# quarterly monitor

## OF ECONOMIC TRENDS AND POLICIES IN SERBIA

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#### **SPOTLIGHT ON**

Spotlight on 1:

The Effects of the Suspension of the Law on Local
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Expenditure Behavior of Local Governments:
<b>2007–2009</b>

#### Tony Levitas

This paper analyzes the impact of the suspension of the Law on Local Government Financing on revenue and spending management. The author looks into macroeconomic effects of the suspension of the law, the response of local governments to the situation and gives recommendations to improve the system of financing local governments in Serbia.

#### Spotlight on 2:

#### Sonja Avlijaš, Dejan Molnar

This paper analyze two types of services provided by local governments – the construction and reconstruction of local roads and streets and solid waste management – as well as an impact of lower transfers to municipalities in 2009.

#### Spotlight on 3:

#### Microcredit in Serbia – Is it (Really) Necessary?...77

#### Daniel Gies

This paper explains what microcredits are, what is their goal, sources and role in Serbia. The author presents results of a research on the reasons to take microcredits, their use and alternative (cheaper) financing, offers recommendations, suggestions and conclusions on how to improve microcredit activity, while highlighting their potential importance for the overall economic development of Serbia.

# **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**



An economy ridden with high inflation, a weakening dinar and a high debt "drives off" foreign investors and is condemned to low output growth. Low economic growth is further exacerbating all of Serbia's economic and social problems – from high unemployment and the resulting poverty, to the needed reduction of the budget deficit.

The main response to the currently high inflation and unstable exchange rate that the Government has at its disposal is to decrease public spending. Specifically, in 2011 the consolidated fiscal deficit has to be reduced from 5% to 4% of the GDP and at the same time the public investment should reach 4% of the GDP, implying that current expenditure and tax revenues are in balance. Cutting the deficit and directing public spending towards investments would mean that the Government is complying with the legally binding fiscal rules, i.e. that it will embark on reducing the medium-term deficit to 1% of GDP in the 2011 pre-election year as well. The speed of Serbia's future growth depends upon the credibility of this program, as a low state deficit is crucial for reducing the financial country risk and for the resulting investment growth.

The inflation in Serbia is high and accelerating vigorously. It is likely to reach 11% in this year, but if we look at the second half of the year, or the last four months the inflation rate is around 15%. This is the alarmingly high inflation level which should be decreased to the 4.5% target in 2011. While it is highly doubtful whether such a reduction can be achieved, it is certain that the inflation will spiral out of control unless the fiscal deficit is reduced. The good news is that the impending public pension and wages increase will apparently be limited to 2% instead of 6%, which is what it should have been, based on the inflation rate in the second half of the year. This measure has partially contained the wave of populism of a part of the Government, which has sought to unfreeze wages and pensions, first in June, then in October, eventually imposing a bad compromise to unfreeze these in January. A full wage and pension indexation (around 6%) in January would cause a new wave of inflation.

The dinar is depreciating despite the fact that NBS has sold around  $\notin 2.4$  bn in 2010. The cause is the exter-

nal deficit which, despite having been halved compared to the pre-crisis level, could not be covered with the now substantially reduced foreign capital inflows. A reduction of the fiscal deficit and public spending is needed to keep imports and external deficit under control, thus preventing further pressure on the fall of the dinar. Foreign capital inflows, essential for the stability of the dinar, will critically depend on the credibility of the Government's fiscal policy, i.e. on whether the latter will comply with the IMF agreement concerning the 2011 deficit. An additional  $\in 2.5$  bn, i.e. 8% of the GDP, in foreign capital is required annually and Serbia could achieve this provided that it pursues a responsible fiscal policy and implements the required reforms.

The Government has agreed with the IMF to reduce the fiscal deficit to 4.1% in 2011, but the last minute decision questions the credibility of deficit reduction as 2011 unfolds. The main reduction consists in not indexing wages and pensions to the full inflation rate, however this will not suffice. It is now becoming clear that in order to reduce the deficit and curb inflation, it would have been much better to begin unfreezing wages and pensions in April, as initially agreed. Public investment will amount to a maximum 3% of the GDP, which is insufficient, in view of its importance for immediate economic recovery and future economic growth.

However, the main danger in 2011 is that the arrival of proceeds from Telekom's privatization and the approaching elections might revive ideas on stimulating economic activity by increasing government spending and deficit. This would ignite inflation, increase the external deficit, lead to a further depreciation of the dinar and prolong the spiraling growth of the public debt which increased from the pre-crisis 25% to almost 40% of the GDP. Then foreign and domestic investments would significantly decrease, economic growth would come to a halt and solving the key problem – high unemployment – would be impossible.

In contrast to the previous scenario, compliance with fiscal rules would ensure, in the next five year period, a reduction of the state deficit to 1% of the GDP, thus strongly underpinning sustainable economic growth. In fact, there are already some indications in 2010 that the GDP growth has been led by net exports growth, as exports grew by 21%, and imports only by 8% in the first ten months. The dinar exchange rate played a significant role in this, in other words the decrease of the unit labor costs, denominated in euros, during the crisis significantly increased the competitiveness of Serbia's economy. The foregoing gives hope that the future growth in Serbia can be founded on growth of exports and domestic savings (i.e. net exports). The same model of growth has been proposed in EBRD's latest Transition Report, as well as in a recent domestic study on Serbia's new model of economic growth 2011–2020.

Highlights 1 (Ranđelović, S. and Arsić, M.) examines the recent budget realignment for 2010, but more importantly – the basic elements of the 2011 budget and its sustainability. This is important because of the previously expressed position that a reduced budget deficit in 2011 has to be the Government's main response to the current economic instability. *Highlights 2* (Arsić, M.) analyzes the effects of the current policy of subsidizing investments in Serbia and matches it against the alternative, i.e. creating a favorable investment climate and equal conditions for all investors through adequate reforms. This second road is longer and more arduous for the Government, nevertheless it is the only one that would ensure the required lasting growth of investments.

Spotlight on 1 (Levitas, T.) analyzes the impact of the suspended enforcement of the Law on Financing of Local Self-Government on the manner in which revenues and expenditures are managed by local selfgovernment. The author examines the macroeconomic impact of the suspension of the Law, the way in which local self-governments responded to the new situation and gives recommendations for improving the system of financing local self-government in Serbia. Spotlight on 2 (Avlijaš, S. and Molnar, D.) is an attempt to analyze two types of services that are in the jurisdiction of local self-governments - construction and reconstruction of local highways and roads and solid waste management and the impact of the reduction of funding allocated to municipalities in 2009. Spotlight on 3 (Gies, D.) explains what microloans are, what their purpose, sources and role are in Serbia. The author presents the results of studies on the reasons for taking microloans, their use and alternative (cheaper) sources of funding, gives recommendations and conclusions about ways for improving microloans and emphasizes their potential importance for Serbia's overall economic development.

N.Mcgrobat

# TRENDS

## 1. Review

The emergence of Serbia's economy from recession is marked by divergent economic trends. As the recovery in economic activity is gaining momentum, so is inflation, while at the same time foreign capital inflows are decreasing. In the forthcoming period the co-existence of these trends will not be feasible. Successful economic recovery requires a stable macroeconomic environment – or else it will be debilitated by escalating internal and external instabilities. The latest data on the accelerating inflation growth in November and a sharp downturn of industrial production in October are very alarming.

The reduction of the consolidated state deficit in 2011 to 4.1% of GDP, as agreed with the IMF and coordinated with the recently adopted fiscal rules, is a step in the right direction. A reduction in public spending would deflate the pressure on prices, exchange rate and public debt growth, thus significantly aiding economic recovery.

Inflation is high and threatening to spiral out of control. In the first eleven months of 2010, it has reached 10%, already exceeding, by two percentage points, the upper bound of NBS target band for the whole year (8%). The acceleration of inflation in the second half of the year was largely influenced by food prices, but already by October and November other prices too reached an almost identical growth rate (see Section 5. "Prices and the Exchange Rate"). By the end of the year, total inflation is likely to reach around 11%, thus positioning Serbia (together with Ukraine) among the countries with the highest inflation rates in Europe.

The elevated inflation level from August to November is particularly alarming. If we annualize the inflation rate of the last four months, it would exceed 15%. This is the actual level of inflation with which we will be entering 2011 and which needs to be contained now. Achieving the NBS inflation target for 2011 set at 4.5% ± 1.5% seems a difficult challenge to attain from this angle.

The balance of payments current account deficit in 2010 will be EUR 2.5 bn, i.e. around 8% of GDP (see Section 4. "Balance of Payments and Foreign Trade"). Although this current account deficit cannot be considered particularly high for Serbia, given that in the pre-crisis period it had even reached six billion euro (18% of GDP), there are difficulties in financing it in 2010. In the pre-crisis period, foreign capital inflows were higher than the current account deficit, so the NBS foreign currency reserves increased and the dinar strengthened. In 2010, the capital inflows dwindled to the extent that they are not even sufficient to finance a current account deficit which is 60% lower compared to the one before the crisis. Consequently, NBS foreign currency reserves are shrinking and the dinar is weakening. Since the beginning of the year, the dinar depreciated against the euro by 11.5% in nominal terms and 2.5% in real terms.

The Gross Domestic Product is likely to grow by 1.5% in 2010, thus compensating for only about half of the production drop from the previous year (see Section 2 "Economic Activity"). The economic recovery in Q3 has continued at a slightly faster pace compared to the previous quarter. The seasonally adjusted GDP grew by over 0.8% compared to the previous quarter which would equate to a solid annual growth pace of around 3.5% at an annual level. The non-agricultural GVA, which is a more reliable indicator of economic activity growth, has been recovering even faster and its annual growth rate in Q3 would amount to around 4.5%.

It is possible that the labor market has begun to react positively to the evident recovery of economic activity (see Section 3. "Employment and Wages"). Preliminary data indicate that the decline in employment in the second half of 2010 has significantly slowed down in comparison to the previous quarters. Nevertheless, we are always very cautious in assessing employment trends. The latest statistics on poverty are worrisome, as they indicate that unfavorable labor market trends and unemployment growth in the past two years have had an impact on the increase of the poverty rate of the population from 6.1% in 2008 to 8.8% in 2010.

Exports are a key driver of economic recovery. In the first ten months of 2010 exports grew by 21% in comparison to the same period last year. At the same time, imports had a significantly smaller year-on-year (y-o-y) growth rate amounting to 8.2%. Hence, the trade deficit decreased and net imports are still positively contributing to GDP growth. Due to a faster recovery of exports than that of other macroeconomic aggregates, the structure of Serbia's economy has changed. The share of exports of goods and services in the GDP reached 35% in Q3 and was by five percentage points higher than before the crisis.

The current dinar value is conducive to exports growth. The unit labor costs (ULC) calculated in euros indicate that Serbia's price competitiveness significantly increased compared to the precrisis period, mostly owing to the depreciation of the dinar (see Table T2-5). In 2010, EUR-ULC returned almost to 2005 levels, compensating for the loss of price competitiveness which resulted from the appreciation of the dinar in the period from 2005 to 2008. Perhaps this could also be linked to the fact that Serbia recorded a much faster economic recovery compared to its neighbors, where fixed and low-flexibility exchange rates are predominant.

However, the opportunity that presents itself for a relatively quick economic recovery could very easily be missed, if the country fails to ensure medium-term economic stability. To accomplish this goal it will firstly be necessary to carry into effect the planned budget for 2011, which entails reducing the fiscal deficit to 4.1% of the GDP and changing the structure of public spending in favor of a greater share of investments (see Highlights 1 "Serbia's Revised 2010 Budget and 2011 Fiscal Policy ").

The first necessary step has been made towards achieving the deficit target for 2011. The increase of public pensions and wages in January will amount to only 2% after all, instead of the unsustainable 6% (which is how much it would have been if the pensions and wages had been adjusted for the inflation rate in the second half of 2010, as planned). In addition, an agreement was reached to freeze subsidies at the nominal level from 2010, which was nevertheless relativized by the fact that it does not apply to all subsidies, as important state incentives and subsidized loans are exempted from the freeze.

However, the aforesaid reduction of spending will still not suffice to achieve the deficit target for 2011. Therefore some exacted fiscal policy decisions had to be taken. There will be a higher than planned increase in cigarette excises as of January 1<sup>st</sup> and the remaining adjustments will be achieved in the least desirable way – by decreasing public investments. Although it was announced that public investments in 2011 would amount to 4% of GDP, their effective level is not likely to exceed 3%.

Reducing government spending is also necessary because of the fast-growing public debt. The public debt at the end of October exceeded 38% of GDP and is recording a vigorous growth (see Section 6. "Fiscal Flows and Policy"). Since the beginning of the year, the public debt's share in the GDP increased by seven percentage points and since the beginning of the crisis by as much as 13 percentage points. The relative growth of the public debt in 2010 was primarily influenced by the fiscal deficit, but also by the continuation of the depreciation of the dinar (given that the largest portion of the debt is denominated in euro while the GDP is realized in dinars). The growth of the public debt also contributes to the increase of the external debt which is very close to the limit of 80% of GDP.

The rapid growth of the public debt is exerting a negative impact on the country's credibility and increasing the country risk to foreign investors/creditors. The consequence of an increased country risk is a high interest rate on loans, which in turn affects the whole economy. We note that Serbia's EMBI (index used for assessing the investment risk in emerging markets) is twice higher than the average in emerging Europe and only lower to that of Ukraine and Belarus. The amount of Serbia's public debt is also restricted by law to a maximum 45% of GDP and we are now less than seven percentage points away from reaching this limit. The upward trend of the public debt must therefore be reversed. That is why it is best to use Telekom sales proceeds for an early repayment of a portion of the public debt. The worst solution would be to use these proceeds for current spending. Furthermore, it would be contrary to the fiscal rules adopted. However, this scenario cannot be entirely ruled out, especially as the following year is a pre-election year. Loosening fiscal policy in this case would further raise pressure on prices and depreciation of the dinar and decrease chances for the much needed foreign capital inflows. Under these circumstances monetary policy would be forced to strongly increase its restrictiveness, which would eventually debilitate economic recovery.

#### Serbia: Selected Macroeconomic Indicators, 2004-2010<sup>1)</sup>

			Annual	Data			Quarterly Data							
	2004	2005	2006	2007	2009	2000		20	)9			2010		
	2004	2005	2000	2007	2008	2009	Q1	Q2	Q3	Q4	Q1	Q2	Q3	
Prices and the Exchange Rate							y-o-y <sup>2)</sup>							
Consumer Price Index				6.5	11.7	8.4	10.1	8.7	7.9	5.9	4.4	4.0	6.5	
Retail Price Index	10.1	16.5	12.7	6.8	10.9	10.1	9.8	9.9	9.4	9.2	7.2	6.9	7.9	
Real fx dinar/euro (avg. 2005=100) <sup>3)</sup>	100.5	100.0	92.1	83.9	79.7	84.1	86.0	84.3	82.6	83.5	85.3	86.1	87.8	
Nominal fx dinar/euro (period average) <sup>3)</sup>	72.62	82.92	84.19	79.97	81.46	93.90	93.71	94.17	93.24	94.47	98.60	101.30	105.15	
Economic Growth						у-	o-y, real growth	2)						
GDP (in billions of dinars)	1,381	1,684	1,962	2,302	2,723	2,815								
GDP	8.3	5.6	5.2	6.9	5.5	-3.1	-4.3	-4.5	-2.2	-1.7	0.4	2.0	1.7	
Non-agricultural GVA	6.4	6.8	7.5	8.7	5.7	-2.8	-3.7	-3.7	-2.2	-1.8	0.6	2.4	2.6	
Industrial production	7.1	0.8	4.7	3.7	1.1	-12.1	-17.0	-17.8	-10.6	-3.8	2.8	6.9	3.7	
Manufacturing	9.7	-0.7	5.3	4.2	0.7	-15.8	-22.6	-21.6	-14.6	-5.4	4.6	7.1	4.7	
Average net wage (per month, in dinars)4)	14,108	17,478	21,745	27,785	29,174	31,758	30,120	31,808	31,737	33,366	31,924	34,192	34,372	
Registered Employment (in millions)	2.047	2.056	2.028	1.998	1.997	1.901	1.958	1.901	1.882	1.861	1.838	1.815	1.807	
Fiscal data			in % of	GDP					У	-o-y, real growth	ı			
Public Revenues	41.2	42.1	42.4	42.1	41.5	38.6	-12.6	-13.4	-4.2	-5.0	-4,0	2.5	-3.6	
Public Expenditures	40.0	39.7	42.7	42.8	43.7	42.7	-3.4	-6.0	-0.3	-9.2	-1,4	-3.1	-3.2	
						in	billions of dinar	s						
Overall fiscal balance (GFS definition) <sup>3)</sup>	17.5	14.8	-33.5	-58.2	-68.9	-121.8	-12.4	-45.5	-23.9	-40.0	-24,1	-31.2	-28.8	
Balance of Payments						in mil	lions of euros, fl	ows <sup>2)</sup>						
Imports of goods <sup>6)</sup>	-8,302	-8,286	-10,093	-12,858	-14,964	-11,052	-2,755	-2,680	-2,705	-2,913	-2,658	-3,036	-3,175	
Exports of goods <sup>6)</sup>	2,991	4,006	5,111	6,444	7,416	5,977	1,291	1,538	1,547	1,602	1,472	1,870	1,933	
Current account <sup>7)</sup>	-2,197	-1,805	-3,137	-4,994	-6,089	-2,041	-978	-246	-344	-472	-760	-597	-517	
in % GDP 7	-11.6	-8.6	-12.9	-17.2	-18.2	-6.8	-14.4	-3.3	-4.4	-6.0	-10.9	-7.9	-6.8	
Capital account <sup>7)</sup>	2,377	3,863	7,635	6,126	6,180	2,174	991	275	371	537	689	585	498	
Foreign direct investments	773	1,248	4,348	1,942	1,824	1,372	643	251	113	366	284	136	176	
NBS gross reserves	349	1,675	4,240	941	-1,687	2,363	-240	880	716	1,007	-367	-321	-313	
(increase +)								- 2)						
Monetary data	102 159	175 200	202 702	400 105	475 110	in millior	1s of dinars, e.o.	a. stock"	529 420	570 701	562 520	547 240	402 800	
NDS net own reserves	103,130	1/3,200	302,765	400,195	4/5,110	5/6,/91	502,000	469,002	526,459	5/6,/91	505,529	547,249	495,699	
NBS net own reserves , in min of euros	1,291	2,030	5,655	5,051	5,502	1 206 224	5,505	3,234	3,001	1 206 224	3,032	3,267	4,004	
Credit to the non-government sector	110 712	100 126	260 661	201 607	412 766	565 204	1,213,643	1,216,702	1,245,755	565 204	604 792	651 122	691 704	
FX deposits of households	10,713	190,150	200,001	361,087	413,700	505,294	430,832	401,401	402,027	505,294	11.5	14.6	10.2	
M2 (y-o-y, real growth, in %)	10.4	20.6	50.0	27.0	2.9	9.6	-5.2	2.1	0.9	9.6	11.5	14.0	10.5	
Credit to the non-government sector	27.5	28.0	10.5	24.9	25.2	5,2	21.7	10,4	11,0	5,2	0,5	17.5	10.7	
(y-o-y, real growin, In %)	23.0	29.6	28.6	35.0	42.0	45.8	45.0	45.8	44.5	45.8	48.2	51.6	52.5	
Credit to the hon-government sector, in % GDP	23.5	27.0	20.0	55.0	42.0	45.0	45.5	45.0	44.5	45.0	40.2	51.0	52.5	
Financial Markets		1.057	2.650	2 025	1.100	1 212		1 1 70	1.545					
BELEXING (In Index points)	1,161	1,954	2,658	3,831	1,198	1,312	844	1,173	1,548	1,312	1,307	1,238	1,226	
rumover on BSE (in mil. euros)	423.7	498.8	1,100.4	2,004.4	884.0	443.7	61.2	/2.6	55.8	254.0	49.4	46.3	39.5	

Source: FREN.

1) Detailed data (monthly series) given on internet page: www.fren.org.rs.

2) Unless marked differently.

3) The calculation is based on 12-month averages for annual data, and three-month averages for quarterly data.

4) Data for 2008 represent adjusted figures based on a wider sample for the calculation of an average wage. Thus, the nominal wages for 2008 are comparable with nominal values for 2009 and 2010, but not with previous years.

5) We monitor the overall fiscal result (fiscal balance according to GFS 2001) – Consolidated surplus/deficit adjusted for "budgetary lending" (lending minus repayment according to the old GFS).

6) The Republic's Statistics Office has changed its methodology to calculate foreign trade. As of 01.01.2010, Serbia started implementing the general system of trade, in line with recommendations from the U.N. Statistics Department, which represents a wider concept than the previous one, offering better adjustment to criteria given in the Balance of Payments and the System of National Accounts. For a more detailed explanation see QM20, section 4, Balance of Payments and Foreign Trade.

7) The National Bank of Serbia changed its Balance of Payments methodology in Q1 2008. The change in methodology has led to a smaller current account deficit and a smaller capital account balance. For a more detailed explanation see QM12, section 6, Balance of Payments and Foreign Trade.

8) The NBS net own reserves represent a difference between net foreign exchange reserves of NBS and the sum of foreign exchange deposits of commercial banks and foreign exchange deposits of the government. See section Monetary Flows and Policy for more detail.

9) The value of index on a last day of the monitored period.

10) The total turnover value at the Belgrade Stock Exchange includes the values of traded shares and foreign currency savings bonds. The mid-exchange rate for the monitored period was used to calculate the dinar turnover values in the stock market into euros.

## 2. Economic Activity

Economic activity continued recovering in Q3 2010. The GDP rose by around 1.7%, and the non-agricultural GVA by around 2.6% year-on-year. Estimates based on the flow of seasonally adjusted non-agricultural GVA indicate that the economy will grow by over 4% per annum, putting Serbia at the forefront of the region. These data should, however, be interpreted with caution, because economic activity in Q3 was still 2% lower than before the crisis, and will at this rate need another six months to reach the pre-crisis level. Recovery of production is still concentrated in the export-oriented sectors, while some of the activities focusing on the domestic market continued declining in 2010 (e.g. construction). This is why a major share of the economy, and the population, is still not feeling the positive effects of having overcome the recession. Although the continued high growth of exports in Q3 is the chief engine of economic recovery, domestic spending has recorded a rise as well. The GDP structure is visibly changing due to the depreciation of the dinar and the growth of exports - exports of goods and services in Q3 exceeded 35% of the GDP, i.e. were more than five percentage points higher than before the crisis. Unit labor costs measured in euros indicate the significant impact the depreciation of the dinar has had on the increase of the price competitiveness of the national economy. Industrial production grew by 4.1% y/y in Q3, while seasonally adjusted indices indicate that it grew at a faster rate than in Q2. Economic activity will probably continue speeding up in the forthcoming quarter, but QM nevertheless does not expect GDP to grow by much more than 1.5% in 2010

#### **Gross Domestic Product**

According to QM's preliminary estimates<sup>1</sup> based on available data on economic activity results, the GDP grew by around 1.7% y/y in real terms in Q3 (Table T2-1). The non-agricultural GVA, which QM considers a more reliable measure of economic activity, recorded a y/y growth of around 2.6% in Q3.

The recovery of economic activity that began in the latter half of 2009 continued in Q3, as the seasonally adjusted GDP quarterly growth indices indicate.<sup>2</sup> Viewed from this perspective, the GDP grew over the previous quarter by slightly over 0.8%, which would correspond to a solid growth rate of around 3.5% per annum. If economic activity continues increasing at a similar pace in the next quarter, GDP growth may slightly exceed 1.5% in 2010.

Economic recovery is probably somewhat faster than the one indicated by the GDP growth trend. The rate of economic recovery would stand at a relatively high 4.5% a year if agricultural production, which fell in Q3<sup>3</sup>, is excluded from the GDP.

Seasonally adjusted indices indicate that, regardless of its visible recovery, the value of the GDP was still around 2% lower in Q3 than before the crisis. If this rate of growth continues, the precrisis production level will be reached in mid-2011, which is in conformity with *QM*'s estimations (made in 2009) that economic activity would not reach its 2008 level before 2011.

Economic activity continues recovering in Q3

Y/y growth assessed at around 1.7%

<sup>1</sup> 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.

<sup>2</sup> To ensure comparability, QM derived seasonal adjustment by applying the X12 ARIMA methodology that is also used for seasonally adjusting industrial production.

<sup>3</sup> Exogenous factors (the weather) affect agricultural production the most, wherefore the non-agricultural GVA is a more reliable indicator of the underlying trend of economic activity.

		Y-o-y indices													
	2005	2006	2007	2008	2000		20	009			2010		Q1/10	2000	
	2003	2008	2007	2008	2009	Q1	Q2	Q3	Q4	Q1	Q2	Q3 <sup>2)</sup>	Q1/02	2009	
Total	105.6	105.2	106.9	105.5	96.9	95.7	95.5	97.8	98.3	100.4	102.0	101.7	137.5	100.0	
Taxes minus subsidies	110.2	99.8	109.5	103.8	94.3	92.0	90.4	96.4	97.8	100.6	102.8	102.0	147.0	15.8	
Value Added at basic prices	105.0	106.4	106.5	105.9	97.4	96.4	96.5	98.1	98.4	100.4	101.9	101.7	131.8	84.2	
Non agricultural Value Added	106.8	107.5	108.7	105.7	97.2	96.3	96.3	97.8	98.2	100.6	102.4	102.6	141.5	87.8 <sup>3)</sup>	
Agriculture	95.1	99.8	92.2	108.6	100.7	99.9	101.4	100.8	100.6	99.7	98.4	97.0	106.4	12,2 <sup>3)</sup>	
Manufacturing	99.9	105.6	104.8	101.2	84.7	79.3	79.9	86.0	93.0	102.0	105.7	104.4	99.5	13,7 <sup>3)</sup>	
Construction	102.0	107.7	110.8	101.5	85.7	90.0	86.4	83.6	82.7	87.5	88.1	92.0	114.1	3,2 <sup>3)</sup>	
Transport, storage and communications	123.4	129.3	120.1	112.5	106.5	103.8	106.7	107.8	107.4	107.8	106.6	106.0	309.6	17,9 <sup>3)</sup>	
Wholesale and retail trade	122.0	110.3	119.9	106.8	91.1	92.6	90.8	91.7	89.5	93.3	101.3	104.0	209.8	12,7 <sup>3)</sup>	
Financial intermediation	111.9	112.2	115.6	113.5	104.3	105.3	105.3	103.7	103.0	105.2	106.9	106.5	184.7	5,1 <sup>3)</sup>	
Other	102.1	100.6	101.5	103.6	101.2	101.3	101.3	101.7	100.5	100.1	100.2	100.0	113.2	35,3 <sup>3)</sup>	
Source: SORS															

Table T2-1. Serbia: Gross Domestic Product, 2005–2010<sup>1)</sup>

3) Share in GVA.

Construction and Agriculture decreasing...

...Trade accelerating the most Solid growth of Observed by *activity*, most areas recorded a y/y rise in production (Table T2-1). A y/y decline was recorded in Agriculture, Construction and Electricity Production and Distribution<sup>4</sup>. Agriculture declined over Q3 2009 due to the lesser production of wheat than last year, while somewhat more auspicious trends were noticeable in construction as its decline was lesser than in the previous quarters. Wholesale and retail trade spearheads the sectors that have been recovering; its growth accelerated the most over Q2.

*rowth of* The y/y growth of domestic and export demand is given in Table T2-2. Q3 evidences a quite rapid recovery of aggregate demand, which grew by around 6.2% in real terms y/y. When total demand is observed by components, domestic demand shows a 3.2% and export demand an 18.5% rise in real terms over the same period in 2009 (Table T2-2).

#### Table T2-2. Serbia: Growth of Aggregate Demand and Components, 2005–2010

	2006	2007	2008	2009 -		200	)9		2010				
	2000	2007	2008	2009	Q1	Q2	Q3	Q4	Q1	Q2	Q3		
					Y-o-y iı	ndices							
GDP	105.2	106.9	105.5	96.9	95.7	95.5	97.8	98.3	100.4	102.1	101.7		
Aggregate demand	109.3	110.3	107.1	91.9	91.5	85.2	87.4	93.9	100.2	105.0	106.2		
Domestic demand	106.0	106.9	105.6	94.0	94.9	86.1	89.4	94.1	98.7	102.3	103.2		
Export demand	125.1	125.6	113.3	83.3	78.4	81.8	79.7	93.3	106.9	116.0	118.5		
Source: QM based on NI	BS and SORS	data											

# Export demand in the lead

The considerable lead export demand had over the other observed aggregates in Q3 has led the QM to conclude that exports are still the main engine of economic recovery. Q3, however, also saw a major y/y increase in domestic demand (Table T2-2).

Despite the high growth of exports, the relatively high y/y rise in imports in Q3 resulted in the negative share of net exports in GDP annual growth (the trade deficit was higher in Q3 2010 than in Q3 2009). This data may only at first glance appear to clash with QM's assessment that export demand, rather than domestic demand, is the main engine of economic recovery. If the import of energy-generating products, which strongly grew in Q3, were to be excluded from to-tal imports, net exports would be recording y/y growth and continuing to positively affect overall production growth. The value of imported energy-generating products is largely dependent on the change in their prices in the international market and the business policies of a limited number of national importers, rather than a reflection of essential changes in national economic aggregates.

#### Visible signs of changes in the structure of the economy

es Exports in euros are the only GDP component approximating the pre-crisis level in 2010. On the other hand, the GDP measured in euros (due to the depreciation of the dinar since the onset of the crisis) was as many as 15% lower in Q3 2010 than in Q3 2008. This is why the share of exports in the GDP has changed substantially, which may be indicating that Serbia will come out of the crisis with a different structure of the national economy. Namely, the exports of goods

At constant prices in 2002.
 *QM* estimate.

<sup>4</sup> Due to its minor share, electricity production and distribution is under Other in Table T2-1.

Graph T2-3. Serbia: Aggregate and Domestic Demand to GDP Ratio, 2001–2010



and services reached 35% of the GDP in Q3, i.e. over five percentage points more than in the pre-crisis period.

Graph T2-3 shows (aggregate and domestic) demand to production ratio. The spending to production ratio (domestic demand to GDP ratio – the bottom line on Graph T2-3) warrants particular attention. Spending exceeded production by 16.4% in Q3. This indicates a relative increase in spending over Q2, when this percentage stood at 14.5%, but also that (notwithstanding the rise) domestic demand was still at an unusually low level for the national economy. For, in the years preceding the crisis – the difference between spending and production usu-

ally exceeded 20%. The structure of economic recovery, based more on the growth of exports than of domestic demand, indicates that the drop in domestic demand compared to production caused by the crisis will probably be more permanent in character.

Unit labor costs
 Unit Labor Costs<sup>5</sup> (ULC), both those measured in dinars and those measured in euros, stabilizing...
 Ized in Q3 at a level similar to the one in Q2 (Graphs T2-4 and T2-5). Year on year, ULC in dinars were around 5% and ULC in euros were around 10% lower than in Q3 2009.

at a much lower level....at a much lower level....

The ULC fall when the share of labor force costs in the value added generated by such labor falls, which is essentially a positive trend. In Serbia's case, however, the decline of the ULC in dinars compared to the pre-crisis level is chiefly attributed to the substantial fall in employment, which was deeper than the decline in production.<sup>6</sup> The possible stabilization of the ULC in Q3 vis-à-vis Q2 may be indicating that the trend of declining employment is finally slowing down and, hopefully, reversing.

Graph T2-4. Serbia: Real Unit Labor Costs in the Economy and Industry, 2005–2010





#### Competitiveness visibly greater than before the crisis

Unit labor costs measured in euros (euro-ULC) indicate the international competitiveness of a national economy because they define the highest domestic cost component (labor costs) vis-à-vis value added. The *QM* calculated the euro-ULC in the manufacturing industry (which produces by far the greatest share of tradable products) and in the entire economy.<sup>7</sup>

Graph T2-5 presents the movement of the euro-ULC in the entire economy and the manufacturing industry. Q3 evidences the stabilization of the euro-ULC at a level similar to the one in Q2, which was considerably lower than before the crisis. In 2010, the levels of the euro-ULC

<sup>5</sup> Unit labor costs in dinars are calculated for the economy (excluding the agriculture and state sectors) and the industry.

<sup>6</sup> More in Section 3 Employment and Wages in this issue of QM.

<sup>7</sup> Excluding the State and Agriculture sectors.

in the manufacturing industry and the entire economy were similar to the ones in Q2 2005, i.e. before the onset of the strong appreciation of the dinar. The data on the values of the euro-ULC and their return to the 2005 level indicate that the national economy has (thanks to the depreciation of the dinar and the flexibility of the labor market) restored the competitiveness it had lost by the real appreciation from 2006 until the crisis. The greater price competitiveness of the domestic economy may give significant impetus to the further increase in exports.

#### Box 1. Serbia's Economic Growth in the Regional Context

The latest EBRD and IMF October 2010 estimates of the economic growth of the countries in the region point to two facts: (1) that this is one of the regions hit the hardest by the crisis, and (2) that Serbia's economic recovery is much faster than that of the neighboring countries.

Albania, which had not been hit by recession at all, is the only country that will have a somewhat higher GDP growth rate than Serbia in 2010. The year 2010 will be a year of recession or stagnation for all other major regional economies. Table T2-6 shows the 2009 and 2010 growth rates and projections of the neighboring countries.<sup>1</sup>

			Ү-о-у	(%)		
	2009	Q1	Q2	Q3 <sup>1)</sup>	2010 <sup>1)</sup>	2011 <sup>1)</sup>
Hungary	-6.3	-1.1	0.5	2.1	0.8	1.7
Romania	-7.1	-3.2	-1.5	-2.3	-2.0	0.9
Bulgaria	-4.9	-0.8	-0.3	0.2	0.4	2.4
Albania	3.3	2.0	3.3	2.7	3.0	2.2
Bosnia i Herzegovina	-2.8	-	-	-	0.8	2.2
Montenegro	-5.7	-	-	-	-0.6	2.5
Croatia	-5.8	-2.5	-2.5	-0.7	-1.5	1.9
Macedonia	-0.7	-1.1	0.4	2.2	0.5	2.3
Serbia <sup>2)</sup>	-3.1	0.4	2.0	1.6	1.6	2.9
Total	-5.6	-1.4	0.0	-0.6	-0.3	1.7
Source: EBRD, FREN 1) EBRD estimate						
2) Weighted averages						

#### Table T2-6. Neighboring Countries: GDP Growth, 2009–2011

Serbia exports around 40% of its goods to the neighboring countries, wherefore their slower economic recovery also leads to the slower growth of Serbia's exports to these markets. Serbia's exports to the neighboring countries in the first nine months of 2010 were still lower by some 10% than before the crisis, while its exports to the rest of the world have nearly reached the precrisis values.

The slow economic recovery in the region definitely negatively impacts on Serbia's economic growth. The IMF and EBRD projections that the region cannot expect stronger economic recovery in 2011 are concerning in that context. Both the IMF and the EBRD estimate that the economic growth of the neighboring countries (calculated as the weighted averages of the individual countries) will not reach 2% in 2011 (Table2-6).

1 To ensure the full comparability of the data in the Table, *QM* used the EBRD estimates for Q3 and the whole 2010 rather than the FREN estimate. The EBRD estimate is, however, nearly identical to that of FREN.

#### **Industrial Production**

Industrial production continues its solid y/y growth

Manufacturing industry contributing to y/y growth the most Industrial production saw a 3.7% growth in Q3 over the same period last year (Table T2-7). The somewhat lower y/y growth of industrial production than in the previous quarters is largely due to its comparison with a somewhat higher base, given that industrial production began recovering in Q3 2009.

Given its large share, the manufacturing industry affected the overall industrial production the most. The manufacturing industry grew by 4.7% y/y in Q3 (Table T2-7). The high y/y increase, of nearly 14% was recorded by mining and quarrying, while the level of electricity, gas and water production and supply was 4.2% lower in Q3 than in the same period last year.

	Y-o-y indices													
	2005	2006	2007	2008	2000		20	09			2010		2000	
	2005	2000	2007	2008	2009	Q1	Q2	Q3	Q4	Q1	Q2	Q3	2005	
Total	100.8	104.7	103.7	101.1	87.9	83.0	82.2	89.4	96.2	102.8	106.9	103.7	100.0	
Mining and quarrying	102.1	104.1	99.4	103.6	95.7	92.8	90.1	100.1	99.2	110.3	118.1	113.8	6.7	
Manufacturing	99.3	105.3	104.2	100.7	84.2	77.4	78.4	85.3	94.6	104.6	107.1	104.7	72.8	
Electricity, gas, and water supply	106.6	102.2	102.8	101.8	100.6	99.2	98.7	103.9	100.7	95.9	102.7	95.8	20.5	
Source: SORS														

Table T2-7. Serbia: Industrial Production Indices, 2005–2010

Seasonally adjusted indices higher than in Q2 Graph T2-8 shows the seasonally adjusted indices of industrial production in the entire industry and in the manufacturing industry. Seasonally adjusted data indicate that industrial production is again on an upward trajectory in Q3 after a quarter of stagnation. Seasonally adjusted data reaffirm that industrial production is accelerating despite the slowdown in Q3 (compared to the first half of the year).





Even more encouraging is the fact that the solid growth of industrial production in Q3 was achieved without the customarily greatest share of basic metals production (which dropped in July and August due to the overhaul of the US Steel Serbia blast furnace). When this fact is taken into account, it can be concluded that the recovery of the rest of the industry actually accelerated considerably in Q3.

Graph T2-9 presents the y/y growth of specific sectors with sizable shares in the manufacturing industry. The greatest changes over Q2 were recorded in the basic metals production. The chemical and rubber and plastics industries

continued growing at solid rates, while the food industry slowly began embarking on an upward trajectory. These results show that the observed acceleration of industrial production growth in Q3 cannot be attributed only to a few individual, export-oriented sectors, but may also indicate the onset of recovery on a somewhat broader front. However, several months will have to pass before this assessment is substantiated.

#### Visible recovery of the production of intermediate goods

Table T2-10 demonstrates that three groups of products – energy, intermediate and consumer goods - recorded y/y production growth in Q3 2010, while the production of investment goods continued declining year on year.



Graph T2-9. Serbia: Year on Year Growth of Specific Manufacturing Industry Sectors, 2008–2010 The production of intermediate goods in Q3 increased by 10.4% over the last year, but this time thanks to the growth of the rest of the group rather than a rise in basic metals production. If basic metals are excluded from the intermediate goods sector, its y/y growth would be even greater and stand at 13% (Table T2-10). Production of consumer goods had a slight y/y (0.3%) increase, which can be attributed the most to the food industry, while energy production grew by 2.3% due to greater exploitation of oil. The continuing negative trends in the production of investment goods give rise to some concern.

					,	Y-o-y indi	ices					Share <sup>5)</sup>
	2005	2006	2007	2008		20	09			2010		2000
	2005	2000	2007	2008	Q1	Q2	Q3	Q4	Q1	Q2	Q3	2009
Total	100.6	104.7	103.7	101.1	83.0	82.2	89.4	96.2	102.8	106.9	103.7	100.0
Energy <sup>1)</sup>	103.9	102.5	101.2	101.5	98.3	96.5	102.0	100.5	97.2	105.8	102.3	30.1
Investment goods <sup>2)</sup>	74.2	90.0	105.4	105.5	71.4	77.6	76.4	87.6	103.4	90.5	90.9	5.3
Intermediate goods <sup>3)</sup>	104.9	106.7	104.9	100.0	65.1	66.0	81.4	103.2	114.1	121.4	110.4	26.9
Intermediate goods without basic metals	101.5	101.3	107.3	98.8	69.6	73.4	81.5	93.3	104.1	104.2	113.0	20.6
Consumer goods <sup>4)</sup>	101.6	112.0	107.1	97.9	85.0	84.7	88.5	87.5	102.2	103.0	100.4	36.6
Consumer goods without food industry	96.3	128.3	109.2	96.3	79.5	69.5	82.9	76.5	104.5	112.7	93.2	12.6

Table T2-10. Serbia: Components of Industrial Production, 2005–2010

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

Decline of construction activity somewhat milder... Construction activity was around 8% lower in Q3 than in the same period last year, i.e. it declined less than in Q2, when it fell by 12% y/y. QM is of the view that the *cement production index*<sup>8</sup> is the most reliable of all indicators of movements in construction (Table T2-11). Cement production was around 4% lower in Q2 2010 than in Q2 2009, which, on the one hand, confirms that construction is still in the zone of relatively deep y/y decline, but may, on the other hand, indicate somewhat more auspicious trends in construction in the coming quarters.

#### ...and estimated at around 8%

	Y-o-y indices										
	l quarter	ll quarter	III quarter	IV quarter	total						
2001	89.5	103.5	126.9	148.1	114.2						
2002	83.6	107.9	115.6	81.6	99.1						
2003	51.1	94.4	92.7	94.4	86.6						
2004	118.8	107.4	98.5	120.1	108.0						
2005	66.1	105.0	105.8	107.4	101.6						
2006	136.0	102.7	112.2	120.2	112.7						
2007	193.8	108.9	93.1	85.0	104.4						
2008	100.1	103.7	108.1	110.1	105.9						
2009	34.1	81.4	86.0	75.3	74.4						
2010	160.7	96.9	96.0								

Table T2-11 Serbia: Cement Production,

Among the other construction indicators published by the SORS, *QM* singles out the *value* of the completed construction work in Q3, which indicates that construction activity, particularly the construction of buildings, has fallen by 11.9% over Q3 2009. This also suggests that - no matter which methodology is applied – construction is without doubt the sector hit the hardest by the economic crisis. However, if one takes into account that the decline in the value of completed construction work exceeded 14% in Q2, one may take the Q3 percentage as indication that this sector of the economy is starting to recover.

The projections of construction activity in the en-

#### Projections nevertheless slightly better

suing period are also slightly better. The value of contracted construction work was as many as 60% higher in Q3 than in the same period last year. It should, however, be borne in mind, that contracting of construction work nearly ground to a halt in 2009 and the y/y rise should be viewed in that perspective. All in all, construction activity may possibly gradually increase in the upcoming period.

Greater government involvement in investment projects would contribute to the recovery of construction by the end of 2010 and in 2011. QM noted a substantial increase in state capital spending<sup>9</sup> in Q3, while for quite a while now, there have been announcements of stepping up work on major infrastructural projects, such as the construction of Corridor X, and the state's involvement in boosting residential construction.

<sup>8</sup> 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.

<sup>9</sup> More in Section 6: Fiscal Flows and Policies in this issue of QM.

# 3. Employment and Wages

The negative trends in the labor market continued in Q3, albeit at a slower pace. Although unemployment stagnated, employment continued falling. Most of the people who lost their jobs turned inactive rather than unemployed and preliminary data show that most of them opted for early retirement. Formal employment continued dropping – around 10,000 people were left jobless between March and September 2010, while the decline in employment in the 100 selected large companies considerably slowed down. The manufacturing industry evidenced the greatest fall in employment in the past six months – by 9,000 i.e. 3% within the sector. The average real wage continued growing in Q3, by 1.8%, but its growth was substantially lower than in the previous period and ground to a halt in October. The increase in the average nominal wage mildly accelerated, reaching 8.4% y-o-y in Q3. In the public sector, the average real wage fell in the health and education sectors and remained at the same level in the administration and local public companies. The 1.8% real y-o-y growth of the average wage is the consequence of the 6% rise in the average real wage in the corporate sector.

#### **Employment**

Negative trends in the labor market continued in Q3 as unemployment stagnated and employment continued falling

> Most people losing their jobs turned inactive rather than unemployed

Labor market indicators continued deteriorating in Q3 2010, although this negative trend considerably slowed down over the previous year. Despite the fact that the growth of unemployment halted between April and October 2010, employment continued declining, albeit at a considerably slower pace, indicating an increase of the inactive population.

Although the results of the Labor Force Survey (LFS) conducted in October 2010 are not available yet, preliminary analyses indicate that the unemployment rate has not grown since April 2010. The employment rate continued falling, because the people who have lost their jobs have turned inactive. The optimistic presumption that most of these people are elderly workers who have opted for early retirement, and/or the young, who are going back to school because they cannot find another job can only be confirmed once the October LFS results are published and data are analyzed by age groups, education levels and gender.

		Total number of employed 15-64 <sup>2)</sup>	Number of employed in agriculture and unpaid family workers	umber of employed in agriculture and Emplo apaid family workers			Total number of unemployed 15- 64	Unemployment rate 15-64			
			15-64 <sup>3)</sup>	Total	Male	Female	_ 01 _	Total	Male	Female	
		1	2	3	4	5	6	7	8	9	
2008	April	2,652,429	670,141	54.0	62.3	46.0	432,730	14.0	12.4	16.1	
	October	2,646,215	589,240	53.3	62.2	44.7	457,204	14.7	12.7	17.3	
2009	April	2,486,734	437,957	50.8	58.7	43.3	486,858	16.4	15.0	18.1	
	October	2,450,643	411,303	50.0	57.4	42.7	516,990	17.4	16.1	19.1	
2010	April	2,278,504	326,623	47.2	54.3	40.3	572,501	20.1	19.4	21.0	
	October							20.0*			

Table T3-1. Serbia: Employment and Unemployment According to the Labor Force Survey1,2008-2010

Source: Labor Force Survey (LFS), SORS.

Notes: \*FREN forecast based on preliminary data.

1) The Labor Force Survey has been conducted twice a year since 2008 - in October and in April.

2) Persons between 15 and 64 years of age are considered to be of working age.

3) Until October 2008, the LFS did not comprise the 15-64 age group classification for the number of employed in agriculture and contributing household members, only 15+.

Formal employment also continued dropping between March and September 2010, although its decline slowed down compared to the previous two years (Table T3-2, column 1). The total number of formally employed in the March-September 2010 period fell by around 0.6% i.e. by 10,000. Compared to September 2009, this decline was much greater – by 60,000 or 3.3%.

This drop in employment in the preceding period is fully attributed to lower employment in legal entities by 0.7% over March 2010 i.e. by 2.3% over September 2009 (Table T3-2, column 2),

Formal employment continued falling by around 10,000 between March and September 2010 The fall in employment can fully be attributed to the drop in employment in legal entities, because data on entrepreneurs are still unavailable

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given that the September 2010 data on entrepreneurs, i.e. the self-employed and their employees, are not available yet (Table T3-2, column 3).

Table T3-2. Serbia: Number of	f Registered Employ	yed and Unemployed \	Workers <sup>1)</sup> , 2005-2010
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					Entrepreneurs			
		Total no. of employed	Employees in legal entities <sup>2)</sup>	Total	No. of entrepreneurs	No. of employees with entrepreneurs	Total no. of employees	Number of unemployed (NES)
		1 (=2+3)	2	3 (=4+5)	4	5	6 (=2+5)	7
					in thousand	s		
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	1,911	1,411	500	210	290	1,701	758
	September	1,868	1,383	485	211	274	1,657	737
2010	March	1,817	1,362	455	199	257	1,618	778
	September	1,807	1,351	455	199	257	1,608	721

Source: SORS – the semi-annual report on employed persons and wages of the employed persons RAD-1/P; the survey amending the semi-annual survey RAD-1; the semi-annual survey on private entrepreneurs and their employees RAD-15; the National Employment Service (NES). Note: September data were adjusted on the basis of the semi-annual survey RAD-1/P for March 2010.

Footnotes:

1) By the registered number of employed, we refer to the formal economy, i.e. those employees with employment contracts and for whom social security contributions are being paid. By the registered number of unemployed, we refer to those persons that have registered with the National Employment Service (NES).

Firing of workers in 100 selected large companies slowing down substantially Within the sample of selected 100 large companies in Serbia, whose employment trends we monitor as well, 480 people lost their jobs between March and September 2010. Therefore, the decline of employment in these companies substantially slowed down in the preceding six months compared to the pre-crisis period (employment in these companies fell by 16,000 i.e. 7.3% in the January 2009-March 2010 period).

#### Table T3-3. Serbia: Public Sector Employment, 2005-2010

				Em	ployees in legal en	tities		
				Public sector				
			From the budge	et	Public en	terprises	- Public sector -	
		Administration - all levels	Education and culture	Health and social work	National public	Local public	total	Other"
		1	2	3	4	5	6	7
					in thousands			
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	933
	September	64	123	142	88	57	473	910
2010	March	62	124	142	87	56	472	890
	September	63	122	143	86	56	470	878

Source: SORS

Note: The total balance of public sector staff in the Table does not comprise the employees of the Ministry of Defense and Ministry of the Interior, although their salaries are funded from the state budget. Their numbers are estimated at around 80,000, and they account for another 4% of all employed persons in Serbia. Precise data on their numbers and average wages are not published by the SORS for security reasons. Footnote:

1) Private, socially-owned and mixed enterprises (without entrepreneurs). This number is arrived at by subtracting the numbers of public company workers and others, whose wages are funded from the budget, from the total number of employees in legal entities.

The manufacturing industry still accounted for the greatest decline of employment in legal entities in the March-September 2010 period - by 9,000 i.e. by 3% within the sector. Around 2,000 people (around 1% within the sector) in the Wholesale and Retail Trade sector lost their jobs in the same period. Not one sector saw any real growth of employment, when the seasonal oscilla-

The greatest slump in employment in the past six months was recorded in the manufacturing industry – by 9,000 i.e. by 3% within the sector tions in specific sectors are discounted (Table P-5 in the Analytical Annex).

The fall of administratively defined unemployment by around 57,000 (7.9%) in the March-September 2010 period (Table T3-2, column 7) does not necessarily reflect the trends in economically defined employment, because it covers only the people using the services of the National Employment Service.

Apart from the seasonal fall of employment in the education sector by around 2,000, which *QM* still is unable to explain, public sector employment remained almost unchanged between March and September 2010 (Table T3-3).

#### Wages

The average real wage continued growing in Q3 2010, by 1.8% y-o-y, i.e. much less than in the previous quarter, when it rose by 3.2% y-o-y (Table T3-4). The y-o-y real average wage stayed at the same level in October 2010.

Although the growth of the average real wage substantially slowed down, the rise in the average nominal wage mildly accelerated in Q3 2010, to 8.4% y-o-y (over 7.3% in Q2). The average net wage in euros stood at 327 euros in Q3, falling by 2.2% over the previous quarter. The average wage in euros dropped by 3.8% over Q3 2009, when it stood at 340 euros (Table T3-4).

The average real wage in the public sector fell by around 5% y-o-y in Q3 in the Health and Social Work and the Education and Culture sectors and in state public companies, while the average real wages in the administration and local public companies remained at the same level y-o-y (Table T3-5).

The 1.8% real y-o-y growth of the average wage in Serbia is above all due to the 6% rise in the average real wage in the corporate sector.

#### Table T3-4. Average Monthly Wages and Y/Y Indices, 2008-2010

		Average Mor		Average Gross Monthly Wage Index <sup>2)</sup>		
	Total labour costs <sup>3)</sup> , in dinars	Net wage, in dinars	Total labour costs, in euros	Net wage, in euros	nominal	real
	1	2	3	4	5	6
2008 2009	47,882 52,090	29,174 31,758	586 554	357 337	117.8 108.8	105.5 101.0
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
Q4	54,689	33,366	579	353	105.4	99.9
Dec	60,265	36,789	628	383	106.9	100.8
2010						
Q1	52,261	31,924	530	324	105.7	101.1
Q2	55,989	34,192	548	335	107.3	103.2
Q3	56,435	34,372	537	327	108.4	101.8
Oct	56,382	34,422	530	324	108.3	99.4

Source: SORS Notes:

1) Data for 2008 are adjusted on the basis of the expanded data sample used to calculate the average wage, which now includes the salaries of those employed by entrepreneurs.

2) Y/y wage indices of average monthly gross earnings for 2008 were calculated on the basis of average earnings in 2007 and 2008 and the old sample that does not include those employed by entrepreneurs. However, these indices are comparable with the indices for 2009, given the fact that the expansion of the sample of earnings preserved their growth dynamics and only reduced their nominal value by about 12%.

3) Total labor costs (TLCs) comprise employer's total average expense per worker, including all taxes and social security contributions. TLCs stand at around 164.5% of the net wage. Gross wage growth indices are equal to total labor cost indices, because the average TLC is greater than the average gross wage by a fixed 17.9% of employer based social security contributions.

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September 2010 The average real wage continued growing in Q3, increasing by 1.8% y-o-y, and then ground to a halt in October

Number of workers

almost unchanged between March and

in the public

sector remains

Growth of the average nominal wage mildly accelerated, to 8.4% y-o-y in Q3

The average real wage in the public sector fell in the health and education sectors and in state public companies and remained at the same level in the administration and local public companies

The 1.8% real y-o-y
growth of the average
wage in Serbia is due
to the 6% rise in the
average real wage in
the corporate sector

Table T3-5. Serbia: Gross Wages in the Public Sector, 2004-2010, Y/Y Real Indices

		From the budget		Public ent	terprises		
	Administration - all levels	Education and culture	Health and social work	National public	Local public	Other <sup>1)</sup>	Serbia average
	1	2	3	4	5	6	7
2004	107.4	107.7	110.9	107.9	113.4	113.7	111.4
2005	105.9	106.0	100.8	100.5	103.0	106.9	107.1
2006	109.1	107.2	109.4	110.8	102.9	113.7	111.3
2007	111.1	114.7	123.8	116.7	105.0	114.1	114.6
2008	100.7	105.7	101.3	101.2	95.9	105.7	105.5
2009	95.5	96.7	97.4	98.3	98.2	104.1	101.1
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	99.8	97.9	99.4	98.4	100.8	105.1	102.5
Q2	94.0	97.4	98.1	99.0	99.3	104.8	102.0
Q3	93.6	96.2	96.9	98.1	95.4	102.9	100.1
Q4	93.0	93.6	93.5	96.0	95.9	104.0	99.9
2010							
Q1	95.8	96.1	96.1	102.2	98.0	103.5	101.1
Q2	101.0	96.7	95.1	102.1	98.3	106.6	103.2
Q3	100.4	95.1	94.6	94.5	99.8	106.0	101.8

Source: SORS. Notes:

1) Column 6 includes private, socially-owned and mixed enterprises (excluding entrepreneurs).

2) Column 6 shows the estimated value arrived at by deducting the public sector wage bill from the total wage bill and then dividing the difference by the number of workers employed in the corporate sector (column 7, Table T3-3).

3) Real y/y wage indices in columns 6 and 7 for 2008 and 2009 were calculated on the basis of the expanded sample for the calculation of the average wage, which now includes also workers employed by entrepreneurs.

## 4. Balance of Payments and Foreign Trade

The current account deficit in Q3 2010 was €517 mn (6.8% of GDP). The share of the deficit in GDP was lower relative to the values recorded in the previous two quarters owing primarily to an increased current transfer inflow throughout Q3 and to the almost unchanged amount of goods deficit in GDP. On the other hand, the modest capital inflow was insufficient to cover the current deficit resulting in the further decline of the NBS foreign exchange reserves in Q3. Exports recorded further significant y-o-y growth (24.9%) and imports started to accelerate (17.4%). The analysis of seasonally adjusted exports indicates a slowdown compared to the previous quarters - the growth rate of 6.2% at the annual level - but this underscores the recovery of all export components. Imports speed up due to recovery of domestic demand but this tendency is still to a great extent a consequence of high imports of energy. In fact, the net exports upon exclusion of energy imports give a positive contribution to economic recovery. The faster recovery of exports against imports has led to a decrease in the foreign trade deficit in the first ten months of 2010, relative to the same period last year which is an indicator of the positive contribution of the net exports to the recovery of GDP. Still, due to the recovery of domestic demand, the acceleration of imports in the forthcoming period will lead to a deficit growth and enhance the problem of its funding. The estimated current account deficit for the entire 2010 shall be about 8% of GDP, i.e. somewhere in the vicinity of €2.5 bn. In addition, the NBS will sell approximately the same amount (about €2.6 bn) during 2010 to defend the domestic currency if it retains the same level of intervention until the end of this year.

The current account deficit in Q3 2010 stood at €517 mn. Denominated in terms of the percentage of realized gross domestic product, the current account deficit was 6.8% and was lower compared to the values recorded in both previous quarters of the current year (Table T4-1). The recorded decrease in participation of the current account deficit is mainly a consequence of the increased current transfer inflow during Q3, while the amount of goods deficit in the GDP remained almost unchanged.

In Q3 2010, the goods deficit stood at €1,242 mn. It accounted for 16.3% of GDP, which is approximately equal to the values previously recorded in Q1 and Q2 (Table T4-1). Despite the fact that Q3 exports recorded a faster recovery than imports, this alone was not sufficient to decrease the value of the goods deficit. In fact, in view of the fact that the imports coverage by exports is 58%, it would be necessary for exports to grow almost twice as fast as imports in order to decrease the goods deficit. Since this was not the case in Q3, the goods deficit recorded a y-o-y growth of 8%.

A total of €1,933 mn worth of goods was exported, while imports amounted to €3,175 mn. In Q3, exports accounted for 25.4% of GDP, considerably higher than in the pre-crisis period when exports accounted for 22.2% of GDP in 2007 and 2008. On the other hand, imports, with 41.7% of GDP in Q3, were below the pre-crisis values recorded for 2007 and 2008, when they accounted for 45% of GDP (despite the change in the methodology used for calculation of the value of imports introduced from the beginning of 2010 which effectively broadens their reach). In addition, in relation to the pre-crisis period the imports coverage by exports has increased by 10 percentage points since the beginning of 2010, the already mentioned methodology changes introducing a broader reach of imports notwithstanding. Although the change in the foreign trade exchange structure in favor of exports is evident, the data indicate that imports have been gaining speed since the beginning of this year and – taking into account the fact that they are below pre-crisis levels - that there is room for their further growth.

However, one should bear in mind that imports of energy products were extremely high in the recorded overall imports growth in Q3<sup>1</sup>. This leads to the conclusion that the growth in domestic

The current account deficit recorded a drop in its share in the GDP since the beginning of 2010...

...due to the almost constant value of the goods deficit in the GDP and the increased inflow of current transfers, primarily remittances

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<sup>1</sup> See Section "Imports" for further details.

demand was not as significant as suggested by the data at first glance. With the exception of energy products, net exports recorded a year-on-year drop of 16.2%, thus confirming that the contribution of export demand to the production growth in the course of Q3 was considerable. In addition, since the beginning of 2001, exports seem to be the basic driving force behind the economic recovery. In the first ten months of 2010, the exports growth stood at 21% above the value recorded in the same period of the year before, with imports recording an 8.2% growth over the same period. Thus, the trade deficit has been reduced and net exports positively contribute to the GDP.

Net current transfers in Q3 amounted to  $\notin 854$  mn (11.2% of GDP). Such an amount of net current transfers is high compared to their normally recorded share in GDP in 2008 (7.6% of GDP) and in relation to the first two quarters of 2010 (Table T4-1). Within the scope of the current transfers, remittances account for most of the inflows in Q3, amounting to  $\notin 610$  mn net, i.e., 8.0% of GDP. Such a share of remittances in GDP exceeds that of 2008 by 3 GDP percentage points. Remittances remain relatively high in Q3 2010 as well, compared to the quarterly values recorded in the first half of that same year (Table T4-1).

In 2010, we expect a relatively low current account deficit level (compared to the pre-crisis period) and a significant drop in foreign currency reserves due to insufficient capital inflow

A very modest inflow of capital was recorded in Q3, amounting to only €186 mn accompanied by a €313 mn drop in foreign currency reserves Should such exports trend continue and imports mildly accelerate in the ensuing quarter, the total goods deficit for 2010 is expected to be around 17% of GDP. On the other hand, we can expect the high remittance inflow to continue, i.e., to reach approximately 7% of GDP annually for the year 2010 and, consequently, the net current transfers to reach 10% of GDP. This means that the estimated current account deficit for 2010 will be at the level of about 8% of GDP, i.e. in the amount of approximately &2.5 bn. However, despite such a low current account deficit rate compared to the deficit values recorded before the crisis, the problem of insufficient capital inflows becomes more and more evident creating depreciation pressure resulting in depletion of foreign currency reserves. Further to the point, certain recovery of domestic demand is expected by the end of 2010 and at the beginning of 2011, which may lead to a deficit growth and aggravate the already existing problem of its funding.

The financial account was characterized by very modest foreign capital inflows amounting to  $\notin$ 186 mn<sup>2</sup>. Direct investments, trade loans and public sector borrowing accounted for most of the capital inflows in this quarter. The modest capital inflows on this account, together with the deposit withdrawal and net repayment of financial loans by banks and businesses,<sup>3</sup> is an indicator of the problem with financing the current deficit (Table T4-1) reflected not only in financing the presently relatively low current deficit (with considerably lower values than in the pre-crisis period) but also in the prospects for financing the latter in the forthcoming period.

Net FDI in the amount of €175.5 mn made up most of the capital inflow (out of which €100 mn was recorded in July)<sup>4</sup>, while portfolio investments remained low and other investments recorded negative values (Table T4-1). The high level of trade loans (€249 mn), the modest amount of net financial credits and the considerable currency and deposits account outflow<sup>5</sup> (Table T4-1) stand out as the most significant items among the other investments.

Continued net repayment of liabilities by banks and businesses and borrowing by the NBS and public sector Q3 witnessed banks additionally repaying, in the net amount, their short-term loans while the net value of their long-term loans slightly increased (see Table T4-1). Businesses recorded repayment of their liabilities in approximately the same amount. However, in contrast with the banks, businesses only repaid their long-term loans. On the other hand, Q3 saw an increase in net public sector borrowing (€315 mn, table T4-1) and the NBS (in the amount of around €50 mn as part of the fifth tranche of the IMF loan).

<sup>2 €204</sup> mn adjusted for the balance of errors and omissions

<sup>3</sup> There is an objective difference in the foreign debt trends among the banks and enterprises as presented in Section "Balance of Payments" and those in the ensuing section titled: "Foreign Debt". The discrepancies are due to difference in data obtained from various sources (Sector for Economic Analyses and Researches in section "Balance of Payments" and Sector for International Cooperation of the National Bank of Serbia – data used with respect to foreign debt)

<sup>4</sup> FDI primarily consisted of investments in financial sector, trade and steel and drinks production,. V Report on inflation, NBS. November, 2010

<sup>5</sup> The underlying cause of the data discrepancy between the Balance of Payments and Section 7 "Monetary Flows and Policy" lies in the fact that in the Balance of Payments, the NBS includes transactions with non-residents, whereas the Monetary review includes residents' deposits as well

#### Table T4-1. Serbia: Balance of Payments

				20	09			2010	
	2008	2009	Q1	Q2	Q3	Q4	Q1	Q2	Q3
				in n	nillions of euro	s			
CURRENT ACCOUNT	-6,089	-2,041	-978	-246	-344	-472	-760	-597	-517
Goods	-7,549	-5,075	-1,464	-1,142	-1,158	-1,312	-1,186	-1,166	-1,242
Export f.o.b <sup>1)</sup>	7,416	5,977	1,291	1,538	1,547	1,602	1,472	1,870	1,933
Import f.o.b	-14,964	-11,052	-2,755	-2,680	-2,705	-2,913	-2,658	-3,036	-3,175
Services	-173	19	-39	20	-2	40	-19	5	-1
Export	2,741	2,500	568	599	669	664	537	635	737
Import	-2,914	-2,481	-607	-578	-671	-624	-555	-629	-739
Income, net	-922	-502	-123	-95	-129	-155	-167	-192	-127
Receipts	558	500	117	149	112	122	107	121	92
Payments	-1,480	-1,002	-240	-245	-241	-277	-273	-313	-219
Current transfers, net	2,554	3,518	648	971	944.9	954	611	755	854
o/w grants	163	197	39	37	40	82	29	20	35
o/w private remittances, net	1,692	2,618	456	769	732	660	415	543	610
CAPITAL ACCOUNT	13	2	-1	-1	1	3	0	0	1
FINANCIAL ACCOUNT	6,180	2,174	991	275	371	537	689	585	498
Direct investment, net	1,824	1,372	643	251	113	366	284	136	176
Portfolio investment, net	-91	-55	-4	-58	6	0	38	26	16
Other investments	2,760	3,220	112	962	969	1,177	1	101	-7
Trade credits	4	625	264	93	257	10	-109	128	249
Loans	3,499	1,414	-721	679	623	832	514	-275	93
NBS	0	1,114	0	783	0	332	0	237	50
Government	98	258	13	105	68	72	189	198	315
Commercial banks	125	894	-513	22	798	587	525	-396	-138
Long-term	-274	492	19	50	279	144	558	-6	18
Short-term	399	402	-532	-28	519	443	-32	-390	-156
Other (enterprises)	3,275	-853	-221	-230	-243	-159	-200	-315	-134
Currency and deposits	-713	760	569	190	-334	335	-405	249	-348
Other assets and liabilities	-30	0	0	0	0	0	0	0	0
Allocation of SDR	0	422	0	0	422	0	0	0	0
Reserves Assets (- increase)	1,687	-2,363	240	-880	-716	-1,007	367	321	313
ERRORS AND OMISSIONS, net	-104	-135	-12	-28	-27	-67	71	12	18
OVERALL BALANCE	-1,687	2,363	-240	880	716	1,007	-367	-321	-313
PRO MEMORIA									
_					in % of GDP				
Current account	-18.2	-6.8	-14.4	-3.3	-4.4	-6.0	-10.9	-7.9	-6.8
Balance of goods	-22.6	-16.9	-21.5	-15.2	-14.9	-16.6	-17.0	-15.3	-16.3
Exports of goods	22.2	19.9	19.0	20.5	19.9	20.2	21.2	24.6	25.4
Imports of goods	-44.7	-36.9	-40.5	-35.8	-34.8	-36.8	-38.2	-39.9	-41.7
Balance of goods and services	-23.1	-16.9	-22.1	-15.0	-14.9	-16.1	-17.3	-15.3	-16.4
Current transfers, net	7.6	11.7	9.5	13.0	12.2	12.1	8.8	9.9	11.2
GDP in euros <sup>2)</sup>	33,442	29,977	6,806	7,487	7,774	7,909	6,958	7,602	7,605

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).

Shrinking of NBS foreign currency reserves recorded in Q3 continued in October The overall drop in the foreign currency reserves in the first 9 months amounted to €1 bn, with Q3 accounting for €313 mn of this decline (Table T4-1). The downward trend of NBS foreign currency reserves continued in October as well<sup>6</sup>. The depletion of foreign currency reserves during the first ten months of 2010 was largely caused by the NBS interventions in the interbank foreign currency market. In fact, since the beginning of this year, inclusive of October, the NBS sold around €2.2 bn, i.e., approximately €660 mn per quarter. Should it retain the level of interventions maintained hitherto in defending the domestic currency, the NBS will have sold around €2.6 bn in 2010. In the past four months of 2010 – July to October – the NBS cumulatively sold €770 mn in an effort to defend the exchange rate. In addition, in the past four months, as in the first half of the year, the NBS had to appropriate a certain sum for repayment of liabilities with foreign creditors and frozen foreign account deposits. Inflow of foreign currency reserves was more than modest regardless of the July European Investment Bank (EIB) loan amounting to €28 mn and the September loan inflows – €226 mn – about one-fourth of which accounts for a portion of the tranche drawn from IMF funds.

#### **Foreign Debt**

Q3 saw a fall in the Serbian foreign debt (Table T4-2). The lower value of the total foreign debt, both in absolute and relative terms (as a percentage of the gross domestic product) relative to the situation of three months before, comes as a consequence of the continued debt repayment on

6 http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=4639&konverzija=no

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Serbia's foreign debt decrease in Q3 - a consequence of private sector's debt repayment and methodology change the part of the private sector almost, as much as a consequence of a change in the methodology of calculating statistical data on foreign debt (see the Note below Table T4-2).

#### Table T4-2. Serbia: Foreign Debt by Structure, 2007–2010

	2007	2008		2	009	2010			
	2007	2008	Mar	Jun	Sep	Dec	Mar	Jun	Sep
			stoc	:ks, in EUR r	nillions, end	of the perio	d		
Total foreign debt	17,789	21,800	21,445	21,687	21,784	22,787	23,278	23,828	23,115
(in % of GDP) <sup>2)</sup>	60.2	65.2	71.5	72.3	72.7	76.0	77.7	79.5	77.1
Public debt	6,130	6,386	6,528	7,199	6,824	7,231	7,582	8,349	8,874
(in % of GDP) $^{2)}$	20.7	19.1	21.8	24.0	22.8	24.1	25.3	27.9	29.6
Long term	6,096	6,369	6,509	7,182	6,805	7,230	7,582	8,349	8,874
o/w: to IMF	0	0	0	771	757	1,110	1,157	1,483	1,455
o/w: Government obligation									
under IMF SDR allocation	0	0	0	0	0	0	0	0	444
Short term	34	18	19	18	19	2	0	0	0
Private debt	11,659	15,414	14,917	14,488	14,960	15,556	15,697	15,479	14,241
(in % of GDP) <sup>2)</sup>	39.5	46.1	49.8	48.3	49.9	51.9	52.4	51.7	47.5
Long term	10,372	13,006	12,970	12,785	13,019	13,275	13,500	13,699	12,945
o/w: Banks debt	2,801	2,301	2,270	2,267	2,549	2,694	2,968	3,305	3,279
o/w: Enterprises debt	7,571	10,705	10,700	10,518	10,471	10,580	10,532	10,394	9,667
Short term	1,287	2,408	1,948	1,703	1,941	2,281	2,197	1,781	1,295
o/w: Banks debt	1,163	1,605	1,154	1,029	1,530	1,991	1,987	1,625	1,146
o/w: Enterprises debt	124	803	794	674	411	290	210	155	149
Foreign debt, net <sup>1)</sup> , (in% of GDP) <sup>2)</sup>	27.6	40.8	44.5	42.7	40.9	40.6	42.8	44.5	44.2

Source: NBS

Note: Since September 2010 methodology for the external debt statistics has been changed so that the external public debt includes obligations under the IMF SDR allocation (€443,5 mn), which was used in December 2009, as well as capitalized interest to Paris Club creditors (€86,4 mn), while the loans concluded before December 20, 2000, under which the payments have not been effected, are excluded from the external debt of the private sector (€875,4 mn of which €397 mn relate to domestic banks and €478,4 mn to domestic enterprises).

1) Total foreign debt less NBS currency reserves.

2) Annual actual GDP figures in euros are used for each year. QM estimate of GDP is used for 2010.

Q3 saw the public sector debt grow by €525 mn. This increase can be attributed to the September inclusion of the amount Serbia received from IMF by the end of 2009 under the quota increase arrangement<sup>7</sup> and the capitalized interest toward the Paris Club of creditor nations (see the Note below Table T4-2). Had it not been for this inclusion, the public foreign debt would have remained almost unchanged in Q3.

Unlike the public sector, the private sector continued to repay its foreign liabilities in Q3, recording, in addition to the methodological decrease of the private debt amount, a real decrease (both banks and enterprises). We estimate that the real reduction of the businesses' foreign debt was almost exclusively accounted for by repayment of long-term loans (reducing the debt by  $\notin$ 250 mn) and the banks' by repayment of short-term ones. However, the repayment (by banks and enterprises alike) was recorded largely due to the methodology changes, i.e., due to exclusion of the loans approved prior to December 20, 2000 – under which no repayments were effected of the private sector's foreign debt (see the note below Table T4-2).

Since the beginning of 2010, foreign debt trends have been driven by public debt increase, private sector repayment and methodology changes Compared to the total foreign debt balance at the end of the previous year, a mild increase was recorded due to the intensive repayment of the private sector debt and a rather hasty public sector borrowing. Since the beginning of the year, the public sector's debt recorded the following growth dynamic:  $\leq 353 \text{ mn}$  in Q1<sup>8</sup>,  $\leq 767 \text{ mn}$  in Q2<sup>9</sup> and  $\leq 525 \text{ mn}$  in Q3<sup>10</sup>. In comparison to December 2009, the private debt is by four percentage points lower. Banks additionally borrowed abroad raising long-term loans, but at the same time, they repaid a significant portion of their short-term debts (Table T4-2). Enterprises considerably reduced their foreign debt with Q3 recording much faster repayments than the previous two quarters, primarily due to the changed methodology.

<sup>7</sup> For details, see "Public Debt Analysis" in Section 6: "Fiscal Flows and Policy" in this issue of QM.

<sup>8</sup> Credits of the International Bank for Reconstruction and Development, and Ioans raised with other international financial institutions. See in: "Fiscal Flows and Policy", "Analysis of Public Debt Trends", QM20.

<sup>9</sup> Q2 increase, a consequence of: weakening of euro towards other currencies, withdrawal of part of the third and the fourth tranche under the stand-by arrangement with the IMF and additional use of foreign loans. For details, see QM21 Section 4 "Balance of Payment and Foreign Trade", "Foreign Debt"

<sup>10</sup> See previous paragraph.

Such changes in the foreign debt (both real and methodological) contributed to a marked change in its structure, i.e. they caused the records to show the participation of public debt in the total foreign debt to reach almost 40% by the end of September, while before the crisis, (by the end of 2008) the public debt accounted for less than 30% of the total debt.

#### Export

Exports recovery continued in Q3

Q3 2010 saw the value of exported goods reach the amount of €1.931 mn. This is an increase of
24.6% relative to Q3 2009 (Table T4-3). The fast exports recovery continued in October as well – the overall exports stood at €682.3 mn, recording a y-o-y increase of 20.6%..

All product groups recorded a positive y-o-y exports value change (Table T4-3). For the most part, the recovery of *Bulky exports* can be attributed to the global price increase of certain export products (e.g. the cereal prices quoted in euros went up by 21% y-o-y, metal prices by 45% y-o-y). However, the cereal prices contributing to the considerable y-o-y growth in cereal exports in Q3 notwithstanding, a further analysis indicates that the exports of cereals recorded a 10% growth compared to the previous year. On the other hand, despite such an upward trend of the global prices, Q3 recorded a considerable slowdown in the iron and steel exports growth (Table T4-3). The export trend for these products is a consequence of the temporary shutdown of one of the US Steel Serbia blast furnaces, causing a halt in the production of basic metals.

#### Table T4-3. Serbia: Exports, Y-o-y Growth Rates, 2009–2010

	Exports		2009			2010 <sup>1)</sup>			2009			2010 <sup>1)</sup>	
	share in 2009	Q1	Q2	Q3	Q1	Q2	Q3	Q1	Q2	Q3	Q1	Q2	Q3
	%			mil.e	uros					y-o-y growt	h rate (%)		
Total	100.0	1,276	1,529	1,551	1,467	1,884	1,931	-23.8	-22.5	-24.9	14.9	23.2	24.6
Bulky exports	24.2	296	350	385	422	496	537	-36.0	-36.1	-35.9	42.3	41.6	39.3
Iron and steel	7.7	101	85	131	162	195	182	-54.0	-72.7	-56.3	60.2	130.4	39.0
Non ferrous metals	5.3	65	76	90	109	132	152	-48.4	-41.1	-33.4	68.3	75.0	69.3
Fruits and vegetables	5.4	62	84	98	75	80	114	-5.2	30.0	-9.6	21.6	-4.8	16.2
Cereal and cereal products	5.7	68	106	66	75	89	88	30.3	141.6	16.0	10.0	-16.6	33.7
Underlying exports	75.8	980	1,179	1,166	1,045	1,389	1,395	-19.2	-17.3	-20.4	6.7	17.8	19.7
Core	30.3	429	467	441	438	522	583	-21.8	-20.3	-27.8	2.1	11.8	32.1
Clothes	6.5	115	109	79	72	69	81	29.5	32.5	-9.6	-37.7	-36.4	2.2
Miscellaneous manufactured articles, n.e.s.	4.1	50	61	66	47	65	72	-35.2	-24.0	-23.2	-5.8	6.3	9.5
Manufactures of metals, n.e.s.	4.0	48	65	62	44	67	68	-36.4	-20.7	-24.4	-8.0	2.2	9.2
Rubber products	2.8	44	39	43	54	52	55	-22.5	-32.2	-32.3	23.6	33.6	27.0
Electrical machinery, apparatus and appliances	5.0	62	74	77	78	108	122	-1.0	4.0	-6.1	25.5	46.8	58.7
Organic chemicals	0.5	8	6	5	29	27	28	-83.1	-88.0	-90.1	261.5	357.9	501.2
Plastics in primary forms	1.2	20	19	4	29	32	37	-49.9	-53.1	-88.4	47.1	69.9	753.8
Footwear	2.3	37	33	39	38	33	44	-8.4	-19.5	-13.6	0.8	2.4	14.8
Paper, paperboard and articles of paper pulp	2.4	32	38	36	36	42	40	-2.0	-3.3	4.1	12.1	11.4	11.4
Non-metal mineral produce	1.5	13	24	30	11	27	35	-54.7	-46.1	-33.5	-9.4	12.2	17.9
Other	45.6	551	712	724	607	867	812	-17.0	-15.1	-15.2	10.2	21.7	12.1

Source: SORS

1) Figures that are in millions of euros and y-o-y growth rates were obtained based on the data from Statistical Office of the Republic of Serbia calculated using new methodology. For details see Box 1, "Changes to foreign trade methodology used by the Statistical Office of the Republic of Serbia".

Seasonally adjusted exports are still on the rise, though a bit slower than in the previous quarters

Q3 2010 recorded a growth in seasonally adjusted exports but only by 1.5% relative to the previous quarter, i.e., 6.2% at the annual level (Graph T4-4). This poses a slowdown relative to the previous three quarters (when exports grew at the annual rate of around 30%), however exports (share of exports in gross domestic product) reached and exceeded the pre-crisis level, in both absolute and relative terms, as already explained in the previous chapter on Balance of Payments.

Although Q3 2010 saw the lowest seasonally adjusted exports growth rate in relation to the previous three quarters, the picture is somewhat different viewed across months: a fall in July relative to the previous month, followed by the August growth relative to July and September growth relative to August (-3.4%,1.4% and 4.4%, respectively).

A more precise picture of seasonally-adjusted values is obtained with the exclusion of iron and steel and nonferrous metals

In addition, a more precise picture of seasonally-adjusted export values is obtained after the exclusion of iron & steel and non-ferrous metals, when, after the high growth rate recorded in the previous three quarters, the growth slows down a bit in Q3 to about 2.2% in relation to Q2, i.e., 9.3% at the annual level (Graph T4-5).



The recovery of seasonally-adjusted Underlying exports is of major importance because it also indicates a certain recovery of all other exports components The seasonally-adjusted value of *Underlying exports* indicates that the recovery – though at a somewhat slower rate – continues. The annualized growth rate of seasonally-adjusted Underlying exports in Q3 was approximately equal to that of the overall seasonally-adjusted exports indicating a crucial recovery of this component's exports as well. This fact is of major importance considering that the products grouped in the *Underlying exports* make up <sup>3</sup>/<sub>4</sub> of overall exports (Table T4-5).

Within *Underlying exports*, the Core component recorded mild growth acceleration while *Other exports* slowed down (Table T4-5).The recovery of the *Other exports* component in Q3 accounted for about one-fourth of the overall year-on-year exports growth, the contribution of the Core component being 37%<sup>11</sup>. In the previous quarter, 44% of the overall growth was owing to the expansion of *Other exports* while the Core component accounted for another 15%.

#### Imports

#### Q3 witnessed faster imports recovery...

...although mostly due to the growth in energy imports... Imports of goods in Q3 stood at €3,285 mn, i.e., 17.2% more than in the same period of the year before (Table T4-6). In October, 2010 imports recorded a modest y-o-y growth of 1.9% and amounted to €1033.4 mn.

Energy imports grew by 66.7%. The growth of energy products was recorded owing to the global energy price hike (energy prices quoted in euros increased by 25% at the y-o-y level), as well as to the increased quantities of imported energy (33% at the y-o-y level). The imports growth, energy excluded, at a y-o-y rate considerably lower than that recorded by overall imports, indicates that the imports acceleration was caused mostly by external factors, i.e. that the real recovery of domestic demand in Q3 was slower than implied by the data on overall imports<sup>12</sup>.

Table T4-6.	Serbia: Imports,	Y-o-y Growth	Rates, 2009–2010
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	Imports		2009 <sup>1)</sup>			2010 <sup>1)</sup>		2009			2010 <sup>1)</sup>			
	(2009)	Q1	Q2	Q3	Q1	Q2	Q3	Q1	Q2	Q3	Q1	Q2	Q3	
	in %		mil.euros						y-o-y growth rate (%)					
Total	100.0	2,855	2,778	2,804	2,713	3,066	3,285	-25.7	-33.8	-32.6	-5.0	10.4	17.2	
Energy	17.1	542	338	367	550	545	611	-28.3	-49.8	-47.0	1.6	61.1	66.6	
Intermediate products	34.2	726	832	884	737	959	1,089	-30.8	-33.6	-31.8	1.5	15.3	23.2	
Capital products	23.5	496	522	520	386	490	528	-28.0	-38.2	-35.5	-22.2	-6.1	1.6	
Durable consumer goods	3.9	89	81	79	83	82	85	-15.8	-37.1	-31.5	-7.1	0.3	7.9	
Non-durable consumer goods	18.1	352	355	368	344	376	390	-10.4	-8.7	-10.4	-2.3	5.7	5.8	
Other	3.2	651	649	585	614	615	581	-19.5	1.9	-19.9	-5.7	-5.2	-0.6	
Imports excluding energy	82.9	2,314	2,439	2,437	2,163	2,521	2,674	-25.0	-30.2	-29.0	-6.5	3.4	9.7	

1) Figures that are in millions of euros and y-o-y growth rates were obtained based on the data from Statistical Office of the Republic of Serbia calculated using new methodology. For details see Box 1, "Changes to foreign trade methodology used by the Statistical Office of the Republic of Serbia".

11 Contribution is calculated as the absolute changes in export components and the absolute changes in total exports ratio in relation to the same quarter of the year before.

<sup>12</sup> See section "Economic Activity" in this issue of QM.

...may also be partly assigned to the recovery of intermediary products Q3 witnessed a continuation in the fast recovery of intermediary products at the y-o-y rate of 23.2%. Owing to their largest share in overall imports (34.2%) these products have a major contribution in the acceleration thereof. In fact, the contribution of the growth in imports of *Intermediary products* in the growth of overall imports amounts to 43%<sup>13</sup>. In addition, the positive growth rate of *Capital goods*, recorded for the first time after six consecutive negative quarterly values (Table 4-6) is also of essential importance for the recovery of the domestic economy. The share of *Capital goods* in total imports amounted to 23.5%. For this reason, although their contribution to the overall imports growth, at a modest realized y-o-y growth, is low (2%) – the recovery of these goods will contribute not only to the further acceleration of imports, but also to the recovery in economic activities in the ensuing period.

Consumer products, too, recorded a certain degree of recovery in line with the gradual recovery of domestic consumption, while imports of the item listed as *Other* still recorded y-o-y decline (Table 4-6). *Non-durable consumer goods* recorded the same y-o-y growth rate as in Q2, in contrast to *Durable consumer goods* whose imports in Q3 gained speed after a modest y-o-y growth of the previous quarter (Table T4-6).

<sup>13</sup> Contribution is calculated as the absolute changes in export components and the absolute changes in total exports ratio in relation to the same quarter of the year before.

# 5. Prices and the Exchange Rate

During Q3 both overall and underlying inflation notably accelerated and this trend carried on in October, as well. Thus, overall inflation reached 8.3% from the beginning of year until October and already in that month it exceeded the upper bound of NBS target band for the entire year ( $6\% \pm 2\%$ ). The overall inflation in Q3 amounted to 10.8% annualized, while the underlying inflation of 9.5% annualized as registered in this quarter was also extremely high. Particularly conducive to inflation growth was the rise in food prices, i.e. industrial food products, to be precise. The exchange rate continued to depreciate mildly, and so in Q3, the dinar nominally lost to euro about 2%. In November the exchange rate stabilized, but from the year beginning, dinar nominally declined by about 11%. During Q3, high inflation however helped to keep the dinar real exchange rate stabile throughout the quarter despite the nominal depreciation. The real depreciation of dinar/euro exchange rate amounted to about 3% from the beginning of year.

#### **Prices**

Inflation in Q3 continued to accelerate

Overall inflation in Q3 amounted to 2.6% or 10.8% annualized (Table T5-1). Following a considerable inflation slowdown in the second half of 2009 a high price growth extended to the third quarter in a raw – in Q2 inflation amounted to 2.5% (or 10.4% annualized), while in Q1 it was 1.9% (or 8.0% annualized). The year-on-year inflation rate also continued to accelerate and at the end of Q3 it amounted to 7.7%. High y-o-y inflation rate was due to high monthly rates, but also due to low comparison basis – in Q3 2009, due to a drop in economic activity, prices registered a slump (deflation) of 0.7%. A similar situation was found in Q4 2009 when inflation was no more than 0.4%, which means that the forthcoming quarter will also see high y-o-y inflation rates.

#### Table T5-1. Serbia: Consumer Price Index, 2007–2010

		C	Consumer price ind	ex	
	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
Jun	131.3	8.3	7.0	0.0	12.6
Sep	130.3	7.3	6.2	0.3	-2.9
Dec	130.8	6.6	6.6	-0.3	1.6
2010					
Jan	131.4	4.8	0.5	0.5	4.3
Feb	131.8	3.8	0.7	0.3	1.9
Mar	133.4	4.7	1.9	1.2	8.0
Apr	134.1	4.3	2.5	0.6	8.4
May	136.1	3.7	4.1	1.5	13.8
Jun	136.7	4.2	4.5	0.4	10.4
Jul	136.6	5.1	4.4	-0.1	7.8
Avg	138.5	6.6	5.9	1.4	7.3
Sep	140.3	7.7	7.2	1.3	10.9
Oct	141.7	8.9	8.3	1.0	15.5

Source: SORS

\* Graph rates represent monthly moving averages for three months, annualized. (For instance, the March value was obtained by annualizing the average of monthly price growth for January, February and March.)

By comparison with the forecast made by the QM editorial board on the inflation movement by the end of year published in the previous issue<sup>1</sup>, inflation is growing even faster than the worst case scenarios anticipated. Namely, our assumption on a relatively high food prices proved to be accurate, but underlying inflation exceeded our predictions. In addition, some prices, for which we assumed that they would remain almost unchanged in the third and fourth quarter, slightly increased – in the first place, the prices of oil, alcoholic beverages and tobacco. Based on price movements in Q3 and based on similar assumptions delineated in Highlight 3 of QM 21, we have arrived at the conclusion that the annual inflation will approximate 11% towards the end of 2010.

Already in October inflation at an annual level got ahead of the NBS target band

Food price growth mostly contributed to inflation High inflation (1.0% compared to the previous month) was also registered in October and so total inflation from the beginning of year reached 8.3% and already in this month it went beyond the NBS target band for the entire year. Inflation in the period from June to October amounted to 3.6% or as much as 11.3% annualized. As a reminder, inflation in the first half of the year amounted to 4.5% or 9.2% annualized.

In Q3, inflation was mostly driven by the rise in prices of food products which accounts for almost a half of the total inflation in this quarter (Table T5-2). Prices of meat, bread, oil and milk and dairy products increased most. On the other hand, prices of fresh vegetables dropped in Q3 by about 20%, decreasing overall inflation. In addition to food, the growth in prices registered in Q3 was significantly driven by the rise in tobacco prices, as well as higher prices of electricity and water. The escalation in prices of these products and services account for about 20% of the total price rise in Q3. Table T5-2 shows that in the first half of the year inflation was considerably under the influence of movements in energy prices. Thus higher prices of electricity and oil derivatives explain about 30% of price increases in the first half of the year. Starting from June, however, the impact of food prices on overall inflation dramatically rose.

#### Table T5-2. Serbia: Consumer Price Index: Contribution to Growth by Selected Components, 2010

	Share in CPI (in %)	Price increase in Q3 (in %)	Contribution to overall CPI increase (in %)	Price increase in H1 2010 (in %)	Contribution to overall CPI increase (in %)	Price increase Jun-Oct 2010 (in %)	Contribution to overall CPI increase (in %)
 Total	100.0	2.6	100.0	4.5	100.0	3.6	100.0
Food and non–alcoholic beverages	37.8	3.4	48.5	3.2	26.6	4.8	49.5
Food	34.1	3.2	41.9	3.4	26.0	4.6	43.1
Alcoholic beverages and tobacco	5.1	4.8	9.3	9.4	10.7	5.1	7.2
Tobacco	3.8	5.6	8.1	10.1	8.6	5.6	5.9
Clothing and footwear	6.0	0.9	2.0	0.9	1.2	3.0	5.0
Housing, water, electricity, gas and other fuels	15.1	2.4	13.7	7.2	24.1	3.3	13.8
Electricity	6.6	1.1	4.6	7.5	18.8	1.8	5.7
Furniture, household equipment, routine mainter	nance 4.9	2.4	4.5	4.5	4.9	3.7	5.0
Health	4.3	1.6	2.5	4.3	4.0	1.9	2.2
Transport	11.0	1.4	5.9	6.7	16.4	1.9	5.9
Oil products	4.7	1.0	1.7	9.7	10.1	1.0	1.3
Communications	3.5	1.2	1.6	0.5	0.4	0.7	0.7
Other items	15.8		13.6		12.1		11.2
Source: SORS and QM estimates							

In Q3 underlying inflation also continues to grow In Q3, there was a further acceleration of underlying inflation<sup>2</sup>. Underlying inflation in Q3 amounted to 2.3% or 9.5% annualized (Graph T5-3). In the first quarter, underlying inflation totaled 7.3% annualized and in the preceding quarter it amounted to 6.8% annualized, which makes growth evident. Underlying inflation was mainly aggravated by the rise in prices of culture-related services, as well as furniture and household items. We may assume that the acceleration in underlying inflation was partly caused by dinar depreciation in the first half of the year. The pass-through from exchange rate to underlying inflation in 2010 is relatively high. Since underlying inflation in the first nine months of this year totaled 5.7% and nominal depreciation

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<sup>1</sup> See QM issue 21, Highlight 3.

<sup>2</sup> According to the *QM* definition, underlying inflation is made up of the Consumer Price Index less prices of food, energy, alcoholic beverages and tobacco. This definition complies with that of a price index monitored by Eurostat and is thus internationally comparable. The share of underlying inflation in overall inflation stood at 41.1%. Underlying inflation is close in concept to core inflation monitored by the NBS, the principal difference between the two being that underlying inflation excludes all foodstuffs, whereas core inflation excludes only fresh fruit and vegetables.

in dinar/euro exchange rate over the same period amounted to 9.8% – simple calculation shows that the pass-through amounts to as much as 0.58. If we take into consideration the period from the beginning of crisis (i.e. from September 2008 to September 2010), the simple pass-through is calculated at 0.43 (underlying inflation in this period amounted to 16.3%, while the nominal depreciation was 38.0%).

#### Graph T5-3. Serbia: CPI and Underlying Inflation Trend, Annualized Rates, in %, 2008–2010



Note: The graph rates represent monthly moving averages for three months, annualized. (For instance, the March value was obtained by annualizing the average of monthly price growth for January, February and March.)

Core inflation<sup>3</sup> also spiked in Q3 and reached as much as 4.7%, or 20.3% annualized. This quarter clearly shows the difference between core and underlying inflation. Namely, core inflation does not include prices of fresh fruit and vegetables (that dropped during Q3), but it includes prices of other food products. The prices of food products (in the first place meat, milk and dairy products) extravagantly rose in Q3, so core inflation in this quarter was extremely high. On the other hand, underlying inflation does not account for fruits and vegetables or any food products which is why the rise in underlying inflation in Q3, although high, was much below the rise in core inflation.

October also suffered high underlying inflation. Underlying inflation registered in this month totaled 0.9% which means that from June to October underlying inflation amounted 3.2% or

10.0% annualized. In the first half of the year, underlying inflation amounted to 3.7% or 7.5% annualized.

Serbia is drastically ahead of other surrounding and EU countries by its underlying inflation rates Compared to selected EU countries, only Romania has a similar inflation rate as Serbia, whereas all other countries registered extremely low or negative rates of underlying inflation in Q3 2010 (Table T5-4). It should be taken into account that Romania's slightly higher inflation is a consequence of VAT rate increase.

#### Table T5-4. Selected Countries: Underlying Inflation (CPI, Food, Energy, Alcoholic Beverages and Tobacco Excluded), 2009–2010

	2009Q1	2009Q2	2009Q3	2009Q4	2010Q1	2010Q2	2010Q3	
			annı	alized rates,	in %			
Bulgaria	3.1	0.9	2.5	3.2	-0.9	0.3	-0.3	
Romania	13.1	1.0	2.9	2.7	1.7	5.2	9.9	
Czech Republic	4.2	0.4	-1.9	-1.5	1.9	1.5	-1.1	
Hungary	4.1	7.4	9.0	0.2	3.5	2.1	0.5	
Poland	4.3	5.0	0.8	0.4	0.7	1.9	0.7	
Slovakia	1.5	0.1	0.5	0.6	0.3	0.2	0.7	
Slovenia	1.2	3.4	-5.6	1.4	-1.0	4.6	-6.8	
Estonia	-2.8	-0.1	3.0	-3.2	0.5	4.1	2.4	
Latvia	9.4	-4.4	-5.1	-6.7	-4.6	-1.4	-0.2	
Lithuania	6.8	-4.7	1.6	-3.9	-4.6	-0.3	-0.4	
Euro zone	-0.4	1.9	-0.1	3.0	-0.9	1.7	0.4	
EU	0.4	2.4	0.7	2.7	-0.3	2.1	0.7	
Serbia	13.8	10.3	6.0	3.2	7.1	7.8	9.5	
Source: Eurostat, SORS and QM estin	nates							

<sup>3</sup> Core inflation measures movements in prices of goods and services established in the free market. Core inflation is monitored by the NBS and is close in concept to underlying inflation (see previous footnote).

#### **Exchange Rate**

Dinar depreciation continued in Q3... In Q3, the dinar to euro depreciation continued and for these three months dinar lost nearly 2% of its nominal value. Depreciation continued in October and the exchange rate stabilized only during November. From the beginning of year, the dinar to euro exchange rate nominally weakened by about 11%.

...due to very low net capital inflows The reasons behind nominal depreciation firstly lie with a reduced supply of Euros caused by very low net capital inflows. This mostly resulted from a high level of cross border deleveraging and a sharp downturn in undertaking new cross border loans. The other cause is the still high risk premium for Serbia, which rocketed after the emergence of crisis in Greece in April and May 2010. Following the onset of the Greek crisis, risk premium registered an upward movement in all countries of the region, but later on while risk premia in most neighboring countries returned to pre-crisis levels, they remain elevated in the case of Serbia.. This explains why Serbia pays higher price of capital on international markets and why its inflows are lower. Smaller capital inflows are also the ramification of the fact that some of the expected inflows from international institutions have not yet been realized. Finally, during the last several months there has been a significant growth in the imports of fuels which additionally boosted demand for euros and pressured the exchange rate.









Due to high inflation, real exchange rate remained unchanged in Q3 The real RSD/EUR exchange rate practically remained unchanged during Q3. For reasons of high inflation in Serbia as compared to other Euro zone countries, the real exchange rate mildly appreciated in August, September and October despite the nominal depreciation. In this way, at the end of third quarter, the real exchange rate was practically in line with the level found at the end of second quarter (Table T5-7). This put an end to the real deprecation trend which lasted from mid 2009 to the second quarter in 2010 (Graph T5-6). The real exchange rate grew about 18% weaker compared to the values from September 2008 (onset of the financial crisis), and compared to the values from Q1 2008 it declined by about 5%.

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		Nomin	al			Real		_
	exchange rate (FX) <sup>1)</sup>	base index <sup>2)</sup> (avg.2005 = 100)	y-o-y index <sup>3)</sup>	cumulative index <sup>4)</sup>	real FX <sup>5)</sup> (avg.2005 = 100)	y-o-y index <sup>3)</sup>	cumulative index <sup>4)</sup>	USD/EUR Rate <sup>6)</sup>
				monthly e	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
June	80.2460	96.8	98.9	100.9	78.5	91.7	97.2	1.5556
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								
March	94.4951	114.0	113.7	108.2	86.1	104.0	102.2	1.3041
June	93.7408	113.1	116.8	107.4	83.4	106.3	99.0	1.4027
September	93.2990	112.5	122.1	106.9	82.5	111.2	98.0	1.4554
December	95.9833	115.8	109.9	109.9	84.7	100.6	100.6	1.4597
2010								
January	97.2874	117.3	104.7	101.4	84.6	97.9	99.8	1.4281
February	98.7951	119.1	105.5	102.9	85.6	100.1	101.0	1.3698
March	99.7048	120.2	105.5	103.9	85.8	99.6	101.3	1.3576
April	99.4032	119.9	105.6	103.6	85.0	99.9	100.3	1.3424
May	100.9779	121.8	106.7	105.2	85.7	101.5	101.1	1.2538
June	103.5079	124.8	110.4	107.8	87.8	105.3	103.6	1.2219
July	104.7048	126.3	112.4	109.1	88.1	106.9	104.0	1.2761
August	105.2965	127.0	112.9	109.7	87.9	106.3	103.8	1.2909
September	105.4352	127.2	113.0	109.8	87.4	105.8	103.1	1.3043
October	106.3318	128.2	114.1	110.8	87.5	105.8	103.3	1.3891

#### Table T5-7. Serbia: RSD/EUR Exchange Rate, 2005–2010

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 the previous year.

4) Cumulative is the ratio of the given month and December of the previous year.

5) The calculation of the real exchange rate takes into account EuroZone inflation. Index calculation:  $RE = (NE/p) \times p^*$ , where: RE - real fx index; NE - nominal fxindex; p – Serbia RPI index; p\* - EuroZone CPI index. 6) Period average.

Trends

## **6. Fiscal Flows and Policy**

In the course of Q3 2010, seasonally adjusted real revenues of the consolidated government sector continued to moderately grow against the previous quarter. The total increase in public revenues resulted from a moderate increase in VAT revenues, while revenues from other taxes mostly stagnated. The increase in VAT revenues indicates a moderate recovery in domestic demand, evidenced also by imports data. At the same time, real, seasonally adjusted public spending moderately declined against the previous quarter. The decline is the result of lower spending on pensions and purchases of goods and services, while spending on public sector workers posted its first increase after four consecutive quarters (due to a one-off payment of financial assistance to public sector employees). As a result, the consolidated fiscal deficit in Q3 stood at 3.6% of quarterly GDP. Based on the first three quarters, as well as on preliminary figures on the Republic's budget deficit for October, it can be expected that the total fiscal deficit for the whole of 2010 will stay within the planned 4.75% of GDP. Serbia's public debt reached 11.62 billion euros at the end of Q3 2010 (around 38.5% of GDP), which is around 860 million euros more than at the end of Q2. The main increase in public debt in the course of Q3 resulted from an inclusion of the IMF loan, based on increase of Serbia's quota in that institution as well as from old debts which have been regulated in the meantime (e.g. the debt of SFRY to Kuwait) in public debt figures. Fiscal policy in the first three quarters of 2010 has balanced between the need to support economic activity and the necessity to control risks stemming from accelerating inflation and an expanding foreign trade imbalance. Even though the structure of the public spending has not shown any significant improvement in the mentioned period (in sense of increased public investments at the expense of lower current consumption), some positive changes can be observed in the structure of the current consumption, through higher spending on social assistance to the poorest and spending to service state arrears.

#### **General Trends and Macroeconomic Implications**

Seasonally-adjusted public revenues posted moderate increase in Q3 against Q2...

> ...first of all owed to an increase in VAT revenues

> > 200,000

190.00

185.0

Q3 '08 Q4 '08 Q1 '09 Q2 '09 Q3 '09 Q4 '09 Q1 '10 Q2 '10 Q3 '10

Source: Calculations by the author

In the course of Q3 2010, seasonally adjusted real revenues of the consolidated government sector grew moderately by 0.3% against the previous quarter, with the growth weaker compared to the one seen in Q2. Compared with the same quarter of last year, real revenues of the government sector fell again, by 3.6%.

The increase in seasonally adjusted real tax revenues in the course of Q3 is mostly owed to a real increase in seasonally adjusted revenues from the value added tax, which rose by 1.4% against Q2. At the same time, revenues from excise duties, personal income tax and the corporate income tax remained almost unchanged compared with the previous quarter. The real decline in seasonally adjusted revenue in Q3 against the previous quarter was also seen in customs revenues

Graph T6-1. Serbia: Seasonally Adjusted, Real (quarterly) Revenues and Spending of the Government Sector in Millions of RSD (2005=100) (1.5%) and revenues from social contributions (2.6%).

The moderate increase in VAT revenues can represent an indicator of a moderate recovery of domestic demand, also evidenced by imports data. On the other hand, the divergent movement in seasonally adjusted revenues from labour taxes (revenues from personal income tax have expanded by 0.2% against Q2, and revenues from social contributions fell by 2.6%), represents an indicator of tax evasion trends, particularly in the field of mandatory social security contribution payments.

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Also, labour tax revenues trends result from an ongoing negative employment trends.

In the course of Q3, public spending posted a moderate decline against the previous quarter Following an increase in the previous two quarters, real, seasonally adjusted spending of the consolidated government sector fell in the course of Q3 compared with the previous quarter by 1%. The decline in public spending mainly resulted from shrinking seasonally adjusted public spending on purchases of goods and services as well as on pension payments. On the other hand, the biggest increase was noticed in seasonally adjusted capital spending in real terms. For the first time in four consecutive quarters of declines – spending on public sector employees modestly rose in Q3 2010 against the previous quarter, as a result of one-off payments of financial aid of 5,000 dinars per public sector employee whose net monthly wage does not exceed 50,000 dinars. Compared with Q3 of the previous year, consolidated spending of the government sector fell by 3.2% in real terms in Q3 2010.

Even though seasonally adjusted capital spending in Q3 significantly rose in real terms against Q2, the general assessment is that there has been no significant improvement in the structure of public spending through cuts in current spending and an increase in investments. However, certain relocations of the current spending in favour of socially vulnerable persons (through one-off payments to beneficiaries of aid to poor families) is seen as positive.

On the other hand, the payment of one-off financial assistance to public sector employees (with a monthly wage below 50,000 dinars) represents a flat rate transfer towards certain groups of population, limiting the impact on the economic status of the poorest.

The effects of redistribution would have been much more positive if the funds were to be redirected to social transfers based on property and income status of the recipients (resulting in higher one-off assistance to those groups). Also, the timing of the payment of one-off assistance was inadequate, because of already relatively high inflationary pressures.

Consolidated deficit in Q3 stood at around 28.8 billion dinars As a result of described developments, the consolidated deficit in Q3 stood at 28.8 billion dinars, or approximately 3.6% of (quarterly) GDP. The total consolidated deficit of the government sector in the first three quarters of 2010 stood at 84.2 billion dinars, roughly around 3.7% of GDP in the first three quarters of 2010. Even though there is a risk that the fiscal deficit in absolute terms exceeds the planned level (considering the fact that nominal spending of the government sector in absolute terms exceeds plan) – it has been assessed that a slightly higher inflation rate and consequently larger nominal GDP will leave the relative fiscal deficit in 2010 within the planned 4.75% of GDP.

		2008			2009					2010				
	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q1-Q3		
						in billions o	of dinars							
I TOTAL REVENUE	283.3	311.8	1145.9	258.8	267.1	297.0	323.6	1,147	266.6	292.9	309.4	868.9		
II TOTAL EXPENDITURE	-286.6	-359.3	-1195.7	-270.3	-306.3	-315.1	-356.2	-1247.9	-286.1	-317.8	-329.7	-933.6		
III "OLD" DEBT REPAYMENT, NET LENDING AND RECAPITALIZATIONS	-2.7	-3.9	-19.1	-0.9	-6.3	-5.8	-7.4	-20.4	-4.6	-6.4	-8.5	-19.5		
o/w Net lending 2)	-2.7	-3.9	-19.1	-0.9	-6.3	-5.8	-7.4	-20.4	-4.6	-6.4	-8.5	-19.5		
IV TOTAL EXPENDITURE, GFS (II+III)	-289.3	-363.2	-1214.8	-271.2	-312.6	-320.9	-363.6	-1268.3	-290.7	-324.2	-338.3	-953.1		
V CONSOLIDATED BALANCE (I+IV), GFS definition <sup>3)</sup>	-5.9	-51.3	-68.9	-12.4	-45.5	-23.9	-40.0	-121.8	-24.1	-31.2	-28.8	-84.2		
VI FINANCING (FREN's definition)	0.2	17.5	13.5	28.9	40.2	11.4	86.8	167.3	21.8	22.8	29.6	74.3		
VII ACCOUNT BALANCE CHANGE (V+VI)	-5.7	-33.8	-55.4	16.4	-5.3	-12.4	46.8	45.4	-2.3	-8.4	0.8	-9.9		
VIII TOTAL REVENUE/GDP (%)	40.3	42.7	41.7	40.6	37.9	41.0	43.3	40.7	38.8	38.0	38.7	38.5		
IX TOTAL EXPENDITURE/GDP (%)	(41.1)	(49.7)	(44.3)	(42.5)	(44.4)	(44.3)	(48.6)	(45.1)	(42.3)	(42.1)	(42.4)	(42.3)		
X CONSOLIDATED DEFICIT/GDP (%)	(0.8)	(7.0)	(2.5)	(2.0)	(6.5)	(3.3)	(5.4)	(4.3)	(3.5)	(4.1)	(3.6)	(3.7)		

#### Table T6-2. Serbia: Consolidated Balance of the General Government Sector<sup>1)</sup>, 2008-2010

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, Republic institute for Health Insurance, 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 capital increase. The consolidated balance (cash surplus/deficit according to GFS) represents a difference between current revenues and earnings from the sale of non-financial

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. Notes: See Table P-10 in Analytical Appendix for detail.

#### The Republic's budget deficit stood at 14 billion dinars in October

In the course of October, real budget revenues of the Republic of Serbia fell significantly, by 14.5%, compared with the same month of the previous year.<sup>1</sup> The decline in real budget revenues in October resulted mainly from a big real decline in revenues from excise duties, which were almost a half what they were in the same month of the previous year. Such developments could represent an indicator of the falling demand (consumption), but also of increasing tax evasion (particularly for products subject to excise duties). Beside that, the fall in revenues from excise duties additionally resulted from the fact that the last day of October, when excise duties are being calculated for the second half of the month, was a non-working day (Sunday), so that payments of excise duties for that period were made on the first following day (November 1), which will be seen as part of November budget revenues.

October 2010 budget spending rose 2.2% in real terms against the same month of the previous year, which is mainly owed to a significant real increase in spending on interest rate payments. Other spending categories (except for capital and other spending) have all fallen in real terms against the same month of 2009.

As a result of described budget revenues and spending of the Republic, the budget deficit of the Republic stood at 14 billion dinars in October (with the average monthly budget deficit of 9.4 billion dinars in the January – September 2010 period).

#### The Analysis of Particular Taxes and Public Spending Items

# In Q3 consumption taxes diverge

In the course of Q3 of 2010, there were no significant oscillations in total revenues from consumption taxes, but some tax revenues were divergent. Seasonally adjusted real revenues from VAT in Q3 rose by 1.4% compared with Q2, while revenues from excise duties remained unchanged, with customs revenues falling by 1.5% compared with the previous quarter. A moderate increase in VAT revenues could represent an indicator of modest recovery of domestic demand, which is also evidenced by the imports figures (see chapter "Balance of Payments").

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

			Consumption taxes			01		
	Public revenues	VAT	Excise duties	Customs duties	VAT	Excise duties	Customs duties	Other tax revenues
Q1 2009	95.6	103.0	103.0	86.9	88.8	96.1	84.4	87.3
Q2 2009	96.4	87.9	105.7	87.9	96.6	99.2	87.1	100.6
Q3 2009	104.5	106.9	105.2	94.0	101.6	97.9	106.6	123.5
Q4 2009	98.4	101.8	102.0	96.1	96.1	94.5	92.5	101.9
Q1 2010	97.0	100.2	92.7	97.8	99.6	102.7	102.4	96.5
Q2 2010	101.8	97.8	102.0	100.3	99.2	97.5	99.9	111.9
Q3 2010	100.3	101.4	100.0	98.5	100.2	97.4	100.2	94.6
Total index in Q3 (Q1 2009=100)	2010 93.9	97.8	110.5	66.6	82.8	86.0	74.4	113.0
Source: FREN c	alculations.							

Compared with the pre-crisis period (Q1 2009), seasonally adjusted public revenues were 6.1% lower in Q3 2010, mainly as a result of declining revenues from all taxes, except from excise duties and other tax revenues. The increase in revenues from excise duties resulted from a multiple, regular and extraordinary increases in excise duty rates, while the increase in other tax revenues resulted from the introduction of a mobile telephony tax.

Revenues from social contributions decline and revenues from income tax stagnate Unlike the previous quarter, total revenues from labour taxes posted a modest decline compared with Q2. The decline is the result of the fall in real seasonally adjusted revenues from contributions of 2.6% compared with Q2 and a very moderate increase in revenues from income tax, of 0.2%. The diverging movement of revenues from income tax and social contributions, as well as the figures on the movements of revenues from various social contributions subitems, indicate a widening tax evasion in social contribution payments. The evasion is particularly prominent in payments of pension and disability insurance contributions, with tax evasion levels a bit lower for health contribution payments, because the entitlement to healthcare services is conditioned

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<sup>1</sup> In 2010, the Ministry of Finance made methodology adjustments in presenting budget revenue and spending data, which negatively affects full comparability of the data for 2009 and 2010.

by the payment of health insurance contributions, which makes the control of employers by the employees more rigorous. Considering that social contributions represent the most important category of public revenues, an improved efficiency in payment collection represents the precondition for the consolidation and sustainability of the revenue side of the consolidate budget of the government sector.

Real, seasonally adjusted revenues from corporate income tax in Q3 were almost the same as in Q2 (a 0.2% increase). Such a result can be explained by the fact that the tax is being paid in advance, based on the results achieved in the previous year, resulting in almost equivalent quarterly payments.

#### **Box 1. Fiscal Responsibility Rules**

In October 2010, Serbia adopted amendments to the Budget System Law, introducing fiscal responsibility rules, which already exist in 80 countries, in order to ensure a long-term sustainability of Serbia's public finances. The law defines general and specific fiscal rules.

The goal of implementing fiscal rules is to lower the fiscal deficit of the general government sector from 4.75% of GDP in 2010 to 1% of GDP in 2015, primarily through cuts in current spending. General fiscal rules target the annual medium-term fiscal deficit of 1% of GDP, allowing for the fiscal deficit to be below target in years when GDP growth exceeds its potential, or above target in years when GDP growth rate is below its potential. This rule is being implemented through a formula to determine the fiscal deficit target. This essentially imposes an obligation to pursue anti-cyclical fiscal policy, which is both correct and desired.

General fiscal rules set the public debt (excluding the restitution-based liabilities) at a maximum 45% of GDP. Amendments to the law also introduce fiscal rules for local governments, setting the fiscal deficit target for local governments at 10% of their revenues in a given year.

Specific fiscal rules define the way of indexation of public sector wages and pensions, aimed at lowering spending on pensions from close to 13% to 10% of GDP, and spending on public sector wages from nearly 10% to 8% of GDP.

Beside the introduction of fiscal responsibility rules, amendments to the law also envisage the appointment of a three-member Fiscal Council, as an independent supervisory body. The basic responsibilities of the Council include the assessment of the government's economic policy in order to fulfil fiscal targets, the assessment of whether the Government itself respects defined fiscal rules, the assessment of fiscal risks and the probability of whether the government will fulfil fiscal targets, etc.

With the adoption of fiscal responsibility rules and the appointment of the Fiscal Council, the issue of strategic public finance management is being defined according to modern practices, based on relevant aspects of the up-to-date economic theory and the best international practices. This also gives institutional prerequisites to ensure medium- and long-term sustainability of the public finances in Serbia, to improve the credit rating of the country and build a stable, predictable and sustainable macroeconomic environment. The fiscal responsibility law increases chances for a responsible fiscal policy in the future, while offering no guarantees that it will happen. The success of the law will essentially depend on the readiness to give advantage to long-term economic and social goals versus short-term political points.

	Public expenditures	Staff expenditures	Purchase of goods and services	Subsidies	Pensions	Capital expenditures
Q1 2009	95.6	93.6	94.4	74.7	102.4	73.9
Q2 2009	103.2	101.1	104.5	93.5	99.1	118.1
Q3 2009	99.1	99.0	95.9	115.4	100.2	92.7
Q4 2009	93.7	99.1	99.2	80.2	98.2	97.2
Q1 2010	103.2	97.0	102.8	113.4	98.3	108.8
Q2 2010	101.4	98.8	97.0	115.0	97.8	90.4
Q3 2010	99.0	100.9	98.8	105.8	99.4	112.9
Total index in Q3 2010 (Q1 2009=100)	94.8	89.8	92.6	89.2	95.3	87.4
Source: FREN calculations	; ;					

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

Consolidated, seasonally adjusted spending of the government in Q3 2010 were 5.2% lower compared with the pre-crisis levels (Q1 2009). Even though the relative decline was the biggest for spending on subsidies and capital spending, the most significant contribution to the decline in overall public spending came from falling spending on public sector employees and on pensions (due to a nominal freeze of public sector wages and pensions in 2009 and 2010), as well as the decline in spending on purchases of goods and services, because those three categories represent more than 2/3 of the total public spending.

Spending on employees, subsidies and capital spending posted growth in Q3... Real, seasonally adjusted spending on employees in Q3 was 0.9% higher than in the previous quarter, while spending on subsidies rose by 5.8%, with capital spending rising 12.9% against Q2. The increase in spending on employees is owed to a one-off payment of 5,000 dinars per public sector worker whose net wage does not exceed 50,000 dinars. The significant increase in capital spending can be explained by intensified works on big infrastructure projects, while the increase in spending on subsidies is the result of continued subsidized lending to ensure liquidity and provide cheaper consumer loans to households.

#### Table T6-5. Serbia: Consolidated Balance of the General Government Sector<sup>1)</sup>, 2006-2010

							in	billions of din	ars							
	2006	2007			2008					2009				20	10	
	Q1-Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q1-Q3
I PUBLIC REVENUES	865.8	1,002.0	269.4	281.4	283.3	311.8	1,145.9	258.8	267.1	297.0	323.6	1,146.5	266.6	292.9	309.4	868.9
1. Current revenues	865.5	995.4	268.9	280.3	282.6	311.3	1,143.1	258.3	266.2	296.2	318.3	1,139.2	266.2	292.4	308.9	867.5
Tax revenue	756.0	870.0	234.4	247.4	248.3	270.2	1,000.4	229.8	237.1	256.9	276.5	1,000.3	236.1	255.6	269.3	760.9
Personal income taxes	118.6	115.8	29.7	34.1	33.6	39.0	136.5	30.9	33.5	33.6	35.5	133.5	31.1	34.5	34.4	100.1
Corporate income taxes	18.3	29.7	15.0	8.1	7.4	8.5	39.0	12.8	5.6	6.1	6.7	31.2	11.7	6.5	6.5	24.7
VAT and retail sales tax	225.1	265.5	73.2	77.0	73.8	77.7	301.7	69.4	67.9	76.1	83.5	296.9	71.9	77.3	83.2	232.4
o/w: Net VAT and retail sales tax <sup>2)</sup>	224.5	260.3	73.2	77.0	73.8	77.7	301.7	69.4	67.9	76.1	83.5	296.9	71.9	77.3	83.2	232.4
Excises	86.9	98.6	23.7	26.6	29.5	30.3	110.1	24.4	30.7	38.4	41.3	134.8	27.2	35.1	42.5	104.8
Custom duties	45.4	57.4	14.8	16.9	16.3	16.8	64.8	11.5	11.7	11.7	13.2	48.0	9.5	11.0	11.3	31.8
Social contributions	231.4	270.3	69.7	75.9	78.7	88.5	312.7	73.4	79.7	80.9	84.8	318.8	74.9	79.4	79.7	234.1
a/w: contributions excluding offsets with SDF <sup>21</sup>	221.9	269.8	69.7	75.9	78.7	88.5	312.7	73.4	79.7	80.9	84.8	318.8	74.9	79.4	79.7	234.1
Other taxes	30.3	32.8	8.4	8.8	8.8	9.5	35.6	7.4	8.1	10.3	11.4	37.1	9.8	11.8	11.5	33.1
Non-tax revenue	109.6	125.4	34.4	32.9	34.3	41.1	142.7	28.5	29.1	39.3	41.9	138.8	30.2	36.8	39.6	106.6
2. Capital revenues	0.3	5.3	0.3	0.5	0.3	0.2	1.4	0.3	0.5	0.0	0.0	0.9	0.0	0.2	0.0	0.2
II TOTAL EXPENDITURE	-888.4	-1,031.5	-254.0	-295.8	-286.6	-359.3	-1,195.7	-270.3	-306.3	-315.1	-356.2	-1,248	-286.1	-317.8	-329.7	-933.6
1. Current expenditures	-807.0	-919.5	-242.0	-272.7	-260.5	-314.4	-1,089.6	-259.0	-286.4	-292.0	-317.9	-1,155	-272.6	-300.5	-304.0	-877.1
Wages and salaries	-204.4	-238.3	-66.5	-74.0	-71.3	-81.4	-293.2	-70.3	-75.6	-73.8	-82.2	-302.0	-72.7	-76.0	-76.3	-225.0
Expenditure on goods and services	-135.9	-168.1	-34.0	-44.2	-45.2	-57.9	-181.2	-35.9	-47.2	-46.2	-58.2	-187.4	-39.7	-47.9	-49.0	-136.6
Interest payment	-30.2	-17.9	-6.0	-2.6	-5.1	-3.4	-17.2	-5.8	-4.5	-7.1	-5.0	-22.4	-8.0	-8.3	-8.2	-24.5
Subsidies	-55.6	-63.7	-13.3	-22.2	-13.9	-28.3	-77.8	-11.0	-14.7	-18.7	-18.6	-63.1	-11.2	-18.4	-22.1	-51.7
Social transfers	-360.4	-409.3	-117.9	-122.4	-120.4	-136.0	-496.8	-132.8	-139.1	-139.3	-145.2	-556.4	-137.1	-144.0	-142.3	-423.5
o/w: pensions <sup>®</sup>	-227.7	-259.9	-74.8	-81.5	-83.6	-91.1	-331.0	-94.5	-96.6	-97.1	-99.2	-387.3	-97.1	-97.5	-98.2	-292.8
Other current expenditures	-20.5	-22.1	-4.2	-7.3	-4.6	-7.3	-23.5	-3.2	-5.2	-6.9	-8.7	-24.0	-3.9	-5.9	-6.1	-15.9
2. Capital expenditures <sup>6</sup>	-81.3	-112.1	-12.0	-23.1	-26.1	-44.9	-106.0	-11.3	-20.0	-23.0	-38.2	-92.5	-13.5	-17.3	-25.7	-56.5
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	-10.9	-15.3	-7.3	-5.2	-2.7	-3.9	-19.1	-0.9	-6.3	-5.8	-7.4	-20	-4.6	-6.4	-8.5	-19.5
IV TOTAL EXPENDITURE, GFS (II+III)	-899.3	-1,046.8	-261.4	-301.0	-289.3	-363.2	-1,214.8	-271.2	-312.6	-320.9	-363.6	-1,268	-290.7	-324.2	-338.3	-953.1

Source: Table P-10 in Analytical Appendix

See footnote 1) in Table T6-2

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

Note: To calculate real growth, an average base index of retail prices was implemented (base December 2003) on quarterly figures.

...while a decline was seen in spending on purchases of goods and services, and pensions Real, seasonally adjusted spending on purchases of goods and services, posted a decline for the second consecutive quarter, of 1.2% compared with the previous quarter. Considering that this is a current spending category, with a prominent share in total spending, their decline is seen as positive. However, additional caution is necessary in planning the reduction of those spending forms so that the normal functioning of public services is not threatened and to avoid that the damages resulting from inefficient public sector outweigh the benefits of the savings made.

Due to a nominal freeze of pensions in 2009 and 2010, seasonally adjusted spending on pensions were falling for the fourth consecutive quarter compared with the previous quarter, with the Q3 decline (of 0.6%) lower than declines posted in previous quarters. Since there was no nominal
pension increase in Q3, it seems that the slowdown in real decline in seasonally adjusted spending on pensions can be explained by an increase in the number of beneficiaries of the pension and disability insurance.

Table T6-6. Serbia: Consolidated Balan	ce of the General Government Sector <sup>1)</sup> , 2006-2010

								reain	increase (in %	o)							
	2006	2007			2008					2009					2010		
	Q1-Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1 - Q4	Q1	Q2	Q3	Q1 - Q3	in comparison to previous quarter
I PUBLIC REVENUES	7.0	8.6	7.6	5.2	2.8	-0.7	3.3	-12.6	-13.7	-4.2	-5.0	-8.7	-4.0	2.5	-3.6	-1.8	3.8
1. Current revenues	6.8	7.9	7.7	5.0	3.7	0.1	3.5	-12.6	-13.7	-4.2	-6.3	-9.1	-4.0	2.6	-3.6	-1.7	3.8
Tax revenue	5.4	8.0	7.6	5.2	3.6	0.1	3.7	-10.8	-12.9	-5.4	-6.3	-8.8	-4.3	0.7	-3.1	-2.2	2 3.5
Personal income taxes	11.9	-8.4	7.1	8.1	4.5	6.5	6.3	-5.3	-10.8	-8.7	-16.5	-10.8	-6.0	-3.8	-5.1	-4.9	-1.8
Corporate income taxes	58.0	52.1	15.2	30.0	45.3	-0.2	18.5	-22.2	-37.2	-25.4	-27.3	-27.0	-15.2	7.5	-0.1	-6.3	-0.6
VAT and retail sales tax	-7.3	10.6	8.7	5.7	-0.3	-2.3	2.5	-13.6	-19.9	-5.8	-1.5	-10.2	-3.5	6.4	1.1	1.3	5.8
o/w: Net VAT and retail sales tax 21	0.3	8.8	11.3	10.3	1.3	-2.3	4.5	-13.6	-19.9	-5.8	-1.5	-10.2	-3.5	6.4	1.1	1.3	5.8
Excises	8.3	6.5	5.7	-1.5	2.4	-1.7	0.7	-6.2	4.9	18.8	24.6	11.6	3.9	6.8	2.4	4.3	19.2
Custom duties	3.9	18.6	10.5	8.8	0.9	-8.7	1.8	-29.4	-37.4	-34.5	-27.8	-32.4	-23.1	-11.9	-10.4	-15.1	0.8
Social contributions	12.5	9.6	6.9	4.4	5.2	2.5	4.3	-4.1	-4.5	-6.1	-12.2	-7.0	-4.9	-6.9	-8.8	-6.9	-1.3
o/w: contributions excluding offsets with SDF 21	11.3	14.1	7.0	4.6	5.2	2.8	4.5	-4.1	-4.5	-6.1	-12.2	-7.0	-4.9	-6.9	-8.8	-6.9	-1.3
Other taxes	11.1	1.7	-4.5	-5.8	4.0	-1.6	-2.3	-20.5	-16.8	6.1	10.0	-4.9	23.3	36.8	3.9	19.8	-4.2
Non-tax revenue	17.1	7.4	8.5	3.3	4.5	-2.7	2.6	-24.6	-19.5	4.7	-6.7	-11.3	-1.6	18.1	-6.7	2.3	5.8
2. Capital revenues	56.3	1,703.2	-55.6	81.3	-89.6	-87.7	-76.8	-25.4	-3.2	-89.8	-83.4	-41.4	-97.6	-64.3	-26.0	-73.5	-86.6
II TOTAL EXPENDITURE	13.7	8.9	2.4	20.1	1.8	-1.4	4.5	-3.2	-5.9	0.5	-9.2	-4.8	-1.4	-3.1	-3.2	-2.6	i 2.0
1. Current expenditures	10.6	6.9	6.9	19.5	2.3	2.3	6.9	-2.6	-4.6	2.5	-7.4	-3.3	-1.9	-2.0	-3.7	-2.6	-0.6
Wages and salaries	7.0	9.4	12.7	15.0	9.2	8.5	10.9	-3.8	-7.1	-5.3	-7.5	-6.0	-3.7	-6.1	-4.4	-4.8	-1.3
Expenditure on goods and services	12.9	16.1	0.8	8.1	-1.3	-11.4	-2.8	-3.8	-2.9	-6.5	-8.1	-5.7	3.1	-5.1	-1.9	-1.6	i 0.5
Interest payment	52.6	-44.4	-12.2	-31.4	-3.1	-10.6	-13.3	-13.4	55.9	28.8	33.4	19.0	29.1	71.2	5.8	30.6	i -3.8
Subsidies	-10.0	7.6	27.5	88.2	-29.7	0.5	10.1	-24.7	-39.8	22.9	-39.8	-26.0	-5.3	16.6	9.2	8.1	18.4
Social transfers	13.7	6.5	6.0	19.0	6.8	8.1	9.5	2.4	3.3	5.7	-2.2	2.2	-3.8	-3.3	-5.5	-4.2	-2.8
o/w: pensions <sup>9</sup>	11.1	7.1	8.5	14.9	16.4	20.1	14.9	15.0	7.7	6.1	-0.3	6.7	-4.3	-5.6	-6.4	-5.5	-1.1
Other current expenditures	2.9	1.1	-15.7	62.5	-18.9	-20.6	-4.3	-30.9	-35.5	35.6	9.6	-6.7	12.7	6.3	-18.1	-3.3	1.1
2. Capital expenditures <sup>4</sup>	57.7	29.3	-44.5	28.1	-3.2	-21.0	-14.7	-14.3	-21.3	-19.2	-22.0	-20.4	11.5	-19.2	3.2	-3.2	46.3
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	47.6	-53.9	649.7	338.0	-63.5	-46.9	12.3	-88.6	10.3	97.1	74.7	-2.4	360.3	-4.9	35.1	38.9	30.6
IV TOTAL EXPENDITURE CES (II - III)	12.0	0.2	5.0	21.7	0.1	.2.2	4.6			1.4		.4.9	0.1	.2.1	-2.5	-20	

Source: Table P-10 in Analytical Appendix

See footnote 1) in Table T6-2

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

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 rose by around 860 million euros (around 2.8% of GDP) in Q3 At the end of Q3 2010, Serbia's total debt stood at 11.62 million euros (38.5% of GDP<sup>2</sup>), which is by around 860 million euros (around 2.8% of GDP) higher than at the end of Q2 2010.<sup>3</sup> The public debt growth in the course of Q3 2010 was significantly higher than the quarterly fiscal deficit in the same period. In fact, a significant part of the public debt growth in Q3 2010 (around 400 million euros) stemmed from the inclusion of the amount received from the IMF at the end of 2009, based on a quota expansion, in official figures of the Ministry of Finance. Also, in the course of Q3, liabilities (of around 376 million euros) towards some governments and financial institutions (e.g. debt to Kuwait) were included in the public debt, even though those were previously treated as unregulated liabilities.

Table T6-7. Serbia: Public Debt, 2000-2010

						in billions of	of EUR					
_	31.12.2000.	31.12.2005.	31.12.2006.	31.12.2007.	31.12.2008.	31.03.2009.	31.07.2009.	30.9.2009.	31.12.2009.	31.03.2010.	30.06.2010.	30.09.2010.
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	7.97	8.48	8.51	8.46	8.76	9.18	9.98
Domestic debt	4.11	4.26	3.84	3.41	3.16	3.21	3.69	3.79	4.05	4.10	4.10	4.21
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.76	4.79	4.72	4.41	4.67	5.07	5.76
II. Indirect debt	-	0.66	0.80	0.85	0.93	0.96	1.21	1.36	1.39	1.50	1.59	1.65
III. Total debt (I+II)	14.17	10.28	9.38	8.88	8.78	8.93	9.70	9.87	9.85	10.27	10.77	11.62
Public debt / GDP	169.3%	50.2%	36.2%	29.4%	25.6%	28.9%	31.4% <sup>1</sup>	32.0%	31.30%	31.10%	32.70%	38.50%
Source: The Ministry of	of Finance of	f the Republ	ic of Serbia									

According to available figures, the majority (more than 4/5) of the public debt growth in Q3 refers to additional (direct) borrowing abroad. Of close to 11.6 billion euros in total public debt, 10 billion euros refers to direct state liabilities and 1.6 billion euros to indirect liabilities. Of direct state liabilities, 4.2 billion euros represent domestic debt and 5.8 billion euros external debt. A significant part of the fiscal deficit in Q3 was financed through Treasury bill and note issues in the local market, as well through the sale of hard currencies held by the state with the National

<sup>2</sup> According to the Ministry of Finance calculations

<sup>3</sup> Even though according to official Ministry of Finance figures the absolute public debt growth stood at 860 million euros in Q3, the same data show that the public debt grew by 5.8% of GDP in Q3 over Q2 (even though 860 million euros measured by the official assessments of GDP value for 2010 is equivalent to 2.8% of GDP). The difference in the official figures of the Ministry of Finance is probably partially caused by the change in the estimated value of GDP, used as the basis to calculate the relative volume of the public debt in Q2 and Q3 of 2010.

Bank of Serbia. Net government liabilities based on issued debt stood at 151.6 billion dinars at the end of Q3, 15.6 billion dinars more (roughly equivalent to the entire increase in domestic debt) than at the end of Q2 2010. Considering that the fiscal gap in Q3 stood at 28.8 billion dinars, it can be concluded that a significant part of the fiscal deficit in Q3 was financed through external borrowing.

The Republic of Serbia concluded in September a series of contracts on a loan to finance its budget deficit, worth 250 million euros, with ten commercial banks (KBC Banka, Nova Kreditna Banka Maribor, Eurobank EFG, Vojvodjanska banka, Hypo-Alpe-Adrija banka and Erste banka, Banka Intesa, Unicredit banka Srbija, Raiffeisen banka and Societe Generale banka). The decision to borrow from banks has resulted from a declining success rate in selling Treasury bills. The loan contracts envisage repayment period of five years, with a one-year grace period. The government has also negotiated a possibility to repay the debt earlier, which had reflected on the interest rate. This loan has not been presented as part of the public debt at the end of Q3, because relevant loan contracts were ratified by the Serbian Parliament in November. The agreed interest rate comprises the three-month EURIBOR (currently at 1%) and an additional margin, ranging from 4.25% (KBC Banka) to 5.3% (Erste Banka). The government borrowing from commercial banks does not necessarily need to be negative *a priori*, because it encourages transfers of foreign savings from parent banks to Serbia, which has a positive impact on the balance of payments. However, the loan cost is relatively high and unfavourable, particularly in the context of the further expected increase in EURIBOR in the coming period. It would, therefore, be necessary to take advantage of early repayment of those loans as soon as possible, either through new borrowing from international financial institutions under more favourable terms, or from public company privatisation revenues.

Serbia's public debt in the course of Q3 (excluding the amount based on Serbia's increased quota at the IMF received in late 2009, as well as the unregulated debt to Kuwait and other creditors) rose by around nine billion dinars, i.e. around 84 million euros. During the same period, capital spending stood at 25.7 billion dinars, which means that the ratio between capital spending and public debt growth based on current financing stood at 2.85 in Q3 – which can be seen as favourable (in previous quarters only 1/3 of the new debt was used for investment and 2/3 for current consumption). However, considering that Q3 deficit was higher than the net debt growth in the same period, it can be concluded that the Q3 deficit was financed from other sources (e.g. part was financed from the mentioned funds received from higher IMF quota in 2009). Therefore, the favourable ratio of capital spending and debt increase in Q3 can be considered exceptional and temporary and still does not indicate any significant turnaround in terms of using the funds raised through additional borrowing.

### Box 2. The Currency Structure of Serbia's Public Debt and Exchange Rate Risk

During the pre-crisis period (at the end of Q3 2008) the currency structure of Serbia's public debt was exceptionally unfavourable, because the share of the dinar denominated debts stood at only around 3%, while the debt in foreign currencies accounted for around 97% of the debt (of which the most part, around 75.5% was euro-denominated debt). The high share of foreign currency-denominated debt made the public debt sustainability significantly exposed to the exchange rate risk. The impact of the public debt sustainability exposure to the exchange rate risk was dual over the past two years. Since the end of Q3 2008 until the end of August 2010 (the last available figure) the dinar denominated debt rose to 14.9% of the public debt, while the share of the euro-denominated debt fell to 63.9% (the share of the U.S. dollar denominated debt is the result of the fact that the fiscal deficit was largely financed through Treasury bill issues (dinar-denominated) over the past two years. The described change in the currency structure of the public debt sustainability and the level of state spending on interest rate payments.



On the other hand, during the period since the end of Q3 2008 and the end of August 2010, the exchange rate of the dinar against the euro has depreciated by around 21% in real terms, which has had a negative impact on the public debt sustainability. Considering that euro-denominated debt still represents a significant part of the public debt, it is estimated that the exposure of the public debt sustainability to the exchange rate risk is significant. Therefore, a further change in the currency structure of the public debt in the coming period towards an increasing share of the dinar denominated debt appears to be desired and justified.

The official public debt figures of the Ministry of Finance still do not include numerous categories of government liabilities (debts by local governments, unallocated debt of the SFRY, arrears for purchased goods and services, etc.) and it is therefore believed that the real volume of public debt is higher than the officially reported one by several percentage points of GDP. The inclusion of all those government liabilities in the public debt, along with adjustments made in Q2, the total volume of public debt is nearing the upper limit of 45% of GDP set by general fiscal responsibility rules. Therefore, the compliance with general fiscal rules in relation to the level of the public debt and ensuring the medium-term sustainability of the public debt is possible only through strict respect of other fiscal rules related to spending on pensions and public sector wages, as well as related to the fiscal deficit in the coming years. In that respect, any further government borrowing in the coming period should be limited and restricted only to financing of major infrastructure projects, the implementation of which would have a multiplying effect on economic growth.

Also, it would be economically justified to consider using part of the receipts from the sale of some big, public companies (e.g. Telekom Srbija) next year to repay part of the existing debt, which carries relatively high interest rates (e.g. debt to the London Club of creditors, which carries a 6.75% annual interest). This would reduce current spending in the coming years, related to interest rate repayments, while enabling compliance with established fiscal rules related to the volume of the public debt. On the other hand, big infrastructure projects could be financed through borrowing from international financial institutions, at significantly more favourable terms. An alternative scenario, according to which the Telekom Srbija privatisation revenue would be kept on a special account, to finance capital projects, would pave the way for additional pressure from interested parties (e.g. trade unions) towards higher current spending in the pre-election and election year, which would lead to a risk of irrational spending of the funds.

# 7. Monetary Flows and Policy

The growth in real M2 slowed down in Q3 compared to the previous quarter, as a consequence of decreased lending to the non-government sector, mainly the corporate sector. As a result of the enforcement of the new Insolvency Law, the savings and time deposits in Q3 for the first time negatively contributed to the growth in M2. The share of non-performing loans in total loans, slightly decreased in Q3 to 11.88%, fuelled by decrease in non-performing loans to the corporate sector. Lending to the corporate sector and households in Q3 amounted to €405 mn, which is a decline in respect to bank lending in the previous quarter (€853 mn). The trend of corporate sector de-leveraging, which started at the beginning of the financial crisis, continued throughout Q3, in which cross-border credits posted a negative growth of €134 mn. In the same period, a decline was noted in the sources for new bank lending, as a consequence of repayment of foreign liabilities by banks, while domestic deposits had a neutral effect on the situation. The increase of the benchmark interest rate by one percentage point did not have any significant impact on the shrinking REPO stock trend present since the beginning of the year. NBS interventions on the interbank currency market continued in Q3 too, in which €595 mn were sold. This contributed to the decrease of the NBS net own reserves, which was nevertheless neutralized by an increase in NDA, whereby the fall in reserve money was stabilized in Q3 and stood at -0.3% of initial H.

## Monetary System: Money Supply Structure and Flows

The growth in real M2 slowed down...

...as a consequence of the negative credit growth to the non-government sector in Q3

Q3 saw a negative NFA growth...

...along with a declining NDA growth...

The growth in real M2 slowed down in Q3 and stood at 10.3% y-o-y (in Q2 real growth stood at 14.6%, Table T7-2). The negative credit growth to the non-government sector, which in Q3 stood at 6.7% y-o-y after adjustment<sup>1</sup>, was identified as a cause of the decelerated growth in M2. The cause of the reduced lending to the non-government sector is the negative growth trend of new credits to the economy of 5.9% yo-y (which stood at 8.9% in Q2), while household credits have retained the same growth rate of 8.5% y-o-y as in Q2.

Graph T7-1. Serbia: Money and its Components<sup>1)</sup>, 2004–2010



By analyzing the individual elements in the M2 growth (Graph T7-1), we noted for the first time since 2002, i.e. since these data are comparable, that the dinar savings and time deposits have recorded a negative contribution to the growth rate. This decline which has been noted, is the consequence of the enforcement of the new Insolvency Law<sup>2</sup>. Pursuant to this Law – insolvency proceedings are initiated against companies whose accounts have been blocked for over three years, which led to the decline in savings and time deposits in Q3. Consequently, of the total nominal M2 growth of 20.12% in Q3, savings and time deposits posted a negative growth rate of -2.38% (in Q2 0.57%). Without this effect, the contribution of savings and time deposits in Q3 would have been positive, since the sum of blocked funds on the accounts of the enterprises exceeds the amount by which the savings and time deposits have decreased. Foreign currency deposits, standing at 21.41%, still accounted for a dominant share in total growth (20.5% in Q2), while M1 slightly increased its share to 1.09% (in Q2 its contribution was 1.02%).

In Q3 money supply posted a 0.8% growth of initial M2 (cumulative growth in Q3 less growth in Q2, Table T7-2). The underlying cause of the low M2 growth is the weaker growth of net

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<sup>1</sup> Based on our methodology that we applied for the correction of the growth rate, we assume that at least 70% of these loans were issued with currency clause.

<sup>2</sup> The Insolvency Law entered into effect as of January 24th of the current year.

#### ...which resulted in a slight increase of money supply

domestic assets (NDA) of 1.9% of initial M2 (in Q2 6.2%), aggravated by the negative growth of net foreign assets (NFA) of -1.1% of initial M2. The negative NFA growth in Q3 is a consequence of sales of foreign currency on the interbank market, in order to prevent excessive fluctuation of the dinar exchange rate. The NDA growth in Q3 is owed to the combined effect of the increase in lending to the non-government sector of 3.5% of initial M2 and the shrinking capital in the monetary sector amounting to 4.8% of initial M2. This synergic action caused the NDA to start contributing to the M2 growth, which represents a reversal of the trend noticed at the beginning of 2009.

		200	08			200	9			2010	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
				· ·	у-	o-y, in %					
M2 <sup>1)</sup>	41.0	33.7	24.5	9.8	6.5	12.1	10.4	21.3	19.9	22.1	20.
Credit to the non-government sector <sup>2)</sup>	36.4	30.3	29.4	33.7	33.8	27.7	22.3	16.1	14.4	25.0	27.
Credit to the non-government sector <sup>2)</sup> , adjusted <sup>3)</sup>	35.3	30.7	32.2	23.6	20.9	13.9	7.7	10.2	10.4	16.2	16.
Households	43.3	35.5	19.5	15.7	7.4	1.5	4.4	3.7	7.9	16.1	18.
Enterprises	31.0	28.1	39.5	28.1	28.8	20.9	9.3	13.6	11.6	16.3	15.
					real	y-o-y, in %					
M2 <sup>1)</sup>	26.2	19.2	12.2	2.9	-3.2	2.1	0.9	9.8	11.5	14.6	10.
Credit to the non-government sector <sup>2)</sup>	22.0	16.2	16.6	25.2	21.7	16.4	11.8	5.2	6.3	17.3	16.
Credit to the non-government sector <sup>2)</sup> , adjusted <sup>3)</sup>	21.1	16.4	19.0	15.7	9.4	2.7	-2.8	-0.5	2.6	8.8	6.
Households	28.2	20.7	7.6	8.3	-2.8	-8.6	-5.8	-6.4	0.3	8.7	8.
Enterprises	17.3	14.1	25.6	19.9	16.5	9.0	-1.3	2.5	3.7	8.9	5.
					cumulative, i	n % of openin	ng M2 <sup>4)</sup>				
M2 <sup>1)</sup>	5.5	4.8	9.0	9.8	2.3	7.0	9.5	21.3	1.1	7.7	8.
M2 dinar <sup>1)</sup>	-2.5	-2.7	-1.1	0.5	-1.9	0.6	2.2	4.2	-2.7	-1.6	-2.
Foreign deposits (households and enterprises) <sup>5)</sup>	5.6	7.7	12.5	2.3	-0.1	2.9	4.1	11.2	1.3	3.3	4.
Valuation adjustments <sup>6)</sup>	2.4	-0.2	-2.3	7.0	4.4	3.4	3.2	5.9	2.6	5.9	7.
NFA, dinar increase	3.6	-3.2	-3.0	-8.8	2.2	0.4	3.6	8.9	-0.9	-0.6	-1.
NFA, fx increase	1.2	-3.0	-1.0	-14.5	-1.1	-2.1	1.1	4.5	-2.7	-4.4	-6.
Valuation adjustments <sup>6)</sup>	2.5	-0.2	-2.0	5.7	3.3	2.5	2.5	4.4	1.8	3.8	4.
NDA	1.9	8.0	12.0	18.7	0.2	6.6	6.0	12.4	2.1	8.3	10.
o/w: credit to the non-government sector <sup>2)</sup> , adjusted <sup>3)</sup>	4.8	12.8	22.2	22.0	3.6	5.1	83	11.6	3.0	11.1	14
o/w: net credit to government <sup>7)</sup>	-0.6	1.0	1.9	7.0	-2.0	4.1	6.1	5.2	0.8	4.1	4
o/w: NBS and com. banks capital and reserves	-3.5	-4.6	-6.3	-16.4	0.7	-5.5	-9.9	-13.7	-0.2	-11.1	-6.
·					cumulativ	ve. in % of GD	P <sup>8)</sup>				
Net credit to government <sup>7)</sup>	-0.3	03	0.7	2.2	-0.9	14	. 21	17	0.3	16	1
o/w: dinar credits	-0.8	-1.3	-1.0	0.8	-0.5	1.7	2.4	1.7	0.6	1.3	10
Cradit to the nen government costor <sup>2)</sup> adjusted <sup>3)</sup>	3.5	4.4	6.6	10.7	3.4	3.5	4.2	6.4	2.0	7.2	

### Table T7-2. Serbia: Money and Component Aggregates, 2008–2010

Source: Table P-12 in Analytical Appendix

1) Money supply: components – see QM Analytical and Notation Conventions.

2) Credits to the 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 the assumption that 70% of credits to the non-state 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 foreign currency deposits to M2 growth measures only the contribution of an increase in foreign currency denominated foreign currency deposits. so that their revaluation produces exchange rate differentials.

6) Exchange rate differentials refer to the difference between the contribution of NFA to M2 growth measured in dinars and the contribution of NFA to M2 growth measured in foreign currencies.

7) Credits to the state: net – the difference between credits (dinars and foreign currency) and deposits (dinar and foreign 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 centered.

The share of nonperforming loans declined at the end of O3...

...but still remains above acceptable level According to data from the Credit Bureau, the share of non-performing loans in total lending stood at 11.88% at the end of September (Table T7-3), which represents a slight fall in relation to the previous quarter. There is an evident decline in the share of loans to entrepreneurs, which has increased the share of overdue loans to 15.7% of the total amount. However, it should be noted that loans to entrepreneurs, which stand at 4%, account for the least individual share in the credit portfolio, which is why this deterioration is not so alarming. On the other hand, credits to the corporate sector that accounted for the biggest share with 78.5%, recorded a slight decline to 13.83%, largely accounting for the overall decline in their share at the end of Q3.

#### Table T7-3. Serbia: The Share of Non-Performing Loans in Total Lending, 2009–2010

		200	09			2010	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep
			balance	at the end o	of period		
Corporate	11.05	14.86	13.24	12.14	11.62	14.18	13.83
Entrepreneurs	5.28	8.93	10.21	11.21	12.19	13.73	15.7
Natural persons	5.36	6.19	6.63	6.69	6.37	6.79	7.04
Total	9.1	12.1	11.2	10.8	10.14	11.99	11.88
ource: Credit Bureau of the Serbian Bank A	ssociation						

#### Table T7-4. Serbia: Monetary Review, 2008–2010

		20	08			200	9			2010	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
-					in millions	of dinars, end o	f period				
STOCK											
NFA	596,215	534,403	536,102	483,707	504,072	486,784	517,908	570,534	559,408	563,269	549,806
o/w: NBS gross reserves	788,296	720,967	745,070	724,755	772,902	832,817	888,389	1,022,861	1,049,068	1,103,542	1,056,399
o/w: commercial bank foreign liabilities	-264,865	-251,182	-279,131	-349,703	-345,733	-351,420	-419,017	-500,336	-540,076	-540,431	-544,477
NDA	357,307	412,802	448,498	508,826	511,535	575,119	569,336	633,447	658,351	732,914	756,197
Net credit to government 1)	-120,644	-103,539	-94,156	-53,042	-76,033	-14,887	4,838	-4,340	3,916	42,404	43,258
Net dinar credit	-53,126	-67,826	-60,934	-14,199	-27,201	31,692	52,467	33,822	50,763	71,864	88,847
Net fx credit	-67,518	-35,713	-33,222	-38,843	-48,832	-46,579	-47,629	-38,162	-46,847	-29,460	-45,589
Credit to the non-government sector 2)	908,598	953,977	1,018,307	1,126,111	1,215,843	1,218,702	1,245,735	1,306,224	1,389,783	1,523,040	1,583,687
Other items, net	-430,647	-437,636	-475,653	-564,243	-628,275	-628,696	-681,237	-668,437	-735,348	-832,530	-870,748
M2 <sup>3)</sup>	953,522	947,205	985,134	992,533	1,015,607	1,061,903	1,087,244	1,203,981	1,217,759	1,296,183	1,306,003
M2 dinar <sup>3)</sup>	367,648	365,834	380,015	395,088	378,094	401,120	416,996	436,784	403,722	417,948	402,995
Fx deposits (households and economy)	585,874	581,371	605,119	597,445	637,513	660,783	670,248	767,197	814,037	878,235	903,008
STRUCTURAL INDICATORS											
Currency outside banks/Dinar deposits	23.7	23.5	23.2	29.5	26.0	25.3	24.8	28.0	27.0	26.5	28.7
(households and economy), in %											
Fx deposits (households and economy) / M2 (%)	61.4	61.4	61.4	60.2	62.8	62.2	61.6	63.7	66.8	67.8	69.1
Velocity (GDP <sup>4)</sup> / M2)	2.6	2.7	2.7	2.7	2.6	2.5	2.6	2.4	2.4	2.3	2.3
M2 / GDP <sup>4)</sup>	0.39	0.37	0.37	0.38	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Credits to the non-government sector / GDP <sup>4)</sup>	0.37	0.37	0.38	0.43	0.5	0.5	0.4	0.5	0.5	0.5	0.5
Non-perofrming loans <sup>5)</sup> (in % of total loans)	4.4	5.3	6.0	5.8	9.1	12.1	11.2	10.8	13.8	12.0	11.9
Money multiplier (dinar M2/H)	2.6	2.0	2.3	1.2	1.4	1.6	1.8	1.7	1.9	2.2	2.2

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) For more details, see: J. Dimitrijević, "Non-performing loans in Serbia – What is the right measure?", QM6.

## **Banking Sector: Lending and Sources of Financing**

### In Q3 bank lending to the corporate and household sectors amounted to €405 mn...

...while cross-border credits continued to post negative growth

The withdrawal of funds from REPO investments continued in Q3 pushing down the REPO stock to a record low level while part of the funds collected in this manner was redirected towards purchases of Treasury bills Bank lending to the corporate and household sectors through new loan facilities stood at  $\notin$ 405 mn in Q3, which represents a decline against the previous quarter (in Q2 lending stood at  $\notin$ 854 mn, Table T7-5 and Table T7-6). The corporate sector's share in this amount stood at  $\notin$ 246 mn in new loans, which represents a decrease compared to the previous three quarters, while household borrowing accounted for  $\notin$ 159 mn (Table T7-6). The state (in contrast to the previous quarters) refrained from borrowing from commercial banks in Q3. Consequently, a minimum change of nine million euro was recorded (in Q2  $\notin$ 348 mn were withdrawn Table T7-5). As the corporate sector continued to repay debts to foreign creditors, cross-border credits posted a negative growth of  $-\notin$ 134 mn. With the decline in new credit growth and the cross-border credits' negative growth, the total credit growth to the corporate and household sectors stood at  $\notin$ 271 mn in Q3, which is below the average of the previous three quarters.

The National Bank decided to increase the benchmark interest rate in Q3, as the inflation drew closer to the upper bound of the target band, but this had no significant influence on the decision of commercial banks on investments in REPOs. The withdrawal of funds continued in Q3, for the fourth consecutive quarter, by €394 mn (in Q2 €320 mn, Table T7-5) pushing down the REPO stock to €640 mn. This was largely affected by the real rate of return on REPO operations<sup>3</sup>, which was negative during most of Q3. The funds released after the withdrawal from REPO investments, were reinvested by the banks into Treasury bills of the Ministry of Finance. In Q3 €471 mn worth Treasury bills were sold<sup>4</sup> and the rate of success of the issue stood at 50% for most auctions, even for Treasury bills with three- and six-month maturities. This triggered an additional increase in the executive rate for bills with all types of maturities.

<sup>3</sup> See section "Financial Markets" Graph T8-4.

<sup>4</sup> Section "Fiscal Flows and Policy" examines the balance of the state's net liabilities for issued treasury bills calculating the nominal value of sold treasury bills, while section "Monetary Flows and Policy" monitors the market value on the issue's selling date

		20	08			200	19			2010	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
				in millions o	of euros, cumu	lative from th	e beginning	of the year			
Funding(-, increase in liabilities)	258	-717	-2,140	-833	958	61	-1,171	-2,790	7	-117	-68
Domestic deposits	-162	-464	-1,134	-95	235	-336	-691	-1,633	131	-233	-236
Households deposits	-192	-518	-842	84	-40	-270	-551	-1,314	-137	-323	-500
dinar deposits	-18	-19	-28	-63	46	-2	-30	-89	30	21	25
fx deposits	-174	-499	-813	147	-87	-268	-521	-1,225	-167	-343	-525
Enterprise deposits	29	54	-292	-180	276	-67	-140	-319	268	89	264
dinar deposits	365	394	261	198	171	5	-174	-284	213	84	232
fx deposits	-336	-340	-554	-378	105	-72	34	-35	55	5	32
Foreign liabilities	564	601	138	-165	299	186	-558	-1,271	-196	40	90
Capital and reserves	-144	-855	-1,144	-572	424	212	78	114	72	77	78
Gross foreign reserves(-,decline in assets)	-333	-386	-316	-18	-407	-449	-5	311	53	-120	197
Credits and Investment <sup>1)</sup>	697	1,175	2,888	700	156	1,057	1,980	2,844	397	1,279	1,281
Credit to the non-government sector, total	614	1,402	2,595	2,022	226	381	696	1,183	411	1,264	1,669
Enterprises	406	915	2,099	1,574	331	465	700	1,097	319	897	1,142
Households	207	487	496	448	-104	-84	-4	86	91	368	527
Placements with NBS (Repo transactions and treasury bills)	116	-126	361	-1,419	40	256	694	625	-125	-445	-839
Government, net <sup>2)</sup>	-33	-101	-68	98	-110	421	590	1,036	112	460	451
MEMORANDUM ITEMS											
Required reserves and deposits	-369	-275	-97	-225	-191	-225	-185	36	54	-182	-188
Other net claims on NBS <sup>3)</sup>	6	246	28	422	-385	-380	-481	-158	-287	-272	-195
o/w: Excess reserves	0	207	-13	443	-409	-394	-501	-177	-279	-252	-173
Other items <sup>4)</sup>	-202	-192	-490	-330	-166	-158	-254	-99	-147	-331	-692
Effective required reserves (in %) <sup>5)</sup>	30	29	28	30	30	28	26	25	26	24	24

Table T7-5. Serbia: Banking Sector Activity – Sources and Structure of Lending, Adjusted<sup>1)</sup> Flows, 2008–2010

Source: Table P-14 in Analytical Appendix

1) The calculation of the increase in lending is based on the assumption that 70% of the total lending is euro-indexed. The increase for the original dinar values of deposits was calculated based on the average exchange rate for the period. For foreign currency deposits - as the 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 the new calculations of all other items.

NBS securities include treasury bills and NBS bills that sell at the repo rate and at the rate set by the market in auctions of maturities exceeding 14 days.
Net credits to the state: credits granted to the state less state deposits held with commercial banks. The state includes all levels of government: the Republic and local governments.

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

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

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

An increase in household deposits in Q2, which was neutralized by the decline in corporate deposits along with banks' repayments to foreign creditors resulted in a decline in sources for new bank lending

The slight growth of domestic deposits along with banks' repayment to foreign creditors led to a decline in sources for new bank lending in Q3. Sources for new bank lending in Q3 shrunk by  $\notin$ 49 mn (in Q2 they grew by  $\notin$ 110 mn, Table T7-5). This decline occurred as a result of banks' repayments to foreign creditors amounting to  $\notin$ 50 mn, with a minimal growth of domestic deposits of  $\notin$ 3 mn. As part of domestic deposits, household deposits recorded a growth of  $\notin$ 177 mn in Q3, exclusively through increase of foreign currency deposits. On the other hand, companies decreased their deposits by  $\notin$ 175 mn, which fully neutralized the effect of the household deposits growth on the sources for new bank lending.

#### Table T7-6. Serbia: Borrowing of Companies and Households, 2008–2010

		20	08			20	09			2010	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
				qua	arterly grow	rth of stock	, in millions	s of euros			
Total loans to enterprises and households from domestic banking sector and direct foreign borrowing by enterprises	1,333	1,624	2,174	468	82	-10	71	329	311	539	271
Loans to enterprises and households from domestic banking sector	614	789	1,157	152	226	158	315	488	411	854	405
Loans to enterprises	406	509	1,162	135	331	138	235	398	319	577	246
Loans to households	207	280	-6	17	-104	20	80	90	91	276	159
Direct foreign liabilities of enterprises	719	835	1,017	316	-144	-167	-244	-159	-100	-315	-134
Direct foreign liabilities of enterprises and banks' credits to enterprises from domestic banking sector	1,125	1,344	2,179	451	187	114	158	239	219	263	112
				quai	terly growt	h of stock,	n % of qua	rterly GDP			
Total loans to enterprises and households from domestic banking sector and direct foreign borrowing by enterprises	17.4	18.3	23.8	5.5	1.2	-0.1	1.0	3.9	3.7	6.8	3.6
Loans to enterprises and households from domestic banking sector	8.0	8.9	12.7	1.8	3.3	2.3	4.6	5.8	4.9	10.7	5.3
Loans to enterprises	5.3	5.7	12.7	1.6	4.8	2.0	3.4	4.7	3.8	7.2	3.2
Loans to households	2.7	3.1	-0.1	0.2	-1.5	0.3	1.2	1.1	1.1	3.5	2.1
Direct foreign liabilities of enterprises	9.4	9.4	11.1	3.7	-2.1	-2.4	-3.6	-1.9	-1.2	-3.9	-1.8
Direct foreign liabilities of enterprises and banks' credits to enterprises from domestic banking sector	14.7	15.1	23.9	5.3	2.7	1.7	2.3	2.8	2.6	3.3	1.5
Source: FREN											
1) See footnote 1 in Table T7-5.											

The share of corporate loans decreased to 69.2% of GDP in Q3 (in Q2 this share amounted to 71.6% Table T7-7). This decline can be explained by weaker corporate and household borrowing, which, along with the negative cross-border credit growth pushed down the share of loans in the GDP, while the negative effect of the depreciation of the dinar was reduced compared to the previous quarters.

Table T7-7. Serbia: The Ratio of Outstanding Credit Stock to Companies and Households to GDP, 2008–2010

		2	008			20	009			2010	
	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	65.3	66.3	70.2	80.6	84.9	81.9	80.1	81.7	83.4	86.6	86.2
Loans to enterprises and households from domestic banking sector Loans to enterprises Loans to households	36.7 23.0 13.7	36.9 23.4 13.5	38.5 25.7 12.8	42.0 27.6 14.5	44.5 29.8 14.7	43.8 29.5 14.3	43.9 29.7 14.2	45.1 30.5 14.7	46.8 31.7 15.1	49.9 33.6 16.3	51.7 34.6 17.0
Direct foreign liabilities of enterprises	28.7	29.4	31.7	38.6	40.5	38.1	36.2	36.6	36.6	36.6	34.5
Direct foreign liabilities of enterprises and banks' credits to enterprises from domestic banking sector	51.7	52.8	57.4	66.2	70.2	67.6	65.8	67.0	68.3	70.3	69.2

### **The Central Bank: Balances and Monetary Policy**

The decline of reserve money was reduced in Q3 despite the fall in NBS net own assets...

...owing to the positive effect of NDA increase

The fall in *reserve money* noted at the beginning of the year was stabilized in Q3, in which a minimal change of the situation was recorded of -0.3% of the initial H (in Q2 it recorded an 11.1% decline, Table T7-8). Due to interventions on the interbank foreign currency market, NBS net own assets additionally declined in Q3, by 26.3% of initial H. Nevertheless, this negative effect was neutralized owing to the significant growth of net domestic assets (NDA) which increased by 26.1% of initial H in Q3 (4.8% growth in Q2), primarily owing to the withdrawal of commercial banks' funds from REPO investments. The NBS did not change its reserves requirement levels in Q3<sup>5</sup> for dinar and foreign currency deposits, but as a consequence of the effects of the new measures enforced pursuant to the amendments to the Decision<sup>6</sup> on Banks' Reserve Requirements, the growth of the banks' dinar liquidity continued.

#### Table T7-8. Serbia: NBS – Currency Purchases and Sterilization, 2008–2010<sup>1)</sup>

		200	08			20	09			2010	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
FLOW				in millions	of dinars, cum	ulative from	the beginnin	g of the year			
NBS own resreves <sup>2)</sup>	4,695	19,115	56,373	27,211	-5,590	-12,043	29,771	64,094	-37,703	-76,916	-141,888
NBS own reserves (in euros)	58	237	706	312	-59	-128	319	668	-378	-743	-1,346
NDA	-39,752	-13,347	-66,941	122,232	43,117	-54,266	-118,637	-126,108	-712	11,197	75,454
Government, dinar credits	267	618	0	81	-308	-310	-310	398	5	-9,946	-9,942
Government, dinar deposits	-28,386	-41,088	-36,706	8,638	-17,155	-8,376	3,021	-40,135	6,554	11,738	19,401
o/w: municipalities	-8,329	-7,405	-5,073	-909	-4,415	-2,026	2,199	3,130	1,450	1,322	2,270
Repo transactions <sup>3)</sup>	-11,243	8,014	-28,597	127,517	-8,455	-29,024	-69,849	-61,506	12,105	34,979	87,176
Other items , net <sup>4)</sup>	-390	19,109	-1,638	-14,004	-17,199	-16,556	-51,499	-24,865	-19,376	-25,574	-21,181
н	-35,057	5,768	-10,568	149,443	-48,707	-66,309	-88,866	-62,014	-38,415	-65,719	-66,434
o/w: currency in circulation	-6,613	-7,454	-5,388	13,007	-11,856	-9,009	-7,193	5,566	-9,663	-7,841	-5,771
o/w: excess liquidity	-39,840	-22,293	-39,483	1,602	41,330	-41578	-51043	-14227	-33665	-30871	-21232
INCREASE					cumulati	ive, in % of o	pening H <sup>5)</sup>				
NBS own resreves <sup>2)</sup>	3.5	14.3	42.1	20.3	-1.8	-3.9	9.6	20.8	-15.3	-31.2	-57.5
NDA	-29.7	-10.0	-50.0	91.3	-14.0	-17.6	-38.4	-40.9	-0.3	4.5	30.6
Government, dinar deposits	-21.2	-30.7	-27.4	6.4	-5.6	-2.7	1.0	-13.0	2.7	4.8	7.9
Repo transactions <sup>3)</sup>	-8.4	6.0	-21.4	95.2	-2.7	-9.4	-22.6	-19.9	4.9	14.2	35.4
Other items , net <sup>4)</sup>	-0.3	14.3	-1.2	-10.5	-5.6	-5.4	-16.7	-8.1	-7.9	-10.4	-8.6
н	-26.2	4.3	-7.9	111.6	-15.8	-21.5	-28.8	-20.1	-15.6	-26.7	-26.9
o/w: currency in circulation	-4.9	-5.6	-4.0	9.7	-3.8	-2.9	-2.3	1.8	-3.9	-3.2	-2.3
o/w: excess liquidity	-29.7	-16.6	-29.5	1.2	-13.4	-13.5	-16.5	-16.5	-13.7	-12.5	-8.6

Source: Table P-14 in Analytical Appendix

1) "State" includes all levels of Government: the Republic and local government.

2) For more details see section 8 "Monetary Flows and Policy", Box 4, QM5.

3) This category includes NBS T-bills and repo operations.

4) Other net domestic assets include: domestic credits (net claims against banks, excluding NBS T-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. 5) "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.

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<sup>5</sup> For a detailed overview of the NBS banks' reserve requirements, please see Table T7-9, QM21.

<sup>6</sup> At the beginning of March, NBS adopted the Amended Decision on Banks' Reserve Requirements, which provided to decrease the reserve requirement levels for the dinar and foreign currency base.

		200	07			200	8			200	19			2010	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
							stock, i	n millions of e	uros						
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	5,940	5,609	5,438	5,211
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	-3,519	-3,667	-3,633	-3,258
Gross foreign reserves	693	712	690	1,403	1,070	1,017	1,087	1,385	978	936	1,380	1,694	1,750	1,589	1,906
Foreign liabilities	-3,906	-3,630	-3,688	-3,782	-3,218	-3,180	-3,644	-3,947	-3,648	-3,761	-4,505	-5,213	-5,417	-5,221	-5,164
NBS, net	8,626	9,048	9,345	9,495	9,394	8,931	9,557	8,013	7,975	8,036	8,694	9,459	9,275	9,070	8,469
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	10,657	10,522	10,661	10,019
Foreign liabilities	-193	-198	-190	-168	-183	-198	-170	-167	-180	-877	-857	-1,198	-1,246	-1,591	-1,551
IMF	6	1	3	4	3	1	1	-9	-14	-769	-756	-1,113	-1,160	-1,499	-1,469
Other liabilities	-200	-199	-193	-171	-186	-199	-171	-159	-166	-108	-101	-85	-87	-92	-82
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	9,459	9,275	9,070	8,469
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	-2,916	-3,031	-3,309	-3,293
1.2 Government deposits	-1,247	-1,160	-1,172	-1,034	-874	-478	-457	-459	-536	-521	-542	-513	-593	-474	-491
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	6,030	5,652	5,287	4,684
(1.3 = 1 - 1.1 - 1.2)															
						in millions of	euros, cumu	lative from th	e beginning of	the year					
NFA of Serbia	249	967	1,183	1,952	131	-348	-116	-1,665	-146	-239	118	489	-332	-503	-729
Commercial banks, net	-24	270	190	809	232	216	-178	-183	-108	-263	-564	-957	-148	-114	261
Gross foreign reserves	-14	5	-17	695	-333	-386	-316	-18	-407	-449	-5	309	56	-105	212
Foreign liabilities	-10	266	207	114	564	601	138	-165	299	186	-558	-1,266	-204	-8	49
NBS, net	274	696	993	1,143	-101	-563	62	-1,482	-38	23	682	1.446	-183	-389	-990
Gross foreign reserves	-233	194	483	610	-86	-534	65	-1,482	-25	733	1,371	2,477	-135	5	-637
Foreign liabilities	507	502	510	532	-15	-30	-2	1	-13	-710	-690	-1,031	-49	-393	-353
IMF	187	182	184	185	0	-2	-3	-12	-5	-761	-747	-1,104	-47	-386	-356
Other liabilities	320	320	327	348	-15	-28	1	13	-7	51	58	74	-2	-7	3
NBS, NET RESERVES-STRUCTURE													0		
1. NBS, net	274	696	993	1,143	-101	-563	62	-1,482	-38	23	682	1,446	-183	-389	-990
1.1 Commercial banks deposits	-148	-269	-374	-200	-2	243	66	1,219	55	-90	-280	-725	-115	-393	-377
1.2 Government deposits	63	149	137	275	161	557	578	575	-76	-61	-82	-54	-80	39	22
1.3 NBS own reserves	188	577	756	1,218	58	237	706	312	-59	-128	319	668	-378	-743	-1,346
(1.3 = 1 - 1.1 - 1.2)															

Table T7-9. The Structure of Serbia's Foreign Exchange Reserves – Stock and Flow, 2008–2010

Source: NBS Notes:

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

...which exceeded two billion euro since the beginning of the year

NBS began to increase the benchmark interest rate in response to the accelerating inflation in Q3 In order to stabilize the dinar exchange rate, NBS sold around  $\notin$ 595 mn on the interbank foreign currency market in Q3 (Table T7-10, which, together with the placements at the beginning of the year, exceeded the amount of two billion euro. As a consequence of these interventions – net own reserves decreased by  $\notin$ 603 mn in Q3 (in Q2 net own reserves decreased by 365 mn, Table T7-9). In August and then again in September, NBS increased the benchmark interest rate by 0.5 percentage points thus reversing the declining trend which had been present since the beginning of 2009. This was followed by a new increase in October by 0.5 percentage points and eventually in November the NBS decided to increase the benchmark interest rate to 10.5% prompted by the fact that the inflation broke the upper bound of the target band for this period.

#### Table T7-10. Net Monthly Foreign Currency Trade NBS – Banks and Exchange Offices, 2006–2010

	Interbank fx market (NBS-commercial banks)	Exchange offices	Total	
(-, net sale of foreign currency by NBS)				
	in mill	ions of euros		
January-December 2006	350	367.8	718	
January-December 2007	-704.8	1161.2	456	
January-December 2008	-1304	507	-797	
January-December 2009	-656.9	128.2	-529	
January 2010	-245.5	0	-246	
February 2010	-196	0	-196	-631.5 in Q1 2010
March 2010	-190	0	-190	
April 2010	-5	0	-5	
May 2010	-359	0	-359	-785.0 in Q2 2010
June 2010	-421	0	-421	
July 2010	-231	0	-231	
August 2010	-182.5	0	-183	-595.2 u Q3 2010.
September 2010	-181.7	0	-182	

# 8. Financial Markets

In Q3 the value of turnover on the stock market further decreased, but the count of transactions performed, on the Prime Market in particular, greatly increased, led by the activities of small investors. The Belgrade Stock Exchange indices continued to decline – as opposed to the indices registered on the stock exchanges in the region – but this trend took a turn at the beginning of Q4 when domestic indices started to look up again. The FFCD bond market, for the first time after almost two years, registered a rise in turnover, whereas yields continued to drop. The yield curve was still virtually flat, reflecting the investors' concerns regarding future economic growth and inflation rate movements. The yields on the Republic of Serbia T-bills continued to grow in Q3 so as to compensate for the diminished interest of investors caused by the dinar depreciation and inflation rate growth. After the slump, real repo yields started to grow in the second half of Q3 encouraged mostly by the further increase of the NBS reference rate.

The value of turnover on the Belgrade Stock Exchange continued to sink, whereas the transaction volume significantly increased

The increased

transaction volume on the share market in Q3 is owed to the Stock Exchange Prime Market The value of turnover on the Belgrade Stock Exchange continued to fall in Q3 and, with 2.7 bn dinars of turnover realized, it represents the minimum registered since 2005 (Graph T8-1). Despite the record-low turnover, Q3 saw a historical maximum number of transactions, with almost 132 thousand registered transactions. In combination with a small value of turnover, this resulted in the bottom value of an average transaction on the Belgrade Stock Exchange amounting to 20 thousand dinars, which is indicative of a great activity of small investors in the first place. The market section most accountable for this leap in executed transactions is the Stock Exchange Prime Market, where the number of transactions rocketed in August and September. As the shares of Oil Industry of Serbia (NIS a.d. Novi Sad) entered the Prime Market, it is assumed that the citizens who wished to sell their shares accounted for this activity boom. The growth in the number of transactions performed, mostly on the Prime Market section of the share market, continued in the October.



Graph T8-1. Volume and Structure of Share Trading, 2006–2010

Belgrade Stock Exchange Indices recorded a slump in Q3

Q3 saw the Belgrade Stock Exchange indices decline in value (Graph T8-2). The BELEX15<sup>1</sup>

<sup>1</sup> Index of the most liquid shares listed on the Belgrade Stock Exchange.

#### Graph T8-2. BELEXfm, BELEX15 and SRX EUR indices, 2010



Graph T8-3. Real (with regard to inflation as measured using HCPI) and Nominal Repo Yields, 2006-2010



index dropped by 2.2% while BELEXline<sup>2</sup> and SRX<sup>3</sup> EUR indices lost 0.9% and 0.8%, respectively. During the same period, the indices of other stock exchanges in the region, with the exception of the Sarajevo Stock Exchange index, registered an upward movement. Also, Q3 saw further drop in values in the turnover on the share market, whereas FFCD bond market registered its first rise in turnover, so it is safe to assume that dinar depreciation made investors drop investments in shares and encouraged them either to venture other markets in the region or to invest more in FFCD bonds denominated in EUR. However, the index movement in Q4 does not corroborate this assumption. Namely, from October to mid November, the Belgrade Stock Exchange indices showed positive trends, while indices of

Real repo yields, measured relative to inflation, declined over July and August due to inflation rate growth...

...in September these yields showed a recovery owing to the increase in the nominal repo rate

Real repo yields with regard to the euro/ dinar exchange rate, started to look up in August due to the increase in the nominal interest rate and the dinar appreciation Q4 saw growth thanks to the rise in the reference rate despite dinar depreciation stock exchanges in the region, BiH excluded, slumped, although the local currency continued to depreciate throughout this period.

Real yields, measured relative to inflation, of the NBS repo transactions amounted to 2.9% at the beginning of Q3 (Graph T8-3). During July and August, yields measured in this manner slid despite the increase in the nominal repo rate by 50bp over the same period due to the

growth in inflation rate. The beginning of September saw a drop in real yields to about 0.8%. This, followed by yet another 50bp rise in the NBS reference rate, helped increase real repo yields to 1.3%.

The depreciation of local currency affected real yields of 2w repo operations measured as nominal yields adjusted for expected movements in the euro/dinar exchange rate (changes to the exchange rate over the

Graph T8-4. Repo Yields Adjusted for Expected Exchange Rate Movements and Nominal Yields, 2006–2010



2 Overall stock index of the Belgrade Stock Exchange

<sup>3</sup> Index of the 8 most liquid shares on the Belgrade Stock Exchange as calculated by the Vienna Stock Exchange (Wiener Börse).

#### Graph T8-5. Changes in Yield Curves for RS T-bills



preceding three months<sup>4</sup>) in July (Graph T8-4). At the beginning of Q2, real yields calculated in this way approximated -8.2%, and by the end of July they slid to -17.4%. In August, the NBS changed the direction of its policy and raised the nominal rate by 50bp, which was accompanied by a mild dinar appreciation, causing real yields thus measured to go up to -1.1% towards the end of August. In September there was new dinar depreciation, but the NBS increased the nominal rate by another 50bp, which brought about the continuation of positive trends in real yields which reached 2.8% by the end of Q3.

The dinar continued to weaken in Q4 to which the NBS responded by further increasing the reference rate and so the real yields reached 6.4% by the end of October.

The yield curve of the Republic of Serbia T-bills shifted upward during Q3, i.e. T-bills of all maturities registered positive trends in their yields (Graph T8-5). Yields increased between 90bp and 335bp and at the beginning of Q4 they ranged from 11.2% to 13.4%, depending on their maturity. The curve yield is regular, i.e. T-bills yields with longer maturities exceed the yields of T-bills with shorter maturities so as to compensate investors for the increased risk of keeping investments over a longer period. Since the realization percentage of auctions held by the RS





Treasury, considered to be an indicator of investors' interest, stood at 50% on average, it may be inferred that the appeal to investors was weak. This was most probably a consequence arising equally from depreciation in the local currency and from the inflation rate growth. This drop in demand gave rise to increased yields to T-bills. The major average realization level, round 80% in Q3, was registered in thee-month T-bills which are least risky for investors given their short maturities.

After the downward trend in the values, the volume and turnover of FFCD bonds increased in

Q3. The realized volume amounted to EUR 15.8 million and the turnover was round EUR 14.2 million which is a growth of nearly 78% and 85%, respectively. The trend of reducing activities on this market commenced in Q3 2008, when the world financial crisis escalated, all the way to the last quarter which saw the lowest activity records ever – the volume and turnover mostly plummeted or stagnated compared to the preceding period.

Average yields on bonds of all maturities, continued in their downturn even in Q3 2010 (Graph T8-6). In Q3 there was almost parallel downward shift in the yield curve, i.e. depending on bond maturities, yields dropped between 36bp and 44bp. Towards the end of Q3, the curve is virtually flat with a mild inversion tendency, i.e. the yield to a bond of shortest maturity – A2011, exceeds the yield to a bond with longest maturity – A2016. The curve's steepness, i.e. the difference in yield between A2011 and A2016 bonds, stood at just 4bp. The flat yield curve generally points to investors' insecurity regarding future inflation movements and economic growth.

However, the downward trend on yields to FFCD bonds coincides with the escalation of the world economic crisis. The drop in yields speaks of an increased demand which may be explained by the investors' departure from the stock market and substituting it with safer FFCD bonds due to increased risks.

In Q3 RS T-bills yields continued to grow

The volume and turnover on the FFCD bond market climbed in Q3 after two years of slackened activity

In Q3 2010, the FFCD bond market registered a decline in average yields on bonds of all maturities

The average yield curve for FFCD bonds was virtually flat at the end of Q3

<sup>4</sup> A detailed explanation of this approach to calculating real yield rates is provided in the text entitled "The Exchange Rate and Policy of the National Bank of Serbia: 2002–2006", Spotlight on: 1, issue 5 of QM.

# 9. International Environment

Global recovery continues as expected, allaying fears of the recession double dipping. There are still risks, above all of financial system "shocks" similar to the one caused by the Greek crisis in Q2. Of the developed countries, the US is recovering faster than the eurozone, while China is still at the forefront of the developing countries. IMF projects that Central and Eastern European countries<sup>1</sup> will continue to recover.

#### Recovery continuing, risks still exist

The economy is recovering as expected at the global level, but risks to its growth still exist. The IMF projects that global economic activity will expand by 4.8% in 2010 and by 4.2% in 2011. It projects that developing countries will grow at the rate of 7.1% and 6.4% and that the developed countries will grow at the rate of 2.7% and 2.2% growth rates in 2010 and 2011 respectively. In Q3, the US economic growth rate stood at 2.5%<sup>2</sup> and its GDP approximated the pre-recession level. Projections are, however, that this growth rate is still insufficient to significantly effect a drop in the unemployment rate, standing at nearly 10%. The US FED launched a second round of "quantitative easing", entailing the purchase of long-term securities to stimulate economic activity. It plans to buy 600 billion dollars worth of securities. The euro strengthened against the dollar after the crisis in Greece calmed down and the FED announced "quantitative easing". On the other hand, uncertainties about how the problems of eurozone countries burdened by great debts would be addressed are encouraging the dollar's strengthening against the euro. The US Administration has been pressuring China to devalue its currency, wherefore the risks of a US-China trade war are not negligible. According to the initial data on the eurozone, its GDP grew by 0.4%<sup>3</sup>, a substantial although expected slowdown over the 1% GDP growth in Q2. Germany again had higher growth than the other countries (0.7%), which was primarily stimulated by export demand. There are still substantial disparities among the eurozone countries, significantly impeding the European Central Bank's endeavors to adequately formulate the monetary policy. China, India and Brazil are expected to continue supporting eurozone exports, but domestic demand is unlikely to recover significantly in 2011, largely due to the necessary savings measures. Uncertainties about the liquidity of several eurozone members increase returns on state bonds, resulting in higher borrowing costs.

	Real GDP									Inflation			
·	Real growth (%)					Real growth (%) <sup>3)</sup>				Consumer prices (%) <sup>4)</sup>			
	2007	2008	2009	2010 <sup>2)</sup>	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q1 2010	Q2 2010	Q3 2010		
USA	1.9	0.0	-2.6	2.6	0.2	2.4	3.0	3.1	2.4	1.8	1.2		
Japan	2.4	-1.2	-5.2	2.8	-1.4	4.4	2.4	4.1	-1.2	-0.9	-0.8		
China	14.2	9.6	9.1	10.5	10.7	11.9	10.3	9.6	2.1	2.8	3.5		
Euro area	2.9	0.5	-4.1	1.7	-2.0	0.8	1.9	1.9	1.1	1.5	1.7		
Germany	2.7	1.0	-4.7	3.3	-2.0	2.1	3.9	3.9	0.8	1.1	1.2		
France	2.3	0.1	-2.5	1.6	-0.5	1.1	1.6	1.8	1.3	1.6	1.5		
UK	2.7	-0.1	-4.9	1.7	-3.0	-0.3	1.7	2.8	3.3	3.4	3.1		
Italy	1.5	-1.3	-5.0	1.0	-2.8	0.5	1.3	1.0	1.3	1.4	1.6		
Russian Federation	85	5.2	-79	4.0	-29	3 1	5.2	27	7.2	5.9	62		

#### Table T9-1. World: Economic Growth and Inflation, 2007-2010<sup>1)</sup>

1) Sources: IMF, Eurostat, OECD, National Bureau of Statistics of China, Russian Federal State Statistics Service

2) The 2010 annual rates were projected by the IMF

3) Year on year GDP growth rates

4) Compared to the same period in 2009

<sup>1</sup> According to the IMF classification, Central and East Europe comprises the following countries: the Baltic states (Estonia, Latvia and Lithuania), the Central European states (Hungary and Poland), the South East European states - EU member states (Bulgaria and Romania), non-EU states (Albania, Bosnia-Herzegovina, Croatia, Macedonia, Montenegro and Serbia) and Turkey.

<sup>2</sup> Seasonally adjusted annualized quarter-on-quarter growth rate. Table T9-1 shows the corresponding y/y growth rates.

<sup>3</sup> Seasonally adjusted quarterly growth rate.

		R	(%)		Consumer prices (%)			Curren balance	t account e (% GDP)	Budget deficit (% GDP)		
	2009	Q1 2010 <sup>2)</sup>	Q2 2010	Q3 2010	2010 <sup>3)</sup>	2009 4)	2010 <sup>5)</sup> (I-IX)	2010 <sup>3)4)</sup>	2009	2010 <sup>3)</sup>	2009	2010 <sup>3)</sup>
Bulgaria	-4.9	-0.8	-0.3	0.2	0.0	2.5	3.0	2.2	-9.5	-3.0	-0.9	-4.9
Romania	-7.1	-3.2	-1.5	-2.3	-1.9	5.6	6.2	5.9	-4.5	-5.1	-7.4	-6.8
Hungary	-6.3	-1.1	0.5	2.1	0.6	4.2	3.5	4.7	0.2	0.5	-4.1	-4.2
Croatia	-5.8	-2.5	-2.5	-0.7	-1.5	2.4	1.3	1.9	-5.3	-3.8	-4.1	-5.3
FYR Macedonia	-0.8	-1.1	0.4	2.2	1.2	-0.8	1.6	1.9	-7.2	-3.9	-2.6	-2.5
BIH	-3.1				0.5	-0.4	1.1	2.4	-6.9	-5.5	-5.7	-4.5
Serbia(QM)	-3.1	0.4	2.0	1.7	1.5	8.4	7.3	6,2 <sup>6)</sup>	-6.8	-8.0	-4.3	-4.8

Table T9-2. Selected Indices in the Neighboring Countries<sup>1)</sup>

1) Sources: IMF, Eurostat and EBRD.

2) Annual growth rates, source: Eurostat (for Macedonia and Croatia: EBRD)

3) IMF projections, Regional Economic Outlook (October 2010).

4) Inflation: period average, source: IMF, Regional Economic Outlook (October 2010), for Serbia: SORS and QM

5) Growth of prices from the beginning of the year until end Q3. Sources: Eurostat, Bosnia-Herzegovina Statistics Agency, Statistical Office of the Republic of Macedonia, SORS, QM estimates. HICPs were used for Bulgaria, Romania, Hungary and Croatia and ICPs for the other countries.

6) The end-of-period corresponding inflation rate (December 2010/December 2011) stands at around 11% (stood at 6.6% for 2009 and at 7.7% for September 2010). The 2009 and 2010 data regard the period averages, while column 2010 (I-IX) regards the cumulative increase in prices in the first three quarters.

**External demand still** The countries of Central and Eastern Europe are also recovering. The IMF projects that their economic activity will grow by 3.7% in 2010 and by 3.1% in 2011. Economic growth in the region has been stimulated primarily by the recovery of exports, given the still constrained domestic demand, so that the future economic trends largely depend on the circumstances in the economies of the developed European countries. The economies in the region are distinguished by the differences between their current and pre-crisis GDP levels. Latvia's GDP is nearly 20% lower than before the crisis, Bulgaria's and Romania's by around 10%. Slovakia and the Czech Republic recovered the most rapidly, while Poland's GDP did not fall. As the post-crisis growth has depended above all on external demand, which will not soar in the short term, recovery will most probably maintain its present pace. The inflation rates vary from one country to another, but there are no risks of high inflation for now.

Inflation: various<br/>tendenciesIMF projections of inflation rates indicate various tendencies in the region – the projected mo-<br/>vement of inflation largely depends on the foreign exchange regime and level of abatement of<br/>economic activity, as well as on the impact of specific factors in individual countries - e.g. higher<br/>VAT in Romania. Nevertheless, estimates are that most countries do not risk higher inflation<br/>despite the higher food prices.

# HIGHLIGHTS

## Highlights 1. Serbia's Revised 2010 Budget and 2011 Fiscal Policy

Milojko Arsić\*

### Saša Ranđelović\*\*

Serbia's economy shows divergent trends in the past two quarters. On one side, there are signals of economic recovery based mainly on export demand, while on the other hand inflation has accelerated. The current account deficit, even though reduced, is still significantly higher than capital inflows, generating constant depreciation pressures on the dinar and on foreign exchange reserves. The depreciation of the exchange rate, in turn, accelerates inflation and damages the assets of the economy and households, which have borrowed in foreign currencies. The financing of the fiscal deficit through borrowing, the dinar depreciation and the settlement of old debts had led Serbia's public debt to 38% of GDP at the end of the third quarter, or 13 percentage points higher than two years ago.

Serbia's overall fiscal policy framework for the coming years has been determined with fiscal responsibility rules. Those rules anticipate a gradual reduction in the fiscal deficit and strict control of the public debt in the coming years. However, the question is whether Serbia has space for an expansive fiscal policy even if we temporarily neglect fiscal responsibility rules. The reasons to discuss this topic is that economists, businesses and the general public directly or indirectly propose the expansiveness of the fiscal policy through tax cuts and/or higher public spending.

High imbalances in the balance of payments, constant depreciation pressures and the accelerating inflation indicate that room for a fiscal stimulus to additionally encourage Serbia's economic recovery is definitely limited. Any likely increase in domestic demand, through higher government spending, would additionally widen external imbalances, due to which pressures to spend limited foreign exchange reserves and/or the dinar depreciation would be even greater. Under such circumstances, keeping inflation within planned<sup>1</sup> targets would require additional monetary policy tightening, through higher interest rates and other monetary policy measures. Along with an increased monetary policy restrictiveness, the volume of credits available for corporate and household clients would shrink, further reducing personal spending and investment. Falling personal consumption and investments would mean a decline in overall domestic demand, annulling the effects of the fiscal stimulus. Thus, instead of economic recovery, the final result of any fiscal expansion would be an increase in economic uncertainties (inflation, dinar depreciation), as well as crowding out of private investment and private consumption. Due to high inflation and high external imbalances, Serbia finds itself in a less favorable situation than other countries which are recovering from recession. The majority of the countries recovering from recession have inflation rate of around zero and low foreign deficit (which is not the case with Serbia), leaving them space not only for fiscal stimuli (if their public debt is not excessive), but also for an expansionary monetary policy.

The high level of public (and of external) debt, coupled with the country's low credit rating, additionally cuts space for fiscal expansion. Empirical studies show that a critical level of the external and public debt of a country with low credit rating, which is the case with Serbia, is significantly lower than the one corresponding to the usual limits for external (80% of GDP) and public debt (60% of GDP). Furthermore, with a flexible exchange rate and high indebtedness, countries with a low credit rating have a fiscal multiplier not only below 1 but possibly turning negative<sup>2</sup>. Based on the abovementioned, it can be concluded that the fiscal deficit and the public debt as defined by fiscal rules, represent the upper limit and that it would be welcome that they are below the levels allowed by the rules.

Following is the short analysis of the revised budget of the Republic of Serbia for 2010, as well as the fiscal policy framework for 2011.

#### 1. Revised Budget of the Republic of Serbia for 2010

The revised budget of the Republic of Serbia for 2010 was adopted in November, mostly adjusting official budget items on the revenue and spending side to realities between January and October, and to a lesser degree to changes in the economic policy through the end of the year. The revised budget envisages total budget revenues of the Republic at 660 billion dinars, with spending planned at 780 billion. The envisaged deficit of the Republic for 2010 is 120 billion dinars which is still consi-

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<sup>1</sup> The targeted inflation for the next year is defined at 4.5% plus/minus 1.5%, which can be assessed as a relatively high level of inflation that does not leave too much space for possible increase in targeted inflation in Serbia.

<sup>2</sup> See e.g. Reinhart C., and V. Reinhart (2009) "Fiscal stimulus for debt intolerant countries", MPRA i Ilzetzki et al. (2009), "How big are Fiscal Multipliers", CEPR, Policy Insight No. 39.

#### Highlights

The budget deficit of 120 billion dinars, planned with the revised budget, is by around 13 billion dinars bigger compared with the previously planned deficit (107 billion dinars). The increase in the planned deficit represents a net effect of a moderate increase in planned budget revenues by 3.5 billion dinars and an increase in the total amount of budget spending, by 16.5 billion dinars. The increase in the budget revenues mainly resulted from accelerated inflation in the second half of the year, i.e. the price increase above plan.

Table 1. The Incrase in Public Spending as Envisaged by the Revised Budget of the Republic

The increase in certain categories of public spending					
Pensions	13.5				
Social protection	3.0				
Debt rapayments for communal services	3.0				
Additional subsidies for the real sector	2.1				
One-off aid to public sector employees	2.0				
Urgent assistance for Kraljevo	1.0				
Transfers to municipalities and MUP	1.0				
Education	0.9				
Interventions in the milk market	0.7				
Replenishing mazouth for commodity reserves	0.4				
Savings made on spending for expropriation, capital spending and other spending	(11.0)				
Total (net) increase in budget spending	16.5				
Source: Ministry of Finance of the Republic of Serbia					

The net increase in budget spending of the Republic by 16.5 billion dinars is the result of a gross increase in current spending items by 27.5 billion dinars and a reduction in capital spending by around 11 billion dinars. The growth in public spending has mainly resulted from an increase in spending on pensions, which rose by 13.5 billion dinars (around 0.4% of GDP) under the revised budget. The increase in pension spending had resulted from the payment of one-off aid to pensioners and from increased transfers to the PIO fund to ensure regular pension payments. The need for additional transfers to the PIO fund shows that the collection of social contribution payments in 2010 has weakened, due to a declining number of workers and due to further deterioration in contribution payments. Also, the revised budget envisages additional, relatively significant funds for social protection, repayment of debt arrears, payments of subsidies, transfers to local governments, etc. Savings made in capital spending were due to delayed implementation of some big infrastructure projects, which is difficult to justify, considering that this is the third year of this cabinet's term and that there was plenty of time in the past to eliminate any inherited obstacles (bad expropriation law, a lack of projects, a lack of financing etc.). the reduction of public investments compared with the plan contributes to the deterioration of the structure of public spending, resulting in negative consequences for the recovery of the economy<sup>3</sup> and its future growth. Also, speaking of capital projects that are due to be completed in the coming period, the reduction in capital spending in 2009 in fact only means their postponement, i.e. a transfer of the resulting deficit, to a point of time in future.

Even though it is inconvenient that the share of current spending has grown at expense of capital spending, the revised budget has improved the structure of public spending. The main part of the spending increase relates to social purposes, for which Serbia has never set aside sufficient funds. The payment of debt arrears, increased transfers to local governments, as well as higher subsidies for agriculture – represent positive changes in the fiscal policy.

From a macroeconomic point of view – the revised budget continues a fiscal policy in place in the previous part of the year. That means further balancing between stimuli for economic recovery and risks of accelerating inflation and expanding external imbalances. The revised budget itself has no significant impact as it is not likely to significantly affect macroeconomic aggregates. The revised budget adjusts fiscal policy to a higher GDP without any intention to additionally significantly stimulate the economy or to curb inflation and smooth external imbalances through restrictive measures.

#### 2, Fiscal Policy Framework for 2011

The global fiscal policy framework for 2011 has been set by the fiscal responsibility rules<sup>4</sup>. In line with those rules, the consolidated deficit of the government will be 4.1% of GDP or around 140 billion dinars in 2011. Consolidated public revenues can be relatively accurately assessed based on expected real growth of macroeconomic aggregates (consumption, wages, imports, etc), inflation, exchange rate etc., as well as based on so far adopted/agreed changes in tax and customs policies. The forecast public revenues in 2010 were based on an expected real GDP growth of 3%, spending increase weaker than GDP growth, inflation of 4.5%. so far adopted/agreed changes in tax and customs policies will lead to a reduction in public revenues against GDP. A continued implementation of the Stabilization and Association Agreement with the EU will lead to a fall in customs revenues by around eight billion dinars, while the lifting of a mobile telephony tax will result in a 6 billion dinar fall in fiscal revenues. Some additi-

<sup>3</sup> Most of empirical research shows that public investments have the biggest multiplying effect on an economy.

<sup>4</sup> According to the budget calendar, the government of the Republic of Serbia is obliged to adopt the draft budget for the next year by November 1 of the current year. However, at the time of preparation of this analysis, the government had not yet adopted the Las on the Budget of the Republic of Serbia for 2011. Instead, the public has been notified only of global framework agreed with the IMF, as well as some key measures to achieve those goals.

onal revenue can be generated based on a property tax reform, higher excise duties on cigarettes and possible lifting of some tax relief on the capital gains tax, but the expected cumulative effects of those measures are relatively modest and would not exceed eight billion dinars. Also, some funds can be generated from a better control of social contribution payments. Based on previous calculations, it turns out that consolidated public revenues could amount to 38.6% of GDP next year.

Along with projected revenues and the given deficit consolidated public spending in 2011 can be around 42.7% of GDP. In the introductory part, we listed arguments against public spending and the fiscal deficit being higher than those defined by the fiscal responsibility rules. Therefore, the key question is whether it is possible to fit individual spending items in a general framework for state spending in 2011. The answer to that question is positive, only under condition that some major public spending items are significantly reduced from their planned levels. The key measure to bring spending to sustainable levels is to significantly reduce the January indexation of wages and pensions<sup>5</sup>. Instead of indexation by the full amount of inflation over the past six months, which would be around 5%, pensions and wages will rise in January by 2% the most<sup>6</sup>. This measure will ensure savings of around 0.8% of GDP. However, the mentioned savings will not be enough to achieve the goals defined by the fiscal rules, therefore, additional savings of around 1% of GDP are needed. At the time of preparing this QM issue, details of planned savings have not been made public, but they would have to encompass a relatively large number of the current spending items. One of important savings measures planned for the next year is the freeze of subsidies at the 2010 level. The announced increase in transfers to local governments by 25% compared with this year, with additional revenues based on the property tax reform, will create conditions to limit the maximum level of local taxes, which over the past years, in some local municipalities reached excessive levels.

The 2011 fiscal deficit will be financed through further borrowing in the local market (Treasury bill issues, borrowing from local banks) as well as through borrowing abroad (World Bank and other international financial institutions). Besides, it is expected that part of the fiscal deficit, created based on big infrastructure projects, is financed from Telekom Srbija privatization revenue.

As the IMF arrangement is ending in the course of 2011, which is at the same time the first year of implementation of newly adopted fiscal responsibility rules, the 2011 fiscal deficit in line with the fiscal rules is very important for the achievement of medium-term macroeconomic goals. The violation of those rules in the first year of their implementation would have an extremely negative impact on economic policy credibility, with negative consequences for the country's credit rating and foreign capital inflows, whether in the form of credit or foreign direct investment. In that respect, the projected fiscal deficit of 4.1% of GDP is considered as adequate. However, the absence of a significant change in the structure of public spending, in favor of higher public investments, will be unfavorable. Therefore, the drafting of the budget and fiscal policy for 2011 should take into account a possibility to make additional savings in some significant public spending items, to release funds to finance public investments.

The implementation of a proposal of Deputy Prime Minister Mladjan Dinkic7 to spend a half of the Telekom Srbija privatization revenue to repay expensive credits - would significantly contribute to a long-term sustainability of public finances. By doing so, the public debtto-GDP ratio would fall by 2-3 percentage points. Also, some savings would be made in the cost of financing, because expensive credits (e.g. to the London Club of creditors) would be replaced with cheaper credits to build infrastructure. Additional advantage of this proposal is that drawing credits from international institutions will assume that projects the money is spent on are subject to economic sustainability tests, which would not be the case for projects indirectly financed with privatization revenues. Finally, using part of the Telekom Srbija privatization revenue to repay expensive credits - should ensure that the funds are not spent on financing current consumption (wages, pensions, subsidies, etc). The very awareness of budget recipients (workers, pensioners, subsidy beneficiaries) that the government has significant funds on its accounts in the pre-election year, could encourage budget beneficiaries to put pressure on the government in order to get access to some of those funds.

<sup>5</sup> The idea itself to increase wages and pensions in January 2011 was disputable since the moment it was unveiled to the public. In paradox, the idea was initiated by the government and trade unions have come up with their own demands only later. Already at the time it was possible to assess that the implementation of the plan will create major problems for public finances. The reduction of the wage increase from e.g. 5% to 2% only reduces the scope of the problem, but does not solve the problem. An additional problem is that the lower than initially promised increase in wages and pensions damages the credibility of the government, but that is the necessary price to pay to give up unsustainable policies.

<sup>6</sup> The increase of wages and pensions in January by 2% is contrary to the fiscal responsibility rules which envisage wages and pension adjustments in January 2011 for inflation rate in the previous six months. Therefore, it is necessary to change fiscal responsibility rules along with the budget for the next year, so that there are no demands for the government to pay the difference between the levels defined by fiscal responsibility rules and those established by the 2011 budget.

<sup>7</sup> Even though this idea was supported by most economists, it had become politically relevant once it was accepted by Deputy Prime Minister Mladjan Dinkic.

# Highlights 2. Supporting Investment and Employment in Serbia: subsidies versus business environment improvement

#### Milojko Arsić \*

In order to stimulate domestic and foreign investment and employment over the past few years, the Government of the Republic of Serbia has pursued a policy of low tax rates, high direct subsidies, generous tax incentives and "soft" budget credits. Despite such incentives, the investment rate in Serbia has remained low and unemployment rate high. Based on that, it cannot be concluded that the listed state-intervention measures have not had a positive impact on employment and the economy - it is possible that investments would have been even lower and unemployment higher in case of the absence of those incentives. However, high spending and modest results of the policy of subsidies beg a series of questions about its efficiency and possible alternatives. First, the question is whether an increased investment and employment rate, resulting from subsidies, was profitable related to the cost. It is necessary to include in the cost of subsidies not only direct budget spending but also administrative costs related to subsidies, as well as long-term loss in efficiency resulting from subsidyrelated distortions. Eventually, the question is whether the implementation of some other measures, such as an improvement of the business environment, would more efficiently lead to an increase in investments and employment.

Overall, tax rates in Serbia are low compared with tax rates in European countries. From an investment point of view, the capital gains tax is an especially important tax, and at 10% in Serbia, it is one of the lowest in Europe. Along with the low capital gains tax, investors are granted numerous tax reliefs and tax holidays, so that an effective capital gains tax amounts to 5-6% and is probably the lowest in Europe. This prompts a question whether it is justified to grant generous tax relief and holiday with an already low capital gains tax. An additional problem is that a variety of incentives and reliefs for the capital gains tax create distortions, which lower economic efficiency<sup>1</sup>. As a result of the low tax rate and a series of reliefs and incentives, the share of revenues from the capital gains tax in Serbia stood at 1.5% of GDP before the crisis, which is significantly below a

weighted average of 2.7% of GDP in the EU. Of all 27 EU member states, only Germany had the lower share of revenues from the capital gains tax before the crisis. Other tax rates in Serbia (income tax, VAT) – are also low compared with neighboring countries. The level of social insurance contributions are relatively high, because of which the fiscal burden on labor costs is somewhat above the average in the European countries.

## a) Characteristics and Results of Subsidy Policies in Serbia

Government subsidies (state aid) represent a heterogeneous group of incentives, which can be classified in three basic groups according to the nature of approval: *direct subsidies, tax incentives and favorable* (subsidized) *loans.* State subsidies are being approved for a variety of purposes, such as: to encourage employment, develop small and medium enterprises, overhaul and restructure enterprises, etc. Also, significant funds are being approved to subsidize certain sectors, such as agriculture, transportation, mining, tourism and more balanced regional development.

The share of subsidies in the Serbian GDP over the past few years was significantly above the average seen in new, as well as old EU member states. During the pre-crisis year of 2008, the share of subsidies in Serbia's GDP was 3.6 times higher than the EU average<sup>2</sup>, while the share of subsidies in Serbia's GDP was almost double the average of the EU-member states of central and south-east Europe<sup>3</sup>. Of those countries, only Hungary had a higher share of subsidies in its GDP than Serbia.

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<sup>1</sup> Inadequate bookkeeping treatment of some items in companies' balance sheets, creates additional distortions in taxing capital gains. See unpublished masters degree paper by Dragan Draca 'International financial reporting standards and taxation of capital gains in Serbia'. Due to inadequate bookkeeping treatment of some balance-sheet items, tax liabilities of some companies can be significantly increased and some other reduced.

<sup>2</sup> For the sake of comparison with the EU, subsidy figures exclude subsidies for agriculture, fishing and transportation. In the EU countries, subsidies for agriculture are being financed from the EU budget, accounting for 0.6% of EU's GDP, but the share of subsidies varies from country to country. Over the past decades, there is a trend of the falling share of subsidies for agriculture in the EU budget, as a result of resistance from the member states which do not have significant agriculture production, but also as a result of pressures on the EU from the World Trade Organization. It is expected that the EU will continue to lower spending on agriculture in the future. In Serbia, the share of subsidies for agriculture stood at around 1% of GDP, falling to 0.5% of GDP in 2009. Subsidies for transportation fully refer to Železnice Srbije and their share in Serbia's GDP stood at around 0.4%/

<sup>3</sup> The Report on granted state aid does not include some forms of subsidies such as a free allocation of land to build business facilities or the sale of land at prices below their market value. Besides, some state subsidies are created indirectly, via public enterprises. Also, some subsidized loans in 2009 were not included in the Report. That's why it is assessed that the real size of state subsidies in Serbia exceeds the volumes mentioned in the Report.

Table 1. Government Assistance in Serbia and the EU in 2008, Excluding Aid to Transportation, Agriculture and Fishing, % of GDP

e: The report on granted government assistance in the Republic of Serbia in 2009, try of Finance						
Serbia	1.5					
Poland	0.8					
Romania	0.47					
Bulgaria	0.12					
Slovakia	0.42					
Czech Republic	0.78					
Slovenia	0.66					
Hungary	1.81					
EU 12 new members	0.72					
EU 15 old members	0.4					
EU 27 members	0.42					

Economic subsidies in Serbia over the past years, as percentage (%) of GDP, significantly varied which could indicate an absence of a long-term policy of subsidies. In the period 2003-2005, subsidies had mostly declined as percentage of GDP, and then mainly increased.

Sourc

Minis

Graph 2. State Aid, Excluding Agriculture, Fishing and Transportation



Looking at the instruments of approval, within subsidies - an almost equal share is seen at tax incentives and direct subsidies, with a relative importance of tax incentives over the past three years expanding and the relative importance of direct subsidies shrinking. Within the category of direct subsidies, subsidies to small and medium enterprises represent the most important component, with the share in total subsidies moderately increasing over the past three years - to close to 42% in 2009. The second, by importance, are direct subsidies for new jobs, with the share in total subsidies in the course of 2007-2009 tripled to 18% in 2009. Third come subsidies to the railway company Železnice Srbije, with a share in direct subsidies in 2009 of 14%. The decline in direct subsidies for the restructuring and overhaul of companies has accelerated, but their share stood at

Incentives approved for the capital gains tax dominate the group of tax incentives, while tax holidays for the income tax based on employment of certain labor groups are far less important.

Subsidized loans represent the third instrument of state aid, which according to official figures had a 15% share in total subsidies in 2009 (it is worth notifying that real subsidies from this category were probably higher than those represented in the Report). In the case of credits, state subsidies result from a difference between market interest rates and lower interest rates for the lending approved by state institutions (the Development Fund and the Export Insurance and Financing Agency).

# Table 3. State Aid in Serbia, According to Instruments of Approval (% of GDP)

	2007	2008	2009
Total	2.1	1.9	2.3
Direct subsidies	1	0.9	0.9
Tax incentives	0.7	0.6	1.1
Favorable loans	0.4	0.5	0.3

Source: The report on granted government assistance in the Republic of Serbia in 2009, Ministry of Finance Note: Subsidies for agriculture are excluded (transportation is included)

The biggest share of subsidies, direct or indirect, is designed to increase employment and investments. An economic justification for subsidies lies in the fact that they reduce private cost of labor and capital and therefore encourage employment and investment. Empirical studies around the world show that those measures, under certain circumstances, can have a positive impact on employment and investments, but that impact is usually not worth the cost<sup>5</sup>. Despite a high share of subsidies in GDP, the investment rate in Serbia over the whole of the previous decade was significantly lower, and the unemployment rate significantly higher than the average in the countries of Central and Southeast Europe<sup>6</sup>.

<sup>4</sup> A detailed presentation of the structure of subsidies according to the purpose can be found in the Report on granted state assistance in the Republic of Serbia, Ministry of Finance.

<sup>5</sup> See e.g.. Hungerford, T. and J. Gravelle (2010) "Business Investment and Employment Tax Incentives to stimulate the Economy", *Federal Publications*, Paper 701.

<sup>6</sup> Interestingly, Hungary is the only country of Central and Southeast Europe with a higher subsidy rate than Serbia and a lower investment rate than Serbia in 2008.

	Investment	Rate of
	% of GDP	unemployment
Bulgaria	33.4	5.6
Czech Republic	24	4.4
Estonia	29.3	5.5
Latvia	30.2	7.5
Lithuania	24.8	5.8
Hungary	20.1	7.8
Poland	22	7.1
Romania	33.3	5.8
Slovenia	28.9	4.4
Slovakia	25.9	9.5
Croatia	27.6	9.8
Macedonia	23.7	-
Average value without Serbia	26.9	6.7
Serbia	23.2	14
ource: Eurostat, SORS		

Table 4. Investments in Fixed Funds and the Unemployment Rate in 2008

However, it can be assumed that state subsidies in Serbia have had a certain positive impact on employment and investments. *Under other unchanged circumstances*, employment and investments would have probably<sup>7</sup> been lower than in the absence of subsidies. The question is, however, whether those results are worth their cost, as well as whether better results would have been achieved with other measures at the same cost. Serbia has spent on various subsidies, excluding subsidies for agriculture, more than 2% of GDP, and a logical question is whether better results would have been achieved if part of the mentioned funds was, for example, invested in the construction of infrastructure, fight against corruption, simplification of rules and their improved implementation, an improved anti-monopoly policy, etc.

To evaluate the results of subsidies, it is necessary to calculate the resulting distortion as part of their longterm costs. Subsidies frequently change relative prices, giving wrong signals about the economic justification of a certain project. Considering that a society assumes financing of a part of private costs through subsidies, while the results stay exclusively in the private sector – it cannot be excluded that subsidies are being approved for some projects that are not socially justified but are profitable for the private sector.

Considering that subsidies are not available to all market participants, they frequently violate the conditions of fair competition, which is particularly seen in a situation of widespread corruption. Some of interventionist measures also create ground for abuse on the part of subsidy beneficiaries. The longer the subsidies are in place, the greater a chance for abuse to expand.

An excessive reliance on interventionist measures leads to a neglect of reforms that would have improved business environment. The choice of those measures is understandable to a degree, from a political economy point of view, because they yield quick results which are obvious and can be directly linked to certain politicians. On the other hand, measures to improve business environment yield results in the longer run, their effects are dispersed and they cannot be easily capitalized on. As a rule, subsidies are discretionary and can be directed to certain regions or to certain social groups to strengthen the support of the electorate.

The choice of subsidies as a way to encourage investments and employment, instead of activities that improve economic environment, can be explained by the fact that an improvement of the business environment would lead to a significant realocation of income, i.e. it would mean the loss of privileges for various interest groups (monopolists, some suppliers, etc) as well as the loss of rent divided by businesses, bureaucrats and political parties.

The employed in public administration at all levels have an interest to obstruct an improvement of the economic environment in order to maintain discretionary powers and the rent resulting from a disorderly system. The slowdown in so-called guillotine of laws well illustrates the obstruction of activities designed to lower the discretionary powers of the bureaucracy and the resulting benefits. This means that bureaucracy, at all levels of power, is strongly encouraged to obstruct the improvement of the economic environment.

Finally, abandoning the policy of generous subsidies and a shift to a policy of improvements of the business environment is directly opposed to interest of various influential groups. Those groups typically comprise beneficiaries of state subsidies as well as interest groups which reap advantages from an existing business environment compared to a situation they would find themselves in a well-organized competitive environment.

# b) Business Environment in Serbia and Possibilities of its Improvement

The low investment rate and high unemployment, despite significant direct and indirect subsidies, indicates the existence of some other important obstacles hampering the level of investments and employment. One of the possible ways to identify obstacles to investment and

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<sup>7</sup> The effect of subsidies can also be negative if they crowd out some efficient, private-sector activities.

to an increase employment in Serbia, are the rankings on the lists of competitiveness published by the World Economic Forum and the World Bank. According to the latest assessment of the Forum, Serbia ranked 93<sup>rd</sup> in terms of global competitiveness. The list of fields that need improvement is long, and this time our focus is on those assessed as effective obstacles to investment and employment in Serbia.

From an economic point of view, an unfavorable business environment generates certain costs and risks for the private sector, consequently having a negative impact on investments and employment. The improvement of the investment and business environment should lead to lower costs and risks of doing business, with key aspects:

- The elimination of administrative barriers,
- Clampdown on corruption,
- The construction and upgrade of infrastructure,
- Improvement of competition policies,
- Strengthening of financial discipline,
- Regulation of ownership issues.

Administrative barriers in the form of complex, nontransparent and unnecessary procedures, increase the cost of doing business in Serbia in various ways. The most recent assessments by the World Economic Forum rank Serbia 129th in the world in terms of regulatory burdens on the economy. Demands to fill in unnecessary and complex forms, or the requirement to obtain a large number of licenses, directly increase the cost of doing business. Besides, the time the companies spend on waiting for a license, opinion, interpretation of certain rules, etc. from government institutions can also be treated as a form of cost slowing down business in Serbia. In the modern world, where the time value of money is an important factor in business decision making, waiting for a construction permit for more than a year, as is the case in Serbia, represents such a cost that can hardly be made up for with low taxes or state subsidies. Similarly, long waiting periods for an opinion from government institutions also affect the business.

The elimination of administrative barriers in Serbia has started with so-called guillotine of laws. After initial positive results, it seems that the process has significantly slowed down in 2010, while there has been no simplification or the abolishment of the rules that make doing business in Serbia difficult. Therefore, it would be necessary in the coming period to focus on regulations that effectively restrict business activities rather than the abolishment of outdated rules that have no impact. The guillotine of laws should be a *permanent* activity of the government, counterbalancing its *permanent* need to bring complex, and sometimes unnecessary regulations.<sup>8</sup>

One of serious obstacles to investment, which damages Serbia's investment environment, is a high degree of corruption. According to the Transparency International research, Serbia ranks 83rd on a corruption perception index in the world and fares worse than the majority of countries in Central and Southeast Europe, with the exception of Bosnia-Herzegovina and Albania. Based on statements of business leaders it can be concluded that the degree of corruption is particularly high on local government levels. The bribe companies pay to corrupt state officials represents a form of an additional tax paid by entrepreneurs and enterprises. Considering the middlemen and the risks, the cost of corruption exceeds the amount of funds paid as a bribe to state officials. The existence of corruption has an excessive negative impact on the business environment, because it damages the level playing field, which is essential for any economic progress. The high degree of corruption has a negative impact on foreign investors, because some of them avoid doing business in countries where bribing officials is the condition for a business success. The abolishment of unnecessary and the simplification of other rules is vital for the clampdown on corruption. On top of lengthier prison sentences, it is also necessary to tighten sanctions for corrupt officials, to include the confiscation of property financed by bribe money, as well as the permanent ban on public sector employment.

The present state of infrastructure in Serbia can be assessed as unsatisfactory. According to the World Economic Forum's assessments, Serbia ranked 107<sup>th</sup> according to this indicator. Such a state of infrastructure is the consequence of an exceptionally low level of investments during 1980s and 1990s, but also because of the damage caused by NATO bombing. The progress, made over the past ten years of transition, mainly consists of the upgrade of the existing infrastructure, while the construction of the new infrastructure was relatively modest. The exception is the mobile telephony sector, which has made a very dynamic development during the past ten years, as a result of liberalization and the presence of new, relatively cheap technologies.

The construction of modern transportation, energy and telecommunications infrastructure indirectly contributes to the reduction of the cost of doing business in Serbia. The developed transportation infrastructure cut

<sup>8</sup> E.g. it is unclear if new rules, which refer to the construction industry, eliminate old obstacles and introduce new ones.

telecommunications infrastructure cuts the cost of the transfer of information. A reliable supply of electricity, gas and other forms of energy and their availability across the Republic is equally necessary to keep production processes uninterrupted. The developed infrastructure leads to significantly higher revenues due to a transfer of goods, passengers, energy and information across Serbia's territory.

An efficient functioning of the goods markets in Serbia represents an important condition for long-term, sustainable economic growth. That implies the improvement of the existing legal framework for the competition policy<sup>9</sup>, an upgrade of the expert capacities of the Commission for the Protection of Competition and an efficient practical implementation of the legal framework. Legal changes implemented in 2009 eliminate some of the key weaknesses of the previous law, but new legal solutions have certain shortcomings<sup>10</sup>. In the coming period, the greatest progress is required in the field of improving the expert capacity of the Commission for the Protection of Competition, as well as in the segment of sanctioning of those entities which abuse their dominant market position. Also, the liberalization of some infrastructure activities (electricity generation, railway transport, gas distribution, etc) would contribute to their greater efficiency, as it was the case with the mobile telephony.

the cost of the transport of people and goods, while the

A successful functioning of a market economy demands financial discipline, which implies that all market participants pay their liabilities in line with a contract and the law. If contractual parties are not capable of servicing their liabilities, it is necessary to implement an efficient payment collection system, receivership procedures or ultimately the elimination from the market through liquidation. Ten years after the start of transition, financial non-discipline remains widespread in Serbia, liabilities are serviced with great delays or in some cases remain unpaid. Furthermore, there are demands for the economic system to adjust to such a distorted condition, instead of changing the condition itself. Demands for VAT to be paid on the basis of collected payments are an example for requests to adjust the tax system to distorted business conditions. Instead, it is necessary to adopt measures to ensure that payment deadlines are gradually adjusted to usual business standards.

Financial non-discipline is the consequence, primarily, of a relatively large number of insolvent enterprises in

Serbia. The elimination of insolvent companies from the market is vital to establish financial discipline. That requires an efficient implementation of the receivership laws, to result in restructuring of insolvent companies with creditors' consent, a change of the owner or the liquidation of the companies. Inefficient and expensive receivership procedures also contribute to companies not servicing their debts.

A special form of financial non-discipline is represented in the behavior of companies, which boasts a dominant monopsonist position in the market, i.e. large retail chains. Such companies often condition their business partners with unusually long payment deadlines by the monopsonist (deadlines are 3-6 months), they cut the price of the product they buy and reap extra-profits. Companies with a dominant market position use others' funds free of interest, while their partners owe money to their banks, suppliers, workers and the state. Such behavior of monopsonists triggers a chain reaction through the economy, resulting in an increase in mutual debts and to illiquidity of enterprises. A possibility to impose such contracts to business partners is necessary to be taken into account as part of assessment over whether a company has a dominant position in the market. In this case, even when contracts are formally not violated, it is evident that the behavior abuses the dominant market position.

An efficient functioning of the market economy demands clearly defined ownership rights. The process of privatization of socially-owned enterprises has significantly contributed to the defining of ownership rights in Serbia. However, some segments of ownership rights are still not clearly defined, generating risks in the economy. This is primarily about resolving denationalization issues, about the privatization of the city construction land and the differentiation of ownership rights between various government levels (municipalities,, cities, provinces and the Republic).

The presence of uncertainty in terms of ownership rights, e.g. whether some property will be denationalized or not – creates uncertainty among investors, having a negative impact on the investment levels in Serbia. Even though the new constitution allows the existence of private ownership of the city construction land, legal conditions translating the right into practice have only recently been established. A partial privatization of the city construction land would contribute to an increased land trade, supporting the development of the construction industry.

<sup>9</sup> The importance of the competition policy can be understood from a famous letter sent by a group of economists – Nobel Prize winners – to Yeltsin in mid-1990s – saying that if there is a secret of success of market economies, it lies in competition, not in private ownership.

<sup>10</sup> See Ristic, B "The implementation of anti-monopoly policy in Serbia: experience to date and recommendations', *Quarterly Monitor*, No. 19

#### Conclusion

Subsidies represent an expensive and inefficient way to stimulate investment and employment, which only partially offsets weaknesses of Serbia's economic system. The end of the economic crisis would mark a convenient moment for a radical cut in subsidies. Many of the subsidizing mechanisms applied in Serbia are not in line with EU Directives, because they violate competition. Additionally, it is necessary to change the structure of subsidies to ensure significant funds to subsidize research and development activities and to improve environmental protection. In future, instead of subsidies, activities aimed at boosting investment and employment need to focus on improvements of the business environment. To make the improvements of the business environment a success, it is necessary to overcome resistance in political structures, state bureaucracy and various interest groups.

# **SPOTLIGHT ON:**

# The Effects of the Suspension of the Law on Local Government Finance on the Revenue and Expenditure Behavior of Local Governments: 2007–2009<sup>\*</sup>

Tony Levitas \*\*

This article examines the revenue and expenditure responses of local governments to the decrease in their revenues caused by the current economic downturn and by the Government of Serbia's (GoS) suspension of the transfer system put in place by the 2006 Local Government Finance Law (LGFL). The article summaries the findings of an earlier study, and extends this study through the analysis of previously unavailable expenditure data for 2009<sup>1</sup>. It also makes some concrete proposals for a new round of intergovernmental reform.

The structure of the note is straightforward. The first section briefly reviews the (shortlived) achievements of the LGFL. Here, we show how the LGFL raised local government revenues by almost 10% while simultaneously reducing the revenue gap between poorer and richer jurisdictions.

The second section examines the overall effect on local government budgets of the suspension of the LGFL and the recent economic downturn. Local government revenues declined in real terms 13%, falling to levels below those that prevailed before the implementation of the LGFL. Paradoxically, however, inter-jurisdictional equity continued to improve during the economic crises. The data also suggest that the allocation of transfers from the GoS to local governments is becoming more discretionary, and the rules-based system put in place by the LGFL is unraveling.

The third section highlights how local governments behaved in response to the steep decline in their total revenues in 2008 and 2009. Here we look first at how local governments attempted to "claw back" some of their revenue losses by more aggressively using their powers to impose and collect taxes, fees and charges. Then we look at what expenditures they cut; didn't cut; or passed off to third parties as payment arrears.

The data show that local governments significantly raised their own revenues, and that most of this growth came from better collection of the Property Tax from physical persons, and better collection of the Land Use Fee from businesses. It is unclear how fast payment arrears are rising, but it can be assumed that they are rising, and rising most steeply around Public Utility Companies (PUCs) and Budget Users.

Not surprisingly, investment spending plummeted 26% (c.17 bn RSD) between 2007 and 2009 and virtually disappeared among the poor. Subsidies to PUCs and MZs – both operating and capital – were also hard hit. The only significant type of expenditure – by economic category – that increased was Wages, which rose 9% to 41 bn RSD and now represents 21% of total local government expenditures. Much of this growth however, was due to statutory wage increases, particularly for preschool teachers who are paid by local governments, but whose wages are effectively set by the GoS.

<sup>&</sup>lt;sup>\*</sup> I am grateful to Dusan Vasiljevic and Tatijana Pavlovic-Krizanic for comments on an early draft of this note.

<sup>&</sup>lt;sup>\*\*</sup> Intergovernmental Finance expert for the Urban Institute in Washington D.C. and an advisor to the Standing Conference of Towns and Municipalities 1 Tony Levitas, "Statistical Brief for the Roundtable on Sharing the Burden of Intergovernmental Reform "Local Government Finances: Before the Law on Local Government Finance; During its Full Operation; and Under its Partial Suspension (2004, 2007, 2009) (USAID MEGA Project, May 2009) pgs. 1-21. Unless indicated otherwise, all data in the note comes from the Treasury Department of the Ministry of Finance and has been converted into 2009 values by the use of official GoS data on inflation. The population numbers used to calculate per capita values are derived from the 2002 Census.

Related to this, is the rather surprising fact that if we look at local government spending by function – as opposed to economic category – the most significant *increase* came in the area of Preschool Education: here, expenditures *rose* almost 20% – to 15 bn RSD – and spending on preschools now represents almost 9% of total local government expenditure. Less surprisingly –given the social distress that comes with recessions – social welfare spending shot up 24% – to 8 bn RSD – or 2.4% of total expenditures. Spending on the environment also rose, though less sharply and from a lower base. Or put another way, spending on everything else fell.

In the fourth and final section we make some proposals for a next round of intergovernmental reform. These proposals hinge on the restoration of a rules-based system of intergovernmental transfers. They also entail a technical change in the way the current threshold for equalization is calculated. Less specifically, but no less urgently, they require the GoS to seriously engage with the issues of property tax reform and utility regulation, as well as with role of local governments in Serbia's education system.

# I. The Achievements of the Local Government Finance Law (LGFL)

Prior to 2007 the amount of shared taxes and general grants that local governments received from the national government were determined in the annual Budget Law of the Government of Serbia and changed from year to year. This changed in 2007 with the implementation of the 2006 Law on Local Government Finance (LGFL). The LGFL introduced four fundamental changes into Serbia's intergovernmental finance system.

1. All local governments were given a 40% share of the Personal Income Taxes (PIT) collected in their jurisdictions by the national government (Article 35).

2. The size of the General Grant pool that the national government allocates to local governments for general revenue support every year was pegged at 1.7% of the value of GDP in the last year for which there is available data (Article 37).

3. An equalization rule was introduced as a first call on the allocation of the General Grant to local governments. The rule guarantees all local governments whose per capita revenues from shared taxes are less than 90% of the national per capita average of shared tax (calculated without the shared revenues of the "cities<sup>1</sup>") an equalization grant equal to the difference between their per capita PIT revenues and 90% of the national average.

4. The property tax was made a local government own revenue, and local governments were given the right to set the rate of the tax (within limits determined by the national government) and to fully administer it.

5. The changes introduced by the LGFL were designed to give Serbia a rules-based system of intergovernmental finance; to make local government grants and transfers predictable from one year to the next; and to both increase and make more equitable local government revenues as a whole. Table L1-1 below shows the main gains achieved by the LGFL.

<sup>1</sup> At the time of the passage of the LGFL, the Local Government Law of Serbia granted four local governments the status of Cities (Belgrade, Novi Sad, Niš, and Kragujevac). In 2009, another 19 local governments were granted this status, bringing the number of cities to 23. Since most of these new cities are richer than the average jurisdiction the national per capita average of PIT revenues has effectively declined for equalization purposes under the LGFL. We address this problem later in the article.

	2006		2007	04 Chango	
-	Revenue	Per Capita	Revenue	Per Capita	% Change
1st Quartile <sup>1)</sup>	7,302,569,945	8,640	12,233,153,176	10,894	126%
2nd Quartile	14,039,907,133	11,196	12,582,157,219	13,283	11 <b>9</b> %
3rd Quartile	22,043,581,396	14,234	25,691,667,987	16,505	116%
4th Quartile	43,720,544,993	22,140	47,081,008,310	23,591	107%
Bg, NS	91,259,962,288	48,661	97,394,642,242	51,932	107%
Total Revenue	178,366,565,756	23,789	194,982,628,935	26,005	109%
Revenue from the General Grant; and as					
% of Total Revenue	24,659,748,831	14%	41,622,462,259	21%	154%
Ratio of 1st to 4th quartile	N.A	2.8	N.A	2.4	-13%
Ratio of 1st quartile to Belgrade, Novi					
Sad	N.A	5.6	N.A	4.8	-15%

רable L1-1. Local Government Revenues Before and Afte المالية ال	er the Passage of the LGFL (in 2009 RSD)
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As can be seen from Table L1-1, total local government revenues increased by 9% in real terms after the passage of the LGFL. Moreover, all of this growth was driven by the growth of the General Grant, which increased from 24.6 bn RSD in 2006 to 41.6 bn RSD in 2007. Equally importantly, the passage of the Law substantially improved the equity of Serbia's intergovernmental finance system.

This can be seen from the fact that the per capita revenues of the poorest two quartiles of local governments increased most radically – 126% and 119% – while the per capita revenues of the richest quartile and those of Belgrade and Novi Sad increased by only 7%. As a result of the faster per capita revenue growth among poorer municipalities the ratio of the richest quartile to the poorest quartile of local governments declined 13%, from 2.8 to 1, to 2.4 to 1. Similarly, the ratio of Belgrade and Novi Sad's per capita revenues to those of the poorest quartile declined 15%, from 5.6 to 1, to 4.8 to 1.

# II. The Macro-Effects of the Suspension of the Law on Local Governments

Unfortunately, the gains introduced by the LGFL in the adequacy, predictability and equity of Serbia's intergovernmental finances were short-lived: in the Spring of 2009, and under pressure from the global economic crisis, the GoS decided to effectively suspend the law by slashing 15 bn RSD from the transfer system. Moreover, it continued these cuts into 2010. Indeed, the LGFL has now been in suspension for about as long as it was in effect. Worse, it is still unclear what the GoS will do in FY 2011.

Table L1-2 below shows the effects of the suspension of the LGFL in the same terms as the previous table. As can be seen from the Table, local government revenue fell by almost 30 bn RSD, or 15% between 2007 and 2009. Indeed, total local government revenues in 2009 were about 8% less (13 bn RSD) than they were in 2006. About 13.5 bn of the 30 bn loss (45%) between 2007 and 2009 came from the suspension of the transfer system, and about 16 bn from the decline in other revenues due to the economic downturn.

### Table L1-2. Local Government Revenues Before and After the Suspension of the LGFL (in 2009 RSD)

	2007		2009	% Change	
-	Revenue	Per Capita	Revenue	Per Capita	% Change
1st Quartile <sup>1)</sup>	12,233,153,176	10,894	8,908,073,566	10,410	-4%
2nd Quartile	12,582,157,219	13,283	12,649,736,859	11,862	-11%
3rd Quartile	25,691,667,987	16,505	24,863,502,611	14,054	-15%
4th Quartile	47,081,008,310	23,591	38,376,545,706	19,871	-16%
Bg, NS	97,394,642,242	51,932	80,654,852,368	43,006	-17%
Total Revenue	194,982,628,935	26,005	165,452,711,110	22,066	-15%
Revenue from the General Grant; and as % of Total Revenue	41,622,462,259	21%	28,157,725,905	17%	-20%
Ratio of 1st to 4th quartile	N.A	2.4	N.A	1.9	-20%
Ratio of 1st quartile to Belgrade, Novi Sad	N.A	4.8	N.A	4.1	-13%

But while the adequacy and predictability of the intergovernmental finance system took a beating after the suspension of the LGFL, the equity of the system improved. This can be seen be the further decline in the ratios between the wealthiest jurisdictions and the poorest: The ratio of the per capita revenues of 4<sup>th</sup> quartile of local governments to the 1st Quartile declined from 2.4 to 1 in 2007 to 1.9 to 1 in 2009 while the ratio of per capita revenues of Belgrade and Novi Sad to the 1<sup>st</sup> Quartile fell from 4.8 to 1 to 4.1 to 1 over the same period.

There are two main reasons for this. The first is that the fall off in economic activity led to steep declines in property transactions and new investment, and with it the halving of local government revenues from the (shared) tax on the Transfer of Absolute rights and the (own-revenue) Land Development Fee. Most of this loss came in wealthier jurisdictions with active property markets, particularly Belgrade.

The second reason is more complicated. In the Budget Memorandum for 2009, the GoS anticipated giving local governments 25.7 bn RSD in General Transfers. This was 16 bn less than 2007, and almost 25 billion less than what it should have given if the LGFL had been applied<sup>2</sup>. In fact however, the total value of General Transfers given out by the GoS in 2009 was 28.2 bn, or about 2.5 bn more than was initially planned.

The good news here is that most – if far from all – of these unplanned grants were given to poorer jurisdictions, helping to further improve the equity of the system. The bad news is that not only did the GoS suspend the LGFL, but that old habits of highly discretionary – and politicized "giving" seem to have returned in force.

# III. The Revenue and Expenditure of Responses of Local Governments to the Economic Crisis and the Suspension of the LGFL

## **IIIA.** Revenues

Graph L1-3 below shows that all categories of revenues (per capita) declined during the recession and after the suspension of the LGFL. What is interesting however, is that while the General Transfer fell the most, revenue from shared Wage Taxes fell the least. This shows that Serbian employers – both public and private – restrained from firing employees despite the recession.

# Graph L1-3. Structure of LG Revenues (per capita, 2009 RSD)



Own revenues declined by 10%, of which revenues from the Land Development Fee – the single largest own revenue – plummeted 39%. As a result, local governments lost almost 9 bn RSD – a sum equivalent to close to 6% of their total revenues in 2009. Similarly, revenues from the sale and lease of local government assets – the Land Lease Fee and Lease income – fell 25%, knocking another 2.4 bn of total revenues.

These revenues fell particularly fast in richer jurisdictions and are closely connected to the fall in revenues from the (shared) Tax on the Transfer of Absolute Rights. In other words, the real estate crash that came with the recession squashed local government income from both their own property and from the property markets around them.

Nonetheless, and perhaps more importantly, local governments managed to claw back some of their losses elsewhere by making more aggressive use of their powers to impose and collect local taxes, fees and charges. As can be seen from Table L1-4, revenues from the Land Use Fee increased the most – 18% – and

yielded local government almost 1.7 bn in new revenue. Unfortunately, we do not know how much came from legal entities because the Chart of Accounts does not require local governments to distinguish between persons and firms with respect to the Fee. But we do know from case studies, that in most jurisdictions 70 to 90% of the Fee is derived from businesses. Here, in other words, it looks like local governments turned to tax businesses first in an effort to make themselves whole.

<sup>2</sup> The GDP in 2008 was 2,790 mn RSD. 1.7% of this is 50.2 mn RSD.

Spotlight on: 1

	2007	2009	% change
Self-Contribution Fee	1,895	2,047	8%
Property Tax	7,989	9,148	15%
of which Physical Persons	3,576	4,387	23%
Legal Entities	4,414	4,761	8%
Communal Fees and Charges and other local income	11,178	12,369	11%
Business Sign Tax	3,280	3,261	-1%
Land Use Fee	9,733	11,439	18%
Land Lease Fee and Lease Income	9,437	7,099	-25%
Land Development Fee	24,698	15,124	- <b>39</b> %
Fines, Penalties, Interest and Dividends	2,213	2,565	16%
total own revenues	70,425	63,052	-10%
own revenues as a % of total	37.0%	40.0%	

Table L1-4. The Structure of	<b>Local Governments</b>	Own Revenues, 2007-	–2009 (in 2009 RSD, mns)
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They also however, sharply increased – by 15% – their collection of the Property Tax – yielding them 1.2 bn in additional income. Unlike with the Land Use Fee, however we can see that most of this growth came not from taxing businesses – yields here grew by only 8% – but from the extension of the property tax to individuals who had not paid the tax before: here yields increased by a striking 23%. Local governments also managed to squeeze another 1.2 bn in "new money" from "Other Communal Fees and Local Income".

Or put another way, local governments managed – despite the hard times – to increase taxation on both individuals and firms by a total of 4.5 bn RSD – a sum equal to close to 3% of their total revenues in 2009. Whatever else, this demonstrates a certain seriousness in the way they used their recently expanded fiscal powers under very challenging circumstances.

Here, it is also worth noting that despite widespread – and often legitimate complaints – about local government abuse of the Business Sign Tax (a.k.a 'the firmarina'), revenues from this source did not go up during the crisis. This does not mean that some local governments didn't use the Sign Tax to engage in "predatory taxation". It does suggest, however, that this was not a knee-jerk response to budget shortfalls.

Table L1-5 below shows how major revenue categories performed between 2007 and 2009 by quartile. What can be seen from the Table is that cuts in the General Grant hit richer jurisdictions particularly hard: while the 1<sup>st</sup> quartile of local governments saw no decrease in transfer payments relative to 2007, and the 2<sup>nd</sup> quartile saw a decrease of 8%, the losses for the 3<sup>rd</sup> and 4<sup>th</sup> quartiles, as well as for the cities of Belgrade and Novi Sad were much more profound -24%, 32%, 46%.

Table L1-5. Per Capita Revenues by Source and Quartile, 2007 and 2009

			2007					2009					2009/2007	7	
Quartile	1st	2nd	3rd	4th	BG, NS	1st	2nd	3rd	4th	BG, NS	1st	2nd	3rd	4th	BG, NS
Wage & Property Transfer Tax	3,598	4,553	6,550	8,801	19,044	3,063	4,008	5,773	7,652	16,463	-15%	-12%	-12%	-13%	-14%
General Grant	5,155	4,954	4,419	4,880	6,467	5,134	4,557	3,339	3,340	3,492	0%	-8%	-24%	-32%	-46%
Property Tax and Land Use Fee	546	640	1,228	2,099	5,439	494	797	1,374	2,257	6,678	-10%	25%	12%	8%	23%
Land Development Fee, Land Lease Fee & Lease Income	183	337	899	2,815	13,985	137	334	737	2,033	8,808	-25%	-1%	-18%	-28%	-37%
Other Own Revenue	941	1,525	1,936	2,728	3,943	914	1,489	2,303	3,142	4,121	-3%	-2%	19%	15%	5%
Other	428	633	490	795	1,335	394	251	209	521	251	-8%	-60%	-57%	-34%	-81%
Debt and Asset Sales	185	443	792	869	1,719	274	426	318	927	3,193	48%	-4%	-60%	7%	86%
Total	11,034	13,085	16,314	22,987	51,932	10,410	11,862	14,054	19,871	43,006	-6%	-9%	-14%	-14%	-17%

There are two reasons for this. The first is that the GoS allocated 200 mn RSD to the 60 poorest municipalities in the middle of 2009. The other is that a larger share of the remaining 2.4 billion in unplanned transfers – those above the amount anticipated in the Budget Memorandum – went to poorer jurisdictions.

With the exception of the poorest quartile, all other groups of local governments responded to extreme budgetary pressure by increasing their collection of the Property Tax and the Land Use Fee. The exceptionally high growth of these revenues -25% – in the 2<sup>nd</sup> quartile seems to be driven by the very aggressive attempts of the larger jurisdictions in this group – Leskovac, Loznica and Novi Pazar – to compensate lost transfers with higher land taxation.

All groups of local governments saw declines in revenues from the Land Development Fee, the Lease Fee (zakupnina) and Rental Income (zakup poslovnog prostora). But the losses for Belgrade and Novi Sad – 37% – were exceptionally high. These cities lost almost 5,000 RSD per capita from the collapse of property markets during the recession.

The steep decline in these revenues and in revenues from the general grant for richer jurisdictions, combined with the relative stability of grants for poorer ones explains the improvement of the equity of the intergovernmental finance system between 2007 and 2009. Needless to say however, while the equity of the system may have improved, its adequacy, predictability, and transparency have sharply deteriorated.

Finally, local government revenue from borrowing increased 48% in the 1<sup>st</sup> quartile – but from a very low base; and even more sharply – 86% – in Belgrade and Novi Sad, but from a much higher base and a much stronger foundation. Revenues from borrowing in the  $2^{nd}$  and  $4^{th}$  quartiles were relatively stable – -4% and 7%. But they dropped sharply in the  $3^{rd}$  quartile (60%). Whether this was a conscious decision by local governments in this group to limit their exposure is unclear. What does seem to be clear, however, is that the crisis was not accompanied by a massive "flight to debt" – or at least not to bank loans (as opposed to payment arrears).

### **IIIB. Expenditures**

Not surprisingly, local governments responded to the steep decline in revenues caused by the recession and the LGFL's suspension by slashing investment spending 16%. This generated "savings" of more than 12 bn RSD – a sum close to the amount lost from with the transfer cuts. This can be seen from Table L1-6 below.

	2007	% of Total	2009	% of Total	% Change
Other	7,754,128,989	4%	9,123,497,419	5%	18%
Other Operating Subsidies	8,424,912,307	4%	9,606,107,158	5%	14%
Operating Subsidies MZs	14,676,436,958	7%	13,228,167,834	8%	-10%
Operating Subsidies PUCs	17,876,503,664	9%	9,809,497,565	6%	-45%
Capital Subsidies MZs	8,193,354,106	4%	3,202,126,771	2%	-61%
Capital Subsidies PUCs	10,126,635,461	5%	5,350,496,520	3%	-47%
Capital Investment	50,259,506,644	25%	42,407,721,143	24%	-16%
Wages	37,079,531,560	18%	40,543,037,895	23%	9%
Goods and Services	47,698,925,990	24%	41,891,269,220	24%	-12%
Total Expenditures	202,089,935,679	100%	175,161,921,525	100%	-13%
Total Revenues	194,981,191,727	96%	165,452,711,110	94%	-15%
Expenditures Over Revenues	4.0%		6.0%		61%

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Table LT-6. The Structure and Com	position of Local Government Ex	penditures in 2007 and 2009	(IN 2009 KSD)

Even more striking than the decline in investment spending, however, is the radical reduction of both capital and operating subsidies to MZs and PUCs, particularly the latter. Collectively these subsidies fell by a whopping 19.2 bn RSD, far outstripping the reductions in direct capital spending by local governments. Local governments, in other words, clearly attempted to push a good deal of their revenues losses onto the backs of MZs and particularly PUCs – the latter of which represent 12.8 bn of the 19.2 bn in expenditure cuts.

Both the positive and negative implications of this movement can hardly be underestimated. On the positive side, the reductions in subsidies should push PUCs to pay greater attention to both the cost of their services and the collection of user charges, and thus represents – at least in theory – a positive step towards greater full cost recovery in the utility sector.

Unfortunately however, we do not have information on what happened to utility prices – which still are at least theoretically capped by the GoS – or to the collection of utility fees and charges. But either way, it does seem that the crisis has created opportunities for the GoS to encourage the commercialization of local public utilities – but only if it makes substantial efforts to improve the regulatory framework in which they operate.

On the negative side, however, it is also certain that many local governments slashed subsidies to PUCs simply to balance their books and that utilities – instead of reducing costs or raising own revenues – are running-up payment arrears to suppliers – potentially on massive scale. This is an extremely disturbing possibility because it can take years to work out interlocking debt between public sector agents, as for example it has (repeatedly) in Ukraine.<sup>3</sup>

<sup>3</sup> In the Spring of 2009 the Standing Conference of Serbian Cities and Municipalities conducted a survey of local government payment arrears (payment

## The Effects of the Suspension of the Law on Local Government Finance on the Revenue and Expenditure Behavior

Indeed, until recently Serbia seems to have managed to keep this not uncommon characteristic of transitional economies under reasonable control. But the question now is, is this still the case? Or has the combination of recession and transfer cuts pushed Serbia onto the slippery slope of accelerating payment arrears? This is a question that desperately needs to be researched.<sup>4</sup>

Despite the budget crunch, local governments managed to raise expenditures on wages 9% – an increase of about 3.2 bn, and 14% or 1.2 bn on subsidies to institutions other than MZs and PUCs, meaning to other budget users and NGOs. The latter increase was probably driven by the social distress that accompanied the recession and was spent in the form of grants to actors somehow trying to maintain living standards or to provide services to those in needs because as we will see in a moment, spending on Social Welfare increased sharply.

The 9% increase in wages was evenly divided between direct employees of City hall and the employees of municipal budget users, the vast majority of which are Preschool Teachers whose wages – though not employment – is basically controlled by the GoS (in negotiation with the Teachers Unions). Some of the increase may also represent a growth in severance payments, as at least some local governments moved to reduce employment in line with GoS guidelines. Unfortunately, however, we do not have solid data in this area. Either way, however, it does seem that local governments managed to slow wage growth, if not fully contain it.

Table L1-7 below presents local government spending by function in 2007 and 2009. The most significant decline in spending by function came in the areas of Community Development – 21% – Transport and Roads – 29% – and General Economy Activity – 27%. These areas are strongly associated with the decline in investments and in subsidies to PUCs and MZs. Together, the first two of them – Community Development<sup>5</sup> and Roads – amounted to 19 bn RSD in expenditure cuts, by far the largest share of them.

	2007	% of Total	2009	% of Total	% Change
2,3,7 - DefenseSafetyHealth	2,094,594,927	1%	1,452,254,669	1%	-31%
5 - Environment	3,651,918,229	2%	4,242,111,269	2%	16%
0 - Social Protection	6,583,703,628	3%	8,174,937,886	5%	24%
8 - Sport	5,161,065,884	3%	6,117,118,520	3%	19%
9 - Secondary Education	5,611,134,081	3%	3,854,593,662	2%	-31%
6 - Housing	8,502,126,171	4%	7,339,756,264	4%	-14%
9 - Primary Education	10,390,510,883	5%	8,716,929,058	5%	-16%
8 - Culture	12,375,479,805	6%	11,221,516,031	6%	-9%
9 - Preschools	12,673,965,257	6%	16,177,759,655	9%	28%
4 - Economic Activity	14,051,464,389	7%	10,261,512,288	6%	-27%
4 - Transport and Road	31,880,677,850	16%	22,769,877,360	13%	-29%
1- General Services	40,949,003,929	20%	36,787,811,038	21%	-10%
6 - Community Development	48,164,290,645	24%	38,045,743,824	22%	-21%
Total	202,089,935,679	100.0%	175,161,921,525	100.0%	-13%

Table L1-7. The Com	position of Local (	Government Exi	penditures by l	Function, 2007	' and 2009 (ir	1 2009 RSD
	position of Local v	Sovernment Ex	periore by i	1 unction, 2007	unu 2007 (ii	12002 130

But by far the most surprising finding in this Table is the very rapid and real growth of spending on Preschools – up 28% and 3.5 bn RSD – even while spending on Primary and Secondary Education fell, and this by substantial amounts (16% and 31% respectively). What is going on here is not entirely clear, though the fact that local governments pay preschool teachers wages is certainly driving some, probably even most of the growth<sup>6</sup>. What is clear is that there is a crying need for the Ministry of Education to recognize that local governments play an important role in the sector, and what they do and don't do has implications for the education of the nation.

arrears in local government budgets, and also in municipal direct and indirect budget beneficiaries and PUCs). The total amount of payment arrears in the 105 municipalities who responded to the survey amounted to 17 billion RSD on April 30 2009, of which 12 billion came from PUCs. (17 bn RSD was equal to more than 10% of local government revenues in the same year.)

<sup>4</sup> On this note, it is worth paying attention in Table 5 to the increase in the gap between total expenditures and total revenues from 4% in 2007 to 6% in 2009. Why expenditures should exceed revenues in any case is not altogether clear, though some of this clearly comes from the poor recording of carry-overs from previous years. What is suspicious is that carry-overs from 2008 should have been higher than in 2006.

<sup>5</sup> The category Community Development includes spending on water supply and sewage as well as for other general purpose municipal infrastructure. 6 It is perhaps also worth noting that in most jurisdictions, preschool systems are not run directly by the municipality, but by self-standing Preschool Agencies. These Agencies make lumps sum budget requests to municipal governments and collect all parental fees and charges and in many local governments are something of a black box.

Elsewhere, it is understandable why spending on Social Welfare should increase by 24% during the recession. And it is good that spending on the Environment also rose 16% despite the downturn. It is less obvious, however, why spending on Sport should rise 19% in the face of the same hardships.

Table L1-8 below presents the composition and structure of local government expenditures in 2007 and 2009 in per capita terms. As can be seen from the Table, investing spending declined 26% as while wages rose 9%. This affected the relative share of these expenditures in total local government spending, with investment spending declining on from 34% of total spending in 2007 to 29% in 2009. Meanwhile, wages rose from 18% of spending in 2007 to 23% in 2009.

Table L1-8. Changes in the Composition and Structure of Local Government Expenditures, 2007 and 2009 (in 2009 RSD per capita)

	Expenditures per capita			Structure of the Expenditures (u %)		
	2007	2009	% Change	2007	2009	% Change
Other	1,034	1,217	18%	4%	5%	36%
Operating Subsidies	5,465	4,354	-20%	20%	19%	-8%
Wages	4,945	5,407	9%	18%	23%	26%
Goods and Services	6,362	5,587	-12%	24%	24%	1%
Investment	9,146	6,797	-26%	34%	29%	-14%
Total	26,953	23,361	-13%	100%	100%	0%

The relatively high share of investment spending in total spending that local governments maintained even in the face of severe budget pressures is comforting. It is however, less comforting than it might be, after a look at that data in Table L1-9. This Table shows the percent of all investment spending by Quartile, as well as the share of investment in the total spending of that Quartile.

	2007		2009		2007	2009	
Quartile	Investment	% of Total	Investment	% of Total	% of Quartile	% of Quartile	
1	1,514,237,278	2%	1,281,245,435	3%	14%	14%	
2	2,144,572,299	3%	1,797,270,074	4%	17%	13%	
3	5,736,794,069	8%	3,836,843,781	8%	24%	16%	
4	13,013,864,101	19%	8,966,146,695	18%	34%	23%	
BG, NS	46,170,028,465	67%	35,078,838,448	69%	52%	40%	
Total	68,579,496,211	100%	50,960,344,433	100%	39%	29%	

Table L1-9. Total Investment Spending by Quartile and as a % of each Quartile's Total Spending

As can be seen from the Table, only 5% of all investment spending takes place in the two poorest quartiles, while a whopping 86% is carried out in the richest quartile and in Belgrade and Novi Sad. Moreover, these proportions have not changed much between 2007 and 2009. What this means is that whatever the improvement in the equity of Serbian intergovernmental finances that have come from system the LGFL or as by-product of the crisis – have not been sufficient to substantially increase the investment spending of poorer local governments.

Indeed, while the share of investment spending in the total spending of the two poorest quartiles has remained relatively stable over the last 3 years, it is also extremely low and now accounts for less than 15% their total expenditures. Perhaps even more disturbing is the steep decline in investment spending in the 3<sup>rd</sup> and 4<sup>th</sup> Quartiles: for the 3<sup>rd</sup> Quartile, investment spending as a share of total spending declined from 24% in 2007 to 16% in 2009, while in the 4<sup>th</sup> Quartile it feel from 34% to 23%. The sharpest decline however, was in Belgrade and Novi Sad where it fell from 52% of total expenditures in 2007 to a still robust, but substantially diminished 40% in 2009.

# **IV. Conclusions and Recommendations**

It is hard to argue that with respect to inter-governmental finances in Serbia, that the glass is now or still half full: local government revenues are way down; payment arrears are going up; the allocation of grant monies is increasingly "discretionary"; and the GoS still has not articulated a clear policy with respect to transfers for FY 2011, to say

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nothing about its posture towards the LGFL as a whole or the development of some clearer mid-term strategy.

Indeed, if there is water in the glass most of it comes from local governments: it is they who are increasing the collection of own revenues; they who have been struggling to maintain investment rates; they who have increased spending on Preschool Education and Social Welfare; and they who have begun to impose some financial discipline on PUCS. In fact, the only water in the glass coming from the GoS are the still vague promises that "transfers will be restored", and the recent decision to reinvest the Intergovernmental Finance Commission mandated by the LGFL with the status it deserves.

So let us begin with the Commission. There is a crying need to resume a substantive dialogue between the national government and local governments about a host of pressing issues. And the decision to reinvigorate the Commission is a good start on this front, if in fact the Commission is used to discuss issues and not just to rubber stamp decisions that have already been made. With that said, let us at least identify the issues that should be on the Commission's agenda.

The first and most obvious is, of course, what will happen with the General Grant next year. Here a variety of numbers are being bandied about. But so far at least, nobody within the GoS has even mentioned the possibility of restoring the LGFL, or for that matter restoring the Law, but perhaps lowering the share of the GDP used to define the size of the General Grant. This is unfortunate because the real structural issue going forward is the restoration of a rules based system in which local government revenues are adequate, predictable, and reasonably equitable.

The second, less visible but nonetheless crucial issue is the recalibration of the equalization threshold contained in the LGFL. This is important because after the LGFL was passed the 2007 Law on Territorial Organization increased the number of local government thats are considered Cities from 4 to 21. Because the current equalization rule calculates the threshold for equalization on the bases of the average per capita income of local governments "without cities" the creation of 17 new cities has significantly reduced the threshold.

In 2009 (and perhaps) 2010 the MoF continued to calculate the threshold has if there were only four Cities. If however, it begins to calculate the threshold in accordance with the rule then the threshold at which local governments begin to be entitled to equalization grants would fall from 5,400 RSD per capita to 4,600 RSD per capita. As a result, 28 jurisdictions of the 88 jurisdictions that currently receive equalization grants, including 3 new cities (Leskovac, Novi Pazar, and Loznica) would no longer receive them, and the total amount of money earmarked for equalization grants would drop from about 2.8 bn RSD to 1.4 bn RSD<sup>7</sup>. This would radically worsen the situation of Serbia's already hard pressed poorer jurisdictions.

The third issue that needs to be addressed is Property Tax Reform. Here, there are three critical problems: the first is simply reducing or eliminating statutory abatements and exemptions that radically lower the yield of the tax and make it extremely inefficient to administer. The second is giving local governments the power to impose and collect taxes from tax payers who fail to file tax declarations. And third, and most difficultly, is redefining how the base of the tax should be calculated, particularly, but not only for businesses.

In any case, the real point is that the GoS cannot expect to increase the fiscal responsibility of local governments simply by reducing grants and transfers: on the contrary, if this effort is to be successful the GoS must equip local governments with the instruments they need to responsibly raise their own revenues. And at moment, the Property Tax is one of the two best instruments – that can be reasonably "given" to them.

The other, strangely enough, is better utility regulation. At a minimum, this means removing the caps on utility prices, caps that under the current circumstances are prompting the build-up of payment arrears. More importantly over the medium term however is the establishment of a regulatory framework that encourages local governments to commercialize the operation of their PUCs; which pushes them towards full cost recovery pricing; and which makes privatization of at least some communal services possible. The current draft legislation on Local Public Utilities is a promising start in this. But so far, it seems that the legislation is not being discussed in relationship to the overall intergovernmental finance system – of which it is part – but as a sort of one-off initiative from the Ministry of the Environment.

<sup>7</sup> The simplest way to fix this problem is to calibrate the equalization system against the true national average of per capita shared taxes, but to use a lower percentage of this average to set the equalization level. In 2009, the national average of shared taxes for all jurisdictions was about 8,300 RSD per capita. Thus, if the percentage of this average used to determine the equalization level was set at 65% then the equalization level would stay at the same level it was before the creation of 19 new cities (0.65 \* 8,300 = 5,400).

Similarly, the GoS has to be more cognizant of the fact that not only has it cut local government revenues over the last few years, but that it is has also been assigning them new functions and increasing their operating costs. The most significant example of this is with the wages of Preschool teachers, and the absence of a serious dialogue between national and local governments about education is both disturbing and dangerous. But education is not the only area in which the GoS seems to be expecting local governments to pay for many of its good intentions. For example, in the last few years local governments have been charged with creating communal police forces; opening Youth Offices and Gender Equality Commissions; employing staff with university degrees and adopting new spatial and urban plans, without any acknowledgement that these services have costs.

Finally, the GoS should take steps to ensure that the allocation of capital grants is directed to those local governments who really cannot afford to pay for new investment on their own. As we have seen, the investment spending of poorer local governments in Serbia is still extremely low, despite the overall improvement in the equity of the system. Restoring the transfer system would obviously put more money in the hands of poorer jurisdictions. But it may not be enough to bring their investment rates up. As such, the GoS should consider requiring that poorer jurisdictions pay a smaller percentage of the total costs of investments that are receiving grant support from the national government, and of requiring the line ministries that control capital grants to articulate clearly defined grant procedures and co-financing norms that favor poorer jurisdictions.

Spotlight on: 2

# Road Building and Waste Management under Fiscal Constraints – Case Study of Six Serbian Municipalities<sup>1</sup>

Sonja Avlijaš\* Dejan Molnar\* This article attempts to analyze two services, which lie within the responsibility of local self-governments: i) building and reconstruction of local roads and streets and ii) solid waste management. As fiscal capacities of local authorities were reduced with the 2009 cuts in transfers, which are still ongoing, municipalities have struggled even more than before the crisis to invest into their economic development. The findings of the research suggest that in order to protect current consumption, construction of local roads has completely stalled, as an aftermath of reduction in sources of finance, while day-to-day solid waste management activities have not been affected. However, solid waste management suffers from lack of investment into equipment and sanitary disposal of garbage, although these are required by environmental laws, which are an important part of the EU accession agenda. The research is based on qualitative interviews with representatives of relevant local institutions in six municipalities across Serbia.

# 1. Introduction

This paper attempts to give an overview of locally delivered services in a sample of municipalities, in light of fiscal pressures created during the global economic crisis, which hit Serbia in late 2008. The following two services which lie within the responsibility of local self-governments are being examined: i) building and reconstruction of local roads and streets and ii) solid waste management. Cost variations between these services across our sample of local self-governments and local public utility companies are also being examined, along with some sources of these variations and obstacles to their standardization.

The findings presented in the article are part of a wider research endeavor conducted by the Foundation for the Advancement of Economics (FREN) on behalf of USAID's Municipal Economic Growth Activity (MEGA) program, the aim of which was to improve analytical understanding of how local revenues are being allocated and expended in Serbia in times of economic crisis, since one of the most important tools for local development is effective management of fiscal policy at the local level. Services local governments offer to their citizens represent some of the basic vehicles for improving welfare outcomes in their communities, and are also indicators of how effective local governments are in fostering local development.

Serbia has been under severe fiscal pressures ever since the start of the global economic crisis. As part of the country's precautionary stand by financial arrangement with the IMF, which was to add to macroeconomic stabilization, public sector expenditures have been cut, which for local administrations entailed a reduction in the number of employees and significantly lower transfers to local self-governments. Through a breach of the 2006 Law on Financing Local Self-Governments, central government transfers to local authorities were cut by 15 bn dinars (around 150 mn euros) in 2009, as well as in 2010, and this trend is most likely to continue in 2011. These reductions have amounted to an average 13% of local budgets in real terms, and are currently below the level they were at before the adoption of the 2006 Law on Financing Local Self-Governments (Levitas, 2010). Since these reductions, along with lower local tax revenues during the crisis, have significantly impeded financial capacities of local authorities, the question raised in this research is whether provision of local public services, such as road construction and garbage disposal, has been adversely affected as a consequence.

This article is structured as follows: section 2 presents the research methodology applied, section 3 shows the main findings of the research, while section 4 offers some concluding remarks.

<sup>1</sup> This paper presents findings of FREN's research project, which was financially supported by USAID's MEGA project.

<sup>\*</sup> Quarterly Monitor and FREN

<sup>\*\*</sup> Faculty of Economics, University of Belgrade, and FREN

## 2. Methodology

The research presented in this paper is based on qualitative interviews conducted with local authorities in six municipalities across Serbia. Since the services we investigated are road building and reconstruction and solid waste management, we interviewed representatives from local institutions such as construction directorates (*direkcije za izgradnju*) and local public utility companies in charge of solid waste management. Findings from interviews were mostly corroborated through accounting records acquired from the interviewed institutions.

Since our research strategy required access to information on local institutions which many are reluctant to give out (even when they are legally obliged to do that) as well as willingness of local authorities to be interviewed, the sample was mostly made up of municipalities, which have, over the years, participated in USAID's MEGA program<sup>2</sup>. Interviews were conducted in the following six municipalities: Kragujevac, Leskovac, Sombor, Užice, Zrenjanin and Kovačica, although we were not able to collect quantitative data on the cost of all investigated services in each municipality. The first five municipalities are classified as cities, meaning that they account for a large share of Serbia's population and finances, when the biggest metropolitan areas such as Belgrade, Novi Sad and Niš are excluded from the sample. They are also geographically spread out to account for all parts of Serbia. On the other hand, Kovačica was chosen since it is a smaller municipality, and particularly interesting for our research because it opted to outsource solid waste management to the private sector (along with Leskovac), in order to cope with fiscal pressures.

During interviews with local stakeholders, we collected data on the number of employees engaged in the delivery of each of the examined services as well as staffing costs. We also calculated the ratio of these items to the relevant idiosyncratic characteristics of examined localities, i.e. their surface and population, in order to make the results comparable across local self-governments. Finally, we compared output indicators (e.g. construction directorate costs per 1 km of road) through time and across municipalities.

We collected data on the two analyzed services for years 2008, 2009 and 2010, and we used the average of 2008–09 as the comparison baseline against 2010. The 2008–09 average was chosen as baseline because central government transfers to local self-governments were cut in mid 2009, so local authorities found ways to finance the already started commitments for that year, in many cases through short term bank loans or accumulation of arrears within their supply chain. Thus, we consider 2010 to be the first year where a full-fledged impact of cuts in transfers was felt.

## 3. Discussion of Results

The first part of this section assesses the effect of the economic crisis on building and reconstruction of local roads and streets, while its second part summarizes its effect on solid waste management.

## 3.1 Local Road/Street Building and Reconstruction

In this analysis, we only focus on capital investment into road building and reconstruction, as it was not possible to obtain data on current expenditures allocated to road maintenance. Responsibility for organizing building and reconstruction of local roads is delegated to local public companies known as construction directorates. These companies are financed from the municipal/city budget to organize and supervise road and street building and reconstruction, while they outsource actual construction work to other public or private bidders, through national level public tenders.

Therefore, in order to analyze expenditures involved in road building and reconstruction, we divide them into two categories: costs of the construction directorates' salaries and other employee related expenditures, and the actual material costs of building and reconstruction. Costs of building and reconstruction can be further split into costs of building new roads and costs involved in reconstruction of the existing road network. We observe these types of cost independently across our sample of municipalities in the three tables below.

The number of employees in all construction directorates across our sample of municipalities<sup>3</sup> has remained almost unchanged between 2008 and 2010 (Table L2-1, columns 1 and 2). However, comparisons across municipalities shown differences between productivity levels of their construction directorates. We use "length of local paved roads

<sup>2</sup> One municipality from the sample - Kovačica - has not participated in the MEGA program.

<sup>3</sup> Although we interviewed representatives of construction directorates in all six municipalities, we obtained quantitative data only for five of them, since Sombor did not provide any.

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per construction directorate employee", expressed in kilometers, as a proxy for productivity. According to this indicator, some municipalities are more efficient than others, i.e. they manage more kilometers of paved roads with less staff in their construction directorate. Kragujevac with its 42.5 km per employee is by far the best performer according to this indicator, and as such, it is almost a fourfold more efficient than Leskovac, which manages to oversee 11.8 km per construction directorate employee. Finally, although Kovačica is the second worst performer according to this indicator, it is a specific case because of the municipality's size. It has only one employee, which oversees the entire road network. Užice and Zrenjanin have very similar performance according to this indicator, half way between the very efficient Kragujevac and the very inefficient Leskovac (see Table L2-1, column 3).

The staffing cost, i.e. the total wage bill of workers in construction directorates, was also stable between 2008 and 2010 (Table L2-1, columns 4 and 5). We did not find significant variations in staffing costs between municipalities, except for Leskovac, whose wage bill per 1 km of paved road is almost twice as high as in some other municipalities, which is due to the significantly higher number of employees in the construction directorate per 1 km of roads than in other municipalities from the sample. Representatives of local authorities in Leskovac argue that this high number of employees has to do with the fact that Leskovac covers a large area on a hilly terrain and that it takes a long time for staff to travel around the municipality to oversee work in progress.

	Number of e	mployees <sup>1)</sup>	Length of paved roads per employee (in km)	Monthly wage bill per 1 km of paved roads (in RSD)	
	Average 2008-09	2010 <sup>2)</sup>	Average 2008-10	Average 2008-09	2010 <sup>2)</sup>
Municipality	1	2	3	4	5
Kovačica	1	1	13.1	3,053	3
Kragujevac	8	8	42.4	2,407	2,526
Leskovac	22	23	11.8	4,378	0 <sup>3)</sup>
Užice	6	6	26.8	2,606	2,652
Zrenjanin	7	7	24.5	2,805	2,541

### Table L2-1. Construction Directorates – Staffing Costs, 2008–2010

Source: Local administration records

1) Includes only those employees working on activities related to road (re)construction

2) Data for 2010 are until May, when they were collected.

3) Wages to staff were not paid out at all in the first few months of 2010, since there were not enough resources in the municipal budget.

When it comes to building of roads during our period of analysis, fiscal restrictions imposed onto local self-governments in the middle of 2009 have had a negative impact on investment into new roads. In 2010, we can observe a complete stall of building activity, i.e. there were no plans to build new local roads in any of the municipalities from our sample during 2010 (Table L2-2, columns 1-4).

However, this complete stall in investment into new roads did not seem to come as a shock to local communities, since even during 2008 and 2009 investment into new local roads was limited, except in Kovačica, where investment was financed externally, from the budget of the Vojvodina province, and in Kragujevac, where it was financed as part of the preparations for the "Fiat" car industry brownfield investment, and was therefore concurrent to central government's financing of roads of national importance in the area.

Construction prices per 1 km of local roads show very small variations between 2008 and 2010 in almost all observed municipalities. When we compare construction prices across municipalities, there are some, yet not very significant differences, with the highest cost in Zrenjanin, of 22 millionn RSD per 1 km, and the lowest in Užice, with 16 million RSD per 1 km, while the average price of construction of 1 km of local road for the entire sample is 17.5 million RSD (Table L2-2, columns 5 and 6). Observed cost variations between municipalities are explained by terrain differences and required preparation of land, as well as the differences in cost between different types of roads<sup>4</sup>.

When it comes to reconstruction of existing roads, activity in 2010 has completely stalled in Užice and Zrenjanin in comparison to the previous two-year period, while in Kovačica, no reconstruction work has been conducted in any of the three observed years (Table L2-3, columns 1- 4). While lower activity in road reconstruction in Kovačica and Kragujevac can be explained through the fact that new roads have been built over the past several years, so there is less need for reconstruction, the situation in Užice and Zrenjanin can be directly linked to their reduced fiscal ca-

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<sup>4</sup> Interview with construction directorate representatives, Zrenjanin, 15/05/2010
pacities. Finally, reconstruction in Leskovac picked up in 2010, in comparison to the previous two-year period, and we have found out from the interviews with local authorities that it was dictated by a personal commitment of the Mayor, who wanted to reconstruct some important roads even if that meant that staff was not going to receive their wages (which they claim they had not received for three months prior to our interviews in May 2010). According to their testimonies, this move has also resulted in other current expenditure arrears, mostly to suppliers.

	Lei	ngth of newly bu	Price of building 1km of paved roads (in mil. RSD)			
	Averag	e 2008-09	2010 <sup>1)</sup>			
	km	% of total road length	km	% of total road length	Average 2008-09	2010 <sup>1)</sup>
Municipality	1	2	3	4	5	б
Kovačica	2.3	17.6	0	0	16.3	16.3
Kragujevac	37	2.9	0	0	17	20
Leskovac	0	0	0	0	19	19
Užice	0.6	0.4	0	0	16	16
Zrenjanin	0	0	0	0	22	22

#### Table L2-2. Construction of New Roads, 2008-2010

Prices of reconstruction per 1 km of local roads show very small variations between 2008 and 2010 in almost all municipalities from the sample (Table L2-3, columns 5 and 6). Observed across municipalities, variations in costs are lower in the case of building new roads, i.e. they are more uniform, while in Kragujevac, reconstruction is said to cost the same as construction of new roads<sup>5</sup>. Representatives of construction directorates justify such high cost on the grounds that the type of reconstruction of roads they do is capital reconstruction, rather than current expenditures on road maintenance.

#### Price of reconstructing 1 km Length of reconstructed roads (in km) of road (in mil. RSD) Average 2008-09 2010<sup>2)</sup> Average 2010<sup>2)</sup> % of total % of total 2008-09 km km road length road length 3 1 5 Municipality 2 4 6 n/a<sup>1)</sup> n/a<sup>1)</sup> Kovačica 0 0.0 0.0 0.0 Kragujevac 0.7 0.2 1.6 0.4 17 20 Leskovac 7.4 12.5 15.4 6.2 18.4 12.5 Užice 12.5 0.0 0.0 12 7.8 12 Zrenjanin 13 7.6 0.0 0.0 15.4 15.4

#### Table L2-3. Reconstruction of Existing Roads, 2008–2010

Source: Local administration records

No reconstruction took place in this period.
 Data for 2010 are until May, when they were collected.

According to the findings from our interviews, building and reconstruction of local roads and streets have been visibly affected by cuts in transfers from the central government, which took place in mid 2009. There has been no investment in construction of new roads/streets in any of the municipalities from our sample planned for 2010, while only expenditures for road reconstruction, and only in some municipalities, were envisaged.

Although needs for building and reconstruction of roads and streets vary across municipalities, all of the interviewed local representatives have emphasized the necessity for building of new roads and significant reconstruction of old

<sup>5</sup> Interview with construction directorate, Kragujevac, 31/05/2010

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ones in their communities. However, in some locations, such as Kovačica and Kragujevac, there has been some investment over the last few years, so their needs were less pressing. Finally, local authorities have pointed that since almost the only sources for financing construction of new local roads and streets over the past three years (as well as earlier) have been higher tiers of government, it is in fact national priorities (and regional, in case of Vojvodina) that determine which municipalities will receive the funds, while local self-governments do not have a say. In that sense, their discretionary power to attract investment via development of physical infrastructure is impeded, especially since local authorities perceive the process of allocation of resources from the central government is much politicized.

#### 3.2 Solid Waste Management

In this section, we examine the impact of the global financial crisis on garbage collection/disposal activity at the local level, having in mind reduced fiscal capacities of municipalities. Since utility companies, which are in charge of solid waste management, have two main service users: (i) the public sector (municipality/city) and (ii) the private sector (citizens and companies) – we analyze the costs involved in provision of garbage collection and disposal to these two types of clients separately.

Local self-governments as service users pay the local utility company responsible for solid waste management to maintain public cleanliness and hygiene. Garbage collection in the main public streets and squares is therefore financed from the municipal budget. Besides regular garbage collection, local self-governments also finance street washing and the "spring cleaning of the city". These services for public needs make up only about 5%–10% of the total business activity of the solid waste management companies. Local self-governments report that they do not give any subsidies to public utility companies, although it is possible that they subsidize them indirectly, through higher bills that they invoice to local self-governments for the services they perform.<sup>6</sup>

Utility companies we interviewed in our sample municipalities reported that they have not experienced any payment arrears since the onset of the economic crisis and that local self-governments are paying their liabilities regularly.

	Local budget expenditures per 100km <sup>2</sup> (in '000 RSD)		Local budget expenditures per 1,000 inhabitants (in '000 RSD)		Number of employees per 100km <sup>2</sup>	Number of employees per 1,000 inhabitants	Monthly wage bill per 100km <sup>2</sup> (in RSD)	Monthly wage bill per 1,000 inhabitants (in RSD)	
	Average 2008- 09	2010 <sup>3)</sup>	Average 2008- 09	2010 <sup>3)</sup>	Average 2008-10	Average 2008-10	Average 2008-09	2010 <sup>3)</sup>	
Municipality	1	2	3	4	5	б	7	8	
Kovačica	0	0	0	0	5.7	0.9	n/a	n/a	
Kragujevac	7,006	7,186	335	344	28.4	1.4	1,269,461	68,239	
Leskovac	433	433	52	52	9.4	1.1	270,856	32,690	
Sombor	1,910	2,589	249	338	5.2	0.7	152,801	22,142	
Užice	7,796	8,996	649	749	6.9	0.6	389,805	37,459	
Zrenjanin	6,448	6,033	677	633	5.2	0.5	302,413	31,902	

#### Table L2-4. Municipal Expenditures on Solid Waste Management, 2008–2010

Source: Local administration records; Republic Development Bureau, Census 2002 updates

Notes:

1) Only those employees/departments involved and responsible for solid waste management in the cases where local utility company is responsible for other activities are accounted for. 2) Kovačica has made a deal with the private company they are in partnership with to get the service of garbage collection for the municipality for free.

3) Data for 2010 are until May, when they were collected.

Local budget expenditures for public cleanliness have been almost constant between 2008 and 2010 in four of the six municipalities we investigate, while they have grown in Sombor and Užice, by 35 and 15 per cent respectively (Table L2-4, columns 1–4). The reason for such high expenditure increases in Sombor is that the utility company has increased its outreach in 2010, by beginning to collect garbage in 10 settlements which did not have this service before. Local budget expenditures versus municipality surface ratios show that local communities which have implemented private-public partnerships (PPPs) – Kovačica and Leskovac – have drastically lower expenditures per m<sup>2</sup> of municipality surface and per 1,000 inhabitants, than those municipalities in which solid waste management is in public ownership (Table L2-4, columns 1–4).

The ratio between the number of employees in the utility company in charge of solid waste and municipality surface shows certain standardization across all examined municipalities. While the city of Kragujevac stands out as much more inefficient than other municipalities when we compare the number employees in charge of solid waste management by municipality surface, its ratio converges with other municipalities once we express the number of employees

<sup>6</sup> This is something that is difficult to track down through qualitative interviews.

per 1,000 inhabitants, i.e. its population density justifies the need for a larger number of employees per 100 km<sup>2</sup> of municipality surface. Finally, the relative number of employees is the lowest in Kovačica and Sombor, which is explained by the fact that Kovačica has a PPP with a private company in charge of solid waste, while Sombor has a generally low level of employment in its public companies<sup>7</sup>. Although privately operated, the solid waste management company in Leskovac has a larger number of employees than it was necessary because it was a part of the deal with the private investor to keep 100 employees extra on the payroll than the company needed (Table L2-4, columns 5 and 6).

Staffing cost of public utility employees in charge of waste management are also rather uniform across municipalities, when expressed in relative terms. Similarly to the number of employees, Kragujevac is an outlier when we express the wage bill per 100 km<sup>2</sup> of municipality surface, while it converges to a certain extent when the population is taken into account. Nevertheless, it remains the municipality with the highest share of wage expenditures on waste management among the surveyed ones (Table L2-4, columns 7 and 8).

The other 90-95% of solid waste management companies' business activity is market-oriented and consists of collection of garbage for citizens and companies. Municipal assemblies determine the price of this service, which depends on several criteria, such as zoning<sup>8</sup> and the type of client<sup>9</sup>, while ceilings on prices of these services are determined at the national level.

Public utility companies in charge of solid waste management have complained during our interviews about increasing arrears in payments for their services by citizens and businesses. However, since according to their estimates, the rate of payment collection has decreased on average by only 5%, the companies report that on a daily basis, these arrears have not affected their ability to operate.

We also calculate the costs of solid waste management per citizen in every municipality from our sample. Since costing units are not standardized across municipalities<sup>10</sup>, we used the data from the 2002 Population Census about meters squared of living space in order to standardize this indicator. In that way, we were able to express the costs of garbage collection per 1 citizen on a monthly basis. The results of this exercise are shown in the Table L2-5 below.

	Monthly price	Collect	ion frequency	Population density (number of inhabitants per km <sup>2</sup> ) 4	
	per citizen (in RSD)	city center	wider city center area		
Municipality	1	2	3		
Kovačica	80.0	daily	once a week	63.6	
Kragujevac	87.6	daily	once a week	208.8	
Leskovac (Jablanički okrug)	55.0	daily	once a week	82.9	
Sombor	121.0	daily	twice a week	76.7	
Užice	89.6	daily	once a week	120.1	
Zrenjanin	103.5	daily	once a week	95.3	

#### Table L2-5. Garbage Collection Price per Citizen, 2008–2010

Sour 1) Data for 2010 are until May, when they were collected

Costs of solid waste services per citizen vary across examined municipalities, from 55 RSD in Leskovac to 103.5 in Zrenjanin (Table L2-5, column 1). The main conclusion that stems from these calculations is that prices of garbage collection are significantly lower in those municipalities where the private sector is involved, i.e. in Leskovac and Kovačica (55 RSD and 80 RSD per citizen, respectively). This is a particularly important observation, as Leskovac could justify a relatively higher price, due to its low population density (82.9 inhabitants per km<sup>2</sup>), large municipality surface area and limitations on the firing of excess workforce from the private solid waste management company.

The price of service also varies because of the frequency of garbage collection (Table L2-5, columns 2 and 3). The price is the highest in Sombor (121 RSD monthly per citizen), but the frequency of garbage collection is also the highest (twice per week). Moreover, and as expected, prices are higher where population density is lower, as it implies higher handling costs for the company.

<sup>7</sup> For greater detail, see Spotlight on "Cutting Employment in Local Administrations – Has it Worked?" in issue 21 of the Quarterly Monitor.

<sup>8</sup> Municipalities/cities are divided into several parts/zones, depending on how far their location is from the city center. The prices for waste management depend on the city zone (location) in which the client lives/operates.

<sup>9</sup> Prices are different for private individuals and companies.

<sup>10</sup> Some prices are expressed per m<sup>2</sup>, some per household, while others per citizen.

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Comparing the monthly price of garbage collection per citizen with municipality area also offers some insights. Namely, the price is higher in those cities/municipalities which cover larger area (measured by km<sup>2</sup>). In our sample, Zrenjanin and Sombor have the highest prices (103.47 RSD and 121.00 RSD, respectively), but also those two cities have the largest area (1,326 km<sup>2</sup> and 1,178 km<sup>2</sup>, respectively).

While the economic crisis has not had a negative impact on garbage collection frequency, we find its adverse consequences at the investment side of the coin. Except in Leskovac, where in an entrepreneurial move, city management introduced a public-private partnership, there are no adequate garbage disposal sights (depots) in other municipalities/ cities that we visited. This is because local communities do not have the financial capacity for new investments into sanitary depots, although the law obliges them to. A possible solution lies in public-private partnerships in solid waste management, but only a small number of municipalities around Serbia have so far decided to implement them.

Although the crisis has not affected the frequency of garbage collection, there is a visible lack of investment in the field, which will matter in the medium term. Furthermore, investment capacity of solid waste management companies was low even before the financial crisis. As public utility service pricing policy in Serbia is controlled and services are underpriced due to fears of inflation, utility companies have not been able to create investment potential for mechanization and technology modernization. This directly leads the utility companies to deplete their assets, which in the longer run leads to lower service quality and an increase in current operations and maintenance costs (due to aging equipment)<sup>11</sup>.

Since the onset of the economic crisis, which caused fiscal contraction at the local level, there have been few (symbolic) new investments in the business (new mechanization and trucks) or reorganization and improvement of infrastructure (construction of regional depots).

### 4. Concluding Remarks

This research has served to give an overview of public service delivery in local self-governments, and as such to open doors for other investigations which would deal with financing of local economic development. The main findings from our case studies suggest that municipalities do not have financial capacities to invest into improving life in their communities, and that this has been worsened since the breach of the 2006 Law on Financing Local Self Governments. Namely, road construction at the local level has been affected by the 2009 cuts in central government transfers, as there is no money in local budgets for investing into new road networks. Although day-to-day functioning of solid waste companies, in terms of garbage disposal, has not been adversely affected, local public utility companies in charge of waste management do not have the financial capacities to invest in new technology and equipment in order to improve their services as well as environmental consequences of inadequate garbage disposal.

These observations point to the fact that while municipalities are managing to finance current consumption as well as cope with delivering services on a daily basis, they are unable to finance their longer term responsibilities, which in turn reduces their perspectives for attracting private sector investment and/or creating jobs for their citizens is being threatened. Municipalities are being denied central financing yet the legislative framework keeps them away from accessing cheaper capital than bank loans, as well as liberalizing utility prices. Finally, as it seems that most decisions, which have to do with local development, are still being made at the central level, it may be worthwhile to question the real level of decentralization, as local self-governments' mandates remain unfunded.

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<sup>11</sup> For a more detailed discussion, see Highlights 3 "The Impact of Utilities Price Liberalisation on Inflation in Serbia" in issue 21 of the Quarterly Monitor.

## Microcredit in Serbia – Is it (Really) Necessary?

Daniel Gies '
This text assesses the provision of microcredit in Serbia as an alternative source of financing to start-up entrepreneurs and poor people to facilitate their self-employment activities. Microcredit borrowers in most cases lack access to commercial bank loans because of their small size, absence of collateral and perceived high risk. These constraints are only partially mitigated in Serbia by the existence of various government-subsidized credit programs, which have a beneficial impact on the targeted populations but at a large cost that is borne by the state budget. Microcredit providers are funded by social investors as well as international donors, offering the potential of easing the financial burden on the state by reducing subsidy levels to banks. Increasing the scale of microcredit with a regulatory framework that allows non-bank lending by non-depository institutions can increase Serbia's access to foreign direct investment, and also result in significantly higher credit access for job creation and entrepreneurship activities.

### 1. Introduction

The visit to Serbia in October 2010 of Mohammad Yunus, well-known for receiving the Nobel Peace Prize in 2006 for his work in developing the fundamentals of microcredit, provides observers with a useful opportunity to assess the benefits of microcredit and whether it is an appropriate tool for employment creation and poverty-alleviation in Serbia. The goal of this text is not to discuss his visit to Serbia, but rather to examine whether or not the business model of microcredit, pioneered by Mr. Yunus and others during the 1970's and 1980's, has a place in Serbia in terms of its potential contribution to employment creation and poverty alleviation. Microcredit is defined as the provision of loans to (usually) low-income borrowers, including the self-employed, who typically lack access to loans from the banking sector. In this text, the term microcredit is used to specify the provision of microloans, and does not include provision of other financial services such as deposits, insurance, etc.

Microcredit has existed in Serbia at a small level for over 10 years, mainly supported by various international donors and social investors. Since 2005, the Serbian organizations involved in providing microcredit have been required to conduct their activities in partnership with a licensed bank, in accordance with the Law on Banks and other applicable legislation. The decision to restrict lending activities primarily to banks was justified, in the view of many experts including this author, in order to maintain high lending standards and to provide long-term financial sector stability during the economic crises of the past decade. Clearly the goal of financial sector stability has been achieved, to the credit of the National Bank of Serbia and Serbian policy-makers. It is now time to examine whether other non-bank lending models, such as those of microcredit providers, can have a beneficial impact on job creation and poverty alleviation in Serbia.

### 2. Background of Microcredit

Modern forms of microcredit were created to address market gaps in the provision of credit, primarily to poor and rural populations. In developing economies, banks seldom provide microcredit to serve the needs of low-income families and women-led households. These groups are often denied access to credit for any purpose, making the debate of the level of the interest rate and the other terms and conditions of credit irrelevant. The question of "access to credit" is the fundamental basis and the main justification of microcredit.

This lack of access to credit for the poor or for entrepreneurial start-ups is attributable to practical difficulties arising from the business model of banks. For example, commercial banks require that borrowers have a stable source of income out of which principal and interest can be paid back according to contractual terms. However, the income of self-employed and small enterprises is often not stable, regardless of their size. A large number of small loans

<sup>\*</sup> Consultant for Microfinance Policy, European Bank for Reconstruction and Development (EBRD)

are needed to serve the poor, but banks prefer dealing with large loans in small numbers in order to minimize their operating costs. Banks also look for collateral with a clear title – which many low-income households do not have. In addition, bankers tend to consider low-income households and start-ups a high risk, imposing very high information-monitoring costs on their operations.

From the demand side, access to credit is very important for poor people: it often provides a cushion that enables people to cope with unexpected events, as well as to gather usefully large sums of money for investment in livelihood activities, milestone social events such as weddings and funerals, or for payment of school fees. Credit also enables people to acquire income-producing and household assets and to cover major medical expenses, and to invest in production and trading activities that leverage their relatively low cost of labor (CGAP, 2003).

As access to financial services reduces vulnerability and helps poor people to increase their income, improving this access has become an important part of many development initiatives. Actors in the rural development and social assistance sectors that seek to improve livelihoods and reduce the risks of the poor often try to identify financial institutions that can provide these services. In many cases, no financial institutions can be found that are willing to fill this role. This has been the case in "developed" Europe for many years, but now European policy makers are taking a closer look at microcredit as a tool to reach marginal populations, start-ups, and other actors who are left out of the formal financial sector.

### 3. Microcredit in the European Union

In light of Serbia's planned ascension to the European Union, this paper uses the definition of microcredit as defined by the European Commission. In general terms, the EC defines microcredit in Europe as addressing the needs of two groups: "micro-enterprises", defined as enterprises employing less than 10 people (which includes over 90% of all European enterprises) and "disadvantaged persons" (unemployed or inactive people, those receiving social assistance, immigrants, IDPs, etc.) who wish to go into self-employment but do not have access to bank lending services.

While microcredit takes many forms and performs different roles in the European Union, in the Member States and regions it is often used as a means of encouraging the growth of self-employment and the formation and development of micro-enterprises. In many cases this is linked to efforts to promote the transition from unemployment into self-employment. In the strategic vision of the European Union, microcredit is of particular importance for rural areas and can play an important role in helping to integrate minorities and immigrants both economically and socially.

Under EU legislation (Article 4 of Directive 2006/48/EC) microcredit institutions fall under the scope of EU prudential regulation only if they receive deposits from the public. If microcredit providers do not receive deposits or other repayable funds from the public and are not prudentially consolidated by a credit institution, the EU Capital Requirement Directive does not oblige them to be subject to specific harmonized capital requirements. EU policy is that regulation and supervision must be proportionate to the risks that microcredit institutions pose, so that it does not put a brake on the supply of microcredit.

The average microloan in the EU is in the range of EUR 7,000–7,500 (European Microcredit Network, 2008). While there is an active microcredit sector in many EU member countries, and a number of actions have been taken at the EC level to reinforce the growth of the sector, there are continuing efforts to do more to promote microcredit. In its "Communication on Financing SME's" (2006) the EU drew attention to obstacles blocking the development of microcredit, calling on Member States: "to ensure that national legislation facilitates the provision of microcredit (loans less than EUR 25,000). Such loans offer an important means to encourage entrepreneurship through self-employment and micro-enterprises, in particular among women, and minorities. This instrument favors not only competitiveness and entrepreneurship, but also social inclusion."

It is this realization in many EU countries that microcredit has a role to play in employment creation and social inclusion that is highlighted here. Large EU members such as France, Germany, Poland and Spain, among others, have come to the conclusion that their governments cannot meet all of the needs of their poverty-afflicted populations. Allowing for a mix of approaches including microcredit supplements the level of resources that can be brought to bear on employment and poverty alleviation.

### 4. The Environment in Serbia

Now we move to the Serbian environment. In comparison to other countries in the region, Serbia continues to struggle with unemployment and low economic growth. According to recent employment indicators there is over 18% unemployment rate in the country, which represents a significant increase in comparison to data of 2008 and 2009. The structure of the unemployed is unfavorable, characterized by long-term unemployment and with the dominant share being residents of rural areas. Additionally, there is a relatively high poverty rate, assessed at 8.8% of the population in June 2010.

The Serbian banking sector, with few exceptions, only rarely reaches start-up entrepreneurs and the poor population who request loans to engage in productive activities. The principal reasons that banks are *unable* to provide services to these groups are high transaction costs coupled with small transaction sizes. This makes it very difficult for the bank to cover costs; and without full cost recovery, long-term sustainability is impossible. At the same time, many banks are *unwilling* to provide services, in part because of the perceived high risk of financing poor clients and start-ups, but also because they would need to invest significant resources in changing their business model to serve this clientele.

In the Serbian case, banks are faced with reduced profitability on lending to these types of clients due to the provisioning requirements of the National Bank of Serbia (NBS) in its "Decision on Bank Balance Sheet Assets and Off-Balance Sheet Items". This Decision requires banks, in most cases, to heavily provision for loans to those without formal income or employment. Although this Decision and similar regulation plays a strong role in ensuring bank health and overall financial sector stability in Serbia, it restricts the banks' ability to reach out to the unemployed, start-up enterprises, and to ethnic minorities, among others, who wish to engage in entrepreneurial activities but whose lack of "official income" results in the high provisioning levels by the banks.

A consistent and prolonged effort by the existing microcredit providers in Serbia has been made to overcome these constraints and ensure that credit-worthy applicants are able to access loans for a productive purpose. Currently there are three non-bank microcredit institutions in Serbia (AgroInvest, Micro-Development, MicroFinS) that operate through a local bank and have a combined total portfolio of approximately EUR 16,600,000 in loans to over 19,500 borrowers. These institutions were founded during the 1999-2002 period with emergency funding from donors (UNHCR, ICRC, etc) or international NGOs (World Vision) in order to respond to Serbia's post-conflict economic collapse. They serve clients who have suffered from recent conflicts, such as refugees and the internally-displaced, as well as those without access to credit or economic opportunities in a wider sense.

The major characteristics of the non-bank microcredit institutions operating in Serbia (Lalovic, 2008) are the following:

- Microcredit is mainly entrepreneurial and production loans based on internationally-accepted methodologies, ranging from EUR 300 to EUR 3,000, with the average loan size in Serbia being between EUR 800 and EUR 1,100;

- The local microcredit institutions lend to their clients in Serbian dinars, with no foreign currency clause, due to their methodology of supporting clients and helping them by removing their currency risk. Thus, for the past decade the microcredit providers have been unknowingly facilitating "de-euroization" efforts;

- Microcredit institutions in Serbia are characterized by a very high repayment rate (over 95% up to 60 days). This is the combined result of very strict approval criteria applied at the client assessment stage, and the strong relationship maintained with their clients which significantly improves the collection of loan repayments. MFIs take great care not to over-burden their clients and work with them over long periods of time helping them to steadily develop their business activities;

- The microcredit providers in Serbia bear the currency risk and also provide training, education and support that make their credit products generally more expensive than bank credit, but result in better customer monitoring a better repayment rates than the formal banking sector;

- Microcredit institutions must work through partner banks which charge high mediation fees, further increasing the interest rates charged by the institutions;

- Microcredit institutions also have a strong focus on their social mission, and devote a fixed percentage of their annual budgets to social causes. They engage in efforts to improve the lives of the poor population by undertaking various initiatives such as programs for children, donations to schools, hospitals, playgrounds, etc.

#### Microcredit in Serbia – Is it (Really) Necessary?

The fact that there is a large number of borrowers served by the microcredit institutions demonstrates that market demand exists for these types of credit products, despite the presence of commercial banks, bank-administered government subsidy programs, the activities of the National Employment Agency, and other interventions that are presumably cheaper and more formal than microcredit. As these microcredit providers are externally audited, as such it is verifiable that they place needed credit products on the market and do so in accordance with the Law on Banks and the other legal requirements of Serbia.

### 5. Serbian Approaches to Increasing Credit

One of the causes of the high-level of poverty and unemployment in Serbia is that poorer citizens, particularly those in rural areas in central and southern Serbia, lack access to credit products that would facilitate self-employment and entrepreneurship activities. The Serbian banking sector, despite the support of various government programs, has been only partially successful in substantially increasing credit provision and resulting employment creation in these areas.

The availability of government subsidies to increase the provision of lending services has played a strong role in this partial success. In general, the main government instruments for increasing the financing and development of employment for individuals, agricultural households and SME's are the Serbian Development Fund, the Ministry of Agriculture, subsidized credit lines provided through banks supported by the Ministry of Economy and Regional Development and the National Bank of Serbia. Unemployed people are served through the National Employment Agency and other state institutions.

These instruments constitute by far the greatest financial volumes of support provided to SMEs, registered farmers, households, and the unemployed. Many of these schemes use financial resources allocated from the budget of the Government of Serbia by facilitating loans at extremely low interest rates. Sources of this funding originate from the government budget and also from repayments of previously-given credits, sales of public property, as well as programs that the government decides to implement on a yearly basis e.g. start-up credits for financing new companies.

It is not the focus of this text to provide observations on the effectiveness of the subsidized credit policies of the Serbian government. However, recent statements by the relevant ministries indicate that the level of this state support to subsidize lending will be reduced in the coming years. It is suggested here that expanding the provision of microcredit in Serbia, which is exclusively funded by non-state sources, can play a strong role in plugging this funding gap over the coming years. To examine this more closely, it is the current status of provision of microcredit in Serbia that is the topic of the next chapter.

### 6. Field Research on the Uses of Microcredit

The assessment of the potential benefits of formalizing microcredit institutions in Serbia cannot be completed without a detailed discussion of the microcredit that is being provided to its under-served citizens today. In this chapter, a closer look is given to the provision of microcredit and bank loans to the poor and to entrepreneurial start-ups in Serbia.

The Serbian microcredit providers, as mentioned previously, provide credit to over 19,500 people primarily located in the rural areas of Serbia. The question is – who are their customers? Why don't they take advantage of the (cheaper) offer of the commercial banks, or at the very least the government programs that are available?

It is clear from even a cursory examination that the microcredit organizations place their loans at a much higher interest rate (up to 6–8% higher annual interest than the average commercial bank rate) and as such, one would expect that the demand on the market for these credit products to be low. However, as field evidence shows, the microcredit institutions cannot meet the demand for their credits, particularly in the more isolated communities of Serbia. Despite the higher cost of such credit, and the presumed lack of creditworthiness of the borrowers of these institutions, there continues to be a high demand for these products.

Why is this? To find the answer, a comprehensive survey of current microcredit clients was conducted in September and October 2010 by the author, consisting of physical interviews of over 500 households that recently accessed a microloan from at least one microcredit institutions in Serbia. This survey was supplemented by desktop research, high-level interviews and field observations in a number of rural areas, as well as interviews with policy-makers in the Serbian government and banking sectors.

The survey attempted to answer a number of questions about the background and status of the "average" user of nonbank microcredit services, his/her ability (or lack thereof) to access a formal bank loan, the reasons of their inability to access bank credit, and their reason for approaching a microcredit provider as well as their expressed purpose for the micro-loan.

The respondents were exclusively those who meet the borrowing criteria of the Serbian microcredit institutions, i.e. those who were using the loan for a productive purpose related to self-employment, agricultural production, business start-up or other similar purpose. The survey itself was conducted in a random sampling of active microcredit clients in the villages surrounding the towns of Čačak, Kraljevo, Užice, Leskovac, Prijepolje, Vranje, Kruševac, Pirot, Zaječar, Jagodina, Valjevo and Novi Pazar under the supervision of a US survey expert with significant microcredit experience, and the (Serbian-speaking) author of this article. A team of four Serbian surveyors/interviewers were involved in most of the data collection, supported by an IT expert for data sorting and cleaning. The results of the survey are quantified by topic, below:





Table L3-2. Survey Respondent Classification







**Gender:** Of the 500 clients interviewed, 216 of the respondents were men (43.2%) and 284 were women (56.8%).

**Status:** The employment and livelihood status of the borrowers in eight response categories (listed in order of frequency) were as follows: Unemployed: 173 (34.53%), Small Business Owner: 83 (16.6%), Government Employee: 79 (15.7%), Registered Farm: 45 (8.9%), Pensioner: 44 (8.8%), Vehicle Driver: 35 (6.9%), Self-Employed: 31 (6.2%), and Other: 11 (2.2%).

**Purpose of Microcredit Loan:** Of the 500 respondents who received a loan from a microcredit providers in Serbia in the past six months, the following were the primary purpose of the loan use: To Establish a New Business (Start-Up): 10.4%, To Buy Equipment: 24.6%, To Buy Livestock: 46.2%, To Pay Communal and Other Taxes: 3.4%, To Acquire Business Space: 10%, To Hire Workers: 0.2%, To Pay Other Debts: 4.4%, Other: 0.8%.

**Average Loan Size:** Of the 500 respondents who received a microloan, only 29 received a loan in excess of RSD 500,000. The overall average loan size for the 500 survey respondents was RSD 108,235.

**Reasons for Selecting the Non-Bank Microcredit Provider:** Of the 500 respondents who received a microloan, only 439 responded to the question of why they selected the microcredit provider for their credit needs. Of these, 237 (54%) said that the microcredit provider "best met their needs" and 153 (35%) said that "they could not access credit from a commercial bank" while 49 (11%) indicated "branch location" as their prime reason for using the microcredit service.

**Desire for a Bank Loan:** Of the 500 survey respondents, all of them (by definition, as only current microcredit borrowers were surveyed) indicated that they needed a loan for productive activities. Of these, 377 (75.4%) indicated that they would be open to a bank credit if the terms and conditions met their requirements. These 377 individuals estimated their credit needs as varying from RSD 60,000 to RSD 750,000 with the average credit demand being a total of RSD 309,420 (EUR 2,892). The remaining 123 respondents (26.6%) indicated that they were satisfied

with the offer of the microcredit provider and would not approach a bank under any circumstances.



# Table L3-4. Reasons for Borrowing from a

#### Table L3-5. Bank Loan Applications of **Micro-Borrowers**



Eligibility for a Bank Loan: Of these 377 respondents who would approach a bank to apply for a loan (in most cases to access lower interest rates than available from microcredit providers) only 162 (43%) actually did so and spoke to one or more local banks about a credit application. The remaining 215 of the respondents (57%) did not approach a bank due to the complexity of the application, lack of a nearby bank branch office, because they believed that they were not eligible for a loan, or another reason (see below).

Receipt of a Bank Loan: Of the 162 respondents who actually approached a bank with a credit application, a loan was approved for 102 (63%) of them, and rejected for 60 (37%) of them. Of the 102 approvals, 26 (24.5%) loan disbursements had been made in the past year, while 22 (20.8%) of them had occurred in the past 12-24 months, and 58 (54.7%) of them had been disbursed over 2 years ago.

Level of Indebtedness: Of the 102 respondents who have received a bank loan in the past 24 months, the loan was still current for 68 (13.6% of all respondents) of them, indicating a possible state of overindebtedness. This is a strong concern of the microcredit institutions, although the effects of lending to the overindebted are usually mitigated by increased client analysis and the use of the Credit Bureau by these institutions. The current level of microcredit repayment (94.6% on-time repayment over 60 days) is a strong indicator that debt levels are not overly burdensome for the clients of the microcredit institutions.

Government-Subsidized Bank Loan: Of the 102 respondents who actually received a bank loan, only 19 (18.63%) of them received a loan under a government-subsidized program. In priority order, the programs or institutions awarding the 19 subsidized loans (out of 500 borrowers) were the Serbian Ministry of Agriculture (63%), Ministry of Economy (21%), National Employment Agency (10%) and other (5%). The rate of subsidized loans accessed against the number of actual credit seekers surveyed (19 out of 500) was 3.8%.

During the survey, the top three factors that were identified during the interview process by the borrowers as the advantages of non-bank microcredit compared to bank credit were the following:

a) Accessibility. In accordance with the microcredit methodology currently used in Serbia, rural loans are propagated by village counselors who conduct outreach and client education so that borrowers are very acquainted with loan terms and procedures. Also, the loan officers regularly visit the villages and usually have good communication with current and potential clients (28%).

b) Loan currency and size. Microcredit providers in Serbia lend exclusively in dinars and bear 100% of the currency risk of such loans (when it exists on the basis of their EUR-denominated assets). The clients surveyed also indicated that they are satisfied with the currency and loan size amounts, and would not be willing to make a change (24%).

c) Quality of services. Many microcredit clients indicated that they appreciate the relationship with the loan officers and their help in collecting monthly payments (they come to the villages and take the funds to pay it into the bank). In most cases the village counselors are highly-trusted by the clients as a result of their specialized training in microcredit methodology, more so than bank personnel (18%).

The results of the household survey were illustrative because they provide a sampling, albeit relatively small, of why a non-bank microcredit product is of interest to a specific segment of the Serbian population. A number of conclusions can be drawn from this study, of which one is that there is clearly a large body of unemployed and marginalized populations in Serbia who chose to access microcredit rather than bank credit for their self-employment activities despite its higher cost. Recommendations on how to expand credit access for marginalized groups, on how to lower the interest rate for these types of borrowers, as well as how to facilitate their entrance into the formal economy, are provided in the following chapter.

### 7. Recommendations for Microcredit Provision in Serbia

The research conducted has shown that Serbian banks have not been completely successful in terms of increasing credit outreach to vulnerable sectors and populations. The research also shows that alternative lending models that have been successful in other countries, such as microcredit, may offer Serbian policy-makers additional resources toward increasing access to finance as a tool to reducing unemployment. This tool is being increasingly used in the developed countries of the EU, particularly as specialized microcredit institutions can be found in Belgium, Finland, France, Germany, Hungary, Ireland, Italy, Poland, Romania, Slovakia, Spain, Sweden, and the United Kingdom which currently serve over 1,500,000 micro-borrowers (European Commission, 2007).

Should such a regulatory regime be supported by Serbian policy makers, a number of recommendations are posed here in the context of international "best-practice" for microcredit, adapted to the Serbian context (source: EBRD Microfinance Policy Advisory). The starting point of the below recommendations for establishing an efficient system of microcredit to poor citizens and start-ups in Serbia is a need to establish necessary legal regulations. The regulatory regime would need to determine the level of supervision, regulatory control over business activities, evaluation of the impact and effectiveness, etc. Recommendations to facilitate best practices (CGAP, 2006) include the following:

**MINIMAL Regulation of Microcredit Organizations:** The regulation of non-depository micro-lending needs only a minimal approach for the following basic reason – there are no deposits to lose and no risk to the broader financial sector if a poorly-managed institution fails. Microcredit regulation should focus on transparency and consumer protection, instead of attempting to prevent the failure of the institutions by over-regulation. However, the inclusion of "truth in lending" and prevention of money laundering (AML) clauses will provide for better transparency and should be mandated in the same way as for the banks.

LACK of Interest Rate Ceilings / Caps for Microcredit Organizations: It is usually the case that interest rates charged by microcredit organizations are, on average, higher than that of commercial banks. But interest rate ceilings can damage poor people's access to financial services simply because no organization will be able to afford to lend to them using the interest rates of commercial banks or government-subsidy programs. Microcredit organizations will not be able to cover their costs, will not be able to grow and will be not become financially sustainable unless they can charge adequate interest rates.

**ROLE of Government as an Enabler, not a Direct Provider of Microcredit Services:** Experience has shown that private providers of microcredit are more efficient than state providers. Governments should play an important role in setting a supportive policy environment that stimulates increased development of financial services while facilitating poor people's financial inclusion. The key things that the Government can do for microcredit are to maintain macro-economic stability, avoid interest-rate ceilings, and not offer unsustainable, subsidized, (often high-delinquency) loan programs which distort the market for the banks or microcredit providers.

**MODEL of "For-profit" Microcredit is Superior to "Non-profit" Models:** The majority of microloans dispensed throughout the world today come from for-profit microcredit institutions, rather than donation-dependent non-governmental organizations (NGOs). Sustainable (i.e., profitable) microcredit providers can continue to serve their clients without needing ongoing infusions of donor/government subsidies, and can fund exponential growth of services for new clients with commercial financing sources. This is important because the main argument for microcredit profitability is to give private-sector financiers the incentive to invest in microcredit institutions. Governments and donors, particularly in Serbia, will not have the financial resources to invest into a non-profit microcredit sector. Without private-sector funding and a profit motive, sustainable expansion will not be possible.<sup>1</sup> It is difficult to estimate how many generations it would take to reach 250,000 poor households in Serbia if funding would come only from donors and NGOs.

Facilitating the expansion of non-bank microcredit providers offers an additional potential benefit for Serbian policymakers. Using the case of Bosnia-Herzegovina as an example, in 2009 the asset base of the BiH microfinance sector constituted 6.6% of the total assets of commercial banks, roughly EUR 770 million out of EUR 11.5 billion (MixMarket 2009). Of this amount, over 90% was provided by international donors and social investors, the provision of which has led to significant growth in credit provision to the rural areas and to marginalized populations.

Although the microcredit experience for Bosnia has not been without problems (and the causes of these, such as the lending bubble, the lack of a Credit Bureau and the resulting overindebtedness of micro-borrowers, are beyond

<sup>1</sup> One example of this is Grameen Bank. Grameen Bank reaches over 7 million clients globally, which is quite impressive. On the other hand, it took Mohammad Yunus (Grameen Bank's founder) over 35 years to achieve this.

the scope of this text) it has led to very high levels of credit provision to struggling and marginalized populations of Bosnia. This has contributed significantly to economic growth and employment (Hartarska and Nadolnyak, 2007) and an increase in investment levels into small enterprises.

Assuming that a similar microcredit regulatory regime could be implemented for Serbia, many domestic microcredit practitioners believe that it is not unrealistic to assume that a high level of resources, well over EUR 100 million of direct foreign investment, could be mobilized from donors and social investors for Serbia's marginalized populations in the upcoming 2–3 years. This could have a significant effect on job creation, poverty alleviation and that could equal or exceed the resources currently provided from the state budget to achieve these goals.

### 8. Conclusion

With the vast majority of current microcredit borrowers from the survey not able or not willing to access bank credit, the survey supports the hypothesis that Serbia needs and would benefit from microcredit. The Serbian government's activities to promote access to finance has been a series of government-subsidized loan programs targeting mainly larger entrepreneurs, which operate through banks and have lengthy application procedures. These programs make it possible for entrepreneurs that already have access to loans to access them at lower cost. At the same time, poverty and unemployment is addressed through social programs that cannot possibly reach all eligible populations due to government resource restrictions. This is particularly true today as the IMF and other international observers believe that Serbia needs to significantly reduce government expenditures in the near term.

Adding a new non-bank and non-depository financial institution legal form into the financial system would expand the institutional basis for the provision of microcredit, and would significantly encourage a more competitive and consequently more efficient credit market for micro and small businesses. Expanding microcredit will create a positive situation for the system: low income borrowers will receive access to finance, and banks will gain new clients who graduate from microcredit institutions and increasingly seek more formal banking and payment services.

Implementation of a microcredit regulatory model will also reduce the extent of unregulated private moneylenders who are often the only option for microenterprises to access credit. If designed properly, such a system will also facilitate the entry of these borrowers into the formal economy, resulting in increased tax receipts. Over-exuberant lending to Serbian citizens and micro-businesses can be mitigated by the microcredit institutions having a very strict, tried and tested methodology, reporting to the Credit Bureau, designed specifically to prevent client overindebtedness.

The results of this survey and desktop research show that microcredit, already existing in Serbia, is meeting the demand by Serbian borrowers and low-income households for credit products that they cannot access from the formal banking sector. Increasing the scale of this model with a regulatory framework that allows non-bank and non-depository microcredit can increase the level of foreign direct investment into the sector significantly. This will result in increased access for those in Serbia who lack access to bank credit and present little threat to its overall financial sector stability.

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