July 2011
IMF Country Report No. 11/213

Republic of Serbia: Ex Post Assessment of Longer-Term Program Engagement and Ex Post Evaluation of Exceptional Access—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Republic of Serbia

The following documents have been released and are included in this package:

- This document was prepared by a staff team of the International Monetary Fund based on information available at the time it was completed on June 29, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its **July 13, 2011** discussion of the staff report that concluded the Ex Post Assessment of Longer-Term Program Engagement and Ex Post Evaluation of Exceptional Access.
- A statement by the Executive Director for the Republic of Serbia.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF SERBIA

Ex Post Assessment of Longer-Term Program Engagement and Ex Post Evaluation of Exceptional Access

Prepared by an Interdepartmental Staff Team[1]

Approved by the European and the Strategy, Policy, and Review Departments

June 29, 2011

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EXECUTIVE SUMMARY

In 2001, Serbia was recovering from the ravages of war, international sanctions and economic mismanagement: output had collapsed, inflation was rampant, and the external position was non-viable. Today, the country is an EU aspirant. Macroeconomic stabilization has by and large been achieved, debt is manageable, and there is a modern banking system in place. A Fund-supported program helped the country navigate the global financial crisis, and recovery is in train. But despite these successes, substantial vulnerabilities and a large structural reform agenda remain.

Challenges and progress

Significant progress in achieving macroeconomic stabilization and advancing structural reforms was made under the 2001 Stand-by Arrangement (SBA), reflecting strong policy implementation and political commitment to the program. The ensuing Extended Arrangement (EA) (2002-2006) aimed at consolidating the gains achieved under the SBA and securing debt relief. But performance under the EA was patchy: while important progress was made in several areas, macroeconomic performance fell short of expectations, and structural reforms lagged. Robust but unbalanced growth in an environment of copious capital inflows and high euroization, combined with lingering structural weaknesses, led to rising external imbalances, and ultimately to high external vulnerabilities. When the global economic crisis hit, the authorities requested a SBA, which they intended to treat as precautionary, but which eventually became a disbursing arrangement and was augmented to exceptional access levels. The 2009–2011 SBA achieved its primary objective of preserving macroeconomic and financial stability. The Fund-supported financial sector strategy to safeguard financial stability was one of the program's clear successes. But opportunities to undertake far-reaching structural fiscal and other growth-oriented reforms were missed.

The role of the Fund

Given Serbia's fragmented politics and resulting weak coalition governments, an important feature of the Fund's role was to serve as an internal coordination device. In retrospect, the Fund was least successful in carrying out this role during the EA, where ownership was weak, and more decisive advice on the policy mix could have been provided. By contrast, the Fund's involvement in the authorities' 2009 financial system support program under the 2009 SBA was one of several examples of how quick and coordinated action can prevent a crisis. But it was only when there was a confluence between the Fund's internal coordination role, the promise of financial support, and strong ownership, that the political momentum to undertake bold structural reforms could be found.

The road ahead

The question for the Fund is how to best help Serbia complete and entrench the transition to a more balanced growth model, and tackle its remaining structural reform challenges. The authorities have expressed interest in a new SBA which they intend to treat as precautionary. While there are risks to continued engagement, arising from the difficulties in reaching policy consensus before the upcoming elections, a new arrangement could provide a framework for sound macroeconomic policies and a commitment device, especially if structural reforms are credibly addressed. However, past experience in Serbia suggests that a program can strengthen policy discipline in a politically challenging environment only in the presence of strong ownership.

I. Introduction

1. **Serbia has undergone a significant transformation over the last 10 years, going from post-conflict devastation to being a legitimate aspirant to EU accession status.** In 2001, Serbia was emerging from a decade of regional conflict, international sanctions, and economic mismanagement which had delayed its economic transition relative to its peers: output had collapsed, inflation was rampant, and the external position was unviable. Two Fund arrangements later, substantial progress had been made in stabilizing the economy, reducing debt, and strengthening the banking system. Robust but unbalanced growth, and a reliance on external financing, however, left Serbia vulnerable to the 2008 global financial crisis. By the expiration of the last SBA in April 2011, the recovery from the global crisis was in train, but considerable vulnerabilities remain, and the country's transition to a more balanced growth is incomplete.

2. **This report combines the Ex Post Assessment (EPA) and Ex Post Evaluation (EPE) for Serbia.** The report covers the past ten years of the Fund's relationship with Serbia.[2] During seven of those years there were three Fund arrangements in place: the 2001 SBA (June 2001–May 2002), the 2002 EA (May 2002–February 2006), and the 2009 SBA (January 2009–April 2011).[3] The objective of the EPA is to provide an analysis of the economic problems facing the country, a critical review of progress during the Fund-supported programs, and a forward-looking assessment that takes into account lessons learned, and presents a strategy for future Fund engagement. The EPE component of the report reviews the 2009 SBA with exceptional access. The report is based on numerous Fund documents, other written material, and interviews with Fund staff, and present and former authorities.

3. **The report focuses selectively on the issues critical to understand Serbia's achievements and challenges during its engagement with the Fund**. The report is organized along four key areas: i) fiscal policy and structural fiscal reforms; ii) monetary and exchange rate policy; iii) banking sector; and iv) state-owned enterprises. In each of these areas, the report seeks to identify the factors that contributed to the successes and failures of Fund program engagement with Serbia. An attempt was made to reflect the risks, constraints, and political realities and uncertainties existing at the time of program design and implementation. It should be kept in mind, however, that evaluating the success of the Fund's engagement is complicated by the absence of a counterfactual. The report also proposes policies to address the current challenges and discusses alternatives for the future Fund relationship with Serbia.

4. **The rest of the report is organized as follows:** the next section provides an overview of events; Section III focuses on the achievements and challenges in four key areas; Section IV

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[2] Serbia continues the membership in the Fund of the Federal Republic of Yugoslavia (since 1992) and of the state union of Serbia and Montenegro (since 2006).

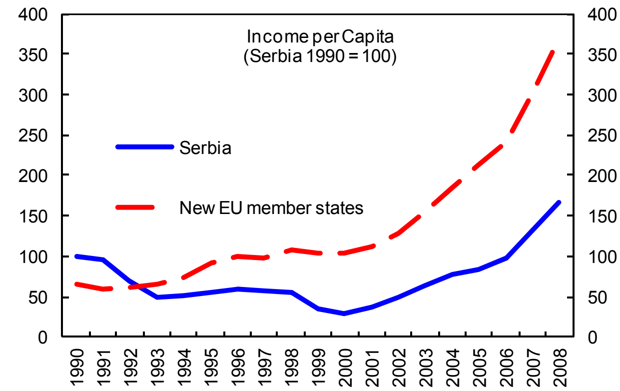
[3] After the expiration of the EFF, outstanding Fund credit exceeded 100 percent of quota, hence Serbia was subject to surveillance under the modality of PPM in 2006. Earlier repurchases, however, implied that PPM was no longer required in 2007.

presents the Ex Post Evaluation of Exceptional Access under the 2009 SBA; Section V concludes and draws lessons for future Fund engagement.

II. Overview

A. Initial Conditions

5. At the end of the 1990s, Serbia's situation was dire. Output was 50 percent of its 1989 level, and from having been well above the levels of what later became the EU-10 group, per-capita income trailed far behind its peers. Industry and public infrastructure were in disrepair, reflecting war destruction and under-investment. There were a large number of internally displaced people and refugees, inflation was running above 100 percent, and the external position was nonviable due to a crushing external debt burden (Country Report No. 01/93, and Figure 1).[4] [5]



Source: World Economic Outlook.

6. Macroeconomic instability was intertwined with severe structural weaknesses. A large part of economic activity was channeled through inefficient, loss-making state-owned and socially-owned enterprises, resulting in a significant drain on domestic savings. The largely insolvent banking system was an essential vehicle of government financing, fueling monetary expansion and inflation. A legacy of hyperinflation, the freezing of foreign exchange deposits in the early 1990s, and a parallel exchange rate market had resulted in low confidence in the dinar. A highly restrictive trade and foreign exchange rate regime, widespread administered prices, and regulated employment contracts and wage determination, further complicated the landscape.

7. Favorable political conditions and the initiation of reforms in late 2000 paved the way for a Fund-supported program. Following the overthrow of the Milosevic regime in October 2000, and the formation of a federal government dominated by reformists, conditions seemed ready for decisive policy actions to turn the economy around. After a short post-conflict program during the period December 2000–March 2001, which focused on bringing inflation under control and improving the country's institutional capacity, a SBA was approved to support

[4] The Federal Republic of Yugoslavia's external debt (largely in arrears) was estimated at US$11.5 billion at end-2000, equivalent to about 142 percent of GDP, with over 22 percent owed to multilaterals, 39 percent to Paris Club creditors, and 20 percent to London Club creditors. The share of Montenegro was estimated to be 6 percent of the total debt.

[5] The numbers in Figure 1 and in Table 5 do not reflect the recent revision to historical GDP data.

an ambitious strategy of restoring macroeconomic stability and tackling Serbia's deeply-entrenched challenges (Table 1 and Box 1).[6]

Table 1. Main Features of Serbia's IMF Arrangements, 2001–2011

Facility		Date of approval	Date of expiration	Amount approved in million of SDRs (percent of quota)	Amount drawn in million of SDRs (percent of quota)	Phasing
SBA		6/11/2001	3/31/2002	200 (43)	200 (43)	Four equal-sized tranches
	Extension	3/21/2002	5/31/2002	…	…	
EA		4/15/2002	5/13/2005	650 (139)	587.5 (126)	Thirteen equal-sized tranches
	Extension	5/13/2005	12/31/2005			
	Extension	12/21/2005	2/28/2006		63 (13)	
SBA		1/16/2009	5/15/2010	351 (75)	256 (55)	Frontloaded, first tranche two-thirds of total available disbursements
	Extension and Augmentation	5/15/2009	4/15/2011	2619 (560)	1110 (243)	Frontloaded, first tranche 95 percent of quota

Source: IMF Reports.

B. A Tale of Two Stabilizations: 2001 Stand-by Arrangement and 2002 Extended Arrangement

Road to stability (2001–2002 SBA)

8. **Significant progress with economic stabilization was achieved under the 2001 SBA, reflecting a virtuous circle between policy implementation and political commitment to the program.** The authorities were convinced that early economic achievements through strict implementation of the program were essential for establishing market confidence, building broad support for reform, and ensuring its sustainability. They were, thus, keen to adhere to prudent macroeconomic policies, advance economic restructuring, and intensify efforts to catalyze external assistance, including debt relief. As a result, significant progress was made in achieving the macroeconomic objectives of the program, as reflected in a sharp decline in inflation, a strengthened foreign reserve position, and output recovery in line with program expectations (Box 1 and Figure 1).

9. **Policy achievements on the structural front were equally impressive.** The ambitious reform agenda, backed by program conditionality, succeeded through consistent implementation. Major reforms to enhance fiscal efficiency and transparency and streamline the tax system were implemented, and the legal and institutional frameworks for bank restructuring and enterprise privatization put in place, in coordination with the World Bank, allowing important progress in these areas. The authorities' firm commitment to reform, buttressed by strong incentives provided by the prospects for normalizing relationships with multilateral and Paris Club creditors, was a key contributor to the success on the structural front.

[6] Prior policy actions in the areas of fiscal, pricing, foreign trade, and banking sector policies were implemented ahead of the approval of the SBA, agreement was reached on an arrears clearance plan for the World Bank, and financing assurances received from Paris Club creditors.

Box 1. Key Elements of the 2001 Stand-By Arrangement and 2002 Extended Arrangement

The 2001 SBA

Strategy. The primary objective was to set the basis for a viable external position and sustainable output recovery by reducing macroeconomic imbalances, advancing economic restructuring and catalyzing external assistance, including debt relief.

Nominal anchor. Strict limits on the central bank's accumulation of net domestic assets and wage freezes in the public sector (government and public enterprises) served as the main nominal anchors under the program. A crawling peg regime was to provide a "visible" nominal anchor, with the rate of crawl defined ex ante to reinforce disinflation.

Fiscal consolidation and a new financing model. Monetization of fiscal deficits was to be reduced. Financing for reconstruction and reform efforts was to rely on foreign assistance and privatization receipts. This also entailed putting an end to the monetization of quasi-fiscal deficits of the state enterprise sector, turning earmarked extra-budgetary revenues of state enterprises into budget transfers, and reducing the need for budgetary subsidies through administered price increases and wage restraint. The strategy also relied on enhanced revenue efforts under a streamlined tax system.

Structural reforms. The structural reform agenda covered measures related to: (i) the budget process and tax administration, and fiscal transparency; (ii) bank resolution and restructuring; (iii) privatization and public utility tariffs; and (iv) reforms of trade and foreign exchange systems.

Debt relief. The program took on board the intentions of Paris club creditors to accept rescheduling/rollover of arrears and current maturities, and capitalization of moratorium interest if needed, with comparable treatment from other bilateral and commercial creditors.

Access. Financing at 200 percent of quota over nine months was intended to help build up reserves and reduce external debt arrears.

The 2002 EA

Strategy. The program was designed as a continuation of the previous SBA. It sought to achieve: low inflation, medium-term fiscal consolidation, sustainable growth and external viability, through tight credit policies, official financing of the fiscal deficit, external debt relief, and far-reaching structural reforms.

Nominal anchor. Accumulation of net domestic assets was to remain very limited during the first years of the program to consolidate the inflation gains from the previous SBA, combined with a supportive wage and pricing policy in the public sector**.** The exchange rate was to continue to serve as the nominal anchor.

Fiscal policy. The program envisaged an initial increase in the fiscal deficit of 5.7 percent of GDP to support reform efforts, and subsequent consolidation on the back of expenditure reduction and revenue-enhancing reforms. A key component of the fiscal strategy was a reorientation of resources from current to capital spending.

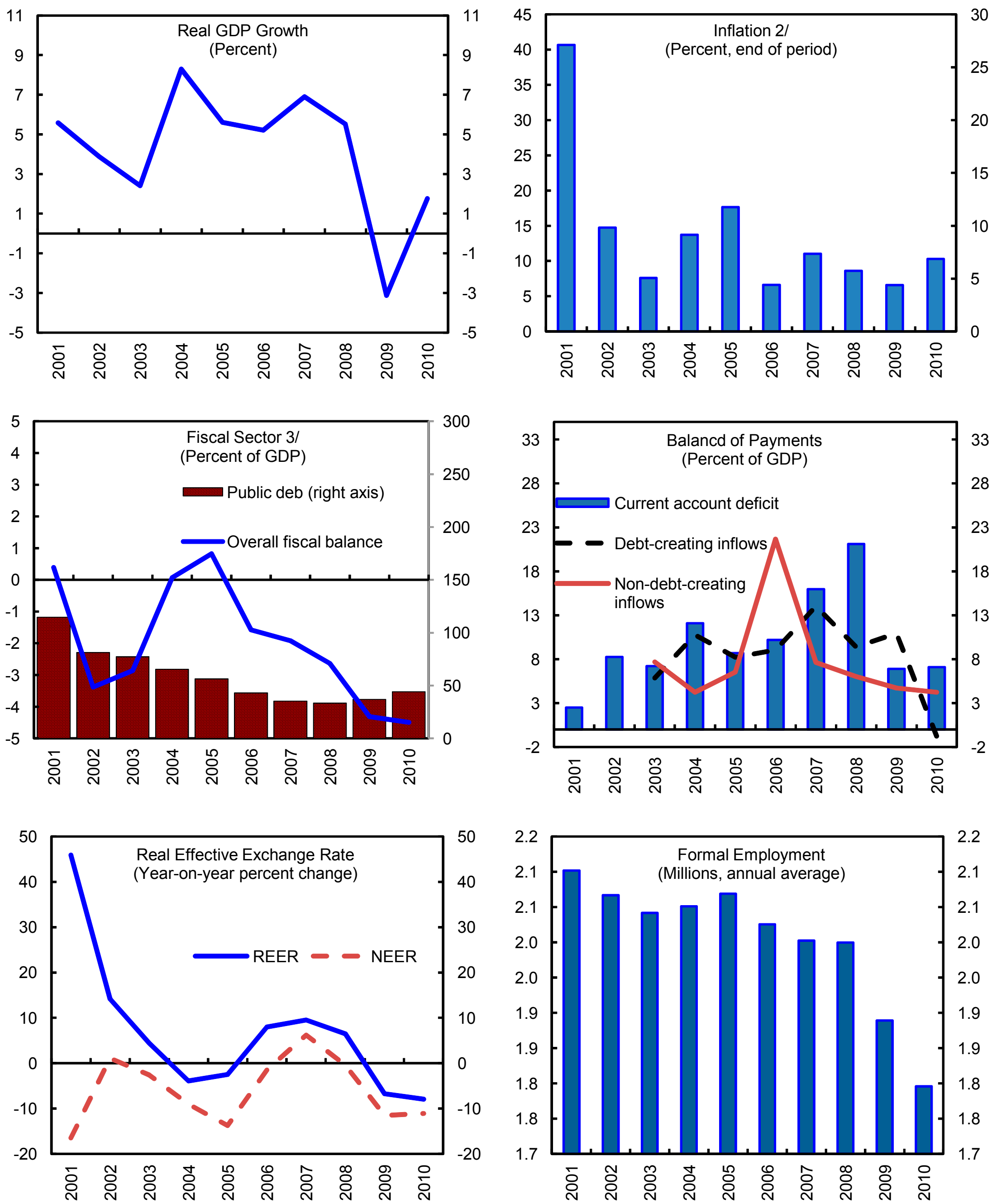
Structural reforms. Structural reforms were concentrated in the areas of tax administration and public expenditure management, liberalization of the foreign exchange market, and bank supervision and regulation. Additional reforms sought to streamline expenditures (reducing overstaffing and improved targeting of social benefits) and restructuring and privatizing the bulk of socially-owned enterprises.

Debt relief. In November 2001, agreement was reached on Paris club debt relief (accounting for around 40 percent of total external debt), involving two-phases: the first one upon approval of the EA (66 percent), and the second one upon completion of the last review.

Access. Financing at 139 percent of quota over three years was expected to provide the country with adequate balance of payments support while undertaking the extensive stabilization and reform agenda, and allowing for further reserve accumulation.

Misreporting. The purchase made following the fifth review was found to be noncompliant because the information provided about the wage bill was inaccurate and had exceeded the ceilings under the program. In light of the fact that the deviation was minor, and corrective action was taken, a waiver of nonobservance was granted and the program brought back on track.

Figure 1. Serbia: Long-Term Macroeconomic Developments, 2001–2010 1/



Sources: National Bank of Serbia; Statistical Office of the Republic of Serbia; IMF World Economic Outlook; and Fund staff estimates.
1/ Some of the numbers differ from those reported throughout the report reflecting more recent data revisions.
2/ Retail price index until 2006.
3/ Includes foreign grants.

Stabilization with emergence of vulnerabilities (2002–2006 EA)

10. **The EA aimed to consolidate the gains achieved under the 2001 SBA, secure debt relief, and advance crucial structural reforms needed for sustained growth**. While the strategy of the 2001 SBA was considered appropriate, it was evident that more time was needed for it to bear fruit. A follow-up EA was therefore put in place, and the agreement reached on restructuring Paris Club debt made conditional on its approval and completion (Box 1). It was clear at the outset that the program faced daunting challenges. Enterprise restructuring, a key element of the program, involved difficult decisions on employment against a backdrop of scarce fiscal resource to mitigate the social impact. The streamlining of pensions, transfers, and state-sector employment—essential to achieving fiscal sustainability—was also subject to implementation risks (Country Report No. 02/105).

11. **The program encountered success initially, but macroeconomic performance fell short of expectations**. Inflation began to fall initially, based on disinflation through a quasi-peg exchange rate regime, and GDP growth was strengthened. By the fourth review, however, signs of progress were increasingly mixed. Unexpectedly strong capital inflows and buoyant domestic demand, in part reflecting weak incomes policies, resulted in a resurgence of inflation and widening of external imbalances, undermining the exchange rate-based stabilization. As a result, the inflation and external objectives were missed, despite multiple policy adjustments (Table 2). With monetary policy overwhelmed by the external inflows, fiscal policy became an essential tool for domestic demand management.

12. **Implementation of economic reforms throughout this period was complicated by a difficult political environment**. Following the assassination of the Prime Minister in 2003, political tensions halted economic reforms for almost a year. Structural reforms were reinvigorated after elections in 2004: legislation to strengthen banking supervision adopted, a VAT introduced in 2005, and bank and other privatization advanced (see Annex 1 on structural conditionality). The fragile political situation, with constant threats of early elections, extradition requests for war crime suspects, and political uncertainties, affected the ability of subsequent minority governments to press ahead with the more difficult reforms. Enterprise restructuring stalled and little headway was made under the program to reduce public employment, and streamline subsidies and transfers.

13. **Political uncertainties undermined program ownership, resulting in implementation delays**. The fifth review was delayed because of differing views between the staff and authorities on the magnitude of fiscal and monetary policy tightening needed to deal with the rising inflation and external imbalance.[7] Discussions on the sixth (final) review were also delayed by the failure to pass the pension reform in line with program commitments. While structural conditionality

[7] The EA, originally scheduled to expire on May 13, 2005, was extended twice until December 31, 2005 and February 28, 2006 to allow for completion of the fifth and sixth reviews (EBS/06/15).

was eventually implemented or compensated, triggering the final Paris Club debt relief, there was a sense that Serbia's delivery of policies had been half empty, particularly in the area of structural reforms.

Table 2. Performance Under the Extended Arrangement, 2002–05[8]
(Percent of GDP, unless otherwise noted)

	2002	2005	Change
Inflation (percent)			
2002 program	20.7	7.3	-13.4
Outcome	14.8	17.7	2.9
Current account (excl. VAT impact) 1/			
2002 program	-12.8	-8.8	4
Outcome	-13	-12.8	0.2
Growth (percent)			Average
2002 program	4	5	4.8
Outcome	4.5	6.3	5.6
Capital account			Cumulative
2002 program	6.1	4.7	19.3
Outcome	11.9	18.8	58.1
Fiscal balance			
2002 program	-5.7	-4.2	1.5
Outcome	-4.6	0.8	5.4
Gross official reserves (USD billions)			
2002 program	1.6	2.9	1.3
Outcome	2.3	5.8	3.5

Source: Country report No. 06/384.
1/ Corrected for the impact of the introduction of the VAT in 2005.

14. While the EA helped preserve stability and sustain growth, opportunities for macro-critical reforms that would have entrenched stability were missed, and new vulnerabilities emerged. Large capital and remittance inflows bedeviled the macroeconomic framework, boosting domestic demand, and leading to unsustainable current account deficits. Lagging structural reforms and a weak business climate in turn restricted the supply response and further fueled demand pressures. Prudent fiscal policy, coupled with privatization proceeds, drove debt reduction and put debt sustainability on firm grounds, but failed to compensate for the unfavorable private sector savings-investment balances. Monetary and exchange rate policies alternated between external and disinflation goals, contributing in part to widespread financial euroization and the build-up of significant private sector foreign exchange (FX) exposures.

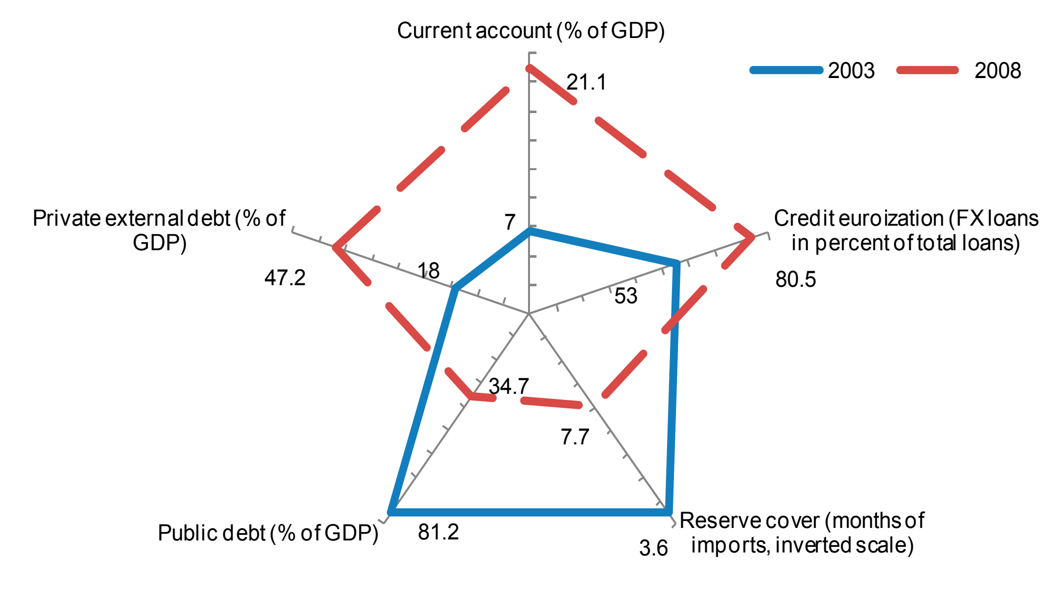
[8] The figures correspond to those available at the expiration of the arrangement, and therefore do not reflect subsequent revisions of national statistics.

C. Vulnerabilities to the Fore: 2006–2008

15. Continued capital inflows and policy relaxation after the expiration of the EA led to rising external deficits and vulnerabilities. GDP growth at 5–6 percent during the post-program monitoring period (PPM) was robust, but unbalanced, relying excessively on external financing and led by domestic absorption. Domestic demand pressures were aggravated by a pro-cyclical fiscal stance ahead of the 2007 elections, facilitated by large privatization proceeds and limited incentives for fiscal discipline following the Paris and London Club debt write-downs. The authorities responded with strong monetary policy tightening, which after the adoption of an informal inflation targeting (IT) regime in 2006, implied greater exchange rate flexibility and a higher policy interest rate. The ensuing sharp currency appreciation helped tame inflation, but at the expense of an exploding current account deficit (21 percent of GDP in 2008) and growing private sector indebtedness (Figure 2). Prudential measures to contain credit growth, notably higher FX reserve requirements, encouraged a large volume of direct corporate off-shore borrowing, partially guaranteed by local bank subsidiaries.

16. Political gridlock prevented further progress on the structural front, aggravating underlying vulnerabilities. Gains obtained at the end of the EA in containing pensions and wages in the public enterprise sector were quickly overturned. State- and socially owned enterprises, continued to drain domestic savings, while fixed investment remained low. Lags in implementing crucial structural reform during previous years, resulted in a difficult business environment, and a small and undiversified exports sector (Box 2).

Figure 2. Vulnerability Indicators, 2003 and 2008

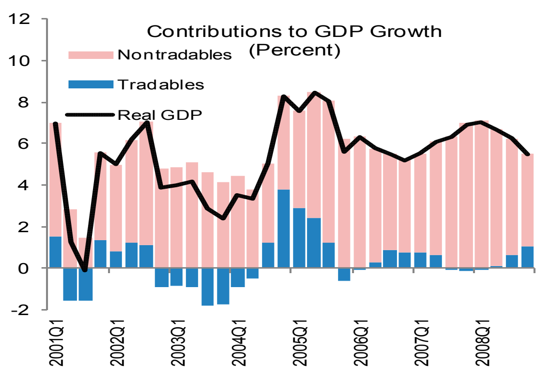


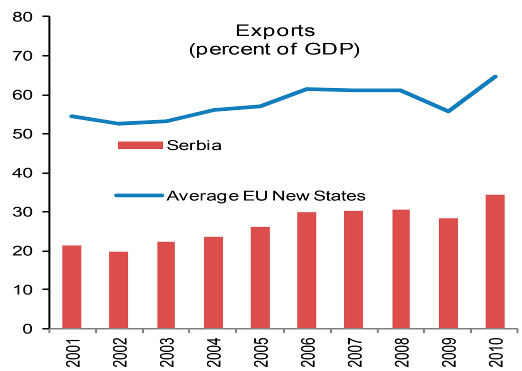
Sources: National Bank of Serbia and Ministry of Finance.

Box 2. Export Performance and Business Climate

Serbia's export potential was heavily affected by the developments in the 1990s. In 2000, Serbian exports stood at 20 percent of GDP—compared with almost 70 percent in 1990—lower than in most countries in the region, as a consequence of the armed conflicts, international isolation, and the interruption of long-established trade relations.

Economic growth recovered in the 2000s, but was led primarily by the non-tradable sectors. While output growth averaged around 5½ percent in 2001-08, the tradable sector accounted for less than one quarter of the overall expansion. As a result, exports as a share of GDP in 2008 were less than half the level in comparator countries, while imports (at 60 percent of GDP) were much closer to regional averages (68 percent for the new EU states).

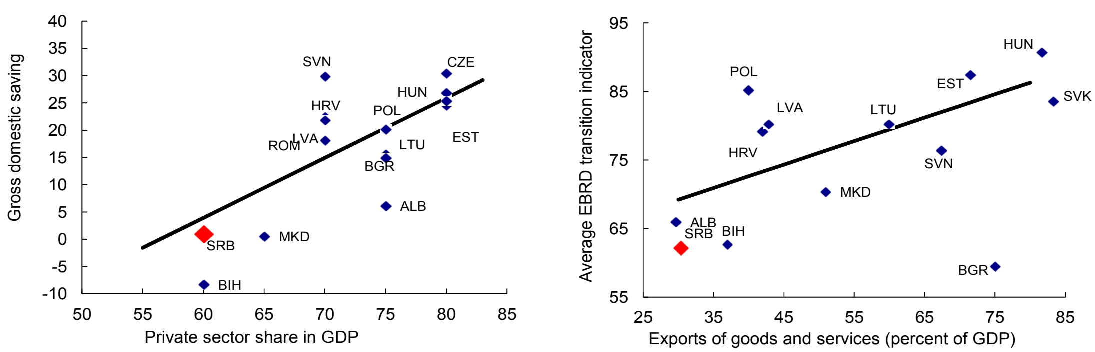




Source: Serbian Statistical Office; and WEO.

Slow structural reforms contributed to Serbia's lagging export performance. While euro wages in Serbia were broadly in line with transition peers, the share of private sector in GDP was much lower. Domestic savings and investment levels were also well under transition country norms. Serbia scored low on the EBRD transition indicators (particularly on large enterprise privatization and restructuring, and competitiveness policies), and ranked much lower than the new EU states in the 2008 World Bank's Doing Business report (particularly on starting and closing a business, and protecting investors).

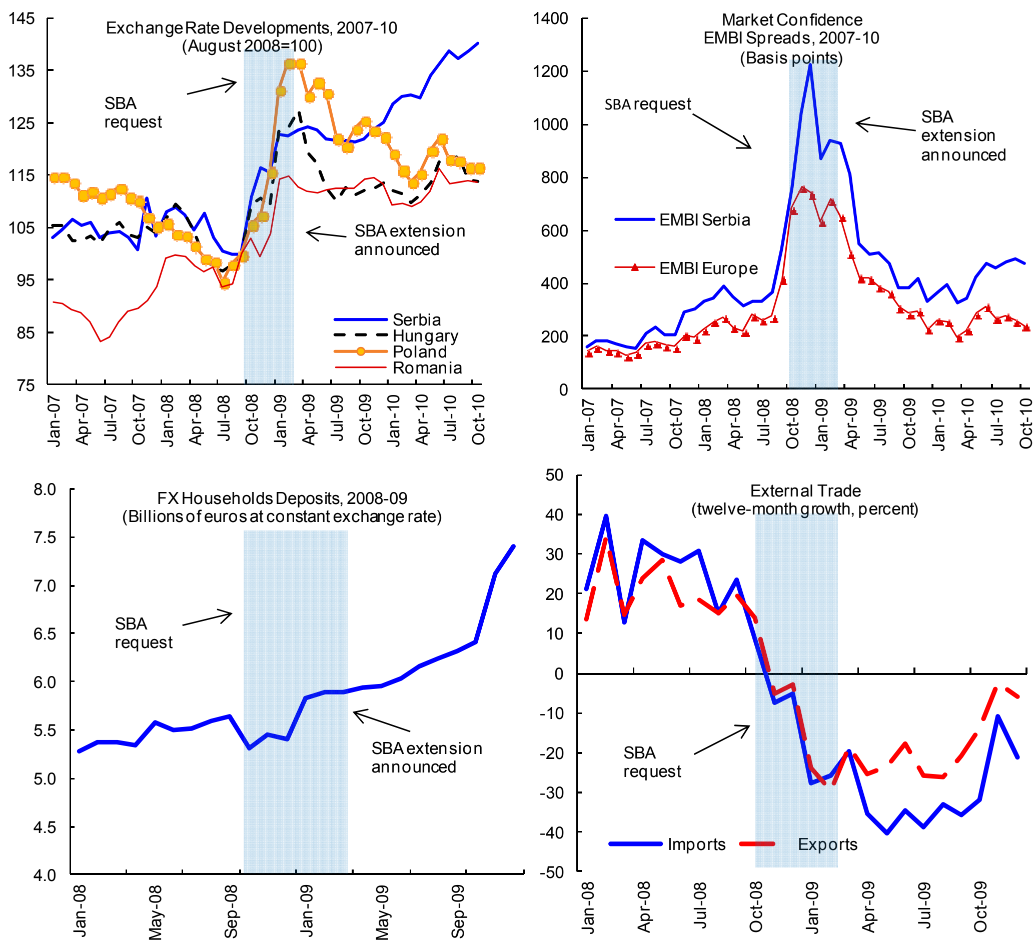
Private Sector and Economic Performance, 2008
(percent)



Source: Serbian Statistical Office; WEO; and EBRD transition indicators.

D. The Unmasking of an Unsustainable Growth Model: 2009 Stand-by Arrangement

17. **When the global financial crisis spilled over into Serbia in September 2008, the authorities quickly requested Fund assistance**. The crisis hit through trade and financial channels, and initially resulted in a soaring sovereign spreads, and a substantially depreciating exchange rate (the dinar depreciated by over 20 percent vis-à-vis the euro from September 2008 to March 2009). Households briefly withdrew deposits from the banks, and credit growth from domestic banks and cross-border sources slowed down. Serbia's large financial buffers—banks were liquid and well-capitalized and the National Bank of Serbia (NBS) had ample reserves—were considered to be an adequate first line of defense, but the authorities sought Fund support to underpin an orderly rebalancing of the economy and to safeguard macroeconomic and financial stability (Box 3).[9] The authorities requested a low access (75 percent of quota) SBA, which they intended to treat as precautionary, distinguishing Serbia from the "emergency SBAs" negotiated with Hungary, Latvia, and Ukraine.



Sources: National Bank of Serbia; and Bloomberg.

[9] Throughout the report, NBS refers to both the National Bank of Serbia and to the National Bank of Yugoslavia. The new name was adopted in February 2003.

Box 3. Key Elements of the 2009 Stand-By Arrangement

Strategy. The overarching aim of the program was to safeguard macroeconomic and financial stability, through a tightening of the fiscal stance, maintaining a managed float under a strengthened IT framework, and making use of financial sector buffers, while enhancing financial sector crisis preparedness.

Nominal anchor and financial sector policies. The program aimed to strengthen the focus on inflation targets as the main nominal anchor. To improve communication of the inflation objectives, the NBS was expected to switch from targeting core inflation to headline CPI inflation. The managed floating exchange rate regime was to be maintained. Financial stability was to be ensured by preventive measures to strengthen risk monitoring, including regarding liquidity and nonperforming loans (NPLs).

Fiscal policy. Years of procyclical policies and unexpected underperformance of financing and tax collections made containment of the 2008–2009 budget deficits necessary. Carryover effects and pre-commitments in terms of extraordinary pension increases, however, limited the room for fiscal maneuver. To achieve a medium-term structural deficit target of about 1 percent of GDP, the program sought to reduce current spending, while at the same time creating space for capital outlays.

Structural reforms. With EU integration as the end-goal, the program envisaged advancing privatization and enterprise restructuring, streamlining of the regulatory framework to improve the business climate, and controlling wage policies in state enterprises.

Access. Access of 75 percent of quota was justified by the risks of a potentially significant shortfall of financing in light of high potential liquidity drains in the global environment.

18. **The program was subject to significant downside risks**. While the new EU-oriented 10-party coalition government that had taken power in July 2008 enjoyed greater political backing than its predecessors, it still only held a sliver of a majority in parliament, and was comprised of parties with disparate ideologies. This raised questions about the authorities' ability to adhere to fiscal discipline and carry out needed structural reforms. The largely foreign-owned banking system's dependence on rollover of parent funding, combined with an inadequate financial crisis resolution framework, and the high level of corporate cross-border debt posed risks of a full-blown crisis. Taken together, these challenges posed considerable difficulties for projections and program design, and it was clearly stated at the outset of the program that a redesign, including moving to a higher access disbursing arrangement, was a possibility. In light of these uncertainties, prior actions in the area of fiscal, monetary, and financial policies were used to support the authorities request for the arrangement (see Annex 2).

19. **The deterioration in the global environment prompted a request for extension of the arrangement and augmentation of access**. By March 2009, it became clear that the external and domestic environment was deteriorating rapidly. As a result, program projections looked increasingly overoptimistic and serious concerns emerged about Serbia's capacity to cover its large external financing needs. In response, the authorities requested augmentation to exceptional access levels and the extension of the arrangement from 15 to 27 months (see section IV below).

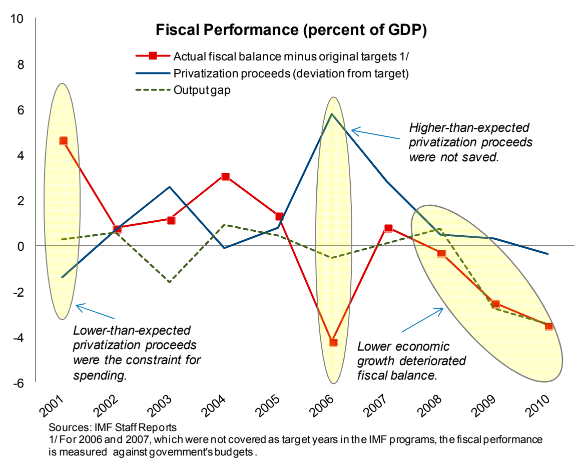
III. Key Issues in Fund Engagement: A Tapestry of Achievements and Challenges

20. The nature of the Fund's engagement with Serbia has evolved reflecting Serbia's transformation over the past ten years. The focus of Fund engagement evolved from *achieving* macroeconomic stabilization and facilitating debt relief in the early programs to *preserving* macroeconomic and financial stability in the context of the global crisis during the latest program. While the underlying imbalances and vulnerabilities in the economy shifted, achievements in the early programs, such as banking sector reforms, contributed to the success of the 2009 SBA. Similarly, long-standing challenges identified at the beginning of Serbia's engagement with the Fund, such as in enterprise restructuring and structural fiscal reforms, had a bearing on the nature of program design and implementation in the later programs. This section selectively reviews the achievements and challenges in four key areas: i) fiscal policy and structural fiscal reforms; ii) monetary and exchange rate policy; iii) banking sector; and iv) state and socially owned enterprises.

A. Fiscal Policy: A Decade of Stop-gap Measures and Slow Structural Reforms

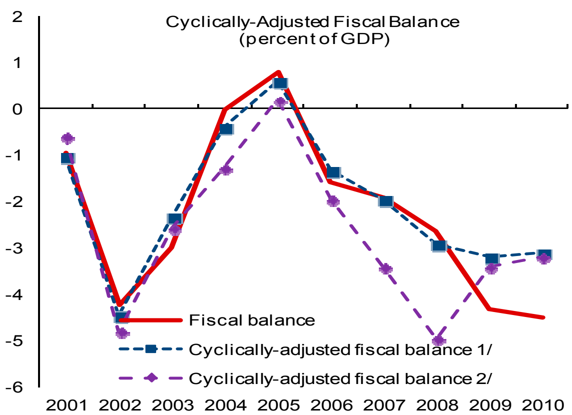
21. The design of fiscal programs over the past decade reflected shifting economic conditions and vulnerabilities. This section seeks to address two questions: (i) was the fiscal effort under the various programs sufficiently ambitious to support program objectives, and (ii) was it of sufficient quality and, therefore, likely to be sustainable?

22. Fiscal restraint contributed to disinflation efforts in the early programs. Reconstruction and reform efforts in the early programs were supported with official assistance. At the same time, inflationary pressures were contained by limiting recourse to domestic financing, combined with nominal wage freezes in the public sector (in 2001under the SBA, and in 2003 under the EA). In the event, fiscal deficits were lower than targets, with fiscal restraint largely reflecting external financing shortfalls.

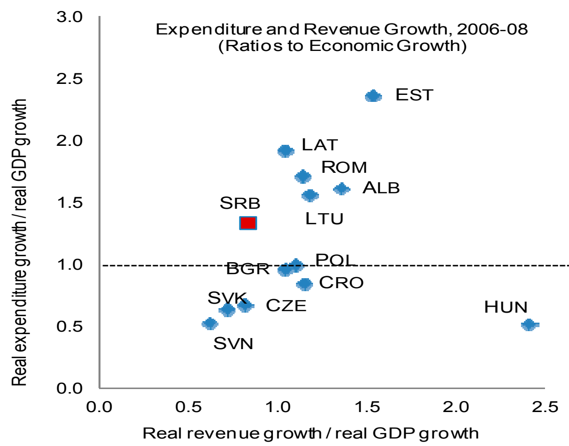


23. In the face of widening current account deficits, the focus of fiscal policy under the EA shifted to the containment of external imbalances. With capital inflows surging, and external imbalances widening, the Fund increasingly called for a tighter fiscal stance to support demand management under the quasi-peg regime. The newly elected reformist government, formed in March 2004, agreed to a major fiscal tightening in response to the external pressures. Fiscal policy was tightened beyond program commitments in 2004, and a further consolidation agreed to for 2005 (to generate a surplus). The fiscal adjustment of over 5 percentage points of GDP during 2002–2005 was sizeable, but achieved partly though indirect tax hikes, and aided by the revenue-boosting effects of buoyant domestic demand. The retrenchment achieved through *permanent* cuts in the wage bill, as originally envisaged under the program, was modest by comparison, aggravating underlying macroeconomic tensions.

24. During the PPM period, the fiscal stance became strongly pro-cyclical. The authorities argued that the budget surpluses for 2006–07 originally agreed to in the sixth review of the EA would unduly constrain fiscal options and were "unrealistic" in light of the large infrastructure needs. They instead favored a balanced budget and proposed to finance higher investment spending and personal income tax cuts with mobile phone receipts of 1.6 percent of GDP to be accounted as revenue.[10] Staff strongly cautioned against the relaxation, pointing to external sustainability concerns associated with the proposed stance, and the need to boost domestic savings. In the event, the fiscal position deteriorated markedly during 2006–08, with sharp increases in capital expenditures, wage bills, and pensions.



Sources: Ministry of Finance; and Fund staff calculations.
1/ Adjusted for the effect of the output gap.
2/ Adjusted for the effects of the output and absorption gaps. The latter is the deviation between actual absorption and absorption level consistent with sustainable external balance.
1/ 2/ in percent of potential GDP



Sources: WEO ; and Fund staff calculations.
Note: The X and Y axis show the average ratio s of real revenue and real expendiutre growth to real GDP growth during 2006 - 08, respectively.

25. In retrospect, the considerable build-up of external vulnerabilities in the run-up to the crisis suggests that fiscal policies should have been more prudent. On a cyclically-adjusted basis (adjusted for the output and absorption gaps), the fiscal effort under the EA was less demanding than suggested by the overall fiscal balance. A tighter fiscal stance in 2004–05 —supported by a stronger retrenchment in wages, subsidies, and transfers—would have been in order, in view of the need to moderate domestic demand and contain external imbalances (see section III B). Greater fiscal tightening was also warranted to build more robust cushions during the 2006–08 period of rapid growth. However, in the absence of balance of payments needs during this period, it is not surprising that staff calls for greater fiscal prudence went unheeded and, in contrast to many transition peers, real expenditures grew faster than available revenues (excluding privatization proceeds).

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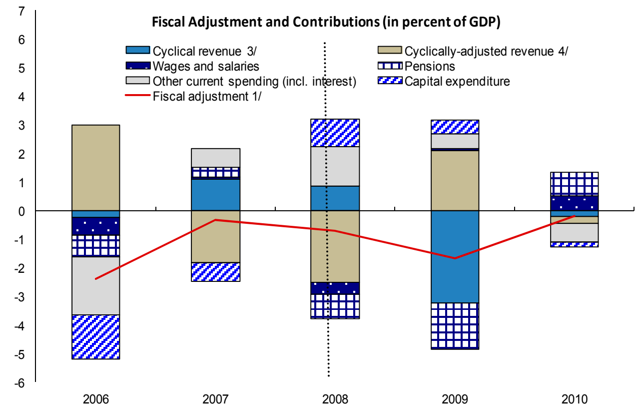
[10] On staff fiscal definitions for the general government (which placed the license receipts below the line), the proposals implied a significant reversal in the fiscal stance relative to 2005.

26. A restrictive fiscal policy was one of the pillars of a broader strategy designed to preserve macroeconomic and financial stability during the 2009 SBA. The rationale for the proposed stance was three-fold: i) given the earlier expansionary policies, there was little scope for countercyclical loosening; ii) financing was tight; and iii) there was a need to restore market confidence. As the crisis intensified, the revised program aimed for additional fiscal adjustment in response to plunging revenue collections**,** while facilitating an orderly rebalancing of the economy. In the event, fiscal targets were relaxed as the macroeconomic situation worsened by allowing automatic stabilizers to operate.



1/ Fiscal adjustment is a reduction (increase) in the fiscal deficit (the fiscal surplus) from the previous year (in percent of GDP). For example, fiscal adjustment in 2006 is the change in the fiscal balance from 2005.
2/ Positive (negative) signs above indicate contributions to fiscal consolidation (deterioration).
3/ Cyclical revenue is calculated as direct taxes (and grant) multiplied by the output gap with the assumption of revenue elasticitiy of one and indirect taxes multiplied by the domestic absorption gap with the assumption of revenue elasticity of one (adjusted for the share of consumption in absorption).
4/ Cyclically-adjusted revenue is total revenue minus cyclical revenue.

27. The 2009 SBA broadly achieved its fiscal adjustment targets but, as in the past, relied largely on ad hoc measures. The main measures included: (i) reducing the public wage bill, mainly by freezing public wages and pensions and curtailing employment, and (ii) across-the-board cuts in discretionary spending, while preserving critical social spending programs. These measures sought to offset significant spending increases embedded in the 2009 budget, resulting from the previous year's election promises.[11] The authorities' preference was for a purely expenditure-based strategy, while staff, concerned about implementation risks, argued for a more balanced revenue-expenditure mix (including an upfront VAT increase). It was agreed that the ad hoc measures would need to be replaced over time by more durable and higher-quality spending reforms of wages and pensions. But progress in these areas was slow and details of the envisaged reforms not clearly spelled-out during the program period.

28. During much of the period covered by this report, political instability encouraged a reliance on short-term measures, with the resulting failure to place the fiscal accounts on a sustainable path. Serbia's fragmented politics continuously hindered and delayed the implementation of measures to streamline social benefits, transfers, and public employment. As a result, against repeated Fund advice, virtually every program review after 2003 included stop-gap measures to meet the fiscal target. As such, the quality of fiscal adjustment remained weak, with heavy reliance on indirect taxes (excises) during the EA, and, on the expenditure side, nominal wage freezes, reductions in investment, and restraint in discretionary spending. While some progress was made during the period covered by this EPA in reducing

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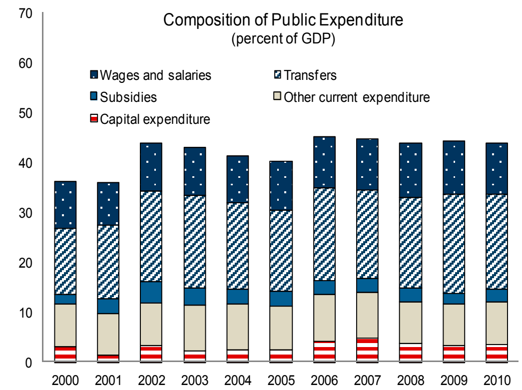
[11] A staff visit in September 2008 estimated that the fiscal promises of the new government would add 5 percent of GDP to the 2009 budget (see http://www.imf.org/external/np/ms/2008/092408.htm).

nondiscretionary spending, it fell short of program objectives, as well as of the adjustment required to ensure medium-term fiscal sustainability.[12]

29. Consequently, a rigid structure of expenditures was maintained. Serbia's general government expenditure-to-GDP hovered around 45 percent since 2002, higher than many of its regional peers and more typical of an advanced economy. The slow pace of enterprise and pension reforms, and an oversized public sector served to reinforce expenditure rigidities, reducing the flexibility of fiscal policy in demand management (Box 4). Nondiscretionary expenditures accounted for over 70 percent of total expenditures, dominated by outlays in the social sectors (social protection, health, and education). Public investment was crowded out, and remained relatively low (about 3½ percent of GDP in 2010) in comparison to regional peers.



Source: IMF staff reports and Ministry of Finance in Serbia.

30. Structural reforms over the past decade placed emphasis on improving tax policy and modernizing Serbia's fiscal institutional framework. In tax policy, building on a major reform that helped streamline the tax system under the 2001 SBA, key achievements included the introduction of the VAT and the elimination of the financial transactions tax under the EA. Progress was also made with improving revenue administration and strengthening the operations, collection, and enforcement capacity of the collection agencies. Important steps were taken to strengthen public financial management since the 2001 SBA (see Box 4). The adoption of fiscal responsibility legislation to establish a strong fiscal framework anchored by a medium-term deficit target was a commendable achievement under the 2009 SBA.[13]

31. A large unfinished agenda, however, remains. Containing pension and wage growth in a sustainable manner and addressing expenditure rigidities remains crucial to create fiscal space for priority spending, while meeting the fiscal rule. Further progress in improving budget preparation and implementation, reducing fiscal risks, enhancing the effectiveness of tax administration, and a careful evaluation of the fiscal impact of property restitution will also be required to ensure fiscal sustainability.[14]

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[12] A clear lesson from past episodes of large fiscal consolidations is that durable adjustment relied primarily on expenditure reductions. See, *Experience with Large Fiscal Adjustment*, Occasional Paper 246.

[13] The fiscal responsibility framework (FRF) is anchored by a numerical fiscal balance rule converging to a medium-term general government deficit of 1 percent of GDP, while allowing automatic stabilizers to operate in response to output growth deviations from a "trend" growth rate, and allowing for capital spending in excess of 5 percent of GDP. The balance rule is supplemented by a debt ceiling of 45 percent of GDP (excluding restitution debt), and indexation rules for pensions and wages.

[14] Quasi fiscal deficits of public enterprises and contingent liabilities arising from external borrowing guarantees continue to pose significant fiscal risks.

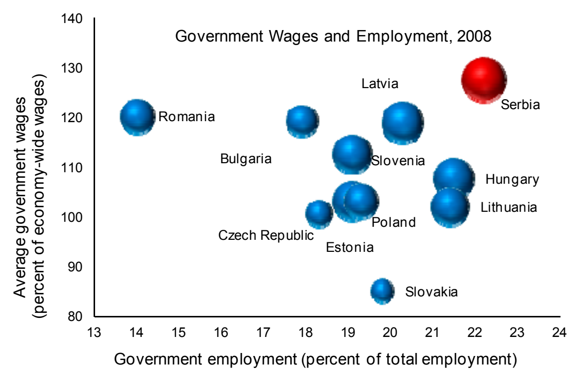
Box 4. Structural Fiscal Reforms

Notwithstanding considerable progress over the past decade to modernize the fiscal institutional framework, much remains to be done to support durable fiscal consolidation.

Public Financial Management. Supported by TA from the IMF's Fiscal Affairs Department (FAD), important steps were taken to strengthen the budget process and increase transparency since the 2001 SBA, including the establishment of a treasury and a single treasury account, the implementation of a financial management information system, and the establishment of internal and external audit functions. Significant institutional achievements were the enactment of the 2002 Budget System Law and its amendment under the 2009 SBA, which codified the fiscal responsibility framework including numerical fiscal rules. Further efforts are needed to strengthen the fiscal framework, including improving budget preparation, execution, and reporting, strengthening capital budgeting, and defining the institutional coverage of the general government.

Tax administration. FAD has provided extensive TA to strengthen tax administration throughout Serbia's engagement with the Fund. Reform achievements include the adoption in 2003 of a new law on tax administration, the establishment of a functional organization structure and a large taxpayer office, and implementation of the VAT system in place of the previous sales tax system. In addition, a taxpayer compliance strategy was adopted under the 2009 SBA. Nevertheless, significant shortcomings remain in several areas, including compliance management, upgrading of IT, overhauling legislation and business processes, and reorganizing headquarters and field structures.

Public wages and employment. Civil service reform undertaken in 2005 with World Bank support aimed at reduction of staff and rationalization of the pay scale. However, wages and staffing levels in the government sector are still relatively high by regional standards, resulting in one of the highest wage bills in the region (over 12 percent of GDP in 2010). Relatively generous pay granted at lower grade levels has also resulted in a compression ratio that is significantly lower than the OECD average.



Note: The size of the bubble indicates government wage bill in percent of GDP.
Sources: Eurostat; and Statistical Office of Serbia.

Pension reforms. The pension fund has consistently run large deficits (around 7.5 percent of GDP in 2010), among the highest in the region, covered by central government transfers. The deficits reflect a high replacement rate (at over 70 percent of the net average wage this is higher than in many OECD countries) and a low contributor base. Reform efforts in 2005 and 2009, among other elements, introduced gradual increases of retirement ages and modified the indexation formula seeking to rein in outlays. However, given a rapidly aging population, additional steps are needed to put the finances of the pension system on a sustainable footing.

B. Monetary Policy: The Quest for an Appropriate Nominal Anchor

Early exchange-rate based stabilization

32. **Exchange-rate-based stabilization and tight credit policies were key elements in the strategy to reduce inflation during the early programs**. The exchange rate became the nominal anchor in October 2000, at the same time as prices were liberalized and the foreign exchange market unified. As a complement, strict limits on the central bank's accumulation of net domestic assets were imposed under the 2001 SBA. The original strategy agreed between staff and the authorities was to let the dinar depreciate slowly in a controlled manner to safeguard competitiveness and avoid exit problems associated with fixed exchange rate regimes.

The choice of a crawling band, with the rate of crawl defined ex ante, reflected the need to reinforce disinflation and avoid eroding market confidence in an environment of growing foreign inflows and rapid re-monetization.

33. **While the strategy encountered success initially, stronger-than expected capital inflows and booming domestic demand unsettled the focus of monetary and exchange rate policy**. The stable nominal exchange rate contributed to lowering inflation from over 100 percent in 2000 to below 10 percent in 2003.[15] At the same time, buoyant domestic demand, fueled by remittances, rapid credit expansion by the newly-established foreign banks, and increased foreign borrowing by privatized companies, led to a burgeoning current account deficit. The exchange rate appreciated by 7 percent in real effective terms between end-2002 and end-2003, but external competitiveness remained broadly appropriate.[16]

34. **Between 2003 and 2006, policies oscillated between addressing internal and external goals, ultimately attaining neither in the absence of an adequate policy mix**.

- With disinflation in train, attention shifted to the large external imbalance. In early 2003, the exchange rate policy was modified to allow for gradual dinar depreciation under an unannounced crawling band regime (Table 3). Staff supported the authorities' decision to assign priority to the external objective. However, the ensuing depreciation in the context of a highly euroized economy with large exchange rate pass-through, combined with a post-election adjustment of administered prices resulted in a resurgence of double-digit inflation in 2004.
- As inflation concerns resurfaced, the authorities decided in mid-2005 to slow down the pace of depreciation, considering the large current account deficit a more medium-term risk given available financing. In addition, monetary policy was tightened through the increased use of repo operations and higher reserve requirements on foreign currency deposits and foreign borrowing of banks, combined with prudential measures to stem credit growth. Staff concurred that the crawling band, periodically adjusted in line with targeted inflation, provided a valuable guide for inflation expectations, but pointed to the risk of jeopardizing the current account target through potential real appreciation. These risks were to be mitigated by tighter-than-previously programmed fiscal and monetary policy.
- Eventually, both inflation and the current account deficit remained high in the face of a weak interest rate transmission channel, continued demand pressures and strong capital inflows, and the erratic monetary and exchange rate policies likely contributed to financial euroization and the failure to anchor inflationary expectations.

35. **In a landscape roiled by strong inflows, staff advice did not provide a clear solution to the policy dilemma**. It can be argued that fiscal policy was not sufficiently supportive of the

[15] The 2003 inflation figure also reflected election-related delays in updating administered prices.

[16] Staff's analysis suggested that the real effective exchange rate was broadly aligned with fundamentals (Country Report No. 03/296).

authorities' chosen exchange rate anchor. Given the magnitude of inflows, however, it is far from obvious that an even tighter fiscal policy would have been able to reduce the current account deficit sufficiently. As discussed earlier, a tighter fiscal policy could have helped break inflation inertia, especially through stricter wage and incomes policies. Staff appropriately pointed to the risks entailed by the authorities' strategy, given fiscal rigidities and soft budget constraints in public enterprises. Staff, in turn, placed greater emphasis on addressing the external imbalance, advocating tighter monetary and fiscal policies, as well as a more flexible exchange rate policy to lower the current account deficit (Country Report No. 05/233). In retrospect, and in light of the fact that even sustaining a stable exchange rate ended up being too costly in the face of surging inflows, it is unlikely that this policy mix could have been successfully implemented.

Table 3. Serbia: Monetary Policy Regimes, 2001–2011

	Exchange Rate Regime		Inflation objectives (eop)	
			Program	Outturn
2001-2002	Announced fixed band to euro (± 1/2 percent)	2001	30-36	40.7
	Exchange rate based stabilization	2002	21	14.8
Jan-March 2003	Unannounced crawling band to euro (±1/2 percent) - pace adjusted ex post to inflation	2003	12	7.8
March-Sep 2003	Managed float (post PM assassination)			
Sep 2003-Dec 2004	Unannounced crawling band to euro (±1/2 percent) - pace adjusted ex post to inflation	2004	7	13.7
Jan 2005-Mar 2006	Unannounced crawling band to euro (±1 percent from Oct 2005) - pace set ex ante targeting 10 percent nominal depreciation	2005	9-10	17.7
March 2006-Aug 2008 1/	Managed float	2006	11.5	6.6
Sep 2006-Dec 2008 2/	Informal inflation targeting	2006	7-9	6.6
		2007	4-8	11
		2008	3-6	8.6
Jan 2009-Present	Formal inflation targeting	2009	5.5-9.5	6.6
		2010	4-8	10.3

Sources: IMF staff reports and National Bank of Serbia.

1/ Post-program monitoring.
2/ Program inflation objectives refer to NBS objectives in this period.

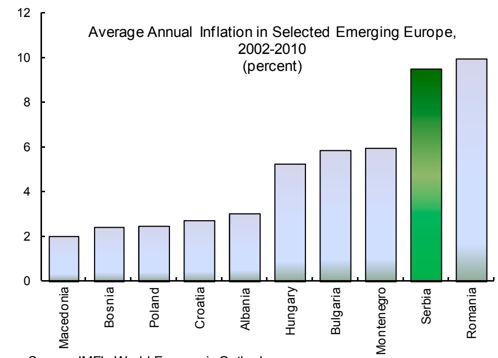
The move to IT

36. **Faced with escalating sterilization costs in early 2006, the authorities sought an alternate nominal anchor.** Escalating sterilization costs from their attempts to tighten monetary conditions forced the authorities to shift towards greater exchange rate flexibility, with the anticipation of moving to an eventual float. Staff concurred with this decision, given the large capital inflows, strong credit growth, and high political uncertainty during this period. Other potential nominal anchors (money, nominal GDP) were subject to large uncertainty in an environment of rapid structural change. In September 2006, an interim framework based on a flexible exchange rate regime and the control of monetary aggregates was adopted, with the eventual intention of shifting to full-fledged IT. With substantial Fund TA, the institutional setup for IT was gradually enhanced.

37. **The new regime helped to bring inflation under control, but an inconsistent policy mix aggravated external imbalances leading up to the crisis**. Aided by a double-digit real appreciation resulting from NBS's policy of high interest rates, inflation declined from 14.5 percent at end-2005 to around 6 percent at end-2006. The informal IT framework was

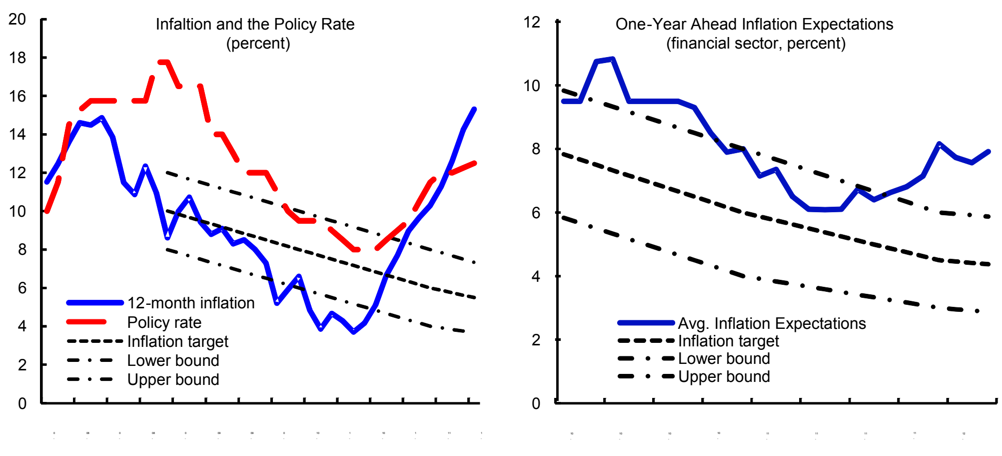
perhaps the only realistic option available to the monetary authorities at the time, in light of the high volatility of monetary aggregates, past experiences with the quasi-peg, and inadequate supportive policies. However, the combination of tight monetary policy and expansionary fiscal policy against a backdrop of surging capital inflows contributed to the buildup of unsustainable current account deficits in the run-up to the crisis.

38. The implementation of IT has been complicated by a challenging environment, and inflation has remained volatile. Administered prices still comprise a substantial share of the price index that lies outside the influence of the NBS. Supply shocks affecting food and fuel prices, which comprise a large share of the consumer price index, have been a significant and recurrent factor, pushing inflation above or below targets. The high degree of euroization severely hampers the ability of the NBS to affect economic activity through changes in the policy rate, leaving the exchange rate channel as the main transmission mechanism for changes in the policy rate.



Source: IMF's World Economic Outlook.

39. Serbia's (short) experience with IT has been mixed to date, with central bank credibility proving hard to establish. Central bank independence and efforts to strengthen the transparency, formal modeling, and communication practices to support the full-fledged IT framework adopted in 2009 were commendable achievements. However, bringing down inflation expectations has proved hard. More recently, price pressures triggered by food price shocks and the currency depreciation pushed inflation back in the double-digit range towards end-2010, and inflation expectations moved further away from their targets. Further strengthening the effectiveness of the monetary policy transmission mechanism remains a challenge.



Source: National Bank of Serbia.

C. Banking Sector: A Remarkable Makeover

40. **In 2000, the banking system was largely insolvent**. The turbulence of the 1990s had led to massive disintermediation, directed credits to enterprises were pervasive, corporate governance was poor, and regulation and supervision inadequate. The general public had little confidence in the banking system since the freezing of households' foreign exchange deposits in 1991 and the 1993 hyperinflation episodes. The NBS prevented the collapse of the system by extending credit to problem banks and suspending the enforcement of prudential regulations. A survey of the banking system in 2000 found that about 30 banks (including the six largest banks)—jointly accounting for about 80 percent of the assets of the banking system—were insolvent.

41. **The 2001 SBA successfully and expeditiously cleaned-up the banking system**. With technical assistance from the Fund, the World Bank and bilateral donors, the NBS adopted a comprehensive restructuring strategy and followed it through.[17] In total, 28 banks accounting for almost two-thirds of the book value of the system's assets were put into bankruptcy, out of which 23 were liquidated. Program conditionality also supported upgrading the legal and institutional framework to facilitate liquidation and establish a deposit insurance scheme. The decision to swiftly liquidate the problem banks instead of rehabilitating them significantly lowered the fiscal costs associated with the reform.

42. **Program conditionality under the EA rightly focused on establishing proper bank governance and updating the legal and regulatory framework**. A new banking law was introduced, in line with the 2005 FSAP recommendations. In particular, the regulatory and supervisory frameworks were updated in line with internationally generally accepted sound principles, especially in the areas of capital adequacy, large exposures, lending to connected parties, and risk management. The program also envisaged large-scale privatization of the remaining nationalized banks, but progress in this area was limited.

43. **By the end of the EA, the banking system had been substantially strengthened, but there were signs of emerging financial stability risks**. Improving financial health engendered greater confidence in the banking system and precipitated rapid re-monetization. The entry of foreign banks in previous years (accounting for 70 per cent of the market in 2005) led to a sharp increase in intermediation, although overall credit-to-GDP at 30 percent was low by regional standards. While banks generally had matching FX asset and liability positions, they were indirectly exposed to unhedged borrowers, making them vulnerable to a depreciation of the dinar.

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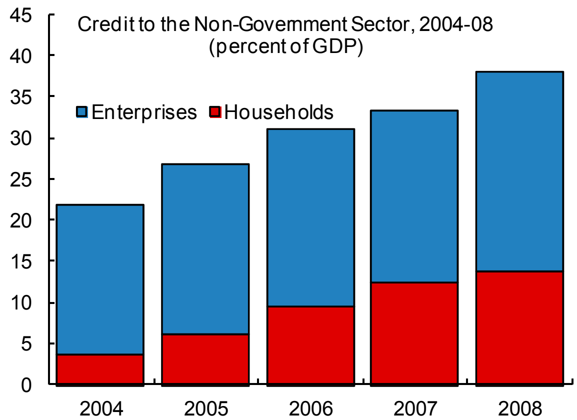
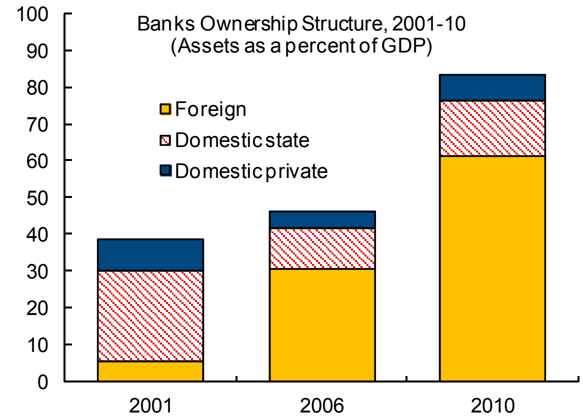
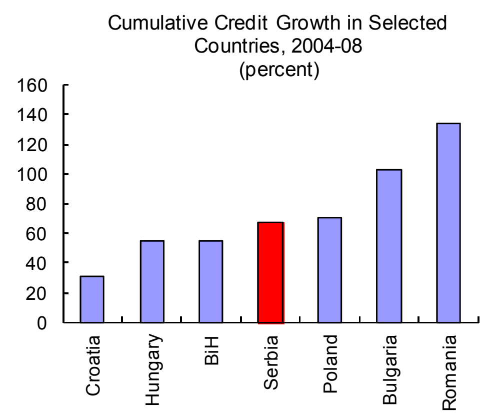
[17] To enable bank restructuring, changes were effected to the legal and institutional framework, including to the Law on Financial Rehabilitation, Bankruptcy and Liquidation of Banks, to allow the Bank Rehabilitation Agency to perform the functions of a bank liquidator, and the deposit insurance scheme.





Source: National Bank of Serbia.

44. **On the eve of the global financial crisis, the banking system was sound but vulnerabilities remained high**. Rapid credit expansion financed by surging capital inflows had prompted the NBS to strengthen prudential measures. In particular, the NBS tightened reserve requirements by broadening the base to cover external liabilities and raising the rate, and introduced regulations to limit retail lending and shorten the maturity of cash loans.[18] High provisioning and reserve requirements discouraged short-term borrowing domestically, which combined with a ban on private short-term external borrowing, contained the growth of short-term liabilities. As a result, credit growth prior to the crisis was relatively subdued compared to other countries in the region, and the banking system was liquid and well capitalized (Table 4). The measures introduced by the NBS succeeded in moderating banks' credit growth, but had the unintended effect of encouraging direct cross-border borrowing by un-hedged enterprises.



Source: IFS.

Table 4. Serbia: Financial Soundness Indicators, 2008 and 2010

	2008	2010
Capital adequacy ratio (percent)	21.9	19.9
Return on equity (percent)	9.3	5.4
Nonperforming loans (percnt of gross loans)	11.3	16.9
Total provisions to NPLs	188	144
Liquid assets to total assets	43.3	35.1
FX loans to total loans	81.9	79.7

Source: National Bank of Serbia.

[18] Additional regulations limiting retail lending to 150 percent of banks' capital and shortening the maturity of cash loans from ten to two year were introduced.

45. When the crisis hit, an immediate priority was to maintain confidence in the banking sector. Households, in part responding to alarmist media reports, but also mindful of their 1990s experiences of deposit freezes and financial collapse, withdrew sizeable deposits. Though banks' large liquidity buffers accommodated the deposit withdrawals, interbank market spreads widened and banks hoarded FX-liquidity. In response, the NBS boosted FX liquidity by easing FX reserve requirements and expanding deposit insurance coverage. In addition, the crisis management framework for the financial sector was strengthened, supported by Fund TA, and measures were taken to intensify preventive efforts through enhanced monitoring of banks. A key measure under the 2009 SBA was the formalization of understandings between the government, the NBS and the Deposit Insurance Agency (DIA), on their respective responsibilities in maintaining financial sector stability.

46. As the crisis intensified, a Fund-facilitated agreement to bail in foreign banks was the cornerstone of the 2009 SBA. The program sought pre-emptive action to establish a common crisis response framework among financial institutions aimed at stabilizing financial sector conditions and softening the impact of the crisis on private section balance sheets. A key pillar of this strategy was to obtain assurances from foreign banks to roll over their exposures under the auspices of the authorities' Financial Sector Support Program (FSSP) (Box 5). The incentives for banks to voluntarily agree to a coordinated rollover were high as the failure to do so could have triggered a vicious downward spiral of FX depreciation, deleveraging and escalating bank losses, potentially ending in a currency-cum banking crisis. In the event, rollover rates in Serbia remained high, reflecting, in part, the authorities' ability to closely monitor the agreed bank-by-bank exposure floors based on monthly reporting requirements.

Box 5. The Financial Sector Support Program (FSSP)

The FSSP was voluntary and open to all banks during the period March 2009–December 2010, and included a mix of commitments and incentives (Country Report 09/158):

- **Parent bank commitments.** Under the so-called Vienna Initiative (later named European Bank Coordination Initiative (EBCI)), ten foreign parent banks committed in March 2009 to maintain, until the end of 2010, their cross-border exposures vis-à-vis Serbia, amounting to credit exposures of €8.7 billion (25 percent of GDP) at end-2008. Additional formal commitments by parent banks included provision of adequate liquidity and capital, and participation in diagnostic studies.
- **Domestic banks commitments.** Domestic banks committed to facilitate conversion of FX and FX-linked loans into domestic currency, work with the NBS toward developing a common loan workout scheme, facilitate loan restructuring, and extend loan maturities.
- **Incentives for participating banks**. Banks participating in the FSSP were granted access to two new liquidity facilities established by the NBS, in dinars and foreign currency. The first aimed to help banks with loan restructuring, while the FX swap facility offered banks a swap line out of a designated pool of funds of up to €1 billion.
- **General incentives available to all banks.** These included amending several macro-prudential regulations for the duration of the program, including raising the limit on subordinated debt-to-Tier 1 capital ratio to encourage recapitalization, eliminating reserve requirements for new external borrowing, lowering the share of required reserves on FX liabilities to be held in dinars, and relaxing the net open FX position limit.

47. The Fund-supported FSSP played a crucial role in helping avert a financial meltdown. Although the NPLs share of total loans increased to almost 18 percent at end-2009 from 12 percent at end-2008, banks had large buffers to absorb potential losses. Diagnostic studies and stress tests conducted for all 31 banks over 2009–2010, found that the banking system was liquid and well-capitalized, even under the most extreme scenario employed. Interviews conducted for this report agreed that parent bank involvement, in combination with Fund engagement and strong ownership by the authorities, were key elements of the program's success in preserving financial stability.

48. Progress in strengthening the banking system over the last decade has been remarkable, but some challenges remain. Vulnerabilities in the banking system include the weak quality of credit portfolios, as reflected in the high level of NPLs, the high level of euroization and associated large potential exposures to un-hedged clients, and spillovers from the EU periphery. In addition, as highlighted by the 2009 FSAP, some weak points in the regulatory environment and its implementation remain (Box 6).

Box 6. 2009 FSAP: Summary of Recommendations

- Improve the risk-based approach and risk management within banks
- Apply consolidated and cross-border supervision
- Bolster the bank resolution framework
- Introduce a comprehensive crisis management framework
- Enhance the deposit insurance scheme
- Effect structural improvements to the other financial services sector

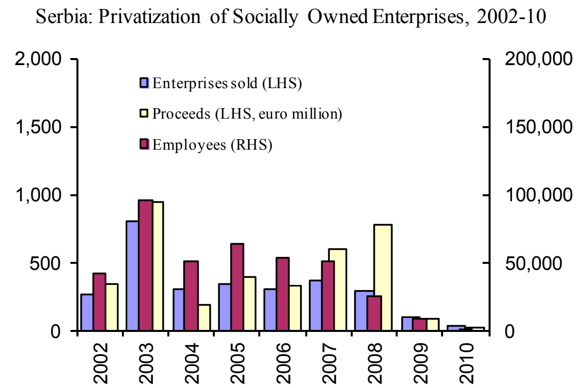
D. State-and Socially-Owned Enterprises: A Difficult Legacy

49. **Company reform in Serbia started later than in other Central and Eastern European transition economies**. In 2000, the bulk of the labor force was employed in state and socially-owned enterprises (SSOEs).[19] Most companies were inefficiently organized, loss-making, overstaffed, and suffered from poor corporate governance. Their survival depended in many instances on subsidies, accumulation of arrears, and—if they had a monopolistic position—on administrative price hikes.

50. **The 2001 SBA laid the ground to jumpstart the privatization process**. The program identified the enterprise sector as one of the root causes of macroeconomic imbalances. A new legal and regulatory framework was put in place in 2001 with the objective of accelerating the privatization process and attracting strategic investors. As the program was negotiated when World Bank engagement in Serbia was ruled out due to arrears, the Fund took the lead in formulating conditionality in this area. When World Bank support started in May 2001, the program monitored progress in privatization in coordination with the World Bank through structural conditionality. In addition, quasi-fiscal losses of the electricity company were reduced by increases in tariffs agreed under the program and wages of state enterprises frozen.

51. **During the EA, the World Bank took the lead on enterprise restructuring**. The EA program did not provide a detailed roadmap for reforms in this area. Instead, it focused on limiting the budgetary impact of the SSOEs by safeguarding the electricity pricing policy and containing the wage bill of the largest state enterprises. Private sector developments were closely monitored, but conditionality was entrusted to the World Bank, in line with the new policy of streamlined conditionality.

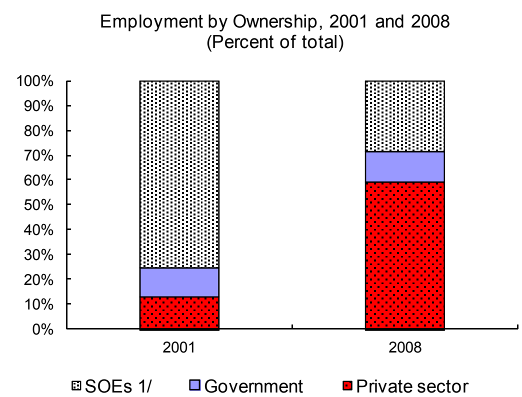
[19] The large share of "social ownership" reflected the legacy of former Yugoslavia, with enterprises run by their work forces, which also had a claim on profits. The Serbian Constitution (2006) recognizes collective (or social) assets separately from private and public assets, and specifies that collective assets should over time be privatized.



52. The privatization process gained momentum in the early 2000s but soon ran out of steam. Almost 1,000 medium-sized enterprises were privatized in auctions and 25 large enterprises in international tenders during 2001–03. Political tensions, however, halted economic reforms by almost a year, hindering the timely adoption of critical legislation, including a new bankruptcy law that was needed to allow efficient resolution of enterprise liquidation. Vested interests and a fragile political situation also contributed to an increased reluctance to tackle the more difficult remaining cases, which required restructuring or liquidation, and would have entailed significant employment losses in an environment of already high unemployment (Box 7).

53. The need for accelerating structural reforms gained urgency as external imbalances ballooned, resulting in a retooling of conditionality in 2004. New conditionality under the program aimed to strengthen the institutional framework and to hasten privatization, with a focus on restructuring of large public enterprises. In addition, a new World Bank-backed bankruptcy law—which emphasized creditor rights and procedural deadlines—took effect from 2005. As a result, reforms in this area regained some momentum.

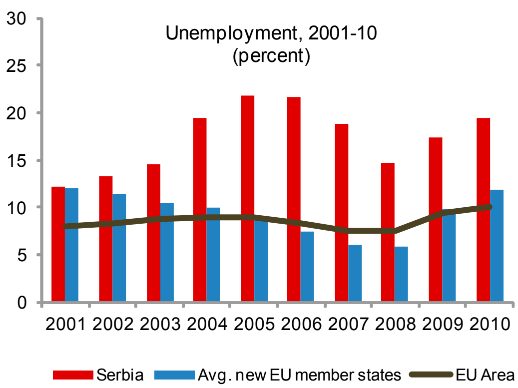
54. Delayed enterprise reforms during the EA contributed to the build-up of vulnerabilities in the run-up to the global crisis. Despite the ambitious plans at the outset of the program and initial successes, as the EA expired, a large share of resources was still held in uncompetitive and loss-making enterprises. As a result, the share of the private sector in GDP only increased from 40 to 55 percent between 2001–2005, with one-third of non-financial enterprises reporting losses, funded in large part by subsidies, accrual of wages and contribution arrears. State- and socially-owned firms were characterized by wages out of line with productivity, and acted as *defacto* wage leaders for the rest of the economy (Box 7). Alongside the credit boom, corporate dissaving on a large scale compounded external pressures, and weakened the supply side of the economy.



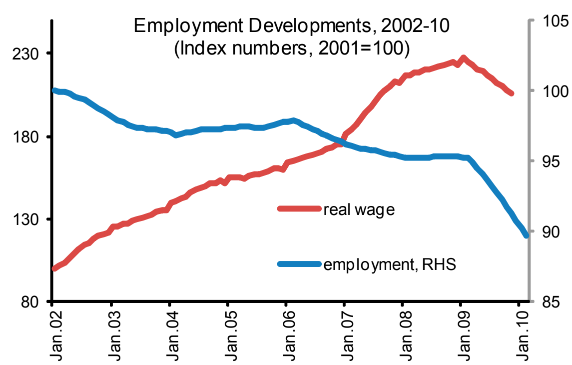
Source: Serbian Statistical Office.
1/ Includes mixed ownership.

Box 7. Labor Market Developments

Real wages grew significantly throughout the decade, although unemployment in Serbia remains consistently higher than in transition peers. The overall employment rate has remained below the EU average (in 2005, it stood at 42 percent as compared to 67 percent for the EU). By contrast, real wages grew at an annual rate of about 12 percent during 2001–08, accelerating to almost 20 percent between the completion of the EA and the 2009 SBA. With the non-private sector accounting for about 40 percent of the total work force in 2008, public sector wages largely determine the overall wage level in the economy. A labor survey conducted by the World Bank in 2005, found that jobs in state-and socially-owned enterprises, on average, paid, 25 and 12 percent more than the private sector, respectively.

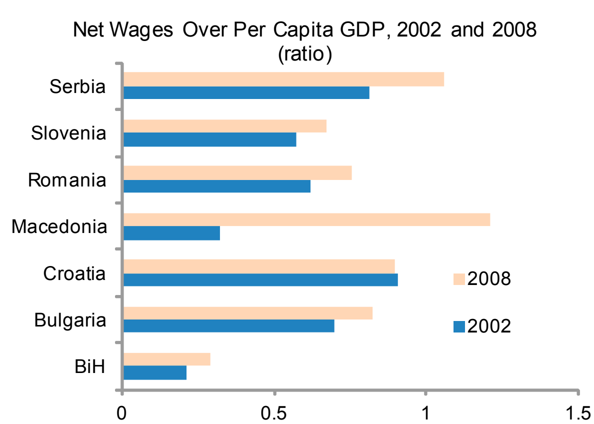


Source: Serbian Statistical Office; and Eurostat.

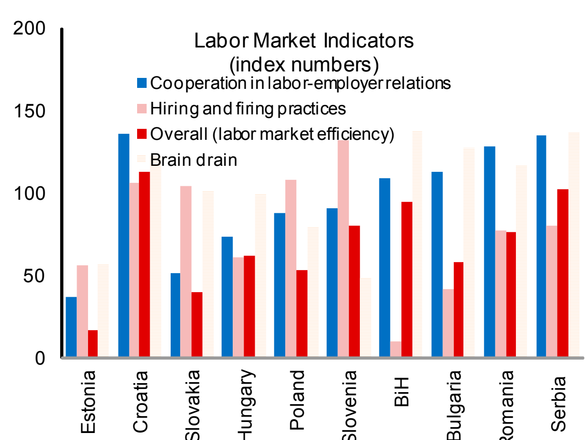


Source: Serbian Statistical Office.

Labor costs in Serbia have remained relatively high throughout the period. Between 2002 and 2008, unit labor costs (as proxied by yearly net wages as a share of per capita GDP) in Serbia increased in relation to its transition peers, and remained significantly higher than in the new EU states from the region (Bulgaria, Romania, and Slovenia). Labor market efficiency indicators also remain below regional averages, particularly with respect to hiring and firing workers, brain drain, and labor-employer relations.



Source: Serbian Statistical Office.



Source: EBRD.

55. **While the 2009 SBA envisaged further progress on enterprise restructuring, actual outcomes were disappointing**. In the end, attempts to divest public enterprises were understandably hampered by uncertain external conditions and weak investor interest. Progress in divesting the remaining 800 SSOEs, which had over 10,000 workers requiring state support, was modest. Other envisaged initiatives, such as corporatization of public enterprises, and the adoption of private management contracts also stalled. As with the EA, program conditionality aimed primarily to contain the budgetary costs of SSOEs through structural benchmarks on wages and employment, leaving a substantial reform agenda untouched.

56. **In retrospect, a greater focus on enterprise restructuring and privatization was warranted in Fund supported programs given its macro-critical nature**. The experience of other transition countries, such as Bulgaria, show that Fund conditionality in the structural area can serve as a blueprint for reform and facilitate policy coordination within the country, if ownership by a reformist government is present, and structural impediments have the potential to precipitate crises.[20] Early successes in the 2001 SBA reinforce this view. While Fund conditionality in this area was significantly strengthened under the EA in response to widening economic imbalances, these efforts came too late in the program. The lack of broad political consensus, a favorable pre-crisis external environment, and the fact that limited progress on the structural front in Serbia was not viewed by authorities as "crisis-inducing" during the EA is suggestive of why reforms lagged, and did not feature more prominently as program ingredients.

IV. Ex Post Evaluation of Exceptional Access Under the 2009 Stand-by Arrangement

57. **This section covers the two EPE objectives: evaluation of the policy response and program performance**. Specifically, it focuses on the following issues: the appropriateness of program design; suitability of the Fund financing strategy; compliance with exceptional access procedures; and performance and macroeconomic outcomes under the program. The section covers the period May 2009–April 2011.

A. Was Program Design Appropriate?

58. **In light of the abrupt deterioration in the external environment, the main objective of the augmented SBA was to facilitate an orderly rebalancing of the economy**. Large external vulnerabilities on the eve of the global crisis and severely diminished capital flows raised the specter of a painful adjustment. Against this background, the program aimed to smooth the needed adjustment from the unsustainable pre-crisis growth model by providing external financing and serving as a platform to launch long-delayed structural reforms to strengthen the supply side of the economy (Country Report No. 09/158). The revised program featured three main elements:

[20] In the case of Bulgaria, close links between SOEs and banks added urgency to restructuring of the former (See Bulgaria EPA in Country Report 04/176.)

- Additional fiscal adjustment to avoid high and unsustainable fiscal deficits under unchanged policies.
- Financing assurances from foreign parent banks to maintain their exposure to Serbia and to keep their subsidiaries well-capitalized.
- Exceptional financing, including additional financing from other IFIs.

59. Program conditionality appropriately focused on fiscal adjustment. The revised program targeted a smaller fiscal deficit (by more than 3 percentage points of GDP in 2009 and 2.5 percentage points in 2010) compared to what would have been the case under unchanged policies. The stronger fiscal adjustment was to be achieved through restraint in both capital and current spending, given the unexpectedly steep decline in the tax-to-GDP ratio, while protecting social spending. The program also included structural conditionality aimed at improving public financial management and tax administration, with the help of Fund TA.

60. A formal bail-in agreement with the ten largest parent banks was the cornerstone of the financial sector strategy. As described earlier, the FSSP asked foreign banks to provide voluntary assurances to broadly maintain their exposure to Serbia and to keep their subsidiaries well capitalized, based on stress tests. The signing of a detailed crisis preparedness plan by the NBS, the government and the deposit insurance agency (DIA) was made a prior action under the arrangement for the completion of the first review.

61. Crisis prevention measures included actions in support of financial sector stability. Structural benchmarks under the revised program aimed to strengthen fiscal and financial contingency planning, including (i) the adoption by the DIA of detailed action plans for state-owned banks to minimize potential needs for budget support, and (ii) stress tests for the 12 largest banks and four banks with majority state ownership (later extended to all banks) to assess potential recapitalization needs under adverse scenarios.

62. Conditionality under the arrangement was concentrated on safeguarding financial system stability and ensuring fiscal consolidation. While staff noted that structural reforms were urgently needed, the light conditionality in this area reflected the prevailing view at the Fund the time of the SBA approval that that programs supported by "emergency SBAs" should focus on preserving stability. It was also clear from the onset that there was limited scope for privatization of large public utilities amid the global financial turmoil. When it became clear that a financial meltdown had been averted, the program incorporated additional structural conditionality in mid-2009 aimed at entrenching fiscal sustainability (pension reform, fiscal responsibility framework) and repairing the balance sheet of the banks and the corporate sector (out-of court debt restructuring framework).

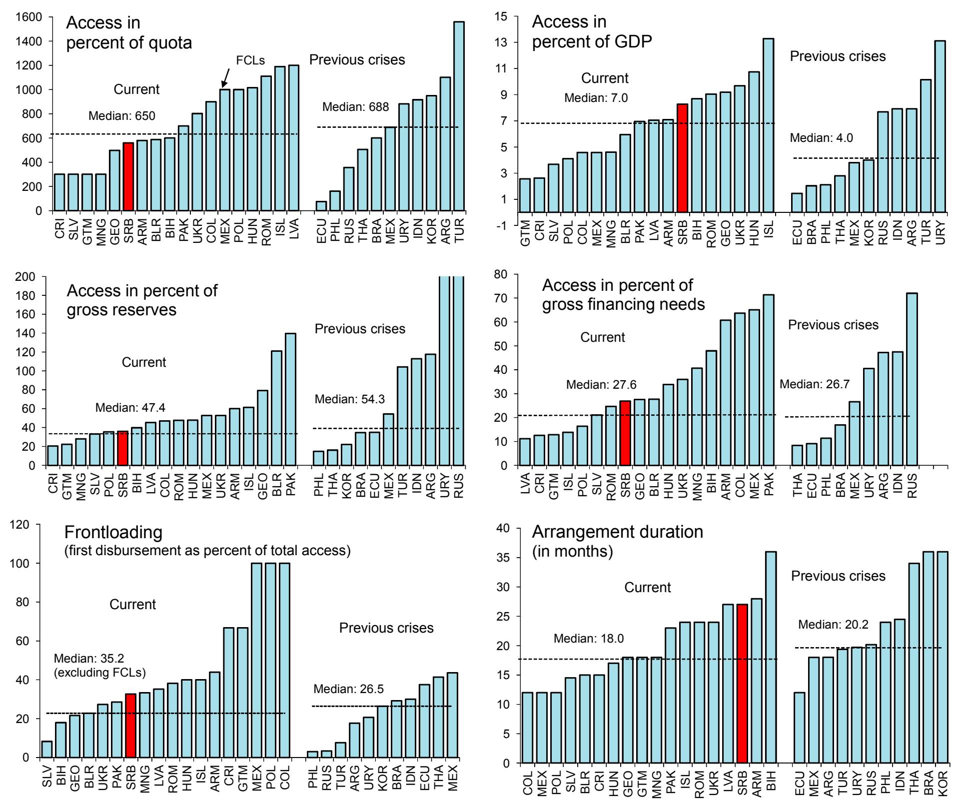
B. Was the Fund's Financing Strategy Suitable?

63. The high level of Fund access was seen as necessary to cover the projected external financing gap. Serbia faced financing requirements of €3.5 billion (11.5 percent of GDP) during 2009–11. At the time of the augmentation request, net external borrowing had turned negative and FDI inflows slowed to a trickle: the projected balance on the capital and financial account for 2009 had been revised down from 13.4 to 3.2 percent since the initial SBA request. Absent

Fund financing, this suggested major difficulties in covering the mainly private sector external rollover needs and debt service and the narrowing, but still large, projected current account deficit. Only about 10 percent of the projected gap in 2009 was expected to be filled by prospective official financing from the EU and the World Bank.

64. **Fund financing for Serbia was in line with other high access cases**. Under the 2009 SBA, access was increased to about €3 billion (560 percent of quota), or roughly 30 percent of gross financing needs, which would allow gross international reserve coverage to remain comfortable. Both in terms of percentage of access of quota and percent of rollover rates (85 percent across different private external debt categories: 70 and 100 percent for nonbank and bank debt, respectively), the arrangement was in line with other exceptional access cases at the time, but higher than in previous crises. Serbia's program was longer and entailed more frontloading than other exceptional cases, as well as programs during previous crisis episodes. This was justified by the perceived need for upfront assistance to restore market confidence and the program's ambition to make some headway on structural reforms (Figure 3).

Figure 3. Access, Phasing and Duration in Current and Past Capital Account Crises



Source: WEO and staff estimates.

65. **In any event, only half of the resources available under the 2009 SBA were drawn, as the external financing environment proved more benign than feared**. Starting with the fourth review, Serbia made only partial drawings of the available tranches. The scaling down of purchases (50 percent of the available funds at the completion of the fourth review, and 15 percent upon completion of subsequent reviews) reflected reduced external financing needs, the desire to avoid the increased charges associated with cumulative drawings in excess of

300 percent of quota, and the fact that EU official financing was conditional on a disbursing IMF arrangement.

C. Were Exceptional Access Procedures Observed?

66. In line with the exceptional access procedures, the augmented SBA request was assessed against four criteria:[21]

- **Criterion 1: Exceptional balance of payments pressures**. At the time of the request to augment the SBA, such pressures had not yet materialized, despite a loss of reserves and pressure on the currency. Therefore, this criterion was not met. However, in the 2004 review of exceptional access guidelines it was acknowledged that a need for exceptional access could arise under special circumstances, even in the absence of a full-blown capital account crisis. Given the major uncertainties surrounding external financing conditions, the extent of global deleveraging, and the real risk of a loss of confidence and associated possibility of a deposit run and a banking crisis, the criterion can be considered met according to this extended definition.

- **Criterion 2: Sustainable public debt position in the medium term**. This criterion was met. The debt sustainability analysis suggested that debt-to-GDP ratios would increase over the program horizon, but were sustainable in the medium term. Resumption of catch-up growth, combined with continued structural reforms, was expected to bring debt ratios back to a declining trend by 2012. Sensitivity to various shocks was adequately portrayed in the program request.

- **Criterion 3: Access to private capital markets**. This criterion was met. At the time of the request to augment the SBA, it was argued that Serbia had good prospects of regaining access to private capital markets by mid- to late-2010. This assessment turned out to be too conservative, as evidenced by the recovery of T-bill auctions in the second half of 2009.

- **Criterion 4: Strong adjustment program**. This criterion was assessed candidly in the request to augment the SBA. The program was considered to provide a reasonably strong prospect of success, even if the magnitude of the challenges faced posed considerable implementation risks. Against this, staff pointed to the broad endorsement of the program by the coalition government, the authorities' recent track record of delivering on their commitments, and the passage of a supplementary budget to front load the fiscal adjustment.

67. There was an appropriate level of early Board involvement in the period leading up to the request for augmentation of the SBA. A Board meeting was held in March 2009, to discuss the need for the augmentation of the SBA to exceptional access levels. A report assessing the risks for the Fund and its liquidity position was provided to the Board, consistent with exceptional access procedures.

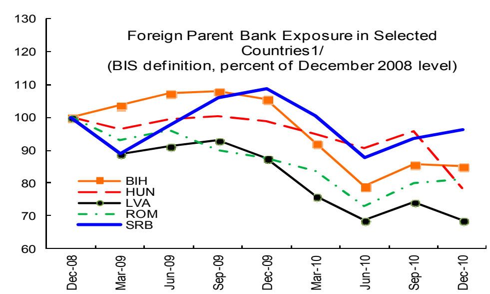
[21] The EPE assessment was undertaken against current exceptional access criteria.

D. Performance Under the Program

68. This section discusses performance under the program from three perspectives: (a) compliance with conditionality, (b) macroeconomic outcomes compared to projections at the time of program design, and (c) a comparison with peers' experience during the crisis.

69. Performance under the 2009 SBA was broadly satisfactory on the quantitative side, but structural reforms advanced more slowly than envisaged. Quantitative conditionality was generally met under the arrangement, although the fiscal deficit exceeded the targets for the second and fourth reviews owing to weak revenue collection and delayed implementation of measures, and the upper bound of the inflation consultation band for the seventh review was missed by a substantial margin. Many structural benchmarks were, however, only met partially or with delays, partly justifying staff's concern at the approval of the 2009 SBA. There was partial observance of the structural benchmark on freezing wages in public enterprises. The second review was delayed, due to disagreements about the composition of fiscal adjustment in 2010. Conditionality on pension reforms, the fiscal responsibility framework, and the tasking of a specific unit in the Ministry of Finance to review increased VAT refunds, was met, albeit with delay. Staff dealt appropriately with these challenges, with prior actions and revised timeframes used in some instances to ensure compliance and take into account technical and political constraints.

70. The program contributed to its objective of mitigating the fallout from the global financial crisis on output and helped rebalance the economy. The banking system weathered the external shocks well and risk spreads stabilized. The formal bail-in agreement with foreign banks under the SBA was largely honored, and rollovers remained at a comparatively high level.[22] From this perspective, the authorities' financial sector strategy was one of the program's clear successes. At the same time, the tighter fiscal stance under the program helped in reducing the large absorption overhang.



Source: BIS.
1/ External positions of reporting banks vis-à-vis all banks.

71. Amid significant macroeconomic volatility, the external imbalance closed faster than expected. The adjustment occurred on account of higher remittances, and a strong contraction of imports as domestic demand fell (Figure 4). Moreover, as growth started to recover in 2010, exports provided the key impulse, aided by the dinar depreciation. Due to the narrowing current account deficit and a resumption of capital inflows during the program period, reserve coverage turned out better than expected. Inflation, however, exhibited large volatility, undershooting the NBS's target in late 2009 and overshooting it in late 2010, reflecting volatile food prices and dinar depreciation.

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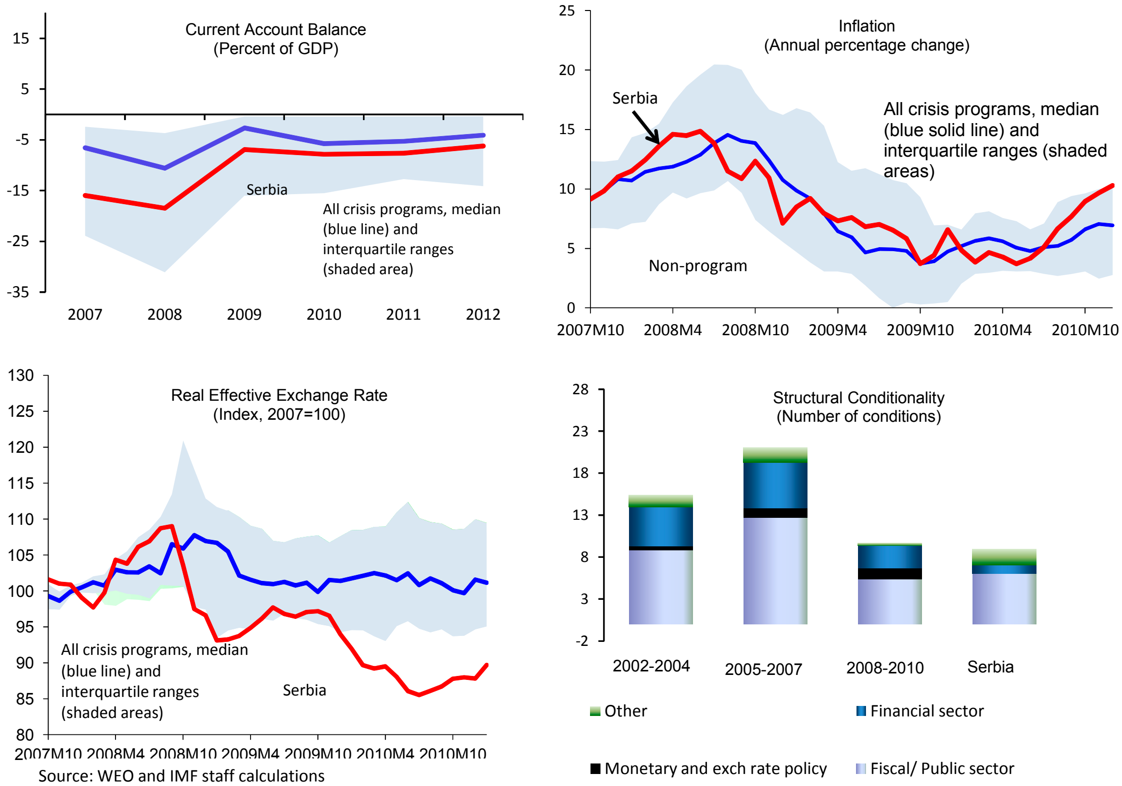
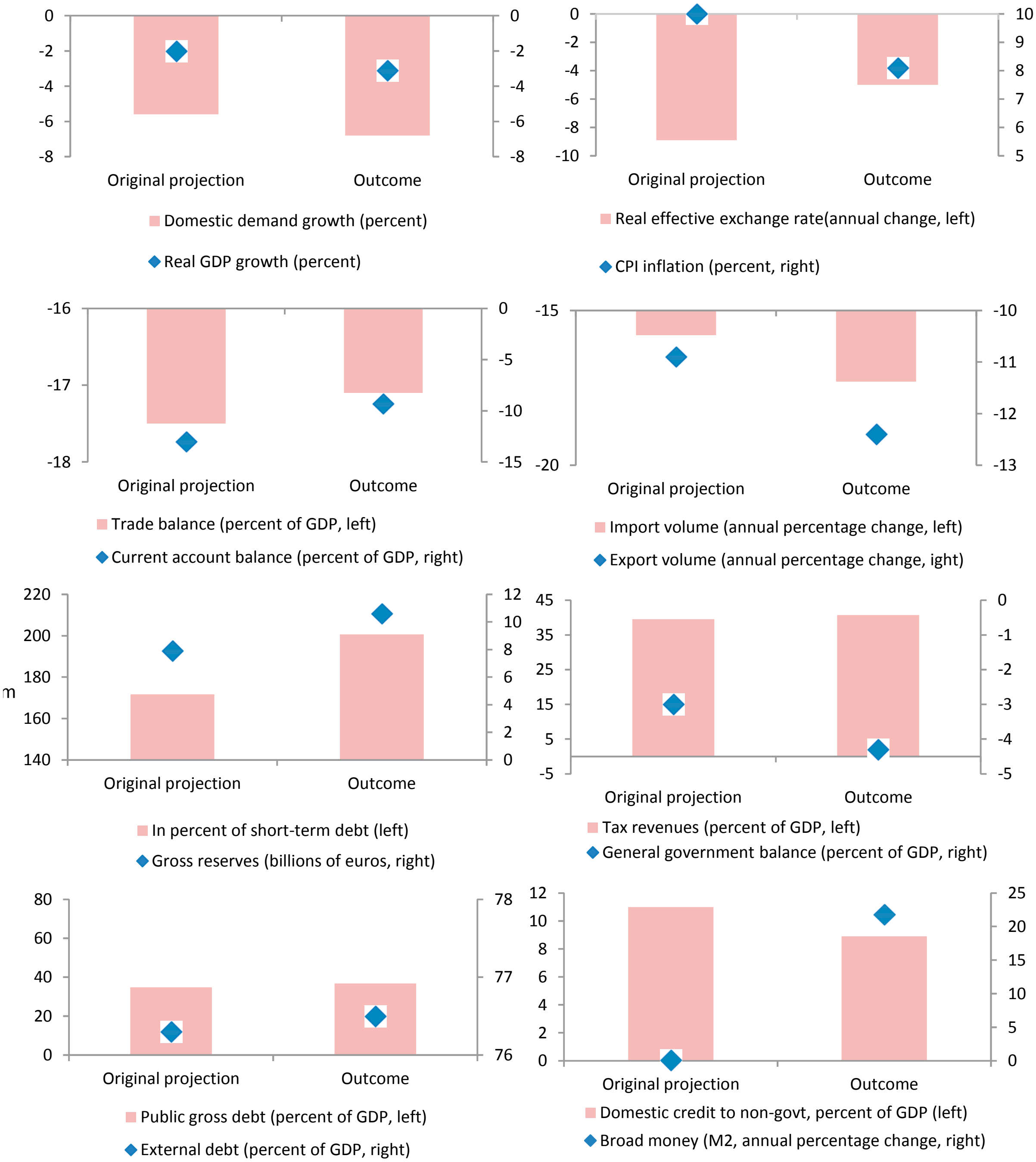
[22] There appear to be a number of reasons why rollovers in Serbia remained at a relatively high level compared to the other participants in the EBCI (Hungary, Bosnia Herzegovina, Romania, and Latvia), as well as the other CEE countries. The authorities' ability to closely monitor the agreed bank-by-bank exposure floors based on monthly reporting requirements was important; the degree of credit euroization, and the extent of external stability risks across countries also likely played a role.

72. Serbia's performance under the program was largely in line with peers, although the extent of external adjustment was more pronounced. The contraction in GDP was limited relative to other program cases, although inflation was much more variable. While the fiscal consolidation undertaken was in line with that of peers, the adjustment of the current account and real exchange rate were more extensive in Serbia (see figure below). The number of structural benchmarks and prior actions, as well as the extent to which conditionality was met, were also close to other SBA s put in place during the crisis.



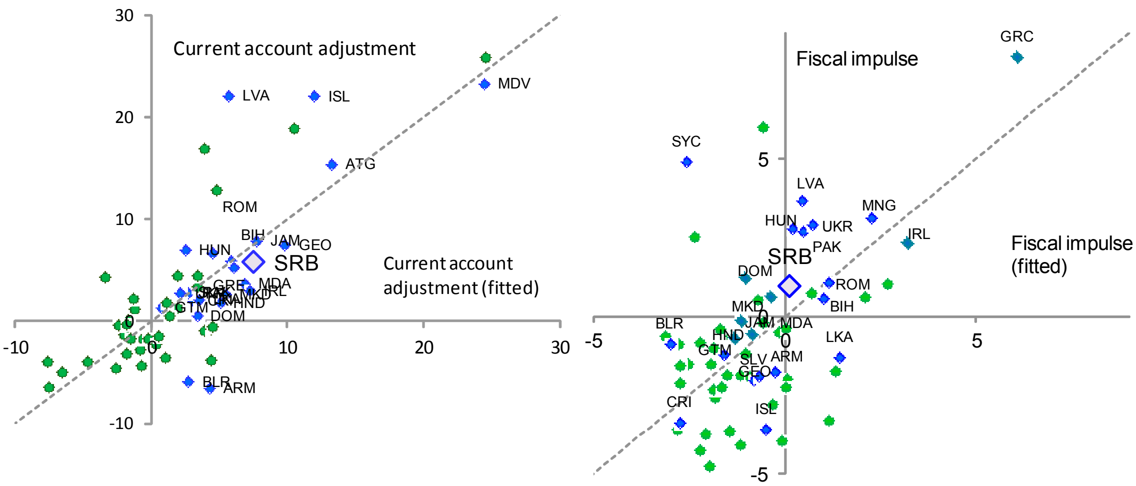
Source: WEO and IMF staff calculations

Figure 4. Comparison of Macroeconomic Projections and Outcomes, 2009



Source: WEO; and IMF staff calculations

73. Comparative macroeconomic developments largely reflected different initial vulnerabilities. A regression analysis was conducted to investigate the extent to which the actual external and fiscal adjustment in Serbia was in line with initial vulnerabilities. Specifically, the initial external (public) debt and current account (fiscal) deficit were regressed on the current account (fiscal) adjustment. The analysis suggests that the larger current account adjustment experienced by Serbia was appropriate given its high initial deficit and debt situation, and in line with peers (see figure below). A broadly similar conclusion arises with respect to the degree of fiscal adjustment when taking into account the initial fiscal deficit and public debt stock.



Note: An observation above (below) the 45 degree line would indicate more (less) adjustment than what the model would predict.
Source: IMF staff estimates.

V. Conclusions and Lessons for Future Fund Engagement

A. What Has Motivated the Long Term Engagement?

74. Several factors motivated the long engagement with Serbia, although the relative emphasis placed on each changed over time. In the first SBA, these included difficult economic conditions, the need for Fund's "stamp of approval" for donors and agreement with the Paris and London Clubs, and a desire for policy advice. EPA interviews highlighted that while that the financial role of Fund support declined over time, the internal coordination/external anchor and catalytic roles were a permanent feature of Fund supported programs:

- Political fragmentation, resulting in weak government coalitions, implied the constant need to seek a coordinator/anchor for domestic policies. This role was primarily played by the Fund, and by the World Bank and the EU to varying degrees. The Fund was generally well-regarded in Serbia, so that its support for a certain measure typically added to its legitimacy. In this respect, the importance of Fund endorsement was particularly important in the context of the 2009.

- The catalytic effect on financing was central to the EA, which had securing debt relief from the Paris and London Clubs as one its main objectives. The catalytic effect was also important during the 2009 SBA as the program served as an umbrella to attract financing from the EU and the World Bank, as well as to generate support for the EBCI.

- In contrast to the EA, the financing role was an important feature of the 2009 SBA. Even when the program was regarded as precautionary, the likelihood of becoming a disbursing arrangement was significant. When the crisis erupted at the end of 2008, the program provided an adequate safeguard against external downside risks. In the end, the financing role of the program was probably not its most important feature, but the large access granted at the time of the augmentation provided the needed buffer and helped restore market confidence.

B. Comparing Failure and Success

75. **After a decade of decline, post 2000 reforms turned Serbia around**. Despite an initial difficult starting point, an extensive Fund-supported reform agenda— including macroeconomic stabilization after 2000, banking sector restructuring, and privatization— helped engender brisk economic growth, and a healthy banking system that weathered the crisis well. Through this process and with the assistance of the Fund, economic institutions have improved, in particular with the establishment of the fiscal responsibility law, the adoption of inflation targeting, and strengthening of banking supervision and regulation. But the difficult legacy of the incomplete structural transformation of the economy have remained, reflected in high unemployment, volatile inflation, expenditure rigidities, and widespread euroization—and associated vulnerabilities.

76. **The Fund shares some responsibility for the uneven performance during the EA, but deserves credit for contributing to the success of the recent SBA**. Interviews conducted for the report suggest that the EA was characterized by widening disagreement between the authorities and staff on the policy mix, possibly in part due to shifts in Fund positions. That said, the EA had a spotty implementation record reflecting, in part, weak program ownership. It should be noted, however, that the crisis backdrop provided an opportunity to forge an important partnership with the Serbian authorities' in the 2009 SBA. Fund staff's advice and the use of the Fund-supported program as a commitment device provided critical support to the authorities' financial sector program and politically difficult fiscal policies.

77. **The unfinished structural agenda was a disappointment**. The authorities' eagerness to signal a relatively quick pace of reforms in 2001 resulted in an ambitious agenda in the earlier programs that eventually lost steam. The pending institutional reform measures lost their urgency outside the stabilization context and once debt-relief was forthcoming, and easy external financing was available, incentives for reform might have weakened. Political fragmentation and vested interests provided a challenging backdrop and contributed to the hesitant and piecemeal progress in structural reforms, leaving underlying macroeconomic vulnerabilities largely unaddressed in the run-up to the crisis. With the exception of the first SBA, these constraints resulted in a common pattern in Serbia's programs consisting of frontloaded macroeconomic adjustment and gradual implementation of macro-critical structural reforms.

78. **The global crisis was a missed opportunity for undertaking far-reaching structural reforms**. As the recovery from the global crisis took hold, the structural reform agenda in the 2009 SBA was refocused but, in retrospect, this fell short of what could have been allowed for by the improving economic conditions. While program reviews mentioned the need to reduce public

employment through reforms in health care, education, and public administration, little headway was made under the SBA on this account. Progress on growth-oriented structural reforms (enterprise restructuring, business climate) was similarly slow. While political fragmentation, vested interests, and the crisis setting likely played a role in the case of the former, the Fund could have pushed more forcefully on the latter front.

C. Lessons Learned

79. **Ownership and a favorable political landscape are essential preconditions for program success**. Serbia's experience suggests that the right incentive structure can increase ownership. The debt restructuring expected after the successful completion of the 2001 SBA, and fears of a financial meltdown in 2008 provided powerful incentives for action. At the same time, lack of political commitment undermined implementation under the EA. In this regard, it should also be noted that Serbia's volatile and fragmented politics did not always provide an environment conducive to bold policy action and deep reforms.

80. **Quick, coordinated action, with a large upfront provision of liquidity can be effective in preventing a crisis**. The timeliness and size of the financing package in the 2009 SBA and its coordinating role in the EBCI were instrumental in avoiding a financial meltdown. The large-scale intervention also helped improve market confidence.

81. **Program design needs to be consistent with its stated objectives**. With the benefit of hindsight, a stronger focus on the structural agenda with associated conditionality regarding enterprise restructuring was warranted in earlier programs to deliver on the macroeconomic objectives and address underlying vulnerabilities. Many Fund programs implemented prior to the 2002 guidelines on streamlining conditionality had detailed structural benchmarks to guide this process. Absent this lever, it is possible that a greater use of prior actions would have helped advance the structural reform agenda. Given that much of this agenda is outside the Fund's core area of expertise, it also points to the need for close collaboration and coordination, especially with the World Bank and the EU. While it could be argued that the macroeconomic stabilization focus of the 2009 SBA was less ambitious in scope than the previous arrangements, its design was successful in achieving the desired outcome.

82. **Flexibility in program implementation can be important to secure the desired objectives**. The success of the 2009 SBA can in part be attributed to the flexibility in adapting the program to the prevailing circumstances. In particular, the relaxation of the fiscal balance targets in light of a worse-than-projected macroeconomic environment and concerns for social implications were appropriate given the lack of financing problems and the reasonable level of public debt. Similarly, the extension of deadlines to comply with structural benchmarks (pension reform, budget system law, and out-of-court debt restructuring) proved to be the right decision, as all these reforms were eventually adopted.

83. **Durable fiscal adjustment needs to be supported by institutional and structural reforms**. Serbia has relied excessively on stop-gap measures to achieve fiscal consolidation in the past, especially wage and pension freezes, which ultimately proved to be politically unsustainable and resulted in substantial spending overruns. It is still early to assess the impact

of the fiscal responsibility framework, but in the absence of durable, "high-quality" fiscal reforms, fiscal credibility can be easily undermined.

D. Policy Challenges Going Forward

84. Substantial progress has been achieved in the last ten years, but the remaining challenges are still very significant. The transition towards a more sustainable growth model, the authorities' stated objective, remains incomplete. Despite a narrowing of the current account in the aftermath of the crisis, financial spillovers risks remain elevated, given large cross-border exposures of the corporate and banking sector from euro-periphery countries. Inflation has again surged into double digits owing to supply shocks and inertia in administered prices**.** Capital inflows have resumed, but could reverse. Adhering to the fiscal rule could prove challenging given upcoming elections. Finally, a large unfinished structural agenda remains. Going forward, reform efforts, with or without a Fund arrangement, should focus on the following objectives:

- ***Developing a sustainable growth model***. Since the crisis, the absorption overhang has been reduced, and domestic savings are rising, but the transition to a more balanced growth model remains incomplete. To achieve balanced growth, policies will need to support an increase in domestic savings and put in place a business environment that encourages private sector investment, production, and exports. In the current environment of ample global liquidity, the risk of back-sliding into the old, domestic-demand driven growth model is not negligible.
- ***Securing low and stable inflation.*** High and variable inflation remains a problem. The IT regime should be strengthened in order to improve the effectiveness of the monetary policy transmission mechanism and reduce inflationary expectations. This requires, continuing with efforts to de-euroize the economy and developing domestic capital markets.
- ***Achieving durable fiscal adjustment.*** Abiding by the fiscal rules should be the linchpin of fiscal policy. This will require bold structural expenditure reforms, including a reduction in public employment through reforms in health care, education, and public administration. Steps to continue strengthening tax administration and public financial management should be pursued, to support the fiscal adjustment and enhance the effectiveness of public administration. Additional reforms will also be necessary to ensure the sustainability of the pension system.
- ***Creating fiscal space for investment.*** Large infrastructure needs to support tradable sector growth call for the creation of additional fiscal space The authorities should strengthen the institutional framework for capital budgeting to limit fiscal risks and increase the effectiveness of public investment.
- ***Strengthening financial sector stability.*** Further strengthening the banking sector's regulatory framework would require moving to internationally accepted approaches for sound corporate governance, risk management, capital management and transparency, as well as clarification of the elements of regulatory eligible capital, liquidity requirements and leverage ratio. Accordingly, moving to Basel II should be a priority. In addition, still-outstanding issues arising from the 2009 FSAP recommendations should be implemented.

- ***Implementing pro-growth reforms.*** Improving the business climate to attract foreign capital and boost potential output and exports should be a key priority.
    - SOE reform should focus on privatization and restructuring of the large enterprises, and addressing the problem of unsuccessfully privatized formerly socially-owned enterprises. In addition, there is a need to increase transparency of public enterprise operations, and strengthen government control on public enterprise financial plans, particularly on their wage bill.
    - To catch up with regional peers, Serbia would need to lower the cost of doing business by facilitating the transfer of land ownership; improving the system of property registration; streamlining the licensing system; strengthening contract enforcement by courts; and promoting competition.
    - There is a need to consider measures aimed at making the labor market more flexible, by reducing hiring and firing costs, and other rigidities that impede job creation. The unemployment rate has been well above 10 percent for more than a decade, with substantial social costs.

85. There are also political and social risks. Growth has rebounded since the crisis, but the ensuing economic rebalancing has had social and political ramifications. Sustained wage freezes in the public sector coupled with high inflation have affected purchasing powers. The private sector shed a large number of jobs during the crisis, and unemployment remains high. Companies are struggling to repair their balance sheets in the wake of the large depreciation and tightened credit standards. Parliamentary elections are scheduled for early 2012 and there may be a new government coalition in place, but its composition is highly uncertain. Reflecting these constraints, the political situation may not be as amenable to painful reforms and there may be a risk of austerity fatigue. The uncertainty is partly offset by the broad consensus to advance EU accession.

E. Future Fund Engagement and Exit Strategy

86. The Serbian authorities are interested in a new precautionary SBA to anchor fiscal discipline and address the current policy challenges. Other stakeholders, including the EU, the financial sector, and the trade unions have also expressed their support for a new program. A new SBA can play a useful role as a coordination device for the government and serve as an anchor for polices (particularly in a pre-election year), send a positive signal to investors, and coordinate the contribution of other IFIs.

87. While there are potential benefits from a new program there are also risks to continued engagement. First, the Fund would be exposed to reputational risks if it ends up supporting a program that is perceived as weak or needs to be revised frequently due to policy slippages. In fact, one of the key lessons from the crisis experience is that only a comprehensive structural reform effort will put Serbia on a more sustainable growth trajectory. Second, the political situation poses a risk, and a key challenge will be to build policy consensus in a pre-election environment. Serbia's complex political economy suggests that solutions will not be found easily, which could imply that ownership and pace of reforms will continue to be uneven.

88. The balance of risks and benefits suggests that a successor arrangement can provide distinctive advantages, assuming that structural reforms are credibly addressed.

- The absence of immediate balance-of-payments needs point to a precautionary arrangement. At the same time, external vulnerabilities and risks are considerable, suggesting that the size of the program needs to be sufficient to handle a drawdown of foreign banks exposures.
- A successor program also needs to strike a balance between conflicting objectives in terms of length. The uncertainty surrounding the timing and outcome of upcoming elections argue for a shorter arrangement. At the same time, deep-rooted structural policy reforms would require a substantive time frame if they are to be tackled in a meaningful way.
- In view of a large remaining structural reform agenda, but taking into account the limitations posed by the election calendar, a realistic program should focus on undertaking reforms in a few key areas. In this regard, consideration could be given to establishing vital program conditions as prior actions ahead of program approval.

89. Consideration could also be given to maintaining a surveillance-only relationship, but it could be less effective in maintaining policy discipline. Serbia's past experience with PPM suggests that a surveillance-only relationship would be a less effective external anchor for the authorities' policies. But the modalities of surveillance could be tailored to provide for enhanced monitoring, perhaps tied to the budget cycle, given past difficulties in meeting targets. One drawback of this modality is that it represent a less intense and frequent policy dialogue, and thus could be less useful in underpinning policy coordination and commitment given high political fragmentation.

90. The EU accession process is the natural exit from a Fund program relationship. If the new program is short, and with the expectation that EU accession will be granted in the medium term, one more program could be envisaged to support structural reform efforts under a new government. The EU accession process is expected to replace the external anchor role of a Fund program.

Table 5. Serbia: Selected Economic and Social Indicators, 2001–10

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
	(Percent change, unless otherwise indicated)									
Real GDP	5.6	3.9	2.4	8.3	5.6	5.2	6.9	5.5	-3.1	1.8
Real domestic demand (absorption)	15.1	9.4	1.6	13.6	-3.8	6.2	11.5	6.3	-8.5	-1.4
Consumer prices (average)	87.9	22.9	13.7	12.8	15.4	11.5	11.6	12.4	8.1	6.2
Consumer prices (end of period)	40.7	14.8	7.6	13.7	17.7	6.6	11.0	8.6	6.6	10.3
Nominal gross wage	128.9	52.6	35.4	23.1	22.5	23.2	22.4	17.8	-3.3	7.5
Real net wage	0.0	25.3	11.7	11.6	5.5	10.4	14.5	4.8	-10.5	1.2
Registered employment	…	-1.7	-1.2	0.5	0.9	-2.1	-1.1	-0.1	-5.5	-4.9
Unemployment rate (in percent)	12.2	13.3	14.6	19.5	21.8	21.6	18.8	14.7	17.4	20.0
Nominal GDP (in billions of dinars)	762	973	1,126	1,381	1,683	1,962	2,277	2,661	2,713	2,932
	(Percent of GDP)									
General government finances										
Revenue	36.8	42.4	42.5	43.0	43.0	44.2	44.0	42.8	42.3	41.8
Expenditure	37.2	45.8	45.5	42.9	42.2	45.8	45.9	45.5	46.7	46.4
Current	35.0	42.1	42.3	40.2	39.2	41.1	40.5	40.9	42.5	41.8
Capital and net lending	2.3	3.7	3.1	2.7	3.0	4.6	5.4	4.6	4.2	4.6
Fiscal balance (cash basis)	-0.4	-3.4	-2.9	0.0	0.8	-1.6	-1.9	-2.7	-4.5	-4.7
Gross debt	114.5	81.2	77.8	65.4	56.3	43.0	35.6	34.2	38.2	45.7
	(End of period 12-month change, percent)									
Monetary sector										
Money (M1)	79.8	79.8	10.9	8.3	31.0	37.1	25.3	-3.8	8.7	-2.2
Broad money (M2)	52.7	52.7	27.5	30.4	43.1	38.4	44.5	9.6	21.8	13.9
Domestic credit to non-government	62.6	62.6	25.1	44.6	51.2	17.1	36.9	35.0	15.9	29.0
	(End of period, percent)									
Interest rates (dinar)										
NBS repo rate	9.7	9.7	10.6	16.3	19.2	14.0	10.0	17.8	9.5	11.5
Deposit rate	2.6	2.6	2.7	3.6	3.7	5.1	4.1	6.4	5.1	5.6
	(Percent of GDP, unless otherwise indicated)									
Balance of payments										
Current account balance	-2.5	-8.3	-7.2	-12.1	-8.7	-10.2	-15.9	-21.4	-7.1	-7.3
Exports of goods	15.9	14.7	17.0	17.3	19.7	22.0	22.4	22.7	20.7	26.1
Imports of goods	36.1	36.0	37.6	44.6	40.7	43.3	45.7	48.7	38.5	43.0
Trade of goods balance	-20.2	-21.4	-20.4	-27.3	-20.9	-21.4	-23.1	-26.0	-17.7	-16.8
Capital and financial account balance	6.9	13.6	12.8	13.0	18.6	32.0	18.4	16.7	11.1	2.5
External debt	97.3	74.4	69.0	59.5	61.3	66.8	66.6	62.9	78.7	81.6
of which: Private external debt	20.7	24.5	22.3	22.7	28.8	38.4	42.1	46.0	54.0	54.4
Gross official reserves (in billions of euro)	1.3	2.2	2.8	3.1	4.0	8.7	9.5	8.2	10.6	9.7
(In months of prospective imports)	2.3	3.3	3.6	4.3	4.0	6.6	6.3	7.7	8.6	6.8
(Percent of short-term debt)	93.5	180.0	198.7	425.0	200.3	294.5	268.4	162.3	200.7	183.6
(in percent of broad money, M2)	87.6	88.6	89.6	90.6	91.6	112.4	84.5	72.7	74.9	76.5
Exchange rate (dinar/euro, period average)	59.7	60.7	65.1	72.6	82.9	84.2	80.0	81.5	93.9	103.5
REER (annual average change, in percent; + indicates appreciation)	45.3	14.9	5.2	-3.6	-3.1	7.0	7.4	4.5	-5.0	-7.7
Social indicators										
Per capita GDP (in US$)	1,524	2,013	2,630	3,177	3,391	3,958	5,336	6,616	5,642	5,233
Population (in millions)	7.52	7.50	7.48	7.46	7.44	7.41	7.38	7.35	7.32	…
Absolute poverty rate (in percent)	…	14.0	…	14.6	…	8.8	8.3	6.1	6.9	9.2

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

1/ Fiscal balance adjusted for the automatic effects of the output gap both on revenue and spending.

Annex 1. Serbia: Structural Conditionality Under the 2002–06 Extended Arrangement

Description 1/	Type of Conditionality 2/	Area	Target Date	Status
Submission to parliament of proposed foreign exchange law and completion of draft implementing regulations	PA	Monetary sector	Prior action for program approval	Met
Increase electricity prices by 50 percent on average	PC	SOE restructuring and privatization	end-June 2002	Met
Permit commercial banks to initiate and settle payments among themselves on behalf of enterprises and individuals	PC	Financial sector	end-December 2002	Met
Parliamentary approval of budget for 2003 consistent with program understandings	PA	Fiscal sector	First review prior action	Met
Increase electricity prices by 20 percent in dinar terms	PC	SOE restructuring and privatization	end-June 2003	Modified
Parliamentary approval of the increase in diesel excises and issuance of government decree on raising pension contributions	PA	Fiscal sector	Third review prior actions	Met
Increase electricity prices by 10 percent in dinar terms	PC	SOE restructuring and privatization	end-June 2004	Met
Parliamentary adoption of the bankruptcy law	PC	Private sector development	end-June 2004	Not met. Done with delay
Parliamentary approval of the revised budget for 2004	PA	Fiscal sector	Fourth review prior action	Met
Submission to Parliament of the draft 2005 budget	PA	Fiscal sector	Fourth review prior action	Met
Issue tender for three largest socially-owned enterprises	PA	SOE restructuring and privatization	Fourth review prior action	Met
Submit to parliament amendments to the laws on (i) the Yugoslav Army and (ii) Union-level Civil Employees	PA	Fiscal sector	Fourth review prior action	Met
Enact amendments to the law on the Privatization Agency enabling the Privatization Agency to act as the bankruptcy trustee agency for state-and socially-owned enterprises	PC	SOE restructuring and privatization	end-December 2004	Met
Enact amendments to the law on (i) the Yugoslav Army and (ii) Union-Level Civil Employees	PC	Fiscal sector	end-December 2004	Not met. Done with delay
Government to (i) register the new transmission and dispatch company (ii) adopt an action plan for the restructuring of EPS	PC	SOE restructuring and privatization	end-February 2005	Not met. Done at sixth review
Government to adopt formal decision on pension reform	PA	Fiscal sector	Fifth review prior action	Met
NBS to increase statutory reserve requirements	PA	Financial sector	Fifth review prior action	Met
Parliament to adopt the law amending the privatization law	PA	SOE restructuring and privatization	Fifth review prior action	Met
Government to transfer the 8 monitored state-owned companies to the privatization agency	PA	SOE restructuring and privatization	Fifth review prior action	Met
Parliament to adopt a supplementary budget	PC	Fiscal sector	end-July 2005	Met
City of Belgrade to adopt a revised budget	PC	Fiscal sector	end-July 2005	Met
Parliament to abolish the current law on NIS and allowing for the unbundling of the oil and gas company NIS into four separate companies	PC	SOE restructuring and privatization	end-July 2005	Not met
Government to spin off, register and transfer to the Privatization Agency 65 companies, non-core assets, and hotels from the 8 monitored state-owned enterprises	PC	SOE restructuring and privatization	end-September 2005	Not met. Done with delay
Parliament to enact a pension reform envisaging cuts in permanent expenditure of at least 1 percent of GDP	PC	Fiscal sector	end-October 2005	Not met
Government to spin off, register and transfer to the Privatization Agency all the remaining companies, non-core assets, and hotels from the 8 monitored state-owned enterprises	PC	SOE restructuring and privatization	end-October 2005	Not met
Government to submit a 2006 budget envisaging cuts in permanent expenditure of at least 1 percent of GDP	PC	Fiscal sector	November 1, 2005	Met
Government to enact a new banking law	PC	Financial sector	November 15, 2005	Not met. Done with delay
Adopt a new Law to provide for a NBS Supervisory Board and amend the Law on Banks and Other Financial Institutions and establish a regulatory framework in line with international standards	SB	Financial sector	end-June 2002	Partially met
Publish IAS-based financial statements of the NBS	SB	Financial sector	end-June 2002	Met
Submit draft Law on Securities Market to Parliament	SB	Private sector development	end-June 2002	Met
Decide on (a) privatization plans for banks under NBS enhanced supervision and administration and (b) resolution plans for banks under control of the BRA	SB	Financial sector	end-June 2002	Partially met
Establish a Treasury in the Ministry of Finance	SB	Fiscal sector	end-September 2002	Met
Amend the accounting law to adopt international accounting standards	SB	Fiscal sector	end-September 2002	Not met. Done with delay
Create a unified taxpayer identification number	SB	Fiscal sector	end-December 2002	Met
Serbia, Montenegro: Reach agreement on timetable for harmonizing at the latest by end-2005 trade, customs, and indirect tax regimes		Fiscal sector	end-April 2003	Not met. Done at third review
Government to approve restructuring strategies for seven large SOEs	SB	SOE restructuring and privatization	end-April 2003	Not met. Done at third review
Bring ministries and other direct budget users under the treasury single account	SB	Fiscal sector	end-June 2003	Largely met

Annex 1. Serbia: Structural Conditionality Under the 2002–06 EA (concluded)

Description 1/	Type of Conditionality 2/	Area	Target Date	Status
Establish Large Taxpayers Units for Nis, Novi Sad and Kragujevac	SB	Fiscal sector	end-September 2003	Met
Adopt secured transactions law	SB	Private sector development	end-September 2003	Met
Serbia adopt resolution plan for the largest bank in consultation w ith Fund staff	SB/PA	Financial sector	end-September 2003	Not met. Done as prior action for third review
Establish and implement a public sector centralized payroll system.	SB	Fiscal sector	end-December 2003	Not met
Adopt new law to provide for a National Bank Supervisory Board.	SB	Financial sector	end-December 2003	Met
Offer majority or controlling stakes to strategic investors in at least 3 of the banks subject to law s on Paris and London Club debt and frozen foreign currency deposits	SB	Financial sector	end-December 2003	Not met
Offer majority or controlling stakes to strategic investors in one of the banks affected by the July 2002 law s on Paris and London Club debt and frozen foreign currency deposits	SB	Financial sector	end-May 2004	Met
Submit to Parliament the draft Law on VAT	SB	Fiscal sector	end-June 2004	Not met. Done w ith delay
Adopt strategy to recover value of non-performing assets of closed banks and those associated w ith Paris and London Club	SB	Financial sector	end-June 2004	Substantially met
Complete the conversion of all Paris and London Club as w ell as FFCD into state-ow ned equity in banks to be privatized	SB	Financial sector	end-June 2004	Largely met w ith delay
Offer majority or controlling stakes to strategic investors in tw o additional banks affected by the July 2002 law s on Paris and London Club debt and frozen foreign currency deposits	SB	Financial sector	end-September 2004	Met
Begin recovering value from impaired assets acquired by the state through BRA portfolio	SB	Financial sector	end-September 2004	Not met
Put in place operational institutions and supporting legislation to ensure implementation of the bankruptcy law	SB	Financial sector	end-November 2004	Not met
Agree w ith World Bank on key elements of civil service reform consistent w ith restraining the 2005 budgetary w age bill	SB	Fiscal sector	end-November 2004	Met
Prepare a plan to reduce tax arrears to the budget	SB	Fiscal sector	end-November 2004	Met
Submit to Parliament a draft law to convert existing government debt to the NBS into tradable securities	SB	Financial sector	end-November 2004	Met
Offer majority or controlling stakes to strategic investors in one additional bank affected by the July 2002 law s on Paris and London Club debt and frozen foreign currency deposits	SB	Financial sector	end-December 2004	Met
Close banks that do not meet the minimum capital requirement, unless reputable investors recapitalize them,	SB	Financial sector	end-December 2004	Met
Launch the privatization tender for Niska Banka		Financial sector	end-December 2004	Met
Establish a supervisory body to license, supervise, and regulate bankruptcy trustees	SB	Private sector development	end-February 2005	Not met. Done w ith delay
Adopt Law on Civil Service	SB	Fiscal sector	end-March 2005	Not met
Adopt the law s on Deposit Insurance, BRA and Bank Bankruptcy	SB	Financial sector	end-March 2005	Not met. Done at 6th review
Reduce the stock of tax arrears to the budget by 5 billion dinars	SB	Fiscal sector	end-June 2005	Met
Launch privatization tenders for at least 7 socially-ow ned enterprises	SB	SOE restructuring and privatization	end-June 2005	Met
Government to adopt , after close consultation w ith the World Bank staff, a restructuring plan for the mining company RTB Bor	SB	SOE restructuring and privatization	end-June 2005	Met
Launch privatization auctions 130 socially ow ned enterprises	SB	SOE restructuring and privatization	end-June 2005	Met
Launch an international tender for advisor for the privatization of NIS, including advice on selling a majority stake in the oil refineries	SB	SOE restructuring and privatization	end-July 2005	Not met. Done w ith delay
Parliament to adopt amendments to the leasing law and the NBS law granting the authority for regulating and supervising leasing companies to the NBS	SB	Financial sector	end-July 2005	Met
Government to launch an international tender a financial advisor for the privatization of DDOR	SB	SOE restructuring and privatization	end-July 2005	Met
Prepare an action plan for restructuring employment in the health sector	SB	Fiscal sector	end-September 2005	Met
Initiate bankruptcy procedures against 5 large socially ow ned companies under the new bankruptcy law	SB	SOE restructuring and privatization	end-September 2005	Partially met
Launch privatization auctions for 230 socially ow ned enterprises	SB	SOE restructuring and privatization	end-September 2005	Met
Launch an invitation for interest in Vojvodanska Banka	SB	Financial sector	end-September 2005	Met
Launch privatization tenders for at least 7 socially-ow ned enterprises	SB	SOE restructuring and privatization	end-October 2005	Met
Adopt a time-bound corrective action plan for Dunav, the second-largest socially ow ned insurance company	SB	Financial sector	end-November 2005	Not met. Done w ith delay

1/ Excludes conditionality on the government of Montenegro.

2/ PA=prior action, PC=structural performance criterion, SB=structural benchmark.

Annex 2. Serbia: Structural Conditionality Under the 2009–11 SBA

Description	Type of Conditionality 1/	Area	Target Date	Status
Government to submit to Parliament the Republican and Social Security Fund budgets consistent with the program	PA	Fiscal sector	Prior action for program approval	Met
NBS and government to sign MoU on respective responsibilities in achieving inflation objectives	PA	Financial sector	Prior action for program approval	Met
NBS and government to sign MoU on roles and responsibilities of different players in maintaining financial stability	PA	Financial sector	Prior action for program approval	Met
Adopt state enterprises' business plans that conform to general government wage and employment policy in 2009 and ensure profit transfers to the state	SB	Private sector development	End-January 2009	Not met. Done at second review
Adopt the business plan of the Road Company	SB	Fiscal sector	End-January 2009	Not met. Done at second review
Government to submit to Parliament revised 2009 Republican and Social Security Fund budgets consistent with the program, including provisions ensuring a freeze in public sector wages in 2009	PA	Fiscal sector	First review prior action	Met
Government to submit to Parliament legal provisions that ensure tax measures as per program understandings	PA	Fiscal sector	First review prior action	Met
Parties to finalize the appendix to the MoU on Financial Sector Stability detailing contingency measures and respective roles of the NBS, the government, and the DIA.	PA	Financial sector	First review prior action	Met
MoF to prepare three-month rolling cash flow plan for the Republican budget	SB	Fiscal sector	End-June 2009	Met
Deposit Insurance Agency to adopt action plans for with state participation.	SB	Financial sector	End-June 2009	Met
MoF to charge a specific unit to review the reasons for the sharp increase in VAT refunds and credits in 2008	SB	Fiscal sector	End-June 2009	Not met. Done with delay
NBS to complete a diagnostic study of the 12 largest banks and the four banks with majority state ownership.	SB	Financial sector	End-September 2009	Partially met
Government to submit to parliament a 2010 budget consistent with the program, including supporting legislation	PA	Fiscal sector	Second review prior action	Met
Submit to parliament a draft pension reform law.	SB/PA	Fiscal sector	End-February 2010	action for the 4th review
Adopt large state enterprises' business plans that conform to general government wage and employment policy in 2010 and ensure profit transfers to the state	SB	Fiscal sector	End-February 2010	Partially met
Adopt amendments to relevant credit enforcement laws and regulations strengthening the corporate debt restructuring framework.	SB	Financial sector	End-March 2010	Met with delay at 7th review
Government to submit to parliament a draft Budget System and Responsibility Law	SB/PA	Fiscal sector	End-April 2010	action for the 5th review
Risk management unit at tax administration to establish and integrated taxpayer compliance strategy.	SB	Fiscal sector	End-July 2010	Met
Government to issue a decision to ensure public staff cuts at the central government level will be implemented as enacted by law in December 2009.	PA	Fiscal sector	Fourth review prior action	Met
Government to adopt or submit to parliament amendments to relevant laws and regulations strengthening the corporate debt collection and restructuring framework.	SB	Financial sector	End-September 2010	Not med. Partially done at 6th review
Government to submit to parliament a 2011 budget	PA	Fiscal sector	Sixth review prior action	Met
Government to re-submit to parliament the pension law	PA	Fiscal sector	Sixth review prior action	Met
Government to submit to parliament package of laws strengthening the corporate debt and restructuring framework	SB	Financial sector	End-February 2011	Met

1/ PA=prior action, PC=structural performance criterion, SB=structural benchmark.

Annex 3. The Authorities' Response

The authorities concurred with the key findings of the report and appreciated the forward-looking assessment of the challenges ahead.[23] They thought that, overall, the report was balanced and appropriately reflected challenges and progress in Serbia during the period under review. They had the following observations on specific points:

- On *structural reforms,* they noted that political fragmentation and the resulting weak coalition governments played a crucial role in constraining the pace and success of reforms. While greater ownership on part of the authorities was warranted, they stressed that program measures could have given greater prominence to promoting growth-oriented reforms (enterprise restructuring and business climate) needed for an export-led strategy.

- On *the EA,* they noted that the report could strengthen the discussion of achievements under the program. In addition, they emphasized the role of government wage policy, robust privatization receipts, and the inflow of FDI in the nontradable sectors as factors that contributed most to the build-up of vulnerabilities in the run-up to the crisis.

- On *fiscal issues,* the Ministry of Finance noted that measures were adopted to reduce staffing in the public administration by 10 percent under the 2009 SBA, but acknowledged that limited progress was achieved at the local government level.

- On *inflation developments*, they noted that further analysis was needed to better understand the structural (supply-side) factors that have resulted in high and volatile inflation in Serbia relative to its transition peers.

The NBS provided some editorial suggestions to clarify the exposition in some places.

[23] A draft report was discussed with the authorities during a mission to Belgrade in June 23–24, 2011.

Public Information Notice (PIN) No. 11/101
FOR IMMEDIATE RELEASE
July 27, 2011

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

IMF Executive Board Discusses Ex Post Assessment of Longer-Term Program Engagement and Ex Post Evaluation of Exceptional Access for Republic of Serbia

On July 13, 2011 the Executive Board of the International Monetary Fund (IMF) discussed the Ex Post Assessment of Longer-Term Engagement and Ex Post Evaluation of Exceptional Access for Serbia.

Background

The Ex Post Assessment reviews Serbia's economic performance under Fund-supported programs during the period 2001-2011. During seven of those ten years there were three Fund arrangements in place. The Ex Post Evaluation reviews the 2009 Stand-by Arrangement with exceptional access.

The report concludes that substantial progress has been achieved in the last ten years of the Fund's involvement with Serbia. In 2001, Serbia was recovering from the ravages of war, international sanctions and economic mismanagement: output had collapsed, inflation was rampant, and the external position was non-viable. Macroeconomic stabilization has by and large been achieved over the past decade, debt is manageable, and there is a modern banking system in place. The most recent Fund-supported program helped the country navigate the global crisis and safeguard financial stability, and recovery is in train. But despite these successes, significant vulnerabilities and a large structural reform agenda remain.

The report further concludes that a new Fund-supported program could help Serbia complete and entrench the transition to a more balanced growth model, and tackle its remaining structural reform challenges. In particular, a new arrangement could play a useful role as a coordination device for the government and serve as an anchor for polices in a pre-election year, send a positive signal to investors, and coordinate the contribution of other International Financial

Institutions. Past experience with Fund involvement in Serbia suggests that strong ownership is an essential precondition for program success.

Executive Board Assessment

Executive Directors agreed with the conclusions of the Ex Post Assessment and Ex Post Evaluation. They noted that Serbia has made substantial progress towards macroeconomic stabilization in the ten years of its engagement with the Fund. The country also attained debt sustainability and put in place a modern banking system. The 2009-2011 Fund-supported program also helped Serbia navigate the global financial crisis, and recovery is ongoing. However, progress on the structural reform agenda has lagged. To transition to a more balanced growth model, Serbia still needs to address significant challenges and vulnerabilities and implement far-reaching reforms.

Directors recognized the important progress in achieving macroeconomic stabilization and advancing structural reforms under the 2001 Stand-By Arrangement. Results under the 2002–2006 Extended Arrangement however were less consistent. While there was progress in several areas, macroeconomic performance fell short of expectations. Robust but unbalanced growth amid large capital inflows and lagging structural reforms contributed to rising external imbalances and vulnerabilities in the run-up to the global crisis.

Directors agreed that the 2009 Stand-By Arrangement, subsequently extended and augmented to exceptional access, facilitated an orderly rebalancing of the economy amid the global crisis and helped safeguard financial sector stability. Under this arrangement, macroeconomic performance was broadly satisfactory but progress on structural reforms was slower than envisaged. Directors considered the program’s focus on three main elements—fiscal adjustment, bail in of foreign banks, and exceptional financing—to be appropriate.

In general, Directors concurred with the lessons from the ex post assessments. They agreed that the right incentive structure can help increase critically important ownership of policies in a difficult political environment. Program design needs to be consistent with the stated objectives, which would have warranted a greater focus on Serbia’s structural agenda. In addition to close collaboration with other international financial institutions, greater use of prior actions could have been helpful in this regard. Directors also highlighted the merits of flexibility in adapting the program to prevailing circumstances, and the need for durable fiscal adjustment to be supported by institutional and structural reforms.

Directors noted that continued engagement with the Fund, possibly in the context of a low-access precautionary arrangement, could play an important role to anchor fiscal discipline and address remaining policy challenges. At the same time, experience suggests that strong ownership to support implementation of decisive policies and critical reforms will be essential for the success of a future program.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the Ex Post Assessment of Longer-Term Program Engagement and Ex Post Evaluation of Exceptional Access for Republic of Serbia is also available.

Statement by Mr. Weber and Mr. Antic on Republic of Serbia
July 13, 2011

On behalf of our Serbian authorities, we thank staff for the comprehensive and candid Ex-Post Assessment (EPA) and Ex-Post Evaluation (EPE) report that revisits the Fund's involvement with Serbia over the last decade. The report duly highlights not only Serbia's accomplishments under a series of Fund supported programs, but also the challenges that remain to be addressed going forward. The Serbian authorities broadly share the staff's conclusions and their appraisal of the quality of cooperation between the country and the IMF.

The authorities would like to emphasize that they consider the Fund programs over the years to have provided appropriately flexible guidance for the design and implementation of policy measures that have helped anchor prudent macroeconomic policies. This guidance received traction at all stages of the economic transition process and under changing political circumstances. The authorities acknowledge and appreciate the Fund's valuable assistance and advice in a sometimes difficult environment of a political landscape in flux.

Fund staff showed full understanding of such political dynamics and successfully adjusted its approach to political realities over time without compromising on program objectives and conditions. While program ownership was strong early in the decade, Fund arrangements later on took on increased importance as a way to ensure political commitment and policy coordination.

After a decade of close program cooperation with the Fund, it seems appropriate to recall some key achievements under these programs. These achievements stood the test of the financial crisis and clearly helped the country weather the adverse external shocks of the past few years.

– Following debt restructuring, Serbia has benefited from a low external debt burden and favorable maturities. This has allowed Serbia to limit its dependence on external financing.

– The introduction of inflation targeting in 2006 mandated the National Bank of Serbia (NBS) to pursue low inflation as the main objective of monetary policy. This step went hand in hand with exchange rate flexibility, which proved to be a valuable shock absorber.

– Serbia has accumulated a healthy level of reserves that underpins its resilience against macroeconomic shocks. Despite sizeable foreign exchange interventions in 2008 and 2009 to smoothen exchange rate volatility, these reserves remain high.

- Bold reforms have enabled the development of a well-capitalized banking sector with high foreign participation. The banks retained their commitments in Serbia during the financial crisis in the context of the Vienna Initiative.
- A fiscal rule and a fiscal council were introduced in 2011 to better control fiscal deficits and public debt. The fiscal rule in fact became a main policy anchor for the last part of the 2009 Stand-By Arrangement and will remain so.

Despite these successes, the authorities recognize that their track record in enacting structural reforms under Fund programs is mixed and that this reform agenda is far from complete. Such reforms will be essential to advance on the path to a more sustainable growth model that relies more on a competitive export sector and a business-friendly environment that helps reduce unemployment. The authorities concur with the lessons drawn in the report that set out the priorities for future Fund engagement. They favor a continued Fund involvement in order to tackle the outstanding structural reform challenges and further entrench a culture of macroeconomic stability. Such involvement will likely be requested in the coming months in the form of a low access precautionary arrangement.

The authorities would like to point out that, although differences of views do exist, the Fund has maintained a positive public image in Serbia. This positive image reflects an established climate of trust between the authorities and staff, facilitated by frequent staff and management visits, and staff's excellent relations with the trade unions and the media.

Serbia has maintained a consistent record of transparency. All reviews under the four Fund programs reviewed were published, as were all Post Program Monitoring (PPM) and Article IV Consultation documents. In line with this well-established tradition, the Serbian authorities consent to the publication of the staff paper.