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

September 16, 2011

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

## REPUBLIC OF SERBIA

## LETTER OF INTENT

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Belgrade, September 16, 2011

Dear Ms. Lagarde,

The Stand-By Arrangement (SBA) that expired in April 2011 helped us to contain the adverse trade and financial spillover effects from the global financial crisis to Serbia. It also helped to catalyze fiscal and structural policies that should—over the medium term—bring our transition growth model in line with best-performing peers in Eastern Europe.

But the global financial crisis seems by no means to have run its full course, and downside risks to our exports and external funding sources, particularly with regards to EU countries, remain elevated. At the same time, compared with the fall of 2008, our own economy will be able to face any new adverse shocks from a much more balanced external position. Nevertheless, to insure against downside risks and to better anchor our policy framework, we request that the Fund support our new program through a new SBA for a period of 18 months in the amount of SDR 935.4 million (200 percent of quota).

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 (NBS) intend to implement under the new SBA. Our program has the full support of all coalition partners in the present government, and we plan to implement it firmly, notwithstanding upcoming parliamentary and local elections in early 2012. 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 (TMU). There will be six reviews of the arrangement by the Fund, scheduled to be completed by mid-November 2011, mid-February 2012, mid-May 2012, mid-August 2012, mid-November 2012, and mid-February 2013, to assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve its objectives.

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/ | /s/ |
| Mirko Cvetkovic | Dejan Soskic |
| Prime Minister and Minister of Finance | Governor of the National Bank of Serbia |

## REPUBLIC OF SERBIA

## MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

September 16, 2011

## I. RECENT ECONOMIC AND POLICY DEVELOPMENTS

1. **The Serbian economy is only gradually recovering from its severe slump, but inflation has been volatile, while the external trade deficit remains elevated.** Sparked by a recovery of exports to the EU, real GDP grew by about 1 percent in 2010, accelerating to 2¾ percent in the first half of 2011. However, job shedding in the private sector continued throughout the slow recovery, and the unemployment rate is now well above 20 percent. Inflation surged starting in mid-2010, propelled by a series of food price shocks and pass-through from exchange rate depreciation, but has peaked at over 14 percent in April. On the external side, the massive trade deficit in 2008 was almost halved by 2010, but it still remains at a level that requires significant external borrowing.

2. **In response to the global financial crisis, we conducted prudent macroeconomic policies:**

- When output and employment slumped in 2009, our ***fiscal policy*** had to adjust both to correct the underlying weak budget position and to off-set the massive drag on fiscal revenue owing to the rebalancing of the unsustainable external position. To consolidate these gains, we put in place a rule-based fiscal responsibility framework that strikes a reasonable balance between the pace of fiscal adjustment and avoiding an excessively pro-cyclical stance.

- As regards ***monetary policy,*** we maintained and strengthened our inflation targeting framework in a difficult environment of high food price volatility and persistent inflationary pressures from a large exchange rate correction. Despite the recent run-up in headline inflation, inflation expectations remained reasonably well anchored.

- Our ***banking sector*** has weathered the crisis well, reflecting countercyclical prudential policies during the credit boom that created ample liquidity and capital buffers. An important role was also played by our Financial Sector Support Program, which launched an unprecedented private sector involvement (PSI) initiative, supported by both foreign- and domestically-owned banks.

- Finally, progress on ***structural policies*** has admittedly been slower than hoped for, particularly as regards restructuring the large public sector. However, the crisis provided an unfavorable backdrop for implementing far-reaching reforms; and, our structural reform efforts have been in line with what was achieved in other countries in the region.

## II. Program Objectives and Economic Outlook

3. **The program will have two main objectives**:

- First, to preserve macroeconomic and financial stability. Thus, the program seeks to implement monetary, financial, and fiscal policies that will contain internal and external imbalances in what could be an increasingly difficult and uncertain global and regional economic setting.
- Second, to improve the investment climate through specific and targeted structural reforms that address key growth bottlenecks and which command high ownership on the side of implementing agencies.

Our ultimate economic objective remains to put Serbia on a sustainable real convergence growth toward EU income levels.

4. **The baseline macroeconomic framework projects slow real GDP growth, further disinflation, and continued capital inflows to finance the current account deficit**:

- ***GDP growth*** is now projected to effectively stall during the second half of 2011, resulting in annual growth of 2 percent, although there may be upside risks from agriculture, while growth is projected to resume again in 2012. Reflecting the rebalancing of the economy, GDP growth will continue to be driven mainly by investment and exports, whereas consumption growth is expected to remain subdued, reflecting mainly continued job losses in the private sector.
- ***CPI inflation*** is projected to fall well into single digits at end-2011, to come within the NBS tolerance band by mid-2012, and to continue converging toward the middle of the NBS band thereafter.
- The ***current account deficit*** is expected to temporarily rise, before declining gradually over the medium term, stabilizing at around 6 percent of GDP, with the bulk of financing coming from FDI and most of the remainder from bank-intermediated flows.

5. **An abrupt slowdown in regional growth and trade, as well as adverse spillovers from euro-area financial tensions, represent the main risks for the Serbian economy.** Our economy has close trade links to EU and regional economies, while our banking system is largely owned by euro-area banks, some of which could face stress in their own home markets. Thus, as in 2008, our economy could be exposed to significant adverse spillovers if trading partner growth slows or prices of key Serbian export commodities decline sharply. At the same time, availability and pricing of external funding could deteriorate. However, Serbia will face any shocks from a much stronger external position compared with the 2008-09 spillovers. In addition, the NBS's foreign exchange reserves and banks' liquidity and capital

buffers remain comfortable, while the legal and policy frameworks for dealing with problem banks have been upgraded.

## III. ECONOMIC POLICIES

6. To achieve our program objectives, we will pursue the following policies:

- **We will continue fiscal adjustment during 2011–12 in line with minimum requirements of our fiscal responsibility framework**. We believe that fiscal consolidation, consistent with deficit targets of 4½ and just below 4 percent of GDP for 2011 and 2012, respectively, is needed for two main reasons: (i) the fiscal deficit remains well above the medium-term level considered prudent given Serbia's debt level and fiscal risks; and (ii) during a pre-election period, there is a particularly pressing need to reassure investors and the Serbian public that public finances remain under control. In this context, it is important to note that the fiscal deficit rule prescribes the minimum fiscal adjustment required by the fiscal responsibility framework. Given the elevated level of the deficit, we note that the room for letting automatic fiscal stabilizers operate will likely be limited if the growth outlook dims further.

- **On monetary policy, we will continue to use inflation targets as the economy's nominal anchor.** This monetary policy regime has served Serbia relatively well over the last few years, and we will therefore continue to target headline inflation, while maintaining a managed floating exchange rate.

- **Financial stability policies will need to continue to preempt, and, if necessary, be ready to react to shocks.** Our dinarization strategy is designed to reduce financial stability risks over the medium term, mainly through encouraging corporates to avoid or hedge against foreign exchange risks. While present bank liquidity and capital buffers remain reassuring, supervisors will need to monitor closely liquidity and non-performing loans at individual banks.

- **Structural reforms that boost the economy's low capacity to produce, save, and export remain critical for the medium-term success of the Serbian economy.** Serbia's transition to a more efficient, private-sector dominated economy is lagging considerably behind best-performing peers in the region. Thus, we will put in place specific structural reforms that assure property rights, improve the management and transparency of the public enterprise sector, and increase labor market flexibility to support private sector job creation.

### A. Fiscal Policy

7. **In the supplementary budget for 2011, we will target the fiscal deficit of 4½ percent of GDP, in line with the fiscal rule.** Revenue collections this year seem to underperform relative to the 2011 budget, particularly with regard to VAT and social contributions. At the same time, higher-than-expected inflation will result in additional

outlays on wages and social transfers, while the decentralization law adopted by parliament in June will start shifting resources from the central to the local governments in October, and additional capital spending plans have emerged during the year, yielding a fiscal gap of about 1 percent of GDP. As a prior action for SBA approval, we will submit to parliament in September a supplementary budget for 2011. The requirements for the prior action are specified in the TMU (¶12), and include a revised financial plan for the *Roads of Serbia* consistent with the program.

8. **The 2011 fiscal gap will be closed mainly by cutting spending allocations.** We will focus on cutting non-priority capital spending (including on local projects) (½ percent of GDP) and constraining ministries' and other agencies' ability to spend on goods and services and net lending (¼ percent of GDP). The practice of intransparent one-off wage bonuses to particular segments of public employees will be discontinued. Given the tight overall spending envelope and as a consequence of the adverse effect of the decentralization law on central government resources, there will be effectively no room for additional discretionary spending allocations at the Republican budget level. In addition, we are strongly committed to offset through additional spending cuts at the Republican level any spending in excess of agreed targets at other government levels.

9. **We will implement additional fiscal adjustment in 2012.** Under the baseline macroeconomic scenario, the fiscal deficit rule implies a target of 3.9 percent of GDP in 2012. With unchanged fiscal policies, however, current projections would have suggested a fiscal gap of about 2½ percent of GDP. Close to one half of the fiscal gap reflects the full-year effect of the new decentralization law.

10. **We intend to close the identified 2012 fiscal gap primarily through cutting spending.** The fiscal package for 2012 is envisaged to include as the main measures: (i) shifting spending responsibilities, particularly on capital spending and local road maintenance, from the Republican to local governments (¾ percent of GDP); (ii) cuts in subsidies at the Republican level (¼ percent of GDP); (iii) a sharp reduction of net lending operations (½ percent of GDP); (iv) cutbacks in planned low-priority capital and goods and services spending (¾ percent of GDP); and (v), several minor revenue measures, including increasing royalties for mining rights and measures to increase tax compliance (¼ percent of GDP). The 2012 budget will be further discussed at the time of the first review.

11. **We plan to cover the bulk of our near-term financing requirements by issuing a eurobond.** Strong appetite for government paper has helped us to extend the average maturity of our outstanding T-bill stock from about 5 months at end-2010 to about 11 months and has also allowed us to build up a relatively comfortable deposit position of 2½ percent of GDP. In September, we plan to issue a eurobond to cover the remaining financing needs for the year. Should international market conditions turn unfavorable due to global financial tensions, we would try to rely on additional T-bill issuance and domestic bank loans. As a last resort, we could draw on our deposit buffer.

12. **We will take measures to increase payment discipline throughout the public sector.** There is evidence that some payment arrears have been accumulating, in particular at the local government level. We will begin to monitor arrears more closely, and commit to no further arrears accumulation under the program. In order to better control and monitor payment discipline at the local government level we will, by end-December require, as a structural benchmark, that all general government entities report payment arrears on a monthly basis (TMU ¶15). Also, we will introduce obligations for all governments levels to pay outstanding bills due over 60 days by law and a sanctioning mechanism will be put in place, including accrual of penalty interest. In addition, transfers from the Republican budget to local governments will be earmarked for payments on overdue loans or called government guarantees, if applicable.

13. **Additional politically difficult reforms will be needed to ensure a more efficient, fair, and fiscally sustainable public pension system.** With pension contribution rates and budget transfers to the pension system already at very high levels and given Serbia's unfavorable demographics, we face two broad options: cutting pension replacement rates drastically to what would likely be socially unacceptable levels, or to raise effective retirement ages and improve labor market incentives to increase the number of contributors per pensioner. Our preference is for the second option. Therefore, in line with reform efforts in other European countries, we expect that the next government and parliament will need to raise effective retirement ages as a matter of priority, not least in view of the fact that retirement age increases need to be phased in over many years. To prepare technically these reforms, with support from the World Bank, we will study the option of targeting a fiscally affordable and socially sustainable replacement rate for a "standard pensioner," i.e. a pensioner with an average contribution period of 40 years to the pension fund. We will also study options to bring retirement arrangements for coal miners and other professions working under difficult conditions in line with best international practice.

14. **A fiscally responsible draft restitution law has been submitted to parliament.** The draft law, submission of which is a prior action for SBA approval, proposes in-kind restitution where possible, and envisages a cap of about 6 percent of GDP on financial compensation for cases where in-kind restitution is not possible.

15. **We also believe that the next government should consider a revenue-neutral tax reform that would include direct tax cuts.** As discussed already under the previous SBA, the next government should consider a comprehensive tax reform that trades reductions in social contributions for increases in indirect taxes, and possibly also property taxes. This reform would help tradable sector competitiveness, stimulate job creation in the formal sector, and curb activities in the informal sector, although it would have to be carefully designed to address issues of tax regressivity and tax administration.

*16.* **We will tighten requirements for new laws that have significant deficit-increasing implications.** The Pay-As-You-Go principle of matching changes in spending and revenue already imbedded in the Budget System Law (BSL) will be strengthened. In particular, to limit the risk of enacting fiscally irresponsible laws in the course of the year, as a structural benchmark under the program the BSL will tighten requirements for: (i) adopting offsetting measures in response to discretionary fiscal policy relaxations outside of the annual budget process and (ii) estimating financial effects for any draft legislation that may be submitted to parliament (TMU, ¶13).

17. **We plan to strengthen capital budgeting.** The government envisages the following actions to address capital budgeting problems: (i) develop a multi-annual capital budget, underpinned by predictable revenue envelopes (structural benchmark for end-2011; TMU ¶13); (ii) streamline procurement rules for domestically-financed capital spending; (iii) strengthen the capacity of the Budget Preparation Department to evaluate capital investment proposals; and (iv) set up a new unit for public investment in the Ministry of Finance tasked with coordinating and monitoring project identification, evaluation, selection, preparation and financing.

**18. We intend to upgrade the capacity of public debt management.** To better monitor and manage debt risks, we will as a matter of urgency: (i) operationalize the debt data management system; and (ii) strengthen the capacity to assess the risks and trade-offs between alternative debt issuance strategies.

19. **We will modernize further our tax administration to strengthen tax compliance.** To improve compliance, the risk management unit at the tax administration agency will adopt a taxpayer segment-focused risk treatment plan for 2012 (structural benchmark for end-2011). Other steps in this area include plans to link the collection of all wage-related taxes and contributions with the payout of net wages before the end of the year (TMU ¶14).

### B. Monetary and Exchange Rate Policies

20. **While inflationary pressures are expected to continue to recede, further policy actions will have to await the resolution of inflation outlook risks**. As it became evident that inflation had reached its peak in April, we have lowered the policy rate by 75 basis points in two steps since May. With little pressures from aggregate demand and high unemployment, declining food prices due to a strong agricultural season and lower global commodity prices, and no expected impact from exchange rate fluctuations, we anticipate that inflation will continue on a downward path toward the target tolerance band. Nevertheless there are risks: adverse financial spillovers from the euro area could raise the country risk premium, fiscal policy could be loosened prior to next year's elections, and food price pressures may resume if the late summer agricultural seasons turns out to be disappointing. In this context, future policy decisions will depend on the materialization of these risks. Under the program, inflation developments will continue to be monitored using a standard inflation consultation clause (Table 1, and ¶7-8 of TMU). Interventions in the

foreign exchange market will continue to aim at limiting excessive volatility and, if needed, preserving financial stability.

## C. Financial Sector Policies

21. **Further aligning the banking sector's regulatory framework with best international and regional practices remains a priority**. The NBS has announced adoption of the Basel II framework effective end-2011, and has already published the set of by-laws. Important elements under the new framework include: (i) maintaining the capital adequacy ratio (CAR) for the banking sector at 12 percent; (ii) adjusting the capital adequacy decision relating to term debt instruments in line with Basel II; (iii) introducing a capital conservation buffer of 2½ percent, thereby prohibiting profit distribution for banks with CARs below 14½ percent; and (iv) adjusting the calculation of bank's regulatory capital adequacy. In the context of the Basel II implementation, we are also envisaging some relaxation of the conservative bank provisioning regime, while maintaining significant buffers relative to international accounting standard provisions. We expect that the combined impact of these changes will have a negligible impact on required capital levels for the banking sector as a whole.

22. **We believe we have all the necessary supervisory tools to deal with a possible severe downside scenario in the banking system.** We are closely monitoring particularly vulnerable segments of the banking system. Our cooperation with foreign home supervisors has strengthened appreciably, including through our participation in supervisory colleges. During 2010, the bank distress resolution framework was comprehensively reviewed and updated in line with sound international practices.

23. **We will continue our efforts to reduce un-hedged foreign exchange exposures.** Large un-hedged foreign exchange positions, especially in corporate balance sheets, are a source of financial stability risks and constrain the effectiveness of monetary policy. As low and stable inflation are key pre-conditions for higher dinarization, we are committed to continuing our prudent macroeconomic policies. In addition, the NBS and the government in September signed a memorandum laying out a detailed dinarization strategy with two main prongs: (i) promote the use of dinars by developing further the primary and secondary dinar bond markets, issuing long-term dinar securities by IFIs, and using incentives to promote savings in dinar; and (ii) reduce un-hedged foreign exchange risks by developing hedging instruments, while continuing public education on foreign exchange risks. In addition, we will continue to press foreign banks and their home supervisors to proactively support our strategy to reduce un-hedged foreign exchange risks.

## D. Structural Policies

24. **We are initiating long-delayed measures to clarify and guarantee property rights in Serbia**:

- **Construction land**. To facilitate a pickup in foreign direct investment, the remaining bottlenecks for converting construction land from public into private ownership will be addressed. In particular, we have drafted amendments to the law on urban planning and construction and other decisions that would substantially simplify conversion procedures, including by fostering an independent valuation process by credible professional assessors. We will continue to monitor progress on the conversion issue in regular reports that would be made available to the public, and will consider further steps should this progress fall short of expectations.

- **Restitution law**. While the proposed law gives primacy to in-kind restitution, it would protect legitimate private owners, as privatized enterprises would not be subject to in-kind restitution claims. As implementation of the law would play a major role in dispelling private investor uncertainty, we will create and publicize, with periodic updates, an accurate database of properties that are the subject of restitution claims.

25. **To restructure and privatize our still large public enterprise sector, we will take the following actions**:

- **Socially owned enterprises**. As a matter of priority, we plan to resolve the problem of the formerly socially-owned enterprises that are currently in the portfolio of the privatization agency. A working group comprising representatives of the Ministry of Economy, the privatization agency, and other experts will be tasked with providing a plan by the end of the year that includes: (i) an analysis of the viability of the enterprises; (ii) how viable companies can survive without Republican budget subsidies; and (iii) how to transfer some of the responsibilities stemming from the operations of these enterprises to local governments.

- **Large state owned enterprises (SOEs)**. Our focus on SOEs during the program will be to improve their governance and efficiency, and eventually privatize most of them by attracting strategic investors. To help achieve this, during the program period we will: (i) institute stricter government control and monitoring of all SOEs, including establishing binding targets on their wage bills (structural benchmark for end-2011; TMU ¶23); (ii) complete the incorporation of all large SOEs (structural benchmark for end-2012; TMU ¶23); (iii) improve the transparency of SOEs’ operations by publishing regularly their financial results; and (iv) strengthen the managerial professionalism and operational independence of SOEs, including through selection of managers strictly based on professional criteria.

26. **To spur creation of much-needed private sector jobs, we also plan to reform the labor market, sequenced in two steps**:

- In the first step, as an end-October structural benchmark, the Ministry of Labor will submit to the Social and Economic Council amendments to the labor law that: (i) base the calculation of severance pay only on the duration of employment with the last employer; and (ii) extend the duration of fixed-term contracts from one to three years (TMU ¶22). It is expected that the amendments would be forwarded to parliament in due course.

- In the second step, we will conduct a comprehensive review of other labor market rigidities, active labor market policies, and collective bargaining, with additional reforms to be supported by structural benchmarks in future program reviews.

27. **In addition, we will continue to push forward with a broad array of other structural reforms.** First, in cooperation with the World Bank, we will build on the recent acceleration of progress in implementing the regulatory guillotine. Second, while our legal framework for competition policy is now broadly in line with European standards, we will improve implementation, including through upgrading the capacity of the Competition Commission, drawing on the lessons of a recent peer review of the framework. Third, the just-enacted energy law is a significant step in the right direction opening up opportunities for reforming this important sector, which we intend to pursue in cooperation with the World Bank and EBRD. Fourth, we will work on realizing the significant potential of our agricultural sector in co-operation with the World Bank and other donors. Finally, we will intensify our efforts in promoting Serbia's trade integration, including re-establishment of supply chains that were broken over the past two decades.

## IV. Program Monitoring

28. 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, with definitions provided in the attached Technical Memorandum of Understanding. Quantitative targets for September and December 2011 are PCs.

Table 1. Serbia: Quantitative Conditionality Under the SBA, 2011 1/

| | 2011 | |
|---|---|---|
| | Sept. Prog. | Dec. Prog. |
| Quantitative Performance Criteria | | |
| Floor on net international reserves of the NBS (in billions of euro) | 4.7 | 4.5 |
| Ceiling on consolidated general government overall deficit (in billions of dinars) 2/ | 110 | 153 |
| 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 |
| Ceiling on contracting or guaranteeing by the public sector of new nonconcessional external debt (over one year, in millions of euro) 2/ 3/ | 993 | 1950 |
| Ceiling on accumulation of public sector external payment arrears (continuous, in millions of euro) | 0.0 | 0.0 |
| Inflation Consultation Bands (in percent) | | |
| *Central point* | 9.5 | 7.9 |
| Band, upper limit | 11.5 | 9.9 |
| Band, lower limit | 7.5 | 5.9 |
| Indicative Targets | | |
| Ceiling on current expenditure of the Serbian Republican budget (in billions of dinars) 2/ | 614 | 827 |
| Ceiling on gross accumulation of payment arrears of the Serbian Republican budget (in billion of dinars) | 0.0 | 0.0 |
| 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/ | 30 | 30 |

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 under the SBA, 2011-2012 [1]

| Measure | Target Date |
|---|---|
| **Prior actions** | |
| 1. Submit to parliament a 2011 supplementary budget and adopt supporting measures consistent with the program (¶7) | September 22, 2011 |
| 2. Submit to parliament a restitution law that includes a fiscally responsible cap on financial restitution payments(¶14) | September 22, 2011 |
| **Structural benchmarks** | |
| 1. Labor Ministry to submit to Economic and Social Council amendments to labor legislation that bases severance pay on duration of employment at last employer and extends duration of fixed contracts (¶26) | End-October 2011 |
| 2. Adopt a taxpayer segment focused risk treatment plan for 2012 (¶19) | End-December 2011 |
| 3. Strengthen capital budgeting framework (¶17) | End-December 2011 |
| 4. Tighten Pay-As-You-Go rules in the Budget System Law (¶16) | End-December 2011 |
| 5. Introduce stricter financial control on largest SOEs, including wage bill targets (¶25) | End-December 2011 |
| 6. Begin reporting on a monthly basis payment arrears for all consolidated general government entities (¶12) | End-December 2011 |
| 7. Complete incorporation of all large SOEs (¶25) | End-December 2012 |

[1] Additional structural benchmarks may be agreed in the context of future reviews.

## REPUBLIC OF SERBIA

## TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This Technical Memorandum of Understanding (TMU) 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 August 1, 2011, except as noted below.

### A. Floor for Net International Reserves of the NBS

| | In billions of euro |
|---|---|
| Outstanding stock: | |
| End-July 2011 | 5.8 |
| Floor on international reserves: | |
| End-September 2011 (performance criterion) | 4.7 |
| End-December 2011 (performance criterion) | 4.5 |

2. **Net international reserves** (NIR) of the NBS are defined as the difference between reserve assets and reserve liabilities, measured at the end of the quarter.

3. For purposes of the program, **reserve assets** are readily available claims on nonresidents denominated in foreign convertible currencies. They include the NBS holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, and the country's reserve position at the Fund. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered (e.g., pledged as collateral for foreign loans or through forward contracts), undivided assets of the former Socialist Federal Republic of Yugoslavia (SFRY), NBS' claims on resident banks and nonbanks, as well as subsidiaries or branches of Serbian commercial banks located abroad, claims in foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options), precious metals other than monetary gold, assets in nonconvertible currencies, and illiquid assets.

4. For purposes of the program, **reserve liabilities** are defined as all foreign exchange liabilities to residents and nonresidents with a maturity of less than one year, including commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options, including any portion of the NBS gold that is collateralized), and all credit outstanding from the Fund. Excluded from reserve liabilities are undivided foreign exchange liabilities of the SFRY, government foreign exchange deposits with NBS, and amounts received under any SDR allocations received after August 20, 2009.

5. For purposes of the program, all foreign currency-related assets will be valued in euros at program exchange rates as specified below. The program exchange rates are those that prevailed on July 31, 2011. Monetary gold will be valued at the average London fixing market price that prevailed on July 31, 2011.

**Cross Exchange Rates and Gold Price for Program Purposes**

| | Valued in: | | | | |
|---|---|---|---|---|---|
| | RSD | Euro | USD | SDR | GBP |
| Currency: | | | | | |
| RSD | 1.0000 | 0.0098 | 0.0140 | 0.0088 | 0.0086 |
| Euro | 102.1252 | 1.0000 | 1.4333 | 0.8964 | 0.8773 |
| USD | 71.2517 | 0.6977 | 1.0000 | 0.6254 | 0.6121 |
| SDR | 113.9315 | 1.1213 | 1.5990 | 1.0000 | 0.9826 |
| GBP | 116.4084 | 1.1399 | 1.6338 | 1.0217 | 1.0000 |
| Gold | 116,033.6310 | 1,136.19 | 1,628.5 | 1,018.4 | 996.7453 |

6. **Adjustors.** For program purposes, the NIR target will be adjusted upward *pari passu* to the extent that: (i) after August 31, 2011, the NBS has recovered frozen assets of the SFRY, 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 NIR floor will also be adjusted upward by any privatization revenue in foreign exchange received after August 31, 2011. 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

7. 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.

8. 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. Fiscal Conditionality

9. **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, the Roads of Serbia Company (JP Putevi Srbije) and any of its subsidiaries; and foreign-financed expenditures by the company Corridors of Serbia. Any new extrabudgetary fund or subsidiary established over the duration of the program would be consolidated into the general government.

10. **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.

11. **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.

12. **Supplementary 2011 budget (prior action).** The government will submit the 2011 supplementary budget to parliament, as well as enact a package of supporting measures consistent with the program by September 22, 2011. In particular: (i) given the target for the general government budget deficit in 2011 of RSD 153 billion, the Republican budget deficit (including the balance of own-resource budgets but excluding foreign-financed capital spending) would be limited to RSD 134 billion; (ii) Republican budget expenditure including transfers to other levels of government will not exceed RSD 850 billion; (iii) a government decision will ensure a surplus in the balance of own-resource budget users of at least RSD 9 billion in 2011; and (iv) a revised financial plan of the *Roads of Serbia* will be consistent with the full-year deficit of RSD 1.6 billion.

13. **Fiscal responsibility and capital budgeting.** The following two changes to the Budget System law will be introduced**.**

- Amended Article 47 would clarify that new legislation adopted in the course of the fiscal year that envisions a reduction of revenues or an increase in expenditures should be *simultaneously* accompanied by legislation with an offsetting effect on the fiscal deficit, (i.e., envisioning either an increase in revenues or a decrease in expenditures). Amended Article 48 would extend the requirements for an estimate of the financial effects to any legislative proposals that are submitted to Parliament (not just those that are submitted to the government). These estimates would be required to contain an opinion of the Ministry of Finance regarding their accuracy. In addition, the Ministry of Finance would prepare a rulebook that would contain a set of minimum requirements for such estimates.

- A new article on medium-term investment priorities would be inserted, to require budget beneficiaries in charge of public investment to determine medium-term public investment priorities and deliver them to the Ministry not later than by 15 March. Also, the Ministry should deliver to budget beneficiaries the instruction on the contents of plans expressing the medium-term public investment priorities, and the government should be required to adopt the combined and harmonized plan of medium-term public investment priorities. The adopted medium-term public investment plan should be included in the revised Memorandum and plans for the implementation of medium-term public investment priorities shall be prepared as a part of financial plans of budget beneficiaries.

14. **Tax administration**. Building on the 2011 compliance strategy's principles for compliance management, the risk management unit at the tax administration should develop and adopt a taxpayer segment-focused risk treatment plan for 2012, which describes on a segment basis: (i) the exact compliance problems to be mitigated within that year; and (ii) the compliance measures (including guidance, audit, enforcement, and other means) that will be utilized to achieve this and ensure overall improvements in compliance (structural benchmark for end-December 2011).

15. **Domestic arrears.** For program purposes, domestic arrears are defined as the belated settlement of a debtor's liability which is due under the obligation (contract) for more than 60 days, or the creditor's refusal to receive a settlement duly offered by the debtor. The program will include indicative targets on the change in domestic arrears of all consolidated general government entities as defined in ¶15 above except local governments. Arrears to be covered include outstanding payments on wages and pensions; social security contributions; obligations to banks and other private companies and suppliers; as well as arrears to other government bodies.

## D. Ceilings on External Debt

16. **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.

17. 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 purposes of the program, the public sector comprises the consolidated general government, the Export Credit and Insurance Agency (AOFI), and the Development Fund.

18. 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.

19. **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. Ceiling on External Debt Service Arrears

20. **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.

21. **Reporting.** The accounting of non-reschedulable 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.

## F. Other Structural Reforms

22. **Labor law.** The labor law that would be submitted to the Social and Economic Council would include the following main changes. First, Article 37 would be amended to

lengthen the maximum length of fixed contracts from 12 months to 3 years. Second, revised Article 158 would stipulate that the existing method of calculation of severance benefits for redundant employees would be based on employment history with the last employer, instead of the entire employment period of a given employee. Any other changes to the law that may be introduced concurrently should not increase the restrictiveness of the labor market regulation.

23. **Large state owned enterprises (SOEs)**. The SOEs 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. Under the program, wages bills for large SOEs will be adjusted using the indexation formula applicable for pensions and public sector wages and salaries set out in the Budget System law. In addition, the Ministry of Finance will ensure that the payment of wages by large SOEs during the course of the year is consistent with their approved annual financial plans. Finally, by end-2012, the government will make the needed changes to the legal framework and the foundation acts of large SOEs to permit their incorporation as joint stock companies, including the right to own the assets currently in their use.

24. **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 of Serbia, 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 25$^{th}$ 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.

Data Reporting for Quantitative Performance Criteria

| Reporting Agency | Type of Data | Timing |
|---|---|---|
| NBS | Net international reserves 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 |