April 21, 2005
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 04/113-2

2:50 p.m., December 15, 2004

2. Serbia and Montenegro—Report on Noncomplying Purchases, Breach of Obligations Under Article VIII, Section 5, and Recommendation for Waiver of Nonobservance of Performance Criterion; Fourth Review Under the Extended Arrangement, Financing Assurances Review, and Request for Waiver of Performance Criteria and Modification of End-December Performance Criterion

Documents: EBS/04/165 and EBS/04/167

Staff : Sorsa, EUR; Donovan, PDR

Length: 40 minutes

Executive Board Attendance

A. Krueger, Acting Chair

Executive Directors	**Alternate Executive Directors**
	A. Al Nassar (SA), Temporary
	B. Reichenstein (GR), Temporary
	O. Cuny (FF)
	J. John (UA), Temporary
	T. Miyoshi (JA), Temporary
	J. Prader (BE)
	L. Croitoru (NE), Temporary
	C. Faircloth (CO), Temporary
	M. Barootchi (MD), Temporary
	V. Srinivas (IN), Temporary
A. Mozhin (RU)	I. Zakharchenkov (RU), Temporary
	D. Nintunze (AE), Temporary
	B. Seong (AU), Temporary
	T. Nguema-Affane (AF), Temporary
	G. Cipollone (IT), Temporary
	A. Maciá (BR), Temporary
	P. Williams (UK), Temporary
M. Schwartz (CE)	
	M. Choueiri (MI), Temporary
	G. Sidlauskas (NO), Temporary
	C. Todesca-Bocco (AG), Temporary
	J. Xu (CC), Temporary
	A. Raczko (SZ)
	S. Antic (SZ), Temporary
	W. Wesaratchakit (ST), Temporary

A.S. Linde, Acting Secretary
T. Orav, Assistant

Also Present
IBRD: I. Domac, C. Jungr. European Department: M. Deppler, M. Gorbanyov, B. Horvath, P. Sorsa, P. Thomsen. External Relations Department: L. Mboto Fouda. Fiscal Affairs Department: S. Cakir, D. Chua. Legal Department: R. Mundkur. Middle East and Central Asian Department: M. Zavadjil. Monetary and Financial Systems Department: V. Etropolska, N. Saker. Office of the Managing Director: A. Mazarei. Policy Development and Review Department: D. Donovan. Secretary's Department: P. Ramlogan. Advisors to Executive Directors: J. Haegeli (SZ), N. Yamasaki (JA), I. Zakharchenkov (RU).

2. SERBIA AND MONTENEGRO—REPORT ON NONCOMPLYING PURCHASES, BREACH OF OBLIGATIONS UNDER ARTICLE VIII, SECTION 5, AND RECOMMENDATION FOR WAIVER OF NONOBSERVANCE OF PERFORMANCE CRITERION; FOURTH REVIEW UNDER THE EXTENDED ARRANGEMENT, FINANCING ASSURANCES REVIEW, AND REQUEST FOR WAIVER OF PERFORMANCE CRITERIA AND MODIFICATION OF END-DECEMBER PERFORMANCE CRITERION

The Acting Chair (Ms. Krueger) noted that, before beginning the discussion of the Fourth Review under the Extended Arrangement, Financing Assurances Review, and Request for Waiver of Performance Criteria and Modification of end-December Performance Criterion, the Board needed to consider the Managing Director's *Report on Noncomplying Purchases, Breach of Obligations under Article VIII, Section 5*. Management planned to release a public statement on Serbia and Montenegro's noncomplying disbursement, and, based on standard practice, the statement would include a factual section, followed by a paragraph on the noncomplying disbursement. Following a brief discussion, Directors agreed with the proposed decisions on the Extended Arrangement—Report on Noncomplying Purchases, and Waiver of Nonobservance of Performance Criterion, and on the Misreporting of Information—Breach of Obligations Under Article VIII, Section 5 (see page 38). Directors then commenced discussion on the Extended Arrangement—Review, Financing Assurances Review, Waiver and Modification of Performance Criteria, and Rephasing of Purchases.

The staff representative from the European Department (Ms. Sorsa) made the following statement:

> This statement summarizes information that has become available since the issuance of the staff report for the fourth review under the Extended Arrangement (EBS/04/165, 12/01/04). The statement does not change the thrust of the staff appraisal in the report.
>
> Recently released macroeconomic data are broadly in line with projections in the staff report. Notwithstanding the recent moderation in wage growth, the rising inflation and further acceleration in private sector credit in October indicate continuing demand pressures:
>
> - The 12-month inflation rate in Serbia rose to 11.9 percent in November, and is now projected to reach 12–12.5 percent at end-2004.
>
> - Growth in economy-wide real wages in Serbia decelerated to 4.4 percent year-on-year in October, reflecting slowing nominal wage growth (from 21 percent in September to 18 percent in October) and rising inflation.
>
> - Credit growth in Serbia accelerated further in October, with real growth rates reaching 32 percent for total private sector credit and 101 percent for lending to households.

- Gross foreign assets of the National Bank of Serbia rose from $3,368 million (in constant exchange rates) at end-July to $3,826 million at end-November.

All prior actions for the review have been completed.

The 2005 budget—in line with program understandings—was passed by Parliament on November 20, 2004.

As to the tightening of conditions for consumer lending envisaged in the Memorandum of Economic and Financial Policies, the National Bank of Serbia informed the Fund staff that the majority of banks—representing 69 percent of total banking system assets—have amended their lending conditions by limiting the monthly payment-to-net income ratio to 30 percent and requiring a minimum down payment of 20 percent of the value of purchased goods.

Mr. Zurbrügg and Mr. Antic submitted the following statement:

The authorities of Serbia and Montenegro welcome the staff reports, which present a candid assessment of the main economic challenges. Our authorities broadly share the staff's assessment of policy options and the constraints regarding their implementation. They appreciate the continuation of the dialogue with the staff, which has helped in formulating an adequate policy response.

On the political front, a new pace will be established in strengthening relations between Serbia and Montenegro and the European Union on the basis of a two-track approach for Serbia and Montenegro's accession to the EU. The enhanced prospects of accession provide a clear goal and framework for moving ahead with reforms. The authorities of Serbia and Montenegro expect that trade arrangements with the EU concerning particular sectors will be concluded soon.

Since our last discussion, the current political environment in Serbia and Montenegro has slightly improved. The Serbian minority government has recently obtained confidence votes in parliament on three occasions. Despite a generally difficult political environment, the authorities were able to move forward with important reform laws.

While the current Fund-supported program deals with a number of outstanding problems of a structural nature, it also must preserve macroeconomic stability. This makes the task of policymakers very challenging. The complexity of the problems has led to the prolonged discussions between the authorities and the staff on this review. However, it is clear that reforms have regained momentum in the second-half of 2004, which can be observed from strong fiscal adjustment, the revival of privatization, and the beginning of utility sector restructuring.

Recent Developments

The growth rate in 2004 is higher than previously projected and will reach 6 percent, due to a rebound of industrial production and strong agricultural output. The rebound in industrial production is important, as it originates from privatized firms. Another characteristic of this industrial growth is that it is broadly based, providing some reassurance that high growth rates will continue in the future. The service sector has remained vibrant.

Inflation in Serbia will be higher than projected and will reach the double-digit range in 2004. High domestic demand and one-off exogenous shocks were behind the surge in inflation. It is expected that inflation in 2005 will fall under 10 percent and gradually decline to low single digits over the medium term. Inflation in Montenegro continues to decline and will remain below 3 percent in 2005.

The current account deficit deteriorated further and will reach 13 percent of GDP in 2004. The authorities are well aware of the risks associated with this development. In the short term, they are responding by restraining domestic demand through a policy mix of strong fiscal adjustment, prudent incomes policies, containing rapid credit growth, and improving the competitiveness of the traded goods sector. In the long term, the only viable means to increase exports is through structural reform of the real sector.

Fiscal Policy

Fiscal policy in 2004 has been geared to curb inflation and safeguard the external position. This orientation will continue in 2005. The strong fiscal adjustment of 3 percent of GDP (including redundancy payments) over 2004 and 2005 is being achieved mainly through expenditure cuts. Revenues are broadly in line with the program targets, while expenditure has been under tight control in the second-half of 2004. The shift toward indirect taxes is continuing and will receive an additional push with the introduction of the value-added tax in Serbia on January 1, 2005.

The rationalization of expenditures in Serbia is based on the plan that all non-interest current expenditure items will be scaled back as a percentage of GDP. Wages and subsidies are carrying the brunt of the expenditure cuts executed in the second-half of 2004 and those planned for 2005. The law governing labor relations in public institutions will be amended to facilitate the reduction of the work force and increase labor mobility in the public sector. To facilitate re-employment of retrenched workers, budgetary support of active labor market policies will increase in 2005. A cut of subsidies by 0.5 percent of GDP in 2005 should initiate faster restructuring of the real sector. A push in the same direction will come from the Transition Fund, which will sharply increase coverage of the costs of redundant workers.

Next year will be the first in which Serbia will post a positive overall balance (excluding Foreign Loans Finance Projects). Although it amounts to only 0.1 percent of GDP, the surplus is an important sign that the country has started to create adequate resources for repaying public loans.

Total and tax revenues are projected to decline in 2005, thus signaling the reduction of the state's role in the economy. Lower taxes, together with a shift in the tax burden from labor to consumption, should have positive effects on growth, savings, and job creation. The elimination of the distortionary Financial Transaction Tax and fees and taxes on securities transactions in January, 2005, as well as a reduction of the corporate income tax, will create a more conducive business environment.

Fiscal adjustment in Montenegro is based on expenditure cuts. The high level of non-discretionary spending will be reduced mainly through cuts in employment financed from the budget. Discretionary spending (subsidies and net lending) will also decline. To safeguard the deficit target, the authorities will make any revenue reducing tax policy changes conditional on the availability of adequate revenues or offsetting measures.

Monetary Policy

The tightening of monetary policy began in mid-2004 with the objective of curbing the widening current account deficit and growing inflation. The National Bank of Serbia (NBS) raised the interest rate on its bills in June and increased reserve requirements by 3 percentage points in August. A similar policy of tight credit control will prevail in 2005.

The monetary authorities are well aware of the risks that credit growth poses to macroeconomic stability. The rapid credit expansion, particularly the strong increase in lending to households, has contributed to the widening of the current account deficit. While some of the increase in credit growth can be explained by financial deepening and normal cyclical upturns, as the credit to GDP ratio is still low by regional standards, there is clearly an important excessively cyclical component. The authorities agree with the staff that swift action is needed to contain the risks stemming from excessive credit growth. As a response, they are introducing a package that contains the following measures:

- The NBS will broaden the reservable asset base. This measure should help remove a bias in favor of foreign-sourced funding, by including as reservable assets the stock of commercial banks' foreign borrowing of maturities of up to 4 years and all new foreign borrowing.

- The NBS issued a guideline to banks on consumer credit that recommends a limit on the monthly payment-to-net income ratio and requiring a down payment.

- The NBS will prepare a detailed loan survey, which will include analysis on the basis of industry, currency, and term structure. Detecting balance sheet problems before they impact the economy will help contain external vulnerability.

As a sign of reduced regulatory forbearance, banking supervision has been strengthened by more frequent on-site supervision. The monetary authorities will be strict in enforcing existing regulation on minimal capital requirements and will withdraw the license of banks with inadequate levels of capital. The state's influence in the banking sector will be further reduced by the upcoming finalization of further sales of public banks.

The NBS will continue with its flexible exchange rate policy that requires a careful balance between the objectives of reducing external imbalances and lowering inflation. The flexibility of the exchange rate will contribute to an improvement in competitiveness, while at the same time strengthening confidence in the dinar.

Structural Reforms

The key challenge in the real sector remains the creation of a conducive business climate and the improvement of growth and export performance through privatization. The reduction of the tax burden in 2005, the acceleration of privatization efforts, and improvements to the bankruptcy framework are crucial in this regard. The privatization of socially-owned companies and restructuring of public utilities is regaining momentum, supported by cuts in subsidies and clearly defined resources for redundant workers. In socially-owned sectors, well-established auctions and tenders are now operational for viable companies, while an effective bankruptcy procedure will soon be put in place for ailing companies. A third component of the effort to accelerate privatization is debt workout for large, heavily-indebted socially-owned enterprises. Amendments to the Privatization Law will enable the write off of enterprises' debt to state creditors and public utilities, conditional upon the actual sale or final bankruptcy.

The restructuring of state-owned companies will combine hard budget constraint measures (subsidy cuts and strict wage controls) with measures that introduce competition and improve efficiency. A significant work force cut is planned in 2005. The regulatory framework for natural monopolies will be in place at the end of 2004 with the creation of an independent regulatory agency.

London Club Negotiations

The negotiations with the London Club were completed in September 2004. The agreement implies the reduction of Serbia's debt to commercial banks by 62 percent, which the Paris Club accepted as a broadly comparable treatment with its own debt relief. On November 1, 2004, Serbia made its $40 million goodwill payment into an escrow account, while

reconciliation is close to being completed. Approximately 94 percent of the eligible creditor claims have been fully reconciled. Serbia was also assigned a B+ rating by Standard and Poor's, which applies to both the sovereign and new bonds that will result from the proposed London Club exchange. The authorities expect to launch new bonds during the first quarter of 2005.

Conclusion

The authorities of Serbia and Montenegro are fully aware of the complex nature of the transition challenges that the country is facing, and of the downside risks to the Fund-supported program. They want to emphasize their full commitment to preserving macroeconomic stability and speeding up structural reforms. In line to their commitment to transparency, the authorities of Serbia and Montenegro consent to the publication of the staff report.

Mr. Padoan and Mr. Cipollone submitted the following statement:

We thank the staff for the well-written document and Mr. Zurbrügg and Mr. Antic for their preliminary statement that clarifies the strategy of the authorities in the coming months. After the third review, the situation remains quite critical. More substantial and decisive actions are needed for the economy to jump onto a more sustainable path. We share the staff's concerns on the large downside risks that might materialize if the identified policies are not fully implemented in a timely manner.

Fiscal Policy

Continuing with a tight fiscal policy is key to reversing the large and widening current account deficit. In this respect, we fully agree with Messrs. Zurbrügg and Antic that the projected 3 percent fiscal deficit cut (excluding redundancy payments) over two fiscal years (2004 and 2005) is essential. We also recognize that this target is ambitious, taking into account the efforts already made, mainly by Serbia, and the commitment to further spending cuts, including on the wage bill and subsidies. However, we urge the authorities to remain committed to this plan and to be prepared for further tightening, if needed. The planned tax cuts in Montenegro, and the shift of tax burden towards indirect tax in Serbia, raise concrete uncertainties on their overall capabilities to reach such fiscal targets. We agree with the staff that tax cuts should either be postponed or take place in more than one stage.

Monetary Policy

The current credit expansion is worrisome. The ongoing "euroization" of the economy clearly puts a limit on the capacity of monetary policy to contain credit expansion. We agree that supervisory capabilities should be strengthened and regulatory and prudential standards should play a larger role to prevent

liquidity and solvency risks implied in the current euroization process. However, can the staff comment on whether an approach based on ceilings on debt servicing capacity, as was adopted in the case of Romania and recently proposed for the Czech Republic, could be applied in Serbia and Montenegro?

Exchange Rate Regime and the Debt Sustainability Analysis

As stressed several times, we believe that the exchange rate policy is overburdened by pursuing domestic and external objectives. In the Memorandum of Economic and Financial Policies, we noted the authorities' willingness to give to "the exchange rate policy more flexibility to contribute to improving competitiveness." Since the external debt level remains quite high, even after the expected final tranche of debt relief to be granted by the Paris Club in 2005, we are concerned by the sharp increase that might be caused by a depreciation, as highlighted by the stress test on page 94 of the staff report.

Structural Reforms and Competitiveness

Notwithstanding the very high level of imports, the weakness in the current account is a source of concern, because of the absence of a significant improvement in the export side, which reflects a lack of progress on the structural front. Gains to competitiveness will have to be secured both by gradual and credible disinflation, and progress with respect to the production base. With real wages rising faster than productivity, a tightening of incomes policies is welcome. However, sustainable growth will have to rely on substantial improvements on the supply side. Measures suggested in Box 1 of the staff report are a step in the right direction. By implementing these policies, Serbia and Montenegro would be in a far better position to exploit the benefits of the prospect of deeper integration with the European Union than it has to date.

Financing Gap in the Coming Years

The external financing needs for the coming years are quite substantial, even after the foreseen substantial increase in assistance from bilateral donors. Can the staff comment on how the authorities intend to finance this gap?

Mr. Meissner and Ms. Reichenstein submitted the following statement:

We support the conclusion of the fourth review under the Extended Arrangement, including the Financing Assurances Review and the waiver for nonobservance and modification of performance criterion. With four (out of ten) end-June and two end-September performance criteria missed, program performance has only been mixed. However, due the authorities' efforts to correct the slippages, we support the waiver. While we can agree to a waiver for noncomplying purchases, we do not regard the deviation from the previously reported data as minor (0.2 percent of GDP), especially with a view to the

important role of fiscal consolidation under the Fund-supported program. On the other hand, we acknowledge the corrective measures taken by the authorities.

Macroeconomic developments in Serbia and Montenegro have been mixed. While the recent pick-up in growth is welcome, we are concerned about rising inflation and the widening of the current account deficit. The authorities' recent policy shift to a more restrictive fiscal and monetary policy stance, and the intended acceleration of structural reforms, are steps in the right direction. It is also encouraging to learn from Mr. Zurbrügg's and Mr. Antic's preliminary statement that the authorities were able to move forward with important reform laws, despite a generally difficult political environment. The main challenge for the future will be to reach parliamentary consensus to move ahead with necessary reforms.

We commend the authorities for their strong commitment to fiscal consolidation. Given its impact on demand, inflation, and external imbalances, fiscal policy continues to be a political priority. The recently adopted supplementary budget allowed for a considerable reduction of Serbia's fiscal deficit. Furthermore, the authorities have successfully turned their policy focus toward expenditure rationalization, thereby providing the basis for an overdue reduction in the public spending ratio. However, a more comprehensive approach is needed in order to gain fiscal sustainability. Recent expenditure cuts concentrated on the small, but essential, category of capital spending, while current transfers and subsidies, as well as the wage bill, all accounting for a considerably large part of the budget, have practically remained unchanged. Even if the 2005 budget implies larger cuts in non-priority spending, these could be insufficient, especially against the backdrop of revenue uncertainties resulting from recent tax reforms. Thus, containing the growth of social transfers, streamlining public employment, and containing the public wage bill will be indispensable to reach a solid fiscal policy stance.

The current account deficit for 2004 and 2005 continues to be a major cause for concern. With exports per capita among the lowest in the region, competitiveness needs to be improved by pursuing prudent fiscal and monetary policies, accompanied by indispensable structural reforms. In particular, as Serbia and Montenegro's labor costs are higher than in most of the region's European Union accession countries, cost-competitiveness should be improved by adequate wage setting. In this regard, the authorities' plan to keep wage increases below inflation is welcome. In addition, we note that paragraph 8 of the staff report asserts improved competitiveness will boost exports in 2005. However, it remains unclear what will trigger this improvement. Can the staff comment on whether an implicit assumption is being made for a stronger depreciation of the real exchange rate in 2005 than in 2004, when the dinar only marginally depreciated in real terms?

Serbia and Montenegro's long-term fiscal stability will largely be determined by progress with structural reforms. Therefore, we support the staff's call to move ahead with the restructuring and privatization of state-owned enterprises. The restructuring of the large number of the socially-owned enterprises, whose inefficiencies constitute a major burden on the budget, should be accelerated.

We welcome the authorities' success in fighting inflation in recent years. Moreover, with actual inflation regaining momentum, the authorities moved to a restrictive monetary policy stance by raising required reserve ratios. Additional regulatory measures might become necessary to dampen credit growth, which is mainly driven by foreign currency borrowing. The authorities should stand ready to tighten conditions promptly, should credit growth fail to decelerate as programmed.

Given Serbia and Montenegro's dependence on a continued inflow of foreign direct investment (FDI), it is important to improve the business climate. Past years' FDI inflows contributed to a large extent to the financing of the current account deficit. However, in 2004, FDI slightly decreased, thus indicating a decrease in privatization revenue.

With growing concerns about external debt dynamics and resulting financing risks, debt restructuring with the London Club creditors was one of the key requirements of past reviews. Against this backdrop, we welcome the July London Club agreement. However, as pointed out by the staff, the positive effects from the July London Club agreement are largely compensated by the unfavorable widening of the current account deficit and an increasing share of (foreign) debt-financing. The increase in foreign borrowing is a matter of concern and should be carefully monitored.

Mr. Oh and Mr. Seong submitted the following statement:

Key Points

- We commend the authorities on progress toward the rationalization of budget spending, and welcome the recent pick-up in privatization and restructuring of banks and socially-owned enterprises.

- Further efforts are needed to press ahead with structural reforms.

- The authorities need to provide a supportive macroeconomic and regulatory environment to encourage the private sector to grow, and to diversify the export base.

- The authorities' bold plans for tight wage discipline and retrenchment in state-owned enterprises is welcome.

- Further strengthening of supervision is required, and the authorities should stand ready to tighten credit market conditions promptly.

We thank the staff for the informative report and Mr. Zurbrügg and Mr. Antic for their clear and helpful preliminary statement. Amidst challenging political conditions, significant progress has been made toward the rationalization of budget spending, and we welcome the recent pick-up in privatization and restructuring of banks and socially-owned enterprises. Therefore, we wish to limit our comments to highlight some issues related to structural policy and the current account deficit.

It is certainly disappointing that several performance criteria were missed despite the staff's assessment that performance under the Fund-supported program is broadly on track. Having said that, we commend the authorities for the progress that has been made, and welcome the authorities' firm commitment to accelerate restructuring and privatization in 2005. We note that bank reform and privatization will certainly enhance the impact of increased financial intermediation on growth. Accelerating the privatization and restructuring of socially-owned enterprises is also critical for improving export performance and achieving rapid and sustainable growth. While reform implementation, in particular, the stricter incomes policies and enterprise restructuring, will be a challenge for the minority government, and the required employment cuts could lead to social tensions, further efforts are needed to press ahead with structural reforms.

We are concerned about the deterioration of the current account balance since 2002, and the persistently large deficit in the coming years, despite adjustment. In addition to the measures designed to speed up structural reforms in order to boost productivity and competitiveness, the authorities need to provide a supportive macroeconomic and regulatory environment to encourage the private sector to grow and diversify the export base. The significant progress on resolving outstanding issues with the European Commission in relation to the sugar trade, and on bilateral Free Trade Agreements with neighboring countries such as Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Moldova, and Romania, is particularly welcome. We look forward to the finalization of the trade agreement to liberalize trade in textiles with the European Union, and the conclusion of the WTO accession process.

In order to help keep wage growth below productivity growth, we are encouraged by the authorities' bold plans for tight wage discipline and retrenchment in state-owned enterprises. We note that average wages, at 190 euro per month in Serbia and Montenegro, are higher than in most of the region's EU accession countries. We wonder to what extent higher wages have driven strong import growth. The growth rate of imports has risen drastically since the third-quarter of 2003, with the imports of consumer goods increasing. However, it appears the composition of imports has not changed significantly during this

period (figure on page 10 of the staff report) and we would welcome staff's comments.

We share the staff's view that supervision needs to be further strengthened, and the authorities should stand ready to tighten credit market conditions promptly should credit growth fail to decelerate as programmed. Real credit growth (28 percent in the year through September in Serbia and 40 percent in the year through August in Montenegro), with most loans denominated in, or indexed to foreign currency, is significant enough to raise concerns about the credit risks for banks, while the supervisory capacity of the National Bank of Serbia (NBS) is only being gradually strengthened. We were encouraged to see that the NBS has issued guidelines to banks on consumer credit, recommending a limit on the monthly payment-to-net income ratio and requiring a down payment, in the preliminary statement. However, in addition to these microeconomic measures, it is most desirable that, in the not-too-distant future, macroeconomic techniques be adopted to deal with this issue, including further interest rate increases or tighter aggregate capital requirements on household loans by banks (against the background of surging credit growth to households).

In conclusion, we support the completion of the fourth review under the Extended Arrangement and Financing Assurance Review, including the request for waiver and modification of the performance criteria.

Mr. Silva-Ruete and Ms. Todesca-Bocco submitted the following statement:

We thank the staff for a well-written set of papers, and Mr. Zurbrügg and Mr. Antic for their candid preliminary statement. Serbia and Montenegro's macroeconomic performance has been satisfactory but mixed, with GDP increasing at a higher pace than expected (6 percent and 5 percent envisaged for 2005 and 2006 respectively), inflation higher than forecasted, and a widening current account deficit, estimated to reach 11 percent of GDP by the end of 2004 (9.6 percent after grants). The current account deficit is largely explained by strong import and insufficient export growth. The staff points out that the response in terms of fiscal, monetary, incomes, and structural policies is adequate, although subject to considerable implementation risks. The staff also describes the political situation as fragile and promotes an extensive structural reform agenda.

We would like to provide the following comments regarding the main challenges facing the authorities during the process:

Competitiveness

Export growth remains the lowest in the region. The staff report indicates that exports are equal to only about one-third of imports. Additionally, the strong increase in imports is largely explained by consumer goods that are not related to investment projects—i.e., an increase in production capacity. The staff report

suggests that both real depreciation and structural reforms would be needed to improve the economy's competitiveness and make the external balance sustainable.

In our view, it is necessary to differentiate short-term stabilization policies from long-term structural reforms. Current account imbalances may result from exchange rate misalignment and/or excessive domestic absorption requiring short/medium-term adjustments, but also from more deeply-rooted factors, such as an undiversified export structure. In the short term, the financial impact of currency devaluation should be taken seriously into consideration, since it may lead to insolvency. Given the existence of significant currency mismatches and the likely contractionary effect of devaluation, monetary and fiscal policies should probably not be overly austere, lest they result in disorderly balance sheet effects. Moreover, they may inhibit the investment needed to improve exports performance.

In the long run, the right structural reforms need to be put in place. Many developing countries are essentially characterized by underdeveloped export sectors with non-diversified export structures, mainly based on natural resources. Fostering and diversifying exports is one of the key elements of economic development. At the same time, high consumer goods imports are also a structural problem among less developed economies. Although real depreciation can certainly help to reduce imports and boost exports (assuming feedback effects from currency mismatches are under control), Serbia and Montenegro needs to develop a deliberate export strategy to ensure long-term current account sustainability. In addition, adequate excise taxation could be considered to discourage consumer imports. As noted above, competitiveness and investment are closely related. The ratio of domestic investment to GDP is approximately 16 percent, which seems a rather low for a driving force of the real economy.

Prudential Regulation

The continuing euroization of local balance sheets increases the currency risk in both the enterprise and banking sectors. Our main concern regards borrowers' exposure to exchange rate devaluation and their future ability to service loans denominated in, or indexed to foreign currency. We concur with the need to reinforce regulatory powers to avoid currency mismatches.

Structural Reforms

In the field of structural reforms, we would like to emphasize the importance of the consistent regulation of natural monopolies, particularly as regards public utility companies. The impact of sound regulation in such key sectors on competitiveness cannot be stressed enough. Adequate regulatory legal frameworks are difficult to achieve overnight. Hence, just as in the case of other structural reforms, sequencing must be taken into consideration. Privatization

should probably only be pursued once proper legal frameworks, including the establishment of professional and independent regulatory agencies, are in place.

Social Impact

There are risks associated with structural reforms in terms of employment and income distribution. The transition from a centrally-planned to a market economy entails large-scale reallocation of labor, which implies massive job destruction and creation. As correctly stated in the staff report, both stricter income policies and enterprise restructuring comprise serious challenges for the government, "especially in terms of employment cuts that could lead to social tensions". Although the report points out that safety net and active labor market polices (with World Bank participation) will be reinforced, there may still be some room for sequencing structural reforms and reinforcing social safety nets. It has been the experience of some economies that redundant employment in state-owned enterprises is not easily reabsorbed by the private sector. An additional effort may have to be undertaken with assistance from international financial institutions to help Serbia and Montenegro during this painful process. Unemployment benefits, severance payments, and active labor market policies (micro credit programs, labor training, and job search support) must be in place and running before the process starts. This is particularly significant given the country's already high unemployment rate (above 30 percent). A worsening of unemployment in Serbia and Montenegro's at the current time could exacerbate social unrest.

Finally, we would like to congratulate the authorities for their negotiations on settling pending arrears. We support the authorities' requests, and wish them the best of results.

Mr. Steiner and Mr. Cobos submitted the following statement:

We deem as very positive the news that Serbia and Montenegro's estimated growth for 2004 will be stronger than projected, supported by robust domestic demand. Strong demand is the result of rising real wages and credit growth, which have in turn fueled inflation as well as imports. The latter has caused the external current account deficit to widen to worrisome levels. In addition, exports remain low as a percentage of GDP, owing in part to inefficient state-owned enterprises. Despite the renewed pace of reform, we are somewhat concerned with the implementation of the Fund-supported program given the government's limited support in congress.

While we praise the authorities for cutting back fiscal spending in order to curtail aggregate demand and help bring down inflation, we note that wages in the public sector have continued to increase. The government announced that initial steps will be taken in early 2005 to help centralize the payroll system to permit greater control over the wage bill. We encourage the authorities to stage a

complete civil service evaluation, which should shed light on the right size and objectives of the public work force. On the revenue side, the introduction of the value-added tax and the reduction of other taxes should encourage savings, investment, and incentives to work. In Montenegro the authorities have dismissed advice to curtail additional spending before tax reforms are implemented. Instead, they have decided to go ahead with the announced tax changes and a limited plan to freeze the wage bill. Deficient coordination between Serbia and Montenegro could be damaging for the implementation of a sound fiscal policy in the future.

The main concern at the macroeconomic level is that real wages are rising faster than productivity. Wages in euro terms are higher than in neighboring countries due to an overly-appreciated dinar. All these effects make the export sector very fragile, posing risks to medium- and long-term economic development. Structural reforms should focus on a gradual depreciation of the local currency and on reforms to enhance competitiveness, including a better aligning of the wage increases to developments in productivity.

The real growth of money is a sign of confidence in the financial sector. However, high credit growth is a source of concern, as it is mainly directed towards consumption. In turn, excess liquidity in banks is based on foreign currency indexed borrowing. These dynamics could jeopardize the health of the financial system in the event of a serious erosion of the credit portfolio. Therefore, we welcome the decision to broaden the reservable base to include commercial banks' foreign borrowing of up to four years and all new foreign currency borrowing. These measures should help contain credit demand by raising real interest rates and by removing the bias favoring banks' foreign borrowing. At the same time, efforts should be made to strengthen the National Bank of Serbia's supervisory powers and to promote competition.

In view of the authority's strong commitment to the program, we support the completion of the fourth review and the request for a waiver. We agree with the Managing Director's recommendation on the noncomplying purchase, given the prompt corrective actions put in place and the measures adopted to avoid any future reoccurrence.

Mr. Mozhin and Mr. Zakharchenkov submitted the following statement:

We commend the staff for the clear and concise report and Mr. Zurbrügg and Mr. Antic for their helpful preliminary statement. The country's performance under the Fund-supported program has been mixed. Generous wage increases have fueled import growth and pushed up inflation, while exports remain sluggish due to slow progress in the implementation of structural reforms. As a result, the current account deficit widened to 13 percent of GDP and inflation accelerated to an estimated 12-12.5 percent by the end of this year. The authorities have responded by tightening monetary and fiscal policies beyond program commitments. However, several quantitative and structural performance criteria and benchmarks were not

observed, although some were met with a delay or missed by a small margin. We understand that the authorities, perhaps, did their best in a difficult political environment, and support their request for waivers and modification of end-December performance criterion.

With respect to the noncomplying purchases, the issue of a breach of performance criterion on net credit of the banking sector to the consolidated general government had already been reported to the Board in July, but the information on the amount of deviation was not correct at that time. Since the authorities have already implemented steps to avoid the occurrence of such incidents in the future, we agree with the overall assessment of the Managing Director that no action should be taken by the Executive Board with respect to the noncomplying purchases.

Looking ahead, we agree with the policies outlined in the Memorandum of Economic and Financial Policies for the period ahead, and wish to highlight three areas that warrant particular attention by the authorities, namely, fiscal policy, rapid credit growth to the private sector, and the need to accelerate structural reforms.

We welcome the authorities' commitment to tighten fiscal and income policies to cool off domestic demand and improve the external position. The envisaged fiscal deficit reduction by 3 percentage points of GDP in 2004–05 is very impressive. We noted that fiscal adjustment thus far had been achieved mainly through cuts in capital spending, while current transfers, subsidies, and the wage bill have remained largely unchanged. In this regard, the envisaged rationalization of spending, including on the wage bill and subsidies in 2005, is commendable. Like other Directors, we are concerned about uncertainties surrounding the 2005 budget deficit target in Montenegro as a result of the ongoing tax reforms. We urge the authorities to implement additional expenditure cuts, if necessary, to achieve program objectives. Finally, we noted that fiscal deficits in both Serbia and Montenegro in 2005 are expected to be financed by a large extent through foreign financing and privatization receipts. We wonder whether the authorities have any contingency plans in case these sources of financing do not materialize as envisaged, especially with regard to privatization receipts.

Rapid credit growth to the private sector in both Serbia and Montenegro is a source of concern. Steps proposed by the monetary authorities to address this issue, including broadening the reservable asset base, new guidelines to banks on consumer credit, and increased supervision, are appropriate.

Acceleration of structural reforms is critical in order to improve the competitiveness and the export performance of the economy. The authorities' commitment to speed up privatization and restructuring of socially-owned enterprises is welcome. Proposed reforms aimed at strengthening bankruptcy procedures and restructuring public utilities are also steps in the right direction.

With these remarks we support the proposed decisions and wish the authorities well.

Mr. Kremers and Mr. Croitoru submitted the following statement:

Key Points

- The envisaged tightening of fiscal policy in Serbia and Montenegro through a non-priority spending cut is appropriate. Capital expenditure cuts should be reversed in upcoming years.

- We support the measures aimed at increasing the cost of credit and containing debt build-up. More formal requirements for prudential regulation would have better served the program goals, and enhanced supervision is needed.

- Incomes policies are critical for taming domestic demand and wage pressures, and helping competitiveness in Serbia.

- Progress in enterprise privatization and restructuring remains the main challenge. More attention should be paid to inter-enterprise arrears and tax arrears, as they appear to undermine macroeconomic policies.

General

Despite the nonobservance of some end-June and end-September performance criteria by a small margin, Serbia and Montenegro have progressed in implementing their economic program. In view of the already implemented policy measures, and of the envisaged policy actions, we support the proposed decision. It is encouraging that structural reforms have been reinvigorated recently, and since mid-year fiscal and monetary policies have been strengthened beyond program targets to contain external imbalances and inflation. However, while the current account deterioration and higher-than-programmed inflation can partly be explained by exogenous factors, they point mainly to fundamentals, particularly slow structural reforms and a weak wage policy.

It appears that the impetus for the macroeconomic adjustments beyond original program targets to preserve macroeconomic performance and contain risks has been the need to compensate for slower progress in the structural area. Delays in accelerating substantial structural reforms aimed at hardening budget constraints will be reflected in slower economic growth. While slow structural reforms are explained by the fragile political situation, they are also linked to the existence of vested interests. Can the staff comment on whether the latter might be better addressed by enhancing conditionality of the program with respect to enterprise restructuring?

More attention should be paid to inter-enterprise and tax arrears, as they appear to undermine macroeconomic policies. We note that two-thirds of excess inflation, as compared to program targets, is explained by domestic factors, particularly wages. Wage increases have also contributed to the widening of the current account deficit. Moreover, wage increases beyond productivity in socially-owned enterprises seem to have been made possible by arrears build-up and subsidies. From this perspective, we welcome the envisaged curtailment in subsidies by 0.5 percent of GDP, and invite the staff to provide information on the current status and main features of the authorities' plans to reduce enterprise arrears to the budget. Moreover, even with a strong plan to reduce tax arrears, it is possible for state-owned enterprises—as experience in other countries has shown—to move arrears to utilities (especially electricity and heating producers) and, thus, indirectly back to the budget. Did the staff discuss with the authorities the possibility of imposing a ceiling on enterprise arrears to the energy sector? Perhaps the staff could also provide an overview of developments with regard to inter-enterprise arrears and tax arrears in Serbia and Montenegro, particularly as a percent of GDP.

Fiscal Policy

We welcome the envisaged tightening of fiscal policy in Serbia and Montenegro and note that, as compared to the previous review, the authorities have programmed for a spending cut to play a significant role in the 2005 budget deficit reduction. It is also commendable that in Serbia spending on subsidies and the wage bill will be reduced to allow for higher resource allocation for enterprise restructuring, active labor market policies, and safety net reinforcement. We support the staff's view that capital expenditure cuts should be reversed in upcoming years, and encourage the authorities to proceed vigorously in enhancing public expenditure management, implementing public employment reform, and reducing tax arrears. We also welcome the authorities' readiness to further tighten fiscal policy if the current account deficit does not decline as envisaged.

In Serbia, the authorities' orientation to shift towards indirect taxes, which will encourage savings by lowering the tax burden and increasing efficiency, is consistent with the need to restrain the current account deficit. With the new tax structure in place, efforts should focus on tax administration reform to improve tax compliance and reduce the gray economy.

Monetary and Exchange Rate Policy

The envisaged monetary tightening and prudential measures are welcomed, but supervision should be further strengthened. We support the measures aimed at increasing the cost of credit and containing debt build-up. With respect to prudential regulations for consumer lending, we agree with the staff that more formal requirements would have better served program goals. We also think that supervision should be enhanced, including by initiating supervision of

leasing activities, to make sure that banks' balance sheets remain sound during a period of strong credit growth. To set the stage for efficient supervision, compliance with existing prudential requirements should be reinforced.

We agree that, given the large and growing current account deficit, the exchange rate will need to continue to balance the objective of reducing both inflation and the external deficit. In this light, the exchange rate should be able to adjust to current account, wage, and inflation developments.

Wage Policy

Given the low impact of monetary policy in a highly-euroized economy, incomes policies are critical for taming domestic demand and wage pressures in Serbia. The wage policy for 2005 is also central to increasing the competitiveness of the economy. In this light, we welcome the authorities' decision to keep wage increases below inflation in both the budgetary sector and state enterprises, and to treat the wage bill ceiling on the monitored public utilities as a performance criterion from end-December 2004. Can the staff can indicate whether the authorities are ready to strengthen the credibility of the wage bill target in case that signs emerge that the respective targets will not be reached?

Structural Policies

Progress in enterprise privatization and restructuring remains the main challenge on the road to a market-based economy. In addition to the progress made in adopting the new bankruptcy law and allowing an increase in average electricity prices, more difficult reforms need to be implemented. The privatization and restructuring process in socially-owned enterprises is expected to accelerate with the entry into force of new bankruptcy procedures. However, the law will not be fully operational until an appropriate institutional framework is in place. Can the staff can elaborate on the urgent need for a Bankruptcy Supervisory Agency and a Bankruptcy Unit under the Privatization Agency, in particular, their roles as compared to economic courts? The government should also support this process by implementing further cuts in subsidies and a stricter policy against tax arrears. We welcome the plan to restructure large public enterprises, in particular, in the energy, railway, and telecommunications sectors.

Mr. Gakunu and Mr. Nintunze submitted the following statement:

We thank the staff for a balanced report and Mr. Zurbrügg and Mr. Antic for their insightful preliminary statement. We find the Serbian and Montenegrin authorities' efforts to implement their reform program convincing, despite a sensitive political environment. We commend them for their satisfactory economic performance. In particular, we are pleased to note real GDP is expected to grow more robustly than programmed in 2004 and financial intermediation has deepened, reflecting growing confidence in the economy due to prudent policies

followed over the past years. We observe, however, that inflation has exceeded program goals, in part due to increased wages and higher oil prices, while the external current account deficit aggravated, reflecting also in part the impact of higher oil prices, as well as sluggish exports.

Looking ahead, a key challenge for the Serbian and Montenegrin authorities is to further strengthen the implementation of macroeconomic policies capable of containing risks associated with the widening of the external current account deficit. Other important challenges include resurgent inflation and the need to accelerate structural reforms. In this regard, we welcome the authorities' determination to tighten fiscal, monetary, and incomes policies beyond program commitments, and to step up structural reforms, all necessary to reduce domestic demand, adjust to the oil-shock, and improve export competitiveness.

In view of mitigating external risks, the 2005 fiscal program targets a lower budget deficit than in the initial Fund-supported program, which is commendable. In this regard, the envisaged fiscal reforms are appropriate, as they aim at improving efficiency of the taxation system, including a shift to indirect taxes with the introduction of the value-added tax, as well as substantial restraint in recurrent spending, namely, on wages and subsidies. We also note that, notwithstanding these cuts, the budget takes into account safety nets to lessen the social costs of transition reforms, including necessary payments to support public administration reforms.

With regard to monetary and exchange rate policies, we welcome the progress made to tighten monetary policy, including the measures implemented since August to contain credit growth and to limit external risks. We encourage the authorities to further strengthen banking sector supervision, including an increase in the reserve requirement to support tightening in credit conditions, by both broadening the reserve base to foreign borrowing by banks, as well as issuing the guidelines on prudential rules for consumer credit.

The exchange rate policy has been appropriate in balancing external and inflation objectives. While awaiting the exchange rate review in the forthcoming Article IV consultation, we encourage the authorities to maintain the current stance of promoting economic competitiveness and preserving price stability.

We note that the authorities' structural reform agenda remains substantial and appropriate to develop the private sector, improve economic competitiveness, enhance fiscal and external sustainability, and bolster growth. The authorities have rightly stepped up the pace of reforms since mid-year by adopting number of critical reform laws, including those on the energy sector, the value-added tax, and bankruptcy. We encourage the authorities to accelerate the implementation of their reform program, including the restructuring and privatization of state-owned enterprises.

We support the proposed decisions and wish the authorities continued success in all their endeavors.

Mr. Wang and Mr. Xu submitted the following statement:

We thank the staff for the comprehensive papers, and Mr. Zurbrügg and Mr. Antic for their informative preliminary statement. In a difficult political situation, implementation of the program in Serbia and Montenegro has been mixed. While growth in 2004 will exceed projections, both inflation and the current account deficit will be in double-digits, mainly driven by high domestic demand. The key challenge for the authorities is how to address the deep-rooted structural problems, while giving top priority to macroeconomic stability. Given the complexity of the transition issue, a coordinated and comprehensive policy package—fiscal and monetary policy together with structural reforms—is needed to achieve the goals of the current Fund-supported program. We are impressed by the authorities' strong determination and carefully-designed reform agenda, as underscored by Mr. Zurbrügg and Mr. Antic in their preliminary statement. To prevent the downside risks—correctly identified by the staff—from materializing, the authorities need to redouble their efforts to implement the reforms more forcefully.

Fiscal Policy

A tight fiscal policy is essential to combat growing inflation and a worsening current account deficit. To this end, we are encouraged that the strong fiscal adjustment of 3 percent of GDP over 2004–05 is being pursued, mainly through expenditure cuts. While recognizing its positive effects on savings, investment, and job creation, the authorities should also be aware that the proposed lower tax burden, shift to indirect taxes, and resulting lower revenue-to-GDP ratio will put implicit pressure on fiscal consolidation. We welcome the ongoing and future rationalization of outlays; expenditure cuts should focus on government spending, the wage bill, and subsidies.

Monetary Policy

As the authorities and the staff are aware, rapid credit expansion has contributed to the worsening current account deficit and growing inflation. To rein in credit expansion, the package introduced by the National Bank of Serbia (NBS)—broadening the reservable asset base, issuing a guideline to banks on consumer credit, and conducting a detailed loan survey—is timely and appropriate. We encourage the NBS to carefully examine the effectiveness of these measures, and to continue to monitor the development of credit growth. In light of the declining effectiveness of monetary policy under growing euroization, banking supervision is becoming increasingly important in mitigating the risks associated with rapid credit expansion. Some additional measures could be considered if credit expansion is still out of control.

Structural Reforms

The underlying deep-rooted weaknesses, which could undermine efforts to stabilize the economy, can only be addressed through comprehensive structural reforms. The lack of competitiveness in Serbia and Montenegro, as compared to other central and east European transition economies, to a large extent explains its deteriorating external position. Accordingly, we believe improving competitiveness should be one of the main targets of structural reform. We commend the authorities on their wide-ranging structural reform agenda—accelerating privatization efforts, improving the bankruptcy framework, and lowering tax burden—and believe it could improve competitiveness in the medium term. On the other hand, these reforms could also create favorable business climate and attract foreign direct investment—an important means of financing the current account deficit—and help improve fiscal sustainability by reducing socially-owned enterprises' reliance on the government budget.

Given the heavy external debt burden, we welcome the authorities' completion of negotiations with the London Club, which will also facilitate future dialogue with the Paris Club. Finally, we wish to express our support for the proposed decisions.

Mr. Sukada and Mr. May submitted the following statement:

We thank the staff for their balanced assessment and Mr. Zurbrügg and Mr. Antic for their insightful preliminary statement that clarifies the strategy of the authorities in the coming months. We commend the Serbian and Montenegrin authorities for their good progress and economic performance under the Extended Arrangement. We are encouraged by the higher-than-targeted growth rate in 2004, the continued strong growth prospects in the medium term, as well as the completion of all performance criteria, albeit with some delays. While supporting the proposed completion of the fourth review, we note that some of the structural benchmarks and indicative targets were not met, and hence join the staff in encouraging the authorities to enhance policy implementation.

As highlighted in the staff report, we concur that the widening of the external imbalance and the rise in inflation should be the main concern of the program going forward. In this respect, the fourth Extended Arrangement review has appropriately focused on macroeconomic policies and the advancement of structural reform.

In their efforts to contain the external imbalance, we welcome the authorities' measures to consolidate macroeconomic policy, especially through a significant fiscal adjustment of up to 3 percent of GDP for 2004–05, aimed at reducing the fiscal deficit from the original target of 1.3 percent to below one percent of GDP. Although the current account deficit would start improving in 2005 as a result of the fiscal adjustment, the risk of fiscal deficits still remains

large in the medium term. As such, the tightening of policy should be considered beyond the 2004–05 time frame, and be carried out appropriately in order to meet all intended targets. In this regard, we encourage the authorities to enhance the supporting fiscal reforms in tax administration, public expenditure management, public employment, and arrears monitoring.

While undertaking the fiscal tightening measures, the negative impact on pro-poor spending needs to be monitored closely. Accordingly, we support the authorities' stand in maintaining a soft cut of subsidies and the budgetary wage bill. Their planned nominal wage increase is also desirable if it supports public administration reforms by retaining high-caliber civil servants within the administration vis-à-vis private sector competition. However, given the need for infrastructure rehabilitation in the post-conflict period, we agree with the staff's recommendation that capital expenditure, which was projected to decline by 0.3 percentage points of GDP, needs to be increased in subsequent years.

On monetary policy, we welcome the NBS' plan to introduce repo operations in early-2005 to enhance the efficiency of open market operations and improve liquidity management. In addition, we support the focus on broadening the reservable base, which would increase the cost of credit, contain debt built-up, and remove the bias favoring lending financed by foreign borrowing. The increase of the capital adequacy ratio would also help increase the cost of credit. Given the highly-euroized economy, which would limit the impact of monetary policy, prudential measures to contain credit growth would play a significant role in containing the current account deficit. We commend the authorities on the introduction of alternative measures to contain the risks stemming from excessive credit growth, as highlighted in Mr. Zurbrügg's and Mr. Antic's statement. The authorities should place greater urgency on banks to adopt these guidelines together with any additional measures needed to curb excessive consumer credit growth as soon as possible, given that credit growth to households increased to 101 percent in October and not all banks have as yet adopted the stricter guidelines.

On the issue of competitiveness, as noted in Box 1, page 11, of the staff report, exports per capita in Serbia and Montenegro are among the lowest in the region. The staff's analysis also indicates that high labor costs and the appreciation of the real exchange rate have contributed to the poor export performance. As competitiveness is one of the major determinants of a country's export capacity, and a significant contributor to a country's current account deficit, we welcome the authorities' commitment to enhance the structural reforms as highlighted in the preliminary statement.

Apart from the above comments, we also support the proposed waiver of nonobservance of performance criteria, as they were missed by a small margin or adopted with a short delay, as well as the modification of the end-December

performance criterion. We are encouraged by the authorities taking measures to improve policy implementation in these areas.

Mr. Antic made the following statement:

I would like to reiterate that my authorities' regret for the case of misreporting. The misreporting occurred in second-half of 2003, when the Road Fund issued promissory notes. The problem was discovered in the second-half of 2004, when the accounts of the Road Fund were incorporated into the Treasury Single Account. My authorities want to stress that this incorporation into the Treasury Single Account will preclude similar behavior in the future, and all accounts of direct budget users are now under the control of the Treasury Single Account.

To further strengthen the control over the issuance of the public debt, provisions in the new public debt law will require a priori approval from the Ministry of Finance for any new borrowing by all public entities. In addition, the authorities are tightening internal control and auditing procedures. My authorities firmly believe that the measures they have taken will prevent the occurrence of similar cases in the future.

Mr. Srinivas made the following statement:

We thank the staff for their comprehensive report and Mr. Zurbrügg and Mr. Antic for their helpful preliminary statement. We agree with the thrust of the staff appraisal. Since the last review, we note that the political environment has improved; the government has won a confidence vote in parliament and the authorities have been able to move forward with important reform laws. The political goal of seeking European Union accession provides a clear framework for preserving macroeconomic stability and moving ahead with structural reforms.

We join Mr. Meissner and Ms. Reichenstein in observing that macroeconomic developments in Serbia and Montenegro have been mixed, with the pick-up in the growth rate accompanied by rising inflation and widening of the current account deficit. To address these challenges, tighter-than-programmed policies are required. We call for better policy implementation, given the mixed record of program performance that has witnessed four end-June and two end-September performance criteria being missed. The external vulnerability and macroeconomic program risks have increased with double-digit inflation and higher-than-program current account deficits reducing the favorable effects of the London Club agreement on debt dynamics. We note that the slow progress in enterprise restructuring has resulted in persistently low exports. A sustainable correction in external balances requires measures beyond demand management, including tightening of fiscal, monetary, and incomes policies.

On the fiscal front, we are encouraged by the authorities commitment to bring fiscal deficit to below 1 percent in 2005. However, revenue collections in the first year following the introduction of a value-added tax tend to remain subdued given the adaptability of small traders to documentation work, and greater efforts may be required on restraining non-priority spending. We join Mr. Padoan and Mr. Cipollone in saying that, given the ambitious fiscal adjustment being targeted, the planned tax cuts in Montenegro could be postponed or take place in more than one stage. That said, we welcome the elimination of the distortionary financial transactions tax in January 2005. The authorities plans for wage discipline and retrenchment in state-owned enterprises are subject to implementation risks, given that average wages, although higher than the region's other EU accession countries, are only 190 euros per month. We also join Mr. Sukada and Mr. May in saying that the tightening of fiscal policy should be considered beyond the 2004–05 time frame, and be carried out appropriately in order to meet all intended targets.

On the monetary policy front, rapid credit growth to the private sector requires close monitoring. Given the low impact of monetary policy in a highly-euroized economy, we support the authorities' efforts for increasing the capital adequacy ratio, guidelines on tightening conditions for bank lending, and introduction of stronger measures for monitoring the growth of consumer credit. We join Mr. Silva-Ruete and Ms. Todesca-Bocco on the need to reinforce regulatory powers to avoid currency mismatches to protect borrowers' exposure to exchange rate devaluation and their future ability to service loans denominated in, or indexed to foreign currencies.

The unbundling of the electricity company and restructuring of the railways would provide necessary boost to structural reforms. We invite the staff's comments on the amendments in the privatization law to write off enterprise debts to state creditors, and its impact on the balance sheets of banks and institutional financers. We call on the authorities for better targeting of subsidies.

We support the completion of the fourth review under the Extended Arrangement and the request for waivers. Can the staff provide updated information on the 10th and 11th purchases, and the tentative time frame for postponing the fifth review?

Mr. Sidlauskas made the following statement:

As described in the well-written report by the staff, whose assessment I broadly share, program implementation proved to be rather difficult, as evidenced by the number of requested waivers and the regrettable instance of misreporting to the Fund, reflecting the complex political situation and the profoundness of the structural problems. On the other hand, the authorities reinforced the implementation of the program in the second-half of this year,

demonstrated efforts to catch up with the program targets, and implemented all prior actions. Therefore, I agree with the proposed decisions, while limiting my remarks to three points.

First, I welcome the active use of fiscal policy to address the persistently high current account deficit and the resurgence of inflation. I also support the efforts to shift part of the tax burden from income to consumption in order to promote savings, but such a transition should be carefully planned so as not to loosen the fiscal stance. Nevertheless, I have some concerns that the authorities' commitments to curb the growth of public wages and reduce subsidies could fall victim to political pressures.

Second, the resurgence in inflation demonstrates that monetary policy with twin targets has limited possibilities in coping with one-off exogenous shocks and a spike in domestic demand. In this regard, I look forward to a more in depth discussion on the overburdened exchange rate policy during the forthcoming Article IV consultation. The high share of loans denominated in foreign currency and some weak spots in the banking supervision exaggerate the risks of the worrisomely rapid credit growth. Therefore, along with the tight monetary policy, banking supervision should be strengthened and regulations to limit credit and foreign currency risk accumulation should be promptly employed. In this regard, I welcome the envisaged increase in the capital adequacy ratio to 10 percent in March, 2005.

Finally, I want to stress the need for the steadfast implementation of an ambitious structural reform agenda. As noted by Mr. Padoan and Mr. Cipollone, sustainable growth will have to rely on a substantial improvement in the supply side of the economy, which will also support Serbia and Montenegro's European Union integration efforts. Thus, issues related to corruption, organized crime, and the rule of law should be addressed promptly to create a more favorable business climate. The comprehensive role of the public sector in the economy should be reduced in favor of the more efficient private sector. In this regard, I am encouraged by the authorities' efforts to proceed with the privatization of state enterprises. However, I am somewhat concerned with the plans, described the helpful preliminary statement by Mr. Zurbrügg and Mr. Antic, to write off the debts of indebted socially-owned enterprises upon their sale or bankruptcy. I would like the staff to elaborate on the possible impact of such plans on the financial soundness of utility enterprises and the implied cost for the state budget.

Mr. Prader made the following statement:

The Extended Arrangement with Serbia and Montenegro is approaching its final phase with a mixed track record. Fiscal performance has been better than expected. Although inflation is still above its targeted level, monetary policy nevertheless deserves credit for bringing it down from a very high level. The strengthened emphasis on banking supervision is especially welcome in the face

of increased risks stemming from credit growth. In addition, a set of reform laws enacted since mid-year, coupled with advanced bank and enterprise privatization, have set the stage for further economic recovery.

The widening external current account deficit and continued high unemployment are two important indicators of the weaknesses of the Serbian and Montenegrin economy. It is striking that, at the beginning of 2003, the external current account deficit for 2004 was programmed at 9.4 percent of GDP, but it became clear that this target will be missed by some 4 percentage points. It appears that the Serbian and Montenegrin economy is not able to produce attractive exports and cannot compete with imports. In addition, it is evident that this economy is not in a position to offer regular jobs to one-third of the active population, which has an important bearing on social security and the financial viability of health, education, and pension funds. The growing current account deficit also reflects weak incomes policies. Therefore, we support the staff's recommendation of tighter incomes policies in order to address the current account and competitiveness problems of Serbia and Montenegro and to contain inflation.

We understand from the statement of the staff representative that growth in economy-wide real wages in Serbia has decelerated to 4.4 percent year-on-year in October. However, this is still very high. We are concerned by the authorities' argument that "the planned nominal wage increases were necessary to support public sector reforms." This view may reflect a perceived political inability to implement the necessary measures for dealing with the worsening problems related to inflation and the current account deficit. This perceived political constraint underlines the risk built into this program.

Advancing structural reforms, in particular, banking and enterprise restructuring, is the key ingredient of the recipe for sustained economic growth recommended by the Fund and the Bank. The emphasis on creating both a dynamic private sector and an efficient public sector, as well as on increasing social protection, are rightly set at the center of the Bank's Country Assistance Strategy, which the Bank's Board is to discuss tomorrow. Structural reforms could ease the problem of a low level of exports, help bring the gray economy into the formal economy, and provide employment for those who currently have no jobs and those who will become redundant following the envisaged layoffs in the army and the public administration. Most important, these reforms can also ease the heavy fiscal pressure.

Against this background, the planned ambitious fiscal tightening is a step in the right direction and needs to be maintained or even strengthened. Prioritizing expenditures becomes especially important in the face of the rigid expenditure structure and low public investment. Reducing subsidies further would be an option, especially as many of them—e.g. subsidies to bigger families irrespective

of their income, subsidies to railways, and certain subsidies in agriculture—are not justified from the economic point of view.

In this context, we find it unusual that the medium-term fiscal framework for Serbia, presented in the Budget Memorandum for 2005 and beyond, which was endorsed by the Serbian government in October, 2004 and is now posted on the webpage of the Serbian Ministry of Finance, projects an increase well above the current level of the fiscal costs for subsidies and restructuring. At the same time, these projections envisage only a modest increase in public investment. In this context, we wonder whether the staff has discussed with the authorities their long-term views and prospects. We would also appreciate comments on the status of the projections in the Budget Memorandum.

Successful completion of the current Fund-supported program is a condition for a further 15 percent reduction of Serbia and Montenegro's Paris Club debts. From review to review, Serbia and Montenegro is meeting the performance criteria, targets, and benchmarks with growing difficulty. On each occasion, the number of waivers recommended for Board approval, and delays in program implementation, has grown. This could be seen as an indicator of decreasing ownership. It also implies that the Board is assuming a growing responsibility for bringing this program to a successful conclusion.

As we appreciate the authorities' efforts thus far to achieve macroeconomic stability, we, again, agree with the waivers proposed at this review. We regret the mistake identified in the figures on net credit to the government, which was reported at the previous review. Nevertheless, we agree with the proposed waiver, because of the preventive steps taken by the authorities.

Mr. Cuny made the following statement:

I would like to thank the staff for their focused report and Messrs. Zurbrügg and Antic for their clear and useful statements. Despite a mixed record, we support the completion of the fourth review under the Extended Arrangement, as well as a request by the authorities for a waiver of performance criteria and the modification of an end-December performance criterion.

Important developments have occurred since the last review, resulting in a much higher level of growth. This is also welcome development, as noted by Mr. Zurbrügg and Mr. Antic in their preliminary statement, because it is broadly-based and the private sector has largely contributed to this result.

The agreement on foreign debt reduction with the London and Paris Clubs is a second recent positive achievement, but these good results have materialized with further worrying developments with respect to aggregate demand and prices, fueled by an unsustainable increase in credit. This has caused an unprecedented

current account deficit, which could rapidly erode gains from the recent London and Paris Club agreements.

The structural reform process has also regained some momentum in the summer with the passing of a new Bankruptcy Law and the plan to privatize three banks, but much remains to be done to restore the economy's competitiveness. This is a crucial issue, as a continued current account deficit could rapidly return the country to an unsustainable foreign debt position. In order to increase exports, there is no alternative to structural reforms, as a depreciation of the real exchange rate could place the country in a difficult situation with respect to reimbursing foreign debt.

Timely implementation of the reforms is important, as the country needs to regain some competitiveness before the end of the grace period in 2007. On structural reforms, I concur with Messrs. Kremers and Croitoru that improved supervision of the banking sector appears to be essential to avoid a recurrent surge in aggregate demand. Avoiding a stop-and-go evolution of the economy also requires following the staff's advice on the further tightening of fiscal policy, as emphasized by Messrs. Padoan and Cipollone, as well as Mr. Prader. The authorities' commitment to further reduce the fiscal deficit is welcome, but it seems a rather difficult objective to achieve if the envisaged tax cuts are implemented as scheduled. The first-best option would certainly involve tax cuts while still meeting fiscal targets. However, the still fragile political situation, combined with the possibility of new parliamentary elections, calls for seriously envisaging the possibility of delaying all the tax cuts. This would certainly be a second-best solution, as the improvement of the business climate is urgent, but democratic and macroeconomic stability should remain the first objective.

Ms. Williams made the following statement:

We broadly support the staff appraisal and support the completion of the fourth review with requested waivers on modifications of the performance criterion. I would like to make three points.

Firstly, we agree with other Directors that progress has been mixed, and the focus on fiscal and monetary discipline is now appropriate. We welcome the action by the authorities to tighten fiscal policy in 2004-05 beyond the original program commitment, contributing to a fiscal deficit below one percent in 2005. It is also appropriate that the staff remind us on the first page of the document of the volatile political and domestic situation, especially in Serbia, and the limited ability of the minority government to push through unpopular reforms, as stricter incomes policies and enterprise restructuring will be a challenge for the minority government, and required employment cuts could lead to social tensions.

As noted at the time of the third review, we recognize the economic need to contain demand pressures in the economy, but we also need to ensure that cuts

to the budgetary wage bill are fiscally feasible, and this is a fine balancing act. We note that the nine percent wage increase for 2005 is below inflation.

It is crucial that the reform-minded authorities within the government feel that they own the incomes policies if they are to be able to sell this to the rest of Parliament, and then on to the population. When fiscal pressures come from outside the government, rather than the lack of fiscal will within the government, the Fund must be patient and supportive of the reform-minded authorities. We welcome the work that the Fund and the authorities have done to find agreement on a middle ground on cuts in over-staffed enterprises, and to hold down wage increases that exceed productivity as far as it can be agreed is feasible.

Secondly, a steady and phased commitment to enterprise restructuring and reinvigoration of the export industry is clearly now the appropriate route forward. The recent enactment of structural reforms and progress in recent banks and enterprise privatizations is very welcome, but it will need to be continued and reinforced. The privatization program must be credible and transparent if newly privatized firms are to increase exports and generate revenue sufficient to replace receipts from privatization.

Thirdly, rapid consumer credit growth is also a great concern, although not unusual for the region. A certain degree of catch up is to be expected, but the recent surge in lending, particularly to households, is worrying, and we encourage the Fund to continue to work closely with the National Bank of Serbia to bolster supervisory capacity.

Mr. John made the following statement:

Several positive developments stand out in 2004, notably, growth in excess of expectations and the completion of an agreement with London Club creditors. It is encouraging that the strong industrial production that contributed to higher growth reflected developments in privatized entities—a point stressed in the helpful statement of Messrs. Zurbrügg and Antic. In addition, while the misreporting on end-December 2003 net bank credit to government is disappointing, ongoing efforts to extend the Treasury Single Account—which led to the discovery of misreporting—represent an important step in improving expenditure management.

Despite some positive developments, considerable downside risks remain. We again echo the staff's concerns regarding fiscal policies and the need to reduce the high level of current expenditures. The authorities should focus on the quality of spending to create the space to increase public investment and reduce taxation, helping to foster formal private sector development. Particularly worrying has been wage growth, which has outstripped productivity and helped fuel inflation, and is now expected to be well above the original projection. We are encouraged by the staff's supplemental statement reporting that growth in

economy-wide real wages in Serbia decelerated to 4.4 percent following substantially higher rates earlier.

In this context, we welcome the authorities' revised commitments under the Extended Arrangement. The 2005 program includes several politically difficult decisions, such as cuts in the wage bill, elimination of subsidies, and reform of social funds, for which we commend the authorities. However, implementation will be the real test for success. As such, we encourage the authorities to continue their close collaboration with the Fund and the Bank, and welcome the strong commitment expressed by Messrs. Zurbrügg and Antic.

Serbia and Montenegro continue to face large external imbalances, with the current account deficit expected to exceed the 2004 target by a significant amount, prompting the need to tighten fiscal policies. While higher-than-expected oil prices contributed to import growth, the staff rightly stresses the debt financing of oil and non-oil imports and how this increases external vulnerability and could reduce the favorable effects of the London Club agreement. Furthermore, the continued growth of consumer imports, such as automobiles, rather than intermediate goods, suggests declining competitiveness and the need for structural measures to boost efficiency in the economy.

The Serbian and Montenegrin economy continues to suffer from a weak supply-side response to the improved environment and renewed access to major markets. Accelerating the pace of structural reforms will be critical to increasing productivity and thereby the competitiveness necessary to boost exports, private sector growth, and job creation.

As highlighted in Box 4 of the staff report, much remains to be done on structural reforms to catch up to the progress made by others in the region. The restructuring and privatization of state- and socially-owned enterprises will become more difficult now that the most attractive firms have been sold. The heavy accumulation of arrears by the remaining enterprises only adds to the urgency to privatize, restructure, or liquidate these companies to allow more productive uses of their physical capital, labor, and real estate. In this vein, we welcome passage of the new bankruptcy law earlier this year, but wish to underscore the staff's comments on the need for a well-functioning Bankruptcy Supervisory Agency and Bankruptcy Unit within the Privatization Agency to ensure implementation of the law. The authorities' plans to impose hard budget constraints on state-owned companies will be important to speeding the achievement of privatization and restructuring objectives.

We welcome the commitment to re-energize banking reform, including through privatizations and resolution of problem banks in Serbia. Though starting from a low base, the rapid growth in credit in both republics, combined with planned introduction of a new deposit insurance law, will require improvements

to banking supervision. In this respect, we look forward to the recommendations of the FSAP review planned for February 2005.

Finally, as Board members may be aware, the U.S. State Department has determined that Serbia does not meet the standards laid out in our legislation on cooperation with the International Criminal Tribunal for Yugoslavia. Consistent with that determination and our legislative obligations, we ask to be recorded as abstaining on the proposed decision on completion of the fourth review of the Extended Arrangement and eighth financing assurances review.

Mr. Faircloth made the following statement:

Performance under the arrangement has been mixed and program risks appear to have increased. Rising inflation, the widening current account deficit, and the still heavy debt burden are all sources of concern. Alleviating these risks will require decisive efforts, both to strengthen the implementation of prudent macroeconomic policy and accelerate long-standing structural reforms. Doing so will undoubtedly prove challenging, given the fragile political environment, but is unavoidable if risks are to be effectively managed. Therefore, we are hopeful that the authorities will be able to forge a broad-based consensus to push policy reforms forward as they have done recently on a number of critical legislative items. With this in mind, I can be brief as we largely concur with the staff's recommendations and many points raised by other Directors.

First, we welcome the authorities' intention to tighten fiscal, monetary, and incomes policies beyond program commitments. Fiscal consolidation clearly has an important role to play, given its impact on demand, inflation, and external imbalances. We support the authorities' focus on expenditure rationalization, but agree with Mr. Meissner and Ms. Reichenstein that a comprehensive approach in that context is needed. It would not be advisable to squeeze capital spending, which can boost growth potential, to largely preserve the relatively high level of current transfers and subsidies or maintain a relatively high wage bill.

The authorities will also need to carefully monitor the impact of planned tax reforms, as these will reduce revenues. In that context, we would have preferred a relatively coordinated policy approach, which links the implementation of proposed tax changes to the curtailment of spending. In addition, accelerating the restructuring and privatization of inefficient and loss-making state-owned enterprises will be crucial in supporting fiscal and development objectives. We are pleased to learn from the staff that this aspect of the reform agenda is expected to accelerate in 2005, following a disappointing track record in recent years.

Second, on monetary policy, we welcome the monetary tightening since August and the prudential measures that have been implemented to tighten credit conditions. We agree, however, that there is scope to strengthen supervision

further, and that the authorities may need to take further action should credit growth not decelerate as programmed.

Finally, as regards the structural agenda, initiatives to strengthen the investment climate are a priority. Implementation of the proposed incomes policies and the privatization and restructuring program, as well as the newly improved and strengthened bankruptcy procedures, will certainly help in this effort by boosting competitiveness. However, as noted in Box 4 of the staff report, a well-functioning Bankruptcy Supervisory Agency and Bankruptcy Unit is needed to render this new law operational, and we encourage the authorities to follow up in this context.

The staff representative from the European Department (Ms. Sorsa) made the following statement in response to Directors' questions and comments:

I would like to answer some of the questions raised in the statements, and they were mainly in three areas: fiscal policy, the external sector, and structural reforms.

On fiscal policy, a number of questions concerned arrears to the budget. We are in the process of quantifying these arrears in cooperation with the government. At this point, we estimate that tax arrears to the budget are approximately 1.5 percent of GDP. The government has prepared a plan for reducing these arrears. They have divided enterprises with arrears according to type, for example, those that are under privatization, in bankruptcy, or those that can recovered or rescheduled, and we will discuss this issue in more detail during the next mission. The authorities have set target dates at six month intervals to try to recover some of these arrears.

On the energy sector, there was a question on whether we have discussed with the authorities a ceiling to lower arrears. This is also going to be part of our discussions in Serbia and Montenegro in January, 2005 when we will attempt to assess the arrears situation of public enterprises.

There was a question on the financing of the budget in the event that privatization revenues or donor funding prove insufficient. In this regard, there is an adjustor in the program that allows somewhat higher domestic financing, approximately 1.3 percent of GDP in Serbia, if some of the financing does not materialize. There are also other measures available to the government, such as adjustments to the reserve line in the budget or with respect to nonpriority expenditures. However, the authorities expect strong receipts from privatization, for example, the sale of one bank that is at an advanced stage in privatization would fully satisfy budgetary expectations on revenues from privatization in 2005.

There was one additional question on fiscal policy related to the medium-term projections in the Finance Ministry's website. We have not discussed this with the authorities, as our discussions have only been on the 2005 budget. There is an Article IV consultation mission going to Serbia and Montenegro in January, 2005 and we will discuss the medium-term fiscal plans of the government then in more detail at that time.

On the balance of payments, there was a question concerning financing. I believe Mr. Padoan pointed out that there is a large financing gap, and asked how that would be financed. I should note that the Fund-supported program ends next spring, and as such there is no Fund financing assumed beyond that time. There is a potential for another arrangement, and our estimates on financing provided by other multilateral organizations are quite conservative. Hence there is potential to get more funding from the World Bank, the European Bank for Reconstruction and Development, and so on for financing the gap. In addition, the policy measures that are currently being undertaken can lower the financing needs by reducing the current account deficit. Private companies and banks may also resort to private funding from the markets to finance imports.

On the sources of improved competitiveness of exports, the expected real depreciation of the exchange rate, as well as increasing exports from the companies that were privatized in 2003, are important factors. On the supply side, slower wage growth would improve competitiveness with some lag next year as well.

On the structure of imports, we have seen an increase in consumer goods, especially imports of cars, and some of these are recorded as capital goods, hence there have been worrying changes in the structure of imports. However, there have also been some signs that imports of capital goods and intermediate goods are growing, which could be a good sign for the supply response to reforms.

There were a number of technical questions on the bankruptcy agencies. The roles of the economic courts, the Supervisory Agency, and the Bankruptcy Unit are as follows: the courts approve the settlement; the Supervisory Agency appoints the Trustees who do the actual accounting for the bankruptcy case in terms of assets and liabilities and their realization, and the Bankruptcy Unit in the Privatization Agency selects state trustees to deal with the bankruptcy of socially-owned companies, as these have significant inter-governmental debts. Therefore, a special unit must deal with their bankruptcies. Additional details can be provided on request.

There was a question on whether enhanced conditionality might better support the restructuring of either the socially-owned or public companies. I think this is an issue we will continue to discuss with the government during the next review.

There was a question on debt write offs and their impact on financial discipline. In this regard, the government's assumption of the debts of socially-owned enterprises creates a clear moral hazard risk. At the same time, if these companies are allowed to go bankrupt, then it may take longer for these companies to be privatized as an attempt is made to recover these claims through the bankruptcy process. One way to improve discipline is to make these write offs conditional on privatization. In addition, the government has stated that they would make an effort to lower the selling price of these entities to compensate for some of these debts.

On the question of the timing of the fifth review, we have a mission planned both an Article IV consultation and a Fifth Review for mid-January, 2005. If all goes well, we will try to present these documents to the Board at end-March.

The Acting Chair (Ms. Krueger) made the following summing up:

Executive Directors welcomed the pick-up in growth and increase in international reserves, but expressed concern at the rise in inflation and in the already large external current account deficit. While this mainly reflects rapid growth of domestic demand driven by increases in wages and consumer credit, high international oil prices and the still low level of exports also contributed to the high deficit. Progress with structural reforms, in particular with enterprise restructuring, has been mixed contributing to weak external competitiveness. Directors welcomed the London Club deal as a major step towards improving debt sustainability.

Against this background, Directors were encouraged by the authorities' decision to tighten fiscal, monetary, and incomes policies beyond program targets. While supporting the economic program for 2005, Directors stressed that it is essential to resist political pressures to relax policies, and to address resolutely the structural reform agenda.

Directors welcomed the substantial fiscal tightening in 2004–05 as a major contribution to containing domestic demand and improving the external balance. They considered that the lower tax burden and the shift to indirect taxes will improve incentives to work and to invest. They were also encouraged that the rationalization of spending is addressing the needed reduction in the size of government while creating scope for capital spending over time. However, a number of Directors called for a more comprehensive effort to rationalize expenditure in light of revenue uncertainties resulting from the tax cuts. In particular, they advised greater restraint on current spending, including subsidies, transfers, and the wage bill to make room to regularize debt service payments, and for increased investment spending in the years ahead. Directors observed that fiscal consolidation also calls for dealing with quasi-fiscal activities of state-owned and socially-owned enterprises. They recommended that the authorities

prepare contingency plans in case the envisaged financing of the public sector, including privatization receipts, does not materialize.

Regarding Montenegro, Directors welcomed the reduction of inflation to low single digits, but cautioned the authorities against over-reliance on tax cuts in the effort to reduce the size of the shadow economy. They recommended an acceleration of structural reforms in order to reduce dependence on the budget.

Directors noted with concern that the acceleration in credit expansion, particularly the rapid growth in consumer lending, has contributed to the external current account deficit. They therefore welcomed the Serbian monetary authorities' decision to contain credit growth and prudential risks, particularly by applying reserve requirements to commercial banks' new foreign borrowing, and issuing a guideline on prudential rules for consumer credit. They urged the authorities to stand ready to act promptly to tighten credit further should the recent measures fail to slow the rapid pace of credit expansion. Directors noted that growing euroization is increasing banks' exposure to exchange-rate risk. In this context, they stressed the need to further strengthen banking supervision and strictly enforce prudential regulations.

Directors broadly agreed that exchange rate policy would need to balance appropriately the objectives of reducing the external current account deficit and lowering inflation. More active implementation of the structural reform agenda will also help to enhance external competitiveness.

Directors noted with concern that progress in structural reforms has been mixed, particularly with respect to the long overdue restructuring of large state-owned and socially-owned enterprises. Against this background, they emphasized that accelerating restructuring and privatization will be critical for sustaining strong economic growth and reducing the external current account deficit and inflation over the medium term. In this context, they welcomed the Serbian authorities' plans for tighter wage discipline, retrenching the workforce in large state-owned enterprises, and speeding privatization. They also supported appropriate social safety nets and active labor market policies to mitigate the adverse effects on unemployment. Directors stressed, however, that perseverance in pursuing the structural reform agenda, including the forceful implementation of the new bankruptcy legislation, will be crucial for increasing productivity and reallocating resources towards viable and more export-oriented enterprises. They also emphasized the importance of further improvements in the business environment for private sector development.

Directors welcomed the July London Club agreement—on terms comparable to those granted by the Paris Club—as a major step towards a sustainable external position. They underscored, however, that the comprehensive implementation of the economic reform program will be crucial for reducing the external current account deficit and ensuring a favorable underlying debt trend.

The Executive Board took the following decisions:

Extended Arrangement—Report on Noncomplying Purchases, and Waiver of Nonobservance of Performance Criterion

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 nonobservance 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. (EBS/04/167, 12/3/04)

Decision No. 13392-(04/113), adopted
December 15, 2004

Misreporting of Information—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 and 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. (EBS/04/167, 12/3/04)

Decision No. 13393-(04/113), adopted
December 15, 2004

The Executive Board took the following decision, with one abstention from Mr. John (UA):

Extended Arrangement—Review, Financing Assurances Review, Waiver And Modification of Performance Criterion, and Rephasing of Purchases

1. Serbia and Montenegro has consulted with the Fund in accordance with paragraphs 3(e) and (0) of the Extended Arrangement for Serbia and Montenegro to review program implementation and financing assurances, and to reach understandings regarding the phasing of and conditions for disbursements during the remainder of the arrangement.

2. The letter dated November 29, 2004 from the Minister of Foreign Economic Relations of Serbia and Montenegro, the Deputy Prime Minister of the Republic of Serbia, the Deputy Prime Minister of the Republic of Montenegro, the Minister of Finance of the Republic of Serbia, the Minister of Finance of the Republic of Montenegro, the Governor of the National Bank of Serbia and the Chairman of the Central Bank of Montenegro (the "Letter"), together with its Memorandum of Economic and Financial Policies (the "MEFP") and Technical Memorandum of Understanding (the "TMU") shall be attached to the Extended Arrangement for Serbia and Montenegro, and the letters dated April 26, 2002, April 1, 2003, July 11, 2003, and May 21, 2004 from the authorities of Serbia and Montenegro, and their attachments, shall be read as supplemented and modified by the Letter, including its attached MEFP and TMU.

3. Accordingly, the Extended Arrangement for Serbia and Montenegro shall be modified as follows:

(a) paragraph 2(a) of the arrangement shall be revised to read as follows:

"(a) Purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 50 million until August 15, 2002, the equivalent of SDR 100 million until November 15, 2002, the equivalent of SDR 150 million until February 15, 2003, the equivalent of SDR 200 million until May 15, 2003, the equivalent of SDR 250 million until July 28, 2003, the equivalent of SDR 300 million until November 15, 2003, the equivalent of SDR 350 million until February 15, 2004, the equivalent of SDR 400 million until August 15, 2004, the equivalent of SDR 462.5 million until February 15, 2005, and the equivalent of SDR 587.5 million until April 30, 2005.";

(b) a new paragraph 3(a)(viii) shall be added to read as follows:

"(viii) the ceiling on the wage bill of the monitored public enterprises, cumulative from the beginning of the year,";

(c) for December 31, 2004 and March 31, 2005, the floor and ceilings for the quantitative performance criteria referred to in paragraphs 3(a)(i) to 3(a)(viii) of the arrangement shall be as specified in Table 1 (Selected Economic and Financial Indicators) to the MEFP and further specified in the TMU;

(d) the following structural performance criteria shall be added as paragraph 3(cccc), after paragraph 3(ccc) of the arrangement:

"(cccc) (i) after December 31, 2004 if Serbia and Montenegro has not enacted the amendments to the laws on the Yugoslav Army and on the Union-Level Civil Employees, reducing the redundancy payment from twenty-four to twelve months' wages and the dismissal notice time from three months to thirty

days, as specified in Table 3 to the MEFP and further specified in paragraph 14 of the MEFP, or

(ii) after December 31, 2004 if the Republic of Serbia has not enacted the amendments to the law on the Privatization Agency, enabling the Privatization Agency to act as the bankruptcy trustee for state- and socially-owned enterprises, as specified in Table 3 to the MEFP and further specified in paragraph 33 of the MEFP, or

(iii) after February 28, 2005 if the Republic of Serbia has not legally registered the new transmission and dispatch company, which will be owned separately from EPS, and adopted a time-bound action plan for implementation of the EPS restructuring, as specified in Table 3 to the MEFP and further specified in paragraph 35 of the MEFP; or";

(e) paragraph 3(e) of the arrangement shall be revised to read as follows:

"(e) after November 14, 2002, May 14, 2003, November 14, 2003, August 14, 2004, February 14, 2005, and April 29, 2005 until the respective reviews contemplated in the second paragraph of the letter dated April 26, 2002 are completed; or"

(f) paragraph 3(f) of the arrangement shall be revised to read as follows:

"(f) after August 14, 2002, November 14, 2002, February 14, 2003, May 14, 2003, July 28, 2003, November 14, 2003, February 14, 2004, August 14, 2004, February 14, 2005, and April 29, 2005, until financing assurance reviews are completed, provided that no such reviews shall be necessary if Serbia and Montenegro does not have outstanding sovereign external payments arrears to private creditors and, by virtue of the imposition of exchange controls, there are no outstanding non-sovereign external payments arrears; or".

4. The Fund further decides:

(a) that the fourth review, contemplated in paragraph 3(e), and the eighth financing assurances review, contemplated in paragraph 3(f), of the Extended Arrangement for Serbia and Montenegro are completed; and

(b) that Serbia and Montenegro may make purchases under the Extended Arrangement, notwithstanding the nonobservance of the June 30, 2004 structural performance criterion on Parliament adopting the bankruptcy law, specified in paragraph 3(ccc) of the arrangement, and the September 30, 2004 quantitative performance criteria on the contracting or guaranteeing of new nonconcessional external debt from: multilateral creditors by the public sector, specified in paragraph 3(a)(iv) of the arrangement, and on the issuance of new guarantees and the assumption of bank or enterprise debt by the public sector, specified in paragraph 3(a)(vi) of the arrangement, on the condition that the information

provided by Serbia and Montenegro on performance under these criteria and on the implementation of the measures specified as prior actions in Table 3 to the MEFP, and further specified in the MEFP, is accurate. (EBS/04/165, 12/1/04)

Decision No. 13394-(04/113), adopted
December 15, 2004

APPROVAL: April 28, 2005

SHAILENDRA J. ANJARIA
Secretary