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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED

DEVELOPMENT POLICY LOAN

IN THE AMOUNT OF EUR 66.1 MILLION

(US$70 MILLION EQUIVALENT)

TO

THE REPUBLIC OF SERBIA

FOR THE

DISASTER RISK MANAGEMENT DEVELOPMENT POLICY LOAN WITH A CATASTROPHE-DEFERRED DRAWDOWN OPTION

April 6, 2017

Social, Urban, Rural & Resilience Global Practice
Europe and Central Asia Region

SERBIA - GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of February 28, 2017)

Currency Unit = Euros (EUR)
0.943 EUR = US$1.00

ABBREVIATIONS AND ACRONYMS

CAT-DDO	Catastrophe-Deferred Drawdown Option
CPF	Country Partnership Framework
CTA	Consolidated Treasury Account
DPL	Development Policy Loan
DRF	Disaster Risk Finance
DRFI	Disaster Risk Finance and Insurance
DRM	Disaster Risk Management
ERL	Emergency Recovery Loan
EU	European Union
FAAARO	Office for Flood Affected Areas Assistance and Rehabilitation
FDI	Foreign Direct Investment
FMC	Financial Management and Control
GDP	Gross Domestic Product
GFDRR	Global Facility for Disaster Reduction and Recovery
GRS	Grievance Redress Service
ICR	Implementation Completion and Results Report
IEG	Independent Evaluation Group
IMF	International Monetary Fund
MoF	Ministry of Finance
NBS	National Bank of Serbia
NDRMP	National Disaster Risk Management Program
NPL	Nonperforming Loan
NSDI	National Spatial Data Infrastructure
PDNA	Post Disaster Damage and Needs Assessment
PDO	Program Development Objective
PFM	Public Financial Management
PIMO	Public Investment Management Office
RNA	Recovery Needs Assessment
SAI	State Audit Institution
SBA	Stand-By Arrangement
SDC	Swiss Agency for Development and Cooperation
SECO	Swiss State Secretariat for Economic Affairs
SEEC CRIF	Southeast Europe and Caucasus Catastrophe Risk Insurance Facility
SEM	Sector for Emergency Management
SOE	State-owned Enterprise
TA	Technical Assistance
UN	United Nations

Vice President	:	Cyril E Muller
Country Director	:	Ellen A. Goldstein
Senior Practice Director	:	Ede Jorge Ijjasz-Vasquez
Practice Manager	:	David Sislen
Task Team Leaders	:	Joaquin Toro, Elif Ayhan, and Benedikt Lukas Signer

SERBIA DISASTER RISK MANAGEMENT DEVELOPMENT POLICY LOAN WITH A CATASTROPHE-DEFERRED DRAWDOWN OPTION

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This document was prepared by an International Bank for Reconstruction and Development (IBRD) team consisting of Jose Joaquin Toro (Task Team Lead, GSURR), Elif Ayhan (Co Task Team Lead,

GSURR), Benedikt Lukas Signer (Co Task Team Lead, GFM3A), Vica Rosario Bogaerts (GSURR), Darko Milutin (GSURR), Ko Takeuchi, (GSURR), Lazar Sestovic (GMFDR), Aleksandar Crnomarkovic (GGEVP), Nikola Ille (GGSVP), Cesar A. Cancho (GPV03), and Trang Van Nguyen (GPV03). This operation will be undertaken under the general guidance of Ellen Goldstein (Country Director, ECCU4), Ede Jorge Ijjasz-Vasquez (Senior Director, GSURR), and David Sislen (Practice Manager, GSURR).

SUMMARY OF PROPOSED LOAN AND PROGRAM

Borrower	Republic of Serbia
Implementation Agency	Ministry of Finance
Financing Data	IBRD Loan Amount: EUR 66.1 million (US$70 million equivalent)
Operation Type	Development Policy Loan with a Catastrophe-Deferred Drawdown Option (Single tranche)
Pillars of the Operation and Program Development Objective(s)	The Program Development Objective (PDO) is to strengthen Serbia's institutional and legal framework to effectively manage the physical and fiscal impact of natural hazards. This objective will be achieved by supporting policy reforms under three operational pillars: • Pillar A: Strengthening the Borrower's legal and institutional framework for post-disaster reconstruction and disaster and climate risk management • Pillar B: Strengthening the Borrower's technical capacity for planning and implementing disaster and climate risk management activities • Pillar C: Reducing the fiscal impact and strengthening the Borrower's financial capacity to respond to the adverse impact of natural hazards, particularly those exacerbated by climate change
Result Indicators	A1 - PIMO staffed and functioning A2 - Borrower has adopted a Systematization Act to operationalize a new government institution or agency to implement the Law on Natural and other Hazard Risk Reduction and Emergency Management B1 - National probabilistic flood risk assessment completed B2 - Number of sectors and institutions using an open-source geospatial platform with risk information B3 - Number of sectors and local self-governments that have applied the post-disaster loss and needs assessment methodology B4 - Annual publication of monitoring report on the implementation of the National DRM Action Plan C1 - Fiscal risk unit established, staffed, and functioning C2 - Fiscal incentives and DRFI plans enacted for budgetary protection instruments against natural disasters at the local level C3 - An analysis of consolidated information on historical post-disaster expenditure data is produced annually and submitted to the Budget Department
Overall risk rating	Moderate
Climate and disaster risks *(required for IDA countries)*	Are there short and long term climate and disaster risks relevant to the operation (as identified as part of the Systematic Operations Risk-rating Tool environmental and social risk rating)? Yes [X] No [ ]
Operation ID	P157489

IBRD PROGRAM DOCUMENT FOR A PROPOSED DEVELOPMENT POLICY LOAN TO THE REPUBLIC OF SERBIA

1. INTRODUCTION AND COUNTRY CONTEXT (INCLUDING POVERTY DEVELOPMENTS)

1. **The proposed US$70 million Disaster Risk Management Development Policy Loan (DPL) with a Catastrophe-Deferred Drawdown Option (CAT-DDO) supports the Borrower's ambitious and robust reform program to increase Serbia's resilience to the adverse impact of natural hazards.** Building on lessons learned from recent disaster events, the Government has started to shift toward a more comprehensive and proactive approach to manage disaster and climate risks. Significant legislative and institutional reforms have been successfully passed, including the Borrower's approval of the National Disaster Risk Management Program (NDRMP). During consultations for a comprehensive disaster risk finance program, the Government identified contingent financing as a critical component of its strategy to secure access to immediate post-disaster liquidity to meet emergency and recovery needs, ensuring that budget resources are not diverted from ongoing development programs.

2. **Serbia is vulnerable to a wide variety of natural hazards, including floods, landslides, droughts, and earthquakes.** Over the past 15 years, Serbia has been most frequently affected by weather-related hazard events. In April 2006, for example, the Danube and its tributaries reached its highest levels in 100 years due to heavy precipitation. This led to widespread flooding in various municipalities in Vojvodina and central Serbia. More than 225,000 ha were affected, and an estimated 11,000 people were displaced or homeless. The total flood damage was estimated as EUR 35.7 million. One year later, in November 2007, massive floods took place in the south of the country. Torrential floods in the basin of the river Velika Morava and its tributaries negatively affected the population and severely damaged bridges and roads. Most recently, the May 2014 floods caused significant damages and losses amounting to EUR 1.7 billion, equivalent to 4.8 percent of gross domestic product (GDP).[1]

3. **Recent studies indicate that Serbia is particularly sensitive to future climate and precipitation change, with weather-related events expected to become more frequent and intense**.[2] Modelling conducted with support from the World Bank suggests that a 100-year flood could cause severe economic and environmental impacts, and large shares of the population near the rivers are expected to be severely affected. Furthermore, studies predict that rising temperatures and spatial and temporal precipitation regime changes will result in an increase in the intensity and frequency of flood events in Serbia. For example, if Serbia had experienced a 100-year flood event in 2016, the affected GDP would have been an estimated US$4 billion. In 2080, however, the affected GDP from the same type of event would range from US$7 billion to about US$20 billion.

4. **When a disaster hits, inequalities are exacerbated because poor people lose more.** As a result of the 2014 floods, real GDP growth was approximately 1 percentage point lower and the Serbian economy contracted by 1.8 percent, as compared to a pre-floods baseline estimate of 0.5 percent

[1] Serbia 2014 Floods Recovery Needs Assessment; Government of Serbia, World Bank, United Nations Development Programme, and European Union (EU).

[2] Climate Change 2013: The Physical Science Basis. Contribution of Working Group I to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change [Stocker, T.F., D. Qin, G.-K. Plattner, M. Tignor, S.K. Allen, J. Boschung, A. Nauels, Y. Xia, V. Bex, and P.M. Midgley (eds.)]. Cambridge University Press, Cambridge, United Kingdom and New York, NY, USA.

growth.[3] The disaster had a disproportionate impact on the poor and vulnerable population, as it was estimated that 125,000 persons were pushed into poverty, resulting in an increase of nearly 7 percent over the previous year's poverty headcount.[4] The negative impact on livelihoods and employment was also more acute in vulnerable groups such as persons with disabilities, women, and Roma and among rural population. With a growing concentration of population and assets in urban areas, the economic costs of adverse natural events in Serbia are likely to increase in the future.

5. **The proposed operation is a key component in the efforts of the Government to shift to a more comprehensive cross-sectoral approach for Disaster Risk Management (DRM).** In recent years, the country has taken important steps toward moving from emergency response to proactive management and reduction of risk from disasters. The country is enhancing its legal and institutional DRM framework, focusing on actions to build resilience in the context of the 'Hyogo Framework for Action 2005–2015' and the 'Sendai Framework for Disaster Risk Reduction 2015–2030'. The adoption of the NDRMP in December 2014 was a key milestone in setting out the agenda.

6. **The World Bank Group has a long partnership with the Government to build the country's resilience in line with the NDRMP.** In the aftermath of the 2014 floods, the World Bank provided financial and technical support for a Recovery Needs Assessment (RNA), in partnership with the United Nations Development Programme and the EU. Subsequently, the World Bank has started to provide support through a comprehensive technical assistance (TA) package to support the implementation of the NDRMP.[5] This includes, among other things, support for building institutional capacity for risk reduction investments and emergency preparedness, improving early warning systems, and developing innovative risk financing solutions with around US$9.7 million funding from the Global Facility for Disaster Reduction and Recovery (GFDRR), European Union Pre-accession Instrument, Swiss Agency for Development and Cooperation (SDC), and Swiss State Secretariat for Economic Affair (SECO).

7. **At the same time, the World Bank is financing a EUR 227.48 million flood emergency recovery operation (ERL)[6] and other efforts to build Serbia's resilience to disasters and climate change.** The ERL focuses on providing support to the sectors most affected by the floods, including energy, agriculture, and flood protection. The implementation of the ERL is proceeding smoothly with a total disbursement of around 65 percent. After completing all major investments in energy and agriculture sectors, the Government of Serbia is willing to reallocate most of the remaining unallocated funds of the ERL for additional flood protection activities, including design and investment packages, which add up to EUR 14 million. The detailed investment packages at this moment include designs for future flood protection, rehabilitation and works for immediate flood protection, goods for flood monitoring, and other consulting services. Most recently, the World Bank approved the West Balkans Drina River Basin Management Project with the objective to improve mechanisms and capacity of Bosnia, Serbia, and Montenegro to plan and manage the transboundary Drina River Basin (US$8.7 million). This project includes pilot investments

[3] National Bank of Serbia (NBS).
http://www.nbs.rs/export/sites/default/internet/english/18/18_3/presentation_invest.pdf.
[4] Poverty measured using an anchored relative poverty line (60 percent of median disposable income) was estimated to increase from 24.6 to 26.4 on account of the floods damages. (Source: Serbia 2014 Recovery Needs Assessment).
[5] National Disaster Risk Management Program (P154128).
[6] Serbia Floods Emergency Recovery Project (P152018).

in Serbia's climate resilience, such as the conceptual design for flood protection of the Mačva plain and the upgrading of existing flood protection along the Lim Riverin Šarampov.

8. **Finally, the World Bank has been supporting the development of Serbia's catastrophe insurance market through the South East Europe and Caucasus Catastrophe Risk Insurance Facility (SEEC CRIF)[7] since 2011**. As a result of this support, the population of Serbia now has access to highly affordable high-quality catastrophe products which are available through nine insurance companies and hundreds of insurance agents, retailers, and banks. In addition, the project raised awareness of consumers about catastrophe insurance; brought attention of regulators, governments, and insurance companies to the importance of catastrophe insurance as a product line; stimulated supply of such products; and enabled the Government to utilize sustainable market-based mechanisms for delivering affordable catastrophe insurance products.

9. **The development objective of the proposed operation is to strengthen Serbia's institutional and legal framework to effectively manage the physical and fiscal impact of natural hazards.** This objective will be achieved by supporting policy actions that are aimed at (a) strengthening the Borrower's legal and institutional framework for post-disaster reconstruction and disaster and climate risk management, (b) strengthening the Borrower's technical capacity for planning and implementing disaster and climate activities, and (c) reducing the fiscal impact and strengthening the Government´s financial capacity to respond to the adverse impact of natural hazards, particularly those exacerbated by climate change.

10. **The CAT-DDO will provide the Government with a fiscal buffer to reduce the impact of future disasters on its fiscal balance as well as critical bridge financing for immediate response.** The Government is faced with a challenging macroeconomic and fiscal environment, embarking on reforms to reduce its budget deficit and public debt. The 2014 floods tipped the economy back into recession, leading to a contraction of GDP and increase in public debt. The Government also faced a severe liquidity challenge in responding to the floods and was reliant on outside assistance. Disaster risk finance helps the Government manage contingent liabilities from natural disasters arising from Government spending on response and recovery, as well as through guarantee issues mainly for state-owned enterprises (SOEs). Recent research by Standard and Poor's showed a link between increasing disaster losses and potential negative effects on sovereign credit ratings and highlighted the role of Disaster Risk Finance and Insurance (DRFI) in mitigating that risk (Standard and Poor's. 2015. *Storm Alert: Natural Disasters Can Damage Sovereign Creditworthiness*.).

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

11. **Serbia's recent economic performance has been positive, as growth recovers from the three recessions experienced over 2009 to 2014.** After growing by 5.9 percent a year on average during the decade before the 2008 global financial crisis, the economy contracted by 3.1 percent in 2009 and, after a timid recovery in 2010 and 2011, fell back into recession in 2012 and 2014. While the 2009 recession was mainly due to the severe impact of the global crisis, the 2012 and 2014 recessions were primarily caused by a drought and severe floods, respectively. In response to the slowdown and a sharp buildup in public debt, Government reforms have focused on fiscal consolidation and structural reforms to restore a sustainable growth path and address external and fiscal imbalances. Supported by the recovery of

[7] South East Europe and Caucasus Catastrophe Risk Insurance Facility (Serbia and FYR Macedonia (P110910).

industrial production following the 2014 floods, positive growth returned in 2015 (at 0.8 percent) and picked up further in 2016 (to reach 2.8 percent, y/y). Industry was the primary driver, with real value added up 4.3 percent y/y in 2015 while real agriculture value added fell 7.7 percent, hit by a summer drought. The recovery continued in 2016, with strong y/y growth of 2.8 percent (according to flash estimates) the highest growth rate since 2008.

12. **Investment and exports have supported the recovery in growth.** Unlike in 2014, when all components of GDP had a negative contribution to growth, investment and exports increased significantly in 2015 (up 7.7 percent and 10.2 percent in real terms y/y, respectively), aided by the recovery from the floods and improved external demand. However, consumption has been under pressure from cuts in public sector wages and pensions and increased by a mere 0.1 percent y/y in 2015. In 2016, an increase in growth was seen, reaching an estimated 2.8 percent y/y. Consumption had a significant positive contribution to growth (of 1 percentage point) as both private and government consumption recovered, compared to 2015. Net exports contributed 1.5 percentage points to this growth despite a strong growth of imports in recent months (in part because export-oriented business still have a high import component). Investment contributed by 0.2 percentage point to the overall growth of economy in 2016. Within investment, increased public investment offset some slowing in private investment growth, as foreign direct investments (FDIs) declined and the growth of capital goods imports and loans to enterprises slowed.

13. **Improved export performance has supported Serbia's external adjustment following the crisis, with the current account deficit falling from 11.5 percent of GDP in 2012 to 4 percent in 2016.** Since 2010, particularly in 2013, when the carmaker FIAT started production in Serbia, exports have been a significant driver of growth and narrowing of the trade deficit. Following the 2014 floods, exports recovered to grow by 7.8 percent in 2015 (in euro) and were up 12.1 percent y/y in 2016. The fall in the merchandise trade deficit supported a narrowing of the current account deficit, particularly in 2013, although an improved service balance and net transfers were the main drivers of the narrowing in 2015. The current account deficit continued to decline in 2016, mainly due again to a lower trade deficit, reaching 4 percent of GDP. In the financial account, FDI has been on a positive trend until 2016, moving from 2.1 percent of GDP in 2012 to 5.5 percent in 2015, thus more than covering the current account.

14. **The recent recovery in economic activity has been reflected in improved labor market outcomes.** High unemployment is a long-standing issue in Serbia. The unemployment rate reached a peak of 24 percent in 2012 but declined since. Results from 2015 and 2016 were particularly encouraging with the annual unemployment rate falling to 17.7 percent and then to 13 percent in Q4 2016, as growth recovered. After a decline in real wages over three consecutive years (2013-2015), mainly because of reduction of wages in the public sector, real wages recovered in 2016 (up 2.6 percent). Wages recovered in 2016 in part because public sector wages increased by 1.9 percent y/y as limits on wages adjustment were partially lifted, while private wages rose by 4.7 percent.

15. **Despite monetary policy easing, inflation continues to undershoot the inflation target band of the NBS.** Low energy and food prices, and still relatively weak domestic demand, contributed to average consumer price inflation of 1.2 percent in 2016, below the NBS target band of 4±1.5 percent. Faced with low inflation, the NBS has lowered its key policy rate several times over the last couple of years. The latest rate cut was in July 2016 (to 4 percent). The NBS's inflation targeting framework and a recent decision to lower the target band (to 3±1.5 percent) and commitment to maintain a flexible exchange rate appear appropriate, although high levels of euroization limit the monetary transmission mechanism.

16. **While falling against a strengthening U.S. dollar, the Serbian dinar has been relatively stable against the euro.** The current account improvement in 2015 and 2016 supported the exchange rate against the euro. But—in line with other emerging economy currencies—the dinar depreciated significantly against the U.S. dollar in 2015 (with the annual average exchange rate down 11.8 percent y/y), particularly earlier in the year. In early 2016, the dinar depreciated slightly against the euro, but it has remained stable since. The NBS continues to intervene regularly to prevent more significant fluctuations in the exchange rate against the euro. The average real effective exchange rate depreciated by 5 percent in 2015 relative to 2014, and in 2016 it was down a further 1.3 percent (on its 2015 average level).

17. **The financial system is broadly stable, although weaknesses remain in some state-owned banks.** The Serbian financial system weathered the global financial crisis and successive recessions relatively well, but a weak domestic economy resulted in a substantial increase in nonperforming loans (NPLs) and reduction in profitability. However, in 2016, NPLs started to fall and stood at 17 percent as of December 2016. While banks remain well-capitalized and liquid, additional challenges emerged related to the situation in Greece, since four Greek banks are operating in Serbia (accounting for about 11 percent of total assets in Q3 2016). The NBS has taken steps to prevent any shocks in these and other commercial banks through intensified oversight. In addition, NBS and the government work more actively on privatization of remaining state owned banks.

Table 1. Key Macroeconomic Indicators and Projections

	2012	2013	2014	2015e	2016p	2017p	2018p	2019p
Real Economy	**Annual percentage change, unless otherwise indicated**							
GDP (nominal, Serbian dinar)	5.2	8.2	0.8	3.5	4.0	4.6	6.4	6.6
Real GDP	−1.0	2.6	−1.8	0.8	2.8	3.0	3.5	3.5
Contributions:								
Consumption	−1.2	−0.6	−1.1	0.1	1.0	1.3	2.0	2.5
Investment	0.6	−1.5	−0.1	1.5	0.2	1.2	1.2	1.0
Net Exports	−0.4	4.8	−0.6	−0.8	1.5	0.5	0.3	0.0
Exports	0.3	7.4	2.3	4.5	5.7	4.0	4.1	4.2
Imports	0.7	2.6	3.0	5.4	4.2	3.4	3.9	4.32
Unemployment rate (average, LFS)	24.0	22.1	19.2	17.7	15.3	15.0	14.8	13.5
GDP deflator	6.3	5.4	2.7	2.7	1.1	1.6	2.8	3.0
Consumer Price Index	12.2	2.2	1.7	2.1	1.6	2.8	3.0	3.0
Fiscal Accounts	**Percentage of GDP**							
Expenditures	46.6	43.5	46.3	44.0	43.7	42.5	42.0	41.5
Revenues	39.4	37.9	39.7	40.4	42.4	41.2	40.8	40.5
General Government Balance	−7.2	−5.6	−6.6	−3.7	−1.4	−1.4	−1.2	−1.0
Public and Publicly Guaranteed Debt (end of project)[a]	57.4	60.9	71.8	75.6	74.6	73.1	70.2	66.9
Selected Monetary Accounts	**Annual percentage change, unless otherwise indicated**							
Base Money	5.2	25.9	10.9	17.1	20.5			
Credit to nongovernment	9.8	−4.5	6.1	2.0	2.5			
Interest (key policy interest rate)	11.3	9.5	8.0	4.5	4.0			
Balance of Payments	**Percentage of GDP, unless otherwise indicated**							
Current Account Balance	−11.5	−6.1	−6.0	−4.7	−4.0	−3.9	−3.9	−3.9
Exports	26.5	30.8	31.9	33.9	37.3	37.9	39.1	40.1
Imports	44.2	42.9	44.3	45.8	47.5	48.5	49.4	50.1
FDI	2.1	3.6	3.7	5.4	5.5	4.8	4.3	4.2

	2012	2013	2014	2015e	2016p	2017p	2018p	2019p
Gross Reserves (EUR, billions, end of project)	10.9	11.2	9.9	10.4	—	—	—	—
In months of next year's imports	7.4	7.4	6.3	6.4	—	—	—	—
In percent of short-term external debt	209	279	292	281	—	—	—	—
Terms of Trade	−0.9	1.0	0.8	1.5	—	—	—	—
Exchange Rate (EUR, average)	113	113	117	121	123	—	—	—
Other memo items								
GDP nominal in EUR, billions	31.6	34.3	33.3	33.5	34.1	35.2	37.4	39.3

Notes: (a) World Bank projections. Includes nonguaranteed debt of local governments.
Source: Ministry of Finance (MoF); World Bank estimates; International Monetary Fund (IMF); NBS.

18. **The recovery in credit growth continued in 2016.** Total loans were up 7.5 percent in December 2016 (y/y) mainly because of a significant increase of banks' lending to the Government sector. Household loans were up 10.5 percent while those to enterprises (both private and public) were 3.1 percent lower y/y. This was primarily driven by reduction of loans to SOEs, as loans to private enterprises increased by 2 percent in 2016.

19. **The Borrower's fiscal consolidation program, established in 2014, has contributed to a significant improvement in fiscal performance.** The general Government deficit in 2015 was 3.7 percent of GDP, down from 6.6 percent in 2014. The deficit reduction came primarily as a result of increased revenues (up 4.6 percent y/y in nominal terms). Nominal Government expenditures declined by 1.9 percent as a result of major savings from wage and pension reforms (down by 8.4 percent and 3.5 percent, respectively). These measures served as an immediate response to the need to control expenditures. Solid budget performance has continued in 2016. According to preliminary figures, revenues were up 8.7 percent y/y in 2016, although in this case, the main driver was better collection of excises and value-added tax. Expenditures rose by 3 percent, driven by purchases of goods and services and capital expenditures (up 10 percent and 35 percent, respectively). The general Government deficit in 2016 was just one-third of its value in 2015 and is now estimated to be 1.4 percent of GDP for 2016 (down from a previously projected 4 percent). Unlike in previous years when government needed to rely on immediate savings measures (cuts in pensions and wages), now government benefits from reform of the SOEs since there was a major savings in spending on subsidies. Reform of SOEs (both commercial and utility companies) was strongly supported by the Bank, through SOE DPL and PEPU DPL series. In addition, govern now has a much better control over the wage bill, again thanks to the support provided by the Bank.

20. **General Government debt (including guarantees), started to fall in 2015, having reached 75.6 percent of GDP at end-2015**. Although the deficit narrowed, Government debt as a share of GDP increased in 2015 by almost 4 percentage points compared to end-2014 data, partially explained by the U.S. dollar strengthening in early 2015 (with 33 percent of debt dollar-denominated). With debt repayments exceeding new borrowing, Government debt decreased by EUR 663 million over the first nine months of 2016 to reach 73.5 percent of GDP, but it then increased again in the last quarter to reach estimated 74.6 percent of GDP by the end of December. Given the marked rise in the stock of debt over the recent years, much of which was acquired at a time of relatively high interest rates, interest payments are a rising fiscal burden on the budget (7.5 percent of projected 2016 spending or 3.3 percent of GDP). Current financing conditions for Serbia are, however, favorable due to (a) strong global demand for emerging market debt, pushing yields and spreads down, and (b) Serbia's own stronger macrofiscal fundamentals. As a result, Serbian bonds trade at spreads that were until recently more associated with investment grade credit

(Serbia is currently rated in or near the BB- range by the ratings agencies, or 3 to 4 notches below investment grade).

21. **Guarantees take up a large part of the total public debt (8.7 percent of total debt at end-2016).** Most of the issued guarantees (85 percent of total guarantees) are for public enterprises and SOEs. A relatively large share of this high-cost state-guaranteed debt was contracted over the past few years when market conditions were more expensive. The amortization and interest payments on activated guarantees is projected at just under 2 percent of total Government spending in 2016, or around 5 percent of debt service.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

22. **Growth is projected to rise from 0.7 percent in 2015 to 3.5 percent by 2019, underpinned by a more supportive external demand, improved investment, and a gradual recovery of consumption.** Fiscal consolidation measures will limit the contribution of domestic demand to growth through 2017 but structural reform progress should support investment and employment. After contracting in 2013 and 2014, private investment has been supporting recent growth, reflecting improvements in the investment climate (including, for example, reforms to construction permits), and is projected to contribute around 1 percentage points to growth over the medium term. As activity and employment picks up, consumption is expected to be again the main driver of growth after 2017.

23. **The gradual narrowing and stabilization of the current account deficit is set to continue, declining to 3.9 percent of GDP by 2019.** Improvements in the goods trade deficit will continue, in part due to external developments (low energy prices and recovery in the EU) and as a result of recent foreign investments, while the services surplus will also rise gradually. FDI inflows, supported by reform progress, are projected to be a solid 4–5 percent of GDP. These inflows are expected to provide the bulk of the net financing of the current account deficit, reducing external sustainability risks. Nevertheless, gross external financing requirements remain sizeable at around 16 percent of GDP over the projection period, with debt disbursements accounting for approximately three-quarters of overall external financing sources, highlighting potential vulnerability to shifts in international financial conditions.

24. **Inflation is set to pick up gradually as domestic demand recovers.** As domestic demand picks up, inflation is projected to rise, returning to the NBS target band in 2017. Monetary policy will continue to be implemented through an inflation targeting framework combined with a flexible exchange rate (with any intervention focusing on managing excess currency volatility).

25. **Implementation of the Borrower's ambitious fiscal consolidation and structural reforms program will support a continuation of the downward trajectory of the public debt ratio.** As mentioned, the fiscal consolidation program, supported by the IMF Stand-By Arrangement (SBA), focuses on reducing public sector wage bills and pension costs, along with a reduction in fiscal support to public enterprises, in conjunction with broad-ranging structural reforms. Over the medium term, the deficit is projected to fall to around 1–1.5 percent of GDP, with spending declining from 46.3 percent in 2014 to 41.5 percent of GDP by 2019, mostly through cutting recurrent spending (wages and pensions). The revenue-to-GDP ratio is set to rise slightly (from 39.7 percent of GDP in 2014 to 40.5 percent in 2019), with exports and investments, the main drivers of growth, not seen as helping revenues (for example, value-added tax) significantly. National budget for 2017 is based on a conservative projection of revenues (to drop by 0.8 percent of GDP compared to 2016). Still, the deficit is expected to remain the same as a percent of GDP, based on a further reduction of expenditures. Budgetary savings are expected to come primarily from lower subsidies in 2017, as there will be a partial increase in public sector wages and pensions.

26. **Under the baseline scenario, public debt-to-GDP is projected to fall from its peak of 75.6 percent at end-2015 to under 67 percent by 2019.** Assuming the fiscal consolidation strategy is implemented as planned through completion of the IMF program in 2018, the primary balance will improve from −3.7 percent of GDP in 2014 to an average 1.8 percent of GDP surplus over the period 2017-2019. However, given the high initial level of debt, even with this fiscal consolidation, public debt-to-GDP will remain high over the projection period, declining below 70 percent only by 2019. The Borrower's gross fiscal financing needs also remain significant. In 2017, gross financing needs are projected at approximately 16 percent of GDP. Between 2016 and 2017, external debt amortizations are projected to increase from 2 to 5 percent of GDP, with the maturing of a 5-year US$750 million dollar-denominated eurobond in November 2017 and a EUR 293 million commercial loan.

27. **The projected public debt path is highly sensitive to any slippages in the fiscal consolidation plan, weaker-than-expected growth or to a negative real exchange rate shock.** With regard to the debt profile, only around 21 percent of central government debt is variable interest rate, with 79 percent fixed. Most public debt is external direct debt (39 percent of GDP) while domestic direct public debt accounts for 24.5 percent of GDP as of end-January 2017. Foreign-currency debt is high, with 40 percent in euro and 34 percent in U.S. dollar versus 21 percent denominated in local currency. As a result, a sharp real depreciation would move the debt ratio up markedly. Both slippages in fiscal consolidation progress and lower-than-anticipated growth could also lead to the debt ratio rising again.

28. **The macroeconomic policy framework is considered adequate for the proposed operation.** The authorities are committed to adjust fiscal policy as needed to maintain debt sustainability over the medium term while supporting growth through structural reform progress. The macro-fiscal framework is supported by the precautionary IMF program, while underpinning reforms are supported by Bank's DPLs (SOE and PEPU DPL). Substantial downside risks to the macroeconomic framework remain, however, both external and internal. External risks relate to a lower-than-expected EU recovery would affect Serbia through exports, remittances, and capital flows. Higher volatility in international financial markets could also pose risks to the outlook through financial channels given Serbia's refinancing needs and foreign currency debt burden and also via real channels through their potential spill over to external demand. A deterioration of the financial situation of foreign parent banks could similarly jeopardize credit recovery and undermine growth. Key domestic risks arise from the implementation of the fiscal reform program. If some of these risks were to materialize, the Government would need to undertake even greater fiscal consolidation efforts to ensure that public debt remains sustainable. To mitigate these risks, the Government is working, including with the EU and international financial institution partners, to ensure that key reforms (for example, on public administration, SOEs, and public enterprises) remain on track.

2.3 IMF RELATIONS

29. **The Executive Board of the IMF approved a three-year, SDR 935.4 million (about EUR 1.2 billion, 200 percent of quota) new SBA for Serbia on February 23, 2015**. The Serbian authorities have indicated their intention to treat the program as precautionary. The program is based on three main pillars: restoring public finances' health; increasing the stability and resilience of the financial sector; and implementing comprehensive structural reforms, to form a solid foundation for job creation and return to sustained high growth. The World Bank and the Fund have worked in close cooperation, for example, with the World Bank working both with the Government and the Fund team in providing upstream inputs on public enterprise restructuring as part of the design of the SBA; in helping the Government develop a clear, time-bound restructuring plan for these public enterprises; and in assisting with the complex

dialogue on the energy tariff reform. The World Bank continues this close cooperation as the Fund program moves with the Program implementation.

3. THE BORROWER'S PROGRAM

30. **In recent years, the Government has taken actions to strengthen the legal framework to reduce and better manage disaster and climate risks.** Key milestones include the adoption of the Law on Emergency Situations (2009), which made multi-hazard vulnerability assessments at national and municipal levels mandatory; the Law on Amendments to the Law on Emergency Situations (2011), which introduced the concept of risk-informed recovery; the National Strategy for Emergency Management and Disaster Risk Reduction (2011), which defined five new strategic goals; the Law on Post-Flood Rehabilitation (2014), which regulated the rehabilitation from floods and activation of landslides in the areas affected by floods that took place in May 2014; the Law on Reconstruction following Natural and other Hazards (2015), which reformed the assistance and reconstruction system and introduced the concept of building-back-better; and finally, the amendment to the Law on Public Procurement (2015), which introduced special rules for public procurement to allow for a timely post-disaster response.

31. **The Government has also made substantial progress in strengthening its institutional landscape.** In the aftermath of the May 2014 floods, the Government established the temporary Office for Flood Affected Areas Assistance and Rehabilitation (FAAARO) to coordinate all reconstruction activities across sectors. The achievement of FAAARO over a relatively short period is commendable. Guiding the implementation of reconstruction activities in the amount of US$520 million, while ensuring adherence to principles of accountability and transparency, required the establishment of new rules and procedures and the improvement of coordination among stakeholders. To continue FAAARO's work, the Law on Reconstruction following Natural and other Hazards (2015) established the Public Investment Management Office (PIMO) as a permanent body within the Government as the legal successor to FAAARO, with the mandate to manage the reconstruction activities following disasters.

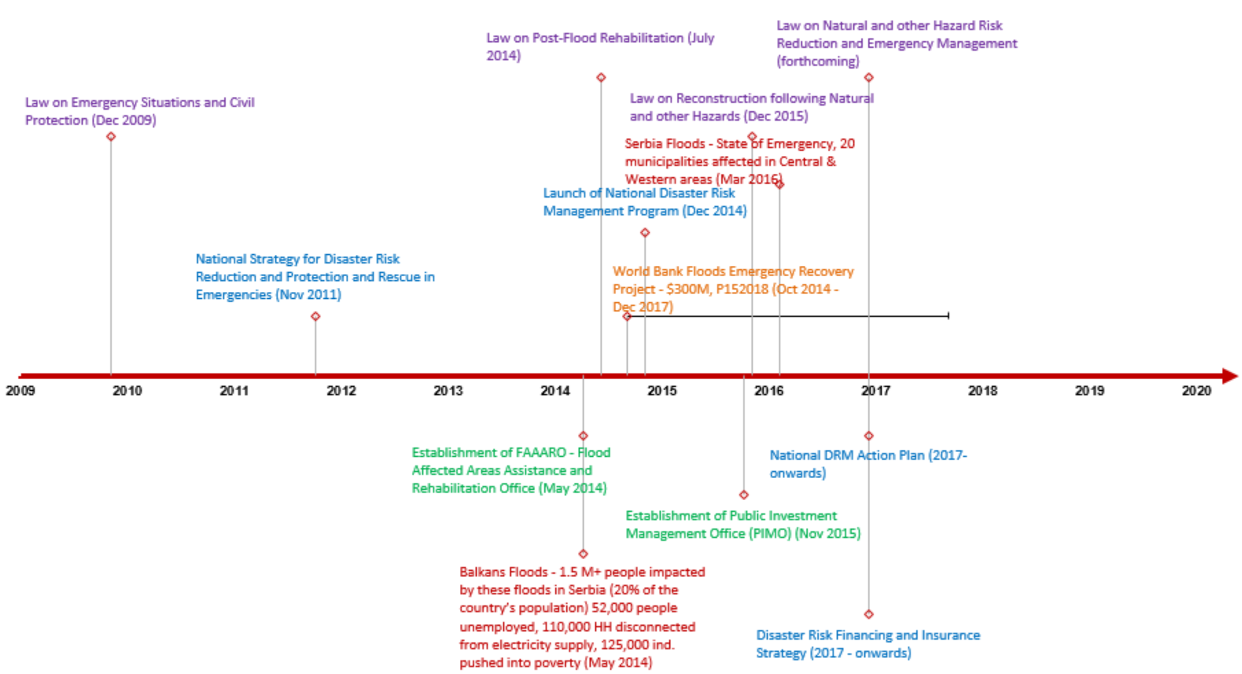
32. **Building on these actions, Serbia's NDRMP was approved in December 2014, showing commitment to changing the Borrower's approach to address disaster and climate risk.** The NDRMP is fully aligned with the Sendai Framework 2015–2030 which was adopted by United Nations (UN) Member States on March 18, 2015 at the Third UN World Conference on Disaster Risk Reduction in Japan. The program articulates the agreed overarching principles and preferred outcomes for disaster management in Serbia in the following areas: (a) institutional strengthening, (b) risk identification and monitoring, (c) structural and nonstructural risk reduction measures, (d) preparedness and early warning, (e) DRFI solutions, and (f) recovery planning. The key implementing agencies of the NDRMP include the MoF, the Ministry of Interior, PIMO, the Ministry of Agriculture and Environmental Protection, the Ministry of Public Administration and Local Self-government, the Ministry of Construction, the Ministry of Transport and Infrastructure, and the Serbian Government European Integration Office. Most recently, the Government approved the National DRM Action Plan to operationalize the NDRMP.

33. **Despite progress, these are the initial steps for a more sustainable and systematic approach to address disaster and climate risk.** While PIMO was initially created as an ad hoc structure to respond to the 2014 floods, PIMO successfully managed to transform itself into a permanent institution driving key efforts to advance the disaster risk management agenda. While its legal mandate was limited to post-disaster reconstruction, PIMO led the development of the NRDMP and the National Action Plan and built consensus on the roles and responsibilities of the various stakeholders. Moving forward, it will be key to ensure that PIMO can focus on leading post-disaster efforts across sectors, while another authority

focuses exclusively on ex ante efforts to prevent and reduce the impact of disasters. To this end, the Government will establish Serbia's first dedicated DRM authority through the Law on Natural and other Hazard Risk Reduction and Emergency Management. A clear division of responsibilities is expected to reinforce the Borrower's ownership of the DRM agenda and its commitment to shift from a reactive to a proactive way to address disasters. With regard to operationalizing the NDRMP, the National DRM Action Plan (2017–2020) will identify and guide activities to be implemented by the various line agencies with support the new DRM authority.

34. **The MoF is building a comprehensive approach to financial resilience, anchored in its broader management of fiscal risks, to become a more effective risk manager rather than an emergency borrower reliant on international support.** The MoF has developed a DRFI strategy and is setting up a dedicated fiscal risk management unit, both supported by World Bank TA. This CAT-DDO is a key part of this strategy, ensuring that Serbia will be adequately prepared to absorb the fiscal shock of natural disasters and has sufficient access to rapid liquidity for emergency response and recovery. Other priorities under the strategy include better coordination with local self-governments on post-disaster financing and increasing insurance penetration. This builds on a partnership of Serbia with the World Bank since 2010 for the establishment of the SEEC CRIF to increase catastrophe risk insurance for homeowners.

Figure 1. Overview of Key Milestones



Note: HH = Household.

Box 1. Declaration of a Natural hazard event according to Law on Reconstruction Following Natural and Other Hazards in Serbia

According to Articles 30, of the Law on Emergency Situations, a state of emergency shall be declared "when the risks and threats or the actual consequences of natural and other hazards for the population, environment, and material goods are of such scope and intensity that the occurrence or consequences thereof cannot be prevented or eliminated through usual activity of the competent authorities and agencies, thus requiring use of special measures, forces, and resources, intensifying their operation mode, for the purpose of mitigation and elimination thereof."

Articles 31 and 32 of the Law on Emergency Situations stipulate that a declaration of the state of emergency can be issued (a) for the territory of the Republic of Serbia by the Government, (b) for the territory of the autonomous province by the executive body of the autonomous province, (c) for the territory of a city by the mayor, and (d) for the territory of a municipality by the president of the municipality.

Once a state of emergency is declared pursuant to the Law on Emergency Situations, the Government will consider the issuance of a declaration of natural or hazard event, pursuant to Article 5 of the Law on Reconstruction Following Natural and Other Hazards. As stated in the said Law on Reconstruction, a natural and other hazard event is defined as an event caused by the impact of natural forces or human activity, disrupting normal living to the extent which exceeds the regular capability of individuals and local community to recover without the assistance of the state, and resulting in pecuniary damage which exceeds 10 percent of the gross domestic product in a local self-government unit. As an exception, the Government may declare a natural or other hazard event and decide to allocate government assistance even though the damage inflicted amounts to less than 10 percent of the budget of a local self-government unit, when special legitimate reasons to do so exist. Following cessation of a natural and other hazard's direct impact, the Government shall declare the end of the natural and other hazard.

With respect to this CAT DDO, only declarations in respect to natural hazard events (i.e., events resulting from a natural disaster, not resulting from human activity) made pursuant to Law on Reconstruction Following Natural Disaster and Other Hazard by the Government will be considered as eligible to trigger the Cat-DDO.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

35. **The program development objective of the proposed operation is to strengthen Serbia's institutional and legal framework to effectively manage the physical and fiscal impact of natural hazards.** This objective will be achieved through reforms under three pillars:

- Pillar A: Strengthening the Borrower's legal and institutional framework for post-disaster reconstruction and disaster and climate risk management
- Pillar B: Strengthening the Borrower's technical capacity for planning and implementing disaster and climate risk management activities
- Pillar C: Reducing the fiscal impact and strengthening the Borrower´s financial capacity to respond to the adverse impact of natural hazards, particularly those exacerbated by climate change

36. **The proposed operation contributes to the national objective to reduce disaster risk as articulated in the Sendai Framework for Action 2015–2030, which was adopted by the Government at the Third UN World Conference on Disaster Risk Reduction in Sendai, Japan.** The policy measures

supported by this DPL build on and further strengthen the Borrower's ongoing efforts to strengthen legislation and institutional arrangements for reconstruction and DRM and effective implementation of the Borrower's program, the NDRMP. The Borrower's program is set forth in the Letter of Development Policy (annex 2). In addition, as a quick and flexible source of financing, the CAT-DDO will provide bridge financing until other sources of financing (for example, concessional funding, bilateral aid, and emergency reconstruction loans) are being mobilized following a natural disaster.

37. **The proposed operation will be the first ever CAT-DDO in the Europe and Central Asia Region**. The Borrower's establishment of an adequate ex ante macroeconomic environment and the existence of a satisfactory DRM framework make Serbia eligible for this operation. Similar to CAT-DDOs in other countries, this CAT-DDO will be supported by Programmatic DRM and Disaster Risk Finance TA engagement to support the achievement of program results across the three pillars of this operation. Since the introduction of the CAT-DDO in 2008, the World Bank has approved 12 CAT-DDOs for a total value of US$2.3 billion. Eight of these were in Latin America and the Caribbean and four in East Asia and Pacific, South Asia, and Africa (see table 2). Lessons learned from the existing Implementation Completion and Results Report (ICR) of four CAT-DDOs were considered while preparing this operation. The lessons learned are described in annex 5.

Table 2. Overview of CAT-DDOs

Country	Year	Amount (US$, millions)
Philippines	2015	500
Peru	2015	400
Seychelles	2014	7
Sri Lanka	2014	102
Colombia	2011	250
El Salvador	2011	50
Panama	2011	66
Philippines	2011	500
Peru	2012	100
Guatemala	2009	85
Colombia	2009	150
Costa Rica	2008	65

38. **The design of this DPL with a CAT-DDO built on conclusions from several pieces of analytical work, including the Independent Evaluation Group (IEG) Report 'Hazards of Nature, Risks to Development: An Evaluation of World Bank Assistance for Natural Disasters',**[8] **'Natural Hazards, UnNatural Disasters - The Economics of Effective Prevention',**[9] **the 'Sendai Report',**[10] **and 'Financial Protection against Natural Disasters'.**[11] These conclusions include the following: (a) disasters must be managed instead of being treated as exogenous shocks to development that cannot be proactively

[8] Hazards of Nature, Risks to Development: An IEG Evaluation of World Bank Assistance for Natural Disasters. 2006. World Bank Independent Evaluation Group, World Bank, Washington, DC.
[9] Natural Hazards, UnNatural Disasters - The Economics of Effective Prevention. 2010. World Bank and United Nations.
[10] The Sendai Report: Managing Disaster Risks for a Resilient Future. 2012. World Bank.
[11] Financial Protection against Natural Disasters: An Operational Framework for Disaster Risk Financing and Insurance. 2014. World Bank.

addressed, (b) DRM is most efficient when based on adequate risk identification, (c) an ex ante strategy to finance reconstruction is essential for faster recovery after a disaster event, (d) prevention pays and governments can take many actions to reduce disaster risk without incurring additional costs, (e) it is important to secure the availability of a flexible source of funding to cover early recovery in case of a natural disaster, (f) the implementation of a DPL with a CAT-DDO should be set in a broader disaster risk financing strategy, (g) improvements in budget execution mechanisms are critical to successful implementation, and (h) proactively managing the contingent liabilities from disasters can protect the Borrower's budget and fiscal balance.

39. **Drawdown condition, financial features, and renewals are as follows:**

- **Drawdown triggers.** Under this DPL, funds may be drawn upon a Borrower's declaration of a "natural and other hazard emergency" (as per its Law on Emergency Situations) and a "natural and other hazard disaster" in its territory (as per its Law on Reconstruction Following Natural and Other Hazards in Serbia (2015)). The drawdown will take place only if such "natural and other emergency" results from a natural disaster, and under the terms and conditions specified in the Financing Agreement. After the Government makes a declaration of natural and other hazard emergency, it will coordinate with the MoF to make a decision on triggering the drawdown.

- **Financial features.** The financial features of the DPL with a CAT-DDO are similar to those available for the Deferred Drawdown Option for Development Policy Loans, with one exception: the DPL with a CAT-DDO would have a revolving feature, that is, amounts repaid before the closing date would be available for subsequent drawdown.

- **Drawdown period and renewals.** The drawdown period for the proposed operation will be three years and may be renewed up to four times. The World Bank will monitor the implementation of the DRM program. If it is not being implemented in a satisfactory manner, the borrower may not be eligible to submit a disbursement request. The adequacy of the macroeconomic framework is assessed at effectiveness and reconfirmed at renewal. Renewal would take place no earlier than one year and no later than six months before the expiration date. The renewal would be aligned with World Bank procedures for extension of closing dates beyond two years. Renewals would require that the original program remain largely in place.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar A: Strengthening the Borrower's legal and institutional framework for post-disaster reconstruction and disaster and climate risk management

40. Reforms under this pillar focus on providing the legal basis and operational capability to new Government entities to guide all disaster-related policy making and implementation of ex ante and post-disaster measures. Given the increased frequency of flood events in recent years, the majority of measures will focus on weather-related events.

Prior Action 1

41. The borrower has issued Decree No. 95/15 to establish the PIMO and adopted the Law on Reconstruction following Natural and other Hazards to operationalize the PIMO with the mandate to

support reconstruction, carry out procurements of goods and services, coordinate the work of other agencies involved in reconstruction, and organize post-disaster damage and needs assessments.

42. **Legal evidence.** Decree 05 No.110-12429/215 (National Gazette 95/15 of RS, dated November 19, 2015) and the Law on Reconstruction following Natural and other Hazards (National Gazette of RS, 112/15, dated December 30, 2015).

43. Recognizing that Serbia lacked an adequate system to respond to overwhelming needs in the aftermath of the 2014 floods, the Government established FAAARO as the temporary national authority for reconstruction. FAAARO's responsibilities were to collect and verify data on damages, develop sectoral reconstruction programs, raise funds, coordinate aid distribution, and supervise the implementation of reconstruction activities. During a period of 18 months, FAAARO worked with various sectors involved in the reconstruction process. Results included the following: (a) 21,000 families received financial aid exceeding a total of US$44 million, (b) financial and in-kind assistance was provided to more than 2,000 small- and medium-size enterprises, and entrepreneurs and 26,000 farmers, (c) works on reconstruction and improvement of flood protection infrastructure were carried out at more than 300 sites across Serbia (US$28 million), and (d) the electric power system was restored to avoid power blackouts (US$150 million). In total, FAAARO guided the implementation of reconstruction and recovery activities in the amount of US$520 million.

44. This experience provided the opportunity to further strengthen Serbia's legal and institutional framework to manage post-disaster processes. An important legal action included the adoption of an amendment to the Law on Public Procurement to introduce special rules for public procurement to allow for a timely post-disaster response (National Gazette No. 68/15, dated August 12, 2015). These special rules stipulated the use of a fully transparent and open model of public procurement, with shorter deadlines for the submission of bids. Full transparency of public tender procurements resulted in a considerable increase in the number of bidders, which reduced contract prices significantly and allowed the Government to deliver more than was initially planned.

45. Other important actions to enhance Serbia's institutional capacity were the establishment of the PIMO as the permanent national authority for reconstruction through Decree No. 95/15 (National Gazette, dated November 20, 2015) and the adoption of the Law on Reconstruction following Natural and other Hazards (National Gazette 112/15, dated December 30, 2015) which stipulated that the PIMO would take over all rights and obligations from FAAARO. The action to transform an ad hoc structure into a permanent institution demonstrated a strong long-term commitment to ensure a high level of responsiveness and transparency in all reconstruction activities in the aftermath of disasters.

46. Additional improvements to Serbia's legal and institutional arrangements could further reinforce the Borrower's commitment to shift policy emphasis from a reactive disaster response approach to a proactive disaster prevention. As a new permanent institution, PIMO did not only focus on reconstruction activities, but it also proactively led efforts to advance the disaster and climate risk management agenda. Moving forward, the Government recognizes that it will be key to ensure that PIMO focuses primarily on its post-disaster mandate and another institution takes the lead on ex-ante efforts. The Law on Natural and other Hazard Risk Reduction and Emergency Management will allow the creation of such an institution and help to further clarify the roles and responsibilities of relevant ministries, different levels of the government from the national level to local self-government units, and the private sector.

Results Indicators

- (A1) PIMO staffed and functioning as demonstrated by the adoption of a Systematization Act, which sets out the number of positions and responsibilities for the PIMO, and submission of annual reports to the borrower's Cabinet covering the post-disaster damage and needs assessments, the amount of post-disaster assistance for reconstruction and recovery, and the number of beneficiaries as stipulated in the Law (Baseline [2017]: Staffing initiated. Target [2020]: Staffed and annual reports submitted).

- (A2) Borrower has adopted a Systematization Act to operationalize a new government institution or agency to implement the Law on Natural and other Hazard Risk Reduction and Emergency Management

Pillar B: Strengthening the Borrower's technical capacity for planning and implementing disaster and climate risk management activities

47. This pillar supports the Government to operationalize the NDRMP. While the NDRMP has been designed to cover all types of disasters, the NRDPM will prioritize weather-related events in the first years of implementation.

Prior Action 2

48. The borrower, issued Government Conclusion No. 05 217-1906/2017-1 to adopt the National DRM Action Plan which identifies the activities to be implemented under the NDRMP.

49. **Legal evidence.** Government Conclusion Decision No. 05 217-1906/2017-1, Belgrade, March 3, 2017.

50. In 2014, the NRDMP (Conclusion No. 05 217-16233/2014-1, dated December 19, 2014) was established to promote proactive DRM by articulating the principles and desired outcomes for disaster management in Serbia in the following areas: (a) institutional strengthening, (b) risk identification and monitoring, (c) structural and nonstructural risk reduction measures, (d) preparedness and early warning, (e) DRFI solutions, and (f) recovery planning. To operationalize the Program, the Government has adopted the National DRM Action Plan (2017–2020). Under this DPL with a CAT-DDO, the Government and the World Bank have agreed to monitor results related to risk assessment, data sharing, and disaster risk financing, given the long-term commitment to TA in these areas. It should be noted that the results related to disaster risk financing are captured under Pillar C.

51. To comply with the EU Directive on the Assessment and Management of Flood Risks (hereinafter, EU Flood Directive) which calls for establishing mechanisms to assess flood hazard and risk, the Government considers the generation of more hazard and risk information a priority. Between 2010 and 2012, the Directorate for Water of the Ministry of Agriculture, Forestry, and Water Management conducted a detailed flood risk assessment in 24 flood-prone areas (the upstream section of the Južna Morava and tributaries of the Velika, Južna, and Zapadna Morava) with financial support from the EU. This assessment resulted in 100- and 1,000-year return period flood risk maps. Moving forward, it will be key to scale up this assessment to include the remaining 75 flood-prone areas to cover the entire country. The improved flood risk information which would be generated by such an assessment will be a fundamental building block to strengthen the Borrower's capacity to*,* among other things, design disaster and climate risk mitigation works, such as dikes or retention areas, restrict building in high-risk flood zones, and

improve hydrometeorological forecasting. These activities are expected to result in a reduction of damages caused by future floods and droughts and improve Serbia's overall resilience to climate change.

52. Another area which has become a priority is the improvement of accessibility and sharing of hazard and risk information. No central information portal for this information currently exists, and the existing mechanism for sharing spatial data is cumbersome and resource intensive. Recognizing that no single agency can be solely responsible for generating, communicating, and using hazard and risk information, Serbia has started to take steps toward strengthening institutional mechanisms and policies on sharing spatial data and other risk information. The Law on State Survey and Cadaster (Article 165) states that the Serbia National Spatial Data Infrastructure (NSDI) will be established as a single platform for accessing information. The Government has started to lay the foundation for the establishment of the NSDI by developing a metadata profile in line with the EU INSPIRE Directive to ensure that all hazard and risk information follows the same standard and format, thus enabling its use for development planning. The next important step will be to build the technical capacity of entities, such as the Republic Geodetic Authority, the Republic Hydrometeorological Service of Serbia, and the Public Water Management Companies, to generate hazard and risk information following the metadata profile and make this available through the NSDI. Moreover, it will be key to prioritize sectors which were most affected by the 2014 floods, such as the agricultural and energy sectors.

53. Systematically collected and robust disaster damage and loss data is an essential element of disaster and climate risk management processes. Serbia currently lacks standards for data collection and recording. This practice represents a challenge to the reporting on disaster risk reduction targets. To address this gap, the Government is planning to support local self-governments to use a standardized data collection methodology, the Post Disaster Damage and Needs Assessment (PDNA). In the aftermath of the 2014 floods, the PDNA methodology was applied for the first time in Serbia to assess and quantify the damages and losses for reconstruction and recovery. At the time, key government stakeholders at national and local levels across sectors were trained and applied the PDNA methodology. Moving forward, it will be key to continue to build the technical capacity of all stakeholders mandated to collect data in the aftermath of a disaster to apply this methodology. Similar to the efforts related to the open-source geospatial platform described above, it will be key to focus on the sectors and local self-governments most affected by the 2014 floods.

Results Indicators

- (B1) National flood risk assessment completed (Baseline [2017]: 0. Target [2020]: Assessment completed).

- (B2) Number of sectors and institutions that are using an open-source geospatial platform with risk information (Baseline [2017]: 0. Target [2020]: 5).

- (B3) Number of sectors and local self-governments that have applied the post-disaster loss and needs assessment methodology (Baseline [2017]: 0. Target: [2020]: 3 sectors and 15 percent of local self-governments).

Pillar C: Reducing the fiscal impact and strengthening the Borrower's financial capacity to respond to the adverse impact of natural hazards, particularly those exacerbated by climate change

54. This pillar supports the Government to adopt and implement a Disaster Risk Finance Program (DRFP) to more effectively respond to the financial impacts of disasters. Given the frequency of weather-related events, it is expected that Government will have to respond most often to these types of events.

Prior Action 3

55. The borrower, through its National Cabinet, has adopted a DRF Program to guide the implementation of financial protection measures to: (a) maintain fiscal health at the national level, necessary to support long-term rehabilitation and reconstruction needs, (b) develop sustainable disaster risk financing mechanisms for local self-governments, and (c) reduce the impact of disasters on the poorest and most vulnerable population.

56. **Legal evidence***.* Government Conclusion No. 5 401-1893/2017, Belgrade, March 3, 2017.

57. Financial shocks caused by natural disasters can negatively affect economic growth and development progress if the Government cannot mobilize funds on time, to finance adequate emergency response and early recovery/reconstruction, or has to reallocate resources from other development priorities. Contingent credit is one component in a combination of different financial instruments to effectively meet the cost of disasters of different severity and frequency.

58. The Government, with the support of the World Bank, has carried out a DRFP diagnostic to understand how disaster response and reconstruction is currently financed. The current lack of fiscal space resulting from ongoing fiscal consolidation efforts pursued by the Government means that it is difficult to set aside considerable amounts of budgetary resources for contingencies. While the Government has established contingent budgetary reserves and several other mechanisms, the current disaster funds seem insufficient to cover even smaller recurrent losses. The Government remains even more exposed to more extreme events, relying heavily on ex post mechanisms such as budget reallocations or international donor assistance for response and recovery (see table 3).

Table 3. Amount of Funds Currently Available for Disaster Response

Disaster Risk	Financing Source Available	Amount of Funds Available
High-risk layer (for example, major floods, major earthquakes)	Donor assistance	Unpredictable and unreliable (for example, in 2014 the total commitment was EUR 235 million, often in kind)
	Emergency borrowing	Unpredictable (for example, EUR 227.5 million drawn from World Bank for 2014 floods emergency recovery)
	Insurance of public assets	Unclear but very low
Medium-risk layer (for example, regional floods, minor earthquakes)	Contingent financing	Not currently available (CAT-DDO under preparation)
Low-risk layer (for example, localized floods, droughts, landslides)	Budget funds: Permanent Budgetary Reserve	EUR 17,000 (originally budgeted, increased one-off by 2014 supplementary budget to almost EUR 20 million)
	Budget funds: Compensation for Damage Caused by the Natural Disasters (account 484)	EUR 700,000 (originally budgeted, increased one-off by 2014 supplementary budget to approximately EUR 1.5 million)
	Budget reallocation	Unclear (10 percent of each appropriation available immediately; higher if

Disaster Risk	Financing Source Available	Amount of Funds Available
		supplementary budget is passed)

59. The Government will establish a fiscal risk unit within the MoF as a centralized authority to monitor and manage fiscal risks, including those arising from natural disasters. A review of current fiscal risk management functions across the Government has been carried out to identify gaps and options to strengthen this agenda. This is closely linked to a functional review of the MoF overall, which identified the establishment of such a unit as a one-action step. The mandate of the unit will likely be to: (a) identify, quantify, monitor, and disclose fiscal risks, including from natural disasters, (b) provide advice to the Minister of Finance on issues of fiscal risk, and (c) coordinate all Government entities that are involved in or relevant for fiscal risk management. A fiscal risk statement from the unit will provide a summary of the unit's work in identifying, and quantifying, and monitoring risks, and communicating the risk faced from various sources regularly to decision makers.

60. Based on the DRF diagnostic, the fiscal risk unit in the MoF will oversee the implementation of a national disaster risk financing program. The DRFP program sets out priorities for the Government to become a proactive financial risk manager rather than an emergency borrower and supports municipalities to strengthen their financial resilience. The CAT-DDO is one key step in adopting instruments to fill the current financing gap. An analysis of historical expenditure data and updated information provided to the Budget Department will be the first step toward revising and improving various budgetary contingency mechanisms.

61. A significant share of disaster costs is borne by local self-governments. To strengthen financial resilience of municipalities, the PIMO is working toward developing and enacting a set of incentives to facilitate increased use of budgetary protection instruments against the financial consequences of natural disasters at the local level. A first step for local self-governments will be the preparation and adoption of DRF Plans that set out their current funding mix for natural disasters and their strategy for securing sufficient funds when faced with disaster shocks. PIMO will provide official confirmation to municipalities that they will not be penalized for buying insurance by a corresponding reduction in government aid in case of a disaster. Such fiscal incentives, for example, could be requirements linked to post-disaster reconstruction grants. A good international example is Mexico's Fund for Natural Disasters, which reduces post-disaster reconstruction assistance for assets at the subnational level if they are not insured. This could also be linked to the Borrower's use of insurance solutions through the SEEC CRIF.

Results

62. Pillar C will be measured by the following results:

- (C1) Fiscal risk unit staffed and functioning as demonstrated by adoption of the Systematization Act, which sets out the number of positions, the identification and quantification of disaster related contingent liabilities, and submission of an annual statement on fiscal risks, including from natural disasters (Baseline [2017]: Not staffed. Target [2020]: Staffed, contingent liabilities from disasters identified and quantified, and fiscal risk statement published).

- (C2) Government of Serbia prepared and enacted a set of fiscal incentives and a model DRFI plan for local governments to facilitate wider use of budgetary protection instruments against the financial consequences of natural disasters at the local level (Baseline [2017]:

Not enacted. Target [2020]: Fiscal incentives enacted and at least 3 municipalities have adopted a DRF plan).

- (C3) An analysis of consolidated information on historical post-disaster expenditure data is produced annually and submitted to the Budget Department (Baseline [2017]: Consolidated historical post-disaster expenditure information not collected. Target [2020]: Data collected and submitted to the Budget Department).

Table 4. DPO Prior Actions and Analytical Underpinnings

Prior Actions	Analytical Underpinnings
Prior action 1	• Government of Serbia. 2014. *Serbia Floods*: *Rapid Needs Assessment*. Belgrade. A rapid assessment was carried out in affected communities with support of the World Bank, UN, and European Commissions. The findings of the assessment were used to inform the post-disaster reconstruction and recovery process. • World Bank. 2015*. Resilient Recovery: An Imperative for Sustainable Development*. Washington, DC: World Bank Group. This report documents the challenges in planning and implementing post-disaster recovery, examines good practice in building disaster resilience, and shares lessons learned in strengthening disaster recovery systems • European Commission. 2015. *Guidance for Recording and Sharing Disaster Damage and Loss Data*. Luxembourg. This report provides guidance to EU member states in improving the coherence and completeness of the national disaster damage and loss data recording process necessary for supporting evidence-based DRM policies and action.
Prior action 2:	• World Bank. 2010. *Natural Hazards, Unnatural Disasters: The Economics of Effective Prevention*. Washington, DC: World Bank Group. This report assesses the economics of disaster prevention. The report highlights different kinds of preventive actions to be considered by national governments. • World Bank. 2012. *The Sendai Report: Managing Disaster Risks for a Resilient Future*. Washington, DC: World Bank Group. This report provides a framework for DRM and identifies priorities and opportunities for the World Bank. World Bank. 2014. • World Bank. 2014. *World Development Report 2014: Risk and Opportunity: Managing Risk for Development*. Washington, DC: World Bank Group. This report provides a broad analytical framework for risk management, including natural disasters. • Government of Serbia. 2014. *Serbia Floods: Rapid Needs Assessment*. Belgrade. • UNISDR (United Nations International Strategy for Disaster Reduction). 2015. *The Sendai Framework for Disaster Risk Reduction 2015–2030*. New York: United Nations. The Sendai Framework is the successor instrument to the Hyogo Framework for Action 2005–2015. The Framework was adopted by the UN Assembly following the Third United Nations World Conference on Disaster Risk Reduction. Serbia made a voluntary commitment to implement the Framework. The draft Action Plan is aligned with the Framework. • World Bank. 2016. *Unbreakable: Building the Resilience of the Poor in the Face of Natural Disasters.* Washington, DC: World Bank Group. This

Prior Actions	Analytical Underpinnings
	report demonstrates that efforts to reduce poverty and disaster risks are complementary and makes the case how action to improve resilience makes economic sense. • World Bank. Forthcoming. *Serbia Open Data for Resilience Needs Assessment for Serbia*. This report supports the development of a strategy for enhancing data sharing and open data practices related to DRM.
Prior Action 3	• Cummins, J. David, and Olivier Mahul. 2009. *Catastrophe Risk Financing in Developing Countries: Principles for Public Intervention*. Washington, DC: World Bank Group. • World Bank. 2014. *Financial Protection against Natural Disasters: An Operational Framework for Disaster Risk Financing and Insurance.* Washington, DC: World Bank. • Clarke, Daniel Jonathan, Gallucio, Darcy, and Mahul, Olivier. 2016. *Disaster Risk Finance as a Tool for Development: A Summary of Findings from the Disaster Risk Finance Impact Analytics Project*. Washington, DC: World Bank Group. • World Bank. 2016. *Europe and Central Asia: Country Risk Profiles for Floods and Earthquakes*. Washington, DC: World Bank. This report includes a risk profile for Serbia which is based on a quantitative risk assessment derived from global flood and earthquake models. The profile provides estimations with regard to fatalities, affected population, affected GDP, and capital loss. • World Bank. 2016. *Serbia DRF Diagnostic*. Washington, DC: World Bank. This report provides an overview of the current status of disaster risk financing in Serbia and identifies challenges, including a post-disaster funding gap and lack of proactive risk financing approach. Related stakeholder consultations resulted in agreement on the need for a comprehensive DRFI strategy. • World Bank. 2017. *Establishing a Fiscal Risk Management Department in the Ministry of Finance of Serbia.* This summary report of a TA project reviews current fiscal risk management practices in Serbia and outlines options for establishing a dedicated unit to centralize such functions. • World Bank. Forthcoming. *Review of Fiscal Risk Units in Latin American Countries.* This review carried out in support of the advisory services engagement in Serbia summarizes lessons learned in the establishment and functioning of fiscal risk units in Colombia, Bogota, Peru, Panama, and Mexico.

4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

63. **The proposed DPL is fully aligned with the Country Partnership Framework (CPF) for FY16–20, presented to the Board of Executive Directors in May 2015, and will contribute to the cross-cutting theme on climate change and DRM.** The CPF recognizes that making Serbia's economy more climate-resilient is an increasingly important part of the country's development agenda. DRM is integrated in the CPF as an inherent part of the policy coordination and rationalization agenda (Objective 1b: creating a more effective public administration and improving select service delivery) and financial risk mitigation through the Catastrophic Risk Insurance Facility (Objective 2b: creating a more stable and accessible financial sector). The CPF also addresses climate risk mitigation through the engagement on energy sector reform (Objective 1c: a more efficient and sustainable power utility and Objective 2d: enhanced

infrastructure networks).

64. **The DPL will complement other World Bank operations that support the resilience agenda in Serbia.** In January 2011, the World Bank Executive Board approved the SEEC CRIF Program, which aims to increase access of homeowners, farmers, the enterprise sector, and government agencies to financial protection from losses caused by climate change and geological hazards. The SEEC CRIF recently closed, but with the support of SECO, the World Bank continues to support the facility. In September 2014, an EUR 227.48 million Floods Emergency Recovery Project was approved to support the restoration of the power system capability to reliably meet domestic demand, protect livelihoods of farmers in the flood-affected areas, protect people and assets from floods, and improve Serbia's capacity to respond effectively to disasters.

65. **The proposed operation directly contributes to the achievement of the World Bank's twin goals.** The 2014 World Bank development report 'Risk and Opportunity - Managing Risk for Development' showed that the poor are vulnerable to falling deeper into poverty when they are hit by negative shocks such as natural disasters. This, in turn, makes them more vulnerable for future disasters. A recent World Bank report, 'Unbreakable: Building the Resilience of Poor in the Face of Disasters' (2016), demonstrates that multiple reasons exist why the poor are often hit the hardest, including their inability to cope and recover and the permanent impact of disasters on their health and education. DRM interventions can significantly reduce the potential impacts of disasters and protect existing development gains.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

66. **As part of the preparation of the proposed operation, consultations were conducted with the relevant government agencies and other relevant stakeholders**. Under the coordination of FAAARO and the SEM within the Ministry of Interior, a working group was formed to plan, coordinate, and carry out the consultations. The process included active participation of the Standing Conference of Towns and Municipalities, Ministry of Public Administration and Local Self-Government, local authorities, academia, and civil society. This was achieved through joint workshops, reviews and consultations, and public debates organized across the country.

67. **Among development partners and donors, the EU and the Swiss Government are key collaborators in the areas supported by the proposed program.** Following the RNA, the European Commission, World Bank, GFDRR, and the SDC supported the development of the NDRMP. The UN, SDC, and GFDRR continued to support the initial implementation of the NDRMP and the development of the National Action Plan. The work on open data and data sharing is supported by the SDC, while the European Commission provides support to flood risk assessment activities. Finally, the work with the MoF in the preparation of the disaster risk financing program was developed under a partnership between the SECO and the World Bank's Disaster Risk Financing and Insurance Program to support middle-income countries in building their financial resilience. The program provides tailored advisory services and institutional capacity building on the public financial management (PFM) of natural disasters.

68. Throughout the drawdown period, the Government and the World Bank will maintain a close policy dialogue on DRM issues through both ongoing initiatives and planned initiatives. Close coordination will also be maintained with other international organizations actively assisting Serbia in the area of DRM.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

69. **Overall, the Government policies supported by the Serbia CAT-DDO are expected to have a positive poverty and social impact in the medium term.** In line with the proposed operation's main objective to strengthen Serbia's institutional and legal framework to effectively manage the physical and fiscal impact of natural hazards, positive impacts in the medium term from each of the supported reforms are expected, given the strong links existing between poverty and vulnerability to natural hazards.

70. **Overall, clear evidence of a strong two-way link between poverty and natural hazards exists.** While poverty increases vulnerability to adverse natural events, disaster shocks also foster poverty and human capital losses, eventually leading to poverty traps. The 2014 floods demonstrated that the poorest households are the most vulnerable to suffer from disasters associated with adverse natural events and weather related events: an estimated 125,000 persons were pushed into poverty, resulting in an increase of nearly 7 percent over the previous year's poverty headcount.[12] The policy reforms supported by this operation are crucial to promote an efficient and coordinated National Disaster Risk Management policy and development strategy, which may contribute to break the existing links between poverty and natural shocks. Limited DRM can push poor households to engage in undesirable coping responses that may have both short and long-term consequences on poverty, inequality, and human capital accumulation. Efficient risk management policies may foster development, both because they may increase resilience of the population and because they might allow people to take advantage of new opportunities for improvement.[13]

5.2 ENVIRONMENTAL ASPECTS

71. **Prior actions selected for the proposed operation are not likely to cause significant negative effects on Serbia's environment, forests and other natural resources.** On the contrary, prior actions of the operation, if properly executed and with comprehensive environmentally related protection measures, can enhance proper natural resource and environmental management. Under prior action 1, the establishment of a regulatory and institutional framework and coordination mechanisms to manage and finance post-disaster reconstruction processes will lead to better and more environmentally friendly planning of critical reconstruction activities, including removal and disposal of debris, location of shelters, and recovery of ecosystems. Prior action 2, approval by the National Cabinet of the DRM Action Plan, will enable risk information to be more widely available for integration of natural resource management and ecosystem information and measures into disaster risk planning at the strategic level. At the same time the prior action supports the development of a sound knowledge base to develop flood protection programs at the national and subnational level, further reducing the vulnerability of the population. This could also support the development of integrated watershed management, possibly including the protection of forests and improved agricultural practices.

72. **Serbia has made progress toward alignment of its policies with the EU environmental acquis, but further efforts are needed to strengthen the administrative capacity and implementation**

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[12] Poverty measured using an anchored relative poverty line (60 percent of median disposable income) was estimated to increase from 24.6 to 26.4 on account of the floods damages. (Source: Serbia 2014 Recovery Needs Assessment).

[13] World Bank. 2014. *World Development Report: Risk and Opportunity. Managing Risk for Development*. Washington, DC: World Bank.

framework for management of environmental risks. The Law on Environmental Protection establishes the legal framework for environmental protection and includes provisions for environmental impact assessment, integrated pollution prevention and control, nature protection, air, water, soil protection, and waste management which are regulated by separate laws and bylaws. The Law on Environmental Protection has a number of provisions concerning environmental liabilities, notably based on the principle of polluters' and legal successors' liability, which stipulate that any legal or natural entity that is involved in activities negatively affecting—that is, damaging the natural environment—is liable. This is including in the case of liquidation or bankruptcies—and that the polluter or its legal successor is responsible for eliminating the cause of pollution and related direct or indirect consequences. Authorities are preparing a new Law on Environmental Liabilities, which will be aligned with the EU Directive 2004/35/EC of April 21, 2004, and is expected to refine and clarify the institutional mechanisms to prioritize and address environmental liabilities. Finally, a new Law on Waters is currently being drafted, which is envisioned to be in line with the EU Directive 2000/60/EC of October 23, 2000 (EU Water Framework Directive) and the Directive 2007/60/EC of November 6, 2007 (EU Floods Directive).

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

73. **The assessment of the country's PFM system in relation to designing disbursement and auditing arrangements for the operation is based on the available diagnostic work in this area in Serbia.** It primarily builds on the 2015 Public Expenditure and Financial Accountability assessment as well the functional review of the MoF conducted in 2016, relevant chapters of EU Progress Reports, annual SIGMA assessments of public expenditure management and public internal financial control, and in-country reports such as those by the Fiscal Council. Disbursement and auditing arrangements have been determined based on the prevailing fiduciary environment, standard procedures for DPL disbursements and experience with similar operations in Serbia.

74. **Number of reforms have been undertaken aiming to make PFM more efficient, but further improvements are needed.** The Government has undertaken a number of PFM reforms, making efforts to strengthen Treasury operations and financial controls, legislative and institutional framework, budget classification and coverage, internal and external audit. These reforms are encouraging, strengthening the transparency, accountability, and control framework. However, sizeable challenges remain, as highlighted in the 2015 Public Expenditure and Financial Accountability Report, and Public Internal Financial Control (including internal audit and financial management and control [FMC]) still has a long path to cross to respond to EU requirements in the accession process. Nevertheless, the existing inherited system of internal controls is not so weak to represent a major risk for the operation.

75. **Execution of the budget is operated by the Treasury and established processes, controls, and procedures provide sufficient assurance about budget execution system**. The budget is executed for payments through the Consolidated Treasury Account (CTA) operated by the Treasury. Functioning of the CTA is assessed to be reliable with adequate controls instituted and statements and reconciliations produced on daily basis. Foreign currency funds have not yet been integrated within the CTA, so foreign currency transactions are consolidated in Treasury reports only in certain intervals. Integration of these funds within the CTA is one of the next reform steps and is expected to be implemented by 2016. Payments are done within budget appropriations (defined by either the original or supplementary budget), and hard system controls are in place which prevent payments from exceeding annual budget appropriations by a given budget beneficiary. The annual budget is published and available on the Internet. With regard to cash and liquidity management, each budget beneficiary is assigned with a payments quota for the coming quarter which is revised every month, and similarly payments exceeding

such quotas do not get processed. The Public Procurement Law of 2013 and its amendment in 2015 significantly strengthened the legal framework for public procurement in Serbia, although capacity constraints have undermined implementation.[14]

76. **Financial controls have been gradually strengthened in recent years.** While the Public Internal Financial Control framework has been established by provisions of the Budget System Law, functions of internal audit and FMC in practice still require significant development. An internal audit has been established in a majority of public sector entities but further efforts to increase its effectiveness are needed. A FMC function is yet to be established in a large number of entities and written procedures either do not exist or are not applied in practice. The State Audit Institution (SAI) has come a long way in staffing and coverage of audited public expenditures but further challenges remain in expanding the number of audited entities and responding to the broad scope of audits mandated by legislation. The SAI completed the audit of the 2015 annual financial statements of the Government and issues identified in previous years persist, for example, lack of appropriate systems of internal controls, deficient information on nonfinancial assets, and compliance with public procurement law.

77. **The control environment and procedures applied in the NBS and the Treasury are considered adequate.** As per the World Bank's assessment of the NBS and the Treasury system, the institutional and operational arrangements had been deemed reliable. Based on the assessment, since 2012, Designated Accounts for all World Bank's loans are opened in the NBS. Annual independent financial audits of the NBS do not identify any significant issues either. The auditors (Deloitte) issued a clean (unmodified) opinion on the NBS financial statements for 2015, as well as the previous years. Audits conducted by the SAI, as well as diagnostic assessments, likewise show that Treasury operating is one of the strengths of the country's PFM system.

78. **The PFM system and the** Borrower's **commitment to reform, taken together, are adequate to support the operation.** As described, the Bank's diagnostic work although identifying areas for improvement, concludes that key dimensions of the PFM system are reliable to support the operation. The government is committed to further enhance the system as evidenced by the adoption of the PFM Reform Program in December 2015 and further follow up actions with the view of implementing the measures included in the Program.

79. **If the deferred drawdown option is utilized, the operation will be a single-tranche loan to the Republic of Serbia.** The loan proceeds will be made available to the borrower upon the activation of the deferred drawdown option based on fulfilling the withdrawal tranche release condition. The proposed loan will follow the World Bank's disbursement procedures for DPLs. In case of activation of the DDO, IBRD will deposit the proceeds of the loan into a foreign currency deposit account that forms part of the country's official foreign exchange reserves, designated by the borrower, to be held at the NBS. This account will be managed by and subject to control of the MoF. The borrower shall ensure that, upon the deposit of the loan into this account, it is available to finance government expenditures and management of public debt and that it is accounted for in the budget execution system.

80. **No audit of the deposit account will be required but rather a confirmation letter to be provided.** In the case of above occurrence, the MoF will provide IBRD with written confirmation that the loan proceeds were received in an account of the Government that forms part of the country's official foreign

[14] To address these problems, the Government's Procurement Reform Strategy of 2013 identifies priority reforms in three areas: capacity building, process improvements, and performance measurement.

exchange reserves, and an equivalent amount has been accounted for in the country's budget management system. This confirmation letter should be delivered within 30 days of the receipt of loan proceeds. No additional arrangements to mitigate fiduciary risks, such as audit, are required as the disbursement arrangements are confined to the NBS and CTA.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

81. **The MoF and PIMO will monitor the progress of the proposed operation during the entire drawdown period.** The MoF will have an overall coordination and decision-making role while the PIMO will monitor the implementation of the indicators. The World Bank will monitor both the macroeconomic environment and the implementation of the program supported by the DPL during the drawdown period. This will be done through frequent visits to the country and regular communications with the MoF, PIMO, and key sectors.

82. **The World Bank will monitor the status of the program implementation through biannual implementation support missions and by tracking the output indicators.** As part of the monitoring and evaluation process, the World Bank will track the baseline and output indicators provided in the policy and results matrix (annex 1) based on the economic and legislative data provided by the Government agencies and disclosed in the official sources. The World Bank team will conduct supervision visits in the country to maintain the dialogue with the authorities and to assess the compliance of the authorities with contractual provisions under the loan agreement. The outcomes of the supervision visits will be reflected in the Implementation Status and Results Reports. An ICR will be completed within six months of the closing date of the program.

83. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

84. **The overall risk associated with this proposed operation is Moderate.**

85. **Political and governance: Moderate risk.** At the program level, the political context is relatively stable and not likely to affect the operation's Program Development Objective (PDO). The PIMO has been a strong institutional champion for moving the agenda forward. In addition, the Government of Serbia has signed the Paris Agreement on Climate Change, demonstrating the Borrower's commitment to the climate change adaptation and DRM agenda and its recognition of the need to integrate resilience and disaster reduction efforts into development decisions.

86. **Macroeconomic: Substantial risk.** Although recent economic and fiscal performance has been positive, substantial macrofiscal risks to the PDOs remain. External macro risks relate to Europe's overall economic recovery or adverse shifts in global financial market sentiment while internal risks arise primarily from the high level of public debt, notwithstanding the reduced fiscal deficits, and the rate of progress on crucial but politically difficult reforms such as public employment rightsizing. In order to minimize the possible impact from these risks, the government is implementing a set of measures and reforms aimed at: (a) putting public finances on a sustainable path (as supported by the ongoing IMF program), and (b) creating a business environment conducive to private-sector led growth.

87. **Sector strategies and policies: Moderate risk.** At the program level, policies and strategies are evidence based and are articulated in the Borrower's national policies and programs such as the NDRMP, which are aligned with overall country development objectives and Government priorities. Although the risk-reduction program is based on adopted legal policies, potential institutional changes in the PIMO could bring uncertainty to its leadership in effectively coordinating some of the policy areas.

88. **Technical design of project or program: Low risk.** The Government, UN, EU, and the World Bank have worked together to develop the NDRMP and helped the development of the DRM Action Plan in a participatory manner. At the same time, the World Bank has extensive experience with this type of instrument.

89. **Institutional capacity for implementation and sustainability: Moderate risk.** Over the past two years, the Government has taken significant steps to move from a reactive approach to disasters to a more proactive risk reduction approach. However, moving forward, the Government will need to address challenges related to consolidating and deepening the implementation of risk reduction measures and post-disaster recovery policies. This will require coordination across government ministries and among national and local levels of government. The various institutions and agencies involved will need to work together effectively and combine their respective mandates and comparative advantages to move the policies forward.

90. **Fiduciary: Moderate risk.** The financial management risk is based on predetermined country financial management risk, not related to stand-alone assessment of this operation only. The country risk is mitigated by the fact that the most reliable parts of the PFM system are used for implementation of the DPL (that is, Treasury and NBS). The assessments of PFM performance acknowledge progress from ongoing reforms and identifies areas needing further strengthening, including with respect to the transparency, accountability, and control framework to mitigate the fiduciary risks associated with the PFM system in Serbia.

91. **Environment and social**: **Moderate risk.** No significant adverse environmental impacts are expected; social and environmental risks are moderate. Through successful implementation of various Bank operations, including the Floods Emergency Recovery Project, the Government has demonstrated adequate experience and capacity to conduct environmental and social due diligence during the execution of this operation. More generally, the country started to develop a more systematic approach to reduce risk and therefore, it is creating the basis for positive environmental and social impacts. While this process is medium term, disasters can occur while these measures are being put in place, which might have a negative effect on the environment and poverty.

Table 5. Summary Risk Ratings

Risk Categories	Rating (High, Substantial, Moderate or Low)
1. Political and governance	M
2. Macroeconomic	S
3. Sector strategies and policies	M
4. Technical design of project or program	L
5. Institutional capacity for implementation and sustainability	M
6. Fiduciary	M
7. Environment and social	M
8. Stakeholders	L
9. Other	n.a.
Overall	**M**

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Action	Results
Pillar A: Strengthening the Borrower's legal and institutional framework for post-disaster reconstruction and disaster and climate risk management	
Prior Action 1: Law on Reconstruction following Natural and other Hazards. The borrower has issued**.** Decree 05 No.110-12429/2015 to establish the PIMO and adopted the Law on Reconstruction following Natural and other Hazards to operationalize the PIMO with the mandate to • Support reconstruction, • Carry out procurements of goods and services, • Coordinate the work of other agencies involved in reconstruction, and • Organize post-disaster damage and needs assessments. In order to demonstrate the functioning of PIMO, PIMO is required to submit annual reports on its activities. The submission of these reports does not rely on the occurrence of a disaster. Legal Evidence: Decree 05 No.110-12429/2015 (National Gazette 95/15 of RS, dated November 19, 2015) and the Law on Reconstruction following Natural and other Hazards (National Gazette of RS, 112/15, dated December 30, 2015). Coordination: PIMO.	A1 - PIMO staffed and functioning as demonstrated by (a) adoption of a Systematization Act, which sets out the number of positions and responsibilities and (b) submission of annual reports to the borrower's Cabinet covering the post-disaster damage and needs assessments, the amount of post-disaster assistance for reconstruction and recovery, and the number of beneficiaries as stipulated in the Law. (Baseline [2017]: Staffing initiated. Target [2020]: Staffed and annual reports submitted) A2 – The Borrower has adopted a Systematization Act to operationalize a new government institution or agency to implement Law on Natural and other Hazard Risk Reduction and Emergency Management adopted. (Baseline [2017]: Systematization act not adopted. Target [2020]: Borrower has adopted a Systematization Act)

Prior Action	Results
Pillar B: Strengthening the Borrower's technical capacity for planning and implementing disaster and climate risk management activities	
Prior Action 2: National DRM Action Plan The borrower, through its National Cabinet, issued Decision No. X to adopt the National DRM Action Plan, which identifies the activities to be implemented to operationalize the NDRMP. The program focuses on the following areas: institutional capacity building, disaster risk identification and monitoring, structural and nonstructural risk reduction, early warning systems and preparedness, disaster risk financing, and resilient recovery. Legal Evidence: Government Conclusion 05Decision No. 217-1906/2017-1, Belgrade, March 3, 2017. Coordination: PIMO	B1 - National flood risk assessment completed. (Baseline [2017]: 0. Target [2020]: Assessment completed) B2 - Number of sectors and institutions that are using an open-source geospatial platform with risk information. (Baseline [2017]: 0. Target [2020]: 5) B3 - Number of sectors and local self-governments that have applied the post-disaster loss and needs assessment methodology. (Baseline [2017]: 0. Target: [2020]: 3 sectors and 15 percent of local self-governments)
Pillar C: Reducing the fiscal impact and strengthening the Borrower´s financial capacity to respond to the impact of adverse natural hazards, particularly those exacerbated by climate change	
Prior Action 3: DRF Program The borrower, through its National Cabinet, has adopted a DRF Program strategy to guide the implementation of financial protection measures to • Maintain fiscal health at the national level, necessary to support long-term rehabilitation and reconstruction needs; • Develop sustainable disaster risk financing mechanisms for local self-governments; and • Reduce the impact of disasters on the poorest and most vulnerable population. Legal Evidence: Government Conclusion 05 No. 401-1893/2017, Belgrade, March 3, 2017. Coordination: MoF	C1 - Fiscal risk unit established, staffed, and functioning as demonstrated by (a) adoption of the Systematization Act which sets out the number of positions and (b) the identification and quantification of disaster related contingent liabilities, and submission of an annual statement on fiscal risks, including from natural disasters. (Baseline [2017]: Not staffed. Target [2020]: Staffed, contingent liabilities from disasters identified and quantified, and fiscal risk statement published) C2 - GoS prepared and enacted a set of fiscal incentives and a model DRFI plan for local governments to facilitate wider use of budgetary protection instruments against the financial consequences of natural disasters at the local level. (Baseline [2017]: Not enacted. Target [2020]: Fiscal incentives enacted and at least 3 municipalities have adopted a DRF plan including the information and capacity to access disaster risk insurance.) C3 - A report on consolidated information on historical post-disaster expenditure data is produced annually and submitted to the Budget Department.

Prior Action	Results
	(Baseline [2017]: Consolidated historical post-disaster expenditure information not collected. Target [2020]: Data collected and submitted to the Budget Department.)

ANNEX 2: LETTER OF DEVELOPMENT POLICY (DRAFT)

MINISTRY OF FINANCE

Dr. Jim Yong Kim
President
The World Bank
1818 H Street, N.W.
Washington, D.C., 20433

Belgrade, February 10, 2017

REF: Letter of Development Policy

Disaster Risk Management Development Policy Loan with a Catastrophe-Deferred Drawdown Option

This letter summarizes critical aspects of the program that the Government of Serbia is committed to implement to reduce disaster risk and increase resilience to the socio-economic and fiscal impacts of natural disasters.

Strategic Basis and Background

In May 2014, the Republic of Serbia was affected by the most severe floods in the past 120 years. The floods affected more than 1.6 million people, or 22% of the total population in 119 municipalities in Serbia. The Government, with the support of the European Union, United Nations and World Bank, carried out a comprehensive damage assessment and proposed measures for recovery and rehabilitation of the flood affected areas.

The government further focused on risk identification and awareness, and ensuring that this informs future investments in the protection of people and assets from large-scale damaging consequences of severe disasters. To that end, in December 2014, the Government adopted the National Disaster Risk Management Programme (Conclusion 05 Number 217-16233/2014-1 of 19 December 2014). The objective of the National Program is the development of an adequate, long-term disaster risk management system in the Republic of Serbia.

Key structural reforms

In recent years, the government has taken significant steps to strengthen the legal framework to reduce and better manage disaster and climate risks. Key milestones include: the adoption of the Law on Emergency Situations and Civil Protection (2009) which made multi-hazard vulnerability assessments at national and municipal levels mandatory; the Law on Amendments to the Law on Emergency Situations (2011) which introduced the concept of risk-informed recovery; the National Strategy for Emergency Management and Disaster Risk Reduction (2011) which defined five new strategic goals; the Law on Post-Flood Rehabilitation (2014) which regulated the rehabilitation in the areas affected by floods in May 2014; the Law on Reconstruction following Natural and other Hazards (2015), which reformed the assistance and reconstruction system and introduced the concept of building-back-better; and finally the amendment to the Law on Public Procurement (2015) which introduced special rules for public procurement to allow for a timely post-disaster response.

The government has also made substantial progress in strengthening its institutional landscape. In the aftermath of the May 2014 floods, the government established the temporary Office for Flood Affected Areas Assistance and Rehabilitation (FAAARO) to coordinate all reconstruction activities across sectors. The achievement of FAAARO over a relatively short period of time is commendable. Guiding the implementation of reconstruction activities in the amount of USD$ 520 million, while ensuring adherence to principles of accountability and transparency, required the establishment of new rules and procedures and improved coordination among stakeholders. The Law on Reconstruction following Natural and other Hazards (2015) established the Public Investment Management Office (PIMO) as a permanent body within the government as the legal successor to FAAARO with the mandate to manage the reconstruction activities following disasters.

The NDRMP is fully aligned with the Sendai Framework 2015-2030 that was adopted by UN Member States on 18 March 2015 at the Third UN World Conference on Disaster Risk Reduction in Japan. The Program articulates the agreed overarching principles and preferred outcomes for disaster management in Serbia in the following areas: (i) institutional strengthening; (ii) risk identification and monitoring; (iii) structural and non-structural risk reduction measures; (iv) preparedness and early warning; (v) disaster risk financing and insurance solutions; and (vi) recovery planning. The NDRMP also sets out the general framework for a comprehensive program of risk reduction related activities, as well as for the coordination and management of funds.

Implementing the National Disaster Risk Management Program through the Cat DDO

The government is committed to strengthen Serbia's institutional DRM framework to effectively manage the physical and fiscal impact of natural hazards. This DPL CAT DDO will support institutional and policy reforms under three pillars:

- Pillar A: Strengthening the Government's legal and institutional framework for post-disaster reconstruction and disaster risk management.

  This pillar will support the legal basis and operational capability of government entities established to guide and effectively implement ex-ante and post-disaster measures. The Government has issued Decree No.95/15 to establish the Public Investment Management Office (PIMO) and adopted the Law on Reconstruction following Natural and other Hazards to operationalize PIMO. Its mandate include to support reconstruction; carry out procurements of goods and services; coordinate the work of other agencies involved in reconstruction; and organize post-disaster needs assessments. PIMO will be fully staffed and provide annual reports to Government cabinet.

- Pillar B: Strengthening the Government's technical capacity for planning and implementing disaster risk management activities.

  The main objective of this pillar is to operationalize the National Disaster Risk Management Program, through the adoption of a National DRM Action Plan, which identifies activities to be implemented under the program. The Action Plan focuses on institutional capacity building, disaster risk identification and monitoring, structural and nonstructural risk reduction, early warning system and preparedness, and disaster risk financing and resilient recovery. These areas will lead to a national flood risk assessment, sectors and institutions adopting open-source geospatial risk information, the adoption of a methodology for post-disaster loss assessment, and the annual report on the implementation of the Action Plan.

- Pillar C: Reducing the fiscal impact and strengthening the Government´s financial capacity to respond to natural disasters.

  The objective of this pillar is to support the adoption and implementation of a DRFI Program to more effectively respond to the financial impacts of disasters. The adoption of the program will help to maintain fiscal health at the national level, necessary to support long-term rehabilitation and reconstruction needs; develop sustainable disaster risk financing mechanisms for local self-governments; and reduce the impact of disasters on the poorest and most vulnerable population. These activities will result in the establishment of a fiscal risk unit in the Ministry of Finance, the preparation of disaster risk financing Action Plans by local self-governments, and an annual report of consolidated information of historical post-disaster expenditure, submitted to the Budget Department.

Sincerely,

Dušan Vujović
Minister of Finance
Republic of Serbia

ANNEX 3: FUND RELATIONS ANNEX

IMF Executive Board Completes the Sixth Review of Serbia's Stand-By Arrangement

Press Release No. 16/563, December 16, 2016

The Executive Board of the International Monetary Fund (IMF) on December 16, 2016 completed the sixth review of Serbia's economic performance under the Stand-By Arrangement (SBA). The completion of the review will make available the cumulative amount of SDR 662.575 million (about €850.8 million). The Serbian authorities have indicated their intention to continue treating the arrangement as precautionary.

The Executive Board approved the 36-month, SDR 935.4 million (about €1.2 billion at the time of approval) SBA for Serbia on February 23, 2015 (see Press Release No. 15/67).

Following the Executive Board's decision, Mr. Tao Zhang, Deputy Managing Director and Acting Chair, issued the following statement:

"The Fund-supported program is delivering positive results, underpinning macroeconomic management and structural reforms in Serbia. The economy continues to strengthen, supported by the authorities' efforts to improve public finances, address structural weaknesses, and strengthen the financial sector. Employment is rising, inflation remains firmly under control, and public debt has started to decline. Full implementation and strong ownership of the reform agenda are critical to consolidate hard-won gains, improve the business climate, and support Serbia's medium-term growth.

"Significant progress has been made on fiscal consolidation in 2016, on account of strong revenue and ongoing expenditure control. Institutional reforms aim to secure fiscal sustainability and improve public services. Priorities include eliminating domestic arrears, reforming the public administration and wage system, and strengthening public investment management. Further efforts are also needed to minimize fiscal risks through a restructuring of unviable state-owned enterprises, especially in the mining, energy, and transportation sectors, while enhancing social safety nets. The authorities are taking steps to strengthen public project appraisal and implementation, and modernize the educational system.

"The reduction in the inflation target reflects improved macroeconomic fundamentals and market confidence. The lower target should support the dinarization strategy and help reduce long-term interest rates. The current cautiously accommodative monetary policy stance remains consistent with the new target.

"Financial sector reforms have strengthened the resilience of the sector. The strategy for resolving nonperforming loans has helped reduce the overall bad loan ratio, and the authorities remain committed to its full implementation, especially with respect to state-owned banks.

"Serbia has achieved notable improvement in the business environment, but more needs to be done to boost investor confidence and medium-term potential growth. Particular efforts should be made to improve the court system, strengthen the quality of the judiciary process, and facilitate the use of effective out-of-court arbitration."

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	**Significant Positive or Negative Environment Effects (yes/no/to be determined)**	**Significant Poverty, Social, or Distributional Effects Positive or Negative (yes/no/to be determined)**
Pillar A: Strengthening the Borrower's legal and institutional framework for post-disaster reconstruction and disaster and climate risk management		
Prior Action 1	Positive effect on environment (medium term)	Positive effect on poverty (medium term)
Pillar B: Strengthening the Borrower's technical capacity for planning and implementing disaster and climate risk management activities		
Prior Action 2	Positive effect on environment (medium term)	Positive effect on poverty (medium term)
Pillar C: Reducing the fiscal impact and strengthening the Borrower's financial capacity to respond to the adverse impact of natural hazards, including those exacerbated by climate change		
Prior Action 3	Positive effect on environment (medium term)	Positive effect on poverty (medium term)

ANNEX 5: CAT-DDO RELEVANT LESSONS LEARNED

1. To date, there have been only ICRs and IEG reviews of the following four CAT-DDOs: Guatemala, El Salvador, the Philippines, and Colombia. The following lessons have been disclosed publicly:

- Development Policy Operations with CAT-DDOs can help introduce broader concepts for DRFI. As contingent credit, the CAT-DDO could be an affordable source of financing and complements existing market-based disaster risk financing instruments such as insurance, catastrophe bonds, and reserve funds. These instruments can be combined to retain the risk from smaller, more frequent events, or to transfer the risk from less frequent, higher-impact events, based on an assessment of risks, desired coverage, available budget, and cost-efficiency. These assessments can be supported through TA and implemented as part of a country's overall DRFI strategy.

- CAT-DDOs can serve as instruments of broader engagements, such as providing a platform to bring other sectors and institutions and enhance the DRM policy dialogue with TA.

- DPLs support governments in implementing reforms to improve their policy and institutional framework. The impact of the reform program is closely related with the quality of the policy matrix, which should include specific, measurable, and attributable outcome indicators with baselines and targets, given their importance for the quality of the policy dialogue.

- Reporting responsibilities and monitoring arrangements should be agreed with the borrower in the early stages of the operation to improve the effectiveness and monitoring of the policy measures supported by DPL.

- DPLs with a CAT-DDO can provide the opportunity to elevate DRM issues to oversight agencies (in particular, finance, budget, and economic planning) that may not otherwise be deeply engaged in the policy dialogue.

- The implementation of a programmatic TA to support the policy areas of the CAT-DDO can facilitate substantive policy dialogue, enhance implementation effectiveness, and sustain policy actions even after full disbursement of the loan. It is important for the World Bank to provide adequate resources for implementation and TA to sustain the policy dialogue with a broad set of DRM stakeholders.

- A diagnostic of the country's legal framework at appraisal and a constant dialogue with the government's legal department during supervision can be an effective tool to identify legal constraints that would allow the country to benefit from the revolving feature of this type of loan and act accordingly.

- Given the revolving option of the credit line, the World Bank needs to develop a more consistent result framework to correctly assess the feasibility of achieving the development objective within the constraint of the total time available for implementation.