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PROJECT PERFORMANCE ASSESSMENT REPORT



REPUBLIC OF SERBIA

Private and Financial Sector  
Policy Based Guarantee

**Report No. 106176**

JUNE 6, 2016

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and Development / The World Bank  
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**Report No.: 106176**

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**REPUBLIC OF SERBIA**

**PRIVATE AND FINANCIAL SECTOR POLICY BASED GUARANTEE  
(P102651)**

**June 6, 2016**

**IEG Human Development and Economic Management Department**  
*Independent Evaluation Group*

## Currency Equivalents (annual averages)

*Currency Unit = Dinar (SRD)*

2011	US\$1.00	SRD 73.22
2012	US\$1.00	SRD 83.31
2013	US\$1.00	SRD 85.14
2014	US\$1.00	SRD 83.67
2015	US\$1.00	SRD 113.29
2016	US\$1.00	SRD 113.29

## Abbreviations and Acronyms

DIA	Deposit Insurance Agency
DPL	Development Policy Loan
DPO	Development Policy Operation
EC	European Commission
EU	European Union
Euribor	Euro Interbank Offer Rate
IBRD	International Bank for Reconstruction and Development (World Bank)
ICR	Implementation Completion Report
IEG	Independent Evaluation Group
IEGHE	IEG Human Development and Economic Management Department
IMF	International Monetary Fund
M&E	Monitoring and Evaluation
NBS	National Bank of Serbia
OECD	Organization for Economic Co-operation and Development
OP	Operational Policy
OPCS	Operations Policy and Country Services
PBG	Policy-Based Guarantee
PFDPL	Programmatic Private and Financial Development Policy Loan
PFPBG	Private and Financial Sector Policy Based Guarantee
PPAR	Project Performance Assessment Report
RRG	Rolling Reinstatable Guarantee
SIDA	Swedish International Development Cooperation Agency

## Fiscal Year

Government: January 1 – December 31

Director-General, Independent Evaluation	: Ms. Caroline Heider
Director, Human Development and Economic Management	: Mr. Nick York
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<p>This report was prepared by Zeljko Bogetic, with the research analyst support of Lancine Conde, who assessed the project in June - October 2015. The report was peer reviewed by Shahrokh Fardoust and panel reviewed by Chad Leechor. Viktoriya Yevsyeyeva and Yezena Yimer provided administrative support.</p>
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## Principal Ratings

	ICR*	ICR Review*	PPAR
Outcome	Highly satisfactory	Satisfactory	Satisfactory
Risk to Development Outcome	Moderate	Moderate	Moderate
Bank Performance	Highly satisfactory	Highly satisfactory	Highly satisfactory
Borrower Performance	Highly satisfactory	Satisfactory	Highly satisfactory

\* The Implementation Completion Report (ICR) is a self-evaluation by the responsible Bank department. The ICR Review is an intermediate IEGWB product that seeks to independently verify the findings of the ICR.

## Key Staff Responsible

Project	Task Manager/Leader	Division Chief/ Sector Director	Country Director
Appraisal	Aurora Ferrari	Lalit Raina	Jane Armitage
Completion	Aurora Ferrari	Lalit Raina	Jane Armitage

**IEG Mission: Improving World Bank Group development results through excellence in evaluation.**
**About this Report**

The Independent Evaluation Group assesses the programs and activities of the World Bank for two purposes: first, to ensure the integrity of the Bank's self-evaluation process and to verify that the Bank's work is producing the expected results, and second, to help develop improved directions, policies, and procedures through the dissemination of lessons drawn from experience. As part of this work, IEG annually assesses 20-25 percent of the Bank's lending operations through field work. In selecting operations for assessment, preference is given to those that are innovative, large, or complex; those that are relevant to upcoming studies or country evaluations; those for which Executive Directors or Bank management have requested assessments; and those that are likely to generate important lessons.

To prepare a Project Performance Assessment Report (PPAR), IEG staff examine project files and other documents, visit the borrowing country to discuss the operation with the government, and other in-country stakeholders, and interview Bank staff and other donor agency staff both at headquarters and in local offices as appropriate.

Each PPAR is subject to internal IEG peer review, Panel review, and management approval. Once cleared internally, the PPAR is commented on by the responsible Bank department. The PPAR is also sent to the borrower for review. IEG incorporates both Bank and borrower comments as appropriate, and the borrowers' comments are attached to the document that is sent to the Bank's Board of Executive Directors. After an assessment report has been sent to the Board, it is disclosed to the public.

**About the IEG Rating System for Public Sector Evaluations**

IEG's use of multiple evaluation methods offers both rigor and a necessary level of flexibility to adapt to lending instrument, project design, or sectoral approach. IEG evaluators all apply the same basic method to arrive at their project ratings. Following is the definition and rating scale used for each evaluation criterion (additional information is available on the IEG website: <http://worldbank.org/ieg>).

**Outcome:** The extent to which the operation's major relevant objectives were achieved, or are expected to be achieved, efficiently. The rating has three dimensions: relevance, efficacy, and efficiency. *Relevance* includes relevance of objectives and relevance of design. Relevance of objectives is the extent to which the project's objectives are consistent with the country's current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in Poverty Reduction Strategy Papers, Country Assistance Strategies, Sector Strategy Papers, and Operational Policies). Relevance of design is the extent to which the project's design is consistent with the stated objectives. *Efficacy* is the extent to which the project's objectives were achieved, or are expected to be achieved, taking into account their relative importance. *Efficiency* is the extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and benefits at least cost compared to alternatives. The efficiency dimension generally is not applied to adjustment operations. *Possible ratings for Outcome:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

**Risk to Development Outcome:** The risk, at the time of evaluation, that development outcomes (or expected outcomes) will not be maintained (or realized). *Possible ratings for Risk to Development Outcome:* High, Significant, Moderate, Negligible to Low, Not Evaluable.

**Bank Performance:** The extent to which services provided by the Bank ensured quality at entry of the operation and supported effective implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of supported activities after loan/credit closing, toward the achievement of development outcomes. The rating has two dimensions: quality at entry and quality of supervision. *Possible ratings for Bank Performance:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

**Borrower Performance:** The extent to which the borrower (including the government and implementing agency or agencies) ensured quality of preparation and implementation, and complied with covenants and agreements, toward the achievement of development outcomes. The rating has two dimensions: government performance and implementing agency(ies) performance. *Possible ratings for Borrower Performance:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.





## Preface

This Project Performance Assessment Report (PPAR) was prepared by Zeljko Bogetic (task team leader) under the supervision of Mark Sundberg (manager, IEG Public Sector Evaluations). Research support from Lancine Conde and team assistant support from Viktoriya Yevsyeyeva and Yezena Zemene Yimer in IEG, and Ivana Klencovljevic and Ana Markovic in the Bank’s Belgrade office are gratefully acknowledged. The PPAR team wishes to express sincere gratitude to the government officials, stakeholders, and Bank staff interviewed, who provided their perspective and valuable information in the course this assessment (see Appendix C).

This PPAR is the first in a series of four currently under way to assess the early performance of Policy-Based Guarantees (PBGs). The other three operations in the series include two in the Former Yugoslav Republic of Macedonia and one in Montenegro. All four operations took place in Western Balkan countries during 2011–14.<sup>1</sup> Following completion of the four PPARs, an Independent Evaluation Group (IEG) learning product is envisaged to synthesize high-level lessons from the early use of the PBG instrument, with a view to its potentially wider applicability to Bank member countries.

This report evaluates the Private and Financial Sector Policy-Based Guarantee (PFPBG) to Serbia, which was approved on February 10, 2011. The operational phase of the policy reforms supported by the operation ended on the effectiveness date of April 15, 2011; this report takes this as the closing date of the guarantee. By contrast, the Implementation Completion Report (ICR) refers to April 13, 2017, as the “closing date,” although that is the date of the expiration of the guarantee.<sup>2</sup> This peculiarity about closing/expiry of the guarantee date is specific to guarantees, in contrast to investment lending operations, for example.

The total amount disbursed by the underwriting international commercial bank was US\$400 million, as envisaged at Board approval.

This report presents findings based on a review of the project appraisal documents, the Implementation Completion and Results Reports, Implementation Completion and Results Review, aide memoires, International Monetary Fund (IMF) and World Bank reports, and other relevant materials. An IEG mission visited Belgrade during June 22–26, 2015, to interview government officials, the staff of the IMF, think tanks, Bank staff, and other stakeholders (see appendix C for the complete list of persons interviewed). Bank staff members, donor representatives, and other information providers were also

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<sup>1</sup> See appendix B for a brief historical overview of Policy-Based Guarantees (PBGs) at the Bank. It should be noted that in contrast with earlier PBGs, the PBGs approved in the past five years have substantial policy reform content and they are much closer to standard Development Policy Operations (DPOs) in design. Indeed, the latest reform of the DPO framework by Operations Policy and Country Services treats PBGs as a type of DPO.

<sup>2</sup> In guarantees, there is a distinction between two key dates: (1) the closing of the guarantee, which is when the Bank stops monitoring the program implementation (and starts ICR preparation); and (2) the expiration of the guarantee, which is when the Bank stops accepting calls on the guarantee. (See, for example, World Bank 2013a, p. 17, para 52.)

interviewed at headquarters and by telephone. This work was carried out in parallel with, and benefited from, a separate PPAR of a PBG to FYR Macedonia.

The assessment aims to verify whether the operation achieved its intended outcomes. It provides additional evidence and analysis of relevant and comparative data for a more complete picture of the outcomes and the factors that influenced them. By covering the period between 2011 and mid-2015, it offers an opportunity for broader lessons and a longer time perspective, beyond the closing of the operation, as well as reflection on the sustainability of policy reforms and long-term factors that drove outcomes. Finally, the report draws lessons that are intended to inform future operations of this nature in other countries.

Following standard IEG procedures, the report was sent to the government officials and agencies in the Republic of Serbia for review and comments, no comments were received.

## Summary

This Project Performance Assessment Report (PPAR) reviews the Private and Financial Sector Policy-Based Guarantee (PFPBG) to Serbia, which was approved on February 10, 2011.

The PPAR provides a fresh look at this operation four years after the completion of the reform program. It reviews the existing evidence and brings new evidence to light based on additional country-specific and comparative data and information on institutional reforms and international metrics, as well as insights from over 40 semi-structured interviews with stakeholders in the country and at the Bank. This allows the report to provide some perspective on the sustainability of reforms supported under the PFPBG over the medium term. This medium-term perspective is part of the Independent Evaluation Group (IEG) effort to gain greater insights into the impact of budget support in countries with significant levels and duration of Development Policy Operation (DPO) support.

The objectives of the operation were to (i) facilitate Serbia's access to international markets and assist the country in achieving longer tenor and lower interest terms on its external commercial loans; (ii) enhance the business environment to support private sector investment; (iii) strengthen financial discipline with continued reform of the non-private enterprise sector, with a particular focus on bankruptcy; and (iv) build a stable and more efficient financial sector through continued restructuring of state holdings in banking, crisis preparedness, support to insurance sector development, and promotion of the development of capital markets.

The PFPBG was originally envisaged as the third in a series of private and financial sector Development Policy Loans (DPL). But the series was truncated, and the third operation was converted early in the preparation into a *stand-alone Policy-Based Guarantee*, while keeping essentially the same policy framework of the original DPL. Under the Operational Policy governing guarantees, which at the time guided Policy-Based Guarantees (PBGs), there was no possibility of a programmatic guarantee, hence the stand-alone design of the PBG. The International Bank for Reconstruction and Development (IBRD) guarantee covers the principal amount of a commercial bank borrowing of US\$400 million, with a six-year bullet maturity on a non-accelerable basis. Following tender procedure, the government selected Société Générale as the commercial bank to provide the loan.

For reasons elaborated below, the relevance, design, and results of the PFPBG largely met the high expectations of financial and policy reform objectives specified at the outset. The Bank took a calculated risk with the new instrument in order to deliver to the client on its request for a much larger volume of financing than was possible under the DPL. The Bank team worked vigorously to develop the operation using a de facto new instrument, to maintain broad policy dialogue, to provide ongoing technical support to the client government, and to act as a facilitator in the discussions between the government and the external commercial banks that provided the financing.

The government showed strong ownership of the reform agenda. A relationship of partnership and trust characterized the cooperation between the Bank and the government. As a result, the operation featured good design and outcomes, despite the difficult external environment in the euro area in the aftermath of the Great Recession and the escalation of the Greek debt crisis. Most of the reform agenda showed high achievements. One part of the reform agenda - strengthening financial discipline in the state enterprise sector - achieved its targeted outcomes, but in the context of a subsequent hiatus in the pace of enterprise reform, which only picked up in late 2014 with new International Monetary Fund (IMF) and Bank programs.

The following is a brief summary of the main conclusions of the PPAR assessment with respect to its key components: relevance of objectives and design, achievement, Bank and borrower performance, and monitoring and evaluation (M&E).

The relevance of objectives was high. Objectives were closely aligned with the Bank's strategic documents and the Bank's strategy. They were highly relevant to country conditions and the need to accelerate and complete the transition to a market economy. Critical policy areas - improving the business climate, enhancing financial discipline, and strengthening financial sector stability and efficiency - were identified based on considerable analytical work, especially the Serbia Country Economic Memorandum, Financial Sector Policy Notes, and Public Expenditure Review.

Design was highly relevant. The financial objectives of the operation in terms of facilitation of the country's access to international markets, lengthening maturity, and improving terms of sovereign borrowing were highly relevant to country conditions, especially considering the market turbulence and regional and euro area risks at the time. These objectives were well-linked to the design of the PFPBG, as well as the desired outcome of the country eventually accessing markets independently. Policy reform objectives were appropriately chosen based on long-standing policy dialogue, extensive consultation, and analytical work. Objectives were linked within a broader policy framework to specific actions. Prior actions were few, clear, and concrete, and they were linked to outcome indicators, over half of which were quantifiable. Some prior actions were particularly critical (for example, maintenance of the high capital adequacy ratio) in view of the high external uncertainty and potential shocks, and they served well to focus the policy reform and help ensure sustainable reform gains.

Achievement of objectives was satisfactory, and achievement of financial objective was notable. The government managed to double maturity and substantially lower the cost of borrowing using the PBG. As anticipated, this subsequently led to Serbia independently and regularly accessing international markets on favorable terms and longer-term maturities. Policy reform objectives also showed high achievement. Of the 18 outcome indicators, 15 were fully achieved and 1 was partly achieved, an overall achievement ratio of 89 percent. All critical actions and outcomes, especially in the external financial and financial sector policy areas, were achieved. A field visit, interviews, and additional evidence indicate that a large majority of reforms were sustained, several reforms were deepened, and outcomes improved further with the passage of time. In one area - enhancing financial discipline—required actions were also completed and outcomes were achieved and sustained, but there was a subsequent hiatus of some two and a half years

before these reforms achieved renewed momentum in late 2014 and 2015, in the context of new IMF and Bank support programs. This was heavily influenced by the extremely adverse economic conditions of a triple recession (2009, 2012, and 2014) and very high unemployment, which limited the government's political room to maneuver within the state enterprise reform agenda. Within a medium-term perspective, financial sector reforms supported by the PBG, especially the bank resolution framework and maintenance of high capital adequacy, proved critical in strengthening the resilience of the banking sector to absorb adverse economic and external shocks.

Bank performance was highly satisfactory. Taking into account the difficult economic and external conditions and risks that the Bank took, Bank performance could be considered an example of good practice. The Bank took calculated risks with a new instrument in order to meet the borrower's need for a larger and timely volume of borrowing while supporting a broad policy reform agenda. As the first PBG in a decade, it was a pioneering effort and it was highly successful. It built on a relationship of trust with the government and a broad policy dialogue. It provided substantial informal technical assistance to the Public Debt Administration, building on the past technical assistance as part of the earlier DPLs. The Bank also acted as a trusted partner and facilitator in the dialogue of the government with commercial banks. Following the approval of the operation, the Bank maintained monitoring and dialogue and worked to sustain the reform momentum. The Bank also closely coordinated with the IMF and several bilateral partners (for example, SIDA, the Swiss government), and there was clear division of labor and complementarity between the IMF (focusing on macroeconomic policies) and the Bank (focusing on structural issues).

Borrower performance was highly satisfactory. Government ownership was high. The government performed well on macroeconomic policies and in structural policy areas. Quality of the reporting, cooperation, dialogue, and engagement of technical counterparts was high. Key government agencies, including the Ministry of Finance, the National Bank of Serbia (NBS), and the Ministry of Economy and Regional Development were highly cooperative and coordination of the Ministry of Finance was high. A key agency for the financial objectives of the operation - the Public Debt Administration - worked closely with the Bank team on a tight schedule to ensure the timely completion of the many complex details of the financial architecture of the operation, which was new to all the parties involved: the government, the Bank, and the external commercial underwriting bank.

The M&E framework was rated substantial. It featured clear objectives, prior actions, and indicators, and solid linkages among them. Half of the indicators were quantitative and most were identifiable, clear, and measurable. Many showed sustained achievement over time. In some cases, indicators could have more clearly and explicitly defined the baseline, and some indicators were more in the nature of outputs and intermediate outcomes. Use of some critical indicators informed policy adjustments and improvements, especially in the areas of improving the business climate and financial sector reform.

## Lessons

With informed hindsight four years after the operation, several lessons are worth highlighting that may be of broader relevance.

First, PBGs are a potentially **important instrument** that could expand the tool kit of Bank assistance in client countries. It could be relevant for many countries seeking to strengthen access to international financial markets while advancing policy reforms. It fills the niche between commercial borrowing and traditional DPOs, while providing client borrowers with better-than-commercial terms and larger volumes than would be available under a DPO.

Second, this satisfactory operation shows that the Bank can productively take **informed risks** with new and innovative instruments in order to support client needs in a timely fashion that would not have been possible with standard instruments of Bank support. The Bank had an option to take a low-risk approach and extend a standard DPL, which would have been in line with Bank strategy. Also, external market turbulence might have suggested a more cautious approach with a standard DPL. In that scenario, however, the borrower would have had to borrow additional amounts in the external markets at much more unfavorable terms, raising its short-term debt service. The Bank's innovative approach with a PBG was risky, but it helped strengthen the relationship of trust with the government.

Third, the PBG can be a particularly effective instrument of budget support under **certain conditions**. Those conditions are likely to include the following: vulnerable economies (large and small) needing substantial external financing on favorable terms and on a timely basis; a solid track record of macroeconomic performance, debt management, and policy reform and a good dialogue with the Bank; and a period of heightened international market risks and worsened access and terms of sovereign borrowing. These conditions are quite prevalent in international markets. Yet PBG use at the Bank has been very limited so far. This may suggest that, with more information disseminated among the Bank Regions and the borrowers, there is scope for a wider use of PBGs in the future. This could also be helped by recent Operations Policy and Country Services (OPCS) reform that moved the PBGs to the revised Operational Policy (OP) 8.60 framework governing development policy operations, thereby explicitly recognizing that PBGs are essentially a unique type of DPL.

Fourth, a PBG can unlock **multiple benefits** to the borrower, which may not be easily captured by alternatives such as a standard DPL: The borrower was able borrow the larger amount (because of the Bank's set-aside policy, which accounts for only one-quarter of the PBG against the country's borrower limit) needed at the right time and on favorable terms in the context of the PBG, and its short-term debt service was lower than would have been the case otherwise; it was able to open the door to substantial subsequent international borrowing at favorable terms; the borrower was able to establish itself in the eyes of international investors and broaden the investor base; and the borrower was highly motivated to deliver on reforms, in part because of a relationship of trust with the Bank, the large volume of borrowing, and perhaps also because of the presence of a third party (foreign commercial bank providing funding), which provided additional pressure on the timing and closure of the loan. To guard against the risk of the

PBG being used to postpone the necessary reforms and adjustment—a potential issue with any large-scale borrowing—a strong reform program is critical to the success of the operation.

Fifth, it is important to recognize that **risks such as a bullet repayment** feature could add to the borrower's risk of repayment in the future unless it is accompanied by ex ante provisions equal to the amount required under a standard annual repayment schedule. Repayment options and their pros and cons should be discussed at length with the client. Standard repayment schedules should normally be preferred, and bullet repayments should be accompanied by a Bank recommendation (or requirement) to the borrower to make annual provisions.

Sixth, strong and relevant design and high achievement is much more likely when the operation's design is informed by considerable **knowledge work, intensive and longer-term Bank engagement and dialogue, and a relationship of trust** between the Bank and the borrower.

Seventh, Bank staff **engagement in innovative operations must be more intensive and accompanied by considerable informal technical assistance** to inform the borrower of the benefits and risks and help it navigate the preparation of a hitherto little-known instrument or type of Bank operation.

Nick York  
Director  
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# 1. Background and Context

1.1 Four issues are important in understanding the broader development context relevant to the assessment of this operation: (i) the difficult external environment after the Great Recession and market turbulence in the aftermath of the escalation of the Greek debt crisis in 2009, (ii) the strong engagement and good policy dialogue that the Bank and the International Monetary Fund (IMF) had with Serbia in support of its economic reforms, (iii) the country's solid track record with economic management and reform momentum at the time, and (iv) Serbia's politics and their interplay with economic policy reforms.

1.2 Serbia's external environment in late 2010 and 2011 was characterized by a very sluggish euro area recovery and weak trade and capital flows, which stymied the country's recovery from a deep recession. Also, many European countries experienced reduced access to markets and elevated sovereign spreads on external borrowing. The escalation of the Greek (2009-10), Portuguese (2010), and Irish (2011) crises resulted in a substantial rise in sovereign spreads of these and some other European countries. Markets curtailed access and spreads rose, especially for smaller countries outside the euro area, such as Serbia.

1.3 Against this backdrop, the Bank has had a vibrant economic policy dialogue with Serbia. The broad dialogue reflected government's ownership and efforts to restart reform of the economy after an almost two-decade delay brought about by virulent hyperinflation, regional wars, chaotic disintegration of the former Yugoslavia, economic sanctions, and massive losses in output and employment. After the peaceful break-up of Serbia and Montenegro into two countries in 2006, in particular, the Serbian government restarted reforms, focusing its attention on reintegrating Serbia into the international and financial markets and jump-starting long-delayed reforms. Despite major shocks during the global recession, sound macroeconomic management helped the country avoid the major banking crisis that engulfed some European countries. This solid track record of reforms and continuity of policy dialogue with the Bank were important prerequisites of the country's accessing financing using the Policy-Based Guarantee (PBG).<sup>3</sup> Also, An IMF enhanced stand-by arrangement of EUR 3 billion was developed in close cooperation with the Bank's Private and Financial Sector Policy-Based Guarantee (PFPBG).

1.4 The Bank had previously supported Serbia's reforms through a series of Development Policy Operations (DPO). Before the PFPBG, the Bank approved two private and financial sector DPOs - Public Expenditure Development Policy Loans 1 and 2 - which were originally part of a series of three Development Policy Loans. In the event, the series was terminated after the second operation, and the third loan was converted into a stand-alone PFPBG at the request of the government of Serbia, but the policy framework and the policy matrix remained largely unchanged. The PFPBG has, therefore, helped maintain the continuity of major policy reforms in the same broad areas of the business environment, state-owned

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<sup>3</sup> According to the Operations Policy and Country Services (OPCS) rules at the time, a country was eligible for a PBG if it met three criteria: (i) the country should have a strong track record of performance, and its structural, social, and macroeconomic policy package should be satisfactory; (ii) the country should have a sustainable external financing plan; and (iii) the country should have a coherent borrowing strategy, which will enable it to become a borrower in its own name without a guarantee in the medium term.

enterprises, and the financial sector (box 1.1); in addition, it allowed the country to access international markets in the desired volume and on favorable terms. More broadly, the quality of policies and institutions were improving as measured by the Bank's country policy and institutional assessment metrics, especially in the areas of public sector institutions and social inclusion policies.

1.5 The government's motivation to opt for a PFPBG instead of a Development Policy Loan (DPL) was to: (i) ensure timely and sufficient volume of external borrowing on favorable terms at a time when markets were almost closed for small, vulnerable countries such as Serbia, and (ii) establish favorable benchmarks and broaden investor interest for the country's future commercial borrowing.

**Box 1.1. Major Reforms under Programmatic Private and Financial Development Policy Loans (PFDPL) 1 and 2**

Business environment: Beginning of regulatory review of business regulations (regulatory impact analysis) (PFDPL 1), Laws on protection of competition, bankruptcy, and state aid adopted (PFDPL 2).

Financial discipline and state-owned enterprises: Privatization law passed. About 300 state-owned enterprises privatized (PFDPL 1). Sale of remaining shares of 39 socially owned enterprises completed (PFDPL 2).

Financial sector: Deposit insurance agency capitalized (PFDPL 1), diagnostic of all commercial banks completed, National Bank of Serbia adoption of liquidity framework and strategy of consolidation of banks, law on mandatory traffic insurance (PFDPL 2).

Most of the reforms and outcomes supported under PFDPL 1 and 2 were achieved (PFDPL ICR Review). The PFPBG directly supported subsequent reforms in each of these policy areas, reflected in its policy reform objectives.

*Source:* Project Documents of PFDPL 1 and 2; World Bank 2011a, and project appraisal documents for PFDPL 1 and 2.

1.6 Important motivation was also provided by Serbia's ability to obtain a volume of borrowing under the PFPBG that was four times higher than under the standard DPL; this was a result of the Bank's policy of accounting only one-quarter of a PFPBG against the Bank's "headroom" country borrowing limit, while 100 percent would be applied against a DPL. This policy had been put in place by the Bank's senior management to provide an incentive to the countries to use the new PBG instrument. Until the Serbia PFPBG, only three countries had previously availed themselves of this instrument: Cote d'Ivoire, Argentina (1999), and Colombia (2001).<sup>4</sup> The PFPBG absorbed the key lessons from these early PBGs in that (i) they have the potential to leverage significant financing for client countries facing a difficult international environment and (ii) they can support completion of a longer series of reforms. Serbia's PFPBG was the first PBG in the Bank in a decade; as such, it was a pioneering operation in the Europe and Central Asia Region.

1.7 To better understand the context - in addition to the regional recession, high unemployment, and financing constraints - it is important to recognize that the operation's

<sup>4</sup> See Appendix B for details.

reform program targeted issues that were very difficult politically, including financial discipline in socially owned and state-owned enterprises. A major consequence of Serbia's delayed transition because of regional wars in the 1990s was the persistence of a large and mainly unreformed socially and state-owned enterprise sector.<sup>5</sup> Many of those enterprises, which lost the markets of a much larger former country of Yugoslavia as well as many external markets, became unviable, yet they were not restructured or closed. This resulted in a drain on the budget and pressures on the banking system to extend explicit direct and indirect subsidies and loans, with little result in terms of financial, efficiency, and organizational improvements. The social and political dimension of the problem of excess employment in these enterprises was particularly intractable. Therefore, strengthening financial discipline in this sector was a key part of structural reforms and needed improvements in the competitiveness of Serbia's economy.

1.8 Against this backdrop, the government has shown resolve to pursue reforms supported by the IMF and the Bank. There was momentum for reforms and hope that the euro area and Balkan region's recovery would continue uninterrupted. Also, the government of Serbia had a record of solid macroeconomic management under difficult conditions. But there were clouds on the horizon, especially with respect to the pace of euro area recovery, which provided the key context for reforms. This and major structural constraints, including long delays in the transition and the unreformed public sector and unfavorable investment climate, contributed to the very high chronic unemployment, in excess of 20 percent of the labor force. The youth unemployment rate exceeded 50 percent. In this environment, reforms over the medium term were vulnerable to changes in the economic environment and political support for reforms. The reforms under the PFPBG were implemented with high achievement, as elaborated below. However, starting a year after the closing of the operation, for a period of two and a half years, between mid-2012 and late 2014, there was hiatus in reforms, in large part because of fragmented politics during a coalition government. Fiscal adjustment and structural reforms regained momentum in late 2014 with the support of new IMF and Bank programs.

1.9 The remainder of the report assesses the PFPBG operation and its key building blocks. The appendixes provide details on administrative aspects of the operation and statistical information.

## **2. Objectives, Design, and their Relevance**

2.1 It is important to recognize that the PFPBG combined the elements of:

- A financial guarantee
- A DPO supporting broad policy reform.

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<sup>5</sup> Socially owned enterprises had a negative definition of ownership in that no particular group was a residual claimant, but there was strong employee influence. This ownership structure was less amenable to restructuring, privatization, and bankruptcy and, partly as a result, these processes were delayed for this category of enterprises. By contrast, state enterprises were incorporated companies with full or dominant ownership of the state.

As a result, it featured dual objectives: ensuring financial benefits arising from the financial guarantee as well as policy reform.

2.2 The financial objectives of the operation were to facilitate Serbia's access to international markets and assist the country in achieving longer tenor and lower interest terms on its external commercial loans. While not explicit in the development objectives, it is clear from the program document that the key reason for the choice of the instrument and its timing was facilitation of access to international markets on favorable terms. This is especially clear in the program summary, program description, and in the policy matrix in annex 2 of the program document.<sup>6</sup> As a result, this Project Performance Assessment Report (PPAR) adds this key objective to the standard policy reform objectives. Moreover, it takes the view that all policy-based guarantees should explicitly include financing objectives within the project's development objectives. The policy reform objectives were: (i) enhancing the business environment to support private sector investment, (ii) strengthening financial discipline with continued reform in the non-private enterprise sector, with a particular focus on bankruptcy, and (iii) building a stable and more efficient financial sector through continued restructuring of state holdings in banking, crisis preparedness, supporting insurance sector development, and promoting development of capital markets.

2.3 Envisaged originally as the third in a series of private and financial sector DPLs, the operation was converted on request by the borrower early in the preparation into a stand-alone policy-based guarantee. The policy framework of the original DPL remained substantially unchanged. Under the Operational Policy on guarantees, which at the time guided PBGs, there was no possibility of a programmatic guarantee, hence the stand-alone design of the PBG.

## Relevance of Objectives

Relevance of objectives is rated **high**.

2.4 The objectives were highly relevant to country conditions and the need to accelerate and complete the transition to a market economy and reintegration into the international markets. This, indeed, required a strong emphasis on private sector development and restructuring of a large, inefficient public sector. At the same time, it called for strengthening of financial sector stability and resilience in the wake of the strong financial spillovers from the global and euro area crises.

2.5 The operation's policy objectives were closely aligned to the government's development strategy for the period 2006–12, and this remained so at the time of this review. The strategy emphasized high-level objectives of increasing welfare of the population by achieving high rates of economic growth, reduction of unemployment, and increased competitiveness. To this end, the strategy recognizes the need for the country to quickly

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<sup>6</sup> The program document notes in the program summary that PFPBG “will be used to enhance a borrowing transaction from the international loan market. The guarantee will lead to improvements in pricing and tenor, and it will contribute to enhancing Serbia's further access to international financial markets” (World Bank 2011b, p. ii). The policy matrix in annex 2 of the document also has explicit reference to the financing objective as well as outcome indicators.

make up the time lost because of a long delay in the transition in order to offer “support for private sector development and efficiently restructure and close of non-viable state enterprises with appropriate economic and social safeguards.” These objectives were part of a broader government strategy of institutional strengthening and economic convergence on the road to eventual membership in the European Union (EU).

2.6 The objectives were also substantially relevant for the Bank’s strategy, and they remained relevant at the time of review. The FY08–11 Country Partnership Strategy (World Bank 2007) and 2009 Country Partnership Strategy Progress Report (World Bank 2009a) indicate that Bank strategy supported the government’s policy priorities in three key areas: (i) private sector–led growth to ensure income convergence with Europe, (ii) increased economic opportunities and broader participation in economic growth, and (iii) management of environmental and disaster risks. In particular, the Bank’s Programmatic Private and Financial Development Policy Loan (PFDPL) series supported the first two policy priorities. PFPBG objectives were especially geared toward the first objective of fostering private sector–led growth. PFPBG was closely coordinated with the IMF-supported, three-year program (2009–11), which also supported macroeconomic stability and fiscal and banking sector reforms. Several bilateral development partners also supported specific elements of Serbia’s reforms.

## Relevance of Design

Relevance of design was rated **high**.

2.7 The financial objectives of the operation in terms of facilitation of the country’s access to international markets were highly relevant to country conditions. They were well linked to the design of the PFPBG, as well as the desired outcome of the country eventually accessing markets independently. The other, related financial objective of lengthening the tenor and reducing interest rates of external commercial borrowing was equally important in the context of very high sovereign spreads, which penalized small countries even when they had comparatively solid macroeconomic management.

2.8 Policy objectives of supporting private sector growth were appropriately linked with reform activities such as simplification of business entry by creating a single window for registration of employees, improving the legal framework for strengthening corporate governance by preparing a law on business entities, as well as streamlining business regulations and reducing compliance costs to businesses. The objective of strengthening financial discipline was also well linked with the need to facilitate bankruptcy of nonviable socially owned enterprises and to enforce financial discipline by reducing subsidies in those enterprises. And the objective of building a stable and more efficient financial system was appropriately linked with activities aimed at short-term crisis preparedness and bank resolution, which was, in turn, clearly linked to the diagnostic assessments and bank recapitalizations leading to the target outcomes of a capital adequacy ratio of at least 12 percent (which was higher than the European norm at the time of 10 percent). Similarly, restructuring and divestment of state-owned banks was expected to result in the consolidation of the banking system, a more robust banking system, and a reduction in the number of state-owned banks.

2.9 All the prior actions were completed as envisaged (table 2.1). The IEG mission interviews and visits document that behind each prior action there has been a process of intensive policy dialogue, analytical work, and continuity of reforms. Considered within the context of broader policy reforms and previous reforms supported under PFDPL 1 and 2, these actions were appropriately limited in numbers, as well as concrete, significant within the country context, and measurable. Legislative reforms in prior actions are also significant (such as passing modern laws on banking, deposit insurance, and the deposit insurance agency incorporating good international practice), reflecting the efforts to accelerate institutional reforms within the broader framework of institutional convergence to the EU. Finally, the PPAR mission visit found that each of these prior actions had been sustained as of mid-2015.

**Table 2.1. Serbia PFPBG - Prior Actions**

Prior actions in Program Document	Status
The borrower's government has approved the draft Law on Business Entities, satisfactory to the Bank, and submitted it to its parliament for adoption.	Completed
The borrower has completed a comprehensive review of regulation of business activities, and the borrower's government has approved the recommendation of that review.	Completed
The Registry of Regional Development Measures and Incentives, satisfactory to the Bank, has been established within the Serbian Business Registers Agency (SBRA) and is operational.	Completed
The National Bank of Serbia (NBS) has completed a diagnostic assessment of all banks operating in Serbia in accordance with the methodology adopted under the Second Programmatic Private and Financial Development Policy Loan provided by the Bank, and enforced bank recapitalization to a capital adequacy ratio of 12 percent.	Completed
The borrower's parliament has (i) enacted amendments satisfactory to the Bank to the Law on Banks, Law on Bankruptcy and Liquidation of Banks and Insurance Companies, Law on Deposit Insurance, and the Law on Deposit Insurance Agency; and (ii) enacted the Law on Budget for the year 2011, which contains a provision satisfactory to the Bank on the state guarantee to the Deposit Insurance Agency,	Completed
Banks with borrower majority ownership have been merged, privatized, or restructured in accordance with the strategy adopted under the Second Programmatic Private and Financial Development Policy Loan provided by the Bank.	Completed

*Source:* World Bank 2011a, b.

2.10 The choice of the lending instrument was highly relevant. The government specifically sought quick-disbursing budget support, and this mandated a DPL-type instrument. However, the DPL could not be used to deliver the volume of financing needed by the government. Given the government's objectives of accessing international markets at times of market turbulence and its need for a high volume of financing while pursuing a wide reform agenda, a PFPBG - a hybrid lending instrument combining elements of a guarantee and a standard DPL - was the right choice. It allowed crowding-in of large, private, commercial bank financing of the government budget, which would have otherwise been prohibitively costly to the government - if it was available at all in prevailing market conditions. And it ensured delivery of a broad DPL policy reform agenda. By increasing volume of financing to \$400 million, well beyond what was possible under the DPL option

(\$100 million), the PFPBG has probably strengthened the incentives of the government to stay the course and implement the ambitious reforms

### **3. Implementation**

3.1 The Bank extended the PFPBG in 2011. It was the first such operation extended by the Bank in more than a decade. Given that there was no recent experience with the instrument, the Bank team had to engage the government and the Bank's internal structures in intensive consultations to ensure that the government made an informed choice and that the operation was fully in compliance with Bank regulations and that internal processes were respected. It also required several parts of the Bank to work in concert under the direction of the country director: task management, country team management, the Financial and Private Sector Development Network (lead network), the Poverty Reduction and Economic Management Network, Treasury, and the Finance Credit Risk Department. The PPAR team interviews and stakeholder consultations indicate that the Bank practiced strong internal coordination, considerable consultation, and intensive collaboration with the relevant government agencies, led by the Ministry of Finance.

3.2 The implementing agency for the government of Serbia was represented by the minister of finance, who was also the prime minister. The government and the Bank closely coordinated with the Ministry of Economy and the National Bank of Serbia (NBS), which were other key agencies involved in the reforms supported under the PFPBG. There were no co-financers. By design, the PFPBG budget support was provided by the underwriting bank, Société Générale, with the World Bank providing guarantee for the principal.

3.3 No safeguard policies were triggered by the operation. Based on the inspection of prior actions, no adverse distributional effects are anticipated from policies supported by the operation. Further, the operation is not expected to result in major direct adverse, or irreversible, environmental impacts in the short term.<sup>7</sup>

## **4. Achievement of the Objectives**

### **Objective 1: Facilitating Access to International Markets – High**

4.1 The financial objectives of the operation were to (i) facilitate Serbia's access to international markets and (ii) assist the country in achieving longer tenor and lower interest terms on its external commercial loans. The design of the PFPBG - as a hybrid of a World Bank guarantee and a DPO - was well suited to the achievement of this objective, because it guaranteed the principal of the international commercial loan and supported the policy dialogue and a broad front of reforms. This was especially important because the international markets were almost closed at that time for smaller European countries, and market terms for Serbia were prohibitive. The operation helped the country (i) achieve access

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<sup>7</sup> This is in part due to the legislative and institutional nature of many prior actions, and also because none of the actions relate to issues of forestry, agriculture, and mining that might have direct environmental and social repercussions.

to the needed volume of external financing; (i) obtain favorable terms, establishing a benchmark for subsequent international commercial borrowing; and (iii) access subsequent international commercial borrowing on reasonable terms.

4.2 Two outcome indicators - appropriately chosen - were that the government of Serbia will raise funding independently from international markets and raise euro loan funding with maturity of more than three years, at an interest rate below the Euro Interbank Offered Rate (Euribor) plus 500 basis points.

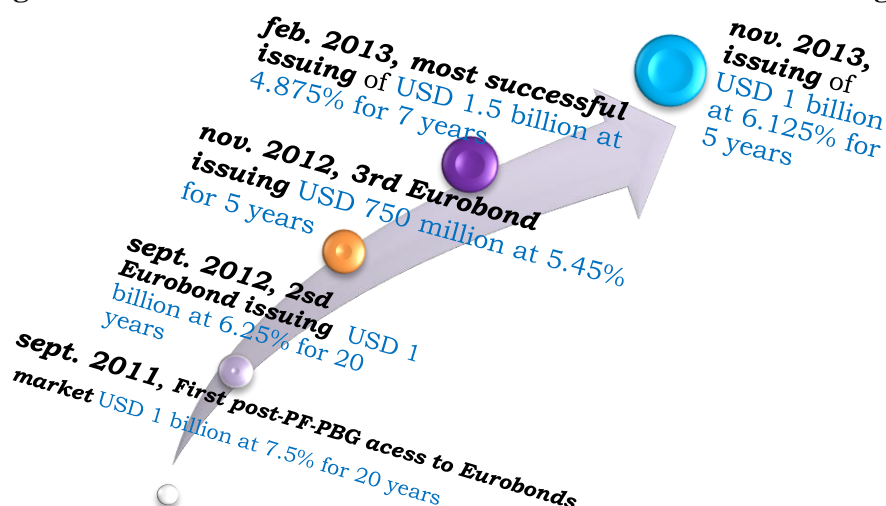
4.3 The operation has laid important groundwork for the sustained achievement of both outcome indicators. Before the operation, Serbia was borrowing only from local commercial banks, in euros, at interest rates between 8 to 11 percent (with spreads over the Euribor of about 6–8 percent) and with maturities no longer than three years. By contrast, the PFPBG provided an international commercial loan from Société Générale, with a World Bank guarantee, of \$400 million, for six years, at an interest rate of 4.5 percent. This meant doubling of maturity and borrowing at spreads over Euribor of just above 1 percent.

4.4 Beyond these substantial, direct financial benefits of doubling maturity and reducing cost, the operation had other important, catalytic benefits. By establishing such a favorable benchmark at this turbulent times in the international markets, the operation has provided an important positive signal to the markets that this creditworthy country is, indeed, able to borrow at those terms. This has potentially reduced the perception of the country's sovereign risk at a time of extreme risk aversion and generally heightened sovereign spreads. Also, the operation has helped introduce the country to the markets for the first time, and it helped broaden its investor base, making it more known and potentially attractive to investors in the future.

4.5 Subsequent to the PFPBG, the government of Serbia successfully accessed international markets independently at much longer maturities than before the PFPBG and at a reasonable cost of borrowing. Serbia has since borrowed about US\$5 billion in direct market borrowing at reasonable terms, substantially broadening the investor base and establishing itself as a reliable borrower (figure 4.1).



**Figure 4.1. Serbia's Post-PFPBG International Market Borrowing Terms**



Source: Serbia, Ministry of Finance (2015).

## **Objective 2: Enhancing the Business Environment to Support Private Investments – High**

4.6 Considerable Bank analytical work and comparative indicators suggested that the business environment in Serbia has been one of the binding constraints on domestic investment and growth (for example, Investment Climate Assessment [World Bank 2004], Public Expenditure Review [World Bank 2009b], Private Sector Note, Financial Sector Assessment Report (World Bank and the IMF, 2010), and Doing Business Indicators). There was also an ongoing policy dialogue and diagnostic work done under the Country Economic Memorandum that informed the operation, even though the report itself was only completed later (World Bank 2012a). As a result, the policy focus on the business environment was highly relevant. This analytical knowledge has also shaped the design of specific policy reforms and policy actions supported under the operation.

4.7 The following summarizes the assessment of outcome achievement for each policy reform area: further simplification of business entry; improving the legal framework for strengthening corporate governance and facilitating business operations; streamlining regulations of business activities and reducing compliance costs; improving the legal and institutional framework for competition, and improving the effectiveness of enforcement of court decisions.

### ***Further simplification of business entry***

4.8 To simplify business entry, the government created a single window to register employees in the Pension and Health Funds. This was expected to result in the main *outcome indicator: reduction of the business compliance costs estimated at up to EUR 15 million by end-2010. Achieved.*

4.9 The creation of a single window and a single form for registration of employees in the Pension and Health Funds resulted in significant simplification and reduction of costs of compliance, estimated at euro 15 million. This was the last in a series of improvements in business registration, starting with the establishment of the Serbia Business Registration Agency as a one-stop shop for business registration in mid-2009. This has resulted in the significant reduction in the number of procedures required for registering a business in Serbia, as well as the increase in the number of registered companies (EC 2014). For example, in late 2011, starting a new business took 13 days and cost 7.9 percent of income per capita, compared to 56 days and 15 percent in 2005. Business Environment and Enterprise Performance Surveys also document managers' views that various processes improved, making entry easier (World Bank 2012a, p. 67; World Bank and IFC 2012). Discussions during the IEG mission visit also indicate that these gains were sustained through early 2015 and that there were no noticeable policy reversals in this regard. Furthermore, the EU Progress Report for Serbia (EC 2014) indicates that a large number of new companies were established (8,574), and more than three times the number of companies closed during the period (2,562), suggesting both significant entry and "creative destruction" in terms of unviable firm exit.

4.10 More broadly, Serbia's rating on the Doing Business scale advanced significantly during 2011–13. It has simplified the insolvency process by introducing a series of measures, such as private bailiffs, reducing the starting prices for the sale of assets, and prohibiting appeals. The new private bailiff system also made it easier to enforce contracts. Serbia has also made starting a business easier by eliminating the paid-in minimum capital requirement. As a result, Serbia's overall rank has improved to 86th in 2013, up from 92nd in 2012.

***Improving legal framework for strengthening corporate governance and facilitating business operations***

4.11 To this end, the government approved the draft Law on Business Entities, satisfactory to the Bank, and submitted it to parliament for adoption (prior action). Shortly thereafter, the law was enacted (Serbia 2011, Law on Companies). This was expected to result in the main *outcome indicator: improved legal framework for corporate governance. Over the medium term, such a framework will support (a) increased independence of the internal supervision body of Joint Stock Companies, (b) increased shareholder rights, (c) stronger role of nonexecutive and independent members of the board, and (d) increased transparency of reporting. Achieved.*

4.12 The law was prepared with considerable policy dialogue and input from the World Bank staff. This law consolidated many aspects of company law that were international good practice, but in Serbia these had been fragmented among different pieces of legislation with often overlapping, ambiguous, and conflicting rules. For example, it helped harmonize conflicting provisions between the existing law on business entities and the law on the securities market. It also simplified company legislation by eliminating duplication with another law on private entrepreneurs, which was terminated. It defined legal choices for corporate governance for various types of business entities.

4.13 Beyond improvements in the overall corporate legal framework, Serbia made major improvements in the strength of investor protection as measured by the Doing Business

Indicators. It moved up from the 74th among 183 world economies to 32nd in 2014/15. Specific dimensions of investor protection also compare favorably with the regional averages and some for Organization for Economic Cooperation and Development (OECD) countries, especially the extent of shareholder rights (table 4.1). While the indicator does not measure all aspects related to the protection of minority investors, a higher ranking does indicate that an economy's regulations offer stronger investor protections against self-dealing in the areas measured. In that regard, the index is strongly indicative of the progress in the outcome indicators related to shareholder rights, a stronger role for nonexecutive members of the board, and increased transparency.

**Table 4.1. Serbia: Protection of Investors Index**

	Serbia	ECA	OECD
Doing Business 2015 rank	32.0	-	-
Doing Business 2014 rank	32.0	-	-
Change in rank	0.0	-	-
<b>INDICATOR (2015)</b>			
Extent of disclosure index (0–10)	7.0	6.4	6.6
Extent of director liability index (0–10)	6.0	4.8	5.4
Ease of shareholder suits index (0–10)	4.0	6.7	7.2
Extent of conflict of interest regulation index (0–10)	5.7	6.0	6.4
Extent of shareholder rights index (0–10.5)	10.0	7.8	8.0
Strength of governance structure index (0–10.5)	8.0	4.4	4.6
Extent of corporate transparency index (0–9)	3.0	5.4	6.1
Extent of shareholder governance index (0–10)	7.0	5.9	6.2
Strength of minority investor protection index (0–10)	6.3	5.9	6.3

Source: Doing Business Indicators 2010–15, World Bank and IFC.

### ***Streamlining regulations of business activities and reducing compliance costs***

4.14 In this policy area, the government has completed a comprehensive review of business regulations governing business activities, and it approved the recommendations of that review (prior action). *Outcome indicator: new set of regulations in place reflecting (a) elimination of not less than 190 unnecessary regulations, and (b) the amendment of 25 regulations and 20 laws by the end of 2011. Implemented regulations are to lead to annual cost savings for businesses of at least EUR 120 million by end-2011. Achieved.*

4.15 Following several years of reforms that led to the introduction of the Regulatory Impact Analysis and its mainstreaming in the regulatory review and reform process, the government implemented additional reforms. The objective was a major elimination and replacement of many outdated and unnecessary regulations. This resulted in much greater consistency of regulations (Penev and Marusic 2011). By end-2011, this process of review, elimination, and revision had been substantially completed, with documented elimination of

192 regulations as well as the amendment of 30 laws and the promulgation of 30 new regulations. This led to estimated annual savings of over euro 140 million. For example, about one-third of these savings were realized from the simplification of hitherto onerous procedures and unnecessarily rigid rules on business handling and deposit of cash in their bank accounts. A one-stop shop for registering workers has also reduced the regulatory burden on businesses and resulted in an estimated saving of some euro 15 million. Other savings were generated by eliminating arbitrary requirements on the use of stamps and official seals of the companies, use of vehicles for official travel, and regulations on the use of company names on their websites. These reforms eliminated a series of regulatory requirements whose main impact was to directly increase business costs on a recurrent basis while contributing little or nothing to the benefits for businesses and consumers.

### ***Improving legal and institutional framework for competition***

4.16 This was to be achieved by putting in place regulations for the implementation of the Law on Competition. *Outcome: Improved competition framework in place, which, over the medium term, will strengthen the authority of Commission for Protection in (a) determining abuse of dominant position and existence of cartels and (b) imposing enforcement measures. Achieved.*

4.17 The Law on Competition has resulted in a substantial improvement in the regulatory framework for competition in Serbia and it has been aligned with the EU directives. Nine regulations were adopted to help implement legal provisions in the areas of definition of market criteria for competition, requests for exemptions, special group exemptions, identification, concentration, Statute of the Commission of the Protection of Competition, determination of fines, penalties, and payments, relief measures, requests, and approval of proposed concentration. Also, several instructions (for example, on calculation of total income of parties engaged in merger and concentration of economic activity) and decisions were adopted to clarify and facilitate implementation of specific articles of the law (for example, on participants in mergers and concentration in the market for public procurement) (Serbia, Commission for Protection of Competition site <http://www.kzk.gov.rs/en/>).

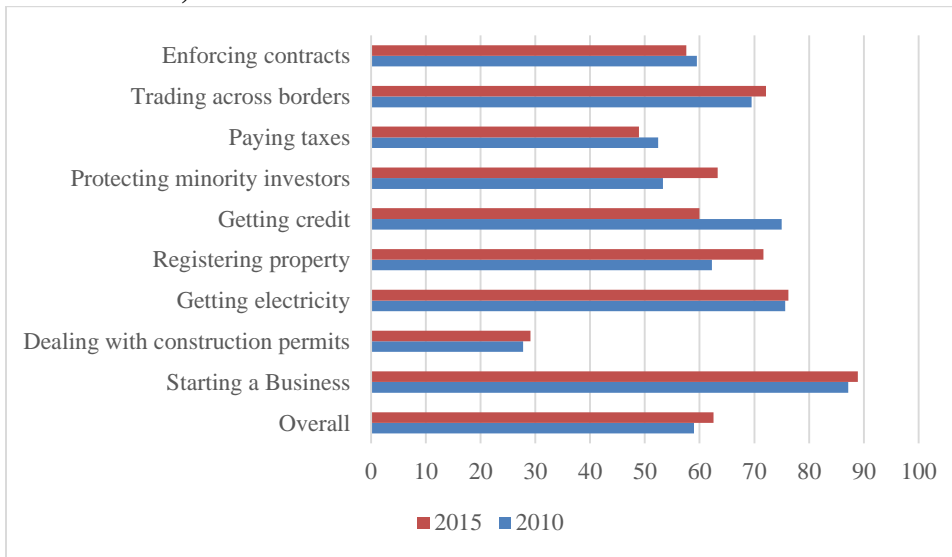
### ***Improving effectiveness of enforcement of court decisions and authentic documents***

4.18 These improvements were expected from the approval of a new Law on Enforcement and Security, which was submitted to the parliament (prior action). *Outcome: Improved enforcement framework in place which supports, over the medium term: (a) streamlined proceedings, and (b) introduction of professional enforcement officers. Not achieved.*

4.19 The Law on Enforcement and Security was adopted. The law streamlines the legal procedures for enforcement and also introduces professional enforcement officers (private bailiffs), who are licensed by the Ministry of Justice. So the legal side of these reforms has been completed broadly as planned. However, this has not yet translated into tangible improvements in the quality of enforcement measured by *relative international metrics*. According to data collected by Doing Business (World Bank and IFC 2012), for example, enforcing a contract requires 36 procedures, takes 635 days, and costs 31.3 percent of the value of the claim, figures which were unchanged from 2010. Globally, in 2012 Serbia stood

at 104 in the ranking of 183 economies on the ease of enforcing contracts, a deterioration from 94th position a year before. This relative deterioration in the measured enforcement of contracts is also visible compared to the frontier (the best country in enforcement of contracts of 183 surveyed economies—Ireland) (figure 4.2). Another way comparing Serbia's enforcement of contracts is to contrast it with the *average for its region of Europe and Central Asian countries*. In this comparison, enforcement of contracts in Serbia takes 36 procedures versus the average of 37.1 in the Region, suggesting that Serbia is about in the middle of the group. However, it takes substantially longer in Serbia to enforce a contract (635 days), compared to the average for the Region (411 days).

**Figure 4.2. Serbia: Doing Business Indicators - Distance from the Frontier (100 = Best Performance)**



Source: Doing Business Indicators (2010–15), World Bank and IFC.

### **Objective 3: Strengthening Financial Discipline – Modest**

4.20 Overall, institutional reforms and outcome indicators supporting this objective were achieved. But the field visit suggests that they were slow to translate into tangible gains in fiscal discipline using other metrics, such as the size of enterprise subsidies. Also, field discussions and review of policy analysis since 2011 indicates strongly that the overall pace of enterprise reform has been slow, and in some important areas (such as large state enterprises) it stalled during the following two and a half years. Limited enterprise reform was restarted, however, in late 2014, with support of new IMF and Bank programs. Overall, given the uneven implementation, sustainability of achievements of this objective is in question, even though it must be recognized that reforms have accelerated since late 2014. On balance, the achievement of this objective is rated **modest**.

4.21 Under the PFPBG, this reform agenda was pursued in two main policy areas: facilitating exit through bankruptcy of socially owned enterprises, and improving financial discipline in those enterprises. This area of policy reform proved more difficult to implement, in large part because of the political and social implications of the bankruptcy and exit of many public enterprises.

### ***Facilitating bankruptcy of socially owned enterprises***

4.22 This policy agenda was important for the overall restructuring of the economy in view of the continued soft budget constraints of many socially owned enterprises. Many such enterprises continued to operate despite becoming unviable because of a permanent loss of regional markets or technological competitiveness. As a result, they became a considerable burden on the budget that ex post financed their losses. Yet, the legal and regulatory framework for effective bankruptcy was lacking.

4.23 The first action under this agenda was putting in place the implementation regulations for the Law on Bankruptcy, approved by the Ministry of Economy and Regional Development and/or the Serbian government. The expected *outcome was an improved bankruptcy framework, which over the medium term will lead to (a) an increase of initiation of bankruptcy cases of qualified entities, (b) higher recovery rates and lower costs, and (c) shorter resolution time. Achieved.*

4.24 Following the passage of the landmark Law on Bankruptcy (2009), the government put in place a number of implementing regulations to make bankruptcy a more efficient process. This includes approving the implementing regulations of the law focused on various dimensions of the process, including reorganization, fees of administrators, code of ethics, and so on. These regulations helped significantly clarify how the law was to be applied in practice. It also included a Law on Agency for Licensing of Bankruptcy Administrators. As a result, many socially owned enterprises entered the bankruptcy process. The Doing Business Indicators show improvement in the closing business indicator for Serbia by fifteen slots in relative rankings compared with the previous year. To be sure, the backlog of unviable enterprises remains large, and the process continues to be relatively slow.

4.25 The second action on this agenda was filing of bankruptcy procedures of at least 10,000 entities with blocked accounts over a three-year period. *Outcome was to reduce the number of entities with bank accounts that have been blocked by 6,000 by end-2010. Achieved.*

4.26 Automatic bankruptcy triggers under the law resulted in the initiation of filing for over 13,000 bankruptcy cases with blocked accounts over three years. As a result, close to 10,000 entities have been declared bankrupt and erased from business registries. Field interviews suggest that, indeed, the bankruptcy law resulted a significant upturn in the closure of many unviable enterprises.

4.27 The third action was the initiation of bankruptcy procedures for at least 160 qualifying companies from the Privatization Agency portfolio between January 1, 2010, and November 30, 2010. The expected *outcome was: The portfolio of companies in the Privatization Agency restructuring, auctions, and tenders is reduced as bankruptcy procedures are undertaken, sending an additional positive signal to the markets. Achieved.*

**Table 4.2. Privatization Agency Portfolio, November 2010**

<b>Status</b>	<b>Number of socially owned enterprises</b>	<b>Number of state-owned enterprises</b>
Bankruptcy/ forced liquidation	673	0
Auction	25	47
Tender	6	19
Restructuring	50	84
Privatization suspended	201	50
Under preparation	0	21
<b>Total</b>	<b>955</b>	<b>221</b>
<b>Grand total</b>		<b>1,176</b>

Source: Privatization Agency data.

4.28 The target has been achieved and substantially exceeded. As the table shows, 673 enterprises entered the bankruptcy process. And a number of socially owned and state enterprises entered various processes of restructuring or privatization. To be sure, one large group of socially owned enterprises saw their privatization processes suspended, partly because of competing ownership claims associated with the breakup of the former Yugoslavia.

4.29 Since late 2011, these processes have continued, although the pace has been comparatively slow, in part reflecting many competing ownership claims, that some enterprises were placed under the “protection” of the state from privatization and restructuring for a long time, and the political constraints. Nevertheless, in mid-2015, there were 526 companies in the process of ownership restructuring and privatization; many of these were new companies that entered the process, compared with those entering in 2010. A large subset of those - 353 enterprises - are in the process of accelerated resolution of their ownership status through one of the three avenues: bankruptcy (189 enterprises), takeover by the state into state ownership status (47), and release of protection from restructuring/privatization, which opens the way for various forms of restructuring (including bankruptcy) (111 enterprises). (Serbia, Fiscal Council of the Republic of Serbia 2014).

4.30 Looking beyond bankruptcies, it is useful to ask the question whether these processes led to tangible, broader improvements in the management of public enterprise - for example, by reducing the direct and indirect subsidies to public enterprises. This would be the next logical step in reforms. On this score, however, little progress had been achieved until 2015. The parliament’s fiscal watchdog estimates that since 2011 those enterprises absorbed some 2 percent of GDP annually in direct and indirect subsidies, rising to 3 percent of GDP in 2014 (Serbia, Fiscal Council of the Republic of Serbia 2014).

4.31 In 2015, however, the recently elected government embarked on an ambitious fiscal consolidation program supported by a three-year IMF program. These reforms, on track as of mid-2015, may presage accelerated enterprise reforms, especially for some of the largest state enterprises (including the electricity company, the state gas company, and the state

railways) that had been the main source of fiscal burden in the enterprise sector (IMF 2015). For example, a major source of quasi-fiscal pressures, the issuance of guarantees to public enterprises, which averaged about 3 percent of GDP, was substantially curtailed to 0.4 percent of GDP in 2015 and going forward (IMF 2015, p. 29). Looking back in this longer perspective, therefore, the establishment of the legal framework for bankruptcy and restructuring under the PFPBG has been an important step in the enterprise reform process.

### ***Improving financial discipline in the socially and state-owned sector***

4.32 A major consequence of the large socially owned and state-owned sector has been the lack of financial discipline reflected in various fiscal and quasi-fiscal subsidies. As a result, these enterprises represented a considerable burden on the government budget. The lack of comprehensive and updated information on various forms of state aid (direct subsidies) and other forms of subsidies and their enterprise beneficiaries contributed to the lack of financial discipline. To help begin resolving this problem, under this policy area, the government completed the following prior action: The registry of Regional Development Measures and Incentives, satisfactory to the Bank, has been established within the Serbian Business Registers Agency and is operational. *Expected outcome: Establishment of a comprehensive record of state support measures, including subsidies and grants contributing to better expenditure management and more transparency. Achieved.*

4.33 This institutional outcome has been achieved, in that the Registry of Regional Development Measures and Incentives has been established and is operational. The registry centralized an electronic database of measures and incentives of significance for regional development. It became operational as part of the Serbian Business Registers Agency on February 1, 2011. It contains information on the type of documents required for providing incentives for regional development, intended purpose of incentives, financial characteristics of incentives, incentive providers and beneficiaries, territorial allocation of incentives, sources of funding, and other information (Serbian Business Register Agency 2015). All government ministries and agencies involved in the provision of state aid are required to provide the relevant information and data to the registry. Again, while the measures and outcome indicators have been achieved, within the medium-term perspective, the government has been slow to tighten financial discipline and make substantial progress on enterprise restructuring. After a hiatus between 2012 and 2014, it is only in 2015 - in the context of the ongoing IMF-supported work - that a substantial program of structural reforms, including enterprise restructuring, is now under way.



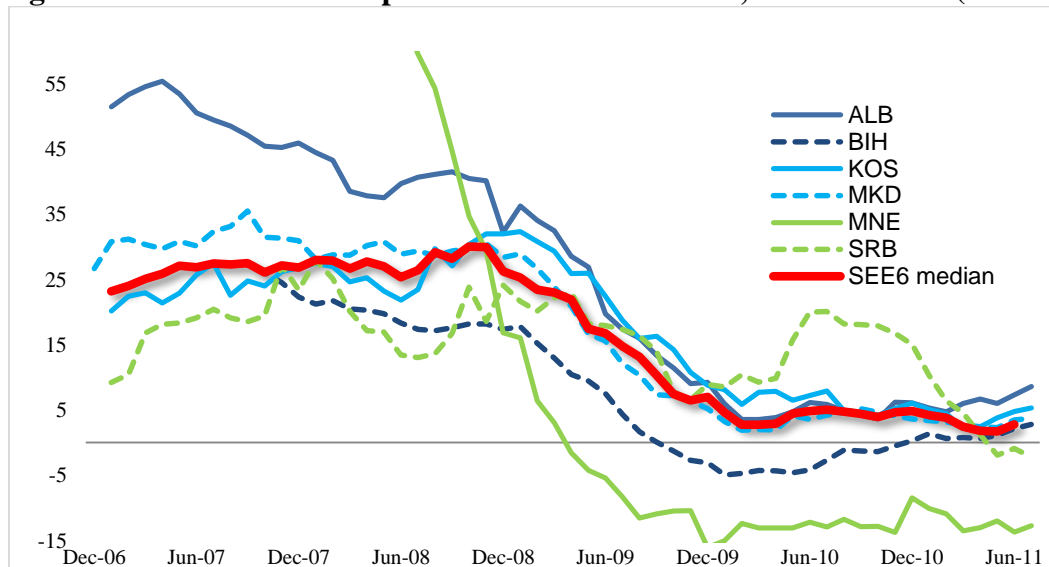
## Objective 4: Building a Stable and More Efficient Financial Sector – High

4.34 This objective was pursued through three sets of policy areas: strengthening crisis preparedness and the bank resolution framework, restructuring and divestment of state-owned banks, and strengthening of the insurance sector.

4.35 Under the **strengthening crisis preparedness and the bank resolution framework**, the government completed the prior action: The NBS has completed the diagnostic assessment of all banks operating in Serbia in accordance with the methodology adopted under the Second Programmatic PFDPL provided by the Bank and has enforced bank recapitalization to a capital ratio of 12 percent. The expected *outcome was: Capital Adequacy Ratio of the banking system is maintained at the level of at least 12 percent. Achieved.*

4.36 The NBS and the government of Serbia have, from the outset of the global crisis, implemented conservative regulatory and oversight policy, which helped the country weather the impact on the banking system. The credit boom-and-bust in Serbia was moderate compared to some other countries in the Western Balkan region (figure 4.3). The NBS carried out a comprehensive bank diagnostic in 2009 and a regular exercise is carried out every six months. As a result, Serbia has managed to maintain a high capital adequacy ratio since the global crisis, for both the system as a whole and for most individual banks. In 2011, Serbia had a capital adequacy ratio (regulatory capital as percentage of risk-weighted assets) of 19.1, the highest in the Western Balkans and much higher than many European banking systems. It has since increased gradually and it stood at 20.3 as of first quarter 2015. Other indicators of capital adequacy—tier 1 capital to risk-weighted assets, and capital to assets—show equally strong levels and trends (NBS 2015; World Bank 2014).

**Figure 4.3. South East Europe: Real Growth of Credit, Year-on-Year (Percent)**



Source: World Bank 2012b.

4.37 In recent years, a few smaller banks have been recapitalized in an orderly fashion, essentially by raising capital from existing or new shareholders (Metals Banka, Komercijalna

Banka, and Credy Banka). These recapitalizations did not have a noticeable impact on the overall capitalization or the confidence of the public in the banking system. At a time when banking systems in many European countries were under pressure, including from systemic risks, Serbia's banking system has maintained capital adequacy, liquidity, and the confidence of the public.

4.38 The second prior action under the crisis preparedness and resolution framework was: The borrower's parliament has (a) enacted amendments satisfactory to the Bank to the Law on Banks, Law on Bankruptcy, Law on Bankruptcy and Liquidation of Banks and Insurance Companies, Law on Deposit Insurance, and the Law on Deposit Insurance Agency, and (b) enacted the Law on Budget for the year 2011, which contains a provision satisfactory to the Bank on the State Guarantee to the Deposit Insurance Agency (DIA). *The outcome was: Bank resolution framework improved through the introduction of (i) bridge bank resolution on a closed bank basis for a systemic bank, and (ii) financial assistance in the form of grants, loans, or guarantees based on a least-cost test performed by DIA, and emergency funding arrangements for DIA. Achieved.*

4.39 The amendments satisfactory to the Bank to the Law on Banks, Law on Bankruptcy, Law on Bankruptcy and Liquidation of Banks and Insurance Companies, Law on Deposit Insurance, and the Law on Deposit Insurance Agency have been enacted as envisaged. The new resolution framework was substantially improved, and bridge bank resolution on a closed-bank basis for a systemic bank and financial assistance on a least-cost basis was introduced. It is also important to note that the previously implicit government guarantee was made explicit. A euro 100 million credit line from commercial banks was committed to support DIA in case of contingencies. Field discussions indicate that this bank resolution framework was, indeed, important in dealing with some subsequent cases of bank resolution and recapitalization, all of which were orderly and did not result in systemic risks or loss of confidence in the banking system.

4.40 The third action under the crisis preparedness and resolution framework (which was not a prior action) was: strengthened deposit insurance payout functions, as evidenced by (i) Managing Board approval of a satisfactory procedure for payout of insured deposits, and a concept paper on adjustment of premiums to the optimal size of the DIA, (ii) the DIA designed and tested an adequate payout software, and (iii) provisions of the DIA and the NBS Memorandum of Understanding on sharing of information have been implemented. *The outcome: Through introduction of payout software and payout procedures and implementation of a Memorandum of Understanding with the NBS, the deposit insurance scheme can make fast payouts. Achieved.*

4.41 Increases in the size of the insurance fund and payout ratio made the fund much larger, at euro 140 million, capable of handling a failure of a midsize bank, following good international practice. Payout software has been tested and implemented, and provisions of the DIA and NBS Memorandum of Understanding on sharing information as well (NBS 2015).

4.42 **Restructuring and divestment of state-owned banks** has been the second policy area under this objective. To this end, the main reform action (prior action) was: Banks with

borrower majority ownership have been merged, privatized, or restructured in accordance with the strategy adopted under the second PFDPL provided by the Bank. *Outcome: Consolidation of the Republic of Serbia holdings in banking sector: banks with government ownership reduced from four to two by 2010. **Achieved.***

4.43 The governments pursued a policy of bank divestment and restructuring. Government ownership was reduced from four banks (Credy, Postanska, Privredna Pancevo, and Srpska Banka) by a combination of approaches, including sale to a foreign buyer (Credy) and merger (Postanska and Privredna into a consolidated state bank). This resulted in the consolidated Postanska and Srpska Banka in state ownership. As of 2015, these policies were sustained. There are currently 30 banks with operating licenses in Serbia, with the same two in majority state ownership. Additional bank privatization is being planned under the ongoing IMF-supported reform program.

4.44 **Strengthening of the insurance sector** has been the third policy area under this objective. The first action was: Amendments to the Law on Insurance, setting the framework for converting state insurance company Dunav's ownership from social to state-owned, is approved by the government and submitted to the parliament for approval. *Outcome: Dunav's social ownership was replaced by state ownership, paving the way for subsequent privatization. **Not achieved.***

4.45 While the legal action was complete, this did not lead to the expected outcome of ownership transformation of Dunav. It was expected that privatization would be initiated by 2013, but as of mid-2016, this had not happened.

4.46 The second action was: Amendments to the Law on Insurance requiring the separation of life and non-life insurance by the end of 2011 are enacted by parliament. *Outcome: Life and non-life insurance business lines were separated by end-2011. **Partly achieved.***

4.47 The action was completed and the amendment of the law required separation of life and non-life insurance. This was not completed by the end of 2011, but it was eventually done.

4.48 **Supporting capital market development** was the fourth policy area under this objective. The main policy action here was as follows: Range of longer-maturity T-bills issued to establish a benchmark yield curve: maturities of T-bills will increase from 3 months to 6, 12, 18, and 24 months. *Outcome: Increased mobilization of capital by providing more options to investors and longer-term funding for the government in local currency. **Achieved.***

4.49 The government made considerable, steady progress in increased mobilization of capital at longer-term funding in local currency. Compared with the situation in late 2010/early 2011, when mostly short-term T-bill financing was available, government T-bills are now available in all short-term maturities. Moreover, the government is now issuing bonds in local currency in maturities of 2, 3, 5, and 10 years. This gave rise to a regular, positively sloped yield curve over long maturities. In addition, the government is also issuing

53-week T-bills in euros and government bonds denominated in euros in maturities of 2, 3, 5, and 10 years at favorable rates, from 1.49 percent (53 weeks) to 4.5 percent (10 years) (Serbia, Public Debt Administration 2015).

4.50 Beyond the government paper, there is now a much wider menu of options available to investors in Serbia's capital market. For example, the Belgrade stock exchange has expanded the number of listed companies from only 6 in 2011 to 66 in 2015, of which 42 are included in the BELEX line index. Market capitalization had reached over 6 billion euros as of August 2015 (see Belgrade Stock Exchange website: <http://www.belex.rs/>).

## 5. Ratings

### Outcome: Satisfactory

5.1 The objectives of the operation were highly relevant, both in terms of the government's strategic priorities and the Bank's strategy, at the time of the operation's approval and closing and at the time of review. Similarly, design was highly relevant, combining the objectives of facilitating access to international markets with policy reform objectives in the areas of business climate, financial discipline in state-owned enterprises, and financial sector and capital market development. These policy areas represent a continuum of reforms from the two previous PFDPLs, and the associated policy actions rested on a considerable body of analytical work that informed the operation's design.

5.2 Relevance was heightened in the context of the international market turbulence and the government's need for larger financing of the budget. The PBG was a hybrid (guarantee/DPL), innovative instrument that met the government's need for greater budgetary financing than would have been possible under a standard DPL, while supporting policy reform in key areas.

5.3 Efficacy was strong. Out of 18 target outcome indicators, 15 were fully and one partly achieved, resulting in an 89 percent achievement ratio. In particular, the critical indicators under objectives 1 (facilitating access to international markets), 2 (enhancing business environment), and 4 (building a stable and more efficient financial sector) were achieved. Achievement of objective 3 (enhancing financial discipline) in terms of actions and indicators was also complete. But these actions did not translate into further reform progress until the most recent re-start of structural reforms under the new IMF-supported program in 2015. In other reform areas supported under the PFPBG, PPAR field visits found that policy reforms and target indicators were sustained, and some reforms advanced further.

5.4 The achievements and sustainability of these reforms and outcomes should be seen in the context of the particularly difficult external and domestic environment that prevailed between 2011 and mid-2015. At the time of approval of the operation, the macroeconomic framework, based on the prevailing euro area and regional projections, envisaged strong recovery of the Serbian economy from a low base, achieving growth rates of about 5 percent in the medium term. In the event, however, since the deep recession in 2009 (with real GDP declining by over 3 percent), the Serbian economy experienced a new double-dip recession in

2012 and 2014, in the context of extremely sluggish euro area recovery and new concerns about the euro area banking and debt situations, as well domestic supply shocks (for example, major droughts and floods) (see World Bank 2012b, 2013b, 2014). As a result, Serbia's real GDP level has yet to recover to the pre-global recession level in 2008, and unemployment has only very recently started to decline from very high double-digit levels. In this difficult context, the achievements in the reform areas of maintaining stability of the domestic financial sector, accessing international markets, and improving aspects of business registration are particularly important. At the same time, these developments, and fragmented domestic politics and political support for structural reforms in the state enterprise sector, help explain why more progress was not achieved compared with expectations at the time of PFPBG approval in 2011.

### **Risk to Development Outcomes: Moderate**

5.5 Most reform actions and outcomes supported under the operations were sustained over the past four years under difficult external and domestic conditions. This suggests resilience in maintaining development outcomes in the face of adversity. Still, Serbia's economy faces substantial macro-financial, external, and policy implementation risks. But the overall sense is that those risks are moderated by improved capacity of the government to deal with them, as well as the new reform program that is currently under way with strong international support. As a result, risk to outcomes is rated moderate.

5.6 On the macroeconomic side, while the banking system remains well capitalized and provisions are high, the large level of nonperforming loans poses a threat under conditions of new major shocks. This risk is mitigated by continuous, close monitoring of the banking sector risks and stronger capacity of the NBS and the government to deal with banking sector shocks than was the case four years ago. There are also significant fiscal risks, with public debt levels currently exceeding 70 percent of GDP and difficult fiscal consolidation under way, which relies in large part on the ability of the government to maintain tight control over public sector wages and pensions, something that had proved difficult in the past. The new government's majority in parliament and strong ownership, backed by the new IMF and Bank budget support, help moderate these risks.

5.7 External risks, including those from the new spillovers from the Greek crisis or other vulnerable European economies, remain. But the government's monetary and fiscal tools and capacity to cushion these impacts are now stronger than four years ago, in large part because of the intervening reforms.

5.8 Finally, despite strong ownership and ongoing reform with substantial international backing, the scale of Serbia's fiscal consolidation in the coming years and structural reforms in the enterprise sector will require continued political support in the medium term. It is noted that reforms and fiscal consolidation have accelerated since late 2014 with the support of the IMF and the Bank. However, risks of slow implementation and erosion of political support remain.

## **Bank Performance: Highly Satisfactory**

### *Quality at entry: highly satisfactory*

5.9 The PFPBG was an innovative, pioneering operation in the Western Balkan region that met the critical need of the borrower for larger financing than would have been possible under a standard DPL. This required considerable investment of the time of Bank management and staff—over and above what would be required under a standard DPL. This included explaining the potential benefits and costs of the operation to the borrower, as well as providing considerable informal technical support to the Ministry of Finance and the Public Debt Administration in preparation for accessing international markets in this set-up for the first time. This has built on the continuity of past technical assistance to the administration under the PFDPL 2. The team also invested considerable efforts in navigating the Bank’s internal processes to prepare a de facto new instrument operation.

5.10 Field interviews indicate a long-standing relationship of trust between the Bank and the borrower and strong appreciation of the Bank staff’s intensive engagement with the client. Particularly appreciated was ongoing technical support to the Public Debt Administration to make sure that the operation was put together in a timely fashion to meet the budget cycle of the government. The Bank closely coordinated with the IMF and had a clear division of labor and complementarity of focus: the IMF concentrated on macro policies, and the Bank on structural reforms.

5.11 The Bank provided timely and critical support to the client for a broad front of structural reforms in the areas of business climate, financial discipline, and financial sector reforms. Preparation of the operation was rapid (under six months), but this did not compromise the quality of design and the dialogue, both of which were of high quality and reflected continuity of reforms and engagement. The Bank has held a vibrant policy dialogue building on past PFDPL 1 and 2 as well as public expenditure DPLs and considerable analytical work focused on aspects of investment climate, public expenditures, and growth and financial sector diagnostics.

### *Quality of supervision: highly satisfactory*

5.12 Finally, the Bank team remained engaged and provided continued monitoring of the reform program and dialogue with the government following the approval of the operation and the completion of the operational portion.

## **Borrower Performance: Highly Satisfactory**

5.13 Government ownership was high. It reflected the borrower’s trust in the Bank’s ability to deliver and its need for the timely and large volume of financing the instrument was able to provide. Key government ministries and agencies—Ministry of Finance, its Debt Management Department, NBS, and Ministry of Economy and Regional Development, among others—were closely engaged in the policy dialogue. They were able to coordinate to put together and implement a broad reform program.

5.14 Borrower reporting and provision of information to the Bank staff was highly satisfactory. Cooperation with the Bank team was strong throughout. Productive and direct virtual communications with the Bank's technical counterparts were frequent and helped maintain continuity of dialogue between missions. All prior actions were met, as well non-prior actions, which were part of the policy matrix, and the achievement of outcomes was high.

### **Monitoring and Evaluation: Substantial**

5.15 **Design.** Objectives of the operations were clearly specified and linked to actions, and outcome indicators reflected those objectives. Indicators were generally measurable and identifiable. Eight of 18 outcome indicators were quantitative, making their assessment relatively straightforward. Several are high-value indicators that are monitored in the course of government economic and financial monitoring (such as financial adequacy ratios, yields on government paper, and number of banks with majority state ownership). The others were identifiable legislative or regulatory events or institutional actions or improvements. In many cases, the same or related indicators could be tracked and updated four years after operation approval, which made it possible to obtain a sense of sustainability of reform actions and outcomes. Data required were generally available from the government's public sources from the relevant ministries and agencies (such as the Ministry of Finance, NBS) and/or comparative international indicators (Doing Business Indicators and others). While in most cases the relevant baseline is clear or implicit, baselines could have been defined more clearly and made more explicit.

5.16 Indicators were embedded within the institutional frameworks in that they were clearly associated with data and information available from the relevant ministries and agencies (for example, capital adequacy ratio data monitored and publicly and regularly reported by NBS; yields on government's T-bills that are monitored and publicly and regularly reported by the Public Debt Administration of the Ministry of Finance).

5.17 **Implementation.** Slightly more than half of the indicators in the project appraisal document were quantitative and measured. Indicators were owned by the borrower agencies and there was considerable consultation and agreement with the borrower on the choice of the indicators. There was also wide consultation with other stakeholders (IMF and the Swiss Agency for Development and Cooperation, for example). The Ministry of Finance, Public Debt Administration, NBS, and Ministry of Economy and Regional Development were responsible for monitoring and evaluation (M&E) and reporting, with a coordinating role played by the Ministry of Finance. This function was carried out effectively. Finally, because it is embedded in the existing institutional structure and often relies on existing, highly monitored indicators, M&E indicators in place are sustained over time.

5.18 **Utilization.** Use of outcome indicators informed the direction and outcomes of some important reforms. For example, it was critical for the financial sector reform pillar for the NBS and the government to maintain a high capital adequacy ratio throughout the post-approval period. This highly monitored indicator influenced NBS activities with respect to monitoring and diagnosing the health of the banking system and in its periodic stress tests. Similarly, information on yields on government paper is used by the Debt Management

Administration and the Ministry of Finance in calibrating implementation of its debt management strategy and its regular issuance of domestic debt. In the area of investment climate, Doing Business Indicators are closely monitored by the government and Ministry of Economy and Regional Development and Ministry of Finance in particular, and actions are formulated in response in order to reduce perceived and real costs of doing business.

## 6. Lessons

6.1 With informed hindsight four years after the operation, several lessons are worth highlighting that may be of broader relevance.

6.2 First, PBGs are a **potentially important instrument** that could be used effectively to support client countries in tapping international markets on favorable terms in combination with other lending and advisory instruments to help countries meet the development challenges of the twenty-first century. These challenges included the need to make structural reforms necessitated by global or regional crises, fund and manage large and complex development projects, work toward meeting the Sustainable Development Goals, and address issues related to climate change. Through this and similar guarantee instruments, the Bank Group could raise its leverage ratio, particularly if it fails to raise its capital base, in order to help its clients meet their development challenges of the next 15-to-20 years. Learning about the PBG in the context of Serbia and other client countries is both timely and important to the Bank Group's business model and strategy going forward.

6.3 Second, this highly satisfactory operation shows that the Bank can productively take **informed risks** with new and innovative instruments to support client needs in a timely fashion in a manner that would not have been possible with standard instruments of Bank support. The Bank had an option to take a low-risk approach and extend a standard DPL, which would have been in line with the existing Bank strategy. Also, external market turbulence could have suggested a more cautious approach with a standard DPL. In that scenario, however, the borrower would have had to borrow additional amounts in the external markets at much more unfavorable terms, raising its short-term debt service and fiscal pressure. The Bank's innovative approach with the PBG was risky, but it helped deliver the benefits to the client when needed. As a result, it strengthened the relationship of trust with the government.

6.4 Third, this operation shows that the PBG can be a particularly effective instrument of budget support under **certain conditions**. Those conditions are likely to include the following: a small, vulnerable economy needing substantial external financing on a timely basis; a solid track record of macroeconomic performance, debt management, and policy reform and a good dialogue with the Bank; and a period of heightened international market risks and worsened access and terms of sovereign borrowing. The instrument should also be relevant for larger countries facing similar borrowing and reform challenges. These conditions are quite prevalent in international markets. Yet PBG use at the Bank has been limited so far. This may suggest that, perhaps with more information disseminated among the Bank Regions and the borrowers, there is scope for a wider use of PBGs in the future. This could also be helped by recent OPCS reform that moved the PBGs to the revised OP8.60



framework governing development policy operations, explicitly recognizing that PBGs are essentially a sui generis type of DPL.

6.5 Fourth, the PBG can unlock **multiple benefits** to the borrower, which may not be easily captured by alternatives such as a standard DPL: the borrower was able borrow the larger amount (because of the Bank's set-aside policy, which accounts only one-quarter of the PBG against country's borrower limit) needed at the right time and on favorable terms in the context of the PBG, and its short-term debt service was lower than it would otherwise have been; it was able to open the door to substantial subsequent international borrowing at favorable terms; the borrower was able to establish itself in the eyes of international investors and broaden the investor base; and the borrower was highly motivated to deliver on reforms, in part because of a relationship of trust with the Bank, the large volume of borrowing, and also perhaps because of the presence of the third party (that is, a foreign commercial bank providing funding) supplying additional pressure on the timing and closure of the loan.

6.6 Fifth, it is important to recognize that **risks such as a bullet repayment** feature could add to the borrower's risk of repayment in the future unless it is accompanied by ex ante provisions equal to the amount required under a standard annual repayment schedule. Repayment options and their pros and cons should be discussed at length with the client. A standard repayment schedule should normally be preferred, and bullet repayments should be accompanied by a Bank recommendation (or requirement) that the borrower make annual provisions.

6.7 Sixth, strong and relevant design and high achievement are much more likely when the operation's design is informed by considerable **knowledge work, intensive and longer-term Bank engagement and dialogue, and a relationship of trust** between the Bank and the borrower. Developing and maintaining a relationship of trust with the borrower should be explicitly high on the agenda of country management. In its absence, ownership, quality of the dialogue, and the design and implementation are likely to suffer.

6.8 **Complex and comprehensive reforms** of large socially or state-owned enterprise sectors take time to implement. They also involve political, social, and fiscal risks. This calls for a carefully phased approach and realism in what can be accomplished in the short term and the time frame of a single operation.

6.9 Seventh, Bank staff **engagement in innovative operations must be more intensive and accompanied by considerable informal technical assistance**. Such stepped-up assistance can be used to inform the borrower of the benefits and risks and help it navigate the preparation of a hitherto little-known instrument or type of Bank operation.



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## Annex A. Basic Data Sheet

### PRIVATE AND FINANCIAL SECTOR POLICY BASED GUARANTEE (P102651)

#### Key Project Data (amounts in US\$ million)

	Appraisal estimate	Actual or current estimate	Actual as % of appraisal estimate
Total project costs	400.00	400.00	100%
Loan amount	400.00	400.00	100%

#### Cumulative Estimated and Actual Disbursements

	<i>FY11</i>
Appraisal estimate (US\$M)	400.00
Actual (US\$M)	400.00
Actual as % of appraisal	100%

#### Project Dates

	Original	Actual
Concept review	09/07/2010	04/15/2011
Appraisal	12/28/2010	12/28/2010
Board approval	02/10/2011	02/10/2011
Signing	04/08/2011	04/08/2011
Effectiveness	04/15/2011	04/15/2011
Expiration of guarantee	04/13/2017	04/13/2017

#### Staff Time and Cost

<i>Stage of project cycle</i>	<i>Staff time and cost (Bank budget only)</i>	
	Number of staff weeks	US\$ thousands (including travel and consultant costs)
<b>Lending and supervision</b>		
FY11	104.8	104.8
<b>TOTAL</b>	<b>104.8</b>	<b>104.8</b>

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Andrej Popovic	Private Sector Development Specialist	

## Annex B. The Bank's Experience with Policy Based Guarantees

Although the Bank introduced the PBG in 1975 and has completed eight operations, there is very little independent evaluative evidence on the instrument's effectiveness and development impact.<sup>8</sup> Between 1975 and 2015, the Bank implemented PBGs in Côte d'Ivoire (1975), Argentina (1999), Colombia (2001), Serbia (2001), the former Yugoslav Republic of Macedonia (2012, 2013), Montenegro (2012), and Albania (2015) (see table B.1). IEG (then OED) evaluated the \$5.6 million Côte d'Ivoire operation in 1985, rating its development outcome as unsatisfactory.<sup>9</sup> The \$250 million PBG for Argentina, which was an innovative use of the guarantee instrument was called, but the ICR does not seem to be publicly available.<sup>10</sup> There is, however, a brief ICR Review for the Argentina Special Structural Adjustment Loan, in which part of the second tranche was cancelled and allocated to a separate \$1.1 billion PBG. IEG rated this operation's development outcome and borrower performance as unsatisfactory.<sup>11</sup> A more extensive discussion of the Argentine experience can be found in IEG's evaluation of the guarantee instrument at the World Bank Group.<sup>12</sup> No

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<sup>8</sup> For a list of policy-based guarantees, see <http://www.worldbank.org/projects/search?lang=en&searchTerm=Policy-Based%20Guaranteee>.

<sup>9</sup> <http://www.worldbank.org/projects/P001113/small-scale-enterprise-project?lang=en>. Neither the ICR Review nor the PPAR for that operation is publicly available.

<sup>10</sup> <http://www.worldbank.org/projects/P068845/argentina-policy-based-guarantee-operation?lang=en>

<sup>11</sup> IEG ICR Review – AR Special SAL (SSL), 2003, <http://lnweb90.worldbank.org/oed/oeddoctib.nsf/DocUNIDViewForJavaSearch/8525682E0068603785256C54006BA2D0?OpenDocument>

<sup>12</sup> [http://siteresources.worldbank.org/EXTGUARANTE/Resources/guarantees\\_eval\\_full.pdf](http://siteresources.worldbank.org/EXTGUARANTE/Resources/guarantees_eval_full.pdf). According to this IEG evaluation (2009), in the case of the two PBGs, for Argentina and Colombia, the guarantees exerted considerable leverage—generating financing of 4.7 times the value of the PBG in Argentina and 6.3 times its value in Colombia. The Colombia operation achieved investment grade status, which enabled the country to reestablish access to international capital markets at a time when investor interest was low or nonexistent. In Argentina, although the country was able to access both U.S. and non-U.S. capital markets at similar terms, the PBG enabled it to issue a significantly larger bond (\$1.2 billion) than would otherwise have been possible at the time. In Argentina and Colombia, although both countries had previously accessed international capital markets, the PBGs effectively reintroduced their large bond issues to international markets at a time when they were either closed to emerging market economies or constrained to small volumes. Following the collapse of the Argentinean financial system, the country's adjustment program went off track, and reforms that were intended to be supported by a Bank adjustment loan as well as the PBG financing were not achieved. In Colombia, when the PBG was issued, the government had been implementing a broad reform program supported by a Bank Financial Sector Adjustment Loan. The Bank's self-evaluation of the [project noted that in this context](#), hybrid policy loan/guarantee operations might provide more policy leverage and better sequencing than stand-alone policy guarantee operations. The Bank's decision to extend repayment terms on the called PBG in Argentina effectively ended its ability to use rolling, reinstatable PCGs. The Rolling Reinstatable Guarantee (RRG) mechanism for PCGs was introduced on a pilot basis in 1999, and three PCGs were issued using it between 1999 and 2001—in Thailand, Argentina, and Colombia. However, according to IEG's 2009 evaluation of the World Bank Group instrument, given difficulties in modeling and valuing the credit enhancement, RRGs were seen as being penalized by the market. This, in turn, was seen as affecting the value placed on direct Bank bond issues, thereby potentially raising the cost of borrowing for the Bank. In this context, in 2000 the Bank adopted a very cautious approach to future transactions using the RRG structure. Then, in 2002, the PBG in Argentina was called when Argentina failed to service the outstanding bond. Rather than enforce the 60-day period in

PPAR seems to have been prepared for this very complex and large operation, which was large to fill the financing gap in the IMF program defending Argentina's peg to the dollar (through its currency board). For the Colombia PBG (\$230.3 million), there is an ICR Review<sup>13</sup> which rates the development outcome as moderately satisfactory and is critical of the guarantee operation, arguing that international capital market inefficiencies were not in Colombia's favor despite the PBG (mainly because of the collateral damage from the Argentine guarantee debacle, which resulted in immediate downgrading of Colombia's bonds (backed by the World Bank guarantee). The PPAR for the Colombia FSAL rates the overall operation as satisfactory, but does not evaluate the PBG portion of the financing operation.<sup>14</sup> ICRs were conducted for the Serbia PBG operation, the two Macedonia operations, and the operation for Montenegro (the Albanian PBG is too recent to have been reviewed).

**Table B.1. World Bank Policy-Based Guarantee, 1975–2015**

Project title	Country	Project ID	Commitment (US\$ millions)	Status as of September 2015	Approval date
Albania Public Finance Policy-Based Guarantee	Albania	P149765	226.7	Active	March 27, 2015
FYR Macedonia Public Expenditure Policy-Based Guarantee	Macedonia, former Yugoslav Republic of	P133791	201.5	Active	January 8, 2013
Montenegro Financial Sector Policy-Based Guarantee	Montenegro	P130157	79.2	Active	June 28, 2012
FYR Macedonia Policy-Based Guarantee	Macedonia, former Yugoslav Republic of	P125837	134.9	Active	November 10, 2011
Private and Financial Sector Policy-Based Guarantee	Serbia	P102651	400.0	Active	February 10, 2011

which Argentina had to repay the Bank for the guarantee to roll over, the Bank rescheduled the loan, causing the guarantee to lapse. The market immediately downgraded the issue and also downgraded the RRGs in Thailand and Colombia.

<sup>13</sup> Implementation Completion Report (ICR) Review for Colombia FSAL (2003). [http://imagebank.worldbank.org/servlet/WDSContentServer/IW3P/IB/2014/06/07/000020051\\_20140607172723/Rendered/PDF/000020051\\_20140607172723.pdf](http://imagebank.worldbank.org/servlet/WDSContentServer/IW3P/IB/2014/06/07/000020051_20140607172723/Rendered/PDF/000020051_20140607172723.pdf)

<sup>14</sup> The PPAR for the FSAL simply mentions that "most of the resources of the FSAL second tranche were used to fund a PBG in March and May 2001" and then goes on to indicate that "this assessment does not cover the outcomes (nor Bank and borrower performance) under the PBG, as the PBG has not yet closed and remains active today." [http://ieg.worldbankgroup.org/Data/reports/PPAR-40139-P006884-Colombia\\_Financial\\_SALs.pdf](http://ieg.worldbankgroup.org/Data/reports/PPAR-40139-P006884-Colombia_Financial_SALs.pdf)



<b>Project title</b>	<b>Country</b>	<b>Project ID</b>	<b>Commitment (US\$ millions)</b>	<b>Status as of September 2015</b>	<b>Approval date</b>
Colombia Policy-Based Guarantee	Colombia	P072723	220.3	Closed	March 8, 2001
Argentina Policy-Based Guarantee Operation	Argentina	P068845	250.0	Closed	September 16, 1999
Small-Scale Enterprise Project	Côte d'Ivoire	P001113	5.6	Closed	August 21, 1975

Source: World Bank (<http://www.worldbank.org/projects/search?lang=en&searchTerm=Policy-based%20guarantee>).

Note: For active and closed projects, the commitment amount at Board approval is shown in U.S. dollars. These figures do not reflect any cancellations.

## **Appendix C. List of Persons Met**

### **World Bank Staff**

Mr. Dusko Vasiljevic, PBG Private Sector Economist, World Bank  
 Ms. Jasna Vukoje, Senior Program Assistant, World Bank  
 Mr. Lazar Sestovic, Senior Economist, World Bank Group  
 Ms. Aurora Ferrari, Practice Manager, Finance and Markets Global Practice, PBG Task Team Leader, World Bank  
 Mr. Andrej Popovic, Private and Financial Sector Specialist, World Bank  
 Ms. Marina Wes, former lead economist for Serbia, World Bank  
 Ms. Jane Armitage, former Country Director for Western Balkans, World Bank  
 Mr. Gianfranco Bertozzi, lead specialist, World Bank Group

### **Government of Serbia and Experts**

Mr. Dusan Vujovic, Minister of Finance, Ministry of Finance  
 Mr. Nenad Mijailovic, State Secretary, Ministry of Finance  
 Mr. Diana Dragutinovic, Former Minister of Finance, Ministry of Finance  
 Professor Miroljub Labus, independent expert and professor emeritus, Former Deputy Prime Minister and Minister of Economy of Serbia, Ministry of Finance  
 Professor Pavle Petrovic, President of the Fiscal Council of Serbia, Government of Serbia  
 Mr. Nikola Altiparmakov, member, Fiscal Council of Serbia, Government of Serbia  
 Professor Milojko Arsic, member, Fiscal Council of Serbia, Government of Serbia  
 Mr. Vladimir Vuckovic, Faculty of Economics, University of Belgrade  
 Mr. Branko Drcelic, Head of the Public Debt Management Agency  
 Mr. Milosch Dragic, Head of the Public Debt Management Agency  
 Mr. Dejan Soskic, University of Belgrade, Former governor of the National Bank of Serbia (NBS)  
 Mr. Luka Andric, Law Office, PBG Lawyer  
 Mr. Mirko Cvetkovic, Former Prime Minister and Finance Minister of the Republic of Serbia  
 Ms. Tanja Kuzmanovic, Former Advisor to the Prime Minister and Minister of Finance, Ministry of Finance  
 Mrs. Goran Radosavljevic, Advisor to the former Prime Minister and Minister of Finance, Ministry of Finance  
 Office of Soci t  G n rale, Belgrade, Serbia

### **International Monetary Fund**

Mr. Bogdan Lissovolik, Former IMF Representative  
 Mr. Kim Daeheng, IMF resident representative, Belgrade office, International Monetary Fund (IMF)  
 Mrs. Desanka Nestorovic, Economist, Belgrade Office, International Monetary Fund (IMF)

### **International Commercial Banks**

Ms. Sonja Miladinovski, Executive Board Member, Soci t  G n rale Bank  
 Mr. Dragoljub Veljic, Soci t  G n rale Bank