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The Foundation for the Advancement of Economics (FREN)
Kamenička 6, Beograd
Tel/Fax: 011 3021 069
E-mail: office@fren.org.rs
http://*www.fren.org.rs*

ASSOCIATES IN THIS ISSUE
Ivan Kalafatić
Tatjana Karaulac
Aleksa Nenadović
Ivan Rajić
Saša Ranđelović
Svetozar Tanasković

TRANSLATION
Gordana Filipović
Jelena Kukrić
Duška Tomanović
Uroš Vasiljević

DESIGN OF INNER PAGES
Stefan Ignjatović

PRINTING PREPARATION
Maja Tomić

COVER DESIGN
Nikola Drinčić

PRINTING OFFICE
Alta Nova

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The Analytical Appendix can be found at www.fren.org.rs.

Analytical and Notation Conventions

Values

The data is shown in the currency we believe best reflects relevant economic processes, regardless of the currency in which it is published or is in official use in the cited transactions. For example, the balance of payments is shown in euros as most flows in Serbia's international trade are valued in euros and because this comes closest to the measurement of real flows. Banks' credit activity is also shown in euros as it is thus indexed in the majority of cases, but is shown in dinars in analyses of monetary flows as the aim is to describe the generation of dinar aggregates.

Definitions of Aggregates and Indices

When local use and international conventions differ, we attempt to use international definitions wherever applicable to facilitate comparison.

Flows – In monetary accounts, the original data is stocks. Flows are taken as balance changes between two periods.

New Economy – Enterprises formed through private initiative

Traditional Economy - Enterprises that are/were state-owned or public companies

Y-O-Y Indices – We are more inclined to use this index (growth rate) than is the case in local practice. Comparison with the same period in the previous year informs about the process absorbing the effect of all seasonal variations which occurred over the previous year, especially in the observed seasons, and raises the change measure to the annual level.

Notations

CPI – Consumer Price Index

Cumulative – Refers to incremental changes of an aggregate in several periods within one year, from the beginning of that year.

H – Primary money (high-powered money)

IPPI – Industrial Producers Price Index

M1 – Cash in circulation and dinar sight deposits

M2 in dinars – In accordance with IMF definition: cash in circulation, sight and time deposits in both dinars and foreign currency. The same as M2 in the accepted methodology in Serbia

M2 – Cash in circulation, sight and time deposits in both dinars and foreign currency (in accordance with the IMF definition; the same as M3 in accepted methodology in Serbia)

NDA – Net Domestic Assets

NFA – Net Foreign Assets

RPI – Retail Price Index

y-o-y - Index or growth relative to the same period of the previous year

Abbreviations

CEFTA – Central European Free Trade Agreement

EU – European Union

FDI – Foreign Direct Investment

FFCD – Frozen Foreign Currency Deposit

FREN – Foundation for the Advancement of Economics

GDP – Gross Domestic Product

GVA – Gross Value Added

IMF – International Monetary Fund

LRS – Loan for the Rebirth of Serbia

MAT – *Macroeconomic Analyses and Trends*, publication of the Belgrade Institute of Economics

NES - National Employment Service

NIP – National Investment Plan

NBS – National Bank of Serbia

OECD – Organization for Economic Cooperation and Development

PRO – Public Revenue Office

Q1, Q2, Q4, Q4 – 1st, 2nd, 3rd, and 4th quarters of the year

QM – *Quarterly Monitor*

SORS – Statistical Office of the Republic of Serbia

SDF – Serbian Development Fund

SEE – South East Europe

SEPC – Serbian Electric Power Company

SITC – Standard International Trade Classification

SME – Small and Medium Enterprise

VAT – Value Added Tax

From the Editor

Serbia's economy is facing a substantial fall in output, and the latest April data do not seem to indicate that it has touched bottom. This is therefore the fundamental problem that economic policy needs to address directly. Inflation is now not an issue, and neither is the depreciation of the dinar – both have been temporarily reined in by the deep recession. However, in the medium term, after the crisis is over, economic growth will no longer be able to rely on enormous inflows of foreign capital and spending considerably exceeding production; it will also be impossible to curb inflation using an overvalued dinar. To achieve acceptable and sustainable economic growth, economic reforms and policies will be needed that will moderate spending, primarily government spending, and at the same time tackle the related issue of the overvalued dinar.

The fall in output (GDP) in the first quarter (Q1) of some 6% indicates that Serbia has entered a deep recession; April data confirm this trend, and hence GDP is set to fall substantially in 2009, in all likelihood by some 5%. New loans have completely dried up, which has, coupled with a major fall in export demand, led to a drop in output. This wave has yet to spill over into a substantial fall in employment, but this will necessarily follow if the recession lasts and companies begin to go out of business. Obviously this is neither desirable nor socially sustainable.

The other side of the coin is that the recession has led to a *forced downward adjustment of the foreign deficit*. The reduction in domestic spending has led to a major fall in imports, meaning that the current account deficit has dropped substantially despite lower exports. This external balance "hole" nearly halved, from the usual €6 bn to the likely €3 bn in 2009. Such a significant reduction in the amount of necessary foreign inflow can now be met mainly by funds obtained from the IMF and through government borrowing intended to cover the budget deficit, as well as through other minor inflows. On the other hand – again with IMF assistance – the government and the NBS managed to delay payment of companies' foreign loans due in 2009 amounting to some €5 bn. The external deficit is thus covered for this year, which prevented a crash of the dinar and even made it "stable". The costs of such stability, however, is deep recession; it can be sustained only as long as the recession lasts. The necessary revival in economic activity and its accompanying rise in consumption will again raise the foreign deficit and put pressure on the dinar.

The recession has curbed inflation, as we predicted would happen as early as December (see *QM* 14). This is indicated by only a small growth of unregulated prices set in the market (core inflation), which in fact reflect underlying inflation. This trend was obscured somewhat by the high growth of regulated prices over the first five months of the year. The same holds true for the high monthly inflation in May (1.5%), which is nearly exclusively the consequence of rising oil prices and the seasonal hike in prices of agricultural products rather than of market forces.

The unjustified fear of high inflation has led to *belated and insufficient monetary easing* on the part of the NBS. The reference interest rate was very high over the past five months, and so it remains (at 13%), when contrasted with the expected inflation rate (8.8% according to NBS) and the deep recession. Such a recession calls for a major cut in the reference interest rate to push banks strongly to lend dinars to the flagging economy instead of to the NBS (through repo operations). This would be the right, and indeed the only remaining, way to pull the economy out of recession – as the fiscal policy foreseen by the rebalance of the budget can hardly do so.

Government *subsidized loans* are *limited in their reach* and represent a *roundabout way* of providing the new funding necessary for the economy. Less than €300 mn in these loans have been granted to the economy, while the government has borrowed nearly €500 mn from domestic banks. In addition, domestic banks have about €1 bn in repo investments with the NBS. A much more sensible policy than subsidizing would be for the NBS to reduce its reference interest rate and for the government to refrain from borrowing from domestic banks; this would direct a substantial portion of the €1.5 bn in bank assets into the economy. On the other hand, subsidizing is always a stimulus for those wishing to pocket some government money (rent-seeking). It is likely that banks would have lent some of this money even without the subsidies awarded for this purpose. Finally, the government has failed where it could have been the most effective in boosting economic activity, namely in investing into infrastructure.

Fiscal policy, agreed with the IMF and approved through the rebalance of the budget in late April, will not result in a marked stimulation of consumption and output, as the foreseen deficit of 3% of GDP is only slightly higher than the one in 2008 (2.5%). There are, however, *significant risks* of 2009 seeing an even higher deficit. First, because measures aimed at cutting public spending foreseen in the budget rebalance were passed in haste and after scant reflection, which means it is highly unlikely for them to be realized in full (see *Highlights* 2). Second, due to the larger than expected drop in output, it is possible that tax revenues will be lower, leading to a greater budget deficit.

In a scenario somewhat less favorable than that foreseen in the rebalance, the 2009 fiscal deficit could grow substantially, say to 4.5% of GDP (*Highlights* 1). In this case the IMF agreement calls for an increase of VAT and pay cuts across the public sector to prevent this rise in the deficit. However, such measures would push the economy into an even deeper recession – thus a greater deficit is probably a better solution, provided external financing is found. Government borrowing at home, both past and future, is harmful because it crowds out the private sector from the domestic banking market. Additional public spending in this field therefore does not provide a stimulus to demand and production, but rather merely a redistribution of the same spending – from the public sector to the government.

Due to the deep recession, the nominal *dinar exchange rate* has remained unchanged for several months, while on the other hand overall prices have been rising, which, taken together, has led to a rise in the real value of the dinar. If the NBS keeps a high interest rate and the recession deepens further, this could lead even to a nominal appreciation, implying its larger real appreciation. This rise in the value of the dinar is rather unfavourable for the Serbian economy; any further rises should be prevented by, among other things, a cut in the NBS interest rate. Indeed, it would be desirable for the dinar to gradually lose value in real terms over this year and the next, i.e. for the dinar's depreciation rate to be higher than the inflation rate. This would leave Serbia much better prepared for the end of the recession.

In the medium term, after the crisis is over, there will be no return to the time when Serbia's output and consumption growth was based on enormous inflows of foreign capital through loans and the sale of domestic companies. Future inflows of foreign capital will see a major reduction, and Serbia will likely exit the crisis burdened by a substantial foreign debt – the current debt of some 70% of GDP could rise to a critical 80% by 2010 through proposed borrowing from the IMF as well as the government's borrowing to cover its deficit. *Domestic consumption* will therefore have to *grow more slowly than output*, bringing the foreign deficit to a manageable level.

The above requires the *government* to cut (relative to GDP) its spending in the years ahead, and to replace the deficit with a surplus – in effect, to achieve net savings. This calls for a well thought-out reform of the public sector, as distinct from *ad hoc* measures contained in the current budget rebalance, as well as political will for the reforms to be seen through.

Private sector spending will remain greater than its revenue, which means that this sector will continue recording a deficit, but it will necessarily have to come down. Household spending should be reined in by slowing down the growth of loans granted to this sector, as well as by putting brakes on wage growth. The latter will be aided by the fall in public sector wages in real terms in this year and the next. Spending or investment in the economy will be limited by the ability to attract foreign savings: investments and loans.

Finally, the additional *loss of value of the dinar* in real terms (real depreciation) will probably be necessary, along with a previous slowdown in the growth of consumption, to bring the foreign deficit down to a sustainable level, i.e. one that may be met from reduced capital inflows. A lower value of the dinar will on its own drive consumption down as it will make imported goods more expensive, and thus also reduce the income available for other goods. In addition, a higher value of the euro will direct demand away from more expensive foreign products towards cheaper domestic ones, also boosting exports in the process. The latter will then affect the growth of domestic output, while both will lead to a relative reduction in the foreign deficit in the medium term.

Highlights in this issue of *QM* examine the response of Serbia's economic policy to the crisis, analysing the measures taken and assessing their possible effects. In *Highlights* 1, Bogdan Lissovolik, the IMF's new Resident Representative in Belgrade, presents the agreement with the Fund and analyses potential risks faced by Serbia's economy as well as possible responses on the part of economic policy. The following three *Highlights* (Arsić, M., Altiparmakov, N. and Ranđelović, S.) delve deeper into fiscal policy foreseen in the budget rebalance, analysing its weaknesses and alternatives, and go on to deal with Serbia's public debt. *Highlights 5* (Kokotović, S.) describes changes to monetary policy in reaction to the crisis. The final, sixth *Highlight* presents recommendations from two roundtables organized by the Foundation for the Advancement of Economics (FREN) dealing with issues of labor market statistics.

Texts in the *Spotlight On* section deal with specific yet important issues of Serbia's institutional reform. In *Spotlight On 1*, Predrag Jovanović, head of Serbia's Public Procurement Agency, presents an analysis of experiences, weaknesses and challenges in this important field that accounts for some €4 bn in yearly spending. *Spotlight On 2* highlights the conclusions of a wider USAID-funded project, the Serbian Economic Growth Activity, presenting a draft of the new Securities Law for Serbia and contrasting the new solutions with the weaknesses of current legislation. A roundtable has already been held to discuss this new legislative draft, and this article should serve as a basis for further public discussion.

TRENDS

1. Review

Recession is the fundamental problem facing Serbia's economy. The fall in economic activity in Q1 in relation to the same period of the previous year stands at above 6%, while firm signs of recovery are yet to appear. In most previous issues of *QM* we have focused on the current account deficit and high inflation as key signs of problems faced by the Serbian economy. Now, with economic activity declining, the drop in the current account deficit and the slowing of inflation do not indicate long-awaited qualitative improvements to the domestic economy; rather, they are side effects of an even more serious problem.

The fall in economic activity in 2009 will in all likelihood exceed the planned 2%. We estimate that the fall in activity will reach some 5% by the end of the year unless a major (highly unlikely) upturn occurs in the trend of production over the rest of the year. The most recent April data point to stagnation if not an outright deepening of the fall in economic activity in relation to Q1. April's y-o-y drop in industrial production amounted to 21.1%, while manufacturing fell by 23.3%. We must emphasize that industrial production had recorded a less pronounced fall in Q1, of 16.9%, with manufacturing seeing a drop of 22.5%. April exports were lower by 25.6% in relation to the same period the previous year, standing at a level similar to that seen over the first three months of 2009, when exports suffered a fall of 23.8%.

The direct cause of the fall in production in Q1, which we estimate at about 6% (non-agricultural GVA) is a drop in both domestic and export demand (see Section 2, Economic Activity). Domestic demand dropped by 7% in real terms in relation to the same period a year before, while export demand fell by as much as 21%. Due to its growing share in the total demand (80%), domestic demand has had a greater impact on the decline of overall demand and economic activity than export demand. The fall in domestic demand and its causes (the downturn in lending) are also apparent in the trend and structure of the broadest money supply aggregate, M2, which has for the first time since 2001 seen a y-o-y fall in real terms, of 3.2% (see Section 7, Monetary Flows and Policy).

Employment shrunk in Q1, but the reduction was not as pronounced as the fall in economic activity. According to data from the Labor Force Survey, the employment rate in April was 2.5 percentage points lower than in October, while the unemployment rate rose from 14.7% to 16.4% (see Section 3, Employment and Wages). Employment reacts to changes in the macroeconomic environment more slowly than other aggregates. Unit labor costs (ULCs), measuring the share of labor force costs in added value, thus rose sharply in Q1 – by about 10% in relation to the same period one year before. To take a simplified view, changes to ULCs indicate that companies have thus far not started laying off considerable numbers of employees, as a response to the sudden drop in production. It is apparent, however, that wages will not be sustainable at current levels unless production recovers; employment will probably have to take an additional cut, albeit a delayed one.

The drop in the current account deficit is mainly a consequence of recession. The current account deficit stood at under 12% of GDP in Q1, or €810 mn, a reduction of as much as €480 mn in relation to the same period the year before (see Section 4, Balance of Payments and Foreign Trade). At the root of the drop in the current account deficit is the fall in imports. Although the fall in domestic demand and production has had the greatest impact on this downturn in imports, the y-o-y drop in energy prices has also contributed. Such a reduced current account deficit, amounting to somewhat more than €3 bn at the annual level, can be financed, thus lessening depreciation pressures and stabilizing the dinar exchange rate (see Section 5, Prices and the Exchange Rate). The dinar has, over the past three months (March – May), even appreciated against the euro by 1.5% in real terms.

Foreign debt has not risen in nominal terms, but its share in GDP has grown due to the fall in production and depreciation. The first quarter even saw some repayment of foreign liabilities. Foreign debt stood at €21.5 bn in late March, as compared with the €21.8 bn in late December 2008. The share of foreign debt in GDP rose from 65% to about 70% in spite of a nominal drop in Q1, due to the downturn in economic activity, which, coupled with the depreciation of the dinar, made GDP expressed in euros substantially lower than in 2008.

Inflation has been dampened by recession, although the Retail Price Index rose by as much as 8.7% over the first five months of 2009. Inflation was, however, primarily caused by administrative measures (rising excise duties and prices under direct administrative control), as well as exogenous factors (greater oil prices). Market (core) inflation, measuring movements in the prices of products and services whose prices are formed in the free market, has not exceeded 0.4% per month since March, which, when annualized, translates into annual inflation of less than five percent. Similar tendencies are in evidence when one considers other indicators that measure inflation. The Consumer Price Index rose by 4.8% from the start of the year to April. However, if we were to exclude from this index the rise in the prices of oil and products made more expensive due to administrative measures, the rise from early 2009 to April would be seen to have amounted to a mere 2.8%, or 8.8% annualized.

The impact of depreciation on inflation has not been major. As the dinar's exchange rate has stabilized over the past three months, we are now able to approximate the pass-through from depreciation to inflation. This amounted to 0.2, i.e. a nominal depreciation of 1% affected the rise of core inflation by some 0.2%. This indicates that even a depreciation greater than that seen in Serbia after the economic crisis escalated is no threat to macroeconomic stability.

The drop in economic activity implies risks and problems in the monetary sector that require careful analysis (see Section 7, Monetary Flows and Policy). What is indicative is the rising share of non-performing loans in the total sum of loans granted. This amounted to 11.4% in late March, which was some 2.5 times as much as in late December 2008, when it had stood at 4.5%. The number of companies whose accounts have been frozen has exceeded 60,000, an increase over the usual number – in January 2008, this number was 40,000. Banks have therefore been switching their investments from companies to safer destinations, with some 150 bn dinars now invested in the NBS repo stock and government securities. The repo stock alone has increased by over 40 bn dinars since early February. This has brought about an unlooked-for sterilization of the money supply in spite of efforts on the part of the government and, to a lesser extent, the NBS to increase lending to the economy. Increased sterilization of the money supply has led to the money multiplier reaching a low level of 1.4 in Q1. The money multiplier (dinar M2/H) exceeded 2 when the economy was expanding.

The recession has also reduced government revenues. The real fall in tax revenues seen in Q1 amounted to as much as 12.6% in relation to the same period the previous year (see Section 6, Fiscal Flows and Policy). At the same time, due to unsatisfactory revenue inflows, Q1 2009 also saw a real drop in public expenditure, reaching 3.4% in relation to the same period a year before. Despite the Q1 consolidated budget deficit of 1.8% of GDP, we consider Q1 fiscal policy restrictive, as the consolidated budget deficit stood at as much as 7% of GDP in Q4 2008 – the first quarter of 2009 thus saw fiscal policy restrictiveness rise substantially when compared to the previous quarter.

The rebalance of the 2009 budget provides for a consolidated budget deficit of 3% of GDP. As the 2008 deficit had amounted to 2.5% of GDP, the planned deficit for 2009 does not imply too great an increase in expansiveness. The consolidated budget deficit planned for 2009 is a compromise between the need to increase the deficit and the possibility of funding it. If economic activity falls by more than 2% – the figure foreseen in the new budget – we may be in for another rebalance and a possible rise in the deficit.

Serbia: Selected Macroeconomic Indicators, 2004-2009[1)]

	Annual Data					Quarterly Data				
						2008				2009
	2004	2005	2006	2007	2008	Q1	Q2	Q3	Q4	Q1
Prices and the Exchange Rate						**y-o-y[2)]**				
Retail Price Index - total	10.1	16.5	12.7	6.8	10.9	11.3	12.0	10.7	8.9	9.8
Retail Price Index - core inflation[3)]	7.9	14.8	10.3	3.9	9.0	6.4	9.1	10.2	10.5	11.3
Real fx dinar/euro (avg. 2005=100)[4)]	100.5	100.0	92.1	83.9	79.7	82.5	79.7	75.0	81.7	86.0
Nominal fx dinar/euro (period average)[4)]	72.62	82.92	84.19	79.97	81.46	82.65	81.07	77.12	85.02	93.71
Economic Growth						**y-o-y, real growth[2)]**				
GDP (in billions of dinars)	1,388	1,692	1,988	2,329	2,745	…	…	…	…	…
GDP	8.2	6.0	5.6	7.1	5.4	8.5	6.0	4.9	2.8	-6.5
Non-agricultural GVA	6.6	7.3	7.9	8.8	5.4	8.3	6.3	5.0	2.5	-6.1
Industrial production	7.1	0.8	4.7	3.7	1.1	6.0	2.3	1.0	-5.0	-16.9
Manufacturing	9.7	-0.7	5.3	4.2	0.7	4.4	3.7	0.4	-6.0	-22.5
Average net wage (per month, in dinars)[5)]	14,108	17,478	21,745	27,785	29,174	26,814	28,846	29,435	31,599	30,120
Registered Employment (in millions)	2.047	2.056	2.028	1.998	1.997	1.995	2.002	1.998	1.993	1.981
Fiscal data			**in % of GDP**					**y-o-y, real growth**		
Public Revenues	41.2	42.1	42.4	42.1	41.5	7.6	5.2	2.8	-0.7	-12.6
Public Expenditures	40.0	39.7	42.7	42.8	43.7	3.8	21.7	-0.4	-3.5	-3.4
						in billions of dinars				
Konsolidovani bilans (def. GFS)[6)]	17.5	14.8	-33.5	-58.2	-68.9	8.0	-19.6	-5.9	-51.3	-11.7
Balance of Payments						**in millions of euros, flows**				
Imports of goods	-8,302	-8,286	-10,093	-12,858	-15,052	-3,470	-3,956	-4,008	-3,617	-2,591
Exports of goods	2,991	4,006	5,111	6,444	7,419	1,665	1,969	2,061	1,723	1,292
Current account[7)]	-2,197	-1,805	-3,137	-4,994	-5,882	-1,305	-1,764	-1,524	-1,290	-811
in % GDP[7)]	*-11.6*	*-8.6*	*-12.9*	*-17.2*	*-17.4*	*-17.3*	*-20.4*	*-16.6*	*-15.1*	*-11.8*
Capital account[7)]	2,377	3,863	7,635	6,126	5,977	1,399	1,672	1,430	1,476	834
Foreign direct investments	773	1,248	4,348	1,942	1,800	807	650	133	210	641
NBS gross reserves (increase +)	349	1,675	4,240	941	-1,760	29	-310	257	-1,736	-249
Monetary data						**in billions of dinars, e.o.p. stock[2)]**				
NBS net own reserves[8)]	103,158	175,288	302,783	400,195	475,110	420,508	417,579	440,936	475,110	502,606
NBS net own reserves[8)], in mn of euros	1,291	2,050	3,833	5,051	5,362	5,109	5,287	5,757	5,362	5,303
Credit to the non-government sector	342,666	518,298	609,171	842,512	1,126,111	908,598	953,977	1,018,307	1,126,111	1,215,843
FX deposits of households	110,713	190,136	260,661	381,687	413,766	410,836	419,824	431,261	413,766	450,852
M2 (y-o-y, real growth, in %)	10.4	20.8	30.6	27.8	2.9	26.2	19.2	13.3	2.9	-3.2
Credit to the non-government sector (y-o-y, real growth, in %)	27.3	28.6	10.3	24.9	25.2	22.0	16.2	17.8	25.2	21.7
Credit to the non-government sector, in % GDP	23.9	29.6	28.6	35.0	42.0	36.9	37.4	38.3	42.0	45.9
Financial Markets										
BELEXline (in index points)[9)]	1,161	1,954	2,658	3,831	1,198	3,068	3,092	1,942	1,198	844
Turnover on BSE (in mil. euros)[10)]	423.7	498.8	1,166.4	2,004.4	884.0	210.8	365.7	176.9	130.6	61.2

Source: FREN.

1) For more details (monthly series) see www.fren.org.rs.

2) Unless noted otherwise.

3) Core inflation measures the price movements of goods and services that are not under administrative control, but formed freely on the market. In January 2009, the Statistical Office of the Republic of Serbia stopped publishing the data for core inflation, so data from this period onward are QM's estimate, based on available data.

4) Calculation based on twelve-month averages for annual data and three-month averages for quarterly data.

5) Data for 2008 have been corrected on the basis of the widened reach of the sample used in calculating the average wage. Thus nominal wage values for 2008 are comparable with nominal values for 2009, but not with those for previous years.

6) Overall fiscal balance (GFS 2001 methodology) - Consolidated fiscal surplus/deficit adjusted for "budgetary loans" (lending minus repayment according to old GFS methodology).

7) In Q1 2008, NBS changed the Balance of Payments methodology. Due to this change, there is a drop in current account deficit, and a decrease in the capital account balance. For a more detailed explanation, see QM 12, Section 6, Balance of Payments and Foreign Trade.

8) NBS net own reserves = NBS fx reserves, net - (foreign deposits of commercial banks + government foreign deposits). For details see section Monetary Flows and Policy.

9) Index value at the last day of the given period.

10) Total turnover on Belgrade Stock Exchange, includes turnover of stocks and FFCD bonds. Dinar amounts for stocks turnover are converted into euros using the average exchange rate for the given period.

Trends

2. Economic Activity

The global financial crisis was completely transmitted to the Serbian real sector in Q1. We estimate the y-o-y drop in GDP at 6,5%, and the drop of non-agricultural GVA at 6,1%. Although economic activity will by the end of the year decrease slightly less than in Q1, 2009 will without a doubt be a year of deep recession. Both exports and domestic demand are declining more sharply than production and this is the main cause for an abrupt drop in economic activity. The bad results of economic activity in Q1 also point to the weaknesses in economic growth, which relied for the most part on domestic demand stimulated by high foreign capital inflows. Unit labour costs have grown strongly due to a production decrease that was not followed by a proportionate decrease in wages and employment. High ULC growth also shows that the existing employment level will be hard to maintain in the period to come. Industrial production underwent a y-o-y decrease of 16.9% in Q1 and construction was at the level of half of the activities from previous year's Q1. It can be concluded that the described economic activity calls for expansive fiscal and monetary policies.

Gross Domestic Product

We estimate the drop in GDP at around 6,5%...

According to *QM*'s preliminary estimate, based on the available data on the results of economic activity[1], the real y-o-y drop in GDP in Q1 stood at around 6,5% (Table T2-1). Non-agricultural GVA, which is considered as a more reliable measure of economic activity, underwent a y-o-y drop of around 6,1%, nearly equal to the total GDP drop.

...and the drop of non-agricultural GVA at around 6,1%

This large y-o-y drop in economic activity is for the most part the consequence of the global financial crisis' impact on the economy – a drop in aggregate demand and an increase in insolvency of domestic companies. However, the decrease in economic activity in Q1 was somewhat bigger than it would have been, had the economy been affected only by the mentioned influences. Namely, in January Serbia suffered a stoppage in gas delivery and the winter was a bit colder than last year, which had an additional unfavourable impact on certain sectors, such as construction. It should also be taken into account that Q1 2008, to which we compare economic activity in the first three months of 2009, was a quarter of an unusually high economic activity. All of this brings us to the conclusion that the y-o-y GDP drop in Q1 is probably larger than it will be during the rest of the year.

When observed according to the production principle, the biggest fall was registered in construction – a decrease of 50% in Q1 in relation to the same period last year. (Table T2-1). This sharp decrease in construction in Q1 derives from a combined impact of the economic crisis and exogenous factors – less working days due to a colder winter. Still, bearing in mind that construction in Q1 does not have a big share in GDP, the fall in manufacturing industry and wholesale and retail trade is much more important for the total economic activity drop. Manufacturing industry registered a drop of 21% in Q1, while wholesale and retail trade had a somewhat milder, but still significant drop of around 8%.

In relation to the same period last year, growth in economic activity in Q1 was registered only in two sectors – Financial intermediation and Transport, storage and telecommunications (Table T2-1). The increase in Financial intermediation can partly be ascribed to the depreciation of the dinar, since growth is measured in dinars, even though activities in this sector are mostly conducted in euros. Data on the increase in the sector of Transport, storage and telecommunications are still unavailable, but as this sector has already been achieving large increases due to the expansion in

1 The methodology we used for estimating GDP is based on the estimates of real growth of gross value added in individual sectors of the economy according to the production principle, which were than summed up and the tax component was added. The modifications compared to the methodology of the Statistical Office of the Republic of Serbia (SORS) are partly related to the indicators on the basis of which we estimate sectoral growth, and which we consider to be more reliable indicators of actual sectoral growth in certain cases (e.g. cement production in construction). Also, since we have fewer indicators at our disposal than SORS, we include in the estimate indirect indicators which are not an integral part of the official statistical methodology, and we also conduct deeper analyses of trends in individual sectors, as well as a demand analysis.

the field of telecommunications, which is not directly influenced by the economic crisis, a y-o-y growth in this sector is expected in Q1 and is estimated at around 5%.

When estimating agricultural activity in Q1, we are still of the careful opinion that growth will be zero compared to the same period last year. First available agricultural activity indicators point to a somewhat smaller production in 2009 compared to last year, since it is almost certain that grain yields will be significantly lower than previous year.

Table T2-1. Serbia: Gross Domestic Product, 2005–2009[1)]

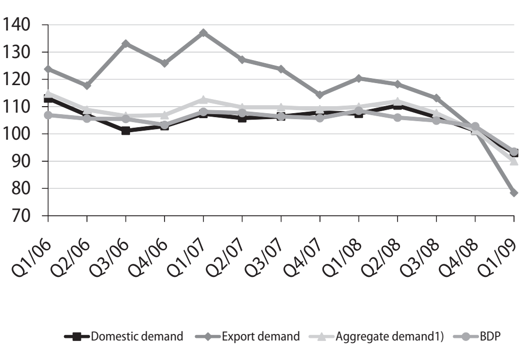
	Y-o-y indices									Base index	GDP share
	2005	2006	2007	2008	2008				2009	(jan-mar)$_{09}$/	2007
					Q1	Q2	Q3	Q4	Q1[2)]	(jan-mar)$_{02}$	
Total	105.6	105.2	106.9	105.4	108.5	106.0	104.9	102.8	93.5	132.1	100.0
Taxes minus subsidies	110.2	99.8	109.5	104.2	109.9	104.4	102.1	101.7	90.0	147.7	16.4
Value Added at basic prices	105.0	106.4	106.5	105.8	108.3	106.5	105.6	103.2	94.5	129.8	83.6
Non agricultural Value Added	106.8	107.5	108.7	105.4	108.3	106.3	105.0	102.5	93.9	132.8	88,2[3)]
Agriculture	95.1	99.8	92.2	109.1	109.0	108.3	109.8	109.0	100.0	109.0	11,8[3)]
Manufacturing	99.9	105.6	104.8	101.3	104.7	104.6	101.0	95.6	79.0	92.3	15,8[3)]
Construction	102.0	107.7	110.8	101.7	104.8	105.7	99.8	96.6	50.0	76.6	3,6[3)]
Transport, storage and communications	123.4	129.3	120.1	112.9	118.0	115.7	110.8	108.4	105.0	783.9	16,4[3)]
Wholesale and retail trade	122.0	110.3	119.9	107.1	111.6	105.8	107.6	104.3	92.0	223.0	13,6[3)]
Financial intermediation	111.9	112.2	115.6	110.2	114.3	110.1	108.9	108.3	107.0	160.6	4,6[3)]
Other	102.1	100.6	101.5	103.1	104.6	102.8	103.2	102.1	98.8	109.0	34,1[3)]

Source: Statistical Office of the Republic of Serbia (SORS).
1) In constant prices in 2002.
2) QM estimate.
3) Share in VA.

A 10% decrease in aggregate demand

On Graph T2-2 we have presented the real y-o-y growth of domestic, export and aggregate demand, as well as the real GDP growth. Aggregate demand in Q1 is lower by around 10% in relation to the same period last year. The graph also demonstrates that the decrease in aggregate demand has been sharper and faster than the decrease in economic activity, which we can interpret in the context of cause and effect links. Namely, the sudden decrease in aggregate demand was, all things considered, the "trigger" that led to the decrease in economic activity.

Graph T2-2. Serbia: Real y-o-y Growth of GDP and Aggregate, Domestic and Export Demand, 2006–2009



Source: *QM* based on SORS data
1) Aggregate demand = domestic demand + export.

In the scope of aggregate demand, export and domestic demand can be analysed individually. Even though the drop in export demand in Q1 was significantly bigger, the total demand decrease was more strongly influenced by the domestic demand due to its significantly bigger share. Domestic demand participated with 56,7% in the real decrease of demand of around 10% in Q1, while export demand participated with 43,3%.

Export demand in Q1 had a larger decrease than domestic demand (Graph T2-2), putting the export oriented part of the economy in a more unfavourable position than the rest of the economy. The y-o-y drop in domestic demand amounted to 21,6% in Q1. Export demand slowdown is transmitted primarily to the decrease in production in the manufacturing industry, where most of export goods are produced (Table T2-1).

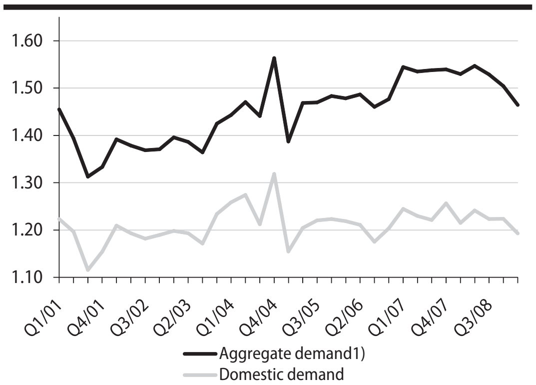
Domestic demand is much more important for economic activity because of its share in the total demand – around 80%. Domestic demand also continued the slowdown trend in Q1 and its real y-o-y decline is estimated at around 7%. The decrease in domestic demand in Q4 was influenced by low real wage growth and what is in essence a halt in credit activities[2]. Despite the consolidated

2 For more details see Section 3, "Employment and Wages" and Section 7, "Monetary Flows and Policy" in this issue of QM.

budget deficit of 1,8% GDP in Q1, fiscal policy was restrictive in Q1. Namely, the consolidated budget deficit in Q4 2008 amounted to 7% GDP, so Q1 witnessed a significant increase in fiscal policy restrictions in relation to previous quarter[3]. It should especially be pointed out that despite the deficit increase compared to Q1 2008 (when a consolidated budget surplus was registered), public expenditures in Q1 were lower than in the same period last year and that the deficit was created due to an even larger decrease in tax revenues[4].

Consumption (domestic demand) is still disproportionately high when compared to production, but its share in the GDP is decreasing slowly (Graph T2-3). In Q1 consumption was 19% higher than production, while in Q4 2008 it was higher by 22%. All relevant aggregates decreased significantly in Q1 – GDP, domestic and export demand – so we can talk about a transitional period here, the one that comes before the establishment of new relations between them, which will probably be stabilised after a few quarters.

Graph T2-3. Serbia: Aggregate and Domestic Demand Ratio to GDP, 2001–2009



Source: *QM* based on SORS data
1) Aggregate demand = domestic demand + export.

The real sector will probably have to face numerous external restrictions in the long term, which will make the existing consumption-production relationship hard to maintain. The main problem lies in the question how will the discrepancy between consumption and production be financed from now on, since it has exceeded 20% of GDP over the last few years (Graph T2-3). Foreign direct investments and credits will remain below the usual level from previous years for a longer period due to the global financial crisis.

It is thus necessary to continue the commenced balancing trend in consumption and production. The optimal way to balance consumption and production is achieved by higher growth in exports than in other observed aggregates. The focus of the adjustment is thus on total production growth and not on the always painful domestic demand decrease. The other way of adjustment is the mentioned decrease in domestic demand. The balance is then achieved by the increase in both consumption and production, which are afterwards stabilised on a lower level than the start level.

Even though there are obvious advantages to exports and in increasing their share in GDP, there are numerous difficulties, which will make this hard to implement in the period to come. Above all, export demand is in an even sharper decline than the domestic one due to the strong influence of the financial crisis and it will, all things considered, recover gradually. However, economic policies that would aim at stimulating exports would help go through the crisis less painfully and set healthy grounds for economic growth in the future. Exchange rate policy is certainly in the category of such policies.

In the described context it is important to mention that two essential agreements ensuring the needed time for the gradual balancing of consumption and production have been reached. The first one is the agreement with IMF on a €3 bn credit for Serbia and the second one is the agreement with foreign banks in the framework of the Vienna Initiative, according to which these banks are obliged not to withdraw their capital from Serbia. We will therefore carefully monitor the relationship between the domestic demand and production in the following issues of QM, since this relationship will be the key for long-term economic growth and macroeconomic stability in the following period.

Unit labour costs (ULC) measured in dinars registered an abrupt and high growth in Q1 (Graph T2-4). If we observe the y-o-y indices, the y-o-y ULC growth both in industry and in the

3 The consolidated state balance is also under the influence of seasonal factors. As a rule, Q4 witnesses the highest and Q1 the lowest deficit. Q1 2009 saw an increase in fiscal policy restrictions even if we exclude the impact of seasonal factors.
4 For more details, see Section 6, "Fiscal Flows and Policy" in this issue of QM.

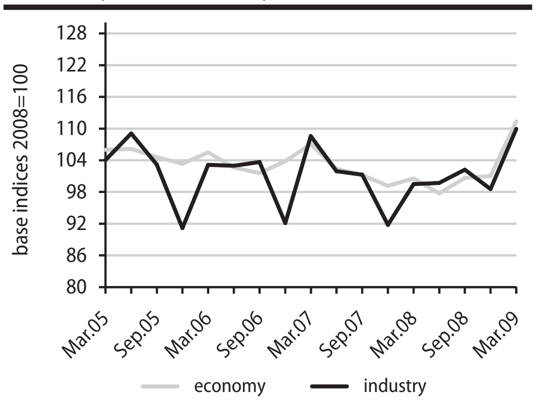
Unit Labour Costs in industry registered significant growth

Existing employment level hard to maintain

economy (state and agriculture excluded) amounts to about 10%. The high y-o-y ULC growth was influenced by a sharp decline in production, which was not followed by an equal deceleration of wages or the reduction of the number of employees. Simply put, companies have yet to react to the sharp decline in production by a large lay-offs[5]. Examples from practice confirm these figures, since a large number of companies have sent workers on paid leaves in the existing circumstances of reduced production but have not laid them off. As a rule, employment reacts late to changes in production, but the ULC growth is a clear indication that the current level of employment will not be sustainable barring the case of a trend reversal and production recovery.

Euro-ULCs decreased despite the real depreciation...

Graph T2-4. Serbia: Real Unit Labor Cost in Economy and Industry, 2005–2009



Source: QM based on SORS and NBS data.

Unit labor costs measured in euros (euro-ULCs) indicate the international competitiveness of the domestic economy because they define the biggest domestic cost component (labor costs) in relation to value added. Euro-ULCs are calculated for the processing industry, which produces by far the biggest share of tradables, as well as for the total economy[6]. We emphasize that such an analysis monitors only the relative change of competitiveness (ULC) in relation to the average in 2004, and that we are not giving an assessment of whether the domestic economy is, or is not, competitive on the international market.

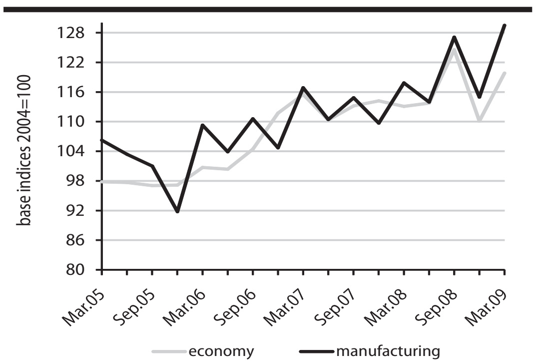
There was a sudden growth in euro-ULCs in Q1 when compared to Q4 (Graph T2-5). Despite the real depreciation of the dinar and the wage growth slowdown, production decreased much more in Q1, so the ULCs measured in euros have grown as well. Nevertheless, it should be taken into account, in this case too, that the domestic economy is in a period of escalating economic crisis and that both euro and dinar ULCs are currently susceptible to significant changes.

...but competitiveness has probably incerased

Euro-ULCs are therefore not ideal indicators of changes in competitiveness when there are sudden changes in the production level, since the changes in employment level are much slower than the changes in production. *Real depreciation of the dinar*[7] is probably a better measure for short-term competitiveness change in Q1.

We shall illustrate this assumption by a concrete example. Suppose that there are two extreme cases in the macro environment of the first quarter: (1) a company that has temporarily stopped production due to the economic crisis and has sent its employees on paid leave and (2) a company that has continued to work with no changes. In the first case, ULCs and therefore euro-ULCs as well, will increase significantly, irrespective of depreciation, while in the second case, the euro-ULCs will decrease under the influence depreciation. Hence, competitiveness can only be measured meaningfully for the second company, whose products are still on the market, since the first company is practically inactive. Consequently, the change in the value of the dinar with regard to the euro represents a better indicator of short-term changes in competitiveness during the time of crisis, in relation to euro ULCs.

Graph T2-5. Serbia: Real Unit Labor Cost in Euro, Economy and Manufacturing, 2005–2009



Source: *QM* based on SORS and NBS data.

5 Certain employment decrease has occurred in Q1, but it is not even nearly proportionate to the production decrease, which can be seen in ULC growth.
6 Excluding state and agriculture sectors.
7 For more details see section 5, "Prices and the Exchange Rate" in this issue of QM.

Industrial Production

Strong decline in industrial production

Industrial production recorded a fall of 16.9% compared to the same period last year (Table T2-6). Given the fact that industrial production recorded a relatively moderate y-o-y decline of 5% in Q4 2008, Q1 has witnessed the biggest slowdown trend in industrial production since we started monitoring it.

Table T2-6. Serbia: Industrial Production Indices, 2005–2009

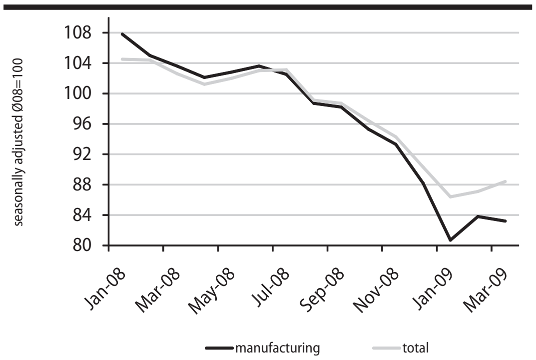
	Y-o-y indices									Share
					2008				2009	
	2005	2006	2007	2008	Q1	Q2	Q3	Q4	Q1	2008
Total	100.8	104.7	103.7	101.1	106.0	102.3	101.0	95.0	83.1	100.0
Mining and quarrying	102.1	104.1	99.4	103.6	106.0	101.8	103.0	102.7	92.7	6.2
Manufacturing	99.3	105.3	104.2	100.7	104.4	103.7	100.4	94.0	77.5	75.5
Electricity, gas, and water supply	106.6	102.2	102.8	101.8	112.0	96.1	103.2	96.9	99.2	18.3

Source: SORS.

Manufacturing industry decreased by 22,5%

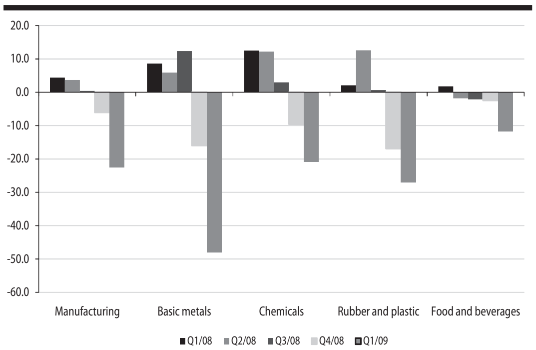
The industrial production decrease is concentrated in the manufacturing industry, which has the biggest share in industrial production. All the negative aspects of the crisis have influenced the manufacturing industry – the decrease in both domestic and export demand and company insolvency. The y-o-y drop in industrial production in the manufacturing industry in Q1 amounts to 22,5%. The production and distribution of electric energy, gas and water is almost at the same level as last year, i.e. it registered a slight y-o-y drop of 0,8%, while the mining and quarrying sector in Q1 posted a 7,3% y-o-y decline.

Graph T2-7. Serbia: Industrial Production, Seasonally Adjusted Indices, 2008–2009



Source: SORS.

Graph T2-8. Serbia: Y-o-y Growth of Selected Sub-sectors, 2008–2009



Source: SORS.

Graph T2-7 shows seasonally adjusted industrial production indices for total and manufacturing industry. We can notice a significant drop in industrial production since the middle of 2008, which culminated in January 2009. The industrial production slowdown coincides with the aggregate demand trend (Graph T2-2).

After January, the industrial production decline stopped. There was even a slight index recovery (Graph T2-7). However, it should be taken into account that January was a specific month due to the gas delivery stoppage, so it is still early to talk about a trend reversal. In the following months we will definitely determine if the industrial production decline has really stopped.

Graph T2-8 shows the y-o-y growth of certain sectors with a significant share in manufacturing industry. We notice that the industrial production drop in Q1 has occurred in all the observed sectors, but that the biggest drops are in the export-oriented sub-sectors.

Food industry, which has the biggest share in total industry production, has seen a y-o-y drop of 11,8% in Q1. Even though this drop is much lower than those observed in other sectors (Graph T2-8), it is very indicative, since in 2008 we had a successful agricultural season and that the demand for food industry products has not decreased as much as the demand in other sectors. We presume that the insolvency of companies had a crucial impact on the drop in food production.

The decrease in the other observed sub-sectors of the manufacturing industry was mostly influenced by the decrease in export demand. This decrease is much higher than the one caused by insolvency problems. For example, basic metals production stands at 50% of the production achieved in Q1 2008.

When observed by purpose…

When observed by purpose (Table T2-9) – we can notice a decline in all of purpose-specific product groups. The lowest y-o-y drop of 1,7% in Q1 was registered in energy production. On one hand, higher energy consumption was influenced by a slightly colder winter than last year; while on the other, the drop in economic activity influenced the decrease in energy consumption. The total result of this purpose-specific product group in Q1 is a similar production level as the one achieved last year. Nevertheless, in the following months, a drop in production is expected even in this domain.

…the biggest decline in the production of intermediary products

The biggest decline in Q1 was recorded in the production of intermediary products – 34,9%. When we exclude the production of basic metals from the intermediary products group this decline is somewhat smaller but is still sharp – 30,4% (Table T2-9). The production of investment goods, which was in the lead in 2008, registered a decline of 27,9% in Q1, while consumer goods production is 14,9% lower in relation to the same period last year.

Table T2-9. Serbia: Components of Industrial Production, 2005–2009

	Y-o-y indices									Share[5]
	2005	2006	2007	2008	2008				2009	2008
					Q1	Q2	Q3	Q4	Q1	
Total	100.6	104.7	103.7	101.1	106.0	102.3	101.0	95.0	83.1	100.0
Energy[1]	103.9	102.5	101.2	101.5	110.2	98.2	102.4	96.4	98.3	26.6
Investment goods[2]	74.2	90.0	105.4	105.5	106.5	118.3	105.0	92.1	72.1	6.0
Intermediate goods[3]	104.9	106.7	104.9	100.0	106.0	106.8	99.7	87.2	65.1	30.4
Intermediate goods without basic metals	101.5	101.3	107.3	98.8	105.1	107.1	95.3	89.1	69.6	22.6
Consumer goods[4]	101.6	112.0	107.1	97.9	99.4	97.5	100.0	101.8	85.1	37.0
Consumer goods without food industry	96.3	128.3	109.2	96.3	95.8	96.5	103.4	108.5	80.1	14.2

Source: SORS.
1) Extraction of coal, crude oil, natural gas, electricity and water supply.
2) Manufacture of metal products excluding machines (sections 281,282 and 283 Classification of Activities), manufacture of machines and equipment (excluding electric), manufacture of office machinery and computers, radio TV and communications equipment, precision and optical instruments, manufacture of motor vehicles and trailers, manufacture of other transport equipment.
3) Mining of metal and non-metallic ores, stone quarrying; manufacture of textile yarns and fabrics, wood and cork products (except furniture), cellulose, paper and paper products, rubber and plastic products, chemical products (except pharmaceuticals and home chemicals products), petrochemicals, construction materials, basic metals, sub-sector of metal goods production except machines (sectors 284, 285, 286 and 287), electric machines and appliances, and recycling sub-sector.
4) Food industry products, tobacco products, clothing, leather products and footwear, publishing products, pharmaceutical products and home chemicals products, furniture and various other products.
5) Share in total industrial production.

Construction

Sharp decrease in construction activity

Construction activity in Q1 is higher by about 50% in relation to the same period last year. Among several inconsistent indicators describing the movements in construction, we consider the cement production index as the most reliable one[8] (Table T2-10). Cement production in Q1 is about 65,9% lower than the production from the same period last year.

8 Cement consumption would have been a reliable indicator, but it is not available at the quarterly level. Research has shown that cement production is a relatively reliable source for approximating consumption.

Table T2-10. Serbia: Cement Production, 2001–2009

	Y-o-y indices				
	I quarter	II quarter	III quarter	IV quarter	total
2001	89.5	103.5	126.9	148.1	114.2
2002	83.6	107.9	115.6	81.6	99.1
2003	51.1	94.4	92.7	94.4	86.6
2004	118.8	107.4	98.5	120.1	108.0
2005	66.1	105.0	105.8	107.4	101.6
2006	136.0	102.7	112.2	120.2	112.7
2007	193.8	108.9	93.1	85.0	104.4
2008	100.1	103.7	108.1	110.1	105.9
2009	34.1	-	-	-	-

Source: SORS.

Out of the other construction indicators published by the Statistical Office of the Republic of Serbia the value of construction works performed in Q1 is nominally lower by 11%, and in constant prices 17% lower compared to the same period last year.

Construction decrease expected in 2009

The construction activity decline was mostly influenced by the drop in demand and the deceleration in companies' investment activities. However, it should be taken into account that in Q1 2009 there were less working days than last year due to a colder winter. It is precisely for this reason that we will wait for Q2 results in order to be able to estimate the underlying trend in construction activity. There is no doubt that construction activity in 2009 will undergo a decline due to the economic crisis, but it is still too early to assess the size of the decline.

3. Employment and Wages

The employment rate has dropped by 2.5 percentage points since October 2008, while the unemployment rate has grown from 14,7% in October 2008 to 16,4%, in April 2009, according to the most recent Labor Force Survey data. This trend points to a worsening of labor market conditions. Formal employment has also continued to fall. The newest RAD survey data show that this fall can primarily be ascribed to the decrease in the number of employees with legal entities. National Employment Service data on initiating and terminating employment contracts also point to the net decrease in the number of employees. The y-o-y real wage growth rate is positive, but shows a slowdown trend – it fell from 4,1% in Q4 of 2008 to 2,6% in Q1 2009. Nominal wage growth decelerated as well. Public sector wage growth is still below the Serbian average, which was expected taking into account government measures introduced in order to overcome the consequences of the current economic crisis - freezing and decreasing public sector wages.

Employment

April 2008 saw a drop in the employment rate of 2.5 percentage points and a rise in the unemployment rate

In April 2008 the working-age population (15 – 64) employment rate amounted to 50.8%, which represents a decline of 2.5 percentage points compared to October 2008. In the same period, the working-age population (15 – 64) unemployment rate has grown from 14.7% to 16.4% (Table T3-1). These are the labor market trends according to the most recent data from the Labor Force Survey (LFS), conducted by Statistical Office of the Republic of Serbia (SORS) in April 2009. These results were not unexpected, heaving in mind that the consequences of the global economic crisis began to show in Serbia already in Q4 of 2008.

Table T3-1. Serbia: Employment and Unemployment in Labor Force Survey, 2004–2009

		Total number of employed 15-64 2)	Number of employed in agriculture and unpaid family workers 15-64 3)	Employment rate 15-64	Total number of unemployed 15-64	Unemployment rate 15-64
		1	2	3	4	5
2004	October	2,735,977	641,720	53.4	664,002	19.5
2005	October	2,574,139	586,708	51.0	718,773	21.8
2006	October	2,516,794	501,937	49.8	691,877	21.6
2007	October	2,525,570	521,420	51.5	585,472	18.8
2008	April	2,652,429	670,141	54.0	432,730	14.0
	October	2,646,215	589,240	53.3	457,204	14.7
2009	April	...	...	50.8	...	16.4

Source: Labor Force Survey (LFS), SORS. Notes:
1) Labor Force Survey was, until 2008, conducted once per year - in October. Since a pilot LFS was conducted in April 2008, we have semi-annual data for 2008 - those for April and October.
2) Population aged 15-64 is considered working-age population.
3) To October 2008 LFS there was no classification for the number on those employed in agriculture and unpaid family workers for the 15-64 age contingent of the population, so that by October 2008 for this category of employees, we have data for the classification of 15+.

Number of employees with legal entities continues to show the decreasing trend registered in the previous quarters

According to the unadjusted data from the SORS RAD survey, formal employment continued to decline between September 2008 and March 2009, which is primarily a result of a decrease in the number of employees with legal entities.

Manufacturing industry and construction saw the biggest drops, while the sectors of education and wholesale and retail trade saw employment growth

The period between September 2008 and March[1] 2009 saw a significant decrease in the number of employees with legal entities (Table T3-2), especially in the manufacturing and construction industry, where the number of employees dropped by around 14,000 (4% of sector employment) and 2000 (2.5% of sector employment) respectively, In the same period, the sector of hotels and restaurants lost 1000 jobs (4.3% of sector employment), (Table P-5 in Analytical appendix).

1 The data for March 2009 are unadjusted data for February 2009.

The same period witnessed a gain of around 3000 jobs in education (2.2% of sector employment) and around 2,000 jobs in wholesale and retail trade (1% of sector employment), (Table P-5 in Analytical appendix).

The number of employees with entrepreneurs remains the same but with a different structure, which is the consequence of updating the records of the Serbian Health Insurance Fund

The number of employees with entrepreneurs grew from 323,000 in September 2008 to 359,000 in March 2009. On the other hand, March 2009 saw a decrease in the number of entrepreneurs compared to September 2008, from 245,000 to 209,000. The total number of entrepreneurs and their employees has thus remained unchanged between September 2008 and March 2009 and amounts to 568,000 (Table T3-2). According to the information from SORS, the cause of this fall is the updating of the Health Insurance Fund records at the end of 2008 from which SORS takes the data on the number of entrepreneurs. Nevertheless, it should be taken into account that the data for March are unadjusted data for February 2009 and are not entirely reliable.

The total number of wage employees rose due to a significant increase in the number of employees with entrepreneurs

Finally, the total number of wage employees (column 6, Table T3-2) rose by 24,000 compared to September 2008, that is to say 11,000 when compared to March 2008, which is exclusively the consequence of an increase in the number of employees with entrepreneurs. This growth was most probably caused by the described methodological change and does not reflect real trends in formal self-employment and employment.

Table T3-2. Serbia: Number of Registered Employed and Unemployed[1], 2004–2009

		Total no. of employed	Employees in legal entities[2]	Entrepreneurs			Total no. of employees	Number of unemployed (NES)
				Total	No. of entrepreneurs	No. of employees with entrepreneurs		
		1 (=2+3)	2	3 (=4+5)	4	5	6 (=2+5)	7
				in thousands				
2004	March	2,065	1,601	464	208	255	1,856	…
	September	2,037	1,560	477	210	267	1,827	843
2005	March	2,070	1,557	513	228	285	1,842	884
	September	2,067	1,536	531	230	300	1,836	898
2006	March	2,032	1,496	536	228	308	1,804	920
	September	2,019	1,447	572	242	330	1,777	915
2007	March	2,004	1,438	566	239	327	1,765	913
	September	2,001	1,428	573	245	328	1,756	808
2008	March	2,006	1,432	574	245	329	1,761	795
	September	1,998	1,424	574	245	329	1,753	726
2009	March	1,981	1,413	568	209	359	1,772	758

Source: SORS Semi-annual Report on the Employed and Wages RAD-1/P; Additional Survey to the Semi-annual RAD-1 Report; Semi-annual Report on Small Businesses and Their Employees RAD-15; National Employment Service (NES).

Notes:

1) By the registered number of employed, we refer to the formal economy, i.e. those employees with employment contracts and for whom social security contributions are being paid. By the registered number of unemployed, we refer to those persons that have registered with the National Employment Service (NES). NES moved from monitoring the number of job seekers to the number of unemployed persons in September 2004. This is why we do not have these data for the previous period (column 7).

2) Data in March 2009 are uncorrected data for February 2008. These are the most recent data available.

From September 2008 to March 2009 there was a significant drop of around 11,000 jobs in public companies (11.7% of sector employment), (Table T3-3). However, the total fall in public sector employment is somewhat smaller and amounts to 4,000 workplaces, due to the increase of around 7,000 employees financed from the budget.

Table T3-3. Serbia: Employees in the Public Sector, 2004–2009

		Employees in legal entities						
		Public sector						
		From the budget			Public enterprises		Public sector - total	Other[1]
		Administration - all levels	Education and culture	Health and social work	National public	Local public		
		1	2	3	4	5	6	7
		in thousands						
2004	March	63	117	147	125	57	509	1,092
	September	63	116	148	124	57	508	1,052
2005	March	63	119	148	122	61	513	1,044
	September	61	117	147	112	61	498	1,038
2006	March	60	118	141	105	61	485	1,011
	September	58	117	138	102	60	475	972
2007	March	58	121	138	100	59	476	962
	September	59	120	139	100	58	476	952
2008	March	60	124	140	99	58	481	951
	September	61	122	141	100	58	482	943
2009	March	64	125	142	89	57	478	935

Source: SORS.

Note: Those employed in the Ministry of Defense and the Ministry of the Interior, even though financed from the budget do not enter the total balance of the employed persons presented in this table. Their numbers are estimated at around 80,000, and they add another 4% to the total number of employed in Serbia. The data on their exact numbers and wages are not published by the SORS because of national security concerns

Footnotes:

1) Private, socially-owned and mixed ownership enterprises (without entrepreneurs). This column is not disaggregated further due to data availability limitations. The number presented in column 7 is calculated by subtracting the total number of employees in public enterprises and those financed from the budget from the total number of employees in legal entities from Table T3-2.

According to the National Employment Service data, a decreasing trend in the number of unemployed has decelerated with regard to the 2008 e-o-y figures

National Employment Service (NES) data on initiating and terminating employment contracts offer at this moment probably a more reliable picture of the net change in the number of employees than the RAD survey data. Namely, by following the dynamics of initiating and terminating employment contracts, we can see that from the beginning of October 2008 until February 2009, the decrease in the number of employees amounted to 9,000 and 13,500 by the end of April. Aside from that, NES data show that the decreasing trend decelerated in the first months of 2009 compared to the end of 2008.

On the basis of administrative data from NES, there was an increase of 32,000 unemployed persons for the first time since March 2006 (Table T3-2). However, there are still less unemployed people registered with NES than in March 2008.

Wages

As of this issue of *Quarterly Monitor*, wages will be published in accordance with the sampling frame from the SORS RAD survey.

Y-o-y real wage growth rate has fallen from 4.1% in Q4 2008 to 2.6% in Q1 2009

Real wage growth continued to decelerate in Q1 2009, but was still positive. The y-o-y real wage growth rate has fallen from 4.1% in Q4 2008 to 2.6% in Q1 2009, but this slowdown trend is significantly lower than in December 2008 (12%) and amounts to 0.5 percentage points. Bearing in mind the change in the sampling frame on the basis of which the average wages are calculated (inclusion of employees with physical persons that led to a sharp decrease in published data on the average wage), that is to say observing the 2008 wages calculated in accordance with the new frame, we can see that real wages in Q1 2009 are approximately at the same level as in the last quarter of the previous year. This is also confirmed by the data for April 2009 when the average real wage was at about the same level as last year.

Nominal wages continue to grow slowly, which is partly owed to the change in the samling frame within the RAD survey

Nominal wages continued to grow in Q1 2009 (12.5% compared to Q1 2008), but the slowdown trend started in 2008 can still be seen (the nominal y-o-y growth rate is 2.6 percentage points lower than the growth rate in Q4 2008, and even 6.8 percentage points compared to Q1 2008). The slowdown trend was also registered in April 2009 (12.3% compared to April 2008). It is interesting that the nominal wage growth rate in Q1 2009 is somewhat higher than in December 2008 (by 0.5 percentage points).

The slowdown in the nominal wage growth is partly due to the change in methodology used to calculate average wages within the RAD-1 survey, which we described in issue 15 of *Quarterly*

Monitor. As a reminder, as of January 2009 SORS has widened the sampling frame of the units observed. Now, aside from the wages paid to employees with legal entities, the wages paid by entrepreneurs (natural persons) are also taken into account. Data on the wages of employees with entrepreneurs are taken from the records kept by the Public Revenue Administration of the Ministry of Finance.

Table T3-4. Serbia: Average Monthly Wage and Real Y-o-y Wage Indices, 2004–2009

	Average Monthly Wage				Average Gross Monthly Wage Index[2)]	
	Total labour costs[1)], in dinars	Net wage, in dinars	Total labour costs, in euros	Net wage, in euros	nominal	real
	1	2	3	4	5	6
2004	24,234	14,108	334	194	123.7	111.4
2005	30,142	17,478	364	211	124.4	107.1
2006	37,493	21,745	445	258	124.4	111.3
2007	45,723	27,785	572	347	121.9	114.6
2008*	47,882	29,174	586	357	117.8	105.5
2007						
Q1	41,319	25,103	517	314	124.2	118.5
Q2	44,684	27,165	551	335	122.6	118.6
Q3	46,108	28,019	576	350	121.7	114.1
Q4	50,781	30,855	644	392	119.8	108.2
Dec	56,736	34,471	713	433	116.5	104.1
2008*						
Q1	43,957	26,814	532	324	119.3	105.2
Q2	47,351	28,846	584	356	119.4	103.1
Q3	48,322	29,435	627	382	117.9	105.0
Q4	51,898	31,599	602	366	115.1	104.1
Dec	56,399	34,348	637	388	112.0	103.1
2009						
Q1	49,444	30,120	525	320	112.5	102.6
April	49,769	31,351	523	329	112.3	103.8

Source: SORS.
Note: Data for 2008 are updated on the basis of expanded data include in sample for computing the average earnings. Therefore, the nominal value of earnings for 2008 is comparable with the nominal value of 2009, but are not comparable with previous years.
Footnotes:
1) Total labor costs include empoloyer's total average expense per worker, including all taxes and social security contributions. TLCs amount to around 164.5% of the average net wage.
2) Gross wage indices are equal to total labor cost indices, because the average TLC is larger than the average gross wage by a fixed 17.9%.

Table T3-4 shows the trends in average monthly wages. Due to the change in the sampling frame for calculating wages from the beginning of 2009, the data in the Table are adjusted in such a way as make the 2008 data comparable with the average monthly wage from Q1 2009. Net wages for 2008 (column 2) are recalculated in line with the new methodology. On the basis of these wages the values of total labor costs in dinars and euros were determined, as well as the net wages in euros (columns 1, 3 and 4). Y-o-y indices of average monthly gross wages for Q1 2009 (nominal and real) are calculated by comparing the corresponding values of wages calculated by the new methodology, while the indices for 2008 are determined by comparing the values of wages calculated using the old methodology. Supposing that the dynamics of the wages paid by entrepreneurs and legal entities are the same, y-o-y wage growth indices are comparable.

The depreciation of the dinar continues to have an impact on the variations of the average wage expressed in euros

In Q1 2009, the average net wage was €320, which represents a decrease of 14.6% compared to Q4 2008 (when the average net wage amounted to €366). Nevertheless, compared to Q1 2008 (€324) the decrease is much smaller and amounts to 1.49% (Table T3-4). These variations in the average wage expressed in euros are, for the most part, a result of the depreciation of the dinar in the preceding period.

The biggest y-o-y real wage growth was registered in the hotels and restaurants sector and in wholesale and retail trade

Table T3-5 shows the trends in y-o-y gross wage real indices in different sectors. The last column (Q1 2009) shows gross wage trends in Q1 2009 compared to the 2008 average calculated in accordance with the new methodology. Observing the y-o-y change of the average wage in different sectors, it can be concluded that almost all sectors saw real gross wage growth. The sectors that saw y-o-y growth[2] of real gross wages in Q1 2009 are the following: hotels and restaurants (17.8%), trade (12%) and financial intermediation (11.8%) with the biggest y-o-y growth, followed by construction (5.7%) and real estate activities (2.5%).

2 Except agriculture (1,5) and fishing (5,6), both susceptible to big seasonal variations.

The drop in real gross wages registered for the first time in the sectors of education and manufacturing industry

The drop in real gross wages in Q1 2009 is registered in the sectors of education (-3.2%) and manufacturing industry (-1.7%). The education sector and the manufacturing industry underwent a significant gross wages trend change – a negative trend appears for the first time since we started monitoring the series.

Table T3-5. Serbia: Average Gross Wages by Activities, Y-o-y Real Indices, 2006–2009

	2006	2007	2008	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009
Total	111.3	114.6	105.5	114.2	108.2	105.2	103.1	105.0	104.1	102.6
Agriculture, forestry and water works supply	114.7	107.6	111.2	108.2	106.3	113.0	113.0	110.3	108.3	101.5
Fishing	92.6	86.7	127.5	101.5	103.0	118.0	179.7	87.8	124.6	105.6
Mining and quarrying	113.5	118.5	101.2	111.3	106.4	91.9	98.9	105.7	108.2	104.4
Manufacturing	113.7	111.6	105.8	109.7	106.8	108.3	103.2	105.6	105.9	98.4
Electricity, gas and water supply	106.3	118.7	97.1	110.1	103.8	82.4	98.8	102.7	104.3	103.2
Construction	112.9	117.2	107.2	112.9	106.1	108.7	105.0	107.5	107.6	105.7
Wholesale and retail trade, repair	114.5	113.1	108.2	113.5	105.1	109.4	107.4	108.0	108.1	111.9
Hotels and restaurants	109.5	112.9	103.9	115.6	109.2	110.0	104.1	102.9	98.8	117.8
Transport, storage and communications	108.5	108.9	104.0	108.4	106.9	105.8	102.6	104.6	102.8	101.5
Financial intermediation	112.4	109.1	98.3	105.2	106.7	93.4	95.6	103.9	100.3	111.8
Real estate, renting activities	103.4	119.6	98.5	116.6	119.0	105.2	95.3	97.6	96.0	102.5
Public administration and social insurance	109.2	111.3	100.7	113.2	102.2	98.3	100.6	101.3	102.7	100.6
Education	108.9	114.3	106.5	116.3	110.5	110.2	106.1	104.9	104.7	96.8
Health and social work	108.5	123.9	101.5	127.2	112.0	105.6	99.4	100.9	100.2	100.3
Other community, social and personal service	105.0	107.4	101.6	110.6	101.0	102.1	100.5	101.2	102.5	101.8

Source: SORS, RAD-1 Survey.
Notes: Data for Y-o-y Real Indices in Q1 2009. are average for January and February 2009. These are the most recent data available.

The public sector saw a decrease in real wages, except in local public companies, where growth is still below the Serbian average

The public sector saw y-o-y growth only in local public companies (1.1%), which is below the average for Serbia, where a rate of 2.5% was recorded. Negative rates of wage growth, aside from the education, were seen in health sector and public companies (1.7%, 0.3% and 1.2% respectively).

Table T3-6. Serbia: Gross Wages in Public Sector 2004-2009, Y-o-y Real Indices

	From the budget			Public enterprises			
	Administration - all levels	Education and culture	Health and social work	National public	Local public	Other[1]	Serbia average
	1	2	3	4	5	6	7
2004	107.4	107.7	110.9	107.9	113.4	113.7	111.4
2005	105.9	106.0	100.8	100.5	103.0	106.9	107.1
2006	109.1	107.2	109.4	110.8	102.9	113.7	111.3
2007	111.1	114.7	123.8	116.7	105.0	114.1	114.6
2008	100.7	105.7	101.3	101.2	95.9	105.7	105.5
2007							
Q1	111.5	112.6	125.4	129.8	113.8	117.3	118.5
Q2	118.6	119.2	131.5	118.9	104.5	117.4	118.6
Q3	114.1	116.7	127.5	112.5	104.1	112.5	114.1
Q4	100.1	110.3	111.0	105.8	97.4	109.0	108.2
2008							
Q1	99.2	109.5	105.6	94.3	98.5	107.3	105.2
Q2	99.6	104.8	99.4	103.0	89.0	104.2	103.1
Q3	100.8	104.7	101.1	103.6	91.7	106.3	105.0
Q4	103.3	103.7	99.2	103.9	104.4	105.1	104.1
2009							
Q1	100.1	98.3	99.7	98.8	101.1	105.1	102.5

Source: SORS.
Footnotes:
1) Column 6 includes private, socially-owned and mixed ownership enterprises (without entrepreneurs).
2) Column 6 represents the value for each time period inferred from difference between the total wage bill and the public sector wage bill, which is then divided by the number of employees in the economy (column 6, Table T3-2).

4. Balance of Payments and Foreign Trade

Q1 2009 saw record lows in Serbia's current account deficit (11.8% of GDP) and goods deficit (19.0% of GDP), accompanied by sharp y-o-y drops in imports of 25.3% and in exports of 22.4%. The financial account was positive due to inflows of FDIs, cash and deposits, as well as because of a fall in foreign currency reserves. Banks have to a large extent been repaying short-term loans taken out over the previous quarter. The crisis has hit Serbia, as evidenced by a pronounced fall in imports due to shrinking domestic demand, as well as by a fall in exports caused by the global situation and declining domestic production.

The exceptionally low current account deficit – € 810 mn, or 11.8% of GDP – recorded in Q1 2009…

The current account deficit amounted to €810.7 mn in Q1 2009 (11.8% of quarterly GDP). Such a low value has not been seen for the past two years, ever since the switch to new methodology in monitoring balance of payments data.[1] The current account deficit amounted to 17.4% of GDP in 2008 (or, by individual quarter, 17.3%, 20.4%, 16.6% and 15.1% in Q1, Q2, Q3 and Q4, respectively). The lower current account deficit seen in Q1 was solely the consequence of a drop in the foreign trade deficit, in turn caused by a marked fall in imports and exports due to global recession, falling demand and declining production.

…was caused by the marked drop in the value of both imports and exports

The goods deficit reached a two-year low in Q1, falling to €1.3 bn (19.0% of GDP)

The first three months of 2009 recorded a goods deficit amounting to €1.3 bn (19.0% of estimated quarterly GDP). In both absolute and relative terms, this is the lowest value when compared to corresponding levels seen in 2007 and 2008 (in 2007, the share of the goods deficit in GDP fluctuated between 20.9% seen in Q3 and 24.8% in Q4, while 2008 saw values of between 21.3% in Q3 and 24.1% in Q1, Table T4-1). Compared with Q4 2008, the share of the goods deficit in GDP was lower by 3.2 percentage points. The sharp drop in domestic and foreign economic activity caused a major reduction in the value of imports and exports in Q1 2009. Imports recorded a very low quarterly value of €2,590.9 mn (37.8% of GDP), whereas exports stood at €1,292.1 mn, or 18.9% of GDP, which is noticeably lower in comparison to quarterly values for the past two years.[2]

Exports fell by 22.4% y-o-y, while imports declined by 25.3%

The first quarter of 2009 saw exports fall by 22.4% y-o-y, while imports declined by 25.3%. Since imports slowed more markedly than exports, the goods deficit fell by €505.9 mn y-o-y, a drop of 28.0%. As net current transfers remained virtually unchanged, and as net factor transfer outflows stood at a slightly lower level than last year, it is clear that the 37.9% y-o-y drop in the current account deficit can be ascribed exclusively to the fall in the foreign trade deficit (Table T4-1).

The current account deficit was met from two sources – FDIs and NBS foreign currency reserves

The current account deficit was covered from two sources: NBS foreign currency reserves (which were reduced by €248.5 mn) and the remainder of the financial account (FDIs amounting to €641 mn, less €4.2 mn – the amount of portfolio investments withdrawn – and net outflows of other investments totalling €51.1 mn, see Table T4-1). February accounted for €450 mn of total Q1 FDIs (with €400 mn received in early February as payment for NIS, the national oil company). If the change in foreign currency reserves is excluded from the quarterly value of the financial account of €831.7 mn, it becomes apparent that Q1 2009 recorded a surplus of €583.2 mn. When viewed in this light, the financial account surplus represents just 40% of the Q1 2008 financial account (€1,428.5 mn) when changes to foreign currency reserves are excluded. The capital account – which recorded a surplus of €8.5 mn last year – stands balanced in Q1 (with a deficit of €0.7 mn).

Q1 saw a substantial repayment of liabilities arising from financial loans, totalling €722.9 mn

When viewed at the y-o-y level, commercial loans have seen a slight drop in Q1 (-3.3%) to €95.4 mn. A hallmark of Q1 2009 has been a substantial repayment of liabilities arising from financial

1 Since January 2007, balance of payments data have been prepared using new NBS methodology (for a detailed explanation, see Section 6, Balance of Payments and Foreign Trade, in QM 12, as well as http://www.imf.org/external/np/sta/bop/BOPman.pdf).

2 Corrected NBS data on imports and exports (f.o.b.) calculated in accordance with IMF methodology were used in the analysis of the balance of payments (Balance of Payments Manual, Fifth Edition, IMF: http://www.imf.org/external/np/sta/bop/BOPman.pdf, whereas SORS data was used for the analysis of imports and exports. The SORS data differs methodologically from NBS data; hence the discrepancies in the imports and exports figures and growth rates.

loans, totalling €722.9 mn. Banks repaid €578.6 mn over this three-month period, of which €560 mn were repayments of short-term loans taken out over the last trimester of 2008. The private sector borrowed €274.2 mn in long-term loans, at the same time repaying €386.1 mn; net repayment of long-term liabilities by this sector thus amounted to €111.9 mn. The private sector also repaid €32.2 mn in liabilities arising from short-term loans (Table P-10 in the Analytical Appendix).

Cash and deposits saw substantial inflows (€576.5 mn)

The first quarter recorded major inflows of cash and deposits, totalling €576.5 mn (especially with regard to the high negative value of this item in Q1 2008, with a drop of nearly €1.4 bn). This indicates a partial recovery of trust in the banking sector on the part of the public.

Foreign currency reserves declined by €248.5 mn over the first three months

Foreign currency reserves declined over the first three months of 2009 by €248.5 mn cumulatively (Table T4-1). The increase in foreign currency reserves of €179.9 mn recorded in February failed to offset drops of €382.3 mn and €46.2 mn seen in January and March respectively, so that foreign currency reserves were down by €248.5 mn relative to late 2008.

Table T4-1. Serbia: Balance of Payments[1)]

	2007	2008	2008				2009
			Q1	Q2	Q3	Q4	Q1
				in millions of euros			
CURRENT ACCOUNT	-4,605	-5,882	-1,305	-1,764	-1,524	-1,290	-811
Goods	-6,629	-7,633	-1,805	-1,987	-1,947	-1,894	-1,299
Export f.o.b[2)]	6,373	7,419	1,665	1,969	2,061	1,723	1,292
Import f.o.b	-13,001	-15,052	-3,470	-3,956	-4,008	-3,617	-2,591
Services	-254	-178	24	-72	-107	-23	-36
Export	2,304	2,739	676	637	733	692	567
Import	-2,558	-2,917	-652	-710	-840	-715	-603
Income, net	-600	-929	-139	-308	-125	-357	-124
Receipts	517	561	145	137	158	121	117
Payments	-1,116	-1,490	-284	-445	-283	-479	-242
Current transfers, net	2,877	2,859	615	604	655	985	648
o/w grants	166	210	43	64	52	50	38
o/w private remittances, net	2,065	2,206	412	614	430	750	460
CAPITAL ACCOUNT	-314	6	8	0	-2	-1	-1
FINANCIAL ACCOUNT	4,742	5,977	1,399	1,672	1,430	1,476	834
Direct investment, net	1,821	1,800	807	650	133	210	641
Portfolio investment, net	678	-92	-48	-38	26	-31	-4
Other investments	2,977	2,509	669	750	1,528	-439	-51
Trade credits	328	71	99	-77	-167	216	95
Loans	3,403	3,134	232	812	1,362	728	-723
NBS	-92	0	0	0	0	0	0
Government	121	52	1	14	11	26	0
Commercial banks	167	95	-538	-88	334	387	-579
Long-term	-130	-340	-163	-90	27	-114	-19
Short-term	297	435	-375	2	307	501	-560
Other (enterprises)	3,206	2,987	769	886	1,017	316	-144
Currency and deposits	-652	-666	352	32	333	-1,383	576
Other assets and liabilities	-102	-30	-13	-17	0	0	0
Reserves Assets (- increase)	-734	1,760	-29	310	-257	1,736	249
ERRORS AND OMISSIONS, net	177	-101	-103	91	96	-185	-22
OVERALL BALANCE	734	-1,760	29	-310	257	-1,736	-249
PRO MEMORIA							
				in % of GDP			
Current account	-15.9	-17.4	-17.3	-20.4	-16.6	-15.1	-11.8
Balance of goods	-22.8	-22.6	-24.1	-23.0	-21.3	-22.2	-19.0
Exports of goods	21.9	22.0	22.3	22.8	22.5	20.2	18.9
Imports of goods	-44.8	-44.5	-46.4	-45.8	-43.8	-42.5	-37.8
Balance of goods and services	-23.7	-23.1	-23.7	-23.9	-22.4	-22.5	-19.5
Current transfers, net	9.9	8.5	8.2	7.0	7.2	11.6	9.5
GDP in euros[3)]	29,037	33,795	7,484	8,633	9,157	8,521	6,853

Source: NBS.

1) Original data in US dollars converted into euros at the monthly level using monthly averages of official daily NBS mid rates.

2) Exports f.o.b. using NBS methodology adjusted to IMF BOPM-5.

3) Quarterly values. Annual GDP converted into euros using the average annual exchange rate (average of official NBS daily mid rates).

Trends

Foreign Debt

Serbia's total foreign debt now amounts to €21,445 mn (64.7% of GDP)

Serbia's foreign debt stood at €21,445 mn in March 2009, €3.5 bn more than in March 2008 (Table T4-2). The share of total foreign debt in GDP amounted to 64.7%, or 5.3 percentage points more than in March last year. This rise in the foreign debt as percentage of GDP is the consequence of a simultaneous y-o-y rise in foreign borrowing, depreciation of the dinar in relation to the euro, and the fall in GDP expressed in euros. A reduction amounting to €355 mn is apparent when one compares the current overall debt situation with that seen in late 2008 – this fall happened due to the private sector, primarily banks, repaying their short-term liabilities to a great extent.

Table T4-2. Serbia: Foreign Debt by Structure, 2005–2009

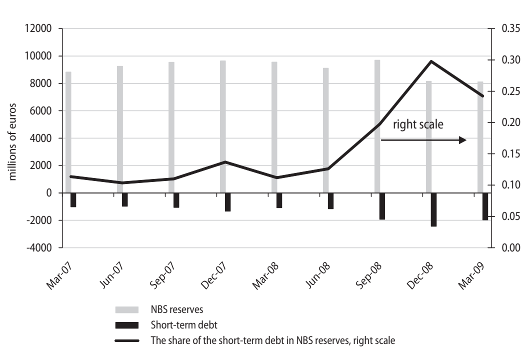
	2005	2006	2007	2008				2009
				Mar	Jun	Sep	Dec	Mar
	stocks, in EUR millions, end of the period							
Total foreign debt	13,064	14,884	17,789	17,957	18,647	20,530	21,800	21,445
(in % of GDP)	*61.9*	*59.8*	*61.3*	*59.4*	*58.6*	*61.3*	*64.5*	*64.7*
Public debt	7,714	6,420	6,130	6,035	6,047	6,282	6,386	6,528
(in % of GDP)	*36.5*	*25.8*	*21.1*	*20.0*	*19.0*	*18.7*	*18.9*	*19.7*
Long term	7,630	6,363	6,096	6,003	6,016	6,247	6,369	6,509
o/w: to IMF	732	185	0	0	0	0	0	0
Short term	84	57	34	32	32	35	18	19
Private debt	5,350	8,464	11,659	11,922	12,599	14,248	15,414	14,917
(in % of GDP)	*25.3*	*34.0*	*40.2*	*39.5*	*39.6*	*42.5*	*45.6*	*45.0*
Long term	4,156	7,263	10,372	10,883	11,482	12,366	13,006	12,970
o/w: Banks debt	1,260	2,929	2,801	2,660	2,333	2,357	2,301	2,270
o/w: Enterprises debt	2,895	4,334	7,571	8,223	9,149	10,009	10,705	10,700
Short term	1,194	1,201	1,287	1,039	1,118	1,882	2,408	1,948
o/w: Banks debt	924	942	1,163	770	769	1,118	1,605	1,154
o/w: Enterprises debt	271	259	124	269	349	764	803	794
Foren debt, net [1], (in% of GD	38.5	23.6	28.1	27.8	30.0	32.2	40.4	40.2

Source: NBS.
1) Total foreign debt less NBS currency reserves.

Public foreign debt amounted to €6,528 mn in March 2009 (19.7% of GDP)

Over the past year Serbia's foreign debt rose by a nominal €493.0 mn, and fell in relative terms (i.e. expressed as % of GDP) by 0.3 percentage points of GDP. Public foreign debt amounted to €6,528 mn in March 2009[3] (19.7% of GDP, Table T4-2). In relation to the situation seen three months before, public foreign debt was up by €141.6 mn or 0.8 percentage points of GDP.

Graph T4-3. Serbia: Short-Term Foreign Debt and Foreign Currency Reserves, 2007–2009



Source: NBS.

Private foreign debt stood at €14.9 bn, or 45.0% of GDP

Private foreign debt amounted to €14.9 bn, or 45.0% of GDP. The value recorded at the end of March 2009 was higher by €3 bn than that seen in March 2008. However, this figure stands €497 mn – 5.5 percentage points – lower in relation to the situation at year-end 2008. The reason behind this drop in the private foreign debt is the repayment of loans, primarily short-term ones, previously taken out by banks and companies.

There has been substantial repayment of liabilities, especially short-term ones

Long-term liabilities were repaid to the tune of €36.4 mn – mostly (€30.9 mn) by the banking sector. The first quarter of 2009 saw banks repay most short-term loans taken out in Q4 2008.

3 The part of this text analyzing pubic debt (see Highlights 4, Public debt of the Republic of Serbia, in the Highlights section of this issue of QM) uses data published by the SORS that include only regulated state debt. On the other hand, the part of the text analyzing foreign debt uses NBS data that differ in methodology from SORS information (NBS data also include non-regulated state debt). This accounts for the difference in the indicated value of public foreign debt.

Total short-term loan repayment amounted to €460.6 mn, of which the banking sector accounted for €451.7 mn. The greatest part (91%) of the substantial reduction in private debt recorded in Q1 can be ascribed to the repayment of short-term liabilities by banks. Notwithstanding the drop in foreign currency reserves, the major reduction in overall short-term foreign debt has contributed to a fall in the ratio of debt to foreign currency reserves, from 29.7% in Q4 2008 to 24.2% in Q1 2009 (Graph T4-3).

EXPORTS

The impact of the crisis on Serbia's exports has increased in Q1 2009…

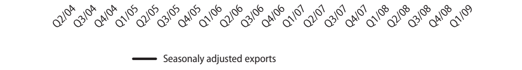
…with exports recording a y-o-y fall of 23.8%

Ever since 2004, exports have been recording exceptionally high y-o-y growth rates. Thus in 2005 and 2006 exports grew at a y-o-y rate of 34.1%; the figure for 2007 was 25.9%, while in 2008 exports slowed slightly, recording an average y-o-y growth of 16.1%. Although exports did see robust y-o-y growth of 20%, over the first three quarters of last year, this decelerated rapidly in Q4, due to the global financial crisis, to a very low 1.7%. The impact of the crisis on Serbia's overall exports became even more pronounced in Q1 2009: exports of goods declined by a dramatic 23.8% (Table T4-5) in relation to the same period one year before.

When individual months of Q1 2009 are considered, February saw the greatest y-o-y fall in the value of exports (29.5%). January recorded a drop in exports of 23.9% in relation to January 2008, while a slightly lower drop was seen in March, 18.5% at the y-o-y level. We cannot, however, base any conclusions as to the future trend on this recovery of exports in March in relation to January – and especially February – since forecasts are rather unreliable in a time of crisis.

When one eliminates seasonal influences and compares consecutive quarterly values, the dramatic fall in exports over the first three months of 2009 becomes even more apparent (Graph T4-4). In relation to Q4 2008, exports were down by 12% in Q1 2009. If this quarterly downward trend were to continue, exports would fall by 40% at the y-o-y level within one year. From the second quarter of 2008 onward, viewed at the quarterly level, exports have slowed. Annualized q-o-q changes to exports in Q2 2008 stood at 2.2%, only to become negative in the second half of the year and then go further into negative territory (the fall amounted to 7.7% in Q3 2008 and 32.0% in Q4).[4] The trend of falling exports that began last year became even more marked in Q1 2009, when the value of exported goods fell by an annualized q-o-q rate of 40% (Graph T4-4). This indicates a drop in global demand in evidence since mid-2008, which has also had an impact on Serbian exports.

Graph T4-4. Serbia: Seasonally-Adjusted Exports, by Quarter, 2004–2009



Source: SORS, QM.

The values of both export components, bulky exports and underlying exports, also recorded substantial falls at the y-o-y level

Values of both export components usually followed by the *Quarterly Monitor*, *bulky exports* and *underlying exports*, also declined markedly at the y-o-y level over the first three months of 2009 (Table T4-5).

4 Use of seasonal adjustment methods leads to slight variations in seasonally adjusted data as the amount of data changes.

Table T4-5. Serbia: Exports, Y-o-y Growth Rates, 2008–2009

	Exports share	2009 Q1	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1
	%	mil.euros	y-o-y growth rate (%)				
Total	100.0	1,276	20.5	23.8	19.6	1.7	-23.8
Bulky exports	27.1	296	1.9	13.8	8.0	-0.2	-36.0
Iron and steel	13.0	101	3.6	40.6	36.0	-10.7	-54.0
Non ferrous metals	6.4	65	4.5	-0.9	-1.2	-25.7	-48.4
Fruits and vegetables	4.4	62	13.9	-14.5	-8.0	-0.9	-5.2
Cereal and cereal products	3.4	68	-19.1	-20.3	-29.6	93.4	30.3
Underlying exports	72.9	980	29.6	28.0	25.0	2.3	-19.2
Core	30.5	429	23.5	13.7	9.3	-9.8	-21.8
Clothes	4.9	115	15.5	12.0	2.4	22.1	29.5
Miscellaneous manufactured articles, n.e.s.	4.2	50	50.7	25.4	9.1	-13.5	-35.2
Manufactures of metals, n.e.s.	4.3	48	26.9	1.3	-0.5	-10.3	-36.4
Rubber products	2.9	44	3.3	5.5	27.8	-19.2	-22.5
Electrical machinery, apparatus and appliances	3.9	62	50.9	21.7	30.3	2.8	-1.0
Organic chemicals	2.3	8	7.9	25.7	-5.3	-50.3	-83.1
Plastics in primary forms	1.9	20	34.4	10.1	6.7	-41.9	-49.9
Footwear	2.2	37	15.8	8.4	9.0	3.8	-8.4
Paper, paperboard and articles of paper pulp	1.9	32	21.4	13.5	1.9	-7.2	-2.0
Non-metal mineral produce	2.0	13	10.3	19.9	16.7	-4.9	-54.7
Other	42.3	551	35.0	40.4	39.4	12.2	-17.0

Source: SORS.

Bulky exports were down by 36.0% at the y-o-y level

A hallmark of bulky exports was very fast growth in 2004, 2005 and 2006. Over this three-year period, y-o-y changes in the value this component amounted to some 45%. Growth slowed over the following two years (y-o-y growth stood at 14.0% in 2007 and 6.3% in 2008), primarily as a consequence of falling global demand for iron and steel and non-ferrous metals (together accounting for 70% of bulky exports by value) – and thus a drop in quantities exported, as well as the fall in the price of these products in the global market since the second half of 2008. After bulky exports reached historic lows in late 2007 and early 2008,[5] Q2 and Q3 2008 saw the growth trend stabilize, at 13.8% and 8.0% respectively, before the global crisis caused another disruption. Bulky exports again reached levels similar to Q4 2007 lows in Q4 2008 (with a slight drop of 0.2%), only for levels of this component to suffer a complete collapse since the start of 2009 (with a fall of 36.0% at the y-o-y level, Table T4-5). When viewed by month, the trend is similar to movements in overall exports: the greatest y-o-y fall was recorded in February (40.9%), January saw a slightly smaller drop (36.9%), while the figure for March was an indication of modest recovery, with a y-o-y drop in value of 30.6%.

The value of exports of iron and steel has continued to follow the downward trend seen since the end of 2008

The value of *iron and steel* exports, part of the *bulky exports* component, fell by 54.0% y-o-y in Q1 2009, continuing the trend started in late 2008 when the first blast furnace at US Steel's Smederevo plant was shut down (Table T4-5). As global steel prices have stabilized over the last two quarters, we can conclude that the fall in the value of exports of these products can be ascribed to the drop in the quantity exported, which is in turn due to the fall in global demand. This has also had a substantial impact on the production of these products since the start of 2009. US Steel Serbia cut its working week to 32 hours in March; Blast Furnace No. 2 was idled in April. Final production did not cease altogether, but rather continued at a reduced rate, with US Steel Serbia currently sourcing semi-finished products from its plant in Kosice, Slovakia. The company has announced its intention to restart Blast Furnace No. 1 on the June 1st, but this does not necessarily imply a full recovery in production – the blast furnace will be restarted to produce a semi-finished product that cannot be made in Kosice, but it is still not known how long the market will require this type of product. As economic recovery in Europe and the rest of the world is still a long way off, we do not expect substantial growth in the value of exports of iron and steel in the near future. In addition, monthly data seem to confirm these expectations

5 Mainly due to plant reconstruction at US Steel Serbia, which substantially cut the production of steel.

– with the figure for March (a y-o-y fall of 53.5%) confirming the trend seen over the previous two months (down by 54.2% at the y-o-y level).

Exports of non-ferrous metals suffered a major fall

Exports of non-ferrous metals (in Serbia mainly aluminium and copper) recorded a substantial fall in Q1. The Q1 fall in the value of exports of these products amounted to 48.4% at the y-o-y level (Table T4-5). Copper prices have risen slightly in the global market since the beginning of the year, while aluminium prices have remained the same. This is an indicator of the fact that the fall in value can be ascribed to a drop in the quantity of non-ferrous metal products exported. As over 80% of all copper and over 50% of all aluminium produced is used in construction, electrical appliances and transport equipment, we do not expect to see a major recovery in exports of non-ferrous metals, as it is these sectors that have been especially hit by the global economic crisis.

Exports of fruit and vegetables recorded a slight drop in value…

…while cereals and cereal products saw y-o-y growth due to the low base used for comparison

Exports of fruit and vegetables saw their exports drop in value by 5.2%, while cereals and cereal products recorded growth of 30% (Table T4-5). However, it needs to be taken into consideration that cereal exports grew in comparison to Q1 2008, when the export ban on wheat and corn was in force.[6] If we were to compare export values of these products seen in Q1 2009 with those achieved over the rest of 2007 and 2008, they would be seen to be about average.

The value of *underlying exports* fell by 19.2% in Q1. Both the *core* and the *other* component of underlying exports were down, by 21.8% and 17.0% at the y-o-y level respectively (Table T4-5). This is the first quarter since Q2 2004 that the *other* component has seen a y-o-y fall.

The value of underlying exports fell in Q1…

…due to a fall across all core segments…

The *core* group has seen the value of nearly all of its components decline. The fall was especially pronounced for *organic chemicals* (83.1%), *plastics in primary forms* (49.9%) and *non-metallic mineral products* (54.7%). *Clothing* was the only segment to see export growth, at a rate of 29.5% (Table T4-5).

…as well as a drop in the other component

Monthly movements in components of *underlying exports* were identical to those seen by *total* and *bulky* exports – a sudden y-o-y fall in January (*underlying exports* fell by 18.3%, with *core* dropping by 18.6% and *other* down by 18% at the y-o-y level) that deepened in February (*underlying exports* falling by 25.2%; when disaggregated, a drop in *core* of 30.8% and in *other* of 20.7%), with a slight recovery in March (*underlying exports* down by 14.3%; *core* and *other* down by 16.0% and 12.9% at the y-o-y level respectively). These movements indicate that these two components are susceptible to external fluctuations, contrary to earlier expectations, and that a major recovery is not likely – as valuable as it would be to a future recovery of Serbia's overall exports.

IMPORTS

The major slump in the value of imports has continued due to recession…

The first quarter of 2009 saw the value of imports fall by 25.7%, continuing the trend begun as a consequence of the recession in late 2008. In addition, when imports are disaggregated into individual components, each one of them is seen to have recorded a fall.

…with imports falling by 25.7% in relation to last year

After seeing usual growth of some 25% throughout 2007 and the first half of 2008, imports began to decelerate slightly in Q3 2008 (with a y-o-y growth rate of 19.1%), only for the trend to reverse sharply in Q4 and for total imports to go down 2.8% at the y-o-y level. Although the dinar has stabilized since the beginning of the year, the recession has deepened to such an extent that domestic demand for imported products has slumped by 25.7% in Q1 in relation to the same period one year before (Table T4-7).

When imports are viewed by month, January is seen to have recorded a y-o-y drop of 27.8%; February and March saw drops of 28.3% and 21.9% respectively. This downward trend of imports means its fall is significantly greater in absolute terms in relation to the drop in exports. The resulting drop in foreign trade has led to a much lower goods deficit, as well as a drop in the current account deficit and an improvement in Serbia's overall foreign trade situation.[7]

6 For more details see Section 6, Balance of Payments and Foreign Trade, in previous issues of QM.
7 For more details see the first section of this article.

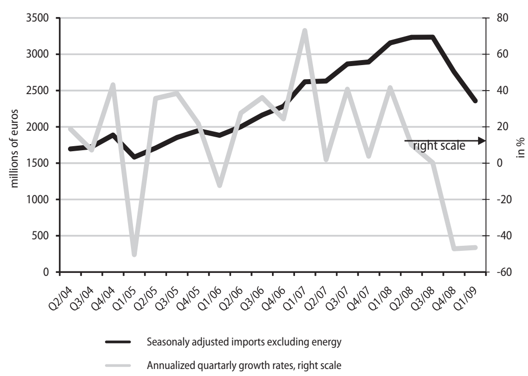
The y-o-y fall in imports less energy amounted to 25.0% in Q1

Imports less energy fell by 25.0% in Q1, while energy imports were down by 28.3% at the y-o-y level (Table T4-7). This decline in energy imports was affected by January's gas crisis, when the value of energy imported fell by 29.4% in relation to January 2008.

Seasonally-adjusted imports less energy also recorded substantial drops in Q1 2009. As compared to the final quarter of 2008, the fall in value of these imports amounted to 14.5%, or 46.5% at the annual level. As opposed to the gradual q-o-q decline recorded in the second half of 2008, the value of imports saw the first and most drastic q-o-q downturn of 14.8% (47.2% annualized) over the last quarter, with the negative trend remaining similarly negative in Q4 this year (Graph T4-6). This is a consequence of the recession in Serbia that has over the last two quarters become apparent in imports as well.

Imports of intermediate goods were down by 30.8% at the y-o-y level

Graph T4-6. Serbia: Seasonally Adjusted Imports Less Energy, by Quarter, 2004–2009



Source: SORS, *QM*.

Imports of intermediate goods were down by 30.8% at the y-o-y level, the same as the y-o-y drop seen in each individual month of Q1. If this trend continues, it could cause a substantial reduction in domestic production and thereby cut exports.

The value of imports of capital goods was down in Q1 by 28.0% compare to last year…

The value of imported capital goods was down in Q1 by 28.0% compare to last year (Table T4-7). Capital goods less motor vehicles recorded a drop of 21.3% compared to last year. When viewed by month, imports are seen to have fallen by most in January (24.2%); this was followed by another fall, of 20.7% in February, while the drop was lowest in March, standing at 19.9% at the y-o-y level. However, it is still too early to predict a recovery in imports based on these data.

…with capital goods less motor vehicles trending towards recovery

Table T4-7. Serbia: Imports, Y-o-y Growth Rates, 2008–2009

	Imports share (2008)	2009	2008				2009
		Q1	Q1	Q2	Q3	Q4	Q1
	in %	mil.euros	y-o-y growth (%)				
Total	100.0	2,683	22.8	27.5	19.1	-2.8	-25.7
Energy	20.0	565	32.5	53.2	51.2	5.7	-28.3
Intermediate products	34.4	831	16.2	16.0	12.8	-5.9	-30.8
Capital products	24.8	612	19.5	32.6	10.4	-11.9	-28.0
Capital products excluding road vehicles	16.8	438	9.3	29.3	13.1	-6.0	-21.3
Durable consumer goods	3.9	112	31.3	34.8	13.5	2.6	-15.8
Non-durable consumer goods	14.3	463	26.6	21.1	19.5	4.2	-10.4
Other	2.7	100	32.4	16.6	12.3	21.2	-19.5
Imports excluding energy	80.0	2,118	20.3	22.8	13.1	-4.7	-25.0

Source: SORS.

Values of imported durable and non-durable consumer goods were down

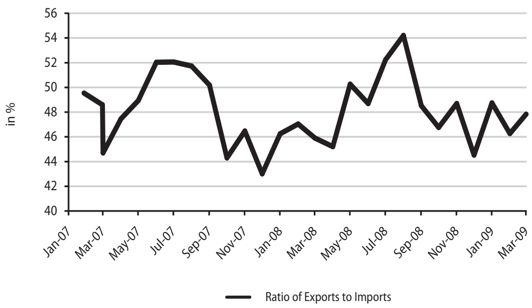
Imports of durable consumer goods fell by 15.8%, while those of non-durable consumer goods were down by 10.4% (Table T4-7). Monthly y-o-y growth rates of both of these components indicate a substantial fall in February and a less pronounced one in March.

This situation seems to indicate that the fall in imports was mainly generated by businesses (high, stable negative growth rates of intermediate and capital goods imports) rather than households – i.e. that it is a consequence of the recession and that no significant recovery is in sight for now.

Quarterly ratio of exports to imports stands at 47.6%

The ratio of exports to imports has remained high since the start of the year. Its quarterly value amounts to 47.6%, or 1.2 percentage points more than in Q1 2008. Monthly export/import ratio figures have remained high (Graph T4-8), notwithstanding a seasonal drop seen in December

Graph T4-8. Serbia: Ratio of Exports to Imports, 2007–2009



Source: SORS.

(caused by increased imports over the holiday season).

The global financial crisis and recession have led to a fall in Serbia's imports greater than that seen by exports. This has in turn caused a reduction in the trade deficit (and improved the current account deficit as a whole), albeit at the cost of substantially pushing down production. As Serbia's economy recovers from the recession, production and imports will begin to grow again. However, imports will be unable to reach high levels seen previously, as there will no longer be major capital inflows from abroad that could be used to finance this. The only possible means of achieving such high import levels will be the growth of Serbian exports.

5. Prices and the Exchange Rate

Total inflation over the first four months of 2009 was very high, but our estimate is that the underlying inflation trend is lower, and may even be showing certain signs of slowing down. Inflation as measured using the Retail Price Index (RPI) amounted to 7% over the first four months, or 22.8% annualized, while the figure obtained using the Consumer Price Index (CPI) stood at 4.8%, or 15.2% when annualized. However, inflation was mainly spurred on by administrative measures (an increase in excise duties and rising administratively controlled prices) and exogenous factors (the rise in the price of oil). Core inflation, measuring movements in the prices of products and services whose prices are established by the market, accounted for only 20% of the rise in the RPI over the past four months. Similarly, when oil products and products whose prices rose due to administrative measures are excluded from the CPI, it is seen to have risen by 2.8% from January to May, or 8.8% annualized; the annualized increase amounted to 10.0% in Q4 2008. After depreciating substantially over the last three months of 2008, the dinar's exchange rate has remained stable since mid-January, while the NBS has not intervened in the foreign exchange market in March and April. The real depreciation of the dinar against the euro from the start of the economic crisis (i.e. since mid-September) to April amounted to about 15%.

Inflation was very high in Q1 …

Inflation as measured using the Retail Price Index (RPI) has been very high since early 2009: Q1 saw a rate of 5.8%, i.e. as much as 25.6% annualized. As of April, the rise in retail prices has stood at 7.0%, or as much as 22.8% annualized. As a reminder, the rise in retail prices in Q4 2008 amounted to a mere 0.2% annualized (Table T5-1). The y-o-y inflation rate stood at 9.8% over the whole of Q1, while the figure for April was 10.0%.

Table T5-1. Serbia: Retail Price Index and Core Inflation, 2005–2009

	Retail Price Index					Core Inflation				
	base index (avg. 2005 =100)	y-o-y growth	cumulative index	monthly growth	3m moving average, annualized[1)]	base index (avg. 2005 =100)	y-o-y growth	cumulative index1)	monthly growth	3m moving average, annualized[1)]
2006										
Mar	110.0	14.4	2.2	0.3	9.1	108.1	11.7	1.7	0.8	7.0
Jun	113.7	15.1	5.7	0.0	14.4	110.4	11.3	3.9	0.6	8.7
Sep	114.1	11.6	6.1	-0.2	1.4	112.1	10.1	5.5	0.6	6.6
Dec	114.7	6.6	6.6	0.1	2.1	112.5	5.8	5.8	0.0	1.2
2007										
Mar	116.1	5.6	1.2	0.8	5.1	112.4	4.0	-0.1	0.1	-0.4
Jun	119.5	5.1	4.2	0.6	12.0	113.4	2.7	0.8	0.5	3.7
Sep	122.6	7.4	6.9	0.8	10.9	115.9	3.4	3.1	1.0	9.4
Dec	126.3	10.1	10.1	1.3	12.6	118.6	5.4	5.4	0.9	9.5
2008										
Mar	129.8	11.8	2.8	1.2	11.6	120.3	7.0	1.4	0.6	5.8
Jun	134.0	12.1	6.1	1.0	13.4	124.7	10.0	5.2	1.4	15.7
Sep	134.8	9.9	6.7	0.2	2.4	127.7	10.2	7.7	0.9	9.9
Oct	136.4	10.6	8.0	1.2	6.8	129.2	10.7	8.9	1.1	12.7
Nov	136.2	9.2	7.8	-0.1	5.2	130.1	10.7	9.7	0.7	11.4
Dec	134.8	6.8	6.7	-1.0	0.2	130.6	10.1	10.1	0.4	9.2
2009										
Jan[2)]	138.8	8.9	3.0	3.0	7.9	131.9	10.9	1.0	1.0	8.8
Feb	142.0	10.7	5.3	2.3	18.6	133.5	11.6	2.2	1.2	10.9
Mar	142.7	9.9	5.8	0.5	25.6	134.0	11.4	2.6	0.4	10.8
Apr	144.3	10.0	7.0	1.1	16.7	134.4	10.5	2.9	0.4	7.9

Source: SORS, NBS.

1) Moving averages of monthly price increases for three months, annualized (e.g., the value for March was obtained through annualization of the average of monthly price increases in January, February and March).

2) The Statistical Office of the Republic of Serbia discontinued the practice of publishing core inflation data in January 2009. Thus core inflation data from that period onward are *QM* estimates based on available information.

… but above all as a consequence of a rise in regulated prices

However, such substantial price growth over the first four months of 2009 was mainly caused by administrative corrections, and is to a lesser extent the reflection of events in the market.

Namely, the contribution of core inflation[1] to total inflation as measured using the RPI amounted to 20% over the first four months of 2009, while the contribution of prices and services under administrative control or heavily influenced by exogenous factors (“non-core” inflation) stood at as much as 80% (Table T5-2). Core inflation over the first four months of the year stood at 2.9%, or 9.1% annualized. On the other hand, non-core inflation over the same period amounted to as much as 11.7%, or 39.3% annualized.

Table T5-2. Serbia: Retail Price Index, Contribution to Growth by Selected Components, 2009

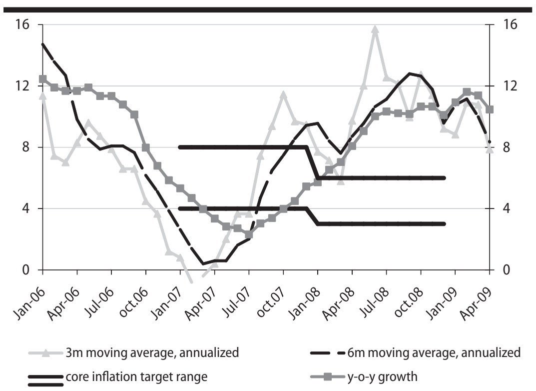
	Share in RPI	Price growth in the period Apr09 / Dec08	Annualized price growth in the period Apr09 / Dec08	Contribution to RPI growth in the period Apr09 / Dec08
		in %		
Total RPI	100.0	7.0	22.8	100.0
Core inflation	49.5	2.9	9.0	19.7
"Non-core" inflation	50.5	11.7	39.3	80.3
Agricultural products	4.1	9.8	32.4	5.4
Tobacco products	4.2	14.9	51.7	8.6
Electricity	7.7	0.0	0.0	0.0
Liquid fuels and lubricants	9.3	19.7	71.6	24.8
Medicines	2.2	20.2	73.7	6.0
Social protection services	1.9	0.9	2.8	0.2
Public services	8.6	15.3	53.2	17.9
Transportation services	3.3	26.3	101.6	11.9
PTT services	3.9	6.9	22.3	3.7
"Non-core" inflation, other items	5.4	2.3	7.1	1.7

Source: SORS and *QM* estimates.
Note: SORS discontinued the practice of publishing core inflation data in January 2009. Core inflation data for the period since January 2009 are thus *QM* estimates based on available information.

Core inflation slowed down in March and April

Core inflation over the first four months of 2009 was not low, standing as it did at 2.9% (or 9.1% annualized), but it does seem to have been exhibiting clear signs of slowing down in March and April (Graph T5-3). After relatively high core inflation seen in January and February, of 1.0% and 1.2% respectively, the rate fell to slightly below 0.4% per month in March and April. Core inflation in March and April thus amounted to 4.5% at the annual level.

Graph T5-3. Serbia: Core Inflation (in %), 2006–2009



Source: SORS and *QM* estimates.
Note: SORS discontinued the practice of publishing core inflation data in January 2009. Core inflation data for the period since January 2009 are thus *QM* estimates based on available information.

Additional confirmation of the slowdown in core inflation is provided by a closer look at movements in the prices of products and services making up core inflation. Namely, the greatest contribution to core inflation over the first four months of 2009 was made by the rise in prices of alcoholic beverages. This rise was to a large extent a consequence of administrative measures, i.e. the government’s decision to raise the excise duty on beer. Although they make up just some 6% of the core price index, alcoholic beverages accounted for as much as 23% of the rise in core prices.

When we exclude the effect that rising excise duty on alcoholic beverages has had on core inflation, we can conclude that core inflation was somewhat lower in early 2009 than in the

1 Core inflation measures price movements of products and services that are not under administrative control but are rather freely traded on the market. Thus, the price of electricity, oil products, utilities, etc. are excluded from core inflation figures. In addition, core inflation does not include agricultural products as their prices are heavily influenced by seasonal factors. We must underline that this section treats core inflation as a part of the Retail Price Index. Since late 2008 SORS has not published core inflation figures, meaning that the analysis of core inflation is based on QM estimates using available information.

last quarter of 2008. If alcoholic beverages are excluded, core inflation over the first four months of 2009 amounted to some 2.3%, or about 7% annualized.[2] Core inflation stood at 2.2% in Q4 2008, or 9.2% annualized.

Inflation slowed down despite a significant depreciation…

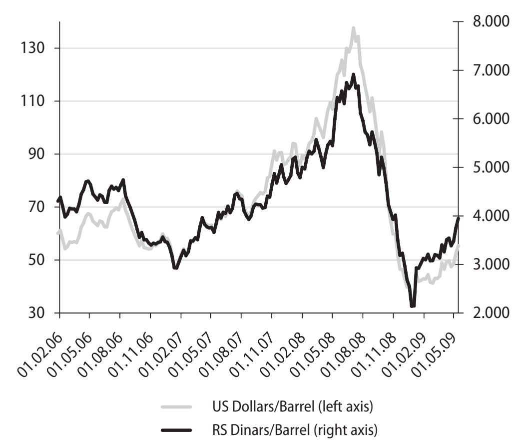
The pass-through from the exchange rate to core inflation amounted to some 0.23 from September 2008 to April 2009. The same period saw the exchange rate depreciate by 23.1%, while core inflation fluctuated by 5.2%.

…above all because of a large drop in demand and economic activity

The slowdown in core inflation since the start of 2009, especially in March and April, occurred despite the relatively substantial depreciation of the dinar. Our estimate is that this slowdown is primarily the consequence of a major drop in both aggregate and domestic demand, as well as the fall in economic activity. As shown in greater detail in Section 2, Economic Activity, the real y-o-y fall in domestic demand stood at as much as 7%, while aggregate demand dropped by 10%. As both aggregate demand and economic activity will in all likelihood remain relatively low for the rest of the year, our estimate is that core inflation will too remain moderate, and will probably not exceed levels seen in March and April.

"Non-core" inflation is very high

Graph T5-4. World: Weekly Ural Crude Prices in USD and RSD, 2006–2009



Source: Energy Information Administration, US Department of Energy.

As for non-core inflation, it amounted to 11.7% for the first four months, or 39.3% annualized. The greatest contribution to non-core inflation, as well as to total inflation, was made by oil products. Their prices rose by 19.7% since the beginning of the year, contributing 25% to total inflation. The rise in the prices of oil products was directly caused by rising oil prices on the global market, and by the rise in excise duty. After having dropped sharply in the second half of 2008, oil prices are rising again in 2009. Although current crude oil prices in dollars are a far cry from record highs seen in the summer of 2008, they have nonetheless risen by 45% from late December to mid-May, or by over 60% in dinars (Graph T5-4). In addition, a major contribution to inflation was also made by utility prices (with an overall contribution to inflation of 18%), transportation (12%), tobacco (8%), medicines (6%) and agricultural products (5%).

Inflation as measured by RPI could amount to around 10% by the end of the year

Our rough estimate is that inflation as measured using the RPI could stand at about 10% at the end of 2009. To reach this approximation we have used different assumtions about the chages in core and non-core inflation rates. As for core inflation, our assumption is that it will continue rising at a monthly rate of some 0.4%, in line with its movements throughout March and April. In estimating non-core inflation we start from the assumption that, by the end of the year, electricity prices will rise by some 10% (generally keeping with the rises in electricity prices over the past several years), that prices of agricultural products will rise by another 5%, and that the rest of non-core inflation will not see significant changes. Let us stress that this estimate is illustrative only, as any forecast has to be tentative in an environment where it is unclear how long the global downturn will last and how it will affect the economy. The main unknown factors that may affect such an estimate relate to further movements in the price of crude oil on the world market (judging by current analyses, these are either not expected to rise by much, or are even thought to be in for a mild drop – which is why we have factored in the assumption that oil prices will remain unchanged), as well as further changes of the dinar exchange rate.

Inflation as measured by CPI was also high in Q1…

Inflation measured by the Consumer Price Index (CPI) was also very high in Q1. It amounted to 3.8%, or 16.3% annualized (Table T5-5). As of April, inflation as measured by the CPI stood at

2 If only beer is excluded from core inflation, this index is seen to have stood at about 2.6% over the first four months of 2009, or some 8.1% annualized.

4.8%, or 15.2% annualized. The CPI has in 2009 become the official measure of inflation in Serbia: this index is calculated using methodology adopted by EU countries, and is thus comparable at an international level. The primary difference in relation to the RPI is the weighting of certain goods and services. The CPI uses weights set according to household consumption structure based on the Household Consumption Survey and the structure of final household consumption, whereas weights used for the RPI represent the structure of retail trade in goods and services used in household consumption, based on retail trade data. Therefore, the CPI is a more precise indicator of the impact of movements in prices on the standard of living. Among other things, food products have a larger share in the CPI than in the RPI, while oil products figure in the CPI less than they do in the RPI. A detailed description of the main characteristics of the CPI and its comparison with the Retail Price Index can be found in the previous issue of *QM*.[3] We will continue monitoring both indices, still devoting a great deal of attention to the RPI as a longer data series is available. In the coming issues of QM we will gradually shift our focus to CPI. Comparative movements in these two indices are shown in Graph T5-8.

Table T5-5. Serbia: Consumer Price Index, 2007–2009

	Consumer Price Index				
	Base index (avg. 2006 =100)	y-o-y growth	cumulative index	monthly growth	3m moving average, annualized[1)]
2007					
Mar	102.5	4.1	0.7	0.6	2.8
Jun	105.5	4.0	3.7	0.4	12.7
Sep	109.5	8.0	7.6	1.6	16.8
Dec	113.0	11.0	11.0	1.2	13.1
2008					
Mar	116.4	13.6	3.0	1.6	12.7
Apr	118.2	14.6	4.6	1.5	15.7
May	120.3	14.5	6.5	1.8	21.6
Jun	121.2	14.8	7.2	0.7	17.4
Jul	119.8	13.9	6.1	-1.1	5.7
Aug	120.3	11.5	6.4	0.4	-0.2
Sep	121.4	10.9	7.5	1.0	0.9
Oct	123.7	12.3	9.5	1.8	13.5
Nov	123.9	10.9	9.6	0.2	12.6
Dec	122.7	8.6	8.6	-0.9	4.4
2009					
Jan	125.4	10.0	2.1	2.1	5.6
Feb	126.9	10.7	3.4	1.2	10.2
Mar	127.4	9.4	3.8	0.4	16.3
Apr	128.6	8.8	4.8	0.9	10.9

Source: SORS.
1) Moving averages of monthly price increases for three months, annualized.

… but the underlying inflation trend is lower and it seems that it is slowing down

Our estimate is that the underlying inflation trend, as measured using the CPI, still remained low over the first four months of 2009, and even decelerated slightly. As we already explained in the analysis of the RPI, the rise in consumer prices was primarily a consequence of administrative measures and corrections in state-controlled prices, as well as of changes in the price of oil products, which are under the dominant impact of exogenous factors (i.e. changes in the price of crude oil on the world market).

The underlying inflation trend was 8.8% over the first four months, but 10% in Q4 2008

When we exclude alcoholic beverages and tobacco, oil products, heating and pharmaceutical products from the CPI, the rest of the index rose by 2.8% over the first four months of 2009, or 8.6% annualized (Table T5-6). We must point out that these products and services make up just 13.4% of the CPI, but that they accounted for as much as a half of the entire increase in this index over the first four months of 2009. Overall CPI growth amounted to just 1.1% in the previous quarter (Q4 2008), or 4.3% annualized. However, such low growth was primarily the consequence of a major drop in the price of oil products caused by a sharp fall in the price of crude oil. When these products and services (alcoholic beverages and tobacco, oil products,

3 See Box 1, Section 3, Prices and the Exchange Rate, Quarterly Monitor 15.

heating and pharmaceuticals) are excluded, price growth in Q4 2008 amounted to 2.4%, or 10% annualized. Thus, we can say that a mild slowdown in the underlying inflation trend has been in evidence over the first four months of 2009.

Table T5-6. Serbia: Consumer Price Index, Growth of Selected Components, 2008–2009

	Price growth Dec08 / Sep08	Annualized price growth Dec08 / Sep08	Price growth Apr 09 / Dec08	Annualized price growth Apr 09 / Dec08
	in %			
Total	1.1	4.3	4.8	15.1
Alcoholic beverages and tobacco, heat energy, fuels and lubricants, pharmaceuticals	-7.8	-27.6	18.3	65.6
Total w/o alcoholic beverages and tobacco, heat energy, fuels and lubricants, pharmaceuticals	2.4	10.0	2.8	8.8

Source: SORS.
Note: Alcoholic beverages and tobacco, oil products, heating and pharmaceuticals account for 13.4% of the CPI.

Oil products, housing, alcoholic beverages and tobacco made the greates contribution to the rise in inflation

The contribution of certain groups of products to total CPI growth, as well as the rise in prices of these groups since the start of 2009 and in Q4 2008, is shown in Table T5-7. As already noted, the greatest contribution was made by products whose prices had grown as a consequence of administrative measures. On the other hand, the Clothing and Footwear and Furniture and Household Furnishings groups are to a large extent made up of products and services that are mainly imported (i.e. affected by changes in the dinar exchange rate) and whose prices are set on the market. These two groups have been recording relatively moderate growth. Prices in the Clothing and Footwear group rose by just under 1.5% over the first four months, or a mere 4.4% annualized. The Furniture and Home Furnishings group has seen price growth of 2.1% since the beginning of the year, or 6.5% annualized.

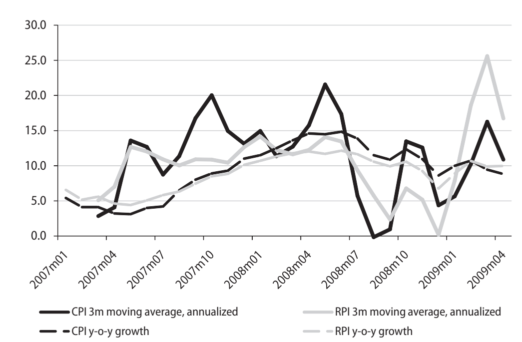
Table T5-7. Serbia: Consumer Price Index, Selected Components and Contribution to Inflation Growth, 2008–2009

	Share in CPI	Price growth in the period Dec08 / Sep 08	Contribution to CPI growth in the period	Price growth in the period Apr09 / Dec08	Contribution to CPI growth in the period
	in %				
Total	100.0	1.1	100.0	4.8	100.0
Food and non – alcoholic beverages	34.3	2.1	69.5	2.5	17.2
Alcoholic beverages and tobacco	4.8	1.1	5.2	14.2	14.0
Clothing and footwear	6.5	3.1	19.5	1.5	1.9
Housing, water, electricity, gas and other fuels	16.5	5.0	79.0	4.4	14.9
Heat energy	0.9	5.8	4.9	25.8	4.7
Furniture, household equipment, routine maintenance	5.5	0.7	3.9	2.1	2.3
Health	4.6	-1.7	-7.4	14.1	13.2
Pharmaceutical products	3.0	-3.4	-9.7	20.4	12.5
Transport	11.5	-8.5	-94.5	11.4	26.6
Fuels and lubricants	4.7	-22.4	-100.7	19.7	18.7
Other items	16.3	1.6	24.7	3.0	9.8

Source: SORS.

Based on price movements observed thus far, we can make a tentative estimate of what the inflation rate as measured using the CPI will be at the end of 2009. In our view, inflation as measured using the CPI could be about, or slightly below, 10%. As with our forecast of inflation as measured using the RPI, we must underline that this estimate should also be taken with a grain of salt, bearing in mind all the uncertainties surrounding the effects and duration of the economimc crisis.

Graph T5-8. Serbia: Movements in the Consumer Price Index and the Retail Price Index (in %), 2007–2009



Source: SORS.

Exchange Rate

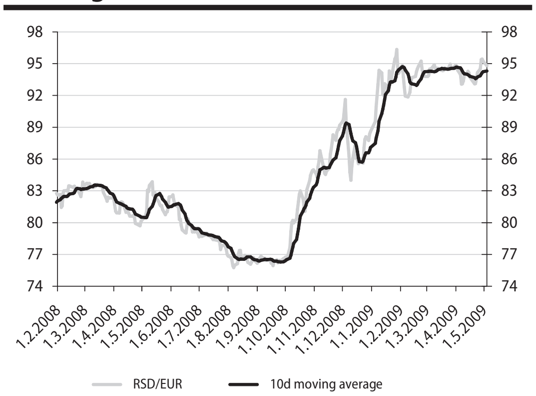
The dinar exchange rate has been stable since mid-January …

The dinar/euro exchange rate was very stable from January to April, generally ranging between 93 and 96 dinars to €1 (Graph T5-9). In the first half of January the dinar underwent a relatively substantial depreciation, losing some 4% of its value against the euro in just two weeks: the exchange rate went up from about 89.5 to some 93 dinars to €1. From mid-January to mid-May the rate has been hovering within the relatively narrow band of between 93 and 96 dinars to €1.

… and NBS has not intervened in March and April to defend the exchange rate

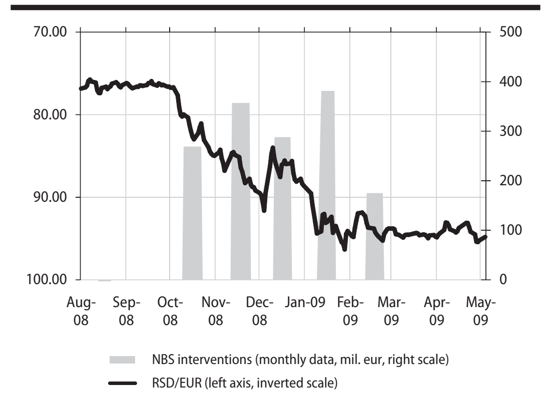
After the dinar began depreciating strongly in October last year – as a consequence of the global economic crisis, the stalling of capital inflows, and the knee-jerk reaction on the part of the public, which resulted in about €800 mn in foreign currency deposits being taken out of banks in October and November 2008 – NBS intervened aggressively to stabilize the exchange rate. Direct intervention by the NBS in the foreign exchange market amounted to €914 mn in Q4 2008 and €556 mn in January and February 2009, a total of €1.47 bn (Graph T5-10). These interventions were accompanied by changes in regulations governing reserve requirements.[4] As a result of all these measures, but also due to the sharp decline in imports brought about by a fall in

Graph T5-9. Serbia: Daily RSD/EUR Exchange Rate, 2007–2009



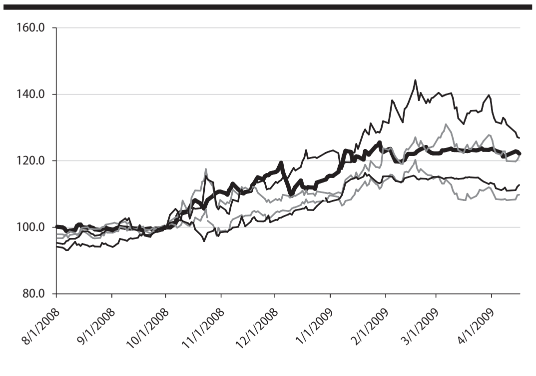
Source: NBS.

Graph T5-10. Serbia: Daily RSD/EUR Exchange Rate and NBS Interventions, 2008–2009



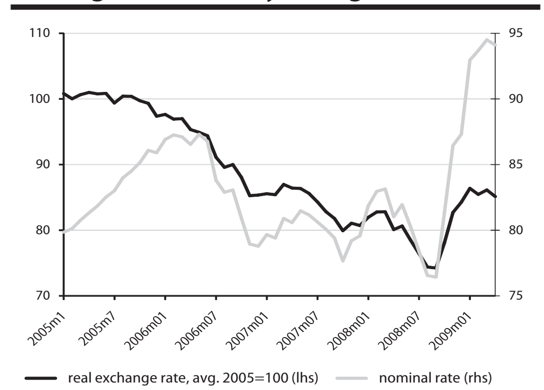
Source: NBS.

Graph T5-11. Nominal Exchange Rates, Selected Currencies/Euro, 1 October 2008 = 100



Source: European Central Bank, NBS.

Graph T5-12. Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly Averages, 2005–2009



Source: NBS.

4 For a detailed analysis of NBS measures and their effects, see Section 7, Monetary Flows and Policy in this issue of *QM*.

Trends

economic activity, the dinar exchange rate stabilized; there has been virtually no intervention by the NBS in the foreign exchange market since March. The signing of the agreement with the IMF will certainly give an additional boost to the dinar's stability, so no major shifts in the exchange rate should be expected over the coming several quarters. The nominal depreciation of the dinar since the beginning of the crisis is roughly comparable to that seen by other Eastern European currencies (Graph T5-11).

The real exchange rate depreciated by around 15% since the beginning of the crisis …

The real exchange rate depreciated by 2.2% in Q1 (Graph T5-12). Nearly all of this real depreciation that occurred in January in relation to December is a consequence of the nominal depreciation seen in late 2008 and early 2009. April recorded real appreciation of slightly over 1%, so that when the real exchange rate in April is considered it becomes apparent that depreciation since the end of last year has been as low as 1% (Table T5-13). If the period since the start of the major nominal depreciation is taken into account – i.e. if one considers the dinar's value from September 2008 to April 2009 – it will be seen that the currency has depreciated by 14.6% in real terms.

… but the real depreciation is now stopping

Table T5-13. Serbia: RSD/EUR Exchange Rate, 2005–2009

	Nominal				Real			
	exchange rate (FX)[1]	base index[2] (avg.2005 = 100)	y-o-y index[3]	cumulative index[4]	real FX[5] (avg.2005 = 100)	y-o-y index[3]	cumulative index[4]	USD/EUR Rate[6]
				monthly exchange rate				
2005								
December	85.9073	103.6	109.3	109.3	97.4	94.9	94.9	1.1861
2006								
December	78.7812	95.0	91.7	91.7	85.4	87.7	87.7	1.3210
2007								
December	79.5669	96.0	101.0	101.0	80.7	94.6	94.6	1.4563
2008								
March	83.1319	100.3	102.8	104.5	82.8	95.2	102.6	1.5516
April	81.0287	97.7	100.6	101.8	80.1	92.7	99.2	1.5770
May	81.9403	98.8	100.6	103.0	80.6	93.4	99.9	1.5569
June	80.2460	96.8	98.9	100.9	78.5	91.7	97.2	1.5556
July	78.3728	94.5	97.2	98.5	76.4	90.7	94.7	1.5773
August	76.5517	92.3	95.6	96.2	74.4	89.8	92.2	1.4987
September	76.4226	92.2	96.3	96.0	74.2	90.8	92.0	1.4387
October	81.2956	98.0	104.7	102.2	78.1	97.7	96.7	1.3309
November	86.4508	104.3	109.2	108.7	82.7	102.0	102.5	1.2726
December	87.3002	105.3	109.7	109.7	84.3	104.4	104.4	1.3482
2009								
January	92.9458	112.1	113.6	106.5	86.4	105.4	102.5	1.3327
February	93.6865	113.0	112.9	107.3	85.5	103.2	101.4	1.2797
March	94.4951	114.0	113.7	108.2	86.1	104.0	102.2	1.3041
April	94.1074	113.5	116.1	107.8	85.1	106.3	101.0	1.3204

Source: NBS, SORS, Eurostat.
1) Monthly average, official daily NBS mid rate.
2) Ratio of fx in Column 1 and average fx in December 2002.
3) Ratio of fx in Column 1 and fx for the same period in previous year.
4) Cumulative is the ratio of given month and December of previous year.
5) The calculation of the real exchange rate takes into account Eurozone inflation. Index calculation: RE = (NE/p) x p*, where: RE - real fx index; NE -nominal fx index; p - Serbia RPI index; p* - Euro area CPI index.
6) Period average.
Note: 12-m and 3-m averages are used for annual and quarterly data, respectively

The real dinar/euro exchange rate is calculated, by definition, by adjusting the nominal exchange rate for the difference in prices between Serbia and the Eurozone. Prices in Serbia have thus far been measured using the RPI, which is why *QM* has been using this index to calculate the real exchange rate. However, as the CPI will henceforth be used as the official measure of inflation, we need to also consider changes in the real exchange rate as obtained using this index. Usage of the CPI has an added advantage in that this index is directly comparable to the index used to measure price movements in the Eurozone. It is also of interest to take into account movements in the real exchange rate when the entire CPI is not considered, but rather only its tradable components. The real exchange rate is a measure of global competitiveness and when viewed in this context, the sole aspects of importance are prices of *only* those goods and services that may be traded internationally, while overall price levels – including non-tradable goods and services – can be excluded. Changes in the real exchange rate using various price indices are shown in Table T5-14.

The real exchange rate calculated using the CPI has depreciated by 3.2% since the beginning of the year; depreciation from September to April amounted to 15.9%. The somewhat greater depreciation in relation to the real exchange rate obtained using the RPI was caused by the fact that the inflation rate over the period observed is higher when measured using the RPI than when the CPI is used. This is primarily a consequence of the greater weight of oil products and goods and services whose prices are under administrative control in RPI than in CPI. The real exchange rate calculated by using prices of only tradable goods and services depreciated by 3.5% since the beginning of the year, while the figure for the period from September 2008 to April 2009 stood at 17.4%. The reason for this is that prices of tradable goods rose by less than those of non-tradable goods (as underlined several times in the Inflation section, the period observed saw greatest increases in the prices of administratively-controlled goods and services, a large part of which are non-tradable) – thus the difference in changes in prices of tradable goods between Serbia and the Eurozone is smaller than the total difference in changes in prices.

Table T5-14. Serbia: Changes to Real Exchange Rate Obtained Using Various Price Indices (in %)

	RPI	CPI	CPIt
	change of real exchange rate, in %[1]		
Apr09 / Dec08	1.0	3.2	3.5
Apr09 / Sep08	14.6	15.9	17.4
Apr09 / Apr08	6.3	7.4	9.1

Source: NBS, SORS, Eurostat, *QM* estimates.
1) Positive value denotes depreciation.
Note: RPI – real exchange rate calculated using the Retail Price Index for Serbia and the Harmonized Index of Consumer Prices for the Eurozone; CPI – real exchange rate calculated using the Consumer Price Index for Serbia and the Harmonized Index of Consumer Prices for the Eurozone; CPIt – real exchange rate calculated using *only* tradable goods from the Consumer Price Index and the Harmonized Index of Consumer Prices for Serbia and the Eurozone, respectively.

6. Fiscal Flows and Policy

Public revenues posted a significant real decline in Q1 2009 compared with the plan, as well as compared with the amount collected in the same period last year. For the second consecutive quarter, the real level of public revenues fell compared with the same period last year, but in Q1 2009 the decline was much steeper than in the previous quarter. Such a steep decline in public revenues resulted, first of all, from a significant decline in revenues from indirect taxes, which represents a strong indicator of recessionary trends in the Serbian economy. At the same time, due to dissatisfying results in revenue collection, public expenditures also fell in real terms in Q1 2009, by 3.4% against the same period last year. Public expenditures fell in Q1 at a slower pace than public revenues, leaving a consolidated fiscal deficit at 11.7 bn dinars. The state of public finances deteriorated additionally in April – the budget deficit of the Republic of Serbia stood at 16 bn dinars, so the total budget deficit in the first four months of the year amounted to 27 bn dinars, or 36% of the deficit agreed with the IMF for 2009.

General Trends and Macroeconomic Implications

The real level of revenues has fallen strongly, the fall in expenditures is slower, the deficit expands

The real fall in public revenues, posted in Q4 2008, continued in Q1 2009, but the decline in Q1 2009 (12.6%) was significantly stronger than in the previous quarter (0.7%). The economic contraction in the first quarter of 2009 and a significant real decline in revenues from indirect taxes indicate that a strong slowdown in public revenue collection results from recessionary trends in the Serbian economy.

Looking at particular taxes, a real decline in revenues from all taxes can be observed in Q1 2009, but the decline is stronger in indirect tax collection (taxes on consumption: first of all customs duties and VAT, while the real fall in revenues from excise duties was somewhat weaker). A sizeable real decline was also observed in revenues from the corporate income tax, which indicates that the liquidity in the economy significantly deteriorated at the start of 2009.

Consolidated public expenditures posted a 3.4% decline in real terms in Q1 2009, against the same period last year. Looking at individual expenditure items, nearly all of them fell in real terms (except for social transfers and capital expenditures), but the decline was most marked in subsidies, expenditures on goods and service purchases and expenditures on interest payments. It is important to note that in Q1, real expenditures on wages fell (by 3.8%) compared to the same period last year, while the volume of transfers to the Pension and Disability Insurance Fund (PIO Fund)[1] grew by 15% in real terms. The growth in expenditures on transfers to the PIO Fund to pay for pensions resulted from a significant pension increase in real terms in Q4 2008, as well as a fall in revenues in real terms from pension contributions (by 4.1% against Q1 2008).

Seasonal factors and tight expenditures in Q1 resulted in a lower fiscal deficit

As a result of the abovementioned trends, the consolidated fiscal deficit in Q1 2009 stood at 11.7 bn dinars (in the same period last year, during the temporary budget financing, Serbia posted a surplus of 8 bn dinars). The consolidated fiscal deficit in Q1 2009 is equivalent to 1.8% of quarterly GDP, which is far below the deficit agreed with the IMF for the whole of 2009, of 3% of annual GDP. However, it is necessary to note that the relatively low level of the deficit in Q1 was to a great extent due to seasonal influences, but it was also the result of extreme restrictiveness in the execution of government expenditures. In Q1 2009, the state executed mainly non-deferrable public spending (wages, pensions, interest payments, etc.), while deferrable spending (purchases of goods and services, subsidies, other public expenditures, etc.) were executed entirely restrictively.

1 The Pension and Disability Insurance Fund does not have an official translation of its name to English. We use the Serbian abbreviation - PIO.

Table T6-1. Serbia: Consolidated balance of the general government sector[1], 2006–2009

	2006	2007	2008					2009
	Q1-Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1
I TOTAL REVENUE	865.8	1,000.7	269.4	281.4	283.3	311.8	1,145.9	258.8
II TOTAL EXPENDITURE	-888.4	-1,031.5	-254.0	-295.8	-286.6	-359.3	-1,195.7	-269.6
III "OLD" DEBT REPAYMENT, NET LENDING AND RECAPITALIZATIONS	-10.9	-15.3	-4.4	-5.2	-1.2	0.6	-10.1	-0.9
o/w Net lending [2]	*-10.9*	-15.3	-4.4	-5.2	-1.2	0.6	-10.1	-0.9
IV TOTAL EXPENDITURE, GFS (II+III)	-899.3	-1,046.8	-258.4	-301.0	-287.8	-358.7	-1,205.8	-270.5
V CONSOLIDATED BALANCE (I+IV), GFS definition[3]	-33.5	-46.1	11.0	-19.6	-4.4	-46.9	-59.9	-11.7
VI FINANCING (FREN's definition)	119.6	24.2	5.0	-12.2	-1.3	11.4	2.9	45.4
VII ACCOUNT BALANCE CHANGE (V+VI)	86.2	-21.9	16.0	-31.8	-5.7	-35.4	-57.0	33.7

Source: Table P-11 in Analytical Appendix.
The General Government – all government levels (the Republic, province, municipalities) and their budget beneficiaries and organizations of mandatory social security (PIO Fund, the Health Insurance Fund, the National Employment Service). Excludes public companies and NBS.
The item corresponds to the term "Expenditures on the purchase of financial assets" in PFB, i.e. to the item "net lending" in the IMF presentation. Those are credits to students, farmers, loans granted through the Development Fund, repayment of debts to pensioners, and expenditures on capital increase.
The consolidated balance (cash surplus/deficit according to GFS) represents the difference between current revenues and earnings from the sale of non-financial assets (i.e. capital revenues) and current expenditures and expenditures on the purchase of non-financial assets (i.e. capital spending). Beside those, spending also includes an item which includes repayment of domestic debts – pensions, budgetary lending and capital increases. Thus defined, the result measures the liquidity impact of government transactions on the economy. See methodological discussion in Frame 1, Quarterly Monitor No. 3 for details.
Considering the one-off character of revenues raised from the sale of the mobile telephony license, we treated this revenue as financing, unlike the Ministry of Finance, which treated it in its statements as part of current non-tax revenues.
FREN estimate based on unofficial information on changes of tax credit claims by companies from the state and on an analysis of the flows of VAT return presented in PFB.
Notes: See Table P-11 in Analytical Appendix for detail.

In April, Serbian budget revenues underperformed, expenditures grew, the deficit significantly expanded

Following a temporary recovery in public revenues, as well as of overall public finances in March 2009, results in April were completely unfavourable. The volume of Serbian budget revenues[2] in April fell nominally by 12% and by 20% in real terms compared with the same month last year. In April, expenditures were 3.2% up in nominal terms, but 6.2% down in real terms compared with the same month of 2008. As a consequence of unfavourable trends in revenue and spending flows, the budget deficit in April stood at 16 bn dinars. The total budget deficit of the Republic of Serbia in the first four months of the year stood at 27.2 bn dinars, i.e. 36.5% of the budget deficit agreed under the IMF arrangement[3]. The budget deficit of the Republic of Serbia in April was financed through the issuance of three-month treasury-bills, which have become the most important instrument for financing the budget deficit since the beginning of the year. (See *Highlights 4*, Public Debt of the Republic of Serbia for more detail).

There is a great uncertainty over the execution of the fiscal policy agreed with the IMF

Bearing in mind that in the first four months, when due to seasonal factors the government, as a rule, achieves a better financial result than for the whole year, almost 36.5% of the full-year fiscal deficit had been achieved – prompting concern over whether the budget deficit and the consolidated deficit of the public sector will be kept within the planned framework. The answer to this depends on economic activity in the coming period of the year, as well as on whether the government will strictly implement the fiscal policy measures agreed with the IMF. It is estimated that the fiscal deficit can be kept within the planned framework only under condition that there is a moderate economic recovery in the second part of the year and if fiscal policy measures are implemented consistently. Considering that economic recovery in the second half of the year is relatively unlikely, it also seems that is unlikely that the fiscal deficit can be kept within the planned framework. Also, possible inconsistencies in the implementation of measures agreed with the IMF could additionally increase the fiscal deficit over the agreed level.

In the second part of the year, additional fiscal policy adjustments can be expected

Therefore, the question is whether additional, restrictive measures should be adopted in the case of the fiscal deficit moving towards a higher level than planned (and agreed with the IMF) in 2009, or whether an additional expansion of the deficit is justified (in agreement with the IMF)? Due to the depth of recessionary trends and a relatively low level of the public debt, the

2 At the time of writing, figures on the consolidated balance of the general government in April 2009 are not available, but based on experience so far, the results in the consolidated balance could be somewhat more favourable. Namely, local governments, as a rule, achieve a surplus in the first part of the year.

3 Under the IMF agreement, the budget deficit in 2009 cannot exceed 74.5 bn dinars, while the deficit of the consolidated general government may amount to 90 bn dinars.

additional expansion of the fiscal deficit appears to be a more convenient solution. It would be more convenient if the deficit were to be, to a greater extent, financed from abroad in order to avoid crowding out of private investments in Serbia.

Analysis of Individual Tax Forms and Individual Public Spending Items

Revenues from indirect taxes and the corporate income tax posted the most drastic decline

The real level of revenues from indirect taxes in Q1 2009 fell significantly compared with Q1 2008. Customs revenues posted the most drastic decline in real terms (29.4% against the same period in 2008), followed by revenues from VAT (13.6%), while the decline in revenues from excise duties, although obvious, was somewhat weaker (6.2%), mainly due to an increase in excise duties. Such a drastic decline in customs revenues is a result of three groups of factors: the decline in imports (measured in euros) of 25.7% compared with Q1 2008, and the decrease in customs duties on imports from the European Union as of February (because of the launch of the implementation of the Stabilization and Association Agreement with the EU), which had a negative impact on the level of customs revenues, as well as a strong dinar depreciation against the euro, which, on the other hand, had a positive impact on customs revenues. The influence of those factors can explain the fall in revenues from VAT, paid on the import of goods.

There are indications of deteriorating tax payment discipline

For the first time after a long period, revenues in Q1 from the wage tax fell (by 5.3%) and so did the revenues from mandatory social security insurance (by 4.1%). Considering that the average gross salary paid in Serbia in Q1 2009 was 2.6 % up in real terms against the same period last year, and that in the meantime there was no drastic increase in unemployment (See Section 3, Wages and employment) it can be concluded that a lack of fiscal discipline, i.e. an increase in tax evasion and late payments of tax liabilities, can be partly blamed for the decline in revenue from the wage tax and social security contributions.

In Q1, the corporate income tax continued its decline in real terms, which started in Q4 2008, but the decline in Q1 2009 was very strong (22.2%). The mentioned real decline in revenues from the corporate income tax can be explained by the declining profitability in the economy since the second half of 2008[4], the deteriorating liquidity and the weakening of fiscal discipline.

Expenditures items fall in real terms, the biggest decline in deferrable spending…

Consolidated public expenditures in Q1 fell by 3.4% in real terms against the same period last year, resulting from a divergent movement of some public expenditure items. On one hand, most of the expenditure categories were significantly reduced, while transfers to the PIO Fund (to finance pensions) were expanded. In the first quarter of 2009, total transfers for pension payments rose by 15% in real terms compared with the same period last year, as a result of a cumulative nominal increase in average pensions in the course of 2008 by around 35% and a real fall in revenues from social security contributions, posted in Q1. Because of that and despite a double-digit decline in subsidies in real terms, in spending on the purchase of goods and services and in expenditures on interest payments, as well as a real fall in expenditures on employees for the first time after a long while, consolidated expenditures were significantly reduced. The relative importance of the growth of this type of expenditures is illustrated by the fact that spending on pensions in Q1 2009 made up 34.9% of consolidated public expenditures, while the share of expenditures on pensions in consolidated expenditure in the same quarter of 2007 and 2008, stood at 27.7% and 28.6% respectively.

…except for expenditures on pensions, which rose by 15 % in real terms

In Q1, for the first time after a while, spending on employees fell in real terms (by 3.8%) compared with the same period last year, as a result of a decision to freeze wages in the public sector through 2009.

Expenditures on goods and services fell by 16.8 % in real terms in Q1 against the same period last year, first of all because of a need to first finance from available sources so-called non-deferrable items (wages in the public sector, transfers to the PIO Fund for pension payments,

4 It is estimated that 2008 was extremely heterogeneous from the standpoint of business activities: in the first part of the year, the economy posted strong growth, but there was a slowdown in economic activity in the second half of the year, which accelerated in Q1 2009. Financial reports which refer to the whole of 2008 give average results for the whole year and therefore do not reflect the weak performance of the economy in the last quarter of 2008.

etc.) while the financing of the remaining expenditure items, which are by their nature partially (over the short-term) deferrable, was executed in line with current capacities.

Besides spending on social transfers, capital expenditures grew in real terms (by 14.7%), which can be partially explained by the fact that Serbia had temporary budget financing in Q1 2008, so that there was no significant financing of capital expenditures in that period, making the base for comparison lower. Under the circumstances of exceptional recessionary trends, an emphasis on capital expenditures designed to finance large infrastructure projects could create a significant impact in order to encourage economic activity and new employment.

Table T6-2. Serbia: consolidated balance of the general government sector[1)], 2006–2009

	2006	2007	2008					2009	12-m								Comparing to previous period
									2006	2007	2008					2009	
	Q1-Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q1-Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q1 / Q4
	in bn. dinars								real growth, in %								
I PUBLIC REVENUES	**865.8**	**1,000.7**	**269.4**	**281.4**	**283.3**	**311.8**	**1,145.9**	**258.8**	**6.8**	**8.4**	**7.6**	**5.2**	**2.8**	**-0.7**	**3.4**	**-12.6**	**-20.2**
o/w: Public revenues excluding VAT liabilities to enterprises and offsets with SDF [2), 3)]	*855.6*	*995.2*	*269.4*	*281.4*	*283.3*	*311.8*	*1,145.9*	*258.8*	*8.9*	*9.1*	*8.3*	*6.5*	3.3	-0.6	4.0	-12.6	*-20.2*
1. Current revenues	855.5	995.4	268.9	280.3	282.6	311.3	1,143.1	258.3	6.7	7.9	7.7	5.0	3.7	0.1	3.7	-12.6	-20.2
Tax revenue	756.0	870.0	234.4	247.4	248.3	270.2	1,000.4	229.8	5.4	8.0	7.6	5.2	3.6	0.1	3.9	-10.8	-18.2
Personal income taxes	118.6	115.8	29.7	34.1	33.6	39.0	136.5	30.9	11.9	-8.4	7.1	8.1	4.5	6.5	6.5	-5.3	-23.9
Corporate income taxes	18.3	29.7	15.0	8.1	7.4	8.5	39.0	12.8	58.0	52.1	15.2	30.0	45.3	-0.2	18.7	-22.2	45.2
VAT and retail sales tax	225.1	265.5	73.2	77.0	73.8	77.7	301.7	69.4	-7.3	10.6	8.7	5.7	-0.3	-2.3	2.7	-13.6	-14.1
o/w: Net VAT and retail sales tax [2)]	*224.5*	*260.3*	*73.2*	*77.0*	73.8	77.7	301.7	69.4	*0.3*	8.8	*11.3*	*10.3*	*1.3*	*-2.3*	*4.7*	*-13.6*	-14.1
Excises	86.9	98.6	23.7	26.6	29.5	30.3	110.1	24.4	8.3	6.5	5.7	-1.5	2.4	-1.7	0.9	-6.2	-22.6
Custom duties	45.4	57.4	14.8	16.9	16.3	16.8	64.8	11.5	3.9	18.6	10.5	8.8	0.9	-8.7	2.0	-29.4	-34.2
Social contributions	231.4	270.3	69.7	75.9	78.7	88.5	312.7	73.4	12.5	9.6	6.9	4.4	5.2	2.5	4.5	-4.1	-20.3
o/w: contributions excluding offsets with SDF [3)]	*221.9*	*269.8*	*69.7*	*75.9*	78.7	88.5	312.7	73.4	*11.3*	*14.1*	*7.0*	*4.6*	*5.2*	*2.8*	*4.7*	*-4.1*	-20.3
Other taxes	30.3	32.8	8.4	8.8	8.8	9.5	35.6	7.4	11.1	1.7	-4.5	-5.8	4.0	-1.6	-2.1	-20.5	-25.0
Non-tax revenue	109.6	125.4	34.4	32.9	34.3	41.1	142.7	28.5	17.1	7.4	8.5	3.3	4.5	-2.7	2.8	-24.6	-33.2
2. Capital revenues	0.3	5.3	0.3	0.5	0.3	0.2	1.4	0.3	56.3	1,703.2	-55.6	81.3	-89.6	-87.7	-76.8	-20.3	21.0
II TOTAL EXPENDITURE	**-888.4**	**-1,031.5**	**-254.0**	**-295.8**	**-286.6**	**-359.3**	**-1,195.7**	**-269.6**	**13.7**	**8.9**	**2.4**	**20.1**	**1.8**	**-1.4**	**4.7**	**-3.4**	**-27.9**
1. Current expenditures	-807.0	-919.5	-242.0	-272.7	-260.5	-314.4	-1,089.6	-254.4	10.6	6.9	6.9	19.5	2.3	2.3	7.1	-4.3	-22.2
Wages and salaries	-204.4	-238.3	-66.5	-74.0	-71.3	-81.4	-293.2	-70.3	7.0	9.4	12.7	15.0	9.2	8.5	11.1	-3.8	-16.9
Expenditure on goods and services	-135.9	-168.1	-34.0	-44.2	-45.2	-57.9	-181.2	-31.1	12.9	16.1	0.8	8.1	-1.3	-11.4	-2.6	-16.8	-48.4
Interest payment	-30.2	-17.9	-6.0	-2.6	-5.1	-3.4	-17.2	-5.8	52.6	-44.4	-12.2	-31.4	-3.1	-10.6	-13.2	-13.4	60.6
Subsidies	-55.6	-63.7	-13.3	-22.2	-13.9	-28.3	-77.8	-11.0	-10.0	7.6	27.5	88.2	-29.7	0.5	10.3	-24.7	-62.6
Social transfers	-360.4	-409.3	-117.9	-122.4	-120.4	-136.0	-496.8	-132.8	13.7	6.5	6.0	19.0	6.8	8.1	9.7	2.5	-6.1
o/w: pensions [5)]	*-227.7*	*-259.9*	*-74.8*	*-81.5*	*-83.6*	*-91.1*	*-331.0*	*-94.5*	*11.1*	*7.1*	*8.5*	*14.9*	*16.4*	*20.1*	*15.1*	*15.0*	-0.2
Other current expenditures	-20.5	-22.1	-4.2	-7.3	-4.6	-7.3	-23.5	-3.4	2.9	1.1	-15.7	62.5	-18.9	-20.6	-4.1	-25.8	-54.5
2. Capital expenditures[6)]	-81.3	-112.1	-12.0	-23.1	-26.1	-44.9	-106.0	-15.1	57.7	29.3	-44.5	28.1	-3.2	-21.0	-14.5	14.7	-67.6
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**-10.9**	**-15.3**	**-4.4**	**-5.2**	**-1.2**	**0.6**	**-10.1**	**-0.9**	**47.6**	**-53.9**	**346.5**	**338.0**	**-83.8**	**-108.6**	**-40.3**	**-88.6**	**-77.1**
IV TOTAL EXPENDITURE, GFS (II+III)	**-899.3**	**-1,046.8**	**-258.4**	**-301.0**	**-287.8**	**-358.7**	**-1,205.8**	**-270.5**	**13.0**	**9.2**	**3.8**	**21.7**	**-0.4**	**-3.5**	**4.1**	**-5.8**	**-28.4**

Source: Table P-11 in Analytical Appendix.
See footnote 1) in Table T7-1.
Sales tax/VAT less new tax credits of the corporate sector.
Contributions less compensations conducted between the PIO Fund, Development Fund and companies which owe to the PIO Fund.
Refers only to spending on current pensions.
Capital expenditures exclude projects financed from foreign sources (except in 2004, See footnote 16 in Table P-11).
Note: Real growth was calculated by applying the average base Retail Price Index (base December 2003) on quarterly figures.

7. Monetary Flows and Policy

In the course of Q1 the money supply (M2) fell for the first time since the launch of stabilization measures and reforms in 2000. Compared with Q1 of 2008, M2 fell by 3.2% in real terms due to inflation, despite its nominal 2.3% growth. Corporate lending slowed down, while the household sector was repaying debts in Q1, which speaks of a strong recessionary pressure and a fall in aggregate demand. Both in Q1 and in the preceding quarter, companies almost stopped borrowing abroad (€-144 mn). The inflow of new funds for bank lending remained minimal: capital and reserves denominated in euros fell by €424 mn and corporate deposits by €276 mn, while new foreign currency savings rose by €87 mn. Due to an evident contraction in economic activity and sources for new credits, the amount of non-performing loans rose to 9%, which can develop into a major problem for the banking sector in the future. In the course of Q1, banks repaid their foreign creditors €299 mn worth of credits raised in Q4, while banks' REPO purchases rose despite the lowering of the NBS' reference interest rate, indicating a lack of preparedness on the part of banks to lend any surplus dinar liquidity to corporates. After a disinflationary trend had been established, the National Bank of Serbia (NBS) initiated monetary policy easing, aggressively lowering its reference rate, currently at 14%. However, bearing in mind a low inflation rate in Q1, we believe that the reference interest rate could go further down, thus redirecting banks from repo purchases to lending to corporate and household sectors. Beside that, NBS adopted a series of monetary policy and bank supervisory measures in February, which led to an increased liquidity in the foreign exchange market, creating conditions for the implementation of the government's programme of subsidized loans for liquidity, investment and consumer credits. Despite privatization revenue from NIS, the NBS net foreign exchange reserves fell by €59 mn in Q1 as a result of sizeable NBS' interventions on the interbank forex market. Talks with the IMF on a €3 bn *stand-by* arrangement started in March (the first €800 mn loan tranche already arrived at the end of May), which should stabilize the level of NBS reserves following their decline in Q1.

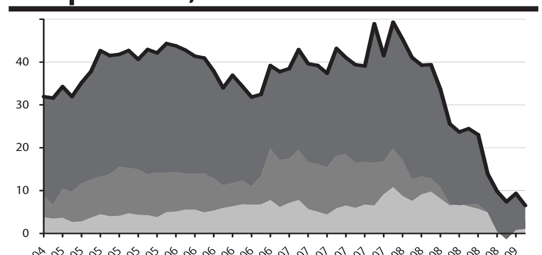
Monetary System: Structure and Money Supply Flows

A decline in real M2 has been registered for the first time…

For the first time since reforms had been launched in 2000, M2 posted a y-o-y decline in real terms in Q1. The M2 decline in real terms stood at 3.2% (in Q4 2008 it grew by 2.9% in real terms), even though there was a nominal growth (Table T7-2). The y-o-y growth rates of credit to the non-state sector in real terms continued to slow down significantly to 9.4%[1] (15.5% in Q4). Of that amount, following a slowdown throughout 2008, lending to households posted a decline in Q1 and the y-o-y rate in real terms, adjusted for exchange rate changes, was negative at -2.8% (8.3% in Q4). Credits to the corporate sector also slowed down, with the y-o-y real rate of growth dropping to 16.5% (19.7% in Q4).

...speaking of strong recessionary pressure in the Serbian economy

Graph T7-1. Serbia: Money and its Components[1)], 2004–2009



Source: Table P-12 in Analytical Appendix.
The share of money components has been calculated as a ratio of their growth to M2 value in the same period last year, making the sum equivalent to a 12-month increase in broad money (M2).

An analysis of individual contributions of money supply elements within M2 shows a continued negative contribution of M1 to M2 growth (-1.78%), while the size of savings and time deposits stabilized at 2.8% following a decline (in Q4 to 1.4%). The greatest contribution to M2 growth in Q1 came from foreign exchange deposits (Graph T7-1), which posted a 5.42% growth (8.48% in Q4) – part of which stemmed from the dinar depreciation in Q1. The decline in real M2 implies an additional shrinking of liquidity and a strong recessionary pressure in Serbia.

1 Calculations based on our growth rate adjustment methodology take into account changes in the exchange rate (our assumption is that at least 70% of approved credits are denominated to a foreign currency).

Nominal money supply growth in Q1 is mainly owed to …

… new subsidized credits to non-state sector …

… and the increase in NFA led by exchange rate differentials

The total increase of money supply in Q1 stood at 2.3% of the M2 stock at the start of the year (Table T7-2). This nominal growth was the result of an increase in foreign currency deposits in nominal terms, along with an increase in credits to the non-state sector based on subsidized liquidity loans. The increase in Net Foreign Assets (NFA) was 2.2% of the M2 stock at the start of the year. This growth was positive because of exchange rate differentials which had offset a real decline in foreign currency deposits. The contribution of Net Domestic Assets (NDA) to money supply growth in Q1 was low, at 0.2% of the M2 stock at the start of the year. The main influence on growth came from credits to the non-state sector of 3.6%. The credit growth to the non-state sector mainly refers to subsidized liquidity loans to corporates, initiated by the government and the NBS at the start of February. Despite the effects of those components on money supply growth, the real growth was still negative, when the rise in the Consumer Price Index of 5.8% is taken into account.

Table T7-2. Serbia: Money and Component Aggregates, 2006–2009

	2006	2007				2008				2009
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
	y-o-y, in%									
M2[1)]	39.2	42.9	37.4	39.4	41.5	41.0	33.7	24.5	9.8	6.5
Credit to the non-government sector[2)]	17.5	21.6	23.9	28.0	38.3	36.4	30.3	29.4	33.7	33.8
Credit to the non-government sector[2)], adjusted [3)]	24.1	26.3	30.2	31.2	38.4	35.3	30.7	32.2	23.6	20.9
Households	62.2	58.4	54.7	53.6	50.6	43.3	35.5	19.5	15.7	7.4
Enterprises	11.1	14.2	20.2	21.1	32.2	31.0	28.1	39.5	28.1	28.8
	real y-o-y, in %									
M2[1)]	30.5	35.3	30.7	29.7	28.6	26.2	19.2	12.2	2.9	-3.2
Credit to the non-government sector[2)]	10.2	15.2	17.8	19.1	25.6	22.0	16.2	16.6	25.2	21.7
Credit to the non-government sector[2)], adjusted[3)]	16.4	19.8	24.1	22.2	25.6	21.1	16.4	19.0	15.7	9.4
Households	52.1	50.1	47.4	43.1	36.7	28.2	20.7	7.6	8.3	-2.8
Enterprises	4.2	8.3	14.5	12.8	20.1	17.3	14.1	25.6	19.9	16.5
	cumulative, in % of opening M2[4)]									
M2[1)]	39.2	5.9	11.0	23.9	41.5	5.5	4.8	9.0	9.8	2.3
M2 dinar[1)]	19.8	-0.1	0.8	6.8	16.8	-2.5	-2.7	-1.1	0.5	-1.9
Foreign deposits (households and enterprises)[5)]	25.7	4.0	10.1	17.3	24.5	5.6	7.7	12.5	2.3	-0.1
Valuation adjustments[6)]	-6.4	1.9	0.0	-0.1	0.2	2.4	-0.2	-2.3	7.0	4.4
NFA, dinar increase	41.1	5.2	12.0	14.5	24.4	3.6	-3.2	-3.0	-8.8	2.2
NFA, fx increase	48.4	3.1	12.0	14.7	24.2	1.2	-3.0	-1.0	-14.5	-1.1
Valuation adjustments[6)]	-7.3	2.2	0.0	-0.1	0.3	2.5	-0.2	-2.0	5.7	3.3
NDA	-1.9	0.6	-1.1	9.4	17.1	1.9	8.0	12.0	18.7	0.2
o/w: credit to the non-government sector[2)], adjusted[3)]	27.3	6.6	19.6	28.3	36.6	4.8	12.8	22.2	22.0	3.6
o/w: net credit to government[7)]	-17.4	-4.1	-7.7	-7.0	-1.9	-0.6	1.0	1.9	7.0	-2.0
o/w: NBS and com. banks capital and reserves	-13.2	-2.2	-7.4	-11.6	-17.9	-3.5	-4.6	-6.3	-16.4	0.7
	cumulative, in % of GDP[8)]									
Net credit to government[7)]	-3.4	-1.3	-2.1	-1.9	-0.5	-0.3	0.3	0.7	2.2	-0.9
o/w: dinar credits	0.6	-1.2	-2.3	-2.1	-1.1	-0.8	-1.3	-1.0	0.8	-0.5
Credit to the non-government sector[2)], adjusted[3)]	4.3	2.6	5.4	7.7	9.8	2.7	4.4	6.6	10.7	3.4

Source: Table P-12 in Analytical Appendix.
Money supply: components – see Analytical and Notation Conventions of *QM*
Credits to the non-state sector – credits to the corporate sector (including local governments) and households.
Flows have been adjusted for the changes in the exchange rate. Adjustments have been made under assumption that 70% of credits to the non-state sector (both households and the corporate sector) have been euro-indexed.
The starting M2 marks the M2 stock at the start of the year, i.e. at the end of the previous year.
The contribution of foreign currency deposits to M2 growth measures only the contribution of an increase in foreign currency denominated foreign currency deposits so that their revaluation produces exchange rate differentials.
Exchange rate differentials refer to a difference between the contribution of NFA to M2 growth measured in dinars and the contribution of NFA to M2 measured in foreign currencies.
Credits to the state, net – the difference between credits (dinar and foreign currency) and deposits (dinars and foreign currency) of the state. The state does not include local governments, which are treated as non-state sector.
GDP used in calculations is annually centred.

An increase in non-performing loans is visible in Q1

A new negative occurrence noticed in Q1 refers to a trend of growth in non-performing loans against total credits. Their level reached around 9% (in Q4 2008 it stood at 4.46%), which is a cause for concern and calls for vigilance when this indicator is concerned (Table T7-3). Non-performing loans to legal entities have the greatest individual share in the total, having exceeded 12%[2]. In the absence of growth of new lending sources, coupled with a growing risk and the cost of lending, credit activity in the previous quarter had fully died out, leading to a drastic increase in illiquidity of the domestic economy. Considering that at the same time both domestic and foreign demand significantly shrank, the number of companies whose accounts had been blocked started to grow rapidly. According to our estimates, a critical point for this indicator is 10%-12% of total lending, following which the banking system could lose a significant portion of capital and dip into a serious liquidity crisis. In Q1, the money multiplier was low (1.4) (in Q4 2008 it was 2.2), reflecting the lack of preparedness of the banking sector to lend under more

2 The Credit Bureau of the Serbian Bank Association: "The status of debt based on bank loans and matured, overdue liabilities, as at 31.03.2009".

acceptable conditions and of a further slowdown in lending. This led to an undesired sterilization of money supply, despite the government and NBS' efforts to boost the volume of credits to the economy. The share of foreign currency deposits of the corporate sector and households posted a minor growth but still held onto high levels of 62.8% (in Q4 it stood at 60.2%). The high level of euroization in the Serbian economy is even higher than in Croatia, which is considered to be a highly-euroized economy with the euroization level of 55.7%[3].

Table T7-3. Serbia: Monetary Review, 2006–2009

	2006	2007				2008				2009
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
STOCK	in millions of dinars, end of period									
NFA	407,565	441,048	484,388	500,302	563,524	596,215	534,403	536,102	483,707	504,072
o/w: NBS gross reserves	715,114	719,381	730,668	751,920	765,615	788,296	720,967	745,070	724,755	772,902
o/w: commercial bank foreign liabilities	-307,742	-318,598	-286,848	-290,860	-299,659	-264,865	-251,182	-279,131	-349,703	-345,733
NDA	231,055	234,991	224,279	291,193	340,174	357,307	412,802	448,498	508,826	511,535
Net credit to government [1)]	-100,061	-128,909	-149,081	-144,385	-112,290	-120,644	-103,539	-94,156	-53,042	-76,033
Net dinar credit	-8,776	-35,782	-62,290	-56,369	-34,251	-53,126	-67,826	-60,934	-14,199	-27,201
Net fx credit	-91,285	-93,127	-86,791	-88,016	-78,039	-67,518	-35,713	-33,222	-38,843	-48,832
Credit to the non-government sector [2)]	609,171	666,007	732,402	786,873	842,512	908,598	953,977	1,018,307	1,126,111	1,215,843
Other items, net	-278,055	-302,107	-359,042	-351,295	-390,048	-430,647	-437,636	-475,653	-564,243	-628,275
M2[3)]	638,620	676,039	708,667	791495	903,698	953,522	947,205	985,134	992,533	1,015,607
M2 dinar[3)]	283,116	282,299	288,329	326,341	390,307	367,648	365,834	380,015	395,088	378,094
Fx deposits (households and economy)	355,504	393,740	420,338	465,154	513,391	585,874	581,371	605,119	597,445	637,513
STRUCTURAL INDICATORS										
Currency outside banks/Dinar deposits (households and economy), in %	31.9	26.2	29.1	25.1	24.6	23.7	23.5	23.2	29.5	26.0
Fx deposits (households and economy) / M2 (%)	55.7	58.2	59.3	58.8	56.8	61.4	61.4	61.4	60.2	62.8
Velocity (GDP[4)] / M2)	3.3	3.3	3.2	2.9	2.6	2.6	2.7	2.7	2.7	2.6
M2 / GDP[4)]	0.30	0.31	0.3	0.3	0.38	0.39	0.37	0.37	0.38	0.4
Credits to the non-government sector / GDP[4)]	0.29	0.30	0.32	0.34	0.35	0.37	0.37	0.38	0.43	0.5
Non-perofrming loans[5)] (in % of total loans)	4.7	4.9	4.69	5.20	5.1	4.4	5.3	6.0	5.8	9.1
Money multiplier (dinar M2/H)	2.0	2.4	2.0	2.3	2.3	2.6	2.0	2.3	1.2	1.4

Source: Table P-13 in Analytical Appendix.
See footnote 7) in table T7-2.
See footnote 2) in table T7-2.
Money supply: components – see Analytical and Notation Conventions.
See footnote 8) in table T7-2.
The ratio of credits with permanent overdue payments of 90 days or more to total credits. Source for the figure is the Credit Bureau of the Serbian Bank Association; see more detail in J. Dimitrijevic "Non-performing loans in Serbia – What is the right measure?", QM6.

Banking Sector: Lending and Sources of Financing

In Q1, domestic banks increased the total volume of lending to companies by €331 mn

In the course of Q1, banks raised their lending to the corporate sector and households by €226 mn (in Q4 2008 by €152 mn). The increase in extended loans resulted from a €331 mn growth in credits to the corporate sector (in Q4 2008 €135 mn), while at the same time households were reducing their indebtedness, repaying €104 mn worth of debts, which can be attributed to a strong impact of the crisis on household borrowing. In Q1, the same pattern occurred in the corporate sector, which repaid €144 mn worth of their debts to foreign creditors. Foreign bank creditors remained reluctant to increase lending; this reluctance started in the middle of the previous year (in Q4 €316 mn, in Q3 1.017 bn, in Q2 €835 mn, Table T7-5). With a practically negative growth in cross-border credits, the entire lending to the corporate sector comes from the domestic banking sector. However, due to the corporate sector's debt repayments to foreign creditors and due to debt repayments by households, this growth has fallen to €82 mn, which is exceptionally low compared with the previous year (in Q4 €468 mn, in Q3 €2.174 bn, in Q2 €1.624 bn, Table T7-5). The Government of the Republic of Serbia and the NBS have responded by adopting of a series of measures at the start of February, which have enabled lending to corporates and households at interest rates of 5%-6% for euro-indexed loans. This has led to a certain recovery in the banking sector's lending activity. According to the Ministry of Economy and Regional Development figures, banks approved €268 mn worth of liquidity loans, €500.000 worth of investment credits and €14 mn worth of consumer credits by the beginning of May.

…while households reduce their indebtedness

3 Source: The Croatian National Bank, www.hnb.hr/monet/hmonet.

Table T7-4. Serbia: Banking Sector Activity – Sources and Structure of Lending, Adjusted[5)] Flows, 2006–2009

	2006	2007				2008				2009
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
	in millions of euros, cumulative from the beginning of the year									
Funding(-, increase in liabilities)	-5,237	-325	-1,061	-2,574	-4,582	258	-717	-2,140	-833	958
Domestic deposits	-2,245	-339	-757	-1,819	-3,254	-162	-464	-1,134	-95	235
Households deposits	-1,200	-329	-652	-1,059	-1,652	-192	-518	-842	84	-40
dinar deposits	-124	-35	-57	-97	-135	-18	-19	-28	-63	46
fx deposits	-1,076	-295	-595	-963	-1,518	-174	-499	-813	147	-87
Enterprise deposits	-1,045	-10	-105	-760	-1,602	29	54	-292	-180	276
dinar deposits	-739	23	112	-324	-1,138	365	394	261	198	171
fx deposits	-307	-33	-218	-437	-464	-336	-340	-554	-378	105
Foreign liabilities	-1,660	-10	266	207	114	564	601	138	-165	299
Capital and reserves	-1,331	25	-569	-962	-1,441	-144	-855	-1,144	-572	424
Gross foreign reserves(-,decline in assets)	-77	-14	5	-17	695	-333	-386	-316	-18	-407
Credits and Investment[1)]	3,100	687	1,294	2,488	3,626	697	1,175	2,888	700	156
Credit to the non-government sector, total	1,541	575	1,508	2,315	2,945	614	1,402	2,595	2,022	226
Enterprises	536	313	865	1,271	1,660	406	915	2,099	1,574	331
Households	1,006	263	644	1,044	1,285	207	487	496	448	-104
Placements with NBS (Repo transactions and treasury	1,637	200	-11	438	849	116	-126	361	-1,419	40
Government, net[2)]	-79	-89	-203	-264	-168	-33	-101	-68	98	-110
MEMORANDUM ITEMS										
Required reserves and deposits	1,813	-146	242	349	441	-369	-275	-97	-225	-191
Other net claims on NBS[3)]	0	13	-44	-104	-44	6	246	28	422	-385
o/w: Excess reserves	-50	20	-56	-103	-92	0	207	-13	443	-409
Other items[4)]	499	-110	-464	-57	-78	-202	-192	-490	-330	-166
Effective required reserves (in %)[5)]	36	34	37	34	31	30	29	28	30	30

Source: Table P-14 in Analytical Appendix.

As of this issue, the methodology for the calculation of the increase in lending has been changed because data on distribution of credits by maturities is no longer available. We still maintain the assumption that 70% of the total lending is euro-indexed. The increase for original dinar values of deposits was calculated based on the average exchange rate for the period, for fereign currency deposits – as a difference in stocks, calculated at the end-of-period exchange rate. Capital and reserves were calculated at the end-of-period exchange rate of the euro and exclude exchange rate differentials that would have emerged from new calculations of all other items.

NBS securities include treasury bills and NBS bills that sell at the repo rate and at the rate set by the market in auctions of maturities exceeding 14 days.

Net credits to the state: credits granted to the state less the state deposits held with commercial banks; negative values mean a higher increase in deposits over credits. The state includes all levels of the government: the Republic and local governments.

Other NBS claims (net): the balance between commercial bank claims against the NBS based on cash and disposable reserves, and their liabilities towards NBS

Commercial banks' balance sheet items: other assets, deposits of legal entities undergoing receivership, interbank relations (net) and other liabilities excluding capital and reserves.

Effective reserve requirements represent the share of mandatory reserves and deposits in the total of deposits (households, corporates) and banks' borrowing abroad. The base to calculate the reserve requirements excludes subordinated debt, due to unavailability.

Banks increase REPO purchases in Q1 …

… after a significant decline in Q4

Unlike Q4, when we witnessed a flight from REPO purchases equivalent to around €1.780 bn, due to early repayment of debts to foreign creditors, banks increased REPO and six-month bill purchases in Q1 by €40 mn, thus ending a trend from Q4. With those REPO operations, banks additionally contributed to the decline of the multiplier and the volume of REPO purchases would have been lower if banks had agreed to lend their funds at lower interest rates to companies and households. The total capital of the banking sector continued to fall. In Q1 the decline amounted to €424 mn (in Q4 2008 it fell by €572 mn), which results mainly from the dinar depreciation in that quarter, because the capital is calculated in dinars.

In Q1 banks cut their foreign debts

Deposits of the corporate sector continued to shrink in Q1 by €276 mn (in Q4 the decline was €113 mn), which speaks of a continued decline in liquidity in the economy (Table T7-4). A positive move was noticed with household deposits, first of all foreign currency deposits, which led to a growth of €40 mn (in Q4 2008 the volume of household deposits fell by €758 mn). Banks gathered some funds through a cut in net credits to the state by €110 mn in Q1 as a result of growth in the deposits of local governments, probably based on the sale of NIS. In Q1, we also saw new NBS measures designed to release liquidity from the reserve requirement accounts, as part of a package of measures of the government and the NBS aimed at maintaining financial stability. Thanks to subsidized loans approved by banks, banks withdrew €191 mn from the NBS in the absence of new savings of companies and households. Also in the course of Q1, the NBS cut its reference interest rate three times – to its current level of 14%. Debts of the banking sector to foreign creditors fell by €299 mn in Q1 following repayment of credit lines, which banks had been forced to take (in Q4 borrowing stood at €387 mn) in order to repay early the deposits of local savers during the first crisis shock.

Table T7-5. Serbia: Borrowing of Companies and Households – the Impact on Aggregate Demand

	2006	2007				2008				2009
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
	quarterly growth of stock, in millions of euros									
Total loans to enterprises and households from domestic banking sector and direct foreign borrowing by enterprises	746	1,053	2,157	1,537	1,542	1,333	1,624	2,174	468	82
Loans to enterprises and households from domestic banking sector 1)	222	575	933	807	630	614	789	1,157	152	226
Loans to enterprises	-21	313	552	406	389	406	509	1,162	135	331
Loans to households	243	263	381	400	241	207	280	-6	17	-104
Direct foreign liabilities of enterprises	524	478	1,224	730	912	719	835	1,017	316	-144
Direct foreign liabilities of enterprises and banks' credits to enterprises from domestic banking sector	503	791	1,776	1,137	1,301	1,125	1,344	2,179	451	187
	quarterly growth of stock, in % of quarterly GDP									
Total loans to enterprises and households from domestic banking sector and direct foreign borrowing by enterprises	10.4	16.3	30.1	20.0	18.0	17.4	18.3	23.8	5.5	1.2
Loans to enterprises and households from domestic banking sector	3.1	8.9	13.0	10.5	7.4	8.0	8.9	12.7	1.8	3.3
Loans to enterprises	-0.3	4.8	7.7	5.3	4.5	5.3	5.7	12.7	1.6	4.8
Loans to households	3.4	4.1	5.3	5.2	2.8	2.7	3.1	-0.1	0.2	-1.5
Direct foreign liabilities of enterprises	7.3	7.4	17.0 2)	9.5	10.7	9.4	9.4	11.1	3.7	-2.1
Direct foreign liabilities of enterprises and banks' credits to enterprises from domestic banking sector	7.0	12.3	24.8	14.8	15.2	14.7	15.1	23.9	5.3	2.7

Source: FREN.
1) See footnote 1) in table T7-4.
2) Of which 9.1% of GDP refers to one credit to Telekom for the purchase of the Bosnian Serb Republic's Telekom Srpske.

The ratio of lending to companies to GDP rises to EU levels

Just like in the previous quarter, due to a massive depreciation of the dinar, the share of lending in GDP grew (in dinar terms), even though credit activity, calculated in original currencies, ground to a halt. In Q1, the balance of credits from the domestic banking system and directly from abroad exceeded 70% of GDP, which had led Serbia to EU levels[4] (66.2% in Q4 2008, Table T7-6). With this share, companies will find it increasingly difficult to borrow from banks.

Table T7-6. Serbia: the Ratio of Outstanding Credit Stock to Companies and Households to GDP

	2006	2007				2008				2009
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
Total loans to enterprises and households from domestic banking sector and direct foreign borrowing by enterprises	44.8	48.2	52.5	55.5	60.0	65.3	66.3	70.2	80.6	86.3
Loans to enterprises and households from domestic banking	27.7	29.5	31.7	33.0	34.4	36.7	36.9	38.5	42.0	45.2
Loans to enterprises	18.1	19.0	20.3	20.6	21.6	23.0	23.4	25.7	27.6	30.3
Loans to households	9.6	10.5	11.3	12.3	12.8	13.7	13.5	12.8	14.5	14.9
Direct foreign liabilities of enterprises	17.1	18.7	20.8	22.6	25.6	28.7	29.4	31.7	38.6	41.1
Direct foreign liabilities of enterprises and banks' credits to enterprises from domestic banking sector	35.2	37.7	41.2	43.2	47.1	51.7	52.8	57.4	66.2	71.4

Source: FREN.

The Central Bank: Balances and Monetary Policy

Reserve money fell in Q1…
… as a result of a fall in net own reserves…
… due to interventions on the interbank forex market…
… and exasperated by a decline of all NDA elements

The reserve money level fell significantly in Q1 2009, by 15.8 % (Table T7-7). The reserve money (H) has fallen as a result of the decline in net own foreign currency reserves of the NBS (they stood at 1.8% of initial H) primarily as a consequence of defending the exchange rate (interventions on the interbank forex market, net currency purchases from exchange offices, currency purchases from the state, exchange rate differentials, etc). At the same time, net domestic assets (NDA) of the central bank posted a significant decline (in Q1 they stood at 14% of the initial H). In Q1, NDA fell because of the growth in the dinar deposits of the state (in Q1 5.6% of initial H), an increase in repo purchases (2.7% of initial H) and the decline in other net domestic assets (5.6% of initial H), which had additionally sterilized the reserve money (Table T7-7).

The reduction in NBS net own reserves…
… due to significant interventions on the interbank forex market…
… even bigger decline prevented due to privatization revenue

The net own reserves of the NBS fell in Q1 by around €59 mn (the fall by 394 million euros in Q4, Table T7-9). Transactions on the forex market – the selling of hard currencies to banks and currency purchases from exchange offices (Table T7-10) – had a strong impact on NBS' net own reserves, leading to their decline in Q1 to the tune of €513 mn. On the other hand, the decline was partially offset by an increase in foreign currency deposits following the sale of NIS, as well as by a devaluation impact. However, this contribution of the change in the exchange rate was negligible and the decline in net own reserves would have been much more dramatic if there had been no increase in privatization revenue by €400 mn[5].

4 Euro area accounts – Monthly Bulletin, Integrated economic and financial accounts by institutional sector. Data 14-05-2009.
5 Part of the NIS privatization revenues went through local governments (in Vojvodina), entering commercial bank accounts.

Table T7-7. Serbia: NBS – Currency Purchases and Sterilization, 2006–2009[1)]

	2006	2007				2008				2009
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
FLOW	in millions of dinars, cumulative from the beginning of the year									
NBS own resreves[2)]	145,315	15,066	46,140	60,267	97,636	4,695	19,115	56,373	27,211	-5,590
NBS own reserves (in euros)	1,783	*188*	*577*	*756*	*1,218*	*58*	*237*	*706*	*312*	*-59*
NDA	-105,744	-46,278	-57,938	-72,100	-72,440	-39,752	-13,347	-66,941	122,232	43,117
Government, dinar credits	120	-710	-735	-735	-5,639	267	618	0	81	-308
Government, dinar deposits	17,540	-30,939	-56,748	-44,985	-10,107	-28,386	-41,088	-36,706	8,638	-17,155
o/w: municipalities	*-3,500*	*-6,768*	*-13,485*	*-11,933*	*-516*	*-8,329*	*-7,405*	*-5,073*	*-909*	*-4,415*
Repo transactions[3)]	-132,903	-16,675	-2,094	-34,961	-67,950	-11,243	8,014	-28,597	127,517	-8,455
Other items , net[4)]	9,499	2,046	1,639	8,581	11,256	-390	19,109	-1,638	-14,004	-17,199
H	39,571	-31,212	-11,798	-11,833	25,196	-35,057	5,768	-10,568	149,443	-48,707
o/w: currency in circulation	14,811	-9,792	-3,395	-3,088	8,488	-6,613	-7,454	-5,388	13,007	-11,856
o/w: excess liquidity	16,516	-13,061	-3,309	-6,293	20,605	-39,840	-22,293	-39,483	1,602	41,330
INCREASE	cumulative, in % of opening H[5)]									
NBS own resreves[2)]	154.0	11.2	34.5	45.0	72.9	3.5	14.3	42.1	20.3	-1.8
NDA	-112.1	-34.6	-43.3	-53.8	-54.1	-29.7	-10.0	-50.0	91.3	-14.0
Government, dinar deposits	18.6	-23.1	-42.4	-33.6	-7.5	-21.2	-30.7	-27.4	6.4	-5.6
Repo transactions[3)]	-140.9	-12.5	-1.6	-26.1	-50.7	-8.4	6.0	-21.4	95.2	-2.7
Other items , net[4)]	10.1	1.5	1.2	6.4	8.4	-0.3	14.3	-1.2	-10.5	-5.6
H	41.9	-23.3	-8.8	-8.8	18.8	-26.2	4.3	-7.9	111.6	-15.8
o/w: currency in circulation	15.7	-7.3	-2.5	-2.3	6.3	-4.9	-5.6	-4.0	9.7	-3.8
o/w: excess liquidity	17.5	-9.8	-2.5	-4.7	15.4	-29.7	-16.6	-29.5	1.2	-13.4

Source: Table P-14 in Analytical Appendix.
"State" includes all levels of governments: the Republic and local governments.
The definition of net own reserves of NBS has been given in part 8 "Monetary Flows and Policy", Box 4, QM5.
This category includes NBS bills and repo operations.
Other net domestic assets include: domestic credits (net claims against banks, excluding NBS bills and repo transactions, net claims against companies) together with other assets (capital and reserves; and items in the balance: other assets and other liabilities), adjusted for exchange rate differentials.
"Initial H" marks the stock of the reserve money (H) at the start of the stated year, i.e. the end of the previous year.

Table T7-8. Banks' Reserve Requirement Levels with the NBS[1)], March 2006-March 2009

	12/2004	05/2005	07/2005	10/2005	11/2005	03/2006	04/2006	05/2006	11/2006	12/2006	10/2007	10/2008	12/2008
Rate on:													
DINAR DENOMINATED BASE	21	20	20	18	18	18	18	18	15	10	10	10	10
more then 1 month dinar time deposits											5	5	5
non-resident accounts with maturity up to 2 years:								60	60				
non-resident accounts with maturity over 2 years:								40	40				
FX DENOMINATED BASE	21	26	29	35	38	40	40	40	40	45	45	45	45
thereof: new external bank borrowings after septmeber 2008 [2)]												0	
NEW FX SAVINGS DEPOSITS[3)]	47	47	45	41	38	40	40	40	40	40	40	40	
SUBORDINATED CAPITAL						20	20	20	20	20	20	20	
thereof: new external bank borrowings novo zaduženje banaka after septmeber 2008[4)]												0	

Source: NBS.
1) Applied to an average daily book value of the base in the last calendar month, and effective as of 17th of the next month. A bank is obliged to maintain an average daily reserve balance at the level of calculated reserves.
2) Until April 2006 and since December 2006, banks' borrowing abroad was treated equally regardless of maturities. Therefore, this sub-category has no values as at March 2006 and since December 2006, i.e. a single hard currency base is applied to all inflows from abroad based on commercial banks' borrowing.
3) According regulations which were in effect until December 2005, commercial banks' liability to set aside funds with the NBS based on collected new foreign currency savings deposited by households (savings accounts deposited after June 30, 2001) – were regulated by a separate NBS decision. The regulation became unique from the moment of equalization of the mandatory reserve rate on all foreign currency assets of commercial banks.
4) Since October 2008, new banks' borrowing abroad has been exempt from the reserve requirements until the expiry of the borrowing, while previous mandatory reserve rates apply for old borrowing.
5) As of December 17, 2008, the base to calculate the reserve requirement is the volume of liabilities as at September 30, 2008 and the rule will be implemented between December 17, 2008 and January 17, 2010.
6) Since May 17, 2008, 10% of the calculated foreign currency reserves is held in dinars; since November 17, 2008 20% of the calculated foreign currency reserves is held in dinars and since December 17, 2008 40 percent of the calculated foreign currency reserves is held in dinars.
Notes:
According to valid regulations, the mandatory reserve requirements, which banks keep with the NBS, include:
– dinar base: dinar deposits (including the state), dinar loans (including the state), securities and other dinar liabilities.
– Foreign currency base: foreign currency deposits (including the state), foreign currency indexed dinar deposits, foreign currency loans (including the state), subordinated capital, securities, other foreign currency liabilities and other foreign currency assets received from abroad from services the bank provides on behalf and for the account of third parties.
Dinar and foreign currency base excludes: liabilities to the NBS; until December 2005, liabilities arising from private foreign currency savings deposited with banks after June 30, 2001; liabilities for the repayment of debt for old foreign currency savings and liabilities for the repayment of rescheduled debt to the Paris Club and the London Club. The base is lowered for the amounts of long-term housing loans insured by the National Corporation for Housing Loans Insurance.

Table T7-9. The Structure of Serbia's Foreign Currency Reserves – Stock and Flow, 2006–2009

	2006	2007				2008				2009
	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
					stock, in millions of euros					
NFA of Serbia	5,164	5,413	6,130	6,347	7,116	7,246	6,768	7,000	5,451	5,305
Commercial banks, net	-3,188	-3,213	-2,918	-2,998	-2,379	-2,147	-2,163	-2,557	-2,562	-2,670
Gross foreign reserves	707	693	712	690	1,403	1,070	1,017	1,087	1,385	978
Foreign liabilities	-3,895	-3,906	-3,630	-3,688	-3,782	-3,218	-3,180	-3,644	-3,947	-3,648
NBS, net	8,352	8,626	9,048	9,345	9,495	9,394	8,931	9,557	8,013	7,975
Gross foreign reserves	9,052	8,819	9,246	9,535	9,662	9,577	9,129	9,727	8,180	8,155
Foreign liabilities	-700	-193	-198	-190	-168	-183	-198	-170	-167	-180
IMF	-181	6	1	3	4	3	1	1	-9	-14
Other liabilities	-519	-200	-199	-193	-171	-186	-199	-171	-159	-166
NBS, NET RESERVES-STRUCTURE										
1. NBS, net	8,352	8,626	9,048	9,345	9,495	9,394	8,931	9,557	8,013	7,975
1.1 Commercial banks deposits	-3,210	-3,358	-3,478	-3,584	-3,409	-3,411	-3,166	-3,343	-2,191	-2,136
1.2 Government deposits	-1,309	-1,247	-1,160	-1,172	-1,034	-874	-478	-457	-459	-536
1.3 **NBS own reserves** (1.3 = 1 - 1.1 - 1.2)	3,833	4,021	4,410	4,589	5,051	5,109	5,287	5,757	5,362	5,303
					in millions of euros, cumulative from the beginning of the year					
NFA of Serbia	2,620	249	967	1,183	1,952	131	-348	-116	-1,665	-146
Commercial banks, net	-1,737	-24	270	190	809	232	216	-178	-183	-108
Gross foreign reserves	-77	-14	5	-17	695	-333	-386	-316	-18	-407
Foreign liabilities	-1,660	-10	266	207	114	564	601	138	-165	299
NBS, net	4,357	274	696	993	1,143	-101	-563	62	-1,482	-38
Gross foreign reserves	4,083	-233	194	483	610	-86	-534	65	-1,482	-25
Foreign liabilities	274	507	502	510	532	-15	-30	-2	1	-13
IMF	567	187	182	184	185	0	-2	-3	-12	-5
Other liabilities	-294	320	320	327	348	-15	-28	1	13	-7
NBS, NET RESERVES-STRUCTURE										
1. NBS, net	4,357	274	696	993	1,143	-101	-563	62	-1,482	-38
1.1 Commercial banks deposits	-1,485	-148	-269	-374	-200	-2	243	66	1,219	55
1.2 Government deposits	-1,089	63	149	137	275	161	557	578	575	-76
1.3 **NBS own reserves** (1.3 = 1 - 1.1 - 1.2)	1,783	188	577	756	1,218	58	237	706	312	-59

Source: NBS.

Notes: Foreign currency reserves of the NBS are treated differently in the monetary survey and in NBS' balance sheet. In the monetary survey, this category includes IMF loans and other external liabilities, while the NBS balance sheet, beside the listed items, also includes foreign currency deposits of commercial banks (reserve requirements and other foreign currency deposits.

Table T7-10. Net Monthly Foreign Currency Trade NBS – Banks and Exchange Offices, Nov. 2006-March 2009

	Interbank fx market (NBS-commercial banks)	Exchange offices	Total	
(-. net sale of foreign currency by NBS)				
	in millions of euros			
Monthly average January-October 2006	-64	151	87	
November 2006	260	131	391	
December 2006	154	86	240	
January 2007	-412	42	-370	
February 2007	-14.8	86	72	-238 in Q1 2007
March 2007	-54.1	114	60	
April 2007	0	137	137	
May 2007	-75.9	160.1	84	+288 in Q2 2007
June 2007	-19	85.7	67	
July 2007	-22	93.9	72	
August 2007	-23	106	83	+195 in Q3 2007
September 2007	-20	60	40	
October 2007	-4	72	68	
November 2007	-20	76	56	+212 in Q4 2007
December 2007	-40	128	88	
January 2008	-57	63	6	
February 2008	-129	39.6	-89	-168 in Q1 2008
March 2008	-105	20.6	-84	
April 2008	-64	31.2	-33	
May 2008	-38	54.3	16	+29 in Q2 2008
June 2008	0	45.3	45	
July 2008	0	26.8	27	
August 2008	3	33	36	+88 in Q3 2008
September 2008	0	24.7	25	
October 2008	-269	55	-214	
November 2008	-357	16.9	-340	-746 in Q4 2008
December 2008	-288	96.3	-192	
January 2009	-381.3	23.6	358	
February 2009	-175.1	12.6	-163	-513 in Q1 2009
March 2009	0	7.6	7.6	

Source: NBS.

8. Financial Markets

The downward trend in activity on the Belgrade Stock Exchange continued in Q1 2009, as evidenced by both the value of trading and the number of transactions. Drops in activity were recorded in both the continuous and the discontinuous segments. Belgrade Stock Exchange indices continued falling throughout Q1, but have recovered since the beginning of Q2. BELEX15, the blue-chip index, rose by some 57% from the beginning of Q2 to late May, while BELEXline, the Belgrade Stock Exchange overall index, grew by about 39%. The NBS cut its reference interest rate by 125bp to 16.50% in Q1, and by the end of April, total cuts reached 250bp, leaving the interest rate at 14%. Real yields on repo operations measured relative to inflation followed the cut in the nominal interest rate, while real yield measured relative to the dinar/euro exchange rate rose owing to the stabilization of the dinar. The market in frozen foreign currency deposit (FFCD) bonds stagnated in comparison with the previous quarter, with yields falling for all maturity periods.

The downward trend in activity on the Belgrade Stock Exchange continued in Q1

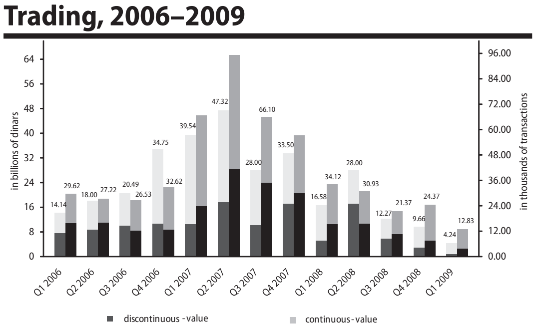
The downward trend in activity on the Belgrade Stock Exchange continued in Q1 (Graph T8-1). The value of trading and the number of transactions halved in relation to the previous quarter. The value of trading in Q1 amounted to a total of 4.24 bn dinars (a fall of 56.08%), while the same period saw some 12,800 transactions (a drop of 47.35%). Despite temporary growth in some quarters, the value of trading on the Belgrade Stock Exchange has been falling since Q2 2007, and its cumulative fall up to Q1 2009 amounted to 91%. The number of transactions fell continuously, by 86.5% in total.

The structure of trading shows that both the continuous and the discontinuous segments have seen drops in activity. The value of trading fell by 48.88% in the continuous and by 75.05% in the discontinuous segment in relation to Q4 2008, while the number of transactions fell by 45.84% and 50.75%, respectively.

This structure of trading on the Belgrade Stock Exchange, along with the fact that the average value of a transaction has continued to fall in Q1 (by 16.58%), indicates that this quarter, like the previous one, was marked mainly by activity on the part of small investors who have continued the trend seen since the last quarter of divesting from the Serbian market, likely for fear of the global crisis.

Belgrade Stock Exchange indices continued following a downward trend in Q1

Graph T8-1. Volume and Structure of Share Trading, 2006–2009



Source: www.belex.rs

After a short-lived upward correction in late 2008, Belgrade Stock Exchange indices continued losing value in Q1 2009, only to see a change in the trend and a rise in the index late in the quarter and continuing into Q2 2009 (Graph T8-2). Investors attempting to cut their losses in a declining market have been selling any shares they were able to – generally blue-chip shares – which has resulted in the blue-chip index, BELEX15, falling more than BELEXline, the overall index. BELEX15[1] lost 30.24% of its value, BELEXline[2] lost 28.92%, while SRX[3] EUR lost 35.47% in Q1. New historic lows stood at 354.39ip and 153.42ip for BELEX15 and SRX EUR, respectively, and were reached on May 11th. BELEXline reached its historic low of 844.36ip on April 1st.

Belgrade Stock Exchange indices saw substantial growth starting in early April

After reaching new historic lows, all indices began growing, a trend which carried over into Q2 2009. From the beginning of Q2 to early May BELEX15 grew by 57.54%, while BELEXline

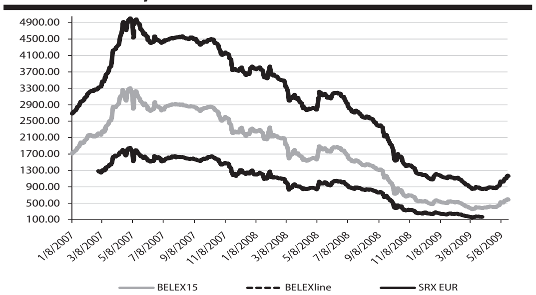
1 Index of the most liquid shares on the Belgrade Stock Exchange.
2 Overall stock index of the Belgrade Stock Exchange.
3 Index of the 8 most liquid shares on the BSE calculated by the Vienna Stock Exchange (Wiener Börse).

gained 39.20%. It should be noted, however, that the Belgrade Stock Exchange also saw a short-lived upward correction in late 2008, which is why data for all of Q2 2009 needs to become available before it is seen whether this is indeed a sign of recovery for the Belgrade stock exchange after a long period of decline.

Regional stock market indices have continued falling in a trend carrying over from Q1

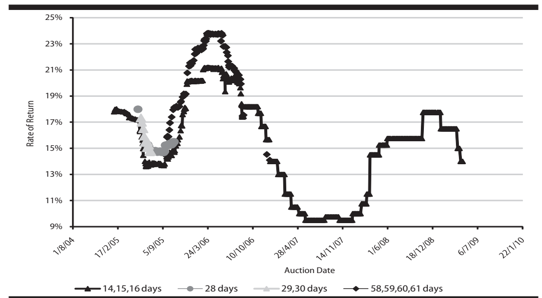
Regional stock market indices, like those of the Belgrade Stock Exchange, declined in Q1 2009, although by less than BELEX15, which lost about 30% of its value in Q1, compared to 28.32% for Sarajevo's SASX-10, 16.63% for the Montenegrin MOSTE, 9.83% for the Banja Luka BIRS, 20.66% for the Romanian BET, and 13.55% for Montenegro's NEX20; Croatia's CROBEX and the Bulgarian SOFIX shed 18.11% and 22.61%, respectively. As before, the greater loss in value recorded by the Belgrade Stock Exchange can be attributed to the shallow nature of the Serbian market, as well as, in all likelihood, the withdrawal of foreign investors who had accounted for most of the trading on the Belgrade Stock Exchange during its period of growth. This is further borne out by the share of foreign investors in trading on the stock market, which fell in Q1 only to rise again in April along with a renewed rise in the value of shares.

Graph T8-2. BELEXfm, BELEX15 and SRX EUR Indices, 2007–2009



Source: www.belex.rs, www.wienerborse.at

Graph T8-3. Repo Yields by Maturity, 2004–2009



Source: NBS.

NBS cut its interest rate by 125bp to 16.50% in Q1 and further reduced it by the end of April, bringing cuts to 250bp in total and leaving the rate at 14%

In Q1, the NBS embarked upon a policy of cutting the reference interest rate (Graph T8-3). At a meeting held in late January, the NBS Monetary Board cut the 2w repo rate by 125bp, to 16.5%. This level was retained until the end of the quarter only to be cut in early Q2 2009 by an additional 150bp, to 15%, and then by a further 100bp, to 14%, in late April.

Real repo yields measured relative to changes in the euro/dinar exchange rate rose in Q1

In spite of cuts to the NBS reference interest rate, Q1 2009 saw real yields on 2w repo operations measured in relation to movements in the euro/dinar exchange rate (changes in the exchange rate over the previous three months[4]) grew, but remained negative throughout Q1, becoming positive again only in April as the dinar appreciated starting in late January and stabilized in February (Graph T8-5). Real yields calculated using this method amounted to some 21% in early Q2, but dropped to 9% in April.

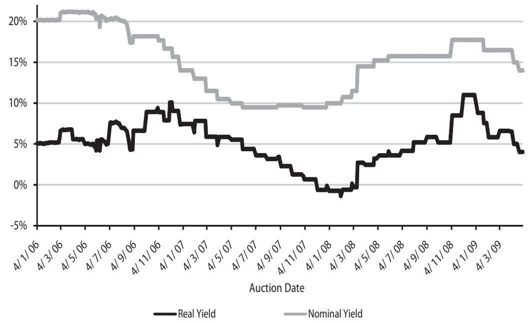
Real repo yields measured relative to inflation fell in Q1

As for real yields measured relative to the inflation rate, they fell in Q1 2009 (Graph T8-4). On the one hand, the NBS cut its reference rate, and, on the other, January and February saw a drop in the inflation rate – meaning that real yields measured relative to inflation fell from 8.81% in January to nearly 5.84% in February.

Interest rates in the money market followed, as usual, the nominal repo rate (Graph T8-6). The average spread between the repo rate and the BELIBOR 2w rate (same maturity as repo agreements) increased by 50bp throughout Q1 to about 105bp, while the spread between the repo rate and the overnight BEONIA rate amounted to 86bp – but, unlike before, the BEONIA rate was higher, which may be considered as normal since BEONIA is an interbank rate, while the repo rate – with its longer maturity period – is set by the central bank.

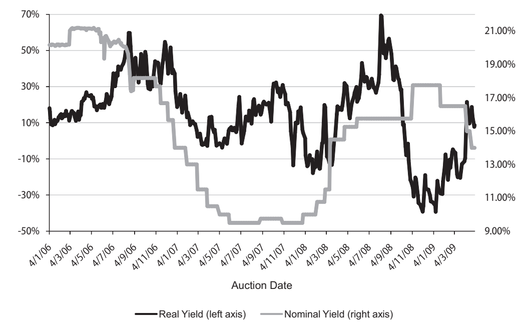
4 A detailed explanation for the use of this approach in calculating real yields can be found in Udovički, K. and Đoković, V, "The Exchange Rate and Policy of the NBS in Serbia: 2002-2006", Spotlight On 1, *QM* 5.

Graph T8-4. Real (with regard to inflation as measured using RPI) and Nominal Repo Yields, 2006-2009



Source: NBS.

Graph T8-5. Real (with regard to RSD/EUR exchange rate) and Nominal Repo Yields, 2006–2009



Source: NBS.

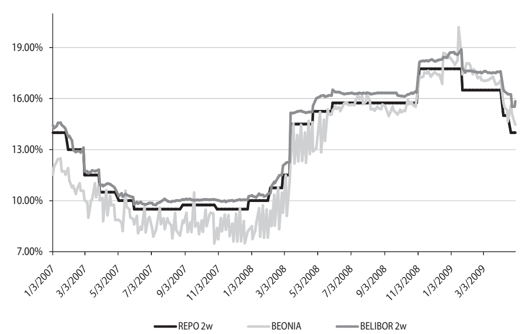
Q1 saw continuing major growth of yields on Republic of Serbia treasury bills

Substantial growth of yields on the Republic of Serbia treasury bills (T-bills), which started in late 2008, continued into 2009 (Graph T8-7). T-bill yields rose from 9.91% in late 2008 to 16.5% by the end of Q1 2009. All treasury bills sold in Q1 have three-month maturity; the issues were worth 2 and 3 bn dinars, respectively, but high yields failed to tempt investors – the realization rate was between 16.68% and 73.24%. Republic of Serbia T-bill auction methods underwent a major overhaul in 2009 with the aim of establishing a stable market in government securities; this has had a significant impact on the efficiency of the market. The next issue of *QM* will provide more details about the progress in the T-bill market.

Volume and turnover on the FFCD market stagnated in relation to the previous quarter

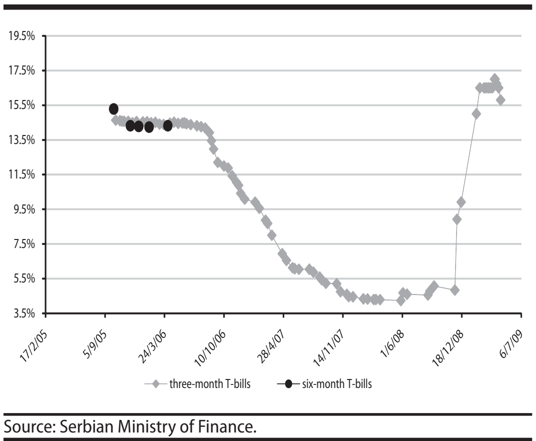
Both the volume and the turnover in the frozen foreign currency deposits (FFCD) market stagnated in Q1 2009, even exhibiting a slight downward trend (Graph T8-8). The volume of trading amounted to some €21.92 mn, while turnover stood at €15.92 mn, 1.47% and 6.13% less, respectively, than in the previous quarter. Activity more than doubled relative to Q1 2008 (with volume growing by 65.74% and turnover by 56.37%); this, nevertheless, does not indicate a change in the trend, since Q1 2008 saw very low activity (primarily because of the fact that elections were being held at the time) – that was an exception rather than the trend.

Graph T8-6. Repo, BEONIA and BELIBOR 2w Rates, 2007–2009



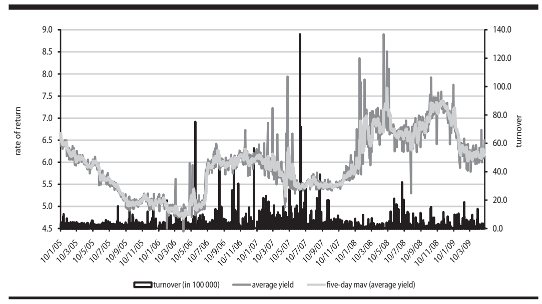
Source: NBS, Reuters.

Graph T8-7. Yields in T-bill Market, 2005–2009



Source: Serbian Ministry of Finance.

Graph T8-8. Average Yield on FFCD Bonds



Source: www.belex.rs

1) The graph does not depict extraordinary yield of A2006 bond of 42% on 10 March 2006.

Note: The graph was derived as the weighted average yield on securities from A2006 to A2016. Turnover values for each of the securities were used as weights.

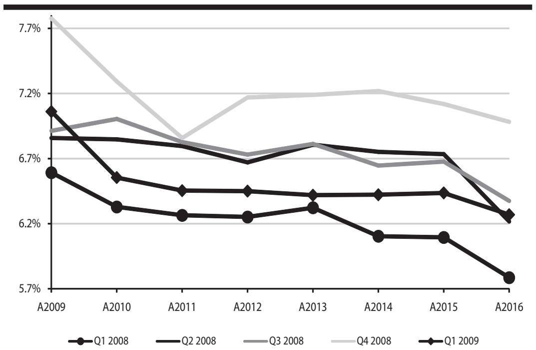
Trends

Q1 2009 saw falling yields across FFCD bonds of all maturities

Average yields on bonds of all maturities, except A2009, fell in Q1 2009 (Graph T8-9). If we exclude A2009, which will mature soon and thus behaves atypically, this drop in yields represents a change in the trend. Yields on FFCD bonds had been growing since early 2008, but saw a fall in Q1 2009 of between 40bp and 80bp. The average yield curve is nearly flat, with rather slight differences in yields on bonds of varying maturities. In Q1 the average yield on A2010 was 6.55%, while the yield on A2016 stood at 6.27% - a difference of 28bp.

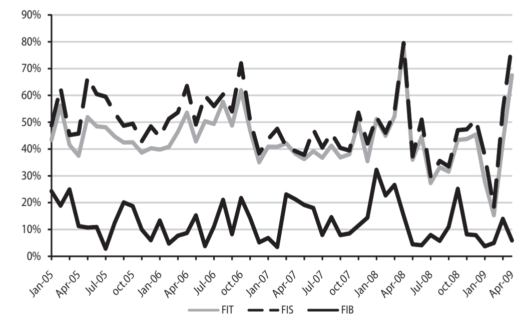
The average yield curve for FFCD bonds flattened out in Q1 2009.

Graph T8-9. Average Yield Curves on FFCD Bonds



Source: www.belex.rs

Graph T8-10. Foreign Investor Share in BSE Turnover, 2005–2009



Source: www.belex.rs
Legend: FIT- Foreign Investor Share in Total Turnover, FIS - Foreign Investors in Equity Market, FIB- Foreign Investors in Bond Market.

The share of foreign investors in the turnover on the Belgrade Stock Exchange fell in Q1 2009, but in April approached historic highs, both on the stock market and in overall turnover

The relative share of foreign investors in the turnover on the bond market (FIB curve, Graph T8-10) fell in Q1 2009, when January and February recorded new historic lows of 3.7% and 4.9%, respectively. On the stock market (FIS curve, Graph T8-10) Q1 saw the average share of foreign investors drop relative to the previous quarter, but April witnessed a recovery with foreign investor share rising to 79.26%, very close to the historic high recorded in April 2008. Finally, the share of foreign investors in overall turnover fell throughout Q1 2009, but, like the situation in the stock market, revived in April, approaching its historic highs. It should be noted, however, that values used to measure foreign investor share are relative: their growth could mean less activity on the part of domestic investors rather than more involvement by foreign ones; in addition, overall activity on the Belgrade Stock Exchange is still on the decrease.

9. International Environment

Global output decline is decelerating and more and more indicators are pointing towards an end of the recession. The recession, however, deepened in the previous quarter, particularly in Asia. The International Monetary Fund revised its projections downwards. Testing of the solvency and stability of major financial institutions was conducted in the USA. GDP growth in the Eurozone was lower than expected, and the EU faces the challenge of conducting a coordinated fiscal policy. Japan opted for a major fiscal package to counter the recession and deflation. East European countries recorded a greater contraction than expected and cutting state spending without undermining the efficiency of the administration will be the most difficult part of their reforms.

Table T9-1. World: Economic Growth and Inflation, 2006-2009[1)]

	Real GDP							Inflation		
	real growth (%)			real growth, seasonally ajusted (%)				y-o-y (%)		
	2006	2007	2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q3 2008	Q4 2008	Q1 2009
USA	3.0	2.2	1.3	3.3	-0.5	-6.3	-6.1	5.2	1.5	-0.2
Canada	2.8	2.5	0.6	0.6	0.9	-3.5	-7.5	3.4	1.9	1.2
Japan	2.2	2.1	-0.4	-4.5	-1.4	-12.1	-15.2	2.2	1.0	0.2
China	11.1	11.4	9.0	11.0	5.2	2.2	5.8	5.3	2.5	-0.6
India	9.4	8.7	6.2	5.9	6.5	0.0	1.8	9.0	10.2	9.4
Euro area	2.9	2.7	0.7	-1.0	-1.0	-6.2	-9.8	3.8	2.3	1.0
Germany	3.1	2.6	1.0	-2.0	-2.2	-8.6	-14.4	3.3	1.7	0.8
France	2.2	1.9	0.7	-1.6	-0.7	-5.7	-4.7	3.6	2.0	0.7
UK	2.8	3.1	0.7	-0.1	-2.8	-6.1	-7.4	4.8	3.9	3.0
Italy	1.9	1.7	-0.9	-2.5	-3.2	-8.3	-9.4	4.1	2.9	1.4
Russia	6.7	8.1	5.6	6.4	5.8	-12.8	-21.0	14.9	13.8	13.9
Bulgaria	6.0	6.1	6.0	7.1	6.8	3.5	-3.5	12.5	9.3	5.1
Romania	6.9	6.0	7.1	9.3	9.2	2.9	-6.4	8.2	6.9	6.8
Hungary	3.8	1.3	0.6	1.3	0.1	-1.7	-4.7	6.3	4.2	3.0
Croatia	5.0	5.6	2.4	3.4	1.6	0.2	…	7.4	4.5	3.8
FYR Macedonia	4.0	5.9	5.0	6.2	5.5	2.1	…	8.4	5.5	1.0
BIH	6.9	6.0	5.5	…	…	…	...	8.5	5.5	1.6
Serbia	*5.6*	*7.1*	*5.4*	*6.0*	*4.9*	*2.8*	*-6.5*	*10.7*	*8.9*	*5.8*

Sources: Eurostat, JPMorgan, National Bank of Bulgaria, National Bank of Romania, National Bank of the Republic of Macedonia.
1) GDP rates for Serbia, Macedonia, Bosnia, Bulgaria, Romania, Hungary and Croatia are year-on-year rather than seasonally adjusted annual rates.

World

Recession probably nearing its end

There are reliable signs that the decline of global output is abruptly slowing down but global demand is still not showing a V-shaped recovery. More and more indicators signal that the recession is nearing its end in developed economies. Stimulus packages have yielded results and consumer spending in the USA rose mildly in Q1. The US real estate market is probably stabilizing and the prices are nearing an equilibrium level. Real estate prices are, however, expected to continue falling until the end of the year.

According to the latest IMF predictions, global growth in 2009 will be negative, standing at -3.8%. The IMF revised the rates downward again due to the deepening of the recession relative to January. The recession deepened, but there have also been signs of possible rapid recovery. Growth in the Eurozone is projected at -4.2% in 2009, which is quite lower than the growth projection for the US (-2.8%), the epicenter of the crisis. The dollar has strengthened recently, primarily because capital flew to the safe haven of US bonds as the crisis expanded. The big fiscal package positively affected personal spending and the prices of houses are slowly stabilizing as well.

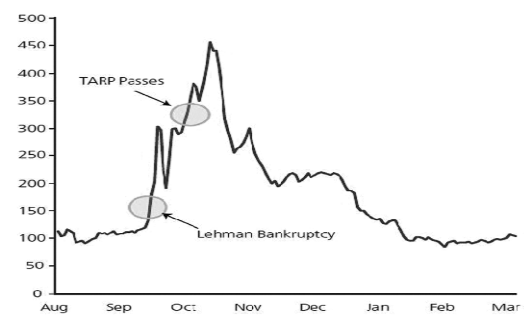
China likely to be the first to rise out of crisis

Developed Asian countries experienced a greater growth contraction than expected. Given that Asian banks had not bought US mortgage bonds, the conviction was that they would buffer the crisis in the region. However, the plunge in demand for their goods, above all consumer products, had greater effects than planned. Projection for Japan's growth was revised downward by as much as 3.6pp, to -6.2% in 2009. This is why Japan is planning a major fiscal stimulus package worth 3% of GDP. China and India are better off than other countries thanks to the lower share of exports in their GDPs and their fiscal packages for stimulating domestic demand. They will record positive growth but with quite a few recession elements – literature often defines this stage as "growth recession"[1]. In the latest IMF report, China's growth was revised downward less than for any other country,, by only 0.2%, projecting it at 6.5% in 2009. Asia will probably be the first to rise out of the crisis thanks to China's and Japan's stimulus packages and no financial system instability problems.

Continued stabilization of the situation in the capital market

The IMF revised upward its forecast for losses incurred by the financial crisis. They are projecting that €4 tr of losses will have to be written off balance sheets, on a global level. This means that €1.7 tr of additional capital will be needed for financial institutions in the US, UK and Europe[2]. A new plan for stabilizing the US banking system is being implemented. Distrust of financial institutions has been waning and the latest measure by the monetary authorities entails testing 19 banks with assets exceeding €100 bn dollars to establish the actual state of these banks. Banks found to be in need of additional capital will have to take money from the state or sell bonds to satisfy norms. The plan has so far been well received by investors and the test results are better than expected. The spread between the LIBOR and three-month Treasury bills is a good measure of the investors' trust in the financial system. The spread has now fallen to "pre-Lehman" levels (Graph T9-2). The testing, however, does not actually address the banks' problems and merely buys them time. They will be at the brink of solvency even after the plan, because it is unlikely that the Treasury will be able to muster political support and aggressively restore order in their balance sheets. Banks are now being given funds and are expected to cover their losses from their future revenues and become solvent in the long-term[3].

Graph T9-2. Spread between the LIBOR and Three-Month Treasury Bonds (in basis points)



Source: *Deloitte.*

Coordinated fiscal policy and stimulus packages are the chief moves to be taken towards recovery in the European Union. The Eurozone's problem lies in the fact that monetary authority is central but fiscal authority is not. The positive effects of the stimulus packages thus expand across the Eurozone while the costs are borne by the country that introduced them locally. In other words, the Eurozone faces the "free rider" problem and, more importantly, the problem of risks from an uncoordinated policy that may have negative effects. Transfers and public spending are expected to have the greatest effects while subsidies and tax facilities are expected to have lesser effects[4]. Moreover, there is no plan in the Eurozone for testing banks and forcing them to recapitalize wherefore the investors are cautious with respect to European banks. The IMF revised upward its forecast of total losses on mortgage securities and indications are that most such securities are outside the US, on the balance sheets of European banks.

East European countries have been increasingly suffering damage from the crisis due to declining external demand and the contraction of capital inflows. Investors have begun concentrating on individual countries more and more and capital has not been fleeing the whole region at the same rate. Economies with high current account deficits and high inflation are thus hit the hardest. East Europe risks becoming the next region in which the consequences of the crisis will deepen because of its macroeconomic weaknesses and the halt in capital inflows[5]. Countries will inevitably have to apply different policies for overcoming the crisis – Russia, for instance, will have to dampen the negative effects of its deteriorating terms of trade, while most other countries will have to prove to investors that they have clear plans for raising fiscal discipline in the future,

1 Growth during which employment falls.
2 World Economic Outlook, IMF April 2009.
3 Deloitte Investment Advisors, Economic & Market Review, First Quarter 2009.
4 Regional Outlook Europe, April 2009.
5 Domino Theory, The Economist, 26 February 2009.

most probably by restructuring the administration without undermining its efficiency to a great extent. Most East European countries will be unable to implement stimulus packages because of their high budget deficits or these packages will need to be quite restricted, concentrating on specific problems. Moreover, the regulatory framework and the supervision of the banking system ought to prevent the recurrence of excessive stimulation of demand through cross border credits, which is unsustainable in the long term.

United States of America

Good news – personal spending is recovering

The negative 6.1%[6] growth in Q1, similar to the results in Q4 2008 (-6.3%) may lead to the conclusion that the recession is not abating. However, the very structure of growth is more favorable, and the prospects for further recovery are now greater than in the previous quarter. The effects of the stimulus packages have yielded results and personal consumption in the USA recorded a mild increase in Q1, standing at 2.2%7 over the previous quarter, after a fall of circa 4% in the previous two quarters. Personal spending, accounting for over two-thirds of GDP, is the first component to plunge and drag down the economy in times of recession but it is also the first component to recover at the end of recession. These data indicate that this may well be the case. Although personal incomes have fallen, tax reliefs have led to an increase in disposable incomes, which stimulated the growth of consumption in Q1. Consumption is unlikely to continue recovering at this rate[8] because it is under pressure from stricter credit approval conditions and the trend of rising unemployment. Moreover, non-agricultural economic supply fell by 7.3% in Q1[9], the greatest quarterly fall in the past fifty years which is sure to positively affect growth in Q2. Fixed investments nosedived. State spending also recorded a greater decline than expected, while the drop in exports came as an unpleasant surprise.

This was the worst quarter for housing construction in the past fifty years. This sector now accounts for merely 2.7% of the total GDP, which is drastically less than in Q4 2005 at the climax of the real estate market boom, when it accounted for 6.2% GDP. The real estate market is expected to stabilize as spending recovers.

The US Administration's attitude towards banks has been subjected to increasing public criticism given the perception that they enjoy a special status, better than companies in other sectors of the economy. The other sectors are left to go bankrupt, while banks are aided at the expense of tax payers. The privileged status of banks is apparent also in the case of General Motors (GM). President Obama criticized hedge funds for resisting lowering their profits on GM bonds, and argued that major banks decided to cut earnings on credits to this car company while hedge funds were not demonstrating solidarity because they refused to reap lower profits from GM bonds they had bought. The argument is not altogether accurate because hedge funds risked their own money, whilst banks can now demonstrate "solidarity" after having obtained extremely favorable credits from the state. Had they obtained money under the same conditions as the banks, hedge funds would definitely have displayed "solidarity" as well. As opposed to the planned $30 bn, Citibank need draw only $5 bn within the Geithner Plan. It appears that "zombie banks" have definitely been created, that they are on good terms with the Administration and coordinate their business operations and steps with it, in return for financial and political support. The US Administration has also begun interfering in the business decisions of banks and insurance companies (sometimes going as far as reviewing their marketing expenses because those expenses are obvious to voters), making pro-libertarian businessmen increasingly frustrated. Given that a good part of Wall Street voted for Obama, newspapers often note that most of those voters had hoped that Obama would not really try to realize the leftist plans he spoke of in the campaign. Many thought he spoke about them "in the heat" of political struggle without actually intending to implement them. President Obama is, however, for now advocating extremely pro-left ideas

6 All quarterly GDP rates hereinafter are seasonally adjusted annualized rates, unless otherwise specified.
7 Quarterly seasonally adjusted annualized rate.
8 BNP Paribas, Eco Flash, Economic Research Department, April 2009, No. 169.
9 Quarterly seasonally adjusted annualized rate.

for the taste of the US society. He will probably have to "soften" his views in face of the increasing opposition to them, although he has secured himself comfortable support in the Senate after one Republican Senator crossed over to the Democrats.

Sale of toxic bank assets plan adopted

The Administration adopted the Public-Private Investment Program (PPIP) for purchasing toxic assets[10] which envisages for this purpose the establishment of funds that will be a mix of private and state capital. These funds[11] will buy pools of "toxic" securities at auctions. The value of toxic securities has fallen by 70% on average since the crisis began. By selling them, the bank balance sheets will thus rid themselves of the ballast and become more solvent. Those interested in buying such securities will have difficulties raising money because credits are hard to come by, while the official prices are extremely disputable because there is practically no liquidity. The PPIP addresses the issue in the following manner: the state shall provide credits, which will boost the purchase of toxic assets and liquidity; this will resolve the problem of the banks' balance and set the "real price" of toxic securities[12]. This "real price" will very likely be higher than the one that could be attained in the free market after short-term nationalization, so that private investors will probably not face losses, but will make non-market gains. Krugman[13] criticized the program because it essentially subsidizes private investors. The state will establish the limit of losses a private investor can sustain, beyond which all other losses will be sustained by the state. Moreover, interest rates on credits offered private investors[14] will be favorable.

President Obama has been criticized by businessmen for excessively interfering in the economy and bank operations and for helping major capitalists make big profits easily thanks to the PPIP, mostly at the expense of the tax payers. However, criticisms of the President for being excessively leftist are much more visible in the public, and it is often forgotten that he has saved through the stress tests the banks from sustaining further losses and that he may have been somewhat lenient towards them, so that, in the end, he has ultimately provided much more support to banks than to other stakeholders in the economy.

Total annual inflation stood at -0.2% in Q1. Although inflation was negative, views are that deflation has not set in yet. Such total inflation is primarily a consequence of the high base because of high energy prices in 2008. Base inflation is stable, standing at around 1.8%. Deflation sets in when manufacturers begin cutting down prices at a large scale, but this was done only by car manufacturers in late 2008. The growth rate of base inflation is stable but would have neared zero in April had the excise tax on cigarettes not been changed. The significant rise in excise taxes upped the prices of cigarettes by over 10% and manufacturers passed nearly the whole excise tax amount on to the consumers. The high percentage of slack capacity often leads to deflation wherefore the tempo of recovery is linked to risk of deflation.

The reference interest rate in December was cut almost to zero, standing at 0.125%. Given the low inflation, this instrument is not fully efficient. The reference interest rate will almost certainly remain at this level until 2010 given that inflation is expected to remain low and deflation is possible.

The latest payroll number is lower than expected although the Administration hired over 60,000 surveyors for the 2010 population census. Company job losses, although lower than in the first quarter of 2009, remain high and unemployment rose to 8.9% in April.

Positive signs on the labor market

Positive signals are coming from the labor market indicating greater prospects that recession is nearing its end notwithstanding the rise in the unemployment rate. In April, 611,000 people lost their jobs in the private sector, which is less than the average monthly job loss of 710,000 in the first quarter of 2009. Job losses in the manufacturing industry in April were 25% lower than the monthly averages in Q1. Surveys show that the rate of lay-offs is expected to fall. Moreover, the

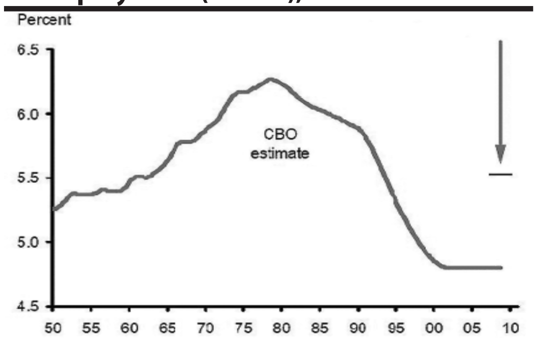
10 The plan entails the founding of Public-Private Investment Funds (PPIPs) under special conditions.
11 The funds will control the pools although the state will lend over 90% of the required capital.
12 The public-private investment program: An assessment, Brookings Institution.
13 „Geithner plan arithmetic", Paul Krugman, 23 March 2009.
14 Private investors need to fulfill the 'major capital' criterion e.g. an institution that registers at an auction must inter alia have at least 10 billion dollars of eligible assets in its portfolio.

number of work hours in that sector has increased. The rate of growth of aid to the unemployed has been falling and lay-offs appear to be slowly abating, although companies have not been employing new workers. The monthly unemployment growth rate has also been declining.

Unemployment rate is moving upward in the long term

Surveys show that the NAIRU rate[15] will increase in the long-term, probably to over 6%[16]. The NAIRU rate was lower than 6% over the past twenty years (Graph T9-3). The time when the US had much lower unemployment rates than Europe is slowly becoming a thing of the past. This indicates that the lower NAIRU in the USA was not only due to its more mobile labor force but also due to other factors as well. Frictional unemployment increases when the qualifications of the labor force and types of vacancies are mismatched. The lower the supply of the labor force with the necessary qualifications, the more difficult it will be for employers to find workers for vacancies. Moreover, mass lay-offs in the financial, retail and construction sectors have marked the onset of the sectoral transformation of demand. New demand for employees will not occur in the above-mentioned sectors; this will definitely increase the discrepancy between labor force supply and demand. This structural imbalance in the labor market increases frictional unemployment and thus the NAIRU rate.

Graph T9-3. USA: Natural Rate of Unemployment (NAIRU), 1950–2009



Source: *Barclay's Research*.

Global trade fell sharply at a rate unprecedented in the last few decades. US exports temporarily recorded a growth rate of 1.5% in February but dropped again already in March. US imports and exports are, however, expected to grow if the global economy recovers. There are already signals of a sharp increase in the number of loaded containers on the West Coast. The balance of payments deficit stood at $89.9 bn in Q1 and the volume of trade fell this quarter as well. The rate of fall in exports has, however, abated, as has the rate of decline in imports at the end of the quarter, in March.

Eurozone

GDP data show deepening recession in Q1 2009. The fall stood at 9.8% and this was the fourth consecutive quarter that witnessed contraction. Detailed GDP data are yet to be published, but contraction can most probably be attributed to the drop in aggregate demand, both domestic and foreign. Expectations were that the fall would stand at around 7% and the news reminded investors that the recession is not definitely over. Lesser retail sales lead to the conclusion that personal spending fell for the second successive quarter.

Although GDP growth was lower than expected, financial markets did not react overly pessimistically. First, investors hope that the reduction in stocks is the chief reason for the low growth in Q1 and that its replenishment in the following quarter will step up growth. Second, the positive signals from the US and China instill hope that foreign demand will improve and thus encourage weak exports.

Germany records surprisingly low growth

Germany underperformed the most: growth stood at -14.4%, but investors are optimistic and focusing on good news regarding industrial output and on the survey at the end of Q1. As industrial output is quite correlated to GDP growth, growth has possibly recovered in Q1 in response to lesser supply and increased foreign demand.

France's growth was as expected (-4.7%) above all due to more stable personal consumption than in other countries. This may not be good news because there is a chance that France is merely falling behind other countries in experiencing the recession phenomena and that the growth rate

15 Unemployment is at the NAIRU level during the realization of the potential growth rate. Inflation usually sharply accelerates if unemployment falls a little below that rate.
16 According to Congressional Budget Office (CBO) surveys, NAIRU stood at around 4.75% in the US in the previous decade.

may drop at a later time. France protects workers from lay-offs: employers have to pay laid-off workers almost their whole wages over the following two years. Laid-off workers thus have no reason to drastically cut consumption. It remains to be seen whether the resistance of the French economy or a time-lag due to specific labor legislative provisions is at issue.

Survey results indicate recession is about to end

Previous recessions in Europe ended after several surveys yielded positive results. These surveys include: the survey of the expectations in the manufacturing industry, the European Commission demand for services survey, new orders in the manufacturing industry, expectations in the service sector and the survey of new jobs in the service sector. All surveys but the one on expectations in the service sector recorded mild growth, which has led many economists to think that it is highly likely that recession is drawing to an end.

The European Central Bank bought around €60 bn of covered bonds, extended the long-term liquidity provision from 6 to 12 months and lowered its reference rate from 1.25% to 1%. All these measures are aimed at reducing aversion to risk, stepping up investments and preventing the contraction of housing and consumer credits. The purchase of covered bonds is interesting given that, contrary to the FED, the ECB refused to purchase toxic assets from the financial institutions and did not even conduct the bank tests. Rumor has it that the the ECB Governing Council is highly influenced by the German lobby, given Germany's interest in the covered bonds market because most covered bonds originate in that country. The stabilization of the financial market is the argument invoked to explain why the ECB began purchasing these instruments strongly affected by the crisis in the US. The policy rate is expected to drop further – to 0.5% in September.

Annual inflation stood at 1% in Q1. Total annual inflation slowed down significantly in March, especially in Spain (where it was negative) and in Belgium. Inflation in the tourist service sector was low due to base effects, given that Easter last year fell much earlier than it usually does. The price of petrol also declined in March and the food prices grew more slowly than usual. The situation continued in Q2, with total annual inflation remaining at the same level in April as well, which was somewhat below expectations. As the ECB aims at inflation rates "below, but close to, 2%", measures will have to be taken to restore the desired level of inflation because this inflationary trend will continue until the end of the year. This is a very sensitive issue, because measures have negative effects as well and their efficiency may be brought into question. This is why the ECB will probably opt for a patient approach and non-aggressive measures. It has not announced any specific measures yet; moreover, there appears to be some insecurity and vagueness as exemplified by the contradictory statements recently made by senior ECB officials[17]. Some investors perceive this as a negative phenomenon inciting uncertainty and thus increasing their aversion to risk and the premium they seek.

Demand for credits has been falling as companies have been undertaking less and less fixed investments. On the other hand, the supply of bank credits has also been declining because credit approval conditions are still being tightened. Over 20% of the banks are expected to stiffen household and corporate credit approval conditions over the next three months. Banks fear that many companies will be unable to repay their credits unless the recession ends soon.

A common Eurozone bond is a good idea for the future

Eurozone country bonds are becoming attractive due to expectations that the euro will strengthen vis-à-vis the yen and the dollar[18]. Now that the strengthening of the dollar and yen due to lesser leverage at the global level has more or less ended, preference factors are on the euro's side.

Not all bonds are attractive, however. Given that some countries have deficit problems, their bond spreads have increased during the crisis, but the average risk at the Eurozone level could be reduced through diversification by introducing a new instrument in the financial market. Recommendations are that a common European bond denominated in Euros be introduced[19]. The new bond would have great liquidity; it would probably be the most liquid bond in the world,

17 "ECB Officials Clash on Next Steps, Snubbing Truce", Bloomberg.
18 Allianz Global Investors: Capital Markets Monthly, May 2009.
19 "A common Euro-zone bond: A good idea with challenging practical problems", Goldman Sachs, February 2009.

which would lower the cost of borrowing. Disagreements might arise as to which guarantees individual countries would provide. One option is that all countries would guarantee all bonds. The other is that individual countries would guarantee only their debts, which would be part of a common pool on the basis of which the bond would be issued. The first option would probably result in lowering costs for the region as a whole, because the reduction of risk premiums in countries with lower ratings would be greater than the increase in risk premiums in countries with higher credit ratings. Liquidity premiums are extremely high at times of financial crisis, like today, and its existence would considerably relieve the budgets of EU member states. However, practically it is now almost impossible to issue such a bond that would yield all the listed positive effects in the short term. There is also the problem of moral hazard – if, after the common bond is introduced, a country violates the agreement on fiscal costs and thus transfers the costs on to other countries. Although extremely desirable, a common bond is a long-term project requiring elaborated and coordinated fiscal discipline as well as political support from member-states. This example again brings to the fore the shortcomings of the EU arising from the lack of the necessary centralism in decision-making, especially in this crisis period.

Unemployment has rapidly risen in the Eurozone, above all due to cost pressures on manufacturers. Unemployment increased from 8.4% in January to 8.9% in March. Germany even had a two-year trend of declining unemployment, but this reversed in November 2008. In Q1, unemployment in Germany rose by 0.5pp, to 8.1%. The trend continued in Q2 as well and unemployment stood at 8.3% in April. Further lay-offs are expected even if the optimistic economic predictions prove true. Unemployment in the Eurozone may exceed 11% by the end of the year and, consequently, economic recovery may be obstructed by the effects of lower personal consumption[20].

The trade deficit in Q1 stood at €9 bn. At the end of the quarter, in March, a mild surplus of €0.4 bn was recorded – quite contrary to expectations of economists who had predicted a deficit similar to the one in the preceding months. While imports in March broadly remained at the February level, exports increased. The structure of exports changed. The decline in exports in January was evenly distributed, but it segregated by regions in March. Exports to US, China and OPEC member-states rose, while trade with Japan fell.

Japan

Japan recorded extremely negative GDP growth in 2009 – 15.2% – but surveys indicate a recovery of industrial output in late Q1, so that growth is expected to stagnate rather than decline in Q2. Personal spending continued contracting notwithstanding tax relief provided for by the previous fiscal package, while private sector investments[21] recorded an unprecedented fall. Only state consumption recorded growth, albeit lower than in late 2008.

Central Bank of Japan introduced unconventional measures

Japan has not yet quite fully recovered from the effects of the long-lasting deflation from 1999 to 2003. Given its prior experience, the Central Bank of Japan became proactive and began planning measures to prevent deflation from gaining in momentum. The Japanese government voted in a record high budget for the new fiscal year beginning in April 2009 – 6.6% higher than the preceding one. The state deficit will be 6.8% next year according to OECD forecasts. Consequently, the current 170% debt-to-GDP ratio, one of the highest amongst developed countries, will increase. The reference interest rate was lowered in December almost to the minimum, to 0.1%, and there is no scope for lowering it further, but the authorities opted for unconventional measures. The Central Bank of Japan is buying high rated bonds from commercial banks and if they need capital, Japanese banks can issue and sell stock to the Central Bank. Furthermore, part of the foreign currency reserves will be used to increase corporate liquidity.

Large fiscal stimulus package voted in

The Japanese government announced a large fiscal stimulus package standing at around $150 bn or around 3% of GDP. The package will comprise a broad scope of measures – aid to the unemployed, subsidies to buyers of new ecological cars, investments in infrastructure, subsidies

20 BNP Paribas, Ecoflash, No. 09–196.
21 All private sector investments apart from investments in housing construction

to farmers and local authorities, as well as funds for stabilizing the financial system. The package aims to recover production and spending and prevent a deflationary spiral from gaining in momentum. Given that Japan is highly indebted, it remains to be seen whether this move will undermine its credit rating.

Total annual inflation fell in Q1 and stood at -0.3% in March, contrary to 0% in January. As had been expected, the first negative y-o-y change in base inflation[22], standing at -0.1%, was recorded in March. This was the first negative base inflation since September 2007. This corroborates fears of deflation although the depreciation of the yen increases the level of prices through imports.

Unemployment rose from 4.1% in January to 4.8% in March. This is a significant change and the supply of jobs reached its record low in the past seven years. However, unemployment is still much lower than in most other developed economies.

The current account surplus stood at merely ¥112 bn in January but increased in February and March, wherefore the surplus in Q1 totaled nearly ¥1,700 bn, which is still 18% less than the surplus in Q4 2008 and as much as 74.3% less than the surplus in Q3 2007. The increase in the surplus signifies the slow recovery of external demand. However, foreign revenues will remain low for a while due to the drop in profits of Japanese companies in the West.

Central and East Europe

The countries in the region will have to implement institutional and technological reforms.

Even if the recession does not last long, East European countries will have to address the issue of their basis for growth in the future. The countries in the region will simply be unable to base their development on increasing foreign debt, especially as long as currency risk remains high, and they will be unable to base their investments primarily on foreign capital inflows, because the times of high global liquidity are behind us[23]. They will simply have to implement difficult systemic reforms, both institutional and technological, and eliminate the other weaknesses covered up by the high growth they witnessed thanks to copious capital inflows. One of the solutions would be to let the candidate countries join the Eurozone and thus eliminate currency risk. The determination of the appropriate exchange rate would be problematic however. An excessively high exchange rate would endanger exports necessary to tide over the crisis, while an overly low rate would lead to a rise in the percentage of defaults on credits denominated in a foreign currency.

Romania

Stand-by arrangement signed

As forecast in the previous issue of QM, Romania signed a stand-by arrangement with the IMF. The strong growth in the first three quarters of 2008 (averaging 9% y-o-y) halted and the structure of growth changed. Growth fell to a little under 3% in Q4 and became negative in Q1 (-6.4%). Last year's growth was based on strong domestic demand and an increasing deficit in the volume of merchandise trade. Fixed investments dropped due to lower demand and lesser supply of bank credits. Only state spending rose late last year, while overall spending fell. Fixed investments grew at an average rate of 30% y-o-y in the first three quarters, but only 2.8% in Q4.

The arrangement with the IMF entails tightening the belt, like in Serbia. Fiscal discipline relaxed in 2008, resulting in a deficit of 5.4% of GDP. The Parliament adopted a new budget in February 2009, under which the fiscal deficit is to be reduced to 2% of GDP in case growth reaches 2.5% in 2009. The growth projection was revised to -4% in the meantime and the budget will soon have to be adjusted in order to conform with the targeted fiscal deficit as agreed with the IMF. The arrangement on nearly €13 bn over a two-year period was agreed in March. Romania simultaneously negotiated €7 bn worth of credits with several institutions (WB, EBRD, EIB).

22 Base inflation that excludes fresh food but not fuel
23 Global Economic Outlook, Q2 2009, Deloitte Research.

Also, nine foreign banks in Romania, accounting for 70% of the market, pledged to continue operating in Romania and supplying their subsidiaries with capital if need be.

Depreciation halted The economic slowdown helped bring total inflation down from 9.1% in July 2008 to 6.9% in February 2009. Although inflation mildly rose over January, the Romanian Central Bank decided to cut the reference interest rate by 25bp – to 10% – because no major inflationary risks in the medium term are foreseen. Total inflation is predicted to fall to 4.5% by the end of the year, the upper bound of the formal target range. The current account deficit fell at the end of the year, but ultimately stood at around 12% of GDP in 2008. The current account deficit in January halved relative to January 2008, which is a positive sign, but it remains to be seen whether this trend will continue. The risk that the number of defaults on credits denominated in euros would increase due to the depreciation of the Romanian currency intensified fears that the financial crisis would deepen in Romania in early 2009. However, the depreciation of 35% compared to July 2007 halted in late February and the Central Bank intervened with €4 bn. The arrangement with the IMF and EU support significantly influenced macroeconomic stability and the stabilization of the exchange rate.

The Romanian Finance Minister stated that he expected foreign direct investments to be lower by a third than in 2008, when they amounted to $9.2 bn, but they will probably be lower given that Standard&Poor's cut the state's debt rating at the end of 2008. Credit growth remained high in January (around 20% per annum), but it took a major plunge compared to last May, when credit growth stood at 50%. Retail also fell in January, by 0.9% month on month, and is expected to continue dropping. Unemployment, which stood at 4.9% in February, is expected to reach 8.1% by the end of the year.

Factory capacity utilization declining Large factories have been halting production due to lack of demand. Like in the case of US Steel in Serbia, the drop in the price of steel has led the biggest Romanian steel plant ArcelorMittal Galati, which has already laid off part of its workforce, to draft a plan for voluntary termination of employment. If the demand for Dacia vehicles continues falling, this company will cut 3,000 jobs. As the Eurozone is experiencing a slowdown and half of Romanian exports are destined for that market, foreign demand will negatively affect growth. Annual exports dropped 24% in January while exports to non-EU countries experienced an even greater decline.

Bulgaria

Economic growth in Q1 in Bulgaria was negative (-3.5%) but this contraction was milder than in most East European countries. The threat of recession prompted the authorities to opt for a fiscal stimulus package of $280 mn for investments: $122 mn will go to local authorities, $32 mn to the Ministry of Defense and $21 mn for road reconstruction. It is, however, highly unlikely that the package will help avert recession.

Big natural gas field discovered A field near the border with Romania with quality gas with low sulphur levels was discovered close to the border with Romania this year. If the tests of the US company that discovered the gas field prove correct, the capacity of the gas field will be sufficient to satisfy Bulgaria's need for gas over a three-year period.

Bulgaria risks deflation Bulgaria faces the risk of deflation. This problem could be resolved by devaluing the lev, which is fixed to the euro, but it is unlikely that such a decision will be taken. A fixed rate instills investor confidence and it has had stabilizing effects; on the other hand, a lot of credits are denominated in euros and repayment of household credits would be jeopardized after the devaluation. This is why the Government has been avoiding and putting off such a decision. If it does make such a decision, it will be at the last minute, when the process of deflation will have already gained in momentum. Factors affecting deflation comprise stocks of goods, capacity utilization and inflation of manufactured goods. Capacity utilization stands at 70%, while manufacturing inflation stood at 2.2% in January, much less than in July, when it amounted to 15.4%. Manufacturers' stocks have been amassing since the end of 2005 and such a combination indicates a very high risk of deflation. Moreover, the financial crisis will lead to a contraction of credits and lesser chances of refinancing them, which will diminish the growth of the money mass and liquidity.

The risk of bankruptcy has increased in the banking sector. Domestic banks will have to repay foreign debts because foreign creditors will curtail investments in East Europe and refinancing options. Annual borrowing growth of the banking sector exceeded 100% last August and fell to 57% already in December. The rate will continue falling because it is unsustainable in the long term and the risk of some banks going bankrupt is high because a good part of the recent credits are short-term. According to the Bulgarian Central Bank data, as many as 75% of the foreign bank debts are short-term. The bankruptcy of a bank may deepen the recession awaiting Bulgaria.

GDP growth will slow down as indicated by the 8% annual fall in industrial production in December. Also, growth of credits to the private sector nearly ground to a halt at the end of 2008. The Bulgarian Central Bank thus cut the reserve requirement rate in order to increase the credit flow to the private sector.

After a fiscal surplus equal to 1.5% of GDP in 2008, it was announced that the targeted surplus in the medium term would be 3%. The European Commission expects that the surplus will stand at merely 2% over the next two years due to lower growth. Reserves from the fiscal surpluses achieved over recent years have built up and now stand at 12% GDP. The funds will be used to repay foreign debt if needed. Foreign currency reserves fell from September 2008 to March 2009, primarily due to a cut in the reserve requirement rate. Despite the decrease, foreign currency reserves cover 95% of Bulgaria's short-term foreign debt.

Currencies

The dollar strengthened at the beginning of Q1 but has had the tendency of falling since March. This is probably due to to apprehensions about the expansive monetary policy and growing public debt[24]. The demand for bonds is worryingly low, because of low interest rates and concerns about where the limits of US borrowing are. However, large spending and the high deficit will, however, help the US overcome the recession before other countries, but they will probably not help the EUR/USD rate exceed 1.40 by the end of the year[25]. The fall in the volume of carry trade is a factor contributing to the changes in the currency ratios due to the trend of drastically cutting interest rates in markets in which carry funds invested.

Commodities

Price of oil recovers

Demand for oil fell in 2008, especially in developed countries, whilst oil production rose, leading to an increase in supply, particularly in the US. The positive news about the state of the economy and optimism that the end of the recession is near have, however, affected the price of oil, which now stands at $60/barrel. The price is expected to rise further in the medium term[26] particularly given that investments in new oil fields and the maintenance of the existing capacities are insufficient to sustain the level of supply. According to a model that correctly forecast the fall in the price of oil last year, the price of one barrel is expected to reach $65 at the end of 2009[27].

According to forecasts, there is no room for high steel price growth until the end of the year forecast

Attention should also be devoted to the raw material on whose price a good part of Serbia's exports hinges. The price of steel has more than halved since last summer, above all due to lesser activity in construction and industries of developing countries, particularly China. This led to lesser demand and manufacturers across the world shut capacities in the face of lower profit margins and funding problems. Steel production fell in Serbia as well. Given that both supply and demand dropped, the price of steel has remained relatively stable since the beginning

24 HSBC, Global Investment Perspective, April 2009.
25 Economic Market Monitor, BNP Paribas, April 2009.
26 IMF World Economic Outlook, April 2009.
27 Barclay's Research, 2nd quarter 2009.

of the year. A major hike in the price of steel can, however, hardly be expected because the problems of the automobile industry and other steel consumers led to projections for the demand for steel in the latter half of the year being revised downward. This is why the projections for the average price of European hot rolled steel coils were revised to $536/ton[28]. Application of technical analysis methods leads to the conclusion that there is plenty of room for the price of steel to continue dropping. Structural changes favoring supply in the recent years have, however, changed the way in which prices are set. There are fewer sellers of steel today than before and they are in a kind of an informal relationship, the effects of which resemble that of cooperation within OPEC; steel manufacturers simultaneously and rapidly reduce supply as soon as they realize that demand is declining. This generates resistance to the downward movement of prices, non-existent in models of technical analysis, wherefore one cannot fully rely on their conclusions. This is why both demand and profit in steel production ought to be taken into account. The cost of iron ore has indeed fallen and thus significantly reduced the costs of steel production, which allows for higher profits in the steel industry. Steel producers' resistance to the downward movement of prices will be smaller if input prices remain low. Judging by everything, that will happen[29] because iron ore producers currently do not have great negotiating power.

The awakening of protectionism in the US is an important factor in the upward movement of steel prices. Given that steel producers are traditionally experienced lobbyists, they will most probably skillfully use the recessionary climate and succeed in persuading the Administration to increase protectionist measures to protect the US steel industry. These measures will be justified by proclaiming the need to preserve jobs. This will allow for an increase in the price of steel in the US and thus indirectly in the rest of the world.

There is a risk that grain prices will grow

Food prices are not as high as they were last year but there are risks that this group of products may experience rising inflation. Prices of meat and dairy products slumped and this year will probably not witness a drastic upward change in trend. The risk is tied to grain because supply can be sensitive to drought or natural disasters. The price of corn, soy and wheat will depend on US supplies, because yield in South America has fallen short. China, on the other hand, has been buying unexpectedly high quantities of food, especially soy, wherefore the price of soy reached its seven-month high of $11.6 in May. If oil prices continue to increase, that will definitely have an inflationary effect on food prices. The most severe consequences will be felt by poor countries in which the elasticity of food prices has already changed. Although prices at the bourses and in developed countries fell considerably since last year, they have not changed to that extent in the markets of poor countries. The prices became very elastic upward in that group of countries and fairly inelastic downward, impeding the resolution of social problems.

28 Goldman Sachs forecast, while Morgan Stanley predicts the price will reach 502$/t.
29 Price of iron ore is mostly set in negotiations between Chinese steel producers and several leading mining companies.

HIGHLIGHTS

Highlights 1. Revised and Augmented IMF Standby-Arrangement with Serbia

Macroeconomic Developments: Crisis Intensifying

The global financial crisis came quickly to Serbia. Beginning in September 2008, private capital inflows slowed sharply and trade flows plunged. Output growth was markedly decelerating, while the dinar lost some 20% vis-à-vis the euro between September and January 2009, despite substantial net sales of foreign currency by the NBS. The authorities responded to the crisis quickly, by taking several stabilization measures, some of which formed part of the precautionary standby arrangement (SBA) with the IMF approved on January 16th, 2009.

But since this original SBA was designed, Serbia's external and financial environment – like in much of Eastern Europe – has deteriorated further: nominal export and import flows in euros fell in the first quarter by about 25% below last year's levels. Output, domestic demand, and, especially, fiscal revenues have been lagging significantly behind initial projections. Moreover, an abrupt slowing of net capital inflows is likely to open up sizable external financing gaps in 2009–11, projected to add to about €3.5 bn, despite an expected rapid narrowing of the large current account deficit.

The Augmented IMF Arrangement: a Three-Pillar Cooperative Approach

In the face of the worsening global environment, the revised and augmented SBA approved on May 15th, 2009 envisions IMF's financial support of about €2.9 bn. The program aims at facilitating an orderly rebalancing of the economy, which is unavoidable given Serbia's severely unbalanced external position and its high external debt. The once-booming capital inflows have not only dried up but are also unlikely to recover to the high levels observed before September 2008. Thus, both the private and the public sector will need to reduce their spending in line with sustainable incomes and available external financing. The new agreement with the IMF seeks to smooth – not prevent – the needed adjustment in spending in both sectors by mobilizing external financing that would otherwise not be available, while providing a framework to launch long-delayed structural reforms to strengthen the economy's still weak supply side.

Against this backdrop, the authorities' revised program strategy is based on three pillars:

• **Additional fiscal adjustment:** With private sector spending and income shrinking relative to their boom-related levels, tax bases are also falling. But spending in recent budgets was predicated on a continued economic boom, and would give rise to high and unsustainable fiscal deficits if no measures were taken.

• **Financing assurances from foreign parent banks:** These have been asked to provide voluntary assurances to broadly maintain their exposure to Serbia and to keep their subsidiaries well capitalized, based on stress tests.

• **External financing from IFIs**: The EU and the World Bank are expected to provide some additional contributions, but the bulk of the new external financing under the program would be provided by the IMF.

The three pillars are mutually reinforcing: each is essential for a "cooperative equilibrium". In particular, seeking financing assurances from key foreign banks should reduce uncertainty and partly compensate for the volatile external environment, thereby supporting macroeconomic and financial stability. In addition, fiscal and financial contingency planning, including through the planned diagnostic stress tests of banks, should make the revised program strategy robust toward more pessimistic scenarios.

Revised Outlook: Downside Risks Dominate

The program's framework envisions lower growth but also faster external adjustment than considered previously. A drop in GDP by 2% in 2009 is assumed, with a U-shaped recovery pattern and no growth in 2010. The current account deficit is expected to adjust perceptibly, on account of the sharp drop in domestic demand due to the slowdown in wages and credit and some real exchange depreciation. Given the depressed international environment, exports are expected to recover only in 2011. Inflation is projected to remain somewhat higher than previously anticipated, reflecting the large depreciation so far, which is likely to feed further into prices despite declining commodity prices and domestic demand.

[*] Resident representative of International Monetary Fund in Serbia.

Table 1. Baseline and Downside Scenarios, 2008–2009

	2008	2009	
	Estimate	Program	Downside
		annual change, in percent	
Real GDP	5.4	-2	-6
Domestic demand	5.9	-5.6	-13.1
Inflation (eop)	8.6	10	9
		in percent of GDP	
Current account balance	-17.1	-13	-9.3
Capital and financial account	12.4	3.2	-0.9
Fiscal balance	-2.5	-3	-4.6
		euro billions	
External financing gap	0	2.4	2.3

Source: Serbian authorities and IMF staff estimates and projections.

A downside scenario illustrates the risks to the program. While its growth projection is broadly in line with other forecasts for the Southeastern European region, these have been revised downward repeatedly. This pattern of downgrades could continue, due to further downward revisions to the global outlook, a further deterioration of consumer and investor confidence in Serbia, or a full-fledged credit crunch as banks struggle to identify solvent private-sector borrowers. As a result of reduced domestic demand, the external adjustment could be yet much faster; however, with lower capital inflows, the external financing gap would likely remain broadly unchanged.

Toward Durable Expenditure-Based Fiscal Consolidation

Fiscal policy remains the central element of and challenge to the program. Under unchanged policies, the fiscal deficit would rise to over 6% of GDP in 2009, and continue to increase over the medium term. This reflects two key factors: (1) a declining revenue-GDP ratio as the economy rebalances away from (relatively higher-taxed) consumption and imports; and (2) strong nominal inertia in key budgeted spending items like public wages and pensions, which account for almost two thirds of total budget spending. In fact, even with a nominal freeze this year, nominal average pensions are set to expand by 13.25% in 2009 reflecting past increases.

The authorities' revised 2009-10 fiscal program limits the fiscal deficits to 3% of GDP in 2009 and 2,5% in 2010. These deficit targets strike a compromise between the need to signal that fiscal sustainability will be maintained and to avoid a strongly procyclical fiscal stance. In view of the considerable downside risks to the macroeconomy, fiscal policy responses may again need to be recalibrated, likely involving a mix of additional budget financing and further adjustment measures. On the latter, the program envisions contingency measures, which include an increase in the VAT rate and cuts in public wages.

The authorities' revised 2009 budget plan focuses on recurrent spending measures of some 3% of GDP. The measures largely center on cutting discretionary spending on goods and services, subsidies, capital, and net lending across all government levels, by directly cutting allocations to ministries, transfers to local governments, and ministries' own resource budget. In addition, the measures include reductions in the public wage bill and some revenue increases (income taxes on dividends and royalties, excise taxes, property and car taxes), and additional dividend payments. Social spending remains largely protected from nominal cuts.

Sustainability of this adjustment is key. In this respect, fiscal policy measures under the program carry risks that require careful monitoring and a prompt policy response. A major risk is that the spending cuts would generate further budgetary arrears, since the targeted cuts in discretionary expenditures (by 26%) are deep, being concentrated only in a few areas. There may also be delays, slippages, or coordination problems in the de-facto implementation of the budget measures. An accumulation of any arrears or payment delays is disruptive to the economy, and needs to be avoided at all cost.

The IMF-supported program contains several measures to address these fiscal risks. These include a better monitoring of arrears, strict control of commitments, monthly expenditure prioritization, and policy coordination across levels of government. Delays in following through on these steps would be self-defeating. This particularly regards improving the quality and timeliness of data, which are essential for a correct diagnosis and a proper activation of the envisioned contingency measures.

Ultimately, fiscal sustainability will hinge on the political will and the effectiveness of structural fiscal reforms to control spending. If the 2009 fiscal adjustment measures remain in effect through 2010, this should suffice to achieve the 2.5% of GDP deficit target. In particular, the authorities already announced that public wages and pensions will remain frozen through 2010. For the medium term, structural fiscal reforms in the health, education, pension, and public administration sectors are envisioned, in part with technical assistance from IFIs and other donors. These steps will be discussed during the next program reviews.

Financial Sector and Monetary Policies

The authorities have launched an innovative financial sector support program (FSSP). Participation in it is voluntary and open to all banks. The FSSP received broad support during a financial sector coordination meeting in Vienna on March 27th, with ten large parent banks and their home supervisors. The latter broadly endorsed the framework and expressed willingness to assist the NBS in cross-checking data. Participating parent banks signed a public statement supporting Serbia's economic program and expressing their willingness to work toward making specific exposure commitments and making their subsidiaries in Serbia well-capitalized. In exchange, participating banks have been granted access to two new liquidity facilities established by the NBS: an extended dinar liquidity facility and a foreign exchange swap facility. By now, almost all Serbian banks have agreed to provide commitment letters required for participation in the FSSP.

A proactive strengthening of the frameworks for corporate and household debt restructuring will be key to mitigating and overcoming the crisis. The FSSP already includes a mix of commitments and incentives designed to facilitate private sector debt restructuring, but additional initiatives may be needed. Moreover, there are concerns that the bankruptcy framework would not be able to handle a sudden surge in case load, while increasing the effectiveness of the court system and the capacity of bankruptcy administrators may take time.

The NBS will continue to focus on inflation as the nominal anchor and strengthen the monetary policy framework, including improving coordination of regulated price adjustment. Serbia's inflation remains one of the highest in the region, mostly due to persistently high inflation expectations and large increases in regulated prices. So far in 2009, adjustment of regulated prices has been higher than envisaged. These trends have raised end-2009 projected inflation to 10% (the upper bound of the NBS's pre-announced inflation target range), although inflation would be lower in a downside scenario. Close coordination between the NBS and the government will be critical.

Due to high inflation, the NBS has kept its reference rate at a relatively high level, but scope for some easing may soon open up should downside risks materialize. The repo interest rate remains one of the highest in the region due to persistent inflation and concerns over capital outflows. By now, the NBS has cut its policy interest rate to 14%, following broad stability of the exchange rate and some deceleration in regulated prices since February. Going forward, the implementation of monetary policy in 2009–10 could be challenging and may require use of auxiliary policy instruments and strong communication. The authorities remain committed to maintaining the managed floating exchange rate regime.

Structural Policies: Toward Sustainable Growth

The current difficulties present an opportunity to tackle some key structural reforms. With hindsight, it is all too clear that Serbia's undersized private sector constrains domestic saving, export capacity, and productivity, while its oversized public sector encourages consumption, social entitlements, and excessive wage growth. While the global financial crisis may not be conducive to pushing ahead with the still extensive privatization agenda, it is a key opportunity in addressing long-standing – politically difficult – issues such as streamlining business regulations, improving competition, and resolving the problems of land ownership and restitution. These steps are key to generating sustainable growth and exports and would be the focus of future program reviews.

Highlights 2. Scope and Limits of the Revised Budget and Accompanying Economic Policy Measures of the Republic of Serbia

*Milojko Arsić**

Macroeconomic developments in Q1 of 2009 were significantly less favourable than planned at the time of adoption of the economic policy for the year. Instead of the projected GDP growth of 3.5%, a 4%-5% contraction[1] looks more likely, based on developments in the first months of 2009. One of the important consequences of a contracting GDP is that the level of public revenues in real terms would have been much lower under unchanged fiscal policy, and the fiscal deficit would have been larger than planned. It is estimated that the consolidated fiscal deficit in 2009 would have amounted to around 6% of GDP, instead of the officially planned 1.75% of GDP under unchanged fiscal policies. Such a level of the fiscal deficit is not sustainable either in the short run – because of a lack of financing capacity, or in the long run – because of an excessive increase in public debt.

*Faculty of Economics of the University of Belgrade and FREN.

1 At the end of 2008, when economic policy for 2009 was being planned, there were warnings that the rate of growth would be below the projected one. However, at the time, there had been no analytically backed forecasts that would have anticipated a contraction of GDP in 2009. The first assessments of GDP contraction in 2009 appeared only at the end of January, when data was released on the industrial output decline in December 2008.

Developments in international economic relations during Q1 2009 are also significantly less favorable than planned. While the current account deficit moderately declined, the financial account surplus was also drastically reduced. Moreover, due to economic hardship in the region and in Serbia, there was a real threat that foreign banks would withdraw from Serbia previously approved loans, which would have meant that instead of attracting capital inflows, Serbia would be facing capital outflows. Such developments in international economic relations in the first months of 2009 contributed to a depreciation of the dinar and a fall in foreign exchange reserves. The persistence of mentioned trends could, in a relatively short period of time, threaten the country's external liquidity.

Revised 2009 Budget and Agreement with the IMF

It was therefore necessary to significantly redefine Serbia's economic policy, to adjust it to the changed macroeconomic environment. That, first of all, implied bringing the fiscal deficit back to a sustainable framework, but also ensuring additional foreign currency liquidity to avoid a possibility of a balance of payments crisis. In order to define new economic policy measures for 2009 and 2010, the Government of Serbia and the International Monetary Fund started negotiations in mid-March. The most important measures agreed with the IMF refer to fiscal policy and were designed to lower the fiscal deficit from around 6% of GDP[2], which would have been created with the initially adopted fiscal policy, to the level of around 3% of GDP.

Economic policy measures agreed with the IMF were adopted by the National Assembly at the end of April in the form of a Law on Budget Revision and a series of accompanying tax laws. According to the revised budget, a fiscal adjustment equivalent to 3.5% of GDP has been planned. Most of the adjustments will be achieved through a reduction of spending – equivalent to 3% of GDP. The spending cuts will be achieved through savings at all levels of the state: the budget of the Republic, social security funds, local communities, etc. By economic functions, spending cuts will encompass the majority of public spending items: wages, pensions, current material costs of the state, subsidies, etc. Beside the reduction in public spending, steering the deficit lower to around 3% of GDP will also require an increase in tax revenue equivalent to around 0.5% of GDP.

2 The IMF has officially forecast that the contraction of Serbia's GDP in 2009 would be 2%. But the IMF projection of fiscal revenues, which would have materialized under unchanged fiscal policy, correspond to a greater decline in GDP than mentioned, suggesting that the proposed fiscal policy contains some degree of reserve, i.e. that the adopted fiscal policy would be adequate even if GDP contraction exceeded 2%.

The most important savings planned in the Government's programme are:

• the reduction of discretionary (deferrable) spending in the budget of the Republic of Serbia by 26% , amounting to 40 bn dinars or around 1.3% of GDP;

• the reduction of transfers to local governments by 15 bn dinars or around 0.5% of GDP;

• the freezing of public sector wages and a temporary cut in public sector wages exceeding 40,000 dinars and limiting the maximum wage to six monthly wages in the Republic (which will lead to savings of 0.4% of GDP);

• the reduction of healthcare costs by 4 bn dinars or more than 0.1% of GDP.

Beside those, additional savings will be achieved through a realocation of funds within the state sector:

• Serbia's budget will take 40% of own revenues of some budget beneficiaries, creating savings in the consolidated state sector of 12 bn dinars or 0.4% of GDP;

• Public companies owned by the Republic will contribute to the budget of the Republic 5 bn dinars worth of profits or 0.2% of GDP.

The planned spending cuts and reallocations within the state sector will create savings worth 89 bn dinars, which amounts to 3% of Serbia's GDP in 2009.

The government's program also envisages an increase in public spending by around 16 bn dinars (more than 0.5% of GDP), with most of the revenue generated from:

• an increase in excise duties on crude oil derivatives (additional revenue of around 5 bn dinars);

• additional taxation of mobile telephony services (additional revenue of around 3 bn dinars);

• additional taxation of higher value property (additional revenue of around 3 bn dinars).

Beside the abovementioned, additional revenues will also be generated through an adjustment of the tax base for the annual property tax with the market value of the property, and through equalizing the tax treatment of authorship contracts with other earnings.

Considering that the level of public spending over the past years was inappropriate for the country's level of development, the government's commitment to achieve most of the fiscal adjustment through a public spending cut – has been assessed as positive. The reduction of public spending by around 3% of GDP represents the biggest fiscal adjustments in Serbia's newer economic history[3]. Achieving the planned adjustment, a significant

3 Greater adjustment was achieved only at the time of hyper-inflation,

part of disproportion between high public spending and the level of development of the country would be eliminated.

Analysis of Adopted Measures

The adopted measures can be assessed for their economic and social implications, as well as for a capacity to consistently implement them.

It has been assessed that political and social acceptability had a great weight during the process of drafting the measures and that the impact of the measures on the overall economy and individual sectors (e.g. telecommunications) was neglected, as well as their impact on the redistribution of income, the functioning of the state sector (education, culture, etc.) etc. As a consequence of an immense influence of political factors, the measures both on the revenue[4] and on the expenditure side which would have had an impact on the entire economy and all segments of the population are missing. Because of that, the burden of the crisis has been transferred to certain sectors of the economy (telecommunications, state institutions with own revenues) and certain segments of population (those employed in the state sector, those employed under authorship contracts, owners of luxurious property), instead of being widely dispersed to all sectors of the economy and all segments of the population. By giving up the correction of general taxes, which would have imposed a proportionately lower burden on everyone, a disproportionate burden has been imposed on some sectors of the economy and some segments of the population. Examples of the disproportionate burden include taxing mobile telephony services by a specific 10% tax, as well as a form of confiscatory "tax" on own revenues of budget beneficiaries of as much as 40%. Such taxes, which selectively tax some activities and institutions, severely violate the allocative neutrality of the tax system.

It is estimated that chances are slim for the planned reduction in public spending to be fully achieved. The planned reduction in public spending encompasses such measures that their strict implementation faces big difficulties. One of the most important measures in the government's package is the reduction in discretionary spending, which mainly includes current spending for the functioning of the state sector, by as much as 26% on average. It is estimated that serious difficulties will occur during the implementation of the planned 26% cut in discretionary spending. As a consequence of a consistent implementation of the measure, state institutions could halt regular payments of their liabilities to suppliers (utilities, the electricity producer, NIS, pharmaceuticals makers, producers of office material, etc.). A failure of state institutions to pay will additionally aggravate the liquidity situation and strengthen recessionary trends. Beside that, the planned reduction of spending could also result in a deteriorating quality of services provided by state institutions to citizens and the corporate sector. Due to all those difficulties, chances are believed to be slim for the planned reduction of discretionary revenues by 26% to materialize.

A cut in transfers to local communities represents a justifiable pressure towards downsizing local governments, but it will have a series of negative consequences such as a decline in local investments, a reduction in social payments at the local level and an increase in local utility prices due to a cut in subsidies.

Also, chances are slim for some of the measures, such as taking 40% of own revenues from some budget beneficiaries, to generate planned revenues. The taking of 40% of own revenues from some budget beneficiaries represents a specific tax on a part of gross revenues. It is expected that budget beneficiaries will try to lower the volume of their own revenues to be paid to the budget through various mechanisms, from seeking exception to the rule to transferring part of own revenues to dependant companies. That is why it is believed that this measure will also fail to generate the planned volume of revenues for the budget of the Republic of Serbia.

Besides, taking 40% of own revenues of some budget beneficiaries and entire profits from public companies will generate a series of problems, including negative selection, or rather a punishment of some budget beneficiaries who earn their revenue on the market and of public companies which earn profits. Considering that the budget will take over 40% of own revenues of some[5] budget beneficiaries and the entire profits of public companies, this could lead to a deteriorating quality of service of budget beneficiaries, i.e. the slowing development of public companies. As a consequence of taking 40% of own revenues, certain problems will probably appear such as mounting overdue payments by budget beneficiaries to suppliers, a significant deterioration of the functioning of budget beneficiaries whose revenues will be partly taken over by the budget,

when hyper-inflation destroyed the real level of revenues and spending.

4 A detailed analysis of the possibilities of ensuring additional tax revenues through general taxes (VAT, income tax) is presented in the Highlight "Tax reform in the light of IMF talks" in this issue of *QM*. The Highlight analyzes the consequences of a higher VAT rate or income tax rate on the economic environment and on the distribution of the burden of the crisis between different segments of the population.

5 The Law on the Budget envisages numerous exceptions from proposed measures, creating a problem of arbitrary selectiveness in dividing budget beneficiaries to those who will have a mandatory obligation to pay a part of their own revenues and those who will be exempted from it.

an attempt to transfer the cost to services' consumers (an increase in tuition fees), etc. A separate problem is that some of the budget beneficiaries (some faculties, theatres, etc) – whose funds will be paid to the budget – already operate in a competitive environment. Under such circumstances there is a realistic threat of weakening the position of state institutions (faculties, theatres) against competing private institutions. Due to the listed weaknesses, some of the proposed measures should be replaced by more appropriate ones.

Within the set of tax measures, along with an increase in excise duties on crude oil derivatives, a specific sales tax has been temporarily introduced on mobile telephony services (a form of excise duty). The introduction of the additional tax on mobile telephony services can hardly be justified because the sector is propulsive and has positive external effects: over the past years, the sector had posted strong growth, attracted significant amounts of foreign capital, etc. A special problem is that Telecom Serbia, dominating the telecommunications sector in Serbia, will be hit by the listed measures in two ways: an additional tax has been introduced on its services and the company will have to pay its entire profits to the budget. At the same time, Telecom Serbia is a highly indebted company operating in a strongly competitive environment. The additional tax on mobile telephony services should be temporary, i.e. it is necessary for the tax to be scrapped after a relatively short period of implementation. The equalization of the tax treatment of authorship contracts with the tax treatment of other earnings is in line with tax principles. However, the measure was adopted without prior notice and without preparing the public, because of which strong resistance to the implementation of the measure can be expected. Announcements that the measure will be given up, following strong resistance by those employed in cultural institutions, represent an additional example of how dominating political criteria are when defining economic policy measures.

With the adoption of agreed economic policy measures and the IMF acceptance of the agreement with Serbia, conditions have been created to draw €3 bn from the IMF this year and the next. Drawing the funds will strengthen the foreign currency reserves of the NBS and significantly reduce the risk of a balance of payments crisis in Serbia. The agreement with the IMF will favourably influence the readiness of foreign banks to maintain their existing credit exposure to Serbia, as well as the readiness of investors to invest in Serbia. Overall, the IMF agreement will help Serbia weather the global economic crisis at a cost similar to that in other countries, without additional shocks that would have emerged as a result of a balance of payments crisis.

To summarize, the Government of Serbia will have serious difficulties in implementing the measures agreed with the IMF and, as a result, additional measures can be expected in the second half of 2009. The direction of additional measures will depend to a great degree on economic activity, consistency in the implementation of adopted measures, and the results of their implementation. However, it already seems probable that new measures will be necessary to ensure additional revenues, and an increase in the fiscal deficit and a reduction in some expenditure cannot be excluded.

Highlights 3. Tax Reforms in Light of Talks with the IMF

Nikola Altiparmakov [*]

Fiscal adjustment amounting to 100 bn dinars was the primary requirement set by the International Monetary Fund (IMF) within the recently approved stand-by arrangement with the Republic of Serbia. Given the worsening of the economic crisis, it was assessed that the consolidated government deficit would reach 190 bn dinars i.e. more than 6% GDP in the absence of adequate measures. Given that such a deficit was unsustainable, the arrangement with the IMF envisaged a fiscal adjustment of 100 bn dinars to bring the deficit down to a sustainable level of 3% of GDP, which could be funded from non-inflationary sources (above all credits of multilateral institutions).

The Serbian government reviewed the economically, socially and politically acceptable options for achieving the 100 bn dinar adjustment by a combination of cutting public expenditures and increasing public revenues. This text will review the main economic ideas of specific tax reforms discussed with the aim of increasing public revenues. Most of the described tax reforms were ultimately dismissed and, instead of systemic solutions, the Government opted for a set of partial measures, which are reviewed in greater detail in Highlights 2, devoted to the rebalancing of the budget, in this issue of the QM.

[*] Fiscal advisor, USAID Serbia Economic Growth Activity (SEGA) project.

Increasing the VAT Rate

Excessive consumption (both public and private) and the extremely low level of exports (around 22% GDP in 2008) are the chief macroeconomic problems plaguing Serbia. The Value Added Tax (VAT) is the main form of taxing (private) consumption and is logically the first option that ought to be deliberated. Fundamental economic logic tells us that increased taxing of consumption ought to result in a lower level of (private) consumption in Serbia. It should also be highlighted that exports are not liable to VAT. Therefore, we can conclude that increasing the VAT rate would result not only in the necessary increase in public revenues, but would also positively affect the realization of the priority economic policy goals – to reduce consumption and increase exports.

Many economists have over the years been recommending that the public revenue structure be "recomposed" to boost Serbia's regional competitiveness and stimulate export-oriented and more labor-intensive industries. This could be achieved by reducing direct taxes on wages at the expense of increasing indirect taxing of consumption via the VAT.[1] One of the ways to increase public revenues during the economic crisis was to increase the VAT rate first and, once the economic crisis ended, begin the equivalent reduction of fiscal levies on earnings.

Increasing the VAT rate was actually the first option discussed both by experts and the general public. Raising the VAT rate (the general 18% rate and the reduced 8% rate) by 1pp would have increased public revenues by 18 bn dinars per annum. This option was, unfortunately, dismissed – too easily, perhaps, both by the general public and employers and trade unions.

Introduction of a "Solidarity" Tax

Introduction of a 6% solidarity tax on all personal income categories on a temporary basis (during the economic crisis) was the next measure for increasing public revenues that was deliberated. The measure entailed doubling the tax-exempt wage threshold - from nearly 6,000 to 12,000 dinars - to additionally protect citizens with lowest incomes during the crisis.

Table 1. Proposed WageTax BurdenWages

Net Wage in dinars	Solidarity Surcharge in dinars	Solidarity Surcharge % net wage	Proposed Net Wage in dinars
Minimum Wage - 15.434	-187	-1.2%	15,621
Brake-even wage - 17.628	0	0.0%	17,628
Average Wage - 30.000	1,059	3.5%	28,941
2x Average - 60.000	3,627	6.0%	56,373
3x Average - 90.000	6,195	6.9%	83,805
5x Average -150.000	11,330	7.6%	138,670

Table 1 shows that the tax burden would have increased progressively, starting from the break-even net monthly wage of 17,628 dinars. The tax burdens on 400,000 workers with lowest wages would thus not have increased (or would have slightly dropped) and the increase in the tax burden would have fallen on the 1.5 million workers with higher earnings. The idea of introducing the solidarity tax and simultaneously doubling the tax-exempt wage threshold actually constitutes a form of increasing income tax progressiveness in Serbia – this idea has been deliberated a lot in recent years.[2]

From the fiscal point of view, a positive aspect of the solidarity tax is that it would have applied also to pensions exceeding 12,000 dinars. The one-off 10% increase in pensions in November 2008 had actually led to a fiscally unsustainable level of spending on pensions – the y-o-y increase in average pensions in November 2008 stood at as much as 35% in nominal terms, i.e. 21% in real terms! In consequence, overall spending on pensions in 2009 will amount to nearly 14% GDP and will rank Serbia amongst the negative European record-holders, right behind Italy. Moreover, the ratio between the average net wage and the average net pension in Serbia (67% in April) is unprecedented in the region and in Europe. For instance, this ratio stands at under 60% in Slovenia, at 52% in Montenegro, at 41% in Croatia and under 40% in Bulgaria!

The solidarity tax was expected to bring in 30 bn dinars in public revenues, or 30% of the necessary fiscal adjustment. As opposed to the idea of increasing the VAT rate, which was easily dismissed, the solidarity tax idea was discarded after it met with fierce and tumultuous displeasure of the public at large. It seems that the main reason for such public reaction lies in the initially irresponsible statements by officials aiming to curry favor with the voters, who first thought that "tycoons" and local parvenus would bear the burden of the solidarity tax. However, the fact is that no country in the world, be it developed or in transition, is able to effectively tax "the rich" who draw income from capital that they can (completely legally) register in one of the numerous tax havens. One of the main conclusions reached at the recent G20 summit was that a coordinated crackdown needs to be launched on tax havens and tax avoidance. It remains to be seen how realistic these promises are. However, the fact of the matter in Serbia and in most countries is that the greatest tax burden is borne by the so-called middle class. Robin Hood is an attractive movie topic, but the Sheriff of Nottingham is an inevitability in the real world!

1 "VAT in Serbia – Two Years On", QM 7, 2007.

2 "Reforming Personal Income Tax", QM10 December 2007.

Property Tax Reform

The property tax system is overburdened by social aspects and has thus been fulfilling its tax function relatively ineffectively. Property is subject to a progressive tax burden entailing four tax rates: 0.4%, 0.8%, 1.5% and 3%. The tax base, which is systematically underestimated, is the first problem that arises in applying the property tax in practice. Although the tax authorities have been assessing the market value of real estate fairly realistically when setting the property transfer tax, official estimates made when setting the property tax have been systematically underrated vis-à-vis the real market value of property.[3] This is the first source of underestimated tax obligations regarding property tax.

The law further lays down considerable tax base reductions through real estate depreciation – 1.5% per year up to a maximum depreciation of 70%. However, is it justified to further reduce the tax base on grounds of depreciation if the credibly estimated market value of the real estate is taken as the tax base? In any case, the legally prescribed annual 1.5% depreciation rate is too high and the maximum depreciation rate should not exceed 30%.

Finally, the Law also envisages tax credits amounting to 40% of the tax liability for real estate owners residing in the property and 10% tax credits per each household member – up to a maximum of 70% tax allowance. Socially motivated tax allowances of this type are frequent in practice. It is, however, difficult to efficiently target the vulnerable categories of the population in this manner. The social effects of the prescribed tax credits are thus extremely disputable. On the other hand, the negative fiscal effects of numerous property tax deductions are evident: property tax revenues in Serbia are lower than revenues from property transfer taxes – which in itself is an anomaly!

Given the short timeframe, the Government refrained from enacting systemic amendments to the Law overnight and limited its efforts to operational improvements in estimating the tax bases of the property tax. Local governments were accordingly advised to be guided by the relevant real estate market value estimates used to set the property transfer tax when assessing the official property tax bases. Projections are that the property tax bases should thus be increased by around 15% and bring in around 1 bn dinars of additional public revenues a year. It should, however, be borne in mind that the collection of the property tax itself has been ceded to the local governments during the fiscal decentralization process. It remains to be seen how successful various local governments will be in implementing the Serbian Government recommendations.

Conclusion

The recent talks with the IMF reminded the general public that the process of tax reforms in Serbia halted after the VAT was introduced in 2005. Serbia had been qualified as a leader in tax reforms in the region at the beginning of the millennium. In the meantime, its neighbors adopted new personal and corporate income tax systems (most introduced flat-tax systems) and completed their tax reforms.

Serbia needs to establish a sustainable and predictable tax system as soon as possible if it wishes to remain competitive in the region. The first step in that direction would definitely comprise a comprehensive income tax reform that would introduce a simple, transparent and regionally competitive system of taxing personal income.

3 "Reform of the Taxation System", CLDS/USAID, 2003.

Highlights 4. Public Debt of The Republic of Serbia[1]

Milojko Arsić[*], *Saša Ranđelović*[**]

The public debt to GDP ratio represents one of the most important indicators of fiscal policy sustainability of a certain country. In the course of previous years, Serbia was in a comfortable position in respect to its public debt sustainability: the absolute level of the public debt had been falling year after year, while state expenditures on interest rates on public debt were among the lowest in Europe. Due to high GDP growth rates and the appreciation of the real exchange rate of the dinar[2], the debt-to-GDP ratio has been falling rapidly. Since the start of 2009, the situation has radically changed: the state has intensified its borrowing in order to finance the fiscal deficit, so that the absolute debt level has grown. Beside that, GDP in real terms is expected to fall in 2009 and the real exchange rate of the dinar is expected to depreciate, forcing the public debt-to-GDP ratio to grow. The state has initiated major infrastructure projects (Corridor 10 highway, a gas pipeline, a bridge across the Sava river in Belgrade, etc) and announced

* and ** Faculty of Economics, University of Belgrade and FREN.

1 Starting from the next issue of *Quarterly Monitor*, the public debt analysis will become a regular part of the chapter „Fiscal flows and policy". Considering that this topic has been analysed in *QM* for the first time, this issue gives a brief overview of the public debt movement between 2001 and Q1 2009. Future issues of Quarterly Monitor will focus on the analysis of the current movement of the public debt.

2 Because around 97% of Serbia's public debt is denominated in foreign currency, an appreciation or depreciation of the real exchange rate of the dinar significantly contributes to the public debt-to-GDP ratio.

new projects (a subway in Belgrade, modernization of railways along Corridor 10, modernization of the Belgrade-Bar railway, a construction of a highway to the Adriatic Coast, bridges across the Danube river, etc) most of which will be financed from credits. This all points to a necessity to carefully monitor Serbia's public debt to avoid slipping into heavy indebtedness and a debt crisis from a fairly comfortable position the government still enjoys.

a) The public debt status in 2001-2008

In the period between 2000 and the end of Q1 2009, the total volume of Serbia's public debt had been reduced from €14.2 bn (169.3% of GDP) to €8.9 bn (28.9% of GDP). Public debt had fallen significantly for various reasons.

First of all, after 2000, agreements had been reached with international financial institutions, as well as with creditor clubs on a write-down of a significant amount of debt of the former Yugoslavia (SFRY and FRY). In December 2001, an agreement was signed with the Paris Club of creditors (sovereign creditors) on a write-down of 66% of the debt of FRY (51pp were written off right after the signing of an extended financing facility with the IMF, which was done in 2002, and an additional 15pp write-off was to follow after the IMF issued a positive assessment on successful fulfillment of the three-year arrangement, which was achieved in 2006). An agreement with the London Club of creditors (commercial creditors) on a 62% debt write-down, and repayment of the remaining debt over a period of 20 years, with a five-year grace period, was signed in July 2004. In the course of the first five years, the interest rate was set at 3.75%, rising to 6.75% between years six and twenty.

Second, Serbia has regularly serviced its matured public debt in the abovementioned period. For example, in the period since 2001, it has repaid €1.5 bn of debts stemming from private foreign currency savings. Additionally, in 2006 and 2007, Serbia repaid its debt to the World Bank early (more than €400 mn).

Third, the fact that the fiscal deficit in the past years had been almost fully financed from privatization revenue had also contributed to the reduction of the absolute level of debt denominated in euros. For example, privatization revenues in the 2006-2008 period were sufficient to finance a fiscal deficit equivalent to 2% of GDP.

Table 1. Serbia: Public Debt, 2000–2009

	Changes in the public debt of the Republic of Serbia in bn. US dollars					
	31.12.2000.	31.12.2005.	31.12.2006.	31.12.2007.	31.12.2008.	31.03.2009.
I. Total direct debt	14.2	9.6	8.6	8.0	7.9	8.0
Domestic debt	4.1	4.3	3.8	3.4	3.2	3.2
Foreign debt	10.1	5.4	4.7	4.6	4.7	4.8
II. Indirect debt	-	0.66	0.80	0.85	0.93	0.96
III. Total debt (I+II)	**14.2**	**10.3**	**9.4**	**8.9**	**8.78**	**8.93**
Public debt / GDP	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.9%**	**28.9%**
	Currency structure and interest rate structure of the public debt of Serbia					
	Currency structure				**Interest rate**	
	RSD	EUR	USD	Other	Fixed	Variable
As at 31.12.2007.	3.7%	75.7%	13.8%	6.9%	77.0%	23.0%
As at 31.12.2008.	2.6%	75.4%	14.5%	7.6%	76.0%	24.0%
As at 28.02.2009.	2.7%	73.9%	15.6%	7.7%	76.0%	24.0%

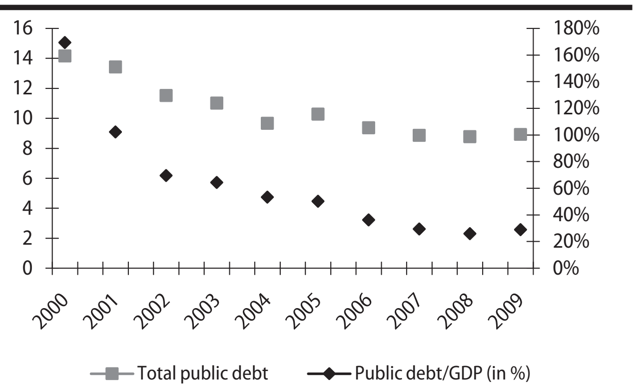
Source: Ministry of Finance.
Indirect liabilities fully refer to liabilities to foreign creditors, so that the total external debt amounts to €5.74 bn (4.8 direct debts + 0.96 indirect debts).

The public debt-to-GDP ratio has constantly fallen as a result of three factors:

- the decline in the absolute level of public debt
- an increase in GDP in real terms
- the appreciation of the real exchange rate of the dinar.

As a result of those factors, the public debt-to-GDP ratio fell from almost 170% at the end of 2000, to 25% of GDP by mid-2008. Considering that most of the debt is euro-denominated, the depreciation of the dinar during Q4 2008 and even more so in Q1 2009, has led to an increase in the public debt-to-GDP ratio. Due to a combined impact of the depreciation of the dinar and the contraction of real GDP, the public debt-to-GDP ratio rose in Q1 2009 by 3pp.

Graph 2. Movements of Serbia's Public Debt in Absolute and Relative Terms, 2000–2009



Source: Ministry of Finance.

b) The status and structure of the public debt at the start of 2009

The total public debt of the Republic of Serbia at the end of Q1 2009 stood at €8.9 bn or 28.9% of GDP. During Q1 2009, the absolute size of the public debt rose by €150 mn or around 0.5% of GDP. However, during Q1, the public debt-to-GDP ratio in Serbia rose by 3pp first of all as a result of a contracting GDP and the dinar depreciation, and to a lesser extent as a result of an increase in absolute public debt levels.

The structure of the public debt shows that 89% of it refers to direct liabilities, while 11% refers to indirect liabilities (based on the guarantees which the Republic of Serbia has issued for other parties' borrowing, including public companies; indirect liabilities fully refer to external debt). By creditors, 74% of the public debt refers to external debt (direct and indirect) while 26% of the public debt refers to domestic debt. Almost 97.2% of liabilities is denominated in foreign currencies (dominantly in euros), while only 2.8% refers to borrowing in dinars. Such currency structure of the public debt indicates strong exposure of Serbia's public debt to currency risk. On the other hand, when interest rates are concerned, more than three quarters of the total debt is borrowing at fixed interest rates, while variable interest rates apply to roughly a quarter of the total debt.

Interest rates on most of Serbia's public debt are low, which is why the cost of interest payment on public debt in previous years accounted for only 0.7% of GDP – one of the lowest levels in Europe. However, with the expiry of maturities during which Serbia serviced credits to foreign lenders under favourable terms, and with the start of significant borrowing on the local financial market at relatively high interest rates, the share of spending on interest payments will increase and is estimated to account for more than 1% of GDP in 2009.

During February 2009, the government started issuing three-month treasury bills with an annual interest rate of 16.5%[3]. A relatively high interest rate, combined with a stable exchange rate and a decline in the central bank's repo rate, has contributed to a significant investor interest in treasury-bills. As a result of those circumstances, the stock of investments in treasury bills rose from around 2 bn dinars at the end of 2008 to 4.5 bn dinars at the end of March, soaring to almost 40 bn dinars in early May 2009. That means that in the period between end-March and mid-May alone, the total public debt of the Republic of Serbia had grown by €300 mn or more than 1% of GDP through borrowing on the local financial market. Based on this, it can be concluded that treasury bills have become an important, but relatively expensive source of financing of Serbia's budget deficit.

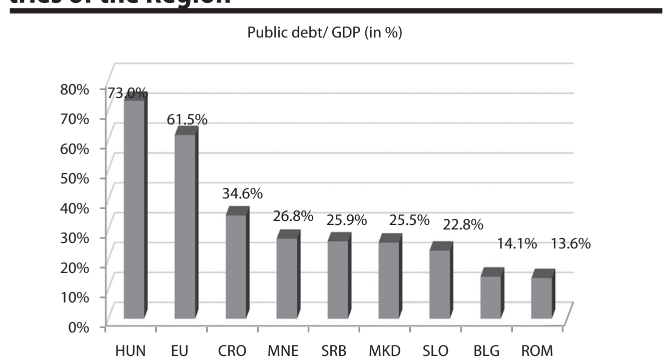
According to NBS figures, Serbia's external public debt at the end of Q1 2009 stood at €6.5 bn, which is €750 mn more than the foreign debt presented in the figures of the Ministry of Finance. The difference between the size of the external public debt, and therefore the total public debt, is the result of the methodology according to which the NBS includes non-regulated public debt in the total public debt, while the Ministry of Finance includes only regulated public debt. The most significant non-regulated public debt refers to the debt to China (€290 mn), Kuwait (€330 mn), Libya (€38 mn), the London Club (€63 mn). It is certain that regulating the listed debts will as a result lead to an increase in the total public debt, but it is still uncertain to what extent. Serbia wants the listed countries to write down the same percentage of the debt as all other members of the Paris Club (66%), a demand they have so far rejected.

c) The level of public debt in neighbouring countries

The majority of neighbouring countries also had a relatively low public debt-to-GDP ratio at the end of 2008. Romania and Bulgaria had a public debt-to-GDP ratio of below 20%; in Slovenia, Macedonia, Serbia and Montenegro the ratio stood between 20% and 30%, and at 34.6% in Croatia. Of all the countries in the region, Hungary is the only exception with a public debt-to-GDP ratio of 73% (which is far above the average for 27 EU member countries 61.5%).

But the level of indebtedness of the countries of the region at the end of 2008, as an indicator of their public debt sustainability, should be taken with some reserve. Some of those countries are in the process of receiving significant additional loans from the EU and international financial institutions to strengthen their foreign exchange reserves and secure the stability of their fiscal systems, which can significantly change the picture of the level of their indebtedness. Beside that, a depreciation of their currencies in real terms, as well as an expected contraction of their GDP in real terms in 2009, will cause an additional and significant increase of the public debt-to-GDP ratio in most countries of the region.

Graph 3. The Share of Public Debt in GDP, in the Countries of the Region



Source: Eurostat and websites of related ministries of finance.

3 In previous years, interest rates on treasury-bills have been below the inflation rate, which is why investments in treasury-bills were been exceptionally low.

d) Expected changes in Serbia's public debt in the medium term

In the course of 2009 and coming years, a turnaround is expected concerning the absolute levels of Serbia's public debt, as well as a change in its share in GDP. A fiscal deficit of around 3% of GDP in 2009, and a slightly lower deficit planned for the coming years, will in most part be financed by new state borrowing on international and local financial markets. The most important lending will come from international financial institutions (the World Bank, the EBRD, EIB), the EU and foreign governments, intended for the financing of infrastructure projects. Beside those, the government is expected to borrow on the local financial market through short-term treasury-bill issues, and indirect borrowing by the state from a consortium of local banks is also possible. Net growth in Serbia's public debt in 2009 and the following two years is estimated at between €2 bn and €3 bn, which accounts for 7%-10 % of Serbia's GDP in 2009.

The public debt sustainability in the coming medium-term period will depend not only on the changes in the absolute debt levels, but also on GDP growth and changes of the real exchange rate of the dinar. Assuming that Serbia's public debt will rise to €12 bn in 2011, and that GDP in 2011 will be about 5% higher than in 2009, and that the real exchange rate of the dinar against the euro will remain unchanged[4], it follows that the public debt-to-GDP ratio in 2011 could mount to 38% of GDP.

An increase in the public debt-to-GDP ratio, along with an expected borrowing at market conditions, will raise the cost of public debt servicing. Assuming that the average interest rate on public debt will be around 4%[5], the cost of interest payments would rise to around 1.5% of GDP in 2011, which is significantly more than now.

An expected faster expansion of the public debt in the coming medium-term period additionally raises the question of improved public debt management. For example, taking into account the currently exceptionally low level of interest rates on the world financial markets, it appears that that this could be a convenient time for refinancing a part of the existing public debt (debt to the London Club of creditors, and possibly debt to some other creditors). This would lead to significant savings in terms of interest payments due in the coming years.

Also, the efficient allocation of funds raised through state borrowing will come into focus. Considering that credits raised by the state are to a great extent aimed at financing public investments, it is necessary to improve the selection criteria and the realization of investment projects. The improvement of public investment efficiency, along with the expected positive external effects, can also contribute to accelerating GDP growth, which would increase Serbia's public debt sustainability.

As part of the new IMF arrangement, it has been agreed to draw credits to strengthen the country's foreign currency reserves by around €3 bn, or around 10% of expected GDP in 2009. Even though the debt of the NBS to the IMF is not part of the public debt, that debt is an integral part of the public sector debt, and is ultimately guaranteed by the state. The debt of the NBS to the IMF will significantly contribute to an increase in external indebtedness of the country. Assuming that the real exchange rate remains constant, and assuming zero GDP growth in 2010, the abovementioned debt will lead to an increase in Serbia's external debt related to GDP by around 10pp. Taking into account the planned government borrowing abroad, as well as private sector borrowing – the total volume of the external debt could achieve the limit of around 80% of GDP already in 2010 or 2011.

4 Considering that round 97% of the debt is denominated in a foreign currency, a depreciation of the real exchange rate of the dinar would lead to an increase in the share of public debt in GDP, while an appreciation of the real exchange rate of the dinar would lead to a falling share of the public debt in GDP.

5 A relatively low average interest rate would be a consequence of the low interest rate (2%) on private hard currency savings, which accounts for 30% of Serbia's total public debt.

Highlights 5. Depth of Recession Forcing the National Bank of Serbia to Relax Monetary and Prudential Policies

Srđan Kokotović *

Even though the National Bank of Serbia (NBS) already in Q4 tried to stimulate new foreign borrowing by banks (and under favorable conditions of falling interest rates on the European money market – the so-called EURIBOR), in order to increase the supply of credits on the domestic market, there has been no major surge in lending activity. The chief reason on the one hand lay in the lack of available funds on the European market, which was totally blocked, and, on the other, in Serbia's extremely unfavorable risk perception. The Serbian Government and the NBS thus adopted a package of measures in February to subsidize corporate liquidity and investment loans as well as consumer loans. This package in the domain of monetary policy and bank

* *Quarterly Monitor*, FREN.

supervision policy entails: (a) reductions for mandatory reserve requirements on foreign currency deposits equaling the amount of extended subsidized loans, (b) loosening of requirements regarding the household loans to capital ratio (increased from the maximum of 150% to 200%) and (c) abolition of the 30% mandatory deposit on consumer credits. The NBS simultaneously slashed its reference interest rate on a number of occasions, from the initial 17.75% to 14% in early May. This and the mentioned budget subsidies led to some growth of credit activity in Q1, at least with respect to corporate liquidity loans. The funds for these loans came from the reserves banks held with the NBS and, to a lesser extent, from greater foreign currency savings. Although this package of measures positively affected corporate liquidity, the funds were exclusively domestic.

The potential outflow of around €5 bn to repay cross-border credits, would have posed a much greater threat in 2009, given the restricted possibilities for refinancing these obligations, at least on a commercial basis. Payment of these cross-border loans would not only have resulted in the illiquidity of most companies, but also in a crisis of the domestic currency given the high trade deficit. This is why the IMF launched an unconventional initiative on restructuring corporate obligations arising from cross-border loans maturing in 2009 during the talks on increasing the stand-by arrangement to €3 bn. To that aim, a meeting of the IMF, the NBS, ten major bank groups operating in Serbia and their home supervisors was held in Vienna on March 27th. The talks resulted in a joint communiqué of the participants in which the banks expressed the wish to retain their overall level of exposure (sum of loans and deposits given to banks, legal and natural persons in Serbia, minus obligations to those persons) in Serbia at the end-2008 level. Moreover, they stated in the communiqué that stress tests would be conducted to establish whether any banks risk undercapitalization (i.e. that their regulatory capital fall under the legal minimum) in the event the economic crisis takes an extremely unfavorable turn. They also expressed willingness to invest the necessary additional capital if such an event occurs. The NBS stated that 31 of the 34 banks operating in Serbia agreed with the proposal by the set deadline i.e. most of the other banks apart from the mentioned largest 10 also joined in the initiative.

The NBS in return introduced a set of incentives for banks which decided to join the plan ("carrot") to improve their liquidity and cautiously ease the criteria for calculating capital adequacy and risk provisioning. The chief incentives entail foreign currency swap transactions between banks and the NBS, which significantly reduce the need of the banks to deal in foreign currency on the interbank forex market to meet their obligations and NBS' regulatory requirements. This will lead to a fall in foreign exchange transactions amongst banks on that basis, which will further result in alleviating the daily variations in the dinar/euro exchange rate. This measure has already been applied in other countries, whose currencies recorded large daily variations due to a lack of foreign currency (primarily in South East Asian states, but also amongst central banks of the most developed states). Foreign currency swap transactions will allow banks with a short-term need for foreign currency and a surplus of dinars to temporarily sell the dinars to the NBS in exchange for foreign currency under the obligation to conduct the reverse transaction after the agreed deadline and mutual settlement of interest rates for both currencies.

The NBS will also approve short-term dinar liquidity loans *based on collateral* (NBS and government securities, long-term government dinar and foreign currency securities, foreign currency funds deposited in a separate account at the NBS and on the basis of portfolios of insured mortgage credits). As per *reserve requirements on foreign currency deposits*, the banks will be able to allocate 35% instead of the hitherto 40% calculated mandatory reserve requirement on foreign currency deposits in dinars. This facility led to a partial withdrawal of foreign currency from the market but, on the other hand, it has improved the banks' dinar liquidity, as exemplified by the BEONIA interest rate (interest rate on overnight interbank loans) in May, which for the first time in several months fell below the repo rate. Improved profitability is what the banks stand to gain from this measure: earnings on dinar placements are much greater than earnings on euro placements (implying also a relatively stable exchange rate); this improvement in liquidity will give banks room to increase dinar placements (in repo placements, Finance Ministry treasury notes and credits to other banks, corporations and private citizens). As far as the so-called *open foreign currency position of banks* is concerned, there are indications that they will be allowed again to go "short" or "long" (have lesser or greater foreign currency assets than foreign currency liabilities) up to 20% of the capital (the limit stood at 10% at the end of 2008). This measure will yield two positive effects. Banks will be able to extend more currency-indexed loans and thus make use of the current high dinar liquidity. This may lead to a partial "recovery" of the market for unsubsidized corporate and private loans. On the other hand, it will bring relief in terms of organization, given that the previous 10% level required banks to constantly control and manage the daily changes in the open foreign currency position, which is extremely dynamic and changes considerably during the day in most banks and whenever a major foreign currency transaction is conducted. A minor downside of this measure is the possible fall in available foreign currency on the forex market, which the banks may purchase and hold in their accounts to protect themselves from currency risk. What is at issue here is €400 mn - the potentially maximum amount of foreign currency that may be withdrawn from the forex market. This will not, however, have strong effects due to the NBS' increased capacity to maintain liquidity on the interbank forex market after the conclusion of the stand-by arrangement with the IMF and the inflow of €3 bn into the foreign currency reserves. Moreover, the introduction of foreign currency swap transactions between the central bank and the commercial banks, but also the banks' inability to pay their foreign currency obligations abroad will have positive effects on the current foreign exchange rate equilibrium.

For banks that joined the program of rescheduling foreign obligations, the NBS has also eased criteria for calculating the so-called capital adequacy by allowing them to include in their capital subordinated liabilities (liabilities arising from credits with maturing dates exceeding five years and paid upon the settlement of all other debts and obligations and before the payment of stock) up to 75% (instead of the hitherto 50%) of their core capital. The foreign parent banks for their part assumed the obligation to recapitalize their affiliates in Serbia if the NBS stress tests show that these subsidiaries are not fulfilling the legal requirements regarding capital adequacy calculated in this manner. This measure is a compromise between the NBS, which tried to induce the banks to apply the old recipe and conduct another round of recapitalization (and inflow of foreign direct investments), and the foreign commercial banks – which, with their solvency severely threatened, are not willing to invest more capital in their affiliates in Serbia. In any case, no major foreign currency inflows on these grounds ought to be expected because the banks in Serbia already have an extremely high level of capital and the so-called capital adequacy ratio (ratio of capital to risky assets). Even if the economic situation deteriorates further, and banks are forced to allocate new loan loss provisions on these grounds as well (the direct consequence of which include reduction of capital and the capital adequacy ratio), there will most probably be no need for recapitalization. And finally, criteria for calculating loan loss provisions and assessing loan quality have been eased by explicit permission not to perceive loan rescheduling as the deterioration of the financial status of the borrower providing that the rescheduling entail a significant extension of loan maturity and the conversion of indexed credits to 'pure' dinar credits. The last measure, aiming to reduce the degree of overall loan euroization will not have major effects as long as the difference between interest rates on dinar credits *with or without* the foreign currency clause (interest rate differential) is extremely high – as it is now (assessed at around 10 pp). For this measure to succeed, the repo rate must be significantly lowered, whereby the interest rate differential will be reduced and speed up the mentioned conversion of loan with the foreign currency clause into 'pure' dinar credits.

We are of the view that this is the right time for the NBS to cut the repo rate. Expectations are that inflationary pressures will ease further; indeed, they were not the result of growing demand in 2009, but the correction of the disparity of administratively controlled prices. Given that the current recession affects rapid disinflation, reducing the repo rate will not significantly endanger the fulfillment of the inflation target but may have very good effects on reducing euroization and stimulating economic activity. The Serbian Government in that context adopted measures for subsidizing dinar credits without the foreign currency clause by 3.5pp with respect to the repo rate (whereby the nominal interest rate on liquidity credits falls to a tolerable 10.5% while the repo rate stands at 14%), which may bring about some headway and reduce the degree of loan euroization. The right measure would however be to reduce the NBS repo rate and establish normal credit flows at mutually acceptable terms between the banks and the economy without state intervention. This thesis is corroborated also by the fact that the dinar liquidity of the banking sector significantly increased as of mid-May and that the banks were at an average holding between 5 bn and 10 bn dinars more on their interest rate free giro accounts than they are obliged to (according to the calculated reserve requirements). Moreover, repo placement stands at nearly 100 bn dinars and the placement in the Finance Ministry treasury notes stands at around 45 bn dinars. Summing up all these liquidity surpluses, we assess that banks could place a sizable proportion of the 150 bn dinars in the form of "pure" dinar credits to companies and households without endangering their liquidity. This could have extremely favorable effects on the above-mentioned euroization, but the repo rate needs to be reduced first.

Highlights 6. Labor Statistics in Transition

Conclusions from FREN's Roundtables[1]

Conclusions and recommendations of Round Table I "Labor Market Status Data: Assessment of Existing Data Sources, Their Relevance and Reliability" held on December 29th, 2008:

1. The Labor Force Survey (LFS) is the primary and most important official source of information on the labor status of the population. Only the LFS provides official, internationally comparable data on the activity, employment and unemployment of the working-age population and specifically on the relative expressions of these indicators.

Although this conclusion is well known to the round table participants, an additional serious effort needs to be invested in highlighting the importance of the LFS and its results amongst the media, economic policy-makers, but also economists not specializing in the labor market and other experts and public officials in order to avoid the parallel use and combining of labor status data from other, above all administrative, sources. The parallel or predominant use of administrative data may sometimes prove useful in detailed expert analyses or in research of formal sector employment and administratively registered unemployment, but it should be avoided in the public discourse, especially when presenting the labor market status with the help of summary indicators, because such use leads to confusion and derogates the LFS results. Thus, the **Statistical Office of the Republic of Serbia (SORS) should stop calculating and publishing the administrative unemployment rates for Serbia**.

2. The international comparability of the LFS is at an extremely high level but there is room for further improvement.

Thanks to the methodological changes in 2004 and 2008, above all in the questionnaire, the LFS attained a high degree of compatibility with the International Labor Organization (ILO) and Eurostat standards and recommendations. Still, LFS users noted during the discussion that there were some minor deviations from the standards and prevailing world practice in terms of population coverage, observed units, as well as concepts and definitions. As far as observation units are concerned, it should be highlighted that they comprise persons within households, not households, and that the survey procedure therefore needs to be specified to ensure personal interviews of all household members over 15 years of age, whenever feasible. As per concepts and definitions, a minor adaptation of the questionnaire would enable a more thorough and precise definition of underemployment and of the real and usual working hours.

3. Methodological improvements of the LFS in 2004 and 2008, however, pose a challenge to monitoring information on the labor status of the adult population over time.

The methodological changes in 2008 introduced new questions, which cover various forms of atypical labor involvement of the adult population more comprehensively. When these questions are hypothetically left out, an alternative result, which is methodologically comparable with the results of the previous surveys, is obtained. It can therefore be generally concluded that three-fourths of the 4pp drop in the unemployment rate between October 2007 and October 2008 (from 18.8% to 14.7%) can be attributed to adding new questions to the survey and that the remaining one-fourth is a result of the positive trend.

A greater challenge, however, arises from the changes introduced in 2004 - when the question classifying some labor force members as so-called occasionally active, a category that does not exist in ILO standards, was removed from the questionnaire. Researchers and statisticians need to continue cooperating to establish whether it is possible to find an algorithm that will allow for the comparability of pre- and post-October 2004 LFS data.

4. Presentation of LFS data should be partly amended and expanded to include new content.

The format of the public announcements of LFS results available on the Internet needs to be amended so as to base the absolute and relative indicators on data related to the working age population (15-64 years of age) and not on data related to the adult population (15 years and older). The new content to be covered by the announcements should include at least the following: underemployment, real and usual working hours, the discouraged jobless and a broader concept of unemployment.

Cooperation between the survey "producers" and "users" needs to be intensified in order to further supplement the detailed annual LFS bulletin with additional data and indicators, including estimates of the informal economy, types of unemployment, earnings and other complex categories marking a move from tabulation to analytical presentation.

1 FREN implemented the project «Labor Statistics in Transition» in December 2008-February 2009 in cooperation with the Statistical Office of the Republic of Serbia and the Serbian Deputy PM's Poverty Reduction Strategy Implementation Team. The project included two expert round tables, the conclusions of which are presented in this text.

5. The LFS ought to be conducted at least twice a year; a quarterly basis would be optimal.

In 2009, it is crucial to preserve the newly-established semi-annual dynamics of conducting the LFS and begin conducting it on a quarterly basis in 2010, or 2011 at the latest, in accordance with European standards. Surveying on a quarterly basis would allow for a more precise identification of seasonal influences and help suppress the use of administrative sources of data on the labor force in the public discourse.

6. The RAD survey is a good source of data on formal employment, but it can, by no means, be used used in lieu of the LFS, not even when analyzing employment.

The RAD survey covers the formal sector – companies, institutions and organizations, as well as entrepreneurs and the self-employed operating legally. The survey covers business entities, not directly employed persons and households. It is not fully comprehensive even with respect to the formal sector, given that, at the very least, it does not include the army and the police. On the other hand, it probably overestimates self-employment and employment with entrepreneurs because it applies the criterion of the formal registration of health insurance contribution payments, which may be a purpose in itself. However, a controlled and cautious use of the RAD survey for analytical and research purposes may be useful given that data on employment in the corporate sector are monitored on a monthly basis and practically provide census coverage of large and medium-sized companies. However, its limitations should always be clearly underlined.

7. The rate of publishing LFS results needs to be further stepped up.

SORS has already stepped up the speed of processing the LFS data and publishing the results to less than three months from the day of field work completion. Cutting this period down to three or four weeks is, however, completely feasible.

8. Greater access to detailed (including individual) data needs to be provided for research purposes.

There is still only a small number of analytical studies based on detailed individual data in the LFS, RAD and National Employment Service administrative registers. To encourage labor market research, organizations with jurisdiction over such data are advised to allow research organizations easier access to data, with the necessary restrictions related to private information confidentiality.

Conclusions and Recommendations of Round Table II "Informal Employment: Potential Data Sources and Research Practice", held on February 10th, 2009:

9. There are two chief ways of systematically covering informal employment – by monitoring informal companies and family businesses i.e. by monitoring employment in the informal sector, and by monitoring informal jobs, be they in the informal or formal sector. Although both concepts have their advantages, we are of the view that the approach based on the coverage of informal jobs is more precise and yields better results in Serbia.

There are major differences between the two concepts although they appear very similar. The latter approach, departing from individuals performing informal jobs, is capable of drawing more precise distinctions when it comes to the relatively frequent borderline cases in Serbia. For instance, persons can be informally employed (unregistered) even in formal sector companies. They can also spend part of their workday performing jobs in the formal sector and the other part working in the informal sector. The practice of "dual payrolls" as a form of informality in formal companies can also be identified by analyzing the labor involvement of individuals and their jobs but it is much more difficult to identify by analyzing companies. By applying the criterion for classifying companies by size (World Bank 2006), employment in the **informal sector** has to date been estimated once on the basis of LFS results. An estimate of i**nformal employment** on the basis of LFS results has also been conducted once to date and it analyzed jobs by applying the latest methodology adopted by the International Conference of Labor Statisticians in 2003 (SORS, 2008). The latter analysis became possible only once new criteria for classifying formal and informal jobs were introduced in the LFS conducted by SORS, as of April 2008.

10. There are additional avenues for achieving better coverage of informal employment - by examining individuals' working hours in formal and informal jobs.

We believe that a more realistic picture of informal employment is provided by the methodology based on the features of the jobs (company registration, existence of labor contracts, social insurance, payment of taxes) and applied by SORS, which followed the recommendations of the ILO and the International Conference of Labor Statisticians. It should, however, be refined further because it now classifies each individual as either formally or informally employed and thus misses the opportunity to also express formal and informal employment (and their proportional shares in total employment) in working hours.

11. **Informal employment in Serbia was estimated at 646,000 or 23% of total employment in October 2008. As expected, informal employment is most widespread amongst household members assisting in family businesses (100% by definition), in agriculture and amongst the self-employed outside of agriculture.**

This summary percentage of informal employment - 23% - is much lower than the hitherto estimates of informal sector employment in the LFS (37% in 2006) and the 2002 and 2007 Living Standards Measurment Survey (33% and 35% respectively). These results are unfortunately not directly comparable for the above mentioned reasons and are thus not mutually contradictory, nor do they call for special interpretation. They merely indicate the essential methodological differences between the surveys.

12. An interesting and challenging side-effect of estimating formal non-agricultural employment (calculated by subtracting the number of informally employed from the total number of employed persons, outside of agriculture) is the need to explain the significant difference of 100,000 less employed persons outside of agriculture in the LFS, compared to the formal non-agricultural employment estimated on the basis of the RAD survey. To explain that discrepancy, the features and methodology of the RAD survey need to be reviewed in detail – this will be the subject of the following round table.

Non-agricultural employment stood at 1,973,000 according to October 2008 LFS data and at 1,993,000 according to RAD September 2008 data. RAD, however, does not cover employment in the army and police, assessed at minimum 80,000. The discrepancy between the estimated levels of non-agricultural employment in the two surveys thus increases to around 100,000. Several potential explanations of the discrepancy were reviewed during the debate – the possibility of registering the same person multiple times in the RAD survey, which is impossible in the LFS, that the RAD survey shows a greater number of workers in the public sector than there really are; that the size of the working age population on the basis of the LFS sample may be underestimated. The participants concluded that they needed to learn about the RAD survey methodology in greater detail in order to be able to reliably identify the causes of such major numerical discrepancies.

13. Research of the changes in and the structure of informal employment faces at least the following challenges: "intensity" of informal employment, quality of informal employment, informal wage fund expressed as the percentage of the total wage fund.

"Intensity" of informal employment entails the fact that the estimated 23% of the total number of employed persons can at an average have a considerably greater or lesser number of working hours than the formally employed. This is why it is relevant to give the share of informal working hours into the total number of working hours.

The quality of informal employment entails its structural features, above all breakdown by education, qualifications, sector and geography. Following structural changes over time can provide important insights in the evolution of the features of informal employment. Since the late 1990s and early 2000s, informal employment has apparently tended to predominate amongst the less educated, less qualified groups of workers in less paid sectors and less developed regions.

Assessing the share of the "informal wage fund" in the total wage fund on the basis of the LFS would significantly contribute to the assessment of the share of informal economy in the GDP because the assessed "informal wage fund" could serve as a key proxy for estimating the size of the informal economy. This exercise is fraught with major problems requiring additional research and a creative approach given the following circumstances. First, it is generally believed that respondents tend to conceal incomes from unregistered rather than from legal jobs, and, as a rule, earnings acquired through illegal means are totally left out. Second, as mentioned, such research would have to differentiate between earnings by individuals holding multiple jobs differing in formality status, and notably differentiate between dual payrolls in formal private companies.

SPOTLIGHT ON

Public Procurement in Serbia – Scope of the Reforms

Dr. Predrag Jovanović*

Public procurement accounts for some 15% of GDP of developed European countries, according to OECD estimates. The Public Procurement Law that came into force on July 13th, 2002 was the first law to regulate in a modern manner public procurement in Serbia, estimated at €4 bn per annum. The new Public Procurement Law, which came into effect on January 6th, 2009, regulates public procurement procedures and the work of regulatory institutions broadly in accordance with European standards and good practice. The Law, however, crucially deviates both from European standards and realistic needs in terms of the resources (capacities) the state has placed at the disposal of the regulatory bodies to exercise their legal duties, whereby the application of the Law will be seriously constrained. Another major problem arises from the passiveness of the key monitoring institutions, such as the State Audit Commission and the judicial authorities and their monitoring and prosecution of abuse in the field of public procurement. The key weaknesses of the public procurement system in Serbia do not lie in the legislation, but in the capacity and the enforcement of the regulations.

1. Introduction

Major importance is attached to public procurement in developed countries. According to OECD estimates[1], public procurement accounts for around 15% of GDP of developed European countries, which clearly indicates the importance of public procurement for the economic and social development of developed states.

Public procurement has a higher share in the GDP of less developed countries – up to 30%. Countries in transition thus began regulating public procurement in the mid-1990s by passing public procurement laws: Slovakia in 1993, the Czech Republic in 1995, Slovenia in 1997, etc.

The Public Procurement Law, which came into force on July 13th, 2002, was the first systemic anti-corruption law passed in Serbia after the changes in 2000. It comprised modern provisions on public procurement, the annual value of which is assessed at €4 bn.

Given the major relevance public procurement has for the development of the economy, functioning of all state institutions and the quality and volume of services the state provides to its citizens, this analysis will aim to give an overview of the headway made in building the public procurement system, its key weaknesses and ways to address them in the upcoming period.

The analysis will begin by assessing the regulatory (legislative) framework, above all the degree of its compliance with European directives and good practice developed in EU member states. It shall then review the institutional framework that is to enable the practical application of the legal provisions. It will also review the real effects of the enforcement of the Law in previous years and indicate areas where the greatest savings can be made in the future. It will conclude by summing up the practical measures that need to be taken to cut costs and improve the effectiveness of the public procurement system.

2. Public Procurement - Regulations

Public procurement accounts for 15% of Serbia's GDP, which clearly corroborates why it is crucial to regulate this area by law.

* Director of the Public Procurement Office.

1 "Integrity in Public Procurement – Good Practice from A to Z", OECD, Paris, 2007.

The Public Procurement Law that came into effect on July 13th, 2002 was the first and main law to regulate public procurement procedures. The second is the State Audit Institution Law regulating the monitoring of the regularity and justifiability (expediency) of public procurement. In addition, the Law on the Budget System regulates internal oversight of the regularity of public procurement. Finally, the Criminal Code and the Criminal Procedure Code comprise provisions on the investigation and adjudication of major abuses in the field of public procurement.

The Public Procurement and State Audit Institution Laws were modeled after Slovene laws regulating these areas. A comparative analysis[2] of the public procurement systems in EU member-states shows that the procedures and institutions envisaged by the Serbian Public Procurement Law are highly in accordance with the ones in the EU.

On the other hand, the Criminal Code does not comprise a provision specifically penalizing violations of public procurement procedures; such crimes fall under "abuse of office". This shortcoming has no doubt severely constrained the efficient sanctioning of violations of the Public Procurement Law.

It can be concluded that the Public Procurement Law, regulating the public procurement procedures and the work of regulatory institutions, is in accordance with European standards and good practice to a great extent. The same may be said of the State Audit Institution Law.

From the viewpoint of public procurement, the Criminal Code is, however, deficient inasmuch as it lacks provisions that would adequately sanction illegal conduct in the field of public procurement.

The following section will endeavor to assess the adequacy of institutional capacity vis-à-vis legislative jurisdiction. In other words, we will try to assess the extent to which regulatory institutions charged with public procurement have the capacity to efficiently exercise the duties prescribed by the Law.

3. Institutional Framework

There are 112,000 direct and indirect budgetary beneficiaries in Serbia, and they conclude an average of circa 150,000 public procurement contracts every year. The system is characterized by a high degree of decentralization in which each procuring entity is entitled to conduct its own procurement procedure but is simultaneously held liable for the regularity of the procedure.

Apart from the procuring entities, the system rests on the following three regulatory pillars:

1) The Ministry of Finance, the remit of which includes proposing primary and subsidiary legislation and providing interpretations of and opinions on legal provisions; the Republican Commission for the Protection of Bidders' Rights, which acts as a second-instance authority protecting rights in public procurement procedures and taking final decisions on bidders' appeals by annulling the procedures (in part or entirety) or dismissing the bidders' appeals as groundless; and the Public Procurement Office, which monitors the public procurement procedures, especially negotiated procedures reportedly warranted by extraordinary circumstances.

2) The audit system comprising internal audit units within each procuring entity and external auditing performed by the State Audit Institution, charged with checking both the regularity of the procedures and the justifiability (expediency) of public procurement.

3) The judicial system, comprising prosecution offices conducting investigations and launching proceedings against those in breach of the Law and courts handing down penalties for violations of the Law.

An assessment of the public procurement institutions as a whole calls for a review of how developed and functional each of them is and how well they are coordinated amongst themselves.

The Republican Commission for the Protection of Bidders' Rights is not independent yet; rather, it operates within the Public Procurement Office, although the new Public Procurement Law that came into force on January, 6th 2009 sets out that the Commission shall be an independent authority the members of which shall be elected by the National Assembly. The autonomy of the Commission and its independence from the executive is essential because the Commission is the second-instance organ taking final decisions on appeals of the regularity of public procurement procedures. Given that the appellant is disputing the decision of the procuring entity, it transpires that an executive authority is a party to every proceeding on the protection of rights. Therefore, if the authority taking a

2 "Central Public Procurement Structures and Capacity in Member States of the European Union", SIGMA Paper No. 40, Paris, 2007.

final decision in such disputes (the Commission) is also part of the executive, its impartiality and objectivity may be brought into question.

Besides its status, the Commission must have sufficient staff and an adequate budget to be able to perform the extremely responsible job entrusted to it and within the short deadline provided by the law – 15 days.

The Serbian Public Procurement Office has much less staff than similar institutions in former transition countries that joined the EU in 2004 and 2007. Moreover, the Office's budget is much smaller than the budgets of its counterparts in other transition countries (comparable data for 2008 are given in Table 1).

Table 1. Comparable Data on Staff Numbers and Budgets of Public Procurement Agencies by Country in 2008

Country	Budget (in euros)	Number of employees	Name of the institution	Country population (in millions)*
Albania	540,000	36	Public Procurement Agency	3.2
Romania	2,500,000	96	Public Procurement Agency	21.6
Hungary	5,700,000	82	Public Procurement Council	10.1
Slovakia	1,475,000	110	Public Procurement Agency	5.4
Serbia	294,600	19	Public Procurement Office	7.4
Lithuania	1,330,000	73	Public Procurement Agency	3.4

Source: Public Procurement Office.
*Population figures are given as an indirect indicator of the size of the public procurement markets in the given states.

The 2007 plan envisaged the establishing of modern internal audit units within 18 major procuring entities and three large funds: the Health Insurance Fund, the Pension and Disability Insurance (PIO) Fund and the National Employment Service. Such units have to date been set up only within six (of the total of 12,000) procuring entities.

The situation regarding external auditing has not moved beyond the initial step – the State Audit Institution Council has been elected but no audit reports have been drafted yet.

Judicial authorities, too, have been unable to perform their duties and adequately penalize the abuse of public procurement. Transparency Serbia's data on legal entities and responsible persons finally convicted on misdemeanor charges for violating the Public Procurement Law in 2006 show that only 27 procuring entities in all of Serbia were convicted for misdemeanors and 17 of them (i.e. two-thirds) were handed down the mildest penalties – a reprimand or a fine under 10,000 dinars, although the Law envisages fines of up to 200,000 dinars. Such mild penalties seem truly inappropriate given the values of the procurements amounting to several million, even tens of millions of dinars[3].

Of the 28 penalized responsible persons in 2006, 13 were issued a reprimand or ordered to pay a fine under 5000 dinars. Apart from misdemeanor penalties, there are no data on any final convictions for the abuse of office or another crime in the Criminal Code related to the abuse of the public procurement procedures since 2002, when public procurement procedures were first regulated by law.

It may be concluded that the powers (duties) of the Serbian regulatory public procurement institutions (Commission and Office) are defined in accordance with European standards[4]. The resources (capacities) the state has placed at their disposal to exercise their legally prescribed duties is the point where they crucially deviate from both European standards and real needs, thus severely constraining the enforcement of the Law.

Apart from the insufficient capacities of some institutions, another major problem is the passiveness of the relevant institutions, such as the State Audit Institution, and the judicial authorities that ought to investigate and adjudicate abuse in the area of public procurement.

We will now review the practical effects of the inadequate institutional framework in the 2002-2008 period.

3 For example, in a case in which the Public Procurement Office filed misdemeanor charges against a legal person for violating the Law in a multi-million procurement procedure, the misdemeanor judge issued the legal person a reprimand, explaining that "a fine would make a dent in the budget".
4 SIGMA, 2007.

4. Results Achieved in the Field of Public Procurement (2002–2008)

The annual value of public procurement in Serbia as reported in the reports procuring entities are legally bound to submit to the Public Procurement Office every year amounts to €2 bn, or 8% of GDP (Table 2).

Table 2. Value of Public Procurement (in billions of euros) and its share in GDP (in %)

Year	2003	2004	2005	2006	2007	2008
Public procurements	1.5	1.5	1.5	2	2.5	2.9
Share	8.4	7.6	7.1	7.9	7.84	8.6

Source: Public Procurement Office.

The value of public procurement is, however, higher given that only 2,000 of the 12,000 procuring entities in Serbia have met their legal obligation to submit their annual reports to the Public Procurement Office.

With the aim of making the most realistic assessment possible, we started from the OECD estimate[5] that public procurement accounts for around 15% of GDP in developed European countries. If one presumes that the share of public procurement in Serbia's GDP also stands at 15%, the value of public procurement per annum can be conservatively estimated at €4 bn.

The primary goal of public procurement is to achieve the best value for money. The following prerequisites need to be fulfilled to attain that goal: to ensure free competition amongst bidders by providing all potential bidders with timely information about the public procurement tenders, in order to give them enough time to prepare their bids, as well as to ensure that the requirements in the tender documentation are not discriminatory. This is why *transparency* and *non-discrimination* are the two key principles of public procurement. They are best achieved in competitive procedures entailing a notice of public tenders and participation of all interested bidders.

On the other hand, a negotiated procedure allows the procuring entity to invite only some bidders or even only one bidder and conduct negotiations with them/it under non-transparent circumstances. Such negotiated procedures result in higher prices and lower quality than procedures entailing free competition.

This is why the share of negotiated procedures in the total number of procedures is one of the primary parameters for assessing the successfulness of the public procurement system.

One of the chief duties of the Public Procurement Office in the past has been to give opinions on whether conditions were met for conducting bidding procedures without ex ante publication. Table 3 demonstrates the relative relevance of this procedure vis-à-vis procedures entailing the publication of a public notice and participation of all potentially interested eligible bidders.

Table 3. Competitive v Negotiated Procedures (in %)

Type of procedure	2002	2003	2004	2005	2006	2007	2008
Competitive procedures (open and restrictive)	36	79	76	73	73	72	70
Negotiated procedures	64	21	24	27	27	28	30

Source: Public Procurement Office.

The share of negotiated procedures in 2002, the first year in which the Public Procurement Law was applied, clearly indicates the procuring entities' tendency to conclude most contracts in negotiated procedures. However, the share of negotiated procedures dropped significantly in the first two years of the work of the Public Procurement Office (2003 and 2004), to under 25%.

To objectively assess whether this share of negotiated procedures is satisfactory, we shall apply the PEFA methodology[6] used by the World Bank in its evaluation of public procurement systems in its regular annual reports. Serbia has progressed from rating C in 2002 to rating A in 2003 and 2004.

5 OECD, 2007.

6 According to the PEFA (Public Expenditure and Financial Accountability) methodology applied by the World Bank, rating C is allocated if the share of competitive procedures is less than 50%, rating B if the share of such procedures ranges between 50% and 75% and Rating A if the share of competitive procedures exceeds 75%, Public Financial Management Performance Measurement Framework, PEFA Secretariat. World Bank, Washington DC, USA, June 2005.

However, the share of competitive procedures from 2005 to 2008 declined and Serbia scored less, lowering its rating to B (Table 3).

The initial improvement can be ascribed to the launch of the Public Procurement Office on January 15th, 2003. Its primary goal was to suppress the number of negotiated procedures by rendering opinions. Namely, a procuring entity planning to launch a negotiated procedure was legally bound to first seek the opinion of the Public Procurement Office on whether it established the existence of objective or extraordinary circumstances set out in the Law that would justify the restriction of competition. The Office in practice gave mostly negative opinions and advised the procuring entities to opt for open procedures. It thus acted pre-emptively, preventing the launching of uncompetitive procedures in the first place.

The procuring entities, however, subsequently identified and began increasingly abusing the loopholes in the public procurement procedures oversight system. Namely, while the best bid selection stage is controlled by the Public Procurement Office, the first stage (public procurement planning) and the third stage (realization of the contract) are beyond the scope of the Public Procurement Law and the Office. The State Audit Institution Law regulates oversight of public procurement planning by entrusting the State Audit Institution with checking the justifiability (expediency) of a specific public procurement – for instance, whether a state authority with a staff of 10 needs 30 PCs or five official cars in view of its remit.

The third stage, the fulfillment of contract obligations, is to be overseen and controlled by the State Audit Institution, the budgetary inspection and even the police if there are suspicions of abuse. There have been instances of concluded contracts being amended (through adding annexes) by increases in prices, extensions of the deadlines, etc. with the selected bidders ultimately turning out to be the most expensive and unfavorable ones. This is why all developed countries devote special attention to monitoring the execution of the contracts to avoid abuse rendering the whole public procurement procedure senseless. The State Audit Institution is to play the key role in performing such checks.[7]

Having noted the absence of checks and monitoring in the first and third stages of public procurements, the bidders increasingly chose to make use of these deficiencies as of 2005. This led to an increase in contracts awarded to bidders who had already concluded contracts with the entities by simply annexing and extending the existing contracts. In result, other bidders had no chance to bid. The absence of transparency and competition definitely adversely affected the prices and other conditions. This tendency is reflected in the rise in the relative relevance of negotiated procedures (under which the contracts were ammended) vis-à-vis competitive procedures in the past four years.[8]

Regulation of the public procurement procedures has led to savings ranging between 8% and 15% in the 2002-2008 period (Table 4).

Table 4. Comparative Overview of Savings

	2002*	2003	2004	2005	2006	2007	2008
Value of savings (bn dinars)	1.1	10.3	7.7	16.3	16.2	18.2	25.5
Share in public procurements (%)	9	12	8	15	11	11	13

Source: Public Procurement Office.
* Savings are measured as the differences between the estimated and contracted values of public procurement. The value of public procurement is estimated on the basis of the price of the object of procurement in the previously contracted public procurement of that object; if the given object was not purchased during the year, the ongoing market price of the procured object is taken as the estimated value.

In assessing whether the level of savings is satisfactory, it is advisable to compare it with international standards. The OECD assesses that around 20% of the total contracted value is lost due to corrupt public procurement in developed countries. This percentage is, however, higher in less developed countries, ranging from 40% to 50% of the contracted value of public procurement[9]. Bearing this in mind, the following conclusions may be drawn:

1) Annual savings averaging around 10% achieved in the 2003-2008 period thanks to the regulation of the public procurement procedures, and ranging between €200 mn and €300 mn in absolute terms, are considerable.

7 Senior officials of the Slovene State Audit Institution state that oversight of public procurement procedures accounts for 80% of the Institution's activities.
8 Data on annexes can be established only by field investigations that would be conducted by internal and external audits (State Audit Institution), inspection authorities and investigation bodies. Moreover, the crucial role of judicial authorities must always be borne in mind given the strong preventive (deterring) effects on potential perpetrators of adequate and efficient (timely) sanctioning of abuse in this field by the courts.
9 OECD, 2007.

2) Additional savings, which can be achieved by improving the public procurement system, especially by boosting the efficiency of checks and oversight, are estimated at around 20%, or between €400 mn and €600 mn.

3) If all savings potentials in public procurement were used, Serbia would save between €600 and €900 mn every year just from stifling corruption.

When deliberating how to make public procurement savings, one needs to start by identifying which categories of procuring entities have the greatest potential for savings. The breakdown of public procurements by procuring entities (Table 5) shows that the majority of public procurement contracts – two-thirds of the overall value – are concluded by public companies, at both the level of the Republic and the local levels (public utility companies). Therefore, one percent savings in this category of procuring entities has double the effect of one percent savings by all other procuring entities put together.

Table 5. Public Procurements by Groups of Procuring Entities (in %)

Group of procuring entities	2002	2003	2004	2005	2006	2007	2008
Government bodies	33	26	20.06	17	15	16	23.42
Public companies	63.7	59	56.4	56	65	63	57.46
Public institutions	3.3	11	14	22	13	12	12.7
Town and municipal administration	-	4	9	5	8	9	6.42

Source: Public Procurement Office.

The 2004 amendments to the Law introduced a 20% preferential advantage to domestic vis-à-vis foreign manufacturers. As data in Table 6 show, this measure has had considerable effects on the value structure of public procurements with respect to the relative ratio of domestic and foreign bidders.

Table 6. Comparative Overview of Procurements by Value of Contracts Awarded to Bidders from Serbia, the EU and non-EU states (in %)

Country of bidder	2002	2003	2004	2005	2006	2007	2008
Serbia	79	84	91	91	91	95	93
EU	19	13	6	4	5	2	4
Non-EU countries	2	3	3	5	4	3	3

Source: Public Procurement Office.

This measure is, however, limited to the period of transition given that EU regulations prohibit all lasting forms of discrimination. The Stabilisation and Association Agreement (SAA) thus stipulates that the 20% preference for domestic economic entities remain in effect two years following the entry into force of the SAA, that it be cut to 15% in the third year, then to 10% in the fourth year, and finally to be abolished in the fifth year.

5. Conclusion

The key weaknesses of the public procurement system can be summed up in the following manner.

Legislation – the Criminal Code does not comprise a separate provision penalizing violations of the public procurement procedures.

Institutional framework – the capacities of the Public Procurement Office and the Commission for the Protection of Bidders' Rights are way below the standards in the region and, which is especially important, they are inadequate to fulfill the goals and duties arising from the Public Procurement Law. The internal and external audit authorities are not operational. Judicial authorities are not playing an active role in investigating and adjudicating violations of the Public Procurement Law.

It is thus clear that the key weaknesses of the Serbian public procurement system lie not in the legislation but in the capacities and the application of the regulations.

This phenomenon (that the legal regulations are good but that there are no conditions for their efficient enforcement) is a common feature of all anti-corruption mechanisms in Serbia today share.

Serbia scored 62 out of 100 points on the 2008 Index of the US organization Global Integrity, which has been monitoring the existence and efficiency of anticorruption mechanisms across the world. It is worth noting that this is two points less than in 2006, when Serbia was also assessed.

Global Integrity rated the legislation framework 75 points and law enforcement with only 45. Administration and civil service were rated the worst – 41 points, and public procurement got the highest rating in this category – 66, while privatization was ranked the lowest – 24 points.

Nearly identical conclusions and recommendations were voiced in the European Commission Progress Report on Serbia's progress within the Stabilisation and Association Process. The 2007 Report states:

"Serbia's public procurement system remains weak and needs to be further strengthened, both in legislative and administrative terms. Substantial efforts are needed both in terms of amending the legislation and strengthening the capacity to implement the requirements of the SAA.

To a degree, the negative tendencies have been counterbalanced by the professionalism of those working in public procurement institutions."

The 2008 Progress Report reiterates and to an extent elaborates the conclusion and recommendation in the 2007 Report:

"The public procurement institutions, including the Public Procurement Office and the Commission for the Protection of Bidders' Rights have insufficient physical and human resources... The implementation of a non-discriminatory and well functioning public procurement system in Serbia continues to be adversely affected by the weaknesses in the public administration's internal audit system, by the absence of a fully functioning Supreme Audit Institution, as well as by corruption.

Additional efforts in the coming period are needed in terms of amending the legislative alignment, implementating a public procurement strategy and strengthening the capacity to implement the requirements of the SAA."

Departing from the identified weaknesses of the public procurement system in Serbia and the recommendations of international organizations, the measures that must be taken can be summed up in the following manner:

– The Government needs to draft and adopt a Strategy for Improving the Public Procurement System.

– The Commission for the Protection of Bidders' Rights needs to be established as an independent and autonomous authority with an adequate budget and offices as soon as possible.

– The Public Procurement Office needs to be provided with adequate offices, equipment and staffing enabling it to exercise the new duties envisaged by the recently adopted Public Procurement Law.

– The State Audit Institution needs to be provided with means to efficiently exercise the legal powers related to monitoring the justifiability and regularity of the conducted public procurement procedures.

– Internal audit units need to be established pursuant to the Law on the Budget System.

– Public procurement staff in procuring entities needs to undergo comprehensive training with bidders, in order to be able to efficiently and properly conduct public procurement procedures in accordance with the new Law.

– Prerequisites need to be provided to ensure more active involvement of the judicial authorities in investigating and penalizing abuses in the field of public procurement.

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New Securities Act – a Competitive Necessity for Serbia

USAID Serbia Economic Growth Activity

The existing Securities Law contains substantial conceptual shortcomings that prevent further development of the Serbian capital market. The new draft law seeks to harmonize the legislation with EU Directives, IOSCO Principles and other international practices and therefore relies on a new market development strategy advocating an upgrade of the stature of the Belgrade Stock Exchange market by removing from admission to trading those companies in which there is no significant trading interest, removal of obligation to trade in equity securities on the stock exchange and strengthening of the Securities Commission by providing adequate supervision and enforcement powers that are called for in IOSCO standards. In addition to passing the new securities law, it is critical to simultaneously pass amendments to the Company Law, in particular, to enable public offers.

Although the 2006 Law on the Market of Securities and Other Financial Instruments (2006 Law) generally represented an improvement over prior Serbian securities legislation, it falls substantially short of conformity with EU legislation and omits many key requirements of EU Directives, which reflect best practices in securities legislation that realistically could and should be applied at the present in Serbia. The 2006 Law also does not reflect the implementation of a number of the Objectives and Principles of Securities Regulation (IOSCO Principles) issued by the International Organization of Securities Commissions (IOSCO). As a member of IOSCO, the Commission is required to use its best efforts to seek implementation of securities legislation that is consistent with IOSCO guidance. Perhaps even more importantly, the 2006 Law also has substantial conceptual shortcomings that prevent the development of a well-regulated Serbian capital market.

Given the above, the draft Law provided by USAID experts is intended to replace in its entirety the Law on the Market of Securities and Other Financial Instruments (2006 Law) and to meet two main objectives: (1) to make Serbian securities regulation as compliant with EU Directives as possible under current circumstances, and (2) to make Serbian securities regulation compliant with IOSCO Objectives and Principles of Securities Regulation and other international best practices in securities regulation.

EU Harmonization

In order to generate interest from and the trust of foreign investors, Serbia needs to harmonize its securities legislation with international standards. In the case of EU harmonization, the draft law is generally fully harmonized with applicable EU legislation with the exception of the EU takeover and UCITS legislation and three EU-related exceptions relating to "pass porting", investor-compensation schemes and "systematic internalizers".

The draft law does not address the requirements of the EU Takeover Directive because Serbia has a separate Law on Takeovers. Many experts agree that the Law of Takeovers is an extremely poor law regardless of whether it is compared to EU requirements or any other international standard and drafting a new law should be a legislative priority.

The draft law does not address the requirements of the EU UCITS Directive applicable to investment funds either, as there is a separate Law on Investment Funds. Although it requires selective amendments to fully comply with the UCITS Directive and to address a limited number of other problems, this is generally a sound law.

The draft law is intended to comply with the requirements of the EU Prospectus Directive in terms of prospectus requirements, procedures for approving publication of a prospectus, and by adopting the EU requirements for exemptions from the public offer and prospectus publication requirements. One exception is that the draft law does not include the two-tier approach[1] to prospectus disclosure from the EU Prospectus Directive because it would unnecessarily complicate matters with two sets of prospectus regulations. Given that the current disclosure

1 The EU Prospectus Directive requirements apply to public offerings of over €2.5 mn. The Directive permits lesser prospectus requirements for public offerings between €100,000 and €2.5 mn, assuming that these offerings do not result in admission to trading on a regulated market, in which case the stronger requirements apply.

requirements for public offerings fall substantially short of international best practices and that there have been no public offerings, it seems that the sounder approach for Serbia, consistent with the EU requirements, is one set of prospectus requirements for public offering and admission, and the EU prescribed exemptions for nonpublic offerings.

Furthermore, the authors believe that Serbia should not be obligated to follow pass-porting provisions whereby it recognizes EU member states' securities actions as sufficient to permit offerings or admission to trading in Serbia of securities from issuers from these member states until Serbia is an EU member itself and has reciprocal privileges. For now, the draft proposes to include a set of provisions for such offerings that would not be limited to offerings from EU or OECD member countries as is the case with the 2006 Law provisions, but would retain the Commission's authority to review and approve these foreign offerings.

The issue of including EU requirements for investor compensation schemes, that is when a broker-dealer company fails, is something that might be debated further. The draft does not include these provisions with the rationale that, under current economic conditions, this would place an additional cost burden on broker-dealers and authorized banks who are already suffering. More importantly, the number of persons with brokerage accounts in Serbia is so small that unlike bank deposits and the need for deposit insurance, there appears to be little systemic risk regarding brokerage company failures.

With respect to the concept of systemic internalizers and a few other EU definitions, drafters believe these are unnecessary at present, and may be dealt with in secondary legislation when and if the activities envisioned by such concepts and definitions arise in Serbia.

With respect to the timing or effectiveness of the EU provisions included in the draft law, drafters believe that it is best to include the foundation of EU legislation proposed in the draft law and to seek passage of the law as soon as possible. However, deferral of the effective date of some provisions may be appropriate.

Compliance with IOSCO Principles

By contrast, a more aggressive approach in the draft law is proposed with respect to implementation of the IOSCO Principles. The Commission has been a member of IOSCO since 2002. As a member, the Commission is obligated by IOSCO's By-Laws to use its best efforts to implement the IOSCO Principles. At present, Serbian securities law and the Commission's regulations fall substantially short of these Principles. There is really no justification for further delay in adopting more robust regulations required by the IOSCO Principles. This is particularly true in the case of international cooperation where an IOSCO resolution requires all members to use their best efforts to become signatories by 2010 to the IOSCO Multilateral Memorandum of Understanding, relating to information sharing and enforcement assistance.

Role of Securities Law in Protecting Investors

The draft clearly indicates that the role of securities regulation is to regulate *public offering* and *secondary trading* of financial instruments. The 2006 Law wrongly indicates that the role of securities regulation and regulator is to regulate the conditions and procedure of issuing securities. The correct role of a securities law is to address the disclosure requirements that should apply when securities are offered to the public and publicly traded, in order to ensure that investors are protected against fraud and other deceptive and manipulative practices. The provisions currently included in the Company Law and the 2006 Law that permit the Commission to approve essentially all issuances of securities are a serious mistake and should be deleted.

Public Company and Public Offering Redefined

One of the major problems with the 2006 Law are incorrect definitions. The draft Law uses definitions that are either taken verbatim from EU legislations or are in full compliance with them. For example, serious shortcomings in definitions of "public company" and "public offering" in the current law are corrected in line with EU Prospectus Directive. The 2006 Law seems to be based on the mistaken assumption that the only way a company may become a public company is through a successful public offering of its securities approved by the Commission. This is simply not true as there are a number of circumstances in which a company can become a public company without a prospectus for a public offering approved by the Commission.

There are three ways that an issuer of securities may be considered a "public company" under the draft law. A public company is an issuer: (a) that has successfully completed a public offering of securities approved by the Commission, (b) whose securities are admitted to trading on a securities market in the Republic, (c) an issuer with more than 100 holders of a class of its equity securities as of the end of its most recent financial year.

This definition does not prevent a public company with less than 100 shareholders from being admitted to public trading. However, if a public company were removed from public trading on the Belex and still had 100 or more shareholders, it would remain a public company subject to the draft law because 100 or more shareholders is a sufficient public shareholder interest to warrant application of the investor protection provisions of the securities law.

The draft Law also proposes changes in the definition of "public offering" from the 2006 Law. In the draft law, 'public offering of securities" is defined as a communication: (a) made in any form to 100 or more persons, excluding qualified investors, or (b) made by way of general solicitation or advertising, including electronic means, which presents sufficient information on the terms of an offer and the securities offered so as to enable an investor to decide to purchase or subscribe to these securities. This definition is also applicable to the placing of securities through financial intermediaries.

The public offering process is based upon the EU Prospectus Directive requirements. Among the key changes the draft law proposes are: primary and secondary offerings may be included in the same offering, the EU block building approach to creating a prospectus is adopted, the prospectus requires financial statements with an auditors' report, "preliminary notification" introduced to allow offers but not sales prior to the Commission's approval of the prospectus for publication, all notices and publications may be done electronically. Newspaper publications and announcements are allowed but not required.

The regulatory consequences of these changes are that no Commission approval would be required for most exempt transactions but it would be granted more authority in cases which have more important consequences for public investors such as rights offerings.

Regulated, Securities and OTC Markets

There are currently three definitions of a market in the draft law: (1) regulated market, the EU MiFID term; (2) securities market, which is intended to include licensed markets, such as the Belex, which meet many but possibly not all of the EU criteria to be a regulated market, and (3) "OTC market" which is defined as an informal market that is not required to have an operator and whose trading system is informational and does not commit buyers and sellers to binding trades; in other words trades are negotiated. These definitions differ from the definitions of "organized market" and OTC market" in the 2006 Law, which have serious conceptual flaws and have been discarded.

There is a problem in using the term "regulated market" only in line with MiFID and other EU Directives. The reason is that at best, only the top tier of equity trading on the Belex might be considered a regulated market component. All other shares, traded on the so called "unregulated" component of the Belex, can not fulfill requirements in terms of the information provided regarding these issuers or the transparency of securities transaction reporting in their shares. In order to address this problem, the draft law also defines "securities market" so that a securities market, such as the Belex, would continue to be licensed under the Law as a market operator.

As it will be discussed later, the principal EU requirement that appears to prevent the Belex from currently being considered a regulated market is the fact that at present Belex is not administering EU type disclosure and reporting requirements for the vast majority of the some 1,800+ issuers admitted to trading. It is not doing so now with respect to the more rudimentary requirements under the 2006 law.

The draft law defines an OTC market as a market that does not need to be licensed and does not need to have a licensed market operator and trading system that results in a binding contract and rules. The 2006 Law is premised on the mistaken assumptions that an OTC market has to be a market with a market operator and that all OTC markets or their market operators must be licensed. However, most countries have OTC markets, especially for debt securities, that are not organized, regulated or licensed markets with market operators. The EU Directives do not require that a country's OTC markets must be regulated markets while the IOSCO Principles do not require that all markets must be licensed by the regulator.

Essential Company Law Changes

It is critically important that proposed changes in the Company Law be coordinated with the draft securities law, especially if public offerings are to be possible. Amendments that are proposed clarify that a joint stock company deals directly with the Central Registry in registering its securities without Commission involvement so that the Commission is supposed to be a securities regulator, not a company registrar. It is also proposed that closed joint stock companies should not be subject to the draft law's public offering or public company reporting provisions because closed joint stock companies must have less than 100 shareholders and cannot make public offerings.

With respect to the conversion of closed joint stock companies to open joint stock companies, the Company Law should be amended to require only amendment of its Articles of Association for a closed joint stock company to convert to an open joint stock company. The Commission would not be involved in this process until such time as the converted open company proposed to make a public offering, seek admission to trading, or otherwise fell within the definition of a public company.

The proposed changes of the Company Law would also allow an open joint stock company to raise its minimum capital by public or *nonpublic offering*. The current requirement of a public offering restricts capital formation options and results in open companies becoming publicly owned prematurely, which is potentially damaging to investors. The fact that nonpublic offerings have been abused in the past may be addressed by inserting in the draft law, and ideally in the Company Law as well, a provision clarifying how investors and shareholders are to be counted.

Public Company Obligations

One of the greatest problems with the current Serbian securities regulation is that Serbian financial reporting practices at present are a disaster waiting to happen. Major changes are essential if we hope to have a well developed securities market in which investors will have confidence.

The draft law proposes public company obligations in line with the EU Transparency Directive, which applies to the securities of issuers admitted to trading on a regulated market.

The draft law requires much more timely annual audited and first six months unaudited financial statements, and require the auditors' report to accompany the annual audited financial statements, unlike the current practice of producing it as much as three months later. In this respect, the draft proposes April 30th, as a deadline for publishing annual audited financial statements and for semi-annual unaudited financial report 60 days after the end of the first six months.

Secondary Trading Changes

One of the objectives of the 2006 Law was to centralize all trading of equity securities on the Belex. Although it is reasonable to assume that Serbia does not require more than one licensed securities market, there are two important problems resulting from implementing the above objectives:

Problem No. 1 - Serbia has significantly fewer companies than expected, which are capable of being viable public companies with shares in which there is a significant trading interest and liquidity;

Problem No. 2 - A securities law that is overly prescriptive in attempting to dictate how secondary trading of securities must occur.

Both of these problems have resulted in a less than optimal environment for the development of Belex and for the harmonization of Serbia's capital market and regulations with EU requirements. The draft law proposes the following solutions.

Solving Problem No. 1. – Reduce the number of companies admitted to public trading - As already discussed, it is reasonable to assume that the number of public companies in Serbia that may eventually meet sound listing requirements and have securities in which there is a sufficient interest to permit continuous trading is 100-200 companies. Therefore, policy makers need to realize that it was not a good idea to attempt to force 1800 companies to be traded on the BSE. **The capital markets strategy that is recommend by the new draft law for Serbia going forward is to upgrade the stature of the Belex market by removing from admission to trading those companies in which there is no significant trading interest, and distancing it as much as possible from these companies by**

permitting whatever limited trading there is in such companies to take place OTC on an intermediated basis through licensed broker-dealer companies.

In fact, the number of companies admitted to public trading at Belex represent a serious obstacle in complying with EU disclosure and reporting requirements.

All of the exchanges listed in the table, with the exception of Poland, the most successful one by far, are from countries that went through, and in some cases are continuing, mass privatization that has involved many thousands of formerly state owned enterprises with shares having been distributed at no or low cost to thousands of workers and other citizens. The result in each of these countries was that many companies with many shareholders were privatized and made available for securities trading. The consequence also was that many of these companies never traded, many others had only limited trading, and that the companies that fell within these categories were companies who by virtue of financial size, poor management, results of operations and competitiveness were simply not suited to be publicly traded companies. They generated no interest from public investors.

Exchange	Equity Issuers
Bratislava	Main market: 27; Parallel market: 110; Regulated Free market: 190
Bucharest	Three listed tiers: 69; Unlisted shares: 31
Budapest	A List: 21; B List 22
Bulgaria	Official market: 22; Unofficial market: 315
Ljubljana	Total issuers: 86; of which 7 on prime market
Prague	Main market: 17; Free market: 11
Warsaw	Main market: 310; Parallel market: 38
Zagreb	Total issuers: 376

These exchanges are also of interest because all of them except Zagreb are from countries that are EU members, and Croatia is moving expeditiously to qualify for EU membership. All of these EU country stock exchanges have realized that, in order to certify themselves as regulated markets under the requirements of MiFID and other EU legislation, they need to limit the number of companies admitted to trading to those public companies that are willing to comply with EU disclosure and reporting obligations per the EU Transparency Directive, that the exchanges as well as the regulator have a responsibility to administer and enforce these requirements and the companies that should continue to be traded on their separate unlisted, parallel or unofficial market tiers should be limited to companies that actually have the potential to become viable public companies.

Finally, each of these exchanges is in a country that is more economically developed than Serbia in terms of measures such as GDP per capita. Although some of these countries are smaller in population, logically all of them should have more companies that are viable publicly traded companies.

Four of the exchanges, all from EU member countries (Romania, Hungary, Slovenia and the Czech Republic) do not have more than 100 issuers of shares admitted to trading regardless of how one subdivides the trading tiers on the market. No matter how the issuers are divided, there is no exchange in this list with more than 500 issuers of equity securities admitted to trading.

By contrast, over 1,800 issuers of shares that are admitted to trading on Belex represent a major problem in terms of Belex being considered an EU regulated market and the ability to implement provisions of the draft law regarding public company obligations. Especially, the MiFID Directive clearly requires that for a regulated market to be considered to be operating a fair, orderly, and efficient market, the regulated market must maintain effective arrangements to verify that issuers of securities admitted to trading comply with their legal obligations regarding initial, ongoing and ad hoc disclosure requirements. This is simply not being done now by either Belex or the Commission, even with respect to the most rudimentary form of disclosure and reporting requirements, and there is no way it can be done for 1800+ issuers with respect to the more robust requirements under the draft law.

Therefore, the obvious solution is to remove most of these companies from Belex. This would not be for the purpose of trading the shares of these companies on a different OTC market. If the shares are not trading now, there is no reason to believe they will trade elsewhere. Removal would be with the reasonable expectation that that there would be no trading or only very limited trading in these shares. Essentially, this is what has been done in Romania and the other countries listed above.

There is another very important reason that the number of companies admitted to trading on Belex needs to be reduced. Serbia currently has approximately 35 auditing firms with approximately 200 individuals capable of performing audits. This may be one of the reasons why the Accounting and Auditing Law currently sanctions a highly questionable and risky practice of permitting companies to produce annual financial statements as late as June 30th, of the following year, and not requiring an audit report on such financial statements until September 30th.

These deadlines and the separation of the audit report from the annual financial statements are in serious conflict with IOSCO Principles relating to disclosure and financial reporting, as well as the EU Transparency Directive, which requires that annual financial statements and auditors' report be publicly available no later than four months after the end of the financial year reported upon. There is no way to do this with over 1800 companies. There is a way to meet these goals for 100-200 companies, which is what many of the other exchanges are working with and which is likely to be the maximum number of Serbian companies in which public investors will ever have serious interest.

Solving Problem No. 2. – Allow trade of securities outside Belex – In solving this problem it is important to recognize that one of the fundamental rights of citizens of any country is the right to own property, including securities, and that one of the most fundamental rights of ownership is the right to alienate or transfer property. Securities markets are intended to help persons purchase and sell securities. They are not intended to introduce unnecessary regulations that infringe upon the property rights of persons who wish to do so. Unfortunately, the 2006 Law includes several provisions that ignore and frustrate the above objectives.

Specifically, the concept that trading in securities on the Belex should require a public offer is fallacious and is not required to facilitate the current order-match auction trading system. There are circumstances in many securities markets, including markets organized on order-driven, auction principles, whereby block trades and cross trades are negotiated privately without public offer and merely executed on or reported to the market. And of course, there is the question on an illiquid market such as Serbia's, what does an investor do to sell his shares if he tries through his broker to place a public offer to sell on the Belex and no one has placed a public offer to buy? Should the investor be prevented from selling his shares by other means?

The draft law is based on the assumption that it is not the role of government to prescribe how markets trade; it is only the role of government to ensure that markets are fair and orderly and investors are not manipulated or deceived. Therefore, the draft law introduces EU requirements and IOSCO Principles in regulating secondary trading of securities. These require the law to allow for market competition. Drafters believe that Belex should continue to operate a second market tier for a much smaller number of public companies, preferably less than 500 and provide a trading venue for corporate and municipal debt that meets issuer and investor needs.

However, the draft Law must allow for the possibility of alternative markets arising. Extension of the draft Law to OTC markets is necessary to regulate the government securities market that already exist and other OTC markets that may arise. It is also possible and desirable in an illiquid market to have a well functioning auction market with price transparency that also allows for price negotiation. The current provisions of the 2006 Law which require all secondary offers to be a public offer are a serious obstacle to doing so.

The draft Law proposes an exemption from the requirement for Belex trading of equity securities to address illiquidity conditions that currently prevail with respect to most share issues admitted to trading on Belex. The proposal was revised to address concerns about potential manipulation to achieve off-exchange trading and represents what is commonly referred to as an "agency cross" transaction. The revised rule allows one or more broker-dealers who are members of the securities market to negotiate a purchase or sale transaction for a security admitted to trading on the securities market, provided that before the transaction is completed, the broker-dealer company[ies] must immediately enter the proposed transaction in the trading system of the securities market, in order to permit one or more other, member broker-dealer companies to offer a price improvement for the entire transaction within the price parameters and the time period as specified in rules of the securities market. If such price improvement is not offered within the specified time periods and parameters, the proposed transaction should be permitted and immediately reported on the securities market's transaction reporting system.

Role of the Securities Commission

One of the main objectives of the draft Law is also to provide the Securities Commission with adequate supervision and enforcement powers that are called for in EU legislation and IOSCO Guidance and redirect its focus to those regulatory activities that are the most important to achieving investor protection and fair and orderly trading of securities.

By removing oversight by the Ministry of Finance, the Commission is made a truly independent agency consistent with IOSCO Principles. It is important to emphasize that while the IOSCO Principles do advocate independence, they also advocate that the regulator must be transparent and accountable in all of its actions. This is addressed by indicating that the Commission is self-funded with fees published in a tariff book exposed to a public comment process and all Commission's decisions have to be made public.

The draft Law also proposes to add to the competencies of the Commission the authority to license, regulate and supervise credit rating agencies and the authority to administer the provisions of the new Law on Anti-Money Laundering and Financing of Terrorism as it relates to persons subject to Commission supervisions.

Furthermore, the draft proposes improved enforcement powers for the Commission and calls for taking into consideration the particular areas of risk associated with different market participants in inspections.

Is it too early for EU compliant securities regulation?

EU Directives are not just for developed economies. In fact, there are already eight formerly socialist countries with historical market development and transition experience similar to that of Serbia, which have successfully become members of the EU. There are some other EU member countries whose markets are not really developed markets. There are also other countries, former Yugoslav Republics, who are now likely to become EU members ahead of Serbia. Croatia, for example, has adopted a comprehensive Capital Markets Law that became effective on January 1st, 2009 and complies fully with EU capital markets directives.

Polls continue to show that a significant majority of Serbian citizens favor entry into the EU. It also seems that many market participants support a law compliant with EU Directives. The fact that Serbia's capital market lost a decade of progress in the 1990s while other countries were transitioning to market economies is not a sound argument for delaying the adoption of EU-compliant securities legislation. It is an argument for accelerating the process. Otherwise, the market development gap with other countries will widen.

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