

BUFF/ED/20/137

August 20, 2020

**Statement by Mr. Inderbinen and Mr. Djokovic on Republic of Serbia
Executive Board Meeting
August 26, 2020**

On behalf of the Serbian authorities we would like to thank staff for their engagement, constructive interactions and comprehensive assessment of policies, as well as for a valuable and balanced report. The authorities are also grateful to the Executive Board and management for their continued guidance and support. Serbia and the Fund have a long history of engagement and dialogue, which the authorities highly appreciate, and even more so during fluid and uncertain times as at present. While the overarching goal of the Policy Coordination Instrument is to guide the macroeconomic policies and structural reforms, while enabling conditions to foster growth and preserving stability, at present the PCI is helping assess the impact and calibrate the response to the COVID-19 crisis, identify and mitigate risks, and support the implementation of the reform agenda. Crisis management is a priority at the current juncture, but at the same time the sustained reform momentum under the program remains relevant for Serbia in the context of the gradual re-opening of the economy and returning to normalcy, and also against the background of the ongoing EU accession.

Recent developments

Serbia entered the crisis much more prepared and in better condition than in the past, with restored macroeconomic stability, more sustainable public debt and available fiscal space, repaired banking sector balance sheets, low inflation and high reserves. The ambitious fiscal adjustment implemented since 2015, guided by a three-year SBA and the current PCI, brought public debt down from about 70 percent to 52 percent of GDP, restored confidence and created needed policy buffers. Monetary policy has successfully kept inflation low, close to the target, with low inflation volatility, while maintaining high reserves and relative exchange rate stability, which is preferred in the context of still high euroization. Over the same period the authorities have been implementing a broad set of reforms to buttress growth and employment, including cleaning-up banks' balance sheets and enabling supply of credit to the economy, reforming the SOEs and implementing labor market reforms. The economy

also recorded a notable economic expansion prior to the COVID-19 shock, averaging 4.3 percent over the last two years. Economic activity continued to be strong in Q1 2020, recording 5 percent growth, while the projections for the whole year were indicating a healthy growth of about 4 percent.

Crisis response

The Serbian authorities responded promptly to the pandemic by implementing a set of strict containment measures, with the objective of saving human lives, limiting the spread of the virus, while strengthening the capacity of the health system to cope with the pandemic. Serbia was successful in containing the first wave of the pandemic, with a relatively low loss of lives and without overstressing the health system. The containment measures were lifted in May. Still, as in many countries, the number of cases started to creep up again in July, but has broadly stabilized since then and is showing signs of a gradual trend decline over the past few weeks.

The pandemic has adversely impacted the economy and the outlook, but a resolute containment and the health system response, paired with the sizable set of fiscal and monetary measures aimed to support the economy, has helped cushion the shock. Furthermore, the favorable structure of the economy, including a bigger share of agriculture and food processing and limited reliance on tourism and travel, has helped limit the damage. The Serbian authorities consider that the economy will contract by 1½ percent this year, less than projected by staff. The Q2 GDP flash estimate (-6.5 percent), which came out better than expected, points in that direction.

In response to the shock, the authorities expanded healthcare spending, and deployed a substantive economic response package. The response is commensurate with the available fiscal space, and aimed to support businesses and preserve employment, while protecting the vulnerable. Key measures include deferment of labor taxes and social security contributions, universal cash transfers, payment of minimum wage to corporates, deferment of corporate income tax advances, and new loans to the SMEs. The NBS enacted a three-month moratorium on bank loan repayments for households and corporates, to avert liquidity pressures and contain credit risks for banks. The moratorium was extended to end-September. The SME sector is also benefiting from a partial state-guaranteed loan scheme, devised with the participation of banks, which reduces the costs of financing, supports provision of credit, while limiting the risks to the banking sector. Total cost of the package is estimated at 7.2 percent of GDP. Some of the measures were extended through end-September, with an additional fiscal cost of 1.2 percent. Some of the extended measures were scaled down, with a view to taper and end support, and, if needed, shifting to a more targeted and sector-oriented approach. It is important to note that the increased health spending and the fiscal measures to support the economy were channeled through a supplementary budget, in line with the well-established budgetary process, thus preserving transparency and

accountability of crisis spending. Further, the supplementary budget has been reviewed by the Fiscal Council, and the financial accounts will be audited by the State Audit Institution—both bodies are already a key part of the Serbian budgetary framework. At the same time, the tax authority is closely monitoring the implementation of tax deferrals, to prevent potential misuse or fraud.

Fiscal policy

At present, fiscal policy is appropriately geared towards combating the crisis and supporting the economy, within the available fiscal space. Financing needs, which have reached 14 percent of GDP, are mostly already covered, including through the recent USD 2bn Eurobond placement, while there is a clear plan for securing the remaining financing.

While noting that the outlook remains uncertain, the authorities expect that the recovery will be taking strong hold in 2021. In that context, they remain committed to shift the focus of fiscal policy towards debt reduction and consolidation. The authorities concur that containing current spending should be a priority. This would include keeping wage and pension growth moderate. The recently introduced indexation of pensions, which links the growth of pension to average nominal wage growth and inflation, will help in that regard. At the same time the authorities remain committed to creating fiscal space for increasing public investments, a key element for supporting recovery, closing the infrastructure gap and enabling long-term growth.

Monetary and financial sector policies

The National Bank of Serbia promptly reacted to the deteriorating economic conditions in March and April, and further eased its monetary policy stance, informed by low inflation, an open output gap and anchored expectations. The key policy rate was lowered from 2.25 to 1.25 percent. At the same time, the NBS provided dinar and FX liquidity, broadened the range of accepted collateral, and enabled a liquid secondary government debt market. The NBS secured a euro liquidity line with the ECB, and it has ample policy space to provide additional support to banks at its disposal, if conditions deteriorate.

The banking system remains well capitalized and, after recovering from a temporary tightening of liquidity conditions in March, highly liquid. The capital adequacy ratio stood at 22.6 percent at the end of Q1. Financial intermediation has continued to improve, and provision of credit to the economy continued to grow at about 12 percent yoy in Q2, supported by an accommodative monetary stance and the loan guarantee scheme. NPLs declined to 3.9 percent in May. At this juncture, the uncertainty surrounding the outlook is impairing a clear assessment of the potential spillovers to the financial sector. However, banks' robust balance sheets, high liquidity and capital adequacy, as well as the NBS readiness to provide liquidity as needed, provide a sizable buffer. The results of the NBS

macroprudential stress test show that the banks would weather the potential materialization of its adverse scenario reasonably well.

SOE and structural policies

Over the past years, Serbia has made progress in implementing reforms of SOEs, to improve their operational viability and to contain fiscal risks, while substantially reducing state aid. The reforms, supported by the relevant IFIs, have been focused on comprehensive financial and corporate restructuring, appropriate regulatory price adjustments, and enhanced revenue collection. Under the PCI-supported program, the authorities have focused on resolving four big non-strategic SOEs, which will reduce the associated fiscal risks. RTB Bor, a copper mine and smelter, has been sold to a strategic partner from China; and the fertilizer plant Azotara has entered into bankruptcy. The authorities are actively seeking a buyer for MSK and Petrohemija,

The authorities are stepping up efforts to change EPS's legal status into a joint-stock company, and to improve its corporate governance. At the same time, they are assessing the electricity tariffs with a view to secure full cost recovery, while limiting the impact on vulnerable segments of the population. With the support of EBRD, the authorities are preparing an SOE policy document, which will help organize the state enterprise ownership function and provide guidance for strengthening SOE governance.

The multi-year preparation for the ambitious reform of public sector wage system, which included several rounds of consensus-building consultations with relevant social actors, have been progressing towards the implementation phase, planned for 2021. The reform envisages unification of grade levels across the general government, including education, civil service and the health sector among others, to ensure employees are granted equal pay for equal work in a more transparent and systematic manner. However, the outbreak of pandemic has shifted the immediate priorities and, more importantly, has reduced available fiscal space for the reform. At current time, the authorities are evaluating options to implement the reform while limiting costs to the budget.

The authorities confirm their strong commitment to preserving macroeconomic stability, limiting growth of public debt and pursuing sustainable growth. The authorities agree that, in that context, the forthcoming fifth review of the PCI will be pivotal in shaping the 2021 budget, and the related fiscal adjustment.