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Republic of Serbia: Letter of Intent and Technical Memorandum of Understanding

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Letter of Intent (LOI)

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C., 20431
U.S.A.

Belgrade, December 3, 2009

Dear Mr. Strauss-Kahn:

1. On most fronts, our program is working well. Financial tensions have eased, GDP and exports have been broadly in line with what was anticipated at the time of the first review of our Stand-by Arrangement (SBA), and inflation is receding faster than projected. However, in some areas the fallout from the global financial crisis for our economy has been worse than anticipated. In particular, with the pre-crisis boom in domestic and cross-border credit abruptly brought to a halt, corporate payment problems and insolvencies are rising. Employment is falling, and domestic demand and imports are contracting more sharply than projected. As a consequence, while the large external current account deficit is narrowing much faster than expected, fiscal revenues have been falling short of what was programmed.
2. Notwithstanding these challenges, we have implemented the program in most areas (Tables 1-2): The end-September 2009 performance criteria on the floor on net foreign assets of the National Bank of Serbia (NBS), the ceiling on new short-term external debt, and the ceiling on external payment arrears were all observed, as were the indicative targets on the ceilings on current expenditures and accumulation of domestic guarantees by the budget. September inflation was only slightly below the program target range. However, the performance criterion on the general government deficit for end-September 2009 was missed, reflecting revenue shortfalls.
3. Most structural reforms were also implemented as planned. Specifically, three benchmarks were fully observed: (i) adopting an action plan for the remaining banks with majority state ownership; (ii) preparing a three-month rolling cash flow plan for the Republican budget; and (iii) adopting a business plan for the Road Company of Serbia. The benchmark on adopting business plans with wage increases for ten large state enterprises in 2009 conforming to those of the general government was mostly met. Planned actions in the revenue administration reform were completed. Finally, while the NBS conducted onsite diagnostic studies and stress tests for the fifteen largest banks and one majority state-owned bank, studies for the three other banks with majority state ownership were postponed to end-2009 owing to the incipient merger of two of the banks.

4. In consideration of this performance and given our continued commitment to macroeconomic stability and structural reforms, we request a waiver for the nonobservance of the end-September 2009 performance criterion on the general government deficit, the completion of the second review of the SBA, and the disbursement of SDR 319.6 million. In view of the changed macroeconomic outlook, we also request a modification of the quantitative performance criteria for the remainder of the year, in particular an increase of the ceiling on the general government deficit, a reduction in the inflation target for end-2009, and a rephrasing of the remaining purchases under the program. The next review and financing review, assessing end-March performance criteria, is envisaged for late May 2010. Our commitment to the program is underscored by the coalition government's decision to implement an ambitious spending-based fiscal adjustment program, including through continued nominal freezes of public wages and pensions in 2010, a significant downsizing of public administration in 2010 and beyond, and our commitment to undertake key reforms in the pensions, education, and health areas.

5. We believe that the policies and measures set forth in this memorandum are adequate to achieve the objectives of the program, and stand ready to take any additional measures that may be appropriate for this purpose. The Government of the Republic of Serbia will consult with the IMF in advance on the adoption of such additional measures in accordance with the IMF's policies on such consultations. As usual, we intend to make these understandings public, and agree with the publication of the staff report and this letter.

Macroeconomic Framework for the Remainder of 2009 and 2010

6. Despite our efforts to sustain economic activity, the economic outlook deteriorated somewhat further relative to earlier program projections. We now expect a 3 percent decline of real GDP this year, with a modest recovery of 1.5 percent real GDP growth in 2010. This year, domestic demand, particularly investment spending, is expected to slump, in part reflecting tight credit market conditions. While easing external financing pressures, the subdued demand has also put strains on the fiscal position, mainly through lowering tax revenues. Along with the expected improvement in the external environment, activity is expected to stabilize in the remainder of the year and begin to recover in 2010. Recent data on industrial production are encouraging in this regard. But uncertainties about the strength of the economy remain.

7. Inflation is expected to remain on a declining trend. Weak domestic demand and moderating wage growth have substantially eased inflation pressures in recent months, and we expect CPI inflation to end the year somewhat below the lower band under the inflation consultation clause, although within the NBS target range of 6–10 percent. Consequently, we propose to lower the bands under the inflation consultation clause by 2.5 percentage points in 2009. In 2010, inflation is expected to decline further to mid-single digits.

8. External adjustment has proceeded faster than expected, owing to the sharp contraction of domestic demand. The external current account deficit is now projected to decline to 8 percent of GDP in 2009. Export growth is expected to regain strength only in 2011, and the external current account deficit is projected to stabilize at about 8 percent of GDP over the medium term.

9. The external financing situation has improved and financial flows appear to have stabilized. Going forward, we expect external financing flows to be sufficient to accommodate reduced financing needs. Foreign parent banks are expected to maintain their exposures to Serbia. Private inflows, financing from the IMF, other international financial institutions, and the EU, together with the new SDR allocation should be sufficient to meet all external financing needs in 2009.

Fiscal Policy

10. Our preferred fiscal adjustment strategy for 2009–10 and beyond reflects a broad consensus within our coalition government. The strategy aims at restoring sound public finances over the medium term, mainly through coordinated and balanced restraints on spending on public wages and pensions. Our strategy can be summarized in seven points:

- First, for 2009, we plan to achieve the fiscal deficit target of 4½ percent of GDP.
- Second, for 2010, we aim at a revised deficit target of 4 percent of GDP. This will require us to maintain most of the fiscal measures put in place in 2009—particularly the nominal freezes of public pensions and wages.
- Third, looking beyond 2010, we will continue with structural spending reforms, to reduce the share of current spending in GDP to 32½ percent by 2015. At the same time, we will improve the targeting of social benefits. Moreover, we envisage increases in capital spending, in line with the strategic priorities set by the National Infrastructure Council.
- Fourth, we will undertake further efforts to modernize our tax administration, with specific benchmarks to be agreed during the next review, and broaden tax bases. However, significant tax rate increases, including VAT increases, will only be considered as measures of last resort to achieve fiscal consolidation.
- Fifth, to contain contingent fiscal liabilities, we will closely monitor and maintain financial discipline in state enterprises, while preparing most of them for privatization as soon as market conditions allow. Potential obligations related to property restitution claims will have to respect our tight budget constraints.
- Sixth, we will put in place more effective legal and procedural constraints and sanctions against procyclical and electoral spending pressures.

- And seventh, we will improve debt management with a view to developing the domestic debt market, while lowering rollover risks.

11. We plan to contain the fiscal deficit in 2009 to 4½ percent of GDP by strictly observing the overall general government spending envelope of about 1,270 billion dinars programmed earlier in the year. Reflecting weaker revenues, the fiscal deficit during the first nine months of 2009 was ¾ percent of GDP higher than programmed. The revenue shortfalls reflected mainly lower indirect tax collections, due to weaker consumption and imports, and lower non-tax revenue. Spending execution has been tight, and spending arrears have been kept in check. The larger-than-programmed fiscal deficit was mainly financed by issuing short-term T-bills.

12. For 2010, we plan to reduce the fiscal deficit to 4 percent of GDP. This relatively high deficit target reflects our somewhat backloaded spending-based adjustment strategy, as well as a compromise between supporting the expected weak recovery and keeping the already high structural fiscal deficit in check. However, should the recovery in economic activity be stronger than presently expected, we will save cyclical revenue overperformance. We have aim to secure additional funding from the World Bank and the EU, and plan to further tap the T-bills market. The 2010 budget will be based on the following spending policies:

- As regards the 2010 public wage bill, we plan to freeze all general government wages and salaries in nominal terms; public administration staff at the Republican and local level will be reduced by about 10 percent at the beginning of 2010; these measures will be accompanied by a hiring freeze at all levels of government, including for temporary contracts. We estimate that these measures will contain the general government wage bill in 2010 at about 300 billion dinars (9¼ percent of GDP).
- The nominal freeze on pensions will be extended through 2010, with the next indexation adjustment scheduled for April 2011. This measure should contain net spending by pension funds in 2010 to about 395 billion dinars (12¼ percent of GDP). Other non-targeted social benefits will remain frozen in nominal terms. Targeted social benefits (family and child allowances) will not only be indexed but also likely increase owing to a heavier case load.
- We will maintain the 2009 discretionary spending cuts, including the reduction in transfers to local governments, and plan to gradually phase out the credit subsidy programs introduced in 2009.
- As regards capital spending and net lending, we will aim to protect productive investment and accelerate the implementation of foreign-financed capital projects. At the same time, the joint project with Fiat to restructure Zastava car factory will cost the budget almost ½ percent of GDP in 2010.

13. Starting in 2010, additional reforms will be put in place to constrain public wage costs durably over time. In particular, our medium-term objective is to reduce the general government wage bill to about 8 percent of GDP. This will require additional structural reforms in the education and health sectors, along the lines of the recent recommendations by the World Bank.

14. By end-February 2010, we will submit a draft law to Parliament to reform the pension system (structural benchmark). Building on earlier reform efforts and anticipating considerable demographic pressures on pension finances, this new law will put Serbia's pension system on a more sustainable financial basis. Our overall guiding objective for reform and cost containment is to reduce net spending by pension funds to about 10 percent of GDP by 2015, from an estimated level of 13 percent of GDP in 2009. Key elements of the new law will include: (i) increasing the minimum retirement ages for both men and women from 53 to 58 years; (ii) limiting strictly extra service credits to a limited number of eligible job positions; (iii) increasing the minimum contribution period and phasing out more than half of the extra service credit for women; and (iv) tightening the eligibility for survivor pensions. These measures will need to be implemented at a gradual pace but will be designed to become fully effective around 2020. However, as demographic and migration trends become clearer over the next few years, additional parametric reforms of retirement ages, minimum contribution periods, and early retirement incentives will likely have to be considered. We also plan to strengthen contribution collection efficiency, including by registration of all social security payers in a single central registry. In 2011, to also balance parallel efforts to contain the public sector wage bill, we plan to resume inflation indexation as envisaged under present law. To allow pensioners to share some of the upside potential in our economy, and consistent with our medium-term objective to reduce the share of pension spending in GDP, should real GDP growth exceed a threshold of 4 percent, pensions will in addition be increased by the excess of growth over the threshold.

15. We will ensure wage discipline in public enterprises. The government will adopt for ten large state enterprises business plans for 2010 consistent with a nominal freeze of wage bills by end-February 2010 (structural benchmark). Moreover, we will adopt all necessary measures to ensure a wage bill freeze at the level of local government utilities by end-March 2010.

16. To maintain fiscal discipline beyond 2010 in line with our spending-based adjustment strategy, we will need to strengthen significantly budget rules and procedures. The recently adopted Budget System Law (BSL) already introduces medium-term spending ceilings over the next three years, and envisages improved transparency through tax expenditure budgets. Our intention is to make concerted efforts to implement the current law by enhancing budget preparation, execution, and reporting capacities, but we also intend to transform the present BSL into a Budget System and Responsibility Law (BSRL) tailored to Serbia's specific circumstances and needs. To this end, the Ministry of Finance has appointed a working group consisting of local experts, which will provide a detailed proposal on how to further

strengthen the present legal rules, procedures, and enforcement penalties to effectively guard against spending and deficit biases by end-February 2010. A draft BSRL should be adopted by the government and forwarded to parliament by end-April 2010 (structural benchmark).

Financial Sector Policies

17. We will build further on the substantial improvement of our contingency planning made under the program. Regarding the legal framework underpinning the recently adopted financial crisis preparedness plan, the NBS in cooperation with the government is preparing a set of legal amendments to make the framework fully operational.

18. We will maintain our Financial Sector Support Program (FSSP), which proved vital for safeguarding financial stability. The NBS will continue to simplify, and—in a limited number of areas—relax macro-prudential regulations, notably as regards to provisioning, and asset classification rules. Onsite diagnostic studies and stress tests are on pace to be finalized for the remaining banks by end-2009 (structural benchmark). In parallel, the NBS will continue to work with foreign supervisors and parent banks to facilitate fulfillment of the commitments by key foreign banks to maintain their exposure to Serbia. Given the eased financial sector tensions and lower external financing needs, we are studying the feasibility of gradual lowering the exposure commitments ahead of the next bank coordination meeting, tentatively planned for early 2010. It is not expected that this course of action would significantly affect the availability of domestic financing for the government.

19. Meanwhile, there is a critical need to improve the framework for debt restructuring in view of the rapid growth of corporate loan delinquencies (structural benchmark). To deal with the issue of blockages of bank accounts on the basis of promissory notes, by end-March 2010, the NBS will introduce mandatory registration of promissory notes in a single database and explore options to replace the first-come-first-served payout procedure from blocked accounts with an alternative envisaging more equitable payouts. Alongside, the Ministry of Economy and the NBS will lead efforts to establish an out-of-court loan workout framework.

20. State ownership in banks will be phased out as soon as feasible. However, the planned privatization of the four banks with majority state ownership has been postponed owing to the unfavorable market environment. Nevertheless, by June 2010 we plan to merge Postanska Stedionica bank with Privredna bank and Pancevo bank and finalize negotiations on privatization of Credy bank with a private investor. As regards Srpska bank, we are still evaluating our options. In addition, by end-2009, we will seek to work with other shareholders to complete the recapitalization of Kommercialna bank by end-2009.

21. Looking ahead, developing the financial market remains a key medium-term priority. We will continue improving the T-bills auction procedures, which has already resulted in a substantially higher demand for government securities by both banks and other institutions. To foster the development of a meaningful yield curve—an important reference for the financial market—we plan to gradually widen the maturity spectrum and increase the

weighted average maturity of treasury securities. In the upcoming months, we will also study options to develop secondary bond markets, and to guard against the refinancing risks associated with the relatively short maturity of T-bills, we will strengthen budget cash and debt management.

Monetary and Exchange Rate Policy

22. Monetary policy will remain focused on maintaining inflation within the pre-announced 2010 target range of 4-8 percent. The NBS expects to continue easing monetary policy, albeit with caution given the risks of persistent inflation expectations, the potential for faster-than-expected recovery of aggregate demand, further increases in international energy prices, and the planned upward adjustments of regulated prices. Under the program, inflation developments will continue to be monitored using a standard consultation clause. In line with the monetary policy framework, we will maintain the existing managed float exchange rate regime.

23. We plan to improve coordination between the government and the NBS regarding plans for regulated price adjustment. The government's preliminary plan envisaging the 2010 adjustment of regulated prices by on average 9 ± 2 percent needs to be analyzed and elaborated further, as it provides a critical input for the NBS inflation forecast. In particular, price changes need to be scrutinized based on a careful analysis of the financial situation of state-owned energy companies and local government finances. In the coming weeks, we plan to assign this task to a new working group comprising technical experts from the NBS, Ministry of Finance, and other relevant ministries and agencies.

Structural Policies

24. **We continue to strive to modernize public enterprises and utilities by opening them to private participation:**

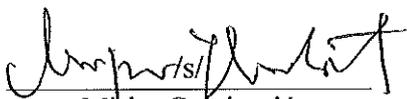
- **Large state enterprises.** Based on case-by-case studies, we will move ahead with corporatization, when necessary, followed by full or partial privatization, joint ventures, or a private management contract. Car manufacturer Zastava has been absorbed in a joint venture with Fiat, which has started a major investment program to modernize and expand production. We have embarked on an ambitious restructuring of the airline company JAT, and we hope to privatize the pharmaceutical company Galenika through a tender offer in early 2010. The restructuring of the railway company will also be accelerated with a view to reduce the need for continuous large-scale subsidies in the medium term. To increase transparency, we will publish audited annual financial statements of state enterprises.
- **Local enterprises.** By end-March 2010, the government will launch, in collaboration with municipalities, a comprehensive review of the business and financial conditions of all locally owned companies and utilities, with a view to reducing losses and

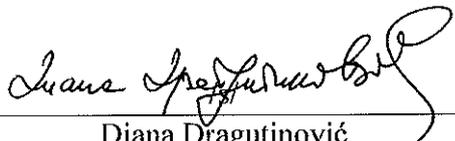
budget transfers, while improving service delivery and preparing for private sector participation. The Ministry of Economy and Regional Development will prepare a strategy for transforming locally owned utilities and determining ways and modalities of private capital involvement.

- **We plan to continue the privatization program of socially owned enterprises in 2010.** We aim at privatizing or liquidating the majority of the remaining socially-owned enterprises and non-core companies spun off from public utilities.

25. **Efforts will continue to improve the business environment and foster private sector development.** We have launched a regulatory review aimed at streamlining business regulations by eliminating, clarifying, or reconciling rules and regulations that undermine the predictability of the business environment or significantly raise the cost of doing business. Importantly, we have created a new anti-corruption agency with new expanded powers and responsibilities. The agency will become operational as of January 1, 2010, and replace the present committee for the resolution of conflict of interest. We are also considering various initiatives to strengthen the competitive environment in domestic markets and in the import sector, and intend to reduce wasteful subsidies where possible. Furthermore, we will also strive to resolve the still pending, but potentially very difficult, issues of land ownership and restitution.


 Radovan Jelašić –
 Governor of the National
 Bank of Serbia


 Mirko Cvetković
 Prime Minister


 Diana Dragutinović
 Minister of Finance

Attachments

Table 1. Serbia: Quantitative Conditionality Under the SBA, 2008-10 1/

	2008		2009							2010	
	Dec.		March		June		Sept.		Dec.	March	Dec.
	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Rev. Prog.	Prog.	Proj.
Quantitative Performance Criteria											
Floor on net foreign assets of the NBS (in billions of euro)	5.0	6.1	5.1	6.0	4.4	5.9	3.6	5.3	4.3	4.0	3.5
Ceiling on consolidated general government overall deficit (in billions of dinars) 2/	64	69	15	12	34	55	58	79	134	23	129
Ceiling on contracting or guaranteeing by the public sector of new short-term external debt (up to and including one year, in millions of euro) 2/	0	0	0	0	10	0	10	1.6	10	20	20
Ceiling on contracting or guaranteeing by the public sector of new nonconcessional external debt (over one year, in millions of euro) 2/	50	0	200	0	550	100	550	100	550	200	600
Ceiling on accumulation of government external payment arrears (continuous, in millions of euro)	0	0	0	0	0	0	0	0	0	0	0
Inflation Consultation Bands (in percent)											
<i>Central point</i>	10.0	8.6	9.2	9.4	8.0	8.3	9.5	7.3	7.5	5.4	6.5
Band, upper limit	12.0	n.a.	11.2	n.a.	10.0	n.a.	11.5	n.a.	9.5	7.4	8.5
Band, lower limit	8.0	n.a.	7.2	n.a.	6.0	n.a.	7.5	n.a.	5.5	3.4	4.5
Indicative Targets											
Ceiling on current expenditure of the Serbian Republican budget (in billions of dinars) 2/	635	633	190	152	335	331	520	506	695	182	729
Ceiling on gross accumulation of domestic guarantees by the Republican budget, the Guarantee Fund, and the Development Fund and domestic borrowing by the Guarantee and Development funds (in billions of dinars) 2/	n.a.	n.a.	n.a.	n.a.	50	7	50	15	50	13	50

1/ As defined in the Letter of Intent, the Memorandum on Economic and Financial Policies, and the Technical Memorandum of Understanding.

2/ Cumulative from January 1.

3/ Excluding loans from the IMF, EBRD, EIB, EU, IBRD, KfW, Eurofima, CEB, IFC, and bilateral government creditors, as well as debt contracted in the context of restructuring agreements.

Table 2. Serbia: Proposed New Conditionality

Measure	Target Date	Rationale for Conditionality
Prior action		
1. Government to submit to parliament a 2010 budget consistent with the program, including supporting legislation.	Before Board date	To commit to a credible fiscal adjustment package
Structural benchmarks		
1. Government to submit to parliament a draft pension reform law including measures as specified in TMU (¶ 20).	February 2010	To safeguard medium-term fiscal sustainability
2. Government to submit to parliament a draft Budget System and Responsibility Law, including supporting legislation (TMU ¶21).	April 2010	To anchor authorities' medium-term fiscal adjustment plans and commitments to safeguard fiscal sustainability
3. Authorities to adopt amendments to relevant credit enforcement laws and regulations strengthening the corporate debt restructuring framework (TMU ¶24).	March 2010	To address the issue of account blockages, which have triggered unnecessary bankruptcies, and enhance banks' ability to deal with rising NPLs
4. Authorities to adopt large state enterprises' business plans that conform to general government wage and employment policy in 2010 and ensure profit transfers to the state (TMU ¶19).	February 2010	To limit build-up of contingent liabilities by ensuring consistent wage and employment policies and profit transfers to the government budget

REPUBLIC OF SERBIA

Technical Memorandum of Understanding

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

A. Floor for Net Foreign Assets of the NBS

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

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

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

Cross Exchange Rates and Gold Price for Program Purposes 1/

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

5. For purposes of the program, **foreign reserve liabilities** are defined as any foreign-currency-denominated short-term loan or deposit (with a maturity of up to and including one

year); NBS liabilities to residents and nonresidents associated with swaps (including any portion of the NBS gold that is collateralized) and forward contracts; IMF purchases; and loans contracted by the NBS from international capital markets, banks or other financial institutions located abroad, and foreign governments, irrespective of their maturity. Undivided foreign exchange liabilities of SFRY are excluded. Also excluded are the amounts received under any SDR allocations received after August 20, 2009.

6. On September 30, 2009 the NBS's net foreign assets, evaluated at program exchange rates, were Euro 6,450 million; foreign reserve assets amounted to Euro 9,848 million, and foreign reserve liabilities amounted to Euro 3,398 million.

7. **Adjustors.** For program purposes, the NFA target will be adjusted upward *pari passu* to the extent that: (i) after September 30, 2009, the NBS has recovered frozen assets of the FRY, assets of the SFRY, long-term assets, and foreign-exchange-denominated claims on resident banks and nonbanks, as well as Serbian commercial banks abroad; and (ii) the restructuring of the banking sector by the Deposit Insurance Agency involves a write-off of NBS foreign exchange-denominated liabilities to resident banks. The NFA floor will also be adjusted upward by any privatization revenue in foreign exchange received after September 30, 2009. Privatization receipts are defined in this context as the proceeds from sale or lease of all or portions of entities and properties held by the public sector that are deposited in foreign exchange at the NBS, either directly, or through Treasury.

B. Inflation Consultation Mechanism

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

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

C. Ceiling on External Debt Service Arrears

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

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

D. Ceilings on External Debt

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

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

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

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

E. Fiscal Conditionality

16. **The general government fiscal balance**, on a cash basis, is defined as the difference between total general government revenue (including grants) and total general government expenditure (irrespective of the source of financing) as presented in the "GFS classification table" and including expenditure financed from foreign project loans. For program purposes, the consolidated general government comprises the Serbian Republican budget (on-budget and own revenue), local governments, the pension fund (employees, self-employed, and

farmers), the health fund, the National Agency for Employment, and the Road Company (JP Putevi Srbije) and any of its subsidiaries. Any new extrabudgetary fund or subsidiary established over the duration of the program would be consolidated into the general government. Revenues of the Republican budget exclude profit transfers from the NBS. Expenditures exclude the clearance of arrears of the Road company accumulated up to end-2008.

17. **Adjusters.** The deficit ceiling will be adjusted upward for the additional expenditure that may be needed for potential lender-of-last-resort operations under the financial stability framework (LOI, ¶18), following consultation with IMF staff. It will be increased (respectively reduced) in 2009 by the amount of project loans disbursed by foreign creditors listed in TMU ¶13 above to the general government in excess of (respectively, lower than) the program projections indicated in the table below, in consultation with IMF staff, on the basis of actual disbursements as jointly reported by the Ministry of Finance and the NBS. This adjustment does not apply to program loans and general budget support.

Disbursements of project loans by foreign creditors

From January 1, 2009 to:	Program projections (billions of dinars)
December 31, 2009	12.0

Disbursements of project loans by foreign creditors

From January 1, 2010 to:	Program projections (billions of dinars)
March 31, 2010	4.3
June 30, 2010	8.5
September 30, 2010	12.8
December 31, 2010	17.0

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

19. The **large public enterprises** monitored under the program include the following 10 enterprises or their successors: JP Elektroprivreda Srbije (EPS), JP Elektromreza Srbije (EMS), JP Transnafta, JP Srbijagas, JP PTT Srbije, JP Jugoslovenski Aerotransport, JP Zeleznice Srbije, JP Srbijasume, JP Aerodrom Nikola Tesla Beograd, JVP Srbijavode. This

list excludes JP Putevi Srbije (the Road company), which is considered part of general government, JP Naftna Industrija Srbije (NIS), which is in majority private ownership, and JP Srbija Telekom, which competes with other telecommunication providers. Going forward, the program will include monitoring of the aggregate wage bill of local utilities.

20. **Pension law.** The new pension draft law should be submitted to Parliament by end-February 2010. This draft law should tighten early retirement rules, including by (i) gradually increasing the minimum early retirement age from currently 53 years to 58 years for both men and women by 2020, (ii) restricting retirement before the minimum early retirement age to only a limited number of occupations; (iii) increasing the minimum service requirement for retirement for women from 35 to 38 years and gradually phasing out more than a half extra service credit for women; and (iv) raising the eligibility age for survivor's pensions to 58 years for men and to 53 for women. Further, the draft law will impose strict limits on extra service credits to a limited number of eligible professions. Contribution collection efficiency would also be strengthened, including by registering of all social security payers in a single central registry. In the new draft law, indexation of pensions from the year 2011 onward will be limited to CPI indexation augmented to include a growth bonus, in line with the medium-term objective to reduce net spending of pension funds to about 10 percent of GDP. Specifically, semi-annual indexation of pensions to the CPI as under the current law will resume in April 2011, and, should the previous year's real GDP growth rate exceed a threshold of 4 percent, the pension increase would be augmented by the difference between the actual growth rate in the previous year and the threshold (end-February 2010).

21. **Fiscal responsibility legislation.** The present Budget System Law (BSL) will be amended to further strengthen fiscal discipline. Amendments should be adopted by the government and submitted to parliament that: (i) establish a simple and transparent rule that strengthens control over the medium-term fiscal framework; (ii) strengthen fiscal procedures of the current BSL, potentially including by setting up an independent fiscal council; and (iii) establish effective fiscal monitoring and enforcement mechanisms (end-April 2010).

22. **Ceiling on the accumulation of domestic loan guarantees (gross) extended by the Republican budget, the Guarantee Fund, and the Development Fund.** The ceiling also includes the contracting of any domestic loans by the Development and the Guarantee Funds. It excludes any guarantees extended under the financial stability framework (LOI, ¶18), unless such loans or guarantees are extended to entities other than financial sector institutions.

23. **Reporting.** General government revenue data and the Treasury cash situation table will be submitted weekly on Wednesday; updated cash flow projections for the Republican budget for the remainder of the year five days after the end of each month; and the stock of spending arrears of the Republican budget, the Road company, and the social security funds 15 days after the end of each month. General government comprehensive fiscal data (including social security funds) would be submitted by the 25th of each month. The large

state-owned enterprises listed in paragraph 19 will submit quarterly accounts and the wage bill data [45] days after the end of the quarter.

F. Financial Sector Conditionality

24. **Amendments to the legal framework for debt restructuring shall focus on two areas: account blockages based on promissory notes and an out-of-court loan workouts.** As regards to the first area: (i) the NBS will establish mandatory registration of promissory notes using a uniform format—containing essential loan details and blockage conditions, and early recall options—in a single registry; and (ii) as regards out-of-court loan workouts, the Ministry of Economy and the NBS, in consultation with the Ministry of Finance and banks, shall prepare the necessary legal and regulatory amendments to establish a framework allowing key creditors—based on their relative exposure—to quickly initiate and implement out-of-court workouts of corporate loans. These changes are to be adopted by the government by end-March 2010 (structural benchmark). Also, the Ministry of Economy, together with the NBS, will explore options to replace the first-mover advantage in account blockages with a more equitable payout.

Data Reporting for Quantitative Performance Criteria

Reporting Agency	Type of Data	Timing
NBS	Net foreign assets of the NBS (including adjusters)	Within one week of the end of the month
Ministry of Finance	Consolidated government overall deficit	Within 25 days of the end of the month
NBS and Ministry of Finance	New short-term external debt contracted or guaranteed by the public sector	Within four weeks of the end of the quarter
NBS and Ministry of Finance	New nonconcessional external debt contracted or guaranteed by the public sector	Within four weeks of the end of the quarter
Ministry of Finance	Government external payment arrears	Within two weeks of the end of the month
NBS	CPI inflation	Within four weeks of the end of the month
Ministry of Finance	Current expenditure of the Serbian Republican budget	Within 25 days of the end of the month
Ministry of Finance	Gross accumulation of domestic guarantees by the Republican budget, the Guarantee Fund, and the Development Fund and domestic borrowing by the Guarantee and Development Funds	Within eight weeks of the end of the month