share of pensions is expected to be above 11 percent of GDP. We have modified the Budget System Law and Pension Insurance Law accordingly in December 2014.

- We have initiated a comprehensive public wage system reform to improve quality and efficiency by aligning base wages, unifying pay grades across comparable jobs, streamlining the structure of coefficients, and integrating other elements of pay into base wages across all general government sector entities. A single Law on Wages of State Employees will replace a battery of laws setting the key principles and parameters of the new system for most sectors (but not public enterprises), including the principle of same pay for generic jobs across all sectors. The new Law will be submitted to the National Assembly by June 2015. Implementing regulations will be adopted by end-October 2015, mapping every existing job into a new classification and specifying non-linear wage adjustment rules that will enable the introduction of new wage grades while respecting the financial envelope set by this program. The transition period to the new wage system will be determined in the course of 2015.

- We will reduce spending on goods and services by lowering the mark up on procurement from domestic suppliers from 15 percent to 5 percent in 2015, and eventually eliminating it by 2018, for which we have amended the Procurement Law in early February 2015. This will also reduce the cost of capital spending.

- We have eliminated agricultural subsidies for land over 20 hectares and for land leased from the Government of Serbia. We have modified the Law on Agriculture accordingly in December 2014.

- We will reduce state aid to SOEs, including subsidies, net lending, and payments from the budget for guaranteed and nonguaranteed debt of the SOEs. We have adjusted network fees on natural gas distributed by Srbijagas to generate €60 million on an annual basis, effective from February 1, 2015 until the government finds alternative measures with the same revenue effects, in consultation with the IMF staff. This additional revenue will enable Srbijagas to pay a part of its debt obligations, and will correspondingly reduce the payments of its called guarantees from the budget. We will reduce the operating costs of Serbia Railways, and reduce subsidies accordingly. We will introduce an excise tax on electricity to reduce inefficiency of consumption.

- We will reduce subsidies to public broadcasting companies in 2015 and will eliminate them in 2016.

- To ensure proper protection of the vulnerable segments of the population, the existing social safety net will be maintained.

9. **We will implement additional fiscal measures during 2016-17.** Our primary focus will be on the continued reduction of mandatory expenditures through the following measures:

- We will continue reducing the cost and increasing the efficiency of general government, through its organizational and functional restructuring, in accordance with the new Public Administration Reform Strategy, adopted by the government in January 2014. By end-March 2015, we will conduct an analytical overview of the public administration system with a view to identifying sectors with the highest potential for efficiency gains and employment reduction. These will then undergo in depth functional reviews, producing estimates of additional savings to be attained through restructuring by end-October 2015, in time for incorporation in the 2016 budget. Throughout 2015 we will also advance the data and legal infrastructure necessary to accomplish additional savings in 2016 and 2017 by introducing e-government. We are thus committed to attaining a further reduction of the general government wage bill and other labor associated costs budgeted under goods and services by 5 percent in both 2016 and 2017.

- We will amend the Local Government Financing Law, which will rationalize transfers and the revenue sharing mechanism to local governments and provide incentives to raise their own revenues. This law will be amended by June 2015 (structural benchmark), and will be implemented as of January 1, 2016.

- We will introduce an excise tax on non-alcoholic drinks (excluding water).

10. **We will aim to reduce fiscal risks and will prepare contingency measures.** In this regard, we will not rely on short-term external debt financing (performance criterion), and we will not accumulate public sector external debt payment arrears (performance criterion). We will also refrain from accumulating domestic payment arrears (indicative target). Our efforts to reduce public spending will be monitored through a ceiling on the current augmented primary expenditure excluding capital spending and interest payments of the Serbian Republican

Budget (quantitative performance criterion). If revenues are reduced due to an exogenous shock, we will consider contingency measures, such as raising the VAT rate and gasoline excise tax. On the other hand, if the revenue collection exceeds the projected amounts in 2015, the gains would be used to repay public debt in 2015. If the revenue gains are sustainable, a portion could be also used, in consultation with the Fund, for high priority infrastructure projects in future years.

B. Structural Fiscal Policies

11. To underpin the fiscal consolidation, limit risks and strengthen institutions, we will pursue the following structural policies in the fiscal area:

- To increase fiscal transparency, we classified as "spending above the line" all payments for guarantees serviced by the government, repayment of debt taken over, payments for arrears, and costs related to resolution of financial institutions in the 2015 Budget.

- We will review and clearly define the coverage of general government to be compatible with European System of Accounts (ESA) 2010, and will include social security funds with all health fund indirect beneficiaries, road and corridor funds, and own-source revenue and expenditures of indirect budget beneficiaries (excluding education and local governments) within the 2016 budget documentation. We will include education and local governments in the budget documentation by end-2016. In parallel, we will include all Indirect Budget Beneficiaries of the central government in the Financial Management Information System gradually by end-2016, taking into account their technical and technological capacity.

- We are committed to performing a fiscal impact analysis of all new legislative initiatives under the "pay-as-you-go" rule of Article 48 of the Budget System Law. For this, we will issue an instruction to line ministries on how to calculate and report the estimated fiscal impact by end March 2015.

- The National Assembly approved in the 2015 Budget Law the overall three-year expenditure ceilings of the Republican budget (without Indirect Budget Beneficiaries) that are aligned with the general government expenditures, as specified in the program and the Fiscal Strategy for 2015-17, which is to be adopted in early February 2015. We will also improve the planning of the contingency reserve to support the credibility of the ceilings.

- We will strengthen cash management by re-establishing a Liquidity Committee in February 2015 including, but not limited to, representatives of the Treasury, Tax Administration, Public Debt Administration, Budget Preparation Department, Macro-Fiscal and Analysis Department, and the NBS.

- To strengthen the control of the public sector wage bill, we have made significant progress in setting up a comprehensive registry of public sector employees. We will finalize and validate this registry by adopting the legal framework necessary to ensure full coverage of the public sector employees—all employees at the republican and local government levels, in public agencies and institutions, and SOEs—by end-June 2015 (structural benchmark). We will amend Article 93 of the Budget System Law to specify the necessary data submissions and all responsible agencies.

- We will ensure that a full assessment of all proposed Public-Private Partnerships (PPPs) is reviewed by the Ministry of Finance (MOF), including the PPPs' key financing features, cost-benefit analysis, and risk sharing arrangements with the government. We will also include a fiscal risk statement on all PPPs from the 2016 budget onwards. In this regard, we will set up a special fiscal risks management unit at the MOF by March 2015. Furthermore, to improve control of fiscal implications and risks, we will amend the existing Law on PPPs by June 2015 to mandate that all PPPs are submitted to the government for consideration only with prior approval by the MOF.

- We will implement recommendations of the World Bank and IMF TA missions on Public Debt Administration organizational structure and changes in the Law on Public Debt, including setting up a department for asset management.

12. To secure savings from the corporate and financial restructuring of major SOEs, we will introduce a number of public financial management changes.

- We will create a strong and stable institutional framework for monitoring SOEs. As a first step, we will adopt a government decree that will regulate the roles and responsibilities of the MOF, Ministry of Economy (MOE), and line ministries with respect to monitoring, supporting best governance practices, financial reporting, and transparency of SOEs, by March 2015 (structural benchmark). We will ensure quarterly provision of financial statements of SOEs to both the MOE and MOF from January 2015. We will strengthen the SOE monitoring unit in the MOE which will focus, in collaboration with the relevant line ministries, on corporate strategy and governance, and operational efficiency of SOEs. In agreement with the MOE, the SOE financial monitoring function will be created in the fiscal risks management unit in the MOF, which will focus on reviewing and compiling the financial reports and statements of SOEs and evaluate the fiscal implications.

- To enhance the payment discipline between public sector entities, we will broaden the scope of the Law on Payments in Commercial Transactions, to include transactions between public entities (including SOEs), in consultation with the IMF, by June 2015 (structural benchmark). This law will define monitoring and enforcement mechanisms for improving payment discipline in the public sector, to be implemented from January 2016. We will also modify the Decree (see TMU) that regulates the conditions under which transfers from the budget can be reduced.

- We will strictly limit issuance of state guarantees from January 1, 2015. In this regard, we will not issue any new state guarantees for liquidity support (continuous PC). We have reflected this in the Budget Law for 2015 and will modify the Public Debt Law accordingly by June 2015. Furthermore, we will set limits on issuance of new state guarantees for viable project loans (quarterly PC) in annual budgets, in line with the overarching debt sustainability objective, and consult the Fund staff before authorizing the issuance of guarantees. To avoid any misuse of guaranteed project loans, the fiscal risks unit at the MOF will monitor their implementation.

- We changed the Law on Development Fund in January 2015 to remove the article which stipulates that all guarantees issued by the Development Fund (DF) are backed by the Republic of Serbia (prior action). We will establish an indicative ceiling on the below-the-line lending by the Republican Government. In addition, we will only provide such loans to public entities with high probability of repayment. We will also proceed with the diagnostic analysis of the DF, followed by proposals to improve governance and operational procedures of the DF by end-2015.

13. In order to raise the efficiency of revenue collection, we are committed to improving tax administration based on recommendations of the September 2014 IMF technical assistance mission. We will appoint the Director of Serbia's Tax Administration with an appropriate skill set in February 2015 and we will transfer responsibility for investigation of economic crime cases to a relevant agency by end-March 2015. We will adopt and implement by end-March 2015 the *Tax Administration Transformation Program 2014–19* developed by the MOF as the official medium-term reform program (structural benchmark). Our priorities are to (i) strengthen the tax administration's governance, (ii) streamline organizational structures of headquarters and field offices, including by reallocating employees to facilitate compliance efforts, (iii) phase in a modern compliance risk management approach, (iv) strengthen arrears management, including write off procedures, (v) modernize information technology systems and business processes, and (vii) improve coordination and information exchange with other government agencies.

C. Monetary and Exchange Rate Policies

14. We see the current inflation targeting framework as the most viable option for maintaining stable inflation and protecting the economy against external shocks. We remain committed to the objective of keeping inflation within the inflation tolerance band (4±1½ percent). Inflation developments will be monitored via a consultation clause with consultation bands set symmetrically around the central projection of headline CPI (Table 1). As the fiscal adjustment takes hold and external financing conditions stabilize, we see room for rebalancing the policy mix towards looser monetary policy, in line with the inflation outlook and financial stability. This easing, however, will be gradual and will depend on external financing conditions.

15. We will maintain the existing managed float exchange rate regime in line with the inflation targeting framework. We believe that exchange rate flexibility provides a needed buffer against external shocks. In light of this, foreign exchange interventions will be limited to smoothing excessive exchange rate volatility without targeting a specific level or path for the exchange rate, while considering the implications for financial sector stability and meeting the inflation target. The current level of gross international reserves is above the levels determined by most reserve metrics and we will maintain adequate coverage throughout the program, which will be monitored by a floor on net international reserves (performance criterion).

16. In order to reduce risks to macroeconomic stability, we will continue capital account liberalization in a gradual way. Many of the capital account transactions, such as FDI and long-term flows, have already been liberalized, with the remaining restrictions related broadly to short-term capital and deposit flows. In order to limit balance of payments pressures under the program, the capital account liberalization required in the context of EU accession will be gradual, particularly in removing restrictions on short-term foreign inflows to domestic securities and the ability of residents to open deposit accounts abroad.

17. During the period of the SBA we will not, without Fund approval, impose or intensify restrictions on the making of payments and transfers for current international transactions, nor introduce or modify any multiple currency practices or conclude any bilateral payment agreements that are inconsistent with Article VIII of the IMF's Articles of Agreement. Moreover, we will not impose or intensify import restrictions for balance of payments reasons.

D. Financial Sector Policies

18. Our policies will support financial sector stability and the banking sector's ability to cope with shocks, while improving financial intermediation. We will put priority on the following: (i) further strengthening the supervisory and regulatory framework; (ii) improving the bank resolution framework and enhancing our crisis preparedness; (iii) stepping up efforts to address the high stock of non-performing loans (NPLs); and (iv) implementing a strategy for publicly-owned banks. These policies will follow the ongoing harmonization of the financial sector legislation with EU standards.

19. We will enhance the supervisory and regulatory framework. The NBS implemented the Basel II framework in late 2011 and is planning to introduce the Basel III framework in the medium term. In preparation, the NBS will benchmark its prudential standards against the EU's CRD IV package, with proposals for further reform to be finalized by end-December 2015. In doing so, the NBS will, inter alia, aim to introduce additional capital requirements for banks deemed systemically important reflecting the EU's CRD IV package. Meanwhile, the NBS stands ready to take necessary measures to ensure that banks maintain sufficient capital and liquidity. The NBS aims to intensify its supervisory cycle, ensuring that systemically important banks and institutions with the highest risk rating are subjected to on-site inspections on an annual basis. Finally, we will enhance our framework for macro prudential policy, leveraging international best practices.

20. In view of the current uncertain economic environment, we are undertaking a program of special diagnostic studies of banks operating in the Republic of Serbia, in line with similar initiatives in many EU countries.

- The diagnostic studies, to be completed by end-September 2015 (structural benchmark) with the help of external consultants, will be based on terms of reference that will be agreed with IMF staff by end-March 2015.
- The diagnostic studies will be guided, to the extent possible, by strengthened collateral valuation standards and minimum requirements for appraisers, to be finalized in consultation with IMF staff.
- The NBS will use the studies to foster conservative implementation of IFRS accounting standards and disclosure practices. Moreover, it will use the experiences obtained to strengthen its prudential framework and supervisory approach, in particular the Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items.

21. We have undertaken several legislative changes to strengthen the bank resolution and financial safety net frameworks. We legislated comprehensive revisions of the bank resolution framework—comprising amendments to the Law on Banks, Law on NBS, Law on Deposit Insurance, Law on Deposit Insurance Agency and Law on Bankruptcy and Liquidation of Banks and Insurance Companies, as well as abrogation of the Law on the Assumption of Assets and Liabilities of Banks for the purposes of safeguarding stability of the financial system of the Republic of Serbia—in early February 2015 (prior action), and the new framework will be effective from April 1, 2015. Our broad objective is to develop a general, flexible resolution framework for banks, giving the possibility to calibrate resolution strategies for institutions whose failure could trigger systemic disruptions. In making these proposals, we have relied on recent IMF technical assistance. In view of Serbia's ongoing EU accession process, the new framework is broadly guided by the Bank Recovery and Resolution Directive (BRRD). The main changes are as follows:

- Clarifying principles and objectives of resolution in legislation and introducing a single administrative resolution proceeding;
- Expanding NBS's resolution mandate while separating supervision and resolution functions within the NBS. The NBS will take on the responsibility for designing resolution strategy, including for gone concern banks. The mandate of the Deposit Insurance Agency (DIA) will be refocused on the deposit insurance function;
- Broadening the resolution toolkit to allow for the orderly resolution of all banks without severe systemic disruption and without exposing taxpayers to loss, while enhancing crisis preparedness. For this, we will develop the recovery and resolution plans for banks whose failure could trigger systemic disruption;

- Enhancing the safety net framework. We will strengthen the financial and institutional capacity of the DIA, to enable it to meet its deposit insurance obligations and serve as a core part of the financial sector safety net. We have increased insurance premiums for 2014-15 to replenish the Deposit Insurance Fund (DIF). In addition, we have obtained a €145.3 million loan from the World Bank as seed funding for the DIF, and secured a €200 million credit line from the EBRD. The DIA's operational capacity will be enhanced by (i) improving governance, (ii) strengthening the asset recovery process, and (iii) increasing information sharing between the NBS and the DIA.

22. We will launch a comprehensive strategy to address the NPL overhang. The high level of NPLs poses risks to financial stability and constrains financial intermediation. We will develop a comprehensive strategy for NPL resolution, in collaboration with the IMF, WB, and EBRD by end-June 2015. The strategy will include the following elements:

- Review and strengthen banks' capacity for dealing with NPLs. The planned diagnostic studies will provide an initial insight into banks' policies and procedures for working out distressed loans. We will issue guidance for banks' management of NPLs, including the creation of specialized workout units within banks, the implementation of which will take into account the findings of the special diagnostic studies.

- Remove obstacles to write-offs and asset sales. We will identify and eliminate impediments to loan write-offs by banks and asset sales to private investors. As difficulties with collateral valuations hinder NPL market development, we will legislate valuation standards and minimum criteria governing the activities of collateral appraisers. We will create the framework for licensing private professional valuators according to international best practices.

- Strengthen the in-court corporate insolvency regime and introduce a personal insolvency framework. Our objective is to make corporate and household debt resolution more efficient and timely. We will amend the Law on Corporate Bankruptcy to remove bottlenecks for in-court corporate debt resolution which need to be identified through further analysis, and establish a law on personal insolvency.

- Promote out-of-court corporate debt restructuring. We established the framework for voluntary corporate debt restructuring in 2011, yet this mechanism remains underutilized. We will review the effectiveness of the existing legal framework and will develop policy measures to address obstacles to effective debt restructuring. In order to improve out of court foreclosure and better align incentives for debt restructuring, we are revising the Mortgage Law to allow purchases of collateral property free from lower-ranked liens. We will conduct workshops to promote awareness by market participants and disseminate best practices.

23. We will strengthen state-owned banks. We will continue to implement the comprehensive strategy for state-owned banks which was adopted in May 2014. In particular, we will bolster institutions that fulfill a strategic function in the Serbian banking system, while selling or winding down in an orderly fashion other state-owned institutions, including via asset and liability transfers. Where necessary, we will strengthen banks' corporate governance and risk control frameworks, in accordance with international best practices.

24. We will continue to implement our dinarization strategy. This strategy is based on three pillars: (i) maintaining overall macroeconomic stability; (ii) creating favorable conditions for developing the dinar bond market; and (iii) promoting hedging instruments. In this regard, since November 2013 we have liberalized borrowing in dinars by the IFIs, and further increased maturity of dinar-denominated securities in the local market by successfully placing a 10-year dinar denominated T-bond.

25. We will support credit to SMEs. Given the importance of SMEs for Serbia's economy and the limited access to credit by this sector, we will support lending to SMEs through EIB's credit lines ("Apex loans"). We will streamline loan approval procedures.

E. Structural Policies

26. We will implement a comprehensive structural reform agenda to attract investment, support growth, and rebalance the economy on its path towards EU integration. We will focus on specific policies that (i) sustain job creation, (ii) reform state-owned enterprises, and (iii) improve the overall business environment.

27. Job creation is a central element of our economic policies. In July 2014, we made legislative changes to support labor market flexibility and job creation. Specifically, we enacted amendments to the Labor Law that rationalized severance payments by linking them to the length of current employment, limited the blanket extension of collective bargaining agreements, increased the duration of short-term contracts from one to two years, and clarified separation rules. In September 2014, we adopted (as part of the National Employment Strategy for the period from 2011 to 2020) a comprehensive National Employment Action Plan for 2015 (NEAP 2015), which sets out well-defined priorities to support employment. It includes specific programs that offer job matching services, career counseling and training for both pre-redundancy and the unemployed, employer subsidies targeting disadvantaged job seekers, employee subsidies, self-employment support, public works, active measures for employees with disabilities and co-financing of active labor market policies. Many of these programs will continue to be developed in close consultation with the World Bank and EU partners. Going forward, to support implementation of the Action Plan we will take the following actions:

- We will amend the Law on Employment by end-March 2015 to better align the disbursement of social benefits for the unemployed with specific training programs.
- Given that collective agreements are essential for the implementation of the Labor Law, and that all collective agreements concluded before the amendments of the Labor Law

will expire by end-January, 2015, we have prepared new collective agreements where appropriate.

- Further, with the aim of improving the social dialogue, we will adopt a new Law on Social Partnership and Collective Bargaining by end-2016.

28. We are committed to wide-ranging reforms of socially-owned and state-owned enterprises to improve their operational viability and limit fiscal risks. A clear priority is to significantly reduce state aid to SOEs through (i) curtailed direct or indirect subsidies, (ii) limited issuance of new guarantees, and (iii) enhanced accountability, transparency and monitoring of these enterprises. We will implement strategies for two broad categories of state-owned companies: (i) companies in the portfolio of the Privatization Agency, some of which are currently protected under a bankruptcy moratorium; and (ii) other large SOEs including the electricity, gas, railways, and road companies.

29. We will ensure the resolution of over 500 enterprises in the portfolio of the Privatization Agency through either privatization or bankruptcy, in accordance with the recently revised Privatization Law. Since August 2014, we have collected letters of interest for these companies, and we have adopted an action plan for bankruptcy procedures for 188 companies in early February 2015. On the basis of agreement with the World Bank, we will initiate bankruptcy proceedings for companies with weak privatization prospects in early February 2015, while ensuring a government decision on adequate budgeting of social benefits in lieu of severance payments as per legislative provisions in the Labor Law.

30. We aim to privatize or find strategic partners for a number of SOEs and concession projects. We will use the proceeds primarily for reducing the stock of public debt but possibly also for funding future financially viable and high return investment projects. The size of investment funding will be determined in consultation with the Fund staff. To support the operation of the telecommunication sector on a strictly market basis, we will launch a privatization tender for Telekom Serbia during the course of 2015. We will eliminate state aid—including budget subsidies, government guarantees, lending from the budget or any other forms of public support—to Zelezara Smederevo, a steel producer, and prevent accumulation of arrears by this company (prior action). At the same time, we will explore long-term concession partnerships for managing the Belgrade airport and operating Corridor XI.

31. We are committed to restructuring the large SOEs to contain the additional fiscal costs that would arise without a change in policies. We will also ensure adequate service provision. In particular, we will focus on the electricity, gas, railways, and road companies which are among the largest public enterprises. To anchor the corporate restructuring process and set the enabling legal framework for reform in the energy sector, the National Assembly approved in December 2014 a new Energy Law in line with EU Directives. To implement the needed corporate and financial restructuring in each of these companies over the medium term, we will take the following steps:

- **Elektroprivreda Srbije (EPS).** On November 27, 2014, we adopted a corporate restructuring plan that focuses on streamlining the organizational structure and management and staff rightsizing, to avoid the need for state aid to EPS in the future. We will also support EPS in preparing a financial restructuring plan based on improved collections, increased efficiency, costs savings, and tariff increases, to be adopted by the government by end-March 2015 (structural benchmark). In this regard, we will support EPS to request an increase of the regulated electricity price for end consumers. This, in combination with an excise tax, would result in a total price increase of 15 percent as of April 1, 2015. Additional adjustments will follow in April 2016 if necessary. Following the restructuring process and financial consolidation, we will seek minority private investment participation that could further enhance the viability of the company and ensure its professional management. The restructuring process will be prepared in close consultation with the World Bank and EBRD. These plans will continue to be implemented through 2016-2017.

- **Srbijagas.** We adopted corporate restructuring plans for Srbijagas in December 2014, which include a framework for unbundling of its distribution section. In line with the fiscal program, we will divest part of Srbijgas' non-core assets and resolve the companies which have been a major source of arrears: Zelezara Smederevo in February (see ¶30 above), Azotara and MSK by end-March, and Petrohemija by end-April 2015. We will hire an independent consultant to develop a financial restructuring plan based on improving collection and increasing the transit and network fees, and the plan will be adopted by end-October 2015, in time for incorporation in the 2016 budget (structural benchmark). The terms of reference for the financial restructuring plan will be prepared with the assistance of the World Bank and the EBRD. These measures will ensure that Srbijagas' financial position does not deteriorate further, thus containing the need for additional state aid in line with the fiscal program.

- **Railways of Serbia**. The government established a Railway Reform Steering Committee, led by the Deputy Prime Minister and including senior representatives from relevant Ministries and entities, to provide overall direction of the reforms. The company will be unbundled according to EU practices into separate passenger, freight, infrastructure, and a holding company by end-March 2015. To support the corporate and financial reorganization of the company, we appointed the director and senior management team in January 2015. The corporate restructuring plan will be centered on asset disposal, network re-optimization, and staff rationalization. Importantly, the freight section will receive no further subsidies and will operate on a pure commercial basis from January 2018. To support market competition, an infrastructure usage fee will be introduced by end-December 2015. We will also continue with the reorganization and improvement of business plans for the holding company, the state-owned passenger and infrastructure companies to strictly limit the amount of state aid disbursed over the medium term. We will cooperate closely with the World Bank, EBRD and EU in determining the optimal corporate and financial restructuring plans, with the help of independent consultants.

These plans will be adopted by the government by end-September 2015 (structural benchmark).

- **Roads of Serbia.** The merger of Roads of Serbia with Corridors of Serbia is expected to be finalized by March 2015 and will result in a single company tasked with road construction and maintenance in Serbia. While we expect efficiency gains from the consolidation of operations, we will also take action on the revenue side by revisiting the adequacy of toll rates and on the expenditure side by removing rigidities in pricing maintenance contracts by March 2016. The savings should result in lower budget support in the future. We will also explore concession options for the construction and maintenance of Corridor XI. The corporate and financial restructuring plans will be developed in close consultation with the World Bank.

32. We will develop a comprehensive program to enhance Serbia's competiveness and business environment to support investment, job creation and private sector development. The program will be developed in close consultation with the World Bank and EBRD (including through the Investment Climate and Governance Initiative) and will ensure that growth-supporting policies are well coordinated and targeted. Specific actions will focus on the following areas:

- To foster investment, we adopted the regulatory framework for the establishment of one-stop shops for issuing construction permits in December 2014, to be operational by end-June 2015. We will also adopt the framework that regulates the conversion of land usage into ownership rights by end-December 2015.

- To enhance predictability and reduce corruption and the grey economy, we will adopt a new Law on Inspection Oversight by end-June 2015.

- We will adopt a new Investment Law that will replace and broaden the scope of the Foreign Investment Law to include domestic investments by end-March 2015. In addition, the new law will regulate the operations of the Quick Response Office for Investment within the MOE to enable the efficient coordination of investment related permits.

- We will develop plans for the rationalization of investment promotion programs, in particular the Development Fund, and their agencies, including a reform of the two agencies administering investment incentives and export financing programs (Serbian Export Credit and Insurance Agency (AOFI) and Serbia Investment and Export Promotion Agency (SIEPA)), by end-December 2015.

- We will implement an action plan to improve the business environment for SMEs based on the SME strategy for 2015-2020 prepared by the MOE.

- We will work to enhance innovation capacity through stepping up the work of the Innovation Fund and reform the system of financing research institutions.

- As part of our job creation initiatives, we will improve targeting of Active Labor Market Policies and implement rationalization and reorganization of the National Employment Service.

PROGRAM MONITORING

33. Progress in the implementation of the policies under this program will be monitored through quarterly quantitative performance criteria (PCs) and indicative targets (ITs)—including an inflation consultation clause, continuous performance criteria (CPCs) and structural benchmarks (SBs). These are detailed in Tables 1 and 2, with definitions provided in the attached Technical Memorandum of Understanding. Quantitative targets are set for end March, June, September and December 2015.

Table 1. Serbia: Quantitative Program Targets 1/

	2015			
	March Prog.	June Prog.	Sep Proj.	Dec Proj.
I. Quantitative performance criteria (quarterly)				
1 Floor on net international reserves of the NBS (in millions of euros)	6,290	6,063	5,718	5,835
2 Ceiling on the augmented deficit of the consolidated general government 2/ 3/ (in billions of dinars)	55.7	96.3	153.1	232.1
3 Ceiling on augmented current primary expenditure of the Serbian Republican Budget excluding capital expenditure and interest payments (in billions of dinars)	207.4	429.2	657.2	906.3
4 Ceiling on gross issuance of new guarantees by the Serbian Republican Budget for project and corporate restructuring loans (in millions of euros)	0	121	401	481
5 Ceiling on contracting or guaranteeing of new short-term external debt by the General Government, Development Fund, and AOFI (up to and including one year, in millions of euros)	0	0	0	0
II. Continuous performance criteria				
6 Ceiling on gross issuance of new guarantees by the Serbian Republican Budget and the Development Fund for liquidity support (in billions of dinars)	0	0	0	0
7 Ceiling on accumulation of external debt payment arrears by General Government, Development Fund, and AOFI (in billions of euros)	0	0	0	0
III. Indicative targets (quarterly)				
8 Ceiling on gross accumulation of domestic payment arrears by the consolidated general government except local governments, the Development Fund, and AOFI (in billions of dinars)	0	0	0	0
9 Ceiling on borrowing by the Development Fund and AOFI (in billions of dinars)	0	0	0	0
10 Ceiling on new below-the-line lending by the Republican Government (in millions of euros)	176	250	314	384
IV. Inflation consultation band (quarterly)				
Outer band (upper limit, 2.5 percent above center point)	4.2	5.5	5.1	6.7
Inner band (upper limit, 1.5 percent above center point)	3.2	4.5	4.1	5.7
End of period inflation, center point 4/	*1.7*	*3.0*	*2.6*	*4.2*
Inner band (lower limit, 1.5 percent below center point)	0.2	1.5	1.1	2.7
Outer band (lower limit, 2.5 percent below center point)	-0.8	0.5	0.1	1.7

1/ As defined in the Letter of Intent, the Memorandum of Economic and Financial Policies, and the Technical Memorandum of Understanding.
2/ Cumulative since 01-01-2015.
3/ Refers to the fiscal balance on a cash basis, including the amortization of called guarantees.
4/ Defined as the change over 12 months of the end-of-period consumer price index, as measured and published by the Serbian Statistics Office.

Table 2. Serbia: Prior Actions and Structural Benchmarks

Measures	Target date
I. Prior Actions	
1 Approval by the National Assembly of the 2015 budget and the accompanying legislation consistent with the program fiscal parameters (MEFP ¶8).	Met
2 Approval by the National Assembly of legislative changes related to the comprehensive revision of the bank resolution framework (MEFP ¶21).	Met
3 Amendments of the Law on Development Fund by removing the article stipulating that all guarantees issued by the Fund are backed by the Republic of Serbia (MEFP ¶12).	Met
4 Elimination of state aid—including budget subsidies, government guarantees, lending from the budget, or any other forms of public support—to steel producer Zelezara Smederovo and preventing accumulation of arrears by this company (MEFP ¶30).	In progress
II. Structural Benchmarks	
Fiscal	
1 Adoption by the Government of a decree that regulates the role and responsibility of the Ministry of Finance, Ministry of Economy and the line ministries with respect to monitoring SOEs and PPPs (MEFP ¶12).	Mar-15
2 Adoption of the Tax Administration Transformation Program 2014-19 developed by the MoF as the official medium term reform program (MEFP ¶13).	Mar-15
3 Adoption by the Government of a financial restructuring plan for EPS (MEFP ¶31).	Mar-15
4 Approval by the National Assembly of amendments to the Local Government Financing Law (MEFP ¶9).	Jun-15
5 Finalization and validation of a full registry of public employees, including all employees at the central government and local level, and in public agencies and institutions, and SOEs (MEFP ¶11).	Jun-15
6 Approval by the National Assembly of changes to the Law on Payments in Commercial Transactions to include transactions between public entities including SOEs (MEFP ¶12).	Jun-15
7 Adoption by the Government of a corporate and financial restructuring plan for Railways of Serbia, to be prepared by an independent consultant (MEFP ¶31).	Sep-15
8 Adoption by the Government of a financial restructuring plan for Srbijagas, to be prepared by an independent consultant (MEFP ¶31).	Oct-15
Financial	
9 Completion of special diagnostic studies of banks (MEFP ¶20).	Sep-15

Attachment II. Technical Memorandum of Understanding

1. This Technical Memorandum of Understanding (TMU) 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 December 31, 2014, except as noted below.

A. Floor for Net International Reserves of the NBS

	In millions of euro
Outstanding stock:	
End-December 2014	7,008
Floor on international reserves:	
End-March 2015 (performance criterion)	6,290
End-June 2015 (performance criterion)	6,063
End-September 2015 (indicative target)	5,718
End-December 2015 (indicative target)	5,835

2. **Net international reserves** (NIR) of the NBS are defined as the difference between reserve assets and reserve liabilities, measured at the end of the quarter.

3. For purposes of the program, **reserve assets** are readily available claims on nonresidents denominated in foreign convertible currencies. They include the NBS holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, and the country's reserve position at the Fund. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered (e.g., pledged as collateral for foreign loans or through forward contracts, guarantees and letters of credit), NBS' claims on resident banks and nonbanks, as well as subsidiaries or branches of Serbian commercial banks located abroad, claims in foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options), precious metals other than monetary gold, domestically acquired gold without international certificates, assets in nonconvertible currencies, and illiquid assets.

4. For purposes of the program, **reserve liabilities** are defined as all foreign exchange liabilities to residents and nonresidents with a maturity of less than one year, including commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options, including any portion of the NBS gold that is collateralized), and all credit outstanding from the Fund. Excluded from reserve liabilities are government foreign exchange deposits with NBS, and amounts received under any SDR allocations received after August 20, 2009.

5. For purposes of the program, all foreign currency-related assets will be valued in euros at **program exchange rates** as specified below. The program exchange rates are those that prevailed on September 30, 2014. Monetary gold will be valued at the average London fixing market price that prevailed on September 30, 2014.

Cross Exchange Rates and Gold Price for Program Purposes, September 30, 2014

	Valued in:				
	RSD	Euro	USD	SDR	GBP
Currency:					
RSD	1.0000	0.0084	0.0107	0.0072	0.0066
Euro	118.8509	1.0000	1.2695	0.8563	0.7808
USD	93.6202	0.7877	1.0000	0.6745	0.6150
SDR	138.7994	1.1678	1.4826	1.0000	0.9119
GBP	152.2168	1.2807	1.6259	1.0967	1.0000
Gold	113,888.97	958.25	1,216.50	820.53	748.20

Source: NBS

6. **Adjustors.** For program purposes, the NIR target will be adjusted upward by the value of long-term assets and foreign-exchange-denominated claims on resident banks and nonbanks as well as Serbian commercial banks abroad, recovered by the NBS since December 31, 2014. The NIR floor will be adjusted upward by the full amount of any eurobond issuance proceeds cumulative since December 31,2014. The NIR floor will also be adjusted upward by the value of domestically acquired gold for which certification was obtained after December 31, 2014. The NIR floor will also be adjusted upward by any privatization revenue in foreign exchange received after December 31, 2014. Privatization receipts are defined in this context as the proceeds from sale, lease, or concession 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

7. 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.

8. Breaching the inflation consultation inner band limits (specified in MEFP, Table 1) at the end of a quarter would trigger discussions with IMF staff on the reasons for the deviation and the proposed policy response. Breaching the outer limits 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. Fiscal Conditionality

9. The general government augmented 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) including expenditure financed from foreign project loans, payments of called guarantees, cost of bank resolution and recapitalization, cost of debt takeover if debt was not previously guaranteed, repayments of debt takeover if debt was previously guaranteed, and payment of arrears. For program purposes, the consolidated general government comprises the Serbian Republican government (without indirect budget beneficiaries), local governments, the Pension Fund, the Health Fund, the Military Health Fund, the National Agency for Employment, the Roads of Serbia Company (JP Putevi Srbije) and any of its subsidiaries, and the company Corridors of Serbia. Any new extra budgetary fund or subsidiary established over the duration of the program would be consolidated into the general government. Privatization receipts are classified as a financial transaction and are recorded "below the line" in the General Government fiscal accounts. Privatization receipts are defined in this context as the proceeds from sale, lease, or concession of all or portions of entities and properties held by the public sector.

10. Government augmented primary current expenditure of the Republican budget (without indirect budget beneficiaries) includes wages, subsidies, goods and services, transfers to local governments and social security funds, social benefits from the budget, other current expenditure, net lending, payments of called guarantees, cost of bank resolution and recapitalization, cost of debt takeover if debt was not previously guaranteed, repayments of debt takes over if debt was previously guaranteed, and payment of arrears. It does not include capital spending and interest payments.

Adjustors:

- The quarterly ceilings on **the general government augmented fiscal deficit and the augmented primary current expenditure of the Republican budget** will be adjusted upward (downward) to the extent that cumulative severance payments (including payments from the Transition Fund) exceed (fall short of) the programmed levels up to the yearly budgeted amount.

Cumulative programmed severance payments (in billions of dinars)

	End-March 2015	End-June 2015	End-Sep 2015	End-Dec 2015
Programmed cumulative severance payments	3	10	19	29

- The quarterly ceilings on the **augmented primary current expenditure of the Republican budget** will be adjusted upward (downward) to the extent that (i) cumulative earmarked grant receipts exceed (fall short of) the programmed levels and (ii) cumulative proceeds from small-scale disposal of assets recorded as non-tax revenues exceed the programmed levels up to a cumulative annual amount of 2 billion dinars in 2015. For the purposes of the adjustor, grants are defined as noncompulsory current or capital transfers received by the Government of Serbia, without any expectation of repayment, from either another government or an international organization including the EU.

11. Cumulative receipts from earmarked grants and small-scale asset disposal (in billions of dinars)

	End-March 2015	End-June 2015	End-Sep 2015	End-Dec 2015
Programmed cumulative ear-marked grants receipts	2.5	5	7.5	10
Programmed cumulative receipts from small-scale disposal of assets	0	0	0	0

12. Ceiling on the gross issuance of debt guarantees by the Republican Budget for project and for liquidity support. Guarantees for liquidity support are defined in this context as guarantees related to loans provided without any pre-specified purpose other than satisfying funding needs of the company that ensure its normal production and business activities. Guarantees for viable project loans are defined in this context as guarantees related to loans with high probability of repayment provided with a pre-specified objective establishing that all funding should be used for well-defined investment or corporate restructuring projects, confirmed by a reliable feasibility study and/or the investment or restructuring plan endorsed by the government.

13. Ceiling on below-the-line lending by the Republican Government. Below-the-line lending is defined as the lending by the Republican Government which is used to provide financing to entities outside the General Government coverage. Below-the-line lending by the Republican Government will only be provided in cases where the probability of repayment is assessed to be high. These entities include the Deposit Insurance Agency (DIA), beneficiaries of the APEX lending program, and EPS, among others.

14. Ceiling on borrowing by the Development Fund and the Export Credit and Insurance Agency (AOFI). Borrowing by the Development Fund and AOFI is defined as gross accumulation of financial claims on these entities.

15. The amendments to the Budget System Law will involve a modification specifying the following wage and pension indexation rule:

Fiscal sustainability rule imposes that the share of general government salaries in GDP do not exceed 7 percent, and that the share of pensions in GDP do not exceed 11 percent.

After 2014, salaries and/or pensions will not be increased in the years in which the share of general government salaries in GDP is above 7 percent, and/or share of pensions in GDP is above 11 percent.

In years in which it is expected that the share of general government salaries in GDP will be below 7 percent, indexation will take place twice a year. In April, salaries will be indexed by the previous 6-month CPI inflation and previous year annual real GDP growth above 3 percent, and in October, salaries will be indexed by the previous 6-month CPI inflation, but taking into account that after these indexations the share of general government salaries in GDP must be below 7 percent.

In years in which it is expected that general government pension payments will be below 11 percent, indexation will take place twice a year. In April, pensions will be indexed by the previous 6-month CPI inflation and previous year annual real GDP growth above 3 percent, and in October, pensions will be indexed by the previous 6-month CPI inflation, but taking into account that after these indexations the share of general government pensions in GDP must be below 11 percent.

16. Domestic arrears. For program purposes, domestic arrears are defined as the belated settlement of a debtor's liability which is due under the obligation (contract) for more than 60 days, or the creditor's refusal to receive a settlement duly offered by the debtor. The program will include indicative targets on the change in domestic arrears of (i) all consolidated general government entities as defined in ¶8 above, except local governments; (ii) the Development Fund, and (iii) AOFI. Arrears to be covered include outstanding payments on wages and pensions; social security contributions; obligations to banks and other private companies and suppliers; as well as arrears to other government bodies.

D. Ceilings on External Debt

17. Definitions. The ceilings on contracting or guaranteeing of short-term external debt (with maturities up to one year) consolidated general government, the AOFI, and the Development Fund applies not only to debt as defined in point 9 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements, Decision No. 6230-(79/140), as amended, 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. For program purposes, debt is classified as external when the residency of the creditor is not Serbian. 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.

E. Ceiling on External Debt Service Arrears

18. Definition. External debt-service arrears are defined as overdue debt service arising in respect of obligations incurred directly or guaranteed by the consolidated general government, the Export Credit and Insurance Agency (AOFI), and the Development Fund, 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.

19. 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.

F. Prior Action on Eliminating State Aid to Zelezara Smederevo

20. Eliminating state aid to Zelezara Smederevo and preventing accumulation of arrears by this company can be implemented by either (i) signing a Strategic Partnership Investment Agreement with a private investor for Zelezara Smederevo, or (ii) adopting a Government Decision to resolve Zelezara Smederevo in a way that eliminates state aid to this company and prevents accumulation of arrears. Servicing of old government-guaranteed debts (outstanding before the completion of the prior action) is not considered state aid for program purposes.

G. Reporting

21. General government revenue data and the Treasury cash position table will be submitted weekly; updated cash flow projections for the Republican budget for the remainder of the year fourteen calendar days after the end of each month; and the stock of spending arrears of the Republican budget, the Road of Serbia, and the social security funds 45 days after the end of each quarter. General government comprehensive fiscal data (including social security funds) would be submitted by the 25th of each month.

Data Reporting for Quantitative Performance Criteria		
Reporting Agency	Type of Data	Timing
NBS	Net international reserves of the NBS (including data for calculating adjustors)	Within one week of the end of the month
Statistical Office and NBS	CPI inflation	Within four weeks of the end of the month
Ministry of Finance	Augmented deficit of the consolidated general government	Within 25 days of the end of the month
Ministry of Finance	Augmented current primary expenditure of the Republican Budget excluding capital expenditure and interest payments	Within 25 days of the end of the month
Ministry of Finance	Gross issuance of new guarantees by the Republican Government for (i) project and corporate restructuring loans and (ii) gross issuance of new guarantees by the Serbian Republican Government for liquidity support.	Within three weeks of the end of the month
Ministry of Finance	New short-term external debt contracted or guaranteed by the general government, the Development Fund and AOFI.	Within four weeks of the end of the quarter
Ministry of Finance	External debt payment arrears by general government, Development Fund and AOFI.	Within four weeks of the end of the month
Ministry of Finance	Gross accumulation of domestic payment arrears by the Republican budget, the Development Fund, and AOFI	Within four weeks of the end of the month
Ministry of Finance	Borrowing by the Development Fund and AOFI	Within four weeks of the end of the month
Ministry of Finance	Cumulative below-the-line lending by the Republican Government	Within 25 days of the end of the month
Ministry of Finance	Severance payments by general government, with a breakdown by government level.	Within four weeks of the end of the quarter
Ministry of Finance	Earmarked grants and receipts from small-scale disposal of assets	Within four weeks of the end of the quarter

Annex I. Serbia: Public Sector Debt Sustainability Analysis[1]

The Public Debt Sustainability Analysis (DSA) indicates the existence of significant vulnerabilities of debt dynamics to various shocks under the program scenario (baseline scenario under the DSA). This is reflected in the persistently high public debt levels and large gross financing needs over the projection period, which are further exacerbated in the event of shocks to economic growth, the exchange rate, primary fiscal balance, interest rate, and the realization of contingent liabilities. The programmed fiscal adjustment is sizeable, yet it is needed to reverse the upward trend of public debt by 2017. Future privatization of profitable SOEs and EU integration constitute upside risks for debt dynamics.

1. **General government debt has increased substantially during the last few years.** Total gross debt reached almost 61½ percent of GDP in 2013—almost doubling from the 2008 level—owing to expansionary fiscal policies and sluggish output growth since the start of the global financial crisis. The public debt fiscal rule, which sets the public debt ceiling at 45 percent of GDP, was thus breached. About 8½ percent of Serbia's public debt consists of government guarantees to large SOEs and local governments. Unguaranteed local government debt is negligible (about ½ percent of GDP as of 2013). External public debt accounts for 60 percent of the total, while more than ¾ of total public debt is denominated in foreign currencies. Most external debt is owed to multilateral and bilateral creditors (57 percent of total external public debt), which has helped Serbia keep interest cost relatively low. However, the share of market debt has been increasing rapidly since the first eurobond issuance in 2011, suggesting that debt costs will increase further. Domestically-issued debt, dominated by T-bills and T-bonds with maturities above 12 months, increased as a share of total debt significantly over the last five years.

2. **The DSA analysis is based on the macroeconomic assumptions under the program scenario.** Real GDP is estimated to have contracted by 2 percent in 2014 reflecting the effects of the floods, weak domestic demand, and moderate growth in the Euro area. A gradual recovery is projected in the medium term to about 3½ percent of GDP, partly reflecting confidence effects of fiscal consolidation and structural reforms. Inflation is expected to stay within the tolerance band of the NBS. The fiscal deficit is projected to decline gradually from estimated 7½ percent of GDP in 2014 to about 2¾ percent of GDP by 2020, supported by a multi-year fiscal consolidation program focused on expenditure restraint, notably through wage and pension bill rationalization, and reduced state aid to SOEs. The current account deficit is expected to narrow as Serbia embarks on export-led growth, while import compression due to fiscal consolidation is partly offset by higher capital imports associated with FDI.

[1] The baseline scenario of the DSA reflects the program scenario outlined in the MEFP.

3. Serbia faces high risks to debt sustainability despite the significant fiscal adjustment assumed in the baseline scenario (Figure 1). Serbia's public debt is estimated to have reached about 70 percent of GDP in 2014, and will remain above this level during the projection period, despite the relatively sizeable fiscal adjustment proposed for 2015–17 (3½ percent of GDP on a structural basis). As a result, Serbia's public debt is highly vulnerable under all shock scenarios. Specifically, the debt profile is highly susceptible to exchange rate fluctuations due to the large share of public debt denominated in foreign currencies. Moreover, limited absorption capacity of domestic banks and high domestic interest rates suggest that Serbia will increasingly have to rely on external market financing in the future, thereby embedding significant risks to adverse market sentiment. In the DSA, a significant fraction of gross external financing is secured through the issuance of eurobonds, reaching about $1.2 billion a year on average during 2015–20.

4. The fan charts illustrate the possible public debt dynamics over the medium term, using a symmetric and asymmetric distribution of risks, with the latter imposing no positive growth and no primary balance shocks. In this scenario, the asymmetric fan chart shows the presence of significant risks to the debt outlook, which further indicate the need for fiscal consolidation.

5. Financing needs are projected to remain large, and would remain highly vulnerable to shocks. The gross financing needs are driven by a number of factors: (i) the rapid buildup of debt during the recent years in a context of large fiscal deficits, entailing large debt repayments in the years ahead, (ii) the authorities' strategy to lengthen the maturities of domestic securities has helped temporarily, and the breathing space it has provided is narrowing, and (iii) repeated issuance of eurobonds given the low interest rates environment (5 eurobonds were issued in 2011–13 for a total of $5.25 billion or 12¼ percent of 2014 GDP). In fact, two eurobonds totaling $1.75 billion (almost 4½ percent of 2014 GDP) will mature in 2017–18, representing a critical market test for Serbia. In the absence of fiscal consolidation, rollover risks and budget financing will pose major challenges.

6. Past forecast errors were caused by exogenous shocks, but also weaker fiscal discipline in the absence of an IMF-supported program (Figure 2). In particular, real GDP growth was lower than anticipated in 2009 due to a sharp output contraction amid the global financial crisis, and later in 2012 following severe weather shocks that affected agricultural and industrial output. However, the unexpected large primary fiscal deficit in 2012 was driven by significant slippages due to election spending and bank recapitalization and resolution costs.

7. The projected fiscal adjustment is relatively sizeable, as indicated by the fact that Serbia is in the top quartile of fiscal adjustments observed during 1990–2011 for advanced and emerging economies with debt greater than 60 percent of GDP (Figure 2). Nevertheless, this fiscal effort is the lower bound of the adjustment that Serbia needs to undertake to stabilize and later reduce the public debt level. Under the DSA baseline (program) scenario, gross public debt will rise steadily until 2016 peaking at 78½ percent of GDP, after which it will start declining as the primary balance reaches its debt-stabilizing level (Figure 3).

Public debt is projected to continue declining throughout the DSA projection horizon, reaching about 72¼ percent of GDP by 2020.

8. **The projected decline in public debt is susceptible to a number of shocks**, particularly a growth slowdown, a real exchange rate shock, and the realization of contingent liabilities (Figure 5):

- **Growth shock**. If projected real GDP growth for 2016–17 is lower by one standard deviation (3¾ percentage points lower in both years than in the baseline), the debt-to-GDP ratio would peak at 89¾ percent of GDP by 2017–11¾ percentage points of GDP higher than under the DSA baseline scenario.

- **Primary fiscal balance shock.** A shock that leads to a worsening of the primary balance by about ½ percent of GDP on average during 2016–20, relative to the DSA baseline scenario, would result in a significant deviation from the medium-term fiscal consolidation path, implying higher debt levels. Public debt could reach 75 percent of GDP by 2020, compared to 72¼ percent of GDP under the DSA baseline scenario.

- **Interest rate shock.** Although interest payments currently account for a relatively small share of the budget relative to other emerging countries, the shift from concessional to market financing will impose a significant burden on the budget and worsen debt dynamics. This scenario simulates a permanent increase in interest rates by 200 basis points starting in 2016, on top of the projected gradual increase in international interest rates envisaged under the DSA baseline scenario. Higher borrowing costs will worsen the headline fiscal deficit, and require more borrowing for budget financing. The public debt ratio would be about 2¾ percentage points of GDP higher than in the baseline scenario by 2020.

- **Real exchange rate shock.** The large share of foreign currency debt gives rise to significant vulnerabilities to currency depreciations. A 13 percent real depreciation (comparable to what Serbia experienced in 2005 and 2008) will push public debt to 83¼ percent of GDP in 2016, well above the 78¼ percent of GDP projected under the DSA baseline scenario, before declining slightly to about 79 percent of GDP by 2020.

- **Combined shock.** In the extreme case of multiple shocks affecting growth, the primary fiscal balance, interest rates, and the exchange rate, Serbia's public debt ratio could reach 98½ percent of GDP by 2020. The associated gross financing needs could peak at about 30 percent of GDP by 2020, about 10 percentage points of GDP higher than under the DSA baseline scenario.

- **Contingent liability shock.** This scenario considers a one-time increase in non-interest expenditures (equivalent to a one-off financial sector bailout of 10 percent of total banking assets), which combined with the above growth shock, would push public debt to 87¼ percent of GDP in 2016, and around 85½ percent of GDP through 2020. Gross financing needs would climb to about 22½ percent of GDP in 2017, slightly declining to 25 percent of GDP in 2020. Other sources of contingent liabilities not modeled under this shock include the stock of non-guaranteed debt of state- and socially owned enterprises and restitution debt.[2]

9. Debt reductions from asset sales and a new concessional loan constitute upside risks. Current DSA baseline assumptions do not incorporate proceeds from possible privatization of viable state-owned enterprises, as well as potential disbursement of another concessional loan from the United Arab Emirates (UAE) in the amount of $2 billion (4.7 percent of 2014 GDP), which could be used to retire expensive market debt.[3] In addition, the current DSA baseline scenario does not factor in the potential benefits from EU accession negotiations, which could strengthen economic governance and boost structural reforms.

[2] Restitution debt refers to compensations for nationalization of property after World War II. The 2011 restitution law capped total financial compensations at EUR2bn (about 6½ percent of 2014 GDP).

[3] A disbursement of $1 billion already took place in the second half of 2014.

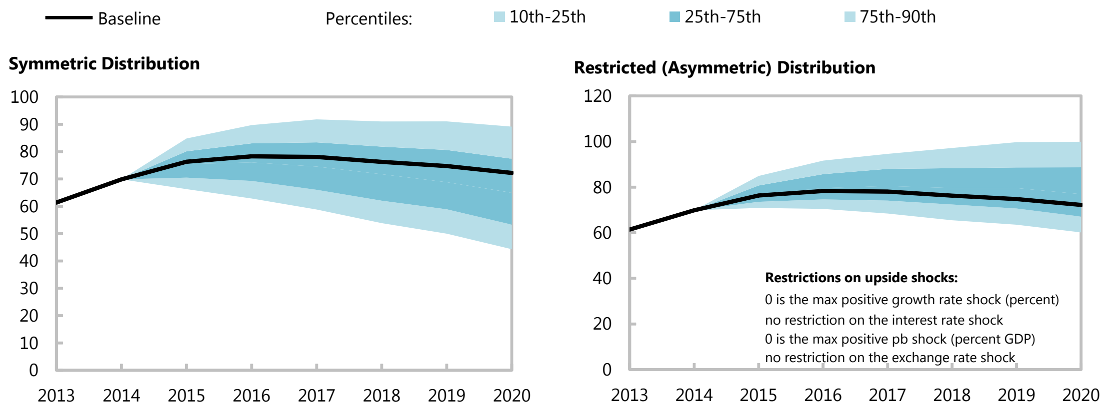
Figure A.1. Serbia: Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

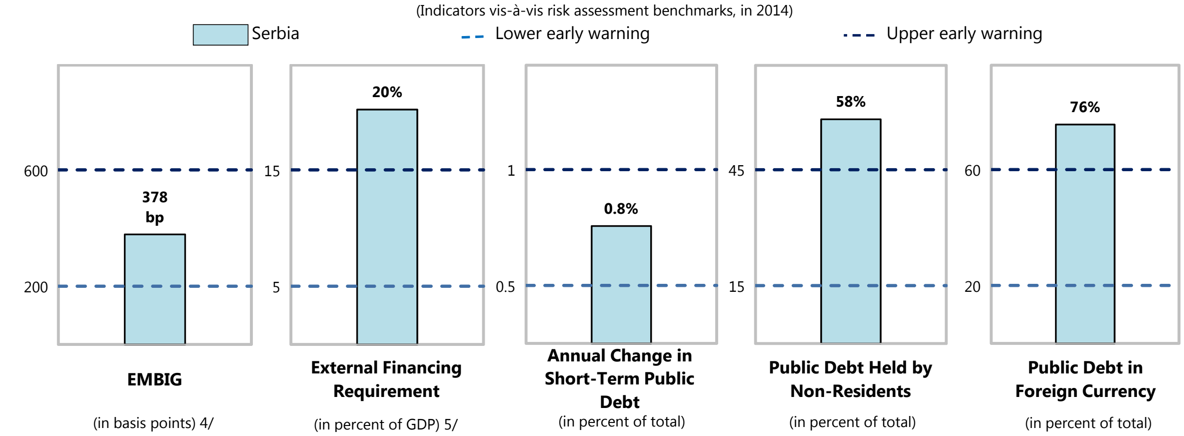
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

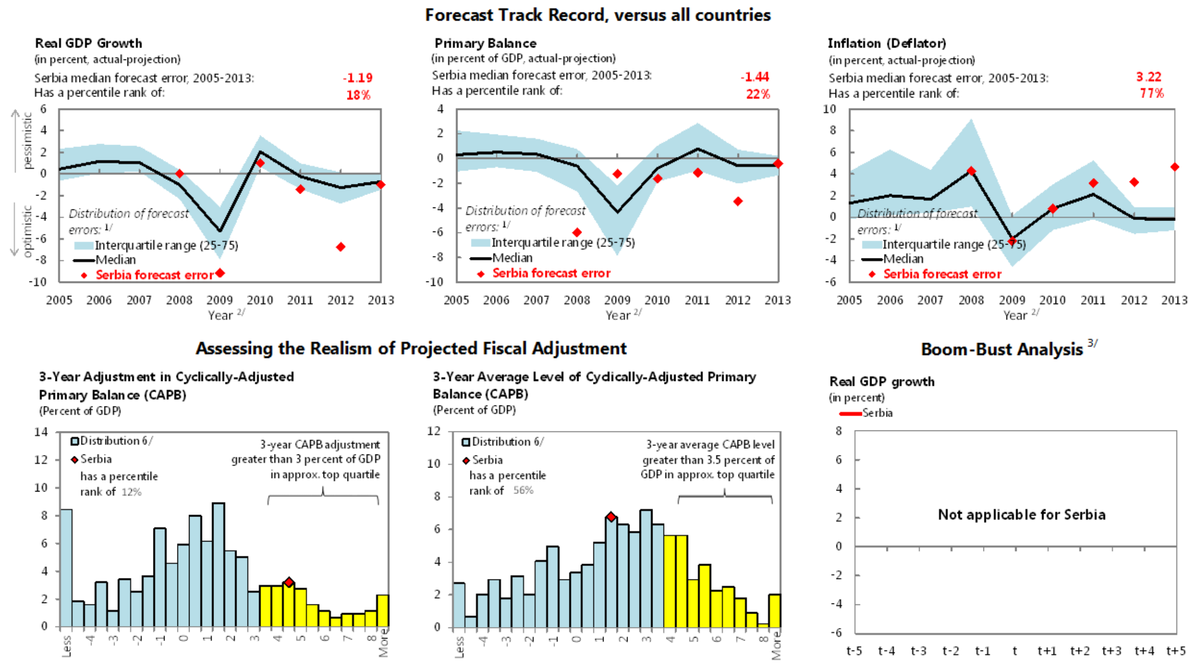
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 14-Oct-14 through 12-Jan-15.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure A.2. Serbia: Public DSA - Realism of Baseline Assumptions



Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Serbia, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure A.3. Serbia: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(In percent of GDP unless otherwise indicated)

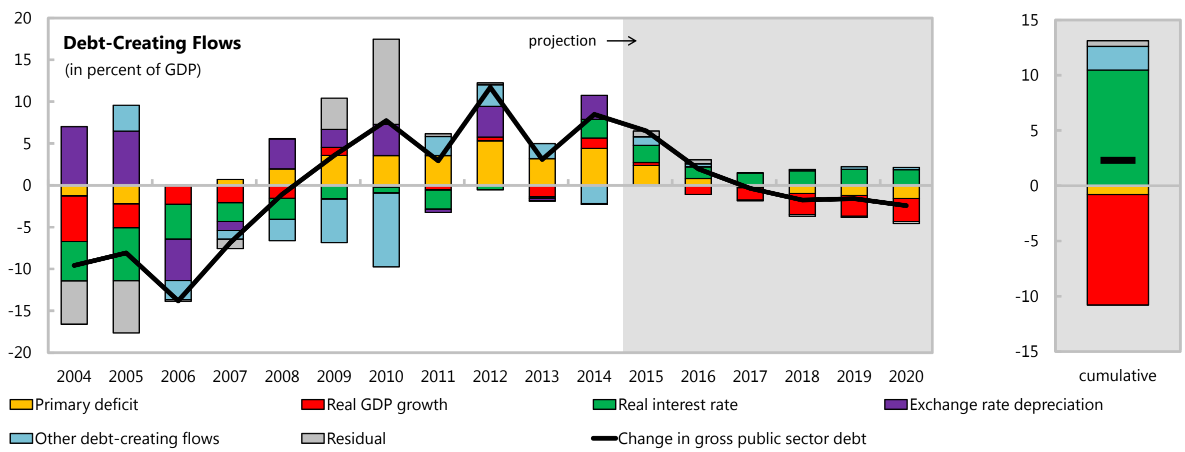
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	45.2	61.4	69.9	76.4	78.4	78.0	76.2	74.6	72.2
Of which: guarantees	4.4	8.5	8.0	9.5	9.0	8.5	7.9	7.3	6.7
Public gross financing needs	7.5	16.2	17.4	16.9	16.7	19.1	19.2	17.7	20.8
Real GDP growth (in percent)	3.2	2.6	-2.0	-0.5	1.5	2.0	3.5	3.5	4.0
Inflation (GDP deflator, in percent)	9.3	5.4	2.2	2.7	4.1	4.1	4.0	4.0	4.0
Nominal GDP growth (in percent)	12.9	8.2	0.1	2.2	5.7	6.2	7.6	7.6	8.2
Effective interest rate (in percent) [4/]	3.2	5.3	5.8	5.7	6.1	6.2	6.6	6.9	6.9

As of January 12, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		435
5Y CDS (bp)		332
Ratings	Foreign	Local
Moody's	B1	B1
S&Ps	BB-	BB-
Fitch	B+	B+

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-1.5	3.1	8.5	6.5	2.0	-0.4	-1.8	-1.6	-2.4	2.3	
Identified debt-creating flows	-1.7	3.2	8.6	5.8	1.5	-0.3	-1.6	-1.5	-2.2	1.8	
Primary deficit	1.7	3.2	4.4	2.4	0.8	-0.3	-1.0	-1.2	-1.6	-0.8	-0.6
Primary (noninterest) revenue and grants	40.6	37.9	39.4	38.7	37.7	36.9	36.8	36.7	36.6	223.4	
Primary (noninterest) expenditure	42.3	41.1	43.8	41.1	38.5	36.6	35.8	35.5	35.0	222.6	
Automatic debt dynamics [5/]	-2.1	-1.8	6.3	2.4	0.3	0.0	-0.8	-0.6	-0.9	0.5	
Interest rate/growth differential [6/]	-4.3	-1.5	3.5	2.4	0.3	0.0	-0.8	-0.6	-0.9	0.5	
Of which: real interest rate	-2.8	-0.2	2.2	2.1	1.4	1.5	1.7	1.9	1.9	10.5	
Of which: real GDP growth	-1.5	-1.4	1.2	0.3	-1.1	-1.5	-2.5	-2.5	-2.8	-10.0	
Exchange rate depreciation [7/]	2.2	-0.3	2.9	…	…	…	…	…	…	…	
Other identified debt-creating flows	-1.3	1.8	-2.2	1.0	0.4	0.0	0.2	0.3	0.3	2.1	
Privatization/Deposits Drawdown (negative)	-2.4	1.0	-1.2	0.5	0.3	0.0	0.1	0.2	0.2	1.4	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Net issuance of guarantees to SOEs	1.0	0.8	-1.0	0.5	0.1	0.1	0.0	0.0	0.0	0.8	
Residual, including asset changes [8/]	0.2	-0.1	-0.1	0.7	0.5	-0.1	-0.2	-0.1	-0.2	0.5	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees, defined as Guarantees issued by the central government to State-owned enterprises.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

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

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

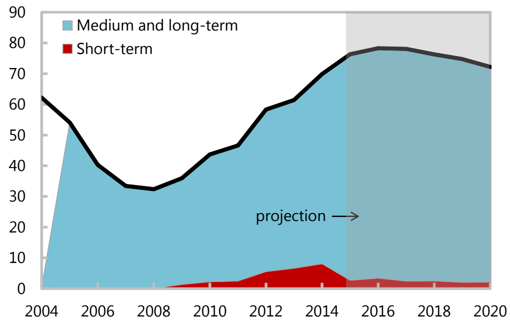
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure A.4. Serbia: Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

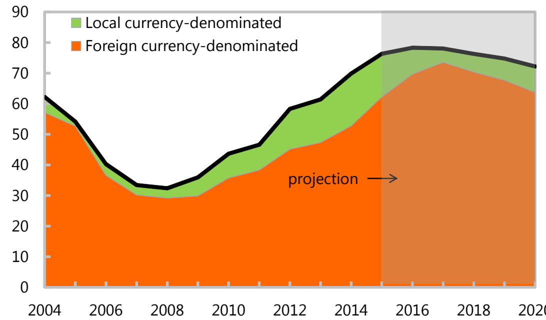
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

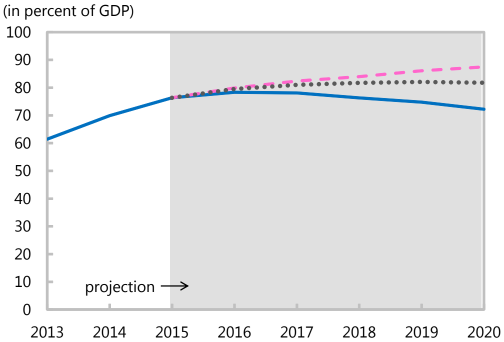


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

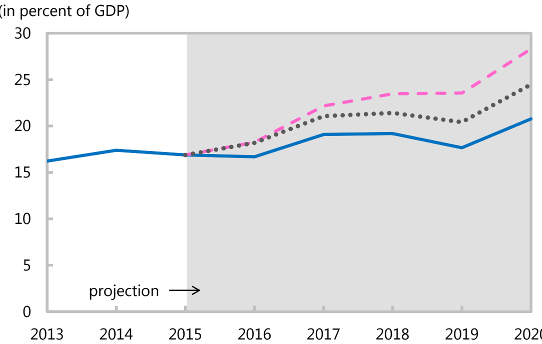
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

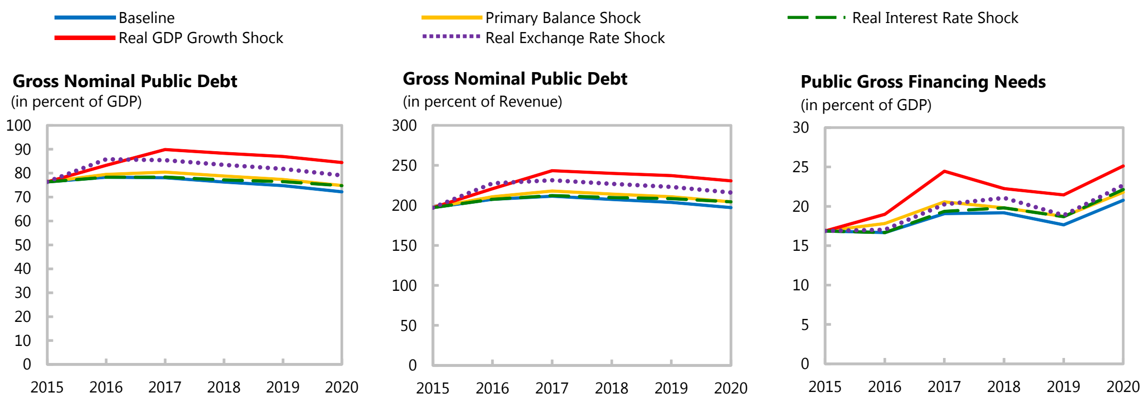
Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	-0.5	1.5	2.0	3.5	3.5	4.0
Inflation	2.7	4.1	4.1	4.0	4.0	4.0
Primary Balance	-2.4	-0.8	0.3	1.0	1.2	1.6
Effective interest rate	5.7	6.1	6.2	6.5	6.9	6.9
Constant Primary Balance Scenario						
Real GDP growth	-0.5	1.5	2.0	3.5	3.5	4.0
Inflation	2.7	4.1	4.1	4.0	4.0	4.0
Primary Balance	-2.4	-2.4	-2.4	-2.4	-2.4	-2.4
Effective interest rate	5.7	6.1	6.2	6.6	6.9	7.0

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	-0.5	2.0	2.0	2.0	2.0	2.0
Inflation	2.7	4.1	4.1	4.0	4.0	4.0
Primary Balance	-2.4	-2.4	-2.4	-2.4	-2.4	-2.4
Effective interest rate	5.7	6.1	4.7	3.6	2.7	2.3

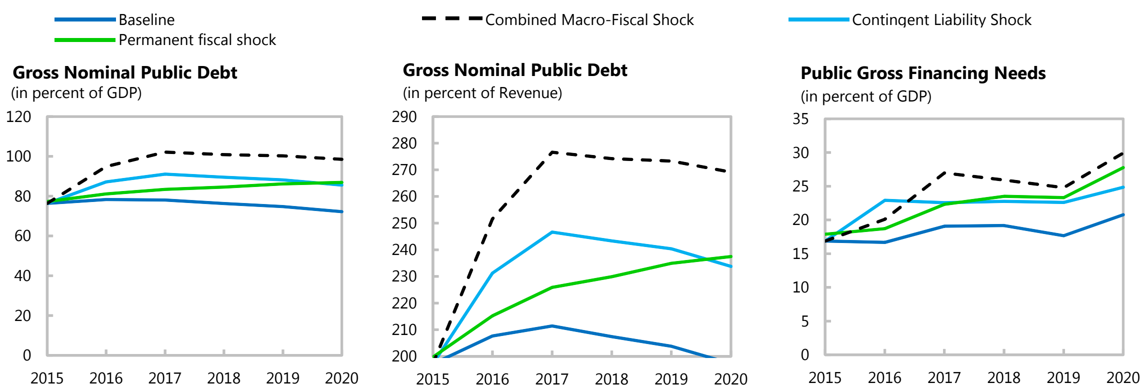
Source: IMF staff.

Figure A.5. Serbia: Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

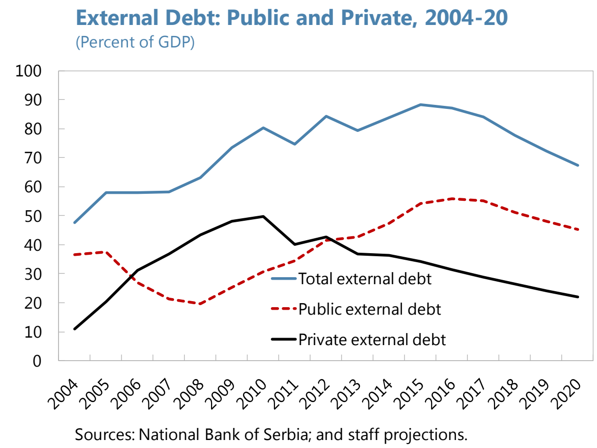
Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	-0.5	1.5	2.0	3.5	3.5	4.0
Inflation	2.7	4.1	4.1	4.0	4.0	4.0
Primary balance	-2.4	-2.0	-0.9	1.0	1.2	1.6
Effective interest rate	5.7	6.1	6.3	6.7	7.0	7.0
Real Interest Rate Shock						
Real GDP growth	-0.5	1.5	2.0	3.5	3.5	4.0
Inflation	2.7	4.1	4.1	4.0	4.0	4.0
Primary balance	-2.4	-0.8	0.3	1.0	1.2	1.6
Effective interest rate	5.7	6.1	6.6	7.4	8.1	8.3
Combined Shock						
Real GDP growth	-0.5	-1.9	-1.4	3.5	3.5	4.0
Inflation	2.7	3.3	3.3	4.0	4.0	4.0
Primary balance	-2.4	-2.5	-2.9	1.0	1.2	1.6
Effective interest rate	5.7	6.7	6.4	7.3	8.0	8.1

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	-0.5	-1.9	-1.4	3.5	3.5	4.0
Inflation	2.7	3.3	3.3	4.0	4.0	4.0
Primary balance	-2.4	-2.5	-2.9	1.0	1.2	1.6
Effective interest rate	5.7	6.1	6.3	7.0	7.2	7.1
Real Exchange Rate Shock						
Real GDP growth	-0.5	1.5	2.0	3.5	3.5	4.0
Inflation	2.7	8.6	4.1	4.0	4.0	4.0
Primary balance	-2.4	-0.8	0.3	1.0	1.2	1.6
Effective interest rate	5.7	6.7	6.0	6.4	6.8	6.8
Contingent Liability Shock						
Real GDP growth	-0.5	-1.9	-1.4	3.5	3.5	4.0
Inflation	2.7	3.3	3.3	4.0	4.0	4.0
Primary balance	-2.4	-6.1	0.3	1.0	1.2	1.6
Effective interest rate	5.7	6.6	6.7	7.0	7.2	7.0

Source: IMF staff.

Annex II. Serbia: External Sector Debt Sustainability Analysis[1]

1. Total external debt has fluctuated around 80 percent of GDP since 2010, as private sector deleveraging has compensated for rising public sector external borrowing, but a gradual decrease is projected over the medium-term. Public external debt has been growing since 2008 and is projected to maintain an upward path for a few more years as a result of significant financing needs and favorable international market conditions. On the other hand, the private sector has been deleveraging since 2010 (after several years of significant net external borrowing) and is expected to maintain this trend throughout the projection period. As fiscal consolidation takes hold, total external debt and gross financing needs are expected to decrease gradually over the medium term, reaching 67½ and 16 percent of GDP respectively by 2020.



2. The main driver of the projected reduction in total external debt is a contraction in the current account deficit before interest payments, which is expected to drop from 3½ percent of GDP in 2014 to about 1 percent of GDP in 2019, together with a steady real GDP growth of 3-4 percent over the medium term. This reflects a significant improvement in the trade balance, partly associated with the fiscal adjustment embedded in the program scenario. As shown in alternative scenarios, if the current account, growth, interest rates, and real exchange rate depreciation remain at historical levels, the external debt is expected to remain on an increasing trajectory throughout the projection period, reaching 94 percent of GDP by 2020.

3. The external debt path is particularly sensitive to real exchange rate depreciation shocks. As shown in the shock scenarios, a 30 percent real depreciation would cause external debt to exceed 130 percent of GDP during the first year and to remain above a 100 percent of GDP over the projection period. A ½ standard deviation current account shock or a combination of ¼ standard deviation temporary shocks to exchange rate depreciation, interest rate, and the current account, would also have a significant impact on the debt level over the medium term.

4. Finally, a potential increase in interest rates is also a significant source of risk. Although the implicit interest rates for Serbia have been fairly stable in the past (a ½ standard deviation shock would only lead to a 40 bps increase in the interest rate, as shown in the shock

[1] The baseline scenario of the DSA reflects the program scenario outlined in the MEFP.

scenarios), potential increases in expected depreciation or an eventual increase in global interest rates could lead to much larger increases in the interest rates faced by the country with the corresponding adverse impact on debt dynamics.

Table A.1. Serbia: External Debt Sustainability Framework, 2010–20 1/

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2010	2011	2012	2013	2014			2015	2016	2017	2018	2019	2020	Debt-stabilizing non-interest current account 6/
Baseline: External debt	80.3	74.5	84.3	79.3	83.8			**88.2**	**87.1**	**84.0**	**77.7**	**72.3**	**67.4**	**-6.5**
Change in external debt	6.8	-5.7	9.7	-4.9	4.5			4.4	-1.1	-3.1	-6.3	-5.4	-4.9	
Identified external debt-creating flows (4+8+9)	10.2	-10.2	20.1	-6.1	4.9			1.2	-0.4	-1.2	-2.6	-2.8	-3.2	
Current account deficit, excluding interest payments	4.1	6.0	9.0	3.5	3.4			1.9	1.9	1.6	1.5	1.2	1.1	
Deficit in balance of goods and services	20.5	20.8	22.7	15.3	14.2			11.9	10.7	9.7	9.3	8.9	8.8	
Exports	45.2	46.2	47.6	55.8	53.9			56.4	56.4	58.1	59.4	60.8	61.0	
Imports	65.7	67.0	70.3	71.2	68.1			68.3	67.1	67.8	68.7	69.7	69.8	
Net non-debt creating capital inflows (negative)	-2.9	-5.6	-2.1	-3.6	-3.6			-4.0	-3.8	-4.0	-4.2	-4.2	-4.2	
Automatic debt dynamics 2/	9.0	-10.6	13.1	-6.0	5.0			3.3	1.5	1.2	0.1	0.3	-0.1	
Contribution from nominal interest rate	2.3	2.3	2.7	2.8	2.3			2.8	2.8	2.8	2.9	2.8	2.6	
Contribution from real GDP growth	-0.5	-0.9	0.9	-1.9	1.6			0.5	-1.2	-1.6	-2.7	-2.5	-2.7	
Contribution from price and exchange rate changes 3/	7.2	-11.9	9.6	-6.9	1.0			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 4/	-3.4	4.5	-10.3	1.1	-0.4			3.2	-0.7	-1.9	-3.7	-2.6	-1.8	
External debt-to-exports ratio (in percent)	177.5	161.3	177.2	142.1	155.6			156.5	154.5	144.7	130.8	119.0	110.5	
Gross external financing need (in billions of US dollars) 5/	9.0	10.7	9.7	10.0	7.9			6.4	5.6	7.3	7.6	7.2	8.9	
in percent of GDP	23.1	23.0	23.8	22.1	17.9	10-Year	10-Year	15.7	13.0	15.8	15.3	13.5	15.6	
Scenario with key variables at their historical averages 6/								**88.2**	**91.7**	**93.3**	**93.0**	**93.4**	**94.2**	**-7.8**
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
Nominal GDP (US dollars)	39.0	46.5	40.8	45.5	44.0			40.7	43.3	45.9	49.4	53.1	57.2	
Real GDP growth (in percent)	0.6	1.4	-1.0	2.6	-2.0	2.0	3.4	-0.5	1.5	2.0	3.5	3.5	4.0	
GDP deflator in US dollars (change in percent)	-8.9	17.4	-11.4	8.9	-1.3	3.9	13.3	-7.2	4.8	3.9	4.1	3.9	3.5	
Nominal external interest rate (in percent)	2.9	3.4	3.2	3.7	2.8	3.7	0.9	3.1	3.3	3.4	3.7	3.9	3.9	
Growth of exports (US dollar terms, in percent)	4.0	21.7	-9.7	31.1	-6.7	14.4	24.3	-3.3	6.4	9.2	10.2	10.0	8.0	
Growth of imports (US dollar terms, in percent)	-4.3	21.3	-7.9	13.0	-7.4	9.5	28.2	-7.4	4.6	7.1	9.2	9.1	7.8	
Current account balance, excluding interest payments	-4.1	-6.0	-9.0	-3.5	-3.4	-7.9	5.1	-1.9	-1.9	-1.6	-1.5	-1.2	-1.1	
Net non-debt creating capital inflows	2.9	5.6	2.1	3.6	3.6	5.8	4.0	4.0	3.8	4.0	4.2	4.2	4.2	

1/ Baseline reflects the program scenario described in the main document.

2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

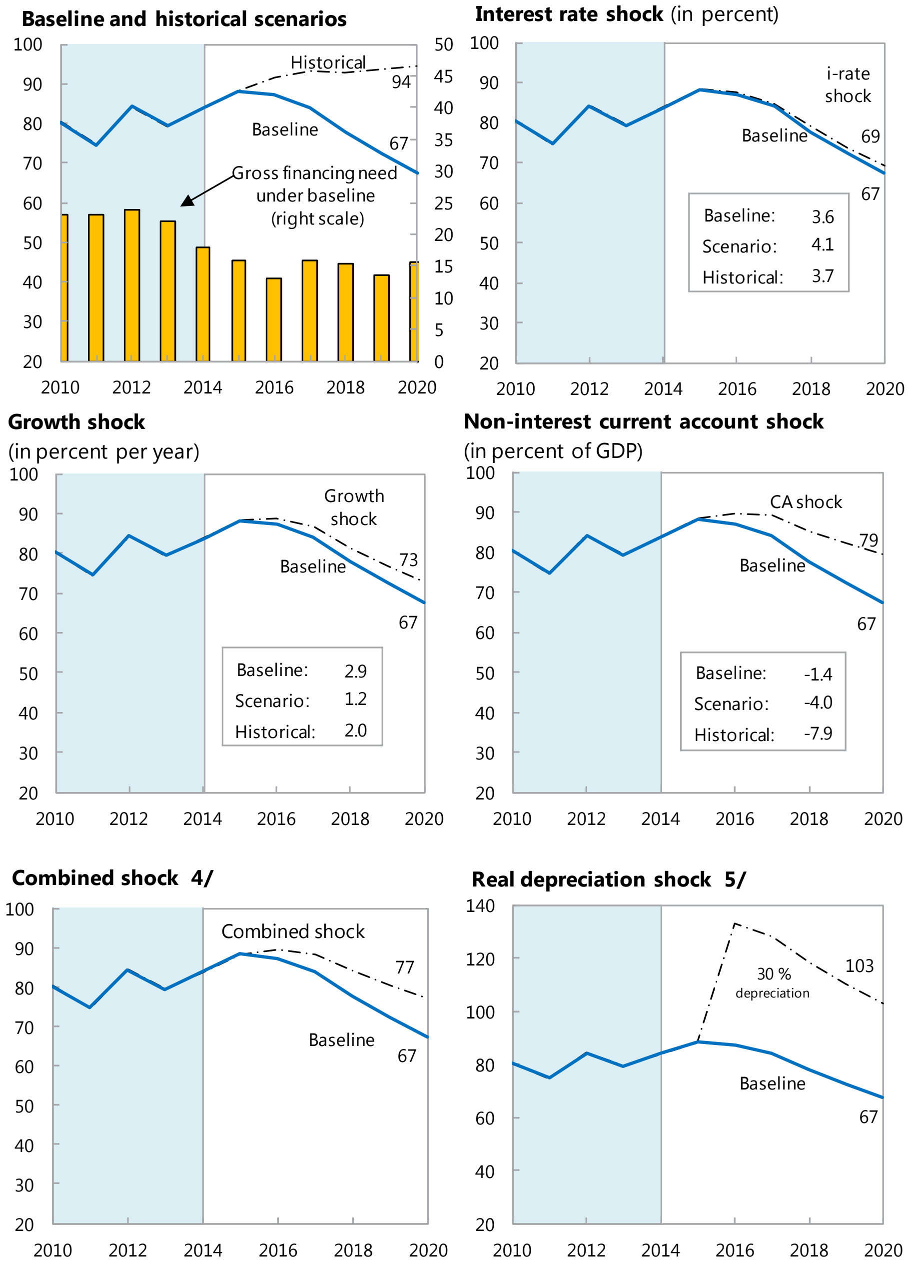
4/ For projection, line includes the impact of price and exchange rate changes.

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

6/ 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.

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

Figure A.1. Serbia: External Debt Sustainability: Bound Tests 1/ 2/ 3/
(External debt in percent of GDP)



Sources: International Monetary Fund, Serbia 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/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Baseline reflects the adjustment scenario described in the main document.
4/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
5/ One-time real depreciation of 30 percent occurs in 2016.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SERBIA

February 6, 2015

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND REQUEST FOR STAND-BY ARRANGEMENT—INFORMATIONAL ANNEX

Prepared By | European Department

CONTENTS

FUND RELATIONS

(As of December 31, 2014)

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.

General Resources Account	**SDR Million**	**Percent Quota**
Quota	467.70	100.00
Fund Holdings of Currency	595.23	127.27
Reserve Position	0.00	0.00

SDR Department	**SDR Million**	**Percent Allocation**
Net cumulative allocation	445.04	100.00
Holdings	44.23	9.94

Outstanding Purchases and Loans	**SDR Million**	**Percent Quota**
Stand-by arrangement	127.51	27.26

Latest Financial Arrangements

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-By	Sep 29, 2011	Mar 28, 2013	935.40	0.00
Stand-By	Jan 16, 2009	Apr 15, 2011	2,619.12	1,367.74
EFF	May 14, 2002	Feb. 28, 2006	650.00	650.00

Projected Payments to Fund
(In millions of SDR)

	Forthcoming				
	2015	2016	2017	2018	2019
Principal	115.84	11.68			
Charges/Interest	1.05	0.25	0.20	0.20	0.20
Total	116.89	11.93	0.20	0.20	0.20

Implementation of HIPC Initiative: Not Applicable.

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

Safeguards Assessment: An update of the safeguards assessment of the National Bank of Serbia (NBS) has been initiated and envisaged to be completed by the first review. The latest safeguards assessment for the NBS has been completed in December 2011. The assessment found that the NBS has implemented several recommendations of the 2009 assessment that have further strengthened its financial safeguards. Multi-year external auditor appointment has been introduced and an independent external assessment of the internal audit function has been conducted. Governance has been strengthened with the NBS Council's new role, which provides oversight of external and internal audits, financial reporting, and the system of internal controls. The assessment recommended improvements in external audit procedures, disclosures in financial statements, and data compilation procedures. Subsequent to the assessment completion, amendments to the NBS Law, which included inter-alia dismissal of the Council members, have raised concerns about NBS autonomy, which the authorities took steps to restore in line with staff's advice.

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.

Last Article IV Consultation: Concluded on July 1, 2013 (IMF Country Report No. 13/206).

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. 10/147).

Technical Assistance since Last Article IV Consultation (May 2013)[1]:

Department	Timing	Purpose
FAD	Jan. 2015	Public Financial Management
STA	Jan. 2015	Government Finance Statistics
STA	Dec. 2014	National Accounts
FAD	Sep. 2014	Tax Administration
MCM/LEG	Sep. 2014	Reform of the Bank Resolution Framework
STA	Apr. 2014	Government Finance Statistics
STA	Mar. 2014	Quarterly National Accounts

[1] The list does not include visits by regional advisors.

FAD	Dec 2013	Strengthening Budget Planning, Execution and Reporting
MCM	Sep. 2013	Currency Composition of External Debt
MCM	Aug. 2013	Strengthening Banking Supervision, Resolution, and Financial Stability Frameworks

In addition, technical assistance was available through resident advisors covering tax administration, public financial management, and real sector statistics.

Resident Representative:

Mr. Daehaeng Kim took his position as Resident Representative in July 2013.

WORLD BANK GROUP RELATIONS

Partnership with Serbia's Development Strategy

The World Bank has been discussing the policy reform agenda with successive governments since 2001, and has been actively engaged with the new government since winning a mandate and assuming office in April 2014. Support for the government's reform efforts and development strategy from the World Bank and the IMF follow the agreed division of responsibilities between the two institutions.

The Fund takes the lead on macroeconomic policies (fiscal, monetary, and exchange rate) aimed at maintaining macroeconomic stability and facilitating sustainable growth, while the Bank takes the lead on structural policies aimed at medium to long-term adjustment. In areas of direct interest to the Fund, the Bank leads the policy dialogue in: (i) public administration reform; (ii) health and education; (iii) social safety net reform and the monitoring of the impact of the crisis on the poor; and (iv) reforms with a bearing on the business environment, with special focus on the performance of publicly owned enterprises (electricity company EPS and the railways company). The Bank and the Fund have jointly led the policy dialogue in the financial sector.

The World Bank

Total International Development Association (IDA) credits and grants committed to the Republic of Serbia (Serbia) by the Bank since 2001 amount to approximately $740 million, with an additional $1,107.4 million in International Bank for Reconstruction and Development (IBRD) loan commitments (as of December 2014). The Bank has assisted Serbia to make progress against key objectives set out in the Country Partnership Strategy (CPS) for FY12–15: (i) encouraging a more competitive economy, and (ii) improving the efficiency and outcomes of social spending. In addition, the World Bank provided an extraordinary support to the government in their effort to overcome devastating impact of floods from May 2014. The Floods Emergency Recovery Project loan in the amount of $300 million will help Serbia meet critical needs in the energy and agriculture sectors, repair damaged flood control infrastructure, and better respond to natural disasters. The government has made progress on these two priorities with the support of World Bank financial and analytical products and is benefitting from the Emergency Recovery Loan ($300 million).

The Bank started the work on the new Country Partnership Framework (CPF) by preparing the Systematic Country Diagnostics (SCD). The draft report has been prepared and discussed with a broad range of stakeholders. The authorities have requested significant budget support around the structural reform agenda and discussions on the lending envelope under the new CPF will begin shortly.

As of December 2014, Serbia has a portfolio of 8 Bank-supported projects with a total commitment value of $1,109.2 million (including IBRD and IDA). The current portfolio has a heavy infrastructure component, comprising the Corridor X highway project and the Road Rehabilitation Project aiming to promote regional integration and spur economic growth. In the social sectors the program is focused on the health sector. In the financial sector the Bank is providing support to strengthening financial sector safety nets. In the context of the Emergency Recovery Loan, the Bank has also reengaged on energy sector reform and on flood prevention and disaster risk mitigation. Finally a real estate management project, focusing on property registration and valuation, is at the final stages of preparation. The Bank is also preparing policy lending to support the reform of the public enterprise sector, starting with a series of two budget support operations on the resolution of the public and socially owned enterprises currently in the portfolio of the Privatization Agency. Finally the Bank will during 2015 prepare two result-based financing operations, one on public sector wage and employment reform and one on competitiveness and jobs.

International Finance Corporation (IFC)

Serbia became a shareholder and member of IFC in 2001. Since then, IFC's investment in Serbia has totaled $2.2 billion, including $795 million in funds mobilized from partners, in 55 projects across a variety of sectors. IFC's committed investment portfolio in Serbia as of June 30, 2014 was $642.5 million. In FY14, IFC invested $302.4 million in Serbia, including $215 million mobilized from MIGA. So far, in FY15, IFC provided a $18.78 million mortgage finance loan to Komercijalna Banka Beograd. IFC is focusing its investments services in Serbia on increasing access to finance by supporting the development of local financial institutions, especially ones that concentrate on small and medium enterprises, agribusiness and manufacturing. IFC's advisory services aim to improve the investment climate, performance of private sector companies, and to attract private sector participation in development of infrastructure projects, with a special emphasis on renewable energy. Through investment and advisory services, IFC will continue to partner with clients in strategic sectors crucial for Serbia's long-term sustainable development, with a particular focus on: the financial sector (with a special emphasis on small and medium enterprises and energy efficiency lending), climate change (including investments in infrastructure and energy sectors), agribusiness (with an emphasis on food retail and manufacturing), value-added manufacturing, business infrastructure (with a focus on logistics and distribution), sub-national finance (with a focus on municipal infrastructure and waste management). Across all sectors, IFC prioritizes investment in Serbia's less-developed regions and in projects that contribute to greater economic diversification and regional integration.

Multilateral Investment Guarantee Agency (MIGA)

As of October 2014, MIGA's outstanding portfolio in Serbia consisted of 8 contracts of guarantee with total gross exposure of $785 million. All projects are in support of foreign banks' operations in Serbia and are aimed at supporting the lagging recovery in the country's banking sector and economy. MIGA's continuing support to these projects signals the Agency's efforts to continue to underwrite projects in Serbia, encourage inward FDI, and add to the World Bank Group's strategy of encouraging private sector development in the country.

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STATISTICAL ISSUES

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[2] 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)*.

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

The real sector data are compiled by the Statistical Office of the Republic of Serbia (SORS). Annual and quarterly nominal and volume measures of GDP by activity are available from 1996 onwards. Nominal annual GDP estimates by expenditure are available from 1995. Quarterly GDP estimates by expenditure both at current prices and in volume measures are available from 1996 onwards.

The national accounts statistics of the Republic of Serbia are based on conceptual framework of the 2008 SNA/ESA 2010. After the introduction of this new system in October 2014, the GDP series were revised up by an average of around 7 per cent, with variations across years. The increase in level is partly caused by methodological changes, and partly by statistical changes. Of the methodological changes, about 1 percent of GDP is a result of the recommendations of the ESA2010 to treat research and development and military hardware as capital goods in the GDP compilation. An additional two percent is due to changes according to the ESA95 that are now being included with the current revision. The statistical changes relate to a better coverage of own-account construction of dwellings (about 0.4 percent), illegal activities (about 0.7 percent) and actual rentals (about 0.5 percent). Methodological changes were introduced in the compilation of volume measures of GDP with the adoption of chain-linked volume measures, replacing the previous fixed base estimation process. Also the scope of the estimates were recently extended with the compilation of annual volume measures of GDP by final expenditures and the compilation of expenditure-based quarterly GDP, both at current prices and in volume terms. These estimates were disseminated for the first time on March 29, 2013.

Procedures for the compilation of the estimates of annual GDP by production are in line with internationally recommended practices. Estimates for achieving exhaustiveness in the production

[2] Recent examples of STA technical assistance missions include the SDDS assessment and the national accounts missions of FY 2011, as well as national accounts missions in FY 2012–2015.

account estimates are being produced with an adequate methodology and compiled at very detailed levels.

Sources and method for the compilation of GDP by expenditures are in general, adequate. Weaknesses in the estimates of gross fixed capital formation are due to the lack of coverage of unincorporated enterprises in the survey on investments, but starting in 2013 these enterprises are included in the survey. Separate estimates of changes in inventories are disseminated from 2007.

Reconciliation between the independent annual GDP estimates based on the production and expenditure approach is being made at aggregate levels, although the original differences are not significant. The gap between the quarterly estimates of GDP by expenditure and GDP by production is closed by a residual covering the statistical discrepancy plus changes in inventories and net acquisition of valuables. There are no reliable independent estimates of changes in inventories on a quarterly basis.

The SORS compiles and disseminates monthly indices for consumer prices, producer prices, industrial production, as well as unit-value indices for imports and exports. Concepts and methods used to compile the CPI, as well as other price statistics, attempt to reflect international standards and best practices.

B. Balance of Payments Statistics

Balance of payments statistics are compiled by the NBS. Starting from April 2014, BOP data are compiled in accordance with the Sixth Edition of the Balance of Payments and International Investment Position Manual (BPM6). Currently, historical data according BPM6 are published for 2012 and 2013. During the transition period, the NBS will continue publishing data for period 1997-2011 compiled using the Fifth Edition of the Balance of Payments Manual (BPM5).

The compilation procedures are generally appropriate; however, the source data for compiling various current account transactions could be further improved. In particular, additional programs should be developed to collect data to estimate unrecorded trade of goods and services and private transfers (workers' remittances in kind).

Serbia reports balance of payments statistics to STA for publication in the IFS and the *Balance of Payments Statistics Yearbook*.

C. Government Finance Statistics

Monthly government finance statistics is compiled and published by the Ministry of Finance on a cash basis following the methodology of the Manual on Government Finance Statistics 1986 (GFSM 86). The sector coverage of these data is not clearly articulated. Principal data sources are the Republican Treasury and budgetary execution reports of the spending ministries and first-level budget units. These data form the basis for the cash-based annual GFS data transmitted to the IMF for the GFS Yearbook (GFSY) based on the Government Finance Statistics Manual 2001 (GFSM 2001).

Since 2001, Serbia has made efforts to bring the existing budget reporting system in line with the GFSM 2001 methodology. Full compliance has not yet been 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 needs to be brought in line with international statistical standards. The sector classification of the general government sector needs to be reviewed and accrual accounting needs to be gradually introduced in the GFS reporting. 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.

The Serbian authorities take steps to harmonize the sectorization of public sector units in line with the GFSM 2014 requirements in the context of the ongoing technical assistance provided by the Fund. Data on the general government operations and financial balance sheet based on the revised register of public units would be available in spring 2016.

D. Monetary and Financial Statistics

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.

Further improvements could be made. The coverage of monetary statistics could be improved by including banks in liquidation (as their data are not available on a timely or comparable, International Accounting Standard-specified, basis).

Table of Common Indicators Required for Surveillance

(As of February 6, 2015)

	Date of Latest Observation	Date Received	Frequency of Data[4]	Frequency of Reporting[4]	Frequency of Publication[4]
Exchange rates	Feb 5, 2015	Feb 6, 2015	D and M	D and M	D and M
International reserve assets and reserve liabilities of the monetary authorities[1]	Feb 5, 2015	Feb 6, 2015	D	D	M
Reserve/base money	Feb 5, 2015	Feb 6, 2015	D and M	W and M	W and M
Broad money	Nov 2014	Dec 26, 2014	M	M	M
Central bank balance sheet	Nov 2014	Dec 26, 2014	M	M	M
Consolidated balance sheet of the banking system	Nov 2014	Dec 26, 2014	M	M	M
Interest rates[2]	Feb 5, 2015	Feb 6, 2015	D	D	D
Consumer price index	Dec 2014	Jan 12, 2015	M	M	M
Revenue, expenditure, balance and composition of financing – general government	Dec 2014	Jan 30, 2015	M	M	M
Revenue, expenditure, balance and composition of financing– central government	Dec 2014	Jan 30, 2015	M	M	M
Stocks of central government and central government-guaranteed debt[3]	Dec 2014	Jan 27, 2015	M	M	M
External current account balance	Nov 2014	Jan 2015	M	M	M
Exports and imports of goods and services	Nov 2014	Jan 2015	M	M	M
GDP/GNP	2014:Q3	Nov 28, 2014	Q	Q	Q
Gross external debt	Nov 2014	Jan 2015	M	M	M
International Investment Position[5]	Sep 2014	Dec 2014	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Including currency and maturity composition.

[4] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Semi-annually (SA), Annually (A), Irregular (I); or Not Available (NA).

[5] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

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FOR IMMEDIATE RELEASE
February 26, 2015

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

IMF Executive Board Concludes 2014 Article IV Consultation with the Republic of Serbia

On February 23, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Serbia.

The Serbian economy is facing serious challenges. GDP contracted by an estimated 2 percent in 2014 on account of continued falling domestic demand aggravated by floods, and weak economic activity in trading partners. This, together with the low imported inflation, pushed Serbia’s inflation rate below the National Bank of Serbia’s inflation tolerance band, allowing some easing of monetary policy. The very high rate of unemployment remained one of the largest social concerns, as chronic structural rigidities continued to undermine the overall competitiveness of the economy.

Public debt continued to rise to an uncomfortably high level, prompting a new policy course towards stabilization and reform. Partial fiscal consolidation measures implemented in recent years were insufficient and the fiscal deficit rose to 7½ percent in 2014, due to higher state aid to loss-making state-owned enterprises and ballooning mandatory spending. Public debt reached about 70 percent of GDP in 2014. The new government appointed in April 2014 set a course towards fiscal consolidation and reform by passing difficult but necessary structural reforms and fiscal consolidation measures in the second half of 2014.

The financial sector has remained broadly resilient in the face of challenging economic conditions, but pockets of vulnerabilities persist. Overall capitalization appears strong and banks remain liquid. High levels of NPLs, particularly in the corporate sector, are one of the main challenges, requiring a comprehensive strategy for their resolution, although regulatory loan-loss reserves provide cushion against credit losses. Accumulating vulnerabilities in some state owned banks led to their failures, generating sizeable fiscal costs and exposing challenges in the application of the bank resolution framework.

[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.

To support their economic policies over 2015–17, the authorities have requested the IMF's assistance. The program aims to restore public debt sustainability, strengthen competitiveness and growth, and boost financial sector resilience. It will be supported by an IMF Stand-by Arrangement (see Press Release No. 15/67), which is expected to be precautionary.

Executive Board Assessment[2]

Noting the serious challenges facing the Serbian economy, the directors welcomed the authorities' renewed commitment to implement an ambitious reform package to restore macroeconomic stability, strengthen the financial sector, and boost growth prospects.

Directors agreed that significant budgetary adjustment is needed to address fiscal risks and put the public debt ratio on a downward path. They supported a consolidation strategy centered on reducing mandatory spending and aid for state-owned enterprises. Directors commended the authorities for underpinning the credibility of their fiscal plans with an early implementation of difficult, but necessary, measures in these areas. Additional fiscal reforms for the period ahead include strengthening tax administration, policy frameworks, and public financial management.

Directors agreed that the inflation targeting regime remains appropriate for Serbia, despite challenges in its implementation. Directors noted that, in light of the planned fiscal consolidation, a gradual monetary easing will be needed to support domestic demand, although the pace of adjustment should be mindful of external financing conditions and the evolution of inflation expectations. Directors welcomed the increased exchange rate flexibility and underscored that foreign exchange interventions should be used only for smoothing excessive volatility.

Directors agreed that the authorities' policy package for the financial sector will strengthen its resilience and maintain stability. They took note of the recent legislative reform of the bank resolution framework and encouraged an early undertaking of diagnostic studies that would guide further regulatory and supervisory actions. Directors also called for prompt design and implementation of a comprehensive strategy for reducing distressed debt.

Directors concurred that deeper structural reforms are essential to restore competitiveness, stimulate private investment, and support growth over the medium term. They welcomed the recent amendments of the Labor Law, the additional steps in pension reform, and the simplification of construction permits. Directors emphasized that further reforms of state-owned

[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

enterprises, including restructuring and privatization, will be critical for improving their commercial viability and limiting fiscal risks. More broadly, they called for stepped-up efforts to improve the business environment and to stimulate private sector activity and job creation.

Republic of Serbia: Selected Economic Indicators

	2010	2011	2012	2013	2014	2015 Proj.
Output, prices and labor market	(percent change, unless otherwise indicated)					
Real GDP	0.6	1.4	-1.0	2.6	-2.0	-0.5
Real domestic demand (absorption)	-1.5	3.1	-0.5	-1.1	-1.8	-2.4
Consumer prices (period average)	6.1	11.1	7.3	7.7	2.1	2.7
Consumer prices (end of period)	10.2	7.0	12.2	2.2	1.8	4.2
GDP deflator	5.9	9.6	6.3	5.4	2.2	2.7
Unemployment rate (in percent)	20.0	23.6	24.6	23.0	19.7	...
Nominal GDP (in billions of dinars)	3,067	3,408	3,584	3,876	3,881	3,967
General government finances	(percent of GDP)					
Revenue	39.9	38.2	39.4	37.9	39.4	38.7
Expenditure	44.6	43.1	46.6	43.5	46.8	44.6
Current	40.0	38.9	42.5	40.8	43.0	40.6
Capital and net lending	4.4	4.1	3.8	2.5	3.0	3.2
Fiscal balance (cash basis)	-4.5	-4.7	-6.9	-5.4	-6.6	-5.1
Augmented fiscal balance	-4.7	-4.9	-7.2	-5.6	-7.5	-5.9
Primary fiscal balance (cash basis)	-3.6	-3.6	-5.3	-3.2	-4.4	-2.4
Gross debt	43.7	46.6	58.3	61.4	69.9	76.4
Monetary sector	(end of period 12-month change, percent)					
Money (M1)	-2.2	16.8	3.8	23.7	10.9	6.9
Broad money (M2)	13.7	10.4	9.2	4.2	7.5	4.0
Domestic credit to non-government 1/	17.5	8.3	3.3	-5.2	0.0	-0.1
Interest rates (dinar)	(period average, percent)					
NBS key policy rate 2/	9.1	11.6	10.1	11.1	9.0	...
Interest rate on new FX and FX-indexed loans 2/	8.6	8.2	8.0	7.3	6.2	...
Interest rate on new dinar deposits 2/	10.5	10.8	9.9	9.3	7.3	...
Balance of payments	(percent change, unless otherwise indicated)					
Current account balance	-6.4	-8.6	-11.5	-6.1	-6.1	-4.7
Exports of goods	25.0	25.3	26.5	30.8	32.5	33.9
Imports of goods	-40.4	-41.2	-44.2	-42.9	-45.1	-45.0
Trade of goods balance	-15.5	-15.9	-17.8	-12.1	-12.6	-11.1
Capital and financial account balance	1.8	13.3	7.9	9.4	2.3	7.3
External debt	80.3	74.5	84.3	79.3	83.8	88.2
of which: Private external debt	49.6	40.0	42.7	36.8	36.4	34.1
Gross official reserves (in billions of euro)	10.0	12.1	10.9	11.2	9.9	10.6
(In months of prospective imports)	7.2	8.5	7.4	7.4	6.7	7.0
(Percent of short-term debt)	195.7	322.2	207.5	262.3	278.2	372.4
(in percent of broad money, M2)	78.6	85.2	76.8	76.2	66.5	67.4
(percent of risk-weighted metric)	...	...	...	228.3	204.6	218.0
Exchange rate (dinar/euro, period average)	103.5	102.0	113.0	113.1	117.2	...
REER (annual average change, in percent; + indicates appreciation)	-7.9	9.3	-7.4	7.8	-2.1	-2.2

Sources: Serbian authorities; and IMF staff estimates and projections.
1/ At constant exchange rates.
2/ Period average for the actual available data.

Statement by the IMF Staff Representative on the Republic of Serbia
February 23, 2015

This statement provides information that has become available since the issuance of the staff report. The new information does not alter the thrust of the staff appraisal.

The preliminary 2014 fiscal deficit outturn was better than expected, although the improvement appears to be largely due to one-off factors. The augmented general government deficit was 6⅔ percent of GDP— lower than projected in the staff report (Table). Stronger revenues—both tax and non-tax—accounted for the largest part of the improvement, mainly because of one-off factors, such as extraordinary VAT payment from the power company due to higher flood-related electricity imports and unexpected dividends and fees from public enterprises (which were not related to a fundamental change in their financial position). In addition, capital expenditure was somewhat lower. As a result, staff assess that the structural primary fiscal deficit was marginally lower relative to the staff report. At the same time, public debt reached 72½ percent of GDP, somewhat higher than expected, mostly on account of exchange rate valuation effects and a smaller drawdown of government deposits.

The prior action on eliminating state aid to steel producer Zelezara Smederevo (ZS) has been met. In accordance with their program commitments, the authorities adopted a government Decision on February 17 to produce a management contract for this company, to allow operation of the company without state aid or accumulation of arrears.

The authorities have fulfilled a number of program commitments since the issuance of the staff report. On February 12, they have appointed a new head of Tax Administration. On February 8, the government adopted a Decision establishing a Working group for monitoring liquidity of the budget consisting of representatives of Ministry of Finance, the National Bank of Serbia, Public Debt Administration, the Tax Administration, and the Treasury. The functions of the Working Group include information exchange, analysis of budget execution reports, projection of revenues and expenditures and monitoring and analysis of cash flows.

Serbia: General Government Fiscal Operations (Program Scenario), 2013-14
(Percent of GDP)

	2013	2014	
		SR	Prel.
Total revenue	**37.9**	**39.4**	**40.0**
Tax revenue	33.4	35.0	35.3
Of which: VAT	9.8	10.4	10.6
Nontax revenue	4.2	4.1	4.4
Capital revenue	0.1	0.0	0.1
Grants	0.1	0.2	0.2
Total expenditure and net lending	**43.5**	**46.8**	**46.6**
Current expenditure	40.8	43.0	43.0
Capital expenditure	2.1	2.6	2.5
Net lending	0.3	0.3	0.4
Amortization of activated guarantees	0.2	0.8	0.8
Augmented fiscal balance	**-5.6**	**-7.5**	**-6.6**
Public debt/GDP	61.4	69.9	72.5

Sources: Ministry of Finance; and IMF staff calculations.

Statement by Daniel Heller, Executive Director for the Republic of Serbia and Vuk Djokovic, Senior Advisor to the Executive Director February 23, 2015

On behalf of our Serbian authorities, we would like to thank management and staff for supporting the request for a precautionary Stand-By Arrangement (SBA) in the amount of SDR 935.4 million (200 percent of quota). The arrangement will be instrumental in underpinning and strengthening macroeconomic management and keeping Serbia's fiscal consolidation and structural reforms on track. Our authorities intend to treat the arrangement as precautionary, given the comfortable international reserves position and continued access to external financing. The Serbian authorities very much appreciate staff's strong engagement as well as the constructive policy dialogue, which has provided an accurate assessment of the Serbian economy. The report highlights important vulnerabilities in the context of the current weak external environment, slower global growth and potential adverse regional spillovers, and highlights the numerous challenges and risks that Serbian policymakers face. The program builds on the already strong reform momentum, and envisages the ambitious, yet essential set of policy reforms to be implemented, including fiscal consolidation and structural fiscal reforms. Moreover, the program design provides a realistic and achievable path to stabilize public debt, strengthen the financial sector, and improve competitiveness.

Outlook

The Serbian government, which took office in April 2014 with a broad and stable parliamentary majority, started its term with a clear aim to (i) stabilize public finances, (ii) accelerate the implementation of needed structural reforms, (iii) improve competitiveness, (iv) strengthen regional cooperation, and (v) advance towards the EU membership. The implementation of this comprehensive reform agenda already started in mid-2014 with the launch of ambitious labor and pension reforms, followed by important fiscal consolidation measures—mostly the implementation of wages and pensions cuts—and the passing of the amendments to the Urban Planning and Construction Law. In the second half of 2014, the government started discussions with the Fund on a possible program to underpin its economic policies and reform momentum. The authorities and staff have subsequently agreed on a 36 month precautionary arrangement to support the implementation of the aforementioned comprehensive reform agenda and reduce vulnerabilities in the financial sector. The authorities consider that the successful implementation of the program will be pivotal in strengthening the credibility of implemented policies and relaunching growth.
The Serbian economy weakened in 2014 and is expected to remain slightly negative in 2015, while the growth is expected to pick up in 2016. In May 2014, the country was hit by devastating floods which severely disrupted economic activity. Owing to flood-linked damages and disruptions in the mining and energy sector and the weak growth of Serbia's

trading partners, the Serbian economy contracted in 2014 by two percentage points. Growth in 2015 is expected to be slightly negative, as the weakening in domestic demand due to the significant frontloaded component of consolidation measures, will only be partially offset by higher net exports. A moderate recovery is expected in 2016, based on the upturn of domestic demand and further net exports growth.

Fiscal policy

Fiscal adjustment continues to be at the core of the program with the Fund. The authorities are fully committed to implementing the needed fiscal consolidation within the program framework, with the aim of achieving fiscal sustainability and stabilizing and reducing public debt in the medium term. This implies a package of fiscal measures of 4¾ percentage points over the course of the program. Acknowledging the need to promptly stabilize public finances, the government has started the consolidation process, well before the program discussions, by implementing important fiscal measures. In fact, in the second half of 2014, the authorities have decided to reduce two key expenditure categories, namely wages, both in the public and state owned enterprises (SOEs) sector, and pensions. The authorities have also decided to freeze wages and pensions with the objective of reducing their share in GDP over the medium term from 10 and 13 percent respectively, to 7 and 11 percent. In other words, nominal wages and pensions will remain unchanged until these ratios are achieved.

The other key building blocks of the fiscal consolidation package are (i) a substantial reduction in state aid, particularly to SOEs and (ii) a rightsizing of employment in the public sector. More specifically, on the former (i), the fiscal drag from the loss-making SOE, which has been on the rise in recent years, will be substantially reduced by lowering direct and indirect state aid to these SOEs, limiting issuance of new guarantees and, improving their monitoring, transparency and governance. In cooperation with the World Bank, the restructuring and divestiture of about 500 socially owned enterprises in the portfolio of the Privatization Agency will be accelerated. On the latter (ii), public sector employment will be reduced by five percent annually over the course of the program, through the extension of the attrition rule and targeted layoffs. These rationalization efforts will be underpinned by the recently launched centralized employment registry, which effectively monitors public sector employment and wages.

The Serbian authorities also plan to enact and implement broad civil service reform, with the objective of increasing the quality of public services and improving the efficiency of the public sector. In parallel, the authorities will review the transfers to local governments in order to make the system of intergovernmental transfers increasingly efficient and fair. Expenditure cuts are going to be paired with the broad and overreaching tax administration reform, in line with the Fund's technical assistance (TA) recommendation, to improve tax collection efficiency and reduce the gray economy. Finally, the containment of pension expenditures in the medium term will be supported by the pension system reform enacted in mid 2014, which equalizes the retirement age for woman and man to 65 years, increases the minimum retirement age to 60 years and introduces actuarial penalties for early retirement.

Monetary and exchange rate policies

The Serbian authorities consider that the inflation targeting framework has served well, apart from some implementation challenges due to a highly euroized economy. Currently, headline CPI inflation is below the target band due to the fall in energy and food prices, unanticipated flat regulated prices and weak domestic demand. However, the National Bank of Serbia (NBS) expects inflation to accelerate in spring 2015, to reach the target band in mid 2015, and respectively reach the target of 4 percent by the end of 2015. On February 12, the NBS Executive Board decided to keep the reference rate unchanged at 8 percent. Our authorities consider that a gradual relaxation of monetary policy will be appropriate once the fiscal consolidation efforts start delivering their effects, taking also into account external financing conditions.

The NBS continues to be committed to the managed floating exchange rate regime for the dinar. Although exchange rate flexibility helped absorbing external shocks, Serbia's shallow foreign-exchange market remains prone to excessive volatility. Recent NBS interventions were geared towards the objective of smoothing such volatility and preserving financial stability. In moving forward, the NBS interventions will continue to be aimed at smoothing excess volatility and providing liquidity to the market, without targeting a specific level of dinar exchange rate. The level of NBS international reserves remains high by standard metrics.

Financial sector

Serbian banks are well capitalized and liquid due to cautious policies. The weaknesses identified in some state-owned banks have been promptly addressed, in some cases with recourse to public money. The capital adequacy ratio for the banking sector stands at almost 20 percent, and all banks have regulatory capital above the minimum of 12 percent. The non performing loans are relatively high, predominantly within the corporate portfolio; however, large regulatory loan-loss provisioning provides a sizable cushion to a potential distress.

The Serbian authorities have made progress in strengthening the bank resolution and financial network framework, in line with the Fund's TA recommendations. A set of laws aimed at clarifying roles and actions of different actors in case of bank resolution has been enacted in January 2015. By the end of the third quarter, the authorities will complete diagnostic studies to identify possible vulnerabilities in the banking system and accurately assess possible capital shortfalls. Our authorities consider that the results of this balance sheet quality review will provide additional insights, help pursue adequate policies and improve the oversight of the system. They also expect the outcome of the review to be manageable.

Business environment

With the support of the World Bank, our authorities are pursuing a broad and comprehensive structural reform agenda to enhance the business environment. In July 2014, the authorities have made important adjustments in the labor law to enhance the flexibility of the labor market and unify severance costs. The Urban Planning and Construction Law, which has been amended in December 2014, will significantly simplify and speed up the process of obtaining building permits, including by establishing a one-stop shop. To remove one of the key bottlenecks, the authorities are also committed to developing, by the end 2015, a framework that regulates the conversion of building land usage rights to ownership rights.

EU integration

Serbia is making important progress towards EU membership. After granting Serbia the Candidate status in 2012, the European Council decided in late 2013 to initiate the accession negotiations with Serbia. These negotiations with the EU started officially with the first Intergovernmental Conference, which took place in January 2014. Moreover, in 2014 the screening processes of the several chapters of *acqui communautaire* were initiated.

Conclusion

The authorities are convinced that the agreed upon policies are adequate for reaching the objectives defined in the Letter of Intent, and placing the country on a more balanced growth path after the expiration of the program. The authorities are aware of the surrounding risks and remaining vulnerabilities, stemming primarily from the volatile external environment and the elevated financing needs but also from potential fiscal slippages. They remain committed to prudent macroeconomic policies, focusing their strategy on containing debt, improving competitiveness, and reducing financial vulnerabilities. If new measures are needed to achieve the program objectives, the authorities stand ready to take such actions in consultation with the Fund. In case of significant changes to the main program assumptions, the authorities are also ready to take, in consultations with the Fund, additional measures to protect the objectives of the program.

(in percent of broad money, M2)	78.6	85.2	76.8	76.2	66.5	67.4
(percent of risk-weighted metric)	...	...	...	228.3	204.6	218.0
Exchange rate (dinar/euro, period average)	103.5	102.0	113.0	113.1	117.2	...
REER (annual average change, in percent;						
+ indicates appreciation)	-7.9	9.3	-7.4	7.8	-2.1	-2.2

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

1/ At constant exchange rates.

2/ Period average for the actual available data.