Republic of Serbia: Letter of Intent (LOI)

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

Belgrade, March 21, 2011

Dear Mr. Strauss-Kahn:

1. Our program has continued to perform well. All end-December 2010 performance criteria were observed (Table 1). In particular, the 2010 fiscal deficit target was met by a considerable margin. We also fulfilled the program's structural benchmark, as the *Law on Voluntary Corporate Financial Restructuring* has been submitted to Parliament. As expected previously, December inflation exceeded the upper program band by 2¼ percentage points. In line with the inflation consultation clause, the National Bank of Serbia (NBS) sent a letter that explains the reasons for relatively high inflation and the monetary policy response.

2. GDP growth has remained on track, but the much-needed transition from consumption-led to more export-led growth is proving more painful than expected. Growth is estimated to have reached 1¾ percent in 2010, and is projected to increase to 3 percent in 2011. The sharp real depreciation over the last two years has leveled the playing field for companies in our tradable sector, as reflected in the rebound of exports to the EU. But the depreciation has also adversely affected the balance sheets of companies with unhedged foreign exchange loans. Small- and medium-sized companies in the nontradable sectors are going through a particularly wrenching economic adjustment, and employment in both the formal and informal segments of the private sector has contracted sharply. Although job security in the public sector remained high, nominal wage and pension freezes sustained through 2009-10 have cut into real incomes of public sector workers and pensioners.

3. Inflation remained high during recent months, reflecting mainly global and local food price shocks, but also the cumulative impact of nominal exchange rate depreciation. The 2010 current account deficit is estimated at 7 percent of GDP, significantly better than expected, mainly due to higher remittances, but also a narrower trade deficit. Capital inflows have reversed course over the last few months, responding to relatively high nominal T-bill yields. But foreign investors are also attracted by sounder economic fundamentals and our improved policy framework, including the new fiscal responsibility legislation. This has been reflected in some appreciation of the dinar and no need for official interventions in the foreign exchange market.

4. We remain determined to use fiscal and monetary policies appropriately to respond to the challenges confronting us:

- As regards fiscal policy, we will implement policies in 2011 and beyond that are consistent with the fiscal responsibility legislation. We are determined to resist trade union pressures for large, sustained increases in wages in excess of the two additional indexation steps already envisaged for May and November 2011. Such wage increases would put fiscal and price stability at risk. To protect the most vulnerable segments of our population, we have already allocated substantial additional resources in the 2011 budget. At the same time, if revenues at the consolidated central government level (Republican budget and social security funds, but excluding own resource budgets) overperform relative to target and overall spending remains in line with budget projections, we plan to use part of the revenue overperformance to provide limited, targeted, and one-off payments to public wage and pension recipients. However, these additional one-off payments will be capped at 0.35 percent of GDP.

- As regards monetary policy, we have responded to the inflation surprise in a measured but determined manner, increasing the policy rate by 425 basis points since August 2010, as well as by scaling back the scheduled easing of reserve requirements during the first quarter of 2011. We will continue to use the full array of our policy tools to ensure that inflation expectations remain reasonably anchored and to bring inflation back into our announced tolerance target band by at the turn of 2011/12.

5. In consideration of our good implementation record, we request the completion of the seventh and last review under the Stand-By Arrangement (SBA) and that SDR 319.6 million be made available. However, in view of our limited balance-of-payments needs, we intend to purchase only SDR 46.7 million.

6. As the SBA comes to an end, we consider that many of the key objectives set at the outset of the program have been achieved, but we also recognize that much remains to be done to lock in a more sustainable growth model. In particular, the SBA has helped contain adverse spillover effects from the global financial crisis that erupted in September 2008. Serbia's economy has so far weathered the crisis better than most of its neighboring peers, and the transition to more export-led growth is making progress. Notwithstanding the large shocks, the financial sector proved highly resilient, and financial crisis preparedness was enhanced. However, the crisis has also taken its toll, especially in the private sector part of the labor market. We intend to build on our achievements by persevering with disciplined macroeconomic policies and by accelerating the pace of structural reforms in the period ahead to secure greater economic prosperity.

Mirko Cvetković
Prime Minister and Minister
of Finance

Dejan Šoškić
Governor of the National Bank
of Serbia

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

	2009								2010										
	March		June		Sept.		Dec.		March		June			Sept.		Dec.			
	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Act.	Prog.	Adj.	Act.	Prog.	Act	Prog.	Adj.	Prel.
Quantitative Performance Criteria																			
Floor on net foreign assets of the NBS (in billions of euro)	5.1	6.0	4.4	5.9	3.6	6.5	4.3	6.6	4.0	6.2	4.9	4.9	5.4	4.6	5.0	4.0	4.0	4.9
Ceiling on consolidated general government overall deficit (in billions of dinars) 2/	15	12	34	55	58	79	134	121	23	24	72	69	55	109	84	148	152	137
Ceiling on contracting or guaranteeing by the public sector of new short-term external debt (up to and including one year, in millions of euro) 2/	0	0	10	0	10	2	10	2	20	0	20	20	0	20	0	20	20	0
Ceiling on contracting or guaranteeing by the public sector of new nonconcessional external debt (over one year, in millions of euro) 2/ 3/	200	0	550	100	550	100	550	100	200	0	550	550	140	600	170	600	600	180
Ceiling on accumulation of government external payment arrears (continuous, in millions of euro)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Inflation Consultation Bands (in percent)																			
Central point	9.2	9.4	8.0	8.3	9.5	7.3	7.5	6.6	5.4	4.7	4.0	4.0	4.2	5.3	7.7	6.0	6.0	10.3
Band, upper limit	11.2	n.a.	10.0	n.a.	11.5	n.a.	9.5	n.a.	7.4	n.a.	6.0	6.0	n.a.	7.3	n.a.	8.0	8.0	n.a.
Band, lower limit	7.2	n.a.	6.0	n.a.	7.5	n.a.	5.5	n.a.	3.4	n.a.	2.0	2.0	n.a.	3.3	n.a.	4.0	4.0	n.a.
Indicative Targets																			
Ceiling on current expenditure of the Serbian Republican budget (in billions of dinars) 2/	190	152	335	331	520	506	695	689	182	165	354	354	353	548	543	750	750	747
Ceiling on gross accumulation of domestic guarantees by the Republican budget and the Development Fund and domestic borrowing by the Development Fund (in billions of dinars) 2/	n.a.	n.a.	50	7	50	15	50	15	13	16	50	50	18	50	18	50	50	38

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

2/ Cumulative from January 1.

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