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January 16, 2009

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

December 25, 2008

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

Belgrade, December 25, 2008

Dear Mr. Strauss-Kahn:

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

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

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

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

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

Sincerely,

/s/

Mirko Cvetković
Prime Minister

/s/

Diana Dragutinović
Minister of Finance

/s/

Radovan Jelašić
Governor of the National Bank of Serbia

REPUBLIC OF SERBIA

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

December 25, 2008

I. ECONOMIC AND POLICY DEVELOPMENTS

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

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

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

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

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

II. Economic Objectives and Outlook

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

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

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

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

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

III. Economic Policies

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

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

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

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

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

A. Fiscal Policy

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

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

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

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

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

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

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

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

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

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

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

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

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

B. Monetary and Exchange Rate Policies

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

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

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

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

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

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

C. Financial Sector Policies

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

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

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

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

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

D. Structural Policies

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

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

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

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

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

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

IV. Program Monitoring

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

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

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

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

2/ Cumulative from January 1.

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

Table 2. Serbia: Structural Conditionality, 2008–09

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

TECHNICAL MEMORANDUM OF UNDERSTANDING

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

A. Floor for Net Foreign Assets of the NBS

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

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

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

Cross Exchange Rates and Gold Price for Program Purposes 1/

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

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

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

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

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

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

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

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

B. Inflation Consultation Mechanism

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

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

C. Ceiling on External Debt Service Arrears

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

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

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

D. Ceilings on External Debt

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

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

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

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

E. Fiscal Conditionality

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

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

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

Disbursements of project loans by foreign institutions

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

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

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