

## Serbia's Standby Arrangement: Taking Stock

*In April 2011, Serbia's standby arrangement with the IMF is set to expire. Performance under the program has differed across areas. The short-term – crisis-management -- part of the program succeeded in achieving a reasonable fiscal deficit path and in protecting financial stability during the program. But structural measures aimed at boosting long-term economic flexibility and growth fared less well. Looking ahead, Serbia's main economic challenge is to mount a massive structural reform effort to leverage its regained cost competitiveness for a more sustained and less risky growth.*

### What worked?

The spillover of the global crisis into Serbia was relatively well-contained, especially taking into account high initial external vulnerabilities and difficult regional environment.

Serbia's recession was not as deep as in most other economies in the region, and output began to recover already in the second half of 2009. The recovery was helped by the net exports' response to the dinar depreciation and balanced fiscal policies. However, measurement issues may also have played a role in a better recorded GDP outcome in Serbia relative to other countries.

Foreign banks generally kept exposures. The March 2009 agreement – supported by foreign banks' roll-over -- helped ease financial tensions. Most banks kept their commitments in 2009-10, although there were exceptions. The NBS had good data and was vigilant in detecting “free riders” – this may have helped better enforce compliance, at least in comparison to other countries with similar coordination initiatives.

The deep cumulative depreciation helped restore cost competitiveness without a significant financial crisis. Banks were in good shape to withstand the depreciation shock owing to their capital and liquidity cushions and hedged positions. The key risks regarded the balance sheets of unhedged borrowers in foreign exchange, with households being in better shape than corporates due to mattress money and FX deposit buffers.

Expenditure controls in the Republican budget were effective in achieving overall deficit objectives (though at the expense of severe cuts in investment spending). The large upfront fiscal adjustment of April 2009 was crucial, and the nominal freezes of public wages and pensions were generally adhered to through end-2010. As a result, the program's quarterly fiscal targets were generally met. The final overall fiscal stance (deficits of about 4-4½ percent of GDP in 2009-11) has been neither too loose nor too tight, and a vicious circle of disappointing growth and procyclical fiscal tightening has been avoided. Finally, reasonable fiscal rules have been put in place.

### Key challenges yet to address

- **Weak labor market.** While part of the reported job losses reflected a shift to the grey economy and “legacy” factors such as delayed transition, the performance was a

major disappointment. And the composition of the losses – skewed toward the young – is not good given the need to build high-quality on-the-job human capital.

- **Worsening corporate balance sheets.** Highly leveraged corporates have been hit by depreciation, and this is showing in their NPL ratios (of over 20 percent). The program aims to alleviate the problem by improving tools for corporate debt workouts.
- **Rising inflation.** CPI growth accelerated rapidly on the back of food price increases both in Serbia and in the region. Given the chronically high inflation in Serbia, the inflation outcome reflected a missed opportunity rather than a truly new problem. In any case, the NBS' response has been appropriately forceful.
- **Poor structure of public spending in 2009-2011.** Capital spending has been sacrificed due to overruns in current expenditure, while prioritization and implementation of investment projects remains poor.
- **Lack of longer-term curbs on current spending.** The pension law enacted in late-2010 was only a modest step in the right direction. The once-promising rationalization of the civil service got stuck during implementation, while steps to reform health care and education are at an early stage.
- **Slow growth-oriented structural reforms.** Attempts to improve the business climate often faltered, as did privatizations and the upgrading of specific laws and institutional procedures and practices, especially in the areas of competition, public procurement, labor regulations, and property rights. Restructuring of the still large and inefficient public enterprises proceeded slowly. To be sure, some progress in these areas was made, but it was “too little too late.”

### Looking ahead

Fixing Serbia's problems is proving a complex task. But if Serbia is to become a truly competitive and prosperous economy within the EU, there is no alternative to politically painful structural reforms. The IMF program helped forestall an economic implosion and provided (limited) breathing room. It is up to the policymakers to persevere with wage moderation and complete the unfinished structural reform agenda.