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May 15, 2009

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

April 30, 2009

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

Mr. Dominique Strauss-Kahn Belgrade, April 30, 2009
Managing Director
International Monetary Fund
Washington DC

Dear Mr. Strauss-Kahn:

We have implemented strong macroeconomic policies over the past months and have received the support of the IMF for our program through a Stand-By Arrangement (SBA) for a period of 15 months in the amount of SDR 350.775 million (75 percent of quota), approved by the Executive Board of the IMF on January 16, 2009. At the time, in view of Serbia's comfortable international reserves position and continued, if reduced, access to external financing, we intended to treat the arrangement as precautionary—and indeed, we did not draw on the amounts made available.

Since then, however, both the global economic environment and domestic activity in Serbia have deteriorated more sharply than anticipated. Output weakness will likely be deeper and more protracted. Therefore, after careful review, we have revised the macroeconomic framework guiding our policies and have adjusted our policy response to the changed circumstances. We have also reached understandings with foreign banks and their home supervisors on rollover of current exposures, and we are seeking assurances of additional financial support from the European Union and the World Bank.

The attached Memorandum of Economic and Financial Policies (MEFP) outlines the revised economic policies that the Government of the Republic of Serbia and the National Bank of Serbia intend to implement during the remainder of 2009 and in 2010 to safeguard Serbia's macroeconomic and financial stability.

In particular, we will revise the 2009 budget to adjust to the much lower revenues and limit the deficit to 3 percent of GDP, consistent with available non-inflationary financing, while ensuring a fair distribution of the adjustment. We are determined to curb recurrent spending at all levels of government, including by freezing public wages and pensions in nominal terms from now on throughout 2010 and by cutting discretionary spending. On the revenue side, we envisage moderate increases in excise taxes. These and other temporary measures will help adjust to the tight financing constraints in the short term, while we engage in durable structural reforms that bring public expenditure in line with the new constraints imposed by the international economic outlook. Moreover, we will set up a comprehensive financial sector support program to prevent and limit financial instability; continue to conduct monetary policy in a prudent way to contain inflation; and implement structural reforms to boost the economy's potential output.

In support of our strengthened program, we request (i) augmentation of the SBA, namely by increasing access to SDR 2,619.120 million (equivalent to about €3 billion, or 560 percent of our quota in the IMF) to help fill the external financing gap projected for 2009–11; (ii) extension of the SBA by one year to mid-April 2011 (for a total duration of 27 months); and (iii) rephasing of access accordingly, with SDR 1,917.570 million (about €2.2 billion, or 410 percent of quota) made available in 2009.

We also request: (i) completion of the first review under the SBA; (ii) modification of the June 2009 performance criteria; (iii) a waiver of applicability of the end-March 2009 performance criterion on the overall fiscal deficit (as complete and verified information is not yet available); (iv) completion of the financing assurances review; and (v) the purchase of SDR 701.550 million (about €0.8 billion, or 150 percent of quota) made available under the existing SBA and following approval of its modification.

Implementation of our program will be monitored through quantitative performance criteria, structural benchmarks, and an inflation consultation clause, as described in the attached MEFP and Technical Memorandum of Understanding. There will be quarterly program reviews of the arrangement by the IMF; the second one will be scheduled to be completed by mid-September 2009, to assess progress in implementing the program and reach understandings on any additional measures that may be needed to achieve its objectives. Further quarterly program reviews will be scheduled for completion by mid-December 2009 and mid-March 2010. Moreover, each purchase under the SBA will be subject to financing assurances reviews.

We believe that the policies set forth in the attached memorandum are adequate to achieve the objectives of our economic program, but we will take any further measures that may become appropriate for this purpose. We will consult with the IMF on the adoption of these measures and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultations. And we will provide all information requested by the IMF to assess implementation of the program.

Sincerely,

/s/

Mirko Cvetković
Prime Minister

/s/

Radovan Jelašić
Governor of the National
Bank of Serbia

/s/

Diana Dragutinović
Minister of Finance

Attachment I

REPUBLIC OF SERBIA

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

April 30, 2009

I. INTRODUCTION

1. This memorandum updates and supplements the Memorandum of Economic and Financial Policies (MEFP) and the Technical Memorandum of Understanding (TMU) attached to our Letter of Intent of December 25, 2008. It reports on recent developments under the program supported by the Stand-By Arrangement (SBA) approved by the IMF in January 2009, and updates our economic objectives and policy agenda.

2. **Performance under the program supported by the SBA was broadly satisfactory.** Most quantitative performance criteria (PCs), the indicative target, and the inflation target under the inflation consultation clause for end-December 2008 and end-March 2009 were met. However, the PC on the ceiling on the consolidated general government deficit for end-December 2008 was missed by some ¼ percent of GDP; and the relevant fiscal information is not yet fully available for end-March 2009. The two structural benchmarks on adopting business plans of the Road Company and of state-owned enterprises will be completed only with delays in May 2009.

II. ECONOMIC AND POLICY DEVELOPMENTS

3. **Since the SBA was negotiated in November 2008, Serbia's external and financial environment has deteriorated abruptly and relentlessly; domestic activity is slumping**. As elsewhere in the region, nominal exports and imports started to contract in November 2008. Net external borrowing and domestic credit have slowed sharply. In January 2009, over the previous year, industrial production dropped by 17 percent, and exports and imports in euro terms fell by 24 and 38 percent, respectively.

4. **Projections of trading partner growth and regional capital flow projections have continued to be downgraded.** As of end-March 2009, the IMF projected a 3 percent decline in the EU's output in 2009, with growth essentially flat in 2010. Prospects for net capital flows to Eastern Europe beyond rollover of existing liabilities are also increasingly dim.

5. **Inflation has been broadly in line with the revised inflation targeting framework.** CPI inflation reached 10.7 percent in February, still inside the target band for end-March. However, the sharply slowing economy seems to have had little mitigating pressures on prices yet, partly owing to the large depreciation and regulated price increases. With inflation

pressures remaining high, the NBS has maintained a relatively high policy interest rate at 16½ percent.

6. **The 2008 fiscal outturn was weaker than expected.** While the program's headline fiscal deficit of 2½ percent of GDP was missed by a relatively small margin, indirect taxes and social security contributions underperformed significantly (by 1 percent of GDP), reflecting dismal trade data and mounting problems of tax compliance. The revenue shortfall was largely offset by lower cash spending, but also by accumulation of expenditure arrears. The government finalized the sale of a majority share of the NIS oil company in February 2009, yielding 1¼ percent of GDP.

7. **A number of supportive policies aimed at softening the credit slowdown were adopted.** The government launched a program of interest subsidies and loan guarantees aimed at stimulating bank loans to the economy of up to 4 percent of GDP. Some bank loans extended under this program are also supported by relief from reserve requirements. In addition, the NBS has relaxed some capital and down-payment requirements for bank lending and announced an exemption from reserve requirements of new foreign borrowing by banks contracted after October 2008.

III. Economic Objectives and Outlook

8. **The main objective of the program remains safeguarding macroeconomic and financial stability amid a rapidly and sharply deteriorating global financial and economic environment.** Serbia faces the double burden of reducing a very large external imbalance, while exports and external finance have been curtailed by what will likely be the deepest global economic downturn since World War II. In this difficult setting, the program seeks to put in place reinforced policies that will lead to orderly adjustments of production, demand, credit, and external financing flows. These policies should enable the economy to emerge more balanced and ready to resume sustainable real convergence growth toward EU income levels, which is Serbia's ultimate economic objective.

9. **The program's revised macroeconomic framework reflects the short-term economic and financial adjustments that are likely to occur during the program period:**

- **Real GDP** is now projected to decline by 2 percent in 2009, and, in line with global and regional growth assumptions, is set to be flat in 2010. This already markedly more pessimistic projection is still subject to downside risks, regarding both the depth and duration of the slowdown, reflecting mainly uncertainty over international developments.

- **Inflation** is now projected to remain around 10 percent throughout 2009, and to start declining to 8 percent by end-2010. The disinflationary forces of a slowdown in domestic demand will be counteracted by pass-through effects from the recent nominal exchange rate depreciation.

- The **external current account deficit** is now projected to decline more rapidly, to about 13 percent of GDP in 2009, from close to 17 percent last year. Export growth is expected to recover only in 2011, and the external current account deficit is projected to normalize at about 5 percent of GDP over the medium term.

- Available **external financing** is now projected to fall well short of previous assumptions. Foreign direct investment and new external loans are expected to be much smaller than last year, resulting in net capital inflows of only 2 percent of GDP in 2009, compared with 12½ percent in 2008.

10. **Despite the sizeable adjustment in domestic demand, we now project external financing gaps of about €2.4 billion in 2009 (7½ percent of GDP) and €1 billion in 2010 (3¼ percent of GDP).** Compared with previous projections, financing requirements are projected to shrink due to the lower current account deficit, but debt amortization is higher due to the rise in short-term debt, and available financing is projected to be lower.

IV. Economic Policies

11. **To achieve our program objectives, we have revised our strategy in three key respects:**

- **First, we are targeting significantly larger fiscal adjustment.** The slumping revenues can only partly be compensated by increasing fiscal deficit targets, reflecting both tight constraints on available non-inflationary financing and the reversion of the revenue-to-GDP ratio back to a lower, sustainable level consistent with the correction of the large external imbalance. Containing the fiscal deficit will require additional fiscal adjustment measures. In the short term, we will need to rely largely on temporary and, in part, distortionary measures, including nominal spending cuts. However, we will use the breathing space provided by these measures to design more structurally sound policies—with support and advice from International Financial Institutions (IFIs)—to align spending plans with a sustainable revenue envelope over the medium term.

- **Second, we are seeking financing assurances from foreign banks to at least maintain their exposures to Serbia.** In particular, it will be crucial to obtain specific commitments from parent bank groups to keep their exposure vis-à-vis Serbia and to keep their subsidiaries sufficiently capitalized to withstand an even sharper downturn than we presently project.

- **Third, we are requesting additional financial support from IFIs.** The macroeconomic adjustment needed to close the projected financing gap would, in our view, put an undue stress on the economy and the financial system, given the high euroization of corporate and household liabilities. Thus, we are requesting that the IMF and other international lenders step up significantly their financial support.

A. Revised Fiscal Policy

12. **Under unchanged policies, fiscal deficits in 2009–10 would surge to 6–7 percent of GDP.** In 2009, the sharp widening of the deficit by some 4 percent of GDP is due to the carry-over of the 2008 revenue shortfall (1 percent of GDP), automatic fiscal stabilizers (1½ percent of GDP), but also a deteriorating structural fiscal position as underlying growth has slowed markedly (1½ percent of GDP).

13. **We will limit the 2009 fiscal deficit to 3 percent of GDP.** The implied moderate relaxation in the fiscal target (from 1¾ percent of GDP) avoids shifting to a strongly procyclical stance, while signaling that public finances remain on a sound footing. Importantly, this represents the maximum deficit that can be financed in a noninflationary way. Additional budget support, including from the World Bank and the European Union, will still be required. To achieve the revised deficit target, the government will submit to Parliament a supplementary 2009 budget for the Republic and the social security funds consistent with the revised program, including the necessary legal provisions on supporting measures (prior actions).

14. **On the expenditure side, our strategy aims at a wide and balanced distribution of the adjustment effort across all levels of government and budget institutions.** We will focus on tightening recurrent spending on wages, pensions, and discretionary spending at all levels. In particular, we will: (i) freeze all general government and public enterprise wages and salaries in nominal terms in 2009 and 2010; (ii) extend the nominal freeze of pension benefits to end-2010; and (iii) freeze hiring at all levels of government, including for temporary contracts, with only duly motivated and limited exceptions. Moreover, we will cut spending by (i) cutting discretionary budget allocations in all ministries of the Republican budget by 40 billion out of the originally budgeted 155 billion dinars; (ii) returning to the Republican budget 40 percent of own resources of budgetary institutions in 2009; (iii) reducing transfers to local governments (while ensuring that this fully translates into spending cuts); and (iv) cutting transfers to the health fund, with a corresponding reduction in its budget on goods and services. Each of these institutions will determine the required policy changes and savings measures needed to adjust to the tighter budget resources. Social and priority capital spending will be protected, however. In addition, we will aim at accelerating the implementation of IFI-financed capital projects to provide some stimulus to growth. Given the high implementation risks, we will take all necessary steps to enforce these measures. Deviations from the strict nominal wage and pension freezes envisaged for 2010 under our program will only be considered if growth and budget revenues in 2010 exceed significantly present program projections, and after consulting with the IMF.

15. **Revenue-raising measures, with limited adverse impact on growth, will include:** (i) raising excise taxes on gasoline (to 43.5 dinars) and diesel (to 30 dinars); (ii) introducing a new excise tax on mobile phone services; (iii) raising levies on cars; and (iv) taking steps to broaden the base and improve collection of the property tax. In addition, we will require higher dividend payments by profitable public enterprises in 2009.

16. **We will also take determined action to improve revenue administration and compliance.** This will involve steps to reinforce audit processes, but also to improve taxpayer services. Importantly, we will assign a specific unit to monitor VAT collection and review the reasons for the sharp increase in VAT refunds and credits in 2008 by end-June 2009 (structural benchmark, see TMU) and adopt new procedures for VAT verification and audits by end-2009.

17. **These emergency measures will be supplemented by more lasting structural reforms to ensure the durability of fiscal adjustment**. To this end, we will initiate education, health, and pension systems reforms, focusing on permanently reducing the level of public spending while improving service delivery. Details on specific reform plans will form part of the discussions at the next program review.

18. **Coordination across all levels of government, as well as strengthening of public financial management, will be key to successful program implementation.** Local governments and the health fund will need to play an important role in the fiscal consolidation by targeting balanced budgets. Thus, key municipalities and the province of Vojvodina will contribute to the consolidation effort. Further, should policies on wages and spending not be in line with the adjustment targets, we will promptly cut their transfers. To avoid arrears accumulation, the Ministry of Finance will prepare three-month rolling treasury plans with clear expenditure prioritization by June 2009 (structural benchmark). It will strengthen ex ante controls over commitments, and set up a monitoring system for arrears at the general government level tracking spending from the commitment to the payment stage on a monthly basis. We will promptly clear the arrears of the Road Company of Serbia and stay recurrent in our payment obligations going forward. We will tightly control the provision of additional guarantees by the Guarantee and National Development Funds and by the Republican budget (indicative target).

19. **Despite these measures, achieving the revised 2009 fiscal target may prove to be challenging in view of downside risks.** The government stands ready to take measures to preserve program objectives, including by increasing VAT rates and cutting nominal wages.

20. **For 2010, we plan to reduce the general government deficit to 2½ percent of GDP given continued tight financing constraints.** This adjustment largely reflects the full-year effect of our 2009 measures, including the extension of the nominal freeze in pension benefits and public sector wages through end-2010.

21. **We will improve fiscal data monitoring and reporting.** We are still facing shortcomings in the reporting of fiscal data by local government and social and other funds, as well as the treatment of foreign-financed projects which are not paid through the single treasury account. To reduce risks of inadvertent misreporting of fiscal data, we will—with technical support from the IMF—review and amend our fiscal reporting procedures for different levels of government, and ensure that all Project Implementation Units and the NBS inform the Treasury immediately about all transactions related to foreign loans. Monitoring of arrears will be strengthened. Finally, we will include a projected amount of 12 billion dinars of foreign-financed projects on the spending side of the revised 2009 budget.

B. Monetary and Exchange Rate Policies

22. **Monetary policy will remain focused on achieving low and stable inflation.** The NBS will seek to maintain a monetary policy stance consistent with the announced inflation targets, using its policy interest rate and other auxiliary instruments. Should the projected overshooting of our inflation targets for end-2009 materialize—due to past exchange rate depreciation and larger-than-anticipated adjustment of regulated price—the NBS will communicate to the public the reasons for such overshooting and an outline of planned corrective policy actions. Developments in monetary and credit aggregates, including net domestic assets of the central bank, will be monitored as a cross-check of the NBS's inflation analysis. In line with standard EU practices, the NBS will not extend credit to the public sector, either directly or through primary market purchases of government debt obligations, except for potential operations to be agreed under the financial stability framework (see ¶26). Under the program, inflation developments will be monitored using a standard consultation clause (see TMU).

23. **In line with this framework, we will maintain the present managed float exchange rate regime.** The NBS will use limited and targeted interventions aimed at smoothing shocks and preserving financial stability, in a way that will remain consistent with achieving the inflation targets. Recognizing the importance of maintaining an adequate level of international reserves as a buffer against external and financial sector vulnerabilities, the NBS will not allow its net foreign assets, valued at program exchange rates, to fall below the agreed program floors throughout 2009.

24. **We will continue to strengthen the monetary policy framework during the program period.** With the government's support and consistent with EU *acquis* requirements, the NBS will propose amendments to the Law on the NBS by end-2009 to prohibit NBS lending to the public sector, clarify procedures for the recapitalization of the central bank, and, more generally, enhance the independence of the NBS. Other measures will include strengthening the NBS's policy decision making capacity, including by upgrading the inflation modeling and forecasting framework.

C. Financial Sector Policies

25. **In the financial sector area, we will continue to enhance our preparedness to deal with consequences of the global financial turmoil.** We will put in place a detailed crisis response plan specifying the roles and responsibilities of the government, the NBS, and the Deposit Insurance Agency (DIA) in reacting to various contingencies (prior action). In support of this plan, the NBS will conduct a comprehensive review of the legal framework for collateral and debt restructuring in the next few months.

26. **To further support financial stability, the government and the NBS will introduce a comprehensive financial sector support program (FSSP).** Aiming at stabilizing market conditions and softening the impact of the crisis on private sector balance sheets, the FSSP will offer banks access to new liquidity facilities while creating incentives for loan restructuring under a common framework, promoting de-euroization of loans, and discouraging early recalls of non-delinquent loans. In parallel, in the context of the Vienna Initiative, the NBS is intensifying cooperation with foreign supervisors, notably to facilitate fulfillment of commitments to be obtained from key foreign banks to maintain their exposure to Serbia. Moreover, the NBS, in consultation with IMF, will complete diagnostic studies of all banks, including sensitivity analyses based on a downside scenario. Diagnostic studies for the 12 largest banks and the 4 banks with majority state ownership will be completed by end-September 2009, and for all banks by end-2009 (structural benchmarks).

27. **Looking ahead, developing the dinar bond market remains a key medium-term priority.** By mid-2009, the Ministry of Finance will strengthen the institutions charged with implementing its public debt management strategy. To help step up the regular issuance of government bonds, it will fine-tune the T-bill auction procedure by increasing transparency and market determination of interest rates.

28. **State ownership in banks and the remaining insurance company will be phased out as soon as market conditions permit.** Due to difficult market conditions, we are still exploring options for the remaining banks with state participation. We plan to adopt detailed action plans for these banks, with consolidation of the four majority-owned state banks into a single bank before privatization as a key option, by end-June 2009 (structural benchmark). To facilitate our overall privatization plans, as well as to promote stock market development, by end-2009, the government will also submit to Parliament a new Securities Law conforming with EU regulations.

D. Structural Policies

29. **We will continue to restructure state-owned enterprises, increase private sector participation, and improve the investment climate.** The ongoing economic crisis will not deter us from pursuing our structural reform agenda to complete the transition to a market economy. On the contrary, we will take measures to: (i) privatize, restructure, put in bankruptcy, or liquidate a wide range of public enterprises, utilities, non-core companies

spun off from public utilities, and socially owned enterprises; and (ii) eliminate, clarify, or reconcile rules and regulations that undermine the predictability of the business environment or significantly raise the cost of doing business. While actual sales of large state-owned enterprises will likely be postponed due to unfavorable market conditions, we will continue to prepare enterprises for eventual privatization. We have started a regulatory review aimed at streamlining business regulations. Importantly, we will also strive to resolve the still pending, but politically very difficult, issues of land ownership and restitution. To improve the bankruptcy framework and help liquidate loss-making enterprises, we will also amend the bankruptcy law.

30. **Our goal is to modernize public enterprises and utilities by opening them to private sector participation.**

- **Large state enterprises.** Based on case-by-case studies, we will move ahead with corporatization (when necessary) followed by full or partial privatization, joint ventures, or a private management contract. The restructuring of the airline company JAT has started, following the failed tender, with the objectives of rationalizing costs and reorganizing operations. The privatization process of the pharmaceutical company Galenika has also started, with the privatization advisor developing a strategy; a tender for selling 70 percent of the capital is expected to be launched in the second half of 2009. We expect to make a decision this year on the privatization model for the telecom company, and to launch a tender for a privatization advisor for the Belgrade airport. We will accelerate the restructuring of the railway company. To increase transparency, we will publish audited annual financial statements of state enterprises.

- **Local enterprises.** The government will launch, in collaboration with municipalities, a comprehensive review of the business and financial conditions of all locally owned companies and utilities, with a view to reducing losses and budget transfers, while improving service delivery and preparing for private sector participation. The Ministry of Economy and Regional Development will prepare a strategy for transforming locally owned utilities and determining ways and modalities of private capital involvement.

31. **We plan to complete the privatization program of socially owned enterprises.** The Ministry of Economy aims at finalizing in 2009 the privatization or liquidation of some 800 socially owned enterprises and non-core companies spun off from public utilities. Regarding the remaining large socially owned enterprises, we have set up a joint venture between the car manufacturer Zastava and Fiat, and will try a similar approach for RTB Bor (copper mining company), which failed twice to be sold through tender.

32. **We will ensure the same wage discipline in public enterprises as in the general government.** To avoid adverse wage dynamics and encourage rationalization, the

government will adopt state enterprises' business plans that conform to general government wage and employment policies by end-May 2009. It will adopt all necessary decrees to ensure a wage freeze similar to that in the general government, and will subsequently closely monitor wage bill developments in these enterprises (TMU, ¶19).

V. Program Monitoring

33. Progress in the implementation of the policies under this program will be monitored through quarterly quantitative performance criteria (PCs) and indicative targets, structural benchmarks, and an inflation consultation clause. These are detailed in Tables 1 and 2. The attached TMU contains definitions and adjustors. Quantitative targets through December 2009 are PCs. Conditionality, including related to the 2010 budget, will be added to the program at the time of the next review.

Table 1. Serbia: Quantitative Conditionality Under the SBA, 2008-09 1/

	2008 2/		2009 2/				
	End-Dec.		End-March		End-June	End-Sept.	End-Dec.
	Program Targets	Prelim. Actual	Program Targets	Prelim. Actual	Revised Program Targets	Program Targets	Program Targets
Quantitative Performance Criteria							
Floor on net foreign assets of the NBS (in billions of euro)	5.0	6.1	5.1	6.0	4.4	3.6	2.5
Ceiling on consolidated general government overall deficit (in billions of dinars)	64	69	15	...	35	60	90
Ceiling on contracting or guaranteeing by the public sector of new short-term external debt (up to and including one year, in millions of euro)	0	0	0	0	10	10	10
Ceiling on contracting or guaranteeing by the public sector of new nonconcessional external debt (over one year, in millions of euro) 3/	50	0	200	0	550	550	550
Ceiling on accumulation of government external payment arrears (continuous, in millions of euro)	0	0	0	0	0	0	0
Inflation Consultation Bands							
Central point	10.0	8.6	9.2	9.4	8.0	9.5	10.0
Band, upper limit	12.0	n.a.	11.2	n.a.	10.0	11.5	12.0
Band, lower limit	8.0	n.a.	7.2	n.a.	6.0	7.5	8.0
Indicative Target							
Ceiling on current expenditure of the Serbian Republican budget (in billions of dinars)	635	633	190	...	335	520	691
Ceiling on gross accumulation of domestic guarantees by the Republican budget, the Guarantee Fund, and the Development Fund and domestic borrowing by the Guarantee and Development funds	n.a.	n.a.	n.a.	n.a.	50	50	50

1/ As defined in this Letter of Intent, Memorandum on Economic and Financial Policies, and Technical Memorandum of Understanding.
2/ Cumulative from January 1.
3/ Excluding loans from the IMF, EBRD, EIB, EU, IBRD, KfW, Eurofima, CEB, IFC, and bilateral government creditors, as well as debt contracted in the context of restructuring agreements.

Table 2. Serbia: Structural Conditionality, 2009

Action	Timing	Status
Prior actions		
1. **Fiscal policy.** Government to submit to Parliament revised Republican and social security funds budgets for the remainder of 2009 consistent with the program, including provisions ensuring a freeze in public sector wages in 2009.	Before Board meeting	
2. **Fiscal policy.** Government to submit to Parliament legal provisions that ensure tax measures as per program understandings.	Before Board meeting	
3. **Financial sector.** Parties to finalize the Appendix to the MoU on Financial Sector Stability detailing contingency measures and respective roles of the NBS, the government, and the DIA.	Before Board meeting	
Structural benchmarks		
1. **Budget framework.** Government to adopt the business plan of the Road Company of Serbia consistent with the program.	End-January 2009.	Rescheduled for end-May 2009.
2. **Budget framework and wage policy.** Government to adopt state enterprises' business plans that conform to general government wage and employment policy in 2009 and ensure profit transfers to the state.	End-January 2009.	Rescheduled for end-May 2009.
3. **Budget management.** Ministry of Finance to prepare a three-months rolling cash flow plan for the Republican budget consistent with the annual budget targets.	End-June 2009	
4. **Revenue administration.** Ministry of Finance to charge a specific unit to review the reasons for the sharp increase in VAT refunds and credits in 2008.	End-June 2009	
5. **Financial sector.** Deposit Insurance Agency to adopt detailed action plans for the remaining banks with state participation.	End-June 2009	
6. **Financial sector.** NBS to complete a diagnostic study of the 12 largest banks and the four banks with majority state ownership.	End-September 2009	

TECHNICAL MEMORANDUM OF UNDERSTANDING

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

A. Floor for Net Foreign Assets of the NBS

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

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

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

Cross Exchange Rates and Gold Price for Program Purposes 1/

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

5. For purposes of the program, **foreign reserve liabilities** are defined as any non-government foreign-currency-denominated short-term loan or deposit (with a maturity of up to and including one year); NBS liabilities to residents and nonresidents associated with swaps (including any portion of the NBS gold that is collateralized) and forward contracts;

IMF purchases; and loans contracted by the NBS from international capital markets, banks or other financial institutions located abroad, and foreign governments, irrespective of their maturity. Undivided foreign exchange liabilities of SFRY are excluded.

6. On March 20, 2009 the NBS's net foreign assets, evaluated at program exchange rates, were euro 6,022 million; foreign reserve assets amounted to euro 8,255.5 million, and foreign reserve liabilities amounted to euro 2,233.5 million.

7. **Adjustors.** For program purposes, NFA will be adjusted upward *pari passu* to the extent that: (i) after March 20, 2009, the NBS has recovered frozen assets of the FRY, assets of the SFRY, long-term assets, and foreign-exchange-denominated claims on resident banks and nonbanks, as well as Serbian commercial banks abroad; and (ii) the restructuring of the banking sector by the Deposit Insurance Agency involves a write-off of NBS foreign exchange-denominated liabilities to resident banks. The NFA floor will also be adjusted upward by any privatization revenue in foreign exchange received after March 20, 2009. Privatization receipts are defined in this context as the proceeds from sale or lease of all or portions of entities and properties held by the public sector that are deposited in foreign exchange at the NBS, either directly, or through Treasury.

B. Inflation Consultation Mechanism

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

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

C. Ceiling on External Debt Service Arrears

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

11. **Reporting.** The accounting of nonreschedulable external arrears by creditor (if any), with detailed explanations, will be transmitted on a monthly basis, within two weeks of the end of each month. Data on other arrears, which are reschedulable, will be provided separately.

D. Ceilings on External Debt

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

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

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

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

E. Fiscal Conditionality

16. **The general government fiscal balance,** on a cash basis, is defined as the difference between total general government revenue (including grants but excluding budget support grants from the European Union or any of its components) and total general government expenditure (irrespective of the source of financing) as presented in the "GFS classification table" and including expenditure financed from foreign project loans. For program purposes, the consolidated general government comprises the Serbian Republican budget (on-budget and own revenue), local governments, the pension fund (employees, self-employed, and farmers), the health fund, the National Agency for Employment, and the Road Company (JP Putevi Srbije) and any of its subsidiaries. Any new extrabudgetary fund or subsidiary established over the duration of the program would be consolidated into the general government. Revenues of the Republican budget exclude profit transfers from the NBS.

Expenditures exclude the clearance of arrears of the Road company accumulated up to end-2008.

17. **Adjusters.** The deficit ceiling will be adjusted upward for the additional expenditure that may be needed for potential lender-of-last-resort operations under the financial stability framework (MEFP, ¶25), following consultation with IMF staff. It will be increased (respectively reduced) in 2009 by the amount of project loans disbursed by foreign institutions listed in TMU ¶13 above to the general government in excess of (respectively, lower than) the program projections indicated in the table below, in consultation with IMF staff, on the basis of actual disbursements as jointly reported by the Ministry of Finance and the NBS. This adjustment does not apply to program loans and general budget support.

Disbursements of project loans by foreign institutions

From January 1, 2009 to:	Program projections (billions of dinars)
March 31, 2009	1.7
June 30, 2009	4.2
September 30, 2009	7.1
December 31, 2009	12.0

18. **Government current expenditure of the Republican budget** (excluding expenditure financed by own sources) includes wages, subsidies, goods and services, interest payments, transfers to local governments and social security funds, social benefits from the budget, other current expenditure, and net lending. It does not include capital spending. The ceiling will be adjusted for the additional expenditure that may be needed for potential lender-of-last-resort operations under the financial stability framework (MEFP, ¶25).

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

20. **Action plan on tax administration.** The specific plan is understood to include the following elements:

- **Short term.** (i) Conducting a review (for March 2009) comparing VAT input credit claims on imports for each taxpayer with the customs records of imports by the taxpayer during the same period. (ii) Conducting an in-depth analysis and preparing a report on the sources for growth in VAT refunds and excess VAT credit since 2005 to determine if these volumes are legitimate and what changes are required in procedures. (iii) Charging a specific unit in headquarters with the ongoing responsibility for monitoring the overall performance of the VAT, analyzing trends and potential threats to revenue, and recommending actions to improve the performance (structural benchmark for end-June 2009).

- **Medium term.** (i) Redesigning the VAT refund risk-based selection system placing emphasis on the value of each claim and more reliance on the compliance history of the claimant, fast track refunds for claimants with good compliance history, and concentrating audits on new claimants and those with poor compliance history. (ii) Developing procedures to systematically verify input credits claimed in the domestic VAT on imported goods with customs import records on an ongoing basis (end-December 2009).

21. **Ceiling on the accumulation of domestic loan guarantees (gross) extended by the Republican budget, the Guarantee Fund, and the Development Fund.** The ceiling also includes the contracting of any domestic loans by the Development and the Guarantee Funds. It excludes any guarantees extended under the financial stability framework (MEFP, ¶25), unless such loans or guarantees are extended to entities other than financial sector institutions.