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Private Sector Development and Business Enabling Environment Assessment

Financial Sector Assessment

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ACRONYMS

AMCHAM	Serbian-American Chamber of Commerce
AML	Anti-Money Laundering
BCPs	Basel Core Principles
BIS	Bank for International Settlements
CAR	Capital Adequacy Ratio
CFT	Combating the Financing of Terrorism
CPI	Consumer Price Index
DIA	Deposit Insurance Agency
EBRD	European Bank for Reconstruction and Development
ERM	Enterprise Risk Management
EU	European Union
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FIU	Financial Intelligence Unit
FSAP	Financial Sector Assessment Program
FSSA	Financial Sector Stability Assessment
FSSP	Financial Sector Support Program
GDA	Global Development Alliance
GDP	Gross Domestic Product
IAIS	International Association of Insurance Supervisors
IFC	International Finance Corporation
IFIs	International Financial Institutions
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISA	International Standards of Auditing
IT	Information Technologies
KfW	*Kreditanstalt für Wiederaufbau*
MEGA	Municipal Economic Growth Activity
NBFIs	Non-Bank Financial Institutions
NPLs	Non-performing Loans
NBS	National Bank of Serbia
OECD	Organization for Economic Cooperation and Development
PAYG	Pay-As-You-Go
RoAA	Return on Average Assets
RoAE	Return on Average Equity
SAM	Serbian Association of Managers
SEGA	Serbian Economic Growth Activity
SMEs	Small and Medium-sized Enterprises
SOE	State-owned Enterprise
TA	Technical Assistance
UN	United Nations
USAID	United States Agency for International Development
UST	United States Treasury
VAT	Value Added Tax
VPF	Voluntary Pension Fund
WTO	World Trade Organization

EXECUTIVE SUMMARY

I. Background

The following report, "Recommendations for USAID Financial Sector Assistance to Serbia: 2011-2015", has been prepared by Michael Borish and Company, Inc. (MBC) for USAID-Serbia for its internal strategic planning purposes related to possible bilateral assistance for Serbia in the coming years. The report provides an assessment of recent developments and issues for future USAID planning, a general overview of the financial sector and recommendations on what is considered the best use of USAID assistance in resolving critical issues for 2011-2015.

II. Major Findings Related to the Financial Sector

A. Macroeconomic and Monetary

- The recent global economic and financial crisis has tested Serbia, and the results have been broadly positive.
- There is broad acknowledgement that significant structural weaknesses persist, and that these could present challenges in the future in the event of another crisis as well as delay prospects for receiving a future invitation to join the European Union.
- The lack of competitiveness is a consequence and cause of a vicious cycle in which enterprises are often inefficient and/or unable or unwilling to pay taxes.
- Getting the government to induce needed reforms will be complex, costly, risky, and multi-dimensional in terms of requirements.
- Moreover, for enterprises in the private sector to assume greater responsibility, they will need to have mechanisms for clearing arrears and restructuring their finances and operations so that they can become more competitive and creditworthy on a sustainable basis.
- In addition to bank-enterprise issues, there are also substantial inter-enterprise arrears which, along with VAT, add to significant liquidity pressures in the real sector.
- Having accounted for such weaknesses, there is recognition that economic improvements have been made in recent years under difficult political circumstances.
- However, considering the endemic political instability that has persisted and the transformation of national borders, the overall environment for reform has been challenging. Looking ahead, it is clear that many difficult structural-level issues remain.

For USAID: The multitude of risks and challenges means that the upcoming environment for reform could be difficult, even with positive political will and a stable government.

B. Banks and Banking

- The Serbian banking system has undergone major reform in the last decade, and is now well capitalized relative to risk exposures.
- All the key indicators show significant improvement in the banking sector since reforms took hold.
- There are still considerable weaknesses in the banking system, albeit far less severe than in 2000 or 2004.
- There is also considerable work that needs to be done in the field of banking supervision.
- The FSSP is closely linked to a World Bank program that focuses on building a more efficient and stable financial sector along with initiatives to improve the business environment and strengthen financial discipline via privatization, restructuring, and energy sector reform.
- Despite continued weaknesses, the banking system has shown positive trends in the last several years.

For USAID: Continued weaknesses and challenges in the banking sector include the high cost of operations (e.g., high reserve requirements, high repo rates, high net nominal spreads on lending), continued state ownership of up to 15 percent of banking system assets, and limitations on hedging mechanisms in the Serbian banking system.

C. Non-Bank Financial Institutions

- Serbia's non-bank financial institutions are limited in activity, volume and value.
- The World Bank program tied to the FSSP addresses key outcomes in the insurance and securities markets in addition to banking.

For USAID: There are few risks to Serbia at the moment rooted in the non-bank financial sector, consistent with other markets where non-bank financial services are underdeveloped. The impact of the above on USAID planning is more related to the opportunity cost to Serbia of not developing non-bank activities.

D. Financial Sector Infrastructure

- The banking system has shown itself to be stable and well supervised during the recent financial crisis.
- Notwithstanding progress in banking supervision, there are still weaknesses and a need to sustain progress.
- The bankruptcy framework is underdeveloped and generally not used for debt resolution and contract enforcement issues.

- Serbia was slow to introduce legislation against money laundering and to set up a financial intelligence unit.
- The absence of consolidated accounting reduces risk detection capacity at the NBS, although efforts have been made in recent years to strengthen cross-border cooperation with other supervisory agencies.
- IFRS is now fairly common with the EU-based banks, but is hardly in effect elsewhere in the economy.

For USAID: Notwithstanding improvements in financial sector infrastructure in recent years, more work is needed for reforms to be sustained. The impact of the above on USAID planning is that while NBS has reached a threshold as an effective regulator under Basel I, there will be additional challenges as Serbia (1) moves on to Basel II, (2) seeks to develop the non-bank financial sector, (3) promotes development of a more profitable and more efficient system, and (4) seeks to strengthen Serbia's reputation internationally.

E. Real Sector Structural Issues

- Many of the core problems for future financial sector development relate to structural problems in the enterprise sector, as well as governance and tax administration weaknesses throughout the entire economy.
- There is a well defined agenda to enhance the business environment, strengthen financial discipline, and build a more efficient and stable financial system.
- Key legislative reform to strengthen the business environment includes (1) amendments to the Company Law, Enforcement Law, Privatization Law, and Law on Spatial Planning and Construction, and (2) new Laws on Bankruptcy, Competition, and State Aid.
- One of the key weaknesses in Serbia is governance and accounting standards. Serbian businesses do not operate according to the same principles as many other enterprises in the EU or elsewhere in market economies.
- Such principles also clearly apply to the public sector.
- Another key weakness is workforce development.

For USAID: Significant structural problems remain in the government and enterprise sector, and these will only be solved over a period of many years. The impact on USAID planning for financial sector and enterprise/public sector support is that greater strategic cohesion across initiatives/projects is required for USAID to have impact on a long-term basis, and in a manner that supports larger strategic objectives.

III. GENERAL ASSESSMENT OF THE FINANCIAL SECTOR

A. Background

This assignment called for lessons learned from financial sector assistance activities, including the SEGA activity, over the last few years to determine how USAID should move forward with economic growth assistance priorities. The Scope of Work for the financial sector review included several questions:

- Do the problems or needs that gave rise to the SEGA activity (SEGA) still exist, have they changed, or are there new needs that should be addressed?
- Will there be expected results from SEGA that remain unattained at its completion that should continue to receive USAID assistance?
- Should SEGA's implementation strategy be reformulated for future activities?
- Do conditions exist to ensure that financial sector assistance results will have lasting effects?
- Can we confirm that the Government of Serbia wants, needs, and will use USAID technical assistance and training in reforming its economic policies?
- What approaches to technical assistance have been most effective with the Government of Serbia? For example, would conventional assistance implemented by a contractor or grantee be most effective, assistance from a U.S. Government department or agency (such as U.S. Treasury or the SEC), or a combination of both approaches?
- If the assistance in the period 2011-2015 were to be the final phase of U.S. bilateral assistance to Serbia, how would that affect recommendations of assistance objectives and approaches to delivery of that assistance?

B. Future Considerations for USAID Assistance

USAID assistance should be influenced by the following:

- **Strategic Fit with USAID**: Consistent with and reinforces 2011-2015 vision regarding support for Euro-Atlantic institutions. For future USAID assistance, efforts should continue to promote (1) convergence with BIS, IAIS, IOSCO and related international standard-bearers in the financial sector, and (2) effective implementation of reforms that position Serbia to accede to the European Union and other Euro-Atlantic institutions.

- **Comparative Advantage for USAID**: Evidence of capacity, a track record, and superior performance by USAID when compared with other donors. For future USAID assistance, this is clearly in the financial sector, with particular emphasis on legal, regulatory and institutional structures for effective performance and stability.

- **Achievable Medium-term Results**: Complexity/feasibility for achievement regarding USAID and counterparts' capacity to design and implement effectively. For future USAID assistance, this will require a realistic approach to goals and objectives that can be achieved.

- **Sustained Long-term Impact**: Transferability to counterparts as legacy accomplishment by/from USAID. For future USAID work, this will be achievable via the NBS. Other initiatives will need to be explored, taking into account the capacity to operate on a sustainable and/or commercial (cost-recovery) basis.

- **Major Results from Budgetary Resources**: Reflected in how expensive or not the initiatives would be in terms of funding allocations, whether there is a need for co-funding, and if so, what the prospects are for achieving co-funding from other partners. For future USAID assistance, this will require closer coordination with major donors to leverage results from USAID budgeted resources.

- **Scaled re Available Budget**: Balancing achievement objectives with funding parameters to ensure that objectives are aligned with funding, and not out of balance. For future USAID assistance, this relates to the above considerations re results from budgetary resources. This will require potentially greater use of Serbian expertise, as well as possibly lower-cost contractors and/or alliances with other USG agencies.

- **Measurable Performance Indicators**: As reflected in the ease of compilation of key performance indicators and their usefulness as a monitoring tool. For future USAID assistance, this will be relatively easy to structure for the financial sector once clear outcomes and outputs are agreed to with Serbian counterparts.

- **Fill Major Economic Development Gaps**: Addresses critical needs. For future USAID assistance, the approach of continuing to support financial sector reform is critical as a resource for larger economic growth objectives. However, effectiveness will only occur in tandem with other structural reforms, which will require close coordination with the IMF, World Bank and government for the desired results to be achieved. Support for the financial sector without close linkage to reforms in the enterprise sector and government will limit prospects for success.

- **Confidence of Success**: Prospects for achieving planned results. For future USAID assistance, as per the above, confidence of success will be higher if closely coordinated with reforms in the enterprise sector and government. This includes (1) legal, regulatory and institutional requirements that reduce government ownership in the economy, (2) reduce the position of monopolies, (3) allow for faster dispute resolution, and (4) rationalize the entire government approach to taxation, procurement and regulation.

- **Local/Domestic Support ("Buy-in")**: Counterpart cooperation, capacity, support and active participation. For future USAID assistance, this is largely guaranteed via NBS and some of civil society. It is largely guaranteed for the moment in the government, but not guaranteed for the long term.

- **Global Development Alliance**: Prospects for potential partnerships in Serbia with international entities that could be instrumental in furthering strategic objectives. For future USAID assistance, this is an important feature that will be helpful in leveraging resources, accelerating needed reforms, and potentially being indispensable in the establishment of at least one legacy institution.

Specific to future USAID activities, key findings suggest that future assistance should be influenced by the following:

- **Needs**: Some of the original needs that existed in the original SEGA design are still in effect, while new challenges have emerged. For future USAID assistance, the design will need to be more specific in terms of objectives and targets. In some cases, original needs should not be addressed, as they are too complex, costly or politically risky to ensure success. In other cases, continued support is justified.

- **Results**: Not all results will have been attained, partly because of overly ambitious targets, the diversion of resources, and/or lack of political will/government capacity. For future USAID assistance, results will need to be more closely aligned with the core criteria noted above. Above all, greater cohesion will be needed re other USAID initiatives. Areas of likely success and impact that can be achieved by 2015 should drive design.

- **Implementation Strategy**: Achieving a balance of focus and responsiveness is the consensus that has emerged from discussions regarding financial sector assistance to date. For future financial sector assistance work, it will be important to identify achievable targets and objectives, and then build in a measure of flexibility and responsiveness within those areas.

- **Conditions for Lasting Effect**: USAID will need to make choices in terms of priorities and resource allocation. In some cases, the greatest needs should not be addressed because the preconditions for success are missing. In other cases, foundations are in place for success. For future financial sector assistance, it will be important to build on earlier successes that have good prospects for both impact and lasting effect.

- **Government Confirmation re Economic Reform**: While the government is currently pro-reform, the degree of political will relative to the challenge is still unclear. For future financial sector assistance, USAID will need to identify personalities that have demonstrated their commitment to reform, have shown this through their respective institutions, and have articulated a strategic vision that converges with USAID objectives. USAID will also need to minimize the risk of turnover in terms of its institutional partnerships.

- **Approaches**: Counterparts have spoken highly of TA delivered by USAID. Nonetheless, some have commented on a lack of strategic focus that could reduce net impact. For future USAID assistance, USAID will need to (1) be more strategically cohesive and focused, (2) work in tandem with other donors and possibly USG agencies on a complementary and reinforcing manner, and (3) explore less costly approaches to TA delivery.

- **2015 Close Out**: There is considerable work to be done for Serbia to (1) establish a stable macroeconomic framework, (2) sort out distortions in the business and tax environment, and (3) achieve sustainable sources of earnings predicated on export competitiveness so that it is able to (4) weather future shocks without excessive dependence on tight monetary policy and donor funding. For future USAID assistance, USAID will need to continue to focus on areas of current strength and stability, while working with others on critical structural reforms so that Serbia is able to converge with EU accession requirements. This process will not be fully achieved by 2015, but commitment to and implementation of reforms by 2015 should be sufficient to get them on the path to an invitation from the EU.

IV. RECOMMENDATIONS TO USAID

Many options for potential support were considered, but were not among the recommended initiatives because (1) other donors are likely to be or already are involved without any further need for USAID assistance; (2) USAID does not necessarily have a comparative advantage; (3) they may take too long to achieve needed results; or (4) there are too many risks to being able to achieve objectives, including lack of perceived buy-in. (These are discussed in the report.)

There are four broad financial sector initiatives recommended for USAID to pursue. Three build on existing initiatives and are areas where USAID has a successful track record in Serbia and/or other transition countries, and/or represents an area of critical focus. These are (1) continued yet targeted work in **banking supervision**, with particular emphasis on requirements for standardized/simplified approaches to Basel II; (2) implementation of a viable long-term **debt securities market**, with initial focus on the local exchange as a platform for a liquid central government securities market; and (3) support for capacity enhancements regarding **AML/CFT**. A fourth initiative, (4) establishment of a **management institute**, which would serve as a wholesale source of accredited management capacity-building for financial institutions, enterprises, government officials and service providers (e.g., auditors, accountants) by offering MBA and MPA courses in conjunction with one or more US universities. Each of these is briefly summarized below.

► **#1: Strengthening the National Bank of Serbia**: NBS has made significant progress in recent years, and is widely recognized as a source of stability during the recent crisis. However, there are still some areas of needed strengthening. These include:

- Movement to Basel II
- Coordination of Basel II with Financial Stability Capacity
- Coordination of AML/CFT with Other Agencies

USAID assistance would involve short-term (and possibly) long-term TA to (1) coordinate movement to Basel II; (2) strengthen capacity to monitor and manage financial stability issues; and (3) coordinate and strengthen AML/CFT capacity. Specific outputs would include (1) demonstrated supervisory capacity to determine banks' own credit, market and operational risk management capacity and systems to ensure appropriate levels of capital are in place for banking system stability, and in a manner that is not as restrictive with regard to reserve policy; (2) demonstrated capacity to manage stress in the economy resulting from external shocks, macroeconomic or structural imbalances, cross-border exposures, and/or cross-sectoral (e.g., banking and insurance) exposures, and to ensure the financial system is adequately capitalized and able to access liquidity to meet all financial and payment obligations; and (3) capacity to prevent any reputation risk or loss of depositor, creditor or investor confidence as a result of money laundering or criminal financial activity. Partners would be a prime contractor and NBS, with significant coordination envisioned with the IMF and World Bank.

Performance indicators could include:

- Capital adequacy of the banking system
- Numbers of banks below minimum capital adequacy and their share of total assets and deposits
- Earning assets/total assets
- Loans to the non-financial sector/total loans
- Non-performing loans/total loans
- Return on average equity
- Return on average assets
- Average credit, assets, deposits and capital per bank

- Compliance with Basel Core Principles of Banking Supervision
- Implementation of Basel II—standardized and simplified approaches—with particular focus on supervisory capacity to monitor for credit, market and operational risk
- Compliance with IAIS and EU Solvency II requirements in insurance

► #2: Developing the Long-term Debt Securities Markets: Serbia's macroeconomic framework is out of balance due to poor budget management. The result of this inefficiency is that macroeconomic stability is predicated on high levels of foreign exchange reserves to maintain a moderately stable exchange rate, and to maintain confidence among depositors. This imposes an enormous burden on the banks in the form of reserve requirements, making banking a costly business in Serbia. This, in turn, limits the availability and affordability of credit for the private sector. Such constraints in the banking system spill over to the enterprise sector, resulting in significant inter-enterprise arrears as well as other arrears. All of this adds to the cost of business transactions, and keeps the negative spiral moving in a way that makes it difficult to achieve more balanced stability. For these reasons, it is recommended that USAID support development of a long-term debt securities market. Key needs include:

- Debt Management Strategy
- Planning for an Improved Sovereign Rating
- Financial Instruments
- Accounting, Audit and Disclosure

USAID assistance would involve short-term TA to (1) establish criteria and a regulatory framework for development of a liquid long-term debt securities market; (2) develop regulatory capacity to ensure issuers and brokers comply with the regulatory framework; and (3) institute the required accounting, audit and disclosure standards required when issues come to market for ongoing integrity and confidence. Specific outputs would include (1) a long-term yield curve to serve as a benchmark for the pricing of long-term instruments and exposures; (2) financial instruments in which banks, insurance companies, pension funds and others could invest to assist with earnings and asset-liability matching requirements; (3) standards for Ministry of Finance to manage its long-term debt strategy predicated on sound fiscal collections, budget management and planning, and improved sovereign ratings; and (4) modernization of accounting and audit standards consistent with requirements in liquid and transparent capital markets. Additional outcomes potentially would include (5) issuance of mortgage bonds, to provide long-term funding instruments in the insured residential mortgage market; (6) issuance of municipal bonds in Belgrade, Novi Sad, or other municipalities potentially able to attract institutional investment; (7) issuance of infrastructure bonds; and (8) issuance of equities by well managed enterprises. Partners would be a prime contractor, the Securities Commission, Ministry of Finance, and an approved Serbian audit firm with IFRS capacity for public sector debt instruments. Significant coordination is envisioned with the IMF and World Bank.

Performance indicators could include:

- Sovereign ratings
- Value of Treasury securities > 1 year maturity
- Volume of trade in the secondary market in Treasury securities
- Value of other long-term savings instruments available for sale by banks, insurance companies and pension funds
- Number and value of non-Treasury long-term issues (e.g., mortgage bonds, municipal bonds, infrastructure bonds, corporate bonds)

► **#3: Enhance AML/CFT Capacity**: Serbia's economy and investment climate continue to suffer from tax evasion and other weaknesses. This includes criminal transactions. The government was relatively late in establishing a financial intelligence unit, and thus lags behind many neighbors in the region in being able to track suspicious transactions. For these reasons, it is recommended that USAID support efforts to build AML/CFT capacity. Key needs include:

- Organizational Requirements
- Staff Training

USAID assistance would involve short-term (and possibly) long-term TA to (1) tighten up the organizational structure of the Ministry of Finance to have a better understanding of how the Foreign Exchange Inspectorate is reporting to the Anti-Money Laundering Administrative Unit, and assist with the organizational structure and requirements for effective implementation of FATF principles and requirements; (2) increase training of staff (e.g., Ministry of Finance, law enforcement, NBS) as well as obligors; (3) strengthen capacity and systems to monitor suspicious transactions; and (4) coordinate closely with NBS, law enforcement agencies, and other international counterparts to strengthen AML/CFT capacity. Capacity-building efforts would be linked with assistance to the NBS under Initiative #1 to ensure coordination via NBS operational risk assessments of banks and insurance companies (supervision of Know-Your-Customer, etc.) along with its effort to monitor the payment/settlement system. Specific outputs would include (1) demonstrated enhancement of capacity to identify, contain and prosecute suspicious transactions and those responsible for such financial crimes; (2) better public awareness of the costs and penalties associated with such activity; and (3) narrowing of gaps in institutional capacity relative to regional peers. Partners would be a prime contractor, Ministry of Finance, and NBS, with significant coordination envisioned with the IMF and World Bank. USAID should also explore partnerships with UST on this. If feasible, USAID should consider utilizing the same advisor for AML/CFT to assist NBS with their operational risk/IT assessment needs to meet Basel II requirements.

Performance indicators could include:

- Implementation of by-laws
- FATF/Moneyvaal assessment findings of capacity, coordination and effectiveness

► **#4: Strengthen Financial Management Capacities**: Serbia's economy and public sector management continue to suffer from weak financial management capacity. This adversely affects government at all levels due to poor budget management and planning. In the private sector, weakness in this area undermines capacity for long-term investment planning. In the financial sector, it adds to the cost of training new recruits. Key needs include:

- General Accounting and Audit Standards
- Financial Management
- Specialized Management

USAID assistance would effectively provide start-up capital, along with other partners, to establish a US-styled and certified program that would provide needed professional training and development in financial management and other needed disciplines. Direct involvement from USAID would require (1) a general mapping of needs as these relate to enterprise, financial sector, and government management; (2) general outline and framework for coursework priorities, staffing and other requirements, and preliminary costing; (3) methods of oversight, management and coordination among other partners and stakeholders; and (4) formalization of agreement with and commitment from Serbian institutions (government, financial sector, professional associations, universities, etc.) to support, participate, and sustain the Institute. Specific outputs would include (1) introduction of core accounting, audit and financial coursework according to international standards (e.g., IFRS, ISA); (2) narrowing of gaps in business and financial management education relative to regional peers and the EU; and (3) certification to award MBAs, MPAs, and other master's-level education degrees. Partners would be a US university or consortium of universities, the government (e.g., Ministry of Education or Finance or Economy), NBS, professional associations (e.g., Bankers, Chamber of Auditors, AmCham, SAM, Foreign Investor Council), and universities and think tanks (e.g., University of Belgrade, FREM, CLDS). USAID would need to explore GDA possibilities, as well as potentially consider linkage to existing programs in the region (e.g., MBA program with University of Delaware at the University of Sarajevo, EU-oriented programs).

Performance indicators could include:

- Numbers of Serbians trained to deliver Master's-level course work
- Numbers of students attending courses
- Numbers of students receiving certificates and degrees
- Numbers of institutions sending employees to attend coursework
- Numbers of actuaries certified according to international standards

I. INTRODUCTION

A. Background

The following report, "Recommendations for USAID Financial Sector Assistance to Serbia: 2011-2015", is presented to USAID for its internal strategic planning purposes related to possible bilateral assistance for Serbia in the coming years. The report highlights (1) recent developments in the financial sector, along with outstanding issues, gaps and vulnerabilities and how these can impact broader economic and real sector growth in the future; (2) lessons learned from financial sector assistance for future assistance in Serbia, as well as a brief summary of other donors' activity in the area of financial sector reform; (3) recommendations on what is considered the best use of USAID assistance in resolving critical issues for 2011-2015; and (4) key performance indicators for monitoring and evaluation.

Recommendations are based on a series of criteria where USAID assistance is considered to be most potentially useful and effective in achieving success. These criteria for evaluation have been agreed to with USAID, and include:

- **Strategic Fit with USAID**: Consistent with and reinforces 2011-2015 vision regarding support for Euro-Atlantic institutions.
- **Comparative Advantage for USAID**: Evidence of capacity, a track record, and superior performance by USAID when compared with other donors.
- **Achievable Medium-term Results**: Complexity/feasibility for achievement regarding USAID and counterparts capacity to design and implement effectively.
- **Sustained Long-term Impact**: Transferability to counterparts as legacy accomplishment by/from USAID.
- **Major Results from Budgetary Resources**: Reflected in how expensive or not the initiatives would be in terms of funding allocations, whether there is a need for co-funding, and if so, what the prospects are for achieving co-funding from other partners.
- **Scaled re Available Budget**: Balancing achievement objectives with funding parameters to ensure that objectives are aligned with funding, and not out of balance.
- **Measurable Performance Indicators**: As reflected in the ease of compilation of key performance indicators and their usefulness as a monitoring tool.
- **Fill Major Economic Development Gaps**: Addresses critical needs.
- **Confidence of Success**: Prospects for achieving planned results.
- **Local/Domestic Support ("Buy-in")**: Counterpart cooperation, capacity, support and active participation.
- **Global Development Alliance**: Prospects for potential partnerships in Serbia with international entities that could be instrumental in furthering strategic objectives.

Based on these criteria, Annex 1 contains a series of templates by which a range of potential initiatives to remedy key challenges by 2015 (or before) have been evaluated.

The brief assessment and recommendations have been provided by Michael Borish and Company, Inc. (MBC) in conjunction with USAID-Serbia. Mr. Borish has worked closely with Mr. Jim Watson (Private Sector Specialist) during his visit to Serbia (June 9-23, 2009). The financial sector report has also factored in findings and recommendations from an earlier assessment carried out by Denise Lamaute focused on the labor market and workforce development, pension reform, and USAID work in these areas. All content and recommendations are based strictly on the firm's own assessment of developments in Serbia. The opinions expressed in this work are the responsibility of the author, and do not necessarily reflect the official policy of USAID/Serbia or bind USAID to those recommendations.

II. DEVELOPMENTS AND EXPECTED CHALLENGES IN THE MACRO-FINANCIAL SECTOR

A. Monetary and Macroeconomic

1. Recent Developments and Current Status

The recent global economic and financial crisis has tested Serbia, and the results have been broadly positive. While requiring a nearly $4 billion (€3 billion) Stand-By Agreement with the IMF and implementation of a Financial Sector Support Program (FSSP)[1], Serbia's economy and financial system have been able to maintain reasonable stability in the last year during a period of regional and global turbulence. This is largely on the strength of significant foreign exchange reserves built up in recent years as a result of privatization proceeds and non-tradable service sector growth, as well as strict monetary and reserve policy of the National Bank of Serbia (NBS) regarding mandatory required reserves held by the commercial banks.

There is broad acknowledgement that significant structural weaknesses persist, and that these could present challenges in the future in the event of another crisis as well as delay prospects for receiving a future invitation to join the European Union. Serbia's business sector is lacking in competitiveness due to (1) the heavy presence of government-owned enterprises (e.g., utilities and other large employers, many of which are inefficient and/or financially troubled), which translates into Serbia having a comparatively small private sector as a share of GDP by regional standards, and which distorts competition due to (1a) government procurement practices favoring such businesses, (1b) preferences regarding certain licenses and permits, and (1c) other forms of influence-peddling that undermine movement to a competitive market economy; (2) weaknesses in the business environment, including unclear property ownership rights, cumbersome licensing and permit processes, complex and inefficient tax administration, workforce capacity, the bankruptcy framework, and corruption; and (3) the overall inability of enterprises to compete internationally in primary (i.e., agriculture, forestry, fisheries) and secondary (i.e., mining and manufacturing) sector export markets.

The lack of competitiveness is a consequence and cause of a vicious cycle in which enterprises are often inefficient and/or unable or unwilling to pay taxes. This reduces the capacity of the government at all levels to render needed services for enhanced economic competitiveness. This also impinges on government investment levels into physical infrastructure needed for long-term competitiveness, as well as recurrent expenditure needed for ongoing service provision (e.g., health, education, pensions) that also impacts workforce capabilities and competitiveness. The result is that the public sector is considered over-staffed and inefficient,

[1] See IMF Country Report no. 09/158, May 2009.

consuming resources at the expense of other requirements that would enhance the long-term sustainability of incomes, investment and employment that, in turn, would improve long-term fiscal prospects,

Getting the government to induce needed reforms will be complex, costly, risky, and multi-dimensional in terms of requirements. While the public sector is inefficient and needs civil service reform, the private sector is currently unable to step into the void to absorb redundant employees and contribute to privately managed pension funds. With wages and pension costs accounting for two-thirds of the budget, there is a clear need for government to reduce this burden. At the same time, there is very little capacity at municipal levels to assume greater responsibility. Thus, the government is stuck with potentially making a bad situation worse during fragile and turbulent times when the investment climate for private sector development and growth is less robust than in earlier years.

Moreover, for enterprises in the private sector to assume greater responsibility, they will need to have mechanisms for clearing arrears and restructuring their finances and operations so that they can become more competitive and creditworthy on a sustainable basis. The potential comprehensive strategy and framework for enterprise restructuring has not been developed yet, nor have resources from the FSSP been tapped for such purposes as of mid-2009. Meanwhile, banks' non-performing loans are rising, and average bank profits are low in relation to what is needed for a substantial capital build-up. While banks remain solvent and well covered relative to risks in their exposures (as reflected in high capital adequacy ratios), the reality is that banks' average profits in 2008 were little more than €13 million on a pre-tax basis, a low figure by global standards. Return on average asset and equity ratios are relatively low (albeit achieved in a difficult year), and actual profits may not be sufficient to cover the costs associated with needed enterprise restructuring of problem debtors that would then position such troubled companies for privatization, new shareholdings, and enhanced efficiency in performance.

In addition to bank-enterprise issues, there are also substantial inter-enterprise arrears which, along with VAT, add to significant liquidity pressures in the real sector. Large enterprises often delay payments to suppliers, which alone undermines working capital for smaller producers and service providers. This problem is exacerbated by smaller firms and suppliers having to pay VAT when they invoice buyers. Such delays add to inflationary pressures, as suppliers need to add on to margins to cover the costs of payment delays and up-front VAT payments from existing cash resources. Additional arrears in the form of delayed payments by utilities and other enterprises to suppliers, employees and sometimes government (e.g., tax arrears) are roughly estimated by the IMF to account for 10-15 percent of GDP.

Having accounted for such weaknesses, there is recognition that economic improvements have been made in recent years under difficult political

circumstances. Serbia is in far better condition than it was a decade ago,[2] and a number of economic indicators show how GDP, FDI and official reserves have increased, while government has managed to contain fiscal deficits to reasonable levels (until recently). Thus, while weaknesses persist, much has been accomplished under difficult circumstances.

However, considering the endemic political instability that has persisted and the transformation of national borders, the overall environment for reform has been challenging. Looking ahead, it is clear that many difficult structural-level issues remain. These are indicated in the unemployment rate and current account deficits, both reflecting weaknesses in export-oriented competitiveness. Such weaknesses make fiscal policy challenging in Serbia due to a small tax base and weak tax administration and collection relative to expenditure. Moreover, with net FDI tenuous and dependent on an improved business environment, low case scenarios could also push debt servicing requirements to levels that squeeze the economy further. Combined external and domestic debt account for about 90-95 percent of GDP in 2008/09, and future debt servicing requirements on external debt will be costly to the economy. Movement with critical financial sector, real sector, and public sector reforms will be needed for Serbia to eventually get closer to being in a position to negotiate accession to the European Union. The following table highlights some key economic indicators that reflect some of the points above.

Macroeconomic Indicators (2000-08)

(€ *in millions unless otherwise noted*)	**2000**	**2004**	**2005**	**2006**	**2007**	**2008**
GDP (1)	€5,500	€16,610	€19,743	€23,500	€29,500	€34,300(e)
Real GDP Growth	5.3%	8.3%	5.6%	5.2%	6.9%	5.4%(e)
CPI Rate—average (2)	71.8%	9.5%	17.3%	12.7%	6.5%	11.7%
Unemployment Rate (3)	25.6%	31.6%	21.8%	21.6%	18.8%	14.0%
Fiscal Deficit/GDP	-3.0%	-1.7%	+0.1%	-2.3%	-3.8%	-4.7%
Current Account Deficit/GDP	-3.0%	-12.7%	-8.7%	-10.1%	-15.5%	-17.1%
Net Foreign Direct Investment	€54	€710	€1,309	€3,400	€1,800	€1,800(e)
External Debt/GDP (4)	140.0%	62.0%	64.1%	63.3%	60.2%	63.6%
Gross Official Reserves (5)	≈€600	€3,157	€4,000	€8,700	€9,500	€8,100

Notes: (1) GDP per capita was $6,782 in 2008; incidence of poverty was 6.6% in 2007; (2) retail prices used for 2000 and 2004; (3) unemployment calculated in 2000 and 2004 with unemployed as numerator divided by the total of employed and unemployed; (4) adding domestic debt would raise the total stock of debt ratio to about 90-95% of GDP in 2008; (5) gross official reserves approximated seven months of imports of goods and services, while "free net reserves" approximated five months of imports.

Sources: IMF, National Bank of Serbia, author's calculations

2. Risks and Challenges for the Future

Notwithstanding successes during the recent crisis, there are numerous macroeconomic imbalances that will need to be corrected in the coming years for

[2] See "Reforms In Serbia: Achievements and Challenges", Center for Liberal-Democratic Studies, 2008.

Serbia to be in a position to defend itself against subsequent external shocks or adverse developments.

- GDP is not expected to grow until 2011 in real terms, and this is subject to a restoration of growth in Europe and other markets. Even with growth in Europe by then, there is no guarantee that Serbian exports/trade levels will be restored to prior levels, or that remittances and tourism will add to the economy as they have in the past. Likewise, other mitigating factors such as rising oil prices in global markets may add to factor costs of production in Serbia that will undermine export competitiveness while constraining demand in export markets.[3]
- Unemployment rates are high at 14 percent, under-utilization rates are higher[4], and the labor force is broadly considered to be ill-prepared or ill-trained for many modern economic requirements in a globally competitive marketplace.
- Inflation rates remain high at nearly 12 percent, which then has an impact on interest rates charged by banks and other lenders to borrowers. Weighted average interest rates on dinar loans were 17.3 percent in April 2009. Such high costs slow economic development and invite credit risk in loan exposures due to the impact of interest expense on borrower cash flows.
- Serbia has a very low fiscal revenue-to-GDP ratio, reflecting a long list of business environment and institutional weaknesses regarding tax collection and administration. Serbia's fiscal deficit of 4.7 percent in 2008 occurred in spite of a freeze on public sector wages. With two thirds of budgetary expenditure dedicated to wages and pensions, and without additional revenue collection, fiscal prospects for other required expenditure are negative.
- The current account deficit is high at 17.1 percent in 2008. The deficit is high by global standards, twice the levels recorded in Serbia in 2005, and unsustainable because much of the deficit is composed of consumer goods' imports that add little value to domestic economic competitiveness.
- Foreign direct investment (FDI) is low at less than €2 billion. FDI declined in 2007-08 from 2006 levels, and portfolio investment was negative on a net basis in 2008. Until the business environment improves and financial markets develop, such investment into sub-sectors that have a higher economic multiplier may be deterred. Meanwhile, the limited portfolio investment that had entered the Serbian capital markets has since returned to source or been re-allocated to other markets.
- Serbia's sovereign rating is BB- in foreign and local currency with a negative outlook,[5] an indication of the risk premium associated with Serbia. This is a relatively low rating that implies "speculative" signs, and a heightened risk that adverse economic developments

[3] IMF forecasts referred to declining oil prices, which was true until early 2009. However, since publication of the May 2009 SBA Review, oil prices have increased.
[4] Many technically employed workers are not working productively or efficiently.
[5] Ratings received from Standard & Poor's and Fitch Ratings.

could trigger a downgrade. Sovereign spreads have recently been about 900 basis points above the benchmark Emerging Market Bond Index rate, which is high by global standards. This is down from a 1,300 basis point spread in November 2008, but still well above the 500 basis point spread in September 2008.

- While external debt is a reasonable 64 percent of GDP (2008), projected debt service will increase from €5 billion in 2008 to nearly €10 billion in 2014. This is expected to approximate 75 percent of total exports of goods and services, and exceed 20 percent of GDP that year. As this is likely to depend on the issuance of more government securities, interest expense will be more of a cost factor for budget management, and will leave less in the way of revenues available for other needed services and investments.
- Foreign exchange and official reserves remain strong and have helped Serbia during the recent financial crisis. Nonetheless, the high levels of reserves held by NBS also reduce available credit to the real economy, and make available credit more expensive. Moreover, much of the reserve accumulation has derived from privatizations, FDI and tax payments in the non-tradables sector (e.g., banking and finance, telecommunications). Future reserve accumulation may be more difficult if it has to depend increasingly on industrial and resource-based production and exports.
- The build-up of inter-enterprise arrears is particularly costly to small businesses, and puts upward pricing pressure on goods and services due to the need to pay VAT on the date of invoice and to age receivables for up to 300 days.

The impact of the above on USAID planning is that slow reform and continued lack of competitiveness will make it more difficult for Serbia to:

- Achieve real GDP growth on a sustainable basis, or at levels comparable to neighboring countries that are competitors.
- Reduce the unemployment rate and incidence of poverty, and create sustainable jobs that result in rising incomes and well-distributed purchasing power for an increasing number of households.
- Increase capacity to generate foreign exchange, which may lead to future dinar depreciation and, with it, higher rates of inflation and loss of purchasing power for many households.
- Decrease interest rates in the banking system without adding to inflationary pressures.
- Reduce fiscal deficits, which will mean less capacity to meet public needs due to the absence of needed fiscal resources. This also means less funding available from fiscal sources to meet other critical social protection requirements in the future that could become more severe should the economy not turn around after 2010.
- Stimulate trade and investment, already burdened by reduced demand, and poor current prospects for foreign direct investment and privatization.
- Lower the risk premium associated with investment in Serbia, which adds substantial cost to Serbia in attracting such investment.

- Reduce the impact of projected debt service relative to GDP, which will put additional pressure on the macroeconomic conditions of Serbia and potentially translate into lower investment and lending.
- Improve the working capital position of SMEs that supply larger enterprises unless there is more competition, and larger enterprises recognize the value of supply relationships. Part of the arrears problem on inter-enterprise debts is due to the stricter conditions companies have in obtaining loans from a more tightly regulated banking system.

This means that the upcoming environment for reform could be difficult, even with positive political will and a stable government. This is because:

- The economic environment could make it more challenging to generate the tangible results and outcomes that USAID would like to see, such as major GDP and employment growth, significant increases in lending and direct investment, etc. Thus, even well designed and implemented support from USAID will likely not see major favorable results until well into the 2011-2015 program.
- Likewise, because of the institutional capacity-building requirements that may be needed (discussed below), it is uncertain that legal and regulatory reforms alone will be sufficient to generate the kind of impact desired by USAID and other donors, not to mention Serbia.
- Another wild card is the role played by key donors, and the effectiveness of their technical assistance and disbursements. In particular, it remains to be seen at the broad programmatic level what role the World Bank and European Union play in the reform process, particularly as key catalysts for structural adjustment and convergence with EU standards.

B. Banks and Banking

1. Recent Developments and Current Status

The Serbian banking system has undergone major reform in the last decade, and is now well capitalized relative to risk exposures. In the early 2000s, Serbia's banking system was moribund as a result of sanctions from the 1990s, a legacy of imprudent lending activities from the earlier Yugoslav period, a weak and largely informal real sector, and an inadequate legal and regulatory framework. In 2000, the average bank had (1) only $147 million-equivalent in assets, an overvalued figure due to most assets being non-earning; (2) $91 million-equivalent in credit, including claims on government, and also over-stated because banks had not sufficiently provisioned for losses resulting from borrower non-performance; (3) only $10 million-equivalent in deposits, reflecting the absence of confidence and household hoarding of scarce foreign exchange; and (4) $6 million-equivalent in capital, which is more indicative of small "pocket" banks than serious regional and international banks. Most funding derived from outstanding foreign borrowings and other liabilities, while frozen foreign currency accounts were 27.5

percent of total liabilities. Since then, the Serbian banking system has been restructured, and is now largely dominated by EU-based banks from Italy, Austria, Greece and France.[6] Moreover, the legal framework has been strengthened over the years, and with USAID assistance, banking supervision is now effective. This has translated into the banking system playing an increasing role in economic growth over the years, with financial intermediation rates (e.g., broad money-to-GDP) at 36 percent in 2008, double the ratio in 2000. Likewise, capital ratios are high at 22 percent of risk-weighted assets, and the quality of assets is better today than it was in 2000.

All the key indicators show significant improvement in the banking sector since U.S. assistance began. This is reflected in (1) increased lending, with 2008 levels nearly three times levels in 2004; (2) better overall asset quality, with non-performing loans a small fraction of levels in 2000; (3) enhanced earnings, as reflected in positive return measures since 2005; (4) higher depositor confidence, thereby increasing funding for the banking system, and reflected in deposit totals having grown more than three times since 2004; (5) high capital adequacy ratios, at well above 20 percent since the mid-2000s; (6) reduced liquidity constraints, partly resulting from the influx of deposits as well as access to cross-border financing and the superior credit ratings of the foreign banks; (7) better governance and management; and (8) a system that has proven itself able to weather distress and liquidity challenges, with reasonable stability during the recent/global financial crisis. While SEGA alone is not responsible for such developments, the project has clearly been a key contributing factor (as was earlier USAID support for improved banking supervision).

There are still considerable weaknesses in the banking system, albeit far less severe than in 2000 or 2004. The average bank in Serbia is small by global standards, which may presage consolidation in the coming years. The high cost of operations has kept return ratios at fairly low levels (although they are reasonable under current circumstances), and limited the absolute value of net earnings. Banks earned little more than €13 million on average on a pre-tax basis in 2008, and less on an after-tax basis. At the same time, Serbia is "over-banked", as retail networks have spread into unprofitable areas, undercutting bank earnings.

There is also considerable work that needs to be done in the field of banking supervision. While NBS has made major progress over the years, movement to Basel II will require a more risk-based approach that enhances capacity of NBS to determine banks' own capacity for risk management. In the case of the EU-based banks, risk management systems are more complex and better understood than they are at NBS. Thus, NBS capacity to handle pillar 2 of Basel II (supervisory review) will need development. Likewise, the control-oriented approach to supervision will need to shift to a more principles-based approach, which should also encourage banks to be able to manage their asset allocation more freely, and subject to less regulated controls over how they allocate and provision. In this regard, it will be important for

[6] Foreign banks account for about 80 percent of banking system assets.

other structural reforms in the enterprise sector to take hold, namely (1) centralized property and pledge registries, (2) more comprehensive disclosure of credit quality information related to inter-enterprise arrears, (3) comprehensive bankruptcy and debt remediation mechanisms, including efficient dispute resolution mechanisms related to #2, and (4) clear ownership rights to immovable properties in support of a better secured transactions framework.

The FSSP is closely linked to a World Bank program[7] that focuses on building a more efficient and stable financial sector along with initiatives to improve the business environment and strengthen financial discipline via privatization, restructuring, and energy sector reform. Key outcomes in the banking sector that will result from this program include (1) maintenance of capital adequacy for the banking system at a minimum of 12 percent (22 percent at end 2008), with the use of public funds for bank recapitalization utilized only if there is no private sector alternative; (2) enhanced framework for crisis preparedness and crisis management in the event of future shocks; (3) more efficient banking resolution system (in dealing with insolvent and/or illiquid banks unable to meet deposit withdrawal, payment system, or other requirements); (4) well administered and capitalized deposit insurance scheme able to manage fast payouts in the event of need; (5) majority state-owned banks that are profitable and have at least 12 percent capital adequacy ratios; and (6) reduction of the share of government ownership in the banking system to no more than 15 percent of total assets by 2010.

Despite continued weaknesses, the banking system has shown positive trends in the last several years. Much of this has to do with the liberalization of the market, opening up to stronger regional European banks. Another key factor has been strengthened supervision. A third factor has been real GDP growth in recent years, although this is expected to reverse in 2009 and remain flat in 2010 before growth returns. The following table presents some key data indicating progress from earlier years with regard to (1) balance sheet growth in general and per bank, (2) strengthened risk-weighted capital, (3) better asset quality (until very recently), (4) reasonable return ratios under the circumstances, and (5) increasing levels of financial intermediation that have contributed to real GDP growth in recent years.

Banking Sector Indicators (2000-08)

($ in millions unless otherwise noted)	**2000**	**2004**	**2005**	**2006**	**2007**	**2008**
Total Credit	$7,859	$6,152	$7,380	$10,216	$15,554	$17,692
Average Credit per Bank	$91	$134	$175	$265	$435	$512
Total Assets	$12,643	$10,614	$12,658	$21,240	$31,230	$30,604
Average Assets per Bank	$147	$247	$316	$574	$892	$900
Total Deposits (1)	$857	$4,689	$5,512	$9,263	$15,191	$14,197
Average Deposits per Bank	$10	$109	$138	$250	$434	$418
Total Capital	$490	$2,728	$2,833	$4,249	$6,987	$7,027

[7] The World Bank is providing $300 million to the FSSP.

Average Capital per Bank	$6	$63	$71	$115	$200	$207
Capital Adequacy Ratio (2)	n/a	27.9%	26.0%	24.7%	27.9%	22.0%
Non-Performing Loans/Total Loans (3)	27.80%	22.2%	23.8%	4.11%	3.81%	5.29%
Return on Average Assets	n/a	-1.2%	1.1%	1.7%	1.7%	2.1%
Return on Average Equity	n/a	-5.3%	6.7%	10.0%	10.2%	10.6%
Broad Money to GDP	18.00%	24.64%	27.18%	32.04%	38.25%	35.57%
Notes: (1) Deposits do not include Government deposits, nor do they include frozen foreign currency deposits; (2) CAR is regulatory capital to risk-weighted assets; (3) Ratio is net of provisions based on data from nine largest banks; the ratio had increased to 6.58% by February 2009.						
Sources: IMF, National Bank of Serbia, author's calculations						

2. Risks and Challenges for the Future

Notwithstanding progress and recent successes, there are still weaknesses or challenges that persist in the banking sector. These include:

- The high costs of banking (partly due to high reserve requirements) may continue to sustain high net interest margins on loans that are made as part of the cost of doing business. Net spreads as measured by weighted average interest rates on loans less deposits tend to be at 10 percent or more (apart from 2007). Until reserve requirements and other elements of monetary policy ease up, these pricing issues are likely to persist. Such reserve policy is partly driven by inflation and exchange rate considerations, and easing may not occur until Serbia has overcome its many hurdles in the real sector to be competitive in export markets.
- The high costs of banking operations are reflected in the relatively modest return ratios. Until the banking system consolidates further from the current 34 banks to a smaller number, it is less likely that cost savings from efficiencies will help to reduce the overall cost of operations (as measured by transactions, loans, employees, branches, etc.).
- The need for considerable financial and operational restructuring among many of the banks' enterprise borrowers, partly indicated by the rising level of non-performing loans (at 6.6 percent in early 2009). In late 2008, about a third of risk-weighted assets was under stress (delinquent more than 90 days) or impaired in some form. While banks are considered to be adequately capitalized, it is currently unknown what the threshold is for NPL ratios bank by bank before corrective actions may be needed. On the other hand, the major banks are considered to be adequately capitalized, and are also able to access the capital markets via parent banks in the event of any capital shortfalls.
- The need for legal and institutional reforms that affect enterprise performance, namely property rights, dispute resolution, and collateral/secured transactions.

- Uncertainty as to whether the FSSP vehicles for loan restructuring will be sufficient in shifting some of the troubled exposures denominated in foreign currency to those that are dinar-denominated or adequately hedged.[8]
- Uncertainty as to whether continued state ownership in the banking system (albeit limited to 15 percent of total assets, and requiring profitable operations and CARs of at least 12 percent) will serve as a potential vehicle for enterprises with close ties to government officials to defer needed restructuring.
- Uncertainty about how efficient a bank resolution process will be among under-capitalized or insolvent banks in which the state has a large or majority share.
- Relatively low levels of credit (at 35 percent of GDP in 2008) when compared with Europe and even some regional countries, albeit recognizing this is a significant improvement from earlier years when the ratio was lower and asset quality was suspect.
- A shortage of long-term funding better matched with long-term asset exposures. The funding structure of Serbian banks is stable, but long-term funding (on-balance sheet) accounts for less than 10 percent of long-term loans.[9] Notwithstanding guarantees and other off-balance sheet items that may cover for some of the mismatch, this still represents a major mismatch. Future economic growth will require availability of and access to longer-term sources of funding, including deposits and other on-balance sheet items that are generally more stable as a funding source. At the same time, NBS will need to monitor rates paid on such long-term funding sources and the impact this will have on banks' liquidity and profitability.
- Foreign exchange risk is endemic, as 70-75 percent of balance sheet values are either in euro or euro-indexed. While the latter helps to protect lenders, such mechanisms are simply a pass-through of currency risk to borrowers that can culminate in increased credit risk should Serbia experience dinar depreciation. For Serbian borrowers whose sales and cash flow are dinar-based, such a scenario would require greater dinar to service and repay loans. Thus, the potential for such companies to face these challenges would correspondingly challenge lenders' asset quality and earnings, and potentially their liquidity and solvency. It is also currently unclear how much of this risk would apply to the Serbian daughter banks of foreign parents on which exposures have guarantees from the Serbian institutions.
- Borrowers are subject to significant interest rate risk on loans, as most lending is on a variable rate basis and can adjust upward at any point.
- There are limited hedging products available for borrowers and investors to hedge their currency and interest rate risk on exposures or borrowings.

[8] The FSSP provides dinar loans for up to one year, without an explicit rollover provision. Foreign exchange swaps are for two-week periods, although these do have rollover provisions.
[9] Data are for the commercial banks as of year end 2008 from the NBS.

The impact of the above on USAID planning is that the high cost of operations (e.g., high reserve requirements, high repo rates, high net nominal spreads on lending), continued state ownership of up to 15 percent of banking system assets, and limitations on hedging mechanisms in the Serbian banking system will make it more difficult for Serbia to:

- Provide lower rates to borrowers to meet enterprise and household needs, particularly as high nominal lending rates are linked to double-digit inflation rates.[10] Such high nominal rates will affect borrower cash flow, particularly if there are rising inflation rates and/or dinar depreciation given the variable rate and indexed products that dominate the market.
- Encourage more lending (based on sound underwriting standards and without compromising asset quality) due to banks' legitimate concerns about the risks of lending to troubled or uncompetitive enterprises, or exceedingly small enterprises. In the case of the market, many of the SMEs are unable or unwilling to meet the creditworthiness requirements that banks have to approve loans or other exposures. Some of the larger companies do not meet key creditworthiness criteria and/or have powerful connections that would put the banks at risk in the event of a default scenario.
- Facilitate needed financial and operational restructuring among troubled enterprises, as such restructuring would require banks to provision and charge off some of their exposures, which would adversely affect earnings unless the NBS permits forbearance.
- Introduce long-term products that can assist with asset-liability management.

This may mean that USAID should consider focusing on alleviating some of the rigidities of monetary policy, working closely on debtor restructuring, and/or focusing on elements of securities market development that might assist with long-term instruments.

- Compromising monetary policy is not recommended, as it would not only clash with the IMF and NBS, but would also interfere with a reform process from recent years that had seen rising credit and declining interest rates. Thus, while the interim period is likely to be challenging, in all likelihood, banks will revive lending as this is needed to generate earnings, and interest rates will come down when inflationary pressures diminish. In the latter case, much of this is structural/fiscal/governmental, and has less to do with monetary policy.
- As such, an intervention that USAID could consider is getting involved in the enterprise restructuring program, particularly as linked to the FSSP and World Bank program. Even more importantly, efforts should be made by USAID to encourage the World Bank to build in legal and institutional reforms in the areas of SME finance, inter-enterprise

[10] According to the Association of Serbian Banks, under current circumstances, bankers believe they cannot run a profitable business without charging at least 16 percent nominal rates on loans. See "Guide to Serbian Banking and Financial Sector—2009," May 2009.

arrears, dispute resolution and secured transactions as program targets for future assistance.

- Focusing on the development of long-term instruments offered via the securities markets is worthy of support, particularly given long-standing support, recent leadership in developing the new Securities Law, and the need for a government securities market to meet future financing requirements. This is discussed in the Recommendations.

C. Non-Bank Financial Institutions

1. Recent Developments and Current Status

Serbia's non-bank financial institutions are limited in activity, volume and value. There has been progress in recent years in (1) privatizing all but one of the state insurance companies while allowing others (from abroad) to enter the market under regulated conditions (largely, although not completely, compliant with EU standards); (2) introducing leasing, with some regulatory oversight; (3) introducing a framework for voluntary pension funds, and launching such funds; and (4) promoting some investment via the stock exchange. However, by and large, the non-bank financial system is at the beginning stages of development in Serbia.

The World Bank program tied to the FSSP addresses key outcomes in the insurance and securities markets in addition to banking. For insurance, key outcomes are (1) third party motor liability is fiscally secure and a framework to resolve legitimate claims is in force; (2) resolution of failed insurers is carried out according to EU principles; and (3) the government share of insurance premiums written declines to 35 percent by 2010. In the securities markets, key outcomes are (1) development of the capital markets based on an improved and adequate regulatory framework; and (2) the markets are sufficient to provide a benchmark or reference rate for municipal, corporate and infrastructure bond issues. The following box profiles the non-bank financial sector:

Brief Profile of Non-Bank Financial Institutions in Serbia (2008)

Leasing	There are 17 leasing companies which had exposures of about €1.45 billion in leases in late 2008, up from earlier figures that reported contracts at about 84 billion dinar (less than €1 billion). Leasing companies are heavily dependent on foreign borrowings, accounting for about 85 percent of their liabilities. Most leasing companies are part of banking groups. Recent trends have shown an increase in lease contracts for transport, warehousing and communications equipment, as opposed to an earlier focus on commercial trade. However, expectations are that there will be a decline in auto leasing, at a minimum, and this may impact overall volumes for 2009 against 2008.
Insurance	There are 24 insurance companies in Serbia. The penetration ratio (premium revenues-to-GDP) is low at about 2 percent of GDP, well below the EU norm of about 8 percent. Insurance assets are less than 5 percent of total financial system

	assets. Most insurance is for vehicle insurance, property insurance, and other non-life forms (e.g., health insurance). About 10 percent is life insurance.
Voluntary Pension Funds	There are now 10 management companies managing voluntary pension funds (VPFs). VPFs only began operating in Serbia in 2006, and as such, have shown limited accumulation of assets to date—about 4 billion dinar (about $60 million or €45 million). There were about 157,000 VPF service users in late 2008, and average accounts were about $500-equivalent. As of late 2008, net fund assets were only 0.15 percent of GDP, well below norms in Europe (15 percent) and the region (5 percent). VPFs account for about 2 percent of trading on the local stock exchange. While they lost 7 percent of fund value during the recent financial crisis, these losses were well below the average of 75 percent for the Belgrade Stock Exchange. This is due to their conservative asset allocation in which half of assets are in the money market, 30 percent in government bonds, and only 15 percent in equities.
Securities Markets	Securities markets are limited in Serbia. Market capitalization was about €9 billion at the end of 2008, or about 30 percent of GDP. Trading activity as reflected in turnover levels diminished significantly in 2008, and was about 72 billion dinar (€882 million), or about 600,000 dinar (less than €7,000 per transaction). The Government securities market is virtually non-existent apart from the 15-year frozen foreign currency bond that was issued in the early 2000s. To date, the central government has only issued 3-month Treasury bills, although there are now plans to issue 6-month and one-year notes. NBS issues securities as a function of monetary policy, but these are generally liquidity facilities for very short periods. There is no corporate or municipal bond market, nor is there an asset-backed securities market for mortgages, consumer debt, auto lease portfolios, etc. That leaves the equities market, of which there are only three stocks traded on the prime exchange.
Sources: National Bank of Serbia, Securities Commission, "Guide To Serbian Banking and Financial Sector—2009", www.belex.rs	

2. Risks and Challenges for the Future

There are few risks to Serbia at the moment rooted in the non-bank financial sector, consistent with other markets where non-bank financial services are underdeveloped.

- Leasing is still nascent in Serbia, and most borrowings for lease contracts are from banks abroad (or parent banks of banks operating in Serbia).
- Insurance is following prudent principles, with high levels of reserves. The regulatory framework is increasingly aligned with international and EU standards, and there are plans to strengthen solvency requirements. However, the state's ownership position in the industry, as reflected in the high proportion of insurance premiums written set as a maximum target for 2010 (35 percent of total), may distort competition in this industry until the state's share is less.
- Voluntary pension funds have just begun operations two-three years ago. Under difficult circumstances, they have only accumulated about $60 million in assets, although they have

already outperformed the market by suffering minor losses that were well below the norm for those operating on the Belgrade Stock Exchange.

- Securities markets are underdeveloped. There are plans to expand T-bill offerings beyond three-month maturities to six-month issues and one-year issues. However, these are narrow by global standards, and present little risk to government under current circumstances relative to current reserve levels.
- It is currently unclear how much potential there is for near-term issuance of debt instruments apart from central government issues or a mortgage bond backed by insured mortgages from the National Mortgage Insurance Corporation. Municipalities have limited capacity, and infrastructure is not in place at the moment. Infrastructure-related bonds would likely require guarantees, which will be increasingly difficult for the government as its debt load and fiscal deficits increase. To the extent that the central government is required to offer partial or full guarantees on public sector bond issues, this will add to contingent liabilities, and this will impact budget expenditure and allocation decisions.

The impact of the above on USAID planning is more related to the opportunity cost to Serbia of not developing non-bank activities. This is important in a number of ways, including:

- Leasing is another form of lending, and essentially provides SMEs with opportunities to finance equipment purchases or other assets without having to make down payments. However, given the number of EU-based banks in the system, there is little need for USAID assistance in this domain.
- A more robust insurance sector would provide needed coverage to businesses and households that would provide protections that are not in place, or are costly due to the reliance on reinsurance. Assuming their capacity to properly assess and price risk, profitable insurance companies are then in a position to (1) invest in the capital markets, with the particular benefit of serving as investment drivers for long-term instruments due to the nature of life insurance and their needs for asset-liability matching instruments; and (2) design savings instruments that provide households and the self-employed with pension-like benefits that assist households during retirement. The insurance market is already 10 percent life insurance, and there will be opportunities for insurance companies to design policies and products that will help Serbians with long-term retirement savings requirements and coverage. Continued USAID assistance to the NBS as insurance regulator may be worth considering, although this needs to be weighed against other options and limitations on resources. One approach may be to link other forms of continued USAID financial sector assistance (e.g., anti-money laundering, securities market development) to specified activities of the insurance sector.
- The introduction of private pension funds or other savings options is essential to help reduce reliance on the PAYG system that is chronically in deficit and a drain on public finances. However, if contribution rates are too high, companies will be deterred from hiring more permanent employees. Meanwhile, stagnation or declines in purchasing

power will slow voluntary contributions. As noted above in insurance, a fourth option is to have simple savings instruments available on a retail level, and sold by banks, insurance companies and others that are simple to understand, straightforward in terms of how they are invested, and easy to purchase, transfer and convert. It is not clear that USAID should necessarily take the lead with pension reform. As with insurance, one approach may be to link work with the securities market back to how pension funds manage assets and meet their risk management and reporting requirements, rather than taking on the entire challenge of how to make the pension system meet retirement savings requirements without significant fiscal deficits from the PAYG system.

- Securities market development for company issues will require major changes in the corporate culture of Serbia, including governance, accounting/audit standards, disclosure requirements, etc. In this regard, any USAID assistance should be considered long-term. However, there is clear potential and need to develop a government securities market initially. This is due to the future funding needs of the government, as well as the broader market need for benchmark rates that exceed one-year terms.[11] There is also potential to develop a small municipal bond market in larger and well-managed municipalities with a sustainable revenue stream, although this will likely take years. A simple mortgage bond that could attract term funding to reduce asset-liability mismatches would be feasible if backed by the insured housing loans covered by the National Mortgage Insurance Corporation, although this was not included as one of the key outcomes in the World Bank program. A long-term yield curve is needed from sovereign issues for other bond issues to occur. During that time, some of the necessary requirements for viable corporate debt and equity markets can be addressed so that the capital markets can play a role in adding to financing options for enterprises and households.

D. Financial Sector Infrastructure

1. Recent Developments and Current Status

The banking system has shown itself to be stable and well supervised during the recent financial crisis. The National Bank (NBS) has been effective in recent years in overseeing a stable system according to broadly recognized prudential norms. While not fully in compliance with the Basel Core Principles,[12] NBS has made major progress in this area since

[11] The government plans to issue Treasury bills with six-month and one-year maturities this year. However, viable securities markets require longer yield curves. These are also important for banks making long-term loans, as is the case in Serbia.

[12] Key weaknesses identified in early 2008 involved (1) accountability and transparency, (2) capacity to assess banks' capital adequacy and risk management systems, (3) market, operational and liquidity risk issues, (4) supervisory approaches, (5) consolidated supervision, and (6) home-host coordination. Improvements have been made in these areas since the self-assessment, and an updated FSAP/FSSA in 2009 will provide a new set of ratings on the degree of NBS (non-)compliance with the Basel Core Principles.

2000, and now has a strategy to evolve towards standardized and simplified approaches to Basel II. More recently, the NBS intervened to inject liquidity into the system, helping the banks emerge from temporary dislocations in the markets. Thus, from an overall stability position, the banks are showing high levels of reserves and capital under well regulated conditions, and these buffers helped them in the recent crisis. Banking supervision at NBS is credited as having been a key factor in maintaining stability. Further efforts under the FSSP and World Bank program are expected to bolster crisis preparedness.

Notwithstanding progress in banking supervision, there are still weaknesses and a need to sustain progress. Banking supervision still needs to strengthen risk management capacity, including its own capacity to assess banks' risk management systems. As noted above, several of the larger EU-based banks have more complex systems available to them from parent banks than NBS would be able to supervise under Basel II. Assistance is needed in IT and sophisticated modeling, particularly as many of the EU-based banks' parents are moving on to more sophisticated systems and operations under Basel II. Bank examiners will need continued and expanded training to be in a position to assume their responsibilities under pillar 2 of Basel II, namely supervisory review of banks' capacity to manage credit, market and operational risks and the adequacy and sufficiency of capital buffers. Moreover, assistance in this domain should also be linked to efforts to strengthen capacity re money laundering and other financial crimes. This will include coordination with the Ministry of Finance and law enforcement agencies.

The bankruptcy framework is underdeveloped and generally not used for debt resolution and contract enforcement issues. The bankruptcy framework is currently under review, and new legislation is anticipated by late 2009. This is part of the World Bank program to strengthen financial discipline (mainly in the public enterprise sector), and additional legislation is expected at a later date to deal specifically with the bankruptcy and liquidation of banks. However, the judiciary is not experienced or trained to be effective in this domain. Processing of commercial disputes takes a long time, as do other cases due to lack of judicial capacity and weak management systems. The threat of bankruptcy is insufficient to induce creditors and debtors to utilize specialized out-of-court adjudication to resolve problem loans as a vehicle for corporate restructuring. Moving forward with liquidation (for at least partial recovery) is difficult because companies can easily establish new companies without being liable to the original creditor. When bankruptcy and liquidation procedures are utilized, recovery rates are low, at about 25 percent of outstanding obligations (vs. 28 percent in the region and 69 percent in the OECD). Time required is 2.7 years (vs. 3.1 years in the region and 1.7 years in the OECD). Costs of the process are also comparatively high, at 23 percent of the estate (vs. 13 percent in the region and 8 percent in the OECD.)[13] Improvements are expected with the new legal framework, but developing institutional capacity for effective implementation will require time and effort, both in the financial sector as well as the enterprise sector.

[13] Data from www.worldbank.org

Serbia was slow to introduce legislation against money laundering and to set up a financial intelligence unit. This has now been established in the Ministry of Finance, but institutional capacity building is required for this unit to be effective. This includes (1) tightening up on the organizational structure of the Ministry of Finance to have a better understanding of how the Foreign Exchange Inspectorate is reporting to the Anti-Money Laundering Administrative Unit, and (2) increased training of staff (e.g., Ministry of Finance, law enforcement, NBS) as well as obligors. Past experience via the SEGA program was positive, and assistance in this area is all the more important as it permeates the entire economy. Likewise, as it is housed in the Ministry of Finance, support for this should be closely linked to developments under NBS supervision, and potentially the securities markets.

The absence of consolidated accounting reduces risk detection capacity at the NBS, although efforts have been made in recent years to strengthen cross-border cooperation with other supervisory agencies. NBS has tightened up on the qualifications of auditing firms permitted to do bank audits. However, due to the significant degree of funding from regional banks and cross-border guarantees by the banks in Serbia, there is a risk that off-balance sheet items are insufficiently reported in a manner that would permit NBS to detect key risks before they become problematic. The upcoming FSAP is expected to address this issue later in 2009.

IFRS is now fairly common with the EU-based banks, but is hardly in effect elsewhere in the economy. Borrowers do not provide such statements, and many enterprises are audited by smaller firms that have traditionally focused on tax-oriented accounting. Movement to consolidated accounting is something that should be considered for the financial sector, particularly as banks in Serbia are universal and engaged in other financial services.

2. Risks and Challenges for the Future

Notwithstanding improvements in financial sector infrastructure in recent years, more work is needed for reforms to be sustained. Several of these areas will require coordination capabilities, such as (1) cross-border supervision, (2) coordination with the Securities Commission (in due time), and (3) coordination on illegal and suspicious financial transactions, and potentially with the auditing firms. These include:

- Closure on areas where NBS is not in full compliance (or largely compliant) with the Basel Core Principles.
- Establishment of needed capacity and systems for NBS to be an effective regulator of banks that, in many cases, have or will have more advanced risk management systems and modeling capabilities than NBS.

- Development of a sound dispute resolution and bankruptcy framework that is scaled to the needs and capacity of both the banks and the enterprises, but with sufficient authority to induce needed restructuring work to unfold.
- To the extent that bankruptcy and dispute resolution occurs within the courts, better case management and faster processes.
- Capacity building in the area of money laundering and combating the financing of terror and other illegal activities.
- Movement to consolidated accounting and supervision so that NBS has a better understanding of the fundamental risks to financial stability along with banking sector safety and soundness.
- Enhanced governance capacity and structures in the real sector, including better use of internal data at the firm level to manage risks and report on such risks to creditors and investors at an early stage to mitigate the potential loss that can occur from such risks.

The impact of the above on USAID planning is that while NBS has reached a threshold as an effective regulator under Basel I, there will be additional challenges as Serbia (1) moves on to Basel II, (2) seeks to develop the non-bank financial sector, (3) promotes development of a more profitable and efficient system, and (4) seeks to strengthen Serbia's reputation internationally. Key challenges include the need for NBS and other regulators to:

- Adapt to more universal activities undertaken by licensed financial institutions.
- Strengthen risk-based supervision of insurance consistent with IAIS and EU Solvency II requirements, and train companies and regulators in IFRS.
- Develop increasingly effective coordination mechanisms between NBS and the Securities Commission over time as that market eventually develops.
- Ensure that any mandatory or voluntary contributions made to pension funds and/or invested in savings instruments (potentially issued by insurance companies or banks) enjoy maximum investor/consumer protection, including portability across institutions (albeit with reasonable fees attached).
- Develop more effective coordination mechanisms for ongoing cross-border monitoring of financial system risks with other financial sector regulators.
- Develop capacity to monitor for macro-financial stability, including more advanced modeling techniques.
- Ensure that all key financial regulatory and law enforcement institutions have adequate capacity to detect and act on suspicious transactions.
- Ensure capacity is developed in a manner consistent with requirements for eventual EU accession.

E. Real Sector Structural Issues

1. Recent Developments and Current Status

Many of the core problems for future financial sector development relate to structural problems in the enterprise sector, as well as governance and tax administration weaknesses throughout the entire economy. Until legislation, regulations and traditional practices are streamlined and overhauled, the system will continue to function well below potential. Current activities focused on legal and regulatory reform are encouraging. However, there will still be significant obstacles to change in many quarters, and developing institutional capacity for effective implementation of reforms will also require time and investment. That elections often interfere with progress will also put future reform activities at risk, particularly if the current downturn in the economy persists beyond 2010 and the public associates the reform agenda with slower (or no) growth and negative economic effects.

There is a well defined agenda to enhance the business environment, strengthen financial discipline, and build a more efficient and stable financial system. The outcome is expected to be (1) a better environment for business start-ups, (2) increased investment from domestic and foreign sources, and (3) enhanced capacity for employment creation, as well as (4) a more efficient and cost-effective public sector. Restructuring, commercialization, and privatization of most remaining state holdings in the financial sector is also expected to make a contribution to this effort, as well as to improve corporate governance structures across the economy as a whole.

Key legislative reform to strengthen the business environment includes (1) amendments to the Company Law, Enforcement Law, Privatization Law, and Law on Spatial Planning and Construction, and (2) new Laws on Bankruptcy, Competition, and State Aid. This effort is being accompanied by a regulatory "guillotine" process across the government that is assessing the need to eliminate, revise, or re-write 2,000 regulations as they apply to the business sector in Serbia. The outcome of this effort is expected to significantly improve the business environment, although capacity for implementation may face limitations. Moreover, some areas of difficulty are expected to persist due to the political sensitivity and actual cost to many involved. These include (1) the loss of control by some state enterprises that have monopoly positions in the economy (e.g., utilities), and serve as a major source of employment, benefits and patronage; (2) local level issues related to the ownership of urban property, practices involved in the issuance of permits and licenses related to land use management and development, and property tax assessments and collections; (3) centralization of and electronic access to comprehensive and linked property and pledge registries; and (4) restitution (or related compensation) of nationalized or confiscated properties.

One of the key weaknesses in Serbia is governance and accounting standards. Serbian businesses do not operate according to the same principles as many other enterprises in the EU or elsewhere in market economies. While the Big 4 and at least one other second-tier accounting firm have offices in Serbia, most businesses do not follow international standards of accounting or auditing. At the same time, such audits are costly for businesses that have often had trouble accessing market sources of credit or investment, particularly small-scale enterprises. Thus, as elsewhere, there is a major divide in the economy, with most enterprises following narrow tax-oriented accounting policies (to the extent they have any policies beyond fundamental cash management) that are considered to be broadly inadequate for licensed financial institutions considering making loans or investments. In general, corporate governance standards and accounting practices will need to more closely converge with market standards for Serbian businesses to become more competitive. This will include movement to more open and accurate disclosure of asset quality and obligations. A simplified framework for tax compliance at reasonable rates would very likely facilitate movement in this direction. (In economies where the formal or informal tax burden is high, there are incentives to hide assets and under-report income.)

Such principles also clearly apply to the public sector. The government's accounts have reportedly not been audited. Good governance practices and modern accounting standards are considered key to accountability, integrity and public trust. The willingness of the household and enterprise sector to pay taxes in the future will largely depend on perceptions of how effective and honest government is in managing resources and rendering critical services.

Another key weakness is workforce development. A constant topic raised in discussions was how unsuitable labor force skills and knowledge are for a modern economy. This is reflected at the vocational level as well as at the managerial level. There is widespread recognition of the need for practical, Master's degree-level business and management education for the enterprise sector as well as the government.

2. Risks and Challenges for the Future

Significant structural problems remain in the government and enterprise sector, and these will only be solved over a period of many years. Key real sector areas that will need transformation for Serbia to converge with EU and international standards, and which are relevant for financial stability and financial sector performance, include:

- Governance standards, which are linked to ethics, accounting standards, and a general corporate culture that recognizes transparency and disclosure as more beneficial to the economy and functioning of the market.
- Tax administration, balancing the legitimate needs of government for revenues to cover needed services and investments, and enterprises and citizens that will need to comply to

benefit from such needed services. De-politicizing the tax process will be essential, as will other government practices at the central and local levels.

- Once the regulatory "guillotine" process is carried out and a new legal/regulatory framework is in place, there will need to be ongoing regulatory impact assessments to ensure the continued viability and effectiveness of such regulations across the economy. This can be a government function, but should also involve a range of stakeholders, namely business associations as well as think tanks that are objective.
- While there appears to be significant momentum at the central government level under the current coalition to move ahead with reforms, major obstacles are expected to remain at the local government level. This includes implementation of any Law on Spatial Planning and Construction and Law on Urban Land, and implementation of a sound system for property tax valuation and collection. Delays in the centralization and electronic access of comprehensive and linked property and pledge registries can also be expected to reduce process efficiency and potentially lessen lending and investment.
- Workforce development is another long-term challenge that involves reform of the entire education system, as well as the introduction of modern standards and principles for management. While companies are willing to train new personnel, this represents an additional cost that reduces Serbia's competitiveness. Solutions are likely to require long-term commitments that involve planning, investment and time.

The impact of the above on USAID planning for financial sector and enterprise/public sector support is that greater strategic cohesion across initiatives/projects is required for USAID to have impact on a long-term basis, and in a manner that supports larger strategic objectives. Key considerations for USAID are:

- Continued financial sector support can serve as a vehicle for real sector reforms. As an example, financial institutions offering credit require the observance of accounting and reporting standards, which reflect some form of governance that meets underwriting requirements of the institution making the loan or offering the guarantee. Having enterprises meet such standards serves to enhance their competitiveness as a requirement for obtaining financial resources.
- The reform process is subject to significant political risk, particularly as the last five governments have averaged 1.6 years in office. While the current coalition looks like it might finish its term, USAID will need to work with institutions that are relatively stable, and have demonstrated performance as well as political will.
- There is a need to build up civil society capacity not only for democratic purposes, but precisely because of recent government turnover and political instability. Targeting groups that are able to promote continued reforms irrespective of electoral outcomes helps to build institutions and, in the process, move Serbia along the path to the EU and Euro-Atlantic institutions.
- Workforce development is a major challenge, and one that likely exceeds USAID resources and capacity. Nonetheless, there are targeted interventions that could help to

boost human capital, namely introduction of MBA and MPA programs with various specializations. This should be linked to one or two US-based programs, and possibly be a new institution such as an American-Serbian Management Institute or cooperation with an existing academic institution in Serbia and structured as a legacy institution. This would not solve all of Serbia's workforce development problems, but would address a clear gap in the economy. (See Recommendations.)

III. LESSONS LEARNED FOR FUTURE ASSISTANCE TO THE FINANCIAL SECTOR IN SERBIA

A. Background

The SEGA project is part of **USAID Serbia's Strategic Objective 1: Democratic Governance of the Market Economy Strengthened**. The broad objectives of SEGA include:

- Accelerate ongoing economic reform processes in the sphere of macroeconomic policy, financial sector strengthening, capital markets development and private sector growth.
- Strengthen the supervisory oversight and risk management capacity of the entire financial sector in Serbia.
- Upgrade the human resource and technological capacity of all relevant counterparts, including government institutions and local economic research institutions.
- Improve the government's ability to communicate its message competently and openly about significant reform agendas.
- Provide limited assistance to the government with aspects of the restructuring of state- and socially-owned companies.
- Promote fiscal decentralization through close cooperation with USAID implementing partner under the *Municipal Economic Growth Activity (MEGA)*.

The project has coordinated closely with the National Bank of Serbia, Ministry of Finance, Ministry of Labor and Social Welfare, and other related institutions. SEGA has also cooperated and coordinated with the World Bank and International Monetary Fund, both of which are keenly engaged in the stabilization, restructuring and reform of the banking system, and reform of the pension system.

This assignment is not an evaluation of SEGA performance. Nonetheless, the assignment calls for lessons learned from SEGA activities over the last few years to determine how USAID should move forward with economic growth assistance priorities.

The Scope of Work for the financial sector review included several questions. These are answered below, and constitute findings based on discussions with Serbian counterparts, SEGA advisors, and USAID personnel.

- **Do the problems or needs that gave rise to the SEGA activity (SEGA) still exist, have they changed, or are there new needs that should be addressed?**

There is no question that progress has been made in the area of banking and banking supervision. However, the rest of the financial sector is comparatively under-developed, and this now is proving itself to be an issue regarding macroeconomic policy—namely that the system is dependent on high levels of reserves to safeguard stability, and yet the high reserve levels mean there are fewer resources available for lending and investment. Meanwhile, the lack of investment resources is compounded by the weak state of fiscal affairs. The absence of a government securities market only weakens debt management and public policy. Therefore, many of the broad macroeconomic weaknesses and financial structures continue to exist, notwithstanding progress with banking.

At the "micro" or structural level, non-bank financing is still limited. There is more confidence in the system than before, as reflected by higher levels of deposits. However, confidence remains fragile, as reflected in the €1 billion in deposit withdrawals in 4Q 2008. Such fragile confidence means there is limited willingness to commit other resources for longer-term savings/retirement requirements. The initial accumulation of assets in VPFs has flattened, and accounts currently average only $500-equivalent. Thus, the long-term savings/retirement/pension issues persist, and the annual net losses of the PAYG system continue to add to the fiscal deficit.

The securities market remains small and generally illiquid. One of the key challenges moving ahead is the need to develop a long-term government securities market. Past emphasis in Serbia and the region has often been on equities and the stock exchange. However, these markets are not viable until sound governance, accounting, and disclosure standards are in place. This is a function of corporate culture and institutional capacity, and takes years to develop. Serbia is well behind the region in accounting and audit reform, and needs a dedicated strategy to address this for future economic and financial sector development. There is increasing recognition that debt instruments under more conservative parameters and practices are a more practical way to proceed, particularly in current times when risk aversion is high.

New needs have emerged, most notably the importance of a comprehensive strategy for contingency planning and crisis preparedness/management. This has given rise to the need for better coordination and cooperation across regulatory agencies within countries, and across borders. This is particularly pertinent in Serbia where foreign banks from nearby countries dominate the banking market, Given Serbia's limited domestic market and recent dependence on reserves partly built up from foreign direct investment and remittance flows, and given its increasing trade volumes with the EU in particular, financial stability is essential for domestic stability. In an environment in which there is likely to be less foreign direct investment, and potentially less in the way of remittance inflows, Serbia will need to become more export-competitive in the tradable goods sector. Given that this is true in the region at large, this means that Serbia will need to develop competitive capacity at a time when other countries are seeking to do the same thing, which will put downward pressure on export prices and make it more difficult for Serbia to generate needed foreign exchange. This will put pressure on the dinar exchange rate, as will increasing debt service payment requirements in the coming years (well before 2015). Serbia has faced hardship before, but in many ways, the conditions are different than they were at the beginning of the SEGA project.

Core needs that will need to be addressed: (1) development of a long-term government securities market; (2) accounting and audit reform and modernization; and (3) expanded capacity to manage financial stability issues on a domestic and cross-border basis, predicated on enhanced risk management capacity at the structural (i.e., financial institutions and enterprise) level and improved fiscal/debt management capacity.

Relevance to USAID: The above initiatives are all ambitious. SEGA has established a foundation for continued work re development of a government securities (and debt) market, and development of risk management capacity in the financial sector for regulators and market institutions.

- **Will there be expected results from SEGA that remain unattained at its completion that should continue to receive USAID assistance?**

SEGA has accomplished a great deal, and this has been recognized by counterparts. On the other hand, there are several initiatives that will be unattained at the completion of the project. These include (1) risk management capacity in the banking sector, particularly the non-foreign banks; (2) accreditation of banking supervisors; (3) full compliance with the Basel Core Principles for banking supervision; (4) risk-based insurance supervision; (5) IFRS training for the insurance industry and supervisors at NBS; (6) association development and self-regulatory capacity in the insurance sector; (7) implementing regulations needed to accompany the Securities Law that is expected to be adopted in 2009/10; (8) improving disclosure standards on the exchange; (9) enhancing Securities Commission capacity with regard to risk-based supervision; and (10) implementing IT systems for electronic reporting by market participants to the Securities Commission.

Other areas of focus where results will not have been achieved include (11) reform of the corporate income tax; (12) review of tax incentives for savings vehicles; (13) improvements in tax collections; (14) building capacity at the Anti-Money Laundering Commission; (15) training obligors on new AML legislation and by-laws; (16) developing a public awareness campaign on money laundering; (17) conducting a public awareness campaign on private pension funds; (18) strengthening the Association of Private Pension Funds; and (19) improving tax incentives for private pension contributions.

Core needs that will need to be addressed: (1) capacity for financial stability, which actually encompasses #1-10 above, as well as #14-16; and (2) development of long-term savings instruments that relate to #12 and #19 above.

Relevance to USAID: The areas cited above (#1-10, 12, 14-16, 19) should continue to receive USAID assistance, particularly as these relate to future growth and stability. These are inter-related, and therefore should not just be supported on a "silo" basis, but in a manner that recognizes that these parts of the financial system will be increasingly inter-connected over time. This will require better coordination between NBS and the Securities Commission, and with the multitude of regulatory and supervisory authorities in neighboring markets and around the globe (e.g., payment systems issues, AML/CFT).

Some of the additional initiatives deserve ongoing support, namely #12, #14-16, and #19 linked to #12, while other related initiatives probably do not constitute the best allocation of USAID resources. The rationale for continuing to support some and not others is presented below:

- *Fiscal Policy and Administration (#11-13)*: While the time may not be propitious to consider tax incentives for savings vehicles, in the long run, tax inducements to encourage people to save for retirement will likely be needed to eventually reduce the burden of the PAYG deficit on the overall budget. Thus, tax features to savings instruments should be revisited when the time is right (#12). This should be done not only in conjunction with #19 re private pension contributions, but also for banks and insurance companies to allow them to use their retail networks to broaden coverage to the whole country. However, given the complexity and politicization of tax policy, it is recommended that USAID not dilute its focus by taking on such ambitious tasks as corporate income taxes and tax collection, which are shrouded in political uncertainty and which can be addressed by the IMF, World Bank, or EU members.

- *Anti-Money Laundering (#14-16)*: All three areas should be supported because of the importance of capacity for the stability and reputation of the financial system (and country), as well as because of the delay in getting the FIU running. In this regard, the US is also viewed as having a comparative advantage. USAID should explore partnerships with UST on this. If feasible, USAID should also consider utilizing the same advisor to assist NBS with their operational risk/IT assessment needs to meet Basel II requirements.

- *Private Pensions (#17-19)*: The importance of pillars 2-3 are recognized for long-term savings, and to gradually reduce or eliminate fiscal deficits resulting from the loss-generating PAYG system. However, under current economic circumstances, USAID should not focus on the pension system. Rather, focusing on #12 in a generic sense should expand out the pillar 4 option (e.g., individual retirement savings instruments) that is likely to be more suitable for Serbia for the foreseeable future. Private pension funds should be encouraged to offer these instruments, as should insurance companies and banks. In the end, if the public policy objective is to increase private retirement savings and gradually reduce the burden of the PAYG system on the budget, then a simpler and more retail-oriented strategy may be more suitable for Serbia, particularly as the mandatory second pillar is not currently feasible (in light of all the restructuring the Serbian enterprise sector will need to go through and the need to keep the tax burden down to provide incentives for hiring).

- *Development of the Actuarial Profession*: Among the additional tasks not originally foreseen, the effort made to date in building the actuarial profession should be supported, continued and expanded. This has much to do with the future of the contractual savings market (e.g., insurance, pension), but even more so because of the potential contribution that can be made to enterprise risk management. Serbian banks, enterprises and service providers (e.g., accounting and audit firms) will need to have licensed risk management experts to help Serbia with overall governance requirements for competitiveness. Increasingly, companies are evaluated on the basis of their risk management capacity, including their comprehensive enterprise risk management capacity. This is a mix of skills, but requires precise and technical capabilities. As statistics improve based on data accumulation and disclosure, actuarial analyses will be important in contributing to Serbia's competitiveness. Existing support should continue, and this should be a natural feed into the development of a legacy institution, such as a management institute. Along with other core management courses for both the public and private sectors, a management institute would serve as the vehicle for 21st century management skills in Serbia. The actuarial specialization will not only serve as an advantage to Serbia, but will likely draw students from the region and help Serbia create a high value-added niche that is currently lacking.

- **Is the implementation strategy for financial sector assistance valid or should it be reformulated for future activities?**

USAID future assistance strategy to the financial sector should be reformulated to be more cohesive and synergistic with other USAID initiatives. It should remain focused on financial sector policy and the regulatory framework, particularly as no other donor has distinguished itself in this niche. The IMF and World Bank have led the larger macro-prudential and programmatic reform efforts, and EBRD and multiple EU donors (e.g., KfW, FMO) have been directly involved with market institutions and lending programs. However, USAID is the only donor that has been consistently involved in detail work regarding financial sector regulation and implementation. Moreover, it has stepped into the legal void (e.g., Securities Law) when others have either failed or been absent. Thus, USAID should retain its strategic niche and focus on this area.

In this regard, one of the key requirements for future development is to ensure that banking supervision moves from a prescriptive, control-oriented approach to one that is more risk-based, consistent with Basel II principles. This will require enhanced capacity at NBS to assess banks' own internal capacity to manage and price risk. However, banks will need to be able to more freely determine how they wish to allocate their assets in pursuit of higher earnings. In this regard, a number of reforms will be required, not the least of which are progress on the issue of related legal, institutional and financial sector infrastructure (e.g., property rights and unified/central property registry, unified national/central pledge registry, alternative dispute resolution to shrink inter-enterprise arrears, inclusion of inter-enterprise arrears into the credit information bureau reports). In this regard, close coordination with the IMF and World Bank is recommended.

Moving forward, USAID's future assistance strategy to the financial sector should increase linkage to other initiatives. As examples for future design consideration:

- *Financial Sector and Local Economic Development Mix*: There is woefully limited capacity in most municipalities. One of the ways to consolidate focus across the financial sector and local economic development projects (such as MEGA) is to identify common challenges to core objectives. For instance, key challenges at the macroeconomic level will involve agreement on and eventual implementation of the Law on Spatial Planning and Construction, and the Law on Ownership of Urban Property. While local government-focused in orientation, these laws will ultimately enfranchise ownership rights, which will finally provide investors with clarity and certainty about whether to move ahead with investment under transparent and competitive conditions. (This assumes there is a future solution to the restitution issue.) This will increase investment and employment, which will increase inflows via the balance of payments and increase fiscal revenues at all levels. Accompanied by improved practices regarding the issuance of permits and licenses related to land use management and development at the local level, this will foster increased investment (assuming tax policy, including the full complement of payroll deductions for benefits, is conducive). And then further accompanied by modernization of property tax assessment practices and collections, a viable tax base will potentially evolve at the local level. This, in turn, will then make it potentially feasible for certain municipalities to issue bonds. However, this will also depend on adoption of financial reporting standards based on sound accounting and audit practices that could be driven by the future financial sector assistance project with regard to securities market development (following on to the role SEGA has played with the Securities Law). In short, the future local economic development project could focus on (1) permits and licensing related to land use management and planning, and (2) property tax assessments and collection. The most successful municipalities could then be candidates for initial issues of municipal bonds, which would give them an additional financing source to fund needed infrastructure, etc. The future financial sector assistance project would be able to work with those municipalities to bring those bonds to market during the 2011-2015 period.

- *Financial Sector and/Competitiveness Mix*: The design of the Competitiveness project is to identify winning sectors, and provide firm-specific support by pushing a range of reforms from the ground up to facilitate exports and general revenue/employment growth and competitiveness. At a minimum, companies identified as "excellent" should be presented to lenders that are looking for dynamic and well-managed companies. While there is little overlap in terms of the financial sector activities, dialogue would potentially help link companies with certain lenders whose niche focus is on these companies. For instance, SMEs would likely be more attractive to ProCredit or Opportunity Bank. Even more importantly, any initiatives under the new financial sector assistance that would focus on an improved business environment and competitiveness would want to learn from the lessons of the Competitiveness project. To the extent that the latter project is representative, it is possible that the project should drive the agenda for SEGA in terms of non-financial sector considerations on policy reform or interventions, including technical assistance. This is important for next-stage reform of risk-based banking supervision that should be less prescriptive in terms of regulatory rules and controls, and increasingly reliant on banks' internal capacity to evaluate, manage and price risks when making lending decisions. A good source of information on these issues will be Opportunity Bank, given its involvement at the grass-roots level and familiarity with how rigidities in the system interfere with better resource allocation for SMEs. ProCredit Bank would also be a good source of information and guidance in this domain.

- *Financial Sector and Bankruptcy Mix*: There is significant potential overlap between this project and SEGA due to the significant degree of restructuring required in the enterprise sector, and how this impacts the financial sector. In short, there should be close coordination between the two to maximize opportunities to restructure businesses to be more competitive, and to open up the market to greater competition. This will include liquidation in some cases, and restructuring and divestiture in others. A strong bankruptcy framework that encourages voluntary debt restructuring between parties tied to efficiency improvements that enhance the enterprise's competitiveness and long-term creditworthiness should be encouraged.

- *Financial Sector and Agriculture Mix*: As the financial sector is not particularly interested in primary agriculture, no effort was made to assess these prospects. However, agribusiness/food processing is a critical sector in the economy, and critical for the financial sector. Thus, any USAID initiatives should be mindful of this sector in the economy being an area of competence and competitiveness in Serbia, and one with growth prospects. The recent progress made with warehouse receipts is a step forward for farmers and financial institutions.

Core needs that will need to be addressed: (1) Strategic cohesion with and synergy across USAID projects; (2) coordinated reforms with the IMF and World Bank; (3) broad commitment to the components of financial stability; (4) implementation of a more risk-based approach to banking supervision predicated on key institutional and infrastructure reforms that disclose inter-enterprise arrears and seek to enhance SME liquidity; and (5) enhanced options for asset allocation to bolster earnings and capital by financial institutions.

Relevance to USAID: Future USAID assistance to the financial sector needs to graduate beyond Basel I supervision, even if NBS has not achieved full compliance with the BCPs. Future USAID assistance also needs to select core areas of focus. Recommendations above reflect this focus: (1) financial stability; (2) risk management capacity, including capacity of NBS to assess banks' risk management capacity; (3) AML/CFT capacity enhancement, including linkages to operational risk capacity of the institutions supervised by NBS; (4) enhanced coordination with other regulators, inside Serbia and abroad; (5) methods of promoting retail savings instruments to address long-term retirement savings challenges, as well as to broaden and diversify product and service competition in the financial sector; and (6) securities market development, with particular focus on the central government securities market, and then feasible issues, which are more likely to be plain vanilla mortgage bonds than infrastructure or municipal bonds or corporate debt/equity instruments. Coordination with other USAID projects would improve the environment so that a well regulated financial sector can meet the financing needs of the private sector at competitive, affordable rates.

- **Do conditions exist to ensure that financial sector assistance results will have lasting effects?**

Conditions exist to ensure that SEGA's results will have lasting effects with NBS. Such conditions are not guaranteed with regard to the Securities Commission or in the area of public sector finance. While the current government is pro-reform and carrying out many positive initiatives (e.g., regulatory guillotine), there is less demonstrated capacity in the government to carry out requirements for comprehensive reform. For this reason, it is suggested that future USAID assistance be more focused and targeted on institutions where capacity exists (e.g., NBS), and/or on initiatives that are focused to compensate for the lack of capacity at institutions that would be involved (e.g., AML unit in the Ministry of Finance, Securities Commission, higher education).

Such conditions and relationships do not guarantee success. Even with NBS, movement to a more risk-based system implies a less directly control-oriented approach to banking supervision. NBS is likely to continue to focus on reserve management for monetary and broader stability purposes, particularly as structural and fiscal weaknesses in government and the enterprise/household sector imply continued loose fiscal policy. Moreover, rising debts and the lack of investment and export competitiveness will cause strain if NBS wants to maintain some measure of exchange rate stability. As such, continued high reserve requirements in the coming years may lead NBS to maintain a more control-oriented approach, which will then make it more difficult to get resources out to the SME sector for employment and GDP growth over time.

Core needs that will need to be addressed: (1) Greater strategic cohesion with and synergy across USAID projects; (2) coordinated reforms with the IMF and World Bank; (3) broad commitment to the components of financial stability; (4) implementation of a more risk-based approach to banking supervision predicated on key institutional and infrastructure reforms that disclose inter-enterprise arrears and seek to enhance SME liquidity; and (5) enhanced options for asset allocation to bolster earnings and capital by financial institutions.

Relevance to USAID: Future USAID assistance needs to work with other donors to carry out other legal and institutional reforms that constrain SME growth and development, while focusing on targeted aspects of the financial system to increase (1) earnings opportunities and (2) lending to and investment in competitive and creditworthy companies. Meanwhile, (3) development of a bond market, starting with Government securities, will help with #1, and potentially ease restrictive monetary requirements over time, as reflected in NBS reserve policy.

- **Can we confirm that the Government of Serbia wants, needs, and will use USAID technical assistance and training in reforming its economic policies?**

The Government of Serbia wants, needs and will use USAID TA and training to reform economic policies. This is already in evidence in many cases. However, this has been true in some areas more than others. Continued challenges with urban property rights and the business environment issues associated with local government administration remain critical risks. Notwithstanding any challenges in policies, there will be a major challenge with implementation. Throughout the economy, there is evidence of (1) larger companies abusing their positions and running up arrears on obligations to smaller suppliers, (2) government-owned utilities and other companies imposing charges that are inconsistently applied and serve as a tax on private investment, and (3) local vested interests able to obtain government contracts based on non-competitive standards. Moreover, the entire challenge of tax administration remains unsolved. All of these (and other unmentioned) structural weaknesses undermine large economic development objectives.

Core needs that will need to be addressed: (1) Greater strategic coordination of reforms with the IMF, World Bank, EU and other relevant donors; and (2) government stability and longevity to pursue the reform agenda, including making institutional changes that move Serbia closer to market economy standards.

Relevance to USAID: The need for commitment beyond legal and policy changes to actually ensure these new policies are implemented. In some cases, quick hits can be achieved. But the enormity of the challenge suggests that there will be continued resistance in many quarters, particularly if the regional and global economy does not pick up by 2011.

- **What approaches to technical assistance have been most effective with the Government of Serbia? For example, would conventional assistance implemented by a contractor or grantee be most effective, assistance from a U.S. Government department or agency (such as U.S. Treasury or the SEC), or a combination of both approaches?**

There is broad recognition of effective delivery of assistance under SEGA for the financial sector, namely the NBS. Thus, a mix of highly skilled professionals on a long- and short-term basis has been recognized as making a major contribution to the NBS as the rock of stability during the current crisis. This reputation is long-standing, and pre-dates SEGA as there is also recognition that banking reforms in recent years were built on earlier reforms initiated after 2000.

There is also recognition of effectiveness with the Securities legislation being developed, although additional TA for the Securities Commission has not (yet) been recognized, partly due to recent initiation, and partly due to lack of capacity at the Commission.

As for delivery, there were few suggestions of any importance on how to improve. Some counterparts were aware of UST assistance, although there was limited detail in this regard.

In some cases, the view was held that Serbian nationals could assume some responsibilities. However, there was little criticism of a heavy presence of US contractors. More broadly, Serbian counterparts in government and the private sector believe that their own reform process started later than many others, and therefore a more permanent presence of US contractors in Serbia is warranted as they are still making up for lost time. Serbians frequently alluded to Croatia's position vs. Serbia in a number of areas, and the belief that this is the main regional peer for Serbia to emulate in terms of reforms for future positioning re the EU.

Core needs that will need to be addressed: No real suggestions apart from greater strategic and tactical cohesion, as noted above.

Relevance to USAID: As per the above. The main challenge will be combining focus with responsiveness.

- **If the assistance in the period 2011-2015 were to be the final phase of U.S. bilateral assistance to Serbia, how would that affect recommendations of assistance objectives and approaches to delivery of that assistance?**

The recommendations and approaches are based on the assumption that the assistance period 2011-2015 is the final phase of US bilateral assistance. As with any program, there will be continued gaps or weaknesses. However, the recommendations in this report are based on 2015 being the last year of bilateral assistance.

B. Future Considerations for USAID Assistance

USAID assistance should be influenced by the following:

- **Strategic Fit with USAID**: Consistent with and reinforces 2011-2015 vision regarding support for Euro-Atlantic institutions. For future USAID assistance, efforts should continue to promote (1) convergence with BIS, IAIS, IOSCO and related international standard-bearers in the financial sector, and (2) effective implementation of reforms that position Serbia to accede to the European Union and other Euro-Atlantic institutions.

- **Comparative Advantage for USAID**: Evidence of capacity, a track record, and superior performance by USAID when compared with other donors. For future USAID assistance, this is clearly in the financial sector, with particular emphasis on legal, regulatory and institutional structures for effective performance and stability.

- **Achievable Medium-term Results**: Complexity/feasibility for achievement regarding USAID and counterparts' capacity to design and implement effectively. For future USAID assistance, this will require a realistic approach to goals and objectives that can be achieved. There is greater stability at NBS than in government ministries. As such, the probability of achieving medium-term results is higher via continued work with the central bank than it is with government ministries.

- **Sustained Long-term Impact**: Transferability to counterparts as legacy accomplishment by/from USAID. For future USAID assistance, this will be achievable via the NBS. Other initiatives will need to be explored, taking into account the capacity to operate on a sustainable and/or commercial (cost-recovery) basis.

- **Major Results from Budgetary Resources**: Reflected in how expensive or not the initiatives would be in terms of funding allocations, whether there is a need for co-funding, and if so, what the prospects are for achieving co-funding from other partners. For future USAID assistance, this will require closer coordination with major donors to leverage results from USAID budgeted resources.

- **Scaled re Available Budget**: Balancing achievement objectives with funding parameters to ensure that objectives are aligned with funding, and not out of balance. For future USAID assistance, this relates to the above considerations re results from budgetary resources. This will require potentially greater use of Serbian expertise, as well as possibly alliances with other USG agencies.

- **Measurable Performance Indicators**: As reflected in the ease of compilation of key performance indicators and their usefulness as a monitoring tool. For future USAID assistance, this will be relatively easy to structure for the financial sector once clear outcomes and outputs are agreed to with Serbian counterparts.

- **Fill Major Economic Development Gaps**: Addresses critical needs. For future USAID assistance, the approach of continuing to support financial sector reform is critical as a resource for larger economic growth objectives. However, effectiveness will only occur in tandem with other structural reforms, which will require close coordination with the IMF, World Bank and government for the desired results to be achieved. Support for the financial sector without close linkage to reforms in the enterprise sector and government will limit prospects for success.

- **Confidence of Success**: Prospects for achieving planned results. For future USAID assistance, as per the above, confidence of success will be higher if closely coordinated with reforms in the enterprise sector and government. This includes (1) legal, regulatory and institutional requirements that reduce government ownership in the economy, (2) reduce the position of monopolies, (3) allow for faster dispute resolution, and (4) rationalize the entire government approach to taxation, procurement and regulation.

- **Local/Domestic Support ("Buy-in")**: Counterpart cooperation, capacity, support and active participation. For future USAID assistance, this is largely guaranteed via NBS and some of civil society. It is largely guaranteed for the moment in the government, but not guaranteed for the long term. Willingness of counterparts to commit resources in conjunction with USAID-funded assistance could serve as a proxy for domestic support.

- **Global Development Alliance**: Prospects for potential partnerships in Serbia with international entities that could be instrumental in furthering strategic objectives. For future financial sector assistance, this is an important feature that will be helpful in leveraging resources, accelerating needed reforms, and potentially being indispensable in the establishment of at least one legacy institution.

Specific to future assistance to financial sector strengthening, key findings suggest that future assistance should be influenced by the following:

- **Needs**: Some of the original needs that existed in the original SEGA design are still in effect, while new challenges have emerged. For future USAID assistance, the design will need to be more specific in terms of objectives and targets. In some cases, original needs should not be addressed, as they are too complex, costly or politically risky to ensure success. In other cases, continued support is justified.

- **Results**: Not all results will have been attained, partly because of overly ambitious targets, the diversion of resources, and/or lack of political will/government capacity. For future USAID assistance, results will need to be more closely aligned with the core criteria noted above. Above all, greater cohesion will be needed re other USAID initiatives. Areas of likely success and impact that can be achieved by 2015 should drive design.

- **Implementation Strategy**: Achieving a balance of focus and responsiveness is the consensus that has emerged from a discussion of past performance under SEGA. For future USAID assistance, it will be important to identify achievable targets and objectives, and then build in a measure of flexibility and responsiveness within those areas.

- **Conditions for Lasting Effect**: USAID will need to make choices in terms of priorities and resource allocation. In some cases, the greatest needs should not be addressed because the preconditions for success are missing. In other cases, foundations are in place for success. For future USAID assistance, it will be important to build on earlier successes that have good prospects for both impact and lasting effect.

- **Government Confirmation re Economic Reform**: While the government is currently pro-reform, the degree of political will relative to the challenge is still unclear. For future assistance, USAID will need to identify personalities that have demonstrated their commitment to reform, have shown this through their respective institutions, and have articulated a strategic vision that converges with USAID objectives. USAID will also need to minimize the risk of turnover in terms of its institutional partnerships. This means that if there is a shift in cabinet, that sufficient capacity should exist to continue the work agreed to, and not be wholly dependent on the highest levels of government for sustained commitment and support.

- **Approaches**: Counterparts have spoken highly of TA delivered by USAID. For future assistance, USAID will need to (1) be strategically cohesive and focused and (2) work in tandem with other donors and possibly USG agencies on a complementary and reinforcing manner.

- **2015 Close Out**: There is considerable work to be done for Serbia to (1) establish a stable macroeconomic framework, (2) sort out distortions in the business and tax environment, and (3) achieve sustainable sources of earnings predicated on export competitiveness so that it is able to (4) weather future shocks without excessive dependence on tight monetary policy and donor funding. For future assistance, USAID will need to continue to focus on areas of current strength and stability, while working with others on critical structural reforms so that Serbia is able to converge with EU accession requirements. This process will not be fully achieved by 2015, but commitment to and implementation of reforms by 2015 should be sufficient to get them on the path to an invitation from the EU.

C. Brief Summary of Other Donor Activity in the Financial Sector

Apart from the IMF and World Bank, some other donors have been active in selected areas of financial sector developed. This area was not explored in great deal, but in most cases, there was little knowledge among counterparts of what other donors had done in the field.

The most commonly referenced activities were in SME lending, and work with the Deposit Insurance Agency. In terms of SME lending, ProCredit Bank is capitalized by several German (e.g., IPC, KfW), Dutch (e.g., DOEN, FMO) and international groups (e.g., IFC), and is the leading lender to SMEs in Serbia. EBRD has also implemented some SME lines of credit through commercial banks, most recently a €45 million facility through UniCredit. As for the Deposit Insurance Agency (DIA), KfW of Germany is providing assistance.

IV. RECOMMENDATIONS TO USAID

A. Background

USAID has been active in Serbia since 1997. A total of $203 million has been programmed for economic growth and development. Of this, a significant share of assistance has been dedicated to financial sector reform. Since 2001, the USAID assistance program has allocated more than $109 million to support financial sector legislation and regulation, banking supervision, insurance sector legislation and regulation, securities markets development, pension reform, macroeconomic analysis and fiscal policy.

The next five years of programming, from 2011-15, envision a period in which Serbia continues to build on structural reforms that help to boost financial stability while also potentially diversifying financial sector players to induce additional competition. The current system has shown itself to be stable, yet costly in terms of reserve requirements. Return ratios are low, and the vast majority of enterprises are still unable to access or afford mainstream credit from the banking sector. Much of this has to do with a wide range of structural defects in the system, culminating in a high degree of gray market activity.

While the banking sector is relatively stable, significant challenges persist. These will need to be addressed so that Serbia can be prepared for future external crises over which it has no real control. Likewise, ongoing reforms will be needed in the financial sector, government and private sector so that Serbia can increasingly converge with EU requirements for a future invitation to negotiate membership.

As part of this effort, USAID is evaluating its current programming and preparing for a new or revised strategy for 2011-2015. Specific financial support initiatives recommended to be pursued under this new strategy are presented below. These are recommended priorities, taking into account findings and observations from sections II and III.

B. Recommendations

There are four broad financial sector initiatives recommended for USAID to pursue. Three build on existing initiatives and are areas where USAID has a successful track record in Serbia and/or other transition countries, and/or represents an area of critical focus. These are (1) continued yet targeted work in **banking supervision**, with particular emphasis on requirements for standardized/simplified approaches to Basel II; (2) implementation of a viable long-term **debt securities market**, with initial focus on the local exchange as a platform for a liquid central government securities market; and (3) support for capacity enhancements regarding **AML/CFT**.

A fourth initiative, (4) establishment of a **management institute** that would serve as a wholesale source of accredited management capacity-building for financial institutions, enterprises, government officials and service providers (e.g., auditors, accountants) by offering MBA and MPA courses in conjunction with one or more US universities.

Each of these is discussed below. Detailed templates evaluating strategic considerations and prospects for success are presented in Annex 1.

► #1: Strengthening the National Bank of Serbia

NBS has made significant progress in recent years, and is widely recognized as a source of stability during the recent crisis. However, there are still some areas of needed strengthening. These include:

- *Movement to Basel II*: NBS has a strategy to move on to Basel II. This will require a less prescriptive approach to banking supervision to one that is more risk-based or principles-based. This will require enhanced NBS supervisory capacity to evaluate the credit, market and operational risk management systems of the banks.

- *Coordination of Basel II with Financial Stability Capacity*: NBS is currently undergoing a crisis preparedness exercise. In the future, the maintenance of financial stability in Serbia will depend on more balance between monetary and fiscal policy, as well as on enhanced coordination with other regulatory institutions within Serbia and across borders. The predominance of EU-based banks and high level of cross-border funding flows will require closer integration with regional supervisory bodies. NBS will also need additional expertise in financial modeling to coordinate ongoing stress testing and scenario analyses.

- *Coordination of AML/CFT with Other Agencies*: The integrity and reputation of the Serbian financial system partly rests on its ability to detect and act on suspicious transactions. In the meantime, due to the high degree of informal sector transactions, there is a major opportunity for money laundering and other financial crimes. Meanwhile, organizationally, the financial intelligence unit is housed in the Ministry of Finance (see below). Thus, efforts to link systems utilized for operational risk assessments of banks and insurance companies (supervision of Know-Your-Customer, etc.) along with monitoring of the payment/settlement system should be coordinated to support the broader AML/CFT effort, and vice-à-versa.

USAID assistance would involve short-term (and possibly) long-term TA to (1) coordinate movement to Basel II; (2) strengthen capacity to monitor and manage financial stability issues; and (3) coordinate and strengthen AML/CFT capacity. Specific outputs would include (1) demonstrated supervisory capacity to determine banks' own credit, market and operational risk management capacity and systems to ensure appropriate levels of capital are in place for banking system stability, and in a manner that is not as restrictive with regard to reserve policy; (2) demonstrated capacity to manage stress in the economy resulting from external shocks, macroeconomic or structural imbalances, cross-border exposures, and/or cross-sectoral (e.g., banking and insurance) exposures, and to ensure the financial system is adequately capitalized and able to access liquidity to meet all financial and payment obligations; and (3) capacity to prevent any reputation risk or loss of depositor, creditor or investor confidence as a result of money laundering or criminal financial activity. Partners would be a prime contractor and NBS, with significant coordination envisioned with the IMF and World Bank.

Strengthening the NBS

Strategic Consideration	Prospects	Comments
Strategic Fit	Consistent with support for Euro-Atlantic institutions.	Central banks are critical to the financial sector stability of the country. Without financial sector stability, Serbia's prospects for joining the EU diminish, which would work against the strategic objective of support for Euro-Atlantic institutions.
Comparative Advantage for USAID	Strong prospects for success. USAID is uniquely positioned to provide assistance.	No other donor has been involved at the structural level. Relations are good between NBS and USAID. IMF would like USAID to continue with its support during a crucial period.
Achievable Medium-term Results	Much is achievable in the medium term, although full implementation of Basel II in banking is unlikely. Results in non-bank areas may be more difficult to achieve.	SEGA has a work plan through late 2010, and key initiatives have been identified for 2011-15. These are achievable, although modest levels of achievement (e.g., standardized and simplified approaches to Basel II) should be targeted prior to introducing complexity into the system.
Sustained Long-term Impact	Building additional capacity at NBS as it approaches EU accession and introduces Basel II will have significant impact in the long term.	USAID has been working with NBS for nearly a decade. NBS is a clear candidate to serve as a "legacy institution" for USAID. Apart from the IMF, no other institution has worked closely on such an ongoing basis as USAID.
Major Results from Budgetary Resources	Results will exceed budgetary resources, as demonstrated during the recent crisis. NBS has acknowledged the importance of USAID support in building NBS capacity. Results will also strengthen coordination, which means strengthening other institutions along with NBS.	USAID TA has been beneficial in contributing to recent stability, and this has occurred partly due to the institutional capacity-building taken on by USAID nearly a decade ago. Because NBS has additional resources, USAID assistance is then positioned to achieve more than what direct assistance would accomplish.
Scaled re Available Budget	USAID TA is more in demand than USAID funding.	One of the advantages for USAID to working with NBS is that the latter has additional funds to implement TA as needed. There is opportunity for USAID project involvement benefit from NBS sources as well as IMF and

		other funds' sources.
Measurable Performance Indicators	There are numerous indicators of banking and financial stability that are regularly and easily compiled, and useful as a monitoring tool.	Specific performance indicators to be determined. Indicators are easily measurable (e.g., capital adequacy ratios in banking, solvency ratios in insurance, reputation of all licensed banks re AML/CFT), and can easily be broadened to include monetary, macro-prudential and purely structural indicators.
Fill Major Economic Gaps	TA serves as a key contributor to stability, which is indispensable for investment and sustainable economic growth.	A stable banking and financial system is essential for economic growth and development. This is fundamentally accomplished by raising public confidence (depositors) and the intermediation of savings for investment into the economy (loans). These benefits are particularly evident under stable or growing macroeconomic scenarios. Ongoing support will help to close gaps between Serbia and its neighbors as well as with the larger gaps re EU.
Confidence of Success	Strong prospects for achieving planned results.	High probability of success due to the initial capacity built up, and the strong mandate NBS enjoys. NBS is also not subject to the same turnover as other central government institutions. Likewise, USAID enjoys a strong reputation within NBS.
"Buy-in"	NBS would like continued support, as would IMF.	Counterpart cooperation, support and active participation have been in effect for nearly a decade. There is buy-in, and recognition by Serbians and donors that USAID assistance is properly positioned at the NBS.
Prospects for Global Development Alliance	Potential for partnership more likely with other USG or other regulatory institutions.	Uncertain if GDA is optimal for central banks. Alliances are more likely with the Fed or other US regulatory agencies, including UST. This could be enlarged to include FTAF-type assistance for AML/CFT which sometimes runs through the UN.

► #2: Developing the Long-term Debt Securities Markets

Serbia's macroeconomic framework is out of balance due to poor budget management. While fiscal deficits over the decade have not been exceedingly deep, the government still suffers from low revenue collection. However, there is still a substantial cost to the economy, as many households and companies are required to pay informal taxes. Moreover, because of poor and inequitable tax administration, much of the economy operates in the shadows to avoid reporting income and assets. The result of this inefficiency is that macroeconomic stability is predicated on high levels of foreign exchange reserves to maintain a moderately stable exchange rate, and to maintain confidence among depositors. This imposes an enormous burden on the banks in the form of reserve requirements, making banking a costly business in Serbia. This, in turn, limits the availability and affordability of credit for the private sector. Such constraints in the banking system spill over to the enterprise sector, resulting in significant inter-enterprise arrears as well as other arrears. All of this adds to the cost of business transactions, and keeps the negative spiral moving in a way that makes it difficult to achieve more balanced stability.

For these reasons, it is recommended that USAID support development of a long-term debt securities market. Key needs include:

- *Debt Management Strategy*: This project would complement other assistance from the IMF and World Bank on debt management, but gear it to market practices. This would involve planning for issues that would run beyond the one year issue planned for later in 2009 to issues that would run up to five years.

- *Planning for an Improved Sovereign Rating*: Because Serbia has traditionally relied on donor debt and commercial loan syndication, it has not established a framework at the Ministry of Finance for strategic planning related to achieving an investment-grade rating.

- *Financial Instruments*: Because there is no yield curve, there are no instruments for institutional investors (limited as they are). Establishing a long-term yield curve would provide banks, insurance companies and pension funds with earning asset opportunities and instruments to help with asset-liability management. This would also help to provide citizens with options for future retirement savings that could potentially contribute to a long-term solution to reduce the impact of the PAYG imbalance on the fiscal deficit (which would assist with debt management and an improved sovereign rating).

- *Accounting, Audit and Disclosure*: Serbia significantly lags other markets. This project would target standards to assist with government securities initially, but with spillover effects in other markets over time.

USAID assistance would involve short-term TA to (1) establish criteria and a regulatory framework for development of a liquid long-term debt securities market; (2) develop regulatory capacity to ensure issuers and brokers comply with the regulatory framework; and (3) institute the required accounting, audit and disclosure standards required when issues come to market for ongoing integrity and confidence. Specific outputs would include (1) a long-term yield curve to serve as a benchmark for the pricing of long-term instruments and exposures; (2) financial instruments in which banks, insurance companies, pension funds and others could invest to assist with earnings and asset-liability matching requirements; (3) standards for Ministry of Finance to manage its long-term debt strategy predicated on sound fiscal collections, budget management and planning, and improved sovereign ratings; and (4) modernization of accounting and audit standards consistent with requirements in liquid and transparent capital markets. Additional outcomes potentially would include (5) issuance of mortgage bonds, to provide long-term funding instruments in the insured residential mortgage market; (6) issuance of municipal bonds in Belgrade, Novi Sad, or other municipalities potentially able to attract institutional investment; (7) issuance of infrastructure bonds; and (8) issuance of equities by well managed enterprises. Partners would be a prime contractor, the Securities Commission, Ministry of Finance, and an approved Serbian audit firm with IFRS capacity for public sector debt instruments. Significant coordination is envisioned with the IMF and World Bank.

Initial estimates of resources needed for implementation include the following:

- Short-term advisor to assist with long-term debt management strategy and sovereign ratings.
- Short-term advisor to assist with relevant accounting and disclosure standards for a long-term government issue. This could possibly be a long-term position if it involves hands-on capacity-building work with the Securities Commission.

Development of a Long-term Debt Securities Market

Strategic Consideration	Prospects	Comments
Strategic Fit	Consistent with support for Euro-Atlantic institutions.	Securities markets are important for the diversification of financial products, and tradability of such products on an open and transparent basis. Development of the securities markets would help Serbia move closer to EU standards.
Comparative Advantage for USAID	Reasonable prospects for success.	USAID work on the Securities Law has been praised by stakeholders. It is therefore positioned to assist with the next stages, implementing regulations and capacity building. Relations are good between the Securities Commission and USAID. Development of a Government securities market is consistent with IMF objectives, as stated in the FSSP.
Achievable Medium-term Results	Much is achievable in the medium term, although capacity constraints at Securities Commission make this more challenging.	SEGA has a work plan through late 2010, and key initiatives have been identified for 2011-15. The current proposal actually enlarges the effort, which will make it more challenging to achieve in the medium term. However, in the absence of such a debt market, it is unclear how reserve requirements in the banking system will come down, how net spreads will decline, and how credit will become more available and affordable in the enterprise/SME sector.
Sustained Long-term Impact	Building capacity at Ministry of Finance and the Securities Commission will have significant impact in the long term.	The focus of this effort is to induce greater discipline with regard to debt and fiscal management, which will make Serbia less dependent on external sources of reserves for macroeconomic stability. Such a change in operations would represent a major departure from current operations, and have a long-term impact.
Major Results from Budgetary Resources	Results will strengthen fiscal and debt management, add to macroeconomic stability, and contribute to rising financial intermediation which will help with employment creation and GDP growth.	Outcomes are expected to include more efficient methods for pricing long-term exposures, introducing new long-term instruments for saving/investment, and enhanced accounting and audit standards. These will help to increase investment, improve prospects to reduce the PAYG pension system, and establish the foundation for disclosure needed for liquid markets to function properly.
Scaled re Available Budget	Depending on the level of work required for accounting and audit standards, this initiative can be scaled.	This initiative is structured to focus on central Government finance issues initially, thereby narrowing the scope and requirements for issues.
Measurable Performance Indicators	There are numerous indicators that would be easily compiled and useful as a monitoring tool.	Specific performance indicators to be determined. Indicators are easily measurable (e.g., improvements in sovereign ratings, extension and narrowing of short- and long-term yield curves, issues sold and value traded).
Fill Major Economic Gaps	A more balanced macroeconomic framework is needed to reduce the high reserve requirements imposed on the banking	The economy is currently dependent on foreign exchange reserves for macroeconomic and financial stability. The reserve accumulation from past years will be at risk in the coming years. Thus, for a desired easing of monetary policy without adding to inflationary pressures, well

	system and to reduce the cost of credit for creditworthy borrowers.	managed debt and fiscal policy is required.
Confidence of Success	Medium prospects for achieving planned results.	Medium probability of success due to (1) the involvement of two domestic counterparts, (2) dependence of the debt and fiscal management strategy on structural and other government reforms, and (3) need for capacity building at the Securities Commission.
"Buy-in"	Ministry of Finance planning to issue up to one-year securities. Securities Commission seeks USAID support.	Agreement with Ministry of Finance on debt management and issuance strategies would need to be agreed. This may be risky, as the fiscal deficit is rising, and sound budget management will require significant reforms. The Securities Commission is benefiting from current SEGA support and would like it to continue.
Prospects for Global Development Alliance	Potential for partnership more likely with other USG or other regulatory institutions.	Uncertain if GDA is optimal for this initiative

► #3: Enhance AML/CFT Capacity

Serbia's economy and investment climate continue to suffer from tax evasion and other weaknesses. This includes criminal transactions. The government was relatively late in establishing a financial intelligence unit, and thus lags behind many neighbors in the region in being able to track suspicious transactions. For these reasons, it is recommended that USAID support efforts to build AML/CFT capacity. Key needs include:

- *Organizational Requirements*: This project would tighten up the organizational structure of the Ministry of Finance to have a better understanding of how the Foreign Exchange Inspectorate is reporting to the Anti-Money Laundering Administrative Unit.

- *Staff Training*: Increased training of staff (e.g., Ministry of Finance, law enforcement, NBS) as well as obligors is needed to raise public awareness of the costs to the economy, as well as in technical areas related to detection.

USAID assistance would involve short-term (and possibly) long-term TA to (1) tighten up the organizational structure of the Ministry of Finance to have a better understanding of how the Foreign Exchange Inspectorate is reporting to the Anti-Money Laundering Administrative Unit, and assist with the organizational structure and requirements for effective implementation of FATF principles and requirements; (2) increase training of staff (e.g., Ministry of Finance, law enforcement, NBS) as well as obligors; (3) strengthen capacity and systems to monitor suspicious transactions; and (4) coordinate closely with NBS, law enforcement agencies, and other international counterparts to strengthen AML/CFT capacity. Capacity-building efforts would be linked to assistance for the NBS under Initiative #1 to ensure coordination via NBS operational risk assessments of banks and insurance companies (supervision of Know-Your-Customer, etc.) along with its effort to monitor the payment/settlement system. Specific outputs would include (1) demonstrated enhancement of capacity to identify, contain and prosecute suspicious transactions and those responsible for such financial crimes; (2) better public awareness of the costs and penalties associated with such activity; and (3) narrowing of gaps in institutional capacity relative to regional peers. Partners would be a prime contractor, Ministry of Finance, and NBS, with significant coordination envisioned with the IMF and World Bank. If feasible, USAID should consider utilizing the same advisor for AML/CFT to assist NBS with their operational risk/IT assessment needs to meet Basel II requirements.

Initial estimates of resources needed for implementation include the following:

- Short-term advisor for AML/CFT technical, operational and systems requirements who would possibly be a long-term advisor if this person is suitable to assist the NBS with their systems, IT and operational risk assessment needs for Basel II.
- Short-term advisor to assist with relevant organizational and inter-institutional coordination and communication protocols.

Support to Ministry of Finance and NBS for AML/CFT

Strategic Consideration	Prospects	Comments
Strategic Fit	Consistent with support for Euro-Atlantic institutions.	AML/CFT capacity is essential for a sound financial system, and for the national reputation of the Serbian market and business environment. Capacity is also a strategy priority for Euro-Atlantic institutions.
Comparative Advantage for USAID	Strong prospects for success. USAID/USG is uniquely positioned to provide assistance.	Donor assistance has been limited, although assistance received from SEGA has been well utilized. Relations are good between NBS and USAID, and USAID is uniquely positioned in this regard to assist with coordination and capacity building between Ministry of Finance and NBS.
Achievable Medium-term Results	Much is achievable in the medium term, although prevalence of tax evasion and criminal elements creates challenges.	All assistance objectives are achievable in the medium term. This is a recommended intervention to help Serbia make up for its late establishment of a financial intelligence unit.
Sustained Long-term Impact	Building additional capacity at Ministry of Finance and NBS will have significant impact in the long term.	Capacity enhancement in this area will strengthen Serbia's overall reputation, helping to create long-lasting benefits to the economy.
Major Results from Budgetary Resources	Results will exceed budgetary resources and strengthen coordination between Ministry of Finance and NBS, as well as with international counterparts.	AML/CFT TA provided by USAID could be spread across multiple institutions, providing some resource leveraging. This is particularly the case regarding NBS. It is possible that ST advisory assistance in AML/CFT could involve someone who would assist NBS with some of their IT assessment needs of the banks, an explicit need for the coming years. Meanwhile, that same advisor may be positioned to assist with the specific AML/CFT tasks of the Ministry of Finance.
Scaled re Available Budget	Scaled according to needs, with anticipated benefits greater than direct costs.	TA linkage to both AML/CFT and supervisory capacity at the NBS will generate significant systemic benefits.
Measurable Performance Indicators	There are numerous indicators that can be compiled, although these may be more judgmental re capacity.	Specific performance indicators to be determined. To be driven by FATF principles in a manner similar to BCPs for banking supervision and guidelines from the Financial Stability Forum for financial stability issues.
Fill Major Economic Gaps	TA serves as a key contributor to financial stability and a sound reputation, which is required for investment, long-term growth and convergence with EU requirements.	A stable financial system requires capacity to identify, contain and manage risks related to criminal financial activity. Support for AML/CFT capacity will help achieve this, and will boost confidence in Serbia re the investment climate, rule of law, etc. It will also help to close gaps between Serbia and its neighbors as well as with the larger gaps re EU. This is important as Serbia is a relatively late entrant re the establishment of a financial intelligence unit.
Confidence of Success	Strong prospects for achieving planned results.	High probability of success due to existing capacity at NBS, relationship of USAID, and earlier successful

		collaboration between SEGA and the financial intelligence unit. Risks are the degree of criminality in the system.
"Buy-in"	Ministry of Finance would like USAID support for this initiative.	Counterpart cooperation and support can be expected.
Prospects for Global Development Alliance	Potential for partnership more likely with UST.	Uncertain if GDA is optimal for this activity.

► #4: Strengthen Business Financial Management Capacities

Serbia's economy and public sector management continue to suffer from weak financial management capacity. This adversely affects government at all levels due to poor budget management and planning. In the private sector, weakness in this area undermines capacity for long-term investment planning. In the financial sector, it adds to the cost of training new recruits. Key needs include:

- *General Accounting and Audit Standards*: Educational institutions would introduce curricula that would offer standard accounting and audit training consistent with IFRS, ISA and other standards recognized by the accounting profession. Course work is needed for financial accounting (external reporting), cost accounting (internal managerial accounting), and government accounting.

- *Financial Management*: Educational institutions would offer courses in financial management involving asset management, investment planning, capital allocation, pricing, risk measurement and management, and related needs. Specific principles for enterprises and financial institutions would be part of an MBA program. Specific principles for governments (e.g., central, municipal) would be part of an MPA program.

- *Specialized Management*: Education institutions would offer shorter and more customized management certification programs. These would be shorter and involve less course work, and would be tailored to meet specific needs of systematically important institutions and sectors. Such certification programs would also be designed to round out broad management skills among specialized personnel to give them exposure to areas outside their expertise.

USAID assistance would effectively provide start-up capital, along with contributions from other partners, to establish a US-styled and certified program that would provide needed professional training and development in financial management and other needed disciplines. Direct involvement from USAID would require (1) a general mapping of needs as these relate to enterprise, financial sector, and government management; (2) general outline and framework for coursework priorities, staffing and other requirements, and preliminary costing; (3) methods of oversight, management and coordination among other partners and stakeholders; and (4) formalization of agreement with and commitment from Serbian institutions (government, financial sector, professional and business associations, universities, etc.) to support, participate, and sustain the Institute. Specific outputs would include (1) introduction of core accounting, audit and financial coursework according to international standards (e.g., IFRS, ISA); (2) narrowing of gaps in business and financial management education relative to regional peers and the EU; and (3) certification to award MBAs, MPAs, and other Master's-level education degrees. Partners would be a US university or consortium of universities, the government (e.g., Ministry of Education or Finance or Economy), NBS, business and professional associations (e.g., Bankers, Chamber of Auditors, AmCham, SAM, Foreign Investor Council), and universities and think tanks (e.g., University of Belgrade, FREM, CLDS). USAID would need to explore GDA possibilities, as well as potentially consider linkage to existing programs in the region (e.g., MBA program with University of Delaware at the University of Sarajevo, EU-oriented programs).

(1) As noted above, it is recommended that USAID explore a multi-party alliance with a US university or consortium of universities, the government, NBS, professional associations, domestic universities and think tanks, and potential benefactors (e.g., wealthy Serbian-Americans).

Strengthening Business Financial Management Capacities

Strategic Consideration	Prospects	Comments
Strategic Fit	Consistent with support for Euro-Atlantic institutions.	Financial management expertise and practical skills are needed for institutional strengthening throughout the economy. These are also essential for a better understanding of governance standards and requirements.
Comparative Advantage for USAID	Strong prospects for success. USAID is well positioned to provide assistance in conjunction with others.	There is widespread need, and no systemic or strategically coordinated effort to remedy these business education weaknesses.
Achievable Medium-term Results	Much is achievable in the medium term, although full development of a comprehensive MBA and/or MPA program may not be achievable by 2015.	Significant progress can be made in developing a curriculum, training professors, and moving towards the award of a class of MBAs or MPAs by 2015. Alternatively, one-year management degrees may also be feasible.
Sustained Long-term Impact	Addressing these needs will have a will have significant impact in the long term.	Capacity enhancement in this area will strengthen Serbia's capacity to introduce modern management and financial management techniques throughout the economy. This will have significant and long-lasting benefits to the economy, as well as assist with progress towards convergence with EU standards.
Major Results from Budgetary Resources	Results will exceed budgetary resources.	USAID assistance would achieve results well in excess of direct financial contributions due to the pooling of resources from other partners. A management institute should be structured to be a legacy institution.
Scaled re Available Budget	Scaled according to needs, with anticipated benefits greater than direct costs.	There is recognition that this is an investment that requires agreement with multiple parties. A specific business plan with a strategy and budget would need to be developed. Resource commitments would then shape the phasing and build-up of capacity. In this regard, the project would be scaled.
Measurable Performance Indicators	There are numerous indicators that can be compiled with ease once operations commence.	Specific performance indicators to be determined. Simple measures would include numbers of Serbians trained to deliver course work, numbers of students attending, numbers of students receiving certificates and degrees, numbers of institutions sending employees to attend coursework, etc.
Fill Major Economic Gaps	The absence of trained management personnel is a considerable weakness in the economy. A management institute would help fill that gap.	A market-based economy that is well managed, balanced, and with sustainable growth prospects requires sound financial management. A management institute would address these gaps, with benefits in all sectors of the economy.
Confidence of Success	Strong prospects for achieving planned results.	High probability of success due to existing capacity within Serbia that simply needs training for more practical applications. USAID can continue to build on successes, like actuarial training to make this a permanent offering

		that helps to build needed quantitative modeling and risk management capacity in the economy.
"Buy-in"	Likelihood of broad-based support for this—from government, the private sector, and the financial sector.	Counterpart cooperation and support can be expected.
Prospects for Global Development Alliance	Partnership required for implementation and funding.	GDA is optimal for this activity. Alliances with one or more US universities will be essential. Serbian-American benefactors are potentially willing to establish a legacy institution. AmCham members may also be able to obtain commitments from parent companies to endow chairs, etc. This includes the Big 4.

C. Other Potential Options for USAID Support

Other areas of potential support were considered, but are not among the four recommended initiatives because (1) other donors are likely to be or already are involved without any further need for USAID assistance; (2) USAID does not necessarily have a comparative advantage; (3) they may take too long to achieve needed results; or (4) there are too many risks to being able to achieve objectives, including lack of perceived buy-in. These are discussed below.

1. Direct Financing into the Market

► Lines of Credit

Lines of credit are not recommended for USAID. Other donors have them in place, and USAID already is providing funding via Opportunity Bank.

► Credit Unions and Micro-finance Institutions

There are no credit unions in Serbia, and the former savings and credit institutions have now been re-licensed as banks. USAID support for Opportunity Bank addresses small-scale credit and deposit mobilization issues.

► Leasing

Leasing has received support from USAID in the form of support for NBS regulatory oversight. Banks are equipped to engage in leasing. No incremental USAID assistance is considered needed. This is also not considered an area of comparative advantage. In emerging markets, this is more of an area of specialization and focus by the IFC. To the extent that any additional support is provided, this could come from the Competitiveness and BES projects as a specific financing tool to be utilized by their client firms.

► **Guarantee Fund**

As with lines of credit, USAID and others have not always had success with guarantee funds. USAID could consider use of a DCA guarantee for specific enterprises. But this would come from other projects (e.g., BES, Competitiveness), not from a future financial sector assistance project. Alternatively, should USAID support the debt securities market initiative (#2), it is possible that a partial payment guarantee to investors could be utilized for a mortgage bond or municipal bond. However, this would need to be determined at a later date. There is no perceived requirement for off-balance sheet support to banks. To the extent that USAID is seeking to support financing of SMEs, its support for Opportunity Bank appears to address this issue.

► **Insurance Sector Development**

SEGA is already helping with NBS regulation/supervision of the insurance sector. Support for this sector is warranted on a limited and indirect basis, namely by (1) continuing to strengthen NBS supervisory capacity (as part of the larger effort to bolster financial stability); (2) enhancing AML/CFT capacity, and ensuring that insurance companies are not utilized as channels for money laundering; and (3) developing long-term financial instruments so that insurance companies can also offer retirement savings instruments, as well as have instruments in which to invest to assist them with asset-liability management. However, net of these efforts, there is no compelling reason for USAID to be more involved in the insurance sector unless USAID chooses to become more active in health sector reform or pension reform. The third activity above is related to pension reform.

► **Establishment of an Enterprise Fund**

USAID-supported Enterprise Funds have achieved notable successes in many transition countries. However, because resources are limited and institutional capacity needs are so great, it is recommended that USAID not pursue this approach. Beyond that, USAID is providing firm-level support through the BES and Competitiveness projects, and has an equity stake in SEAF which invests in private enterprises.

2. Institutional Support

► **Deposit Insurance**

Deposit insurance is an important foundation for long-term confidence and stability. The recent increase in coverage up to €50,000 per account reflects the importance of deposit safety and soundness to financial stability, particularly given the legacy of past losses associated with deposits. However, the DIA is already receiving assistance from KfW. Should specific requests emerge for help with (1) validation that assets are being invested conservatively and according to investment policy parameters, (2) financial modeling re stress testing and scenario analysis, or (3) payout administration and contingency preparation, future USAID assistance should consider targeted short-term assistance. However, in meetings with various parties, there was no significant need expressed for such assistance.

► **Accounting/Audit**

USAID assistance for enhanced accounting and audit capacity is included in the strengthened business financial management initiative. The standard comprehensive accounting and audit project normally supported by USAID is desirable, but not recommended as a top priority because of the resources required, and uncertainty of achievement by 2015. The initiative constitutes a more focused approach to addressing key standards and educational/training requirements, and could involve work with the associations on the condition they demonstrate commitment. However, expanded work in this domain would likely exceed USAID resource commitments.

► **Property and Pledge Registries**

There is considerable need for reform regarding urban land privatization for clarity of ownership rights. Work is under way, and new legislation may be adopted in 2009. However, even with new legislation, difficulties with implementation may carry forward for several years. Cadastral work has likewise been under way for several years. While this is one of the most critical needs in the business environment, it is also too ambitious for future USAID assistance to take on. What is recommended is that via MEGA and the Competitiveness projects, that USAID support plans to centralize the property registry and to make it available electronically to lenders in support of future development of a secured transactions framework (i.e., use of such land with clear ownership rights as collateral for financing). Likewise, with regard to the pledge registry, the Competitiveness project should include support for efforts to centralize the pledge registry, and to make it more efficient. It currently is operated on a regional basis, and transactions involving pledged assets can change hands without such information being available via the pledge registry. Some of this involves the ease with which defaulting businesses can walk away from obligations, establish new companies, and transfer assets and pledges without consequences. Reforming these practices is essential for a better business environment and financial sector. However, these reforms can be supported via other USAID projects.

► Credit Information Bureau

The credit information bureau of the Bankers Association is reported to work well. The only proposal is for the credit bureau to increase its disclosure to include inter-enterprise arrears as a means of providing lenders and others with information on companies that are seriously delinquent on their payments to suppliers. However, desirable as this is, it should be part of a larger strategy to clean up and de-monopolize the enterprise sector. Such an endeavor exceeds USAID resource availability.

► Associations

Work with associations is desirable as a basis for capacity building. However, instead of working directly with individual associations, the initiative to strengthen business financial management is intended to provide needed capacity to association members on a broad basis, rather than pre-selecting specific associations with which to work. Thus, the initiative is intended to clearly strengthen the accounting and auditor associations/chambers. The initiative puts this on a more voluntary basis while staying open to other associations that may show greater interest and results (e.g., AmCham, Foreign Investor Council, Serbian Association of Managers).

► Tax Administration

Significant reform and improvement is needed in the field of tax administration. However, this activity is not recommended as the degree of project management would make this difficult to implement. Other proposed activities under future USAID assistance are intended to provide incentives for the Government to act on tax administration reform, such as working on a long-term government securities market. However, given the complexity and politicization of tax policy, it is recommended that USAID not dilute its focus.

V. INDICATORS FOR MONITORING AND EVALUATION

The following represents some preliminary indicators for ongoing USAID monitoring and evaluation of progress in the financial sector.

1. Support to NBS

- Capital adequacy of the banking system
- Numbers of banks below minimum capital adequacy and their share of total assets and deposits
- Earning assets/total assets
- Loans to the non-financial sector/total loans
- Non-performing loans/total loans
- Return on average equity
- Return on average assets
- Average credit, assets, deposits and capital per bank
- Compliance with Basel Core Principles of Banking Supervision
- Implementation of Basel II—standardized and simplified approaches—with particular focus on supervisory capacity to monitor for credit, market and operational risk
- Compliance with IAIS and EU Solvency II requirements in insurance

2. Development of the Long-term Debt Securities Market

- Sovereign ratings
- Value of Treasury securities > 1 year maturity
- Volume of trade in the secondary market in Treasury securities
- Value of other long-term savings instruments available for sale by banks, insurance companies and pension funds
- Number and value of non-Treasury long-term issues (e.g., mortgage bonds, municipal bonds, infrastructure bonds, corporate bonds)

3. Capacity Enhancement of AML/CFT

- Implementation of by-laws
- FATF/Moneyvaal assessment findings of capacity, coordination and effectiveness

4. Strengthening of Business Financial Management Capacities

- Numbers of Serbians trained to deliver Master's-level course work

- Numbers of students attending courses
- Numbers of students receiving certificates and degrees
- Numbers of institutions sending employees to attend coursework
- Numbers of actuaries certified according to international standards

ANNEX I: BIBLIOGRAPHY

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