quarterly monitor

OF ECONOMIC TRENDS AND POLICIES IN SERBIA

Issue 28 • January–March 2012

Belgrade, June 2012

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

TRANSLATION
Darko Popović
Vladica Đukić
Marjeta Pevec

DESIGN OF INNER PAGES
Stefan Ignjatović

PRINTING PREPARATION
Maja Tomić

COVER DESIGN
Nikola Drinčić

PRINTING OFFICE
Alta Nova

VOLUME
100 copies

Quarterly Monitor of Economic Trends and Policies in Serbia (*QM*) was created by Kori Udovički, who was the Editor-in-Chief of the first six issues of *QM*. For issues seven to twenty three, the Editor-in-Chief of *QM* was Prof. Pavle Petrović. Diana Dragutinović was the Editor-in-Chief of *QM*24. Since issue *QM*25-26 the Editor-in-Chief of *QM* is Milojko Arsić.

Table of Contents

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

In Serbia, as in other countries in the region, recession trends continue – the GDP is declining for the third consecutive quarter and the unemployment increases. However, the decline in the economic activity and the unemployment growth are notably lower than during the first wave of recession and if European economies recovery in the next few months, chances are that they will be short-term. However, unlike other countries in the region, in Serbia, internal and external imbalances are increasing, which negatively affects the potential recovery of its economy.

While the other European countries are intensively decreasing their fiscal deficits and debate whether the decreasing speed is excessive, the fiscal deficit, in Serbia, is growing. In 2011, fiscal deficit in Serbia amounted to 5% of GDP, while in the first quarter of 2012 it stood at about 7% of the quarterly GDP – partly due to a one-time pre-election spending. It is estimated that with the continuation of the current policies, fiscal deficit will amount to over 6% of GDP in 2012. A high fiscal deficit and the increase in the government guarantees have directly influenced the increase of the public debt, which at the end of March reached about 50% of GDP, and it is estimated that, by the end of the year, the public debt will be about 55% of GDP. The Public debt in Serbia has entered the critical zone in which its financing costs are growing (see Section 6, Fiscal Flows and Policy), and the probability of a debt crisis is relatively high (see Highlights 1).

A greater part of Serbia's fiscal deficit is structural, i.e. systemic in nature and maintains a relatively permanent discrepancy between the tax system and public expenditure policies, while the smaller part is a consequence of the economic crisis. In 2011, the structural deficit was exceeding 4% of GDP, while the contribution of the economic crisis to the fiscal deficit amounted to less than 1% of GDP.

The most important measures of the economic policy which led to the formation of the structural fiscal deficit are: the reduction of the labor taxes and transfer of certain products to a lower VAT rate in 2007, a high wage growth in 2006-2007, pension increase by as much as 32% in 2008, as well as so called fiscal decentralization in 2011. In 2012, in the pre-election period, the fiscal deficit was increased additionally, with most of the spending being temporary, while the structural deficit rose by about 0.2% of GDP, as a consequence of the changes in the Law on Police and adoption of the Regulation on salaries at the local level. However, the outgoing government has adopted draft law for the reduction of VAT on the baby equipment and the increase of the tax-free threshold to ten thousand dinars. Implementation of such laws would lead to additional increase in structural deficit by about 0.3% of GDP.

Another worrying trend in the Serbian economy is a strong growth of the current account deficit which in 2011 amounted close to 10% of GDP, while in the first quarter of 2012 it reached 16.5% of GDP. Although a significant improvement is expected in the rest of the year, it is estimated that the current account deficit would amount to about 12% of GDP in 2012. The current account deficit in Serbia is significantly higher than in other countries of the region, in which it does not exceed 5% of GDP, with the exception of Albania and Bosnia and Herzegovina. Increase in the current account deficit throughout 2011 and at the beginning of 2012 is a consequence of the increase in a fiscal deficit, a delayed effect of last year's real appreciation of the dinar, the fall in a global demand, but also some short terms factors.

The current account deficit of 12% of GDP (about €3.5mn) is unsustainable even in the normal times, and in the times of crisis, when capital inflows are drying up (€1.5bn expected in 2012), it is a serious problem which can jeopardize macroeconomic stability. Inability to finance the current account deficit with capital inflows is the main reason for the intense depreciation of the dinar and the reduction in NBS foreign exchange reserves during the first five months of 2012. Depreciation of the dinar affects reduction of the current account deficit towards the balanced level, but with a certain lag, it affects the inflation growth and increases the cost of repayment of the foreign currency denominated loans. It is therefore essential that the deficit in a current account balance is reduced to sustainable level that under normal circumstances in the world capital market is estimated at about 6% of GDP. It is important that the reduction of the current account deficit is not done only by the depreciation of the dinar but also by the reduction of the aggregate demand, as a result of reduction of the fiscal deficit.

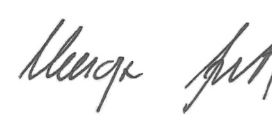
The unfavorable trends in the public finance and balance of payment specify the first priority of the new government and that is a fiscal consolidation. In May, the Fiscal Council published a complete proposal for the fiscal consolidation whose implementation would reduce the fiscal deficit to about 5% of GDP in the current year and about 3% in 2013 (see the original document on the website of the Fiscal Council and Spotlight On 1). Realization of the proposed fiscal consolidation aims at achieving a balanced budget over the next four years. Major part of the fiscal consolidation (about 5% of GDP) would be achieved by reducing the share of a current public spending in GDP (pensions, labor costs, subsidies, repeal of the changes to the law on decentralization, the cost of purchasing goods and services, etc.), increasing taxes by about 1% of GDP, while the public investments would increase by about 1% of GDP. A significant reduction of the fiscal deficit during the period 2012-2013 would minimize the risk of the public debt crisis and reduce the current account deficit, which would lead to the stabilization of the exchange rate and the reduction of the inflationary pressures.

The fiscal consolidation, with the real depreciation of the dinar already achieved in the first quarter of 2012, represents the key to maintaining macroeconomic stability without which the economic growth could not be achieved. To what extent the fiscal consolidation is important can be seen in the numerous examples from the world in which countries apply harsh and unpopular austerity measures and increase taxes to accomplish it. We are close to the case of Slovenia, which has a lower fiscal deficit than Serbia and about the same share of the public debt to GDP ratio, but has already resorted to the radical austerity measures such as the reduction of nominal wages. It is unlikely that the economists in almost all European countries are ignorant and their politicians irresponsible to apply such drastic austerity measures and increase taxes instead of increasing spending and reducing taxes as some politicians from Serbia suggest.

Fiscal consolidation which prevents the public debt crisis and balance-of-payments crisis, thus providing macroeconomic stability, is a necessary, but not sufficient condition for launching a long-term sustainable economic growth and reducing unemployment. To start the economic growth, a number of structural reforms are required, some of which would be implemented through a program of the fiscal consolidation. Fiscal consolidation would reduce the country risk which would result in lower interest rates for the economy and increased foreign investments. In addition to the reforms listed in the program of fiscal consolidation, a number of other reforms are necessary to promote the economic growth and employment. Among these reforms, of particular importance are the elimination of complicated and unnecessary regulations that increase the costs and risks of doing business in Serbia and are a source of corruption, development of financial discipline, improvement of competition policies, development of the financial markets, reform of the labor markets, etc.

In general, the key to the recovery of the Serbian economy is in structural reforms, which eliminate systemic barriers to economic progress, rather than fiscal incentives. Space for fiscal incentives in Serbia is very limited and their range is very small. On the other hand, potential costs and risks are high due to the public debt growth and growth of the external deficit as a result of the incentives.

This issue of the Quarterly Monitor (QM) contains one Highlights (Arsić and Ranđelović) which analyses the effects of a fiscal decentralization from the perspective of its impact on the fiscal deficit and efficiency of public spending and concludes that these results are extremely negative. It is therefore recommended to repeal changes to the law on fiscal decentralization. Spotlight On 1 (Arsić), sums up the arguments which deny the populist attitudes that only minor adjustments of the current fiscal policy are needed, which would be achieved through better tax collection, savings in the procurement of goods and services, reducing subsidies, etc., without the necessity to freeze wages and pensions and increase taxes. Also, libertarian proposals to achieve fiscal consolidation through eliminating all subsidies, dismissing the half of employees in the public sector or by reducing the cost of goods and services by 50% are challenged. While populist proposals basically mean postponement or abandonment of fiscal consolidation, which would lead to the debt crisis, libertarian proposals would provide fiscal consolidation but would lead to the collapse of some of the basic functions of the state. Spotlight On 2 (Arsić), analyses the situation in about 1300 companies that are under state control, which employ significant resources (wealth, labour), receive direct subsidies of about 2.5% of GDP, indirect subsidies of more than 1.5% of GDP but provide a modest contribution to GDP. Spotlight On 2 proposes the completion of restructuring and privatization of public companies in a relatively short time as well as measures to improve the efficiency of public enterprises, privatization of some of them and the liberalization of activities in which they operate. Reform of enterprises under state control has a broader economic impact, not only fiscal, and it is necessary for development of financial discipline and efficient use of resources.



TRENDS

1. Review

Macroeconomic trends significantly worsen in Q1 2012. The economy is in recession, the current deficit is growing and so is unemployment, and with all this, the inflation accelerates. More detailed analysis indicates that the poor results in the first quarter were strongly influenced by a number of temporary factors – such as a state of emergency in February, a pre-election fiscal expansion, the problems in the production of the certain large enterprises, and even the purchase of shares of Telecom from the Greek company OTE. However, even when we exclude all temporary and one-off factors, macroeconomic trends call for caution and require a thoughtful and coordinated response from the economic policy. Such a response was mostly absent in early 2012 - a fiscal policy in Q1, as in April, was pre-electoral in nature (immoderately expansive), while the NBS was trying to mitigate the consequent excessive drop in the dinar exchange rate with increased interventions in the interbank market.

The economy is in recession. The year-on-year decline in the real GDP in Q1 is estimated at 1.3%, and this is the third consecutive quarter in which the value of a seasonally adjusted GDP has gradually reduced (see Section 2 „Economic Activity"). The unemployment, as an additional indication of a recession - is in growth - which also confirms our assessment of the situation in which the domestic economy is. The current recession is not as strong as the one after the first wave of crisis (2008 and 2009), so our estimate of GDP growth in 2012 remains slightly optimistic and unchanged compared to the previous editions of QM, that is 0% (for the entire year). This actually means that after the fall of production in Q1 we still expect the start of a recovery in the second half of the year, led by the growth in net exports. However, compared to our previous forecasts, a risk grows that such a recovery will not occur, primarily because of the possible unpleasant surprises from the euro area, which would lead to a negative growth of GDP in 2012, but also because of the growing domestic imbalances that can result in the economic crisis and a greater decline in GDP.

A reversal of the economic activity trend in the remaining part of the year would require a change in the basic drivers of the economic growth. The model according to which the economic growth would be driven by domestic consumption is unsustainable, not only in the middle-term but also in the short-term. Developments in Q1 are the best confirmation of this assertion. In fact, private and especially public spending had a relatively high growth in Q1 2012 (real year-on-year growth in government spending was 7.5%). The consequences were the growth of current deficit, the depreciation of the dinar and the unsustainable growth of the public debt, not the increase in the economic activity and employment - as advocates of fiscal stimulus expect. The two mentioned macroeconomic aggregates - the balance of payments and fiscal deficit - deserve a special attention in this review, because, whether we can avoid a possible crisis and macroeconomic instability depends upon their trends in the future.

The current account deficit amounted to 1160 million in Q1, an increase of over 50% over the same period last year, when it stood at 760 million euros. The largest part of the explanation for this growth lies in the part of the current trends in the trade balance - exports and imports.

Exports of goods and services in euros marked an annual decrease of 2.2% in Q1, while imports increased by 4.1%, which led to a significant increase in trade deficit (see section 4 "Balance of payments and foreign trade"). The reasons for this increase are temporary, but also essential in nature. Under temporary factor we primarily consider unusually large drop in the exports in February, during the state of emergency caused by extreme weather conditions. Therefore, in February, a drop in exports of over 20% occurred (seasonally adjusted in relation to January), which has been compensated in March. Another factor that influenced the decline in exports in Q1, for which we are not entirely sure whether it is temporary or permanent in nature, is the delay in the production of compounds of the Železare Smederevo steel plant influencing the exports of iron and steel to decline by 63%, compared to Q1 2011. The growth of imports on the other hand was influenced by unusually high imports of energy, which was, again, the consequence of a cold winter, but also a growth in the prices of these products. In addition to temporary, we have found also the essential reasons for the increase in the current account deficit, and those are (previously mentioned) the growth of domestic consumption, which exerted a pressure on the import increase, as well as the accumulated appreciation of 2011, which favours the growth of imports and reduction of exports.

High imbalance in the current account would be much less dangerous if, at the same time, is not accompanied by a strong contraction of capital inflows. Net capital inflow in Q1 amounted to only 90 million euros, which represents a very strong decrease in comparison to the same period last year when over 800 million euros entered the country. Even when we exclude one-time capital outflow caused by repurchase of Telekom Srbija shares from the Greek telecommunication company OTE in the amount of 380 million euros, and the withdrawal of capital from Telenor (about 120 million euros), our estimate remains the same – that the capital inflows are significantly reduced and that this trend is likely to remain unchanged throughout the 2012. With high current account deficit and insufficient capital inflows from abroad, pressures on the reduction of the foreign exchange reserves and the depreciation of the dinar exchange rate are getting stronger.

It is not difficult to imagine the possible trends in the balance of payments by the end of the year. Current account deficit will decrease, as directly indicated by the trends of seasonally adjusted exports and imports in March and April, and economic analysis that explains what lies behind these observed trends. This analysis indicates the following reasons for reducing the current deficit by the end of the year: 1) the effects of a number of temporary factors that have influenced strong growth of the current deficit are over – here we primarily refer to the fiscal expansion, which will undoubtedly be reduced after the elections, even without a probable fiscal consolidation, 2) relatively strong depreciation of the dinar in the first half of 2012 will rise import prices and, with a slightly larger delay, stimulate the growth of exports and 3) the announced start of a serial production of car company Fiat Automobili Srbija could significantly affect the growth of exports, of course, provided that there is no delay in the realization of these plans. The other side of the coin - the capital inflows - will probably remain insufficient to finance even this expected, decreased, current deficit in the remaining part of the year. The main reasons for the low capital inflows are relatively permanent and will not change so quickly. These are primarily 1) an adverse economic cycle in the Eurozone where, by far the largest part of investments in Serbia comes from, 2) tightened regulation of the banking sector in the EU, which triggers the outflow of the capital from "daughter" banks to their European plants and 3) increased risk of the region and the country and related rise in prices and lower availability of loans.

Described fundamental imbalance between the high current account deficit (the deficit will remain relatively high, no matter how much reduced in the remaining part of the year) and a lack of capital inflows that would finance this deficit, became obvious from the beginning of 2012, particularly in April and May. NBS sold over 1.2 billion euros from the beginning of the year in order to prevent excessive weakening of the dinar, but in the same period the dinar nominally declined by approximately 15%, compared to the euro (see Section 5 "Prices and exchange rate"). NBS is now turning to additional measures which could affect the stabilization of exchange rates - increase of the reference interest rate and change in the structure of reserve requirements - but without removing the essential reason for the balance of payments imbalance, ranges of these measures are likely to remain limited.

Probably more important measures to preserve macroeconomic stability in the time of perceived balance of payments imbalances are still on the side of fiscal policy. Fiscal policy should be strongly consolidated in accordance with the recommendations of the Fiscal Council in May. The recommended consolidation would affect the balance of payments twice - on the one hand considerably lower government spending would affect the reduction of imports and thus help reducing the current account deficit, and on the other hand clear signal would be given to the financial markets, which would result in a significant reduction of a country risk and increase of the capital inflow from abroad on the basis of the credit growth and FDI growth. The lower country risk is reflected in lower interest rates on borrowing, not only the state but also the economy and population, but it would also greatly contribute to the growth of a foreign direct investment. Note that the country risk measured by EMBI (Emerging Markets Bond Index) from the beginning of the year rose by about 100 BP. What is particularly worrying is that it seems that for some time the risk grows faster in comparison with the one in the similar countries from the region (Croatia, Hungary).

A sharp fiscal consolidation is necessary not only because of its positive impact on the broader macroeconomic aggregates such as balance of payments, but primarily because the public finances in Serbia are itself on the unsustainable trajectory (see Section 6 “Fiscal Flows and Policy”). Public debt has exceeded 50% of GDP at the end of May, which, for the countries of similar development level as Serbia, is the level at which debt crisis is highly probable. What is more worrying is the trend of public debt, i.e. its rapid growth since 2008. Public debt rose by over 20 percentage points in the period of just over for years – form 29.2% of GDP to over 50% of GDP. Continuation of similar trends will very quickly result in debt crisis thus the trend must be reversed as soon as possible.

The key driving force behind the public debt growth is the fiscal deficit, which almost lost control in the first four months of the year. The consolidated general government deficit from January to April amounted to 80 billion dinars which means that more than half of the planned deficit for the entire year (152 billion dinars) is spent in the first for months. Although we expect the growth of the fiscal deficit to slow down by the end of the year, and the total deficit in 2012 to stand at around 200 billion dinars, it will again lead to an increase of the public debt at the end of the year to over 55% of GDP and to potential problems which so large debt carries. It is therefore essential that the new government immediately takes decisive measures which will reduce the fiscal deficit and thus reverse the trend of public debt. Due to a size of the problem we believe that comprehensive measures must be taken on both the revenue and the expenditure side of the budget. Without these measures, we estimate that the debt crisis is highly likely.

Inflation was somewhat pushed aside due to the escalation of some other problems (balance of payments and fiscal deficit), but this does not mean that it should not be observed with extreme caution. The growth of prices in the first four months of 2012 slightly accelerates, primarily due to the increase in the prices of food, gasoline and cigarettes, while the underlying inflation (Consumer Price Index excluding the prices of food, energy, alcoholic beverages and tobacco) remains stable and relatively low. Underlying inflation suggests that the actual trend of the growth in the prices in the first four months of 2012 is about 5% at the level of the whole year - what would be the overall inflation in 2012 if there are similar trends continued until the end of the year. However, we expect this trend to somewhat accelerate in the following period, because we expect an increase in inflation due to the sharp depreciation of the dinar and the fiscal expansion. This acceleration should not be excessive, because low aggregate demand and stabilization of energy prices and the stock of goods on world markets (primarily agricultural and food products) are pushing inflation down. All that remains is to wait the data for May and June, which will probably give us more reliable framework within which we expect inflation in 2012. Our current estimate is that the inflation will most likely stay single-digt even with the eventual rising of the VAT rate for two or more percentage points.

High unemployment remains a major structural problem of the domestic economy. According to the available, yet incomplete data, negative trends in the labour market continue (see Section 3 “Employment and wages”). Unemployment rate rises, and has probably already reached 25% of the working age population, and the employment rate continues to fall and will probably drop below 45%. The decrease of employment is taking place only in the private sector, while in the public sector we even recorded minor growth of employment – completely opposite from the overall trends in the labour market and highly necessary decrease in public expenditure. In this number of QM under the Section 3 "Employment and wages" we have specially analysed low activity of the working population as one of the characteristics and special problems of the labour market in Serbia.

Serbia: Selected Macroeconomic Indicators, 2004–2012

	Annual Data							Quarterly Data								
								2010				2011				2012
	2005	2006	2007	2008	2009	2010	2011	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Prices and the Exchange Rate								y-o-y[1]								
Consumer Price Index[2]	16.5	12.7	6.5	11.7	8.4	6.5		4.4	4.0	6.5	9.6	12.7	13.6	10.6	7.9	4.7
Real fx dinar/euro (avg. 2005=100)[3]	100.0	92.1	83.9	79.7	84.1	86.5		85.3	86.1	87.2	86.7	83.0	78.3	79.9	80.5	84.6
Nominal fx dinar/euro (period average)[3]	82.92	84.19	79.97	81.46	93.90	102.90		98.60	101.30	105.15	106.56	104.00	99.80	101.51	102.09	108.01
Economic Growth								y-o-y, real growth[1]								
GDP (in billions of dinars)	1,683.5	1,962.1	2,276.9	2,661.4	2,720.1	2,881.9	3,175.0	..	..	..	..	..	..	..		
GDP	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-0.2	1.0	1.7	1.2	3.0	2.5	0.6	0.6	-1.3
Non-agricultural GVA	5.8	4.9	6.1	4.1	-4.2	1.6	1.4	-0.4	1.7	3.3	1.9	3.5	2.4	0.0	0.1	..
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	1.1	7.3	4.3	-1.8	6.4	3.6	-1.8	0.4	-5.9
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	2.5	8.1	5.8	-0.4	5.8	0.6	-2.1	-4.4	-7.1
Average net wage (per month, in dinars)[4]	17,478	21,745	27,785	29,174	31,758	34,159		31,924	34,192	34,372	36,149	35,108	37,994	38,760	40,139	39,068
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805		1.838	1.815	1.796	1.773	1.769	1.755	1.755	1.738	1.734
Fiscal data				in % of GDP								y-o-y, real growth				
Public Revenues	42.1	42.4	42.1	41.5	38.6	-1.5		-4,0	2.5	-3.6	-1.3	-2.8	-6.6	-3.8	-4.7	1.7
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7		-1,4	-3.1	-3.2	0.3	-3.0	-4.9	1.1	-5.4	10.0
								in billions of dinars								
Overall fiscal balance (GFS definition)[5]	14.8	-33.5	-58.2	-68.9	-121.8	-136.4		-24,1	-31.2	-28.8	-52.3	-26.3	-42.4	-44.4	-45.1	-54.1
Platni bilans								in millions of euros, flows[1]								
Imports of goods[6]	-8,286	-10,093	-12,858	-15,917	-11,096	-12,176	-13,952	-2,659	-3,032	-3,182	-3,302	-3,269	-3,392	-3,440	-3,850	-3,395
Exports of goods[6]	4,006	5,111	6,444	7,416	5,978	7,402	8,438	1,473	1,861	1,938	2,129	1,955	2,163	2,169	2,151	1,852
Current account[7]	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,968	-760	-615	-519	-188	-760	-621	-683	-903	-1,159
in % GDP[7]	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-9.3*	*-11.7*	*-8.7*	*-7.2*	*-2.6*	*-10.7*	*-7.5*	*-8.3*	*-11.1*	*-16.5*
Capital account[7]	3,863	7,635	6,126	7,133	2,207	1,986	2,752	698	596	488	204	644	566	642	899	1,008
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	284	136	176	265	307	259	661	600	-372
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-367	-321	-313	73	168	33	1,078	523	-916
Monetary data								in millions of dinars, e.o.p. stock[1]								
NBS net own reserves[8]	175,288	302,783	400,195	475,110	578,791	489,847	606,834	563,529	547,249	493,899	489,847	460,348	484,971	514,453	606,834	615,234
NBS net own reserves[8], in mn of euros	2,050	3,833	5,051	5,362	6,030	4,609	5,895	5,652	5,287	4,684	4,609	4,455	4,860	5,083	5,895	5,376
Credit to the non-government sector	518,298	609,171	842,512	1,126,111	1,306,224	1,660,870	1,897,034	1,389,783	1,523,040	1,583,687	1,656,905	1,658,603	1,700,248	1,714,617	1,784,237	1,897,034
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	604,783	651,132	681,704	732,066	730,892	742,597	744,100	775,600	834,253
M2 (y-o-y, real growth, in %)	20.8	30.6	27.8	2.9	9.8	1.3		14.5	17.1	11.4	2.4	-5.4	-8.0	-1.2	2.7	10.7
Credit to the non-government sector (y-o-y, real growth, in %)	28.6	10.3	24.9	25.2	5,2	13.9		9.1	19.9	17.9	15.0	4.5	-1.0	-1.1	0.5	10.5
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	53.8		50.3	54.4	55.7	57.5	55.9	55.6	54.6	55.2	57.3

Source: FREN

1) Unless indicated otherwise.

2) Data for 2004, 2005 and 2006 are based on the Retail Price Index. SORS switched to using the Consumer Price Index to calculate inflation in 2007.

3) The calculations are 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 calculating the average wage. Thus, the nominal wages for 2008 are comparable with nominal wages for 2009 and 2010, but are not comparable with previous years.

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

6) The Statistical Office of the Republic of Serbia has changed its methodology for calculating foreign trade. As from 01/01/2010, in line with recommendations from the UN Statistics Department, Serbia started applying the general system of trade, which is a broader concept that the previous one, in order to better adjust to criteria given in the Balance of Payments and the System of National Accounts. A more detailed explanation is given in QM no. 20, Section 4, "Balance of Payments and Foreign Trade".

7) The National Bank of Serbia changed its methodology for compiling the balance of payments in Q1 2008. This change in methodology has led to a lower current account deficit, and to a smaller capital account balance. A more detailed explanation is given in QM no. 12, Section 6, "Balance of Payments and Foreign Trade".

8) The NBS net own reserves represent the difference between the NBS net foreign currency reserves and the sum of foreign currency deposits of commercial banks and of the foreign currency deposits of the government. More detailed explanations are given in the Section Monetary Flows and Policy.

2. Economic Activity

Economic activity trends are deteriorating. Real y-o-y GDP fall in Q1 2012 amounted to about 1.3%, and seasonally adjusted index shows a decrease in production compared to Q4 2011. The Serbian economy is in recession because seasonally adjusted GDP is declining for three consecutive quarters – and so is employment. The recession, which the Serbian economy is currently in, is not as deep as the one in the first wave of the crisis (fall of 2008 and 2009). By the end of the year we expect a start of the recovery driven by the growth in the net exports, which will contribute to the overall economic growth in 2012 of about 0% - despite poor results in the first quarter. However, there is a growing risk that the economic growth in 2012 will be negative, and this will primarily depend on the outcome of the crisis in the EU with which the domestic economy is closely linked. Depreciation of the dinar in the first half of the year has had undoubtedly a positive effect on the growth of the domestic economy, although this still does not reflect on the movement of the Euro-ULC (which we use to measure the price competitiveness of the domestic economy). Industrial production declined in Q1, but the latest data for April may be the first hint of the recovery. Construction in Q1 continues a solid growth from the previous year, which will probably slow down as the year progresses.

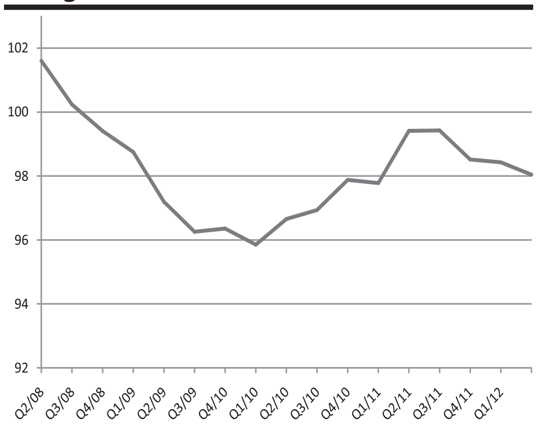
Gross Domestic Product

Y-o-y decline of GDP in real terms at around 1.3% in Q1

According to preliminary SORS estimates based on the available economic activity performance data, real y-o-y GDP growth in Q1 stood at 1.3%. This estimate is in accordance with our expectations from the previous QM. Y-o-y GDP growth rates continue to gradually declined from Q1 2011 when the y-o-y growth was 3%. These data clearly indicate the gradual deterioration of trends in economic activity in the previous year.

Seasonally-adjusted indices suggest the reducing in the production

Graph T2-1. Serbia: Seasonally adjusted GDP growth (2008=100)



Source: *QM* estimates based on SORS data

Trends in economic activity can best be shown using seasonally-adjusted data. Graph T2-1 shows seasonally-adjusted GDP growth indices in comparison with the 2008 average. Seasonally adjusted indices confirm that the trend of the production recovery from the crisis in 2008 and 2009 stopped after Q1 2011, and that from then on the economic activity has gradually decreased. Q1 2012 also saw a decline in the production compared to the previous quarter (by about 0.4%). The trend of seasonally adjusted GDP indicates that the level of production from Q1 2011 will be achieved, at best, in Q3 or Q4 2012. In the next quarter (Q2), smaller annual decline in production, which we estimated to be about 1%, will probably be achieved.

Economic activity is still significantly below its pre-crisis level

Nearly four years after the outbreak of the first wave of crisis, economic activity is still 3% lower than the level it held in Q1 2008 (Figure T2-1). Some expectations that the economic crisis from the autumn of 2008 will have "double-dip" and leave lasting effects on the economic activity, seem to be confirmed. An illustration of this statement is that the level of production in early 2008 (under the optimistic assumption of recovery from the second half of 2012) will be reached in 2013 or 2014 year, in other words, five to six years after the outbreak of the crisis. In terms of the future developments in the economic activity in Serbia, decisive influence will probably have the outcome of the crisis in the eurozone, with which the Serbian economy is closely linked. Although we are still unable to totally exclude the possibility of a further deterioration of the economic conditions in the coming quarters, we still estimate that the stabilization is more probable.

Trends

GDP likely to stagnate in 2012

If the situation in the international environment is stabilized as we predict and the Serbian economy gets back on the path of recovery in the ensuing quarters (similar to that taken after the first wave of the crisis), GDP growth in 2012 relative to 2011 will be about 0%. Therefore, we hold on to the estimate from the previous two editions of QM, for now, (QM25-26 and QM27) when we expressed the expectation that the economic activity in 2012 will be stagnant. However, compared with the previous forecasts, risks that the economic growth in 2012 will be negative are now much higher.

Construction and telecommunications lead

Growth in GDP considered by production is shown in Graph T2-2. This Graph shows growth by individual sectors of the economy up to and including the latest official data regarding Q4 2011.[1] The sectors of construction and information and communication saw relatively high real growth, while trade recorded the greatest drop. Similar trends, viewed by production sectors, are also expected in Q1 for which there are still no official data available. In Q1 we expect significantly smaller decline and a gradual recovery of the trend of trade - as indicated by available data on volume of retail trade. On the other hand, this recovery will be compensated (and surpassed) by the negative impact of the further decrease in the manufacturing industry on GDP. Manufacturing mostly contributed to the decline of the economic activity in the last twelve months, because it crossed the path from the high y-o-y increase of 6.2% in Q1 2011 (Table T2-2) to a fall in Q1 of 2012 of over 5%.

Table T2-2. Serbia: Gross Domestic Product by Activity, 2008-2012[1)]

	2008	2009	2010	2011	2011				share
					Q1	Q2	Q3	Q4	2011
Total	103.8	96.5	101.0	101.6	103.0	102.5	100.6	100.6	100.0
Taxes minus subsidies	101.4	98.3	100.9	101.9	103.4	103.2	100.9	100.7	17.7
Value Added at basic prices	104.5	96.4	101.3	101.5	103.1	102.3	100.5	100.5	85.0
Non agricultural Value Added	104.1	95.8	101.6	101.4	103.5	102.4	100.0	100.1	89.5[2)]
Agriculture	108.7	100.8	99.6	100.9	98.4	100.8	102.2	101.3	10.5[2)]
Manufacturing	100.8	84.2	100.9	100.6	106.2	101.8	98.1	97.7	14.0[2)]
Construction	104.7	80.3	92.9	107.7	99.1	111.0	109.2	108.6	4.1[2)]
Wholesale and retail trade	106.7	92.5	101.7	94.5	100.2	94.7	91.6	92.6	13.0[2)]
Transport and storage	97.4	90.0	108.2	103.1	108.8	103.0	102.3	98.9	5.4[2)]
Informations and communications	110.8	110.0	105.4	108.4	105.2	109.7	109.8	108.7	8.4[2)]
Financial sector and insurance	113.4	105.5	107.2	101.0	105.7	100.9	99.5	98.0	3.9[2)]
Other	103.7	101.6	100.8	102.0	102.9	103.1	100.6	101.6	40.6[2)]

Source: SORS
1) In the previous year's prices
2) Share in GVA

For a more detailed analysis of the Serbian economy, it is necessary to analyze GDP *by use*. Because SORS does not publish GDP data *by use* at the quarterly level, *QM* analysis is based on circumstantial indicators. It is our belief that, if quality analysis of economic activity and quality economic policy is desired, it would be exceptionally useful for state institutions to monitor GDP *by use* at the quarterly level. Let us reiterate that such a practice is common in almost all statistical offices in Europe. We pointed out the necessity of regular monitoring of quarterly GDP data *by use* in several papers published in previous issues of QM.[2]

The high growth of consumption prevented a drop in y-o-y economic activity in Q1 of over 1.3% ...

When GDP is observed by use (private consumption, public consumption, investment and net exports), the y-o-y decline of 1.3% of GDP in Q1 is actually the sum of two divergent trends: 1) high-growth of public, and slightly lower, but positive, growth of a private consumption, and 2) a strong decline in investments and net exports. Public spending in real terms recorded a high y-o-y growth of 7.5% in Q1, thus contributing to a positive y-o-y growth of GDP by 1.2 percentage points (pp). Private consumption had significantly lower y-o-y growth in comparison with the public spending, but because of the larger share in GDP, private consumption contributed

1 For some industry sectors: construction, manufacturing, mining, electricity, and, to some extent, agriculture, trade and financial services, there are movement indicators for Q3 2011. That is why our analysis of these sectors partly includes Q3 as well.
2 See the Highlights: "How Much Has Economic Activity Really Declined in 2009?" *QM* 17, and Highlights: "The Reliability of Official Gross Domestic Product Data in Serbia", *QM* 24.

more to GDP growth- by 1.4 percentage points. Investments negatively contributed to the economic growth in Q1 by 1 percentage point, while net exports contributed to the GDP decline by about 3 percentage points. All components combined together indicate an annual decline in production of about 1.4% in Q1, which is consistent with the preliminary assessment by SORS, standing at 1.3%.

But these trends are unsustainable - even in the short term.

These trends - the growth of the consumption and a reduction in net exports and investment - result in a dangerous increase of macroeconomic imbalances, and as such they are - unsustainable. Current account deficit has increased sharply in Q1, and the fiscal deficit reached nearly 55 billion dinars from the beginning of the year until the end of March. The consequence of all this (and other factors) was also a strong depreciation of the dinar in the first five months of 2012. All these trends point to the unsustainable structure of economic growth in Q1.

Private and public consumption will no longer be able to drive growth

The annual growth of the public and private consumption in Q1 was temporary, not only because it causes macroeconomic imbalances, but also because of the difficulty of its further funding. Public consumption will have to considerably reduce its growth in the rest of the year, because further increase of the deficit and the public debt which public consumption would have to be funded from, is economically unsustainable. Available data indicate a solid annual growth of private consumption real terms in Q1 (between 2.5% and 3%), but in this case we also expect slower growth by the end of the year. Wage mass, financing most of the private consumption, will slow its growth, as a consequence of employment reduction (wage mass depends on wages and employment), and we have noticed quite a slowdown in the credit activity of the population, which will probably continue in the future.

Investments are in the decline

Investments recorded y-o-y decline in Q1 and we don't expect significant changes in the remaining part of the year. Fall of exports and domestic production of capital goods indicate the decline of the investment activity. Some other indicators slightly mitigate the observed adverse trends – these are the slight increase in lending activity of the economy and growth in cement production, as the basic building material and a high growth in the public investments. Somewhat lower level of investments in 2012, in comparison to 2011, is expected, since the major projects from 2011 (FIAT, NIS) are completed. Without new projects of a similar size, it is hard to expect that a high level of investment activity from 2011 can be reached. Therefore by the end of the year, we do not expect any significant changes compared to Q1. Although we do not expect this to happen, we must not ignore the risks of further deepening of the investment activity fall in the remaining part of the year. It is likely that the public investments will slow its growth recorded in Q1, but their share in total investments is not large, and will not significantly change the overall trends. A sudden drop in lending activity, which may occur under the influence of several channels on the financial sector (an increase in country risk, non-performing loans, capital withdrawals of banks whose parent companies are from the EU, etc.), could be much more dangerous for a decrease in the investments.

Recovery in the second half of the year depends on the growth of net exports

The fall in net exports in Q1 is most likely temporary - until the end of the year we expect the change of the trend, acceleration in the growth of export and a slowdown of import. In the first quarter, exports of goods and services recorded an annual decrease of 2.2%, while imports of goods and services recorded an annual increase of 4.1%. A more detailed analysis reveals that the overall export was affected significantly by the decrease in exports of base metals, presumably because of the problems that Železara Smederevo steel plant faced, but also the extraordinary circumstances in February (a state of emergency due to the unusually cold winter), when the exports marked an annual decrease of 20%. The growth of imports in Q1 was significantly affected by the high growth of imports of energy products (18.5%), which was also partly conditioned by one-time circumstances (an unusually cold winter). In the remaining part of the year, we expect the growth in the net exports due to: 1) a completion of the adverse impact of temporary factors from Q1, 2) start in serial production of the FIAT automobili Srbija company 3) depreciation of the dinar in late 2011 and in the first half of 2012, which affects the increase of the price competitiveness of the domestic economy. Despite all the aforementioned reasons, it still remains somewhat uncertain whether the growth in net exports in the remaining part of the year will be

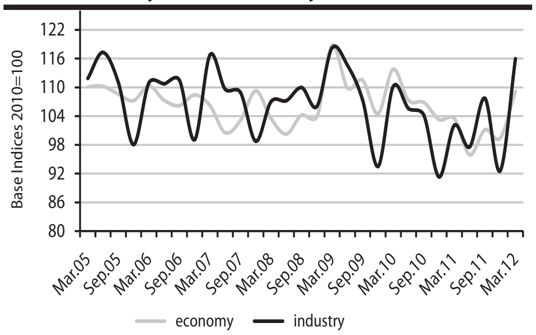
Trends

sufficient to reverse the trend of GDP. This means that the growth of net exports first needs to make up for the inevitable slowdown in the private consumption and the government spending in the remaining part of the year, but also that the growth of net exports needs to be sufficient enough to reach over and reverse the trend of GDP. It is our opinion that this is possible, along with significant risks. In that case economic growth in 2012 will be 0%.

Unit labor costs temporary incline

Unit Labour Costs[3] (ULC), measured in dinars, continued to increase in Q1, which means that the share of labour costs in the realized added value has been in incline, making it an unfavourable trend (Graph T2-3). More detailed analysis reveals that in Q1 multiple factors influenced ULC to increase significantly. First of all, ULCs are always seasonally slightly higher in Q1 than in all other quarters, because many sectors of the economy significantly reduce their activity during the winter, which is usually not fully accompanied by the reduction in the wages and employment. Besides the usual seasonal increase in ULC, a temporary additional growth in Q1 was influenced by the relatively high growth of wages which, in the observed quarter, significantly increased their real growth (partly due to the disinflation).[4] Finally, it should be noted that during the state of emergency in February there was an irregular, sharp decline of some economy sectors (manufacturing), while employment in this period remained somewhat unchanged. Aforementioned factors are considered temporary and that is why ULC will drop considerably from next quarter on.

Graph T2-3. Serbia: Real Unit Labor Costs in the Economy and Industry, 2005-2012



Source: *QM* based on SORS and NBS data

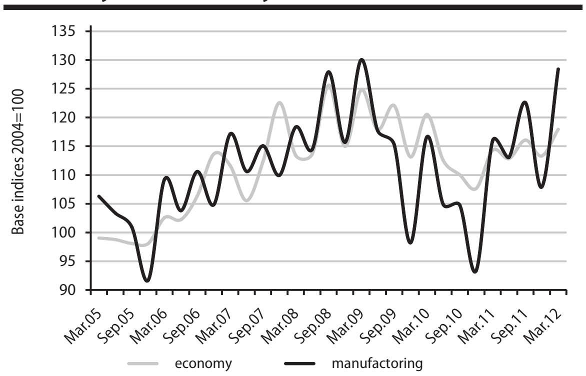
Somewhat surprisingly moving of euro-ULC ...

Unit labor costs measured in euros (euro-ULC) are an indicator of the price competitiveness of the Serbian economy because they define the greatest national cost component (labor costs) in relation to added value. We calculate euro-ULC for the manufacturing sector (that produces by far the greatest share of tradable goods), and for the economy as a whole,[5] as shown in Graph T2-4. We use 2005 as the benchmark year for observing changes in euro-ULC, because that is the year when significant decline in the price competitiveness of the Serbian economy began due to the strong appreciation of the national currency that only ended when the economic crisis escalated in Serbia.

... which have increased substantially in Q1

The graph shows that the euro-ULCs have significantly increased in Q1, especially in the manufacturing industry. This information hides mainly temporary factors that have been described in previous paragraphs. It should be noted that the growth of euro-ULC in manufacturing is largely a direct consequence of the fall in production in February due to the state of emergency. Under such circumstances, production freezes for the short period of time, but there is no need to reduce employment (and the data showed – earnings too) as the reason for the fall in production is not fundamental, but of a temporary nature.

Graph T2-4. Serbia: Real Unit Labor Costs in the Economy and Industry, 2005-2011



Source: *QM* based on SORS and NBS data
Note: the growth of euro-ULC on the graph represents the decline in price competitiveness

3 Unit Labor Costs in dinars are calculated for the economy (excluding the Agriculture and Public Administration sectors) and industry.
4 For more details see Section Employment and Wages in this issue of *QM*
5 Excluding the Public Administration and Agriculture sectors.

The dinar depreciation will certainly increase the price competitiveness starting from the next quarter

The decline in the dinar value has positive influence on the increase of price competitiveness of domestic economy. Due to the described temporary factors this effect was not seen Q1, but we expect that the data for the next quarter will show a rapid increase of price competitiveness of the economy (probably for more than 10%). The growth of the price competitiveness (reducing Euro-ULC) will be strong support to the further increase in net exports which we expect to grow significantly in the second half of the year and be a crucial factor of the economic growth in the future. Therefore, we consider a controlled depreciation of the dinar actually desirable from the viewpoint of the recovery and future sustainable growth in the economic activity. We therefore believe that a recent weakening of the dinar exchange rate in May and early June, if under control, may be useful for the Serbian economy in the medium term.

Industrial production

Industrial production falling in Q1

Industrial production recorded high y-o-y fall of 5.9% in Q1 2012. This decline is in line with our expectations set forth in the previous QM. Within the scope of the industrial production manufacturing industry had the worst performance and recorded an annual decline of 7.1%. The fall in electricity supply amounted to 3.4%, while mining production was at the same level as in the year before (Table T2-5). The y-o-y indices of growth in Q1 however, are not the best indicators of the actual situation in the industrial production because they were under very strong influence of meteorological conditions in early February.

Table T2-5. Serbia: Industrial Production Indices, 2007-2012

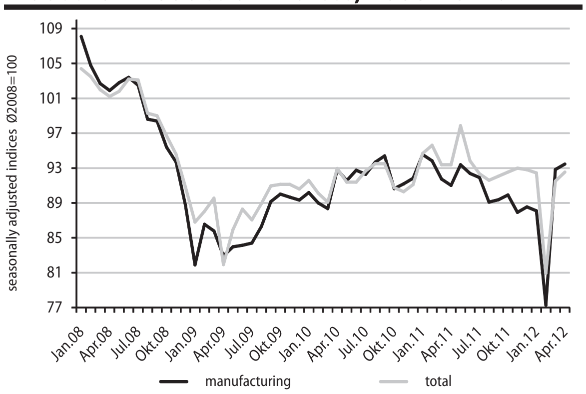
	Y-o-y indices										share
	2007	2008	2009	2010	2011	2011				2012	2011
						Q1	Q2	Q3	Q4	Q1	
Total	104.1	101.4	87.4	102.5	102.2	106.4	103.6	98.2	100.4	94.1	100.0
Mining and quarrying	100.2	105.3	96.2	105.8	110.4	107.5	118.8	103.6	115.0	100.1	9.9
Manufacturing	104.6	101.1	83.9	103.9	99.6	105.8	100.6	97.9	95.6	92.9	73.1
Electricity, gas, and water supply	103.2	102	100.8	95.6	109.7	107.5	113.2	101.7	117.1	96.6	17.0

Source: SORS

It is possible that the seasonally adjusted indices indicate a necessary change in the trend

Graph T2-6 shows seasonally-adjusted production indices of industry as a whole and manufacturing in particular. Seasonally-adjusted data indicate that, with smaller fluctuations, from Q1 2011 there was a significant drop in industrial production, particularly in the manufacturing industry and that the trend lasted until the end of 2011. However, Q1 2012 saw unusual movements which primarily reflect the impact of state of emergency on industrial production (Figure T2-6). After February, in which there has been an extraordinary decline in industrial production by over 10 percentage points, March saw not only expected to recover, but the seasonally adjusted index of the manufacturing industry significantly outperformed their value it had before the fall in February. Although at that point we could not be sure whether there is a shift in the trend of industrial production on the horizon, or it is temporarily increased to compensate for the backlog from the February, the latest data from April shows that a shift in the trend is indeed possible (Figure T2-6). This shift is actually necessary in order to avoid a decline in production in 2012 and in order for the economic activity to remain at the same level as in 2011 (GDP growth of 0%). In the previous part of this paper we have shown

Table T2-6. Serbia: Seasonally Adjusted Industrial Production Indices, 2008-2012.



Source: SORS

that for that the growth of net exports in the second half of the year is necessary, which does not mean anything else but the recovery of manufacturing industry - which produces by far the largest number of export products.

Forecasts for the next quarter are optimistic, but still unreliable

In the next quarter (Q2) we therefore expect significant decline of the annual industrial production compared to that of Q1. Although our forecast is still highly unreliable, because of large fluctuations in the past few months - we expect that industrial production will have annual decline of about 2%, and it will move in a positive annual growth index that can happen in Q3 2012, of course provided that there isn't a further escalation of the crisis in the eurozone. In Graph T2-6 we note that the industrial productions, nearly 3 years since the recovery has started, is still more than 10% below its pre-crisis level. Latest trends indicate that the pre-crisis level of the industrial production cannot be reached before the middle of 2013.

All groups of industrial products declining

A breakdown by use (Table T2-7) shows that all groups of goods entered negative y-o-y production growth in Q1. Energy production and consumer goods, as expected, had a slightly milder decline, because of the lower elasticity of demand for these products (most of the production of consumer goods is food industry).[6] On the other hand, a high decrease in the production of intermediate goods we associate with problems in the production of compounds of the Železara Smederevo steel plant. Decline in production of investment goods by over 10% likely announces lower investment activity in 2012.

Table T2-7. Serbia: Components of Industrial Production , 2005-2012

	Y-o-y indices								
	2008	2009	2010	2011	2011				2012
					Q1	Q2	Q3	Q4	Q1
Total	101.4	87.4	102.5	102.1	106.4	103.6	98.2	100.4	94.1
Energy[1)]	101.7	98.8	97.7	106.2	103.7	111.3	96.5	114.5	95.9
Investment goods[2)]	105.9	79.3	93.6	103.2	132.2	103.7	100.3	99.1	89.1
Intermediate goods[3)]	100.3	78.4	109.2	102.2	113.8	98.4	93.6	92.9	90.8
Consumer goods[4)]	101.6	86.8	102.1	95.4	96.5	98.1	95.8	90.5	97.4

Source: SORS

Construction

Relatively high growth of construction in Q1 ...

Latest construction statistics made available by SORS indicate extremely high y-o-y growth of this sector of the economy. The value of construction work performed rose by about 20% in real terms in Q1. We view these data with a degree of caution, since construction statistics are, according to some indicators, biased toward state-owned and other large companies.

Taking into consideration the fact that the construction sector comprises a large number of small and medium-sized enterprises, whose statistical monitoring is very unreliable, we use the cement production index as an additional indicator for monitoring this sector of the economy[7] (Table T2-8). Although not sufficiently precise, we believe that data obtained in this way are a good additional indication of possible trends in construction.

6 The movement of energy production is further influenced by the business polic of a small number of large companies (NIS, EPS) - thus large fluctuations in production are often (Table T2-7)

7 Cement consumption would be the most appropriate indicator, but data on cement consumption are not available at the quarterly level. Studies have shown that cement production approximates consumption with relative reliability.

Table T2-8. Serbia: Cement Production, 2001-2011

	Y-o-y indices				
	Q1	Q2	Q3	Q4	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	97.4	101.1
2011	97.7	101.3	96.2	97.7	98.3
2012	107.9	-	-	-	-

Source: SORS

Table T2-8 shows that cement production had y-o-y growth of 7.9%. Taking both figures into consideration we believe that the real annual growth in construction activity was between 10% and 15%. The reason for this forecast lies in our belief that official construction statistics probably overestimate the growth of this sector but that cement production is also not are liable enough indicator to consider its value as absolutely representative.

But the figures for Q1 are not the best indicator of actual trends in construction activity

However, data for Q1 we take with some reserve since the construction activity in Q1 was seasonally very low. Even relatively small changes in activity can lead to very high changes in the y-o-y indices. Therefore, we will wait for data from the next quarter for the final evaluation of the trends in construction activity. Our estimate from the previous QM was that the construction activity is likely to stagnate in 2012, at the same level of 2011. If, however, positive indications from Q1 continue in Q2, preliminary estimates will be revised upward.

3. Employment and wages

Although the results of the Labour Force Survey (LFS), conducted in April 2012, are not yet available, it is expected that the employment rate has continued to decline, while the unemployment rate has continued to rise during the period between October 2011 and April 2012. According to the data from the survey "RAD" (Work) a formal employment continued to decline between September 2011 and March 2012, though at a considerably slower pace when compared with a previous six-month period. The average real wage continued to grow even in the first quarter of 2012 and it is higher by 6% in comparison with the same period of the previous year: wages in the public enterprises increased by 7.4% and in economy by 6.7%. For the first time after three full years in which the periods of the year-on-year decline and stagnation in wages took turns, wages in administration and in the sector of education and culture started to increase.

Employment

Continuation of negative trends in the Labour Market

According to the survey "RAD", formal employment continued to decline between September 2011 and March 2012, though at a considerably slower pace in comparison with the previous six-month period (Table T3-2, Column 1). The total number of formally employed in the period from September 2011 to March 2012 decreased by 0.23%, or 4,000 persons. The decline of formal employment was much more pronounced year-on-year, so between March 2011 and 2012 it amounted to 17,000 persons, i.e. 1%.

The decline in employment is fully attributed to the decline in the number of employed with legal entities

Table T3-1. Serbia: Employment and Unemployment According to the Labor Force Survey[1], 2008–2011

		Total number of employed[2]	Number of employed in agriculture and unpaid family workers 15-64[3]	Employment rate 15-64 15-64 god.			Total number of unemployed 15-64	Unemployment rate 15-64		
				Total	Male	Female		Total	Male	Female
		1	2	3			4	5		
2008	April	2,652,429	..	54.0	62.3	46.0	432,730	14.0	12.4	16.1
	October	2,646,215	443,243	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	2,269,565	352,724	47.1	54.4	39.9	565,880	20.0	19.0	21.2
2011	April	2,191,392	340,528	45.5	52.2	38.8	649,155	22.9	22.7	23.1
	October	2,141,920	329,378	45.3	52.5	37.9	690,782	24.4	23.5	25.6

Source: Labor Force Survey (LFS), SORS.
Notes:
1) Labour Force Survey is conducted twice a year since 2008 - in October and in April.
2) Persons of 15-64 years of age are considered to be working population.
3) Prior to October 2008 LFS there was no 15-64 age group classification for the number of employed in agriculture and contributing household members, only 15+.

An employment drop in the past six months highest in the manufacturing industry

The decline in employment in the previous six-month period is fully attributed to the decline in the number of employed with legal entities (Table T3-2, Column 2), while the number of employed with entrepreneurs has remained unchanged (Table T3-2, Column 3).

Employment increased by about 2,000 persons in the public administration and public enterprises

Sector breakdown indicates that the greatest decline occurred in the Manufacturing industry of 4,000 persons, i.e. 1.3% within the sector. The employment declined slightly in the Agriculture and Construction sectors, while it increased in the area of Information and Communication, as well as in the Public administration (both sectors by 1,000 persons) and Education (2,000 persons) (Table P-5 in the Analytical Appendix.)

Within the public sector, employment in the public administration and public enterprises increased by a total of 2,000 persons in the period between September 2011 and March 2012 (Table T3-3).

The number of unemployed registered at the National Employment increased by 40,000 persons, i.e. 5.1% between September 2011 and March 2012. (Table T3-2; Column 7). These data, although indicative, do not necessarily reflect the trends in the economically defined unemployment, as they only cover the persons who use the services of the National Employment Service, regardless of their real labour market status.

The number of registered unemployed increased by about 40,000 persons

Table T3-2. Serbia: Number of Registered Employed and Unemployed[1], 2004–2012

		Total no. of employed	Employees in legal entities[2)]	Entrepreneurs: Total	Entrepreneurs: No. of entrepreneurs	Entrepreneurs: No. of employees with entrepreneu	Total no. of employees	Number of unemployed (NES)
		1 (=2+3)	2	3 (=4+5)	4	5	6 (=2+5)	7
				in thousands				
2004	March	2,065	1,601	464	208	255	1,856	..
	September	2,037	1,560	477	210	267	1,827	843
2005	March	2,070	1,557	513	228	285	1,842	884
	September	2,067	1,536	531	230	300	1,836	898
2006	March	2,032	1,496	536	228	308	1,804	920
	September	2,019	1,447	572	242	330	1,777	915
2007	March	2,004	1,438	566	239	327	1,765	913
	September	2,001	1,428	573	245	328	1,756	808
2008	March	2,006	1,432	574	245	329	1,761	795
	September	1,993	1,425	568	245	323	1,748	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	1,775	1,348	427	183	244	1,592	721
2011*	March	1,755	1,349	405	176	230	1,579	774
	September	1,738	1,337	401	174	227	1,564	743
2012	March	1,734	1,333	401	203	198	1,531	783

Source: SORS – The semi-annual report on employed persons and wages of the employed persons RAD-1/P; the update to the semi-annual survey RAD-1; Semi-annual survey on private entrepreneurs and their employed workers RAD-15; the National Employment Service.
Notes: The data for September were corrected on the basis of semiannual survey RAD-1 / P of March 2011.
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.
2) By the registered number of unemployed, we refer to those persons that have registered with the National Employment Service (NES). NES moved from monitoring the number of job seekers to the number of unemployed persons in September 2004. This is why we do not have these data for the previous period (column 7).

Table T3-3. Serbia: Public Sector Employment, 2004–2012

		Employees in legal entities						
		Public sector						
		From the budget			Public enterprises		Public sector - total	Other[1)]
		Administration - all levels	Education and culture	Health and social work	National public	Local public		
		1	2	3	4	5	6	7
					in thousands			
2004	March	63	117	147	125	57	509	1,092
	September	63	116	148	124	57	508	1,052
2005	March	63	119	148	122	61	513	1,044
	September	61	117	147	112	61	498	1,038
2006	March	60	118	141	105	61	485	1,011
	September	58	117	138	102	60	475	972
2007	Mart	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
2011	March	61	124	143	84	57	469	880
	September	62	122	143	84	57	469	868
2012	March	63	122	143	85	57	470	863

Source: SORS.
Note: Those employed in the Ministry of Defense and the Ministry of the Interior, even though financed from the budget, do not enter the total balance of the employed persons presented in this table. Their numbers are estimated at around 80,000, and they add another 4% to the total number of employed in Serbia. The data on their exact numbers and wages are not published by the SORS because of national security concerns.
Footnotes:
1) Private, socially-owned and mixed ownership enterprises (without entrepreneurs). This column is not disaggregated further due to data availability limitations. The number presented in column 7 is calculated by subtracting the total number of employees in public enterprises and those financed from the budget from the total number of employees in legal entities from Table T3-2.

Although the results of the Labour Force Survey conducted in April 2012 are not yet available, we do not expect significant changes in the key indicators of the labour market. As shown in the Table T3-3, from the year 2008, since the survey has been conducted twice a year, in April and October, the employment rate has had a downward trend. A mere 45.3% of working population aged 15-64 had a job in October 2011. The participation rate has decreased as well, currently standing below 60%. These trends highlight the stagnant labour market in Serbia with low employment opportunities. Although the public often speaks of a high unemployment rate as a main problem of Serbian labour market, low activity of a working population is equally concerning. Together, they indicate the insufficient utilization of labour resources.

Table T3-4. Indicators of the labour market situation for the persons of working-age (15-64), 2008-2011.

	October 2008.	April 2009.	October 2009.	April 2010.	October 2010.	April 2011.	October 2011.
Activity rate	62.6	60.8	60.5	59.1	58.8	58.9	59.9
Employment rate	53.3	50.8	50	47.2	47.1	45.5	45.3
Unemployment rate	14.7	16.4	17.4	20.1	20	22.9	24.4
Inactivity rate	37.4	39.2	39.5	40.9	41.2	41.1	40.1

Source: SORS, Labour Force Survey, Statements.

The transitions between the main labour market states: employment, unemployment and inactivity, which are contained in the transition matrices such as these given in the Table 3-4, as well bear witness to the stagnant labour market in Serbia. Rows of the matrix show the status of the individual in the initial period (April 2011), while the columns show the status of the same individual in the following period (October 2011). Each cell in the matrix indicates the number of individuals in the each of the nine status pairs on the labour market over the period of observation.

The construction of the transition matrices requires the panel data. Given that the half of the samples within the Labour Force Survey remains unchanged between the two Surveys, it enables observation of the employment status changes of a certain number of the same individuals during the six-month period.

Table T3-4 indicates that, during the year 2011, the probability for an unemployed individual to find a job after six months was very low- 9.2%. In the countries of European Union, transitions from unemployment to employment amount to a slightly less than 30% in the case of Belgium, Slovenia, Italy and the Czech Republic, while 45% of unemployed find a job after a year in the UK, Spain, Austria, Lithuania and Estonia[1]. Although these data came from the observing a longer time period, a year, it is still concerning that the trasition probability from the status of unemployed to employed is much lower in Serbia than in a significant number of European countries.

The table further shows that the large number of unemployed, as much as 18.4%, became discouraged in finding a job and withdrew from the labour market after six months. Meanwhile, the inflow of individuals in the status of unemployed was moderate- probability for the employed person to lose a job after six months amounted to 5.3%.

Finally, transitions from inactivity to employment and unemployment are very low and amount to 3%. In other words, a few people decide to enter the labour market, and equally small number of individuals truly succeeds in doing so. However, in this regard, we do not lag behind the countries such as France, Belgium, Slovenia and Spain. On the other hand, a somewhat larger number of individuals, over 5%, get out of inactivity in Austria, Lithuania, Estonia, Great Britain and the Netherlands.

1 Christine Erhel and Mathilde Guergoat-Larivière Labour market status, transitions and gender: a European perspective, http://hal.archives-ouvertes.fr/

Table T3-5. Trends in the labour market from April 2011 to October 2011

Status in April 2011		Status in October 2011 Employed	Unemployed	Inactive	Total
	Employed	2,059,893	121,828	98,848	2,280,569
		90,3%	5,3%	4,3%	100%
	Unemployed	59,991	470,338	119,734	650,063
		9,2%	72,4%	18,4%	100%
	Inactive	3,105,931	100,082	3,160,914	
		3,1%	3,0%	93,9%	100%
Total		2,225,815	692,248	3,379,496	6,297,559
		35,3%	11,0%	53.70%	100%

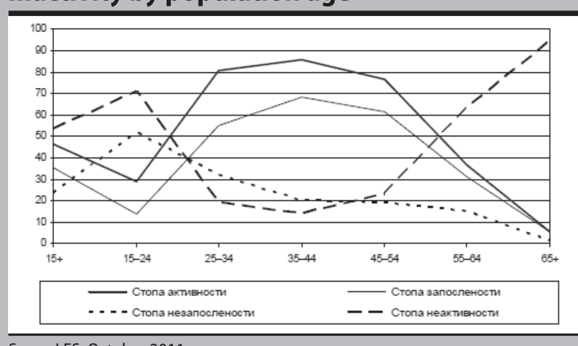
Source: *QM* estimates based on LFS from April 2011 and October 2011

Frame 1. (Non)active ageing

The year 2012 in the European Union is marked as the year of active ageing and solidarity between generations[1]. The principal of active ageing is one of the key economic and social objectives of the European Union that is faced with the chronic problem of the population ageing and the sustainability of the existing pension systems. In the recent years, the European Council has in several occasions issued the conclusions aimed at increasing the employability of older workers[2]. The conclusions suggest that the population ageing will not only cause problems in the financing the pension system and health care system, but also in the functioning of the labour market. Increased participation of the older workers in the labour market, considering their knowledge and experience that grows with age, is an important factor contributing to a smart, sustainable and inclusive growth that stands in the basis of the strategy *Europe 2020*. Measures propagated and gradually introduced in the Member States, despite the political unpopularity, include the increase of the effective time spent in the labour market by five years, gradual retirement and so-called part-time pensions.

Inactivity rate in Serbia is most recognizable among the population aged between 55 and 74 (Graph T3-1). The inactivity within this group is not uniform and increases with the age of individual. Reduced activity for this part of the working population is dominantly, in slightly more than 75%, caused by one reason- pension. However, more than 350.000 inactive persons of this age are not retired.

Graph T3-1: The movement in the rate of activity, employment, unemployment and inactivity by population age



Sorce: LFS, October 2011

As there is a difference in the status, so do the older workers differ in terms of transition between the working statuses. In Table T3-5 it can be noticed that among the individuals aged 65-74 during 2011, no transition to the status of unemployed occurred (the same phenomenon occurred between LFS in October 2010 and in April 2011); either the majority of people remained inactive between the two surveys, or they directly transited from the employment to inactivity.

On the other hand, individuals aged from 55 to 64 achieve greater dynamics in the labour market than the persons aged 65-74, but considerably lower in comparison to the entire population. For instance, a very low percentage of an unemployed in this age group finds

1 See more: http://europa.eu/ey2012/

2 "Dealing with the impact of an ageing population in the EU (2009 Ageing Report), "Equal opportunities for women and men: active and dignified ageing" (2009), "Active ageing" (2010)

a job after six months-a mere 1.6%. In the EU countries, indeed after a year, as much as 15% of unemployed in this age group finds an employment. Furthermore, it is noted that a significant number of the unemployed in this group became inactive after six months- as much as 34.7%. Of course, a number of them have reached the retirement age, but percentage this high may indicate also the discouragement in a job search.

Table T3-6 Trends in the labour market for older people, April 2011- October 2011

Status in April 2011		Status in October 2011 Employed	Unemployed	Inactive	Total
55-65 years	Employed	354,960	8,735	30,984	394,679
		89.90%	2.20%	7.90%	100.00%
	Unemployed	1,168	47,271	25,713	74,152
		1.60%	63.70%	34.70%	100.00%
	Inactive	26,712	12,334	803,772	842,818
		3.20%	1.50%	95.40%	100.00%
Total		382,840	68,340	860,469	1,311,649
		29.20%	5.20%	65.60%	100.00%
65-74 years	Employed	60,007		28,892	88,899
		67.50%		32.50%	100.00%
	Inactive	12,976		1,423,423	1,436,399
		0.90%		99.10%	100.00%
Total		72,983		1,452,315	1,525,298
		4.80%		95.20%	100.00%

Source: QM estimates based on LFS from April 2011 and October 2011

Previous strategic documents and practical policies of the activation of older workers did not provide significant results. Since 2006, subsidies of social security contributions and income tax exemptions have been introduced for employers who hire workers older than 50 years. Employment subsidies are among the most expensive active labour market policies per user, and the evaluation of the effect these measures had in other countries are mixed (See QM 27). In Serbia, they have made modest results- a mere 11,000 older workers have been hired due to this programme over the last six years.

In the period from 2006 and 2009, the program "*Severance to job*" was conducted with the aim to assist the older workers, who received a severance pay in the process of a company privatization, in finding a new job in the private sector or starting their own businesses. The study Nojkovic et al. (2010) found a strong positive causal connection between the participation in the program and the employment probability.

Other activation measures, such as *flexible forms of employment,* which are often more preferable for older workers, are still not developed sufficiently in Serbia. Employments with partial (or part-time) working hours are discriminated against by the taxation system, due to a high minimum social security contributions base, hence very rear- they account for only 9% in the total employment, and even less in the formal sector.

The activation of older workers in Serbia seems not to be desirable as a goal in itself. It is still seen as a last resort policy, or a side effect of delaying retirement rights for older workers. Indeed, with the latest changes made to the Pension and Disability Insurance Law 2010, provisions were introduced to discourage the early retirement. On the other hand, early withdrawal from the labour force is in some way favoured through certain provisions of the Labour Code. For example, the amount of the severance pay is based on the total years of service, rather than depend on the employment duration solely with the last employer. This provision often serves as the substitute for the early retirement. Severance payment based on the total years of service reduces not only the labour supply of the older workers, but also the demand for their services. In QM 27, we wrote about this problem and the fact that the changes of this Law provision were rejected by the representative trade unions at the meeting of the Social and Economic Council in October 2011. Moreover, the line Ministry has agreed with this decision.

Wages

The average real wage in Q1 2012 continues to grow y-o-y

The average real wage in Serbia in the first quarter of 2012 continues to grow year-on-year, and this time by 6%. As the last quarter of 2011, early 2012 was marked by a highest wage growth in the public enterprises, as much as 7.4%, but a significant wage growth, by 6.7% occurred in the economy (private, community and mixed enterprises).

Table T3-7. Serbia: Gross Wages in the Public Sector, 2004-2001, Y-o-Y Real Indices

	Average Monthly Wage[1]				Average Gross Monthly Wage Index[2]	
	Total labour costs[3], in dinars	Net wage, in dinars	Total labour costs, in euros	Net wage, in euros	nominal	real
	1	2	3	4	5	6
2008	47,882	29,174	586	357	117.8	104.8
2009	52,090	31,758	554	337	108.8	100.6
2010	55,972	34,159	543	332	107.5	101.2
2011	62,213	38,000	610	373	111.1	100.0
2008						
Q1	43,957	26,814	532	324	119.3	106.0
Q2	47,351	28,846	584	356	119.4	104.2
Q3	48,322	29,435	627	382	117.9	105.2
Q4	51,898	31,599	602	366	115.1	104.0
Dec	56,399	34,348	637	388	112.0	103.1
2009						
Q1	49,444	30,120	525	320	112.5	102.2
Q2	52,164	31,808	552	337	110.2	101.3
Q3	52,065	31,737	558	340	107.7	99.8
Q4	54,689	33,366	579	353	105.4	99.5
Dec	60,265	36,789	628	383	106.9	100.2
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
Q4	59,204	36,149	556	339	108.3	98.8
Dec	64,784	39,580	609	372	107.5	97.5
2011						
Q1	57,539	35,108	553	338	110.1	97.7
Q2	62,177	37,994	623	381	111.1	97.7
Q3	63,386	38,760	622	380	112.3	101.5
Q4	65,749	40,139	644	393	111.1	102.9
Dec	72,056	43,887	700	426	111.2	103.9
2012						
Q1	83,846	39,068	591	362	111.0	106.0

Source: SORS.
Footnotes:
1) Column 6 includes private, socially-owned and mixed ownership enterprises (excluding entrepreneurs).
2) Column 6 shows an estimate calculated by deducting the wage bill in the public sector from the total wage bill. The difference is divided by the number of workers employed in the real sector (column 7, Table T3-3).
3) Real y-o-y wage indices in columns 6 and 7 from 2008 onwards are calculated on the basis of the expanded sample for calculation of average earnings, which now includes entrepreneurs.

For the first time in three full years in which the periods of y-o-y decline and stagnation of wages took turns, wages in the sectors of administration and education and culture started to increase. The wages in Q1 2012 had a real growth by 4.9% in comparison with the same quarter in the year 2011 in the sector of education and culture, and by 4.7% in the public administration on the all government levels. The wage growth is the result of the combined effects of the deflation and wage increase in the mentioned sectors in the year 2011. By way of a reminder, in April 2011, in accordance with the regulations defined by the Law on the Budget System, wages in the public system nominally increased by 5.5%, and the increase was based on the price growth plus half of the GDP growth. Then, inflation rate suddenly dropped and mild nominal increase in wages occurred, by 1.5%, in public sector in October 2011. Downward trend in inflation rate continued, thus the aforementioned nominal increase led to a real wage increase.

However, looking at the real seasonally adjusted data on net wages in these sectors, it can be noticed that the wages remained unchanged in the first quarter this year compared to the last quarter of 2011. Only in the national enterprises real net wages increased by 7.1%, as well as in local enterprises by 1.6%. Table T3-7 shows also that the April wage growth in the public sector last year mostly affected the wage growth in the sector of Education and Culture by as much as 3.5% in Q2 in comparison to Q1, while in the sector of Health and Social Work wages increased by 2.5%.

T3-8: Real seasonally adjusted net wages, chain indices

	Administration all levels	Education and Culture	Health and Social Work	National public	Local public
2011, Q1	96	96.4	99.7	107.2	97.7
2011, Q2	101.8	103.5	102.5	99	101.3
2011, Q3	102.2	100.6	98.7	102.4	100
2011, Q4	100.7	100.4	101.1	98.8	100.4
2012, Q1	100	100.1	100.4	107.1	101.6

Source: *QM* estimates

Observed in Euros, the average net wage decreased after several consecutive quarters of growth throughout the past year. Labour cost reduced as well, from 644 € in Q4 2011 to 591€ in the first quarter of this year.

Table T3-9. Serbia: Average Monthly Wages and Y-o-Y Indices, 2008–2011

	Average Monthly Wage[1)]				Average Gross Monthly Wage Index[2)]	
	Total labour costs[3)], in dinars	Net wage, in dinars	Total labour costs, in euros	Net wage, in euros	nominal	real
	1	2	3	4	5	6
2008	47,882	29,174	586	357	117.8	104.8
2009	52,090	31,758	554	337	108.8	100.6
2010	55,972	34,159	543	332	107.5	101.2
2011	62,213	38,000	610	373	111.1	100.0
2008						
Q1	43,957	26,814	532	324	119.3	106.0
Q2	47,351	28,846	584	356	119.4	104.2
Q3	48,322	29,435	627	382	117.9	105.2
Q4	51,898	31,599	602	366	115.1	104.0
Dec	56,399	34,348	637	388	112.0	103.1
2009						
Q1	49,444	30,120	525	320	112.5	102.2
Q2	52,164	31,808	552	337	110.2	101.3
Q3	52,065	31,737	558	340	107.7	99.8
Q4	54,689	33,366	579	353	105.4	99.5
Dec	60,265	36,789	628	383	106.9	100.2
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
Q4	59,204	36,149	556	339	108.3	98.8
Dec	64,784	39,580	609	372	107.5	97.5
2011						
Q1	57,539	35,108	553	338	110.1	97.7
Q2	62,177	37,994	623	381	111.1	97.7
Q3	63,386	38,760	622	380	112.3	101.5
Q4	65,749	40,139	644	393	111.1	102.9
Dec	72,056	43,887	700	426	111.2	103.9
2012						
Q1	83,846	39,068	591	362	111.0	106.0

Source: SORS

Notes:

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

2) Y-o-Y average monthly gross wage indices for 2008 were calculated on the basis of average earnings in 2007 and 2008 based on the "old" sample that does not include those employed with entrepreneurs. 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%.

4. Balance of Payments and Foreign Trade

The current account deficit of the balance of payments for Q1 2012 has been increasing and moving away from its equilibrium level. The increase of current deficit, followed by a decline in capital and a significant spending of foreign currency reserves since the beginning of 2012 indicates that there might be a danger of a possible balance of payments crisis, if these trends were to continue. During Q1 2012, the current deficit was 1,159 million euros (16.5% of GDP), which is the highest quarterly amount of a current deficit since Q4 2008. This increase is the result of the rise in foreign trade deficit and a lower influx of current transfers. Domestic demand is rising (due to the high fiscal deficit), while the foreign demand is falling, which leads to lower domestic exports, while the imports have increased compared to the previous year. The trade deficit amounted to 1,542 million euros, i.e. 21.9% of GDP, and it is 4-5 percentage points of GDP above the average values of 2009, 2010 and 2011. Capital inflow in the first three months of the current year was extremely low, and the main source of covering the current deficit were the forex reserves of NBS, which were diminished in Q1 by 916 million euros. Unfavourable developments in the EU and neighbouring countries, together with a lack of important measures of domestic economic policies, can lead to further deepening of balance of payments imbalances and to the more pronounced problem of financing the growing current account deficit during 2012. On the other hand, the current depreciation of the dinar could affect favourably the current account in the future, given that its effect occurs with a time lag. Still, a strong fiscal consolidation and continued cooperation with the IMF are needed, as well as major structural reforms in order to reduce external imbalances in the medium and long term, as well as the pressures on weakening the local currency.

Balance of payments current account deficit was on the rise in Q1 2012

Balance of payments current account deficit is on the rise, and in Q1 2012 it amounted to 1,159 million euros (16.5% of GDP, Table T4-1). This is the highest quarterly amount of the current deficit since Q4 2008 (whether expressed in absolute terms or as a share of GDP, Figure T4-2 and Figure T4-3). In the last three years, the current account deficit of the national economy was well below the previous high values, i.e. much closer to long-term sustainable level. Increase of the current deficit since the beginning of 2012 means moving away from the equilibrium level again, which, together with a modest inflow of capital, had a negative impact on the value of dinar. The recorded growth of the current deficit is a result of the increase in foreign trade deficit and lower inflow of current transfers. The increase of foreign trade deficit is due to the growing domestic demand (due to high fiscal deficit at the beginning of the year) and the decline of exports caused by the decline in economic activity in the domestic exports, adverse weather conditions, and the departure of "US Steel Serbia". Since the changes in the exchange rate are reflecting on the foreign trade exchange with a time lag, we expect in the following quarters of 2012 a positive impact of the exchange rate developments, i.e. effect of real depreciation recorded in the second half of the previous and beginning of the current year. From the year on year perspective, the current deficit is higher by half of its value from Q1 2011.

In 2012, it is likely to expect a higher level of deficit as compared to previous three years, as well as problems in its financng.

By the end of 2012, the unfavourable external events (crisis in the Eurozone and the present uncertainty - and consequently lower private capital inflows and current transfers, as well as the unfavourable economic situation in neighbouring countries[1]), increased political and economic instability in Serbia could lead to further deepening of the balance of payments imbalances and the more pronounced problem of financing the growing deficit. On the other hand, the present exchange rate depreciation will surely have the opposite effect, mitigating the adverse impacts. In addition, a significant start of activities in the automotive industry could to a large extent have a positive impact on current deficit through the increase of exports. Finally, strong fiscal consolidation[2] and a continued cooperation with the IMF, as well as the policy implementation of

1 For details, please see section 8. „International environment" in this issue of QM.

2 On the necessity of implementing a strong fiscal consolidation, see Spotlight 1 in this issue of QM.

necessary structural reforms, would have long-term positive impact on the external imbalances. Specifically, the new agreement with the IMF would have multiple positive effects on stabilising the balance of payments. First, the necessary reduction of the fiscal deficit would lead to a decline in domestic demand and imports, which would further contribute to the reduction of foreign trade and, consequently, current deficit. Second, cooperation with the IMF would lead to increased investor confidence and significant inflow of capital. Also, the arrangement with the IMF would mean the direct protection from the balance of payments crisis with the withdrawal of funds that would strengthen the foreign reserves.

Table T4-1. Serbia: balance of payments

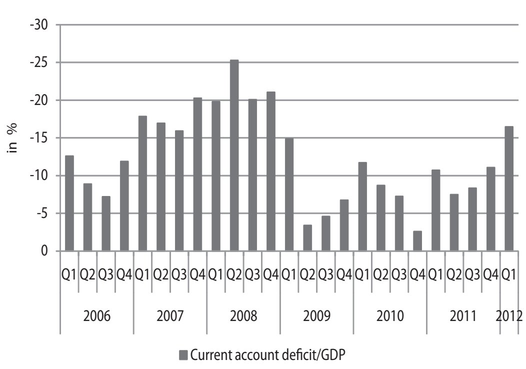
	2009	2010	2011	2010				2011				2012
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
	mil. euros											
CURRENT ACCOUNT	-2,084	-2,082	-2,968	-760	-615	-519	-188	-760	-621	-683	-903	-1,159
Goods	-5,118	-4,774	-5,514	-1,186	-1,171	-1,244	-1,173	-1,314	-1,230	-1,271	-1,699	-1,542
Export f.o.b[1)]	5,978	7,402	8,438	1,473	1,861	1,938	2,129	1,955	2,163	2,169	2,151	1,852
Import f.o.b[1)]	-11,096	-12,176	-13,952	-2,659	-3,032	-3,182	-3,302	-3,269	-3,392	-3,440	-3,850	-3,395
Services	18	5	161	-19	5	-1	20	28	12	12	109	38
Export	2,500	2,667	3,032	537	635	737	758	631	720	816	865	676
Import	-2,482	-2,662	-2,872	-555	-629	-739	-738	-604	-708	-803	-756	-638
Income, net	-502	-670	-758	-167	-205	-127	-171	-112	-252	-195	-198	-229
Receipts	500	438	428	107	108	92	131	101	100	101	126	109
Payments	-1,002	-1,108	-1,186	-273	-313	-219	-302	-214	-352	-296	-324	-338
Current transfers, net	3,518	3,356	3,143	611	755	854	1,136	638	849	771	885	574
o/w grants	197	193	206	29	20	35	109	49	41	39	77	26
o/w private remittances, net	2,618	2,383	2,165	415	543	610	815	450	596	546	573	359
CAPITAL ACCOUNT	2	1	-3	0	0	1	0	-1	0	-1	0	-3
FINANCIAL ACCOUNT	2,207	1,986	2,752	698	596	488	204	644	566	642	899	1,008
Direct investment, net	1,372	860	1,827	284	136	176	265	307	259	661	600	-372
Portfolio investment, net	-51	39	1,619	38	35	4	-38	520	246	871	-18	76
Other investments	3,249	158	1,107	10	104	-6	50	-15	93	188	840	388
Trade credits	654	83	651	-109	125	249	-183	133	124	116	277	108
Loans	1,414	830	-413	523	-270	93	483	-879	34	226	206	-20
NBS	1,114	341	45	0	237	50	54	-4	52	-3	0	-4
Government	258	735	687	167	198	315	55	29	275	297	86	18
Commercial banks	894	626	-729	525	-396	-123	619	-691	-132	-10	104	-150
Long-term	492	619	419	558	-6	33	34	3	10	99	307	-84
Short-term	402	6	-1,148	-32	-390	-156	585	-694	-142	-109	-203	-66
Other (enterprises)	-853	-872	-416	-170	-309	-148	-246	-214	-160	-58	16	115
Currency and deposits	760	-754	870	-405	249	-348	-250	731	-65	-153	357	300
Other assets and liabilities	0	0	0	0	0	0	0	0	0	0	0	0
Allocation of SDR	422	0	0	0	0	0	0	0	0	0	0	0
Reserves Assets (- increase)	-2,363	929	-1,801	367	321	313	-73	-168	-33	-1,078	-523	916
ERRORS AND OMISSIONS, net	-124	96	219	62	19	31	-16	118	54	42	4	154
OVERALL BALANCE	2,363	-929	1,801	-367	-321	-313	73	168	33	1,078	523	-916
PRO MEMORIA												
	in % of GDP											
Current account	-7.2	-7.4	-9.3	-11.7	-8.7	-7.2	-2.6	-10.7	-7.5	-8.3	-11.1	-16.5
Balance of goods	-17.7	-17.1	-17.4	-18.3	-16.6	-17.4	-16.2	-18.5	-14.8	-15.5	-20.8	-21.9
Exports of goods	20.6	26.5	26.6	22.7	26.3	27.1	29.5	27.5	26.1	26.5	26.4	26.3
Imports of goods	-38.3	-43.6	-44.0	-41.0	-42.9	-44.4	-45.7	-46.1	-40.9	-42.0	-47.2	-48.2
Balance of goods and services	-17.6	-17.1	-16.9	-18.6	-16.5	-17.4	-15.9	-18.1	-14.7	-15.4	-19.5	-21.4
Current transfers, net	12.1	12.0	9.9	9.4	10.7	11.9	15.7	9.0	10.2	9.4	10.8	8.2
GDP in euros[2)]	28,966	27,956	31,744	6,491	7,070	7,166	7,229	7,096	8,297	8,190	8,161	7,039

Source: NBS

1) Expot and limport f.o.b, according to the NBS methodology adjusted to IMF BOPM-5.

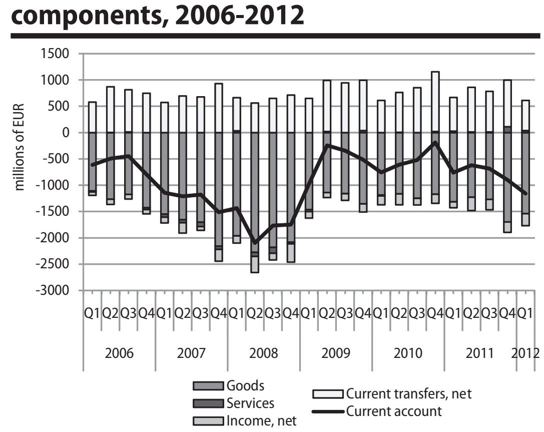
2) Quarterly values. Conversion of the annual GDP to euros is done according to the average annual exchange rate (average of official daily middle rates of NBS).

Figure T4-2. Share of current account deficit in GDP, 2006-2012



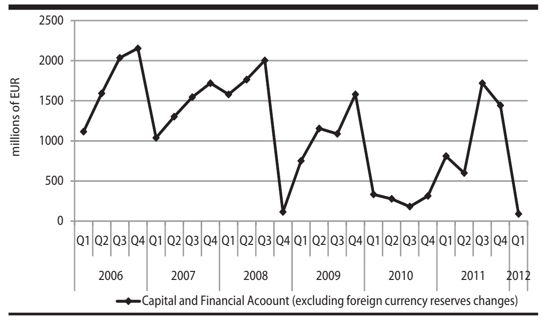
Source: NBS, *QM*

Figure T4-3. Current account and its components, 2006-2012



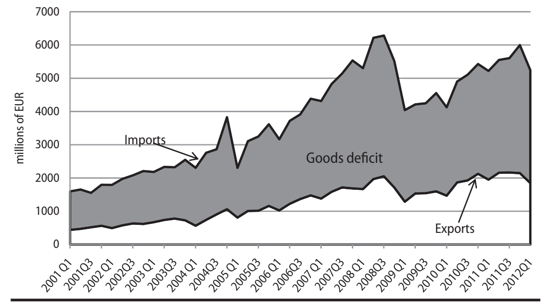
Source: NBS, *QM*

Figure T4-4. Capital and financial accounts, 2006-2012



Source: NBS, *QM*

Figure T4-5. Import of goods, export of goods, and trade deficit, 2001-2012



Source: NBS, *QM*

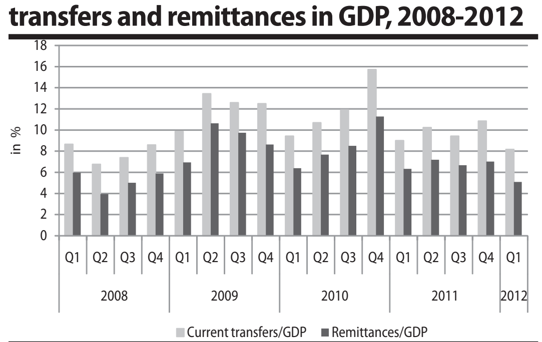
The increase in current account deficit in Q1 is the result of growing foreign trade deficit and lower inflows of current transfers.

The increase in current account deficit in Q1 is the result of growing foreign trade deficit, and of relatively low-level inflow of current transfers. Trade deficit amounted to 1,542 million euros, i.e. 21.9% of GDP. Realised trade deficit continues its rise recorded at the end of 2011 and it is one percentage point above the actual participation in the last quarter of 2011 (see Table T4-1). Trade deficit is above the average values of 2009, 2010 and 2011 by 4-5 percentage points (Figure T4-5). Rise of the trade deficit is the result of the growing domestic demand (due to high fiscal deficit) and declining foreign demand, which leads to a decrease of domestic exports, while the imports are on a slight rise compared to the previous year. In Q1, the exports amounted to 1,852 million euros (26.3% of GDP), while the imports were 3,395 million euros (48.2% of GDP). The exports are 5.2% below, while the imports are 3.9% above the values of Q1 last year. This brings the y-o-y deficit increase to 17.4%. The coverage of imports by exports in this period declined by 5 percentage points - from 60% recorded in Q1 2011 (and in the whole 2011) to 55% in Q1 2012.

Low inflow of current transfers is primarily due to lower inflows of remittances

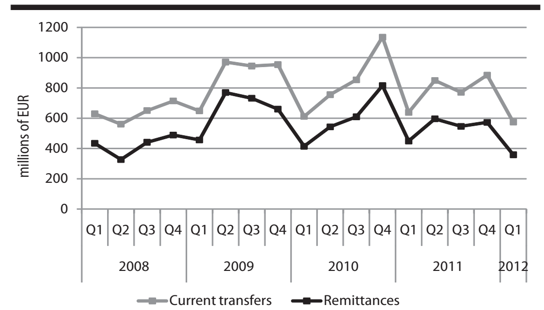
Inflow of current transfers, especially remittances, is in a noticeable decline. During Q1, inflow from current transfers amounted to 574 million euros, accounting for 8.2% of the corresponding quarterly GDP. Given the values of 2009, 2010 and 2011 (12.1% of GDP, 12.0% of GDP and 9.9% of GDP, respectively) this kind of inflow is reduced and closer to the values from the period before the crisis (e.g. 7.8% of GDP in 2008). The inflow of remittances amounted to 359 million euros, i.e. 5.1% of GDP, which is the value of pre-crisis level in 2008 (5.2% of GDP, Table T4-1) and significantly lower than the inflow of remittances in previous three years (Figure T4-6 and Figure T4-7). The current reduction in inflows of remittances (and consequently the current transfers) may be a result of a greater crisis in the Eurozone, i.e. significant economic problems faced by member states, such as job losses and increased uncertainty in both the EU and other countries, which are senders of transfers (remittances). On the other hand, the reduced inflow in Q1 could only indicate a short-term fluctuation of inflows, which is seasonal and is leading to lower levels of remittances at the beginning of each year (Figure T4-6 and Figure T4-7). However, remittances are by one fifth, and current transfers by one tenth below the values recorded in the first quarter of last year.

Figure T4-6. Share of inflows of current transfers and remittances in GDP, 2008-2012



Source: NBS, *QM*

Figure T4-7. Inflow of current transfers and remittances, 2008-2012



Source: NBS, *QM*

Capital inflow in the first three months of current year is extremely low

The problem of financing the deficit, that could possibly mark the entire 2012, appeared at the very beginning of the year – in Q1 2012. The capital inflow in the first three months of the current year was extremely low – 92 million euros (see Figure T4-4)[3]. The low inflow of capital in this period is the result of a high FDI outflow, the low amount of portfolio and other investments. So in Q1, foreign reserves were diminished by 916 million euros, which covered most of the current deficit (Table T4-1).

...due to FDI outflows, modest portfolio investments and discharge of financial loans

During Q1, a substantial outflow of capital based on FDI was recorded – 372 million euros net. This is primarily a consequence of the repurchase of Telecom Serbia shares from the Greek telecoms company OTE in the amount of 380 million euros and the withdrawal of partial Telenor capital (around 120 million euros)[4]. Portfolio investments were modest, amounting to 76 million euros. Other investments amounted to 388 million euros, out of which 300 million euros was the inflow of funds to the *Cash and depo*mmercial loansTrade credits were 108 million euros, while the financial loan account recorded a slight discharge in the amount of 20 million euros. Banks discharged their net short-term and long-term loans. At the end of 2011, the banks pulled large amounts of money from their parent banks abroad in order to improve the state of annual financial reports, and then returned the money at the beginning of 2012. In Q4 2011, the companies reversed the trend of debt settlements abroad recorded since the onset of the crisis and in Q1 2012 borrowed the additional 115 million euros net, almost entirely in long-term loans.

No considerable inflow of capital is expected in 2012

No considerable inflow of capital is expected in 2012. The high amount of FDI in 2011 was related to several large projects, that are either completed or in final stages, as well as to the sale of the company "Delta Maxi". That is why we cannot count on a significant amount of FDI before next year. In addition, given the current situation in the EU and the national economy, aside from the lack of a significant FDI, the absence of a more significant activity of portfolio investors on the domestic market is quite probable as well. This indicates that without larger structural changes in the Serbian economy, that would lead to the increase of exports and creation of an investment attractive environment, the foreign loans and/or reduction in forex reserves would, in that case, be the main source of covering the current deficit. That is, the expected influx of investments of around 1 billion euros in 2012 (estimate of the level of investments as a sum of possible smaller investments) will be considerably below the expected level of the current deficit. Hence, if the current account deficit is around four billion euros, the difference will have to be covered either by additional loans or by the additional reduction in the foreign reserves, which will exert considerable pressure on the exchange rate and could cause a balance of payments crisis.

In the first four months of 2012, there was a decrease of foreign reserves by 1.67bn euros, out of which 709 million euros were spent on the defence of the exchange rate

Forex reserves were decreased by 916 million euros during Q1 (Table T4-1). In January, the outflow of capital through banks was around half a billion euros (return of funds pulled from abroad at the end of 2011 from parent banks, in order to improve the state of annual financial reports). In February, the biggest part of the forex reserve outflow was due to the matured RS state securities denominated in euros, in the amount of 204 million euros, as well as due to the NBS interventions in an attempt to mitigate excessive daily fluctuations in the exchange rate (189 million euros). In March, a net decrease in foreign reserves of 92 million euros was recorded, where the largest outflow was due to the NBS interventions on the interbank foreign exchange market in the amount of 310 million euros. Forex reserves were diminished in April as well, so at the end of the month they amounted to 10,387 million euros5. In April, the largest part of that reduction was the result of withdrawal of mandatory forex reserves of the banks. The banks withdrew 470 million euros due to the regulatory changes of NBS (reduction of rate at which banks calculate the mandatory forex reserves, followed by the increased rate of forex reserves of banks in dinars). Additional 210 million euros of foreign reserves in April were used for the defence of the value of the national currency. In total, in the first four months, just for the interventions on interbank foreign exchange market, the forex reserves were decreased by 709 million euros, while the total decline of forex reserves was 1.67 billion euros. Still, even though the foreign reserves are diminishing, they are still covering six to seven months of imports of goods and services.

3 247 million eurs with the Errors and omissions account.
4 Source: National Bank of Serbia.
5 http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=5756&konverzija=no

Exports

In Q1 exports recorded a decrease of 5.2% y-o-y

In Q1 2012, exports were 1,860 million euros, which is 5.2% below last year's value (Table T4-8). The decline in exports is the result of a considerable y-o-y decrease of value of *Bulky exports* (-30.6%), while the *Underlying exports* recorded a y-o-y growth of 7.4%. Primarily, the realised export performance was the result of a sudden drop in exports of *Iron and steel* (-63.0%), due to new circumstances at the "Železara Smederevo" steel factory. Additionally, the cold weather resulted in modest production results during Q1 and a lower level of exports of other export products.

A 1.7% year on year increase in prices in euros of exporting goods was recorded. Figure T4-9 shows that terms of trade (ratio of export and import prices) recorded a slight hight variation in the index. A certain decrease was recorded in Q4 2011 (probably due to a drop in food prices and a rise in global energy prices). Still, the index values shown were often above 100. Therefore, the fact that in Q1 the terms of trade index was 99.3, i.e. only by 0.7% lower than in Q1 2011(Figure T4-9) shows that the decline of foreign trade activity cannot be attributed to the deterioration of the price ratio of export and import goods.

In addition to a significant decline of exports in Iron and steel, a y-o-y decline in export value has been recorded in all other Bulky export goods as well

Besides the significant y-o-y decline in Q1 in export of Iron and steel, a y-o-y decline in the export value of all other goods within the Bulky export category was recorded as well. y-o-y exports of non-ferrous metals has dropped by 22.8%, partly due to the fall of prices, and partly due to the reduced export quantities. After the extremely high level recorded in Q1 2011, global prices of non-ferrous metals have gradually declined during 2011, only to rise again in Q1 2012. In Q1 2012, global prices of these products in euros were 13.9% below the average prices of Q1 2011[6]. Therefore, the decline in exports quantities was 10.3%, which is probably a consequence of diminished production due to the adverse weather conditions at the beginning of the year. The exported values of Fruits and vegetables and Cereal and cereal products were below Q1 of last year by 9.1% and 1.6% respectively (Table T4-8).

Underlying exports recorded a YOY growth due to the significant increase of Other exports

Underlying exports recorded a y-o-y growth of 7.4%. Within it, exports of goods in the *Core* group were almost at the level of Q1 of the previous year, while there was a significant rise of 12.6% of export of goods categorised under the group *Other.*

Table T4-8. Serbia: Exports, y-o-y growth rate, 2010–2

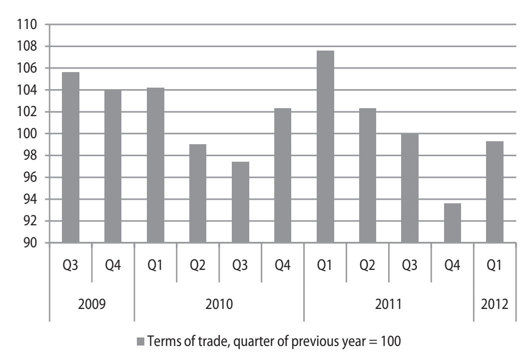
	Exports share in 2011	2011[1]				2012[1]	2011[1]				2012[1]
		Q1	Q2	Q3	Q4	Q1	Q1	Q2	Q3	Q4	Q1
	in %	mil. euros					y-o-y growth rate (in %)				
Total	100.0	1,961	2,157	2,157	2,162	1,860	33.7	14.5	11.7	2.1	-5.2
Bulky exports	27.7	649	574	566	551	450	53.9	15.7	5.5	-12.1	-30.6
Iron and steel	8.4	239	186	147	140	88	47.4	-4.8	-19.4	-23.3	-63.0
Non ferrous metals	7.4	164	178	158	128	127	50.5	34.9	3.7	-3.1	-22.8
Fruits and vegetables	5.6	92	92	147	141	84	22.4	15.4	29.0	9.4	-9.1
Cereal and cereal products	6.2	154	117	114	142	151	104.1	32.4	29.5	-22.4	-1.6
Underlying exports	72.3	1,312	1,583	1,591	1,611	1,410	25.5	14.0	14.1	8.0	7.4
Core	29.7	577	632	673	627	582	31.7	21.3	15.4	5.9	0.9
Clothes	4.1	82	80	96	89	89	13.5	15.3	18.2	5.9	9.1
Miscellaneous manufactured articles, n.e.s.	3.4	60	74	77	77	61	27.2	13.6	5.6	7.4	2.9
Manufactures of metals, n.e.s.	4.2	68	97	100	90	78	52.6	45.6	47.0	15.2	15.3
Rubber products	3.2	76	65	65	63	72	40.0	25.9	18.4	12.0	-4.4
Electrical machinery, apparatus and appliance	6.3	124	134	141	135	137	58.9	24.1	15.7	-3.0	10.6
Organic chemicals	0.6	12	12	11	15	9	-58.7	-56.3	-61.3	-16.8	-22.4
Plastics in primary forms	1.9	43	42	41	36	20	48.5	30.7	10.4	6.4	-53.0
Footwear	2.3	51	45	55	44	49	35.0	34.7	23.1	3.2	-3.3
Paper, paperboard and articles of paper pulp	2.3	45	52	50	49	48	26.5	25.4	24.6	15.9	6.4
Non-metal mineral produce	1.4	17	32	38	29	17	47.2	17.1	8.7	13.1	0.1
Other	42.5	735	951	918	984	828	21.0	9.7	13.1	9.4	12.6

Source: RZSSORS

1) data in millions of euros, as well as the year on year growth rates, were obtained based on the data from the Statistical Office of the Republof Serbia (RZSSORS) and calculated according to the new methodology. For details, see QM issue no.20, Box 1, "Changes to foreign trade methodology used by the Statistical Office of the Republic of Serbia".

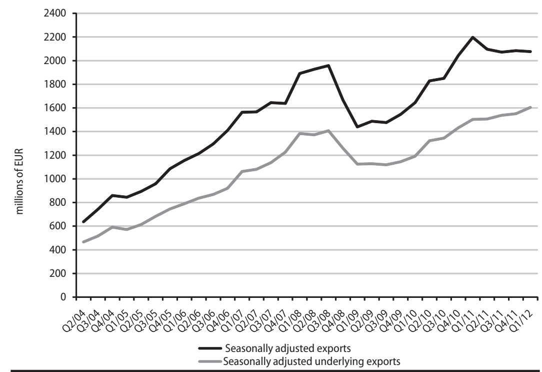
6 Fall of prices in dollars is more pronounced and it's 17.4%, due to the weakening of the euro against the dollar.

Figure T4-9. Terms of trade index, 2009-2012



Source: RZSSORS, *QM*

Figure T4-10. Serbia: Seasonally adjusted exports and seasonally adjusted underlying exports, quarterly, 2004-2012



Source: RZSSORS, *QM*

Seasonally adjusted values confirm the significant impact of the decline of** Bulky exports **on the reduction of total exports in Q1

Seasonally adjusted export in Q1 was 2,075 million euros and by 0.4% lower than the exports from the previous quarter – which represents a reduction of 1.6% on an annual level. Still, the seasonally adjusted *Underlying export*[7] has been recording a quarter on quarter value growth ever since Q3 2009. Thus, the seasonally adjusted value of the *Underlying export* is by 3.5% over the value of Q4 2011, i.e. by as much as 14.7% annualised (Figure T4-10). This confirms that the current decline in exports is the result of the recorded drop in *Bulky exports* – primarily the decrease of exports of iron and steel due to the exit of US Steel, but also of all other products in this category.

Significant impact of** Iron and steel **on total exports, but a small one on net exports

Just how much have the production and exports of US Steel been significant for the total exports of Serbia is also shown by the fact that the exports of *Iron and steel* made as much as 13% of total domestic exports in the period before the crisis (after the crisis, this share dropped to around 8% in 2009, 10% in 2010 and 8.5% in 2011). Thus, the exports in Q1 2012, after the exclusion of Iron and steel, recorded a rise as compared to Q1 2011 by 2.9%. Also, the seasonally adjusted value of such exports was by 3.2% higher than in Q4 2011, i.e. 13.6% annualised. However, it is important to mention that even though the American company was a large exporter, it was also a large importer. That is, the value of exports and imports of goods in the *Iron and steel* group compared to the GDP value indicates a low value of net exports. From 2004 to 2011, the export of Iron and steel was 2-3% of GDP, and the import was 1-2% of GDP, so the net exports were 1% of GDP at the most. So, even though the decline of *Iron and steel* production contributed significantly to the decline of exports in Q1 2012, it had almost no impact on the rise of the foreign trade deficit in this quarter (0.03 percentage points of GDP).

However, the lack of a substantial activation of the production of *Iron and steel*, coupled with the current economic problems in the EU and surrounding countries, will probably cause a continuation of a negative trend in the growth of total exports until the end of the year. This will further lead to a diminished coverage of exports by imports and a decreased inflow of foreign currency in this respect, which would, combined with the high domestic demand, exert additional pressures on the exchange rate and the forex reserves.

7 Total exports excluding the exporting values of Bulky exports: Iron and steel, Non-ferrous metals, Cereal and cereal products, and Fruits and vegetables.

Imports

Year on year growth of imports of 4.7% in Q1

In Q1, imports recorded a rise of 4.7% year on year[8]. Observed individually – by its components - *Energy, Intermediary goods, Capital goods*, as well as *Durable consumer goods* recorded a y-o-y growth of 10-12%. Over Q1, the imported value of *Non-durable consumer goods* was significantly above the last year's value (30.6%). On the other hand, the import of goods in the *Other* group was by one third below the value of the first quarter of 2011. It should be noted that the importing prices in Q1 were by 2.3% higher than the prices of the same period in 2011, i.e. the imported inflation contributed to a certain extent to the rise of the value of imports (especially in the import of energy, equipment, raw materials, and food)[9].

Unfavourable structure of imports still pronounced

The import of *Intermediary goods* is slightly accelerating the growth (y-o-y rate of 11.7%), while there is a decline in growth of imports of *Capital goods*. The imported value of *Durable consumer goods* in Q1 2012, after the negative growth rates of the previous year, recorded an increase of 12.0%, year on year (Table T4-11). A larger import of *Non-durable consumer goods* in Q1 2012, compared to the same period last year, indicates an unfavourable structure of imports. On the other hand, import of *Other* goods is on a significant decline.

Energy prices in the world recorded a rise at the beginning of 2012, so the y-o-y growth of global prices in euros in Q1 was 17.6%[10]. Thus, during Q1, having in mind the stated growth of prices, there was a drop in imported energy by about 5%, despite the rise of energy imports due to the extremely cold weather.

Table T4-11. Serbia: Imports, y-o-y growth rate, 2010–2012

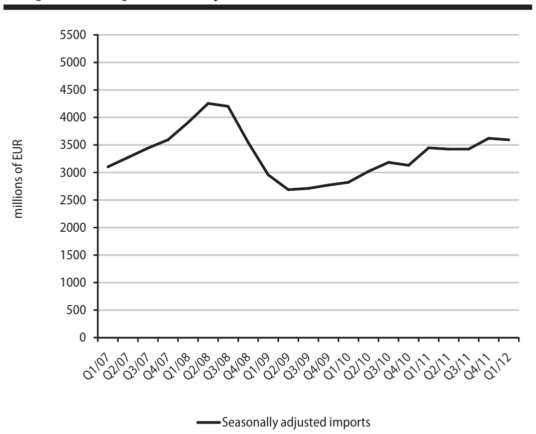
	Imports share 2011	2011[1)] Q1	Q2	Q3	Q4	2012[1)] Q1	2011[1)] Q1	Q2	Q3	Q4	2012[1)] Q1
	in %	u mil. euros					in %				
Total	100.0	3,374	3,502	3,538	3,983	3,534	24.3	14.2	7.7	16.5	4.7
Energy	18.6	729	583	545	823	814	32.5	7.0	-10.7	58.2	11.6
Intermediate products	32.2	1,023	1,240	1,197	1,175	1,143	38.9	29.3	9.8	6.7	11.7
Capital products	16.2	521	550	573	690	574	35.0	12.2	8.5	20.8	10.2
Durable consumer goods	2.3	72	78	83	100	81	-12.7	-4.7	-2.2	-5.2	12.0
Non-durable consumer goods	12.2	370	411	444	527	483	7.7	9.4	13.9	12.2	30.6
Other	18.5	659	640	695	667	439	7.2	4.0	19.6	2.8	-33.3
Imports excluding energy	81.4	2,645	2,919	2,992	3,160	2,720	22.3	15.8	11.9	9.1	2.8

Source: SORS

1) Data in millions of euros, as well as the year on year growth rates were obtained based on the data of the Statistical Office of the Republic of Serbia, calculated according to the new methodology. For details, see QM issue no.20, Box 1 "Changes to foreign trade methodology used by the Statistical Office of the Republic of Serbia".

Seasonally adjusted imports indicate a slight growth trend since mid 2009, but also that its values are still below those before the crisis

Figure T4-12. Serbia: Seasonally adjusted imports, quarterly, 2007-2012



Source: NBS, SORS, *QM*

The value of seasonally adjusted imports in Q1 2012 is below the values from Q4 2011 by 0.8% (3.0% annualised). Still, the figure shows a slight growth trend of imports as of the second half of 2009, with certain oscillations. A slow recovery of imports have impacted the levels of imports to still be lower than before the crisis. That is, after the sudden decline at the start of the global financial crisis, the imports at the beginning of 2012 still haven't reached the values from Q2 and Q3 2008 (15% below the imported values from that period, Figure T4-12).

8 The section of the article dealing with the balance of payments analysis uses data for exports and imports f.o.b. (free on board), published by NBS in line with the IMF methodology („Balance of Payments Manual", fifth edition, IMF; http://www.imf.org/external/np/sta/bop/BOPman.pdf.). Part of the article dealing with the analysis of imports and exports uses the data from the RZS, where the value of exported goods is expressed according to the f.o.b. type of value, and the value of imported goods according to the c.i.f. (cost, insurance, freight) type of value. That is why a discrepancy may occur in the stated imports, as well as in the growth rates.

9 SORS and NBS, Inflation report, May 2012, p. 11.

10 The year on year growth of global prices in dollars is 12.8%, which, together with the appreciation of dollar against euro, contributes to the energy prices expressed in euros in Q1 2012 being above the last year's levels by 17.6%.

Foreign debt

Serbia's foreign debt at the end of March was 24,068 million euros, i.e. 76.0% of GDP

Serbia's foreign debt at the end of March was 24,068 million euros, i.e. 76.0% of GDP, which is practically the same as at the end of 2011. As previously mentioned, on the one hand, Q1 saw a discharge of the banking sector's debt (short-term[11]), while the private sector took on an additional debt of 138 million euros for long-term loans[12]. Foreign debt of the public sector was by 118 million euros lower than in the previous three months (Table T4-13).

Table T4-13. Serbia: Structure of foreign debt, 2008–2012

	2009	2010				2011				2012
		Mar.	Jun	Sep.	Dec.	Mar.	Jun	Sep.	Dec.	Mar.
	stocks, in EUR millions, end of the period									
Total foreign debt	22,487	22,943	23,456	23,115	23,786	22,672	22,734	23,860	24,125	24,068
(in % of GDP) 2)	78	79	82	81	85	79	76	77	76	76
Public debt	7,764	8,122	8,921	8,874	9,076	8,861	9,138	10,433	10,773	10,655
(in % of GDP) 2)	27	28	31	31	32	31	31	34	34	34
Long term	7,762	8,122	8,921	8,874	9,076	8,861	9,138	10,433	10,773	10,655
o/w: to IMF	1,110	1,157	1,483	1,455	1,529	1,475	1,506	1,582	1,618	1,581
o/w: Government obligation under IMF SDR allocation	422	440	469	444	449	434	428	449	459	449
Short term	1	0	0	0	0	0	0	0	0	0
Private debt	14,724	14,820	14,535	14,241	14,710	13,811	13,597	13,427	13,352	13,412
(in % of GDP) 2)	51	51	51	50	53	48	46	44	42	42
Long term	12,720	12,919	13,076	12,945	12,880	12,696	12,630	12,569	12,704	12,834
o/w: Banks debt	2,597	2,867	3,195	3,279	3,362	3,347	3,413	3,551	3,782	3,784
o/w: Enterprises debt	10,123	10,052	9,881	9,667	9,518	9,348	9,217	9,018	8,922	9,050
Short term	2,003	1,901	1,459	1,295	1,830	1,116	966	858	648	578
o/w: Banks debt	1,713	1,691	1,304	1,146	1,731	1,036	895	785	582	515
o/w: Enterprises debt	290	210	155	149	100	79	72	73	66	63
Foreign debt, net 1), (in% of GDP)2)	41	43	45	47	49	45	43	41	38	41

Note: As of September 2010, the methodology of the statistics of foreign debt has been changed, so that now the public sector foreign debt includes obligations under the IMF SDR allocation (448.9 million euros), used in December 2009, as well as the capitalised interest towards the Paris club creditors (49.8 million euros), while the foreign debt of the private sector now excludes the loans concluded prior to December 20, 2000, for which no payments are made (867.3 million euros, out of which 403.3 million euros relates to domestic banks, and 464.0 million euros relates to the domestic enterprises). The foreign debt data shown in the Table were calculated according to the new methodology.
Source: NBS, *QM*
1) Total foreign debt less NBS forex reserves.
2) The sum of GDP value of the observed quarter and of previous three quarters was used.

Variations of the exchange rate significantly impact the expressed dynamic of the foreign debt

Still, significant variations of the exchange rate are responsible to a large extent for the expressed changes in the foreign debt. That is, the current depreciation of euro against other currencies leads to the increase of debt expressed in euros, while the movement of dinar additionally affects the amount of GDP, thus contributing to the variations of the foreign debt activity expressed in % of GDP. In the foreign debt structure, the largest share belongs to the debt in euros (76.3%), then in dollars (13.3%). Special drawing rights make 8.5% of the foreign debt, the Swiss franc has 3.9%, while the rest of the debt (0.7%) goes to other currencies[13]. Having in mind this currency structure, during Q4 2011, out of 265 million euros of increase in the foreign debt, almost ¾ (195 million euros[14]) of the recorded growth were due to the weakening of euro against other listed currencies.

U odnosu na mart 2011 godine porast spoljnog duga posledica rasta duga javnog sektora

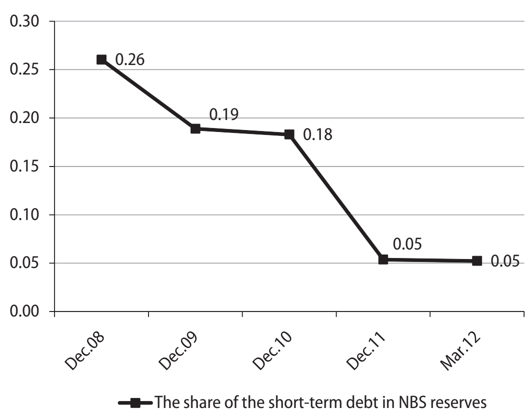
However, at present, the weakening of dinar could have a greater impact on the expressed level of the foreign debt. That is, the value of the national GDP expressed in euros declines with the fall of national currency. Thus, if we calculate the value of GDP realised in the last three quarters of 2011 and the first quarter of 2012, at the average rate in March 2012 of 110.9 dinars to a euro, and then compare the debt value with thus calculated value of GDP[15], we find that the foreign debt makes as much as 82% of its value.

11 Long-term loans of banks and the discharge of short-term loans from the private sector were negligable in Q1.
12 Here, we are repeating the citing of the debt of the banks and private sector from the section of the article on balance of payments because of the slightly different values due to different data sources: Sector for international cooperation of the National Bank of Serbia (foreign debt data) and Sector of economic analysis and research, Statistical department for balance of payments of the National Bank of Serbia (balance of payments data).
13 Debt Analysis of the Republic of Serbia, September 2011, NBS.
14 Debt Analysis of the Republic of Serbia, December 2011, NBS.
15 In the denominator we use the sum of GDP values of the observed and previous three quarters. E.g. If we want to calculate the share of foreign debt in GDP for Q1 2012, we divide the value of the foreign debt at the end of Q1 with the sum of quarterly values of GDP from Q2 2011, Q3 2011,Q4 2011 and Q1 2012.

Compared to March 2011, the rise of foreign debt is the result of the growth of public sector debt

For a period of one year (March 2011 - March 2012), Serbia's foreign debt grew by 1.4 billion euros. This is solely a result of additional borrowing of the state, since the private sector discharged 400 million euros of debt. The foreign debt of the public sector at the end of Q1 2012 was by 1.8bn euros higher than in the previous year. Discharge of the private sector is the result of a reduction of short-term loans of banks and enterprises. The private sector is indebted for 138 million euros. The banks increased the long-term loans by 437 million euros, while the enterprises reduced the long-term debt by close to 300 million euros, compared to March 2011. In this period, the share of short-term debt in total debt was decreased (from 5% to 2.5%), which slightly improved the structure of foreign debt by maturity according to the original maturity, as a result of a reduction of short-term debt of the banks (Table T4-13). One of the indicators of the vulnerability of an economy used is the share of short-term debt in the total foreign debt. In Serbia, this indicator has been on a considerable decline since 2008, and is currently 0.05 (Figure T4-14). This ratio of short-term debt and forex reserves is currently extremely favourable, but it still requires continuous monitoring, given the increased uncertainty.

Figure T4-14. Serbia: Share of short-term foreign debt in forex reserves, 2008-2012



Source: NBS, *QM*

Compared to the state of foreign debt at the end of March 2011, the foreign debt of the public sector has increased from 39% to 44% of the total debt value, while the foreign debt of the private sector has decreased from 61% to 56% of the total foreign debt value. It is our estimate that in 2012, the foreign debt will grow in favour of the public sector debt, while the private sector will have a smaller room for borrowing abroad, given the current events in Europe. Above all, unless the government spending is not strictly limited, there could be a significant increase of the public sector's foreign debt and thus of the total foreign debt.

By the end of 2012, the unfavourable external developments, combined with the political and economic instability in Serbia, may lead to further deepening of balance of payments imbalances and a more pronounced problem of financing the growing deficit. Therefore, in 2012, the expected growing current account deficit, if accompanied by a low influx of capital, could cause further borrowing or further reduction of foreign reserves, exert strong pressure on the currency and risk balance of payments crisis.

5. Prices and the exchange rate

The price growth in the first four months of 2012 accelerated, primarily due to the increase in the prices of food, gasoline and cigarettes, while the underlying inflation remained stable. However, year-on-year inflation rate was very low, mainly because of the base effect, i.e. due to a comparison with a high price growth over the same period last year. "Base effect" will soon be exhausted, thus from May on, the increase in the y-o-y inflation rate is expected. The increase in inflation in the coming months will be affected by a sharp depreciation of the dinar, as well as a significant fiscal expansion over Q1 and April. On the other hand, low aggregate demand and a calming down of the energy and commodity prices (mainly agricultural products and foodstuff) on the world market will act disinflationary. Besides the fact that year-on-year inflation rate will rise later in the year, if there are no major external shocks, it will most likely remain single-digit by the end of the year, even with the possible increase in the rate of VAT. The dinar strongly depreciated since the beginning of the year, and this trend has accelerated since the mid of May. Depreciation is a result of a high fiscal deficit, growing balance of payment deficit and political uncertainties regarding the formation of a new government. The real exchange rate has depreciated as well, and now, the whole real appreciation, which lasted from the mid of 2010 to the mid of 2011, is practically "cancelled". Although the depreciation is basically favourable for the export competitiveness, it increases the expenses of servicing debt for the economy that is highly euroized. Therefore, it is not clear whether depreciation has a net positive impact on the businesses of all the exporters.

Prices

First four months of the year 2012 are marked by acceleration in inflation, even though y-o-y price growth rate was record low due to the base effect. The price growth in the first four months amounts to 2.6%, i.e. 8.1% when annualized. If we consider the period from February to April, the price growth is even higher and it amounts to 10.6% when annualized. For comparison, let us remind that inflation in the entire second half of the year 2011 was mere 0.2%, i.e. about 0.4% when annualized. However, in April, year-on-year inflation rate stood at mere 2.7%. The reason for such low y-o-y inflation rates is primarily the base effect; namely, the same period last year recorded an exceptionally high inflation (e. g., the increase in the prices in the first four months of 2011 amounted to as much as 5.5%), and now, because of the comparison with such a high base, year-on-year inflation rate stands very low.

Year-on-year inflation has been in a constant fall since April in the last year, now standing at the lower limit of NBS target band, but from May it will begin to increase. As of May, "base effect" will be exhausted, thus the y-o-y inflation rate will certainly be on the rise. It is possible to expect, though not certain, that the monthly inflation rates later in the year will be higher than in the second half of the previous year, standing probably at a similar level as in the first quarter of 2012. Both significant depreciation of the dinar, which we have recorded since the beginning of the year, as well as a high fiscal deficit from the first four months will contribute to a higher inflation rates. On the other hand, the energy and commodity prices (mainly agricultural products and foodstuff) in the last few months have been in a decline on the world market; in addition, *futures* prices indicate that even by the end of the year, these prices will remain at the lower level than at the beginning of the year, and possibly fall further. Such dynamics in the prices of energy and commodities was primarily the result of the increased risks in the global economy, possible further escalation of the crisis in the Euro zone and slow recovery of the U.S. economy. Finally, one-time inflation jump in the second half of the year can be expected, due to a possible increase in the VAT rates, but also the increase in the administratively controlled prices (electricity, heating, etc…). Taking into account all mentioned factors, it is clear that there are plenty of uncertainties concerning inflation trends later in the year. Nevertheless, we expect that, unless there are no extreme shocks (e.g., the collapse of the eurozone due to the sovereign debt crisis) at the end of the year, inflation will be exceeding the upper limit of the NBS target band for December (target band for December is 2.5% to 5.5%), but still remaining single-digit.

Table T5-1. Serbia: Consumer Price Index, 2007-2011

	Consumer price index				
	Base index (avg. 2006 =100)	Y-o-y growth	Cumulative index	Monthly growth	3m moving average, annualized
2007					
dec	113.0	11.0	11.0	1.2	13.1
2008					
dec	122.7	8.6	8.6	-0.9	4.4
2009					
dec	130.8	6.6	6.6	-0.3	1.6
2010					
mar	133.4	4.7	1.9	1.2	8.0
jun	136.7	4.2	4.5	0.4	10.4
sept	140.3	7.7	7.2	1.3	10.9
dec	144.2	10.2	10.2	0.3	11.7
2011					
mar	152.2	14.1	5.5	2.6	24.1
jun	154.0	12.6	6.8	-0.3	4.8
sept	153.3	9.3	6.3	0.2	-1.7
dec	154.3	7.0	7.0	-0.7	2.5
2012					
jan	154.4	5.6	0.1	0.1	1.2
feb	155.7	5.0	0.9	0.8	1.0
mar	157.4	3.4	2.0	1.1	8.4
apr	158.4	2.7	2.6	0.6	10.6

Source: SORS

The price growth in the first four months of this year is primarily the result of the rise in the prices of foodstuff, as well as the increase in the prices of gasoline and cigarettes. Food products are "responsible" for the 40% of the overall inflation, primarily because the fruit prices increased, as well as the prices of eggs and dairy products. Of the total price growth, 68% is caused by the rise in the prices of foodstuff, gasoline and cigarettes (Table T5-2).

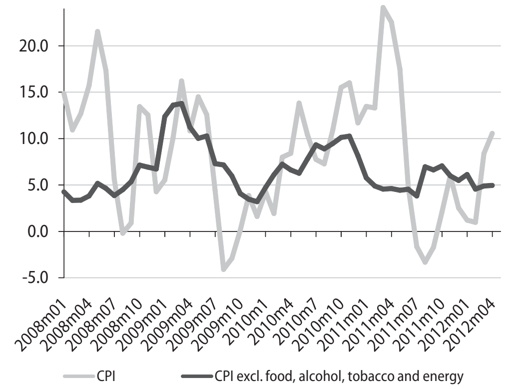
Table T5-2. Serbia: Consumer Price Index: Contribution to Growth by Selected Components

	Share in CPI (in %)	Price increase in Q4 2011	Contribution to overall CPI increase (in p. p.)	Price increase January - May 2011	Contribution to overall CPI increase (in p. p.)	Price increase May - December 2011	Contribution to overall CPI increase (in p. p.)
Total	100.0	2.6	2.6	7.1	7.1	-0.1	-0.1
Food and non–alcoholic beverages	38.8	2.8	1.1	11.0	4.2	-4.1	-1.6
Food	35.0	3.0	1.1	11.4	3.9	-4.8	-1.7
Alcoholic beverages and tobacco	5.4	5.1	0.3	12.8	0.6	-1.4	-0.1
Tobacco	4.0	5.8	0.2	16.0	0.6	-2.8	-0.1
Clothing and footwear	5.1	-0.2	0.0	-0.3	0.0	3.7	0.2
Housing, water, electricity, gas and other fuels	16.5	1.6	0.3	7.1	1.2	2.3	0.4
Electricity	7.2	0.0	0.0	13.5	0.9	0.0	0.0
Furniture, household equipment, routine maintenance	4.4	3.2	0.1	2.1	0.1	5.8	0.3
Health	4.3	1.4	0.1	5.0	0.2	-0.4	0.0
Transport	10.5	6.7	0.7	6.0	0.6	3.1	0.3
Oil products	4.8	10.1	0.5	10.1	0.4	3.0	0.1
Communications	4.1	-0.5	0.0	-1.8	-0.1	5.4	0.2
Other items	11.0		0.1		0.3		0.2

Source: SORS i *QM estimate*

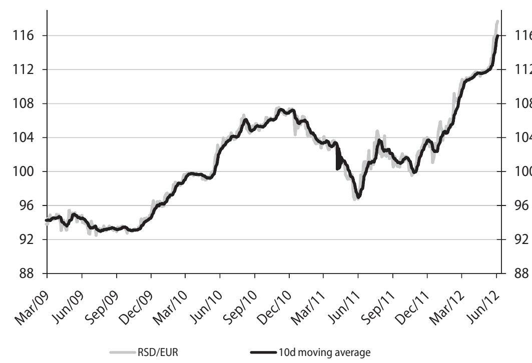
On the other hand, underlying inflation remains stable and relatively low (Graph T5-3). In the first quarter of 2012, underlying inflation amounts to 1.7%, i.e. 5.1% when annualized. The main factor for the low underlying inflation is a weak aggregate demand and low economic activity. However, recent depreciation of the dinar could lead to a certain rise in the underlying inflation over the next several months.

Graph T5-3. Serbia: CPI and Underlying Inflation Trend, Annualized Rates, in %, 2008-2011



Source: SORS i *QM estimate*

Graph T5-4. Serbia: Daily RSD/EUR Exchange Rate, 2009-2012



Source: NBS

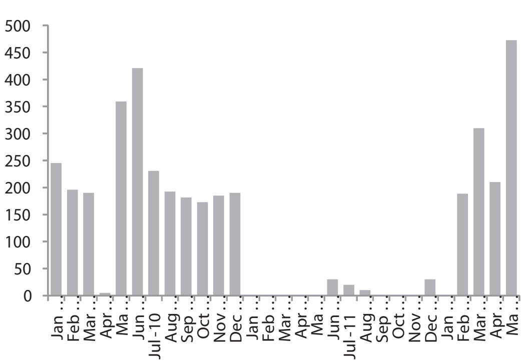
The exchange rate

The dinar is constantly weakening against euro since the beginning of the year, especially in the previous months, thus, the nominal exchange rate depreciated by nearly 15% from the last week of December to the early June. Over the first quarter, the dinar/euro exchange rate depreciated by 8%. Then, throughout April and early May, rate was mostly stable, only to see another strong depreciation in the second part of May and early June (Graph T5-4).

After a break during most of 2011, NBS again intervened intensively in the market to mitigate the depreciation of the dinar. Since the beginning of the year until the early June NBS has sold 1.2 billion Euros from the foreign currency reserves. In May, NBS sold a total of 473 million Euros, the highest monthly value of the intervention (Graph T5-6). However, while the depreciation is mitigated, it is not stopped.

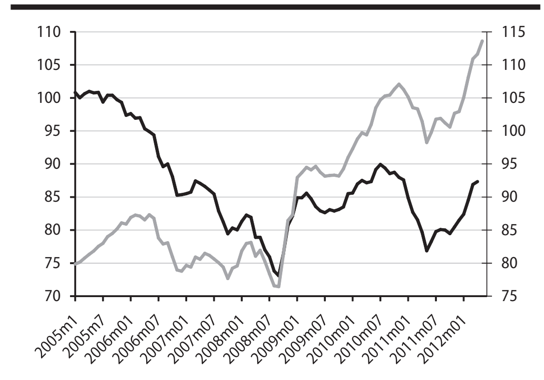
The dinar depreciation is the result of several factors. It was contributed by a strong growth of a fiscal deficit in the first four months of the year 2012, and in relation to that, the increased need for deficit financing and public debt amortization. This creates insecurity among the foreign investors, thus some of them, for now, give up a further investment in the government securities and in order to close their positions in Serbia, they buy Euros, thereby creating depreciation pressure. Moreover, the current account deficit has been relatively high for several months in a row (due to a falling export, but somewhat higher export which is, among other things, a

Graph T5-5. Serbia: NBS intervention, sale of foreign currency, Monthly averages, millions of Euros 2010–2012



Source: NBS

Graph T5-6. Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly averages, 2005–2011



Source: NBS, SORS and *QM* estimate

consequence of the energy import growth). In Q1, the current account deficit amounted to 1159 million Euros, considerably higher than 760 million Euros in Q1 last year. Unlike the most of the previous year, when financial account was mostly in big plus, in Q1 2012 it was balanced (due to the outflow from purchase of Greek shares in Telekom, thus much lower portfolio investment inflow than in Q1 of the previous year[1]). As a result of a higher current account deficit and quite modest net inflows of the financial account, the overall balance of payment is in a deficit, which also creates a substantial depreciation pressures. Finally, the political uncertainty regarding the formation of a new government, as well as their policy to be implemented[2], also increases the risk for the foreign investors in Serbia, which again has a negative impact on the rate. The increase of the NBS reference interest rate and the other measures adopted by NBS in the early June, could contribute, not only to the stabilization of the dinar, but also to a moderate increase in its value. However, the dinar exchange rate will essentially depend on the fiscal policy in the coming years, but as well on the factors to which both the Government and NBS have a relatively modest impact. One of the most significant rate determinants is the inflow of the foreign capital in the form of foreign investments and loan, whose amount depends both on the domestic factors (economic environment) and the trends in EU and narrow Region. The possible crisis in EU could have a negative impact on the economy of Serbia from a lower capital inflow, as well as from reduced demand for goods from Serbia.

From the beginning of the year to the April, the real dinar/euro exchange rate depreciated by some 7.2%. Looking at a slightly longer period, from May 2011 to April 2012, the real exchange rate depreciated by as much as 13%, therefore, the real appreciation that lasted from the mid 2010 to the mid 2011 was largely "cancelled" (Graph T5-7). The real exchange rate is now roughly standing at the level as in the first half of the year 2007. The depreciation rate is generally favourable for the export competitiveness of Serbia; however it leads to the increase of the expenses of servicing debt, both for the country and for the private sector. Most of the exporters from Serbia have debts pegged to the euro, and many of them also have import component in their own expenses, thus it is not certain that depreciation for a short term has a positive effect even on the income of the most exporters. In the medium term, the effect of the depreciation is almost certainly positive, because in that period companies and citizens can change their behaviour so to adjust to the new circumstances.

6. Fiscal trends and policy

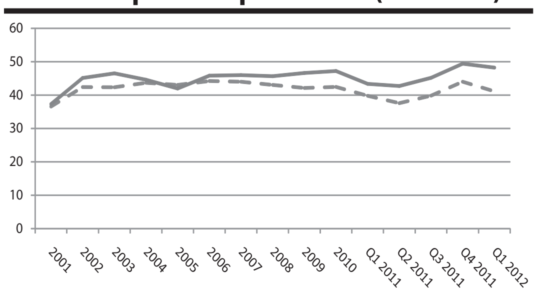
In Q1 2012, a consolidated fiscal deficit of 54 bn RSD (around 7.1% of the quarterly GDP) has been achieved, which is significantly higher compared to the projected deficit. Similar trends were continued in April as well, so the consolidated fiscal deficit in the first four months amounted to 78bn RSD.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

General tendencies and macroeconomic implications

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

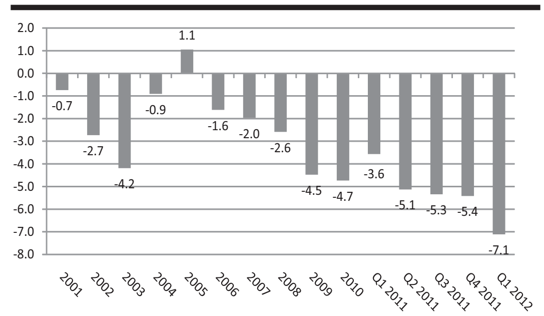
Consolidated fiscal deficit in Q1 2012 was 54.1bn RSD, i.e. around 7.1% of quarterly GDP. The official dynamic of realising public revenues, expenditures and fiscal deficits, as arranged with the IMF, which would enable the total annual fiscal deficit to remain within the foreseen limits, means that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

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



Source: *QM* calculations

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



Source: *QM* calculations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Source: Table P-10 in Analitical Appendix
1) Includes all levels of government (central, provincial and municipal) and their budget beneficiaries and social security organizations (Serbian Pension and Disability Insurance Funds, Health Insurance Funds, National Employment Service, but not public enterprises and the NBS.
2) The item corresponds to the item "Net acquisition of financial assets for policy purposes" in the PFB (in accordance to GFS 2001), i.e. to the item "net lending" or "lending minus repayment" in the IMF presentation (i.e. GFS 1986). It comprises loans to students, financing of the National Corporation for Housing Loan Insurance and the like.
3) See Table P-10 in Analytical appendix and/or Box 2.

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

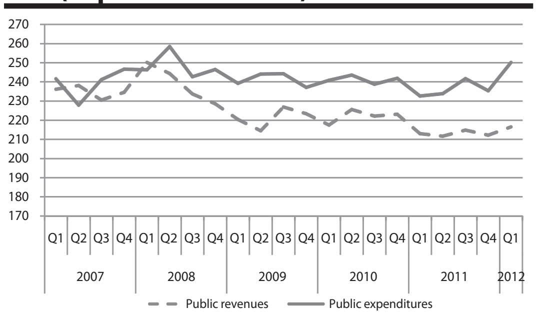
Consolidated public revenues on a gradual rise in Q1

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

Consumption taxes revenues are gradually declining

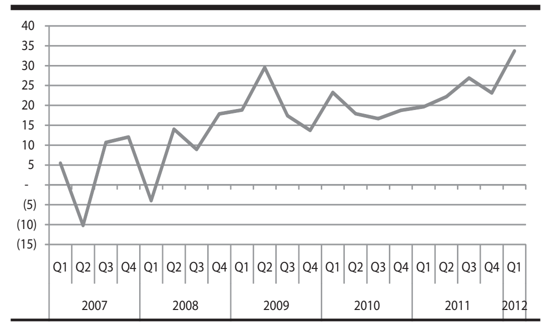
Total real seasonally adjusted consumption taxes revenues (VAT, excise and customs) in Q1 2012 have gradually declined compared to the previous quarter, as well as compared to the same period last year.

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



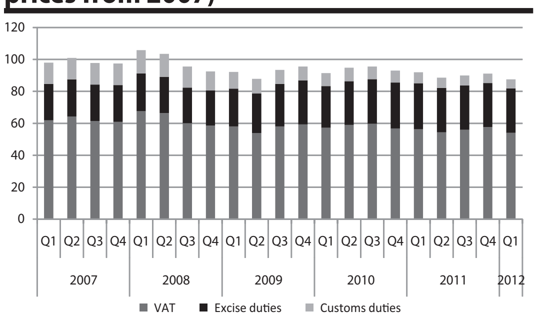
Source: *QM* calculations

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



Source: *QM* calculations

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



Source: *QM* calculations

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

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

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

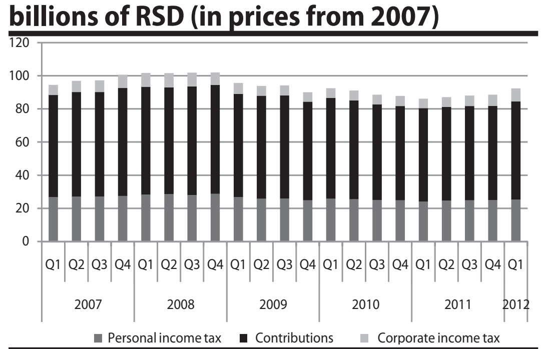
regular annual indexation of excise taxes, performed in January, but also the fact that part of the excise duties for the second half of December 2011 were settled in early January 2012, since the last day of December fell on a weekend. Slower growth of the excise revenues is partly due to a relatively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

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

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

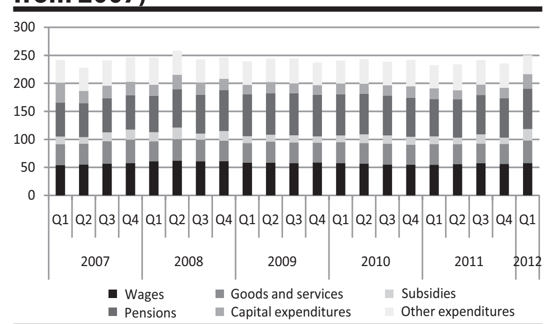
Q1 also recorded a very strong growth in real seasonally adjusted revenues from corporate income tax, which was 16% higher compared to the previous quarter. Strong growth of revenues from corporate income tax is the result of payment of taxes on capital gain realised from the sale of retail chain Maxi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

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



Source: *QM* calculations

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



Source: *QM* calculations

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

Public expenditures in Q1 on a strong rise

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

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

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

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

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

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

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

Public Debt Analysis

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

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

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

Amount at the end of period, in billions EUR

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

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

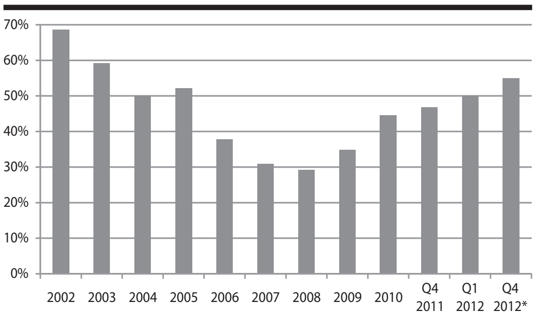
...there is also a growth trend in guarantees...

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

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

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

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

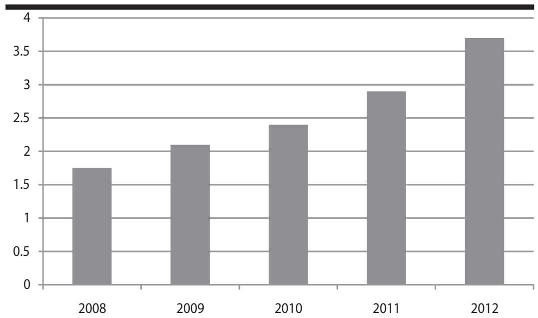


Source: *QM* (*for Q4 2012 – QM's estimate)

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

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

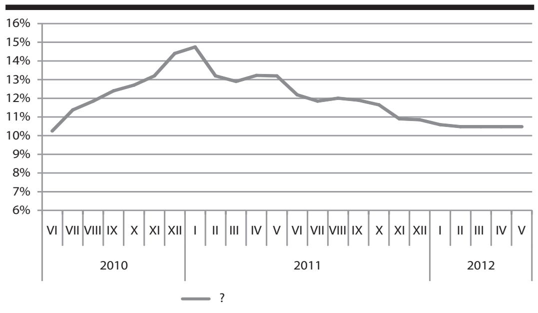
T 6-11. Serbia: Implicit interest rates on the public debt



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

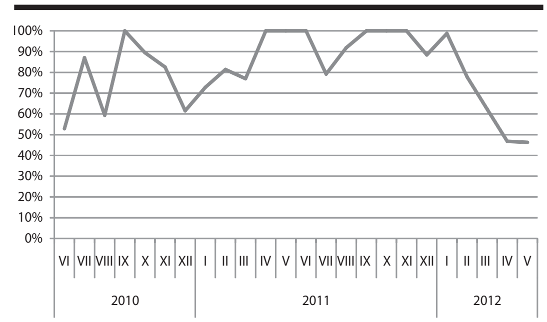
The constant and rapid growth of the public debt, in the absence of a credible plan to reduce fiscal deficits in a relatively short time, in circumstances of increased instability on global financial markets, leads to a more difficult securing of new loans for financing the fiscal deficit of Serbia,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

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



Source: *QM*

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



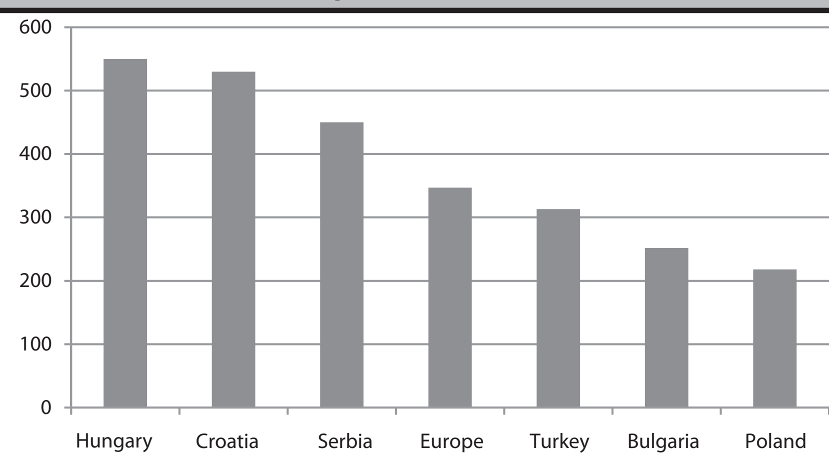
Source: *QM*

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

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

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

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



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

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

Appendices

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

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

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

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

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

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

7. Monetary Trends and Policy

Due to strong depreciation pressure on the exchange rate, the NBS stepped up its interventions on the inter-banking foreign currency market which resulted in the decrease of the primary issue in Q1. Despite an intervention of about 490 million Euro, the Dinar exchange rate continued to weaken which had a negative effect on a majority of economic indicators. The trend of inflation weakening continued from the start of the year leading the NBS to additionally lower the key policy rate in January to 9.5%. Along with this measure the NBS changed the Decision on mandatory reserves covering hard currency sources of financing to additionally relieve hard currency liquidity and stabilize the exchange rate in April but with no great effect on the depreciation trend. The real growth of the money mass following the correction to the exchange rate year on year stands at around 5% which is the result of the effects of a somewhat lower base and slight increase in overall credit placements with the economy. Compared to the end of last year, M2 dropped in real terms by about 4%. The placement of the banking sector in Q1 is at a somewhat higher level compared to the same period of last year. Most of the growth of the placements is in the economy which the state also increased its indebtedness. On the source side, there is a drop in Q1 because the economy withdrew deposits of some 640 million Euro which strengthened the decrease of capital in the banking sector of 80 million Euro. The negative trend of increasing unpaid loans continued in Q1 as the consequence of an increase in tardiness in collecting loan payments from companies.

Central Bank: Balance and Monetary Policy

Significant drop in primary issue in Q1...

... as consequence of NBS interventions on inter-banking foreign currency market

From the start of the year, the NBS has faced things in the Serbian economy which had divergent effects on the further implementation of monetary policy. On one hand, price stability which was established at the end of last year with year on year inflation at the lower level of the target corridor confirms that the path monetary policy took in 2011 was right. On the other hand, other indicators of macroeconomic position in Q3 deteriorated. The fast depreciation of the Dinar, recession trends in the real sector, deterioration of balance of payments trends [1] with an expected rise of inflation by the end of the year[2] show that low inflation in Q1 was not such a big success. If the trend continues, which is very likely, the NBS will have to introduce much more concrete (unpopular) measures to protect the basis of the monetary system. Following a year of stability on the inter-banking foreign currency market, constant pressure on the Dinar forces the NBS to step up its interventions in Q1. For that purpose, the NBS sold about 490 million Euro in Q1 (Table T7-1) which resulted in just an easing of the drop. As a consequence of the sale of the foreign currency, the net own reserves on the NBS balance recorded a drop of –17.6% of the value of the primary issue at the start of the year. This drop and slight increase of net domestic assets (NDA) the sum effect on *primary money* at the end of Q1 is negative and stands at 15.2% of the level of primary money at the start of the year.

The repo stock after almost a year of increases in Q1 recorded a drop. Following increased placements in January and no activity in February, banks withdrew some 150 million Euro in March which led to a decrease of 28 million Euro in REPO placements in Q1. An additional drop in REPO stock (Table T7-1) came about because of the effects of the depreciation of the Dinar because of which the repo rate was corrected by the changes in the exchange rate at the end of Q1 was negative and stood at –19.08%. In the same period, auctions of treasury bonds collected about 855 million Euro which is a significant growth compared to the previous quarter (in Q4 2011 bond sales at auction brought in some 340 million Euro). In Q1 the level of sales of treasury bonds at auction improved significantly compared to the end of last year when it exceeded 40% of the issue on offer in only a few cases. The increased realization came happened thanks in part to

1 More details on growth of foreign trade deficit in section Balance of Payments and Foreign Trade

2 Inflation growth can be expected because of the fact that the program of fiscal consolidation announced an increase of the VAT rate as well as the wasting of the effect of high base for calculation of year on year inflation (see section “Prices and the Exchange Rate”)

the drop in the key policy rate which led banks to transfer funds placed in REPO to the purchase of treasury bonds which are more profitable.

Table T7-1. Serbia: NBS Interventions and Foreign Currency Reserves 2009-2012

	2009				2010				2011				2012
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
Repo stock (in milions of euros)	1,050.96	1,276.77	1,721.12	1,593.79	1,406.63	1,037.51	626.87	449.00	549.77	746.09	1,000.42	1,174.84	1,055.98
NBS interest rate	16.50	13.00	12.00	9.50	9.00	8.00	9.00	11.50	12.25	12.00	11.25	9.75	9.50
NBS interest rate[1)]	15.08	12.00	11.18	8.91	8.60	7.68	8.36	10.44	10.74	10.65	10.29	9.11	9.21
NBS interest rate[6)]	5.13	27.04	11.51	-31.19	-2.30	-19.45	3.20	21.90	13.99	-7.14	25.90	6.51	-19.08
NBS interventions on FX market (in milions of euros)	-513.00	46.00	18.20	-80.90	-631.50	-785.00	-595.20	-321.50	5.00	-30.00	-30.00	-30.00	-488.50
INCREASE							**cumulative, in % of opening H[5)]**						
NBS own resreves[2)]	-1.9	-4.0	9.6	20.8	-15.3	-31.2	-57.5	-61.0	-8.9	14.0	26.8	73.9	-17.6
NDA	-13.8	-17.4	-38.4	-40.9	-0.3	4.5	30.6	33.6	-0.7	-15.5	-28.6	-51.8	2.4
Government, dinar deposits	-5.6	-2.7	1.0	-13.0	2.7	4.8	7.9	3.1	-4.6	-3.3	3.6	2.7	-5.1
Repo transactions[3)]	-2.8	-9.4	-22.6	-19.9	4.9	14.2	35.4	42.5	-6.9	-15.3	-32.2	-47.5	2.2
Other items , net[4)]	-5.4	-5.2	-16.7	-8.1	-7.9	-10.4	-8.6	-7.9	10.9	3.1	0.0	-7.0	5.3
H	-15.7	-21.4	-28.8	-20.1	-15.6	-26.7	-26.9	-27.3	-9.6	-1.5	-1.8	22.1	-15.2
o/w: currency in circulation	-3.8	-2.9	-2.3	1.8	-3.9	-3.2	-2.3	-1.5	-5.8	-4.2	1.3	12.4	-3.3
o/w: excess liquidity	-13.3	-13.4	-16.5	-16.5	-13.7	-12.5	-8.6	-6.8	-3.8	2.5	-5.5	6.3	-13.6
							in millions of euros, cumulative from the beginning of the year						
NBS, net	-37.96	23.11	681.73	1,446	-183	-389	-990	-1,059	56	282	1,374	2,203	-1,070.60
Gross foreign reserves	-25.10	732.72	1,371.41	2,477	-135	5	-637	-654	16	308	1,426	2,334	-1,138.11
Foreign liabilities	-12.86	-709.61	-689.68	-1,031	-49	-393	-353	-405	41	-26	-52	-131	67.51
IMF	-5.40	-760.71	-747.41	-1,104	-47	-386	-356	-408	37	-32	-59	-132	58.24
Other liabilities	-7.46	51.09	57.72	74	-2 0	-7	3	3	4	6	7	1	9.27
NBS, NET RESERVES-STRUCTURE					0								
1. NBS, net	-37.96	23.11	681.73	1,446	-183	-389	-990	-1,059	56	282	1,374	2,203	-1,070.60
1.1 Commercial banks deposits	52.72	-92.92	-280.43	-725	-115	-393	-377	-374	22	226	109	-462	459.45
1.2 Government deposits	-76.30	-61.30	-82.21	-54	-80	39	22	18	-232	-258	-1,009	-455	263.40
1.3 **NBS own reserves** (1.3 = 1 - 1.1 - 1.2)	-61.54	-131.11	319.09	668	-378	-743	-1,346	-1,415	-154	250	474	1,286	-347.74

Source: NBS.
1) State includes all levels of government: republic and all local government levels.
2) Definition of NBS net own reserves is provided in section 8 Monetary Trends and Policy, Frame 4, *QM* no. 5.
3) This category includes Treasury Bonds NBS (BZ), and repo operations.
4) Other domestic assets include: domestic loans (net bank debts not including BZ and repo transactions; net economy debts) together with other assets (capital and reserves; and items in balance: other assets and other assets and liabilities) and corrected by exchange rate differentials.

NBS additionally lowers key policy rate...

... because of weaker inflation in Q1

Due to a drop in the inflation rate in Q1, the NBS decided at a session of its executive board in January to correct the key policy rate by 0.25 percentage points and it now stand at 9.5%. Bearing in mind the effect this interest rate has on the interest rates of commercial banks and the low level of credit activity, the question is whether the NBS could have lowered the rate earlier to ease the conditions for new debts. Along with the change in the key interest rate, the NBS in April changed the decision on the level of mandatory reserve for hard currency sources with the rate lowered to 22% for sources of financing with a due date of more than three years and to 29% for debts with a shorter due date. The new decision raise the obligation of Dinar allocation of the mandatory hard currency reserve under differentiated rates from 20% for sources of up to two years and 15% for those with due dates of more than two years. The increase in the part of the mandatory hard currency reserve in Dinars is meant to sterilize part of the Dinar funds which, in combination with the releasing of foreign currency funds from the mandatory reserve, should ease the depreciation pressure on the exchange rate. This measure, because of large balance of payments problems and unresolved fiscal consolidation, failed to achieve any great success over the past two months.

Trends

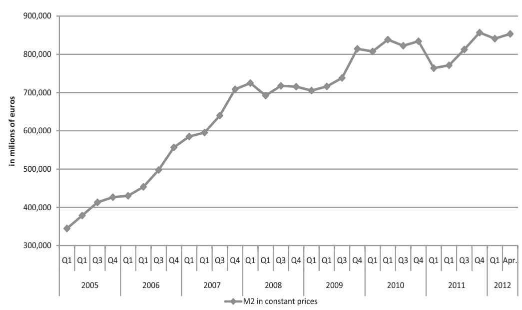
Monetary System: Structure and Trends of the Money Mass

Real growth of money mass at year on year level speeds up in Q1 ...

... but record dropped compared to previous quarter

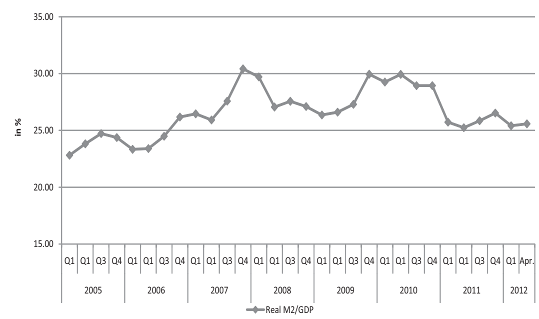
The money mass recorded a growth of 10.1% in real terms year on year in Q1 which is the result of increased credit placements in the non-state sector of 10.5% at year on year level as well as the somewhat lower base in Q1 of 2011. Following the correction in the Dinar exchange rate the real year on year credit growth rate stands at 4.9% (Table T7-4). Due to the significant effect of the Dinar depreciation in the first three months, the state of the money mass (M2) in the first three months is almost unchanged compared to the end of 2011 despite the positive effect of the increase in the NDA.

Graph T7-2. State of money mass in permanent prices, 2005–2012



Source: FREN

Graph T7-3. Serbia: trends of money mass as percentage of GDP, 2005-2012



Source: FREN

The participation of the hard currency deposit increases with the growth of the money mass...

...while other elements record drops

The year on year M2 growth rate in Q1 which stood at around 14% was dominantly affected by an increase of the hard currency deposits at a rate of 9.26% year on year (in Q4 2011 the deposit growth rate stood at 4.5% year on year). Other elements in the same period recorded drops in their contribution to the M2 growth, primarily in savings and time deposits with a rate of 1.97% year on year (in Q4 2011 the contribution of savings and time deposits stood at 2.64% year on year) and the M1 which has dropped slightly compared to the previous quarter. The noted changes within the framework of the mentioned aggregates can be explained with the effect that the constant depreciation of the Dinar in Q1 had on the currency structure of deposits. The state also contributed to the overall change by spending funds from own hard currency deposits with the NBS and new issues of treasury bonds which recorded higher realization rates compared to the previous period.

Table T7-4. Serbia: growth of money and aggregates contributing to it, 2009–2012

	2009				2010				2011				2012
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
						y-o-y, in %							
M2[1]	6.5	12.1	10.4	21.3	19.9	22.1	20.1	13.1	8.0	3.7	8.1	10.1	14.0
Credit to the non-government sector[2]	33.8	27.7	22.3	16.1	14.4	25.0	27.1	27.2	19.3	11.6	8.3	7.7	14.4
Credit to the non-government sector[2], adjusted[3]	20.9	13.9	7.7	10.2	10.4	16.2	16.8	19.9	16.7	13.0	11.8	8.1	8.6
Households	7.4	1.5	4.4	3.7	7.9	16.1	18.7	18.9	25.1	20.6	17.8	5.7	5.7
Enterprises	28.7	20.9	9.3	13.6	11.6	16.3	15.8	20.4	12.8	9.4	8.8	9.3	10.1
						real y-o-y, in %							
M2[1]	-2.7	3.5	2.9	13.8	14.5	17.1	11.4	2.4	-5.4	-8.0	-1.2	2.7	10.1
Credit to the non-government sector[2]	22.2	17.9	14.0	9.0	9.1	19.9	17.9	15.0	4.5	-1.0	-1.1	0.5	10.5
Credit to the non-government sector[2], adjusted[3]	10.2	4.3	-0.5	3.2	5.3	11.3	7.8	7.9	1.8	0.2	2.2	0.9	4.9
Households	-2.1	-7.1	-3.6	-2.9	2.9	11.1	9.6	16.8	9.2	7.0	7.8	-1.3	2.0
Enterprises	17.3	10.7	1.0	6.4	6.5	11.3	6.9	3.7	-1.6	-3.0	-0.4	2.1	6.3
						in bilions of dinars, end of period							
M2[1]	1,015.4	1,061.7	1,087.2	1,204.0	1,217.8	1,296.2	1,306.0	1,360.8	1,315.6	1,344.8	1,412.2	1,498.0	1,499.7
M2[1] dinars	378.1	401.1	417.0	436.8	403.7	417.9	403.0	410.5	382.7	402.0	433.8	486.5	445.0
Fx deposits (enterprise and housholds)	637.3	660.6	670.2	767.2	814.0	878.2	903.0	950.3	932.9	942.8	978.3	1,011.5	1,054.7
						cumulative, in % of opening M2[4]							
M2[1]	2.3	6.9	9.5	21.3	1.1	7.7	8.5	13.1	-3.3	-1.2	3.8	10.1	0.1
NFA, dinar increase	2.2	0.4	3.6	8.9	-0.9	-0.6	-1.7	-5.3	-1.9	-1.4	9.5	11.9	-5.6
NDA	0.1	6.5	6	12.4	2.1	8.3	10.2	18.4	-1.4	0.2 0.5	-5.7 -2.0	-1.8	5.7

Source: NBS

1) Money mass: components – Analytical and notation conventions QM.

2) Credits to non-state sector – loans to the economy (including local government) and households.

3) Trends are corrected for exchange rate changes. Correction were conducted on assumption that 70% of loans to non-state sector (both households and economy) indexed against the Euro.

4) Initial M2 signifies state of M2 at start of respective, that is end of previous year.

Banking Sector: Placements and Sources of Financing

Credit placement from domestic sources slower...

... while slight growth of cross-border continues in Q1

Compared to the last quarter of 2011, the credit activities of the domestic banking sector slow slightly in Q1. Domestic banks placed a total of 309 million Euro with the economy and population in Q1 (in Q4 2011 386 million Euro were placed, Table T7-5). The growth of overall placement is completely the result of the increased debts of the economy by 375 million Euro, while in the same period the population continued to repay debts to banks by 67 million Euro (in Q4 2011, the population lowered its debts by 32 million Euro). A segment of the subsidized loans also continued slowing down its activities due to the fact that the only funds remaining are for subsidized housing loans. In Q1 some 90 million Euro in subsidized loans were approved, and in the coming period we cannot expect any significant growth of credit activity in this segment. As positive, we assess the increase of cross-border loans for the second quarter in a row , which rose in Q1 by 115 million Euro. On that basis, the credit placement in Serbia from domestic and foreign sources in Q1 increased by 470 million Euro. In the same period, the participation of credits in the GDP rose to 87% in Q1 (Graph T7-7). This growth came about as the result of two combined effects from the start of the year. The smaller part is the noted growth of the overall credit placement in Q1 while the larger part is the consequence of the depreciation of the Dinar bearing in mind the large-scale Euro-ization in Serbia which had an effect on the rise in the overall debts in Dinars.

Table T7-5. Serbia: bank operations – sources and structure of placements, correct[1)] trends, 2009-2012

	2009				2010				2011				2012
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
	in millions of euros, cumulative from the beginning of the year												
Funding(-, increase in liabilities)	958	61	-1,171	-2,790	7	-117	-68	-1,495	603	69	-822	-1,083	672
Domestic deposits	235	-336	-691	-1,633	131	-233	-236	-836	206	-148	-844	-1,169	589
Households deposits	-40	-270	-551	-1,314	-137	-323	-500	-1,020	-92	-295	-483	-655	-49
dinar deposits	46	-2	-30	-89	30	21	25	12	24	13	-68	-182	30
fx deposits	-87	-268	-521	-1,225	-167	-343	-525	-1,032	-116	-308	-416	-473	-79
Enterprise deposits	276	-67	-140	-319	268	89	264	184	298	147	-361	-513	638
dinar deposits	171	5	-174	-284	213	84	232	151	176	13	-128	-350	362
fx deposits	105	-72	34	-35	55	5	32	33	122	134	-233	-164	275
Foreign liabilities	299	186	-558	-1,271	-196	40	90	-563	580	634	678	545	3
Capital and reserves	424	212	78	114	72	77	78	-96	-183	-416	-656	-459	80
Gross foreign reserves(-,decline in assets)	-407	-449	-5	311	53	-120	197	430	-720	-674	-517	-923	-199
Credits and Investment[1)]	156	1,057	1,980	2,844	397	1,279	1,281	2,285	309	1,270	2,158	2,771	409
Credit to the non-government sector, total	226	381	696	1,183	411	1,264	1,669	2,434	216	1,030	1,554	1,940	309
Enterprises	331	465	700	1,097	319	897	1,142	1,756	191	766	1,189	1,607	375
Households	-104	-84	-4	86	91	368	527	678	25	263	365	333	-36
Placements with NBS (Repo transactions and treasury bills)	40	256	694	625	-125	-445	-839	-1,010	86	268	529	720	-28
Government, net[2)]	-105	421	590	1,036	112	460	451	861	7	-28	75	111	128
MEMORANDUM ITEMS													
Required reserves and deposits	-191	-225	-185	36	54	-182	-188	-115	-157	-429	-210	391	-552
Other net claims on NBS[3)]	-385	-380	-481	-158	-287	-272	-195	-229	17	123	2	110	-199
o/w: Excess reserves	-409	-394	-501	-177	-279	-252	-173	-220	22	123	-3	100	-187
Other items[4)]	-166	-158	-254	-99	-147	-331	-692	-565	-136	-195	-246	-601	150
Effective required reserves (in %)[5)]	30	28	26	25	26	24	24	23	23	21	21	24	22

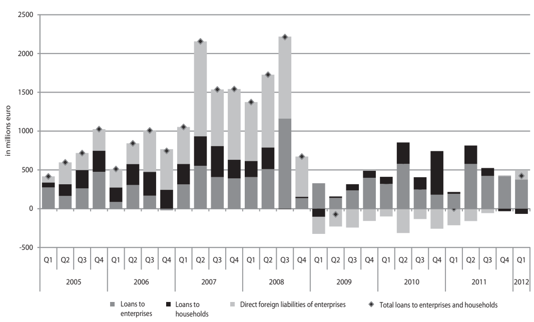
1) Calculating the rise is done with the assumption that 70% of the overall placement is indexed against the Euro. The rise for original Dinar values of deposits are calculated on the average exchange rate for the period. For hard currency deposits – as the difference calculated by the exchange rates at the ends of the periods. Capital and reserves are calculated by the exchange rate at the ends of the period and do not include the effects of the changes in the exchange rate from the calculation of the remaining balance.
2) NBS bonds include state bonds and treasury bonds sold at the repo rate and a rate set on the market for permanent auction sales with a due date of more than 14 days.
3) Net state crediting: credits approved to the state are decreased by the state deposit in business banks; the negative prefix signifies a higher growth of deposits than loans. The state includes all levels of government: republic level and local government level.

Sources for new placements of banks drop in Q1...

...due to withdrawal of economy deposits

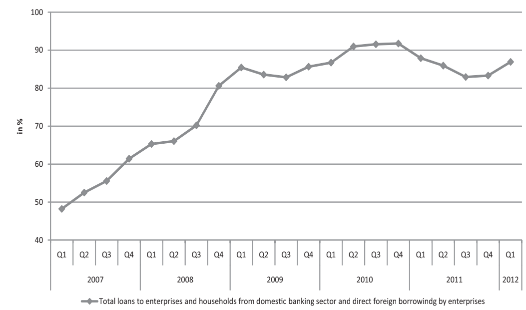
We note on the side of the sources for new bank placements that as in previous year there is a drop in this period which in Q1 stood at 672 million Euro (Table T7-5). This decrease is in large part the product of the withdrawal of economy funds from their accounts totaling 638 million Euro, both in Dinars and in hard currency. Somewhat the drop in sources was caused by the withdrawal of 80 million Euro from the accounts of capital and bank reserves. The only element which had a positive effect in Q1 were hard currency deposits by the population which increased by some 80 million Euro which is mainly the consequence of the strengthening of the Euro while the opposite effect on the Dinar deposit side saw a reduction. Following the NBS decision to lower the rate of the mandatory hard currency reserve in April we expect the released part of the reserves to neutralize the lowering of the source for new credits which was recorded in Q1.

Graph T7-6. Serbia: economy and population debts, 2005-2012



Source: FREN

Graph T7-7. Serbia: overall loan debts in % of GDP-a, 2005-2012

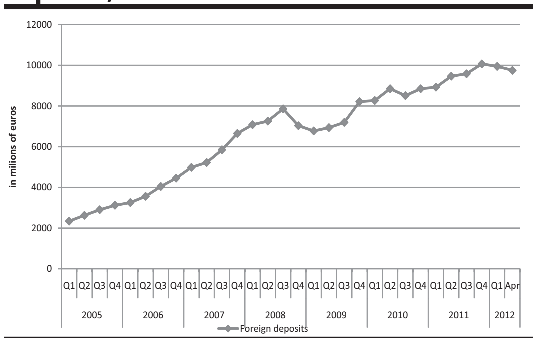


Source: FREN

No sign of improvement in segment of non-collectable loans

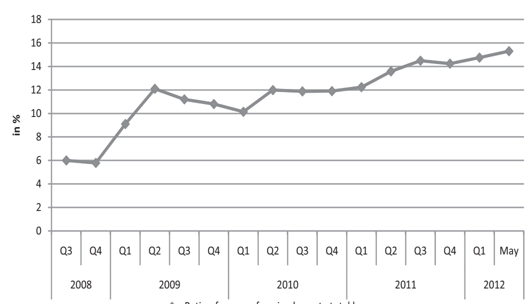
The trend of an increase in the participation of non-collectable loans in the overall placement continued in Q1. From the start of the year, the overall participation of non-collectable loans rose to 14.75% of the overall placement sum at the end of March (Graph T7-10). The increase of the participation is noted within the credits placed with private individuals but the growth in the participation of non-collectable loans to companies to 17.72% (in Q4 2011 that participation stood at 17.07%) had the greatest effect since these credits also have the highest level of participation in the overall mass of approved loans. The bad situation in the banking sector is reflected by the fact that despite the introduction of receivership in the Agrobanka A.D. since May when its operating license was revoked because it had insufficient capital for risk insurance in credit operations. At present there are several other banks which are at high risk in their credit operations and are under NBS scrutiny and there is a possibility that they could face the same scenario as the Agrobanka unless they introduce significant changes in their operations.

Graph T7-8. Serbia: level of hard currency deposits, 2005-2012



Source: NBS

Table T7-9. Serbia: participation of non-collectable debts by type of debtor, 2008-2012



Source: FREN

Graph T7-10. Serbia: participation on non-collectable loans in overall placement, 2008-2012

	2008	2009				2010				2011				2012	
	Dec.	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	May
	balance at the end of period														
Corporate	6.86	11.05	14.86	13.24	12.14	11.62	14.18	13.83	14.02	14.39	16.23	17.44	17.07	17.72	19.07
Entrepreneurs	3.66	5.28	8.93	10.21	11.21	12.19	13.73	15.7	15.8	15.66	15.75	16.99	17.07	16.05	17.86
Individuals	3.78	5.36	6.19	6.63	6.69	6.37	6.79	7.04	6.71	6.79	7.1	7.4	7.24	7.57	7.45

Source: FREN

8. International environment

The global recovery slows down, but there are still significant changes in the growth rates among the groups of countries. The group of the developed countries (USA, Germany and some smaller countris) has realized a solid growth, but with signals of a slowdown, while the bigger part of the eurozone is either in stagnation, or in reccession. The developing countries go through a similar situation- Eastern Asia has achieved high growth rates, though with the signals of a slowdown, while the countries of Central and Easter Europe are either stagnating or moving to recession. Inflation in the developed countries is decreasing, while in some developing countries is still relatively high. Since the bigining of the year, major developed economies haven't seen any significant changes in the monetary and fiscal policy. However, the major economies are currently debating whether the countries achieving a relatively fast growth (USA, Germany, some smaller countries) should continue with the strong fiscal consolidation or slow down, so that their demands attract the economies of the rest of the world. The unravelling of the economic and political crisis is still uncertain, and possibility of poor outcome is heightened due to political problems in Greece, as well as the problems in the banking sector in Spain.

Global Trends

The IMF, according to the latest published estimate, slightly corrected the growth rate upwords in 2012 at a global level, by 0.2 percentage points. The global economy should have a growth rate of 3.5%, developed countries 1.4% and developing countries 5.7%. The Eurozone should record a negative growth of 0.3%, primarely due to a downturn in activity in Spain and Italy. Based on the subsequently published data and forecasts for the individual countries and global regions, it can be expected that the IMF will correct downwards the growth estimates for this year.

The global economy stands is in a turbulent state, thus any additional shocks could trigger a new global crisis. Two risks could cause such a scenario: re-detoriation of the condition in the eurozone due to an uncertain solvency of the Member States and the growth of the geopolitical risks on the Near and Middle East, and with regard to this, a possible leap in the oil price. The agreement on the Fiscal Compact in the EU and the ECB intervention to increase the liquidity, had a positive influence on the recovery of European countries, which were in a solid position even before that, while their positive impact on the Mediterranean members of the EU was mostly absent. The IMF's Chief Economist (Oliver Blanchard), using IT jargon, called these measures *a firewall* and pointed out that these are not a final solution, but a current aid, as they cannot eliminate the problems of a high debt, low growth and a lack of competitiveness.

According to the IMF, there is some room for maneuver within the monetary policy of the ECB. However, there is a problem in this case as well- is there a monetary policy that is optimal for the entire eurozone? On the one side, there are Germany, Austria and some other countries that realize relatively high economic growth and have low unemployment rate and to which the expansionary monetary policy is not only unnecessary, but also undesirable. On the other side, there are countries such as Italy, Spain, Portugal, Greece and others, that would welcome the monetary expansion.

Accordingly, it can be concluded that, at least in a short-term, there is no monetary policy optimal for all the EU Members. However, when considering long-term goals of the Member States, it might be possible to reach the optimal monetary policy that would include moderate expansion in the EU-wide and the internal devaluation in the noncompetitive states.

Economists and polititians are currently debating whether there is room for a further fiscal stimulans and in which countries. Fiscal stimulans is usually recommended for developed countries realizing high growth (USA, Germany and some smaller countries). The developing countries, especially China, have room for fiscal stimulation. However, the problem is that these stimulanses, short-term observed, are more needed by their partners (France, Spain, Italy, countries of Central and Eastern Europe, etc.) than the above mentioned countries (USA, Germany, China, etc.). However, looking on a long-term basis, a crisis deepening in Italy, Spain, Greece, Portugal and others could irreversibly jeopardize the growth of Germany, USA and the global recovery.

Financial markets exhibit some kind of inconsistent behaviour. First, there is a significant pressure to reduce the public debts of heavily indebted countries, and then, when the requirements for savings are met, and as a consequence the economy growth slows down, those same investors are being surprised by the low growth and react negatively again. It should not discourage countries with a problem of a high public debt that the only way out of the crisis is a credible medium-term reform plan, which includes spending cuts by implementing the measures, which will lead to the increased competitiveness in the medium and long term.

According to the recent estimates, GDP growth, in the U.S. during Q1, amounted to 2% annually, slightly lower than expected. The greatest support to the growth was provided by the personal consumption, warmer weather and increased employment. The investing of companies and the public spending reduced, while the net exports contribution to GDP growth was neutral. There were no changes in the monetary policy, inflation was under control, and the recovery pace in the first quarter was relatively in line with the FED expectations, while the future fiscal policy framework is to be determined after the upcoming presidential elections.

Tendencies in the EU

The eurozone economy stagnated during the first quarter of 2012- both annually and quarterly. However, movements by the groups of countries are highly different. German economy, in Q1, established a solid economic growth, which, in comparison with a previous quarter, amounted to 0.5%. Unemployment in Germany in April was 6.8%, which is the lowest level in 20 years. Similar positive tendencies were recorded in the group of countries that are tightly associated with Germany (Austria and others). Nevertheless, some data from April and May, such as, e.g., a substantial decline in car sales, suggest a slowdown in the German economy growth. The situation is, of course, completely different in the eurozone periphery- the decline in Spain and Italy was recorded (as much as 0.8% q/q). The uncertainity in Greece has a negative impact on the investors in the period when their activity is needed for the consolidation of the economic growth in the eurozone. Given that the short-term indicators are quite low in the last two months, the eurozone growth might be negative in the next quarter.

Within the eurozone in its impact on the economic growth of Serbia, of particular importance are its main export markets - Italy and Germany. The reduction of exports from Serbia had a strong impact on a slowdown in the GDP growth rate, thus, it is advisable to comment on the prospects of change in the export demands of its major trading partners. In Germany, a solid personal consumption will affect the level of imports to continue growing, while Italy's import level is expected to mildly decrease over 2012. Export from Serbia to Italy, over Q1 is by 64,8mn € lower than in the first quarter of 2011, and now amounts to about ¾ of the last year. Annually, this is a drop by as much as 25 percentage points. It is evident that the export from Serbia to Italy survived a substantial drop when compared with the total drop of goods import from the countries outside the EU to Italy. The main reason for the fall is the cessation of the U.S. Steel operations, which exported to Italy significant amounts of tinplate, hot rolled and cold rolled products. Nevertheless, it is certain that besides the closing of the U.S.Steel, the reduction of exports from Serbia to Italy, in the next period will be affected by the tendency to reduce its import demand. Contrary to the cooperation with Italy, exports from Serbia to Germany recorded a growth over a first quarter, annually by about 8%.

The economy of Italy suffers a negative impact of the crisis in the eurozone. The costs of Italy and Spain's borrowing are highly correlated with the outcome of the political situation in Greece. When the government borrowing costs increase, simultaneously there is an increase in the borrowing costs of the Italian banks, which are therefore forced to tighten the credit conditions to the economy. Fiscal consolidation reduces the employment rate and with that the domestic demand, thus companies are having a hard time deciding whether to increase the investments, especially when banks tightened loan conditions. Citizens, in the time when the situation on the labour market is not likely to improve, rearly decide on making a major purchase, thus it is expected to drop by 2.3% over 2012. Italy, above all, has a problem with a low growth, and not with a budget deficit. This can be seen from the fact that Italy, in the past, frequently recorded the primary budget surplus, meaning that the entire fiscal deficit was the consequence of interest payments. Italian economy productivity per working hour since 2005 has increased by 0.8%, and the average growth on the eurozone level amounts to about 5%. Therefore, the structural reforms are a necessity. Measures directed to this, cannot contribute to a short-term growth, but the long-term one.

However, the budget deficit could soon become the core of the problem due to the effects of a low growth. The growth rate is lower than the borrowing costs, so the public debt is in a constant growth in relation to GDP. The amount of the public debt is very high, thus, as a significant portion of bonds is to be collected (in 2012, Italy will need to rollover the bonds in the amount of 20% of GDP), there is a risk that the investors would not be interested in buying the bonds in this extent. Besides the problem of a high public debt and the low growth, Italy has a problem with banking sector, which is dependent on the financing through money market, and not through deposit. In these risky times, it is possible that the institutions on the money market are to reduce the willingness to lend to Italian banks. Therefore, in addition to labour market reforms and productivity increase, it is necessary to reform the banks in terms of their borrowing structure. Fortunately, real estate market in Italy didn't collapse, so the banks are not further burdened by the losses in that sector, but they have a significant share of Italian bonds in their portfolio.

On the last meeting of the executive board of the ECB, the reference rate has not been changed, and is still at the level of 1%. A general view on the inflation and growth has not much changed from the previous meetings. The overall inflation should be exceeding 2%, and there are equalized risks for deviation in any direction. Increase in the indirect tax or a shock at a goods market, would lead to the increase in the inflation rate, while a slowdown in the growth would lead to its decrease. There is no big chance for indirect effects, even despite the oil price growth the increase in the price of final products did not accelerate. This suggests that the firms are forced to offer discounts to stimulate the demand. Labour prices are not likely to increase due to a current unemployment.

The uncertainity was decreased in the months before the Greek elections by the long-term repo operations, but it will be continued with the accommodative monetary policy, as the growth in the eurozone is not certain. The President of ECB Mario Draghi stated that the positive effects of the long-term repo operations are felt, thus the credit conditions are more favourable, though it is not certain whether there would be a continuation with unconventional instruments. The essence of the EU Growth Compact is made of structural reforms in the field of productivity and in the labour market. According to some studies, the most responsible for high unemployement in some EU Member States is the over-protection of the employees through the union and the law. Reference rate might be corrected in a downward trend, though the ECB represents a somewhat tougher stance in this respect than the IMF. The ECB viewpoint is that in the conditions of a harsh fiscal consolidation, the expansionary monetary policy can hardly be of significant influence on the growth rate, while the negative effects can be dominant, so caution should exist in terms of further reduction of the reference rate. If future Greek government countinues with the anti-crisis program, it will be a good time to access some type of a common bond issuing. For starters, it is possible to launch the common treasury bills, with up to one-year maturity, which could help tracing the way towards the issuance of the eurozone common long-term bond.

Tendencies in Central and Eastern Europe

The recent forecast for Central and Eastern Europe are somewhat pessimistic. For most countries in Central and Eastern Europe, the European Comission (EC) and EBRD have reduced the growth estimates for this year and the forecasts for the next one. The reasons for a slowdown of both growth and fall are negative tendencies in the developed European countries from where the bulk of investmens comes to Central and Eastern Europe. Moreover, some lending institutions are withdrawing funds from Central and Easter Europe, both for the problems and the new regulations in their home countries, and for the increased risk crisis in the region. It is expected that the European banks will withdraw the capital in the region by 4% of a total amount of domestic loans, unless some significant changes occure on the financial market. A particular risk referes to the countries where there is a considerable activity of Greek banks and that may have much higher reduction in leverage. Furthermore, both stagnation and recession in the developed countries negatively affect the export of the Central and Eastern European countries.

Fiscal stimulation, as an option, is usually not available to the countries of Central and Eastern Europe, because the risk of a public debt crisis is higher than a potential gain of fiscal stimulus. Therefore, these countries massively enforce fiscal consolidation with various combinations of reducing public spending and increasing taxes. The character of fiscal consolidation in these countries is highly affected by socialistically oriented parties that rise to power. Slovakia, Romania and Croatia have obtained new governments of leftist views, which announce the continuation of a fiscal consolidation, but with less reliance on savings, and more on the tax increase. However, some right-wing governments, such as Hungary, realize most of the fiscal consolidation by increasing taxes without any significant reduction in spending. Unlike aforementioned countries, the new Slovenian government, at least for now, enforces fiscal consolidation by reducing public expanditures, with a nominal wage reduction in the public sector etc.

The new government in Slovakia is planning to reduce the budget deficit in the next few years - it should amount to 1.7% of GDP in 2015. The current proposals in Slovakia are those for the reintroduction of the increase in synthetic personal income tax in the corporate income tax from 19% to 23%, increase in the excise duties on alcohol and cigarettes, the introduction of a new tax on luxury goods. The government of Slovakia is committed to the fiscal consolidation, but mostly through an increase in revenue, which could worsen a long-term perspective of Slovakia. However, there is a little chance for that, because the tax rates in Slovakia were initially low, so it will remain at a competitive level even after the increase in rates. It remains uncertain whether these measures will be introduced and whether they will be sufficient to meet the set objectives of the budget deficit.

Last year, Croatia had a zero growth after two years of contraction, and this year, the growth rate of GDP will drop again. The new government has, at least for now, transferred the focus of fiscal consolidation to the increase of tax revenue. The public revenues were increased in the period from January to April by 5.6% annually, primarily due to the increase in VAT and income taxes, while the expanditures were by 0.8% lower. It is still uncertain whether the Croatian government will successfully implement the savings announced, which, in all likelihood are not enough. The structural reforms in the labour market will increase the labour market flexibility and equalize the rights of the employed in the public and private sector, and the employment contract for an indefinite period in the public service will not be extended. This will increase the unemployment in a short-term, but will create conditions for improving the long-term growth. After preservation of the Croatia's rating, a foreign demand for government bonds increased, thus the decline in the rate of the kuna was stopped and reversed.

In Romania, after the measures for reducing the public spending and the tax increase, public protest ensued and eventually led to a collapse of the government in April, because it was voted of no confidence in the parliament. Shortly after, a vacuum in the negotiations with the IMF was created, and the Romanian leu devalued against the euro to a historical minimum value. The newly formed government with the socialist Prime Minister continued the negotiations, and it requires, as of June, the rise in the wages on two occasions in the public service, to pacify a discontent among the people. Wages of the public servants will be increased by 16% until the end of the year, and "the health tax", charged earlier, will be restored to the retirees with the low pensions (this will increase the deficit by 0.1% of GDP). Therefore, the planned budget deficit was increased from 1.9% to 2.2%. It remains to be seen how this deficit will be achieved with the aforementioned increased expanditures.

Romanian Central Bank has, since November, reduced the reference rate four times, each time by 0.25 percentage points, thus it amounts to 5.25%. Inflation is decreasing - overall annual dropped from 3.2% in December 2011 to 2.4% in April of this year. By way of a reminder, in March last year stood at as much as 8% at an annual rate, thus, current inflation is closer to the planned. The Central Bank wants to maintain the liquidity of the banking system, in the situation when some banks withdraw the money from Romania, and at the same time encourage the economic activity. Therefore, it is expected that, in this year, the reference interest rate will remain unchanged, but will probably increase the minimum reserve ratio for the deposits in a domestic currency. A moderate withdraw of the capital occurred in the last year, which didn't have much impact on the rate and the level of foreign reserves. The GDP growth was forecast by the EC to stand at 1.4% over the year 2012. It is evident that the planned wage increases by 16% are a preparation for the success in the upcoming parliamentary elections in November. The example of Romania suggest that there is a risk of such a scenario in other countries of the region and that the ensuring the political stability is a complementary process to the fiscal consolidation.

The economy of Hungary recorded a drop by 0.7% at an annual level during Q1. The EC preassures the Hungarian government for making "non-European" laws, and the EU finance ministers decided to suspend the funding to help the underdeveloped areas of nearly 500 mn € for the next year, if the country does not show a clear progress in the fiscal consolidation. It is necessary that in 2011 it meets its budget deficit target of 2.5%, and provides a deficit lower then 3% from the next year. It is evident that this is a form of a pressure on the Hungarian government, whose undemocratic changes in the Law on the Judiciary and Central Bank and the introduction of controversial taxes are highly unexceptable for the EC. The formal reason, i.e. exceeding the budget deficit amount, is not met in 19 out of 27 countries of the EU.

It is expected that the Hungarian government will crack under pressure in order to reach the agreement with the IMF, because it is necessary to provide the financial aid to prevent the interest growth on the government bonds. Currently, the interest rate amounts to 8%, highest in the Central Europe, and if it remains at that level, Hungarian public debt will become unsustainable. Therefore, it is almost certain that the concessions are to be made in order to continue the negotiations with the IMF, and the stalling of the Hungarian government is a part of a political marketing and strategy. According to the government sources, the precautionary arrangement in the amount of 15bn € is planned and last 3 years. The IMF stated that the negotiations will begin only when the government takes adequate steps to ensure the independence of the Central Bank.

Hungary has proposed a plan of a new "crisis" taxes that are consistent with the already negative image of the Prime Minister Orban. From the January next year taxes on the financial transaction of 0.1% will be introduced. They will mainly affect the companies and physical entities, but there is a plan of a restriction that would help a big capital coming into the country to be partially spared. The tax on telecommunications, by the number of minutes during conversation and the number of text messages, will be applied as of June. Such a plan fits in with the intention of the Hungarian government to increase the amount of revenue through indirect taxes. Another contradiction in this government- the new economic program declaratively protects citizens who are not "wealthy" in order to obtain their political support, but indirect taxes, in fact, affect equally all layers of the population- both rich and poor. This is an example of how political populism, which manipulates with the voters discontent over the crisis, represents a threat to the successful implementation of the economic reforms, because it annuls the urgency of structural reforms.

HIGHLIGHTS

Highlight 1 - Amendments to the Law on Financing of Local Self-Government: An Analysis of Results and Suggested Changes

*Milojko Arsić**

*Saša Ranđelović***

From the standpoint of macroeconomic stability and efficiency of use of taxpayer funds, the first results of implementing the Law on Financing of Local Self-governments are extremely negative. Amendments to the legislation had a direct impact on the increase of the overall fiscal deficit in the first quarter of 2012 by RSD 11-12bn. Results from the first quarter confirm the estimates published in the QM even before the enactment of the Law, that its amendments will contribute to the increase of the fiscal deficit by around 45bn RSD in 2012, equivalent to 1.5% of GDP. The growth of fiscal deficits on the basis of decentralisation has directly influenced the increase of the foreign trade deficit, and indirectly the increase of the exchange rate and the creation of inflationary pressures. The local governments have mostly used the additional funds to increase current expenditures on subsidies, on purchase of goods and services, and the increase of wages, while the level of local public investments declined in real terms. Local subsidies have risen by as much as 55%, expenditures for purchase of goods and services increased by nearly 30%, while wages rose by 10% in real terms. The local social welfare expenditures increased by 25% in real terms, but it is not certain how much of this strong increase was well targeted, and how much of it was merely in the service of the election campaign. Furthermore, there are indications that new forms of unproductive spending have occurred at the local level, such as forming of new extra-budgetary institutions, agencies, etc., while at the state level preparations are being made for merging, reducing and cancelling such institutions. Finally, it is expected that in the case of keeping the existing law, there would almost certainly be an increase in the number of employees at the local level, although there is already a high surplus of employees (6-8 thousand) at this level of government.

By increasing the participation of local communities in wage tax by 40% at the expense of the Republic, without transferring the obligations from the state to the local level, a vertical imbalance in public finances in Serbia has been created. Even before the amendments to the Law came into power, the Quarterly Monitor estimated[1] that these changes, all other things being equal, will lead to the increase of the consolidated fiscal deficit in 2012 by about 1.5% GDP2. It also pointed out that fiscally irresponsible changes to the Law on Financing Local Self-governments will lead to a diminished efficiency of the state, i.e. the increased unproductive spending of the taxpayers' funds. Contrary to this opinion, the proponents argued that local communities will use the extra funds to increase local public investments.

As a result of implementing the Law on Financing Local Self-governments in late 2011 and the beginning of 2012, highly divergent trends of real revenue and expenditure have been achieved at different state levels. In Q4 of 2011, Republic of Serbia's budget (RS budget) revenues declined by 10.1% compared to the same period of the previous year, and there was a slight decline in revenues of the Health Insurance Fund of the Republic of Serbia (HIFRS), while the revenues of local self-governments recorded a slight increase (0.3%). Divergent trends became even more pronounced in Q1 2012, when the RS budget revenues continued to decline in real terms compared to the same period last year (by 4.2%), while local government revenues grew strongly in real terms (by as much as 26.1%) compared to the same period last year. Central government revenue decline was primarily a result of the transfer of a substantial portion of revenue from wage tax to the local level, and to a lesser extent the fall in economic activity. On the other hand, growth in revenues of local governments is primarily a result of the additional influx from wage tax, but also of an increase in non-tax revenue, which is a bit of a paradox.3 This suggests that local communities have not used the additional revenues from wage tax for the elimination and significant reduction of various non-tax levies (taxes, fees and other quasi-fiscal duties), even though that was initially one of the arguments for the redistribution of wage tax revenues.

Similar to revenues, divergent trends have been achieved in total expenditures as well. While the state expenditures in the first quarter increased by 10% in real terms, expenditures of local communities have incre-

* Faculty of Economics in Belgrade and FREN

** Faculty of Economics in Belgrade and FREN

1 See Arsić, M. (2012) „Quarterly Monitor no. 24"

2 By subsequent transfer of maintenance of local roads to local self-governments, the impact of the Law on financing local self-governments on the increase of the fiscal deficit has been reduced, but it is uncertain by how much. While the suggested changes to the law claimed that the transferred responsibilities will amount to 10bn RSD, the representatives of the Roads of Serbia claim that the transferred responsibilities amount to 2-3bn RSD.

3 Non-tax revenues of the local levels of the government in Q4 2011 were higher in real terms by 14.7% compared to the same period in the previous year (after making the methodological adjustment for 2010 by excluding the 7 bn RSD of special / once-off non-tax revenues collected by the City of Belgrade).

Table 1 Serbia: Year-on-year (Y-O-Y) growth rate in real terms of public revenues and expenditures by government levels

	Q4 2011/Q4 2010			Q1 2012/Q1 2011		
	Budget of the Republic	Health insurance fund	Local self-governments	Budget of the Republic	Health insurance fund	Local self-governments
A Total public revenues (I)+(II)	-10.1	-0.1	0.3	-4.2	5.2	26.1
I Current revenues (1)+(2)	-8.5	1.3	10.2	-4.3	5.9	30.6
1. Tax revenues	-8.9	0.5	37.3	-4.0	4.7	44.8
1.1. Customs	-21.4	-	-	-18.6	-	-
1.2. Personal income tax	-49.3	-	64.4	-49.7	-	69.9
1.3. Corporate income tax	-3.5	-	-	52.7	-	-
1.4. VAT	1.6	-	-	-4.0	-	-
1.5. Excise duties	-4.6	-	-	4.6	-	-
1.6. Property taxes		-	-5.1	-	-	5.0
1.9.Other taxes	-47.0	-	-13.1	-38.3	-	-9.3
1.10. Social security contributions	-	0.5	-	-	4.7	-
2. Non-tax revenues	-6.0	48.3	14.7	-6.4	242.6	-3.8
II Capital revenues	-	354.1	277.1	61.8	795.7	925.1
III Transfers from the other levels of government	-	-3.7	-39.5		3.7	10.4
B Total public expenditures (I)+(II)+(III)+(IV)	-8.4	-9.1	0.1	10.3	3.3	17.7
I Current expenditures	-3.4	-8.8	-3.3	7.2	3.3	24.5
1.1 Wages	6.4	-10.1	5.4	7.8	2.8	10.5
1.2 Social contributions on behalf of employer	4.4	-9.0	3.9	7.5	1.5	10.3
1.3. Goods and services	-10.7	-4.6	4.7	9.7	1.8	28.6
1.4 Interest payments	10.1	-110.8	45.1	52.8	-88.9	48.3
1.5 Subsidies	-11.3	-	-38.4	36.3	-	55.0
1.6 Social insurance and social assistance	-15.0	-28.8	13.2	-24.0	31.5	24.0
1.7 Transfers to the other levels of government	-1.0	-	-	10.3	-	-
1.8 Other current expenditures	-25.3	-36.7	8.2	-21.9	-	11.8
II Capital expenditures	-41.7	-66.6	9.2	140.1	-	-13.5
III Strategic reserves	-80.5	-	22.1	-92.1	-	62.6
IV Net lending	-42.7	-	14.3	-19.7	-	-7.2

Source: *QM* calculation

ased by nearly 18% in real terms. Much of the real growth of expenditures at the state and local level in first quarter was temporary, i.e. it was related to the discretionary spending and not to the permanent increase of state obligations, and it was directly related to the election campaign. It is therefore expected that after the campaign, the state will bring back its expenditures to "normal" levels, as it simply cannot afford to finance an expenditure growth of 10% Y-O-Y. Quite contrary to this, the local communities will strive to increase their spendings (by hiring new employees, forming new enterprises and agencies), in order to turn the extra revenues from wage tax to permanent "rights".

It is noticeable that the local self-governments used most of the additional tax revenue for increasing current expenditures: wages, expenditures on goods and services, subsidies, and social protection expenditures. For two consecutive quarters, the expenditures on salaries of employees in local self-governments have had a real growth as compared to the same period last year, and this growth is accelerating. In Q4 2011, the RS and local self-government budget spending on employees grew in real terms by a similar dynamic, while in Q1 2012, the real growth of wage bill at the local level (10.5%) was significantly larger than at other government levels (7.8% RS budget, and 3.3% HIFRS). The growth of expenditures on salaries of employees in local self-governments came as a consequence of the adoption of the Decree in late 2011, which made an adjustment to the coefficients for the calculation of earnings of employees in local self-governments, motivated by additional revenues that became available to local self-governments after the application of amendments to the Law on Financing of Local self-governments started.

Similar trends were recorded in expenditures on goods and services as well. In Q4 2011 and Q1 2012, this type of spendings grew significantly faster at the local than at the central level. In Q4 the expenditures on goods and services of the RS and HIFRS budgets declined in real terms, while the same spendings gradually increased at the local level (by 4.7%), compared to the same period last year. In the following quarter, these expenditures had a real growth at all state levels, the one on the local level being the highest, with expenditures on goods and services increasing by 28.6% in real terms, compared to the same period last year, which is three times faster than on the central level. The increase in expenditures on goods and services at the local level recorded in the last two quarters, could be a result of settlement of arrears by local communities for previously acquired goods and services, which is judged to be necessary and justified. However, in that case, it should be expected that the growth of these expenditures would slow down in the coming quarters. If, however, their high growth continues in the future, it will indicate that local communities used the additional tax revenues for permanent increase of current spendings on procurement of goods and services, which is judged to be unjustified.

Apart from spending on goods and services, Q1 also saw a strong growth in real terms of expenditures on subsidies and social assistance, as well as transfers from the budget of local self-governments. The increase of expenditures on subsidies (for local public enterprises) is estimated as unjustified and undesirable from the perspective of economic efficiency, since these expenses are already quite high, and are not related to the results of implementing programmes for improvement of business performance of these companies.

On the other hand, use of additional tax revenues to finance social protection is considered as desirable. However, it is estimated that these are mostly spendings on benefits which are not means tested, in function of the election campaign, rather than well-targeted transfers. At the same time, the data show that capital expenditures at local levels of the government, after a moderate growth in Q4, recorded a higher real decline in Q1 2012, while capital expenditures from the RS budget in Q1 grew strongly (which is a result of delaying settlement of liabilities from Q4 2011 for the next quarter).

Conclusion

Based on the above, it can be concluded that the application of new methods of distribution of revenues from wage tax on significantly contributed to the creation of a high consolidated fiscal deficit in the previous two quarters, as it has enabled an increased current public spendings at the local level, without decreasing the obligations at the state level.

The redistribution of wage tax resulted in the increase of consolidated fiscal deficit by RSD 11-12bn quarterly, i.e. around RSD 45bn annually. Assuming the vertical distribution of income goes back to a sustainable level from the period 2006-2008, which includes a transfer from the state to local communities in amount of 1.7% GDP, the fiscal deficit would be reduced by about RSD 30bn on annual level. In addition to this, increasing revenues of local communities without transferring any significant additional obligations, results in a growth of unproductive spending on salaries, subsidies, procurement of goods and services. Moreover, an acceleration of this process can be expected through the growth of employment at the local level, formation of unnecessary agencies, etc., as well as realisation of investments that are not priorities. In a world of limited resources, where priorities have to be constantly made, it is certainly more important for the advancement of economy and employment growth to modernise the existing core railway lines and build a network of highways, as this will create new jobs in the industry and the production sector, than financing construction of certain aqua parks, sports arenas, etc. as practiced in some municipalities.

It is therefore proposed to bring the distribution of revenues from wage tax between the state and local communities back to the scheme which was applied before the amendments to the Law on Financing Local Self-governments, while the transfers from state to local communities should be increased to 1.7% GDP, i.e. by around RSD 15bn a year. That would mean that the Republic of Serbia would collect 60% of revenues from wage tax, while the local communities would get 40% of those revenues, but also the additional transfer of about RSD 15bn. Alternatively, it is possible to increase the state participation in wage tax to 50%, to have the state pay out transfers in amount of 1.7% GDP, and to transfer to local communities additional obligations in the area of social protection in the amount of RSD 5-6bn, provided that the obligations for maintenance of local roads, transferred to local level amount to RSD 2-3bn.

It is also important to reallocate the wage tax revenues from local self-governments to the Republic as soon as possible, so that the local communities would not turn the temporary increase in expenditures into a permanent one. It will be much harder to realise the reallocation once the local self-governments hire new employees, form new enterprises, agencies, etc.

Literature:

— Arsić, M. (June 2011) „An Analysis of the Proposal to Increase the Local Governments' Share in the Wage Tax“, Quarterly Monitor no. 24, FREN.

— Fiscal Council (June 2011) „Analysis of the Fiscal Effects of the Draft Decentralisation Law Proposed in the Serbian Parliament by 'Ujedinjeni Regioni Serbije'"

SPOTLIGHT ON:

Does Serbia need a fiscal consolidation and how can it be realised[1]

*Milojko Arsić**

At the end of May, the Fiscal Council proposed a comprehensive and consistent programme of fiscal consolidation, which contains measures whose aim is to achieve a balanced budget by year 2016. This implies reduction of fiscal deficit by 1% of GDP this year and by 2% of GDP next year. The largest part of fiscal consolidation would be achieved by reducing current expenditures (-5% of GDP) and, to a lesser extent, by raising taxes (+1% of GDP), while an increase in public investment is proposed (+1% of GDP). The immediate objectives of fiscal consolidation are to ensure macroeconomic stability in order to prevent a public debt crisis and reduce external imbalances, while the ultimate goal is creating conditions for growth in economic activity and employment. Programme of the Fiscal Council is not the only one possible, so new proposals and alternatives are welcome. However, it is estimated that some alternative proposals that have emerged in the first days after the publication of the Fiscal Council's programme, do not contribute to the improvement of fiscal consolidation, but rather directly threaten its goals. The first group is made up of populist proposals according to which, a minor adjustment in fiscal policy is needed that could be realised by an improved collection of taxes, savings in public procurement, elimination of certain subsidies, and others, while freezing of salaries and pensions, as well as raising taxes are unnecessary. The second group consists of libertarian proposals according to which consolidation can be achieved by eliminating all subsidies, laying off half of the employees in the public sector or by reducing spending on goods and services by 50%. While the populist proposals basically mean a delay or abandonment of fiscal consolidation, which would lead to a debt crisis, the libertarian proposals would secure fiscal consolidation, but would lead to a destruction of some of the basic functions of the state (education, health care, security, etc.), which would jeopardize the ultimate goals of the fiscal consolidation – growth of GDP and employment.

Introduction

Public debt of the Republic of Serbia exceeded the legally prescribed limit of 45% of GDP at the end of 2011. The Law on Budget System prescribes that, during the adoption of the new or a rebalance of the current budget, the Government of Serbia adopts a credible plan for mid-term consolidation of public finances, which would enable the public debt in the coming years to return to sustainable, legally prescribed parameters and thus avoid a potential debt crisis.

In the recent report "Proposed Measures of Fiscal Consolidation 2012-2016", the Fiscal Council of Serbia analysed in detail the current state of public finances in Serbia, quantified the necessary extent of savings in short and mid term, and suggested a list of possible savings in various segments of Serbia's public sector. It was estimated that in the absence of urgent measures of fiscal consolidation, the fiscal deficit would exceed 200 billion RSD this year, which is 50bn RSD above the amount foreseen by 2012 fiscal policy. In order to avoid a debt crisis and a liquidity crisis in a short time, the Fiscal Council estimated that by 2013, it is necessary to realise savings of around 1bn euros. Also, in order to secure solvency of public finances and stabilise the level of public debt, it is necessary to reduce the budget deficit, in the mid-term from 2014 to 2016, by additional 1.2bn euros, in order to achieve a balanced budget by year 2016, and return the public debt to its legal limits.

* Faculty of Economics in Belgrade and FREN
1 We would like to thank Nikola Alatiparmakov for useful comments and suggestions made on the fist draft of the article.

In addition to quantifying the problem, the Fiscal Council also analysed various parts of the public sector, as well as possible savings for each one of them. They started with "socially acceptable" austerity measures, that were broadly discussed in the public in the last months – a systematic fight against the grey economy and tax evasion, improvement of public procurement processes, dissolving agencies and other state institutions whose duties could be performed within a government ministry, rationalisation of state subsidies, and cancelling the negative effects of the so-called fiscal decentralisation of last year. However, having in mind the scope of the problem and a huge gap between budget revenues and expenditures, the necessary savings cannot be achieved solely by popular measures, and it is clear that the pending fiscal consolidation has to include two of the most significant budget items – salaries and pensions on the side of expenditures, and VAT on the side of revenues. Economically speaking, it is almost always optimal to implement fiscal consolidation on the side of expenditures, without raising the taxes. However, that would require a one-off (nominal) reduction in salaries and pensions by 5-6%, followed by their freezing for one year. Given the social and political challenges that would follow a nominal reduction of salaries and pensions, the Fiscal Council also presented a scenario that does not involve a reduction of salaries and pensions, but only freezing them over a period of 18 months. However, this scenario requires an increase of both VAT rates by 1 percentage point, as well as increasing excise on tobacco products and alcoholic beverages, in order to close the gap between the budget revenues and expenditures[2].

Fiscal Council's programme is not the only possible programme for achieving fiscal consolidation in Serbia, but for now, it is the only complete and consistent programme. New initiatives and alternative proposals, as well as more detailed elaboration of the proposals within the programme, are certainly welcome. However, some of the alternative proposals that emerged in the first days after publishing the Fiscal Council's programme do not contribute to the improvement of the programme, but would rather mean abandonment of fiscal consolidation or collapse of basic functions of the state.

For quite some time in the general public, among the politicians and economists, there have been claims about the public finances in Serbia that are far away from reality. This is probably one of the reasons that unfounded and unsubstantiated proposals are emerging for solving problems in Serbian public finances. These proposals can be categorised in two basic groups. The first group consists of proposals whose application is justified, but they drastically overestimate their affect on state balance sheets and ignore the time dynamics that these measures would have on public finances – proposals from this group can be described as populist. This group consists of suggestions for improvement of tax collection, combating grey economy, improvement of public procurement, dissolvement of redundant state bodies, reducing the number of employees in the public sector, etc. All these suggestions are necessary and indisputable, but their affect on the state's balance sheet is insufficient to bring the public finances in Serbia back in sustainable parameters, and in addition, it would take several years to achieve savings by applying these measures.

The allure of these suggestions is in the fact that they seemingly offer a solution for sustainable fiscal consolidation that would not affect the broad strata of the population (potential voters), but only corrupt officials (public procurement), dishonest businessmen (grey economy) and useless bureaucrats (dissolving redundant government bodies). However, relying exclusively on these measures will not lead to the necessary reduction of fiscal deficit, which means their implementation would delay fiscal consolidation. To what extent these measures are unrealistic is also confirmed by policies implemented in other European countries, that have a smaller grey economy, more efficient public procurement, more productive bureaucracy, and still most of them were forced during this crisis to apply tough austerity measures (freezing or reduction of salaries), as well as a considerable tax increase.

The second group consists of proposals mainly from the academic (libertarian) circles, whose application would lead to a fast fiscal consolidation, but also to a drastic collapse or abolishment of some of the basic functions of a modern state. These measures include suggestions for cutting the number of employees in the public sector by half, to eliminate all subsidies, and halve the spending on goods and services. The division in these two groups is conditional, since the proposals in the second group often present and extreme version of otherwise necessary and justified savings.

The following will analyse several proposals from the first and second group, in order to point out their weaknesses.

2 Fiscal Council also proposed a tax reform, which is similar to the proposal put forth two years ago, and which was supported by the then Minister Dragutinovic. The most important measures in tax reform are the increase of fiscal burden of consumption and the reduction of the fiscal burden of labour. Fiscal Council's proposal includes increasing the standard VAT rate to 22%, as well as transferring 1/5 of products, observed in value, from reduced to standard rate of VAT, and a reduction in tax burden of average earnings from 65% to 54%. In addition to that, the tax reform proposes an increase in excise duties on cigarettes and alcoholic beverages, abolition of tax reliefs for taxes on profit, increased coverage of assets with taxes, as well as abolition of a number of quasi-fiscal duties, or their merger and reduction.

1. Fiscal consolidation is completely unnecessary

Some opinions can be heard in the public that Serbia doesn't really need a fiscal consolidation – that the current large gap between the budget revenues and expenditures is the result of the global economic crisis and that public finances will balance themselves out once the crisis is over. However, the imbalance in public finances of Serbia is of structural nature and stems only by a small part from the global economic crisis, and for the most part from the systematic imbalance between taxes and public expenditure policies. Systemic imbalances in Serbian finances appeared in the mid 2006, when the previous arrangement with the IMF was completed, and the country generated high one-off privatisation revenues (Mobtel, The Vojvodjanska Bank, Belgrade Department Stores, etc.). Unfortunately, the revenues from privatisations were not invested in the infrastructure, but were used for unsustainable increase of public expenditures, on the one hand (salaries and pensions were significantly increased in 2007 and 2008), while on the other hand, the tax revenues were decreased (in 2007, there was a reduction in tax on earnings, and some products were transferred from the higher to the lower VAT rate). The last big systematic blow the Serbian finances suffered in 2011, when as part of the so-called fiscal decentralisation 400 million euros of tax revenues were transferred from the state budget to local self-governments, without the corresponding transfer of responsibilities and liabilities. That is why the problems of public finances of Serbia are of structural nature, and the Fiscal Council's proposal actually foresees solving the problems through applying measures contrary to those that caused the problem in the first place, meaning: reduction or at least freezing of salaries and pensions as a response to the unsustainable increase of 2007 and 2008, cancelling out the negative effects of the so-called fiscal decentralisation from 2011, as well as increase of tax rates (VAT) as a response to the unsustainable unilateral reduction of taxes on earnings and the switch to a lower rate of VAT from 2007.

2. The situation in Serbian public finances is not extremely risky, and therefore requires relatively moderate adjustments of the existing fiscal policy

At the basis of this opinion, there is a belief that Serbia's public debt is not that high compared to the debts of the developed countries, and therefore no harsh measures are necessary in order to reduce the fiscal deficit. It is concluded that there is no need for a VAT increase or freezing of salaries and pensions, and instead, all that is needed in order to achieve fiscal consolidation is an increase of excise, savings in the procurement of goods and services, suppression of grey economy, reduction in subsidies, and a gradual rationalisation in the major spenders' sectors (education, health care, etc.).

A mild adjustment of fiscal policy implies a gradual reduction of fiscal deficit and a continuation of the high growth of public debt in the coming years. This would mean a continuation of the fiscal policy from 2009-2010. However, the circumstances have significantly changed compared to the stated period: public debt of Serbia has reached 50% of GDP, a series of debt crisis in Europe have diminished investor confidence in the solvency of the states, expansionary policy no longer has the support of IMF, and salaries and pensions in Serbia were frozen at the time.

It is estimated that a mild adjustment of fiscal policy in Serbia is very risky, because it would significantly increase the likelihood of a debt crises. A continuation of a high fiscal deficit policy would directly influence the maintenance of high deficit in current balance of payments. In that case, the entire burden of bringing the foreign deficit back to sustainable levels would lie on the depreciation of dinar, which would considerably increase costs of servicing the foreign debt of the state, enterprises and citizens, and with a certain time lag, there would be an increase in inflation as well. To the extent that the depreciation of dinar would not reduce the external imbalance, NBS would be forced to spend foreign exchange reserves, and to tighten the restrictiveness of the monetary policy. Any termination of the agreement with the IMF could trigger a suspension of financing of the public debt and fiscal deficit of Serbia by commercial investors. Also, it is estimated that revenues from any sales of a public enterprise or a bank would not be sufficient to replace the commercial investors who finance the fiscal deficit and the public debt of Serbia.

When considering whether Serbia needs a strong fiscal consolidation or just mild adjustments of the existing policy, we need to remind ourselves that most of the European countries in the last two years increased their tax rates and applied severe austerity measures, that led to a reduction of the share of primary fiscal deficit in GDP, on average by about 3 percentage points. Former Yugoslav countries were late in this process, but they are currently implementing programmes of strong fiscal adjustment. Slovenia, whose share of public debt in GDP is similar to Serbia, while its fiscal deficit is lower, adopted severe measures of austerity, which include a reduction in nominal salaries in the public sector. Croatia increased its VAT rate, announced relatively mild austerity measures, but apparently that will not be sufficient, so they will have to adopt additional austerity measures. So a question arises – are the economists and politicians of European countries wrong, and are overestimating the risk of a debt crisis and ignoring the need for fiscal stimuli, or are perhaps some Serbian economists and politicians wrong?

3. The public debt of Serbia is not a problem, but rather the borrowing limit of 45% of GDP is set unrealistically low

An opinion can often be heard in the public that the public debt limit for Serbia of 45% of GDP is set too low, because the EU member states have a prescribed limit of public debt of 60% of GDP. However, this comparison is inadequate as it omits one of the most important factors that affect a sustainability of a debt – credibility/solvency of the debtor. Thus the developed countries that have a high credit rating and a history of successful loan repayments in the past, can afford a higher level of debt than the developing countries, such as Serbia, who have in the past few decades relatively often gone through the process of restructuring and writing off the public debt.

Higher credit rating allows the developed countries to borrow at much more favourable conditions than the transitioning countries, such as Serbia. For example, interest rate on twenty or thirty-year American or German bonds is around 2%. On the other hand, Serbia is forced to borrow against five-year (or shorter) dinar bonds at the rate of 15%.[3] Therefore, it is clear that Serbia cannot afford the level of public debt that some of the developed Western countries can.

Empirical studies show that in the past, half of the developing countries entered a crisis with the level of public debt amounting to 43% of GDP or less. That is why the transition countries in the region target the level of public debt that is much lower than 60% of GDP, which is prescribed for EU member states. For example, last year neighbouring Bulgaria adopted fiscal rules prescribing a maximum public debt of 40% of GDP. Other countries in the region (Slovenia, Romania, Slovakia) are either applying or planning severe measures of fiscal consolidation, with the level of public debt relative to GDP similar to or lower than Serbia.

4. Serbia has an enormous surplus of employees in the public sector, so it is possible to lay off half of the employees at the state level or at the level of the republic administration. Laying off of extra employees would achieve considerable savings, without compromising the availability and quality of public services.

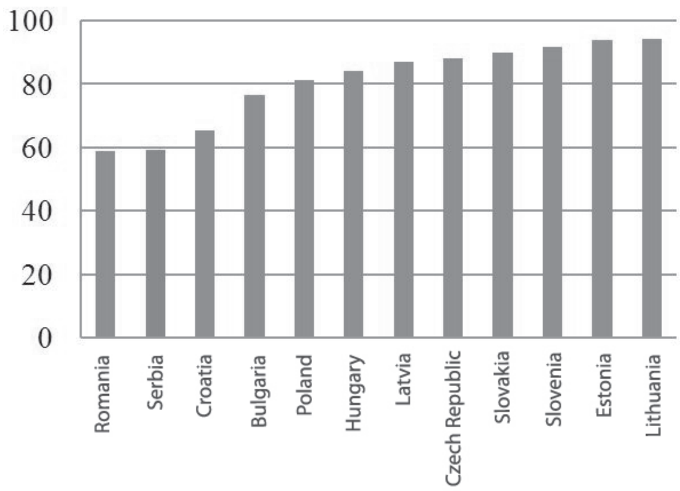
The public sector in Serbia, excluding public enterprises, employs around 440 thousand workers, out of which there are 34 thousand employees in the republic administration. Around 12% of GDP is spent on salaries of public sector employees, while around 0.9% of GDP is spent on salaries of those employed in the republic administration. It is apparent that the expenditure of the employees in the public sector are unsustainable in the long term, but there is a question whether this is predominantly a result of an excessive number of employees or salaries that are high compared to the private sector and to the level of economic development.

The first question to be answered is whether there really is an enormous number of employees working in the public sector in Serbia. A rough answer could be obtained by comparing the number of public sector employees per 1000 inhabitants in Serbia and other countries. This comparison is quite relevant, as the number of public sector employees in relation to the population stems from the functions performed by states, and most European states are performing similar functions. For example, all states perform functions such as defence, internal security, and judicial functions, and for these sectors there are empirical norms set as to how many soldiers, policemen, judges, etc. per capita are needed. Over the last 100 years or so, the European countries have taken on some new functions, such as public health care, public education, social protection, etc. The state's involvement in these sectors is the result of the inefficiency of the market[4], as well as the progress of civilisation that implies that certain services, such as primary and high school

3 Nominal interest rate of 7.25% that Serbia pays on a 10-year dollar bond issued last Autumn, is just a portion of the cost of servicing the debt. In addition to this amount, it is necessary to include the amount of depreciation of dinar against the US dollar, which was over 20% in the meantime.

4 Inefficiency of the market in the stated sectors is the result of asymmetric information and negative selection that it would lead to, moral hazard, existence of external effects, etc. State intervention is justified by an opinion that some services, such as education and health care, should be available to all citizens, regardless of their financial means.

Figure 1. Employment in public sector per 1000 inhabitants



Source: World Bank (2010)

education, and partly higher eduction as well, or health care services, should be available to all citizens. And it is precisely these services that now employ the largest number of employees working in modern states, and Serbia as well.

A comparative review of the number of employees in the public sector[5] per 1000 inhabitants shows that the total number of employees in Serbia in relation to the population is among the lowest in the group of the observed countries. Aside from this, it can be observed that the number of employees in the public sector per 1000 inhabitants is moving in a relatively narrow intervals, which is the result of the abovementioned normatives that stem out of the functions of the state.

It cannot be concluded from the above that there is no surplus of public sector employees in Serbia, as it is possible that the number of public sector employees in all states that Serbia is compared to is excessive, but it can still be concluded that this surplus is not enormous, i.e. 30% or 50% of the total number of employees, as some experts and politicians are claiming.

Additional evaluation of the employee surplus in the public sector could be performed by a microeconomic research of productivity at the level of individual institutions: hospitals, schools, municipalities, police stations, courts, tax administration, etc. World Bank conducted such a research in 2008 for some of these sectors and it was estimated that employee surplus in education was 5-7 thousand. Similar results were obtained in the case of health care as well, where the identified surplus in non-medical personnel was around 6-8 thousand. During 2009, the government of the Republic of Serbia conducted a comparative analysis of the employment in the local self-government, and found that the surplus of employees at the local level is 6-8 thousand.

It was also estimated that there is a surplus of employees at the republican level of 4-5 thousand. The sum of all previous numbers gives a surplus of employees at the state level of around 5% of the total number of employees. Based on these estimates, it would be possible to lay off around 25 thousand employees in the public sector, without affecting the quality and availability of public services. Of course, the implementation of these measures would not be painless, which is probably the reason why it has been delayed for several years now, even though there were concrete plans for the rationalisation of the network of schools, health institutions, reduction of number of employees in local and state administration.

Table 1. Total number and structure of employees in the public sector

Central level administration	34.313
Local level administration	60.810
Military	36.000
Police	48.414
Justice	21.723
Culture and social protection	7.798
Education	125.127
Health care	104.599
Total	438.784

Source: Fiscal Council

5 The state sector implies the sector of general government, i.e. all those institutions that are directly and indirectly financed from fiscal or quasi-fiscal resources.

Another, more common proposal is to halve the administration at the republican level. It is important to remember that the republic administration performs some of the functions, without which it is hard to imagine even a classic, let alone a modern state. It is possible to reduce the number of employees by 4-5 thousand and still have the state perform its functions equally as well as it does now. The preliminary analyses also show that the stated surplus is mainly among the employees at the ministries, administration of social security funds, the Republic Geodetic Authority, etc.

Table 2. Total number and distribution of employees in public administration at the level of the Republic

Pension Fund (PIO) administration	3.264
Republic Fund of Health Insurance (RZZ administration	2.420
National Employment Agency (NSZ) administration	1.992
Republic administration	26.637
Customs administration	2.842
Tax administration	6.856
Treasury department	1.245
Geodetic authority	2.670
Employees at the ministries	6.672
Other employees at the republican level	6.352
TOTAL, administration at the level of the Republic	34.314

Source: Fiscal Council

Naturally, this does not mean that it is unnecessary or impossible to reduce the cost of employees in the public sector, but this would mainly be done by reducing the gap in salaries between the public and the private sector. Based on the comparative analysis by countries, it is concluded that the salary gap between the public and private sector in Serbia is bigger than in other countries. Even though this gap, presented in the chart, is probably overestimated due to the fact that part of the salaries in private sector is paid in cash, it is still large. Even if the differences in salaries between the public and the private sector were adjusted based on the difference in the level of education, they are still great. Therefore, it can be concluded that both from the economic and moral perspective, the salaries in the public sector should be frozen in order to reduce these unjustifiably large differences.

Table 3. Salaries in the public sector and the rest of the economy, 2008

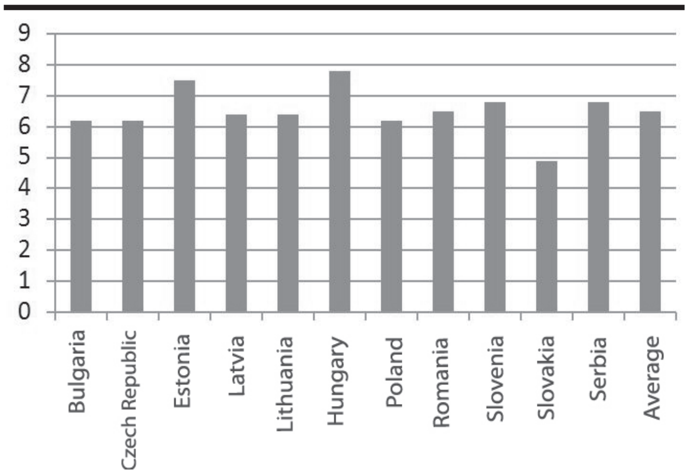
Country	Salary gap between the public sector and the rest of the economy in %
Serbia	39,6
Latvia	31,9
Hungary	30,1
Estonia	24,6
Slovenia	27,4
Lithuania	28,0
Poland	24,9
Romania	20,3
Bulgaria	27,2
Slovakia	22,6
Czech Republic	20,3
EU 10 – average	25,8

Source: IMF

It can thus be concluded that the savings on salaries in the public sector are possible and necessary, and most of them could be achieved by freezing salaries during 2012-2013, and then raising them at a rate slower than that of GDP, in line with the fiscal rule. Freezing, followed by a slower growth rate of salaries than that of GDP would decrease the share of cost of labour in the public sector by 1-1.5% of GDP in the next few years, depending on the hight of inflation and growth rate of GDP. The savings from reducing the number of employees are not negligible and in the next few years could amount to about 0.5% of GDP. In order for this measure to lead to permanent savings, it is very important to make thorough preparations, so that laying off employees, whose engagement is necessary in the public sector, can be avoided. This is exactly what happened in Serbia in 2006, when public sector laid off employees who were essential for its functioning (anaesthesiologists, professors of mathematics, physics and English, etc.), with high severance pays. Therefore, the state had a double expense – first for severance pays, and then for hiring new employees with the same qualifications. A possible attempt to halve the number of employees at the level of the Republic would yield high fiscal savings, but it would require a drastic reduction of all state functions or elimination of certain functions, and this would mean a huge economic and civilisational step backwards.

5. It is possible to significantly reduce or even halve the expenses on purchase of goods and services in the public sector, because there is corruption in public procurement.

Graph 2. Expenditures on goods and services, selected European countries, % of GDP



Source: Government finance statistics, Eurostat, for Serbia - Bulletin of Public Finance

Expenditures on goods and services consist of very heterogenous items among which the most important are the expenditures on the purchase of medicines in health care, on heating and other utility services, expenditures on fuel and electricity, on maintenance of state owned buildings and equipment, expenditures on office material, etc. The accounting item "expenditures on goods" in Serbia is also credited with expenses for financing salaries of employees in scientific institutes (The Vinča Institute, institutes in the fields of biological and medical sciences, etc.) in the amount of around 10bn RSD (0.3% of GDP), which artificially increases the cost of procurement of goods and services. When it comes to possible expenditure on goods and services, it is necessary to keep in mind that the scope and structure of these expenses is to a large extent defined by functions of the modern states and by technology, so the resulting difference in the share of expenditures on goods and services in GDP by countries is relatively small. The differences in prices at which the states procure goods and services, move in a relatively narrow interval, especially when it comes to goods that are subjects of international trade. In Serbia, prices of medicines, fuel, computer equipment, office material, army and police uniforms, and auto spare parts are on average similar to those of surrounding countries. Prices of certain products, such as the utility services, electricity, gas or of labour (e.g. salaries of scientists, ITs, consultants, etc.) on average are lower in Serbia than in the region. For these reasons, the expenditure on goods and services in Serbia, seen as the % of GDP, is at an average level of new EU member states.

The preceding facts disprove the estimates of many economists and politicians, who see in expenditures on goods and services a great potential for savings. There are some savings potentials in them, but they are far from justifying halving these expenditures or reducing them by 600 million euros.

This raises a question of why there is a mass-spread belief that these costs can be drastically reduced? The answer to this question is that there is probably a methodological error, where the observed irrationalities in an individual case are extrapolated to all procurements in the public sector[6]. Simply put, just because a certain product or service is procured at a 30% higher rate than that of the market, does not mean that all products procured by the state are paid at higher than market rates. Moreover, it is not even possible, because a large part of what the state procures

6 Other contributing factors are the lack of data on the amount and structure of public procurement by type of goods and services, state levels, as well as lack of data on prices at which government bodies are procuring goods and services. This data should be collected, processed, published and then used for analyses by government bodies that are responsible for public procurement and fight against corruption. Instead of data and detailed analyses on where exactly the unproductive spendings are and how much they are, their representatives quote anecdotal observations that are available even to the laymen, and based on them draw general, often wrong conclusions.

relates to public utilities, electricity, fuel[7], etc. procured from public enterprises at prices that are even lower than the market prices.

The second reason why potential savings are overestimated is that too often a fact is ignored, that in many sectors the state is not purchasing enough quantities of goods and services. An insufficient public procurement of goods and services is in some cases transferred to the citizens, even though they have already paid taxes and contributions in order to get a particular service (e.g. medicines and other medical services), while in other cases, there is simply an insufficient procurement of goods and services for providing educational, medical and security services[8].

It cannot be concluded from the above that there are no irrationalities or corruption in the public procurement of goods and services, but it is certain that they are smaller than could be concluded based on individual cases. In order to achieve savings from procurement of goods and services, it is necessary to improve the system of public procurement and toughen the fight against corruption. However, a large part of thus created savings should be used for improving the quality of state services, meaning: better supply of medicines, introducing new generation medication, better supply of the army, the police, education, etc. Finally, one should bear in mind that prices of certain goods and services that play a significant role in state expenditures, such as utility services, electricity or gas, will almost certainly rise in the future, so the state will have bigger expenditures on the procurement of the same quantities of the mentioned goods. It can be estimated from the above that net savings from procurement of goods and services will amount to around 0.5% of GDP.

Indirect confirmation of the assessment that savings of several percentage points of GDP or 600 million euros on procurement of goods and services cannot be achieved, comes from the fact that Serbia has approximately the same percentage of expenditures for goods and services as new EU member states, although these countries on average have a better system of public procurement and lower levels of corruption. Possible attempts to halve the stated expenditures, as suggested by some economists, would jeopardise some of the basic functions of government, which have highest expenditures on procurement of goods and services (health care, police, military, tax administration, etc.).

6. It is possible to eliminate all subsidies and thus save 3% of GDP

Subsidies from the budgets of the Republic, local self-governments and extra-budgetary funds, amount to around 3% of GDP. This section registered over the last few years some of the most drastic unproductive spending of tax payers' funds. Subsidies in Serbia are significantly higher than in other countries, so the Fiscal Council recommends reducing their share in GDP by 2% in mid term. In addition, there would be a reduction or elimination of subsidies that are not included in state's consolidated balance sheet, and which are approved through the Development Fund and other extra-budgetary funds.

However, some economists propose eliminating subsidies in their entirety and in this way solve to a large extent the problem of fiscal consolidation in Serbia. Naturally, the elimination of subsidies would by almost 3% of GDP help the fiscal consolidation, but the question is whether that would be economically and socially justified. In case of implementation of such a policy, Serbia would probably become the only country in the world that does not approve any subsidies. Complete elimination of subsidies is also unjustified from the perspective of economic theory, as it would reduce the amount of goods that create positive external effects.

Aside from that, practical ramifications of such a measure would be drastic: it would almost certainly lead to termination of the railways, the prompt initiation of bankruptcy for all companies in process of restructuring, and the loss of about 100 thousand jobs. With the elimination of agricultural subsidies, Serbia would become the only country in Europe that does not grant such subsidies, which would adversely affect the already low competitiveness of our agriculture, reduce exports, etc. Reducing subsidies for utility companies would require a one-time increase in utility prices and the price of public transport in Belgrade for several tens of percent.

While temporary elimination of subsidies for restructuring companies and other enterprises under the jurisdiction of the Privatisation Agency could be considered, it is our estimate that elimination of subsidies for agriculture and railway is economically and socially unjustified. Besides, the reduction of subsidies for local utility companies should be gradual and in parallel to the reduction of costs of their operations and a raise in prices for their services.

7 Estimates of possible savings often ignore these expenses, which are quite important in terms of balance sheets, but have little room for savings.
8 Anecdotal examples are: the lack of anti-hail rockets, lack of spare parts for military aircrafts, obsolete police equipment, and others.

7. Raising taxes is not necessary, as the required growth of revenues can be achieved by a more efficient taxation of the grey economy.

There is an opinion often present in the public that additional revenues could be generated by a more efficient taxation of the grey economy, without raising the taxes. It is a bit paradoxical to give such categorical statements about potential revenues from the taxation of the grey economy, without a single substantial research on grey economy being done in Serbia in the last 10 years. Instead, some quite unsubstantiated estimates have appeared in the public, which are mainly based on anecdotal observations that are, by virtue, misleading. And the explanations given often contain major methodological errors9, which further reinforces the doubts about the validity of such estimates.

A more precise answer to the question of how additional funding can be achieved by taxing the grey economy, requires that it first be estimated. In addition, it is necessary to bear in mind that even in the most organised of states, there is a grey economy and it is nowhere less than 10% of GDP. However, even this estimate may not be enough, because the assessment of possible revenue growth must also take into account the state of tax administration in Serbia and the necessary time to improve it.

Certain economic activities can survive only if they are, to a bigger or lesser extend, performed within grey economy, and in the period of crisis, the percentage of such activities increases. Therefore, a zealous attempt to tax these activities would lead to their elimination, and the government revenues would temporarily drop. Shutting down stores, restaurants and businesses that operate partly in grey economy and partly legitimately, would mean loss of revenue for the state not only from the taxes these businesses were paying, but also from the consumer taxes paid by their employees.

One of the arguments that could considerably deny the possibility of generating significant additional revenues from grey economy is that the share of tax revenues in Serbia's GDP is high in relation to the tax rates. The conclusion would not be different if the GDP increased by around 15%, by how much it is probably underestimated. The share of tax revenues in Serbia's GDP would still be high in relation to the given tax rates, which means that the grey economy in Serbia is not significantly higher than the average.

Of course, one cannot conclude from the above that there is no potential in Serbia for generating additional revenue by more efficient taxation, but this potential is a lot smaller than the necessary revenue increase. It is estimated that a better organisation of tax administration would in a relatively short time increase the tax revenues by around 0.5% of GDP – this would be achieved by improving the technology of payments of taxes and salary contributions, suppressing corruption in tax administration, etc. After that, the additional revenue increase from grey economy would face greater difficulties, because a strict application of regulation would imply the closing down of shops, blocking of enterprises, enforced collection of claims, etc. - which would in turn cause a reduction in state revenues. General suppression of grey economy can hardly be realised without solving a general problem of financial indiscipline, and at the core of this problem are companies going through restructuring.

8. It is not necessary to freeze pensions, but only to collect debts of companies towards the pension fund or realise savings in some other items.

Opinions on the possibility of resolving the pension fund deficit by collecting debts of companies towards the Pension Fund (PIO) have often been presented in the public. It is clear that, even if these receivables were collectable, they would not be able to increase the revenue of the Pension Fund permanently, but rather only once. However, the majority of these claims are related to the enterprises undergoing restructuring and other failed public and private companies, so the best case scenario would entail collecting merely several percent of the total receivable amount – by publishing the list of biggest tax debtors, this became obvious even to the general public.

Avoiding freezing of pensions by realising additional savings on some other expenditure items would also be impossible, because those savings are already taken into account in the fiscal consolidation programme. Namely, the

9 E.g. Often in the estimates of grey economy, gross value is quoted, and not the added value. In addition, in some cases, a partial tax evasion is treated as a total one. The grey economy is mixed with activities not covered by the statistics, that are subject to taxes, and sometimes the non-taxable activities are considered as grey economy, such as the sale of agricultural products on the green market. In addition, financial indiscipline is often mistaken for grey economy, cases where tax payers regularly report their obligations, in order to avoid criminal charges, but they don't pay them, as they are insolvent – e.g. this is often the case with enterprises undergoing restructuring.

consolidation programme includes savings on other expenditure items, except for public investments and social aid. However, these savings are not enough to reduce the public spending to a sustainable level, so the freezing of pensions is necessary. If, however, the freezing of pensions is not accepted, a sustainable fiscal consolidation would require even bigger savings on other items, which could mean: reduction of nominal salaries instead of their freezing, elimination of subsidies to companies undergoing restructuring, and launching bankruptcy for all listed companies, additional savings on goods and services, which would probably lead to shortages in the public sector, etc.

9. Budgetary and extra-budgetary agencies and funds should be dissolved, and thus realise savings.

Savings in this area are possible and are counted on in fiscal consolidation, but they are not of great significance to balance sheets. Regardless, it is necessary to eliminate unproductive spending in this area, in order to show that there are no privileged or protected institutions or individuals. The room for savings lies in the overlap of responsibilities between various agencies, between agencies[10] and line ministries, as well as in the improved parliamentary control of their expenses, including the cost of salaries and procurement of goods and services. In some cases, it is possible to dissolve agencies and funds or to merge them together or with certain ministries.

However, some agencies were established in order to take over certain government functions that were often in conflict with interests of political parties that were members of the government (Agency for Protection of Competition, Telecommunications Agency, Energy Agency, Anti-corruption Agency, State Audit Institution, Office of the Ombudsman, etc.). International experience shows that establishment of such agencies creates an opportunity to promote activities within their jurisdiction. Besides, the establishment of these agencies is part of the EU integration process. In these cases, the focus of activities should not only be on effective control of agencies' expenses, but also on improving the efficiency of their operations, which means that the Agency for Protection of Competition would successfully prevent abuse of monopoly position, the Anti-Corruption Agency would detect individual irregularities in the procurement of goods and services, etc.

There is a lot of confusion in the public about expenditures of agencies, so some of the oldest functions of the state are classified under agencies, such as Security Information Agency (BIA), Military Security Agency (VBA), etc. Therefore, dissolvement of such agencies would not be acceptable if we want to have a sovereign state. If want to have a state, we need to pay for it, and funding of the state through borrowing is possible only in the short term, as shown by examples of many other countries.

10. VAT should not be increased. All austerity measures should be implemented and tax collection improved before possibly increasing the VAT.

This position is a direct outcome of overestimating potential cost savings in positions of current spending, in particular cost savings for the purchase of goods and services, reduction of number of employees, elimination of various state institutions, as well as overestimating possibilities of generating additional revenues from better taxation of the grey economy. Essentially, this view represents a special case of claim no. 2, whereby the state and trends in public finances of Serbia are not particularly risky, and therefore require only a moderate and gradual adjustment of the current fiscal policy.

Implementation of such a policy would lead to a fast realisation that these savings are not enough, that fiscal deficit is still high, and the accelerated borrowing would rapidly continue.

Another drawback of this proposal is that realisation of such savings requires considerable time, and preventing the further growth of debt requires a fast and considerable reduction of the fiscal deficit. Therefore, the only real alternative to the increase of VAT is a reduction of the nominal level of salaries of the public sector employees and the pensions[11] - that is the only way to rapidly and considerably reduce the fiscal deficit, without raising the taxes.

---

10 The public has created confusion regarding the functioning of agencies, funds and other institutions, as well as possible savings in this area. It is a very diverse group of institutions, some of which are classic budgetary institutions such as the BIA, VBA, etc., while others are relatively new extra-budgetary institutions, which have their own extra-budgetary income. The only thing that is common to all these institutions is that they are called agencies.

11 In case of pensions, it is not certain whether or not their reduction is legally possible, i.e. whether it is constitutional.

11. Increasing VAT will not lead to an increase in revenues, because the companies will move to grey economy, or a milder argument – increase of revenues will only be temporary, and will then drop in relation to GDP, requiring another increase of VAT in a year or two.

Empirical studies, which estimate the isolated effect of raising the VAT rate on revenues, show that this increase on average leads to a considerable increase of state revenues[12]. A similar conclusion can be reached by simply observing the movement of revenues from VAT in relation to GDP in the countries that have increased the VAT rate over the years. In all countries that have increased the VAT rate during the last recession, there was an increase in the share of VAT revenues in GDP[13], while revenues from other taxes have mainly dropped. Still, a more precise estimate of the effect of an increased VAT rate on tax revenues requires an application of econometric models in order to control the influence of other factors (change of aggregate demand structure, negative cyclical effect of the production gap on VAT in the period of recession, etc.) on VAT revenues.

However, what is indisputable is that the tax increase alone in the case of Serbia is not enough for fiscal consolidation. That is why the Fiscal Council proposed a programme where 4/5 of consolidation are carried out by reducing the current expenditures, and only 1/5 by raising taxes. Therefore, if the state only increases the VAT and does not implement austerity measures on the side of expenditures, or implements them only partially, the state will find itself in a real problem in a year or two.

Conclusion

Populist proposals on fiscal consolidation are partly the result of ignorance about public finances in Serbia, although that is not the only reason. Part of the reason is a consequence of an intention of some economists and politicians to offer seemingly fast and painless solutions, that would not affect majority of citizens, but such solutions simply do not exist. Sometimes, the populist proposals are formulated by the opinion that burden of fiscal consolidation should not be on the citizens of Serbia, but rather the government. However, the government is not a physical entity, so it cannot bear the cost of fiscal consolidation.

It would be good if the entire burden of fiscal consolidation is reduced to the elimination of socially and economically unacceptable expenditures, such as the abolition of fees related to public procurement, reduction of high salaries in the agencies and funds, the lay off of redundant civil servants, and the collection of taxes from the privileged and dishonest businessmen. Unfortunately, this is not possible, because the savings on socially unacceptable expenditures are insufficient, so it is necessary for the significant part of the cost of fiscal consolidation to be born by the citizens of Serbia. The only questions is how these costs would be distributed: would the majority of the burden be born by the public sector employees (freezing of salaries), the public sector beneficiaries (pensioners, subsidy beneficiaries), or all citizens of Serbia (increase of VAT). It would seem that many proposals for fiscal consolidation contain a misleading or deceptive belief that there are measures that will not affect anyone but the corrupt and redundant civil servants and the privileged and dishonest businessmen. Offering easy, fast and painless solutions by some economists indicates a lack of responsibility, as well as a breach of some elementary professional standards.

At the other end of the extreme, in relation to populist proposals, are the libertarian proposals that contain radical measures, such as: elimination of all subsidies, lay off of the half of employees in the public sector, reduction of salaries and pensions by 20-30%, which would in principle secure a fiscal consolidation, but would have extremely adverse economic and social effects. While the populist proposals essentially mean a postponement or abandonment of fiscal consolidation, the libertarian proposals would result in a collapse of some of the fundamental functions of a modern state, such as public eduction and public health care.

Literature:

1. Arsić (2009) “Fiscal Consolidation and Public Sector Reform”, Quarterly Monitor no.19, FREN

2. Fiscal Council (2012) “Proposed Measures of Fiscal Consolidation 2012-2016“

3. EU (2012) “Taxation trends in EU”

4. World Bank (2008) “How to Do More With Less”

12 It is unusual how much the Serbian economists believe in the Laffer curve, even though its validity is not empirically substantiated very much.
13 EU (2012) Taxation trends in EU

Reform of State Owned and Public Enterprises[1]

Milojko Arsić *

After ten years of transition, there are still some 1,300 enterprises under state control in Serbia (state owned and social enterprises, which are still in the process of privatization, large public enterprises and local public enterprises). High proportion of these enterprises in GDP, employment and social wealth negatively affect economic efficiency, encourage financial indiscipline, corruption, etc. From the fiscal standpoint, the state-controlled enterprises receive substantial direct government subsidies and thus contribute to the increasing public spending and fiscal deficit. In addition, these companies receive various forms of indirect subsidies, such as government guarantees for loans, toleration of tax evasion, "linking years of service", which have resulted in an increase in the current and future public spendings and reduction of revenues. A serious program of reforms for these companies would lead to the fiscal savings, but would also increase the overall efficiency of the domestic economy. Priorities should be as follows: for companies that are still under the jurisdiction of the Privatization Agency - to end the process of privatization in the next two years, primarily for troubled companies that are in restructuring status; for large public and state owned enterprises – to improve efficiency and accountability in governance, which would lead to a reduction of direct and indirect subsidies and privatization of some of the large state enterprises operating in the competitive conditions; for the local public companies – to improve operations, which would reduce the need for substantial direct subsidies these companies receive from local governments.

1. Introduction

After more than a decade since the beginning of the transition process, in the Serbian economy, there is still a very high percentage of companies in the state and public ownership. It is estimated that currently about 1300 companies, which are under a state control, operate in Serbia, either by virtue of majority state ownership or on the basis of the effective management control (in the companies in the restructuring proces), with about 280 000 employees, i.e. over 15% of total formal employment in Serbia. These companies can be divided into three broad groups:

1) Companies under the control of the Privatization Agency. This group included about 600 companies with around 100 000 employees.

2) Large public and state owned enterprises. This group can be further divided into two subgroups:

a) Public companies that perform services of general interest and operate in the regulated market under conditions of monopolistic competition (e.g. EPS (Electric Power Industry of Serbia), P.E. Roads of Serbia, Srbijagas, P.E. of PTT Communications Srbija). In this group there are about ten companies with around 80 000 employees.

b) Large state owned enterprises operating in competitive industries (e.g. Telekom Srbija, Galenika, Jat Airways, Sartid, Ski Resorts of Serbia), etc. This group consists of about 40 companies with around 33 000 employees.

3) Local public companies. This group consists of about 650 companies with around 70 000 employees. Local utility companies are most important in this group.

Although, during the last decade, a substantial progress has been made in the restructuring of state owned enterprises and privatization of public enterprises, the situation in this area is unsatisfactory. There are still a large number of non-privatized social enterprises, while the restructuring of public and other state owned enterprises is unfinished. Leaving aside the economic and legal differences between state owned (public and others) and social enterprises, their common feature is that, directly or indirectly, they are controlled by the state. Participation of enterprises under state control in Serbia's GDP is very high, which adversely affects economic efficiency, encourage financial indisci-

* Faculty of Economics, University of Belgrade and FREN

1 We thank Dusko Vasiljevic who assisted in the preparation of this text. The largest part of the data used in this text was obtained from unpublished World Bank study, which refers to improving the management of enterprises under state control.

pline, corruption, etc. In 2010 the total loss of all civil, social and public companies amounted to about one billion euros (about 3.5% of GDP).

From the fiscal standpoint, it is relevant that the state controled enterprises receive significant direct government subsidies, thus contributing to the increase in the public spending and fiscal deficit. In addition, these companies receive various forms of indirect subsidies such as government guarantees for loans, toleration of tax evasion, "linking years of service", which have resulted in an increase in current and future public spendings and reduction of revenues. Total government expenditures for support of these companies - including direct subsidies from the Serbian state budget and the budgets of local governments, transfers for linking years of service and expenditures for servicing the guaranteed debt - in 2010 amounted to about 2.7% of GDP and in 2011 about 2.3% of GDP. Therefore, the restructuring and privatization of enterprises under state control is essential, not only for improving of the efficiency of the economy but also for successful fiscal consolidation. Additionally, from a fiscal (point of view) standpoint, it is relevant that privatization of enterprises under state control offers the ability of direct or indirect reduce of the public debt, but also for the growth of tax revenue in the future.

In the next section we present the current status and major issues for each of the major groups of state owned and public enterprises. Then, in the fourth (section) chapter, we estimate the total support that these companies receive from the state. In the last section we present proposals for measures that could improve the situation in this area.

2. Overview

2.1. Enterprises under the jurisdiction of the Privatization Agency

Since the beginning of transition in Serbia, the Privatization Agency privatized nearly 2500 companies, and collected approximately 2.6 billion euros. Although, especially in the beginning, significant results were achieved, the pace of privatization has slowed down considerably in recent years. From 2002 to 2008 in average 320 companies were privatized a year, and from 2009 to 2011, only 47 companies in average. This slowdown is primarily a consequence of two factors: first, the remaining social enterprises are relatively problematic, and second, there was a decrease in the interest from investors because of the economic crisis. Beside the slowdown in privatization, in the last few years, a process of transforming the failed privatized companies into state owned companies is also present.

Under the jurisdiction of the Privatization Agency, there are currently about 600 companies of different sizes, with about 100 000 workers. Agency's portfolio is heterogeneous: Includes twenty very large enterprises (with more than 1000 employees), about 60 enterprises with between 250 and 1000 employees, and about 90 enterprises with no employees (most of these companies is in the liquidation process), and more than 130 companies with 1-10 employees. These companies have very different history: some of them are in the process of restructuring during the past ten years, and most have gone through several unsuccessful attempts of privatization, while others returned to the jurisdiction of the Agency upon the termination of the privatization contract, and third are relatively small public enterprises that also went through a series of unsuccessful attempts of privatization. The Agency's portfolio consists of a number of companies to which the final status solution was made more difficult by the legal problems (e.g. companies associated with former Yugoslav republics or with Kosovo), or by unclear division of responsibilities among various levels of government (eg, companies such as local media).

Enterprises under the jurisdiction of the Agency make significant losses (total losses amount to about 1.5% of GDP per year) and accumulate considerable payments lag. In 2010, more than 500 companies in the Agency's portfolio made losses. In the past three years, an average loss of the entire portfolio was over 400 million euros a year. The vast majority of these enterprises survive only thanks to the government support through direct and indirect subsidies.

Enterprises in the Agency's portfolio survive primarily due to the "indirect subsidies" from the state, but also, the support through direct subsidies is significant. "Indirect subsidies" include tolerance for unpaid taxes and contributions (e.g. only in 2011 debt these enterprises made for unpaid taxes and contributions increased by about 15 billion dinars), as well as non-payment of obligations to other public and state owned enterprises. As a result, companies from the portfolio of the Agency accumulated substantial debts for unpaid obligations to the state and public enterprises. Unusual and very significant subsidy for these companies is so-called linking years of service (see box).

A particular problem is the status of "restructuring", which is used to permanently protect some of the most troubled companies from bankruptcy. In order to avoid a politically problematic process of solving the fate of these companies, and the fate of employes working in them, about 170 companies from the portfolio of the Agency is in the status of "restructuring" for unlimited time. Most large enterprises under the jurisdiction of the Agency would not be able to survive in a market in their current state, and would need extensive restructuring or resolution through bankruptcy or liquidation. However, resolving the status of these companies requires political determination, because it is associated with loss of jobs, but also with resistance from management and from some politicians.

Box 1. Linking years of service

Linking years of service represents untypical indirect subsidie whose beneficiaries are mostly workers in the enterprises under the jurisdiction of the Privatization Agency. In 2010 and 2011, the amount of this subsidy was about 360 million euros in total. In the year when this subsidy is paid, this operation does not affect the increase in public expenditures and fiscal deficit, because part of the transfer to the pension fund, intended for payment of pensions, is simply declared as the transfer from the state budget for linking years of service of those workers whom companies have not paid pension contributions in the past. Seem as though linking years of service is simply an accounting operation, which costs nothing. However, this subsidy increases the implicit obligations of the state regarding future pensions. The number of years of service is directly proportional to the initial amount of pensions, and with the payment of years of service tax, the state obligations to workers- future retirees- are increased. Hence, the phrase "linking years of service" is a euphemism for increasing the implicit debt to future retirees.

In addition to the fact that these transfers are financially significant, problematic, as well, is the fact that, thanks to this transfers, the employees of enterprises under the jurisdiction of the Agency, receive privileged treatment in relation to employees in private companies that have financial difficulties (if employers of workers in private enterprises do not pay contributions to the Pension and Disability Insurance Fund, the employees can not qualify for the retirement, nor can they count on co linking years of service from the state).

Enterprises from the portfolio of the Privatization Agency also accumulate considerable payment lags towards private suppliers, and are often generators of illiquidity in the entire chain of companies. On the basis of incomplete data, it is estimated that the total amount of debts to private suppliers in late 2011 amounted to almost half a billion euros.

These enterprises control significant resources and thus prevent their reallocation to more productive use. Asset's book value of these enterprises is over 5 billion euros. Although the trustworthiness of this information is in question, the fact is that certain enterprises control very valuable assets, in particularly land and buildings. Resolving the fate of these companies would allow mentioned resources to be much more productively used.

Although they received considerable support from the state and employ a large number of workers, the contribution from enterprises from the portfolio of the Privatization Agency to the Serbia's overall economy - is very modest. These companies employ about 5% of total formal employment in Serbia. However, the gross added value of these companies is less than 1.5% of GDP in Serbia. Labour productivity is very low, and is estimated to be about 4000 euros per worker, less than a third of average labour productivity in the Serbia's enterprise sector.

2.2. State Level Public Enterprises (SLPEs) and other state owned enterprises

In line with the privatization of social enterprises, a number of measures, aimed at restructuring public enterprises, were initiated. Among these measures, most important are: the price adjustment in regard to costs, reduce redundancy, separating out non-core activities, the division of a vertically integrated monopoly (a division of EPS to EPS and EMS - Public Enterprise for electric energy transmission and transmission system control). Most public enterprises have realized significant investment in equipment and infrastructure (important exceptions are the JAT and the Serbian Railways), which contributed to improving the quality and reliability of their services. In some activities in which public enterprises operate, effective liberalization was implemented (telecommunications, air transport, most of the postal services, production and distribution of oil, gas distribution, etc.), while in other areas (production of electricity) liberalization is only formal.

The privatization of public enterprises is at the very beginning (NIS is the most important case). It is estimated that in the pre-crisis period, opportunity to privatize public enterprises that can operate under competitive conditions, at relatively favourable prices, was missed. Moreover, as a consequence of the economic crisis and inadequate management, the state took ownership over some industrial enterprises (Železara Smederevo steel plant, Galenika) or indirectly through Srbijagas. Taking over these enterprises was mainly forced in order to prevent their bankruptcy, which would probably be completed in liquidation. Although not so relevant from the macroeconomic point of view, it is estimated that the establishment of new public enterprises in commercial activities (Ski Resorts of Serbia) is economically unjustified.

The portfolio of state level public enterprises and other enterprises in which the state holds a majority share, now consists of about 50 companies, some of them are among the biggest companies in Serbia and play a significant role in the overall economy. This portfolio, which consists of approximately 50 enterprises, can be divided into two broad subgroups: 1) enterprises that operate in sectors with commercial competitors (e.g. pharmaceuticals, tourism, transport, etc.) and 2) a large public companies that operate in regulated sectors, often in conditions of monopoly, or companies that provide services to public infrastructure (e.g. power distribution, railway infrastructure).

The largest public companies are particularly important for the competitiveness of the entire Serbian economy, because they provide key inputs for all other companies in the country. The challenge for government is to maintain correct balance of numerous, and often conflicting, goals in managing these companies. As the owner, the government should ensure that these companies operate efficiently, and to conduct investment policy which will ensure their long term sustainability. As a regulator, government should ensure that the tariffs are compatible with efficient long-term operation, but also to protect consumers from possible abuses of monopoly position.

Big public companies achieve poor operating results, do not have sufficient incentives to increase efficiency and are faced with pressures to keep prices of services on a socially acceptable level. As a result, the level of investment is low and threatens the long-term operation sustainability of some of these companies. Measuring the operational performance requires the development of appropriate indicators. For example, a recent report by the World Bank, found that the productivity of the Serbian Railways is only 29% of EU average (in comparison to 58% of the EU average in Croatia and 69% in Poland), while only 54% of freight cars and 28% of passenger cars have been operational in 2008. A good example of companies in which the effect of achieving social objectives (in terms of tariffs, and in terms of employment) leads to an insufficient level of investment is EPS. According to the report of the World Bank, the company has major problems due to insufficient investment, while Serbia is faced with a possible crisis in the supply of electricity. More than a half (53%) of EPS manufacturing facilities is older than 30 years, less than a quarter of transmission lines and substations are in good condition, distribution losses (due to depleted distribution network, faulty meters and theft) now reache 15.8% gross electricity consumption (versus 5.6% in the Czech Republic and 5.2% in Slovakia).

Seven of the twelve largest public and state owned enterprises have noted the loss of 343 million euros in 2010. In order to mitigate the effects of bad business, public and state owned enterprises receive substantial help from the state. Direct subsidies are limited to two companies, Serbian Railways and PEU Resavica (public company for underground extraction of coal). However, in recent years the issuance of state guarantees for their debt represents highly striking aspect of support for public companies is. In addition, state support includes debt service for some companies, as well as tolerating delays in the payment of certain obligations towards the state owned and other public enterprises.

The reasons for the weak economic and financial performance of public enterprises are numerous: low prices, surplus employees, neglected and overexploited equipment and infrastructure, and poor management of these enterprises. Here we specially focus on analyzing the most important indicators of poor management of public enterprises, for it is an important factor of inefficiency, which has yet not been examined in detail.

Most of the measures for improving the management of public companies do not require large resources, such is the case with the modernization and construction of infrastructure, nor high social costs, as is the case with the release of surplus employees or increasing prices. However, improving the management of public enterprises would lead to a loss of personal and political rent, and reduce irregular employment (political party, family, etc.). In order to successfully improve the management of public enterprises, it is necessary to take measures to prevent these illegal interests. Some of the most important indicators of inefficient management of public companies are[2]:

2 Most recommendations for improving the operational management of public enterprises are taken from unpublished World Bank study.

- Transparency in publishing the results of operations is limited, especially when it comes to operational indicators, plans and results. Reporting on operational indicators of business is almost entirely limited to the annual business plans, which are not publicly available. Although business plans contain plenty of detailed information, they are primarily related to short-term financial plans (i.e. plans for next year), and very little attention is paid to the evaluation of results achieved. Noticeable is the lack of focused and coherent framework for evaluating the results, which could for example consist of a small number of carefully selected indicators of financial and operational performance (which should also be internationally comparable) that would be actively used to monitor the enterprise business by the owner (state) and were publicly available.
- Although the Ministry of Finance supervises the business plans and financial statements of public companies, this surveillance is largely focused on respect of the financial guidelines, and not the quality of strategic planning and ongoing management.
- Although the public and state owned enterprises differ in their legal status (e.g. some are organized as public companies that fall under the Law on Public Enterprises and Activities of general interest, and some are corporatized and fall under the Law on Enterprises) and market structure, all these companies are suffering from weaknesses in the corporate and financial management.
- The process of appointing of the management of public and state owned enterprises is very politicized. Nominally, the government appoints the board members and directors of these companies, but in practice, this largely depends on the mutual agreement of political parties.
- Politicisation is associated with the decision making process, in which, policy objectives are the priorities (e.g. maximization of employment and relatively high wage levels, as well as maintaining low tariffs as a "social" category).
- It is estimated that for some of the large state owned enterprises in the commercial sector there are good prospects for privatization. Companies like Telekom, Galenika, Ski Resorts of Serbia et al., could be good candidates for privatization. For companies where the State decides to retain a majority stake in the medium term, priority should be to increase the efficiency with adequate regulatory policy.

In addition to the inefficient management and cost inefficiency (redundancy, relatively high wages, inefficient procurement, etc...), an important cause of loss of some state level public enterprises are the low prices of their services. This is especially important in the case of EPS and Srbijagas, whose products are sold at prices lower than cost. Low prices of electricity and gas, besides affecting the losses of these companies, increase the probability that in the future these companies will not able to repay loans for which the state has issued a guarantee.

State level public enterprises and local public enterprises are faced with problems in the collection of services from other companies and citizens. Especially great obligations to public companies, whose collection is unlikely, have companies in restructuring that are under the control of the Privatization Agency.

Legal or informal barriers for investment in sectors in which public companies operate, as well as the unfavourable economic environment, prevent or hinder the entry of private capital in activities public companies deal with. In the case of electricity generation, low price discourages commercial investors to enter into the construction of private thermal and hydro power plants.

2.3. Local public enterprises

Local public enterprises are a heterogeneous group that differ in size and market conditions in which they operate. Some of them operate in industries that are natural monopolies, while others work in industries where competition is possible. Currently there are about 645 local companies whose founders are municipalities or cities, and they employ about 70,000 employees. Most of them (348) are the local utility companies, some of which offer their services as natural monopolies, including the companies for water supply and sewerage. There are also plenty of local companies that provide commercial services, e.g. parking services, market maintenance companies, companies maintaining cemeteries. Finally, there is a group of companies that provide non-commercial services, such as companies for parks, street cleaning, licensing, etc... However, the most important groups are the local utility companies, which employ about 80% of the total number of employees employed in local enterprises.

Problems in the functioning of local public enterprises are similar to those that are a hindrance in the work of state level public enterprises:

- their efficiency, which is low on average, varies considerably from one to another local government;
- appointment process of the management is often politicized. As in the case of public enterprises at the national level, in local public enterprises economic efficiency is generally not a priority, but are social and political goals (as previously stated, this involves maximizing the number of employees and relatively high wages, and maintain low tariffs as a "social" category)
- low cost of some utilities (heating in many communities, public transport in Belgrade, etc..) directly influence the occurrence of loss of utility companies and the growth of budget subsidies;
- local enterprises in aggregate have high losses and receive substantial subsidies.

3. Direct and indirect subsidies to state-owned and social enterprises

A significant number of state owned and social enterprises ran business inefficiently, and in a sum, they realize heavy losses. Many of them have survived thanks to the abundant support of the state through direct and indirect subsidies. The total monetary cost for the support to these enterprises-which include direct subsidies from the Republic of Serbia budget and the budget of the local governments, transfers for linking the years of service and the expenses for servicing the guaranteed debt- amounted to about 2.7% of GDP in 2010, and about 2.3% of GDP in 2011. Besides the fact that these costs are quite high, they are often non-transparent and not based on the *cost–benefit* analysis of the effects. Apart from these direct subsidies, companies recieved a very strong support in the form of indirect subsidies: tolerating the accumulation of the debt for the unpaid taxes and contributions, the unpaid obligations towards the public enterprises, as well as extending the government guarantees for debt. Overall, accumulated debt for the unpaid taxes and contributions, the debt towards the public enterprises and issued government guarantees reached over 12% of GDP at the end of 2011 (Table 1).

Table 1a. Subsidies to enterprises controlled by the state (% GDP

	„Monetary" expanditures (average of 2010 and 2011)			
	Direct subsidies	Expanditures for servicing guaranteed debt	Transfers for linking years of service	**Total**
Portfolio of the Privatization Agency	0.3*	0.0	0.5	0.7
Public and large SOEs	0.5	0.3	0.1	0.8
Local public enterprises	0.8	0.0	..	0.8
Total	1.6	0.3	0.6	2.5
	„Soft" budgetary support (status at the end of December 2011)			
	Status of issued government guarantees	Accumulated debt to state (taxes, contributions, Fund for development, etc…)	Accumulated debt to public enterprises	**Total**
Portfolio of the Privatization Agency	0.2	3.6	1.5	5.3
Public and large SOEs	5.7	0.9	0.3	7.0
Local public enterprises	0.0	..	..	..
Total	5.9	4.6	1.7	12.2

Table 1b. Subsidies to enterprises controlled by the state (millions of euros)

	„Monetary“ expanditures (average of 2010 and 2011)			
	Direct subsidies	Expanditures for servicing guaranteed debt	Transfers for linking years of service	**Total**
Portfolio of the Privatization Agency	94*	0	172	266
Public and large SOEs	160	76	12	248
Local public enterprises	223	0	..	223
Total	477	76	184	737
	„Soft“ budgetary support (status at the end of December 2011)			
	Status of issued government guarantees	Accumulated debt to state (taxes, contributions, Fund for development, etc…)	Accumulated debt to public enterprises	**Total**
Portfolio of the Privatization Agency	74	1,100	441	1,616
Public and large SOEs	1,742	288	84	2,113
Local public enterprises	0	..	..	..
Total	1,816	1,388	525	3,729

Sources: Ministry of Finance, the Privatization Agency, Fund for the development, evaluation by authors
* Includes subsidies from the Republican budget, which the company obtained through the Development Fund, the funds "loans for special purposes" that are placed from the ministrie through the Fund for Development, and subventions from the replacement of the funds of the Development Fund.
Notes: Data on direct subsidies, transfers for linking years of service and state government guarantees are the original data of the Ministry of Finance and Development Fund. Data on accumulated debt to the state and the public enterprises are estimates based on incomplete data obtained from the Ministry of Finance and Privatisation Agency.

3.1. Enterprises in the jurisdiction of the Privatisation Agency

Enterprises under the jurisdiction of the Privatisation Agency recieve significant support through the “indirect” subsidies, primarely a tolerance for evasion of obligations to the state and public enterprises. Most of the enterprises under the jurisdiction of the Agency realize losses: the losses from 2008 to 2010 amounted to about 350 to 400 mn € on average per year. In order to survive despite these losses, the enterprises under the jurisdiction of the Agency are tolerated the non-payment of the obligations for taxes and contributions, as well as obligations to the public companies. The enterprises under the Privatization Agency accumulated about 1.1bn euros of debt to the state, and somewhat over 400mn euros of debt to public enterprises. Debts to the state include the debts for the unpaid taxes and contributions, as well as the debts to the Development Fund.

In 2011 only, the debts for the unpaid taxes and contributions were increased in the gross amount by about 15bn dinars, i.e. about 150 mn euros. The majority (more than 80%) of the accumulated debts to state refer to the enterprises in the status of restructuring.

In addition, these enterprises recieve generous direct subsidies in the amount of about 95 mn euros annually (this also includes “soft” loans which are mostly not repaid, thus, also treated as a subsidy). These funds are mainly invested by the Development Fund. They include subsidies from the budget of the Republic of Serbia (about 35mn euros a year) which enterprises recieve through the Development Fund, “special purpose loans” which are generally not repaid and are the expense for the Budget (are also invested by the Development Fund, more than 50mn euros a year), as well as the subsidies from the recourcers of Development Fund.

3.2. Public enterprises of the Republic of Serbia and other state-owned enterprises

The main forms of support to public and large state-owned enterprases are direct subsidies (even though they refer to only two enterprises) and in the last few years, extending the government guarantees for loans. As noted earlier, Serbian Railways and PEU Resavica recieve direct subsidies from the state: from 2009 to 2011 direct subsidies had a total amount of 378mn euros for Railway, and 57 mn euros for PEU Resavica.

In the last few years, there has been a rapid expansion of the extending government guarantees. Total guarantees issued to the public enterprises reached 1.7bn euros at the end of 2011. A particular problem is that in the last three years the purpose of extending the guarantees has substantially changed. Untill the year 2009, guarantees were mostly issued for infrastructural projects, while recently, guarantees for economically unjustified purposes are being increasingly issued- maintainance of a current liquidity, refinance of existing obligations, procurement of goods and services.

In addition, the state support includes servicing debts for some enterprises. For this purpose, the state has set aside a somewhat more than 150mn euros in total, in 2010 and 2011. Finally, the government support is reflected in the tolerance of lags in the payment of certain obligations to the state and other public enterprises. At the end of 2011, the accumulated debt of public enterprises for the unpaid obligations to the state and other public enterprises is estimated at about 360 mn euros, i.e. more than 1.2% of GDP (most of the accumulated debt refers to the obligations of Serbian Railways (Zeleznica Srbije)).

3.3. Local public enterprises

In 2010, the local enterprises recieved about 225mn euros (about 0.8% of GDP) of direct subsidies from the local authorities[3], and the similar amount is estimated for the year 2011. It is noticable that subsidies are concentrated in the large cities. More than two-thirds of the total amount of the direct subsidies to the local governments refers to the subsidies to three largest cities. The largest single user of the local direct subsidies is GSP Beograd. In 2010, from the budget of the city of Belgrade was spent about 34mn euros for the subsidies to GSP Beograd, and in 2011, about 47mn euros. Of a particular problem is that a mere ten percent of this amount refers to the subsidy for the capital expenditures, while the rest of the subsidy is used to finance the current business.

4. The reform of state-controlled enterprises

4.1. The reform of the enterprises under the jurisdiction of the Privatization Agency

The main objective of the reforms in the enterprises in this sector is the complition of the privatization process during the following two years. After more than a decade since the begining of the transition, there are no more valid reasons to postpone the privatization of the enterprizes that remained under the jurisdiction of the Agency. To achieve this objective, it is possible to implement the following measures:

- To determin the deadline for the privatization of the enterprises, and if that isn't possible, to ran their bankruptcy. To increase the chances for privatization, it is possible to write off the old debts of the enterprises with the introduction of the hard budgetary constraints afterwards. If the enterprises re-accumulated the debts, bankruptcy procedure would be initiated even before the privatization deadline.
- To revise the Decree on Restructuring[4] so as to limit the time of the process of enterprise restructuring (e.g., no more than 18 months). During this period, enterprises would be privatized, and if that is not possible, their bankruptcy would be initiated.
- In the case of the enterprises under restructuring, measures to improve their menagement would be undertaken, similar to the measures proposed for the public enterprises, to increase the chances for their privatization.
- In order to perserve the social stability, it is necessary to provide the additional funds for the social protection of the employees who will lose their job in the process of the privatization. It is estimated that the necessary funds amount to several hundred million Euros (probably between 300 and 500mn), which is comparable to the amount transferred for the linking years of service and the direct subsidies that these enterprises receive during the period of two years. The costs could be reduced if there would be an immediate implementation of the decisive reforms which would improve economic environment and attract investments that would at least partially absorb the excess employees in the enterprises under the Agency's jurisdiction. These funds should be available for a limited period of time, so the workers reluctant to abandon the failed enterprises have a clear motive to opt for this step.

3 Direct subsidies to public enterprises of the provincial government of Vojvodina, which in 2010 amounted to about 18 million euros, were also included.
4 Regulation on the procedure and method of privatization, restructuring of companies, the Government of the Republic of Serbia.

4.2. The reform of the State Level Public Enterprises

From the standpoint of the public finances, the main objective of the public enterprises reform is to decrease the direct and indirect subsidies to public enterprises. The direct subsidies to the state level public enterprises would probably not reduce significantly, but with the same level of subsidies, a higher efficiency in a service delivery would be ensured.[5] However, the indirect subsidies (guarantees, linking years of service, not paying taxes, etc...) could be fairly reduced. In addition, the privatization of some public enterprises could provide the considerable funds for the direct (the existing debts return) or indirect decrease of the public debt (the financing of a reduced future fiscal deficit with the revenues from the privatization). From the standpoint of the public finances of the government subsidies users, the privatization of the public enterprises is preferable, even if it doesn't bring significant budgetary inflows- an example of such a privatization could be JP Resavica.

From an economic standpoint, the objective of the restructuring is to improve the efficiency of public enterprises, and that could be achieved by applying the following measures:

- By improving the corporate governance; the Government should complete the corporatization of the remaining large public enterprises.
- To achieve the expected benefits of corporatization, it is necessary to establish the implementation of the transparent and professional framework for the appointment of directors and members of the public enterprises management and supervisory boards.
- For the large public enterprises, it is necessary to strengthen the role of the state as a leader, including the way it manages the public enterprises and monitors their doing business. One possible approach is a clear delegation of authority and responsibility to a specialized department of the Ministry of Finance, which could help reduce the unfavourable political impacts and facilitate the capacity strengthening to be focused and more efficient.
- An important element in the reform of the public enterprises should be the development of the integrated performance management system, which would include the development of "key performance indicators". The achieved results would be publicly proclaimed. It is also necessary to introduce the firm budget constraint (i.e. to prevent the accumulation of the unpaid obligations and unjustified guarantee issuance).
- To distinguish more clearly the role of the public enterprises in the carrying out the services from the public interest and their commercial business. One possible model are contracts to provide services of public interest. Public enterprises would commit to a certain level and quality of service of public interest that are not commercially viable, and for this would receive a direct compensation from the state. This compensation should gradually replace all other forms of support (e.g., subsidies for a current operations and guarantees for borrowing).
- Apart from the reforming the system of subsidies and issuance of guarantees, a system of tariff determination should also be reformed, as well as the appointing authorities, so that they are based on the achieved operating results of the enterprises, measured by both financial and "key performance indicators".
- The current system of the state aid is fragmented; it is necessary to develop a unique and comprehensive database for all forms of the state support, which would include public and large state-owned enterprises, the enterprises under the jurisdiction of the Privatization Agency and local public enterprises.

Improving the management of the public and industrial enterprises (Galenika at al.), which are directly or indirectly owned by the state, could increase the chances for their privatisation. From the standpoint of the economic efficiency, privatization of the enterprises operating in competitive conditions, such as Telekom, Galenika, Smederevo Steelworks, enterprises owned by Srbijagas, Ski resorts of Serbia et al. Furthermore, it is reasonable to consider the privatization of some parts of EPS. Liberalization of the activities in which public enterprises operate would contribute to improving their performances in different ways: the prices of their products would be in compliance with the costs, reducing unproductive expenses would be necessary for the enterprises to survive in the market, various direct and indirect forms of state aid would become illegitimate because they would disrupt the competition. Moreover, effective liberalization of the electricity production and rail transport would reduce the need for the EPS and the Serbian Railways' borrowing, and thus limit the growth of indirect debt of Serbia.

5 The largest part of direct subsidies is now meant for railway, which could be expected in the future. However, restructuring of the railways should ensure that subsidies go to the maintenance and modernization of infrastructure, not salaries.

Box 2. Financial indiscipline:problems and possible solutions

Problems with the collection of claims, that public enterprises have, are a part of a general problem of financial discipline, which has a long tradition in Serbia. A large number of participants on the market do not pay their obligations in the contractual and statutory deadlines. Moreover, enterprises that have a dominant position on the market impose the unsustainably long contractual deadlines to settle its obligations. From the standpoint of fiscal consolidation, non-payment of taxes is one of the important forms of the financial indiscipline. Based on the listsof the largest tax debtors, it is quite certain that the most of the claims on that basis will not be charged or will be charged a minimum percentage in relation to the value of the claim. It is a similar situation with the public companies, which have relatively high claims from the economic entities that are under state control.

Some of these enterprises, like the ones in the restructuring, are protected by the law from the forced payment and initiation of bankruptcy procedure. The debts of insolvent enterprises are transferred in a chain reaction through the economy so to create the chains of illiquidity. Accumulation of due, but unpaid claims is also contributed by the relatively expensive and time-consuming bankruptcy procedure. Inadequate legal solutions which would prevet systematic fraud by the entrepreneurs who create enterprises, accumulate obligations, and than liquidate enterprises-also affect the growth of the unpaid claims. The current world economic crisis has further intensified the previously present systematic causes of the financial indiscipline.

The establishment of the financial discipline is an important condition for improving the safety of business operations and overall economic environment in Serbia. The main precondition for solving the problem of financial indiscipline is the existence of the efficient bankruptcy procedure which would quickly and at little cost exclude the insolvent enterprises from the market. The efficient bankruptcy procedure requires both appropriate legislation, and the training of all the participants in the mentioned process. One of the preconditions for the efficient and non-selective implementation of the bankruptcy procedure is a relatively quick resolution of the status of the enterprises in restructuring. Another measure that could contribute to the improvement of the financial discipline is the statutory limitation of deadlines for the settlement of obligations. It is possible that legislative solution is to be adopted already, which would immediately shorten the deadlines to 60 days, and in the next few years to 30 days. Shortening of the period for the obligation settlement would make redundant the extremely problematic proposals to extend the deadlines for the payment of VAT or introduce the VAT collection by the charged realization. It is necessary to establish the financial discipline with the reforms, rather than the tax system adapting to the financial indiscipline as given and unchangeable condition.

Public enterprises and other participants in the market have serious problems with the collection of claims. Enterprises in restructuring and local communities have the largest debts to public companies. Improving the payment of claims of public companies is possible as a part of systematic measures for the improvement of overall financial discipline in Serbia. Citizens' debt problems to public enterprises could be solved by combine use of measures of social policy (in the case of the poor) and forced payment from other citizens. [6]

While the improvement of management and the improving the cost efficiency contributed to the improving the financial performances of public enterprises, in some cases, it is necessary to increase the prices of their services. This primarily refers to the increase in the prices of electricity and gas that are now well below the market prices. Increasing the prices of the aforementioned services is important as well from the standpoint of fiscal consolidation. Although EPS and Srbijagas do not receive direct budgetary subsidies, the government issued relatively high guarantees for their debts. If the prices of their services permanently remained below the level, it could lead to the activation of the government guarantees for the debts of the aforementioned enterprises. The increase in the service prices of the mentioned enterprises should be gradual, not only for the protection of the standard of living, but also for the risks that the higher prices are used for the strengthening of the cost inefficiency.

6 In the case of electricity even stealing of electricity is not negligible, which is particularly widespread in wild unhygienic settlements.

4.3. Reform of the local public enterprises

With the local enterprises restructuring it is possible to achieve relatively large reduction of the direct subsidies, which local governments grant to utility enterprises. The business operations improvement of the local public enterprises includes four groups of activities:

- Completion, improvement and the implementation of the legislative framework for conducting public utility activities (new law on communal activities, the use of the public-private partnership and granting concessions, application of the Public Property Act, etc...);
- Improving the management of local public enterprises (corporatization and other measures, as well as at the level of the Republic);
- Increasement of the prices at the level of long-term costs;
- Improvement in the cost efficiency of the local enterprises (reducing redundancy, more efficient public procurement, etc.; see the section on the fiscal decentralization);

In the case of local services that are not natural monopolies, the privatization of utility enterprises or their parts is possible, as well as the liberalization of some services (public transport). In the case of public-private partnership, the extreme caution is needed, due to a potentially great opportunity for corruption.

Literature

— Arsić M. and D. Vasiljević (2007) „Restrukutrirranje i privatizacije javnih preduzeća u Srbiji", *Quarterly Monitor No. 9.*, FREN

— World Bank (2011) *Railway Reform in South East Europe and Turkey: On the Right Track?*,.

— World Bank (2011) *Republic of Serbia Country Economic Memorandum*,.

CIP - Katalogizacija u publikaciji
Narodna biblioteka Srbije, Beograd

33 (497.11)

QUARTERLY monitor of economic trends and policies in Serbia / Editor in Chief Milojko Arsić. - 2011, iss. 1 (january/july)- . - Belgrade (Kamenička 6) : The Foundation for the Advancement of Economics, 2005- (Belgrade : Alta Nova). - 30 cm

Dostupno i na: http://www.fren.org.yu. - Tromesečno. - Ima izdanje na drugom jeziku: Kvartalni monitor ekonomskih trendova i politika u Srbiji = ISSN 1452-2624 ISSN 1452-2810 = Quarterly monitor of economic trends and policies in Serbia
COBISS.SR-ID 126940428