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## REPUBLIC OF SERBIA: LETTER OF INTENT (LOI)

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

Belgrade, June 10, 2010

Dear Mr. Strauss-Kahn:

1. Our program has continued to perform satisfactorily. All but one end-March 2010 quantitative performance criteria were observed (Table 1). The ceiling on the general government deficit was exceeded by a small margin owing to shortfalls in revenues. We have also made progress on the structural benchmarks for end-May. As a prior action for the Board meeting in late June, the revised pension law will be submitted to Parliament. We have also prepared draft fiscal responsibility legislation in line with the agreed benchmark to discipline fiscal policy beyond 2010, but the remaining important details regarding the numerical fiscal rules and the fiscal council still need to be settled.

2. Unfortunately, our economy is unlikely to recover as quickly as we had hoped for, and we see risks of further adverse spillovers to the region from the Greek debt crisis and economic tensions in the euro area. Available indicators for the first quarter suggest that growth momentum remains insufficient and too uneven to revive the labor market, mostly reflecting lack of external demand impulses and depressed investment; at the same time, we are encouraged by clear signs that the economy has been rebalancing in the right direction, relying less on consumption-driven and debt-driven growth than before the crisis. We remain hopeful that the economy will begin to pick up speed later in the year in line with our baseline growth projection, but will conduct our policies with downside risks firmly in mind. More positive has been the pronounced decline in inflation, which provides us with an opportunity to durably stabilize inflation in the low single digit range. Also, our international reserve position has strengthened, creating ample scope for the National Bank of Serbia to maintain stable conditions in the foreign exchange (FX) market.

3. In consideration of our satisfactory implementation record in a difficult environment and our continued commitment to the program's objectives, we request the completion of the fourth review under the Stand-By Arrangement (SBA) and that SDR 319.6 million be made available. However, in view of our strengthened reserve position, we intend to purchase only SDR 46.7 million at this time. We also request a waiver for the non-observance of the missed performance criterion and the completion of the financing assurances review. The fifth program review, assessing performance relative to end-June 2010 performance criteria and benchmarks, and a financing assurances review are envisaged for September 2010. The sixth

program review, assessing performance relative to end-September 2010 performance criteria and benchmarks, and a financing assurances review are envisaged for November 2010.

4. 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.

#### **Revised Macroeconomic Framework for 2010–11**

5. We expect real GDP to grow at 1½ percent in 2010 and 3 percent in 2011, with employment growth turning positive only in 2011. Reflecting the need to rebalance our economy away from consumption-led growth, our policies are aimed at creating conditions conducive for investment and exports to act as important drivers of growth. The slower pace of the economic recovery, in combination with sluggish consumption and imports, will negatively impact tax revenues and result in higher fiscal deficits than previously planned. Nevertheless, we are confident that we will be able to maintain discipline on the spending side of the budget, which will also be important to assure our population and foreign investors that we are keeping our fiscal house in order.

6. Inflation has persistently undershot the NBS target over the last few months, reflecting low aggregate demand, falling food prices, and weak pass-through of exchange rate depreciation. But we project inflation to increase gradually in the second half of 2010 given the low base in the previous year, exchange rate pass-through, and more stable food prices, and inflation should end the year close to the NBS target of 6 percent ( $\pm 2$  percent). We project inflation to decline further in 2011, to around 4½ percent.

7. We expect the external current account deficit to remain contained, with the continued narrowing of the trade deficit offset by higher external interest and dividend payments and by lower remittances. Following a contraction in 2009, export volume growth is expected to turn positive in 2010 but to regain double-digit strength only in 2012.

8. The external financing situation is projected to remain favorable in 2010 and beyond. Foreign parent banks are expected to broadly maintain their exposure to Serbia, notwithstanding the relaxation of the exposure floors from 100 percent to 80 percent in April 2010. Other private inflows, including foreign direct investment, along with financing from international financial institutions and the EU, should be sufficient to meet all external financing needs in 2010. We expect FX reserves to decline modestly but to remain at an adequate level.

## **Fiscal Policy**

9. The slow and uneven economic recovery has put new pressures on the public finances. The program ceiling for the fiscal deficit in the first quarter was missed by a narrow margin. This was mainly due to lower revenues, particularly indirect taxes, relative to the end-2009 revenue forecast, which was based on higher GDP growth and import projections. The shortfall was partly compensated by under-execution of spending. At the same time, some spending ministries and local governments have made significant demands for larger spending allocations covering a wide range of purposes.

10. In this difficult setting, we remain committed to our stated fiscal strategy under the program. In particular, fiscal consolidation efforts will remain focused on containing current spending in the budget, particularly on public wages and pensions, while creating room for higher capital spending. Tax policies will remain steady and predictable, while revenue shortfalls that reflect a slower-than-projected recovery of the economy will be accommodated through higher fiscal deficit targets to avoid a pro-cyclical bias. At the same time, we will step up our efforts to protect the most vulnerable parts of the population from the consequences of the economic downturn through targeted programs. We recognize that this strategy will require continued difficult policy choices, perseverance, and coordination, with all spending ministries required to strictly observe their agreed budget ceilings and to avoid accumulating arrears.

11. Reducing by 2015 the general government wage bill to about 8 percent of GDP and net pension spending to about 10 percent remain key anchors in our efforts to restore sounder public finances. To share the burden of fiscal consolidation fairly, we plan to implement the following specific wage and pension policies:

- The nominal public wage freeze will be maintained through 2010. Regular semi-annual indexation of public wages will start in 2011, with adjustments in April 2011 and April 2012, based on CPI inflation during the previous six months and  $\frac{1}{2}$  of the real GDP growth rate (if positive) achieved in the previous year, and the October 2011 adjustment based on CPI inflation during the previous six months.
- The nominal pension freeze will also be maintained through 2010. Regular semi-annual indexation of pensions through April 2012 will be based on the same rule as specified for public wages. After the April 2012 indexation, pensions will continue to be indexed semi-annually to CPI inflation, and, starting in April 2013, an annual real GDP growth bonus will be equal (if positive) to real GDP growth achieved in the previous year minus 4 percent. This indexation formula will be maintained until net pension spending falls to about 10 percent of GDP.
- To soften the adverse consequences of the crisis on public wage and pension recipients with lower incomes in 2010 after two years of nominal freeze, we have

mobilized RSD 4 billion dinars of additional resources mainly using higher dividend transfers from profitable state-owned enterprises to provide targeted one-off relief during the second half of 2010.

- In the 2011 budget, we plan to provide only limited one-off payments amounting to about RSD 4 billion dinars to public sector employees and pensioners in January.
- A draft pension law including parametric pension reforms that tighten early retirement rules and limit extra service credits and the agreed new pension indexation arrangements (TMU, ¶21) will be submitted to Parliament as a prior action for completing the fourth review.
- The implementation of the public administration staff cuts at central and local government levels enacted by law in December 2009 could not be implemented at the pace and scope envisaged. We recognize that non-implementation of these cuts, or implementation in an uneven manner across budgetary institutions, could severely undermine the credibility of any further structural reform initiatives to rationalize public employment. We will therefore issue a government decision to ensure that staff cuts at the central level will be implemented as mandated by law, a prior action for completing this review.
- Over the coming months, we will continue to work closely with the World Bank to design reform measures to reduce employment in the health and education sectors, while raising efficiency; efforts to reform the pay-and-grading system in these sectors will need to observe the agreed public wage bill limits.

12. The continued fallout from the crisis on the more vulnerable parts of our population requires us to mobilize additional fiscal resources to provide targeted relief. After significant improvements over the past decade, poverty is estimated to have increased again to 6.9 percent in 2009, from 6.1 percent in 2008. Apart from the measures for lower-income public wage and pension recipients already mentioned, we plan to transfer RSD 1 billion to the poorest municipalities and increase the allocation for targeted social assistance programs in 2010 by about RSD 1½ billion, while a reform of these programs to improve their targeting and coverage will go into effect in 2011. Given that recent increases in poverty rates are particularly concentrated and severe in rural areas, we also plan to clear the long-standing farmer pension arrears (about RSD 7 billion) ahead of schedule in 2010.

13. We will strengthen the credibility of our budgetary commitments through fiscal responsibility legislation. The working group formed for this purpose has reached preliminary agreement that draft legislation should include the following key elements:

- Fiscal rules for public wages and pensions: The draft law incorporates the agreed public wage and pension indexation rules; in addition, public wage and employment

policies during 2012–15 will be constrained by a rule to gradually reduce the general government wage bill to 8 percent of GDP and pension bill to about 10 percent of GDP by 2015.

- Rule for fiscal balance: One of the options under consideration is a numerical rule that the planned general government fiscal deficit for the coming year can at most amount to the estimate of the deficit for the current year minus a correction factor that would take into account the distance between the estimated deficit for the current year and the medium-term deficit target (1 percent of GDP).
- Rule for public debt and guarantees: The draft law will likely impose limits on the accumulation of public guarantees and a binding upper ceiling on the amount of debt and guarantees that the general government can incur.
- Fiscal council: The draft law envisages the creation of a council in charge of implementing the fiscal responsibility legislation. Combining the fiscal council with the recently set up state audit institution is one of the options under consideration.
- The Ministry of Finance will also consider other amendments to the Budget System Law and other laws: To strengthen budget preparation, execution, and monitoring, some of the concepts and definitions in the law will be clarified; the budget calendar will support a top-down approach to the budget process; own resource revenues will be better integrated in the budget and the Treasury Single Account (TSA); and more flexibility in the budget execution will be reached.
- The Budget Memorandum for 2010–12, planned to be issued by July 15, will already reflect some of these elements. We now plan to submit the fiscal responsibility legislation to parliament by September 15, before the completion of the fifth review.

14. Against this backdrop, we will implement the spending side of the 2010 budget largely as budgeted, with a higher fiscal deficit target of 4¾ percent of GDP accommodating the revenue shortfall due to the weaker-than expected economy. In particular, relative to budget plans, we expect that spending will be under-executed by about RSD 10 billion, while higher-than-budgeted non-tax revenue of about RSD 6.5 billion will provide the scope for financing the planned additional spending. For 2011, we plan to reduce the fiscal deficit to below 4 percent of GDP.

15. Should revenues in 2010 exceed present projections, we are fully committed to save the revenue over-performance in line with the principle that automatic fiscal stabilizers should be allowed to operate in both directions.

16. We are also studying further reforms of the tax system. The main objective is to reduce the direct tax wedge on labor arising from social security contributions and wage taxation, while offsetting resulting revenue losses through adjustments in indirect taxation. In

line with our fiscal strategy, (i) the tax reform will be broadly revenue neutral; (ii) tax administration will be appropriately strengthened to implement the reform; (iii) key stakeholders will be consulted early to avoid undue surprises; and (iv) if reform measures turn out to be regressive on balance, we will provide adequate targeted social assistance.

17. With regard to tax administration reform, we remain committed to adopting an integrated taxpayer compliance strategy by end-July, which will: (i) be developed in full consultation with internal and external stakeholders; (ii) include an in-depth analysis of compliance risks and mitigation options; and (iii) establish the direction for each functional department's operational plans.

18. We also see an urgent need to adopt a multiyear approach to budgeting. Multiyear investment planning would ensure a predetermined envelope of resources, avoid excessive fragmentation of tender procedures, and minimize transaction costs. This multiyear investment planning will be integrated in the yearly multi-annual budget process, ensuring consistency between current and capital spending.

### **Monetary and Exchange Rate Policy**

19. Monetary policy will remain focused on keeping inflation close to the pre-announced 6 percent ( $\pm 2$  percent) target for 2010 and 4.5 percent in 2011. We see some scope for continued easing of the monetary stance, including through the gradual phasing in of lower reserve requirements. But we will remain attentive to upside inflation risks associated with exchange rate pass-through from depreciation, a reversal of food price declines, an increase in Serbia's FX risk premium, and a possibly faster-than-expected recovery of aggregate demand. Under the program, inflation developments will continue to be monitored using a standard consultation clause.

20. In line with our inflation targeting framework, we will maintain the existing managed float exchange rate regime. FX interventions will continue to be used to smooth out excessive exchange rate volatility or to provide liquidity to the market as needed to ensure its smooth operation, without targeting a specific level or path for the exchange rate.

21. We have adopted several amendments to the NBS law to harmonize it with the 2006 Constitution and align it with international best practices. The amendments will strengthen the NBS's independence in many important areas. In particular, the NBS will determine the exchange rate regime, with the government's consent, and implement the exchange rate policy. The tasks performed by the NBS for the Republic of Serbia as well as the NBS's scope for providing credit to the public sector have been clearly delineated. The amendments also clarify the procedure for the treatment of NBS profits and the coverage of potential NBS losses. Finally, the amended law will strengthen the system of checks and balances, as well as transparency and auditing procedures.

## **Financial Sector Policies**

22. Fostering the use of the local currency in financial transactions is a policy priority, as unhedged currency exposures can undermine financial stability and the effectiveness of monetary policy. We are following a three-pronged strategy to reduce euroization of Serbia's economy: (i) maintaining macroeconomic stability, thus providing an environment of low and stable inflation; (ii) developing the primary and secondary local currency bond markets; and (iii) developing the FX hedging market. To this end, we have: (i) reduced the dinar reserve requirements; and (ii) raised the local currency share in government debt. To foster secondary market development, we have introduced regular reporting on secondary trade in government securities. Finally, we limited some of the government credit support programs to dinars only. Shortly, we will adopt changes in the FX law to foster development of the FX hedging market. Possible regulatory measures include further promotion of dinar lending through reserve requirement policy.

23. We have made progress in improving the corporate debt restructuring and collection framework. The by-law on prepackaged reorganisation plans was adopted in May. Its provisions aim to provide sufficient protection for creditors, set more clear requirements for debtors and thus minimize uncertainties for all parties, and streamline procedures. We are also in the process of submitting revised amendments to the law on payments transactions, with a view to creating a centralized registry for promissory notes, thus improving the transparency of these instruments. The Working Group on out-of-court debt restructuring has started to meet and is on track to produce a strategy note by end-June.

24. The Ministry of Finance is revising the banking sector regulations. The legislative initiative seeks to establish transparent procedures and tools in the event of a systemic banking crisis and seeks also to improve procedures for dealing with problem banks in normal times. Our aim is to have the legislation enacted by end-September 2010.

25. We are closely monitoring developments in the banking system and stand ready to intervene, should action be required. Any such intervention will be guided by our crisis management framework and will be closely coordinated among the NBS, Ministry of Finance, and the Deposit Insurance Agency. As indicated by recent diagnostic studies and stress tests, the Serbian banking system—including the subsidiaries of Greek banks—remains highly liquid and well capitalized.

## **Structural Policies**

26. We are committed to structural reforms that address the key bottlenecks for shifting to a more export-led model of growth. Improvements in the business environment of the formal economy, as well as more and better public infrastructure, are crucial for export-oriented companies. We launched a comprehensive regulatory “guillotine” project to do away with unnecessary business regulations, with an estimated annual cut in the costs of



doing business of RSD 20 billion. After some delays, there has been renewed progress, and we expect that the project will be finalized by July 2010. Upon completion of the guillotine, we will step up “impact analysis” of all new business-relevant legislation, with a focus on creating a business-friendly environment. Among relatively recent legislative actions are laws that aim to strengthen competition and improve public procurement. However, implementation of these laws has lagged, and we intend to rectify that as soon as possible. In particular, we will take steps to make the hitherto weak Competition Commission fully operational and to appoint members of the Commission for Protection of Bidders’ Rights. We will also align the Company Law with EU rules on corporate governance and establishment.

27. To maximize the gains from a more trade-oriented economy, we are vigorously pursuing efforts to improve Serbia’s international trade environment. We started the implementation of the interim trade agreement with the EU in January 2009, followed by the EU putting it into force in February 2010. We are committed to finalizing Serbia’s WTO accession process and are hopeful that accession will take place in 2011. We plan to resolve outstanding issues, mainly related to the provision of some financial services and trade in some agricultural products, through bilateral discussions in the coming months.

28. We are convinced that privatization has to be a critical ingredient in the export- and domestic savings-based growth model. We believe, on the basis of evidence from other countries, that privatization contributes to export growth and the generation of domestic savings, the latter mainly through higher corporate savings. If market conditions allow, we intend to privatize a 40 percent stake in Srbija Telekom in 2010. We also continue preparations for the sale of the airline company JAT. For now, we have had to suspend the privatization of pharmaceutical company Galenika due to the lack of interest from qualified bidders. We will, however, resume our efforts to privatize Galenika once market conditions improve. We are also pursuing the privatization or forced liquidation of a large number of smaller companies and state assets. Moreover, we intend to corporatize all large state enterprises, including state utilities and the railway company, by end-2010.

/s/

Mirko Cvetkovic  
Prime Minister

/s/

Radovan Jelasic  
Governor of the National Bank  
of Serbia

/s/

Diana Dragutinovic  
Minister of Finance

Attachment

Table 1. Serbia: Quantitative Conditionality Under the SBA, 2009–10 1/

	2009								2010					
	March		June		Sept.		Dec.		March			June	Sept.	Dec.
	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Adj.	Act.	Prog.	Prog.	Proj.
<b>Quantitative Performance Criteria</b>														
Floor on net foreign assets of the NBS (in billions of euro)	5.1	6.0	4.4	5.9	3.6	6.5	4.3	6.6	4.0		6.2	4.9	4.8	4.6
Ceiling on consolidated general government overall deficit (in billions of dinars) 2/	15	12	34	55	58	79	134	121	23	21	24	72	109	149
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	10	0	10	2	10	2	20		0	20	20	20
Ceiling on contracting or guaranteeing by the public sector of new nonconcessional external debt (over one year, in millions of euro) 2/ 3/	200	0	550	100	550	100	550	100	200		0	550	600	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	0	0
<b>Inflation Consultation Bands (in percent)</b>														
<i>Central point</i>	9.2	9.4	8.0	8.3	9.5	7.3	7.5	6.6	5.4		4.7	4.0	5.3	6.0
Band, upper limit	11.2	n.a.	10.0	n.a.	11.5	n.a.	9.5	n.a.	7.4		n.a.	6.0	7.3	8.0
Band, lower limit	7.2	n.a.	6.0	n.a.	7.5	n.a.	5.5	n.a.	3.4		n.a.	2.0	3.3	4.0
<b>Indicative Targets</b>														
Ceiling on current expenditure of the Serbian Republican budget (in billions of dinars) 2/	190	152	335	331	520	506	695	689	182		165	354	546	737
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.	50	7	50	15	50	15	13		16	50	50	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.

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1. Table 2. Serbia: Structural Conditionality, 2010

Measure	Target Date	Comment
Prior actions		
1. Government to submit to parliament a comprehensive pension law, incorporating both parametric reforms and a revised indexation formula, effective April 2011 (TMU ¶21).	Before Board meeting	To support the medium-term fiscal consolidation strategy.
2. Government to issue a decision to ensure that public administration staff cuts at the central government level will be implemented as enacted by law in December 2009 (TMU ¶20).	Before Board meeting	To support the medium-term fiscal consolidation strategy.
Structural benchmarks		
3. Risk management unit at tax administration to establish an integrated taxpayer compliance strategy (TMU ¶23).	July 2010	To address tax noncompliance and improve voluntary compliance.
4. Government to submit to parliament a draft Budget System and Responsibility Law (TMU ¶22).	September 15, 2010	To anchor authorities' medium-term fiscal adjustment plans and commitments to safeguard fiscal sustainability.
5. Authorities to adopt or submit to parliament amendments to relevant laws and regulations strengthening the corporate debt collection and restructuring framework (TMU ¶26).	September 2010	To address the issue of account blockages and foster out-of-court loan workouts to minimize unnecessary and costly bankruptcies and enhance banks' ability to deal with rising NPLs.

**TECHNICAL MEMORANDUM OF UNDERSTANDING**

**REPUBLIC OF SERBIA**

**Technical Memorandum of Understanding**

1. This memorandum 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 October 1, 2008, except as noted below.

**A. Floor for Net Foreign Assets of the NBS**

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

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

4. For purposes of the program, all foreign currency-related assets will be evaluated in Euros at **program exchange rates** as specified below. For the remainder of 2010, 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.

<b>Cross Exchange Rates and Gold Price for Program Purposes 1/</b>				
		Valued in		
	RSD	euro	USD	SDR
Currency:				
RSD	1.0000	0.0106	0.0134	0.0093
euro	94.0972	1.0000	1.2647	0.8715
USD	74.4028	0.7907	1.0000	0.6891
SDR	107.9718	1.1475	1.4512	1.0000
Gold		727.35	919.875	633.88

1/ March 11, 2009.

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 the SFRY are excluded. Also excluded are the amounts received under any SDR allocations received after August 20, 2009.

6. On March 31, 2010 the NBS's net foreign assets, evaluated at program exchange rates, were €6,152 million; foreign reserve assets amounted to €10,445 million, and foreign reserve liabilities amounted to €4,293 million.

7. **Adjustors.** For program purposes, the NFA target will be adjusted upward *pari passu* to the extent that: (i) after March 31, 2010, the NBS has recovered frozen assets of the FRY, assets of the SFRY, long-term assets, and foreign-exchange-denominated claims on resident banks and nonbanks, as well as Serbian commercial banks abroad; and (ii) the restructuring of the banking sector by the Deposit Insurance Agency involves a write-off of NBS foreign exchange-denominated liabilities to resident banks. The NFA floor will also be adjusted upward by any privatization revenue in foreign exchange received after March 31, 2010. 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 the 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 can be rescheduled, 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. For program purposes, debt is classified as external when the residency of the creditor is not Serbian.

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), and the Development Fund.

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

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

#### **E. Fiscal Conditionality**

16. **The general government fiscal balance**, on a cash basis, is defined as the difference between total general government revenue (including grants) 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. 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, following consultation with IMF staff. It will be increased (respectively reduced) in 2010 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, 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.

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 service providers. Going forward, the program will include monitoring of the aggregate wage bill of local utilities.

20. **Reduction in the number of public employees.** In line with the Law No 104/09, the government will: (i) adopt a separate act for 11 remaining agencies that would set the limit of permanently employed public employees in each agency within the aggregate limit of 28,400 employees in the Republican Administration; (ii) adopt an act on specifying total number of “fixed-term employees due to increased workload,” persons employed under a service contract, and those under contract on temporary and occasional jobs, those employed through youth and student associations, and persons employed on other basis; (iii) finalize systematization plans in all Ministries and Agencies in the Republican Administration; and (iv) adopt a decision by the government that starting from September salaries from the Republic of Serbia budget for the Ministries and Agencies subject to the Law will be paid only for the maximum number of employees determined in line with this Law (prior action, June 2010).

21. **Pension law.** The new pension draft law should be submitted to Parliament in June. 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 2023, (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 one-half of 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 all social security payers in a single central registry. The draft law will also contain a revised pension indexation rule, effective from April 2011. Under the indexation formula the semi-annual CPI-based indexation formula would be augmented to include (i)  $\frac{1}{2}$  of the real GDP growth rate (if positive) achieved in the previous year in April 2011 and April 2012; and (ii) from April 2013 onwards an annual growth premium if the previous year’s GDP growth rate exceeded 4 percent. The growth premium will be calculated as the difference between the actual growth rate in the previous year and the 4 percent threshold (prior action, June 2010).

22. **Fiscal responsibility legislation.** The present Budget System Law (BSL) will be amended to further strengthen fiscal discipline. Amendments to all relevant public finance legislation 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; and (iii) establish effective fiscal monitoring and enforcement mechanisms, potentially including by setting up an independent fiscal council. Further, binding ceilings on pension and general government wage spending for 2010-12 should be included in the fiscal responsibility framework (structural benchmark, September 15, 2010).



23. **Tax administration reform.** The risk management unit at the tax administration agency should adopt a fully integrated taxpayer compliance strategy that has been developed in full consultation with all internal and external stakeholders and is based on the identification of the major risks to revenue and appropriate resource allocation to ensure the highest impact on collections. The strategy should focus on improving voluntary compliance and reducing noncompliance (structural benchmark, end-July 2010).

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

25. **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 25<sup>th</sup> 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

26. **Improvements to the framework for debt collection and restructuring will focus on two areas: account blockages based on promissory notes and out-of-court loan workouts.** As regards the first area, the NBS, in consultation with the government, will finalize amending the law on payments transactions to introduce registration of promissory notes using a uniform format—containing essential loan details and blockage conditions—in a single registry. The Ministry of Economy, together with the NBS, will explore alternatives to the first-mover advantage in account blockages. As regards out-of-court loan workouts, the Ministry of Economy and the NBS, in consultation with the Ministry of Finance and banks, shall (i) establish an out-of-court restructuring mechanism working group comprising representatives of the Ministries of Finance and Economy, NBS, tax authorities and selective bank representatives; (ii) draft a corporate debt restructuring strategy note proposing the main features of an out-of-court restructuring mechanism (such as the form of the framework, coverage of debtors, and role of the NBS) and identify the legal changes needed to support such a mechanism by end-June 2010; (iii) submit draft legislative changes for government approval by end-August 2010; and (iv) submit the package of the legislative changes to Parliament by end-September 2010 (structural benchmark).

## Data Reporting for Quantitative Performance Criteria

Reporting Agency	Type of Data	Timing
NBS	Net foreign assets of the NBS (including adjustors)	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
Statistical Office and 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 and the Development Fund and domestic borrowing by the Development Fund	Within eight weeks of the end of the month