International Monetary Fund

Republic of Serbia
and the IMF

Press Release:
IMF Completes Fifth Review Under Stand-By Arrangement with Serbia and Approves €366.5 Million Disbursement
September 28, 2010

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Republic of Serbia: Letter of Intent, and Technical Memorandum of Understanding

September 9, 2010

Mr. Dominique Strauss-Kahn Belgrade, September 9, 2010
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Dear Mr. Strauss-Kahn:

1. Our program continues to perform satisfactorily. All end-June 2010 quantitative performance criteria were observed (Table 1). We have also met the structural benchmark on drafting a taxpayer compliance strategy. The fiscal responsibility amendments to the Budget System Law have been drafted, and we will submit the revised law to parliament as a prior action for the IMF Executive Board meeting in late-September (Table 2).

2. The economy is recovering, albeit at a slower pace than we had hoped. Economic indicators for the second quarter of 2010 suggest that growth momentum has strengthened, although employment continued to decline. We expect that the economy will pick up speed during the second half of 2010, in line with the program's projection of moderate but accelerating growth during 2010–11. After inflation had remained below the target tolerance band for six consecutive months, July inflation was within the band. Going forward, we expect to durably stabilize inflation in the low single digit range, although we are concerned about the possible second-round effects of food price increases. Reflecting the adverse spillovers from the Greek crisis, capital flows were disappointing during the second quarter and sovereign risk premia shot up across the region, putting pressure on the exchange rate and constraining our ability to cover budget financing requirements through the issuance of dinar T-bills. With concerns about the Greek crisis subsiding, we also expect that risk premia will gradually normalize across the region, although we have to remain alert to the possibility of new external shocks.

3. In consideration of our good implementation record in a difficult environment and our continued commitment to the program's objectives, we request the completion of the fifth review under the Stand-By Arrangement (SBA) and that SDR 319.6 million be made available. However, in view of our limited balance-of-payments needs at present, we again intend to purchase only SDR 46.7 million at this time. We also request the completion of the financing assurances review. The sixth program review, assessing performance relative to end-September 2010 performance criteria and benchmarks, and a financing assurances review are envisaged for October 2010. The seventh and last program review, assessing performance relative to end-December 2010 performance criteria and benchmarks, and a financing assurances review are envisaged for February 2011.

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

Revised Macroeconomic Framework for 2010–11

5. We continue to expect real GDP to grow at 1½ percent in 2010 and 3 percent in 2011. This pace will likely be insufficient to generate positive employment growth in the near term. But, given nominal wage restraint over the last two years and the recent dinar depreciation, we believe that our labor costs are now sufficiently competitive to underpin broad and balanced growth, which should, albeit with a lag, pay off in sustainable employment increases and higher labor productivity over the medium term.

6. Inflation was below the NBS's target tolerance band throughout the first half of 2010, reflecting persistently low aggregate demand and falling food prices. While we eased monetary policy to counteract the disinflationary impact of these factors on projected inflation, a more forceful policy response to bring inflation back within the tolerance band more quickly was not advisable given the country's high risk premium and financial stability concerns. However, with agricultural product prices surprising on the upside during recent months, due to a poor summer harvest and increased international wheat prices, we believe that risks to inflation are now tilted to the upside. Inflation is projected to increase gradually in the second half of 2010, and should end this year somewhat above the NBS target of 6 percent, but well within the present tolerance band (±2 percent). We project inflation to remain in the upper half of the target tolerance band during most of 2011, moderating toward the end-year target of 4½ percent (±1.5 percent).

7. We expect the external current account deficit to widen again in 2010, following a drop of more than 10 percent of GDP in 2009. The still high trade deficit is from now on expected to narrow only slowly, notwithstanding strong growth in exports. Higher external interest and dividend payments and lower current transfers, especially remittances, will contribute to the widening of the external gap in 2010. In 2011, we expect the current account deficit to stabilize. We do not anticipate any major challenges in covering our external financing requirements during the remainder of 2010 and in 2011. Relative to the first half of 2010, and as confidence in the region returns, our central projection assumes that private inflows will recover. But, given our still high external financing needs, the availability of sufficient sustainable inflows will need to be monitored carefully. Our foreign-exchange (FX) reserves remain at an adequate level, and should be sufficient to deal even with challenging external scenarios.

Fiscal Policy

8. Our fiscal performance was firmly on track during the second quarter, after we narrowly missed the deficit target in March. The deficit target for June was met by a comfortable margin. Revenue collection exceeded plans, helped by stronger-than-projected imports in dinar terms, while expenditure execution remained below plans.

9. For the year 2010 as a whole, we now envisage a small overperformance of general budget revenues (1½ billion dinars). We plan to save this overperformance, in line with a deficit target of RSD 148 billion (4¾ percent of GDP) for 2010. The own-resource budgets of ministries and other government agencies are now projected to receive significantly higher revenue (RSD 10 billion) than earlier projected, but these funds are difficult to monitor and control in our complex budget system, and will probably be spent. At the same time, expenditure underexecution, in particular in the capital budget, could create some scope for budgetary re-allocations later in the year. At this point, we estimate this amount at about RSD 6 billion. However, the sum of demands for additional spending by the Ministry of Economy (mainly for credit and other stimulus measures), the Pension Fund (to allow a prompt and fair one-off payment to pensioners), and the Ministry of Agriculture (to address shortages in milk supply) are likely to significantly exceed the eventual sum available for budgetary re-allocations. We will therefore have to prioritize, and a decision will likely be reached at the time of the next review in October.

10. As a matter of priority the Ministry of Finance will ensure that the increased allocation of RSD 1½ billion for targeted social assistance programs (including RSD 880 million for soup kitchens, delivery of lunch packages for the elderly, and programs for poor municipalities) will be available for implementation starting in October at the latest. A new Social Welfare Law will take effect starting in 2011 and should help appreciably improve the living standards of the most vulnerable parts of the population.

11. Should revenues in 2010 exceed present projections, we remain fully committed to saving the additional revenue overperformance, in line with the principle that automatic fiscal stabilizers should be allowed to operate in both directions.

12. The somewhat weaker market appetite for dinar-denominated T-bills, combined with possible delays in the disbursement of some external loans, will likely impact our financing strategy for 2010. Although this strategy will need to remain flexible, we now project a reduced net volume of T-bill sales relative to what we expected during the previous review, tilted toward shorter maturities. We also may draw down a small portion of our comfortable deposit buffer, while euro-denominated bank financing will be tapped to cover the remaining financing gap.

13. To strengthen budgetary discipline beyond 2010, we will incorporate in our Budget System Law several fiscal responsibility provisions (TMU, ¶20), including:

- A fiscal rule constraining the general government deficit. This rule will set a medium-term deficit target of 1 percent of GDP. If persistent deviations from this medium-term target arise, they will need to be corrected over time at a minimum by about one third per year, but taking into account the economy's pace of growth. Growth exceeding (falling short of) a 4 percent benchmark would allow for faster (slower) correction of the fiscal gap.

- "Golden rule" thresholds to facilitate temporarily high public investment. In particular, given Serbia's still large public investment needs, and given the considerable scope for privatization proceeds, the deficit will be allowed to exceed the maximum thresholds implied by the fiscal balance rule by the amount of public investment exceeding 4 percent of GDP in 2011 and 5 percent of GDP annually during 2012–15. However, the portion of public investment above these ceilings that can be reflected in a higher consolidated general government deficit relative to the general fiscal rule cannot exceed 2 percent of GDP.

- A debt limit. The fiscal balance rule will be supplemented by a limit on the amount of gross public debt, including public guarantees, of 45 percent of GDP, but excluding future liabilities related to restitution.

- Special rules governing public wages and pensions. As specified in the pension law already submitted to parliament, the nominal pension freeze will be maintained through end-2010, with nominal public wages treated in a symmetric manner. Starting in 2011, and through April 2012, increases in pensions and public wages will continue to be treated symmetrically (for details, see TMU ¶20).

- The establishment of an independent fiscal council. The council will be composed of three members in charge of overseeing the implementation of the fiscal responsibility provisions, including preventing possible abuse of the public investment thresholds by shifting current spending to public investment spending.

14. For 2011, and in line with the fiscal responsibility provisions, we plan to achieve a general government deficit target of 4 percent of GDP. As projected revenue is likely to decline further by almost 1 percent of GDP, and since we plan to keep the allocation for public investment at least at the 2010 level (3½ percent of GDP), the available envelope for current expenditure and net lending will be tight. As regards the indexation of public pensions and wages, we now plan to move the first semi-annual CPI inflation indexation step from April 2011 forward to January 2011, while canceling the earlier planned one-off payment to public sector employees and pensioners in January of RSD 4 billion. This modified indexation plan will allow an earlier compensation for possible food price increases during the second half of 2010. The next CPI inflation indexation step in April 2011 will then cover only the prior three months (plus a growth bonus), while the October CPI inflation

adjustment will take place as previously envisaged. We presently estimate the net cost of shifting indexation forward to January at about RSD 4 billion.

15. We have initiated the privatization tender of Telekom Srbija, with potentially significant implications for our fiscal policies during the years ahead. However, in the event that large-scale privatization receipts materialize from this transaction early next year, we are determined to stick to our fiscal deficit targets for 2011 and beyond, consistent with the fiscal responsibility legislation. In particular, Telekom privatization receipts will not be used to finance increases in recurrent spending and net lending operations.

16. In line with the structural benchmark under the program, we have adopted a taxpayer compliance strategy. A separate unit responsible for risk analysis and audit of large taxpayers will be established. We have also adopted an overall tax administration strategy, which envisions the creation of a centralized accounting system with single taxpayer accounts, an introduction of e-filing and e-payments, a centralized database, and a system for efficient human resource management.

17. Starting with the 2011 budget, the Ministry of Finance will be in charge of implementing multiyear budget planning, with a view to improving the planning and execution of priority programs, in particular much-needed infrastructure investments.

18. Notwithstanding repeated delays, we remain committed to implementing structural reforms in the health and education sectors to lend more credibility to our fiscal responsibility target to reduce the general government wage bill to 8 percent of GDP by 2015, with support from the World Bank. Efforts to reform the pay-and-grading system in these sectors will need to be in line with the wage bill target.

Monetary and Exchange Rate Policy

19. Monetary policy will remain focused on keeping inflation within the pre-announced target tolerance bands centered on a 6 percent target for end-2010 and 4½ percent for end-2011. Key risks to our inflation projection arise from uncertainties regarding food prices, exchange rate pass-through to prices, the FX risk premium, and the speed of the euro area's economic recovery. Based on the current inflation outlook and our assessment of inflation risks, we have signaled a possible tightening in our monetary stance.

20. In line with our inflation targeting framework, we will maintain the existing managed float exchange rate regime. FX interventions will continue to be used to smooth excessive exchange rate volatility or to provide liquidity to the market, as needed to ensure its orderly operation, without targeting a specific level or path for the exchange rate.

21. Implementation of the changes to the reserve requirement system adopted in March is proceeding as planned. Through increased credit activity, the effective FX reserve

requirement rate has already declined from a starting level of 40 percent to below 35 percent. By the time the transition to the new system is completed, in April of 2011, the new reserve requirement rate will have fallen to 25 percent on FX liabilities. The simplified system will result in enhanced transparency and efficiency gains, while restoring reserve requirements as an effective monetary policy instrument.

Financial Sector Policies

22. As agreed in Vienna in March 2009, foreign parent banks have maintained their exposures vis-à-vis Serbia, providing a key ingredient for the successful stabilization of the financial sector after the global financial crisis spilled over into Serbia in late-2008. With the crisis having subsided, these exposure commitments have lost much of their urgency, and we reduced the bank-by-bank exposure floors from 100 percent to 80 percent of their end-2008 level beginning in April 2010. At the same time, our regulations require that we will continue to hold banks participating in our Financial Sector Support Program (FSSP) accountable for observing their commitments, including to keep banks well capitalized and liquid, and FSSP incentives will only be available to banks that remain compliant.

23. Our credit support programs helped mitigate the fallout from the sudden bust in credit markets. But we also recognize that credit markets are now functioning more normally and that there is a case for gradually phasing out these programs, which should be announced well in advance. But we also believe that the phase-out should be contingent on a sustained economic recovery. Thus, by the time of the next review, and coordinated with the 2011 budget planning exercise, we intend to announce an exit strategy that will provide borrowers and banks with the details needed to make informed business plans.

24. We have made substantial progress on improving our debt collection and restructuring framework. First, following the adoption of the by-law on prepackaged reorganization plans in May, the first cases were successfully negotiated and concluded. Second, we will soon submit revised amendments to the Law on Payment Transactions to parliament. And third, the working group on out-of-court debt restructuring has drafted a package of legal amendments. However, further discussions between the stakeholders will be necessary to reach full agreement on the complex legal changes involved, and we need to postpone achieving the structural benchmark (TMU, ¶23) to end-November.

25. The implementation of the Basel II framework is on track, and banks will be obliged to use the new accord starting on January 1, 2011. Following two years of preparatory work, the NBS issued the relevant documentation in the first half of this year. Comments received from most banks confirmed their readiness for the new framework. But we still have to align reporting guidelines with EU standards and to issue the loan classification rules.

26. Finally, reducing the financial stability risks from high euroization remains a key priority, and we have moved from general talk to specific actions. The working group on

local currency market development has agreed on specific steps to reduce risks from FX lending. To facilitate FX hedging, we will move ahead with changes in the FX Law and launch a public awareness campaign on the need to hedge. The bank representatives in the group have committed to develop a standardized forward contract. Finally, international financial institutions (IFIs) participating in the group have confirmed their interest in issuing local currency bonds.

Structural Policies

27. We have made some further progress on growth-oriented structural reforms. Given the difficult financial market environment, privatization has been put on hold, with the exception of the preparation for sale of Telekom Srbjia. The restructuring of several key public enterprises, in particular JAT (airline) and ZTP (railway), is proceeding. The recommendations of the guillotine project of cutting unnecessary regulations have only been partially implemented. At the same time, the by-laws and institutions needed to implement the law on competition remain to be put fully in place, and the long-pending company and securities laws have yet to be adopted. In this context, we recognize that the recent proliferation of various charges and levies imposed by various ministries and local governments, and earmarked for their spending, has adversely impacted the business climate.

28. During the remainder of the program, we will take steps to accelerate our structural reform agenda. After assessing all the circumstances, we have decided to sell the majority stake in Telekom Srbjia. We are committed to accelerating the restructuring of JAT and ZTP. We will continue implementing guillotine project and step up our efforts to improve other aspects of the business environment. In particular, we will take steps to fully implement the laws on competition and public procurement, and submit to parliament the company and securities laws by end-2010. We will also review all recent charges and levies imposed by all levels of government and discontinue these practices in the 2011 budget.

/s/
Mirko Cvetkovic
Prime Minister

/s/
Dejan Soskic
Governor of the National Bank
of Serbia

/s/
Diana Dragutinovic
Minister of Finance

Attachment

Table 1. Serbia: Quantitative Conditionality Under the SBA, 2009–10 1/

	2009								2010						
	March		June		Sept.		Dec.		March		June			Sept.	Dec.
	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Adj.	Act.	Prog.	Prog.
Quantitative Performance Criteria															
Floor on net foreign assets of the NBS (in billions of euro)	5.1	6.0	4.4	5.9	3.6	6.5	4.3	6.6	4.0	6.1	4.9		5.4	4.6	4.0
Ceiling on consolidated general government overall deficit (in billions of dinars) 2/	15	12	34	55	58	79	134	121	23	24	72	69	55	109	148
Ceiling on contracting or guaranteeing by the public sector of new short-term external debt (up to and including one year, in millions of euro) 2/	0	0	10	0	10	2	10	2	20	0	20		0	20	20
Ceiling on contracting or guaranteeing by the public sector of new nonconcessional external debt (over one year, in millions of euro) 2/ 3/	200	0	550	100	550	100	550	100	200	0	550		140	600	600
Ceiling on accumulation of government external payment arrears (continuous, in millions of euro)	0	0	0	0	0	0	0	0	0	0	0		0	0	0
Inflation Consultation Bands (in percent)															
Central point	9.2	9.4	8.0	8.3	9.5	7.3	7.5	6.6	5.4	4.7	4.0		4.2	5.3	6.0
Band, upper limit	11.2	n.a.	10.0	n.a.	11.5	n.a.	9.5	n.a.	7.4	n.a.	6.0		n.a.	7.3	8.0
Band, lower limit	7.2	n.a.	6.0	n.a.	7.5	n.a.	5.5	n.a.	3.4	n.a.	2.0		n.a.	3.3	4.0
Indicative Targets															
Ceiling on current expenditure of the Serbian Republican budget (in billions of dinars) 2/	190	152	335	331	520	506	695	689	182	165	354		353	548	750
Ceiling on gross accumulation of domestic guarantees by the Republican budget and the Development Fund and domestic borrowing by the Development Fund (in billions of dinars) 2/	n.a.	n.a.	50	7	50	15	50	15	13	16	50		32	50	50

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

2/ Cumulative from January 1.

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

Table 2. Serbia: Structural Conditionality, 2010

Measure	Target Date	Comment
Prior action		
1.Government to submit to parliament a draft Budget System and Responsibility Law (TMU ¶20).	Before Board meeting	To anchor the authorities' medium-term fiscal adjustment plans and commitments to safeguard fiscal sustainability.
Structural benchmarks		
2. Authorities to adopt or submit to parliament amendments to relevant laws and regulations strengthening the corporate debt collection and restructuring framework.	November 2010	To address the issue of account blockages and foster out-of-court loan workouts to minimize unnecessary and costly bankruptcies and enhance banks' ability to deal with rising NPLs.

TECHNICAL MEMORANDUM OF UNDERSTANDING

REPUBLIC OF SERBIA

Technical Memorandum of Understanding

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

A. Floor for Net Foreign Assets of the NBS

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

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

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

Cross Exchange Rates and Gold Price for Program Purposes 1/

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

1/ March 11, 2009.

5. For purposes of the program, **foreign reserve liabilities** are defined as any foreign currency-denominated short-term loan or deposit (with a maturity of up to and including one year); NBS liabilities to residents and nonresidents associated with swaps (including any portion of the NBS gold that is collateralized) and forward contracts; IMF purchases; and loans contracted by the NBS from international capital markets, banks or other financial institutions located abroad, and foreign governments, irrespective of their maturity. Undivided foreign exchange liabilities of the SFRY are excluded. Also excluded are the amounts received under any SDR allocations received after August 20, 2009.

6. On June 30, 2010 the NBS's net foreign assets, evaluated at program exchange rates, were €5,442 million; foreign reserve assets amounted to €10,170 million, and foreign reserve liabilities amounted to €4,728 million.

7. **Adjustors.** For program purposes, the NFA target will be adjusted upward *pari passu* to the extent that: (i) after June 30, 2010, the NBS has recovered frozen assets of the FRY, assets of the SFRY, long-term assets, and foreign-exchange-denominated claims on resident banks and nonbanks, as well as Serbian commercial banks abroad; and (ii) the restructuring of the banking sector by the Deposit Insurance Agency involves a write-off of NBS foreign exchange-denominated liabilities to resident banks. The NFA floor will also be adjusted upward by any privatization revenue in foreign exchange received after June 30, 2010. Privatization receipts are defined in this context as the proceeds from sale or lease of all or portions of entities and properties held by the public sector that are deposited in foreign exchange at the NBS, either directly, or through the Treasury.

B. Inflation Consultation Mechanism

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

9. Breaching the inflation consultation band limits at the end of a quarter would trigger discussions with IMF staff on the reasons for the deviation and the proposed policy response. A deviation of more than 1 percentage point from either the upper or the lower band specified in Table 1 would trigger a consultation with the IMF's Executive Board on the reasons for the deviation and the proposed policy response before further purchases could be requested under the SBA.

C. Ceiling on External Debt Service Arrears

10. **Definition.** External debt-service arrears are defined as overdue debt service arising in respect of obligations incurred directly or guaranteed by the public sector, except on debt subject to rescheduling or restructuring. The program requires that no new external arrears be accumulated at any time under the arrangement on public sector or public sector-guaranteed debts. The authorities are committed to continuing negotiations with creditors to settle all remaining official external debt-service arrears.

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

D. Ceilings on External Debt

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

13. Excluded from the ceilings are loans from the IMF, EBRD, EIB, EU, IBRD, KfW, CEB, Eurofima, IFC, and bilateral government creditors, as well as debt contracted in the context of restructuring agreements. For the purpose of this performance criterion, the public sector comprises the consolidated general government, the Export Credit and Insurance Agency (AOFI), and the Development Fund.

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

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

E. Fiscal Conditionality

16. **The general government fiscal balance,** on a cash basis, is defined as the difference between total general government revenue (including grants) and total general government expenditure (irrespective of the source of financing) as presented in the "GFS classification table" and including expenditure financed from foreign project loans. For program purposes,

the consolidated general government comprises the Serbian Republican budget (on-budget and own revenue), local governments, the pension fund (employees, self-employed, and farmers), the health fund, the National Agency for Employment, and the Road Company (JP Putevi Srbije) and any of its subsidiaries. Any new extrabudgetary fund or subsidiary established over the duration of the program would be consolidated into the general government. Expenditures exclude the clearance of arrears of the Road Company accumulated up to end-2008.

17. **Adjusters.** The deficit ceiling will be adjusted upward for the additional expenditure that may be needed for potential lender-of-last-resort operations under the financial stability framework, following consultation with IMF staff. It will be increased (respectively reduced) in 2010 by the amount of project loans disbursed by foreign creditors listed in TMU ¶13 above to the general government in excess of (respectively, lower than) the program projections indicated in the table below, in consultation with IMF staff, on the basis of actual disbursements as jointly reported by the Ministry of Finance and the NBS. This adjustment does not apply to program loans and general budget support.

Disbursements of project loans by foreign creditors

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

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

19. The **large public enterprises** monitored under the program include the following 10 enterprises or their successors: JP Elektroprivreda Srbije (EPS), JP Elektromreza Srbije (EMS), JP Transnafta, JP Srbijagas, JP PTT Srbije, JP Jugoslovenski Aerotransport, JP Zeleznice Srbije, JP Srbijasume, JP Aerodrom Nikola Tesla Beograd, JVP Srbijavode. This list excludes JP Putevi Srbije (the Road Company), which is considered part of general government, Naftna Industrija Srbije (NIS), which is in majority private ownership, and Telekom Srbija, which competes with other telecommunication service providers. Going forward, the program will include monitoring of the aggregate wage bill of local utilities.

20. **Fiscal responsibility legislation**. Amendments to the present Budget System Law (BSL) have been adopted by the government, and will be submitted to Parliament in

September 2010 as a prior action for the fifth review. These amendments include the following main provisions:

- Target a medium-term deficit target for the general government of 1 percent of GDP.

- Set a debt ceiling of 45 percent of GDP for the general government, which includes direct debt and guarantees issued by the general government, but excludes obligations based on restitution.

- Establish a rule to ensure that the actual fiscal deficit is on average equal to the medium-term deficit target, by setting the fiscal deficit target each year equal to the previous year actual deficit, minus 30 percent of the difference between the previous year actual deficit and the medium-term deficit target, minus 40 percent of the difference between the projected growth rate of the economy for that year and a benchmark growth rate of 4 percent per year.

- Set "golden rule" thresholds to facilitate temporarily high public investment. The deficit will be allowed to exceed the maximum thresholds implied by the fiscal balance rule by the amount of public investment exceeding 4 percent of GDP in 2011 and 5 percent of GDP annually during 2012–15. However, the portion of public investment above these ceilings that can be reflected in a higher consolidated general government deficit relative to the general fiscal rule cannot exceed 2 percent of GDP.

- Establish an independent fiscal council consisting of 3 members in charge of monitoring the implementation of the fiscal responsibility provisions.

- Establish special rules governing the indexation of pensions and public sector wages and pensions as follows:

    (i) Individual public sector salaries and pensions would increase in January 2011 by the amount of consumer prices growth in the previous six months. In April 2011 and April 2012, these salaries and pensions would increase by the amount of consumer prices growth in the previous three and six months respectively, both augmented by half of GDP growth in the previous year if that growth was positive.

    (ii) In October 2011 and October 2012 the salaries and pensions would increase by the inflation growth in the previous six months.

    (iii) During 2013–2015 the public sector wage bill shall grow at the consumer prices growth rate increased by a half GDP growth in the previous year.

(iv) During 2013–2015 average pensions shall grow at the consumer prices growth rate increased by the GDP growth over 4 percent.

(v) Fiscal rules regulating the development of pensions and salaries shall continue to apply after 2015, until pensions reach 10 percent of GDP and salaries reach 8 percent of GDP.

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

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

F. Financial Sector Conditionality

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

Data Reporting for Quantitative Performance Criteria

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