INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/263

REPUBLIC OF SERBIA

September 2017

2017 ARTICLE IV CONSULTATION, SEVENTH REVIEW UNDER THE STAND-BY ARRANGEMENT AND MODIFICATION OF PERFORMANCE CRITERIA—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF SERBIA

In the context of the 2017 Article IV Consultation, Seventh Review Under the Stand-By Arrangement and Modification of Performance Criteria for the Republic of Serbia, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board.
- A **Press Release** summarizing the views of the Executive Board as expressed during its August 30, 2017 consideration of the staff report that concluded the Article IV consultation with the Republic of Serbia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on August 30, 2017, following discussions that ended on July 5, 2017, with the officials of the Republic of Serbia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 11, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Serbia.

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

Letter of intent sent to the IMF by the authorities of the Republic of Serbia*
Memorandum of Economic and Financial Policies by the authorities of the Republic of Serbia*
Technical Memorandum of Understanding*
*Also included in Staff Report

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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International Monetary Fund
Washington, D.C.

Press Release No. 17/339
FOR IMMEDIATE RELEASE
September 6, 2017

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with Serbia

On August 30, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Serbia and completed the seventh review of Serbia's economic performance under the Stand-By Arrangement (SBA) (see Press Release No. 17/336).

Serbia's economy has strengthened impressively since the adoption of the economic program supported by the SBA. Serbia was in a difficult macroeconomic situation prior to the start of the program in early 2015, with stagnant growth, an unsustainable fiscal position, and rising non-performing loans in banks. Two years later, macroeconomic performance has made a major turnaround. Economic growth is expected to reach 3 percent this year. The fiscal deficit should narrow to 1.1 percent of GDP—the lowest level since 2005—and public debt is heading down faster than projected. Contrary to expectations, the larger than planned fiscal tightening has been associated with increased growth, reflecting the confidence engendered by decisively tackling the public debt sustainability concerns. Moreover, unemployment is falling sharply, along with the level of banks' non-performing loans, while inflation has been maintained at low levels.

Continued reform efforts are needed to address remaining vulnerabilities and structural weaknesses. Serbia has pursued a comprehensive reform agenda encompassing public enterprises and State Owned Enterprises (SOEs), public administration, the financial sector, and the business climate. Overall progress has been good. But there have been delays in some areas—notably in reforms of public administration, public services and SOEs. The economy is still overburdened by a large and inefficient public sector, with too little reliance on the productive private sector. The labor market is characterized by low participation rates, especially of women, and a high degree of informality. Future growth will thus depend on further improving the environment for private sector investment and employment growth. While Serbia's ranking in business surveys has risen markedly, improvements are still needed in areas such as streamlining and modernizing tax administration, increasing transparency and predictability of public fees and charges, and ensuring a more efficient and independent judicial system.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

(continued…)

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the significant economic improvement since the last Article IV consultation and achieving the key macroeconomic targets under the Fund-supported program, which has helped improve confidence, strengthen growth, and increase employment. Looking ahead, Directors considered that significant structural challenges and downside risks remain. They urged the authorities to solidify hard-won gains by continuing to build stronger institutions and making further ambitious progress on implementing the structural reform agenda, which are necessary to improve economic efficiency bolster private sector-led growth, and are essential aspects of the EU accession process.

Directors commended the strong revenue performance. While this has allowed for a smaller than envisaged contraction of expenditure, Directors stressed that containing non-discretionary current spending remains an important priority. This is necessary to ensure that debt will remain on a declining path, while creating fiscal space for needed capital spending and potentially for targeted reductions in tax burdens. Directors also urged that reforms in areas that have faced delays should be carried out expeditiously, including modernizing education, strengthening tax administration, and restructuring of state-owned enterprises and utilities.

Directors agreed that monetary policy has succeeded in keeping inflation under firm control. While noting that broad exchange rate stability has reinforced confidence and helped reduce euroization, they highlighted the need to allow for day-to-day exchange rate flexibility, consistent with the inflation-targeting regime.

Directors welcomed that financial sector reforms under the program have strengthened the resilience of the sector, helping to support future growth. They stressed that efforts to reduce NPLs need to continue, and that reforms of state-owned financial institutions need to be accelerated.

Directors recognized that Serbia's business environment has strengthened, but considered that impediments to private investment and growth remain. Directors stressed the need to strengthen judicial processes, especially judicial independence and reducing delays in court decisions. They encouraged the authorities to strengthen labor force participation, particularly among women.

It is expected that the next Article IV Consultation with the Republic of Serbia will be held in accordance with the Executive Board decision on consultation cycle for members with Fund arrangements.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Serbia: Selected Economic and Social Indicators (2014-2018)					
	2014	2015	2016	2017 Proj.	2018 Proj.
Real sector (percent change, unless otherwise indicated)					
Real GDP	-1.8	0.8	2.8	3.0	3.5
Real domestic demand (absorption)	-1.1	1.4	1.1	2.2	3.0
Consumer prices (average)	2.1	1.4	1.1	3.4	3.0
GDP deflator	2.7	2.7	1.1	2.5	2.8
Unemployment rate (in percent) 1/	19.9	18.2	15.9	…	…
Nominal GDP (in billions of dinars)	3,908	4,043	4,200	4,434	4,719
General government finances (percent of GDP)					
Revenue	39.7	40.4	42.4	41.8	41.2
Expenditure	46.3	44.0	43.7	42.9	42.0
Fiscal balance 2/	-6.6	-3.7	-1.4	-1.1	-0.8
Primary fiscal balance (cash basis)	-3.7	-0.5	1.8	2.0	2.1
Structural primary fiscal balance 3/	-2.6	0.0	1.8	2.0	2.1
Gross debt	71.9	76.0	74.1	70.9	67.9
Monetary sector (end of period 12-month change, percent)					
Money (M1)	9.7	17.0	20.3	11.8	10.7
Broad money (M2)	8.3	7.2	9.8	6.9	6.8
Domestic credit to non-government 4/	-1.1	2.8	1.8	6.8	7.0
Interest rates (dinar) (period average, percent)					
NBS key policy rate	9.0	6.1	4.4	…	…
Interest rate on new FX and FX-indexed loans	6.0	5.0	4.1	…	…
Balance of payments (percent of GDP, unless otherwise indicated)					
Current account balance	-6.0	-4.7	-4.0	-4.0	-3.9
Exports of goods	31.9	33.9	37.3	39.8	41.1
Imports of goods	-44.3	-45.8	-47.5	-49.9	-50.7
Capital and financial account balance	1.4	4.5	1.4	3.5	4.1
External debt	83.1	84.0	81.8	76.1	71.3
Gross official reserves (in billions of euro)	9.9	10.4	10.2	10.0	10.1
Exchange rate (dinar/euro, period average)	117.2	120.8	123.4	…	…
REER (annual average change, in percent; + = apprec.)	-2.0	-1.6	-1.1	1.7	1.5
Social indicators					
Per capita GDP (in US$)	6,199	5,244	5,376	5,630	6,085
Population (in million)	7.1	7.1	7.0	7.0	7.0

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

1/ Unemployment rate for working age population (15-64).

2/ Includes amortization of called guarantees.

3/ Primary fiscal balance adjusted for the automatic effects of the output gap both on revenue and spending as well as one-offs.

4/ At program exchange rates.

Press Release No. 17/336
FOR IMMEDIATE RELEASE
August 30. 2017

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation and Completes Seventh Review of Serbia's Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) today completed the seventh review of Serbia's economic performance under the Stand-By Arrangement (SBA). The completion of the review will make available an additional SDR 54.565 million (€64.9 million) available to Serbia under the SBA, bringing the total funds available to SDR 771.705 million (€918.5 million). The Serbian authorities have indicated that they do not intend to draw on the resources available under the arrangement.

The Executive Board today also concluded the 2017 Article IV consultation with Serbia. A respective press release will be issued separately.

The Executive Board approved the 36-month, SDR935.4 million (about €1.2 billion at the time of approval) SBA for Serbia on February 23, 2015 (see Press Release No. 15/67).

Following the Executive Board's decision, Mr. Tao Zhang, Deputy Managing Director and Acting Chair issued the following statement:

"The program remains on track and is supporting improved confidence and stronger growth. Real GDP is now above pre-crisis levels and labor market conditions are firming, while inflation remains anchored within the target band and the current account deficit has narrowed. At the same time, building stronger institutions and further progress on implementing the structural reform agenda are needed to improve economic efficiency, bolster private sector-led growth, and put Serbia on a faster convergence path to create a platform for EU accession.

"Strong revenue performance has supported an important fiscal consolidation and allowed for much less expenditure contraction than originally envisaged. However, containing non-discretionary current spending remains an important priority to support the needed debt reduction while creating fiscal space for higher capital spending and potentially for targeted reductions in tax burdens. Reforms in areas that have faced delays – modernizing education, strengthening tax administration, and restructuring of state-owned enterprises and utilities – should be carried out expeditiously.

“Monetary policy has succeeded in keeping inflation under firm control. The broad exchange rate stability has reinforced confidence and helped reduce euroization, but there is a need to continue allowing day-to-day exchange rate flexibility, consistent with the inflation-targeting regime.

“Financial sector reforms under the program have strengthened the resilience of the sector. It is now in a stronger position to fully support future growth. However, efforts to reduce NPLs need to continue, and reforms of state-owned financial institutions need to be accelerated.

“Serbia’s business environment has strengthened, but impediments to private investment and growth remain. Initiatives to improve property registration and limit parafiscal charges need to be followed through, and efforts are needed to strengthen judicial processes, especially to improve judicial independence and reduce delays in court decisions. Strengthening labor force participation, particularly among women, is also essential.”

INTERNATIONAL MONETARY FUND

REPUBLIC OF SERBIA

August 11, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION, SEVENTH REVIEW UNDER THE STAND-BY ARRANGEMENT, AND MODIFICATION OF PERFORMANCE CRITERIA

EXECUTIVE SUMMARY

Context. Serbia continues to make good progress in addressing macroeconomic imbalances, supported by the Stand-By Arrangement (SBA), contributing to improved confidence and stronger growth. However, structural challenges remain, and it is important to continue the reform momentum, taking advantage of synergies with the EU accession process.

Fiscal policy. Public finances have improved significantly under the program, with structural adjustment exceeding program targets. The challenge ahead is to improve the fiscal framework to institutionalize recent gains and reduce fiscal risks from SOEs.

Monetary and exchange rate policy. The inflation targeting framework remains appropriate. Improved policy credibility warrants a greater role for the flexible exchange rate as a shock absorber and to support the authorities' dinarization strategy.

Financial sector policy. Reforms under the program have helped ensure financial sector resilience. Good progress has been made in resolving NPLs as well as harmonizing the regulatory framework with EU standards. Reforms of state-owned financial institutions remain to be completed, and further efforts are needed to improve financial sector inclusion and intermediation.

Structural reforms. Progress has been made in resolving loss-making SOEs, but reforms to eliminate fiscal risks remain incomplete. Further efforts, notably to improve the business environment and strengthen judicial independence and efficiency, will foster robust private sector-led growth in the medium term.

Program status. The 36-month SBA with access of SDR 935.4 million (143 percent of quota, or about €1.1 billion) approved on February 23, 2015, is broadly on track. All end-March and end-June 2017 performance criteria (PCs) were met, most with significant margins. Most structural benchmarks (SBs) have been implemented, although some with delays. Completion of the review will make available SDR 772.664 million. The authorities intend to continue treating the arrangement as precautionary.

Approved By
Thanos Arvanitis and Petya Koeva Brooks

Discussions were held in Belgrade during June 22–July 5, 2017. The staff team comprised James Roaf (head), Ruben Atoyan, Christine Richmond (all EUR), Pietro Dallari (FAD), Rachid Awad (MCM), Serpil Bouza (SPR), Sebastian Sosa (resident representative), Desanka Nestorović and Marko Paunović (Belgrade office). Vuk Djoković (OED) attended some discussions. HQ support was provided by Min Kyu Song, Ouafia Akil and Patricia Mendoza (all EUR).

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CONTEXT

1. **Serbia continues to make good progress in addressing macroeconomic imbalances and structural challenges.** The implementation of recommendations from the last Article IV consultation in February 2015—aimed at reducing fiscal deficits and restoring public debt sustainability, boosting financial sector resilience, and strengthening competitiveness and growth—has been strong, supported by the 36-month SBA approved concurrently (Box 1). Synergies with the EU accession process provide support for the reform momentum.

2. **These policies have delivered a turnaround in the economy.** Prior to the start of the authorities' program, GDP had yet to revive after the global financial crisis, and public debt and bad loans in banks were both rising fast. In just two and a half years, the fiscal deficit has been reduced by nearly 5 percent of GDP and the public debt path turned around. Growth has returned convincingly and sustainably, employment is rising and unemployment falling. Inflation has remained under firm control, while nonperforming loans (NPLs) are falling rapidly.

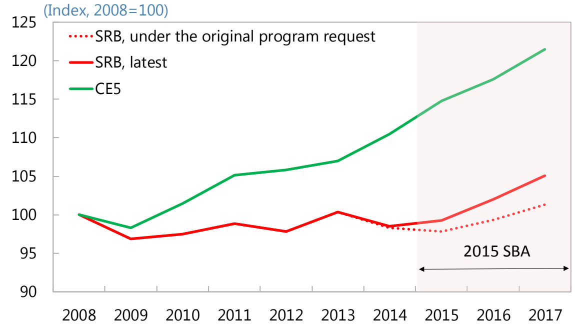
3. **Nevertheless, further progress in implementing the structural reform agenda is necessary to put Serbia on a faster convergence path.** The economy remains excessively reliant on the public sector, with a large shadow economy and a formal private sector that is too small to provide for a high standard of living across the whole society. Reforms in public administration and restructuring of state-owned utilities, enterprises and financial institutions remain incomplete. More progress is needed in areas such as judicial, tax administration, and education reform, while public infrastructure needs remain large. Growth also needs to be made more inclusive through higher labor market participation, especially of women, and better targeted social assistance.

4. **The new government confirmed its commitment to prudent macroeconomic policies and market-oriented reforms.** Following the victory of former PM Aleksandar Vučić in the April presidential election, a new coalition government led by Ana Brnabić was confirmed by parliament in late June. The new government has a high degree of continuity with the previous one, and the PM and President expressed their commitment to policy continuity also.

RECENT ECONOMIC DEVELOPMENTS

5. **The good program performance continues to support improved confidence and stronger growth** (Tables 1–8). The economic recovery continues with real GDP now surpassing pre-crisis levels, and growth starting to emulate more dynamic regional

Real GDP
(Index, 2008=100)



Sources: IMF, WEO database; and IMF staff estimates
Note: CE5-CZE, HUN, POL, SVK, SVN.

peers. Real GDP grew by 2.8 percent in 2016, supported by strong net exports, continued recovery of industrial production, and strong investment (Figure 1). While real GDP growth decelerated to 1.2 percent yoy in 2017Q1, due in part to electricity disruptions, high frequency indicators point to continued solid growth in manufacturing and trade. Labor market conditions continue to firm: the unemployment rate fell to 15.2 percent in March and employment rose to 54.3 percent (from 19.7 percent and 52.1 percent in 2016Q1, respectively), resulting in net job creation of 81.5 thousand mainly in the formal, service and industrial sectors.

Box 1. Implementation of Past Fund Advice

Implementation of past Article IV recommendations has been strong, supported by the SBA. Fund advice aimed at reducing fiscal deficits and restoring public debt sustainability, boosting financial sector resilience, and strengthening competitiveness and growth. The authorities' commitment to this agenda is demonstrated by their strong program implementation, albeit with some delays in structural reforms.

Fiscal policy. Fund advice focused on achieving a significant fiscal consolidation, mainly through: (i) containing mandatory spending; (ii) reducing state aid, and (iii) strengthening public financial management. A strong rebound in revenues helped achieve a larger fiscal adjustment than originally planned, and an earlier decline in debt, while allowing (in consultation with Fund staff) a somewhat slower reduction in wage and pension bills. Measures have been implemented to strictly limit state aid to public and state-owned enterprises and to reduce the accumulation of arrears to EPS and Srbijagas. There have been some improvements in the PFM area, notably in budgeting, arrears monitoring and control, while measures to strengthen the public investment management framework (enhancing the project appraisal process and establishing a single project pipeline) have been implemented more recently. Progress in tax administration reform has been modest.

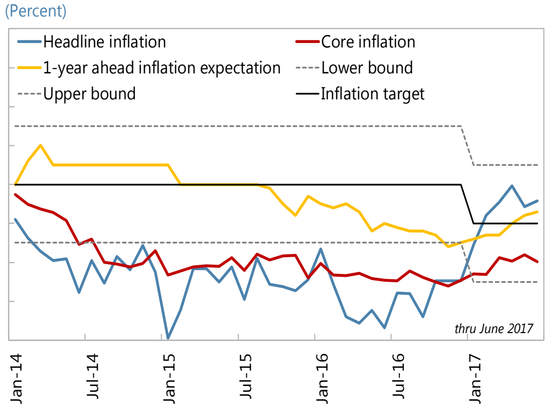
Monetary and financial sector policies. Fund advice included maintaining inflation targeting and a flexible exchange rate regime, and rebalancing the fiscal and monetary policy mix to allow for a gradual reduction of policy rates. Financial sector policy recommendations included enhancing regulatory and supervisory frameworks, thorough assessment of bank asset quality, and a comprehensive strategy for addressing NPLs. The NBS succeeded in keeping inflation under control through 2015-16 while reducing interest rates. The managed floating regime has kept the exchange rate broadly in line with fundamentals, although staff has continued to recommend a gradual increase the day-to-day flexibility of the exchange rate. The authorities have taken strong actions to strengthen financial sector soundness and stability, including asset quality review, implementation of Basel III standards, and pursuit of a comprehensive NPL resolution strategy. Reforms of state-owned financial institutions are being implemented with delay, however.

Structural reforms. The Fund recommended comprehensive structural reforms, aiming at improving the business environment and competitiveness, and resolving and reforming SOEs. The authorities have maintained their commitment to this ambitious and broad-based agenda, although political resistance and capacity constraints have delayed implementation in some areas. Progress has been made in restructuring large state enterprises including the electricity, gas and railway companies, with financial improvements, unbundling of operations, and reductions in excess staffing. Overall good progress has also been made in resolving enterprises in the portfolio of the former Privatization Agency, with almost 350 companies resolved through either bankruptcy or privatization, although resolution of some of the 17 "strategic" companies has been delayed. Efforts to strengthen the business climate have been rewarded both in improved rankings in business surveys, and on the ground in stronger investment, including FDI.

6. Headline inflation has increased within the NBS target band, but core inflation remains subdued. Headline CPI inflation picked up to 3.6 percent yoy in June, due to food and energy prices. Core inflation, however, rose much less (to 2.0 percent), and inflation expectations remain anchored well within the NBS target band (Figure 4). Lending interest rates have declined to historic lows and a revival of credit growth (particularly to households) has continued, supported by the accommodative monetary policy stance, eased bank credit conditions, and improved business and consumer confidence (Figure 6).[1]

Serbia: Inflation

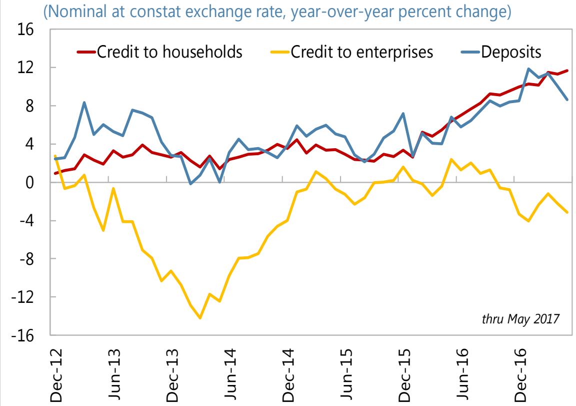
(Percent)



Sources: Bloomberg; National Bank of Serbia (NBS); and IMF staff estimates.

Serbia: Banks' Credit to the Economy and Deposits

(Nominal at constat exchange rate, year-over-year percent change)

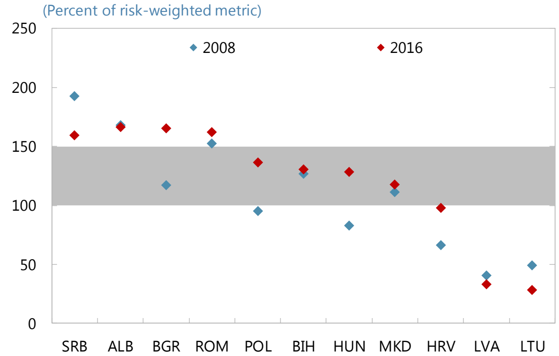


Sources: Haver Analytics; National Bank of Serbia; and IMF staff calculations.

7. The external position has strengthened. The current account deficit narrowed to 4 percent of GDP in 2016 on account of strong exports supported by past investments (Figure 2). Net FDI flows reached 5½ percent of GDP in 2016, the highest level since 2012 and fully covering the current account deficit. Yields on government securities have fallen markedly (Figure 3). Market conditions have improved recently, reversing temporary depreciation pressures due to moderate portfolio outflows in late 2016 and early this year. The dinar has strengthened by 3.1 percent versus the euro since the beginning of the year, and the NBS has been purchasing forex from the market. International reserves stood at €10.2 billion atend-2016, comfortably around the top of the recommended adequacy thresholds.[2] In March, Moody's upgraded Serbia from B1 to Ba3 (matching the corresponding S&P and Fitch ratings).

International Reserves

(Percent of risk-weighted metric)



Source: IMF staff calculations.

[1] Subdued credit to enterprises reflects the dampening effect of large write-offs of corporate NPLs.

[2] Gross reserves correspond to 159 percent of the ARA metric (assuming Serbia returns to a floating exchange rate classification) and 136 percent of the metric (assuming the current stabilized de facto exchange rate

(continued)

8. Strong fiscal adjustment has continued, reducing debt sustainability risks. The general government deficit in 2016, at 1.3 percent of GDP, was nearly 0.8 percentage points lower than envisaged in the sixth review. The general government registered a surplus in January-June of RSD44.1 billion, 1.8 percent of GDP above the unadjusted program target. Growth of tax revenue remains strong, while non-tax revenue was higher primarily due to one-off sources.[3] In 2016, higher capital spending and one-off expenditures were more than offset by savings on interest, subsidies, and transfers, while in 2017H1 spending lagged, due to temporary factors. The general government debt-GDP ratio fell to about 66 percent as of end-June, and is expected to be around 71 percent of GDP at end-2017, compared with its peak of 76 percent in 2015.

Serbia: General Government Fiscal Operations, RSD billion

	January - December 2016			January - March 2017			January - June 2017		
	Prog.	Act.	Diff.	Prog.	Act.	Diff.	Prog.	Act.	Diff.
Total revenue	**1,754.9**	**1,779.2**	**24.3**	**408.4**	**434.3**	**25.9**	**866.5**	**921.5**	**55.1**
Tax revenue	1,510.4	1,522.3	11.9	364.7	370.8	6.2	767.0	799.1	32.1
of which: VAT	447.5	453.5	6.0	114.4	109.6	-4.8	228.8	229.1	0.3
of which: Social security contributions	462.1	464.0	2.0	111.8	114.0	2.2	233.9	239.8	6.0
of which: Excises	264.8	265.6	0.8	62.9	64.9	2.0	128.6	130.0	1.4
Non-tax revenue	225.7	239.5	13.8	41.5	60.9	19.4	94.6	117.2	22.7
Capital revenue	5.9	8.0	2.1	0.0	0.7	0.7	0.0	1.9	1.9
Grants	12.9	9.4	-3.5	2.2	1.9	-0.3	4.9	3.3	-1.6
Total expenditure	**1,843.6**	**1,833.2**	**-10.4**	**440.4**	**422.6**	**-17.9**	**902.6**	**877.4**	**-25.3**
Current expenditure	1,671.1	1,651.4	-19.7	405.8	400.1	-5.7	824.4	808.5	-15.9
Capital expenditure	130.0	139.3	9.3	20.0	12.0	-8.1	55.8	47.5	-8.3
Net lending	3.5	3.3	-0.1	0.7	2.2	1.5	2.0	7.3	5.4
Amortization of activated guarantees	39.0	39.1	0.1	13.9	8.3	-5.6	20.5	14.1	-6.5
Fiscal balance	**-88.7**	**-54.0**	**34.7**	**-32.0**	**11.8**	**43.8**	**-36.2**	**44.1**	**80.3**
Memo:									
Wage bill (excluding severance)	355.9	352.1	-3.8	85.6	86.7	1.1	178.0	178.2	0.2
Primary current expenditure of the Republican budget	896.9	887.7	-9.2	212.2	198.5	-13.7	433.5	413.6	-19.9
General government debt (percent of GDP)	73.7	74.1	0.4	70.7	69.7	-1.0	70.8	66.1	-4.7

Sources: Ministry of Finance, IMF staff calculations.
Note: Programmed as of the Sixth Review.

PROGRAM PERFORMANCE

9. Quantitative program conditionality has been met and the structural reform agenda has also advanced (MEFP Tables 1-2). The authorities reiterated their commitment to all program objectives and targets.

classification); see paragraph 24 for a more detailed discussion on the reclassification of Serbia's exchange regime.

[3] VAT revenue growth can be explained by rising C-efficiency. Higher non-tax revenue was boosted by higher dividend payments and proceeds from asset sales by local governments in 2016. In March 2017, the NBS transferred RSD9.6 billion to the Republican budget from proceeds related to debt recovery from bankrupt state banks in the portfolio managed by the DIA. Under GFSM2001 (¶5.87), staff considers this to be a super-dividend paid by the NBS. Under the program there is an adjustor which caps the amount of dividend revenue that can be used to meet the fiscal deficit target.

- **All quantitative and continuous PCs were observed.** All end-December, end-March and end-June quantitative performance criteria were met with comfortable margins. Inflation remained within the inner consultation limit and, in recent periods, has stayed close to the mid-point of the NBS target band.

- **Most SBs have been implemented, albeit some with delays due in part to the presidential election, and four remain outstanding.** The authorities met two end-December SBs on the amendments to the Law on Tax Procedure and strengthening the framework for real estate appraisals. In June, they adopted a decree aimed at strengthening the project appraisal process, establishing a single project pipeline (end-December 2015 SB), and adopted the 2017 decisions under the Law on Ceilings on the Number of Employees (end-March SB). In August, they submitted amendments to the corporate insolvency law to the National Assembly (end-December SB), and are expected to complete the independent assessments of the Development Fund and the export promotion agency (end-April SB). Delays linger on adoption of action plans for restructuring in the education sector and social services administration, resolution of Azotara and MSK (both end-March SBs), adoption of an organizational plan for state tax administration, and adoption of secondary legislation for local governments and public services (both end-June SBs). The strengthened monitoring instituted in the context of the sixth review has helped contain electricity and gas payment arrears.

OUTLOOK AND RISKS

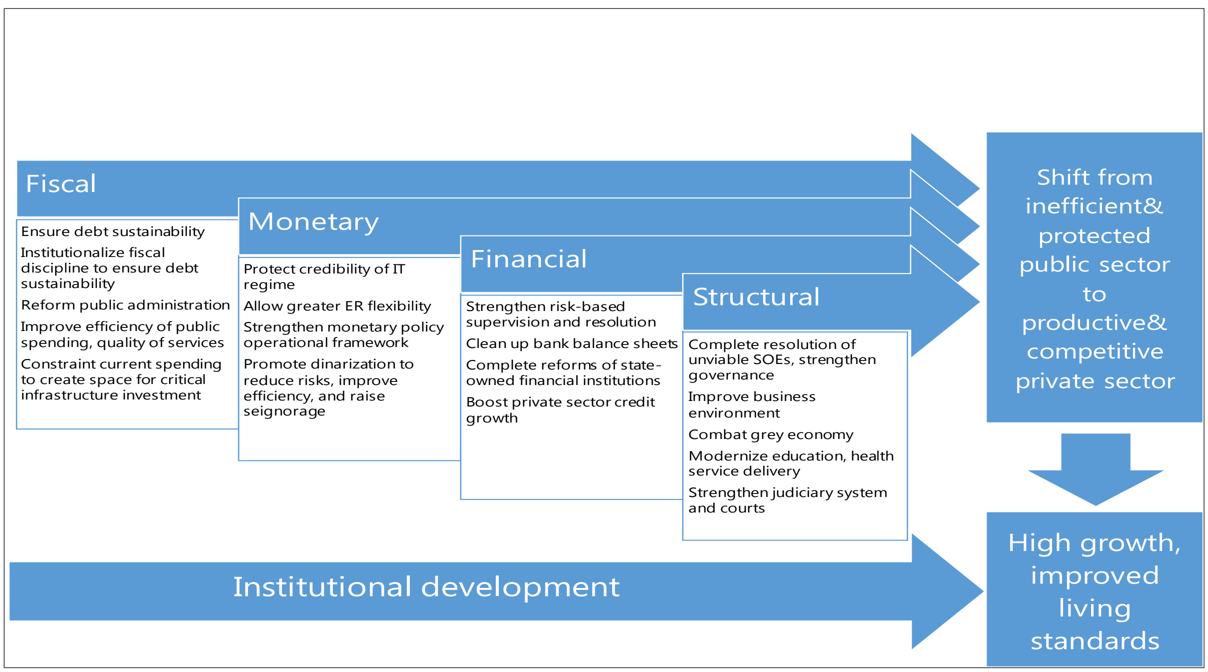
10. The baseline macroeconomic outlook is positive. The economy is projected to be in cyclical balance in 2017 and into the medium term, with an output gap close to zero and inflation near the center of the target range. GDP growth (both actual and potential) is projected to strengthen gradually from 3 percent this year to 4 percent in the medium term, as consumption rebounds and the business and investment environment improves further, on the assumption structural reforms continue. The current account deficit is projected to remain around 4 percent of GDP throughout the medium term as strong exports offset recovering domestic demand and somewhat worsening terms of trade.

11. The external stability assessment suggests that Serbia's external position is broadly consistent with fundamentals and desirable policy settings, but subject to vulnerabilities. Serbia's current account deficit has improved significantly since the global financial crisis, adjusting from 21 percent of GDP in 2008 to 4 percent in 2016. While the large negative net international investment position (NIIP, estimated at -104 percent of GDP in 2016) poses a vulnerability, its favorable composition tilted towards a high share of net FDI liabilities (76 percent of GDP in 2016) and high amount of FX reserves mitigate external vulnerabilities. Furthermore, continued efforts to boost export competitiveness and attract foreign investment, coupled with a prudent fiscal policy, can ensure that the external position remains sustainable (Annexes V and VII).

12. Domestic and external risks remain elevated. Public and external debt have declined but are still high, and Serbia remains susceptible to possible adverse spillovers from regional developments and market volatility (Annex I). In the short term, there are downside risks to the 2017 growth projections from the electricity disruptions earlier in the year and unfavorable weather. Complacency or political resistance in delivering on structural reforms, or failure to maintain fiscal discipline, could reduce medium- and long-term growth prospects, compromise the quality and durability of fiscal adjustment, and ultimately exacerbate underlying debt sustainability concerns.

POLICY DISCUSSIONS: CEMENTING MACROECONOMIC STABILITY AND PROMOTING SUSTAINABLE GROWTH

The Article IV discussions centered on institutional development for nurturing robust private sector-led economic growth. The review discussions focused on a need to cement hard-worn macroeconomic and fiscal gains, reduce fiscal risks from SOEs, further strengthen financial stability, and boost employment and productivity.

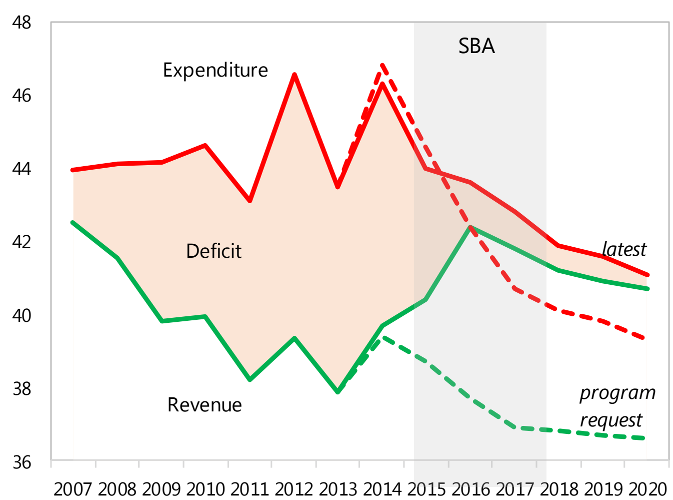


A. Fiscal Policy: Maintaining Public Debt Sustainability

Background

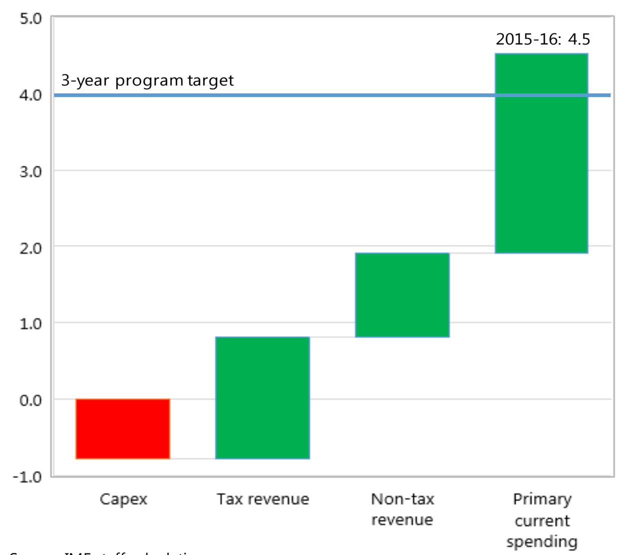
13. Public finances have improved significantly under the program. The total structural adjustment achieved in 2015–16 is estimated at 4.5 percent of GDP, exceeding the agreed target of 4 percent of GDP for the full three-year program. This level of adjustment has been achieved through strong revenue over-performance and tight control over Republican level current expenditure. Serbia's headline deficit in 2017 is projected to be about 1.1 percent of GDP under updated revenue assumptions and approved budget expenditure, significantly lower than the 1.7 percent of GDP projected at the time of the sixth review. The success in reducing structural fiscal imbalances without preventing the acceleration of economic growth may be explained by low fiscal multipliers, reflecting the endogenous response of monetary and exchange rate policy to fiscal consolidation, confidence effects of the strengthened policy framework and structural reforms on expectations, and liquidity buffers from remittances and the large informal economy (see Box 2).

Fiscal Improvement
(Percent of GDP)



Source: Serbian authorities and IMF staff calculations and projections.

Structural Fiscal Adjustment under SBA, 2015-16
(Percent of GDP)



Source: IMF staff calculations.

14. Notwithstanding the fiscal gains under the program, Serbia's fiscal institutions remain weak:

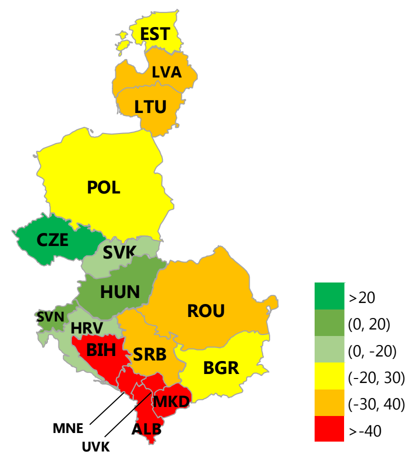
- **The current fiscal rules framework**—a combination of debt, deficit, and indexation rules—exhibits several significant shortcomings thereby undermining its operational effectiveness and credibility.
- **Reforming Serbia Tax Administration (STA) has proved challenging.** The 2016 tax administration diagnostic and assessment exercise highlighted major shortcomings, including STA governance, compliance risk management, and information technology

systems. The STA faces challenges in developing and implementing a comprehensive transformation strategy, partly because of a lack of resources.

- **Financial problems in some local self-governments and local public utilities have emerged** (for example, arrears to Republic-level utility companies and suppliers). However, the MOF currently lacks adequate mechanisms and authority to address these challenges.

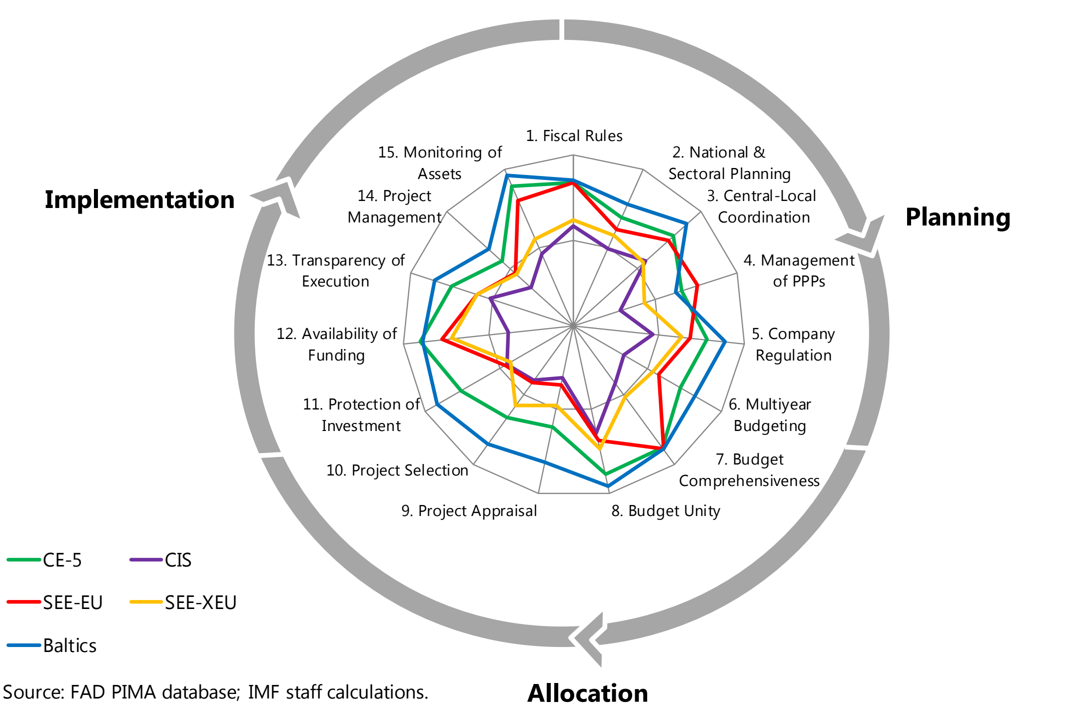
15. Serbia faces significant public infrastructure gaps. Large gaps in quantity and quality of infrastructure are present in areas of transportation, energy generation and transmission, and telecommunication. These impediments significantly constrain private sector development and integration into European supply chains and pose headwinds to faster income convergence. But closing infrastructure gaps is likely to prove challenging given Serbia's limited fiscal space and weaknesses in public investment management frameworks.

Infrastructure Gap Index



Sources: WDI, EIA, IRF, Eurostat, and IMF staff calculations.
Note: Infrastructure Gap Index calculates the gap between a country's infrastructure and that of an average EU member. In the following area's railway density, motorway density, installed capacity for power generation, phone lines and cellular subscriptions, broadband internet connections, and air transport passengers. The index value ranges between 50 to -65 with a value of zero reflecting EU-28 average.

Strength of Public Investment Management by Institution



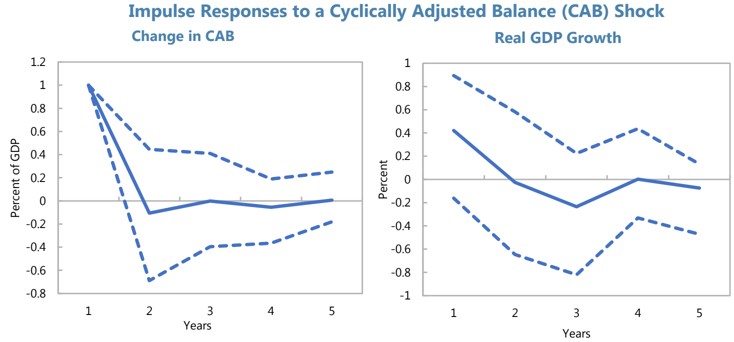
Source: FAD PIMA database; IMF staff calculations.

Box 2. Fiscal Multipliers in Serbia

Despite the even larger than planned fiscal adjustment realized under the program, growth in Serbia surprised on the upside. This goes against the common assumption that fiscal contractions have a negative impact on growth. However, there are a number of factors suggesting that multipliers could be very low in Serbia, including that it is a small open economy with monetary and exchange rate policy autonomy; confidence effects when the fiscal adjustment is sufficiently large to revise expectations to the upside; and buffers from remittances and the grey economy that can dampen a temporary reduction in disposable income. Academic studies have reached similar conclusions.[1] Empirical analysis also points to very low multipliers and large margins of uncertainty:

Structural fiscal balance shock. We simulated a 1 percent of GDP contraction in the cyclically adjusted balance (CAB) using a VAR model and annual data from 2000-16. The results show that the impact on growth is *positive,* but small and statistically not significant.

Impulse Responses to a Cyclically Adjusted Balance (CAB) Shock



Source: WEO data and IMF staff calculations.
Note: The size of the shock is normalized to 1 percent of GDP. Dashed lines indicate 95 percent confidence bands.

Separate government spending and revenue shocks. Using the same VAR methodology, the findings are in line with the evidence obtained when simulating a shock to the CAB. The fiscal multiplier to a government spending shock is positive, but small. On the other hand, the GDP impact of a revenue shock is also positive. As above, these estimates are not statistically significant at all horizons.

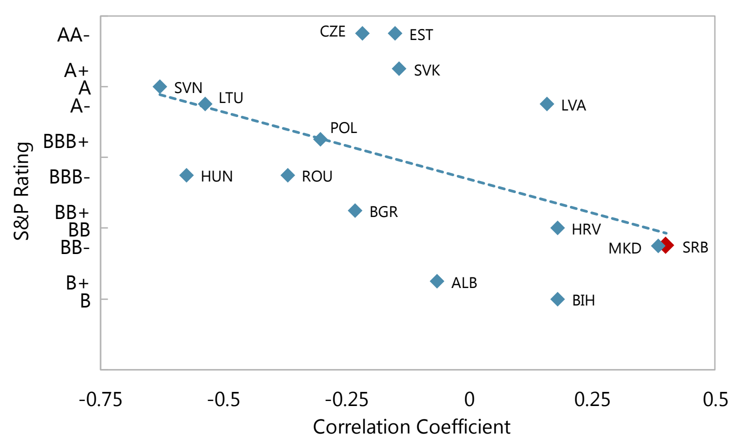
Fiscal multipliers

Years	Cyclically adjusted balance	Government spending	Government revenues
1	0.42	0.08	0.60
	(-0.16,0.89)	(-0.29,0.41)	(-0.01,1)
3	0.18	0.40	0.32
	(-1.83,1.91)	(-0.32,1.08)	(-0.11,0.67)
5	0.11	0.44	0.31
	(-2.89,2.69)	(-0.49,1.34)	(-0.07,0.61)

Note: The first column shows multipliers to a 1 percent of GDP increase in the cyclically adjusted balance (CAB). Multipliers to a government spending (revenue) shock are computed as the ratio of the cumulated response of output and the cumulated response of government spending (revenue). This ratio is rescaled by the average share of government spending (revenue) to output in order to express the multiplier in euro-to-euro terms. Values in parenthesis indicate 95 percent confidence interval.

Cross country comparison. Simple correlations between changes in growth and changes in the structural primary balance are consistent with low multipliers in Western Balkan countries. This may reflect the impact of changes in investor perceptions – the confidence effect of fiscal tightening may overtake its contractionary effect. This explanation is supported by comparing the correlations with country ratings, since confidence effects may be more important when ratings are low.

Correlation of Growth and Fiscal Impulses vs. Sovereign Ratings 1/



Sources: IMF staff estimates.
1/ Sensitivity to fiscal impulse is measured by the correlation between changes in the structural primary balance and changes in real GDP growth. Crisis years are excluded to avoid results being dominated by large swings in GDP unrelated to fiscal policy.

[1] See for example: Fiscal Multipliers in Emerging Europe (P. Petrović, M. Arsić and A. Nojković), Republic of Serbia Fiscal Council Research Paper 14/01); The size and determinants of fiscal multipliers in Western Balkans: comparing Croatia, Slovenia and Serbia (Milan Deskar-Škrbić and Hrvoje Šimović), EFZG Working Paper Series No 15-10.

Policy Discussions

Cementing Fiscal Gains, Reducing Fiscal Risks

16. The authorities and staff agreed that preserving hard-won fiscal gains is a priority. Serbia's public debt is sustainable but subject to significant vulnerabilities of debt dynamics to various shocks (Annex VI). Given the still elevated level of public debt and gross financing needs, large share of foreign currency denominated debt, lingering vulnerabilities in SOEs, and some downside risks to growth, fiscal overperformance in 2017 relative to the current baseline should be used to raise capital spending (where feasible given implementation constraints) or reduce debt. Continued tight control of mandatory spending is a priority:

- **Government rightsizing**. As of end-April, permanent general government (plus local public utilities) employment had been reduced by more than 25,000 relative to end-2014, although nearly half of these gains were offset by higher fixed-term and contractual hiring (more than 11,000). In June, the authorities adopted the 2017 decision under the Law on Ceilings on the Number of Employees, setting detailed employment limits for institutions of the general government (**end-March SB**). The authorities agreed that the focus needs to shift from attrition-based cuts to optimizing resource allocation. A preliminary draft of the time-bound action plan for administrative restructuring in the education sector (**end-March SB**) was produced in June. However, additional time is required to produce more detailed actionable items consistent with the World Bank functional review. Work on social services administration will continue. Staff urged the authorities to be ambitious and forward looking, fully taking into account demographic changes and educational needs of the future workforce.

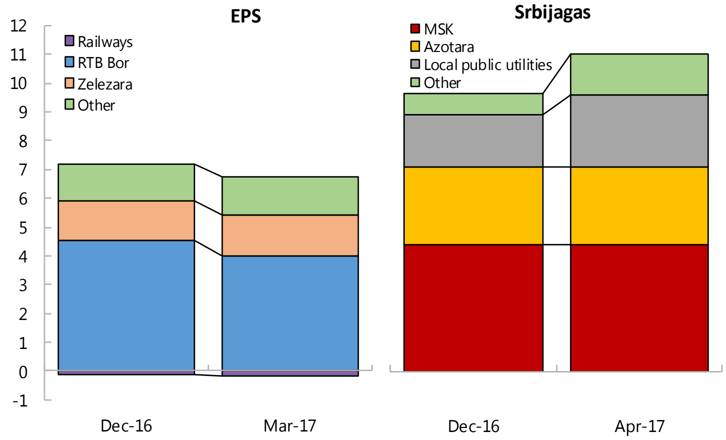
- **Wage system reform**. The 2016 Law on Public Sector Employees Wage System set the stage for reducing disparities of pay for similar work across different ministries. As a first step towards its implementation, the government adopted the new job catalogue (**prior action**), required for mapping employees into the new wage structure. The authorities aim for parliamentary passage of secondary legislation for local government and public services (health, education, culture, and social protection) by end-September (**end-June SB**). Staff stressed the importance of allocating sufficient resources to ensure successful implementation with the 2018 budget. Secondary legislation for all other sectors (including police and army) is to be adopted by end-2018 in time for the 2019 budgetary cycle.

- **Other.** Staff urged the authorities to amend the Law on the Financial Support to Families with Children to provide for greater parental allowances, in parallel with the elimination of VAT refunds for baby items. Staff also pressed the authorities to improve the targeting of existing social programs before creating new programs.

17. While significantly reduced under the program, risks from contingent liabilities remain significant. Discussions focused on actions to mitigate these risks:

- **Arrears.** Over January 2016 to April 2017, the authorities reported the accumulation of 0.4 percent of GDP in energy arrears from some public enterprises and SOEs (including Azotara, MSK, RTB Bor, and Railways), medical institutions, and local governments; while municipal pharmacy and health center arrears to drug suppliers totaled around 0.2 percent of GDP. The authorities and staff agreed that resolution of these arrears should be guided by the overarching principle of eliminating fiscal costs, avoiding adverse incentives, and removing the underlying factors behind arrears accumulation. The authorities noted that increased transparency brought about by publishing the top 20 debtors on the company websites and Srbijagas' decision to disconnect delinquent users were having the intended positive compliance effect. The authorities also noted their efforts to establish a new e-invoice system designed to capture all transactions involving public entities, which they intend to roll out in 2018.

Domestic Energy Arrears
(Cumulative from January 2016, RSD billions)



Sources: EPS, Srbijagas, IMF staff calculations.

- **State aid.** The authorities and staff agreed that there should be no state aid beyond what has already been budgeted to companies undergoing restructuring or resolution, including Srbijagas, Petrohemija, MSK, Azotara, RTB Bor, and Resavica.

- **High-speed rail.** The authorities informed the mission that the planned Belgrade-Budapest rail link is moving ahead, mainly via contracts with bilateral partners. Project documents have been completed and IFI support is being provided to ensure that these in line with EU requirements. The first financial contract was signed in May and construction is slated to commence in November. The first portion will be completed in three years. Staff urged the authorities to transparently record the transactions in the budget and plan for maintenance costs.

Strengthening Fiscal Frameworks and Institutions

18. Sustaining the recovery of tax revenue, while at the same time making space for growth-enhancing tax policy changes, requires reconsidering the tax policy mix and accelerating the pace of reforms of tax administration, along with further social security reforms (Box 3):

- **Modernization of the state tax administration is critical for increasing revenue collection, and improving the business climate.** With the risk management unit now operational, implementation of strategic risk initiatives of the 2017 tax compliance plan is under way. The authorities established and operationalized the second instance appeal unit at the MoF, while ensuring an independent substantive tax appeal function remains within the tax administration. Staff urged the authorities to institutionalize dissemination by the MoF of the details of cases when issuing tax opinions. The Tax Administration Transformation Program (adopted by the Government in mid-2015), however, has faced setbacks due to capacity constraints and lack of political support. The restructuring plan identifying the staffing and responsibilities of 36 main branches has not yet been adopted by the government (**end-June SB**). As an interim step, the STA will adopt a new systematization plan establishing a risk management unit and a taxpayer service department. Staff urged the authorities to refocus attention on the transformation plan, updating it to take into account advice from the recent FAD technical assistance mission. The authorities committed to adopt a government decision identifying non-core activities (**new end-October SB**) to be transferred or separately managed within the STA.

- **Staff recommended strengthening further the direct tax and pension systems to reduce tax inefficiency, improve the labor market, and support the business environment.** Specifically, consideration should be given to (i) simplifying the PIT and CIT codes, with a view to improve the progressivity of labor taxation while broadening tax bases; (ii) making better use of property taxes; and (iii) raising faster the women's pension age in line with the men's and addressing generous provisions for hardship workers and survivor benefits. The authorities saw the merit of these reforms but felt that policy continuity was more important in the short-term. Staff and the authorities agreed that before moving ahead with any major reform, rigorous analysis of the costs and benefits were necessary.

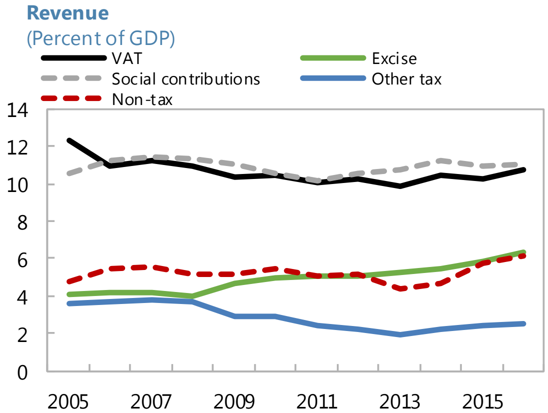
19. The authorities and staff agreed that a strong fiscal framework should be anchored by a robust fiscal rule. Specifically, the objective should be to put in place a new framework based on (i) strong institutional significance of the debt limit as the primary medium-term anchor for fiscal policy; (ii) a transparent and credible operational rule to help achieve the objective, while also helping to improve accountability and facilitate transition towards the EU fiscal framework; and (iii) a strengthened role of the Fiscal Council. Staff stressed the importance of proper sequencing of reforms, including the risk of failure from establishing a new rule without adequate institutional support. Staff recommended the authorities consider two possible simple and easily understood options: an expenditure rule (modified structural balance) or a balanced budget rule (Annex II). The authorities agreed that this was an opportune time to consider a new fiscal rule and stressed the importance of having a framework that has full government ownership and is implementable.

Scaling up Public Infrastructure

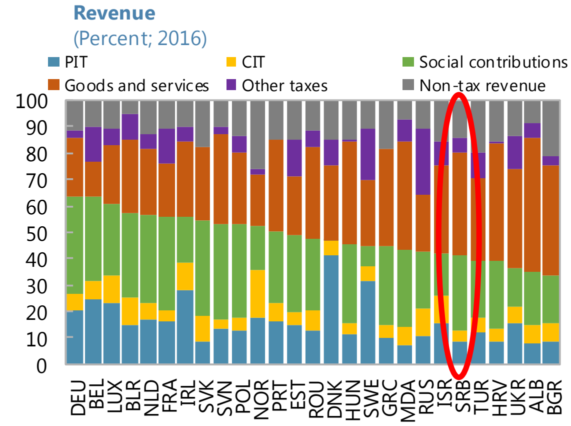
20. The authorities recognized the need to scale up public infrastructure (Annex III). Staff recommended a multi-pronged approach centered around (i) containing current spending and mobilizing domestic revenues; (ii) strengthening public investment management frameworks to improve efficiency of public and PPP investments; and (iii) greater regional

Box 3. Revenue Mobilization in Serbia[1]

Revenue as a share of GDP fell sharply between 2008 and 2013 as Serbia was hit by the global financial crisis and growth declined. However, by 2016 revenue almost fully recovered to pre-crisis levels, partially due to increases in various tax rates. Compared to Emerging Europe, Serbia has higher levels of revenue, but it relies more heavily on goods and services taxes and social insurance contributions (SIC). To sustain the revenue recovery the authorities should reconsider the tax policy mix and the bases of key tax sources, and press ahead with their Tax Administration Transformation Program (2015-2020).



Sources: IMF staff calculations.



Source: IMF, WEO database.

On the **tax administration** front, the authorities' Transformation Program (2015-2020) sets out an ambitious program of reforms. This should create a modern TA utilizing e-based business processes, delivering taxpayer services and modern compliance risk management. This will require many fewer, but larger offices, organized differently, with more highly-skilled employees. To realize their objectives, the authorities should focus on:

- Ensuring that the tax administration has a clear vision for its future operations that is supported by the government in a manner that is transparent to the broader community.
- Use of a project management framework to ensure the Transformation Program is progressing as planned.
- Incorporate the implementation of technical assistance advice into the project management framework to ensure proper prioritization, coordination, and consistency of approach.
- Adopting a new operational model which separates the administration of core and non-core tax activities and significantly consolidates the administration of core tax activities.

In **tax policy**, in order to reduce tax inefficiency, particularly in the labor market, and to support the business environment, reforms of the direct tax system should focus on the following areas:

- **Corporate income tax.** Streamline divergences between accounting and tax rules for determining the tax base. Assess Serbia's international tax rules, in particular, anti-avoidance against profit shifting.
- **Tax incentives** are excessively used; they can be further streamlined without undue adverse impact on investment. Targeted accelerated depreciation can be more effectively deployed to incentivized marginal investment in key strategic growth sectors.
- **Architecture of personal income tax.** Reduce the number of tax schedules to three: wages, portfolio income and capital gains, and self-employed income. Introduce consistent tax treatment for public pension contributions and benefits. Simplify the taxation of small and micro businesses.
- **Social insurance contributions.** Align the thresholds of wage taxation and SIC to prevent discontinuities in the labor tax wedge and regressivity. Consider distinguishing the application of minimum contributions between self-employed and wage-earners.
- **Property tax.** Provide a single, uniform tax base for all taxable properties. Clarify the policy objectives of inheritance and gift taxes, and reconsider their current use as local taxes.

[1] Prepared by Chris Barlow, Irena Jankulov Suljagic (both FAD), and Christine Richmond (EUR).

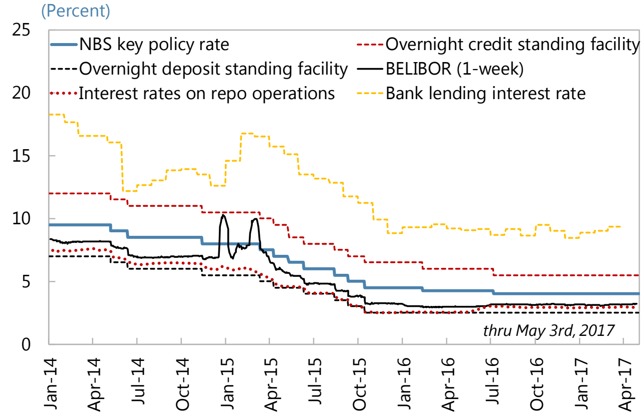
coordination in developing infrastructure and securing concessional financing (including the Instrument for Pre-Accession Assistance funding). The authorities are making progress in improving the management of PPP projects and budget comprehensiveness. Specifically, the Law on PPPs and Concessions will be amended to harmonize PPP legislation with EU standards and provide for a more active role of the Ministry of Finance in coordination, selection, and approval of PPP projects at the national level. Budget comprehensiveness has been significantly strengthened as all project loans have been brought on budget starting with the 2017 cycle. The government also adopted a decree to strengthen project appraisal and create a single project pipeline coordinated through the National Investment Committee (**SB end-December 2015**).

B. Monetary and Exchange Rate Policy: Keeping Inflation under Control and Encouraging Dinarization

Background

21. The NBS has maintained a prudent policy stance. With core inflation remaining subdued, stable inflation expectations, and uncertainty over the impact of diverging monetary policy stances of leading central banks on global capital flows, the NBS has held the key policy rate unchanged at 4 percent since July 2016. Portfolio inflows have resumed and appreciation pressure on the dinar has started to develop in May, leaving room for the NBS to preserve its moderately accomodative stance in an envrionment of rising headline inflation. Excess reserves of the banking system remain high and the overnight interbank rate has fluctuated close to the deposit facility rate.

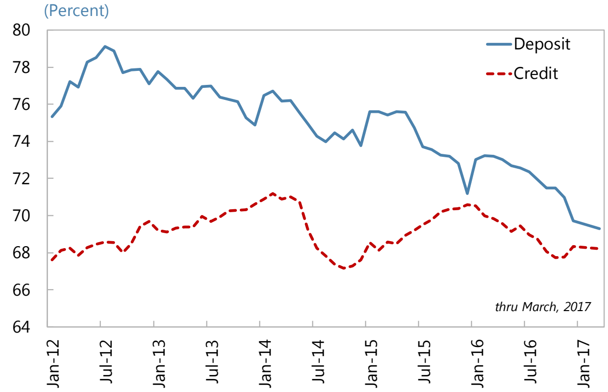
Serbia: Interest Rates
(Percent)



Sources: Haver Analytics; and National Bank of Serbia.

22. The authorities' dinarization strategy is gradually yielding results. The 2012 strategy is based on three pillars: (i) strengthened macroeconomic environment under inflation targeting and a managed floating exchange rate; (ii) expansion of dinar credit by promoting dinar denominated instruments and markets; and (iii) promote hedging of existing foreign currency risks in the nonbank sector and

Deposit and Credit Euroization
(Percent)



Sources: National Bank of Serbia (NBS); IMF staff estimates.

discourage buildup of new risks. To this end, the NBS has imposed higher reserve requirements on FX deposits, required partial dinar funding for the reserve requirement on FX deposits, and introduced differentiated remuneration of the required reserves favoring local currency. It also differentiated the prudential debt service-to-income ratios by currency and borrower's income and abolished the compulsory deposit for dinar loans. The Ministry of Finance increased the share of its borrowing in domestic currency. By end-2016, euroization of deposits has declined to 70 percent, while credit euroization has also been falling in the past 18 months.

Policy discussions

Strengthening the inflation targeting framework and flexible exchange rate regime

23. **The NBS reaffirmed its commitment to inflation targeting.** The inflation targeting regime helps anchor inflation expectations and remains appropriate for Serbia, particularly given Serbia's improved macro policy framework, stronger credibility of the NBS, and major fiscal consolidation. The authorities and staff agreed that the current policy rates remain appropriate for now. Going forward, staff and the authorities agreed on the need to adjust monetary policy to changes in the inflation outlook as needed to keep inflation within the target band. On the basis of projected inflation and exchange rate developments, gradual mopping up of excess liquidity in the banking system through repo operations—and moving the NBS repo rate closer to the key policy rate—will be warranted. Staff also advised to seek opportunities to further gradually narrow the interest rate corridor to improve the signaling role of policy rates and enhance transparency.

24. **Improved market conditions warrant bolder exchange rate flexibility.** The NBS remains committed to a managed float exchange rate policy, which continues to work well as an absorber of external shocks, limiting interventions to smoothing out excessive volatility. However, staff noted that RSD/EUR exchange rate movements remained within a 2 percent range in 2016, supported by two-sided NBS interventions thus warranting reclassification of the de facto exchange rate arrangement from "floating" to "stabilized" (effective January 28, 2016). The NBS agreed that day-to-day fluctuations of the exchange rate against the euro have subsided significantly since early 2016 but attributed this mainly to the success of macroeconomic stabilization under the program. Staff welcomed the accommodation of significant dinar strengthening in recent months and reiterated its advice that greater exchange rate flexibility will be appropriate given Serbia's improved fundamentals. This would help to develop the forex market, counteract perceptions of tight exchange rate management, and support the authorities' dinarization strategy. Taking into account recent exchange rate movements, the classification is expected to revert to "floating" in the future.

Advancing dinarization

25. **The authorities plan to review their 2012 dinarization strategy in light of recommendations of the recent IMF technical assistance (Annex IV).** Staff advised that two-way exchange rate flexibility, regulatory measures to manage interest rate differentials,

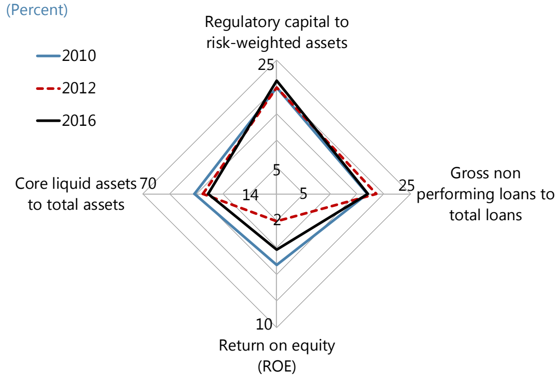
development of local and foreign currency markets, and improved communication would help overcome entrenched euroization motives. Similarly, strengthened monitoring of banks' FX exposures, fuller dissemination of information on risks of FX borrowing, and use of macro-prudential measures would encourage prudent pricing of FX risks. The authorities broadly agreed with these recommendations but highlighted a preference to proceed gradually while carefully considering the possible impact of regulatory measures on banks' and depositors' behavior. They also discussed plans to enhance the existing communication framework by strengthening the NBS dinarization report and launching a financial literacy campaign to alter public perceptions toward inflation, exchange rate stability, and the authorities' dinarization efforts.

C. Financial Sector: Ensuring Soundness and Improving Intermediation

Background

26. Banking sector conditions remain sound. Data for the first four months of 2017 point to continued resilience, with an average capital adequacy ratio of over 22 percent and a gradual improvement in asset quality. Banking sector profitability has generally improved. Robust deposit growth has continued. The NBS has adopted regulations to implement Basel III capital and liquidity standards starting from June 30, 2017.

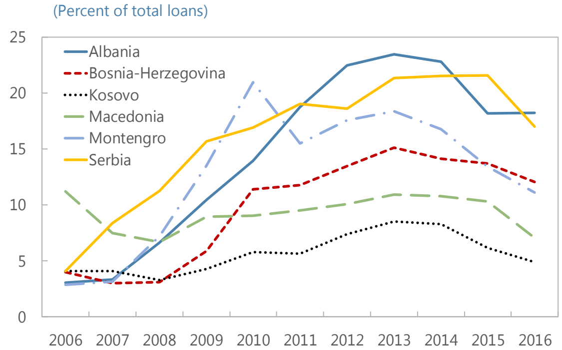
Financial Soundness Indicators, 2000-16
(Percent)



Source: National Bank of Serbia.

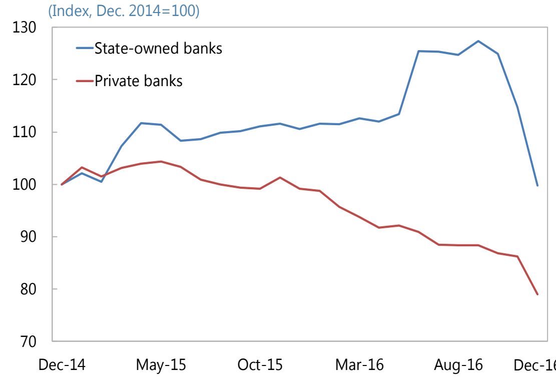
27. The authorities have made good progress on resolving NPLs, although state-owned banks have lagged. The gross NPL ratio dropped to 15.6 percent in June, more than 7 percentage points down from its peak in 2015. Preliminary data suggest that write-offs were the main driver, supported by the authorities' comprehensive NPL resolution strategy. Still, progress is uneven, with write-offs concentrated in banks with foreign or IFI capital. Good

Nonperforming Loans
(Percent of total loans)



Sources: Country Authorities; IMF, FSI; and IMF staff estimates.
Note: Macedonia and Bosnia-Herzegovina 2016 data is 2016Q3.

Serbia: Change in Gross NPLs
(Index, Dec. 2014=100)



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

results are being achieved in the implementation of the NPL resolution strategy aimed at enhancing bank's treatment of NPLs, further developing the NPL resolution market, strengthening out-of-court debt restructuring, and improving in-court debt resolution and mortgage framework. To this end, new legislation governing the real estate appraisal profession was adopted in December and amendments of the insolvency law to improve secured creditor rights were adopted by the government in August (**both end-December 2016 SBs**). In addition, an authentic interpretation of the Law on Enforcement and Security was recently submitted to parliament to clarify a legal ambiguity related to the transfer of the seller's rights to the buyer in the context of distressed assets' sales.

28. Implementation of the strategy for state-owned financial institutions is advancing with some delays. The process of hiring external consultants to support the implementation of strategic guidelines for Banka Poštanska Štedionica (BPS) faced some setbacks but was completed in May. The bank's new management has stepped up efforts to resolve NPLs and address significant gaps in its governance and risk management framework. In August, the government approved the updated strategy for state-owned banks, prepared in collaboration with IFIs and aimed at identifying strategic decisions for smaller banks (including arrangements for strengthening their corporate governance) and timelines for their executions. The independent diagnostic review of the state-owned insurance company Dunav Osiguranje was completed (**end-November 2016 SB**) and independent assessments of the Development Fund and the export promotion agency (AOFI) are expected to be completed in August (**end-April SB**).

Policy Discussions

Strengthening financial sector stability and regulatory framework

29. The NBS is making good progress in harmonizing the regulatory framework with EU standards. Basel III capital and liquidity coverage regulations became effective starting end-June 2017, establishing countercyclical capital buffers, and systemic risk capital buffers on banks with significant foreign currency credit portfolios. In addition, the NBS has adopted a framework for domestic systemically important banks (DSIBs), identifying seven banks as DSIBs and subjecting them to additional capital buffers. The authorities and staff agreed that the effective enforcement of these regulations will strengthen the resilience of the banking sector and further align the prudential framework with international standards. The authorities expect no significant issues related to banks' compliance with the new minimum capital requirements, but some technical challenges remain in relation to reporting and capacity. Staff underlined the importance of continuing NBS engagement with banks to ensure a smooth implementation process.

Accelerating NPL Resolution

30. The authorities, in collaboration with IFIs, identified several remaining obstacles for NPL market development. A thorough review of the implementation conducted by the NPL resolution working group identified further measures that could significantly accelerate resolution of NPLs: (i) amending the Civil Procedure Law to allow the change of plaintiff in respect of a sale of distressed assets in the course of litigation or the finalization of pending litigation; (ii) improving the performance, accountability and capacity of bankruptcy administrators; and (iii) removing remaining impediments for the efficient functioning of the mortgage framework. In addition, the current framework still subjects the resolution of retail NPLs to constraints limiting banks' ability to address this significant part (around 20 percent) of their overall NPL portfolios. Staff encouraged the authorities to address these impediments through introducing legislative amendments, exploring changes to the fiscal and regulatory frameworks, developing rules and procedures for the effective enforcement of the new corporate insolvency law, and improving the performance of cadastral services.

Reforming State-Owned Financial Institutions

31. Delays in reforming state-owned financial institutions need to be addressed:

- **Staff urged swift implementation of the new strategy for BPS with the assistance of recently hired external consultants**. Staff also advised to align the composition of the supervisory board with the bank's current ownership structure, discussed ongoing efforts to strengthen the bank's governance and risk management framework and to further reorient its business activities into the retail sector, and recommended steps to address the overhang of distressed assets.

- **Staff also encouraged timely implementation of the recently updated strategy for state-owned banks**. The authorities noted that the privatization of Komercijalna Banka is under way and expected to publish tenders for expressions of interest in August 2017 with the aim to finalize the privatization by end-June 2018. Staff urged the authorities to also implement the strategic options for smaller state-owned banks.

- **Staff welcomed the government's intentions to privatize Dunav Osiguranje.** The authorities indicated that the company has been working to address the findings of the diagnostic study and to update their business plan accordingly.

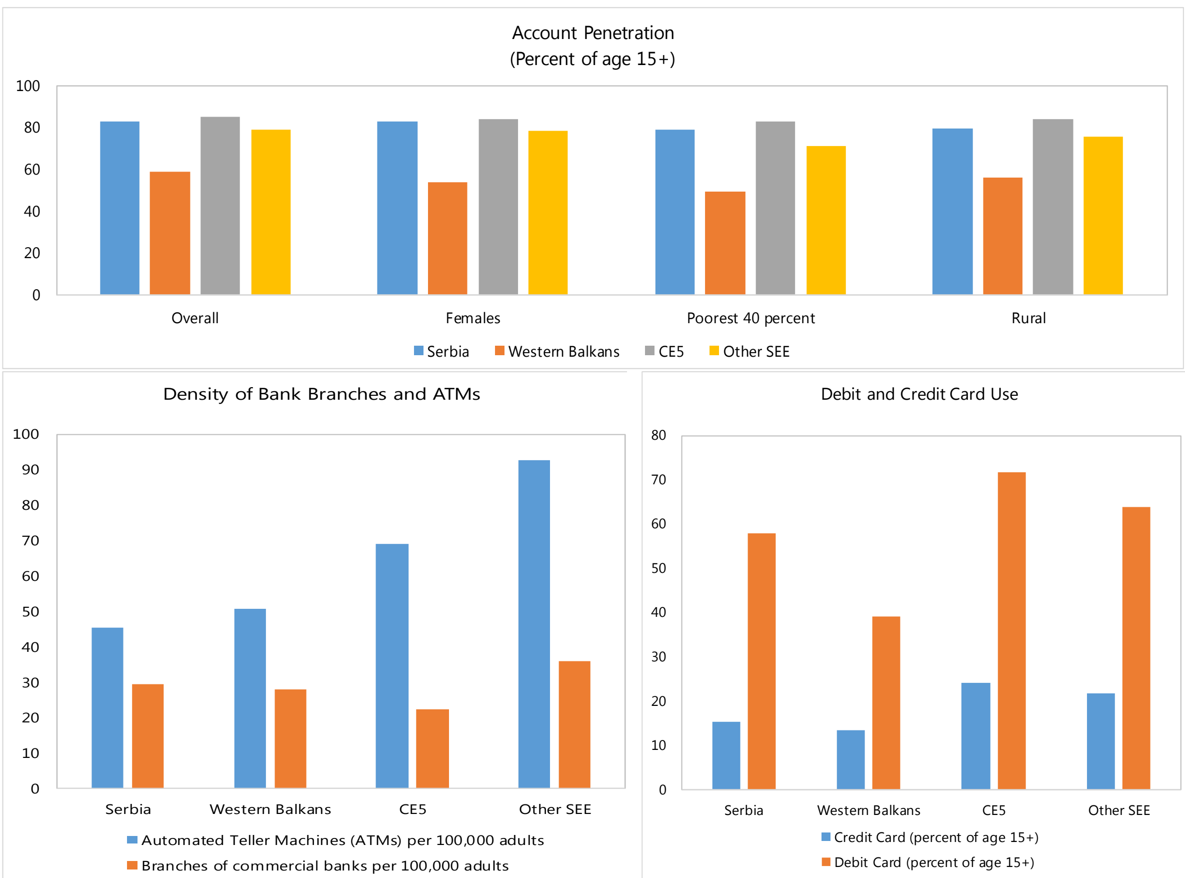
- **The authorities and staff discussed the need to overhaul the development finance framework to align it with Serbia's requirements and best international practices.** Staff discussed the main findings of the independent assessments of Serbia's development agencies. The authorities agreed that the agencies should recognize the assessment findings, and develop corrective action plans to preserve their capital (**SB for end-October**). Staff recommended assessing Serbia's development finance needs and consideration of possible frameworks with sound and adequately overseen development institutions.

Improving financial inclusion and intermediation

32. Staff advised the authorities to expand financial inclusion. The mission noted that improving financial access to various categories of the population and enhancing the use of electronic payment services will be important for laying down a foundation of more sustainable and broad-based economic growth. Staff also advised to consider the case for allowing entry of dedicated microfinance institutions under an appropriate supervisory framework. The authorities agreed on a need to enhance financial inclusion in Serbia but saw this as a medium-term priority. They indicated that discussions are ongoing about developing a framework for non-deposit taking financial institutions.

Development of capital markets would also enhance the capacity of Serbia's financial system. Staff noted the potential role of deeper capital markets as means of supporting economic and structural reforms. The authorities indicated their plans for a diagnostic study of obstacles to capital market development, and to establish a working group with the aim to develop a strategy in this regard.

Selected Financial Inclusion Indicators



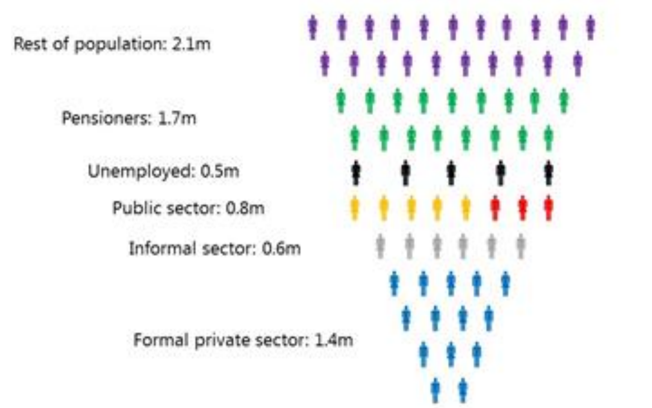
Source: World Bank

D. Structural Reforms: Strengthening Competitiveness and Growth

Background

34. The structure of the labor market is unbalanced and lacks the dynamism necessary for robust, private sector-led growth. The formal private sector, comprised of about 1.4 million workers and 70,000 private companies[4], is the chief source of both sustainable economic growth and tax revenue to pay for pensions, public wages, and public services. However, at only about 20 percent of the total population, it is too small to support a high standard of living for the whole country. This stands in contrast to countries such as Germany and the U.K., which have formal private employment about twice as large relative to the population.

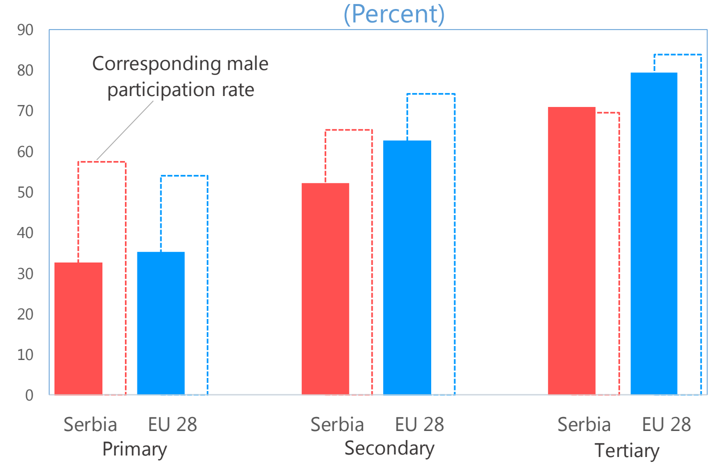
Labor Market



Note: Public sector is comprised of 0.5m in the government and 0.3m in SOEs.
Source: IMF staff calculations.

33. Along with other Western Balkan countries, Serbia has one of the lowest labor force participation rates in Europe, especially among women. With the exception of very low-skilled labor, overall labor force participation rates are noticeably lower in Serbia than the EU average. Importantly, the significantly lower female participation relative to the EU is persistent across all age groups and education levels. Within Serbia, the gender gap—defined as the difference between labor force participation of men and women—is also large among people with lower levels of educational attainment, although not for those with tertiary education. Staff analysis (WP, forthcoming) suggests women's potential contributions to the economy are held back by education, migration, disincentives in tax and maternity leave policies, and inadequate childcare and family leave policies.

Female Labor Participation by Education Level
(Percent)



Source: EUROSTAT; ILOSTAT.

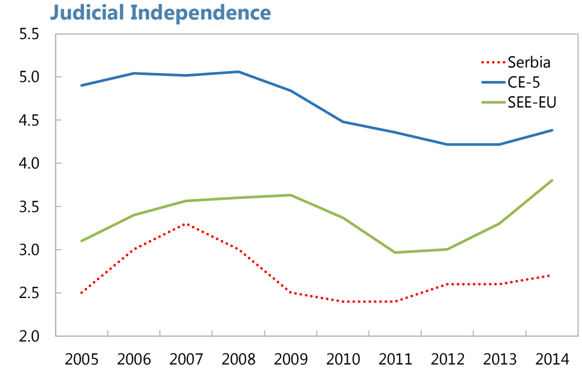
[4] Enterprises with at least one employee.

34. Judicial reforms remain incomplete. There is an urgent need to improve the court system, strengthen the quality and independence of the judiciary process, and facilitate the use of effective out-of-court arbitration (see Box 4).

Box 4. Judicial Reforms[1,2]

Serbia's track record with judicial reforms has been uneven. Judicial reforms in 2001 provided a legal basis for the organization and operation of general and specialized jurisdiction and prosecutors' offices, professional freedoms and guarantees for judges and public prosecutors. Further advancements in judicial independence were made in 2006 with the adoption of the National Judicial Reform Strategy (NJRS). Resistance to reforms, however, has persisted arising from vested interests among judges and political parties (seeking to maintain effective control over the judicial system). In this environment, early gains have not been sustained and the World Bank's 2014 Judicial Review highlights significant problems with the perception of judicial independence – 56 percent of lawyers, 50 percent of the public and business sector, 33 percent of prosecutors and 25 percent of judges reported that the judicial system was not independent.

Judicial Independence



Sources: World Economic Forum.

Note: Higher value implies greater independence. CE-5-Czech Republic, Hungary, Poland, Slovakia, and Slovenia; SEE-EU-Bulgaria, Croatia, and Romania.

The 2013-18 NJRS acknowledges the urgent need to reform the judicial system. One of the key priorities is to increase judicial independence by creating a system in which the work of judicial institutions and office holders is free of any undue/prohibited interference or pressures that might obstruct the course of justice, regardless of its source. This is envisaged to be achieved through several amendments to the existing laws. More progress, however, might be needed in areas that could facilitate further strengthening of institutional quality and prevent reform reversals. To support the business environment, consistent interpretation of legislation, clearing case backlog, and equal treatment will be key.

Increased cooperation with the EU in the context of the accession process could act as an external anchor for judicial reforms. Alignment of Serbia's national legal framework with EU requirements could help to overcome domestic political resistance for judicial reforms, particularly in the area of judicial independence and selection and nomination of judges.

[1] Prepared by Ruben Atoyan, Ara Stepanyan and Svetlana Vtyurina (EUR).

[2] Caution is needed when comparing survey-based structural indicators across countries.

35. Progress is being made in addressing the SOEs in the former Privatization Agency portfolio, but some strategic enterprises remain to be resolved. At end-2014, Serbia had over 1,400 state-controlled enterprises with more than 250,000 employees. This included almost 800 state and local public enterprises, as well as more than 600 socially-owned enterprises. By June 2017, more than 275 companies had entered bankruptcy and more than 45 were privatized. Some 26,000 employees from around 320 companies have received severance payments, while about 150 companies with some 52,000 employees remain.

Policy Discussions

Improving The Business Climate

36. Staff supported the authorities' focus on improving the business climate. Policy certainty is a key input for private sector development—for example in the application of fees and charges, interactions with tax officials, and legal rulings—that would benefit from better coordination across government. The authorities noted that macroeconomic stability also played an important role in improving Serbia's business sentiment. The authorities also pointed to efforts undertaken since 2014 aimed at removing obstacles to private sector development and attracting new investments that have made it easier to register property, get construction permits, and start a business and were paying off (3.2 percent increase in active enterprises in 2016; 21.4 percent increase in construction permits issued in 2016).

37. The authorities agreed that supporting the formal private sector will be key to achieving higher growth. The authorities pointed to their strategy for combatting the grey economy adopted in late 2015, which focused on labor, market, and tax inspection activities as well as a tax lottery to incentivize people to request fiscal receipts. An action plan for 2017 was adopted in May. Staff suggested the authorities evaluate their strategy to seek ways to make it more effective going forward. Staff and the authorities also discussed ongoing efforts to restructure the education sector (**end-March SB**), including curriculum reform, which if fully implemented would help develop a skilled labor force for a modern market economy. The authorities also noted their plans to amend the Law on Charges by end-2017 (**new end-November SB**) in order to improve transparency and predictability of parafiscal charges facing businesses.

38. Persistent unemployment and low labor force participation have deep structural roots in Serbia and depend on factors well beyond the labor market itself. With the working age population set to decline, policies need to target raising labor market participation, notably of women. Staff believes that reform of labor taxation and parental benefits and access to affordable childcare are important, but would not in themselves be sufficient to secure the needed higher participation. In addition, structural reforms, institutions enabling better functioning of a market economy, and enhanced active labor market policies are preconditions for creating employment opportunities. Staff also urged the authorities to become less reliant on tax incentives for employment creation and to let existing tax holidays expire.

Reform of SOEs

39. Staff urged the authorities to press ahead with resolution and reforms of the SOE sector, taking advantage of improved market conditions. The authorities noted that while progress has not been as rapid as originally envisaged, work in conjunction with other IFIs is ongoing:

- **Elektroprivreda Srbije (EPS).** Problems with electricity production emerged in early-2017, a result of unfavorable weather conditions but also longstanding management and planning weaknesses. The authorities explained that they were developing a strategy to strengthen management capacity with support from IFIs, focusing on corporate governance, procurement frameworks and planning, and benchmarking. They foresee production recovering to 2016 levels. Staff urged the authorities not to jeopardize the medium-term outlook for short-term gains and to complete the process of hiring qualified management. Meanwhile the overall reform program is progressing; rightsizing is yielding results broadly in line with the 2016-19 systematization plan and the phase of mandatory separation should be implemented by end-2017. Following household tariff increases in 2015 and 2016, the authorities will announce a moderate increase from October 2017, which will help ensure adequate resources for needed maintenance and investments.

- **Srbijagas:** The company's financial position has improved, notwithstanding rising international gas prices and U.S. dollar appreciation, and has contributed to lower amortization of activated guarantees for the Republican budget. As with EPS, the new requirement to publish details of large arrears cases, as well as the company's decision to disconnect delinquent users, appears to be contributing to better payment discipline. Staff urged the authorities to carefully assess the feasibility of current and future investment projects.

- **Railways of Serbia.** The implementation of the systemization plan is proceeding as planned and about 2,400 employees will separate in 2017. In 2016, 430 kilometers of rail lines were closed and a decision on the closure of additional 670 kilometers of rail lines in 2017 is under preparation. All companies are current with suppliers, including EPS. A maintenance plan is to be completed by year-end.

- **RTB Bor.** Recovering international copper prices have improved the company's liquidity situation and it remains current on electricity payments and servicing of past liabilities regulated by the pre-pack bankruptcy agreement. The authorities reported that one-off subsidies of RSD 2 billion in the 2017 budget have been used to cover past energy arrears, and gave assurances of no further direct budgetary support in the year. They intend to continue discussions with potential investors and reach a decision on how to proceed by end-year. Staff noted the importance of addressing legacy and ongoing environmental risks.

- **Petrohemija, MSK, and Azotara.** To date all three companies have serviced their gas bills, complying with the program commitment of prepayment (for MSK and Azotara). In late March, the government published invitations for selection of privatization models for all three companies. The authorities reiterated their commitment to resolve the companies and privatization/strategic partner tenders are due to be launched in early fall.

- **Resavica.** A comprehensive restructuring plan is being prepared, in consultation with the World Bank, envisaging rightsizing targets and the closure of unviable mines. The process of mine conservation is likely to be prolonged (3–5 years) due to its technical complexity. Staff urged the authorities to develop a multiyear strategy, including estimates of severance payments to be financed by the budget and the socioeconomic consequences of mine closures.

- **Galenika.** A privatization tender in early 2017 failed as creditors and the investor did not agree on restructuring old debts (EUR 70 million). The authorities plan to launch another tender by mid-August using a new strategy that has been agreed with commercial bank creditors. Staff urged the authorities to initiate bankruptcy procedures if the tender fails.

PROGRAM MODALITIES

40. Staff proposes updated program conditionality (MEFP Tables 1–2):

- **A prior action** was set on the adoption of a new job catalog (a critical element of the public wage reform) to support the implementation of the Law on Public Sector Employees Wage System (aimed to reduce disparities of pay for similar work across different ministries).

- **The performance criterion** on the general government deficit is augmented for September and December 2017, in line with quarterly projections. Additional adjusters are set on one-off debt transactions for the general government deficit and the current primary spending by the Republican budget.

- **One SB is proposed to be modified and reset.** The new plan for administrative restructuring in education (part of an SB for March 2017) is expected to be adopted by the government by **end-September**.

- **New SBs** are proposed with a view to support the structural reform focus of the new government in 2017: (i) for **end-October** on the Development Fund and AOFI to fully recognize losses on the credit portfolio, take measures to prevent further deterioration in asset quality, and identify solutions to resolve impaired; (ii) for **end-October** on the adoption of a government decision that identifies the non-core activities of the STA to be transferred or separately managed within the STA to support the focus on core tax activities; and (iii) for **end-November** on the initiation of public debate on a draft Law on Charges that will ensure greater predictability and transparency.

41. Serbia's capacity to meet potential repayment obligations to the Fund remains strong. In case of full drawing of the amount under the SBA (Table 10), repayments to the Fund at the end of the projection period would remain manageable at 0.7 percent of GDP, or 4.8 percent of gross reserves (Table 11). Although public debt is expected to remain high during the program period, strong program implementation would put it on a firm downward path

(Annex VI). Serbia has a strong record of repayment to the Fund. Staff does not expect Serbia to draw on the SBA given its high level of reserves.

42. Serbia has small sovereign arrears outstanding. It intends to resolve US$45 million in arrears to Libya, which arose in 1981 due to unsettled government obligations related to a loan for importing crude oil, after establishing the appropriate government counterpart. Staff urged the authorities to resolve these arrears as soon as possible.

STAFF APPRAISAL

43. Serbia has achieved an impressive economic improvement since the last Article IV was concluded in early 2015. Following five years in which GDP remained essentially flat while the public finances deteriorated alarmingly, Serbia adopted a comprehensive program supported by the SBA approved in February 2015. The macroeconomic results have exceeded the (admittedly cautious) expectations underpinning the program, notably with growth resuming earlier and more strongly, notwithstanding a larger and more rapid fiscal adjustment than programmed. Serbia is now enjoying robust growth and rising employment, with public debt on a firm downward path.

44. Strengthened commitment is needed to ensure full implementation of planned structural reforms. Under their program the authorities have pursued a very broad and ambitious reform agenda, encompassing public administration, public utilities and SOEs, the labor market, the financial sector, and the business environment. Overall progress has been good. However, there have been delays in some reform areas – notably in optimizing public administration in areas such as education and tax administration and restructuring of state-owned enterprises and utilities. It is important that these reforms are carried out expeditiously to improve economic efficiency and ensure a public sector supportive of growth.

45. Serbia also needs to build stronger institutions to consolidate the achievements so far and create a platform for future growth and EU accession. The Fund-supported program has provided a framework for the needed strong fiscal adjustment, but it is now time to consider revamping Serbia's fiscal rules to establish credible guidance to fiscal policy in the medium term. Monetary and exchange rate policy frameworks can also be strengthened, and the full implementation of the NBS dinarization strategy will support sound and dynamic financial intermediation. Better public infrastructure and administration, and strengthening the rule of law in general, would have high payoffs in boosting medium-term growth.

46. Containing mandatory current spending remains an important fiscal policy priority. The strong revenue performance under the program has allowed for markedly less expenditure contraction than originally planned. But spending on pensions, public wages and subsidies remain relatively high, and it will be important to continue their gradual downward paths as shares of GDP in order to provide fiscal space for needed capital spending and potentially for targeted reductions in tax burdens, particularly on employment.

47. Monetary policy has succeeded in keeping inflation under firm control, however, greater exchange rate flexibility on the back of improved market conditions will reinforce the inflation-targeting regime. The fiscal tightening and improvement in confidence under the program allowed the NBS to reduce interest rates significantly, and also warranted the reduction in the inflation target band implemented in 2016, bringing it into line with emerging market peers. The broad exchange rate stability has reinforced confidence and helped reduce euroization but the change in de facto classification to a "stabilized" regime illustrates the need to allow for greater day-to-day movement, consistent with the inflation targeting framework. Serbia's external position is broadly consistent with fundamentals and desirable policy settings, but subject to vulnerabilities related to large negative net international investment position.

48. Financial sector reforms have been one of the most successful elements of the authorities' program. The NBS has assiduously implemented a broad agenda aimed at ensuring bank soundness, reducing the high levels of bad loans, and modernizing accounting and regulatory standards to bring them into line with international standards. The banking sector has now largely put the legacy of the global financial crisis behind it and is in a much better position to fully support future growth. However, efforts to further reduce NPLs need to continue, and reforms of state-owned financial institutions have faced delays and need to be accelerated.

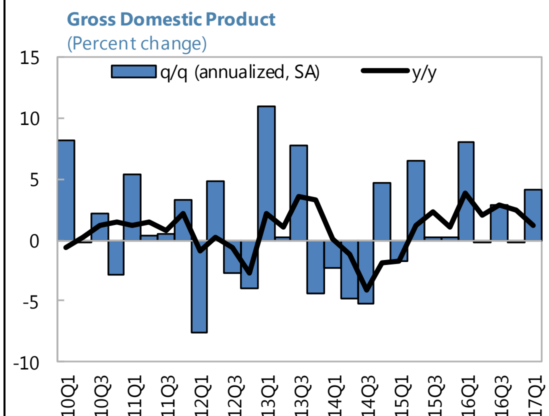
49. The business environment has strengthened but significant impediments to investment and growth remain, including the judicial system and public infrastructure gaps. Serbia's ranking in business surveys has risen markedly since the start of the program, with the improvement reflected in robust investment growth, including from abroad. Initiatives to improve property registration and to limit parafiscal charges need to be followed through, and it would also be important to find ways to strengthen judicial processes, especially to improve judicial independence and reduce delays in court decisions.

50. Reforms to public investment management also need to be implemented decisively. The program has provided room for higher spending on public infrastructure, and the authorities are also pursuing plans for significant regional transport projects with multilateral and bilateral partners. The biggest priority in this area is to strengthen public investment management, including rigorous project selection and appraisal to ensure scarce resources and technical capacity are directed to projects with the highest returns.

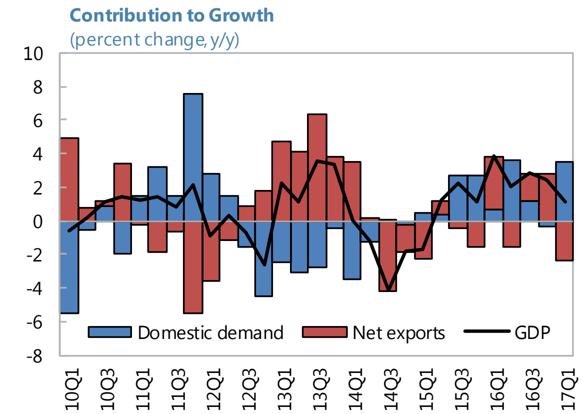
51. In light of the progress so far and the authorities' policy commitments going forward, staff supports the completion of the Seventh Review under the Stand-By Arrangement. It is recommended that the next Article IV consultation with Serbia be held on the 24-month cycle, in accordance with Decision No. 14747–(10/96) on consultation cycles.

Figure 1. Serbia: Real Sector Developments, 2010–17

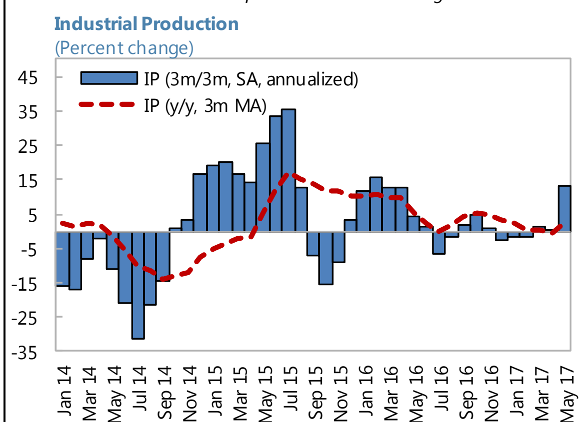
Growth decelerated in 2017Q1…



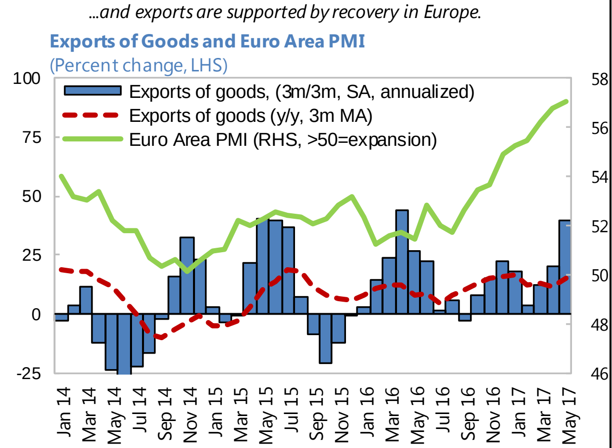
…due to weaker net exports, partly caused by energy imports.



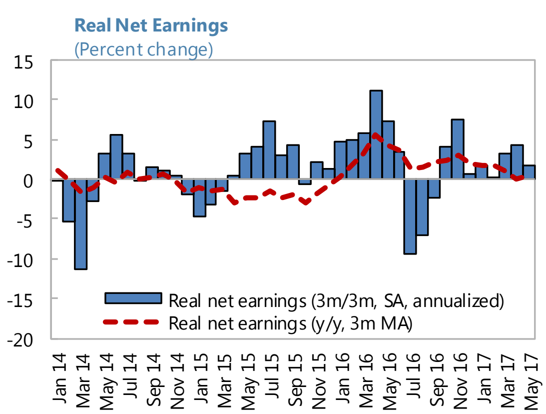
Industrial production is rebounding…



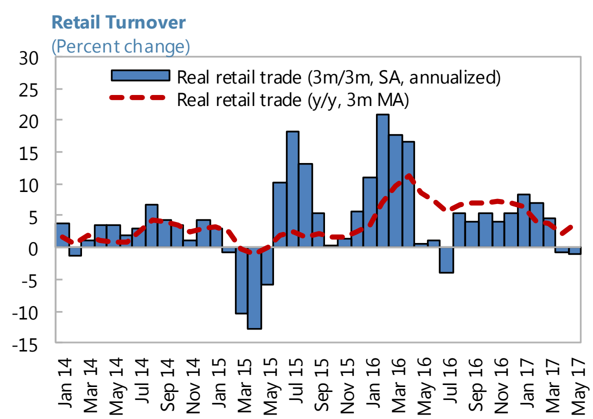
…and exports are supported by recovery in Europe.



Real net earnings continue to grow…

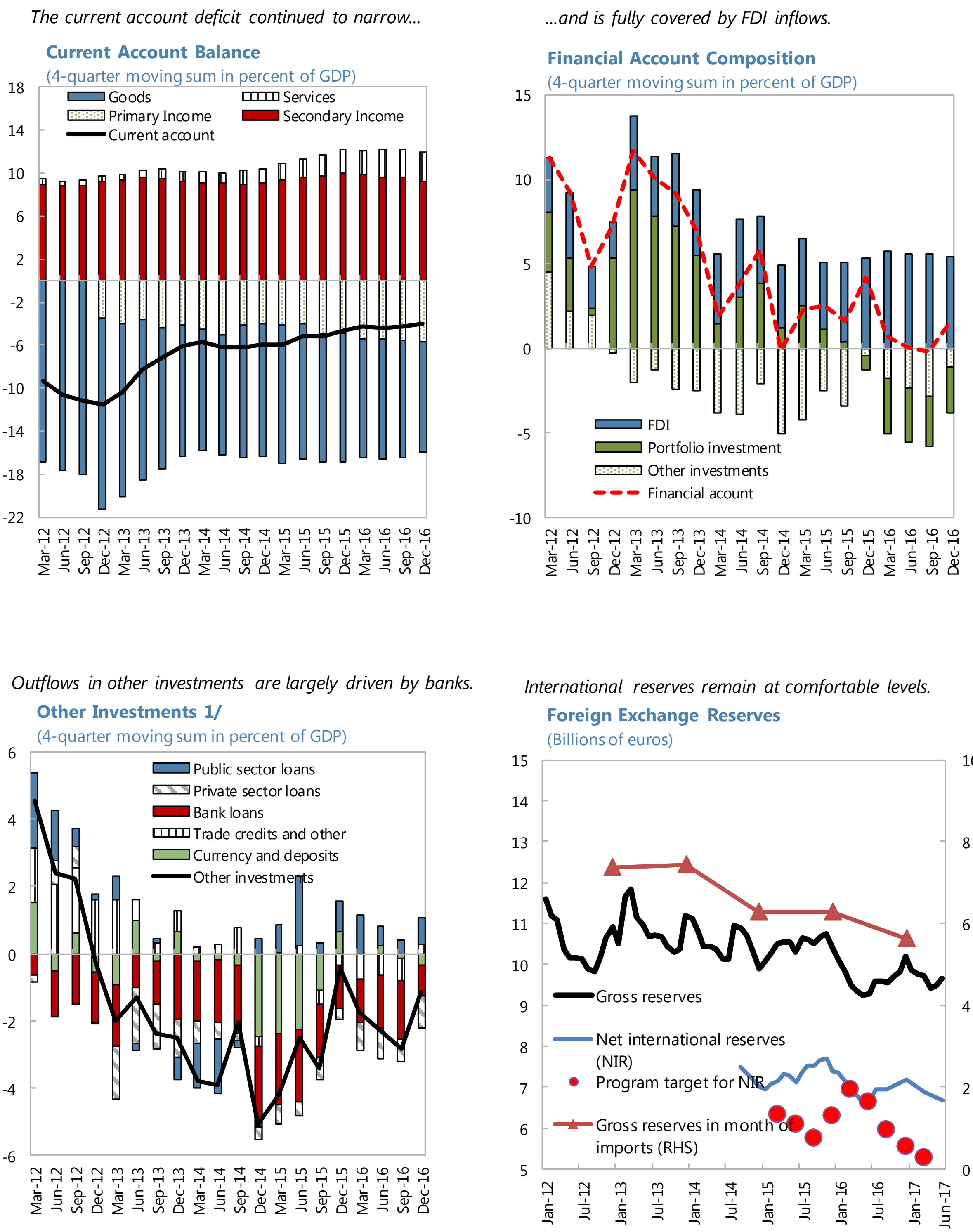


…and so does real retail trade.



Sources: Haver, SORS and IMF staff calculations.

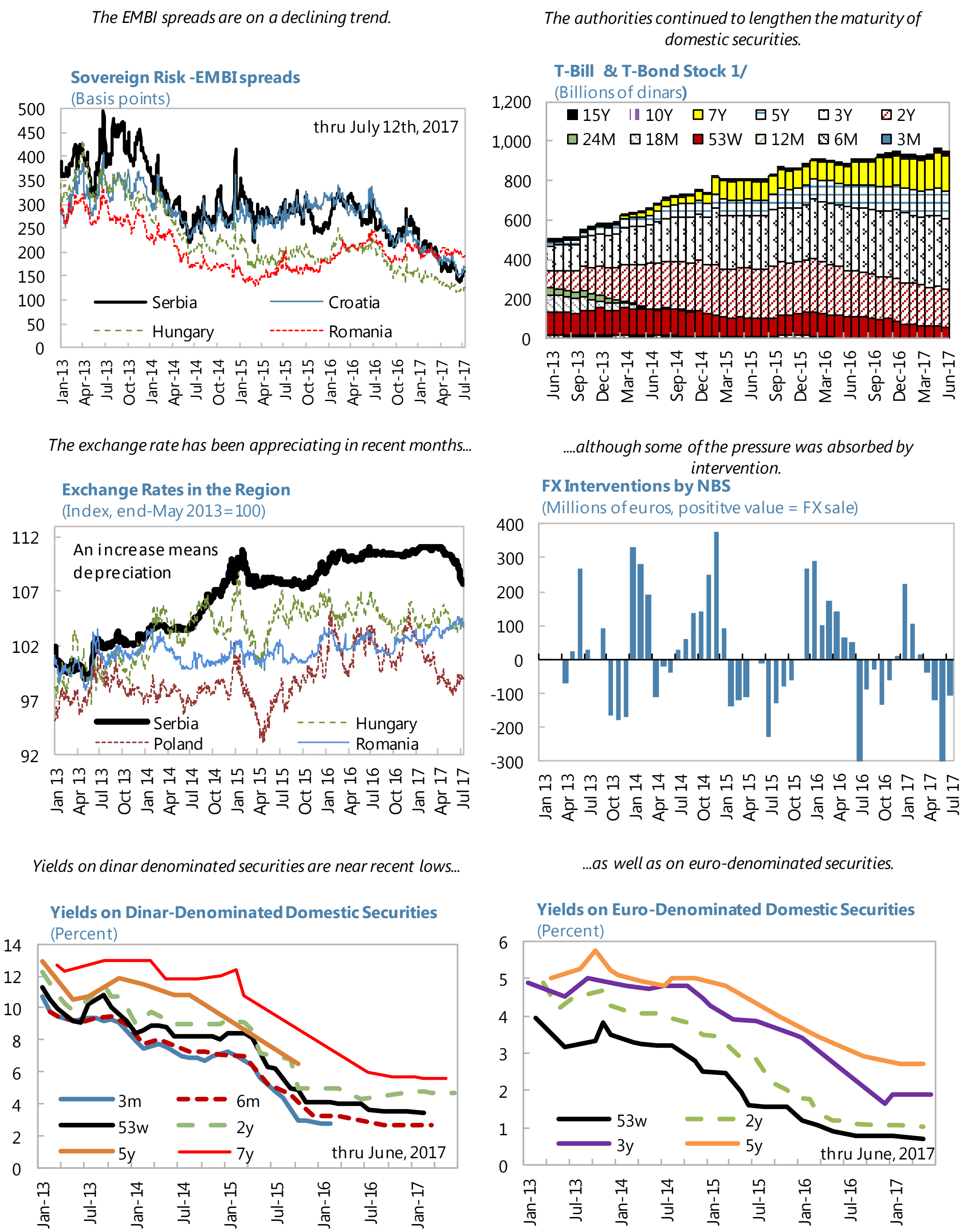
Figure 2. Serbia Balance of Payments and NIR, 2012–17



Sources: Haver; and IMF staff calculations.

1/ BPM5 data spliced with BPM6 going forward starting March 2013.

Figure 3. Serbia: Recent Financial and Exchange Rate Developments, 2013–17



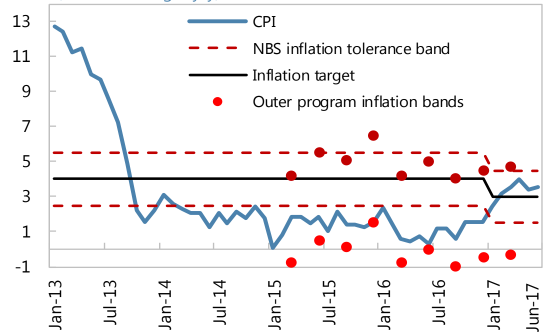
Sources: Serbian Authorities; Bloomberg Finance L.P.; and Haver.

1/ Sum of dinar and FX-denominated securities at current exchange rate.

Figure 4. Serbia: Inflation and Monetary Policy, 2013–17

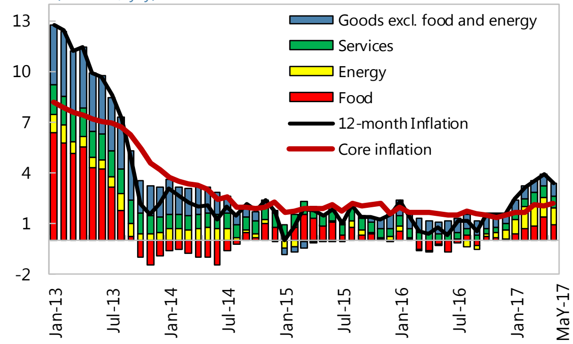
Headline inflation returned within the target band...

Inflation
(Percent change, y/y)



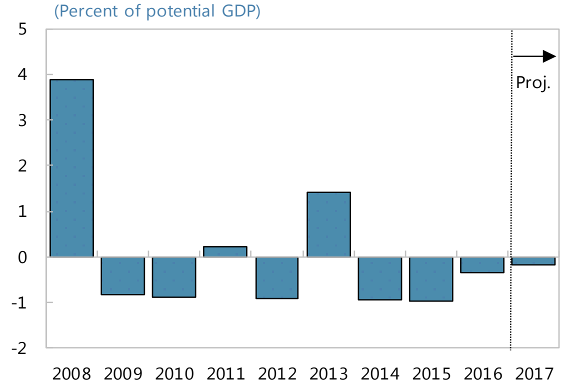
...and continues to be mostly driven by higher food and energy prices.

Contribution to Annual Inflation
(Percent, y/y)



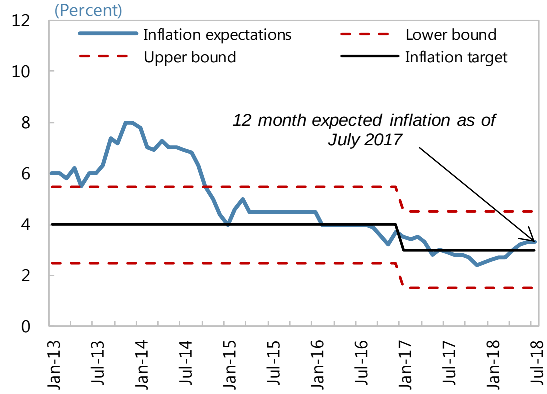
The output gap is closing...

Output Gap
(Percent of potential GDP)



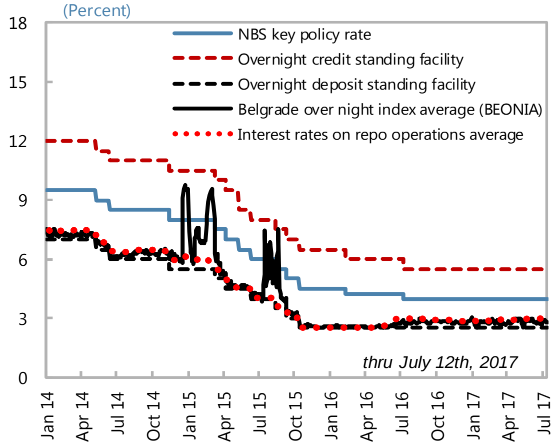
...and inflation expectations are stable.

One-Year Ahead Inflation Expectations
(Percent)



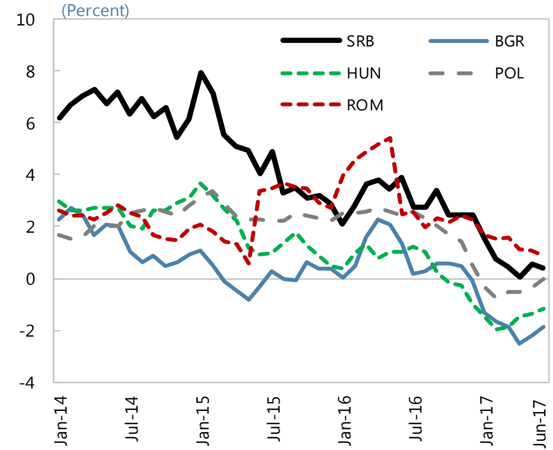
The NBS has kept the key policy rate at a historic low level...

Interest Rates
(Percent)



...and it is broadly consistent with peer countries in real terms.

Policy Rate in Real Terms in Selected Countries 1/
(Percent)

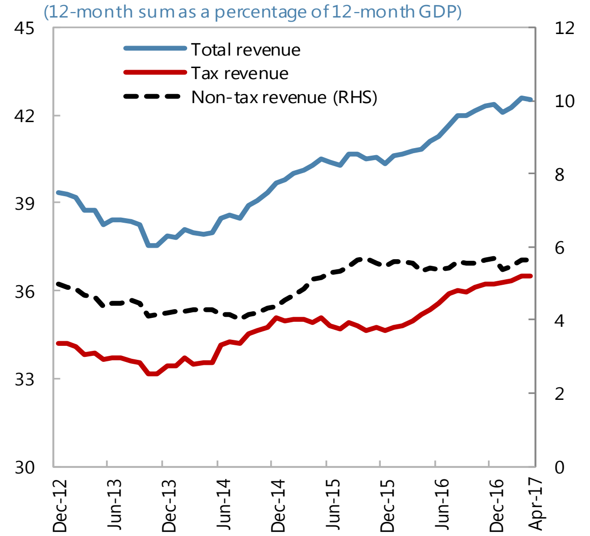


Sources: Haver; Bloomberg Finance L.P.; National Bank of Serbia (NBS); SORS; and IMF staff estimates and projections.
1/ Nominal policy rate adjusted by inflation over the past 12 months.

Figure 5. Serbia: Fiscal Developments, 2012–17

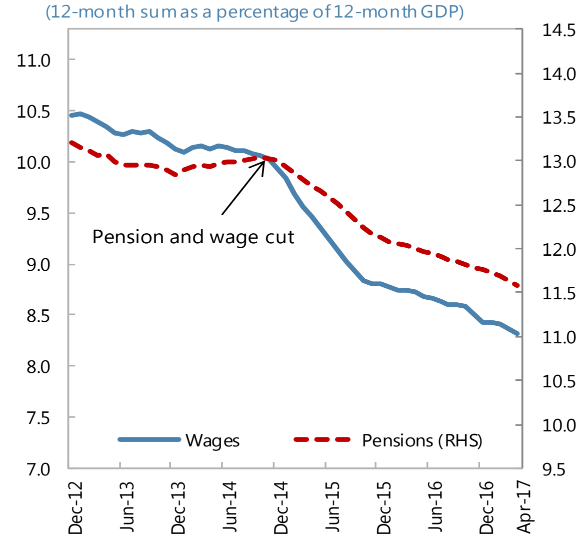
Revenues have been increasing as a share of GDP, with tax revenue playing an increasingly important role…

Total Revenue and its Composition
(12-month sum as a percentage of 12-month GDP)



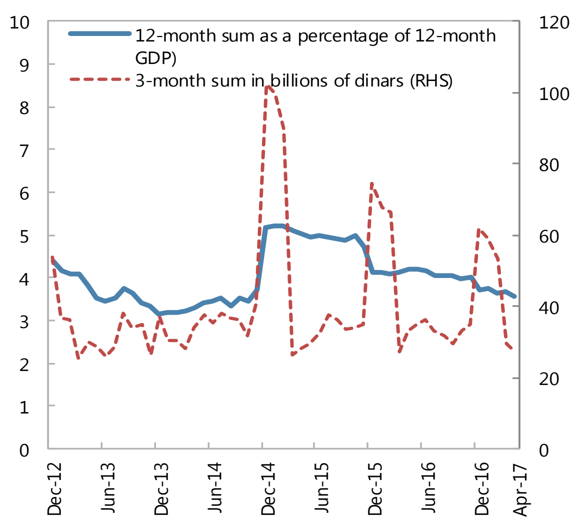
…while wage and pension expenses are falling as a share of GDP.

Wages and Pensions
(12-month sum as a percentage of 12-month GDP)



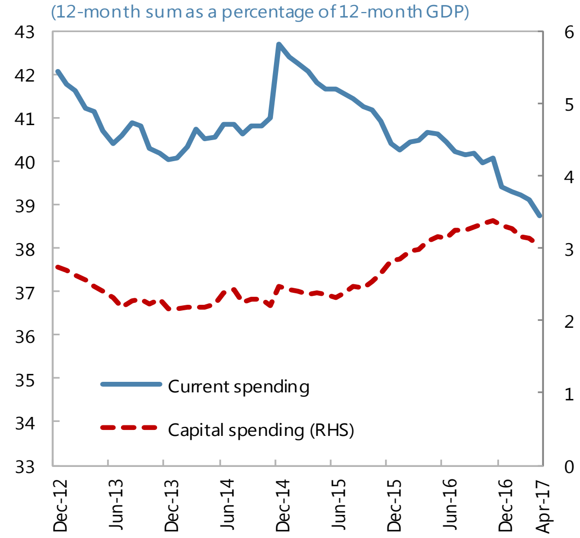
State aid has been on a declining trend…

State Aid 1/



…supporting the adjustment of current spending and creating space for capital spending to expand.

Current and Capital Spending
(12-month sum as a percentage of 12-month GDP)

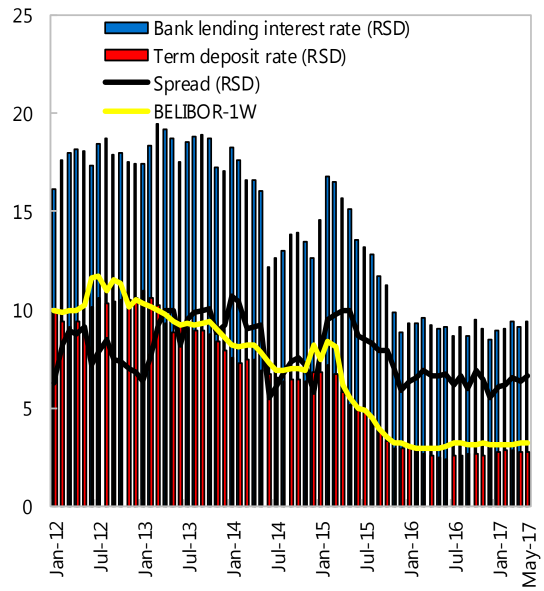


Sources: Ministry of Finance; and IMF staff calculations.
1/ State aid includes direct subsidies, net lending through the budget, assumption of SOE's debt, and the service of guaranteed debt called by creditors.

Figure 6. Serbia: Selected Interest Rates, 2012-17

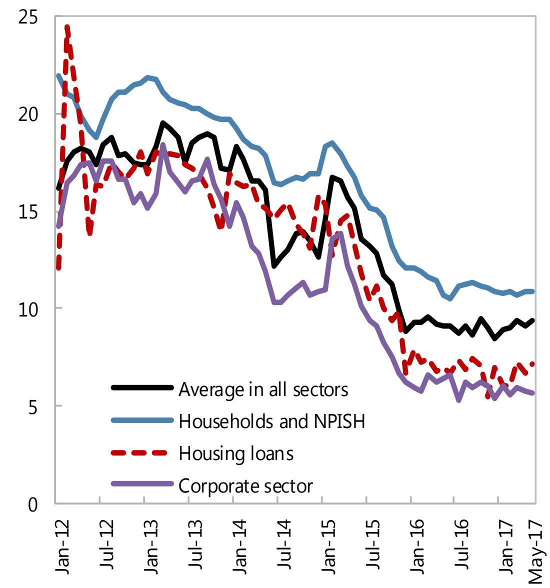
Easing of monetary policy has led to a decline in dinar interest rates...

Selected interest rates (RSD)
(Percent)



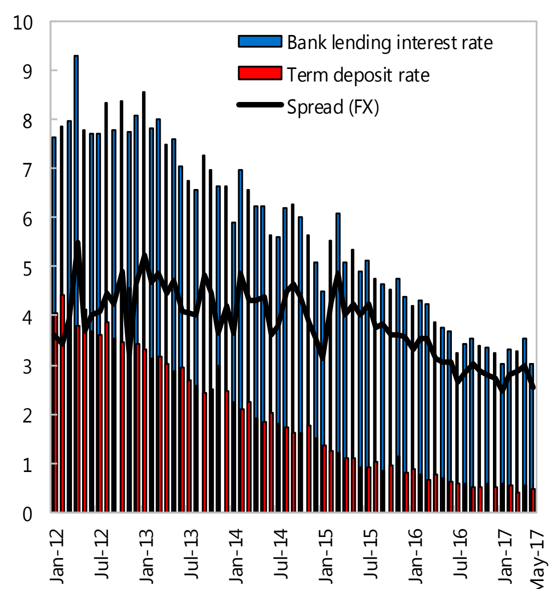
...in both corporate and household markets.

Bank lending interest rates: RSD
(Percent)



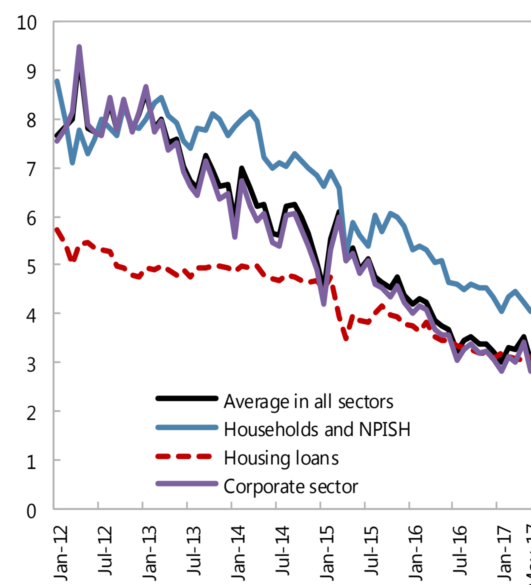
FX (or FX-linked) interest rates have been declining, too...

Selected interest rates (FX and FX-linked)
(Percent)



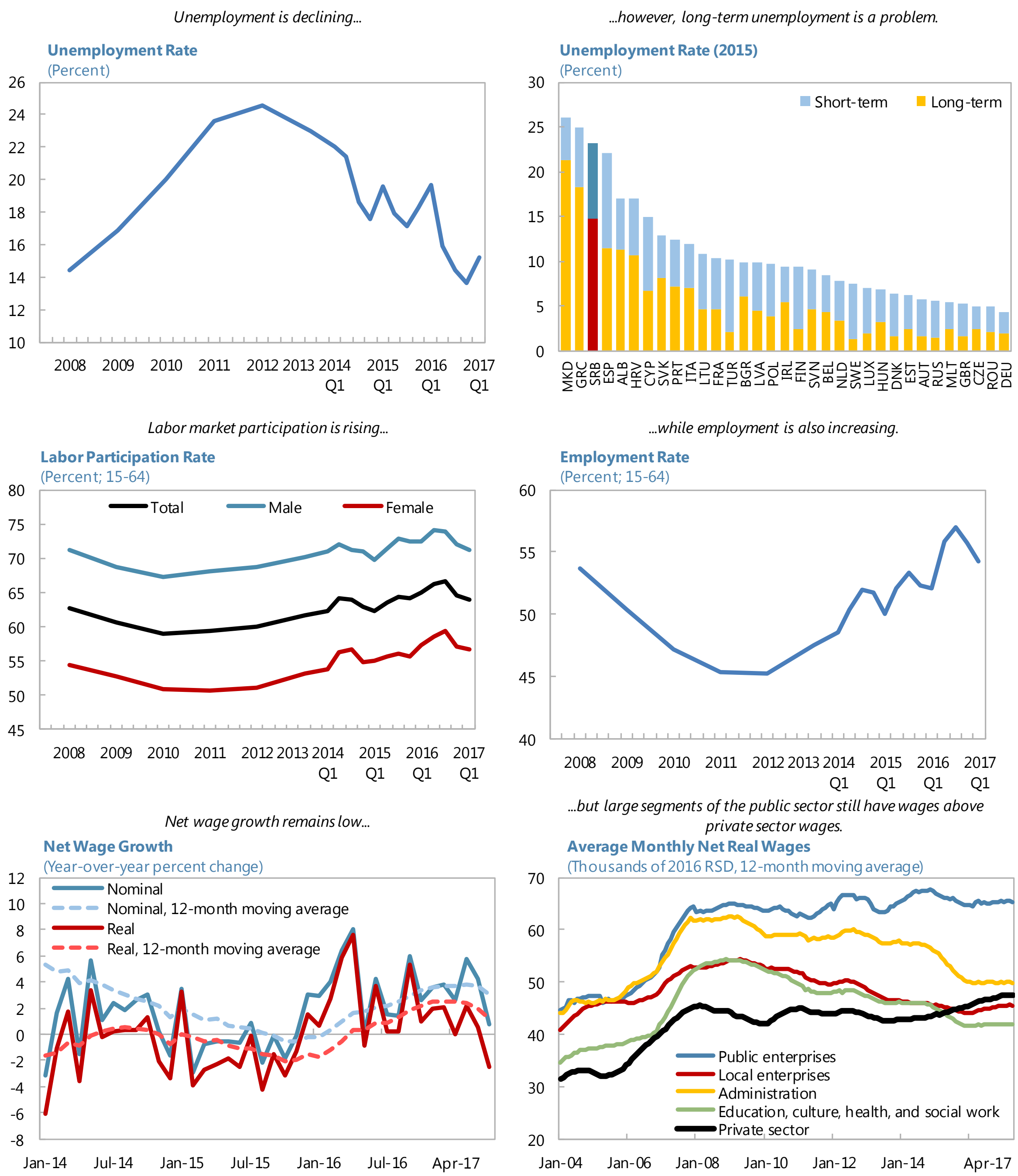
...most recently on account of lower lending rates to the corporate sector.

Bank lending interest rates: FX and FX-linked
(Percent)



Source: NBS.

Figure 7. Serbia: Labor Market Developments, 2008-17



Sources: International Labour Organization; OECD database; Republic of Serbia National Employment Service; Statistical Office of the Republic Serbia;and IMF staff calculations.

Table 1. Serbia: Selected Economic and Social Indicators, 2013–18

	2013	2014	2015	2016		2017		2018
				6th	Prel.	6th	Proj.	Proj.
	(Percent change, unless otherwise indicated)							
Real sector								
Real GDP	2.6	-1.8	0.8	2.7	2.8	3.0	3.0	3.5
Real domestic demand (absorption)	-1.9	-1.1	1.4	1.8	1.1	2.2	2.2	3.0
Consumer prices (average)	7.7	2.1	1.4	1.1	1.1	2.4	3.4	3.0
GDP deflator	5.4	2.7	2.7	1.3	1.1	1.6	2.5	2.8
Unemployment rate (in percent) 1/	23.0	19.9	18.2	...	15.9	...	...	...
Nominal GDP (in billions of dinars)	3,876	3,908	4,043	4,203	4,200	4,397	4,434	4,719
	(Percent of GDP)							
General government finances								
Revenue	37.9	39.7	40.4	41.8	42.4	40.9	41.8	41.2
Expenditure	43.5	46.3	44.0	43.9	43.7	42.6	42.9	42.0
Current	40.8	42.7	40.4	39.8	39.4	38.5	38.3	37.7
Capital and net lending	2.5	2.8	2.9	3.2	3.4	3.3	3.8	3.8
Amortization of called guarantees	0.2	0.8	0.7	0.9	0.9	0.8	0.8	0.5
Fiscal balance 2/	-5.6	-6.6	-3.7	-2.1	-1.4	-1.7	-1.1	-0.8
Primary fiscal balance (cash basis)	-3.2	-3.7	-0.5	1.2	1.8	1.4	2.0	2.1
Structural primary fiscal balance 3/	-3.1	-2.6	0.0	1.3	1.8	1.5	2.0	2.1
Gross debt	61.1	71.9	76.0	73.7	74.1	72.4	70.9	67.9
	(End of period 12-month change, percent)							
Monetary sector								
Money (M1)	23.7	9.7	17.0	17.5	20.3	10.5	11.8	10.7
Broad money (M2)	4.2	8.3	7.2	9.2	9.8	5.3	6.9	6.8
Domestic credit to non-government 4/	-5.3	-1.1	2.8	5.5	1.8	3.8	6.8	7.0
	(Period average, percent)							
Interest rates (dinar)								
NBS key policy rate	11.0	9.0	6.1	...	4.4	...	...	...
Interest rate on new FX and FX-indexed loans	7.3	6.0	5.0	...	4.1	...	...	...
	(Percent of GDP, unless otherwise indicated)							
Balance of payments								
Current account balance	-6.1	-6.0	-4.7	-4.2	-4.0	-3.9	-4.0	-3.9
Exports of goods	30.8	31.9	33.9	35.9	37.3	37.9	39.8	41.1
Imports of goods	-42.9	-44.3	-45.8	-46.5	-47.5	-48.5	-49.9	-50.7
Trade of goods balance	-12.1	-12.3	-11.9	-10.6	-10.2	-10.7	-10.1	-9.6
Capital and financial account balance	9.5	1.4	4.5	1.1	1.4	3.9	3.5	4.1
External debt (percent of GDP)	79.4	83.1	84.0	79.3	81.8	75.7	76.1	71.3
of which: Private external debt	36.8	34.6	32.7	30.1	32.0	28.2	29.4	26.9
Gross official reserves (in billions of euro)	11.2	9.9	10.4	9.3	10.2	9.3	10.0	10.1
(in months of prospective imports)	7.4	6.3	6.3	5.3	5.6	5.0	5.1	4.8
(percent of short-term debt)	278.8	427.0	337.5	249.7	214.2	257.9	243.8	296.5
(percent of broad money, M2)	76.2	65.8	64.6	53.9	58.7	50.0	53.5	50.8
(percent of risk-weighted metric)	189.6	171.4	171.0	154.2	159.4	152.3	156.5	157.1
Exchange rate (dinar/euro, period average)	113.1	117.2	120.8	...	123.4	...	...	...
REER (annual average change, in percent; + indicates appreciation)	7.8	-2.0	-1.6	-0.6	-1.1	0.3	1.7	1.5
Social indicators								
Per capita GDP (in US$)	6,352	6,199	5,244	5,369	5,376	5,617	5,630	6,085
Population (in million)	7.2	7.1	7.1	7.1	7.0	7.1	7.0	7.0

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

1/ Unemployment rate for working age population (15-64).
2/ Includes amortization of called guarantees.
3/ Primary fiscal balance adjusted for the automatic effects of the output gap both on revenue and spending as well as one-offs.
4/ At program exchange rates.

Table 2. Serbia: Medium-Term Framework, 2014–22

	2014	2015	2016		2017		2018	2019	2020	2021	2022
			6th	Prel.	6th	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(percent change)										
Real sector											
GDP growth	-1.8	0.8	2.7	2.8	3.0	3.0	3.5	3.5	4.0	4.0	4.0
Domestic demand (contribution)	-1.2	1.6	2.0	1.2	2.5	2.4	3.4	3.5	4.6	4.7	4.7
Net exports (contribution)	-0.6	-0.8	0.6	1.5	0.5	0.6	0.1	0.0	-0.6	-0.7	-0.7
Consumer price inflation (average)	2.1	1.4	1.1	1.1	2.4	3.4	3.0	3.0	3.0	3.0	3.0
Consumer price inflation (end of period)	1.8	1.6	1.5	1.5	2.8	3.6	3.0	3.0	3.0	3.0	3.0
Output gap (in percent of potential)	-0.9	-1.0	-0.5	-0.3	-0.3	-0.2	0.0	0.0	0.0	0.0	0.0
Potential GDP growth	0.5	0.8	2.1	2.1	2.8	2.8	3.4	3.5	4.0	4.0	4.0
Domestic credit to non-gov. (program exchange rate) 1/	-1.1	2.8	5.5	1.8	3.8	6.8	7.0	4.9	5.3	5.6	5.8
	(percent of GDP, unless otherwise indicated)										
General government											
Revenue	39.7	40.4	41.8	42.4	40.9	41.8	41.2	40.9	40.7	40.5	40.4
Expenditure	46.3	44.0	43.9	43.7	42.6	42.9	42.0	41.6	41.2	40.9	40.9
Current	42.7	40.4	39.8	39.4	38.5	38.3	37.7	37.4	37.0	36.7	36.6
of which: Wages and salaries	9.9	8.8	8.6	8.4	8.4	8.3	8.2	8.1	8.0	8.0	8.0
of which: Pensions	13.0	12.1	12.0	12.0	11.6	11.4	11.2	11.1	11.1	11.0	11.0
of which: Goods and services	7.9	7.5	8.0	8.1	8.0	8.2	8.2	8.2	8.1	8.1	8.0
Capital and net lending	2.8	2.9	3.2	3.4	3.3	3.8	3.8	3.8	3.9	3.9	3.9
Amortization of called guarantees	0.8	0.7	0.9	0.9	0.8	0.8	0.5	0.4	0.4	0.4	0.3
Fiscal balance 2/	-6.6	-3.7	-2.1	-1.4	-1.7	-1.1	-0.8	-0.7	-0.5	-0.5	-0.5
change (+ = consolidation)	*-1.0*	*2.9*	*1.6*	*2.3*	*0.4*	*0.3*	*0.3*	*0.1*	*0.2*	*0.1*	*0.0*
Primary fiscal balance	-3.7	-0.5	1.2	1.8	1.4	2.0	2.1	2.1	2.1	2.0	2.0
change (+ = consolidation)	*-0.5*	*3.2*	*1.6*	*2.2*	*0.3*	*0.2*	*0.1*	*0.0*	*0.0*	*0.0*	*0.0*
One-off fiscal items, net 3/	-0.7	-0.1	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Structural primary balance	-2.6	0.0	1.3	1.8	1.5	2.0	2.1	2.1	2.1	2.0	2.0
change (+ = consolidation)	*0.5*	*2.6*	*1.4*	*1.9*	*0.1*	*0.2*	*0.1*	*0.0*	*0.0*	*0.0*	*0.0*
Structural primary balance net of capital expenditures	-0.1	2.8	4.4	5.1	4.7	5.6	5.8	5.8	5.8	5.8	5.8
Gross debt	71.9	76.0	73.7	74.1	72.4	70.9	67.9	64.4	60.8	57.5	54.4
Effective interest rate on government borrowing (percent)	4.5	4.4	4.5	4.3	4.5	4.4	4.3	4.4	4.3	4.4	4.5
Domestic borrowing (including FX)	5.9	5.8	5.9	5.7	6.0	6.5	5.4	5.5	5.6	5.6	5.6
External borrowing	3.5	3.5	3.6	3.3	3.5	3.2	3.6	3.6	3.7	3.7	3.7
	(percent of GDP, unless otherwise indicated)										
Balance of payments											
Current account	-6.0	-4.7	-4.2	-4.0	-3.9	-4.0	-3.9	-3.8	-3.8	-3.8	-3.7
of which: Trade balance	-12.3	-11.9	-10.6	-10.2	-10.7	-10.1	-9.6	-9.4	-9.5	-9.5	-9.6
of which: Current transfers, net (excl. grants)	8.7	9.5	9.0	9.0	8.9	9.0	8.4	8.0	8.0	8.0	8.0
Capital and financial account	1.4	4.5	1.1	1.4	3.9	3.5	4.1	4.8	4.6	4.6	4.4
of which: Foreign direct investment	3.7	5.4	5.2	5.5	4.8	4.8	4.3	4.2	4.2	4.2	4.2
External debt (end of period)	83.1	84.0	79.3	81.8	75.7	76.1	71.3	67.7	63.7	59.8	55.9
of which: Private external debt	34.6	32.7	30.1	32.0	28.2	29.4	26.9	25.1	23.3	21.8	20.3
Gross official reserves											
(in billions of euros)	9.9	10.4	9.3	10.2	9.3	10.0	10.1	10.5	10.9	11.2	11.6
(in percent of short-term external debt)	427.0	337.5	249.7	214.2	257.9	243.8	296.5	220.2	227.6	235.6	243.3
REER (ann. av. change; + = appreciation)	-2.0	-1.6	-0.6	-1.1	0.3	1.7	1.5	1.0	1.2	1.2	1.2

Sources: NBS, MoF, SORS and IMF staff estimates and projections.

1/ Using program dinar/euro and dinar/swiss franc exchange rates for converting FX and FX-indexed loans to dinars.

2/ Includes amortization of called guarantees.

3/ Calculated as one-off revenue items minus one-off expenditure items. Negative sign indicates net expenditure.

Table 3. Serbia: Growth Composition, 2014–22

	2014	2015	2016		2017		2018	2019	2020	2021	2022
			6th	Prel.	6th	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
			(Percent change, unless otherwise noted)								
Real											
Gross Domestic Product (GDP)	-1.8	0.8	2.7	2.8	3.0	3.0	3.5	3.5	4.0	4.0	4.0
Domestic demand	-1.1	1.4	1.8	1.1	2.2	2.2	3.0	3.2	4.2	4.2	4.2
Consumption	-1.2	0.1	1.3	1.1	1.4	1.5	2.6	2.8	4.0	4.1	4.2
Non-government	-1.3	0.5	0.6	0.8	1.4	1.3	2.5	2.9	4.0	4.3	4.5
Government	-0.6	-1.5	3.9	2.3	1.6	2.3	3.0	2.7	4.3	3.2	2.7
Investment	-0.4	7.7	3.9	1.1	5.4	5.1	4.8	4.6	4.6	4.8	4.6
Gross fixed capital formation	-3.6	5.6	6.4	4.9	5.7	5.3	4.8	5.1	4.8	5.1	4.9
Non-government	-5.8	3.9	5.0	2.6	5.5	3.6	5.0	5.0	5.0	5.0	5.0
Government	13.6	17.0	14.7	18.5	7.0	14.2	3.9	5.6	4.0	6.0	4.4
Exports of goods and services	5.7	10.2	9.2	11.9	7.7	9.0	7.5	7.5	7.3	7.4	7.3
Imports of goods and services	5.6	9.3	6.2	6.8	5.3	6.4	6.0	6.4	7.1	7.3	7.2
			(contributions to GDP, percent)								
Gross Domestic Product (GDP)	-1.8	0.8	2.7	2.8	3.0	3.0	3.5	3.5	4.0	4.0	4.0
Domestic demand (absorption)	-1.2	1.6	2.0	1.2	2.5	2.4	3.4	3.5	4.6	4.7	4.7
Net exports of goods and services	-0.6	-0.8	0.6	1.5	0.5	0.6	0.1	0.0	-0.6	-0.7	-0.7
Consumption	-1.1	0.1	1.2	1.0	1.3	1.4	2.3	2.5	3.6	3.6	3.7
Non-government	-1.0	0.3	0.5	0.6	1.0	1.0	1.8	2.0	2.8	3.1	3.2
Government	-0.1	-0.3	0.7	0.4	0.3	0.4	0.5	0.5	0.7	0.6	0.5
Investment	-0.1	1.5	0.8	0.2	1.2	1.1	1.0	1.0	1.0	1.1	1.0
Gross fixed capital formation	-0.7	1.0	1.2	0.9	1.2	1.1	1.0	1.0	1.0	1.1	1.0
Non-government	-1.0	0.6	0.8	0.4	0.9	0.6	0.8	0.8	0.8	0.9	0.9
Government	0.3	0.4	0.4	0.5	0.2	0.5	0.1	0.2	0.2	0.2	0.2
Change in inventories	0.6	0.5	-0.4	-0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	2.3	4.5	4.5	5.7	4.0	4.7	4.2	4.3	4.4	4.6	4.7
Imports of goods and services	3.0	5.4	3.8	4.2	3.4	4.2	4.0	4.4	5.0	5.3	5.4
			(Percent change, unless otherwise noted)								
Nominal											
Gross Domestic Product (GDP)	0.8	3.5	4.0	3.9	4.6	5.6	6.4	6.6	7.1	7.1	7.1
Domestic demand (absorption), contribution to GDP growth	1.1	2.7	2.4	1.7	4.7	5.8	6.1	6.6	7.6	7.5	7.6
Net exports of goods and services, contribution to GDP growth	-0.2	0.8	1.5	2.1	-0.1	-0.3	0.3	0.1	-0.5	-0.4	-0.4
Non-government	1.3	2.2	1.7	1.6	3.8	4.7	5.6	5.9	7.1	7.4	7.6
Government	0.6	-5.3	5.5	3.9	2.4	5.4	5.5	5.8	5.8	5.8	5.8
Investment	-0.1	11.5	1.1	-0.5	8.4	8.3	6.4	7.3	8.7	6.9	6.3
Gross fixed capital formation	-2.4	9.7	5.5	4.6	7.9	8.4	7.9	8.0	8.1	8.1	8.1
Non-government	-5.0	8.2	4.0	1.4	7.6	6.7	8.1	8.2	8.1	8.1	8.2
Government	15.1	18.6	13.5	21.5	9.2	15.9	7.0	7.2	8.2	8.1	7.6
Exports of goods and services	6.2	11.3	9.4	13.3	9.5	11.1	9.2	9.6	8.8	9.3	9.1
Imports of goods and services	5.3	7.7	5.0	7.2	8.4	10.1	7.6	8.5	8.8	9.1	8.9
Memorandum items:											
GDP deflator (percent)	2.7	2.7	1.3	1.1	1.6	2.5	2.8	3.0	3.0	3.0	3.0
Nominal GDP (billions of dinars)	3908	4043	4203	4200	4397	4434	4719	5030	5388	5772	6183

Sources: Serbian Statistical Office; and IMF staff estimates and projections.

Table 4a. Serbia: Balance of Payments, 2014–22
(In billions of euros)

	2014	2015	2016		2017		2018	2019	2020	2021	2022
			6th	Proj.	6th	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
					(Billions of euros)						
Current account balance	-2.0	-1.6	-1.5	-1.4	-1.4	-1.5	-1.5	-1.5	-1.7	-1.8	-1.9
Trade of goods balance	-4.1	-4.0	-3.6	-3.5	-3.8	-3.6	-3.7	-3.8	-4.1	-4.5	-4.8
Exports of goods	10.6	11.4	12.3	12.7	13.5	14.4	15.8	17.2	18.7	20.5	22.4
Imports of goods	-14.8	-15.4	-15.9	-16.2	-17.2	-18.0	-19.5	-21.0	-22.9	-25.0	-27.2
Services balance	0.5	0.7	0.9	0.9	1.1	1.0	1.2	1.4	1.5	1.6	1.8
Exports of nonfactor services	3.8	4.3	4.5	4.6	4.8	5.0	5.3	5.8	6.3	6.9	7.6
Imports of nonfactor services	-3.3	-3.5	-3.6	-3.7	-3.7	-3.9	-4.1	-4.5	-4.8	-5.3	-5.8
Income balance	-1.3	-1.7	-1.9	-2.0	-1.9	-2.2	-2.3	-2.4	-2.5	-2.7	-2.8
Net interest	-0.9	-1.0	-0.9	-1.0	-0.8	-0.9	-1.0	-1.0	-1.0	-1.1	-1.1
Current transfer balance	3.0	3.3	3.1	3.2	3.3	3.3	3.3	3.3	3.5	3.7	4.0
Others, including private remittances	2.9	3.2	3.1	3.1	3.2	3.2	3.2	3.3	3.5	3.7	4.0
Capital and financial account balance 2/	0.5	1.5	0.4	0.5	1.4	1.3	1.6	2.0	2.0	2.1	2.2
Foreign direct investment balance	1.2	1.8	1.8	1.9	1.7	1.7	1.6	1.7	1.8	2.0	2.1
Portfolio investment balance	0.4	-0.3	-0.7	-0.9	-0.3	-0.5	0.2	0.6	0.3	0.2	0.1
of which: debt liabilities	0.4	-0.2	-0.7	-0.9	-0.3	-0.5	0.2	0.6	0.3	0.2	0.1
Other investment balance	-1.1	0.0	-0.7	-0.4	0.0	0.0	-0.3	-0.4	-0.1	-0.1	0.0
Public sector 2/ 3/	0.7	0.5	0.2	0.3	0.2	0.3	0.0	-0.3	0.0	-0.1	0.0
Domestic banks	-1.5	-0.1	-0.7	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other private sector 4/	-0.4	-0.4	-0.2	-0.2	-0.3	-0.3	-0.3	-0.1	0.0	0.0	0.0
Errors and omissions	0.3	0.4	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-1.2	0.3	-1.1	-0.3	0.0	-0.2	0.1	0.4	0.4	0.4	0.4
Financing	1.2	-0.3	1.1	0.3	0.0	0.2	-0.1	-0.4	-0.4	-0.4	-0.4
Gross international reserves (increase, -)	1.8	-0.2	1.1	0.3	0.0	0.2	-0.1	-0.4	-0.4	-0.4	-0.4
Financing Gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Use of Fund credit, net	-0.6	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Purchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-0.6	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: NBS; and IMF staff estimates and projections.

1/ Some estimates, in particular for private remittances and reinvested earnings, are subject to significant uncertainty.

2/ Excluding net use of IMF resources.

3/ Includes SDR allocations in 2009.

4/ Includes trade credits (net).

Table 4b. Serbia: Balance of Payments, 2014–22
(Percent of GDP)

	2014	2015	2016		2017		2018	2019	2020	2021	2022
			6th	Prel.	6th	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
					(Percent of GDP)						
Current account balance	-6.0	-4.7	-4.2	-4.0	-3.9	-4.0	-3.9	-3.8	-3.8	-3.8	-3.7
Trade of goods balance	-12.3	-11.9	-10.6	-10.2	-10.7	-10.1	-9.6	-9.4	-9.5	-9.5	-9.6
Exports of goods	31.9	33.9	35.9	37.3	37.9	39.8	41.1	42.2	42.9	43.8	44.6
Imports of goods	-44.3	-45.8	-46.5	-47.5	-48.5	-49.9	-50.7	-51.6	-52.4	-53.3	-54.2
Services balance	1.4	2.2	2.7	2.6	3.0	2.9	3.1	3.3	3.4	3.4	3.5
Income balance	-4.0	-5.0	-5.4	-5.7	-5.5	-6.0	-5.9	-5.8	-5.7	-5.7	-5.6
Current transfer balance	9.0	10.0	9.1	9.3	9.2	9.2	8.5	8.0	8.0	8.0	8.0
Official grants	0.3	0.5	0.1	0.2	0.3	0.2	0.1	0.0	0.0	0.0	0.0
Others, including private remittances	8.7	9.5	9.0	9.0	8.9	9.0	8.4	8.0	8.0	8.0	8.0
Capital and financial account balance 2/	1.4	4.5	1.1	1.4	3.9	3.5	4.1	4.8	4.6	4.6	4.4
Capital transfers balance	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment balance	3.7	5.4	5.2	5.5	4.8	4.8	4.3	4.2	4.2	4.2	4.2
Portfolio investment balance	1.1	-0.9	-2.0	-2.7	-0.7	-1.4	0.5	1.5	0.6	0.5	0.2
Other investment balance	-3.4	0.0	-2.1	-1.3	-0.1	0.1	-0.7	-0.9	-0.2	-0.1	0.0
Public sector 2/ 3/	2.2	1.4	0.5	0.9	0.7	0.9	0.0	-0.7	-0.1	-0.1	0.0
Domestic banks	-4.5	-0.2	-2.0	-1.5	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Other private sector 4/	-1.1	-1.2	-0.6	-0.7	-0.8	-0.8	-0.7	-0.2	-0.1	0.0	0.0
Errors and omissions	0.8	1.2	0.0	1.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-3.7	0.9	-3.2	-0.8	0.0	-0.5	0.2	1.0	0.8	0.8	0.7
Memorandum items:											
Export growth	1.0	6.7	8.4	12.1	9.4	12.7	9.9	9.3	8.8	9.4	9.3
Import growth	0.4	4.1	3.8	5.6	8.3	10.9	8.2	8.2	8.8	9.1	9.1
Export volume growth	1.7	8.7	9.9	13.0	8.6	10.1	8.1	7.5	7.3	7.4	7.3
Import volume growth	1.9	8.8	6.5	7.9	6.3	7.2	6.6	6.4	7.1	7.2	7.2
Trading partner import growth	4.7	2.5	3.7	4.9	5.1	5.7	4.8	4.0	4.0	4.0	4.0
Export prices growth	-0.7	-1.9	-1.4	-0.8	0.7	2.3	1.6	1.6	1.4	1.9	1.8
Import prices growth	-1.5	-4.3	-2.6	-2.1	1.9	3.4	1.5	1.7	1.6	1.8	1.8
Change in terms of trade	0.8	2.6	1.2	1.3	-1.2	-1.1	0.1	-0.1	-0.2	0.1	0.0
Gross official reserves (in billions of euro)	9.9	10.4	9.3	10.2	9.3	10.0	10.1	10.5	10.9	11.2	11.6
(In months of prospective imports of GNFS)	6.3	6.3	5.3	5.6	5.0	5.1	4.8	4.5	4.3	4.1	3.9
(in percent of short-term debt)	427.0	337.5	249.7	214.2	257.9	243.8	296.5	220.2	227.6	235.6	243.3
(in percent of broad money, M2)	65.8	64.6	53.9	58.7	50.0	53.5	50.8	49.6	47.9	46.2	44.5
(in percent of risk-weighted metric) 5/	171.4	171.0	154.2	159.4	152.3	156.5	157.1	153.7	153.3	155.5	155.6
GDP (billions of euros)	33.3	33.5	…	34.1	…	36.0	38.4	40.8	43.7	46.8	50.2

Sources: NBS; and IMF staff estimates and projections.

1/ Some estimates, in particular for private remittances and reinvested earnings, are subject to significant uncertainty.

2/ Excluding net use of IMF resources.

3/ Includes SDR allocations in 2009.

4/ Includes trade credits (net).

5/ Gross reserves at end-2016 correspond to 159 percent of the ARA metric (assuming Serbia returns to a floating exchange rate classification) and 136 percent of the ARA metric (assuming the current fixed exchange rate classification).

Table 5. Serbia: External Financing Requirements, 2014–22

	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Proj.					
1. Total financing requirement	**4.2**	**4.1**	**4.1**	**6.0**	**5.7**	**5.4**	**6.8**	**7.2**	**6.7**
Current account deficit	2.0	1.6	1.4	1.5	1.5	1.5	1.7	1.8	1.9
Debt amortization	4.0	2.3	3.1	4.8	4.1	3.4	4.8	5.1	4.5
Medium and long-term debt	3.8	2.2	2.8	4.1	3.4	2.7	4.1	4.4	3.8
Public sector	2.2	0.9	1.0	3.1	2.4	1.5	2.8	3.3	2.7
Of which: IMF	0.6	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Of which: Eurobonds	0.0	0.0	0.2	0.8	0.9	0.0	1.3	1.9	0.0
Of which: Domestic bonds (non-residents)	1.0	0.0	0.0	1.0	0.5	0.7	0.7	0.7	0.7
Commercial banks	0.9	0.8	1.0	0.2	0.3	0.4	0.5	0.4	0.5
Corporate sector	0.7	0.6	0.8	0.7	0.7	0.8	0.8	0.7	0.6
Short-term debt	0.2	0.1	0.3	0.7	0.7	0.7	0.7	0.7	0.7
Public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	0.2	0.1	0.2	0.6	0.6	0.6	0.6	0.6	0.6
Corporate sector	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Change in gross reserves (increase=+)	-1.8	0.2	-0.3	-0.2	0.1	0.4	0.4	0.4	0.4
2. Total financing sources	**4.2**	**4.1**	**4.1**	**6.0**	**5.7**	**5.4**	**6.8**	**7.2**	**6.7**
Capital transfers	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment (net)	1.2	1.8	1.9	1.7	1.6	1.7	1.8	2.0	2.1
Portfolio investment (net) 1/	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt financing	3.8	2.2	2.6	4.3	4.0	3.7	5.0	5.3	4.6
Medium and long-term debt	3.7	1.9	1.9	3.6	3.4	3.0	4.3	4.6	3.9
Public sector 2/	2.9	1.2	1.1	2.9	2.6	1.8	3.0	3.5	2.8
Of which: Eurobonds	0.0	0.0	0.0	0.0	1.0	0.5	1.5	2.0	0.0
Of which: Domestic bonds (non-residents)	1.5	0.0	0.0	1.3	0.6	0.8	0.8	0.8	0.8
Commercial banks	0.2	0.2	0.3	0.2	0.3	0.4	0.5	0.4	0.5
Corporate sector	0.6	0.5	0.5	0.5	0.5	0.8	0.8	0.7	0.6
Short-term debt	0.1	0.3	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Public sector	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	0.1	0.2	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Corporate sector	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other net capital inflows 3/	-0.8	0.2	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
o/w trade credit and currency and deposits	0.9	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
3. Total financing needs	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Memorandum items:									
Debt service	4.8	3.2	4.0	5.7	5.1	4.4	5.8	6.2	5.7
Interest	0.8	0.9	1.0	0.9	1.0	1.0	1.0	1.1	1.1
Amortization	4.0	2.3	3.1	4.8	4.1	3.4	4.8	5.1	4.5

Sources: NBS; and Fund staff estimates and projections.

1/ Only includes equity securities and financial derivatives.
2/ Excluding IMF.
3/ Includes all other net financial flows and errors and omissions.

Table 6a. Serbia: General Government Fiscal Operations, 2014–22 1/
(In billions of RSD)

	2014	2015	2016		2017		2018	2019	2020	2021	2022
			6th	Prel.	6th	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
					(Billions of RSD)						
Revenue	1,552	1,632	1,755	1,779	1,799	1,853	1,944	2,057	2,192	2,336	2,499
Taxes	1,370	1,400	1,510	1,522	1,573	1,609	1,706	1,810	1,929	2,063	2,203
Personal income tax	146	147	155	155	163	165	176	187	200	213	225
Social security contributions	440	443	462	464	488	492	525	561	601	643	689
Taxes on profits	73	63	78	80	81	93	99	103	107	113	117
Value-added taxes	410	416	447	454	467	473	502	535	571	612	658
Excises	212	236	265	266	270	277	291	304	320	341	365
Taxes on international trade	31	33	36	36	39	38	39	42	46	54	58
Other taxes	57	63	66	67	65	71	75	79	83	88	92
Non-tax revenue	171	221	226	239	212	231	226	236	253	262	281
Capital revenue	2	3	6	8	0	0	0	0	0	0	0
Grants	9	7	13	9	13	12	11	11	10	10	14
Expenditure	1,810	1,780	1,844	1,836	1,874	1,902	1,980	2,093	2,221	2,362	2,529
Current expenditure	1,669	1,633	1,671	1,654	1,693	1,699	1,779	1,880	1,992	2,116	2,266
Wages and salaries 2/	389	356	359	354	370	369	386	406	431	460	492
Goods and services	310	303	338	339	350	364	387	412	435	465	496
Interest	115	130	139	132	139	137	136	140	140	145	153
Subsidies	158	134	120	113	108	108	114	120	132	142	152
Transfers	697	710	715	717	725	723	757	801	853	905	972
Pensions 3/	508	490	505	503	510	505	528	561	596	634	683
Other transfers 4/	189	219	210	214	215	217	229	241	257	271	289
Capital expenditure	97	115	130	139	143	161	173	185	200	217	233
Net lending	15	3	3	3	4	6	6	7	7	8	9
Amortization of activated guarantees	30	30	39	39	35	35	22	22	22	21	21
Unidentified measures (cumulative)	...	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fiscal balance without amortization of activated guarantees (	-228	-118	-50	-18	-40	-14	-15	-15	-7	-5	-8
Fiscal balance	-258	-149	-89	-57	-75	-49	-37	-36	-29	-26	-30
Statistical discrepancy	0	0	0	0	0	0	0	0	0	0	0
Financing	258	149	89	57	75	49	37	36	29	26	30
Privatization proceeds	2	1	0	5	0	0	0	0	0	0	0
Equity investment	0	0	0	0	0	0	0	0	0	0	0
Domestic	123	120	113	23	154	118	21	-5	15	15	28
Banks	82	165	202	131	53	107	8	-11	11	8	14
Government deposits ((-) means accumulation)	-56	32	60	35	-16	-5	2	-1	2	-2	1
Securities held by banks (net)	117	93	140	78	78	120	19	16	36	38	42
Other domestic bank financing	22	39	2	17	-9	-7	-14	-26	-27	-28	-28
Non-banks (incl. non-residents)	41	-45	-90	-107	101	12	13	7	4	7	14
Securities held by non-banks (non-residents, net)	98	35	4	-16	116	30	13	7	4	7	14
Others (incl. amortization)	-58	-80	-93	-91	-16	-18	0	0	0	0	0
External	133	28	-24	29	-78	-70	16	41	14	11	1
Program	0	17	11	0	25	25	0	0	0	0	0
Project	66	55	57	73	59	68	58	42	45	61	76
Bonds and loans	88	12	22	23	116	117	179	87	230	268	173
Amortization	-20	-56	-114	-67	-278	-278	-221	-88	-262	-318	-247
Residual Financing gap/Discrepancy	0	0	0	0	0	0	0	0	0	0	0
Memorandum items:											
Wages and salaries excluding severance payments	389	356	356	354	368	366	386	406	431	460	492
Arrears accumulation (domestic)	-6	-3	0	-1	0	0	0	0	0	0	0
Quasi-fiscal support to SOEs (gross new issuance of guarantees)	120	105	4	86	23	23	19	19	18	21	21
Government deposits (stock)	174	142	82	107	98	112	110	111	109	110	110
Gross public debt	2812	3074	3099	3114	3183	3145	3206	3238	3275	3316	3365
Gross public debt (including restitution)	3090	3317	3342	3357	3426	3388	3449	3461	3477	3498	3526
Nominal GDP (billions of dinars)	3908	4043	4203	4200	4397	4434	4719	5030	5388	5772	6183

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

1/ Includes the republican budget, local governments, social security funds, and the Road Company, but excludes indirect budget beneficiaries (IBBs) that are reporting only on an annual basis.

2/ Including severence payments.

3/ Includes RSD10 billion military pension payment in 2015 following a Constitution Court ruling.

4/ Excluding foreign currency deposit payments to households, reclassified below the line.

Table 6b. Serbia: General Government Fiscal Operations, 2014–22 1/
(Percent of GDP)

	2014	2015	2016		2017		2018	2019	2020	2021	2022
			6th	Prel.	6th	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
					(percent of GDP)						
Revenue	39.7	40.4	41.8	42.4	40.9	41.8	41.2	40.9	40.7	40.5	40.4
Taxes	35.0	34.6	35.9	36.2	35.8	36.3	36.2	36.0	35.8	35.7	35.6
Personal income tax	3.7	3.6	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.6
Social security contributions	11.3	10.9	11.0	11.0	11.1	11.1	11.1	11.2	11.2	11.1	11.1
Taxes on profits	1.9	1.5	1.9	1.9	1.8	2.1	2.1	2.0	2.0	2.0	1.9
Value-added taxes	10.5	10.3	10.6	10.8	10.6	10.7	10.6	10.6	10.6	10.6	10.6
Excises	5.4	5.8	6.3	6.3	6.1	6.2	6.2	6.0	5.9	5.9	5.9
Taxes on international trade	0.8	0.8	0.9	0.9	0.9	0.8	0.8	0.8	0.8	0.9	0.9
Other taxes	1.5	1.6	1.6	1.6	1.5	1.6	1.6	1.6	1.5	1.5	1.5
Non-tax revenue	4.4	5.5	5.4	5.7	4.8	5.2	4.8	4.7	4.7	4.5	4.6
Capital revenue	0.1	0.1	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants	0.2	0.2	0.3	0.2	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Expenditure	46.3	44.0	43.9	43.7	42.6	42.9	42.0	41.6	41.2	40.9	40.9
Current expenditure	42.7	40.4	39.8	39.4	38.5	38.3	37.7	37.4	37.0	36.7	36.6
Wages and salaries 2/	9.9	8.8	8.6	8.4	8.4	8.3	8.2	8.1	8.0	8.0	8.0
Goods and services	7.9	7.5	8.0	8.1	8.0	8.2	8.2	8.2	8.1	8.1	8.0
Interest	2.9	3.2	3.3	3.1	3.2	3.1	2.9	2.8	2.6	2.5	2.5
Subsidies	4.0	3.3	2.9	2.7	2.5	2.4	2.4	2.4	2.5	2.5	2.5
Transfers	17.8	17.6	17.0	17.1	16.5	16.3	16.0	15.9	15.8	15.7	15.7
Pensions 3/	13.0	12.1	12.0	12.0	11.6	11.4	11.2	11.1	11.1	11.0	11.0
Other transfers 4/	4.8	5.4	5.0	5.1	4.9	4.9	4.9	4.8	4.8	4.7	4.7
Capital expenditure	2.5	2.8	3.1	3.3	3.3	3.6	3.7	3.7	3.7	3.8	3.8
Net lending	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Amortization of activated guarantees	0.8	0.7	0.9	0.9	0.8	0.8	0.5	0.4	0.4	0.4	0.3
Fiscal balance without guarantees (cash basis)	-5.8	-2.9	-1.2	-0.4	-0.9	-0.3	-0.3	-0.3	-0.1	-0.1	-0.1
Fiscal balance (incl. amortization of called guarantees)	-6.6	-3.7	-2.1	-1.4	-1.7	-1.1	-0.8	-0.7	-0.5	-0.5	-0.5
Statistical discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing	6.6	3.7	2.1	1.4	1.7	1.1	0.8	0.7	0.5	0.5	0.5
Privatization proceeds	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Equity investment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic	3.1	3.0	2.7	0.6	3.5	2.7	0.4	-0.1	0.3	0.3	0.5
Banks	2.1	4.1	4.8	3.1	1.2	2.4	0.2	-0.2	0.2	0.1	0.2
Government deposits ((-) means accumulation)	-1.4	0.8	1.4	0.8	-0.4	-0.1	0.1	0.0	0.0	0.0	0.0
Securities held by banks (net)	3.0	2.3	3.3	1.9	1.8	2.7	0.4	0.3	0.7	0.7	0.7
Other domestic bank financing	0.6	1.0	0.1	0.4	-0.2	-0.2	-0.3	-0.5	-0.5	-0.5	-0.5
Non-banks (incl. non-residents)	1.0	-1.1	-2.1	-2.6	2.3	0.3	0.3	0.1	0.1	0.1	0.2
Securities held by non-banks (non-residents, net)	2.5	0.9	0.1	-0.4	2.6	0.7	0.3	0.1	0.1	0.1	0.2
Others (incl. amortization)	-1.5	-2.0	-2.2	-2.2	-0.4	-0.4	0.0	0.0	0.0	0.0	0.0
External	3.4	0.7	-0.6	0.7	-1.8	-1.6	0.3	0.8	0.3	0.2	0.0
Program	0.0	0.4	0.3	0.0	0.6	0.6	0.0	0.0	0.0	0.0	0.0
Project	1.7	1.4	1.3	1.7	1.3	1.5	1.2	0.8	0.8	1.1	1.2
Bonds and loans	2.2	0.3	0.5	0.5	2.6	2.6	3.8	1.7	4.3	4.6	2.8
Amortization	-0.5	-1.4	-2.7	-1.6	-6.3	-6.3	-4.7	-1.7	-4.9	-5.5	-4.0
Residual Financing gap/Discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:											
Wages and salaries excluding severance payments	9.9	8.8	8.5	8.4	8.4	8.3	8.2	8.1	8.0	8.0	8.0
Arrears accumulation (domestic)	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Quasi-fiscal support to SOEs (gross new issuance guarantees)	3.1	2.6	0.1	2.1	0.5	0.5	0.4	0.4	0.3	0.4	0.3
Government deposits (stock)	4.5	3.5	2.0	2.5	2.2	2.5	2.3	2.2	2.0	1.9	1.8
Gross financing need	16.2	16.5	15.4	13.4	16.0	15.3	13.7	10.6	13.4	13.9	12.2
Gross public debt	71.9	76.0	73.7	74.1	72.4	70.9	67.9	64.4	60.8	57.5	54.4
Gross public debt (including restitution)	79.1	82.0	79.5	79.9	77.9	76.4	73.1	68.8	64.5	60.6	57.0
Nominal GDP (billions of dinars)	3,908	4,043	4,203	4,200	4,397	4,434	4,719	5,030	5,388	5,772	6,183

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

1/ Includes the republican budget, local governments, social security funds, and the Road Company, but excludes indirect budget beneficiaries (IBBs) that are reporting only on an annual basis.

2/ Including severence payments.

3/ Includes RSD10 billion military pension payment in 2015 following a Constitution Court ruling.

4/ Excluding foreign currency deposit payments to households, reclassified below the line.

Table 7a. Serbia: Monetary Survey, 2014–22

	2014	2015	2016		2017		2018	2019	2020	2021	2022
			6th	Act.	6th	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
(Billions of dinars, unless otherwise indicated; end of period) 1/											
Net foreign assets 2/	1037	1087	1063	1156	1070	1100	1115	1169	1216	1261	1300
in billions of euro	8.5	8.9	8.6	9.4	8.6	9.0	9.0	9.5	9.9	10.2	10.6
Foreign assets	1475	1480	1408	1512	1413	1451	1468	1522	1568	1613	1652
NBS	1208	1272	1165	1271	1169	1212	1227	1281	1327	1373	1412
Commercial banks	267	208	243	241	243	239	241	241	241	240	240
Foreign liabilities (-)	-438	-393	-345	-356	-343	-351	-352	-353	-353	-352	-351
NBS	-27	-8	-5	-6	-5	-5	-5	-5	-5	-5	-5
Commercial banks	-412	-385	-340	-350	-338	-345	-347	-347	-347	-347	-346
Net domestic assets	785	874	1,071	989	1,178	1,195	1,336	1,429	1,540	1,660	1,795
Domestic credit	2,005	2,164	2,428	2,321	2,564	2,558	2,723	2,825	2,962	3,109	3,273
Government, net	123	223	373	341	426	452	460	449	460	468	482
NBS	-256	-228	-215	-210	-231	-210	-208	-209	-207	-209	-208
Claims on government	1	1	1	4	1	3	3	3	3	3	3
Liabilities (deposits)	258	229	216	214	233	213	211	212	210	211	210
Banks	379	451	588	551	658	662	669	658	667	677	690
Claims on government	457	538	681	638	751	746	753	743	752	761	774
Liabilities (deposits)	78	87	93	87	93	84	85	85	85	85	84
Local governments, net	-8	-7	-19	-20	-19	-21	-21	-21	-21	-21	-21
Non-government sector	1,890	1,948	2,074	2,000	2,158	2,127	2,283	2,396	2,523	2,662	2,811
Households	725	760	839	840	882	935	1,003	1,053	1,108	1,170	1,235
Enterprises	1,140	1,162	1,207	1,127	1,247	1,162	1,247	1,309	1,378	1,454	1,536
Other	25	26	28	34	29	30	33	34	36	38	40
Other assets, net	-1,220	-1,291	-1,356	-1,332	-1,386	-1,363	-1,387	-1,396	-1,422	-1,450	-1,478
Capital accounts (-)	-927	-952	-982	-1,016	-998	-1,031	-1,041	-1,038	-1,052	-1,066	-1,081
NBS	-307	-341	-351	-391	-351	-385	-385	-385	-385	-385	-385
Banks	-620	-610	-631	-625	-647	-647	-656	-653	-667	-681	-696
Provisions (-)	-279	-317	-323	-281	-336	-293	-304	-314	-323	-333	-343
Other assets	-14	-23	-51	-34	-51	-39	-42	-44	-47	-51	-54
Broad money (M2)	1823	1955	2134	2146	2248	2295	2452	2598	2755	2921	3095
M1	402	470	553	566	611	632	700	762	833	911	997
Currency in circulation	130	140	156	159	172	174	192	209	229	250	274
Demand deposits	271	330	397	407	439	459	508	552	604	661	723
Time and saving deposits	173	192	198	195	218	223	247	269	294	322	352
Foreign currency deposits	1248	1292	1384	1385	1419	1439	1504	1567	1628	1688	1746
in billions of euro	10.3	10.6	11.2	11.2	11.5	11.7	12.2	12.7	13.2	13.7	14.2
Memorandum items: (year-on-year change unless indicated otherwise)											
M1	9.7	17.0	17.5	20.3	10.5	11.8	10.7	8.8	9.4	9.4	9.5
M2	8.3	7.2	9.2	9.8	5.3	6.9	6.8	6.0	6.1	6.0	6.0
Velocity (Dinar part of money supply)	6.8	6.1	5.6	5.5	5.3	5.2	5.0	4.9	4.8	4.7	4.6
Velocity (M2)	2.1	2.1	2.0	2.0	2.0	1.9	1.9	1.9	2.0	2.0	2.0
Deposits at program exchange rate	3.8	7.2	7.9	8.5	4.8	7.3	6.2	5.7	5.9	5.8	5.8
Credit to non-gov. (current exchange rate)	3.2	1.2	3.1	3.0	1.7	2.9	4.1	3.2	3.6	4.0	4.1
Credit to non-gov. (program exchange rates) 3/	-1.5	1.0	2.0	1.9	1.5	3.4	3.7	3.2	3.7	4.2	4.3
Domestic	-1.1	2.8	5.5	1.8	3.8	6.8	7.0	4.9	5.3	5.6	5.8
Households	3.8	4.7	9.7	9.8	4.9	11.7	7.1	4.9	5.3	5.6	5.7
Enterprises and other sectors	-4.0	1.7	2.7	-3.3	3.1	3.2	7.0	5.0	5.4	5.7	5.8
External	-2.2	-2.4	-5.0	2.2	-3.6	-3.4	-3.6	-1.2	-0.5	0.0	0.0
Credit to non-gov. (real terms) 4/	1.4	-0.3	1.6	1.4	-1.0	-0.7	1.0	0.2	0.6	1.0	1.1
Domestic credit to non-gov. (real terms)	1.2	1.5	4.9	1.1	1.2	2.6	4.2	1.9	2.2	2.4	2.5
Households	5.7	3.1	8.8	8.8	2.2	7.4	4.2	1.9	2.2	2.4	2.5
Enterprises and other sectors	-1.5	0.4	2.3	-3.8	0.5	-0.5	4.2	1.9	2.2	2.4	2.5
External	1.8	-3.7	-5.1	2.0	-6.0	-7.4	-6.0	-4.0	-3.5	-3.0	-3.1
12-m change in NBS's NFA, billions of euros	-0.2	0.3	-0.8	0.1	0.1	-0.3	0.0	0.4	0.3	0.3	0.3
Deposit euroization (percent of total) 5/	73.8	71.2	70.0	69.7	68.3	67.9	66.6	65.6	64.4	63.2	61.9
Credit euroization (percent of total) 5/	67.6	70.6	68.5	68.3	68.0	67.5	66.5	65.5	64.5	63.5	62.5

Sources: National Bank of Serbia; and IMF staff estimates and projections.
1/ Foreign exchange denominated items are converted at current exchange rates.
2/ Excluding undivided assets and liabilities of the FSRY and liabilities to banks in liquidation.
3/ Using program dinar/euro and dinar/swiss franc exchange rates for converting FX and FX-indexed loans to dinars.
4/ Calculated as nominal credit at current exchange rates deflated by the change in the 12-month CPI index.
5/ Using current exchange rates.

Table 7b. Serbia: NBS Balance Sheet, 2014–22

	2014	2015	2016		2017		2018	2019	2020	2021	2022
			6th	Act.	6th	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Billions of dinars, unless otherwise indicated; end of period) 1/										
Net foreign assets	1182	1265	1160	1265	1164	1206	1222	1276	1322	1367	1407
(In billions of euro)	9.7	10.4	9.4	10.3	9.4	9.8	9.9	10.3	10.7	11.1	11.4
Gross foreign reserves	1208	1272	1165	1271	1169	1212	1227	1281	1327	1373	1412
Gross reserve liabilities (-)	-27	-8	-5	-6	-5	-5	-5	-5	-5	-5	-5
Net domestic assets	-601	-647	-639	-663	-645	-668	-639	-651	-652	-648	-633
Net domestic credit	-294	-305	-288	-272	-294	-283	-254	-267	-267	-263	-249
Net credit to government	-256	-228	-215	-210	-231	-210	-208	-209	-207	-209	-208
Claims on government	1	1	1	4	1	3	3	3	3	3	3
Liabilities to government (-)	-258	-229	-216	-214	-233	-213	-211	-212	-210	-211	-210
Liabilities to government (-): local currency	-103	-125	-131	-95	-131	-95	-95	-95	-95	-95	-95
Liabilities to government (-): foreign currency	-154	-103	-85	-119	-102	-117	-116	-117	-114	-116	-115
Net credit to local governmens	-46	-61	-46	-43	-46	-45	-45	-45	-45	-45	-45
Net claims on banks	-7	-30	-41	-33	-30	-42	-15	-26	-29	-23	-10
Capital accounts (-)	-307	-341	-351	-391	-351	-385	-385	-385	-385	-385	-385
Reserve money	581	618	521	602	519	539	583	624	670	720	773
Currency in circulation	130	140	156	159	172	174	192	209	229	250	274
Commercial bank reserves	212	248	171	221	147	155	172	187	205	224	245
Required reserves	158	145	146	147	149	153	159	166	173	179	185
Excess reserves	54	103	25	73	-2	3	12	21	32	45	60
FX deposits by banks, billions of euros	2.0	1.9	1.6	1.8	1.6	1.7	1.8	1.8	1.9	2.0	2.1

Sources: National Bank of Serbia; and IMF staff estimates and projections.
1/ Foreign exchange denominated items are converted at current exchange rates.

Table 8. Serbia: Banking Sector Financial Soundness Indicators, 2012–17

	2012	2013	2014	2015	2016	2017	
						Mar	Apr
Capital adequacy							
Regulatory capital to risk-weighted assets	19.9	20.9	20.0	20.9	21.8	22.3	22.3
Regulatory Tier 1 capital to risk-weighted assets	19.0	19.3	17.6	18.8	20.0	20.6	20.6
Nonperforming loans net of provisions to capital	31.0	32.7	31.0	25.9	17.6	17.1	17.0
Capital to assets	20.5	20.9	20.7	20.3	19.5	19.9	20.0
Large exposures to capital	61.9	52.8	72.1	68.2	86.0	85.1	85.1
Regulatory capital to total assets	12.2	12.2	11.4	11.9	12.7	13.2	13.2
Asset quality							
Nonperforming loans to total gross loans	18.6	21.4	21.5	21.6	17.0	16.8	16.5
Sectoral distribution of loans (percent of total loans)							
Deposit takers	0.3	0.3	0.8	0.1	0.5	0.1	0.5
Central bank	2.1	5.8	0.4	1.6	1.7	2.9	1.7
General government	3.0	2.3	2.3	1.7	1.5	1.5	1.5
Other financial corporations	1.6	1.6	0.5	0.7	0.9	0.7	0.9
Nonfinancial corporations	58.2	54.1	56.3	55.9	52.6	51.5	51.2
Agriculture	3.0	2.7	3.5	3.7	3.6	3.5	3.2
Industry	17.9	18.4	19.2	18.4	16.5	16.1	16.0
Construction	5.8	4.6	4.2	3.8	4.1	4.0	4.1
Trade	15.0	13.5	13.9	13.9	14.3	14.3	14.1
Other loans to nonfinancial corporations	16.5	14.9	15.6	16.2	14.1	13.6	13.7
Households and NPISH	33.0	34.8	38.3	39.1	41.5	41.9	42.5
Households and NPISH of which: mortgage loans to total loans	16.1	16.8	18.0	18.1	17.9	17.8	17.8
Foreign sector	1.9	1.1	1.4	0.9	1.4	1.3	1.7
Specific provision for NPLs to gross NPLs	50.0	50.9	54.9	62.3	67.8	68.1	67.7
Specific and general provisions for NPLs to gross NPLs	111.1	105.5	107.6	106.4	108.5	108.6	110.1
Specific and general provisions for balance sheet losses to NPLs	120.7	113.8	114.5	114.2	118.9	118.6	120.4
Specific and general provisions to NPLs	126.5	117.9	118.4	118.2	123.2	122.9	124.7
Specific provision of total loans to total gross loans	10.2	11.9	12.7	14.4	12.4	12.3	12.0
Earnings and Profitability							
Return on assets	0.4	-0.1	0.1	0.3	0.7	2.3	2.2
Return on equity	2.0	-0.4	0.6	1.5	3.3	11.4	10.9
Liquidity							
Customer deposits to total (noninterbank) loans	93.2	103.4	108.1	114.4	121.9	119.9	119.4
Foreign-currency-denominated loans to total loans	74.1	71.6	70.1	72.3	69.4	67.8	68.5
Average monthy liquidity ratio	2.1	2.4	2.2	2.1	2.1	2.2	2.1
Average monthy narrow liquidity ratio	1.6	1.8	1.7	1.7	1.7	1.8	1.7
Sensitivity to Market Risk							
Foreign-currency-denominated liabilities to total liabilities	80.1	76.7	74.7	72.7	71.1	71.7	71.8
Total off-balance sheet items to total assets	103.5	111.0	207.3	234.1	219.9	220.4	217.5
Classified off-balance sheet items to classified balance sheet assets	26.1	28.7	27.6	30.6	32.4	33.2	33.7

Source: National Bank of Serbia.

Table 9. Serbia: Balance of Payments (Precautionary SBA Shock Scenario), 2013–22 1/

	2013	2014	2015	2016	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
				(Billions of euros)						
Current account balance	-2.1	-2.0	-1.6	-1.4	-2.4	-2.3	-2.2	-2.2	-2.0	-1.9
Trade of goods balance	-4.2	-4.1	-4.0	-3.5	-4.6	-4.5	-4.5	-4.6	-4.7	-4.8
Exports of goods	10.5	10.6	11.4	12.7	13.4	14.9	16.5	18.2	20.2	22.4
Imports of goods	-14.7	-14.8	-15.4	-16.2	-18.0	-19.5	-21.0	-22.9	-25.0	-27.2
Services balance	0.3	0.5	0.7	0.9	1.0	1.2	1.4	1.5	1.6	1.8
Exports of nonfactor services	3.4	3.8	4.3	4.6	5.0	5.3	5.8	6.3	6.9	7.6
Imports of nonfactor services	-3.1	-3.3	-3.5	-3.7	-3.9	-4.1	-4.5	-4.8	-5.3	-5.8
Income balance	-1.4	-1.3	-1.7	-2.0	-2.2	-2.3	-2.4	-2.5	-2.7	-2.8
Net interest	-0.9	-0.9	-1.0	-1.0	-0.9	-1.0	-1.0	-1.0	-1.1	-1.1
Others, including reinvested earnings	-0.5	-0.5	-0.7	-0.9	-1.2	-1.3	-1.4	-1.5	-1.6	-1.7
Current transfer balance	3.2	3.0	3.3	3.2	3.3	3.3	3.3	3.5	3.7	4.0
Official grants	0.0	0.1	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Others, including private remittances	3.1	2.9	3.2	3.1	3.2	3.2	3.3	3.5	3.7	4.0
Capital and financial account balance 1/	3.3	0.5	1.5	0.5	0.9	0.7	2.0	2.0	2.1	2.2
Capital transfer balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment balance	1.2	1.2	1.8	1.9	1.7	1.6	1.7	1.8	2.0	2.1
Portfolio investment balance	1.9	0.4	-0.3	-0.9	-0.5	-0.3	0.6	0.3	0.2	0.1
of which: debt liabilities	2.0	0.4	-0.2	-0.9	-0.5	-0.3	0.6	0.3	0.2	0.1
Other investment balance	0.1	-1.1	0.0	-0.4	-0.3	-0.7	-0.4	-0.1	-0.1	0.0
Public sector 1/ 2/	0.4	0.7	0.5	0.3	0.3	0.0	-0.3	0.0	-0.1	0.0
Domestic banks	-0.5	-1.5	-0.1	-0.5	-0.1	-0.2	0.0	0.0	0.0	0.0
Other private sector 3/	0.1	-0.4	-0.4	-0.2	-0.5	-0.5	-0.1	0.0	0.0	0.0
Errors and omissions	0.2	0.3	0.4	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	1.3	-1.2	0.3	-0.3	-1.5	-1.6	-0.3	-0.1	0.1	0.4
Financing	-1.3	1.2	-0.3	0.3	1.5	1.6	0.3	0.1	-0.1	-0.4
Gross international reserves (increase, -)	-0.7	1.8	-0.2	0.3	0.4	1.6	0.3	0.4	0.5	0.0
Use of Fund credit, net	-0.6	-0.6	-0.1	0.0	1.1	0.1	0.0	-0.2	-0.6	-0.3
Purchases	0.0	0.0	0.0	0.0	1.1	0.1	0.0	0.0	0.0	0.0
Repurchases	-0.6	-0.6	-0.1	0.0	0.0	0.0	0.0	-0.2	-0.6	-0.3
				(Percent of GDP)						
Current account balance	-6.1	-6.0	-4.7	-4.0	-6.7	-6.1	-5.5	-5.0	-4.3	-3.7
Trade of goods balance	-12.1	-12.3	-11.9	-10.2	-12.7	-11.8	-11.1	-10.6	-10.1	-9.6
Exports of goods	30.8	31.9	33.9	37.3	37.1	38.9	40.5	41.8	43.2	44.6
Imports of goods	-42.9	-44.3	-45.8	-47.5	-49.9	-50.7	-51.6	-52.4	-53.3	-54.2
Services balance	0.9	1.4	2.2	2.6	2.9	3.1	3.3	3.4	3.4	3.5
Income balance	-4.1	-4.0	-5.0	-5.7	-6.0	-5.9	-5.8	-5.7	-5.7	-5.6
Current transfer balance	9.2	9.0	10.0	9.3	9.2	8.5	8.0	8.0	8.0	8.0
Official grants	0.1	0.3	0.5	0.2	0.2	0.1	0.0	0.0	0.0	0.0
Others, including private remittances	9.1	8.7	9.5	9.0	9.0	8.4	8.0	8.0	8.0	8.0
Capital and financial account balance 1/	9.5	1.4	4.5	1.4	2.6	1.8	4.8	4.6	4.6	4.4
Capital transfers balance	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign direct investment balance	3.6	3.7	5.4	5.5	4.8	4.3	4.2	4.2	4.2	4.2
Portfolio investment balance	5.6	1.1	-0.9	-2.7	-1.4	-0.8	1.5	0.6	0.5	0.2
Other investment balance	0.3	-3.4	0.0	-1.3	-0.9	-1.7	-0.9	-0.2	-0.1	0.0
Public sector 1/ 2/	1.2	2.2	1.4	0.9	0.9	0.0	-0.7	-0.1	-0.1	0.0
Domestic banks	-1.3	-4.5	-0.2	-1.5	-0.4	-0.4	0.0	0.0	0.0	0.0
Other private sector 3/	0.4	-1.1	-1.2	-0.7	-1.4	-1.3	-0.2	-0.1	0.0	0.0
Errors and omissions	0.5	0.8	1.2	1.7	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	3.9	-3.7	0.9	-0.8	-4.2	-4.3	-0.7	-0.3	0.2	0.7
Memorandum items:				(percent change unless indicated otherwise)						
Export growth	25.6	1.0	6.7	12.1	5.1	11.5	10.8	10.3	10.9	10.8
Import growth	4.7	0.4	4.1	5.6	10.9	8.2	8.2	8.8	9.1	9.1
Export volume growth	21.9	1.7	8.7	13.0	2.7	9.7	9.0	8.8	8.9	8.8
Import volume growth	2.7	1.9	8.8	7.9	7.2	6.6	6.4	7.1	7.2	7.2
Trading partner import growth	1.9	4.7	4.0	4.9	5.7	4.8	4.0	4.0	4.0	4.0
Export prices growth	3.0	-0.7	-1.9	-0.8	2.3	1.6	1.6	1.4	1.9	1.8
Import prices growth	2.0	-1.5	-4.3	-2.1	3.4	1.5	1.7	1.6	1.8	1.8
Change in terms of trade	1.0	0.8	2.6	1.3	-1.1	0.1	-0.1	-0.2	0.1	0.0
Gross official reserves (in billions of euro)	11.2	9.9	10.4	10.2	9.8	8.2	8.0	7.6	7.1	7.1
(In months of prospective imports of GNFS)	7.4	6.3	6.3	5.6	5.0	3.9	3.4	3.0	2.6	2.6
(in percent of short-term debt)	278.8	427.0	337.5	214.2	238.9	241.6	166.5	158.3	148.5	149.2
(in percent of broad money, M2)	76.2	65.8	64.6	58.7	52.5	41.4	37.5	33.3	29.1	27.3
(in percent of IMF risk-weighted metric) 4/	189.6	171.4	171.0	159.4	153.3	128.0	116.3	106.6	98.0	95.4
GDP (billions of euros)	34.3	33.3	33.5	34.1	36.0	38.4	40.8	43.7	46.8	50.2

Sources: NBS; and IMF staff estimates and projections.

1/ Excluding net use of IMF resources.
2/ Includes SDR allocations in 2009.
3/ Includes trade credits (net).
4/ Gross reserves at end-2016 correspond to 159 percent of the ARA metric (assuming Serbia returns to a floating exchange rate classification) and 136 percent of the ARA metric (assuming the current fixed exchange rate classification).

Table 10. Serbia: Schedule of Purchases under the Stand-By Arrangement

	Available on or after	Amount of Purchase			Cumulative	Conditions
		In millions of SDR	In millions of euros 1/	In percent of quota 2/	In percent of quota 2/	
1	2/23/2015	187.080	233.4	40	40	Board approval of arrangement.
2	6/7/2015	116.925	147.9	25	65	Observance of continuous and end-March 2015 performance criteria, and completion of the review.
3	9/7/2015	116.925	147.4	25	90	Observance of continuous and end-June 2015 performance criteria, and completion of the review.
4	12/7/2015	70.155	89.1	15	105	Observance of continuous and end-September 2015 performance criteria, and completion of the review.
5	3/7/2016	70.155	88.4	11	116	Observance of continuous and end-December 2015 performance criteria, and completion of the review.
6	6/7/2016	46.770	58.4	7	123	Observance of continuous and end-March and end-June 2016 performance criteria, and completion of the review.
7	12/7/2016	54.565	69.1	8	131	Observance of continuous and end-September 2016 performance criteria, and completion of the review.
8	3/7/2017	54.565	69.3	8	140	Observance of continuous and end-December 2016 performance criteria.
9	6/7/2017	54.565	68.3	8	148	Observance of continuous and end-March 2017 performance criteria, and completion of the review.
10	9/7/2017	54.565	67.9	8	156	Observance of continuous and end-June 2017 performance criteria.
11	12/7/2017	54.565	67.9	8	165	Observance of continuous and end-September 2017 performance criteria, and completion of the review.
12	2/15/2018	54.565	67.9	8	173	Observance of continuous and end-December 2017 performance criteria.
	Total	935.400	1,174.9	173	173	

Source: FIN, WEO.
1/ At projected WEO exchange rates.
2/ Serbia's current quota is SDR 654.8 million.

Table 11. Serbia: Indicators of Capacity to Repay the Fund, 2013–22 1/ 2/

	2013	2014	2015	2016	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
Fund repurchases and charges										
In millions of SDRs	579	502	117	12	8	18	18	121	475	371
In millions of euro	663	574	147	15	11	22	22	150	591	463
In percent of exports of goods and NFS	4.7	4.0	0.9	0.1	0.1	0.1	0.1	0.6	2.2	1.5
In percent of GDP	1.9	1.7	0.4	0.0	0.0	0.1	0.1	0.3	1.3	0.9
In percent of quota	123.8	107.2	25.0	1.8	1.3	2.7	2.7	18.5	72.5	56.7
In percent of total external debt service	10.9	11.9	4.5	0.4	0.2	0.4	0.5	2.6	9.6	8.2
In percent of gross international reserves	5.9	5.8	1.4	0.1	0.1	0.3	0.3	2.0	8.2	6.5
Fund credit outstanding (end-period)										
In millions of SDRs	624	128	12	0	881	935	935	832	371	7
In millions of euro	701	151	15	0	1096	1163	1161	1034	462	9
In percent of exports of goods and NFS	5.0	1.0	0.1	0.0	6.0	5.7	5.2	4.2	1.7	0.0
In percent of GDP	2.0	0.5	0.0	0.0	3.0	3.0	2.8	2.4	1.0	0.0
In percent of quota	133.4	27.2	2.5	0	135	143	143	127	57	1
In percent of total external debt	2.6	0.5	0.1	0.0	3.9	4.3	4.2	3.7	1.7	0.0
In percent of gross international reserves	6.3	1.5	0.1	0.0	11.2	14.1	14.6	13.5	6.4	0.1
Memorandum items:										
Exports of goods and NFS	13,963	14,451	15,631	17,314	18,342	20,246	22,352	24,577	27,171	29,996
Quota (in millions of SDRs)	468	468	468	655	655	655	655	655	655	655
GDP	34,277	33,335	33,484	34,119	36,032	38,362	40,778	43,675	46,826	50,244
Total external debt service	6,057	4,840	3,242	4,034	5,705	5,079	4,412	5,821	6,178	5,660
Public sector external debt	14,633	16,151	17,183	16,986	17,937	17,720	18,050	18,160	17,762	17,418
Total external debt	27,231	27,694	28,119	27,893	28,200	27,307	27,545	27,615	27,217	26,873
Total external debt stock excluding IMF	26,534	27,543	28,104	27,893	27,093	26,132	26,370	26,311	25,340	24,542
Gross international reserves	11,189	9,907	10,377	10,205	9,813	8,235	7,950	7,677	7,208	7,123

Source: Fund staff estimates.

1/ Based on the assumption of full drawing under the Precautionary SBA shock scenario.

2/ Serbia chose to be grandfathered for the calculation of commitment fees and surcharges, therefore, Serbia's old quota of SDR 467.7 million is used for the purpose of calculating surcharges in this table. It does not make a difference if the current quota were used, with surcharges being zero under both old and current quotas. Serbia's current quota is SDR 654.8 million.

Annex I. Risk Assessment Matrix

Source of Risks	Relative Likelihood	Time Horizon	Expected Impact	Policy Response
EXTERNAL				
Retreat from cross-border integration. A fraying consensus about the benefits of globalization could lead to protectionism and economic isolationism, leading to reduced global and regional policy collaboration with negative consequences for trade, capital and labor flows, sentiment, and growth.	**High**	**Short to Medium Term**	**Medium** • Reduced upside from deeper integration into global and European supply chains, reduced trade and FDI, and increased capital flows volatility would adversely impact Serbian economy.	*Short term:* • Flexible exchange rate should serve as a first line of defense. • Fiscal policy should allow automatic stabilizers to work as needed. • The NBS should provide liquidity support, if needed. • The precautionary SBA arrangement could provide financing, if needed. • Decisive progress on structural reforms should anchor confidence and improve competitiveness. *Medium term:* • Continue fiscal consolidation with growth friendly measures to support growth (including infrastructure improvements). • Maintain financial stability to weather external shocks.

Source of Risks	Relative Likelihood	Time Horizon	Expected Impact	Policy Response
Policy and geopolitical uncertainties: **Policy uncertainty and divergence.** Two-sided risks to U.S. growth with difficult-to-predict policies and global spillovers. In Europe, uncertainty associated with negotiating post-Brexit arrangements and with upcoming major elections. Policy divergence could lead to rising global imbalances and exacerbate exchange rate and capital flow volatility.	High	**Short to Medium Term**	Medium • Uncertainty can weigh on market sentiment, increase funding costs, and dampen investment outlook. Mitigating factors: • Sufficient international reserve buffers; • Well capitalized and liquid banking system; • Precautionary SBA.	*Short term:* • Flexible exchange rate should serve as a first line of defense. • Fiscal policy should allow automatic stabilizers to work as needed. • The NBS should provide liquidity support, if needed. • The precautionary SBA arrangement could provide financing, if needed. • Decisive progress on structural reforms should anchor confidence and improve competitiveness. *Medium term:* • Continue fiscal consolidation with growth friendly measures to support growth (including infrastructure improvements). • Maintain financial stability to weather external shocks.

Source of Risks	**Relative Likelihood**	**Time Horizon**	**Expected Impact**	**Policy Response**
Financial conditions: **Significant further strengthening of the US dollar and/or higher rates.** As investors reassess policy fundamentals, as term premia decompress, or if there is a more rapid Fed normalization, leveraged firms, lower-rated sovereigns and those with un-hedged dollar exposures could come under stress. Could also result in capital account pressures for some economies.	High	**Short Term**	Medium • Investors could reduce demand for Serbia's assets, resulting in capital inflow reduction/outflows and dinar depreciation. • Costs of sovereign and banks' borrowing will increase.	• Flexible exchange rate should serve as a first line of defense. • Fiscal policy should allow automatic stabilizers to work as needed. • The NBS should provide liquidity support, if needed. If pressures persist, interest rates should be increased to stem capital outflows. • The precautionary SBA arrangement could provide financing, if needed. • Decisive progress on structural reforms should anchor confidence and improve competitiveness.
European bank distress: Strained bank balance sheets amid a weak profitability outlook could lead to financial distress in one or more major banks with possible knock-on effects on the broader financial sector and for sovereign yields in vulnerable economies.	Medium	**Short term**	Medium Mitigating factors: • Sufficient international reserve buffers; • Well capitalized/liquid banking system; reduced reliance on parent funding; • Precautionary SBA.	

Source of Risks	Relative Likelihood	Time Horizon	Expected Impact	Policy Response
Weaker-than-expected global growth: **Significant China slowdown and its spillovers:** Key near-term risks are disruptive drying up of liquidity for weaker borrowers in the interbank market and increasing pressure on the Renminbi, which could lead to overcorrection. Weak domestic demand further suppresses commodity prices, roils global financial markets, and reduces global growth (Likelihood: low in short-term, medium thereafter). **Structurally weak growth in key advanced and emerging economies:** Low productivity growth (U.S., the Euro Area, and Japan), a failure to fully address crisis legacies and undertake structural reforms, and persistently low inflation (the Euro Area, and Japan) undermine medium-term growth in advanced economies (high likelihood). Resource misallocation and policy missteps, including insufficient reforms, exacerbate declining productivity growth in emerging markets (medium likelihood).	**Low/ Medium** **High/ Medium**	**Short to Medium Term** **Medium Term**	**Medium** • Direct investment and indirect (through EU supply chains) trade linkages to China would lower investments to and exports from Serbia. • Financial volatility raises risk aversion, causing capital outflows from emerging markets, including Serbia. **High/Medium** • Significant trade linkages with Europe would weaken growth in Serbia through lower exports and adverse confidence effects. • Asset quality of the banking system would deteriorate as growth slows.	*Short term:* • Monetary policy stance should be eased, make use of exchange rate flexibility. • Fiscal policy should allow automatic stabilizers to work as needed. • The NBS should provide liquidity support, if needed. • The precautionary SBA arrangement could provide financing, if needed. *Medium term:* • Continue fiscal consolidation, boost domestic demand through reallocating spending toward infrastructure investments. • Maintain financial stability to weather external shocks, tight supervision to monitor banking risks. • Accelerate structural reforms to improve competitiveness.

DOMESTIC				
Domestic policy errors and political uncertainty: • Premature relaxation of fiscal discipline. • Political resistance or hesitation to delivering on structural reforms. • Weakening of EU accession prospects as domestic policy anchor	High/ Medium	**Short to Medium Term**	**High** • Weaker fiscal discipline could compromise the quality and durability of fiscal adjustment; expose debt sustainability risks. • Unfinished structural reform agenda would reduce growth prospects, preserve over-reliance on the public sector and large informal economy, and leave unaddressed contingent liabilities.	• Maintain strong policies and strengthen institutions as a foundation of strong and sustainable growth. • Complete resolution of unviable SOEs. • Refrain from populistic pressures to relax fiscal discipline, strengthen institutional framework for fiscal rule. • Foster more inclusive growth through higher female labor market participation and better targeted social assistance.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Annex II. Towards a New Fiscal Rule for Serbia[1]

A. Introduction

1. **Against a backdrop of rising debt and deficits, in late-2014 Serbia embarked on an ambitious consolidation program aimed at restoring the sustainability of its public finances.** Now, after more than two years, Serbia can report a 4.5 percent of GDP primary structural adjustment, the lowest headline fiscal deficit since 2005, general government debt on a downward path, and an improved macroeconomy. Serbia should take the opportunity to "lock in" its hard-won gains and anchor fiscal policy with the development of a new fiscal rule and supporting framework.

2. **This Annex is arranged in four parts.** The first part discusses global trends in fiscal rules and the EU experience. The second part examines Serbia's previous experience with fiscal rules. The third part provides two initial proposals for a new fiscal rule. Finally, the annex concludes with some issues for consideration if Serbia is to move ahead seriously and adopt a new fiscal rule.

B. Global Trends

3. **As of end-2015, 85 countries had at least one (national or supranational) fiscal rule in place, with debt and balanced budget rules being the most popular** (Figure 1).[2] Slightly more than half the countries report having a supranational fiscal rule.[3] Advanced countries tend to adopt fiscal rules with more flexibility, through cyclical or structural adjustments, reflecting their exposure to global shocks, greater institutional capacity, and different needs. Emerging market countries tend to make less use of fiscal rules with cyclical or structural adjustments unless they are in Emerging Europe or heavily dependent on natural resources.[4]

4. **In the European Union (EU), there is an intricate set of constraints provided by the fiscal governance framework.** On top of the four supranational fiscal rules, all 28 EU member

[1] Prepared by Marko Paunovic and Christine Richmond (EUR).

[2] See Schaechter et al. (2012) and the IMF Fiscal Rules Dataset, 1985-2015: http://www.imf.org/external/datamapper/fiscalrules/map/map.htm

[3] There are four supranational treaties in place: Stability and Growth Pact (SGP) in Europe; West African Economic and Monetary Union (WAEMU); Central African Economic and Monetary Community (CEMAC); and Eastern Caribbean Currency Union (ECCU).

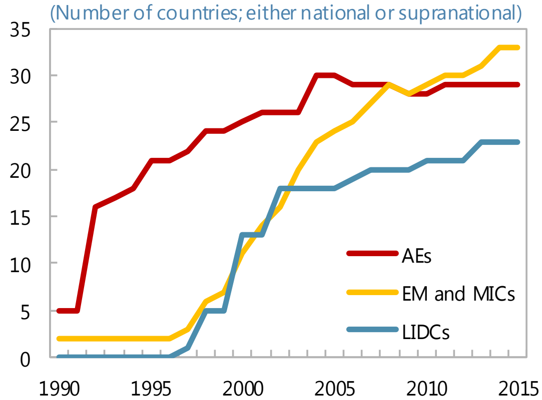
[4] Also see IMF (2009).

(continued)

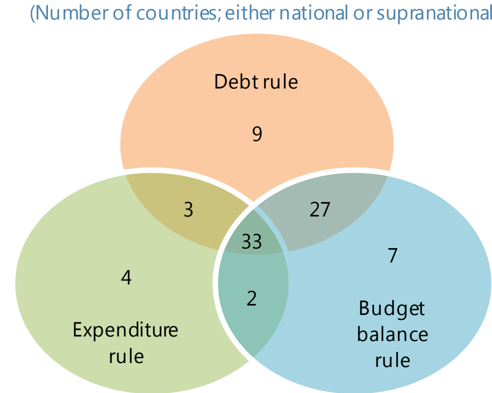
states also have national fiscal rules.[5,6] Such a system leads to complicated monitoring and public communication, lack of transparency, and risks inconsistency and overlap between the different parts of the system (Andrle et al., 2015). The IMF has suggested that reforming the fiscal governance in the EU should involve reducing the number of numerical fiscal rules, create incentives to build sufficient buffers during "good times", enhance enforcement through greater automaticity, and improve compliance by creating more credible sanctions (Andrle et al., 2015).

Figure 1. Fiscal Rules Around the World

Fiscal Rule
(Number of countries; either national or supranational)



Fiscal Rule Combinations
(Number of countries; either national or supranational)



Source: IMF Fiscal Rules Database, 1985-2015.

C. Serbia's Experience with Fiscal Rules[7]

5. In 2010, Serbia introduced its fiscal rules and established the Fiscal Council through amendments to the Budget System Law (BSL). Numerical rules were introduced for general government debt, general government fiscal deficit, as well as for total wage and pension expenditures.

6. Public debt was limited to 45 percent of GDP, excluding future restitution claims (which are capped by the BSL at EUR 2 billion, or about 6 percent of GDP). Public debt includes all direct government debt and all issued general government guarantees. The BSL stipulates that if the public debt ceiling is compromised, the Government must submit a 'Program on Debt Reduction' to Parliament.

[5] The four (broad) rules are: (i) converge towards the 60 percent of GDP debt target; (ii) nominal deficit should not breach the 3 percent of GDP; (iii) improve structural balance-to-GDP ratio to a benchmark rate until reaching the country-specific medium-term objective; (iv) government spending (net of new revenue measures) is constrained to grow in line with trend GDP. See Ardrle et al. (2015).

[6] The Fiscal Compact (effective January 1, 2013) called for anchoring EU rules at the national level.

[7] For additional details, see Begovic et al. (2016).

7. In addition to the debt rule, the general government deficit rule was defined by the formula:

$d_t = d_{t-1} - a(d_{t-1} - d^*) - b(g_t - g^*)$,

where d_t and d_{t-1} are general government deficits (expressed in percent of GDP) in years t and t-1; d^* is a targeted long term deficit (defined in the BSL as 1 percent of GDP); g_t is the projected GDP growth rate in year t; and g^* is the medium-term potential growth rate. Parameters *a* and *b* influence the pace of adjustment and were defined in the BSL for the 2011 – 2014 period (a = 0.3 and b = 0.4), while g* was set at 4 percent. The deficit rule covers the headline deficit and leaves room for countercyclical fiscal policy. At the time of adopting the BSL, the formula was as follows:

$d_t = d_{t-1} - 0.3(d_{t-1} - 1\%) - 0.4(g_t - 4\%)$

8. The BSL also introduced indexation rules for public sector wages and pension for the 2011 – 2015 period, as a measure to control expenditure. It stipulated that these rules would also apply in the post-2015 period, until share of pensions in GDP dropped below 10 percent of GDP and share of wages in GDP dropped below 8 percent of GDP.

9. The BSL provided an exception for capital expenditure. If the share of capital expenditure is above 4 percent of GDP (in 2011) or above 5 percent of GDP (in the 2012 – 2015 period), up to 2 percent of GDP of capital expenditure above the threshold would not be counted towards the deficit.

10. The BSL has been amended 9 times between 2010 and 2015, with the changes usually targeting the wage and pension indexation rules. However, key rules on debt and deficit were not amended as they did not, in fact, represent an operational obstacle as no specific sanctions or corrective actions were envisaged. The BSL also envisages the possibility for temporary deviation from the rule due to "natural disasters and external shocks which can jeopardize the health of the people, national security or reduce economic activity". Although this exception provides for significant flexibility, it has never been formally activated.

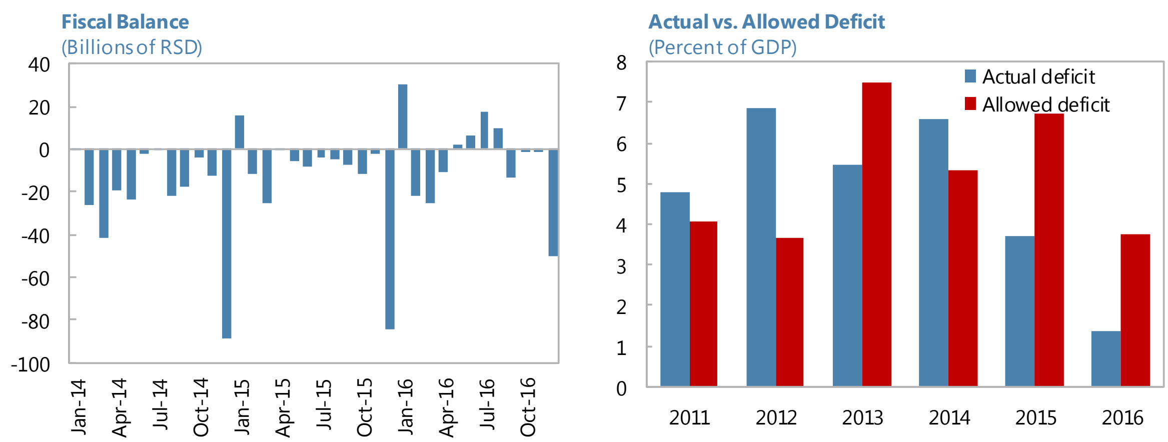
Some problems with the framework

11. The deficit rule is complicated, especially since the implementation mechanism relies on public pressure. The rule requires a minimum understanding of mathematics and the general public, media, and politicians have mostly ignored this rule in the public debate. All the focus was put on the debt rule because it is simple and straightforward. Also, the deficit rule is based on projections, so it can be manipulated. Since the budget is usually prepared in the fall, actual numbers for the current year (such as d_{t-1}) are still unknown. If revenue and expenditure were more or less stable during the year this would not necessarily present a problem. However, since spending on some items during the last two or three months of the year are especially large (most notably for capital investment and project loans, but also for some goods and services), estimating the deficit in the current year is not a trivial task (the deficit in December represented 34 percent of total deficit in 2014; 56 percent in 2015; and 88 percent in 2016).

12. Similarly, g_t is a projection and was probably initially set at a level which was too high. As a result, the deficit rule allowed for an adjustment that was too slow. For example, the rule would have allowed a deficit of almost 7 percent in 2015, as projected growth at the time of budget preparation was -0.5 percent (while the growth realization was +0.8 percent).

13. The initial public debt ceiling of 45 percent of GDP proved to be unrealistic and lacked credibility from the beginning. The rule was already violated in 2011, within one year of its adoption.

Figure 2. Fiscal Balance



Sources: MoF Serbia, IMF staff calculations.

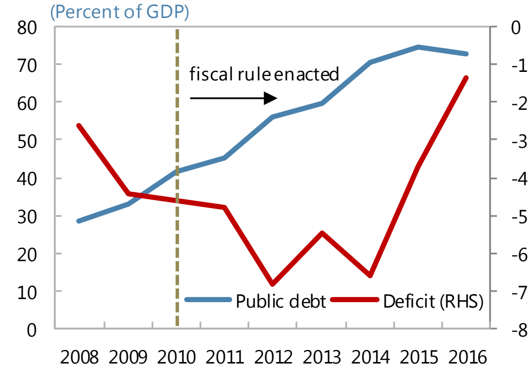
14. Deficit numbers can be (and were) manipulated, by misclassifying expenditure and revenue as below-/above-the-line items. Budget accounting in Serbia is still conducted on a cash basis, with unclear rules and practices as to which items should be treated as revenue or expenditure and which items should be treated as financing operations. This means that the government can easily hide the actual deficit by shifting spending below-the-line, or shifting some receipts as revenues above the line. For example, instead of giving a direct subsidy to a company (which would be an expenditure), the government may either: a) take over some debt from the company and then repay the debt "below the line"[8]; or b) issue bonds and transfer them to the company (when they mature, the government "pays back the debt" below the line). These kinds of transactions became more frequent in the period after the fiscal rules were adopted and were recognized as expenditure only by the next government. Furthermore, many

[8] The current IMF arrangement records debt assumptions as expenditure.

current expenditures can easily be reclassified as capital expenditure to make use of the public investment by-pass provision to permit a higher deficit.

15. There were no sanctions or enforcement mechanism envisaged. The BSL did not envisage any sanctions for violating the deficit rule (either ex ante, at the point of budget adoption, or ex post, when execution is known). The BSL assumed that the Government would not willingly violate the BSL and that there would be credible public opinion sanctions against such behavior. Regarding the debt ceiling, the BSL envisaged an obligation by the Government to prepare and present to the Parliament a document called the "Program for Public Debt Reduction". The Government formally fulfilled this obligation by adding 3-4 pages to the Fiscal Strategy.

Public Debt and Deficit
(Percent of GDP)



Sources: MoF Serbia.

16. The effect of the numerical fiscal rules was very limited. After the introduction of the various rules, the fiscal deficit significantly increased, resulting in a continuous increase of the public debt. Only beginning in 2014 when the government embarked on a planned fiscal consolidation was the country able to significantly reduce the deficit and put the public debt on a downward trajectory. There is no evidence that the fiscal rules framework contributed to this correction: instead the motivation appears to have been recognition by the government and the public that Serbia was at increasing risk of fiscal crisis, with the adjustment monitored and supported by the IMF program.

D. Two Suggestions

17. Following EU fiscal rules could be appealing given Serbia's EU accession candidacy. However, given the complexity of the existing EU system even for more advanced economies (see Andrle et al., 2015), at this juncture Serbia would be better served by tailoring a fiscal rule to its national situation, considering its previous experience with a fiscal rule and capacity constraints. This would also be broadly consistent with the EU Fiscal Compact, which calls for fiscal rules to be anchored at the national level. At the same time it is important that any fiscal rule adopted by Serbia should not be inconsistent with EU fiscal frameworks.

18. The fiscal rule needs to credibly help Serbia deliver on its fiscal policy objective. With general government debt still above 70 percent of GDP, Serbia's objective should be to ensure fiscal sustainability and bring debt down to a more reasonable level. To help achieve this objective, Serbia needs to identify a shorter-term operational target, which is directly under the control of government, while also having a close and predictable link to debt dynamics.

19. The debt anchor for Serbia should be sufficiently low to protect the country against negative shocks, but also provide space for financing priority public investment projects.

Weighing these trade-offs, a general government gross debt[9] limit – including all government guaranteed debt, unguaranteed local government debt, arrears, and restitution – of 60 percent of GDP could be appropriate.[10] It is important to note, however, that achieving the debt limit should not be considered sufficient. Instead, Serbia should aim for debt to be comfortably below this limit, so as to allow for negative shocks to be accommodated without putting the limit at risk.

20. Given Serbia's previous experience with fiscal rules, and, in particular, institutional limitations, this note considers two possible fiscal rules to help Serbia achieve its fiscal sustainability objective: (1) an expenditure growth rule, which would help Serbia transition towards the existing EU system; and (2) an overall balance rule, adjusted for one-off measures, which would be simple, transparent, and easy to communicate with the public. Either rule could help Serbia meet its objective to achieve fiscal sustainability, but each approach has its pros and cons.

Expenditure rule (modified structural balance rule)

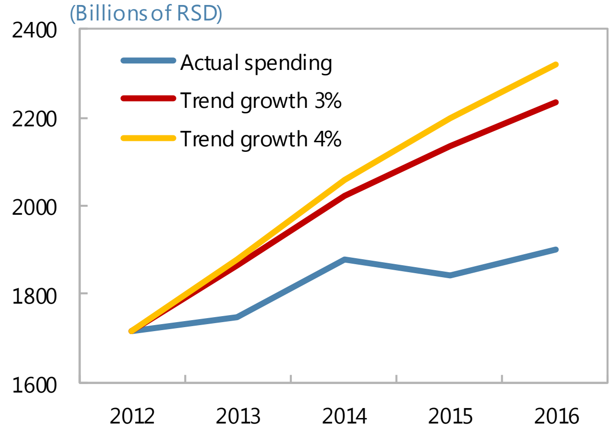
21. One option for Serbia is to replace the existing deficit rule with an expenditure growth rule, as a simple form of structural balance rule (SBR). Since complexity and transparency of a rule are very important in Serbia's context, the SBR can be simplified by assuming that structural revenues grow at the same pace as trend GDP. Therefore, the SBR can become equivalent to an expenditure rule where expenditures are allowed to grow at a trend GDP rate (assuming that the deficit level is in line with the medium-term target) (also known as an expenditure benchmark in EU fiscal rule framework). In Serbia's case, for example, when debt is above 60 percent of GDP, expenditures could grow at a rate of trend GDP – 2 percent. This could help ensure consolidation and a declining debt path. When debt is below 60 percent of GDP, expenditures could grow at a rate of trend GDP. In addition, the expenditures should be adjusted for planned revenue measures (tax policy changes).

22. Such a rule can be fairly simple and would provide clear operational guidance. It would allow for economic stabilization, as expenditures (and the headline deficit) would not be directly linked to actual growth and revenue. Another advantage compared to the current system is that it would be easier to communicate the rule to the public and to monitor compliance.

[9] While there are merits of looking at net debt (gross debt minus financial assets), measuring net debt is challenging, particularly because it is difficult to know which government assets are truly liquid. See Dippelsman et al. (2012).

[10] This compares to an effective debt limit of 54 percent of GDP (including restitution) under the existing fiscal rule. A proper calibration exercise is warranted to assess whether the debt target is prudent enough to ensure that the debt dynamics remain under control even after a series of bad shocks.

Actual Spending vs. Expenditure Rule
(Billions of RSD)



Sources: IMF staff calculations.

23. At the same time, this rule also has some weaknesses. Primarily, it would be difficult to link the rule to debt sustainability, as there is no direct link to the actual revenue. This rule may also lead to an operational budgeting problem, as a large share of spending happens in the last few months of the year. The overall spending envelope for the next year critically depends on the projection for the current year, which can be very difficult to predict correctly. Additionally, the medium to long run effect of such a rule critically depends on the assumption of the trend GDP growth rate, which is also difficult to correctly predict.[11] Translating trend growth into nominal spending limits also raises challenges arising from inflation and may deliver a bigger (smaller) change than the desired real spending increase if actual inflation is below (above) the projection. Finally, there is a risk of creating disincentives for the government to collect revenues as over-performance in tax collection cannot be spent.

24. Actual spending over the last 5 years has been growing markedly more slowly than such a rule would have allowed. However, now that Serbia has achieved a much more sustainable deficit level, higher expenditure growth rates may be expected and therefore constraining overall spending growth may be an appropriate option.

Balanced budget rule

25. As an alternative, the authorities could consider adopting a simple balanced budget rule. Specifically, staff considers that a primary balance, adjusted for one-offs, could be appropriate.[12] To support policymakers achieving the fiscal policy objective (debt below 60 percent of GDP), a binary set of primary balance limits (excluding one-offs) could be chosen: if debt is above 60 percent of GDP, the primary balance (excluding one-offs) floor should be 1.5 percent of GDP; if debt is below 60 percent of GDP, the primary balance (excluding one-offs) floor should be set at 0.5 percent of GDP.[13] The authorities should not target the primary balance floor every year, but instead aim to be above the floor to allow for countercyclical policy space.

[11] Recent FAD analysis indicates that the sensitivity of Serbia's overall level of tax revenue to economic activity is likely low in the long-run.

[12] Primary balance, excluding one-offs = (total revenue – one-off revenue) – (total expenditure – interest expense-one-off expenditure).

[13] Further analysis would be required to refine the optimal parameters, which would depend on estimated medium term growth and real interest rate projections, among other things., The levels shown here would be consistent with an overall fiscal balance of -1.5 percent of GDP in 2017, and would ensure that Serbia achieved the debt objective by 2022, under staff's baseline.

26. There are benefits associated with a simple fiscal rule. Use of the primary balance would provide a close link to debt sustainability and offer clear operational guidance to policymakers. It would also be easy to communicate to the public and to monitor. Finally, from a practical view point, interest expenses are not under the control of policymakers in the short-run, and may be volatile, thus their exclusion would not force policymakers to make short-term spending adjustments to achieve the target.

27. Such a rule would, however, face some tradeoffs. Most importantly, the proposed rule would not have an economic stabilization feature, and at times could prove pro-cyclical. However, structural balance rules—which adjust for the economic cycle – rely on levels of potential GDP and output gap that, in practice, are difficult to measure, particularly in real-time, and may result in large ex-post adjustments. Another challenge with the primary balance, adjusted for one-offs, is that it requires pre-defining one-offs and temporary factors in order to avoid their discretionary use.

28. Careful consideration would need to be given as to what constitutes a legitimate "one-off" expenditure or revenue item. While IMF staff has tried to identify one-off items during the current SBA, it is not a conclusive list.[14] Box 1 summarizes some guiding principles on one-offs, however, it would be more practical for the Fiscal Council to be given the task of determining whether a one-off is indeed valid, given the Serbia-specific context.[15]

Box 1. Guiding Principles when Adjusting for One-offs

- Size: only adjust for measures having a significant impact (each one above 0.1 percent of GDP);
- Duration: the impact of one-offs should be concentrated in one or two years;
- Nature: one-offs are typically, but not exclusively, included in capital transfers.
- Many deficit-increasing measures should not be regarded as one-offs, since although they may intend to be temporary, often they become permanent. For instance, crisis-related discretionary fiscal stimulus measures should not be excluded from reported structural balances as they have an impact on domestic demand, may prove difficult to reverse, and are a result of discretionary fiscal policy;
- Adjust for one-offs sparingly. If in doubt, do not make any exclusion;

If adjustments are made, report fiscal balances with and without one-offs.

Source: Villafuerte et al. (2012).

[14] Some of the one-off transactions recorded as revenue by the authorities include super-dividends, debt issued at a premium, and telecom spectrum auctions. One-off expenditure transactions include debt assumptions, court rulings, salary bonuses, and severance payments for rightsizing schemes.

[15] See Joumard et al. (2008) for additional guidance on adjusting for one-offs.

E. Issues for Consideration

The success of any fiscal rule in Serbia will require several issues to be addressed:

29. The scope of general government is still unclear. There are currently two separate lists of general government institutions which are used for different purposes: a legacy list based on a national legal definition and a recently list compiled according to ESA 2010 and GFSM 2014. The latter is based on international statistics compilation guidelines, and serves macroeconomic analysis. The list based on ESA 2010 and GFSM 2014 guidelines is not yet finalized, since several institutional units are still under review (by Eurostat). Finalizing this list will lead to a number of institutional units being included in the scope of general government such public or state owned enterprises that rely significantly on budget support or nonmarket revenue to cover expenses. Finalization will also provide clarification on whether all state institutions of higher education need to be included in the scope of general government. There are ongoing efforts with Eurostat to finalize this process.

30. Recent history has demonstrated some of the weaknesses of the existing public accounting system. The system of classifying revenues and expenditures (such as recording of government guarantees, recapitalizations, debt write-offs, arrears clearance operations and debt assumptions) does not follow international best practices and should be thoroughly reviewed and reformed. For example, the system does not envisage or easily facilitate consistent recording of debt and deficit according to international statistical guidelines. This is especially evident with guarantees – although issued guarantees are included in the national definition of public debt, it was possible for these transactions not to be accounted as deficit (neither at the point of issuance of the guarantee, as the deficit in Serbia is reported on a cash basis, nor at the point of repayment of the guarantee as debt repayment is booked as a financial transaction). Also, bank recapitalizations were not initially included in the deficit, as well as some arrears clearance transactions. Additionally, it should be stressed that although the Ministry of Finance publishes monthly reports which are mostly in line with international accounting standards, they must also prepare all the reports in line with national legislation and these reports are not published nor presented to the Parliament. Importantly, because the national public accounting is not fully aligned with international statistical guidelines, links with the implications on the wider macroeconomic framework are less easily made. Fiscal rules, if they are to be legally binding, would need to be directly translatable to national legally defined categories.

31. The Fiscal Council has played an instrumental role in raising the profile of the discussion of fiscal issues in Serbia. Their role is well suited for the current system of fiscal rules, but any change would have to be followed by extending their mandate. For example, if the new rule envisages accounting for one-off transactions, the responsibility for classifying such transactions should be given to the Fiscal Council. Also, if an expenditure rule is adopted, the Fiscal Council should have a role in defining some of the main parameters. The Fiscal Council should also have the role of commenting on the annual budget and how it is in line with the fiscal rule.

32. Enforcement of the rule may represent a challenge. The current system mostly relies on a "name and shame" approach whereby the Fiscal Council would publicly criticize the Government with the main goal of increasing political costs of running unsustainable fiscal policy. More formal mechanisms are needed in situations when the Government is clearly violating the rule (for example, automatic sanctions could be prescribed which would trigger freezing of pensions and public sector wages or an automatic VAT rate increase), noting that enforcement that relies on intervention after a breach of the rules occurs tends to be less effective than arrangements that deter violations before they occur.

33. Budgeting practices will need to be changed. To support fiscal discipline, Serbia should restructure its budget processes to promote following the rules. A medium-term budget orientation (medium-term expenditure framework) can be used to support a budget path consistent with the rule (Schick, 2003) and move the authorities away from using across-the-board actions to meet short-term targets. Moreover, closer adherence to the budget preparation calendar would allow for more time for preparation, prioritization, and assessment.

34. The legal base of the rule is very important for the enforcement of the rule in the Serbian context. Namely, a law cannot constrain the National Assembly, as it can adopt any legislation which is in accordance with the Constitution. For example, although the existing BSL defined that the deficit cannot be higher than some formula-defined level, the Parliament can still adopt the annual budget which envisages a higher deficit. In that sense, it is difficult to expect that any numerical fiscal rule defined by a Law will be effectively enforced. Constitutionalizing at least some aspects of fiscal rules, such as including a debt objective and establishing the Fiscal Council, could help improve the enforcement of the rule, make it more difficult to reverse the fiscal rules, reflect broad consensus on the issue, and support fiscal discipline (see, for example, IMF, 2009).[16] However, at the end of day, if there is no commitment or public pressure to following the rules, enshrining it in the Constitution will not itself ensure it is observed.

35. The current escape clause is too vague. Currently the fiscal rule has a very general escape clause: the fiscal rules can be suspended due to natural disaster and external shocks which could jeopardize the health of the people, national security, or reduce economic activity. This should be sharpened to be more specific: suspension of the rule if specific events (war, natural disaster, or national state of emergency) with a cost above some determined threshold, or a drop in GDP growth greater than a specific amount. This should be calibrated taking into account budget sensitivity to output fluctuations and considering past shocks. If the escape clause is to be activated, it should be confirmed by the Fiscal Council

[16] Amending the Constitution would require a two-thirds majority of Parliament. Given the nature of the proposed changes, a referendum may not be required. The rationale for including the Fiscal Council in the Constitution is to make it more difficult for the government to influence them. The current Constitution already has established two similar control bodies outside of the executive branch of Government: Supreme Audit Institution and the Ombudsman.

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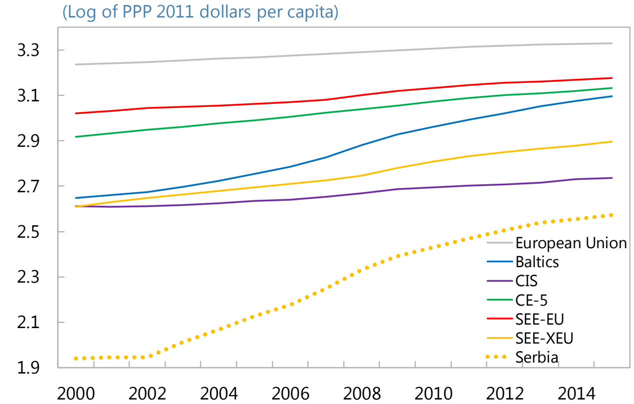
Annex III. Public Infrastructure Gaps: Challenges and Opportunities[1]

A. Context

1. The weakness of public infrastructure in Serbia and other Western Balkan countries has a long history and complex roots.[2] The industrial revolution came to the region significantly later than to more advanced countries in Europe, which was reflected in the development of basic infrastructure. The legacy of the past has been aggravated by the disintegration of former Yugoslavia (involving both destruction of existing infrastructure and prolonged delay in new investment), pronounced political fragmentation of the region, and delays in the process of the European integration and reforms. While several recent initiatives supported by the EU, IFIs, and bilateral donors have helped improve regional infrastructure, more significant progress has been prevented by the lack of sufficient budgetary space to co-finance projects, weaknesses in administrative and financing planning frameworks, corruption and lack of transparency, and political instability (Figure 1).

Figure 1. Public Capital Stock

(Log of PPP 2011 dollars per capita)



Sources: FAD database and IMF staff calculations.

2. Shortages of core public infrastructure have been a headwind for higher economic growth and faster income convergence. Specifically, poor transport networks have constrained connectivity of producers and consumers to global markets; insufficient and/or unreliable provisions of utilities (e.g., water and energy) have restricted production capacity and undermined economies' attractiveness for foreign and domestic investors; and underdeveloped communications networks have slowed dissemination of information and knowledge.

3. An increase in public infrastructure investment is likely to have both short- and long-term effects on economic activity.[3] In the short run, the investment is likely to boost aggregate demand and, given the complimentary nature of infrastructure services, by crowding in private investment. In the long run, it is likely to have a supply-side effect as the productive capacity of the economy increases with higher infrastructure capital stock, especially if efficiency of public investments (manifested by strong frameworks for project selection, implementation,

[1] Prepared by Ruben Atoyan (EUR) based on the forthcoming European departmental paper.

[2] See Holzner, Stehrer, and Vidovic (2015).

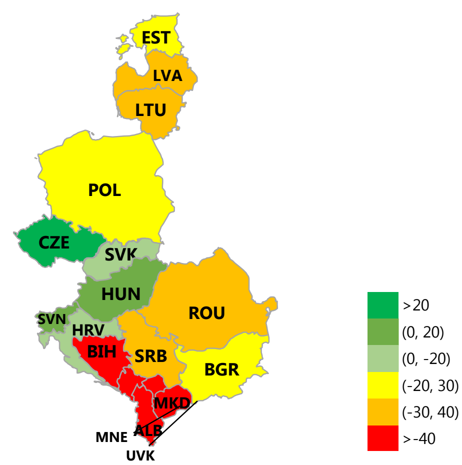
[3] See IMF (2014).

and monitoring) is high. Ultimately, increasing public infrastructure investment raises potential output and—if public investment efficiency and the elasticity of output to public capital are sufficiently high—determine the evolution of the public debt-to-GDP ratio over the medium and long term.

B. Serbia's Infrastructure Gaps

4. Like other countries in the region, Serbia is characterized by insufficient transport infrastructure, mediocre connectivity to the rest of the world, and limited capacity for power generation.[4] Specifically, quantitative indicators—compared with average EU levels and adjusted for the size of countries and populations—suggest largely inadequate motorway density and weak airport capacity and utilization (Figure 2). While railway density is less of a bottleneck, it falls short of levels observed in Serbia's more dynamic peers in Central Europe. Similarly, while phone connectivity appears to be broadly adequate, broadband internet connections are scarce. Finally, installed capacity for power generation—an important indicator for assessing investment attractiveness of the country by foreign investors—is very weak.

Figure 3. Infrastructure Gap Index

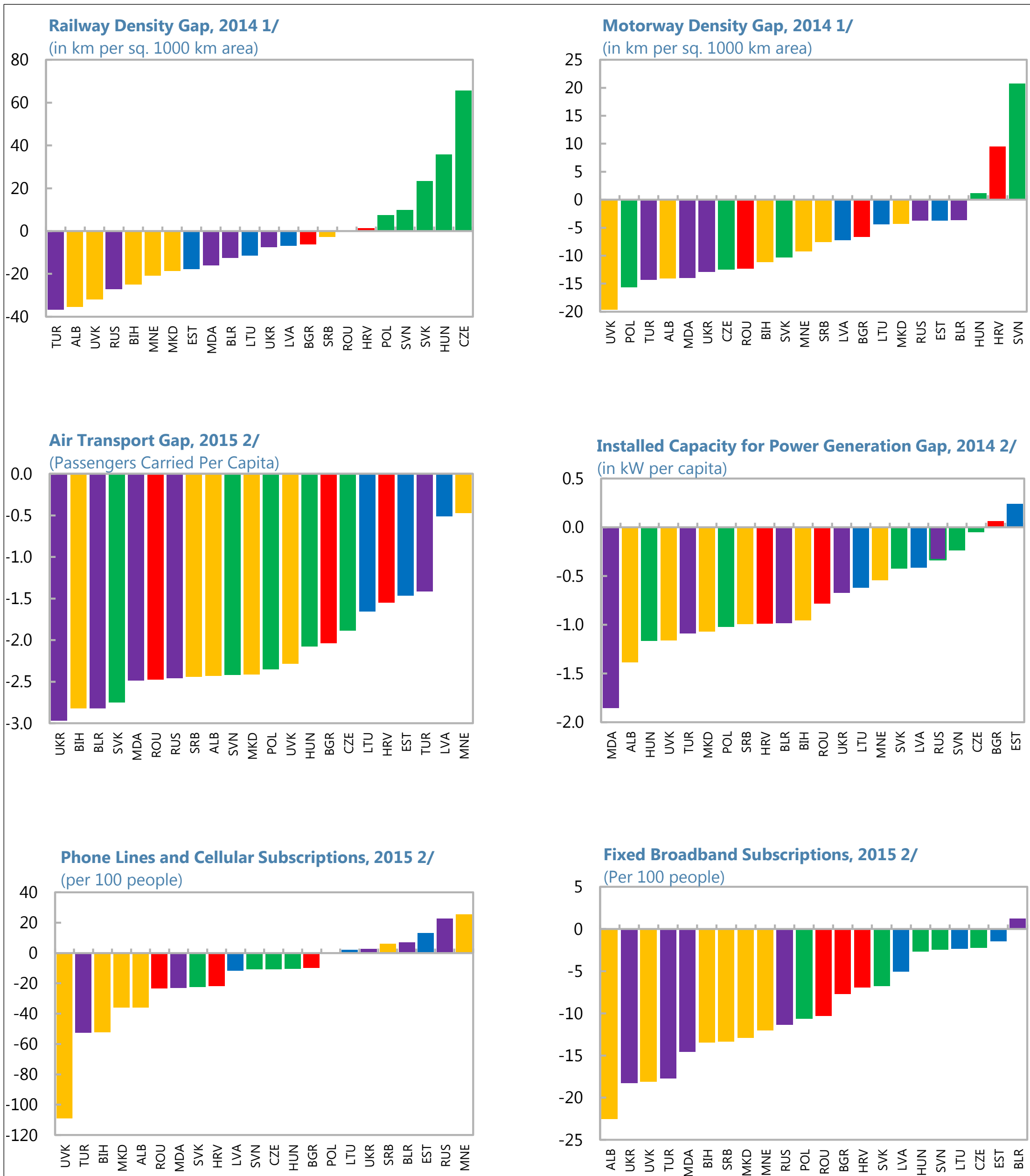


Sources: WDI, EIA, IRF, Eurostat, and IMF staff calculations.
Note: Infrastructure Gap Index calculates the gap between a country's infrastructure and that of an average EU member. In the following area's railway density, motorway density, installed capacity for power generation, phone lines and cellular subscriptions, broadband internet connections, and air transport passengers. The index value ranges between 50 to -65 with a value of zero reflecting EU-28 average.

5. Serbia's overall shortage of infrastructure is significant, posing constraints on private sector development and integration into European supply chains. An aggregated index of individual components of public infrastructure highlights two important insights (Figure 3). First, the overall level of infrastructure development in the Western Balkans is lower than elsewhere in CESEE countries. This limits deeper regional integration, prevents Western Balkan countries from reaping of benefits of the economy of scale, and reduces their attractiveness as a destination for FDI inflows. Second, Serbia's overall gap, at over 30 percent below the EU average level, is somewhat less binding than in other Western Balkan countries but is far from emulating infrastructure development of more dynamic regional peers that managed to exploit growth benefits of the integration into European supply chains.

[4] The list of public infrastructure components discussed here is far from being exhaustive. Ports, local roads, water supply and treatment infrastructure, as well as health, education, and R&D infrastructure are all very important. Nevertheless, the gaps presented here are likely to be representative of the overall stage of public infrastructure development.

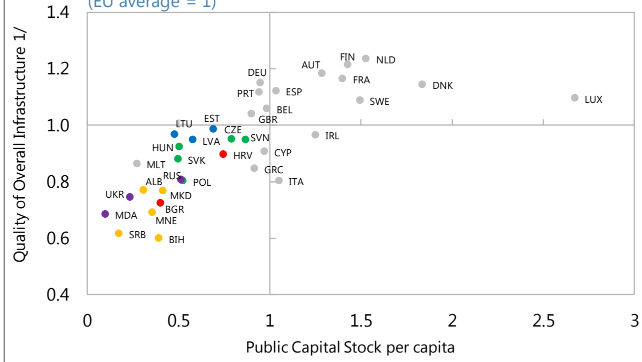
Figure 2. Public Infrastructure Gaps



Sources: WDI database, International Road Federation, Eurostat, EIA, and IMF staff calculations.
1/ Gaps are computed vis-a-vis EU average adjusted for population density.
2/ Gaps are computed vis-a-vis EU average.

6. Public infrastructure gaps are aggravated by the poor quality of the existing infrastructure. Survey-based indicators suggest that Serbia stands out even among other Western Balkan countries in terms of meagre perceptions of the quality of the existing infrastructure (Figure 4). This likely suggests that the true infrastructure gaps in Serbia are significantly larger than suggested by the quantitative metrics presented above.

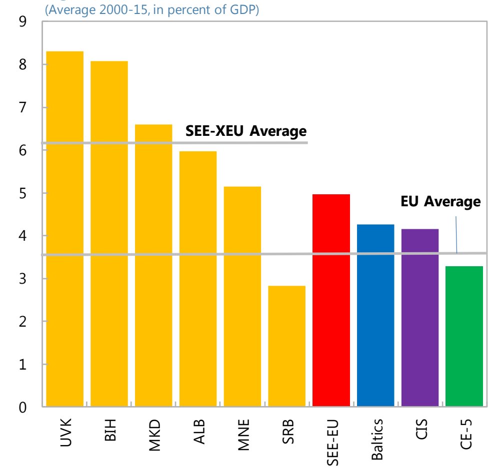
Figure 4. Quality of Overall Infrastructure and Public Capital Stock, 2015
(EU average = 1)



1/ WEF measures the quality based on surveys.
Sources: WDI database, FAD database, and IMF staff calculations.

7. The current pace of investments in public infrastructure is insufficient to quickly bridge the gaps. Over last decade and a half, Serbia's public investments averaged about 3 percent of GDP, significantly lower than public investment rates in other CESEE countries and only about a half of rates enjoyed by other Western Balkan countries. With low initial stocks, these modest investment rates suggest that the current shortage of infrastructure will be protracted.

Figure 5. Public Investment
(Average 2000-15, in percent of GDP)

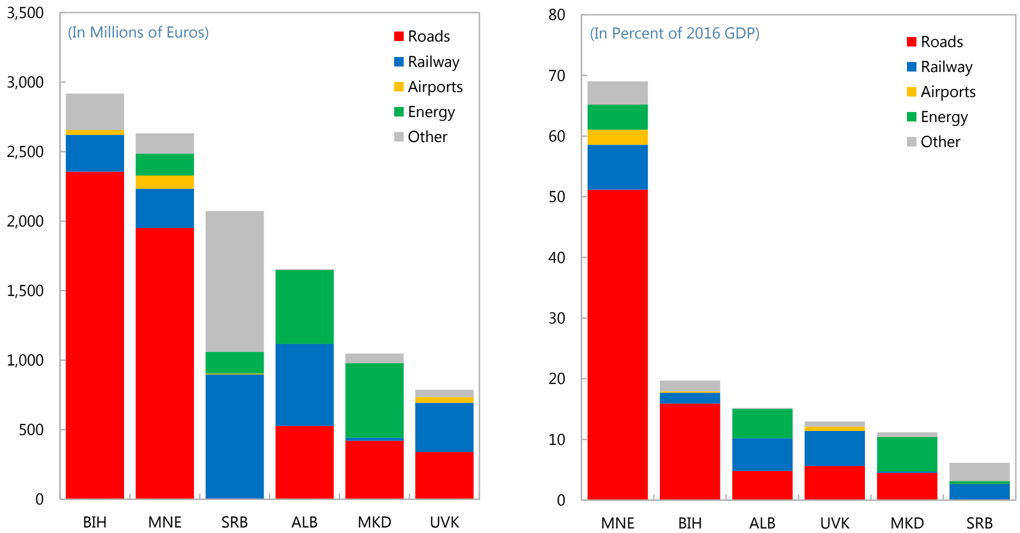


Sources: Fiscal Affairs Database and IMF staff calculations.

C. National Frameworks and Fiscal Space

8. National priorities recognize the critical importance of addressing large infrastructure bottlenecks. In all Western Balkan countries, Single Project Pipelines have been established—in coordination with the EU institutions—to identify priorities and seek financing for projects aimed at addressing the existing infrastructure gaps. The scale and focus of the national pipelines vary significantly but the overall focus on improving transport infrastructure (especially roads and railways) and upgrading energy generation capacity is prominent in the region (Figure 6). For Serbia, top projects in the Single Project Pipeline include railway, energy, and waste management investments. The overall cost of top projects, at about 7 percent of GDP, is relatively low compared to regional peers.

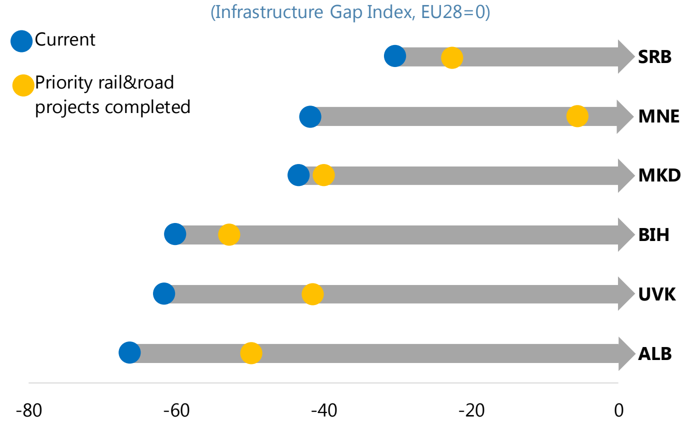
Figure 6. Top 15 Projects in National Single Project Pipelines



Source: National authorities, WEO, and IMF staff calculations.

9. Implementation of priority projects would help significantly reduce infrastructure gaps. Back-of-the-envelope calculations suggest that full completion of rail and road projects alone would close on average about a quarter of the current infrastructure gaps of countries in the region (Figure 7).[5] For Serbia, the estimated impact of implementing these projects would entail about 8 percentage points improvement, reducing the overall public infrastructure gap vis-à-vis EU countries: from 30½ percent to 22½ percent. Furthermore, completion of envisaged projects in such areas as energy, airport, and waste management would help to further close Serbia's remaining infrastructure gaps, albeit these are more difficult to quantify.

Figure 7. Estimated Impact of Priority Projects on Infrastructure Gaps
(Infrastructure Gap Index, EU28=0)



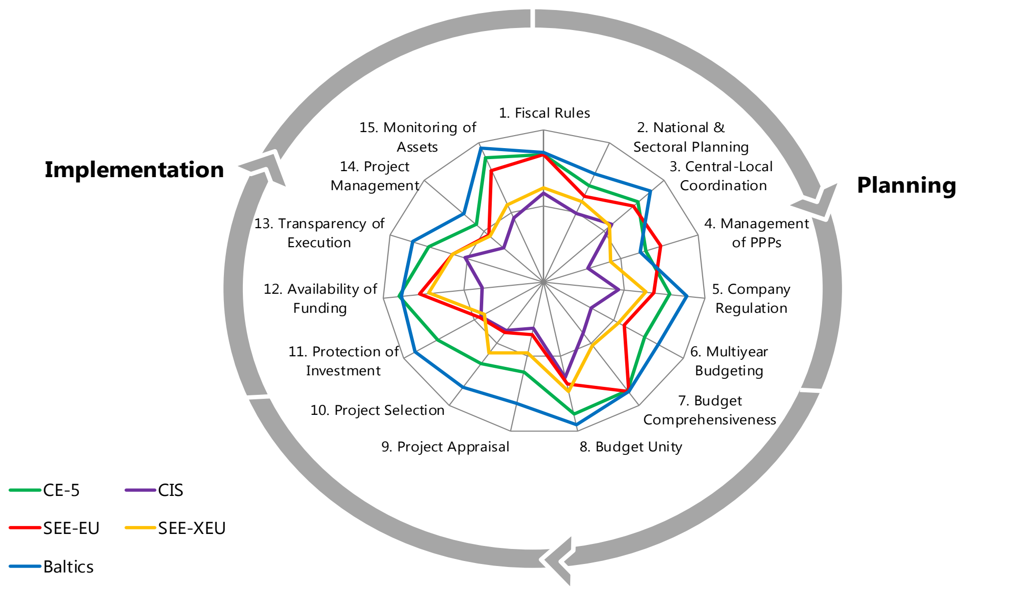
Sources: Sources: WDI, EIA, IRF, Eurostat, and IMF staff calculations.

[5] Calculations for Montenegro suggest a much larger reduction of the infrastructure gaps on account of implementing priority rail and road projects. This needs to be taken with a grain of salt, however, as the country's project pipeline includes projects that are likely to be economically unviable and fiscally unsustainable.

10. The public investment management framework, however, needs to be strengthened to realize the gains of public spending on infrastructure. Public investment can be an important catalyst for economic growth, but the benefit of additional investment depends crucially on its efficiency. For Western Balkan countries, Public Investment Management Assessments (PIMA) carried out by the IMF point to significant institutional weaknesses of public investment management practices (Figure 8). For Serbia, these weaknesses are pronounced along all three dimensions (Box 1): (i) planning sustainable investment across the public sector; (ii) allocating investment to the right sectors and projects; and (iii) implementing projects on time and on budget. More precisely, coordination between ministries and agencies during the planning phase are highly fragmented and burdened by the lack of an overarching national investment strategy, making it difficult to efficiently prioritize projects. Resource allocation is also undermined by insufficient budgetary coverage, with significant capital spending undertaken by SOEs usually not included in budget documentation. Information on multiannual capital costs in the Fiscal Strategy report is limited. There is no centralized data base of investment projects and limited information on total lifetime costs poses difficulties for tracking overruns and delays. Protection of resources allocated to projects during implementation phase is also not assured, and monitoring of implementation is weak. Ex-post audit is confined to externally financed projects and ex-post reviews are generally not undertaken by the government.

11. On the positive side, Serbia has made efforts to improve the management of PPP projects and budget comprehensiveness. In 2016, amendments to the 2011 Law on PPPs and Concessions sought to harmonize PPP legislation with EU standards, as well as to provide a more active role of the Ministry of Finance in coordination, selection and approval of PPP projects at the national level. The PIMA recommendation of strengthening budget comprehensiveness has been implemented, with all project loans being brought on budget in the 2017 cycle.

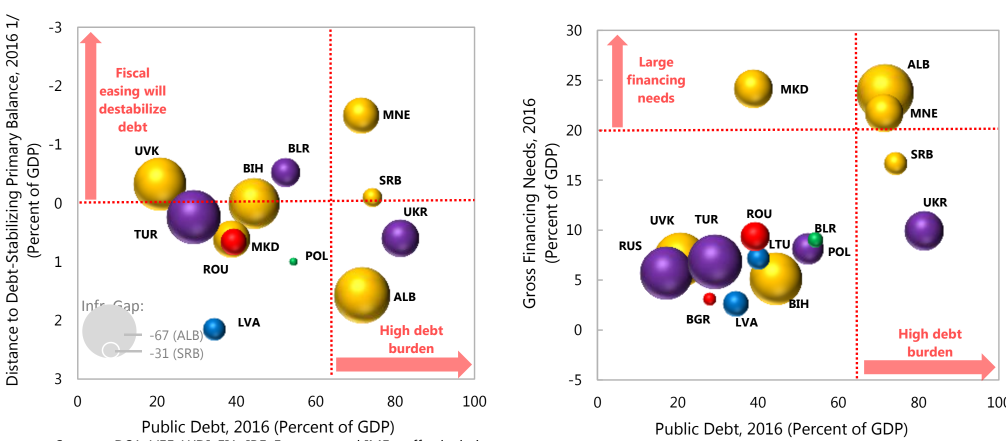
Figure 8. Strength of Public Investment Management by Institution



Source: FAD PIMA database; IMF staff calculations.

12. Fiscal space is limited, making the closure of the gaps more challenging. High debt burdens, sensitivity of debt dynamics to fiscal easing, and large financing needs of the public sector make it difficult for Serbia and other Western Balkan countries to significantly increase infrastructure spending (Figure 9). This highlights the importance of sustained fiscal consolidation for creating room for critical infrastructure investment. Moreover, out of average annual general government spending of 44 percent of GDP over the last decade, capital spending was only slightly above 3 percent of GDP. Thus, the priority should be given to improving the structure of budgetary spending by shifting expenditure away from current spending and more towards capital spending. Also, the use of PPP investments—which has

Figure 9. Fiscal Space and Infrastructure Gaps



Sources: DSA, VEE, WDI, EIA, IRF, Eurostat, and IMF staff calculations.
1/ Computed as a difference between actual (cyclically-adjusted) and debt-stabilizing primary balances.

been limited throughout the region—can be increased, conditional on improvements of the PPP management framework.

Box 1. Public Investment Management Assessment (PIMA)

The PIMA TA mission (April 2016) indicated that there was considerable room for improvement in the efficiency and productivity of public investment in Serbia. Key recommendations to strengthen PIM included:

- Development of a national planning framework to ensure coordination between all public bodies, including the clarification of their roles and responsibilities in this process;
- Establishment of a single pipeline for investment projects to reinforce prioritization;
- Including a more comprehensive list of the largest public investment projects in the annual budget documentation, as well as multiannual capital spending levels over the budget and two subsequent years broken down by spending units.
- Creation of a database of large investment projects in the Ministry of Finance to help monitor and report physical progress in the projects;
- Systematic ex-post audits and more frequent ex-post reviews; and
- Tasking a suitable authority with the stock-taking, valuation and reporting of the stock of public immovable assets.

D. Simulations: Surge in Public investment

13. **Model-based simulations of a surge in public investment—calibrated to the size of Serbia's Single Project Pipeline—provide a useful framework for assessing the dynamics of key variables under different scenarios** (Figure 10).[6]

- **The domestic financing (baseline) scenario** assumes that the surge is financed by domestic bank borrowing. Under this scenario, growth dividends are likely to be muted (less than 0.1 percentage points increase in annual growth rate compared with current projections) as the boost to aggregate demand arising from higher public investment is offset by crowding out of private investment and feebler domestic consumption (weakened by increased taxing of consumption needed to service the new debt). The debt burden is likely to increase rapidly (peaking at about 78 percent of GDP), leaving debt vulnerabilities high throughout the foreseeable future.
- **The improved policies scenario** assumes that the surge in public investment is coupled with improved efficiency of public spending (by bringing public investment management frameworks to par with those in CE-5 countries) and greater regional coordination (improving returns on public investment). Under this scenario, growth dividends are somewhat higher, but

[6] Based on a computable general equilibrium model with economic growth as an endogenous variable (see Buffie et al, 2012).

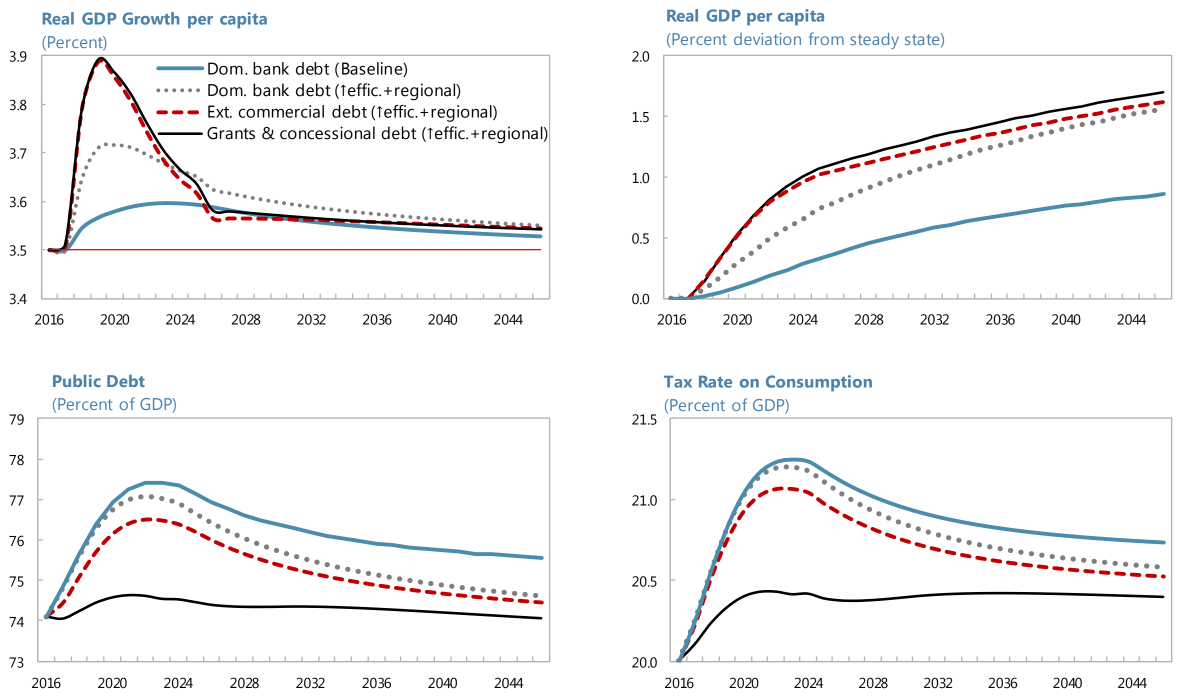
while debt ratios come down a little faster than under the baseline, debt-related vulnerabilities are likely to remain high through the medium-term.

- **The external financing scenario** assumes both improved policies, and that these facilitate access to external financing at lower costs and longer maturities. Under this scenario, private investment crowding out would be avoided, thus significantly improving the growth outlook (almost 0.5 percentage points higher medium-term growth rates than current projections). Debt rises by less than in the first two scenarios, but vulnerabilities remain.

- **The concessional financing scenario** assumes that the surge in public investment is financed by a 50/50 mix of grant financing and concessional IFI financing. This is the most favourable scenario as it would eliminate both the crowding out of private investment and the need to significantly increase the tax burden on the economy (the investment surge is essentially self-financed, as far as the country is concerned). Importantly, this combination of grant/concessional financing and higher growth would effectively eliminate any increase in debt overhang due to the surge.

14. Public infrastructure development is likely to speed up income convergence. The analysis suggests that an appropriately designed and regionally coordinated public infrastructure development, coupled with strengthening of public investment management frameworks, could significantly increase per capita income. Under the most favourable scenario, full implementation of projects already in Serbia's national pipeline would imply a long-term improvement in the level of real GDP per capita close to 2 percentage points above what would have been achieved under the steady state. Keeping in mind that additional investments would be needed to fully close the infrastructure gaps, the speeding up of Serbia's income convergence could be very significant.

Figure 10. Public Investment Surge Simulations 1/



Source: IMF staff calculations.
1/ Assumes a cumulative increase in public investment of 7 percent of GDP spread over seven years; macroeconomic parameters are calibrated to Serbia's 2016 levels; public investment efficiency is calibrated to average SEE-XEU (baseline) and CE-5 (high efficiency) levels; return on public investment is 20 percent (baseline) and 25 percent (regional coordination).

E. Conclusions and Policy Recommendations

15. Serbia faces significant public infrastructure gaps, constraining private sector development and integration into European supply chains and posing headwinds to faster income convergence. Scaling up public investment rates, however, is likely to prove challenging due to Serbia's limited fiscal space and weaknesses in the public investment management framework. In this context, a four-pronged approach is likely to be most effective:

- First, Serbia needs to continue making progress on fiscal consolidation and containing current spending to reduce risks to debt sustainability, lower funding costs, and, create room for critical infrastructure spending.

- Second, consorted efforts are needed to strengthen public investment management frameworks to improve Serbia's planning, allocation, and implementation capacities and therefore ultimately reduce waste and improve efficiency of public and PPP investments.

- Third, greater regional coordination in developing infrastructure would help maximize growth returns on investment, improve the region's investment attractiveness and European integration,

- Fourth, while to a large extent outside Serbia's control, much larger allocations of grants and concessional financing from the EU, other bilaterals and the IFIs would strongly improve growth dividends while maintain fiscal sustainability – but only if combined with improved investment allocation and management.

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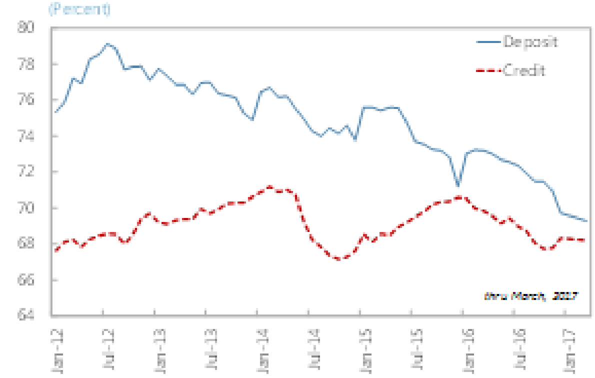
Annex IV. Serbia's Dinarization Process: Remaining Challenges and Recommendations

A. Recent Dinarization Trends

1. **The degree of euroization in Serbia remains high.** Although there has been some progress in recent years, Serbia remains one of the most financially euroized countries in South-Eastern Europe. At the end of 2016, about 70 percent of total bank deposits and loans were denominated or indexed to foreign currency. Moreover, almost 80 percent of total public debt is denominated in foreign currency. This high degree of euroization poses financial stability risks and affects monetary policy transmission mechanisms.

Deposit and Credit Euroization
(Percent)

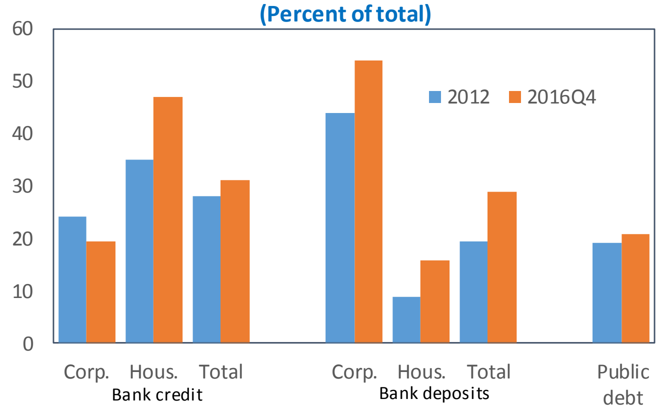


Sources: National Bank of Serbia (NBS); IMF staff estimates.

2. **A dinarization strategy was launched in 2012.** The strategy was built on three pillars: (i) strengthening the macroeconomic environment by delivering low and stable inflation; (ii) developing the market for dinar securities; and (iii) developing a market for foreign exchange hedging instruments. Macroeconomic imbalances have been reduced drastically and inflation has remained moderate on the back of an inflation targeting regime with a relatively stable exchange rate, coupled with fiscal discipline. The NBS has introduced several measures to promote dinarization, including higher reserve requirements on, and lower remuneration of, FX deposits; requirements of partial dinar funding for reserve requirements on FX deposits; and prudential debt service-to-income ratios differentiated by currency and borrower's income level. Meanwhile, the Ministry of Finance has increased the share of debt in domestic currency, by issuing dinar securities at lengthened maturities.

3. Additional efforts are needed to ensure a gradual yet sustained dinarization process. The dinarization strategy has brought some positive results, but progress has been uneven. The share of local currency deposits has increased by almost 10 percentage points since 2012. However, dinarization of household deposits remains very low, at only 15 percent of total deposits. Although dinarization of consumer loans has increased by almost 10 percentage points to over 45 percent, mortgages remain fully in foreign currency, and the share of corporate loans in dinars remains low at only 20 percent of the total. Moreover, based on estimates of the "natural" level of euroization, Serbia has sizable room to de-euroize, since euroization exceeds the level expected given the country's size, openness and degree of financial integration and development.

Dinarization Indicators
(Percent of total)



Source: National Bank of Serbia.

B. Policy Recommendations

4. Recent IMF technical assistance highlighted key measures to update and strengthen the dinarization strategy.[1] The report examined the main drivers of euroization in Serbia to inform a broad set of recommendations. These range from (i) macroeconomic policy measures aiming at protecting the value of the local currency for savers; (ii) measures to promote the development of key markets (money and security markets in dinars, foreign exchange risk hedging market); and (iii) prudential measures to promote bank funding in dinars and to ensure unhedged borrowers fully internalize foreign exchange risk.

5. Relative exchange rate stability has been an important component of the dinarization strategy's first pillar. Stable and low inflation and broad exchange rate stability has boosted confidence in the dinar, thereby reducing the attractiveness of FX deposits to preserve purchasing power or as a hedge against currency depreciation. To the extent that macroeconomic stability is maintained over time, the insurance value FX deposits should decline further. At the same time, excessive and protracted exchange rate stability may also promote complacency about FX risks among unhedged borrowers and fuel loan euroization.

[1] See IMF (2017).

6. The transition to full-fledge inflation targeting with increased exchange rate flexibility will help support dinarization further. There is an extensive literature on euroization (or, more generally, dollarization) explaining why high levels of euroization may persist even after price stability has been achieved and maintained for several years, due to the portfolio responses of risk-averse agents.[1] Increased exchange rate volatility in the context of low and stable inflation would promote two-way risks in FX markets, weakening one-way bets and fostering dinar deposits based on economic agents' optimal portfolio decisions. It would also encourage borrowers to fully internalize FX risks.[2] The transition towards higher exchange rate flexibility, however, should be gradual considering several factors: still entrenched depreciation expectations; large unhedged FX positions by borrowers; and still high—although declining—exchange rate pass-through to inflation. The timing and modalities of this transition should strike a balance to address financial stability risks on the one hand, while on the other to prevent excessive delays that may increase complacency vis-à-vis FX risks and encourage large unhedged positions.

7. Greater efforts to support the development of dinar and foreign exchange markets are needed. The NBS should calibrate open market operations to target neutral liquidity allotment. More balanced liquidity conditions would help support the development of secured and unsecured interbank markets, as well as secondary markets in government securities. Legal impediments to the development of repo and derivatives markets should be tackled. Strengthening local currency government bond markets, by issuing retail bonds and further extending the yield curve, would provide a benchmark and facilitate bank funding and pricing of long-term loans in dinars. The development of a market for bank bonds in dinars would provide banks with term funding in local currency and allow them to extend fixed-rate dinar loans, reducing liquidity risks and maturity mismatches. Finally, there is scope for deepening the FX market and developing the FX risks hedging market.

8. Prudential measures to promote banks' funding in local currency and to address underpricing of FX risk by unhedged borrowers would help deepen dinarization. These measures would enhance the resilience of banks to FX risks, facilitating the transition to a monetary policy increasingly oriented toward price stability and less focused on exchange rates stabilization. They should also increase the incentives to internalize FX risks. Although several measures are already in place, some adjustments could be introduced:

[1] Specifically, the minimum variance portfolio (MVP) model (Ize and Levy-Yeyati, 2003) implies that if the volatility of real exchange depreciation is lower than that of inflation, savers would prefer to hold foreign currency deposits.

[2] The empirical literature on the impact of exchange rate flexibility on de-euroization (or de-dollarization) is vast. A recent paper (IMF, 2016) examines this impact for a sample of 33 EMEs during 1997-2015, finding that higher volatility indeed supports the de-dollarization process. Kokenyne et al. (2010) show that "two-way" exchange rate volatility fosters de-dollarization by rendering foreign exchange risk more apparent. García-Escribano and Sosa (2010) and Luca and Petrova (2007) find similar results for a sample of Latin American and transition economies, respectively.

- Raising remuneration of reserve requirements in dinars to levels above the deposit facility rate, and reducing remuneration of FX required reserves to the level of ECB deposit facility rates (even if negative) to eliminate the implicit subsidy of FX deposits.
- Increasing the marginal reserve requirement ratio on FX deposits for banks with a share of FX deposits exceeding a certain threshold.
- Adjusting the deposit insurance scheme to increase the maximum amount of guaranteed deposits in dinars compared to that of foreign currency deposits.
- Adopting a definition and classification of hedged/unhedged borrowers and differentiating them in the application of prudential measures.
- Re-introducing maximum debt-servicing cost-to-income ratios and adopting higher risk weights on foreign currency loans for unhedged borrowers.

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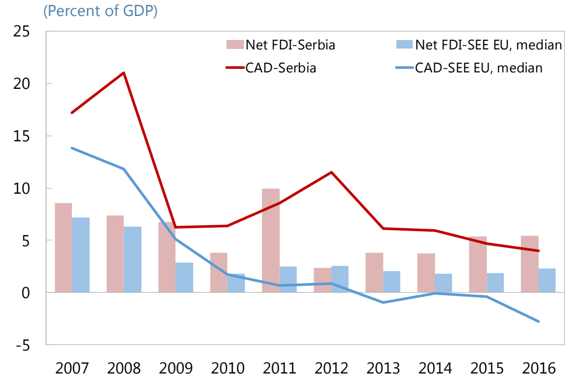
Kokenyne, A., J. Ley, and R. Veyrune, 2010, “Dedollarization,” *IMF Working Paper* 10/188 (Washington: International Monetary Fund). http://www.imf.org/external/pubs/ft/wp/2010/wp10188.pdf

Luca, A., and I. Petrova, 2008, “What Drives Credit Dollarization in Transition Economies?” *Journal of Banking and Finance*, Vol. 32, pp. 858–69.

Annex V. External Sustainability Assessment

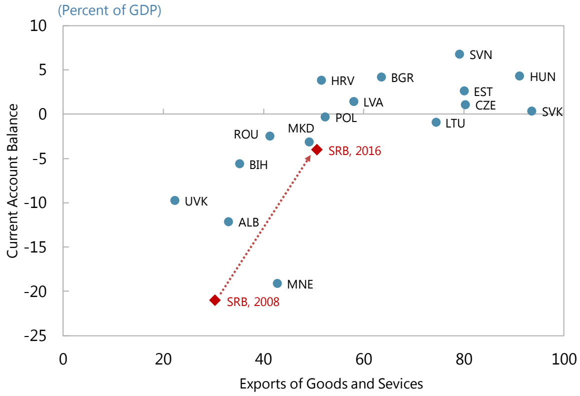
1. Serbia's external sector has undergone significant adjustments since the aftermath of the global financial crisis, although there is room for further improvement. The current account deficit has continued to narrow since the 2008 global financial crisis and the exchange rate has partially recouped its losses. By end-2016 Serbia's current account deficit shrank to just
4 percent of GDP compared to a high
21 percent of GDP in 2008, owing mainly to higher exports. FDI has increased and, in the last two years, fully covers the current account deficit. Private remittances remain significant and stood at 7½ percent of GDP in 2016, down from its crisis peak of 10 percent of GDP. The exchange rate has stabilized significantly in recent years.

Current Account Deficit and Foreign Direct Investment
(Percent of GDP)



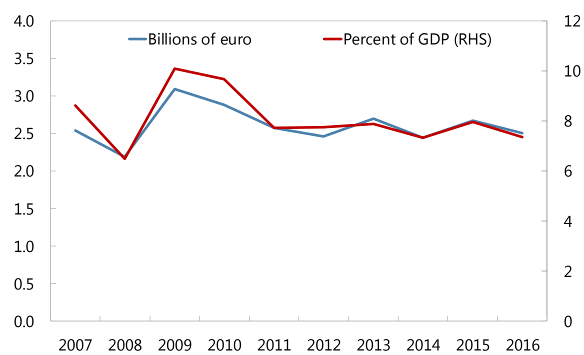
Sources: Country authorities' data; IMF, WEO database; and IMF staff calculations.

Current Account and Exports of Goods and Services, 2016
(Percent of GDP)



Source: IMF, WEO database.

Serbia: Private Remittances

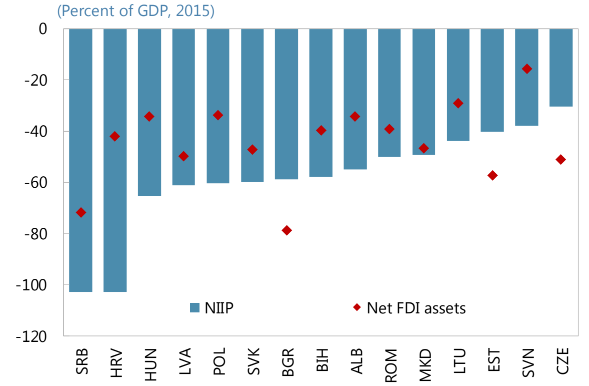


Sources: Country authorities' data.

2. Serbia's net international investment position (NIIP) is high but it favorable composition mitigates external vulnerabilities. Serbia's NIIP is estimated at -104 percent of GDP in 2016 and is much more negative than the average for countries in the region (-55 percent of GDP). While total gross external debt of 82 percent of GDP in 2016 remains high and poses a vulnerability (see Annex VI), there are several mitigating factors. First, nearly all net foreign liabilities in Serbia are of long-term liabilities rather than short-term. The recent increase in Serbia's net foreign liabilities has been driven by robust buildup of foreign direct investment where net FDI liabilities stood at
76 percent of GDP in 2016. Second, much of recent FDI inflows have been diversified in term of origin, and focused in export-oriented industries. Third, while Serbia's NIIP is larger than the threshold of

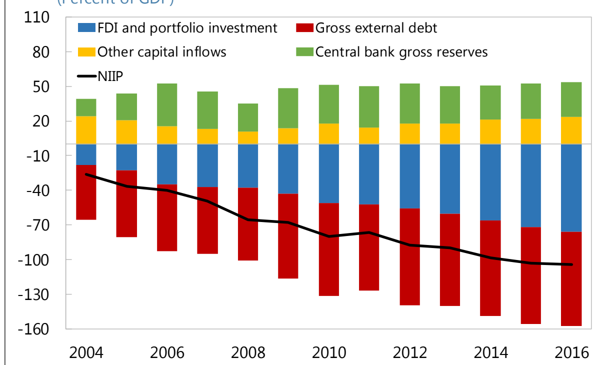
50 percent of GDP in absolute terms, which according to Catao and Milesi-Ferretti (2013) [1] is a significant crisis predictor, its net foreign *debt* liabilities estimated at 29 percent of GDP for 2016 is below the estimated tipping point of 35 percent of GDP. Finally, Serbia's has an ample international reserve position with official reserves around the top of the recommended bounds of the IMF reserve adequacy metric.[2]

Net International Investment Position
(Percent of GDP, 2015)



Sources: IMF, BOP and IIP database; IMF, WEO database; and IMF staff calculations.

Serbia: Net International Investment Position
(Percent of GDP)

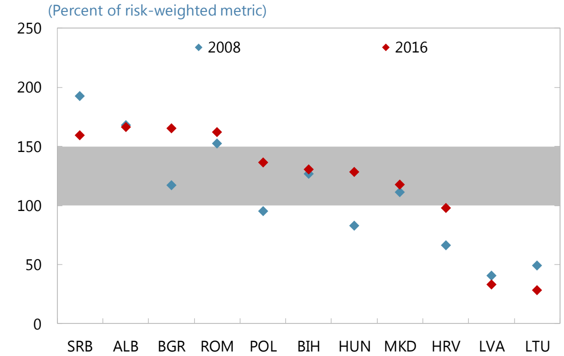


Sources: IMF staff calculations and country authorities' data.

3. **The EBA-Lite methodology suggests that the external position is broadly consistent with fundamentals and desirable policy settings, but subject to vulnerabilities.** Special consideration is given to the external sustainability (ES) approach due to the Serbia's large negative NIIP position.

- **The external stability (ES) approach** applied here focuses on the scenario where the goal is to bring the NIIP close to regional average of -

International Reserves
(Percent of risk-weighted metric)



Source: IMF staff calculations.

[1] See Catao, L.A.V. and G.M. Milesi-Ferretti (2013), "External Liabilities and Crises," IMF Working Paper WP/13/113. The paper finds not only that a ratio of NIIP to GDP that exceeds a threshold of 50 percent in absolute terms is a significant crisis predictor, but also that such a tipping point is typically associated with net foreign debt liabilities above 35 percent of GDP. Consistent with the definition in the paper, net debt liabilities are defined as the difference between debt assets (portfolio debt securities, other investment and foreign exchange reserves) and debt liabilities.

[2] Gross reserves at end-2016 correspond to 159 percent of the ARA metric (assuming Serbia returns to a floating exchange rate classification) and 136 percent of the ARA metric (assuming the current stabilized de facto exchange rate classification). Reserves in the range of 100-150 percent of the composite metric are considered adequate for precautionary purposes. See IMF, "Assessing Reserve Adequacy", 2011 and "Assessing Reserve Adequacy-Further Considerations", 2013.

55 percent of GDP over a 20-year horizon[3]. This would require a somewhat lower current account deficit of 2½ percent of GDP and a slightly more depreciated exchange rate by 3½ percent. Staff views the exchange rate gap well within the margin of error but a stronger current account position would help to further mitigate external vulnerabilities.

EBA-Lite Estimates of Current Account Norm and Exchange Rate Gap

	External Sustainability 1/	Current Account	Real Effective Exchange Rate
Underlying current account	-3.7	-4.0	-
Current account norm	-2.6	-7.9	-
REER gap	3.6	-12.5	3.0

Note: For the ES approach the underlying CA is the 2022 projected one. For the CA and REER the underlying CA is the 2016 one.
1/ Stabilizing NIIP at -55% of GDP in 20 years.

- **The current account (CA) approach** estimates Serbia's current account norm at -8 percent of GDP, suggesting an exchange rate undervaluation of 12½ percent. However, Serbia's NIIP position of -104 percent of GDP is an input into this calculation, leading to a higher current account norm[4]. The most significant contributors to the high current account deficit are Serbia's (i) high old age dependency ratio; (ii) aging speed (interreacted with the relative dependency ratio); and (iii) its low productivity relative to others. These fundamentals suggest lower savings and a higher current account deficit. This underscores the importance of generating sufficient public savings now, as the fiscal costs of an aging population may further exacerbate the external vulnerabilities in the future. Staff's view is that a current account norm of -8 percent of GDP is likely overestimated, as Serbia should lower its debt-related external vulnerabilities in the medium-term, and that the undervaluation indicated by the CA approach should be discounted accordingly.

[3] Given that FDI liabilities comprise a larger share of the net international investment position in Serbia relative to the region, bringing Serbia's net foreign liabilities down to the regional average may not be feasible.

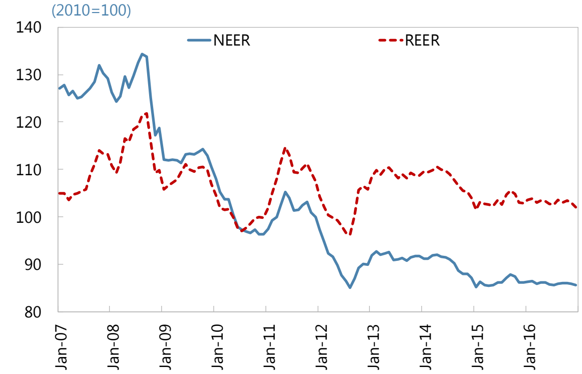
[4] The regression behind this model suggests a small positive coefficient between NFA and current account putting more weight on the theory that high external liability position suggest higher income expenses and, therefore, higher current account deficit.

- Consistent with the ES approach, **the real effective exchange rate (REER) approach** also points to the need for a slightly more depreciated exchange rate (again, with the extent of any overvaluation being within the margin of error).

4. Further reducing the share of net foreign *debt* liabilities in Serbia's NIIP position requires continuous effort to reduce the current account deficit, attract foreign investment and improve competitiveness. In staff's view, this could be achieved by structural reforms that can increase the currently low labor productivity and export competitiveness and widen the narrow export base. Furthermore, continuing with reforms to ease doing business would help attract more foreign direct investment, which could also increase the productivity of the tradable sector. These reforms should be supported by a prudent fiscal policy over the medium term to increase public savings and preserve wage competitiveness.

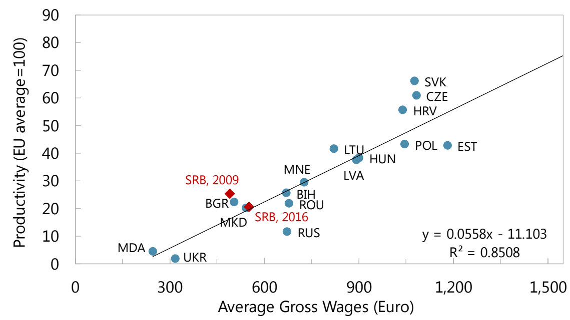
Serbia: Nominal and Real Effective Exchange Rate

(2010=100)



Source: IMF, INS database.

Wages and Labor Productivity, 2016 1/



1/ EU average = 100 (excl. Luxemburg), productivity calculated using 2016 IMF WEO projections for GDP.

Sources: Haver Analytics; IMF, World Economic Outlook; and IMF staff calculations.

Annex VI. Public Debt Sustainability Analysis

Staff assesses Serbia's public debt to be sustainable. The sizable fiscal adjustment achieved in 2015 and 2016 has reversed the persistent increase in public debt since the aftermath of the global financial crisis. However, the Public Debt Sustainability Analysis also indicates the existence of significant vulnerabilities of debt dynamics to various shocks scenarios. This is due to the still high public debt levels, large gross financing needs, and the large share of foreign currency denominated debt. Maintaining the recent downward path in public debt requires continued fiscal discipline and delivering on structural reforms that will contribute to higher real growth.

1. The persistent upward trajectory of general government debt has been reversed in 2016, owing to sizable fiscal adjustment achieved under the current program. General government debt followed a sharp upward trajectory since the global financial crisis, reaching a high 76 percent of GDP in 2015-more than double its 2009 level. Expansionary fiscal policies, sluggish output growth, a rise in government guarantees to large SOEs and local governments, high real interest rates and a significant exchange rate depreciation (especially in 2014 with respect to the U.S. dollar), all were significant contributors to increase. As of 2016, about 6½ percent of GDP of Serbia's public debt consists of government guarantees to large SOEs and local governments. External public debt accounts for 60 percent of the total, while more than 75 percent is denominated in foreign currencies (Figure 4). Most external debt is owed to multilateral and bilateral creditors (61 percent of total external public debt), which has helped Serbia keep interest costs relatively low. However, the share of market debt has been increasing rapidly since the first eurobond issuance in 2011 Domestically-issued debt, dominated by T-bills and T-bonds with maturities above 12 months, increased as a share of total debt significantly over the last five years.

2. The DSA analysis is based on the macroeconomic assumptions under the program scenario. Real GDP grew by 2.8 percent in 2016, more than projected in the last DSA. A further increase is projected in the medium term to about 4 percent, partly reflecting confidence effects of fiscal consolidation and structural reforms. Inflation is expected to stay within the NBS tolerance band. The primary balance recorded a surplus of 1.8 percent of GDP in 2016, 0.8 percentage points higher than envisaged under the last DSA, and reversing the deficit trend observed since 2008. To continue building on this successful momentum, the program now envisages a primary account surplus of 2 percent of GDP for 2017 (0.7 percentage point of GDP higher compared to the last DSA). This is to be supported by expenditure restraint, notably through wage and pension bill rationalization, and reduced state aid to SOEs. The current account deficit was 4 percent of GDP in 2016, an all-time low since 2003, financed mainly by higher FDI inflows.

3. Serbia faces risks to debt sustainability despite the significant fiscal adjustment assumed in the baseline scenario (Figure 1). Even though Serbia's public debt is estimated to go down from its current level of 74 percent of GDP to 54 ½ percent of GDP by

2022, public debt and gross financing needs are still high and; thus, still exhibits vulnerabilities under all shock scenarios. Gross financing needs are projected at 13 percent of GDP in 2022, a significant improvement compared to the last DSA owing to strong fiscal adjustment observed under the program and longer term debt maturity structure (Figure 3). However, in 2020 and 2021, two large Eurobonds will come to maturity, leading to gross financing needs of 15 and 14 percent of GDP, respectively, where 15 percent is considered to be a benchmark level for emerging markets. Specifically, the debt profile is susceptible to real growth shocks and exchange rate fluctuations due to the large share of public debt denominated in foreign currencies. The debt fan charts also illustrate the risks related to different shocks with emphasis on the impact of interrupted fiscal adjustment as illustrated by the asymmetric distributions charts that results from assuming no positive shocks to the primary balance.

6. **Past forecast errors were caused by exogenous shocks, but also weaker fiscal discipline (Figure 2).** Real GDP growth was lower than anticipated in 2009, due to a sharp output contraction amid the global financial crisis, and later in 2012 and 2014 due to severe weather shocks that affected agricultural and industrial output. However, the unexpectedly large primary fiscal deficits in 2012 and 2014 were driven mainly by bank recapitalization and resolution costs. In 2012, slippages due to election spending also contributed to the large primary fiscal deficit. For comparison of growth and levels of output in absence of fiscal adjustment, the DSA assumes a medium fiscal multiplier of 0.5 which seems more appropriate for economies that are smaller and more open. This assumption is also more in line with multipliers observed by other emerging economies in the region[1]. However, evidence from VAR analysis suggests multipliers in Serbia could be lower still, or even negative (see Box 2).

7. **The fiscal adjustment under the program has been sizeable, as indicated by the fact that Serbia is in the top quartile of fiscal adjustments observed during 1990–2011 for advanced and emerging economies with debt greater than 60 percent of GDP (Figure 2)**. The total structural adjustment in 2015-16 was already large at about 4.4 percent of GDP. A primary surplus of 1.8 percent of GDP was recorded in 2016 and going forward it is assumed that this will be maintained.

8. **Vulnerability to real exchange rate and GDP growth shocks are key concerns (Figure 5).** As illustrated by the macro-fiscal stress tests, shocks to GDP growth and the real exchange rate would significantly deteriorate debt and gross financing needs dynamics. If projected real GDP growth for 2018–19 is lower by one standard deviation (3 percentage points lower in both years than in the baseline), the debt-to-GDP ratio would peak at 73.8 percent of GDP by 2019–9½ percent of GDP higher than under the DSA baseline scenario. In addition, the large share of foreign currency debt gives rise to significant vulnerabilities to currency

[1] See 2014 FAD paper on "Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections."

depreciations. A 13 percent real depreciation would push public debt to 73 ½ percent of GDP in 2018, an increase of nearly 5 ½ percent of GDP compared to the baseline scenario.

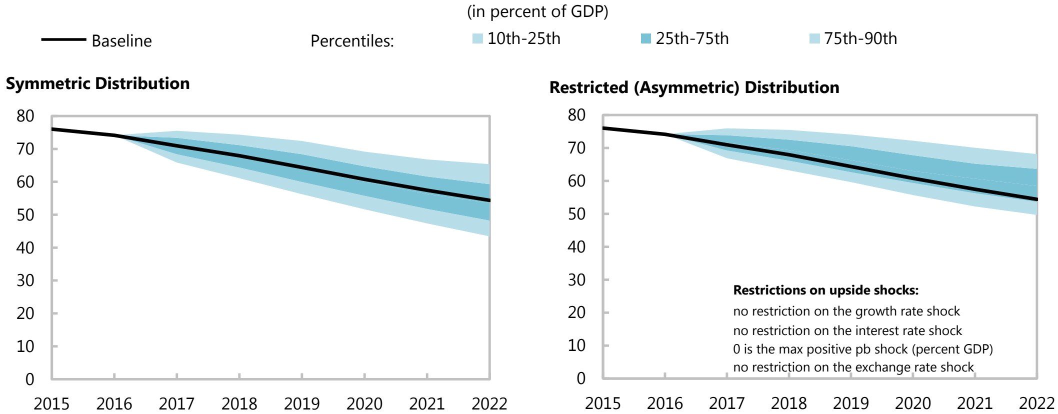
Figure A.1. Serbia: Public DSA Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

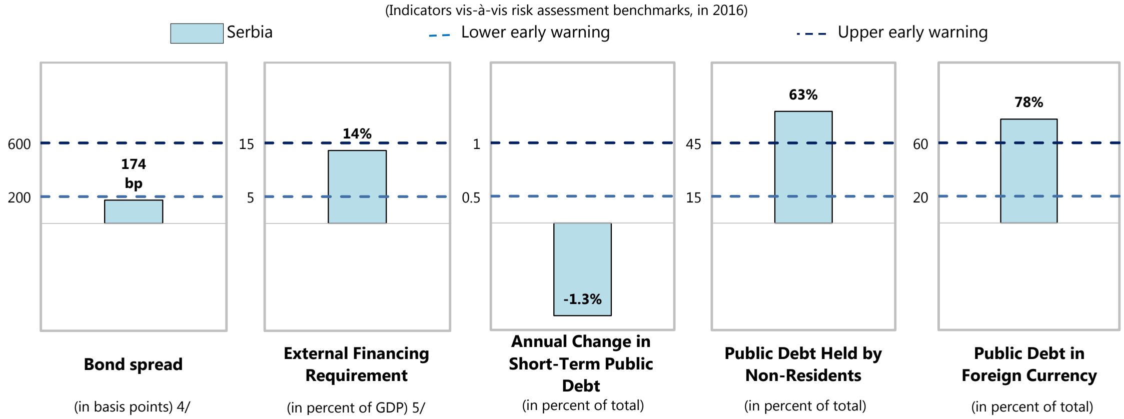
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

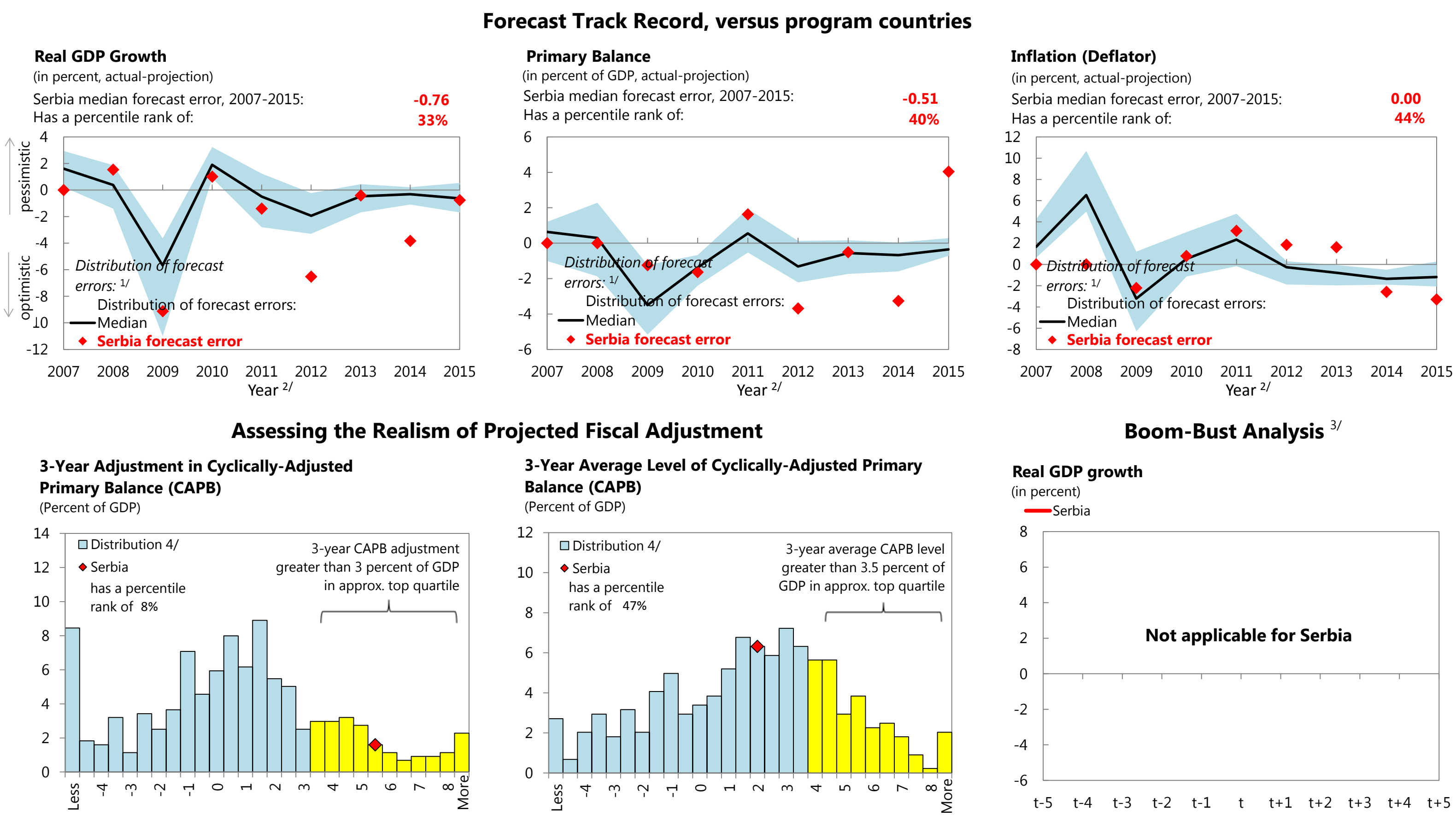
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 10-Mar-17 through 08-Jun-17.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure A.2. Serbia: Public DSA-Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes program countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Serbia, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure A.3. Serbia Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

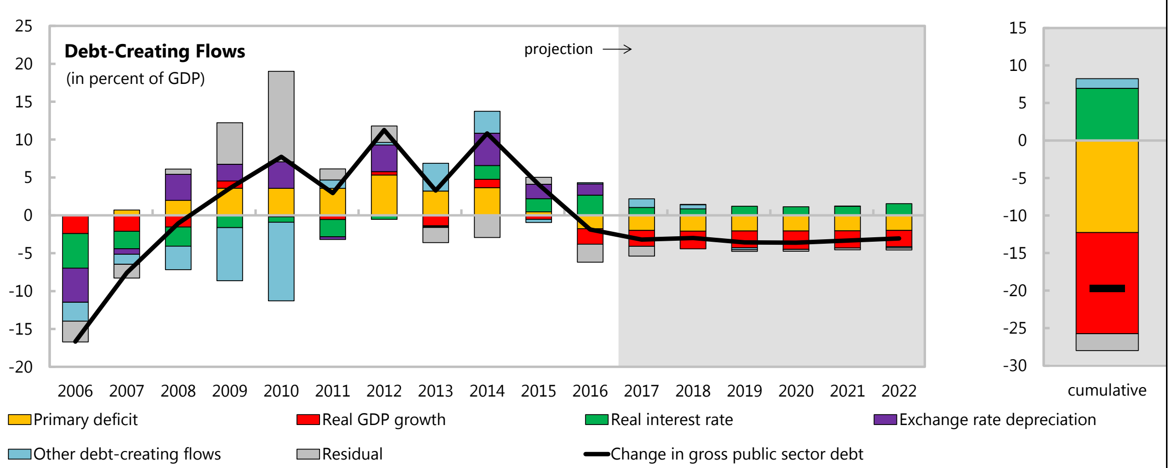
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2006-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	47.1	76.0	74.1	70.9	67.9	64.4	60.8	57.4	54.4
Of which: guarantees	5.6	7.2	6.3	5.6	5.3	5.0	4.6	4.3	4.0
Public gross financing needs	10.3	16.5	13.4	12.3	10.6	7.8	15.0	14.1	13.1
Real GDP growth (in percent)	1.6	0.8	2.8	3.0	3.5	3.5	4.0	4.0	4.0
Inflation (GDP deflator, in percent)	7.6	2.7	1.1	2.5	2.8	3.0	3.0	3.0	3.0
Nominal GDP growth (in percent)	9.5	3.5	3.9	5.6	6.4	6.6	7.1	7.1	7.1
Effective interest rate (in percent) [4/]	3.8	5.2	4.7	4.0	4.2	5.0	5.0	5.3	6.0

As of June 08, 2017		
Sovereign Spreads		
EMBIG (bp) 3/		145
5Y CDS (bp)		169
Ratings	Foreign	Local
Moody's	Ba3	Ba3
S&Ps	BB-	BB-
Fitch	BB-	BB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.6	4.1	-1.9	-3.2	-3.0	-3.6	-3.6	-3.3	-3.0	-19.8	
Identified debt-creating flows	0.2	3.2	0.5	-1.9	-3.0	-3.3	-3.4	-3.1	-2.8	-17.5	
Primary deficit	2.8	0.5	-1.8	-2.0	-2.1	-2.1	-2.1	-2.0	-2.0	-12.3	-0.8
Primary (noninterest) revenue and grants	40.1	40.4	42.4	41.8	41.2	40.9	40.7	40.5	40.4	245.4	
Primary (noninterest) expenditure	43.0	40.8	40.6	39.8	39.1	38.8	38.6	38.4	38.4	233.2	
Automatic debt dynamics [5/]	-0.8	3.1	2.1	-1.1	-1.5	-1.0	-1.3	-1.1	-0.6	-6.5	
Interest rate/growth differential [6/]	-2.1	1.2	0.6	-1.1	-1.5	-1.0	-1.3	-1.1	-0.6	-6.5	
Of which: real interest rate	-1.4	1.7	2.7	1.0	0.8	1.2	1.1	1.2	1.5	7.0	
Of which: real GDP growth	-0.6	-0.5	-2.0	-2.1	-2.3	-2.2	-2.4	-2.3	-2.1	-13.5	
Exchange rate depreciation [7/]	1.2	1.9	1.5	…	…	…	…	…	…	…	
Other identified debt-creating flows	-1.8	-0.4	0.2	1.1	0.6	-0.2	0.0	0.0	-0.2	1.3	
Privatization/Drawdown of Deposits (+ red	-2.4	-2.3	-0.9	0.2	-0.1	0.0	0.0	0.1	0.0	0.2	
Contingent liabilities	0.6	1.9	1.1	-0.5	-0.1	-0.1	-0.1	0.0	0.0	-0.7	
Net lending outside budget	0.0	0.0	0.0	1.5	0.7	-0.2	0.1	0.0	-0.2	1.8	
Residual, including asset changes [8/]	1.4	0.9	-2.4	-1.3	0.0	-0.2	-0.2	-0.2	-0.3	-2.2	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

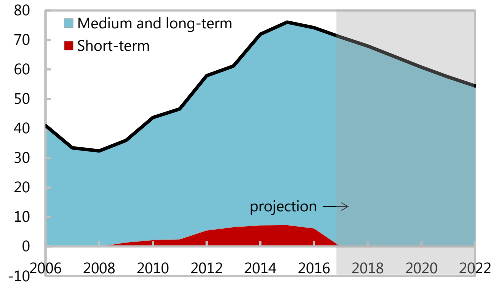
8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

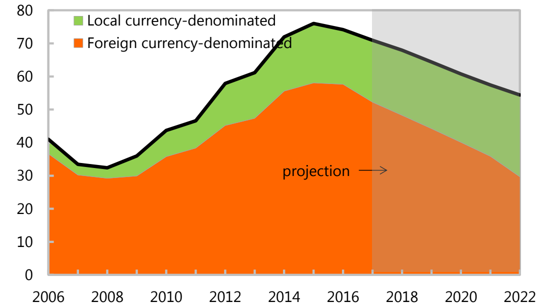
Figure A.4. Serbia Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



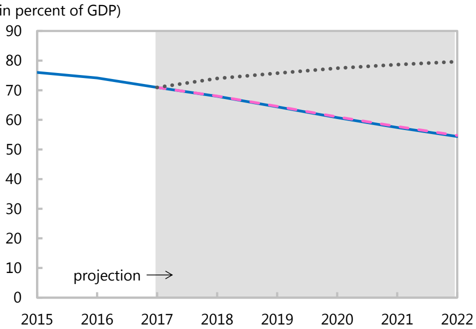
By Currency
(in percent of GDP)



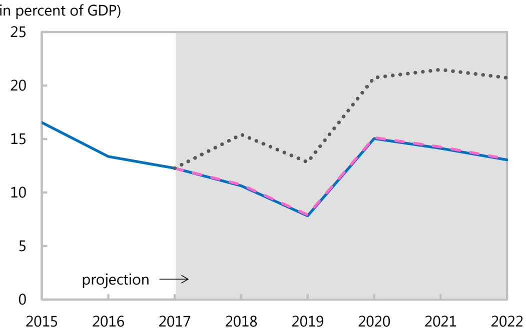
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

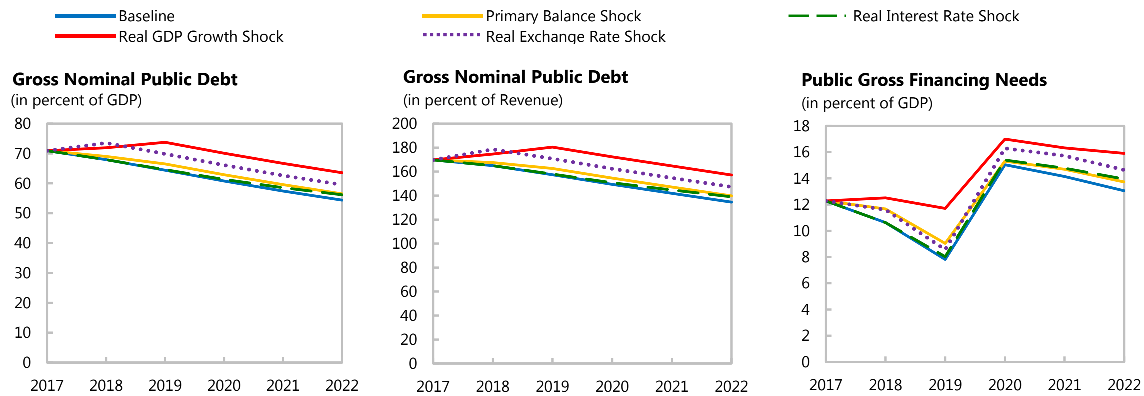
Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.0	3.5	3.5	4.0	4.0	4.0
Inflation	2.5	2.8	3.0	3.0	3.0	3.0
Primary Balance	2.0	2.1	2.1	2.1	2.0	2.0
Effective interest rate	4.0	4.2	5.0	5.0	5.3	6.0
Constant Primary Balance Scenario						
Real GDP growth	3.0	3.5	3.5	4.0	4.0	4.0
Inflation	2.5	2.8	3.0	3.0	3.0	3.0
Primary Balance	2.0	2.0	2.0	2.0	2.0	2.0
Effective interest rate	4.0	4.2	5.0	5.0	5.3	6.0

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.0	1.3	1.3	1.3	1.3	1.3
Inflation	2.5	2.8	3.0	3.0	3.0	3.0
Primary Balance	2.0	-2.4	-2.4	-2.4	-2.4	-2.4
Effective interest rate	4.0	4.2	4.1	3.6	2.9	3.0

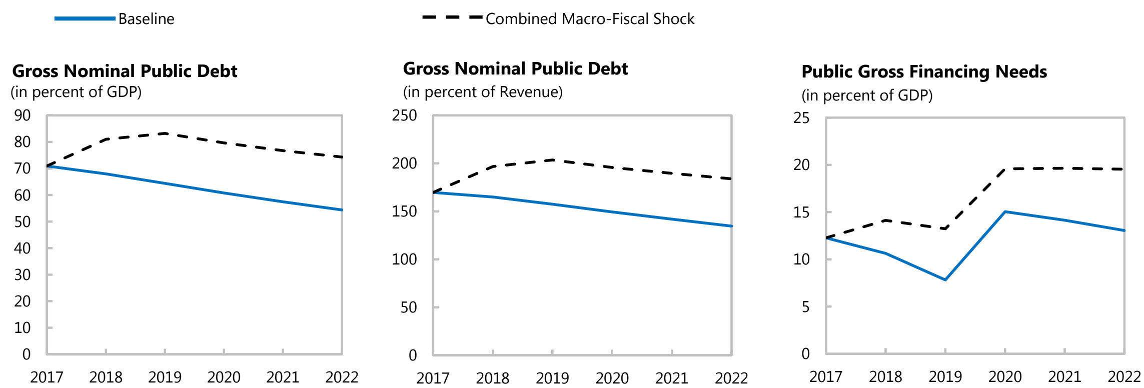
Source: IMF staff.

Figure A.5. Serbia Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2017	2018	2019	2020	2021	2022
Primary Balance Shock						
Real GDP growth	3.0	3.5	3.5	4.0	4.0	4.0
Inflation	2.5	2.8	3.0	3.0	3.0	3.0
Primary balance	2.0	1.1	1.0	2.1	2.0	2.0
Effective interest rate	4.0	4.2	5.0	5.1	5.3	6.0
Real Interest Rate Shock						
Real GDP growth	3.0	3.5	3.5	4.0	4.0	4.0
Inflation	2.5	2.8	3.0	3.0	3.0	3.0
Primary balance	2.0	2.1	2.1	2.1	2.0	2.0
Effective interest rate	4.0	4.2	5.4	5.6	6.3	7.4
Combined Shock						
Real GDP growth	3.0	0.6	0.6	4.0	4.0	4.0
Inflation	2.5	2.1	2.3	3.0	3.0	3.0
Primary balance	2.0	0.7	-0.8	2.1	2.0	2.0
Effective interest rate	4.0	4.6	5.3	5.6	6.3	7.3

	2017	2018	2019	2020	2021	2022
Real GDP Growth Shock						
Real GDP growth	3.0	0.6	0.6	4.0	4.0	4.0
Inflation	2.5	2.1	2.3	3.0	3.0	3.0
Primary balance	2.0	0.7	-0.8	2.1	2.0	2.0
Effective interest rate	4.0	4.2	5.1	5.2	5.4	6.1
Real Exchange Rate Shock						
Real GDP growth	3.0	3.5	3.5	4.0	4.0	4.0
Inflation	2.5	7.2	3.0	3.0	3.0	3.0
Primary balance	2.0	2.1	2.1	2.1	2.0	2.0
Effective interest rate	4.0	4.6	4.9	5.0	5.3	6.0

Source: IMF staff.

Annex VII. External Sector Debt Sustainability Analysis

External debt is assessed to be sustainable over the medium term, but subject to risks. In a scenario of continued fiscal adjustment, the current account deficit would decline further and would be fully financed by foreign direct investment inflows similar to the last two years. This would allow the country to put external debt on a firm downward path over the medium term. External financing needs would nevertheless remain high and constitute a risk. Moreover, the debt path is particularly sensitive to real exchange rate shocks, given that most of the external debt is denominated in foreign currency and given the potential impact of a sizable depreciation on economic activity. A reversal in fiscal adjustment could also deteriorate debt dynamics as interest rates and the current account deficit would increase, and economic activity would likely slow down.

1. **Total external debt has fluctuated on average around 80 percent of GDP since 2010, as private sector deleveraging has compensated for rising public sector external borrowing, but a gradual decrease is projected over the medium-term.** Public external debt has been growing since 2008 but is projected to continue its downward trend since 2016[1]. The private sector in general has been deleveraging since 2010 (after several years of significant net external borrowing) and is expected to maintain this trend throughout the projection period. As fiscal consolidation continues, total external debt and gross financing needs are expected to decrease gradually over the medium term, reaching about 56 and 12.7 percent of GDP respectively by 2022.

2. **The main driver of the projected reduction in external debt is a contraction in the current account deficit.** The current account deficit excluding interest payments has decreased from 3½ percent of GDP in 2014 to only 1.2 percent of GDP in 2016. In the medium term, the current account deficit before interest is assumed to remain stable close this level. FDI is projected to remain above 4 percent of GDP throughout the medium term and interest payments as a share of GDP are projected to gradually decline by a ½ percentage points of GDP by the end of the projection period. Finally, economic growth is expected to recover gradually reaching levels close to 4 percent. As shown in alternative scenarios, if the current account, growth, interest rates, and real exchange rate depreciation remain at historical levels, external debt would be expected to remain on an increasing trajectory throughout the projection period, reaching 91 ½ percent of GDP by 2022.

3. **The external debt path is particularly sensitive to real exchange rate depreciation shocks.** As shown in the shock scenarios, a 30 percent real depreciation would cause external debt to reach 104 percent of GDP during the first year and to stabilize at 81 percent of GDP by 2022.

4. **A reversion in fiscal adjustment measures could also have a significant impact on external debt dynamics.** This could lead to higher current account deficits, higher interest rates

[1] In March Moody's upgraded Serbia's sovereign rating from positive to stable (from B1 to Ba3) citing the notable fiscal consolidation and recent structural reforms that have increased the country's economic resilience to shocks.

and a slowdown in economic activity, a situation illustrated by the combined shock scenario. An exchange rate depreciation, also likely in the absence of fiscal adjustment, would deteriorate prospects of external debt sustainability even further.

Table 1. Serbia: External Debt Sustainability Framework, 2012-2022

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2012	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022	Debt-stabilizing non-interest current account 6/
Baseline: External debt	84.3	79.4	83.1	84.0	81.8			**76.1**	**71.3**	**67.7**	**63.7**	**59.8**	**55.9**	**-5.7**
Change in external debt	9.7	-4.8	3.6	0.9	-2.2			-5.6	-4.8	-3.6	-4.0	-3.9	-3.8	
Identified external debt-creating flows (4+8+9)	13.6	-4.1	4.3	1.1	-3.0			-3.1	-2.9	-2.8	-2.9	-2.8	-2.8	
Current account deficit, excluding interest payments	9.1	3.7	3.5	2.0	1.2			1.4	1.4	1.3	1.4	1.4	1.4	
Deficit in balance of goods and services	22.3	14.9	14.5	10.8	8.4			7.9	7.1	6.7	6.8	6.7	6.7	
Exports	46.6	54.1	57.5	51.8	56.1			58.5	60.7	62.5	63.6	64.7	65.6	
Imports	68.8	68.9	72.0	62.6	64.5			66.4	67.9	69.2	70.3	71.4	72.3	
Net non-debt creating capital inflows (negative)	-2.1	-3.5	-3.7	-5.2	-5.4			-4.8	-4.3	-4.2	-4.2	-4.2	-4.2	
Automatic debt dynamics 1/	6.5	-4.3	4.5	4.4	1.2			0.3	0.1	0.1	-0.1	0.0	0.0	
Contribution from nominal interest rate	2.2	2.5	2.5	2.4	2.8			2.6	2.5	2.5	2.4	2.4	2.3	
Contribution from real GDP growth	0.8	-2.0	1.5	-0.6	-2.3			-2.4	-2.5	-2.3	-2.5	-2.4	-2.2	
Contribution from price and exchange rate changes 2/	3.5	-4.8	0.5	2.6	0.6			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-3.8	-0.7	-0.6	-0.2	0.8			-2.5	-1.9	-0.9	-1.1	-1.1	-1.1	
External debt-to-exports ratio (in percent)	181.0	146.9	144.5	162.1	145.6			130.1	117.5	108.3	100.1	92.4	85.2	
Gross external financing need (in billions of US dollars) 4/	10.7	9.7	8.0	4.3	4.9			6.8	6.2	5.5	7.1	7.5	7.0	
in percent of GDP	26.3	21.3	18.0	11.7	13.0	10-Year	10-Year	17.3	14.6	12.1	14.7	14.6	12.7	
Scenario with key variables at their historical averages 5/								**76.1**	**79.4**	**82.8**	**85.9**	**88.8**	**91.6**	**-4.6**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	-1.0	2.6	-1.8	0.8	2.8	1.7	3.1	3.0	3.5	3.5	4.0	4.0	4.0	
GDP deflator in US dollars (change in percent)	-5.5	6.1	-1.0	-3.6	-0.9	1.9	9.4	1.3	4.0	2.9	3.0	2.8	2.7	
Nominal external interest rate (in percent)	2.7	3.2	3.0	2.8	3.4	3.5	1.0	3.3	3.6	3.7	3.8	3.9	4.1	
Growth of exports (US dollar terms, in percent)	-14.7	29.8	3.2	-24.3	10.1	9.6	25.5	8.8	11.7	9.7	8.9	8.7	8.3	
Growth of imports (US dollar terms, in percent)	-13.0	12.0	1.4	-26.9	4.6	6.1	28.9	7.3	10.0	8.6	8.9	8.5	8.2	
Current account balance, excluding interest payments	-9.1	-3.7	-3.5	-2.0	-1.2	-6.7	5.8	-1.4	-1.4	-1.3	-1.4	-1.4	-1.4	
Net non-debt creating capital inflows	2.1	3.5	3.7	5.2	5.4	4.4	1.3	4.8	4.3	4.2	4.2	4.2	4.2	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

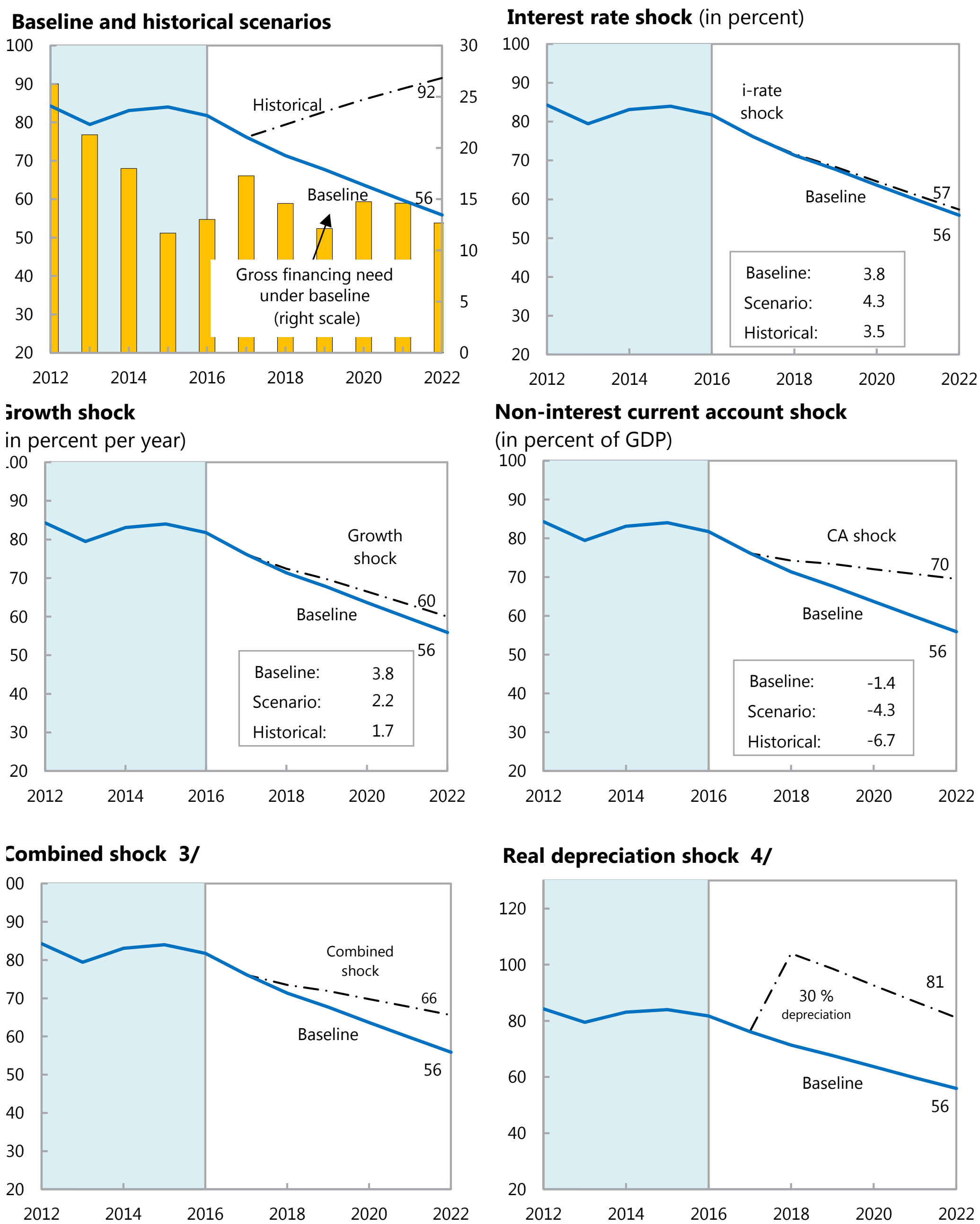
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The 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.

6/ 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.

Figure 1. Serbia: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and 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. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2018.

Appendix I. Letter of Intent

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

Belgrade, August 4, 2017

Dear Ms. Lagarde:

Our economic program, supported by the Stand-By Arrangement (SBA) approved by the IMF Executive Board on February 23, 2015, has been instrumental in reducing Serbia's long-standing internal and external economic imbalances. The attached Memorandum of Economic and Financial Policies (MEFP) describes progress made so far and sets out the economic policies that the Government of the Republic of Serbia and the National Bank of Serbia (NBS) intend to implement under the SBA. Our program continues to be fully supported by all coalition partners in the newly formed government, indicating strong commitment to and ownership of envisaged policies.

Quantitative program conditionality has been fully met and progress has been made on structural benchmarks. The end-March and end-June PCs on NIR, the fiscal deficit, and current primary spending have all been met, by considerable margins. Inflation has remained within the NBS target band and within the inner limit of the program inflation consultation clause. As a prior action for the review, we adopted a new job catalog to support the implementation of the Law on Public Sector Employees Wage System. In June, we adopted a decree aimed at strengthening the project appraisal process, establishing a single project pipeline (end-December 2015 structural benchmark). We met the end-December structural benchmarks on the amendments to the Law on Tax Procedure and strengthening real estate appraisal frameworks. In early August, we submitted the amendments to the corporate insolvency law to the National Assembly (end-December structural benchmark). In June, we adopted the 2017 decisions under the Law on Ceilings on the Number of Employees (end-March structural benchmarks). In August, the independent assessments of the Development Fund and the export promotion agency will be completed (end-April structural benchmark).

We recognize that accelerating structural reforms is critical for achieving program objectives. In this context, the policies under our program will continue to focus on consolidating fiscal gains and reducing public debt, pursuing a wide financial sector agenda, and implementing broad-based structural reforms. In support of the program, we have specified additional structural benchmarks for the coming period.

Given Serbia's comfortable international reserve position and continued access to external financing, we intend to treat the arrangement as precautionary. Therefore, we would not make the purchases when they become available. The implementation of our program will continue to be monitored through quantitative performance criteria, indicative targets, structural benchmarks, and an inflation consultation clause, as described in the attached MEFP and Technical Memorandum of Understanding (TMU).

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

We wish to make this letter available to the public, along with the attached MEFP and TMU, as well as the IMF staff report on the combined 2017 Article IV Consultation and seventh review under the SBA. We therefore authorize their publication and posting on the IMF website, upon the Executive Board's completion of the review. These documents will also be posted on the official website of the Serbian government.

Sincerely,

/s/
Ana Brnabić
Prime Minister

/s/
Jorgovanka Tabaković
Governor of the National Bank of Serbia

/s/
Dušan Vujović
Minister of Finance

Attachments: Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

Attachment I. Memorandum of Economic and Financial Policies

1. **This memorandum sets out our economic program for the remainder of 2017.** The program aims to maintain a foundation for healthy economic growth by addressing Serbia's short-term and medium-term economic challenges. To this end, the program focuses on policies to ensure macroeconomic stability, most notably by maintaining fiscal sustainability, bolster resilience of the financial sector, and improve competitiveness of the economy.

2. **Significant progress has been made since the economic program started.** Bold fiscal consolidation, which started in late 2014, has taken place, reforms in the financial sector are progressing as planned, and the initiation of comprehensive restructuring in the state-owned enterprises is starting to yield positive impacts on their efficiency and financial discipline.

3. **The goals of the economic program are compatible with our aspirations to become an EU member, having started the accession process in January 2014.** Implementing this program will allow Serbia to realize the significant potential for convergence towards EU income levels.

Recent Economic Developments and Outlook

4. **Serbia's economic recovery continues**. Growth reached 2.8 percent (yoy) in 2016, supported by stronger net exports and private investment. The labor market continues to strengthen, with employment rising and unemployment falling. The headline CPI inflation has picked up (3.6 percent, yoy, in June) mainly on account of higher food and energy prices, while core inflation remains moderate (2 percent, yoy, in June). The external current account deficit continued to narrow in 2016 and remains fully covered by foreign direct investment. Yields on government securities and bank lending rates have declined markedly since the start of the NBS easing cycle.

5. **We expect the consistent implementation of the policy actions and reforms envisaged under our economic program to maintain the virtuous cycle of boosting confidence, improving private sector dynamism, and fostering economic growth**.

- **Real GDP** is expected to expand at 3 percent in 2017 and to gradually rise to 4 percent over the medium term, on account of improved market confidence, stronger private sector employment and real wages and credit growth, and the positive effects of structural reforms.
- **Annual headline CPI inflation** is projected to average 3.4 percent in 2017, supported by a pick-up in import prices and a narrowing output gap. And in the medium term, inflation is expected to stay within the inflation target range.
- **The current account deficit** is expected to remain at about 4 percent of GDP in 2017 and over the medium term, as strong exports offset increased consumption and

investment. External financing will continue to rely mostly on FDI as well as on bilateral and project loans.

6. **The program scenario faces domestic and external risks.** Serbia remains exposed to external risks, including regional spillovers and renewed episodes of global market volatility. Delays in implementing structural reforms, particularly in the area of SOE restructuring, could compromise sustainability of the fiscal adjustment. This, in turn, could slow down the reduction of public debt and deteriorate growth prospects.

Economic Policies

A. Fiscal Policies

7. **We are committed to preserve the hard-won fiscal gains to put the still high public debt-to-GDP ratio firmly on a downward path.** The estimated structural fiscal adjustment in 2015–2016 amounted to 4.5 percent of GDP, exceeding the target of 4 percent of GDP for the full three-year program. This sizeable adjustment has been driven by stronger revenues and tight control of current spending. Given the still elevated level of public debt, we intend to build on this adjustment in 2017, aiming for a headline deficit of 1.1 percent of GDP.

8. **The fiscal outturn in 2016 showed significant overperformance.** At 1.3 percent of GDP, the general government deficit was nearly 0.9 percentage points lower than projected in the sixth review, and the lowest record since 2005. The public debt-to-GDP by end-2016 was at about 74 percent, about 2 percentage points below the end-2015 figure.

9. **Strong fiscal performance continued in the first half of 2017.** The general government recorded a surplus of RSD 11.8 billion in Q1, overperforming the adjusted program target by RSD 45.9 billion (1 percent of annual GDP), and we recorded a surplus of RSD44.1 billion in H1, overperforming the adjusted program target by RSD79.2 billion (1.8 percent of annual GDP). These good results are largely on account of strong revenue, temporary under-execution of capital expenditure, and lower interest rate bill.

10. **For the remainder of 2017, our primary focus is the continued restraint of mandatory expenditures in line with the budget**. We remain committed to further reduce the general government wage and pension bill as a share of GDP. Any space created by revenue overperformance will be directed to priority capital spending and repayment of expensive debt, while allowing current primary spending up to the program ceiling. Rightsizing efforts will continue in line with the objectives of public administration reform (see paragraph 12). We will submit the amendments to the law on financial support to families with children by end-September to increase parental allowances, while eliminating VAT refunds for baby items, with a view to provide benefits earlier and reduce the tax administration burden.

11. We will aim to further reduce fiscal risks and will prepare contingency measures as needed. In this regard, we will not rely on short-term external debt financing (quantitative performance criterion) and we will rebuild fiscal buffers at least to the end-2016 level. We will not accumulate public sector external debt payment arrears (continuous performance criterion). We will also refrain from accumulating domestic payment arrears (indicative target). Our efforts to reduce public spending will continue being monitored through a ceiling on the current primary expenditure, excluding capital spending and interest payments, of the Serbian Republican budget (quantitative performance criterion). If revenues are reduced due to an exogenous shock, we will consider contingency measures, such as raising the VAT rate and gasoline excise tax.

B. Structural Fiscal Policies

12. We are progressing with reforms of the general government employment and wage system.

- As of end-April 2017, public sector permanent employment (including local public utilities) had been reduced by about 26,000 employees compared to the end-2014 level, mostly through attrition. To support these efforts and provide guidance for further rightsizing efforts, in June we adopted the 2017 Decision of the Maximum Number of Employees in the Public Sector under the Law on Ceilings on the Number of Employees setting detailed limits on positions for each institution of the general government (excluding professional soldiers) and local utility companies, (**end-March structural benchmark**). We will continue to apply an employment freeze, with exceptions managed through the Employment Commission, taking into account individual institutions' employment ceilings, budgetary envelopes, and specialist staffing needs.

- Going forward, rightsizing efforts will be guided by detailed systemization plans and availability of fiscal space at the institutional level. To this end, by end-September we will adopt an action plan for administrative restructuring in the education sector based on functional reviews developed in conjunction with the World Bank (**end-March structural benchmark, modified and reset to end-September**). For education, the plan will identify primary and secondary schools to be closed or merged at the start of the academic year 2018-19. It will also better align educational profiles with demographic changes and workforce needs and include closing intake of at least 25 percent of current TVET profiles (i.e., 106 profiles).

- Since January 2016, for the entities subject to the Law on Ceilings, the renewal of the fixed or temporary contracts will be permitted only if entities are complying with the ceilings stated by the Law and if the share of temporary employees is below 10 percent of the number of permanent employees or in the exceptional cases defined in the Law.

- To support implementation of the Law on Public Sector Employees Wage System, the government adopted a new job catalog (**prior action**) in July and the parliament will approve by end-September the necessary secondary legislation for local governments and public services (health, education, culture, and social protection) (**end-June structural benchmark**). Secondary legislation for all other sectors (including police and armed forces) will be adopted by end-2017.

13. To underpin fiscal consolidation, limit risks, and strengthen institutions:

- We will review and clearly define the coverage of general government to be compatible with European System of Accounts (ESA) 2010 and GFSM 2014 by 2018. As in 2016, we will submit financial plans of social security funds with estimates for their indirect beneficiaries to the National Assembly, in parallel with Republican budget. We will include all indirect budget beneficiaries of the central government in the Financial Management Information System (FMIS) gradually by end-2019. Throughout 2017, we are continuing to work to upgrade the budget execution system to be able to support the integration of new users. To meet our 2018 goal to include prisons and cultural institutions in FMIS, we plan to hold training sessions in 2017Q4. In 2019, social protection institutions will be integrated, having in mind that they are the most numerous and diverse and will need to upgrade their capacities over the period 2017-2019.

- To improve budget discipline and transparency we amended in 2016 the Budget System Law to include all currently extra-budgetary project loans within the budget, starting in 2017, and withhold transfers from local governments not complying with the new instructions on how to project their revenues on the basis of current year receipts. We have also worked to improve budget planning and execution in health institutions.

- We have introduced new regulations and guidelines to improve public investment management. In particular, in June we adopted a decree aimed at strengthening the project appraisal process (**structural benchmark for December 2015**), to establish a unique project pipeline and clearly define its links with multi-annual planning and annual budget procedures.

- We are committed to ensure that a full assessment of all proposed Public-Private Partnerships (PPPs) is reviewed by the Ministry of Finance (MOF), including PPPs' key financing features, cost-benefit analysis, and risk sharing arrangements with the government. In this regard, we set up a special fiscal risks management unit at the MOF and included a fiscal risk statement on all PPPs in the Medium-Term Fiscal Strategy from the 2017 budget. Furthermore, to improve control of fiscal implications and risks, we amended the existing Law on Public-Private Partnership and Concessions mandating that PPPs larger than EUR 50 million are submitted to the government for consideration only after receiving the MOF's consent. By end-2017 we will adopt additional amendments to the Law aimed at limiting overall fiscal exposure, ensuring a competitive tender process.

- In the health sector, the number of employees in the public sector has been reduced from about 123,000 in 2010 to about 113,000 in 2016 (8 percent reduction), through a combination of attrition and targeted redundancies focused on nonmedical staff. The projected number of employees in health sector for 2017 is 112,331, which includes 2,500 new staff to be contracted by the HIF by end 2017. The next key next step is to implement health financing reforms, including a transition toward financing based on outputs and outcomes. In the hospital sector, first 14 hospitals will be contracted on partial financing by case payments for inpatient care using Diagnostic Related Groups (DRGs) as of January 1, 2018. The remaining 56 hospitals (including clinical centers) will undergo training, capacity building and information system support so as to be ready to be contracted on partial financing based on DRG by January 1, 2019. Implementation of performance-based financing for primary care is expected to take place by end-2017.

14. To secure savings from the corporate and financial restructuring of public enterprises and SOEs, we are introducing a set of public financial management changes.

- To enhance the payment discipline between public sector entities, we broadened the scope of the Law on Payments in Commercial Transactions to include transactions between public entities (including SOEs), starting in January 2016. We are working on a new e-invoice system covering the public sector based on a unique invoice code that would be required at the time of invoicing. The contract for the first steps to establish the new system, envisaging the procurement of required IT resources, has been signed. To stop accumulation of arrears to EPS and Srbijagas, since late-2016 (i) Srbijagas must not provide gas to delinquent companies or institutions (except in limited identified priority cases where gas payments will be made out of the budget reserve), (ii) any gas supplies to Azotara or MSK will only be provided on the basis of prepayment, and (iii) we have been publishing monthly reporting of overdue receivables to Srbijagas and EPS of their top 20 debtors on the companies' web pages.

- We have been strictly limiting issuance of state guarantees since January 1, 2015. In this regard, we will not issue any new state guarantees for liquidity support, or state guarantees for any company in the portfolio of the former Privatization Agency (continuous performance criterion). The Government will continue to refrain from issuing any implicit state guarantees.

- The diagnostic analysis of the Development Fund (DF) and the export promotion agency (AOFI) by an independent consultant will be completed in August (**end-April structural benchmark**). Based on this study, by end-October supervisory boards of these institutions will adopt Decisions fully recognizing losses on the credit portfolio, taking measures to prevent further deterioration in asset quality, and identifying solutions to resolve impaired assets **(new structural benchmark)**. The supervisory board will adopt a decision to fully recognize losses to safeguard DF's capital, we will refrain from providing any financing without high-quality collateral to SOEs. By end-2017, we will identify needs and options for development finance activities.

15. To raise the efficiency of revenue collection, we are committed to improve tax administration. This work continues to be based on recommendations of the September 2014 IMF technical assistance mission and the Tax Administration Diagnostic Assessment Tool review. We are implementing the Tax Administration Transformation Program 2015–20 as the official medium-term reform program. Our priorities are to (i) strengthen the Tax Administration's governance, (ii) streamline organizational structures of headquarters and field offices, (iii) reduce non-core activities, (iv) phase in a modern compliance risk management approach, (v) strengthen arrears management, including write-off procedures, (vi) modernize information technology systems and business processes, and (vii) improve coordination and information exchange with other government agencies.

- Due to implementation constraints, we have not been able to adopt a government decision on an organization plan for the non-headquarter based tax administration functions consistent with business needs of modern tax administrations and determining the physical location and staffing numbers for these functions (**end-June structural benchmark**). As a first step, in August we will adopt a new systematization plan establishing a risk management unit and a taxpayer service department. We will develop a plan to address our archive and accommodation transition needs.

- In November 2016, the National Assembly approved amendments (**end-December 2016 structural benchmark**) to the Criminal Code to extend the investigations powers and competences of tax authorities to enable the audit of unregistered businesses and strengthen the function of the tax police.

- To enhance the effectiveness of the review of tax appeals, we have established and operationalized the second instance appeal unit at the MoF, while maintaining an independent and substantive review function within the tax administration. We have also institutionalized the dissemination of case details by the MoF when issuing tax opinions.

- To reignite our reform efforts, by end-2017 we will update our Transformation Program so that it focuses on the concrete transformation objectives and reflects the recommendations of recent IMF technical assistance. We will also adopt a government decision by end-October (**new structural benchmark**), which identifies non-core STA activities to be transferred or separately managed within the STA with deadlines to complete the moves. The aim is that by June 2019 all remaining non-core STA activities will be managed separately, while core STA tasks are consolidated into no more than 36 offices.

C. Monetary and Exchange Rate Policies

16. We see the current inflation targeting framework as the most viable option for maintaining stable inflation and protecting the economy against external shocks. In November 2016, we lowered the inflation target from 4±1½ percent to 3±1½ percent for 2017-18, which we consider better aligned with improved macroeconomic fundamentals and our medium-term objectives. We remain committed to the objective of keeping inflation within the inflation tolerance band and inflation developments will continue to be monitored via a consultation clause with consultation bands set around the central projection (Table 1). Since the inception of the program in early 2015, as fiscal adjustment took hold and external financing conditions remained stable, we reduced the key policy rate by 400 basis points by mid-2016, to 4 percent, to support returning of headline inflation into the tolerance band. Since July 2016, we have kept the policy rate unchanged at that level, taking into account the inflation outlook and external environment.

17. We will maintain the existing managed float exchange rate regime in line with the inflation targeting framework. We believe that exchange rate flexibility provides a needed buffer against external shocks. In light of this, foreign exchange interventions will continue to be used to smoothing excessive short-term exchange rate volatility without targeting a specific level or path for the exchange rate, while considering the implications for financial sector and price stability. The current level of gross international reserves is well above the level that could be considered as necessary for precautionary purposes. We will maintain adequate coverage throughout the program, monitored by a floor on net international reserves (quantitative performance criterion).

18. We will continue to implement our dinarization strategy. This strategy is based on three pillars: (i) maintaining overall macroeconomic stability; (ii) creating favorable conditions for developing the dinar bond market; and (iii) promoting hedging instruments. We will continue to use our monetary policy and prudential framework to support the dinar instruments, and we will further communicate the importance of the dinarization for overall financial stability. Macroeconomic imbalances have been reduced significantly and inflation has remained low and stable on the back of an inflation targeting regime with a relatively stable exchange rate, coupled with fiscal discipline, which should all support dinarization. In the last few years, we have also introduced several measures to increase dinarization, such as higher reserve requirements on and lower remuneration of FX deposits, requirement of partial dinar allocation for reserve requirements on FX deposits, and mandatory down-payment ratios for FX loans. Meanwhile, we have increased the share of public debt in domestic currency, issuing dinar securities at longer maturities. By end-2016, dinarization of deposits has increased to 30 percent, while dinarization has also increased for household lending. The dinarization strategy will be further improved based on recommendations of the recent Fund staff technical assistance, aiming at promoting the development of money and security markets in dinars and foreign exchange risk hedging markets, promoting banks' funding in local currency, and addressing underpricing of FX risk by unhedged borrowers.

19. To reduce risks to macroeconomic stability, we will continue capital account liberalization in a gradual way. Many of the capital account transactions, such as FDI and long-term flows, have already been liberalized, with the remaining restrictions related broadly to short-term capital and deposit flows. To limit balance of payments pressures under the program, the capital account liberalization required in the context of EU accession will be gradual, particularly in removing restrictions on short-term capital flows and the ability of residents to open deposit accounts abroad.

20. During the period of the SBA we will not, without IMF approval, impose or intensify restrictions on the making of payments and transfers for current international transactions, nor introduce or modify any multiple currency practices or conclude any bilateral payment agreements that are inconsistent with Article VIII of the IMF's Articles of Agreement. Moreover, we will not impose or intensify import restrictions for balance of payments reasons.

D. Financial Sector Policies

21. Our policies will support financial sector stability and enhance the financial sector's ability to cope with shocks, while improving financial intermediation. Priority will be given to: (i) further reducing nonperforming loans (NPLs); (ii) assessing asset quality and provisioning practices; (iii) further strengthening the supervisory and regulatory framework in line with EU standards; (iv) operationalizing the new bank resolution framework; and (v) fully implementing the strategy for state-owned banks.

22. The implementation of the NPL resolution strategy is yielding positive results, with NPL ratios falling by more than 7 percentage points since the 2015 peak. Following various regulatory initiatives during 2016 (including the introduction of enhanced reporting requirements for NPLs and more stringent prudential standards for restructured loans), the NBS is reviewing the implementation of recently introduced supervisory requirements on distressed asset management, including the preparation of bank-specific NPL resolution strategies. To this end, the NBS will discuss banks' medium-term operational targets for reducing NPLs to acceptable targets. In addition:

- The Law on Real Estate Appraisers was adopted by the National Assembly in December 2016 (**structural benchmark**). Further amendments to the regime that regulates the profession of court-sworn experts, to be implemented during 2018, will ensure that the technical standards and rules for professional conduct envisaged under the Real Estate Appraiser Law will also be applied to real estate appraisals prepared in the context of enforcement procedures under the Law on Enforcement and Security.

- In early August, we submitted the amendments of the corporate insolvency law to parliament (**end-December 2016 structural benchmark**) with a view to be adopted by end-October 2017.

- To resolve legal ambiguity related to the transfer of the seller's rights to the buyer in the context of distressed assets' sales, in July we submitted to parliament an authentic interpretation of article 48 of the Law on Enforcement and Security, with a view to be adopted by parliament by end-September.

- The prudential framework for non-deposit taking financial institutions that is currently under consideration could also enable the sale of nonperforming retail receivables to regulated investors outside the banking sector.

23. Banks have continued to improve their reporting framework. The NBS is working with banks and their external auditors to prepare for implementation of IFRS9 starting January 1, 2018, and discuss the implications for banks' financial positions and systems.

24. We continue to strengthen financial sector supervision. Implementation of Basel III-compliant regulatory standards on capital, liquidity, and risk management, as well as updated standards on disclosure and regulatory reporting, has become effective as of end-June 2017. Minimum capital requirements have been reduced from 12 percent to 8 percent, while additional capital buffers have been introduced—in line with the EU's Capital Requirement Directive—to ensure that banks will remain well capitalized. The required reserves for estimated loan losses will remain in force until 2019, but recent amendments allow banks to reduce the required reserve in accordance with improvements of their NPL ratios. Multi-year action plans for strengthening the NBS' prudential oversight over the insurance and banking sectors are being implemented, which include the introduction of a more risk-sensitive supervisory cycle for banks. The review of banks' recovery plans will provide the NBS with further insights in the critical functions and intra-group linkages of banks, as well as banks' preparedness to dealing with sudden shocks.

25. The NBS continues to enhance its macroprudential policy framework. Regulatory amendments for the introduction of new macroprudential instruments have been developed and adopted as part of the implementation of Basel III. The NBS has enhanced its framework for implementation of its macroprudential instruments, in line with recommendations of with IMF technical assistance. Specifically, in June 2017 the NBS has adopted (i) the Decision establishing countercyclical capital buffers (currently set at 0 percent); (ii) the Decision prescribing a systemic risk buffer rate of 3 percent on FX and FX-linked lending to corporates and households to be applied to banks based on their contributions to risks related to euroization; and (iii) the Decision determining the list of systemically important banks and their required capital buffers of 1 or 2 percent.

26. The NBS continues to strengthen its bank resolution capabilities. Guidelines for independent valuation in the context of bank resolutions are being finalized and the preparation of a Resolution Manual is progressing.

27. Reforms of state-owned financial institutions are progressing. We are strengthening our oversight over financial institutions with state-ownership. In May, we hired external consultants to support the implementation of the new strategy for Banka Postanska Stedionica, with a particular focus on (i) the bank's commercial reorientation towards retail banking, entrepreneurs, micro-enterprises and small enterprises, (ii) improvements of the bank's internal organization, corporate governance and risk management, (iii) enhancement of its IT infrastructure and (iv) preparation of a business plan for the period 2018-20. Final reports on these issues will be completed by end-August (end-October in the case of the business plan). In early August, the government updated the 2014 strategy for state-owned banks, with the aim to identify strategic options for the smaller banks. The diagnostic review of Dunav Osiguranje (**end-November structural benchmark**) was completed and remedial actions are being implemented; and government decisions on privatization of socially-owned and state-owned capital will be adopted by end-December. We selected a privatization advisor for Komercijalna Bank, the second largest bank in Serbia, and plan to publish tenders for expressions of interest by September, with a view to completing the privatization by end-June 2018, subject to market conditions.

28. We will continue to support credit to SMEs. Given the importance of SMEs for Serbia's economy and the limited access to financing by this sector, we have been supporting lending to SMEs through EIB's credit lines ("Apex loans"), and we have established an NBS working group to consider the introduction of the framework for functioning of non-deposit financial institutions.

29. We have established a working group on capital market development. We will prepare a diagnostic report, in consultation with the World Bank, with a view to inform the government's strategy to enhance capital markets.

E. Structural Policies

30. We continue implementing a number of comprehensive structural reforms to attract investment, support growth, and rebalance the economy on its path towards EU integration. We will continue to focus on policies that (i) promote job creation, (ii) reform state and socially-owned enterprises, and (iii) improve the overall business environment and private investment climate.

31. We are improving the targeting of social protection programs. We are preparing a new Law of Social Protection which will replace the existing legislation that governs the eligibility and conditions to receive social assistance, with the aim to improve the effectiveness and targetedness of the cash welfare allowances.

32. We continue implementing wide-ranging reforms of socially-owned and state-owned enterprises to improve their operational viability and limit fiscal risks. Our priority is to significantly reduce fiscal costs of SOEs through (i) curtailing direct or indirect subsidies, (ii) strictly limiting issuance of new guarantees, and (iii) enhancing accountability, transparency and monitoring of these enterprises. To this end, we are implementing strategies for three broad categories of state-owned companies:

- Large public enterprises, such as electricity, gas, railways, and road companies (see below). These reforms are supported by the World Bank and EBRD.
- 17 strategic companies in the portfolio of the former Privatization Agency. We have fully resolved 6 companies and are forcefully pursuing resolution of the remaining ones through either privatization tender or initiating insolvency (including pre-pack bankruptcy).
- Other (over 500) enterprises in the portfolio of the former Privatization Agency.

33. We are committed to continue restructuring large public utilities and transport companies to enhance efficiency and contain additional fiscal costs. To implement the needed corporate and financial restructuring in each of these companies over the medium term, we have taken several steps and plan to take the following ones:

- **Elektroprivreda Srbije (EPS).** In consultation with the World Bank and EBRD, we adopted the financial restructuring plan for EPS in June 2015. The plan includes: (i) increases in revenues through enhanced bill collections, reduced technical and commercial losses, and regulated tariff increases and (ii) a reduction of operational cost including through increased efficiency, optimization of the supply mix, and staff reduction. Consistent with the five-year rightsizing target specified in the financial restructuring plan, the EPS supervisory board has adopted, in consultation with the World Bank, a credible 2016-19 optimization plan. In 2016, about 2,000 employees left the company, of which approximately 1,500 through voluntary separation and the rest through attrition. We have established the criteria for the second round of rightsizing in consultation with the World Bank and in line with the labor optimization plan, and a new window to apply for voluntary separation will be opened in August, aiming at reducing the number of employees by 1,000 by end-2017; and by end- 2017, EPS will complete the closure of two inefficient power generation plants, which are already not operating (end-June **structural benchmark**). Following a household tariff increase of 4.5 percent in August 2015 and 3.8 percent in October 2016, another increase of at least 2 percent will be effective in October, which will help ensuring adequate resources for needed maintenance investments. We have engaged the World Bank with a view to enhance corporate governance, management, and procurement and planning frameworks of EPS. We will change the legal status of EPS to a joint stock company, in line with the ongoing corporate restructuring process and financial consolidation, aiming to improve the viability of the company and ensure its professional management.

- **Srbijagas.** A new organizational structure consisting of subsidiaries for transmission and distribution became effective in August 2015. In line with the fiscal program, we have divested part of Srbijagas' non-core assets and are pursuing permanent resolution of the companies which were a major source of arrears in the past—Azotara, MSK, and Petrohemija—in such a way that ensures no further budget support or accumulation of arrears. More generally, payment discipline has improved following the adoption of the financial consolidation plan for Srbijagas in March 2017 and the implementation of measures in November 2016 to improve collection rates to prevent future accumulation of arrears. A new investment appraisal methodology, proposed by the World Bank based on an economic and financial cost-benefit framework and including other relevant appraisal criteria, will be adopted by end-October. The new methodology will be used to assess all future projects as well as projects currently in the pipeline. These measures will help improve Srbijagas' financial position and put the company on a sustainable path, thus containing the need for additional state aid.

- **Railways of Serbia**. The corporate restructuring plan is centered on asset disposal, network re-optimization, and staff rationalization. Importantly, the freight section has received no further subsidies and has operated on a purely commercial basis from August 2015. To support market competition, we have allowed network access to private operators since February 2016. We will also continue the reorganization and improvement of business plans for the state-owned passenger and infrastructure companies and the fourth company, to strictly limit the amount of state aid disbursed over the medium term. We are implementing the financial restructuring plan adopted in October 2015 and developed in consultation with the World Bank, EBRD and EU. An updated labor rightsizing plan has been adopted in June, based on new organizational structure proposals prepared in consultation with the World Bank. Following a reduction of 3,146 positions in late 2016 the plan targets additional 2,394 positions by end-2017. In addition, we have closed 422 km of railway lines in 2016 and additional 669 km in April. Railway companies have also fully assigned responsibilities for electricity payments, and will ensure no reemergence of arrears to EPS.

- **Roads of Serbia.** We have increased toll rates by 10 percent, from January 1, 2017 to allow adequate infrastructure maintenance. Further increases will be gradually phased in based on an assessment of the adequacy of toll rates prepared with the assistance of the World Bank by end-February 2018. We have adopted a plan to remove rigidities in pricing maintenance contracts, which will cover 3,000 km in 2017. We will also explore concession options for the construction and maintenance of Corridor XI. The corporate and financial restructuring plans for Roads of Serbia will be developed in 2017 and 2018 in close consultation with the World Bank.

34. Regarding the few strategic companies for which resolution is still pending:

- We have re-initiated the privatization tender for PKB, with a view to finalize the process by end-December 2017.
- We have launched a call for a privatization advisor for RTB Bor, and discussions with potential investors are ongoing, including on addressing environmental risks. We expect to launch the tender for privatization by end-October. So far in 2017, the company has been meeting all liabilities, including on taxes, wages, and electricity, as per the pre-pack agreement. No additional subsidies beyond the budgeted RSD2 billion, will be allocated to the company in 2017 and 2018.
- We are developing, with the assistance of the World Bank, an action plan for Resavica mines, identifying the closure timetable for at least 4 unviable mines starting in 2017; allowing for reduction of subsidies from the budget; including rightsizing targets and measures to minimize social costs. In December 2016, we settled long-standing wage arrears.
- We have restructured Petrohemija to eliminate any fiscal risks (including through securing a long-term supply contract from NIS) and have launched a public call for Letters of Interest for a strategic investor in March. In April, the company filed for bankruptcy proceedings in accordance with a pre-pack. This process will be completed by mid-August and we expect to launch a public call for privatization by end-September.
- We have received a number of expressions of interest from potential strategic investors for Azotara and MSK, and expect to receive binding offers by end-September. If the privatization process does not succeed we will initiate bankruptcy procedures by end-October (**end-March structural benchmark**). In the meantime, since January 2017 we have ensured that Srbijagas will not provide any gas to these companies except on the basis of prepayment.
- We have reached an agreement with Galenika's bank creditors and will adopt a government decision by end-July with a view to launch a new privatization tender by end-August a to complete privatization process by the end of the year.

35. We continue to resolve the 500 plus enterprises in the portfolio of the former Privatization Agency through either privatization or bankruptcy, in accordance with the revised Privatization Law. By June 2017, more than 275 companies entered bankruptcy, and more than 45 were privatized since end-2014. About 26,000 employees from around 320 companies have received severance payments. Around 150 companies with near 52,000 employees remain to be resolved, including the strategic enterprises.

36. We aim to privatize or find strategic partners for a number of SOEs and concession projects. We will use the proceeds primarily for reducing the stock of public debt but possibly also for funding future financially viable and high return investment projects. The size of investment funding will be determined in consultation with IMF staff. We have received letter of interests for long-term concession partnerships for managing the Belgrade Airport, with a deadline to submit binding offers by end-October and to sign a concession agreement by early 2018.

37. We continue to enhance Serbia's competitiveness and business environment to support investment, job creation and private sector development. Supported by the World Bank and EBRD, specific actions will focus on the following areas:

- An all-electronic system for issuing construction permits has been in place since January 2016. To simplify the procedures of registering properties and reduce the costs we are working on a digitalization project of ownership register entry.

- By end-November, we will initiate public debate on a draft Law on Charges **(new structural benchmark)**, which will replace existing laws and by-laws to regulate charges at all levels of government, to ensure greater predictability and transparency. We aim to adopt the new Law by end-2017.

- We have declared 2017-18 as years of the fight against the gray economy, and have updated the national program adopted in late 2015.

- We will submit amendments to the Company Law to the National Assembly by end-September with a view to adopt it by end-2017, in order to harmonize with EU legislation, including to provide the legal framework for cross-border mergers of companies operating in the EU.

- Supported by the World Bank's Competitiveness and Jobs project, we are expanding the coverage of active labor market policies and reforming the National Employment Service, to improve the efficiency of its programs and enhance the quality of services provided both to unemployed and employers.

- We will also advance the data and legal infrastructure necessary to accomplish savings in 2017 by introducing e-government and reducing staff in non-core functions. An action plan to implement the government strategy on e-government has been designed, to support this process.

Program Monitoring

38. The arrangement has shifted to a semiannual review schedule. Under the new schedule, reviews will be concluded based on end-March and end-September test dates and conditionality, with interim purchases in June and December made available based on meeting performance criteria. Progress in the implementation of the policies under this program will be monitored through quarterly quantitative performance criteria (PCs) and indicative targets (ITs)—including an inflation consultation clause, continuous performance criteria (CPCs) and structural benchmarks (SBs). These are detailed in Tables 1 and 2, with definitions provided in the attached Technical Memorandum of Understanding.

Table 1. Serbia: Quantitative Program Targets 1/

	2016 2/												2017								
	Mar			Jun			Sep			Dec			Mar			Jun			Sep	Dec
	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog.	Act.	Prog.	Adj. Prog.	Act.	Prog.	Prog.
I. Quantitative performance criteria (quarterly)																					
1 Floor on net international reserves of the NBS (in millions of euros)	6,912	...	6,942	6,599	...	6,616	5,932	...	6,944	5,511	...	7,196	5,262	...	6,885	5,044	...	7,076	5,358	5,674
2 Ceiling on the general government fiscal deficit 3/ 4/ (in billions of dinars)	53.9	38.4	15.9	78.3	61.7	18.2	81.3	60.5	4.5	112.0	100.3	54.2	32.0	34.1	-11.8	36.1	35.0	-44.1	-0.2	48.7
3 Ceiling on current primary expenditure of the Serbian Republican Budget excluding capital expenditure and interest payments (in billions of dinars) 3/	206.1	200.3	197.6	426.6	420.5	416.0	637.0	639.4	622.4	885.0	899.2	887.7	212.2	212.1	198.5	433.5	431.6	413.6	647.4	893.9
4 Ceiling on gross issuance of new guarantees by the Serbian Republican Budget for project and corporate restructuring loans (in millions of euros) 3/	35	...	0	35	...	0	100	...	0	180	380	200	80	...	20	160	...	80	180	180
5 Ceiling on contracting or guaranteeing of new short-term external debt by the General Government, Development Fund, and AOFI (up to and including one year, in millions of euros)	0	...	0	0	...	0	0	...	0	0	...	0	0	...	0	0	...	0	0	0
II. Continuous performance criteria																					
6 Ceiling on gross issuance of new guarantees by the Serbian Republican Budget and the Development Fund for liquidity support (in billions of dinars)	0	...	0	0	...	0	0	...	0	0	...	0	0	...	0	0	...	0	0	0
7 Ceiling on accumulation of external debt payment arrears by General Government, Development Fund, and AOFI (in billions of euros)	0	...	0	0	...	0	0	...	0	0	...	0	0	...	0	0	...	0	0	0
8 Ceiling on gross issuance of new guarantees by the Serbian Republican Budget and the Development Fund to any company in the portfolio of the Former Privatization Agency (in billions of dinars).	0	...	0	0	...	0	0	...	0	0	...	0	0	...	0	0	...	0	0	0
III. Indicative targets (quarterly)																					
9 Ceiling on accumulation of domestic payment arrears by the consolidated general government except local governments, the Development Fund, and AOFI (in billions of dinars) 5/	0.0	...	0.0	0.0	...	-0.7	0.0	...	0.2	0.0	...	-0.3	0.0	...	-0.2	0.0	...	-0.4	0.0	0.0
10 Ceiling on borrowing by the Development Fund and AOFI (in billions of dinars)	0.0	...	0.0	0.0	...	0.0	0.0	...	0.0	0.0	...	0.0	0.0	...	0.0	0.0	...	0.0	0.0	0.0
11 Ceiling on new below-the-line lending by the Republican Government (in millions of euros) 3/	128	...	31	160	...	82	262	...	103	364	...	117	91	...	6.4	208	...	18.6	334	446
IV. Inflation consultation band (quarterly)																					
Outer band (upper limit, 2.5 percent above center point)	4.2	...	...	5.0	...		4.0	...		4.5	...		4.7	...		5.0	...		5.3	5.3
Inner band (upper limit, 1.5 percent above center point)	3.2	...	...	4.0	...		3.0	...		3.5	...		3.7	...		4.0	...		4.3	4.3
End of period inflation, center point 6/	*1.7*	...	*0.6*	*2.5*	...	*0.9*	*1.5*	...	*0.6*	*2.0*	...	*1.5*	*2.2*	...	*3.5*	*2.5*	...	*3.6*	*2.8*	*2.8*
Inner band (lower limit, 1.5 percent below center point)	0.2	...	...	1.0	...		0.0	...		0.5	...		0.7	...		1.0	...		1.3	1.3
Outer band (lower limit, 2.5 percent below center point)	-0.8	...	...	0.0	...		-1.0	...		-0.5	...		-0.3	...		0.0	...		0.3	0.3

1/ As defined in the Letter of Intent, the Memorandum of Economic and Financial Policies, and the Technical Memorandum of Understanding.
2/ Original program targets as specified in IMF Country Report 15/347.
3/ Cumulative since the beginning of a calendar year.
4/ Refers to the fiscal balance on a cash basis, including the amortization of called guarantees.
5/ Through the 3rd review, the authorities reported all outstanding accounts payable (>1 day past due), a more stringent definition than per the TMU.
6/ Defined as the change over 12 months of the end-of-period consumer price index, as measured and published by the Serbian Statistics Office.

Table 2. Serbia: Prior Actions and Structural Benchmarks

Measures	Target date	Status
Prior Actions		
1 Adoption by the government of a new job catalog to support implementation of the Law on Public Sector Employees Wage System (MEFP ¶12, fourth bullet).		Met.
Structural Benchmarks		
Fiscal		
1 Adoption by the government of by-laws aimed at strengthening the project appraisal process (MEFP ¶8, third review).	December 31, 2015	Not met. Adopted in June.
2 Government adoption of amendments to the Law on Tax Procedure and the Criminal Code to extend the powers and competences of tax investigation, in order to enable the audit of unregistered businesses and improve the function of the tax police (MEFP ¶15, second bullet).	December 31, 2016	Met.
3 Adoption by the government of time-bound action plans for administrative restructuring in education sector and social services administration, based on World Bank functional reviews (MEFP ¶12, second bullet).	March 31, 2017	Not met. Modified and reset to end-September.
4 Adoption by the government of 2017 decisions under the Law on Ceilings on the Number of Employees (MEFP ¶12, first bullet).	March 31, 2017	Not met. Adopted in June.
5 Resolution of Azotara and MSK through privatization or regular bankruptcy procedure (MEFP ¶34, fifth bullet).	March 31, 2017	Not met.
6 Closure by EPS of two inefficient power plants and preparation of an updated systematization plan with severance options for additional rightsizing for 2017-19 (MEFP ¶33, first bullet).	June 30, 2017	Not met. Draft systematization plan was completed in February; power plants are not operating.
7 Adoption by the government, in consultation with the IMF, a decision on an organization plan for the non-headquarter based tax administration functions and determining the physical location and staffing numbers for these functions (MEFP ¶15, first bullet).	June 30, 2017	Not met.
8 Adoption by the National Assembly of the secondary legislation for local governments and public services (health, education, culture, and social protection) needed to support implementation of the Law on Public Sector Employees Wage System (MEFP ¶12, fourth bullet).	June 30, 2017	Not met. Job catalog adopted (PA#1).
Financial		
9 Introduction of a new legal and operational framework for transparent real estate appraisals, including: (i) legislation setting clear appraisal standards; (ii) development of a database, accessible to banks and appraisers, for detailed records on real estate valuations filed according to pre-established criteria; and (iii) legislation providing proper supervision of the licensed appraisers. (MEFP ¶22, first bullet).	December 31, 2016	Met.
10 Conduct of a review of the corporate insolvency law and submission of proposed amendments to the National Assembly, in line with recommendations from IMF technical assistance, aimed to ensure: (i) adequate safeguards for the secured creditors rights; and (ii) better value maximization and more predictable and swift disposal of assets where assets are not strictly necessary for rehabilitation (MEFP ¶22, second bullet).	December 31, 2016	Not met. Amendments submitted to the National Assembly in August.
11 Complete the independent assessments of the Development Fund and the export promotion agency (AOFI) (MEFP ¶14, third bullet).	April 30, 2017	Not met. Diagnostic assessments will be completed in August.
Proposed New Benchmarks		
12 Adoption by the government of time-bound action plan for administrative restructuring in education sector, based on World Bank functional reviews (MEFP ¶12, second bullet).	September 30, 2017	
13 Based on results of diagnostic analysis of the Development Fund and the export promotion agency (AOFI), supervisory boards of these institutions adopt decisions to (i) fully recognize losses on credit portfolio, (ii) take measures to prevent further deterioration in asset quality, and (iii) identfy solutions to resolve impaired assets (MEFP ¶14, third bullet).	October 31, 2017	
14 Submission to the National Assembly of a new Law on Charges aimed at ensuring greater predictability and transparency by regulating fees and charges at all levels of government (MEFP ¶37, second bullet).	October 31, 2017	
15 Adoption by the government a decision that identifies the non-core activities of the STA to be transferred or separately managed within the STA with deadlines to complete the move (MEFP ¶15, fourth bullet).	October 31, 2017	

Attachment II. Technical Memorandum of Understanding

1. This Technical Memorandum of Understanding (TMU) sets out the understandings regarding the definition of indicators used to monitor developments under the program. To that effect, the authorities will provide the necessary data to the European Department of the IMF as soon as they are available. As a general principle, all indicators will be monitored on the basis of the methodologies and classifications of monetary, financial, and fiscal data in place on December 31, 2014, except as noted below.

A. Floor for Net International Reserves of the NBS

	In Millions of Euro
Outstanding stock:	
End-December 2014	7,008
Floor on international reserves:	
End-December 2015 (performance criterion)	6,266
End-March 2016 (performance criterion)	6,912
End-June 2016 (performance criterion)	6,599
End-September 2016 (performance criterion)	5,932
End-December 2016 (performance criterion)	5,511
End-March 2017 (performance criterion)	5,262
End-June 2017 (performance criterion)	5,044
End-September 2017 (performance criterion)	5,358
End-December 2017 (performance criterion)	5,674

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

3. For purposes of the program, **reserve assets** are readily available claims on nonresidents denominated in foreign convertible currencies. They include the NBS holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, and the country's reserve position at the Fund. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered (e.g., pledged as collateral for foreign loans or through forward contracts, guarantees and letters of credit), NBS' claims on resident banks and nonbanks, as well as subsidiaries or branches of Serbian commercial banks located abroad, claims in foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options), precious metals other than monetary gold, domestically acquired gold without international certificates, assets in nonconvertible currencies, and illiquid assets.

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

5. For purposes of the program, all foreign currency-related assets will be valued in euros at **program exchange rates** as specified below. The program exchange rates are those that prevailed on September 30, 2014. Monetary gold will be valued at the average London fixing market price that prevailed on September 30, 2014.

Cross Exchange Rates and Gold Price for Program Purposes, September 30, 2014

	Valued in:				
	RSD	Euro	USD	SDR	GBP
Currency:					
RSD	1.0000	0.0084	0.0107	0.0072	0.0066
Euro	118.8509	1.0000	1.2695	0.8563	0.7808
USD	93.6202	0.7877	1.0000	0.6745	0.6150
SDR	138.7994	1.1678	1.4826	1.0000	0.9119
GBP	152.2168	1.2807	1.6259	1.0967	1.0000
Gold	113,888.97	958.25	1,216.50	820.53	748.20

Source: NBS

6. Adjustors. For program purposes, the NIR target will be adjusted upward by the value of long-term assets and foreign-exchange-denominated claims on resident banks and nonbanks as well as Serbian commercial banks abroad, recovered by the NBS since December 31, 2014. The NIR floor will be adjusted upward by the full amount of proceeds from any eurobond issuance and external bilateral budget loans to the General Government since September 30, 2015. External bilateral budget loans, in this context, are loans to the Republican budget provided without any pre-specified purpose other than satisfying funding needs of the public sector. The NIR floor will also be adjusted upward by the value of domestically acquired gold for which certification was obtained after December 31, 2014. The NIR floor will also be adjusted upward by any privatization revenue in foreign exchange received after December 31, 2014. Privatization receipts are defined in this context as the proceeds from sale, lease, or concession of all or portions of entities and properties held by the public sector that are deposited in foreign exchange at the NBS either directly or through the Treasury.

B. Inflation Consultation Mechanism

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

8. Breaching the inflation consultation inner band limits (specified in MEFP, Table 1) at the end of a quarter would trigger discussions with IMF staff on the reasons for the deviation and the proposed policy response. Breaching the outer limits would trigger a consultation with the IMF's Executive Board on the reasons for the deviation and the proposed policy response before further purchases could be requested under the SBA.

C. Fiscal Conditionality

9. **The general government fiscal deficit** (previously referred to as the general government augmented fiscal deficit, see IMF Country Report 15/20, p. 70), on a cash basis, is defined as the difference between total general government expenditure (irrespective of the source of financing) including expenditure financed from foreign project loans, payments of called guarantees, cost of bank resolution and recapitalization, cost of debt takeover if debt was not previously guaranteed, repayments of debt takeover if debt was previously guaranteed, and payment of arrears (irrespective of the way they are recorded in the budget law) and total general government revenue (including grants). For program purposes, the consolidated general government comprises the Serbian Republican government (without indirect budget beneficiaries), local governments, the Pension Fund, the Health Fund, the Military Health Fund, the National Agency for Employment, the Roads of Serbia Company (JP Putevi Srbije) and any of its subsidiaries, and the company Corridors of Serbia. Any new extra budgetary fund or subsidiary established over the duration of the program would be consolidated into the general government. Privatization receipts are classified as a financial transaction and are recorded "below the line" in the General Government fiscal accounts. Privatization receipts are defined in this context as financial transactions.

10. **Government primary current expenditure of the Republican budget (without indirect budget beneficiaries)** includes wages, subsidies, goods and services, transfers to local governments and social security funds, social benefits from the budget, other current expenditure, net lending, payments of called guarantees, cost of bank resolution and recapitalization, cost of debt takeover if debt was not previously guaranteed, repayments of debt takeovers if debt was previously guaranteed, and payment of arrears (irrespective of the way they are recorded in the budget law). It does not include capital spending and interest payments.

Adjustors

- The quarterly ceilings on **the general government fiscal deficit** will be adjusted downward (upward) to the extent that cumulative non-tax revenues of the General Government from dividends exceed (fall short of) programmed levels.

- The quarterly ceilings on **the general government fiscal deficit** will be adjusted downward to the extent that cumulative non-tax revenues of the General Government from debt recovery receipts, debt issuance premiums, receipts from telecom 4G frequency auctions, and concession and Public Private Partnership (PPP) receipts recorded above-the-line exceed programmed levels. The IMF Statistics Department will determine the proper statistical treatment of any concession or PPP transaction signed during the IMF program.

- The quarterly ceilings on **the general government fiscal deficit and the primary current expenditure of the Republican budget** will be adjusted upward (downward) to the extent that cumulative severance payments by the general government for the former and the Republican budget level for the latter (including payments from the Transition Fund) exceed (fall short of) the programmed levels up to the yearly budgeted amount. Severance payments by the Health Fund will be considered made at the point the funds have been transferred by the Health Fund to the Health Institution (for both general government and Republican budget adjustors).

The quarterly ceilings on **the general government fiscal deficit and the primary current expenditure of the Republican Budget** will be adjusted upward by a maximum of (i) by a maximum of RSD 13 billion for 2016 or 2017 to the extent that the Republican Budget assumes the debt of Petrohemija to NIS in the context of the former's resolution in a manner that ensures no further fiscal support, (ii) by a maximum of RSD 25 billion to on-lend or issue a new guarantee to Serbia Gas for the repayment of expensive debt in 2016 or 2017; (iii) by a maximum of RSD 6.75 billion to on-lend or issue a new guarantee to Galenika for the repayment of expensive debt in 2016 or 2017; (iv) by a maximum of RSD 0.6 billion to on-lend or issue a new guarantee to Jat Tehnika for the repayment of expensive debt in 2016 or 2017; and (v) by a maximum of RSD2 billion to on-lend or issue a new guarantee to RTB Bor for the repayment of expensive debt in 2017.

Cumulative Programmed Severance Payments
(In billions of dinars)

	End-Mar. 2016	End-Jun. 2016	End-Sep. 2016	End-Dec. 2016	End-Mar. 2017	End-Jun. 2017	End-Sep. 2017	End-Dec. 2017
Programmed cumulative severance payments (of general government)	9.4	11.4	5.0	5.5	1.4	2.75	4.1	5.5
Programmed cumulative severance payments (of Republican budget)	7.3	9.3	4.5	5.0	1.3	2.6	3.9	5.2

Cumulative Programmed Revenues of the General Government from Dividends, Debt Recovery Receipts, and Debt Issuance at a Premium
(In billions of dinars)

	End-Mar. 2016	End-Jun. 2016	End-Sep. 2016	End-Dec. 2016	End-Mar. 2017	End-Jun. 2017	End-Sep. 2017	End-Dec. 2017
Programmed cumulative dividends	9.6	9.6	9.6	9.6	17.1	17.1	17.1	17.1
Programmed cumulative debt recovery receipts	0	0	0	0	0	0	0	0
Programmed cumulative debt issuance at a premium	0	0	0	0	0	0	0	0
Programmed cumulative receipts from telecom 4G frequency auctions	0	0	0	0	0	0	0	0
Programmed concession and PPP receipts recorded above the line					0	0	0	0

The quarterly ceilings on the **primary current expenditure of the Republican budget** will be adjusted upward (downward) to the extent that (i) cumulative earmarked grant receipts exceed (fall short of) the programmed levels and (ii) cumulative proceeds from small-scale disposal of assets (the sale of buildings, land, and equipment) recorded as non-tax revenues exceed the programmed levels up to a cumulative annual amount of 2 billion dinars in each of 2015, 2016, and 2017. For the purposes of the adjustor, grants are defined as noncompulsory current or capital transfers received by the Government of Serbia, without any expectation of repayment, from either another government or an international organization including the EU.

Cumulative Receipts from Earmarked Grants and Small-scale Asset Disposal
(In billions of dinars)

	End-Mar. 2016	End-Jun. 2016	End-Sep. 2016	End-Dec. 2016	End-Mar. 2017	End-Jun. 2017	End-Sep. 2017	End-Dec. 2017
Programmed cumulative ear-marked grants receipts	1.8	4.0	6.5	11.4	2.0	4.3	7.1	11.5
Programmed cumulative receipts from small-scale disposal of assets	0	0	0	0	0	0	0	0

11. Ceiling on the gross issuance of debt guarantees by the Republican Budget for project and for liquidity support. Guarantees for liquidity support are defined in this context as explicit or implicit guarantees, including comfort letters, related to loans provided without any pre-specified purpose other than satisfying funding needs of the company that ensure its normal production and business activities. Guarantees for viable project loans are defined in this context as explicit or implicit guarantees, including comfort letters, related to loans with high probability of repayment provided with a pre-specified objective establishing that all funding should be used for well-defined investment or corporate restructuring projects, confirmed by a reliable feasibility study and/or the investment or restructuring plan endorsed by the government.

Adjustor

- The quarterly 2016 ceilings on **gross issuance of new guarantees by the Republican Budget for project and corporate restructuring loans** will be adjusted upward to the extent that the new EUR 200 million guarantee by the Republican Budget on a loan from the EBRD to the EPS originally planned for 2015 takes place in 2016.

- The quarterly 2017 ceilings **on gross issuance of new guarantees by the Republican Budget for project and corporate restructuring loans** will be adjusted upward to the extent that a new EUR 30 million guarantee by the Republican Budget on a loan from the EBRD to Railways occurs.

12. Ceiling on below-the-line lending by the Republican Government. Below-the-line lending is defined as the lending by the Republican Government which is used to provide financing to entities outside the General Government coverage. Below-the-line lending by the

Republican Government will only be provided in cases where the probability of repayment is assessed to be high. These entities include the Deposit Insurance Agency (DIA), beneficiaries of the APEX lending program, and EPS, among others.

13. Ceiling on borrowing by the Development Fund and the Export Credit and Insurance Agency (AOFI). Borrowing by the Development Fund and AOFI is defined as gross accumulation of financial claims on these entities.

14. Domestic arrears. For program purposes, domestic arrears are defined as the belated settlement of a debtor's liability which is due under the obligation (contract) for more than 60 days, or the creditor's refusal to receive a settlement duly offered by the debtor. The program will include an indicative target on the change in total domestic arrears of (i) all consolidated general government entities as defined in ¶9 above, except local governments; (ii) the Development Fund, and (iii) AOFI. Arrears to be covered include outstanding payments on wages and pensions; social security contributions; obligations to banks and other private companies and suppliers; as well as arrears to other government bodies.

D. Ceilings on External Debt

15. Definitions. The ceilings on contracting or guaranteeing of short-term external debt (with maturities up to one year) consolidated general government, the AOFI, and the Development Fund applies not only to debt as defined in point 8 of the Guidelines on Performance Criteria with Respect to External Debt in Fund Arrangements, Decision No. 6230 - (79/140), as amended, but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are normal short-term import credits. For program purposes, debt is classified as external when the residency of the creditor is not Serbian. 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.

E. Ceiling on External Debt Service Arrears

16. Definition. External debt-service arrears are defined as overdue debt service arising in respect of obligations incurred directly or guaranteed by the consolidated general government, the Export Credit and Insurance Agency (AOFI), and the Development Fund, except on debt subject to rescheduling or restructuring.[1] 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.

[1] Debt subject to rescheduling or restructuring includes the US$44.7 million in arrears to Libya.

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

F. Reporting

18. General government revenue data and the Treasury cash position table will be submitted weekly; updated cash flow projections for the Republican budget for the remainder of the year fourteen calendar days after the end of each month; and the stock of spending arrears as defined in ¶16 45 days after the end of each quarter. General government comprehensive fiscal data (including social security funds) would be submitted by the 25th of each month.

Receivables of the top 20 debtors to Srbijagas and EPS will be submitted in the agreed-upon templates within fourteen calendar days after the end of each month as well as published on the company websites.

Data Reporting for Quantitative Performance Criteria		
Reporting Agency	Type of Data	Timing
NBS	Net international reserves of the NBS (including data for calculating adjustors)	Within one week of the end of the month
Statistical Office and NBS	CPI inflation	Within four weeks of the end of the month
Ministry of Finance	Fiscal deficit of the consolidated general government	Within 25 days of the end of the month
Ministry of Finance	Current primary expenditure of the Republican budget excluding capital expenditure and interest payments	Within 25 days of the end of the month
Ministry of Finance	Gross issuance of new guarantees by the Republican Government for (i) project and corporate restructuring loans and (ii) gross issuance of new guarantees by the Serbian Republican Government for liquidity support	Within three weeks of the end of the month
Ministry of Finance	New short-term external debt contracted or guaranteed by the general government, the Development Fund and AOFI	Within four weeks of the end of the quarter
Ministry of Finance	External debt payment arrears by general government, Development Fund and AOFI	Within four weeks of the end of the month
Ministry of Finance	Gross accumulation of domestic payment arrears by the general government (without local government, the Development Fund, and AOFI)	Within 45 days of the end of the quarter
Ministry of Finance	Borrowing by the Development Fund and AOFI	Within four weeks of the end of the month
Ministry of Finance	Cumulative below-the-line lending by the Republican Government	Within 25 days of the end of the month
Ministry of Finance	Severance payments by general government, with a breakdown by government level.	Within four weeks of the end of the quarter
Ministry of Finance	Earmarked grants and receipts from small-scale disposal of assets	Within four weeks of the end of the quarter

INTERNATIONAL MONETARY FUND

REPUBLIC OF SERBIA

August 11, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION, SEVENTH REVIEW UNDER THE STAND-BY ARRANGEMENT, AND MODIFICATION OF PERFORMANCE CRITERIA

Prepared By European Department

CONTENTS

FUND RELATIONS

(As of June 30, 2017)

Membership Status: Joined December 14, 1992 (succeeding to membership of the former Socialist Federal Republic of Yugoslavia); accepted Article VIII on May 15, 2002. Serbia continues the membership in the Fund of the former state union of Serbia and Montenegro—previously the Federal Republic of Yugoslavia—since July 2006.

General Resources Account	**SDR Million**	**Percent Quota**
Quota	654.80	100.00
Fund Holdings of Currency	608.04	92.86
Reserve Position	46.78	7.14

SDR Department	**SDR Million**	**Percent Allocation**
Net cumulative allocation	445.04	100.00
Holdings	9.61	2.16

Outstanding Purchases and Loans	**SDR Million**	**Percent Quota**
None	None	None

Latest Financial Arrangements

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-By	Feb 23, 2015	Feb 22, 2018	935.40	0.00
Stand-By	Sep 29, 2011	Mar 28, 2013	935.40	0.00
Stand-By	Jan 16, 2009	Apr 15, 2011	2,619.12	1,367.74
EFF	May 14, 2002	Feb. 28, 2006	650.00	650.00

Projected Payments to Fund
(In millions of SDR)

	Forthcoming				
	2017	2018	2019	2020	2021
Principal					
Charges/Interest	1.27	2.58	2.58	2.58	2.58
Total	1.27	2.58	2.58	2.58	2.58

Implementation of HIPC Initiative: Not Applicable.

Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable.

Safeguards Assessment: The latest safeguards assessment for the National Bank of Serbia (NBS) has been completed in April 2015. The assessment found that the NBS has maintained generally strong controls over its key operations, and amendments to the NBS Law since the previous assessment have reinforced the autonomy of the central bank and its safeguards framework. That said, governance oversight could be further strengthened through the establishment of an audit committee. The assessment also recommended: (i) enhancing procedures for the selection of the auditors to give weight to technical rather than cost criteria; and (ii) amending the charter of the NBS's internal audit function to better support its independence through a functional reporting line to the audit committee. The NBS has subsequently implemented all safeguards recommendations.

Exchange Arrangement: Serbia accepted the obligations under Article VIII, Sections 2, 3, and 4, on May 15, 2002, and maintains a system free of restrictions on payments and transfers for current international transactions, except with respect to blocked pre-1991 foreign currency savings deposits (IMF Country Report No. 02/105). The de jure exchange rate arrangement is a floating system since January 1, 2001. According to the 2009 Monetary Policy Program, the National Bank of Serbia (NBS) implements a managed floating exchange rate regime. The de facto exchange rate arrangement was reclassified from "floating" to "stabilized" (effective January 28, 2016).

Last Article IV Consultation: Concluded on February 23, 2015 (IMF Country Report No. 15/50).

FSAP Participation: Serbia participated in the Financial Sector Assessment Program in 2005, and the Executive Board discussed the Financial System Stability Assessment in February 2006 (IMF Country Report No. 06/96). An update under the Financial Sector Assessment Program was conducted in 2009 and the Executive Board discussed the Financial System Stability Assessment in March 2010 (IMF Country Report No. 10/147).

Technical Assistance since Last Article IV Consultation (February 2015)[1]:

Department	Timing	Purpose
MCM	May. 2017	Primary Dealer System
MCM	May. 2017	Dinarization Strategy
FAD	Mar. 2017	Spending Review and Pensions
FAD	Mar. 2017	Tax Policy
FAD	Mar. 2017	Accounting
FAD	Feb. 2017	Tax Administration
STA	Feb. 2017	Government Finance Statistics
STA	Jan. 2017	External Sector Statistics
FAD	Jan. 2017	Tax Administration
FAD	Dec. 2016	Tax Administration

[1] The list does not include visits by regional advisors.

FAD	Oct. 2016	Public Financial Management
FAD	Oct. 2016	Tax Administration
FAD	Sep. 2016	Tax Administration
FAD	Aug. 2016	Tax Administration
FAD	Apr. 2016	TADAT Assessment
FAD	Apr. 2016	Accounting
STA	Mar. 2016	Government Finance Statistics
STA	Feb. 2016	National Accounts
FAD	Feb. 2016	Tax Administration
FAD	Jan. 2016	Public Investment Management and Public-Private Partnerships
MCM	Oct. 2015	Recovery and Resolution Planning
FAD	Sep. 2015	Budget System Law
STA	Aug. 2015	Government Finance Statistics
FAD	Aug. 2015	Accounting
MCM	Apr. 2015	Primary Dealer System
MCM	Apr. 2015	Nonperforming Loan Resolution
FAD	Apr. 2015	Tax Administration
MCM	Mar. 2015	Insurance Supervision
FAD	Mar. 2015	Accounting

In addition, technical assistance was available through resident advisors covering tax administration and public financial management.

Resident Representative:

Mr. Sebastian Sosa took his position as Resident Representative in July 2016.

WORLD BANK GROUP RELATIONS

Partnership with Serbia's Development Strategy

The World Bank has been discussing the policy reform agenda with successive governments since 2001, and has been actively engaged with the new government since winning a mandate and assuming office in August 2016. Support for the government's reform efforts and development strategy from the World Bank and the IMF follow the agreed division of responsibilities between the two institutions.

The Fund takes the lead on macroeconomic policies (fiscal, monetary, and exchange rate) aimed at maintaining macroeconomic stability and facilitating sustainable growth, while the Bank takes the lead on structural policies aimed at medium to long-term adjustment. In areas of direct interest to the Fund, the Bank leads the policy dialogue in: (i) public administration reform; (ii) health and education; (iii) social safety net reform; and (iv) reforms with a bearing on the business environment, with special focus on the performance of publicly owned enterprises (electricity company EPS, gas supplier Srbijagas, and the railway companies). The Bank and the Fund have jointly led the policy dialogue in the financial sector.

The World Bank

Total International Development Association (IDA) credits and grants committed to the Republic of Serbia (Serbia) by the Bank since 2001 amount to approximately US$740 million, with an additional US$2.3 billion in International Bank for Reconstruction and Development (IBRD) loan commitments (as of May 2017). The Bank has assisted Serbia to make progress against key objectives set out in the Country Partnership Framework (CPF) for FY16–20 which are grouped under two broad focus areas: (i) economic governance and role of state; and (ii) private sector growth and economic inclusion. The current CPF is based on the Systematic Country Diagnostics (SCD). The SCD report has been prepared and discussed with a broad range of stakeholders from government, non-government, private sector, and academia. The authorities have requested significant budget support around the structural reform agenda and the WB portfolio reflects these discussions.

As of May 2017, Serbia has a portfolio of 12 Bank-supported projects with a total commitment value of US$1.7 billion. The current portfolio has a heavy infrastructure component – in total, there are 5 infrastructure projects accounting for about half of the total portfolio. Two largest projects include the Corridor X highway project and the Road Rehabilitation Project aiming to promote regional integration and spur economic growth. In the social sectors the program is focused on the health sector. In the financial sector the Bank is providing support to strengthening financial sector safety nets. In the context of the Emergency Recovery Loan, the Bank has also reengaged on energy sector reform and on flood prevention and disaster risk mitigation. Finally, a real estate management project focuses on property registration and valuation. The Bank also has two development policy lending operations to support the reform of the public enterprise sector and to improve public expenditure management. In addition, the Bank has four result-based financing operations, totaling US$475 million, focusing on public sector wage and employment reform and on competitiveness and jobs. Lastly, the WB Board of Directors recently approved the first Deferred Drawdown Operation (the CAT DDO) for Serbia in order to provide financial support against risks stemming from natural disasters.

International Finance Corporation (IFC)

Serbia became a shareholder and member of IFC in 2001. Since then, IFC's investment in Serbia has totaled US$2.2 billion, including US$795 million in funds mobilized from partners, in 55 projects across a variety of sectors. As of 30 June 2016, IFC's committed investment portfolio in Serbia is US$285 million. In FY16, IFC invested US$69 million in Serbia. In recent years, IFC 's investment level has been modest because of sluggish reform, significant governance issues and inconsistencies in the application of the rule of law. IFC's priorities in Serbia include agribusiness, renewable energy and energy efficiency, and improvements in investment climate. IFC is also focusing its financing on increasing access to finance by supporting the development of local financial institutions, especially those that concentrate on SMEs. Through the joint Global Practices and independently, IFC's advisory services aim to improve the investment climate and the performance of private sector companies, and to attract private sector participation in the development of infrastructure projects.

Under the new World Bank Group's Country Partnership Framework (CPF) for Serbia, IFC will invest US$400-600 million during the FY16-20 period. The upper range of this investment spectrum is dependent upon the successful implementation of laws and enabling regulations supporting private sector investments.

Multilateral Investment Guarantee Agency (MIGA)

As of May 2017, MIGA's total exposure in Serbia is US$821 million across 5 active projects. MIGA's engagement is concentrated in the service sectors (financial, telecom). Going forward, MIGA will explore options to engage in other sectors, including real estate and construction investments, working closely with the IFC.

Prepared by World Bank staff. Questions may be addressed to Carla Pittalis at (202) 473-9597 or Lazar Sestovic +381-3023-709.

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance

General: Data provision is broadly adequate for surveillance with some key data shortcomings in the government finance statistics.

National Accounts: The real sector data are compiled by the Statistical Office of the Republic of Serbia (SORS). Annual and quarterly nominal and volume measures of GDP by activity are available from 1996 onwards. Nominal annual GDP estimates by expenditure are available from 1995. Quarterly GDP estimates by expenditure both at current prices and in volume measures are available from 1996 onwards.

The national accounts statistics of the Republic of Serbia are based on conceptual framework of the 2008 SNA/ESA 2010. After the introduction of this new system in October 2014, the GDP series were revised up by an average of around 7 per cent, with variations across years. The increase in level is partly caused by methodological changes, and partly by statistical changes. Of the methodological changes, about 1 percent of GDP is a result of the recommendations of the ESA2010 to treat research and development and military hardware as capital goods in the GDP compilation. An additional two percent is due to changes according to the ESA95 that are now being included with the current revision. The statistical changes relate to a better coverage of own-account construction of dwellings (about 0.4 percent), illegal activities (about 0.7 percent) and actual rentals (about 0.5 percent). Methodological changes were introduced in the compilation of volume measures of GDP with the adoption of chain-linked volume measures, replacing the previous fixed base estimation process. Also, the scope of the estimates was extended with the compilation of annual GDP by final expenditure in volume terms and quarterly GDP by final expenditure, at current prices and in volume terms. These estimates were disseminated for the first time on March 29, 2013.

Procedures for the compilation of the estimates of annual GDP by production are in line with internationally recommended practices. Estimates for achieving exhaustiveness in the production account estimates are being produced with an adequate methodology and compiled at very detailed levels.

Sources and method for the compilation of GDP by expenditures are in general, adequate.

Reconciliation between the independent annual GDP estimates based on the production and expenditure approach is being made at aggregate levels, although the original differences are not significant. The gap between the quarterly estimates of GDP by expenditure and GDP by production is closed by a residual covering the statistical discrepancy plus changes in inventories and net acquisition of valuables. There are no reliable independent estimates of changes in inventories on a quarterly basis.

Price Statistics: The SORS compiles and disseminates monthly indices for consumer prices, producer prices, industrial production, as well as unit-value indices for imports and exports. Concepts and methods used to compile the CPI, as well as other price statistics, attempt to reflect international standards and best practices.

External sector statistics: Balance of payments statistics are compiled by the NBS and reported to STA for re-dissemination in the IFS and the Balance of Payments Statistics Yearbook. Since April 2014, BOP data have been compiled in accordance with the Sixth Edition of the Balance of Payments and International Investment Position Manual (BPM6). The first BPM6 data were introduced in 2014 starting with Q1 2007 (balance of payments) and Q4 2013 (IIP).

A January 2017 TA mission found that the source data and compilation system are sound. However, additional efforts are needed to (i) pursue the ongoing program of modernization of NBS's database management system to strengthen the basis for the ESS compilation, and (ii) improve the compilation techniques in some areas, including trade-related statistics and financial flows and stocks accrual recording. In particular, adjustments to trade in goods and services are needed to properly record the fob values of trade, incorporate the estimates of illegal and shuttle trade, and identify the companies involved in the processing and merchanting activity to gather information on their gross flows.

Government Finance Statistics: Monthly government finance statistics is compiled and published by the Ministry of Finance on a cash basis broadly following the methodology of the Manual on Government Finance Statistics 1986 (GFSM 86). The sector coverage of these data is not clearly articulated, and is not in line with the definitions of central and general government in the IMF GFS Manuals. Principal data sources are the Republican Treasury and budgetary execution reports of the spending ministries and first-level budget units. These data form the basis for the cash-based annual GFS data transmitted to the IMF for the GFS Yearbook (GFSY) based on the Government Finance Statistics Manual 2001 (GFSM 2001), the last data reported is for 2012.

Since 2001, Serbia has made some efforts to bring the existing budget reporting system in line with the GFSM 2001 methodology, however full compliance has not yet been achieved as implementation of the new chart of accounts, generally consistent with the classifications of the GFSM 2001, has not been completed. The classification of all expenditure of the "National Investment Plan" as capital needs to be brought in line with international statistical standards. The sector classification of the general government sector has been reviewed, but not finalized. Accrual accounting needs to be gradually introduced in the GFS reporting, and the first step in the design of a reconciliation table has been taken. While the data on the clearance of arrears are available monthly, information on the accumulation of new arrears is not available. The reconciliation of fiscal and monetary data is conducted, but not on a regular basis.

The Serbian authorities have taken steps to harmonize the sectorization of public sector units in line with the GFSM 2014 requirements in the context of the ongoing technical assistance provided by the Fund.

Data on the general government operations and financial balance sheet based on the revised register of public units are available.

Monetary and Financial Statistics: Monetary and financial statistics are compiled by the NBS, broadly following the methodology set forth in the *Monetary and Financial Statistics Manual, 2000* (*MFSM*), and meeting the GDDS recommendations with respect to periodicity and timeliness for financial sector data. Monetary data are reported to the Fund using Standardized Report Forms beginning December 2013.

The coverage of monetary statistics includes the central bank and the other depository corporations (ODCs) and could be improved by including remaining ODCs (including banks in liquidation) and other financial corporations.

Serbia has yet to compile and submit to STA Financial Soundness Indicators for publication on the IMF website.

II. Data Standards and Quality

Serbia participates in the General Data Dissemination System (GDDS)/enhanced GDDS (e-GDDS) and its metadata were posted on the IMF Data Dissemination Bulletin Board on May 1, 2009.

ROSC report on Fiscal Transparency was published in May 2009.

Table of Common Indicators Required for Surveillance

(As of July 18, 2017)

	Date of Latest Observation	Date Received	Frequency of Data[4]	Frequency of Reporting[4]	Frequency of Publication[4]
Exchange rates	Jul 17, 2017	Jul 18, 2017	D and M	D and M	D and M
International reserve assets and reserve liabilities of the monetary authorities[1]	Jul 17, 2017	Jul 18, 2017	D	D	M
Reserve/base money	Jul 17, 2017	Jul 18, 2017	D and M	W and M	W and M
Broad money	Jun 2017	Jul 15, 2017	M	M	M
Central bank balance sheet	Jun 2017	Jul 15, 2017	M	M	M
Consolidated balance sheet of the banking system	Jun 2017	Jul 15, 2017	M	M	M
Interest rates[2]	Jul 17, 2017	Jul 18, 2017	D	D	D
Consumer price index	Jun 2017	Jul 12, 2017	M	M	M
Revenue, expenditure, balance and composition of financing – general government	May 2017	Jul 4, 2017	M	M	M
Revenue, expenditure, balance and composition of financing– central government	May 2017	Jul 4, 2017	M	M	M
Stocks of central government and central government-guaranteed debt[3]	May 2017	Jul 4, 2017	M	M	M
External current account balance	May 2017	Jul 2017	M	M	M
Exports and imports of goods and services	May 2017	Jul 2017	M	M	M
GDP/GNP	2017:Q1	Jun 1, 2017	Q	Q	Q
Gross external debt	May 2017	July 2017	M	M	M
International Investment Position[5]	Mar 2017	Jun 2017	Q	Q	Q

[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] Including currency and maturity composition.

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

[5] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

Statement by Miroslaw Panek, Executive Director for the Republic of Serbia and Vuk Djokovic, Senior Advisor to the Executive Director
August 30, 2017

On behalf of the Serbian authorities, we would like to thank staff for constructive policy dialogue and for their valuable policy recommendations. The report includes a thorough and insightful analysis of the macroeconomic situation. In many aspects, we share staff's views on the challenges going forward. The SBA-supported economic program is yielding good results. The implemented policies successfully addressed internal and external macroeconomic imbalances, restored soundness of the financial system and set foundations for sustainable and durable economic recovery. The achievements under the program have been reflected in credit ratings upgrades, historically low sovereign spreads, and substantially improved business environment rankings. The support to reforms remains strong. The victory of the former PM Vučić in presidential election held in early spring, and the suport to the PM Brnabić and her cabinet by the incumbent parliamentary coalition demonstrate political continuity and provide a strengthened mandate to the authorities to continue with the implementation of necessary economic reforms. Furthermore, Serbia remains pledged to the EU integration.

The Serbian authorities continue to be firmly committed to the program and its objectives, which proved instrumental in regaining macroeconomic stability and fostering growth, and confirm their intention to treat it as precautionary.

Recent developments

The Serbian economy grew 2.8 percent in 2016. In 2017, the growth is expected to be driven by recovery in consumption, investments and net exports. Higher real incomes, a result of tangible increase in employment and higher private sector wages, are a key driver of consumption rebound. Both private and public investments continue to grow in 2017, on account of the credible and growth-friendly fiscal consolidation and implemented labor market and other structural reforms, which improved confidence and investment sentiment. FDIs have remained strong both in 2016 and 2017 and are geographically and sectorially diversified. Exports increased about 12 percent in real terms in 2016, and are projected to grow about 9 percent this year. The current account stabilized around 4 percent and is expected to remain at that level, consistent with Serbia's investment needs and the level of domestic savings. Following the period of undershooting, inflation returned to the target band, and is projected to remain within the band, as the credibility of monetary policy has strengthened and the inflation expectations remain well anchored. Labor market conditions have improved, with substantial drop in unemployment. New employment has been mostly created in the private formal economy. Credit activity continues to grow, supported by accommodative monetary policy and improved conditions in the banking sector.

Fiscal policy

The authorities made considerable progress in achieving sustainable and durable fiscal adjustment—critical for placing public debt on a downward path—under the SBA supported economic program. The authorities remain mindful of the need to preserve hard-won fiscal gains and to continue with the prudent policies to achieve more sustainable debt levels. At the same time, policy action is geared towards minimizing fiscal risks and strengthening policy frameworks.

In 2017 fiscal policy will continue with the structural adjustment, while further containing current spending, restoring buffers and creating fiscal space for infrastructural investments. The fiscal consolidation target set under the program—4 percent of structural adjustment over three-year period—has been already achieved, reaching cumulative adjustment of 4.5 percent at the end of 2016. Strong revenue performance and expenditure containment led to the adjustment of the 2017 general government deficit target, which is now set to about 1.1 percent, down from 1.7 percent set in the sixth review. The primary surplus is expected to reach 2 percent at the end of the year. Public debt, which reached its peak in 2015, continues on the downward trajectory, and is estimated to decline to 70.9 percent of GDP at the end of the year.

The authorities are aware of the need to upgrade transportation and other essential physical infrastructure, and, in that context, spare no efforts in planning, securing financing and timely executing essential infrastructure projects within a tight budget envelope. To strengthen efficiency of public investment, the authorities have undertaken a review of the public investment framework with the aim to improve its cost-effectiveness, and transparency of selection process. On this basis, in June the government enacted a decree to streamline all phases of the project cycle, including stipulating a transparent mechanism and guidelines for independent appraisal and evaluation of public infrastructural projects. Also, a single project pipeline has been established.

The authorities remain committed to modernization of the Serbian Tax Administration. They recognize the need for reforms to improve efficiency of tax collection. The 2015-2020 Tax Administration Transformation Program, developed with the support of Fund's technical assistance (TA), will be updated by the year-end, to better guide and provide additional impetus to the reform process. Further strengthening of the PFM framework is ongoing, including measures to gradually bring most indirect budget users to the Financial Management Information System. The budget coverage is being improved by including all project loans in the budget. The authorities, mindful of the staff's advice, are considering major overhaul of the existing rules-based fiscal framework, which paired with already operational Fiscal Council will strengthen further the predictability and credibility of fiscal policies and ensure its sustainability in the medium-term.

Monetary and exchange rate policy

The National Bank of Serbia (NBS) keeps its reference rate unchanged at 4 percent since July 2016. The headline inflation, which after a period of undershooting returned to the inflation corridor earlier this year, is projected to remain stable and within the target band. Price index increases in first quarter were driven by food and energy. Inflationary pressures gradually receded in the second quarter. Core inflation remains low at about 2 percent, while the inflationary expectations of financial and corporate sectors remain anchored within the corridor. The monetary policy stance remains accommodative. The monetary authorities remain cautious and vigilant of global uncertainties, international financial and commodity market developments and risks of divergent monetary policies of major central banks. The achieved macroeconomic stabilization and reduced external and internal imbalances, paired with strengthened credibility of the central bank are helping anchor expectations and facilitating effectiveness of monetary policy.

Promoting use of domestic currency remains a priority for the NBS as a reduction of euroization will reduce risks to financial sector stability and enhance monetary policy transmission. A range of measures has been implemented in the past to foster dinarization, including macro-prudential measures, tax incentives, development of domestic sovereign market for instruments denominated in domestic currency, extending instrument's maturities and building the dinar yield curve. Those efforts, paired with declining interest rate differentials and relatively stable exchange rate are yielding positive results. Lending in dinars has strengthened substantially, particularly to households—in 2016 about 75% of new loans to households were dinar denominated—and the banks have started to offer long-term mortgages in domestic currency. The authorities are considering measures to further strengthen their dinarization strategy, supported by the findings and advice of the recent Fund's TA.

The Serbian authorities remain committed to the inflation targeting regime. The current level of international reserves is high by standard metrics. The central bank will maintain an adequate reserves level throughout the program. Further, given the high euroization of the economy, volatility of capital flows and the financial stability concerns, the exchange rate regime continues to be a managed float, with the foreign exchange interventions aimed at smoothing excessive exchange rate volatility, without targeting a specific level or path of the exchange rate.

Financial sector policies

The Serbian banking sector remains well capitalized and liquid with the capital adequacy ratio of about 22 percent. The financial intermediation continues to improve. Provision of the credit to the economy continues to grow, on the back of the strengthened banking sector balance sheet, improved credit conditions, accommodative monetary policy and increased confidence. Since the inception of the program, the authorities have made a noteworthy progress in implementing financial sector reforms to enhance its resilience and stability, while harmonizing regulatory framework with the EU standards. The bank resolution framework has been substantially strengthened, making bank resolutions more effective and less costly. The implementation of the comprehensive strategy to address the large share of distressed assets within the banking system is yielding strong results, with the share of gross NPLs in total assets falling by 7 percentage points from the 2015 peak, to about 15.6 percent at the end-2016. The supervisory framework has been strengthened recently by introducing the Basel III capital and liquidity standards. The relevant amendments to further strengthen the insolvency framework, improve secured creditors rights, and introduce a new framework for the real estate appraisal were adopted.

Furthermore, the government has updated its strategy for the remaining state-owned banks to provide strategic guidance and strengthen governance. The privatization advisor for the sale of Komercijalna banka—the second largest lender—has been recently selected. Also, the diagnostic analysis of the Development Fund and Export Promotion Agency have been concluded, providing an assessment of the effectiveness of development lending and informing future decisions on the development financing options in Serbia.

State owned enterprises

The authorities have achieved a substantial progress in implementing wide-ranging SOEs reforms to improve their operational viability and limit fiscal risks. Significant advances have been made towards completing resolution of socially-owned companies in the portfolio of the former Privatization Agency—from about 500 companies 320 are being resolved through bankruptcy or privatization, with 26,000 workers who received severance payment. Further, important advances have been made in improving operational and financial viability of large SOEs, while addressing fiscal risks. With the support of other IFIs a broad range of measures has been implemented to restructure large SOEs and improve their governance, operational efficiency, and to strengthen their financial position. These measures yielded tangible results and the implementation of a number of initiated reforms is still in process.

Finally, owing to the broad structural reforms implemented under the program, business climate in Serbia has improved substantially, as reflected in continuous gains on relevant business rankings, and the growing number of a wide range of foreign investments.