

Serbia Country Partnership Strategy for FY08-FY11

108. **Serbia remains vulnerable to exogenous economic shocks.** Economic performance over the past few years has been very strong. Nevertheless, rapidly growing credit and associated private external debt and a stubborn current account deficit illustrate Serbia's continuing vulnerability to external shocks. A sudden increase in lending spreads or a decrease in liquidity could limit continued growth in Serbia and projected improvements in overall creditworthiness.

109. **Continued policy reform will be required to strengthen macro-economic stability and further improve Serbia's creditworthiness.** In particular, the government will need to recalibrate macroeconomic policy in order to reduce the imbalances that have emerged over the last two years, primarily due to fiscal stimulus. Greater fiscal restraint, consistent with the Government's stated intentions, will be important to reduce risks, as will continued structural reform. In addition further efforts to ensure rapid domestic credit growth and increases in private external borrowing are put on a more sustainable footing, and that credit increasingly finances productive investment rather than consumption. If these issues are not tackled, real vulnerabilities remain from the widening current account deficit and rapidly growing private external debt.

110. **Managing risks will require that the Bank Group work cooperatively with the Serbian Authorities in a highly flexible manner in order to encourage Serbia's continued international engagement and integration at a particularly sensitive time.** At the same time, Bank Group support is necessarily dependent on Serbia meeting international responsibilities, particularly in relation to debt servicing, or an agreement being reached that allows an orderly resolution of this issue. Given the very high level of uncertainty in the region, this CPS is perhaps best seen as setting out broad "rules of engagement" rather than as a detailed blueprint for Bank Group support.

VII. CONCLUSION

111. **Serbia is well poised to continue its strong economic performance and make progress toward the goal of full European integration.** While the transition program began relatively recently, significant economic reform has underpinned strong economic growth and real reductions in poverty in Serbia over the past few years. The Government has demonstrated a degree of commitment to undertake difficult but necessary "second generation" reforms that should help to ensure a sustainable growth path for the economy led by a dynamic private sector. Efforts are also evident to ensure that the benefits of growth are distributed widely, and that opportunities for disadvantaged households to participate in the economy are increased. Nevertheless, Serbia and the region have not yet fully moved beyond the difficult legacies resulting from the turmoil of the 1990s. A key challenge will be to ensure that this reform momentum is able to be continued, and that international confidence and regional stability is maintained, at a particularly sensitive time for Serbia. The World Bank Group has the potential to continue to be a strong partner for Serbia as it faces these challenges. This will, however, require the Bank Group to be even more responsive to the demands of a sophisticated middle income client. Further strengthened cooperation with other multilateral and bilateral partners, particularly but not only the EC, will also be critical to strengthen the overall effectiveness of the support that can be provided. Most critically, the World Bank Group will need to be able to respond flexibly in order to calibrate engagement with Serbia in an environment of high uncertainty.