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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
Managing Director
International Monetary Fund
Washington DC

Belgrade, April 30, 2009

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) rephrasing 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

