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OF ECONOMIC TRENDS AND POLICIES IN SERBIA

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

SPOTLIGHT ON

Spotlight on: 1

Lazar Šestović, Marina Wes

The authors provide an analysis of Serbia's economic
growth over the past ten years of transition.
Growth was in this period based on foreign capital
inflows, which dried up due to the crisis and made
this model unsustainable. A new growth model is
therefore needed – one based on competitiveness
– which also requires certain structural reforms.

Spotlight on: 2

Duško Vasiljević

This article argues that Serbia's economic growth
over the past several years was unbalanced
and relied on only some non-tradable sectors.
Emphasis therefore needs to be shifted to the
tradable sector of the economy, and conditions
need to be created for a more robust increase in
productivity of companies from this sector.

Spotlight on: 3

Bogdan Lissovolik

The article analyzes medium-term challenges
facing economic policymakers in Serbia. By
comparing the situation in other economies in
transition and EU member states, and taking
into account factors specific to the Serbian
economy, the author arrives at recommendations
for pursuing an optimal fiscal policy course.

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

The short-term outlook is essentially clear: inflation is slowing down, the exchange rate will likely remain more or less stable – although gradual depreciation would be welcome – while the economy will see a mild recovery. All this notwithstanding, Serbia's economy will in 2010 remain below 2008 production levels, and it is also utterly unclear whether the badly needed growth of output and employment will ensue thereafter. This issue of the *Quarterly Monitor*, in addition to the usual monitoring of current economic trends, devotes special attention to the medium-term outlook, as well as to the issue of which reforms are needed to make Serbia again achieve high growth – this time on a healthy foundation (see *Spotlight on* and *Highlights* in this issue).

European economies in transition, including Serbia, will see slower medium-term growth after the crisis than before it. International Monetary Fund forecasts of the potential medium-term growth rate although rough are nonetheless indicative: Serbia and Bulgaria are expected to record a drop in the growth rate of over 2 percentage points; Croatia is to see a drop of slightly under 1 percentage point, etc. This means that Serbia, which had recorded pre-crisis growth of up to 6% per year, might see medium-term growth of just some 3.5% after the crisis; this is unacceptable when one takes into account high unemployment and low wages.

What are the main reasons behind the deceleration in future growth rates, and what can be done to make the slowdown less pronounced? The first reason, analyses show, is the expected lower inflows of capital into European economies in transition in relation to the pre-crisis period. The second reason is related to high government deficits that have been piling up since the start of the crisis and that could now lead to substantial public debt. Both reasons are of exceptional importance for the economic recovery of Serbia.

A major positive result of European integration is the firm financial linking not only of European Union member states, but also of potential future members and neighbors. A consequence of this is the economically rational flow of capital "downhill", i.e. from developed, "old" Europe to Europe in transition. Serbia has since 2000 seen its fair share of this process. A positive

development has been the fact that Europe in transition has, using savings from the developed part of the continent, begun to catch up, seeing significantly quicker growth than Europe's developed nations. The point is that this economically rational flow of capital is a phenomenon absent from other regions of the world; capital has mainly flowed in the other direction, for instance from China to the United States. Serbia's European orientation is therefore also fundamental when it comes to its future economic growth.

A comparative analysis of capital inflows into Serbia shows, however, that these have been substantially above the average for Europe in transition, i.e. above the level suggested by values of appropriate indicators in Serbia (per capita income, degree of financial integration, etc). Serbia is in this respect similar to most Balkan and Baltic nations. The message is clear: these above-average capital inflows, both into Serbia and into other countries mentioned, will not be seen again after the crisis. In addition, average "downhill" capital flows in Europe will in all likelihood come down, as risks have increased and higher yields will be a precondition for investment.

The above, of course, relates to general trends, while each country will manoeuvre to achieve as good a position as it can within them. Therefore it is crucial that Serbia should speed up its integration into Europe and thereby secure the necessary inflows of foreign savings – loans and investment – that could make it achieve acceptable economic growth. Equally important are reforms at home, which at any rate mostly overlap with Serbia's European integration aims, and which should provide an economic environment that stimulates production – this time of tradable goods (both destined for export and as competition to imports). Possible measures are exhaustively presented in *Spotlight on: 1* and *2*, as well as in *Highlights 3*, which, however, deals with a subject that is narrower in scope but none the less important: to what extent does new legislation on planning and construction remove substantial obstacles (e.g. obtaining construction permits) to greater investment, both foreign and domestic, in Serbia.

Serbia has taken up one opportunity on its road to achieving closer ties with Europe – financial integration

and resulting capital inflows. However, it has completely missed another chance, that of greater integration into the European Union when it comes to production. The result of this failure is Serbia's enormous pre-crisis trade deficit of over 20% of GDP; this could not be financed any longer after the crisis hit, nor will it be financeable in the future. On the other hand, new EU member states in Central Europe are fully integrated and have been seeing foreign trade surpluses. This is a situation Serbia should strive for. It implies a shift in the structure of the economy – two-thirds of economic growth since 2000 came from growth in commerce, banking and telecommunications (see *Spotlight on: 2*), sectors that worked for the domestic market ("non-tradable sectors"). Future growth, if it is to be sustainable, must be generated by tradable sectors – production for export and to provide competition to imports at home. This requires the creation of a favorable environment, or, rather, the implementation of reforms – generally the same ones as are aimed at attracting foreign capital (see *Spotlight on: 1* and *2*).

The exchange rate of the dinar is also an important factor in shifting production towards tradable goods and services. An overvalued currency, given lower capital inflows expected after the crisis, could lead to a long period of very low production growth or even stagnation. It would be a long wait for productivity to adjust the value of the domestic currency to economic strength and thus spur higher growth. Alternatively, if the overvalued exchange rate is not altered, a possible solution is what is now being attempted by the Baltic nations – shrinking absolute wages (by up to 20%) and prices through deep recession. Still, a controlled decrease in the real value of the dinar is the least painful solution: it would not mean instability of the currency, but rather only its reduction to a level that is sustainable and therefore stable.
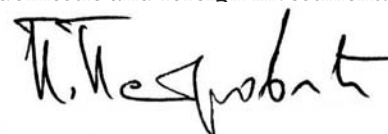
Significant fiscal deficits during and immediately after the crisis, and the resulting high public debt, are another serious impediment to possible future economic growth in Europe's economies in transition. Serbia will see a high fiscal deficit, of some 4% of GDP, both this year and in 2010, even with the severe freezing of wages and pensions. In the future, additional reductions in public spending should be made, along with changes to the structure of such spending – where the share of public investments and interest payments should rise, while the share of current spending (primarily wages and pensions) should decrease. On the other hand, 2011 will be both an election year and the year when the Stand-by arrangement with the IMF expires, meaning that the complete opposite is possible – rising wages,

pensions and spending in general. Medium-term forecasts of public revenues and expenditures without substantial adjustment indicate that Serbia would record very high budget deficits (see *Spotlight on: 3*). Such an untenable fiscal position would brand Serbia as a high-risk country, both with respect to a possible flare-up of inflation and with regard to its ability to repay its debts. Macroeconomic instability is a devastating environment for investment, both domestic and foreign, and has a tangible impact on the reduction of the potential medium-term economic growth rate. High country risk has especially been known to deter foreign investors and creditors, thereby substantially cutting capital inflows that will drop off after the crisis even without this.

To prevent this development and ensure sustainability of public finances, firm political agreement is required on necessary public spending reforms in the medium-term, as well as an attendant agreement on public revenues and expenditures, both overall and by key elements, over a period of several years. As this has so far been unsuccessfully attempted in the Budget Memorandum, the introduction of tighter, legal limitations should be considered to ensure that the agreed-on medium-term fiscal policy framework is adhered to. Fundamentally, this would mean that legislation is brought to introduce fiscal rules in Serbia, which has generally proven successful in a number of countries faced with the necessity of making substantial cuts to public spending and deficits (see *Highlights 1*).

All three articles in *Spotlight on* provide a thorough analysis, each one from a specific perspective and a medium-term viewpoint, of how Serbia's economy has come to be in the state it is in – as well as what lies ahead of us and what we can do: *Spotlight on: 1*, Šestović, L., Wes, M., "Ten Years of Transition: The Serbian Growth Experience - What's Next?", *Spotlight on: 2*, Vasiljević, D., "Serbia's Economic Growth and International Competitiveness ", and *Spotlight on: 3*, Lissovolik, B., "Serbia's Current Challenges in a Cross-Country Perspective".

Highlights 1 and *2* treat important areas of public finance. *Highlights 1* (Arsić, M.) analyzes the draft budget for 2010 and also indicates challenges to come beyond 2010, as well as possible directions of taxation reform, while *Highlights 2* (Arandarenko, M.) covers directions that can be taken in taxing labor. *Highlights 3* (Vasiljević, D.) analyzes the new Planning and Construction Law, on the implementation of which hinges, to a great extent, the inflow of both domestic and foreign investment.

TRENDS

1. Review

Although Q3 saw several substantial changes to Serbia's macroeconomic landscape, the general framework remains unaltered. The trends in evidence in Q3 have generally borne out our expectations aired in previous issues of *QM*. Economic activity is on the upturn, which, however, still does not indicate that 2008 activity levelswill be reached any time soon. The labor market has seen an additional downturn in the total number of people employed, with significant variations depending on the type of employment. Inflation and the current account deficit remained completely stable, while fiscal flows were probably the only surprise in Q3 – these were much more favorable than expected, or even than indicated by forecasts on which the agreement with the IMF was based.

The drop in **economic activity** seen in Q3 was substantially lower in relation to the first half of the year – we estimate the y-o-y real drop in GDP and non-agricultural GVA in Q3 at about 2.1%. The significant increase in economic activity in Q3 relative to Q2 was mainly caused by temporary factors, such as the start of full capacity operation at US Steel Serbia; nonetheless, recovery – albeit substantially less marked – would have in all likelihood begun even without their impact.

Domestic demand was lower by nearly 8% in real terms in relation to the same period one year previously, while export demand slumped by some 20%. Due to its far greater share in relation to export demand, domestic demand made the greatest contribution to the y-o-y fall in overall demand and, consequently, GDP. An encouraging fact is that the trend of major falls in aggregate demand in relation to production has been reversed in Q3. We take this as the definitive confirmation of the fact that effects on businesses of the main driver of the crisis – falling demand – have been exhausted and that businesses can now see recovery, of course starting from a much lower level than before the crisis.

As opposed to economic activity, the labor market has yet to experience all effects of the crisis. The number of people employed underwent a substantial reduction in Q3 in relation to Q2. Also of interest are results obtained by comparing movements of economic activity and employment in Serbia (for more details, see Employment and Wages): analysis shows that the labor market as a whole is undergoing robust adaptation to the crisis environment, with employment falling more than GDP. This means that Serbia has recently been exhibiting very high employment elasticity, of over 1.

The low **current account deficit** in Q3, of 3.4% of GDP, is a consequence of the improving foreign trade balance and high remittance inflows – twice as high in Q3 than pre-crisis averages. The trade deficit stood at 13.5% of GDP in Q3, some 10 percentage points lower than in the run-up to the crisis. Although fundamentally positive, the drop in the trade deficit was nonetheless caused by the impact of undesirable factors on the economy – namely, a reduction in domestic demand and production – and a drop in imports, rather than by a rise in exports.

According to seasonally-adjusted data, imports less energy were 8% down in Q3 on values seen over the preceding quarter, meaning that domestic import demand was still on the downward slope. However, according to the same data, the rate of quarterly decline in the value of imports in relation to Q2 was substantially lower than that seen over the preceding two quarters, which could indicate an end to the trend of falling imports in line with previously voiced estimates of movements in overall domestic demand. Preliminary imports figures for October indicate just such a stabilization, or even a mild recovery in the value of imports in relation to Q3. Seasonally-adjusted exports data indicate that Q3 has not seen any major changes in the exports of goods in relation to Q2 exports (the figure was some 3% lower in relation to Q2). Seasonally-adjusted exports, however, showed pronounced growth in October, probably linked with an increase in production at US Steel Serbia.

Inflation was completely curbed in Q3, with this trend continuing into October and November. If there are no major changes to administratively-controlled prices or a substantial increase in the price of oil, we can expect overall inflation (as measured using the Consumer Price Index, or CPI) to stand at between 7.0 and 7.5 percent. This would mean that inflation over the second half of 2009 was very close to zero, as it had reached levels of 7%, or about 14% when annualized, in the first half of the year. Although data on overall inflation movements indicate otherwise, Q3 has after all not seen a reversal. High inflation over the first two quarters of 2009 was mainly the consequence of rising regulated prices, while market inflation was very low even at that point. The third quarter continued seeing a mild slowdown of market inflation, but the great-

est part of the recorded slowdown in overall inflation was merely the consequence of the uncovering of the actual inflation trend, since Q3 did not see any significant administrative price increases. The latest Retail Price Index (RPI) data for November (1% growth relative to October) would at first sight seem to belie the curbed inflation hypothesis. However, the overall increase was only the consequence of rising prices of agricultural produce and oil, which means that underlying inflation remains low – and may have slowed further in November.

Overall inflation, which will at year-end probably stand close to the lower edge of the NBS target band (of between 6 and 10 percent), as well as the slowdown in underlying inflation, may make room for corrections to some administratively-controlled prices to be made even in 2009. If the planned increases (in the prices of electricity and some utilities) are moved to late 2009, instead of taking place next year, inflation would stand at 8.5% at year-end, still very close to the NBS target band for 2009. This would not jeopardize inflation targets in 2009, and would make more room for relaxation of monetary policy in 2010. In an environment of fragile economic recovery, which we will probably face next year, more room for accommodation by monetary policy could prove very useful.

Gradual relaxation of **monetary policy** continued in Q3. Several consecutive cuts brought the reference interest rate down to 10%, as much as 7.5 percentage points lower in relation to levels seen at the beginning of the year. However, in spite of the trend of cautious lowering of the reference interest rate, the repo stock continued growing, and has now already reached a value of nearly €2 bn. In addition to cutting the reference interest rate, the NBS decided to reduce the dinar portion of the reserve requirement in an attempt to boost dinar liquidity. If we consider movements in the repo stock, treasury securities and the accretion of loans to businesses and households, it becomes apparent that effects of this measure have thus far had the greatest impact on the rise in the repo stock and investment in government securities, rather than on the desired growth of loans to businesses.

Nonetheless, Q3 has for the first time since the beginning of the crisis recorded some indication of a mild recovery in loans to businesses and households – unlike in Q2, the total accretion of credits to businesses and households entered positive territory in Q3. If we exclude repayment of foreign debt to the tune of €244 mn, total accretion of loans to businesses and households by the domestic banking sector amounted to €315 mn, of which most went to businesses in subsidized credits. Loans to businesses, although slightly greater in volume in Q3 in relation to Q2, are still below levels seen at the start of the year, when the crisis was already having a substantial impact on credit activity.

The reason why banks have chosen to invest in safe government instruments (repo operations and Ministry of Finance securities) rather than in businesses can be found in the high share of bad loans in total loans, amounting to 11.3% at the end of Q3 and 11% at the end of October. The percentage of bad loans has declined slightly in relation to Q2, when it stood at 12.1%, but remains substantially above the usual pre-crisis level. Stress tests have shown that economic activity has dominant influence on the amount of net risky assets, which could serve as yet another argument in favor of continued relaxation of monetary policy to boost economic growth.

Fiscal flows were much more favorable in Q3 than over the first half of the year. Tax revenues saw seasonally-adjusted growth of five percent in Q3 in relation to Q2, while public expenditure recorded a seasonally-adjusted fall of 1.3% in relation to the preceding quarter. The consolidated deficit underwent a major reduction in Q3 under the influence of these trends. The deficit recorded in Q3 amounted to 2.9% of quarterly GDP, while overall consolidated government sector deficit seen over the first three quarters of 2009 amounted to some 3.5% of GDP. Data indicate that movements in public revenues in October and November were similar to those seen in Q3, which is why we can expect the consolidated government sector deficit to amount to between 100 and 110 billion dinars in 2009 (3.3 to 3.7 percent of GDP), much lower than had been expected (135 billion dinars, or 4.5% of GDP).

A positive indicator is the fact that real Q3 growth in public revenue was relatively widely dispersed, involving VAT, individual income tax and excise duties. Our belief is that the rise in public revenues was mainly the consequence of the start of a recovery of economic activity, while restrictive fiscal policy measures brought down the real level of public expenditure. The structure of public expenditures, however, continued to deteriorate in Q3. The real level of capital expenditures, as well as expenditures on goods and services, fell substantially in relation to the preceding quarter, while real growth in Q3 relative to Q2 was recorded by expenditures on subsidies and pensions. However, a gradual deceleration of the y-o-y growth rate of budget transfers for pension payments has been in evidence recently, which indicates that the freezing of pensions in 2009 is slowly neutralizing the effects of their excessive growth over the past year.

Public debt is a subject we have devoted a great deal attention to in this and previous issues of *QM*. Although Serbia is a moderately-indebted country as measured by share of public debt in GDP, which amounted to

32% at the end of Q3, we must reiterate that the share of public debt in GDP is now higher by over 25% (6.4% of GDP) in relation to end-2008. The latest data on fiscal developments (indicating a reduction in the deficit) are encouraging with respect to future movements in public debt, but the announced and agreed-upon borrowing by the government with international institutions and foreign bodies and organizations requires careful monitoring. To this should also be added any liabilities Serbia will incur with respect to denationalizing property.

When **financial markets** are considered, it is seen that Q3 recorded a drop in activity on the Belgrade Stock Exchange as measured by the value of trading, while the volume of trading remained at approximately the same level. The drop in activity occurred primarily in the discontinuous market segment, while the continuous segment even saw a rise in the total value of trading. Although the value of Belgrade Stock Exchange indices continued to rise in Q3, the start of Q4 again saw them fall.

Serbia: Selected Macroeconomic Indicators, 2004-2009

	Annual Data					Quarterly Data						
						2008				2009		
	2004	2005	2006	2007	2008	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Prices and the Exchange Rate						y-o-y[2]						
Consumer Price Index	10.1	16.5	12.7	6.8	10.9	11.3	12.0	10.7	8.9	9.8	10.1	7.9
Retail Price Index	7.9	14.8	10.3	3.9	9.0	6.4	9.1	10.2	10.5	11.3	9.9	9.4
Real fx dinar/euro (avg. 2005=100)[3]	100.5	100.0	92.1	83.9	79.7	82.5	79.7	75.0	81.7	86.0	84.3	82.6
Nominal fx dinar/euro (period average)[3]	72.62	82.92	84.19	79.97	81.46	82.65	81.07	77.12	85.02	93.71	94.17	93.24
Economic Growth						y-o-y, real growth[2]						
GDP (in billions of dinars)	1,384	1,687	1,980	2,363	2,791	..	..	..	..	..	..	..
GDP	8.2	5.6	5.2	6.9	5.4	8.5	6.0	4.9	2.8	-4.2	-4.0	-2.1
Non-agricultural GVA	6.6	6.8	7.5	8.7	5.4	8.3	6.3	5.0	2.5	-3.8	-3.5	-2.1
Industrial production	7.1	0.8	4.7	3.7	1.1	6.0	2.3	1.0	-5.0	-17.0	-17.8	-10.6
Manufacturing	9.7	-0.7	5.3	4.2	0.7	4.4	3.7	0.4	-6.0	-22.6	-21.6	-14.6
Average net wage (per month, in dinars)[4]	14,108	17,478	21,745	27,785	29,174	26,814	28,846	29,435	31,599	30,120	31,808	31,737
Registered Employment (in millions)	2.047	2.056	2.028	1.998	1.997	1.995	2.002	1.998	1.993	1.981	1.850	1.835
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	-13.4	-4.2
Public Expenditures	40.0	39.7	42.7	42.8	43.7	3.8	21.7	-0.4	-3.5	-3.4	-6.0	-0.3
						in billions of dinars						
Overall fiscal balance (GFS definition)[5]	17.5	14.8	-33.5	-58.2	-68.9	8.0	-19.6	-5.9	-51.3	-11.7	-44.3	-21.4
Balance of Payments						in millions of euros, flows[2]						
Imports of goods	-8,302	-8,286	-10,093	-12,858	-15,057	-3,479	-3,953	-4,008	-3,617	-2,596	-2,601	-2,636
Exports of goods	2,991	4,006	5,111	6,444	7,428	1,672	1,972	2,061	1,723	1,291	1,535	1,549
Current account[6]	-2,197	-1,805	-3,137	-4,994	-5,873	-1,279	-1,780	-1,524	-1,290	-818	-162	-273
in % GDP[6]	-11.6	-8.6	-12.9	-17.2	-17.4	-17.1	-20.8	-16.7	-15.0	-11.6	-2.1	-3.4
Capital account[6]	2,377	3,863	7,635	6,126	6,060	1,385	1,769	1,430	1,476	806	234	302
Foreign direct investments	773	1,248	4,348	1,942	1,830	831	656	133	210	643	251	113
NBS gross reserves (increase +)	349	1,675	4,240	941	-1,755	32	-309	257	-1,736	-240	880	716
Monetary data						in millions of dinars, e.o.p. stock[2]						
NBS net own reserves[7]	103,158	175,288	302,783	400,195	475,110	420,508	417,579	440,936	475,110	502,606	489,062	528,439
NBS net own reserves[7], in mn of euros	1,291	2,050	3,833	5,051	5,362	5,109	5,287	5,757	5,362	5,303	5,234	5,681
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	1,218,702	1,245,735
FX deposits of households	110,713	190,136	260,661	381,687	413,766	410,836	419,824	431,261	413,766	450,852	461,401	482,827
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	2.1	0.9
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	16,4	11,8
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	45.8	44.5
Financial Markets												
BELEXline (in index points)[8]	1,161	1,954	2,658	3,831	1,198	3,068	3,092	1,942	1,198	844	1,173	1,548
Turnover on BSE (in mil. euros)[9]	423.7	498.8	1,166.4	2,004.4	884.0	210.8	365.7	176.9	130.6	61.2	72.6	55.8

Source: FREN.
1) For more details (monthly series) see www.fren.org.rs.
2) Unless noted otherwise.
3) Calculation based on twelve-month averages for annual data and three-month averages for quarterly data.
4) 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.
5) Overall fiscal balance (GFS 2001 methodology) - Consolidated fiscal surplus/deficit adjusted for "budgetary loans" (lending minus repayment according to old GFS methodology).
6) 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.
7) NBS net own reserves = NBS fx reserves, net - (foreign deposits of commercial banks + government foreign deposits). For details see Monetary Flows and Policy.
8) Index value at the last day of the given period.
9) 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.

2. Economic Activity

The decline in economic activity was much lower in Q3 than in the first half of the year. *QM* **estimates that the GDP and non-agricultural GVA fell around 2.1% y-o-y in Q3. This issue of** *QM* **will endeavor to answer the following question: Did the strong recovery of Serbia's economy begin in Q3? While statistical data suggest that production is reviving much faster than it really is,** *QM***'s analysis demonstrates that the increase in economic activity in Q3 over Q2 is mostly due to the influence of temporary factors, but that recovery, albeit somewhat milder, would probably have begun even without them. Domestic demand was around 8% lower in Q3 y-o-y and contributed the most to the annual decline in total demand and, thus, to the drop in GDP. Unit labor costs – measured both in dinars and in euros - have been falling, which indicates that the labor market is still adjusting to lesser economic activity by cutting real wages and laying off workers. Notwithstanding the y-o-y 10.7% drop, industrial output is much higher than in the first half of the year, while construction activity stagnated near the Q2 level.**

Gross Domestic Product

Fall in economic activity in Q3 estimated at around 2.1%…

According to *QM*'s preliminary estimate,[1] based on available data on economic activity, the y-o-y decline of the GDP in real terms stood at around 2.1% in Q3 (Table T2-1). The non-agricultural GVA, considered a more reliable measure of economic activity, recorded an identical drop y-o-y like the GDP (2.1%).

…which is a much better result compared with Q2

The y-o-y decline in the GDP in Q3 was around two percentage points lower than the fall recorded in Q2. Seasonally adjusted indices also suggest considerably higher economic activity in Q3 than in Q2. Seasonally adjusted GDP growth q/q stood at around 1.5% while seasonally adjusted non-agricultural GVA growth was around 1.2% q/q. Although none of this helped reach the 2008 production level, economic activity was on a quite steep upward trajectory in Q3. The pace at which economic activity accelerated in Q3 vis-à-vis Q2 may best be illustrated by seasonally adjusted annual GDP growth. The trend that began in Q3 corresponds to 5% annual GDP growth.

The analysis of economic activity in Q3 must take into account some other factors as well. This activity is now already compared with the somewhat lower base in Q3 2008 when the crisis began to be felt in the real sector as well, and this is why the year-on-year decline in production is lesser. Some exogenous factors, such as the temporary restart of all *US Steel Serbia* capacities, also significantly contributed to higher economic activity in Q3. Therefore, statistical data are probably indicating that production is recovering more quickly than it really is.[2]

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1 The methodology used to estimate the GDP is based on the methodology of the Statistical Office of the Republic of Serbia (SORS). The real growth of gross value added of individual sectors of the economy is estimated by activity and the tax component is added to the sum of these estimates. Modifications of the SORS methodology are partly related to the indicators on the basis of which sectoral growth is estimated and which the QM authors consider to be more reliable indicators of real sectoral growth in specific cases (e.g. cement production in the construction industry). Also, given that QM authors have fewer indicators at their disposal than the SORS, their estimate also includes indirect indicators which are not a composite part of the official statistical methodology. QM authors also conduct deeper analyses of trends in individual sectors and a demand analysis.
2 One should not disregard the fact that the estimate that economic activity declined around 2.1% was arrived at by using SORS methodology, the weaknesses of which were discussed in Highlights 2 of Quarterly Monitor 17 and that the real decline in economy may be 2% higher. Official assessments of the movement of economic activity are nevertheless used in QM analyses.

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

					Y-o-y indices							Base index	GDP share
						2008				2009		(jan-sep)09/	
	2005	2006	2007	2008	Q1	Q2	Q3	Q4	Q1	Q2	Q3[2]	(jan-sep)02	2007
Total	105.6	105.2	106.9	105.4	108.5	106.0	104.9	102.8	95.8	96.0	97.9	135.9	100.0
Taxes minus subsidies	110.2	99.8	109.5	104.2	109.9	104.4	102.1	101.7	92.2	91.2	97.0	145.0	16.4
Value Added at basic prices	105.0	106.4	106.5	105.8	108.3	106.5	105.6	103.2	96.8	97.2	98.7	134.7	83.6
Non agricultural Value Added	106.8	107.5	108.7	105.4	108.3	106.3	105.0	102.5	96.2	96.5	97.9	139.0	88,2[3]
Agriculture	95.1	99.8	92.2	109.1	109.0	108.3	109.8	109.0	101.6	103.2	103.5	109.7	11,8[3]
Manufacturing	99.9	105.6	104.8	101.3	104.7	104.6	101.0	95.6	79.1	80.0	86.5	95.7	15,8[3]
Construction	102.0	107.7	110.8	101.7	104.8	105.7	99.8	96.6	86.2	83.9	86.0	126.8	3,6[3]
Transport, storage and communications	123.4	129.3	120.1	112.9	118.0	115.7	110.8	108.4	104.1	107.5	108.0	291.0	16,4[3]
Wholesale and retail trade	122.0	110.3	119.9	107.1	111.6	105.8	107.6	104.3	93.7	92.0	90.0	210.7	13,6[3]
Financial intermediation	111.9	112.2	115.6	110.2	114.3	110.1	108.9	108.3	106.1	105.9	106.0	177.5	4,6[3]
Other	102.1	100.6	101.5	103.1	104.6	102.8	103.2	102.1	100.9	101.1	101.6	112.8	34,1[3]

Source: SORS.
1) At constant prices in 2002
2) *QM* estimate.
3) Share in GVA.

Manufacturing industry contributed the most to lower GDP decline

Observed by activity (Table T2-1), the greatest y-o-y decline in Q3, like in the first half of the year, was recorded in the manufacturing industry and construction. The activity of these two sectors was around 14% lower in Q3 than in the same period last year. The y-o-y decline of the manufacturing industry was, however, 6.5% lower in Q3 than in Q2 and it actually contributed the most to the lower decline of the overall GDP in Q3 than in Q2. The y-o-y drop in wholesale and retail trade stood at around 10% in Q3, while the transport and telecommunications sector continued having a positive growth rate, estimated at around 8% in Q3.[3]

QM analyzed the *movement and breakdown* of demand given that the sustainability of economic growth depends the most on demand which initiates it. This will allow for distinguishing between two influences - the influence of exogenous factors and the influence of the supporting trend of the economy, which nonetheless has to be in accordance with the movement of demand - on economic activity in Q3.

No major changes in demand

Table T2-2 shows y-o-y growth of domestic and export demand. Total demand was around 10.6% lower in real terms in Q3 than in the same period last year. The negligible increase in demand in Q3 over Q2, however, does not constitute a significant change that could explain the sudden acceleration of economic activity (Graph T2-3). In real terms, domestic demand was around 8% and export demand around 20% lower y-o-y. The two chief aggregates confirming these findings at the macro level are: *exports* and *imports*, which do not indicate significant changes in Q3 over Q2 either.[4]

Table T2-2. Serbia: Growth of Aggregate Demand and Components, Contributions to Growth, 2005-2009

	2006	2007	2008	2008				2009		
				Q1	Q2	Q3	Q4	Q1	Q2	Q3
				Y-o-y indices						
GDP	105.2	106.9	105.4	108.5	106.0	104.9	102.8	95.8	96.0	97.9
Aggregate demand	109.3	110.3	107.7	109.9	112.0	107.6	101.3	93.0	87.8	89.4
Domestic demand	106.0	106.9	106.3	107.4	110.4	106.2	101.2	96.8	89.2	91.7
Export demand	125.1	125.6	113.3	120.4	118.2	113.2	101.6	78.4	81.8	79.8
				Contributions to Growth (Fall) of aggregate Demand (%)						
Domestic demand	46.7	55.0	67.9	60.3	69.7	64.4	77.1	36.4	70.6	62.1
Export demand	53.3	45.0	32.1	39.7	30.3	35.6	22.9	63.6	29.4	37.9

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

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3 The high growth of the transport and telecommunication sector can also be ascribed to the inadequate estimation methodology. More in Highlights 2. How Much Has Economic Activity Really Declined in 2009?, QM 17.
4 For more details, see Section 4, Balance of Payments and Foreign Trade in this issue of QM.

Due to its much higher share, domestic demand again accounted more than export demand for the decline in total demand in Q3. Domestic demand contributed 62% and export demand 38% to the y-o-y fall in aggregate demand (Table T2-2).

Slowdown in borrowing activity affecting economic decline in 2009 the most

Like in the previous two quarters, the great slowdown in corporate and household borrowing over the previous year contributed the most to the y-o-y decline in domestic demand in Q3.[5] The movement of foreign and domestic loans to households and businesses is given in Table T7-5 (Section 7 of this issue of *QM*). The Table shows that the quarterly growth of loans fell from the average level of around 1.5 billion euros to nearly zero (and was even negative in Q2). The greatest slowdown in borrowing activity occurred back in Q4 2008, when growth fell by 1.5 billion euros. The level of borrowing activity had continued falling until Q2, and Q3 witnessed first indications that loans to businesses and households were mildly recovering (Table T7-5, Section 7 of this issue of *QM*). The movement of economic activity followed a similar dynamic, indirectly demonstrating the role the standstill in borrowing activity has played in the fall in domestic demand and economic activity in 2009.

2009 witnessing strong adjustment of spending to production

Graph T2-3 shows the ratio between spending and production (domestic demand and GDP). Spending is still higher than output but its share in the GDP has been falling significantly. Spending was 13% greater than production in Q3 and was thus at its relatively lowest level since 2001. Spending has ordinarily exceeded production by 20% over the previous years, which has been the greatest structural problem of Serbia's economy. The strong adjustment of spending to production in 2009 arises from the much greater decline in domestic demand than in production and is accompanied by a major decrease of the current account deficit and inflationary slowdown.[6]

Graph T2-3 also shows that the year-long trend of strong decline in aggregate demand vis-à-vis production halted in Q3. The stabilization of the observed macroeconomic aggregates indicates that there are indeed conditions for the onset of a more lasting recovery of economic activity, although most of the economic growth achieved in Q3 vis-à-vis Q2 can be attributed with certainty solely to exogenous factors. Namely, demand would have continued declining vis-à-vis production even if only exogenous factors affected economic activity growth in Q3.

More expansive policies would be desirable

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

Aggregate demand[1]
Domestic demand
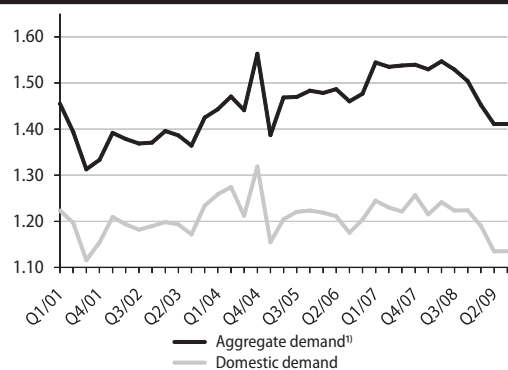
Source: *QM* based on SORS data.
1) aggregate demand = domestic demand + exports.

From the perspective of time, the very low ratio of domestic demand and production (Graph T2-3) indirectly suggests that a somewhat more expansive economic policy (monetary policy in particular) would be acceptable and would probably not result in macroeconomic instability.

ULCs are somewhat higher than usual...

Unit labor costs[7] (ULCs) measured in dinars were still somewhat higher than ordinarily in Q3. The trend of their quarterly decline continued (Graph T2-4). This ULC dynamic should not come as a surprise, given that employment as a rule reacts to changes in production with delay.

... but are slowly falling

The slightly higher than usual ULCs in Q3 indicate that the share of labor costs in achieved value added is still higher than usual and, consequently, that there are still pressures to cut wages and/or the number of workers. The evident trend of the decline in ULCs which began in Q1 (when they peaked) actually demonstrates that the labor market is adjusting to lesser economic activity considerably (slower wage growth and fall in employment) albeit with a delay.

5 For more details, see Section 7, Monetary Flows and Policy in this issue of QM.
6 For more details, see Section 5, Prices and the Exchange Rate, and Section 4, Balance of Payments and Foreign Trade, in this issue of QM.
7 Unit labor costs in dinars are calculated for the economy (excluding the agriculture and state sectors) and the industry.

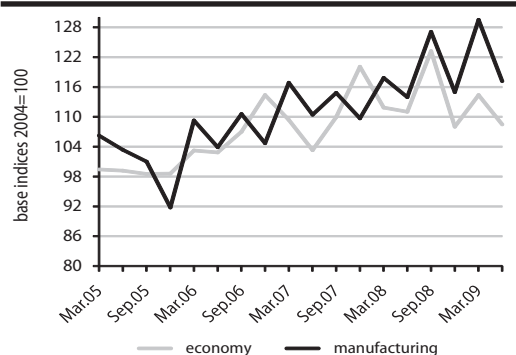**Graph T2-4. Serbia: Real Unit Labor Costs in Economy and Manufacturing Industry, 2005-2009**
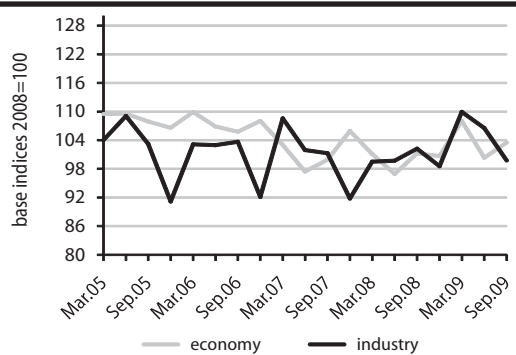
Source: *QM* based on SORS and NBS data.

Graph T2-5. Real Unit Labor Costs in Economy and Manufacturing Industry, 2005-2009

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

Competitiveness is probably improving

Unit labor costs measured in euros (euro-ULCs) indicate the international competitiveness of a national economy because they define the highest national cost component (labor costs) vis-à-vis value added. *QM* calculated the euro-ULCs in the manufacturing industry, which produces by far the greatest share of tradable products, and in the overall economy.[8]

Euro-ULCs are not an ideal measure of change in competitiveness where there has been an abrupt change in the level of economic activity (like in early 2009).[9] However, the euro-ULCs are expected to stabilize as most macroeconomic aggregates defining the euro-ULC stabilize in the latter half of 2009. *QM* will then be able to analyze how the crisis and the depreciation of the dinar affected the international competitiveness of Serbia's economy.

Table T2-5 shows the movement of euro-ULCs in the economy and manufacturing industry. The euro-ULCs underwent unusually great changes since the crisis escalated in the second half of 2008. On the one hand, the real depreciation of the dinar led to a decrease in euro-ULCs, while, on the other, lower economic activity, which was not accompanied by proportional wage and employment cuts, resulted in an increase in euro-ULCs. This instability in the movement of the euro-ULCs is the reason why *QM* will not be taking the euro-ULCs as a measure of competitiveness until the macro-environment in which they are observed is fully stabilized.

Industrial Production

Industrial production decline wanes significantly

Industrial production fell by 10.6% in Q3 over the same period last year (Table T2-6). Notwithstanding the deep year-on-year fall, industrial production actually strongly accelerated over Q2, when its y-o-y decline stood at as many as 17.8%.

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

	Y-o-y indices											Share
					2008				2009			2008
	2005	2006	2007	2008	Q1	Q2	Q3	Q4	Q1	Q2	Q3	
Total	100.8	104.7	103.7	101.1	106.0	102.3	101.3	94.9	83.0	82.2	89.4	100.0
Mining and quarrying	102.1	104.1	99.4	103.6	106.0	101.8	103.0	102.8	92.8	90.1	100.1	6.2
Manufacturing	99.3	105.3	104.2	100.7	104.4	103.7	100.7	94.1	77.4	78.4	85.4	75.5
Electricity, gas, and water supply	106.6	102.2	102.8	101.8	112.0	96.1	103.2	96.0	99.2	98.7	103.9	18.3

Source: SORS.

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8 Excluding the state and agriculture sectors.
9 For more details, see Section 2, Economic Activity, QM16.

Manufacturing industry contributing to recovery the most

Given its high share, the manufacturing industry affected overall industrial production the most. The y-o-y decline of industrial production in the manufacturing industry stood at 14.8% in Q3, much less than in Q2 (Table T2-6). The production and distribution of electricity, gas and water grew by 1.1% y-o-y in Q3, while mining and quarrying in Q3 was approximately at the same level as in Q3 2008.

Graph T2-7 shows the seasonally adjusted industrial production indices for the industry as a whole and the manufacturing industry. It shows a sharp fall in industrial production from mid-2008, very low and unstable levels of production in early 2009 and, finally, the beginning of strong recovery of industrial production in the past few months.

Graph T2-7. Serbia: Seasonally Adjusted Industrial Production Indices, 2008-2009
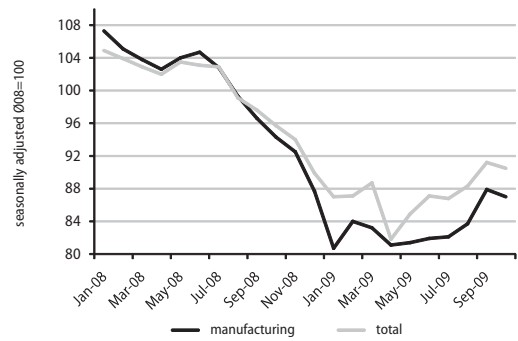
Source: *QM* based on SORS data.

Graph T2-8. Serbia: Year-on-Year Growth of Specific Manufacturing Industry Fields, 2008-2009
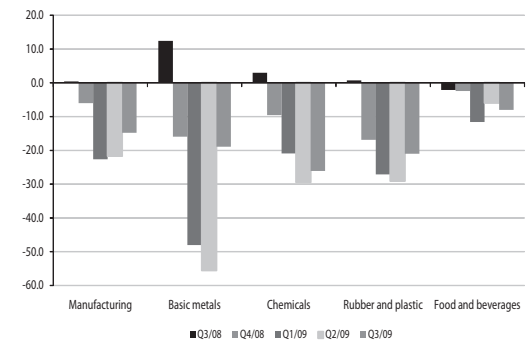
Source: SORS.

Production of basic metals contributed to the recovery of production the most

Graph T2-8 shows the year-on-year growth of specific fields with considerable shares in the manufacturing industry. The production of basic metals underwent the greatest change in Q3 over Q2, while other export-oriented fields suffered somewhat lesser y-o-y decline. The food industry stagnated at a production level which is between 5 and 10 percent lower than last year.

The production of basic metals recorded an 18.9% y-o-y decline in Q3, although it was half the 2008 level in the first six months of 2009. The breakdown of the production of basic metals by month shows that the y-o-y decline in this field of industrial production exceeded 40% in June but recorded positive y-o-y growth rates already in September. The reason for such turbulent dynamics lies in the temporary restart of production in the US Steel Serbia blast furnaces in July because of the international reorganization of production within US Steel. Namely, production in the US Steel facilities in Kosice (Slovakia) had to be temporarily suspended due to technical problems and the Smederevo plant restarted the blast furnaces until the Kosice capacities are re-launched. One blast furnace is expected to stop operating already in December, which will lead to another slowdown in industrial production. If the production of basic metals is excluded from the manufacturing industry, growth of the latter in Q3 over Q2 can be qualified as merely mild.

Food industry stagnating

The food industry, which has the greatest share in industrial production, declined 8% y-o-y in Q3, slightly more than in Q2 (6.7%). The fall in food production is still much smaller than the decline in the other observed fields (Graph T2-8), but what gives cause for concern is that there is no positive trend in the movement of this manufacturing industry field. Given that both the 2008 and 2009 agricultural seasons were successful and demand for food products did not fall as much as demand for other produces, *QM* is of the view that there is greater potential for the growth of the food industry than has been registered.

The plunge in export demand in 2009 affected the movement of other observed manufacturing industry fields the most. The somewhat milder fall in production in Q3 vis-à-vis the rest of 2009 may be very positive indication that export demand is recovering.

Table 2-9 shows a smaller decline of industrial production in nearly all industrial groupings in Q3 over Q2. The production of investment goods was the only grouping that in Q3 recorded a greater y-o-y drop in production over Q2. On the other hand, energy was the only grouping that grew y-o-y in Q3 - by 2%. Production of electricity, which grew solidly in 2009 due to the favorable effects of exogenous factors (hydrological conditions), accounts for a large share of this grouping.

Production of intermediate goods recovering

The production of intermediate goods underwent the greatest change in Q3 over Q2. The production of intermediate goods fell by 18.9% y-o-y in Q3 i.e. 15% less than in it dropped y-o-y in Q2. Although the restart of production in US Steel Serbia without doubt affected this recovery of production the most, the increase in production over Q2 is also evident when the production of basic metals is excluded from the intermediate goods grouping (Table T2-9). The production of consumer goods in Q3 recorded an 11.5% y-o-y drop in Q3. This decline is somewhat deeper if the food industry is excluded from the grouping (-17.1%).

Table T2-9. Serbia: Production of Industrial Products by Groupings, 2005-2009

	Y-o-y indices											Share[5]
					2008				2009			
	2005	2006	2007	2008	Q1	Q2	Q3	Q4	Q1	Q2	Q3	2008
Total	100.6	104.7	103.7	101.1	106.0	102.3	101.3	94.9	83.0	82.2	89.3	100.0
Energy[1]	103.9	102.5	101.2	101.5	110.2	98.2	102.4	96.4	98.3	96.5	102.0	26.6
Investment goods[2]	74.2	90.0	105.4	105.5	106.5	118.3	105.0	92.1	71.4	77.6	76.0	6.0
Intermediate goods[3]	104.9	106.7	104.9	100.0	106.0	106.8	99.7	87.2	65.1	66.0	81.1	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	73.4	81.1	22.6
Consumer goods[4]	101.6	112.0	107.1	97.9	99.4	97.5	100.0	101.8	85.1	83.4	88.5	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	66.5	82.9	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), machines and equipment (excluding electric), office machinery and computers, radio, TV and communication equipment, precision and optical instruments, motor vehicles and trailers, other transport equipment.
3) Mining of metal and non-metal ores, stone quarrying. Manufacture of textile yarns and fabric, wood and pulp products (except furniture), cellulose, paper and paper products, rubber and plastic products, chemical products (except pharmaceuticals and household chemicals), petrochemicals, construction materials, basic metals, sub-sector of metal goods production excluding machines (sections 284, 285, 286 and 287, Classification of Activities), electrical machines and appliances, and the recycling sub-sector.
4) Food products, tobacco products, clothing, leather products and footwear, publishing and printing products, pharmaceutical products and household chemicals, furniture and other various products.
5) Share in total industrial production.

Construction

Construction activity declines around 15%...

Construction activity was around 15% lower in Q3 over the same period last year. *QM* is of the view that the cement production index[10] is the most reliable of the numerous indicators of movements in construction (Table T2-10). Cement production was 14% lower in Q3 over the same period last year.

...as various data confirm

Of the other construction indicators published by SORS, *QM* would like to highlight the value of completed construction in Q2 – which indicates an even greater fall in construction activity than the one estimated by observing only cement production. The value of construction work was 25.3% lower in nominal terms and 28.1% lower in constant prices y-o-y in Q3.

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10 Cement consumption would be the proper indicator but data on cement consumption are not available at a quarterly level. Research has shown that cement production approximates cement consumption relatively reliably.

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

	I quarter	II quarter	III quarter	IV quarter	total
			Y-o-y indices		
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	81.4	86.0	-	-

Source: SORS.

The plunge in construction activity indicates that this was the sector hit the hardest by the economic crisis. Forecasts of construction activity levels will to a great extent depend on the announced acceleration of work on major infrastructural projects, such as the construction of Corridor X, and the state's potential engagement in boosting residential construction.

3. Employment and Wages

The labor market as a whole has very strongly adjusted to the economic crisis – since the start of the crisis, employment has fallen more than the gross domestic product. The main reason for such an unusual trend lies in the duality of the Serbian labor market – while part of the employed enjoys high employment safety, the other part of the population works on the margins and faces very low employment safety. Accelerated restructuring of the state-owned enterprises as well as a significant increase of the minimal wage in January 2009, which placed a burden on employers, have additionally contributed to the observed fall in employment. By ownership structure, the private sector generally continues to adjust to the crisis through job cuts, while the adjustment in the public sector continues via reduction of wages. The average wage in the public sector continues to rise, due to a proportionately bigger reduction in the number of employed who earn lower wages, even though this wage growth is slower than in the previous period. Despite the announced job cuts in the public administration, those will not have a significant impact on the total number of employed in the public sector, which has not yet sufficiently adjusted to current macroeconomic conditions and will probably have to resort to greater wage flexibility in the period to come. Therefore, it is necessary to speed up the adjustment of education and health sectors, as well as public companies, to the conditions of economic crisis and fiscal contraction.

Employment

Unemployment rate has increased by around one percentage point since April 2009

The total unemployment rate in Serbia has increased by one percentage point since April 2009 to 17.4 percent in October, based on the preliminary data from the Labor Force Survey (Table T3-1). This unemployment growth rate was smaller against the rise in unemployment rate between October 2008 and April 2009, and in line with expectations, taking into account that economic contraction in Q3 was significantly lower than in the first half of 2009. A more detailed analysis of the labor market trends in the observed period will be published in the next issue of *QM*, since the majority of data from the Labor Force Survey for October 2009 is not yet available.

Table T3-1. Serbia: Employment and Unemployment According to the Labor Force Survey[1), 2008-2009

		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
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	2,486,734	437,957	50.8	486,858	16.4
	October	..	..	..	..	17,4[4)

Source: Labor Force Survey, Statistical Office of the Republic of Serbia.
Notes:
The Labor Force Survey, launched in 2008, is conducted twice a year, in October and in April.
Persons of 15-64 years of age are considered to be working population.
Until October 2009, the Labor Force Survey had no classification of 15-64 for the number of employed in agriculture and for contributing household members, but only the category of 15+.
Based on preliminary LFS results.

Formal employment continues to decline between March and September 2009, according to the RAD Survey of the Statistics Office of the Republic of Serbia, primarily due to a declining number of employed with legal entities.

Total formal employment with legal entities has fallen by 32,000 persons or 2.3% (Table T3-2). The biggest decline took place in the manufacturing industry, where the number of employees

fell by 16,000 between March and September, representing around 5% decline within the sector. Employment numbers fell, by 2,000 jobs respectively, in the construction sector (around 2.5% decline within the sector), wholesale and retail trade (around 1% decline within the sector), transportation (around 2% decline within the sector) and real estate sector (around 2.5% decline within the sector). Employment did not increase in any sector between March and September 2009, which was in line with expectations when taking into account the current level of economic activity (Table P-5 in Analytical Appendix). Finally, figures on the number of entrepreneurs and their employed workers in September 2009 are still not available.

Table T3-2. Serbia: Number of Registered Employed and Unemployed Persons, 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	1,860	1,428	432	138	293	1,721	758
	September	1,828	1,396	432	138	293	1,689	737

Source: Statistical Office of the Republic of Serbia – The semi-annual report on employed persons and wages of the employed persons RAD-1/P; the update to the semi-annual survey RAD-1; Semi-annual survey on private entrepreneurs and their employed workers RAD-15; the National Employment Service.
Notes:
Talking about the registered number of employed, one refers to the formal economy, i.e. the employed persons with regular and legal employment contracts and whose wages pay taxes and contributions.
Talking about the registered number of unemployed, one refers to the persons who have registered with the National Employment Service. The National Employment Services shifted in September 2004 from following the number of job-seekers to the number of unemployed persons, because of which we have no series for the period before September 2007 (column 7).

The number of registered unemployed has declined due to the traineeship program and public works initiated by the Government

According to the National Employment Service figures, the number of registered unemployed persons fell by around 21,000 between March and September 2009 (Table T3-2). Although those numbers are counter-intuitive when considering current economic trends, it is necessary to bear in mind that, under the new Law on Employment and Unemployment Insurance[1], adopted in May 2009, the average replacement rate (the unemployment benefit-to-previous salary ratio) has fallen and so has the average duration of the entitlement to unemployment benefits. This could have partially led to a fall in the number of registered unemployed. Beside that, under the "First Chance" project initiated by the Ministry of Economy and Regional Development, 10,000 young trainees registered with the National Employment Service have been placed into companies, and this has also had an impact on the total number of the registered unemployed persons. Beside the trainee program, those who have taken part in the public works, which started in March 2009, are also temporarily taken off the unemployment register of the National Employment Service. As at August 31, 2009, the total number of persons participating in public works stood at 11,400[2] .

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1 *Official Gazette* RS, No. 26/09.
2 This number also includes those persons still participating in the ongoing public works which started in 2008.

Table T3-3. Serbia: Public Sector Employment, 2004-2009

		Employees in legal entities						
		Public sector					Public sector - total	Other[1)]
		From the budget			Public enterprises			
		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
	September	64	123	142	88	57	473	923

Source: SORS (Statistical Office of the Republic of Serbia).
Note: Employees at the Defence Ministry and employees at the Interior Ministry, even though financed from the budget, are not included in the total number of employed workers shown in the table. Their total number is estimated at around 80,000 and they contribute with another 4% to overall employment in Serbia. For security reasons, Statistical Office of the Republic of Serbia reports neither the exact number of employees at those institutions nor their average wages.
Footnotes:
Private, socially-owned and joint-stock companies (excluding entrepreneurs). The number is calculated when the number of employees at legal entities from Table T3-2 is deducted from the number of employed persons at public companies and those financed from the budget.

Public sector employment remains almost unchanged

Public sector employment remained almost unchanged between March and September 2009[3], but job cuts in the public administration have been already announced, and they will take place right after the National Assembly adopts the required laws. Namely, based on the Draft Law on the Maximum Number of Employed in the Central Public Administration, the total maximum number of full-time employees will be capped at 28,400, which means that more than 2,000 persons will be made redundant. According to the Draft Law on the Maximum Number of Employed in Local Administration, the number of full-time employees in the local administration will be capped at four persons per 1,000 inhabitants[4], which means that the total number of workers in local governments financed from the local budgets will be around 32,100[5].

The announced job cuts in public administration will not have a significant impact on the total number of those employed in the public sector Increased wage flexibility in the public sector will be difficult to avoid

The total number of jobs to be cut in the public administration (at all levels) will amount to around 8,000, i.e. 12.5%. The public administration accounts for 13.5% of all the persons employed in the public sector (columns 1 and 6 of the Table T3-3), while the biggest numbers of employees are in education and health sectors (columns 2 and 3 of the Table T3-3). Therefore, if job cuts remain limited to public administration, this reduction in employment will have no significant impact on the number of public sector workers – the total impact on the reduction of employment in the public sector would amount to only around 1.7%. Considering that further adjustments of the labor market to the economic crisis and to the increasingly restrictive fiscal policy are needed, it will be difficult to avoid further increase in public sector[6] wage flexibility.

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3 Except for a decline in the number of employed in the education sector by 2,000, which the Statistics Office of the Republic of Serbia is unable to explain.
4 According to the latest Census, Serbia's total population amounts to 7,498,011 persons.
5 The Law envisages a reduction in the number of employees by between 10 and 30 percent in 110 municipalities with surplus employment.
6 As the labor market adjusts to the macroeconomic circumstances through working hours, wages and employment, a balance between those three adjustment mechanisms is necessary.

Trends

Box 1. Poverty in Serbia in the First Half of 2009

Poverty rate, i.e. the share of poor persons in the total population, rose from 7.9% in 2008 to 9.2% in the first half of 2009, which means that the number of absolutely poor rose by around 14% in the observed period. These latest figures from the Household Budget Survey confirm our forecasts of rising poverty, presented in the Highlight 3 of the previous issue of the *QM*. The recent negative labor market trends certainly disproportionately impacted the poorer and more vulnerable population groups. We emphasized in the previous *QM* issue that the economic crisis, through the labor market as its transmission mechanism, mostly impacted those persons who are part of the secondary labor market, i.e. workers with flexible employment contracts, self-employed and those working in the "grey economy". On the other hand, significant inflexibility of the formal labor market has meant slower adjustment of the safer forms of employment to the economic crisis, leading to much faster job losses of those groups in marginal employment and exerting the strongest pressure on the most vulnerable groups.

Wages

Real wage growth came to a halt in Q3, with real wages in October seeing mild year-on-year declines

Year-on-year rates of real wage growth entirely came to a halt in Q3 2009, i.e. real wages rose by only 0.1 percent in Q3. The rise in nominal wages, too, has constantly slowed down, so that the nominal year-on-year wage growth in Q3 stood at 7.7% against 10.2% in Q2 (Table T3-4). Real wages mildly fell in October, by around one percentage point year-on-year.

Table T3-4. Serbia: Average Monthly Wages and Year-on-Year Indexes, 2008-2009

	Average Monthly Wage[1]				Average Gross Monthly Wage Index[2]	
	Total labour costs[3], in dinars	Net wage, in dinars	Total labour costs, in euros	Net wage, in euros	nominal	real
	1	2	3	4	5	6
2008	47,882	29,174	586	357	117.8	105.5
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
Q2	52,164	31,808	552	337	110.2	102.0
Q3	52,065	31,737	558	340	107.7	100.1
Oct	52,049	31,734	559	341	103.9	99.0

Source: Statistical Office of the Republic of Serbia.
Notes:
Figures for 2008 are adjusted based on a widened sample to calculate average wages, which also includes wages of the persons employed by entrepreneurs.
Year-on-year indexes of average monthly gross wages for 2008 were calculated from 2007 and 2008 wages, based on the old sample, which excludes the persons employed by entrepreneurs. However, those indexes are comparable with 2009 indexes, considering that despite the widening of the sample, the pace of wage growth has been kept, with their nominal values reduced by around 12%.
The total labor costs represent the full burden for an employer per worker, including all taxes and contributions, which amount to 164.5% of the net wage.
Indexes of gross wage growth and of total labor cost growth are equal because the total labor costs are higher than the gross wage by a fixed 17.9%.

Public sector wages see a sharper decline in real wages than in Q2

The decline of real wages in the public sector was stronger than in Q2[7]. The most significant year-on-year decline of real wages by 6.2% in Q3 took place in the public administration, as a result of the wage freezes and cuts in the above-average wages, based on the government decision from April 2009 (Table T3-5), which is expected to be in effect until January 2010. Year-on-year real wage growth in the public sector was 2.7% in Q3, which is significantly below 4.8% in Q2 (Table T3-5).

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7 Shown average wages exclude dividend payments to workers of the public companies.

Private sector continues to adjust to the crisis through job cuts, while the adjustment of the public sector mainly comes through wage cuts

The freeze of the minimum wage has contributed to a slowdown in real wages in the private sector

Private sector average wage continues to rise, due to a proportionately bigger reduction in the employment of lower-wage workers

Based on the observed trends, we can conclude that the private sector has continued to adjust to the economic crisis through job cuts, while the public sector is still adjusting exclusively through wage cuts. Following planned cuts in the number of public administration workers in the coming period, the public sector, too, will start adjusting through job cuts, although, as we have already pointed in the previous section, the adjustment will likely be relatively modest compared to the total number of workers in the public sector. Therefore, further adjustments through wage policies and greater flexibility of working hours can be expected.

As an additional measure to adjust the labor market to the crisis, the Serbian government kept the minimum wage at the level agreed in December 2008[8], due to the lack of consensus at the Social-Economic Council in June 2009. The freeze of the minimum wage has contributed to a slowdown in any further real wage increases in the private sector, as a significant number of the workers in the private sector earn the minimum wage. At the same time, the continuing rise of the private sector average wage in a time of crisis can be attributed to the fact that the average wage rises due to a stronger decline in overall employment rates, and particularly in marginal employment, where workers earn lower wages.

Table T3-5. Serbia: Gross Wages in the Public Sector, 2004-2009, Year-on-Year indexes in real terms

	From the budget			Public enterprises		Other[1]	Serbia average
	Administration - all levels	Education and culture	Health and social work	National public	Local public		
	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
Q2	94.6	98.0	98.8	99.7	99.9	104.8	102.0
Q3	93.8	96.4	97.1	98.3	95.7	102.9	100.1

Source: Statistical Office of the Republic of Serbia.
Notes:
Column 6 includes private, socially-owned and joint-stock companies (excluding entrepreneurs).
Column 6 shows an assessed size calculated by deducting the wage bill in the public sector from the total wage bill. The difference is divided by the number of workers employed in the real sector (column 7, Table T3-3).
Year-on-year indexes in real terms in columns 6 and 7 for 2008 and 2009 have been calculated based on a broadened sample for average wage calculation, which includes persons employed by entrepreneurs.

The labor market has strongly adjusted to the crisis – employment numbers have fallen more than GDP. Reasons are: labor market duality, accelerated transition, as well as the minimum wage increase in January 2009

Looking at the first three quarters of 2009, we can conclude that the labor market has strongly adjusted to the crisis and that the adjustments through job cuts have significantly exceeded the fall in GDP in the same period.

According to some analyses based on the Labor Force Survey, Serbia faced very high employment elasticity in the past period (above 1), which speaks of an unusual trend of employment declines exceeding GDP contraction. A similar analysis for Croatia shows that employment declines were half that of GDP contraction. To a great degree, such negative trends in Serbia can be explained by the duality of the labor market. Namely, part of the employees in Serbia

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8 The minimum wage is set by the Socio-Economic Council, based on semi-annual tripartite negotiations between trade unions, employers and the government. Although the crisis had already begun, a significant nominal increase of the minimum wage of almost 13% was agreed in January 2009, so the unilateral government's decision from June 2009 to freeze the minimum wage can be seen as an attempt to reduce the burden imposed on employers in a time of crisis.

Trends

(most often in the public sector) enjoy a great level of employment safety[9], and that segment of the labor market has reacted to the crisis in line with expectations – there is a significant adjustment of employment levels to GDP contraction, but with a certain time lag. The other part of the labor market, so-called secondary labor market, characterized by persons working with flexible employment contracts, self-employed and those in the "grey economy", has adjusted to recession much faster and to a greater extent. Due to a more difficult process of dismissing those workers in safe employment, the labor market has adjusted to the crisis through a disproportionately faster dismissal of workers who had worked on the margins. An additional impact on significant employment declines came from the accelerated pace of restructuring of state-owned and public enterprises (recession forces a faster implementation of some inevitable and unpopular reforms within state and social ownership). Therefore, we believe that this impact is in fact responsible for a deeper decline in employment than in GDP. Finally, we assume that a 13% increase of the minimum wage in December 2008 also contributed to a stronger adjustment of the private sector through job cuts, although the intention of policy makers was quite the opposite – to protect the most vulnerable workers. Although the freeze of the minimum wage in June 2009 was designed to soothe this impact, the question is whether the decision came too late. However, having in mind an almost twice-as-deep fall in employment numbers compared to GDP contraction in the same period, Serbia's economic recovery could lead to fairly fast employment regeneration among those segments of the population with flexible employment contracts. However, taking into account that growth in employment levels usually comes during a later stage of economic recovery, employment increases cannot be expected in the coming year.

Public sector has not yet sufficiently adjusted to new macroeconomic conditions. It is necessary to speed up adjustments to crisis and fiscal contraction in education and health sectors, as well as in public enterprises

At the same time, the public sector has not sufficiently adjusted to the current macroeconomic conditions. Wage freezes in the public administration have only partially led to lower expenditures in the public sector, and similar, if not lesser, will be the impact of the announced job cuts, considering the fact that the entire public administration accounts for only 13.5% of all the workers in the public sector. Therefore, it is necessary to speed up the adjustments in education and health sectors, as well as in public enterprises, to the conditions of economic crisis and fiscal contraction, having in mind convincing World Bank's recommendations presented in the previous issue of the *Quarterly Monitor*, in the article "Doing More With Less" by William Dillinger.

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9 Via full-time contracts.

4. Balance of Payments and Foreign Trade

The low current account deficit in Q3 2009 (€273 mn, or 3.4% of GDP) was again primarily caused by the improving foreign trade account (13.5% of GDP, due to lower domestic demand and production), as well as high remittance inflows. National bank of Serbia (NBS) foreign currency reserves grew by €716 mn in Q3, of which Serbia's special drawing rights with the International Monetary Fund (IMF) accounted for €422 mn. The low level of exports and imports seen in the preceding quarter remained unchanged. The third quarter saw exports of goods worth a total of €1.5 bn, a y-o-y fall in export demand of 26.4%. Such low Q3 exports were caused by two factors: first, a reduction in demand due to the global recession, and second, a worldwide drop in prices of many export products (such as metals, cereals and cereal products) in relation to the time before the crisis. Seasonally-adjusted exports data indicate that Q3 recorded exports of goods 3% lower than Q2, which bears out the assumption that a recovery in exports does not seem to be in sight even a whole year since the crisis began. The value of imported goods stood at €2.7 bn, a y-o-y fall of 32.6%, while seasonally adjusted data on imports less energy show imports have slumped by 8% on the preceding quarter – or, put another way, domestic import demand has been falling ever since the crisis started.

The fall in the foreign trade deficit and growth of remittances again determined the low current account balance of €273 mn (3.4% of GDP) in Q3

The current account deficit remained significantly lower in Q3 than in previous quarters. It amounted to €273 mn (3.4% of GDP, Table T4-1) over the third quarter. Indeed, since balance of payments data calculated using new methodology first became available,[1] only the quarter immediately preceding this one recorded a lower deficit. The global economic downturn initially brought about only a slight improvement in the current account at the end of the previous year (Q4 2008 current account deficit stood at €1.3 bn, or 14.8% of GDP), but improvement became more pronounced as the year went by: €818 mn (11.4% of GDP) in Q1 2009, followed by the record low of €175 mn (2.2% of GDP) in Q2. Although Q3 saw a slight rise in the current account deficit in relation to the preceding quarter (of 1.2 percentage points of GDP, due to a slight worsening of all of its components), the figure was nonetheless lower by 12.7 percentage points of GDP in relation to the same period last year. If the current account is viewed by component, it can be seen that its low value was caused by the fall in the foreign trade deficit and the rise in remittances in Q3 2009, as over the entire period.

Serbia's goods deficit did not see substantial changes relative to the preceding quarter

The Q3 2009 goods deficit amounted to 13.5% of quarterly GDP (previously, its values had stood at 21.7% in Q4 2008, 18.2% in Q1 and 13.6% in Q2 2009). The value of the goods deficit amounted to €1,087 mn over these three months; exports amounted to €1,549 mn (19.3% of GDP), while imports, worth €2,636 mn, made up 32.8% of GDP. Nominal values of imports and exports, as well as the goods deficit, were consistently low since the start of the year (Table T4-1).

As we pointed out in the previous issue of *QM*,[2] the inflow of remittances saw very high quarterly values, contrary to expectations. Remittances amounted to €732 mn in Q3, nearly twice as much as their average in the pre-crisis period (see Table T4-1 for Q1, Q2 and Q3 2008 averages). The unpredictably high value of this current account component in a time of overall recession contributed to the significantly high level of net current transfers in Q3 2009. Over the three months of Q3 net current transfers recorded a value of €945 mn (11.8% of GDP), 4.7 percentage points of GDP above Q3 2008 values (Table T4-1).

The current account deficit was lower by 81.6% in Q3 2009 in comparison to the same period in 2008

The current account deficit was lower by 81.6% in Q3 2009 in relation to the same period one year before (the y-o-y drop over the preceding quarter had been 90.3%). The foreign trade deficit was 45.8% lower than the figure recorded the previous year. On a year-on-year level, exports were lower by 24.6%, while imports decreased by 33.3%.[3] The third quarter again saw a y-o-y

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1 January 2007.
2 See „Balance of Payments and Foreign Trade" in QM 17.
3 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 were 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.

drop in imports greater than that of exports, resulting in a ratio of exports to imports of 59%, which is 6.8 percentage points more than in Q3 2008. The rise in remittances in Q3 2009 in comparison to the same period one year previously amounted to 65.9%.

Q3 capital inflows of €1 bn covered the current account deficit and boosted NBS foreign currency reserves

Capital inflows amounted to €1,019 mn,[4] which both covered the €273 current account deficit and increased NBS foreign currency reserves by €716 mn (Table T4-1). Over the course of Q3 FDI inflows stood at €113 mn; portfolio investment was low, amounting to €3 mn; while inflows of other investments were significant (€900 mn net). When thus considered, inflows of assets stand at 40.9% less than net inflows recorded in Q3 one year before (which saw substantial long-term foreign borrowing by companies).

Bearing in mind the low amount of foreign direct investments, and the negligible inflow of portfolio investments, the greatest source of assets in Q3 was other investments (Table T4-1). The net value of other investments amounted to €900 mn, including net inflows of trade credits (€189 mn) and financial loans (€623 mn); outflows of deposits amounting to €334 mn; and inflows from the International Monetary Fund under special drawing rights allocations (€442 mn).

Substantial foreign borrowing in the form of financial loans was caused exclusively by additional borrowing by the banking sector

Substantial net borrowing was apparent in the form of financial loans, to the tune of €623 mn. As the private sector continued the trend of repaying liabilities in evidence since the start of the year (Table T4-1), the increase in the financial loan account seen in Q3 was exclusively the consequence of additional borrowing by the banking sector. Repayment of cross-border borrowing in the form of long- and short-term loans stood nominally at the level recorded over the previous two quarters (-€221 mn in Q1, -€230 mn in Q2, and -€243 mn in Q3). Banks borrowed €798 mn net, of which most was short-term (short-term loans account for €519 mn, or almost two thirds, of all net bank borrowing).

Table T4-1. Serbia: Balance of Payments

	2007	2008	2008				2009		
			Q1	Q2	Q3	Q4	Q1	Q2	Q3
					in millions of euros				
CURRENT ACCOUNT	-4,605	-5,854	-1,279	-1,800	-1,485	-1,290	-818	-175	-273
Goods	-6,629	-7,581	-1,806	-1,981	-1,899	-1,894	-1,305	-1,073	-1,087
Export f.o.b[1]	6,373	7,422	1,672	1,972	2,054	1,723	1,291	1,536	1,549
Import f.o.b	-13,001	-15,002	-3,479	-3,953	-3,953	-3,617	-2,596	-2,609	-2,636
Services	-254	-170	36	-73	-109	-23	-37	21	-1
Export	2,304	2,744	688	638	727	692	568	599	669
Import	-2,558	-2,914	-652	-711	-836	-715	-605	-577	-671
Income, net	-600	-928	-138	-306	-127	-357	-123	-95	-129
Receipts	517	558	145	137	155	121	117	149	112
Payments	-1,116	-1,487	-282	-444	-282	-479	-240	-245	-241
Current transfers, net	2,877	2,825	629	561	651	985	648	971	945
o/w grants	166	170	34	50	36	50	39	37	40
o/w private remittances, net	2,065	1,952	434	327	441	750	456	769	732
CAPITAL ACCOUNT	-314	12	5	8	0	-1	-1	-1	1
FINANCIAL ACCOUNT	4,742	6,074	1,385	1,769	1,444	1,476	816	204	302
Direct investment, net	1,821	1,824	831	656	127	210	643	251	113
Portfolio investment, net	678	-90	-48	-38	27	-31	-4	-58	6
Other investments	2,977	2,607	635	842	1,569	-439	-63	892	900
Trade credits	328	56	78	-82	-156	216	90	22	189
Loans	3,403	3,262	221	920	1,393	728	-721	679	623
NBS	-92	0	0	0	0	0	0	783	0
Government	121	73	2	25	20	26	13	105	68
Commercial banks	167	119	-542	-43	317	387	-513	22	798
Long-term	-130	-304	-162	-45	17	-114	19	50	279
Short-term	297	423	-379	1	300	501	-532	-28	519
Other (enterprises)	3,206	3,071	760	939	1,056	316	-221	-230	-243
Currency and deposits	-652	-681	349	21	332	-1,383	569	190	-334
Other assets and liabilities	-102	-30	-13	-17	0	0	0	0	0
Allocation of SDR	0	0	0	0	0	0	0	0	422
Reserves Assets (- increase)	-734	1,733	-32	309	-279	1,736	240	-880	-716
ERRORS AND OMISSIONS, net	177	-232	-111	23	41	-185	2	-27	-30
OVERALL BALANCE	734	-1,733	32	-309	279	-1,736	-240	880	716
PRO MEMORIA									
					in % of GDP				
Current account	-15.6	-17.1	-16.8	-20.7	-16.1	-14.8	-11.4	-2.2	-3.4
Balance of goods	-22.4	-22.1	-23.7	-22.8	-20.6	-21.7	-18.2	-13.6	-13.5
Exports of goods	21.6	21.6	21.9	22.7	22.2	19.8	18.0	19.4	19.3
Imports of goods	-44.0	-43.8	-45.6	-45.4	-42.8	-41.5	-36.2	-33.0	-32.8
Balance of goods and services	-23.3	-22.6	-23.2	-23.6	-21.7	-22.0	-18.7	-13.3	-13.5
Current transfers, net	9.7	8.2	8.3	6.4	7.0	11.3	9.0	12.3	11.8
GDP in euros[2]	29,549	34,281	7,621	8,705	9,241	8,715	7,166	7,912	8,035

Source: NBS.
1) Exports f.o.b. using NBS methodology adjusted to IMF BOPM-5.
2) Quarterly values. Annual GDP converted into euros using the average annual exchange rate (average of official NBS daily mid rates).

4 Adjusted for the balance of Errors and omissions.

The rise in foreign currency reserves seen in Q3 2009 continued into October

The rise in foreign currency reserves amounted to €716 mn in Q3 2009. When viewed by month, the increase in NBS foreign currency reserves amounted to €320.5 mn in July (mainly due to inflows related to banks' reserve requirements and money drawn under World Bank and European Investment Bank loans). August saw foreign currency reserves increase by €395 mn (€376 mn in Serbia's special drawing rights with the IMF).[5] September saw almost no change in the foreign currency reserves, with minimal growth of €1 mn (inflows were recorded in a special allocation of special drawing rights with the IMF amounting to €46 mn, as well as in loans granted by the European Investment Bank and the Council of Europe Development Bank; outflows were mainly seen due to repayment of liabilities with foreign lenders and withdrawals of bank assets from separate accounts with the NBS under the reserve requirement). National Bank of Serbia foreign currency reserves increased by €202.7 mn in October, mainly due to inflows under banks' reserve requirements (€165.5 mn net), while outflows were again mainly accounted for by repayments of liabilities with foreign creditors.

Foreign Debt

Table T4-2. Serbia: Foreign Debt by Structure, 2006-2009

	2006	2007	2008				2009		
			Mar	Jun	Sep	Dec	Mar	Jun	Sep
				stocks, in EUR millions, end of the period					
Total foreign debt	14,884	17,789	17,957	18,647	20,530	21,800	21,445	21,687	21,784
(in % of GDP) [2]	*63.0*	*60.2*	*52.4*	*54.4*	*59.9*	*63.6*	*68.6*	*69.4*	*69.7*
Public debt	6,420	6,130	6,035	6,047	6,282	6,386	6,528	7,199	6,824
(in % of GDP) [2]	*27.2*	*20.7*	*17.6*	*17.6*	*18.3*	*18.6*	*20.9*	*23.0*	*21.8*
Long term	6,363	6,096	6,003	6,016	6,247	6,369	6,509	7,182	6,805
o/w: to IMF	185	0	0	0	0	0	0	771	757
Short term	57	34	32	32	35	18	19	18	19
Private debt	8,464	11,659	11,922	12,599	14,248	15,414	14,917	14,488	14,960
(in % of GDP) [2]	*35.8*	*39.5*	*34.8*	*36.8*	*41.6*	*45.0*	*47.7*	*46.4*	*47.9*
Long term	7,263	10,372	10,883	11,482	12,366	13,006	12,970	12,785	13,019
o/w: Banks debt	2,929	2,801	2,660	2,333	2,357	2,301	2,270	2,267	2,549
o/w: Enterprises debt	4,334	7,571	8,223	9,149	10,009	10,705	10,700	10,518	10,471
Short term	1,201	1,287	1,039	1,118	1,882	2,408	1,948	1,703	1,941
o/w: Banks debt	942	1,163	770	769	1,118	1,605	1,154	1,029	1,530
o/w: Enterprises debt	259	124	269	349	764	803	794	674	411
Foreign debt, net [1], (in% of GDP)[2]	24.8	27.6	24.5	27.8	31.6	39.8	42.7	41.0	39.2

Source: NBS.
1) Total foreign debt less NBS currency reserves.
2) Data for 2008 is annual actual GDP in euros for that year. New, lower GDP values are used for 2009 (*QM* estimates).

Total foreign debt in Q3 2009 amounted to €21,784 mn, or 69.7% of GDP

According to NBS data, total foreign debt at the end of the third quarter of 2009 stood at €21,784 mn, which was 69.7% of GDP (Table T4-2). In relation to the external debt situation at year-end 2008, Serbia's foreign debt remained much the same. This slight drop in foreign debt seen over the first nine months of 2009 was a consequence of the reduction in private debt (primarily the substantially lower amount of short-term borrowing), as well as repayment of long-term debts by businesses. The share of foreign debt in GDP rose by 6.1 percentage points over the same period (on account of the drop in the value of GDP).

Government sector foreign debt amounted to 21.8% of GDP at end of September…

…which currently poses no major threat…

Total government sector foreign debt stood at €6,824 mn, accounting for 21.8% of GDP. In relation to its external debt level recorded nine months previously, this figure represents growth of €437 mn (or 3.2 percentage points of GDP). This was the consequence of greater long-term government sector debt (as the first tranche under the IMF stand-by agreement, of €771 mn, was drawn in May 2009). Public sector foreign debt, accounting for 21.8% of GDP according to generally accepted criteria, still poses no danger to its sustainability.[6] Currently a more pressing

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5 Serbia was allocated 388,370,952 in special drawing rights, or €376 mn, on 28 August (346.7 million in special drawing rights under the general allocation) and €45.8 mn on 9 September (41.7 million in special drawing rights under a special allocation); these funds are to be used, as recommended by the IMF and stipulated by legislation adopted in October, for upcoming repayments of Serbia's foreign public debt. The interest on this loan is 0.29% with an unspecified repayment date (Serbia can choose when to repay it).
6 For more details, see analysis of public debt in Part 6, Fiscal Flows and Policy.

*…but a further
increase is expected*

*Banks embarked
on new borrowing,
while businesses
repaid net debts
since the beginning
of the year
and into Q3*

problem is the rather rapid increase in domestic public debt,[7] as well as additional large-scale foreign borrowing by the public sector expected in the near future.

Total private foreign debt at end-September 2009 stood at €14,960 mn, accounting for 47.9% of GDP (Table T4-2). The private sector recorded an amount of foreign debt lower by €454 mn in Q3 2009 than at the end of the previous year. During this period (December 2008 – September 2009), banks raised an additional €172 mn net in new borrowing, while businesses repaid debts of €626 mn net.

The private sector continued repaying foreign debt over the first six months of 2009, only for Q3 to see a slight increase in private debt levels. In relation to June 2009, end-September 2009 saw an increase in private debt, of €472 mn (i.e. 1.5 percentage points of GDP). After following a trend of repaying both long- and short-term liabilities, banks incurred new debt in Q3. Banks raised an additional €282 mn through long-term borrowing in Q3 (Table T4-2), while new short-term bank borrowing over the same period was substantially greater, standing at €500 mn. As opposed to the banking sector, businesses have been recording a drop in foreign indebtedness since the beginning of the year. Businesses repaid €47 mn in long-term liabilities, and €263 mn in short-term debt, in Q3.[8] In relation to year-end 2008, long-term foreign debt of the business sector was lower by €234 mn, while its short-term borrowing was down by €392 mn.

Foreign borrowing by businesses has so far proven to be the dominant route to greater foreign debt. Serbian companies rapidly incurred foreign debt (in the form of cross-border loans) over the entire course of the previous year.[9] However, as this borrowing trend has been reversed since the start of 2009, attention should now be directed at the banking sector – especially in view of the rise in short-term borrowing seen in Q3 – and the public sector, which has indicated its intention to embark on large-scale additional foreign borrowing.

Exports

Table T4-3. Serbia: Exports, Y-o-y Growth Rates, 2008-2009

	Exports share in 2008	2009			2008			2009		
		Q1	Q2	Q3	Q1	Q2	Q3	Q1	Q2	Q3
	%	mil.euros			y-o-y growth rate (%)					
Total	100.0	1,276	1,529	1,520	20.5	23.8	19.6	-23.8	-22.5	-26.4
Bulky exports	27.1	296	350	385	1.9	13.8	8.0	-36.0	-36.1	-35.9
Iron and steel	13.0	101	85	131	3.6	40.6	36.0	-54.0	-72.7	-56.3
Non ferrous metals	6.4	65	76	90	4.5	-0.9	-1.2	-48.4	-41.1	-33.4
Fruits and vegetables	4.4	62	84	98	13.9	-14.5	-8.0	-5.2	30.0	-9.6
Cereal and cereal products	3.4	68	106	66	-19.1	-20.3	-29.6	30.3	141.6	16.0
Underlying exports	72.9	980	1,179	1,134	29.6	28.0	25.0	-19.2	-17.3	-22.6
Core	30.5	429	467	441	23.5	13.7	9.3	-21.8	-20.3	-27.8
Clothes	4.9	115	109	79	15.5	12.0	2.4	29.5	32.5	-9.6
Miscellaneous manufactured articles, n.e.s.	4.2	50	61	66	50.7	25.4	9.1	-35.2	-24.0	-23.2
Manufactures of metals, n.e.s.	4.3	48	65	62	26.9	1.3	-0.5	-36.4	-20.7	-24.4
Rubber products	2.9	44	39	43	3.3	5.5	27.8	-22.5	-32.2	-32.3
Electrical machinery, apparatus and appliances	3.9	62	74	77	50.9	21.7	30.3	-1.0	4.0	-6.1
Organic chemicals	2.3	8	6	5	7.9	25.7	-5.3	-83.1	-88.0	-90.1
Plastics in primary forms	1.9	20	19	4	34.4	10.1	6.7	-49.9	-53.1	-88.4
Footwear	2.2	37	33	39	15.8	8.4	9.0	-8.4	-19.5	-13.6
Paper, paperboard and articles of paper pulp	1.9	32	38	36	21.4	13.5	1.9	-2.0	-3.3	4.1
Non-metal mineral produce	2.0	13	24	30	10.3	19.9	16.7	-54.7	-46.1	-33.5
Other	42.3	551	712	693	35.0	40.4	39.4	-17.0	-15.1	-18.8

Source: SORS.

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7 Domestic debt grew by €582 mn, primarily on account of the sale of treasury bills to cover the public spending deficit caused by growing needs of the pension fund, matured interest on short-term treasury bills, payments of "old", i.e. frozen foreign currency deposits, etc.

8 The same apparent trend was mentioned in the Balance of Payments section, but the analysis is reiterated here due to somewhat different data sources: data supplied by the National Bank of Serbia International Relations Department was used to analyze foreign debt, while those provided by the Economic Analyses and Research Department, Balance of Payments Statistics Division were used in the analysis of balance of payments.

9 See Balance of Payments and Foreign Trade and Monetary Flows and Policy in previous issues of QM.

Exports amounted to €1.5 bn in Q3, a y-o-y drop of 26.4%...

...primarily caused by falling prices of metals in the global market in relation to Q3 2008, as well as poor performance by underlying exports

Year-on-year fall in bulky exports of 35.9% in Q3 2009...

...was primarily caused by falling prices of its components

Exports stood at €1.5 bn, a y-o-y drop of 26.4%. Overall exports, as well as exports disaggregated by component (Table T4-3), do not indicate a recovery in Q3. The monthly overall exports series leads to the same conclusion. Modest indications of recovery seen in June were dashed by values of exported goods for all three months of Q3, all of which were lower than in June. After y-o-y falls in overall exports of 25.4% in April and 24.1% in May, June saw a substantially smaller y-o-y drop in the value of exported goods (-18.2%), only for it to fall further over all three months of the third quarter (-26.9%, -27.1% and -25.4% in July, August and September, respectively). This lack of improvement in overall exports was caused primarily by the drop in prices of metals in the global market relative to Q3 2008, as well as poor performance by *underlying export* (or, rather, individual poor performance by its components, *core* and *other exports*).

The y-o-y fall in *bulky exports* seen in Q3 2009 was slightly lower than that recorded in the preceding quarter (Table T4-3). Exports of iron and steel and non-ferrous metals are still recording substantial y-o-y falls, albeit lower than over the preceding quarter. On the other hand, cereals and cereal products recorded a major slowdown in y-o-y growth in relation to the preceding quarter.

In the course of Q3, the iron and steel product group, part of the *bulky exports* component, recorded a drop in the value of exported goods that was significantly lower relative to the preceding quarter (-56.3% in Q3 in relation to -72.7% in Q2). If we observe monthly series, a very quick deceleration becomes apparent in the negative trend of exports of this product group: -73.8% in June, -69.8% in July, -54.2% in August, and -40.5% in September. Global steel prices have fallen in comparison with Q3 2008: the average price of a ton of steel in July, August and September 2008 amounted to $1,118, while the average price for these three months in 2009 fell to $613 a ton. This is an indication of the very difficult position of iron and steel producers, who have been directly affected by the crisis – in spite of a slight improvement in production, the slump in demand and prices has resulted in substantially lower values of exported goods in relation to the preceding year.

The situation is similar in the global market for non-ferrous metals. Prices began plummeting at the end of 2008 due to falling demand. Global copper and aluminium prices[10] in dollars fell by nearly 50% over just a few months in late 2008. However, prices of these products have been on the increase over the course of 2009, and especially in the past several months. The dollar price of aluminium was up 32% in Q3 on Q1, while the dollar price of copper was up 70% on that seen in early 2009.[11] When viewed at the y-o-y level, dollar prices of metals were one quarter below last year's averages for the same period[12] (taking into account the euro's depreciation against the dollar of 5.1% from Q3 2008 to Q3 2009, the drop in euro prices amounted to 21.4%). This brings us to the conclusion that the actual y-o-y fall in exports of non-ferrous metals in Q3 amounted to 15.3% – in line with the drop in quantities exported. Therefore, of the total y-o-y fall in the value of non-ferrous metal exports (-33.4%, Table T4-3), only a minor part is due to the drop in quantities exported (the contribution of the drop in quantities exported in the fall in the value of exports stood at 46% in Q3): more than half of this fall can be accounted for by changes in global prices.

Value of exported fruit and vegetables fell by 9.6% in Q3 relative to the same period last year; y-o-y cereal export growth rate was also substantially lower (16.0%)

In addition, it is also very important to note that the drop in prices of these products began suddenly in Q4 2008, and, if production remains at the current level or picks up by the end of the year, and if prices at least remain stable (notwithstanding their upward trend seen since the beginning of the year), the negative export trend recorded by these products could end up being substantially lower – or even reversed – which would prove of great importance for the recovery of overall exports and the economy as a whole.

The third quarter saw lower values of exported *fruit and vegetables* in relation to Q3 2008. Fruit and vegetable exports were down 9.6% in Q3 2009 compared with the same period one year

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10 Copper and aluminium account for between 90 and 95 percent of Serbia's exports of non-ferrous metals.
11 Fluctuations in average aluminium and copper prices have been calculated using average monthly dollar price data published by the London Stock Exchange.
12 Based on metal price indices published by the IMF.

previously (Table T4-3). As for cereals and cereal products, Q3 2009 recorded a substantially lower export growth rate (16.0%) in relation to the preceding quarter (141.5%). Since June 2008 saw the lifting of the ban on cereal exports, the slowdown in the exports of these products in Q3 relative to Q2 can partly be explained by the change in the base, which was normalized in Q3 2008, as well as by fluctuations in their prices in the global market: cereal dollar prices were down by one third in Q3 2009 in relation to Q3 2008. However, in nominal terms, Q3 exports were substantially below figures seen in the preceding quarter (this fall can also be explained by the change in prices – Q3 dollar prices were 10% down on Q2 levels). Corn dominated the overall value of cereal exports: the price of corn, higher in the international market than in Serbia, as well as large supplies left over from last year's harvest and the generally good quality of Serbian corn, made it possible to export substantial quantities.[13]

Underlying exports saw a greater y-o-y drop in Q3 2009 than over the previous quarter, both when viewed overall and by individual component

The *core* component recorded a greater y-o-y fall in Q3 than in Q2 2009 (-27.8% in Q3 as opposed to -20.3% in Q2 2009). Exports of clothing, which had seen positive and often very high growth rates, saw a y-o-y fall in Q3 2009 for the first time. Of all products that make up the *core* component, only paper and cellulose products recorded Q3 2009 values that were above those seen in Q3 2008. Organic chemicals and plastics in primary forms saw the greatest drops of the *core* category, as in the previous quarter. As for other products that make up the *core*, the downward trend seen in the previous quarter remained mainly unchanged (Table T4-3).

Other exports recorded a y-o-y fall of -18.8% in Q3 2009, coming after -15.1% in Q2 2009. This indicates that not even this component – one that is primarily expected to see recovery (as it is the least influenced by exogenous factors) – saw recovery in Q3.

Seasonally-adjusted values of overall exports and exports less iron and steel and non-ferrous metals indicate lower exports in Q3 relative to Q2…
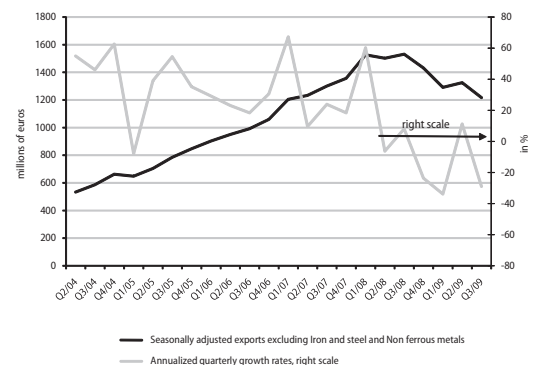
The graph showing seasonally-adjusted overall export values (Graph T4-4) indicates that the seasonally-adjusted value Q3 2009 exports was 3% below Q2 values, a drop of 11.4% when annualized

Graph T4-4. Serbia: Seasonally-Adjusted Exports, by Quarter, 2004-2009
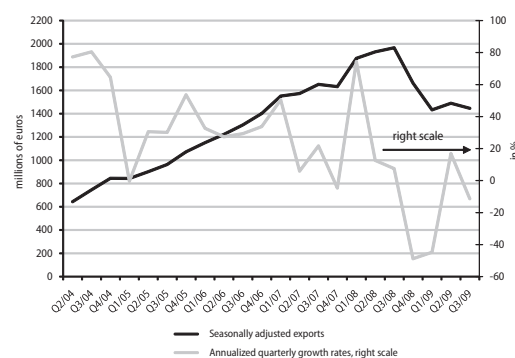
Source: SORS, *QM*.

Graph T4-5. Serbia: Seasonally-Adjusted Exports, Less Iron and Steel and Non-Ferrous Metals, by Quarter, 2004-2009

Source: SORS, *QM*.

…underscoring the lack of expected recovery in Q3

Seasonally-adjusted overall exports data, less iron and steel and non-ferrous metals, indicate an even more marked fall. If we consider the graph showing seasonally-adjusted exports data less two groups of products mentioned above (Graph T4-5) it becomes apparent that Q3 2009 values are 8.2% lower than those seen in the previous quarter, or 29% lower at the annual level. These and other exports data (see Table T4-3 and Graph T4-4) indicate that the recovery in Serbian exports expected in Q3 has failed to materialize, and also do not seem to provide any arguments in support of a more favorable export forecast for Serbia's economy in the short run.

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13 When exported value of individual products is considered, corn exports are seen to have had the greatest value since the start of 2009. Throughout the business year (October 2008 – August 2009), a total of 1.460 million tons of corn were exported, worth €160 mn. Over a million tons (1,027,560 tons) of corn were exported from January to September 2009.

Imports

Imports amounted to €2.7 bn in Q3 2009…

Imports in Q3 2009 amounted to €2.7 bn, a fall of 32.6% in relation to Q3 2008 (Table T4-6). In comparison with Q2, the y-o-y fall in imports was somewhat lower, both overall and by component (with the exception of non-durable consumer goods and the *other* component).

…32.6% down on Q3 2008

Table T4-6. Serbia: Imports, Y-o-y Growth Rates, 2008-2009

|	Imports share (2008)	2009			2008			2009		
		Q1	Q2	Q3	Q1	Q2	Q3	Q1	Q2	Q3
	in %	mil.euros			y-o-y growth (%)					
Total	100.0	2,683	2,716	2,703	22.8	27.5	19.1	-25.7	-33.8	-32.6
Energy	20.0	565	384	422	32.5	53.2	51.2	-28.3	-49.8	-47.0
Intermediate products	34.4	831	956	998	16.2	16.0	12.8	-30.8	-33.6	-31.8
Capital products	24.8	612	683	636	19.5	32.6	10.4	-28.0	-38.2	-35.5
Capital products excluding road vehicles	16.8	438	439	407	9.3	29.3	13.1	-21.3	-39.2	-38.7
Durable consumer goods	3.9	112	99	99	31.3	34.8	13.5	-15.8	-37.1	-31.5
Non-durable consumer goods	14.3	463	495	488	26.6	21.1	19.5	-10.4	-8.7	-10.4
Other	2.7	100	99	60	32.4	16.6	12.3	-19.5	1.9	-19.9
Imports excluding energy	80.0	2,118	2,332	2,280	20.3	22.8	13.1	-25.0	-30.2	-29.0

Source: SORS.

Seasonally-adjusted values of imports less energy continued their quarterly fall

Graph T4-7, showing seasonally-adjusted values of imports less energy, indicates the presence of a quarterly fall in the value of imports in Q3 2009 relative to Q2 2009, but at a lower rate than that recorded over the previous two quarters. According to these data, Q1 2009 saw goods imports of 11.6% less than Q4 2008 (39% at the annual level). Seasonally-adjusted figures for imports less energy stood at 8.6% less in Q2 than in Q1 2009 (30% at the annual level), while Q3 was 7.9% below Q2 2009 values (a fall of 28.3% at the annual level, T4-7).

Energy component saw the greatest y-o-y fall

Graph T4-7. Serbia: Seasonally-Adjusted Imports Less Energy, by Quarter, 2004-2009
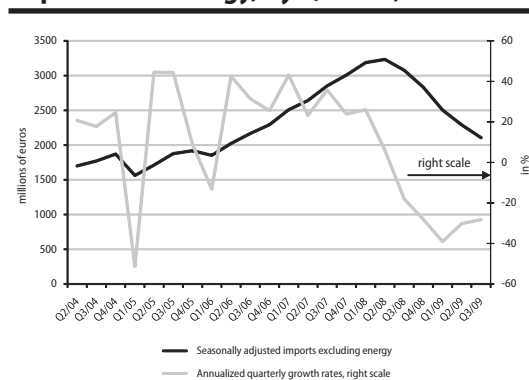
Source: SORS, *QM*.

Imports viewed by component indicate that *energy* recorded the greatest y-o-y fall (-47.0%) in Q3, as it did in the previous quarter. As primary energy prices in dollars (according to the index published by the IMF) were 43.1% down on Q3 2008 (or 40.2% for prices in euros), we can conclude that the quantity of energy imported fell by 11.3% in Q3 at the y-o-y level (the fall in quantity had amounted to 12.1% at the y-o-y level in Q2). Had energy prices remained unchanged, the share of imports in quarterly GDP would have been 3.5% greater than that seen in Q3.

…while other components recorded substantial y-o-y reductions

Imports of *intermediate goods* slowed their fall in Q3 relative to Q2. This was the only component of overall imports that recorded a lower drop in y-o-y values at the monthly level in Q3 (-33.4%, -32.7% and -29.4% for July, August and September, respectively). These fluctuations are in line with the lower y-o-y drop of production in Q3 in relation to the previous quarter.[14] In addition, *capital goods* recorded a lower drop in Q3 relative to the previous quarter (-35.5% in Q3 as opposed to -38.2% in Q2). The y-o-y drop in capital goods imports less motor vehicles amounted to 38.7% and was also lower than the fall seen in the previous quarter (-39.2%). However, the actual values of imports of *intermediate* and *capital goods* in Q3 indicate that domestic demand for these imported products, to a great extent the foundation of domestic production and capital investment, is still at a low level.

The y-o-y fall in imports of *durable goods* of 31.5%, the drop in imports of *non-durable consumer goods* of 10.4%, as well as the fall in *other* imports of 19.9% (after a recovery seen in the preceding quarter; see Table T4-6) could indicate that demand among the domestic public has failed to rise in Q3.

14 See section 2, Economic Activity.

The base for comparison for the coming quarter will be the last quarter of 2008, which saw the impact of effects of the global downturn on reduced imports and exports. This will mean changes to movements in these figures at the annual level. Imports and exports could in the future show trend changes due to the low base and record positive growth rates, although current low levels may be maintained. In essence, the foreign trade situation will primarily depend on the speed with which Serbia's economy comes out of recession, the situation in the global market (demand and prices) and Serbian economic policy, which will, taken all together, determine future imports and exports values, and the amount of the foreign trade deficit.

5. Prices and the Exchange Rate

The third quarter saw a marked slowdown of inflation, a development we had predicted earlier. Having reached 7% (or 14.4% annualized) in first half of the year, in Q3 inflation as measured using the Consumer Price Index (CPI) fell by 0.7% (or 2.9% annualized). The Q3 deflation was primarily caused by drops in the prices of fruit and vegetables and the moderate growth in the prices of most other goods and services. Very importantly, Q3 and October recorded additional falls in the underlying inflation trend (CPI less food, energy, alcoholic beverages and tobacco). The underlying inflation trend thus fell to slightly under 6% annualized in Q3 (the figure had been in excess of 10% for the preceding two quarters); if we consider only September and October, the underlying trend stood at a mere 2.8% annualized rate. The nominal dinar/euro exchange rate was very stable throughout Q3, while the real exchange rate appreciated by 1% – thus bringing overall appreciation from the start of 2009 to some 4%.

Consumer Price Index (CPI)

Q3 saw deflation…

After high inflation seen over the first two quarters, Q3 2009 recorded deflation. The Consumer Price Index fell by 0.7% over this quarter, or 2.9% annualized (Table T5-1). By way of a reminder, over the preceding two quarters the CPI grew by 2.8% and 3.0% respectively (or 16.3% and 12.6% annualized). Price growth from the beginning of the year to September amounted to 6.2%. Year-on-year CPI growth stood at 7.9% in Q3 (as opposed to 8.7% in the preceding quarter). October and November will see a more pronounced drop in the y-o-y inflation rate due to comparison with last year's higher base.

Table T5-1. 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
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
Jun	121.2	14.8	7.2	0.7	17.4
Sep	121.4	10.9	7.5	1.0	0.9
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
May	131.3	9.1	7.0	2.1	14.5
Jun	131.3	8.3	7.0	0.0	12.6
Jul	130.0	8.5	5.9	-0.9	4.7
Aug	129.9	8.0	5.9	-0.1	-4.0
Sep	130.3	7.3	6.2	0.3	-2.8
Oct	130.1	5.2	6.0	-0.2	0.1

Source: SORS.

…primarily caused by falling fruit and vegetable prices

Q3 deflation was caused by a major drop in food prices, primarily those of fruit and vegetables. Food prices fell by 4.4% in Q3 (Table T5-2), mainly due to drops in prices of vegetables (25.1%) and fruit (11.6%). Such pronounced falls in the prices of fruit and vegetables were a consequence of seasonal factors, and probably also due to a certain correction in relation to the preceding quarter (when prices of these products rose somewhat more than had been expected). Prices of other products and services saw minor changes in Q3.

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

|	Share in CPI (in %)	Price increase in Q2 (in %)	Contribution to overall CPI increase in Q2 (in %)	Price increase in Q3 (in %)	Contribution to overall CPI increase in Q3 (in %)
Total	100.0	3.0	100.0	-0.7	100.0
Food and non – alcoholic beverages	34.3	3.5	40.0	-3.9	183.7
Food	30.8	3.6	36.9	-4.4	185.5
Alcoholic beverages and tobacco	4.8	0.2	0.3	0.3	-1.8
Clothing and footwear	6.5	1.6	3.4	1.3	-11.3
Housing, water, electricity, gas and other fuels	16.5	0.6	3.5	1.6	-35.2
Furniture, household equipment, routine maintenance	5.5	2.4	4.4	3.1	-23.0
Health	4.6	7.4	11.5	-0.7	4.7
Transport	11.5	6.8	26.0	1.2	-18.6
Oil products	4.7	16.6	26.0	2.3	-14.4
Other items	16.3	..	9.8	..	1.6

Source: SORS.

Prices of oil products remained stable in Q3

Prices of oil products, which had made a substantial contribution to high inflation in the first half of the year, rose moderately in this quarter and did not have a major impact on price rises. The dollar price of Urals crude oil rose by as much as 96% over the first half of the year, an increase of 113% when converted into dinars (Graph T5-3).[1] Prices of oil products in Serbia rose by 35% over the same period (Graph T5-4) and accounted for nearly a quarter of all price growth in the first six months of 2009. In contrast to this, the price of Urals crude at the end of Q3 remained at approximately the same level as at the end of the previous quarter.

Graph T5-3. World: Weekly Urals Crude Prices, in USD and RSD, 2006-2009
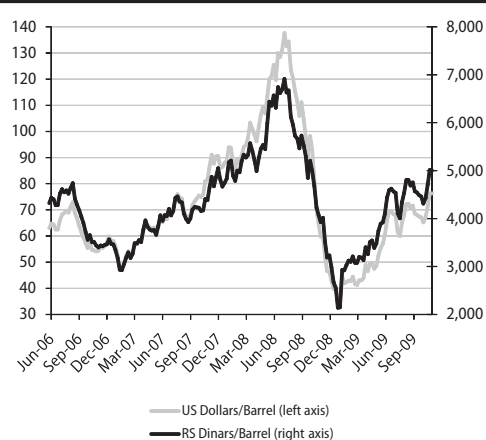
Source: Energy Information Administration (EIA), US Department of Energy.

Graph T5-4. Serbia: Prices of Urals Crude and Oil Products in Serbia, 2006 Average = 100, 2007-2009
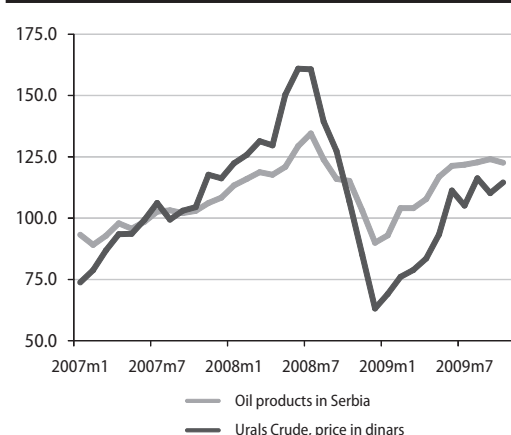

Source: SORS and EIA, US Department of Energy.

Underlying inflation also recorded a noticeable slowdown in Q3…

A more accurate picture of the inflation trend can be obtained by observing the Consumer Price Index excluding food, energy, alcoholic beverages and tobacco. These products are either influenced by exogenous factors (oil prices) and seasonal movements (food prices), or are administratively controlled (prices of alcoholic beverages and tobacco, as they are subject to excise duties). Graph T5-5 shows movements in this underlying inflation trend, and its apparent deceleration: the Q3 rise in the underlying inflation trend amounted to 5.8% at the annual level, while the figure for the preceding quarter was 10.3%, and as much as 13.8% for Q1.

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1 The higher dinar price was caused by the depreciation of the Serbian currency against the dollar over the first half of the year.

…with the trend continuing in October…

Graph T5-5. Serbia: CPI and Underlying Inflation Trend, 2008-2009
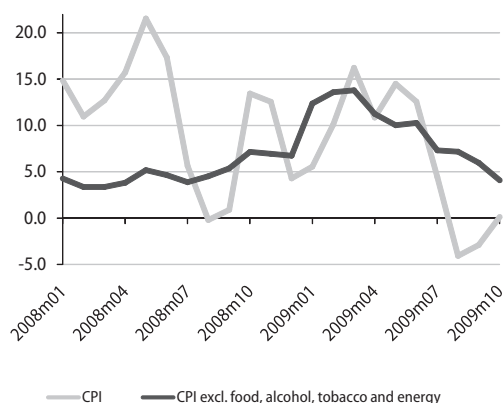
Source: SORS and *QM* estimates.
Note: Graph rates represent monthly moving averages for three months, annualized (e.g. the March value was obtained by annualizing monthly price growth for January, February and March).

…meaning inflation in Serbia is now comparable to levels seen in other Eastern European countries

October saw the downward inflation trend continue. Total inflation in this month amounted to -0.2%, with underlying inflation standing at 0.2%. This was the lowest monthly underlying inflation rate in 2009. In addition, it needs to be noted that the monthly underlying inflation rate has seen constant reduction since July 2009. Thus, in the three months to October, underlying inflation amounted to 1.0%, or 4.1% annualized; if only September and October are considered, the rate will be seen to amount to slightly under 0.5%, or 2.8% annualized.

After a slowdown in September and October, inflation in Serbia has now reached a level comparable with other Eastern European countries. Table T5-6 shows the annualized underlying inflation rate (Consumer Price Index less food, energy, alcoholic beverages and tobacco) in Serbia and selected Eastern European countries. Serbia had up to the end of the third quarter been recording an underlying inflation rate that was among the highest in Europe. However, when September and October data are considered, underlying inflation will be seen to stand at 2.8% annualized – which is comparable with levels recorded by EU countries.

Table T5-6. Selected Countries: Underlying Inflation (CPI less Food, Energy, Alcoholic Beverages and Tobacco), Annualized Rates, 2008-2009

	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1	2009Q2	2009Q3	2009m9 and m10
Bulgaria	13.0	8.7	9.9	5.1	3.1	0.9	2.5	1.7
Romania	8.7	1.2	0.9	9.7	13.1	1.0	2.9	5.6
Czech Republic	15.6	1.1	0.0	-3.0	4.2	0.4	-1.9	-3.8
Hungary	6.4	2.8	-0.2	1.9	4.1	7.4	9.0	-0.2
Poland	4.0	2.3	0.8	0.8	4.3	5.0	0.8	1.1
Slovakia	5.2	1.7	4.1	2.4	1.5	0.1	0.5	1.3
Slovenia	3.6	6.3	0.3	4.2	1.2	3.4	-5.6	1.5
Estonia	7.8	5.0	5.5	0.4	-2.8	-0.1	3.0	-0.1
Latvia	8.0	7.6	5.5	2.6	6.8	-4.7	1.6	4.4
Lithuania	13.9	6.2	9.6	-1.6	9.4	-4.4	-5.1	-0.6
Euro zone	1.2	2.2	0.6	3.5	-0.4	1.9	-0.1	3.3
EU	1.3	2.6	1.0	2.5	0.4	2.4	0.7	3.1
Serbia	3.4	4.7	5.4	6.7	13.8	10.3	5.8	2.8

Source: Eurostat, SORS and *QM* estimates.

Inflation has been very low over the second half of the year…

Barring any significant changes to administratively-controlled prices, or a major rise in the price of oil, we can expect overall inflation (as measured using the Consumer Price Index) to stand at between 7.0% and 7.5% at year-end 2009. This would mean that inflation over the second half of the year was very close to zero, while it had amounted to as much as 7%, or 14% annualized, in the first half of 2009.

…leaving room for a possible adjustment of administratively-controlled prices before the end of the year

Such low overall inflation, as well as the slowdown in underlying inflation, may make room for adjustment of certain administratively-controlled prices. Electricity prices had so far not increased in 2009, which is why rises of up to as much as 20% have been announced. Some utility prices may also be set to rise. If these increases do occur early next year, they alone could push inflation up by about 1.5 percentage points in 2010. On the other hand, if the price rises are deemed necessary (there is some debate, for instance, of how justified any increase in the price of electricity would be if not accompanied by an improvement in the efficiency in the state-run

power company), and bearing in mind the very low inflation rate in the second half of 2009, there could be support for shifting these increases from 2010 to late 2009. In this case inflation at year-end 2009 would stand at around 8.5%. This rate is still fairly close to the centre of the NBS 2009 target band (between 6% and 10%) and would therefore not jeopardize 2009 inflation targets; it would, on the other hand, leave more room for a somewhat more relaxed monetary policy in 2010. In an environment dominated by fragile economic recovery, the most likely scenario for next year, more room for adjustment through monetary policy could prove very useful.

Retail Price Index (RPI)

The RPI saw very moderate growth in Q3…

The Retail Price Index (RPI) rose by just 0.24% in Q3, or 1% annualized. This was, together with Q4 2008, the lowest quarterly RPI growth rate since 2006. The Q3 y-o-y RPI growth rate stood at 9.1%; the figure for the preceding quarter was 10.1%. Cumulative RPI growth from the beginning of the year to September amounted to 9.4%.

As with the CPI, such low RPI growth was mainly caused by drops in the prices of agricultural produce, as well as by stable prices of oil products. The former's share in the RPI is about twice as great as in the CPI. As oil prices, and, consequently, oil product prices recorded strong growth over the first half of the year, the RPI grew more quickly than the CPI.

Table T5-7. Serbia: Retail Price Index, 2006-2009

	Retail Price Index				
	base index (avg. 2005 =100)	y-o-y growth	cumulative index	monthly growth	3m moving average, annualized
2006					
Dec	114.7	6.6	6.6	0.1	2.1
2007					
Mar	116.1	5.6	1.2	0.8	5.1
Jun	119.5	5.1	4.2	0.6	12.0
Sep	122.6	7.4	6.9	0.8	10.9
Dec	126.3	10.1	10.1	1.3	12.6
2008					
Mar	129.8	11.8	2.8	1.2	11.6
Jun	134.0	12.1	6.1	1.0	13.4
Sep	134.8	9.9	6.7	0.2	2.4
Dec	134.8	6.8	6.7	-1.0	0.2
2009					
Jan	138.8	8.9	3.0	3.0	7.9
Feb	142.0	10.7	5.3	2.3	18.6
Mar	142.7	9.9	5.8	0.5	25.6
Apr	144.3	10.0	7.0	1.1	16.7
May	146.4	10.4	8.6	1.5	13.1
Jun	147.1	9.8	9.1	0.4	13.0
Jul	146.8	9.5	8.9	-0.2	7.3
Aug	147.0	9.3	9.0	0.1	1.5
Sep	147.4	9.4	9.4	0.3	1.0
Oct	147.3	8.0	9.2	-0.1	1.1
Nov	148.7	9.2	10.3	1.0	4.8

Source: SORS.

*…while October and November data confirm that a slowdown in the inflation trend is imminent*

October and November data confirm that a slowdown in RPI growth is imminent. Prices measured by this index in October were lower by 0.1% than in September. On the other hand, overall inflation in November was relatively high, standing at 1.0%. However, all of this growth was the product of increases in the prices of agricultural produce (under the influence of seasonal factors) and oil products (affected by global oil prices as an exogenous factor). When these products are excluded, we can conclude that the underlying inflation trend remained exceptionally low in November. Overall inflation at year-end, as measured using the Retail Price Index, will thus probably stand at between 10% and 11%, although inflation had, after major price increases in the first half of the year, seemed set to significantly exceed the psychological barrier of 10%.
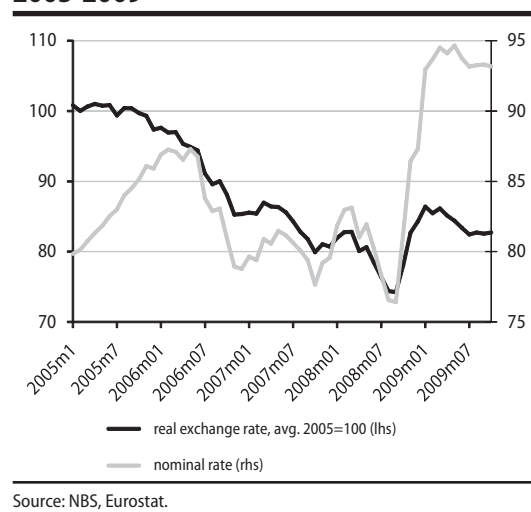
Exchange Rate

The nominal dinar/euro exchange rate was very stable in Q3…

The nominal dinar/euro exchange rate was very stable in Q3, remaining within a very narrow band of around 93 dinars to €1. When the entire quarter is observed, it is seen that the dinar was at its weakest on 1 July, when the exchange rate amounted to 93.6463 to €1, and at its strongest a mere eight days later, standing at 92.4259 to €1. The exchange rate fluctuated within this narrow band over the rest of the quarter (Graph T5-8). Similar movements continued throughout October, with the Serbian currency losing some slight ground to the euro in November. As in the preceding quarter, neither Q3 as a whole nor October or November saw virtually any intervention on the part of the NBS in the foreign currency market. In view of balance of payments data, particularly the very low current account deficit and a mild surplus of the total balance of payments,[2] we can expect no major changes in the foreign currency exchange rate by the end of the year.

Graph T5-8. Serbia: Daily RSD/EUR Exchange Rate, 2008-2009

Source: NBS, Eurostat.
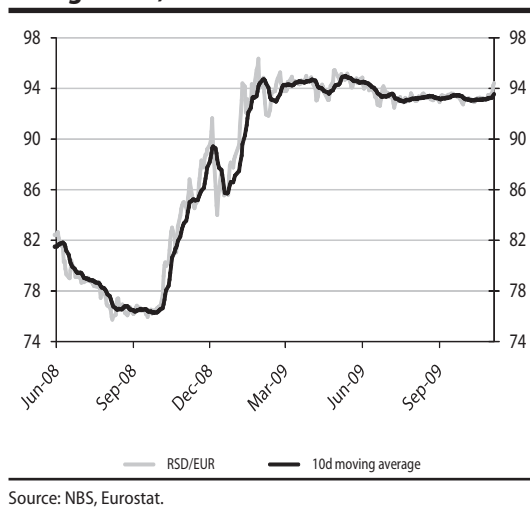
Graph T5-9. Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly Average, 2005-2009

Source: NBS, Eurostat.

…while the real exchange rate continued to appreciate

The real exchange rate, however, continued to appreciate. The real appreciation of the dinar against the euro amounted to 1% in Q3 (Graph T5-9). In relation to January (when the real exchange rate was at its weakest since the crisis began), real appreciation amounted to 4.4%.

In relation to September 2008 (the month the crisis began), real depreciation now stands at 11.2%. By way of a reminder, real depreciation amounted to a relatively substantial 16.3% from September 2008 to January 2009, but the real exchange rate has now gained strength, primarily due to the stability of the nominal exchange rate. Finally, the real exchange rate against the euro has virtually returned to the level seen in March 2008, the month followed by robust appreciation lasting up to the onset of the crisis (Table T5-10).

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2 For more details, see Section 4, Balance of Payments and Foreign Trade.

Trends

Table T5-10. 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			
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
May	94.6553	114.2	115.5	108.4	84.4	104.7	100.2	1.3640
June	93.7408	113.1	116.8	107.4	83.4	106.3	99.0	1.4027
July	93.1547	112.3	118.9	106.7	82.4	107.9	97.8	1.4081
August	93.2647	112.5	121.8	106.8	82.7	111.2	98.2	1.4258
September	93.2990	112.5	122.1	106.9	82.5	111.2	98.0	1.4554
October	93.1665	112.4	114.6	106.7	82.7	106.0	98.2	1.4822

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.

6. Fiscal Flows and Policy

First relevant positive signals in public finances over the past year were registered for the first time in the course of the third quarter (Q3) of 2009. Seasonally adjusted consolidated public revenues rose for the first time in real terms against the previous quarter since the start of 2008. In Q3 2009, seasonally adjusted public revenues were 5.1% higher than in the previous quarter. Especially positive was that the real growth in public revenues was widely dispersed to include Value Added Tax, income tax and excise duties. However, the real level of public revenues in Q3 of the current year was still 4.2% below the same quarter last year. Seasonally adjusted consolidated public expenditures in Q3 2009 were 1.3% lower against the previous quarter and 0.3% below the same quarter last year. The result of the described movements of the consolidated state revenues and spending, was a deficit of 21.4 billion dinars in Q3 (2.9% of quarterly GDP), while the consolidated fiscal deficit in the first three quarters of the year stood at 76.8 billion dinars (around 3.5% of GDP for the first three quarters). At the end of September 2009, Serbia's total public debt stood at 9.87 billion euros, i.e. around 32% of GDP, which was by around 6.4% of GDP higher compared with the end-2008 level and by 0.6% of GDP higher than in July 2009. Data on Serbia's government revenues and spending in October 2009 indicate continued fiscal improvements. Positive trends in public finances in the course of Q3 of the current year partly reflect some economic recovery and partly result from fiscal policy measures. The economic recovery (whether temporary or lasting) had a dominant impact on public revenue growth, while fiscal policy measures were crucial for the reduction of the real level of public spending.

General Trends and Macroeconomic Implications

For the first time in 2009, seasonally adjusted consolidated revenues posted real growth in Q3 against the previous quarter (5.1%)

Seasonally[1] adjusted public revenues, like the majority of the tax instruments vital for the budget, posted growth in Q3 2009 against the previous quarter. Real revenues from Value Added Tax were 10.9% higher in Q3 against Q2, while revenues from excise duties rose 9.9% in real terms. Seasonally adjusted revenues from the Value Added Tax, in positive correlation with domestic demand and GDP, posted growth in real terms against the previous quarter for the first time since the start of 2008. Although the VAT revenue growth was partially influenced by temporary factors (car re-registration, etc), it is estimated that macroeconomic factors had the key influence, such as (temporary or lasting) recovery of domestic demand. Real growth of revenues from excise duties in Q3 largely resulted from an increase in excise duties on crude oil derivatives this year in May. Real growth in Q3 was also seen for revenues from personal income tax, which rose 2.2% against the previous quarter. Of more important tax instruments in Q3 compared to the previous quarter, revenues from customs duties and social contributions underperformed. A wage freeze has also had a significant impact on real level of revenues from personal income taxes. Seasonally adjusted revenues from customs duties were 9% lower in Q3 against the previous quarter, representing the smallest decline against the previous quarter since the start of 2009. The real level of revenues from social contributions was 1.4% lower in Q4 against the previous quarter. The wage and pension freeze has had an impact on revenues from social contributions.

Year-on-year decline of public revenues in real terms slows down in Q3 to 4.2% (in Q1 and Q2 decline was 12.6% and 13.7% respectively)

The recovery of public revenues in Q3 2009 led to a slowdown in year-on-year decline in public revenues in real terms. Namely, in the course of Q3 2009, public revenues fell by 4.2% in real terms compared with the same period last year, while the decline was double digit (12.6% and 13.7%) in the first two quarters of 2009. The year-on-year decline of revenues in real terms in Q3 was significantly lower than in the first two quarters of this year. Looking at the first three quarters of 2009, consolidated state revenues fell by 10.1% against the same period last year.

Although the seasonally adjusted level of more important public revenues rose in Q3, public revenues (in real terms) were lower in Q3 2009 than in the same quarter last year (except for

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1 Comparisons with previous quarters are always based on seasonally adjusted data.

excise duties). The biggest year-on-year decline in real terms was seen in revenues from customs duties (34.5%) and corporate income tax (25.4%), while year-on-year revenue declines from VAT (5.8%), personal income tax (8.7%) and social contributions (6.1%) were significantly smaller – among other things due to positive trends in Q3. Real revenues from excise duties in Q3 were 18.8% higher than in the same period last year, first of all because of a successive increase in excise duties over the past year. Both non-tax and other tax revenues posted growth in Q3 2009.

The real level of seasonally adjusted consolidated public spending in Q3 was 1.3% lower than in Q2

The real level of seasonally adjusted consolidated public spending in Q3 2009 is 1.3% lower than in the previous quarter. Compared with the previous quarter, the real level of capital public spending (7.2%) and spending on purchases of goods and services (3.8%), fell significantly, while spending on employees fell by 0.5% in real terms. Spending on subsidies (15%) fell significantly in the course of Q3 against the previous quarter, while spending on pensions rose by 1.1%.

Year-on-year decline in consolidated state expenditures in real terms slowed down in Q3 to 0.3%

In the course of Q3 2009, year-on-year declines in consolidated state expenditures in real terms slowed down, with the fall amounting to 0.3% (in Q1 the real decline was 3.4% and in Q2 it was 6.4%). By specific spending categories, the real level of spending on employees and on purchases of goods and services in Q3 is lower compared with year ago levels. However, spending in real terms on subsidies, interest rate repayments and social transfers (dominated by transfers to the Pension fund) – rose in real terms in comparison with the same period last year. As a result of the pension freeze since the start of 2009, year-on-year rates of transfers to the Pension fund continued to slow down in Q3. The year-on-year real rate of growth of transfers to the Pesion fund stood at 6.1% in Q3, which is significantly less compared with the first two quarters of 2009 (15% and 7.7%). The slowdown in year-on-year growth of budget transfers for pensions shows that the pension freeze in the course of 2009 gradually offsets an impact of their excessive growth in the previous year.

Looking at the fist nine months of 2009, real spending fell by a total of 3.4% against the same period 2008. The total amount of the consolidated state spending, in the first three quarters of 2009, is around 2% below the spending levels agreed with the IMF in April. Overall, this can be considered as a significant achievement by the government, if the majority of that reduction did not come as a result of lower public investments.

Due to the continued trend of a steeper decline in public revenues against public spending, the consolidated fiscal deficit in Q3 2009 stood at 21.4 billion dinars (around 2.9% of GDP in Q3).

Table T6-1. Serbia: Consolidated Balance of the General Government Sector[1)], 2005-2009

	2006	2007	2008					2009			
	Q1-Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q1-Q3
I TOTAL REVENUE	865.8	1,000.7	269.4	281.4	283.3	311.8	1,145.9	258.8	267.1	297.0	822.9
II TOTAL EXPENDITURE	-888.4	-1,031.5	-254.0	-295.8	-286.6	-359.3	-1,195.7	-269.6	-304.6	-312.6	-886.7
III "OLD" DEBT REPAYMENT, NET LENDING AND RECAPITALIZATIONS	-10.9	-15.3	-4.4	-5.2	-1.2	0.6	-10.1	-0.9	-6.3	-5.8	-13.1
o/w Net lending [2)]	*-10.9*	-15.3	-4.4	-5.2	-1.2	0.6	-10.1	-0.9	-6.3	-5.8	-13.1
IV TOTAL EXPENDITURE, GFS (II+III)	-899.3	-1,046.8	-258.4	-301.0	-287.8	-358.7	-1,205.8	-270.5	-310.9	-318.4	-899.8
V CONSOLIDATED BALANCE (I+IV), GFS definition[3)]	-33.5	-46.1	11.0	-19.6	-4.4	-46.9	-59.9	-11.7	-43.8	-21.4	-76.8
VI FINANCING (FREN's definition)	119.6	24.2	5.0	-12.2	-1.3	11.4	2.9	28.9	40.2	32.4	101.5
VII ACCOUNT BALANCE CHANGE (V+VI)	86.2	-21.9	16.0	-31.8	-5.7	-35.4	-57.0	17.2	-3.6	11.0	24.6
VIII TOTAL REVENUE/GDP (%)	42.4	41.9	43.5	40.7	40.3	42.7	41.7	39.1	37.0	39.7	38.0
IX TOTAL EXPENDITURE/GDP (%)	(44.0)	(43.7)	(42.2)	(43.5)	(41.1)	(49.7)	(44.3)	(40.8)	(43.1)	(42.5)	(41.6)
X CONSOLIDATED DEFICIT/GDP (%)	(1.6)	(1.9)	(1.3)	(2.8)	(0.8)	(7.0)	(2.5)	(1.8)	(6.1)	(2.9)	(3.5)

Source: Table P-10 in Analytical Appendix.
The General Government – all government levels (the Republic, province, municipalities) and their budget beneficiaries and organizations of mandatory social security (Pension Fund, Health Fund, the National Employment Service). Excludes public companies and NBS
The item corresponds to term "Spending for 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 spending on recapitalizations.
The consolidated balance (cash surplus/deficit according to GFS) represents a difference between current revenues and earnings from the sale of non-financial assets (i.e. capital revenues) and current spending and spending 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 recapitalizations. Thus defined, the resultant measures a liquidity impact of the government transactions on the economy. See methodological discussion in Box 1, Quarterly Monitor No. 3 for detail.
Considering a one-off character of revenues raised from the sale of a 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 movements 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-10 in Analytical Appendix for detail.

Consolidated fiscal deficit in Q1-Q3 stands at 76.8 billion dinars (around 3.5% of GDP in the same period)

The consolidated fiscal deficit in the first three quarters of 2009 stood at 76.8 billion dinars (around 3.5% of GDP in Q1-Q3). The deficit, originally (in April) agreed with the IMF for the first three quarters of 2009 was 58 billion dinars, in line with a deficit target of 90 billion dinars, i.e. around 3% of GDP for the whole of 2009. In line with that, the consolidated deficit of 76.8 billion dinars in the first three quarters of the year is higher than the agreed deficit for that period, by around 18.8 billion dinars (i.e. by around 32% more than originally agreed target). However, it is necessary to mention that the consolidated deficit posted in Q3 (21.4 billion dinars) was by around 18% (4.6 billion dinars) lower than the deficit target for Q3 agreed in April with the IMF. An agreement was reached in August with the IMF to increase the consolidated fiscal gap for 2009 to 4.5% of GDP. The structure of the changed deficit, however, by individual revenue and spending items, will be known only after the government completes a new revised 2009 budget. Due to the seasonality of some spending items in Q4 (particularly in November and December), consolidated fiscal spending usually sees significant expansion. Therefore, it is expected that the consolidated deficit of the state comes higher in Q4 than in Q3, which will lead the full-year deficit to between 100 and 110 billion dinars (3.3 – 3.7% of GDP).

Budget revenues rose significantly in October compared with previous months, leaving the budget deficit of 3.4 billion dinars

In the course of October, there was a significant increase in budget revenues compared with average monthly budget revenues from previous months in 2009. The total budget revenues in real terms in October were 4% below their level in the same period last year. Compared with September 2009, budget revenues of the Republic of Serbia were 5.5 billion dinars higher. The budget revenue increase in October 2009 resulted first of all from a significant increase in VAT revenues in real terms, by 9% against October last year. Seasonally adjusted VAT revenues in October were 10.6% higher than in September 2009 (VAT revenues in October were 9.4 billion dinars higher against the previous month). The strong increase in VAT revenues in October 2009 can partially be explained by a fact that small tax payers, who make quarterly VAT payments, were making their tax payments in October, but also due to an increased VAT collection on domestic sales of goods and services. Considering a modest growth in customs revenues at the same time, one can assume that VAT revenue increase (and customs) could have also resulted from possible imports growth.

Budget expenditures in October 2009 do not significantly deviate from spending volumes in the previous months of the year, while they were 2% lower in real terms compared with the same period last year. Due to a significant revenue increase accompanied by relatively unchanged spending levels, the budget deficit of the Republic of Serbia stood at around 3.4 billion dinars, which is significantly lower compared with an average deficit level from previous months (the average monthly budget deficit of the Republic in the period January-September 2009 stood at 9.3 billion dinars). The described movements of revenues and spending of the Republic's budget in October 2009 point to a further fiscal stabilization and improvement. However, it is still unclear if those positive trends will continue in the coming period.

Box 1. Seasonal Adjustment of Time Series

For the majority of fiscal time series, a strong impact of seasonal factors can blur their long-term trends. Thus, real consolidated public spending in Q4 is by 18-20% above average quarterly levels throughout the year. Similarly, the real level of public revenues in Q4 is by around 10% higher than the average quarterly levels throughout the year, while VAT revenues in Q4 are by around 8% above their average quarterly levels throughout the year. A deviation from the average levels for selected time series by quarters, due to seasonal factors' effects, is shown in the following graph.

Based on seasonally adjusted series, it is possible to measure the more recent long-term trends in movements of the time series more precisely, than based on year-on-year growth rates. Seasonally adjusted time series allow us to compare movements in a particular quarter against previous quarters of the same year and not only against the same quarter of the previous year.

Graph T6-2. Serbia: the Seasonal Component in Selected Time Series
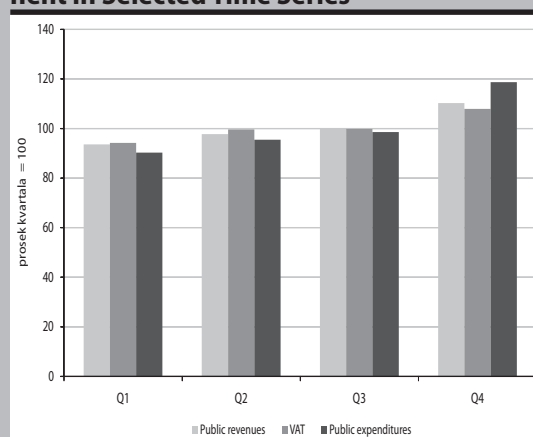
Source: Calculated by the author.

Therefore, starting from this issue of QM, we will analyse the movements of seasonally adjusted time series along with year-on-year growth rates of fiscal series. A TRAMO-SEATS procedure has been used to conduct the seasonal adjustment. Details of the procedure are described in the paper of Catherine Hude and associates "An Empirical Evaluation of the Performance of TRAMO/SEATS on Simulated Series" available on http://www.census.gov/ts/papers/asa00ts.pdf.

An Analysis of Individual Tax Forms and Individual Public Spending

A seasonally adjusted level of the majority of significant tax forms rose in Q3 compared with the previous quarter. The biggest increase was posted within the taxation on consumption – VAT and excise duties. In the case of VAT, this was the first positive growth rate since the start of 2008, while excise duties have been the only tax instrument, which has posted real growth from one quarter to another, starting from Q3 2008 due to an increase in tax rates. Seasonally adjusted revenues from personal income tax posted a moderate growth in Q3, following two quarters of consecutive declines. Revenues from customs duties continue their declining trend, which started in Q3 2008, first as a result of falling import volumes and then as a result of lowering of customs duties on imports originating from the EU. Seasonally adjusted revenues from social contributions in real terms have continued to decline relatively moderately since Q4 2008.

Table T6-3. Serbia: Seasonally Adjusted Quarterly Indices of the Real Level of Tax Revenues (previous quarter = 100)

	Public revenues	Tax revenues	Personal income tax	VAT	Excise duties	Customs duties	Social security contributions
Q2 2008	98.6	98.7	103.6	97.1	92.8	100.2	99.6
Q3 2008	96.6	97.4	100.2	94.5	100.4	93.4	100.5
Q4 2008	98.9	98.4	102.3	96.3	101.4	90.7	99
Q1 2009	93.9	95.1	88.2	98.7	104.1	86.1	96.9
Q2 2009	97.5	96.3	99.1	89.4	102.0	88.9	99.0
Q3 2009	105.1	104.7	102.2	110.9	109.9	91	98.6

Source: Calculated by the author.

In the course of Q3, seasonally adjusted revenues from VAT and excise duties rose in real terms against Q2…

…while revenues from customs duties continued to decline

In the course of Q3 2009, year-on-year declines in real terms for the majority of forms of public revenues slowed down. Thus, revenues from VAT were 5.8% lower against Q3 2008, while in the previous two quarters of 2009 the year-on-year decline stood at 13.6% and 19.9% respectively. At the same time, revenues from customs duties in Q3 are still significantly below their level in the same period last year, with year-on-year decline at 34.5%. Those figures show that positive developments in Q3 were insufficient to make up for negative trends in the previous three quarters. In the course of Q3 2009, real growth rates for revenues from excise duties accelerated (18.8% against Q3 2008). The strong real growth of revenues from excise duties in Q3 results from an increase in excise duties (in May), the impact of which came into full effect as of June, as well as from an improved collection of excise duties and a seasonal increase in consumption of goods subject to excise duties during summer months.

Seasonally adjusted revenues from personal income tax rose modestly against the previous quarter…

In the course of July-September 2009, a trend of real decline in revenues from taxes on production factors continued. Revenues from personal income tax fell by 8.7% in real terms against Q3 2008, which is a slightly more moderate decline compared with the two previous quarters. At the same time, the decline in real revenues from social contributions widened to 6.1 percent year-on-year (from 4.1% and 4.5% respectively in the first two quarters of 2009). The collected revenues from income tax were 9% lower and revenues from social contributions were 1% below plan for Q3 (agreed with the IMF in April).

…while revenues from social contributions fell moderately

In the course of Q3, the trend of a steep decline in corporate income tax revenues continued. During Q3, revenues from corporate income tax were 25.4% lower in real terms against the same period 2008. In line with that, the volume of revenues from the corporate income tax was 24% below plan. The continued decline in corporate income tax revenues remained under the influence of the same factors that existed in the previous two quarters: weaker fiscal discipline, declining liquidity of the corporate sector in 2009 and lower profitability shown for 2008 against 2007.

In the course of Q3, seasonally adjusted consolidated revenues fall in real terms compared with Q2, led by capital spending, spending on purchases of goods and services and spending on employees…

In the course of Q3, seasonally adjusted levels of the majority of spending items fell compared with the previous quarter. The most significant declines were registered for capital spending and spending on purchases of goods and services. The real level of spending on employees posted just a slight decline, while spending on pensions rose by around 1.1% in Q3 against Q2. Spending on subsidies, which have shown high irregularity by months and quarters within the existing annual limits, significantly rose in Q3. It is estimated that the increased spending on subsidies stemmed from an improved liquidity of the budget in Q3 2009.

Table T6-4. Serbia: Seasonally Adjusted Quarterly Indexes of the Real Level of Public Spending (previous quarter = 100)

	Public expenditures	Wages and salaries	Expenditures on goods and services	Subsidies	Pensions	Capital expenditures
Q2 2008	106,7	104,7	103,9	124,3	105,5	127,1
Q3 2008	92,5	97,6	97,3	58,1	102,7	90,1
Q4 2008	102,9	99,7	97,5	133,8	104,8	94,6
Q1 2009	94,9	94,2	99,8	78,2	101,3	77,3
Q2 2009	103,4	101,3	101,1	99,4	98,8	109,7
Q3 2009	98,7	99,4	96,2	115,1	101,1	92,7

Source: Calculated by the author.

The real decline in consolidated state spending in Q3 2009 of 0.3% against Q3 2008 – resulted from a significant reduction in real spending on employees, spending on purchases of goods and services, capital spending and other current spending items. At the same time, spending on subsidies and social transfers rose in real terms.

The freeze of nominal wages in the public sector and a cut in administration workers' wages of above 40,000 dinars, as well as a decision to cut down part-time and temporary work in the public sector, led to a further decline in spending on employees by 5.3% in real terms. Spending on employees in the course of Q3 was around 5% below plan (agreed with the IMF in April).

Spending on purchases of goods and services in Q3 2009 was 6.5% lower in real terms against Q3 2008. At the same time, spending on purchases of goods and services in Q3 – was 11% below plan. Those results show that the government postponed purchases of goods and services non-essential for the continued functioning of the public sector.

…while seasonally adjusted spending on subsidies and pensions rose in real terms against the previous quarter

Spending on subsidies in Q3 2009 rose by 22.9% in real terms against Q3 2008. The total spending on subsidies in Q3 was 17% above plan (agreed with the IMF in April). The high real growth in total spending on subsidies mainly resulted from spending on subsidies for agriculture in Q3, as well as due to the fact that payments of subsidies in the previous quarters had been postponed (real decline in Q1 stood at 24.7% and in Q2 2009 against the same period 2008 the decline was 39.8% in real terms).

In the course of Q3 2009, the trend of expanding social transfers continued, both against the same period last year and against the previous two quarters of 2009. Social transfers rose by 5.7%

in real terms in Q3 2009 against Q3 2008. Spending on pensions, which represents the single largest share of social transfers, posted a 6.6% growth in real terms in Q3 against the same period last year. The decision to freeze nominal pensions throughout 2009 has meant their slower pace of growth in real terms (spending on pensions in Q1 rose by 15% in real terms, while in Q2 it rose by 7% against respective periods in 2008). The total volume of social transfers in Q3 was by 1% above plan, with spending on pensions remaining within the plan.

A possibility to postpone capital spending, coupled with a lack of technical preconditions for big infrastructure projects (failure to prepare project documentation, unresolved ownership issues, etc.) – led to a significant decline in those spending items in real terms in Q3 2009 of 20.4% against Q3 2008 (i.e. 22% against plan). Even though capital spending still represents the spending category to have suffered steepest declines in real terms, it is necessary to note that the decline modestly slowed down in the course of Q3. Thus, capital spending in Q3 was by 16.9% above the capital spending in Q2 2009.

Table T6-5. Serbia: Consolidated Balance of the General Government Sector[1], 2006-2009

	2006	2007			2008				2009			2006	2007			2008				2009		comparing to previous period
	Q1-Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3		Q1-Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q1 - Q3	Q3/Q2
	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	268.1	822.9	6.8	8.4	7.6	5.2	2.8	-0.7	3.4	-12.6	-13.4	-4.2	-10.1	10.4
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	268.1	822.9	8.9	9.1	8.3	6.5	3.3	-0.6	4.0	-12.6	-13.4	-4.2	-10.1	10.4
1. Current revenues	855.5	995.4	268.9	280.3	282.6	311.3	1,143.1	258.3	267.2	820.8	6.7	7.9	7.7	5.0	3.7	0.1	3.7	-12.6	-13.4	-4.2	-10.1	10.5
Tax revenue	756.0	870.0	234.4	247.4	248.3	270.2	1,000.4	229.8	237.5	723.8	5.4	8.0	7.6	5.2	3.6	0.1	3.9	-10.8	-12.8	-5.4	-9.7	7.6
Personal income taxes	118.6	115.8	29.7	34.1	33.6	39.0	136.5	30.9	33.5	97.9	11.9	-8.4	7.1	8.1	4.5	6.5	6.5	-5.3	-10.8	-8.7	-8.4	-0.4
Corporate income taxes	18.3	29.7	15.0	8.1	7.4	8.5	39.0	12.8	5.6	24.5	58.0	52.1	15.2	30.0	45.3	-0.2	18.7	-22.2	-37.2	-25.4	-27.0	6.9
VAT and retail sales tax	225.1	265.5	73.2	77.0	73.8	77.7	301.7	69.4	67.9	213.4	-7.3	10.6	8.7	5.7	-0.3	-2.3	2.7	-13.6	-19.9	-5.8	-13.2	11.3
o/w: Net VAT and retail sales tax[4]	224.5	260.5	73.2	77.0	73.8	77.7	301.7	69.4	67.9	213.4	0.3	8.8	11.3	10.3	1.3	-2.3	4.7	-13.6	-19.9	-5.8	-13.2	11.3
Excises	86.9	98.6	23.7	26.6	29.5	30.3	110.1	24.4	30.7	93.5	8.3	6.5	5.7	-1.5	2.4	-1.7	0.9	-6.2	4.9	18.8	6.7	24.3
Custom duties	45.4	57.4	14.8	16.9	16.3	16.8	64.8	11.5	11.7	34.8	3.9	18.6	10.5	8.8	0.9	-8.7	2.0	-29.4	-37.4	-34.5	-33.9	-0.8
Social contributions	231.4	270.3	69.7	75.9	78.7	88.5	312.7	73.4	80.1	234.0	12.5	9.6	6.9	4.4	5.2	2.5	4.5	-4.1	-16.7	-6.1	-4.9	0.8
o/w: contributions excluding offsets with SDF[5]	221.9	269.8	69.7	75.9	78.7	88.5	312.7	73.4	80.1	234.0	11.3	14.1	7.0	4.6	5.2	2.8	4.7	-4.1	-4.1	-6.1	-4.9	0.8
Other taxes	30.3	32.8	8.4	8.8	8.8	9.5	35.6	7.4	8.1	25.7	11.1	1.7	-4.5	-5.8	4.0	-1.6	-2.1	-20.5	-4.1	6.1	-10.3	26.0
Non-tax revenue	109.6	125.4	34.4	32.9	34.3	41.1	142.7	28.5	29.7	97.0	17.1	7.4	8.5	3.3	4.5	-2.7	2.8	-24.6	-17.9	4.7	-13.1	34.0
2. Capital revenues	0.3	5.3	0.3	0.5	0.3	0.2	1.4	0.3	0.5	0.8	56.3	1,703.2	-55.6	81.3	-89.6	-87.7	-76.8	-20.3	-1.6	-89.8	-33.0	-93.6
II TOTAL EXPENDITURE	-888.4	-1,031.5	-254.0	-295.8	-286.6	-359.3	-1,195.7	-269.6	-306.1	-886.7	13.7	8.9	2.4	20.1	1.8	-1.4	4.7	-3.4	-6.0	-0.3	-3.4	1.9
1. Current expenditures	-807.0	-919.5	-242.0	-272.7	-260.5	-314.4	-1,089.6	-254.4	-286.8	-834.5	10.6	6.9	6.9	19.5	2.3	7.1	4.3	-4.4	1.7	-1.9	0.9
Wages and salaries	-204.4	-238.3	-66.5	-74.0	-71.3	-81.4	-293.2	-70.3	-73.0	-219.8	7.0	9.4	12.7	15.0	9.2	8.5	11.1	-3.8	-10.3	-5.3	-5.5	-3.1
Expenditure on goods and services	-135.9	-168.1	-34.0	-44.2	-45.2	-57.9	-181.2	-31.1	-50.5	-129.2	12.9	16.1	0.8	8.1	-1.3	-11.4	-2.6	-16.8	4.0	-6.5	-4.5	-2.8
Interest payment	-30.2	-17.9	-6.0	-2.6	-5.1	-3.4	-17.2	-5.8	-4.5	-17.4	52.6	-44.4	-12.2	-31.4	-3.1	-10.6	-13.2	-13.4	55.9	28.8	15.4	55.7
Subsidies	-55.6	-63.7	-13.3	-22.2	-13.9	-28.3	-77.8	-11.0	-14.7	-44.5	-10.0	7.6	27.5	88.2	-29.7	0.5	10.3	-24.7	-39.8	22.9	-18.1	26.5
Social transfers	-360.4	-409.3	-117.9	-122.4	-120.4	-136.0	-496.8	-132.8	-139.1	-411.2	13.7	6.5	6.0	19.0	6.8	8.1	9.7	2.5	3.3	5.7	3.8	-0.6
o/w: pensions[6]	-227.7	-259.9	-74.8	-81.5	-83.6	-91.1	-331.0	-94.5	-96.6	-288.2	11.1	7.1	8.5	14.9	16.4	20.1	15.1	15.0	7.7	6.1	9.4	-0.2
Other current expenditures	-20.5	-22.1	-4.2	-7.3	-4.6	-7.3	-23.5	-3.4	-4.9	-12.3	2.9	1.1	-15.7	62.5	-18.9	-20.6	-4.1	-25.8	-39.6	-6.4	-30.6	14.0
2. Capital expenditures[7]	-81.3	-112.1	-12.0	-23.1	-26.1	-44.9	-106.0	-15.1	-19.2	-52.2	57.7	29.3	-44.5	28.1	-3.2	-21.0	-14.5	14.7	-24.2	-20.4	-22.1	16.9
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	-6.3	-13.1	47.6	-53.9	346.3	338.0	-83.8	-108.6	-40.3	-88.6	10.3	97.1	-21.9	-8.0
IV TOTAL EXPENDITURE, GFS (II+III)	-899.3	-1,046.8	-258.4	-301.0	-287.8	-358.7	-1,205.8	-270.5	-312.4	-899.8	13.0	9.2	3.8	21.7	-0.4	-3.5	4.1	-5.8	-5.7	0.6	-3.7	1.7

Source: Table P-10 in Analytical Appendix.
See footnote 1) in Table T6-1.
Sales tax/VAT less new tax credits of the corporate sector.
Contributions less compensations conducted between the Pension fund, the Development Fund and companies which owe to PIO Fund.
FREN estimate. See table P-10 in Analytical Appendix for explanation.
Refers only to spending on current pensions.
Capital spending excludes projects financed from foreign sources (except in 2004, See footnote 16 in Table P-10).
The item corresponds to term "Spending on the purchase of financial assets" in PFB, i.e. "net lending" item in the IMF presentation. Those are credits to students, financing of the National Corporation for Housing Loan Insurance, racapitalizations, etc.
Note: To calculate real growth, an average base index of retail prices was implemented (base December 2003) on quarterly figures.

Public Debt Analysis

Serbia's public debt stood at 9.87 billion euros at the end of Q3, or 170 million euros more than at the end of July

The total public debt of the Republic of Serbia as at September 30, 2009 (according to the Ministry of Finance figures) stood at 9.87 billion euros, or 1.1 billion euros more than at the end of 2008 and by 170 million euros higher than at the end of July 2009. At the same time, the public debt-to-GDP ratio rose to 32% of GDP.

Of the mentioned 9.87 billion euros in total public debt – direct liabilities account for 8.5 billion euros and indirect liabilities for the remaining 1.37 billion euros. Compared with the outstanding debt as at July 31, 2009, there was no significant increase in direct liabilities, while indirect liabilities rose by around 170 million euros.

Net liabilities of the government based on issued Treasury bills stood at 75 billion dinars at the end of Q3

Even though the government continued to issue Treasury bills in the course of Q3, it is obvious that the funds raised were mostly spent on servicing previously issued Treasury bills, thus leading to no significant increase in the government's direct liabilities. The total (net) liabilities of the government based on issued Treasury bills stood at 75 billion dinars at the end of September. Most of the mentioned liabilities refer to three-month Treasury bill issues.

Table 6-6. Serbia: Public Debt, 2000-2009

	31.12.2000.	31.12.2005.	31.12.2006.	31.12.2007.	31.12.2008.	31.03.2009.	31.07.2009.	9/30/2009
				in billions of EUR				
I. Total direct debt	14.2	9.6	8.6	8.0	7.9	8.0	8.5	8.5
Domestic debt	4.1	4.3	3.8	3.4	3.2	3.2	3.7	3.8
Foreign debt	10.1	5.4	4.7	4.6	4.7	4.8	4.8	4.7
II. Indirect debt	-	0.66	0.80	0.85	0.93	0.96	1.2	1.4
III. Total debt (I+II)	**14.2**	**10.3**	**9.4**	**8.9**	**8.78**	**8.93**	**9.70**	**9.87**
Public debt / GDP	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.9%**	**28.9%**	**31,4%[1]**	**32.0%**

Source: The Ministry of Finance of the Republic of Serbia.
The Ministry of Finance GDP estimates for 2009 were used to calculate the share of the public debt in Serbia's GDP, as of September 30, 2009.

Even though Serbia ranks among moderately indebted countries, it is necessary to note that its public debt-to-GDP ratio rose by 6.4% against the end of 2008. The already contracted and future sovereign borrowings from international financial institutions and foreign states and organizations (China, the Russian Federation, the EU) for the completion of major infrastructure projects and to cover the budget deficit could lead to a significant increase in the public debt-to-GDP ratio of the country (by around 7-10% of GDP). This should be increased by likely government liabilities to compensate for nationalized property, raising Serbia's public debt to 40-45% of GDP, estimated to be the upper sustainability limit.

Considering the present level of the public debt, as well as the volumes of contracted borrowing for investment projects, it is vital to remain cautious about any additional state borrowing. Besides, it is necessary to apply a standard economic analysis (cost-benefit analysis) prior to deciding whether an implementation of a certain infrastructure project is justified. Considering the limitations of tax revenues, as well as a narrow space for additional government borrowing, a rigorous selection should ensure the implementation of the most important projects from a potentially vast number of necessary projects.

Trends

7. Monetary Flows and Policy

In the course of Q3, the M2 growth in real terms slowed down to 0.9% year-on-year. Such a low growth rate is mostly owed to a negative year-on-year growth of credit to the non-government sector, which for the first time includes a negative rate of credit growth to the corporate sector of – 1.3% year-on-year. The share of non-performing loans fell to 11.2 % in Q3 (while it was 12.1 % in Q2), which together with positive results of stress tests, conducted by NBS in the course of summer, eases concerns over the stability of the banking sector. In the course of Q3, deposits continued to grow, with corporate deposits rising by 73 million euros and household deposits by 281 million euros. In contrast to previous quarters, banks expanded their foreign liabilities by 744 million euros in Q3. However, the majority of collected funds, banks placed in REPOs, a total of 438 million euros (216 million euros in Q2), even though the central bank lowered its benchmark interest rate to 12% in July. Lending to corporate and household clients rose by 315 million euros in Q3 (in Q2 the growth of the lending was 158 million euros). Together with repayments of foreign loans by companies worth 244 million euros, that leaves a total net growth of credit to corporate and household clients of 71 million euros (in Q2 it was -10 million euros). The policy of banks to invest excess liquidity in REPOs since the start of the year has dominantly led to a decline of reserve money, which continued in Q3, amounting to 7.43 % of the initial H. The fall of the reserve money in Q3 resulted from declining NDA by 21% of initial H, which offset a positive contribution of the growth in NBS net own reserves by 16.3% of initial H. Net own reserves rose by 450 million euros in Q3 (in Q2 they fell by 70 million euros), mainly due to the International Monetary Fund's decision to transfer to Serbia 425 million euros worth of special drawing rights, as part of its wider SDR allocation to all member states.

Monetary System: Money Supply Structure and Flows

Real M2 growth slows in Q3...

...due to falling year-on-year growth of credit to corporates and households

In the course of Q3, real year-on-year growth of M2 slows to 0.9% (Table T7-2) following a modest growth of 2.1%[1] in Q2. The trend of slowing credit growth to the non-government sector – visible since the outbreak of the global financial crisis in Q2 2008 – transformed into a 2.8 percent decline in Q3 when adjusted for exchange rate changes[2]. The negative rate of credit growth to the non-government sector, resulting from falling credit to households since the start of the year, continued in Q3 to stand at -5.8 % year-on-year (-8.6% in Q2). Beside declining credit to households, credit to the corporate sector fell for the first time since we have comparable data, following slower growth rates, the fall amounting to -1.3% year-on-year (9% growth in Q2).

Graph T7-1. Serbia: Money and its Components[1], 2004-2009
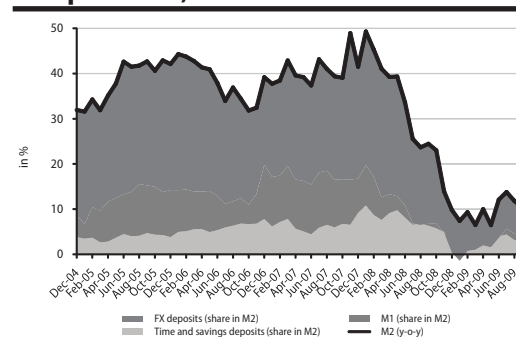
Source: Table P-12 in Analytical Appendix.
1) The share of money components has been calculated as their contribution to growth against the value of M2 versus the same period in the previous year, with the sum of calculated share equivalent to 12-month growth of total money (M2).

An analysis of individual elements in the M2 structure (Graph T7-1) shows that almost a year later M1 again gives a positive contribution of 0.92% to overall growth in Q3 (-0.24% in Q2). Savings and time deposits continued to give a positive contribution in Q3 despite a slight slowdown of growth, 2.83% in Q3 (3.97% in Q2). Hard currency deposits, which still give the biggest contribution to overall M2 growth, also experienced a similar slowdown in growth in Q3 to 6.61% (8.36% in Q2).

1 A negative year-on-year growth rate of real M2 in Q1, registered for the fist time since those figures are comparable -- 2002, preceeded this growth.
2 In our methodology, growth rate adjustment takes into account exchange rate changes (we assume that at least 70% of all granted credits carry an exchange rate link).

Money supply posts nominal 2.6% growth in Q3…

…accompanied by modestly declining NDA…

…and NFA posts 3.2% growth

The total Q3 net growth in money supply stood at 2.6% of M2 at the start of the year (cumulative growth in Q3 less growth in Q2, Table T7-2). The money supply growth mainly resulted from an expansion in net foreign assets (NFA) of 3,2% in Q3, while net domestic assets (NDA) had a negative contribution with a cumulative decline in Q3 of 0.5% of M2 at the start of the year (in Q2 growth of 6.4%). The total NFA growth was based on hard currency denominated growth of NFA by 3.2% of M2 at the start of the year (in Q2 cumulative fall of 1.8% of M2 at the start of the year), while the exchange rate was stable in Q3, so that exchange rate differentials had no impact on NFA. A growth of net credits to the state by 2% of M2 at the start of the year, as well as credit growth to non-government sector by 3.2% of M2 at the start of the year, gave a positive contribution to overall NDA growth. However, the capital increase in the monetary sector, which continued to make a negative contribution of -4.4% of M2 at the start of the year, had an impact on the final NDA size (-6.2% in Q2).

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

	2007				2008				2009		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
					y-o-y, in%						
M2[1]	42.9	37.4	39.4	41.5	41.0	33.7	24.5	9.8	6.5	12.1	10.4
Credit to the non-government sector[2]	21.6	23.9	28.0	38.3	36.4	30.3	29.4	33.7	33.8	27.7	22.3
Credit to the non-government sector[2], adjusted [3]	26.3	30.2	31.2	38.4	35.3	30.7	32.2	23.6	20.9	13.9	7.7
Households	58.4	54.7	53.6	50.6	43.3	35.5	19.5	15.7	7.4	1.5	4.4
Enterprises	14.2	20.2	21.1	32.2	31.0	28.1	39.5	28.1	28.8	20.9	9.3
					real y-o-y, in %						
M2[1]	35.3	30.7	29.7	28.6	26.2	19.2	12.2	2.9	-3.2	2.1	0.9
Credit to the non-government sector[2]	15.2	17.8	19.1	25.6	22.0	16.2	16.6	25.2	21.7	16.4	11.8
Credit to the non-government sector[2], adjusted[3]	19.8	24.1	22.2	25.6	21.1	16.4	19.0	15.7	9.4	2.7	-2.8
Households	50.1	47.4	43.1	36.7	28.2	20.7	7.6	8.3	-2.8	-8.6	-5.8
Enterprises	8.3	14.5	12.8	20.1	17.3	14.1	25.6	19.9	16.5	9.0	-1.3
					cumulative, in % of opening M2[4]						
M2[1]	5.9	11.0	23.9	41.5	5.5	4.8	9.0	9.8	2.3	7.0	9.5
M2 dinar[1]	-0.1	0.8	6.8	16.8	-2.5	-2.7	-1.1	0.5	-1.9	0.6	2.2
Foreign deposits (households and enterprises)[5]	4.0	10.1	17.3	24.5	5.6	7.7	12.5	2.3	-0.1	2.9	4.1
Valuation adjustments[6]	1.9	0.0	-0.1	0.2	2.4	-0.2	-2.3	7.0	4.4	3.4	3.2
NFA, dinar increase	5.2	12.0	14.5	24.4	3.6	-3.2	-3.0	-8.8	2.2	0.4	3.6
NFA, fx increase	3.1	12.0	14.7	24.2	1.2	-3.0	-1.0	-14.5	-1.1	-2.1	1.1
Valuation adjustments[6]	2.2	0.0	-0.1	0.3	2.5	-0.2	-2.0	5.7	3.3	2.5	2.5
NDA	0.6	-1.1	9.4	17.1	1.9	8.0	12.0	18.7	0.2	6.6	6.0
o/w: credit to the non-government sector[2], adjusted[3]	6.6	19.6	28.3	36.6	4.8	12.8	22.2	22.0	3.6	5.1	8.3
o/w: net credit to government[7]	-4.1	-7.7	-7.0	-1.9	-0.6	1.0	1.9	7.0	-2.0	4.1	6.1
o/w: NBS and com. banks capital and reserves	-2.2	-7.4	-11.6	-17.9	-3.5	-4.6	-6.3	-16.4	0.7	-5.5	-9.9
					cumulative, in % of GDP[8]						
Net credit to government[7]	-1.3	-2.1	-1.9	-0.5	-0.3	0.3	0.7	2.2	-0.9	1.4	2.1
o/w: dinar credits	-1.2	-2.3	-2.1	-1.1	-0.8	-1.3	-1.0	0.8	-0.5	1.7	2.4
Credit to the non-government sector[2], adjusted[3]	2.6	5.4	7.7	9.8	2.7	4.4	6.6	10.7	3.4	3.5	4.3

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

The share of non-performing loans fell to 11.2% in Q3…

…but still remains above customary levels

An increased share of non-performing loans in the total amount of approved credits, visible since the start of the year, fell to 11.2% [3] in Q3 (in Q1 the share stood at 9.1%; in Q2 the share stood at 12.1%, Table T7-3). Data issued by the Credit Bureau for July and August, showed an even more significant decline (the share of non-performing loans falling to 10.8%), but it rose back again in September, mainly due to an expanding share of non-performing loans in the corporate sector (13.2%). The share of credit with repayment delayed for more than 90 days in October stood at around 11%, representing a modest decline in the share of non-performing loans against Q3 readings, but still insufficient to fall down to a 10% barrier, beyond which individual banks, which have large amounts of non-performing loans could face a loss of their own capital.

3 The share of non-performing loans in the total amount of granted loans for the current quarter is derived from data from the last month of the observed quarter.

The money multiplier continues the trend of gradual increase since the start of the year, rising to 1.8 in Q3 (in Q2 it stood at 1.6, in Q1 at 1.4, Table T7-3). Still, this level is below the last year's average of 2.2. A weak growth of lending to corporate and retail clients is one of the key reasons for the low level of the multiplier. Expanded investments in REPOs by commercial banks, despite the fact that NBS lowered its benchmark interest rate, still continue to give a negative contribution to the multiplier. The share of hard currency deposits of corporate and retail clients against M2 in Q3 stood at 61.6%, representing a slight decrease against Q2, when it stood at 62.2%.

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

	2007				2008				2009		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
STOCK					in millions of dinars, end of period						
NFA	441,048	484,388	500,302	563,524	596,215	534,403	536,102	483,707	504,072	486,784	517,908
o/w: NBS gross reserves	719,381	730,668	751,920	765,615	788,296	720,967	745,070	724,755	772,902	832,817	888,389
o/w: commercial bank foreign liabilities	-318,598	-286,848	-290,860	-299,659	-264,865	-251,182	-279,131	-349,703	-345,733	-351,420	-419,017
NDA	234,991	224,279	291,193	340,174	357,307	412,802	448,498	508,826	511,535	575,119	569,336
Net credit to government [1]	-128,909	-149,081	-144,385	-112,290	-120,644	-103,539	-94,156	-53,042	-76,033	-14,887	4,838
Net dinar credit	-35,782	-62,290	-56,369	-34,251	-53,126	-67,826	-60,934	-14,199	-27,201	31,692	52,467
Net fx credit	-93,127	-86,791	-88,016	-78,039	-67,518	-35,713	-33,222	-38,843	-48,832	-46,579	-47,629
Credit to the non-government sector [2]	666,007	732,402	786,873	842,512	908,598	953,977	1,018,307	1,126,111	1,215,843	1,218,702	1,245,735
Other items, net	-302,107	-359,042	-351,295	-390,048	-430,647	-437,636	-475,653	-564,243	-628,275	-628,696	-681,237
M2 [3]	676,039	708,667	791495	903,698	953,522	947,205	985,134	992,533	1,015,607	1,061,903	1,087,244
M2 dinar [3]	282,299	288,329	326,341	390,307	367,648	365,834	380,015	395,088	378,094	401,120	416,996
Fx deposits (households and economy)	393,740	420,338	465,154	513,391	585,874	581,371	605,119	597,445	637,513	660,783	670,248
STRUCTURAL INDICATORS											
Currency outside banks/Dinar deposits (households and economy), in %	26.2	29.1	25.1	24.6	23.7	23.5	23.2	29.5	26.0	25.3	24.8
Fx deposits (households and economy) / M2 (%)	58.2	59.3	58.8	56.8	61.4	61.4	61.4	60.2	62.8	62.2	61.6
Velocity (GDP [4] / M2)	3.3	3.2	2.9	2.6	2.6	2.7	2.7	2.7	2.6	2.5	2.6
M2 / GDP [4]	0.31	0.3	0.3	0.38	0.39	0.37	0.37	0.38	0.4	0.4	0.4
Credits to the non-government sector / GDP [4]	0.30	0.32	0.34	0.35	0.37	0.37	0.38	0.43	0.5	0.5	0.4
Non-perofrming loans [5] (in % of total loans)	4.9	4.69	5.20	5.1	4.4	5.3	6.0	5.8	9.1	12.1	11.2
Money multiplier (dinar M2/H)	2.4	2.0	2.3	2.3	2.6	2.0	2.3	1.2	1.4	1.6	1.8

Source: Table P-13 in Analytical Appendix.
1) See footnote 7) in table T7-2.
2) See footnote 2) in table T7-2.
3) Money supply: components – see QM Analytical and Notation Conventions.
4) See footnote 8) in table T7-2.
5) 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

Lending rises in Q3...

The banking sector increased lending to corporate and household clients by 315 million euros in Q3 (158 million euros in Q2, Table T7-4). Around 235 million euros worth of new credits[4] was approved to corporate clients, which is more than in the previous quarter (137 million euros in Q2), but still remained below the volume of credits approved at the start of the year (328 million euros in Q1). Lending to the household sector continued to rise, to 80 million euros in Q3 (20 million euros in Q2), practically offseting debt repayments by the household sector at the start of the year (-104 million euros in Q1). Net lending to the state rose by 169 million euros in Q3, mainly based on new Treasury bill issues (Q2 borrowing of 525 million euros). The trend in the corporate sector to repay debts to foreign creditors, continued in Q3, when foreign borrowing fell by 244 million euros. In contrast to the previous quarter, when negative *cross-border* credits exceeded borrowing from domestic banks, growth of credit to corporate and retail clients stood at 71 million euros in Q3 (in Q2 -10 million euros).

...based on new credits to corporates and households

Banks continue to invest in REPOs….

In the course of Q3, banks continued to invest in REPOs. Despite a cut in the central bank's repo rate to 12%, banks doubled their investment in REPOs and central bank's 6-month bills, to 438 million euros (216 million euros in Q2, Table T7-4). With the additional investment in REPOs, banks have invested a total of 690 million euros in repos so far this year. If the value of Treasury bills of around 580 million euros[5], sold by the Ministry of Finance through the end of September, is added, total capital outflows from the banking sector exceed 1.1 billion euros. Banks continued to boost their capital in Q3 by additional 134 million euros (increase of 212 million euros in Q2), which together with Q2 represents a change against the end of the previous and the start of this year, when banks were cutting down their own capital.

…despite a cut in NBS benchmark interest rate…

4 This amount mainly results from subsidised loans, approved in Q3, worth around 200 million euros. By mid-September, the total volume of subsidised loans reached 812 million euros. http://www.merr.sr.gov.yu/aktivnosti/vesti.php?vestid=599
5 Section „Fiscal Flows and Policy" looks at the status of net government liabilities based on issued Treasury bills, calculating the nominal value of sold Treasury bills, while in the section „Monetary Flows and Policy" we follow the market price on the day of T-bill auction.

Table T7-4. Serbia: Banking Sector Activity – Sources and Structure of Lending, Adjusted[1] Flows, 2006-2009

	2007				2008				2009		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
	in millions of euros, cumulative from the beginning of the year										
Funding(-, increase in liabilities)	-325	-1,061	-2,574	-4,582	258	-717	-2,140	-833	958	61	-1,171
Domestic deposits	-339	-757	-1,819	-3,254	-162	-464	-1,134	-95	235	-336	-691
Households deposits	-329	-652	-1,059	-1,652	-192	-518	-842	84	-40	-270	-551
dinar deposits	-35	-57	-97	-135	-18	-19	-28	-63	46	-2	-30
fx deposits	-295	-595	-963	-1,518	-174	-499	-813	147	-87	-268	-521
Enterprise deposits	-10	-105	-760	-1,602	29	54	-292	-180	276	-67	-140
dinar deposits	23	112	-324	-1,138	365	394	261	198	171	5	-174
fx deposits	-33	-218	-437	-464	-336	-340	-554	-378	105	-72	34
Foreign liabilities	-10	266	207	114	564	601	138	-165	299	186	-558
Capital and reserves	25	-569	-962	-1,441	-144	-855	-1,144	-572	424	212	78
Gross foreign reserves(-,decline in assets)	-14	5	-17	695	-333	-386	-316	-18	-407	-449	-5
Credits and Investment[1]	687	1,294	2,488	3,626	697	1,175	2,888	700	156	1,057	1,980
Credit to the non-government sector, total	575	1,508	2,315	2,945	614	1,402	2,595	2,022	226	381	696
Enterprises	313	865	1,271	1,660	406	915	2,099	1,574	331	465	700
Households	263	644	1,044	1,285	207	487	496	448	-104	-84	-4
Placements with NBS (Repo transactions and treasury bills)	200	-11	438	849	116	-126	361	-1,419	40	256	694
Government, net[2]	-89	-203	-264	-168	-33	-101	-68	98	-110	421	590
MEMORANDUM ITEMS											
Required reserves and deposits	-146	242	349	441	-369	-275	-97	-225	-191	-225	-185
Other net claims on NBS[3]	13	-44	-104	-44	6	246	28	422	-385	-380	-481
o/w: Excess reserves	20	-56	-103	-92	0	207	-13	443	-409	-394	-501
Other items[4]	-110	-464	-57	-78	-202	-192	-490	-330	-166	-158	-254
Effective required reserves (in %)[5]	34	37	34	31	30	29	28	30	30	28	26

Source: Table P-14 in Analytical Appendix.
1) 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 percent 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 hard currency deposits – as a difference in balance, 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.
2) 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.
3) Net credits to the state: credits granted to the state less the state deposits held with commercial banks; a negative prefix means 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
4) Commercial banks' balance sheet items: other assets, deposits of legal entities undergoing receivership, interbank relations (net) and other liabilities excluding capital and reserves.
5) 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.

Q3 sees a visible increase in corporate and retail deposits…

…dinar-denominated deposits in the corporate sector…

…while households continue to increase hard currency denominated deposits

Sources for new bank lending continue to expand in Q3, to 1,232 million euros (Table T7-4). The growth is partially owed to deposits of the corporate sector, which continue to rise in Q3 by 73 million euros. Exceptional growth was noticed in household deposits by 281 million euros, which represents a continuation of a trend since the start of the year (in Q1 – 40 million euros, in Q2 – 230 million euros). Of the total household deposit growth, more than 90% came from hard currency deposits[6], while it was the other way round in the corporate sector (growth of dinar deposits by 179 million euros and decline in hard currency deposits by 106 million euros). In contrast to the previous quarter, banks now put money back in their mandatory reserve and deposit accounts with NBS, which stood at 40 million euros in Q3. Following big repayment of foreign debts by banks at the end of the last year, banks expanded borrowing abroad in Q3 by a new 744 million euros (in Q2 repayments rose by 113 million euros).

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

	2007				2008				2009		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
	quarterly growth of stock, in millions of euros										
Total loans to enterprises and households from domestic banking sector and direct foreign borrowing by enterprises	1,053	2,157	1,537	1,542	1,333	1,624	2,174	468	82	-10	71
Loans to enterprises and households from domestic banking sector	575	933	807	630	614	789	1,157	152	226	158	315
Loans to enterprises	313	552	406	389	406	509	1,162	135	331	138	235
Loans to households	263	381	400	241	207	280	-6	17	-104	20	80
Direct foreign liabilities of enterprises	478	1,224	730	912	719	835	1,017	316	-144	-167	-244
Direct foreign liabilities of enterprises and banks' credits to enterprises from domestic banking sector	791	1,776	1,137	1,301	1,125	1,344	2,179	451	187	114	158
	quarterly growth of stock, in % of quarterly GDP										
Total loans to enterprises and households from domestic banking sector and direct foreign borrowing by enterprises	16.3	30.1	20.0	18.0	17.4	18.3	23.8	5.5	1.2	-0.1	1.0
Loans to enterprises and households from domestic banking sector	8.9	13.0	10.5	7.4	8.0	8.9	12.7	1.8	3.3	2.3	4.6
Loans to enterprises	4.8	7.7	5.3	4.5	5.3	5.7	12.7	1.6	4.8	2.0	3.4
Loans to households	4.1	5.3	5.2	2.8	2.7	3.1	-0.1	0.2	-1.5	0.3	1.2
Direct foreign liabilities of enterprises	7.4	17.0[2]	9.5	10.7	9.4	9.4	11.1	3.7	-2.1	-2.4	-3.6
Direct foreign liabilities of enterprises and banks' credits to enterprises from domestic banking sector	12.3	24.8	14.8	15.2	14.7	15.1	23.9	5.3	2.7	1.7	2.3

Source: FREN.
1) See footnote 1) in table T7-4.

6 In November, NBS said that foreign exchange savings rose to 5.74 billion euros, reaching September 2008 levels, offseting a flight of almost one billion euros in Q4 last year.

The ratio of corporate lending to GDP falls to a lower level

In the course of Q3, the share of corporate lending to GDP fell to 65.8% (Table T7-6). The initial increase of this ratio, which was noticed in Q4 2008 and Q1 2009, was owed mainly to the then depreciation of the dinar, which pushed the ratio of corporate lending to GDP (dinar-denominated) to 70%, even though the volume of credits had fallen in real terms. In the following part of the year, with companies continuing to repay debts to foreign creditors and coupled with a stagnation of domestic credit activity, this ratio had gradually fallen, additionally supported by a mild dinar appreciation since May.

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

	2007				2008				2009		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
Total loans to enterprises and households from domestic banking sector and direct foreign borrowing by enterprises	48.2	52.5	55.5	60.0	65.3	66.3	70.2	80.6	84.9	81.9	80.1
Loans to enterprises and households from domestic banking sector	29.5	31.7	33.0	34.4	36.7	36.9	38.5	42.0	44.5	43.8	43.9
Loans to enterprises	19.0	20.3	20.6	21.6	23.0	23.4	25.7	27.6	29.8	29.5	29.7
Loans to households	10.5	11.3	12.3	12.8	13.7	13.5	12.8	14.5	14.7	14.3	14.2
Direct foreign liabilities of enterprises	18.7	20.8	22.6	25.6	28.7	29.4	31.7	38.6	40.5	38.1	36.2
Direct foreign liabilities of enterprises and banks' credits to enterprises from domestic banking sector	37.7	41.2	43.2	47.1	51.7	52.8	57.4	66.2	70.2	67.6	65.8

Source: FREN.

The Central Bank: Balances and Monetary Policy

Reserve money continues to shrink in Q3 as a result of a drastic fall in NDA, because of continued investment in REPOs...

...despite a significant increase in net own reserves

Reserve money continued to decline, the trend established since the start of the year. In the course of Q3, the reserve money fell by 7.4% of initial H (Q1 decline by 15.8%, Q2 decline by 5.7%, Table T7-7). The decline was mainly caused by falling NDA, which in Q3 stood at 21% of initial H, which had more than offset an increase in NBS net foreign reserves of 13.6% in Q3. The NDA decline is mostly owed to an increase in bank sector investment in REPOs, which rose by 13.2% of initial H in Q3, as well as a decline in other net domestic assets by 11.5% of initial H. At the same time, dinar deposits held by the state with NBS fell by 3.7% of initial H, but this amount was insufficient to fuel NDA growth.

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

	2007				2008				2009		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
FLOW				in millions of dinars, cumulative from the beginning of the year							
NBS own resreves[2)	15,066	46,140	60,267	97,636	4,695	19,115	56,373	27,211	-5,590	-12,043	29,771
NBS own reserves (in euros)	*188*	*577*	*756*	*1,218*	*58*	*237*	*706*	*312*	*-59*	*-128*	*319*
NDA	-46,278	-57,938	-72,100	-72,440	-39,752	-13,347	-66,941	122,232	43,117	-54,266	-118,637
Government, dinar credits	-710	-735	-735	-5,639	267	618	0	81	-308	-310	-310
Government, dinar deposits	-30,939	-56,748	-44,985	-10,107	-28,386	-41,088	-36,706	8,638	-17,155	-8,376	3,021
o/w: municipalities	*-6,768*	*-13,485*	*-11,933*	*-516*	*-8,329*	*-7,405*	*-5,073*	*-909*	*-4,415*	*-2,026*	*2,199*
Repo transactions[3)	-16,675	-2,094	-34,961	-67,950	-11,243	8,014	-28,597	127,517	-8,455	-29,024	-69,849
Other items , net[4)	2,046	1,639	8,581	11,256	-390	19,109	-1,638	-14,004	-17,199	-16,556	-51,499
H	-31,212	-11,798	-11,833	25,196	-35,057	5,768	-10,568	149,443	-48,707	-66,309	-88,866
o/w: currency in circulation	-9,792	-3,395	-3,088	8,488	-6,613	-7,454	-5,388	13,007	-11,856	-9,009	-7,193
o/w: excess liquidity	-13,061	-3,309	-6,293	20,605	-39,840	-22,293	-39,483	1,602	41,330	-41578	-51043
INCREASE				cumulative, in % of opening H[5)							
NBS own resreves[2)	11.2	34.5	45.0	72.9	3.5	14.3	42.1	20.3	-1.8	-3.9	9.6
NDA	-34.6	-43.3	-53.8	-54.1	-29.7	-10.0	-50.0	91.3	-14.0	-17.6	-38.4
Government, dinar deposits	-23.1	-42.4	-33.6	-7.5	-21.2	-30.7	-27.4	6.4	-5.6	-2.7	1.0
Repo transactions[3)	-12.5	-1.6	-26.1	-50.7	-8.4	6.0	-21.4	95.2	-2.7	-9.4	-22.6
Other items , net[4)	1.5	1.2	6.4	8.4	-0.3	14.3	-1.2	-10.5	-5.6	-5.4	-16.7
H	-23.3	-8.8	-8.8	18.8	-26.2	4.3	-7.9	111.6	-15.8	-21.5	-28.8
o/w: currency in circulation	-7.3	-2.5	-2.3	6.3	-4.9	-5.6	-4.0	9.7	-3.8	-2.9	-2.3
o/w: excess liquidity	-9.8	-2.5	-4.7	15.4	-29.7	-16.6	-29.5	1.2	-13.4	-13.5	-16.5

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 section 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.

Box 1. Analysis of Stress Tests Conducted in Serbia's Banking Sector

In the course of summer, the National Bank of Serbia, based on the Vienna Agreement (27.03.2009) and in cooperation with 16 banks with the biggest market share in Serbia, started to collect information necessary to conduct stress tests. Stress tests represent one of the most up-to-date preventive techniques, which assess the vulnerability of banks to changes in macroeconomic factors, in order to establish whether a negative outcome of the financial crisis could jeopardize the stability of a bank, and consequently the safety of private deposits. First stress tests, at the start of the year, were conducted in the banking sector of the United States of America, when FED tested 19 banks, holding two thirds of the total banking sector capital. As a result of those tests, banks that had not shown well under simulated scenarios had to increase their capital by a total of 75 billion dollars. Tests conducted by NBS in the course of summer, were based on gathered information on required provisioning which banks set aside and report as part of balance sheet assets and off-balance sheet items. After having completed the data, NBS had simulated two possible scenarios. The first scenario assumes the continuation of the existing developments through end-2010. The second scenario assumes a significant economic deterioration through end-2010. The "crisis" scenario assumed a 6% contraction in GDP by the end of 2009 along with a nominal dinar depreciation of 12% and a rise in interest rates by 0.1%. In 2010, under the same scenario, GDP would have fallen by additional 3.5%, the depreciation would amount to 10%, accompanied by an increase in interest rates, which were guessed to have increased in 2010 by 2% against the present levels. Based on collected data, NBS had analysed direct effects of simulated scenarios: (a) on non-performing loans, which would cause an increase in spending and a decline in capital of banks; (b) direct impact of an increase of the exchange rate on revaluation of so-called risk-weighted assets (RWA) of banks. This increase emerges as a result of those elements of banks' assets which are hard currency denominated or hard currency linked. For a majority of banks, those are credits and to a lesser extent investments. Following simulated change, one gets results on the value of risk-weighted assets, which are then used to divide the capital of the bank to get a capital adequacy ratio. The legal minimum for the capital adequacy ratio in Serbia is higher than in other countries and stands at 12% (e.g. minimum 8% in the U.S.). Based on the "crisis" scenario, capital adequacy ratio would have fallen from 19% to 18% in 2009 and to 16.42% at the end of 2010. Results of stress tests also show that the major impact on growth of non-performing loans – thus on RWA growth) would have come from contracting economic activity. The RWA elasticity to an expanding output gap had a value of 0.7, while elasticity to depreciation was 0.3 and to interest rate changes 0.4. The dominant impact of the economic activity on the size of RWA could be a solid argument for a continued monetary policy easing in order to stimulate faster economic growth. Stress test results also show that banks in Serbia are much better capitalized than one would have expected of a transition economy and that even a prolonged recession would not have jeopardized the banking system, seen in many previous crises in transition and emerging economies. For the majority of banks in developed countries, capital adequacy ratios are either on the verge or even below the legally set minimum, mainly due to low own capital of banks which can be hardly replenished under the current circumstances in global capital markets. In contrast, banks in Serbia have no such problem and can uninterruptedly continue to grant credits first in line with existing demand and second in line with the capacity of the real sector to borrow. Unfortunately, considering that interest rates remain high, partly due to the country risk and partly due to monetary policy, credit demand is modest. An additional depreciation of the exchange rate in late 2008 and early 2009 has resulted in increased hard currency linked liabilities of the real sector, cutting down their capacity to borrow. Beside those, a capacity of companies to repay debts has been endangered, which could be seen in a growing share of non-performing loans since the start of the year. Apart from determining whether a banking sector is stable, which was the basic goal of stress tests, we can say that under current conditions and based on indicators gathered to date and forecasts for 2010 (which are significantly better than those assumed in simulated scenarios) – banks can increase lending to corporate clients without any major fear, which is additionally supported by monetary policy relaxation and the lowering of interest rate on dinar loans. Since the start of the year, the dinar liquidity of the banking sector additionally improved through cuts in the dinar component of the mandatory reserve requirements, which banks keep with the central bank, and by maintaining high mandatory reserve requirement on hard currency deposits which keep interest rate on hard currency indexed credits high, paving the way for de-euroization of the economy. The assumption is that those developments will lead to a rising share of non-indexed dinar credits, which would at the same time offset possible negative effects of a future depreciation of the dinar. In the end, we need to wait for the real sector to draw the line at the end of the year and analyse cumulative effects of the crisis in the current year, and only then we will know whether beside an obvious capacity for credit growth there is adequate demand for new credit arrangements.

Trends

Table T7-8. Banks' Reserve Requirement Levels with the NBS, 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[4]												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 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 Aril 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 implemented on all inflows from abroad based on commercial banks' borrowing. According to valid regulations until December 2005, commercial banks' liability to set aside funds with the NBS based on collected new hard 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 hard currency assets of commercial banks.

3) 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.

4) 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.

5) Since May 17, 2008, 10% of the calculated hard currency reserves is held in dinars; since November 17, 2008 20 percent of the calculated hard currency reserves is held in dinars; since December 17, 2008 40 percent of the calculated hard currency reserves is held in dinars; since July 18, 2009 30 percent of the calculated hard currency reserves is held in dinars; since October 18, 2009 25 percent of the calculated hard currency reserves is held in dinars; since 18 November, 2009 20 percent of calculated hard currency reserves is held in dinars.

Notes:

According to valid rules, 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.

Hard currency base: hard currency deposits (including the state), hard currency indexed dinar deposits, hard currency loans (including the state), subordinated capital, securities, other hard currency liabilities and other hard currency assets received from abroad from services the bank provides on behalf and for the account of third parties.

Dinar and hard currency base excludes: liabilities to NBS until December 2005, liabilities arising from private hard currency savings deposited with banks after June 30, 2001; liabilities for the repayment of debt for old hard 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.

... owing to increase in IMF SDR holdings

In the course of Q3, gross NBS reserves rose by 638 million euros (Table T7-9). The status of net own reserves of NBS, which exclude the IMF loan, shows an increase by additional 450 million euros in Q3 (a fall by 70 million euros in Q2). This increase was only slightly contributed by transactions in interbank forex market of 18.2 million euros (first of all through purchases from foreign exchange offices, since NBS had not intervened in interbank forex market since mid-February, Table T7-10). The biggest increase in net own reserves took place in August and September, when the IMF, based on special allocation, approved a transfer of 425 million euros worth of special drawing rights to Serbia. The National Bank of Serbia lowered its benchmark interest rate to 12%, and then again in October and November by one percentage point each time, with the benchmark rate currently at 10%. Both in October and November, NBS made decisions related to the dinar component of the reserve requirements. In October, the share of the dinar component was cut to 25%. The latest November cut to 20% resulted in an increase in dinar liquidity by 14.5 billion dinars. In turn, banks had to set aside 153 million euros on their mandatory reserve accounts with NBS. Following an increase in the dinar component late last year, in order to improve hard currency liquidity of banks, NBS is now, with the policy of lowering the dinar component (along with cuts in benchmark interest rate), trying to boost the dinar liquidity in the banking sector and encourage banks to approve more credits.

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

	2007				2008				2009		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
	stock, in millions of euros										
NFA of Serbia	5,413	6,130	6,347	7,116	7,246	6,768	7,000	5,451	5,305	5,211	5,569
Commercial banks, net	-3,213	-2,918	-2,998	-2,379	-2,147	-2,163	-2,557	-2,562	-2,670	-2,824	-3,125
Gross foreign reserves	693	712	690	1,403	1,070	1,017	1,087	1,385	978	936	1,380
Foreign liabilities	-3,906	-3,630	-3,688	-3,782	-3,218	-3,180	-3,644	-3,947	-3,648	-3,761	-4,505
NBS, net	8,626	9,048	9,345	9,495	9,394	8,931	9,557	8,013	7,975	8,036	8,694
Gross foreign reserves	8,819	9,246	9,535	9,662	9,577	9,129	9,727	8,180	8,155	8,913	9,551
Foreign liabilities	-193	-198	-190	-168	-183	-198	-170	-167	-180	-877	-857
IMF	6	1	3	4	3	1	1	-9	-14	-769	-756
Other liabilities	-200	-199	-193	-171	-186	-199	-171	-159	-166	-108	-101
NBS, NET RESERVES-STRUCTURE											
1. NBS, net	8,626	9,048	9,345	9,495	9,394	8,931	9,557	8,013	7,975	8,036	8,694
1.1 Commercial banks deposits	-3,358	-3,478	-3,584	-3,409	-3,411	-3,166	-3,343	-2,191	-2,136	-2,281	-2,471
1.2 Government deposits	-1,247	-1,160	-1,172	-1,034	-874	-478	-457	-459	-536	-521	-542
1.3 **NBS own reserves**	4,021	4,410	4,589	5,051	5,109	5,287	5,757	5,362	5,303	5,234	5,681
(1.3 = 1 - 1.1 - 1.2)											
	in millions of euros, cumulative from the beginning of the year										
NFA of Serbia	249	967	1,183	1,952	131	-348	-116	-1,665	-146	-239	118
Commercial banks, net	-24	270	190	809	232	216	-178	-183	-108	-263	-564
Gross foreign reserves	-14	5	-17	695	-333	-386	-316	-18	-407	-449	-5
Foreign liabilities	-10	266	207	114	564	601	138	-165	299	186	-558
NBS, net	274	696	993	1,143	-101	-563	62	-1,482	-38	23	682
Gross foreign reserves	-233	194	483	610	-86	-534	65	-1,482	-25	733	1,371
Foreign liabilities	507	502	510	532	-15	-30	-2	1	-13	-710	-690
IMF	187	182	184	185	0	-2	-3	-12	-5	-761	-747
Other liabilities	320	320	327	348	-15	-28	1	13	-7	51	58
NBS, NET RESERVES-STRUCTURE											
1. NBS, net	274	696	993	1,143	-101	-563	62	-1,482	-38	23	682
1.1 Commercial banks deposits	-148	-269	-374	-200	-2	243	66	1,219	55	-90	-280
1.2 Government deposits	63	149	137	275	161	557	578	575	-76	-61	-82
1.3 **NBS own reserves**	188	577	756	1,218	58	237	706	312	-59	-128	319
(1.3 = 1 - 1.1 - 1.2)											

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

Table T7-10. Net Monthly Hard 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 u Q4 2008.
December 2008	-288	96.3	-192	
January 2009	-381.3	23.6	358	
February 2009	-175.1	12.6	-163	-513 u Q1 2009.
March 2009	0	7.6	7.6	
April 2009	0	17.8	17.8	
May 2009	0	12.2	12.2	+46 u Q2 2009.
June 2009	0	16.6	16.6	
July 2009	0	7.5	7.5	
August 2009	0	5.7	5.7	+18.2 u Q3 2009.
September 2009	0	5.0	5.0	

Source: NBS.

8. Financial Markets

Activity on the Belgrade Stock Exchange fell in Q3 2009 as measured by the value of trading, while the number of transactions remained at approximately the same level. Activity slumped mainly in the discontinuous market segment, while the continuous segment even saw an increase in the overall value of transactions. Although the rise in value of the Belgrade Stock Exchange indices continued in Q3, the start of Q4 saw another slump. Thus the BELEX15 index rose by some 45% in Q3 only to drop by 9.6% in the first month of Q4. The National Bank of Serbia cut its reference interest rate by 100bp – to 12% – in Q3 2009; this was followed by yet another cut, of 200bp, to a level of 10%. The cut in the nominal repo rate was accompanied by a reduction in real repo yields, both as measured relative to inflation and to the dinar/euro exchange rate. As with the Belgrade Stock Exchange, the market in FFCD (frozen foreign currency deposits) bonds saw a slump in both the turnover and value of trading in Q3. Yields on FFCD bonds dropped across all maturities, while the yield curve remains inverted.

Q3 saw a drop in activity in the Belgrade Stock Exchange as measured by the value of trading, while the number of transactions remained at approximately the same level

The recovery seen by the Belgrade Stock Exchange over the preceding quarter failed to continue into Q3 2009 (Graph T8-1). The third quarter saw some 18.2 thousand transactions, a slight drop in relation to the preceding quarter, which had recorded 18.3 thousand transactions. On the other hand, the dinar value of trading dropped by some 20.3% in relation to Q2, standing at some four billion dinars.[1]

The discontinuous trading segment was responsible for the drop in the value of trading in the stock market seen in Q3

The structure of trading shows that the discontinuous segment – where the value of trading halved in relation to Q2 – was responsible for the drop in activity in Q3, while the continuous segment even recorded a rise in the value of trading, to the tune of 19.5%. The situation is similar when the total number of transactions is considered; this fell by 17% in the discontinuous market segment and rose by 5.3% in the continuous segment in relation to the previous quarter. If the continuous segment is viewed in isolation, the number of transactions will be seen to have grown steadily since Q1 2009, which saw some 9,000 transactions; the value of trading in this segment of the market is still lower than in Q1, when it amounted to about 3.4 billion dinars.

The average transaction value in the Belgrade Stock Exchange is still following the downward trend seen since Q3 2008. The average transaction amounted to some 226,000 dinars in Q3, or 19.8% less than in Q2.

Belgrade Stock Exchange indices continued an upward trend in Q3, but the start of Q4 again saw a drop in value

Graph T8-1. Volume and Structure of Share Trading, 2006-2009
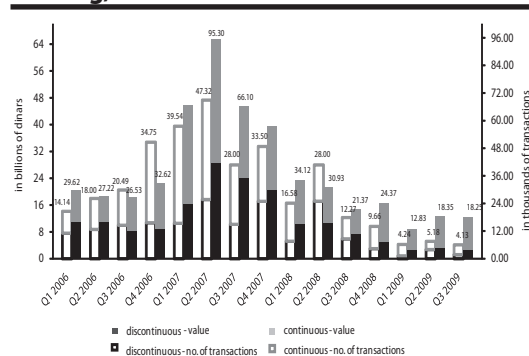
Source: www.belex.co.rs.

Belgrade Stock Exchange indices continued following an upward trend in Q3, but the start of Q4 again saw a drop in their value (Graph T8-2). The BELEX15 index[2] rose by some 45%, BELEXline[3] rose by 32%, while SRX EUR[4] rose by 45.8% in Q3. Regional stock exchange indices also gained ground over this period, but by less than the Belgrade Stock Exchange. The greatest growth, of 34.6%, was recorded by the Bulgarian SOFIX; the smallest, of 4.7%, by the Banja Luka BIRS index. Montenegro's MOSTE and NEX20 rose by nearly 30%. The Croatian Crobex, Sarajevo SASX-10 and Macedonian MBI-10 rose by 15.9%, 8.6% and 22.5%, respectively.

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1 The value of trading recorded in Q2 2009 amounted to some five billion dinars.
2 Index of the most liquid shares listed on the Belgrade Stock Exchange.
3 Overall stock index of the Belgrade Stock Exchange.
4 Index of the 8 most liquid shares on the Belgrade Stock Exchange calculated by the Vienna Stock Exchange (Wiener Börse).

Belgrade Stock Exchange indices saw their quarterly highs at the end of the quarter, or rather on 24 September. These were, for BELEX15, BELEXline and SRX EUR, 862.9, 1,607.9 and 392.4 index points respectively. A drop in the value of these indices ensued thereafter: BE-LEX15, BELEXline and SRX EUR saw drops of 9.6%, 7.5% and 7.5%, respectively, from 24 September to 6 November. Regional indices also saw their value fall in early Q4. The greatest drop was recorded in Montenegro, where MOSTE and NEX20 dropped by 25.9% and 16.3%, respectively, while the Bulgarian SOFIX, Banja Luka BIRS and Croatia's Crobex fell by 9.4%, 1.9% and 2.9%, respectively.

The high volatility of Belgrade Stock Exchange indices, as well as of those of other regional stock markets, was primarily caused by the shallow nature of the market as measured by the volume of trading. As a clear trend of falling volumes has been in evidence since the beginning of the global crisis, markets became even more shallow, making movements in the Belgrade Stock Exchange even more volatile.

Graph T8-2. BELEXfm, BELEX15 and SRX EUR Indices, 2007-2009
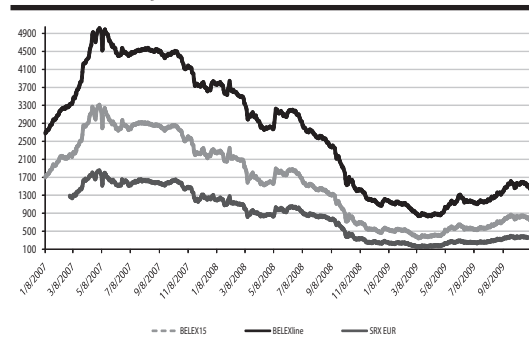
Sources: www.belex.co.rs, www.wienerborse.at.

Graph T8-3. Repo Yields by Maturity, 2006-2009
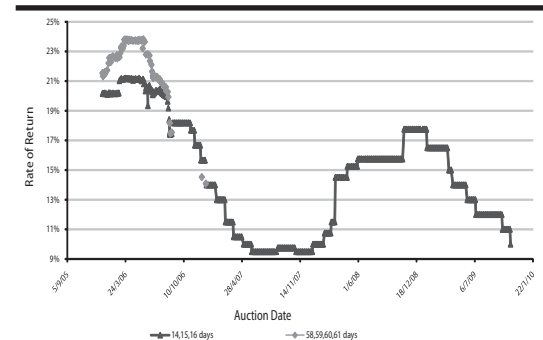
Source: NBS.

The NBS cut its reference interest rate by 100bp, to 12%, in Q3, only to reduce it by an additional 200bp, to 10%, in the first third of Q4.

In Q3 2009, the NBS continued its policy of cutting the reference interest rate first seen in Q1 2009 (Graph T8-3) as a measure directed against the effects of the global downturn on Serbia's economy. In early Q3 the 2w repo rate stood at 13%; the NBS Monetary Board cut the rate by 100bp in mid-July, to 12%. The NBS reference rate was again cut by 100bp both at the end of the first third of October and in early November, which brought it down to 10%. In late 2007, when the NBS embarked on a cycle of increasing the reference interest rate in an effort to curb inflation, the 2w repo rate amounted to 9.5%; the NBS has virtually returned to this level after the latest cycle of cutting interest rates.

Real yields on repo operations as measured relative to fluctuations in the euro/dinar exchange rate fell in Q3

The cut in the NBS reference interest rate affected real yields on 2w repo operations measured relative to fluctuations in the euro/dinar exchange rate (changes to the exchange rate over the preceding three months)[5] in Q3, bearing in mind the relative stability of the dinar's exchange rate against the euro (Graph T8-5). At the start of Q3 real yields calculated in this way amounted to some 16.6% only to drop to about 13.7% at the end of the quarter. These yields were, as usual, rather volatile over the course of the quarter and ranged from 8.5% to 22%. This trend continued into July and August, when real yields measured in this manner amounted to between 18% and 22%.

Real yields on repo operations measured relative to inflation dropped in Q3

If real yields measured relative to the inflation rate are considered, it becomes apparent that Q3 2009 saw them decline further (Graph T8-4). The inflation rate remained relatively stable in Q3, so the NBS policy of cutting the reference interest rate made real yields on repo operations drop from 3.6% in early Q3 to 2.6% at the end of the quarter. As the inflation rate fell by nearly 1.5pp in October, real yields on repo operations rose to about 3% in late October, in spite of the cut in the NBS nominal rate.

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5 A detailed explanation of this approach to calculating real repo yields is provided in K. Udovički, V. Đoković, "The Exchange Rate and Policy of the National Bank of Serbia: 2002–2006", Spotlight on: 1, issue 5 of QM.

Trends

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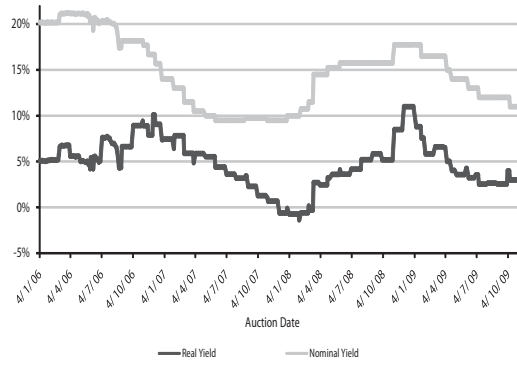
Source: NBS.

Graph T8-5. Real (with regard to the dinar/ euro exchange rate) and Nominal Repo Yields, 2006-2009
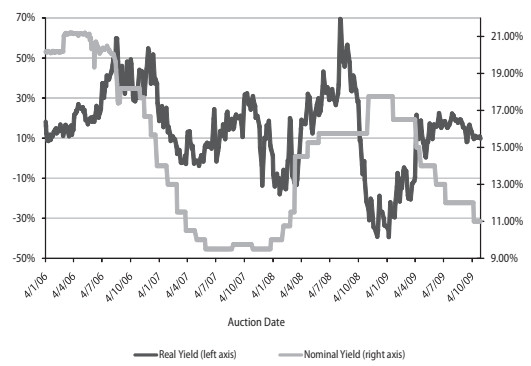
Source: NBS.

Q3 saw yields on Republic of Serbia T-bills continue sliding

The trend of falling yields on Republic of Serbia treasury bills (T-bills) continued into Q3 (Graph T8-7). Yields on 3-month and 6-month issues fell over the quarter by some 200bp. At the start of the Q3, auctions of 3-moth T-bills recorded yields of 14.2%, only for these to drop to about 12.2% by the end of the quarter. The same was true of 6-month T-bills, whose yields fluctuated within the same band. The third quarter saw investors being offered T-bills with one-year maturity for the first time. The nominal value of each issue generally stood at one billion dinars,[6] while realization was nearly always equal to 100%. Yields on 1-year T-bills ranged between 12.5% and 12.6% in Q3. The nearly non-existent difference between T-bill yields indicates that investors do not expect significant economic changes over the next year and do not believe that exposure to 6-month or 1-year maturities entails risk substantially greater than that carried by 3-month T-bills. This primarily indicates expectations of a stable inflation rate and relative exchange rate stability over the coming year.

Graph T8-6. Yields in T-bill Market, 2006-2009
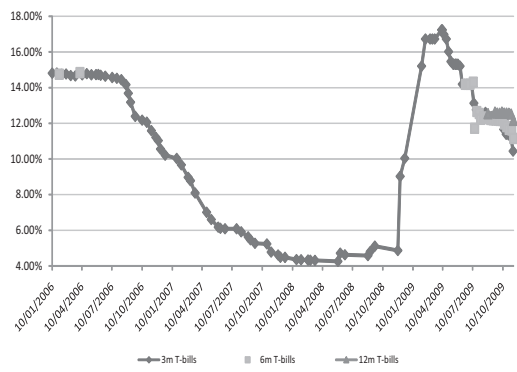
Source: Serbian Ministry of Finance.

Graph T8-7. Average Yield on FFCD Bonds
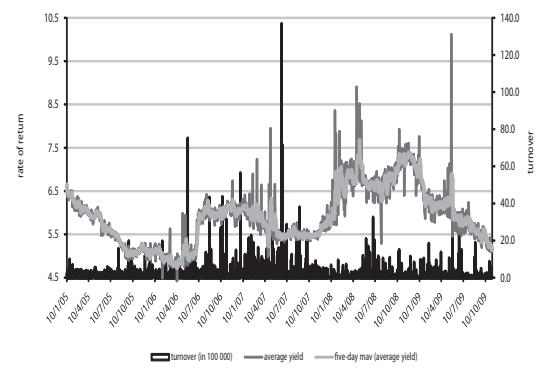
Source: www.belex.co.rs.
1) The graph does not depict extraordinary yield of A2006 bond of 42% on 10 March 2006. Note: The graph was derived as the weighted average yield on securities from A2006 to A2016. Turnover values for each of the securities were used as weights.

Volume and turnover of trading in the FFCD bond market dropped in relation to Q2

Both the total volume and turnover in the FFCD bond market decreased in Q3 in relation to Q2 2009 (Graph T8-7). The volume recorded amounted to some €14.4 mn, while turnover stood at €11.5 mn, 35.6% and 34.4% less, respectively, than over the previous quarter. This level of activity in the FFCD bond market approached the Q1 2008 level when historic lows were recorded.

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6 At the a

Q3 2009 saw a drop of average yields across all maturities in the FFCD bond market

Average yields on bonds of all maturities continued their downward trend into Q3 2009 (Graph T8-8). The third quarter saw a nearly parallel downward shift in the yield curve: depending on bond maturity, yields fell by between 33bp and 63bp. The greatest fall, of 63bp, was recorded by the A2010 bond. The FFCD bond yield curve was inverted in Q3, meaning that shorter-maturity bonds enjoy greater yields than those of longer maturities. On the last day of Q3, yield on A2010 bonds was 5.75%, while that on A2016 was -5.61%, a difference of 13bp. This made the curve somewhat flatter than at the start of the quarter, when the difference amounted to nearly 46bp.

Graph T8-8. Average Yield Curves on FFCD Bonds

The average yield curve on FFCD bonds was inverted in Q3, along with a mild flattening
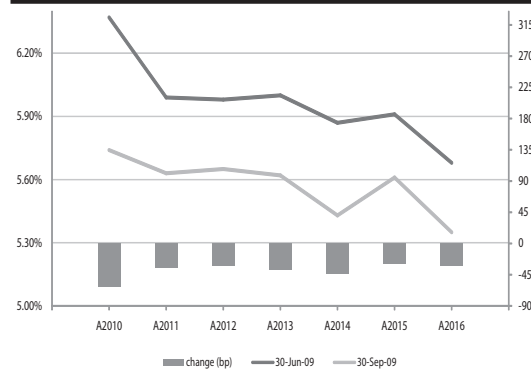
Source: www.belex.co.rs.

Graph T8-9. Foreign Investor Share in BSE Turnover, 2005-2009
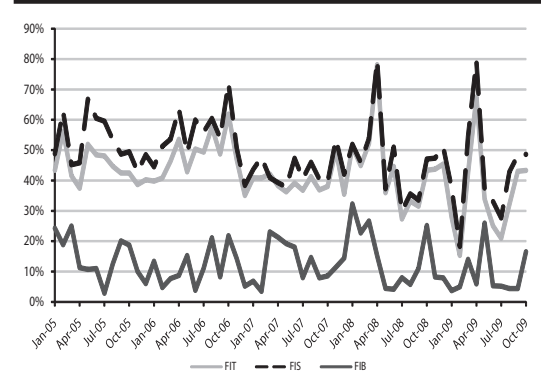
Source: www.belex.co.rs.
Legend: FIT – Foreign Investor Share in Total Turnover, FIS – Foreign Investors in Equity Market, FIB – Foreign Investors in Bond Market.

The share of foreign investors in turnover in the bond market declined in Q3, yet grew in the share market and overall turnover

The relative share of foreign investors in turnover in the bond market (FIB curve, Graph T8-8) declined throughout Q3, from 5.3% in June to 4.4% in September, yet rose in October to 16.5%. The share of foreign investors in turnover rose in a stable fashion in the share market (FIS curve, Graph T8-8) to stand at 48.3% in late Q3, rising to 48.6% in October.

uction held on 30 September, the nominal value of the issue offered amounted to two billion dinars.

9. International Environment

Global recovery is slow and activity remains below pre-crisis level. In developed countries, state interventionism stabilized economic activity and it is on the upturn. Developing countries, led by China, are recovering at a faster rate because they weathered this recession more painlessly than the previous ones. Their economies are spurred by growing prices of raw materials that account for a large share of their exports. Moreover, they adjusted their economic policies to the crisis quite well and conducted them on time. East European and former Soviet countries have had the hardest time getting through the crisis.

World

Recession is probably over, but the pace of recovery remains unclear

Global recession is probably over, but the form of recovery remains unclear. The current surge in activity is primarily the consequence of fiscal incentives, central banks' support to the loan markets and the replenishment of stocks that fell during the crisis. All these factors are temporary in nature and their effects will slowly wane and disappear in 2010. Only then will it become clear how the real economic factors and market conditions will determine the recovery of world economy. Despite fiscal packages across the world, there is no danger of high inflation in the medium term for now because investments and personal spending are low and the factors constraining them will not disappear soon.

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	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q1 2009	Q2 2009	Q3 2009
USA	3.0	2.2	1.3	-6.3	-6.4	-0.7	2.8	0.0	-1.2	-1.6
Canada	2.8	2.5	0.6	-0,9	-1,6	-0,9	…	1.2	0.1	-0.9
Japan	2.2	2.1	-0.4	-3,0	-3,2	0,7	1,2	-0.1	-1.0	-2.2
China	11.1	11.4	9.0	6,8	6,1	7,9	8.9	-0.6	-1.5	…
Euro area	2.9	2.7	0.7	-1,8	-2,5	-0,2	0,4	1.0	0.4	-0.4
Germany	3.1	2.6	1.0	-2,4	-3,5	0,4	0,7	0.8	0.3	-0.2
France	2.2	1.9	0.7	-1,5	-1,4	0,3	0,3	0.6	-0.2	-0.4
UK	2.8	3.1	0.7	-1,8	-2,5	-0,6	-0.4	3.0	2.1	1.5
Italy	1.9	1.7	-0.9	-2,1	-2,7	-0,5	0,6	1.5	0.9	0.1
Russia	6.7	8.1	5.6	1,2	-9,8	-10.9	-8.9	13.7	12.4	11.4
Bulgaria	6.0	6.1	6.0	3.5	-3,5	-4,9	-5,8	6.0	4.1	1.0
Romania	6.9	6.0	7.1	2.9	-6,2	-8,7	-7,1	6.8	6.1	5.0
Hungary	3.8	1.3	0.6	-2,2	-5,6	-7,2	-8,0	3.0	3.6	4.9
Croatia	5.0	5.6	2.4	0.2	-6,7	-6,3	…	3.8	2.8	1.3
FYR Macedonia	4.0	5.9	4.9	2.0	-0.9	-1.4	…	0.9	-0.6	-1.4
BIH	6.9	6.0	5.9	…	…	…	…	1.6	-0.6	-1.4
Serbia	*5.6*	*7.1*	*5.4*	*2.8*	*-4.2*	*-4.0*	*-2.1*	*10.0*	*8.7*	*7.9*

Source: Eurostat, OECD, National Bank of Bulgaria, National Bank of Romania, National Bank of Republic of Macedonia, Russtat, Central Bureau of Statistics of the Republic of Croatia, National Statistical Institute of Bulgaria, State Statistical Office of the Republic of Macedonia, National Bureau of Statistics of China.
1) The GDP growth rate for the USA is the seasonally adjusted annual rate; the growth rate for other OECD countries is seasonally adjusted quarter on quarter, while the rate for the other countries is adjusted quarterly year-on-year.

Trust in the finance system is being restored, but some weaknesses persist. Banks will have to cut their leverage levels because the losses made in the past are slowly being written off while the liquidity loans offered by central banks will slowly decrease. Room for bank credit activity will thus be reduced and this factor will limit the pace of growth in the future. The European economy will be hit harder than the US economy given that companies in Europe depend on bank loans more than those in the USA. Capital flows to developing countries, which were slashed during the crisis, are expected to stabilize or gradually increase. This will prevent growth of investments in new capacities to reach its pre-crisis level, with the exception of China. The credit crunch scenario is quite unlikely in most developing countries, apart from Eastern European and former Soviet states.

Personal spending will be particularly weak in countries whose real estate markets had sunk into a deep crisis

Spending is under pressure from unemployment and companies need to strengthen their balances given the direr financing conditions. Judging by everything, the recovery of private and corporate spending will probably be slow and gradual. Personal spending will be especially anemic in countries that underwent the most marked mortgage securities crises - the US, the UK and some European countries. Savings are continuing recovery in the US and, consequently, discouraging personal spending. Personal spending is the factor that constitutes the greatest risk for the pace of recovery. The only option for maintaining growth is to continue with fiscal stimuli longer than initially planned, thus increasing risk of excessive public debt. The other option is to abolish such measures, which may lead to the destabilization of the financial system and adversely affect the real sector. Continued growth of the world bourse levels could have extremely positive effects on the pace of recovery. Higher levels of stock exchange indices lead to greater spending and security in the financial system, which stimulate the economy. Experience gained during the Great Depression shows that this effect may considerably step up the dynamics of recovery.

It is still too early to abolish expansive macroeconomic policies but preparations for "exit strategies" should commence

It is still too early to abolish the short-term measures restoring confidence in the financial system and expansive macroeconomic policies. In any case, this process warrants caution. Extending their implementation longer than necessary may yield negative effects in the medium term. Such policies should be oriented at medium term goals, financial sector reform, at encouraging profitable branches in the future and changing the composition of global demand. The continuation of fiscal stimulus measures is desirable only if it is accompanied by a reform of public spending to assure investors that deficits will be sustainable; otherwise, the sum effect of the measures will be much smaller or even negative.

Developing countries will raise their discount rates before developed countries do

Monetary policies of developing and developed countries will differ as to when they will begin raising their discount rates. Low inflation in advanced economies allows for maintaining the low rates longer than planned. Developing countries will probably begin raising their discount rates before the developed countries; some are expected to change their foreign currency regimes to boost the effects of the domestic monetary instruments.

The USA is under pressure from both low global demand and the shaken financial system. Recovery will be slower in countries that experienced a financial crisis in addition to recession, because their financial systems will need time to recuperate fully. This is why the investors' risk aversion needs to be reversed as soon as possible, because greater investments in riskier securities would also affect higher personal spending. Part of cyclical unemployment will probably become structural, notwithstanding the high mobility of both US workers and capital. Savings have risen to 5% and show a tendency of further growth because the household balances are still unbalanced. Additional fiscal measures will be taken if the certainty of recovery is disputable, because the monetary instruments have already been used up – the discount rate is at its historical low. The International Monetary Fund is suggesting measures that will prevent the existence of "too big to fail" financial institutions. If size exceeds a specific limit, the prescribed percentage of reserves will increase; this will ensue also if the composition of investments is too complicated and heterogeneous. There are also opinions that such a measure would increase the competitiveness of such companies. Public debt is growing and a strategy to cut it needs to be elaborated; this strategy will have to take into account the health and pension insurance reforms.

The financial system in the eurozone above all relies on the banks wherefore the rigorous loan conditions have considerably affected a drop in investments. This is why European countries have suffered not only from low global demand, but from a decline in domestic demand due to lower investments as well. Some countries have further been hit by a real estate market crisis (Ireland, Spain). Countries with low current account deficits or surpluses have been the most successful. Unemployment is high; like in the USA, it has affected personal spending. The situation in the labor market is inadequate, insiders are over-protected, wherefore the rules need to be changed to encourage employment.

IMF advises East European countries to adopt stricter rules regulating import of foreign capital

East European countries ought to adopt stricter rules on foreign capital imports. East Europe is hit above all by the lower inflow and the withdrawal of financial capital, which has seriously cut

growth in the Baltic states, Bulgaria and Romania. The exchange rates partly cushioned the effects in countries with flexible foreign currency regimes. Bosnia-Herzegovina, Serbia, Hungary, Latvia and Romania negotiated loans with the IMF. In most of these countries, the negative growth rate has fallen, exports have been growing and the stock of supplies has been falling at a slower pace. Lack of credit availability and growing unemployment are their chief problems.

USA

US economy grew by 2.8% in Q3

The initial GDP estimate shows that quarterly growth stood at 2.8% (quarterly seasonally adjusted annual rate) in Q3, but that it was still negative year on year (-2.5%). This growth is to a large extent the consequence of the temporary effects of economic policy measures that stimulated personal and public spending.

Real spending grew by 2.9% due to the "Cash for Clunkers" program and savings fell. Spending will in the near future be constrained by the poor labor market situation and lack of credits for households.

Investments in residential housing recovered after contracting for three and a half years. Government measures, above all loans to first home buyers, are partly to be credited for this upturn. The definite recovery of the real estate market, cannot, however, be ascertained with reliability.

The non-residential investment sector is the sector of economy from which the negative effects could spread to other parts of the economy. Investments in this sector have been falling for the fifth consecutive quarter, albeit more mildly. Demand for equipment is greater than demand for the construction of commercial facilities and the latter is expected to decline further in the near future.

The inventories recorded a lesser rate of decline than in the previous quarter; this positively affected growth, while public spending increased by 3.1% Q/Q. Growth of imports was slightly greater than growth of exports.

The Fed is not concerned about inflation and the low discount rate will remain at the present level for quite some time

Total annual inflation stood at -1.6% and base inflation at 1.5% in Q3. According to the Fed, core inflation is expected to drop mildly, as indicated by the movement of prices of the goods which are included in the index. The situation is reverse as regards total inflation - it is projected to grow and be positive already in 2010. Given the small danger of inflation, core inflation is not expected to grow before 2010 or early 2011, wherefore the Fed decided to keep the policy rate at the current extremely low level for the time being. Use of other instruments - purchase of government and mortgage securities and debts of big agencies involved in funding home-buying during the boom period – will also continue. Some economists are apprehensive about deflation, but the Fed Board of Governors has not expressed any concerns about it for now.

Unexpected unemployment growth rate

The situation in the labor market continued deteriorating. Although the number of non-farm payroll accounts has been falling at a slower rate than over the previous months, the unemployment rate grew more than economists expected. According to the Household Survey, it grew from 9.8% in September to 10.2% in October, thus exceeding the psychological limit of 10% for the first time since 1983. That was the only time, but only within a ten-month period, that unemployment exceeded 10% since the monitoring of the series began. The average number of working hours per week remained unchanged while productivity continued growing in Q3. Growth of unemployment was slower in the services sector than in industry. Two indicators – non-farm payrolls and the Household Survey – create dissonant impressions of the situation in the labor market. Non-farm payrolls recorded results negligibly lower than expected, while the Household Survey underperformed significantly. The payrolls remain at the level approximately reflecting the continuation of economic growth at the present rate, while the Survey suggests slower and more difficult recovery. The divergence between these two indicators cannot continue in the longer term and the labor market trend will become clear soon.

The trade deficit stood at 36.5 billion USD in September, having increased by 18% over the pre-

vious month and reaching its climax since the beginning of the year. The deficit was much higher than had been expected and reflected greater imports due to increased oil purchases, which led to imports exceeding exports. Exports, which have been on the rise for five months in a row, are expected to continue growing as the dollar weakens; so are imports, given that the level of imports always increases during recession recovery.

Recession is probably over, but the measures needed to safeguard the system against similar upheavals in the future have not been implemented yet. Most Americans are embittered by the conduct of senior bank officials, their indolence and squandering, which largely caused the crisis. Dissatisfaction culminated when the media revealed that million dollar bonuses were still handed out to the very people who had brought the companies to ruin. The man in the street is disappointed by the government measures that did not manage to right all the wrongs. The voters' disappointment may lead to lower public support for the financial system reform, which is the key component of the current economic policy. The transition of financial regulations must be fully and meticulously implemented to pre-empt similar problems in the future and help restore investor confidence as soon as possible.

Discussions of measures to cut budget deficit under way

The financial crisis and measures to alleviate it raised the budget deficit to a very high level – it now exceeds 10% of GDP. President Obama's re-election may be brought into question unless the public gains the impression that steps are being taken to cut the deficit down. This endeavor will not be, however, devoid of problems, because an aggressive cut in expenditure may lead to the excessive slowdown of the economy and prove counterproductive – lead to higher deficits in the future. If measures to cut spending are put off, investors may easily become apprehensive about investing in securities, which would lead to a whole range of difficult-to-reverse consequences. The timing of the deficit cut is a sensitive and complicated problem, which the US will inevitably have to address in the near future.

As far as the expenditure side is concerned, social insurance and health care are the main items which will have to be cut. Expenditure for these two items together is several times higher than the sum of interest rates the state pays buyers of government bonds per annum. The health system reform under way aims to increase health care coverage; in order to cut costs, a large proportion of the funding will be transferred from the federal to the state level. The states will thus have greater interest in rationalizing medical treatment costs. There is no doubt that there are segments of the health budget where savings can be made, because some states have been achieving better results than others with the same funds. The reform has, however, just begun and it remains unclear what precisely will be done, because that, too, depends on how the situation unfolds.

The social insurance problem is simpler and the changes to ensue are clearer and easier to apply. The age retirement limit will be higher as will the threshold beyond which the citizens are entitled to Medicare services. Pensions will probably be lower than they are now in particular situations (for instance, if both spouses are alive) and the initial pension after retirement will be set on the basis of inflation during years of service and not on the basis of wage growth rate.

A significant reform of the revenue side of the budget is also expected. Revenues mostly come from individual and corporate income taxes. Such a tax system supports borrowing and spending and burdens labor and investments. Residential loan and medical insurance benefits stimulate borrowing and cost increase. The tax rates are not progressive enough and favor richer citizens. The current tax system is too complicated and it is almost impossible to measure the effects and mistakes. The reform will simplify the system and ensure better effect control and measurement and the focus will be on taxing spending, which now accounts for a small share of state revenues. The reform can be conducted in two ways. The first is to abolish numerous benefits and expand the tax base while cutting the tax rates. The second is to introduce value added tax or a version of it. It remains to be seen which combination will be implemented, because the choice of the model depends above all on the political situation. Given that many measures are unpopular, the end result will be the consequence of the relationship between the parties and voters. This is

why the following idea has been tabled: to change the procedure under which laws are adopted in order to facilitate and speed up the adoption of amendments needed for regulating the deficit in the future.

Eurozone

After declining during the previous five quarters, the eurozone finally grew by 0.4% in Q3 over Q2. Although growth was positive, the GDP was 4.1% lower in Q3 over Q3 2008. As far as major economies are concerned, growth was significant in Germany (0.7%) and Italy (0.6%), somewhat lower in France (0.3%), but still negative in Spain (-0.3%).

Industrial production is recovering

Positive results above all reflected the increased activity of industrial production, which had been hit hard by the global recession. After the volume of activity collapsed in early 2009, industrial production grew by 2.25% over the previous quarter, the highest quarterly rate since 1990. Recovery was primarily driven by fiscal measures and increased global demand, while the cycle of supply level contraction is slowly ending.

 Personal spending has probably grown mildly, above all due to the continued positive effects of the old-for-new car swap program. New car registration continued growing in Q3 (by 1.4%) but this factor will contribute less to growth in the ensuing quarters. Exports positively affected growth due to the recovery of the economies of importing developing countries. Expansion of investments, which plunged in the previous quarters, is projected in the next quarter.

Numerous surveys indicate that the economy will continue growing at a similar pace in Q4 but risks in the medium term have not disappeared. Short term effects of various incentives, which are maintaining the current level of demand, will weaken in 2010. Inventory levels will soon stop falling and their replenishment cannot last long. Domestic demand will be pressured by low capacity utilization levels, growth of unemployment and lack of access to favorable loans.

Total inflation in the eurozone stood at -0.34% and core inflation at 1.27% in Q3 y-o-y. Total inflation remained negative in October, but its rate has calmed down. The total inflation rate will increase in Q4 due to core inflation effects and augmentation of oil prices. Core inflation is under greater pressure from other factors (low capacity utilization, high unemployment) and it will move in the opposite direction from total inflation. Demand is still relatively weak and there is a surplus of unutilized capacities, wherefore the manufacturers are not in the position to raise the prices of their products. The labor market is lagging behind and its recovery is not keeping up with GDP growth so that there are no pressures to raise wages, the level of which determines the intensity of personal spending. All these factors will lead to the continuing decline of the core inflation rate in Q4.

The European Central Bank (ECB) decided to maintain the policy rate at 1%. It stated that recovery was unfolding according to plan but that further steps would not be deliberated before the meeting in December. The decision on whether the ECB will extend its current unconventional measures or start reducing them gradually will be taken after the analysis of data which will be available by that time. If growth recovery is qualified as considerable, the ECB will formulate an exit strategy. Judging by everything, the exit strategy will involve the gradual abolition of some unconventional measures that above all encouraged liquidity. The 2011 inflation projections will be made at the December meeting. If the total inflation forecast for 2011 falls considerably under 2% (ECB's official target), the policy rate will be kept at the present level longer than planned, to encourage economic growth.

Unemployment increasing in eurozone, reaching 19.3% in Spain

In Q3, unemployment in the eurozone increased from 9.5% in July to 9.7% in September. Spain has been struck the most by unemployment, which rose to 19.3%. The unemployment rate in Germany has been declining for two months now, falling by 0.1 percentage point in October – to 8.1%. The decline in unemployment was to a large extent caused by measures leading to the reduction of the number of working hours per worker in order to rein in the growth of unemployment. These measures cannot remain in force indefinitely and unemployment will rise shar-

ply if recovery is slow in 2010. Unemployment is expected to continue growing at the eurozone level; it will probably exceed 10% at the end of the year and continue rising in 2010. This situation will lead to the contraction of household incomes and thus constrain personal spending.

The trade deficit, projected at 2 billion euro, stood at 3.7 billion euros in September and contributed to GDP growth in Q3. Exports have been recovering slowly, above all due to increasing demand in East Asia; US demand has, however, remained weak.

Like the US, the eurozone is contemplating an exit strategy i.e. when it will launch fiscal policy changes. The eurozone deficit is smaller than that of the US and the European Commission projects the average deficit per eurozone country to stand at 6.9% in 2010. Although that percentage is lower than the 10% in the US, the package of measures designed to cut the deficit is less viable given that there is no single fiscal policy in the eurozone. Most economists agree that a single fiscal policy would be a more efficient solution1 but no such change is on the horizon in the near future. This is why efficiency will hinge on the will of the political elites and will be a good test of the real headway in the institutional development of the eurozone as a single entity. The European Commission will monitor and coordinate the process and exert pressure to ensure that the plan is achieved. Ireland, Greece and Spain, whose deficits will exceed 10% in 2010, are in the most precarious situation. The crisis and burst of the real estate bubble in Spain and Ireland demonstrated how low the tax base is in real terms vis-à-vis spending over the past years. Taxes collected during the real estate bubble will not be recovered, so that it will be quite difficult to attain the deficit level proposed by the European Commission – under 3% GDP by 2014 at the latest - even once the economy recovers. France will have a hard time meeting the Commission recommendation, particularly given the elections in 2012. Its public sector is bigger than that of any other country in the eurozone; therefore, rather than increasing taxes, it will have to opt for cutting public administration and entreprises costs. This is why it appears unrealistic that France will achieve the under 3% deficit proposed by the European Commission. Germany and Italy are in a more relaxed position and should not have trouble fulfilling the above-mentioned recommendations. Greece has not been doing anything with respect to reform yet and its public debt will reach 135% GDP in 2011 if it continues in the same vein. It should be noted that investors have continued buying the government securities with relatively low interest rates issued by Greece – as if the risk of unsustainable deficit was not calculated in their price. The explanation may be that investors believe that Greece will be bailed out by funds from European coffers if it encounters problems. Like in the case of US banks which the market perceived as too big for the state to let them fail, which contributed to the forming of unrealistic prices on the bourses, the Commission's relaxed attitude towards member-states that are not cutting their deficits must be avoided at all costs to pre-empt market deviations and their potential chain effects.

Japan

Japanese economy continued growing in Q3, by 1.2% over Q2. All GDP components recorded growth apart from public investments (-1.2% Q/Q) and investments in residential construction (-7.7% Q/Q). Exports grew the most (6.4% Q/Q) due to growing external demand for Japanese products over the previous months. Personal spending achieved solid results (0.7% Q/Q) thanks to government benefits for the purchase of eco cars and devices. For the first time after six quarters, investments in economy recorded positive growth (1.6% Q/Q) and manufacturers increased their stocks of supplies. Net exports and personal spending were the chief sources of growth.

The Japanese central bank has decided to keep the policy rate at 0.1% after ending specific unconventional measures in September because the economy began recovering from recession. Total deflation stood at 2.2% in September, similarly to August, which means that the fall in prices has halted temporarily. Base deflation declined mildly, by 0.1 pp, and stood at 2.3%. The central bank is criticized by the Japanese government and OECD senior officials for not reacting fast enough to the current danger of deflation.

1 Konrad Szelag, *"A single fiscal policy in the Euro area: vision or utopia?"*, National Bank of Poland, Working paper, 2008.

The unemployment rate grew mildly in September, by 0.1 pp, and reached 5.6%, but indicators suggest that the drop in unemployment has reached rock bottom before it had been expected and that the situation in the labor market will stabilize.

The trade surplus stood at 520 billion yen in September, i.e. it was less than the forecast 630 billion, because the monthly growth of exports was below expectations. Exports are expected to stabilize at the current level for a while, until demand of developed countries begins recovering.

Japan changing economic policy after 50-year Liberal Democratic Party rule

After the fifty-year reign by the Japanese Liberal Democratic Party (LDP), Prime Minister Hatoyama formed a government which plans to discontinue LDP's economic policy. It plans to cut investments in infrastructure and has already halted the construction of two dams under the explanation that these projects are not useful enough. The Japanese Post Bank will not be sold off to private investors. More funds will be redirected at the population to encourage domestic spending, which has been slower to recover than external demand. The strategy also includes social measures for families with children and single mothers and the new government has announced serious reforms of the pension and health systems. The problem of public financing poses the main threat to the successful implementation of the above changes. Japan's public debt is much higher than those of other developed countries. Public companies own over 50% of the government securities and are not planning on selling them in the near future because they help them protect themselves from deflation. The problem may arise once the crisis ends and investors turn towards riskier investments, which will reduce demand for government securities and increase their sale. This may lead to a rise in the long-term interest rate and burden economy and spending.

East Europe and Neighboring Countries

Romania

The economic crisis in Romania is accompanied by serious political troubles. The economic situation is better than expected, with GDP growth in Q3 amounting to -7.1% y-o-y although the economists forecast a 9% decline. The situation has begun to stabilize because the conditions for Romanian exports have improved, but domestic demand remains weak and it cannot be ascertained that Romania is definitely coming out of recession.

The Romanian Central Bank cut its policy rate for the fifth time since February. It now stands at 8% and is the highest rate of the kind in the European Union. Given that inflation is at its lowest in the past two years, the policy rate cut ought to stimulate production in the current recession.

Political crisis in Romania may endanger the implementation of the Stand-By Arrangement

Notwithstanding positive news of economic growth, there is a good chance that the situation will be undermined by non-economic factors and that the crisis will deepen. The Social Democrats left the Government, which then got a no-confidence vote in Parliament. This is the first time since the fall of communism that a government lost power in Romania by a parliamentary vote of no confidence. The tactical positioning ahead of the presidential elections and avoidance of responsibility for the unpopular fiscal reforms envisaged in the anti-recession package are the chief reasons for the political crisis. Public sector employees protested against measures to cut their salaries and speed up the lay-off process. Unless the government is formed soon, there will be no vote for the 2010 budget, a prerequisite for the 20 billion euro IMF and EU assistance. The agency Moody's for now qualifies this as expected political noise and factors it in Romania's current rating; it is not expected to endanger the arrangement with the IMF, particularly since the latter has been quite tolerant of the slow pace of reforms. Romania's rating may deteriorate if the crisis extends into the next year. Moreover, if the foreign funds do not arrive soon, Romania will face the problem of paying wages to public company employees, which will lead to fresh strikes and further complicate the political crisis. The implementation of the reform plan is expected to lead to 100,000 lay-offs. The leading parties agree on the 2010 budget deficit target but not on the way to achieve it.

Bulgaria

Bulgaria entered the crisis with a delay and is expected to overcome it with a delay as well. The crisis deepened in Q3 and the GDP growth rate stood at -5.8% y-o-y, lower than in Q2, when it stood at -4.9%. Recovery will be slow because manufacturers are under pressure from lesser domestic demand due to more restrictive borrowing conditions, while the population will be under the influence of fiscal measures that will cut public spending.

Bulgarian economy is in deflation

Bulgaria officially entered deflation in October, because consumer prices fell by 0.3% y-o-y. Inflation is an important factor in Bulgaria's plans to join the European Monetary Union (EMU) and adopt the euro. Under the Maastricht Treaty, the average annual harmonized inflation (based on the HICP index) must not be higher more than 1.5 percent over average of the three lowest inflation rates in the EU. This parameter is now in accordance with the requirements but there are risks that the government stimulus measures may have inflationary effect in the future and or that the national currency destabilizes.

Industrial production plunged in September, as many as 19.3% y-o-y, which is worse than the year-on-year decline in August (15.9%). This was the twelfth consecutive month in which industrial production recorded a negative growth rate y-o-y. The decline in October hit all sectors and was particularly marked in the manufacturing industry (22%). The annual average industrial production growth rate now stands at -15.6%, the lowest since 2000, when the monitoring of the series began. The Government expects the GDP to decline 6.3% in 2009 and 2% in 2010, while the Central Bank is more optimistic and even forecasts 0.5% positive growth in 2010.

The Bulgarian parliament endorsed a law under which a company may be set up with the minimum founding capital of two lev (one euro). This measure was proposed in Bulgaria back in 1996 under the explanation that it increased competition and eliminated the social function of the prior provision. Whereas it took most former communist countries four years to adopt this legal provision, it took Bulgaria 13 years, which may be interpreted as another illustration of the slow pace of economic reforms in this country.

Currencies and Commodities

The dollar weakened in Q3 because the investors' risk aversion was alleviated by better economic indicators across the world. Its exchange rate against the basket of the leading world currencies was 11% weaker in September than in March. The dollar may strengthen by the end of the year only if data indicate slower recovery than presently expected. If this does not materialize, the EUR/USD rate will probably rise to over 1.5 by the end of the year.[2] The price of oil will probably not tend to grow until the end of the year and will remain under 80$ with the high risk of declining, because the supplies are greater than projected. Moreover, traders are factoring low demand in the price of oil until it becomes certain that world economy is recovering at a faster pace.

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2 BNP Paribas estimate.

HIGHLIGHTS

Highlights 1. Fiscal Policy in 2010

Milojko Arsić*

Basic contours of the 2010 fiscal policy are clearly seen from the draft budget adopted by the government. Although the consolidated balance of the government sector for 2010 is not known, it will certainly be in line with the IMF agreement. The basic characteristics of the proposed budgets include a relatively conservative estimate of revenues, a slower growth in spending than the expected GDP growth and an improvement of the economic structure of spending. The proposed fiscal gap of 107 billion dinars represents 3.4% of the estimated 2010 GDP.

Overall, the draft 2010 budget of the Republic of Serbia can be assessed as positive from a balance sheet standpoint, although a somewhat lower deficit would have been more adequate. The key shortcoming of the budget is that the key adjustments will come through *ad hoc* measures, prompting doubts about their long-term sustainability. Beside those, frequently announced tax reforms are missing, while the direction and the pace of reforms of the most important budget beneficiaries (the pension fund, the health and education systems) remain uncertain.

Planned budget revenues in 2010 are by around 1% above the current budget, i.e. by around 5% up against the revenues which are likely to be collected in 2009. Considering an expected inflation of around 6%, the 2010 budget revenues will be by around 1% lower in real terms compared with 2009 levels. If GDP growth meets projections, budget revenues will fall by 0.6 percentage points against GDP. The most significant revenue increase has been planned for excise duties, which posted a significant growth in real terms in 2009. The growth of revenues from excise duties in the coming year partially results from growth carried over from this year, and partially from an expected increase of excise duties on cigarettes. Projected revenues from VAT in the coming year will stay approximately unchanged against 2009. In the case of a more significant global economic recovery and the recovery of the Serbian economy, those revenues could over-perform. Revenues from the personal income tax are expected to post a real decline primarily due to a wage freeze that hits 460,000 persons working in the public sector, or one quarter of the total workforce. The projected decline in revenues

from corporate income tax reflects a deteriorated financial performance of the corporate sector in the course of 2009. At the same time, a relatively steep decline in revenues from customs duties has been projected – as a result of lower customs duties on imports from the EU and an expected moderate imports growth. In the case of a more significant economic recovery of Serbia – the imports growth could bring higher customs revenues than those planned in the budget.

A conservative revenue projection is justified considering still significant risks related to the global economic recovery and thereby of the Serbian economy in the coming year. Although the economic recovery could be higher than the one projected by the budget, one should not neglect a chance of the recovery underperforming[1].

Planned budget spending in the coming year will be around 6% higher than the estimated spending in 2009. A comparison of the budget spending with projected inflation shows that the expenditures will remain unchanged in real terms compared with 2009. In the case of GDP growth meeting the plan – the share of budget spending in GDP will remain approximately unchanged.

The proposed budget contains an improved spending structure – the share of capital spending will be higher compared with current spending. However, an absolute increase in capital spending is relatively modest because the majority of planned investments will be financed from foreign credits, with public companies appearing as direct debtors and the government acting as a guarantor. Unlike previous years, big infrastructure projects, such as Corridor 10 will dominate the planned public investments for 2010 – which can be assessed as positive.

The freeze of pensions and wages in 2010 represents the key measure to cut the real levels of public spending and for halting the real growth in total budget spending. It is planned that labour costs next year rise by only 1% in nominal terms, probably as a result of a lifted decree, which had imposed temporary limits on high wages. Transfers to the pension fund will rise by a nominal 1.4%, despite a freeze in nominal pensions, due to an expected increase in the number of pensioners.

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[1] Serbia's economic growth dominantly depends on global economic trends. Since mid-2009, the global economy shows signs of recovery, but it is still uncertain whether those are indicating a self-sustainable growth or growth still dependent on fiscal stimuli.

Within current spending, the government has planned growth in subsidies, spending on interest rate payments and spending on purchases of goods and services. The real growth in spending on subsidies mainly refers to agriculture and the railways. An increased spending on interest rate payments results from a public debt increase, but also from a fact that the period of extremely low interest rates on some foreign credits is over.

Despite significant improvements, the planned budget deficit is relatively high, at around 3.5% of GDP, while the consolidated fiscal deficit will probably stand at around 4% of GDP, in line with the IMF agreement. The planned 2010 deficit of the consolidated state sector against GDP will be similar to the one in 2009. As a result of the mentioned deficit, the public debt-to-GDP ratio will rise to 36-37%. Considering that the major part of the deficit will be financed from foreign borrowing, the public debt increase will translate into an expansion of the country's external debt by around 3 percentage points of GDP. External borrowing is desirable from the aspect of short-term macroeconomic policy, because it does not lead to crowding-out of private investments, but at the same time, it will raise the foreign debt, which is already at a high level compared with GDP (see section 4 "The Balance of Payments and Foreign Trade"). A quick pace of the government borrowing partially results from a lack of project prioritization. Different coalition partners seek foreign financiers for projects under their jurisdiction, even though some of those projects would not pass a tight economic verification, while other projects (e.g. in the field of energy) could be left to private investors.

Box 1. Transparency of the Serbian Budget

With Serbia's fiscal policy exposed to a wave of criticism, a significant improvement of the structure and the content of the budget of the Republic of Serbia have gone almost unnoticed. The law on the budget and its presentation in the past several years and particularly in the past two years – have increased significantly to almost 500 pages. An increased detail in presenting some budget spending, but also the inclusion of a series of items that have never been contained in the budget spending before, contribute to a greater transparency of the budget and make the control of its execution easier. Of new items, the most significant is the one to present own revenues of budget beneficiaries, as well as a detailed presentation and analysis of the public debt and of the borrowing plans. Also, the government for the first time presents tax spending, i.e. lost tax revenue as a result of granting some forms of tax incentives. Budget items are clearly explained so that everyone who takes interest in reading the budget can learn the purpose of spend-

ing. As a result, those changes improve the transparency of the budget of the Republic of Serbia both during its drafting and adoption. The next movements should aim to improve other stages of the budget process, starting with defining fiscal rules, over the implementation of a *cost-benefit* analysis for project selection, to an improved control of budget execution by budget inspection and the state audit institution.

A mid-term sustainability of the fiscal policy implies a continued reduction of the fiscal deficit over a period of several years, so that the public debt-to-GDP ratio stabilizes at a sustainable level. If a possibility of increasing tax revenues based on higher tax rates or less tax exemptions is excluded, which seems to be the majority stand in the Government, a sustainable fiscal policy in the coming years will imply a continued reduction in the current public spending as a share of GDP – explained in the previous issue of the *Quarterly Monitor*[2]. Considering the structure of the current spending – that implies first of all a minimum real growth in wages and pensions in 2011 and over the next few years.

In the course of 2011 and in the following years, GDP growth is expected to be slower, at around 3-4%, which means that a real growth in pensions and wages should be even lower, so that their share in GDP declines. This is believed to be difficult to achieve, after two years of a freeze of nominal wages and pensions (and an expected decline in their real values in 2009-2010 by around 15%). Difficulties in implementing such policies are even greater if political factors are taken into account, including the government's traditional pre-election indulgence (regular elections are due in 2012), opinions of some coalition partners about minimum wages and pensions, as well as about the pension indexation rules. The implementation of the General Collective Agreement, which would result in a public sector wage hike by 15-20%, will remain frozen throughout 2010, but it is unclear what will happen after the freeze. The chances for wage and pension hike in 2011 and 2012 additionally increase considering that the ongoing agreement with the IMF expires in the first half of 2011.

With a view to the listed economic and political considerations – it is clearly necessary to introduce legal restrictions on fiscal policy, probably through changes in the law on the fiscal system, so that its sustainability is not threatened by political cycles. The adoption of legal restrictions on the fiscal policy, similar to those imposed on monetary policy, could prevent or make harder and limit the abuse of fiscal policy by the present and any future government. Those restrictions would also lead to

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2 See Arsić, M.:„Public sector reform and fiscal consolidation", *QM* 17.

less populism in pre-election campaigns, because many pledges would be assessed as illegal[3]. The introduction of legal fiscal restrictions would at the same time cut down the dependence of the fiscal policy implementation on external factors, such as the IMF or the EU. (It is worth recalling that the expansiveness of the fiscal policy significantly increased right after the expiry of an IMF deal in 2006). Fiscal restrictions would refer to the amount of the consolidated fiscal deficit and public debt, and one should also impose limits on their share in GDP or the pace of growth of key public spending items, such as wages and pensions. Also, it is necessary to make economic verification of implemented infrastructure projects mandatory, through *cost–benefit* analysis and other methods. This would reduce a chance to achieve individual, party, sectoral, regional and other interests at the expense of all the Serbian citizens.

Even though representatives of the Ministry of Finance repeatedly announced this year a comprehensive tax reform as of the beginning of 2010 – the reform is missing. Plans included personal income tax reforms and property tax reforms, as well as revised tax incentives for the corporate income tax and the capital gains tax. It is obvious that the ruling coalition, for the time being, has reached no consensus on whether and what type of a tax reform is necessary.

A thorough tax reform to ensure GDP and employment growth, as well as to eliminate economically unjustified tax incentives, is assessed to be an important integral part of Serbia's new development strategy. Such a reform[4] would first of all assume a reduction in the total fiscal burden on production and higher taxes on consumption. To be precise, the key direction of the reform would be to raise VAT and lower social security contributions. Such re-allocation of the tax burden would contribute to an improved price competitiveness of the Serbian economy, because taxes on production factors are included in export prices, which is not the case with taxes on consumption. A higher tax on consumption (VAT) would, however, raise the prices of imports, which is also in line with a need to reduce Serbia's foreign trade imbalances. A cut in the labour costs, through reduced contributions, would increase Serbia's attractiveness for domestic and foreign investors, which would further increase demand for the labour force.

There is a wide consensus that the existing system of taxing personal income in Serbia is inadequate, even though opinions differ on which direction the reform should take. Essentially, there are two basic stands. According to the first, which was also presented in the previous *QM* issue (Arsić, Ranđelović, Altiparmakov), the existing personal income tax should be replaced with a proportional tax[5] (flat tax) which would be relatively high but would also contain a high amount of tax exempt income. According to the second, presented in Highlights 2 (Arandarenko), in this *QM* issue, a model that combines high tax exempt income along with progressive tax rates (three tax rates have been proposed) would be more appropriate for Serbia. In essence, the first opinion gives advantage to economic efficiency of the tax system (excess tax burden is lower) and to low implementation costs. The second gives advantage to vertical tax equity. Besides, proponents of the proportional taxation believe that such a system is more adequate for a country with low tax morale and a relatively inefficient tax administration – both of which are undisputed characteristics of Serbia.

An important segment of the tax reform is the abandoning of incentives as part of existing taxes, particularly as part of the capital gains tax and a corporate tax, unjustified from an economic point of view. Generous incentives combined with low tax rates, mean a certain loss of tax revenues for Serbia, along with uncertain results in respect to investment and employment growth. Comparative figures for other countries show that such a policy has been fairly unjustified. Therefore, reductions in the mentioned incentives along with a simultaneous elimination of other barriers that directly or indirectly increase the cost of doing business in Serbia are needed. The abandoning or the reduction of administrative barriers, including those existing in tax procedures, as well as a clampdown on corruption would be a significantly more efficient solution for Serbia instead of a generous approval of tax incentives. Tax incentives represent an expensive and mostly inefficient way of making an economy competitive.

Although the reforms of some important public sector[6] segments are underway (judiciary for example), the direction and the pace of reforms in the sectors – the key consumers of the public revenues – are still unknown. Within the framework of the pension reform, from a balance sheet aspect, the most important issues are pension indexation and the minimum ratio of average pensions to average wages. Opinions of relevant political factors largely diverge on whether the pensions would

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3 Of course, there is always a possibility that a new government abandons the listed fiscal restrictions, but likely at a high political price. To avoid easy abandoning of fiscal restrictions some countries, like Germany – have incorporated key fiscal restrictions in the Constitution.
4 The concept of a possible reform, as well as relevant quantifications, can be found in an unpublished paper by Nikola Altiparmakov „The Tax System as Employment and Economic Growth Tool".

5 As a second best solution for Serbia, the authors allow a possibility to introduce a very simple form of a combined or dual taxation, with a maximum of two tax rates.
6 A particularly important reform that refers to almost all public sector segments is so-called „Guillotine" of rules.

be indexed and what would be the minimum pension-to-wage ratio, after the pension freeze is over. Also, there are opinions that the average pension-to-wage ratio needs to be 70%, implying a share of pensions[7] in GDP of 14-16%, which would threaten the sustainability of the fiscal system, but also the overall macroeconomic stability.

Similar uncertainties about the direction and pace of reforms exist for other segments of the public sector, which are big budget consumers. A frequently announced downsizing of the network of elementary and secondary schools has been postponed and it remains uncertain whether and when it would take place. It is also uncertain what steps would be made to improve the quality of public education at all levels[8]. Moreover, steps have been taken occasionally to maintain the existing, inefficient way of functioning, just like in the case of constant yielding to student demands to lower criteria set for the enrolment of the next year of studying. This

is a direct example of supporting inefficiencies – the same result (the completion of studies) is achieved at a greater public, but also private cost. Similar problems exist in the health system, a sector that has made certain reform progress in the past years. Despite repeated findings over many years that the health system employs an unusually high number of non-medical staff, no measures have been taken so far to resolve this problem. The World Bank's study "Doing More with Less" also points to cost inefficiencies of the Serbian public health sector, which is particularly visible at medical centres.

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To summarize, one can conclude that the 2010 fiscal policy has been defined within a sustainable framework. However, mid-term fiscal policy sustainability demands an introduction of strict fiscal rules that would prevent any fiscal policy abuse during political cycles. Also, public sector reforms are necessary to improve the efficiency of the sector in terms of generating better results along with lower cost against GDP. The third important reform segment refers to tax reforms which need to support a new, export-oriented growth strategy, but also to, probably, ensure a somewhat higher level of public revenues against GDP.

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7 A relatively wide interval results from uncertainty about the movement of the wage-to-GDP ratio.

8 A particular problem is a low quality of private education. Due to a well-known problem of assymetric information – the government would, as a system regulator, need to ensure availability of information about the quality of all educational institutions.

Highlights 2. Possible Directions of Labor Tax Reform

Mihail Arandarenko [*]

In its previous issue, *Quarterly Monitor* opened a critical, albeit long neglected issue of fundamental personal income tax (PIT) reform. PIT reform supplements and to a significant extent overlaps with the issue of labor tax reform. Labor taxation comprises not only the taxation of wages and other labor incomes, but social insurance contributions as well. The latter account for a significant (dominant in Serbia) share of labor costs on top of net wages. Labor taxation, of course, does not comprise some significant forms of PIT, above all capital income. Labor income however accounts for 90% of registered taxable personal income; wages account for over 80% of taxable income within labor income.

The text on PIT reform by Dr. Arsić et al in the previous issue rightly highlights the numerous shortcomings of the PIT legislation, above all the devastating fact that the present system does not provide for horizontal or vertical equity by a long shot. The text also notes disregard of the effects taxation has on labor demand gi-

ven the high unemployment rate amongst less skilled workers. It underlines that income tax is low but that the overall fiscal burden on labor (which includes contributions) is nevertheless high and that it has specific adverse effects on labor demand.

To recall, the sum of nominal contribution rates on gross wages stands at 35.8% while the nominal wage tax rate stands at merely 12%, with an adequate, albeit small, tax-free threshold which additionally lowers the effective tax rate. Consequently, social insurance contribution revenues account for over three-fourths and wage tax revenues for less than a fourth of the overall labor tax revenues. It should be borne in mind that the contribution rates are by definition strictly proportional to wages within the minimum to maximum base range – their redistributive effects on wages below and above that range are manifestly regressive.

A recent broader regional study[1] first shows that the labor tax system in Serbia has quite a few regressive features, which, even if equity is disregarded, *inter alia* lowers the profitability of labor investment and increases the costs of labor of low skilled workers, discourages the formalization of informal employment, has adverse ef-

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1 Arandarenko, M. and Vukojević, V.: *Labor Costs and Labor Taxes in the Western Balkans*, World Bank, 2008.

fects on the competitiveness of labor-intensive branches and investments in them, and increases inter-sectoral and inter-regional differences in wages, employment and development. The study also demonstrates that the share of the collected wage taxes in the total collected labor taxes is much smaller in Serbia and, consequently, that the share of the contributions is considerably greater than in other European countries, especially in comparison with the old EU member-states. It finally shows that the implicit tax rate on labor[2] in Serbia is much higher than the EU average and is generally amongst the highest in Europe, undermining the overall level of competitiveness of Serbia's tradable goods and services.

A PIT reform ensuring greater horizontal and vertical equity is a necessary but insufficient prerequisite to eliminate or at least alleviate the multiple negative effects of the current labor taxation system. Given the lack of horizontal equity, the PIT reform is currently a first-rate legal issue in Serbia, while the lack of vertical equity renders it a first-rate political issue. However, it is merely a second-rate economic issue because even an optimal reform of income taxation, if isolated, cannot lead to significant cuts in labor costs, a significant increase in overall labor demand or demand for less skilled labor or the significant improvement of Serbia's international competitiveness. Apart from reforming income taxation, the government must also slash the current overall level of fiscal burden on labor (i.e. the implicit effective tax rate on labor) if it wants to improve international competitiveness and boost aggregate labor demand – an obvious priority of a country with an economically active population of five million and corporate private sector wage employment barely exceeding 900,000.

These first-rate economic goals will be achievable only once the authorities allow the unpacking of parameters regarding social insurance contributions in the context of the labor tax reform and, simultaneously cut the aggregate fiscal burden on labor (i.e. the implicit effective tax rate on labor) in the context of the overall tax system reform.

These deliberations have led us to formulating the following preliminary guidelines for the comprehensive reform of labor taxation in Serbia:

1. Increase the relative share of wage tax revenues and decrease the relative share of revenues from social insurance contributions in the overall labor tax revenue.

2. Reduce the tax burden on labor of low-wage workers by raising the tax-free threshold and lowering the soci-

al insurance contribution rates. The target value of the tax wedge[3] at the minimum wage level, now standing at 37%, ought to be slashed to between 25 and 28 percent. Such a radical cut would increase demand for less skilled labor, encourage investments in labor-intensive low wage sectors and cut the costs of formalizing informal employment.

3. Ensure labor tax progressivity by introducing three progressive non-zero tax rates on labor income (wages). The three rates are needed not only for ensuring vertical equity and yielding sufficient revenues; they would also serve as an instrument for conducting a tax-based incomes policy given the dual labor market and monopolized sectors pushing wage inflation. The tax-free threshold (i.e. the zero income tax rate) needs to be set relatively high, approximately up to the minimum wage level (around 40% of the average wage). The first non-zero nominal rate (ranging from 16 to 20 percent) would also be the only rate levied on around two-thirds of the workers earning below-average wages. The second nominal tax rate (22% to 26%) would cover wages immediately above average and would be the main tax instrument for controlling wage inflation. The third, highest nominal rate (30-35%), applied to incomes exceeding five average wages not burdened by contributions, would serve as a fairer substitute for the current annual income surtax and yield more revenues.

4. Cut the overall combined social insurance contributions rate from 35.8% to maximum 30.0% of the gross wage. It should be noted here that cutting the contributions rate in the context of a comprehensive, income neutral tax reform would not have any effects on the pension amounts or on health service coverage and quality. As is well known, nearly half of all funds for pensions are still provided from the state budget. Similarly, health services are predominantly or significantly funded from general taxes in most European countries.

The above measures would reduce the implicit effective tax rate on labor to a level slightly below the European average, which would significantly boost international competitiveness and aggregate labor demand, but this would *ceteris paribus* entail lower labor tax revenues and an increase in fiscal deficit.

In static context, there are two basic complementary ways to keep the proposed reform fiscally neutral: first, to increase capital income tax through the introduction

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2 The implicit effective tax rate on labor (or the implicit tax wedge on labor) is a macroeconomic indicator derived from aggregate data in national accounts which measures the ratio between total collected taxes on labor and total labor costs in a specific country.

3 The tax wedge is the ratio of total labor taxes (i.e. income taxes and contributions paid partly by employers and partly by employees) to total labor costs, which comprise the net wage and all labor taxes. The tax wedge is used for analyzing the intensity of vertical equity in taxing labor within a country or for comparing the relative tax burden on hypothetical individuals with typical income levels (e.g. 2/3 of the average wage, average wage, 5/3 of the average wage, etc) in different countries.

of a dual or synthetic PIT model and, second, to increase the basic value added tax rate (which would yield much more revenue). Our preliminary assessments show that increasing the VAT by around 3 percentage points would make up for the fiscal gap created by the cut in contribution rates. The simultaneous reconfiguration of income tax, contribution rates and the VAT rate would ensure that the overall macroeconomic and distributive effects of the comprehensive tax reform are positive. In the dynamic context, expanding the labor tax base by formalizing informal employment and stepping up growth of employment due to greater international competitiveness ought to help preserve the previous level of tax revenues notwithstanding the cuts in the average and total burdens on labor.

Highlight 3. What Can the New Planning and Construction Law Bring?

Dušan Vasiljević[*]

Serbia ranks 88th on the list of 183 countries in *Doing Business 2010*, a reference publication of the World Bank and the International Finance Corporation, thus rising two ranks over 2009. *Serbia, however, holds an alarmingly low ranking in the Dealing with Construction Permits category – 174th*. The extent to which this poor rating affects Serbia's overall placement can be calculated, but the extent to which it deters foreign investors contemplating investments in Serbia probably cannot be calculated even approximately precisely. It is even more difficult to estimate the extent to which difficulties in obtaining construction licenses discourage Serbian investors from launching their development plans. One day, someone may attempt to quantify this as well. In the meantime, this text will discuss the chances of the new Planning and Construction Law, passed on 31 August 2009[1], improving the situation in this field.

It is no accident that the text is titled "What Can the New Planning and Construction Law Bring" rather than "What Does the New Planning and Construction Law Bring". The fact is that the effects of the Law will largely be determined by factors outside its scope:

1. The provisions of the subsidiary legislation to be adopted.

2. The capacity of those involved in its enforcement (state administration authorities, agencies, public companies and their regional units, local governments, various institutes, licensed architects....).

3. Political resolve to ensure the adequate application of the Law.

Most who had anything to do with the previous Planning and Construction Law[2] agree that it had failed to achieve hardly any of its strategic goals. More precisely, its application was so disconcertingly poor that we may never find out what its effects would have been had it ever been consistently enforced. The non-fulfilment of legal provisions on the adoption of spatial and urban plans and the disappointing legalization results are merely the most glaring of the many illustrations. *According to some unofficial data, adequate planning documents have been adopted for only 20% of Serbia's territory and less than 10% of illegally built facilities have been legalized*. What is even worse, the practice of illegal construction, defined as a felony under the 2003 Law, not only continued but assumed such proportions that the authors of the new Law decided to allow the legalization of those facilities as well. The construction field is nowadays a showcase example of inefficiency and corruption in the public sector, with huge adverse effects on the sector of economy and the quality of life of Serbia's residents.

The new Planning and Construction Law (PCL) had been heralded as a solution to the numerous problems which made the legally-prescribed construction procedure infamous. Rarely have the results exceeded the announcements as in this case: the provisions of the new Law mark a small (or maybe not that small) revolution in the Serbian legal system – in the fields of construction and spatial and urban planning, but even more so with respect to property law relations.

No Plan, No License

The chief issue is the extent to which the legislator succeeded in fulfilling one of the goals of the new Law – to ensure that the compulsory planning documents are actually adopted. The excessive burden with respect to the adoption of the plans, especially at the local self-government level, was identified as one of the main reasons why these obligations remained unfulfilled in the past. Although the number of legally prescribed planning documents was cut from 9 to 7, practice will show how this cut will effect cuts in resources which the public sector, above all local governments, need to invest to ensure full coverage of the territory of the Republic by appropriate plans.

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1 Official Gazette of the Republic of Serbia No 72/09.
2 Official Gazette of the Republic of Serbia Nos 47/03 and 34/06.

It needs to be recalled that the 2003 Law envisaged the adoption of a Spatial Development Strategy of the Republic. Such a strategy has not been enacted yet and the last planning document adopted for the territory of Serbia dates back to 1995. The authority of the Republic to require of local governments to fulfil their obligations with respect to planning documents will also depend on whether the Republic will do its share and fulfil the announcements by the Ministry of Envornment and Spatial Planning that the Spatial Plan of the Republic will be prepared by May 2010 given that no legal deadline has been set for this obligation.

Another important feature of the new Law is that it envisages the possibility of issuing construction licenses on the basis of spatial plans for special purpose areas and spatial plans of local goverment on condition that the adoption of urban plans is not envisaged for these areas. The provision - under which construction will be prohibited in areas with respect to which general regulation plans envisage the adoption of detailed regulation plans until such plans are adopted - may prove even more relevant. This measure obviously aims at putting a halt to the extremely widespread practice of turning an exception provided for by the law (issuing construction approvals on the basis of zoning requirements enactments for areas for which there are no urban plans) into a rule and one of the chief sources of arbitrariness and corruption in the field of planning and construction. *If this measure proves effective in combating corruption and ensuring better coverage of Serbia's territory by urban plans, it will prove worth the price that may have to be paid – short-term slow-down i.e. delay in projects which would otherwise be implemented under the zoning requirements enactments.*

As far as the dynamic of adopting planning documents is concerned, local governments must adopt spatial plans within 18 months from the day the Law comes into effect while general regulation plans must be adopted within 2 i.e. 3 years. These are the deadlines within which the new Law is expected to prove its full effectiveness. The final text does not include any of the sanctions against defaulting local governments, despite the stentorian announcements of measures ranging from halting transfers to the dissolution of local governments during the public debate on the Draft Law.

Ownership of Construction Land – Backdoor Revolution

Although the initial PCL drafts did not include many novel provisions regarding the construction land regime, the changes in this field in the final text may prove deeper and more important than all the others. These changes were without doubt brought on by the fact that the inadequate regulation of ownership over construction land has been perceived as the chief obstacle to the faster implementation of construction projects and to attracting investments. The novel provisions allowing privatization of construction land in the last draft of the PCL came as a big surprise, especially to those who had expected that laws regulating public property and denationalization would be adopted first. The fact that not even the government has approved these laws yet is extremely regretful, given that the system of land property rights will be fully regulated and the investors will enjoy full legal security only once they are enacted – not even to mention the arguments of fairness and morality.

The key provision in the chapter on construction land is the one allowing all forms of ownership over and the sale of construction land. The Law, however, goes several steps further. It allows persons, who have the right of use of developed construction land or have leased it for 50 years or more, to convert such rights into private ownership. *This marks the greatest step to date towards unifying ownership of facilities and ownership of land.* Furthermore, provinces and local governments shall be entitled to own the construction land which they have the registered right to use. This provision is of far-reaching relevance to local governments and investors. First of all, local governments will now be able to alienate as property undeveloped construction land; the previous Law allowed them only to lease it for 99 years. It will thus be possible to use the land as mortgage and it will be much more attractive to investors, above all foreign ones, who do not place much trust in a system in which they have to pay the full price for the land but are only awarded the right to lease it. All these changes are expected to result in the increase in the value of such land.

Another provision of long-term relevance is the one under which founders of public companies (the Republic and autonomous provinces in case of public companies, cities and municipalities in case of public utility companies) shall have the right of ownership of construction land which the public companies are entitled to use. This provision is also extremely relevant with respect to the strategy of reforming public utility companies, which is now being drafted. The provision will allow the founders – whose public companies have the right to use large areas of undeveloped land – to deliberate whether they are better off letting the companies manage the land (even temporarily), selling it off or leasing it.

The new Law sets out what kind of land a person may acquire the right of ownership over at a fee:

– The land for which all legal perspons acquired the right to use in accordance with laws regulating privatization, bankruptcy and enforcement proceedings, and

their legal successors and,

– State-owned undeveloped construction land for which the right to use was acquired for the purpose of construction in accordance with construction laws in force until 13 May 2003 or in accordance with a decision of a competent authority.

The fee shall be determined as the difference between the market value of the land at the moment of conversion of the right and the costs of acquiring the right to use. Revenues from fees shall be equally divided between and paid into the local government budget and a special restitution fund. The adopted model appears to be the most acceptable way for overcoming the impasse reached because numerous investors, who had acquired extremely valuable sites for next to nothing were unable to build on the lots they had the right to use because the local governments refused to amend the planning documents or even issue them construction approvals on the basis of their right to use the land. *Although there are speculations that the fee charged on these grounds may be high, there are still no assessments of the amount that could be used as reference.*

No Land for Free for Investors without Government Consent

As far as the disposition of construction land is concerned, the new Law for the first time provides for the sale and not merely the lease of construction land owned by local governments. It also sets a minimum 30-day deadline for the submission of public bids or of purchase or lease offers from the day the invitation is made public. The purpose of this provision is to do away with the practice identified in specific communities, which announced the lease of attractive sites but gave very short deadlines, thus preventing potential investors, who had not known of the procedure in advance, from bidding.

Another important novelty is the prohibition of the subsequent reduction of the price of land or the lease fee, a frequent practice of a large number of local governments. Namely, some cities and municipalities practiced offering free land to investors who would commit to opening a specific number of new jobs. Given that the old Law stipulated a competitive procedure (public bids or offers), the city and municipal authorities resorted to subsequently lowering the amount and thus rendered the whole competition procedure senseless. *The new Law prevents this: on the one hand, it renders the construction land disposition procedure more transparent and equitable, whilst, on the other hand, it reduces the cities' and municipalities' maneuvering room for using construction land to attract investors and thus cut unemployment*

and boost economic activity in their jurisdictions. There is still some scope for such a possibility given that the new Law allows local governments to alienate or lease construction land at a price or fee lower than the going market rate, or even for free, but with the prior consent of the Government.

Publicly owned undeveloped construction land may now be included as a share in the founding capital of business and public companies; this issue will be resolved in accordance with a law regulating public property. The manner in which this issue will be regulated will prove extremely significant with respect to the possibility of establishing various forms of private-public partnerships.

Public Revenues from Construction Land – Fewer Forms of Tax, More Order

Revenues from construction land account for a significant share of total local government revenues and often exceed 20%. These revenues (above all the construction land development fee, the construction land usage fee and property tax) account for a large share of the original local government revenues – two-thirds as a rule. The new Law makes significant changes in this area as well.

Graph 1. Share of Specific Revenues in Total Local Government Revenues, 2008

Source: Ministry of Finance.

First of all, it no longer provides for construction land usage fees as a source of revenue for funding construction land development. Under the transitional provisions however, this fee will still be levied pursuant to the provisions of the previous Law until it is integrated in property tax. The provision arises from the fact that the construction land usage fee and property tax bases are very similar and constitute dual taxation. The mere abolition of the fee would, on the other hand, slash local government revenues. This is why the legislator envisaged merging the two fiscal forms by amending property tax on the assumption that the volume of funds collec-

ted through property tax after the unification of the two forms will not be lower than the sum of revenues from the fee and the property tax before they are merged.

The new Law also brings significant changes in the construction land development fee regime. Notably, it establishes the fee-setting criteria, which used to be the competence of the local governments under the previous Law. This change is the result of years-long complaints by investors about the manner in which a large number of local governments determined the fees. The latter had become prone to setting the fees reflecting the presumed economic power of various fee payers rather than the real costs of construction land development at specific sites.

The new Law sets the following criteria: degree of public utility amenities on site, the annual construction land development program, the urban zone, purposes and size of the facility. The Law goes one step further, allowing for only four zoning categories of construction land: residential, commercial and manufacturing and for other purposes. This provision is expected to protect specific activities, which had often been disproportionately burdened by the fee (republican public companies, gas stations, foreign investors, etc), but it still allows for setting higher fees for central sites than for remote ones although the costs of providing public utility infrastructure for the latter may be much higher.

Another novel provision is the one under which the real costs of providing public utility amenities for facilities built on site and paid by the owner shall be deducted from the levied construction land development fee; the deduction may not exceed 60% of the fee, which shall be set in accordance with the criteria for calculating the fee for the specific site. *This provision indicates that local governments are not entitled to allow additional deductions of the construction land development fee*. Namely, a number of municipalities resorted to deducing this fee under specific conditions to attract investors (above all depending on the volume of their investment and the number of new jobs). The deductions sometimes added up to the fee amount.

The Construction Licensing Procedure and Other Important Provisions of the New Planning and Construction Law

Changes in the licensing procedure were obviously partly inspired by the experience of some neighboring countries and adapted to the local circumstances. The most striking changes include the introduction of site information (replacing urban plan extracts) and site permits; the construction approval is replaced by the con-

struction license. The following arguments are provided by those claiming that the licensing procedure will now be faster:

– The list of facilities that may be built without a construction license has been extended.

– The content of the main project for the construction and reconstruction of residential and auxiliary facilities with an area under 400 and 600 square meters respectively has been simplified.

– The administrative authority has the obligation to procure all requirements and data needed for the technical documentation *ex officio* and at the expense of the investor in the event the planning document does not comprise such data. The authorities and organizations authorized to issue such requirements and data are duty-bound to deliver them within 30 days.

– The Law allows for the transfer of construction licenses for facilities under construction.

– The construction license constitutes grounds for the construction of a facility.

The following novel provisions also warrant attention:

– Authorities charged with adopting plans are obliged to publish and make electronically available on the Internet planning documents, which shall be produced in analogous and digital forms.

– The standard of accessibility must be applied to ensure persons with disabilities, children and the elderly free movement and access to public and business facilities, and to residential and business/residential buildings with ten or more apartments.

– The Law introduces the principle of abidance by energy efficiency standards during the construction of facilities.

– The planning document implementation program must comprise sources and resources for funding the projects whereby spatial planning is linked more strongly to budget planning.

– A Central Planning Documents Register shall be established and Internet access to it shall be made available.

– Local governments are obliged to keep Registers of Investors, which shall be available also on the Internet.

– Lists of site licenses shall be made available on the Internet.

Conclusions

The extent to which these measures will actually speed up construction procedures is difficult to predict with reliability because the subsidiary legislation regulating

the relevant details, which can determine the effects of the Law, is yet to be drafted. The relevant minister will pass by-laws regulating the content, manner and procedure for elaborating planning documents, the content and manner of managing and updating the Central Planning Documents Register and the local planning documents information systems, the content of the site information document and the site license, the content and manner of issuing construction licenses, the energy efficiency standards and numerous other crucial issues. Although the Law fails to set deadlines by which the subsidiary legislation must be adopted, the fact is that some of the enactments have already been passed and that others are being drafted.

Another uncertainty about how the new procedures will function concerns the capacities of the local administrative authorities and the public companies and other organizations to apply the law. Moreover, given the greater role of licensed architects, the Serbian Chamber of Engineers will need to monitor the work of its members carefully and react decisively whenever it identifies any irregularities.

Apart from the speed at which the licenses are issued, the other effects of the Law need to be attentively monitored as well. *The Law is expected to help suppress corruption, particularly given that it abolishes enactments on zoning requirements and the arbitrariness that accompanied it and introduces transparency by providing for the Internet publication of plans and licenses, and contains more detailed provisions on the disposition of construction land.* The novel provisions on energy efficiency, too, may have great impact, especially on the construction material production industry and may also lead to higher construction project implementation costs.

Let us go back to the *Doing Business 2010* report mentioned at the beginning of the text. Herewith the ratings Serbia got on the criteria used in the construction licensing category:

Table 2. Dealing with Construction Permits Indicators in Serbia in the Past Three Years

	Doing Business 2008	Doing Business 2009	Doing Business 2010
Ranking	-	172	174
Procedures (number)	20	20	20
Time (days)	204	279	297
Costs (in % GNI per capita)	2,713	2,177	1,907

Source: Doing Business 2010.

These data show well what awaits investors trying to build a facility in Serbia (an office supply warehouse in this case). What is missing is comparing the indicators

to those of specific countries in the region, which would indicate in what respects Serbia lags so far behind the others that it ranks at the bottom of the global competitiveness list.

Table 3. Dealing with Construction Permits Indicators in Serbia in the Regional Perspective

	Procedures (number)	Time (days)	Costs (% of income per capita)
Bulgaria	24	139	436
Greece	15	169	50
Hungary	31	204	10
Romania	17	243	88
Slovakia	13	287	14
G5 Average	20	208	120
Serbia	20	279	1,907

Source: Doing Business 2010.

Comparing Serbia with the group of five countries in this part of Europe is extremely interesting. The number of procedures is identical to the average of the five countries – 20. Serbia does not rank last with respect to the number of days it takes to obtain a construction license but its score is much poorer than the average of the five countries. Not only does Serbia rank last with respect to the costs sub-indicator - costs in Serbia are four times higher than the costs in the country immediately preceding it.

There is no doubt that the construction land development fee accounts for the greatest share of these costs in Serbia, more precisely, over 1,500 GNI per capita. If this cost were slashed, the headway Serbia would make under the costs sub-indicator would also reflect on its ranking in the Dealing with Construction Permits category and definitely on its overall ranking in this index of global competitiveness. Otherwise, Serbia's ranking is likely to continue deteriorating given also the experience of other countries in which licensing efficiency declined during the first year of implementation of the new construction laws.

SPOTLIGHT ON:

Ten Years of Transition: The Serbian Growth Experience - What's Next?

Lazar Šestović [*]

Marina Wes [**]

**Prior to the onset of the international financial crisis the Serbian economy grew strongly, fuelled by both domestic demand and exports, and on the back of significant economic changes since 2000. This growth model was largely financed by easy and cheap access to foreign financing (including from foreign owned banks) and significant capital inflows i.e. FDI. The impact of the global financial crisis on Serbia has been significant already. The inflows of loans and investments dried up almost overnight, the economy went into recession, unemployment increased and living standards have started to deteriorate. The Government is going through a program of ambitious and painful budget reshuffling, and with support of international financial organizations, the impact of the crisis so far has been contained. Moreover, recent high frequency economic data suggest that the economy has bottomed out. However going forward, growth rates are likely to be lower for some years to come. A new growth model will also need to take hold, with an increased focus on competitiveness, and much less reliance on foreign capital inflows. This calls for a renewed importance of structural reforms, in particular within education sector, and infrastructure investment, especially as investors are also likely to become more discriminating.**

1. The Pre-Global Crisis Developments: 2000-2008

The Legacy of the Past.   The renewed transition to a market economy in Serbia began from a very difficult starting point, reflecting a decade of isolation, conflict and poor economic management. By 2000, recorded per capita GDP had fallen to about one half of its 1989 level. Foreign trade volumes also declined sharply while inflation (including hyperinflation in 1993) was chronic. Serbia (then as a part of Yugoslavia) accumulated large domestic and external debts, with the latter reaching around 150% of GDP in 2000. Although cash deficits of the consolidated government were kept low, this was achieved largely through unsustainable expenditure compression, the accumulation of budgetary arrears, non-servicing of public debt, and the toleration of quasi-fiscal deficits in the enterprise and banking sectors. Over that period Serbia's real sector became largely inefficient due to the lack of market orientated ownership structures, the loss of markets, lack of access to working capital, delayed investment and maintenance, and repressive and complicated taxation and regulation. The banking sector, consisting of around 100 socially owned banks, became loss making, with most major banks insolvent.

This pushed a significant portion of the economy into the informal sector, eroding the government's revenue base and leaving many residents with little or no access to social protection. The poor economic performance resulted in a decrease in real earnings with average wage falling from close to EUR 400 in 1990 to just EUR 35 in October 2000, with absolute poverty roughly doubling between 1990 and 2000. This increase in poverty was accelerated by a deterioration in social protection and health services, as available financing fell below existing entitlement levels. The effects of poor economic management were compounded by international sanctions imposed on Yugoslavia from 1992 to 1996 and again in 1998-2000 which severely inhibited trade and investment in the country.

Between 2000 and 2008 the economy grew strongly, fuelled by both domestic demand and exports, and on the back of significant economic changes since 2000. Real growth of gross domestic product (GDP) averaged 5.4

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percent between 2000 and 2008. As a result, output has risen in real terms by 53 percent since 2000. Growth was fueled by high domestic demand linked to a significant credit boom and increases in real wages. The positive supply response also appears to reflect increases in productivity and output of recently privatized and *de novo* firms, as evidenced by the particularly rapid rates of output growth in precisely those sectors which have recently undergone extensive privatization (e.g., steel, cement, retail trade, rubber, tobacco, dairy, sugar and banking) or attracted foreign investors.

Graph L1-1: Contribution to Growth, in percent of GDP, expenditure side
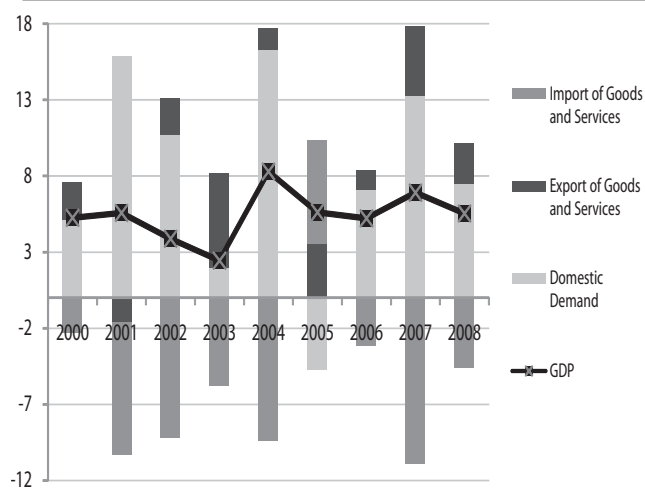
Graph L1-2: Contribution to Growth, in percent of GDP, production side
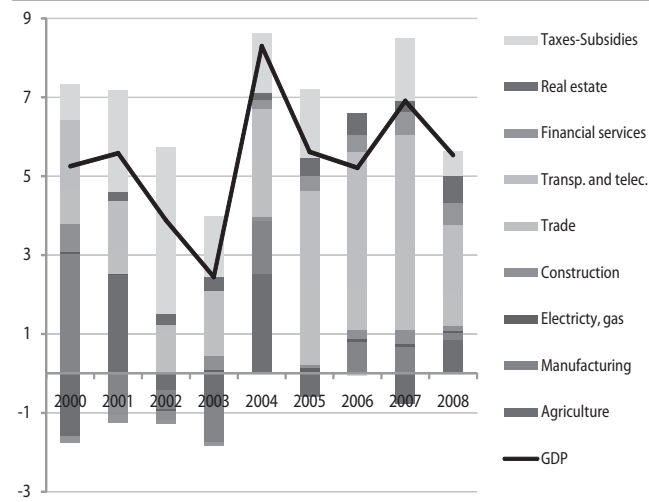
But strong economic growth was accompanied by a widening current account deficit and increasing private sector debt (see Table L1-3). Although exports grew rapidly, domestic demand grew even faster which resulted in very high import levels and consequently a trade deficit reaching about 22 percent of GDP. The current account deficit reached 17.1 percent of GDP in 2008, up from 8.7 percent in 2005, and only a 2.5 percent of GDP in 2001. Most of the increase in the current account deficit (CAD) was due to the increase in the private sector's share in the savings-investment balance; indeed, the private sector accounted for 90 percent of the current account deficit in 2008. Financing of the high CADs required new borrowing and the share of external debt in GDP started increasing since 2005. Most of the increase in the external debt is due to private sector borrowing from abroad. Public debt since the start of transition declined significantly and stood in the last couple of years at about one third of GDP.

Table L1-3: Macroeconomic Performance, 2000-2009

	2000	2001	2002	2003	2004	2005	2006	2007	2008
GDP in USD million	8.661	11.433	15.099	19.671	23.712	25.3	29.603	40.426	50.061
GDP real growth	5,3	5,6	3,9	2,4	8,3	5,6	5,2	6,9	5,5
Inflation, eop	112,0	40,7	14,8	7,6	13,7	17,7	6,6	10,1	6,8
Exchange rate RSD/EUR, eop	59,7	59,7	61,5	68,3	79,1	85,5	79,0	79,2	88,6
CAD, as %GDP	-1,8	-2,5	-8,3	-7,2	-12,1	-8,7	-10,1	-15,6	-17,2
FDI, as %GDP	0,6	1,4	3,1	6,9	4,1	6,1	14,4	6,2	5,3
Official reserves, USD million	523	1.169	2.28	3.55	4.245	5.843	11.889	14.216	11.477
public debt	212,5	102,3	81,2	77,3	65,2	56,1	42,6	33,3	31,6
external debt	152,2	98,8	67,1	62,4	54,3	64,1	63,3	60,2	63,6
Private external debt, as %GDP	23,5	18,2	16,1	15,9	18,6	25,0	37,7	42,5	45,0

Source: World Bank Staff Estimates, IMF, SORS.

Rapid credit growth in the banking sector (primarily in FX-indexed loans) and increased cross-border borrowing of domestic enterprises was a key factor in the overheating of the economy. While deposits grew, lending outpaced the growth in deposits with the loan to deposit ratio increasing from 99 percent at the end of 2007 to 125 percent at the end of 2008 (see Graph L1-4). In addition, since 2007 Serbian enterprises owed more to parent banks than to local banks (by 20 percent) and that increased further to a 43 percent higher stock of debt to foreign than to local banks at the end of 2008 (see Graph L1-5).

Graph L1-4: Loans and Deposits, in RSD Millions, 2006-2008

■ Total Loans   ■ Total Deposits
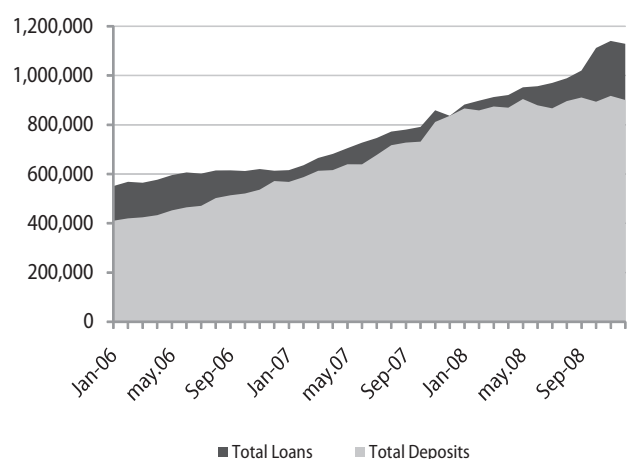
Graph L1-5: Loans to Enterprises from Domestic and Foreign Banks (in EUR millions)

■ External debt of enterprises   ■ Debt to domestic banks
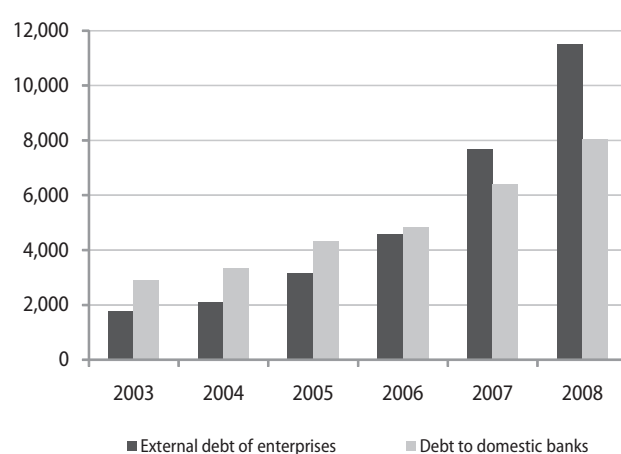
Domestic overheating and external imbalances were not sufficiently counterbalanced by fiscal policies, in particular between 2006 and 2008. The fiscal balance of the consolidated government sector moved from relatively high deficits in the first three years of transition to a period with surpluses between 2004 and 2005 again to a deficits phase between 2006 and 2008 (see Table L1-6). While expenditures decreased in the last couple of years comparing to the peak in 2006, revenues are also lower. The drop in fiscal revenues from 2005 to 2008 (from 42.9 percent of GDP to 40.9 percent) is primarily due to lower collection of VAT, excises and personal income tax revenues - especially in the final quarter of 2008. Capital revenues also decreased sharply. Serbia's social insurance funds covering health, pensions and unemployment, which have run deficits of over 5 percent of GDP since 2007, were key factors in the deteriorating fiscal performance of the consolidated general government. Shortfalls in these funds were covered by transfers from the central government, with the largest transfer for pensions (5 percent of GDP in 2008).

Table L1-6: Public Finances Performance, as %GDP

	2002	2003	2004	2005	2006	2007	2008
Revenue	42,4	42,3	42,9	42,9	43,8	42,4	40,9
Expenditure	45,8	45,2	42,8	42,1	45,4	44,2	43,4
Overall fiscal balance	-3,4	-2,9	0,0	0,8	-1,6	-1,9	-2,5

Source: Ministry of Finance.

Economic growth helped to reduce poverty, but only to limited extent helped to tackle unemployment. Poverty in Serbia fell from 12.7 percent of the population in 2004 to 6.3 percent in 2008, which translates to over 400,000 people rising above the poverty line.[1] Increases in salaries, pensions (see Table L1-7), and social transfers, the main income sources for poor households, drove this reduction. These improvements, however, are not even throughout Serbia: poverty is markedly higher in rural areas—home to about two thirds of all poor Serbians—and among vulnerable groups, particularly refugees and internally displaced people. Poverty is also strongly correlated with the education level of the head of household. The growth also did not result in significant increase in job opportunities. Moreover in the first six years of transition as the economy went through the process of restructuring and privatization the number of unemployed was on rise. Only since 2007 we observed decline in unemployment rates.

Table L1-7: Wages, Pensions and Unemployment Rates

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Average wage, in EUR	45,7	98,5	152,0	176,5	193,3	210,1	262,5	346,9	399,9
Average pension, in EUR	NP	68,9	110,7	124,1	131,9	140,0	160,0	187,3	236,8
Unemployment rate, LFS	12,1	12,2	13,3	14,6	18,5	20,8	20,9	18,1	14,0

Source: Republic Statistics Office, Ministry of Labor.

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1 All poverty estimates for 2008 are based on work-in-progress for the 2009 Serbia Poverty Update (World Bank, forthcoming). Source: Staff calculations using 2008 HBS data and Serbia Poverty Update (2007) for the 2004 estimates. Since 2003 Serbia has moved to using HBS as the source of poverty monitoring. However, the country has also carried out three years of LSMS: 2002, 2003 and 2007, and the poverty estimates using this series show a similar trend in poverty reduction - that poverty declined from 13.6 to 6.6 percent between 2002 and 2007.

2. Crisis Impact and Economic Developments in 2009

Economic activity fell sharply in the final quarter of 2008 and in 2009, due to plummeting activity in the tradables sector. Growth in the last quarter of 2008 declined to 2.8 percent (y-o-y) as compared to an average growth rate of 6.5 percent in the previous three quarters. Preliminary estimates for the first half of 2009 suggest a decline in real GDP of about 3 percent, comparing to the same period of 2008. As shown in Graph L1-8, the growth slowdown in Serbia has been similar in magnitude to that in other European countries, both old EU members (EU 15) and new EU members excl. Bulgaria and Romania (EU 10). Industrial output was about 17.5 percent lower in the first half of 2009 compared to the same period in 2008. More recent industrial production and trade indicators suggest that output is stabilizing in the second half of 2009, indicating a full-year real GDP contraction will be less than originally projected.

Graph L1-8: Quarterly Growth Rates of Real GDP, in %
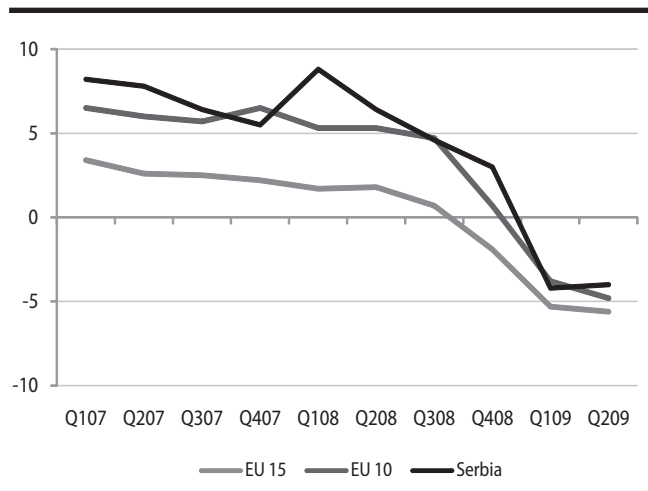
After the sharp contraction following the breakout of the global financial crisis in September 2008, economic activity in Serbia has stabilized, like in the rest of Europe. Led by resurgence in Asia, the global economy is on the road to recovery. Growth has resumed in a number of large EU economies in the second and third quarter of 2009.[2] As shown in the Graph 6 below, the decline in industrial production in Serbia appears to have bottomed out, although the level of industrial production is still down significantly from a year ago. Retail trade in Serbia has still not bottomed out (see the graph L1-9), though there is also seasonality factor involved. Construction sector has been hit hard as well, with the number of issued license in Jan-Sept 2009 being lower by nearly 20 percent than in the same period last year.

Graph L1-9: Industrial Output and Retail Sales, Real Change Indexes Comparing to the Same Month of Previous Year
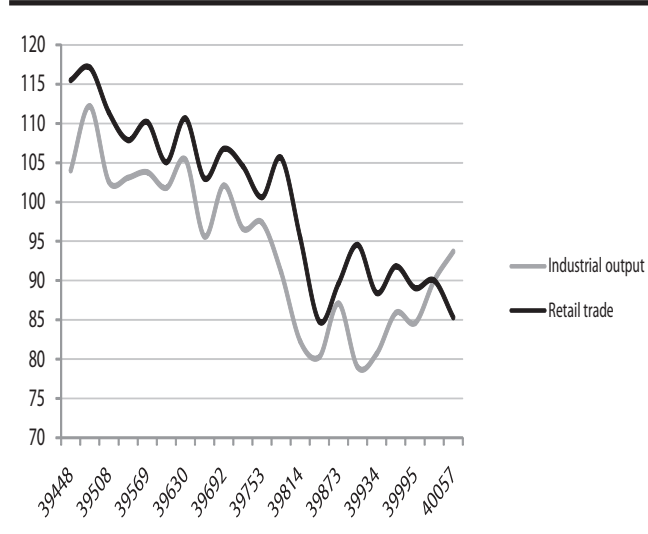
Inflation pressures are receding somewhat, albeit from a high level. Serbia entered the crisis period with relatively high inflation at above 10 percent (in the last quarter of 2008). CPI inflation declined to 5.2 percent in October, down from 7.3 percent in September, mainly on account of decelerating food and utility prices. The CPI is currently below the National Bank of Serbia (NBS) 6-10 percent target band but is expected to slightly increase until the end of the year. Alongside, the NBS has continued its policy of gradual easing, reducing its policy rate to 10 percent in November, down from 17¾ percent in January. The impact on inflation of a 20 percent depreciation of the dinar against the euro in late 2008 was limited, supporting the adjustment of the external accounts.

The current account deficit is forecasted to decline to 7.2 percent in 2009, down from 17.2 percent in 2008. The collapse in external trade, with imports (particularly of intermediate and capital goods) falling particularly steeply, has triggered a correction of the external account deficit in the first three quarters of 2009. Exports in the first three quarters of 2009 were lower by 25 percent (in EUR terms) while imports continued to decline even more and were down 31 percent compared to the same period of 2008. External adjustment has also been assisted by unusually strong unrecorded remittances (which too large extent

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2 EU 10 Regular Economic Report, *From Stabilization to Recovery,* The World Bank, October 2009

probably reflects the use of money kept "under the mattresses"), and more recently, some recovery in exports. Capital inflows have turned positive again since February 2009 and the dinar exchange rate has been roughly stable in 2009, after a more than twenty percent depreciation in late 2008.

In comparative perspective, and given the adjustment in the current account deficit, the growth decline in Serbia has been relatively modest in comparison with other countries in the region. The scale of the contraction in countries across the region has been linked to a number of factors. These include trade openness, export composition, the exchange rate regime, the magnitude of macroeconomic imbalances, and the reliance on growth in sectors such as finance, construction and automobile exports prior to the crisis. In particular, countries with the largest initial imbalances, as reflected in current account deficits, have seen the largest adjustments in the first half of 2009 – see Graph L1-10 below. (EU10 Regular Economic Report, October 2009).

Graph L1-10: Growth Rates and CAD for Selected East European Countries
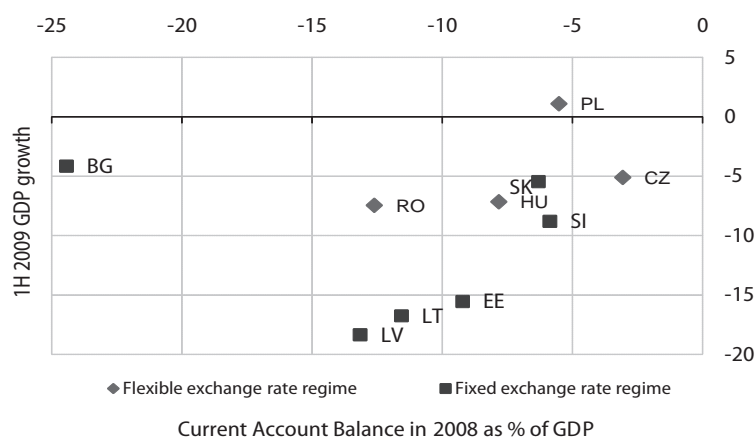
The banking system has weathered the external shocks so far, and foreign banks have maintained their exposure to Serbia. The large share of FX or FX-indexed loans in the portfolios of Serbian banks is a cause for concern (about 75 percent of all loans) and NPLs are increasing (increase from 4.7 as of beginning of the year to 7.6 percent of the total stock of loans by the end of September, see Graph L1-12). However, the risks have been tempered somewhat by the banking system's large share of liquid assets (24.8 percent as of September 2009) and capital buffers (Capital Adequacy Ratio of 21.3 percent as of September). Foreign banks are proving key to maintaining financial sustainability, and are maintaining their exposure to Serbia (see Graph L1-11). Households' foreign currency deposits also recovered and by mid-November reached practically the same level as before the global crisis started, of about EUR 5.7 billion.

The original 2009 budget approved in late 2008 was followed by a supplementary budget approved in May 2009 to rein in the rising fiscal imbalances that followed the effects of the crisis on tax revenues. This involved a massive fiscal

Graph L1-11: Consolidated Banking Sector Assets and Foreign Liabilities, in EUR million
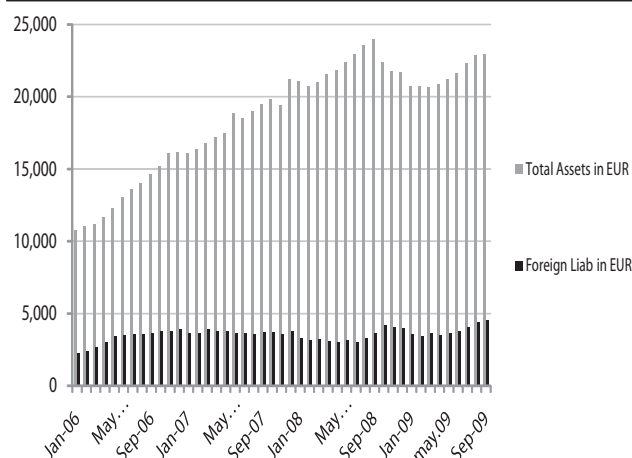
Graph L1-12: Non-Performing Loans in Total as%, by sector
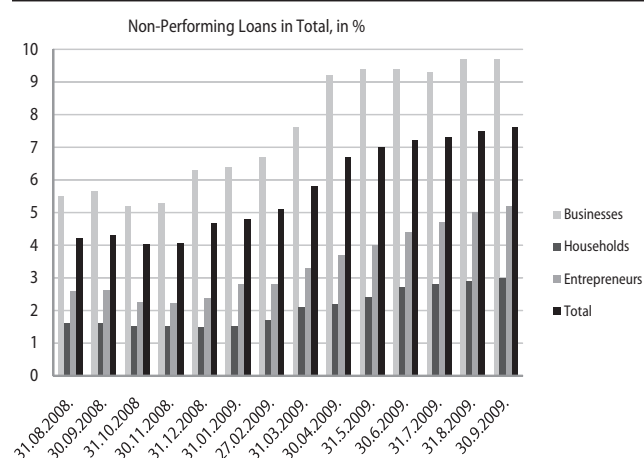
adjustment equivalent to more than 3 percent of GDP (EUR 1.1 billion). Key measures include wage cuts for higher wage staff and a nominal freeze in the wages of all other public employees (a nominal pension freeze had already been implemented earlier in the year), a freeze of new hiring in the public sector, a 15 percent cut in transfers to local governments, and sharp reductions in the discretionary budget of all budget users. The revised budget ensured protection of social spending and envisages an increase in the allocation for unemployment benefits. Other than some delays in the transfers of dividends and other non-tax revenues and complications with enforcing the wage freeze in some public enterprises and local governments, recent budget data seem to confirm that these measures have generally been well implemented and are containing spending under the State budget.

As has happened in other countries in Central and Eastern Europe, public revenues suffered significantly from the impact of the crisis; in Serbia's case the decline also reflects the implementation of the Interim trade Agreement with the EU which eliminated most of the import duties on the goods coming from the EU. As a result, VAT revenues were 10 percent lower in the first half of the year comparing to the same period of 2008 and customs revenues were 26 percent lower than in the same period last year. The original fiscal target for 2009 was a deficit target of 3 percent of GDP. By the summer however, and given the outturn for the first half of the year, this deficit target proved out of reach. The target for the consolidated general government deficit was missed by 0.9 percent of GDP, it is worth noting that this reflects solely the effect of the decline in economic activity in government revenues. In fact, the spending execution remained in line with the IMF-supported program, there was no significant arrears accumulation, and the indicative ceiling on recurrent spending (of the Serbian Republican Budget, in billions of dinars) was met. More recent revenue data indicate an improvement. As of October 2009, revenues are 0.2 percent higher in nominal terms than they were for the same time last year.

The growth slowdown is expected to lead to higher poverty rates. Between 2004 and 2008, the fraction of the poor below the poverty line declined by half. However, with economic growth projected to contract by 4 percent in 2009 from 6 percent growth rate in 2008, the fraction of the poor is expected to increase. Simulations based on data from the most recent household budget survey (HBS 2008) shows that even a 5 percent decrease in the incomes of those above the poverty line will increase poverty by 1.4 percentage points, roughly 90,000 more people. Three transmission channels of the crisis are likely to be the main sources of income declines. First, with industrial production and exports falling sharply in late 2008 and early 2009, some workers will lose their jobs. Second, as the crisis continues the inflow of remittances from the EU might fall due to the recession in those countries, even if at least in the first 6 months of 2009 they have risen by 6 percent compared to the same period in 2008. Finally, since there is a large fraction of the population in the informal economy, the decline in aggregate demand will depress these group's incomes through second round effects. Reduced access to credit because of the global credit crunch is further impacting consumption.

3. 2010 and Beyond: Where to Go from Here?

The worst of the recession may be over, but future growth is likely to be lower than in pre-crisis years. Serbia is projected to decline by about 3 percent in 2009 and to grow by around 1.5 percent in 2010. Weaker domestic demand and shallow capital flows are likely to maintain current account deficits at reduced levels compared to before the crisis. Robust growth is likely to return only once investment and exports rebound and consumer confidence is restored. In view of trade and financial market integration, a sustainable recovery in the EU is needed to support exports and strengthen job prospects in Serbia. In that context, growth in Western Europe does not appear to be relying yet on sustained recovery in private demand and it is unlikely to be underpinned by abundant global liquidity – like it was in the past. Investment is also likely to be dampened by excess capacity and financing constraints in Europe for the foreseeable future.

Serbia's GDP is projected to pick up starting in 2010 (1.5 percent), having declined by about 3 percent in 2009. Growth of about 3-5 percent is expected in 2011-2012. The return to robust and more balanced growth over the medium term is predicated on a turnaround in global growth, but also on structural reforms to make the economy more competitive and more export oriented. Private consumption is projected to gradually decline from the pre-crisis levels of about 78 percent of GDP to about 73 percent by 2012. This reduction in the share of private sector consumption in GDP would lead to higher domestic savings consequently reducing the size of the current account deficit over the medium term. Following a significant drop in 2009, private sector investments are forecast to increase in 2010 and grow robustly throughout the projection period, therefore contributing to GDP real growth by about 1.4 percenta-

ge point of GDP each year throughout the projections period. This assumption is based on the announcements of several potentially very important investments (including the FIAT deal with Zastava) and couple of privatizations (like Galenika or Telekom Srbija).

Significant external adjustment is forecasted. The current account deficit is projected to fall from 17.1 percent of GDP in 2008 to about 7.2 percent by the end of 2012. As with other countries in the region, there has already been a marked reversal in the private sector imbalances, with the current account deficit expected to decline by 8 percentage points of GDP just in 2009. This adjustment process has been driven in the near term by a sharp import decline arising from the drop in domestic demand, and over the medium term by renewed export growth and continuingly strong worker remittances. Capital inflows are expected to cover about 47 percent of the current account deficit between 2009 and 2012, though a significantly smaller share in 2009 and 2010. After a significant decline of official foreign currency reserves in the second half of 2008, these are projected to increase over the projections period including even in 2009.

Capital flows to transition countries are likely to be considerably lower than before the crisis: therefore domestic savings and investment rates need to be raised – and productivity needs to be improved. As financing of the current account deficit will be harder to come by, Serbia's growth strategy can no longer rely to the same extent on high foreign savings and domestic demand. The Serbian current account deficit has stemmed more from a very low level of savings as opposed to high investments. Fast growing countries have investments rates above 30 percent of GDP, financed by high saving rates even in the early stages when per capita incomes are low. Savings rates in China are between 35-45 percent of GDP. In Serbia, the national saving rate has been low at fewer than 10 percent of GDP. However investment rates have been around 20 percent of GDP, financed by high foreign savings at around 10 percent of GDP each year. The challenge will be to increase savings and investment rates significantly in an environment where external financing will be more difficult to come by. In addition Serbia will need to export more and to improve the structure of its exports, including relying more on high-value added industries.

New sources of growth will have to be found. The growth model based on high domestic consumption and financing provided from foreign savings as discussed above, will no longer be sustainable and possible. Serbia needs to look for options to increase productivity, improve its competitiveness, stimulate investments and rely more on private sector led growth. This would require more decisive and committed implementation of structural reforms in the coming period but also implementation of some of the measures that are easily achievable. Serbia's ability to achieve sustained growth while increasing formal employment will depend on its ability to meet two interrelated macrostructural policy challenges. First, the Government can do a lot to promote growth indirectly through policies which affect the non-budget sector. This includes further improvements in the overall investment climate and increases in enterprise and household savings. Second, a large and inefficient public sector remains a serious barrier to private sector led growth.

Entrepreneurs invest when there is a prospect of making profits. Having a private-sector led economy as discussed above plays a big role in prospects for sustainable long-term growth which will result in creation of more jobs and improved standards of living. For that of utmost importance is a sense of confidence and long-term stability, both political and economic. The prospects of EU accession have been central to the credibility of Serbia's prospects particularly for foreign investors, but probably even more for domestic investors. EU integration together with improved regional cooperation means many practical advantages including the access to large markets, adoption of standards and practices from the EU, easier movement of labor and capital etc. Additional positive policy signals come from developing a stable macroeconomic environment, budget discipline and pro-private sector policies. Also important for profitability is the path of inflation, the exchange rate, interest rates and wage rates.

The investment climate is one critical determinant of the level and productivity of investments undertaken. There have been significant reported improvements in Serbia's business climate between 2005 and 2008. The percentage of firms reporting unofficial payments between 2005 and 2008 is down quite dramatically. Significantly fewer problems are also reported with business licensing, tax administration and tax rates. The percentage of firms indicating that courts are problems has also fallen sharply. However as the latest Doing Business report of the World Bank suggests Serbia has plenty of room to improve the business environment. Most importantly Serbia needs to improve a) dealing with construction permits; b) administration of taxes and social contributions, and c) property rights. Serbia is presently ranked worst in the area of construction permits being ranked 174 in the world. This is a major obstacle for so much needed investments as discussed above. The second area which needs immediate response is dealing

with tax and social security funds administrations. The burden on business caused by the number of payments an entrepreneur must make; the number of hours spent preparing and filing tax forms, and paying taxes is enormous and significantly reduces efficiency and profitability of the Serbian private sector. Finally, the area of property rights needs more actions including the completion of the cadastre (presently set for October 2010); improved management of state assets; better contract enforcement and protection of intellectual property.

Table L1-13: Serbia Ranking per World Bank Doing Business Report

Ease of...	Doing Business 2010 rank	Doing Business 2009 rank	Change in rank
Doing Business	88	90	2
Starting a Business	73	108	35
Dealing with Construction	174	172	-2
Employing Workers	94	87	-7
Registering Property	105	99	-6
Getting Credit	4	12	8
Protecting Investors	73	70	-3
Paying Taxes	136	126	-10
Trading Across Borders	69	67	-2
Enforcing Contracts	97	95	-2
Closing a Business	102	102	0

Source: World Bank.

Skills and infrastructure are increasing bottlenecks to the business climate and to growth in Serbia. After the economic crisis first struck, rescue and stabilization dominated the policy agenda. As argued in the World Bank's recent publication, Transition Turns Twenty, now it is time to once more focus on structural reforms to make the business environment more attractive to investors. Going forward, investors may well be more discriminating as evidenced already for instance in the greater variation among country spreads that is already being observed. Comparing the results of the World Bank Group's BEEPS survey in 2005 and in 2008 suggests that a significant increase in complaints about infrastructure and skilled labor, not only in Serbia, but also in other countries in the region. In 2005, 22 percent of respondents in Serbia identified skills and education of workers as a problem to doing business; in 2008, this percentage had increased to 38 percent. The percentage of firms indicating that there were problems with electricity (transport) increased from 15 percent (18 percent) in 2005 to 34 percent (29 percent) in 2008; and firms reporting power outages over the past twelve months nearly doubled from 32 percent in 2005 to 60 percent in 2008.

Strengthening the education and skills of the labor force is key to going forward. Serbia's education system is performing below international averages when compared both to the OECD and to neighboring countries.[3] Serbia took part in the Program for International Student Assessment (PISA) in 2003 and 2006. On both occasions, Serbia's 15-year-olds failed to demonstrate an adequate level of achievement in reading, mathematical and scientific literacy. PISA results are widely used as a proxy for students' future prospects in the labor market[4]. (Table L1-14) Educational institutions, at all levels, also need to be made more accountable for learning outcomes (by monitoring quality and making public information on quality) and by strengthening licensing and accreditation. Financing also needs to be more strategical, for example by allowing financing to follow students (based on capitation formulae) and by building incentives for performance as opposed to making allocations based on outdated norms that bear no relationship to quality.

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3 This part of analysis relies heavily on *"Quality and Equity of Education in Serbia: Educational Opportunities of the Vulnerable – PISA Assessment of 2003 and 2006 data"*, Aleksandar Baucal and Dragica Pavlović-Babić, Ministry of Education of the Republic of Serbia, 2009.

4 As OECD, the administrator of PISA, explains, PISA focuses on young people's ability to use their knowledge and skills to meet real-life challenges, rather than merely on the extent to which they have mastered a specific school curriculum.

Table L1-14: PISA Results for Serbia and a Selection of Countries, 2003 and 2006[1]

	2003	2006	2003	2006	2003	2006
Country	**Math**		**Reading**		**Science**	
Bulgaria	..	413	..	402	..	434
Romania	..	415	..	396	..	418
Serbia	**437**	**435**	**412**	**401**	**436**	**436**
Croatia	..	467	..	477	..	493
Norway	495	490	500	484	484	487
Slovakia	498	492	469	466	495	488
Poland	490	495	497	508	498	498
Slovenia	..	504	..	494	..	519
Finland	544	548	543	547	548	563

Source: Baucal and Pavlović-Babić (2009), p.28. Authors' selection and presentation of PISA data.

Removing infrastructure bottlenecks will further help improve growth prospects. Sustainable management of Serbia's infrastructure assets is critical for improving competitiveness, increasing economic growth and raising living standards. While Serbia is well endowed with infrastructure assets, the key going forward is to improve the management and maintenance of these assets and to undertake strategic and necessary investments. This needs to be undertaken in a manner consistent with national aspirations for EU accession. Improving Serbia's infrastructure assets through better management practices and investments will help create conditions that attract private sector investment and create jobs.

Public spending on infrastructure needs to complement private investment to spur growth. This is a particular challenge for Serbia, since the public sector is already large and there is a need to reduce the overall levels of public spending. High levels of current public spending are crowding out the much-needed public infrastructure spending. Serbia has a history of under-funding maintenance, which has led to the deterioration of much of the regional road network as well as other types of infrastructure. The Government's current priority, nevertheless, is to upgrade segments of Corridor X (which, despite its foreign financing, still implies a considerable Government counterpart contribution). The prospects for financing additional maintenance expenditures by increasing fuel taxes or tolls are limited, although better toll administration could have some impact. Resources for maintenance will instead have to come from efficiency gains, including improvements in the prioritization of maintenance projects and wider use of performance contracts.

How to Achieve These?

In short, Serbia's ability to achieve sustained growth at higher rates while increasing formal employment will depend on its ability to meet two interrelated macro-structural policy challenges. First, the Government can do a lot to promote growth indirectly through policies which affect the non-budget sector. This includes further improvements in the overall investment climate and increases in enterprise and household savings. Second, a large and inefficient public sector remains a serious barrier to private sector led growth. This would require significant restructuring of public finances: increase of public investments while overall public expenditures need to go down. To achieve this further **reduction of current expenditures and expenditure reprioritization will be critical over the medium term.** Spending on pensions, the largest single program of government spending is high, and measures are underway to try to contain it over the medium term. The 2009 and 2010 pension freezes are helping to reduce the replacement rate of benefits, and a package of more structural reforms to contain pension spending over the medium term is also being prepared. A public administration reform is helping to curtail spending on the wage bill of the public administration, i.e. not only the civil service, but also teachers, health workers, local governments, the police and the military.

Serbia's Economic Growth and International Competitiveness

Duško Vasiljević [*]
Serbia's economy experienced a relatively high growth rate since the onset of transition. This growth was, however, unbalanced, mostly relying on merely a few non-tradable sectors. Once the crisis passes, economic growth will have to rely on tradable sectors to a much greater extent. This is why the competitiveness of Serbia's economy i.e. creating prerequisites for stronger growth of enterprise productivity, should be one of the economic policy priorities in the upcoming period. Serbia is insufficiently competitive at the moment and the following factors are critical for improving its competitiveness: the efficiency of state administration and the public sector in general, simplification and greater transparency of procedures, much more effective implementation of the anti-monopoly policy, improvement of macro-economic conditions, improvement of the infrastructure and reform of the education system.

Introduction

Serbia's economy experienced relatively high growth over the past few years, averaging over 6% per annum. This growth, however, primarily relied on only three sectors (Financial Intermediation, Wholesale and Retail Trade, and Transport and Telecommunication) which were credited for around three-quarters of overall economic growth from 2002 to 2008.[1] These three sectors fall within the non-tradable part of the economy (their products mostly cannot be exported) and they mostly rely on the expansion of domestic demand.

The expansion of domestic demand, on which economic growth over the past few years had been based, had been fueled and financed by high foreign capital inflows. The growth of demand was not accompanied by adequate expansion of production, above all in sectors falling within the tradable part of the economy (like the manufacturing industry). This is why economic growth was accompanied by relatively high trade and current account deficits.

While the listed three sectors within the non-tradable part of the economy grew at an average rate of around 15% per annum, the rest of the economy averaged a 2% annual growth rate in the 2002-2008 period. The shares of the three sectors in the GDP increased extremely rapidly. The overall share of Financial Intermediation, Wholesale and Retail Trade, and Transport and Telecommunication in the GDP stood at 24% in 2002 and was one of the lowest amongst comparable East European countries. By 2007, their share increased to 38%, one of the highest amongst comparable countries.

The post-crisis economic growth model will have to rely on sectors within the tradable part of the economy to a much greater extent. It is unlikely that the pre-crisis volume of capital inflows, which had amply funded domestic demand in the past, will be restored soon. Moreover, sectors that had accounted for growth the most have already reached a level that may be qualified as relatively high and will definitely not grow as much in the coming years. Given that the rest of the economy grew at a relatively modest 2% rate a year, it will have to increase its productivity in the upcoming period.

Boosting the competitiveness of Serbia's economy needs to be a key economic policy priority to ensure high economic growth in the medium term based on tradable sectors. Serbia's economy is not highly competitive at the moment. According to the World Economic Forum, Serbia's competitiveness ranks at the average Western Balkan level, but is far below that of the Central and Eastern European states that have joined the EU.

The following measures could increase Serbia's competitiveness in the short and medium term: a public administration reform that will improve the efficiency of the state administration and public sector in general; simplification and increase in transparency of procedures; much more effective implementation of the anti-monopoly policy; improvement of macroeconomic conditions. Significant infrastructural improvements and the reform of the education system are measures that would boost economic competitiveness in the longer term.

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* Center for Applied European Studies and CEVES.

1 This regards non-agricultural gross value added. Agriculture is not taken into account for two reasons. First, it is under the dominant influence of exogenous factors, above all weather conditions. Second, the growth of agricultural GVA in the whole observed period was very low, averaging under 1% a year. In a way, agricultural GVA practically oscillated around the same value and the variations around the value depended above all on the weather conditions.

1. Serbia's Economic Growth

Serbia's economy recorded relatively high growth rates in the past few years, before the onset of the crisis. The average GDP annual growth rate stood at 6.3% in the past five years (2004-2008). According to this indicator, Serbia was amongst the leading CEE countries, preceded only by the economies of Slovakia, Montenegro and Romania (Graph L2-1). In the 2000-2008 period, Serbia's GDP grew 5.4% a year on average. Most other CEE economies also had relatively high growth rates – around 5% or more per annum - during this period.

Two broad groups of CEE states can be distinguished. The first group comprises countries of the so-called Visegrad Four (the Czech Republic, Hungary, Poland, Slovakia) and Slovenia; these countries mostly had negligibly lower GDP growth rates but much smaller current account deficits as well. The second group comprises Balkan and Baltic States, the GDPs of which grew at greater rates but were accompanied by high current account deficits. As Graph L2-2 shows, GDPs of the first group of countries grew by 4.4% on average and GDPs of the Baltic and Balkan countries grew by 7.1% and 5.4% respectively in the 2000-2008 period. The former group, however, had a moderate current account deficit, averaging slightly under 5% GDP, while the Balkan and Baltic States on average had higher current account deficits - around 10% GDP - in this period.

Graph L2-1. Selected Countries: Average Annual GDP Growth Rates, 2004-2008
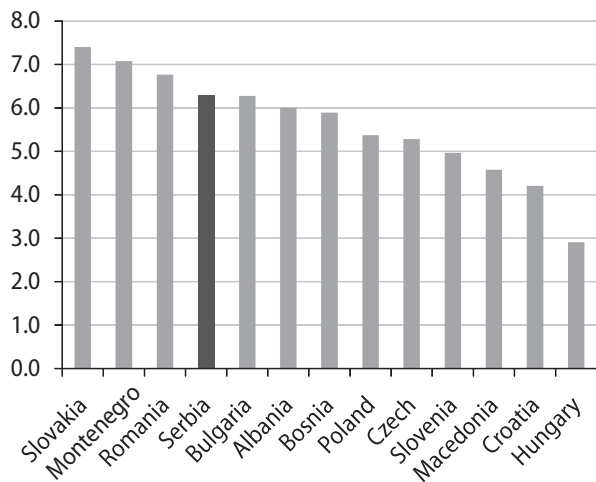
Source: IMF, World Economic Outlook database.

Graph L2-2. Selected Groups of Countries: Average Annual GDP Growth Rate and Average Current Account Deficits (in % GDP), 2000-2008
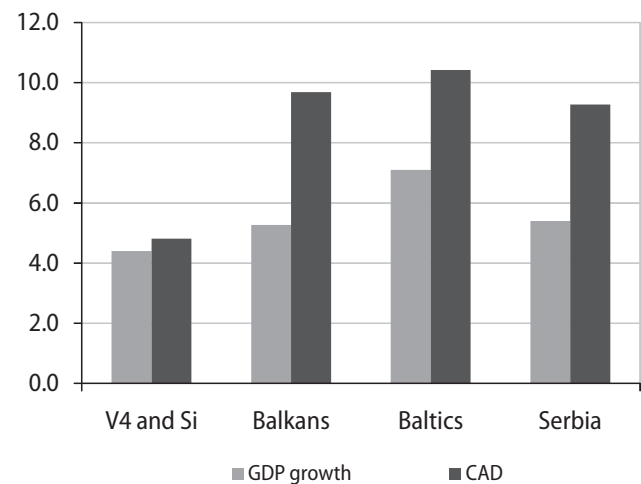
Source: IMF, World Economic Outlook database Note: V4 and Si: the Czech Republic, Hungary, Poland, Slovakia and Slovenia. Balkans: Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia. Baltics: Estonia, Latvia, Lithuania.

Graph L2-3. Serbia, Balance of Payments (in % GDP), 2004-2008
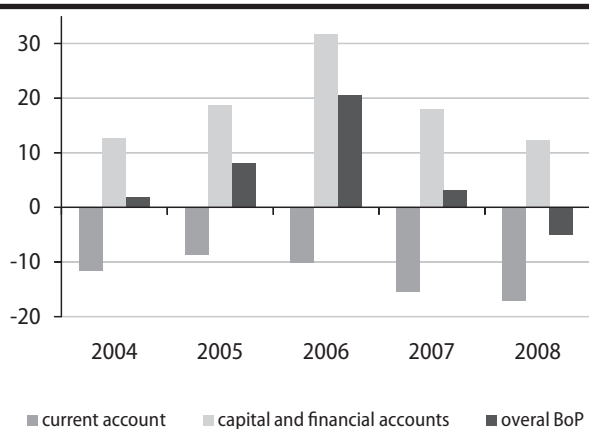
Source: NBS.

Serbia falls within the second group of countries according to these indicators, i.e. countries with relatively high economic growth, albeit accompanied by high current account deficits. During this period, Serbia had no trouble funding its current account deficit from a large capital and financial account surplus (Graph L2-3). The period from 2000 to mid-2008 was mostly characterized by a very easy monetary policy in most major economies and the increasing integration of financial markets in the world. Consequently, large quantities of capital were available wherefore none of the East European states had any trouble funding relatively high foreign deficits. Most of the funds making their way into the country via the capital and financial account had not had the form of investments in new production capacities, but, rather, the form of loans or funds used in privatization.

Which sectors led growth and what was Serbia's economic growth over the past few years based on? The breakdown of economic growth by sector shows that there are two groups of sectors with very different patterns of movement. The first group comprises three sectors: Financial Intermediation, Wholesale and Retail Trade, and Transport and Telecommunication. The Gross Value Added of these three sectors grew as much as 134% in the 2002-2008 period. Their average growth rate stood at 15.4% per annum in this period (Graph L2-4), whilst their share in non-agricultural GVA increased from 24% in 2002 to 39% in 2008 (Graph L2-5). These three sectors accounted for as many as three-fourths of overall economic growth in this period (Graph L2-6).

Graph L2-4. Serbia: Annual GVA Growth Rates of Selected Sectors (in %), 2003-2008
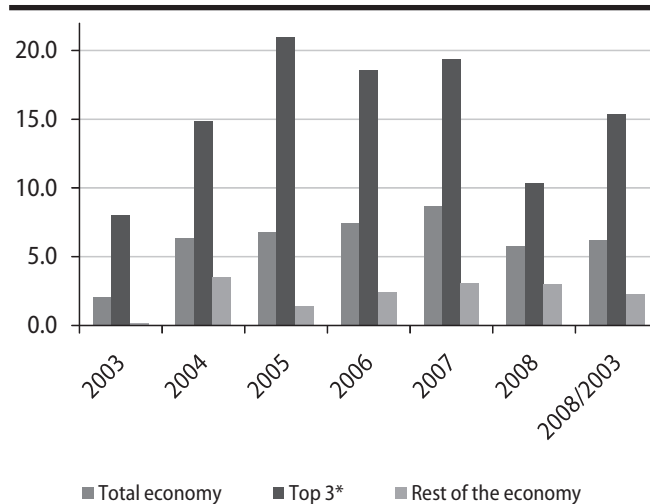
Source: SORS.
* Financial Intermediation, Wholesale and Retail Trade, Transport and Telecommunication.

Graph L2-5. Serbia: Share in Non-Agricultural GVA (in %), 2002–2008
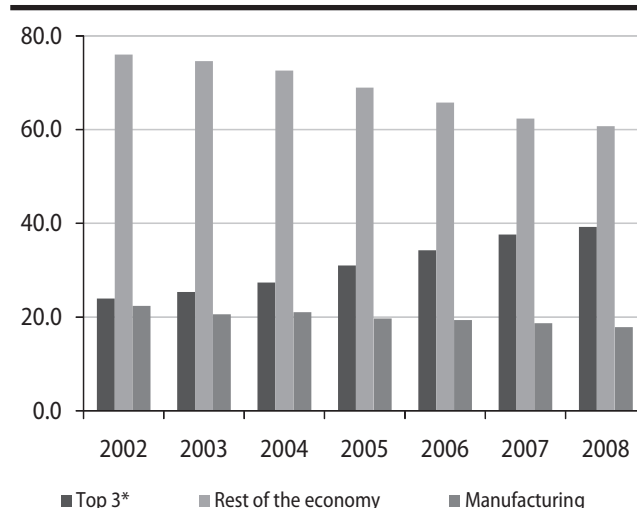
Source: SORS.
* Financial Intermediation, Wholesale and Retail Trade, Transport and Telecommunication.

The second group comprises the other sectors of the economy[2] which developed at a much more modest rate: the rest of the economy increased its GVA by only 14.4% during this period, growing at an average rate of only 2.3% a year. The share of the second group of sectors in non-agricultural GVA fell from 76% in 2002 to 61% in 2008. The manufacturing industry, for instance, increased its GVA by merely 14.5% from 2002 to 2008, growing at a modest average rate of 2.4% a year. The share of the manufacturing industry in non-agricultural GVA dropped from 22.4% in 2002 to 17.9% in 2008 (Graph L2-5).

Graph L2-6. Serbia: Contribution to Non-Agricultural GVA Growth (in % of total growth), 2002-2008
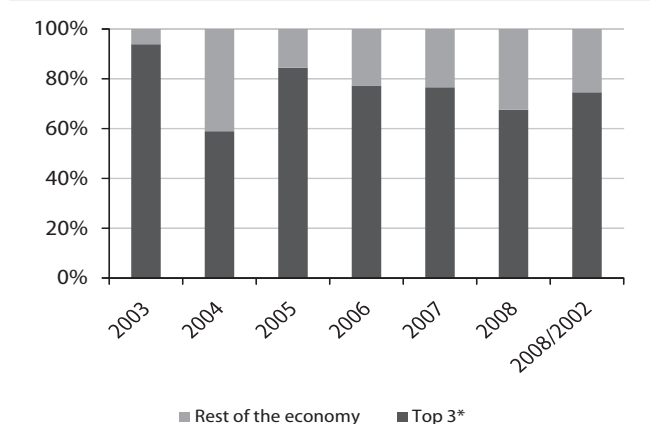
Source: SORS.
* Financial Intermediation, Wholesale and Retail Trade, Transport and Telecommunication.

Is the described pattern common to transition economies? One may assume that other East European economies had passed through a similar stage of development i.e. that the growth of these economies at the onset of transition was based on the same sectors as the growth of Serbia's economy.

Data, however, indicate that although the share of the listed three sectors was at times significant in some other East European countries, it was never as great as it was in Serbia. Graph L2-7 shows how the three sectors (Financial Intermediation, Wholesale and Retail Trade, Transport and Telecommunication) contributed to the growth of the total non-agricultural GVA. As the Graph demonstrates, in no East European country was the share of the three sectors as great as in Serbia, even in the early stage of transition (1994-2000). One of the possible explanations could

2 Mining and Quarrying; Manufacturing Industry; Electricity, Gas and Water Production; Construction, Hotels and Restaurants, Real Estate and Renting Activities, Other Services.

be that the starting point of these three sectors in Serbia had been extremely low and that their high growth was merely the consequence of catching up. Graph L2-8 shows the share of these three sectors in overall non-agricultural GVA. Two conclusions may be drawn from it. First, the share of these three sectors in non-agricultural GVA in Serbia was really at a relatively low level at the onset of transition. The average share of these sectors in other countries was, however, reached already in 2005. The share of these sectors, however, continued growing rapidly in the years that ensued. Second, the growth of the share of the three sectors in non-agricultural GVA was extremely rapid in Serbia. In only five years, the share of these three sectors in Serbia's economy soared from the lowest to one of the highest amongst comparable countries.[3]

Graph L2-7. Selected Countries: Contribution of the Financial Intermediation, Wholesale and Retail Trade, Transport and Telecommunication Sectors to Non-Agricultural GVA Growth (in % of total growth), 1994-2007
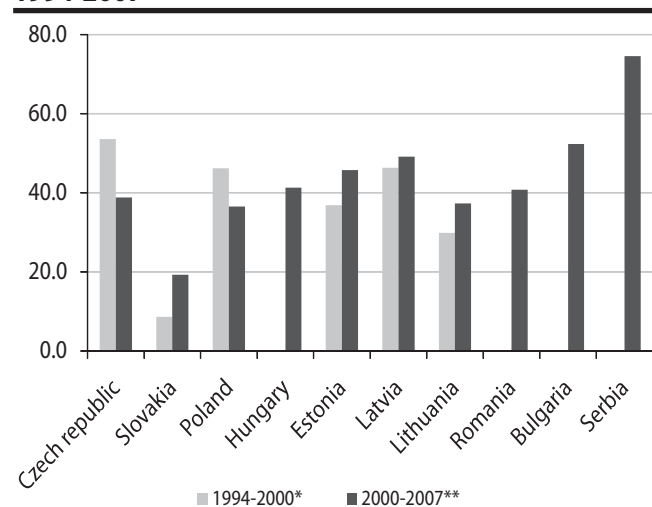
Source: Eurostat, SORS and author's calculations.
* Data for Poland and Lithuania regard the 1995-2000 period.
** Data for Serbia regard the 2002-2008 period.

Graph L2-8. Selected Countries: Share of the Financial Intermediation, Wholesale and Retail Trade, Transport and Telecommunication Sectors in Non-Agricultural GVA (in %), 1996-2007
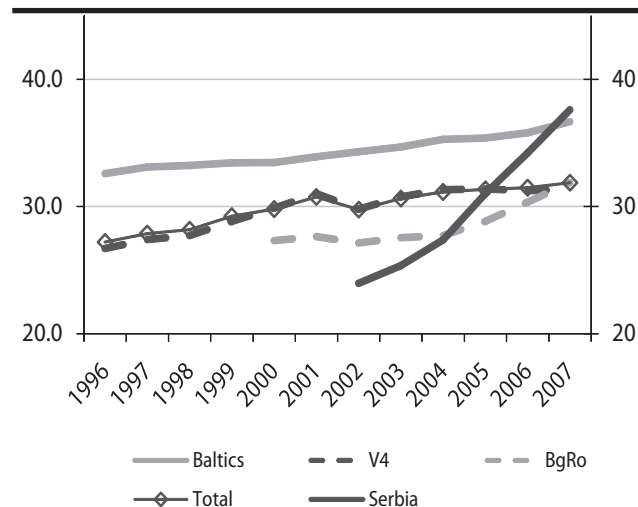
Source: Eurostat, SORS and author's calculations.
Note: Baltic States: Estonia, Latvia and Lithuania. V4: Czech Republic, Hungary, Poland and Slovakia. BgRo: Bulgaria and Romania.

The above analysis indicates that, although relatively high over the past few years, Serbia's economic growth was quite unbalanced and based on non-tradable sectors i.e. on the expansion of domestic demand funded and spurred by ample foreign capital inflows. Namely, growth largely relied on only three sectors (Financial Intermediation, Wholesale and Retail Trade, Transport and Telecommunication). This pattern of growth was not common to other European countries in transition. Although the economic growth of some of them, notably the Baltic States, relied on the expansion of domestic demand, it was to a much greater extent based on the tradable sectors and export growth than in Serbia.

Apart from the fact that foreign capital inflows were directed more at the expansion of demand (via household and corporate loans) and less at boosting production in the tradable sectors (above all the manufacturing industry), two other factors also contributed to this pattern. The first was the significant real appreciation of the dinar in the past few years, which resulted in lowering the competitiveness of the tradable sectors and directing spending at imported products and non-tradable sectors. The dinar appreciated against the euro by around 25% from 2004 to 2008 (Graph L2-9). This led to a circa 15% increase in real unit labor costs in the economy measured in euros, although the real unit labor costs measured in dinars recorded a mild drop in the same period (Graph L2-10). The second factor is that the frequent elections and unstable political situation over the past few years prompted the state to conduct a procyclical fiscal policy that further encouraged domestic demand. Notwithstanding relatively high economic growth, the consolidated government balance was increasingly in deficit in the 2006-2008 period (Graph L2-11).

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3 Analysis of individual countries (not groups of countries like in Graph L2-8) shows that only Estonia and Latvia had greater shares of the observed sectors in non-agricultural GVA than Serbia in 2007.

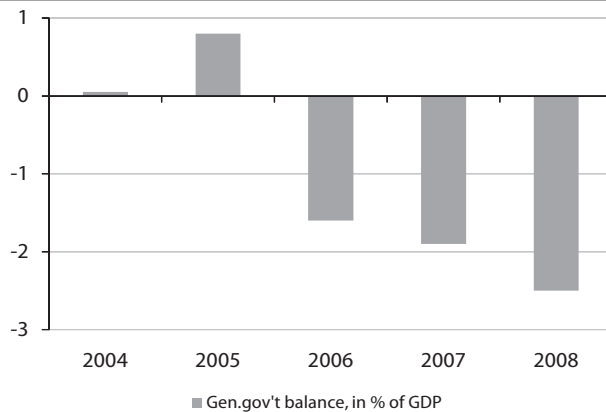**Graph L2-9. Serbia: Monthly Real Dinar/Euro Exchange Rate, 2003–2008**

Real exchange rate (avg.2005=100)
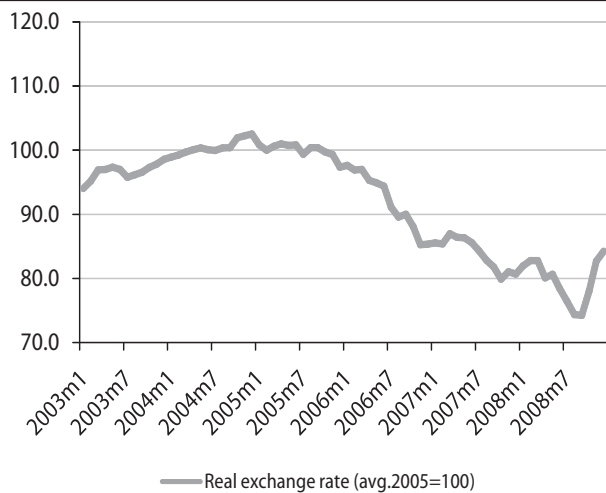
Source: NBS and SORS.

Graph L2-10. Serbia: Real Unit Labor Costs (average 2005=100), 2005-2008

ULC in dinars — ULC in euros
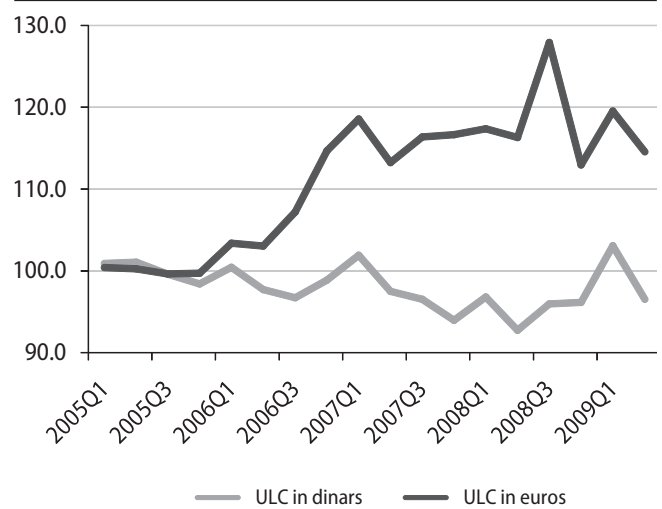
Source: *QM*.

Graph L2-11. Serbia: General Government Balance (in % GDP), 2004-2008

■ Gen.gov't balance, in % of GDP

Source: Ministry of Finance.

Graph L2-12. Selected Countries: Exports of Goods and Services (in % GDP), 2007
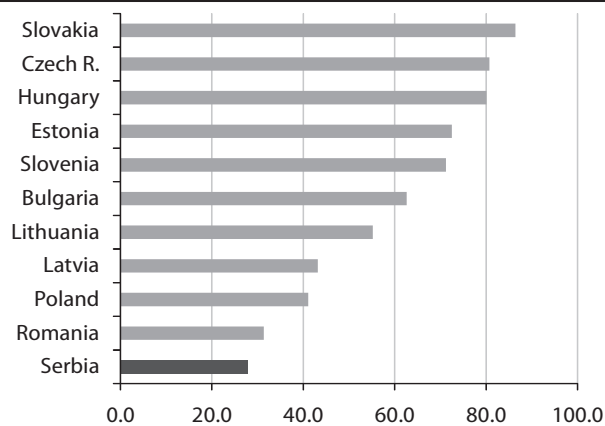
Source: Eurostat and SORS.

2. Competitiveness of Serbia's Economy

We showed in the previous chapter that, since the onset of transition, Serbia's economic growth was based on the expansion of domestic demand funded by high capital inflows and strong growth of the non-tradable part of the economy. Such growth of demand was not accompanied by corresponding development of production or the expansion of the real sector. This growth model, however, is unsustainable in the medium term for at least two reasons. First, the pre-crisis volume of capital inflows, which plunged in the meantime, will probably not be restored in the near future. Second, the sectors, which have driven overall economic growth to date (Financial Intermediation, Wholesale and Retail Trade, Transport and Telecommunications), have already reached a relatively high share of the GDP and their further expansion will definitely be slower in the coming period. As Graph L2-4 shows, all other sectors had very low growth rates, barely exceeding 2% per annum, in the 2002-2008 period. The logical question is: what will spur economic growth after the crisis?

The new growth model will have to rely to a much greater extent on the tradable part of the economy i.e. sectors exporting their products and services (or directly competing against imported products and services in the local market). Macroeconomic data, however, indicate that the contribution of the tradable part of the economy to overall growth is relatively modest, primarily due to low exports. Graph L2-12 gives exports as percentages of GDPs of Serbia and other East European transitional economies and shows that Serbia's exports are the lowest amongst the selected countries.

This is why boosting the competitiveness of Serbia's economy will be a crucial economic policy issue in the upcoming period. An internationally competitive economy can base its growth on international demand to a much greater extent. To small open economies like Serbia, the international market offers much deeper and more elastic demand and also leads national economies to specialize in sectors the growth of which will be sustainable in the longer term.

This chapter will review the competitiveness of Serbia's economy and the analysis will above all rely on one of the best known indices of competitiveness, the Global Competitiveness Index (GCI) developed by the World Economic Forum (WEF). The GCI is based on empirical research that identified a broad spectrum of parameters impacting on the competitiveness of an economy. These parameters comprise macroeconomic and microeconomic factors, as well as institutional development factors. All these parameters together contribute to the competitiveness of a national economy, defined as the set of institutions, policies, and factors that determine the level of productivity of a country.

2.1. Global Competitiveness Index Methodology

The World Economic Forum Global Competitiveness Index is based on the premise that competitiveness is a complex phenomenon affected by a multitude of factors. Numerous factors impacting on competitiveness are grouped in 12 *competitiveness pillars* organized in three groups.

The first group of competitiveness pillars comprises the so-called Basic Requirements. This group consists of the following pillars: (1) Institutions, (2) Infrastructure, (3) Macroeconomic stability, and (4) Health and primary education. The second group comprises the so-called Efficiency Enhancers: pillars (5) Higher education and training, (6) Goods market efficiency, (7) Labor market efficiency (8) Financial market sophistication, (9) Technological readiness, and (10) Market size. The third group, the so-called Innovation and Sophistication Factors, comprises pillars (11) Business sophistication and (12) Innovation.

The importance of individual competitiveness pillar groups depends on the degree of a country's development (approximated by GDP per capita). The first group of pillars, the so-called Basic Requirements, is of the greatest importance to the least developed countries. In addition to Basic Requirements, Efficiency Enhancers are also extremely significant for medium developed countries (including Serbia). Efficiency Enhancers and Innovation and Sophistication Factors are of greatest relevance to the most developed countries.

Each competitiveness pillar comprises a large number of sub-indicators. Depending on the sub-indicator, two sources are used to calculate each of them. "Hard data" i.e. data from international comparative databases (such as the IMF, ILO databases, etc) are used for some of the sub-indicators (e.g. inflation rate, total tax rate, budget deficit, use of personal computers). Hard data in the Annual Reports mostly regard data from the preceding year. This year's Report, for instance, uses 2008 hard data to calculate the Index. On the other hand, values for numerous sub-indicators are derived on the basis of a standardized survey conducted in all countries covered by the research. In each country, a representative sample of companies is surveyed and the survey covers a broad range of questions on business conditions, legal regulations, market relations, the political situation, etc. Survey data participate around 60% and hard data around 40% in the calculation of the index value.[4]

Each sub-indicator (be it from hard data sources or the survey) is normalized on a scale of 1 to 7. The scored sub-indicator values are then weighted and added up and yield scores for each competitiveness pillar. The scores for each competitiveness pillar are then weighted and added up and yield the overall score – the total Global Competitiveness Index Value. The Global Competitiveness Index breakdown, the competitiveness pillar groupings and weights of each pillar group and individual pillars within the groups are given in Table L2-13.

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4 The precise ratio depends on a country's development level given that weights of specific competitiveness pillar groups depend on the country's stage of development.

Table L2-13. Global Competitiveness Index Breakdown

	Group weight within overall index	Pillar weight within group	Pillar weight within overall index
Global Competitiveness Index			
Basic Requirements	**0.400**	…	…
Institutions	…	0.250	0.100
Infrastructure	…	0.250	0.100
Macroeconomic stability	…	0.250	0.100
Health and primary education	…	0.250	0.100
Efficiency enhancers	**0.500**	…	…
Higher education and training	…	0.167	0.084
Goods market efficiency	…	0.167	0.084
Labor market efficiency	…	0.167	0.084
Financial market sophistication	…	0.167	0.084
Technological readiness	…	0.167	0.084
Market size	…	0.167	0.084
Innovation and Sophistication factors	**0.100**	…	…
Business sophistication	…	0.500	0.050
Innovation	…	0.500	0.050

Source: World Economic Forum.
Note: The weight breakdown applies to countries in the second stage of development, which Serbia belongs to.

2.2. Serbia's Ranking in the Global Competitiveness Index

According to the latest Global Competitiveness Index issued in September 2009, Serbia ranks 93rd on the list of 133 states covered by the World Economic Forum survey. Serbia's competitiveness index value stands at 3.77 on a scale of 1 to 7, 7 being the highest score. First place is now held by Switzerland (with a 5.60 score), which overtook the US that had topped the list the previous few years. Singapore is third. Six European, two North American and 2 Asian countries rank amongst the top ten in the GCI.

Serbia has slid 8 places since last year, when it ranked 85th and thus reversed the slight progress over 2007, when it ranked 91st. Serbia's competitiveness index value fell from 3.86 in 2008 to 3.77 in 2009 (it stood at 3.78 in 2007). Table L2-14 gives the overall competitiveness index and individual pillars and Serbia's overall ranking and ranking by pillars.

Serbia slid the most in the Macroeconomic stability pillar over 2008. The value of this pillar fell considerably, from 4.72 in 2008 to 3.88 in 2009 (by 18%). The poorer assessment of this pillar accounts for two-thirds of the decline in the overall value of Serbia's competitiveness index. The lower macroeconomic stability assessment is primarily the consequence of the deterioration of the budget deficit and growth of inflation in 2008 vis-à-vis 2007.[5] Serbia had poorer assessments of most other pillars this year as well, but the decline in the other pillars does not exceed 5% and is much smaller than the decline in the assessment of macroeconomic stability.

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5 2008 data were used for calculating the Competitiveness Index in the Report published in 2009. Similarly, the 2008 Report used 2007 data.

Table L2-14. Serbia: Value of the Competitiveness Index and its Components and Serbia's Rankings in 2008 and 2009

	2008		2009	
	score	rank	score	rank
Global Competitiveness Index	**3.86**	**93**	**3.77**	**85**
Basic Requirements	**4.15**	**88**	**3.90**	**97**
Institutions	3.40	108	3.24	110
Infrastructure	2.68	102	2.75	107
Macroeconomic stability	4.72	86	3.88	111
Health and primary education	5.79	46	5.71	46
Efficiency enhancers	**3.82**	**78**	**3.77**	**86**
Higher education and training	3.91	70	3.83	76
Goods market efficiency	3.68	115	3.70	112
Labor market efficiency	4.36	66	4.18	85
Financial market sophistication	3.94	89	3.87	92
Technological readiness	3.45	61	3.38	78
Market size	3.59	65	3.69	67
Innovation and Sophistication factors	**3.30**	**91**	**3.21**	**94**
Business sophistication	3.51	100	3.45	102
Innovation	3.09	70	2.98	80

Source: World Economic Forum.
Note: The 2008 research covered 134 and the 2009 research 133 countries.

Comparison of Serbia's ranking with those of similar transitional countries is very interesting. It gives a more precise picture of Serbia's competitiveness in a comparative perspective. Table L2-15 gives Serbia's ranking and the average rankings of comparable groups of countries. The Western Balkan group comprises: Albania, Bosnia-Herzegovina, Croatia, Macedonia and Montenegro. The CEE group comprises selected East European EU member-states: Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia.

Several important conclusions can be drawn from Table L2-15. Serbia is slightly below the average of other Western Balkan countries and well behind CEE countries by its overall ranking. Serbia especially lags behind CEE countries with respect to Efficiency Enhancer factors, as many as 45 ranks beneath the CEE group. This gives additional cause for concern given that these very factors are of the utmost importance to the international competitiveness of countries in the same stage of development as Serbia.

Within the Efficiency Enhancers group, Serbia lags behind the CEE group the most in the Goods market efficiency pillar, by 59 places. This competitiveness pillar *inter alia* comprises sub-indicators related to the issues of competition and anti-monopoly policy and Serbia was extremely poorly scored on these sub-indicators. Out of 133 states, Serbia ranks 120th with respect to the intensity of local competition, 131st with respect to the extent of market dominance and 130th with respect to the effectiveness of anti-monopoly policy.

Apart from the Goods market efficiency group, Serbia is also quite poorly ranked with respect to Institutions and Infrastructure (although it lags behind comparable countries slightly less in these pillars). An analysis of the sub-indicators falling within the Institutions pillar leads to the conclusion that the burden of government regulations is one of Serbia's greatest problems. Serbia holds the extremely poor 129th rank on this subindicator. The following sub-indicators also warrant mention: judicial independence, favoritism in decisions of government officials, efficiency of the legal framework in settling disputes and efficiency of the legal framework in challenging regulations. Serbia ranks 110th, 112th, 124th and 115th respectively on these sub-indicators. As regards the Infrastructure pillar, it needs to be noted that Serbia ranks 117th with respect to the quality of its roads and 88th with respect to the quality of its railroad infrastructure. Serbia holds a relatively good rank (33rd) with respect to the telephone lines sub-indicator.

As far as the Higher Education and Training pillar is concerned, Serbia's rank is at the average regional level, but much below the average of the CEE group. Within this pillar, Serbia is relatively well ranked with respect to the quality of math and science education (43rd), but lags the most with respect to the extent of staff training (120th), the local availability of specialized research and training services (90th) and the quality of management schools (90th).

As regards Serbia's comparative advantages, it is relatively well ranked with respect to health and primary education (Table L2-15). It also scores well with respect to market size compared with other Western Balkan countries.

Table L2-15. Selected Countries: Competitiveness Index Ranking, 2009

	Serbia	Western Balkans	CEE
Global Competitiveness Index	**93**	**85**	**54**
Basic Requirements	**97**	**76**	**66**
Institutions	110	87	80
Infrastructure	107	93	81
Macroeconomic stability	111	67	60
Health and primary education	46	57	48
Efficiency enhancers	**86**	**82**	**41**
Higher education and training	76	72	41
Goods market efficiency	112	90	53
Labor market efficiency	85	78	49
Financial market sophistication	92	73	53
Technological readiness	78	65	44
Market size	67	98	44
Innovation and Sophistication factors	**94**	**96**	**59**
Business sophistication	102	97	61
Innovation	80	93	59

Source: World Economic Forum.
Note: Western Balkans: average ranking for Albania, Bosnia-Herzegovina, Croatia, Macedonia and Montenegro. Average ranking for CEE group: Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia.

Graph L2-16. Serbia: Most Problematic Factors for Doing Business, 2008 and 2009
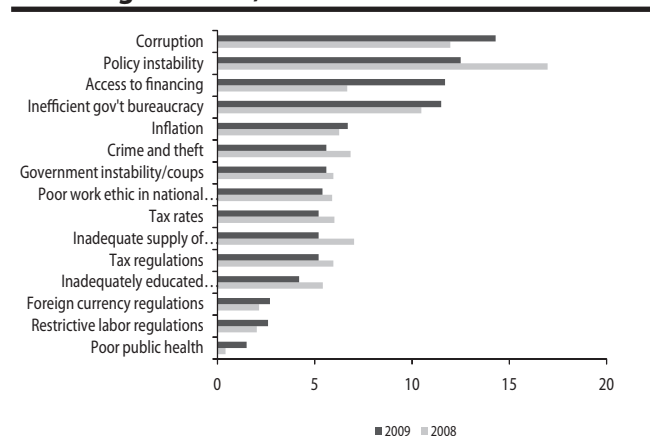
Source: World Economic Forum.
Note: The respondents graded five of the 15 listed most problematic factors by awarding them points on a scale of 1 to 5. The Graph columns depict the weighted average replies.

The World Economic Forum survey also includes a question about the most problematic factors for doing business. Graph L2-16 shows the most problematic factors in 2008 and 2009. The same factors loomed high on the list both years. According to the latest Report, corruption was singled out as the chief problem in 2009; the 2008 list was headed by political instability. Apart from these two factors, inefficient government bureaucracy was high on the list both in 2008 and 2009. Access to financing also emerged as a major problem in 2009, which is most probably the consequence of the economic crisis.

3. Conclusions and Recommendations

This text shows that Serbia's economic growth since the onset of transition has been relatively high, albeit unbalanced. The first chapter explains that growth had mostly been based on only three sectors in the non-tradable part of the economy (credited for three-quarters of economic growth in the 2002-2008 period) and that it will have to be based on the tradable part of the economy to a much greater extent in the future. This is why the key economic policy issue will be to improve the competitiveness of the national economy i.e. create prerequisites for increasing productivity and much greater growth of production of tradable goods.

Chapter 2 analyses why Serbia's economy is not sufficiently competitive today. The following key problems have been identified: the inefficiency of the public administration, complicated and non-transparent administrative procedures and an inadequate anti-monopoly policy. The low competitiveness of Serbia's economy has also resulted in the low exports of Serbian companies.

Reforms aimed at creating a more favorable and predictable business environment have to be undertaken to boost the competitiveness of Serbian economy i.e. create conditions for the stronger growth of productivity of the real sector. Herewith recommendations on the possible directions these reforms could take.

1) *Ensure a much more vigorous and effective implementation of the anti–monopoly policy*. The problem of monopoly has been identified as one of the key obstacles to the more efficient allocation of resources and increase in productivity. The adoption of the new Competition Law should be commended in that respect given that it rectifies some of the

major shortcomings of the previous Law and brings Serbia closer to European standards regulating this important field. Some improvements brought about by the new Law include (1) changes in the competition protection procedure – the new Law introduces a single procedure for establishing violations of competition and pronouncing measures for eliminating the violation (the old Law had an unusual provision under which the measure for eliminating the established violation was pronounced by the misdemeanor authorities; the Commission for the Protection of Competition is now also charged with pronouncing such measures) and (2) a higher threshold has been set with respect to the obligation to report competition – the Commission is thus relieved of dealing with cases not causing disruptions in the market, wherefore the already limited Commission resources can be used to address genuinely problematic cases. The new Law, however, opens some new issues and potential problems, notably (1) the funding of the Commission – under the new Law, the funding of the Commission may depend on government decisions to a greater extent, which raises the issue of its independence from the executive authorities, and (2) the permanence of office of Commission members – under the new Law, there is ample room for the arbitrary dismissal of the Commission chairperson and members, which, too, can affect the independence of the Commission.[6] These issues indicate that although the new Competition Law provides some good grounds for conducting an anti-monopoly policy, this topic is sure to encounter numerous challenges in the near future and warrants special attention of the expert and political public and the public at large.

2) *Simplify and ensure the greater transparency of numerous administrative procedures*. The importance of this issue is highlighted both in the World Economic Forum Report and other relevant analyses. For instance, according to the 2009 World Bank *Doing Business* report, Serbia ranks 137th on a list of 181 countries in the Paying Taxes category. According to that report, 66 various payments need to be made every year (taking up to 279 working hours); the average in South European countries is 46 different payments, while only 13 payments must be made on average in OECD countries. Montenegro is the only neighboring country that tops Serbia in the number of payments (86), while all the other neighboring countries rank better than Serbia. Some steps have been made to simplify procedures, such as the Regulatory Guillotine and Out of the Labyrinth programs and the opening of one-stop shop company registration counters. Such initiatives must continue in the future as well. Construction licensing and urban construction land ownership are important administrative procedural issues highlighted as problematic in numerous analyses of the business environment in Serbia. These issues are often the greatest problems investors face in Serbia.[7] The adoption of the new Planning and Construction Law allows for more effective construction licensing, plan documentation design and for private ownership of construction land. The practical results of the implementation of the Law remain to be seen.[8]

3) *Reform public administration and improve the efficiency of state administration*. The inefficiency and non-transparency of public administration has hampered business, facilitated corruption and unnecessarily burdened the entrepreneurs with superfluous procedures. Public administration reform is a complex endeavor requiring leadership and resolve of the policy makers. Resistance to reform is frequently great, while the results of reform are not immediately visible. The Public Administration Reform Strategy in the Republic of Serbia sets relatively good grounds for reforming public administration. One, however, gains the impression that the public administration reform process has largely slowed down in the past few years – first because of frequent elections and then because of the economic crisis. It would thus be expedient if the first step in public administration reform involved a more decisive implementation of the Strategy. The introduction of the electronic governance principle would boost public administration efficiency as well. Upgrading the IT systems used in public administration and the development of an electronic document management system would be a practical move in that direction.

4) *Establish medium-term macroeconomic stability*. The adoption of the new Law on the Budget System *inter alia* aims at orienting fiscal policy more clearly towards medium-term and predictable planning. The introduction of triennial budget planning and specific changes in the planning process (e.g. introduction of rigid limits on total expenditures by budget user) – should make the budgetary policy more transparent and less susceptible to current political developments. Adoption of a law on fiscal accountability (or integrating the principle of fiscal accountability in the current Law on the Budget System) would additionally facilitate the realization of these goals.

The implementation of the above recommendations would help create a better business environment and improve the competitiveness of Serbia's economy in a relatively short period of time. There are two more recommendations on

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6 See Emil Džudžević *New Law on Competition: new chapter in fighting monopoly*, Highlight 4, QM 17 for details of the new Competition Law.

7 According to the 2009 World Bank *Doing Business* report, Serbia ranks 171st on the list of 181 analyzed countries in the area of construction permits.

8 See Dušan Vasiljević Highlight 3 in this issue of *QM* for a detailed analysis of the new Planning and Construction Law.

how to enhance economic competitiveness in the medium and longer term. The first regards the improvement of infrastructure, above all the road and rail networks, which are in relatively poor shape. This important factor has been a major constraint on business and Serbia must continuously focus on the implementation of the key infrastructural projects (such as Corridor 10). The second recommendation concerns education reform. According to most economic growth theories, the education and technological progress levels of a country are the best predictors of its growth rate in the long term. This is why, for instance, the funding of universities should be linked to a much greater extent to results, such as the number of students who graduated on time, the percent of students who found jobs within six months from graduation, et al.

Spotlight on 3. Serbia's Current Challenges in a Cross-Country Perspective

*Bogdan Lissovolik**

After the initial shock, Serbia seems to be well-positioned to weather the global crisis in the short term. In the context of the IMF-supported program, financial tensions have eased and output is starting to recover. These encouraging trends are also unfolding in many advanced and emerging countries. But, as in other countries, medium-term fiscal trends and risks are emerging as the biggest challenge. A cross-country perspective – relative to the EU countries and across IMF programs – offers some ideas for Serbia. Comparisons with its emerging market peers are more relevant than with advanced countries, and argue for erring on the side of fiscal prudence.

Advent of the Crisis

While the current global financial crisis began in the advanced economies, it quickly spread. In the emerging markets, the crisis took the form of a sudden stop in capital inflows, exacerbated by the collapse in trade and economic activity. Central and Eastern European (CEE) countries, which had benefited from large-scale capital inflows during the global upturn, found themselves at the center of the crisis when advanced country banks cut back exposures. The sudden stop in flows to the emerging markets was much larger than during the prior Asian crisis.

The crisis hit CEEs quite abruptly. These economies, including Serbia, had been growing robustly in the run-up to the crisis (about 6 percent per year median growth during 2003-07), while headline fiscal debts and deficit ratios were falling significantly. But in virtually all cases, the crisis unmasked pre-existing vulnerabilities. Large capital inflows had fuelled credit booms and imports, and many emerging markets experienced overheating and current account deficits, which were mostly financed by external debt.

The IMF had been monitoring these trends and was ready to step in with assistance. The above vulnerabilities had been identified earlier by Fund staff in an internal vulnerability exercise. As the crisis has boosted the demand for IMF resources, it moved quickly to make its lending became more flexible, and financing of over US$160 billion in commitments was made worldwide. Rapid and frontloaded financial assistance on a large scale was key, and programs were put in place quickly (in a matter of weeks in some cases) and the size of the loan packages was aligned with the large financing needs. About two dozen standby arrangements are now in place (virtually all approved since September 2008) and program discussions are under way in a number of other countries.

Why did the countries have to turn to the IMF for help? A recent IMF study[1] concludes that prior *external imbalances* were the key predictor for program participation: program countries on average had a 6 percentage points of GDP higher *current account deficit* than nonprogram countries in 2007. Shortage of *reserves* relative to near-term financing needs also contributed: reserve coverage in 2007 was significantly lower in program than nonprogram countries. Finally, average *credit growth* was higher in program relative to nonprogram cases: credit booms help explain program participation when interacted with external imbalances. Other initial conditions (*growth, inflation*, *fiscal balance,* and *public debt*) were not significantly different between program and nonprogram countries.

Serbia typifies the "external vulnerability" story. Its current account deficit of over 17 percent of GDP in 2008 was among the highest in the region, while in other key respects it had lesser (short-term) vulnerabilities. In particular, the tight prudential policies pursued by the NBS at the height of the boom were instrumental in limiting credit growth, and external reserve coverage was moderate but not low. The standby arrangement with the IMF of some €3 billion, or 10 percent of GDP, intended to address the external vulnerability while smoothing the adjustment.

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1 IMF (2009) Review of Recent Crisis Programs, September 27.

Impact of the Crisis

The crisis proved to be the deepest and the most challenging economic event in the post-war era. The following early observations seem worth highlighting for the CEE and Serbia.

Output losses have been deep across all countries, but the CEEs have been hit especially hard. EC's recent projection of real growth for 2009 in the EU is −4.1 percent, with the mean decline in new (EU-10[2]) member states (mostly emerging markets) of 8¾ percent.[3] In Europe and worldwide, the fall in IMF-supported programs has been larger than in other emerging markets, but controlling for initial conditions (such as worse external imbalances), program participation is not associated with lower growth. In Serbia, the growth estimate for 2009 has recently been revised upward, to some -3 percent. Low export dependence seems to have partly mitigated the crisis, though this will be a disadvantage in a global recovery. Differences in statistical methodology may also explain the relatively smaller drop in output in Serbia.

Graph L3-1: Real GDP Growth
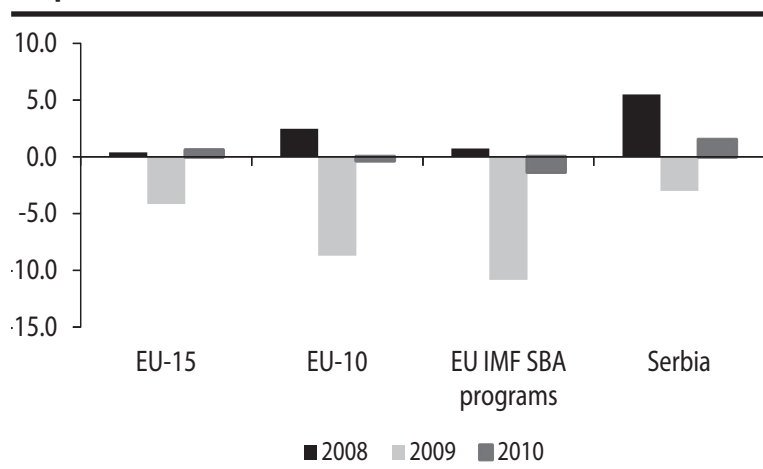
External adjustment has been particularly rapid in emerging markets. The mean current account deficit of EU-10 is now projected to fall from almost 10 percent of GDP last year to some 2 percent of GDP in 2009, well below the level expected in the Spring, with especially dramatic shifts in some countries, such as the Baltics. Globally, controlling for initial external imbalances, this adjustment appears not to have differed between IMF program and nonprogram countries (see (IMF (2009a)). The **Serbian** current account deficit fits this trend and is set to more than halve in 2009 to some 7 percent of GDP.

Table L3-2. Current Account Deficit, % of GDP
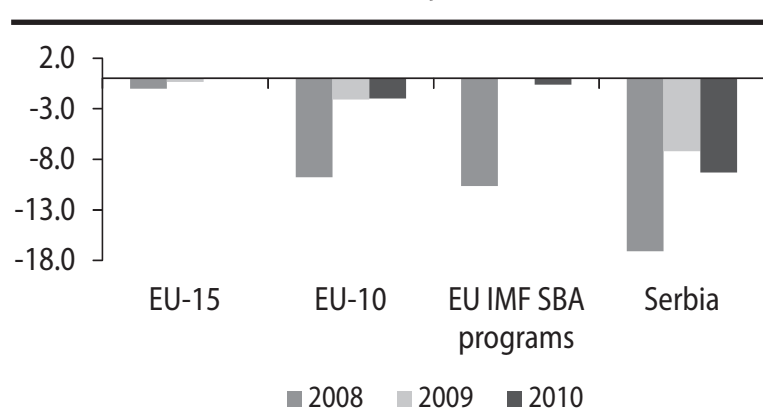
Financial stability was more robust than in past crises. Unlike in the Asian crisis a decade ago, there were no sharp spikes in interest and exchange rates, thus minimizing negative impact on households and companies, and the inflation outlook has generally been benign. And with a few notable exceptions, banking crises have been avoided—a key achievement, since many countries entered the crisis following a credit boom financed by capital inflows. In **Serbia**, the initial exchange rate adjustment has been substantial but not dramatic, and since February the market has steadied. The banking system is particularly well-buffered and the comprehensive bank coordination initiative has been a useful complement to traditional policy measures. But the rising non-performing loans continue to raise concerns over financial vulnerabilities.

Fiscal developments have been worse than expected. The economic slump quickly translated into sharply falling revenues. As a short-term response, unlike in past crises, fiscal deficits were allowed to widen in almost all countries, though not always to the full extent of the economic weakness. In this context, there is a clear difference between

2 EU-15: Belgium, Denmark, Germany, Ireland, Greece, Spain, Italy, France, Luxembourg, Netherlands, Austria, Portugal, Sweden, Finland, United Kingdom
EU-10: Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovenia, Slovakia
EU IMF SBA programs: Latvia, Hungary, Romania
3 In what follows, for EU countries and candidate countries EC's Autumn economic forecasts of early November 2009 are used, given that these are the most recent cross-country forecasts available at the time of writing. For Serbia, concurrent IMF forecasts -- made during the October/November mission -- are used.

advanced and emerging EU countries: cyclically-adjusted fiscal deficits would rise in the "old" EU members (by over 3 percentage points in 2009-10 on average cumulatively), but change little in the new member states, and actually tighten in EU standby program countries. There is a fairly small difference in the change in fiscal position between program and nonprogram (EU) countries, and initial imbalances were higher in the former. This suggests that IMF programs have been quite flexible in allowing fiscal positions to counteract economic weakness. **Serbia's** underlying fiscal position has been quite similar to that of the European emerging countries: structural fiscal deficit would improve marginally between 2008 and 2010.[4]

Graph L3-3. General Government Balance, % of GDP
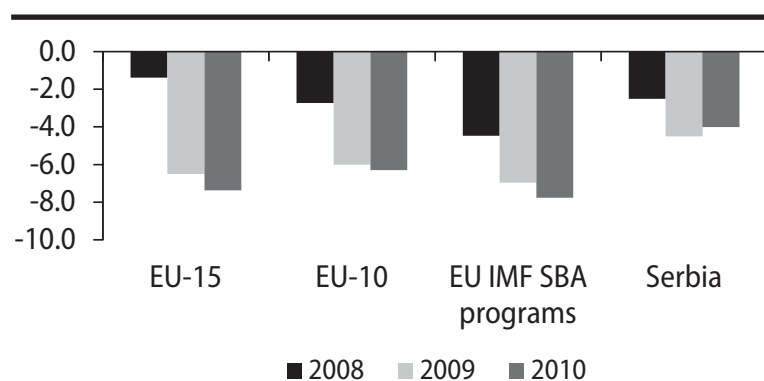
Economic recovery is taking hold. There are indications that the output decline has leveled off in most countries, and upward revisions are underway, particularly for 2010. The projections for EU countries have been revised upward over the past 6 months, and more so for the emerging market countries. In **Serbia**, we project output to grow by 1½ in 2010, against an earlier projection of zero growth for that year.

Table L3-4. Structural Fiscal Balance, % of GDP
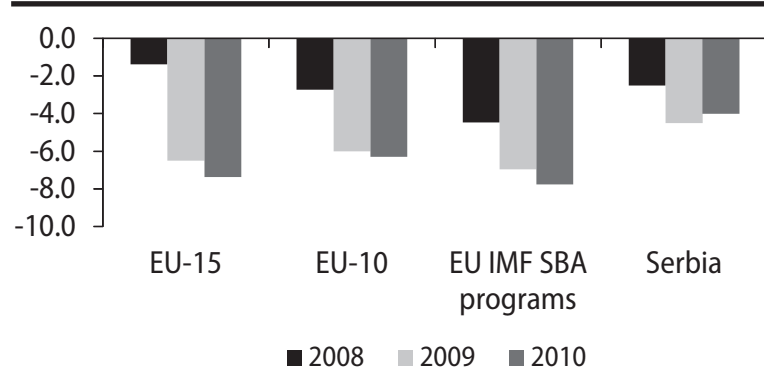
Key Medium-Term Challenge(s)

The easing of immediate crisis pressures is shifting the focus on longer-term sustainability across all countries, including emerging markets. Three key themes emerge in this regard given the impact of the crisis.

Growth outlook. The crisis-related slump has prompted a reconsideration of potential output during and after the boom years. In retrospect, the years 2005-07 probably involved some "froth" of excess growth above the economies' underlying potential, and this was not fully recognized at the time. The role and capacity of the financial sector in contributing to the growth process going forward also needs to be re-evaluated. This has important implications for the prospects for growth and broader macroeconomic framework issues in the medium term, as other sustainability issues crucially depend on the reliability of growth frameworks.

External sustainability. The high current account deficits in the run-up to the crisis were increasingly financed by debt and not FDI, and the external debt-to-GDP ratio did not decline much in many countries despite the high growth. Longer-term external sustainability considerations are particularly relevant for the current program countries, which entered the crisis with very large current account deficits. Going forward, both exchange rate competitiveness and balance sheet effects stemming from FX-denominated liabilities would be important to track.

4 A caveat should be noted: Serbia's structural fiscal balance is not fully comparable to that of other EU countries calculated here because of additional adjustment made by the IMF staff for Serbia for the external absorption gap.

Fiscal sustainability. Faced with severe recession, countries have sought to balance the need to support fragile economies with ensuring sustainable long-run fiscal positions. These decisions entail difficult trade-offs and uncertainties. For example, if potential (and thus future) growth projections are revised, the fiscal stance may be misjudged – as the past seemingly comfortable fiscal positions masked large structural deficits. Crucially, the fiscal frameworks and policies should allow the governments to effectively and promptly implement corrective measures or handle further large pressures.

Of these, fiscal sustainability appears to be the most pressing policy challenge. The problem of potential growth is not yet sufficiently tractable, given the unobservable nature of potential output and need for more data. External sustainability is more directly observable and amenable to policy decisions, but the sharp corrections in the current account underway in Europe are already significantly reducing external vulnerabilities. The fiscal challenge is more imminent and actionable, in that recent policy steps have clearly exacerbated well-known fundamental sustainability concerns such as population aging. A sustainable fiscal position would also contribute to improving medium-term growth and external position.

There is consensus on a need for a credible plan for addressing the fiscal sustainability challenge, both across the advanced and emerging countries.[5] While the fiscal stimulus should not be withdrawn too early to hamper the nascent recovery, it has been recognized that current global fiscal trends are unsustainable. Data indicate that even despite the temporary nature of the fiscal stimulus, a "passive" fiscal exit strategy would not be an option in most countries. Given the deterioration in structural deficit and debt positions induced by the crisis, an economic recovery (including in tax bases), together with a mere withdrawal of the stimulus, will be in most cases insufficient for restoring sustainability. Thus, comprehensive action will be needed on entitlement spending, on other spending, and revenues. In the European context, this is underscored by a recent decision by the EC[6] on the recommended path of deficit correction in many EU countries.

Fiscal Space in Emerging Markets

On the surface, the emerging market economies seem better positioned than advanced countries in withstanding long-term fiscal challenges. Their public debt/GDP ratios – a key indicator of fiscal sustainability – are uniformly and significantly lower, while their projected medium-term growth is higher. As a fairly representative example, the 2008 debt ratio was 27 percent of GDP on average in the new (EU-10) member states (and Serbia's ratio is very similar) versus 58 percent of GDP in the old EU. Moreover, the public debt ratio is projected to jump by a larger amount in 2008-10 in the advanced countries (15 versus 13 percentage points respectively). And in many (but not all) cases, the spending on the key aging-related items as health and education is correspondingly lower in emerging countries.

Graph L3-5. Public Debt, % of GDP

Legend: ■ 2008 ■ 2009 ■ 2010
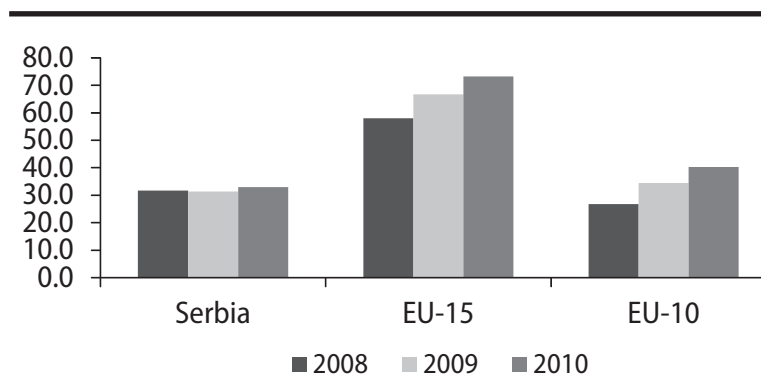
In this context the above relative lack of a structural fiscal expansion in EU-10, in contrast to old EU countries, may be puzzling. Broadly, decisions on discretionary fiscal policies, especially in a crisis, should take into account the so-called "fiscal space." This space may be understood as proxying an appropriate scope for fiscal relaxation. While hard to measure, it clearly relates negatively to the size of public debt and deficits. But in fact the projected fiscal stimulus in the EU in 2009-10 seems to be only weakly correlated with debts and deficits (unless the public debt ratio is very high), so other factors should have been playing an important role in the fiscal decisions of many countries. A composite fiscal space indicator suggested by the EC[7] includes other factors that may restrict it: (a) contingent liabilities to the financial sector, (b) revenue shortfalls from real estate and construction sectors; (c) current account deficits; and (d) the share of rigid (entitlement) public expenditure. The proposed indicator, partly by

5 See http://www.imf.org/external/pubs/ft/spn/2009/spn0925.pdf.
6 See http://ec.europa.eu/economy_finance/thematic_articles/article16132_en.htm
7 See http://ec.europa.eu/economy_finance/thematic_articles/article15893_en.htm.

capturing the role of current account deficits, helps explain why emerging EU countries have less fiscal space than prompted by their (low) debt levels. However, a part of the puzzle remains: while the 2009 measured space is very different across EU countries, it is concentrated among the emerging countries, and they do not seem to be using it to the full extent.

Graph L3-6. Fiscal Space by Member State, 2009
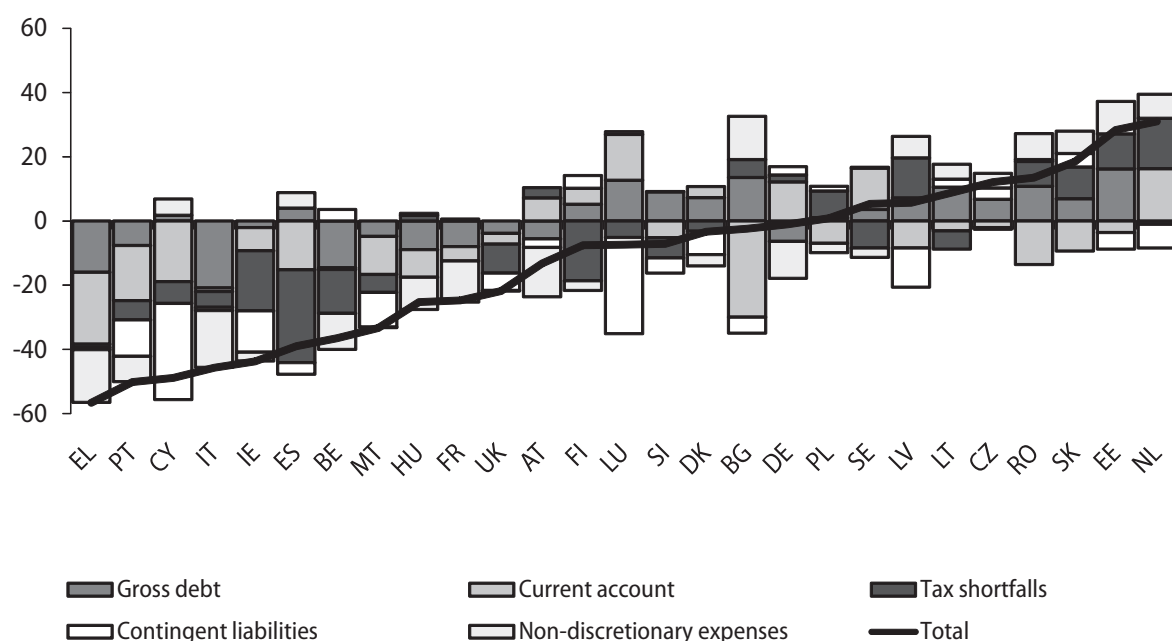
Note: Contigent liabilities represent the potential level of problematic banking assets to the extent these are likely to affect public finances; tax shortfalls are estimated assuming that corporate and property tax proceeds return to their pre-bubble ratio to GDP; non-discretionary expenses are the sum of interest payments on debt and social benefit.
Source: European Comission.

Thus, it is likely that there may be additional elements to the de-facto fiscal space that is hard to systematically capture by the data, and which may explain why the fiscal space in advanced countries may be larger than in emerging countries.[8] These could be the following:

Fiscal position adjusted for the cycle: for example, "initial" structural fiscal deficits in EU-10 have been higher than in EU-15 (some 5 percent of GDP compared to 2¼ percent of GDP in 2008), although this factor may be already partly captured through current account balances.   • Overall **quality/management of public finances**, including ability to control or withdraw stimulus through effective rules. While there are no fully objective measurement indicators, emerging markets, with some exceptions, lag behind on these counts, while advanced countries are way ahead.• Financing constraints are tighter in Central and Eastern European countries. Emerging countries do not have liquid, deep, and long-dated markets for domestic debt. And a few countries (Bosnia, Hungary, Iceland, and Romania) faced significant fiscal financing problems requiring immediate attention. The constraints facing emerging market countries have prevented the massive increases in deficits and debt observed in advanced economies.

• Overall confidence effects are important. For example, a large expansion could dent fiscal credibility and unsettle financial markets. This factor may be proxied by risk premiums on emerging market debt, which are a consequence of not only fiscal factors, but also thin financial markets, prevalent foreign currency public borrowing (more risky from a balance sheet perspective), higher inflation, as well as the global jitters. The confidence factor, however, while additional in some way to the above points, overlaps and interacts with many of them. There is recent evidence (see IMF 2009b) of increased market discrimination across sovereigns, which would be particularly relevant for emerging markets. In sum, even if the revealed lack of fiscal expansion is merely a policy choice, it may well be a rational decision influenced by market discipline, at least in some emerging countries.Serbia's Own Fiscal Challenges
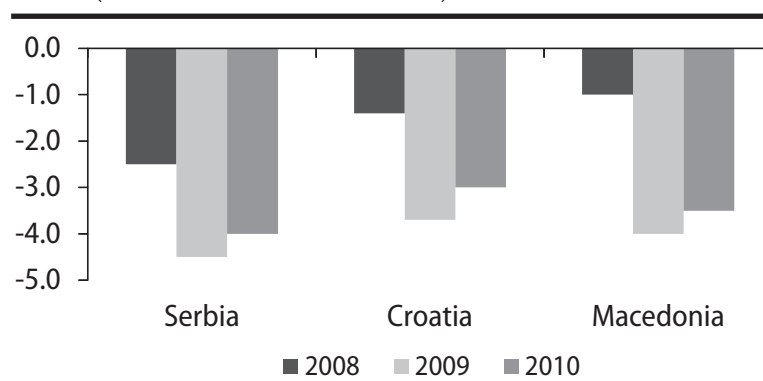
In the context of the previous discussion, Serbia's scope for fiscal space is likely not larger than that of the EU emerging markets. Actually, the majority of factors point to an even lesser fiscal space in Serbia, though there are arguments in both directions. In particular:

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8   The EC underscores that its indicator is an imperfect gauge and could be used for illustrative purposes only.

• On the positive side, the public debt ratio is relatively low (though not that much lower in 2009 than in other EU emerging markets), and so are expected contingent liabilities to the financial sector.

• On the negative side, Serbia's still-high current account deficit, the large entitlement (pension) spending, tight financing constraints at least relative to the EU countries, and other contingent liabilities and risks, such as those related to the burden of public enterprises on the economy or potential restitution claims, point in the other direction.

• The comparative quality of public financial management in Serbia is also probably on the low side, due to lack of effective fiscal rules. Examples include extra increases in Serbia's recurrent spending at the peak of the boom.

Graph L3-7. General Government Balance, % of GDP

Broader indirect indicators such as risk premiums (EMBI spreads) also suggest that Serbia's fiscal space could be on the low side. While spreads have declined recently around the world, they (as of late November 2009) remain high in Serbia – close to 400 basis points over US treasuries, compared to some 240 in Hungary or 160 in Poland. Serbia's low BB- rating points in the similar direction. Low fiscal deficits in non-EU countries that are more comparable to Serbia (such Croatia and Macedonia) are also consistent with this logic. These are projected to be lower than in the EU emerging markets and even slightly lower than in Serbia (see Table). Against this background, Serbia's revised 2009-10 fiscal deficit targets of 4.5 and 4 percent of GDP respectively if anything look on the high side.

A more relevant analysis of Serbia's fiscal vulnerabilities should be based on a detailed assessment of its current and future fiscal position. In this respect, the IMF staff estimates that without a change in policies,[9] Serbia's deficits are likely to rise to unsustainable levels over the medium term.

• First, due to the rebalancing of the economy, the tax-GDP ratio is projected to decline by almost 4 percent of GDP (see Box).

• Second, public spending would remain roughly constant in terms of GDP if the key de-facto spending drivers do not change. In particular, some spending components (capital spending due to the deteriorated infrastructure and the public interest bill given the dwindling share of concessional debt) would be trending upwards.

The resulting fiscal balance, at 7-8 percent of GDP in the medium term, would be very high for Serbia (see Table).

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9 At the time of writing, the full effects of the 2010 budget were not yet decided and published. Thus, assuming only policy measures that had been agreed prior to the October/November budget discussions, the 2010 budget deficit would be about 1 percentage point higher than targeted.

Table L3-8. Serbia: Fiscal Projections under Unchanged Policies, 2007–2015 (In percent of GDP)

	2007	2008	2009 Prog.	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.
Revenue	42.4	40.9	38.3	37.4	36.8	36.7	36.7	36.9	37.2
Expenditure	44.2	43.4	42.8	42.5	42.7	43.0	43.4	44.0	44.9
Current primary	38.3	38.4	38.2	36.9	36.6	36.4	36.3	36.5	36.9
Interest	0.8	0.6	0.8	1.2	1.5	1.6	1.8	2.0	2.1
Capital and net lending	5.2	4.4	3.7	4.4	4.6	5.0	5.3	5.6	5.9
Fiscal balance	-1.9	-2.5	-4.5	-5.1	-5.9	-6.3	-6.6	-7.1	-7.7
Structural balance[1]	-3.6	-4.6	-4.1	-5.4	-6.3	-6.6	-7.0	-7.4	-8.0
Public debt	33.3	31.7	31.5	34.2	36.7	38.9	41.1	43.7	47.2

Source: Ministry of Finance and IMF staff estimates and projections.
1) Actual fiscal balance adjusted for the effects of both the output and the external absorption gaps. See IMF Country Report No. 07/390, Chapter III.

Reducing Serbia's fiscal vulnerabilities would take time and determined progress – in resolving imbalances, enhancing fiscal institutions, and developing debt markets. In this respect, Serbia's authorities have taken a firm stance toward exclusively concentrating fiscal adjustment on spending-based measures, eschewing tax increases. In this context, most crucially, Serbia's fiscal sustainability prospects depend on spending reforms, the thrust of which would be aimed at gradually containing the share of pension (13 percent of GDP) and wage bill (over 10 percent of GDP) spending, which would then be closer to the averages of the other emerging countries. This is a promising approach, but it requires strong and continued political will to implement an array of structural reforms, and its effects will take years to materialize.

Box 1. Serbia's Falling Tax-to-GDP Ratio

One of the adverse surprises of the 2009 downturn in Serbia has been a steep fall in the tax-to-GDP ratio, which is expected to drop by more than 2½ percent of GDP this year alone and by 4 percentage points over 2008-14, in the absence of significant tax policy measures. In advanced economies, tax-to-GDP ratios, with unchanged policies, tend to be relatively stable. But this clearly does not apply to economies undergoing a sharp correction of external imbalances. In Serbia, three groups of factors explain the large drop in the tax ratio:

• The rebalancing of the economy will depress the tax/GDP ratio via two channels: (lower taxed) domestic savings would rise, mainly at the expense of (higher taxed) consumption; and improving external competitiveness should entail a lower share of (higher taxed) wages and rising (lower taxed) profits.

• The external rebalancing of the economy will shift tax collection from relatively easy collection points (imports) to more difficult collections points (domestically produced goods and services).

• Tax compliance is suffering, particularly in the case of cash-constrained enterprises. This effect should taper off over the medium term, particularly if offset by administrative measures.

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– EC (2009b) "Excessive Deficit Procedure steps: the Stability and Growth Pact as the anchor for fiscal exit strategies" November 11, See http://ec.europa.eu/economy_finance/thematic_articles/article16132_en.htm

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