INTERNATIONAL MONETARY FUND

Staff Country Reports

February 2006
IMF Country Report No. 06/58

Serbia and Montenegro: Sixth Review Under the Extended Arrangement, Financing Assurances Review, Request for Waivers of Nonobservance of Performance Criteria, and Proposed Post-Program Monitoring—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Serbia and Montenegro

In the context of the sixth review under the Stand-By Arrangement, financing assurances review, request for waivers of nonobservance of performance criteria, and proposed post-program monitoring, the following documents have been released and are included in this package:

- the staff report for the Sixth Review Under the Stand-By Arrangement, Financing Assurances Review, Request for Waivers of Nonobservance of Performance Criteria, and Proposed Post-Program Monitoring, prepared by a staff team of the IMF, following discussions that ended on December 2, 2005, 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 January 19, 2006. 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 statement by the Executive Director for Serbia and Montenegro.

- a Press Release summarizing the views of the Executive Board as expressed during its February 6, 2006 discussion of the staff report that completed the review and request.

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 on Economic and Financial Policies by the authorities of Serbia and Montenegro*
Addendum to the 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.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

This page intentionally left blank

INTERNATIONAL MONETARY FUND

SERBIA AND MONTENEGRO

Sixth Review Under the Extended Arrangement, Financing Assurances Review, Request for Waivers of Nonobservance of Performance Criteria, and Proposed Post-Program Monitoring

Prepared by the European Department
(in consultation with other departments)

Approved by Poul M. Thomsen and Michael Hadjimichael

January 19, 2006

- **Extended Arrangement (EA).** The fifth review of the three-year EA with Serbia and Montenegro (SCG) approved in May 2002 (SDR 650 million, or 139 percent of quota) was completed on June 29, 2005, with a total of SDR 587.5 million disbursed (Appendix I, IMF Country Report No. 05/233). A further SDR 62.5 million (13.4 percent of quota) would be made available upon completion of this final review. The EA, originally scheduled to expire on May 13, 2005, was extended twice until December 31, 2005 and February 28, 2006 to allow for completion of the fifth and sixth reviews. About $700 million of Paris Club debt relief is conditional on completing the EA.

- **Discussions** took place in Belgrade and Podgorica during October 20–31 and November 29–December 2. The mission met with the Prime Ministers and Deputy Prime Ministers of Serbia and of Montenegro; economic and social ministers; the governors of the central banks; other key officials; and representatives of public enterprises, trade unions, the private sector, and think tanks. It coordinated its work with World Bank staff (Appendix II).

- **Staff.** The mission comprised Ms. Sorsa (head), Ms. Teferra, Messrs. Alvesson, Mottu, and Westphal (all EUR), Ms. Ivanova, Mr. Simone (both FAD), and Mr. Sdralevich (PDR). It was assisted by Mr. Hirschhofer (resident representative). Mr. Antić (OED) attended policy meetings.

- **Letter of Intent (LoI).** The attached LoI and Memorandum of Economic and Financial Policies (MEFP, Appendix III) describe the authorities' policies in 2005 and their program for 2006.

- **Publication.** The authorities have not yet decided on the publication of this staff report. All previous reports were published.

Contents Page

Appendices

Executive Summary

Serbia and Montenegro's performance under the EA has been afflicted by two enduring rigidities: pervasive exchange rate and inflation indexation—a legacy of past hyperinflation; and financially indisciplined and unreformed "socially owned" enterprises. At the policy level, the result has been a seesawing tension between the pursuit of the inflation and the current account objectives, with financial indiscipline (say) prompting a worsening of inflation, a countervailing tightening of exchange rate policy, and a weakening of the external position. Absent decisive measures to address the underlying rigidities, the way forward under the EA has been to tighten fiscal policies in such a way as to keep the otherwise outward-drifting trade-off between inflation and the current account within manageable bounds. Thus, with both inflation and the current account deficit far above initially programmed levels, fiscal policy has been correspondingly much tighter than originally envisaged.

These underlying difficulties have been exacerbated over the past year by large capital inflows, attracted by the opportunities for establishing competitive, export-oriented private enterprises and inherent in an underdeveloped, but increasingly privatized financial sector. The result has been rapid growth of domestic demand, and again sustained pressure on both the current account and especially inflation. This led the authorities to opt for a hardening of exchange rate policy at the time of the fifth review and for a corresponding tightening of fiscal, monetary and incomes policies, as well as more decisive steps on the structural front. In the event, inflation performance has remained disappointing (basically because of the strength of domestic demand and one-off shocks), but the current account has performed somewhat better than expected by the staff.

With a view to completing the sixth (final) review of the arrangement, which would trigger the final Paris Club debt relief, the authorities are implementing a further tightening of fiscal, monetary, and incomes policies and have initiated significant structural reforms. The staff supports completion of the review, but would see any future program as needing to make more decisive progress on the underlying nominal and real rigidities. Post-program monitoring is recommended following the expiration of the EA.

I. Introduction

1. **Program implementation since the fifth review has been mixed, delaying the conclusion of the sixth and final review.**[1] Discussions on the sixth review were prolonged, in particular, by the failure to pass the pension reform in line with program commitments. This required the identification of other permanent expenditure savings in the 2006 budget.

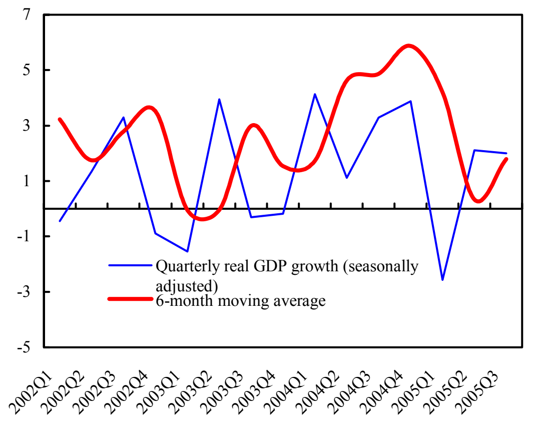
2. **The political situation in Serbia remains fragile, while Montenegro is preparing for a referendum on independence in April.** The governments' position improved following the start of negotiations with the EU in October on a Stabilization and Association Agreement. In Serbia, the implementation of reforms by the minority government has been difficult. The political agenda for 2006, which includes the status of Kosovo, the potential split of the union, and full cooperation with the international criminal tribunal, will be a challenge for policy making.

II. Recent Developments

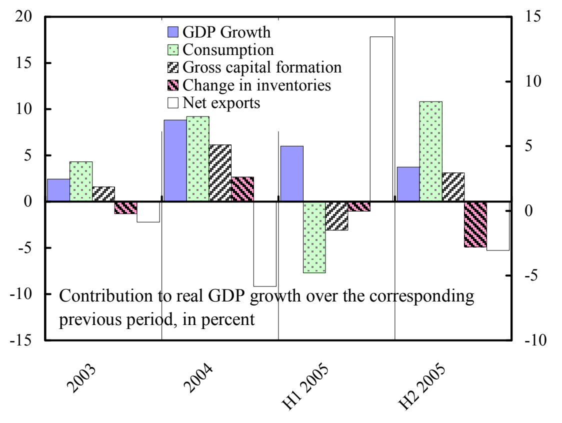
A. Macroeconomic Developments

3. **Growth in 2005 reflected strong net exports, with an increasing contribution of domestic demand after mid-year** (Tables 1–3, Figures 2 and 3*)*. Output started to recover at mid-year following the drop in early 2005 on the heels of the end-2004, VAT-induced surge in investment and stockpiling.[2] Growth was strong in particular in the privatized enterprises and export-oriented sectors, while output declined in the sectors with a large number of

Following strong performance in 2004, GDP growth slowed in Q1 2005 before picking up in Q2-Q3.



Domestic demand dropped temporarily in H1 2005, but recovered strongly in H2.



Sources: Serbian Statistics Office; and IMF staff estimates.

---

[1] Performance under the three-and-a-half-year EA is discussed in Box 1 and Figure 1.

[2] Imports and domestic production were brought forward to the fourth quarter of 2004 in anticipation of the VAT introduction in January 2005.

Box 1: Performance Under the EA, 2002-05

During the EA, policies were shifted to deal intermittently with the inflation and current account objectives. The initial program in 2002 aimed at disinflation with a quasi-fixed exchange rate anchor and reconstruction of the economy through increased public investment and privatization. Although inflation dropped in 2002-03, the current account deficit widened, as slow structural reforms did not generate sufficient exports, and weak incomes policies undermined competitiveness. To contain external imbalances, a managed float was adopted in 2003, supported by greater fiscal tightening than anticipated. As the current account deficit and inflation persisted in 2004, the authorities returned to a crawling exchange rate anchor, to be supported by tighter fiscal and incomes policies, and faster structural reforms.

Performance under the EA, 2002-2005
(In percent of GDP, unless otherwise indicated)

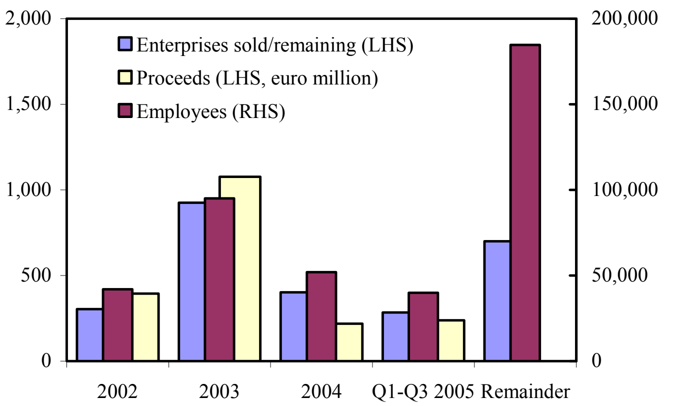
	2002	2005 Proj.	Change
Inflation (in percent)			
2002 Program	20.0	7.0	-13.0
Outcome	14.2	16.6	2.4
Current account			
2002 Program	-12.8	-8.8	4.0
Outcome	-12.9	-10.2	2.7
Fiscal balance			
2002 Program	-5.7	-4.2	1.5
Outcome	-4.5	0.9	5.4
Growth (in percent)			Average 2002-05
2002 Program			4.8
Outcome			5.1

Sources: IMF Staff Reports.

The EA contributed to stabilizing the economy, but important vulnerabilities remain. Since 2001, growth, external reserves, public debt, and the fiscal balance have improved more than initially programmed. Moreover, the public expenditure-to-GDP ratio declined by close to 4 percentage points between 2002-05. The substantial fiscal adjustment during the program was needed to compensate for the worse-than-expected private sector savings-investment balances. In this vein, both inflation and the current account deficit have exceeded the initially set targets and remain unsustainably high, and the still high external and public debt-to-GDP ratios are sources of vulnerability.

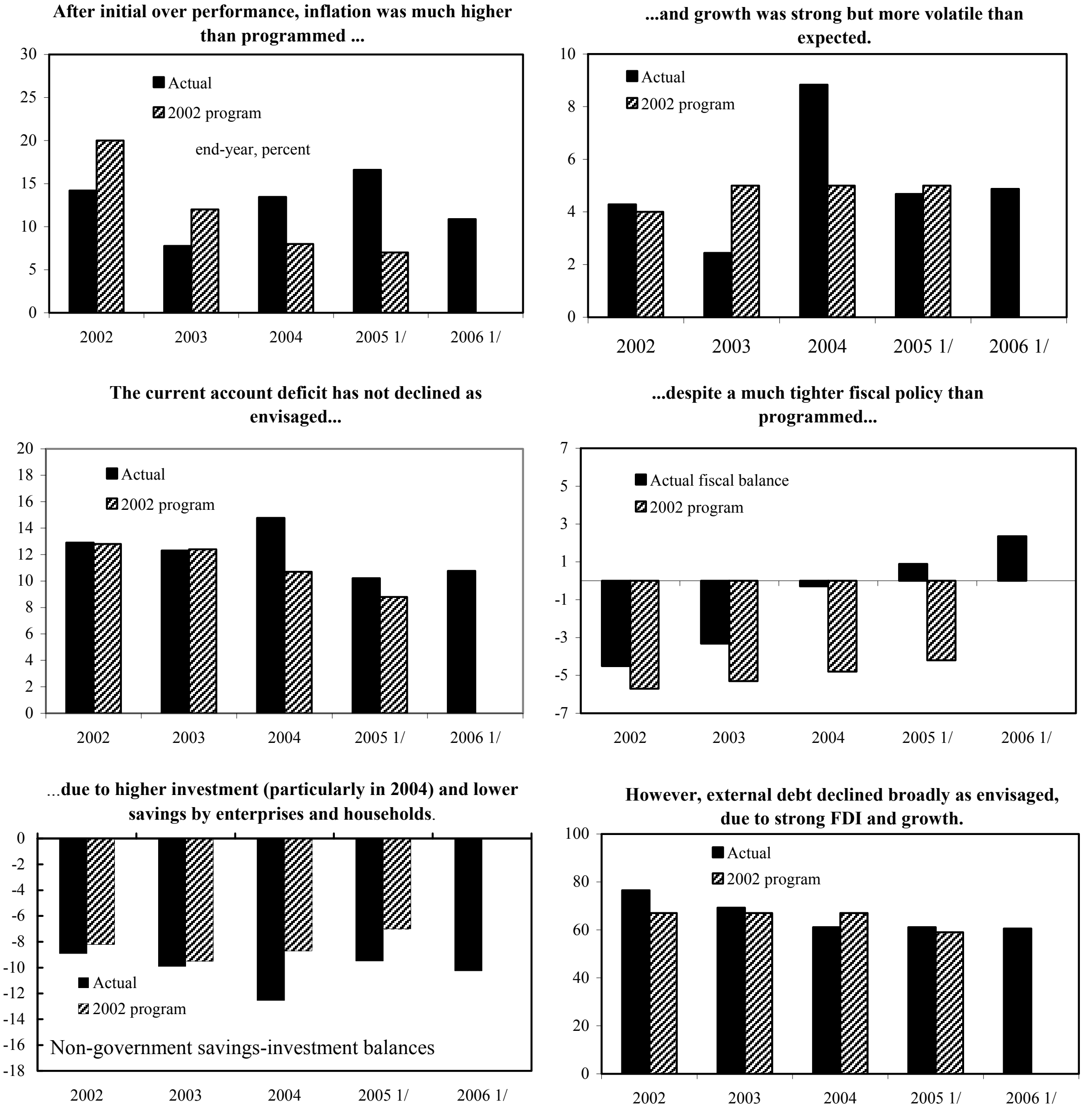
The slow structural transformation of the economy remains a major constraint on potential growth and stabilization. The initial program focused on resolution and privatization of banks and large socially owned enterprises, but had no commitments to restructure public enterprises. During 2001-2004, trade liberalization and tax reforms improved the investment climate, but enterprise privatization lost momentum in mid-2003. With the re-orientation of the program in 2004, privatization of banks accelerated, several bankruptcies were declared, and the restructuring of public utilities advanced. Overall, despite progress in selling smaller socially owned companies, a significant number of large enterprises remain to be restructured and sold, and the share of the private sector in GDP increased only from 40 to 55 percent between 2001-2005.

Serbia: Privatization of Socially Owned Enterprises, 2002-05



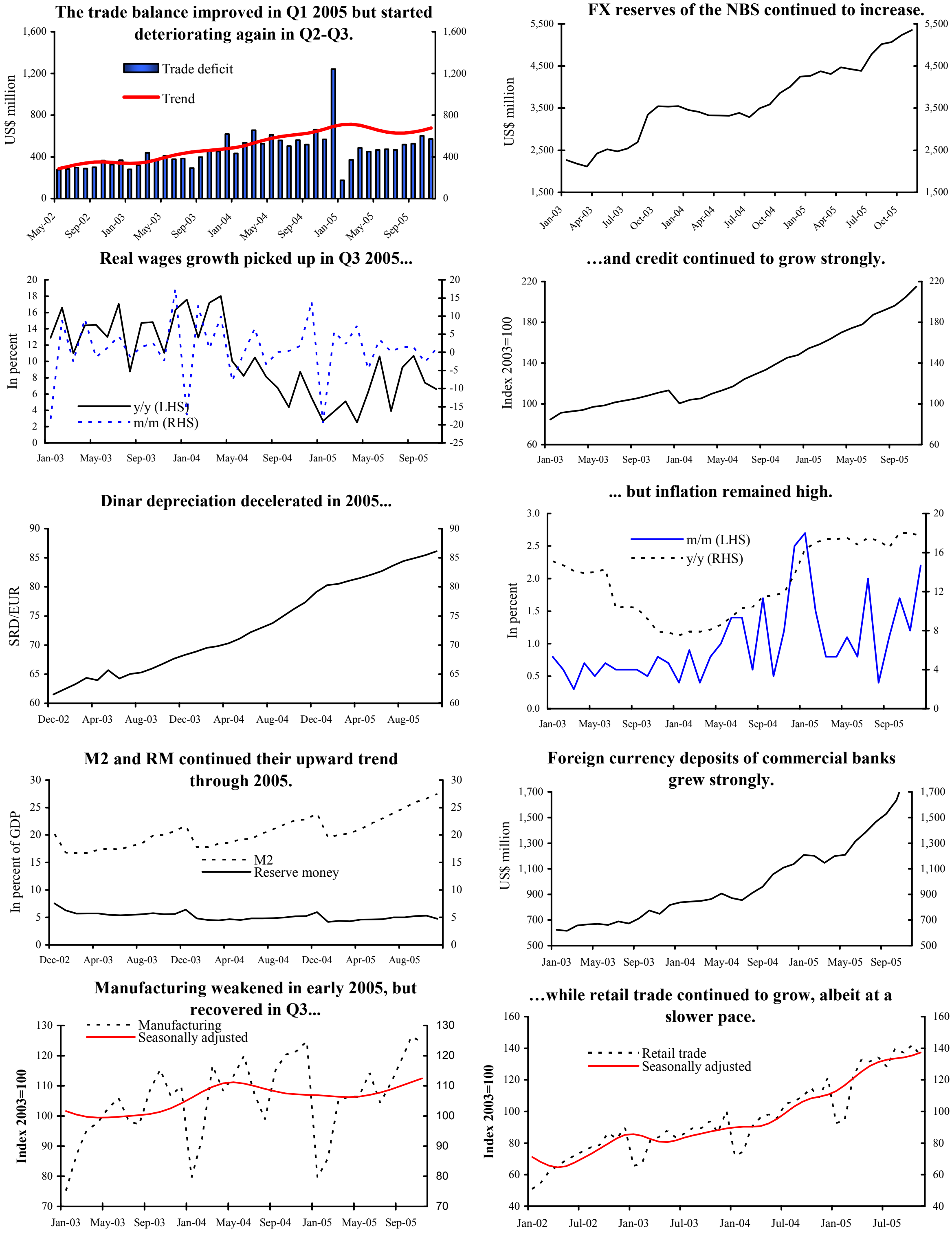
Source: Privatization Agency; and IMF staff estimates.

Figure 1. Serbia and Montenegro: Performance under the EA, 2002–2005
(In percent of GDP, unless otherwise noted)



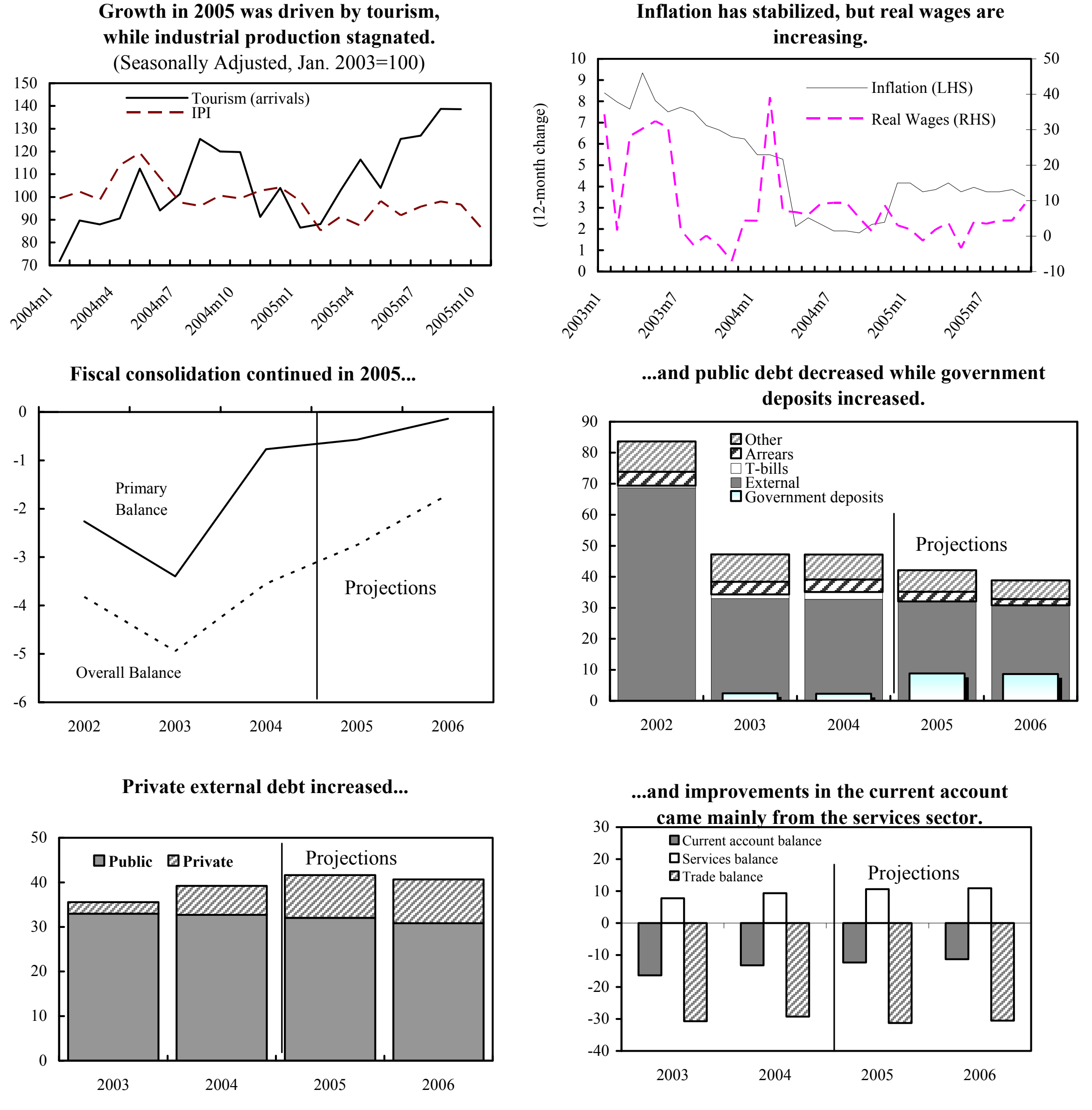
Sources: Serbia and Montenegro authorities; and IMF staff estimates and projections.
1/ Projections.

Figure 2. Serbia: Selected Economic Indicators, 2002-2005



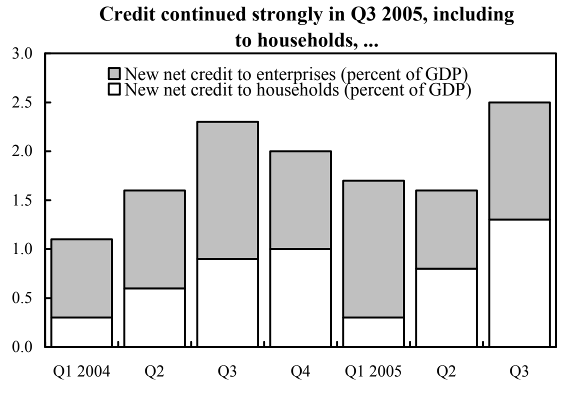
Sources: National Bank of Serbia; Statistics Office of Serbia; and Fund staff estimates.

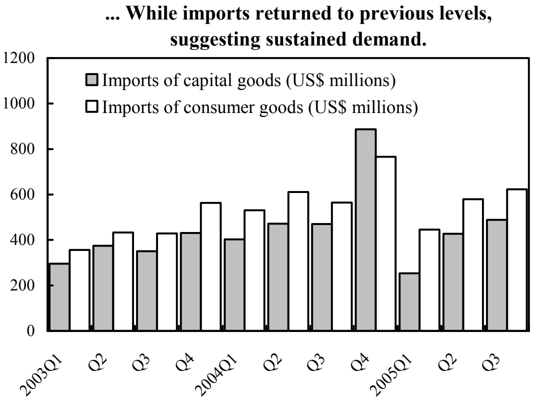
Figure 3. Montenegro: Economic Developments, 2002-2006
(In percent of GDP, unless otherwise indicated)



Sources: Montenegro Statistical Office, Central Bank and Ministry of Finance of Montenegro; and IMF staff estimates and projections.

unrestructured enterprises. Domestic demand picked up at mid-year, as the larger-than-expected capital inflows[3] fuelled credit growth. With still limited competitive domestic supply, this exacerbated macroeconomic imbalances and contributed to inflationary and import pressures. In Montenegro, a good tourism season sustained growth.



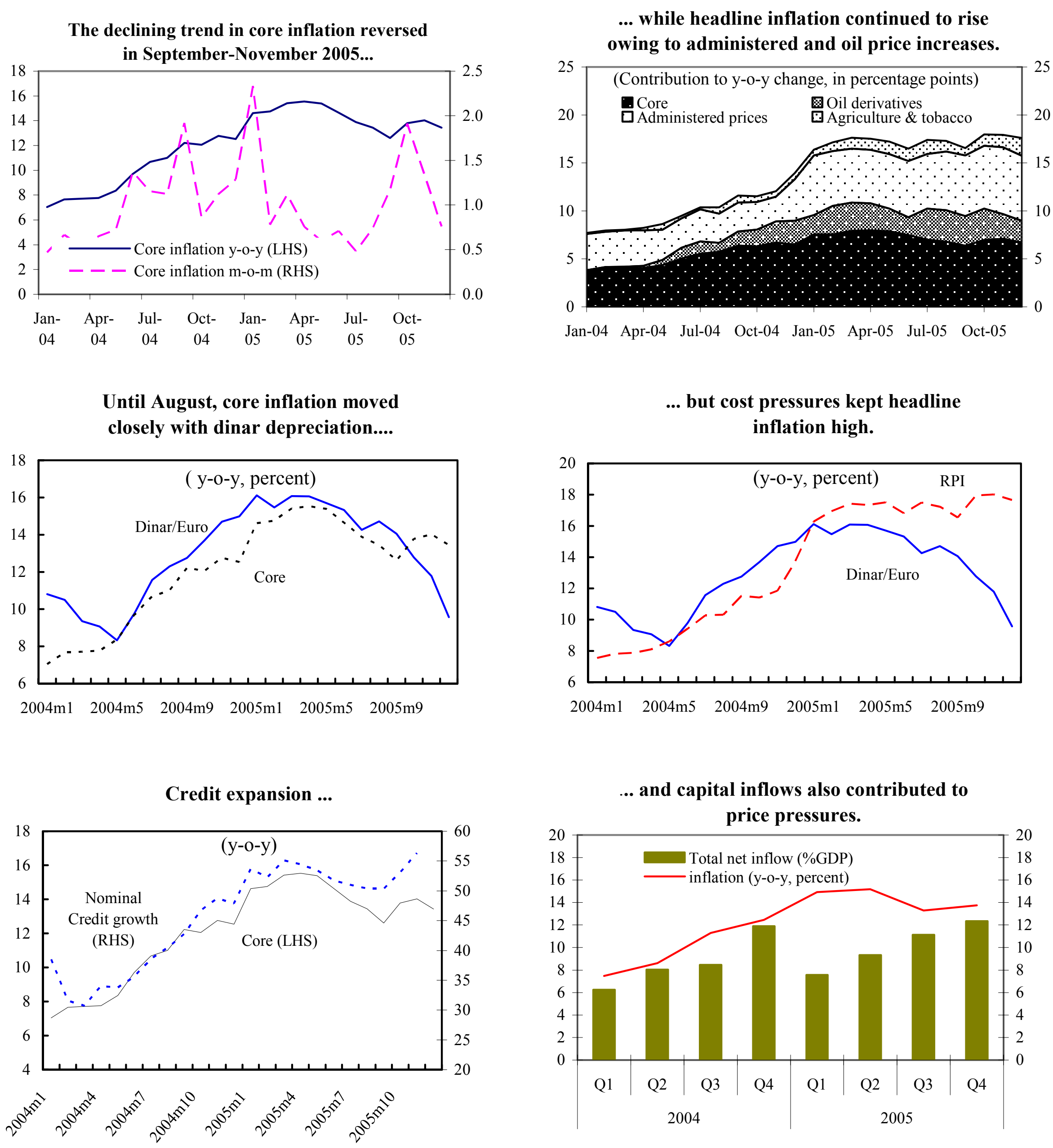


Sources: Serbian Office of Statistics: National Bank of Serbia; and IMF staff estimates.

4. **Inflation stabilized, but at a very high level.** Annual headline inflation in Serbia remained at 17–18 percent throughout 2005 (against the end-year target of 13.8 percent set at the fifth review). In addition to strong demand, this reflected a series of shocks, including the VAT introduction, disruptions to agricultural supply due to flooding, and the rise in world energy prices, which were amplified by the widespread indexation of prices. On the other hand, the decline in core inflation through August, on the heels of the slowing in dinar/euro depreciation as of early 2005, suggests that the pass-through from the exchange rate to prices was high and that the exchange rate helped anchor inflationary expectations (Figure 4). However, this improvement was offset more recently by second-round effects from energy price increases and renewed demand pressures.

[3] Net foreign inflows of capital were 4 percent of GDP above program projections.

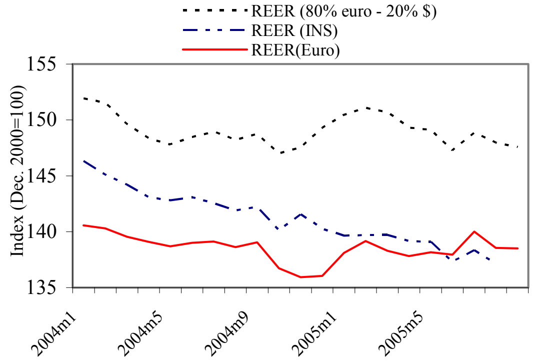
Figure 4. Serbia: Inflation Developments, 2004-05



Sources: Serbian Statistical Office; National Bank of Serbia; and IMF staff estimates.

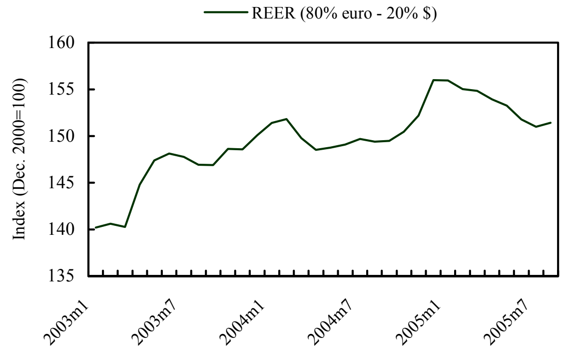
5. **The current account deficit improved more than programmed, but remains large** (Tables 4–6, Figure 5). Aided by favorable commodity prices and the impact of FDI and restructuring, exports grew by 38 percent year-on-year in the first three quarters in dollar terms. In absolute terms, however, they were still less than half of imports, pointing to the structural nature of the trade deficit. Despite rising oil prices, import growth was subdued, reflecting the VAT effect, in addition to tighter macroeconomic policies. Real effective

In Serbia, the real exchange rate appreciated against the euro in 2005, while the REER suggested a depreciation.



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

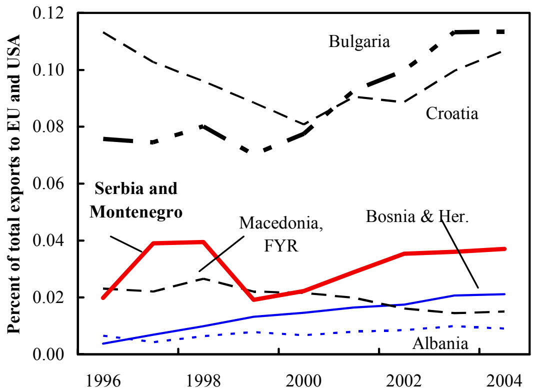
In Montenegro, the real exchange rate started to depreciate in 2005.



Sources: Central Bank of Montenegro; and IMF staff calculations.

exchange rate developments, market share, and comparative cost calculations suggest that competitiveness in Serbia remained adequate, while it continues to be a concern in Montenegro.

Serbia's export share to the EU and USA has increased ...



Source: IMF staff estimates.

...and wages reflect productivity (2004)

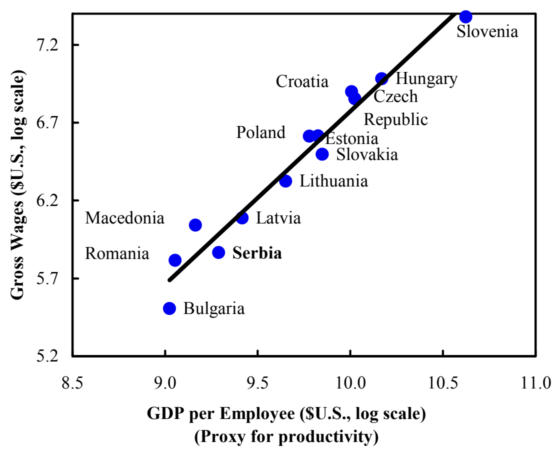
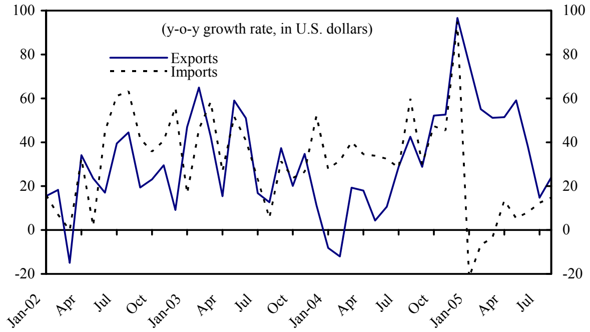
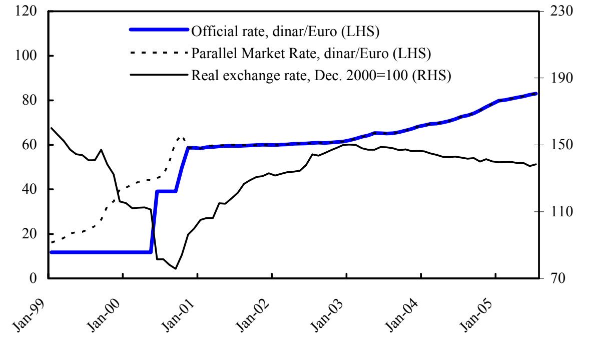


Figure 5. Serbia and Montenegro: External Sector Developments, 2001–05
(In percent of GDP, unless noted otherwise)

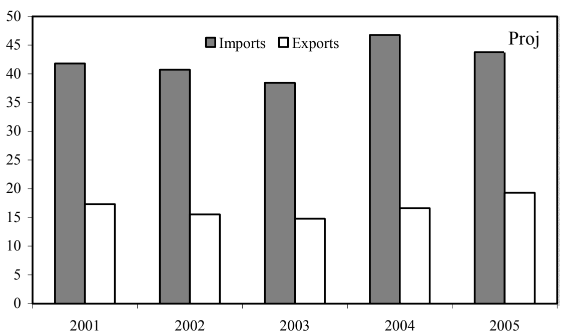
Export growth strengthened in 2005 while import growth dropped significantly.



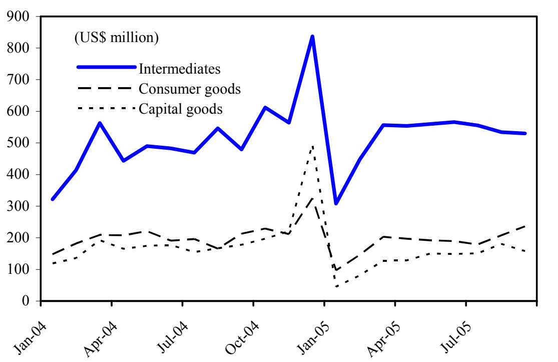
The REER depreciation since 2003...



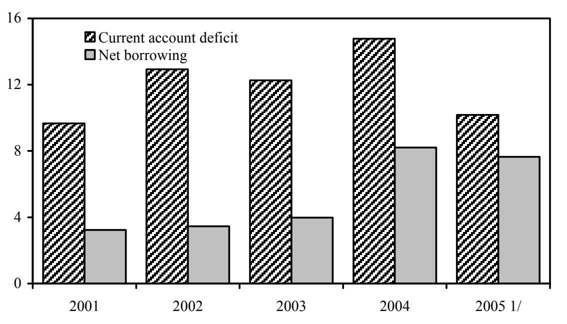
...may have helped exports but imports continue to be much larger than exports.



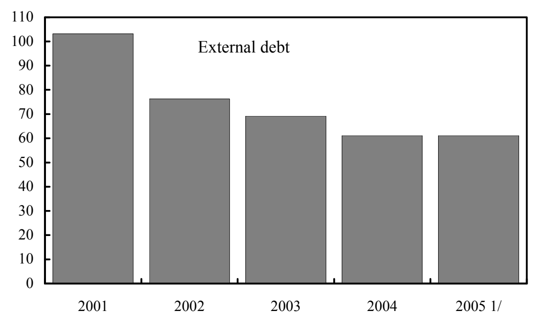
The large increase in imports at end 2004 reflects temporary factors due to the VAT introduction



The current account is increasingly financed by debt-creating flows...



...undermining the favorable debt developments since 2002.



Sources: Serbian Statistics Office; National Bank of Serbia; and IMF staff estimates.
1/ Projection.

6. **Higher-than-expected foreign borrowing increased macroeconomic vulnerability to "sudden stops" or exchange rate shocks.** The surge in foreign loans since 2004 has mainly been related to better access to external capital by recently privatized or newly established enterprises, banks, and leasing companies, in particular from their parent companies abroad. Although short-term debt remains modest, the continued strong foreign borrowing by the private sector, amounting to about 6–7 percent of GDP in Serbia in 2004–05, is of concern. The debt-to-GDP ratio has remained high at about 61 percent. Coupled with large inflows of remittances, equivalent to over 14 percent of GDP, and mostly privatization-related FDI, this boosted gross foreign reserves of the NBS to $5.4 billion at end-November.

Serbia: Financing of the Current Account Deficit, 2004-2005
(In percent of GDP)

	2004	2005 (est.)
Financing	13.5	9.2
1. Debt creating flows	7.6	7.3
Of which		
Medium- to long-term borrowing, net	6.0	6.0
(By borrower)		
Public sector	1.0	1.1
Private sector	5.1	4.9
Banks	2.1	1.9
Corporate sector	2.9	3.0
Short term debt, net	1.6	1.3
2. Non-debt creating flows	8.7	9.0
Of which		
Grants	2.1	1.2
Foreign direct investment	4.0	6.8
3. Change in Central Bank NFA	-2.8	-7.1
(negative figure indicates an increase)		

Source: National Bank of Serbia; and IMF staff estimates.

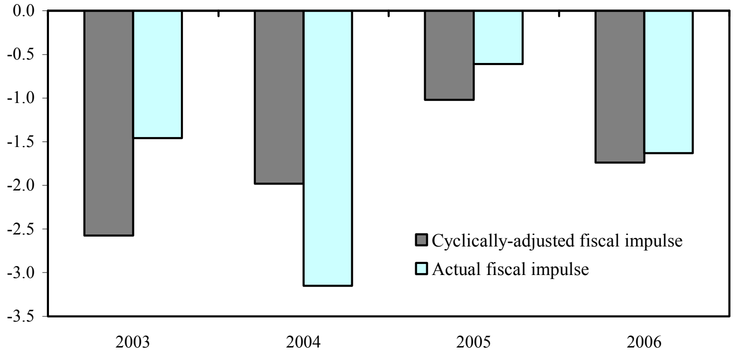
B. Policy Developments

7. **Tight fiscal policies helped contain demand pressures in 2005 (Tables 7–10), but plans for large infrastructure projects can create future fiscal risks.** As described in Box 1, fiscal policy since 2002 has been significantly tighter than in the initial program to compensate for the worse-than-expected private sector savings-investment balances. The general government surplus through September, at 0.6 percent of GDP, reflected these continued prudent policies. Over the whole of 2005, the overall and cyclically adjusted balances (Figure 6) are projected to improve by 1.2 percent of GDP to a consolidated SCG surplus of 0.9 percent of GDP. The small revenue underperformance, mainly due to cuts in oil excises to contain prices, was compensated by savings in subsidies and goods and services, which also helped accommodate overruns in municipal wages and higher capital spending. Moreover, employment rationalization in the army, health, education, and public administration paved the way for permanent expenditure savings. However, the steps initiated in Serbia toward public-private partnerships (PPPs) for the construction and management of toll highways, at an estimated total cost of close to 6 percent of GDP over three years, is of concern. Because of their uncertain economic profitability, these projects, although initially privately funded and managed, may result in large future contingent liabilities as a result of implicit government guarantees.[4] In Montenegro, the programmed

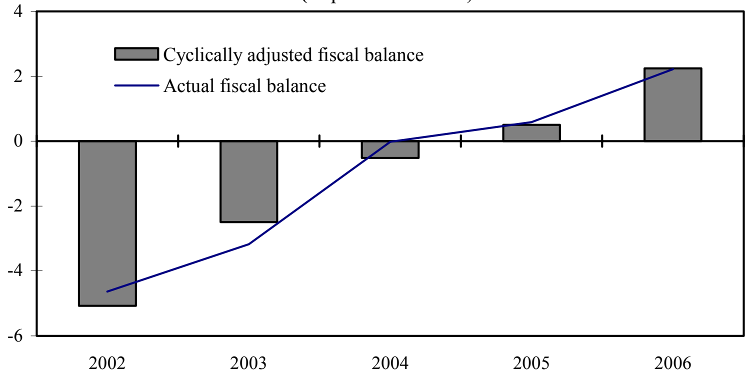
[4] International experience with similar PPPs suggests that insufficient profitability could potentially lead to renegotiation of concession contracts at some point in the future, possibly with adverse fiscal consequences.

Figure 6. Serbia: Cyclically Adjusted Fiscal Balances, 2002-2006 1/

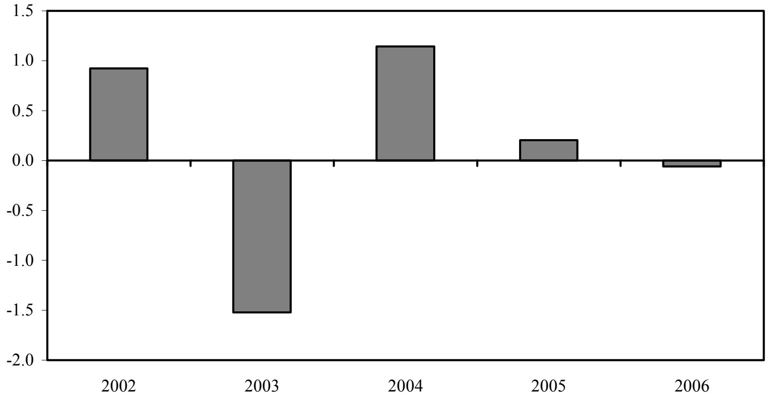
The structural fiscal adjustment since 2003 implied a highly contractionary stance, even in 2004, suggesting that the adjustment was not only due to strong growth.
(In percent of GDP; negative sign = fiscal contraction)



The fiscal tightening in 2005 and 2006 is projected to be mostly of a structural nature given relatively small deviation of output from its trend.
(In percent of GDP)



Following the rebound in 2004, the output gap is expected to narrow.
(In percent of potential GDP; positive sign = actual GDP above potential)



Sources: Serbian authorities; and IMF staff estimates.

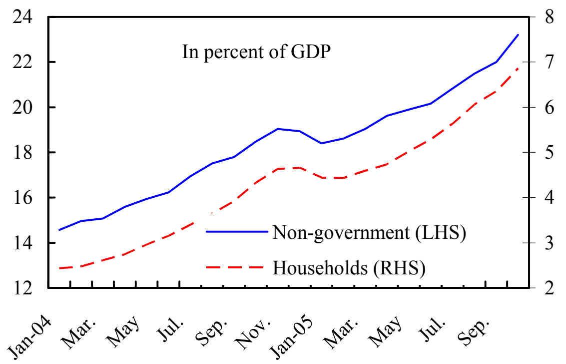
1/ In percent of Serbian GDP. Estimates follow OECD, *Measuring cyclically adjusted Budget Balance for OECD Countries,* OECD Working Paper No. 434, 2005, and involve estimating the elasticities of cyclically dependent budget items with respect to the output gap, and adjusting actual revenue and expenditure components according to the ratio of potential output to actual output and the assumed/estimated elasticities. The years 2005 and 2006 are based on staff projections.

fiscal stance was achieved by higher-than-expected tax revenues, as expenditure targets were undermined by delays with civil service reform and increased capital outlays.

8. **Incomes policy, aimed at containing wage growth in the government and public enterprise sectors in support of the exchange rate anchor and disinflation efforts, was weaker than anticipated.** The wage bill in the monitored public enterprises exceeded program targets due to spending on bonuses,[5] while savings from lay-offs were spent on wages. In the budget sector, wages increased by more than envisaged due to large hikes granted by municipalities and to the reallocation of redundancy allowances to wage increases, mainly in the education sector.

9. **In the face of large foreign exchange inflows, monetary policy in Serbia was insufficiently tight to stem the resulting rapid expansion of broad money and credit** (Table 11, Figure 7). Larger-than-expected capital inflows have created appreciation pressures and attendant interventions have boosted liquidity.[6] The increase in repo operations since June was insufficient to sterilize the excess liquidity, as indicated by negative real interest rates. Furthermore, in the midst of strong credit growth in July, the NBS announced a lowering of the statutory reserve requirement (SRR) on household foreign exchange deposits, sending confusing signals on its monetary stance.[7] The high euro liquidity fuelled an acceleration in net credit growth in the third quarter, especially in the foreign banks, which is estimated to reach 10 percent of GDP by end-year, twice as high as programmed. The policy tightening towards end-year should help contain demand in 2006.

Rapid credit growth continued in 2005.



Sources: National Bank of Serbia.

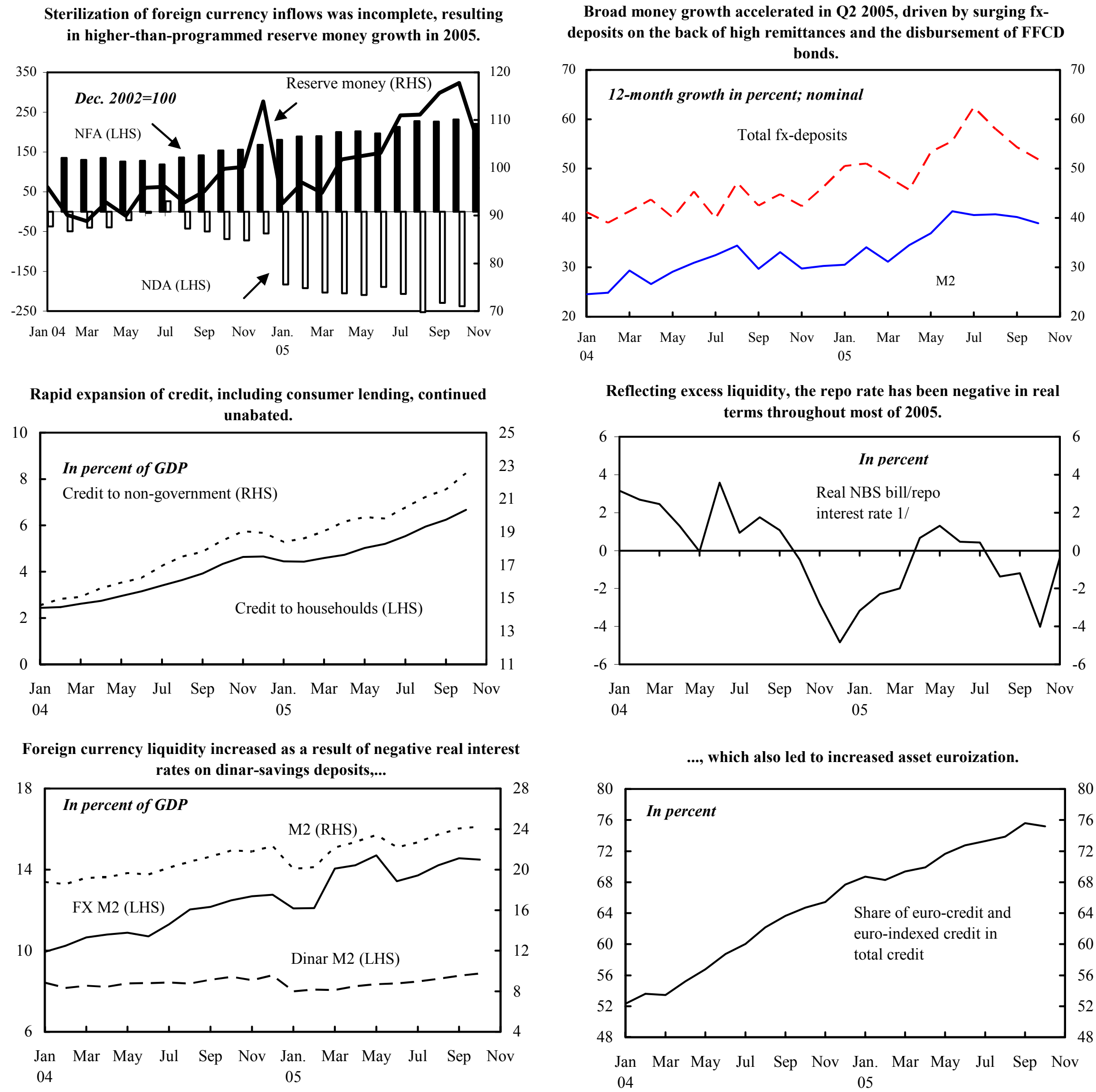
---

[5] The misreporting of wages in relation to the March 2005 performance criterion is addressed in a separate report.

[6] While the limited openness of the capital account creates some scope for monetary policy, the interest rate transmission mechanism is weakened by the high euroization of assets and liabilities. Therefore, the NBS had to rely on prudential measures to deal with foreign currency liquidity in banks.

[7] The SRR on enterprise foreign exchange deposits was increased in August from 26 to 29 percent. The stepwise SRR reduction on household deposits from 47 to 40 percent announced in August was largely neutralized by a subsequent increase in the SRR on enterprise deposits to 35 percent by October. Both SRR rates were unified in December at 38 percent, implying only a slight net tightening. The reservable base was expanded in November to cover all foreign borrowing with no remuneration.

Figure 7. Serbia: Monetary Developments, 2004–2005



Sources: Serbian Office of Statistics; National Bank of Serbia; and IMF staff calculations.
1/ Repo operations replaced the issuance of NBS-bills in January 2005; calculated based on interest rates for 14-day repos and a rolling six-month average of RPI inflation (three months forward-looking/three months backward-looking).

10. **Bank privatization proceeded successfully and supervision improved, but the recent increase in non-performing loans is of concern.** The privatization of four state banks helped raise the share of foreign bank ownership to 63 percent by end-September. To address weaknesses in banking regulation and supervision identified by the FSAP mission, the NBS strengthened supervisory practices and its regulations. The capital adequacy ratio was increased from 10 to 12 percent, effective end-December 2005, and a new banking law aligning current practices towards Basel Core Principles was adopted in November.[8] However, as emphasized in the Financial System Stability Assessment (FSSA), the rapid pace of credit expansion may have started to erode financial stability, as non-performing loans (NPLs) increased in the year through September, including in the foreign banks. Important risks also arise from banks' indirect exposure to exchange rate fluctuations, as euroization of loans—many of which to unhedged borrowers—has reached 73 percent in September.

11. **While overall progress with structural reform during the EA was disappointing, a strengthened reform agenda for 2005 was implemented broadly in line with commitments, albeit with delays.** The share of the private sector in 2005 is estimated to have increased by 5 percentage points to 55 percent of GDP. However, the still large share of resources held in uncompetitive activities in the public or socially owned sectors lowers the growth potential and puts a high burden on demand management to address macroeconomic imbalances.

- In **Serbia**, privatization of the socially owned companies progressed in line with the program, and over 100 companies were declared insolvent under the new bankruptcy law, signaling a tightening of financial discipline. The restructuring of public enterprises progressed with the spin-off of about 100 non-core companies and assets and reductions in overstaffing (14 percent of their employment), while commitments related to the privatization of the state-owned oil and gas conglomerate NIS were met with some delay.

- In **Montenegro**, economic restructuring continued with the completion of the sale of the aluminum complex and of the largest remaining state-owned bank, but privatization in the energy sector was delayed.

[8] The new law strengthens the "fit and proper" provisions applicable to bank owners, directors, and managers; focuses the definition of significant ownership; tightens related-party exposure limits; addresses asset classification and reporting; establishes the role of banks' board of directors in risk management and enables remedial actions to address financial misreporting; and grants statutory protection to NBS staff. Some weaknesses remain regarding consolidated supervision.

III. Policy Discussions

12. **The discussions focused on policies to sustain growth, and reduce inflation and external imbalances in 2006.** There was broad agreement that given the gradual impact of structural reforms on output, maintaining macroeconomic stability in the near term required tight demand management policies. This offered the only credible avenue for achieving relatively reasonable inflation and current account outcomes in the short term. Over the longer term, the continuation of structural reforms was seen as crucial for both growth and lowering the vulnerabilities associated with the external imbalances. It was also acknowledged that the policy mix in Serbia could be limited by structural rigidities. In this context, the burden of demand management fell heavily on fiscal and incomes policies, as the authorities wanted to continue to use the exchange rate policy to anchor inflationary expectations, given the increasing euroization and indexation of prices. However, fiscal policy in turn is hampered by a rigid public spending structure and institutional weaknesses, and incomes policy by public enterprises that still largely operate with soft financial constraints.

13. **Understandings were reached on a package to strengthen current policies to achieve lower inflation and a more sustainable external balance.** Given the lack of progress on the inflation front, the authorities wanted to continue the current policy of slow depreciation of the dinar for the time being. This policy is expected to be consistent with a reduction of inflation in 2006, as the one-off shocks to prices wear out, expectations adapt, and tighter demand management policies take hold. The small nominal depreciation, coupled with tighter demand management and structural reforms, would also aid competitiveness by reducing pressures for real appreciation. However, fiscal, incomes, and, in particular, monetary policies needed to be further tightened to support such policy by containing demand pressures associated with the large inflows of capital. In addition, monetary policy needed to stand ready to sterilize the interventions required in support of the exchange rate policy. In Montenegro, policy discussions focused on the need to continue fiscal consolidation and restrain increases in public wages to protect external competitiveness.

14. **Measures will also be taken to address some of the rigidities reducing policy effectiveness in Serbia.** The flexibility of fiscal policy will be increased by large permanent cuts in spending, while monetary policy effectiveness will improve, if the increases in dinar interest rates succeed in arresting euroization.

15. **The policy mix carries significant risks, but the authorities were confident that the agreed measures would address these challenges.** The staff pointed to the risks that excess demand and the reliance on the exchange rate anchor continue to pose to inflation and external objectives. This is compounded by the fragile political environment in 2006, which could affect implementation of fiscal policy and the pace of reforms (Figure 8, Table 12). Maintenance of a strict incomes policy in public enterprises and in the government sector could also easily falter. Higher real interest rates could attract short-term capital inflows, despite current restrictions, which would complicate monetary management. The authorities

acknowledged the risks but thought that the policy mix struck a realistic balance between inflation and current account objectives.

A. Macroeconomic Framework

16. **Growth is expected to continue to be relatively strong and inflation to decline in 2006, but downside risks remain** (Tables 1, 13–15, Figure 9) (¶15).[9] Potential growth is set to remain largely unchanged, while exports and domestic demand, not least consumption, are likely to remain strong, the further tightening of the macroeconomic policy stance notwithstanding. Against this background, the staff expects GDP growth to remain around 5 percent and the underlying current account deficit to decline only relatively slowly. Achieving the inflation target of 11½ percent by end-year in Serbia will be a challenge. It will require that demand management policies take hold, cost pressures subside, exchange rate expectations adapt, and incomes policies are tightened in the public sector. The risks are amplified by the uncertainties associated with international oil prices. Furthermore, despite policy tightening, the strong credit growth towards end-2005 may spill more into imports than expected, with attendant risks for the current account target. External debt would decline in terms of GDP, albeit at a relatively slow pace (Appendix IV). In Montenegro, growth is expected to remain at 3–4 percent, with inflation at about 3½–4 percent.

B. Fiscal and Incomes Policies

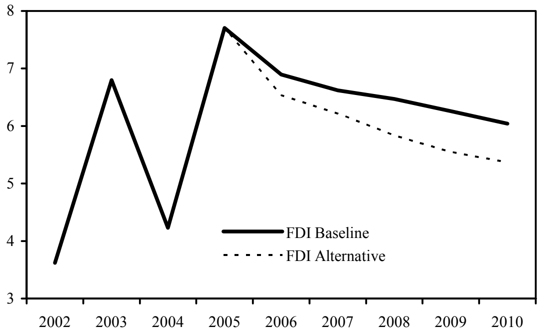
Serbia

17. **The program's fiscal target for end-2005 is expected to be missed on account of pension arrears payments** (¶18–28). The authorities insisted—on the basis of eventually mistaken expectations of revenue overperformance—on starting the clearance of 0.2 percent of GDP of pension arrears already in December 2005. This was agreed on the understanding that this shortfall together with an additional mid-2006 pension arrears payment (0.2 percent of GDP) and any unexpected shortfalls in 2005 will be fully compensated in 2006 so as to ensure that the cumulative 2005–06 fiscal improvement remains 3.6 percent of GDP. The additional revenue and expenditure measures will be announced in government decrees to be issued in January 2006, by the time of the Board meeting (¶27). As a result, the overall surplus target for 2005 was revised down to 1.1 percent of GDP.

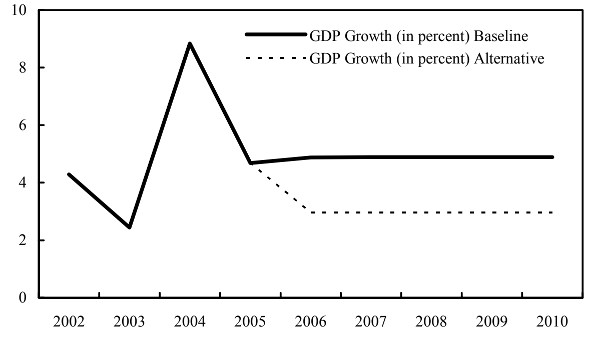
[9] ¶ refers to the relevant paragraph in the MEFP.

Figure 8. Serbia and Montenegro: Alternative Scenarios, 2002-2010
(In percent of GDP, unless otherwise indicated)

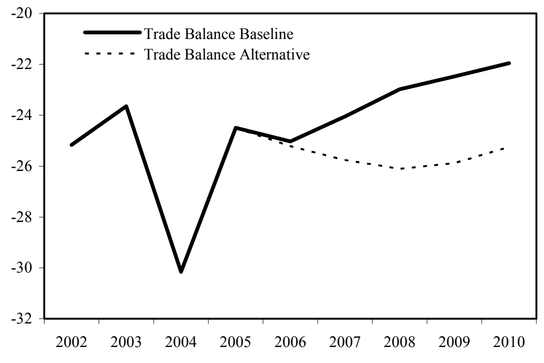
Slower structural reforms accompanied by lower FDI...



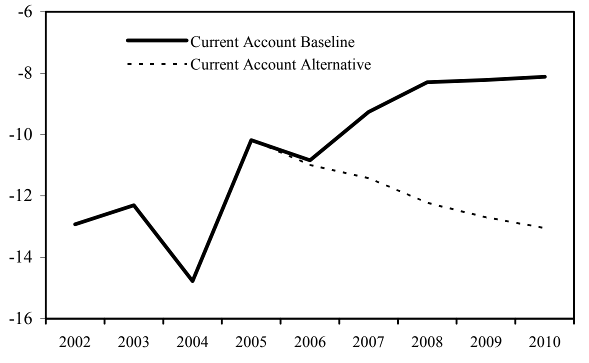
... would lead to lower GDP and export growth,...



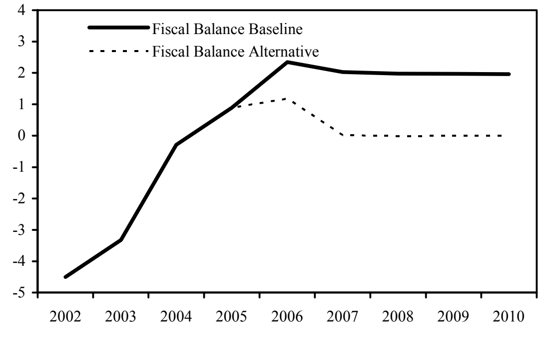
...which in turn would slow down the projected improvements in the trade balance,...



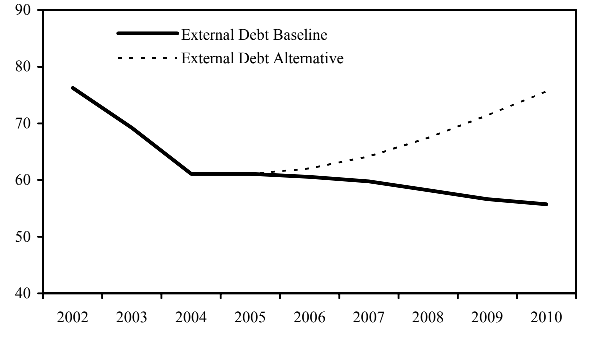
..., the external current account,...



...and the fiscal position.

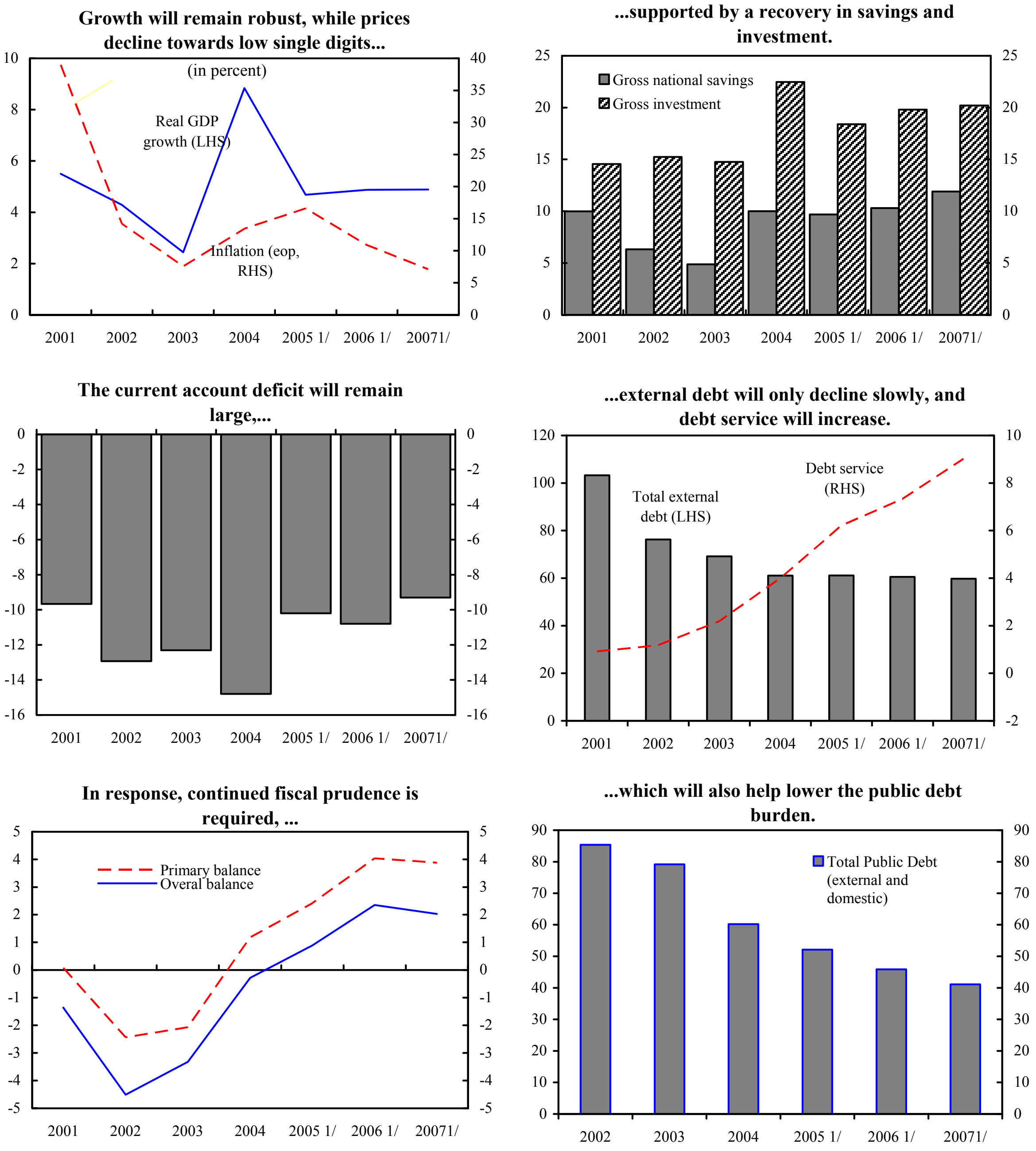


As a result, external debt would be put on an upward path, unless foreign reserves are drawn down significantly.



Sources: SCG authorities; and IMF staff estimates and projections.

Figure 9. Serbia and Montenegro: Baseline Medium-Term Projections, 2001–07
(In percent of GDP, unless otherwise noted)



Sources: Serbia and Montenegro authorities; and IMF staff estimates and projections.
1/ Projections.

18. **The 2006 budget aims at increasing public savings, lowering the size of government, and improving the quality of spending.** It was agreed that the persistently high inflation and the risks to the external balance justified a significant increase in the surplus. The consolidated fiscal position will improve by 1.4 percent of GDP, reaching a surplus of 2.5 percent of GDP. To support sustainability and ensure that the size of government continues to decline and the quality of adjustment improves, the authorities agreed to save any revenue overperformance in 2006 and beyond (Appendix V).

Serbia and Montenegro: Fiscal Policy in 2003-06
(Excluding grants; in percent of GDP)

	2003	2004	2005		2006
			5th Review	Proj.	Proj.
Total revenue	42.7	45.2	44.8	44.2	44.6
Total expenditure	46.0	45.5	43.7	43.3	42.2
Of which:					
Wages	10.4	10.3	10.1	10.6	9.8
Transfers and subs.	23.0	22.1	21.3	20.7	19.9
Capital spending	2.5	2.7	2.4	2.8	3.2
Overall balance	**-3.3**	**-0.3**	**1.2**	**0.9**	**2.4**
of which:					
Serbia	**-2.9**	**0.0**	**1.4**	**1.1**	**2.5**
Montenegro 1/	**-4.9**	**-3.5**	**-2.7**	**-2.7**	**-1.7**

Sources: Finance ministries; and IMF staff estimates.

1/ In percent of Montenegro GDP.

- **Revenues** will increase slightly in terms of GDP. This reflects broadly unchanged tax policies (except for oil excises) and continued improvements in collection. There are downside risks, however, related to uncertainties pertaining to nontax revenue collection and the sustained performance of the VAT.

- Current **expenditure** would drop by 1.4 percent of GDP, mostly due to permanent savings of about 1 percent of GDP. This would create space for a small increase (0.5 percent of GDP) in capital spending to 3 percent of GDP, which both staff and the authorities viewed as long overdue. As a result, the size of government, which remains among the largest in the region, will be curtailed further, and the flexibility of fiscal policy improved in support the exchange rate anchor.

Southeastern Europe: Fiscal Indicators, 2004
(In percent of GDP)

	Overall balance	Expenditure	Wage bill	Transfers	Non-discr. spending (percent of total)	Capital spending	Public debt
Serbia	0.0	46	10	21	67	3	60
Montenegro	-3.5	40	10	17	68	2	48
Albania	-5.3	29	7	8	51	3	55
BiH	-1.9	51	n.a.	19	n.a.	6	31
Bulgaria	1.7	40	5	17	53	4	39
Croatia	-4.9	52	12	22	66	5	54
Macedonia	0.7	37	9	19	76	3	33
Romania	-1.2	31	5	14	62	4	26

Source: IMF staff reports.

19. **The authorities intend to pursue a number of policy reforms in support of the 2006 fiscal targets:**

- The new **Health** Insurance Law enacted in November will rationalize health services and reduce health insurance benefits. In the **army**, the reduction in employment will continue, leading to savings in materials while providing room for arrears repayments and higher capital spending. A wide range of **subsidies** to private, public, and socially owned enterprises and agriculture will be reduced, with the support of measures aimed at restructuring their beneficiaries.

- **Local government** wage bill growth will be limited to 9 percent, which will be enforced through potential cuts in transfers to non-compliant municipalities.

- Prudent **wage policies** are expected to keep the average wage increase below average inflation. The above reforms will rationalize government employment, based on voluntary departures. To reduce the social cost of public sector downsizing, the budget includes outlays for redundancy payments. This is further supported by active labor market policies, training programs and targeted social benefits (see IMF Country Report No. 05/13).

20. **While the approved pension reform will produce savings starting in 2007, the pension system will continue to run large deficits.** The change in the indexation period and the gradual shift to CPI-indexed benefits will save an estimated 1 percent of GDP annually by 2010. Accumulated pension arrears, amounting to about 2.1 percent of GDP, will be cleared in cash over a five-year period and will be accommodated in the medium-term fiscal framework.

21. **Incomes policy in public enterprises will aim at lowering inflationary expectations and encouraging restructuring** (¶41). While pointing to the efforts already

made in 2005, the authorities agreed to limit wage bill growth in the eight monitored public enterprises to 10.3 percent in 2006 (below projected average inflation of 13.1 percent in Serbia). They intend to achieve this objective in part through their ongoing program of employment rationalization, which is expected to lead to a further 6 percent reduction in employment in these enterprises in 2006.

Montenegro

22. **To reduce external imbalances and improve fiscal sustainability, the fiscal deficit will decline further in 2006** (¶29). The authorities' priority was to use the fiscal savings from past employment reductions and the pre-payment of debt with the large privatization revenues to create new agencies required by EU integration. At the same time, it was agreed to reduce the consolidated government deficit by 1 percent of GDP, to 1.7 percent of GDP. Tax revenues will remain stable, as the changes to some tax rates in early 2006 are expected to be revenue-neutral, and the wage bill will continue to decline.

C. Monetary and Exchange Rate Policies and Financial Sector Reform

23. **The Serbian authorities reiterated their preference for continuing the current exchange rate policy in 2006** (¶34). They explained that continued slow nominal depreciation of the dinar, despite pressures toward appreciation from the large capital inflows, reflected a trade-off between inflation and current account objectives. The staff concurred that this policy could contribute to reducing inflation, but pointed to the risks for the external balance through likely real appreciation. It was also concerned with potential underestimation of the exchange rate risk by borrowers. While agreeing that the predictable exchange rate may have contributed to the surge in euro-indexed bank lending and the concomitant indirect credit risk, the authorities considered that this could be addressed by allowing greater exchange rate fluctuations during the year to increase uncertainty around the exchange rate path. The staff noted, however, that this may not lower the risks if the annual depreciation target is known.

24. **There was agreement that a tighter monetary policy in Serbia was needed to support fiscal and incomes policies in containing demand pressures** (¶30–33). However, the maintenance of the exchange rate target with continued strong capital inflows is likely to complicate monetary management. This will require substantial sterilization by the NBS with stepped up repo operations to contain liquidity and demand pressures. In line with the recommendation of the FSAP mission, the NBS started using the 14-day repo rate as the key policy rate to improve the signaling of the monetary policy stance to the public.[10] Moreover, to contain credit growth and euroization, the NBS will continue to use prudential measures, in particular reserve requirements.

[10] The NBS also agreed to establish an interest rate corridor by (i) establishing a single lending facility with interest rates linked to the repo rate; and (ii) increasing the deposit facility interest rate.

25. **The staff welcomed progress in privatizing banks and strengthening the supervisory framework in Serbia, but challenges remain in addressing the prudential risks emanating from rapid credit growth** (¶35–38). As highlighted in the FSSA, efforts will be required to implement the new banking law, eliminate regulatory forbearance, and address the recent increase in NPLs. This involves accelerating the implementation of the Supervisory Development Plan and improving the capacity of the NBS to monitor indirect credit risk resulting from borrowers' exposure to exchange rate risk. Restructuring of the insurance sector, in particular the two largest socially owned companies, is expected to continue.

26. **In Montenegro, the restructuring of the banking sector and improvement of the financial legislative framework will continue** (¶39). The remaining state involvement in commercial banks will be unwound with the sale of minority shares in two more banks. New legislation regarding the banking sector and the central bank, intended to enhance competition and strengthen banking supervision, will be finalized.

D. Enterprise Reform

27. **Enterprise restructuring and privatization will proceed to enhance growth and reduce the structural external deficit** (¶40–44). The Serbian authorities reiterated their commitment to sell the majority stake in the two oil refineries (possibly combined with other assets) of the state-owned conglomerate NIS in 2006, following the hiring of a privatization advisor in January 2006. Restructuring of the electricity and railway companies, as well as of large socially owned conglomerates, including the important mining complex, will continue with World Bank support, and unsellable companies will be declared bankrupt. The authorities also committed to offer all remaining socially owned companies for sale by end-2006, facilitated by the new framework allowing for public debt workouts, conditional on successful privatization. The companies and assets recently spun-off from public enterprises are expected to be sold.

28. **In Montenegro, the momentum for privatization will be maintained** (¶45). Failed or pending tenders will be re-launched, and the non-core assets of the electricity company, an insurance company, and hotels will be sold.

E. Program Issues and Financing Assurances

29. **As corrective actions compensating for the missed performance criteria (PCs) and benchmarks were implemented, the staff supports the authorities' request for waivers** (Appendix III, Annexes A–D). Despite delays and setbacks (pension reform), all measures underlying the Fund's structural conditionality were eventually implemented or compensated. The missed end-June and end-September wage bill targets will be compensated by cutting excess bonus payments and better monitoring of all wages and bonuses in 2006. The missing of the end-June and end-September net credit to government target, mainly due to expenditure overruns, is expected to be corrected by end-year. Four out of five non-observed PCs were missed with short delays, and the underlying measures were

successfully implemented. The fifth non-observed PC, related to pension reform, was compensated by permanent expenditure savings elsewhere in the 2006 budget. **Prior actions** for the completion of the sixth review are related to ensuring the agreed fiscal targets for 2006.

30. **The external financing outlook remains adequate, and negotiations on settling external arrears have progressed.** The Paris Club agreement was implemented with all but one creditor; past debt with China and Russia is being settled; and negotiations with other official and private creditors are progressing—albeit at a relatively slow pace. External grants and loans, FDI, and other capital inflows are expected increase gross external reserves to about $7 billion by end-2006 (about 5 months of prospective imports).

31. **Circumstances warrant post-program monitoring (PPM) following the expiration of the EA.** Fund credit outstanding is currently at about 170 percent of quota and is expected to remain above 100 percent until 2009; the external position remains vulnerable; and no successor arrangement is envisaged in the near term. The authorities' program for 2006, which includes quarterly quantitative targets, provides an appropriate basis for PPM.

IV. Staff Appraisal

32. **Performance under the three-and-a-half-year EA has been mixed.** Output growth has been relatively strong, but has been accompanied by persistent inflation and a large current account deficit. The main reason has been the hesitant and piecemeal approach to structural reform, which, despite a welcome catch-up in 2005, leaves significant macroeconomic risks going forward. While improvements in the business climate, accompanied by restructuring and privatization of banks, helped investment and growth, the slow restructuring of public and socially owned enterprises kept the private sector share in the economy low. The persistence of structural rigidities and the maintenance of uncompetitive sectors constrained domestic output and increased the burden on fiscal, incomes, and monetary policies.

33. **While exports and continued strong domestic demand supported growth in 2005, persistent macroeconomic imbalances and risks remain, despite a tightening of macroeconomic policies.** Higher-than-expected foreign capital inflows boosted liquidity and credit, which in the absence of timely monetary tightening fueled domestic demand, particularly in the second half of 2005, despite restrictive fiscal policies. The strong demand, combined with the earlier impact of various shocks, caused both core and headline inflation to run well above program targets. However, the current account deficit narrowed more than expected, mainly on account of a shift in demand towards non-tradable goods, although the improvement may be temporary given the uncertain effect of the VAT introduction on imports. The continued strong foreign borrowing by the private sector maintained external debt high. This, coupled with the still large current account deficit, the exchange rate anchor, and foreign exchange lending by banks to often unhedged borrowers, increased vulnerability to sudden stops in funding and exchange rate risk.

34. **The authorities have responded to these challenges with a further tightening of macroeconomic policies, and a reinvigoration of structural reform.** The exchange rate anchor, coupled with tighter fiscal, monetary, and incomes policies and the unwinding of the various shocks to prices should help lower inflation in 2006. Together with the expected positive impact on exports from FDI and structural reform, these policies should also help contain the current account deficit and sustain growth.

35. **Although the pension reform fell short of program commitments, the fiscal improvement envisaged for 2005–06 is significant, and its quality is set to improve with the implementation of the agreed permanent expenditure savings.** The large increase in public savings over the program period has been necessitated by the sharply deteriorating private sector savings-investment balance. The commitment to save revenue overperformance is welcome. On expenditures, while the setback to pension reform is regrettable, the compensatory cuts in other permanent spending increase the flexibility of fiscal policy and its medium-term sustainability. Further reforms in the government sector, aimed at continued spending reductions to lower the tax burden in the medium term, remain on the agenda.

36. **Given the risks stemming from the constraints on exchange rate policy, a stricter incomes policy is needed to contain demand and improve competitiveness.** The record has been disappointing and more political determination is needed to support agreed policy targets. While there were slippages in the authorities' attempt to contain wage increases in the budget and public enterprise sectors at the level of the two republics, the staff welcomes efforts to moderate wage increases in 2006, including in local governments and utilities.

37. **The current exchange rate policy in Serbia of managed floating with limited flexibility, which seeks to achieve both the inflation and external balance objectives, carries significant risks.** While the exchange rate anchor should help lower inflationary expectations, it may affect competitiveness and jeopardize the current account target. Moreover, both objectives may be difficult to achieve unless demand is substantially tightened and structural reforms boost supply. Policy implementation is further complicated by the pressures toward appreciation from the large capital inflows, which calls for sterilization of potential interventions. The perceived exchange rate predictability may also contribute to excessive exchange rate risk-taking, despite increased volatility during the year. The exchange rate policy will be further discussed with the authorities at the time of the next Article IV consultation discussions.

38. **Faced with large foreign inflows, monetary policy should have been tightened earlier in 2005 to absorb excess liquidity and stem the rapid expansion of credit.** While the NBS will continue to develop market-based instruments of monetary policy and improve the signaling of its monetary stance, the reliance on prudential measures to contain credit growth needs to continue in the near term.

39. **Significant progress was made in the area of bank privatization, but rapid credit expansion and rising foreign exchange-indexed lending have increased the vulnerability**

of the banking system, calling for strengthened supervision. The enactment of the new banking law is a major step towards aligning prudential standards to international norms. However, bank supervision needs to be strengthened further to meet the challenges posed by the increase in NPLs and indirect credit risk.

40. **Structural reforms are crucial to increasing potential output and addressing macroeconomic imbalances in the medium term, and should be substantially accelerated.** The staff welcomes the intention to offer all remaining socially owned enterprises for sale by end-2006, initiate further bankruptcies, and continue to restructure and privatize public enterprises. The implementation of these reforms requires more political determination than seen so far. Agreed measures should be executed vigorously, despite resistance from vested interests, to ensure that resources move to more profitable activities and contribute to growth and employment.

41. **In Montenegro, continued tight macroeconomic policies are required to improve competitiveness under the euroized monetary regime, and ensure sustainable growth.** Structural reforms will be of paramount importance to increase domestic output and reduce external imbalances. Wage pressures beyond productivity growth in the run-up to elections next year remain a concern and should be resisted.

42. **Overall, while the situation remains subject to significant risks, the staff supports the authorities' request to complete the sixth review under the EA, including the financing assurance review.** Although the process has not been smooth, the authorities have implemented the agreed tightening of policies and made significant strides on the structural agenda. The staff also supports the requests for waivers for the missed PCs, since corrective actions were taken or the targeted measures were adopted with short delays.

43. **The Managing Director recommends PPM for SCG,** as Fund credit outstanding is expected to exceed 100 percent of quota through 2009, the external position remains vulnerable, and no successor arrangement is envisaged in the near term.

Table 1. Serbia and Montenegro: Selected Economic and Financial Indicators, 2002–06 1/

	2002	2003	2004		2005		2006
			5th Review	Est.	5th Review	Proj.	Proj.
	(Percent change, unless otherwise indicated)						
Real economy							
Real GDP	4.3	2.4	7.2	8.8	4.6	4.7	4.9
Serbia	4.5	2.4	7.5	9.3	4.6	4.8	5.0
Montenegro	1.7	2.5	3.1	3.1	3.3	3–4	3–4
Industrial production (period average)	1.7	-2.7	7.5	7.5	5.0	0.0	2.0
Retail prices (period average)	21.2	11.3	9.5	9.5	15.4	16.3	11.4
Retail prices (end of period)	14.2	7.6	13.4	13.4	12.3	16.6	10.9
Serbia	14.8	7.8	13.7	13.7	13.0	17.7	11.5
Montenegro	9.4	6.7	4.3	4.3	3.5	3.6	3.6
Net real wage (period average)	24.0	12.3	11.9	11.9	…	4.4	…
Average net wage (in euros per month)	149	175	192	192	…	205	…
Unemployment rate (in percent) 2/ 3/	13.3	14.6	18.5	18.5	…	…	…
GDP per capita (U.S. dollars)	1,866	2,480	2,877	2,919	3,184	3,139	3,215
	(In percent of GDP)						
General government finances 4/							
Revenue	42.8	42.7	45.2	44.5	44.8	44.4	44.6
Expenditure	47.3	46.0	45.5	44.8	43.7	43.5	42.2
Overall balance (cash basis)	-4.5	-3.3	-0.3	-0.3	1.2	0.9	2.4
Foreign grants	1.1	0.2	0.1	0.1	0.2	0.1	0.2
Foreign loans (net)	1.8	1.2	1.0	1.0	0.9	0.8	0.7
Privatization receipts	2.2	4.3	0.6	0.5	3.1	3.7	2.1
Domestic financing (net)	-0.5	-2.4	-1.4	-1.4	-5.4	-5.4	-5.3
Gross debt 2/ 5/	85.4	79.2	60.2	60.2	53.1	52.1	45.9
of which: Forex-denominated (in percent of total)	91.9	90.3	87.9	87.9	95.1	87.7	88.8
	(12-month percent change)						
Monetary sector (end-of-period) 2/ 6/							
Money (M1)	79.8	10.9	8.0	8.0	6.9	23.7	11.6
Broad money (M2) 7/	52.7	27.5	30.3	30.3	22.2	38.9	27.2
Credit to non-government	49.6	25.1	52.1	47.9	27.0	62.6	33.7
	(In percent)						
Interest rates (weighted average, end of period)							
NBS bills / Repo rate 8/	9.7	10.6	…	16.3	…	15.9 9/	…
Deposit rate	2.6	2.7	…	3.7	…	3.8 9/	…
	(In percent of GDP, unless otherwise indicated)						
Balance of payments							
Current account balance, before grants	-12.9	-12.3	-15.5	-14.8	-11.0	-10.2	-10.8
Underlying current account balance 10/	…	…	-13.7	-13.1	-12.6	-11.7	-10.8
Exports of goods (f.o.b.)	15.5	14.8	17.5	16.6	20.7	19.3	22.6
(Percent change in volume)	13.4	8.0	26.3	20.9	23.0	22.1	21.8
Imports of goods (c.i.f.)	40.7	38.4	48.8	46.8	47.4	43.8	47.7
(Percent change in volume)	23.2	7.3	34.1	31.2	1.4	-1.9	12.8
Underlying imports of goods (c.i.f.) 10/	40.7	38.4	45.8	43.9	50.0	46.5	47.7
(Percent change in volume)	23.2	7.3	26.1	22.8	14.1	11.8	6.2
Trade balance	-25.2	-23.6	-31.0	-30.2	-26.6	-24.5	-25.0
Remittances, net	11.1	10.8	14.6	14.1	14.6	14.4	14.6
Current account balance, after grants	-8.9	-9.7	-13.1	-12.5	-9.5	-8.8	-9.5
Foreign direct investment	3.6	6.8	4.3	4.2	6.4	7.7	6.9
Foreign loans, net	3.5	4.0	8.4	8.2	6.4	7.6	5.1
External debt (end of period; billions of U.S. dollars) 5/	11.8	14.3	14.9	14.9	15.2	16.0	16.3
(In percent of GDP)	76.2	69.2	62.0	61.1	57.1	61.1	60.5
Gross official reserves (in billions of U.S. dollars)	2.3	3.6	4.3	4.3	5.6	5.9	6.9
(In months of prospective imports of GNFS)	3.1	3.4	3.7	4.0	4.3	5.2	5.3
REER (annual average change, in percent; – indicates depreciation) 2/	17.1	5.5	-3.5	-3.6	…	-2.7	…

Sources: Statistical Offices of SCG, Serbia, and Montenegro; National Bank of Serbia; State Ministries of Finance; and IMF staff estimates.

1/ Excluding Kosovo (with the exception of foreign debt).
2/ Excluding Montenegro.
3/ Break in series in 2004, when it becomes consistent with Eurostat/ILO definition.
4/ Fiscal operations of all levels of government, except for Montenegro where it excludes local governments.
5/ Including the first phase of the Paris Club debt reduction in 2002 and implementation in 2005 of the London Club agreement.
6/ At current exchange rates.
7/ Excluding frozen foreign currency deposits.
8/ Repo rates refer to 14-day repos. Repo operations replaced the issuance of NBS bills from January 31, 2005 onward.
9/ November 2005.
10/ Corrected for the surge in imports and remittances at end-2004 ahead of the introduction of the VAT in January 2005.

Table 2. Montenegro: Selected Economic Indicators, 2002–06

	2002	2003	2004	2005		2006
			Est.	5th Review	Proj.	Proj.
Real economy						
Nominal GDP (EUR millions)	1,302	1,433	1,535	1,639	1,644	1,759
Average net wage (in euros per month)	142.2	173.9	195.3	...	...	...
			(Percent change)			
Real GDP	1.7	2.3	3.7	3.3	3-4	3-4
Industrial production	0.6	2.4	13.8	...	...	...
Retail prices (period average)	19.7	7.5	3.1	3.6	3.6	3.6
Retail prices (end of period, 12-month)	9.4	6.2	4.2	3.5	3.6	3.6
			(In percent of GDP)			
General government finances 1/						
Revenue	35.1	34.8	36.4	36.3	37.7	37.5
Expenditure	38.6	39.8	39.9	38.9	40.5	39.2
Of which: Interest	1.0	1.0	1.6	...	0.9	0.9
Cash balance (before grants)	-3.8	-4.9	-3.5	-2.7	-2.7	-1.7
Domestic financing (net) 2/	-3.7	1.7	0.6	-9.9	-8.4	-1.8
Privatization receipts	4.9	1.0	0.4	10.0	9.4	2.2
Public debt (end of period, stock) 3/	85.0	48.6	47.8	...	42.3	39.0
External debt	68.7	33.0	32.7	...	32.0	30.8
Domestic debt	16.4	15.7	15.1	...	10.3	8.2
External debt (end of period, stock) 3/	69.4	35.6	39.2	...	41.6	40.7
Public	68.7	33.0	32.7	...	32.0	30.8
Private	0.7	2.6	6.5	...	9.6	9.8
			(In millions of U.S. dollars)			
Balance of payments - IMF 4/						
Exports of goods (f.o.b.)	...	264.8	504.4	493.2	536.0	573.7
Imports of goods (c.i.f.)	...	-762.1	-1,062.6	-1,145.3	-1,175.1	-1,205.5
Current account balance, before grants	...	-265.4	-252.6	-282.1	-251.9	-234.5
(In percent of GDP)	...	-16.4	-13.2	-13.1	-12.3	-11.3

Sources: Ministry of Finance; Central Bank of Montenegro; Statistical Office of Montenegro; and Fund staff estimates.

1/ Excludes local governments.

2/ Includes FFCD repayments.

3/ Data on foreign debt is preliminary.

4/ Balance of Payments data are preliminary. In particular, information regarding the inter-trade between Serbia and Montenegro remains disputed. If data sourced from Montenegro were used the level of the current account deficit would be lower.

Table 3. Serbia and Montenegro: Macroeconomic Framework, 2002–10

	2002	2003	2004	2005	2006	2007	2008	2009	2010
			Est.			Proj.			
Nominal GDP (billions of dinars)	998	1,189	1,421	1,745	2,069	2,362	2,653	2,952	3,263
				(Percent change)					
Real GDP	4.3	2.4	8.8	4.7	4.9	4.9	4.9	4.9	4.9
Retail prices (end-period)	14.2	7.6	13.4	16.6	10.9	7.1	6.2	5.2	4.8
				(In percent of GDP)					
Gross domestic savings	-8.1	-7.3	-5.2	-4.4	-3.2	-1.5	0.6	1.9	3.2
Non-government	-6.4	-7.3	-8.2	-8.9	-9.6	-7.1	-5.0	-3.8	-2.4
Government	-1.7	0.0	2.9	4.5	6.4	5.6	5.6	5.7	5.5
Net factor receipts and transfers from abroad	14.4	12.1	15.2	14.1	13.5	13.4	13.1	12.7	12.3
Non-government	13.3	12.6	16.0	14.9	14.3	14.2	13.8	13.4	12.9
Government	1.1	-0.5	-0.7	-0.9	-0.9	-0.8	-0.7	-0.8	-0.6
Gross national savings	6.3	4.9	10.0	9.7	10.3	11.9	13.6	14.6	15.4
Non-government	6.9	5.4	7.8	6.1	4.8	7.1	8.8	9.7	10.6
Government	-0.6	-0.5	2.2	3.6	5.5	4.9	4.8	4.9	4.9
Gross domestic investment 1/	15.2	14.8	22.5	18.4	19.8	20.2	21.0	21.9	22.7
Non-government 1/	11.8	12.3	19.8	15.6	16.6	17.0	17.8	18.6	19.4
Gross fixed capital formation	9.7	11.6	16.6	15.9	16.3	16.8	17.5	18.3	19.1
Change in inventories	2.1	0.7	3.2	-0.3	0.3	0.3	0.3	0.3	0.3
Government	3.4	2.5	2.7	2.8	3.2	3.2	3.2	3.3	3.3
Savings-investment balance	-8.9	-9.9	-12.5	-8.8	-9.5	-8.3	-7.4	-7.3	-7.2
Non-government	-4.9	-6.9	-12.0	-9.5	-11.8	-9.9	-8.9	-8.9	-8.8
Government	-4.0	-2.9	-0.5	0.8	2.3	1.6	1.6	1.6	1.6
Foreign savings	8.9	9.9	12.5	8.8	9.5	8.3	7.4	7.3	7.2
Foreign savings including official grants	12.9	12.3	14.8	10.2	10.8	9.3	8.3	8.2	8.1
Net exports of goods and services	-23.3	-22.0	-27.7	-22.8	-23.0	-21.7	-20.4	-20.0	-19.5
Memorandum item:									
Current account balance (before grants)	-12.9	-12.3	-14.8	-10.2	-10.8	-9.3	-8.3	-8.2	-8.1

Sources: SCG authorities; and IMF staff projections.

1/ Including changes in inventories. Break in series in 2004.

Table 4. Serbia and Montenegro: Balance of Payments, 2003–09
(In millions of U.S. dollars, unless otherwise indicated)

	2003	2004		2005		2006	2007	2008	2009
		5th Review	Est.	5th Review	Proj.	Proj.			
Trade balance	**-4,886**	**-7,434**	**-7,344**	**-7,064**	**-6,423**	**-6,730**	**-6,793**	**-6,816**	**-7,004**
(In percent of GDP)	-23.6	-31.0	-30.2	-26.6	-24.5	-25.0	-24.1	-23.0	-22.5
Exports f.o.b.	3,054	4,219	4,044	5,503	5,055	6,082	7,208	8,467	9,628
(percent growth)	26.6	38.1	32.4	30.4	25.0	20.3	18.5	17.5	13.7
(percent growth in euro)	5.8	25.8	20.6	23.6	23.9	24.6	20.7	17.1	13.5
Imports c.i.f.	-7,941	-11,653	-11,388	-12,568	-11,477	-12,812	-14,001	-15,283	-16,632
(percent growth)	25.6	46.8	43.4	7.8	0.8	11.6	9.3	9.2	8.8
(percent growth in euro)	5.0	33.6	30.6	2.2	-0.1	15.6	11.3	8.8	8.6
Services (non-factor services, net)	**336**	**486**	**600**	**771**	**443**	**546**	**663**	**758**	**770**
Receipts	1,130	1,678	1,646	2,178	1,987	2,177	2,366	2,497	2,542
Expenditure	-795	-1192	-1046	-1407	-1545	-1631	-1703	-1739	-1772
Net factor income	**-231**	**-293**	**-291**	**-535**	**-468**	**-666**	**-701**	**-752**	**-822**
Of which: Net interest	-222	-274	-272	-514	-448	-666	-701	-752	-822
Earnings	70	81	81	79	97	124	138	145	152
Payments 1/	-291	-354	-352	-593	-545	-790	-839	-897	-974
Unrequited private and official transfers, net	**2,777**	**4,092**	**3,999**	**3,891**	**4,153**	**3,937**	**4,213**	**4,351**	**4,494**
Private remittances, net	**2,239**	**3,510**	**3,437**	**3,891**	**3,780**	**3,937**	**4,213**	**4,351**	**4,494**
Inflows	2,661	4,129	4,035	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Outflows	-422	-620	-598	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Current account balance, before grants	**-2,543**	**-3,731**	**-3,597**	**-2,937**	**-2,668**	**-2,913**	**-2,617**	**-2,460**	**-2,562**
(In percent of GDP)	-12.3	-15.5	-14.8	-11.0	-10.2	-10.8	-9.3	-8.3	-8.2
Adjusted for VAT effect	n.a.	-13.7	-13.1	-12.6	-11.7	n.a.	n.a.	n.a.	n.a.
Official grants 2/	538	583	562	0	373	0	0	0	0
Foreign direct investment, net	1,405	1,028	1,031	1,698	2,020	1,854	1,870	1,919	1,949
Foreign loans, net	822	2,011	1,999	1,707	2,005	1,381	611	612	826
Medium and long term, net	756	1,588	1,606	1,474	1,671	1,181	411	412	626
Disbursements	974	2,119	2,119	2,179	2,235	2,322	2,010	2,300	3,240
Of which : Official creditors 2/	460	537	537	617	527	452	430	450	460
Amortization	-218	-530	-513	-705	-564	-1,142	-1,599	-1,888	-2,614
Short term, net	66	423	393	234	334	200	200	200	200
Other capital inflows	281	296	58	254	372	261	262	263	264
Commercial banks, net	31	26	88	20	207	0	0	0	0
Capital account balance	**2,539**	**3,362**	**3,176**	**3,679**	**4,604**	**3,497**	**2,745**	**2,797**	**3,043**
(Capital account in euro terms)	2,245	2,704	2,555	2,808	3,698	2,909	1,861	1,896	2,062
Errors and omissions	409	432	505	0	-400	0	0	0	0
Overall balance	**943**	**646**	**646**	**742**	**1,908**	**584**	**129**	**338**	**481**
Financing	**-1,001**	**-3,905**	**-3,905**	**-3,012**	**-1,993**	**-2,799**	**-509**	**-725**	**-893**
Net foreign assets (increase, -)	-1,001	-711	-711	-1,240	-1,993	-1,029	-509	-725	-893
Central Bank, net	-1,001	-711	-711	-1,240	-1,993	-1,029	-509	-725	-893
Gross foreign reserves (increase, -)	-1,277	-719	-719	-1,301	-1,967	-1,079	-400	-408	-405
Of which: IMF purchases	276	243	243	276	183	89	0	0	0
Gross foreign liabilities (increase +)	276	8	8	60	-25	50	-109	-317	-487
IMF repayment	0	-235	-235	-215	-208	-39	-109	-317	-487
Arrears (reduction, -) 3/	0	-3,194	-3,194	-1,772	0	-1,770	0	0	0
Financing expected / to be secured	n.a.	n.a.	n.a.	443	0	383	271	276	280
Official grants 2/	n.a.	n.a.	n.a.	410	0	353	271	276	280
Official borrowing (excluding IMF) 2/	n.a.	n.a.	n.a.	33	0	30	0	0	0
Residual gap	59	3,259	3,259	1,827	84	1,832	109	111	132
Arrears settlement with creditors 3/	0	3,194	3,194	1772	0	1,770	0	0	0
Debt relief from creditors	59	65	65	55	84	12	12	12	0
Memorandum items:									
Current account balance, after grants	-2,005	-3,148	-3,036	-2,527	-2,295	-2,560	-2,346	-2,184	-2,282
(In percent of GDP)	-9.7	-13.1	-12.5	-9.5	-8.8	-9.5	-8.3	-7.4	-7.3
Gross international reserves, USD mn (end period)	3,557	4,302	4,302	5,602	5,870	6,949	7,349	7,757	8,163
(In months of prospective imports of goods & services)	3.4	3.7	4.0	4.3	4.9	5.3	5.2	5.1	4.9
Debt service, cash	451	972	972	1,732	1,719	1,971	2,547	3,102	4,075
(In percent of GDP)	2.2	4.1	4.0	6.5	6.6	7.3	9.0	10.5	13.1
Principal	218	675	675	1,076	1,190	1,181	1,708	2,204	3,101
Interest	233	297	297	656	529	790	839	897	974
External Debt 4/	14,303	14,876	14,876	15,173	16,021	16,276	16,876	17,271	17,657
(In percent of GDP)	69.2	62.0	61.1	57.1	61.1	60.5	59.8	58.2	56.7
Underlying external debt 5/	n.a.	16,652	16,652	18,367	17,809	19,615	20,214	20,610	20,996
(In percent of GDP)	n.a.	69.4	68.4	69.1	67.9	73.0	71.6	69.5	67.4
Net external debt (debt minus gross reserves)	9,860	9,714	9,776	8,731	9,561	8,737	8,936	9,514	9,495
(In percent of GDP)	47.6	40.5	40.1	32.8	36.5	32.5	31.6	32.1	30.5

Sources: SCG authorities; and IMF staff estimates.

1/ Debt service due after debt reduction granted by bilateral and commercial creditors, but before capitalization of moratorium interest (in "debt relief").

2/ Official grants and loans recorded above-the-line are amounts based on conservative assumptions; further possible amounts are shown below-the-line.

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

4/ 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 in 2006.

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

Table 5. Serbia and Montenegro: Indicators of External Vulnerability, 2002–05 1/
(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005 Prel.
Financial indicators				
Public sector debt	85.4	79.2	67.3	52.1
Broad money (percent change, 12-month basis)	52.7	27.5	30.3	38.9
Private sector credit (percent change, 12-month basis)	49.6	25.1	47.9	62.6
Weighted deposit interest rates (percent per month, December) 2/	0.2	0.2	0.3	0.3
Retail prices (percent change per annum, end of period)	14.2	7.6	13.4	14.3
External Indicators				
Exports (recorded exports, percent change, 12-month basis in US$)	19.5	29.9	28.4	26.1
Imports (percent change, 12-month basis in US$)	30.7	25.6	43.4	0.8
Current account balance, before grants	-12.9	-12.3	-14.8	-10.2
Current account balance after grants and FDI	-5.3	-2.9	-8.2	-1.0
Errors and omissions	2.1	2.0	2.1	-1.5
Gross official reserves (in US$ million)	2,280	3,557	4,302	5,870
(in months of imports GS of the following year)	3.1	3.4	4.0	4.9
Central Bank short-term foreign liabilities (in US$ million) 3/	100	100	100	100
Gross reserves of the banking system (in US$ million)	3,063	4,443	5,204	6,600
(in months of imports GS of the following year)	4.2	4.3	4.8	5.5
Short term foreign liabilities of the commercial banks (in US$ million)	74	136	136	n.a.
Foreign currency liabilities of the commercial banks (in US$ million)	1,781	2,651	4,493	4,525
Official reserves/Broad money (M2) (in percent)	72	82	80	93
Official reserves/reserve money (in percent)	194	277	320	538
Short term external debt by original maturity (in US$ million) 4/	1,020	1,056	999	925
Short term external debt by remaining maturity (in US$ million) 4/	1,224	1,731	2,075	2,106
Short term external debt by original maturity (in percent of reserves)	44.7	29.7	23.2	15.8
Short term external debt by remaining maturity (in percent of reserves)	53.7	48.7	48.2	35.9
Short term external debt by original maturity (in percent of total debt)	8.6	7.4	6.7	5.8
Short term external debt by remaining maturity (in percent of total debt)	10.3	12.1	13.9	13.1
Total external debt (In US$ millions)	11,839	14,303	14,876	16,021
Of which : Public and publicly guaranteed debt 5/	10,919	13,348	13,977	15,091
Total external debt (in percent of exports of G&S)	365	342	261	228
External interest payments, cash basis (in percent of exports of G&S)	4.3	5.6	5.2	7.5
External amortization payments, cash basis (in percent of exports of G&S)	1.3	5.2	11.9	16.9
Exchange rate, official (per euro, end of period)	61.5	68.3	78.9	85.2
Real effective exchange rate (annual average, 1995= 100) 6/	73.2	77.2	74.5	n.a.
Sovereign long-term credit rating, Standard & Poor's	n.a.	n.a.	B+	B+
Fitch	n.a.	n.a.	BB-	BB-

Sources: SCG 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 6. Serbia and Montenegro: Stock of External Debt at September 30, 2005 1/
(In millions of U.S. dollars)

Creditor	Total Debt	*Of which:* Arrears 2/ Principal	Interest	Late Interest	Total Arrears
Total debt	15,303	1,545	330	504	2,379
Of which:					
Serbia	14,531	1,496	316	460	2,271
Montenegro	772	49	14	45	108
Multilateral institutions	5,199	9	5	8	21
IMF	918	0	0	0	0
IBRD	2,502	0	0	0	0
IDA	450	0	0	0	0
EUROFIMA	148	0	0	0	0
IFC	116	9	5	8	21
EIB	372	0	0	0	0
European Union	338	0	0	0	0
EUROFOND - CEB	28	0	0	0	0
EBRD	329	0	0	0	0
Official bilateral creditors	3,811	331	188	121	640
Paris Club	3,061	0	0	0	0
Other official bilateral creditors	750	331	188	121	640
Commercial creditors	5,131	559	136	376	1,071
London Club	1,162	29	33	12	74
Other commercial creditors: convertible currencies 3/	3,861	435	91	363	889
Other commercial creditors: nonconvertible currencies 3/	108	95	13	0	108
Short-term debt 3/	1,161	646	1	0	647
Trade credits on oil & gas imports 4/	236	236	0	0	236
Other short-term debt	925	410	1	0	411

Sources: SCG authorities, and IMF staff estimates.

1/ Debt figures reflect the Paris Club debt rescheduling agreement (November 2001) and 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.

Table 7. Serbia and Montenegro: General Government Fiscal Operations, 2003–06 1/

	2003	2004	2005		2006	2003	2004	2005		2006
		Est.	5th Review	Proj.	Proj.		Est.	5th Review	Proj.	Proj.
	(in billions of dinars)					(in percent of GDP) 2/				
Total revenue	**507.9**	**633.0**	**762.3**	**771.7**	**922.4**	**42.7**	**45.2**	**44.8**	**44.2**	**44.6**
Current revenue	503.0	626.7	755.3	763.8	911.7	42.3	44.7	44.4	43.8	44.1
Tax revenue (exclud. other taxes)	436.0	540.9	649.5	661.0	794.1	36.7	38.6	38.2	37.9	38.4
Personal income tax	74.3	81.4	93.9	97.7	119.7	6.2	5.8	5.5	5.6	5.8
Social security contributions	126.0	166.0	192.7	200.4	239.6	10.6	11.9	11.3	11.5	11.6
Corporate income tax	6.8	8.1	10.1	11.9	13.5	0.6	0.6	0.6	0.7	0.7
Retail sales tax/VAT	135.3	170.6	223.5	231.4	273.1	11.4	12.2	13.1	13.3	13.2
Excises	62.1	77.8	86.6	76.7	95.7	5.2	5.6	5.1	4.4	4.6
Taxes on international trade	31.4	36.9	42.7	43.1	52.6	2.6	2.6	2.5	2.5	2.5
Nontax revenue and other taxes	67.0	85.8	105.8	102.7	117.6	5.6	6.1	6.2	5.9	5.7
Capital revenue	4.9	6.3	7.0	8.0	10.7	0.4	0.5	0.4	0.5	0.5
Total expenditure and net lending	**547.4**	**637.1**	**742.7**	**756.2**	**873.8**	**46.0**	**45.5**	**43.7**	**43.3**	**42.2**
Current expenditure	509.3	596.1	694.9	700.9	800.5	42.8	42.6	40.9	40.2	38.7
Wages and salaries	123.3	144.6	171.3	184.7	202.5	10.4	10.3	10.1	10.6	9.8
o/w: severance payments	-	-	7.0	4.0	4.1	-	-	0.4	0.2	0.2
Goods, services, and other current spending	99.9	122.1	139.4	130.4	153.1	8.4	8.7	8.2	7.5	7.4
Interest payment	12.2	19.5	21.5	25.0	32.8	1.0	1.4	1.3	1.4	1.6
Subsidies and other current transfers 3/	274.0	309.9	362.6	360.8	412.1	23.0	22.1	21.3	20.7	19.9
Capital expenditure	29.3	38.1	41.5	49.6	66.8	2.5	2.7	2.4	2.8	3.2
o/w: financed by project loans	6.1	9.5	10.6	7.8	6.9	0.5	0.7	0.6	0.4	0.3
Lending minus repayment	8.7	2.9	6.4	5.7	6.5	0.7	0.2	0.4	0.3	0.3
Overall balance	**-39.5**	**-4.1**	**19.6**	**15.5**	**48.6**	**-3.3**	**-0.3**	**1.2**	**0.9**	**2.4**
(Excluding project loans)	-33.4	5.4	30.3	23.3	55.5	-2.8	0.4	1.8	1.3	2.7
Foreign grants	2.7	1.4	4.0	1.6	2.1	0.2	0.1	0.2	0.1	0.1
Overall balance including grants	-36.8	-2.7	23.7	17.2	50.8	-3.1	-0.2	1.4	1.0	2.5
Financing	**36.7**	**2.7**	**-23.7**	**-17.2**	**-50.8**	**3.1**	**0.2**	**-1.4**	**-1.0**	**-2.5**
Domestic financing	-28.4	-19.5	-91.4	-94.2	-110.7	-2.4	-1.4	-5.4	-5.4	-5.3
Bank financing	-17.3	-0.9	-63.4	-71.4	-87.5	-1.5	-0.1	-3.7	-4.1	-4.2
Non-bank financing	-11.1	-18.5	-28.0	-22.7	-23.2	-0.9	-1.3	-1.6	-1.3	-1.1
Foreign Financing	14.2	14.4	15.6	13.2	15.9	1.2	1.0	0.9	0.8	0.8
Privatization receipts	50.9	7.7	52.1	63.8	44.1	4.3	0.6	3.1	3.7	2.1

Sources: Ministry of Finance of the Republic of Serbia and the Republic of Montenegro; and IMF staff estimates.
1/ Includes the union, republican, and local governments (except for Montenegro), social security funds, and extrabudgetary programs.
2/ GDP of Serbia and Montenegro, excluding Kosovo.
3/ Excluding foreign currency deposit payments to households, reclassified below-the-line.

Table 8. Serbia: General Government Fiscal Operations, 2003–06 1/

	2003	2004 Est.	2005 5th Review	2005 Proj.	2006 Proj.	2003	2004 Est.	2005 5th Review	2005 Proj.	2006 Proj.
	(in billions of dinars)					(in percent of GDP) 2/				
Total revenue	**474.9**	**592.7**	**713.0**	**720.3**	**862.5**	**39.9**	**42.3**	**41.9**	**41.3**	**41.7**
Current revenue	470.1	586.6	706.0	712.6	853.6	39.5	41.9	41.5	40.8	41.3
Tax revenue (exclud. other taxes)	405.4	504.1	604.1	614.7	740.9	34.1	36.0	35.5	35.2	35.8
Personal income tax	70.1	76.9	88.3	92.2	113.3	5.9	5.5	5.2	5.3	5.5
Social security contributions	115.8	153.5	178.6	186.1	223.6	9.7	11.0	10.5	10.7	10.8
Corporate income tax	5.9	6.9	8.2	9.8	12.0	0.5	0.5	0.5	0.6	0.6
Retail sales tax/VAT	126.3	159.1	208.9	215.2	253.6	10.6	11.4	12.3	12.3	12.3
Excises	58.3	73.4	80.9	71.6	89.4	4.9	5.2	4.8	4.1	4.3
Taxes on international trade	28.9	34.3	39.2	39.8	49.0	2.4	2.4	2.3	2.3	2.4
Nontax revenue and other taxes	64.7	82.5	101.9	97.9	112.6	5.4	5.9	6.0	5.6	5.4
Capital revenue	4.8	6.1	7.0	7.7	9.0	0.4	0.4	0.4	0.4	0.4
Total expenditure and net lending	**511.9**	**593.0**	**689.7**	**701.0**	**811.2**	**43.0**	**42.3**	**40.6**	**40.2**	**39.2**
Current expenditure	476.5	555.1	646.3	651.6	742.8	40.1	39.6	38.0	37.3	35.9
Wages and salaries	113.2	132.9	157.1	170.3	185.7	9.5	9.5	9.2	9.8	9.0
o/w: severance payments	-	-	7.0	4.0	4.1	-	-	0.4	0.2	0.2
Goods, services, and other current spending	94.9	114.0	129.8	120.3	141.1	8.0	8.1	7.6	6.9	6.8
Interest payment	11.3	17.7	20.3	23.7	31.4	0.9	1.3	1.2	1.4	1.5
Subsidies and other current transfers 3/	257.2	290.5	339.2	337.3	384.6	21.6	20.7	20.0	19.3	18.6
Capital expenditure	27.9	36.0	37.7	44.5	62.2	2.4	2.6	2.2	2.5	3.0
o/w: financed by project loans	5.6	8.3	8.9	6.1	5.8	0.5	0.6	0.5	0.3	0.3
Lending minus repayment	7.4	1.8	5.7	4.9	6.1	0.6	0.1	0.3	0.3	0.3
Net transfer from Montenegro	2.0	-	-	-	-	0.2	-	-	-	-
Overall balance	**-34.9**	**-0.3**	**23.3**	**19.3**	**51.4**	**-2.9**	**-0.0**	**1.4**	**1.1**	**2.5**
(Excluding project loans)	-29.3	8.0	32.2	25.4	57.2	-2.5	0.6	1.9	1.5	2.8
Foreign grants	1.9	0.9	3.4	1.3	1.6	0.2	0.1	0.2	0.1	0.1
Overall balance including grants	-33.0	0.5	26.6	20.6	53.0	-2.8	0.0	1.6	1.2	2.6
Financing	**33.0**	**-0.5**	**-26.6**	**-20.6**	**-53.0**	**2.8**	**-0.0**	**-1.6**	**-1.2**	**-2.6**
Domestic financing	-29.2	-20.1	-77.9	-82.8	-107.8	-2.5	-1.4	-4.6	-4.7	-5.2
Bank financing	-17.5	0.0	-50.6	-60.7	-85.3	-1.5	0.0	-3.0	-3.5	-4.1
Non-bank financing	-11.7	-20.1	-27.3	-22.0	-22.4	-1.0	-1.4	-1.6	-1.3	-1.1
Foreign Financing	12.9	12.3	12.8	11.2	14.2	1.1	0.9	0.8	0.6	0.7
Privatization receipts	49.3	7.2	38.5	51.0	40.5	4.1	0.5	2.3	2.9	2.0

Sources: Ministry of Finance of the Republic of Serbia; and IMF staff estimates.
1/ Includes the union, republican, and local governments, social security funds, and extrabudgetary programs in Serbia.
2/ GDP of Serbia and Montenegro, excluding Kosovo.
3/ Excluding foreign currency deposit payments to households, reclassified below-the-line.

Table 9. Serbia: Republican Government Fiscal Operations, 2002-06
(In percent of GDP) 1/

	2002	2003	2004 Est.	2005 5th Review	2005 Proj.	2006 Proj.
A Total revenue and grants (1+2+3)	**25.6**	**24.6**	**25.1**	**26.5**	**25.5**	**25.9**
1. Total revenue	**24.7**	**24.2**	**25.0**	**26.3**	**25.4**	**25.8**
1.1. Current revenue	24.7	24.2	25.0	26.3	25.4	25.8
1.1.1 Tax revenue, excl. other taxes	21.2	21.2	21.6	22.9	22.1	22.5
1.1.1.1 Personal income tax	4.4	4.4	3.9	3.1	2.8	3.0
1.1.1.2 Corporate income tax	0.4	0.4	0.5	0.5	0.5	0.5
1.1.1.3 Turnover tax 2/	9.4	9.1	9.6	12.3	12.3	12.3
1.1.1.4 Taxes on international trade	2.4	2.4	2.4	2.3	2.3	2.4
1.1.1.5 Excises	4.5	4.9	5.2	4.8	4.1	4.3
1.1.2 Non-tax revenue and other taxes	3.5	3.0	3.4	3.4	3.4	3.3
1.2. Capital revenue	0.0	0.0	0.0	0.0	0.0	0.0
2. Transfer from Montenegro	0.0	0.0	0.2	0.0	0.0	0.0
3. Grants	1.0	0.2	0.1	0.2	0.1	0.1
B. Total expenditure and net lending (1+5)	**29.1**	**27.2**	**25.9**	**25.2**	**24.7**	**23.9**
1. Total expenditure (2+3+4)	29.0	26.6	25.9	24.9	24.5	23.6
2. Current expenditure	27.1	24.5	23.6	23.3	22.9	21.7
2.1. Expenditure on goods and services	5.9	7.4	6.9	6.7	7.3	7.1
2.1.1 Wages and salaries	3.5	4.6	4.2	4.0	4.2	3.9
2.1.2 Employer contribution	0.8	0.9	0.8	0.8	0.8	0.8
2.1.3 Severance payments	0.0	0.0	0.0	0.1	0.1	0.1
2.1.4 Other purchases of goods and services	1.5	1.7	1.7	1.4	1.9	1.8
2.2. Interest payment	0.7	0.9	1.0	1.2	1.0	1.1
2.3. Subsidies and other current transfers	20.6	16.2	15.6	15.4	14.6	13.4
2.3.1 Subsidies	3.4	2.6	2.5	1.8	1.6	1.4
2.3.2 Transfers to households 3/	3.2	3.1	2.3	2.5	2.7	2.5
2.3.3 Current transfers to other levels of government	14.0	10.4	10.8	11.2	10.3	9.5
Federal budget	6.9	2.7	3.3	2.9	2.9	2.7
Local Budgets	1.3	1.2	1.0	2.1	1.6	1.5
Pension Funds	4.9	5.4	5.0	4.9	4.7	4.1
Health Fund	0.4	0.3	0.2	0.2	0.2	0.0
Labor Market Fund	0.3	0.4	0.6	0.5	0.5	0.5
3. Capital expenditure	1.9	1.8	2.2	1.5	1.6	1.9
4. General reserves	0.0	0.0	0.0	0.1	0.0	0.0
5. Lending minus repayment	0.1	0.6	0.1	0.3	0.3	0.3
Overall budget balance excluding grants	**-4.5**	**-2.8**	**-0.9**	**1.1**	**0.7**	**1.9**
Overall budget balance including grants	-3.5	-2.6	-0.8	1.3	0.7	2.0
Overall budget balance excluding grants and project loans	-3.7	-2.3	-0.3	1.6	1.0	2.2

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

1/ GDP of Serbia and Montenegro, excluding Kosovo.
2/ Retail sales tax up to 2004. VAT from 2005 onward.
3/ Excluding frozen foreign currency deposit payments to households, reclassified below the line.

Table 10. Montenegro: Consolidated Fiscal Operations, 2002–06
(In percent of Montenegro GDP)

	2002	2003	2004	2005		2006
			Est.	5th Review	Proj.	Proj.
Total revenue	**35.1**	**35.0**	**36.4**	**36.3**	**37.7**	**37.5**
Current revenue	35.1	34.9	36.1	36.3	37.6	36.4
Tax revenue	32.8	32.8	34.4	34.7	35.8	35.1
Personal income tax	4.4	4.5	4.2	4.2	4.0	4.0
Social security contributions	11.5	10.6	11.2	10.3	10.5	10.0
Corporate income tax	1.0	0.9	1.1	1.4	1.5	0.9
VAT (Retail sales tax until March 2003)	8.3	9.7	10.3	10.7	11.9	12.2
Excises	4.3	4.1	4.0	4.2	3.7	3.9
Taxes on international trade	3.0	2.7	2.4	2.6	2.4	2.3
Other taxes 1/	0.4	0.2	1.3	1.3	1.8	1.8
Nontax revenue	2.3	2.2	1.7	1.5	2.0	1.2
Capital revenue	0.0	0.1	0.2	0.0	0.2	0.2
Repayment of old fiscal claim	...	...	...	...	...	0.9
Total expenditure and net lending	**38.6**	**37.8**	**37.6**	**36.4**	**37.9**	**36.8**
Current expenditure	35.5	34.2	33.9	32.4	32.0	31.5
Net wages, salaries and allowances	10.0	9.0	9.5	9.1	9.1	9.0
Payroll tax	1.1	1.5	1.7	1.4	1.5	1.5
Purchases of goods and services	3.7	4.2	3.5	3.4	3.5	3.6
Interest payment	1.0	1.0	1.6	0.9	0.9	0.9
Subsidies and other current transfers	19.0	18.0	16.9	17.2	16.7	16.2
Subsidies to enterprises	1.9	1.0	0.6	0.4	0.4	0.4
Transfers to households	17.1	17.0	16.3	16.8	16.3	15.9
Transfers to local government	0.0	0.0	0.0	0.0	0.1	0.1
Other non-interest current expenditure	0.6	0.5	0.7	0.4	0.2	0.2
General reserves 2/	1.0	0.6	0.7	0.7	1.1	1.2
Capital expenditure	1.5	1.6	2.0	2.8	3.8	2.9
Of which : foreign financed project spending	0.6	0.6	1.2	1.3	1.3	0.7
Domestic arrears	0.0	0.0	0.0	0.0	0.6	0.9
Of which : army						
Net lending	0.7	1.4	1.0	0.5	0.5	0.2
Transfer to the Union Budget	**0.0**	**2.2**	**2.3**	**2.6**	**2.5**	**2.4**
Of which: Wages and salaries	...	...	...	1.7	1.7	1.0
Discrepancy	0.3	-0.1	0.0	0.0	0.0	0.0
Overall balance before grants	**-3.8**	**-4.9**	**-3.5**	**-2.7**	**-2.7**	**-1.7**
Overall balance before grants and foreign-financed project loans	**-3.3**	**-4.4**	**-2.4**	**-1.4**	**-1.5**	**-1.0**
Foreign grants	2.1	0.9	0.5	0.5	0.2	0.3
Overall balance	**-1.8**	**-4.1**	**-3.1**	**-2.2**	**-2.5**	**-1.4**
Financing	**1.8**	**4.1**	**3.1**	**2.2**	**2.5**	**1.4**
Domestic financing	**-3.7**	**1.7**	**0.6**	**-9.9**	**-8.4**	**-1.8**
Bank financing	-3.4	1.1	-0.8	-9.4	-7.8	-1.3
Nonbank financing	-0.3	0.6	1.4	-0.5	-0.5	-0.5
Of which: Repayment of FFCDs 2/	-0.3	0.0	-0.3	-0.5	-0.5	-0.5
Foreign financing (net)	**0.6**	**1.3**	**2.0**	**2.1**	**1.5**	**1.0**
Program	0.0	0.8	0.9	0.9	0.4	0.7
Project	0.6	0.6	1.2	1.3	1.2	0.7
Amortisation	0.0	0.0	-0.1	-0.1	-0.2	-0.4
Privatization receipts	**4.9**	**1.0**	**0.4**	**10.0**	**9.4**	**2.2**
Of which : army	...	...	...	...	0.8	...
Memorandum item						
Public sector wage bill (incl. Union army in Montenegro; percent of GDP)	...	...	...	10.8	10.8	10.0
Montenegro Development Fund (Euro millions)	...	...	...	...	...	0.0
Privatization receipts 3/	...	...	...	...	...	35.1
Increase in deposits	...	...	...	...	...	-35.1
Montenegro GDP (Euro million)	1,302	1,433	1,535	1,639	1,644	1,759

Sources: Ministry of Finance of Montenegro; and Fund staff estimates and projections.

1/ 2004 includes previously off-budget revenue and spending, most of which represents an excise surtax on petrol products to finance transportation sector project spending.

2/ Unallocated budgetary reserves; in 2006, possible election costs (€ 5 million) and contingency payments for social transfers were added to reserves.

3/ Expected privatization receipts from KAP.

Table 11. Serbia: Monetary Survey, 2004–06
(In millions of SRD; end of period) 1/

	2004	2005									2006			
	Dec.	Mar.	Jun.		Sep.		Nov.	Dec.			Mar.	Jun.	Sep.	Dec.
	Act.	Act.	Prog.	Act.	Prog.	Act.	Act.	Prog.	Proj.		Proj.	Proj.	Proj.	Proj.
										5/				
Net Foreign Assets 2/	196,631	200,818	204,199	221,362	225,833	245,537	256,855	252,046	268,701	320,860	330,000	329,916	358,527	369,451
(NFA in euro m.)	2,493	2,546	2,589	2,806	2,863	3,113	3,256	3,195	3,406	3,705	3,811	3,810	4,140	4,266
Assets	298,180	304,837	305,904	326,351	329,314	363,323	378,874	363,206	398,633	469,842	490,120	491,294	522,168	537,785
NBS	245,936	258,450	261,600	275,993	281,076	315,633	335,620	312,113	351,705	416,267	439,163	441,227	472,795	490,354
Commercial banks	52,244	46,387	44,304	50,357	48,238	47,691	43,254	51,093	46,928	53,575	50,958	50,066	49,372	47,431
Liabilities (-)	-101,549	-104,020	-101,706	-104,989	-103,480	-117,786	-122,019	-111,160	-129,932	-148,981	-160,121	-161,377	-163,640	-168,334
NBS	-67,842	-63,931	-70,281	-60,448	-67,279	-68,538	-67,518	-70,463	-66,203	-77,793	-82,328	-81,016	-80,343	-78,799
Commercial banks	-33,706	-40,089	-31,424	-44,541	-36,201	-49,248	-54,501	-40,697	-63,729	-71,188	-77,793	-80,362	-83,297	-89,536
Net Domestic Assets 3/	112,093	104,126	113,617	117,187	114,497	134,158	138,523	104,126	137,597	108,088	97,596	129,893	136,838	144,910
Domestic credit	248,149	254,833	…	282,157	…	310,689	348,495	…	352,260	363,790	…	…	…	…
Net credit to government 3/	-21,752	-42,148	-35,289	-37,663	-50,529	-51,427	-57,398	-78,146	-74,146	-74,146	-92,379	-105,090	-137,621	-159,454
Credit	30,402	30,856	…	25,832	…	24,399	21,756	…	…	…	…	…	…	…
Dinar credit	30,255	30,409	…	25,519	…	23,793	21,143	…	…	…	…	…	…	…
NBS	21,427	21,235	…	16,636	…	16,013	15,012	…	…	…	…	…	…	…
Commercial banks	8,828	9,174	…	8,883	…	7,780	6,131	…	…	…	…	…	…	…
Foreign currency credits	147	447	…	313	…	606	613	…	…	…	…	…	…	…
NBS	0	0	…	0	…	0	0	…	…	…	…	…	…	…
Commercial banks	147	447	…	313	…	606	613	…	…	…	…	…	…	…
Liabilities	-52,154	-73,005	…	-63,495	…	-75,826	-79,154	…	…	…	…	…	…	…
Dinar liabilities	-38,762	-52,005	…	-51,297	…	-58,428	-64,920	…	…	…	…	…	…	…
NBS	-28,064	-40,592	…	-36,531	…	-42,847	-49,310	…	…	…	…	…	…	…
Commercial banks	-10,698	-11,413	…	-14,766	…	-15,581	-15,610	…	…	…	…	…	…	…
Foreign currency deposits	-13,392	-21,000	…	-12,198	…	-17,398	-14,234	…	…	…	…	…	…	…
NBS	-9,993	-17,557	…	-6,110	…	-13,274	-7,164	…	…	…	…	…	…	…
Commercial banks	-3,399	-3,442	…	-6,088	…	-4,124	-7,070	…	…	…	…	…	…	…
Short-term government credits to banks	-363	-450	…	-444	…	-506	-502	…	-500	-500	-500	-500	-500	-500
Purchased FFCD bonds	8,240	10,187	10,000	9,727	11,500	12,736	10,622	12,500	11,500	12,500	12,500	14,000	14,000	14,000
Credit to the non-government sector	262,024	287,244	294,712	310,537	312,907	349,886	395,773	332,811	415,406	425,936	441,610	488,099	529,553	560,120
Households	64,441	69,844	…	82,569	…	102,707	120,175	…	…	…	…	…	…	…
Non-profit and other sectors	2,397	2,205	…	2,359	…	3,399	3,946	…	…	…	…	…	…	…
Non-profit and other sector in dinar	2,081	1,929	…	2,021	…	3,072	3,389	…	…	…	…	…	…	…
Non-profit and other sector in fx	316	275	…	338	…	327	557	…	…	…	…	…	…	…
Enterprises in dinar	138,382	157,584	…	169,162	…	188,914	215,221	…	…	…	…	…	…	…
Enterprises in foreign currency	56,804	57,612	…	56,446	…	54,866	56,430	…	…	…	…	…	…	…
Enterprises in fx (euro million)	720	843	…	826	…	803	826	…	…	…	…	…	…	…
Other items, net.	-136,056	-150,707	-155,806	-164,970	-159,381	-176,531	-209,972	-163,039	-219,850	-255,702	-263,635	-266,616	-268,594	-269,256
Broad Money (M2)	308,725	304,944	317,816	338,549	340,331	379,696	395,378	356,172	406,298	428,948	427,595	459,810	495,366	514,361
Dinar-denominated M2	132,249	124,129	128,479	139,277	135,408	156,528	159,274	141,238	165,298	165,298	157,574	170,918	183,663	190,106
M1	106,112	99,676	104,436	112,136	108,910	124,436	124,039	113,404	131,298	131,298	125,384	134,199	143,486	146,512
Currency outside banks	45,165	39,368	41,416	42,316	43,087	47,283	44,271	46,972	46,972	46,972	42,744	46,500	49,884	51,434
Demand deposits	60,947	60,308	63,019	69,820	65,823	77,153	79,768	66,432	84,326	84,326	82,640	87,699	93,602	95,078
Time and savings deposits	26,137	24,453	24,043	27,141	26,497	32,092	35,235	27,834	34,000	34,000	32,190	36,718	40,177	43,594
Fx-deposits (non-frozen)	176,476	180,815	189,337	199,272	204,923	223,167	236,104	214,934	241,000	263,650	270,021	288,892	311,702	324,254
Fx-deposits (non-frozen; euro million)	2,237	2,292	2,400	2,526	2,598	2,829	2,993	2,725	3,055	3,044	3,118	3,336	3,599	3,744
Memorandum items: 4/														
Broad money at curr. exchange rates (SRD billion)	308.7	311.3	327.2	352.8	355.4	396.1	417.8	377.2	429.9	428.9	433.1	472.8	517.3	545.5
Fx-deposits at curr. exchange rates (SRD billion)	176.5	187.1	198.7	213.5	220.0	239.6	258.5	236.0	264.6	263.7	275.5	301.9	333.6	355.4
12-month growth rates (in percent)														
Broad Money (M2)	30.3	31.1	31.1	41.4	25.8	40.2	41.9	22.2	39.2	38.9	39.1	34.0	30.6	27.2
Dinar-denominated M2	13.0	17.6	14.1	23.7	11.7	29.1	29.6	6.8	25.0	25.0	26.9	22.7	17.3	15.0
M1	8.0	12.6	10.9	19.1	9.0	24.6	27.2	6.9	23.7	23.7	25.8	19.7	15.3	11.6
Currency outside banks	5.1	3.6	2.7	4.9	1.5	11.4	12.0	4.0	4.0	4.0	8.6	9.9	5.5	9.5
Fx-deposits	43.0	41.9	45.1	54.1	36.4	48.5	50.7	33.7	49.9	49.4	47.2	41.4	39.2	34.8
Velocity (M1)	13.2	15.5	15.2	14.2	15.1	13.2	13.7	15.2	13.1	13.1	14.9	14.1	13.5	13.7
Multiplier (Dinar M2/Reserve money)	1.7	1.9	1.9	1.9	1.9	2.0	2.2	2.0	2.1	2.1	2.1	2.2	2.2	2.2
Currency/Dinar deposits (in percent)	51.9	46.4	47.2	43.6	46.3	43.3	38.5	49.5	39.7	43.6	37.2	37.4	37.3	37.1
Required reserve ratio (effective, in percent)	24.1	24.4	24.2	22.5	24.2	22.6	20.9	24.2	22.7	20.7	21.8	21.8	21.8	21.8
Excess reserves/Dinar deposits (in percent)	9.1	9.1	6.2	8.7	6.1	8.4	7.8	7.1	8.0	8.8	6.2	5.7	5.3	5.1
Fx-deposits/Broad money	57.2	60.1	60.7	60.5	61.9	60.5	61.9	62.6	61.5	61.5	63.6	63.9	64.5	65.2
SRD-denominated M2/ annualized monthly GDP	9.4	8.0	8.1	8.8	8.2	9.5	9.4	8.2	9.6	9.6	8.4	9.0	9.5	9.5

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 preceeding 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 valued at current exchange rates.
5/ Program exchange rates for end-2005.

Table 12. Serbia and Montenegro: Medium-Term Baseline and Alternative Scenario, 2002-2010
(In percent of GDP, unless otherwise indicated)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
			Est.	Proj.					
					Baseline				
Real GDP growth (in percent)	4.3	2.4	8.8	4.7	4.9	4.9	4.9	4.9	4.9
GDP deflator (in percent)	24.0	16.3	9.8	17.3	13.1	8.7	7.1	6.1	5.4
General government fiscal balance 1/	-4.5	-3.3	-0.3	0.9	2.4	2.0	2.0	2.0	2.0
General government debt (gross) 1/	85.4	79.2	60.2	52.1	45.9	41.1	37.0	33.5	30.3
Trade balance	-25.2	-23.6	-30.2	-24.5	-25.0	-24.1	-23.0	-22.5	-21.9
Current account balance (before grants)	-12.9	-12.3	-14.8	-10.2	-10.8	-9.3	-8.3	-8.2	-8.1
Foreign direct investment	3.6	6.8	4.2	7.7	6.9	6.6	6.5	6.3	6.0
External debt (end of period)	76.2	69.2	61.1	61.1	60.5	59.8	58.2	56.7	55.7
Gross official reserves (in billions of U.S. dollars)	2.3	3.6	4.3	5.9	6.9	7.3	7.8	8.2	8.6
					Alternative Scenario ("slow reform")				
Real GDP growth (in percent)	4.3	2.4	8.8	4.7	3.0	3.0	3.0	3.0	3.0
GDP deflator (in percent)	24.0	16.3	9.8	17.3	13.1	8.7	7.1	6.1	5.4
General government fiscal balance 1/	-4.5	-3.3	-0.3	0.9	1.2	0.0	0.0	0.0	0.0
General government debt (gross) 1/	85.4	79.2	60.2	52.1	46.3	43.0	40.7	39.3	38.0
Trade balance	-25.2	-23.6	-30.2	-24.5	-25.2	-25.8	-26.1	-25.9	-25.2
Current account balance (before grants)	-12.9	-12.3	-14.8	-10.2	-11.0	-11.4	-12.2	-12.7	-13.0
Foreign direct investment	3.6	6.8	4.2	7.7	6.5	6.2	5.8	5.5	5.4
External debt (end of period)	76.2	69.2	61.1	61.1	62.1	64.2	67.5	71.4	75.6
Gross official reserves (in billions of U.S. dollars)	2.3	3.6	4.3	5.9	6.8	7.0	7.3	7.5	7.8

Sources: SCG authorities; and IMF staff estimates and projections.

1/ Coverage as in Table 1.

Table 13. 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	161.7	62.9	85.0	148.5	254.6	255.9	149.7
In millions of U.S. dollars	…	10.2	13.3	17.1	252.8	237.7	92.6	125.3	219.2	375.7	377.6	220.9
In percent of exports of goods and NFS	…	0.4	0.4	0.4	4.4	3.4	1.1	1.3	2.0	3.1	2.8	1.5
In percent of debt service	…	9.6	7.3	3.9	26.0	13.8	4.7	4.9	7.1	9.2	8.6	4.8
In percent of quota	…	1.7	2.2	2.6	36.7	34.6	13.4	18.2	31.8	54.4	54.7	32.0
In percent of gross official reserves	…	0.9	0.6	0.5	5.9	4.0	1.3	1.7	2.8	4.6	4.4	2.5
Fund credit outstanding												
In millions of SDRs	116.9	216.9	416.9	616.9	621.0	793.8	829.2	779.2	662.5	433.3	193.8	52.1
In millions of U.S. dollars	154.2	280.2	539.9	862.6	913.5	1166.7	1221.3	1149.2	977.6	639.4	285.9	76.9
In percent of quota	25.0	46.4	89.1	131.9	132.8	169.7	177.3	166.6	141.7	92.7	41.4	11.1
In percent of GDP	1.8	2.4	3.5	4.2	3.8	4.5	4.5	4.1	3.3	2.1	0.9	0.2
In percent of gross official reserves	29.9	24.0	23.7	24.2	21.2	19.9	17.6	15.6	12.6	7.8	3.3	0.9
Memorandum items:												
Exports of goods and NFS (millions of US$)	2,547	2,743	3,241	4,184	5,690	7,042	8,259	9,574	10,964	12,170	13,486	14,749
Debt service, after debt relief (millions of US$)	56	107	183	436	972	1,719	1,971	2,547	3,102	4,075	4,373	4,617
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	3,557	4,302	5,870	6,949	7,349	7,757	8,163	8,565	8,915

Sources: SCG 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 14. Serbia and Montenegro: Proposed Schedule of Purchases
Under the Extended Arrangement

	Available on or after	Amount of Purchase In millions of SDRs	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	July 28, 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	Purchased.
10.	February 15, 2005	125.0	26.7	Purchased.
11.	November 15, 2005	62.5	13.4	Observance of the relevant July-December 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 15. Serbia and Montenegro: External Financing Requirements and Sources, 2002–08
(In millions of U.S. dollars)

	2002	2003	2004	2005	2006	2007	2008
			Est.		Proj.		
1. Gross financing requirements	**-3,200**	**-4,039**	**-8,258**	**-5,786**	**-7,038**	**-4,725**	**-5,072**
External current account deficit (excl. official transfers)	-2,007	-2,543	-3,597	-2,668	-2,913	-2,617	-2,460
Debt amortization	-43	-218	-513	-942	-1,237	-1,599	-1,888
Medium- and long-term debt	-43	-190	-463	-564	-1,142	-1,599	-1,888
Short-term debt 1/	0	-28	-50	-378	-95	0	0
Repayment of arrears	-39	0	-3,194	0	-1,770	0	0
Gross reserve accumulation	-1,111	-1,277	-719	-1,967	-1,079	-400	-408
IMF repurchases and repayments	0	0	-235	-208	-39	-109	-317
2. Financing	**3,200**	**4,039**	**8,258**	**5,702**	**6,592**	**4,344**	**4,685**
Official grants 2/	624	538	562	373	0	0	0
Foreign direct investment (net)	562	1,405	1,031	2,020	1,854	1,870	1,919
Disbursement from private creditors	236	580	1,975	2,420	2,165	1,780	2,050
Medium and long-term financing	78	514	1,582	1,708	1,870	1,580	1,850
Short-term financing and other capital inflows	158	66	393	712	295	200	200
Disbursement from official creditors 2/	343	460	537	527	452	430	450
Multilateral 3/	285	341	507	472	452	430	450
Other	58	119	30	54	0	0	0
IMF disbursement	295	276	243	183	89	0	0
Accumulation of arrears (exceptional)	0	0	0	0	0	0	0
Debt Relief	71	59	3,259	0	1,770	0	0
Other flows 4/	1,069	721	652	179	261	265	266
3. Financing Gap	**0**	**0**	**0**	**84**	**446**	**380**	**387**
Expected disbursements of grants from donors 2/	0	0	0	0	353	271	276
EU	0	0	0	0	24	0	0
Others (mostly official bilateral creditors)	0	0	0	0	329	271	276
Expected disbursement of loans from donors 2/	0	0	0	0	30	0	0
World Bank	0	0	0	0	0	0	0
IMF	0	0	0	0	0	0	0
EBRD	0	0	0	0	0	0	0
EIB	0	0	0	0	0	0	0
EU	0	0	0	0	30	0	0
Others (mostly official bilateral creditors)	0	0	0	0	0	0	0
Debt relief	0	0	0	84	12	12	12
4. Residual Financing Gap	**0**	**0**	**0**	**0**	**51**	**98**	**100**

Sources: SCG 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. In particular, part of expected EU grant and loan assistance had not yet been approved at the time of preparation of the staff report.

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.

Serbia and Montenegro: Fund Relations

As of December 31, 2005

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

II. **General Resources Account**	SDR Million	%Quota
Quota	467.70	100.00
Fund Holdings of Currency	1,073.96	229.63

III. **SDR Department**	SDR Million	%Allocation
Net cumulative allocation	56.66	100.00
Holdings	21.16	37.33

IV. **Outstanding Purchases and Loans**	SDR Million	%Quota
Extended arrangement	587.50	125.61
Stand-by arrangements	18.75	4.01

V. **Latest Financial Arrangements**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
EFF	5/14/02	2/28/06	650.00	587.50
Stand-by	6/11/01	5/31/02	200.00	200.00

VI. **Projected Obligations to Fund (Expectation Basis)**[1]
(In millions of SDR; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	27.08	50.00	116.67	187.50	166.67
Charges/Interest	26.41	25.20	22.01	15.61	8.20
Total	53.49	75.20	138.68	203.11	174.87

[1] 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.

VII. **Safeguards Assessments:**

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 May 13, 2002. 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 (4/26/02). The proposed remedies by the mission are being implemented.

VIII. **Exchange Arrangement**

Serbia and Montenegro 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 concluded on June 29, 2005.

X. **FSAP Participation**

Serbia participated in the Financial Sector Assessment Program during 2005, and the Financial System Stability Assessment report will be discussed in relation with this review.

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

Department	**Timing**	**Purpose**
MFD/FAD	July 2005	Management of Proceeds of Privatization and Review of PFM (Montenegro)
FAD	July 2005	Public-Private Partnership (Serbia)
MFD	Oct. 2005	Monetary Policy
STA	Nov. 2005	National Accounts Statistics
MFD	Nov. 2005	Monitoring and managing risks emanating from foreign exchange indexed borrowing

Technical assistance missions during the past 12 months from FAD, MFD and STA have contributed significantly to strengthening public debt management (in Montenegro); identifying the risks associated with PPPs (in Serbia); creating a market-based financial system; and improving statistical data provision.

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 directions for NBS reorganization.

XII. **Resident Representative**

Mr. Harald Hirschhofer took up his position as Resident Representative in September 2004.

Serbia and Montenegro: IMF-World Bank Relations

Partnership with Serbia and Montenegro's Development Strategy

1. The government of SCG 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 reviewed by the IMF Executive Board on March 2, 2004 and by the Bank's Board of Directors on March 16, 2004. Progress reports were prepared in 2005 and are currently reviewed by Bank and Fund staff. Support for the Government's development strategy from the World Bank and the IMF follow the agreed upon division of responsibilities between the two institutions.

2. In the context of a program supported by a three-year Extended Arrangement (EA) the Fund takes the lead on macroeconomic policies (fiscal, monetary, and exchange rate) 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.

3. 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 investment lending program is described more fully below.

World Bank Group Strategy

4. A Joint World Bank-IFC Country Assistance Strategy covering FY05-07 was endorsed by the Bank's Board of Directors on December 16, 2004. The CAS has three goals: (i) creating a smaller, more sustainable and more efficient public sector; (ii) creating a larger, more dynamic private sector; and (iii) reducing poverty levels and improving social protection and access to public services. As outlined in the FY05-07 Country Assistance Strategy, the Bank's adjustment lending assistance in Serbia will have a series of up to four envisaged Programmatic Development Policy Lending (DPL) operations, concentrating on two parallel streams: (i) the development of a robust private sector through the Programmatic Private and Financial DPLs; and (ii) the development of a smaller and more efficient public sector through the Programmatic Public Sector DPLs.

5. 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, eight operations have been approved, six in Serbia and two in Montenegro. The latest is a Programmatic and Financial Sector Development Policy Credit, approved by the World Bank Board on December 6, 2005. It supports a reduction in subsidies to enterprises and improvements in the financial sector through privatization of state banks and developing the capacity of the regulatory authority. The first Public Sector Development Policy Loan is scheduled for Board consideration in May 2006, with the goals of supporting a move to a smaller and more efficient public sector.

6. The Bank's program of adjustment lending has been underpinned by analytical studies. The Bank recently finalized an Economic Memorandum for Serbia focusing on the agenda for sustained growth and employment creation and a Public Expenditure and Institutional Review is nearing completion. Reports on agriculture and labor markets are currently under preparation. An Economic Memorandum for Montenegro has just been completed. The recently completed FSAP and Accounting and Auditing ROSC identified a number of key concerns for the authorities.

7. 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 Efficiency 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, an education reform project was recently approved on March 31, 2005. The Bank also supports an Environmental Improvement project, an Energy Learning and Innovation Credit, a Pension System Administration and Improvement Project and a Health Reform project. As of end-April 2005, 21 IDA credits totaling $590 million had been approved for SCG, with adjustment support comprising the majority.

IFC

8. As of October 2005, IFC has committed about $227 million in Serbia and Montenegro. During FY05, IFC committed about $106 million in 5 projects, of which 4 projects were in the financial markets. Donor supported technical assistance (TA) has been an important component of the IFC strategy. The TA work program has reached all sectors through a broad range of delivery methods from market diagnostic surveys, to sector analyses and capacity building programs, to highly specialized restructuring and privatization assistance in the financial sector and real sector.

9. ***In the financial sector***, IFC has been instrumental in catalyzing foreign strategic investors' interest and establishing viable financial institutions. It supported the first

Microfinance Bank, the establishment of Raiffeisen Bank and Raiffeisen Leasing, and supported HVB Serbia to enable it to expand long-term lending, particularly to SMEs, mortgage operations, and lending relating to commercial and residential real estate development. IFC pursued its commercial microfinance strategy by investing in Opportunity Bank Montenegro and in Procredit in Serbia and in Kosovo. It supported debt restructuring of Udruzena Vojvodjanska Banka (UVB) successor banks (Continental Bank, Novosadska Banka, Panonska Banka, Vojvodjanksa Banka and Privredna Bank Pancevo), resolving the issue of arrears due to IFC and participating banks. In Montenegro, the agreement between IFC and the Government of Montenegro on the restructuring of IFC's claims on Montenegrin enterprises and banks is paving the way for additional IFC restructuring and privatization support in the financial sector. IFC already supported the restructuring of Podgoricka Banka through a loan and an equity investment, and has pipeline projects in the financial sector that are helping turn around some of the promising banks and create vibrant financial institutions.

10. ***In the corporate sector***, IFC has provided a loan and an equity investment to Tigar Rubber Company, a leading regional producer of high quality car tires. The financing was accompanied by extensive technical assistance to the company and its SME suppliers implementing a "Supply Chain Management" scheme, which resulted in a high development impact. With the privatization of the real sector taking place, IFC is building a solid pipeline with projects in agribusiness, retail, and real estate sectors. IFC's strategy is to help domestic companies upgrade to EU standards and become more competitive in both domestic and regional markets. It is also looking for opportunities to support local companies become regional players by expanding in FYR Macedonia and Bosnia and Herzegovina, as well as to encourage companies from other countries, such as Croatia and Slovenia, to invest in Serbia and Montenegro.

11. ***In the SME sector***, IFC through SEED has delivered programs to promote SMEs through corporate governance, management training, business planning assistance, leasing initiatives, and linkages between large companies and SME sector. SEED programs also foster standardization and best practices to help local companies. As part of its Alternative Resolution program in Southeast Europe, IFC has launched a center for mediation in Belgrade. With SEED's mandate completed in June 2005, IFC started new programs through the Private Enterprise Partnership South Europe (PEP-SE) that targets SME development in the areas of: (i) access to finance; (ii) business enabling environment and access to markets; and (iii) supply chain linkages.

12. ***In the infrastructure sector***, in tandem with the Bank's program of support, IFC is committed to supporting the restructuring and preparation for privatization of the sector, as well as facilitating private sector participation in the sector. IFC is advising the City of Belgrade on the restructuring and concession of solid waste as well as water and wastewater sector. Also, in order to help public sector entities to attract private sector participation and investments in infrastructure, in July 2005 IFC started its PEP-SE Infrastructure facility. The facility will cover Southeast region including Serbia and Montenegro.

13. IFC's program development, however, depends on further implementation of the Governments reform agenda, the creation of a favorable business climate, and the acceleration of the privatization process. While in the short term IFC will continue to expand its activities in the real and financial sectors, in the longer term IFC will look for opportunities to support Serbia and Montenegro with investments in the energy, telecommunication, and transportation sectors.

MIGA

14. As of October 2005, MIGA's outstanding guarantee portfolio in SCG consisted of 17 contracts of guarantee with a total gross and net exposure of $400 million and $180 million, respectively (6 percent of total net exposure). MIGA's guarantee program in SCG has focused on the financial sector. Fifteen contracts are in the financial sector, ten of which with entities of the Raiffeisen Group, one in the services sector, and one in the manufacturing sector. MIGA is also providing technical assistance to SCG for institutional development and capacity building on investment promotion. It has recently completed a World Bank-funded 18-month TA project for the Serbian Investment and Export Promotion Agency (SIEPA). A follow-on project planned jointly with the European Agency for Reconstruction and aimed at further strengthening SIEPA's investment promotion capacity is currently under preparation. SCG is also a beneficiary country included in MIGA's European Investor Outreach Program for the Western Balkans (EIOP). EIOP is a regional investor outreach and marketing initiative to promote foreign investment into the Western Balkans region.

Joint Staff Assessment (JSA) of the Poverty Reduction Strategies

15. 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, the 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. The 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

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

17. **Public expenditure management**. SCG'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.

18. **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 SCG 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 credits/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.

19. **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 SCG. 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 approved for Montenegro and work has commenced on a pension reform technical assistance operation for Serbia for this fiscal year delivery.

20. 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.

21. 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.

22. **Restructuring and privatization of enterprises and banks**. Beginning in late 2000 in Serbia, and earlier in Montenegro, SCG 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. Bank-Fund cooperation on financial sector issues will continue in the context of the PPFDPL 1 operation. The Bank has increased its involvement in these areas in Montenegro under the second SAC for Montenegro, currently under implementation.

23. **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 extended to the Government of Serbia supports the improvements in Serbia's court administration and the development of a National Judicial Reform Strategy.

Prepared by World Bank staff.

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

January 11, 2006

Dear Mr. de Rato:

The attached Memorandum on Economic and Financial Policies (MEFP) specifies understandings reached with staff in discussions on the completion of the sixth and final review of the Extended Arrangement (EA), extended to end-February 2006.

Since the start of the program in May 2002, macroeconomic imbalances in our economy have been reduced and structural reforms have advanced. This was achieved in an environment of high growth and rising real incomes. In 2005, our prudent macroeconomic policies, most notably further fiscal consolidation, helped reduce the current account deficit relative to GDP from 14.8 percent to an estimated 10.2 percent. In Serbia, unfortunately, the VAT introduction, surging international fuel prices, and the expansionary impact of strong foreign currency inflows on broad money and credit growth have kept inflation above program targets.

To achieve further progress in stabilization and reform and address new challenges, we have updated our economic objectives and policy for 2006, as described in detail in the attached MEFP. On this basis, we request: (a) the completion of the sixth review under the EA; (b) waivers for the non-observance of two end-September 2005 quantitative performance criteria (PCs) (the ceilings for net-credit to government and the wage bill of the monitored stated-owned companies) and of five structural PCs (parliamentary approval of legislation abolishing the law on NIS by end-July; spin-off, registration, and transfer to the Privatization Agency of 65 companies, non-core assets, and hotels from the monitored state-owned enterprises by end-September; spin-off of the remaining non-core companies and assets by end-October; in Serbia, parliamentary approval of a pension reform by end-October in line with the parameters agreed in the context of the fifth review; and parliamentary approval by November 15 of a new law on banks in line with understandings reached in the context of the fifth review); and (c) the purchase of SDR 62.5 million following the completion of the sixth review.

The MEFP specifies corrective measures, most of which are already implemented, to address the non-observance of these PCs. In particular, the non-observance of the two quantitative PCs, which has not tangibly affected our macroeconomic policy stance, has been addressed through subsequently implemented measures. The measures specified through four non-observed structural PCs were implemented with delays. Moreover, to compensate for the deficiencies in the pension reform, we have ensured savings in permanent budgetary expenditures of 1 percent of GDP in 2006 through other measures, most notably the health sector reform approved by the Serbian Parliament in November.

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

Yours sincerely,

/s/
Miroljub Labus
Deputy Prime Minister
Republic of Serbia

/s/
Miroslav Ivanišević
Deputy Prime Minister
Republic of Montenegro

/s/
Mladjan Dinkić
Minister of Finance
Republic of Serbia

/s/
Radovan Jelašić
Governor
National Bank of Serbia

/s/
Igor Lukšić
Minister of Finance
Republic of Montenegro

/s/
Ljubisa Krgović
Chairman
Central Bank of Montenegro

SERBIA AND MONTENEGRO

MEMORANDUM ON ECONOMIC AND FINANCIAL POLICIES

January 11, 2006

I. Introduction

1. This memorandum updates and supplements the Memorandum of Economic and Financial Policies (MEFP) attached to the Letter of Intent of June 8, 2005. It reports on recent developments under the program supported by the Extended Arrangement approved in May 2002 and outlines the economic objectives and policy agenda for 2006.[1]

2. **Performance under the program in 2005 has been mixed.**

- Two of the 12 quantitative performance criteria (PCs) (the ceiling for net-credit to government and the ceiling for the wage bill of monitored state-owned companies) were missed for end-June and end-September (Table 1; Annex A).
- Only four of the nine structural PCs were met fully and on time (Table 3; Annex C). Parliament adopted the legislation on the state-owned oil company NIS with a three-week delay, and the adopted pension law fell short of the agreed parameters. The two PCs on the spin-offs of non-core assets from state-owned enterprises were met with delays, as was the PC on parliamentary approval of the new banking law.
- Most structural benchmarks (SBs) were implemented on time. There were some delays in adopting the schedule to clear arrears in Montenegro and in launching the tender for hiring a privatization advisor for NIS in Serbia. The SB related to the initiation of bankruptcy procedures against large socially owned enterprises was only partially met (procedures were initiated against four rather than five enterprises).
- To achieve the objectives of the program, corrective measures were taken to compensate for the shortfalls and delays (Table 3, Annex C).

3. **Strong growth in domestic demand and exports in 2005 has been accompanied by persistently high inflation and external imbalances.**

- **Real GDP growth in Serbia** remained strong at 6.1 percent in H1 2005 and is expected to reach 4.8 percent in 2005 (9.3 percent in 2004), led by the growing export-oriented, privatized, and restructured sectors, and trade and financial services.

[1] Annex A, attached to this memorandum, contains the quantitative performance criteria and indicative targets for 2005, while Annex B presents indicative targets for 2006. Annexes C and D list the structural performance criteria, structural benchmarks, and prior actions. The Technical Memorandum of Understanding attached to the MEFP of June 8, 2005 remains valid and is not attached here, but is complemented by an Addendum (Annex E). Unless specified otherwise, GDP refers to GDP of Serbia and Montenegro.

- Twelve-month **inflation** in 2005 has remained persistently high at around 17–18 percent. While part of the price pressures reflect high international oil prices, the VAT introduction in January, and seasonal factors in agriculture, strong domestic demand and liquidity in the banking system have kept core inflation at almost 1 percent per month.
- The growth rate of average **real net wages** continued to decline in the first ten months of 2005 to 6.3 percent from 11.2 percent in 2004 over the same period, with diverging trends. Average wages in the private, socially owned, and state-level public enterprises declined, while sharp increases were recorded in the education and culture sector, and local public enterprises.
- The **current account deficit** of Serbia and Montenegro (SCG) is projected to decline from 14.8 percent of GDP in 2004 to 10.2 percent of GDP in 2005 on account of strong exports and the one-off shift of imports to 2004 in anticipation of the VAT introduction. The underlying deficit, net of the VAT effect, is projected to decline from 13.1 percent of GDP in 2004 to 11.8 percent in 2005. The rebound of exports since mid-2004 (with a projected annual growth in 2005 of 25 percent in dollar terms) has been aided by the strong dollar, favorable commodity price trends, and strong investment in export-oriented, privatized companies. Energy imports through Q3 have grown by less than the increase in world prices, due to stock-building at the end of 2004. Owing to strong private remittances (14 percent of GDP projected for 2005) and FDI (7 percent of GDP), NBS gross foreign reserves rose to $5.2 billion (almost 5 months of projected 2005 imports) at end-October 2005 (at current exchange rates).
- The overall **external debt** declined from 61 percent at end-2004 to 58 percent of GDP at end-September 2005, mainly on account of favorable dollar/euro exchange rate developments. However, the increase in the debt financing of the current account deficit raises concerns, as it raises vulnerability to external shocks. Enterprises, including leasing companies, and commercial banks have been particularly active in contracting loans from abroad.
- In **Montenegro**, GDP growth in 2005 is estimated to reach 3-4 percent. This reflects strong tourism activity (up 21 percent in H1 over the same period last year) and domestic demand driven by rapid credit growth, increases in real wages, and large remittances. Nevertheless, inflation remained subdued at 3.3 percent in October. The current account is estimated to have improved in the first nine months of 2005 compared to the same period last year, aided by tourism revenues. However, the trade balance deteriorated due to adverse terms-of-trade developments from oil and aluminum prices, and temporary disruptions in input supplies and bulky exports. FDI continues to be strong, in particular in the telecom and tourism sectors.

4. **Fiscal policy in Serbia has remained tight in 2005, but the clearance of pension arrears in December required a reduction in the fiscal surplus target.** Revenues of the consolidated general government were somewhat weaker than programmed, primarily on account of the reduction in fuel excise taxes in August 2005 and lower-than-projected

non-tax revenue. At the same time, a prudent budget execution and measures to curb subsidies and transfers helped lower overall expenditures to 40.2 percent of GDP. This was achieved despite higher-than-programmed capital expenditure and excessive wage hikes in municipalities that led to an increase in the share of wages in GDP to 9.8 percent, undermining efforts to tighten incomes policy that have been taken in the rest of the government. Moreover, the decision to start the clearance of pension arrears (2.1 percent of GDP) by paying a first tranche (0.2 percent of GDP) in December was accommodated by a downward revision of the targeted surplus relative to GDP from 1.3 percent to 1.1 percent.

5. **In Montenegro, fiscal performance in the first nine months of 2005 was in line with program targets.** VAT revenues exceeded forecasts, and the structure of spending was shifted to infrastructure investment in line with overall expenditure limits. Repayments of domestic payment arrears have been larger than budgeted, but new arrears of €7 million were incurred. The use of privatization revenues to repay debt has lowered public debt to 44 percent of GDP as of September 2005.

6. **In Serbia, rapid expansion in broad money and lending to the nongovernment sector continued, despite various measures aimed at slowing down credit growth.** The increasing confidence in the banking sector is boosting remonetization, which is reflected in an increase in the broad money-to-GDP ratio from 21.5 percent in October 2004 to 24.2 percent at end-October 2005, driven primarily by a surge in foreign-currency deposits. This, together with foreign borrowing by commercial banks, has led to a substantial increase in net credit to the nongovernment sector, which is now projected at 9½ percent of GDP in 2005 compared to 6.8 percent in 2004, with consumer lending accounting for an increasing share. Euroization—measured as the share of foreign currency-denominated plus foreign currency-indexed credit in total credit to the nongovernment sector—increased during the 12 months to October 2005 from 64.7 percent to 75.2 percent.

7. **The NBS has significantly strengthened on-site and off-site supervision and implemented prudential measures to reduce macroeconomic and prudential risks emanating from rapid credit growth**. The Second Phase Supervisory Development Plan was adopted on October 14, 2005 together with a time bound corrective action plan to address Basel Core Principle deficiencies identified by the recent FSAP mission. Other important steps in the transformation to a risk-based approach include the adoption of (i) a strengthened supervisory operating policy; (ii) a standardized report of examination format; and (iii) a CAMEL rating process. Moreover, the NBS has issued a regulation on the monitoring and management of indirect credit risk resulting from borrowers' exposure to exchange rate risk. Amendments to the leasing law transferred the authority for regulating and supervising leasing companies to the NBS.

8. **Substantial progress was also made in bank privatization and the consolidation of the banking system.** Following the successful sale of Jubanka in January 2005, the privatization of two other state-owned banks was completed in Q3 2005 and the tender for the privatization of Vojvodanska Banka was issued on September 30. Owing to progress in

privatization and the acquisition of private domestic banks by foreign banks, the share of the latter in total bank assets rose to 63.3 percent at end-September 2005.

9. **Structural reforms have continued in the enterprise sector in Serbia:**

- **The privatization program of socially owned enterprises (SEs) has advanced and program targets were met.** From January-June 2005, the privatization agency (PA) offered 207 SEs for sale through auctions, with a success rate of 42 percent (compared to a program target of 130 companies offered with a success rate of 40 percent). From January-September, 297 companies were offered, with a success rate of 42 percent (against a program target of 230 companies with a success rate of 40 percent). Regarding tenders, 8 SEs were offered for sale in Q2 2005, of which 4 from the list of companies under restructuring (against a program target of 7 companies, of which 4 from the list). From June-October 2005, 8 more SEs were offered, of which 4 from the restructuring list (against a program target of 7 companies, of which 4 from the list).
- **The government initiated bankruptcy procedures against 4 large SEs undergoing restructuring** (compared to a program target of 5), while an additional one was initiated by a private creditor between June-September 2005. In compensation for the shortfall compared to the program target, the government initiated an additional bankruptcy in July against a large SE not on the list of enterprises undergoing restructuring.
- The process of **conditional write-off** of SEs debt—designed to facilitate privatization—has progressed, and the first company benefiting from the new framework was successfully auctioned in September, with proceeds exceeding the amount of the write-off.

10. **A total of 100 non-core companies, assets, and hotels of state-owned enterprises were spun off between June-November 2005.** Following the spin-off of 33 companies and assets in June, 52 additional non-core assets and companies identified in the previous MEFP were spun off or closed as of end-September (compared to a target of 65[2]). The number of spin-offs or closures was brought to 56 by spinning off 4 companies that had not been identified previously. Between July and end-October, 61 companies and assets previously identified were spun off or closed (compared to a target of 71), plus 5 not identified previously, for a total of 66. In November, one more company was spun off, bringing the total to 67 since July. Thus, the corrected target was met, with a slight delay. The government has also made progress in preparing the spun-off companies for privatization, the first of which was offered for sale in October.

[2] Legal investigations during the spin-off process found that 2 companies did not exist as separate entities, one hotel was destroyed, and 2 companies had merged into 1, reducing the target by 4.

11. **Collection performance of public utilities in Serbia was mixed.** While the collection rate targets for the electricity company (EPS) were met, the collection performance of the oil company (NIS) fell short of the September target by 3½ percentage points. Several large budget institutions and public enterprises, particularly the army, the airline company, the railway company, and local utilities increased their arrears significantly.

12. **While the wage bill in the 8 monitored state-owned companies exceeded the program target, the latter contributed to a substantial rationalization of employment in these enterprises.** Although the core wage bill grew in line with the programmed 7 percent, a higher growth of various bonuses led to a higher overall increase. An estimated 12,000 employees (excluding the reduction in the number of positions by 6,000 owing to spin-offs) left the companies in 2005, resulting in an important increase in productivity.

13. **Privatization in Montenegro progressed.** The privatization of KAP, a large aluminum plant, was completed in December 2005. Podgorička Banka, the largest remaining state-owned bank, was sold to a strategic investor in October 2005 and a tender for Pljevajlska Banka was issued. Moreover, the tender for the sale of Pljevlja thermal power plant and Rudnik coal mine was relaunched in December. In the tourism sector, a tender for the long-term lease of Sveti Stefan and other hotel assets, launched in May, is expected to be concluded shortly. Army assets located on the Montenegrin territory amounting to about €13 million were sold.

14. **The start of the negotiations with the EU on the Stabilization and Association Agreement and the meetings of the WTO Working Parties have marked significant progress in the area of trade.** Serbia and Montenegro conduct these negotiations separately, in line with the "twin track" approach adopted by the EU and the WTO. Meetings of the separate WTO Working Parties for Serbia and Montenegro took place in October. In July, the Serbian Parliament approved a custom tariffs law which harmonizes tariff lines according to HS 2000/2002 standards and the EU combined nomenclature. In November 2005 it passed a foreign trade law consistent with WTO and EU regulations.

II. Economic Objectives and Policies

15. **The macroeconomic objectives for 2006 and beyond focus on reducing inflation and lowering the current account deficit to support sustainable growth.**

- **Real GDP growth** in Serbia is projected to reach about 5 percent in 2006, continuing the strong trend of the past 2 years. The downside risks relate to the adverse impact of high oil prices and the drag on growth from the unreformed industrial sectors.
- Supported by tight demand management policies and structural reforms, 12-month **inflation** in Serbia is projected to decline to 11½ percent at end-2006. The risks to this projection are related to the prevailing inflation inertia and developments in international oil prices, but the government and the NBS are committed to implement the necessary policies to achieve this objective.

- The external **current account deficit** of SCG is projected to reach about 10.8 percent of GDP (a decline of about one percent in the underlying deficit) as restrictive policies continue to contain demand. The deficit should continue to decline in the medium term—reflecting the recovery of exports as structural reforms elicit a supply response and prudent policies strengthen competitiveness—thereby contributing to external sustainability and consistency with expected financing. As structural reforms accelerate and the business climate improves, FDI inflows could play an increasing role in financing the current account deficit. However, foreign assistance and loans will remain an important source of financing.
- The import coverage of **foreign reserves** is projected to remain largely unchanged in 2006 at around 5 months of prospective imports, with a view to guarding against possible risks and the projected rise in external debt service in the medium-term following the expiry of grace periods under debt restructuring agreements.
- In **Montenegro**, economic policies will be geared towards increasing economic growth by strengthening macroeconomic stability, deepening structural reforms, and enhancing the investment climate and public sector operations. Growth is projected to reach 3–4 percent in 2006, reflecting buoyant activity in the tourism sector, expansion of financial services, and strong investment activity, but hampered by the lagging transformation of manufacturing. The main downside risks are related to world market prices for aluminum and oil, and a potential pressure on competitiveness from wages. Inflation is projected to remain at the current level of 3½–4 percent in 2006, and the current account is expected to decline in line with the fiscal tightening.

Serbia and Montenegro: Macroeconomic framework, 2004-06

	2004		2005		2006
	5th Rev.	Est.	5th Rev.	Proj.	Proj.
			(Percentage change)		
Real GDP growth	7.2	8.8	4½–5	4.7	4.9
Serbia	7.5	9.3	4½–6	4.8	5.0
Montenegro	3.1	3.1	3.3	3–4	3–4
Inflation (end period)	13.4	13.4	9 - 10	16.6	10.9
Serbia	13.7	13.7	10	17.7	11.5
Montenegro	4.3	4.3	2½ - 3	3.6	3.6
			(Percent of GDP)		
Domestic investment	17.6	22.5	18.4	18.4	19.8
of which: Gross fixed capital formation	...	19.2	...	18.7	19.6
Domestic savings	-11.3	-5.2	-5.3	-4.4	-3.2
Current account deficit (before grants)	15.5	14.8	11.0	10.2	10.8
Underlying current account deficit 1/	13.7	13.1	12.6	11.7	10.8
Gross official reserves (US$ billion)	4.3	4.3	5.6	6.3	6.9
(In months of projected imports)	3.7	4.0	4.3	5.2	5.3
External debt	62.0	61.1	57.1	61.1	60.5
General government fiscal balance (excl. grants)	-0.3	-0.3	1.2	0.9	2.4

Source: Serbian and Montenegrin authorities.
1/ Corrected for the effect of the introduction of the VAT in 2005.

16. **Economic policies will continue to be geared toward macroeconomic stabilization and structural reforms to increase potential output.** The persistent imbalances between supply and demand, which has contributed to high inflation and a large current account deficit, will have to be addressed by both restrictive demand policies and accelerated structural reforms. In particular, to boost potential output and broaden the export base, the privatization of SEs will continue and the restructuring and privatization of state-owned enterprises will be accelerated.

17. **The PRSP process will continue to guide the development agenda and social policies.** The PRSPs adopted by the Serbian and 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. The Serbian government approved a progress report in October 2005.

A. Fiscal Policy

Serbia

18. **Fiscal policy in Serbia in 2006 will be further tightened to help reduce the current account deficit and inflation.** The surplus of the consolidated general government relative to GDP will be increased by 1.4 percentage points, to 2.5 percent, to achieve these macroeconomic objectives and compensate for the lower-than-programmed fiscal surplus in 2005 resulting from the clearance of pension arrears. The fiscal consolidation will, to a large extent, be achieved through cuts in permanent current expenditures, contributing to surpluses in the republican and health fund budgets. A broadly unchanged tax policy (with the exception of an increase in excise taxes), continued improvements in tax administration, and prudent incomes policies will help achieve these targets. This will allow for an increase in capital spending. To create fiscal space for the clearance of pension arrears, the government will approve revenue and expenditure measures (specified in paragraph 27) that are expected to ensure higher-than-budgeted revenues and lower-than-budgeted expenditures in 2006. In 2006, budgetary revenues in excess of the revised projection (SRD 495 billion for the republican budget) will be saved. In the same vein, in 2007 and the following years, all revenue overperformance compared to the budgets approved by Parliament will be saved.

19. **Tax policy in 2006 will remain broadly unchanged, but the reduction in petroleum excises will be partially reversed.** Given the fragile macroeconomic environment, no further tax cuts will be implemented in 2006.

20. **The decline in expenditure is supported by a tight incomes policy and rationalization of employment in various sectors to ensure a decline in the share of budgetary sector wages in GDP to 9 percent.** The average wage in the central government and the social funds will increase by 11.6 percent, excluding redundancy payments (SRD 4.1 billion), and rationalization of employment is expected to continue. To rein in wage growth in municipalities (in which the wage bill increase will be limited to 9 percent in

2006), the monthly transfer to local governments from the republican budget will be linked to prudent wage policies, as allowed by a provision in the 2006 budget law.

21. **To increase the flexibility of fiscal policy and reduce the high tax burden over time, the government will cut permanent expenditure in 2006 by at least 1 percent of GDP.** This reduction in non-discretionary expenditure is supported by a comprehensive health sector reform, rationalization of employment in the army, and ongoing cuts in subsidies. The latter are supported by underlying structural reforms that help improve the financial performance of state-owned and socially owned enterprises.

22. **The health sector reform will increase efficiency and reduce expenditures**. The new Law on Health Insurance and the Health Fund budget incorporating the proposed permanent cuts in spending (0.6 percent of GDP) were enacted in November 2005. Building on the ongoing reforms, these savings are based on rationalization of medical and non-medical staff and number of hospital beds; a gradual shift in financing practices toward an output-based system; and rationalization of health benefits. The transfer from the Health Fund to health institutions will be reduced by SRD 3 billion in line with the expected increase in copayment collection. The envisaged decompression of the wage structure will not increase the overall wage bill (including social security contributions, taxes paid by the employer, and severance payments) in the health sector beyond SRD 53.5 billion.

23. **The rationalization of the army, supported by an ongoing strategic review, will lead to budgetary savings in 2006 and beyond.** In line with the action plan for army reform adopted in May 2004 by the Minister of Defense, the number of civilian and professional army staff has been significantly reduced in 2005. Together with further rationalization in 2006, as well as a reform in the Military Academy that will reduce the number of students, secondary military school cadets, and recruits in the regular compulsory service by 20 percent, this will allow for a reduction in the wage bill (0.1 percent of GDP) and related savings in goods and services (0.1 percent of GDP). A fraction of these savings (0.1 percent of GDP) will be used to pay arrears to suppliers and upgrade the capital stock.

24. **The reduction of budget subsidies will continue and transfers to the Development and Guarantee Funds will be eliminated, generating savings of 0.4 percent of GDP in 2006.**

- Export stimulation subsidies will be eliminated and agricultural subsidies reduced on December 31, 2005, in line with an agreement with the EU. Subsidies for cash registers for small companies and subsidies to public financial institutions will be discontinued, in line with progress in privatizing the banking sector.
- Subsidies to the railway company ZTP, socially owned companies, and RTS (the public broadcasting company) will be reduced, generally in line with structural reforms in these companies. An amendment to the law on radio-diffusion, adopted by Parliament in 2005, gives RTS the right to collect fees from users with expected collections of about 0.1 percent of GDP, thereby reducing its reliance on subsidies.

While EPS will collect these fees, it will only transfer the amounts actually collected rather than customers' total payment obligations to RTS.

- The Development Fund and the Guarantee Fund will no longer receive resources from the budget and will continue operations exclusively with own resources. The Law on the Development Fund was amended accordingly.

25. **The savings in current spending will allow for an increase in capital spending by about 0.5 percentage points of GDP in 2006.** The government will adopt by end-December 2005 a financial plan for the Road Fund (an extrabudgetary fund) limiting capital outlays and expenditures on goods and services to SRD 23.7 billion in 2006 and limiting its deficit (defined as expenditures, excluding amortization but including repayment of arrears, minus revenues, excluding privatization proceeds and loan disbursements) to SRD 2 billion.

26. **When establishing Public-Private-Partnerships (PPP), the government will follow a prudent strategy to avoid large contingent liabilities.** The legal framework for PPPs will be strengthened in line with the recommendations of Fund technical assistance. This will necessitate amendments to the Law on Concessions to include more detailed requirements for concession proposals, in particular with respect to the proposed allocation of risk, the "bankability" of the project, and hiring financial advisors to assess private and public sector risks. The signed concession contract will be made available to the public. Once PPP contracts are signed, as a first step toward full inclusion in the budget, the government will prepare and publish an annex to the budget law with the following information on the concession contracts (including the Horgoz-Pozega highway or any other projects in 2006): (i) future payment obligations and future expected or contingent government revenues; (ii) terms of the project that may affect the amount and timing of future cash flows; (iii) guarantees extended by the government and their main parameters; (iv) rights and obligations under the concession contract; (v) accounts of the Special Purpose Vehicle (SPV) and clarification of the accounting treatment of the concession by the government and the private partner; (vi) preferential financing provided through government on-lending or via public financial institutions, and any project financing provided by entities owned or controlled by the government; and (vii) a revised macroeconomic framework, using fiscal balances based on the consolidated accounts of the government and the SPV.

27. **The government is committed to improving the medium-term sustainability of the pension fund and clear pension arrears.**

- The **amendments to the pension law** approved in September provide for (i) a gradual increase in the retirement age by 2 years for men and women over a four-year period as of 2008; (ii) a shift from quarterly to semi-annual indexation of pensions; and (iii) a shift to an inflation-based indexation of benefits over the period 2006-2009. The savings from the reform will be felt starting in 2007 and are expected to amount to about 1 percent of GDP per year over the medium-term.

- To clear **arrears to pensioners** amounting to SRD 44 billion, the law on the issuance of pension bonds, approved by Parliament in September 2005, was amended on December 22 to enable cash payments according to a revised schedule.
    - ➢ The first two tranches of arrears of the employees' pension fund (SRD 4 billion each) will be paid in December 2005 and July 2006. The following measures will be taken to accommodate these payments (prior action): (i) increase in fuel excises by at least 1 dinar per liter, expected to yield SRD 2.4 billion in 2006 (formal government decision by January 15, 2006); (ii) cuts in mortgage subsidies and agricultural lending by SRD 1.5 billion (formal government decision to amend the 2006 spending targets and programs by January 15); (iii) cuts in the budgetary reserve and expenditures for goods and services by SRD 1.6 billion (formal government decision by January 15); (iv) payment of NIS tax arrears in the amount of SRD 1.5 billion (NIS Managing Board decision in December 2005), and (v) elimination of tax exemptions for capital imports, estimated at SRD 1 billion (formal government decision); (vi) in case the surplus of the consolidated general government in 2005 falls short of the targeted 1.1 percent of GDP, additional compensatory measures will be approved through a formal government decision by January 15, 2006. In particular, fuel excises would be increased by another dinar per liter. Should this require a revision in the oil excise formula, the respective government decision would be approved in January 2006.
    - ➢ Starting in 2007, the expenditure for arrears clearance will be accommodated within the regular budget, consistent with macroeconomic objectives.

28. **The medium-term budget framework and the treasury system will be improved.** In particular, the Ministry of Finance will develop a three-year budget framework and improve investment planning. Reform of the treasury system will continue with the centralization of the payrolls of direct budget users and the extension of the Treasury Single Account to indirect budget users.

Montenegro

29. **The deficit of the consolidated general government will be contained at 2.7 percent of Montenegro GDP in 2005 and reduced to 1.7 percent of GDP (€30 million) in 2006.** In 2005, expenditure financed from the sale of army assets will be contained within agreed spending limits, and the rationalization of public employment will be stepped up. In 2005 as well as in 2006, any revenue over-performance will be saved or used for additional investment programs or arrears reduction.

- **Tax policy** will remain unchanged except for the revenue-neutral lowering of the VAT rate for accommodation services and introduction of a lower VAT rate on food items and on a number of other products previously exempt.
- **A tight incomes policy will lower the public sector wage bill (including army) from 10.8 percent of GDP in 2005 to 10.0 percent of GDP in 2006.** This will be achieved despite the installation of new agencies as part of efforts towards EU

accession. To contain public sector wage costs and minimize the negative impact on private sector competitiveness, the government will seek to agree with the unions to increase the minimum wage by no more than 5.0 percent in 2006.

- **The budgetary reserve will be increased to meet possible expenditures related to the planned referendum on independence.** Any savings would be used for additional investment or arrears reductions (by €16.7 million in 2006). Verification procedures will be enhanced and an arrears tracking system implemented.
- **To enhance efficiency of public investment, a medium-term investment plan will be prepared by June 2006 in line with international best practices**. The Ministry of Finance will seek technical assistance to build up the necessary analytical capacity. A clear priority of investment projects according to their economic rate of return will be established.
- **The financing operations of the public sector will be geared towards reducing debt and the net interest bill.** Public debt will be gradually reduced from 48 percent of GDP in 2004 to less than 40 percent by 2007. To improve transparency, all accounts of extra budgetary funds with commercial banks will be moved to the central bank, except those few needed for core operational purposes. All proceeds from the privatization of military assets will be deposited in the Central Bank and their use will be accounted for in the budget.
- **The financial operations of the Montenegro Development Fund (MDF) will be placed under the control of the Minister of Finance.** Its expenditure will be consolidated in the general government and its investment financing projects integrated in the government's investment program. The government will conduct a throughout analysis of the future role of the MDF.

B. Monetary and Exchange Rate Policies

30. **Monetary policy will continue to face the challenges posed by high euroization.** To compensate for the weak interest rate channel of monetary policy transmission, the NBS will continue to implement macroprudential measures to slow down credit growth with a view to help containing domestic demand. While the introduction of repo operation in January 2005 was an important step in increasing the reliance on market-based instruments, the use of statutory reserve requirements (SRR) on foreign currency-denominated deposits will continue to play an important role until the development of the market for SRD-denominated deposits and loans increases monetary policy effectiveness.

31. **Monetary conditions will be tightened.**[3] To contain euroization and strengthen the demand for SRD-denominated deposits, the NBS will increase the volume of repo operations

[3] The monetary program for 2006 aims at containing domestic demand and inflationary pressures. The end-period NFA will increase by $435 million, with monthly average NDA declining to SRD –130.4 billion in December 2006, while reserve money will decline in real terms by 3.1 percent (Table 2; Annex B). Broad

(continued…)

by relying on positive real interest rates. By end-January 2006, it will gradually increase the interest rate on 14-day repo operations to 5 percent in real terms (measured on the basis of three month backward-looking and three months forward-looking inflation). In November 2005, the SRR on enterprises' foreign-currency deposits and on commercial banks' foreign borrowing were increased from 29 percent to 35 percent. In December, they were unified with the SRR on households' foreign currency deposits at the level of 38 percent, implying some additional withdrawal of liquidity. The unified SRR will remain at that level, unless a need for adjustments is determined in consultation with Fund staff. The NBS will also step up outright sales of government bonds to reduce structural excess liquidity in the money market. To facilitate the development of the SRD market, SRR on SRD-denominated deposits were reduced from 20 percent to 18 percent in November. The NBS will sterilize higher-than-programmed foreign exchange inflows as needed to keep reserve money on the targeted path and contain credit expansion.

32. **The NBS is streamlining its monetary operations framework to improve the effectiveness of monetary policy.** The key policy variable will be the interest rate on 14-day repos to signal the monetary policy stance. In addition, in November, the NBS established an interest rate corridor by (i) increasing the interest rate on the NBS deposit facility to 6 percent; and (ii) linking the interest rates of its lending facility to the repo rate. To facilitate the development of the SRD-denominated segment of the interbank market, the 80 percent daily minimum requirement for SRR on SRD-deposits will be reduced to 50 percent during 2006 in agreement with Fund staff.

33. **The use of prudential measures to contain macroeconomic and prudential risks resulting from rapid credit growth will continue.** The capital adequacy ratio will be increased from 10 percent to 12 percent on December 31, 2005. To contain the renewed acceleration of consumer lending, the 20 percent downpayment/price ratio and the 30 percent debt-service/income ratio will be applied to all loans to private individuals with a maturity of up to 10 years. The NBS and the government will support the private credit bureau in charge of monitoring individuals' credit risk exposure and payment history.

34. **Exchange rate policy will continue to balance the objectives of reducing inflation and containing the current account deficit.** It will continue to aim at strengthening confidence in the dinar by contributing to reducing inflation, while at the same time striving to maintain external competitiveness. It will be assessed frequently in light of current account, wage, and inflation developments.

---

money is projected to rise by 15½ percent in real terms and the net flow of credit to the nongovernment sector to decline from an estimated 10 percent of GDP in 2005 to about 7½ percent of GDP in 2006.

C. Bank Reform and Financial Sector Supervision

35. **The new banking law in Serbia will substantially strengthen the regulatory and supervisory environment.** The law, adopted by Parliament on November 28, 2005, aligns legislation with Basel Core Principles and EU Directives in all key areas.

36. **The NBS will further strengthen on-site and off-site supervision.** To increase the quality of on-site inspections, the NBS will hire new staff and step up internal and external training. It will ensure the timely implementation of corrective measures. Following the analysis of the commercial banks' first quarterly report on their exposure to indirect credit risk resulting from borrowers' exposure to exchange rate risk, the NBS will enhance the monitoring of this type of credit risk and has requested technical assistance from the Fund. It remains firmly committed to withdrawing the license of banks failing to meet the minimum capital requirement, and will act decisively to eliminate regulatory forbearance in other areas.

37. **Restructuring in the insurance sector will continue.** Following the issuance of a tender for hiring a financial advisor for the privatization of the second-largest socially owned insurance company DDOR, 10 bids were received in September. On this basis, the Managing Board of the Deposit Insurance Agency (DIA) approved the short-list of potential financial advisors on December 7, 2005. The diagnostic report for the largest socially owned insurance company Dunav was submitted by the consultant in November. On this basis, the DIA Managing Board adopted a time-bound corrective action plan on December 7, 2005. The NBS will complete an on-site inspection of Dunav by end-2005.

38. **The momentum in bank privatization will be maintained.** The sale of Niska Banka is expected to be completed by end-2005. For Vojvođanska Banka, the selection of the winning bidder is envisaged for Q2 2006. Moreover, after launching the tender for Panonska Banka on October 28, 2005, the government is committed to offering by end-January 2006 its stakes in Credy Banka. Concurrently, with bilateral assistance, the DIA will further strengthen its reporting requirements, control mechanisms, and governance in other banks equity holdings to preserve their value prior to resolution.

39. **In Montenegro, the government will further improve the legislative framework of the financial sector.** It will prepare a new central bank law and a new banking law, and submit them to parliament in the first half of 2006. The new laws aim at increasing competition and strengthening risk management in banks and the role of the banking supervisor. Moreover, a new insurance law, in accordance with EU directives and international standards, to be submitted to Parliament before end 2005, will create a new independent Insurance Agency in charge of regulating and supervising the sector.

D. Enterprise Sector

40. **In Serbia, the wage bill in the eight monitored state-owned 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

approved in November 2005 a decision establishing quarterly wage bill ceilings for the eight monitored public enterprises in 2006 (Table 2; Annex B).[4] In 2006, the aggregate wage bill in these enterprises will be allowed to grow by 10.3 percent in nominal terms on an annual average basis. By end-December 2005, the government will approve business plans for the monitored companies consistent with the above-mentioned decision.

41. **The restructuring and privatization of SEs will continue.** The Privatization Agency (PA) plans to offer another 120 companies in September-December 2005, and to offer all companies in its portfolio for sale at least once by the end of 2006. Under a World Bank-supported program, the government intends to offer for sale through tenders no less than 18 SEs between October 2005-September 2006, with a success rate of at least 50 percent. The PA will also offer for sale no less than 25 SEs from the list of companies under restructuring, or significant parts thereof, and sell as least 7 of them. Moreover, it plans to offer 450 SEs through auctions during the same period, with a success rate of at least 40 percent. The government will continue to implement its policy of initiating bankruptcy procedures within three months against those SEs that fail twice to be sold through auctions or tenders; it will also initiate bankruptcy proceedings against at least 8 large SEs from the restructuring list between October 2005-September 2006.

42. **Privatization of the spun-off non-core companies and assets will proceed.** The government will complete the process of establishing all these companies as effectively separate companies and clarifying ownership rights, where necessary. It will also appoint by end-December 2005 the government representatives in the managing boards of 38 spun-off non-core companies of public enterprises. The PA will establish a detailed timetable of the necessary actions in this regard, and will proceed with the hiring of financial advisors and other preparations for the sale of the companies. Regarding the 6 non-core companies identified in the previous MEFP that were not spun-off, the government will close, merge, transfer to government entities, or corporatize them by end-December 2005.

43. **The public utilities will strengthen their collections.** In particular, EPS and NIS will enforce penalties on late payments and step up the disconnection of users that are not honoring their obligations for more than two months, including in the case of budget entities or state-owned companies. If the government considers that delivery to these users is imperative for strategic or social reasons, the utility bills will be paid from the budget.

44. **The Serbian government will continue restructuring public utilities and other state-owned companies based on strategic plans.**

- The independent energy regulator, which was legally established in June 2005, will issue tariff methodologies and carry out a tariff review by mid-June 2006.

[4] These are the electricity, petroleum, railway, postal, telecommunication, airline, airport, and forestry companies.

- After unbundling the electricity company Elektroprivreda Srbije (EPS) into two separate companies, the two companies will start functioning as independent enterprises by January 1, 2006. EPS will continue reducing excess labor following the conclusion of a job systematization review in June/July 2006.
- Following the international tender for hiring an advisor for the privatization of NIS, including advice on selling a majority stake in the two refineries in early 2006, the government will sign a contract with the winning bidder by January 15, 2006 (prior action). The international tender for the privatization of the two refineries, possibly combined with other assets, is expected to be launched in April 2006.
- The financial performance of the railway company (ZTP) will be improved by accelerating restructuring. To this end, the 2006 business plan will envisage continued employment rationalization and spin-offs of non-core activities, and acceleration of service withdrawal or closure for loss-making lines.
- To raise transparency, those monitored public utilities that have not yet published an auditor's report on their 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) will do so by end-June 2006. All monitored public companies will publish their 2005 auditor's reports according to the same requirements by end-June 2006.

45. **In Montenegro, privatization will be accelerated and conducted with maximum transparency and accountability.** The government will combine the state holdings in Niksicka Banka to offer them for sale in early 2006. In 2006, it plans to offer a large number of civil and military assets for sale, including all non-core assets of the electricity company (including five small hydroelectric power stations), the Lovcen insurance company, the Crna Gora hotel in Podgoriza, and other smaller hotels. A tender for the Bijela shipyard will be launched in early 2006. Furthermore, the privatization process for the Plantaze vinery will be started in the second half of 2006.

Table 1. Serbia and Montenegro: Quantitative Performance Criteria and Indicative Targets for 2005
Under the 2002–06 Extended Arrangement 1/
(SRD million, unless otherwise noted; end of period)

	2004	2005									
	Dec.	Mar.			Jun.			Sep.			Dec.
	Act.	Program	Program w/adjustor	Act.	Program	Program w/adjustor	Act.	Program	Program w/adjustor	Act.	Indicative Targets
A. Quantitative performance criteria											
Floor on the net foreign assets of the NBS 2/ 3/	1,841	1,608	1,568	2,060	2,029	2,020	2,260	2,304	2,233	2,564	2,712
Ceiling on net domestic assets of the NBS 2/ 4/	-28,485	-22,197	-32,190	-44,935	-51,075	-50,006	-60,472	-60,800	-68,304	-71,144	-81,663
Ceiling on net credit of the banking system to the consolidated general government 2/ 5/ 6/ 7/	-19,106	-10,590	-31,277	-46,702	-43,632	-47,440	-45,447	-61,633	-67,034	-59,380	-90,060
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/	348	100		43	200		167	300		222	400
Multilateral creditors (EBRD, EIB, EU, IBRD, and IFC)	348	100		43	200		167	300		222	400
Serbia	286	92		40	184		163	276		201	368
Montenegro	62	8		3	16		3	24		21	32
Other creditors	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
Ceiling on new guarantees and the assumption of bank or enterprise debt by the public sector 10/	... 15/	0		0	0		0	0		0	0
Ceiling on outstanding external debt service arrears 3/ 11/	1.7 17/	0		2.2 17/	0		0	0		0	0
Ceiling on the wage bill of the monitored public enterprises 12/	33,964 19/	8,030		8,377 19/	15,941	15,831	18,004	24,180	23,866	27,086	32,700
B. Indicative targets											
Ceiling on net credit of the banking system to											
consolidated general government of Serbia 2/ 5/ 6/ 13/	-19,924	-11,992	-25,410	-39,477	-35,289	-39,787	-37,663	-50,529	-59,160	-51,427	-78,146
consolidated general government of Montenegro 2/ 5/ 13/	818	1,402	-5,867	-7,225	-8,343	-7,652	-7,784	-11,104	-7,874	-7,953	-11,914
Ceiling on net domestic assets of the banking system in Serbia 2/ 14/	112,199	124,601		104,315	113,617		117,187	114,497		134,158	104,126
Ceiling on Serbian central government dinar deposits in commercial banks	0	0		0	0		0	0		0	0
Ceiling on change in the arrears of											
the Union government	1,516	0		569 20/	0		1,043	0		1,633	0
the consolidated general government in Serbia	-974	0		3,530 20/	0		-111	0		1,694	0
the consolidated general government in Montenegro	18	0		667	0		501	0		228	0
Expenditure ceiling for the Serbian Republican budget 16/	...	...		89,008	190,846		186,315	297,513		288,184	406,399
Floor on the collection rate of EPS in percent 18/	89.5	...		90.7	90.6		90.4	91.5		92.4	92.3
Floor on the collection rate of NIS in percent 18/	96.6	...		93.1	100.0		98.7	99.0		95.5	100.3

1/ Quantitative performance criteria and indicative targets are defined in Annex E and evaluated—for program purposes—at end-December 2003 exchange rates for December 2004 and March 2005, and at end-December 2004 exchange rates for June and September 2005. In 2005, figures in section A are performance criteria for March, June, and September and indicative targets for December.
2/ The 2005 performance criteria and indicative targets were adjusted by the amount that actual data differed from the estimates for December 2004.
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 maximum adjustment of US$100 million.
4/ Monitored on the basis of monthly averages as defined in the TMU. 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 as defined in the TMU.
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/ Quantitative performance criteria for December 2004 and March 2005; indicative targets for the remainder of 2005. Excludes assumption of debt of socially-owned enterprises at the moment of ownership transfer on the basis of the amendment to the privatizaation law adopted by Parliament on May 23, 2005; also 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/ In 2004, the 7 monitored enterprises were JP Elektroprivreda Srbije, JP Naftna Industrija Srbije, JP PTT Srbije, JP Jugoslovenski Aerotransport, JP Zelenicko Transportno Preduzece Srbije, JP Srbija Sume, and JP Srbija Telekom. For 2005, JP Aerodrom Beograd was added to this list. In the case of spin-offs of activities from these companies through the creation of new companies the wage bill target will be adjusted downwards for the wage bill of the spun-off units. Targets are cumulative since the beginning of the respective year.
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, i.e. end-2003 exchange rates for December 2004 and March 2005 and end-2004 exchange rates for the remainder of 2005.
15/ Data have not been provided by the authorities.
16/ The cumulative expenditure ceiling excludes foreign-financed project expenditures, amortization payments (including all FFCDs), and all own-resource financed expenditures of budgetary units.
17/ The performance criterion was breached on account of arrears of Montenegro vis-à-vis Russia, which were cleared in May 2005.
18/ Cumulative since the beginning of the respective year.
19/ Figures were revised owing to misreporting on wage bill data for end-2004 and end-March 2005.
20/ Starting January 2005, figures were revised to incorporate pension arrears into the overall arrears reporting.

Table 2. Serbia and Montenegro: Indicative Targets for 2006
(SRD million, unless otherwise noted; end of period)

	2005	2006			
	Dec.	Mar.	Jun.	Sep.	Dec.
	Indicative program targets 12/	Indicative targets	Indicative targets	Indicative targets	Indicative targets
Floor on the net foreign assets of the NBS 1/ 2/	2,712	2,661	2,558	2,826	2,951
Ceiling on net domestic assets of the NBS 1/ 3/	-81,663	-117,961	-110,750	-121,618	-130,365
Ceiling on net credit of the banking system to the consolidated general government 1/ 4/ 5/ 6/	-90,060	-105,310	-117,815	-151,673	-174,569
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 7/	400	100	200	300	400
Multilateral creditors (EBRD, EIB, EU, IBRD, and IFC)	400	100	200	300	400
Serbia	368	92	184	276	368
Montenegro	32	8	16	24	32
Other creditors	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 8/	0	0	0	0	0
Ceiling on outstanding external debt service arrears 2/ 9/	0	0	0	0	0
Ceiling on the wage bill of the monitored public enterprises 10/	32,700	9,153	19,536	28,887	38,425
Ceiling on net credit of the banking system to					
consolidated general government of Serbia 1/ 4/ 5/ 11/	-78,146	-92,379	-105,090	-137,621	-159,454
consolidated general government of Montenegro 1/ 4/ 11/	-11,914	-12,931	-12,725	-14,052	-15,115
Ceiling on net domestic assets of the banking system in Serbia 1/	104,126	97,596	129,893	136,838	144,910
Ceiling on Serbian central government dinar deposits in commercial banks	0	0	0	0	0
Ceiling on change in the arrears of					
the Union government	0	0	0	0	0
the consolidated general government in Serbia	0	0	0	0	0
the consolidated general government in Montenegro	0	0	0	0	0

1/ The end-2005 indicative targets were adjusted by the amount that actual data differed from the estimates for December 2004.
2/ 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 maximum adjustment of US$100 million.
3/ Monitored on the basis of monthly averages and subject to the adjustors defined in the TMU.
4/ 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, 2005, 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 the levels in the TMU.
5/ The adjustor for shortfalls in nonbank domestic financing applies as defined in the TMU.
6/ 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, the Serbian Road Fund, and the Serbian and Montenegro special extrabudgetary programs as defined in the TMU.
7/ 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.
8/ Excludes normal import-related credits.
9/ Excludes debts subject to restructuring/negotiations. The nonaccumulation of new external arrears is also a continuous indicative target.
10/ In 2005, the 8 monitored enterprises were JP Elektroprivreda Srbije, JP Naftna Industrija Srbije, JP PTT Srbije, JP Jugoslovenski Aerotransport, JP Zelenicko Transportno Preduzece Srbije, JP Srbija Sume, JP Srbija Telekom, and JP Aerodrom Beograd. In the case of spin-offs of activities from these companies through the creation of new companies the wage bill target will be adjusted downwards for the wage bill of the spun-off units. Targets are cumulative since the beginning of the year.
11/ Consolidated Montenegrin government includes all entities in Montenegro under 6/; the rest of entities under 6/ is included in the consolidated Serbian government.
12/ Reflects, as appropriate, revisions to the NBS' foreign exchange liabilities, credit to government by the banking system, and broad money at end-2004, and adjustments stemming from changes in the reserve requirement ratio on SRD-denominated deposits.

Table 3. Serbia and Montenegro: Structural Conditionality Under the Extended Arrangement (continued)
Prior Actions, Structural Performance Criteria, and Structural Benchmarks, June 2005-December 2005

	Target Date	Implementation
I. Prior Actions for Completion of the Fifth Review		
1. Serbia: Government to adopt a formal decision on a pension system reform that will increase the retirement age by 2 years for men and women over a period of at most 4 years; shift to inflation-based indexation of benefits over a period of at most 4 years; and replace quarterly with annual indexation.		Met. Adopted on June 2, 2005.
2. Serbia: NBS to increase statutory reserve requirements on enterprises' foreign-currency deposits and on commercial banks' foreign borrowing to 26 percent.		Met. Decision on June 1, 2005.
3. Serbia: Parliament to adopt the law amending the privatization law to facilitate debt workouts for socially owned enterprises, conditional upon privatization.		Met. Adopted on May 30, 2005.
4. Serbia: Government to spin off, register, and transfer to the Privatization Agency 33 companies, non-core assets, and hotels of the 8 monitored state-owned enterprises.		Met. Decision on June 17, 2005.
II. Structural Performance Criteria		
1. Serbia: Government to legally register the new electricity transmission and dispatch company, which will be owned separately from EPS, to allow for the implementation of the EPS restructuring plan.	July 15, 2005	Met. Done on July 1, 2005.
2. Serbia: Parliament to adopt a supplementary budget yielding a surplus of 18.9 billion dinars (including FLIPs, excluding amortization) to support the fiscal stance defined in the MEFP.	end-July 2005	Met. Adopted on July 21, 2005.
3. Serbia: Council of the City of Belgrade to adopt a revised 2005 budget that will reduce spending by 3.5 billion dinars to support the fiscal stance defined in the MEFP.	end-July 2005	Met. Adopted on June 3, 2005.
4. Serbia: Parliament to adopt legislation abolishing the current law on NIS and allowing for the unbundling of the oil and gas company NIS into four separate companies.	end-July 2005	Not met. Adopted with delay on August 22, 2005.
5. Serbia: Government to spin off, register, and transfer to the Privatization Agency 65 companies, non-core assets, and hotels from the 8 monitored state-owned enterprises between July-September 2005.	end-September 2005	Not met. Only 52 previously identified non-core assets spun-off. Compensation: see number 7.
6. Serbia: Parliament to enact a pension system reform increasing the retirement age by 2 years for men and women over a period of at most 4 years; shift to inflation-based indexation of benefits over a period of at most 4 years; and replace quarterly with annual indexation.	end-October 2005	Not met. Law adopted on September 29, 2005, fell short of the agreed parameters. Compensation: permanent savings in health sector, army, and subsidies.
7. Serbia: Government to spin off, register, and transfer to the Privatization Agency all the remaining companies, non-core assets, and hotels from the 8 monitored state-owned enterprises.	end-October 2005	Not met. Six from the list remain to be spun-off. Compensation: 6 non-core companies not identified previously were spun-off as of November.
8. Serbia: Government to submit a 2006 budget to Parliament, after consultation with Fund staff, consistent with the parameters defined in the MEFP and envisaging cuts in permanent expenditure of at least 1 percent of GDP.	November 1, 2005	Met. Submitted on October 31, 2005.
9. Serbia: Parliament to enact a new banking law, as indicated in paragraph 32.	November 15, 2005	Not met. Enacted with delay on November 28, 2005.
III. Structural Benchmarks		
A. Fiscal Sector		
1. Serbia: Reduce the stock of tax arrears to the budget by 5 billion dinars by end-June 2005 relative to end-December 2004.	end-June 2005	Implemented.
2. Serbia: Government to prepare an action plan for restructuring employment in the health sector.	end-September 2005	Implemented on September 22, 2005.
3. Montenegro: Withdraw all central government deposits with commercial banks that do not serve as collateral for loan programs.	end-June 2005	Implemented.
4. Montenegro: Government to prepare an inventory of spending arrears of the consolidated budget and to adopt a schedule for their clearance.	end-June 2005	Implemented with delay in September.

Table 3. Serbia and Montenegro: Extended Arrangement, May 2002–December 2005 (concluded)
Prior Actions, Structural Performance Criteria, and Structural Benchmarks, June 2005-December 2005

	Target Date	Implementation
B. Financial Sector		
1. Serbia: Parliament to adopt new laws on deposit insurance, bank liquidation, and the Bank Rehabilitation Agency.	end-July 2005	Implemented on July 15, 2005.
2. Serbia: Parliament to adopt amendments to the leasing law and the NBS law granting the authority for regulating and supervising leasing companies to the NBS.	end-July 2005	Implemented on July 15, 2005.
3. Serbia: Government to launch an international tender for appointing a financial advisor for the privatization of the largest socially owned insurance company DDOR.	end-July 2005	Implemented on July 29, 2005.
4. Serbia: Launch an invitation for the submission of expressions of interest for Vojvodanska Banka.	end-September 2005	Implemented on September 30, 2005
5. Serbia: Government to adopt a time-bound corrective action plan for Dunav, the second-largest socially owned insurance company.	end-November 2005	Implemented with delay on December 15, 2005.
6. Montenegro: Launch a tender to sell a majority stake in Podgoricka Banka.	end-June 2005	Implemented in June 2005.
C. Enterprise restructuring and privatization		
1. Serbia: Government to adopt, after close consultation with World Bank staff, a restructuring plan for the mining company RTB Bor.	end-June 2005	Implemented on June 17, 2005.
2. Serbia: Launch privatization auctions for at least 130 socially owned enterprises between January and end-June 2005.	end-June 2005	Implemented. 207 enterprises offered.
3. Serbia: Launch privatization tenders for at least 7 socially-owned enterprises, of which 4 from the list of companies under restructuring, between April and end-June 2005.	end-June 2005	Implemented. 8 enterprises offered, of which 4 under restructuring.
4. Serbia: Government to launch an international tender for hiring an advisor for the privatization of NIS, including advice on selling a majority stake in the oil refineries.	end-July 2005	Implemented with delay on September 13, 2005.
5. Serbia: Launch privatization auctions for at least 230 socially owned enterprises between January and end-September 2005.	end-September 2005	Implemented. 297 enterprises offered.
6. Serbia: Government to initiate bankruptcy procedures against 5 large socially owned companies under the new bankruptcy law between June-September 2005.	end-September 2005	Partially implemented. Only 4 bankruptcies initiated. A fifth was initiated by a private creditor. Compensation: bankrupcty initiated against a large company not under restructuring.
7. Serbia: Launch privatization tenders for at least 7 socially-owned enterprises, of which 4 from the list of companies under restructuring, between July and end-October 2005.	end-October 2005	Implemented. 8 enterprises offered, of which 4 under restructuring.

Table 4. Serbia and Montenegro: Prior Actions for the Sixth Review Under the Extended Arrangement

1. Serbia: Government to ensure implementation of the measures described in paragraph 27 to accommodate pension arrears payments in 2005–06. These are: (i) increase in fuel excises by at least 1 dinar per liter, expected to yield SRD 2.4 billion in 2006 (formal government decision by January 15, 2006); (ii) cuts in mortgage subsidies and agricultural lending by SRD 1.5 billion (formal government decision to amend the 2006 spending targets and programs by January 15); (iii) cuts in the budgetary reserve and expenditures for goods and services by SRD 1.6 billion (formal government decision by January 15); (iv) payment of NIS tax arrears in the amount of SRD 1.5 billion (NIS Managing Board decision in December 2005), and (v) elimination of tax exemptions for capital imports, estimated at SRD 1 billion (formal government decision); (vi) in case the surplus of the consolidated general government in 2005 falls short of the targeted 1.1 percent of GDP, additional compensatory measures will be approved through a formal government decision by January 15, 2006. In particular, fuel excises would be increased by another dinar per liter. Should this require a revision in the oil excise formula, the respective government decision would be approved in January 2006.

2. Serbia: Government to sign a contract with the winning bidder of the tender for an advisor for the privatization of NIS, including advice on selling a majority stake in the two refineries, in line with paragraph 44, by January 15, 2006.

SERBIA AND MONTENEGRO: ADDENDUM TO THE TECHNICAL MEMORANDUM OF UNDERSTANDING DATED JUNE 8, 2005

I. INTRODUCTION

1. This addendum complements and updates the Technical Memorandum of Understanding (TMU) attached to the Memorandum of Economic and Financial Policies (MEFP) of June 8, 2005. The understandings defined in the TMU as of June 8, 2005 fully apply to the definitions of the indicative targets for 2006 and reporting requirements remain unchanged.

2. For the purpose of measuring the indicative targets, 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 Serbian government continues to comprise the Road Fund, even after its corporatization in 2005. The authorities will inform Fund staff of any new funds or special extrabudgetary programs that may be created 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. INDICATIVE TARGETS

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

3. **Program exchange rates.** For the purpose of measuring the indicative targets for 2006, all euro and foreign currency-related assets will be evaluated at program exchange rates: For 2006, the program exchange rates are US$1 = SRD 73.3898, €1 = SRD 86.6000, and SDR1 = US$ 1.42647. Monetary gold shall be valued at an accounting price of US$416.85 per ounce.

4. **Adjustors.** For the purpose of measuring indicative targets, net foreign assets will be adjusted upward pari passu to the extent that: (i) after December 31, 2005, 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 Deposit Insurance Agency (DIA) 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, 2005 (US$41.5 million through end-March 2006, US$161.9 million through end-June 2006, US$159.5 million through end-September 2006, and US$158.6 million through end-December 2006) with a maximum adjustment of US$100 million. The net foreign assets floors will also be adjusted by the amount that the end-December 2005 outcome deviates from the projections for end-December 2005 measured at program exchange rates.

B. Ceiling on Net Domestic Assets of the NBS

5. **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 SRD 3.8 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.

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

6. **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, 2006, and upward for any decrease. These indicative targets will be adjusted by the amount that the end-December 2005 outcome deviates from the projection for end-2005 at program exchange rates. 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 SRD 6.5 billion for Serbia's and €12 million for Montenegro's consolidated government. 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 2006) with the actual inflows evaluated at the average exchange rates of the month when funds are received:

Serbia (2005, in SRD billion)

	Mar.	Jun.	Sep.	Dec.
External Financing	1.1	10.3	10.1	10.1
Privatization proceeds	5.8	10.3	33.2	40.5

Montenegro (2006, in € million)

	Mar.	Jun.	Sep.	Dec.
External Financing	9.9	11.1	11.2	11.3
Privatization proceeds	13.4	21.9	30.4	39.0

D. Nonbank Domestic Financing

7. **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).

	2006			
	Mar.	Jun.	Sep.	Dec
Projected Nonbank Domestic Financing (cumulative)	0.6	13.9	20.7	22.4

E. Reserve Money

8. **Adjustors.** For program monitoring purposes, reserve money will be adjusted as follows. Should the reserve requirement on SRD-denominated deposits increase (decrease) from the level prevailing on December 31, 2005, 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. Required reserves of banks placed under BRA administration or liquidation will remain part of reserve money for program purposes.

F. Ceiling on the Wage Bill of Serbian Public Enterprises

9. **Definition.** For 2006, the indicative targets are set on a quarterly basis on the cumulative monthly wage bill of eight large public enterprises, namely JP Elektroprivreda Srbije, JP Naftna Industrija Srbije, JP Zeleznicko Transportno Preduzece Srbije, JP PTT Srbije, JP Srbija Sume, JP JAT Airways, JP Telekom Srbija, and JP Aerodrom Beograd. Wages are accounted on an accrual basis, excluding taxes and social security contributions, and include base wages, remuneration for contracted labor, overtime payments, dividend payments, jubilee awards, and any other bonuses.

10. **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-December 2005, the wage bill target will be adjusted downwards for the wage bills of spun-off units. In the case of a legal separation of core components of the eight monitored state-owned enterprises, the wage bill of all companies emerging from such separations will be included under the total wage bill ceiling.

SERBIA AND MONTENEGRO: EXTERNAL DEBT SUSTAINABILITY ANALYSIS

1. This appendix updates the debt sustainability analysis in IMF Country Report 05/233.

Medium-term balance of payments projections

2. The baseline scenario assumes that: (a) exports will grow at an annual average of 21 percent in the first three years (starting with 2005) and 14 percent in the following four years in dollar terms (growth rates in euro terms are similar); (b) imports will grow at about 7 percent in dollar terms in 2005–07 (9 percent in euro terms) and then around 9 percent in the following four years; however, average for 2005–07 is distorted by the effect of the VAT introduction in January 2005, so that the corrected average in this period would be actually higher, reflecting the pent-up demand[1]; (c) FDI related to the privatization process continues to flow in during 2005 and 2006, but is gradually replaced by other types of FDI, including "greenfield" investment, equity investment, and reinvestment in existing companies, building on the success in privatization and improving the business environment; (d) commercial borrowing will increase steadily as the business environment improves; (e) official borrowing will remain moderate, with declining program support being offset by increasing project support; (f) there will be no IMF financial support after the current arrangement; (g) gross international reserves will remain at around 5 months of prospective imports of goods and services.

3. Under the baseline scenario, the debt-to-GDP ratio improves over the next 10 years, albeit at a relatively slow pace, averaging around 61 percent in the first 3 years and around 57 percent in the next five years. The significantly higher projected debt ratios compared to Country Report No. 05/233 reflect the impact of stronger-than-programmed trends in external borrowing, particularly by the private sector. Debt service ratios increase over the time horizon, partly reflecting the increased debt service after the end of the grace period offered by the Paris Club and other bilateral creditors, and stabilize at around 12 percent of GDP and 31 percent of exports. The rise of debt service ratios argues for the maintenance of adequate official reserves to guard against possible risks, while keeping on schedule with the country's external obligations.

[1] 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 economic isolation of the country, and is supported by increasing availability of financing. Exports are expected to show sustained growth in the projection period, reflecting the recovery of the domestic demand of SM's 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.

Stress testing applying the standardized sustainability framework

4. The standard framework for the debt sustainability analysis has been adapted to the particular case of Serbia and Montenegro to take into account the limited availability of data and the exceptional factors that have affected economic performance, as well as data quality, in the course of the 1990s. The historical averages for most key variables are based on the outturns of 2000-2004; deflators are based on 2001-2004 to exclude the inflationary episode following the Kosovo war. Notwithstanding these specificities, this DSA relies exclusively on country data (as it was first done in IMF Country Report No. 04/202).[2]

5. If the key variables (real GDP growth, dollar deflator, nominal interest rate, export and import growth rates, non-interest current account, and non-debt inflows) are set as the historical averages, as defined above, the external debt ratios would decline faster than in the baseline case after the first year, owing to the much higher historical GDP deflator related to dollar depreciation and the lower nominal interest rate partly associated with the delayed start of debt service to the Paris Club creditors.

6. Sensitivity analysis allows to compare the debt-to-GDP ratios under different scenarios. By far, the largest increase in the debt-to-GDP ratio is brought about by a large one-time nominal depreciation in 2006 (due to the significant drop in GDP in dollar terms), even though even in this case the debt ratio declines after the initial peak. The debt dynamics is also negatively affected—even though to a lesser degree—by a shock to the current account (partly due to the exceptionally high 2004 outcome). Shocks to real growth and to the interest rate slightly increase the debt ratio in the medium term, but in the long run the ratio converges to the baseline. The combination of smaller shocks of all the above variables would yield higher debt ratios than the baseline mainly due to the current account shock component.

[2] As discussed in IMF Country Report No. 03/151, previous DSAs used data from four countries in the region (Albania, Bulgaria, Croatia, and Romania) to derive standard deviation; moreover, the historical averages were based on the outturns of 2002 and 2003.

Table 1: Serbia and Montenegro: External Debt Sustainability Framework, 2003-2010
(In percent of GDP, unless otherwise indicated)

	Actual		Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	
			I. Baseline Projections						Debt-stabilizing non-interest current account 5/
External debt	69.2	61.1	**61.1**	**60.5**	**59.8**	**58.2**	**56.7**	**55.7**	**-5.4**
Change in external debt	-7.0	-8.1	0.0	-0.6	-0.8	-1.5	-1.5	-1.0	
Identified external debt-creating flows (4+8+9)	-16.4	0.3	-3.2	1.2	-1.2	-1.9	-1.6	-1.4	
Current account deficit, excluding interest payments	8.6	11.2	6.7	6.6	5.3	4.3	4.2	4.0	
Deficit in balance of goods and services	22.0	27.7	22.8	23.0	21.7	20.4	20.0	19.5	
Exports	20.2	23.4	26.9	30.7	33.9	37.0	39.1	41.2	
Imports	42.3	51.1	49.7	53.7	55.6	57.4	59.1	60.7	
Net non-debt creating capital inflows (negative)	-6.8	-4.2	-7.7	-6.9	-6.6	-6.5	-6.3	-6.0	
Automatic debt dynamics 1/	-18.1	-6.7	-2.3	1.5	0.1	0.2	0.4	0.6	
Contribution from nominal interest rate	1.1	1.3	2.0	2.9	3.0	3.0	3.1	3.3	
Contribution from real GDP growth	-1.7	-2.7	-2.6	-2.8	-2.7	-2.7	-2.6	-2.6	
Contribution from price and exchange rate changes 2/	-17.6	-5.3	-1.7	1.4	-0.1	-0.1	-0.1	-0.1	
Residual, incl. change in gross foreign assets (2-3)	9.3	-8.5	3.3	-1.8	0.4	0.4	0.1	0.5	
External debt-to-exports ratio (in percent)	341.8	261.4	227.5	197.1	176.3	157.5	145.1	135.2	
Gross external financing need (in billions of U.S. dollars) 3/	3448.0	5442.1	5559.8	5846.7	6265.1	7326.4	9017.9	10401.9	
(in percent of GDP)	16.7	22.3	21.2	21.7	22.2	24.7	28.9	31.8	
Key Macroeconomic Assumptions									Projected Average
Real GDP growth (in percent)	3.0	4.4	4.6	4.8	4.8	4.8	4.8	4.8	4.8
GDP deflator in U.S. dollars (change in percent)	29.9	8.3	2.8	-2.2	0.2	0.1	0.1	0.1	-0.3
Nominal external interest rate (in percent)	2.0	2.1	3.6	4.9	5.2	5.3	5.6	6.1	5.4
Growth of exports (U.S. dollar terms, in percent)	29.1	36.0	23.8	17.3	15.9	14.5	11.0	10.8	13.9
Growth of imports (U.S. dollar terms, in percent)	27.4	42.3	4.7	10.9	8.7	8.4	8.1	8.0	8.8
Current account balance, excluding interest payments	-8.6	-11.2	-6.7	-6.6	-5.3	-4.3	-4.2	-4.0	-4.9
Net non-debt creating capital inflows	6.8	4.2	7.7	6.9	6.6	6.5	6.3	6.0	6.5
			II. Stress Tests for External Debt Ratio						Debt-stabilizing non-interest current account 5/
A. Alternative Scenarios									
A1. Key variables are at their historical averages in 2006-10 4/			**61.1**	**50.3**	**43.5**	**38.1**	**33.7**	**30.4**	**-9.8**
B. Bound Tests									
B1. Nominal interest rate is at baseline plus one-half standard deviation			**61.1**	**60.8**	**60.2**	**58.9**	**57.6**	**56.8**	**-5.2**
B2. Real GDP growth is at baseline minus one-half standard deviations			**61.1**	**60.8**	**60.2**	**58.8**	**57.4**	**56.5**	**-5.3**
B3. Non-interest current account is at baseline minus one-half standard deviations			**61.1**	**62.2**	**63.1**	**63.2**	**63.3**	**64.1**	**-5.3**
B4. Combination of B1-B3 using 1/4 standard deviation shocks			**61.1**	**61.6**	**61.8**	**61.3**	**60.8**	**60.8**	**-5.2**
B5. One time 30 percent real depreciation in 2006			**61.1**	**88.5**	**84.5**	**79.9**	**75.2**	**71.5**	**-8.4**

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate; ρ = change in domestic GDP deflator in U.S. 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 debt.
2/ Defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock.
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
4/ Key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
5/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 2. Serbia and Montenegro: Medium-Term External Sustainability, 2000-2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Average 2005-07	Average 2008-10	Average 2000-2010
	(In millions of U.S. dollars, unless indicated otherwise)													
Export growth (US$ terms, in percent)	14.7	4.2	20.4	26.6	32.4	25.0	20.3	18.5	17.5	13.7	11.7	21.3	14.3	18.6
Export growth (euro terms, in percent)	32.5	7.5	14.2	5.8	20.6	23.9	24.6	20.7	17.1	13.5	11.6	23.1	14.0	17.4
Import growth (US$ terms, in percent)	12.6	30.4	30.7	25.6	43.4	0.8	11.6	9.3	9.2	8.8	7.9	7.2	8.6	17.3
Import growth (euro terms, in percent)	30.0	34.5	23.9	5.0	30.6	-0.1	15.6	11.3	8.8	8.6	7.7	8.9	8.4	16.0
Current account balance, before grants	-610	-1,119	-2,007	-2,543	-3,597	-2,668	-2,913	-2,617	-2,460	-2,562	-2,656	…	…	…
in percent of GDP	-7.1	-9.7	-12.9	-12.3	-14.8	-10.2	-10.8	-9.3	-8.3	-8.2	-8.1	-10.1	-8.2	-10.2
Current account balance, after grants	-339	-528	-1,383	-2,005	-3,036	-2,295	-2,560	-2,346	-2,184	-2,282	-2,371	…	…	…
in percent of GDP	-3.9	-4.6	-8.9	-9.7	-12.5	-8.8	-9.5	-8.3	-7.4	-7.3	-7.2	-8.9	-7.3	-8.0
Gross official reserves	516	1,169	2,280	3,557	4,302	6,269	6,949	7,349	7,757	8,163	8,565	…	…	…
in months of prospective imports of GNFS	1.2	2.4	3.1	3.4	4.0	5.2	5.3	5.2	5.1	4.9	4.8	5.2	4.9	4.1
External debt 1/	11,403	11,948	11,839	14,303	14,876	16,021	16,276	16,876	17,271	17,657	18,235	…	…	…
In percent of exports of goods and services	448	436	365	342	252	228	197	176	158	145	135	200.3	145.9	261.9
In percent of GDP	133	103	76	69	62	61	61	60	58	57	56	60.5	56.9	72.3
In percent of government revenue	361	265	178	162	142	138	136	134	131	128	126	136.2	128.3	173.0
External debt service 2/ 3/	56	107	183	436	972	1,719	1,971	2,547	3,102	4,075	4,373	…	…	…
In percent of exports of goods and services	2.2	3.9	5.7	10.4	17.1	24.4	23.9	26.6	28.3	33.5	32.4	25.0	31.4	18.9
In percent of GDP	0.6	0.9	1.2	2.1	4.0	6.6	7.3	9.0	10.5	13.1	13.4	7.6	12.3	6.2
In percent of government revenue	1.8	2.4	2.8	5.0	9.0	14.8	16.4	20.3	23.5	29.5	30.2	17.2	27.7	14.1

Sources: SCG 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.

3/ Cash payments.

SERBIA AND MONTENEGRO: PUBLIC SECTOR DEBT SUSTAINABILITY ANALYSIS

1. This Appendix updates the public sector DSA in IMF Country Report No. 05/233. Under the baseline scenario, Serbia's debt-to-GDP ratio would decline steadily from 52 percent of GDP in 2005 to 30.3 percent of GDP in 2010 (Table 1). While the baseline scenario is broadly similar to the previous one, the debt-to-GDP ratio falls more rapidly after 2006 due to a higher projected primary surplus and privatization proceeds in 2006. The DSA also incorporates the London Club debt rescheduling after the successful negotiations in mid-2004. Following a sizeable fiscal consolidation in 2004 and 2005, the baseline assumes further fiscal tightening in 2006 with a slight reduction in the surplus in 2007, and stable surpluses thereafter.

2. Revenues are projected to decline slowly as the fiscal reforms clear space for reducing the tax burden. Current primary spending is projected to decline in 2006 on the account of employment reduction in the health sector and the army, and reduction in subsidies to public and socially owned enterprises. However, spending is projected to rebound slightly in 2007 and 2008 to accommodate larger repayment of pension arrears scheduled for those years. Subsidies and net lending are assumed to be on a declining path while capital spending, after an increase in 2006, is expected to stabilize at that level and increase only slightly in the medium term. Privatization receipts are expected to slow down over the medium term. Real effective interest rates are assumed to increase over time but will remain negative in dinar terms, as most of the foreign borrowing is concessional.

3. Stress tests were conducted using the standardized methodology adopted in July 2005 (Information Note on Modifications to the Fund's Debt Sustainability Assessment Framework for Market Access Countries — http://www-imf.org/external/np/pp/ eng/205/070105.htm), but with modifications due to data constraints. Historical averages for SCG are incomplete prior to 2000 and data available since 2000 are not representative, as they were affected by debt restructuring operations. Consequently, the 2004 outturn and projected outturn for 2005 were used to replace historical averages for all variables but the interest rate, and the 1997–2001 data for 4 countries in the region (Albania, Bulgaria, Croatia, and Romania) were used to derive standard deviations. The real interest rate was assumed at zero percent for the stress tests.

4. The first stress test ("historical averages") keeps the real GDP growth rate and the primary balance at their 2004-2005 level, and interest rates as described above. This results in much slower reduction in the debt-to-GDP ratio in the outer years relative to the baseline, leading to a reduction in debt-to-GDP ratio by only 14 percentage points as compared to 30 percentage points under the baseline scenario. Other stress tests included (i) higher real interest rates; (ii) lower primary balance; (iii) a combination of higher real interest rate, lower primary balance and lower growth; and (iv) a 10 percent increase in debt-creating flows. These result in a slower decline in the debt-to-GDP ratio than in the baseline scenario. The test with 30 percent one-time real depreciation, in which the debt-to-GDP ratio increases significantly after the shock but declines thereafter, demonstrate the sensitivity of the debt

dynamics to the exchange rate, as almost 90 percent of public debt is foreign currency-denominated. The stress test with a lower real GDP growth shows a return of debt-to-GDP ratio to over 50 percent in the medium term, after an initial decline in 2005–2007.

Table 1. Serbia and Montenegro: Public Sector Debt Sustainability, 2002-2010
(In percent of GDP, unless otherwise indicated)

	Actual			Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	85.4	79.2	60.2	**52.1**	**45.9**	**41.1**	**37.0**	**33.5**	**30.3**	**0.1**
o/w foreign-currency denominated	78.5	71.5	52.9	45.7	40.7	37.3	34.2	31.2	28.4	
Change in public sector debt	-37.8	-6.2	-19.0	-8.1	-6.3	-4.8	-4.1	-3.5	-3.2	
Identified debt-creating flows (4+7+12)	-38.2	-18.6	-9.1	-15.8	-10.8	-7.4	-6.1	-5.3	-4.8	
Primary deficit	2.4	2.1	-1.2	-2.4	-4.0	-3.9	-3.7	-3.6	-3.4	
Revenue and grants	43.9	42.9	45.3	44.4	44.7	44.7	44.7	44.6	44.5	
Primary (noninterest) expenditure	46.3	45.0	44.1	42.0	40.6	40.9	41.0	41.0	41.1	
Automatic debt dynamics 2/	-38.5	-16.3	-7.4	-9.8	-6.6	-4.2	-3.1	-2.4	-2.0	
Contribution from interest rate/growth differential 3/	-26.8	-12.9	-10.6	-9.8	-6.6	-4.2	-3.1	-2.4	-2.0	
Of which contribution from real interest rate	-23.0	-11.0	-5.7	-7.4	-4.4	-2.2	-1.3	-0.7	-0.5	
Of which contribution from real GDP growth	-3.8	-1.9	-4.8	-2.4	-2.2	-2.0	-1.8	-1.7	-1.5	
Contribution from exchange rate depreciation 4/	-11.7	-3.5	3.2	...	...	...	...	...	...	
Other identified debt-creating flows	-2.2	-4.3	-0.6	-3.7	-0.1	0.7	0.7	0.7	0.6	
Privatization receipts (negative)	-2.2	-4.3	-0.6	-3.7	-1.9	-0.9	-0.7	-0.5	-0.4	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (debt of public enterprises)	0.0	0.0	0.0	0.0	1.8	1.6	1.4	1.2	1.0	
Residual, including asset changes (2-3) 5/	0.5	12.4	-9.9	7.8	4.5	2.6	2.0	1.8	1.7	
Public sector debt-to-revenue ratio 1/	194.6	184.4	133.0	117.3	102.7	91.9	82.8	75.2	68.2	
Gross financing need 6/	4.2	3.2	0.7	-0.8	-1.9	-1.5	-1.2	-0.9	-0.8	
in billions of U.S. dollars	0.7	0.7	0.2	-0.2	-0.5	-0.5	-0.4	-0.3	-0.3	
Scenario with key variables at their historical averages 7/				**52.1**	**52.0**	**51.0**	**49.7**	**48.1**	**46.4**	**0.0**
Scenario with no policy change (constant primary balance) in 2006-2010				**52.1**	**43.5**	**40.6**	**38.0**	**35.8**	**33.7**	**0.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline										
Real GDP growth (in percent)	4.0	2.7	7.2	4.8	5.0	5.0	5.0	5.0	5.0	
Average nominal interest rate on public debt (in percent) 8/	1.0	1.4	2.1	3.0	3.6	3.9	4.0	4.2	4.1	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-23.2	-14.9	-7.8	-14.3	-9.5	-5.0	-3.1	-1.9	-1.3	
Nominal appreciation (increase in US dollar value of local currency, in percent)	15.2	5.5	-5.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	24.2	16.3	9.9	17.3	13.1	8.8	7.1	6.1	5.4	
Growth of real primary spending (deflated by GDP deflator, in percent)	23.3	-1.3	5.0	1.3	1.4	5.4	5.2	4.9	5.1	
Primary deficit	2.4	2.1	-1.2	-2.4	-4.0	-3.9	-3.7	-3.6	-3.4	

1/ Gross debt of the non-financial public sector (federal, republican, and local governments, social security funds, and extrabudgetary programs), excluding Montenegro.

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; α = 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/ Derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, including exchange rate changes.

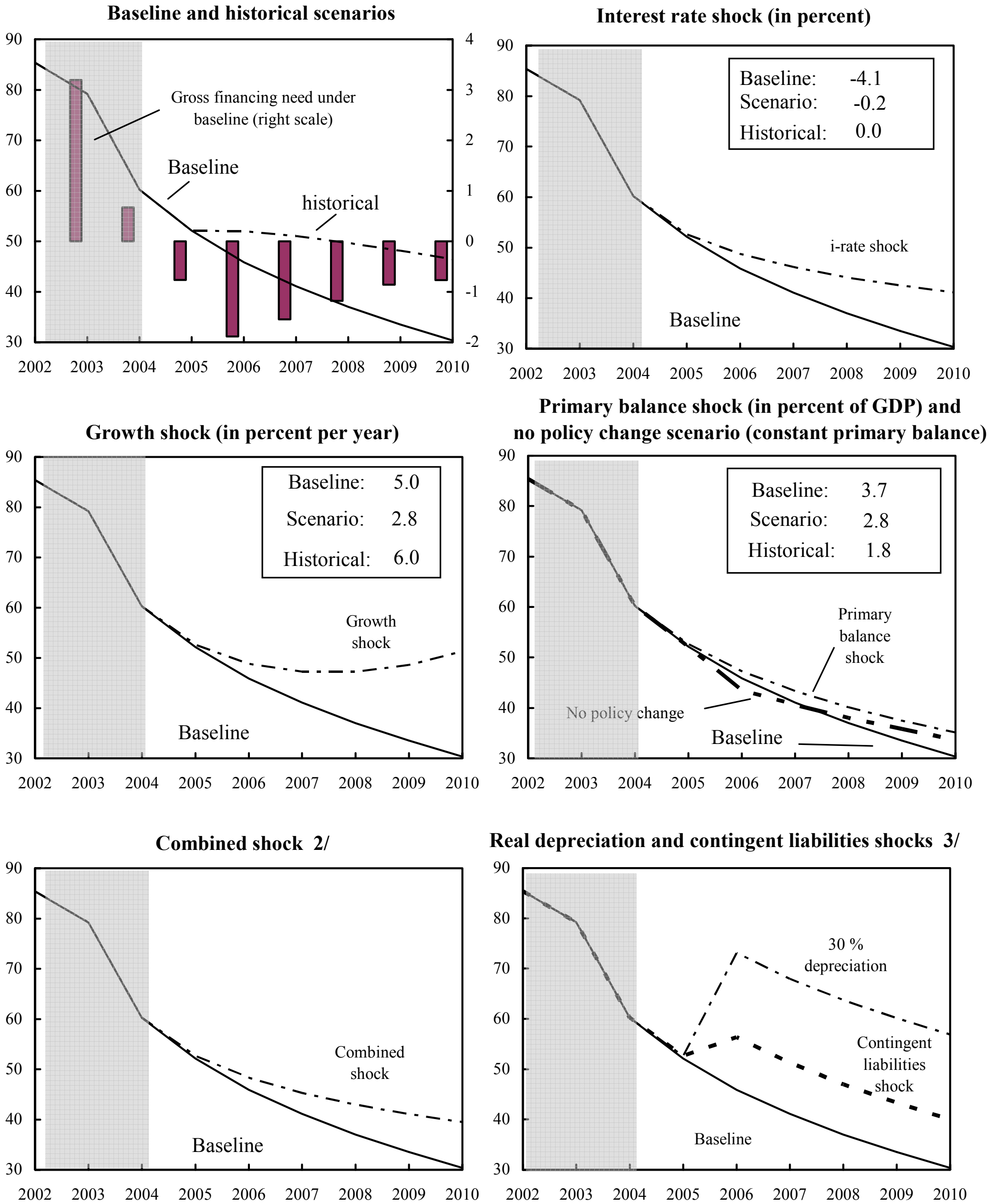
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP. Due to data availability, historical average is calcualted over seven rather than ten years.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1. Serbia and Montenegro: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



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

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of dinar) minus domestic inflation (based on GDP deflator).

Serbia and Montenegro: Statistical Issues

1. In recent years, Serbia and Montenegro (SCG) has been successfully upgrading its statistical system with the assistance of the IMF and other bilateral and multilateral institutions, but international standards are not yet fully met. Official data for all sectors are, nonetheless, sufficiently good to support key economic analysis. In many areas, including monetary and balance of payments sectors, internationally accepted reporting standards have been introduced. However, SCG 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. A major impediment to the compilation and reporting of economic data is the fragmentation of statistical activity between the two Republics and the State Union, hampering coordination. Except for monetary statistics for Serbia compiled by the National Bank of Serbia (NBS), SCG 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 provided a series of technical assistance missions to improve the quality of macroeconomic statistics and support policy analysis. In 2001–2003, STA conducted four missions, two on monetary and financial statistics, a multisector statistics mission, and a balance of payments mission to Serbia. In 2004, there were three missions, on monetary and financial statistics, national accounts, and balance of payments (to Montenegro only). These missions found that there was a critical need for SCG 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 follow-up mission on national accounts took place in late 2005, and further missions are planned for 2006.

3. Pending improvements in the compilation methodologies, as recommended by the various missions, a country page for SCG in envisaged for publication in *International Financial Statistics (IFS)*, with a section for each republic. IFS correspondents should be nominated, and a track record of timely and regular reporting of macroeconomic statistics to STA should be established.

A. Real Sector

4. Real sector data for the republics are compiled by the Republic of Serbia Statistical Office (RSSO), and the Republic of Montenegro Statistical Office (RMSO), while the Serbia and Montenegro Statistical Office (SMSO) disseminates data for the union. Annual current price estimates of GDP by activity and by expenditure are available for Serbia for 1997–2003 and for Montenegro for 1997–2002. In June 2005 the RSSO started publishing quarterly constant price estimates of GDP using the production approach. The agencies have made commendable efforts to adopt the *System of National Accounts (1993 SNA),* but there are still problems with the scope of the accounts and the basis for recording that are not entirely

consistent with the international standards. Moreover, the quality of the source data is uneven, and data sources are in serious need of improvement. A master plan for the improvement of economic statistics was developed with the assistance of EUROSTAT.

5. A major shortcoming in official statistics is the lack of estimates for informal activities, which may account for up to one half of the value added in the economy. To improve the industrial output index, the statistical office broadened the coverage of the index in 2004 to include several hundred small and medium enterprises, but with the drawback of reduced reliability and limited comparability with the data for previous years.

6. The SMSO and the RSSO compile and disseminate retail price indices (RPI), consumer price indices (CPI), producer price indices (PPI), and unit-value price indices for imports and exports. The RSSO plans to introduce a new CPI index in 2006, in line with international standards. In Montenegro, the RMSO compiles a RPI and a CPI. While the frequency and methodology of observation appear adequate, weighting, data storage, and dissemination could be improved.

B. Balance of Payments

7. Balance of payments statistics are currently compiled by the NBS and the Central Bank of Montenegro (CBM). While the data compilation procedures appear appropriate, some components of the balance of payments (e.g., remittances) suffer from substantial underrecording owing to the large proportion of foreign exchange transactions occurring outside official channels. Since 2001, the NBS has made commendable efforts to improve its estimation of actual flows. 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), and removing exchange-rate changes from certain financial transactions, including arrears below the line. In Montenegro, the CBM has recently transferred responsibility for external debt recording to the Ministry of Finance.

8. The union's balance of payments statement covers both constituent states, notably with regard to trade in goods and services, but the compilation of various items still suffers from missing or poor information and inconsistent estimates from state sources, notably with regard to the estimation of trade between Serbia and Montenegro. As a result, the statement continues to show significant net errors and omissions. The NBS compiles a balance of payments statement for Serbia using existing national sources, and the CBM has also begun compiling balance of payments statistics for Montenegro. However, the coordination of technical work at the state level needs to be improved to lay the basis for accurate union-level statistics, including with regard to external debt. A technical assistance mission to the CBM in June/July 2004 assisted with adoption of compilation methodologies consistent with the fifth edition of the *Balance of Payments Manual (BPM5)* and provided recommendations to improve international trade and external debt statistics, as well as Montenegro's international transaction reporting system (ITRS). Close coordination between the NBS and the CBM will be needed to compile balance of payments data on a BPM5 basis for the Union.

C. Government Finance

9. Fiscal statistics are compiled by the Serbian Ministry of Finance and 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. Both report the republican budget implementation data on a monthly basis.

10. While data on the general government are now compiled, they are not fully compliant with the *Government Finance Statistics Manual (GFSM 2001)*. Since 2001, 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.

11. Fiscal data for the central government of Montenegro are based on the new GFS classification. However, data for the social security funds, reported directly by the funds with significant delays, are not compiled on a GFS basis. A new chart of accounts was introduced in Montenegro in 2001, and is being implemented at the local level from mid-2005. SCG began reporting data on general government—including local government—in the 2003 edition of the *Government Finance Statistics Yearbook*.

D. Monetary Accounts

12. 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*. Both meet GDDS recommendations with respect to the periodicity and timeliness of financial sector data. After a break of over a decade, the NBS began reporting to STA monetary statistics for Serbia in November 2002. Since October 2003, the NBS publishes detailed monetary statistics in its monthly *Statistical Bulletin*, which includes tables on monetary statistics, balance sheets and surveys for the NBS and the commercial banks.

13. Serbia introduced new charts of accounts for the NBS and commercial banks in December 2003. Montenegro also introduced new charts of accounts for the CBM (January 2004) and commercial banks (December 2003). Both republics compile monetary statistics from data based on these new charts of accounts. Despite significant progress, there is still 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 and nonresidents and various domestic sectors (including the government sector); and (3) uniform treatment of residents of Montenegro as nonresidents across all macroeconomic statistics in 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.

SERBIA AND MONTENEGRO: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF DECEMBER 31, 2005

	Date of Latest Observation	Date Received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange rates	Dec. 30, 2005	Dec. 30, 2005	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	Dec. 30, 2005	Dec. 30, 2005	D	W	M
Reserve/base money	Dec. 30, 2005	Dec. 30, 2005	D	W	M
Broad money	Nov. 2005	Dec. 27, 2005	M	M	M
Central bank balance sheet	Nov. 2005	Dec. 27, 2005	M	M	M
Consolidated balance sheet of the banking system	Nov. 2005	Dec. 27 2005	M	M	M
Interest rates[2]	Nov. 2005	Dec. 27 2005	M	M	M
Consumer price index	Dec. 2005	Dec. 30, 2005	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	Nov. 2005	Dec. 15, 2005	M	M	M
Revenue, expenditure, balance and composition of financing[3] – central government	Nov. 2005	Dec. 15, 2005	M	M	M
Stocks of central government and central government-guaranteed debt[5]	Nov. 2005	Dec. 15, 2005	M	M	M
External current account balance	Oct. 2005	Dec. 19, 2005	M	M	M
Exports and imports of goods and services	Oct. 2005	Dec. 19, 2005	M	M	M
GDP/GNP	Q3 2005	Dec. 28, 2005	Q	Q	Q
Gross external debt	Oct. 2005	Dec. 16, 2005	M	M	M

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic non-bank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. General government reporting is incomplete; local government expenditure data are available only after a six-month lag.

[5] Including currency and maturity composition.

[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Semi-annually (SA), Annually (A), Irregular (I); or Not Available (NA).

Statement by Fritz Zurbrügg, Executive Director for Serbia and Montenegro and Srboljub Antic, Senior Advisor to Executive Director
February 6, 2006

Introduction

The authorities of Serbia and Montenegro welcome the staff papers that present a candid assessment of the recent economic developments in the country. The papers highlight the accomplishments under the Extended Arrangement (EA), as well as the numerous challenges that policymakers are still confronted with. Our authorities broadly share the staff's assessment on policy options and the constraints regarding their implementation.

Serbia and Montenegro has started negotiations with the EU under the Stabilization and Association Agreement using the "twin track" approach adopted by the EU. This agreement provides a strong framework and unique opportunity to press ahead with the reforms. Significant progress in the trade area was achieved by the approval of the custom tariffs law and foreign trade law, which are consistent with EU and WTO regulations.

As staff noted, the political situation in the country remains fragile. 2006 will be important for finding a political solution between Serbia and Montenegro, while the negotiations on the status of Kosovo should yield some results. The authorities are fully aware of the challenges for policy making in that environment.

The EA had to deal with a number of outstanding problems of structural nature and an omnipresent trade-off between inflation and current account objectives. This made the task of policymakers very difficult. The complexity of the economic problems, together with a divisive political climate explains the high number of waivers and the prolonged discussions between staff and the authorities regarding this final review. However, it is clear that economic reforms are continuing, which can be seen from a strong fiscal adjustment, growth of foreign exchange reserves, and utility sector restructuring.

Reform progress 2000 - present

As this is the final review of the EA, is the appropriate occasion to summarize the main results achieved during this arrangement as well as past programs . The reform process in Serbia and Montenegro is characterized by five main features:

- The country has managed to consolidate the external public debt on a much lower level. Negotiations with the Paris Club (2001) and London Club (2004) enabled significant debt relief. The finalization of the EA will trigger the last portion of the Paris Club debt relief.

- Foreign exchange reserves growth was strong and reserves reached US$5.9 billion at the end of 2005, which covers 5 months of imports. The level of foreign exchange reserves is much higher than projected at the beginning of the arrangement.

- Fiscal adjustment of more than 5 percent of GDP was achieved during 2003-2005. After a long period of deficits, Serbia has a fiscal surplus and will continue with the policy of even higher surpluses in the future.

- Both republics introduced the VAT without problems. The VAT revenues are much higher than the turnover tax in previous years.

- The authorities managed to transform the banking sector from a collection of gambling houses to a group of banks with high credibility. With dominant foreign players, the banking sector has seen a strong increase of the deposit base.

The fruits of these reforms are evident in the economic recovery. After 2000, the economy has grown by a cumulative 28 percent, but it is still significantly below the level of 1990. However, the country is presently facing high inflation and current account deficits, which are the issues that have to be tackled in the future. Therefore, the economic policies in 2006 will be geared toward macroeconomic stabilization, mainly through a further tightening of the policy stance and rapid structural reforms in the real sector.

Fiscal policy

Fiscal consolidation will continue in 2006, through further policy tightening in order to help to reduce the current account deficit and high inflation. In both republics, fiscal tightening will yield more than 1 percent of GDP, with the focus being on expenditure cuts.

After a surplus in 2005, fiscal policy in Serbia in 2006 will be geared to produce a surplus of 2.5 percent of GDP. Fiscal consolidation will be achieved through permanent cuts in current expenditures, while tax policy will stay broadly unchanged. Prudent income policies and continued improvement in tax administration will help to achieve the fiscal target.

In the medium term, the reduction of the high tax burden will be achieved by tight income policies in various sectors, combined with cuts in transfers and subsidies. The average wage growth in the central government, social funds, and the Army will be limited to a small real increase, while the rationalization of employment will continue. The wage bill of municipalities, which recorded a high increase in 2005, will grow below the projected inflation level and will be monitored by the Ministry of Finance. The reform of the health sector will reduce transfers from the Health Fund due to rationalization of health benefits and employment cuts. In the area of subsidies, export subsidies will be cut and agricultural subsidies reduced in line with the agreement with the EU. Subsidies to the railway company will also be reduced, while the Development and Guarantee Fund will no longer receive funds from the budget.

Fiscal consolidation will continue in Montenegro. The fiscal deficit will be reduced by 1 percent of GDP in 2006 mainly by employment cuts and tight income policy in the public sector. The financial operations of the Montenegro Development Fund will be controlled by the Ministry of Finance. Reducing the public debt and net interest bill will be the core of the medium-term policies.

Monetary policy

Monetary tightening in 2006 will aim at containing domestic demand and inflationary pressures. To increase confidence in the dinar, the National Bank of Serbia (NBS) will rely on increasing repo operations and on aggressive moves toward positive real interest rates. Reserve requirements on foreign exchange deposits and on commercial banks' foreign borrowing, that were raised and unified at the level of 38 percent, will remain unchanged. The NBS stands ready to adjust reserve requirements if the macroeconomic situation changes.

Conducting the exchange rate policy of the dinar has been a very difficult task. The continual balancing between two conflicting objectives (reducing inflation and containing the current account deficit) will also be the main feature of the exchange rate policy in 2006. The NBS will frequently assess the exchange rate policy in order to prevent a loss of competitiveness and growing eurization.

The privatization of the banking sector will maintain its momentum in 2006. In the second quarter of 2006, one of the two remaining big state-owned banks will be privatized, while the government of Serbia is negotiating with the EBRD about the recapitalization of the second big state owned bank. A couple of smaller state owned banks in Serbia and Montenegro are also in the process of privatization.

Real sector

2006 should bring the process of privatization of state owned companies close to an end, with the exception of utilities and companies under restructuring. The Privatization Agency will offer for sale all companies in its portfolio by the end of 2006. About a third of the companies under restructuring (25 of them) will be offered for sale through tenders by the end of Q3 2006. The government will continue to implement its policy of initiating bankruptcy procedures against companies that twice failed to be sold through auctions or tenders.

The restructuring of public utilities and other state owned monopolies will combine hard budget constraint measures (subsidy cuts and strict wage controls) with measures that introduce competition. The public utilities will strengthen their collections by enforcing penalties on late payments and disconnecting users that are late on their obligations for more than two months. A prior action regarding the hiring of an international advisor for the privatization of the oil company was completed on time and it is expected that international tenders will be launched in Q2 2006.

Transparency

The EA is the third program with the IMF, after Serbia and Montenegro regained its membership. All reviews under all three programs were published. The authorities believe that the benefits of transparency significantly outweigh all political or economic costs that a publication of IMF reports can cause. In line with the now well established tradition, the authorities of Serbia and Montenegro consent to the publication of the staff documents.

Future relations with the Fund

With the final review of the EA, the country will finalize a phase in its relations with the Fund that was developed for post conflict (and transition) countries. The authorities of Serbia and Montenegro feel that the country is not yet close to graduating from Fund-supported programs. Although macroeconomic conditions are improving, the country still has to address macroeconomic imbalances (high inflation, high current account deficit), an array of structural reforms, and has to explore the issue of the exchange rate regime. Therefore, the Fund's assistance and advice need to play an important role in the design and implementation of future macroeconomic policies, focusing on these issues. The authorities believe that the country will benefit from at least another program with the Fund, the length and type of which will be discussed in due course.

Press Release No. 06/25
FOR IMMEDIATE RELEASE
February 7, 2006

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Sixth Review Under an Extended Arrangement With Serbia and Montenegro and Approves US$90.1 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the sixth and final review of Serbia and Montenegro's economic performance under an Extended Arrangement. The completion of the review enables the release of an amount equivalent to SDR 62.5 million (about US$90.1 million), which would bring total disbursements under the program to SDR 650.0 million (about US$937.2 million).

In completing the review, the Executive Board granted waivers for the non-observance of two end-September 2005 quantitative performance criteria on the ceiling for net credit to government, and on the wage bill of the monitored public enterprises, as well as of five structural performance criteria pertaining to government action on spinning off non-core companies of public enterprises, and parliamentary approval of legislation. In addition, the Board completed a Financing Assurances Review, and called on Serbia and Montenegro to engage in Post-Program Monitoring.

The Executive Board reviewed a non-complying purchase made in 2005 resulting from a misreporting of data. The Board regretted the authorities' failure to provide accurate information, but granted a waiver in light of the minor deviation from the program target and the prompt corrective actions taken by the authorities. The Board also granted a waiver of nonobservance of the performance criterion that gave rise to the non-complying purchase and decided not to take action on the breach of obligations under Article VIII, Section 5, in light of the improvements in monitoring and reporting.

The Extended Arrangement was approved in May 2002 for a total amount equivalent to SDR 650 million (about US$937.2 million) to support Serbia and Montenegro's 2002–2005 economic program (see Press Release No. 02/25). It was extended twice, on May 13, 2005, and December 21, 2005 respectively.

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

"The strong growth and export performances in Serbia and Montenegro are notable and have been supported by an acceleration of structural reforms. In particular, the restructuring and privatization of banks and the improved business climate have boosted investment. At the same time, macroeconomic imbalances have begun to ease on the strength of a substantial fiscal tightening.

“Despite recent improvements, the high inflation and external current account imbalance remain sources of concern. The large current account deficit and the rise in debt-financing have increased the vulnerability to disruptions in external credit markets or exchange rate changes. In this regard, the slippages in incomes and monetary policies are regrettable, in particular the insufficient sterilization of large capital inflows. The imbalances also reflect the slow restructuring of public and socially owned enterprises, which is limiting potential growth and the authorities’ room for maneuver to adjust demand management policies.

“Looking forward to 2006, the envisaged further tightening of macroeconomic policies and acceleration of structural reforms should lower inflationary pressures and reduce the current account deficit, while helping to sustain growth.

“There is a significant fiscal improvement envisaged for 2006. The permanent expenditure savings and the commitment to save higher-than-expected revenues are likely to increase the flexibility of fiscal policy and its medium-term sustainability. At the same time, a stricter incomes policy is needed to contain demand and improve competitiveness.

“Monetary policy in Serbia should continue to be tightened to stem the rapid expansion of credit. The further development of market-based monetary policy instruments by the National Bank of Serbia is welcome, but macro-prudential measures will remain important to contain credit growth in the near term. The enactment of the new banking law represents a major step towards aligning prudential standards to international norms. The rapid credit expansion, rising foreign exchange-indexed lending, and the increase in non-performing loans, point to the need for strengthened bank supervision.

“The current exchange rate policy in Serbia carries risks. While the exchange rate anchor should help lower inflationary expectations, it could endanger the external competitiveness position and slow the necessary adjustment of the external current account imbalance. Therefore, lowering both inflation expectations and the external current account deficit will require tight demand management policies and timely corrections as circumstances change. Over the medium term, success in reducing the imbalances will also depend on progress with structural reforms.

“In Montenegro, a continued tight macroeconomic policy stance is needed to improve competitiveness under the euroized regime. In particular, it will be necessary to resist wage pressures in the public sector in the run-up to the elections. Over the medium term, structural reforms will be of paramount importance to increase productivity, bolster the growth potential, and reduce external imbalances.

“Continued implementation of prudent macroeconomic policies and an acceleration of structural reforms beyond the Extended Arrangement are needed to address the macroeconomic imbalances and foster growth. This will also be key to ensuring the international community’s continued support of Serbia and Montenegro’s adjustment and reform efforts.

“The Executive Board completed the sixth review under the Extended Arrangement, and granted waivers for the non-observance of 2 performance criteria and 5 structural performance criteria in recognition of the authorities’ corrective policy actions,” Ms. Krueger said.