INTERNATIONAL MONETARY FUND

REPUBLIC OF SERBIA

PRELIMINARY DISCUSSIONS ON A NEW STAND-BY ARRANGEMENT

AIDE MÉMOIRE

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1. This aide mémoire summarizes the discussions held during May18-26 in Belgrade on a potential new Stand-By Arrangement (SBA). It was tentatively agreed that the IMF mission will return to Belgrade in late August to try to finalize discussions on a potential new SBA.

Background

2. **Serbia's economy is slowly getting back on its feet, but the welcome shift to more balanced growth based on exports and investment is proving painful.** The global financial crisis unmasked Serbia's unsustainable growth model: the public sector was too large; the tradable sector contributed too little to growth; domestic savings were too low; and the private sector had excessive un-hedged foreign exchange (FX) exposures. The economy slumped in 2009, recovering only haltingly in 2010. In 2011, GDP is expected to expand by 3 percent, fueled by exports to the EU. Growth is hoped to accelerate further to 4½ percent in 2012, as key FDI projects, especially Fiat car production, come on stream. There are also tentative signs of a recovery in investment. However, reflecting wage restraint, tighter credit standards, and massive shedding of private sector jobs, consumption remains subdued.

3. **High inflation and a persistent trade imbalance have been countered by appropriately tight macroeconomic policies.** Inflation over the last eight months has been driven by a series of upside surprises, mainly reflecting the exceptional volatility of Serbia's food prices in response to adverse domestic weather conditions and swings in international food prices. At the same time, the external trade deficit remains high, requiring significant capital inflows to cover it. Against this backdrop, monetary and fiscal policy responses have been appropriate. Since August 2010, the NBS has hiked its policy interest rate by 450 basis points, to 12½ percent, the highest policy rate in emerging Europe, keeping inflationary expectations reasonably anchored. Budgetary policies so far in 2011 seem to stick to spending targets consistent with the intended significant tightening of the underlying fiscal stance, and the government resisted trade union pressures to ad-hoc hikes in public wages. At the same time, high dinar interest rates and the decline in the country risk premium have attracted portfolio inflows, mainly into T-bills, covering external financing needs and appreciating the exchange rate.

4. **The slow recovery paired with internal and external imbalances has raised short-term macroeconomic risks, putting a premium on maintaining responsible fiscal**

and other policies. If inflation pressures prove to be one-off and recede as expected, policy rates can be adjusted downward later in the year to avoid undershooting inflation, but this will also reduce the portfolio inflows that cover the external trade imbalance. Moreover, at least some of the recent short-term inflows could abruptly reverse, and adverse spillovers from the euro-area periphery remain a tangible risk. However, these short-term risks should remain manageable as long as the present and next government stick to the new fiscal rules, keep rollover risks for T-bills in check, and credibly signal to the investor community that the investment climate is improving.

5. **Looking beyond the short term, Serbia needs reforms that allow it to catch up with living standards in better performing transition peers.** From a longer-term perspective, Serbia is seeking to reverse its decline from a relatively rich and export-oriented economy only some 20 years ago to today's lagging and much more closed economy. Moreover, with its population aging fast, Serbia may have only a limited time window of opportunity to act.

Keeping Fiscal Responsibility Pledge

6. **A potential SBA's first purpose will be to support fiscal discipline, while raising government efficiency.** The transition to a more sustainable growth model cannot work if the government sector does not break free from its pre-crisis mode of operation: a large government sector tuned toward consuming and redistributing resources instead of investing in the country's future. The perhaps most difficult task will be to keep a tight lid on public wage and pension bills over the next few years, as indeed required by the fiscal responsibility legislation. Given Serbia's large infrastructure needs, there is also a strong case to increase public investment within the constraints given by the fiscal responsibility rules; this will need to be supported by more effective capital budgeting rules. Another difficult challenge will be to persuade the Serbian public that the present public pension system is simply unaffordable over the longer term, and that it is in the best interest of pensioners and workers to gradually phase in additional increases in effective retirement ages over the next 10-20 years. Finally, the government's longer-term fiscal position should be shielded against incurring fiscally unsustainable restitution claims.

7. **The 2011 budget should be kept in line with the understandings under the previous SBA.** On present projections, higher-than-budgeted spending on general government wages, pensions, and other transfers (½ percent of GDP) necessitated by higher-than-projected inflation will be largely offset by higher revenues. There was agreement that the 2011 general government deficit target of RSD 140 billion (4¼ percent of GDP) could be achieved without significant adjustment measures, as long as spending execution sticks to present budget allocations. However, there will be no scope for additional public wage and pension payments in 2011, while additional spending initiatives would need to be financed through cuts in the approved budget.

8. **On present projections, the general government deficit will need to be reduced from 4¼ percent of GDP in 2011 to 3 percent of GDP in 2012.** Assuming unchanged policies, fiscal adjustment measures equivalent to about 1¼ percent of GDP would be needed. About ½ percent of GDP savings could be achieved through cutting net lending operations. Additional measures could include strict controls of growth in discretionary goods and services expenditures and cuts in subsidies. With elections scheduled for early 2012, closing the fiscal gap in 2012 relying on current spending cuts will undoubtedly be a political challenge, and tax measures may have to be considered as a second-best option.

9. **Looking beyond 2012, containing growth in the overall government wage bill will have to remain the cornerstone of a spending-based adjustment strategy:**

- Without restraining the government's wage bill, it will not only be difficult to keep the fiscal responsibility framework on track, but there will also be a risk that the transition to a more balanced growth model will founder.
- Wage increases should therefore continue to be based on the agreed indexation rules. A possible pay-and-grading reform, which would mainly affect the education and health sectors, would need to be designed to be fiscally neutral.
- Finally, there is scope to rationalize government employment over the medium term and enhance efficiency, including in education and health sectors, as highlighted by the World Bank's "Doing More with Less" report on spending reforms in Serbia.

10. **The mission noted that, in line with pension reform trends, in other countries, Serbia will need to further tighten retirement rules for its aging labor force:**

- In 2010, the ratio of contributors to the pension system to recipients of pensions was only 1.5, one of the lowest pensioner support ratios in Europe. While the low ratio partly reflects the low level of formal private sector employment, it also reflects partly the relatively low effective retirement age of old-age and disability pensioners.
- With populations projected to age rapidly over the next 20 years, almost all countries in Europe are raising (or are debating to raise) statutory retirement ages, with the more ambitious European reformers aiming at a unified retirement age of 67 for both genders, while phasing in retirement age increases over many years.
- To increase the pensioner support ratio, prospective increases in statutory retirement ages will need to be underpinned by stronger incentives for people to work up to the statutory retirement ages, while leaving them the choice to retire earlier with actuarial reductions in the amount of pensions. A further tightening of other early retirement rules, including for coal miners and other professions working under difficult conditions will also be considered.

- Reforms of retirement age rules raise difficult technical issues, including the need to learn from the reform experiences of other countries. The mission therefore proposed to set up a working group by September 2011 to develop a pension reform proposal for retirement age rules by the end of the year.

11. **Resolving Serbia's property restitution issue is important from several angles, but it is also severely constrained by fiscal sustainability considerations**:

- Improving the investment climate, EU integration, and moral imperatives all call for addressing the issue of compensating previous owners of property confiscated under communist rule. However, restitution in kind may by now be impractical in many cases, and may also raise issues of horizontal equity for those who can only receive partial compensation.

- The government is considering resolving the restitution issue based on two principles: (1) using in kind restitution where still possible; and (2) financial restitution for other claims, although, following the lead of other countries, subject to a cap consistent with Serbia's capacity to assume the additional fiscal burden. The mission noted that the fiscal implications of alternative options for the restitution mechanisms need to be carefully evaluated and that a rushed decision could put at risk the sustainability of public finances in a setting where the government's balance sheet is already weak.

12. **The capacity of public debt management to monitor and manage debt risks needs to be upgraded urgently:**

- Most of Serbia's public debt is still on concessional terms. However, over the last two years, the issuance of about 7½ percent of GDP in T-bills, mostly in dinars, has introduced significant rollover risks. Moreover, most of the concessional debt will, over time, have to be refinanced by debt at market terms.

- There was agreement that several debt management weaknesses need to be addressed during the early phase of a potential program through: (1) operationalizing the debt data management system; (2) strengthening capacity to assess the risks and trade-offs between alternative debt issuance strategies; and (3) enhancing coordination and information exchange between debt managers and the NBS. An action plan to address these three weaknesses will be elaborated by end-July.

13. **Improving capital budgeting is urgent given that infrastructure gaps are a key bottleneck for boosting tradable sector growth**:

- Capital budgeting is presently riddled with inefficiencies, including unpredictable medium-term spending allocations, cumbersome procurement procedures, and institutional fragmentation. As a result, with capital budgets already underfunded, actual execution of planned public investment has been low, averaging about 70 percent at the Republican level over the last four years.

- It was agreed to implement in the early phase of a potential program a plan that envisages the following actions: (1) a multi-annual capital budget, underpinned by predictable revenue envelopes; (2) streamlined procurement rules for domestically-financed capital spending; and (3) the setup of a new unit for public investment in the Ministry of Finance tasked with monitoring project identification, evaluation, selection, preparation and financing.

14. **Tax collection is undermined by weak compliance, calling for further actions to modernize tax administration**:

- Serbia's tax compliance is weak, and collection efficiency of social contributions is especially low. Uneven compliance aggravates the already difficult investment climate and is considered unfair by the Serbian public.

- There was agreement that the tax administration needs to develop operational plans for improving compliance, including by upgrading regulations, enhancing staff skills and the number of qualified tax inspectors, and IT capacity. It is planned to establish a structural benchmark under the program, which will aim at ensuring tangible progress regarding increasing collections of social contributions, will be completed by the first or second review.

Improving the Investment Climate

15. **A potential SBA's second purpose will be to improve the investment climate, boosting in particular tradable sector activities**. Serbia's inefficient public enterprise sector is still oversized, and cross-country experiences strongly suggest that restructuring and privatizing the sector would increase Serbia's capacity to produce, save, and export. Labor market reforms should help reduce hiring and firing costs and refocus collective bargaining to maintaining tradable sector competitiveness. Given Serbia's relatively unskilled labor force, the tradable sector will need to attract FDI projects that offer in-house training and bring with them supply networks that give domestic companies the incentives to also upgrade workforce skills. Finally, increasing competition holds the promise of crimping nontradable sector rents, adding a further impetus to the tradable sector.

16. **Reform of most of the large state-owned enterprises should aim at attracting strategic investors, while using the time before their privatization to improve governance and efficiency:**

- Large state enterprises are generally characterized by wages out of line with productivity, overstaffing, lack of investment, technical inefficiencies, and poor corporate governance. As a result, they run substantial quasi-fiscal losses, provide poor services, block entry of more efficient competitors, and act as unwelcome de-facto wage leaders for the rest of the economy. In addition, state-owned energy companies are a bottleneck for a more sustainable energy policy.

- There was broad agreement that most large state enterprises should eventually be privatized. While preparing the enterprises for privatization, their market value could be enhanced by: (1) completing the corporatization of all large state enterprises by December 2012; (2) stronger control and monitoring of enterprises on the part of the Ministry of Finance, including by publishing quarterly financial results; (3) targets on their wage bills; (4) greater managerial professionalism and operational independence, including through selection of managers strictly based on professional criteria; (5) separation and—where possible—sale of non-core activities.

17. **There was consensus that the festering problem of unsuccessfully privatized formerly socialized enterprises needs to be urgently addressed:**

- In these firms, there are up to 100,000 workers (some of which do not perform any work) that require state support. The unsuccessfully privatized enterprises reflect a wide variety of circumstances. Some have experienced temporary financial difficulties with the onset of the crisis, others are kept afloat to reduce political and social concerns, while many are viable candidates for new privatizations. The Privatization Agency has introduced profesionalization of interim management and implemented accountability rules aimed to support the viability of subsequent privatizations.

- An action plan for revamping those enterprises would include: (1) an assessment of the viability of these firms as going concerns; (2) accelerated closure and bankruptcy of non-viable enterprises, accompanied by sale of capital assets and active labor market policy measures to retrain redundant workers; and (3) plans for nursing the viable parts of enterprises to financial health.

18. **Labor market reforms are needed to reverse the slump in private-sector jobs:**

- Over the last two years, the private sector has lost a large number of both formal and informal jobs, whereas government employment has held up. Poor employment outcomes, particularly among younger and older workers, suggest that hiring and firing costs are excessive. Moreover, collective bargaining on wages is dominated by public sector unions, with the setting of public wages mainly constrained by the availability of public funds over the election cycle, rather than by considerations of productivity and external competitiveness. In this setting, it is difficult (without promising significant state aid and other incentives) to attract FDI investors that provide new jobs and much-needed on-the-job training.

- Reforms during a potential program could be sequenced in two steps. As a first step, there was consensus that two obvious rigidities that impede job creation could still be reformed during the term of the present government by: (1) basing the calculation of severance pay only on the duration of employment by the last employer (the present calculation based on the employee's cumulative employment history makes it difficult for older workers to get re-employed); and (2) by extending the duration of fixed-term contracts. As a second step, a comprehensive review and reform of other labor market rigidities, active labor market policies, and collective bargaining should be undertaken.

19. **There is a strong case to accelerate progress in clarifying property rights over construction land, a bottleneck for green-field investment:**

- Slow progress in resolving land ownership has perpetuated uncertainty over the status of much of urban land, hurting investment and undermining economic efficiency. In particular, this regards conversion of land usage rights into ownership for privatized companies and legalization of buildings constructed without permits. While the legislative framework has been repeatedly adjusted to help speed up procedures, de-facto progress in conversion and legalization has remained slow. Further progress has been hampered by uncertain land valuations, financing constraints, red tape, and heterogeneity among—and conflicts within—various levels of government. For example, only 300 out of 3,000 conversion requests have been approved so far, putting many corporations and investors in limbo and facing steep costs.

- While the recent amendments that have drastically reduced fees for legalization should help speed up the process, bolder steps could be considered. A radical and economically the most efficient solution to allow conversion free of charge has been ruled out for equity reasons, but it was agreed to explore the scope for fresh steps that could accelerate the construction land legalization process.

20. **The injection of more competition would be an essential step toward a tradable-based growth model:**

- The lack of competition has been a key cause of Serbia's unsustainable nontradables orientation, as well as of a relatively high level and volatility of consumer prices. In particular, certain nontradables sectors have been favored by the lack of structural reforms in the years prior to the 2008 crisis, apparently enjoying substantial rents. Anecdotal evidence suggests still high margins and market dominance in key segments or retail trade, oil derivatives, food processing, and several other sectors. The 2009 law on competition has been a step in the right direction, but progress in implementation has to be accelerated. In particular, the competition commission needs to be fully staffed and to establish a track record of effective and even-handed decisions. .

- Reforms would focus on: (1) further strengthening of the competition commission; (2) liberalization of administrative barriers to imports; (3) identifying and removing any legislative basis for unwarranted market dominance by public enterprises; and (4) reviewing the effectiveness of the competition law and the implementation of the key by-laws.

Strengthening Financial Sector Stability

21. **Strengthening further banking sector's regulatory framework remains a key priority of financial sector policies**:

- The NBS's supervisory framework has been effective in maintaining financial sector stability in the wake of the global financial crisis. However, the Serbian banking system would benefit from greater emphasis of an internationally generally accepted approach to 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, adoption of the Basel II framework remains a key priority to strengthen further financial sector supervision. To that end, the NBS will publish by end-June the set of by-laws in line with Basel II framework. Also, together with the Ministry of Finance, the NBS has amended the law on banks that align the disclosure requirements with EU and Basel II standards, and also strengthen legal grounds for the NBS to issue relevant by-laws. The full implementation of the set of by-laws is scheduled for December 31, 2011, with the test reporting period set for September 30, 2011.

22. **Promoting dinarization and reducing un-hedged exposures in foreign currency (FX) is the second financial sector priority**:

- The euro dominates Serbia's financial system. While the government has already issued a substantial stock of dinar T-bills, local currency market development is still at an embryonic state, mainly constrained by low domestic savings in dinars. Un-hedged FX positions, especially in corporate balance sheets, also remain too high, a source of financial stability risks and a constraint on monetary policy.

- Providing the dinar with a level playing field against the euro is a long-term and complex challenge. As a pre-condition, monetary and fiscal policies need to remain focused on reducing the level and volatility of inflation within the setting of a managed flexible exchange rate and the current inflation targeting framework.

- By September 2011, the NBS and the government plan to sign a memorandum laying out a detailed dinarization strategy with two main prongs: (i) promote the use of dinars by developing further the primary and secondary dinar bond markets, issuing long-term dinar securities by IFIs, and using incentives to promote savings in dinar; and (ii) reduce un-hedged FX risks by developing hedging instruments, while continuing public education on FX risks.

- Finally, the authorities will continue to request foreign banks and their home supervisors to proactively support the dinarization strategy, including by internalizing the financial stability implications of un-hedged cross-border lending.

Program Design Issues

23. **There was a tentative understanding that a potential new SBA would be precautionary with a length of 18 months, access of 200 percent of quota, and quarterly reviews.** Under the baseline scenario, Serbia is not expected to face actual balance-of-payments financing needs. However, potential balance-of-payments financing needs could arise from adverse financial spillovers from abroad, for example from euro-periphery countries, a sudden reversal of short-term capital inflows, and a global commodity, especially energy, price surge. While these external risks may need to be re-assessed by the time of the next mission, access of about 200 percent of quota (about €1 billion) should provide adequate insurance against adverse scenarios that could be triggered by the above-mentioned external risks.