Trends

6. Fiscal trends and policy

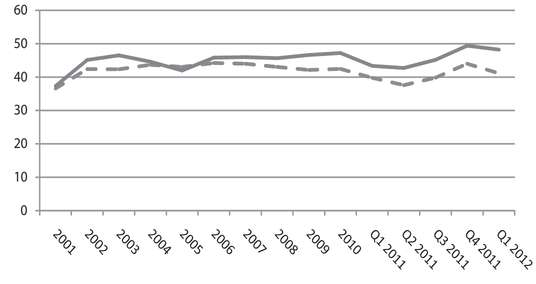
In Q1 2012, a consolidated fiscal deficit of 54 bn RSD (around 7.1% of the quarterly GDP) has been achieved, which is significantly higher compared to the projected deficit. Similar trends were continued in April as well, so the consolidated fiscal deficit in the first four months amounted to 78bn RSD. The deviation from the projected deficit is primarily a consequence of the strong rise of public expenditures. In case of continued trends from Q1 and April, in regard to the macroeconomic movements and fiscal aggregates, it is estimated that the consolidated fiscal deficit in 2012 will exceed 6% of GDP. Much of the increase in fiscal deficit in Q1 is of temporary nature, but the structural deficit was increased by 0.2% of GDP due to the amendments to the Law on Police and the changes of the salary coefficient on local level. In the case of adopting the legislative proposals to increase the non-taxable part of the wages to 10,000 RSD, as well as lower the VAT rate on baby equipment, the structural fiscal deficit would be increased by additional 0.3% of GDP – that is why it is recommended that the new government withdraws these proposals. As a result of a high fiscal deficit realised in Q1, the public debt at the end of this quarter was around 50% of GDP, and in case these trends continue, it is estimated that by the end of 2012, the public debt will exceed 55% of GDP. It is estimated that due to the fast growth of public debt and high fiscal deficit, which is systematic in character, it is necessary to implement a thorough fiscal consolidation. This consolidation would mean a rapid implementation of measures directed towards decreasing the fiscal deficit in 2012 to around 5% of GDP, as well as an implementation of the systematic reforms of the public sector, whose aim would be reduction of fiscal deficit by as early as 2013 by about 2-3% of GDP, and its further reduction in the following few years to under 1% of GDP. Without a rapid implementation of a credible fiscal consolidation plan, there is a high degree of risk of entering a debt crisis in a relatively short time. Structural reforms in all sectors of the main beneficiaries of budgetary funds are necessary not only for the sustainable implementation of a fiscal consolidation, but also for improvement of quality of services in the public sector.

General tendencies and macroeconomic implications

In Q1, the consolidated fiscal deficit was 54.1bn RSD (around 7.1% of quarterly GDP)

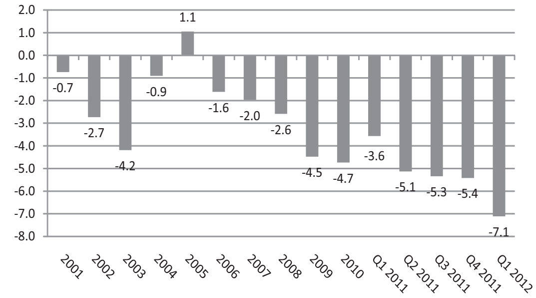
Consolidated fiscal deficit in Q1 2012 was 54.1bn RSD, i.e. around 7.1% of quarterly GDP. The official dynamic of realising public revenues, expenditures and fiscal deficits, as arranged with the IMF, which would enable the total annual fiscal deficit to remain within the foreseen limits, means that the consolidated fiscal deficit in Q1 would be 26bn RSD. Accordingly, it can be concluded that the fiscal deficit of Q1 is significantly higher (by about 28bn RSD) compared to the foreseen amount. The analysis of the projected and actual dynamic of the current public expenditures showed that the abovementioned discrepancy between the projected and actual fiscal deficit is mostly (around ¾) due to the rise of public expenditures beyond the projections, and (around ¼) a result of the fact that public revenues are lower than planned.

Figure T6-1. Serbia: Consolidated public revenues and public expenditures (% of GDP)



Source: *QM* calculations

Figure T6-2. Serbia: Consolidated fiscal balance (% of GDP)



Source: *QM* calculations

The high value of the fiscal deficit in Q1 is primarily the result of a strong rise in public expenditures

Projected consolidated fiscal deficit amounting to 158bn RSD (4.25% of GDP) was projected on the assumption that in 2012, a real economic growth rate of 1.5% would be achieved, even though the estimates of the Fiscal Council at the time were that the upper limit of the expected economic growth in 2012 would be about 0.5%. Even with achieving the GDP growth rate of 1.5% in 2012, public revenues would likely be lower than planned, primarily due to the fact that certain categories of revenue were overestimated in relation to the expected movement of their macroeconomic tax bases. However, the movement of economic activity in Q1 and the indications for the following months, show that it is more realistic to expect an economic growth rate of 0% in Serbia in 2012. Accordingly, the revision of GDP growth rate to 0% will lead to further large negative deviations of public revenue compared to the projections. In Q1, the government also adopted a series of proposals that may result in further reduction of public revenues (reduced rate of VAT on baby equipment from 18% to 8%, in April a considerable reduction in excise rates on petroleum products has been made, and an increase of non-taxable portion of salaries has been agreed as well). It is estimated that in the conditions of stabilisation of market prices of oil derivates, and relatively low rate of inflation, the reduction of excise rates on oil derivatives and the increase of the non-taxable portion of salaries is unjustified, especially since no compensatory measure has been adopted (reduction of certain expenditures or increase of other taxes), that would eliminate the negative impact of these measures on the level of fiscal deficit. It is therefore recommended that the new government should abandon these proposals. The level of fiscal deficit in Q1 was also affected by the fact that a considerable portion of public expenditure (e.g. capital expenditures) and certain tax refunds (e.g. VAT) were postponed from Q4 2011 to Q1 2012.

It was also observed that in the pre-election period there was accelerated realisation of certain categories of public expenditures in relation to the plan (e.g. subsidies for agriculture), which also affected the fiscal deficit in Q1, making it bigger than planned, but it should not affect the overall annual deficit if the total amount of these expenditures stays within the foreseen limits. Aside from that, Q1 saw a significant growth of expenditures on employees (payment of jubilee bonuses to employees in education, increase of almost all current expenditures on the local level – for more details, see Highlight 1), which will affect the deviation of the total fiscal deficit in 2012 in relation to the plan.

From the standpoint of fiscal consolidation, the good news is that much of the growth of expenditures in Q1 was the result of increase in discretionary spending (purchase of goods and services, early payment of subsidies, rise of the public investments, payment of jubilee bonuses, one-off payment of social assistance on the local level, etc.), and not the permanent increase in rights of the budgetary beneficiaries. This means that earlier formed high structural deficit was not significantly increased in the first part of the year. To be more precise, amendments to the Law on Police and the Directive on the coefficients for local self-governments have permanently increased government's obligations, and thus increased the structural fiscal deficit by about 0.2% of GDP. However, the possible adoption of the amendments of tax laws, sent to the Parliament by the previous government (reduced rate of VAT on baby equipment, increase of non-taxable portion of salaries) would result in a permanent reduction in tax revenues and, accordingly, increase the structural deficit by additional 0.3% of GDP. It is therefore recommended that a new government cancels these legislative proposals.

...high level of spending is especially pronounced on the local level

Aside from the rising level of spending on all government levels, the spending on the local level is above the average. In Q1, expenditures of the local self-governments have risen much faster than those of the central government and the Health Insurance Fund. Strong expansion of the local public expenditures relates primarily to the increased spending on subsidies, salaries and purchase of goods and services, while the local public investments have dropped. This indicates that the reallocation of tax revenues to salaries done in 2011, has indirectly contributed to the increase of fiscal deficit in 2012, because the central government lost considerable revenues, while keeping all obligations.

Growth trend of the fiscal deficit continued in April as well. The consolidated fiscal deficit in April amounted to 24bn RSD, and in first four months, 78.2bn RSD total, while according to

Growth trend of the fiscal deficit, caused by a significant rise in public spending, continued in April as well

the projected dynamics agreed with IMF, the fiscal deficit in the first six months of 2012 was supposed to be 61bn RSD. The exceptionally high fiscal deficit in April is the result of a strong rise in public spending, above all on subsidies and on purchase of goods and services. Thus, the real seasonally adjusted public expenditure in April was by 3.4% higher than in March, with subsidy spending rising to as much as 33.7%, and the spending on purchase of goods and services rose by 12.6%. At the same time, the seasonally adjusted capital spending was lower by 6.9%. The exceptionally high increase of subsidy spending is a result of the acceleration of the implementation of certain programmes in the pre-election period, and even though it is considered unfavourable, it should not affect the total annual deficit, provided the amount of total expenditure for these purposes maintains the projected levels. On the other hand, in April, the growth trend of the real seasonally adjusted public revenues rose as well, being 1.8% higher than in March. Growth of public revenues was to a large extent due to the growth in VAT revenues, which were (in real terms and seasonally adjusted) higher in April by 3.5% than in March. Fiscal trends in April indicate a continuation of a gradual recovery of public revenues, but this is not enough to compensate for the exceptionally high increase of public spending, primarily related to the election cycle.

Without a strong and rapid fiscal consolidation, the fiscal deficit will exceed 6% of GDP in 2012

Based on the macroeconomic and fiscal developments in Q1 and projections for the coming quarters, in the absence of urgent measures of fiscal consolidation, which would be adopted in June or July, it is estimated that the consolidated fiscal deficit in 2012 will exceed 6% of GDP, which is almost 2% of GDP more than planned.

This smount of fiscal deficit in 2012 would contribute to the significantly faster growth of public debt in relation to the plan, and it would also affect the amount of deficit in the coming year, which is judged to be unsustainable and would most likely jeopardize the short-term sustainability of public finances in Serbia. Therefore, it is necessary to adopt a rebalance of the state budget by the end of June or July at the latest, as well as accompanying measures of urgent fiscal consolidation, that would make sure the fiscal deficit in 2012 drops to around 5% of GDP. In this regard, the Fiscal Council has estimated the measures of urgent fiscal consolidation in 2012 and the following years to be essential.

Table T6-3. Serbia: Consolidated General Government Fiscal Operations[1], 2008-2012

	2008	2009	2010	2011					2012
				Q1	Q2	Q3	Q4	Q1-Q4	Q1
I TOTAL REVENUE	1145.9	1,147	1,223.4	293.6	311.3	331.3	366.3	1302.5	312.6
II TOTAL EXPENDITURE	-1195.7	-1247.9	-1,329.9	-314.4	-343.9	-371.0	-406.7	-1435.9	-362.1
III "OLD" DEBT REPAYMENT, NET LENDING AND RECAPITALIZATIONS	-19.1	-20.4	-29.9	-5.5	-9.9	-4.8	-4.7	-24.9	-4.7
o/w Net lending [2]	-19.1	-20.4	-29.9	-5.5	-9.9	-4.8	-4.7	-24.9	-4.7
IV TOTAL EXPENDITURE, GFS (II+III)	-1214.8	-1268.3	-1,359.8	-319.9	-353.8	-375.7	-411.4	-1460.8	-366.8
V CONSOLIDATED BALANCE (I+IV), GFS definition [3]	-68.9	-121.8	-136.4	-26.3	-42.4	-44.4	-45.1	-158.2	-54.1
VI ACCOUNT BALANCE CHANGE	-55.4	45.4	-19.2	59.4	51.9	96.3	-19.8	187.7	34.2
VII PRIMARY BALANCE	-46.5	65.6	-102.2	-16.4	-30.4	-33.3	-33.4	-113.4	-38.7

Source: Table P-10 in Analitical Appendix

1) Includes all levels of government (central, provincial and municipal) and their budget beneficiaries and social security organizations (Serbian Pension and Disability Insurance Funds, Health Insurance Funds, National Employment Service, but not public enterprises and the NBS.

2) The item corresponds to the item "Net acquisition of financial assets for policy purposes" in the PFB (in accordance to GFS 2001), i.e. to the item "net lending" or "lending minus repayment" in the IMF presentation (i.e. GFS 1986). It comprises loans to students, financing of the National Corporation for Housing Loan Insurance and the like.

3) See Table P-10 in Analytical appendix and/or Box 2.

Analysis of the dynamics and the structure of public revenues and public expenditures

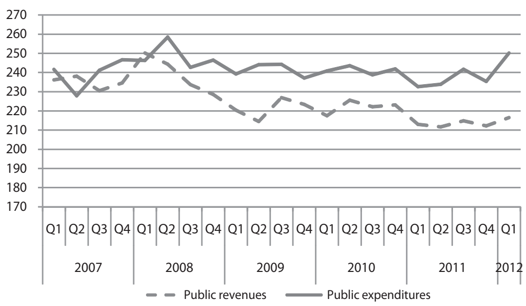
Consolidated public revenues on a gradual rise in Q1

Consolidated seasonally adjusted public revenues in real terms were by 2% higher in Q1 2012 compared to the previous quarter, and a real increase of 1.7% was also achieved compared to the same period last year.[1] The rise of the consolidated public revenues in Q1 is the result of strong growth in revenues from taxes on factors of production and a moderate fall in revenues from consuumption taxes and other tax and non-tax revenues.

Consumption taxes revenues are gradually declining

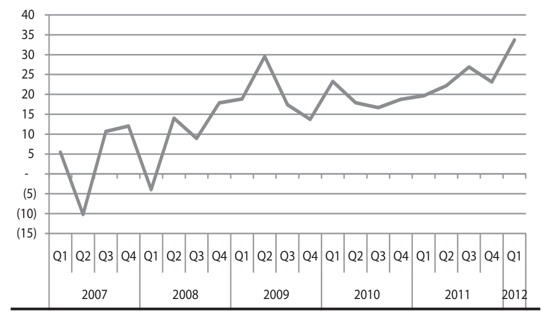
Total real seasonally adjusted consumption taxes revenues (VAT, excise and customs) in Q1 2012 have gradually declined compared to the previous quarter, as well as compared to the same period last year.

Figure T 6-4. Serbia: Seasonally adjusted, consolidated public revenues and public expenditures in real terms, in billions of RSD (in prices from 2007)



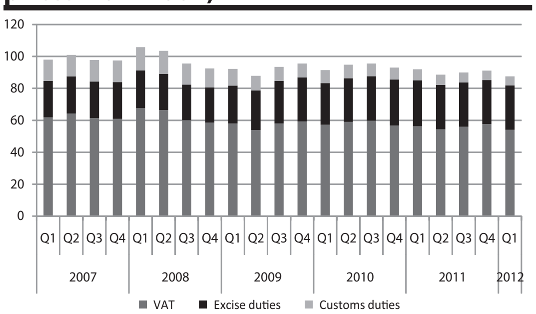
Source: *QM* calculations

Figure T 6-5. Serbia: Seasonally adjusted, fiscal deficit in real terms, in billions of RSD (in prices from 2007)



Source: *QM* calculations

Figure T 6-6. Serbia: Movements of real consolidated seasonally adjusted revenues from consumption tax, in billions of RSD (in prices from 2007)



Source: *QM* calculations

Real seasonally adjusted VAT revenues generated in Q1 were lower in real terms by 6.2% over the previous quarter. Although Q1 saw a drop in economic activity, it is estimated that such a sharp decline in VAT revenues is primarily the result of VAT refunds in amount of about 4bn RSD being postponed from Q4 2011 to the next quarter. When we eliminate the impact of this one-off, accounting transaction, it is estimated that the seasonally adjusted real VAT revenues in Q1 have actually increased in real terms by 0.8% over the previous quarter. That is, even though Q1 saw a decline in economic activity, the change of structure in foreign trade, in terms of growth of imports and fall of exports, as well as the considerable nominal depreciation of dinar, have significantly offset the negative impact of the slowdown in economic activity on the level of revenue from this tax.

On the other hand, the seasonally adjusted revenues from customs in Q1 have dropped in real terms by 4.3% compared to the previous quarter, which, in circumstances of growing imports, could be the result of further successive liberalisation of foreign trade in EU states, in line with the provisions of the Stabilisation and Association Agreement, which stipulate a gradual reduction of customs tariffs at the beginning of each year. Seasonally adjusted revenues from excise taxes generated in Q1 were by 0.9% higher than in the previous quarter, primarily due to the

1 Data on year on year growth of the consolidated public revenues and consolidated public expenditures are presented according to the economic classification in Appendix 1, while the data on the absolute amount of nominal public revenues and public expenditures are presented in Appendix 2.

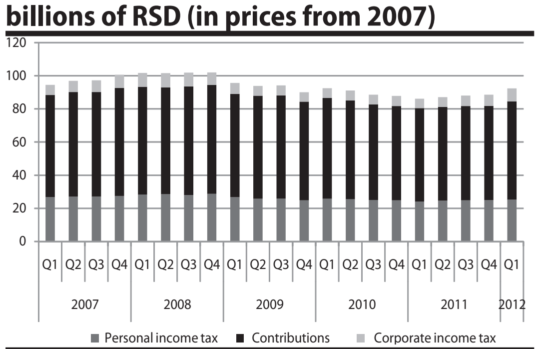
regular annual indexation of excise taxes, performed in January, but also the fact that part of the excise duties for the second half of December 2011 were settled in early January 2012, since the last day of December fell on a weekend. Slower growth of the excise revenues is partly due to a relatively significant tax evasion in sales of diesel fuel, realised by selling diesel fuel as heating oil, which is exempt from excise duty. In the meantime, the government adopted legislation that should prevent this line of tax evasion.

…while the revenues from taxes on factors of production are strongly rising

Q1 saw a moderate growth in revenues from taxes on factors of production. Real seasonally adjusted revenues from social security contributions rose by 4%, and the revenues from personal income tax rose by 1.1%, compared to Q4 2011, as well as compared to the same quarter the previous year. Growth of revenues from income tax and social contributions is the result of growth of mass wages, which occurred primarily due to increased average earnings recorded in Q1 (due to one-off payments made to employees in certain parts of the public sector - jubilee bonuses to employees in education and culture, but also due to a slight increase in the number of employees in the public sector, and the indirect increase of salaries in the Ministry of Interior). However, since the growth in revenues from social contributions is relatively high, it is estimated that it is also the result of increased efforts in terms of collection of public revenues by the Tax Administration, which are primarily focused on the collection of social contributions (e.g. publishing the list of the largest tax debtors, etc.), as well as mass blocking of the tax debtors' bank accounts.

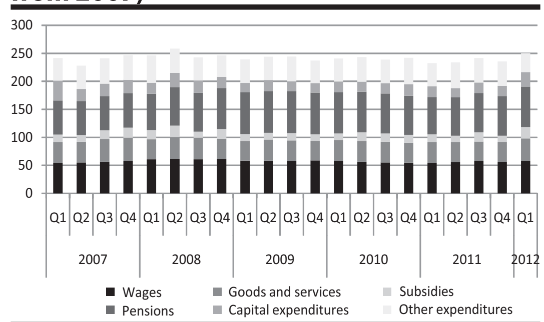
Q1 also recorded a very strong growth in real seasonally adjusted revenues from corporate income tax, which was 16% higher compared to the previous quarter. Strong growth of revenues from corporate income tax is the result of payment of taxes on capital gain realised from the sale of retail chain Maxi to the Belgian Delheize, which was due in March 2012, as well as the fact that some of the major public enterprises, as well as those where the state is the co-owner (such as EPS and NIS), generated in 2011 a relatively high profit, on which taxes were also paid in March 2012.

Figure T 6-7. Serbia: Movements in real consolidated seasonally adjusted revenues from taxes on factors of production, in billions of RSD (in prices from 2007)



Source: *QM* calculations

Figure T 6-8. Serbia: Movements in consolidated seasonally adjusted public expenditures, in billions of RSD (in constant prices from 2007)



Source: *QM* calculations

After the significant decline in Q4 2011, the real seasonally adjusted non-tax and other tax revenues recorded a slight fall in Q1 2012.

Public expenditures in Q1 on a strong rise

Real seasonally adjusted expenditures of the consolidated sector of the government increased by 6.3% in Q1 2012 as compared to the previous quarter, where a growth was recorded in almost all current, as well as capital expenditures. Compared to the same period last year, the consolidated public expenditures in Q1 2012 grew by 10% in real terms.

The highest growth is in the spending on subsidies, interest payments, purchase of goods and services, and capital expenditures

The highest growth in Q1 was recorded in the spending on subsidies, interest payments, purchase of goods and services, and capital expenditures. Real seasonally adjusted expenditures on subsidies were higher in Q1 by around 81% than in the previous quarter, while the spending on purchase of goods and services rose by 12.9%. Movement in the spending on subsidies in the previous period indicate their pronounced volatility. It is estimated that a considerable part of the increase in spending on subsidies realised in Q1 2012 was due to the accelerated realisation of payments on this basis in the pre-election period, especially from the revenues of extra budgetary funds.

Seasonally adjusted expenditures on interest payments grew by 17.1% in Q1 2012, compared to the previous quarter. It is estimated that the increase of spending on interest payments is the result of interest payments on previously issued treasury bills and other instruments of state borrowing becoming due, as well as the nominal depreciation of dinar, since the largest part of Serbia's public debt is denominated in foreign currency. As the level of Serbia's public debt is constantly growing, and new borrowing is done at higher interest rates than the average interest rate of the existing state debt, it is estimated that the growth trend of spending on interest payments will continue in the coming period.

Capital expenditures (real, seasonally adjusted) grew in Q1 by as much as 39.8% compared to the previous quarter. It is estimated that the mentioned strong growth of capital expenditure is the result of the delay in payments of realised capital projects, from Q4 2011 to the next quarter. Although the increase in the share of capital spending is desirable, it is essential for the scope and dynamics of the public investments to be consistent with the need for maintaining fiscal deficit within legally prescribed parameters. That means that the increase of capital spending is desirable and justified only after achieving adequate savings in current public expenditures, and then directing the funds to financing priority projects.

...and there was a moderate increase in the spending on employees and pensions

Real seasonally adjusted expenditures on the employees rose by 3% in Q1 2012, as compared to Q4 of last year. The growth of expenditure on employees is the result of one-off payment of jubilee bonuses to employees in the sector of education and culture, a slight increase in the number of employees in public administration (by about two thousand), as well as increasing salaries at the local level and in certain extra-budgetary funds, which exercise considerable amounts of their own revenues, and regular indexation of salaries of public employees made during the previous quarter. On the other hand, growth in (real seasonally adjusted) spending on pensions, which in Q1 was 2.6% higher than the previous quarter, is a result of further growth in the number of pensioners, as well as regular indexation of pensions in the previous quarter. The salaries of public employees and pensions in October 2011 increased by 1.2%, in line with the rules of their indexation, prescribed by the Law on Budget System. Since the payment of the first part of salaries and pensions for the current month is done in the next month, it means that in Q4 2011, salaries and pensions paid were increased for the last two months, while all three payments in Q1 2012 were increased. Consequently, part of the real growth of seasonally adjusted expenditures on wages in the public sector and pensions were due to the stated dynamic of payments of salaries and pensions.

Public Debt Analysis

Serbia's public debt at the end of Q1 2012 amounted to 14.6 billion euros (about 50% of GDP)

According to official data of the Ministry of Finance, at the end of Q1 2012, the total public debt of Serbia amounted to 14.62 billion euros, which is about 150 million euros more than at the end of 2011. It is estimated that at the end of Q1, the public debt was close to 50% of GDP. The growth of public debt is the result of the fiscal deficit achieved in Q1, depreciation of dinar, and the decline in real GDP. The growth of public debt in Q1 was significantly lower than the fiscal deficit recorded in Q1, due to the financing of a part of fiscal deficit from the previously formed state deposits. However, as a result there was a significant decrease in state deposits, which at the end of Q1 amounted to less than 300 million euros, which is the lower limit of the amount necessary to ensure liquidity of the country. Accordingly, it is estimated that the growth of public debt in the coming quarters will be higher than in Q1, due to the need to finance the deficit in those periods, and increase the levels of state deposits. The need to have an appropriate amount of deposits in the state account with the NBS is particularly evident in conditions of high instability on financial markets, where there is a significant risk of fluctuations in rates of successful realisation of newly issued debt securities.

Table T6-9. Serbia: Public debt[1] 2000-2011.

	Amount at the end of period, in billions EUR											
	2000	2005	2006	2007	2008	2009	2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	11.01	11.58	12.62	12.36	12.46
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.30	5.64	5.65	5.12	5.33
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	5.72	5.94	6.98	7.24	7.14
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	1.68	1.71	2.12	2.11	2.15
III. Total debt (I+II)	14.17	10.28	9.38	8.88	8.78	9.85	12.17	12.70	13.29	14.74	14.47	14.62
Public debt / GDP[2]	169.3%	50.2%	36.2%	29.4%	25.6%	31.3%	41.5%	39.8%	40.6%	44.4%	45.07%	
Public debt / GDP(QM)[3]	169.3%	52.1%	37.8%	30.9%	29.2%	34.8%	44.6%	44.1%	44.0%	47.1%	46.9%	50.0%

1) According to the Public Debt Law, public debt includes debt of the Republic related to the contracts concluded by the Republic, debt from issuance of the t-bills and bonds, debt arising from the agreement on reprogramming of liabilities undertaken by the Republic under previously concluded contracts, as well as the debt arising from securities issued under separate laws, debt arising from warranties issued by the Republic or counterwarranties as well as the debt of the local governments, guaranteed by the Republic.
2) Estimate of the Ministry of Finance of the Republic of Serbia
3) QM estimate (Estimated GDP equals the sum of nominal GDP in the current quarter and three previous quarters)

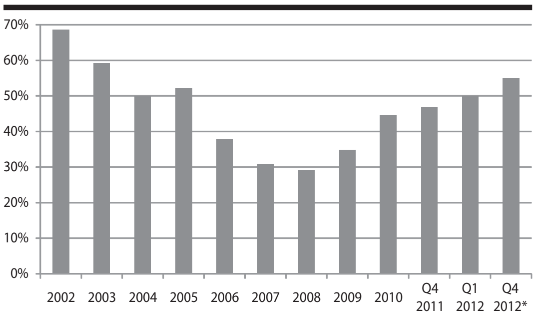
...there is also a growth trend in guarantees...

It was observed that in the period since 2008, there has been a significant acceleration of growth of indirect state liabilities, arising from the issued guarantees. Thus, from the end of 2008 to the end of Q1 2012, the guaranteed public debt rose by about 1.2bn euros, i.e. by about 4% of GDP. It is estimated that there is a positive relationship between the strengthening of state control of public finances in the narrower sense (excluding public enterprises) in the last few years and the increase of borrowing in an indirect way, by issuing loan guarantees to public enterprises. Because it is a category that increases the total amount of contingent liabilities of the country, it is necessary to improve the mechanism for issuing guarantees in terms of restricting their issuance to loans for financing priority projects, which would also limit the maximum amount of guarantees that the state can issue annually, to about 0.6% of GDP annually. It is also necessary to improve the mechanism of selection of projects, for whose realisation guarantees are approved, in order to make sure projects of real priority are selected, that will have the biggest positive effect on the growth of economy and social development of the country.[2] In addition, inclusion of obligations from the issued state guarantees in the state of public debt is in line with the comparable methodology applied in EU countries, but in those countries, the inclusion of guaranteed debt in the state of public debt is not done completely. Rather, a risk assessment is performed for each guarantee, the probability of its activation, and then, based on that, a certain portion of those potential liabilities is included in the state of public debt. In this regard, application of such practice in recording of the public debt of Serbia is recommended. It is estimated that the application of this practice would slightly lower the amount of Serbia's public debt, since a certain part of the indirect liabilities is related to the guarantees issued for the loans of enterprises, that have in the past regularly financed their loan obligations from their own assets (e.g. EPS).

Costs of interest payments are rising, which has an adverse affect on the sustainability of the public debt

The strong nominal and real depreciation of dinar against euro also affected the relative increase in public debt (as % of GDP) in Q1, since most of the public debt of Serbia (80%) is in foreign currency, and the GDP is realised in dinars. The depreciation of the dinar affected not only the level of indebtedness, but also the cost of public debt, including the cost of interest. Although there is no official data on the amount of average interest rate on the public debt of Serbia, the estimates of implicit interest rate (the ratio of the cost of interest payments and public debt) show that the cost of interest on the public debt of Serbia is growing, from less than 2% in 2008 to over 3.5% in 2012, and their growth is expected to continue in the future as well. The increase in costs of interest payments is primarily the result of rising foreign debt levels of the country, changes in the structure of public debt, and depreciation of dinar against euro and other currencies.

Figure T 6-10. Serbia: Movements in the public debt of Serbia (% of GDP)

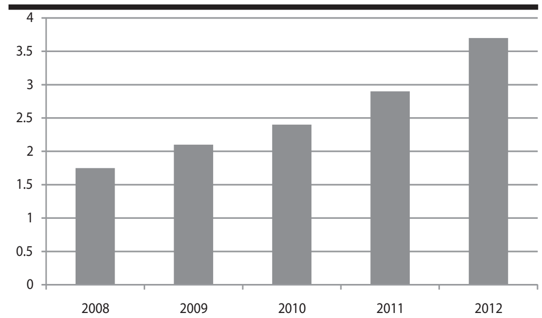


Source: *QM* (*for Q4 2012 – QM's estimate)

2 See: Proposed Measures of Fiscal Consolidation 2012-2016, Fiscal Council of the Republic of Serbia, Belgrade, 2012.

The increase in costs of interest payments indicates a decrease in investor confidence in the solvency of the state, and could jeopardize the sustainability of public debt, even if the interest on most of the debt (around 70%) is paid at fixed rates. Specifically, in the total public debt of Serbia, the share of debt that has low interests rates is reduced (old savings in foreign currency, loans from the World Bank approved under the IDA conditions, etc.), and the share of the new debt, acquired at relatively high interest rates, is increased. Further decrease of investor confidence in the solvency of the state would lead to a significant growth of interest rates on new borrowing, which would make the cost of interest payments rise even more. In circumstances where the costs of interest payment (expressed as % of GDP) exceed the growth rate of GDP, this could lead to an unsustainable growth in the public debt to GDP ratio. Accordingly, in order to contain the costs of interest payments and decrease the implicit interest rate on the country's public debt below the growth rate of GDP, it is necessary to implement a credible plan for fiscal consolidation, that would secure a drastic reduction in the country's fiscal deficit in a relatively short time.

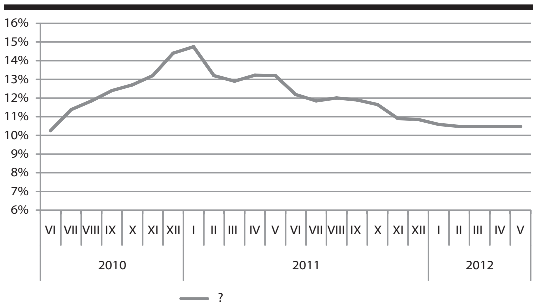
T 6-11. Serbia: Implicit interest rates on the public debt



Source: Proposed Measures for Fiscal Consolidation 2012-2016, Fiscal Council of the Republic of Serbia, Belgrade, 2012.

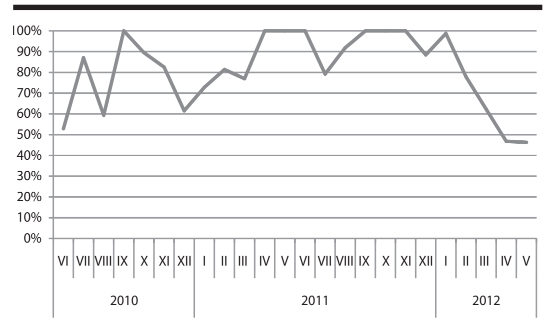
The constant and rapid growth of the public debt, in the absence of a credible plan to reduce fiscal deficits in a relatively short time, in circumstances of increased instability on global financial markets, leads to a more difficult securing of new loans for financing the fiscal deficit of Serbia, as well as to the deterioration of borrowing conditions (increased real interest rates) for the country. This is also shown by data on the movement of successful realisation of issued six-month treasury bills of the Republic of Serbia, as well as on the interest rate that these bills carry. The level of interest rates and the success rate of treasury bills denominated in foreign currency are affected primarily by the country risk, while the treasury bills denominated in dinars are affected by both the country risk and foreign exchange risk.

Figure T 6-12. Serbia: Interest rate on six-month treasury bills denominated in RSD



Source: *QM*

Figure T 6-13. Serbia: Success rate of six-month treasury bills denominated in RSD



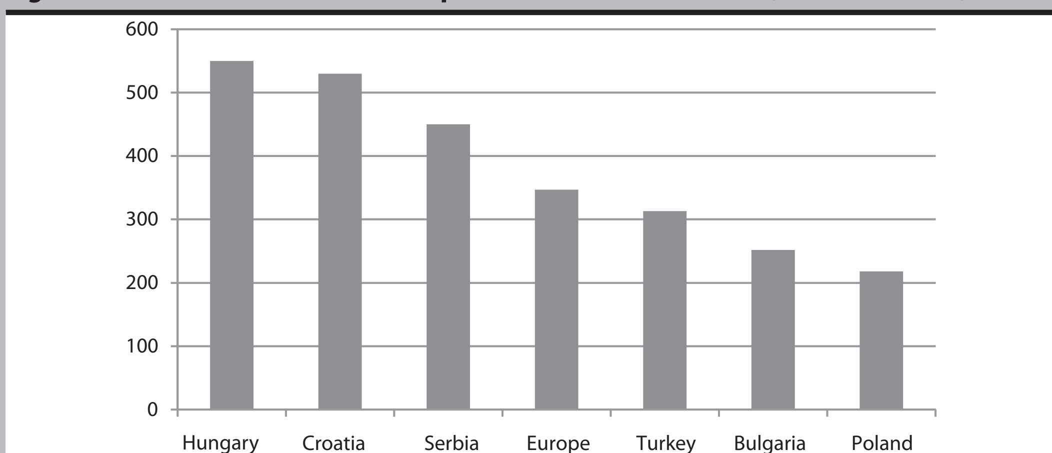
Source: *QM*

It is noticeable that in Q1 there was a drop in the success of issuance of treasury bills denominated in dinars (ratio of bills sold and issued), which is the result of several factors, most notably the freezing of the arrangement with IMF, relatively high fiscal deficit in Q1, uncertainty in terms of fiscal policy that would dominate in the coming period, caused by the political (pre-election) cycle, and the consequent exchange rate volatility. The importance of the impact of the exchange rate risk is also supported by the fact that the success rate of the realisation of treasury bills denominated in euros is still satisfactory. It is also observed that after the sharp fall of the success rate (in treasury bills denominated in RSD) in the period between January and March, there was a certain stabilisation in April and beginning of May 2012. On the other hand, after the rise of average interest rate in Q4 2011, caused primarily by the upset on global financial markets due to the public debt crisis in Eurozone, the interest rate on six-month bills in Q1 was stable, but its real value was quite high, since the rate of inflation in the first quarter was low. It is estimated that there was no significant rise in the interest rate in Q1, because the negative expectations that were caused by the freezing of the arrangement with IMF, have been considerably compensated by the positive expectations due to the acquired candidate status for the EU membership in March 2012. However, despite the instability of the interest rate, the decline of the success rate of the realisation of the treasury bills denominated in dinars indicates there is a risk of country liquidity crisis, but also of a great uncertainty in terms of fluctuations of the exchange rate. Since the large part of Serbia's public debt is related to the issued treasury bills with relatively short maturity, the failure of further issuance of bills would considerably impede the servicing of state obligations for previously issued bills, which could cause negative psychological reactions on the market. That is why avoidance of such a scenario is one more reason for rapid implementation of a plan for thorough fiscal consolidation. The liquidity crisis scenario could be avoided by relying on the larger issue of treasury bills denominated in euros, but this would simultaneously have an adverse effect on long-term sustainability of country's public debt, since the exchange rate risk would become more pronounced, due to the increase in share of foreign debt in the total public debt of the country.

Box 1. Estimate in the level of risk in investing in the state bonds of Serbia and the SEE countries

Increased levels of the country's foreign debt lead to a deterioration in borrowing conditions, i.e. increased interest rate, caused by an increased perception of risk. In that respect, JP Morgan investment bank developed an EMB Index (Emerging Markets Bonds Index), which is an indicator of rate of return on government Eurobonds (and other instruments of state borrowing, denominated in foreign currency), and is considered an approximate indicator of risk of investing in bonds of certain countries. It is considered that the higher the country risk, the higher the value of this index.

Figure T 6-14. Serbia and other European countries: EMB Index (end of Q1 2012)



Source: *QM*, based on the data taken from www.cbonds.info

Value of EMB Index for Serbia at the end of Q1 2012 was around 450 basic points, which is by about 60 basic points less compared to the end of 2011. Compared to other countries, EMB Index for Serbia is lower than those of Hungary and Croatia, but higher than those of Turky, Bulgaria and Poland, as well as compared to the European average. The movements and the state of this index shows that there is still moderate confidence of institutional investors in the securities issued by the Republic of Serbia. However, without the implementation of adequate measures for strong fiscal consolidation, a growth of this index is expected in the future, as well as the rise of interest rates on state borrowing. On the other hand, in case of an implementation of a credible plan for fiscal consolidation, that would lead to a considerable reduction in fiscal deficit, it can be expected that the country risk would decline, so the value of this index could reach the value of Bulgaria, which would make new borrowing considerably cheaper.

Appendices

Annex 1. Serbia: Consolidated General Government Fiscal Operations[1)], 2008-2012 (real growth in %)

	2008	2009	2010	2011					2012	
				Q1	Q2	Q3	Q4	Q1 - Q4	Q1	Q4/Q1
I PUBLIC REVENUES	**3.3**	**-8.7**	**-1.5**	**-2.8**	**-6.6**	**-3.8**	**-4.7**	**-4.6**	**1.7**	**-15.4**
1. Current revenues	3.5	-9.1	-1.5	-2.9	-6.7	-3.8	-3.7	-4.4	1.7	-15.0
Tax revenue	3.7	-8.8	-2.5	-3.1	-6.5	-4.3	-2.3	-4.1	1.9	-12.5
Personal income taxes	6.3	-10.8	-3.9	-7.2	-3.5	-1.1	0.1	-2.9	4.6	-16.1
Corporate income taxes	18.5	-27.0	-3.6	9.2	1.5	4.8	-3.7	3.9	51.5	173.5
VAT and retail sales tax	2.5	-10.2	-0.7	-2.7	-7.9	-6.5	1.3	-4.0	-4.0	-17.4
Excises	0.7	11.6	4.2	13.7	0.7	-0.9	-4.9	0.6	-5.7	-29.7
Custom duties	1.8	-32.4	-14.9	-15.9	-24.4	-23.1	-21.6	-21.5	-18.6	-28.2
Social contributions	4.3	-7.0	-6.5	-7.8	-5.3	-2.2	-0.6	-3.9	4.8	-11.1
Other taxes	-2.3	-4.9	14.5	-7.4	-22.1	-11.5	-17.9	-15.2	-9.6	-16.2
Non-tax revenue	2.6	-11.3	5.8	-1.0	-8.1	-0.5	-11.2	-6.1	0.0	-30.8
2. Capital revenues	-76.8	-41.4	-66.8	3330.6	47.9	746.3	1236.4	468.2	124.1	-44.1
II TOTAL EXPENDITURE	**4.5**	**-4.8**	**-1.7**	**-3.0**	**-4.9**	**1.1**	**-5.4**	**-3.3**	**10.0**	**-11.7**
1. Current expenditures	6.9	-3.3	-2.2	-3.5	-5.2	0.0	-3.4	-3.1	7.9	-8.3
Wages and salaries	10.9	-6.0	-5.9	-6.9	-1.4	5.5	1.0	-0.4	6.6	-6.8
Expenditure on goods and services		-5.7	-0.3	-0.7	-3.6	-6.5	-4.7	-4.3	9.6	-25.4
Interest payment	-2.8	-5.7	-0.3	9.9	27.4	22.8	10.5	17.4	48.1	30.7
Subsidies	-13.3	19.0	40.6	19.2	-26.1	15.3	-24.1	-7.4	42.6	3.8
Social transfers	10.1	-26.0	13.9	-8.2	-8.2	-4.2	-2.8	-5.8	3.3	-6.9
o/w: pensions [5)]	*9.5*	2.2	-3.9	-9.8	-5.0	-2.0	1.2	-3.9	*8.4*	*0.3*
Other current expenditures	14.9	6.7	-6.1	106.6	21.5	-2.8	2.8	23.9	-17.3	-0.5
2. Capital expenditures	-4.3	-6.7	-11.8	6.3	1.4	13.9	-19.8	-5.3	48.3	-40.8
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**12.3**	**-2.4**	**35.2**	**6.3**	**35.7**	**-49.7**	**-58.4**	**-25.6**	**-18.6**	**-1.6**
IV TOTAL EXPENDITURE, GFS (II+III)	**4.6**	**-4.8**	**-1.1**	**-2.9**	**-4.1**	**-0.2**	**-6.8**	**-3.8**	**9.5**	**-11.6**

Source: Table P-10 in Analytical Appendix.
1) See footnote 1) in Table T7-1.
2) Retail sales tax/VAT minus new tax credits to enterprises.
3) Social contributions reduced by refunds between Pension Fund, Serbian Development Fund and enterprises that are debtors of the Pension Fund.
4) QM's estimate, for details see Table P-10 in Analytical appendix.
5) Refers to the current expenditures on pensions.
Note: Real growth is obtained comparing 2003 constant prices quarterly data

Annex 2. Serbia: Consolidated General Government Fiscal Operations[1)], 2008-2012 (nominal amounts)

	2008	2009	2010	2011					2012
				Q1	Q2	Q3	Q4	Q1-Q4	Q1
I PUBLIC REVENUES	**1,145.9**	**1,146.5**	**1,223.4**	**293.6**	**311.3**	**331.3**	**366.3**	**1,302.5**	**312.6**
1. Current revenues	1,143.1	1,139.2	1,215.7	292.9	310.5	330.7	363.8	1,297.9	311.7
Tax revenue	1,000.4	1,000.3	1,056.5	259.1	272.0	286.8	313.1	1,131.0	276.3
Personal income taxes	136.5	133.5	139.1	32.7	37.9	37.9	42.3	150.8	35.8
Corporate income taxes	39.0	31.2	32.6	14.4	7.5	7.6	8.3	37.8	22.9
VAT and retail sales tax	301.7	296.9	319.4	79.3	80.9	86.6	95.7	342.4	79.7
Excises	110.1	134.8	152.2	35.1	40.2	46.9	48.8	170.9	34.6
Custom duties	64.8	48.0	44.3	9.0	9.5	9.7	10.6	38.8	7.7
Social contributions	312.7	318.8	323.0	78.3	85.6	86.9	95.9	346.6	85.9
Other taxes	35.6	37.1	46.0	10.2	10.5	11.4	11.5	43.5	9.7
Non-tax revenue	142.7	138.8	159.2	33.8	38.5	43.9	50.7	166.9	35.4
2. Capital revenues	1.4	0.9	0.3	0.3	0.3	0.3	1.1	2.0	0.6
	0.0								
II TOTAL EXPENDITURE	**-1,195.7**	**-1,248**	**-1,329.9**	**-314.4**	**-343.9**	**-371.0**	**-406.7**	**-1,435.9**	**-362.1**
1. Current expenditures	-1,089.6	-1,155	-1,224.8	-298.1	-323.9	-338.4	-364.4	-1,324.8	-336.8
Wages and salaries	-293.2	-302.0	-308.1	-76.7	-85.3	-89.6	-91.0	-342.5	-85.5
Expenditure on goods and services	-181.2	-187.4	-202.5	-44.7	-52.6	-51.0	-68.1	-216.3	-51.3
Interest payment	-17.2	-187.4	-34.2	-9.9	-12.1	-11.1	-11.7	-44.8	-15.4
Subsidies	-77.8	-22.4	-77.9	-15.1	-15.4	-28.4	-21.5	-80.5	-22.6
Social transfers	-496.8	-63.1	-579.2	-142.6	-150.4	-151.7	-164.2	-609.0	-154.2
o/w: pensions [5)]	*-331.0*	-556.4	*-394.0*	*-99.2*	*-105.4*	*-107.0*	*-111.2*	*-422.8*	*-112.5*
Other current expenditures	-23.5	-387.3	-22.9	-9.1	-8.2	-6.6	-7.8	-31.7	-7.9
2. Capital expenditures	-106.0	-24.0	-105.1	-16.3	-19.9	-32.6	-42.3	-111.1	-25.3
	0								
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**-19.1**	**-20**	**-29.9**	**-5.5**	**-9.9**	**-4.8**	**-4.7**	**-24.9**	**-4.7**
IV TOTAL EXPENDITURE, GFS (II+III)	**-1,214.8**	**-1,268.3**	**-1,359.8**	**-319.9**	**-353.8**	**-375.7**	**-411.4**	**-1,460.8**	**-366.8**

Source: Table P-10 in Analytical Appendix.
1) See footnote 1) in Table T7-1.
2) Retail sales tax/VAT minus new tax credits to enterprises.
3) Social contributions reduced by refunds between Pension Fund, Serbian Development Fund and enterprises that are debtors of the Pension Fund.
4) QM's estimate, for details see Table P-10 in Analytical appendix.
5) Refers to the current expenditures on pensions.