

quarterly monitor

OF ECONOMIC TRENDS AND POLICIES IN SERBIA

Issue 29 • April–June 2012

Belgrade, October 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>

EDITORIAL COUNCIL

Mihail Arandarenko (for the Publisher)
Jurij Bajec
Pavle Petrović
Branko Urošević
Boško Živković

EDITORIAL BOARD

Milojko Arsić (Editor-in-Chief)
Danko Brčerević, Economic Activity
Mirjana Gligorić, Balance of Payments and Foreign Trade
Duško Vasiljević, Prices and the Exchange Rate
Aleksandar Radivojević (Executive Editor)

ASSOCIATES IN THIS ISSUE

Tatjana Karaulac
Aleksa Nenadović, International Environment
Jelena Žarković Rakić, Employment and Wages
Saša Randelović, Fiscal Flows and Policy
Svetozar Tanasković, Monetary Flows and Policy

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

From the Editor 5

TRENDS

1. Review 7

2. Economic Activity 11

3. Employment and Wages 18

4. Balance of Payments and Foreign Trade 24

5. Prices and the Exchange Rate 32

6. Fiscal Flows and Policy 36

7. Monetary Flows and Policy 46

8. International Environment 53

HIGHLIGHTS

Highlight 1

Budget Rebalance and Fiscal Consolidation 57

Milojko Arsić

SPOTLIGHT ON:

Spotlight on: 1

Reform of the System of Quasi-Fiscal Charges for the Improvement of Business Conditions in Serbia 61

Milojko Arsić, Saša Randelović, Milan Pejić

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, Q3, Q4 – 1st, 2nd, 3rd, and 4th quarters of the year

QM – *Quarterly Monitor*

SORS – Statistical Office of the Republic of Serbia

SDF – Serbian Development Fund

SEE – South East Europe

SEPC – Serbian Electric Power Company

SITC – Standard International Trade Classification

SME – Small and Medium Enterprise

VAT – Value Added Tax

From the Editor



The second quarter of 2012 saw some improvements in the economy of Serbia, but new problems arise. On the one side, the economic activity slightly increased, external deficit reduced considerably, but on the other side employment still decreases, while inflation accelerates. Due to a number of unfavourable factors (drought, downgraded credit rating of Serbia, stagnation in the EU), it is expected that the recovery of the economy, in the second half of 2012, will be temporarily stopped, so at the level of the whole year GDP will fall by at least 1%. Decline in economic activity will affect the fact that throughout the second half of the year decrease in employment will continue. In the second half of the year continuation of the current account deficit reduction is expected, but due to the low level of capital inflow, the financing of that reduced deficit will encounter major difficulties. Continuous acceleration of inflation and wide dispersion of products whose prices are rising, suggests that systemic factors (fiscal expansion, growth of foreign exchange rate) are dominant generators of inflation, although the influence of specific factors (increase in the prices of foodstuff and energy) is still significant. Fiscal deficit amounted to about 7% of GDP in the first half of the year, which means that, as previous times, this time a generous pre-election spending was not missing. Proposed budget rebalance, which increases the deficit, despite a substantial increase in taxes, is the result of post-election expansion, which is common in Serbia in the past decade.

The first actions of the new government, and the statements of its members on economic policy, had resulted in the reduction of the already low credit rating, as well as in increase of the risk premium on investment in Serbia. Changes in the Law on National Bank of Serbia and forced resignation of the Governor, jeopardized the independence of the NBS. While some members of the Government proposed spending of foreign exchange reserves, accused foreign investors (especially banks) for the withdrawal of capital from Serbia and exchange rate speculations, announced expansionary fiscal and monetary policy, etc. Although irresponsible assessments and suggestions can still occasionally be heard, the first decision of the new NBS management and Ministry of Finance proposals can be assessed positively. Based on that, it can be concluded that those populist statements do not reflect the firm intentions of the new government. However, these actions and statements have led to a reduction in the credit rating of Serbia,

which will reduce foreign capital inflow, at least over the next few quarters, and negatively affect the economic recovery of Serbia. First actions and statements by representatives of the Government deteriorated relationship with the IMF, increased the suspicion of private investors in Serbia, and it is expected that they will be negatively assessed in EU reports that refer to the assessment of Serbia's progress in reforms.

Starting the fight against corruption is a major activity of the new government, whose success is critical to the creation of the market environment, in which creative entrepreneurs create new value and jobs, instead of, as until now, existing wealth being redistributed in favour of the privileged individuals. If this fight is to be systemic, non-selective and persistent, it could be one of the greatest contributions of the current Government to the progress of Serbia.

In early September, as a first step towards a medium-term fiscal consolidation, the budget rebalance for 2012 was proposed and a framework for fiscal policy in the coming year has been announced. Generally, the fiscal consolidation program represents a huge improvement compared to the policies announced by the representatives of the ruling coalition, but also compared to the policy the former government carried out in the period between mid 2011 and the first half of 2012. In addition to the fiscal consolidation measures, a series of regulations that significantly contribute to the improvement of the situation in the Serbian public finances, have been adopted. Such measures are inclusion of their own revenues in the budget, reform of the system of quasi-fiscal charges, *arrangement* of the wage policy in the public sector, improvement of the public procurement system, etc.

In addition to positive changes, the Budget rebalance and the elements of fiscal policy for the next year have several serious drawbacks. The first shortcoming is that the revised budget for 2012 increases rather than decreases the fiscal deficit. Increase in the fiscal deficit, even if it is temporary and extorted by extraordinary circumstances, seriously threatens the credibility of the fiscal consolidation program. Increasing fiscal deficit sends a bad message to investors, but also makes it difficult to achieve a new arrangement with the IMF. In addition, the increase in the fiscal deficit in the last quarter creates a false picture of a very high fiscal consolidation in the coming year -

maybe some citizens will accept such a picture, but it is sure that with investors and international financial organizations this will not be the case. The post-election expansion followed with the delay of the Government in the implementation of unpopular measures, such as tax increase and spending cuts, are the main reasons for the increase in deficit and spending in the fourth quarter of this year.

The second big shortcoming of the fiscal consolidation program is that it relies mainly on increase of revenue, while significant cuts on expenditure side are missing. It is estimated that increase of taxes was necessary because the systemic fiscal deficit in Serbia is very high (over 4%), so its reduction solely over reduction in expenditures is unlikely (possible only with reduction of nominal level of pensions and wages), would last for a long time, and so the risk of the debt crisis would be very high. Spending cuts in the coming year refer mainly to savings on salaries and pensions, while other current expenditures, within which there is considerable unproductive spending, are not reduced. Although on the majority of these expenses significant savings could not be realized in the short term, for long-term success of the program and its credibility, it would be important to immediately begin reducing public spending. In the short term it is possible to significantly reduce the Republic budget deficit and the deficit of the consolidated government by eliminating vertical imbalance between revenues and expenditures of the Republic and local governments. The effect of eliminating vertical imbalance would be approximately equal to the effect of the VAT increase, and would not force any costs on the citizens – only the State would effectively redistribute existing taxes and obligations.

The third shortcoming of the fiscal consolidation program, which arises from the previous, is that the reduction of the fiscal deficit is planned to be relatively slow, which means that the public debt-to-GDP ratio will increase over at least two to three years. The high amount of the funds needed to finance the fiscal deficit and principal repayment of maturing debt, under the circumstances of low credit rating, insufficiently credible fiscal consolidation program, absence of the arrangement with the IMF and uncertain progress towards the EU, seriously creates the problem of securing funds for its financing, and increases the financing costs. The amount of required funds is such that it is highly unlikely it could be secured by bilateral agreements with other countries, without a significant participation of commercial financiers. Bilateral funds can at best be used for bridging liquidity, while the conditions for re-lending of Serbia with commercial investors are not created.

Proposed budget rebalance for 2012 received a negative evaluation from the Fiscal Council and the IMF, while the measures for 2013 received a number of positive evaluations, also, the proposals, whose implementation aims to quickly reduce spending and deficits, were presented. The finance minister expressed his willingness to accept

suggestions related to 2013 and subsequent years, but it is not certain whether the government is prepared to correct the 2012 rebalance. For the success of the fiscal consolidation it is crucial that the Government corrects the proposed budget rebalance, in order for the negotiations with the IMF – that would lead to the conclusion of the new arrangement – to begin by the end of the year.

Restoring Serbia's public finances on a sustainable path is not an impossible mission, for that, the political will is needed to drop some of the campaign promises, correct the bad and unsustainable programs such as fiscal decentralization, as well as to accelerate the reform of the public sector. It is necessary to reduce losses on rebalance for 7-8 billion dinars, which could be achieved by giving up on some campaign promises, elimination of certain subsidies, etc. In the budget for 2013, it is essential, in addition to the planned austerity measures, transfer obligations of at least 20 billion dinars on the local level, start with the reduction of subsidies and the number of employees in the state sector, continue pension reform, rationalize the school network, improve public procurement, etc.

Although representatives of the ruling coalition, in the period of the adoption of amendments to the Law on NBS, announced radical changes in monetary policy (spending of foreign exchange reserves, reducing interest rates, etc.), so far, decisions in the area of monetary policy, but also announced personnel decisions indicate that the policy continuity is likely. At the first meeting of the new NBS management, decisions were made to increase restrictive monetary policy, which is an adequate response to the acceleration of inflation, depreciation pressures, etc. However, it is very likely that the pressure from influential and privileged businessmen and their political representatives will continue with the aim to solve their business problems using expansive monetary policy.

This issue of Quarterly Monitor (QM) contains one text in the section Highlights (Arsić), which analyses the proposed budget rebalance for 2012, as well as the announced framework for fiscal consolidation in 2013. Spotlight On 1 (Arsić, Randelović, Pejić) analyzes quasi-fiscal and non-tax charges in Serbia, assessing measures of the Government to abolish many of these charges, introduce a procedural order in this area, etc. In Spotlight On 1, additional measures, for the reform of the quasi-fiscal charges, as well as measures that would compensate for the fall of state revenues due to the abolition of these charges, are proposed.



TRENDS

1. Review

Movements of the most important macroeconomic aggregates in Q2 (economic growth, inflation, current deficit, employment and public debt), were almost entirely consistent with, not too much favourable, expectations we stated in the previous issue of QM. This is a consequence of the fact that, in Q2, measures are missing, primarily in the area of fiscal policy, which would reverse the unfavourable course Serbia's economy is on. However, rating agencies and financial markets reacted faster than the Government to the unsustainable trends. In the mid 2012 credit rating for Serbia was downgraded, but even before that, market raised the costs of new borrowings for Serbia. Therefore, our most general assessment is that in Q2 – because of the political cycle and the slow formation of the new Government – the opportunity to stop the unfavourable macro-economic trends, cumulating since the beginning of 2012, was missed. Because of this, all future measures that must be adopted, will cost more, but also, what is of particular danger, the crisis of public debt is becoming slightly more probable.

Preliminary assessments are that GDP achieved real annual decrease of around 0.6% in Q2. This is actually a somewhat better result of economic activity compared to Q1, when the annual decrease of GDP was 1.3%. A slight recovery in Q2, compared to Q1, is confirmed by seasonally adjusted indices of GDP (Table T2-1). More detailed analysis, however, reveals that real (sustainable) recovery in economic activity has not started yet, because the slightly better result in Q2 compared to Q1 was a consequence of the unsustainable growth of public spending. The only two possible lasting engines of economic recovery, investments and net exports, were still in the zone of negative y-o-y growth in Q2. We believe that, by the end of the year, a significant recovery in economic activity is not possible, so the total decrease of GDP in 2012 could be around 1%. There is unfortunately a risk that a fall of GDP in 2012 will be a little higher, in the event that the final assessment of the effects of drought on agricultural production turns out to be less favourable than expected.

Inflation accelerates in Q2, primarily due to the increase in the prices of foodstuff, and this trend continues in July and August (see Section 5. Prices and the Exchange rate). Food prices are not the only reason for the acceleration of inflation. QM analysis shows that market inflation, i.e. inflation calculated by excluding the prices of food, energy, alcoholic beverages and cigarettes from the overall inflation, significantly accelerates, especially from June. Because of this, our opinion is that, beside increase in the prices of food, acceleration of inflation was influenced by some other factors, such as the Dinar depreciation and very expansive fiscal policy in the first half of the year. We estimate that the inflation will be two-digit by the end of the year (probably in the 10% - 11% corridor), which is significantly above the upper limit of NBS target band (Inflation target for December 2012 is 4% with a tolerance band of ± 1.5).

The current account deficit is still at unsustainably high level, although we have noticed some improvements in comparison to Q1 (see Section 4. Balance of Payments and Foreign Trade). Deficit amounted to 718 million in Q2, which is approximately 130 million euros higher than the same period last year. Compared to Q1, when the current account deficit stood at almost 1.2 billion euros, this is a significant improvement – although this improvement is somewhat relativized by the fact that the current account deficit is seasonally higher in Q1 compared to other quarters, and in February, as a result of extremely cold weather, the current account deficit was further increased due to a decrease in exports of around 20%. Our analysis indicates that, by the end of the year, further decrease of the deficit, due to the strong depreciation of the Dinar in 2012 and expected decrease of domestic demand and also possible gradual increase in exports, is probable. We expect that the current account deficit will amount to 10% of GDP in 2012.

Movements in exports deserve special attention, because the growth of exports (with investments) is the only possible engine of economic activity growth over the medium term. Our estimate of trends in exports by the end of the year is difficult, because exports are affected by different factors with opposite directions. On the one side, we expect export growth of Fiat Automobili Srbija Company, and on the other, the reduction in exports of agricultural products as a result of drought. Also uncertain is the

future production of Železara Smederevo which, when operates, has a high percentage share of Serbian exports (significance of this company in the foreign trade balance, however, should not be overestimated, because the company is also a big importer). As an important indicator of future trends in exports, we point out unit labor costs measured in Euros (Euro ULC), because they indicate international price competitiveness of the economy. Euro ULC decreased significantly in Q2, due to the depreciation of the Dinar – which means that the price competitiveness of the economy increased (Graph T2-5). That should be an important stimulus to further growth in exports, so our final estimate is that the exports in the coming period will gradually increase. An additional necessary condition for this to happen is that when we probably reached the level of the course that is appropriate for the model of economic growth based on exports, not to allow now another strong real Dinar appreciation.

On the capital inflow side, in Q2, we recorded a net outflow of capital from Serbia in the amount of nearly 450 million euros. Outflows on the capital balance are the consequence of banks repayments towards foreign countries, with low levels of foreign direct investment and relatively low borrowing of the economy abroad. Because of the current account deficit and capital outflows, in Q2, there were strong depreciation pressures on the dinar exchange rate and reduction of foreign reserves. The Dinar exchange rate, compared to Euro, depreciated by about 1.5% in real terms in Q2 and since the beginning of the year by about 8% (see Section 5 Prices and Exchange Rate). Foreign exchange reserves fell by about 1.1 billion euros in Q2, and since the beginning of the year by the end of August by over 2.1 billion euros, which cannot last indefinitely. We believe that these trends could be permanently changed with credible fiscal policy measures i.e. by implementation of decisive fiscal consolidation, which would reduce the government deficit and bring order to the public finances. Namely, fiscal consolidation would: 1) have direct impact on reducing domestic demand and imports, which would reduce the current deficit, 2) increase the safety of investments in Serbia, which would have a positive impact on the growth of FDI and 3) would reduce the risk of the country, which would lower the price of the borrowing for the economy. It is interesting to note that these, very important, effects of the fiscal consolidation on needed establishment of external balance, are in the public overshadowed by the direct danger of a public debt crisis.

Country risk is increasing. Country risk for Serbia, measured using EMBI (Emerging Markets Bond Index) has not only increased compared to the level it held in May but, what is especially worrying, increased compared to the relevant countries in the region (Croatia, Hungary). Thus now, EMBI for Croatia is by approximately 150 basis points lower than in Serbia, and EMBI for Hungary is lower than the one for Serbia by about 100 basis points, which means that the borrowing for Serbia is about so much more expensive in relation to these countries. We note that only six months ago EMBI for Serbia was lower than the one for Croatia and Hungary. In August credit rating agencies Standard & Poor's and Fitch downgraded Serbia's rating (Fitch only changed its forecast to negative, because their assessment of Serbia's credit rating was already lower, and S&P reduced the credit rating from BB to BB-). The explanation states that there has been a deterioration in fiscal and external financial position of the country, but also that the negative assessment was influenced by the changes to the National Bank of Serbia Law and the absence of a credible plan for fiscal consolidation. In addition, agencies have stated that the credit rating of Serbia in the future is more likely to fall than it is to be improved. The negative outlook indicates that the credit rating of Serbia will fall if the situation remains unchanged until the next revision.

High unemployment remains a big structural problem of the domestic economy. Negative trends on the labor market continue (see Section 3. Employment and Wages). According to the April 2012 Labour Force Survey (LFS) the unemployment rate of the active labor force population (aged 15-64) increased to 26.1%, while the employment rate fell to 44.2%. The fall in employment is still taking place only in the private sector, while in the public sector we have noticed slight increase - totally in contrast with the overall trends in the labor market over the necessary reduction in public expenditure. Even after a year, from the moment Serbian Government adopted the Employment Incentive Decision, we do not see any positive signs in the labor market trends.

Fiscal policy in Q2 was excessively expansive. The consolidated deficit in Q2 amounted to 56 billion dinars and in the first half of the year reached even 110 billion dinars (see Section 6. Fiscal Flows and Policy). We note that in December 2011 it was agreed with the IMF that the fiscal deficit in the first half of the year reaches only 61 billion dinars, which means that already in the first half of the year deviation from the plan is more than 50 billion dinars. The reasons for this deviation are: 1) the deteriorated

macroeconomic environment compared to the plan from December 2011. (lower economic growth, lower value of the Dinar, higher inflation and higher domestic demand) and 2) very expansive fiscal policy in the first half of the year which is reflected in a sharp increase in public expenditure. This large deviation from the plan cannot be compensated in the remaining part of the year, which is practically recognized in the revised state budget for 2012 – which (implicitly) increased consolidated deficit to around 222 billion dinars. The problem we have identified in relation to the revised budget (and in accordance with the report of the Fiscal Council and IMF assessments) is that with these new measures it increases rather than decreases the deficit. Namely, the revised budget new government measures such as thirteenth pension, subsidies to mitigate the effects of drought, increased subsidies in the economy (FIAT, liquidity loans, loans for construction, etc.), as well as increased allocations for employees in certain ministries (MoIA). Such a generous expenditure measures could not be compensated, by the end the year, by increasing taxes and reduced increase of pensions and earnings, because of which, the deficit in 2012 – instead to reduce – actually increased.

The Budget rebalance and proposed changes of legal regulations, practically defined some of the measures from overall fiscal consolidation package. These measures are primarily related to set up of rules for the control of the growth of pensions and salaries in the public sector and tax increase. Also, system for control of budget expenditures of users with their own revenues, was improved, all of which are steps in the right direction. What is left to be done, and without which we do not believe that the successful fiscal consolidation can be implemented, refers to fiscal decentralization. Last year's amendment of the Law on financing local self-government units created vertical imbalance between revenues and expenditures of the central and local levels of government that almost collapsed the system of public finance, about which we wrote in several previous issues of QM. With a lack of this measure, the remaining necessary reforms of expenditures, related to the decrease in employment in the public sector, pension reform, reduction and reform of subsidies system and limit of the issuance of government guarantees for borrowing by public enterprises, are conspicuously absent from the present plans of the Government.

Growth of the public debt in 2012 is very worrying. Level and trend of the strong growth of the public debt indicate that the probability of the debt crisis is highly possible. Public debt rose about 8 percentage points of GDP (from 48% to 56% of GDP) from the beginning of the year. The reason for the increase of the public debt ratio in GDP in 2012 is the high deficit, but also the depreciation of the Dinar, given that the greater part of the public debt is denominated in euros, and the GDP is realized in dinars. The growth of the public debt was also influenced by the state intervention in order to stabilize the banking sector (Agrobanka, Razvojna banka Vojvodine, Privredna banka Beograd). It is very likely that the public debt will reach a level of 60% of GDP by the end of the year, which is for countries like Serbia, the level of public debt at which the possibility of the outbreak of the crisis is highly possible.

Additional problem regarding high public deficit and debt is that it is necessary to acquire about 1.7 billion euros, only until end of 2012, in order to finance the deficit and principal repayment of public debt, and an additional four billion euros in 2013. Announced signing of bilateral agreements will not be able to provide sufficient funds, so the Government will have to try to acquire the remaining needed funds on the financial market. Under current circumstances – without arrangement with the IMF – that will not be possible. Because of this the Government is now forced to quickly adopt the credible mid-term savings plan which will be positively assessed by the relevant institutions. Otherwise, the debt crisis is inevitable.

Monetary policy was faced with not at all easy choice. An obviously expansive fiscal policy and consequent depreciation pressures and accelerating inflation (which at the time was relatively low), indicated that the increase in monetary restrictiveness is needed. On the other hand, slow recovery of the economic activity and growth of unemployment suggested expansionary monetary policy. Between „two harms” the National Bank of Serbia decided to increase the restrictiveness of monetary policy, which we consider justified and in accordance with the legal commitments of NBS relating to the preservation of price stability. Restrictive monetary policy in Q2 was primarily reflected in the sale of foreign currency, which was used to withdraw Dinars, and ease the depreciation pressures (see Section 7. Monetary Flows and Policy).

Another significant change in monetary policy should be emphasized – at its session on July 12, the NBS decided that instead implementing the key policy rate on two week repo transactions of bonds (reverse repo), the rate is to be implemented on one week repo transactions of bonds (standard repo).

The transfer from the reverse to the standard repo is the reaction of the NBS to the change in the direction of operations in the foreign currency market. In simple terms, in conditions of the large inflow of foreign capital, selling of foreign currency created money, and the NBS was forced to restrain inflation by issuing reverse repurchase securities, thus withdrawing excess liquidity. Now, when the direction of transactions in the foreign currency market has been changed, foreign currency offer is significantly lower than the demand, so on the basis of foreign currency transactions Dinar money is withdrawn. In those circumstances, Dinar liquidity drops and a need appears for the NBS to implement standard repo transactions for raising liquidity. We believe that this decision is justified, but that the NBS should carefully monitor the movements in the foreign exchange market in the future, as well as the government borrowing and spending, in order to timely respond in the direction of creating or withdrawing the liquidity.

In the banking sector, Q2 was marked by the reduction in lending of about 170 million euros compared to the end of March. At the same time, however, the economy increased its foreign debt on the basis of cross-border loans. Because of this, decrease in total lending of economy and the population in Q2 was partially mitigated, and stood at around 40 million euros. From July, however, we noticed a new increase in the economy loans from the domestic banking sector and from abroad, which we will carefully analyse in the next edition of QM. Unfortunately, a share of non-performing loans in total loans continued to grow. At the end of June, the share of non-performing loans in total loans amounted to 15.7%, which is an increase by almost one percentage point compared to Q1. The greatest impact on the overall growth of the share of non-performing loans had the legal entities, who recorded an increase of share from 17.7% at the end of March, to 19.3% at the end of June. Compared to the beginning of the first wave of the crisis (end of 2008), share of non-performing loans has nearly tripled, and the reasons for this, apart from the economic crisis, is foreign currency indexation of most loans, but also the lack of caution by banks, which, in the period before the crisis, fought for the increase market share at the cost of less selective granting of loans.

Serbia: Selected Macroeconomic Indicators, 2004–2012

	Annual Data						Quarterly Data							
	2005	2006	2007	2008	2009	2010	2010		2011		2012			
							Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Prices and the Exchange Rate														
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
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
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
Economic Growth														
GDP (in billions of dinars)	1,683.5	1,962.1	2,276.9	2,661.4	2,720.1	2,881.9	-	-	-	-	-	-	-	-
GDP	5.4	3.6	5.4	3.8	-3.5	1.0	-0.2	1.0	1.7	1.2	3.0	2.5	0.6	-1.3
Non-agricultural GVA	5.8	4.9	6.1	4.1	-4.2	1.6	-0.4	1.7	3.3	1.9	3.5	2.4	0.0	-0.7
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	1.1	7.3	4.3	-1.8	6.4	3.6	-1.9	1.3
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	2.5	8.1	5.8	-0.4	5.8	0.7	-3.1	-3.3
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
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
Fiscal data														
Public Revenues	42.1	42.4	in % of GDP		41.5	38.6	-1.5	-4.0	2.5	-3.6	-1.3	-2.8	-6.6	-3.8
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
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
Platni bilans														
Imports of goods ⁶⁾	-8,286	-10,093	-12,858	-15,917	-11,096	-12,176	-2,659	-3,032	-3,182	-3,302	-3,269	-3,392	-3,440	-3,850
Exports of goods ⁶⁾	4,006	5,111	6,444	7,416	5,978	7,402	1,473	1,861	1,938	2,129	1,955	2,163	2,169	2,151
Current account ⁷⁾	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-760	-615	-519	-188	-760	-621	-683	-903
in % GDP ⁸⁾	-8.6	-12.9	-17.2	-21.6	-7.2	-7.4	-11.7	-8.7	-7.2	-2.6	-10.7	-7.5	-8.3	-11.3
Capital account ⁷⁾	3,863	7,635	6,126	7,133	2,207	1,986	698	596	488	204	644	566	642	899
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	284	136	176	265	307	259	661	600
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	-367	-321	-313	73	168	33	1,078	523
Monetary data														
NBS net own reserves ⁸⁾	175,288	302,783	400,195	475,110	578,791	489,847	563,529	547,249	493,899	489,847	460,348	484,971	514,453	606,834
NBS net own reserves ⁸⁾ , in mn of euros	2,050	3,833	5,051	5,362	6,030	4,609	5,652	5,287	4,684	4,609	4,455	4,860	5,083	5,895
Credit to the non-government sector	518,298	609,171	842,512	1,126,111	1,306,224	1,660,870	1,389,783	1,523,040	1,583,687	1,656,905	1,658,603	1,700,248	1,714,617	1,784,237
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	604,783	651,132	681,704	732,066	730,892	742,597	744,100	775,600
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
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
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

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 than 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

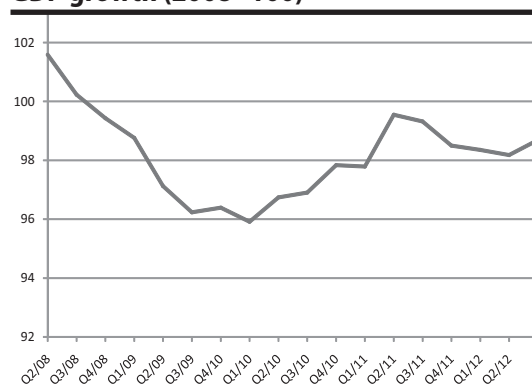
Preliminary data for Q2 indicate slight recovery of the economy, which has been in the recession since mid-2011. It is possible, however, that the observed recovery from Q2 will be short-breathed and that it will not continue in the remaining part of the year. The reason for our doubt about the sustainability of the started recovery is the fact that it still relies on a high state, and slightly smaller private consumption. Not only that this kind of growth cannot indefinitely be financed by the government's borrowing (public debt will probably exceed 60% of GDP at the end of 2012 and possible public debt crises), but also increasing inflation and weakening of the domestic currency react swiftly on the "unhealthy" model of recovery. On the other hand, net exports and investment, which are the only ones that can start sustainable economic growth, are still in the negative zone compared to the same period last year - although there are some positive indications in terms of net exports. We estimate that the drop in GDP in 2012 will amount to about 1%, but there are risks that it will be lower. First of all, the final assessments of the effect of drought on agricultural production can easily be less favourable than expected, which could deepen the overall decline in economic activity. Price competitiveness, in line with our expectations from the QM 28, significantly improved - which can help the necessary increase in net exports in the future. Industrial production had a short-lived boom in April and partly in May, which mostly contributed to the noticed recovery of GDP in Q2. It is worrying, however, that, since then, the trend in industrial production was extremely declining, which is confirmed by the preliminary data for July. Construction decelerated the growth in Q2, and we expect this trend to continue in the coming quarters.

Gross Domestic Product

Y-o-y decline of GDP in real terms at around 0.6% in Q2

...Which is actually an improvement compared to Q1

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



Source: QM estimates based on SORS data

Economic activity is still significantly below its pre-crisis level

High growth of public and slightly lower growth of private consumption

According to preliminary SORS estimates based on the available economic activity performance data, real y-o-y GDP decline in Q2 stood at 0.6%. However, 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. Graph shows that after four quarters of the reduction in economic activity, Q2 saw a slight recovery. One of the most important questions that we will try to answer in this issue of QM is: Is this recovery indication of better economic results in the second half of the year, or is just temporary?

Graph T2-1 also shows that nearly four years after the outbreak of the first wave of crisis, economic activity is still over 3% lower than the level it held in the first half of 2008. 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.

When GDP is observed by use (private consumption, public consumption, investment and net exports), the y-o-y decline of 0.6% of GDP in Q2 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

2. Economic Activity

y-o-y growth of 11.2% in Q2, thus contributing to a positive y-o-y growth of GDP by about 2 percentage points (pp). Private consumption which had significantly lower but positive y-o-y growth, contributed to the y-o-y growth of GDP by just over 1pp.¹ The most important determinants of the private consumption are practically zero real growth of wage mass (as a net result of average wage real growth and decrease in employment) and solid real increase of pension mass. The increase in the trade deficit, compared to the same period last year, led to a decrease of GDP by about 3 percentage points, while the y-o-y drop in investments contributed to about 0.5 pp decline of GDP.

Economic growth based on domestic consumption is not sustainable

Prior analysis indicates that high public spending is practically the only one positively contributing to GDP growth – directly (purchases of goods and services, wage growth), but also indirectly (expenditures on pensions, social security). This fact should be considered as conditional. Namely, net contribution of government spending to economic growth would be obtained only if we subtract the government spending contribution to the increase in imports from that amount. The bad thing is the fact that apart from the external imbalance, high government spending encourages internal imbalance – reflected in the inflation growth.² In the end, it should be noted that government spending is financed by government borrowing, and that cannot last forever. Early as the second half of the year, according to a rebalance (which cannot be called restrictive), fiscal deficit will slightly decline from about 7% of GDP to about 6% of GDP – primarily due to the expected low deficit in Q3. In 2013 further reduce in public spending, by several percentage points of GDP, is announced (which is inevitable), which will then decrease the contribution of this component to GDP growth. As in the previous case, when we evaluated contribution of government spending on the economic growth with reserve, so the impact of this, forthcoming reduction, on the possible slowdown in the economy, should not be overestimated, because it will be followed by reducing imports and balancing of domestic economy.

Net exports may have better results by the end of the year

Compared to Q1, net exports recorded significantly better results.³ However, the question is to what extent this was a consequence of actual trends, and to what extent comparison with Q1, in which, due to the state of emergency caused by the cold weather, exports were lower than usual. By the end of the year slight improvement in net exports results can be expected. This will be a consequence of reduced imports due to depreciation of the dinar and lower domestic demand, while exports could be increase due to the growth of export of FIAT Automobili Serbia company and also as a result of depreciation of the dinar, this time, because it improves the price competitiveness of the domestic economy (which will be better elaborated in the part of the text that refers to unit labor costs). On the other hand, drought and significantly lower production of the agriculture products could considerably slow down expected improvement of foreign trade flows in the remaining part of the year, but also in the next year, because some of the most important export products of Serbia are in that group.

Taking all said into account, due to almost certain slowdown in domestic demand (which was stimulated by government spending) we considered observed recovery of GDP in Q2 as temporary – long-term sustainable recovery is only possible from the beginning of next year. Expected reduction in production in the coming quarters, due to the reduction of domestic demand, will probably not be able to be fully compensated by recovery in exports.

Worse results of agricultural production, than expected, could further reduce GDP

Growth in GDP considered by *production* is shown in Table T2-2. This Graph shows growth by individual sectors of the economy up to and including the latest official data regarding Q1 2012.⁴ The sectors of information and communication and construction saw relatively high real growth, while trade, manufacturing and transport recorded the greatest drop. In Q2 for which there are still no official data available, we expect some changes.

¹ SORS does not publish data on GDP per use on a quarterly basis, QM analysis is based on indirect indicators. We believe that for high quality analysis of economic activity, but also for better economic policy in Serbia, monitoring of GDP per use, on a quarterly basis, by government institutions is of the utmost importance. Note that such practice is common in nearly all statistical bureaus of European countries. The need to regularly monitor the quarterly data of GDP we mentioned in several articles in previous editions of QM

² For more details see Section 5 Prices and Exchange Rate in this issue of QM

³ For more details see Section 4 Balance of Payments and Foreign Trade in this issue of QM

⁴ For some industry sectors: construction, manufacturing, mining, electricity, and, to some extent, agriculture, trade and financial services, there are movement indicators for Q2 2012

Above all, construction will begin a deceleration of its growth, the manufacturing industry will achieve significantly better results compared to Q1, and the trade will probably temporarily enter the positive zone of y-o-y growth. Table T2-2 also shows fairly modest decline in agriculture in Q1, which will certainly increase in the coming quarters. For now, it is still unknown what will be the rate of a decline in production in the coming quarters, which is significantly influenced by drought. In our estimate of the growth in economic activity in 2012, we included a decline in agricultural production of about 10%. In case it turns out that the actual decline in agriculture is even higher, it will reflect on a greater drop in GDP.

Table T2-2. Serbia: Gross Domestic Product by Activity, 2008-2012¹

	2008	2009	2010	2011	2011				2012	Share
					Q1	Q2	Q3	Q4	Q1	2011
Total	103.8	96.5	101.0	101.6	103.0	102.5	100.6	100.6	98.7	100.0
Taxes minus subsidies	101.4	98.3	100.9	101.9	103.4	103.2	100.9	100.7	97.8	17.7
Value Added at basic prices	104.5	96.4	101.3	101.5	103.1	102.3	100.5	100.5	98.9	85.0
Non agricultural Value Added	104.1	95.8	101.6	101.4	103.5	102.4	100.0	100.1	99.3	89.5 ²⁾
Agriculture	108.7	100.8	99.6	100.9	98.4	100.8	102.2	101.3	98.7	10.5 ²⁾
Manufacturing	100.8	84.2	100.9	100.6	106.2	101.8	98.1	97.7	96.9	14.0 ²⁾
Construction	104.7	80.3	92.9	107.7	99.1	111.0	109.2	108.6	107.8	4.1 ²⁾
Wholesale and retail trade	106.7	92.5	101.7	94.5	100.2	94.7	91.6	92.6	96.8	13.0 ²⁾
Transport and storage	97.4	90.0	108.2	103.1	108.8	103.0	102.3	98.9	94.9	5.4 ²⁾
Informations and communications	110.8	110.0	105.4	108.4	105.2	109.7	109.8	108.7	107.4	8.4 ²⁾
Financial sector and insurance	113.4	105.5	107.2	101.0	105.7	100.9	99.5	98.0	101.1	3.9 ²⁾
Other	103.7	101.6	100.8	102.0	102.9	103.1	100.6	101.6	99.1	40.6 ²⁾

Source: SORS

1) In the previous year's prices

2) Share in GVA

GDP estimates must take into account the possibility of a crisis

To answer the question what would be the trend of economic activity in Serbia, first we must consider the risks of the outbreak of the crisis in near future. The main risks are: 1) bad outcome and possible crisis in the eurozone, with which the Serbian economy is closely linked and 2) the possibility of the outbreak of the public debt crisis in Serbia. Although we are still unable to completely exclude the possibility of further deterioration in economic conditions in the coming quarters, the latest data show that the stabilization (though with lower economic growth) in the eurozone is more certain.⁵ On the other hand, growth of the public debt, especially in 2012 – in which public debt could reach 60% of GDP – increases the risk of the outbreak of the crises on this basis, and this possibility cannot be excluded. Public debt crisis results in the collapse of a significant part of the economy of the country affected by the crisis and a large drop in the living standard, and occurs when investors estimate that a particular country will not be able to service its debt and cease to invest funds in government bonds. As a rule, GDP falls by 5-10% in real terms, with rising unemployment and the strong depreciation of the domestic currency. Therefore, it is essential for a country to predict the probability of public debt crisis and to take timely measures to reduce it.⁶

In 2012 GDP is likely to decline about 1%

If our expectation of stabilization in the international environment is realized, and the Serbian economy avoids a public debt crisis in following quarters, a decline in GDP of about 1% will be realized in 2012. The estimate of the economy decrease of about 1% is a reduction of one percentage point compared to the estimates that we presented in previous issues of QM (QM 25-26⁷, QM-27 and QM 28). Reasons for the reduction of the estimate are: 1) drought, that will significantly reduce agricultural production, 2) unfavourable structure of the started recovery in Q2, because of which we estimate that in this way it is not possible to permanently increase economic activity, and the recovery from Q2 we evaluate as a temporary, and 3) downgraded credit rating, which will, at least by the end of this year, reduce the inflow of foreign capital into Serbia.

⁵ For more details see Section 8 International Environment in this issue of QM

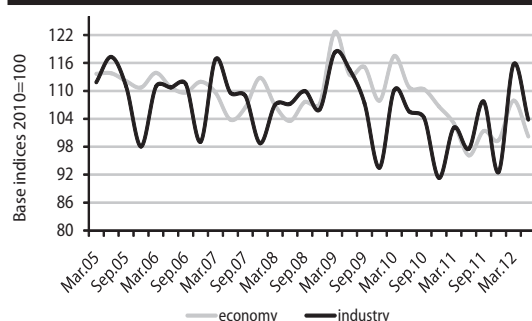
⁶ For more details see Section 6 Fiscal Flows and Policy in this issue of QM

⁷ For more details see Highlights 1. Forecast of Economic Developments for 2012, QM 25-26

**Unit Labor Costs
measured in
dinars at the
expected level**

Unit Labour Costs⁸ (ULC), measured in dinars, decrease in Q2, which means that the share of labour costs in the realized added value has been in decline, making it a favourable trend (Graph T2-3). Detail analysis shows that this decrease of ULC in Q2 is mainly a result of its comparison

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



Source: QM based on SORS and NBS data

with the quarter when they were seasonally, but also due to the effects of some other temporary factors, exceptionally high. It is good, however, that our forecast from QM 28 of a sudden rise in Q1 ULC is not being of a concern, because its temporary nature – is confirmed by the data for Q2. Compared to the same quarter of the previous year ULC are slightly higher. Unfortunately, this means that when we include the change in the level of the average wage into consideration, annual decrease of economic activity, recorded in Q2, is to an even greater extent followed by a fall in employment.

**Euro-ULC movement
indicates significant
improvement of price
competitiveness...**

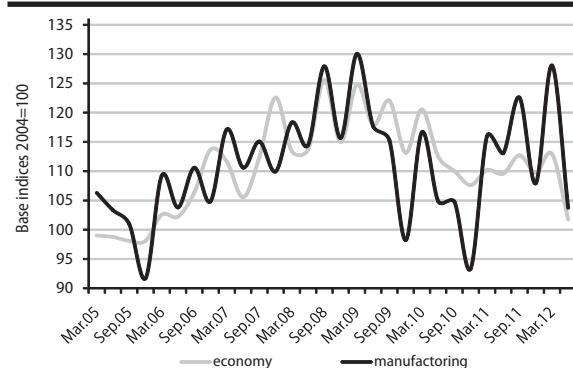
are an indicator of the price competitiveness of the Serbian economy because they define the greatest national cost component (labor costs) in relation to added value. We calculate euro-ULC for the manufacturing sector (that produces by far the greatest share of tradable goods), and for the economy as a whole,⁹ 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.

**...due to the
depreciation of the
dinar ...**

The graph shows that the euro-ULCs have significantly decreased compared to Q1. It should however be noted that the growth of the Euro-ULC in manufacturing industry in Q1 was only temporary, and was mostly a direct result of a sharp fall in production in February, due to the state of emergency. Under such circumstances production stops for a short period of time, but there is no need for reduction of employment (and the data shows – no need for reduction of wages), because the reasons for the fall in production are not fundamental, but temporary in nature.

Now that the temporary factors for euro-ULC increase in Q1 are eliminated, we notice how much the decrease in value of the dinar actually had a positive influence on the increase of price competitiveness of the domestic economy (Graph T2-4). Increase in price competitiveness (reduced euro-ULC) will be a strong support to further increase in net exports, from which we expect

Graph T2-4. Serbia: Real Unit Labor Costs in the Economy and Industry, 2005-2012



Source: QM based on SORS and NBS data

Note: the growth of euro-ULC on the graph represents the decline in price competitiveness

to be a decisive factor in the future economic growth. For that reason, we believe that the weakening of the exchange rate in 2012, unless it gets out of control, may be useful for the Serbian economy in the medium-term. Euro-ULC in Q2 were at a level that is only 3% higher than that of Q2 2005, which may be a good course for the export stimulus and gradual balancing of the current account to a level that is sustainable in long-term (of course if capital inflows are at a satisfactory level). It would not be a good idea, when we probably reached the level of the exchange rate that is appropriate for the model of economic growth based on exports, to again allow real dinar appreciation.

⁸ Unit Labor Costs in dinars are calculated for the economy (excluding the Agriculture and Public Administration sectors) and industry.

⁹ Excluding the Public Administration and Agriculture sectors.

Industrial production

Industrial production falling in Q2

Industrial production recorded a 2.8% y-o-y fall in Q2 2012. This decline is considerably smaller than the one from Q1 2012 (Table T2-5), which is in line with our expectations set forth in the previous issue of QM. Within the scope of the industrial production electricity supply had the worst performance and recorded an annual decline of about 15%, also the mining production recorded worse results, compared to the same period last year. The results of the manufacturing industry, which recorded a slight increase in Q2 compared to the same period last year, of about 0.2%, are somewhat encouraging. We notice that the manufacturing industry in Q2, for the first time in the previous twelve months, recorded a positive y-o-y rate (Table T2-5).

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	Q2	
Total	104.1	101.4	87.4	102.5	102.2	106.4	103.6	98.1	101.3	94.5	97.2	100.0
Mining and quarrying	100.2	105.3	96.2	105.8	110.4	107.5	117.7	102.8	114.8	100.2	94.2	9.9
Manufacturing	104.6	101.1	83.9	103.9	99.6	105.8	100.7	96.9	96.7	93.3	100.2	73.1
Electricity, gas, and water supply	103.2	102	100.8	95.6	109.7	107.5	113.0	101.5	116.7	96.6	85.4	17.0

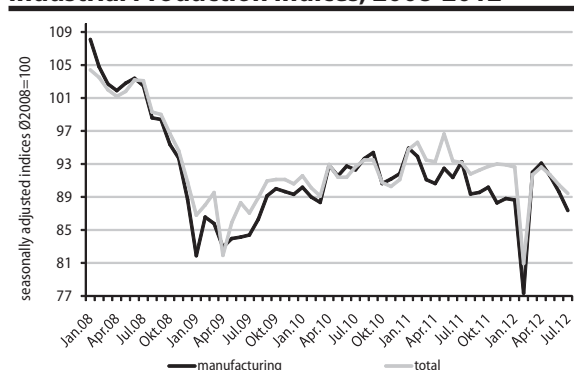
Source: SORS

Seasonally-adjusted indices indicate unfavourable trend

Graph T2-6 shows seasonally-adjusted production indices of industry as a whole and manufacturing in particular. Seasonally-adjusted data indicate that, the industrial production (especially manufacturing industry) had some “take-off” at the beginning of Q2, but since then recorder significant fall in seasonally adjusted indices and with this trend entered Q3. Graph T2-5 clearly shows the influence of the state of emergency in February on industrial production, which at that point fell by over 10%, in just one month. The last data we will mention in the analysis of the Graph of the seasonally adjusted industrial production indices is that industrial production, three years after recovery began, is still over 10% below its pre-crisis level. The latest trends indicate that pre-crisis industrial production levels will not be reached before 2014.

Industrial production by the end of the year is uncertain

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



Source: SORS

Forecast of the industrial production trend (by the end of the year) is still highly unreliable, because of large fluctuations in the past few months. It is highly possible that the gradual increase in the production of the Fiat Automobili Srbija company, will have positive effect on industrial production. On the other hand, bad situation in the production of the base metals (Železara Smederevo), possible slowdown in the food industry (a poor agricultural season), reduction in electric energy production (drought and low water levels) and slowdown in production of building materials - by the end of

the year will have a negative impact on industrial production. Therefore our estimate, with the significant level of uncertainty, is that Q3 and Q4 will be somewhat worse in terms of industrial production compared to Q2.

Divergent trends in the production of industrial groups

A breakdown by use (Table T2-7) shows that, in Q2, the two groups of goods recorded y-o-y decline (energy and intermediate goods), while production of investment goods and consumer goods recorded growth when compared to the same period last year. This result and significant differences in the production of certain industrial goods are also the result of some exogenous factors. In the first place, due to delays in the production of Železara Smederevo, production of entire group of intermediate products is in decline. If we exclude this company from the group,

2. Economic Activity

then it would have recorded y-o-y increase. In addition, the effects of drought and low water levels, which affected the fall of the entire group, should be added. It is interesting to note that this structure of production by industrial groups (increase in production of capital and consumer goods and a decline in production of energy and intermediate goods) is the same as the structure of the recorded export growth in Q2 (section 4. Table T4-8).

Table T2-7. Serbia: Components of Industrial Production , 2008-2012

	Y-o-y indices									
	2008	2009	2010	2011	2011				2012	
					Q1	Q2	Q3	Q4	Q1	Q2
Total	101.4	87.4	102.5	102.1	106.4	103.6	98.1	101.3	94.5	97.2
Energy	101.7	98.8	97.7	106.2	103.7	110.8	96.5	114.2	95.8	88.3
Investment goods	105.9	79.3	93.6	103.2	132.2	97.5	92.5	92.2	92.0	105.4
Intermediate goods	100.3	78.4	109.2	102.2	113.8	103.3	99.1	99.3	89.4	96.3
Consumer goods	101.6	86.8	102.1	95.4	96.5	98.1	97.8	92.4	97.8	104.5

Source: SORS

Construction

Construction slowed down significantly in Q2

Latest construction statistics made available by SORS indicate significant slowdown of this sector of the economy. The value index of construction work performed recorded y-o-y growth of about 20%, in real terms, in Q1, and only 6% in Q2. Noted reduction in construction activity, we accept as true, although 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 economy¹⁰ (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, given the fact that cement is a necessary material for almost all types of construction works. Cement production is also a useful indicator for the assessment of future trends in construction activity, because it precedes it.

Table T2-8 shows that cement production had strong y-o-y decline of around 12%. Cement production data confirms a bad trend in the construction activity, but also casts doubt on the actual achievement of the y-o-y growth in Q2. Taking both figures into consideration (value of construction work and the production of cement), we believe that the real annual growth in construction activity in Q2 was approximately zero. 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 a reliable enough indicator to consider its value as absolutely representative.

The actual level of construction activity is probably about the same as last year ...

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	88.3	-	-	-

Source: SORS

¹⁰ 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.

**...with a significant
worsening trends** In the next quarter, a further slowdown of the construction activity is likely to happen. This is best indicated by the cement production index, which usually slightly precedes the construction activity. In a broader context, our analysis suggests that the level of investment in Serbia declines in 2012, with no indication of change in the coming quarters - which immediately reflects the construction industry.

3. Employment and wages

Data from the April 2012 Labour Force Survey (LFS) indicate continued deterioration of the labor market trends - fall in the employment rate and even larger increase in unemployment rate. The employment rate decreased by 1.1 percentage points, compared to October 2011, and in April stood at 44.2%. The female employment rate has continued to decline, but this time a little slower than the male employment rate. The unemployment rate rose from 24.4% to 26.1% between April and October 2012. Unemployment rate for persons between the age of 15 and 24 stood at an extremely high 50.9%, but compared to the previous six month period it declined by only 1 percentage point. The 55-64 age group recorded highest increase in the unemployment rate of 4 percentage points. As well as the overall, so does the formal employment decrease, but mostly due to the reduction in the number of employees by private entrepreneurs. Finally, the total decline in employment took place in the private sector while employment in the public sector increased by a few thousand in the reporting period. Average real wage decreased in the second quarter after several quarters of growth. However, we notice wage growth in the economy, while the average salary in the administration and public enterprises declined in real terms. The growth of wages in the economy is the result of the combined impact of the minimum wage increase from the April of this year, and the decline in number of workers employed with entrepreneurs

Employment

Labor market trends continued to worsen

The employment rate declined by 1.1 percentage points, compared to October 2011, and in April stood at extremely low 44.2%

First half of the 2012 is characterized by the continuation of negative trends on the labor market which started in 2011: the decline in the employment rate and the number of employees and the increase in the number of unemployed.

As a result of the deepening economic crisis in Serbia, further decrease in employment and even more pronounced increase in the number of unemployed, marks the second quarter of 2012. The number of employed, based on the Labour Force Survey (LFS) data, decreased by about 60,000 persons between October 2011 and April 2012. The employment rate decreased by 1.1 percentage points in the same period and in April 2012 stood at 44.2%. This decrease was even more emphasized compared to the previous six-month period (Table T3-1).

Graph T3-1 shows that since October 2008, since the Labour Force Survey is being conducted twice a year, the employment rate decreased steadily and after four years decreased almost ten percentage points. The current rate of 42.2% is significantly lagging behind the average rate in the European Union, which is slightly less than 70%.

Table T3-1. Serbia: Employment and Unemployment According to the Labor Force Survey¹, 2008–2012

		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
2012	April	2,083,604	317,879	44.2	51.1	37.1	735,209	26.1	25.6	26.7

Source: Labor Force Survey (LFS), SORS.

Notes:

1) Labour Force Survey is conducted twice a year since 2008 - in October and in April.

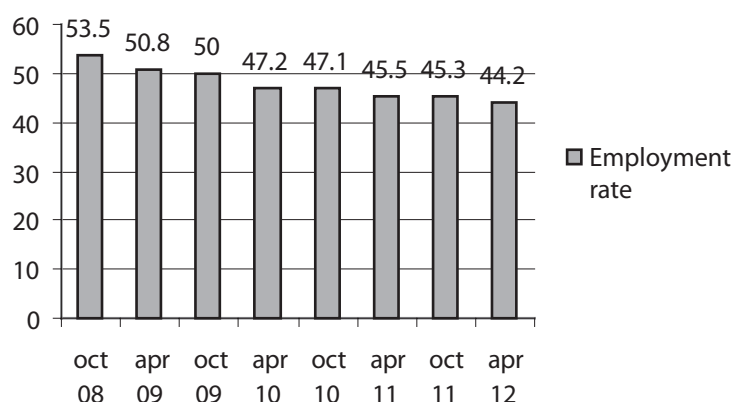
2) Persons of 15-64 years of age are considered to be working population.

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+.

The employment rate of women stood at extremely low 37.1% in October 2011, and the employment rate of men stood at 51.1%.

The employment rate of women dropped by 0.8 percentage points in the period April 2011 – October 2012 and stood at extremely low 37.1%. But this time, unlike the previous six-month period, the employment rate of men decreased even more, by 1.4 percentage points, and in April 2012 stood at 51.1% (see table T3-1).

Graph T3-1. Serbia: Employment rate, 2008–2012.



Source: Labor Force Survey (LFS), SORS.

The unemployment rate increased from 24.4% to 26.1%, while the inactivity rate increased slightly.

According to the Labor Force Survey, number of unemployed increased by about 45,000 persons between October 2011 and April 2012 increasing the unemployment rate from 24.4% to 26.1%. This time, male unemployment rate grew faster, by 2.1 percentage points, than the corresponding rate for women which increased by 1.1 percentage points (see table T3-1).

After a six-month period of stagnation, the inactivity rate rose slightly from 40.1% in October 2011 to 40.3% in April 2012, indicating, along with the rising unemployment, the deepening of the labor market crises.

The unemployment rate among persons aged between 15 and 24 decreased by 1 percentage point between October 2011 and April 2012 and currently stands at 50.9%.

The largest increase in the unemployment rate was recorded in the 55-64 age group, by 4 percentage points

The largest increase in the unemployment rate, of 4 percentage points, mostly affected the oldest members of the working population, those aged 55–64. And for all other age groups (except for those under the age of 25), the unemployment rate rose by 2 percentage points for persons aged 35–44, and by 1.2 percentage points for all others. Observed by the level of education, there was a uniform increase in unemployment for all educational levels of about 2 percentage points.

The unemployment rate declined the most in the region of Vojvodina

Since October 2010, Labor Force Survey monitors unemployment rates for four regions. Until then, the Survey monitored the region of Belgrade, Vojvodina, and the Central Serbia region, and since the October 2010 LFS the Central Serbia region is monitored through: the Šumadija and Western Serbia region and the region of Eastern and Southern Serbia.

In the period between October 2011 and April 2012 the unemployment rate increased in all four regions, but mostly in the Vojvodina region – almost 3 percentage points, slightly under 2 pp in Belgrade and the Šumadija region, and by just 0.1 percentage points in the region of Southern and Eastern Serbia.

Wages

After three consecutive quarters of growth, the average real wage decreased in Q2 y-o-y

The average real wage in Serbia, after three consecutive quarters of growth, this time decreases y-o-y by 0.7%. The economy saw a wage growth of 0.8%, while wages in the public enterprises, the Sector of Education and Culture and the Sector of Health and Social Work, saw real decline compared to the same quarter of the previous year (see Table T3-2 and table T3-3).

3. Employment and Wages

Table T3-2. Serbia: Average Monthly Wages and Y-o-Y Indices, 2008–2012

	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	63,846	39,068	591	362	111.0	106.0
Q2	68,140	41,664	600	367	109.6	105.3

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%.

The wage growth in the economy can be explained by the increase of the minimum wage, from 102 to 115 dinars per hour of work, while the largest number of employees receives the minimum wage works in the private sector. The ratio of minimum and average wage currently amounts to almost 50% and raises the question whether this high minimum wage is sustainable in the future. Our opinion is that the ratio should be brought into the framework of 30 to a maximum of 40% of average wage. Increasing the minimum wage in the pre-election period is an illustration of how the short-term political points can bring a long-term damaging decision.

Table T3-3. Serbia: Gross Wages in the Public Sector, 2004-2012, Y-o-Y Real Indices

	From the budget			Public enterprises		Other ¹⁾	Serbia average
	Administration - all levels	Education and culture	Health and social work	National public	Local public		
	1	2	3	4	5	6	7
2004	107.4	107.7	110.9	107.9	113.4	113.7	111.4
2005	105.9	106.0	100.8	100.5	103.0	106.9	107.1
2006	109.1	107.2	109.4	110.8	102.9	113.7	111.3
2007	111.1	114.7	123.8	116.7	105.0	114.1	114.6
2008	100.7	105.7	101.3	101.2	95.9	105.7	105.5
2009	95.1	96.3	97.0	97.9	97.8	104.1	101.1
2010	99.1	95.1	94.3	98.1	98.0	104.5	101.2
2011	99.2	95.5	97.2	104.0	95.1	101.1	99.9
2007							
Q1	111.5	112.6	125.4	129.8	113.8	117.3	118.5
Q2	118.6	119.2	131.5	118.9	104.5	117.4	118.6
Q3	114.1	116.7	127.5	112.5	104.1	112.5	114.1
Q4	100.1	110.3	111.0	105.8	97.4	109.0	108.2
2008							
Q1	99.2	109.5	105.6	94.3	98.5	107.3	105.2
Q2	99.6	104.8	99.4	103.0	89.0	104.2	103.1
Q3	100.8	104.7	101.1	103.6	91.7	106.3	105.0
Q4	103.3	103.7	99.2	103.9	104.4	105.1	104.1
2009							
Q1	99.8	97.9	99.4	98.4	100.8	105.1	102.5
Q2	94.0	97.4	98.1	99.0	99.3	104.8	102.0
Q3	93.6	96.2	96.9	98.1	95.4	102.9	100.1
Q4	93.0	93.6	93.5	96.0	95.9	104.0	99.9
2010							
Q1	95.8	96.1	96.1	102.2	98.0	103.5	101.1
Q2	101.0	96.7	95.1	102.1	98.3	106.6	103.2
Q3	100.4	95.1	94.6	94.5	99.8	105.8	101.8
Q4	99.4	92.5	91.2	93.5	95.7	102.4	98.8
2011							
Q1	98.1	89.4	92.0	100.6	92.2	100.4	97.7
Q2	97.8	94.4	97.4	99.9	94.3	98.3	97.7
Q3	100.7	97.5	97.6	108.3	95.1	102.5	101.5
Q4	100.0	100.8	102.0	107.3	98.8	103.3	102.9
2012							
Q1	104.7	104.9	102.5	107.4	103.7	106.7	106.0
Q2	105.3	100.7	99.8	103.4	101.5	107.5	105.3

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.

Looking at the real seasonally adjusted data on net wages in these sectors (see Table 3-4), similar trends can be noticed: in Q2, compared to Q1, wages decreased in the public enterprises, the Sector of Education and Culture and the Sector of Health and Social Work, while they increased in the economy.

T3-4: Real seasonally adjusted net wages, chain indices

	Economy	Public State Enterprises	Public Local enterprises	Administration (all levels)	Education and Culture	Health and Social Work
2011, Q1	98.6	109.1	97.4	99.2	96.5	99.7
2011, Q2	100.5	97.3	101.8	100.2	103.3	102.6
2011, Q3	104.8	100.7	99.5	101.1	100.7	98.8
2011, Q4	99.4	100	100.3	100.9	100.5	101
2012, Q1	102.2	109.2	102	100.7	100.2	100.3
2012, Q2	101	94.5	99.7	100.7	99.3	99.6

Source: QM calculations

3. Employment and Wages

Taking into account that by the end of the 2012 fall of GDP is anticipated, we expect that the employment rate will continue to decline and the unemployment rate to increase and that probably the decline in the real value of wages will follow.

Box 1. Increasing activity and employment of young

Labor Force Survey data indicates that the unemployment rate of young people aged 15-24 reached an extremely high 50% in April 2011, and for over a year remained at this level. At the same time, this age group records the highest inactivity rate of 70%.

In FRENs latest study, dealing with the possibilities for the growth of the activity and employment rates in Serbia, special attention is given to the young population, which faces these problems. In this age group many of them are still in school so we expanded our research group to 29 years of age, while International Labour Organization defines young people as those aged between 15 and 24. Education is the main reason for the level of inactivity rates of this age group - data on those who are not actively seeking work.

The table T3-5 shows that the transition dynamic between the work statuses significantly differs for the youth depending whether they are educated or not.

Table T3-5. Transition matrix of youth (15-29), April 2011 – October 2011

Status in April 2011		Status in October 2011			Total
		Employed	Unemployed	Inactive	
Not in School	Employed	253,730	30,311	6,099	290,140
		87.50%	10.40%	2.10%	100.00%
	Unemployed	21,497	139,424	19,563	180,484
		11.90%	77.30%	10.80%	100.00%
	Inactive	21,334	29,985	79,381	130,700
In School	Employed	12,013	0	4,337	16,350
		73.50%	0.00%	26.50%	100.00%
	Unemployed	0	7,234	15,060	22,294
		0.00%	32.40%	67.60%	100.00%
	Inactive	6,345	5,124	523,914	535,383
Total	Total	18,358	12,358	543,311	574,027
		3.20%	2.20%	94.60%	100.00%

Source: QM calculations based on the LFS April 2011 and LFS October 2011

The greatest differences between these two youth groups exist in terms of transitional dynamics of inactivity: most young people in school, 97.9% of them, remains inactive in both periods, unlike the mere 60.7 of the young that are not in school. Additionally, even 22.9% of young people who are not in school passed from inactivity in October of 2010, to unemployment (hence, started active search for a job) in April 2011, while mere 1% of the young in school had a same transition. Finally, even 16.3% of inactive youth who were not in school in October 2010 found a job after six months, and only 1.2% of the young who were at school.

However, in 2011 number of transitions from inactivity to employment significantly rose for young people who are not in school, considerably higher, compared to the previous six-month period (October 2010 – April 2011), when merely 3.5% of young people who are not in school passed from inactivity to employment. This positive development can be explained by the influence of the seasonal factor, but also potentially by intensive use of the active labour market policies by the National Employment Agency and local governments, which recorded the highest expansion in that period, for example the "First chance" program. According to the data from the former Ministry of Economy and Regional Development, around 20 thousands of persons younger than 30 years of age, in 57000 of companies, participated in this program. Additionally,

in the mentioned period, the Promotion of Youth Employment program jointly carried out by the United Nations agencies in Serbia and targeted at the young people without professional education and the young people with additional factors of vulnerability, which are also the groups with the highest inactivity rates - was also very active.

Unfortunately, 2012 saw a reduction in the funds for the financing of active labor market policies (ALMP), influencing the funds for financing of labor market programs targeted at the population of young. As we described in previous issues of QM, practices from the other countries show that the higher spending for active labor market policies pays off, especially in the in-company training and practice domain. Employers, according to research, do not spend funds on education of young workers. They will rather invest in education of more experienced workers which have been in the company for a long time. The Government therefore needs to pay special attention to those young people who dropped out of school or have lower levels of education – for them training and practice is needed the most and the employers are not keen to that if the government does not encourage them.

4. Balance of Payments and Foreign Trade

The current accounts deficit in the balance of payments in Q2 was reduced significantly following the high value recorded in Q1. In Q2 it stood at 718 million Euro and accounted for 9.7% of the GDP. The favorable trend in the reduction of the current deficit in Q2 is primarily the consequence of a delayed effect of the depreciation – and somewhat better results of foreign trade activities, as well as a significant inflow of current transfers. Exports are growing, seasonally adjusted value by 8.7%, while imports continue to be high. In Q2 there was a net outflow of capital of 437 million Euro primarily as the result of the outflow of funds on the basis of changes of regulations on the mandatory reserves of banks but also a very modest inflow of the FDI and portfolio investments. That caused the creation of depreciation pressure and led to a drop in foreign currency reserves of 1.1 billion Euro. On one side, the current drought in the country, halt of production at the “Železara Smederevo” steel plant and rise in oil prices on the world market could contribute to the growth of the current deficit while the start of exports of FIAT automobiles, depreciation of the domestic currency and fiscal consolidation should contribute to its reduction. The effect of the rise of food prices will probably not be sufficient to compensate for the drop in exports and the foreign trade surplus in food exports will be lower this and next year. We expect that more than one billion Euro will be required to cover the current deficit in the second half of the year. If, in the next period, the low level of foreign investment inflow and the net outflow in the accounts of financial credits are repeated more foreign loans will be required to prevent the drop in the NBS foreign currency reserves. That solution could be a problem considering the level of foreign debt owed by the economy and the state and even more difficult bearing in mind the recently reduced credit rating of the country.

Current account deficit of balance of payments in Q2 reduced significantly following high values registered in Q1

The current account deficit of the balance of payments is once again drawing closer to the balanced level following the very high value registered in Q1. In Q2 it stood at 718 million Euro and accounted for 9.7% of the GDP (Table T4-1 and Graph T4-2). The favorable trend of a repeated reduction of the current deficit in Q2 is primarily the consequence of the delayed effect of depreciation (which is in accord with our expectations in the previous issue of *QM*) and also the somewhat improved results in foreign trade activity as well as a significant inflow of current transfers (Graph T4-3). The Achieved value of the current deficit in Q2 is at the level of the average in 2011 and significantly under the value from Q4 2011 and Q1 2012 (11.3% GDP and 17.0% GDP, respectively). The deficit is 22.3%, that is 2.5 percentage points of the GDP above that of Q2 2011. In the January-June period of 2012, the value of the current accounts deficit was 45.3% above the value in the same period of the previous year. The higher current account deficit coupled with the very low capital inflow in Q1 and net outflow of capital in Q2 in the financial account (Graph T4-7) have a negative effect on the value of the domestic currency.

Goods deficit in Q2 significantly under Q4 2011 and Q1 2012

In Q2 the goods deficit stood at 1.27 billion Euro, that is 17.2% of the GDP and was at the level of the average in 2011 (17.4% GDP, Table T4-1 and Graph T4-4). That level of the goods deficit is significantly below the values of Q4 2011 and Q1 2012 when they stood at 21.2% of the GDP and 22.4% of the GDP respectively. Compared to Q2 2011 the goods deficit was higher by 6.4%, that is 2.5 percentage points of the GDP.

Table T4-1. Serbia: Balance of Payments

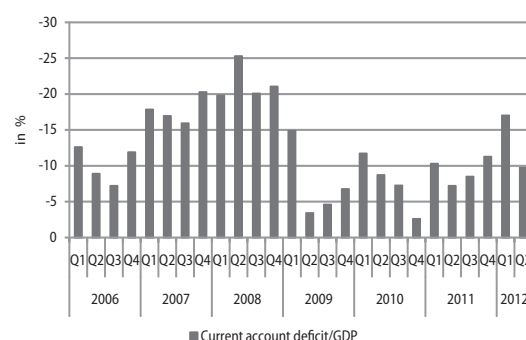
	2009	2010	2011	2011				2012	2012
				Q1	Q2	Q3	Q4	Q1	Q1
				mil. euros					
CURRENT ACCOUNT	-2,084	-2,082	-2,890	-717	-587	-683	-903	-1,177	-718
Goods	-5,118	-4,774	-5,437	-1,271	-1,196	-1,271	-1,699	-1,551	-1,273
Export f.o.b. ¹⁾	5,978	7,402	8,437	1,955	2,162	2,169	2,151	1,852	2,283
Import f.o.b. ¹⁾	-11,096	-12,176	-13,874	-3,226	-3,358	-3,440	-3,850	-3,403	-3,556
Services	18	5	162	28	12	12	109	29	1
Export	2,500	2,667	3,032	631	720	816	865	667	747
Import	-2,482	-2,662	-2,871	-603	-708	-803	-756	-638	-746
Income, net	-502	-670	-758	-112	-252	-195	-198	-229	-211
Receipts	500	438	428	101	100	101	126	109	134
Payments	-1,002	-1,108	-1,186	-214	-352	-296	-324	-338	-345
Current transfers, net	3,518	3,356	3,143	638	849	771	885	574	765
o/w grants	197	193	206	49	41	39	77	26	38
o/w private remittances, net	2,618	2,383	2,165	450	596	546	573	359	523
CAPITAL ACCOUNT	2	1	-2	-1	0	-1	0	-3	-4
FINANCIAL ACCOUNT	2,207	1,986	2,674	601	531	642	899	1,017	663
Direct investment, net	1,372	860	1,827	307	259	661	600	-372	234
Portfolio investment, net	-51	39	1,619	520	246	871	-18	76	58
Other investments	3,249	158	1,029	-58	58	188	840	397	-729
Trade credits	654	83	573	90	89	116	277	117	177
Loans	1,414	830	-413	-879	34	226	206	-20	-135
NBS	1,114	341	45	-4	52	-3	0	-4	0
Government	258	735	687	29	275	297	86	18	91
Commercial banks	894	626	-729	-691	-132	-10	104	-150	-358
Long-term	492	619	419	3	10	99	307	-84	-117
Short-term	402	6	-1,148	-694	-142	-109	-203	-66	-241
Other (enterprises)	-853	-872	-416	-214	-160	-58	16	115	132
Currency and deposits	760	-754	870	731	-65	-153	357	300	-770
Other assets and liabilities	0	0	0	0	0	0	0	0	0
Allocation of SDR	422	0	0	0	0	0	0	0	0
Reserves Assets (- increase)	-2,363	929	-1,801	-168	-33	-1,078	-523	916	1,100
ERRORS AND OMISSIONS, net	-124	96	219	117	56	42	4	163	60
OVERALL BALANCE	2,363	-929	1,801	168	33	1,078	523	-916	-1,100
PRO MEMORIA				in % of GDP					
Current account	-7.2	-7.4	-9.3	-10.3	-7.2	-8.5	-11.3	-17.0	-9.7
Balance of goods	-17.7	-17.1	-17.4	-18.2	-14.7	-15.8	-21.2	-22.4	-17.2
Exports of goods	20.6	26.5	27.0	28.0	26.5	26.9	26.8	26.8	30.9
Imports of goods	-38.3	-43.6	-44.5	-46.3	-41.2	-42.7	-48.0	-49.2	-48.1
Balance of goods and services	-17.6	-17.1	-16.9	-17.8	-14.5	-15.6	-19.8	-22.0	-17.2
Current transfers, net	12.1	12.0	10.1	9.1	10.4	9.6	11.0	8.3	10.3
GDP in euros ²⁾	28,966	27,956	31,203	6,976	8,155	8,051	8,022	6,919	7,400

Source: NBS

1) exports and imports f.o.b, according to NBS methodology adapted to IMF BOPM-5.

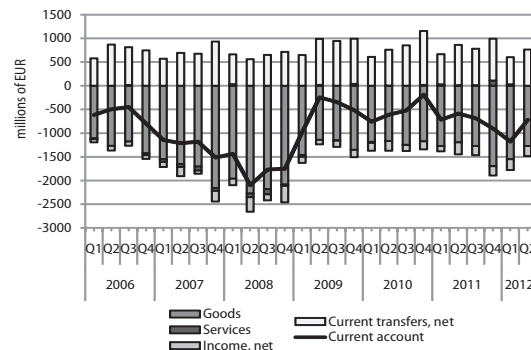
2) Quarterly values. Conversion of annual GDP in Euro based on average annual exchange rate (average of official daily NBS exchange rates).

Graph T4-2. Participation of current deficit in GDP, 2006-2012



Source: NBS, QM

Graph T4-3. Current Account and its Components, 2006-2012

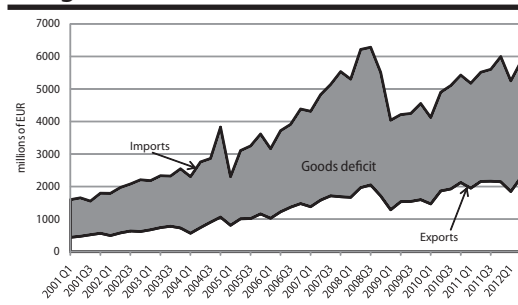


Source: NBS, QM

4. Balance of Payments and Foreign Trade

In Q2 goods were exported worth 2,283 million Euro or 30.9% of the GDP. That participation of exports in the GDP is significantly above the previous values of this indicator (2008: 22.7% GDP, 2009: 20.6% GDP, 2010: 26.5% GDP and 2011: 27.0% GDP, see Table T4-1). Bear in mind that to a greater extent the high percentage of the exports in the GDP is the result of the low level of the GDP in Euro due to the depreciation of the Dinar against the Euro. In Q2 a relatively high value of exports was achieved and stood 5.6% above the value of Q2 2011. Also, according to seasonally adjusted data exports are registering a constant growth and the value

Graph T4-4. Goods imports, goods exports and goods deficit 2001-2012



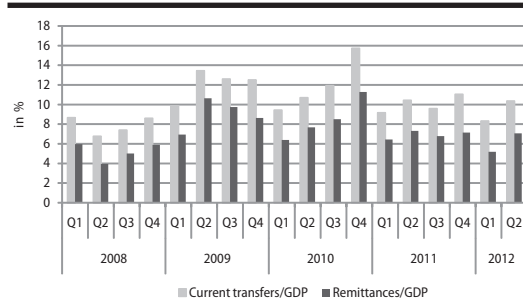
Source: NBS, QM

at the end of Q2 stood at 8.7% above the value achieved in Q1 2012. The recorded growth of exports is explained with the delayed effects of the depreciation of the domestic currency (which started at the end of 2011) and the realization of exports which could not be done during Q1 because of weather conditions¹. Imports in Q2 stood at 3,556 million Euro or 48.1% of the quarterly achieved value of the GDP. The y-o-y rise of imports is 5.9%. The rise in imports in Q2 – as in the previous quarter – caused the significant fiscal expansion which characterized the first half of the year.

Inflow of current transfers and remittances approximately at level of 2011 average and are higher than inflow in Q1 2012

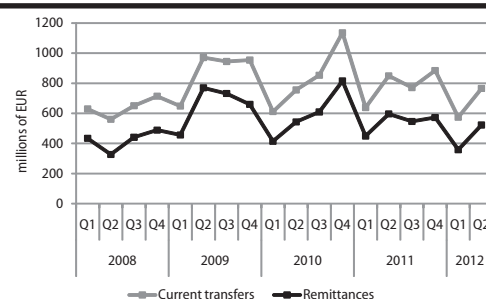
The net inflow of current transfers stands at 765 million Euro (see Graph T4-5 and Graph T4-6). Of that amount 523 million is inflow from remittances. Those values of the current transfers and remittances are slightly higher than the average of 2011 and significantly above the values registered in Q1 2012. The income account saw an outflow of 211 million Euro.

Graph T4-5. Participation of inflow of current transfers and remittances in GDP, 2008-2012



Source: NBS, QM

Graph T4-6. Inflow of current transfers and remittances 2008-2012



Source: NBS, QM

On one hand, the current drought, halt to production in "Železara Smederevo" steel plant, recession in the Euro zone and rise of world oil prices could contribute to the growth of the current deficit...

On the second half of 2012, on one hand we can expect the negative effect on exports in the coming period of bad weather conditions which characterized the current year – as well as the foreign trade and current balance. Namely, the extremely cold weather in February followed by a heat wave and drought in the summer will cause a smaller yield of the main export products: grains, fruit, vegetables and other.² Measures to limit exports of some agricultural products will not have any great effect on the balance of payments of Serbia but will affect the redistribution of income from farmers to industrial processing. Also, the further drop in exports can be expected with *steel and iron*, considering the temporary halt to production at the "Železara Smederevo" steel plant announced for the period from July to the end of September³. Also, if the trend of rising world fuel prices (as registered in July and August) continues in the coming period, it will contribute to the rise in the value of exports and that will have a negative effect on the Serbian

1 see. *Inflation report*, pp. 31.

2 According to initial assessments the corn and soy crop will be halved compared to last year's yield, while the sunflower and sugar beet harvest will be 20-40% lower than last year.

3 <http://www.zelsd.rs/index.php?link=news-view/1211/privremeno-zaustavljanje-proizvodnje-u-zelezari-smederevo>

...while start of export of FIAT automobiles, depreciation of domestic currency and fiscal consolidation should contribute to its reduction

balance of payments. The assessment is that the Euro zone will again fall into recession in Q4 which will probably significantly slow down domestic exports and lead to a rise in the foreign trade and current account deficit.

On the other hand, the lowering of the foreign trade (current) deficit will be influenced primarily by the export of FIAT automobiles. Also, we expect the depreciation of the Dinar – topical this year and late last year – will be reflected in the lowering of the foreign trade (including the current) deficit in the second half of 2012. Additionally, the coming budget amendments should bring some measures of fiscal consolidation which would lead to a drop in imports through a lowering of domestic demand and would help lower the balance of payments imbalance. The net effect of the global rise in food prices on the current deficit is unclear considering that the rise in food prices will be reflected in both export and import products of the domestic economy⁴.

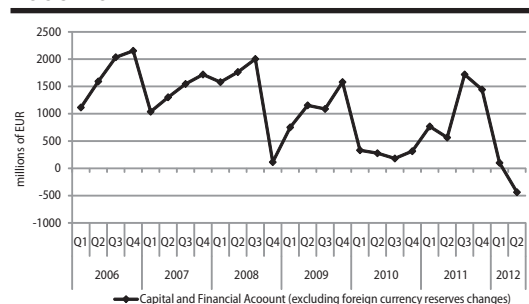
Based on the above, we expect the current deficit by the end of the year to stand at about 3 billion Euro, that is about 10% of the GDP. That means that – bearing in mind that the current deficit was 1.9 billion Euro in the first six months – the monthly amount need to finance the current deficit in the first half of 2012 will be between 150 and 200 million Euro. Bearing in mind also that the first half of the year saw a modest inflow of investments and a negative balance in financial credits, if there are no significant changes by the end of the year, the drop in foreign currency reserves used to cover the deficit could exceed a billion Euros. In that case, the lack of any significant inflow of funds in investments and commercial credits would mean that the alternative to the lowering of the NBS foreign currency reserves is more state debt abroad or a further depreciation of the domestic currency (which is less likely). The solution could be problematic considering the high level of foreign debt of the domestic economy (the foreign debt of the public sector at the end of Q2 reached 55% of the GDP and the level of Serbia's total foreign debt at 79% of the GDP⁵), and is made additionally difficult because of unfavorable conditions considering the recent lowering of Serbia's credit rating.

Q2 2012 sees net outflow of capital 437 million Euro

Q2 2012 saw a net outflow of capital of 437 million Euro⁶ (Table T4-1 and Graph T4-7). The outflow of capital is the consequence of a high negative value of Other investments (-729 million Euro, Table T4-1). The FDI stands at 234 million Euro, while portfolio investments in Q2 are modest and stand at 58 million Euro.

...primarily consequence of withdrawal of funds in Currency and deposits accounts and the net repayment of debts on the basis of financial credits due to the net repayment by banks

Graph T4-7. Capital and financial account, 2006-2012



Source: NBS, QM

The negative balance of other investments is primarily the consequence of the withdrawal of funds from *Currency and deposits* accounts to the value of 770 million Euro with the withdrawal of 627 million Euro in April alone. Of that amount, the largest part is the lowering of bank funds with the NBS due to the change of NBS regulations on mandatory foreign currency reserves introduced in April. Additionally, there has been a repayment of debts on the basis of financial loans due to bank repayments.

The net inflow on the basis of trade credits in Q2 stood at 177 million Euro. The net financial credits are negative (135 million Euro). Banks repaid debts to the value of 358 million Euro (117 million in long-term and 241 million Euro in short-term loans). On the other hand, the economy took out 132 million Euro in loans, including net debts in long-term loans totaling 130 million Euro.

Cumulative drop in foreign currency reserves since start of year 2 billion Euro

The cumulative drop in foreign currency reserves in Q2 is 1.1 billion Euro and the level of NBS foreign currency reserves is 2 billion Euro lower than the level at the end of 2011. The foreign

⁴ The world price of wheat late in July according to IMF figures stood 25.2% higher than at the end of June, while the price of corn rose 24.6% in the same period. Those prices are expected to rise further because of the drought in the USA and Eastern Europ as well as the price of corn used for the production of bioethanol.

⁵ see section *Foreign Debt* below.

⁶ Outflow stands at 377 million Euro with adjustment of account *Errors and Omissions*.

4. Balance of Payments and Foreign Trade

currency reserves were reduced by 725 million Euro in April, 402 million Euro in May, and in June a slight increase of 28 million Euro was registered. In April the drop in foreign currency reserves was mainly due to the changes in NBS regulations (lower rate used by banks to calculate the mandatory foreign currency reserve accompanied by an increase in rates for the mandatory foreign currency reserves of banks in Dinars). The bank withdrew 470 million Euro on that basis. Additionally, early in April banks withdrew the amount they voluntarily kept in March. In April, 210 million Euro of the foreign currency reserves were used to defend the value of the domestic currency. In May, the drop in foreign currency reserves was owed mainly to NBS interventions on the foreign currency market to defend the currency when it spent 473 million Euro. Interventions to defend the exchange rate in June were significantly lower than in April and May and stood at 107 million Euro⁷.

Exports

Exports in Q2 2012 stood at 2.28 billion Euro and recorded a rise of 5.8% y-o-y

Exports in Q2 2012 stood at 2.28 billion Euro. Viewed y-o-y exports recorded a rise of 5.8% following a y-o-y drop in the first quarter (- 5.2%, see Table T4-8). A positive contribution to the rise in exports came from *Capital products, durable and non-durable consumer goods* and products classed as *Other exports*. The y-o-y drop in value was recorded with *Intermediate products* and *Energy* (Table T4-8).

Table T4-8. Serbia: Exports, Y-o-y growth rates, 2010–2012

	Exports share in 2011	2010 ¹⁾	2011 ¹⁾	2011		2012		2012	
				Q1	Q2	Q1	Q2	Q1	Q2
	in %			mil. euros				in %	
Total	100.0	7,393	8,441	1,964	2,157	1,863	2,282	-5.2	5.8
Energy	3.7	344	309	63	117	64	86	1.5	-26.7
Intermediate products	47.5	3,399	4,009	986	1,071	833	995	-15.6	-7.1
Capital products	11.7	873	990	198	245	217	308	9.8	25.5
Durable consumer goods	4.1	320	347	75	90	79	101	5.6	12.3
Non-durable consumer goods	25.2	1,933	2,128	466	499	501	565	7.5	13.2
Other	7.8	525	658	177	135	169	228	-4.6	69.3

Source: SORS

1) data in millions of Euro, and y-o-y growth rate based on data from Statistical Office of the Republic of Serbia (SORS) calculated using new methodology. For details see QM 20, Box1. "Changes to foreign trade methodology used by the Statistical Office of the Republic of Serbia".

Value of exports 4,144 million Euro in first half of year

The value of exports in the first half of the year stood at 4,144 million Euro, which is 0.57% more than the value in the first half of the previous year. The greatest part of domestic exports – approximately a third of overall export activities – consists of: *Grains and grain based products, Electrical appliances, Iron and steel, Ferrous metals and Metal products*. The export of *Grains and grain based products* saw a significant y-o-y rise of 32.7% which is the result of last year's harvest and will probably, due to this year's unfavorable weather conditions, not be repeated next year. Also, a significant growth of exports in the same period was recorded in *Sugar, sugar based products* (21.3%) and *Cattle feed* (28.7%). On the other hand the exports of *Iron and steel* and *Ferrous metals* is significantly below last year's values standing at 54.8% and 26.0% respectively. The continued y-o-y drop in exports of these products is almost certain to the end of the year since even if a foreign investor appears soon, the first results can be expected next year at the earliest.

The low value of exports in Q1 can be explained primarily with the low foreign demand and unfavorable events in the Euro zone, unfavorable weather conditions in the country (extreme cold) and delayed effect of the real appreciation of the Dinar – recorded in mid-2011⁸. The certain recovery of exports in Q2 can be explained to a great extent with the effect of the depreciation of the Dinar and the realization of exports which could not be realized in Q1 because of the weather.

⁷ <http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=5897&konverzija=no>

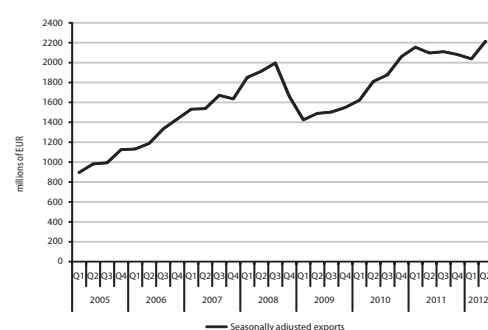
⁸ see QM 28.

In the second half of the year we expect to see a rise in export values based on the export of FIAT automobiles, the further positive effects of the current depreciation of the domestic currency on exports and a rise in world prices of some important export products for the domestic economy (corn, wheat ...). On the other hand, a negative effect on exports could be the result of this year's drought which could limit the potentials of the domestic economy to exporting food products. Also we expect a negative effect of the inactivity of the Smederevo steel plant on exports – which was felt in the first half of the year – and which will be especially evident in Q3 and Q4 bearing in mind the current halt to production.

In July, exports were 3.3% above the values in the same month of 2011

In July, exports stood at 761 million Euro and were 3.3% above the value in the same month of 2011. In the first seven months of 2012, goods were exported to the value of 4.9 billion Euro which is 1% more than the exports in the same period of the previous year. Exports to six countries – Germany, Italy, Bosnia-Herzegovina, Romania, Montenegro and Russia – totaled 2.66 billion Euro of domestic goods (about 55% of the total value of exports in that period).

Graph T4-9. Serbia: Seasonally adjusted exports, quarterly, 2005-2012



Source: NBS, SORS, QM

Seasonally adjusted values indicate a significant recovery of exports in Q2 2012. (Graph T4-9). Namely, following the big drop in 2008, exports began recovering from Q1 2009. This growing trend in exports was halted and turned around early in 2011 and the seasonally adjusted value of exports, with some oscillations, recorded a negative trend in 2011 and in Q1 2012. In Q2, the value of seasonally adjusted exports reached 2,213 million Euro, which is 8.7% above the values of Q1 2012.

Seasonally adjusted values show significant recovery of exports

Imports

Imports in Q2 5.9% higher than in Q2 2011

Imports of goods in Q2 stood at 3,682 million Euro. That is 5.9% higher than in Q2 2011. Energy imports were 12.9% lower than last year while other products saw a y-o-y growth. Imports without energy saw a more pronounced growth – at a rate of 10.1% y-o-y (Table T4-10). Although energy prices in Dollars in Q2 2012 were significantly lower than prices at the start of the year and stood 5.3% under Q2 2011 levels, a significant weakening of the Euro against the Dollar led to energy prices expressed in Euro standing 6.2% higher than last year. The y-o-y drop in value of energy imports in Q2 were solely due to a drop in amounts imported. That could be the consequence of higher oil exploitation in the country which in Q2 was significantly greater than exploitation the previous year (growth indexes compared to the average in 2011: in April 102.0, in May 110.1, in June 110.2)⁹. July and August saw rises in the prices of fuels which could have an unfavorable effect on the value of imports in Q3.

Table T4-10. Serbia: Imports, Y-o-y growth rates, 2010–2012

	Imports share 2011	2010 ¹⁾	2011 ¹⁾	2011		2011		2012	
				Q1	Q2	Q1	Q2	Q1	Q2
	in %			in mill. euros				in %	
Total	100.0	12,622	14,250	3,341	3,476	3,524	3,682	5.5	5.9
Energy	20.0	2,453	2,846	767	626	817	546	6.4	-12.9
Intermediate products	35.3	4,390	5,037	1,130	1,354	1,174	1,364	3.9	0.7
Capital products	19.7	2,336	2,807	664	671	608	684	-8.5	2.0
Durable consumer goods	2.3	373	321	69	75	79	86	15.2	15.0
Non-durable consumer goods	15.3	2,024	2,185	476	519	517	537	8.8	3.5
Other	7.4	1,046	1,053	235	231	329	465	39.8	101.2
Imports excluding energy	80.0	10169	11404	2,574	2,850	2,708	3,137	5.2	10.1

Source: SORS

1) date in millions of Euro, as well as y-o-y growth rate based on data from Statistical Office of the Republic of Serbia (SORS) calculated using new methodology. For details see QM 20, Box 1. "Changes to foreign trade methodology used by the Statistical Office of the Republic of Serbia".

9 Monthly statements by SORS (IH10).

4. Balance of Payments and Foreign Trade

Despite the fact that imports rose in Q2 – viewed y-o-y, the seasonally adjusted value of imports indicates a significant drop in the value of imports compared to the previous two quarters (Graph T4-11). Imports were 4.4% lower than the level of Q4 2011 and Q1 2012. Additionally, the Graph shows that imports continue to be significantly below pre-crisis values.

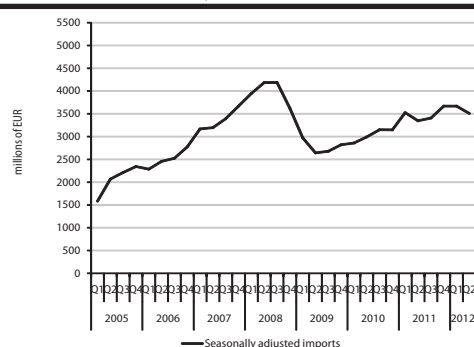
The high value and speeding up of imports early in 2012 was primarily influenced by high domestic demand stimulated by an expansive fiscal policy

We expect fiscal consolidation to act in the direction of lowering domestic demand and imports in the coming period

The value of imports since the start of the year stood at 7.2 billion Euro which is 5.7% over last year's value in the same period. The highest imports were of *Oil, oil derivatives and related products* and *Natural gas, Electrical appliances* as well as *Road vehicles*. The high value and speeding up of imports early in 2012 was primarily influenced by high domestic demand stimulated by an expansive fiscal policy. Additionally, the value of imports in Q1 was caused by last year's appreciation of the Dinar and the increased import of fuels due to extremely cold weather and relatively high prices of fuels in that period.

By the end of this year we expect the current rise in world prices (oil, food...) to be reflected on the rise in domestic imports. On the other hand, we expect certain desirable measures of fiscal consolidation to act in the direction of lowering domestic demand which would lead to a slowing down of imports and easing of the foreign trade imbalance. We also expect the current depreciation of the Dinar to de-stimulate domestic import demand in the coming period.

Graph T4-11. Serbia: Seasonally adjusted imports, quarterly, 2005-2012



Source: NBS, SORS, QM

In July, imports saw a rise of 4.2% y-o-y to stand at 1,255 million Euro. In the January to June period, goods worth a total of almost 8.5 billion Euro were imported or 5.7% more than in the same period of last year. Imports from Russia, Germany and Italy account for almost a third of the overall value of imports in that period.

Foreign Debt

Serbia's foreign debt at end of June 24.1 billion Euro, or 79.3% of GDP

Serbia's foreign debt at the end of June stood at 24.1 billion Euro or 79.3% of the GDP (Table T4-12). Compared to March 2012, the foreign debt was higher by two percentage points of the GDP (rising from 77.3% to 79.3% of the GDP) bringing it very close to the limit of 80% of the GDP. The rise in foreign debt in Q2 is solely the consequence of the growth of the foreign debt of the public sector (rose from 34.2% to 36.3% of the GDP). The foreign debt on the basis of the depreciation of the Dinar against other currencies in the structure of the foreign debt was 278.2 million Euro higher.

Although level of foreign debt in GDP did not vary significantly since the end of 2009, its structure changed significantly in favor of the public sector foreign debt

The level of the foreign debt has been at the same level close to 80% of the GDP for several years. More precisely, in December 2009 the foreign debt reached the level of 78% of the GDP, and after reaching the level of 85% of the GDP in December 2010 it dropped to 77% of the GDP at the end of 2011. Although the level of the foreign debt in the GDP did not vary significantly since the end of 2009, its structure changed significantly in favor of the public sector foreign debt. Namely, the public sector foreign debt at the end of 2009 stood at 34.5% of the overall foreign debt and at the end of June 2012 it rose to 45.8%. The public sector foreign debt in that period increased by 3.3 billion Euro (almost 10 percentage points of the GDP) while at the same time the private sector decreased its foreign debt by 1.7 billion Euro (8 percentage points of the GDP).

At the end of June the public sector foreign debt was 376.4 million Euro higher compared to the end of March 2012 while the private foreign debt was lowered by 358.4 million Euro in the same period. Of the total repayment of debt by the private sector 122 million Euro is repayment of long-term debts while the rest (237 million Euro) was repayment of short-term dues. The smaller amount of the short-term debt is solely the consequence of the decrease of short-term debts by banks.

That speed shows that the structure of the foreign debt continued changing in 2012 and the percentage of public sector foreign debt increased in the overall foreign debt. Additionally, those trends show that the structure of the foreign debt according to the original due date continues to improve thanks to the current short-term repayments that is a significant reduction of the short-term debts of banks.

By the end of the year the foreign debt could rise while maintaining the trend of growth in the public sector debt and repayments of the private sector. If the state takes out foreign loans to finance the deficit, the foreign debt could reach the level of 85% of the GDP at the end of 2012.

Table T4-12. Serbia: Structure of foreign debt, 2009–2012

			2011				2012	
	2009	2010	Mar.	Jun	Sep.	Dec.	Mar.	Jun
			stocks, in EUR millions, end of the period					
Total foreign debt	22,487	23,786	22,672	22,734	23,860	24,125	24,068	24,086
(in % of GDP) ²⁾	77.6	85.1	79.7	77.0	78.5	77.3	77.3	79.3
Public debt	7,764	9,076	8,861	9,138	10,433	10,773	10,655	11,032
(in % of GDP) ²⁾	26.8	32.5	31.2	30.9	34.3	34.5	34.2	36.3
Long term	7,762	9,076	8,861	9,138	10,433	10,773	10,655	11,032
o/w: to IMF	1,110	1,529	1,475	1,506	1,582	1,618	1,581	1,644
o/w: Government obligation under IMF SDR allocation	422	449	434	428	449	459	449	467
Short term	1	0	0	0	0	0	0	0
Private debt	14,724	14,710	13,811	13,597	13,427	13,352	13,412	13,054
(in % of GDP) ²⁾	51.0	52.6	48.6	46.0	44.2	42.8	43.1	43.0
Long term	12,720	12,880	12,696	12,630	12,569	12,704	12,834	12,712
o/w: Banks debt	2,597	3,362	3,347	3,413	3,551	3,782	3,784	3,754
o/w: Enterprises debt	10,123	9,518	9,348	9,217	9,018	8,922	9,050	8,958
Short term	2,003	1,830	1,116	966	858	648	578	342
o/w: Banks debt	1,713	1,731	1,036	895	785	582	515	275
o/w: Enterprises debt	290	100	79	72	73	66	63	67
Foreign debt, net ¹⁾ , (in% of GDP) ²⁾	41.0	49.3	44.8	43.2	41.1	38.7	41.7	45.8

Remark: Since September 2010, the methodology of statistics of the foreign debt has changed so that the public sector foreign debt include dues on the allocation of IMF SDR (466.8 million Euro), were used in December 2009 as well as the capitalized interest towards the Paris Club of creditors (50.9 million Euro) while the private sector foreign debt did not include loans taken prior to December 20, 2000 which are not paid (909.3 million Euro, including 426.3 million Euro with domestic banks, and 483.0 million Euro with domestic companies). Data on the foreign debt in the Table are based on the new methodology.

Source: NBS, QM

1) Overall foreign debt reduced by NBS foreign debt.

2) The sum of the values of the GDP of the monitored quarter and GDP values of previous three quarters was used.

The lowering of Serbia's credit rating early in August brought harder conditions in terms of foreign loans. The lowering of the credit rating of a state causes an increase in the expenses in taking foreign loans and limits the accessibility of new loans and foreign investments. The financing of domestic foreign and public deficits through non-commercial loans (for example from other states and similar) is not sustainable in the long term and should serve only as a temporary solution until favorable commercial conditions for loans are in place (which could happen after the signing of an agreement with the IMF and raising of the credit rating).

5. Prices and the Exchange rate

Q2 recorded a further acceleration of the inflation, to which the main contributor is the rise in the prices of food products, especially meat, fruit and vegetables. Furthermore, Q2 saw the increase in the year-on-year inflation rate (as the base effect keeping y-o-y inflation rate low was “exhausted”), thus the inflation rate in July exceeded the upper limit of the NBS target band. The underlying inflation (inflation excluding food, alcohol, tobacco and energy) began accelerating in June and July, probably as a consequence of the dinar depreciation “spillover”, fiscal expansion and the increases in the prices of food and energy. The inflation at the end of the year will, certainly, exceed the upper limit of the NBS target band (in December 2012, targeted inflation amounts to $4\% \pm 1.5\%$), and probably rise to double digit level (most likely between 10% and 11%). The Dinar depreciated throughout Q2, as well as over July and much of August. Depreciation against the euro, since the beginning of the year to September, amounted to about 12%. As a result of a nominal depreciation, the real exchange rate depreciated as well, but this movement was mitigated by the inflation in Serbia, much higher than in the EU. The real exchange rate against the euro depreciated by about 8%.

Prices

The inflation accelerated in Q2, compared to the previous quarter. The increase in the prices, during Q2, amounted to 3.2% (i.e. 13.2% when annualized), while in the previous quarter, it was 2.0% (i.e. 8.4% when annualized). July recorded slightly lower inflation of mere 0.1% (primarily due to a decrease in the prices of food and vegetables), thus, from the beginning of the year to July, the increase in the prices was 5.4% (Table T5-1).

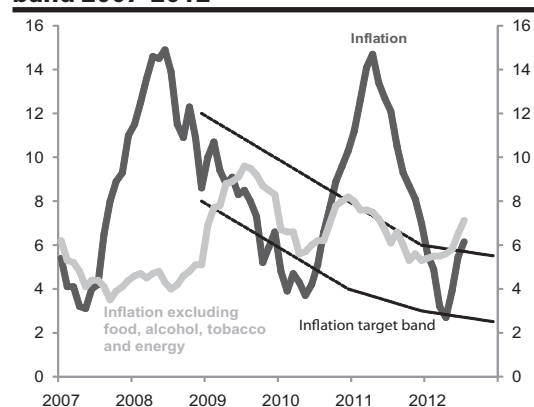
Table T5-1. Serbia: Consumer Price Index, 2007-2012

	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
may	160.5	4.0	4.1	1.4	13.0
jun	162.4	5.4	5.3	1.2	13.2
jul	162.5	6.1	5.4	0.1	11.0

Source: SORS

There was a significant increase, throughout Q2 and July, in the year-on-year inflation rate, which is now exceeding the upper limit of the NBS target band. Although it was already clear throughout Q1 that the monthly inflation rate will accelerate, y-o-y inflation rate continued its decline due to a base effect (i.e. due to a comparison with the extremely high inflation in the same period of the last year), so the y-o-y inflation was running at a record low level of a mere 2.7% in April. However, as of May, the base effect was “exhausted” (i.e. now, the y-o-y inflation rate is compared to the lower price growth in the previous year), rendering the y-o-y inflation rate rapidly grow. In June, y-o-y inflation rate was 5.5%, standing very close to the upper limit of the NBS target band, only to reach 6.1% in July, and thus exceeding the upper limit of the NBS target band (Graph T5-2).

Table T5-2. Serbia: Y-o-y CPI and Underlying inflation rate and NBS target band 2007-2012



Source: NBS

The y-o-y inflation rate will continue to grow in the following part of the year, and at the end of the year, inflation is likely to reach somewhat more than 10%. Given the announced increase in the prices of food (especially meat, but other food products as well), movement in the cereal prices (prices growth caused by the great drought), adjustments to the administratively controlled prices, which have not increased in the first part of the year (e.g. the prices of electricity, gas and certain drugs), as well as the expected increase in the VAT rate, it can be expected the inflation to reach somewhat more than 10% at the end of the year, most likely standing between 10% and 11% (with higher probability of exceeding 11%, than standing below 10%). In

the previous QM issue, we discussed the expectations that the inflation will be contained within single digits at the end of the year; however, since then, there has been a rise in the prices of petroleum products, as well as the increase in the food prices, significantly above the expected level.

The price increase in Q2 was mainly the result of the rise in the foodstuffs prices. Two-thirds of total inflation in Q2 resulted from the increased food prices, and this group showed the highest growth in the prices of meat, fruit and vegetables. All other groups of products and services had a much lower price growth and minor contribution to inflation (Table T5-3). Unlike Q2, July inflation stood very low (a mere 0.1%), primarily due to the seasonal cuts of the vegetable prices and stagnation in the prices of most other foodstuffs. The only significant price increase recorded in July refers to the price of the cigarettes (increased primarily due to the increase in the excise duty).

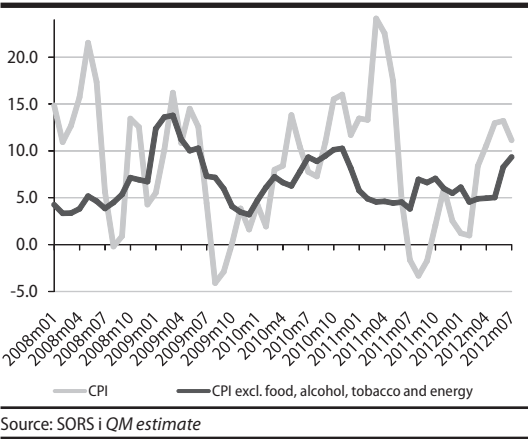
Table T5-3. Serbia: selected components of the Consumer Price Index and their contribution to inflation.

	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	3.2	3.2	2.0	2.0	-0.1	-0.1
Food and non-alcoholic beverages	38.8	5.8	2.2	2.0	0.8	-4.1	-1.6
Food	35.0	6.2	2.2	2.1	0.7	-4.8	-1.7
Alcoholic beverages and tobacco	5.4	0.6	0.0	5.0	0.3	-1.4	-0.1
Tobacco	4.0	0.0	0.0	5.8	0.2	-2.8	-0.1
Clothing and footwear	5.1	1.0	0.1	-0.7	0.0	3.7	0.2
Housing, water, electricity, gas and other fuels	16.5	0.8	0.1	1.5	0.2	2.3	0.4
Electricity	7.2	0.0	0.0	0.0	0.0	0.0	0.0
Furniture, household equipment, routine maintenance	4.4	3.9	0.2	2.1	0.1	5.8	0.3
Health	4.3	1.1	0.0	0.8	0.0	-0.4	0.0
Transport	10.5	2.2	0.2	5.7	0.6	3.1	0.3
Oil products	4.8	1.5	0.1	8.5	0.4	3.0	0.1
Communications	4.1	0.1	0.0	-0.5	0.0	5.4	0.2
Other items	11.0		0.3		0.1		0.2

Source: SORS and QM estimates

Underlying inflation that has been very stable over the first five months of the year showed the signs of accelerating in June and July (Graph T5-4). Underlying inflation (inflation excluding foodstuffs, alcohol, tobacco and energy) over the first five months of the year amounted to an average of 0.4% per month, or 5.2% when annualized. However, underlying inflation in July stood at 1.1%, and 0.8% in August, i.e. an average of 0.9% per month, or 11.5% when annualized. The acceleration of underlying inflation is likely the result of „spillover“ of the fiscal expansion and dinar depreciation, as well as the food and energy price increase. Due to the global scale of the drought, in the following 2-3 quarters, the prices of agricultural and industrial products are expected to increase, which, due to a high share of food in the costs of living, will significantly affect the increase of the inflation in Serbia.

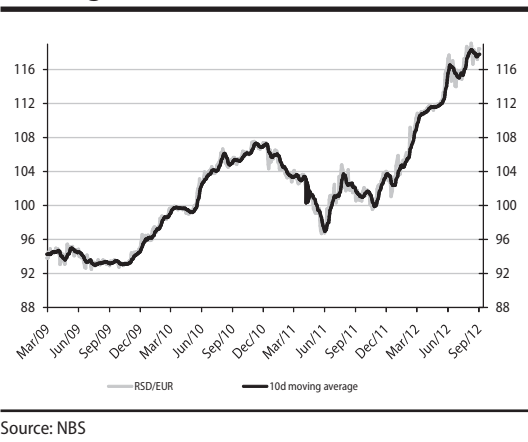
Graph T5-4. Serbia: CPI and Underlying Inflation Trend, Annualized Rates, in %, 2008-2012



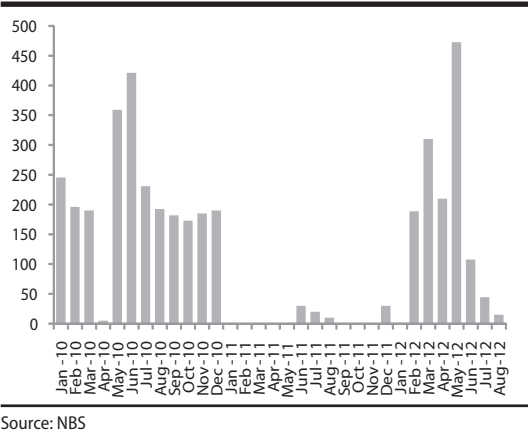
The exchange rate

The dinar has depreciated since the beginning of the year, thus the exchange rate against the euro, from the beginning of the year to September, weakened by about 12%. During Q2, dinar nominally weakened against the euro by 4% (Graph T5-5). July and early August saw accelerating depreciation, making the dinar additionally decrease by nearly 3% in less than month and a half. In the mid-August, NBS decided to increase the share in the dinar portion of allocations of the foreign exchange required reserve. In addition, NBS, in the period from May to August, increased the reference interest rate by a total of one percentage point (from 9.50% to 10.50%). These measures contributed the dinar depreciation trend to halt in the mid-August for the moment. NBS in April and May carried out considerable interventions in the foreign exchange market (record high 473mn Euros were sold in May, see previous QM issue), but as of June 1st (when NBS sold 89.1mn Euros) there hasn't been any serious direct NBS intervention.

Graph T5-5. Serbia: Daily RSD/EUR Exchange Rate, 2009-2012



Graph T5-6. Serbia: NBS intervention, sale of foreign currency, Monthly averages, millions of Euros 2010-2012

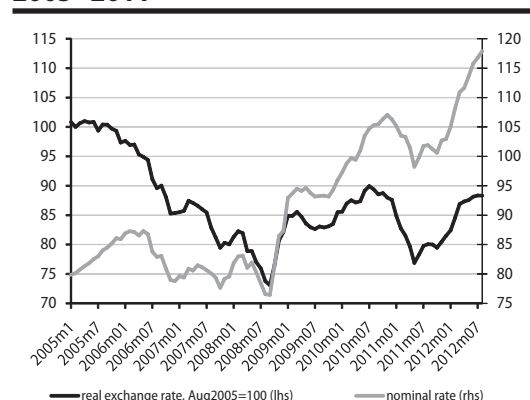


During Q2, the real exchange rate of the dinar against the Euro depreciated by 1.5%. From January to August, the real exchange rate depreciated against the euro by about 8%. Lower depreciation of the real than the nominal exchange rate is the consequence of the inflation being quite higher in Serbia than in Eurozone (from the beginning of the year to August, inflation in Serbia amounted to 6.5%, and in the Eurozone, it was mere 0.9%). However, despite the additional depreciation, the real exchange rate against the euro is still not the lowest since the beginning of the crisis, as it remains stronger than the July level of the year 2010. Namely, the real exchange rate from July 2010 to May 2011, appreciated by nearly 15%, and although it has been steadily depreciating since, only now does it return near the level of July 2010 (Graph T5-7).

The main initiator of the dinar depreciation in the previous part of the year was a high imbalance in the balance of payments in Serbia (see the section on Balance of Payment in Serbia). The demand for foreign exchange was significantly higher than the supply, both on the basis of the deficit in the current account and the capital outflows from Serbia. Imbalance between supply and demand for foreign exchange was partly financed by spending the foreign exchange reserves, while the dinar depreciation decreased the imbalance. The movements at the foreign exchange market by the end of the year are quite unpredictable, thus it is difficult to assess the exchange rate trend. The rest of the year is expected to see the continuation of the deficit reduction in the current account balance, but the movements in the capital balance are quite uncertain.

The crisis in the EU, but as well Serbia's credit rating drop and the lack of the agreement with the IMF, will affect the reduction in the income of the private capital, and the possibility of its outflow is not excluded. However, it is possible that, in the next few months, the state is to provide foreign currency loans (bilateral and commercial) for financing the fiscal deficit and debt refinancing (foreign and local currency), which would increase the supply of the foreign currency. The increase in the supply of the foreign currency, based on the government debt, can temporarily provide the exchange rate stability, or even its appreciation. Nevertheless, the more permanent exchange rate stability is impossible without a re-growth of the private investments in Serbia, and for that, it is necessary to renew the confidence of commercial investors in the solvency of the state and external liquidity of the country.

Graph T5-7. Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly averages, 2005–2011



Source: NBS, SORS and QM estimate
Note: an increase represents depreciation

6. Fiscal Trends and Policy

In Q2 2012, the consolidated fiscal deficit stood at 56.1 billion Dinars (about 6.7% of the quarterly GDP). The consolidated fiscal deficit at the level of the first half of the year stood at 110 billion Dinars (about 6.9% of the half year GDP). The deviation from the planned deficit is primarily the consequence of the strong growth of public spending compared to the planned amount and dynamics as well as the fact that in 2012 there will be a slight drop in economic activity instead of the slight rise which has a negative effect on trends in public revenues. Considering that months after the elections a plan of fiscal consolidation has not been adopted and implemented, if the macroeconomic and fiscal trends continue from the first half of the year, the estimate is that the consolidated fiscal deficit in 2012 will stand at about 6.5% of the GDP. As a consequence of the high fiscal deficit in Q2 and the intervention of the state to stabilize the banking sector, the public debt at the end of that quarter stood at about 54.9% of the GDP (at the end of July – 56.3% GDP). If the existing trends continue, the assessment is that the public debt will stand at around 60% GDP by the end of 2012. Without a quick implementation of a credible plan for fiscal consolidation there is a high degree of risk of a debtor crisis in a relatively short period. Even if certain measures of fiscal consolidation are implemented in the final quarter of 2012, it will not be possible to achieve a significant lowering of the fiscal deficit in the current year. However, with an appropriate plan of consolidation, which would primarily include savings on large categories of current public spending and to a lesser extent on increasing certain taxes, a significant decrease of the fiscal deficit could be achieved next year.

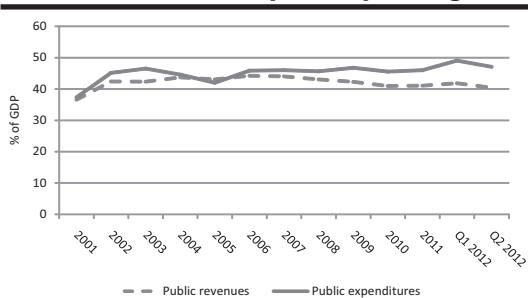
General tendencies and macroeconomic implications

Consolidated fiscal deficit in Q2 stood at 56.1 billion Dinars (about 6.7% of quarterly GDP)

The consolidated fiscal deficit in Q2 2012 stood at 56.1 billion Dinars, or about 6.7% of the quarterly GDP, which is about 21 billion Dinars higher than the planned deficit (agreed with the IMF). The achieved compared to the planned fiscal deficit is to a great extent the consequence of the rise in public expenses above the planned and the fact that instead of a moderate growth of the GDP, 2012 will see a drop in economic activity by 1%, which has a negative effect on the public revenue. On the other hand, the negative effect of the slowing down of economic activity at the level of public revenue was partly compensated by the increase in the absorption gap (deviation of the real deficit of the current account balance of payments from the equilibrium level) which led to a growth of revenues from VAT and customs. However, the assessment is that the second half of the year will see a lowering of the absorption gap (due to the slowing down of imports and/or growth of exports) and these positive effects on the level of public revenue are expected to decrease so that the overall (negative) effect of the drop in economic activity on the level of public revenue will be greater.

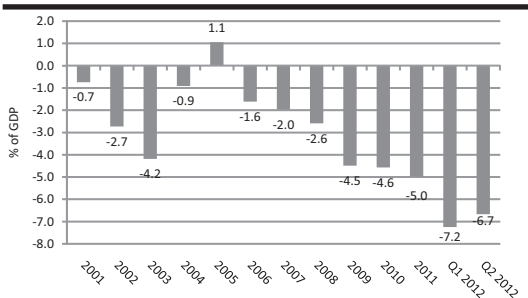
The overall fiscal deficit in the first half of 2012 stood at 110.3 billion Dinars or about 6.9% of the half year GDP. If the existing macroeconomic trends continue and without the implementa-

Graph T6-1. Serbia: Consolidated public revenue and public spending



Source: QM Calculation

Graph T6-2. Serbia: Consolidated fiscal balance



Source: QM Calculation

Slight rise in public revenue is insufficient to compensate strong growth of public spending

tion of measures for a strong fiscal consolidation we expect the consolidated fiscal deficit in 2012 to stand at about 210 billion Dinars (about 6.5% of the GDP) which is more than 2% of the GDP higher than planned.

The deviation of the fiscal deficit from the planned is the consequence of significantly faster rise in public spending compared to revenue growth.

The trend of a moderate real growth of public revenue continued in Q2 both compared to the previous quarter and compared to the same period of the previous year with the growth in Q2 somewhat slower than in the previous quarter. Because of significant oscillations in trends in public revenue and public spending in Q1 and Q2 caused by political and economic reasons, an evaluation of fiscal trends requires an observation of their movement at the level of the entire first half of 2012. We noticed that the real seasonally adjusted public revenue in the first half of 2012 rose slightly compared to the second half of 2011. The assessment is that the rise in revenues is the consequence of a growth of the physical level of imports and its real value which came about because of a strong depreciation of the Dinar from the start of the year, intensified state efforts to collect taxes and social contributions on employee salaries and the effects of once-off factors. Despite the moderate growth of real seasonally-adjusted public revenue, their amount continues to be lower than planned, primarily because of unrealistic assumptions about GDP trends and macroeconomic tax bases in 2012 which the budget for that year was based on and because of somewhat stronger recession tendencies in the global and domestic economies in the first half of 2012. As we said, the increase of the absorption gap partly eased the negative effects of the recession trends on public revenue, but that cannot be expected to happen in the coming period since the absorption gap is expected to decrease.

Following the strong growth recorded in Q1, the real seasonally-adjusted public expense dropped slightly in Q2 compared to the previous quarter. The described dynamics of public spending is the consequence of the election cycle, since all of Q1 was the pre-election period which saw a strong rise in current public spending, which made the basis for comparison in Q2 high and also in the second half of Q2, following the end of the elections, there was a slowing down in public spending trends. That trend in public spending in Q2 is the consequence of a moderate growth in expenses for employees, pensions, purchase of goods and services and other current expenses, a significant drop in capital expenses and expenses for subsidies and a moderate drop in all other categories of public spending. Viewed from the level of the first half of the year, the real seasonally-adjusted public expenses recorded a significant growth compared to the second half of the previous year. The rise in expenses for subsidies is the consequence of the political (election) cycle, which caused a speedier implementation of certain subsidy programs. The rise in expenses for goods and services and for employee salaries was considerably triggered by redistribution of revenues from wage tax in favor of local government, which allowed them a significant increase in allocations for those purposes, especially in the pre-election period. From the perspective of the annual fiscal deficit, the fact that the rise in expenses in the first half of the year (especially in Q1) is a once off thing and has no lasting character (for example early payments of subsidies) is assessed as favorable and we can expect them to slow down in the rest of the year. On the other hand, there is a risk of the introduction of new subsidies (because of the drought, for liquidity loans for the economy and similar) which would, without the implementation of compensating measures in the form of reducing other subsidy programs, which were not announced, lead to the overall expenses for subsidies being higher than planned in 2012.

6. Fiscal Flows and Policy

Table T6-3. Serbia: Consolidated General Government Fiscal Operations¹⁾, 2008-2012

	2008	2009	2010	2011	2012		
					Q1	Q2	Q1-Q2
I TOTAL REVENUE	1145.9	1,147	1,223.4	1302.5	312.6	339.8	652.4
II TOTAL EXPENDITURE	-1195.7	-1247.9	-1,329.9	-1435.9	-362.1	-390.3	-752.4
III "OLD" DEBT REPAYMENT, NET LENDING AND RECAPITALIZATIONS	-19.1	-20.4	-29.9	-24.9	-4.7	-5.6	-10.3
IV TOTAL EXPENDITURE, GFS (II+III)	-1214.8	-1268.3	-1,359.8	-1460.8	-366.8	-395.9	-762.7
V CONSOLIDATED BALANCE (I+IV), GFS definition ³⁾	-68.9	-121.8	-136.4	-158.2	-54.2	-56.1	-110.3
VI ACCOUNT BALANCE CHANGE	-55.4	45.4	-19.2	187.7	-19.9	-22.4	-42.3
VII PRIMARY BALANCE	-46.5	65.6	-102.2	-113.4	-38.8	-42.7	-81.5

Source: Table P-10 in Analytical 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).

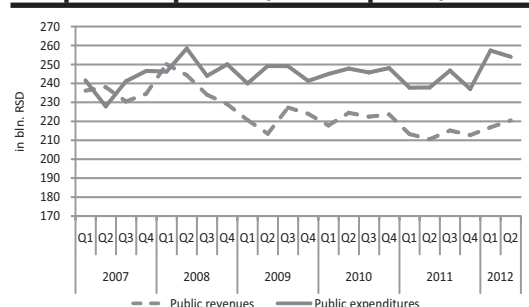
2) The item corresponds to the item "Net acquisition of financial assets for policy purposes" in the PFB (in accordance to GFS 2001), i.e. to the item "net lending" or "lending minus repayment" in the IMF presentation (i.e. GFS 1986). It comprises loans to students, financing of the National Corporation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

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

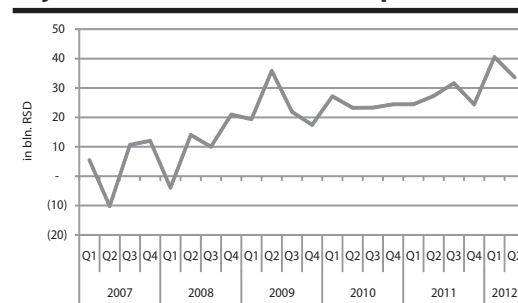
Analysis of dynamics and structure of public revenues and public expenses

Consolidated public revenues continue slight rise in Q2

The consolidated seasonally-adjusted real public revenue in Q2 2012 were 1.7% higher compared to the previous quarter and the real rise in public revenue (of 3.3%) was registered in comparison with the same period of the previous year.¹ The rise in consolidated public revenues in Q2 was recorded in almost all basic types of public revenues. Viewed from the level of the first half of 2012, the real seasonally-adjusted public revenues grew by 2.2% compared to the second half of the previous year, primarily because of the significant growth of revenues from VAT on imports, corporate income tax and a moderate rise in income from labor taxes.

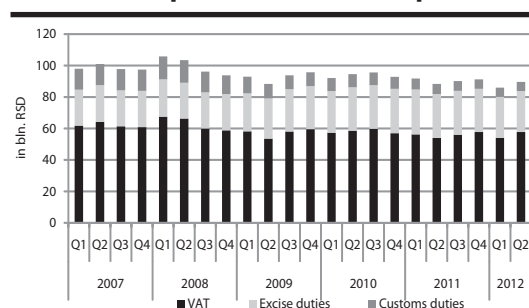
Graph T 6-4. Serbia: Consolidated seasonally-adjusted real public revenues and public expenses (in 2006 prices)

Source: QM Calculations

Graph T 6-5. Serbia: Real seasonally-adjusted fiscal deficit (in 2006 prices)

Source: QM Calculations

Revenues from consumption taxes are rising

Graph T 6-6. Serbia: Trends in real consolidated seasonally-adjusted revenues from consumption taxes (in 2006 prices)

Source: QM Calculations

The overall real seasonally-adjusted revenues from consumption taxes (VAT, excise duties and customs duties) in Q2 2012 rose compared to the previous quarter, with the revenues from VAT showing a significant growth while the real seasonally-adjusted revenues from excise duties stagnated (compared to Q1). Viewed at the level of the entire half of the year, the real seasonally-adjusted revenues from VAT recorded a slight growth (primarily VAT on imports), while the income from both excise duties and customs duties saw a moderate drop compared to the second half of the previous year.

1 Data in y-o-y real growth of consolidated public revenues, consolidated public expenses, according to economic classification, are given in Annex 1, while the data in the absolute amount of nominal public revenues and public spending is given in Annex 2.

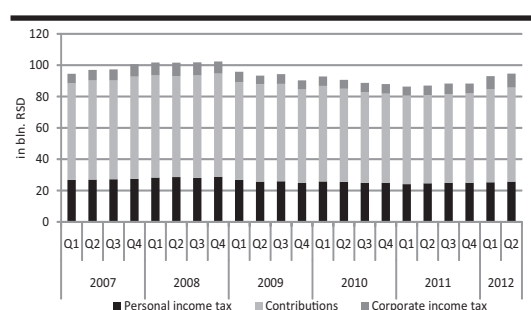
The rise in revenues from VAT is the consequence of an increase in the absorption gap, since imports are VAT taxable, while exports are VAT exempted. However, since the coming period is expected to see a lowering of the current account deficit in the balance of payments, and consequently a drop in the absorption gap, the assessment is that the rise in revenues from consumption taxes, paid on imports is temporary and will decrease with time.

Q2 saw a speedier growth of the real seasonally-adjusted revenues from VAT, which were 2.8% higher than in Q1, while the real revenues from VAT compared to the same period of the previous year were 1.5% higher and similar trends continued in July.² Namely, although Q2 saw negative trends continue in economic activity, there was also a change of structure of the GDP, in favor of increased imports and lower exports, which had a positive effect on VAT revenues. The re-balancing of the economy, contrary to the processes in 2009 and 2010, following the first wave of the crisis, is the consequence of the growth of the physical level of imports, and especially its Dinar value caused by a strong depreciation of the Dinar. The conclusion that the rise in VAT revenues in Q1, and especially in Q2, is the consequence primarily of growth of imports, is confirmed by the data on trends in VAT revenues on domestic consumption and imports. The real seasonally-adjusted VAT revenues paid on imports in the first half of 2012 is 7.1% higher compared to the previous six month period while the real seasonally-adjusted revenue from domestic VAT (paid on supply of domestic goods and services) is lower by 13.1%, compared to the second half of the previous year. Although that change in the foreign exchange is favorable from the point of view of public revenue, it is assessed to be extremely unfavorable from the point of view of long-term economic growth and the balance of payments equilibrium of the country and as such is not sustainable in the long term.

The real seasonally-adjusted revenues from excise duties in Q2 almost stagnated compared to the previous quarter. It is assessed that the stagnation of revenue from excise duties in Q2 is the result of lower consumption of products subject to excise duties, a lowering of duties on oil products early in May 2012 and the fact that the deadline to pay duties for the second half of June fell over a weekend, which meant that some of those dues were paid early in July, and a reduction of maneuvering space for tax evasion through the introduction of duties on heating oil.

For the first time after two years, the real seasonally-adjusted revenue from customs duties did not record any significant drop compared to the previous quarter, but was at almost the same level in Q2 as in Q1, which is the consequence of a growth of imports and the depreciation of the Dinar against the Euro.

Graph T 6-7. Serbia: Trends in real consolidated seasonally-adjusted revenues from taxes on production factors (in 2006 prices)



Source: QM Calculation

context, starting from July 1, 2012 an obligation was imposed on banks to report to the Tax Administration on salaries paid at a daily level, which allowed for more efficient control by the

The real seasonally-adjusted revenues from taxes on personal income and social security contributions in Q2 rose moderately compared to Q1 (by 1.8% and 1% respectively), and a moderate growth was recorded in the entire first half of 2012 compared to the previous six month period. The growth of revenues from taxes on production factors is the consequence of a growth of wage bill, which came about because of a regular indexation of salaries in the public sector in April and because of an extraordinary increase in salary payments for employees especially at local level. Besides that, from the start of 2012 the government stepped up its efforts to collect social security contributions. In that

² The assessment of the growth rate for real seasonally-adjusted revenue from VAT in Q2 compared to Q1 2012 was completed following the transfer of 4 billion Dinars from January 2012 to December 2011, because of a technical delay in refund of VAT in December 2011, which QM 28 wrote about.

6. Fiscal Flows and Policy

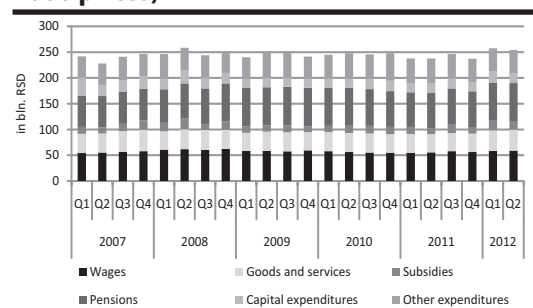
government. At the same time, there were statements that in that context further reforms of the system of collecting personal income tax and social contributions would be introduced along with the stipulation preventing banks from paying salaries without orders to pay the accompanying public revenues. The preliminary assessments on revenues from social contributions in July 2012 showed that the new measures did not lead to a significant increase in collecting them (the real seasonally-adjusted revenues from social contributions rose in July by 1% compared to June) and that a wider range of measures should be drawn up and implemented to raise the level of collection of social contributions (increasing the frequency of controls by the Tax Administration, raising fines, simplifying the system of paying contributions, etc). Also, the assessment is that the failure to collect taxes and contributions is to a great extent the consequence of insolvency of companies and entrepreneurs which cannot operate at a profitable level if they paid those charges in full in the given conditions. That is why the improvement of competition and productivity of the economy is also a vital condition to lower the rate of labor taxes evasion.

In Q2, the trend of a strong growth of real seasonally-adjusted revenues from corporate income tax continued, since they were 7.4% higher than in the previous quarter. The growth of income from corporate income tax is explained among other things with the fact that some of biggest public companies and companies in which the state is co-owner (such as the EPS and NIS) had relatively high profits in 2011 and their advance payments of corporate income tax in 2012 were

also increased. The estimate is that the rise in profits in 2011 and the subsequent rise in income from corporate income tax in 2012 is temporary because it was caused by an appreciation of the Dinar in 2011 (that is positive exchange rate differences on that basis). The assessment is that if the current macroeconomic trends continue without changes in the parameters of those taxes, 2012 and the next year will see a drop in income from corporate income tax.

Following a slight rise in Q1, the real seasonally-adjusted other tax and non-tax revenues saw a higher growth in Q2 compared to the previous quarter.

Graph T 6-8. Serbia: Trends in consolidated seasonally-adjusted public expenses (in 2006 prices)



Source : QM calculation

Public spending slows in Q2

The real seasonally-adjusted expenses of the consolidated government sector in Q2 2012 dropped by 1.3% compared to the previous quarter with the drop being most pronounced in expenses for subsidies and capital expenses. The drop in expenses in Q2 compared to Q1 is the consequence of the fact that they grew strongly in Q1, which raised the basis for comparison. Compared to the same period of the previous year, the consolidated public expenses in Q2 2012 rose in real terms by 9.5%.

At the level of the first half of 2012 the real seasonally-adjusted public spendings rose by 5.7% compared to the second half of 2011 primarily because of the rise in expenses for subsidies, goods and services and employee salaries.

Expenses for goods and services, for employees, for pensions and other current expenses are rising

Expenses for the purchase of goods and services (real, seasonally-adjusted) in Q2 were 1.9% higher compared to Q1, which is especially significant bearing in mind the fact that this category of expense saw a strong growth (of almost 12%) in the previous quarter. The estimate is that the rise in expenses for goods and services is to a great extent the consequence of the redistribution of revenues from wage tax in favor of local government, which allowed them to raise the spending for those purposes indicating an increase of the non-productive spending of public revenues.

Expenses for employees and for pensions (real, seasonally-adjusted) rose slightly in Q2 by 1.4% and 1.2% respectively compared to the previous quarter, primarily because of a regular indexation of those expenses in April by 3.5%, but also due to a special increase in expenses for salaries at the local level. Also, the real growth of expenses for employees (by 6.4%) was recorded in Q2

compared to the same period of the previous year, which is the consequence of a regular indexation of salaries, the introduction of a regular monthly payment of pay supplement of 10,000 Dinars a month for all employees in the police starting from the second half of the previous year, and a special and uncontrolled increase in salaries at the local level.

The most pronounced growth in Q2 was recorded with other current expenses which grew by 10.2% compared to Q1 (real, seasonally-adjusted).

Subsidies and capital expenses drop strongly

Following the strong growth in Q1, the real seasonally-adjusted expenses for subsidies recorded a strong decline of 17.2% in Q2 compared to Q1. That drop is the consequence of the fact that in Q1, because of the election cycle, certain subsidy programs were implemented early and speedily (for example for agriculture) in amounts planned for the whole year. Since new subsidy programs were introduced in the meantime (to deal with the consequences of the drought, for liquidity, etc.) without reducing the existing programs, the assessment is that there is a significant risk of the overall expenses for subsidies in 2012 exceed the planned amount. Since the new subsidy programs were socially and economically justified to a great extent, with the overall amount of expenses for subsidies in Serbia standing very high (compared to the countries of the region and EU member states), the estimate is that the introduction of these subsidy programs should be accompanied with a reduction of other existing subsidy programs (for example for investments and employment, etc).

Following the rise in Q1, the real seasonally-adjusted capital expenses drop significantly in Q2 (by 11.9% compared to the previous quarter). The reduction of the capital expenses in Q2, which is assessed as very unfavorable, is the consequence of the fact that in Q1 a part of the arrears brought forward, from previous quarters were settled, which makes the basis for comparison in Q2 higher and the fact that because of the big fiscal deficit and possible liquidity crisis, the priority in realization was given to current expenses (for salaries, pensions, goods and services), which led to a postponing of realization and payments for the purchase of capital goods.

...while expenses for interest payments drop slightly

The seasonally-adjusted expenses for interest payments in Q2 dropped in real terms by 1.3% compared to Q1. The slight drop in expenses for interest payments could be the consequence of the dynamics of debts maturity. Since the level of public debt in Serbia is growing in continuity and greatly and new loans are taken out at higher interest rates than the average interest rate on the existing government debt (due to the growing debt of the government, the lack of a credible plan for strong fiscal consolidation) with a depreciation of the Dinar against other foreign currency, the assessment is that a rise in expenses for interest payments can be expected in the coming period.

Analysis of fiscal trends at different levels of the government

Revenues at local level rising much faster than at other levels of government

The disaggregated fiscal data by level of the government show divergent trends in public revenue and public expenses at different government levels. Of all three relevant levels, only revenues at local level recorded a strong growth in real terms in Q2 compared to the same period of the previous year (by 31.4%), while revenues of the Republic budget dropped gradually (-0.2%). At the same time revenues of the Republic Health Care Fund (RFZO) rose moderately (3.7%) compared to Q2 2011. The growth of revenue at the local level, much more quickly than the rise in expenses from the consolidated budget, was achieved primarily on the basis of redistribution of revenues from wage tax, from the Republic budget to local government budgets. Also, there is a moderate growth in real terms of the local authorities revenues from property taxes, which could indicate greater efforts by local public revenue offices on a more realistic assessment of the basis for the calculating of those taxes.

...which leads to a strong growth in current public spending at local level

On the other hand, public expenses at local level in Q2 rose significantly faster than expenses at other levels of the government and compared to the overall consolidated public expenses. The rise in expenses at local level covers mainly the increase in salaries, growth of expenses for the purchase of goods and services, subsidies and social security. Unlike previous quarters, Q2 recorded a rise of capital expenses.

6. Fiscal Flows and Policy

Fiscal decentralization led to rise of consolidated fiscal deficit in Q1 and Q2 2012 by about 15 billion Dinars.

The rise in expenses to purchase goods and service could be the consequence of settlement of arrears, created by the local governments in previous periods, which is seen as desirable. However, since those expenses have shown strong growth for the third quarter in a row, this could possibly be a lasting increase in the spending of funds for goods and services. Besides that, a significant rise in expenses on employees and subsidies for the third quarter in a row indicated that there is a risk for additional funds from wage tax being used for a permanent increase in public spending. In that case, the consolidated fiscal deficit would increase by the entire sum of the redistributed revenues from wage tax, which at the level of the first half of the year 2012 stands at about 15 billion Dinars. To reduce the negative effect of fiscal decentralization on the revenue side, at the level of the consolidated fiscal deficit, the recommendation is to return at least a part of the revenues from wage tax to the central level or to transfer part of the functions from Republic to local level.

Table T6-9. Serbia: Rate of real y-o-y growth of public revenue and expenses at all level of power

	Q2 2012/Q2 2011			
	Consolidated budget	Budget of the Republic	Health insurance fund	Local self-governments
A Total public revenues (I)+(II)	4.8	-0.2	3.7	31.4
I Current revenues (1)+(2)	4.5	-0.7	5.4	39.1
1. Tax revenues	5.3	0.3	5.7	52.4
1.1. Customs	-8.6	-8.6	-	-
1.2. Personal income tax	4.6	-48.3	-	74.6
1.3. Corporate income tax	39.9	34.0	-	-
1.4. VAT	6.9	6.9	-	-
1.5. Excise duties	-3.0	10.0	-	-
1.6. Property taxes	12.7	-	-	12.7
1.9. Other taxes	7.6	-5.7	-	7.9
1.10. Social security contributions	6.1	-	5.7	-
2. Non-tax revenues	-1.1	-7.8	-21.6	8.3
II Capital revenues	270.4	208.0	96.4	2,356.3
III Transfers from the other levels of government	0.0	-	-0.5	1.4
B Total public expenditures (I)+(II)+(III)	9.0	6.1	0.7	23.5
I Current expenditures	9.0	9.8	0.7	20.6
1.1 Wages	6.3	7.7	2.1	12.8
1.2 Social contributions on behalf of employer	15.1	27.2	-2.2	31.2
1.3. Goods and services	6.6	6.1	-352.1	57.9
1.4 Interest payments	56.4	65.9	-	29.8
1.5 Subsidies	2.2	-21.4	-8.5	13.6
1.6 Social insurance and social assistance	0.0	9.4	-	-
1.7 Transfers to the other levels of government	37.1	53.3	-	2.3
1.8 Other current expenditures	9.4	-14.8	-	35.4
II Capital expenditures	0.0	-27.7	-	57.4
IV Net lending	-45.7	-54.2	-	-41.0

Source: QM Calculation

Analysis of public debt trends

Serbia's public debt at the end of Q2 stood at 15.3 billion Euro (54.9% GDP)

According to official data from the Finance Ministry, Serbia's total foreign debt stood at 15.3 billion Euro which is about 660 million Euro more than at the end of Q1. The estimate is that the public debt at the end of Q2 stood at about 54.9% GDP.³ Figures for July show that at the end of that month the public debt was higher by 190 million Euro, amounting to 56.3% of GDP. The rise in public debt in Q2 is, to a great extent (about 490 million Euro) the consequence of the rise of public debt by 190 million Euro so that it stood at 56.3% of the GDP. The growth of public

³ Calculated against the sum of the GDP in Q2 and the previous three quarters.

debt in Q2 is mainly (along with 490 million Euro) is the consequence of a fiscal deficit in Q2, depreciation of the Dinar and the drop in the real GDP.

Also, the growth of the public debt in Q2, besides the fiscal deficit, was caused by the government intervention to stabilize the banking sector (forming of New Agrobanka, help to the Vojvodina development bank and similar) to the extent of some 150 million Euro. The funds for those purposes can be recorded as expenses that is part of the fiscal deficit at the time those funds are paid (e.g. when the government issued bonds and paid the funds into the New Agrobanka capital) or at a moment when liabilities on the basis of issued bonds are paid. Whichever of those two approaches are used, they will lead to a growth in the public debt at the moment of borrowing. Regardless of the accounting treatment of those transactions, these are one-off expenses, which do not lead to a permanent increase in public spending and fiscal deficit, which is why those expenses should not be taken into consideration when assessing the scale and effects of the fiscal consolidation measures.

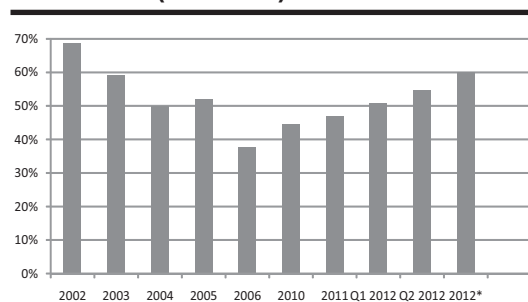
Table T6-10. Serbia: Public debt 2000-2012

	Amount at the end of period, in billions EUR										
	2000	2005	2006	2007	2008	2009	2010	2011	Q1 2012	Q2 2012	31.07.2012
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	12.36	12.46	12.94	13,070.00
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	5.33	5.55	5,592.30
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	7.14	7.39	7,477.70
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.15	2.34	2,399.70
III. Total debt (I+II)	14.17	10.28	9.38	8.88	8.78	9.85	12.17	14.47	14.62	15.28	15,469.70
Public debt / GDP	169.3%	50.2%	36.2%	29.4%	25.6%	31.3%	41.5%	45.07%			
Public debt / GDP (QM)	169.3%	52.1%	37.8%	30.9%	29.2%	34.8%	44.6%	46.9%	50.9%	54.9%	56.3%

Liabilities related to guarantees are rising

The new government debt in Q2 was almost equally distributed to domestic and foreign sources. Also, following the slowing down in Q1, there was a strong growth of guaranteed debt (increase by 190 million Euro in Q2). Since the estimate is that the annual increase in debt related to issued guarantees should not exceed 0.6% of the GDP, a strong growth in guarantees for the first half of the year (about 230 million Euro) is viewed as unfavorable, especially in the context of the fact that transparency and control of use of these funds by the parliament and the public is smaller. Therefore, we recommend a stricter approach to issuing guarantees by the government in the next period, both in terms of amount and in her choice of priorities which will have the greatest effect on economic growth and social development.

Graph T 6-11. Serbia: Trends in Serbian Public Debt (% of GDP)



Source: QM (* for 2012 – QM taking medical tests)

period could also lead to added, extraordinary lending by the government. The estimate is that by the end of 2012 the country's public debt will reach 60% of the GDP which is equal to the maximum permitted level of the public debt to EU member states, that is 15% of the GDP more compared to the limit set in fiscal rules in Serbia. Since, the developing countries saw the crisis in liquidity and solvency at a much lower level of debt (at average 43% of the GDP in average), the estimate is that this level of debt in Serbia significantly raises the risk of a public debt crisis, that is a crisis of liquidity/solvency of the state, especially in the context of high instability at world

In conditions of a lack of credible measures for a strong fiscal consolidation, we estimate that the fiscal deficit in 2012 will significantly exceed the planned amount and will probably stand at about 6.5% of the GDP and could reach 7% of the GDP if new program expenses are added (13th monthly pension for people with low incomes, securing money for the FIAT project and similar). Even in cases when some savings were made and certain taxes were raised in the last quarter, the expected effect on the overall fiscal deficit in 2012 will be limited. Also, the state intervention due to the possible realization of risks in the banking sector in the coming period

capital market. In that respect implementation of fiscal consolidation measures, primarily by lowering current spending and to a lesser extent through the raising of certain taxes, is necessary.

Box 1. Downgrade of Serbia's credit rating – causes and consequences

Credit rating agency Standard & Poor's downgraded Serbia's rating at the beginning of August to BB-, negative outlook, which has been officially explained by the following: a) lack of credible plan of fiscal consolidation in pre-election period, which would provide sustainability of public finances, b) adoption of measures which jeopardize independence of the National Bank of Serbia, leading possibly to changes in monetary policy (and particularly to foreign currency reserves policy) which could have negative impact on financial stability and balance of payment position of the country. With almost the same explanation, soon afterwards, the other credit rating agency – Fitch, lowered the outlook of Serbia's credit rating from BB- stable to BB- negative. Empirical studies show that lowering credit rating of the country is related to increase in borrowing costs – downgrading credit rating by one level leads to increase in EMBI by 1.7%, triggering increase in interest rates (Flores (2010)). At the beginning of September 2012, EMBI for Serbia amounted to 580 basic points, which is by approximately 110 basic points higher than at the beginning of the year. At the same time, EMBI for Serbia is considerably higher compared to almost all countries in the region (Croatia and Hungary – around 380, Lithuania – around 230, Turkey – around 220, Bulgaria – around 130 basic points).

Based on the aforesaid, it is estimated that the recent changes to the Law on NBS, negative trends in economic activity in 2012 and lack of credible measures of fiscal consolidation would lead to increase in the borrowing costs, which could happen at the following issuance of Eurobonds in September. In addition, downgrading of credit rating has negative impact on the terms of borrowing of Serbia's corporate sector abroad, which would have adverse impact on its future growth. Negative effects of lowering credit rating on availability of new loans and the increase in borrowing costs can be temporarily mitigated through borrowing from non-commercial creditors (e.g. with some countries). However, this is not sustainable in the long run, because the funds which can be raised in that manner are limited.

Appendices

Annex 1. Serbia: Consolidated General Government Fiscal Operations¹⁾, 2008-2012 (real growth in %)

	2008	2009	2010	2011					2012		
				Q1	Q2	Q3	Q4	Q1 - Q4	Q1	Q2	Q2/Q1
I PUBLIC REVENUES	3.3	-8.7	-1.5	-2.8	-6.6	-3.8	-4.7	-4.6	1.7	4.8	5.6
1. Current revenues	3.5	-9.1	-1.5	-2.9	-6.7	-3.8	-3.7	-4.4	1.7	4.5	5.2
Tax revenue	3.7	-8.8	-2.5	-3.1	-6.5	-4.3	-2.3	-4.1	1.9	5.3	4.8
Personal income taxes	6.3	-10.8	-3.9	-7.2	-3.5	-1.1	0.1	-2.9	4.6	4.6	11.8
Corporate income taxes	18.5	-27.0	-3.6	9.2	1.5	4.8	-3.7	3.9	51.5	39.9	-53.8
VAT and retail sales tax	2.5	-10.2	-0.7	-2.7	-7.9	-6.5	1.3	-4.0	-4.0	6.9	9.9
Excises	0.7	11.6	4.2	13.7	0.7	-0.9	-4.9	0.6	-5.7	-3.0	13.8
Custom duties	1.8	-32.4	-14.9	-15.9	-24.4	-23.1	-21.6	-21.5	-18.6	-8.6	13.9
Social contributions	4.3	-7.0	-6.5	-7.8	-5.3	-2.2	-0.6	-3.9	4.8	6.1	6.9
Other taxes	-2.3	-4.9	14.5	-7.4	-22.1	-11.5	-17.9	-15.2	-9.7	7.6	17.8
Non-tax revenue	2.6	-11.3	5.8	-1.0	-8.1	-0.5	-11.2	-6.1	0.1	-1.1	8.6
2. Capital revenues	-76.8	-41.4	-66.8	3330.6	47.9	746.3	1236.4	468.2	124.1	270.4	101.3
II TOTAL EXPENDITURE	4.5	-4.8	-1.7	3.0	4.9	1.1	5.4	3.3	10.0	9.0	4.7
1. Current expenditures	6.9	-3.3	-2.2	3.5	5.2	0.0	3.4	3.1	7.9	9.0	6.0
Wages and salaries	10.9	-6.0	-5.9	6.9	1.4	5.5	1.0	0.4	6.6	6.3	7.2
Expenditure on goods and services		-5.7	-0.3	0.7	3.6	6.5	4.7	4.3	9.5	15.1	19.4
Interest payment	-2.8	-5.7	-0.3	9.9	27.4	22.8	10.5	17.4	48.1	6.5	15.5
Subsidies	-13.3	19.0	40.6	19.2	26.1	15.3	24.1	7.4	42.6	56.4	8.3
Social transfers	10.1	-26.0	13.9	8.2	8.2	4.2	2.8	5.8	3.3	2.2	0.8
<i>a/w: pensions⁵⁾</i>	9.5	2.2	-3.9	9.8	5.0	2.0	1.2	3.9	8.4	7.4	1.7
Other current expenditures	14.9	6.7	-6.1	106.6	21.5	2.8	2.8	23.9	17.1	37.1	44.2
2. Capital expenditures	-4.3	-6.7	-11.8	6.3	1.4	13.9	19.8	5.3	48.4	9.4	12.8
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	-45.7	-35.9	15.9
IV TOTAL EXPENDITURE, GFS (II+III)	4.6	-4.8	-1.1	-2.9	-4.1	-0.2	-6.8	-3.8	7.5	8.5	4.9

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 Operations¹⁾, 2008-2012 (nominal amounts)

	2008	2009	2010	2011				2012			
				Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q1-Q2
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	339.8	652.4
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	337.7	649.4
Tax revenue	1,000.4	1,000.3	1,056.5	259.1	272.0	286.8	313.1	1,131.0	276.3	298.1	574.4
Personal income taxes	136.5	133.5	139.1	32.7	37.9	37.9	42.3	150.8	35.8	41.2	77.1
Corporate income taxes	39.0	31.2	32.6	14.4	7.5	7.6	8.3	37.8	22.9	10.9	33.7
VAT and retail sales tax	301.7	296.9	319.4	79.3	80.9	86.6	95.7	342.4	79.7	90.1	169.8
Excises	110.1	134.8	152.2	35.1	40.2	46.9	48.8	170.9	34.6	40.6	75.2
Custom duties	64.8	48.0	44.3	9.0	9.5	9.7	10.6	38.8	7.7	9.0	16.7
Social contributions	312.7	318.8	323.0	78.3	85.6	86.9	95.9	346.6	85.9	94.6	180.5
Other taxes	35.6	37.1	46.0	10.2	10.5	11.4	11.5	43.5	9.7	11.7	21.4
Non-tax revenue	142.7	138.8	159.2	33.8	38.5	43.9	50.7	166.9	35.4	39.6	75.0
2. Capital revenues	1.4	0.9	0.3	0.3	0.3	0.3	1.1	2.0	0.6	1.3	2.0
	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	-390.3	-752.4
1. Current expenditures	-1,089.6	-1,155	-1,224.8	-298.1	-323.9	-338.4	-364.4	-1,324.8	-336.8	-367.6	-704.4
Wages and salaries	-293.2	-302.0	-308.1	-76.7	-85.3	-89.6	-91.0	-342.5	-85.5	-94.4	-179.9
Expenditure on goods and services	-181.2	-187.4	-202.5	-44.7	-52.6	-51.0	-68.1	-216.3	-51.2	-63.0	-114.2
Interest payment	-17.2	-187.4	-34.2	-9.9	-12.1	-11.1	-11.7	-44.8	-15.4	-13.4	-28.8
Subsidies	-77.8	-22.4	-77.9	-15.1	-15.4	-28.4	-21.5	-80.5	-22.6	-25.2	-47.7
Social transfers	-496.8	-63.1	-579.2	-142.6	-150.4	-151.7	-164.2	-609.0	-154.2	-160.0	-314.2
<i>a/w: pensions ⁽⁹⁾</i>	-331.0	-556.4	-394.0	-99.2	-105.4	-107.0	-111.2	-422.8	-112.5	-117.8	-230.3
Other current expenditures	-23.5	-387.3	-22.9	-9.1	-8.2	-6.6	-7.8	-31.7	-7.9	-11.7	-19.6
2. Capital expenditures	-106.0	-24.0	-105.1	-16.3	-19.9	-32.6	-42.3	-111.1	-25.3	-22.7	-48.0
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	-5.6	-10.3
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	-395.9	-762.7

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

7. Monetary Trends and Policy

The macroeconomic environment in Q2 gave out divergent signals on the type of monetary policy the NBS should be conducting. The recession over the previous four quarters and the slow economic recovery in Q2 indicated a need to implement an expansive monetary policy. However, strong depreciation pressure as well as a moderate, but relatively consistent, speeding up of inflation indicated the need to implement a restrictive monetary policy. Also, the autonomous trends in creating money on the basis of operations on the foreign currency market changed direction. At the end of Q2 and during Q3 the restrictiveness of the monetary policy was additionally reinforced by raising the key policy rate and the change of currency structure of the mandatory reserves in the direction of raising the Dinar participation in those reserves. The registered repayment of the debts of the economy in Q2 was temporary and a rise in newly placed credits to the economy was evident at the start of Q3 while cross-border credits continued their upward trend for the third quarter in a row. The sources for new bank placements were reduced in Q2 despite the rise in enterprise and household deposits following a decision by business banks to use a significant portion of their funds to pay foreign debts. The National Bank of Serbia moved from reverse repo transactions in the middle of last year to standard repo transactions which means that now repo transactions are being used to inject liquidity in the market. That change is the NBS response to the altered circumstances because foreign currency transactions were used to date to withdraw liquidity due to the low inflow/outflow of capital while in the past foreign currency transactions were used to create liquidity. In conditions of speedier inflation, standard repo transactions which are used to create added liquidity are indicating a need for great caution by the NBS. The problems with the liquidity of the Serbian economy and the continuing depreciation of the Dinar have additionally increased the participation of NPLs. Except the slight decrease in the second half of 2009. NPLs recorded a constant growth over the past four years without any indication of a possible change in the future.

Central Bank: Balance and Monetary Policy

Drop of reserve money continues in Q2 ...

... due to NBS need to intervene on inter-banking foreign currency market

Level of net own reserves lowered in Q2 ...

... as consequence of sale of foreign currency with the aim of stabilizing the exchange rate

In the second quarter, similar to the previous quarter, fiscal policy was very expansive (see section on fiscal policy), which resulted in a significant creating of money on that basis. On the other hand, the NBS decided on a restrictive monetary policy which in Q2 was primarily reflected in the sale of foreign currency, which was used to withdraw Dinars, and eased the depreciation pressure. The view is that this choice by the NBS in conditions of a highly Euro-oriented economy such as the Serbian is justified because a possible strong depreciation of the Dinar would soon spill over to prices whose stability is the main goal of the NBS. Besides, a strong depreciation of the Dinar would have a negative effect on the economy, the population and the state most of who are indebted in foreign currency or have Dinar loans which are indexed against the Euro. In conditions of a high euroisation of credits, a strong depreciation of the Dinar would certainly spill over to the credit crisis.

Due to the depreciation pressure which continued in Q2, the NBS intervention on the interbank foreign exchange market (IFEM) was intensified. Including the 823 million Euro the NBS used to slow down the depreciation trend, the overall funds used since the start of the year rose to 1.28 billion Euro (Table T7-1). The sale of foreign currency led to a drop in the NBS net own reserves in Q2 by 28% compared to the value of reserve money at the start of the year which had a negative effect on the level of the reserve money. On the other hand, business banks made a great withdrawal of funds from the repo stock at the NBS which had a positive effect on the creating of reserve money and compensated the negative effects of the sale of foreign currency on the IFEM. Along with the spending of part of the deposits which the state had in accounts with the NBS, the overall effect on the level of reserve money was a growth of 31% compared to the value of reserve money at the start of the year.

Table T7-1. Serbia: NBS instruments and foreign reserves 2009-2012

	2009		2010				2011				2012	
	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
Repo stock (in millions of euros)	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	111.98
NBS interest rate	12.00	9.50	9.00	8.00	9.00	11.50	12.25	12.00	11.25	9.75	9.50	10.00
Repo rate adjusted for inflation	8.05	12.16	-5.54	2.95	-6.65	7.56	-17.51	16.11	8.61	19.40	-3.97	-3.53
Repo rate adjusted for changes in the exchange rate	11.51	-31.19	-2.30	-19.45	3.20	21.90	13.99	-7.14	25.90	6.51	-19.08	-12.16
NBS interventions on FX market (in millions of euros)	18.20	-80.90	-631.50	-785.00	-595.20	-321.50	5.00	-30.00	-30.00	-30.00	-488.50	-1278.8
INCREASE	cumulative, in % of opening H⁽¹⁾											
NBS own reserves ⁽²⁾	9.6	20.8	-15.3	-31.2	-57.5	-61.0	-8.9	14.0	26.8	73.9	-17.6	-45.4
NDA	-38.4	-40.9	-0.3	4.5	30.6	33.6	-0.7	-15.5	-28.6	-51.8	2.4	61.3
Government, dinar deposits ⁽³⁾	1.0	-13.0	2.7	4.8	7.9	3.1	-4.6	-3.3	3.6	2.7	-5.1	6.1
Repo transactions ⁽⁴⁾	-22.6	-19.9	4.9	14.2	35.4	42.5	-6.9	-15.3	-32.2	-47.5	2.2	53.7
Other items, net ⁽⁴⁾	-16.7	-8.1	-7.9	-10.4	-8.6	-7.9	10.9	3.1	0.0	-7.0	5.3	1.5
H	-28.8	-20.1	-15.6	-26.7	-26.9	-27.3	-9.6	-1.5	-1.8	22.1	-15.2	15.9
o/w: currency in circulation	-2.3	1.8	-3.9	-3.2	-2.3	-1.5	-5.8	-4.2	1.3	12.4	-3.3	-4.0
o/w: excess liquidity	-16.5	-16.5	-13.7	-12.5	-8.6	-6.8	-3.8	2.5	-5.5	6.3	-13.6	-1.6
in millions of euros, cumulative from the beginning of the year												
NBS, net	681.73	1,446	-183	-389	-990	-1,059	56	282	1,374	2,203	-1,070.60	-2,087.45
Gross foreign reserves	1,371.41	2,477	-135	5	-637	-654	16	308	1,426	2,334	-1,138.11	-2,090.09
Foreign liabilities	-689.68	-1,031	-49	-393	-353	-405	41	-26	-52	-131	67.51	2.64
IMF	-747.41	-1,104	-47	-386	-356	-408	37	-32	-59	-132	58.24	-6.44
Other liabilities	57.72	74	0	-7	3	3	4	6	7	1	9.27	9.07
NBS, NET RESERVES-STRUCTURE	0											
1. NBS, net	681.73	1,446	-183	-389	-990	-1,059	56	282	1,374	2,203	-1,070.60	-2,087.45
1.1 Commercial banks deposits	-280.43	-725	-115	-393	-377	-374	22	226	109	-462	459.45	740.45
1.2 Government deposits	-82.21	-54	-80	39	22	18	-232	-258	-1,009	-455	263.40	488.43
1.3 NBS own reserves	319.09	668	-378	-743	-1,346	-1,415	-154	250	474	1,286	-347.74	-858.58
(1.3 = 1 - 1.1 - 1.2)												

Source: NBS.

1) „State“ includes all levels of government: republic to local government level.

2) Definition of NBS net own reserves in section 8 „Monetary Trends and Policy“, Frame 4, QM No. 5.

3) This category includes NBS bills and repo transactions.

4) Other domestic net assets include: domestic loans (net debts of banks, not including bills and repo transactions; net debts of the economy) along with other assets (capital and reserves; and balance items: other assets and other liabilities) and corrected by exchange rate differentials.

NBS key policy rate raised in Q2 ...**... as well as Dinar share of foreign exchange required reserves**

Following the raising of the key policy rate in June by 50 base points, the NBS made two more corrections of the key policy rate in July and August by 25 base points bringing the current rate to 10.5%. A session of the NBS Executive Board on June 7 decided to change the Decision on Mandatory Reserves by increasing reserve ration on Dinar liabilities with a foreign currency clause to 50% for all maturities. It also raised, for the second time that year, the Dinar share of allocations under foreign exchange required reserves under differentiated rates. For sources of funding with maturity of up to two years, the rate was raised from 20% to 27% while for sources with maturity of over two years, rate was raised from 15% to 19%. Those measures were taken by the NBS in an effort to sterilize a part of the Dinar liquidity of the banking sector and ease the pressure on the exchange rate which was obviously destabilized from the start of the year and increase the foreign currency offer on the interbank market.

At its next session on July 12, the NBS decided that instead implementing the key policy rate on two week repo selling transactions of bonds (reverse repo) the rate would be implemented on one week repo purchasing transactions of bonds (standard repo). With that decision, the NBS practically changed its role to date with the NBS now buying Dinar state bonds from business banks and the business banks buying them back for the value of previously borrowed funds increased by interest. The key policy rate under the new decision sets the lowest interest rate under which business banks buy back bonds. By using that model, the NBS now creates the liquidity of the banking sector by buying bonds instead of selling it as was the case to date. That change in the manner in which repo operations function caused a large drop in repo stocks in Q2. In July, repo stocks based on reverse transactions dropped to zero. The transfer to standard repo transactions means that the NBS now buys bank bonds and injects fresh liquidity on that basis. For now those operations are modest – late in July, the NBS created liquidity from two billion Dinars based on repo bank bonds.

The transfer from the reverse to the standard repo is the consequence of altered macroeconomic circumstances, primarily the change of direction in the effects of transactions on the foreign currency market on creating money. In the previous decade, money was mainly created on the basis of transactions on the foreign currency market in amounts which were greater than the realistic demand for money – which is confirmed by the relatively high inflation in that period. With the aim of suppressing inflation and easing the pressure on the foreign currency market, the NBS issued reverse repo bonds withdrawing surplus liquidity. From the start of the year,

7. Monetary Flows and Policy

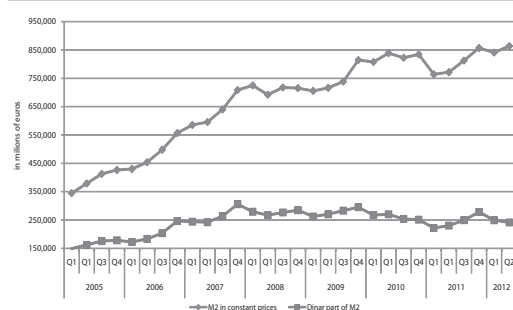
the situation on the foreign currency market was significantly changed – foreign currency offer is significantly lower than the demand and Dinar money was withdrawn on the basis of foreign currency transactions. In those circumstances, Dinar liquidity dropped and a need appeared for the NBS to implement standard repo transactions to raise liquidity. However, the NBS should carefully monitor trends on the foreign currency market in future as well as state operations to adequately react in order to create or withdraw liquidity. Due to the high inflation in Serbia and low real demand for Dinars, the NBS needs to exercise great caution to prevent a start of the depreciation of the Dinar and speeding up of inflation through the creating of added liquidity.

The decisions by the new NBS leadership to raise the key policy rate and increase the restrictiveness of the monetary policy shows that, most probably, following the forced resignation of the governor there would be continuity in monetary policy instead of the announced turnabout. That primarily means that keeping inflation under control would continue to be the main goal of the NBS instead of a “stimulating” of the economy. Of course, pressure can be expected on the NBS in future to create added liquidity in order to get the economy moving or solve the problem of lack of liquidity which masks the problem of the insolvency of part of the Serbian economy.

The invoking of other central banks by the advocates of an expansive fiscal policy is quite inadequate because the conditions in which monetary policy is implemented in Serbia is essentially different and the results of an expansive policy would be different. Serbia has had a dual currency system for several decades which has been partly legalized and in which the Dinar is the inferior currency against the Euro. In the overall money mass, the Dinar accounts for less than 30% and there is a tendency to lower that percentage. The real level of demand for the Dinar is low which means that monetary policy, that is the increase in the offer of the Dinar does not lead to a growth in savings and loans in Dinars but to a growing demand for foreign currency. The rising demand for foreign currency leads to a depreciation of the Dinar which transfers with some delay to the growth of inflation. The rise in the exchange rate and subsequently inflation lowers the real value of the Dinar money mass although its nominal value is higher. That is exactly what happened in the first half of the year when expansive fiscal policy led to an increase in the nominal Dinar money mass but with its real value in Euro and Dinars dropping.

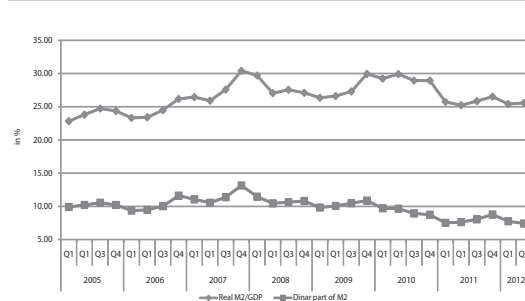
The effect of a possible monetary expansion would a rise in the exchange rate and inflation instead of a growth of savings and loans in Dinars and getting the economy moving. The effect of possible expansive policy on the Dinar exchange rate would be especially strong in circumstances when the offer of foreign currency was very low which, is the case in 2012. In those circumstances, the benefits for privileged credit users would be higher then the expenses while the expenses would be greater than the benefits for other people. The monetary policy in Serbia is forced to balance on a very thin line between the intention to stimulate the economy and the risk of speeding up inflation. It is relevant that the key problems in the Serbian economy are systemic in nature and that they cannot be solved through an expansive monetary and fiscal policy – a drop in economic activity in the first half of the year, despite a very expansive fiscal policy, confirms that convincingly.

Graph T7-2. the state of the money mass in constant prices, 2005–2012



Source: calculation QM

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



Source: calculation QM

Monetary System: money mass structure and trends

Increased state spending and withdrawal of banks from repo placement in Q2 ... had a positive effect on the growth of the money mass

The real level of the money mass was increased in Q2 by 12% y-o-y (in Q1 the real growth was 10.1% y-o-y, Table T7-4). Following the exchange rate differences adjustment due to the depreciation of the Dinar the y-o-y rate is negative and stands at -1.2%, with a drop being registered with households of -2.4% y-o-y while the drop for enterprises stands at 0.5% y-o-y. The rise of the M2 in Q2 viewed in the light of the value of the monetary aggregate at the end of last year is 6%. The money mass was created by Dinar channels, the spending of state deposits in the NBS and the withdrawal of repo placements of business banks while the net side (that is transactions on the foreign currency market) caused a drop in liquidity because of a deficit in the current and capital balance.

The increase in the y-o-y rate of growth of the M2 which in Q2 stood at 18.1% nominally (in Q1 a rise of 14% y-o-y) is owed over 80% to the rise in foreign currency deposits whose y-o-y rate of growth stood at 14.96%. In the same period, the rate of growth of savings and term deposits of 0.78% y-o-y as well as the base M1 with 2.39% y-o-y, decreased their contribution to the growth of M2 to about 17.5% of the overall (in Q1 the total contribution stood at 33.7% of the overall growth of M2).

Table T7-4. Serbia: monetary survey, selected indicators, 2009–2012

	2009				2010				2011				2012	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
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	18.1
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	14.0
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	4.6
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	3.3
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	5.3
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	12.0
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	8.1
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	-1.2
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	-2.4
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	-0.5
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	1,588.6
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	444.6
Fx deposits (enterprise and households)	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	1,144.0
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	6.1
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	-4.5
NDA	0.1	6.5	6	12.4	2.1	8.3	10.2	18.4	-1.4	8.3	-5.6	-1.8	5.7	10.5

Source: NBS

1) Money mass: components – v. Analytical and convention notes QM.

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

3) Trends are adjusted for exchange rate differences. Adjustments made on assumption that 70% of loans to non-state sector (both households and the economy) are indexed against the Euro.

4) Starting M2 means the state of the M2 at the start of one and the end of the previous year.

Banking sector: placements and sources of finance

The economy and the population in Q2 repaid debts to domestic banks ...

Growth of cross-border loans to the economy continues through Q2

The credit placement of the banking sector to the economy and the population in Q2 recorded a drop of 173 million Euro (table T7-5). While the population increased its debts to 42 million Euro, the economy reduced its debts to 214 million Euro and influenced the overall drop in loan placements. We should stress that the net debt reduction of the economy was affected by the writing off of some non-performing loans by several banks. In July that trend ended and there was a growth in new loans to the economy of 237 million Euro. Also, the economy increased its foreign debts based on a rise in cross-border credits. The growth of cross-border credits which started again two quarters earlier, stood at 132 million Euro in Q2 (in Q1 cross-border loans rose by 115 million Euro). Based on these debts, the overall drop in credit activity in Q2 in the economy was partly eased and stood at -41 million Euro. Along with the lower credit placements, business banks withdrew 916 million Euro in Q2 from REPO placements and in July withdrew an additional 107 million Euro which brought the repo stock down to the lowest level since we have been monitoring its movements¹. Part of the withdrawn repo funds were used by

1 Reason for withdrawal of funds from REPO placement is mostly due to NBS decision to move from reverse repo transactions to standard repo transactions.

7. Monetary Flows and Policy

the banks to cover the Dinar share of allocations under foreign exchange required reserve which the NBS raised in April. On the other hand, auctions of treasury bonds brought in more than 620 million Euro from the banking sector. A part of those funds were used to finance earlier issues which have fallen due and the other part to finance state spending in this period. For the same reason, the state withdrew funds in Q2 from accounts with business banks and that raised the net indebtedness by 257 million Euro which partly eased the overall drop in placements by the banking sector in Q1 to 833 million Euro.

Table T7-5. Serbia funding, credit and investment activity, adjusted¹⁾ trends, 2009-2012

	2009				2010				2011				2012	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
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	692
Domestic deposits	235	-336	-691	-1,633	131	-233	-236	-836	206	-148	-844	-1,169	589	146
Households deposits	-40	-270	-551	-1,314	-137	-323	-500	-1,020	-92	-295	-483	-655	-49	-189
dinar deposits	46	-2	-30	-89	30	21	25	12	24	13	-68	-182	30	69
fx deposits	-87	-268	-521	-1,225	-167	-343	-525	-1,032	-116	-308	-416	-473	-79	-258
Enterprise deposits	276	-67	-140	-319	268	89	264	184	298	147	-361	-513	638	336
dinar deposits	171	5	-174	-284	213	84	232	151	176	13	-128	-350	362	304
fx deposits	105	-72	34	-35	55	5	32	33	122	134	-233	-164	275	31
Foreign liabilities	299	186	-558	-1,271	-196	40	90	-563	580	634	678	545	3	345
Capital and reserves	424	212	78	114	72	77	78	-96	-183	-416	-656	-459	80	200
Gross foreign reserves(+, decline in assets)	-407	-449	-5	311	53	-120	197	430	-720	-674	-517	-923	-199	371
Credits and Investment¹⁾	156	1,057	1,980	2,844	397	1,279	1,281	2,285	309	1,270	2,158	2,771	409	-424
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	136
Enterprises	331	465	700	1,097	319	897	1,142	1,756	191	766	1,189	1,607	375	161
Households	-104	-84	-4	86	91	368	527	678	25	263	365	333	-36	-25
Placements with NBS (Repo transactions and treasury bills)	40	256	694	625	-125	-445	-839	-1,010	86	268	529	720	-28	-944
Government, net ²⁾	-105	421	590	1,036	112	460	451	861	7	-28	75	111	128	385
MEMORANDUM ITEMS														
Required reserves and deposits	-191	-225	-185	36	54	-182	-188	-115	-157	-429	-210	391	-552	-418
Other net claims on NBS ³⁾	-385	-380	-481	-158	-287	-272	-195	-229	17	123	2	110	-199	-20
a/w: Excess reserves	-409	-394	-501	-177	-279	-252	-173	-220	22	123	-3	100	-187	45
Other items ⁴⁾	-166	-158	-254	-99	-147	-331	-692	-565	-136	-195	-246	-601	150	222
Effective required reserves (in %) ⁵⁾	30	28	26	25	26	24	24	23	23	21	21	24	22	23

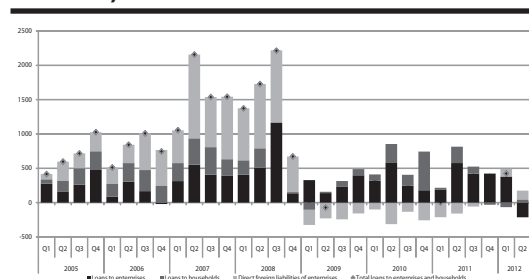
Source: NBS

1) The calculation of growth is based on the assumption that 70% of overall placements is indexed against the Euro. Growth for original Dinar values of deposits are calculated using the average exchange rate for the period. For foreign currency deposits – as the difference in the situation calculated by the exchange rate at the ends of periods. Capital and reserves are calculated using the exchange rate at the ends of periods and do not include the effects of exchange rate changes from the calculations of the remainder of the balance.

2) NBS bonds include state and NBS treasury bonds which are sold at repo rates and a rate set on the market for permanent auction sales with a due date of more than 14 days.

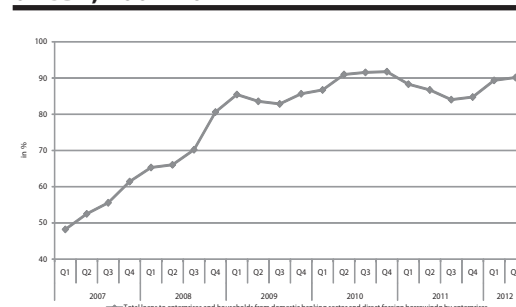
3) Net state crediting: loans approved to the state lowered by the amount of state deposits in business banks; the negative sign means a higher rise in deposits than in credits. The state includes all levels of government: republic and local level.

Graph T7-6. Serbia: credit to enterprises and to households - impact on aggregate demand, 2005-2012



Source: Calculation QM
See footnote 1 in Table T7-5.

Graph T7-7. Serbia: overall credit debt in % of GDP, 2007-2012

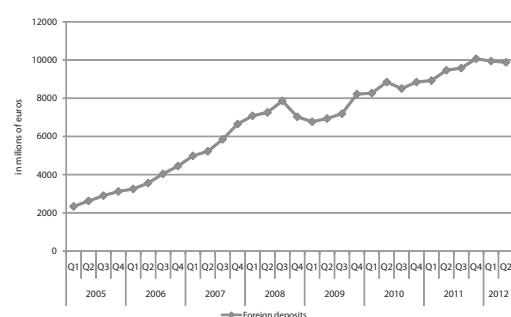


Source: Calculation QM

Drop in sources for new placements continues in Q2...

... despite increase in deposits by enterprises and population

In Q2, the sources for new placements by banks dropped additionally by 20 million Euro with a significant change in its structure. Unlike the previous quarter, the population and the enterprises increased the value of the funds in accounts for domestic and foreign currency deposits with business banks. Deposits by the population increased by 140 million Euro while the enterprises with 302 million Euro had a positive effect on the creating of sources for new bank placements. Despite the increase of deposits by the enterprises and population, banks in the same period decreased their funds by 342 million Euro on the basis of foreign debts while at the same time they withdrew an added 120 million Euro from capital and reserve accounts. That neutralized the positive effect of the growth of deposits by the population and enterprises which caused

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

Source: NBS

the drop in sources for new bank placements. The structure of sources of financing changed in the direction of increasing the importance of domestic sources of financing and lowering of the importance of foreign sources of financing. The growth of the population's deposits in banks shows that despite political instability and problems in a group of domestic banks, the trust of the population in the banking system in the first half of the year was relatively high. That is also shown by the fact that the population increased the level of deposited funds in its accounts with business banks in July when the

bankruptcy of the Agrobank was reported on heavily by the media.

Table T7-9. Serbia: the share of non-performing loans in total loans by type of debtor, 2008-2012

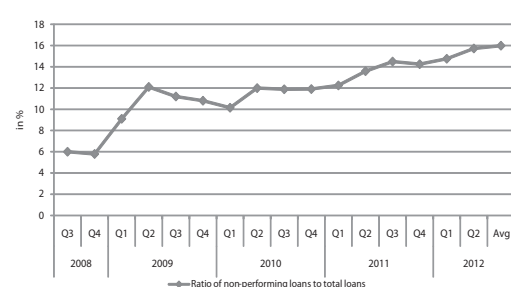
	2008		2009				2010			2011				2012		
	Dec.	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Apr
Corporate	6.86	11.05	14.86	13.24	12.14	11.62	14.18	13.83	14.02	14.39	16.23	17.44	17.07	17.72	18.47	18.02
Entrepreneurs	3.66	5.28	8.93	10.21	11.21	12.19	13.73	15.7	15.8	15.66	15.75	16.99	17.07	16.05	15.72	15.98
Individuals	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	7.69	8.04

Source: Calculation QM

Participation of non-performing loans increases again in Q2 ...

... with main growth among companies and firms

The growth of non-performing loans continued to grow in the first half of the year in the overall approved credits. At the end of June, the overall participation of non-performing loans rose to 15.72% of the overall placement of loans in the Serbian economy (Table T7-9). Falling late with debt payments by more than 90 days, which is taken as the limit to classify loans as non-performing, increased in all three monitored groups of debtors. The greatest influence on the overall growth of the participation of non-performing loans came from corporate sector which saw their participation rise from 17.72% at the end of March to 19.26% at the end of June. A similar rise was registered in the overall sum of loans placed with entrepreneurs while a somewhat smaller growth of non-collectable credits was evident among private individuals. This deterioration does not have any great effect because of the fact that non-collectable loans of entrepreneurs and individuals account for about 18% of overall loans whose repayment is late. If we recall that the participation of non-performing loans prior to 2010 was usually under 10%, the participation of those loans this and the previous year, and the fact that there is a constant growth show that the Serbian economy still has no clear solution to overcome the problem which could grow greater if the depreciation of the Dinar continues making it harder to repay loans which are indexed against foreign currency. The increase of the non-collectable loans is partly the consequence of the economic crisis which has brought difficulties with loan repayment to many solid companies and solvent individuals.

Graph T7-10. Serbia: ratio of non-performing loans to total loans, 2008-2012

Source: Calculation QM

Something similar was registered in other countries but in Serbia it intensified because most loans are based on the Euro. The other reason for the high rise in non-collectable loans is the lack of caution by banks during the credit boom (2003-2008), when loans were approved without a detailed check of business performance and company prospects. In that period, banks primarily invested efforts to take over as much of the market as possible while asking for collateral (mainly property) as security for loans. However, starting with the crisis the value of property and its liquidity dropped significantly² which resulted in the rise in non-performing loans.

2 There are indications that the initial value of the property was often exaggerated.

Frame 1. Expectations to the end of 2012

Although there are just a few months left to the end of the year, there is still some uncertainty about the macroeconomic environment in which monetary policy will be implemented. It is probable, but not certain, that the economy will stagnate (see section on economic activity) but there is great uncertainty about how transactions on the foreign currency market will affect the creating and withdrawal of money. In the coming part of the year we can expect the gradual lowering of the deficit in the current accounts balance to continue but more slowly than expected (lower exports of agricultural and food products, higher electricity imports, contradictory assessments of demand for FIAT automobiles made in Serbia, etc). Significantly greater uncertainty is linked to the assessments of trends in the capital balance. Based on trends from the previous part of the year, as well as Serbia's lower credit rating and the postponing of agreements with the IMF and EU we can expect an outflow of capital or a very modest inflow based on commercial trends in Serbia for the rest of the year. The relatively high deficit in the current balance with a lack of any significant inflow of capital on the basis of commercial transactions would cause a demand for foreign currency higher than the offer. This imbalance could be removed with a high depreciation of the Dinar (which is not very likely) or the spending of NBS foreign currency reserves (which is more likely). It is probable in this scenario that the net effects of transactions on the foreign currency market would result in a drop in Dinar liquidity and that would mean the creating of additional space to reduce the restrictive nature of the monetary policy. However, that space would be relatively modest due to rising inflation and because of the danger of the Dinar depreciating. If the state secures a sufficient amount of foreign currency loans from abroad which would be used to finance the current fiscal deficit or service debt repayments which fall due the situation¹ in the capital balance could change completely. A significant inflow of foreign currency from loans taken out by the state could change the balance between offer and demand on the foreign currency market in favor of foreign currency offer which would result in an appreciation of the Dinar and growth of foreign currency reserves. In this case, the net monetary effect of foreign currency transactions would be higher liquidity which could require the implementation of a restrictive monetary policy. If the state takes out loans in foreign currency in the country, the monetary effect would depend on whether the hard currency used to buy state bonds is secured from abroad or whether investors sell surplus Dinars to the NBS to buy foreign currency to purchase state bonds. If the foreign currency used to buy state foreign currency bonds come from abroad, the monetary effect is the same as if the state took out loans abroad. If the foreign currency is secured in the country by buying currency from the NBS the result would be a withdrawal of Dinars (lower liquidity) but the final monetary effects would depend on whether the state takes out loans to meet its Dinar or foreign currency dues. If the state meets its Dinar dues it could sell foreign currency and create an additional Dinar liquidity but if it met its foreign currency dues the decreased liquidity based on that would be permanent. We should bear in mind that if the state takes out loans in foreign currency that would have a short-term favorable effect on the stabilization of the foreign currency market but is not tenable in the long term because the country's foreign debt and public debt are in a critical zone.

¹ The monetary effect would be especially significant if due Dinar payment were financed by the state taking loans in foreign currency.

8. International Environment

The global recovery continues but at a slower pace than expected, and in addition there are significant variations across regions and countries. While growth in developing countries and the U.S. slows down, the Eurozone is on the verge of “technical recession” which will likely be exacerbated by the end of the year. The main risks to the global economic recovery is the slowdown and possible recession of the Eurozone’s economy, and lack of agreement among the politicians in the U.S. in terms of fiscal policy. Large developing countries are implementing expansionary monetary policy to stimulate growth. The Fed began the third phase of “quantitative easing”, while the ECB launched a new programme of purchasing bonds. A global decline of the inflation rate is expected by the end of the year due to the relatively low growth, but the highly variable price of oil makes the forecasting difficult. In Eastern and Central European countries political populism is jeopardizing arrangements with the IMF and deterring investors.

Global trends

Global recovery in the second quarter is weaker than expected. In many developed and developing countries, growth was slightly lower than expected. That is why the IMF cut global growth rate from 3.6% to 3.5% in 2012, and from 4.1% to 3.9% in 2013. As for the rest of the world, the growth rate for developed countries also declined marginally - from 1.5% to 1.4% for 2012, and from 2.1% to 1.9% for 2013. The forecast was primarily reduced due to the lower growth in the Eurozone. Even the rate for developing countries was reduced from 5.7% to 5.6% in 2012, and from 6.1% to 5.9% in 2013. Slowdown also occurred in China, India and Brazil, not only due to the reduction in external demand, but also due to the decline in domestic demand, primarily because of the measures that were taken in 2011, which were aimed at curbing inflationary tendencies. Due to its proximity to the Eurozone, growth in the countries of Central and Eastern Europe (CEE) has suffered a negative impact of reduced demand for trading partners, as well as continued reduction in lending of European banks that have investments in the region. The forecasted growth rates of 1.9% for 2012 and 2.8% for 2013 for CEE are by far the lowest compared to other regions of the developing countries, and it is expected they will again be adjusted downwards.

According to the IMF, there are two main risks to global recovery - a possible recession in the Eurozone and lack of agreement among the U.S. politicians in terms of fiscal policy. Global growth could be jeopardized if the politicians in the European Union do not proceed with the development of a concrete plan that would help the countries on the periphery and establish fiscal discipline, but these measures should not be too restrictive as they could cause a recession. Apart from the Eurozone, the biggest risk to global growth is a complicated situation in the U.S. in terms of fiscal policy, as there is still no compromise on the rate of taxes and budget spending.

IMF supports the latest expansionary monetary measures in the U.S. and the Eurozone, while for other developed countries it advises that the monetary policy be prepared to use unconventional measures in case the growth slows down, and the fiscal consolidation plans be adjusted if there is a serious downturn. This applies to developed countries, and it must be emphasized that in terms of developing countries, such a change in fiscal consolidation plan may be hazardous to financial stability, particularly where the public debt to GDP ratio is at a relatively high level.

The main risk to growth in the developing countries are external factors, so it is likely that the published growth rates will be adjusted downwards. According to the IMF, financial stability can be compromised during this period of recovery in the developing countries, due to low growth and high aversion to risk of the investors. If there is a withdrawal of capital by foreign investors, there are necessary measures to be taken to protect the sharp decline of the exchange rate, especially in small economies. Economic policy should minimize the negative effects of

lower growth, low inflow or sudden capital outflows. As before, the proposed instruments vary depending on the economic situation of the developing country. Where inflation is low and stable, the reference rates can be reduced in order to incite borrowing. If inflation is relatively high, reduction of the reference rate is not a suitable instrument, even if borrowing is declining. In countries where capital inflows after the crisis have been significantly reduced, it is necessary to implement supervision and regulation of the financial system along with appropriate macroeconomic policies in order to attract investors and reduce risk in the financial system.

The price of oil has expressed great variability in the first half of the year. During the second quarter, the oil price declined, primarily due to lower demand because of the slowdown in global economic activity, but also because of the increased production (Saudi Arabia). However, after the situation in the Eurozone improved, the price of oil started to grow again. According to the latest IMF report, global inflation should decline in the following year, in developed countries to 1.6% and in developing countries to 5.6%, and a decline in raw material prices is expected as well. These forecasts may be changed, because the prices of raw materials, energy and gold have increased due to the expansionary monetary measures in the U.S. and the Eurozone.

Tendencies in the EU

Generally speaking, the economic situation in the Eurozone deteriorated during Q2 - successful countries like Germany slowed down the growth, while the decline in the indebted countries will be higher than previously predicted. On annual basis, after stagnating in Q1, the Eurozone's GDP declined 0.4% in Q2, which is the first annual contraction since Q4 2009. Personal consumption was low due to austerity measures and the uncertainty on the bonds market negatively affected the activity of companies. Due to its strong exports and private consumption, Germany again had the highest growth among the larger Eurozone economies, while in Italy and Spain the recession grew. Austerity measures in these two economies will yield results in the future, but in the meantime, the high interest rates at which these countries are borrowing money are further burdening their economies. A negative growth rate of GDP in the Eurozone is expected in the next quarter as well.

The turning point in the Eurozone was a summit in late June, which indicated that the end of the crisis in the Eurozone is finally near, when it was agreed that the countries on the periphery will have access to the funds from the stabilisation fund. Financial markets reacted positively. There is a possibility that bailout funds intended for banks will be distributed directly and the vicious cycle of aiding the banks through the government, which raised the level of public debt, would be broken. In order to achieve this, a greater financial integration is required, so Germany's condition is establishing a European banking monitoring mechanism, after which the direct assistance to the banks will be possible.

In early July, the ECB reduced the reference rate to 0.75% even though inflation was above the upper limit, but according to the ECB officials, it was certain that the inflation would decline by the end of the year, due to the economic downturn. In addition to the reference rate, the ECB also reduced the reserve requirements on deposits to 0%, which is the new historic low, in order to encourage banks to lend to one another.

ECB launched a new program in early September for purchasing bonds on the secondary market, without specifying the upper limit of funds that would be necessary, nor the time frame. Purchase of bonds would be conditional on completing structural reforms and austerity measures, and it could always be stopped, if the country seeking international aid does not keep its end of the agreement. Purchased bonds will be "sterilized" by selling higher quality bonds of other countries, and their maturity will range from 1 to 3 years. During the summit in June, there was a discussion about whether there will be enough funds to rescue Spain or Italy, and that is why the maximum amount of funds for the intervention was not mentioned, in order to make investors more confident in its efficiency. Also, another difference is that the ECB as a creditor will not have a special status, as was the case during the SMP.

Tendencies in the U.S.

GDP growth in the U.S. during Q2 on annual level was 2.2%, which represents a slowdown compared to Q1, especially if we look at the growth on a quarterly basis. The slowdown is caused primarily by reduced personal consumption. Government spending is again falling, which was to be expected, since this has been the trend since early 2010, as well as the decline in business investment. Exports grew, but at a slower pace than imports, making the contribution of net exports a negative one.

The main threat to the U.S. economy (and the world's growth), which is already declining, is the lack of agreement between the Republicans and the Democrats on the fiscal policy. If by the end of the year the situation remains unchanged, many of the tax cuts will automatically be abolished, and a portion of budget spending stopped. According to the Congressional Budget Office analysis, this would lead to a reduction of fiscal deficit by 500 billion USD, but also to another recession and rising of unemployment in the coming year. The U.S. presidential elections will be held in November, so most analysts think that an agreement will be reached after the election, but that at the same time the election campaigns are creating an atmosphere in which an agreement is currently impossible to reach.

Following the decision in June to proceed with "Operation Twist" in September, the Fed began the third phase of "quantitative easing". It is planned to purchase monthly mortgage bonds in the amount of 40 billion USD, and the deadline in which the record low reference rate would be held at that level has been extended from the end of 2014 to the first half of 2015. Unconventional measures have increasingly less effect, but in a situation of low growth and high unemployment, they are gaining more and more supporters. There is increasing discussion on the possibility of introducing a new target for monetary policy - the growth of nominal GDP.

Tendencies in Central and Eastern Europe (CEE)

The biggest risks to the economic growth of the CEE countries are the slowdown of the Eurozone, where the main factors are export markets, as well as the withdrawal of capital by foreign banks that are active in the region. After the completion of the duration of the Vienna Initiative, a reduction in bank lending has lately intensified, especially in periods when the risk to peripheral Eurozone bond markets was increased. The vulnerability of the economies because of it depends on the parent banks. Certainly the banks with the capital from Greece or Italy are more vulnerable than the banks whose parent company is in Germany. Foreign direct investments can reduce the negative impact of the withdrawal of bank capital. Because of the recession in Eurozone, the level of foreign direct investment from that region to the CEE will be stagnant at best, so it is advisable to direct attention to partners from East Asia as well. If a country has access to the EU market, investors from East Asia gladly use the market proximity and low labor costs, and there are already a lot of success stories (Foxconn, Samsung, etc.). In terms of other risks, longer or deeper contraction in the Eurozone, the countries with a more diversified export will be able to better adapt to the reduced demand. Therefore, it is appropriate to increase exports to the markets of developing countries, where the demand is more certain.

Political populism in some CEE countries is jeopardizing the negotiations or arrangements with the IMF. Populism is associated with defects in the political systems of some countries, which hinder the adoption of the necessary consolidation programmes. Depreciation of the exchange rate, reduced demand for government bonds, and subsequent increase of the country's cost of borrowing are all regular consequences of government's refusal to accept IMF's conditions.

Croatia's economy went back into recession and the growth rate of GDP during Q2 was 2.1%. Consumption is low due to rising unemployment, lack of demand for consumer loans, and the negative effects of the VAT increase. Investments are also low, while the government does not plan major investments before 2013. Exports will depend on the situation in Eurozone, while tourism during summer was a success. The required reserve ratio was reduced, but it will not

affect macroeconomic stability – it is expected that the exchange rate will remain stable and the inflation low. The main risk to the Croatian economy is deteriorating situation in the Eurozone and the possible loss of the current credit rating. In early September, the Fitch agency kept the old credit rating of Croatia, but the forecast has been changed from negative to stable, which is good news and confirms that the government is now implementing a successful fiscal consolidation. Croatia has managed to weather the “Great Recession” without an arrangement with IMF, and it is certain that the state will be able to provide funds to finance the deficit, which dropped significantly this year. Taxes were increased immediately after the formation of the government, and by the end of the year, cuts are planned for budget funded wages, as well as a lay-off of public sector employees. Changing the law reduced the influence of trade unions, and a new collective agreement is foreseen that will eliminate many of the benefits of civil servants, while the restructuring of public enterprises with lay-offs has also been announced. A fiscal deficit of 3.8% is planned, but due to low growth there could be some deviation from the plan, although the government should try at all cost to fulfil the fiscal consolidation measures. The government has announced that it plans two privatisations through sale of government’s shares – fertiliser company “Petrochemicals” and “Croatia Insurance”, so their stock prices recorded significant growth.

Negotiations of Hungary with the IMF started in July and it was expected that an agreement would be reached by the end of the year. The bond market reacted positively and reduced the interest rate on government bonds. It seemed that the negative consequences of unorthodox economic policies and controversial change in the law will finally be reduced by agreement with the IMF. However, it is uncertain now whether an agreement will be reached due to Hungarian government suddenly announcing that it does not accept the reduction of pensions, job cuts in the public sector, and abolishing of atypical taxes and reduction of standard taxes. Financial market players were taken by surprise and reacted negatively to the news, immediately weakening the forint by 1.5% against the Euro.

During Q2 Romania has achieved GDP growth of 1.7% annually, a slight acceleration compared to Q1. The contraction in the Eurozone will negatively impact the growth of the Romanian economy, as 50% of exports are placed on this market, and 80% of foreign direct investment comes from there. Drought will have a negative impact on GDP growth, while inflation will increase due to lower supply of agricultural products in the market. In Romania too, the political situation complicates the implementation of economic reforms and deters investors. The European Union strongly criticised government actions, and financial markets have reacted negatively, so leu depreciated 4.5% against the Euro to historically the lowest value, while the central bank had to defend the exchange rate, which reduced the forex reserves. In addition, several auctions where government bonds were offered were unsuccessful because the borrowing costs were too high. Disagreement with the IMF is visible in the planned increase in public sector wages by 7.4% in December, despite the fact that there was a similar increase in June this year. The government insists on it in order to get the votes of public employees in the upcoming elections. The IMF will most likely agree to these terms, but in order to avoid a significant increase in the projected level of the fiscal deficit (3% was agreed), the government will have to withdraw from capital investments. During the negotiations with the IMF, a 5% increase of natural gas prices was agreed, an accelerated privatisation of public enterprises in the energy sector and the chemical industry, as well as settling of debts of public enterprises towards the state.

HIGHLIGHTS

Highlight 1 - Budget Rebalance and Fiscal Consolidation

Milojko Arsić¹

In early September, as the first steps toward medium-term fiscal consolidation, a revised state budget for 2012 was presented, together with the frameworks for fiscal policy for the coming year. In general, fiscal consolidation programme represents a major improvement over policies announced by the current ruling coalition, but also over the fiscal policy implemented by the former government between mid-2011 and mid 2012. Along with the fiscal consolidation measures, a series of regulations that are significant from the standpoint of state regulation in the Serbian public finances have been adopted. These measures are: inclusion of own revenues in the budget, reform of quasi-fiscal levies, regulation of wage policy in the public sector, review of justification for the existence of extra-budgetary agencies, funds and others. Even though the proposed fiscal consolidation has a number of good measures, the following analysis will focus on its weaknesses, in order to suggest possible ways to eliminate them.

Besides some positive changes, the revised budget and the elements of fiscal policy for the next year have several major drawbacks. The first drawback is that the revised budget for 2012 increases the fiscal deficit instead of decreasing it. The increase in the fiscal deficit, even if it is temporary and forced by unforeseen circumstances (drought), seriously jeopardizes the credibility of fiscal consolidation. The increase of fiscal deficit sends a bad message to investors and credit rating agencies, making the achievement of a new agreement with the IMF more difficult. In addition, increase of the fiscal deficit in the last quarter creates a false image of a very high fiscal consolidation in the coming year - maybe a part of citizens will accept such an image, but it is certain that the investors and international financial institutions will not.

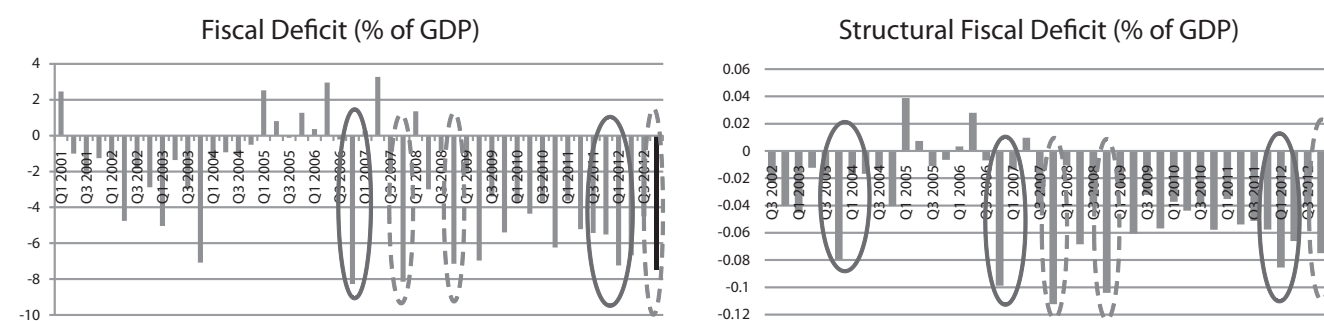
The increase of the deficit caused by the revised budget shows that besides the pre-election expansion in Serbia, there is also a post-election fiscal expansion – while the pre-election expansion wins votes, the post-election one fulfils some of the campaign promises. First significant increase of the fiscal deficit occurred on the eve of the elections held in late 2003. However, after the elections, there was no strong post-election expansion for two reasons. The first reason was that in the first half

of 2004, due to the slow formation of the government, a regime of temporary funding was in force. Another reason was the abandonment of the government of the “developmental” budget, which was one of the main campaign promises of the ruling coalition, and whose implementation would have meant strong fiscal expansion. However, IMF exerted heavy pressure on the then government in order to drop the “developmental” budget – an important instrument of pressure and conditionality was a write-off of debt owed to the Paris Club through application of a restrictive fiscal policy. As a result of this pressure, the government pursued a restrictive fiscal policy until the completion of an agreement with the IMF and the write-off of 15% of the debt to the Paris Club in the first half of 2006. During 2005, a fiscal surplus was achieved, which was the only year since the beginning of transition in Serbia that a fiscal surplus was recorded. However, in the second half of 2006, with the announcement of parliamentary elections, a strong fiscal expansion had begun (launching of National Investment Plan, increase of wages, increase of subsidies, etc.). The possibility of implementing such a policy was facilitated by the expiration of the arrangement with the IMF and by the generated high revenues from privatisation in 2006 (sales of Mobtel, Vojvodjanska Bank, and others). Temporary financing during the first half of 2007 postponed the post-election expansion for the second half of 2007.

Parliamentary and presidential elections of 2008 were called unexpectedly, so there was no pre-election expansion, but the post-election expansion in the second half of 2008 was very strong, although it was clear that a big economic crisis was on its way. The biggest contributors to the 2008 fiscal expansion were two extraordinary increases of pensions – the 12% increase at the beginning of the year, followed by an increase of more than 10% at the end of the year. In addition, a number of other campaign promises were realised as well.

The last election also saw a pre-election expansion. Public expenditures and fiscal deficit began rising from mid 2011 and by the first half of 2012 it had reached enormous proportions. Despite the fact that the economy was in recession, the first half of 2012 saw growth in almost all public expenditures, primarily in discretionary expenditures: subsidies, and spending on procurement of goods and services. However, expenditures on wages and social transfers were growing faster than the statutory dynamic (for more details, see the chapter on fiscal policy and trends).

¹ Faculty of Economics and FREN

Figure 1. Fiscal deficit and parliamentary elections in Serbia

Based on the above it can be concluded that over the past decade, the pre-election expansion lacked only when the elections were called unexpectedly, as was the case in early 2008, while the post-election expansion was absent only in periods of temporary financing (i.e. in the period between the election and the formation of the new government), as well as in the period of a solid arrangement with the IMF.

The proposed revised budget for 2012 continues the practice of post-election fiscal expansion. The consolidated fiscal deficit rises from 216 to 222 billion RSD, despite the tax increases in the last quarter. Expansionary fiscal policy would be even higher if the tax revenues had been increased, in which case the fiscal deficit would reach close to 240 bn RSD. The consolidated fiscal deficit in the fourth quarter, according to the proposed revised budget, will be about 70 bn RSD, which is about 7.5% of quarterly GDP.

The amount of the consolidated fiscal deficit in the fourth quarter far exceeds the usual seasonal increase in the fiscal deficit at the end of the year. Comparing the real level of planned expenditures in Q4 of 2012 with the actual expenditures in Q4 of 2011, we get a more convincing confirmation of expansionary fiscal policy. Planned consolidated budget expenditures in the fourth quarter will be about 500 bn RSD, which will generate real growth of over 10% compared to the same quarter last year². In the first half of the year, the real expenditure growth was 4.9%, while the real level of spending will likely stagnate in the third quarter of this year. Specific reasons for increase in the fiscal deficit are detailed in the analysis of the Fiscal Council³: payment of the so-called 13th pension, salary increases above the level determined by fiscal rules in certain sectors at the state and local level, increase of subsidies, and others.

In addition to fulfilling campaign promises, the growth of the fiscal deficit in the second half of 2012 was also

influenced by a relatively long period of the formation of the new government and its unwillingness to apply immediately after some necessary but unpopular measures for reducing the fiscal deficit, such as a tax increase. There was a legal possibility of raising taxes as of September 1, before the rebalancing of the budget⁴, which would have reduced the fiscal deficit by 5-6 bn RSD. The revised budget for 2012 made the structure of public expenditures worse by reducing the already modest share of public investment in public spending. Public investment should be a key antirecession stimulus, but also an important measure for the long-term sustainable growth of the economy. The occurrence of unplanned expenses, such as expenses for mitigating the effects of drought in conditions when the fiscal deficit is already very high and unsustainable, cannot be an argument for its further increase. Instead of increasing the fiscal deficit, the means for mitigating the effects of drought should have been provided by reducing other expenses.

Second major drawback of the fiscal consolidation programme is that it mainly relies on increasing revenues, while lacking significant savings on the expenditure side - except in the case of salaries and pensions. The increase in the basic rate of VAT, excise tax, corporate tax, etc. will generate additional revenue of around 1.2% of GDP in the next year, or around 1.5% of GDP in the medium term. It was estimated that the tax increase was necessary because the systemic (structural) fiscal deficit of Serbia is very high (over 4% of GDP), so its reduction exclusively through expenditure cuts is highly unlikely (it is possible only with a reduction in nominal wages and pensions). Relying solely on the expenditures, leads to a relatively slow reduction in the fiscal deficit, which would make the risk of a debt crisis very high. An important argument in favour of tax increases as part of fiscal consolidation is that, even after the increase, the tax rates will still be relatively low compared to the regi-

² In order to compare data to the previous year, we used consolidated expenditures that do not include employer social contributions.

³ Fiscal Council (2012)

⁴ Current government of Croatia increased the VAT rate immediately after forming the government and significantly before the rebalancing of the budget, which had a positive effect on fiscal performance of the Republic of Croatia in 2012.

on, which means that it will not jeopardize the international competitiveness of Serbia.

However, as a rule, successful fiscal consolidation programmes are predominantly based on reducing government spending⁵. A typical successful consolidation model is based on one-time tax increase at the very beginning of programme implementation and constant significant reduction in public spending. In contrast, spending in Serbia in the last quarter of 2012 has been rising faster than taxes (despite the tax increase), while its reduction in the coming year is insufficient.

Spending cuts in the coming year mostly come down to savings on salaries and pensions, while other current expenditures (subsidies, spending on goods and services, reducing the number of employees in the public sector, and others) that contain considerable unproductive spending, are not being reduced. Although most of these expenses cannot yield significant savings in the short term, it would be important for the long-term success of the programme and its credibility to start immediately with a reduction in public spending, and that means: reduce or eliminate certain subsidies (elimination of subsidies for new hires, reduction of subsidies for restructuring enterprises and utility companies, etc.), reduce the number of employees in the public sector, realise some savings in the procurement of goods and services, and others.

However, the most significant balance sheet savings in the short term can be achieved by removing the vertical imbalance between revenues and expenditures of the state and local government, by transferring some of the liabilities from the state to the local communities⁶. By partially transferring the funding of salaries of primary and secondary education from the state to the local community, already in 2013 it would be possible to reduce the deficit by 20–30 bn RSD. The effect of eliminating vertical imbalance would be approximately equal to the effect of the VAT increase, without costing the citizens anything, but merely making the state distribute the existing taxes more efficiently. If the vertical imbalance of revenues and expenses is not removed, the reduction of fiscal deficit of Serbia will be slow,

the growth of public debt significant and long-lasting, which jeopardizes the success of the entire fiscal consolidation programme. The relatively fast reduction of the fiscal deficit, which would result in a fiscal balance in four years, besides contributing to the stabilisation of public finances in Serbia and improving its credit rating, would also mean the fulfilment of new, more stringent criteria of the EU, according to which the ceiling of the structural fiscal deficit is 0.5% of GDP.

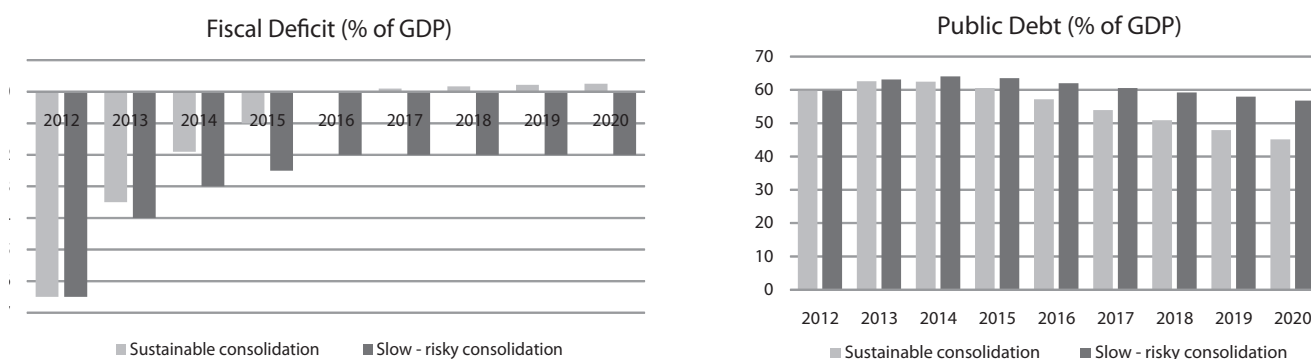
In addition, it is necessary to formulate this year basic directions of the reform of the sectors of main budget consumers, which are critical to the long term sustainability of public finances in Serbia. That means above all adopting a sustainable concept of the pension system reform, implementing the rationalisation of schools, addressing the issue of restructuring companies as it was done with banks 10 years ago, improving the management of state and public utility companies, etc.

The third drawback of fiscal consolidation programme is that a relatively slow reduction of fiscal deficit is planned, which means that public debt to GDP ratio will grow for at least the next two–three years. High amount of funds needed to finance the fiscal deficit and debt principal payments due under conditions of low credit rating, lack of credible fiscal consolidation, absence of an agreement with the IMF, and the uncertain progress towards EU, opens a serious issue of providing funds to finance them, as well as increasing the costs of financing. Necessary funding of state liabilities, even in the event of strong consolidation, is very high and amounts to about 1.5 bn EUR in the period September–December 2012, or 4–5 bn EUR in 2013.

The amount of necessary funds is such that it is highly unlikely that the said funds could be predominantly secured through bilateral agreements with other countries, without a significant involvement of commercial funders. Bilateral funds may, at best, serve to bridge liquidity until an agreement is reached with IMF and country's credit rating improved and stabilised. Otherwise, if no agreement is reached with IMF, the debt crisis is almost certain. Therefore, the public debt trajectory calculated for the scenario of slow fiscal consolidation is more of a computational illustration than a realistic assessment of what would happen in reality. In case of slow, non-credible consolidation that would have no support from the IMF, the fiscal deficit would be reduced spontaneously as it would not have a funding source, which would mean slower growth of public debt, but in that case, GDP would drop significantly, and the dinar would depreciate, so public debt to GDP ratio would be higher than what is presented in the following chart.

⁵ In the case of Serbia, another reason for reducing expenditures is that they are high compared to the country's level of development.

⁶ The claim that fiscal decentralisation did not increase the consolidated fiscal deficit is false. By transferring about 30 bn RSD (net) from the state to the local communities, the state deficit has been increased by 30 billion, while the balance of local communities remained unchanged, which is why the consolidated fiscal deficit rose by 30 billion. These effects are the result of the fact that state's liabilities remained unchanged while its revenue declined. On the other hand, the local communities used the additional revenues for increasing their spending, which means that the difference between their revenue and expenses remained unchanged. This kind of behaviour of the local communities was predictable, and it is consistent to Friedman's assertion that the state will always find expenses on which to spend the funds received from higher taxes.

Figure 2. Fiscal deficit and public debt dynamics in the alternative consolidation scenarios

One of the weaknesses of the new government's fiscal policy is that otherwise good conceptual measures, such as the regulation of the quasi-fiscal levies, are not operationalised in a way that would support fiscal consolidation. Elimination of more than 100 quasi-fiscal levies will reduce the state revenue by about 10 bn RSD (about 0.3% of GDP), which would under other unchanged conditions cause an increase in the fiscal deficit by the same amount. The introduction of quasi-fiscal levies in the budget would somewhat lower the actual losses, but still the net effect of the abolition of duties will be negative. Given the scale of the crisis and the extent of the necessary fiscal adjustment, it is essential to make sure that with the implementation of all measures of fiscal policy their effect on the fiscal deficit be at least neutral, but that they contribute to its reduction. In case of abolishing quasi-fiscal levies, compensation for the lost revenue could be made by increasing the revenue yield of property tax or increasing the corporate tax (see Spotlight On in this issue of QM).

Despite these drawbacks of the current version of the fiscal consolidation programme, restoring Serbia's public finances to a sustainable path is not mission impossible, all it takes is political will. It probably takes the political skill as well to justify giving up on some campaign promises, as well as to correct the bad and unsustainable programmes such as the fiscal decentralisation. It is necessary that the revised budget reduces the spending by 7-8 bn RSD, which could be achieved by giving up on some campaign promises, eliminating certain subsidies, and so on.

In the scope of the budget for 2013, it is necessary along with the planned austerity measures to transfer at least 20 bn RSD of state liability to local communities, as well as continue the reduction of subsidies, number of employees in the public sector by 4-5 thousand a year, to begin reform of all sectors of major budget consumers (pension system, education, health, etc.), as well as reduce the growth of interest costs by restoring investor confidence, etc.

Literature:

- Arsić, M. (2011) "Analysis of the Proposal to Increase the Participation of Local Communities in Income Tax", *Quarterly Monitor* no. 24, FREN
- Arsić, M., Nojković, A., Randelović, S., Mičković, S. (2012) "Structural Fiscal Deficit and Dynamics of Public Debt in Serbia" Publishing Centre of the Faculty of Economics, University of Belgrade (in print)
- Baldacci, E., I. Petrova, N. Belhocine, G. Dobrescu and S. Mazraani (2011) "Assessing Fiscal Stress", IMF Working Paper 11/100
- Baussard, J. F, de Castro and M. Salto (2012) "Fiscal Multipliers and Public Debt Dynamic in Consolidation", *Economics Papers* 460, European Commission
- Dobrescu, D. and F. Salman (2011) "Fiscal Policy during Absorption Cycles", *Working Paper 11/41*, IMF, Washington
- Eduardo, L. (2010), "Fiscal and External Sustainability", Economic Policy and Debt Department, World Bank
- EU (2011) "Treaty on Stability, Coordination, and Governance in Economic and Monetary Union"
- Fiscal Council (2012) "Estimate of the Revised Budget for 2012 and the Proposed Laws With Fiscal Implications" Ministry of Finance and Trade (2012) "Proposal for the 2012 Revised Budget"
- Prescibtero, A. and M. Arnone (2006) "External Debt Sustainability and Domestic Debt in Heavily Indebted Poor Countries" *MPRA Paper* No. 1396

SPOTLIGHT ON:

Reform of the System of Quasi-Fiscal Charges for the Improvement of Business Conditions in Serbia

*Milojko Arsić **

*Saša Randelović ***

*Milan Pejić ****

Over the last decade, significant reforms of the tax system in Serbia have been implemented, which made the most important tax instruments consistent to the best tax practices in the world. Tax rates on the most important tax instruments are low, the base is wide, and the exceptions and exemptions moderate. Despite this, the assessments of the tax system in Serbia of the business community and international organisations dealing with estimates of business conditions are quite negative. One of the important reasons is the non-transparent system of quasi-fiscal charges, whose changes are also unpredictable¹. Application of a complicated system of quasi-fiscal charges is expensive for taxpayers, and the unpredictability of their changes generates business risks. The main parameters of quasi-fiscal charges are often inadequate and arbitrarily determined resulting in violation of the principles of economic efficiency and equity. Therefore reforms of quasi-fiscal charges that would go toward their simplification and better compliance with the principles of efficiency and equity represent an important prerequisite for the improvement of business environment in Serbia. The proposed reforms of the system of quasi-fiscal charges by the Government represent a significant step towards improving the business environment, because it abolishes many unjustifiable charges, defines the legal procedures for introduction of duties in the future, includes all charges in the budget, etc. However, the main weakness of the proposed reforms is that they are not revenue neutral - they increase the fiscal deficit by around RSD 10 billion, which further hinders sustainable fiscal consolidation. A possible solution is to simultaneously implement measures that would lead to an increase in revenue from property taxes, or to increase the corporate income tax rate to 15%.

Introduction

Tax system in Serbia, defined in a broader sense, is characterised by the existence of numerous quasi-fiscal charges at all state levels. The system of quasi-fiscal charges is non-transparent, while its changes are unpredictable, and basic parameters of duties (base, rate, tax payer, etc.) in some cases are arbitrarily defined. Many of the duties are not included in the consolidated Treasury account, so the final number of duties is uncertain, as well as their total revenue. According to the research of NALED, there are close to 400 quasi-fiscal charges in Serbia, that bring a revenue of 2% of GDP to the government, but it is certain that the number of duties and their revenue yield are greater. The changes of quasi-fiscal charges are often unpredictable, and the decisions about it are sometimes made outside the law and the regular parliamentary procedure, which reduces the transparency of the public revenue system. The unpredictability and non-transparency of the quasi-fiscal charges brings uncertainty into the operations of business entities in Serbia – business entities are not sure which taxes they need to pay, nor when will their tax duties change. Aside from that, the basic parameters of quasi-fiscal charges are often inadequately defined, causing distortion in business operations of companies and entrepreneurs.

The amount of duty is sometimes not proportionate to the economic power of the taxpayer, the value of the service, the amount of natural resources used by the taxpayer or the damage it causes to the environment, so in those cases we speak of quasi-fiscal charges.

* Faculty of Economics and FREN

** Faculty of Economics and FREN

*** In the domestic public, the term quasi-fiscal charges usually involves a whole set of non-tax duties imposed by government at all levels, where the amount of duty is greater than the value of the counter-charge or counter-service. However, problems in the public revenue system in Serbia are not only caused by quasi-fiscal, but also a number of fiscal duties, of non-tax character (their number is too large, they are inadequately parameterised, etc.). Since the focus of this paper is on the reform of the entire set of non-tax revenue, not just quasi-fiscal charges, it would be correct to use the term non-tax duties, but because of the frequent use of this term in the public, we will use the term quasi-fiscal charges.

Reform of the System of Quasi-Fiscal Charges for the Improvement of Business Conditions in Serbia

Non-transparent and unstable system of quasi-fiscal charges, with complicated administrative procedures of public revenue are some of the main reasons why Serbia, based on the characteristics of the tax system, is poorly ranked on international competitiveness lists, published by the World Economic Forum and the World Bank. Additional confusion, especially with foreign investors, was created by inadequate classification of duties, and so some of the classic taxes were labelled as charges or fees. Another problem is that some of the fees and charges were set at a significantly higher level than is appropriate to the nature of these instruments, so they often contain a significant if not dominant tax component. In addition, similar quasi-fiscal charges are often introduced (same basis, same taxpayer), which reduces the transparency of the tax system and increases the cost of its implementation. The above shortcomings have entirely cancelled out the positive effects of low tax rates applied in the basic taxes (income tax, VAT).

Therefore, the reform of the system of quasi-fiscal charges represents one of the most important steps toward improvement of business conditions in Serbia. The aim of this reform is to create a simpler and more transparent tax system, whose changes would be relatively rare and predictable. Such a tax system would create lower costs for the taxpayers both in terms of minimizing the excess burden of the tax, and in terms of the compliance costs. The tax system would be fairer, because the tax liability would be better aligned with the economic power of taxpayers, while the fees and charges would more accurately reflect the benefits that companies or citizens would receive from the state, or the damage that their activities are causing to the environment.

In addition, the reform of the system of quasi-fiscal charges should support the fiscal consolidation, which primarily means that the net result of these reforms should be revenue-neutral. In doing so, revenue neutrality can be achieved by compensating for the lost revenue from abolishing certain quasi-fiscal charges or their reduction through increasing the revenue yield from general taxes, such as property taxes. Revenue neutrality of the reform of the system of quasi-fiscal charges could also be achieved by introducing a local corporate income tax of up to 3%. The introduction of a 3% local corporate income tax would also compensate for the lost revenue from company signboard fees, but also for the losses that would be incurred by the abolition or reduction of other local duties.

In addition to the analysis of the current situation and its causes, the purpose of this paper is to systematically define the basic principles of operation of the system of non-tax and quasi-fiscal charges, which should provide a framework for defining concrete measures to reform the existing system of quasi-fiscal charges. Given that some steps towards the reform of the system of quasi-fiscal charges have already been taken by the Government, this paper will analyse their adequacy. Although certain government measures have been announced and partially implemented at the time of the completion of this paper, the importance of the principles defined in this study lies in the fact that they will continue to present a framework for transparent, efficient and fair functioning of the quasi-fiscal charges, and as such should be taken into account in the implementation of further measures which would lead to changes in the functioning of the quasi-fiscal charges in Serbia.

1. Condition and trends

Institutional units of various levels of government (state and local self-government), public agencies, regulatory authorities, departments, administrations, funds and others can be financed by two broad groups of sources of income – tax and non-tax. Tax forms are the dominant part of the budget revenues of the central government and local self-government, while non-tax forms may be imposed by public agencies, regulatory agencies, authorities, and government funds, when they are part of “own-source revenues”. The Law on Budget System defines the non-tax revenues as a type of public revenue which the state collects through mandatory payments of business or physical entities, with an obligation of rendering special services to such entities (fees, taxes, permits, licenses, payments, and other allocations of funds on various grounds) including fines and penalties. However, despite such a definition of non-tax forms, certain payments can be observed that do not fit in the above definition, but are formally included in the group of non-tax revenue. These are the so-called quasi-fiscal charges, and they include those forms of payment that to some extent apply a financial and/or administrative burden on businesses, and for which they either receive no right, goods or services or they get rights, goods or services whose objective value is significantly lower than the relevant tax payment amount.² Classification of revenue can be made on the basis of their economic characteristics (Table 1).

² NALED (2012), *Sooner or Later – System of Non-Tax and Para-fiscal Forms in the Republic of Serbia*, Working paper, Belgrade. The study was done by a team of local and foreign experts gathered around the National Alliance for Local Economic Development (NALED), with the support of USAID Business Enabling Project (USAID BEP).

Taxes include a broad group of revenues where the amount paid is not directly associated with any particular service provided by any level of government. Unlike them, the non-tax revenues (user fees, fees for public services, regulatory fees, specialist fees, etc.) constitute voluntary or mandatory charges that are associated with specific benefits that the individual who pays them receives through the consumption of certain goods and public service. User fees are used for payment of goods or services for which the user receives direct benefit in the value of the amount paid. They are most often associated with the amount of goods or services that the user acquires. Fees for the provision of public services are being introduced in order to compensate for the cost of using public resources or social costs that a user imposes on others through his activities, through the price he pays for the use of those resources or for conducting such activities (this group includes Pigovian taxes, whose aim is to neutralise the negative externalities). Unlike user fees, fees for public services are not directly related to the amount of goods or services that the user acquires, but the user's share in the cost should on average be in accordance with the rights exercised. Regulatory fees (fees for the administration and supervision) are introduced in order to pay for the costs incurred by the state due to processing of various applications and requests of the applicant, or to pay for the inspection and control of the user's activities. In addition to these groups, there are also specialised fees paid on the property, in order to reduce the direct increase in property value caused by the investment. Permits, licenses and other fees could also be introduced, as well as duties that have a mixed character of two or more different groups of public revenues.

Table 1. Classification of public revenues and their basic characteristics

Classification	Example	Basic characteristics
Tax revenues	Income tax, Consumption tax, Excise, Property tax, etc.	Introduced in order to realise revenue for any function of the state. No relation between tax burden and benefit for individual taxpayer.
Non-tax revenues User fees	Consumption of water, electricity, Connection charges, irrigation charges, etc.	Introduced in order to pay for the provision of goods or services that are of direct benefit to the taxpayer. User fees have to be equally distributed between same groups of taxpayers and types of services.
Public service fees	Various utility services (garbage disposal, sewage system, etc.)	The aim is to compensate for the social cost that the user imposes on others through his activity or spending of public resources. User's share in programmes of removing negative externalities cannot exceed the cost he imposes with his activities. User fees have to be equally distributed between same groups of taxpayers and types of services.
Regulatory fees	Construction permits, professional licensing, etc.	Introduced for coverage of costs that the state incurs from processing user's various applications and requests or to pay for the inspections and controls of user's activities. Regulatory fees cannot exceed the stated costs of administration and control.
Specialised fees	Land usage fee, etc.	Introduced in order to reduce direct increase of property value that occurs due to the investment. Must not exceed the increase in property value that occurs due to investments.

Source: Spitzer (2002), "Taxes vs. Fees: A Curious Confusion", *Gonzaga Law Review*, Vol. 38, Issue 2.

Reform of the System of Quasi-Fiscal Charges for the Improvement of Business Conditions in Serbia

A particular problem which reduces the transparency of the tax system in Serbia, and often leads to confusion especially among the foreign investors, is a terminological confusion present in the tax regulations. Some classic taxes are treated as fees in some regulations, as is the case with the land usage fee, which represents a typical property tax, or with company signboard fee which is also a classic tax and not a fee. Also, in many cases in which the user receives a particular service from the state authority, the value of the tax is determined at the level far higher than the cost of providing services, so in this case it could be said that this type of tax is a combination of fees and classic taxes. In the case of certain duties, such as court fees, the tax component dominates, and it could be argued that it is more of a tax than a fee.

There are over 370 different types of non-tax duties in Serbia, about half of which (179) are quasi-fiscal charges (as mentioned above, all non-tax revenue will be marked in this paper as quasi-fiscal charges³). Such a large number of duties, as well as the fact that they can be introduced by central government, local self-governments, independent agencies, regulatory authorities, departments, administrations, funds, etc. without or with little direct control from the Ministry of Finance, represents an important indicator of the urgent need to implement the reform of non-tax revenue system⁴. However, some duties have legitimate purposes and need to exist in a certain form and with minor changes – some of them need to be increased or decreased, and for others the method of calculation needs to be changed. On the other hand, there are taxes that need to be abolished, because they do not meet the basic conditions for their existence⁵ (absence of purpose – what is trying to be achieved with certain duties, as well as the absence of a clear idea on what the realised revenues are supposed to finance), but it is crucial that such revenues be replaced with some other forms (at the local level, property tax is particularly suitable) in order to achieve a revenue-neutral reform. Even though there is a large number of non-tax duties, individual taxpayer pays a significantly smaller number of duties (around several dozen). So for example, environmental taxes are paid only by the polluters, while there are also a lot of charges that are paid on voluntary basis for services for which they are intended.

Table 2. Revenue yield and scope of quasi-fiscal charges at various institutional levels of the government

	Republic	Autonomous province	Cities	Municipalities	Other	Consolidated
Quasi-fiscal charges in bn RSD	29.9	1.9	27.9	12.6	1	73
Number of quasi-fiscal charges	57	15	27	28	5	76
% of quasi-fiscal charges in total quasi-fiscal revenue	40.8	2.6	38.1	17.2	1.35	100
% quasi-fiscal charges in the budget	4	4.1	22.9	16.8	2.7	5.6
quasi-fiscal charges in % of GDP	0.94	0.06	0.88	0.4	0.03	2.31

Source: Author's calculations based on the data from the Treasury Department of the Ministry of Finance

Based on the available data on 2011 revenues from 76 quasi-fiscal charges, their revenue yield and volume by state levels were calculated (Table 2). We can see that, even though the largest number of quasi-fiscal charges is collected at the state level (57, where revenues from 27 of them are shared with the units of local self-government), their revenue yield (around RSD 30 bn or 4% of the state budget) is not the biggest. The largest revenues from these types of charges are realised by the units of local self-government (RSD 42.4 bn), primarily by the cities (RSD 27.9 bn, 22.9% of the budget), followed by the municipalities (RSD 12.6 bn, 16.8% of the budget) and finally by the Autonomous Province of Vojvodina (RSD 1.9 bn, 4.1% of the budget).

In addition to 76 quasi-fiscal charges, the data from the Treasury Department includes 29 other non-tax duties, which mostly represent the source of the state's revenue. Total revenue of non-tax duties for the state (105 different

³ A more precise definition of quasi-fiscal charges, non-tax revenues, etc. can be found in NALED (2012)

⁴ Absence of transparency in introducing certain charges and marginalised role of the Ministry of Finance in controlling this process in which line ministries, agencies, departments and administrations have been given the freedom to create the volume and basic elements of non-tax duties, presents an additional reason for the necessity of this reform.

⁵ Certain quasi-fiscal charges can be classified in this group, because they already have all significant characteristics of a tax, and they can be subsequently replaced by a less distorting type of tax.

taxes) amounted to RSD 46.6 bn in 2011 and they are almost equal to the total of other tax revenues and part of the non-tax revenues (fines and part of the revenue of public enterprises is excluded) that appear in the Law on the Budget. When we add to this the non-tax revenue of the local self-government units (RSD 44.3 bn RSD, out of which RSD 28.9 bn are revenues of the cities, RSD 13.5 bn of the municipalities and RSD 1.9 bn of AP Vojvodina) and other public institutions (RSD 15.4 bn, out of which the largest part are revenues of the public enterprise “Roads of Serbia”) we get a total revenue from non-tax duties at all levels of the state in the amount of around RSD 106 bn or 3.3% of GDP. We can see that the largest part of non-tax revenues is relatively equally distributed between the state’s budget and local self-government units, and that these revenues have seen growth in the past few years. Since the non-tax revenues make a significantly larger part of the budget of local self-governments than that of the state, their growth at local level is more pronounced. Thus, local governments had the highest nominal growth in non-tax revenue in the period 2009–2011, which amounted to 38% (real growth of 17%), while the nominal growth of the state’s non-tax revenue in the same period was 13% (real decrease of 4%).

Regulatory costs for drivers

Over the last few years, adoption of binding regulations has been especially common, and the result has been a significant increase in the cost for drivers. These measures include the regulation to drive with all four winter tires during winter, to buy new first aid kits, and others, as well as the latest regulation that increases the cost of passing the driver’s exam from EUR 200–300 to about EUR 850. The cost of EUR 850 for getting a driver’s licence is double the amount of the average salary in Serbia, which is the equivalent of driver’s exam in Germany costing EUR 4,000 (whereas the real cost of Drivers Ed in Germany is about EUR 1,800).

Proponents of these regulations justify them by saying their application increases the traffic safety, which may be true if we were to estimate the isolated effect of these measures. However, what is lacking in the justification analysis is the cost-benefit part of the analysis. Ignoring the cost, any measure that contributes to road safety would be justified, regardless of the cost. However, consistent application of such a logic would lead to absurd conclusions, such as for example that we should allow only the use of safest cars and prohibit the traffic on all unsafe roads, etc.

Cause and effect of the current system of quasi-fiscal charges

The existence of a large number of duties increases the tax compliance costs for taxpayers, which is an important indicator of its inadequacy. Inadequate parametrisation of fiscal duties, as well as the high compliance costs of the tax system, particularly affect entrepreneurs, micro and small enterprises. High fiscal duties of lump-sum character (as is the case with company signboard fee), increase the costs of micro and small enterprises, which sometimes leads to their transition into the grey zone or to their closure.

Inadequate parametrisation of quasi-fiscal charges leads to significant changes in relative prices, which creates high excess burden of taxation, relative to the one that would be achieved by applying the general tax. In this way the tax system in a broader sense has negative impact on economic efficiency. Besides that, the arbitrariness in determining some quasi-fiscal charges violates the horizontal equity of taxpayers, which means that taxpayers with the same economic power pay a different amount of duties (e.g. in the case of company signboard fee). The obligation of payment of certain fees by users who do not benefit from a particular service or harm the environment is a way of introducing a hidden tax, where the tax parameters are set in such a way that they create distortions. Thus, for example, gross revenues is used as the basis for calculating certain fees which means that immaterial costs are being taxed, and not only the added value. In this way, companies that have the same gross revenues pay the same taxes, even though their economic power measured by operating revenue or profit can vary significantly.

General reasons for excessive and uncontrolled proliferation of quasi-fiscal charges in Serbia are: the intention of the executive authorities at all levels of government to use the introduction of quasi-fiscal charges in order to avoid parliamentary control of spending, absence of clear legal framework that would define the procedure for introducing new charges and low general taxes compared to expenditures. Aside from these general reasons, the growth of quasi-fiscal duties on the local level was a response to a decreased transfer from the central budget, starting in 2009.

Intention of the executive government to reduce/avoid parliamentary scrutiny of spending is present in all countries of the world, and it can be argued that there is some kind of ongoing strategic game between the government and the parliament, where the government is trying to reduce parliamentary control, while parliament is trying to expand and strengthen it. Although this is a common phenomenon in the world, its dimensions in Serbia since 2003 have become worrisome. The existence of permanent motives of the executive government to reduce/avoid parliamentary scrutiny of public spending indicates that the measures preventing it cannot only be once-off measures (abolishing unnecessary taxes), but systematic, in the sense of improving legal restrictions that would more clearly define the restrictions, strengthen the control and corrective role of the Ministry of Finance (e.g. in the case of inadequately high burden on taxpayer, inadequate parametrisation, etc.). This just shows that even if the system of quasi-fiscal charges would for a while be put in order, in several years some new taxes would surface. Something similar happened in Serbia in the period 2001-2003 when almost all taxes were included in the budget, only to immediately after start a process of introducing new taxes that were collected outside the budget, and some even outside the consolidated account of the Treasury. The introduction of such taxes is almost always accompanied by appropriate campaigns claiming that it is a specific duty and it is important that it be outside the budget so as not to be used for other purposes and the like. Attempts to introduce extra-budgetary duties will certainly be present in the future as well, so system restrictions are required in order to minimize it. Introducing new quasi-fiscal charges or changing the number of existing ones without modification of the law⁶ can easily increase the level of revenue, while expenses from thus realised revenue can be spent by state agencies, public enterprises and similar institutions outside the parliamentary control.

The absence of appropriate regulations that would clearly define the procedure of introducing taxes, has encouraged budgets and off-budget institutions at the state level to introduce numerous duties which were inappropriately high, their base inadequate, and taxpayers arbitrarily defined. It is paradoxical that the funds collected from quasi-fiscal charges were sometimes inappropriately spent, allowed by the absence of parliamentary control, even though avoiding the improper spending was one of the main arguments why these duties should remain outside the budget.

The third important reason for the growth of quasi-fiscal charges is the systemic (structural) gap between the low basic taxes (VAT, personal income tax, corporate income tax, property tax, excise tax on cigarettes and alcoholic beverages) and generous public spending. This policy has resulted in high fiscal deficit, which is why all levels of government tried to introduce various quasi-fiscal charges in order to provide additional funds to finance public spending and reduce the budget deficit.

Finally, one important reason for the introduction of new duties and inappropriate increase of existing ones at the local level is a significant reduction in transfers to local communities from the state budget, starting from 2009. By increasing the existing and introducing new taxes, the local communities have partially offset the decline in transfers, but at the same time, by introducing distorting taxes they have made the business conditions worse. One of those duties, which is particularly notorious, is the company signboard fee which some local communities have increased inappropriately, where the increase from one taxpayer to another was pretty arbitrary.

3. Reform of the system of quasi-fiscal charges – principles and recommendations

The existence of a large number of non-tax and quasi-fiscal charges and their heterogeneity precludes the application of a uniform approach to their reforms. In this sense, their almost complete elimination or linear reduction are considered inadequate, since some of these duties should actually exist in the given amount, others should exist, but in a differently defined way, or in a lower amount, while some specific duties should be eliminated all together either by abolishing or merging them with other duties. Given the nature of this issue, it is necessary to define the basic objectives of such a reform, which would constitute a general framework for modification and/or elimination of certain types of these duties.

It is necessary to note that any reform of the system of non-tax and quasi-fiscal charges should be revenue-neutral, i.e. they should not lead to a reduction in total consolidated public revenue, because that would imply further increase of the already high fiscal deficit. Naturally, revenue neutrality can also be achieved by compensating for the reduction of revenue caused by the abolition or reduction of certain taxes, by increasing revenues from general taxes (e.g. property tax) or by introducing a local tax on business in the form of corporate income tax, e.g. at the rate of 3%.

⁶ Inadequate legal framework leaves a large space for using various sectoral laws, by-laws, local decrees, decisions of agencies' or public enterprises' steering committees to introduce various taxes, which can hardly be controlled from the aspect of the entire system (NALED 2012).

Starting from the relevant theoretical framework and experience of developed countries, there can be defined three main groups of objectives/principles of non-tax system reform and quasi-fiscal charges in Serbia:

- **Economic efficiency** – Redefinition of the system of non-tax and quasi-fiscal charges in a way that would minimize the excess burden of taxation and reduce the compliance and administration costs (due to the reduction of number of taxes), which would lead to a reduction in distortionary effects of these taxes on the economic behaviour of enterprises and citizens. In this regard, it is necessary to set up the system so that there is a smaller number of duties that would have a relatively wide scope and low rates, and the mechanism of their payment would be such that implementation costs would be as low as possible.
- **Equity and moderation** – Defining the parameters of duties should be based on the purpose of their introduction, so as to ensure sufficient resources for achieving this goal, while keeping them proportionate to the economic strength of the people who pay these duties.
- **Transparency and predictability** – In addition to the fiscal burden, often an important quality parameter of investment-business environment is also the degree of predictability of the fiscal burden. In this regard, it is essential that all duties (i.e. their basic elements) be governed solely by the law, which would prevent their frequent and rapid change, outside the parliamentary procedures. In addition, it is necessary that the revenues realised by the government on this basis be recorded on the consolidated Treasury account and be reported as part of the state budget, and then allocate funds from that budget for specific purposes. This would improve the transparency of the whole system and reduce the incentives and opportunities for frequent and unjustified adjustments to the rates of certain taxes.

In light of these objectives, i.e. principles of the reform of quasi-fiscal charges in Serbia, it is possible to define concrete proposals of necessary reforms in this area, which can be divided into two groups: i) structural, and ii) systemic and procedural reforms.

3.1 Structural reforms

The objective of structural reforms of non-tax and quasi-fiscal charges in Serbia is to create a system of duties that would make the uncertainty, risks and associated costs lower, and the distribution of burden more equitable and economically efficient. This way the same amount of total public revenue would be collected with less excess burden, lower compliance and administration costs, and with less negative effects on investment and business conditions in the country.

Given the large number of these duties, the aim of this paper is not to elaborate on individual solutions for each type of quasi-fiscal charges, but to define principles that would provide a precise framework for their reform. Consequently, structural measures aimed at improving the equity and efficiency of non-tax and quasi-fiscal charges in Serbia can be grouped into four areas.

a) Replacement of distorting and inequitable charges by appropriate taxes

In conditions of reduced inflow of transfers since 2009, a large number of local governments in Serbia has introduced new and significantly increased some of the existing taxes, some of which were introduced in a manner and an amount that discourages entrepreneurship. A significant increase and a regressive nature of the company signboard fee is often mentioned as an example of distortion and inequity in the system of public revenues in Serbia, especially because this is a moderately important source of public revenue (in 2011, revenues of local governments from this fee amounted to RSD 5 bn). This is a fee that in its economic essence represents a tax, because the company by its pure existence becomes obligated to pay it, and it gets no direct counter-service from the local self-government unit. Normatively speaking, the amount of fees is assessed by local public revenue offices, based on the relevant circumstances of the business entity (type of business, size of business premises, equipment, location and so on). However, in practice, this fee is usually of a lump-sum character and is not directly related to the real economic power of the taxpayer, which is why it is considered extremely inequitable and an important limiting factor in the development of shops and small businesses. In addition, there are numerous other local duties, which are essentially taxes, but are charged in some other, non-tax form, creating equal or greater distortionary effects. Therefore, in order to reduce risks and costs of investments and doing business at the local level, it is necessary to replace existing, numerous duties with a lower number of clearly defined taxes.

Comparative practice indicates various possibilities regarding the introduction of a relatively generous local tax that would make up for the revenues of the existing large number of different local tax, non-tax and quasi-fiscal charges.

Reform of the System of Quasi-Fiscal Charges for the Improvement of Business Conditions in Serbia

One possibility is the introduction of local tax on corporate gross revenues, which would be relatively easy, but also unfair (because they do not take into account the costs arising from the realisation of revenue), and there would also be a problem of spillover revenue to large and developed municipalities where most of the companies are headquartered. An alternative option could be the introduction of local surtax on earnings. In that case, the problem of loss of revenue by developing municipalities would not be so significant, but the introduction of such a tax/surtax would be inefficient due to the increased fiscal burden on labor, which is already relatively high in Serbia.

The third possible option, based on the practice in Germany that has been around for many decades, would be the introduction of a local corporate income tax, that would be paid on the same taxable income as the central corporate income tax, without the possibility of using tax relief, whereby the distribution of revenue from this tax among the municipalities would be done in proportion to the number of employees. Thus the company would calculate its obligation for local income tax, then that revenue would be shared among municipalities and cities in proportion to the distribution of the number of employees of that company by local self-governments in Serbia. Starting from the value of taxable profit of enterprises in Serbia for 2011, it is estimated that in order to match the revenue of company signboard fees, it would be enough to introduce a local income tax at a rate of about 1%. If within such a reform the goal was the abolition of not only the fees for putting up company signs, but also of other local taxes, this could be achieved by increasing the rate of local income tax according to the principle of 1 percentage point of income tax per about RSD 5 bn of lost revenue on other grounds. It is estimated that the rate of local corporate income tax should not exceed 3% (which would be the upper limit of allowable rate under which the municipalities would be able to adjust their local corporate income tax rates), so that together with the existing central corporate income tax rate of 10% (and even with the announced rate of 12%), cumulative corporate income tax rate in Serbia would not exceed 15%. It would still be lower than in most countries in the region, and considerably lower than the average of EU member states (where corporate income tax rate is on average 24.5%), and hence the distorting effects (in terms of impact on the inflow of capital, entrepreneurship, etc.) would not be great. In the case of introducing this tax, it should be ensured that the system of its administration be set up in a way that would minimize the cost (time and resources) of its application (e.g. electronic submission of tax returns, e-payment of taxes, etc.).

Aside from this, comparative tax practice shows that the mining royalty (fee for use of mineral resources), of which one-half of the revenue goes to local governments in Serbia, is among the lowest in Europe, and so it would be justified from the perspective of economic efficiency and equity to consider its increase (particularly in energy resources). Given that the existing mining royalty in Serbia is relatively low, it is estimated that its increase would not significantly affect the interest of foreign companies for exploitation, which means that the loss in efficiency would be relatively small, and at the same time it would provide a space for the abolition or reduction of some others distorting taxes.

Although the entire reform of the tax system (tax, non-tax and quasi-fiscal charges) should be revenue-neutral, it is probably necessary to increase the revenue yield of a certain number of (appropriately parametrised) duties in order to compensate for the revenue losses from the abolition of highly distorting taxes or their merging with some other duties. In this sense, it is estimated that a moderate space for increasing the revenue yield of low-distorting taxes exists in the domain of property tax, which could be achieved by broadening the scope of this tax (by including entities that are in the process of legalisation, etc.), by realistic assessment of the market value of the tax base, and by transitioning to the concept of market value for taxation of property owned by legal entities. It is estimated that the growth of revenue from property taxes based on these measures could be greater than the lost revenue from the land usage fee that would be integrated into the property tax, which would be desirable and cost effective.

b) Merging related taxes

The existence of a significant number of taxes aimed at similar applications often creates confusion in taxpayers as to which of these taxes they are required to pay, as well as an impression of multiple taxation, which creates resistance to the regular settlement of these obligations. In addition, the cost of fulfilling these obligations becomes higher (time and material resources spent on the reporting of these duties, their payment and administration). Therefore, merging related duties is a major step toward reducing the number of non-tax and quasi-fiscal charges, as well as simplifying the system of public revenues. Thus, for example, it is considered that there is no objective need for an annual fee on motor vehicles separate from the tax on the use of motor vehicles, and that in this case it would be proper to consolidate the two duties by including the fee for motor vehicles into the tax on the use of motor vehicles, because it is a duty of general type, which does not offer a direct counter-fee or service.

In a similar way, it would be necessary to integrate the land usage fee into property taxes, because there is no economic justification for having two essentially very similar forms of public revenues on the same tax base.

c) Adequate parametrisation of taxes

As previously stated, one of the main risks of the current system of non-tax and quasi-fiscal charges in Serbia is the lack of predictability in terms of their number, and especially their rate. So with some duties (e.g. company signboard fee) in the period 2008–2011 in some municipalities, the amount of this fee for certain groups of taxpayers has dramatically increased (even multiple times), which hinders a reliable business planning at the company level. It is therefore essential that in most cases the law prescribes a maximum amount of certain duties, where local self-government units or various extra-budgetary funds (depending on the type of duty) would have the right to determine themselves the amount of duty, but within the given limits. Besides, it is possible to condition the increase of duties by the prior approval of the Ministry of Finance. This would contribute to the harmonisation of business conditions in the whole country, and the risks related to business operations would be reduced.

Also, in order to improve economic efficiency and achieve (not just fiscal) objectives of introducing a specific duty, in particular and often significant cases, it would be necessary to change its basic parameters. Thus, for example, in the case of fees for mineral resources, it would be efficient to replace the *ad valorem* fee (expressed as a % of company's revenue) with a fee in a fixed absolute amount per unit of quantity of a certain mineral. In this way, companies would not be "punished" for achieving a better sales price for its products on the market, but rather the fee would lead to the identification of an efficient amount of extracted raw materials, which is actually the purpose of the fee.

Of the total number of non-tax and quasi-fiscal charges in Serbia, a significant portion is related to different environmental taxes. The aim of introducing environmental taxes can be purely fiscal (revenue collection) and/or corrective, related to discouraging activities that generate pollution. In this sense, there is significant room for improving the effectiveness of fiscal duties through consolidation of related duties and, where possible, the affirmation of the principle of introducing environmental tax per unit of pollution, not some other unit (production volume, operating income, etc.), because only such a method of determining the tax base can lead to socially and cost effective outcomes. Thus, for example, in addition to the fee for the use of forests and forest land, which is paid as a percentage of the market value of harvested timber, an obligation to pay compensation for the protection and utilisation of forest functions has been introduced in Serbia, which is calculated as a percentage of total revenues of the company (0.025%). Since the last fee has the character of an environmental tax and not a fee, it would be reasonable to either calculate its rate per unit of pollution/forest utilisation, or to integrate it in the fee for the use of forests and forest lands or to completely abolish it.

d) Compliance of taxes with their economic purpose

Due to the need to provide funds for financing public expenditure, in recent years there has been a common practice of increasing certain taxes above the levels of economic justification, and changing the purpose of these funds, which *de facto* gives fees and charges a character of a tax. In this regard, in order to reduce costs and risks of doing business and improving the predictability and transparency of the system of public revenue, it is necessary to make changes in certain types of duties, whose aim would be their consistent alignment with the economic purpose of these duties.

Thus, the existing policy of court fees (e.g. verification of contracts fee, etc.) associates the rate of fees with the value of the contract, which is why these fees are often considered additional taxes (e.g. VAT or transfer tax is paid on the sale of property, but the court fee for the verification of the contract is sometimes only slightly lower than the tax). Consequently, it is necessary to change the method of determining the rate of these fees so that it reflects the costs borne by the judicial authority for the provision of a particular service. Given that such a change would lead to a reduction in court revenues, it would be necessary to secure additional funds from the budget, collected through general taxation. Therefore, it is necessary to make this adjustment gradually and within a broader reform of the system of public revenues in order to avoid deterioration in the operating conditions of the courts in Serbia.

3.2 Systemic and procedural reforms

It is possible to improve the predictability and regulation of the business environment without the direct reduction/re-parametrisation of duties themselves, assuming an adequate procedure be put in place for their introduction, implementation, administration/collection, which would make the costs and risks of doing business minimal and predictable. In this respect, there are several basic recommendations of a systemic and procedural nature, whose

implementation would significantly improve the predictability and transparency of the system of non-tax quasi-fiscal charges in Serbia.

a) Promotion of the rule that only law can be the basis for introduction of taxes

The costs of application, administration, payment and collection of fiscal charges grow with the increase of their number and complexity of the procedure for their determination. Consequently, it is essential that the introduction of all non-tax and quasi-fiscal charges be regulated by law (if possible - one law, so that companies could avoid the risk of not settling their liabilities due to the lack of information that a specific duty has been introduced or changed). For some specific duties it is justified that their rates be determined by other levels of the government (e.g. local self-governments, agencies, etc.). In order to reduce the risk of excessive and unwarranted increase of certain taxes, it is necessary to prescribe that in order to change the rate of duties that are not limited by law, the prior approval of the Ministry of Finance is required. Thus, if a local self-government unit (which does not have the right to legislate) wants to introduce a new levy or increase an existing one above the current legal limit, it would have to obtain the approval of the Ministry of Finance. Ministry of Finance, in the event of consent, would then propose the changes and amendments to the relevant law to the Serbian Assembly. This would affirm the principle of parity of jurisdiction and responsibilities of the Ministry of Finance for governing the policy of public revenues and expenditures in the state.

b) Introduction of the gross budget principle

One of the main reasons that the extra-budgetary institutions were incited to unrealistically increase the quasi-fiscal charges is that thus generated revenues were almost entirely at their disposal, beyond the control of the Ministry of Finance. Those funds were usually spent on increasing wages, which lead to situation that employees on the same positions (e.g. driver), but in different state institutions have considerably different earnings. In order to reduce the possibility of irrational use of resources, de facto realised from the monopoly created by the state (e.g. the high revenues of the Budget Fund for Forests has not been achieved on the basis of its successful market recognition, but on the basis on the government giving them exclusive rights to collect forest fees), it is necessary for the revenues of extra-budgetary institutions to be recorded on the consolidated Treasury account and that most of it be paid to the state budget, from where they would then be distributed to relevant programmes.

It would be justified to exclude from this rule cases where government institutions realise revenues from providing services on the market, competing their private counterparts (e.g. revenue generated by faculties from the sale of books or provision of educational services), because this would motivate the institutions to improve the quality of their services.

c) Clear distinction between fees, charges and taxes and definition of general rules for determining their rates

The first step in the regulation of non-tax and quasi-fiscal charges refers to clearly distinguishing between fees, charges and taxes, since in Serbia all duties are often referred to by one name (e.g. charge), even though by their economic purpose they represent a different type of public revenue⁷. Precise differentiation by types of duties is necessary as a prerequisite for defining the general rules for determining their rate, which are not the same for taxes, charges and fines.

Fees represent a public revenue, which is paid for a particular service of the government body (e.g. verification of contracts, issuance of certificates, etc.). Accordingly, the rate of fees should be consistent with the costs associated with that service (time and material resources spent by the relevant institution for the provision of a particular service). This would avoid the situation of two entities paying different rates for the same service, which makes the system inequitable.

Charges represent the kind of public revenue that is paid for the use of certain resources (e.g. natural resources). The principle of equity would imply that their rate is determined in proportion to the damage inflicted by the particular taxpayer's activity to a particular resource, i.e. in proportion to the expenses necessary for its restoration or repairing of the caused damages. Determination of the charge in this way affirms the "user pays" principle or "polluter pays" principle. Otherwise, the introduction of the obligation of payment of lump-sum fee charges for all enterprises and/or citizens, makes the system inequitable and distortionary (e.g. forest charge is paid both by a law firm that emits minimal pollution and a chemical company that has a significant impact on the forests in its environment). Although

⁷ Some duties are of mixed character, but since most of them can be classified in one of the mentioned types of public revenues, the paper will from now on focus on those types of duties.

this principle of determining the rate of charges is clear and economically justifiable, its application in practice may be faced with some difficulties. Thus, the land development charge raises the question of whether it should be equal to the marginal costs of entrance of an additional user or to the average total cost of his entry. Application of the principle of marginal costs would mean that the highest charges would be paid by the first users (e.g. first houses built in a particular neighbourhood) due to high fixed costs, while subsequent users would pay less, which would be unfair. Therefore, in this case an approach based on the average total cost (total cost of utility infrastructure divided by the projected number of residential or commercial units in a particular area, weighted by the characteristics of the units, such as surface area, etc.) would be considered more equitable. However, in the case of other charges some different approaches should also be considered.

All other fiscal duties, for which there is no direct counter-service or counter-charge, fall under taxes. The equity principle in taxation would involve cutting them in proportion to taxpayer's economic strength (consumption, assets, income/profits).

d) The availability of a comprehensive review of public revenue

In order to improve the transparency of the system and reduce the cost and risk of doing business, it would be necessary to create a unique electronic review of all taxes and other non-tax and quasi-fiscal charges imposed at the national level, and their basic parameters (who pays, for what, how much, and what are the special rules and exemptions). This type of database, that would be regularly updated, could be made available to the public on the website of the Ministry of Finance and Tax Administration (in Serbian and English) and as such would significantly reduce the risks and costs that companies have on determining and settling their obligations. This would reduce the risk of companies missing the information on the introduction/abolishment or change of certain duties, and would also reduce the administrative costs (e.g. hiring consultants) that the company incurs in order to determine its obligations.

e) Availability of comparative reviews of local duties

In addition to restrictions imposed by the Ministry of Finance or the law, the deterrent factor from the policy of excessive quasi-fiscal charges at the local level could be the pressure from the local public, which could occur if residents and businesses had information about the relative rates of fiscal and quasi-fiscal charges in their area compared to other municipalities and cities. This could be achieved by introducing an obligation for the local authorities to show a list of all local fiscal and quasi-fiscal charges and their parameters in a unique form prescribed by the Ministry of Finance on their website, both in Serbian and English. This would enable the Ministry of Finance to create a single database on their website with parallel overview of local duties across all municipalities, or at least a page with links to databases of all individual municipalities.

f) Promotion of a mandatory public debate in relation to the introduction of or changes to certain duties

In case of planning the introduction or changes to certain non-tax or quasi-fiscal charges, it is necessary to submit a draft amendments to the public and organise a series of round table debates between the representatives of the Ministry of Finance, the interested government institutions, business associations, auditing and consulting companies, and other interested parties, where various options would be analysed for the possible improvement of the proposals under consideration. This way of including the very taxpayers and the public in the process of introducing/changing certain duties would reduce their resistance to paying these duties and it would increase the rate of collection, while the taxpayers would have ample time to include additional costs of these duties in their business plans.

g) Complete computerisation of the payment process of quasi-fiscal charges

For those non-tax and quasi-fiscal charges that would continue to exist after this reform, it should be ensured that the procedures for reporting tax obligations/registration of taxpayers, providing tax calculations to taxpayers and their payment, as well as for accessing the state of obligations should be completely computerised, i.e. conducted online in order to make the cost of implementation and collection as low as possible.

4. Evaluation of government proposals for the abolition of restrictions and quasi-fiscal charges

Reform of quasi-fiscal charges is an important step in the development of public finances in Serbia. According to the government proposal, there is a plan for abolishing more than 100 quasi-fiscal charges, legal regulation of the procedures for introducing them, the increase of authority of the Ministry of Finance in determining local duties, etc. The number of quasi-fiscal charges in Serbia is being reduced by about $\frac{1}{4}$ which will significantly reduce the cost of implementation of the system of public revenue. Reform of quasi-fiscal charges is closely associated with the reactivation of the gross budget principle, according to which all revenues of government institutions need to pass through the budget.

Yet it is estimated that as a result of the relatively rapid reform of the complex system of quasi-fiscal charges, some duties have been abolished that should actually exist. Thus, for example, it has been concluded that the utility fee for keeping catering and entertainment facilities on the water – these facilities pollute the water, thereby causing damage to other citizens (fishermen, swimmers, and they increase the cost of water cleaning). Instead of abolishing such duties, it would have been more appropriate if their parameters were improved, in the sense of reducing the level of duties, and more adequately determine its base and taxpayer. In addition, some of the distortive duties, such as the company signboard fee, should be replaced by economically more desirable duties, rather than just abolishing them and thereby increasing the deficit of local budgets and consolidated government budgets.

Improving the tax system in a broader sense should not be a one-time action, which would consist of the abolition of some duties, but a continuous activity that would improve the structure of the tax system, improve the parametrisation of individual duties, increase the transparency of the tax system, and others. Also, aside from quasi-fiscal charges, the government activity should be focused on reducing regulatory costs that the state imposes through its regulations on its citizens and economy. Previously we mentioned regulations that unnecessarily increase the costs for drivers, but such costs are imposed on businesses as well through the obligation of submitting various reports to the government, and through long, expensive and sometimes unnecessary procedures for obtaining permits, licenses, certificates, etc.

In the context of the analysis of proposed government measures aimed at regulation of the quasi-fiscal charges, an issue of their fiscal implications arises, as well as the question of the possibility of improving business conditions, without losing public revenues or increasing the fiscal deficit.

4.1 Fiscal effects of abolishing quasi-fiscal charges

According to the Ministry of Finance, the abolishing of quasi-fiscal charges will yield savings for the businesses and the citizens of about RSD 10 bn, of which savings at the local level will amount to about RSD 5.5 bn⁸. Therefore, the important question is how is the reduction of state revenue going to affect the state budget and local communities, and thus the consolidated fiscal deficit as well. If appropriate corrective measures for taxes and/or expenditures are not taken, reduction of revenue from quasi-fiscal charges will affect the increase of the consolidated deficit by about RSD 10 bn. Of this amount, the revenue of local communities would drop by about RSD 5.5 billion, while the state revenue would drop by around RSD 4 billion. In doing so, the reduction of quasi-fiscal charges across local communities would be uneven. According to statements of the representatives of some of the smaller local governments, which should be taken with a grain of salt, they stand to lose up to 30% of revenue just with the abolition of company signboard fee.

In the years when a strong fiscal consolidation is needed, which requires rapidly reducing the fiscal deficit, its possible increase due to the reform of quasi-fiscal charges would be unsustainable. Therefore, it is important to complement the elimination of some quasi-fiscal charges by increasing revenues from general taxes, in order to avoid the increase of fiscal deficit. In the case of local communities, the improvement includes widening taxable property, and the harmonisation of the property tax base with market value could generate additional revenues. However, if that is not enough, the possibility of introducing a local corporate income tax could be considered, which would be maximum 3% or increasing the state corporate tax to 15%, with the aim of increasing transfers to local communities.

When it comes to local communities who lost a large percentage of their revenue due to abolishing company signboard fee, it is necessary to bear in mind that this was a bad tax that generated large revenues for their budgets, but it

⁸ Fiscal Council produced a similar estimate, according to which local communities lose RSD 5-6 bn due to abolishing quasi-fiscal charges.

also hindered the opening of new enterprises and businesses. In some cases, high company signboard fee served as a replacement for some other taxes (e.g. local tax on the use of natural resources), so in such cases a tax should be introduced or the existing one increased. In that case, taxpayers would only be companies that use these resources, instead of all companies. If the local communities cannot compensate for revenues from company signboard fees with other taxes, then it is necessary to increase transfers to them from the state. It would not constitute a heavy burden on the state budget, because it is mostly the case of small communities that have small budgets.

From the standpoint of fiscal consolidation, lost revenues of local communities from abolishing quasi-fiscal charges should not be compensated by higher revenue from the wage tax, as these revenues should be used for the transfer of new responsibilities from the state to the local level.

4.2 Is it possible for the state to receive the same revenues, while putting businesses in a better position?

Reform of the system of quasi-fiscal charges should not be observed only from the standpoint of its impact on public finances, but also from the point of impact on economic efficiency. From the standpoint of economic efficiency, it is good if taxes are reduced or if the distorting and complicated taxes are replaced with less distorting and simpler ones⁹. From the standpoint of economic efficiency, it is desirable that the complicated tax system, which consists of a number of arbitrarily defined duties, be substituted by a simpler system, consisting of a smaller number of general taxes. Frequent and unpredictable changes in tax regulations bring uncertainty in the activities of business entities, which has its equivalent in the increase of certain costs.

In the abolition or reduction of any taxes, the benefits of the businesses are greater than the loss of revenue by the state¹⁰. This difference is especially great when high taxes, complicated taxes or taxes that are de-stimulating the entrepreneurship are being abolished or reduced. Such taxes distort relative prices, and the costs of their use are high. The difference is still not that great, and it is possible that consumers might benefit from it as well and not just the businesses. In the abolition of highly distorting taxes, the benefits to the companies exceed the reduction in tax revenues for the state by 20–30%. In addition, by simplifying the tax system and individual taxes, the tax compliance costs are reduced as well by as much as 10%¹¹. This means that if the state lost a total of RSD 10 bn in tax revenues, the total benefits for the businesses and consumers can amount to RSD 13–15 bn. So, the elimination of certain taxes would bring more benefits to the businesses and consumers than it would bring losses to the state, but the difference is modest. Also, the benefit to the businesses and the consumers is long-term only if the state simultaneously reduces the public spending, which means that the fiscal deficit would not be growing – otherwise, in the future businesses and citizens would end up paying through higher taxes what they saved now, plus interest.

However, an important question from the standpoint of fiscal consolidation is whether the tax reform can improve the economic position of businesses and citizens, while at the same time having the state realise the same revenues, i.e. without increasing its deficit. The position of both businesses and individuals would improve if the distorting taxes, such as company signboard fee, would be replaced by less distorting taxes such as property or corporate income tax. Of course, the net profit of the businesses and the consumers in this case would be lower than in the case of the abolition of taxes, and it would stem out of the reduction of costs of administering taxes and the reduction of negative impact of taxation on economic efficiency. This means that, by replacing the bad taxes with better ones, businesses and citizens can be put in a more favourable position, without the state reducing its revenues.

In this regard, it is estimated that the proposed government measures will contribute to the improvement of business conditions through the reduction in risks/uncertainty and costs (duties and their applications). However, the quasi-fiscal charges reform is just one of many measures whose implementation is necessary to reduce the costs and risks of doing business in Serbia. In this regard, it is necessary to implement systemic reforms in other, more significant segments, such as improvement of legal safety, increase in the efficiency of public administration, reduction in corruption, reduction of regulatory costs, establishment of financial discipline, improvement of infrastructure, and others. For the improvement of business environment it is important to maintain macroeconomic stability in Serbia, which is still very fragile, and to adopt a credible fiscal consolidation programme that would be supported by the IMF and whose realisation would contribute to improving the country's credit rating.

⁹ The argumentation becomes more complicated if we take into consideration the way of spending taxes as well – in that case, it is possible that the reduction of taxes, that leads to the reduction of some important government function, can actually reduce the wellbeing of the state.

¹⁰ See the previous footnote.

¹¹ In the case of abolishing taxes, compliance costs are reduced to zero, while in the case of merging several taxes, compliance costs can be reduced by several times.

Reform of the System of Quasi-Fiscal Charges for the Improvement of Business Conditions in Serbia

Based on this, it is estimated that the reform of the system of quasi-fiscal charges, with certain adjustments that would prevent the increase of the fiscal deficit, may have a positive impact on the economic efficiency. A positive effect would be achieved by replacing a complicated and non-transparent system of duties with revenue-neutral, but simpler system whose changes would be predictable. This means that through revenue-neutral tax reform, the state can remain in the same position, while putting the businesses and citizens in a slightly better position. Similar gains in efficiency could be achieved by a revenue-neutral tax reform that would increase the VAT, while reducing the social security contributions¹².

Conclusion

Reform of the system of quasi-fiscal charges is an important condition for improving the business environment in Serbia. The goal of the reform should be simpler and more predictable system of public revenue, which would be superior to the current one from the standpoint of economic efficiency and equity. Reforms would be implemented through abolition of unjustified duties, consolidation of related duties, and replacement of distorting and inequitable taxes with other taxes. From the point of transparency, it is important that the duties in tax regulations are adequately marked and classified, so as to avoid creating confusion about their nature. The second part of the reforms would refer to improving the parametrisation of duties whose application is justified, and that would include aligning taxes with the economic power of taxpayers, fees with the costs of providing government services, and charges with the benefits that the user gets or damages that he creates. An important part of the reform is the establishment of systemic restrictions, in order to avoid developing again after a few years a distorting and inequitable system of quasi-fiscal charges. In this context it is important to consistently re-apply the gross budget principle, as well as introduce all fiscal and quasi-fiscal charges through the laws. It is also necessary that the Ministry of Finance gets a key role in creating all duties at the national level, and to strengthen its supervisory role at the local level.

From the standpoint of fiscal policy, it is important to ensure that the reform of quasi-fiscal charges together with the related reform of general taxes (corporate income tax, property tax), be revenue neutral, so as not to further increase the fiscal deficit. Reforms of quasi-fiscal charges should support the improvement of business conditions in Serbia, as well as the fiscal consolidation programme. The reforms of the system of quasi-fiscal charges proposed by the government represent a significant step towards improving the business environment, as it abolishes a number of unjustifiable duties, defines the legal procedures for the introduction of duties in the future, includes all taxes in the budget, etc. Still the main weakness of the proposed reforms is that they are not revenue neutral - they increase the fiscal deficit by around RSD 10 billion, which further hinders sustainable fiscal consolidation. A possible solution to this problem lies in the increase of revenue from property taxes or increase of corporate income tax rates to 15%.

Literature

- Arsić, M, N. Altiparmakov, S. Randelović, A. Bučić, D.Vasiljević and T. Levitas (2010) "Tax Reform in Serbia – A Look Ahead", USAID and FREN, Beograd
- Bisić, M. (2011) "System of Charges for Use of Natural Resources and Handing Them Over to the Local Self-Government Units"
- Clemens, F. and M. Kolmar (2004) "A Theory of User-Fee Competition" Working Paper No. 1166, CESifo
- David G. D (2003) "Benefit Taxes and User Fees in Theory and Practice", Research Paper
- GIZ (2012) "Improvement of Local Taxation in Serbia – Reform of Company Signboard fee", Draft
- Fiscal Council (2012a) "Proposed Measures of Fiscal Consolidation for 2012-2016"
- Fiscal Council (2012b) "Estimate of the Rebalancing of the 2012 Budget and Law Proposals with Fiscal Implications"
- NALED (2012), "Sooner or Later – System of Non-Tax and Para-fiscal Forms in the Republic of Serbia", Working paper, Belgrade . The study was done by a team of local and foreign experts gathered around the National Alliance for Local Economic Development (NALED), with the support of USAID Business Enabling Project (USAID BEP)
- OECD (2010) "Tax Policy and Economic Growth", OECD Publishing
- Spitzer (2002), "Taxes vs. Fees: A Curious Confusion", Gonzaga Law Review, Vol. 38, Issue 2

¹² See: Arsić et al. (2010), OECD (2010)

CIP - Katalogizacija u publikaciji
Narodna biblioteka Srbije, Beograd

33 (497.11)

QUARTERLY monitor of economic trends and policies in Serbia / Editor in Chief Miloško 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