INTERNATIONAL MONETARY FUND

Staff Country Reports

January 2005
IMF Country Report No. 05/13

Serbia and Montenegro: Fourth Review Under the Extended Arrangement, Financing Assurances Review, and Request for Waiver of Performance Criteria and Modification of End-December Performance Criterion—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Serbia and Montenegro

In the context of the fourth review under the Extended Arrangement, financing assurances review, and request for waiver of performance criteria and modification on end-December performance criterion with Serbia and Montenegro, the following documents have been released and are included in this package:

- the staff report for the fourth review under the Extended Arrangement, financing assurances review, and request for waiver of performance criteria and modification on end-December performance criterion, prepared by a staff team of the IMF, following discussions that ended on October 22, 2004, with the officials of Serbia and Montenegro on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 30, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of December 15, 2004 updating information on recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during its December 15, 2004 discussion of the staff report that completed the review and request.

- a statement by the Executive Director for Serbia and Montenegro.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Serbia and Montenegro*
Memorandum of Economic and Financial Policies by the authorities of Serbia and Montenegro*
Technical Memorandum of Understanding
*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

SERBIA AND MONTENEGRO

Fourth Review Under the Extended Arrangement (EA), Financing Assurances Review, Request for Waivers, and Modification of an end-December 2004 Performance Criterion

Prepared by the European Department
(In consultation with other Departments)

Approved by Susan Schadler and Donal Donovan

November 30, 2004

Fund Relations: The third review of the-three year EA approved in May 2002 (SDR650 million, 139 percent of quota) was completed in June 2004 (Appendix I), with a total of SDR400 million disbursed. Completion of the fourth review will enable SM to receive SDR 62.5 million. The Article IV Board discussion is envisaged in March, 2005 together with the postponed fifth review.

Key issues with the review: Discussions focused on policies to rein in the persistently large current account deficit and resurgence in inflation. The agreed tighter fiscal, monetary and incomes policies should cool off wage and credit growth, which are driving the demand for imports. The bold resumption of structural reforms should over time help increase exports, which remain exceptionally low in reference to GDP. While the envisaged reforms would advance transition and reduce macroeconomic vulnerability, they are subject to large implementation risks.

Discussions: These took place in Belgrade and Podgorica during September 15–29 and October 19–22. The mission met with the President and Prime Minister of Serbia, key economic ministers, central bank governors, representatives of trade unions, the private sector, and think tanks, and coordinated its work with World Bank staff (Appendix II). Mr. Antić (OED) also participated in some of the meetings. The mission comprised Ms. Sorsa (head), Ms. Li, Messrs. Gorbanyov, Horváth, Westphal (all EUR), Sdralevich (PDR), Chua (FAD), Charap and Hirschhofer (outgoing/incoming Resident Representatives).

Letter of Intent: The attached Memorandum of Economic and Financial Policies (MEFP-Appendix III) describes the governments' program for the remainder of 2004 and 2005.

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Appendices

Executive Summary

Background: Macroeconomic developments have been mixed. Growth estimated at 6 percent is stronger than projected, supported by robust domestic demand and a bumper crop in agriculture. However, inflation at 11 percent in October is higher than forecast, and the external current account deficit has widened to an estimated 13 percent of GDP in September. This reflects strong imports due in part to higher oil prices, wage and credit growth and the persistently low level of exports owing to slow structural reforms. Fiscal and monetary policies have been tightened beyond program commitments since mid-year to rein in inflation and the current account deficit, which nevertheless will remain above program targets for the year. Structural reforms have been reinvigorated recently with the enactment of key reform laws and progress with bank and enterprise privatizations. However, the fragile political situation could affect the ability of the reformist minority government to press ahead with bold reforms.

Discussions: These focused on macroeconomic policies to contain risks associated with the widening external imbalance and resurging inflation, and on advancing structural reforms critical to a sustainable correction in the external balance. The authorities agreed to tighten fiscal policies in 20040~~0~~5 beyond program commitme nts with an overall adjustment of about 3 percentage points of GDP (excluding redundancy payments) bringing the 2005 SM fiscal deficit well below one percent of GDP. The 2005 budget includes a shift to indirect taxes, in particular with the introduction of VAT in Serbia. The SM fiscal program also includes substantial restraint in current spending, including on wages and subsidies, making room for expected higher debt service. Staff encouraged even larger cuts in subsidies and the budgetary wage bill to reduce wage pressures, but the authorities insisted that the planned nominal wage increases were necessary to support public administration reforms. The budget includes redundancy payments to support large expected retrenchments, and active labor market policies to help job search. While noting the impact of increased financial intermediation on growth, the Serbian authorities agreed to take measures to tighten credit expansion that is feeding import growth and to strengthen financial supervision to reduce prudential risks. They also agreed to substantially restrict incomes policies in state enterprises and speed up restructuring, while emphasizing the potential social and political difficulties of the reforms. Bank and enterprise privatization will also be accelerated.

Staff appraisal: The response of fiscal, monetary, incomes and structural policies to growing risks is adequate, although subject to large implementation risks. Growth in 2005 is expected to recede to 4~~5~~ percent and inflation to return to single digits by end-year. The rationalization of budget spending is commendable, although wage policy in the budget sector could have been even tighter to contain demand pressures in the economy. While the increase in financial intermediation is welcome, the tightening of conditions for credit and enhanced prudential supervision are necessary to contain external risks. The acceleration of enterprise restructuring and privatization is welcome.

I. Introduction

1. **Program implementation has been mixed (Tables 1–2 of Appendix III).** All but four end-June, and two end-September performance criteria (PCs) were observed. While the end-June ceilings for the NDA of the central bank and bank credit to government in Serbia were missed (mainly due to lower-than-expected privatization revenues and foreign disbursements), they were met at end-September. Montenegro failed to observe the PC on debt guarantees by a small amount in September due to debt workouts related to a privatization transaction, and the PC on new multilateral non-concessional debt at end-June and end-September due to coordination problems now being solved. Performance on structural benchmarks and indicative targets was mixed, calling for better policy implementation.

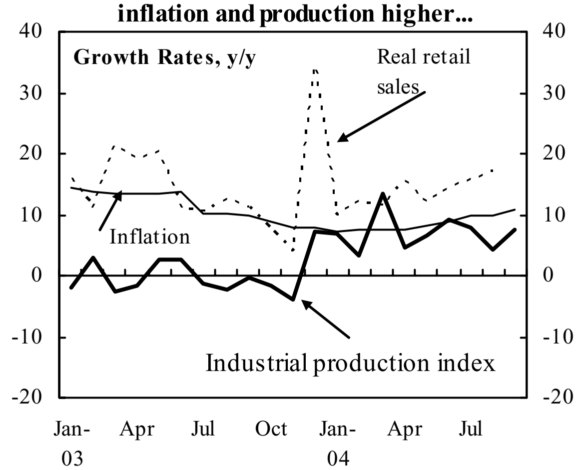
2. **The fragile political situation carries considerable policy implementation risks.** The minority government in office since March co-habits with an opposition, although reformist, President. Its position was strengthened in October with the enactment of the revised budget for 2004 and the appointment of three new Ministers by parliament. However, economic policy discussion is shadowed at times by the political agenda related to extradition requests for war crime suspects, the future of Kosovo, and the sustainability of the SM union. This reduces attention to economic reforms and slows down EU accession prospects.

II. Recent Developments

3. **Macroeconomic risks have increased in 2004:**

- **Led by domestic demand, GDP growth has been robust (Table 1, Figure 1)**. SM GDP growth projected at 6 percent for the year is stronger than programmed, reflecting a bumper crop in agriculture and solid industrial activity. In Serbia, wage increases averaging 12 percent in the year through September boosted domestic demand including for imports, with retail sales growing at 15 percent in the year through August.[1]

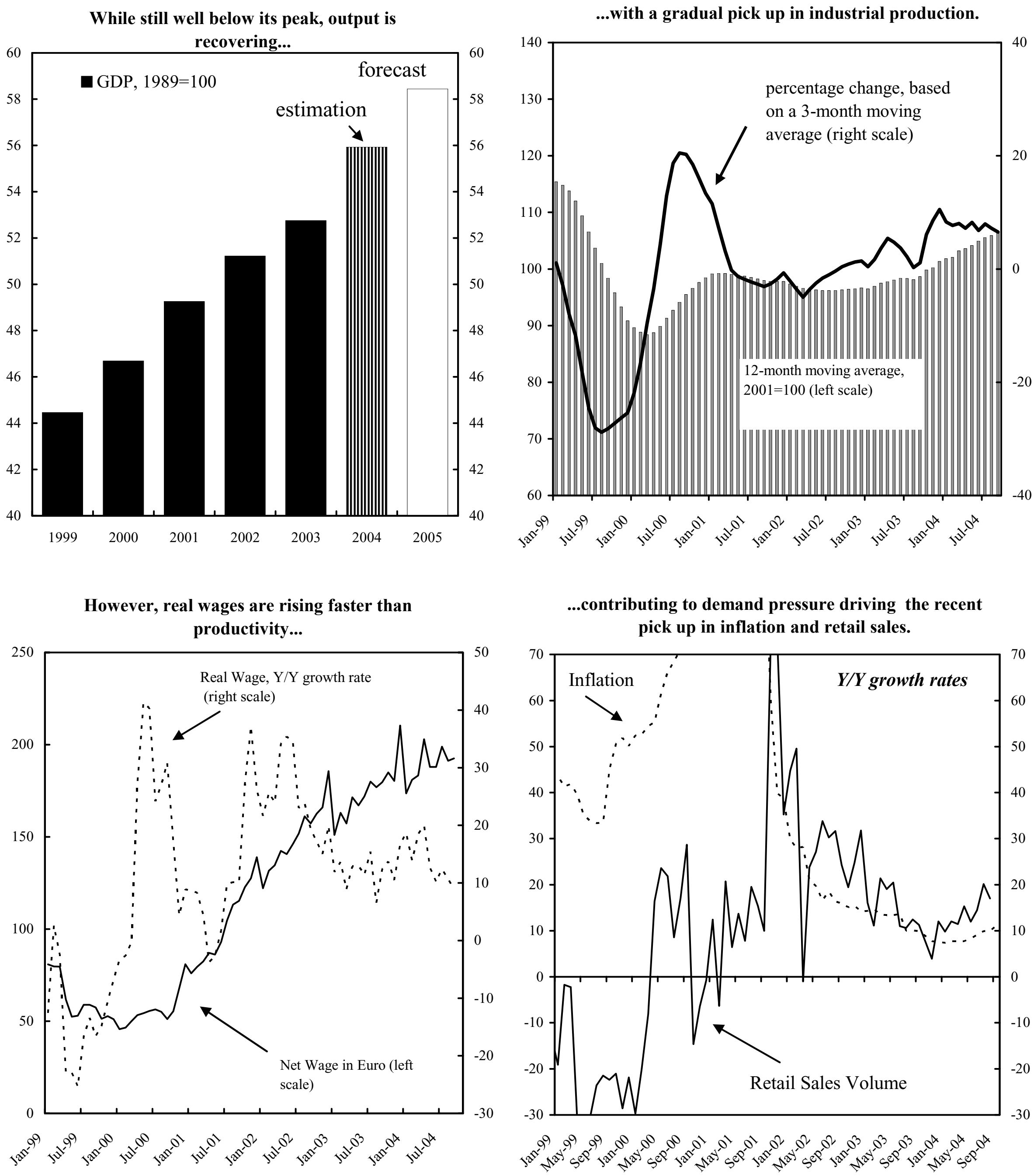
The strong domestic demand pushed both inflation and production higher...



Sources: Serbian Office of Statistics; National Bank of Serbia; and IMF staff calculations.

[1] While data are poor, wage increases beyond productivity seem to have taken place mainly in the socially owned enterprises, enabled by arrears build-up and subsidies. The large pre-election wage increases at end-2003 in the public sector also boosted wage growth in 2004 directly and via the demonstration effect.

Figure 1. Serbia and Montenegro: Output, Wages, Inflation and Retail Sales
January 1999–September 2004 1/



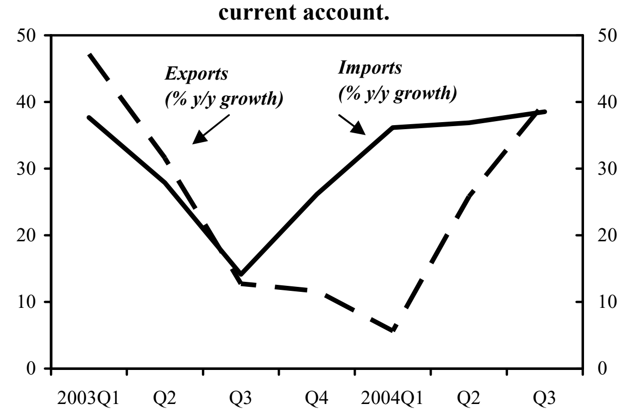
Sources: Serbian Office of Statistics; National Bank of Serbia.
1/ Data refer to the territory of Serbia and Montenegro excluding Kosovo after February 1999.

- **Wage increases along with higher oil prices also pushed inflation beyond program targets.** Twelve-month inflation at 11 percent in October is likely to reach 12–13 percent by end-year compared to 8–9 percent in the program. Two-thirds of the excess is explained by domestic factors, mainly wages, and the remainder by energy prices.

- **While financial deepening and intermediation improved, rapid credit growth has fed rising imports and strained risk management in banks (Table 2, Figure 2).** The 24 percent real growth in broad money in the year through September in Serbia reflects mostly increased confidence in banks. Coupled with a surge in bank foreign borrowing, this has fed credit growth by 28 percent (consumer loans by 93 percent) in real terms in the year through September, albeit from a low base.[2] With most loans denominated in, or indexed to foreign currency, concerns about credit risks for banks are serious. The supervisory capacity of the NBS, which is only gradually being strengthened, is clearly strained. In Montenegro, real credit growth (40 percent in the year through August) raises similar concerns. Despite financial deepening, the efficiency of intermediation remains low with spreads in double digits, which are the highest in the region and suggest the need for more competition in the sector.

- **Higher oil prices, strong import growth, and sluggish exports are likely to keep the current account deficit well above the end-year program target (Tables 3–4, Figure 3).** Import growth, particularly of consumer goods, outpaced export growth. The large trade deficit was partly offset by strong private remittances. The resulting current account deficit of 13 percent of GDP in the year through September is likely to persist until end-year, well above the programmed 11 percent of GDP. Higher-than-programmed oil prices explain about half of the excess. The increasing share of debt-financing (close to 40 percent), including via leasing from abroad,

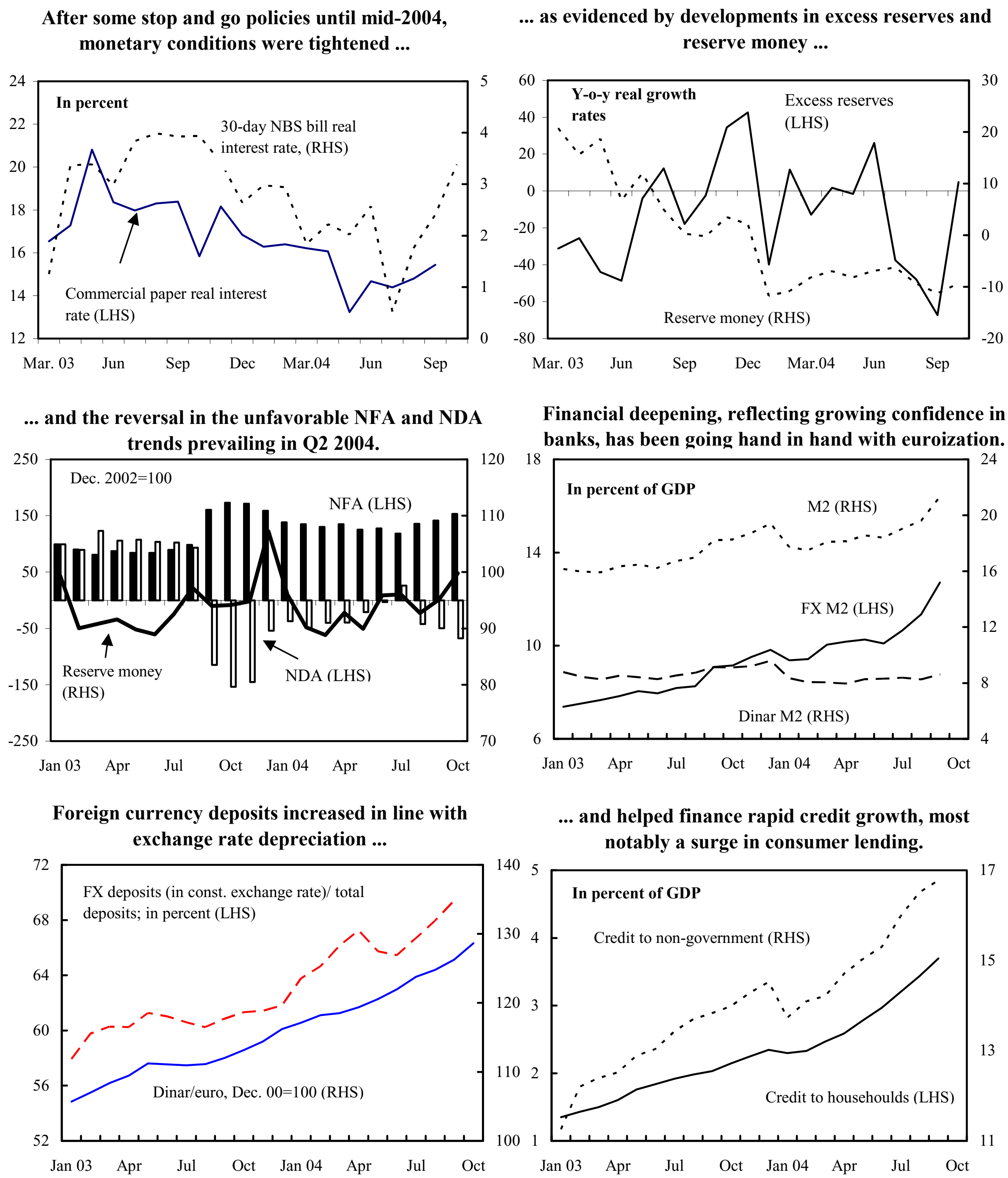
Surge in imports worsened the current account.



Sources: Serbian Office of Statistics; National Bank of Serbia; and IMF staff calculations.

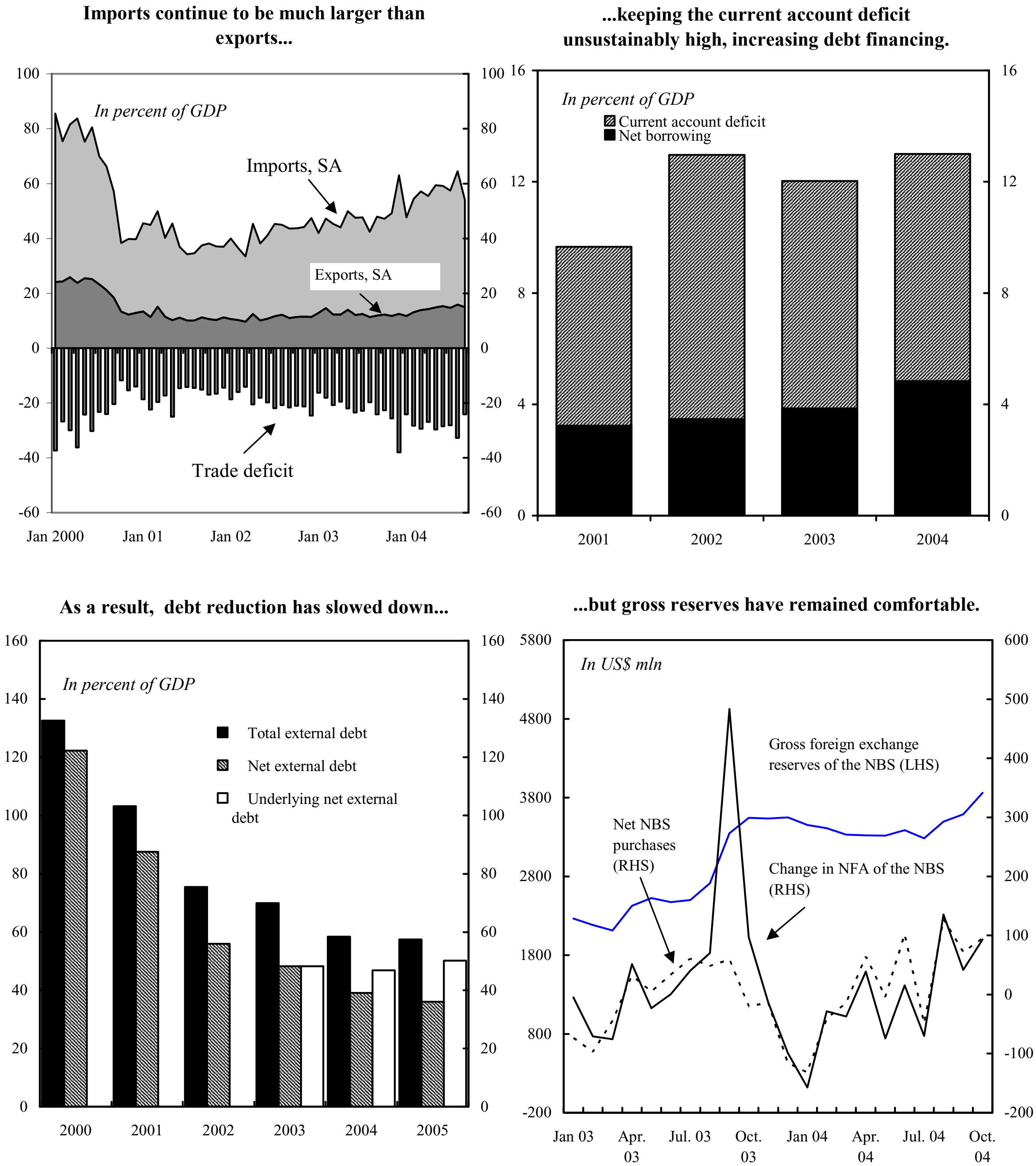
[2] The credit-to-GDP ratio at 17 percent is still low by regional standards (20–30 percent in EU accession countries).

Figure 2. Serbia: Monetary Developments, 2003–04



Sources: Serbian Office of Statistics; National Bank of Serbia; and IMF staff calculations.

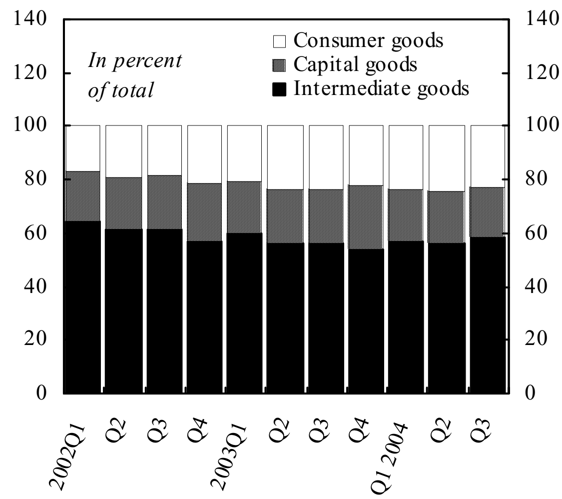
Figure 3. Serbia and Montenegro: External Sector Developments, 2000–05



Sources: Serbian Office of Statistics; National Bank of Serbia; and IMF staff calculations.

raises external vulnerability and reduces the favorable effects from the July London Club agreement on debt dynamics. Indeed, net external debt adjusted for the effect of debt restructuring operations increases by 3 percentage points of GDP between 2004-05, underscoring that the underlying external debt dynamics remains a cause of concern. However, gross international reserves at US$3.7 billion at end October remained in line with program. Serbia received its first credit rating at B+ from Standard&Poors in November.

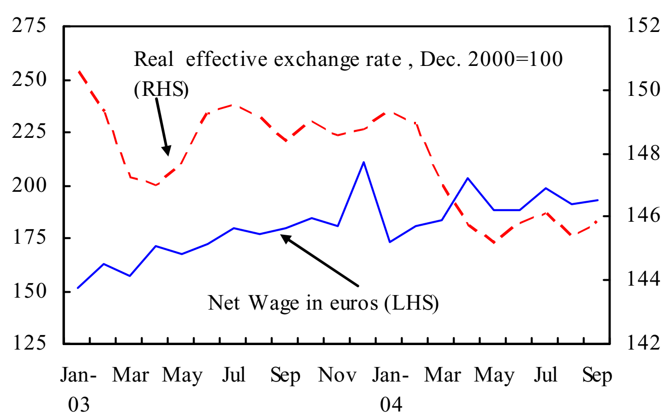
Imports of consumer goods increased...



Source: Serbian Office of Statistics; National Bank of Serbia; and IMF staff calculations.

- **The foreign exchange market stabilized since mid-year overcoming earlier pressures, while the dinar depreciated in real terms.**[3] Confidence in the dinar remains fragile, as indicated by the steady increase in the relative share of foreign currency deposits (controlled for exchange rate changes). This increase was partly a response to the 10 percent nominal depreciation vis-à-vis the euro through end-October. Notwithstanding the surge in inflation and wage increases beyond productivity (Box 1), the RPI-based REER depreciated by some 3 percent during January–October.

Despite increasing wages, the real effective exchange rate depreciated...



Sources: Serbian Office of Statistics; National Bank of Serbia; and IMF staff calculations.

[3] The NBS lost net foreign assets (NFA) of US$303 million during the first seven months of 2004, but accumulated US$340 million in August–October.

Box 1: Competitiveness in SM would benefit from further structural reforms.

The persistently high external current account in SM raises questions about competitiveness. While exports have started to grow faster in 2004, at 18 percent of GDP they remain the lowest in the region, and account only for about a third of imports. This points either to problems with cost-competitiveness and/or to structural weaknesses in the export sector.

Many indicators suggest that problems in the export sector are mainly structural, but also raise questions about cost-competitiveness. Data for many traditional competitiveness indicators such as unit labor costs are not available in SM, thus the analysis relies on some proxies with potentially large measurement problems.

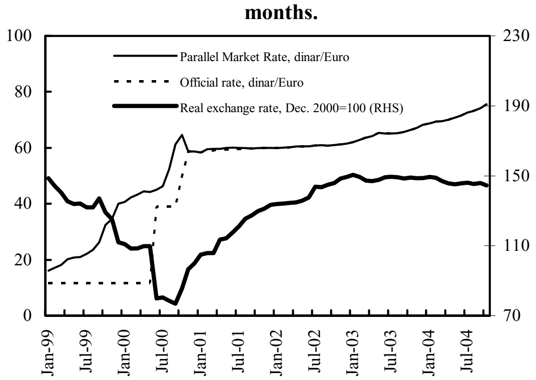
- **Exports per capita at US$250 in SM are among the lowest in the region, suggesting structural problems with exports**. Only Macedonia ranks lower than SM among the republics of the SFR Yugoslavia.

- **Labor costs in SM, with average wages at 190 euro per month, are higher than in most of the region's EU accession countries (chart).** Data on unit labor costs are not available, which might better account for productivity differences.

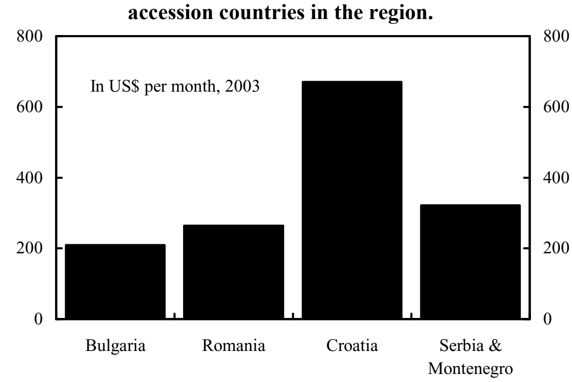
- **Export performance may have been affected by the large real appreciation early in the decade, which is only gradually being reversed.** Between 2000–02 the RPI-based REER appreciated by 96 percent, and remained at this level in 2003. While there may have been some undershooting in 2000 because of the war, data deficiencies and many structural breaks make it difficult to estimate a potential equilibrium real effective exchange rate. The low productivity arising from slow transition reforms and the low level of exports may imply some overshooting in the rate in 2002–03. In 2004, the 10 percent nominal depreciation in the first 10 months may explain some of the recent narrowing in the trade balance, but the full impact on competitiveness of the real depreciation in 2004 can only be expected with some lag (chart).

In sum, the indicators suggest that a range of measures, including structural reforms would be needed to boost competitiveness and make the external balance more sustainable. Measures to speed up reforms in the financial sector, regulatory frameworks, and enterprise restructuring are needed to boost productivity and competitiveness. This should be complemented by incomes policies keeping wage increases in line with productivity. These measures would also help attract FDI, which has been proven to have positive spillovers in developing exports and boosting productivity in other transition countries.

The REER has depreciated slightly in recent months.



Average wages in SM are higher than in most of the EU accession countries in the region.



Sources: Serbian Office of Statistics; National Bank of Serbia: and IMF staff calculations.

4. **Since mid-year, fiscal policy in Serbia has been tightened beyond program targets to contain the external imbalance and inflation (Tables 5–8).** Total revenue is expected to be broadly as programmed for the year with somewhat stronger sales tax receipts compensating for weaker-than-expected non-tax revenue. To offset the H1 spending overruns on subsidies, wages and transfers (0.3 percent of annual GDP), and lower the consolidated deficit for the year relative to GDP by 0.2 percentage points compared to the original program, the revised budget reduces spending on capital and subsidies. In Montenegro, financing constraints have limited the deficit to 4 percent of GDP in line with the program. The 2004 SM deficit is projected at 2.0 percent of GDP.[4]

Serbia: The 2004 republican budget so far has been tighter than programmed...

Percent of SM GDP 1/	**Program Q1-Q3**	**Outturn Q1-Q3**	**Difference**
Total revenue and grants	18.2	18.1	-0.2
Total expenditure	20.3	19.6	-0.7
Of which			
Wages and social funds contributions	3.8	3.8	0.0
Subsides	1.7	1.9	0.2
Transfers to households	4.6	4.7	0.1
Capital expenditures	1.5	1.2	-0.3
Overall balance	-2.1	-1.5	0.6

1/ Numbers appear not to add up because of rounding.

5. **Following a surge in inflation and money market liquidity, monetary policy was tightened in August.** Problems with coordinating liquidity management with the Treasury led to some stop-and-go policies until mid-year. The larger-than-expected drawdown of government deposits at the NBS in H1 and the June reduction of the reserve requirement on foreign currency household deposits by 3 percentage points boosted liquidity, which was not fully eliminated through open market operations. In response to surging inflation, the NBS tightened policy in August by raising the required reserve ratio on all dinar and enterprise forex deposits by 3 percentage points to 21 percent and stepping up open market operations. As a result, real interest rates started to move upwards and banks'excess reserves declined.

6. **Structural reforms have accelerated since mid-year, but SM lags behind in transition in the region (Figure 4).** SM scored lowest (2.4 out of 4) in 2003 in the region on the EBRD's transition index, and the share of the GDP produced by the private sector has remained at only 45 percent. Since June the pace of reforms has picked-up. The Serbian parliament passed 17 critical reform laws in July including those on energy, VAT and bankruptcy. Bank privatization advanced in late 2004 with the issuance of tenders for three banks. Once completed, these privatizations should lower the share of the state in total bank

[4] Compared to IMF Country Report No. 04/202 fiscal deficits for 2003–2005 have been adjusted by moving Frozen Foreign Currency Deposits (FFCD) payments below the line in accordance with GFS.

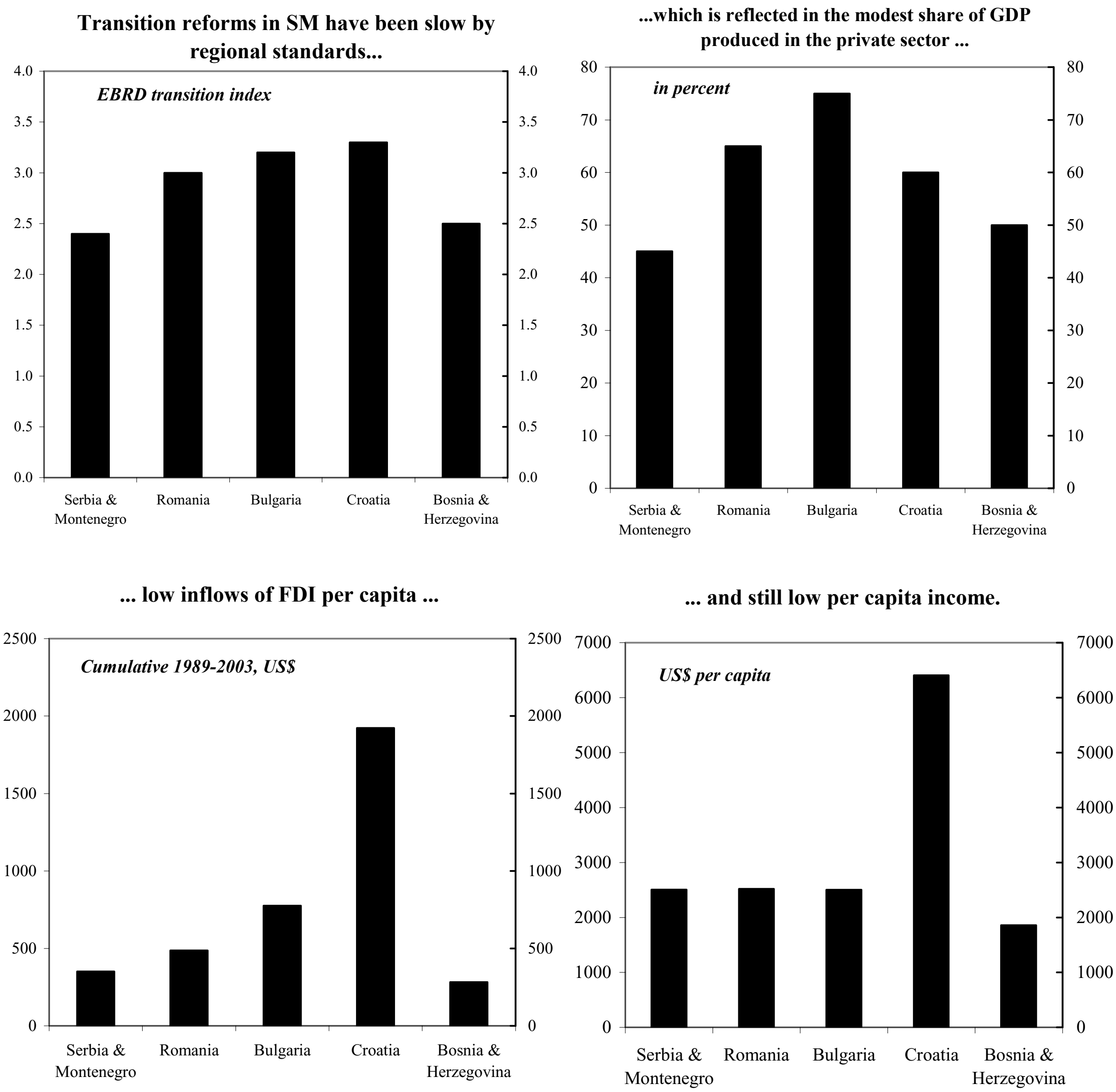
assets from an estimated 3540 percent. Enterprise privatization advanced this year with the issuance of eight tenders for socially-owned enterprises and 191 auctions.[5] In Montenegro, privatization moved forward with the sale of the largest steel producer; that of the aluminum smelter enterprises is expected before end-2004.

III. Report On The Discussions

7. **Discussions focused on policies to contain the risks associated with the widening current account deficit and higher inflation.** The consistently larger than programmed current account deficits and the increase in debt-financing heighten external vulnerability by putting pressure on the already heavy external debt burden of about 58 percent of GDP. These risks are heightened by the likely persistence of higher world oil prices (Box 2). Wage increases beyond productivity have boosted inflation, eroding confidence and competitiveness and calling for tighter incomes policies. Furthermore, the slow progress with enterprise restructuring has resulted in persistently low exports, and potentially significant quasi-fiscal activities. Thus a sustainable correction in the external balance requires measures beyond demand management. To address these risks and challenges, fiscal, monetary and incomes policies need to be tightened beyond program commitments, and structural reform accelerated. This is necessary to reduce domestic demand, adjust to the oil-shock, and improve export competitiveness and external debt sustainability. As a result, the discussions focused on: (i) tighter than programmed fiscal policy in 2004~~0~~5; (ii) further monetary tightening with measures to rein in credit growth, and improving financial supervision in particular of balance sheet risks; (iii) stricter incomes policies to arrest wage increases beyond productivity; and (iv) acceleration of structural reforms beyond program commitments. These policies would maintain the capacity to repay the Fund (Table 9) and ensure a prudent, although still high debt burden (Appendices IV and V).

[5] Many socially-owned and some state enterprises incur losses, partially reflecting quasi-fiscal activities. Staff is currently working on estimating the extent of the problem.

Figure 4. Serbia and Montenegro: Indicators of Transition, 2003



Source: EBRD Transition Report 2003.

Box 2. SM is adjusting to the higher world oil prices by policy tightening and gradual pass-through of prices.

Current oil price forecasts are significantly higher than at the time of the May staff report. Average dollar prices for 2004 and 2005 are now 24 percent and 58 percent higher respectively than the May baseline with only a gradual decline projected in the longer term. This calls for adjustment to the changed terms-of-trade.

Simulations of the effect of the higher oil prices show a moderate impact on SM's current account given the small share of fuel imports in total. Oil, oil-derived products, and gas accounted for around 12 percent of total imports in 2003. Higher oil prices are estimated to increase the current account deficit by 0.7 percent of GDP in 2004 and 1.2 percent in 2005 compared to the May projections. If prices average US$50 per barrel in 2005 (85 percent higher than the May baseline), the current account in 2005 would worsen by about 2 percentage points of GDP.

SM is adjusting to the higher energy prices by some policy tightening and gradual increase in domestic oil prices. The tighter macroeconomic policies aimed at reducing the large current account deficit include some adjustment to higher oil imports, while the controlled domestic energy prices are being increased gradually. Retail gasoline prices are set by government decree based on a rule linking domestic prices to crude oil prices and the dollar. Domestic gasoline and diesel prices were increased in H2, but not yet by the full extent of international price increases. The poor are protected from the increase with targeted subsidies. Further increases in domestic energy prices are expected in 2005. These measures are likely to affect growth and increase inflation in 2005 while reducing the external deficit.

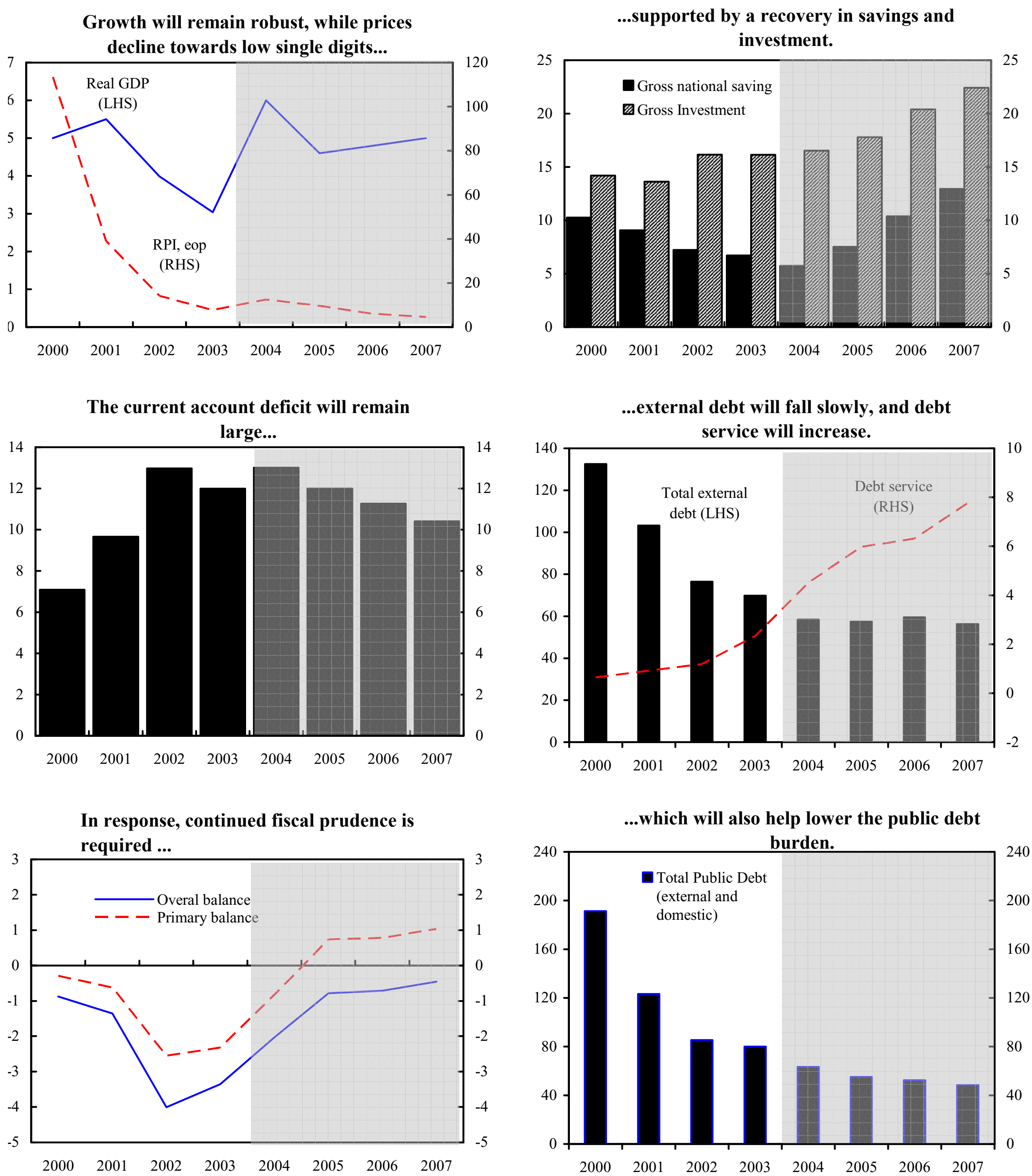
A. The Macroeconomic Outlook and Risks

8. **With prudent policies, macroeconomic performance is expected to remain favorable and the risks contained (Tables 10–12, Figure 5).**

- **Growth in 2005 is projected to recede to 4–5 percent,** reflecting a policy-driven slowdown in consumption against a pick-up in investment and net exports. Growth should reach its potential of 5 percent in the medium-term as economic restructuring advances, and FDI increases.

- **Inflation by end-2005 would fall back to single digits in response to tighter incomes and fiscal policies and the fading of the oil price effect**. These will be sufficient to offset the expected two percentage point boost to inflation from the introduction of the VAT in January. In the medium-term, with prudent policies inflation should fall towards low single digits.

Figure 5. Serbia and Montenegro: Baseline Medium-Term Projections, 2000–07 1/
(In percent of GDP)



Sources: Serbia and Montenegro authorities; and Fund staff estimates and projections.

1/ 2004 onward: program projections

- **The current account deficit should start improving in 2005 in response to the policy adjustments**. Improved competitiveness will boost exports and import growth should be contained at slightly above that of GDP in the medium-term. However, the effects of the recent oil shock will subside only gradually, worsening the current account throughout the medium-term despite adjustment. Prudent policies and the expected completion of Paris Club debt relief in 2005 will help reduce the external debt ratio from the current 58 percent. Reserve coverage of imports will remain stable at around 3½ months.

9. **This favorable scenario is subject to large downside risks.** These are (i) a failure to tighten policies, which could lead to a ballooning of the external deficit, higher inflation and exchange rate pressures; (ii) shortfalls in remittances and lower FDI due to a shift in market sentiment; (iii) higher-than-projected world oil-prices; and (iv) failure to implement structural reforms, which would worsen the structural external imbalance and increase quasi-fiscal activities undermining macroeconomic stabilization. Reform implementation, in particular, of the stricter incomes policies and enterprise restructuring will be a challenge for the minority government. The required employment cuts could lead to social tensions. If the current account does not decline as envisaged, the authorities are ready to further tighten fiscal (non-priority spending) and monetary policies.

B. Fiscal Policy

10. **To reduce external risks, the 2005 program aims to bring the SM fiscal deficit well below one percent, as compared to a deficit of 1.3 percent in the original program (¶10).**[6] The overall fiscal adjustment between 2003~~0~~5 period is about 3 percent of GDP (excluding redundancy payments), which is achieved mainly by

SM: Fiscal policy needs to be tightened to safeguard the external balance...
(SM General Government, in percent of GDP)

	2003	2004		2005	
		3rd Rev.	Proj.	3rd Rev.	Proj.
Total revenue	43.1	43.6	43.3	42.4	42.8
Total expenditure	46.5	45.8	45.3	43.7	43.6
Of which					
Wages and salaries	10.5	10.6	10.6	10.1	10.2
o/w: redundancy payments	...	...	...	...	0.4
Subsidies	3.6	3.6	3.3	2.6	2.7
Transfers to households	19.7	19.0	19.3	19.0	18.7
Overall cash balance	**-3.4**	**-2.2**	**-2.0**	**-1.3**	**-0.8**
(excl. redundancy payments)	-3.4	-2.2	-2.0	-1.3	-0.3
Memorandum items:					
Overall cash balance before grants of:					
Serbian general government	-3.0	-1.9	-1.7	...	-0.6
Montenegrin general government	-0.4	-0.4	-0.3	...	-0.2
Overall cash balance of general government in Montenegro (in percent of Montenegro GDP)	-5.2	-4.0	-4.0	...	-2.8

Sources: Federal and Republican Ministries of Finance, and IMF staff estimates. Numbers may not add up due to rounding.

[6] ¶ refers to relevant paragraphs in the MEFP.

restraint on spending.[7] The projected SM 2005 deficit of 0.8 percent of GDP (0.3 percent of GDP excluding redundancy payments) lowers expenditures by close to 2 percentage points of GDP to offset the expected revenue loss from recent tax reforms in both republics. The deficit should be overfinanced in Serbia by privatization proceeds and foreign assistance, and enable an increase in government deposits at the NBS.

11. **In Serbia, the 2005 budget target is to be achieved by lowering the tax burden and substantial restraint in spending** (¶12¶14). The consolidated Serbian deficit should decline to 0.6 percent of GDP resulting in a primary surplus for the first time in many years. The main objectives of the budget are shrinking the size of the government in the economy, shifting taxation from income to consumption to encourage savings, and creating room for expected higher future interest payments and investment needs.

- **The shift towards indirect taxes should reduce the overall tax burden and increase efficiency.** The introduction of the revenue-neutral VAT replacing the sales tax is a major step towards more efficient taxation. The revenue/GDP ratio should decrease by 0.8 percentage points from the elimination of the financial transactions tax in January 2005, and from measures already adopted in the second half of 2004 (a corporate tax rate cut, lower social taxes on labor). Higher excises and non-tax revenues compensate some of the lower expected revenues from the tax changes (¶4 and ¶13).

- **Restraining non-priority spending should help lower the size of the government.** Spending relative to GDP is to be curtailed by about 2 percentage points in several categories including in subsidies (0.5 percentage points mainly to agriculture and the railway), the wage bill (0.8 percentage points excluding redundancy payments) and in transfers to households (0.5 percentage points). Resources allocated for enterprise restructuring are to increase and their targeting is to improve (¶14). However, capital spending relative to GDP is projected to decline by about 0.3 percentage points, which the staff urged to increase in subsequent years.

- **To mitigate the social impact of the reforms, safety nets and active labor market policies are to be reinforced (Box 3).** The budget includes 0.5 percent of GDP of redundancy payments conditional on net employment cuts in the central and SM union governments and in public enterprises. In addition, funds and programs for active labor market policies are increased.

[7] The FFCD reclassification accounts for 0.3 percent of GDP of the envisaged adjustment over 2003~~0~~5.

Box 3. Social costs of transition reforms will be mitigated by safety nets.

1. Severance payments earmarked in the 2005 budget (0.5 percent of GDP):

- **budget sector** (Serbian central and the SM union government) - 12 monthly salaries
- **socially owned enterprises (Transition Fund)** – SRD 6000 per year of service in the company based on a special Decree from 2001.
- **state enterprises (Transition Fund and enterprise sources) -** same benefit as for socially-owned enterprises, but some companies are to finance redundancies from own revenues.

2. Reinforced unemployment benefits (National Employment Agency-NEA):

- can be received for 3 to 24 months, depending on the number of years worked, for the first 3 months at 60 percent of average wage earned in the last 6 months, and at 50 percent for the remaining eligible period. Those getting redundancy payments cannot receive unemployment benefits.

3. Stronger active labor market policies:

- **introduction of micro-credit programs targeted at laid-off workers.** 0.05 percent of GDP is allocated to assist recently retrenched workers lacking business experience and ineligible for bank loans, to obtain small business loans with subsidized interest.
- **entrepreneurial grants from NEA**. NEA gives small grants (EUR 1000–2000) for the unemployed to start a business.
- **centralization and upgrading of labor training and job search support in the NEA,** including help for job search; skills training; provision of job information; and advice on setting up a business.

12. **The targets are to be supported by fiscal reforms.**

- **Tax administration reforms.** The introduction of the VAT in January is expected to improve tax compliance and reduce the grey economy in line with the experience in the neighboring countries. The criterion for selecting large taxpayers in tax administration should be changed from the size of tax payments to turnover by end-2004, and taxpayer services will be improved (¶15).
- **Public expenditure management**. A Treasury reorganization plan should be drawn up by March to improve control over spending units (¶16). In addition, initial steps are to be taken in early 2005 to help centralize the payroll system to permit greater control over the wage bill (¶17).

- **Public employment reforms.** The wage bill cuts are supported by a net rationalization in employment by 15,000 in Serbian central government and by 6,600 at the SM union government, mainly in the army (¶14). A World Bank-supported public administration reform is expected to decompress wage scales in the central government. This should motivate performance and allow the government to better compete with the private sector for qualified staff.

- **Arrears monitoring** (¶15). To tighten budget constraints especially in socially-owned enterprises and reduce potential quasi-fiscal activities, a plan to reduce enterprise arrears to the budget is to be prepared by end-November 2004.

13. **In Montenegro, as tax reforms are expected to reduce revenues, fiscal policy needs to be tightened through discretionary expenditure cuts (¶18–21).** Because the impact of the reforms on revenues is subject to uncertainties, staff urged more ambitious curtailment in spending than proposed by the authorities, or postponing some of the planned tax cuts. However, the authorities insisted on going ahead with the announced tax changes. Instead, they proposed freezing the wage bill for government employees in nominal terms, and implementing in 2005 the delayed cuts in budgetary employment by 12 percent, in addition to the 4 percent cut in 2004. These measures should limit the consolidated 2005 fiscal deficit to 2.8 percent of Montenegrin GDP.

C. Monetary and Exchange Rate Policies

14. **Monetary tightening in Serbia is accompanied by prudential measures to contain credit growth (**¶24~~2~~5) **.** Given the low impact of monetary policy in a highly euroized economy and the limited instruments for indirect monetary control, prudential measures need to play a double role.[8] While striving to maintain the quality of credit, they also have a macroeconomic role in slowing down credit growth to reduce the current account deficit. In this context, the reservable base is to be broadened to include (i) the stock of commercial banks'foreign borrowing of up to fo ur years; and (ii) all new foreign borrowing by commercial banks independent of maturities.[9] Apart from increasing the cost of credit, this should help contain debt build-up, and remove a bias in favor of financing lending with foreign borrowing, thereby reducing external vulnerability. The cost of lending should also

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[8] The NBS plans to introduce repo operations in early 2005 to enhance the efficiency of open market operations and improve liquidity management (¶23).

[9] Most of the tightening effect of this measure would arise from the marginal reserve requirement under (ii), as only a small fraction of banks'foreign borrowing has a maturity below 4 years. If this measure had been in place since the beginning of 2004, the additional amount of required reserves at end-August would have been 3.3 percent of the sum of reserve money and commercial banks'foreign curre ncy deposits at the NBS on December 31, 2003.

be affected by the increase in the capital adequacy ratio from 8 to 10 percent in March 2005. On consumer lending, the authorities opposed the staff's recommendation of a legally binding regulation as not being provided for under current legislation. Instead, they have issued a guideline tightening conditions for bank consumer loans and requested commercial banks to adopt the guideline. It was agreed that the NBS will monitor closely growth of consumer credit, and introduce stronger measures if necessary. Prudential risks from exposure to exchange-rate risks will also be better monitored. The upcoming FSAP in February 2005 will assess the appropriateness of the regulatory framework to address increasing prudential risks and suggest modalities for initiating supervision of leasing activities.

15. **The exchange rate policy will need to continue balancing between the external and inflation objectives (**¶26). Staff will study any potential increase in the pass-through from the exchange rate to prices as expectations adapt, that could affect exchange rate policy. Against this background, staff and the authorities agreed that exchange rate policy will be reviewed in the forthcoming Article IV mission in January (Appendix VI).

D. Financial Sector Reform

16. **Bank privatization and restructuring are to be accelerated and financial supervision strengthened to lower risks and enhance intermediation (¶27–29).** In Serbia, competition in the sector and efficiency of intermediation should benefit from the expected privatization of six more banks in 2005. Bank supervision is expected to be reinforced to identify potential systemic risks, in particular, in the remaining state banks, and by stricter enforcement of existing regulations including the minimum capital of banks. In Montenegro, bank privatization is also expected to proceed, and a strategy for divesting all state minority holdings from the banking system should be prepared by end-2004.

E. Incomes Policies

17. **Tighter incomes policies are critical for reining in domestic demand and wage pressures in Serbia (¶30).** In the budget sector, wages are assumed to increase by 9 percent in 2005, below the projected 12.5 percent average inflation. In state enterprises, wage discipline is expected to be strengthened by setting a ceiling (subject to a PC) on the increase in the wage bill at seven percent over the 2004 average. This should encourage labor restructuring and cost rationalization. In the socially-owned enterprises, the expected privatization, restructuring and tightening of the budget constraint by lower subsidies and stricter monitoring of arrears to the public sector should exert wage discipline.

F. Enterprise Privatization and Restructuring

18. **Structural reform is to be substantially accelerated to enhance growth, and fiscal and external sustainability (¶31–36).** The large state or socially-owned part of the economy has low productivity, in some cases even negative value-added, large inter-company debts, debts to banks, and arrears to the public sector. In coordination with the World Bank, the program envisages accelerating enterprise restructuring (Box 4**).**

Box 4: The structural reform agenda in Serbia remains substantial.

The 1990s were a lost decade for structural reforms. Serbia's economic potential was heavily affected by armed conflicts, the loss of export markets, and the interruption of long-established production relations. Moreover, the approach to macroeconomic stabilization and structural reform was hesitant and piecemeal rendering Serbia a laggard among Central- and Eastern European (CEE) transition economies.

Structural reforms started in earnest only after the "velvet revolution" in 2000. During 2001–2003, fiscal stabilization, tax reforms, and trade liberalization improved the investment climate. The adoption of the privatization law in June 2001 was key for accelerating privatization through: (a) *tenders* of large enterprises, offering to a strategic investor at least 70 percent of shares; (b) *auctions* of medium-sized enterprises; and (c) *restructuring* and subsequent sales of large loss-making enterprises and/or parts thereof. Privatization gained considerable momentum in 2001–2003, with about 1,000 mostly medium-sized enterprises sold in auctions and 25 large ones in international tenders.

However, reforms slowed down since mid–2003. The assassination of Prime Minister Djindjic in March 2003, subsequent political instability, and changes in government affecting the institutional capacity of the privatization agency led to a virtual standstill of restructuring and privatization. As a result, the private sector share in GDP at 45 percent at end-2003 is significantly lower than in other CEE countries.

The restructuring and privatization of the socially–owned enterprises remains a major challenge. Reflecting Yugoslavia's legacy of "social ownership," socially-owned enterprises are characterized by serious principal-agent problems, as workers and management de facto continue to dispose over ownership rights, while losses are being financed through the budget (through direct subsidies and accumulation of arrears) or the accumulation of arrears to suppliers. Even though 70 large socially-owned enterprises with 140,000 employees (out of a total of 1,850 socially-owned enterprises with 372,000 employees) have officially been "under restructuring" for several years, the process is still in its early stages and substantial overstaffing prevails.

The enactment of a new bankruptcy law in July 2004 is a necessary, but not sufficient condition for implementing an efficient exit mechanism. The previous bankruptcy law—owing, inter alia, to weak incentives for bankruptcy managers to end a bankruptcy proceeding and the absence of clear timelines—exacerbated the prevalence of soft budget constraints. The new law provides for more efficient procedures and strengthened creditor rights, but to render it fully operational, a well-functioning Bankruptcy Supervisory Agency and a Bankruptcy Unit under the Privatization Agency (PA) are urgently needed. Moreover, the law on the PA needs to be amended to empower the agency to act as bankruptcy administrator for state-owned and socially-owned enterprises.

Progress in restructuring state–owned infrastructure companies and preparing them for privatization has been limited, but will accelerate in 2005. While many of them generate sufficient income to cover operating costs, they do not always cover financial losses and investment. A notable exception is the electricity company EPS, where tariff increases have ensured revenues to cover debt service and investment, while on other sectors tariff adjustments continue to be subject to political rather than financial considerations. Moreover, system losses in the electricity and water networks remain substantial and some budgetary institutions and socially-owned enterprises are not fully paying their utility bills. The largely unrestructured railway company ZTP continues to register large operating losses, which are financed from the budget. On the positive side, the new Energy Law, passed in July 2004, provides for the restructuring and unbundling of EPS and the establishment of an independent regulatory framework for the energy sector. In 2005, the government intends to speed up reforms in these companies.

- **Restructuring/privatization via tenders, auctions and share sales is to be accelerated** (¶31). Tighter rules on granting subsidies and monitoring arrears (¶14) should also increase incentives for getting privatized. A new unit in the deputy prime minister's office to coordinate the privatiz ation-related debt work-outs should reduce this bottleneck to privatization. Furthermore, implementation of the new bankruptcy procedures should advance restructuring, as indicated by the experience in other transition countries.

- **State enterprise restructuring/privatization will commence in Serbia**. With heavy overstaffing and depleted capital, the sector is estimated to account for about seven percent of total employment. Electricity sector restructuring in 2005 envisages streamlining employment and unbundling the company. In other state enterprises, non-core assets are to be sold, and employment rationalized with an estimated 15,000 lay-offs in 2005 for which the budget includes specific redundancy payments. A plan for the restructuring of the railway (receiving ¾ of percent of GDP in subsidies) is to be drafted, and further privatization should continue in the telecom sector in both republics. A regulatory framework is also to be put in place for natural monopolies to enhance their efficiency.

IV. Review Issues and Financing Assurances

19. **The program will be monitored with relevant PCs and benchmarks supporting program objectives.** Staff supports the request for waivers for the missed one end-June structural, and the two end-September quantitative performance criteria, as they were exceeded by a small margin or met with a short delay. Program performance was also already boosted by meeting all-but-one end-September PCs, and three of the six prior actions for this review in November. Staff supports the request to modify the end-December 2004 PC on debt accumulation in Montenegro, as it was already missed in September. Given delays in program implementation, staff supports the authorities' request to postpone the fifth review until January 2005 for the end-December performance criteria, and rephase one purchase by combining the 10th and 11th purchases.

20. **Negotiations on settling pending external arrears are advanced, and the external financing outlook remains adequate**. The July London Club agreement is nearly concluded, the Paris Club agreement has been implemented by all but three creditors, and past debt with China and Russia is close to being settled. [10] External grants and loans, and

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[10] SM's debt to the London Club is reduced by 61.5 percent in NPV terms, which the Paris Club has accepted as broadly comparable with granted debt relief. The settlement calls Serbia to issue international bonds for about US$1.08 billion with 3.75 percent coupon and 20-year maturity expected around end-year. It excludes the so-called connected persons debt related to transactions subject to ongoing investigations. Negotiations with other official (Libya and

(continued)

FDI and other capital inflows are expected to keep gross external reserves adequate at US$ 3.7 billion (about 4 months of imports) at end-2004. Staff supports the completion of the financing assurances review, which is still warranted given the remaining arrears.

V. Staff Appraisal

21. **In a fragile political situation SM's economic performance has been satisfactory, but risks have intensified**. The pick-up in growth in 2004 and the increase in financial intermediation reflect growing confidence in the economy and in the broadly prudent policies followed in recent years. The London Club agreement in July was also a major step towards sustainable debt dynamics. At the same time, the persistence of a large current account deficit, increasing debt-financing and surge in inflation highlight increased risks that need to be addressed. The increase in world oil prices also calls for policy adjustments. To address these challenges, tighter-than-previously-programmed fiscal, monetary and incomes policies are required, but faster structural reform is also critical to a sustainable improvement in the external imbalance and reduction in potential quasi-fiscal activities. The fragile political position of the minority government gives rise to considerable implementation risks.

22. **The focus of the fiscal tightening in 2004–05 on expenditure rationalization is welcome, but more attention to quasi-fiscal activities should improve effectiveness and sustainability of fiscal policies.** The envisaged reduction in the deficit relative to GDP during 2004 and 2005 of about 3 percentage points (excluding redundancy payments) is bold. By helping to cool off domestic demand, it should improve the external balance. The lower tax burden and shift to indirect taxes is designed to encourage savings, investment and incentives to work. At the same time, the resulting lower revenue/GDP ratio shifts the pressure of adjustment to expenditures. The envisaged rationalization of spending (including in the wage bill and subsidies) in 2005 will address the long overdue reduction of the size of government and will make room for higher interest payments and investment in the future. The related World Bank-supported reform of the civil service and the reinforced safety nets will increase efficiency in the public sector while mitigating the social cost of the expected employment cuts. The plan to better monitor arrears to the public sector should help address potential quasi-fiscal activities.

23. **The monetary tightening since August and the measures to contain credit growth and prudential risks are welcome, but supervision needs to be further strengthened.** The increase in the reserve requirement should tighten credit conditions, which will be further affected by broadening the reservable base to foreign borrowing by banks and by issuing the guideline on prudential rules for consumer credits. This guideline may also facilitate the deceleration of credit, but more formal requirements would have better ensured the achievement of the program's goals. Thus the authorities should stand ready to

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Kuwait) and commercial creditors are ongoing to obtain debt reduction on terms comparable to the Paris Club agreement.

tighten credit market conditions promptly, should credit growth fail to decelerate as programmed. Continuing euroization increases balance sheet forex risks in the enterprise sector straining supervisory capacities. Staff welcomes the measures to step up banks' risk assessment practices, but it will be imperative to reinforce compliance with existing prudential regulations.

24. **Exchange rate policy in Serbia has been broadly appropriate in balancing inflation and competitiveness objectives.** Exchange rate policy will be reviewed during the forthcoming Article IV consultations.

25. **Incomes policies will be key in slowing inflation, containing domestic demand and improving competitiveness.** The commitment to keep wage increases in the budgetary sector below expected inflation is central to demand management and inflation control. However, the large increases in 2003 would have justified an even tighter ceiling. The authorities' bold plans for tight wage discipline and retrenchment in state enterprises, to help keep wage growth below productivity growth, are commendable, but are subject to large implementation risks.

26. **Faster structural reform is essential to address external risks and improve sustainability of fiscal policy.** The recent pick-up in privatization and restructuring of the socially-owned enterprises is expected to speed-up over the next 6 months, especially with the entry into force of the new bankruptcy procedures. Staff, however, urged even larger cuts in subsidies to reinforce incentives to reallocate resources to viable activities generating growth and exports. Plans to restructure large public enterprises, in particular in the energy sector, the railway and telecommunications, are important. In Montenegro, ongoing privatization of the steel mill and telecommunications needs to be completed without granting energy subsidies.

27. **Staff supports the authorities' request to complete the fourth review under the EA.** Staff also supports waivers for the missed end-June and end-September performance criteria as they were missed by a small margin, as well as the revision to the end-December 2004 PC on nonconcessional external debt in Montenegro. Program implementation and macroeconomic performance have been mixed, but the policies outlined in the MEFP provide an appropriate response to the key risks looking forward. Restructuring of pending debt arrears is nearly completed, and external financing for the program is adequate. Staff also supports combining 10th and 11th purchases and postponing the 5th review, given delays in program implementation.

Table 1. Serbia and Montenegro: Selected Economic and Financial Indicators, 2001–05 1/

		2001	2002	2003	2004		2005
					3rd Rev	Proj.	Proj.
Real economy							
GDP, in billions of DIN		771.8	995.1	1,178.2	1,354	1,371	1,604
Average net real wage, 1997 =100		115	142	160	…	…	…
Average net wage in Euro		102	149	175	…	…	…
				(Percent change)			
Real GDP	...	5.5	4.0	3.0	4 - 5	6.0	4.6
Gross industrial production	...	0.0	1.7	-2.7	…	…	…
Retail prices (period average)	...	91.1	21.2	11.3	8 - 8½	9½	12½
Retail prices (end of period, 12-month)	...	39.0	14.2	7.8	8–9	12–13	9–10
Unemployment rate (in percent)	...	31.3	28.9	34.5	…	…	…
				(Percent of GDP)			
General government finances 2/							
Revenue	...	38.9	42.8	43.1	43.6	43.3	42.8
Expenditure	...	40.3	46.8	46.5	45.8	45.3	43.6
Cash balance	...	-1.4	-4.0	-3.4	-2.2	-2.0	-0.8
Foreign grants		0.7	1.1	0.2	0.3	0.1	0.0
Foreign loans (net)		0.0	1.8	1.2	1.6	0.9	1.1
Of which: Foreign financed projects		0.0	0.8	0.5	0.9	0.7	0.7
Privatization receipts		0.0	2.2	4.3	0.7	0.4	1.6
Domestic financing (Net)		0.7	-1.0	-2.4	-0.2	0.7	-1.9
Commitment balance 3/	...	-1.4	-4.0	-3.4	-2.2	-2.0	-0.8
				(12-month percent change)			
Money supply (end-of-period) 4/							
M1		114.4	79.8	10.6	11.2	10.4	10.1
M2		104.9	52.7	27.5	18.9	32.5	29.1
Balance of payments				(In billions of U.S. dollars)			
Merchandise exports		2.0	2.4	3.0	3.5	4.0	4.6
Merchandise imports		-4.8	-6.3	-8.0	-8.8	-10.5	-11.2
Trade balance		-2.8	-3.9	-4.9	-5.3	-6.5	-6.5
Current account balance, after grants	…	-0.5	-1.4	-1.9	-2.2	-2.5	-2.4
(In percent of GDP)		-4.6	-8.9	-9.4	-9.6	-10.8	-10.3
Current account balance, before grants		-1.1	-2.0	-2.5	-2.6	-3.0	-2.8
(In percent of GDP)		-9.7	-13.0	-12.0	-11.0	-13.0	-12.0
Foreign debt (year-end) 5/	…	11.9	11.8	14.3	12.8	13.5	13.3
(In percent of GDP)		103.2	76.5	69.9	55.1	58.4	57.4
Gross official reserves		1.2	2.3	3.6	3.6	3.7	4.2
(In months of imports of goods and services)		2.4	3.2	3.7	4.3	3.7	3.9

Sources: Federal Statistical Office; National Bank of Serbia; Federal and State Ministries of Finance; and IMF staff estimates.

1/ With the exception of foreign debt, data exclude Kosovo.
2/ Fiscal operations of all levels of government, except for Montenegro where it excludes local governments.
Frozen Foreign Currency Bond payments are now recorded below the line, affecting the measured deficit.
2004 data include previously off-budget fiscal operations in Montenegro amounting to 0.2 percent of GDP.
Excluding redundancy payments, the general government balance in 2005 would be -0.2 percent of GDP.
3/ Excludes arrears of local governments and interest payments due but not paid on foreign debt still under restructuring.
4/ Excludes Montenegro.
5/ The data reflect the first phase of the Paris Club reduction in 2002. Debt relief on comparable terms from other bilateral creditors did not materialize in 2003 as assumed in the original program, but is assumed to take effect in 2004.

Table 2. Monetary Survey of Serbia, December 2003–December 2005
(In millions of dinars; end of period) 1/

	2003	2004								2005			
	Dec.	March	June		Sept.		Dec.			March	June	Sept.	Dec.
	Act.		Progr. 6/	Act.	Progr. 6/	Act.	Progr. 6/	Proj.		Prog.	Prog.	Prog.	Prog.
Net Foreign Assets 2/	172,685	160,020	167,362	147,892	169,918	167,389	172,591	170,938		172,345	168,932	186,173	192,514
(NFA in euro m.)	2,528	2,601	2,450	2,165	2,487	2,450	2,526	2,502		2,523	2,473	2,725	2,818
Assets	242,371	231,637	229,656	225,913	236,591	249,307	240,610	250,237		259,348	258,077	272,911	277,349
NBS	193,962	184,510	186,264	188,640	192,512	197,918	197,217	202,976		214,114	213,170	224,580	228,898
Commercial banks	48,409	47,128	43,392	37,273	44,079	51,389	43,392	47,261		45,234	44,907	48,331	48,451
Liabilities (-)	-69,686	-71,617	-62,294	-78,021	-66,673	-81,919	-68,019	-79,299		-87,003	-89,146	-86,738	-84,835
NBS	-59,740	-57,547	-54,848	-62,938	-59,227	-59,336	-60,573	-60,176		-67,589	-69,440	-66,741	-64,547
Commercial banks	-9,946	-14,070	-7,446	-15,084	-7,446	-22,583	-7,446	-19,123		-19,414	-19,705	-19,997	-20,288
Net Domestic Assets 3/	64,249	74,127	76,128	93,777	92,503	100,523	94,134	117,450		124,601	137,670	144,811	144,924
Domestic credit	153,356	165,957	…	194,593	…	217,308	…	…		…	…	…	…
Net credit to government 3/	-23,586	-24,772	-21,100	-14,198	-14,878	-18,810	-12,469	-12,696		-11,992	-6,377	-10,009	-22,539
Credit	23,250	23,254	…	23,696	…	24,502	…	…		…	…	…	…
Dinar credit	23,130	23,134	…	23,497	…	24,360	…	…		…	…	…	…
NBS	19,051	18,904	…	18,840	…	18,646	…	…		…	…	…	…
Commercial banks	4,079	4,230	…	4,657	…	5,714	…	…		…	…	…	…
Foreign currency credits	120	120	…	199	…	143	…	…		…	…	…	…
NBS	0	0	…	0	…	0	…	…		…	…	…	…
Commercial banks	120	120	…	199	…	143	…	…		…	…	…	…
Liabilities	-46,836	-48,025	…	-37,894	…	-43,313	…	…		…	…	…	…
Dinar liabilities	-25,677	-29,862	…	-28,174	…	-31,382	…	…		…	…	…	…
NBS	-14,305	-17,570	…	-16,273	…	-19,343	…	…		…	…	…	…
Commercial banks	-11,372	-12,292	…	-11,901	…	-12,039	…	…		…	…	…	…
Foreign currency deposits	-21,159	-18,163	…	-9,720	…	-11,931	…	…		…	…	…	…
NBS	-18,108	-15,047	…	-6,621	…	-8,832	…	…		…	…	…	…
Commercial banks	-3,051	-3,116	…	-3,099	…	-3,099	…	…		…	…	…	…
Short-term government credits to banks	-239	-165	…	-262	…	-279	…	…		…	…	…	…
Purchased bonds for repaying frozen deposits	4,897	5,663	…	4,857	…	5,703	…			…	…	…	…
Credit to the non-government sector	172,284	185,231	188,171	204,196	200,198	230,694	201,333	244,695		253,771	263,915	277,439	292,895
Households	28,643	32,383	…	40,248	…	52,060	…	…		…	…	…	…
Non-profit and other sectors	3,815	3,503	…	1,970	…	2,056	…	…		…	…	…	…
Non-profit and other sector in dinar	3,379	3,054	…	1,728	…	1,819	…	…		…	…	…	…
Non-profit and other sector in foreign currency	436	449	…	242	…	237	…	…		…	…	…	…
Enterprises in dinar	88,911	98,925	…	109,146	…	123,218	…	…		…	…	…	…
Enterprises in foreign currency	50,915	50,419	…	52,832	…	53,360	…	…		…	…	…	…
Enterprises in foreign currency (euro million)	745	738	…	773	…	781	…	…		…	…	…	…
Other items, net.	-89,107	-91,830	-90,943	-100,816	-92,817	-116,785	-94,729	-114,550		-117,178	-119,867	-122,618	-125,432
Broad Money (M2)	236,934	234,148	243,491	241,669	262,420	267,912	266,725	288,387		296,945	306,602	330,985	337,438
Dinar-denominated M2	117,040	105,553	112,343	112,612	122,766	121,218	132,300	133,236		134,745	136,746	140,546	145,804
M1	98,223	88,549	94,277	94,134	102,918	99,876	110,698	108,444		101,468	104,593	111,174	119,359
Currency outside banks	42,979	38,004	41,238	40,347	44,647	42,463	47,277	44,913		41,749	44,239	45,102	46,934
Demand deposits	55,244	50,545	53,039	53,787	58,271	57,413	63,421	63,531		59,719	60,354	66,072	72,425
Time and savings deposits	18,817	17,004	18,066	18,478	19,848	21,342	21,602	24,792		33,278	32,153	29,372	26,445
Foreign currency deposits (non-frozen)	119,894	128,595	131,147	129,057	139,654	146,694	134,426	155,152		162,200	169,856	190,439	191,634
Foreign currency deposits (not-frozen), (euro million)	1,755	2,090	1,920	2,098	2,044	2,385	1,968	2,271		2,374	2,486	2,788	2,805
Memorandum items 4/:													
Broad money at current exchange rates (in million dinars	236,933	237,428	250,907	249,502	276,091	300,069	284,804	313,948		331,131	350,527	389,456	405,402
Broad money at current exchange rates (billion dinars)	240.4	237.4	250.9	249.5	276.1	300.1	284.8	313.9		331.1	350.5	389.5	405.4
Foreign currency deposits at current exchange rates (bill	123.4	131.9	138.6	136.9	153.3	178.9	152.5	180.7		196.4	213.8	248.9	259.6
12-month growth rates (in percent)													
Broad Money (M2)	…	25.2	31.7	31.0	26.7	37.7	20.2	32.5		39.5	40.5	29.8	29.1
Dinar-denominated M2	…	6.9	15.6	15.9	12.4	11.0	13.0	13.8		27.7	21.4	15.9	9.4
M1	…	4.0	14.1	13.9	12.7	9.3	12.7	10.4		14.6	11.1	11.3	10.1
Currency outside banks	…	-2.1	9.8	7.5	13.8	8.3	10.0	4.5		9.9	9.6	6.2	4.5
Foreign currency deposits	…	42.8	46.0	44.2	38.5	61.6	23.6	46.5		48.9	56.2	39.2	43.7
Velocity (M1)	…	14.8	14.4	14.4	13.7	14.1	12.7	13.4		15.3	15.1	14.6	13.8
Multiplier (Dinar M2/Reserve money)	…	1.8	1.8	1.8	1.9	1.9	2.0	2.0		2.1	2.0	2.0	2.0
Currency/Dinar deposits (in percent)	…	56.3	58.0	55.8	57.2	53.9	55.6	50.9		44.9	47.8	47.3	47.5
Required reserve ratio (effective, in percent)	…	21.7	24.0	20.8	24.0	23.8	23.9	24.1		24.1	24.1	24.1	24.1
Excess reserves/Dinar deposits (in percent)	…	7.1	8.9	9.5	8.8	7.6	7.9	7.4		6.2	6.0	5.8	5.7
Foreign exchange deposits/Broad money	…	55.5	55.2	54.9	55.5	59.6	53.5	57.6		59.3	61.0	63.9	64.0
Dinar-denominated M2/ annualized monthly GDP	…	8.0	8.3	8.3	8.7	8.6	9.4	9.1		8.7	8.7	8.7	8.8

Sources: National Bank of Serbia; and IMF staff estimates and calculations.

1/ Unless otherwise specified, foreign exchange denominated items are converted at program exchange rates (for each year, the exchange rates prevailing at the end of the proceeding year).
2/ Excluding undivided assets and liabilities of the SFRY and, from 2002 onwards, liabilities to banks in liquidation.
3/ Program figures are ceilings.
4/ Foreign exchange denominated items are vauled at current exchange rates.
5/ Includes foreign exchange liabilities to Paris Club creditors that banks were instructed in mid-November 2002 to book as liabilities to the government in the context of the debt-for-equity swap
6/ Revised to reflect revisions to end-2003 data.

Table 3. Serbia and Montenegro: Balance of Payments, 2000~~0~~5

(In millions of U.S. dollars, unless otherwise indicated)

	2000	2001	2002	2003		2004		2005
				2nd. Rev.	Estimate	3rd. Rev.	Proj. 1/	Revised Program.1/
Trade balance	**-1,788**	**-2,834**	**-3,908**	**-4,750**	**-4,942**	**-5,322**	**-6,492**	**-6,540**
Exports f.o.b.	1,923	2,003	2,412	3,185	3,015	3,483	4,030	4,613
(percent growth)	14.7	4.2	20.4	32.1	25.0	19.4	33.7	14.5
(percent growth in euro)	32.5	7.5	14.2	11.5	4.4	8.0	21.7	13.0
Imports c.i.f.	-3,711	-4,837	-6,320	-7,935	-7,957	-8,805	-10,522	-11,153
(percent growth)	12.6	30.4	30.7	25.6	25.9	10.7	32.2	6.0
(percent growth in euro)	30.0	34.5	23.9	5.0	5.2	0.1	20.4	4.5
Services (non-factor services, net)	**331**	**417**	**293**	**464**	**335**	**464**	**641**	**720**
Receipts	624	740	829	1,165	1,053	1,284	1,548	1,672
Expenditure	-293	-323	-537	-701	-718	-820	-907	-952
Net factor income	**-1**	**-26**	**-111**	**-246**	**-249**	**-475**	**-397**	**-530**
Of which: Net interest	11	-26	-111	-246	-249	-475	-397	-530
Earnings	53	48	62	103	69	83	69	138
Payments 2/	-42	-74	-173	-350	-318	-558	-466	-668
Unrequited private and official transfers, net	**1,119**	**1,915**	**2,343**	**2,260**	**2,933**	**2,756**	**3,745**	**3,570**
Private remittances, net	**848**	**1,324**	**1,719**	**2,260**	**2,402**	**2,756**	**3,231**	**3,570**
Inflows	1,132	1,698	2,089	2,650	2,810	3,156	3,631	3,970
Outflows	-284	-374	-370	-390	-408	-400	-400	-400
Current account balance, before grants	**-610**	**-1,119**	**-2,007**	**-2,272**	**-2,454**	**-2,577**	**-3,017**	**-2,780**
(In percent of GDP) 3/	-7.1	-9.7	-13.0	-10.9	-12.0	-11.0	-13.0	-12.0
Official grants 4/	271	591	624	0	531	0	514	0
Foreign direct investment, net	25	165	562	623	1,405	713	966	1,181
Inflows	...	...	562	751	1,542	744	997	1,212
Outflows	...	...	0	-128	-136	-31	-31	-31
Foreign loans, net	180	374	537	187	789	238	1,123	565
Medium and long term, net	213	299	379	97	723	193	996	445
Disbursements	227	332	421	253	941	500	1,410	1,067
Of which: Official creditors 4/		205	0	139	426	0	339	0
Amortization	-14	-33	-43	-157	-218	-307	-413	-622
Short term, net	-33	75	158	90	66	45	126	120
Other capital inflows 5/	49	629	892	315	280	160	135	195
Commercial banks, net		-274	-144	0	-55	92	138	0
Capital account balance	**255**	**894**	**1,846**	**1,124**	**2,419**	**1,203**	**2,361**	**1,941**
(Capital account in euro terms)	276	998	1954	988	2139	962	1917	1552
Errors and omissions 6/	267	239	320	409	440	337	237	200
Overall balance	**183**	**605**	**784**	**-739**	**935**	**-1,037**	**95**	**-639**
Financing	**-183**	**-5,981**	**-855**	**-5,006**	**-994**	**-4,883**	**-3,355**	**-2,343**
Net foreign assets (increase, -)	-246	-395	-816	-333	-994	-44	-161	-404
Central Bank, net		-395	-816	-333	-994	-44	-161	-404
Gross foreign reserves (increase, -)	-227	-523	-1,111	-611	-1,270	-50	-165	-474
Of which: IMF purchases	152	128	295	279	276	241	239	276
Gross foreign liabilities (increase +)	-19	128	295	279	276	6	4	70
IMF repayment	20	0	0	0	0	-235	-233	-205
Arrears (reduction, -) 7/	63	-5,587	-39	-4,673	0	-4,839	-3,194	-1,939
Financing expected / to be secured	n.a.	n.a.	0	999	n.a.	995	n.a.	782
Official grants 4/	n.a.	n.a.	0	575	n.a.	338	n.a.	400
Official borrowing (excluding IMF) 4/	n.a.	n.a.	0	424	n.a.	657	n.a.	382
Residual gap	...	5,377	71	4,746	59	4,925	3,259	2,200
Arrears settlement with creditors 7/	...	5,377	39	4,673	0	4,839	3,194	1939
Debt relief from creditors	...	0	32	73	59	86	65	112
Memorandum items:								
Trade deficit	-1,788	-2,834	-3,908	-4,750	-4,942	-5,322	-6,492	-6,540
(In percent of GDP) 3/	-21	-24	-25.2	-23.2	-24.1	-22.8	-28.0	-28.2
Current account balance, after grants	-339	-528	-1,383	-1,697	-1,923	-2,239	-2,503	-2380
(In percent of GDP) 3/	-3.9	-4.6	-8.9	-8.1	-9.4	-9.6	-10.8	-10.3
Gross international reserves, USD mn (end period)	516	1,169	2,280	2,891	3,550	3,600	3,715	4,189
in months of prospective imports of goods & services	1.2	2.4	3.2	3.7	3.7	4.3	3.7	3.9
Debt service, cash	56	107	183	433	477	1,014	1,047	1,384
(In percent of GDP) 3/	0.6	0.9	1.2	2.1	2.3	4.3	4.5	6.0
Principal	14	33	43	157	218	542	646	827
Interest	42	74	141	277	259	473	401	556
External Debt 8/	11,403	11,948	11,839	...	14,303	12841	13,547	13,303
(in percent of GDP)	133	103	76	...	70	55	58	57
Underlying external debt 9/	n/a	n/a	n/a	...	n/a	15168	15,316	16,578
(in percent of GDP)	n/a	n/a	n/a	...	n/a	65	66	72
Net external debt (debt minus gross reserves)	10,522	10,140	8,776	...	9,867	9,241	9,084	8,366
(in percent of GDP)	122	88	57	...	48	36	39	36

Sources: SM authorities; and IMF staff estimates.

1/ Revised program figures take into account valuation impact of dollar exchange rate.

2/ Up to 2001, figures indicate debt service actually paid. For 2002 and onwards, debt service recorded above-the-line is after the debt reduction granted by bilateral and commercial creditors, but before the capitalization of moratorium interest (the effect of the latter is recorded as "debt relief from creditors").

3/ Program figures are adjusted to reflect the official revision of the GDP series.

4/ Official grants and loans recorded above-the-line are amounts based on already secured commitments; amounts expected from new pledges are shown below-the-line.

5/ For 2001-2003, including sales of foreign exchange notes by the public (amount above the level implied by trend growth) reflecting currency substitution. For 2003 also includes the foreign currency inflows corresponding to the unfreezing of the accounts held abroad by SM banks.

6/ The positive value in 2005 reflects a systematic errors and omissions component due to the integration of the Serbia and Montenegro balances of payments.

7/ Negotiations are on-going to clear all remaining external arrears.

8/ Including July 2004 debt reduction from London Club, and assuming completion of Paris Club debt relief operation and comparable debt relief by non-Paris Club and commercial creditors (from June 2004 onwards).

9/ Excluding all debt relief concluded or assumed after end June 2004.

Table 4. Serbia and Montenegro: Indicators of External Vulnerability, 1997–2003 1/
(In percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003
Financial indicators							
Public sector debt	…	…	…	119.1	123.2	84.5	76.6
Broad money (percent change, 12-month basis)	23.9	69.4	67.6	61.4	76.6	78.0	28.6
Private sector credit (percent change, 12-month basis)	…	…	128.4	68.6	7.6	49.6	25.1
Weighted interest rates (percent per month, December) 2/	6.3	7.0	3.9	6.8	3.8	2.4	2.1
Retail prices (percent change per annum, end of period)	…	…	49.9	113.5	39.0	14.2	7.8
External Indicators							
Exports (recorded exports, percent change, 12-month basis in US$)	19.5	24.0	-44.7	14.7	10.4	19.5	24.0
Imports (percent change, 12-month basis in US$)	17.0	1.0	-32.0	14.4	30.4	30.7	25.9
Current account balance, before grants	-7.7	-4.8	-7.5	-7.1	-9.7	-13.0	-12.0
Current account balance after grants and FDI	-3.3	-3.9	-6.4	-3.6	-3.1	-5.3	-2.5
Errors and omissions	-0.6	2.0	4.0	3.1	2.1	2.1	2.1
Gross official reserves (in US$ million)	…	326	293	516	1,169	2,280	3,550
(in months of imports GS of the following year)	…	1.1	0.9	1.2	2.4	3.2	3.7
Central Bank short-term foreign liabilities (in US$ million) 3/	…	0	0	0	0	100	100
Gross reserves of the banking system (in US$ million)	…	774	659	882	1,809	3,063	4,436
(in months of imports GS of the following year)	…	2.6	1.9	2.1	3.2	4.2	4.7
Short term foreign liabilities of the commercial banks (in US$ million)	…	…	…	349	59	74	136
Foreign currency liabilities of the commercial banks (in US$ million)	…	…	…	871	775	1,483	2,451
Official reserves/Broad money (M2) (percent)	…	18	30	50	0	74	79
Official reserves/reserve money (percent)	…	59	126	164	0	199	262
Short term external debt by original maturity (in US$ million) 4/	1,048	1,021	987	1,153	1,026	1,020	1,056
Short term external debt by remaining maturity (in US$ million) 4/	1,073	1,038	1,001	1,186	1,069	1,224	1,702
Short term external debt to reserves by original maturity (in percent)	...	313.1	337.0	223.4	87.7	44.7	29.7
Short term external debt to reserves by remaining maturity (in percent)	...	318.3	341.7	229.8	91.4	53.7	47.9
Share of short term external debt to total debt by original maturity (in percent)	10.7	9.7	9.2	10.1	8.6	8.6	7.4
Share of short term external debt to total debts by remaining maturity (in percent)	11.0	9.8	9.3	10.4	8.9	10.3	11.9
Total external debt (in US$ millions)	9,770	10,539	10,744	11,403	11,948	11,839	14,303
Of which : Public and publicly guaranteed debt 5/	8,722	9,518	9,757	10,250	10,922	10,919	13,348
Total external debt (in percent of exports of G&S)	...	267	500	448	436	365	352
External interest payments, cash basis (in percent of exports of G&S)	…	…	…	1.6	2.7	4.3	6.4
External amortization payments, cash basis (in percent of exports of G&S)	…	…	…	0.0	1.2	1.3	5.4
Exchange rate, official (per euro, end of period)	3	12	12	59	61	61.5	68.2
Exchange rate, parallel (per euro, end of period)	5	16	21	30	31	61.5	68.2
REER (annual average, February-December 1994 = 100) 6/	100.4	91.7	66.9	51.4	82.0	91.5	96.4

Sources: SM authorities; and IMF staff estimates.

1/ All stocks are measured end-of-period. Excludes Kosovo, except for external debt.
2/ Weighted average of interest rates on commercial paper, bank bills, and certificates of deposit.
3/ Excluding IMF and liabilities to domestic residents. In 2002, the NBS assumed short-tem external debt of commercial banks of $100 million.
4/ Includes overdue obligations on debt related to imports of oil and gas. Short-term external debt by remaining maturity also includes amortization due in the following year on medium- and long-term debt.
5/ Assuming all long- and medium-term external debt of banks and enterprises is government guaranteed.
6/ Increase denotes appreciation.

Table 5. Serbia General Government Fiscal Operations in 2003–05 1/

	Consolidated General government Excluding Montenegro								Consolidated General Government Including Montenegro							
	2003	**2004**		**2005**	**2003**	**2004**		**2005**	**2003**	**2004**		**2005**	**2003**	**2004**		**2005**
		3rd. Rev.	Proj.	Proj.		3rd. Rev.	Proj.	Proj.		3rd. Rev.	Proj.	Proj.		3rd. Rev.	Proj.	Proj.
	(billion dinars)				(Percent of GDP) 2/				(billion dinars)				(Percent of GDP) 2/			
Total revenue	**474.9**	**547.9**	**552.0**	**634.2**	**40.3**	**40.5**	**40.3**	**39.5**	**507.9**	**590.0**	**593.3**	**686.4**	**43.1**	**43.6**	**43.3**	**42.8**
Current revenue	470.1	547.6	551.9	634.2	39.9	40.5	40.3	39.5	503.0	589.2	592.8	685.8	42.7	43.5	43.3	42.8
Tax revenue	430.1	494.5	509.5	575.5	36.5	36.5	37.2	35.9	461.0	534.3	548.5	624.6	39.1	39.5	40.0	38.9
Personal income tax	70.1	74.1	75.6	82.6	6.0	5.5	5.5	5.1	74.3	79.5	80.6	88.8	6.3	5.9	5.9	5.5
Social security contributions	115.8	135.5	140.0	161.9	9.8	10.0	10.2	10.1	126.1	147.3	151.8	176.2	10.7	10.9	11.1	11.0
Corporate income tax	5.9	7.5	7.3	7.3	0.5	0.6	0.5	0.5	6.8	8.7	8.5	8.8	0.6	0.6	0.6	0.6
Retail sales tax/VAT	126.3	142.8	152.6	179.0	10.7	10.6	11.1	11.2	135.3	153.6	164.6	194.3	11.5	11.3	12.0	12.1
Excises	58.3	76.1	72.3	83.1	5.0	5.6	5.3	5.2	62.1	81.3	76.9	88.8	5.3	6.0	5.6	5.5
Taxes on international trade and operations	28.9	33.0	33.5	39.2	2.5	2.4	2.4	2.4	31.4	36.4	36.2	43.0	2.7	2.7	2.6	2.7
Other taxes	24.7	25.4	28.2	22.5	2.1	1.9	2.1	1.4	24.9	27.7	29.9	24.7	2.1	2.0	2.2	1.5
Nontax revenue	40.0	53.1	42.4	58.7	3.4	3.9	3.1	3.7	42.1	54.9	44.3	61.2	3.6	4.1	3.2	3.8
Capital revenue	4.8	0.3	0.1	0.0	0.4	0.0	0.0	0.0	4.9	0.8	0.5	0.6	0.4	0.1	0.0	0.0
Total expenditure and net lending	**511.9**	**577.5**	**575.5**	**643.0**	**43.4**	**42.6**	**42.0**	**40.1**	**547.4**	**621.5**	**621.1**	**699.0**	**46.5**	**45.8**	**45.3**	**43.6**
Current expenditure	476.5	530.6	541.3	604.7	40.4	39.1	39.5	37.7	508.8	570.7	582.4	654.8	43.2	42.1	42.5	40.8
of which:																
Expenditure on goods and services	201.7	223.4	231.4	262.9	17.1	16.5	16.9	16.4	216.3	241.2	248.0	283.3	18.4	17.8	18.1	17.7
Wages and salaries	113.2	131.2	132.9	149.1	9.6	9.7	9.7	9.3	123.3	143.6	145.0	163.7	10.5	10.6	10.6	10.2
o/w: severance pay	0.0	0.0	0.0	7.0	0.0	0.0	0.0	0.4	0.0	0.0	0.0	8.0	0.0	0.0	0.0	0.4
Purchases of goods and services	88.6	92.1	98.5	113.8	7.5	6.8	7.2	7.1	93.0	97.6	103.0	119.6	7.9	7.2	7.5	7.5
Interest payment	11.3	13.8	15.3	22.8	1.0	1.0	1.1	1.4	12.2	15.4	16.5	24.4	1.0	1.1	1.2	1.5
Subsidies and other current transfers	257.2	286.8	288.7	319.0	21.8	21.1	21.1	19.9	274.0	307.4	309.1	343.4	23.3	22.6	22.6	21.4
Subsidies	40.9	47.9	44.5	43.7	3.5	3.5	3.2	2.7	41.8	48.6	45.1	44.1	3.6	3.6	3.3	2.7
Transfers to households 5/	216.3	238.8	244.1	275.3	18.4	17.6	17.8	17.2	232.1	258.8	264.0	299.3	19.7	19.0	19.3	18.7
Capital expenditure	27.9	37.0	32.5	33.5	2.4	2.7	2.4	2.1	29.3	39.8	35.1	37.3	2.5	2.9	2.6	2.3
of which: financed by project loans	5.6	11.4	7.7	9.8	0.5	0.8	0.6	0.6	6.1	12.6	9.5	11.3	0.5	0.9	0.7	0.7
General reserves 4/	0.0	4.4	0.0	2.1	0.0	0.3	0.0	0.1	0.6	5.1	1.2	3.8	0.0	0.4	0.1	0.2
Lending minus repayment	7.4	5.5	1.8	2.8	0.6	0.4	0.1	0.2	8.7	6.0	2.5	3.1	0.7	0.4	0.2	0.2
Net transfer to other levels of government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net transfer from Montenegro	2.1	3.0	0.0	0.0	0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gap/Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Overall balance	**-34.9**	**-26.7**	**-23.5**	**-8.8**	**-3.0**	**-1.9**	**-1.7**	**-0.6**	**-39.5**	**-31.5**	**-27.8**	**-12.6**	**-3.4**	**-2.2**	**-2.0**	**-0.8**
Excluding project loans	**-29.3**	**-15.3**	**-15.8**	**0.9**	**-2.5**	**-1.1**	**-1.2**	**0.1**	**-33.4**	**-18.9**	**-18.4**	**-1.3**	**-2.8**	**-1.3**	**-1.3**	**-0.1**
Foreign grants	1.9	3.0	0.7	0.0	0.2	0.2	0.1	0.0	2.7	3.6	1.3	0.7	0.2	0.3	0.1	0.0
Overall balance including grants	-33.0	-23.7	-22.8	-8.8	-2.8	-1.7	-1.7	-0.6	-36.8	-28.0	-26.5	-11.9	-3.1	-2.0	-1.9	-0.7
Financing	33.0	23.7	22.8	8.8	2.8	1.7	1.7	0.6	36.7	28.0	26.6	11.9	3.1	2.0	1.9	0.7
Domestic financing	-29.2	-4.0	8.4	-31.4	-2.5	-0.4	0.6	-2.0	-28.4	-3.1	8.9	-31.3	-2.4	-0.2	0.7	-1.9
Foreign Financing	12.9	19.4	10.0	14.4	1.1	1.4	0.7	0.9	14.2	21.8	12.9	16.9	1.2	1.6	0.9	1.1
Privatization receipts	49.3	8.3	4.4	25.8	4.2	0.6	0.3	1.6	50.9	9.4	4.8	26.4	4.3	0.7	0.4	1.6

Sources: Ministry of Finance of Republic of Serbia and Republic of Montenegro; and IMF staff estimates.

1/ Consolidated general government includes the federal, the republican, and local governments (except for Montenegro), the social security funds and the extrabudgetary programs.

2/ Expressed in terms of GDP of the Republic of Serbia and Republic of Montenegro, excluding Kosovo.

3/ 2004 data include previously off-budget fiscal operations in Montenegro amounting to 0.2 percent of GDP.

4/ Expenditures from reserves on H1 overspending in subsidies, wages and net lending are recorded in the expenditure category on which they are spent.

5/ Foreign currency deposit payments to households, formerly classifed above-the-line, are reclassified below-the-line.

Table 6. Serbia: Republican Government Fiscal Operations, 2003~~0~~5

(In percent of GDP) 1/

	2003	2004		2005
		3rd Rev.	Proj.	Proj.
A Total revenue and grants (1+2+3)	**24.8**	**25.7**	**25.0**	**25.6**
1 Total revenue (1.1+1.2)	24.4	25.3	24.9	25.6
1.1 Current revenue (1.1.1+1.1.2)	24.4	25.2	24.9	25.6
1.1.1 Tax revenue (1.1.1.1+...+1.1.1.6)	21.8	22.0	22.5	22.6
1.1.1.1 Personal income tax	4.4	4.0	4.0	3.1
1.1.1.2 Corporate income tax	0.4	0.5	0.5	0.4
1.1.1.3 Turnover (retail sales) tax	9.2	9.2	9.8	11.2
1.1.1.4 Taxes on international trade	2.5	2.4	2.4	2.4
1.1.1.5 Excises	5.0	5.6	5.3	5.2
1.1.1.6 Property taxes	0.3	0.3	0.5	0.3
1.1.1.7 Other taxes	0.0	0.0	0.0	0.0
1.1.2 Nontax revenue	2.6	3.2	2.4	3.0
1.2 Capital revenue	0.0	0.0	0.0	0.0
2 Transfer from Montenegro	0.2	0.2	0.0	0.0
3 Grants	0.2	0.2	0.1	0.0
B. Total expenditure and net lending (1+...+6)	**27.4**	**27.4**	**26.7**	**26.1**
1. Total expenditure (2+3+4)	26.8	27.0	26.7	25.9
2 Current expenditure (2.1+2.2+2.3)	24.8	24.3	24.5	24.1
2.1. Expenditure on goods and services (2.1.1+...+2.1.4)	7.5	6.9	7.2	7.1
2.1.1 Wages and salaries	4.7	4.3	4.3	4.1
2.1.2 Employer contribution	0.9	0.9	0.9	0.9
2.1.2.1 Contribution	0.9	0.8	0.8	0.9
2.1.2.2 Tax	0.0	0.1	0.1	0.0
2.1.3 Severance payments	0.0	0.0	0.0	0.3
2.1.4 Other purchases of goods and services	1.7	1.4	1.6	1.6
2.2. Interest payment	0.9	1.0	1.1	1.4
2.3. Subsidies and other current transfers	16.3	17.7	16.3	15.6
2.3.1 Subsidies	2.7	2.6	2.6	2.0
2.3.2 Transfers to households 3/	3.1	2.4	2.4	2.6
2.3.3 Current transfers to other levels of government	10.5	11.4	11.3	10.9
Federal budget	2.7	3.9	3.5	3.1
Republican budget	0.0	0.0	0.0	0.0
Local Budgets	1.3	1.1	1.4	2.3
Pension Funds	5.5	5.2	5.2	4.4
Health Fund	0.3	0.2	0.2	0.2
Labor Market Fund	0.4	0.5	0.6	0.5
Other transfers	0.0	0.0	0.0	0.0
3. Capital expenditure	1.9	2.1	2.0	1.7
Of which: Budget for recovery and reconstruction	0.5	0.8	0.6	0.6
4. General reserves	0.0	0.3	0.0	0.1
5. New Serbia expenditure	0.2	0.2	0.0	0.0
6. Lending minus repayment	0.6	0.4	0.1	0.2
Overall budget balance including grants (A-B)	**-2.7**	**-1.7**	**-1.7**	**-0.6**
Overall budget balance excluding grants and project loans	**-2.3**	**-1.1**	**-1.2**	**0.1**
Financing (1+2+3)	2.7	1.7	1.7	0.6
1 Domestic financing (net)	-2.6	-0.4	0.6	-2.0
2 Foreign financing (net)	1.1	1.4	0.7	0.9
3 Privatization receipts 2/	4.2	0.6	0.3	1.6

Sources: Ministry of Finance of Serbia; and IMF staff estimates.

1/ Expressed in terms of GDP of SM, excluding Kosovo.

2/ Total privatization revenue accruing to the republican government.

3/ Frozen foreign currency deposit payments to households, formerly classified above-the-line, are reclassified below-the-line.

Table 7. Montenegro: Consolidated Fiscal Operations 2001~~0~~5
(As a percent of GDP)

	2001	2002	2003	2004		2005
	Actual	Actual	Actual	3rd. Rev.	**Proj.**	**Proj.**
Total revenue	**38.0**	**36.5**	**36.5**	**39.0**	**38.5**	**38.2**
Current revenue	38.0	36.5	36.4	38.5	38.1	37.8
Tax revenue	32.9	34.2	34.1	36.9	36.3	35.9
Personal income tax	5.4	4.6	4.7	5.0	4.6	4.6
Social security contributions	10.8	11.9	11.1	10.9	11.0	10.5
Corporate income tax	0.6	1.0	1.0	1.1	1.1	1.1
Retail sales tax / VAT from April 2003 1/	7.1	8.7	10.1	9.9	11.2	11.2
Excises	4.4	4.5	4.2	4.8	4.2	4.2
Taxes on international trade	4.3	3.1	2.9	3.2	2.6	2.8
Other taxes 2/	0.4	0.4	0.2	2.1	1.6	1.6
Extrabudgetary taxes	0.0	0.0	0.0	0.0	0.0	0.0
Nontax revenue	5.1	2.4	2.3	1.6	1.8	1.9
Capital revenue	0.0	0.0	0.1	0.5	0.4	0.4
Total expenditure and net lending	**42.3**	**40.2**	**39.4**	**40.2**	**39.9**	**38.3**
Current expenditure	38.6	36.9	35.7	36.6	35.7	34.0
Net wages, salaries and allowances	9.9	10.4	9.4	9.8	9.6	9.1
Payroll Tax	1.6	1.2	1.6	1.6	1.7	1.6
Employer contributions	0.0	0.0	0.0	0.0	0.0	0.0
Purchases of goods and services	5.9	3.9	4.4	4.9	4.0	4.1
Interest payment	0.1	1.0	1.0	1.5	1.2	1.2
Subsidies and other current transfers	20.7	19.8	18.7	18.6	19.1	17.8
Subsidies to enterprises	1.2	2.0	1.1	0.6	0.6	0.3
Transfers to households 3/	19.5	17.8	17.7	17.9	18.5	17.6
Other non-interest current expenditure	0.5	0.7	0.5	0.2	0.2	0.2
Capital expenditure	2.0	1.6	1.6	2.7	2.5	2.8
of which : foreign financed project spending	0.0	0.6	0.6	1.1	1.6	1.1
General reserves	0.6	1.0	0.6	0.6	1.1	1.2
Net Lending	1.1	0.7	1.5	0.4	0.7	0.2
Transfer to the Union Budget	**0.0**	**0.0**	**2.3**	**2.8**	**2.6**	**2.7**
Discrepancy	0.4	0.3	-0.1	0.0	0.0	0.0
Overall balance before grants	**-4.7**	**-4.0**	**-5.2**	**-4.0**	**-4.0**	**-2.8**
Overall balance before grants and foreign-financed project loans	**-4.7**	**-3.4**	**-4.6**	**-2.9**	**-2.4**	**-1.6**
Foreign grants	3.1	2.2	0.9	0.5	0.5	0.5
Overall balance including grants	**-1.6**	**-1.8**	**-4.2**	**-3.5**	**-3.5**	**-2.3**
Financing	**1.6**	**1.8**	**4.2**	**3.5**	**3.5**	**2.3**
Domestic financing	**1.6**	**-3.9**	**1.8**	**0.3**	**0.5**	**0.1**
Bank financing	0.8	-3.5	1.1	0.8	0.8	0.7
Nonbank financing	0.8	-0.3	0.7	-0.5	-0.3	-0.5
of which: repayment of FFCDs 3/	0.0	-0.3	0.0	-0.5	-0.3	-0.5
Net Foreign Financing	**0.0**	**0.6**	**1.4**	**2.2**	**2.6**	**1.8**
Program	0.0	0.0	0.8	1.1	1.1	0.6
Project	0.0	0.6	0.6	1.1	1.6	1.1
Privatization receipts	**0.0**	**5.1**	**1.1**	**1.0**	**0.4**	**0.4**
Memorandum item						
Montenegro GDP (Euro million)	1,049	1,250	1,375	1,475	1,475	1,580

Source: Montenegrin Ministry of Finance and staff projections.

1/ From FY2002 onwards, retail sales tax includes revenues that were redirected to the Army and the Railway.

2/ 2004 includes previously off-budget revenue and spending, most of which represents an excise surtax on petrol products to finance transportation sector project spending.

3/ Foreign currency deposit payments to households, formerly classifed above-the-line, are reclassified below-the-line.

Table 8. Montenegro: Republican Government Fiscal Operations, 2001–05
(As a percent of GDP)

	2001	2002	2003	2004		2005
	Actual	Actual 1/	Actual	3rd. Rev.	**Proj.**	**Proj.**
A Total revenue and grants (1+2)	**23.3**	**26.7**	**25.7**	**27.5**	**27.3**	**27.6**
1 Total revenue (1.1+1.2)	21.9	24.6	24.8	27.0	26.8	27.1
1.1 Current revenue (1.1.1+1.1.2)	21.9	24.6	24.8	26.8	26.5	26.8
1.1.1 Tax revenue (1.1.1.1+1.1.1.2+1.1.1.3+1.1.1.4)	17.9	22.9	22.9	25.7	25.3	25.5
1.1.1.1 Personal income	5.4	5.3	4.7	5.0	4.6	4.6
1.1.1.2 Turnover (retail sales) tax / VAT after April 2003 1/	5.6	8.6	10.0	9.9	11.2	11.2
1.1.1.3 Excises	3.4	4.5	4.2	4.7	4.2	4.2
1.1.1.4 Taxes on international trade and transactions	0.0	3.1	2.9	3.2	2.6	2.8
1.1.1.5 Other taxes 2/	2.6	0.4	0.2	1.9	1.6	1.6
1.1.1.6 Corporate income taxes	0.0	1.0	1.0	1.1	1.1	1.1
1.1.2 Nontax revenue	4.0	1.7	1.8	1.1	1.1	1.3
1.2 Capital revenue	0.0	0.0	0.0	0.2	0.3	0.3
2 Grants	1.4	2.2	0.9	0.5	0.5	0.5
B Total expenditure and net lending (1+2)	**24.3**	**22.7**	**23.2**	**24.6**	**23.5**	**22.3**
1 Total expenditure (1.1+1.2)	23.7	21.8	21.5	24.0	22.7	21.9
1.1 Current expenditure (1.1.1+1.1.2)	21.8	20.4	19.9	21.2	20.3	19.1
1.1.1 Interest	0.1	1.1	1.0	1.5	1.1	1.2
1.1.2 Non-interest (1.1.2.1+1.1.2.2+1.1.2.3+1.1.2.4)	21.8	19.3	18.9	19.7	19.1	17.9
1.1.2.1 wages and salaries	10.3	9.1	9.8	10.0	9.8	9.2
Net Wages	4.8	5.5	5.1	4.8	4.8	4.5
Allowances	1.0	1.0	0.8	0.9	0.7	0.7
PIT	1.2	1.3	1.2	1.2	1.4	1.3
Contributions	3.2	1.2	2.4	3.1	3.0	2.8
1.1.2.2. Goods and Services	5.3	3.3	3.5	4.3	3.4	3.4
1.1.2.3 Transfers and social benefits to individuals, NGOs 3/ 4/	3.9	3.6	3.5	3.8	4.2	3.8
1.1.2.4 Subsidies to enterprises	1.2	2.0	1.1	0.7	0.6	0.3
1.1.2.5 Other non-interest expenditure and reserves	1.1	1.3	1.1	0.8	1.1	1.2
1.2 Capital expenditure	1.8	1.5	1.6	2.8	2.5	2.8
of which: foreign financed project spending	0.0	0.6	0.6	1.1	1.6	1.1
2 Net lending	0.6	0.8	1.7	0.6	0.8	0.4
C Net transfer to other levels of government	**0.4**	**5.0**	**5.6**	**7.2**	**7.3**	**7.6**
1 Transfers to the PIO	0.1	4.2	2.8	3.7	3.9	4.2
2 Transfers to the Health Fund	0.1	0.4	0.2	0.4	0.5	0.5
3 Transfers to the Employment Fund	0.2	0.3	0.2	0.3	0.2	0.3
4 Transfers to the Union Budget	0.0	0.0	2.3	2.8	2.6	2.7
D Discrepancy	0.2	1.1	0.2	-0.7	0.0	0.0
Overall budget balance before grants (cash)	**-3.0**	**-4.1**	**-4.2**	**-4.0**	**-4.0**	**-2.8**
Overall balance before grants and foreign-financed project loans	**-3.0**	**-3.6**	**-3.6**	**-2.9**	**-2.4**	**-1.6**
Overall budget balance after grants (cash) (A-B-C-D)	**-1.6**	**-2.0**	**-3.3**	**-3.5**	**-3.5**	**-2.3**
Financing (1+2+3)	**1.6**	**2.0**	**3.3**	**3.5**	**3.5**	**2.3**
1 Domestic financing (net) (1.1+1.2)	**1.6**	**-2.9**	**1.0**	**0.9**	**0.5**	**0.1**
1.1 Banking system (1.1.1+1.1.2)	0.8	-2.6	0.3	1.4	0.8	0.7
1.1.1 Central Bank of Montenegro	1.0	0.3	-0.9	0.0	0.0	0.0
1.1.2 Commercial banks	-0.2	-2.8	1.2	1.4	0.8	0.7
1.2 Nonbank	0.8	-0.3	0.7	-0.5	-0.3	-0.5
of which: repayment of FFCDs 4/	0.0	-0.3	0.0	-0.5	-0.3	-0.5
2 Foreign financing (net) (2.1-2.2)	**0.0**	**0.6**	**1.4**	**2.2**	**2.6**	**1.8**
2.1 Disbursements	0.0	0.6	1.4	2.2	2.6	1.8
2.2 Amortization	0.0	0.0	0.0	0.0	0.0	0.0
3 Privatization receipts	**0.0**	**4.3**	**0.9**	**0.4**	**0.4**	**0.4**
Memorandum items:						
Gross wage bill on a commitment basis	10.3	11.5	9.8	10.0	9.8	9.2
Nominal GDP (Euro million)	1,049	1,250	1,375	1,475	1,475	1,580

Source: Montenegrin Ministry of Finance.
1/ After 2002 includes sales taxes that were earlier redirected to Pension Fund, Railway and Army; and assumes full payment of payroll tax by the government to itself on behalf of its employees.
2/ 2004 includes previously off-budget revenue and spending, most of which represents an excise surtax on petrol products to finance transportation sector project spending.
3/ From 2003, the reported wage bill excludes wages of employees of the University of Montenegro; these are now included in "Transfers".
4/ Foreign currency deposit payments to households, formerly classifed above-the-line, are reclassified below-the-line.

Table 9. Serbia and Montenegro: Indicators of Capacity to Repay the Fund, 2000–11

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
					Projections							
Fund repurchases and charges 1/												
In millions of SDRs	…	7.9	10.3	12.2	171.9	163.1	48.9	70.9	135.2	191.5	175.2	104.1
In millions of U.S. dollars	…	10.2	13.3	17.1	252.8	239.7	72.0	104.6	199.5	282.5	258.6	153.5
In percent of exports of goods and NFS	…	0.4	0.4	0.4	4.5	3.8	1.0	1.3	2.3	3.0	2.5	1.4
In percent of debt service	…	9.6	7.3	3.9	24.7	16.7	4.7	5.0	8.5	11.2	9.8	6.1
In percent of quota	…	1.7	2.2	2.6	36.7	34.9	10.5	15.2	28.9	40.9	37.5	22.2
In percent of gross official reserves	…	0.9	0.6	0.5	6.8	5.7	1.6	2.4	4.5	6.2	5.1	2.9
Fund credit outstanding												
In millions of SDRs	116.9	216.9	416.9	616.9	621.0	668.8	641.7	591.7	475.0	297.9	131.3	31.3
In millions of U.S. dollars	154.2	280.2	539.9	862.6	913.5	983.0	945.2	872.7	700.9	439.6	193.7	46.1
In percent of quota	25.0	46.4	89.1	131.9	132.8	143.0	137.2	126.5	101.6	63.7	28.1	6.7
In percent of GDP	1.8	2.4	3.5	4.2	3.9	4.2	4.0	3.5	2.7	1.5	0.6	0.1
In percent of gross official reserves	29.9	24.0	23.7	24.3	24.6	23.5	21.5	20.0	15.7	9.6	3.8	0.9
Memorandum items:												
Exports of goods and NFS (millions of US$)	2,547	2,743	3,241	4,068	5,578	6,285	7,016	7,840	8,576	9,385	10,261	11,228
Debt service, after debt relief (millions of US$)	56	107	183	436	1,026	1,439	1,542	2,111	2,335	2,527	2,643	2,513
Quota (millions of SDRs)	468	468	468	468	468	468	468	468	468	468	468	468
Quota (millions of US$)	617	604	606	654	688	687	689	690	690	690	690	690
Gross official reserves (millions of US$)	516	1,169	2,280	3,550	3,715	4,189	4,394	4,359	4,459	4,589	5,034	5,270
U.S. dollar per SDR	1.32	1.29	1.29	1.40	1.47	1.47	1.47	1.47	1.48	1.48	1.48	1.48

Sources: SM authorities; and IMF staff estimates.

1/ Arrears to the Fund of SDR 101 million were cleared on December 20, 2000. Projections are based on repurchase expectations to ensure consistency with other tables.

Table 10. Serbia and Montenegro: Macroeconomic Framework, 2000–09

	2000	2001	2002	2003	2004		2005	2006	2007	2008	2009
					3rd. Rev.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
GDP (DIN billion)	382	772	995	1,178	1,354	1,371	1,604	1,800	1,973	2,148	2,326
(Percent change)											
End-period inflation (RPI)	113.5	39.0	14.2	7.8	8.5	12.5	9.6	6.0	4.5	3.5	2.5
GDP	5.0	5.5	4.0	3.0	4.4	6.0	4.6	4.8	5.0	5.0	5.0
(In percent of nominal GDP)											
Gross domestic savings	-2.7	-7.2	-7.0	-6.4	-4.0	-8.7	-7.3	-4.7	-1.9	-0.4	1.1
Non-government	-4.4	-7.8	-6.9	-7.3	-5.7	-11.1	-11.3	-8.3	-5.9	-5.1	-4.3
Government	1.6	0.6	-0.1	1.0	1.7	2.4	3.9	3.6	4.0	4.8	5.4
Net factor receipts and transfers from abroad	13.0	16.3	14.2	13.1	11.2	14.4	14.8	15.1	14.9	14.8	14.7
Non-government	12.3	15.6	14.6	14.5	12.7	16.0	16.8	16.9	16.6	16.6	16.4
Government	0.7	0.7	-0.3	-1.4	-1.4	-1.6	-2.0	-1.7	-1.7	-1.9	-1.7
Gross national savings	10.3	9.1	7.2	6.7	7.3	5.7	7.5	10.4	13.0	14.4	15.8
Non-government	7.9	7.8	7.6	7.2	7.0	5.0	5.6	8.5	10.7	11.5	12.1
Government	2.4	1.3	-0.4	-0.5	0.2	0.8	1.9	1.8	2.2	2.9	3.7
Gross domestic investment 1/	14.2	13.6	16.1	16.1	16.8	16.5	17.8	20.4	22.4	23.3	23.8
Non-government	12.2	11.7	12.2	13.4	13.7	13.6	15.2	15.5	17.4	18.2	18.8
Government	3.1	1.6	3.6	2.5	2.9	2.6	2.3	4.6	4.7	4.7	4.7
Savings-investment balance 1/	-3.9	-4.6	-8.8	-9.4	-9.6	-10.8	-10.3	-10.0	-9.5	-8.9	-8.0
Non-government	-4.3	-3.9	-4.6	-6.2	-6.7	-8.7	-9.6	-7.0	-6.7	-6.7	-6.6
Government	-0.7	-0.3	-4.0	-3.0	-2.7	-1.8	-0.4	-2.8	-2.5	-1.8	-1.0
Foreign savings	3.9	4.6	8.8	9.4	9.6	10.8	10.3	10.0	9.5	8.9	8.0
Foreign savings including official grants	7.1	9.7	12.8	12.0	11.0	13.0	12.0	11.3	10.4	9.8	8.8
Net exports of goods and services	-16.9	-20.9	-23.1	-22.5	-20.8	-25.2	-25.1	-25.1	-24.4	-23.6	-22.7
Memorandum:											
Current Account	-7.1	-9.7	-13.0	-12.0	-11.0	-13.0	-12.0	-11.3	-10.4	-9.8	-8.8

Sources: Data provided by the Federal Bureau of Statistics; Ministry of Finance; and IMF staff projections.

1/ Components may not always add up to the total as a result of rounding and inventory changes.

Table 11. Serbia and Montenegro: External Financing Requirements and Sources, 1998–2007
(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003 Est	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.
1. Gross financing requirements	**-720**	**-818**	**-1,074**	**-7,261**	**-3,200**	**-3,942**	**-7,022**	**-6,020**	**-3,778**	**-3,976**
External current account deficit (excluding official transfers)	-660	-764	-671	-1,119	-2,007	-2,454	-3,017	-2,780	-2,652	-2,565
Debt amortization	-60	-54	-47	-33	-43	-218	-413	-622	-881	-1,336
Medium- and long-term debt	-25	-17	-14	-33	-43	-190	-334	-577	-881	-1,336
Short-term debt 1/	-35	-37	-33	0	0	-28	-80	-45	0	0
Repayment of arrears	0	0	0	-5,587	-39	0	-3,194	-1,939	0	0
Gross reserve accumulation	0	0	-227	-523	-1,111	-1,270	-165	-474	-205	35
IMF repurchases and repayments	0	0	-129	0	0	0	-233	-205	-40	-110
2. Financing	**720**	**818**	**1,074**	**7,261**	**3,200**	**3,942**	**7,023**	**2,763**	**2,251**	**2,732**
Official grants 2/	0	0	271	591	624	531	514	0	0	0
Foreign direct investment (net)	113	112	25	165	562	1,405	966	1,181	950	1,200
Disbursement from private creditors	78	30	49	202	236	580	1,197	1,187	950	1,080
Medium and long-term financing	78	30	49	127	78	514	1,071	1,067	800	900
Short-term financing and other capital inflows	0	0	0	75	158	66	126	120	150	180
Disbursement from official creditors 2/	50	29	227	205	343	426	339	0	0	0
Multilateral 3/	…	…	…	205	285	341	302	0	0	0
Other	…	…	…	0	58	85	37	0	0	0
IMF disbursement	0	0	150	128	295	276	239	0	0	0
Accumulation of arrears (exceptional)	86	126	62	0	0	0	0	0	0	0
Debt Relief	0	0	0	5,377	71	59	3,259	0	0	0
Other flows 4/	393	521	290	594	1,069	665	510	395	351	452
3. Financing Gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**3,258**	**1,527**	**1,244**
Expected disbursements of grants from donors 2/	0	0	0	0	0	0	0	400	293	234
EU	0	0	0	0	0	0	0	0	0	0
Others (mostly official bilateral creditors)	0	0	0	0	0	0	0	400	293	234
Expected disbursement of loans from donors 2/	0	0	0	0	0	0	0	657	540	540
World Bank	0	0	0	0	0	0	0	143	0	0
IMF	0	0	0	0	0	0	0	276	0	0
EBRD	0	0	0	0	0	0	0	52	0	0
EIB	0	0	0	0	0	0	0	154	0	0
EU	0	0	0	0	0	0	0	0	0	0
Others (mostly official bilateral creditors)	0	0	0	0	0	0	0	33	540	540
Debt relief	0	0	0	0	0	0	0	2,051	0	0
4. Residual Financing Gap	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**149**	**694**	**470**

Sources: SM authorities; and IMF staff estimates.

1/ Original maturity of less than 1 year.

2/ Official grants and loans recorded above-the-line are amounts based on already secured commitments; amounts expected from new pledges are shown below-the-line.

3/ Not including amortization of the debt to IMF.

4/ Includes other capital inflows, errors and omissions, and change in net foreign assets of commercial banks.

Table 12. Serbia and Montenegro: Stock of External Debt at June 30, 2004 1/
(In millions of U.S. dollars)

Creditor	Total Debt	*Of which:* Arrears 2/ Principal	Interest	Late Interest	Total Arrears
Total debt	13,085	1,632	410	505	2,546
of which:					
Serbia	12,365	1,569	381	453	2403
Montenegro	720	62	29	52	143
Multilateral institutions	4993	97	82	74	253
IMF	965	0	0	0	0
IBRD	2,537	0	0	0	0
IDA	292	0	0	0	0
EUROFIMA	160	0	0	0	0
IFC	285	97	82	74	253
EIB	221	0	0	0	0
European Community	322	0	0	0	0
EUROFOND - CEB	32	0	0	0	0
EBRD	179	0	0	0	0
Official bilateral creditors	3,653	256	168	94	518
Paris Club	2,979	0	1	0	1
Other official bilateral creditors	674	255	167	94	516
Commercial creditors	3,594	640	159	337	1,137
London Club	1,161	25	30	10	65
Other commercial creditors: convertible currencies 3/	2,248	456	104	327	887
Other commercial creditors: nonconvertible currencies 3/	184	159	26	0	184
Short-term debt 3/	845	639	0	0	639
Trade credits on oil & gas imports 4/	243	243	0	0	243
Other short-term debt	396	396	0	0	396

Sources: SM authorities, and IMF staff estimates.

1/ Debt figures reflect the effect of the debt rescheduling agreement of November 2001, which envisaged phased NPV reductions in Paris Club debt of 66 percent in total (of which 51 percent came into force upon approval of the current Extended Arrangement in May 2002), and of the London Club restructuring signed in July 2004.

2/ Regular and late interest calculated in accordance with terms of original agreements.

3/ Debt is not owed by government and does not have government guarantees.

4/ Overdue obligations (trade credits) owed to oil and gas enterprises in Russia and China.

Table 13. Serbia and Montenegro: Proposed Schedule of Purchases
Under the Extended Arrangement

	Available on or after	Amount of Purchase: In millions of SDRs	Amount of Purchase: In percent of quota 1/	Conditions/Status
1.	May 14, 2002	50.0	10.7	Purchased.
2.	August 15, 2002	50.0	10.7	Purchased.
3.	November 15, 2002	50.0	10.7	Purchased.
4.	February 15, 2003	50.0	10.7	Purchased.
5.	May 15, 2003	50.0	10.7	Purchased.
6	August 15, 2003	50.0	10.7	Purchased.
7.	November 15, 2003	50.0	10.7	Purchased.
8.	February 15, 2004	50.0	10.7	Purchased.
9.	August 15, 2004	62.5	13.4	Observance of end-September 2004 performance criteria and completion of the fourth semi-annual review (including financing assurances review).
10.	February 15, 2005	125.0	26.7	Observance of end-December 2004 performance criteria and completion of the fifth semi-annual review (including financing assurances review).
11.	April 30, 2005	62.5	13.4	Observance of end-March 2005 performance criteria and completion of the sixth semi-annual review (including financing assurances review).
	Total	650.0	139.0	

1/ The quota is SDR 467.7 million.

Table 14. Serbia and Montenegro: Millennium Development Goals

	1990	1995	2001	2002	2015 Target
Goal 1: Eradicate extreme poverty and hunger					
Target: Halve between 1990 and 2015 the proportion of people suffering from hunger					
1. Prevalence of child malnutrition (percent under age 5)	...	1.6	1.9	...	...
2. Population below minimum level of dietary energy consumption (%)	...	5.0	9.0	...	...
Goal 2: Achieve universal primary education					
Target: Ensure by 2015 that children can complete a full course of primary education					
1. Net primary enrollment ratio (percent of relevant age group)	69.4	...	74.9	...	...
Goal 3: Promote gender equality and empower women					
Target: Eliminate gender disparity in primary and secondary education by 2015					
1. Ratio of girls to boys in primary and secondary education (%)	102.7	102.9	100.7	...	...
2. Proportion of seats held by women in national Parliament	...	3.0	5.0	7.0	...
Goal 4: Reduce child mortality					
Target: Reduce by two thirds between 1990 and 2015, the under-five mortality rate					
1. Under five mortality rate (per 1,000 births)	30.0	23.0	20.0	19.0	...
2. Infant mortality rate (per 1,000 births)	25.0	20.0	17.0	16.0	...
3. Immunization, measles (% o children under 12 months)	83.0	86.0	90.0	92.0	...
Goal 5: Improve maternal health					
Target: Reduce by three quarters between 1990 and 2015 the maternal mortality ratio					
1. Births attended by skilled health care professionals (percent of total)	...	92.6	98.9	...	...
2. Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	11.0	...	...
Goal 6: Combat HIV/AIDS, malaria and other diseases					
Target: Halt by 2015, and begin to reverse the spread of major diseases					
1. Incidence of turberculosis (per 100,000 people)	...	...	44.8	37.8	...
Goal 7: Ensure future environmental sustainability					
Target: Integrate principles of environmental sustainability into policies and programs					
1. CO2 emissions (metric tons per capita)	12.4	4.6	3.7	...	...
2. Access to improved water source (percent of population)	...	...	98.0	...	...
3. Access to improved sanitation (percent of population)	...	...	100.0	...	...
Goal 8: Develop a global partnership for development					
Targets: Make available new information technologies, affordable essential drugs and implement strategies for productive work for youths.					
1. Fixed line and mobile telephones (per 1,000 people)	165.6	191.5	415.9	489.1	...
2. Personal computers (per 1,000 people)	...	14.2	23.4	27.1	...

SERBIA AND MONTENEGRO: FUND RELATIONS
As of October 31, 2004

I. **Membership Status:** Joined December 14, 1992 (succeeding to membership of the former SFR Yugoslavia); adopted Article VIII on May 13, 2002.

II. **General Resources Account**	SDR Million	%Quota
Quota	467.70	100.00
Fund Holdings of Currency	1,072.04	229.22

III. **SDR Department**	SDR Million	%Allocation
Net cumulative allocation	56.66	100.00
Holdings	13.56	23.92

IV. **Outstanding Purchases and Loans**	SDR Million	%Quota
Extended arrangement	400.00	85.52
Stand-by arrangements	204.33	43.69

V. **Financial Arrangements**

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
EFF	5/14/02	5/13/05	SDR 650.0 million	SDR 400.0 million
Stand-by	6/11/01	5/31/02	SDR 200.0 million	SDR 200.0 million
Emergency Post-Conflict Assistance	12/20/00		SDR 116.9 million	SDR 116.9 million

VI. **Projected Obligations to Fund Under the Repurchase Expectations Assumptions**[11] (In millions of SDR)

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	45.87	139.71	27.08	50.00	116.67
Charges/Interest	5.14	17.67	14.21	13.28	10.83
Total	51.01	157.38	41.29	63.28	127.50

VII. **Safeguards Assessments:**

[11] This schedule presents all currently scheduled payments to the IMF, including repayment expectations where applicable and repayment obligations otherwise. The IMF Executive Board can extend repayment expectations (within predetermined limits) upon request by the debtor country if its external payments position is not strong enough to meet the expectations without undue hardship or risk.

Under the Fund's safeguards assessment policy, the National Bank of Yugoslavia (now NBS) was subject to a safeguards assessment with respect to the Extended Arrangement approved on May13, 2002, which is scheduled to expire on May 13, 2005. A safeguards assessment of the NBY was completed on November 29, 2001. The assessment concluded that substantial risks may exist in the financial reporting framework, internal audit mechanism, and system of internal controls as reported in IMF Country Report No. 02/105. The proposed remedies by the mission are being implemented.

VIII. **Exchange Arrangement**

Serbia and Montenegro (SM) accepted the obligations under Article VIII as of May 2002. The currency of Serbia is the Serbian dinar. On January 1, 2001, Serbia adopted a managed float system. During 1994–99, the dinar was officially pegged to the DM; for most of the period, multiple exchange rates were in effect. Montenegro has adopted the euro as its sole legal tender.

IX. **Last Article IV Consultation**

The last Article IV consultation was held on May 13, 2002.

X. **Technical Assistance to Serbia and Montenegro during the Past 12 Months**

Department	**Timing**	**Purpose**
MFD	Oct 2003	Staff visit to the NBS (Serbia)
	Nov 2003	Banking supervision, domestic payments system, and monetary operations
	Feb 2004	Staff visit to the NBS (Serbia)
	Sep 2004	Monetary operations
FAD	Oct - Nov 2003	Modernizing revenue administration and preparing for VAT implementation (Serbia)
	Jun 2004	Public Expenditure Management (Serbia)
STA	May 2004	Monetary and financial statistics
	Jun-Jul 2004	Balance of payments statistics (Montenegro)
	Sep 2004	National accounts statistics

Technical assistance missions during the past 12 months from FAD, MFD and STA have contributed significantly to tax administration and treasury management; to the creation of a market-based financial system; and to improved statistical data provision, respectively. At this stage of Serbia and Montenegro' s reforms, they have primarily focused on institution-building. The FAD missions reviewed the progress in modernizing tax administration and establishing treasury system, and recommended (i) more clearly delineating the tax policy role of different revenue agencies, (ii) improving taxpayer services and compliance programs based on segmenting the tax base, (iii) strengthening the Treasury's organization and developing its core operations as wells as debt management functions, (iv) reforming the payroll system and strengthening the quality of personnel records in budget institutions to eliminate "ghost employment." The MFD recommendations were key to (i) developing market-based instruments for monetary operations, (ii) improving public sector debt management, (iii) providing a clear focus to future work on enhancing banking supervision practices and (iv) outlining positive directions for NBS reorganization. The STA missions provided an action plan to improve existing statistics by (i) developing comprehensive data sources for national accounts, (ii) applying statistical concepts to organize information on government revenues and expenditures to develop sound government finance statistics, (iii) strengthening the coverage of balance of payments transactions, and (iv) introducing sound classifications in compiling monetary and financial statistics.

XI. Resident Representative

Mr. Harald Hirschhofer took up his position as Resident Representative in September 2004, replacing Mr. Joshua Charap who had been in the office since March 2001.

SERBIA AND MONTENEGRO: IMF-WORLD BANK RELATIONS

Partnership in Serbia and Montenegro's Development Strategy

28. On May 8, 2001 the World Bank's Board approved the succession of the Federal Republic of Yugoslavia (FRY) to SFRY's membership in the International Bank for Reconstruction and Development (IBRD). FRY membership in the International Development Association (IDA) was confirmed on June 11, 2001. Following constitutional changes, FRY completed its transition to Serbia and Montenegro (SM) on February 4, 2003. The government of SM and its two constituent republics of Serbia and Montenegro have highlighted progress in structural reform and stabilization, and outlined their medium-term development strategies in their respective Poverty Reduction Strategy Papers (PRSP). The Joint Staff Assessment (JSA) of the PRSP was endorsed by the IMF Board on March 2 and was reviewed by the Bank's Board of Directors on March 16, 2004.

29. In the context of a program supported by a three-year Extended Arrangement (EA) the IMF takes the lead on macroeconomic (fiscal, monetary, and exchange rate) policies aimed at facilitating sustainable growth. In addition to macroeconomic targets, the Fund has established structural performance criteria and benchmarks in areas such as tax administration, payments system reform, banking reform, financial markets, foreign trade policy, and energy tariffs. Working together with bilateral donors, the Fund has also provided technical assistance in the first three areas.

30. As outlined more fully below, the Bank has complemented the Fund's work through its support to structural reforms. In areas of direct interest to the Fund, the Bank leads the policy dialogue in: (i) public expenditure management; (ii) macroeconomically important sectoral reforms (e.g. in the energy sector), (iii) pension, health and social assistance reform; (iv) the restructuring and privatization of enterprises; and (v) legal reforms with a bearing on the business environment, including labor markets. The Bank and Fund have jointly led the policy dialogue in the financial sector, including on the restructuring and privatization of banks, and in foreign trade. The Bank's program of investment lending, is described more fully below.

World Bank Group Strategy

31. To date the World Bank Group's operations have assisted the government in achieving its overall goals of: (i) restoring macroeconomic stability and external balance; (ii) stimulating near-term growth and creating the basis for a sustained supply response; (iii) improving social well-being of the most vulnerable and building human capacity; and (iv) improving governance and building effective institutions.

32. The first stage of World Bank assistance commenced even before SM's membership. In view of its urgent needs, and concurrent with the arrears clearance process, the Bank established in May 2001 a Trust Fund for FRY (TFFRY) using US$30 million of IBRD surplus net income to provide grant financing for selected priority activities. Five grants totaling US$30 million have been approved under the TFFRY and are currently under implementation. These grants, which were important in laying the foundations for the IDA-financed program, included (i) a private sector technical assistance grant for Serbia, (ii) a financial sector technical assistance grant for Serbia, (iii) a social protection grant for Serbia; (iv) an electric power emergency reconstruction grant for Serbia, and (v) an environmental infrastructure grant for Montenegro.

33. The second stage of assistance began on May 8, 2001, when the Bank's Board of Directors endorsed a first Transitional Support Strategy (TSS) for SM.[12] The TSS contained a three-year IDA envelope of up to US$540 million for SM on a temporary and exceptional basis, with actual lending to depend upon performance against agreed benchmarks. It was envisaged that up to 80 percent of the program could support policy-based lending. A first year program of lending, economic and sector work and technical assistance was outlined. The Transitional Support Strategy Update, discussed by the Bank's Board on August 8, 2002, confirmed the overall approach (including the focus on policy-based lending), and laid out the Bank's program for FY03. A second TSS Update, covering FY04, was endorsed by the Bank's Board on March 16, 2004. A joint World Bank-IFC Country Assistance Strategy (CAS) covering FY05-07, based on the PRSP, is expected to be finalized by end-2004.

34. Given the extensive de jure and de facto devolution of responsibility for economic policy to the member state level, the program of adjustment lending is focused at the republic level. To date, five operations have been approved. In Serbia, a multi-sectoral Structural Adjustment Credit (SAC-approved in January 2002) was designed to enhance fiscal sustainability through reforms of public expenditure management, the energy sector, social protection, labor markets, and health care. A Social Sector Adjustment Credit (approved in April 2003), supported further reforms in pensions, health and labor, while enhancing the focus on social assistance and poverty monitoring. Two Private and Financial Sector Adjustment Credits (PFSAC I and II, approved May 2002 and June 2003 respectively) focus on the growth promotion agenda, assisting the government in: (i) strengthening the financial system through the liquidation of troubled banks and an improved policy and regulatory environment; (ii) privatizing and restructuring socially-owned enterprises; and (iii) improving the investment and business climate., A second multisectoral SAC for Serbia was just negotiated with the focus on improving the business environment, further rehabilitating the energy sector, enhancing social protection and fostering stronger public administration. In Montenegro, the multi-sectoral Structural Adjustment Credit, approved in August 2002, was

[12] A plan to clear SM's arrears to the World Bank was approved with the membership packages that provided for the exceptional consolidation of SM's arrears and principal not yet due into a new package of IBRD loans. These Consolidation Loans were approved by the Board on December 13, 2001, and became effective in early-January 2002.

completed with a final disbursement in January 2004 to support reforms critical to fiscal sustainability as well as economic growth in the areas of public expenditure management, pensions, energy, labor markets, and the business environment. A second multi-sectoral SAC for Montenegro was approved by the Board on September 14, 2004. It focuses on enhancing growth potential, including reforms to the financial, energy, pension, health and public administration sectors.

35. The Bank's program of adjustment lending has been underpinned by analytical studies. In June 2001, the Bank, working together with the European Commission and the federal and republican governments, completed an Economic Recovery and Transition Program (ERTP), which was presented to the Donor Conference held the same month.[13] In 2002, the Bank focused on three complementary studies which covered both republics—a Public Expenditure and Institutional Review (PEIR), a Country Financial Accountability Assessment (CFAA), and a Country Procurement Assessment Review (CPAR). Studies of the agricultural (Serbia) and environmental sectors (both republics) were also completed. The Bank supports an ongoing program on improving the monitoring and analysis of poverty. Poverty Household Surveys for both republics laid the foundations for a Poverty Assessment, completed in 2003. In June 2004 the Bank finalized an Economic Memorandum for Serbia focusing on the agenda for sustained growth and employment creation. An Economic Memorandum for Montenegro will be undertaken in FY05.

36. In both republics, a program of selective investment lending has been designed to assist the authorities to tackle critical impediments to effective public sector management and private sector development, improve social policy and underpin reforms initiated under the Bank-supported adjustment programs. A Trade and Transport Facility for Southeast Europe and an Export Finance project have been approved which cover both Serbia and Montenegro's needs. In addition, in Serbia IDA is supporting an Education project, an Enterprise and Bank Restructuring Technical Assistance operation, an Energy Learning and Innovation project, a Health Reform operation, an Employment Promotion Learning and Innovation project, a Transport Rehabilitation project, and a Real Property Registration and Cadastre project. In Montenegro, the Bank supports an Environmental Improvement project and an Energy Efficiency Learning and Innovation Credit, a Pension System Administration and Improvement Project and a Health Reform project. As of end-June 2004, 18 IDA credits totaling about US$522 million had been approved for SM, with adjustment support comprising the majority.

37. Serbia and Montenegro is of strategic importance for IFC. During fiscal years 2002 and 2003, US$42 million were committed for four projects. In addition, IFC has provided technical assistance on a broad scale to help build institutions and prepare for future investments. With over 20 projects, the technical assistance program has become IFC's third-

[13] *Federal Republic of Yugoslavia—Breaking with the Past: The Path to Stability and Growth*, World Bank Report No. 22267-YU.

largest. In banking, IFC is resolving the former Vojvodjanska Bank Group debt arrears with the possibility to convert outstanding debt into equity upon privatization. IFC has recently agreed on an arrears restructuring with the government of Montenegro with includes an equity participation in Podgoricka Bank. IFC is finalizing an investment in Montenegro's Opportunity Bank. In addition, IFC holds an equity stake in Raiffeisen Bank and in MicroFinanceBank (now ProCredit Bank). In the insurance and leasing sector, IFC has helped improve the regulatory environment and evaluated the pre-privatization restructuring of Dunav Insurance. A leasing facility covering Serbia and Montenegro and other Southern European countries is in the pipeline. In addition, IFC has invested US$40 million in two regional equity funds which support the privatization process in Southern Europe. IFC has also invested 20 million Euro in car tire manufacturer Tigar, complemented by extensive technical assistance. IFC has carried out a broad range of further technical assistance projects and is developing public-private partnership opportunities, especially in solid waste and water management services, oil and gas transport and distribution, and the power cogeneration sector. A Balkan Infrastructure Development Facility which will help develop infrastructure projects and attract commercial financing for private sector participation was established by the IFC and USAID. Opportunities have also been explored in information and communication technology and in health and education. IFC has supported SMEs through its Southeast Europe Enterprise Development facility. Over the short term, IFC intends to expand its activities in the country's financial and general manufacturing sectors. In the longer run, IFC plans to assist the government in attracting private investments in the energy, telecommunications, and infrastructure sectors.

38. MIGA has also played an active role in SM. As of June 30, 2004, MIGA's gross and net exposure in SM were US$196.9 million and US$121.8 million, respectively, covering 11 contracts of guarantee. At 3.8 percent of MIGA's total gross exposure, SM is now MIGA's 7th-largest host country. MIGA continues to underwrite technical assistance for several projects in SM, which are expected to be completed in FY05. MIGA has also been active in providing TA and capacity building assistance. It completed an 18 month program with the Serbian Investment and Export Promotion Agency (SIEPA), supervising funding provided under a World Bank Private Sector Development grant. In April 2004 MIGA launched a TA program in Montenegro with funding provided by the European Agency for Reconstruction.

Joint Staff Assessment (JSA) of the Poverty Reduction Strategies

39. Bank and Fund staff produced a joint assessment of the authorities' poverty reduction strategies as proposed in the PRSP of each republic. Bank staff took the lead in evaluating the structural measures to underpin poverty reduction, while Fund staff assessed the macroeconomic framework underlying the strategies. The JSA enumerates the strengths of the envisioned poverty reduction strategies, notably the focus on harmonization to common EU standards, continuing privatization, an improved business environment, and policies to raise employment. However, staff also found that the reports could usefully have relied on less optimistic assumptions regarding domestic savings, foreign financing inflows and the financing of poverty reduction programs, addressed crime and governance more directly, and provided a sharper sense of prioritization among possible projects. Staff agreed that the

envisioned market-oriented reforms, if implemented in the context of continuing macroeconomic stability, will foster a considerable reduction in poverty.

Bank-Fund Collaboration in Specific Areas

40. As part of its overall assistance to SM, the Bank combines lending, analytical work and technical assistance to support policy reforms, with a focus on the following areas:

41. **Public expenditure management**. SM's weak systems of public financial management had long contributed to macroeconomic instability, a lack of transparency, and the inefficient use of public resources, requiring reforms and institution building in this area. The Bank is taking the lead with a multi-pronged assistance program, which the Fund is complementing with policy conditionality and technical assistance. The Bank's program began with the completion in 2002 of the PEIR, CFAA, and CPAR (see above), which in turn helped to define significant public expenditure management components in the first SACs for Serbia and Montenegro. In Serbia, key reforms supported by the Bank included the adoption of the Law on the Budget System (Organic Budget Law), the first steps toward introducing a treasury system, and enhanced inspection, auditing and procurement procedures. In Montenegro, where legal and institutional reforms had reached a more advanced stage, key reforms include the establishment of a more comprehensive multi-year framework for budget preparation, continued implementation of the interim treasury system, and improvements in the internal audit. Care is being taken to ensure consistency of the PRSP with available budgetary resources.

42. **Energy sector reform**. The combination of low power prices and collection rates, a decade of underinvestment and lack of maintenance, and war-related physical damage, led to power shortages and left SM with loss-making and inefficient electric utilities. As the largest single source of quasi-fiscal pressures, the power sector became an area of particularly close collaboration between the Bank and the Fund. While the Bank has taken the lead in developing the policy agenda, the sector's fiscal impact has also motivated limited but strong conditionality in successive Fund arrangements. The Bank program has combined support for policy reforms with investment loans/grants for critical needs in both Serbia and Montenegro, improved financial management and technical assistance. The SACs for both republics focused on improving the financial position of the republican power utilities through measures to enhance revenues (phased tariff increases and improved collections) or reduce operating costs (e.g. control of the wage bill). Progress in achieving tariff rate targets is being monitored closely both by the Bank and the Fund. In parallel, the electric power emergency reconstruction grant for Serbia under the TFFRY supported urgent repairs, improvements in the financial management of the electric power company, and legal and policy advisory services. The Bank provides continuing support to the sector in Serbia with an Energy Efficiency Credit and complementary Global Environmental Fund grant, now under preparation. The already approved Montenegro Energy Sector Learning and Innovation Credit will introduce automated billing and demand management, facilitate the eventual privatization of distribution services and lay the basis for institutional strengthening.

43. **Pension, health and social assistance reform**. The state pension systems of both Serbia and Montenegro account for about one-third of consolidated public spending, and pension spending as a share of GDP is high by regional standards. Chronic arrears on pension payments and large budgetary transfers to the pension funds in both republics were further evidence that reforms were required to improve pension system financial balance and overall medium-term fiscal sustainability. This created a synergy between Bank and Fund programs. The Bank has taken the lead, including initial pension reforms in its adjustment operations in both republics, and providing required technical assistance through the social protection grant under the TFFRY. The key elements of pension reforms were parametric adjustments to retirement ages and indexation rules which would bring immediate fiscal savings relative to the no reform scenario. The Fund has provided supporting fiscal analysis and included related structural benchmarks in its successive arrangements in SM. The SOSAC for Serbia supported the next reforms of the pay-as-you-go system, as well as preparatory steps for a more comprehensive revamping of the pension system. A Pension Systems Administration Improvement Project was recently approved for Montenegro and work has commenced on a pension reform technical assistance operation for Serbia.

44. Serbia's SAC also included initial reforms of the health care system to begin restoring fiscal balance in that sector, as a basis for improving its functioning and ability to provide basic health care services for all citizens. To this end, the SAC supported the introduction of modest co-payments, adoption of a more limited essential drugs list, the addressing of structural inefficiencies in the delivery system, and the laying of foundations for a new policy and legal framework. The SOSAC deepened this reform agenda. The Bank's involvement in the health care sector in Montenegro has focused on analytical work, most recently under the PEIR and a health sector reform project was approved in June 2004.

45. In Serbia, the Bank's work on reforming other components of the social safety net began with conditionality and technical assistance under the social protection grant under the TFFRY. The SAC supported pilot reforms to enhance the equity and coverage of the main program of social assistance (the so-called Material Assistance to Families), to improve the management of donor funds for such programs, and to begin development of a new Law on Employment regulating benefits for unemployed workers. These reforms were completed and deepened under the SOSAC. The SAC for Montenegro also supported the enactment of a Law on Labor and Law on Employment.

46. **Restructuring and privatization of enterprises and banks**. Beginning in late 2000 in Serbia, and earlier in Montenegro, SM has been engaged in far-reaching reforms of the enterprise and financial sector. In Serbia, the initial focus in the enterprise sector was on creating a transparent legal and institutional framework for privatization to attract strategic investors. The agenda in the banking sector focused on the need to address the deep insolvency of the banking sector in a permanent and fiscally responsible fashion. The Bank and the Fund have worked closely together to support the needed policy reforms, with the Bank taking the lead on the enterprise sector and sharing leadership in the banking sector. The Bank program has combined sectoral adjustment credits focused on these themes with parallel projects to provide technical assistance. The Bank has worked closely with the Fund

to formulate the benchmarks in PFSAC I and II which complement and reinforce the elements of the EA related to financial sector strengthening. Fund conditionality under the EA has focused on facilitating rapid privatization, ensuring that all privatization proceeds flow transparently through the budget, and putting in place control mechanisms in banks prior to their privatization. Under the TFFRY, the Bank provided early support through private and financial sector technical assistance grants. This work is continued under the Privatization and Restructuring of Banks and Enterprises Technical Assistance Project. The Bank has increased its involvement in these areas in Montenegro under the recently negotiated second SAC for Montenegro.

47. **Legal reforms with a bearing on the business environment**. The Bank has taken the lead on business environment and general private sector development. The SAC for Montenegro supported the adoption and initial implementation of the enterprise law, bankruptcy law, and law on secured transactions. The PFSAC for Serbia supported enactment of laws on foreign direct investment and an SME agency, amendments to federal and republican enterprise laws, and preparation of a law on secured transactions. The PFSAC II followed up by supporting the enactment of laws on concessions, leasing, bankruptcy, business registration, and on Agency for Business Services. In addition, the SACs in both republics emphasized reforms of the legal framework for the labor market, promoting employment creation through greater flexibility, and promoting the financial sustainability and effectiveness of unemployment benefit programs. This complements Fund conditionalities related to securities and accounting legislation, and rationalizing employment clauses in social programs associated with privatization and enterprise restructuring. In FY02, the Bank prepared an initial diagnostic study of Serbia' s legal and judicial framework; a small grant supports the improvements in court administration.

Prepared by World Bank staff. Questions may be addressed to Ilker Domac at 458-1138 or Simon Gray at 473- 4011.

November 29, 2004

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

Dear Mr. de Rato:

Firm implementation of our medium-term economic program supported by the Fund under the Extended Arrangement (EA) has permitted good progress in stabilization and reform. To ensure continued progress and address new challenges, we have updated our economic and policy targets for 2004–05, as described in detail in the attached Memorandum on Economic and Financial Policies. On this basis, we request: (a) completion of the fourth semi-annual review (including the eighth financing assurances review) under the EA; (b) waivers for the non-observance of an end-June, 2004 performance criterion (the passage of the Serbian bankruptcy law) and two end-September, 2004 performance criteria (contracting or guaranteeing new nonconcessional external debt from multilateral creditors by the public sector in Montenegro; and non-assumption by the public sector of enterprise debt to banks in Montenegro); (c) the purchase of SDR 62.5 million following the completion of the fourth review; and (d) a rephasing of purchases for the remainder of the program by combining the tenth and eleventh purchase, to become available upon completion of the fifth review which would be postponed to cover the end-December 2004 test date. The non-observed quantitative performance criteria for which waivers are requested were missed by small margins and the Serbian bankruptcy law was adopted with a short delay. We are taking measures to improve policy implementation in these areas.

We believe that the policies and measures described in the attached memorandum are sufficient to achieve our program objectives, but we stand ready to take timely additional measures and seek new understandings with Fund staff, as necessary, to keep the program on track. We will remain in close consultation with the Fund staff on the adoption of these measures, and in advance of any revisions to the policies contained in the attached MEFP in accordance with the Fund's policies on such consultations. We will provide all information to the Fund that it requests to assess the implementation of the program. The program will continue to be reviewed by the Fund, with the discussions for the next review, together with the Article IV consultation, expected in January 2005. The next review will focus on progress in structural reforms (including budgetary employment reduction, enterprise restructuring and privatization, bank reform), and on the implementation of fiscal, monetary, incomes and exchange rate policies. Moreover, each purchase under the arrangement will continue to be subject to a review of the financing of the program.

Yours sincerely,

Predrag Ivanović /s/
Minister of Foreign Economic Relations
Serbia and Montenegro

Miroljub Labus /s/
Deputy Prime Minister
Republic of Serbia

Miroslav Ivanišević /s/
Deputy Prime Minister
Republic of Montenegro

Mladjan Dinkić /s/
Minister of Finance
Republic of Serbia

Radovan Jelašić /s/
Governor
National Bank of Serbia

Igor Lukšić /s/
Minister of Finance
Republic of Montenegro

Ljubisa Krgović /s/
Chairman
Central Bank of Montenegro

SERBIA AND MONTENEGRO

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

November 29, 2004

I. INTRODUCTION

1. This memorandum updates and supplements the Memorandum of Economic and Financial Policies (MEFP) attached to the Letter of Intent of May 21, 2004. It reports on recent developments under the program supported by the Extended Arrangement (EA) approved in May 2002 and updates the economic objectives and policy agenda for the remainder of 2004 and for 2005.[14]

2. **The performance under the program – supported by the Extended Arrangement with the Fund – is broadly on track.** While four end-June performance criteria (PCs) were not met, all but two end-September PCs were observed. The end-June ceilings for the NDA of the central bank and bank credit to government in Serbia were missed, but observed at end-September. In addition, the end-June PC on contracting or guaranteeing new nonconcessional external debt from multilateral creditors was breached by Montenegro; this PC, and that on debt guarantees was also breached at end-September. The Montenegrin government is committed to avoiding similar breaches in the future. The end-June structural PC for Serbia on electricity tariffs was met on time, while that on the bankruptcy law was met with a slight delay owing to scheduling difficulties in Parliament. The end-June and end-September indicative targets on the wage bill of state enterprises were exceeded. A number of additional indicative targets~~on~~ net credit to government, a rrears, banking system NDA, and central government dinar deposits~~we~~re not met at end-June, with the latter two missed also at end-September, calling for improved policy implementation. End-June structural benchmarks on the VAT law and bank privatization, and recovery of banks assets were met (the latter with some delay). The end-September structural benchmarks in Serbia and Montenegro on asset recovery have not been met. Both governments are seeking to address these delays.

3. **Strong growth in 2004 has been overshadowed by accelerating inflation and an increasing external imbalance.**

[14] Annex A, attached to this memorandum, contains the quantitative performance criteria and indicative targets, while Annexes B and C list the structural performance criteria and benchmarks as well as prior actions. Annex D (Technical Memorandum of Understanding, TMU) defines the performance criteria and indicative targets and describes the reporting arrangements.

- **Twelve-month inflation in Serbia rose to 11½ percent in September, driven by cost and demand factors, while inflation in Montenegro fell to 2.1 percent by August.**

- **Real growth is likely to reach 6 percent led by a bumper crop in agriculture and solid industrial growth supported by output gains in recently privatized enterprises.** Demand was boosted by an increase in consumption fed by an estimated 12 ½ percent increase in real wages throughAugust in Serbia and rapid credit growth in both republics (especially in consumer lending and leasing).

- **Rapid growth of foreign currency deposits, along with an increase in foreign loans to banks in Serbia, have continued to fuel lending** to the nongovernment sector, which rose by 30 percent in real terms in the 12 months ending in August—albeit from a low base. In Montenegro, credit growth in the year to August exceeded 40 percent.

- **The SM current account deficit deteriorated further in the first six months of 2004 compared to a programmed improvement, and is projected to reach 13 percent of GDP by year-end.** Imports rose by 32 percent year-on-year especially of cars by more than 50 percent, while export growth lags behind. Higher-than-projected world oil prices account for about 0.7 percent of the projected higher external deficit. Private remittances continue to be high, projected at 14 percent of GDP in 2004, but FDI is expected to fall to 4 percent of GDP, reflecting a slowdown in privatization in the first half of the year. Net foreign reserves rose to US$3.5 billion (3.6 months of projected 2005 imports) at end-September 2004.

- **The debt dynamics will benefit from the recent completion of negotiations with London Club creditors, but the increase in the debt financing of the current account deficit raises concern.** The **London Club** agreement implies a reduction of the debt to commercial banks of 62 percent, reducing the country's overall debt burden by 7 percentage points of GDP. However, an increasing share of the external deficit is financed by debt (about 37 percent) making the country more vulnerable to external shocks. The increase in foreign borrowing is keeping the debt/GDP ratio at a projected 58 percent at end-2004.

- **Confidence in the dinar has remained fragile, and the share of foreign currency deposits in total deposits has increased.** The dinar has depreciated by 2 percent in real effective terms in the year through September.

4. **Fiscal policy in Serbia was tightened after June to safeguard annual inflation and external balance targets, while tax reform advanced.** Total revenue was broadly in line with the program at end-September, and expenditure has been under tight control since July, which corrected for higher than expected spending in the first six months. The shift towards indirect taxes advanced with the elimination of the wage bill tax (July 2004), rationalization of the social contribution rates and bases (July and September 2004),

increases in excises on gasoline, diesel, and cigarettes (July 2004), a new lottery tax (July 2004), reduced corporate income tax to 10 percent (September 2004), and cancellation of the financial transaction tax (effective January 2005). The January 1, 2005 introduction of the VAT will further advance this shift. In Montenegro, total revenue fell below programmed levels despite strong VAT revenue performance, but prudent budget execution has kept the deficit in line with the program.

5. **Monetary policy was also tightened at mid-year to rein in inflation and the widening external deficit.** The NBS raised the interest rate on its bills during June-July, and increased the required reserve ratio by 3 percentage points from August. These measures tightened liquidity by about 0.6 percent of GDP.

6. **The implementation of structural reforms has resumed since July.** Serbian Parliament approved a package of 17 economic reform laws in mid-July. Privatization has recommenced with the issuance of tenders for 8 socially-owned enterprises. Financial sector reform is continuing~~Ju~~banka has been offere d in a public tender as programmed and its sale to a strategic investor is expected to be completed around the end of the year. Tenders for sale of Continental Banka and Novosadska Banka were published in late September. The conversion of all Paris and London Club as well as FFCD-related liabilities into state-owned equity in banks to be privatized is also essentially complete.

II. Economic Objectives and Policies

7. **The economic objectives for 2004-05 and beyond reflect robust growth in incomes while addressing higher inflation and safeguarding a sustainable external position** (Table):

- **Real GDP** is projected to grow by 4½ - 5 percent in 2005, settling at 5 percent in subsequent years as restructuring-related output losses subside, privatization and enterprise restructuring continue, and cumulative FDI inflows reach higher levels.

- **End-period inflation** will accelerate to 12-13 percent in 2004 due in part to one-off exogenous shocks, but is targeted to fall under 10 percent in 2005, and to gradually decline to low single digits over the medium term (inflation in Montenegro is projected to decline to 2½ -3percent in 2004, outperforming original forecasts, and is expected to remain in this range in 2005).

- The external **current account deficit** (before grants) is projected to recede to 12 percent in 2005 as policies aimed at containing domestic demand take effect. Higher oil prices are estimated to account for about a percentage point of this deficit. To ensure external sustainability and remain consistent with expected financing, the deficit is projected to decline steadily thereafter based on a recovery of exports as structural reforms elicit a supply response and prudent policies strengthen competitiveness. As structural reforms accelerate and the business climate improves over the medium term, FDI inflows could play an increasing role in financing the current account deficit, allowing a gradual decline in reliance on foreign assistance and loans.

- The import coverage of **foreign reserves at end-2004** will remain unchanged from end-2003, with a view to guarding against possible risks and preparing for the projected rise in external debt service in the medium-term following the expiry of grace periods under debt restructuring agreements.

8. **Economic policies will be geared to support sustainable growth while narrowing the external current account deficit.** Fiscal policy and monetary policy will support current account adjustment while the health of the financial sector will be improved and structural reforms accelerated to increase export potential with the support of appropriate safety-nets.

Table 1. Macroeconomic framework

	2003	2004		2005	
	Actual	3d Review	Proj.	3d Review	Proj.
	(Percentage change)				
Real GDP Growth	3.0	4 - 5	6.0	4 - 5	4 - 5
Inflation (end period)	7.8	8 - 9	12.5	5.0	9 - 10
Of which : Montenegro	6.7	4.0	2.8	3.5	2.6
	(Percent of GDP)				
Domestic investment	16.1	16.8	16.5	17.5	17.8
Domestic savings	-6.4	-4.0	-8.7	-2.6	-7.3
Current account deficit (before grants)	12.0	11.0	13.0	10.0	12.0
Gross official reserves (US$ billion)	3.6	3.6	3.7	4.2	4.2
In months of projected imports	3.7	4.3	3.7	4.7	3.9
Total external debt	69.9	55.1	58.4	54.1	57.4
Net external debt	48.2	36.2	39.1	32.7	36.1
Underlying net external debt 1/	48.2	. . .	46.8	. . .	50.2
Fiscal deficit	3.4	2.3	2.0	0.9	0.8

Sources: SM authorities; and IMF staff estimates.

1/ Underlying net debt excludes the impact of write-offs in London Club, other commercial, and official bilateral debt.

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

A. Fiscal Policy

10. **Fiscal policy in 2004 and 2005 will continue to anchor the stabilization effort and improve medium-term sustainability**. Fiscal policy will be tightened by 1.4 percent of GDP in 2004 and 1.2 percent (1.7 percent excluding redundancy payments) in 2005, largely through cuts in expenditures. Reflecting the tightened fiscal stance, prudently assumed privatization proceeds (1.6 percent of GDP), and foreign disbursements (1.1 percent of GDP), the fiscal program for 2005 envisages a build-up of government deposits equivalent to 0.6 percent of GDP. As in previous years, privatization proceeds beyond program targets will be used to reduce net government indebtedness—and if consistent with achieving program objectives and in consultation with the Fund in the context of program reviews~~to~~ cover investment and restructuring costs.

Serbia

11. **Fiscal policy for the remainder of 2004 will be tighter than programmed to reduce external vulnerabilities.** To scale back government spending as agreed in the third review, the Parliament passed a budget amendment bill in October (prior action for the Fourth Review). The supplementary budget includes an additional cut of 0.2 percent of SM GDP in view of heightened pressure on the current account deficit in addition to budgetary reallocations in line with the understandings under the Third Review (MEFP paragraph 16). The supplementary budget (i) substantially increases allocations for the social funds to ensure timely payment of entitlements; (ii) allocates resources for payment to London Club creditors (2.5 billion dinars); and (iii) cuts spending relative to the appropriations in the 2004 Budget Law, notably subsidies to agriculture and transportation, net lending, bank restructuring, and goods and services. With these measures, the consolidated fiscal deficit of the Serbian general government is projected to decline from 3.0 percent of GDP in 2003 to 1.7 percent of GDP in 2004 (from 2.5 percent to 1.2 percent excluding FLFPs).[15]

12. **Fiscal policy in 2005 will be further strengthened to support the stabilization effort.** The overall deficit of the Serbian general government in the 2005 budget (whose submission to Parliament is a prior action for the Fourth Review) will be cut by 1.1 percentage points to 0.6 percent of GDP (a surplus of 0.1 percent excluding FLFPs).[16] Since total revenue as a percentage of GDP is expected to fall in 2005 with the legislated reduction of the tax burden, expenditure cuts will bear the brunt of the adjustment while laying a foundation for further fiscal consolidation in the medium term. With a tighter deficit and

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[15] In terms of Serbian GDP, the consolidated Serbian fiscal deficit is projected to decline from 3.2 percent of GDP in 2003 to 1.9 percent of GDP in 2004 (from 2.7 percent to 1.3 percent excluding FLFPs).

[16] In terms of Serbian GDP, the overall deficit will be cut by 1.3 percent of GDP in 2005 to 0.6 percent of GDP in 2005 (a surplus of 0.1 percent excluding FLFPs).

projected privatization proceeds of 1.6 percent of GDP and net external disbursement of 0.9 percent of GDP, the budget sector is expected to reduce it demands on net domestic financing by 2.0 percent of GDP in 2005.

13. **The tax burden will continue to shift from labor to consumption to increase savings, growth and job creation.** A broadly revenue neutral two-rate VAT (standard rate 18 percent, reduced rate 8 percent) will replace the retail sales tax in January 2005. Fees and taxes on securities transactions will be eliminated by January 1, 2005. The various changes in taxes are projected to lower tax revenue to 35.9 percent of GDP in 2005, partially compensated by strengthened collection of nontax revenue boosted by higher dividends from state-owned enterprises. Total revenue would decline by 0.8 percentage points to about 39.5 percent of GDP.

14. **Expenditures will be reduced and rationalized.** Virtually all non-interest current expenditure items will need to be rolled back as a share of GDP. At the same time, the budget will need to make room for larger interest obligations, and higher severance payments to support structural reform. Expenditure as a share of GDP is projected to decline to 40 percent.

- **Longer term fiscal sustainability will call for cuts in the public sector wage bill.** By end-July 2005, government employment will be streamlined by 7 percent in the general government. The Law governing labor relations in public institutions will be amended by end-March 2005 to allow a 12-month severance package for the retrenched workers of the republican budget, to be paid out in two equal installments of CSD 5 billion (0.3 percent of GDP) each, in July 2005 and January 2006 (see paragraph 27 of the TMU). The law will also be amended to increase labor market mobility in the public sector and facilitate the dismissal of redundant workers. The employment cut will create some room within the total wage bill of CSD 79 billion excluding redundancy pay, to pay higher salaries to selected highly-trained government workers to retain their service and motivate performance. In addition, budgetary support for active labor market policies will increase in 2005 to facilitate re-employment of retrenched workers.

- **To achieve further decompression of the public sector wage ratio between skilled and unskilled workers and to keep the growth in the wage bill on a sustainable path, the government will agree on key elements of civil service reform by end-November.** Building on the enactment of the Civil Service Law by end-March 2005 (structural benchmark) and with World Bank assistance, it will formulate a comprehensive plan by end-June 2005 to overhaul the civil service, as part of its overall strategy for public sector administration reform. This plan will cover the reform of the systematization procedure and provide an overall review of the staffing levels across the state administration.

- **To accelerate restructuring, subsidies will be cut by 0.5 percent of GDP in 2005, including in the railway company (ZTP), broadcasting (RTS), agriculture, and**

mining. However, subsidies for enterprise restructuring will be better targeted, and budget resources for the Transition Fund to cover restructuring in socially-owned and state-owned enterprises will sharply increase in 2005, with 1.2 billion dinars (0.1 percent of GDP earmarked for the latter~~see~~ paragraph 27 of the MEFP). To enforce compliance, subsidies will not be given to any entity that is not a registered taxpayer. Effective immediately, no payments from the Transition and Serbian Development Funds will be made to any enterprise that (i) has new arrears to the general government budget excluding penalties on pre-existing arrears starting from September 2004; (ii) raised its wage bill in the past 12 months by more than projected inflation; and (iii) failed to abide by its restructuring program.

- **Pending further reform of the social funds, transfers to the Employee Pension Fund, Farmer Pension Fund, and the Labor Market Fund will continue to enable them to make full benefit payments in 2005.** Despite recent reform, the EPF remains in need of large financial support from the budget on an annual basis. Concurrently, the government will, with World Bank assistance, draw up a plan by end-March 2005 to address the structural problems of the EPF to ensure its medium-term viability. To address the financial plight of the Farmer Pension Fund, a comprehensive plan to deal with the FPF will be made by the same time. Given the tight budgetary situation, recently announced plans for the clearance of one-half month of EPF arrears in 2005 will be made conditional on the overall budgetary revenue performance and, if needed, will be delayed by one year. In any case, this payment will not be made before Q4 2005.

- **To increase efficiency in Union institutions, nominal transfers to the Union budget will remain broadly at their 2004 level.** The ensuing adjustment of 0.4 percent of GDP will be supported by streamlining Union employment by about 15 percent~~inc~~cluding through early retirement, voluntary redundancies, and natural attrition~~in~~ early 2005, and by ot her measures. To this end, (i) 2.0 billion dinars will be earmarked for redundancy payments (see paragraph 27 of the MEFP), and (ii) the Serbian and Montenegrin governments will amend the Law on the Yugoslav Army and the Law on Union-level Civil Employees to harmonize them with Republic-level legislation. The amendments will reduce the amount of redundancy payments from 24 to 12 months and the period of dismissal from 3 months to 30 days (submission to Federal parliament is a prior action and its enactment an end-December performance criterion). The Serbian and Montenegrin governments will work jointly on a strategy to reduce employment in the defense sector through early retirements and cuts in civilian employment. The Serbian and Montenegrin Ministries of Finance will monitor all off-budget military revenues and expenditures of the recently created Military Fund (MF) financed from the sales of military assets and rental income, which will be treated as budgetary spending under the program with the view of their eventual incorporation in the budget. For this purpose, all accounts of the MF will be brought into the Treasury Single Accounts by end-2004.

- **Transfers to local budgets (including for teachers in Vojvođina) will double** to compensate for their loss of sales tax revenues after the introduction of the centralized VAT in 2005 (2 percent of GDP). The share of personal income tax revenue for local budgets will be increased from 30 percent of total collection in 2004 to 40 percent in 2005.

- **Expenditure on goods and services and other programs will be curtailed as a percent of GDP**, while budget-financed capital spending (excluding military spending) will remain broadly constant as a share of GDP.

- While the budget law includes an annual **ceiling on contracting and guaranteeing public debt**, a mechanism will be included in the public debt law to effectively monitor and control the granting of government guarantees and the disbursement of FLFPs to ensure that the desired fiscal policy stance is implemented.

15. **The policies will be supported by reforms in tax administration.** To ensure a smooth introduction of the VAT in January 2005, remaining outstanding enabling decrees for the VAT implementation were issued in October 2004. In addition, the government will request a follow-up VAT technical assistance mission to visit Belgrade in March 2005 to assess the initial VAT implementation and recommend early corrective measures, if needed. In line with international best practice, the selection criterion for large taxpayers will be changed to turnover by end-2004, rather than the current practice based on total revenues collected from 3 tax sources. Taxpayer services will be strengthened. By end-March-2005, taxpayer services for (a) tax law interpretation, (b) filling tax returns, and (c) tax liability information will be extended to all major tax offices country-wide in Belgrade, Novi Sad, Niš and Kragujevac. Finally, to further enhance restructuring and improve financial discipline, the government will develop a plan to reduce enterprise arrears to the budget and social funds by end-November (structural benchmark).

16. **Public expenditure management will benefit from Treasury reorganization and increase control over indirect budget users.** As part of its reorganization, the Treasury will issue an action plan by March 2005 that will fully integrate the Public Payment Agency into the Treasury. With the Road Directorate brought into Treasury Single Account in August, all direct budget users are now fully covered by the TSA. Over the medium term, all accounts of indirect budget users will also be brought into the TSA. As a first step, the Treasury will draw up by June 2005 a full inventory of all indirect budget accounts denominated in dinars and foreign currency. To further strengthen public expenditure management, the government will by end-June 2005 submit a law requiring local governments to publish audited budget accounts.

17. **Reform of the payroll system is a high priority.** The MOF will implement a work program to pull together the present disaggregated payroll data bases and to move to a more centralized payroll processing that will allow fuller control over wage expenditures. To achieve these objectives, the MOF will undertake by end-March an audit of basic personnel records in budget institutions. In addition, it will review the Systematization Act for any

vacant position that is not filled for more than a year and recommend their elimination. The MOF will strengthen its payroll division to allow it to initially construct and maintain a simple but reliable centralized database for all direct budget users. During 2005 this division will develop a program, jointly with the Budget Inspection Service, to carry out routine payroll management checks against the data base of key indirect budget users. By January 2006, the division will develop and introduce a standardized software package and complementary information system.

Montenegro

18. **Fiscal adjustment continues in Montenegro.** The 2004 general government deficit (before grants and foreign loan-financed projects, FLFPs) is targeted at 36.1 million, or 2.4 percent of Montenegrin GDP. In 2005, the fiscal deficit (before grants and FLFPs) will fall to 25.8 million, or 1.6 percent of Montenegrin GDP. Government approval and public announcement of the additional 2004 cuts and submission to the Parliament of the draft budget for 2005 in line with this MEFP will be prior actions for Board consideration of the fourth review. Over the medium term, the government is committed to continue lowering the deficit to ensure fiscal and external sustainability.

19. **The government will maintain a predictable tax environment and protect the revenue base.** Tax reforms will be implemented only in the context of annual budget laws or amended budgets, making revenue-reducing tax policy changes conditional on the availability of adequate revenues or offsetting measures to safeguard the deficit target. Such tax policy changes will not be considered if (i) actual recurrent budget revenues are below the budgeted levels, and/or (ii) the budget has accumulated new expenditure arrears during the year. The government will not extend the VAT rebate program based on retail receipts beyond November 2004. The second step of lowering PIT and social contribution rates that was originally envisaged on December 1, 2004 will only be followed by further reductions in PIT rates during 2005 and beyond if actual revenue performance exceeds projected levels by a sufficient margin to allow such cuts. The decision on further PIT rate reductions will be taken in close consultation with IMF and World Bank staff. There will not be further reductions in social contribution rates during 2005. The planned reduction in the Corporate Income Tax rate from 20 to 9 percent will only be effective from 2006. Finally, the government will refrain from extending new exemptions or differential VAT rates to any sector, and avoid restructuring tax debt in a manner that would undermine its tax collection over the medium term.

20. **Fiscal adjustment will also be supported by prudent expenditure policies.** To reduce the high share of non-discretionary expenditures, the government will cut budget-financed employment from its end-2003 level of 26,000 by 1,000 by end-2004, and by a further 800 in each quarter of 2005. Discretionary spending will be further reduced in 2005, with the amount of net lending and subsidies falling to 0.9 percent of Montenegrin GDP. The government will also avoid new privatization-related spending obligations (i.e., no subsidies or price guarantees will be provided to privatized companies, and no debt to third parties assumed unless already guaranteed by the government). The government will refrain from

spending in the first half of 2005 the 7 million reserve it has set aside in the 2005 budget for the contingency that the December 2004 reductions in social contribution rates result in additional needs for transfers to the Pension and Health Funds. Finally, the government will cap the total amount of subsidy paid to Nikš ć Steelworks under its privatization contract at 0.8 million in the draft 2005 budget and phase this subsidy out completely by end-2008.

21. **The government will continue implementing a cautious strategy of domestic borrowing.** Government net domestic financing (excluding FFCD repayment) will not exceed 12 million in 2004, and 10½ million in 2005. The government will continue developing the treasury bill market extending the maturity profile of its debt. The government will also continue increasing the share of treasury bills in total domestic financing, and will eliminate reliance on non-transparent loan agreements with individual banks and companies by end-2005

D. Monetary and Exchange Rate Policies

22. **The monetary program for the remainder of 2004 will continue tight credit policy to help contain domestic demand and inflationary pressures.** For the year, end-period NFA are programmed to be broadly unchanged, while monthly average NDA will decline slightly from August, implying a 3.5 percent growth in reserve money during the last quarter. Dinar broad money and credit to the economy are projected to rise by 13.8 and 38½ percent during 2004, respectively. The NBSwill stand ready to sterilize foreign exchange inflows to contain credit expansion.

23. **The efficiency of money market operations will be strengthened.** To increase its capacity to manage market liquidity, the NBS will expedite the implementation of repo operations. The government will submit to Parliament a draft law on the settlement of government liabilities to the NBS by end-November 2004, with a view to facilitating by end-2004 the restructuring of government debt held by the NBS into marketable bonds eligible for repo operations. In addition, to enhance public liquidity management and avoid implicit subsidies to banks, the remaining republican government and NBS deposits will be withdrawn from commercial banks by end-2004, except from one bank undergoing privatization. Meanwhile, by end-October 2004, the Ministry of Finance and the NBS will establish joint procedures for strengthening the coordination of fiscal and monetary policies, forecasting market liquidity and demand for T-bills and NBS-bills, determining the schedule for issuing these bills, and projecting government deposit flows.

24. **Macroeconomic risks related to rapid credit expansion will be assessed.** The NBS will prepare by end-March 2005 a detailed loan survey and a regular reporting standard, providing data on loans~~and~~ l easing contracts extended by Serbian bank-owned leasing companies~~by~~ industry, currency denomination, term-structure, and type of borrowers (including a breakdown of loans to households into consumer and mortgage lending), to monitor these risks. To increase transparency in the banking sector, the NBS will publish quarterly reports on banking industry trends starting with the report for end-2004.

25. **The NBS will implement prudential measures to contain macroeconomic risks resulting from rapid credit growth.** The rapid credit expansion, particularly the strong increase in credit to households, has contributed to an unsustainable rise in the current account deficit. Against this background, the following measures will be implemented:

- The NBS will issue by end-December regulations requiring banks to assess and manage credit risk resulting from borrowers' exposure to exchange-rate risk, inter alia by determining borrowers' ability to service loans denominated in or indexed to foreign currency in the event of exchange rate changes.
- The NBS and the government will support the recently established credit bureau in charge of monitoring individuals' credit risk exposure and payment history in accordance with the EU Directives. By end-March 2005, the credit bureau's data base will be extended to comprise data on leasing activities, tax arrears and arrears to utilities, and lending to enterprises.
- The NBS will issue by end-November 2004 a guideline to banks on consumer credits (excluding mortgage loans) that will recommend (i) limiting the monthly payment-to-net income ratio to 30 percent; and (ii) requiring a down payment of at least 20 percent of the purchase price of acquired goods. The NBS will also indicate to banks that stronger measures, including an increase in reserve requirements, will be considered if credit growth fails to slow down significantly. The NBS will inform Fund staff in writing by December 8, 2004 on the details of the banks' response as regards complying with the guideline.
- To remove a bias in favor of foreign-sourced funding, by January 1, 2005 the NBS will broaden the reservable base by including (i) the stock of commercial banks' foreign borrowing of maturities of up to 4 years; and (ii) all new foreign borrowing by commercial banks independent of maturities.
- To reduce prudential risks, the NBS will increase the capital adequacy ratio from 8 percent to 10 percent in March 2005.
- The NBS will explore the modalities for starting to regulate and supervise leasing companies, and work with the government on drafting legislative changes to be discussed with Bank and Fund staff during the upcoming FSAP mission. Meanwhile, the NBS will assess the appropriateness of the current limit for connected lending between banks and leasing companies, while the Serbian government will assess by end-November 2004 the tax treatment of leasing contracts.

26. **Exchange rate policy will continue to balance the objectives of reducing inflation and the external imbalance.** Against the background of a large and growing current account deficit, exchange rate policy will be flexible and contribute to improving competitiveness, while at the same time strengthening confidence in the dinar. Exchange rate policy will be assessed frequently in light of current account, wage, and inflation developments.

E. Bank Reform and Financial Supervision

27. **The NBS will substantially strengthen financial sector supervision.** To this end, it will group all banks and insurance companies according to their respective risk assessment, with their supervisory plans clearly laid out by end November 2004, and cross-check banks' submitted reports against external audit reports by end-2004. An on-site assessment of the bank posing the largest potential systemic risk will be launched by end-2004, and the bank will adopt a time-bound plan by end-2004 to strengthen internal controls and governance. To send a clear signal that regulatory forbearance is ceasing, the NBS will further strengthen on-site and off-site supervision, and strictly enforce existing regulations. In particular, the NBS will withdraw the license of banks that do not meet the 10 million minimum capital requirement by end-2004, unless they are recapitalized by reputable investors with banking experience or meet the requirement through a merger (structural benchmark). The license of further banks~~if~~ any~~fai~~ling to meet the mi nimum capital requirement will be withdrawn by end-March 2005. To improve financial sector transparency and market discipline, all banks, insurance and leasing companies will publish IAS compliant end-2004 financial results by end-June 2005. The NBS will also strictly enforce prudential requirements for insurance companies and require comprehensive year-end audits, with management letters provided to the NBS.

28. **In Serbia, progress in bank privatization and resolution will continue and governance in BRA-controlled banks will be strengthened.** Building on progress in privatizing Jubanka, the BRA will launch the privatization tender for Niška Banka by end-2004 (structural benchmark). Meanwhile, management in the two largest banks with state-majority holdings has been improved. For Vojvođanska Banka, the tender for a privatization advisor was issued on October 7, 2004 with a view to appointing the advisor by end-February 2005, and launching the tender for its privatization in the third quarter of 2005. Concurrently, with bilateral assistance, the BRA will further strengthen its reporting requirements, control mechanisms, and governance in other nationalized banks to preserve their value prior to resolution. After some delays due to legal procedure, the BRA will launch the sale of its residential mortgage loan book by end-2004 and initiate the sale the 25 largest corporate and commercial unimpaired (non-public, not on privatization list, not bankrupt) loans by end-March 2005. Meanwhile, Parliament will adopt new laws on Deposit Insurance, Bank Liquidation, and Bank Rehabilitation Agency by end-March 2005, after consultation with World Bank and IMF staff.

29. **In Montenegro, banking supervision will remain vigilant and bank privatization and asset resolution will continue.** The CBM has further strengthened banking supervision, in particular by further improving compliance with Basel core principles and strengthening the focus on risk management. Moreover, it has remained vigilant in light of rapid credit expansion, inter alia by ensuring that a moderate deterioration in the quality of banks'loan portfolio was appropriately accompanied by an increase in loan-loss provisioning. To further reduce state influence in the banking sector, the government will launch a tender for a privatization advisor for the largest state-owned bank by end-November and sign the contract with the advisor by end-2004. The privatization tender will be launched by end-April, 2005.

The government and the CBM will also prepare a strategy by end-2004 to divest all state minority holdings from the banking system, and refrain from increasing this stake in the banking system in the meantime. The government will begin by end-2004 the sale of non-financial assets carved out from the banking sector, initiating by end-March 2005 the sale of at least 50 percent of the unimpaired assets, and by end-June 2005 all remaining unimpaired assets. To level the playing field for banks and improve Treasury cash management, all republican government deposits with commercial banks will be transferred to the single treasury account in the CBM by end-2004 (structural benchmark), with the exception that republican government deposits at Podgoricka Banka will decline by 2 million from their end-August level, and fall to zero by end-June 2005. Finally, enhanced balance sheets for the central bank and for deposit money banks will be available by end-2004 to improve the monitoring of banking and fiscal developments.

F. Enterprise Sector

30. **Wage bills in state enterprises will continue to be controlled to contain inflation pressures and encourage restructuring.** To help ensure that the state enterprise wage bill remains under control, the government will pass by end-November a decree requiring ex ante approval by the Ministries of Labor and Finance for wage increases in 8 public utilities. On this basis, the government agrees to treat the wage bill ceiling on the 7 monitored public utilities as a performance criterion from end-December 2004.[17] The wage bill in the monitored state enterprises in 2005 will be allowed to grow by 7 percent on an average basis. To facilitate the necessary cost rationalization, detailed business plans, including new organization charts (sistematizacija) will be prepared by end-2004 for most monitored public utilities~~inc~~luding for NIS, EPS, and ZTP ~~cle~~arly showing redundant workers. Redundancy payments for the laid-off workers will be covered from the non-wage budgets of the enterprises and from the Transition Fund in the budget (0.1 percent of GDP). In the event of spin-offs as a result of future restructuring, the monitored wage-bill envelope will be adjusted downward for the wage-bills of the spun-off units.

31. **Accelerating the privatization and restructuring of socially-owned enterprises is critical for improving export performance and for rapid sustained growth.** To this end, we will ensure that:

- The Privatization Agency (PA) will offer for sale, through *auctions*, 135 companies between October 1 and December 31, 2004 and will sell at least 50 percent of these companies; and another 60 companies between January 1 and March 31, 2005, out of which at least 40 percent will be sold.

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[17] The number of monitored enterprises increases to 8 from January 1, 2005 (see paragraph 24 of the TMU).

- The PA will offer for sale 3 companies from the list of *companies under restructuring* through *tenders* or auctions, or parts thereof through asset sales between October 1 and December 31, 2004; and three more companies from the list between January 1 and March 31, 2005. The launch of tenders for 3 companies will be a prior action for the review.

- The PA will complete the first Share Fund sale through a public offer compatible with the Securities Law by December 31, 2004, and submit to Parliament amendments to laws necessary to enable steady progress in Share Fund sales by end-March, 2005. On this basis, it will revive sales of residual state-owned shares in socially-owned enterprises either through public offers or through sales via the Stock Exchange. At least three more such transactions will be initiated by end-March 2005.

- The government will also ensure progress in the remaining large privatization transactions, which will allow the launch of a tender for a privatization advisor for at least one of the following telecom privatization transactions by end-March 2005: (i) mobile telephone operations of Srbija Telekom; (ii) Mobtel; (iii) third mobile license (excluding Srbija Telekom, PTT, and Mobtel from participating as buyers). The government will ensure that all tenders are carried out transparently, in accordance with international best practice.

- To ensure fiscal transparency, all privatization proceeds will be treated as budgetary financing (below the line) and spending will follow normal budgetary procedures.

32. **To accelerate privatization, we envisage debt workouts for large socially-owned enterprises coordinated by a unit under the Deputy Prime Minister's supervision.** The framework for such agreements will be strengthened through amendments to the Privatization Law by [end-2004], which will enshrine the principle of write off of enterprise debts to state creditors and public utilities, conditional upon privatization. To enable the privatization of highly indebted enterprises by reducing their debt without creating moral hazard, write-offs of tax and social contribution arrears, and of obligations to public utilities or state-owned banks will be conditional on actual sale or final bankruptcy, and most often involve a haircut for remaining creditors imposed by an inter-ministerial negotiating group. Private creditors may accept haircuts in return for prompt payment, or may be forced to do so by public sector creditors whenever~~as~~ is mo st often the case~~pu~~blic sector creditors account for the majority of claims.

33. **An effective bankruptcy process provides a critical building block of the government's strategy for strengthening enterprises' financial discipline.** The bankruptcy process will become fully operational by end-February 2005, following the adoption of bylaws to the Bankruptcy Law and the establishment of: (a) a Supervisory Body to license, supervise, and regulate bankruptcy trustees; (b) a specialized unit within the Privatization Agency to act as bankruptcy trustee for state- and socially-owned enterprises. As part of this process, an amendment to the Law on the Privatization Agency enabling the PA to act as the bankruptcy trustee agency for state- and socially-owned enterprises will be

enacted by end-2004 (structural performance criterion). The government will complement rapid progress toward a functioning bankruptcy process by initiating bankruptcy procedures under the new regulations against three large, heavily indebted, and loss-making socially-owned conglomerates under restructuring programs by end-March 2005.

34. **The Serbian government is firmly committed to improving the financial performance of the railway company (ZTP) by accelerating restructuring and downsizing employment.** Delays in restructuring and excessive employment have created large losses and imposed a substantial budgetary burden through annual subsidies of ¾ percent of GDP. Against this background, the Ministry of Capital Investment will prepare by end-February 2005, in consultation with the Ministry of Finance and World Bank and Fund staff, a restructuring plan drawing on the Business Plan for 2004-2008 elaborated by the consulting company *Booz-Allen-Hamilton*. This restructuring plan will provide detailed timetables covering 2005 for (a) reducing labor redundancies; (b) spinning off all non-core activities of ZTP with a view to privatizing them; (c) potentially closing loss-making secondary railway lines, if the respective segments are not taken over by investors in the form of subconcession contracts; and (d) raising the price of passengers'tickets and freight tariffs early in the year. Moreover, the government will submit to parliament by end-March 2005 a transportation law agreed with the World Bank that provides for the unbundling of ZTP into separate transportation and infrastructure companies.

35. **The Serbian government will continue restructuring public utilities based on strategic plans.**

- The government will create an operational regulatory framework with an independent regulatory body for natural monopolies by end-2004, and will prepare a modern law on royalties to be paid by companies involved in extracting natural resources, for which it will request World Bank assistance.

- It will ensure that after its unbundling by end-February 2005 (performance criterion) into two separate companies, one for power generation, distribution and distribution system management, and one for transmission and dispatch, EPS will (i) complete the spin-off of all non-core activities; (ii) reduce its core employment by 7 percent (relative to end-September 2004), in line with the company's strategic plan; (iii) service all its debt to the government in full except for Kosovo-related debt; and (iv) not receive any budgetary subsidy in 2004-2005.

- To enhance collection and strengthen enterprise budget constraints, public utilities will enforce penalties on late payments and cut off supplies to commercial users that are not honoring their payment obligations for more than two months. If the government considers that continuation of delivery to these enterprises is imperative for strategic or social reasons, the utility bills will be paid from the budget.

- Finally, to raise transparency in the sector, all monitored public utilities will publish by end-June 2005 an auditor's report on thei r 2004 accounts in line with IAS prepared by a reputable international auditing firm engaging a review partner with relevant industry experience from outside the local office.

36. **Privatization in Montenegro is proceeding.** The Nikšić steel company has been privatized, hotels are being sold at a brisk pace, and the large aluminum company (KAP) is at an advanced stage in its privatization process. In addition, Montenegro Telecom is expected to be offered for sale in the first half of 2005. The republican budget's privatization proceeds have been conservatively budgeted at 6 million in both 2004 and 2005, but can be higher without affecting deficit targets (i.e., additional privatization receipts will be offset with equal reduction of net domestic financing). The government will refrain from granting electricity subsidies to privatized companies or extending any government guarantees.

G. Foreign Trade System

37. **The foreign trade system is being harmonized internally and liberalized through regional agreements.** Following an agreement on a timetable to harmonize the trade, customs, and indirect tax regimes of the two republics adopted in August 2003, tariff rates have been harmonized with the exception of tariff lines for 56 agriculture products and of special import levies and seasonal tariffs for a range of additional products. All export and import quotas have been eliminated. A Joint Customs office with competence on trade with EU countries has been set up. Even though the harmonization process – as requested by the EU - is not yet complete, the EU has signaled that it could adopt a more flexible approach towards the preparation of a feasibility study for the Stabilization and Association Agreement. Significant progress in the resolution of the outstanding issues with the European Commission relating to sugar trade has allowed the resumption of sugar exports to the EU. A trade agreement to liberalize trade in textiles with the EU is expected to be finalized by the end of the year. Discussions on bilateral Free Trade Agreements with neighboring countries within the initiative of Stability Pact aimed at facilitating trade through harmonized rules and standards, and simplified customs procedures have progressed well. Free Trade agreements with Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Moldova, and Romania have been ratified and implemented, while work is underway to review the trade agreement with Macedonia. Preparations for the WTO accession process are continuing, with the first meeting of the Serbia and Montenegro Task Force for WTO accession envisaged in 2005. Customs operations are expected to be further strengthened, including at the Union level. To avoid backtracking on reforms and maintain a competitive market environment, both member states will refrain from introducing or intensifying import restrictions. Serbia and Montenegro agree to improve the comparability of respective external sector data, and provide foreign debt data on a periodic basis.

III. Program Monitoring

38. **Macroeconomic policy performance under the EA will continue to be monitored through quarterly quantitative performance criteria and indicative targets** (Annex B). Progress in structural reform will be monitored through structural performance criteria and

benchmarks on key policy measures (Annex D). Quarterly targets for 2004 remain as set in the Third Review documents except for a revision in the end-December ceiling on Montenegro's nonconcessional multilateral borrowing and an end-December performance criterion added for the wage bill of monitored state-owned enterprises in Serbia. Quarterly performance criteria are also proposed for end-March, 2005. Parliamentary approval of a revised 2004 budget for 2004 in Serbia and parliamentary submission of annual 2005 budgets for Serbia and for Montenegro in line with policies described in this memorandum, as well as issuing tenders for 3 socially-owned enterprises in Serbia, government approval and public announcement of the additional 2004 budget cuts in Montenegro, and submission to federal parliament of amendments to two laws governing union-level employment will constitute prior actions for Board consideration of the fourth review under the Extended Arrangement (Annex D).

Table 1. Serbia and Montenegro: Quantitative Performance Criteria and Indicative Targets for 2004 and 2005
Under the 2002–05 Extended Arrangement 1/
(In millions of dinars, unless otherwise noted; end of period)

	2003	2004								2005			
	Dec.	Jun.			Sep.			Dec.		Mar.	Jun.	Sep.	Dec.
	End-03	Program		Act.	Program		Act.	Program	Proj.	Program	Program	Program	Program
	Ex. Rates 15/	3rd. Rev. 15/	W/ Adjustor 16/		15/	w/adjustor		15/	15/				
A. Quantitative performance criteria 16/													
Floor on the net foreign assets of the NBS 2/ 3/	1,663	1,525	1,425	1,448	1,473	1,373	1,582	1,594	1,594	1,608	1,498	1,598	1,708
Ceiling on net domestic assets of the NBS 2/ 4/	-20,844	-21,927	-19,427	-17,354	-13,395	-10,895	-21,924	-16,001	-18,931	-22,197	-15,337	-17,453	-20,804
Ceiling on net credit of the banking system to the consolidated general government 2/ 5/ 6/ 7/	-23,238	-19,092	-16,378	-13,620	-13,279	-10,612	-18,368	-11,280	-11,507	-10,590	-4,464	-7,922	-20,011
Ceiling on cumulative contracting or guaranteeing during the year by the public sector of new nonconcessional external debt with original maturity of more than one year 8/	383	500		207	500		237	500	522	100	200	300	400
Multilateral creditors (EBRD, EIB, EU, IBRD, and IFC)	383	500		207	500		237	500	522	100	200	300	400
Serbia	351	460		145	460		175	460	460	92	184	276	368
Montenegro	31	40		62	40		62	40	62 17/	8	16	24	32
Other creditors	0	0		0	0		0	0	0	0	0	0	0
Ceiling on new external debt contracted or guaranteed by the public sector with an original maturity of up to and including one year 9/	0	0		0	0		0	0	0	0	0	0	0
Ceiling on new guarantees and the assumption of bank or enterprise debt by the public sector 10/	0	0		0	0		14	0	0	0	0	0	0
Ceiling on outstanding external debt service arrears 3/ 11/	0	0		0	0		0	0	0	0	0	0	0
Ceiling on the wage bill of the monitored public enterprises, cumulative from beginning of year 12/	27,523	14,376		14,438	21,852		22,183	29,725	30,230	8,030	15,941	24,180	32,700
B. Indicative targets													
Ceiling on net credit of the banking system to													
consolidated general government of Serbia 2/ 5/ 6/ 13/	-23,586	-21,100		-14,198	-14,878		-18,810	-12,469	-12,696	-11,992	-6,377	-10,009	-22,539
consolidated general government of Montenegro 2/ 5/ 13/	348	2,008		578	1,599		442	1,189	1,189	1,402	1,913	2,087	2,528
Ceiling on net domestic assets of the banking system 2/ 14/	64,249	76,128		93,777	92,503		100,523	94,134	117,450	124,601	137,670	144,811	144,924
Ceiling on Serbian central government dinar deposits in commercial banks	4,813	0		2,014	0		1,652	0	0	0	0	0	0
Ceiling on change in the arrears of													
the Union government	…	0		0	0		...	0	0	0	0	0	0
the consolidated general government in Serbia	…	0		n.a. 18/	0		...	0	0	0	0	0	0
the consolidated general government in Montenegro	…	0		395	0		687	0	0	0	0	0	0

1/ Quantitative performance criteria and indicative targets are defined in Annex E and evaluated at end-December 2003 exchange rates for program purposes.
In 2005, figures in section A. are performance criteria for March and indicative targets for the remainder of the year.
2/ These performance criteria will be adjusted by the amount that revised estimates differ from the preliminary end-September 2004 figures.
3/ In millions of U.S. dollars. The net foreign assets floor will be adjusted downward by the shortfall relative to the programed level of net external budgetary financing with a maximur
4/ Monitored on the basis of monthly averages as defined in Annex E. Subject to the same adjustment for excess or shortfall in combined budgetary external financing and privatization proceeds for the consolidated Serbian government as defined in 7/.
5/ For program purposes, the ceilings on net credit of the banking system to the consolidated general government will be adjusted downward by the cumulative increase in the stock of government debt held by the nonbank public (other than that related to the frozen currency deposits), starting from January 1, 2004, and upward for any decrease. In addition, in the event of a shortfall in the sum of net foreign budgetary financing and privatization proceeds, the ceilings will be adjusted upward for the shortfall subject to the total adjustment limit of 6 billion dinar for Serbia and 10 million for Montenegro's consolidated government. The ceilings will be adjusted downward for the excess of combined net external budgetary financing and privatization proceeds relative to budgeted levels that are not used (1) to reduce the government external indebtedness by more than envisaged under the program, or (2) to cover investment and restructuring costs in consultation with the Fund in the context of program reviews.
6/ The adjustors for shortfalls in (i) nonbank domestic financing; and (ii) severance payments apply, as defined in sections II.D, and II.J of the TMU, respectively.
7/ The consolidated general government comprises the Serbian republican and local governments, union level operations, the Montenegrin republican government, the Serbian and Montenegrin social security funds, and the Serbian and Montenegro special extrabudgetary programs.
8/ In millions of U.S. dollars. Excluding loans from the IMF and debt contracted in the context of debt restructuring agreements in the framework of the Paris Club and London Club. The public sector comprises the consolidated general government, the National Bank of Serbia, and the Central Bank of Montenegro.
9/ Excludes normal import-related credits.
10/ Excludes indebtedness arising from the fulfillment of existing government guarantees.
11/ Excludes debts subject to restructuring/negotiations. The nonaccumulation of new external arrears is also a continuous performance criterion.
12/ Indicative target through September 2004; performance criterion from December 2004 onwards. The revised annual target for 2004 was increased by 1.7 percent. The 7 monitored e
JP Elektroprivreda Srbije, JP Naftna Industrija Srbije, JP PTT Srbije, JP Jugoslovenski Aerotransport, JP Zelenicko Transportno Preduzece Srbije, JP Srbija Sume, and JP Srbija Telek
In the case of spin-offs from these companies of activities through the creation of new companies after end-October 2003, the monitored wage bill will be adjusted for the spun-off units
13/ Consolidated Montenegrin government includes all entities in Montenegro defined under 7/; the rest of entities under 7/ is included in the consolidated Serbian government.
14/ Foreign currency-denominated loans and deposits at program exchange rates. Excludes Montenegro.
15/ Reflects, as appropriate, revisions to the NBS' foreign exchange liabilities, credit to government by the banking system, and broad money at end-2003, and adjustments stemming from the raising of the reserve requirement ratio from 18 to 21 percent effective on August 11, 2004.
16/ Given the size of the shortfall in total budgetary support during Jan-June 2004, the NFA floor for end-June was adjusted down by $100 million, and the NDA ceiling for June is adjusted up by D 2.5 billion, the maximum adjustments for both targets allowed under the program.
17/ Revised PC for end-December 2004.
18/ Data on the net-accumulation of arrears have not yet been provided by the authorities.

Table 2. Serbia and Montenegro: Extended Arrangement, May 2002–May 2005
Prior Actions, Structural Performance Criteria, and Structural Benchmarks, January–December 2004

	Target Date	Implementation
I. Structural Performance Criteria		
1. Serbia: Effective July 1, 2004, increase weighted average electricity price for sales to end-users by at least 10 percent in dinar terms from the level prevailing at end-2003.	end-June 2004	Met. Electricity price was increased by an average of 10.6 percent. Decision taken at the Government session on June 24, 2004 and published in Official Gazette (73/2004) on June 25.
2. Parliamentary adoption of the bankruptcy law in line with the MEFP.	end-June 2004	Met with short delay. Waiver is requested. Parliament adopted the Bankruptcy Law on July 17 together with 16 other key pieces of reform legislation following repeated posptonements owing to the need to garner sufficient supporting votes.
II. Structural Benchmarks		
A. Fiscal Sector		
1. Serbia: Submit to Parliament the draft Law on VAT establishing a broad-based VAT with no more than two rates, effective from January 1, 2005.	end-June 2004	Met with short delay. Draft law submitted to Parliament on May 25, 2004. Parliament adopted the VAT law together with other reform legislation on July 17, 2004.
2. Montenegro: withdraw all central government deposits from commercial banks to the Treasury Single Acccount in the Central Bank of Montenegro (for the bank in the process of privatization, the deposits would decline to one half of their end-2003 level, with the remainder to be withdrawn by end- 2005).	end-December 2004	In the Fourth Review the benchmark was reformulated for the bank in the process of privatization: its deposits would decline by 2 million by end-2004, with the remainder to be withdrawn by end-June 2005.
B. Financial Sector		
1. Serbia: Adopt a time-bound strategy to recover value of non-performing assets of closed banks and those associated with Paris and London Club.	end-June 2004	Substantially met. Key aspects of a stategy were presented to and endorsed by the BRA board on April 29, 2004.
2 Serbia: Complete the conversion of all Paris and London Club as well as FFCD-related liabilities into state-owned equity in banks to be privatized.	end-June 2004	Largely met, with delay.
3. Serbia: Offer majority or controlling stakes to strategic investors in one of the banks affected by the July 2002 laws on Paris and London Club debt and frozen foreign currency deposits.	end-May 2004	Met. Public Tender for Jugobanka was announced in the Financial Times on May 28, 2004
4. Serbia: Offer majority or controlling stakes to strategic investors in two additional banks affected by the July 2002 laws on Paris and London Club debt and frozen foreign currency deposits.	end-September 2004	Met.
5. Serbia: Begin recovering value from impaired assets acquired by the state by launching the sale from the BRA portfolio of the 25 largest corporate and commercial loans not prescribed (non-public, not on privatization list, not bankrupt).	end-September 2004	Not met. Revised and Rescheduled.
6. Serbia: Offer majority or controlling stakes to strategic investors in one additional bank affected by the July 2002 laws on Paris and London Club debt and frozen foreign currency deposits.	end-December 2004	
7. Montenegro: Contract out through tenders the collection of carved-out assets from the banking system.	end-September 2004	Not met. Revised and Rescheduled.
8. Montenegro: launch a transparent international tender to sell the state's holdings in Podgoricka Banka to maximize cash privatization proceeds.	end-December 2004	In the Fourth Review the test date was rescheduled from end-December 2004 to end-April 2005.
C. Enterprise restructuring and privatization		
1. Put in place operational institutions and supporting legislation to ensure implementation of the bankruptcy law.	end-November 2004	In the Fourth Review reformulated and elevated from SB to an end-December PC: "Serbia: Enact amendment to the Law on the Privatization Agency enabling the Privatization Agency to act as the bankruptcy trustee agency for state- and socially-owned enterprises."

Table 3. Serbia and Montenegro: Extended Arrangement, May 2002–May 2005
Prior Actions, Structural Performance Criteria, and Structural Benchmarks, September 2004–March 2005

	Target Date	Status	Implementation
I. Prior Actions for Board Consideration of the Fourth Review			
1. Serbia: Parliamentary approval of the revised budget for 2004 in line with the MEFP.		Done	Adopted October 20, 2004
2. Serbia: Submission to Parliament of the draft 2005 budget in line with the MEFP.		Done	Adopted November 20, 2004
3. Montenegro: Government approval and publication of the revised budgetary objectives for 2004 in line with the MEFP.		Revisions submitted to Cabinet	
4. Montenegro: Submission to Parliament of the draft 2005 budget in line with the MEFP.		Draft submitted to Cabinet	
5. Serbia: Issue tender for 3 large socially-owned enterprises			
6. Serbia and Montenegro: Submit to federal parliament amendments to the law on (i) the Yugoslav Army and (ii) Union-level Civil Employees, reducing the redundancy payment from 24 to 12 months' wages and the dismissal notice time from 3 months to 30 days.			
II. Structural Performance Criteria			
1. Serbia: Enact amendment to the Law on the Privatization Agency enabling the Privatization Agency to act as the bankruptcy trustee agency for state- and socially-owned enterprises.	end-December 2004	4th review	
2. Serbia: Enact the amendments to the law on (i) the Yugoslav Army and (ii) Union-level Civil Employees, reducing the redundancy payment from 24 to 12 months' wages and the dismissal notice time from 3 months to 30 days.	end-December 2004	4th review	
3. Serbia: The government will (i) legally register the new transmission and dispatch company, which will be owned separately from EPS; and (ii) adopt a time bound action plan for implementation of EPS restructuring covering accounting separation, introduction of transfer prices, labor restructuring, debt restructuring, asset transfer, and other steps necessary to enable the separated companies to function as independent enterprises from July 1, 2005.	end-February 2005	4th review	
III. Structural Benchmarks			
A. Fiscal Sector			
1. Serbia: Agree with World Bank on key elements of civil service reform consistent with restraining the 2005 budgetary wage bill in line with the MEFP.	end-November 2004	4th review	
2. Montenegro: Withdraw all central government deposits from commercial banks to the Treasury Single Account in the Central Bank of Montenegro (for the bank in the process of privatization, the deposits would decline by 2 million by end-2004, with the remainder to be withdrawn by end-June 2005).	end-December 2004	3rd review	
3. Serbia: Prepare a plan to reduce tax arrears to the budget.	end-November 2004	4th review	
4. Serbia: Adopt Law on Civil Service	end-March 2005	4th review	
B. Financial Sector			
1. Serbia: Offer majority or controlling stakes to strategic investors in one additional bank affected by the July 2002 laws on Paris and London Club debt and frozen foreign currency deposits.	end-December 2004	3rd review	
2. Serbia: Submit to Parliament a draft law to convert existing government debt to the NBS into tradable securities.	end-November 2004	4th review	
3. Serbia: Close banks that do not meet the minimum capital requirement, unless reputable investors recapitalize them, or they are undergoing merger to help them meet this requirement.	end-December 2004	4th review	
4. Serbia: Adopt the laws on Deposit Insurance, BRA and Bank Bankruptcy in consultation with the World Bank and the Fund.	end-March 2005	4th review	
5. Montenegro: Launch the sale of nonfinancial assets carved-out from the banking system.	end-December 2004	4th review	
6. Montenegro: Launch a transparent international tender to sell the state's holdings in Podgoricka Banka to maximize cash privatization proceeds.	end-April 2005	3rd review, rescheduled	
C. Enterprise restructuring and privatization			
1. Serbia: Establish a Supervisory Body to license, supervise, and regulate bankruptcy trustees.	end-February 2005	4th review	

SERBIA AND MONTENEGRO: TECHNICAL MEMORANDUM OF UNDERSTANDING

I. INTRODUCTION

1. This memorandum replaces the Technical Memorandum of Understanding attached to the Memorandum of Economic and Financial Policies of May 21, 2004. It sets out the understandings regarding the definitions of quantitative and structural performance criteria, benchmarks, and indicative targets for the program supported by the Fund under an Extended Arrangement (EA), as well as the related reporting requirements. The key changes in this updated memorandum include definitional changes in the external debt ceilings and data revisions.

2. To monitor developments under the program, the authorities will provide the data listed in each section below to the European Department of the Fund, in accordance with the indicated timing. The quantitative performance criteria and indicative targets will be monitored on the basis of the methodological classification of monetary and financial data that was in place on December 31, 2002, except as noted below. Quantitative performance criteria and indicative targets for end-December 2004, end-March, end-June, end-September and end-December 2005 are specified in Annex A of the Memorandum of Economic and Financial Policies (MEFP).

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

II. QUANTITATIVE CRITERIA: DEFINITIONS AND REPORTING STANDARDS

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

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

- 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: frozen assets of the

Union of Serbia and Montenegro (SM), 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 SM 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. For program purposes, all euro and foreign currency-related assets will be evaluated at **program exchange rates**; for 2004, the program exchange rates are those that prevailed on December 31, 2003. In particular, US$1 = CSD 54.6372, 1 = CSD 68.3129, and SDR1 = US$ 1.4806. Monetary gold shall be valued at an accounting price of US$ 416.85 per ounce. On September 30, 2004, the NBS's foreign reserve assets as defined above amounted to US$3,622.4 million, including gold valued at US$140.4 million.

- For purposes of the program, **foreign reserve liabilities** shall be defined as any foreign-currency-denominated short-term loan or deposit (with a maturity of up to and including one year); NBS liabilities to residents and nonresidents associated with swaps (including any portion of the NBS gold that is collateralized) and forward contracts; IMF purchases; and loans contracted by the NBS from international capital markets, banks or other financial institutions located abroad, and foreign governments, irrespective of their maturity. Undivided foreign exchange liabilities of SFRY are excluded. On September 30, 2004, the NBS's foreign reserve liabilities, as defined above, to nonresidents were US$1,086 million and to residents were US$954 million.

- All assets and liabilities denominated in convertible currencies other than the U.S. dollar shall be converted at their respective exchange rates against the U.S. dollar prevailing on December 31, 2003. All changes in definition or in valuation of assets or liabilities, as well as details of operations concerning sales, purchases or swap operations with respect to gold shall be communicated to the Fund staff within one week of the operation.

5. **Reporting.** Data on foreign reserve assets and foreign reserve liabilities of the NBS shall be transmitted to the European Department of the Fund on a weekly basis within four business days of the end of each business week. To facilitate program monitoring, the NBS will provide the data at the indicated constant prices and exchange rates, as well as at current exchange rates. The NBS will report if any of the reported foreign reserve assets are illiquid, pledged, swapped, or encumbered.

6. **Adjustors**. For program purposes, net foreign assets will be adjusted upward pari passu to the extent that: (i) after September 30, 2004, the NBS has recovered frozen assets of the FRY, assets of the SFRY, long-term assets, and foreign-exchange-denominated claims on resident banks and nonbanks, as well as SM commercial banks abroad; and (ii) the restructuring of the banking sector by the Agency for Deposit Insurance, Rehabilitation, Bankruptcy, and Liquidation of Banks (BRA) involves a write-off of NBS foreign-exchange-denominated liabilities to resident banks. The net foreign assets floor will be adjusted

downward by the shortfall relative to the programmed level of net external budgetary financing cumulative from December 31, 2003 (US$217.4 million through end-December 2004), and cumulative from December 31, 2004 (US$40 million through end-March 2005, US$40 million through end-June 2005, US$95 million through end-September 2005, and US$95 million through end-December 2005) with a maximum adjustment of US$100 million. The net foreign assets floor will also be adjusted by the amount that the end-September, 2004 outcome is revised.

B. Ceiling on Net Domestic Assets of the NBS

7. **Definition.** For purposes of the program, net domestic assets (NDA) of the NBS are defined as the difference between reserve money (as defined in section F) and net foreign assets (as defined in section A), with the latter being converted from U.S. dollars into dinars at the program exchange rates as specified above. The ceiling is established as the monthly average of each month with an end-month test date (i.e., the averages of December 2004, of March, June, September, and December 2005, respectively). The monthly average of NDA for program purposes will be calculated as the difference of the monthly average of reserve money and monthly average of NFA. The monthly average of NFA will be adjusted so that the disbursements of World Bank program loans and EU macro-financial assistance are counted as if they occurred on the first day of the month in which they were effected. As of September 30, 2004, NDA of the NBS so defined were valued at CSD -21,924 million (Annex B).

8. **Adjustors**. The NBS' s NDA ceiling is subject to the same adjustor for excess or shortfall in combined budgetary external financing and privatization proceeds for the consolidated Serbian government as defined in Section C, except that the limit for upward adjustment is CSD 2.5 billion. The adjustment for excesses/shortfalls in combined budgetary external financing and privatization proceeds is asymmetric: (a) it applies to the NDA ceiling but not to the NFA floor (except that shortfalls in budgetary external financing trigger an equal downward adjustment in NFA up to a limit of US$100 million); and (b) upward adjustments in NDA are capped at the equivalent of 0.2 percent of programmed annual GDP, while no limits apply to downward adjustments. This treatment takes into account that: (a) privatization proceeds reflect partly sales to residents (i.e., not directly affecting NFA), so that a downward adjustment in NDA in response to higher than programmed privatization proceeds may not necessarily lead to a corresponding increase in NFA or may do so with a considerable lag (money demand is not stable in the short run); and (b) the need to safeguard foreign reserves.

9. **Reporting.** The ceilings will be monitored on the basis of daily data on NBS foreign reserve assets and liabilities as defined under section A, and reserve money (as defined under section F), supplied to the European Department of the Fund by the NBS within four business days of the end of each business week. To facilitate program monitoring, the NBS will provide daily its foreign reserves liabilities, as well as the amounts and dates of World Bank and EU macro-financial assistance disbursements at the current and the program exchange rates.

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

10. **Definition.** The banking system comprises the NBS and commercial banks licensed by it in Serbia, as well as the CBM and commercial banks licensed by it in Montenegro. The consolidated general government was defined above.

- For program purposes, **net credit of the banking system to the consolidated general government** is defined as all claims other than frozen foreign currency deposit (FFCD), bonds (i.e., credits, securities, and other claims in both dinar and foreign currencies) of the banking system on the consolidated general government less all deposits of the consolidated general government with the banking system, including foreign currency deposits. Foreign currency deposits and foreign-currency-denominated credits to the general government will be reported at the program exchange rates. Net bank credit to the consolidated general government in Montenegro will be monitored on the basis of data supplied by the Montenegrin authorities; at end-September 2004, net credit of the banking system in Montenegro to the consolidated general government in Montenegro amounted to 6.473 million (equivalent to CSD 442 million). At end-September 2004, net credit of the banking system to the consolidated general government so defined was CSD -18,368 million.

11. **Reporting.** The ceilings will be monitored using end-month data on the accounts of the banking system supplied to the European Department of the Fund with a lag not to exceed three weeks.

12. **Adjustors.** For program purposes, the ceilings on net credit of the banking system to the consolidated general governments will be adjusted downward by the cumulative increase in the stock of government debt held by the nonbank public (other than that related to the frozen foreign currency deposits), starting from January 1, 2003, and upward for any decrease. These performance criteria will be adjusted by the amount that the end-December 2003 outcome is revised. In addition, in the event of a shortfall in the sum of net foreign budgetary financing and privatization proceeds, the ceilings will be adjusted upward by 75 percent of the shortfall subject to the total adjustment limit of CSD 5 billion for Serbia's and 6 million for Montenegro's consolidated government. The ceilings will be adjusted downward for the excess of combined net external budgetary financing and privatization proceeds relative to budgeted levels that are not used (1) to reduce the government's external indebtedness by more th an envisaged under the program, or (2) to cover investment and restructuring costs in consultation with the Fund in the context of reviews under the EA. Privatization receipts are defined to include all cash privatization receipts (defined as cash received by the government including the privatization agency), including those channeled to extrabudgetary funds, and from asset sales by the public sector and by state-owned or socially-owned enterprises. Net external budgetary financing is defined to include all budgetary (i.e., non-project) grants and loans, less amortization (on a cash basis). The estimation of the shortfalls (excesses) in the sum of net foreign budgetary

financing and privatization receipts will be based on the following projections (cumulative from the beginning of the year specified) with the actual inflows evaluated at the average exchange rates of the month when funds are received:

Serbia (2004, in billions of dinars)

	Dec
External Financing	11.1
Privatization proceeds	8.3

Serbia (2005, in billions of dinars)

	Mar	Jun	Sep	Dec
External Financing	2.6	2.6	6.5	6.5
Privatization proceeds	4.5	15.1	20.3	25.7

Montenegro (2004, in million)

	Dec
External Financing	39.8
Privatization proceeds	15.0

Montenegro (2005, in million)

	Mar	Jun	Sep	Dec
External financing	7.0	8.0	9.0	10.0
Privatization receipts	1.6	3.2	4.7	6.2

D. Nonbank Domestic Financing

13. **Definition.** Nonbank domestic financing to the consolidated general government is defined as any form of resident financing for the consolidated budget deficit other than (i) from the NBS, (ii) from commercial banks, and (iii) privatization proceeds. This will include domestic financing from nonbank financial institutions, nonfinancial enterprises, households, and all other domestic financing not elsewhere classified. Nonbank domestic financing covers any net change in the consolidated general government liabilities to any of these institutions, representing either direct loans or advances to the consolidated general government or holdings of securities of the consolidated general government, including promissory notes or other contractual obligations. FFCD payments are treated below the line as negative domestic nonbank financing.

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

	2005			
	Mar.	Jun.	Sep.	Dec
Projected Nonbank Domestic Financing	0.0	17.4	20.9	22.5

E. Ceiling on Change in Domestic Arrears

15. For program purposes, indicative targets will be set on the change in domestic arrears. Separate indicative targets will be set for the consolidated general government of Serbia (including union-level spending), and the consolidated general government of Montenegro.

16. **Definition**

- For the purpose of establishing compliance with this indicative target, union-level expenditure is defined to comprise all budgetary activities specified in the Constitutional Charter, including the SM army and the SM pension fund for retired military personnel. The consolidated general government of Serbia is defined to comprise all budgetary institutions financed from the Serbian state budget, the Republican Pension and Invalidity Insurance Fund for Employees, the Republican Pension and Invalidity Insurance Fund for Self-employed, the Republican Pension and Invalidity Insurance Fund for Agricultural Workers, the Republican Health Insurance Fund, the Republican Labor Market Agency, all republican special directorates, and all other budgetary and extrabudgetary funds created by the government of Serbia existing before or created during the period of the program. The consolidated general government of Montenegro is defined to comprise all budgetary institutions financed from the state budget, the Republican Pension and Invalidity Insurance Fund, the Republican Health Insurance Fund, the Republican Labor Market Fund, and all other budgetary and extrabudgetary funds created by the government of Montenegro existing before or created during the period of the program.

- The outstanding stock of domestic arrears comprises wage and pension arrears; arrears with respect to accrued tax and social security contribution obligations, including personal income tax and social security contributions of employees withheld at source; arrears on social entitlement benefits (apart from pensions) to households; arrears incurred with respect to the purchases of goods and services from suppliers; arrears related to the servicing of domestic debt and nonpayment of budgeted transfers to finance union-level expenditures.

- The outstanding stock of wage arrears at a particular date are defined as total accumulated unpaid wages of all employees on the regular payroll of all units belonging to the parts of the general government as defined above, up to the latest preceding regular pay date, which have not been settled by the test date. The total stocks of wage arrears, thus defined, are on a gross basis and are calculated by summing the wage arrears of all units of government with regard to their own employees; transfers between different levels of government for making wage or other payments are excluded from the estimates of these wage arrears.

- Pension arrears are defined as total accumulated pensions due but not disbursed by the pension funds concerned to all pensioners in the pension rolls up to the latest preceding pension disbursement date.

- The outstanding stocks of tax and social contribution arrears at a particular date comprise total accumulated accrued tax obligations of the parts of the general government as defined above that have not been paid by the test date. The total stocks of such arrears are on a gross basis.

- Social entitlement payments, apart from pensions, are defined as all cash payments due directly to, or on behalf of, the population in accordance with stipulations in the law and which are not contingent upon the provision of any services or sale of any goods or assets to the general government by such members of the population in return for these payments. The stock of such entitlement arrears are defined as total accumulated payments due but not disbursed by all units of government up to the test date. Thus defined, these arrears are also on a gross basis and do not include the netting out of any transfers made between different units of the general government for the payment of such entitlements.

- Arrears to suppliers comprise payments delayed beyond what was explicitly specified in relevant contracts, or in the absence of such specification, for two months from the date of submission of bills, for already-effected purchases of goods or services by the government concerned. These include, *inter alia*, arrears to utility companies, arrears incurred with respect to service and maintenance contracts, and payments for capital goods. These arrears are also defined on a gross basis. Thus, overdue tax and other obligations to the government of relevant enterprises are not included in the calculation of the arrears of the government, and netting out of any transfers made between different units of the general government for the payment of such arrears and obligations are also not taken into consideration.

- Arrears to domestic banks and nonbank lenders comprise all overdue payments related to financial contracts between the government and domestic banks, nonbanks, and private lenders.

- denominated claims on government will be converted at the program exchange rate; claims denominated in currencies other than the will first be converted at their respective program exchange rates against the . The change in arrears is defined as the change in the end-period stock of arrears. Changes in wage and pension arrears will be adjusted for the changes in the average wage and average pension in the economy relative to their respective values in September 2004.

17. **Reporting**. Before the last business day of each month following the end of a quarter, data on end-period stocks of arrears for the previous quarter will be supplied to the European Department of the Fund by the Ministry of Finance of Serbia, and the Ministry of Finance of Montenegro.

F. Definition of Reserve Money

18. **Definition.** Reserve money is defined as the sum of currency in circulation (NBY Bulletin, September 2000, Table 3A, column 8) and dinar reserves banks are required to hold at the NBS, plus excess reserves of the commercial banks. Shortfalls in reserves that banks are required to hold will be included in required reserves (and therefore in reserve money), as well as in bank borrowing from the NBS. As of September 30, 2004, the required reserve ratio was at 21 percent of the base as defined in NBS Decision of March 28, 2002. Subsequent changes in the reserve requirement will be reflected in program definitions. The amounts that banks are permitted to hold in securities to satisfy the statutory reserve requirement will be limited to the amount that banks were holding as of December 31, 2000 (CSD 174.1 million). Excess reserves include commercial banks'(1) balances in Giro accounts 620, 621, 623, and 625; (2) overnight deposit in account 205 at the NBS; (3) excess balances above required reserves on account 201 at the NBS (with the shortfall in required reserves counted as negative excess); and (4) cash in vaults.

19. Data on reserve money will be monitored from the daily monetary indicators of the NBS, which will be supplied to the European Department of the Fund weekly by the NBS with a three-day lag. The end-month data is based on the NBS balance sheet, which will be provided to the Fund with a lag of less than three weeks. On September 30, 2004, currency in circulation amounted to CSD 42,463 million, while required reserves amounted to CSD18,738 million, and excess reserves to CSD 2,934 million. For program and projection purposes, monthly averages of reserve money and its components were used. Data on effective reserve requirements and the deposit base used in reserve requirement calculations will be supplied to the European Department on a ten-day basis with a lag of less than a week.

20. **Adjustors.** For program monitoring purposes, reserve money will be adjusted as follows. Should the standard reserve requirement increase (decrease) from the level prevailing on September 30, 2004, the ceiling on net domestic assets would be increased (decreased) by an amount equivalent to the change in the standard reserve requirement ratio multiplied by the programmed deposit base used in the calculation of required reserves. Before making any changes to the reserve requirement, the NBS will consult with Fund staff. Required reserves of banks placed under BRA administration or liquidation will remain part

of reserve money for program purposes. Similarly, the CBM will consult with Fund staff before making any changes to the reserve requirement.

G. Ceiling on External Debt-Service Arrears

21. **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.

22. **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. This accounting will include, separately, arrears owed at the union level, by the Serbian and Montenegrin governments, and other public sector entities; arrears owed by Yugoslav Airlines; and arrears owed to Paris Club creditors, London Club creditors, and other creditors. Data on other arrears, which are reschedulable, will be provided separately.

H. Ceilings on External Debt

23. **Definitions.** The ceiling on contracting or guaranteeing of new nonconcessional external debt by the public sector with original maturity of more than 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), see attachment to this Annex) but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are loans from, or other indebtedness to, the EBRD, the EIB and EU, the IBRD, the IMF, and the IFC. However, in 2004 cumulative from December 31, 2003, contracting or guaranteeing by the public sector of new nonconcessional external debt from the EBRD, the EIB and EU, the IBRD, and the IFC will not exceed US$500 million by end-June 2004, US$500 million by end-September 2004, and US$500 million by end-December 2004 (Annex A defines the separate ceilings applicable for Serbia and for Montenegro). In 2005 cumulative from December 31, 2004, contracting or guaranteeing by the public sector of new nonconcessional external debt from the EBRD, the EIB and EU, the IBRD, and the IFC will not exceed US$100 million by end-March 2005, US$200 million by end-June 2005, US$300 million by end-September 2005, and US$400 million by end-December 2005 (Annex A defines the separate ceilings applicable for Serbia and for Montenegro).Contracting or guaranteeing of new debt will be converted into US$ for program purposes at the cross exchange rates implied by the official NBS exchange rates in effect on the day of the transaction. 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. Second, with regard to the ceiling on new external debt with original maturity of up to and including one year owed by the consolidated general

government or guaranteed by the public sector, the term "debt" has the meaning set forth 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). Excluded from this performance criterion are normal short-term import credits.

24. **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, separately by Serbia and Montenegro, within four weeks of the end of each quarter.

I. Ceiling on the Wage Bill of Serbian Public Enterprises

25. **Definition.** For December 2004, the performance criterion is set on the total annual wage bill of seven large public enterprises: JP Elektroprivreda Srbije, JP Naftna Industrija Srbije, JP Zeleznicko Transportno Preduzece Srbije, JP PTT Srbije, JP Srbija Sume, JP JAT Airways, and JP Telekom Srbija. For 2005, the performance criterion is set on a quarterly basis on the cumulative monthly wage bill of eight large public enterprises (the same seven enterprises as in 2004 plus JP Aerodrom Beograd). Wages are accounted on an accrual basis, excluding taxes and social security contributions, and include overtime payments and bonuses. Ceilings for end-December 2004 and for end-March 2005 are performance criteria set in the Fourth Review.

26. **Adjustors.** In the case of spin-offs of activities from these companies (defined as the spinning off of a unit or its transfer to another entity or temporary/permanent transfers of employees) after end-September 2004, the wage bill target will be adjusted downwards for the wage bills of spun-off units. In the case of EPS, the successor companies (according to MEFP paragraph 35, bullet two) will all be included in the wage ceiling.

27. **Reporting.** The wage bills of the eight monitored state-owned companies will be reported monthly to the European Department of the Fund and the Office of the IMF Resident Representative by the Ministry of Finance (Public Utility Restructuring Unit) with a lag of less than four weeks. Monthly data for JP Aerodrom Beograd will also be provided for the period January through December 2004.

Serbia (In CSD millions)

	2004	2005			
	Dec	Mar	Jun	Sep	Dec
Wage Bill ceiling	30,230	8,030	15,941	24,180	32,700

J. Adjustor for Lower-Than-Targeted Severance Payments

28. Within the overall expenditure envelope of the 2005 budgets for the central government in Serbia, the Union level government, and the Serbian Transition Fund a total

amount of CSD 8.2 billion is envisaged for severance payments, out of which (a) CSD 5.0 billion related to employment reduction in the Serbian central government; (b) CSD 2.0 billion related to employment reduction on the Union level; and (c) CSD 1.2 billion included in the funds for the Transition Fund related to employment reduction in the eight monitored state-owned enterprises listed in paragraph 24 of the TMU. While the expenditures under (a) and (b) will be financed through general budgetary revenue, expenditures under (c) will financed through privatization receipts. To ensure that these budgetary resources can be spent only for the intended severance payments, the ceiling on net credit of the banking system to the consolidated general government (performance criterion) and on net credit of the banking system to the Serbian consolidated general government (indicative target) will be adjusted downwards for the total shortfall of the respective severance expenditures in categories (a), (b), and (c).

Serbia: Projected Cumulative Path of Redundancy Payments in 2005
in billions of dinars

	March	June	September	December
Category a	0.0	0.0	5.0	5.0
Category b	2.0	2.0	2.0	2.0
Category c	1.0	1.2	1.2	1.2
Total	3.0	3.2	8.2	8.2

III. Other Reporting Requirements for Program Monitoring

A. Macroeconomic Monitoring Committee

29. A macroeconomic monitoring committee, composed of senior officials from the Union Government, Serbian and Montenegrin Ministries of Finance, the NBS, CBM, and other relevant agencies, shall be responsible for monitoring the performance of the program, informing the Fund regularly about the progress of the program, and transmitting the supporting materials necessary for the evaluation of performance criteria and benchmarks.

B. Developments on Structural Performance Criteria and Benchmarks

30. The authorities will notify the European Department of the Fund of **developments on structural performance criteria and benchmarks** as soon as they occur. The authorities will provide the documentation, according to the dates in Annex C, elaborating on policy implementation. **The authorities will also notify the European Department of the Fund expeditiously of any economic developments or policy measures (prior to taking such measures in the latter case) that could have a significant impact on the implementation of this program.**

C. Data Reporting

Production and prices

31. Any revision to relevant macroeconomic data will be transmitted within three weeks of the date of the revision.

Public finance

32. Monthly data on public finance will include a consolidated budget report of the state governments (including union level operations), transmitted within four weeks of the end of each month comprising:

- The revenue data by each major item, including that collected by the state and local governments, as well as the social funds (also including ‘own revenue’ of direct budget users);
- Details of current and capital expenditure at the union, state, and local levels, as well as those of the social funds (also including ‘own expenditure’ of direct budget users); and
- Details of budget financing, both from domestic, and external sources, including total privatization receipts and Treasury bill issues and repayments (in the format described in paragraph 27).
- Montenegro will report quarterly arrears data starting from end-December 2003 for the consolidated general government in Montenegro, separating out normal float, and providing end-quarter stocks of arrears and gross repayments of outstanding arrears during each quarter.

Monetary sector data

33. The following data will be transmitted on a daily/weekly/biweekly basis within one/five working days of the end of each day/week.

- Daily movements in gross foreign reserves of the NBS at current and program exchange rates and gold prices, indicating amounts sold/bought at the auction, in foreign exchange offices and on the interbank market, inflows of foreign grants, inflows of foreign loans, and repayments of frozen foreign currency deposits.
- Daily movements in foreign exchange-denominated liabilities of the NBS to (i) nonresidents, (ii) SM resident banks, and (iii) other SM residents.

- Daily movements in liquid foreign exchange assets of SM resident banks as reported by these banks to the NBS.

- Daily movements in reserve money, indicating currency in circulation, the basis upon which required reserves are calculated, required reserves, reserves held, and excess reserves.

- Outstanding stocks of Treasury bills, Treasury bill repayments made during the reporting period, and auction details (yields, amounts per maturity and number of banks participating in the auction per maturity).

- Interbank foreign exchange rates and volume of transactions, including rates and volume of trading outside the fixing session.

- Ten-day report on public sector borrowing and lending from commercial banks and the NBS.

- Ten-day report on required reserves and the reserve base.

34. The balance sheet of the NBS and the consolidated balance sheets of Serbian commercial banks, as well as the balance sheet of the Central Bank of Montenegro and the consolidated balance sheets of commercial banks in Montenegro, will be transmitted on a monthly basis within three weeks after the end of each month. The stocks of government and NBS securities held by banks and by nonbanks, as available to the NBS, detailed information on interbank money market transactions (terms, duration, and participating institutions), and interest rate developments will be transmitted on a monthly basis within two weeks after the end of each month. Credit to government by the banking system is provided with detailed breakdowns on the union, state, and local governments.

35. The following data will be transmitted on a monthly basis:

- NBS foreign exchange reserves held in accounts abroad, foreign banknotes, and foreign securities as well as interest income on foreign assets.

- Data on foreign borrowing by commercial banks with a breakdown according to maturities.

- Individuals'foreign exchange savings in top ten banks.

- Grants and loans disbursement as well as debt amortization and interest payments.

External data

36. The data below will be transmitted as follows:

- The interbank market exchange rate, as the simple average of the daily-weighted average buying and selling rates, will be transmitted on a weekly basis within five business days of the end of the week;

- Balance of payments data on services, private transfers, and capital account transactions will be transmitted on a quarterly basis within four weeks of the end of each quarter;

- Detailed monthly data on the volume and prices of exports and imports, separating out imported petroleum products; and

- External debt data and debt service schedules separately for Serbia and for Montenegro, with breakdown by creditor.

- The CBM will provide quarterly updates of the Montenegro balance of payments, including projections for the current and subsequent year, while the Montenegro Ministry of Finance will provide the external debt and debt service information described above.

Executive Board Decision No. 6230-(79/140) (Guidelines on Performance Criteria with Respect to Foreign Debt) adopted August 3, 1979, as amended by Executive Board Decision No. 11096-(95/100) adopted October 25, 1995, and as amended on August 24, 2000

Point No. 9

(a) For the purpose of this guideline, the term "debt" will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

(i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

(ii) suppliers' credits, i. e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and

(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

(b) Under the definition of debt set out in point 9(a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. However, arrears arising from the failure to make payment at the time of delivery of assets or services are not debt.

SERBIA AND MONTENEGRO: EXTERNAL DEBT SUSTAINABILITY ANALYSIS

This note updates the debt sustainability analysis in IMF Country Report No. 04/202.

A. Medium-Term Balance of Payments projections

The baseline scenario assumes that: (a) exports will grow at an annual average of 20 percent in the first three years (starting with 2004) and 10 percent in the following five years in dollar terms (about 16 percent and 10 percent in euro terms); (b) imports will grow at about 15 percent in the first three years (largely due to the high rates of import growth in 2004) but then decline to a rate slightly higher than nominal GDP[18]; (c) The large FDI inflows of 2003 was mainly on account of the success in the privatization program; the privatization process is assumed to continue in 2004 and 2005, albeit on a smaller scale. Other types of FDI, including greenfield investment and equity investment and reinvestment on existing companies, will rise steadily, reflecting progress in privatization and improving business environment; (d) commercial borrowings will increase steadily as the business environment improves; (e) official borrowing will increase moderately, with declining program support being offset by increasing project support; (f) there will be no IMF support after the current arrangement; (g) the payment to London Club creditors and non-Paris Club official creditors will start respectively in late 2004 and in 2005 after agreements being reached with these creditors on terms comparable to those of Paris Club creditors; (h) gross international reserves will remain at around 3.5 months of imports of goods and services.

Under the baseline scenario, the debt ratios improve over the next 10 years, although the improvement is more modest in the first half of the period, with an increase in 2006 as a consequence of the large debt reduction operations assumed in 2004 and 2005. The debt-to-GDP ratio will average around 56 percent in the first 3 years and around 41 percent in the next five years. Because of the large debt relief component in the external debt dynamics, the underlying debt in percent of GDP, both gross and net of reserves, increases in the years from 2004 to 2006, and only begins to decline in 2007. Debt service ratios, on the other hand, will increase until 2008 and decline gradually afterwards, partly reflecting the increased debt

[18] The assumptions on export and import growth rates take into consideration the experience of other transitional economies and the performance of exports and imports of SM since 2000. The rapid growth of imports partly reflects the large needs for basic investment and consumption goods following the end of the sanction and war, and is more recently supported by increasing availability of financing, especially for consumer goods. Exports are expected to show sustained growth in the projection period, reflecting the recovery of the domestic demand of SMs̓ main trading partners , as well as the impact of the structural reforms, the domestic and substantial foreign investments in recent years, and the increasing trade integration with the rest of the world. Under these assumptions, the average exports and imports growth rates both amount to about 13 percent, respectively, in euro terms during 2000-2011, in line with the experience of other transitional European economies in the past decade.

service after the end of the grace period offered by the Paris Club and other bilateral creditors. The rise of debt service ratios in the latter half of the projection period argues for the maintenance of adequate official reserves to guard against possible risks, while keeping on schedule with the countryѕ ex ternal obligations. Both the external debt and debt service ratios, especially those to exports, increased comparing to the results in IMF Country Report No. 04/202. The increase in the ratios to GDP is related to the revision of nominal GDP figures, and to higher than previously expected commercial borrowings by the newly privatized companies and by foreign-owned banks, mostly from their parent companies abroad.

B. Stress testing applying the standardized sustainability framework.

As explained in IMF Country Report No. 01/176, the standard framework of the debt sustainability analysis is modified in the case of Serbia and Montenegro owing to the uncertainties related to the historical data. In particular, the 1996-2001 data for 4 countries in the region, namely Albania, Bulgaria, Croatia, and Romania, were used to derive the standard deviation. The historical averages are based on the outturns of 2002 and 2003.

If real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are set as the estimates of the 2003 outturn, the external debt ratios would decline much faster than in the baseline case after the first year, owing to the more favorable GDP deflators and nominal interest rate in 2002 and 2003 than in the outer years.

Applying shocks to the parameters, the stress tests indicate that higher debt burden stemming from shocks to the external current account deficit and/or a significant economic downturn would increase the debt ratios substantially, before the ratios improve slightly some time after the end of the shocks. On the other hand, shocks to the interest rate from the historical average do not have a significant impact on the debt ratios, reflecting the fact that the interest rate in 2002 and 2003 was relatively low, partly associated with the delayed start of debt service to the Paris Club creditors, and stress tests for the interest rate do not cause major deviations form the baseline projections because of the starting point. Similarly, as the dollar deflator in 2002 and 2003 was relatively high partly owing to dollar depreciation, and is expected to decline substantially in the projection period, the scenario with shocks to the deflator from its historical average actually generates improved debt ratios relative to the baseline. However, the combination of smaller shocks of all the above variables would yield higher debt ratios than the baseline only in 2004. Finally, a large one-time nominal depreciation in 2004 would substantially worsen the debt ratios due to significant nominal effect on GDP in dollar terms.

Two additional, tailored, scenarios are explored. Under the first, it is assumed that FDI inflows will be significantly lower than under the baseline, and that export and GDP growth are negatively affected with a lag. The debt profile would then worsen significantly, especially in the outer years. Under the second scenario, a loosening of policies starting in 2004 and worsening in 2005 has an expansionary effect on the current account. The debt profile would worsen despite the tightening of policies assumed after 2005.

Table 1. Serbia and Montenegro: External Debt Sustainability Framework, 2003-08
(In percent of GDP, unless otherwise indicated)

	Actual	Projections				
	2003	2004	2005	2006	2007	2008
	I. Baseline Medium-Term Projections					
External debt	69.9	**58.4**	**57.4**	**59.5**	**56.3**	**52.1**
Change in external debt	-6.6	-11.5	-1.0	2.1	-3.1	-4.2
Identified external debt-creating flows	-16.1	-0.6	5.3	5.2	2.0	0.1
Current account deficit, excluding interest payments	8.1	9.1	7.9	7.4	6.8	6.2
Deficit in balance of goods and services	-22.5	-25.2	-25.1	-25.1	-24.4	-23.6
Exports	19.9	24.0	27.1	29.8	31.8	32.4
Imports	-42.4	-49.3	-52.2	-55.0	-56.2	-56.1
Net non-debt creating capital inflows (negative)	-6.9	-4.2	-5.1	-4.0	-4.9	-4.9
Net foreign direct investment, equity	6.9	4.2	5.1	4.0	4.9	4.9
Net portfolio investment,equity	0.0	0.0	0.0	0.0	0.0	0.0
Automatic debt dynamics 1/	-17.4	-5.5	2.6	1.9	0.1	-1.2
Contribution from nominal interest rate	1.3	1.8	2.4	2.6	2.7	2.7
Contribution from real GDP growth	-1.7	-2.7	-2.6	-2.6	-2.9	-2.6
Contribution from price and exchange rate changes 2/	-16.9	-4.5	2.8	1.8	0.2	-1.2
Residual, incl. change in gross foreign assets	9.5	-10.9	-6.3	-3.1	-5.1	-4.3
External debt-to-exports ratio (in percent)	351.6	242.9	211.6	199.5	177.0	160.7
Gross external financing need (in billions of US dollars) 3/	3365.7	4422.7	4720.7	5037.9	5430.9	6102.0
in percent of GDP	16.4	19.1	20.4	21.4	22.0	23.1
Key Macroeconomic and External Assumptions						
Real GDP growth (in percent)	3.0	4.4	4.5	4.6	5.0	5.0
Exchange rate appreciation (US dollar value of local currency, change in percent)	11.7	-2.6	-14.7	-9.5	-4.5	-1.5
GDP deflator (change in domestic currency)	14.9	9.8	11.9	7.1	4.3	3.7
GDP deflator in US dollars (change in percent)	28.4	6.9	-4.5	-3.1	-0.4	2.2
Nominal external interest rate (in percent)	2.2	2.8	4.1	4.7	4.8	5.1
Growth of exports (US dollar terms, in percent)	25.5	37.1	12.7	11.6	11.8	9.4
Growth of imports (US dollar terms, in percent)	26.5	31.7	5.9	6.8	7.0	7.1
	II. Stress Tests for External Debt Ratio					
Standard Stress Test						
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical averag	**69.9**	**45.6**	**31.6**	**23.9**	**16.1**	**10.9**
2. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005	**69.9**	**58.7**	**57.4**	**59.4**	**56.3**	**52.1**
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005	**69.9**	**66.4**	**74.5**	**77.1**	**73.9**	**69.4**
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005	**69.9**	**58.7**	**51.5**	**53.4**	**50.2**	**46.2**
5. Non-interest current account is at historical average plus two standard deviations in 2004 and 2005	**69.9**	**63.7**	**69.4**	**71.9**	**68.7**	**64.3**
6. Combination of 2-5 using one standard deviation shocks	**69.9**	**58.5**	**52.0**	**53.8**	**50.7**	**46.6**
7. One time 30 percent nominal depreciation in 2004	**69.9**	**83.6**	**83.7**	**86.6**	**83.5**	**78.8**
Statistics of the key variables used for stress testing			Average 2004-08			
Current account deficit, excluding interest payments			7.5			
Net non-debt creating capital inflows			4.6			
Nominal external interest rate (in percent) 5/			4.3			
Real GDP growth (in percent)			4.7			
GDP deflator in US dollars (change in percent)			0.2			
Tailored Stress Test						
Looser macroeconomic policies which would significantly increase the current account deficit in 2004 and 2005 relative to the baseline, and policy adjustments in subsequent years bring down the deficit gradually.	**69.9**	**59.5**	**62.7**	**69.3**	**70.7**	**70.7**
Lower FDI in 2004 and 2005, followed by reduced exports and real growth in subsequent years	**69.9**	**60.4**	**61.5**	**72.5**	**78.6**	**82.9**

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
4/ The average of standard deviation of Albania, Bulgaria, Croatia, and Romania between 1996 and 2001
5/ Modified the standard framework by adjusting downwards the end-2001 debt stock by the amount of bilateral debt to be reduced. This would give a more reasonable basis for projection forward.

Table 2. Serbia and Montenegro: Medium-Term External Sustainability, 2000-2011

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Average 2004-06	Average 2007-11	Average 2000-2011
	(In millions of U.S. dollars, unless indicated otherwise)														
Export growth (US$ terms, in percent)	14.7	4.2	20.4	25.0	33.7	14.5	13.0	13.0	10.1	10.1	10.0	10.0	20.4	10.6	14.9
Export growth (euro terms, in percent)	32.5	7.5	14.2	4.4	21.7	13.0	14.1	12.9	10.0	10.0	10.0	10.0	16.3	10.6	13.4
Import growth (US$ terms, in percent)	12.6	30.4	30.7	25.9	32.2	6.0	6.9	7.0	7.1	6.8	6.3	6.3	15.1	6.7	14.8
Import growth (euro terms, in percent)	30.0	34.5	23.9	5.2	20.4	4.5	8.0	6.9	7.0	6.7	6.3	6.3	11.0	6.6	13.3
Current account balance, before grants	-610	-1,119	-2,007	-2,454	-3,017	-2,780	-2,652	-2,565	-2,581	-2,511	-2,098	-1,832	…	…	…
percent of GDP	-7.1	-9.7	-13.0	-12.0	-13.0	-12.0	-11.3	-10.4	-9.8	-8.8	-6.5	-5.3	-12.1	-8.2	-9.9
Current account balance, after grants	-339	-528	-1,383	-1,923	-2,503	-2,380	-2,359	-2,331	-2,347	-2,277	-1,864	-1,598	…	…	…
percent of GDP	-3.9	-4.6	-8.9	-9.4	-10.8	-10.3	-10.0	-9.5	-8.9	-8.0	-5.8	-4.6	-10.4	-7.4	-7.9
Gross official reserves	516	1,169	2,280	3,550	3,715	4,189	4,394	4,359	4,459	4,589	5,034	5,270	…	…	…
in months of imports of goods and services	1.2	2.4	3.2	3.7	3.7	3.9	3.8	3.5	3.4	3.3	3.4	3.4	3.8	3.4	3.2
External debt 1/	11,403	11,948	11,839	14,303	13,547	13,303	13,994	13,876	13,779	13,554	13,173	12,658	…	…	…
As percent of exports of goods and services	448	436	365	352	243	212	199	177	161	144	128	113	218.0	144.6	248.1
As percent of GDP	133	103	76	70	58	57	59	56	52	48	41	37	58.4	46.8	65.9
As percent of government revenue	361	265	179	164	134	135	144	139	129	118	101	91	137.6	115.6	163.4
External debt service 2/	56	107	183	436	1,026	1,439	1,542	2,111	2,335	2,527	2,643	2,513	…	…	…
As percent of exports of goods and services	2.2	3.9	5.7	10.7	18.4	22.9	22.0	26.9	27.2	26.9	25.8	22.4	21.1	25.8	17.9
As percent of GDP	0.6	0.9	1.2	2.1	4.4	6.2	6.6	8.6	8.8	8.9	8.2	7.3	5.7	8.4	5.3
As percent of government revenue	1.8	2.4	2.8	5.0	10.1	14.6	15.8	21.2	21.9	22.0	20.3	18.0	13.5	20.7	13.0

Sources: SM authorities, and IMF staff estimates.

1/ Incorporates the phased 66 percent debt reduction offered by the Paris Club, the debt reduction at comparable terms agreed with the London Club in July 2004, and other comparable action provided by other official bilateral and commercial creditors.

2/ Besides the phased 66 percent debt reduction offered by the Paris Club, assumes a 60 percent capitalization of moratorium interest for the 2002-2005 period (as per the Paris Club agreement). Debt service projections for other official bilateral and commercial creditors are based on the assumption of comparable treatment.

SERBIA AND MONTENEGRO: PUBLIC SECTOR DEBT SUSTAINABILITY ANALYSIS

1. This Appendix updates the public sector DSA in IMF Country Report No. 04/202. Under the baseline scenario, SM's debt-to-GDP ratio would decline steadily from 79.9 percent of GDP in 2003 to 44 percent of GDP in 2008 (Table 1). The debt-to-revenue ratio would decline by 78.5 percentage points over the same period, from 184.4 percent in 2003. The result of the baseline scenario is similar to the one presented in IMF Country Report No. 04/202, although the debt-to-GDP ratio starts to fall more rapidly as of 2005 due to higher GDP growth in 2004 and valuation effect. The DSA now reflects the London Club debt rescheduling (previously assumed to occur in 2004) following successful negotiations in mid 2004. The baseline assumes a gradual fiscal adjustment for 2004–2008. Current primary spending would gradually fall as a share of GDP, but would increase in real terms over time, except in 2005, where cuts in both current and capital spending are large. This medium-term decline reflects cuts in current spending as a result of reform in the budget sector, particularly, in the wage bill and employment, as well as cut in subsidies to the public enterprises, and reduced transfers to the social funds. However, capital spending would pick up in 2006 and thereafter. The primary deficit is projected to improve from 2.1 percent of GDP in 2003 to 0.7 percent of GDP in 2004, before turning into a surplus in 2005 (0.8 percent of GDP). The primary surplus will increase over time as the projected decline in primary spending would outpace the expected decline in the revenue ratio. Privatization receipts are projected to fall, and relatively modest, in the coming years (especially when compared to 2003).

2. Using the standardized methodology set out in *Assessing Sustainability Paper* (see http://www.imf.org/external/np/pdr/sus/2002/eng/052802.htm), but with modifications due to data constraints, stress tests were conducted. Historical averages for SM were incomplete prior to 2000. As a result, and as explained in Appendix IV, the 2002–03 outturns were used to replace historical averages, and the 1997–2001 data for 4 countries in the region Albania, Bulgaria, Croatia and Romania, were used to derive the standard deviation.

3. The first test keeps real GDP growth rate, real interest rate, and the primary balance remain at the 2003 level. This results in a faster reduction in the debt ratio, which declines by 35.1 percentage points of GDP by 2008. The is due to the nominal and real interest effects, which were more conservative than the baseline scenario.

4. Other stress tests, including (i) higher real interest rates, (ii) lower GDP growth, (iii) lower primary balance; (iv) combination of (i)-(iii); and (v) 10 percent increase in debt-creating flows did not result in an increase in the debt-to-GDP ratio from its 2003 level, but would slow the reduction in the debt ratio compared to the baseline scenario.

5. Only the test with a real depreciation of 30 percent in 2004, would increase the 2004 debt ratio beyond the 2003 level; the ratio would then decline thereafter through the projection period, reaching the starting level in 2007.

Table 1. Serbia and Montenegro: Public Sector Debt Sustainability Framework, 2002-2008
(In percent of GDP, unless otherwise indicated)

	2002	2003	Projections 2004	2005	2006	2007	2008
			I. Baseline Medium-Term Projections				
Public sector debt 1/	**86.4**	**79.9**	**63.3**	**55.1**	**52.5**	**48.4**	**44.0**
o/w foreign-currency denominated	79.4	72.2	55.8	49.3	48.0	44.2	40.9
Change in public sector debt	-36.8	-6.5	-16.7	-8.2	-2.6	-4.0	-4.4
Identified debt-creating flows	-38.1	-18.1	-1.3	-1.3	-3.6	-3.5	-4.3
Primary deficit	2.5	2.1	0.7	-0.8	-1.2	-1.4	-2.0
Revenue and grants	44.4	43.3	43.4	42.8	42.8	41.6	41.5
Primary (noninterest) expenditure	46.9	45.4	44.1	42.1	41.6	40.2	39.5
Automatic debt dynamics 2/	-38.4	-15.9	-1.3	0.4	-1.7	-1.6	-1.8
Contribution from interest rate/growth differential 3/	-26.7	-12.4	-10.0	-7.6	-4.4	-3.1	-2.5
Of which contribution from real interest rate	-22.9	-10.2	-5.9	-5.2	-2.2	-0.7	-0.2
Of which contribution from real GDP growth	-3.8	-2.2	-4.1	-2.4	-2.3	-2.4	-2.2
Contribution from exchange rate depreciation 4/	-11.7	-3.5	8.7	8.0	2.8	1.5	0.6
Other identified debt-creating flows	-2.2	-4.3	-0.7	-0.9	-0.7	-0.6	-0.5
Privatization receipts (negative)	-2.2	-4.3	-0.7	-0.9	-0.7	-0.6	-0.5
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes	1.3	11.7	-15.3	-6.9	1.0	-0.5	-0.1
Public sector debt-to-revenue ratio 1/	194.6	184.4	145.8	128.6	122.5	116.3	105.9
Gross financing need 5/	3.5	3.2	2.1	1.0	0.8	0.7	0.2
in billions of U.S. dollars	0.5	0.7	0.5	0.2	0.2	0.2	0.1
Key Macroeconomic and Fiscal Assumptions							
Real GDP growth (in percent)	4.0	3.0	6.0	4.5	4.6	5.0	5.0
Average nominal interest rate on public debt (in percent) 6/	1.0	1.4	1.8	2.8	3.0	3.1	3.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-23.0	-13.5	-8.0	-9.1	-4.1	-1.2	-0.3
Nominal appreciation (increase in US dollar value of local currency, in percent)	15.2	5.5	-12.2	-14.1	-5.8	-3.2	-1.5
Inflation rate (GDP deflator, in percent)	24.0	14.9	9.8	11.9	7.1	4.3	3.7
Growth of real primary spending (deflated by GDP deflator, in percent)	23.5	-0.1	2.9	-0.3	1.4	1.2	2.8
			II. Stress Tests for Public Debt Ratio				
1. Real GDP growth, real interest rate, and primary balance are at 2003 preliminary in 2004-2008		**79.9**	**63.9**	**57.8**	**54.9**	**49.7**	**44.8**
2. Real interest rate is at historical average plus two standard deviations in 2004 and 2005		**79.9**	**72.6**	**71.0**	**67.9**	**63.4**	**58.5**
3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005		**79.9**	**73.1**	**72.6**	**69.0**	**64.1**	**58.5**
4. Primary balance is at historical average minus two standard deviations in 2004 and 2005		**79.9**	**68.2**	**66.5**	**63.6**	**59.3**	**54.5**
5. Combination of 2-4 using one standard deviation shocks		**79.9**	**75.8**	**80.8**	**72.4**	**63.0**	**53.4**
6. One time 30 percent real depreciation in 2004 7/		**79.9**	**96.1**	**88.1**	**84.5**	**79.6**	**74.0**
7. 10 percent of GDP increase in other debt-creating flows in 2004		**79.9**	**73.3**	**65.1**	**62.2**	**57.9**	**53.1**

Variables used for stress tests	Standard Deviation 8/	2003 Prel.	Average 2004-08
Primary deficit	1.8	2.1	-0.9
Real GDP growth (in percent)	4.4	3.0	5.0
Nominal interest rate (in percent) 6/	11.1	3.1 9/	2.8
Real interest rate (in percent)	7.9	-11.8 9/	-4.6
Inflation rate (GDP deflator, in percent)	6.7	14.9	7.4
Revenue to GDP ratio	2.6	43.3	42.4

1/ Consolidated government of Serbia and Montenegro. Covers gross external debt, and net domestic debt.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency; denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
8/ Using average data for Albania, Bulgaria, Croatia, Romania, 1997-2001, subject to availability.
9/ Calculated using debt written off and domestic arrears stock.

SERBIA AND MONTENEGRO: TENTATIVE WORK PROGRAM

Fourth Review under Extended Arrangement –Board Meeting	December 15, 2004
Fifth Review under Extended Arrangement and Article IV Consultation –Mission	January 2005
FSAP first mission	February 2005
Fifth Review under Extended Arrangement and Article IV Consultation –Board Meeting	March 2005
FSAP second mission	March 2005
Sixth Review under Extended Arrangement –Mission	April 2005
Sixth Review under Extended Arrangement –Board Meeting	June 2005

SERBIA AND MONTENEGRO: STATISTICAL ISSUES

1. In recent years, Serbia and Montenegro (SM) has been successfully upgrading its statistical system with the assistance of the IMF and other bilateral and multilateral institutions, but it still does not fully comply with international standards. In many areas, including monetary and fiscal sectors, internationally accepted reporting standards have been introduced. However, SM still makes extensive use of definitions that were developed to accommodate national characteristics and were not updated during the decade when the country was isolated from international developments. Except for monetary statistics for Serbia compiled by the National Bank of Serbia (NBS) as discussed in Section D below, SM does not report data to IMF's Statistical Department (STA) and does not have a page in *International Financial Statistics (IFS).*

2. In response to the authorities' requests, the Fund dispatched a series of technical assistance missions to improve the quality of macroeconomic statistics that would support policy analysis. In 2001-2003, STA conducted four TA missions: two on monetary and financial statistics in 2001 and 2002, a multisector statistics mission (MTSM) in 2002, and a balance of payments mission to Serbia in 2003. In 2004, there was a monetary and financial statistics mission during April 28-May 14, national accounts mission during September 9–23, and a balance of payments mission (to Montenegro only) during June 23-July 6. These missions found that there was a critical need for SM to improve existing statistics by (1) developing comprehensive data sources for national accounts, (2) applying statistical concepts to organize information on government revenues and expenditures to develop sound government finance statistics, (3) strengthening the coverage of balance of payments transactions, and (4) further improving the classification of bank accounts by economic sector and by financial instrument in compiling monetary and financial statistics.

A. Real Sector

3. Real sector statistics are compiled and published by the Federal Statistics Office (FSO), the Statistics Institute of Serbia (SIS), and the Statistics Institute of Montenegro (SIM). The FSO has been compiling national accounts statistics first for the FRY and subsequently for Serbia and Montenegro since 1997. For Serbia, annual current price estimates of GDP by activity and by expenditure approach are available for 1997–2002, while for Montenegro it is only available for 1997-2001. No quarterly data are available. Generally, the methodology follows the *System of National Accounts (1993 SNA),* but there are problems with the scope of the accounts and the basis for recording that are not broadly consistent with the international standards. Overall, the data quality is rather poor, and the data sources are in need of improvement, given the closure, from January, 2003, of the Clearing and Payments Service of Yugoslavia (ZOP), which used to collect information from annual balance sheets and profit/loss statements from all legal entities. The statistical techniques used for the national accounts compilation also need further improvement, and the statistical agencies are aware of this need. These issues are being addressed in a master plan for the improvement of economic statistics, which was developed with the assistance of EUROSTAT.

4. One of the major problems of the official statistics is the lack of estimates for the informal activities, producing up to one half of the value added in the economy. In an attempt to improve the industrial output index, the statistical office has broadened the coverage of the index in 2004 to include several hundred small and medium enterprises, but the downside of this decision was a reduced reliability of the index and its limited comparability with the data for previous years. The coverage of labor force statistics is similarly impaired by incomplete sampling of informal sector activities that result in official unemployment statistics being implausibly high at about 30 percent.

5. The FSO and SIS compile and disseminate, respectively for the union and Serbia, retail price indices (RPI), cost of living indices (COLI), producer price indices (PPI), and unit-value price indices for imports and exports. In Montenegro, the SIM compiles a RPI while the Institute for Strategic Studies and Prognoses, a nonprofit institution, also publishes its own series based on surveys of household consumption. While the frequency and methodology of observation appear adequate, weighting, data storage, and dissemination could be improved.

B. Balance of Payments

6. Balance of payments statistics are currently compiled by the NBS and the Central Bank of Montenegro (CBM). Principal data sources are customs data on merchandise trade as processed by the FSO and information of foreign exchange transactions provided by banks and exchange bureaus. These are complemented by data from the Ministry of International Economic Relations on external grants and loans. The NBS keeps appropriately detailed records of external debt held by commercial banks, the government and itself. While the data compilation procedures appear appropriate, some components of the balance of payments suffer from substantial underrecording owing to the large proportion of foreign exchange transactions occurring outside official channels. Since 2001, the NBS has expended commendable efforts to improve its estimation of actual flows, including the introduction of a new reporting system for banks in October 2002. The NBS could further improve coverage, valuation and classification by adjusting trade data for transactions not explicitly declared (e.g., repairs, shuttle trade and grants in kind), removing exchange-rate changes from certain financial transactions, including arrears below the line, and assuring consistency of data on reserve assets with those in the monetary statistics.

7. At present, not all information in the unionȇs balance of payments statement covers both constituent states, and the statement shows large net errors and omissions. The NBS has begun compiling a balance of payments statement for Serbia by using existing information from the Unionȇs statement, ad justed for imports and exports of Montenegro and financial flows pertaining to transactions between the two constituent states covered under the financial account of the unionȇs statem ent. The CBM has also begun compiling a Montenegro Balance of payments. A balance of payments technical assistance mission to the CBM in June/July 2004 provided recommendations to improve international trade statistics, external debt, and the ITRS. Close coordination between the NBS and the CBM will be needed to compile balance of payments data for the Union.

C. Government Finance

8. Fiscal statistics for Serbia are compiled by the Serbian Ministry of Finance and for Montenegro by the Montenegro Ministry of Finance. Principal data sources are republican treasuries and the budget execution reports of the spending ministries and first-level budget units. For Serbia, revenue data are more timely and reliable than expenditure data, and the information on detailed government operations is available with substantial delays. Montenegro now reports the republican budget implementation data on monthly basis.

9. While data on the general government are now compiled, they are not fully compliant with the *Government Finance Statistics Manual (GFSM 2001)*. Since 2001, the government of Serbia has made efforts to bring the existing budget reporting system in line with GFS methodology. But full compliance is still to be achieved as full implementation of the new chart of accounts, generally consistent with the classifications of the *GFSM 2001*, has not been completed.

10. Fiscal data for the central government of Montenegro are based on the new GFS classification. Data for the social security funds, reported directly by the funds, are compiled with significant delays and not on a GFS basis. A new chart of accounts was introduced in Montenegro in 2001, but still needs to be fully implemented at the local level. SM began reporting data on general government~~inc~~luding local government~~in~~ the 2003 edition of the Government Finance Statistics Yearbook.

D. Monetary Accounts

11. Monetary and financial statistics are compiled by the NBS and the CBM, broadly following the methodology set forth in the *Monetary and Financial Statistics Manual.* After a break of over a decade, the NBS began reporting to STA monetary statistics for Serbia in November 2002. The data included monthly data for January 2002-October 2002, annual data for 1998-2000 and quarterly data for 2001 on analytical accounts of the NBS, other depository corporations, and the banking system, as well as data on interest rates, compiled according to the recommendations of 2001-02 STA missions on monetary and financial statistics. In July 2003, the NBS reported annual data going back to 1995. After a hiatus between December 2003 and July 2004, the NBS resumed its reporting of data to STA in August 2004. The NBS reported data as of September 2004 in its recent submission. Since October 2003 the NBS has also begun publishing detailed monetary statistics in a new monthly *Statistical Bulletin*, which includes tables on monetary statistics, balance sheets and surveys for the NBS and the commercial banks. At present, both the NBS and the CBM meet GDDS recommendations with respect to the periodicity and timeliness of financial sector data.

12. The Republic of Serbia introduced new charts of accounts for the NBS and the commercial banks in December 2003. The Republic of Montenegro also introduced new charts of accounts for the CBM (January 2004) and for the commercial banks (December 2003). Both republics are now compiling monetary statistics from data collected based on the new charts of accounts. Despite significant progress, there is still plenty of room for further

improvements. The monetary and financial statistics mission in 2004 made recommendations to the NBS on methodological issues concerning (1) classification of loan-loss provisions and treatment of nonoperating banks, (2) uniform treatment of residents/nonresidents and various domestic sectors (including the government sector); and (3) uniform treatment of residents of Montenegro as nonresidents across all macroeconomic statistics for the Republic of Serbia. The mission also made detailed recommendations to the CBM for improving (1) the classification of financial instruments, including loan-loss provisions and depreciation, (2) sectorization of government units and funds, and (3) mapping between the charts of accounts of the CBM and other depository corporations with the respective sectoral balance sheets. The mission also developed a prototype Depository Corporations Survey for the CBM to use in reporting data to the IMF.

13. The Fund is in the process of resuming the publication of a country page in *International Financial Statistics (IFS)* for SM. The proposed country page will have a section for each republic. To facilitate the process, the monetary and financial statistics mission in 2004 reiterated the recommendations of the MTSM in 2002 to nominate the *IFS* correspondents and establish a track record of timely and regular reporting of macroeconomic statistics to STA.

Serbia and Montenegro: Core Statistical Indicators
(As of October 31, 2004)

	Exchange rates	International Reserves	Central Bank Balance Sheet	Reserve Money	Broad Money	Interest Rates	Retail Price Index	Exports/ Imports	Current Account Balance	Government Balance	Gross Domestic Product	External Debt/ Debt Service
Date of latest observation	Oct. 25, 2004	Oct. 22, 2004	Oct. 15, 2004	Oct. 15, 2004	Sep 30, 2004	Sep 30, 2004	Oct 2004	Sep 2004	Aug 2004	Jan.-Sept 2004	2003	July 2004
Date received	Oct. 26, 2004	Oct. 25, 2004	Oct. 25, 2004	Oct. 25, 2004	Oct. 28, 2004	Oct. 15, 2004	Oct. 29, 2004	Oct. 29, 2004	Oct. 20 2004	Oct. 29, 2004	Sep. 2004	Sep. 2004
Frequency of data	Daily	Daily	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Annually	Semi-Annually
Frequency of reporting	Daily	Daily	Monthly	Weekly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Annually	Semi-Annually
Source of update 1/	NBS	NBS	NBS	NBS	NBS	NBS	SBS, MBS, FBS	SBS, MBS, FBS	NBS	Ministries of Finance of Serbia and Montenegro	SBS, MBS, FBS	NBS
Mode of reporting	Report to the Fund	Report to the Fund	Report to the Fund	Report to the Fund	Report to the Fund	Report to the Fund	Website	Website	Website	Report to the Fund	Website	NBS
Confidentiality	Public	Confidential	Confidential	Confidential	Public	Public	Public	Public	Public	Public	Public	Confidential
Frequency of publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Annually	Annually	Annually

Notes:
1/ NBS = National Bank of Serbia
FBS = Federal Bureau of Statistics
SBS = Serbian Bureau of Statistics
MBS = Montenegro Bureau of Statistics

Statement by the IMF Staff Representative
December 15, 2004

1. This statement summarizes information that has become available since the issuance of the staff report for the fourth review under the Extended Arrangement. The statement does not change the thrust of the staff appraisal in the report.

2. Recently released macroeconomic data are broadly in line with projections in the staff report. Notwithstanding the recent moderation in wage growth, the rising inflation and further acceleration in private sector credit in October indicate continuing demand pressures:

    - The 12-month inflation rate in Serbia rose to 11.9 percent in November and is now projected to reach 12–12½ percent at end-2004.
    - Growth in economy-wide real wages in Serbia decelerated to 4.4 percent year-on-year in October, reflecting slowing nominal wage growth (from 21 percent in September to 18 percent in October) and rising inflation.
    - Credit growth in Serbia accelerated further in October, with real growth rates reaching 32 percent for total private sector credit and 101 percent for lending to households.
    - Gross foreign assets of the National Bank of Serbia rose from US$3,368 million (in constant exchange rates) at end-July to US$3,826 million at end-November.

3. All prior actions for the review have been completed.

4. The 2005 budget—in line with program understandings—was passed by Parliament on November 20.

5. As to the tightening of conditions for consumer lending envisaged in the MEFP, the NBS informed Fund staff that the majority of banks—representing 69 percent of total banking system assets—has amended their lending conditions by limiting the monthly payment-to-net income ratio to 30 percent and requiring a minimum downpayment of 20 percent of the value of purchased goods.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 04/267
FOR IMMEDIATE RELEASE
December 15, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fourth Program Review and Eighth Financing Assurances Review Under an Extended Arrangement with Serbia and Montenegro, and Approves US$95.6 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the fourth program review and the eighth financing assurances review of Serbia and Montenegro's economic performance under an Extended Arrangement. Completion of the reviews will enable a disbursement in an amount equivalent to SDR 62.5 million (about US$95.6 million) from the IMF immediately.

In completing the reviews, the Executive Board granted waivers for the nonobservance of an end-June 2004 structural performance criterion on adoption of a bankruptcy law and two end-September 2004 quantitative performance criteria on, respectively, contracting or guaranteeing new non-concessional external debt, and on the issuance of new guarantees and the assumption of enterprise debt to banks. The Board also approved a rephasing of future purchases under the arrangement, added to the arrangement a new quantitative performance criterion on the wage bill of monitored public enterprises, and three new structural performance criteria, as well as modified the ceilings and floors to be applied to certain quantitative performance criteria as of December 31, 2004.

The Extended Arrangement was approved in May 2002 for a total amount equivalent to SDR 650 million (about US$994.6 million) to support Serbia and Montenegro's 2002–2005 economic program (see Press Release No. 02/25). So far, Serbia and Montenegro has received disbursements amounting to the equivalent of SDR 400 million (about US$612 million).

Following the Executive Board's discussion on Serbia and Montenegro, Ms. Anne Krueger, Deputy Managing Director and Acting Chair, stated:

"Serbia and Montenegro's economic growth has been strong and the level of international reserves is comfortable, but inflation and the already large external current account deficit have been rising. These developments reflect rapid growth in domestic demand fuelled by large wage awards, rapid credit expansion, a weak export performance, and high international oil prices. Progress in structural reforms, in particular on enterprise restructuring, has been mixed contributing to the low levels of exports. The London Club deal is expected to affect favorably the country's debt dynamics.

"Against this background, since mid-2004 the au thorities have been tightening fiscal and monetary policies to reduce the external imbalance and achieve further disinflation, and they are committed to reinvigorating implementation of structural reforms to establish the conditions for sustained strong growth.

"On fiscal policy, the program envisages a lowering of the tax burden and a shift to indirect taxes that should help improve incentives to work and to invest. On the expenditure side, the rationalization of the budget will contribute to reducing the size of government and increasing the scope for higher capital spending and servicing the debt over the medium term.

"Credit expansion, partic ularly consumer lending, accelerated in the course of 2004 contributing to the rising external current account deficit. The Serbian monetary authorities' decision to contain credit expansion and address prudential risks is thus welcome. It is important to stand ready to tighten bank credit further should the recent measures fail to slow credit growth. Banking supervision needs to be further strengthened and prudential regulations strictly enforced.

"The program envisages an acceleration of structur al reforms, including privatization, to sustain strong economic growth and to increase productivity. Perseverance with the reform agenda, including the implementation of the new bankruptcy legislation, will be crucial for reallocating resources towards viable and more export-oriented enterprises and thereby boosting export growth.

"The Executive Board reviewed two non-complying purchases made in 2004 and a breach of obligations under Article VIII, Section 5 of the Fund's Articles of Agreement, which arose as a result of misreporting on the observance of the end-December 2003 performance criterion on net credit of the banking system to the consolidated general government.

"The Executive Board regretted the authorities' failure to provide accurate information relating to the end-December 2003 performance criterion on the net credit of the banking system to the consolidated general government in Serbia.

"In view of the prompt corrective actions taken by the authorities, the Executive Board decided to grant a waiver of nonobservance of the performance criterion that gave rise to the noncomplying purchases. The Executive Board also decided to take no action on the breach of obligations under Article VIII, Section 5," Ms. Krueger said.

Statement by Fritz Zurbrügg, Executive Director for Serbia and Montenegro and Srboljub Antic, Senior Advisor to Executive Director
December 15, 2004

Introduction

The authorities of Serbia and Montenegro welcome the staff papers that present a candid assessment of the main economic challenges. Our authorities broadly share the staff's assessment of policy options and the constraints regarding their implementation. They appreciate the continuation of the dialogue with staff that has helped in formulating an adequate policy response.

On the political front, a new pace will be established in strengthening the relations between Serbia and Montenegro and the EU on the basis of a two-track approach to Serbia and Montenegro's EU accession. The enhanced prospects of accession provide a clear goal and framework for moving ahead with reforms. The authorities of Serbia and Montenegro expect that trade arrangements concerning particular sectors with the EU will be concluded soon.

Since our last discussion, the current political environment in Serbia and Montenegro has slightly improved. The Serbian minority government was recently granted a confidence vote in the parliament on three occasions. Despite a generally difficult political environment, the authorities were able to move forward with important reform laws.

While the current program has to deal with a number of outstanding problems of structural nature, it has to preserve macroeconomic stability. This makes the task of policy makers very challenging. The complexity of the problems explains the prolonged discussions between the authorities and the staff regarding this review. However, it is clear that reforms have regained momentum in the second part of 2004, which can be seen from strong fiscal adjustment, revival of privatization and the beginning of utility sector restructuring.

Recent developments

The growth rate in 2004 is higher than projected and will reach 6 percent due to a rebound of industrial production and strong agriculture output. The rebound of the industry is important because it comes from its privatized part. Another characteristic of the industrial growth is that it is broad-based, providing some reassurance that high growth rates will continue in the future. The service sector has remained vibrant.

Inflation in Serbia will be higher than projected and will reach a two digit range in 2004. High domestic demand and one-off exogenous shocks were behind the surge in inflation. It is expected that inflation in 2005 will fall under 10 percent and gradually decline to low single digits over the medium term. Inflation in Montenegro continues to decline and will stay in the range below 3 percent in 2005.

The current account deficit deteriorated further and will reach 13 percent of GDP in 2004. The authorities are well aware of the risks associated with this development. In the short term, they are responding by restraining domestic demand through the policy mix of strong fiscal adjustment, following prudent income policies, confining rapid credit growth, and improving the competitiveness in the traded goods sector. In the long run, the only viable solution are structural reforms of the real sector that will increase exports.

Fiscal policy

Fiscal policy in 2004 has been geared to curb inflation and safeguard the external position. This orientation will continue in 2005. The strong fiscal adjustment of 3 percent of GDP (including redundancy payments) over the two years is being achieved mainly through expenditure cuts. Revenues are broadly in line with the program targets, while expenditure has been under tight control in the second half of 2004. The shift toward indirect taxes continues and it will get an additional push with the introduction of VAT in Serbia on January 1, 2005.

The rationalization of expenditures in Serbia is based on the idea that all non-interest current expenditure items will be scaled back as a percentage of GDP. Wages and subsidies are carrying the brunt of the expenditure cuts executed in the second half of 2004 and those planned for 2005. The law governing labor relations in public institution will be amended to facilitate the reduction of the work force and to increase the labor mobility in the public sector. To facilitate re-employment of retrenched workers, budgetary support of active labor market policies will increase in 2005. The cut of subsidies by 0.5 percent of GDP in 2005 should initiate faster restructuring of the real sector. A push in the same direction will come from the Transition Fund that will sharply increase coverage of the costs for redundant workers.

Next year will be the first one, in which Serbia will have a positive overall balance (excluding Foreign Loans Finance Projects). Although it amounts to only 0.1 percent of GDP, the surplus is an important sign that the country has started to create an adequate source for repaying public loans.

Total and tax revenues are projected to decline in 2005, thus signaling the lowering of the state role in the economy. Lower taxes, together with shifting the tax burden from labor to consumption, should have positive effects on growth, savings and job creation. The elimination of the distortionary Financial Transaction Tax and fees and taxes on securities transactions in January 2005, as well as a reduction of the corporate income tax will create a more conducive business environment.

Fiscal adjustment in Montenegro is based on expenditure cuts. The high level of non-discretionary spending will mainly be reduced by cuts in employment financed from the budget. Discretionary spending (subsidies and net lending) will also decline. To safeguard the deficit target, the authorities will make any revenue-reducing tax policy changes conditional on the availability of adequate revenues or offsetting measures.

Monetary policy

The tightening of monetary policy started in mid 2004 with the objective to curb the widening current account deficit and growing inflation. The National Bank of Serbia (NBS) raised the interest rate on its bills in June and increased reserve requirements by 3 percentage points in August. A similar policy of tight credit control will prevail in 2005.

The monetary authorities are well aware of the risks that credit growth expansion poses to macroeconomic stability. The rapid credit expansion, particularly the strong increase in lending to households, has contributed to the widening of the current account deficit. While some of the increase in credit growth can be explained by financial deepening and normal cyclical upturns, as the credit to GDP ratio is still low by regional standards, there is clearly an important excessive cyclical component. The authorities agree with staff that swift action is needed to contain the risks stemming from excessive credit growth. As a response, they are introducing a package that contains the following measures:

- The NBS will broaden the reservable asset base. This measure should help remove a bias in favor of foreign-sourced funding, by including as reservable assets the stock of commercial banks' foreign borrowing of maturities of up to 4 years and all new foreign borrowing.

- The NBS issued a guideline to banks on consumer credits that recommends a limit on the monthly payment-to-net income ratio and requires a down payment.

- The NBS will prepare a detailed loan survey with a breakdown by industry, currency and term structure. Detecting balance sheet problems before they impact the economy will help contain external vulnerability.

As a sign of reduced regulatory forbearance, banking supervision has been strengthened by more frequent on-site supervision. The monetary authorities will be strict in enforcing the existing regulation concerning minimal capital requirements and will withdraw the license of banks without adequate levels of capital. The state influence in the banking sector will be further reduced by the upcoming finalization of further sales of public banks.

The NBS will continue with its flexible exchange rate policy that requires a careful balance between the objectives of reducing external imbalances and lowering inflation. The flexibility of the exchange rate will contribute to improve competitiveness, while at the same time strengthening confidence in the dinar.

Structural reforms

The key challenge in the real sector remains the creation of a conducive business climate and the improvement of growth and export performance through privatization. The lowering of the tax burden in 2005, the acceleration of privatization efforts, and the improvements in the bankruptcy framework are crucial in this regard. The privatization of socially-owned companies and restructuring of the public utilities are regaining momentum, supported by cuts in subsidies and clearly defined sources for redundant workers. In socially-owned sectors, well-established auctions and tenders are operational for viable companies, while an effective bankruptcy procedure will soon be put in place for ailing companies. A third component that has to accelerate privatization is a debt workout for large heavily indebted socially-owned enterprises. Amendments to the Privatization Law will enable the write-off of enterprises' debt to state creditors and public utilities, conditional upon the actual sale or final bankruptcy.

The restructuring of state owned companies will combine hard budget constraint measures (subsidy cuts and strict wage controls) with measures that introduce competition and improve efficiency. A significant work force cut is planned in 2005. The regulatory framework for natural monopolies will be in place at the end of 2004, with the creation of one independent regulatory agency.

London Club negotiations

The negotiations with the London Club were completed in September 2004. The agreement implies the reduction of Serbia's debt to commercial banks by 62 percent, which the Paris Club accepted as a broadly comparable treatment with its debt relief. On November 1, 2004, Serbia made its US$40 million goodwill payment into an escrow account, while reconciliation is close to being completed. Approximately 94 percent of the eligible creditor claims have been fully reconciled. Serbia is also assigned a B+ rating by S&P, which applies to both the sovereign and new bonds that will come out of the proposed London Club exchange. The authorities expect to launch new bonds during the first quarter of 2005.

Conclusion

The authorities of Serbia and Montenegro are fully aware of the complex nature of transition challenges that the country is facing and of the downside risks to the program. They want to emphasize their full commitment to preserving macroeconomic stability and speeding up structural reforms. In line to their commitment to transparency, the authorities of Serbia and Montenegro consent to the publication of staff report.