Serbia and the IMF

Press Release:
IMF Executive Board Completes Seventh and Final Review Under Stand-By Arrangement with Serbia and Approves €353.5 Disbursement
April 8, 2011

Country's Policy Intentions Documents

Serbia: Letter of Intent, Technical Memorandum of Understanding, and Inflation Consultation Letter

March 21, 2011

REPUBLIC OF SERBIA: LETTER OF INTENT (LOI)

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

Belgrade, March 21, 2011

Dear Mr. Strauss-Kahn:

1. Our program has continued to perform well. All end-December 2010 performance criteria were observed (Table 1). In particular, the 2010 fiscal deficit target was met by a considerable margin. We also fulfilled the program's structural benchmark, as the *Law on Voluntary Corporate Financial Restructuring* has been submitted to Parliament. As expected previously, December inflation exceeded the upper program band by 2¼ percentage points. In line with the inflation consultation clause, the National Bank of Serbia (NBS) sent a letter that explains the reasons for relatively high inflation and the monetary policy response.

2. GDP growth has remained on track, but the much-needed transition from consumption-led to more export-led growth is proving more painful than expected. Growth is estimated to have reached 1¾ percent in 2010, and is projected to increase to 3 percent in 2011. The sharp real depreciation over the last two years has leveled the playing field for companies in our tradable sector, as reflected in the rebound of exports to the EU. But the depreciation has also adversely affected the balance sheets of companies with unhedged foreign exchange loans. Small- and medium-sized companies in the nontradable sectors are going through a particularly wrenching economic adjustment, and employment in both the formal and informal segments of the private sector has contracted sharply. Although job security in the public sector remained high, nominal wage and pension freezes sustained through 2009–10 have cut into real incomes of public sector workers and pensioners.

3. Inflation remained high during recent months, reflecting mainly global and local food price shocks, but also the cumulative impact of nominal exchange rate depreciation. The 2010 current account deficit is estimated at 7 percent of GDP, significantly better than expected, mainly due to higher remittances, but also a narrower trade deficit. Capital inflows have reversed course over the last few months, responding to relatively high nominal T-bill yields. But foreign investors are also attracted by sounder economic fundamentals and our improved policy framework, including the new fiscal responsibility legislation. This has been reflected in some appreciation of the dinar and no need for official interventions in the foreign exchange market.

4. We remain determined to use fiscal and monetary policies appropriately to respond to the challenges confronting us:

- As regards fiscal policy, we will implement policies in 2011 and beyond that are consistent with the fiscal responsibility legislation. We are determined to resist trade union pressures for large, sustained increases in wages in excess of the two additional indexation steps already envisaged for May and November 2011. Such wage increases would put fiscal and price stability at risk. To protect the most vulnerable segments of our population, we have already allocated substantial additional resources in the 2011 budget. At the same time, if revenues at the consolidated central government level (Republican budget and social security funds, but excluding own resource budgets) overperform relative to target and overall spending remains in line with budget projections, we plan to use part of the revenue overperformance to provide limited, targeted, and one-off payments to public wage and pension recipients. However, these additional one-off payments will be capped at 0.35 percent of GDP.

- As regards monetary policy, we have responded to the inflation surprise in a measured but determined manner, increasing the policy rate by 425 basis points since August 2010, as well as by scaling back the scheduled easing of reserve requirements during the first quarter of 2011. We will continue to use the full array of our policy tools to ensure that inflation expectations remain reasonably anchored and to bring inflation back into our announced tolerance target band by at the turn of 2011/12.

5. In consideration of our good implementation record, we request the completion of the seventh and last 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, we intend to purchase only SDR 46.7 million.

6. As the SBA comes to an end, we consider that many of the key objectives set at the outset of the program have been achieved, but we also recognize that much remains to be done to lock in a more sustainable growth model. In particular, the SBA has helped contain adverse spillover effects from the global financial crisis that erupted in September 2008. Serbia's economy has so far weathered the crisis better than most of its neighboring peers, and the transition to more export-led growth is making progress. Notwithstanding the large shocks, the financial sector proved highly resilient, and financial crisis preparedness was enhanced. However, the crisis has also taken its toll, especially in the private sector part of the labor market. We intend to build on our achievements by persevering with disciplined macroeconomic policies and by accelerating the pace of structural reforms in the period ahead to secure greater economic prosperity.

/s/

Mirko Cvetkovic
Prime Minister

/s/

Dejan Soskic
Governor of the National Bank of Serbia

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.	Act	Prog.	Adj.	Prel.
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	6.2	4.9	4.9	5.4	4.6	5.0	4.0	4.0	4.9
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	84	148	152	137
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	20	0	20	0	20	20	0
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	550	140	600	170	600	600	180
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	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	4.0	4.2	5.3	7.7	6.0	6.0	10.3
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	6.0	n.a.	7.3	n.a.	8.0	8.0	n.a.
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	2.0	n.a.	3.3	n.a.	4.0	4.0	n.a.
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	354	353	548	543	750	750	747
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	50	18	50	18	50	50	38

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.

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 September 30, 2010 the NBS's net foreign assets, evaluated at program exchange rates, were €5,063 million; foreign reserve assets amounted to €9,842 million, and foreign reserve liabilities amounted to €4,839 million.

7. **Adjustors.** For program purposes, the NFA target will be adjusted upward *pari passu* to the extent that: (i) after September 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 September 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. **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.

20. **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 45 days after the end of each quarter. General government comprehensive fiscal data (including social security funds) would be submitted by the 25th of each month. 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.

REPUBLIC OF SERBIA: INFLATION CONSULTATION LETTER

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund

March 16, 2011

Dear Mr. Strauss Kahn,

1. In December 2010, CPI inflation rose to 10.3 percent, breaching the upper limit of the inflation consultation band (8 percent) agreed under the SBA by more than 1 percentage point. This letter explains: (1) the reasons why inflation has breached the upper limit of the inflation consultation band agreed under the SBA by a significant margin; (2) discusses the policy response; and (3) the outlook for inflation.

2. To summarize, the surprise increase in inflation in the second half of 2010 was mainly driven by three factors: significant shocks to food prices; pass-through from higher than expected dinar depreciation; and rising import prices. In response, starting in August 2010, the NBS has tightened its monetary policy stance substantially. The policy rate has been hiked in seven steps by a total of 425 basis points; moreover, an earlier announced easing of reserve requirements during the first half of 2011 has been largely put off until the inflation outlook is again in line with NBS targets. These measures have succeeded in keeping inflation expectations reasonably anchored, and earlier one-sided depreciation pressures have reversed. Given our policy response so far, our readiness to take further action if needed, and the expectation that most of the shocks will taper off, inflation should gradually return to the NBS' tolerance band at the turn of 2011/12.

Reasons for exceeding the target

3. CPI inflation (year-on-year) remained very low during the first half of 2010, but upside risks surfaced shortly thereafter. Developments through June were driven by low aggregate demand and declining processed food prices. Nevertheless, risks from depreciation pass-through and from the impact of a weak agricultural summer season, resulting in a lower seasonal decline of fruits and vegetables, and large increase in other agricultural prices (wheat, corn etc), were already apparent in July and flagged in the Inflation Report issued in August.

4. The second half of 2010 saw a sharp and unexpectedly strong surge in inflation, leading to the breach of the upper limit of the tolerance band (6±2 percent). The increase in inflation observed since July was driven mainly by three factors:

- *Food price shocks due to bad weather and rising international food prices*. The increase of food prices (food and beverages represents 37.8 percent of the CPI) evident since August was a key contributor to inflation.

- *Depreciation pass-through*. The recent increase in inflation also reflects the weakness of the dinar, fuelled by the euro zone crisis this summer, and possibly combined with a non-linear propagation mechanism. In particular, the observed acceleration of inflation would be consistent with price setters adjusting prices upwards to restore their depleted profit margins after the exchange rate crosses a certain threshold. The dinar depreciated around 40 percent since the start of the global crisis and (on average) by 10 percent last year, while inflation had remained relatively subdued during this period.

- *Recovering import prices*. Falling import prices had contributed to restrain inflation, but they have now recovered strongly contributing to upward inflation pressure. Serbia's import prices rose significantly in the last three quarters of 2010.

5. While initially higher inflation was led by recovering food prices, in recent months, price increases have become more broad-based. The measure of core inflation monitored by the NBS (consisting of CPI exclusive of regulated and agricultural prices) has been steadily increasing, reaching 8.8 percent in December. Core inflation exclusive of other volatile elements, such as processed foods and fuel, had a similar year-on-year increase, although in the second half of the year, the contribution of non-food elements of core inflation was much less than that of processed food.

6. Food prices are on the rise around the globe, but the effect has been particularly pronounced in Serbia. As discussed in the November Inflation Report, food prices in Serbia's neighboring countries rose much less (or even declined) even though they were also facing rising primary agricultural commodity prices. Several steps could help reduce food price volatility in Serbia. The country's efforts to join the EU will support boosting competition in the food market. In addition, high customs duties on food imports will decline and eventually disappear in 2015 with the implementation of the Stabilization and Association Agreement. Finally, the government, in communication with the NBS, is studying measures related to commodity reserves, minimum prices, premium setting, subsidies, which will also seek to reduce food price volatility.

Policy response

7. As a result of the higher inflation, the NBS has taken steps to bring future inflation back into its target range. Specifically, the policy rate has been hiked in seven steps by a total of 425 basis points between August 2010 and March of this year. The NBS has also partially suspended earlier announced decreases in reserve requirements to complement the rate hikes

and reduce the need for additional hikes. As a result of these measures, the policy stance has been significantly tightened.

Inflation outlook

8. Economic activity is expected to recover gradually but there is still a sizeable output gap. The economy is estimated to have grown by around 1¾ percent in 2010 and is projected to grow by 3 percent in 2011 and by 4–5 percent in subsequent years. Under this scenario, an output gap is projected to remain negative over the next few years. Unemployment stands at close to 19 percent, also pointing to significant slack in the economy. The recovery is being led by exports, while domestic demand is expected to start recovering in 2011. The prospects on the external demand front is somewhat clouded by uncertainty surrounding developments in peripheral EU countries. A slowdown in the euro area would dampen prospects for growth in Serbia. On the domestic front, the unfreezing of public wages and pensions starting in January, will give a small boost to demand.

9. Inflation expectations have been consistently above NBS targets but have remained reasonably stable in the face of the acceleration of inflation**.** The various surveys show that one-year-ahead expectations of the financial sector, have risen in recent months, but far less than actual inflation, and remain somewhat above the NBS' target band. For other sectors, expectations are higher.

10. Fiscal policy in 2011 will impart a contractionary impulse, and the budgeted partial indexation of public wages and pensions will also help reduce inflationary pressures. In line with the fiscal responsibility framework, the structural fiscal balance is projected to improve by about 1 percent of GDP. Public wages and pensions were unfrozen after two years, with only moderate nominal increases in January, April, and October. However, as regards regulated prices, higher cigarette excises and energy tariffs will produce a temporary spike in inflation in early 2011.

11. Since late December 2010, the dinar has been on a moderate appreciation trend. Since the trough hit in November, the dinar has appreciated by about 4 percent and is now hovering at around RSD 103 per euro. Since December, NBS interventions in the FX market resulted in a small net purchase of reserves for the first time. The appreciation seems to be the result of a change in market sentiment towards Serbia. Specifically, contrary to what occurred in late 2010, government T-bill auctions have been significantly oversubscribed, and the country risk premium declined.

12. After overshooting the target tolerance band for most of 2011, inflation is expected to decline towards the target by the end of the year. The cost push pressure on food prices and a hefty rise in regulated prices will keep inflation elevated in the first half of 2011 (along with a low base effect) despite low demand and recent appreciation of the dinar. Inflation is expected to fall sharply in the second half of the year and early 2012 on the back of

anticipated relative drop in food prices, and low aggregate demand (along with a high base effect). Given the transmission mechanism, monetary tightening was undertaken since August 2010 is expected to reach its maximum disinflationary impact in the second half of 2011.

13. The NBS will continue to pursue monetary policy in line with targeted inflation in the medium term. The NBS will therefore continue monitoring all relevant inflation factors and will respond in a timely fashion as necessary. The achievement of targeted inflation rates and, more generally, price stability will contribute to a macroeconomic environment conducive to sustainable economic growth and employment, which are the overarching economic policy objectives of the Government of Serbia.

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