European Commission

Ex Post Evaluation of the Macro-Financial Assistance to Serbia

Final Report

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This executive summary exists in English and French and can be downloaded from the website

http://ec.europa.eu/economy_finance/evaluation/index_en.htm

A great deal of additional information is available on the Internet. It can be accessed through the Europa server (ec.europa.eu)

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Executive summary

The Macro-Financial Assistance (MFA) to Serbia was awarded by the Council of the European Union Decision 2009/892/EC on the 30 of November 2009. The 2009 – 2011 MFA was the third provided to Serbia since two MFA operations had already been undertaken in 2001 – 2002 and in 2002 – 2006 to the benefit of Federal Republic of Yugoslavia and State Union of Serbia and Montenegro respectively, entities of which the Republic of Serbia was constitutive at these periods.

The decision to grant the Macro-Financial Assistance 2009 – 2011 was linked to the International Monetary Fund (IMF) financial assistance to Serbia. The MFA Memorandum of Understanding states that disbursement of funds in the framework of the MFA operations is conditional to the satisfactory track record in the implementation of the ongoing Stand-By Arrangement referring to the 2009 – 2011 SBA). Another pre-criterion to disbursement was a positive evaluation, by the European Commission, of the progress made in the implementation of structural reforms. In addition, the MFA was conceived to be complementary to the IMF and World Bank funding, and the volume of funds for the MFA was determined based on the IMF forecasts of the Serbian economy’s needs.

The 2009-2011 Macro-Financial Assistance was awarded in the form of a loan facility of EUR 200 million. To meet this obligation, the Commission was authorized to borrow up to EUR 200 million on the capital markets or from financial institutions.

The MFA operations were expected to be disbursed in two instalments, of EUR 100 million each, taking place over a two-year period. The Memorandum of Understanding was signed on the 5th of July 2010 and the Loan Agreement was signed on the 17th of December 2010, it entered in force on the 12th of April 2011.

On the 15th of April 2011, Serbia submitted to the European Commission a request for the release of the first MFA instalment, accompanied by a report on the fulfilment of the structural reform criteria conditional to the first tranche. Upon fulfilment by Serbia of the conditionalities included in the Memorandum of Understanding, the first instalment of EUR 100 million was disbursed on the 15th of July 2011.

The second tranche was not disbursed because the IMF programme was not on track any more by the end of 2011 and because Serbian financing needs sidestepped. The MFA expired two years after the signature of the Memorandum of Understanding.

The objective of this report is to present our findings from the evaluation of the MFA support operations to Serbia.

Our report is structured in the following manner:

- First, we present the macroeconomic context against which the MFA operation was approved. This allows us to gain an understanding the problems and the needs of the Serbian economy pre-2010, the rationale for the MFA and IMF interventions, and the evolution of the Serbian economy post MFA and IMF support operations. This, in particular, allows us to assess the relevance of the Macro-Financial Assistance’s financial design and policy requirements.

- Second, we assess the macroeconomic impact of the MFA on the Serbian economy through a two- step process:

  - We examine the macroeconomic evolution of Serbia between 2010 – 2012 in order to identify a range of possible impacts of the MFA and assess the extent to which the macroeconomic objectives of the MFA were attained;

  - We conduct a counterfactual analysis seeking to identify the net impact of the MFA and IMF interventions on the Serbian economy; and

This assessment of the macroeconomic impact of the MFA on the Serbian economy helps us assess the **effectiveness** of the MFA operations as well as the **impact** of the MFA to the Serbian economy.

- Third, we address the question of the structural reforms implemented following the policy conditions formulated in the Memorandum of Understanding (MoU) of the MFA. This task has two components:

  - We examine the effectiveness and the modalities of implementation of the structural reforms related to the policy conditions laid out in the Memorandum of Understanding. Based on this, we assess the relevance of the policy conditions and the impact of the corresponding structural reforms for the Serbian economy; and

  - We address the question of whether the corresponding structural reforms would have been implemented in absence of the MFA, thereby assessing the impact on the Serbian Economy.

- Fourth, we examine the external financial sustainability indicators of the Serbian economy and study the impact of the MFA on these indicators.

- Fifth, we address the question of interaction of the MFA with the other components of the international financial assistance to Serbia, in particular the Instrument for Pre-Accession (IPA) provided by the European Union, the IMF SBA 2009-2011 and the World Bank budget support programmes.

This allowes us investigating the potential complementarities or redundancies across the MFA and the programmes mentioned and ultimately inferring the added value of the MFA with respect to these programmes, in particular the IMF programme.

- Sixth, we summarize our evaluation findings and present recommendations for future MFA operations.

Our evaluation findings are based on the fieldwork in Serbia – with interviews with stakeholders from the Serbian government, international financial institutions and the European Commission – the output of the Delphi analysis, an extensive documentation review and economic modeling.

As a result, we are able, and draw conclusions regarding the effects of the Macro-Financial Assistance on the Serbian economy, the optimality of the MFA design, and added value with respect to the IMF, the World Bank assistance as well as EU assistance through IPA.

The aim of the MFA was to provide funds in order to cover the external financing needs of the Serbian economy while ensuring – through appropriate policy conditions – the implementation of structural reforms which would help Serbia achieve medium and long term fiscal sustainability and align its internal financial control on the European Union standards.

From the short-term macroeconomic stabilisation point of view, the MFA and the IMF financial assistance helped preventing the Serbian economy from slipping into a major economic crisis that was not excluded in 2009-2010. The MFA short-term macroeconomic objective of stabilizing the Serbian economy was therefore effectively attained. However the Serbian fiscal and external financial situation remains fragile and subject to numerous risks and challenges. The net contribution of the MFA loan to the macroeconomic stabilization of the Serbian economy, as our counterfactual analysis shows, is likely to have been very limited situating in the range from 0 to 0.05% of GDP loss in absence of the MFA. The impact on the other macroeconomic aggregates is of similar magnitude. The macroeconomic impact of the IMF financial assistance, in its turn, is likely to have been substantial in 2010 (GDP up to 0.3% lower in absence of the IMF funds) and very close to zero in 2011. More important than the direct financial support was the signalling to private actors about the EU intention to help to Serbia in the face of adverse shocks.

Regarding the policy component, in October 2010 the Serbian Parliament voted a Law on Amendments and Addenda to the Budget System Law which formally fulfilled both of the MFA policy conditions: introduction of quantitative fiscal rules and adoption of provisions in the field of Public Internal Financial Control (PIFC) from the PIFC Policy Paper. The involvement of the EU through the MFA was instrumental in pushing for implementation of the measures described in the policy conditions. In absence of the MFA the implementation of these legal acts would probably have been made at a slower pace or even postponed.

The PIFC measures are part of a structural improvement of the Serbian public financial management and contribute to gradually absorbing the *Acquis Communautaire* in the pre-Accession perspective. As such, their implementation is impactful and useful and underlying MFA policy condition made a difference.

The fiscal rules had three components: a cycle-adjusted fiscal deficit rule, a debt rule and a set of indexation rules. Although made part of the Budget System Law in 2010, these rules made little difference to the Serbian economy: the actual fiscal deficits exceeded those fixed by the Fiscal Deficit Rule (mainly for reasons related to electoral cycle), the debt rule was largely breached in 2011 and 2012, while indexation rules – while formally respected – were overturned by ad hoc remuneration of public employees practices. However, the quantitative fiscal rules had the added value of introducing fiscal responsibility as one of the main targets of the economic policy.

Our case study dedicated to fiscal rules went further in investigating the impact of the fiscal rules for the Serbian economy. We show that the Serbian fiscal deficit has been largely structural implying that the fiscal deficit would not be eliminated if GDP growth resumes at its potential level. Serbian fiscal policy has been pro-cyclical in the two years immediately preceding the crisis which dried out the resources for a counter-cyclical response once the crisis occurred. The necessity to cushion the adverse effects of the crisis along with the upcoming elections was the reason why the fiscal rules were largely disregarded by the fiscal policy in 2011-12.
One of the key components of the fiscal sustainability of Serbia is pensions. The issue of the Serbian pension system organization, macroeconomic impact is investigated along with possible reform options.

During the evaluation, no unexpected effects of the MFA have been found.

An examination of the external financial sustainability of Serbia reveals that the country's stance is fragile and subject to numerous risks. Widening current account deficit requires capital inflows which can dry out quickly in the event of a financial crisis. Very high euroisation of the economy exposes it to negative exchange rate shocks. Serbian external debt to GDP ratio has been stable over the period 2010-2012, but remains one of the highest in the region. The foreign currency reserves level, by contrast, is fully adequate and compares favourably to peer countries'. In the Serbian public debt to GDP ratio evolution in 2010-2012, primary fiscal deficit contribution was essential, along with the exchange rate dynamics. Regarding external debt sustainability, current account and capital account dynamics were the main drivers of the fall in the fluctuations of the debt-to-GDP ratio over the period. The MFA contribution to Serbian external financial sustainability was very modest: the gains from cheaper debt are real, but very modest and unlikely to make a difference over the long term. The involvement of the EU to support Serbia – including through MFA – and Serbia's commitment to implement the reforms associated with joining the EU were, however, considered important by the rating agencies with subsequent impact on the Serbian sovereign credit rating. This hints at the MFA exercising an indirect favourable effect, although the latter cannot be assessed quantitatively.

In respect of the design and implementation of the MFA, the terms and conditions and the volume of the MFA loan were fully adequate, although its efficiency for the Serbian economy would have probably been greater had the funds been made available more operationally. Regarding the articulation of the MFA with respect to the other financial assistance programmes, our findings show it was largely complementary to the IMF SBA. In addition, MFA provided a strong political backing for the implementation of the structural reforms agreed between the Serbian authorities and the IMF. The interaction with the Instrument for Pre-Accession also exhibited complementarities with little overlap. Overall, the greatest added value of the MFA with respect to the IMF and World Bank assistance was to provide a political backing for structural reforms within Serbia, and to inform the private economic agents about the EU commitment to support the country – in particular in the accession perspective – both within Serbia and outside.

In backward perspective, the MFA was clearly relevant to the Serbian economy needs. The macroeconomic stabilisation objective of the MFA has been reached, even though the MFA own contribution was very modest. In the structural reform area the MFA contribution was more important, but its effectiveness was only partial (fiscal rules breached) due to exogenous factors. The interaction with other forms of assistance and financial instruments exhibited a lot of complementarities, and the design of the MFA was broadly adequate. The added value from the MFA resides mainly in the political backing of structural reforms and market signalling.

Regarding financial assistance disbursement, the improvement would imply, on the other hand, faster MFA loan disbursement in order to provide MFA funds when they are needed the most and, on the other hand, discontinuation of the new instalments disbursement if during the MFA timeframe financial assistance is deemed unnecessary to ensure external financial sustainability of the recipient country in order to avoid potential windfall effects.

Regarding the policy component of MFA, the enhancement of the MFA mechanism requires, on the other hand, a focus on "quick wins" prior to the disbursement of the first instalment – in order to enable quick disbursement of the loan when it is needed – and, on the other hand, a requirement of sustained policy compliance with the legislation produced in line with the MFA policy requirements, so as to ensure the effectiveness of the structural adjustment.