

**FOR
AGENDA**

EBS/04/167

December 3, 2004

To: Members of the Executive Board

From: The Secretary

Subject: **Serbia and Montenegro—Report on Noncomplying Purchases, Breach of Obligations Under Article VIII, Section 5, and Recommendation for Waiver of Nonobservance of Performance Criterion**

Attached for consideration by the Executive Directors is the Managing Director's report on noncomplying purchases made by Serbia and Montenegro and Serbia and Montenegro's breach of obligations under Article VIII, Section 5, and recommendation for a waiver of nonobservance of a performance criterion, which is tentatively scheduled for discussion on **Wednesday, December 15, 2004**. Draft decisions appear on page 4.

Questions may be referred to Ms. Sorsa (ext. 38657) and Mr. Westphal (ext. 37389) in EUR.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads



Office Memorandum

To: Members of the Executive Board

December 2, 2004

From: The Managing Director

Subject: **Serbia and Montenegro—Report on Noncomplying Purchases, Breach of Obligations Under Article VIII, Section 5, and Recommendation for Waiver of Nonobservance of Performance Criterion**

I. INTRODUCTION

1. **The incorporation of all budgetary accounts into the Treasury Single Account (TSA) in mid-2004 revealed that the information reported to the Fund on net credit of the banking system to the consolidated general government at end-2003 was not correct.** As a result, two purchases under the three-year Extended Arrangement (EA; EBS/02/73, Supplement 2) approved on May 14, 2002 (SDR 650 million, 139 percent of quota) for Serbia and Montenegro (SM) that were made following completion of the third program review on June 7, 2004 were noncomplying.¹ Moreover, the inaccuracy of the reported data gives rise to a breach of obligations under Article VIII, Section 5. This report sets out the reasons for the difference between the previously reported and the revised data, and proposes that (i) a waiver be granted for the nonobservance of the end-2003 performance criterion (PC) on net credit of the banking system to the consolidated general government that gave rise to the noncomplying purchases; and (ii) no action be taken by the Executive Board with respect to the breach of obligations under Article VIII, Section 5.

II. NONCOMPLYING PURCHASES

2. **After the third review of the EA completed on June 7, 2004, SM made the seventh and eighth purchases equivalent to SDR 100 million subject to the observance (or waiver) of performance criteria for end-December 2003.** One of the quantitative PCs called for a SRD 31,563 million (with adjustors) ceiling on net credit of the banking system to the consolidated general government (EBS/04/65, Appendix VI, Annex A). Data provided to staff in May 2004 indicated that this ceiling was breached by SRD 4,312 million or about 0.4 percent of GDP. Based on the reported information, the Executive Board granted the requested waiver of nonobservance. In accordance with Board policy, the decision to grant the waiver was conditional on the accuracy of the information reported by the authorities of SM on performance under the waived PC.

¹ The Executive Board's Guidelines on Misreporting and Noncomplying Purchases in the General Resources Account (Misreporting Guidelines).

3. **Recent information reveals that the seventh and eighth purchases under the EA were non-complying.** On November 2, 2004, staff was informed that the end-December 2003 net bank credit to the consolidated government was exceeded by an additional SRD 2,271 million (about 0.2 percent of GDP), bringing the total amount by which the ceiling was breached to SRD 6,583 million or about 0.6 percent of GDP. The difference arose from the issuance of promissory notes by the Road Fund in the second half of 2003, which was discovered by the Serbian government when the Road Fund was incorporated into the TSA in July 2004. Given the inaccuracy of the figure reported at the time of the completion of the third program review, the condition upon which the Board had granted the waiver of nonobservance was not met. Consequently, the seventh and eighth purchases that became available upon completion of that review were noncomplying purchases within the terms of the Misreporting Guidelines.

4. **On November 24, 2004, the Acting Managing Director wrote to the Ministers of Finance in Serbia and Montenegro informing them of the staff's findings** and seeking the authorities' views before making a recommendation to the Executive Board on how to proceed (Attachment I).

III. THE AUTHORITIES' RESPONSE AND CORRECTIVE ACTION

5. **In his response dated November 30, 2004, the Serbian Minister of Finance regretted the provision of inaccurate information to the Fund (Attachment II).** He emphasized, however, that the incorporation of all budgetary accounts into the TSA, which revealed the inaccuracy of previously provided information, is expected to preclude the reoccurrence of such problems in the future. He also pointed out that the Serbian government has taken additional steps to tighten control over the issuance of public debt instruments and improve expenditure management. The latter includes a comprehensive ledger system that records all government operations and controls budget execution by various budget users. Moreover, he underlined ongoing efforts to strengthen internal control and auditing procedures and stated that he was now proposing a section in the new public debt law requiring ex ante-approval by the Ministry of Finance of any borrowing by public sector entities.

IV. RECOMMENDATION

6. **I recommend that a waiver be granted with respect to the noncomplying purchases given the minor difference between the reported and revised data and the corrective action taken.** Under the Misreporting Guidelines, a waiver of nonobservance in relation to a noncomplying purchase is normally granted "only if the deviation from the relevant performance criterion or other condition was minor or temporary, or if, subsequent to the purchase, the member had adopted additional policy measures appropriate to achieve the objectives supported by the relevant decision." In my assessment, the minor deviation criterion is satisfied in this case. The difference between the reported and final data, representing 0.2 percent of GDP, is minor and does not alter the assessment of the fiscal situation under the program. I would also like to note the Serbian authorities' continuing

commitment to the fiscal objectives under the program, and that corrective action has been taken to improve public expenditure and debt management.

V. ARTICLE VIII, SECTION 5

7. The inaccurate information provided by SM gives rise to a breach of obligations under Article VIII, section 5, but no action by the Board is recommended given the minor nature of the deviation and corrective action taken. Article VIII, section 5 obligates members to provide the Fund with information that it deems necessary for its activities, including, inter alia, information to assess whether or not PCs have been met. As noted above, the inaccurate information concerning net credit of the banking system to the consolidated general government was related to an end-December 2003 PC. The authorities confirmed in their letter dated November 30, 2004 that the provision of inaccurate information was not due to a lack of capacity on the part of SM, and that corrective measures have already been taken to improve public expenditure management.

Attachments (2)

Proposed Decision

The following decisions, which can be made by a majority of votes cast, are proposed for adoption by the Executive Board:

A. Non-complying Purchases under the Misreporting Guidelines

“The Fund takes note of the report of the Managing Director set forth in EBS/04/167 on the two non-complying purchases made by Serbia and Montenegro following completion, on June 7, 2004, of the third review under the Extended Arrangement for Serbia Montenegro (EBS/02/73, Supplement 2, May 14, 2002), and decides to waive Serbia and Montenegro’s non-observance of the performance criterion on net credit of the banking system to the consolidated general government under paragraph 3(a)(iii) of the Extended Arrangement for Serbia Montenegro, on condition that the revised information provided by Serbia and Montenegro on the observance of that performance criterion is accurate.”

B. Breach of Obligations Under Article VIII, Section 5

“The Fund takes note of the report of the Managing Director set forth in EBS/04/167 on the misreporting by Serbia and Montenegro of information on net credit of the banking system to the consolidated general government under paragraph 3(a)(iii) of the Extended Arrangement for Serbia Montenegro (EBS/02/73, Supplement 2, May 14, 2002), and finds that Serbia and Montenegro has breached its obligation under Article VIII, Section 5, of the Articles of Agreement to report accurate information to the Fund.”



INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

FIRST DEPUTY MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

November 24, 2004

Mr. Mladjan Dinkic
Minister of Finance
Belgrade
Serbia

Mr. Igor Luksic
Minister of Finance
Podgorica
Montenegro

Dear Ministers:

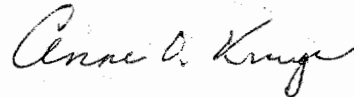
I am encouraged to know that the Serbian authorities have decided to tighten fiscal and monetary policies further in the context of an external situation that remains vulnerable. It has come to our attention, however, that revised data on the net credit to the consolidated government for end-2003 is higher than that reported to the IMF's Executive Board at the time of the third program review in June this year.

At that time, the Executive Board was informed that the performance criterion of net credit from the banking system to the consolidated general government was exceeded by SRD 4312 million, or 0.4 percent of GDP. A waiver was requested, and granted by the Board given that the breach of the performance criterion was temporary. On this basis, Serbia and Montenegro purchased SDR 100 million under the Extended Arrangement. However, I understand that staff was recently informed that this performance criterion was missed by a larger margin, SRD 6583 million, or an additional 0.15 percent of GDP. After the Road Fund was incorporated in the single treasury account in July this year, it was discovered that it had issued promissory notes in 2003 that had not previously been reported to the Fund. While I welcome the increased transparency and better reporting, the June purchase falls under the IMF's provisions governing noncomplying purchases.

Under such circumstances, I am required to report any instances of noncomplying purchases to the Executive Board. The Board may decide either to call upon Serbia and Montenegro to make an early repurchase, or it may grant a waiver for the nonobservance. A waiver will normally be granted, if the deviation is minor or temporary, or if the member has subsequently taken additional measures appropriate to achieve the objectives of the program.

I would appreciate receiving your views on this matter before I make a recommendation to the Executive Board on how to proceed. As this issue must be resolved before the Board can consider the fourth review, I would welcome a response at your earliest convenience.

Yours sincerely,

A handwritten signature in cursive script, appearing to read "Anne O. Krueger".

Anne O. Krueger

cc: Mr. Zurbrugg,
Executive Director for Serbia and Montenegro



Republic of Serbia
MINISTRY OF FINANCE
Cabinet of the Minister

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Belgrade, 30th November 2004

Mr. Rodrigo de Rato y Figaredo
Managing Director
International Monetary Fund
700 19th Street, NW
Washington, DC 20431
USA

Dear Mr. de Rato y Figaredo,

Thank you for the letter of November 24, 2004 on the provision of inaccurate data on net credit to the consolidated general government for end-2003, which has occurred at the time of the third review under the Extended Arrangement approved in May 2002.

As we have already indicated to Fund staff, we discovered the inaccuracy of previously reported data when we incorporated all budgetary accounts into the Treasury Single Account (TSA) in July 2004. At that time we noticed that in the second half of 2003 the Road Fund had issued—without the approval of the Government of Serbia—bills of exchange in the amount of SRD 2,271 million to construction companies for the maintenance and construction of regional roads.

While I regret the provision of the inaccurate information, I would like to emphasize that the very same measure—the incorporation of all budgetary accounts into the TSA—, which helped identify the issue, should preclude such problems in the future. Moreover, I would like to assure you that we have taken additional steps to improve expenditure management and tighten control over the issuance of public debt. In particular, the Ministry of Finance of Serbia has established a new consolidated treasury system, and is now proposing a section in the new public debt law requiring the Ministry of Finance to approve—a priori—any borrowing by public sector entities. In addition, we are in the process of strengthening internal control and auditing procedures.

In light of the relatively small amount involved and the steps we have taken to avoid the reoccurrence of such a problem, we request a waiver for the non-observance of the end-2003 performance criterion on net-credit to the consolidated government.

We understand that the misreporting led to a breach of obligations under Article VIII, section 5, of the Fund's Articles of Agreement. While I hereby confirm that the provision of inaccurate information was not due to a lack of capacity on the part of the Serbian government, I would like to reiterate that the underlying reasons for this problem have been overcome.

Very truly yours,

Mladjan Dinkic