INTERNATIONAL MONETARY FUND

SERBIA: STAND-BY ARRANGEMENT—SECOND REVIEW MISSION

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Recent Economic Developments and Revised Outlook

1. **Immediate financial tensions have eased, and, for now, the banking system has weathered the adverse spillovers from the global financial crisis.** Foreign banks have largely rolled over their external exposure vis-à-vis Serbia, and the large current account deficit has been shrinking fast. Reflecting these developments, the National Bank of Serbia (NBS) has not intervened in the foreign exchange (FX) market since the end of Ferbuary. Meanwhile, as elsewhere in the region, sovereign spreads have narrowed substantially. With the NBS's comprehensive Financial Sector Support Program in place, bank liquidity has improved as households have begun to return FX deposits to banks. Nevertheless, banks have adopted more conservative lending policies and overall credit growth is subdued, notwithstanding government efforts to support lending through subsidies and guarantees. Moreover, non-performing loans have been rising fast.

2. **Performance under the program has been broadly on track, except for the fiscal area**. All end-June 2009 performance criteria, apart from the ceiling on the general government deficit, were met (Tables 1-2). In particular, the fiscal deficit for the first half of 2009 exceeded the ceiling by 1 percent of annual GDP, mainly because of revenue shortfalls owing to a weaker-than-expected economy, and only partial implementation of agreed fiscal measures, but also some efforts by the Ministry of Finance to compensate implementation shortfalls. Most actions in the structural reform area were also implemented as planned. Inflation has remained inside the target band, allowing the NBS to gradually ease its monetary stance.

3. **While the output slump seems to be moderating, the 2009 decline will likely be deeper than originally projected, with stronger external adjustment.** Real GDP is now expected to fall by 4 percent in 2009, compared with a 2 percent decline in the first program review. With the economy's overall spending shrinking faster than income, the external current account deficit is projected at 9 percent of GDP in 2009, compared with 13 percent of GDP in the first program review. Capital inflows have remained low but stable over the last few months; as a consequence, external financing pressures are abating. A modest economic recovery is expected in 2010, with GDP growing by 1½ percent.

Revised Fiscal Policy Requirements

4. **The shift of the Serbian economy from economic boom to bust has unmasked a vulnerable fiscal position**. Revenues during the boom were boosted by unsustainable growth heavily tilted toward consumption, as reflected by high external current account deficits.[1] In the short term, allowing the temporary effects of automatic fiscal stabilizers to increase fiscal deficits is justified given the severe economic contraction and the much faster-than-projected external adjustment, as long as non-inflationary sources of budget financing are available. At the same time, fiscal sustainability will need to be restored through front-loaded reforms of recurrent spending, particularly in public administration, and the pension, health, and education systems.

5. **Therefore, developing a sound and credible fiscal strategy is the key policy challenge.** These reforms will need to be calibrated to provide compensating savings for a declining tax-GDP ratio over the medium term, higher interest payments, and increased capital spending to improve Serbia's deteriorated public infrastructure. The basic theme of fiscal reform efforts will therefore have to be "*Doing More with Less,*"[2] while providing an effectively targeted social safety net. However, many of the spending reforms will yield sizeable spending reductions only a few years down the road, therefore requiring credible political commitment to and steadfast implementation of reforms.

6. **For 2009, there was agreement that a higher fiscal deficit target would be appropriate.** Against the backdrop of weaker economic activity and lower revenue, raising the 2009 fiscal deficit target from 3 to 4½ percent of GDP would broadly accommodate the operation of automatic fiscal stabilizers. Achieving the revised fiscal deficit target assumes, however, measures to address implementation slippages regarding previously agreed fiscal actions, particularly in collecting additional dividends from state-owned enterprises and cutting ministries' own-resource budgets. In addition, meeting the deficit target will require tight control of local government spending and, reflecting short-term implementation constraints, some underexecution of capital spending.

7. **Broad agreement was also reached on initial steps to initiate key medium-term structural reforms of the pension, health, and education systems.** In particular, it is the understanding of the mission that a new draft pension law is planned to be ready for submission to Parliament in December, with key measures including raising the retirement

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[1] The mission estimates that, assuming Serbia's external current account deficit normalizes to a medium-term level of about 6 percent of GDP, the tax-GDP ratio will fall durably by about 4 percent of GDP relative to its level in 2008. This estimate reflects mainly durably lower VAT collections (as consumption is projected to fall relative to GDP) and lower customs revenue (given the SAA agreement with the EU).

[2] See World Bank (June 2009), *Serbia: Doing More with Less: Addressing the Fiscal Crisis by Increasing Public Sector Productivity*.

age for women; tightening early retirement limits combined with actuarially fair penalties; and reducing the extra service credit for women. In addition, any changes in the existing system of pension indexation—after its temporary suspension in the context of nominal freezes of public wages and pensions in 2009-10—will be designed to substantially reduce over the medium term the financial transfers needed from the budget to finance the pension fund. The government, in consultation with the World Bank, will proceed with health, education, and non-pension social benefit reforms.

8. **However, agreement has yet to be reached on how to deal with near-term fiscal gaps, particularly in 2010, since spending reforms will take time to yield their full effects.** As agreed at the time of the last review, the 2010 fiscal projection already assumes a continued freeze in public wages and pensions, as well as a freeze on hiring in the public sector in 2010. There was broad consensus that under current policies the fiscal deficit could increase to 5½ percent of GDP in 2010, although the authorities suggested that revenues may well surprise on the upside. A projected deficit of this size could be difficult to finance and would be inconsistent with sustainable public finances.

9. **Apart from a significant downsizing of public administration, the authorities' present fiscal adjustment plans for 2010 rely mainly on imposing additional nominal freezes, while leaving a fiscal gap.** In line with the structural spending reform agenda, the authorities are developing a promising plan to jumpstart reforms by reducing the workforce in public administration and local governments by a total of 10 percent, and eliminating redundancies in the health and education sectors. Reforms would be targeted to preserve the quality of public service provision. However, the 2010 budget savings would be limited, mainly reflecting severance payments. In addition, the authorities would maintain the 2009 budget cuts, while introducing further nominal freezes—including for a large portion of spending on goods and services, subsidies, and untargeted transfers to households. In the mission's view, this adjustment strategy carries considerable implementation risks. It was agreed that targeted social spending on family and child allowances would remain protected. The mission estimates that the combined measures proposed by the authorities would amount to ¾ percent of GDP, leaving a fiscal gap of some 1¼ percent of GDP.

10. **The mission suggested that a VAT increase could be effective in closing the remaining fiscal gap, but the authorities insisted on a spending-based approach.** Bringing some lower taxed products up to the standard VAT rate and increasing the rates themselves could yield substantial additional revenue in the coming year. These measures could partly compensate for the losses in tax revenue due to the SAA agreement and the projected rebalancing of the economy away from excessive consumption and a high current account deficit. While alternative revenue measures could also be considered, a VAT increase would seem to be least distorting, as it would be broad-based by also taxing the informal economy and support the needed shift away from consumption to investment. In the mission's view, the authorities also have the tools to at least partly offset the demand-reducing impact of a VAT increase. However, the authorities were concerned that a VAT

increase could have a strong adverse impact on economic confidence just when the economy was bottoming out, while taking away the political pressure to implement spending reforms. For these reasons, the authorities wanted to exclusively concentrate on pursuing more ambitious multi-year spending reforms.

11. **There was agreement that tighter monitoring of large state enterprises is needed to limit the build-up of large contingent fiscal liabilities**. Preliminary information suggests that some state enterprises are running large quasi-fiscal deficits as a result of the economic downturn, but also because of long-standing structural distortions that encourage some of these enterprises to maximize their wage bill. A preliminary assessment of the financial situation of the large state public enterprises should be completed over the coming months to design corrective measures to be taken in the context of the 2010 budget. There was also agreement that the wage freeze in most state enterprises in 2010 should continue.

Other Program Issues

12. **Monetary policy should continue to focus on inflation.** Notwithstanding the economic slowdown, it was agreed that further monetary easing should proceed with caution. Despite lower inflation pressures in the second quarter, the risk of overshooting the NBS's 2009 target remains significant. This risk is underpinned by stubbornly high inflation expectations, and pressures anticipated in the last quarter, including a seasonal spike in food prices; continued recovery of oil prices against a likely stabilized or rebounding aggregate demand; potential exchange rate pressures due to increased import demand; and further hikes in regulated prices.

13. **The diagnostic study of banks is on pace with the schedule agreed under the program.** Preliminary results for the twelve largest banks suggest that the banking sector is adequately capitalized and liquid. Meanwhile, a small domestic bank emerged from receivership through recapitalization, while a capital increase in a large domestic bank has been secured by an agreement with the EBRD and other shareholders. As regards the four banks with majority state ownership, the authorities have informed the mission that, unless the current privatization plans materialize, they now plan to finalize their merger in the coming weeks and that the diagnostic study would be performed on the merged bank before end-2009.

14. **The mission proposed changes to the government's credit stimulus program.** The program, launched in February, features a combination of interest subsidies, co-financing, and partial credit guarantees. To ensure attractiveness to banks, the NBS has allowed banks to reduce the base for calculating their required reserves under certain conditions. While the unprecedented nature of the financial crisis at the beginning of the year called for innovative solutions to support activity, as the downturn moderates, restoring the integrity of key instruments of monetary policy becomes more important. In this respect, the mission recommends phasing out the ad-hoc differentiation of reserve requirements, and removing

the interest rate cap on subsidized loans to ensure banks' cost recovery. The authorities indicated plans to maintain the status quo for the remainder of 2009 and, market conditions permitting, to gradually phase out the liquidity loan subsidy program by the end of next year.

15. **The mission further recommends improving the framework for claims enforcement.** It has suggested amendments to the framework of blockage by creditors of delinquent borrowers' bank accounts based on promissory notes. Several aspects of the existing framework facilitate further propagation of delinquencies in the economy, in some cases causing unnecessary bankruptcies. In this context, the authorities could take several measures, including (i) introducing mandatory registration of promissory notes and improving their format, (ii) amending the Law on Payment Transactions to eliminate the first-mover advantage in account blockages; and (iii) incorporating simplified bankruptcy procedures and imposing mandatory bankruptcy for borrowers whose bank accounts have been blocked over a prolonged period of time.

The Way Forward

16. **In the mission's view, it is now time to shift from immediate crisis-fighting mode to putting in place more medium-term oriented policies.** The authorities have broadly implemented agreed policies amidst a difficult economic environment. Nevertheless, the fiscal position has perceptively deteriorated, reflecting both cyclical and structural declines in revenues.

17. **Reaching agreement on a sound and credible fiscal program will remain a key element for the completion of this and the next review of the program.** There was agreement to postpone the second review and combine it with the third review, currently planned to take place in late October. It was also agreed that developing a credible spending-based fiscal adjustment program should be explored in depth over the next few weeks, and be the focus of the discussions during the October mission. However, if developing such a strategy proves infeasible, revenue measures, including a VAT increase, would need to be considered. The mission is confident that all sides will do their best to cooperate and reach agreed policy solutions that will allow the Serbian economy to overcome its current difficulties, while establishing the foundations for more balanced and sustainable medium-term growth.

Table 1. Serbia: Performance for Second Review

Measure	Target Date	Comment
Quantitative performance criteria		
1. Floor on net foreign assets of the NBS	June 2009	Observed
2. Ceiling on consolidated general government overall deficit	June 2009	Not observed
3. Ceiling on contracting or guaranteeing by the public sector of new short-term external debt	June 2009	Observed
4. Ceiling on accumulation of government external payment arrears	June 2009	Observed
Indicative targets		
1. Ceiling on current expenditures of the Serbian Republican budget	June 2009	Observed
2. Ceiling on gross accumulation of domestic guarantees by the Republican budget, the Guarantee Fund, and the Development Fund and domestic borrowing by the Guarantee and Development Funds	June 2009	Observed
Inflation consultation clause	June 2009	Observed
Structural benchmarks		
1. Budget framework. Government to adopt the business plan of the Road Company of Serbia consistent with the program.	May 2009	Expected to be observed
2. Budget framework and wage policy. Government to adopt state enterprises' business plans that conform to general government wage and employment policy in 2009 and ensure profit transfers to the state.	May 2009	Partially observed
3. Budget management. Ministry of Finance to prepare a three-month rolling cash flow plan for the Republican budget consistent	June 2009	Observed
4. Revenue administration. Ministry of Finance to charge a specific unit to review the reasons for the sharp increase in VAT refunds and credits in 2008.	June 2009	Expected to be observed
5. Financial sector. Deposit Insurance Agency to adopt detailed action plans for the remaining banks with state participation.	June 2009	Observed
6. Financial sector. NBS to complete a diagnostic study of the 12 largest banks and the four banks with majority state ownership.	September 2009	Expected to be observed for the 12 largest banks and four other banks. The state-owned banks to be evaluated after their merger by end-2009

Table 2. Serbia: Quantitative Conditionality Under the SBA, 2008-09 1/

	2008 2/		2009 2/			
	End-Dec.		End-March		End-June	
	Program Targets	Actual	Revised Program Targets	Actual	Revised Program Targets	Actual
Quantitative Performance Criteria						
Floor on net foreign assets of the NBS (in billions of euro)	5.0	6.1	5.1	6.0	4.4	5.9
Ceiling on consolidated general government overall deficit (in billions of dinars)	64	69	15.2	14	34.3	58
Ceiling on contracting or guaranteeing by the public sector of new short-term external debt (up to and including one year, in millions of euro)	0	0	0	0	10	0
Ceiling on contracting or guaranteeing by the public sector of new nonconcessional external debt (over one year, in millions of euro) 3/	50	0	200	0	550	100
Ceiling on accumulation of government external payment arrears (continuous, in millions of euro)	0	0	0	0	0	0
Inflation Consultation Bands						
Central point	10.0	8.6	9.2	9.4	8.0	8.3
Band, upper limit	12.0	n.a.	11.2	n.a.	10.0	n.a.
Band, lower limit	8.0	n.a.	7.2	n.a.	6.0	n.a.
Indicative Target						
Ceiling on current expenditure of the Serbian Republican budget (in billions of dinars)	635	633	190	152	335	331
Ceiling on gross accumulation of domestic guarantees by the Republican budget, the Guarantee Fund, and the Development Fund and domestic borrowing by the Guarantee and Development funds	n.a.	n.a.	n.a.	n.a.	50	7.1

1/ As defined in the Letter of Intent, Memorandum on Economic and Financial Policies, and Technical Memorandum of Understanding of the first review of the SBA.
2/ Cumulative from January 1.
3/ Excluding loans from the IMF, EBRD, EIB, EU, IBRD, KfW, Eurofima, CEB, IFC, and bilateral government creditors, as well as debt contracted in the context of restructuring agreements.