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Press Release:
IMF Executive Board Completes Sixth Review Under an Extended Arrangement with Serbia and Montenegro and Approves US$90.1 Million Disbursement
February 7, 2006

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Serbia and Montenegro: Letter of Intent, Memorandum of Economic and Financial Policies and Technical Memorandum of Understanding

January 11, 2006

The following item is a Letter of Intent of the government of Serbia and Montenegro, which describes the policies that Serbia and Montenegro intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Serbia and Montenegro, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington DC 20431

January 11, 2006

Dear Mr. de Rato:

The attached Memorandum on Economic and Financial Policies (MEFP) specifies understandings reached with staff in discussions on the completion of the sixth and final review of the Extended Arrangement (EA), extended to end-February 2006.

Since the start of the program in May 2002, macroeconomic imbalances in our economy have been reduced and structural reforms have advanced. This was achieved in an environment of high growth and rising real incomes. In 2005, our prudent macroeconomic policies, most notably further fiscal consolidation, helped reduce the current account deficit relative to GDP from 14.8 percent to an estimated 10.2 percent. In Serbia, unfortunately, the VAT introduction, surging international fuel prices, and the expansionary impact of strong foreign currency inflows on broad money and credit growth have kept inflation above program targets.

To achieve further progress in stabilization and reform and address new challenges, we have updated our economic objectives and policy for 2006, as described in detail in the attached MEFP. On this basis, we request: (a) the completion of the sixth review under the EA; (b) waivers for the non-observance of two end-September 2005 quantitative performance criteria (PCs) (the ceilings for net-credit to government and the wage bill of the monitored stated-owned companies) and of five structural PCs (parliamentary approval of legislation abolishing the law on NIS by end-July; spin-off, registration, and transfer to the Privatization Agency of 65 companies, non-core assets, and hotels from the monitored state-owned enterprises by end-September; spin-off of the remaining non-core companies and assets by end-October; in Serbia, parliamentary approval of a pension reform by end-October in line with the parameters agreed in the context of the fifth review; and parliamentary approval by November 15 of a new law on banks in line with understandings reached in the context of the fifth review); and (c) the purchase of SDR 62.5 million following the completion of the sixth review.

The MEFP specifies corrective measures, most of which are already implemented, to address the non-observance of these PCs. In particular, the non-observance of the two quantitative PCs, which has not tangibly affected our macroeconomic policy stance, has been addressed through subsequently implemented measures. The measures specified through four non-observed structural PCs were implemented with delays. Moreover, to compensate for the deficiencies in the pension reform, we have ensured savings in permanent budgetary expenditures of 1 percent of GDP in 2006 through other measures, most notably the health sector reform approved by the Serbian Parliament in November.

We believe that the policies and measures set forth in the attached MEFP are adequate to achieve the objectives of our program. However, 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 any revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. We will continue to provide all information to the Fund that it requests to assess the program implementation.

Yours sincerely,

/s/
Miroljub Labus
Deputy Prime Minister
Republic of Serbia

/s/
Miroslav Ivanišević
Deputy Prime Minister
Republic of Montenegro

/s/
Mladjan Dinkić
Minister of Finance
Republic of Serbia

/s/
Radovan Jelašić
Governor
National Bank of Serbia

/s/
Igor Lukšić
Minister of Finance
Republic of Montenegro

/s/
Ljubisa Krgović
Chairman
Central Bank of Montenegro

SERBIA AND MONTENEGRO

MEMORANDUM ON ECONOMIC AND FINANCIAL POLICIES

January 11, 2006

I. Introduction

1. This memorandum updates and supplements the Memorandum of Economic and Financial Policies (MEFP) attached to the Letter of Intent of June 8, 2005. It reports on recent developments under the program supported by the Extended Arrangement approved in May 2002 and outlines the economic objectives and policy agenda for 2006.[1]

2. **Performance under the program in 2005 has been mixed.**

- Two of the 12 quantitative performance criteria (PCs) (the ceiling for net-credit to government and the ceiling for the wage bill of monitored state-owned companies) were missed for end-June and end-September (Table 1; Annex A).
- Only four of the nine structural PCs were met fully and on time (Table 3; Annex C). Parliament adopted the legislation on the state-owned oil company NIS with a three-week delay, and the adopted pension law fell short of the agreed parameters. The two PCs on the spin-offs of non-core assets from state-owned enterprises were met with delays, as was the PC on parliamentary approval of the new banking law.
- Most structural benchmarks (SBs) were implemented on time. There were some delays in adopting the schedule to clear arrears in Montenegro and in launching the tender for hiring a privatization advisor for NIS in Serbia. The SB related to the initiation of bankruptcy procedures against large socially owned enterprises was only partially met (procedures were initiated against four rather than five enterprises).
- To achieve the objectives of the program, corrective measures were taken to compensate for the shortfalls and delays (Table 3, Annex C).

3. **Strong growth in domestic demand and exports in 2005 has been accompanied by persistently high inflation and external imbalances.**

- **Real GDP growth in Serbia** remained strong at 6.1 percent in H1 2005 and is expected to reach 4.8 percent in 2005 (9.3 percent in 2004), led by the growing export-oriented, privatized, and restructured sectors, and trade and financial services.

[1] Annex A, attached to this memorandum, contains the quantitative performance criteria and indicative targets for 2005, while Annex B presents indicative targets for 2006. Annexes C and D list the structural performance criteria, structural benchmarks, and prior actions. The Technical Memorandum of Understanding attached to the MEFP of June 8, 2005 remains valid and is not attached here, but is complemented by an Addendum (Annex E). Unless specified otherwise, GDP refers to GDP of Serbia and Montenegro.

- Twelve-month **inflation** in 2005 has remained persistently high at around 17–18 percent. While part of the price pressures reflect high international oil prices, the VAT introduction in January, and seasonal factors in agriculture, strong domestic demand and liquidity in the banking system have kept core inflation at almost 1 percent per month.
- The growth rate of average **real net wages** continued to decline in the first ten months of 2005 to 6.3 percent from 11.2 percent in 2004 over the same period, with diverging trends. Average wages in the private, socially owned, and state-level public enterprises declined, while sharp increases were recorded in the education and culture sector, and local public enterprises.
- The **current account deficit** of Serbia and Montenegro (SCG) is projected to decline from 14.8 percent of GDP in 2004 to 10.2 percent of GDP in 2005 on account of strong exports and the one-off shift of imports to 2004 in anticipation of the VAT introduction. The underlying deficit, net of the VAT effect, is projected to decline from 13.1 percent of GDP in 2004 to 11.8 percent in 2005. The rebound of exports since mid-2004 (with a projected annual growth in 2005 of 25 percent in dollar terms) has been aided by the strong dollar, favorable commodity price trends, and strong investment in export-oriented, privatized companies. Energy imports through Q3 have grown by less than the increase in world prices, due to stock-building at the end of 2004. Owing to strong private remittances (14 percent of GDP projected for 2005) and FDI (7 percent of GDP), NBS gross foreign reserves rose to $5.2 billion (almost 5 months of projected 2005 imports) at end-October 2005 (at current exchange rates).
- The overall **external debt** declined from 61 percent at end-2004 to 58 percent of GDP at end-September 2005, mainly on account of favorable dollar/euro exchange rate developments. However, the increase in the debt financing of the current account deficit raises concerns, as it raises vulnerability to external shocks. Enterprises, including leasing companies, and commercial banks have been particularly active in contracting loans from abroad.
- In **Montenegro**, GDP growth in 2005 is estimated to reach 3-4 percent. This reflects strong tourism activity (up 21 percent in H1 over the same period last year) and domestic demand driven by rapid credit growth, increases in real wages, and large remittances. Nevertheless, inflation remained subdued at 3.3 percent in October. The current account is estimated to have improved in the first nine months of 2005 compared to the same period last year, aided by tourism revenues. However, the trade balance deteriorated due to adverse terms-of-trade developments from oil and aluminum prices, and temporary disruptions in input supplies and bulky exports. FDI continues to be strong, in particular in the telecom and tourism sectors.

4. **Fiscal policy in Serbia has remained tight in 2005, but the clearance of pension arrears in December required a reduction in the fiscal surplus target.** Revenues of the consolidated general government were somewhat weaker than programmed, primarily on account of the reduction in fuel excise taxes in August 2005 and lower-than-projected

non-tax revenue. At the same time, a prudent budget execution and measures to curb subsidies and transfers helped lower overall expenditures to 40.2 percent of GDP. This was achieved despite higher-than-programmed capital expenditure and excessive wage hikes in municipalities that led to an increase in the share of wages in GDP to 9.8 percent, undermining efforts to tighten incomes policy that have been taken in the rest of the government. Moreover, the decision to start the clearance of pension arrears (2.1 percent of GDP) by paying a first tranche (0.2 percent of GDP) in December was accommodated by a downward revision of the targeted surplus relative to GDP from 1.3 percent to 1.1 percent.

5. **In Montenegro, fiscal performance in the first nine months of 2005 was in line with program targets.** VAT revenues exceeded forecasts, and the structure of spending was shifted to infrastructure investment in line with overall expenditure limits. Repayments of domestic payment arrears have been larger than budgeted, but new arrears of €7 million were incurred. The use of privatization revenues to repay debt has lowered public debt to 44 percent of GDP as of September 2005.

6. **In Serbia, rapid expansion in broad money and lending to the nongovernment sector continued, despite various measures aimed at slowing down credit growth.** The increasing confidence in the banking sector is boosting remonetization, which is reflected in an increase in the broad money-to-GDP ratio from 21.5 percent in October 2004 to 24.2 percent at end-October 2005, driven primarily by a surge in foreign-currency deposits. This, together with foreign borrowing by commercial banks, has led to a substantial increase in net credit to the nongovernment sector, which is now projected at 9½ percent of GDP in 2005 compared to 6.8 percent in 2004, with consumer lending accounting for an increasing share. Euroization—measured as the share of foreign currency-denominated plus foreign currency-indexed credit in total credit to the nongovernment sector—increased during the 12 months to October 2005 from 64.7 percent to 75.2 percent.

7. **The NBS has significantly strengthened on-site and off-site supervision and implemented prudential measures to reduce macroeconomic and prudential risks emanating from rapid credit growth**. The Second Phase Supervisory Development Plan was adopted on October 14, 2005 together with a time bound corrective action plan to address Basel Core Principle deficiencies identified by the recent FSAP mission. Other important steps in the transformation to a risk-based approach include the adoption of (i) a strengthened supervisory operating policy; (ii) a standardized report of examination format; and (iii) a CAMEL rating process. Moreover, the NBS has issued a regulation on the monitoring and management of indirect credit risk resulting from borrowers' exposure to exchange rate risk. Amendments to the leasing law transferred the authority for regulating and supervising leasing companies to the NBS.

8. **Substantial progress was also made in bank privatization and the consolidation of the banking system.** Following the successful sale of Jubanka in January 2005, the privatization of two other state-owned banks was completed in Q3 2005 and the tender for the privatization of Vojvodanska Banka was issued on September 30. Owing to progress in

privatization and the acquisition of private domestic banks by foreign banks, the share of the latter in total bank assets rose to 63.3 percent at end-September 2005.

9. **Structural reforms have continued in the enterprise sector in Serbia:**

- **The privatization program of socially owned enterprises (SEs) has advanced and program targets were met.** From January-June 2005, the privatization agency (PA) offered 207 SEs for sale through auctions, with a success rate of 42 percent (compared to a program target of 130 companies offered with a success rate of 40 percent). From January-September, 297 companies were offered, with a success rate of 42 percent (against a program target of 230 companies with a success rate of 40 percent). Regarding tenders, 8 SEs were offered for sale in Q2 2005, of which 4 from the list of companies under restructuring (against a program target of 7 companies, of which 4 from the list). From June-October 2005, 8 more SEs were offered, of which 4 from the restructuring list (against a program target of 7 companies, of which 4 from the list).
- **The government initiated bankruptcy procedures against 4 large SEs undergoing restructuring** (compared to a program target of 5), while an additional one was initiated by a private creditor between June-September 2005. In compensation for the shortfall compared to the program target, the government initiated an additional bankruptcy in July against a large SE not on the list of enterprises undergoing restructuring.
- The process of **conditional write-off** of SEs debt—designed to facilitate privatization—has progressed, and the first company benefiting from the new framework was successfully auctioned in September, with proceeds exceeding the amount of the write-off.

10. **A total of 100 non-core companies, assets, and hotels of state-owned enterprises were spun off between June-November 2005.** Following the spin-off of 33 companies and assets in June, 52 additional non-core assets and companies identified in the previous MEFP were spun off or closed as of end-September (compared to a target of 65[2]). The number of spin-offs or closures was brought to 56 by spinning off 4 companies that had not been identified previously. Between July and end-October, 61 companies and assets previously identified were spun off or closed (compared to a target of 71), plus 5 not identified previously, for a total of 66. In November, one more company was spun off, bringing the total to 67 since July. Thus, the corrected target was met, with a slight delay. The government has also made progress in preparing the spun-off companies for privatization, the first of which was offered for sale in October.

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[2] Legal investigations during the spin-off process found that 2 companies did not exist as separate entities, one hotel was destroyed, and 2 companies had merged into 1, reducing the target by 4.

11. **Collection performance of public utilities in Serbia was mixed.** While the collection rate targets for the electricity company (EPS) were met, the collection performance of the oil company (NIS) fell short of the September target by 3½ percentage points. Several large budget institutions and public enterprises, particularly the army, the airline company, the railway company, and local utilities increased their arrears significantly.

12. **While the wage bill in the 8 monitored state-owned companies exceeded the program target, the latter contributed to a substantial rationalization of employment in these enterprises.** Although the core wage bill grew in line with the programmed 7 percent, a higher growth of various bonuses led to a higher overall increase. An estimated 12,000 employees (excluding the reduction in the number of positions by 6,000 owing to spin-offs) left the companies in 2005, resulting in an important increase in productivity.

13. **Privatization in Montenegro progressed.** The privatization of KAP, a large aluminum plant, was completed in December 2005. Podgorička Banka, the largest remaining state-owned bank, was sold to a strategic investor in October 2005 and a tender for Pljevajlska Banka was issued. Moreover, the tender for the sale of Pljevlja thermal power plant and Rudnik coal mine was relaunched in December. In the tourism sector, a tender for the long-term lease of Sveti Stefan and other hotel assets, launched in May, is expected to be concluded shortly. Army assets located on the Montenegrin territory amounting to about €13 million were sold.

14. **The start of the negotiations with the EU on the Stabilization and Association Agreement and the meetings of the WTO Working Parties have marked significant progress in the area of trade.** Serbia and Montenegro conduct these negotiations separately, in line with the "twin track" approach adopted by the EU and the WTO. Meetings of the separate WTO Working Parties for Serbia and Montenegro took place in October. In July, the Serbian Parliament approved a custom tariffs law which harmonizes tariff lines according to HS 2000/2002 standards and the EU combined nomenclature. In November 2005 it passed a foreign trade law consistent with WTO and EU regulations.

II. Economic Objectives and Policies

15. **The macroeconomic objectives for 2006 and beyond focus on reducing inflation and lowering the current account deficit to support sustainable growth.**

- **Real GDP growth** in Serbia is projected to reach about 5 percent in 2006, continuing the strong trend of the past 2 years. The downside risks relate to the adverse impact of high oil prices and the drag on growth from the unreformed industrial sectors.
- Supported by tight demand management policies and structural reforms, 12-month **inflation** in Serbia is projected to decline to 11½ percent at end-2006. The risks to this projection are related to the prevailing inflation inertia and developments in international oil prices, but the government and the NBS are committed to implement the necessary policies to achieve this objective.

- The external **current account deficit** of SCG is projected to reach about 10.8 percent of GDP (a decline of about one percent in the underlying deficit) as restrictive policies continue to contain demand. The deficit should continue to decline in the medium term—reflecting the recovery of exports as structural reforms elicit a supply response and prudent policies strengthen competitiveness—thereby contributing to external sustainability and consistency with expected financing. As structural reforms accelerate and the business climate improves, FDI inflows could play an increasing role in financing the current account deficit. However, foreign assistance and loans will remain an important source of financing.
- The import coverage of **foreign reserves** is projected to remain largely unchanged in 2006 at around 5 months of prospective imports, with a view to guarding against possible risks and the projected rise in external debt service in the medium-term following the expiry of grace periods under debt restructuring agreements.
- In **Montenegro**, economic policies will be geared towards increasing economic growth by strengthening macroeconomic stability, deepening structural reforms, and enhancing the investment climate and public sector operations. Growth is projected to reach 3–4 percent in 2006, reflecting buoyant activity in the tourism sector, expansion of financial services, and strong investment activity, but hampered by the lagging transformation of manufacturing. The main downside risks are related to world market prices for aluminum and oil, and a potential pressure on competitiveness from wages. Inflation is projected to remain at the current level of 3½–4 percent in 2006, and the current account is expected to decline in line with the fiscal tightening.

Serbia and Montenegro: Macroeconomic framework, 2004-06

	2004		2005		2006
	5th Rev.	Est.	5th Rev.	Proj.	Proj.
			(Percentage change)		
Real GDP growth	7.2	8.8	4½–5	4.7	4.9
Serbia	7.5	9.3	4½–6	4.8	5.0
Montenegro	3.1	3.1	3.3	3–4	3–4
Inflation (end period)	13.4	13.4	9 - 10	16.6	10.9
Serbia	13.7	13.7	10	17.7	11.5
Montenegro	4.3	4.3	2½ - 3	3.6	3.6
			(Percent of GDP)		
Domestic investment	17.6	22.5	18.4	18.4	19.8
of which: Gross fixed capital formation	...	19.2	...	18.7	19.6
Domestic savings	-11.3	-5.2	-5.3	-4.4	-3.2
Current account deficit (before grants)	15.5	14.8	11.0	10.2	10.8
Underlying current account deficit 1/	13.7	13.1	12.6	11.7	10.8
Gross official reserves (US$ billion)	4.3	4.3	5.6	6.3	6.9
(In months of projected imports)	3.7	4.0	4.3	5.2	5.3
External debt	62.0	61.1	57.1	61.1	60.5
General government fiscal balance (excl. grants)	-0.3	-0.3	1.2	0.9	2.4

Source: Serbian and Montenegrin authorities.

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

16. **Economic policies will continue to be geared toward macroeconomic stabilization and structural reforms to increase potential output.** The persistent imbalances between supply and demand, which has contributed to high inflation and a large current account deficit, will have to be addressed by both restrictive demand policies and accelerated structural reforms. In particular, to boost potential output and broaden the export base, the privatization of SEs will continue and the restructuring and privatization of state-owned enterprises will be accelerated.

17. **The PRSP process will continue to guide the development agenda and social policies.** The PRSPs adopted by the Serbian and the Montenegrin governments in late 2003 outline the key reforms. Social spending will be protected to provide a safety net for those affected adversely by reforms, while its efficiency will be enhanced through the improved targeting of benefits. The Serbian government approved a progress report in October 2005.

A. Fiscal Policy

Serbia

18. **Fiscal policy in Serbia in 2006 will be further tightened to help reduce the current account deficit and inflation.** The surplus of the consolidated general government relative to GDP will be increased by 1.4 percentage points, to 2.5 percent, to achieve these macroeconomic objectives and compensate for the lower-than-programmed fiscal surplus in 2005 resulting from the clearance of pension arrears. The fiscal consolidation will, to a large extent, be achieved through cuts in permanent current expenditures, contributing to surpluses in the republican and health fund budgets. A broadly unchanged tax policy (with the exception of an increase in excise taxes), continued improvements in tax administration, and prudent incomes policies will help achieve these targets. This will allow for an increase in capital spending. To create fiscal space for the clearance of pension arrears, the government will approve revenue and expenditure measures (specified in paragraph 27) that are expected to ensure higher-than-budgeted revenues and lower-than-budgeted expenditures in 2006. In 2006, budgetary revenues in excess of the revised projection (SRD 495 billion for the republican budget) will be saved. In the same vein, in 2007 and the following years, all revenue overperformance compared to the budgets approved by Parliament will be saved.

19. **Tax policy in 2006 will remain broadly unchanged, but the reduction in petroleum excises will be partially reversed.** Given the fragile macroeconomic environment, no further tax cuts will be implemented in 2006.

20. **The decline in expenditure is supported by a tight incomes policy and rationalization of employment in various sectors to ensure a decline in the share of budgetary sector wages in GDP to 9 percent.** The average wage in the central government and the social funds will increase by 11.6 percent, excluding redundancy payments (SRD 4.1 billion), and rationalization of employment is expected to continue. To rein in wage growth in municipalities (in which the wage bill increase will be limited to 9 percent in

2006), the monthly transfer to local governments from the republican budget will be linked to prudent wage policies, as allowed by a provision in the 2006 budget law.

21. **To increase the flexibility of fiscal policy and reduce the high tax burden over time, the government will cut permanent expenditure in 2006 by at least 1 percent of GDP.** This reduction in non-discretionary expenditure is supported by a comprehensive health sector reform, rationalization of employment in the army, and ongoing cuts in subsidies. The latter are supported by underlying structural reforms that help improve the financial performance of state-owned and socially owned enterprises.

22. **The health sector reform will increase efficiency and reduce expenditures**. The new Law on Health Insurance and the Health Fund budget incorporating the proposed permanent cuts in spending (0.6 percent of GDP) were enacted in November 2005. Building on the ongoing reforms, these savings are based on rationalization of medical and non-medical staff and number of hospital beds; a gradual shift in financing practices toward an output-based system; and rationalization of health benefits. The transfer from the Health Fund to health institutions will be reduced by SRD 3 billion in line with the expected increase in copayment collection. The envisaged decompression of the wage structure will not increase the overall wage bill (including social security contributions, taxes paid by the employer, and severance payments) in the health sector beyond SRD 53.5 billion.

23. **The rationalization of the army, supported by an ongoing strategic review, will lead to budgetary savings in 2006 and beyond.** In line with the action plan for army reform adopted in May 2004 by the Minister of Defense, the number of civilian and professional army staff has been significantly reduced in 2005. Together with further rationalization in 2006, as well as a reform in the Military Academy that will reduce the number of students, secondary military school cadets, and recruits in the regular compulsory service by 20 percent, this will allow for a reduction in the wage bill (0.1 percent of GDP) and related savings in goods and services (0.1 percent of GDP). A fraction of these savings (0.1 percent of GDP) will be used to pay arrears to suppliers and upgrade the capital stock.

24. **The reduction of budget subsidies will continue and transfers to the Development and Guarantee Funds will be eliminated, generating savings of 0.4 percent of GDP in 2006.**

- Export stimulation subsidies will be eliminated and agricultural subsidies reduced on December 31, 2005, in line with an agreement with the EU. Subsidies for cash registers for small companies and subsidies to public financial institutions will be discontinued, in line with progress in privatizing the banking sector.
- Subsidies to the railway company ZTP, socially owned companies, and RTS (the public broadcasting company) will be reduced, generally in line with structural reforms in these companies. An amendment to the law on radio-diffusion, adopted by Parliament in 2005, gives RTS the right to collect fees from users with expected collections of about 0.1 percent of GDP, thereby reducing its reliance on subsidies.

While EPS will collect these fees, it will only transfer the amounts actually collected rather than customers' total payment obligations to RTS.

- The Development Fund and the Guarantee Fund will no longer receive resources from the budget and will continue operations exclusively with own resources. The Law on the Development Fund was amended accordingly.

25. **The savings in current spending will allow for an increase in capital spending by about 0.5 percentage points of GDP in 2006.** The government will adopt by end-December 2005 a financial plan for the Road Fund (an extrabudgetary fund) limiting capital outlays and expenditures on goods and services to SRD 23.7 billion in 2006 and limiting its deficit (defined as expenditures, excluding amortization but including repayment of arrears, minus revenues, excluding privatization proceeds and loan disbursements) to SRD 2 billion.

26. **When establishing Public-Private-Partnerships (PPP), the government will follow a prudent strategy to avoid large contingent liabilities.** The legal framework for PPPs will be strengthened in line with the recommendations of Fund technical assistance. This will necessitate amendments to the Law on Concessions to include more detailed requirements for concession proposals, in particular with respect to the proposed allocation of risk, the "bankability" of the project, and hiring financial advisors to assess private and public sector risks. The signed concession contract will be made available to the public. Once PPP contracts are signed, as a first step toward full inclusion in the budget, the government will prepare and publish an annex to the budget law with the following information on the concession contracts (including the Horgoz-Pozega highway or any other projects in 2006): (i) future payment obligations and future expected or contingent government revenues; (ii) terms of the project that may affect the amount and timing of future cash flows; (iii) guarantees extended by the government and their main parameters; (iv) rights and obligations under the concession contract; (v) accounts of the Special Purpose Vehicle (SPV) and clarification of the accounting treatment of the concession by the government and the private partner; (vi) preferential financing provided through government on-lending or via public financial institutions, and any project financing provided by entities owned or controlled by the government; and (vii) a revised macroeconomic framework, using fiscal balances based on the consolidated accounts of the government and the SPV.

27. **The government is committed to improving the medium-term sustainability of the pension fund and clear pension arrears.**

- The **amendments to the pension law** approved in September provide for (i) a gradual increase in the retirement age by 2 years for men and women over a four-year period as of 2008; (ii) a shift from quarterly to semi-annual indexation of pensions; and (iii) a shift to an inflation-based indexation of benefits over the period 2006-2009. The savings from the reform will be felt starting in 2007 and are expected to amount to about 1 percent of GDP per year over the medium-term.

- To clear **arrears to pensioners** amounting to SRD 44 billion, the law on the issuance of pension bonds, approved by Parliament in September 2005, was amended on December 22 to enable cash payments according to a revised schedule.
  - The first two tranches of arrears of the employees' pension fund (SRD 4 billion each) will be paid in December 2005 and July 2006. The following measures will be taken to accommodate these payments (prior action): (i) increase in fuel excises by at least 1 dinar per liter, expected to yield SRD 2.4 billion in 2006 (formal government decision by January 15, 2006); (ii) cuts in mortgage subsidies and agricultural lending by SRD 1.5 billion (formal government decision to amend the 2006 spending targets and programs by January 15); (iii) cuts in the budgetary reserve and expenditures for goods and services by SRD 1.6 billion (formal government decision by January 15); (iv) payment of NIS tax arrears in the amount of SRD 1.5 billion (NIS Managing Board decision in December 2005), and (v) elimination of tax exemptions for capital imports, estimated at SRD 1 billion (formal government decision); (vi) in case the surplus of the consolidated general government in 2005 falls short of the targeted 1.1 percent of GDP, additional compensatory measures will be approved through a formal government decision by January 15, 2006. In particular, fuel excises would be increased by another dinar per liter. Should this require a revision in the oil excise formula, the respective government decision would be approved in January 2006.
  - Starting in 2007, the expenditure for arrears clearance will be accommodated within the regular budget, consistent with macroeconomic objectives.

28. **The medium-term budget framework and the treasury system will be improved.** In particular, the Ministry of Finance will develop a three-year budget framework and improve investment planning. Reform of the treasury system will continue with the centralization of the payrolls of direct budget users and the extension of the Treasury Single Account to indirect budget users.

Montenegro

29. **The deficit of the consolidated general government will be contained at 2.7 percent of Montenegro GDP in 2005 and reduced to 1.7 percent of GDP (€30 million) in 2006.** In 2005, expenditure financed from the sale of army assets will be contained within agreed spending limits, and the rationalization of public employment will be stepped up. In 2005 as well as in 2006, any revenue over-performance will be saved or used for additional investment programs or arrears reduction.

- **Tax policy** will remain unchanged except for the revenue-neutral lowering of the VAT rate for accommodation services and introduction of a lower VAT rate on food items and on a number of other products previously exempt.
- **A tight incomes policy will lower the public sector wage bill (including army) from 10.8 percent of GDP in 2005 to 10.0 percent of GDP in 2006.** This will be achieved despite the installation of new agencies as part of efforts towards EU

accession. To contain public sector wage costs and minimize the negative impact on private sector competitiveness, the government will seek to agree with the unions to increase the minimum wage by no more than 5.0 percent in 2006.

- **The budgetary reserve will be increased to meet possible expenditures related to the planned referendum on independence.** Any savings would be used for additional investment or arrears reductions (by €16.7 million in 2006). Verification procedures will be enhanced and an arrears tracking system implemented.
- **To enhance efficiency of public investment, a medium-term investment plan will be prepared by June 2006 in line with international best practices**. The Ministry of Finance will seek technical assistance to build up the necessary analytical capacity. A clear priority of investment projects according to their economic rate of return will be established.
- **The financing operations of the public sector will be geared towards reducing debt and the net interest bill.** Public debt will be gradually reduced from 48 percent of GDP in 2004 to less than 40 percent by 2007. To improve transparency, all accounts of extra budgetary funds with commercial banks will be moved to the central bank, except those few needed for core operational purposes. All proceeds from the privatization of military assets will be deposited in the Central Bank and their use will be accounted for in the budget.
- **The financial operations of the Montenegro Development Fund (MDF) will be placed under the control of the Minister of Finance.** Its expenditure will be consolidated in the general government and its investment financing projects integrated in the government's investment program. The government will conduct a throughout analysis of the future role of the MDF.

B. Monetary and Exchange Rate Policies

30. **Monetary policy will continue to face the challenges posed by high euroization.** To compensate for the weak interest rate channel of monetary policy transmission, the NBS will continue to implement macroprudential measures to slow down credit growth with a view to help containing domestic demand. While the introduction of repo operation in January 2005 was an important step in increasing the reliance on market-based instruments, the use of statutory reserve requirements (SRR) on foreign currency-denominated deposits will continue to play an important role until the development of the market for SRD-denominated deposits and loans increases monetary policy effectiveness.

31. **Monetary conditions will be tightened.**[3] To contain euroization and strengthen the demand for SRD-denominated deposits, the NBS will increase the volume of repo operations

[3] The monetary program for 2006 aims at containing domestic demand and inflationary pressures. The end-period NFA will increase by $435 million, with monthly average NDA declining to SRD –130.4 billion in December 2006, while reserve money will decline in real terms by 3.1 percent (Table 2; Annex B). Broad

(continued…)

by relying on positive real interest rates. By end-January 2006, it will gradually increase the interest rate on 14-day repo operations to 5 percent in real terms (measured on the basis of three month backward-looking and three months forward-looking inflation). In November 2005, the SRR on enterprises' foreign-currency deposits and on commercial banks' foreign borrowing were increased from 29 percent to 35 percent. In December, they were unified with the SRR on households' foreign currency deposits at the level of 38 percent, implying some additional withdrawal of liquidity. The unified SRR will remain at that level, unless a need for adjustments is determined in consultation with Fund staff. The NBS will also step up outright sales of government bonds to reduce structural excess liquidity in the money market. To facilitate the development of the SRD market, SRR on SRD-denominated deposits were reduced from 20 percent to 18 percent in November. The NBS will sterilize higher-than-programmed foreign exchange inflows as needed to keep reserve money on the targeted path and contain credit expansion.

32. **The NBS is streamlining its monetary operations framework to improve the effectiveness of monetary policy.** The key policy variable will be the interest rate on 14-day repos to signal the monetary policy stance. In addition, in November, the NBS established an interest rate corridor by (i) increasing the interest rate on the NBS deposit facility to 6 percent; and (ii) linking the interest rates of its lending facility to the repo rate. To facilitate the development of the SRD-denominated segment of the interbank market, the 80 percent daily minimum requirement for SRR on SRD-deposits will be reduced to 50 percent during 2006 in agreement with Fund staff.

33. **The use of prudential measures to contain macroeconomic and prudential risks resulting from rapid credit growth will continue.** The capital adequacy ratio will be increased from 10 percent to 12 percent on December 31, 2005. To contain the renewed acceleration of consumer lending, the 20 percent downpayment/price ratio and the 30 percent debt-service/income ratio will be applied to all loans to private individuals with a maturity of up to 10 years. The NBS and the government will support the private credit bureau in charge of monitoring individuals' credit risk exposure and payment history.

34. **Exchange rate policy will continue to balance the objectives of reducing inflation and containing the current account deficit.** It will continue to aim at strengthening confidence in the dinar by contributing to reducing inflation, while at the same time striving to maintain external competitiveness. It will be assessed frequently in light of current account, wage, and inflation developments.

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money is projected to rise by 15½ percent in real terms and the net flow of credit to the nongovernment sector to decline from an estimated 10 percent of GDP in 2005 to about 7½ percent of GDP in 2006.

C. Bank Reform and Financial Sector Supervision

35. **The new banking law in Serbia will substantially strengthen the regulatory and supervisory environment.** The law, adopted by Parliament on November 28, 2005, aligns legislation with Basel Core Principles and EU Directives in all key areas.

36. **The NBS will further strengthen on-site and off-site supervision.** To increase the quality of on-site inspections, the NBS will hire new staff and step up internal and external training. It will ensure the timely implementation of corrective measures. Following the analysis of the commercial banks' first quarterly report on their exposure to indirect credit risk resulting from borrowers' exposure to exchange rate risk, the NBS will enhance the monitoring of this type of credit risk and has requested technical assistance from the Fund. It remains firmly committed to withdrawing the license of banks failing to meet the minimum capital requirement, and will act decisively to eliminate regulatory forbearance in other areas.

37. **Restructuring in the insurance sector will continue.** Following the issuance of a tender for hiring a financial advisor for the privatization of the second-largest socially owned insurance company DDOR, 10 bids were received in September. On this basis, the Managing Board of the Deposit Insurance Agency (DIA) approved the short-list of potential financial advisors on December 7, 2005. The diagnostic report for the largest socially owned insurance company Dunav was submitted by the consultant in November. On this basis, the DIA Managing Board adopted a time-bound corrective action plan on December 7, 2005. The NBS will complete an on-site inspection of Dunav by end-2005.

38. **The momentum in bank privatization will be maintained.** The sale of Niska Banka is expected to be completed by end-2005. For Vojvođanska Banka, the selection of the winning bidder is envisaged for Q2 2006. Moreover, after launching the tender for Panonska Banka on October 28, 2005, the government is committed to offering by end-January 2006 its stakes in Credy Banka. Concurrently, with bilateral assistance, the DIA will further strengthen its reporting requirements, control mechanisms, and governance in other banks equity holdings to preserve their value prior to resolution.

39. **In Montenegro, the government will further improve the legislative framework of the financial sector.** It will prepare a new central bank law and a new banking law, and submit them to parliament in the first half of 2006. The new laws aim at increasing competition and strengthening risk management in banks and the role of the banking supervisor. Moreover, a new insurance law, in accordance with EU directives and international standards, to be submitted to Parliament before end 2005, will create a new independent Insurance Agency in charge of regulating and supervising the sector.

D. Enterprise Sector

40. **In Serbia, the wage bill in the eight monitored state-owned enterprises will continue to be controlled to contain inflation pressures and encourage restructuring.** To help ensure that the state enterprise wage bill remains under control, the government

approved in November 2005 a decision establishing quarterly wage bill ceilings for the eight monitored public enterprises in 2006 (Table 2; Annex B).[4] In 2006, the aggregate wage bill in these enterprises will be allowed to grow by 10.3 percent in nominal terms on an annual average basis. By end-December 2005, the government will approve business plans for the monitored companies consistent with the above-mentioned decision.

41. **The restructuring and privatization of SEs will continue.** The Privatization Agency (PA) plans to offer another 120 companies in September-December 2005, and to offer all companies in its portfolio for sale at least once by the end of 2006. Under a World Bank-supported program, the government intends to offer for sale through tenders no less than 18 SEs between October 2005-September 2006, with a success rate of at least 50 percent. The PA will also offer for sale no less than 25 SEs from the list of companies under restructuring, or significant parts thereof, and sell as least 7 of them. Moreover, it plans to offer 450 SEs through auctions during the same period, with a success rate of at least 40 percent. The government will continue to implement its policy of initiating bankruptcy procedures within three months against those SEs that fail twice to be sold through auctions or tenders; it will also initiate bankruptcy proceedings against at least 8 large SEs from the restructuring list between October 2005-September 2006.

42. **Privatization of the spun-off non-core companies and assets will proceed.** The government will complete the process of establishing all these companies as effectively separate companies and clarifying ownership rights, where necessary. It will also appoint by end-December 2005 the government representatives in the managing boards of 38 spun-off non-core companies of public enterprises. The PA will establish a detailed timetable of the necessary actions in this regard, and will proceed with the hiring of financial advisors and other preparations for the sale of the companies. Regarding the 6 non-core companies identified in the previous MEFP that were not spun-off, the government will close, merge, transfer to government entities, or corporatize them by end-December 2005.

43. **The public utilities will strengthen their collections.** In particular, EPS and NIS will enforce penalties on late payments and step up the disconnection of users that are not honoring their obligations for more than two months, including in the case of budget entities or state-owned companies. If the government considers that delivery to these users is imperative for strategic or social reasons, the utility bills will be paid from the budget.

44. **The Serbian government will continue restructuring public utilities and other state-owned companies based on strategic plans.**

- The independent energy regulator, which was legally established in June 2005, will issue tariff methodologies and carry out a tariff review by mid-June 2006.

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[4] These are the electricity, petroleum, railway, postal, telecommunication, airline, airport, and forestry companies.

- After unbundling the electricity company Elektroprivreda Srbije (EPS) into two separate companies, the two companies will start functioning as independent enterprises by January 1, 2006. EPS will continue reducing excess labor following the conclusion of a job systematization review in June/July 2006.
- Following the international tender for hiring an advisor for the privatization of NIS, including advice on selling a majority stake in the two refineries in early 2006, the government will sign a contract with the winning bidder by January 15, 2006 (prior action). The international tender for the privatization of the two refineries, possibly combined with other assets, is expected to be launched in April 2006.
- The financial performance of the railway company (ZTP) will be improved by accelerating restructuring. To this end, the 2006 business plan will envisage continued employment rationalization and spin-offs of non-core activities, and acceleration of service withdrawal or closure for loss-making lines.
- To raise transparency, those monitored public utilities that have not yet published an auditor's report on their 2004 accounts in line with IAS (prepared by a reputable international auditing firm engaging a review partner with relevant industry experience from outside the local office) will do so by end-June 2006. All monitored public companies will publish their 2005 auditor's reports according to the same requirements by end-June 2006.

45. **In Montenegro, privatization will be accelerated and conducted with maximum transparency and accountability.** The government will combine the state holdings in Niksicka Banka to offer them for sale in early 2006. In 2006, it plans to offer a large number of civil and military assets for sale, including all non-core assets of the electricity company (including five small hydroelectric power stations), the Lovcen insurance company, the Crna Gora hotel in Podgoriza, and other smaller hotels. A tender for the Bijela shipyard will be launched in early 2006. Furthermore, the privatization process for the Plantaze vinery will be started in the second half of 2006.

Table 1. Serbia and Montenegro: Quantitative Performance Criteria and Indicative Targets for 2005
Under the 2002–06 Extended Arrangement 1/
(SRD million, unless otherwise noted; end of period)

	2004	2005									
	Dec.	Mar.			Jun.			Sep.			Dec.
	Act.	Program	Program w/adjustor	Act.	Program	Program w/adjustor	Act.	Program	Program w/adjustor	Act.	Indicative Targets
A. Quantitative performance criteria											
Floor on the net foreign assets of the NBS 2/ 3/	1,841	1,608	1,568	2,060	2,029	2,020	2,260	2,304	2,233	2,564	2,712
Ceiling on net domestic assets of the NBS 2/ 4/	-28,485	-22,197	-32,190	-44,935	-51,075	-50,006	-60,472	-60,800	-68,304	-71,144	-81,663
Ceiling on net credit of the banking system to the consolidated general government 2/ 5/ 6/ 7/	-19,106	-10,590	-31,277	-46,702	-43,632	-47,440	-45,447	-61,633	-67,034	-59,380	-90,060
Ceiling on cumulative contracting or guaranteeing during the year by the public sector of new nonconcessional external debt with original maturity of more than one year 8/	348	100		43	200		167	300		222	400
Multilateral creditors (EBRD, EIB, EU, IBRD, and IFC)	348	100		43	200		167	300		222	400
Serbia	286	92		40	184		163	276		201	368
Montenegro	62	8		3	16		3	24		21	32
Other creditors	0	0		0	0		0	0		0	0
Ceiling on new external debt contracted or guaranteed by the public sector with an original maturity of up to and including one year 9/	0	0		0	0		0	0		0	0
Ceiling on new guarantees and the assumption of bank or enterprise debt by the public sector 10/	... 15/	0		0	0		0	0		0	0
Ceiling on outstanding external debt service arrears 3/ 11/	1.7 17/	0		2.2 17/	0		0	0		0	0
Ceiling on the wage bill of the monitored public enterprises 12/	33,964 19/	8,030		8,377 19/	15,941	15,831	18,004	24,180	23,866	27,086	32,700
B. Indicative targets											
Ceiling on net credit of the banking system to											
consolidated general government of Serbia 2/ 5/ 6/ 13/	-19,924	-11,992	-25,410	-39,477	-35,289	-39,787	-37,663	-50,529	-59,160	-51,427	-78,146
consolidated general government of Montenegro 2/ 5/ 13/	818	1,402	-5,867	-7,225	-8,343	-7,652	-7,784	-11,104	-7,874	-7,953	-11,914
Ceiling on net domestic assets of the banking system in Serbia 2/ 14/	112,199	124,601		104,315	113,617		117,187	114,497		134,158	104,126
Ceiling on Serbian central government dinar deposits in commercial banks	0	0		0	0		0	0		0	0
Ceiling on change in the arrears of											
the Union government	1,516	0		569 20/	0		1,043	0		1,633	0
the consolidated general government in Serbia	-974	0		3,530 20/	0		-111	0		1,694	0
the consolidated general government in Montenegro	18	0		667	0		501	0		228	0
Expenditure ceiling for the Serbian Republican budget 16/	...	...		89,008	190,846		186,315	297,513		288,184	406,399
Floor on the collection rate of EPS in percent 18/	89.5	...		90.7	90.6		90.4	91.5		92.4	92.3
Floor on the collection rate of NIS in percent 18/	96.6	...		93.1	100.0		98.7	99.0		95.5	100.3

1/ Quantitative performance criteria and indicative targets are defined in Annex E and evaluated—for program purposes—at end-December 2003 exchange rates for December 2004 and March 2005, and at end-December 2004 exchange rates for June and September 2005. In 2005, figures in section A are performance criteria for March, June, and September and indicative targets for December.
2/ The 2005 performance criteria and indicative targets were adjusted by the amount that actual data differed from the estimates for December 2004.
3/ In millions of U.S. dollars. The net foreign assets floor will be adjusted downward by the shortfall relative to the programed level of net external budgetary financing with a maximum adjustment of US$100 million.
4/ Monitored on the basis of monthly averages as defined in the TMU. Subject to the same adjustment for excess or shortfall in combined budgetary external financing and privatization proceeds for the consolidated Serbian government as defined in 7/.
5/ For program purposes, the ceilings on net credit of the banking system to the consolidated general government will be adjusted downward by the cumulative increase in the stock of government debt held by the nonbank public (other than that related to the frozen currency deposits), starting from January 1, 2004, and upward for any decrease. In addition, in the event of a shortfall in the sum of net foreign budgetary financing and privatization proceeds, the ceilings will be adjusted upward for the shortfall subject to the total adjustment limit of 6 billion dinar for Serbia and € 10 million for Montenegro's consolidated government. The ceilings will be adjusted downward for the excess of combined net external budgetary financing and privatization proceeds relative to budgeted levels that are not used (1) to reduce the government external indebtedness by more than envisaged under the program, or (2) to cover investment and restructuring costs in consultation with the Fund in the context of program reviews.
6/ The adjustors for shortfalls in (i) nonbank domestic financing; and (ii) severance payments apply, as defined in sections II.D, and II.J of the TMU, respectively.
7/ The consolidated general government comprises the Serbian republican and local governments, union level operations, the Montenegrin republican government, the Serbian and Montenegrin social security funds, and the Serbian and Montenegro special extrabudgetary programs as defined in the TMU.
8/ In millions of U.S. dollars. Excluding loans from the IMF and debt contracted in the context of debt restructuring agreements in the framework of the Paris Club and London Club. The public sector comprises the consolidated general government, the National Bank of Serbia, and the Central Bank of Montenegro.
9/ Excludes normal import-related credits.
10/ Quantitative performance criteria for December 2004 and March 2005; indicative targets for the remainder of 2005. Excludes assumption of debt of socially-owned enterprises at the moment of ownership transfer on the basis of the amendment to the privatizaation law adopted by Parliament on May 23, 2005; also excludes indebtedness arising from the fulfillment of existing government guarantees.
11/ Excludes debts subject to restructuring/negotiations. The nonaccumulation of new external arrears is also a continuous performance criterion.
12/ In 2004, the 7 monitored enterprises were JP Elektroprivreda Srbije, JP Naftna Industrija Srbije, JP PTT Srbije, JP Jugoslovenski Aerotransport, JP Zelenicko Transportno Preduzece Srbije, JP Srbija Sume, and JP Srbija Telekom. For 2005, JP Aerodrom Beograd was added to this list. In the case of spin-offs of activities from these companies through the creation of new companies the wage bill target will be adjusted downwards for the wage bill of the spun-off units. Targets are cumulative since the beginning of the respective year.
13/ Consolidated Montenegrin government includes all entities in Montenegro defined under 7/; the rest of entities under 7/ is included in the consolidated Serbian government.
14/ Foreign currency-denominated loans and deposits at program exchange rates, i.e. end-2003 exchange rates for December 2004 and March 2005 and end-2004 exchange rates for the remainder of 2005.
15/ Data have not been provided by the authorities.
16/ The cumulative expenditure ceiling excludes foreign-financed project expenditures, amortization payments (including all FFCDs), and all own-resource financed expenditures of budgetary units.
17/ The performance criterion was breached on account of arrears of Montenegro vis-à-vis Russia, which were cleared in May 2005.
18/ Cumulative since the beginning of the respective year.
19/ Figures were revised owing to misreporting on wage bill data for end-2004 and end-March 2005.
20/ Starting January 2005, figures were revised to incorporate pension arrears into the overall arrears reporting.

Table 2. Serbia and Montenegro: Indicative Targets for 2006
(SRD million, unless otherwise noted; end of period)

	2005	2006			
	Dec.	Mar.	Jun.	Sep.	Dec.
	Indicative program targets 12/	Indicative targets	Indicative targets	Indicative targets	Indicative targets
Floor on the net foreign assets of the NBS 1/ 2/	2,712	2,661	2,558	2,826	2,951
Ceiling on net domestic assets of the NBS 1/ 3/	-81,663	-117,961	-110,750	-121,618	-130,365
Ceiling on net credit of the banking system to the consolidated general government 1/ 4/ 5/ 6/	-90,060	-105,310	-117,815	-151,673	-174,569
Ceiling on cumulative contracting or guaranteeing during the year by the public sector of new nonconcessional external debt with original maturity of more than one year 7/	400	100	200	300	400
Multilateral creditors (EBRD, EIB, EU, IBRD, and IFC)	400	100	200	300	400
Serbia	368	92	184	276	368
Montenegro	32	8	16	24	32
Other creditors	0	0	0	0	0
Ceiling on new external debt contracted or guaranteed by the public sector with an original maturity of up to and including one year 8/	0	0	0	0	0
Ceiling on outstanding external debt service arrears 2/ 9/	0	0	0	0	0
Ceiling on the wage bill of the monitored public enterprises 10/	32,700	9,153	19,536	28,887	38,425
Ceiling on net credit of the banking system to					
consolidated general government of Serbia 1/ 4/ 5/ 11/	-78,146	-92,379	-105,090	-137,621	-159,454
consolidated general government of Montenegro 1/ 4/ 11/	-11,914	-12,931	-12,725	-14,052	-15,115
Ceiling on net domestic assets of the banking system in Serbia 1/	104,126	97,596	129,893	136,838	144,910
Ceiling on Serbian central government dinar deposits in commercial banks	0	0	0	0	0
Ceiling on change in the arrears of					
the Union government	0	0	0	0	0
the consolidated general government in Serbia	0	0	0	0	0
the consolidated general government in Montenegro	0	0	0	0	0

1/ The end-2005 indicative targets were adjusted by the amount that actual data differed from the estimates for December 2004.
2/ In millions of U.S. dollars. The net foreign assets floor will be adjusted downward by the shortfall relative to the programed level of net external budgetary financing with a maximum adjustment of US$100 million.
3/ Monitored on the basis of monthly averages and subject to the adjustors defined in the TMU.
4/ For program purposes, the ceilings on net credit of the banking system to the consolidated general government will be adjusted downward by the cumulative increase in the stock of government debt held by the nonbank public (other than that related to the frozen currency deposits), starting from January 1, 2005, and upward for any decrease. In addition, in the event of a shortfall in the sum of net foreign budgetary financing and privatization proceeds, the ceilings will be adjusted upward for the shortfall subject to the total adjustment limit of 6 billion dinar for Serbia and €10 million for Montenegro's consolidated government. The ceilings will be adjusted downward for the excess of combined net external budgetary financing and privatization proceeds relative to the levels in the TMU.
5/ The adjustor for shortfalls in nonbank domestic financing applies as defined in the TMU.
6/ The consolidated general government comprises the Serbian republican and local governments, union level operations, the Montenegrin republican government, the Serbian and Montenegrin social security funds, the Serbian Road Fund, and the Serbian and Montenegro special extrabudgetary programs as defined in the TMU.
7/ In millions of U.S. dollars. Excluding loans from the IMF and debt contracted in the context of debt restructuring agreements in the framework of the Paris Club and London Club. The public sector comprises the consolidated general government, the National Bank of Serbia, and the Central Bank of Montenegro.
8/ Excludes normal import-related credits.
9/ Excludes debts subject to restructuring/negotiations. The nonaccumulation of new external arrears is also a continuous indicative target.
10/ In 2005, the 8 monitored enterprises were JP Elektroprivreda Srbije, JP Naftna Industrija Srbije, JP PTT Srbije, JP Jugoslovenski Aerotransport, JP Zelenicko Transportno Preduzece Srbije, JP Srbija Sume, JP Srbija Telekom, and JP Aerodrom Beograd. In the case of spin-offs of activities from these companies through the creation of new companies the wage bill target will be adjusted downwards for the wage bill of the spun-off units. Targets are cumulative since the beginning of the year.
11/ Consolidated Montenegrin government includes all entities in Montenegro under 6/; the rest of entities under 6/ is included in the consolidated Serbian government.
12/ Reflects, as appropriate, revisions to the NBS' foreign exchange liabilities, credit to government by the banking system, and broad money at end-2004, and adjustments stemming from changes in the reserve requirement ratio on SRD-denominated deposits.

Table 3. Serbia and Montenegro: Structural Conditionality Under the Extended Arrangement (continued)
Prior Actions, Structural Performance Criteria, and Structural Benchmarks, June 2005-December 2005

	Target Date	Implementation
I. Prior Actions for Completion of the Fifth Review		
1. Serbia: Government to adopt a formal decision on a pension system reform that will increase the retirement age by 2 years for men and women over a period of at most 4 years; shift to inflation-based indexation of benefits over a period of at most 4 years; and replace quarterly with annual indexation.		Met. Adopted on June 2, 2005.
2. Serbia: NBS to increase statutory reserve requirements on enterprises' foreign-currency deposits and on commercial banks' foreign borrowing to 26 percent.		Met. Decision on June 1, 2005.
3. Serbia: Parliament to adopt the law amending the privatization law to facilitate debt workouts for socially owned enterprises, conditional upon privatization.		Met. Adopted on May 30, 2005.
4. Serbia: Government to spin off, register, and transfer to the Privatization Agency 33 companies, non-core assets, and hotels of the 8 monitored state-owned enterprises.		Met. Decision on June 17, 2005.
II. Structural Performance Criteria		
1. Serbia: Government to legally register the new electricity transmission and dispatch company, which will be owned separately from EPS, to allow for the implementation of the EPS restructuring plan.	July 15, 2005	Met. Done on July 1, 2005.
2. Serbia: Parliament to adopt a supplementary budget yielding a surplus of 18.9 billion dinars (including FLIPs, excluding amortization) to support the fiscal stance defined in the MEFP.	end-July 2005	Met. Adopted on July 21, 2005.
3. Serbia: Council of the City of Belgrade to adopt a revised 2005 budget that will reduce spending by 3.5 billion dinars to support the fiscal stance defined in the MEFP.	end-July 2005	Met. Adopted on June 3, 2005.
4. Serbia: Parliament to adopt legislation abolishing the current law on NIS and allowing for the unbundling of the oil and gas company NIS into four separate companies.	end-July 2005	Not met. Adopted with delay on August 22, 2005.
5. Serbia: Government to spin off, register, and transfer to the Privatization Agency 65 companies, non-core assets, and hotels from the 8 monitored state-owned enterprises between July-September 2005.	end-September 2005	Not met. Only 52 previously identified non-core assets spun-off. Compensation: see number 7.
6. Serbia: Parliament to enact a pension system reform increasing the retirement age by 2 years for men and women over a period of at most 4 years; shift to inflation-based indexation of benefits over a period of at most 4 years; and replace quarterly with annual indexation.	end-October 2005	Not met. Law adopted on September 29, 2005, fell short of the agreed parameters. Compensation: permanent savings in health sector, army, and subsidies.
7. Serbia: Government to spin off, register, and transfer to the Privatization Agency all the remaining companies, non-core assets, and hotels from the 8 monitored state-owned enterprises.	end-October 2005	Not met. Six from the list remain to be spun-off. Compensation: 6 non-core companies not identified previously were spun-off as of November.
8. Serbia: Government to submit a 2006 budget to Parliament, after consultation with Fund staff, consistent with the parameters defined in the MEFP and envisaging cuts in permanent expenditure of at least 1 percent of GDP.	November 1, 2005	Met. Submitted on October 31, 2005.
9. Serbia: Parliament to enact a new banking law, as indicated in paragraph 32.	November 15, 2005	Not met. Enacted with delay on November 28, 2005.
III. Structural Benchmarks		
A. Fiscal Sector		
1. Serbia: Reduce the stock of tax arrears to the budget by 5 billion dinars by end-June 2005 relative to end-December 2004.	end-June 2005	Implemented.
2. Serbia: Government to prepare an action plan for restructuring employment in the health sector.	end-September 2005	Implemented on September 22, 2005.
3. Montenegro: Withdraw all central government deposits with commercial banks that do not serve as collateral for loan programs.	end-June 2005	Implemented.
4. Montenegro: Government to prepare an inventory of spending arrears of the consolidated budget and to adopt a schedule for their clearance.	end-June 2005	Implemented with delay in September.

Table 3. Serbia and Montenegro: Extended Arrangement, May 2002–December 2005 (concluded)
Prior Actions, Structural Performance Criteria, and Structural Benchmarks, June 2005-December 2005

	Target Date	Implementation
B. Financial Sector		
1. Serbia: Parliament to adopt new laws on deposit insurance, bank liquidation, and the Bank Rehabilitation Agency.	end-July 2005	Implemented on July 15, 2005.
2. Serbia: Parliament to adopt amendments to the leasing law and the NBS law granting the authority for regulating and supervising leasing companies to the NBS.	end-July 2005	Implemented on July 15, 2005.
3. Serbia: Government to launch an international tender for appointing a financial advisor for the privatization of the largest socially owned insurance company DDOR.	end-July 2005	Implemented on July 29, 2005.
4. Serbia: Launch an invitation for the submission of expressions of interest for Vojvodanska Banka.	end-September 2005	Implemented on September 30, 2005
5. Serbia: Government to adopt a time-bound corrective action plan for Dunav, the second-largest socially owned insurance company.	end-November 2005	Implemented with delay on December 15, 2005.
6. Montenegro: Launch a tender to sell a majority stake in Podgoricka Banka.	end-June 2005	Implemented in June 2005.
C. Enterprise restructuring and privatization		
1. Serbia: Government to adopt, after close consultation with World Bank staff, a restructuring plan for the mining company RTB Bor.	end-June 2005	Implemented on June 17, 2005.
2. Serbia: Launch privatization auctions for at least 130 socially owned enterprises between January and end-June 2005.	end-June 2005	Implemented. 207 enterprises offered.
3. Serbia: Launch privatization tenders for at least 7 socially-owned enterprises, of which 4 from the list of companies under restructuring, between April and end-June 2005.	end-June 2005	Implemented. 8 enterprises offered, of which 4 under restructuring.
4. Serbia: Government to launch an international tender for hiring an advisor for the privatization of NIS, including advice on selling a majority stake in the oil refineries.	end-July 2005	Implemented with delay on September 13, 2005.
5. Serbia: Launch privatization auctions for at least 230 socially owned enterprises between January and end-September 2005.	end-September 2005	Implemented. 297 enterprises offered.
6. Serbia: Government to initiate bankruptcy procedures against 5 large socially owned companies under the new bankruptcy law between June-September 2005.	end-September 2005	Partially implemented. Only 4 bankruptcies initiated. A fifth was initiated by a private creditor. Compensation: bankrupcty initiated against a large company not under restructuring.
7. Serbia: Launch privatization tenders for at least 7 socially-owned enterprises, of which 4 from the list of companies under restructuring, between July and end-October 2005.	end-October 2005	Implemented. 8 enterprises offered, of which 4 under restructuring.

Table 4. Serbia and Montenegro: Prior Actions for the Sixth Review Under the Extended Arrangement

1. Serbia: Government to ensure implementation of the measures described in paragraph 27 to accommodate pension arrears payments in 2005–06. These are: (i) increase in fuel excises by at least 1 dinar per liter, expected to yield SRD 2.4 billion in 2006 (formal government decision by January 15, 2006); (ii) cuts in mortgage subsidies and agricultural lending by SRD 1.5 billion (formal government decision to amend the 2006 spending targets and programs by January 15); (iii) cuts in the budgetary reserve and expenditures for goods and services by SRD 1.6 billion (formal government decision by January 15); (iv) payment of NIS tax arrears in the amount of SRD 1.5 billion (NIS Managing Board decision in December 2005), and (v) elimination of tax exemptions for capital imports, estimated at SRD 1 billion (formal government decision); (vi) in case the surplus of the consolidated general government in 2005 falls short of the targeted 1.1 percent of GDP, additional compensatory measures will be approved through a formal government decision by January 15, 2006. In particular, fuel excises would be increased by another dinar per liter. Should this require a revision in the oil excise formula, the respective government decision would be approved in January 2006.

2. Serbia: Government to sign a contract with the winning bidder of the tender for an advisor for the privatization of NIS, including advice on selling a majority stake in the two refineries, in line with paragraph 44, by January 15, 2006.

SERBIA AND MONTENEGRO: ADDENDUM TO THE TECHNICAL MEMORANDUM OF UNDERSTANDING DATED JUNE 8, 2005

I. INTRODUCTION

1. This addendum complements and updates the Technical Memorandum of Understanding (TMU) attached to the Memorandum of Economic and Financial Policies (MEFP) of June 8, 2005. The understandings defined in the TMU as of June 8, 2005 fully apply to the definitions of the indicative targets for 2006 and reporting requirements remain unchanged.

2. For the purpose of measuring the indicative targets, the public sector consists of the consolidated general government (comprising union operations, Serbian state and local governments, the Montenegrin state government, the Serbian and Montenegrin social security funds, and the Serbian and Montenegrin special budgetary programs), the National Bank of Serbia (NBS), and the Central Bank of Montenegro (CBM). The Serbian government continues to comprise the Road Fund, even after its corporatization in 2005. The authorities will inform Fund staff of any new funds or special extrabudgetary programs that may be created to carry out operations of a fiscal nature as defined in the IMF's *2001 Manual on Government Financial Statistics,* and will ensure that these will be incorporated within the definition of consolidated general government.

II. INDICATIVE TARGETS

A. Floor for Net Foreign Assets of the NBS and Program Exchange Rates

3. **Program exchange rates.** For the purpose of measuring the indicative targets for 2006, all euro and foreign currency-related assets will be evaluated at program exchange rates: For 2006, the program exchange rates are US$1 = SRD 73.3898, €1 = SRD 86.6000, and SDR1 = US$ 1.42647. Monetary gold shall be valued at an accounting price of US$416.85 per ounce.

4. **Adjustors.** For the purpose of measuring indicative targets, net foreign assets will be adjusted upward pari passu to the extent that: (i) after December 31, 2005, the NBS has recovered frozen assets of the FRY, assets of the SFRY, long-term assets, and foreign-exchange-denominated claims on resident banks and nonbanks, as well as SM commercial banks abroad; and (ii) the restructuring of the banking sector by the Deposit Insurance Agency (DIA) involves a write-off of NBS foreign exchange-denominated liabilities to resident banks. The net foreign assets floor will be adjusted downward by the shortfall relative to the programmed level of net external budgetary financing cumulative from December 31, 2005 (US$41.5 million through end-March 2006, US$161.9 million through end-June 2006, US$159.5 million through end-September 2006, and US$158.6 million through end-December 2006) with a maximum adjustment of US$100 million. The net foreign assets floors will also be adjusted by the amount that the end-December 2005 outcome deviates from the projections for end-December 2005 measured at program exchange rates.

B. Ceiling on Net Domestic Assets of the NBS

5. **Adjustors.** The NBS's NDA ceiling is subject to the same adjustor for excess or shortfall in combined budgetary external financing and privatization proceeds for the consolidated Serbian government as defined in Section C, except that the limit for upward adjustment is SRD 3.8 billion. The adjustment for excesses/shortfalls in combined budgetary external financing and privatization proceeds is asymmetric: (a) it applies to the NDA ceiling but not to the NFA floor (except that shortfalls in budgetary external financing trigger an equal downward adjustment in NFA up to a limit of US$100 million); and (b) upward adjustments in NDA are capped at the equivalent of 0.2 percent of programmed annual GDP, while no limits apply to downward adjustments.

C. Ceiling on the Net Credit of the Banking System to the Consolidated General Government

6. **Adjustors.** For program purposes, the ceilings on net credit of the banking system to the consolidated general governments will be adjusted downward by the cumulative increase in the stock of government debt held by the nonbank public (other than that related to the frozen foreign currency deposits), starting from January 1, 2006, and upward for any decrease. These indicative targets will be adjusted by the amount that the end-December 2005 outcome deviates from the projection for end-2005 at program exchange rates. In addition, in the event of a shortfall in the sum of net foreign budgetary financing and privatization proceeds, the ceilings will be adjusted upward by 75 percent of the shortfall subject to the total adjustment limit of SRD 6.5 billion for Serbia’s and €12 million for Montenegro’s consolidated government. Privatization receipts are defined to include all cash privatization receipts (defined as cash received by the government including the privatization agency), including those channeled to extrabudgetary funds, and from asset sales by the public sector and by state-owned or socially-owned enterprises. Net external budgetary financing is defined to include all budgetary (i.e., non-project) grants and loans, less amortization (on a cash basis). The estimation of the shortfalls (excesses) in the sum of net foreign budgetary financing and privatization receipts will be based on the following projections (cumulative from the beginning of 2006) with the actual inflows evaluated at the average exchange rates of the month when funds are received:

Serbia (2005, in SRD billion)

	Mar.	Jun.	Sep.	Dec.
External Financing	1.1	10.3	10.1	10.1
Privatization proceeds	5.8	10.3	33.2	40.5

Montenegro (2006, in € million)

	Mar.	Jun.	Sep.	Dec.
External Financing	9.9	11.1	11.2	11.3
Privatization proceeds	13.4	21.9	30.4	39.0

D. Nonbank Domestic Financing

7. **Adjustor.** If quarterly net nonbank domestic financing deviates from the projected quarterly cumulative path (coinciding with projected cumulative FFCD payments) provided below in billions of dinars, the excess (shortfall) will trigger an equal downward (upward) adjustment in (i) net banking system credit to the consolidated general government (performance criterion) and in (ii) net banking system credit to the consolidated general government in Serbia (indicative target).

	2006			
	Mar.	Jun.	Sep.	Dec
Projected Nonbank Domestic Financing (cumulative)	0.6	13.9	20.7	22.4

E. Reserve Money

8. **Adjustors.** For program monitoring purposes, reserve money will be adjusted as follows. Should the reserve requirement on SRD-denominated deposits increase (decrease) from the level prevailing on December 31, 2005, the ceiling on net domestic assets would be increased (decreased) by an amount equivalent to the change in the standard reserve requirement ratio multiplied by the programmed deposit base used in the calculation of required reserves. Required reserves of banks placed under BRA administration or liquidation will remain part of reserve money for program purposes.

F. Ceiling on the Wage Bill of Serbian Public Enterprises

9. **Definition.** For 2006, the indicative targets are set on a quarterly basis on the cumulative monthly wage bill of eight large public enterprises, namely JP Elektroprivreda Srbije, JP Naftna Industrija Srbije, JP Zeleznicko Transportno Preduzece Srbije, JP PTT Srbije, JP Srbija Sume, JP JAT Airways, JP Telekom Srbija, and JP Aerodrom Beograd. Wages are accounted on an accrual basis, excluding taxes and social security contributions, and include base wages, remuneration for contracted labor, overtime payments, dividend payments, jubilee awards, and any other bonuses.

10. **Adjustors.** In the case of spin-offs of activities from these companies (defined as the spinning off of a unit or its transfer to another entity or temporary/permanent transfers of employees) after end-December 2005, the wage bill target will be adjusted downwards for the wage bills of spun-off units. In the case of a legal separation of core components of the

eight monitored state-owned enterprises, the wage bill of all companies emerging from such separations will be included under the total wage bill ceiling.