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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.

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Analytical and Notation Conventions

Values

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

Definitions of Aggregates and Indices

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

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

New Economy – Enterprises formed through private initiative

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

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

Notations

CPI – Consumer Price Index

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

H – Primary money (high-powered money)

IPPI – Industrial Producers Price Index

M1 – Cash in circulation and dinar sight deposits

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

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

NDA – Net Domestic Assets

NFA – Net Foreign Assets

RPI – Retail Price Index

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

Abbreviations

CEFTA – Central European Free Trade Agreement

EU – European Union

FDI – Foreign Direct Investment

FFCD – Frozen Foreign Currency Deposit

FREN – Foundation for the Advancement of Economics

GDP – Gross Domestic Product

GVA – Gross Value Added

IMF – International Monetary Fund

LRS – Loan for the Rebirth of Serbia

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

NES - National Employment Service

NIP – National Investment Plan

NBS – National Bank of Serbia

OECD – Organization for Economic Cooperation and Development

PRO – Public Revenue Office

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

QM – *Quarterly Monitor*

SORS – Statistical Office of the Republic of Serbia

SDF – Serbian Development Fund

SEE – South East Europe

SEPC – Serbian Electric Power Company

SITC – Standard International Trade Classification

SME – Small and Medium Enterprise

VAT – Value Added Tax

From the Editor

Macroeconomic trends detected in Q4 of 2012 and at the beginning of 2013 indicate certain signs of amelioration: economy is slowly recovering, inflation is brought under control swiftly, and current account deficit is shrinking. However, a more in-depth analysis indicates that only two or three sections of activity show the signs of economic recovery, while the other sections remain in recession. High unemployment, showing no sign of abating, proves that economic recovery in most sections of Serbian economy has not taken place. Economic recovery in Serbia is hampered by the return of EU recession. Although inflation has been curbed and nominal exchange rate has been stabilized at the end of 2012 and at the beginning of 2013, macroeconomic imbalances remain large. Current account deficit and fiscal deficit are large, and according to the levels of public and foreign debt the possibility of debt crisis cannot be ruled out.

In Q4 a highly expansionary fiscal policy was carried out, but at the beginning of 2013, when fiscal consolidation plan was brought into effect, implementation of a more restrictive fiscal policy began. Restrictive monetary policy followed in Q4 played a decisive role in bringing down inflation. However, macroeconomic backdrop and fiscal policy altered in the meanwhile, which allowed loosening of monetary policy. The new government lost the initial momentum gained in the first few months in power, so the reforms were held up.

In Q4 Serbian economy showed signs of recovery, which we believe is going to be lasting, but, quite slow. Seasonally adjusted GDP in Q4 increased by 0.5% relative to Q3 and the data on industrial production for January 2013 indicate continuation of an upward trend in economic recovery. However, only few sections of economic activity, namely automobile industry, pharmaceutical industry and petroleum industry, show signs of recovery, while most of other sections are stagnant or in recession. The economic growth will, therefore, lead primarily to increase in exports, and employment will not go up in the following two or three quarters. This leads to conclusion that the focus of economic policy and reforms should be on strategic measures intended to recover production in other sections of economic activity, which make up a larger share of Serbian economy, because that is the only way to increase employment. Economic activity is estimated to expand in the first quarter of 2013, and the lowest expected annual growth is 1.5%.

Analysis of the overall economic trends and their interdependence shows that Serbian labor market saw no significant change in 2012. GDP, real wages, personal spending, income taxes and social contributions decreased in the second half of the year. We therefore estimate that the data published by the SORS showing that in 2012 employment increased and unemployment dropped should be taken with a grain of salt. The data do not reflect improvements in labor market but are probably due to certain methodological changes. Euro-denominated unit labor costs grew faster than seasonally adjusted GDP, which points to a decrease in price competitiveness of Serbian economy. Because economic growth is concentrated in few capital intensive industries, employment is not expected to rise in 2013.

Having been curbed swiftly in November 2012, inflation remains low. The impact of long-term determinants (fiscal deficit and exchange rate depreciation in the first half of 2012) and short-term determinants (draught, tax increase) of rise in inflation wore off. Inflation is expected to remain low in the following months, with occasional leaps due to rise in administratively controlled prices. Nominal dinar-euro exchange rate has been quiet steady since mid-Q4. Prior to dinar exchange rate stabilization, a strong nominal and real depreciation of the dinar occurred from January to August, followed by strong appreciation from August to October. Appreciation of the dinar, driven by restrictive monetary policy and inflows of foreign currency through government's borrowing, helped reduce the inflation, but lowered price competitiveness of Serbian economy.

Current account deficit continued to shrink in Q4, but unlike the preceding quarters Q4 saw a considerable capital account surplus. While the current account deficit narrowed due to a healthy increase in exports, capital account surplus is not sustainable in the long run because it is produced through government's borrowing. The scenario from the first half of 2012, when capital inflows came to a sudden stop and consequently a strong depreciation of the dinar occurred, foreign exchange re-

serves of the NBS fell, and finally inflation went up, could repeat. Current account deficit, although narrowing more rapidly, is still large, so economic policy should identify its further shrinking as one of the top priorities in the years to come. At the end of 2012 foreign debt reached almost 90% of GDP. Consequently, the costs of its service will be very high and the possibility of balance of payment crisis cannot be ruled out.

In Q4 a highly expansionary fiscal policy was carried out and resulted in annual fiscal deficit to GDP ratio of 6.6%. Large fiscal deficit in Q4 was due to almost traditionally high pre-election spending. The early results indicate that fiscal consolidation has exerted favorable effects on tax revenues, though slightly below the expectations. However, a more reliable assessment of tax hike effects cannot be made before mid-2013 because, alongside with the tax hike, VAT system saw numerous changes which reduced tax revenues in the first few months of its implementation. The first effects of fiscal consolidation on budget expenditures were noted in 2013, so it will be possible to assess them in a few months. According to the data for the first two months of 2013, we estimate that fiscal deficit to GDP ratio will outrun the targeted 3.6% and according to the detected trends it will reach 4.5%. It is estimated that this high deficit would lead to further borrowing, so it is necessary to propose additional austerity measures to keep the fiscal deficit to GDP ratio under 4%.

Restrictive monetary policy followed from August to October played a key role in swift reduction of inflation. Additionally, it cushioned the effects of fiscal expansion at the end of 2012 on inflation at the beginning of 2013. However, it is estimated that a gradual loosening of monetary policy should start because inflation has been down for three to four months now, economy, exclusive of few sections of activity, is stagnant or in recession, and current account deficit remains high. The motive behind monetary loosening is to reduce current account deficit through moderate depreciation of the dinar – the depreciation would stimulate economic activity growth and employment in the long run. Depreciation would have to be moderate in order not to trigger high inflation or incur heavy losses on foreign-currency debtors. Gradual depreciation of the dinar is a precaution against an abrupt depreciation which might occur if a capital inflow came to a sudden stop. More restrictive fiscal policy implemented at the beginning of 2013 made room for loosening of monetary policy.

The new government's initial momentum towards implementation of economic reforms was soon lost. After only a few months in power, not only are the reforms blocked but there is no indication that the government is planning them. A possible reason behind this could be pre-term parliamentary elections – the issue frequently raised both by the ruling coalition and the opposition. The possibility of pre-term elections narrows the time horizon in decision-making. This means that politicians give advantage to measures producing tangible short-term results even if they incur long-term losses. Accordingly, the government holds up substantial reforms, which, as a general rule, mean some short-term sacrifice and savings for long-term gains. According to the aforementioned, major obstacles to economic reforms in Serbia are encountered in the political system which allows formation of unstable governments composed of too many coalition partners. Instead of implementing the announced reforms, the government more often resorts to measures that are effective in the short run, but discriminatory and have harmful effects on economy in the long run. Some examples of such measures are: write-off of interest and standstill of tax debt, or the announced reduction in the income taxes and social contributions in IT sector exclusively.

This issue of Quarterly Monitor offers two Highlights and one Spotlight. In Highlight 1 (Arsić) economic policies and reforms implemented in the second half of 2012 and at the beginning of 2013 are analyzed. Highlight 2 (Ranđelović) gives the analysis of corporate income tax reforms in Serbia carried out at the end of 2012 and offers recommendations for further reforms. The Spotlight (Ristić i Mijušković) gives a detailed analysis of weaknesses in competition policy in Serbia and offers clear recommendations for its enhancement.

TRENDS

1. Review

Macroeconomic trends detected in Q4 indicate certain signs of amelioration: economy is recovering, inflation is brought under control, and current account deficit is shrinking. However, a more in-depth analysis shows that only two or three sections of activity show the signs of economic recovery, while the other sections remain in recession. Economic recovery is due to increase in production of motor vehicles (Fiat), petroleum products (NIS – Petroleum Industry of Serbia) and pharmaceutical products. These sections of economic activity are the driving forces behind the rise in exports and decrease in current account deficit. High unemployment, showing no sign of abating, proves that economic recovery in most sections of Serbian economy has not taken place. Although inflation has been curbed and nominal exchange rate has been stabilized at the end of 2012 and at the beginning of 2013, large macroeconomic imbalances remain. Current account deficit and fiscal deficit are large, and according to the levels of public and external debt the possibility of debt crisis cannot be ruled out.

In Q4 a highly expansionary fiscal policy was carried out and the fiscal deficit ran at as much as 7.8% of quarterly GDP. Consequently, annual fiscal deficit to GDP ratio was 6.6%, which is in line with our prognosis, but significantly exceeds the Ministry of Finance's predictions of fiscal deficit at 6.1% of GDP announced in mid-November 2012. Monetary policy carried out in the last quarter of 2012 was reasonably restrictive and produced good results: inflation was curbed swiftly in spite of strong fiscal expansion in the period. Implementation of fiscal consolidation program is expected to significantly reduce the fiscal deficit in 2013, though the reduction will not be in line with the forecasts issued by the ministry of finance. On the basis of the trends detected in the first two months of 2013, annual fiscal deficit is estimated to narrow to 4.5% of GDP, which is a considerable but not sufficient decrease relative to 2012. It is therefore necessary to take additional austerity measures to reduce the deficit to about 4% of GDP and slow down the rise in public debt.

Low rate of inflation since November 2012, when most sections of economic activity suffer from recession and high unemployment is stagnating, suggests that the monetary policy can be loosened. Excessively restrictive monetary policy alongside with long-term unsustainable inflow of foreign currency through government's borrowing, lead to excessive appreciation of the dinar. Such appreciation of the dinar is not in line with Serbia's competitiveness and slows down rise in exports, encourages imports and finally leads to slowdown in economic growth and increase in unemployment. We therefore believe that long-term dangers from strong dinar (possibility of balance of payments crisis, slowdown in economic growth, and increase in unemployment) significantly exceed the short-term benefits (purchase of low-priced imported goods).

Before we give a more detailed analysis of the macroeconomic trends and policies in Q4, in the following two paragraphs we will give summary of the results achieved in 2012 and our forecasts for 2013, since Q4 is the final quarter of the year. The analysis of the main macroeconomic indicators in 2012 suggests that the year was quiet specific. Each of the main macroeconomic indicators (economic growth, inflation and current account deficit) experienced sudden speedups, slowdowns, declines after a period of growth and vice versa on several occasions during the year. This is due to different factors: 1) national economic policy – primarily fiscal policy, which changed several times during the year, from immoderate expansionary fiscal policy, prior to elections, in the first half of the year, over an abrupt turn to restrictive fiscal policy in Q3, and back to highly expansionary fiscal policy in Q4; 2) various foreign factors - economic crisis in EU, huge increase in world food prices during the larger part of 2012, changes to banking regulations in EU and consequently capital outflow from Serbia (in the first half of the year), and strong growth in world liquidity and drop in interest rates in the second half of the year; 3) abundance of severe weather events in 2012 – state of emergency declared in February due to extremely low

temperatures and heavy snowfall, and the drought in the summer. When we summarize the macroeconomic indicators in 2012 we see that the impact of the foregoing factors on Serbian economy was unfavorable. Annual GDP significantly decreased (about 1.7%), annual inflation rate was very high (12.2%) as well as current account deficit (about 10% of GDP).

Prospects for 2013 are yet somewhat better. We expect that economic recovery which began in Q4 will continue in 2013 and that GDP will increase by 1.5% (QM estimation). Fiat company production, investments (and production) made by NIS (Petroleum Industry of Serbia) and agriculture (it is very unlikely that the poor agricultural yields produced in 2012 would repeat) will contribute to economic growth in 2013. On the other hand, we expect a slight real contraction of other sections of economy – primarily due to continued decline in domestic demand. In 2013, relative to 2012, inflation will significantly slow down due to expected drop in food prices and fall in domestic demand. In 2013 we expect a single-digit inflation rate of about 7%, which is still somewhat higher than the NBS's target inflation rate. Current account deficit will continue to shrink in 2013 due to increase in net exports (Fiat) and decrease in imports in other sections of activity (again due to decline in domestic demand). We expect the current account deficit to narrow to between 5 and 7% of GDP, which will in a large measure depend on economic recovery in EU and on dinar exchange rate movements. Strong real appreciation of the dinar could slow down the expected decrease in balance-of-payments deficit.

Q4 saw the beginning of the economic recovery, and seasonally adjusted GDP which increased by 0.5% relative to Q3 (see section 2 "Economic Activity") indicates this. As we have already mentioned, economic recovery in Q4 was driven by a strong rise in production in only few sections of economic activity (we can even say in only few enterprises), while most of sections of economic activity remained in recession. Divergent trends can be detected when analyzing GDP per use – a strong increase in net exports stood at one end, and considerable decrease in investments and private consumption at the opposite end.

The latest Labor Force Survey data indicate that employment slightly increased and unemployment decreased in October relative to April 2012 – which we take with a grain of salt (see section 3 "Employment and wages"). It is quite unlikely that employment rose under decreasing economic activity and drop in revenues from personal income taxes and social contributions. It is even more unlikely that the reversal of the employment trend (provided that it occurred) is due to implementation of economic policy measures – though some members of the Government credit themselves with curbed unemployment.

Although we are still lacking the data for December, it is almost certain that the current account deficit will narrow significantly in Q4 relative to Q3 (see section 4 "Balance of Payments and Foreign Trade"). This is the consequence of fall in trade deficit which is primarily driven by the rise in Fiat company's exports. Apart from the exports of motor vehicles, dinar depreciation exerting time-lag effects on the balance of payments, drop in domestic demand and increase in exports of petroleum products also contributed to the fall in trade deficit. Large increase in capital inflow, though of unsatisfactory structure, was recorded in the capital account. The large capital inflow is primarily due to portfolio investments – sale of government bonds (USD 1 billion in October and USD 750 million in November), and to rising interest of foreign investors in dinar-denominated government securities – which resulted in overall net capital inflow of EUR 1.45 billion (in October and November, the months we have the data for). Net FDIs, as the most desirable and the healthiest capital inflow, were very modest and totaled only EUR 158 million in the same period.

After the prices shot up in October due to tax increase, inflation was suddenly curbed in November and December (see section 5 "Prices and exchange rate"). However, y-o-y inflation was still very high and reached 12.2% in December, which is the highest annual inflation rate in the last five years – the period during which consumer price index has been calculated. High inflation in 2012 was mainly due to a steep increase in food prices, while the underlying inflation was quiet low. In Q4 increase in food prices slowed down and underlying inflation sped up slightly. We, however, estimate that the effects of factors behind the rise in underlying inflation (dinar depreciation in the first half of 2012, fiscal expansion, tax increase in October) wore off, and the

inflation is expected to go down in the succeeding months, as well as the overall inflation (with possibility of occasional speedups due to increase in administratively controlled prices – electricity price in May).

Q4 saw a strong nominal (and even stronger real) appreciation of the dinar. For this reason real exchange rate of the dinar against the euro is now, in spite of strong depreciation in the first half of 2012, equal to the one recorded at the end of 2011 – let us remind you that in 2011 dinar strongly appreciated against the euro, which, as we believe, led to increase in current account deficit in the first half of the year. We therefore believe that the foregoing exchange rate does not encourage net exports. Unit labor costs denominated in euros (euro-denominated ULC), which are used to measure price competitiveness of national economy, support this thesis. Euro-denominated ULC increased in Q4 relative to Q3 (Graph T2-4, explained in the text) which indicates that the last appreciation of the dinar significantly weakened price competitiveness of national economy. It is interesting to notice that euro-denominated ULC decreased strongly on several occasions when dinar depreciated. If it had lasted, this would have stimulated the exports. We also detected that these periods were very short, i.e. dinar was allowed to appreciate strongly at the earliest opportunity – in our opinion this is a bad economic policy.

In Q4 a more restrictive monetary policy was carried out, which was the key to bringing down inflation. To offset the effects of fiscal expansion on monetary developments NBS activated reverse REPOs again in Q4 and thus withdrew about EUR 350 million. Due to more restrictive monetary policy inflow of foreign portfolio investments increased again (*carry trade*), which was recorded in the capital account of the balance of payments, on one hand, and resulted in strong appreciation of the dinar, on the other. In this issue of *QM* we place a special stress on the analysis of the dilemmas about how to carry out monetary policy (see Highlight by M.Arsić). We tried to answer the following questions: 1) should the decision whether to adopt a more restrictive monetary policy be guided by still high y-o-y inflation, or by the small rise in prices in the previous few months and forecasts for the following months? 2) does supply-shock inflation, i.e. inflation mainly caused by rise in world prices due to supply shocks (increase in food prices, tax increase, rise in administered prices), require different measures relative to demand-pull inflation? In our opinion, these issues require an expert discussion, and in practical terms, we believe that there is room for moderate and careful loosening up of the monetary policy.

When it comes to fiscal policy, we are not in a dilemma – we think that a more restrictive fiscal policy is necessary; otherwise, public debt crisis would almost certainly arise (see section 6 "Fiscal Trends and Policy"). In 2012 public debt increased by more than EUR 3 billion and public debt to GDP ratio rose from 49.5% to 63% (inclusive of local government debt). Continuation of such trend would certainly lead to crisis. Hence the need for strong measures aimed at fiscal deficit reduction in 2013 and in the succeeding years and consequently reduction in public debt and crisis prevention.

A sharp cut in fiscal policy was made in October 2012 when fiscal consolidation began – economic measure taken by the new Government we deem the most important. The main taxes went up (VAT, excise, corporate income tax) and indexation of nominal pensions and public sector wages of 2% in October 2012 and 2% in April 2013 is actually a decrease in real terms, because the indexation is far below the inflation. These measures, no matter how strong, will not suffice to stop further increase in public debt in 2013 – they will merely slow it down.

Further narrowing of the deficit in 2014 and in the succeeding years is therefore necessary. This can be achieved only through comprehensive structural reforms already in 2013, since they are expected to exert detectible effects one year after being undertaken. We perceive possible pre-term elections as a serious threat to implementation of reforms in 2013 (by adopting Fiscal Strategy the Government actually made a commitment to carry out the reforms). Economic policy makers might be unwilling to undertake the reforms, because they are painful and might dissuade a certain number of voters. We, however, hope that protection of public interest, which we deem more important, i.e. public debt crisis prevention and responsible and in the medium term certainly rational approach to fiscal policy, would prevail.

Serbia: Selected Macroeconomic Indicators, 2005 - 2012

	Annual Data						Quarterly Data							
							2011				2012			
	2005	2006	2007	2008	2009	2010	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Economic Growth							**y-o-y, real growth[1]**							
GDP (in billions of dinars)	1,683.5	1,962.1	2,276.9	2,661.4	2,720.1	2,881.9	..	..	..					
GDP	5.4	3.6	5.4	3.8	-3.5	1.0	3.0	2.5	0.6	0.6	-2.3	-0.6	-2.5	-1.5
Non-agricultural GVA	5.8	4.9	6.1	4.1	-4.2	1.6	3.5	2.4	0.0	0.1	0	1.8	0.2	...
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	6.4	3.6	-1.9	1.3	-5.5	-2.8	-3.6	-0.6
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	5.8	0.7	-3.1	-3.3	-6.7	0.2	-3.8	1.5
Average net wage (per month, in dinars)[2]	17,478	21,745	27,785	29,174	31,758	34,159	35,108	37,994	38,760	40,139	39,068	41,664	41,187	43,625
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	1.769	1.755	1.755	1.738	1.734	1.730	1.726	1.724
Fiscal data			**in % of GDP**							**y-o-y, real growth**				
Public Revenues	42.1	42.4	42.1	41.5	38.6	-1.5	-2.8	-6.6	-3.8	-4.7	1.7	4.8	-0.8	-3.2
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7	-3.0	-4.9	1.1	-5.4	10.3	9.2	-2.9	1.5
							in billions of dinars							
Overall fiscal balance (GFS definition)[3]	14.8	-33.5	-58.2	-68.9	-121.8	-136.4	-26.3	-42.4	-44.4	-45.1	-54.9	-57.0	-36.5	-69.0
Balance of Payments							**in millions of euros, flows[1]**							**oct-nov**
Imports of goods[4]	-8,286	-10,093	-12,858	-15,917	-11,096	-12,176	-3,269	-3,392	-3,440	-3,850	-3,403	-3,577	-3,430	-2,513
Exports of goods[4]	4,006	5,111	6,444	7,416	5,978	7,402	1,955	2,163	2,169	2,151	1,852	2,284	2,244	1,685
Current account[5]	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-760	-621	-683	-903	-1,177	-738	-546	-286
in % GDP[5]	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-10.7*	*-7.5*	*-8.3*	*-11.3*	*-17.6*	*-10.2*	*-7.6*	*-5.5*
Capital account[5]	3,863	7,635	6,126	7,133	2,207	1,986	644	566	642	899	1,017	683	490	240
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	307	259	661	600	-372	234	117	158
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	168	33	1,078	523	-916	-1,100	-340	890
Monetary data							**in millions of dinars, e.o.p. stock[1]**							
NBS net own reserves[6]	175,288	302,783	400,195	475,110	578,791	489,847	460,348	484,971	514,453	606,834	615,234	583,121	608,235	656,347
NBS net own reserves[6], in mn of euros	2,050	3,833	5,051	5,362	6,030	4,609	4,455	4,860	5,083	5,895	5,376	5,037	5,225	5,781
Credit to the non-government sector	518,298	609,171	842,512	1,126,111	1,306,224	1,660,870	1,658,603	1,700,248	1,714,617	1,784,237	1,897,034	1,938,662	1,999,697	1,959,519
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	730,892	742,597	744,100	775,600	834,253	888,372	890,782	909,912
M2 (y-o-y, real growth, in %)	20.8	30.6	27.8	2.9	9.8	1.3	-5.4	-8.0	-1.2	2.7	10.1	12.0	3.4	-2.2
Credit to the non-government sector (y-o-y, real growth, in %)	28.6	10.3	24.9	25.2	5,2	13.9	4.5	-1.0	-1.1	0.5	10.5	8.1	5.9	-2.0
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	53.8	55.9	55.6	54.6	55.2	57.3	59.4	60.5	58.5

Source: FREN

1) Unless indicated otherwise.

2) 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.

3) 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).

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

5) 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".

6) 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 SORS data indicate that economic activity in Q4 was slightly higher than in Q3, as the seasonally adjusted GDP increased by about 0.5%. A more detailed analysis shows that this slight recovery can be attributed to the growth of the production in the company Fiat Automobiles Serbia. This is confirmed by the analysis of GDP per usage, which suggests that the recovery in Q4 started net exports, while domestic demand continued to gradually reduce. At the level of the whole year, 2012 was marked by the drop in economic activity that, according to preliminary data, amounts to about 1.7%. The reason for this decline is a bad agricultural season due to a drought. If we exclude agriculture, GDP in 2012 would actually stagnate. In the year 2013, we expect the growth of economic activity of about 1.5%, which would actually be a sum of more divergent trends. On the one hand, the economic activity growth will be positively affected by the production of the Fiat company, investments (and manufacturing) of the company NIS and agriculture- since it is unlikely for a poor agricultural season such as the one from 2012 to repeat. On the other hand, a slight real decline is expected in the rest of the economy- primarily due to a continued reduction in domestic demand. In this edition of QM we would like to point out that a strong real appreciation of the dinar does not correspond in any case to a sustainable long-term economy growth. Sustainable growth of the economy could be based only on a high growth of net exports, and real dinar appreciation is making it more difficult by reducing the price competitivenes of domestic products.

Gross domestic product

Y-o-y GDP decline in Q4 of around 1.5%

According to preliminary SORS estimates, based on the available economic activity performance data, real y-o-y GDP decline in Q4 stood at about 1.5%. This means that the y-o-y decline of economic activity reduces, since it was 2.5% in Q3.

Seasonally adjusted data confirm a mild recovery in Q4 compared to Q3

Graph T2-1 shows seasonally-adjusted GDP growth indices that suggest a mild recovery in Q4 (0.5%) compared to Q3. Questions we will try to answer in this issue of QM are: what is the recovery in Q4 based on and whether it will continue in the coming quarters? We asked the same questions just two quarters ago, in QM29, while analysing the acceleration of economic activity in Q2 (Graph T2-1). The answer was that the recovery is only temporary, which was subsequently confirmed. Now, it seems that the answer is somewhat different, and that the economic recovery, possibly with temporary fluctuations, should be extended in 2013.

According to preliminary data GDP in 2012 recorded a drop of about 1.7%

Including the preliminary (flash) estimate of the real GDP growth in Q4 into the previous data for the first three quarters the drop of economic activity in 2012 amounts to 1.7%. That is in line with our estimate from the previous issue of QM when we estimated a GDP drop of about 1.8% in 2012. SORS practice is to perform correction of the preliminary assessments, including audits for past few quarters, so it is possible for these results to somewhat change. However, we do not expect that there will be major changes, all the more so as the achieved results are in line with expectations.

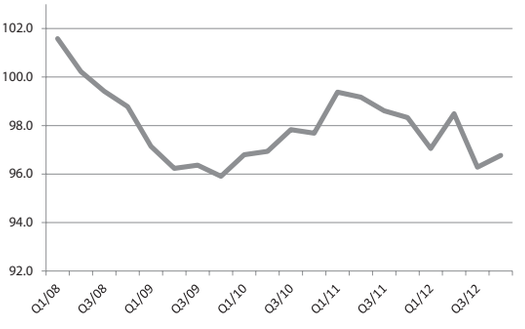
GDP drop is a consequence of the drop in Agriculture

Agriculture production recorded a drop of about 20% in 2012 as a consequence of extreme drought. If we exclude agriculture from the 2012 GDP data, the rest of the economy would actually stagnate – i.e. would achieve insignificant growth of approximately 0.3%. The year 2012, from the economic activity perspective, although aforementioned stagnation may not indicate that, was a very interesting year, with a number of turnovers and extraordinary circumstances and therefore very good to be analysed.

Already at the first sight, Graph T2-1 shows that seasonally adjusted GDP in 2012 was significantly more variable than in previous years. So we entered into 2012 with a downward trend of economic activity, inherited from 2011, which firstly worsened significantly in Q1 2012 and then immediately in Q2 recorded a significant recovery. Second part of the year was marked by an unusually deep decline in Q3 and then, again, recovery in Q4.

In Q1 extraordinary circumstances affected GDP decline to be deeper than expected

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



Source: *QM* estimates based on SORS data

Excessive government spending temporarily increased production in Q2

Extremely harsh winter in February had negative influence on economic activity in Q1. Industrial production was particularly affected and in February recorded seasonally adjusted fall of over 10%. This drop could not be compensated in March, and the economic activity in Q1 had a somewhat deeper fall than we expected.

With the ending of emergency situation from Q1, it was expected that the economic activity in Q2 will record some growth compared to Q1. However, seasonally adjusted GDP in Q2 was not only higher than the one from Q1, but also higher than the one recorded in Q4 2011 (Graph 2). The reason for this result was excessive, pre-election, government spending in the first half of the year (or more precisely by mid-May), which immoderately raised local demand. However, even then we believed that this production recovery was short-breathed.[1] Namely, except for a temporary increase in production, excessive government spending has contributed to a strong acceleration of inflation and high current account deficit – which would lead to slowdown in economic activity, even if the government spending in the coming quarters remained unchanged.

Q3 reviled the real state of the economy

After May, there was a strong contraction in government spending, and Q3 was also the quarter in which the drought affected the agricultural production the most. For all these reasons, seasonally adjusted GDP once again recorded extremely sharp fall, and the economic activity returned to a level at which it would presumably be, if it wasn't for the fiscal expansion in the first half of the 2012. Therefore, we concluded that the impact of the high government spending on economic activity is very short-breathed in Serbia, while the increase of the public debt, as a result of growth in public spending, is relatively permanent.

In Q4 we noticed a moderate recovery

As opposed to Q2, when economic growth was achieved along with high current account deficit and accelerating inflation, in Q4 exactly opposite trends occurred. There was an increase in net exports and the current account deficit reduced, while inflation after a temporary acceleration in October (when taxes have been increased) suddenly halted in November and December. Since the start of the economic recovery has not spurred growth in imbalances, it is, by all accounts, macroeconomically sustainable. The image becomes even clearer when we cross these observations with the analysis of GDP in Q4 by production approach. Seasonally adjusted GDP growth in the mentioned quarter came from the manufacturing industry (production of motor vehicles), while the rest of the economy in the aggregate stagnated. We, therefore, conclude that the economic activity in Q4 was started by the Fiat Automobiles Serbia Company production – which will continue with the expansion in the future - thus we expect that similar trends continue in the following period.

Analysis of GDP trends in 2012 can be further complemented with the production approach data which are presented in Table T2-2. The table shows the growth of individual sectors of the economy ending with the latest official information related to the Q3. We notice that agriculture had by far the largest decline during the year. We can see how the construction activity moved from high growth rates, with which it entered 2012 into the negative zone, but also that already preliminary data for Q4 (not presented in Table T2-2) suggest a very deep decline. Construction activity dynamics somewhat describes the investment dynamics, which in 2011 recorded a very high growth. This growth gradually slowed down during 2012 and in Q4 investments already had a solid year on year decline. The trade approximately followed the dynamics of private consumption (Table T2-2) - had a rise till the middle of 2012, and then again began to fall which the deepened in Q4. Industrial production fluctuated over the year, but in the total sum, it finished the year 2012 at a lower level than it was in 2011.

1 For more details see „Economic activity" from *QM*29

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

	2008	2009	2010	2011	2011				2012			share
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	2011
Total	103.8	96.5	101.0	101.6	101.7	102.8	102.4	100.7	97.7	99.4	97.5	100.0
Taxes minus subsidies	101.4	98.3	100.9	101.6	102.7	102.5	100.6	100.7	96.3	99.0	96.6	17.7
Value Added at basic prices	104.5	96.1	101.0	101.6	102.9	102.3	100.7	100.7	97.9	99.4	97.7	85.0
Non agricultural Value Added	104.1	95.8	101.6	101.5	103.4	102.3	100.2	100.3	100.0	101.8	100.2	89,5[2)]
Agriculture	108.7	100.8	99.6	100.9	98.4	100.9	102.2	101.3	81.8	83.6	82.9	10,5[2)]
Manufacturing	100.8	84.2	100.9	100.6	106.2	101.8	98.1	97.7	96.9	103.2	99.6	14,0[2)]
Construction	104.7	80.3	92.9	107.7	99.7	112.4	112.3	113.2	111.2	103.1	90.1	4,1[2)]
Wholesale and retail trade	106.7	92.5	101.7	94.5	98.5	93.6	90.8	91.9	97.9	102.0	101.2	13,0[2)]
Transport and storage	97.4	90.0	108.2	103.1	108.6	102.9	102.2	98.7	94.8	104.1	101.3	5,4[2)]
Informations and communications	110.8	110.0	105.4	108.4	108.5	111.1	112.6	110.3	110.9	111.7	103.7	8,4[2)]
Financial sector and insurance	113.4	105.5	107.2	101.0	104.6	99.7	98.4	97.3	100.1	104.2	105.6	3,9[2)]
Other	103.7	101.6	100.8	102.0	102.7	103.0	100.5	101.3	99.3	98.5	99.9	40,6[2)]

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

Possible unpleasant surprises in early 2013

Our analysis indicates that the growth in Q4 lies on healthy grounds, and so we think it will continue as well in 2013. Some temporarily oscillations along the way are however possible, some of them even as a result of extraordinary circumstances. So for instance, we expect that the value of GDP in Q1 is influenced by the decline in the production of food industry due to the problems with high levels of aflatoxin in milk products.

In 2013 we expect the same structure of economic activity as in Q4 2012

Observed by use of GDP, Q4 shows a strong growth of net exports, while the other components (in total) were in decline when compared to Q3. More precisely, we could say that the government spending, as opposed to investment and private consumption, rose slightly in Q4, compared to Q3, but we believe that this was only a temporary increase, since in 2013 a sharp reduction in government spending continued. Similar structure of GDP growth is expected in 2013: high growth in net exports and a decline in private and government spending, which will in total result in a positive growth. For now investment trend in 2013 remains unknown. Some big investments are announced (NIS), but the investment trend with which we entered 2013 was extremely negative. Also, it is highly uncertain what will happen with the state investments - while new projects are being opened, activities on existing projects are slowed down during the second half of the 2012.

It is expected that agriculture in 2013 will significantly contribute to economic growth

As a consequence of the drought in 2012, for the year 2013 the average agricultural season is sufficient for agriculture to achieve high year on year growth. Based on the data from the last few decades, it is estimated that it is unlikely for two bad years to repeat consecutively - but the data relating to the longer time period suggest that this possibility is not excluded. However, we expect that the agricultural production will recover in 2013 and that it will significantly contribute to the growth of economic activity (by 1-1.5 p.p).

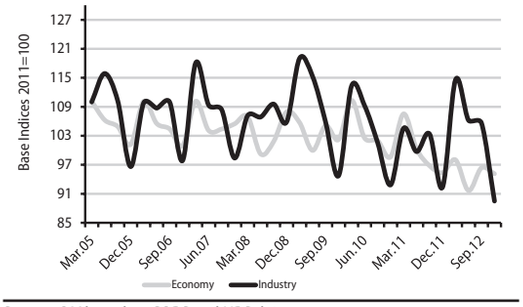
For now we stand by the assessment that the GDP growth in 2013 will be about 1.5%

Taking all analysis and expectations for 2013 into account, we stick to our forecast from the previous edition of QM that economic growth in 2013 will be around 1.5%. Our estimate for 2013 is slightly more conservative than the official (Ministry of Finance and Economy and the NBS) which is in the range of 2-2.5%. We do not exclude the possibility that this will happen, but we feel that there are far too many risks on the negative side that cannot be neglected. The main problem is that the economic growth is concentrated in only two to three sectors, while the rest of the economy is stagnant or in recession. Therefore the possible negative shocks in these sectors (e.g. decrease in demand for automobiles and poor agricultural season), would threaten total recovery of the Serbian economy. An additional problem which we particularly highlight is that there are no appropriate economic policies to fuel the growth of the economy. The strong appreciation of the dinar exchange rate does not help the growth of net exports, although net exports are expected to be the backbone of economic growth in 2013.

Unit Labour Costs measured in dinars slightly decrease

Unit Labour Costs[2] (ULC), measured in dinars, decrease in Q4 compared to the previous quarter, partly as a consequence of seasonal effects and partly as a consequence of the long-term trend of decrease of the labour costs share in the added value (Graph T2-3). ULC decrease in Q4 is basically a favourable trend, because it indicates that the economic recovery, which begun in Q4, is achieved along with the strengthening of the competitiveness of the Serbian economy. Wages are the most important non-exchangeable goods, so the competitiveness of the economy crucially depends on the relationship between wages and productivity.

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



Source: *QM* based on SORS and NBS data

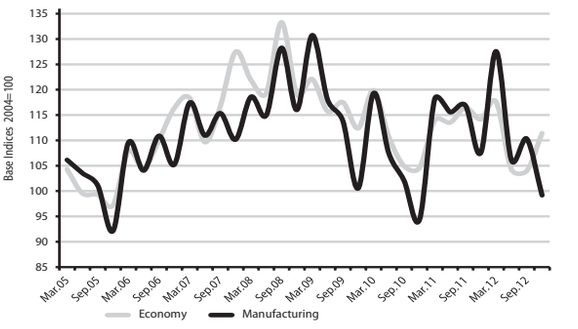
Year on year decline of ULC in the industry is especially encouraging due to the fact that they had significantly higher values compared to the previous year. The reason for the increase of ULC in the industry in the first three quarters is easier to describe on the example of the Steal Plant Smederevo. In this company, the production stopped but the employees were not fired – which automatically enormously increased the cost of labour in added value. Therefore, the fact that the share of labour costs in the industry declined in Q4 despite the existence of the mentioned problems, is very interesting and positive.

Almost chaotic motion of euro-ULC indicates large fluctuations of the exchange rate in 2012

Unit labour costs measured in euros (euro-ULC) are an indicator of the price competitiveness of the Serbian economy because they define the greatest national cost component (labour 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,[3] 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, which ended when the economic crisis escalated in Serbia and the dinar depreciated.

The graph shows that the euro-ULCs significantly increased in Q4 compared to Q3, and that the usual large seasonal reduction in the euro-ULC in the manufacturing industry was to some extent prevented. The reason for this is the strong real appreciation of the dinar in relation to euro in Q4. It is probable that once again the situation repeats, as soon as the inflow of capital enables it, the real appreciation of the dinar is allowed. Such a policy, then, in a very short period cancels all the positive effects depreciation of the dinar could have on the competitiveness of the economy, presumably even before some more tangible benefits of depreciation are achieved. Graph T2-4 shows that in the periods of depreciation of the dinar price competitiveness of the domestic economy improves (reduction of euro-ULC), but also how these periods were short-lived and unstable. The QM standpoint is that important motives for the dinar exchange policy must be to eliminate the imbalance in the balance of payments current account and to encourage the sustainable growth of the economy, which is why we are against the further strengthening of the dinar.

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

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

Industrial production

Industrial production recovering in Q4

Industrial production is at approximately the same level in Q4 as in the same period last year, which is still significantly better result than in Q3 (Table T2-5). Within the scope of the industrial production best results were recorded by manufacturing which is the largest and most important part of industrial production (y-o-y increase of 1.5%), while mining production and electric supply recorded y-o-y fall of 3.7% and 7%. QM estimate is that these changes in the industrial production trend, compared to Q3, were the result of operations of only a few large business enterprises.

Table T2-5. Serbia: Industrial Production Indices, 2008-2012

	Y-o-y indices													Share
	2008	2009	2010	2011	2012	2011				2012				2011
						Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Total	101.4	87.4	102.5	102.2	97.1	106.4	103.6	98.1	101.3	94.5	97.2	96.4	99.4	100.0
Mining and quarrying	105.3	96.2	105.8	110.4	97.8	107.5	117.7	102.8	114.8	100.2	94.2	100.1	96.3	9.9
Manufacturing	101.1	83.9	103.9	99.6	98.2	105.8	100.7	96.9	96.7	93.3	100.2	96.2	101.5	73.1
Electricity, gas, and water supply	102	100.8	95.6	109.7	92.9	107.5	113.0	101.5	116.7	96.6	85.4	95.8	93.0	17.0

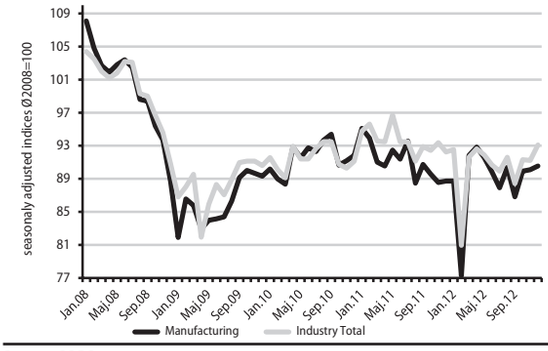
Source: SORS

At the the annual level decline in industrial production of 2.9%

After two years of recovery, 2012 recorded a significant decline in industrial production of 2.9%. All three sectors of industrial production were in decline (Table T2-5). However, we rate industrial production trends as somewhat better than it could be concluded on the basis of an annual drop, given the fact that the economic recovery came at the end of the year. FIAT production growth in the second half of the year more than compensated the decline in production of Smederevo Steel Plant.

Seasonally-adjusted indices also indicate recovery in Q4

Table T2-6. Serbia: Seasonally Adjusted Industrial Production Indices, 2008-2011



Source: SORS

Graph T2-6 shows seasonally-adjusted production indices of industry as a whole and manufacturing industry. Seasonally adjusted data indicate that industrial production (and manufacturing) was on a path of growth in the last three months of 2012, and that with this trend it enters 2013.

Fiat Company mostly contributed to the industrial production recovery

When we analyse industrial production by sectors we notice that several fields strongly increased their activity in Q4 compared to Q3, crucially contributing to the started recovery of industrial production - because other fields in Q4 achieved very similar results to those in previous quarters. Two fields that mostly increased production in Q4 were motor vehicles production and production of petroleum products – which clearly indicates that only two companies Fiat Automobiles Serbia (FAS) and NIS were the most responsible for the positive trend in Q4. Positive image of industrial production during Q4 shows some negative signs, such as a sharp fall in the food industry, which by its share represents the largest area of industrial production.

In Q1 2013 we certainly expect positive year-on-year industrial production indices....

Graph T2-6 clearly shows a sharp drop in industrial production in February 2012, which was actually the result of a state of emergency due to the bad weather. Because of that, industrial production in Q1 2013 will undoubtedly have a solid annual growth. It is however uncertain whether it will achieve higher growth than in Q4 2012 which we measure by the seasonally adjusted indices. In Q1 we expect a significant negative impact on the food industry because of the problems with a high amount of aflatoxin in the milk and milk products.

.....but it is uncertain whether the seasonally adjusted indices will be higher than those recorded in Q4 2012

Observed by use (Table T2-7), we note that the growth structure by purpose groups in Q4 was similar to those in Q3 – production in 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. Although this structure is very similar to the one from the previous quarter, Q4 in total recorded a significantly better result.

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

					Y-o-y indices							
					2011				2012			
	2008	2009	2010	2011	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Total	101.4	87.4	102.5	102.1	106.4	103.6	98.1	101.3	94.5	97.2	96.4	99.4
Energy	101.7	98.8	97.7	106.2	103.7	110.8	96.5	114.2	95.8	88.3	91.4	98.7
Investment goods	105.9	79.3	93.6	103.2	132.2	97.5	92.5	92.2	92.0	105.4	113.7	104.2
Intermediate goods	100.3	78.4	109.2	102.2	113.8	103.3	99.1	99.3	89.4	96.3	89.1	90.0
Consumer goods	101.6	86.8	102.1	95.4	96.5	98.1	97.8	92.4	97.8	104.5	104.6	106.1

Source: SORS

Construction

The decline in construction activity is high in Q4

Latest construction statistics made available by SORS indicate significant slowdown in this sector of the economy. The value index of the construction works performed indicates decline of over 25% in Q4. By observing the official reports for several previous quarters we noticed significant change in the construction industry trend during the 2012. Back in Q1 the value index of construction work performed indicated year-on-year growth of construction activity of about 20% and in Q2 of about 6%, in Q3, the index indicated decrease of 10% and the year ended with a very deep real decline (25.7 %). The decline in construction activity is worrying because the export of the construction could be one of the main drivers of economic growth.

….which is confirmed by the low cement production

Cement production index, which we use as an additional indicator of the construction industry trends, indicates similar trends.[4] (Table T2-8). Namely, the construction sector comprises a large number of a small and medium-sized enterprises, whose statistical monitoring is very unreliable and often outside the sight of the official statistics. Therefore, as an additional indicator for monitoring this sector of the economy we use cement production which is easy to monitor and cement is used in almost all construction works. We believe that data obtained this way, although not sufficiently precise, are a good additional indication of actual state and future trends in construction. Cement production is also a useful indicator for the assessment of future trends in construction activity, because it precedes it. Cement production in Q4 recorded extremely high annual decline of 15% (Table T2-8) which is in the accordance with the abovementioned official data on the value of construction work. We therefore conclude that the construction activity is in sharp decline and it is unlikely that something will fundamentally change in the future.[5]

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	58.2	84.9	79.6

Source: SORS

4 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.

5 Construction activity in Q4 is substantially influenced by meteorological conditions so that quarter (alongside Q1) is not representative for the evaluation of construction activity.

In 2013 we do not expect growth in construction activity

Therefore, we enter the next year with extremely negative trend of construction activity, which will almost certainly lead to a y-o-y decrease in the construction activity in the first half of the year. We also believe that it is unlikely for the second half of the year to see a shift that will lead the overall construction activity into the zone of positive growth in 2013, and so the value of construction activity in 2013 will at best be on a similar level as in 2012. In addition to all said, we note that the planed fiscal framework for 2013 implies the reduction of public investment to GDP share in 2013, which can also indicate continuation of the decline trend in construction activity in 2013.

3. Employment and wages

Analysis based on overall economic trends and their interdependence shows that there were no significant changes in the labor market in Serbia. In the second half of the year GDP and personal spending declined, as well as personal income tax revenues and revenues from social security contributions. Sections of activity employing seasonal workers have been suffering a severe crisis. This all suggests that the results of the Labor Force Survey (LFS), carried out in October 2012 and published in December of the same year, showing improvement in all labor market indicators: increased employment rate and decreased unemployment and inactivity rate, relative to April 2012, should be taken with a grain of salt. We believe that the results do not indicate improvement in the labor market, but that most probably they should be attributed to the new assessment methods of labor market segments. Since the new methodology was employed only in the Survey made in October 2012 we believe that it is not suitable for comparison with the Surveys preceding it. In this QM we will therefore focus our attention on formal employment trends that, as we believe, can be quite reliably assessed. We also think that methodologically comparable data on employment in the last few years must be published as soon as possible. Average real wages continued to fall, and in the last quarter of 2012 y-o-y decline was 1.7%. The decrease in average real wages is in accord with the decline in GDP. Real wages in all public sectors decreased in Q4 due to quiet modest increase in nominal wages by only 2% and much higher rise in inflation. Public enterprises with 6% y-o-y increase are again the exception to the rule.

Employment

According to the Labor Force Survey made in October and published at the end of 2012 all labor market indicators improved: employment rate of working age population (aged 15 to 64 years) increased by 2.2 percentage points while inactivity rate of working age population decreased by 0.7 percentage points. Strong growth of employment alongside with the modest rise in activity rate led to substantial fall in unemployment rate by as many as 3 percentage points (Table T3-1). However, we believe that this is not due to enhanced labor market but most probably to more accurate assessment of some labor market segments, which is explained in more detail in Box 1. We will therefore focus our attention on the analysis of formal employment and its distribution by sections of economic activity.

Table T3-1. Serbia: Employment and Unemployment According to the Labor Force Survey[1], 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
	October	2,201,760	345,883	46.4	53.7	39.1	661,698	23.1	22.1	24.5

Source: Labour forse survey (LFS), SORS.
Notes:
1) Labour Force Survey is conducted twice a year since 2008 - in October and in April.
2) Persons between 15 and 64 years are considered to be of working age.
3) By October 2008 in the LFS classification of employees in agriculture and unpaid family workers for the 15-64 age group did not exist , only 15 +.

Formal employment declines at the beginning of Q4 2012

According to the RAD Survey formal employment decreased by 6,000, i.e. number of entrepreneurs and their employees dropped by 10,000, while the number of employees in legal entities grew by 4,000 from March to September 2012 (Table T3-2).

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

		Total no. of employed	Employees in legal entities[2]	Entrepreneurs			Total no. of employees	Number of unemployed (NES)
				Total	No. of entrepreneurs	No. of employees with entrepreneurs		
		1 (=2+3)	2	3 (=4+5)	4	5	6 (=2+5)	7
					in thousands			
2004	March	2,065	1,601	464	208	255	1,856	..
	September	2,037	1,560	477	210	267	1,827	843
2005	March	2,070	1,557	513	228	285	1,842	884
	September	2,067	1,536	531	230	300	1,836	898
2006	March	2,032	1,496	536	228	308	1,804	920
	September	2,019	1,447	572	242	330	1,777	915
2007	March	2,004	1,438	566	239	327	1,765	913
	September	2,001	1,428	573	245	328	1,756	808
2008	March	2,006	1,432	574	245	329	1,761	795
	September	1,993	1,425	568	245	323	1,748	726
2009	March	1,911	1,411	500	210	290	1,701	758
	September	1,868	1,383	485	211	274	1,657	737
2010	March	1,817	1,362	455	199	257	1,618	778
	September	1,775	1,348	427	183	244	1,592	721
2011	March	1,755	1,349	405	204	201	1,550	774
	September	1,738	1,337	401	203	198	1,535	743
2012	March	1,730	1,339	391	203	188	1,527	783
	September	1,724	1,343	381	197	183	1,526	751

Source: SORS – The semi-annual report on employed persons and wages of the employed persons RAD-1/P; the update to the semi-annual survey RAD-1; Semi-annual survey on private entrepreneurs and their employed workers RAD-15; the National Employment Service.
Notes: The data for September were corrected on the basis of semiannual survey RAD-1 / P of March 2011.
1) By the registered number of employed, we refer to the formal economy, i.e. those employees with employment contracts and for whom social security contributions are being paid.
2) By the registered number of unemployed, we refer to those persons that have registered with the National Employment Service (NES). NES moved from monitoring the number of job seekers to the number of unemployed persons in September 2004. This is why we do not have these data for the previous period (column 7).
3) Figures do not include employees of the Ministry of Defense and Ministry of Interior

Employment in trade suffered the largest drop

Decline in employment in manufacturing, persisting from the beginning of the global economic crisis, continues (about 2,000 employees), in spite of being decreased in intensity in the past two years. In 2012 employment in wholesale and retail trade suffered the largest drop (4,000 employees) which was an expected outcome of decreased purchasing power and retail sales. Employment in other sections of economic activity such as construction, mining, transportation, accommodation and food services, finance and insurance, and arts, entertainment and leisure services increased by 1,000 employees each (Table TP-5).

When it comes to the public sector, employment in public administration and public enterprises suffered a slight decrease of 1,000 employees each, employment in education decreased by 2,000, while employment in local public enterprises increased by 1,000. Net effect of these changes, presented in Table T3-3, is decline in overall employment in the public sector by 1,000 employees.

Table T3-3. Serbia: Employees in public sector 2004-2012

		Employees in legal entities						
		Public sector					Public sector - total	Other[1)]
		From the budget			Public enterprises			
		Administration - all levels	Education and culture	Health and social work	National public	Local public		
		1	2	3	4	5	6	7
		in thousands						
2004	March	63	117	147	125	57	509	1,092
	September	63	116	148	124	57	508	1,052
2005	March	63	119	148	122	61	513	1,044
	September	61	117	147	112	61	498	1,038
2006	March	60	118	141	105	61	485	1,011
	September	58	117	138	102	60	475	972
2007	March	58	121	138	100	59	476	962
	September	59	120	139	100	58	476	952
2008	March	60	124	140	99	58	481	951
	September	61	122	141	100	58	482	943
2009	March	64	125	142	89	57	478	933
	September	64	123	142	88	57	473	910
2010	March	62	124	142	87	56	472	890
	September	63	122	143	86	56	470	878
2011	March	61	124	143	84	57	469	880
	September	62	122	143	84	57	469	868
2012	March	63	122	143	85	57	470	869
	September	64	120	143	84	58	469	875

Source: SORS

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

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

Smaller number of unemployed persons registered with the National Employment Service

The number of unemployed persons registered with the National Employment Service declined by 32,000 from March to September 2012. This is explained by the fact that unemployment rate rises from January to March, when it reaches the peak, because tax reliefs act as an incentive to some unemployed persons to register with the National Employment Service. In Q3 unemployment falls and reaches the trough in September and October due to seasonal jobs (Table T3-2).

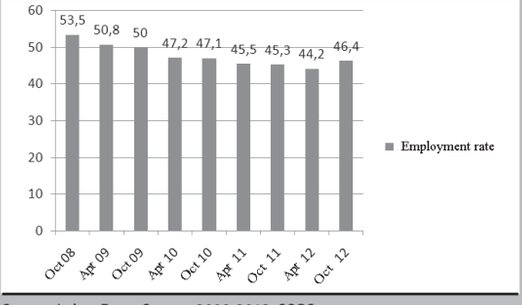
Box 1. Causes of the "drop" in unemployment and the "rise" in employment

When the results of the Labor Force Survey (LFS) carried out in October 2012 were published the drop in unemployment rate by as much as 3 percentage points – from 26.1% in April 2012 to 23.1%, were found extremely surprising. All other labor market related indicators displayed strong negative tendencies – Gross Domestic Product (GDP), revenues from taxes and social contributions and personal spending dropped.

Seasonal jobs are seen as one of the main drivers of decrease in unemployment, which was stated by the representatives of the Ministry of Labor, Employment and Social policy as well.[1] However, very modest seasonal effects in Serbian labor market do not speak in favor of this explanation. This is to say that the data obtained in LFSs conducted twice a year since 2008 shows that employment rate noted from April to October of every respective year did not fluctuate greatly, that larger

1 http://www.blic.rs/Vesti/Ekonomija/362851/Orbovic-Smanjenje-nezaposlenosti-tek-2014-godine

Graph T3-1: Employment rate trends, 2008-2012



Source: Labor Force Survey, 2008-2012, SORS

fluctuations of employment rate occurred in the succeeding six month period, i.e. from October of the current year to April of the following year. Employment rates noted in 2012 are the exception to the rule. Moreover, in the last year sectors of activity employing the largest portion of seasonal workers were severely hit by the crisis.

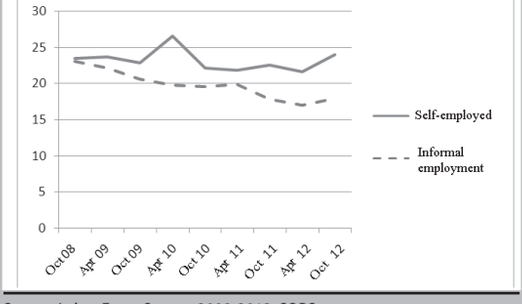
Searching for more plausible explanation we noticed that in the period April-October 2012 employment increased by more than 140,000 or 2.2%. Such growth is expected to boost GDP, but that did not occur – instead, in the analyzed period GDP dropped.

The number of unemployed registered with the National Employment Service (NES) declined by 32,000 from March to September 2012. But, as we have mentioned in the introduction on employment trends, this is explained by the fact that unemployment rate rises from January to March, when it reaches the peak, because tax reliefs act as an incentive to some unemployed persons to register with the National Employment Service. In Q3 unemployment decreases and reaches the trough in September and October.

The number of formally employed, assessed in RAD Survey, was steady in 2012 and amounted to 1,730,000. However, if we take a look into the structure of employment we will see that the growth in the number of self-employed, individual agricultural producers and informally employed outperformed the growth of overall employment, which is the reverse trend relative to the one detected in the last five years when the number of employees falling into these categories decreased at higher rates compared with the number of salaried employees, non-agricultural employees and formally employed.

The number of self-employed aged 15+ increased from 21.6% to 24%, or by slightly more than 85,000 (Graph T3-2). Overall economic trends and the fact that the Government did not provide self-employment incentives cast doubt on the reliability of the data.

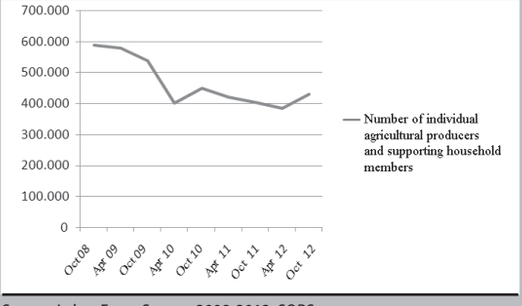
Graph T3-2: Self-employment and informal employment trends, 2008-2012



Source: Labor Force Survey, 2008-2012, SORS

Further on, according to the LFS there was a continuous decline in the number of informal employees from the beginning of 2008 to April 2012 (Graph T3-2) although GDP noted in that period fluctuated. However, in the period April-October 2012 number of informal employees increased, although GDP dropped and the sections of activity with traditionally large number of informal employees (such as construction, accommodation and food service activities, transportation) suffered especially large drop of GDP.

Graph T3-3: Employment trends in agriculture, 2008-2012



Source: Labor Force Survey, 2008-2012, SORS

Finally, according to LFS conducted in October 2012, employment in agriculture (for the population aged 15+) raised by 47,000 or 12.2%. This has been the largest increase in relative and absolute terms noted since 2008. Graph T3-3 shows that from October 2008 to April 2012 employment in agriculture dropped by 200 thousand. This dramatic decrease brings up the question – What

caused such a sharp decrease? Did agriculturers massively abandon their estates, and in 2012, during the worst drought, decided to resume the cultivation?

These trends in the structure of employment cannot be attributed to any specific event that might have occurred between the two Surveys carried out in 2012. If a new Survey methodology has been adopted, or if the method of conducting the last survey has changed, the new methodology must be employed retroactively to obtain comparable data series. Certain approximations would have to be made for this purpose, which is certainly more acceptable than to publish data unsuitable for comparison. Additionally, statistics should explain these unusual variations in the number of employees in agriculture, informal sector and self-employed in the past few years. Reliable data on employment and unemployment trends has crucial importance in economic policy making and different analysis and forecasts.

At this moment we cannot estimate merely on the basis of the LFS that Serbian labor market enhanced. We believe that the results actually reveal potential inconsistency and unreliability of the data collected in the previous Surveys. It is possible that the results obtained in the last Survey are a more accurate reflection of labor market trends and that certain segments were systematically underestimated in the past. It is therefore necessary to publish comparable data series on employment and unemployment in the previous years.

Wages

In Q4 2012 y-o-y average real wages continue to fall

Average real wages continued to fall in the last quarter of 2012, and the y-o-y decline was 1.7% (Table T3-4). In Q4 2012 real wages in all public sectors decreased as well. Public enterprises with as much as 6% increase in real wages are the exception to the rule. Average real wages in private sector, on the other hand, noted 1.8% decline.

Table T3-4. 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
2012	67,724	41,386	599	366	108.9	101.4
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
Q3	67,457	41,187	577	352	106.4	98.4
Q4	71,452	43,625	630	384	108.7	96.8
Dec	76,830	46,923	677	413	106.6	95.1

Source: SORS
Notes:
1) Data for 2008 are adjusted on the basis of a wider sample to calculate the average wage, which includes the salaries of employees of entrepreneurs.
2) Y/y wage indices of average monthly gross earnings for 2008 were calculated on the basis of average earnings in 2007 and 2008 and the old sample that does not include those employed by entrepreneurs. However, these indices are comparable with the indices for 2009, given the fact that the expansion of the sample of earnings preserved their growth dynamics and only reduced their nominal value by about 12%.
3) Total labor costs (TLCs) comprise employer's total average expense per worker, including all taxes and social security contributions. TLCs stand at around 164.5% of the net wage. Gross wage growth indices are equal to total labor cost indices, because the average TLC is greater than the average gross wage by a fixed 17.9% of employer based social security contributions

Table T3-5. Serbia: Gross Wages in the Public Sector, 2004-2012, Y/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
2012	101.2	99.2	98.5	101.8	98.6	102.8	101.6
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
Q3	98.6	96.9	97.6	95.2	96.6	99.3	98.4
Q4	96.1	94.2	93.9	101.2	92.7	97.5	96.8

Source: SORS.

Notes:

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

2) Column 6 shows the estimated value arrived at by deducting the public sector wage bill from the total wage bill and then dividing the difference by the number of workers employed in the corporate sector

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

In the public sector only state enterprises noted growth in real wages

Seasonally adjusted data on real net wages in the public and private sector prove that in Q4 relative to Q3 only public enterprises noted increase in wages by as much as 12.2% (Table T3-6). In the second half of 2012 wages in other public sectors were stagnant, due to fiscal consolidation measures (see section Fiscal trends and policy). Actually, in October 2012 wages in public sector and pensions were increased by 2%, which was much below the overall inflation rate noted in the period April-September (about 10%), so the real wages decreased.

Decline in wages in the private sector noted in the second half of 2012 was driven by two factors: recession-driven stagnant nominal wages and soaring inflation caused by rising food prices, fiscal expansion in the first half of the year, dinar depreciation (curbed in September) and increase in VAT in October. As we have forecasted in QM30, these changes exerted combined effect on inflation which continued to rise and led to decrease in real wages by the end of 2012.

T3-6. Real seasonaly adjusted net wages in economy and public sector

Economy	Public State Enterprises	Public Local enterprises	Administration (all levels)	Education and Culture	Health and Social Work
94.6	98.8	100.8	99	98.9	101.3
92.3	97.6	95.9	97.8	97.9	97
104.5	97.9	96.5	97.9	97.6	97.7

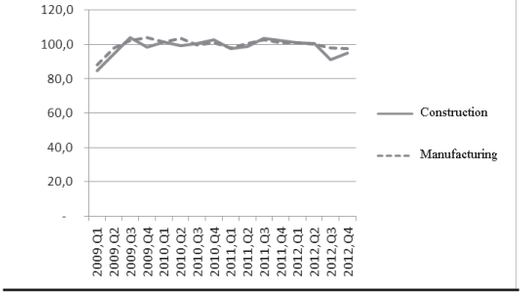
Source: QM estimates

In this issue of QM we are analyzing wage trends by sections of activity (Table TP-6). In 2012 the lowest nominal net wages were earned in accommodation and food service (about RSD 22,000), wholesale and retail trade (RSD 31,000) and in administrative and support service activities (RSD 32,000).

The highest nominal net wages in 2012 were noted in financial and insurance activities (RSD 76,000), electricity and gas supply (RSD 70,000), information and communications (RSD 60,000) and professional scientific and technical activities (RSD 57,000).

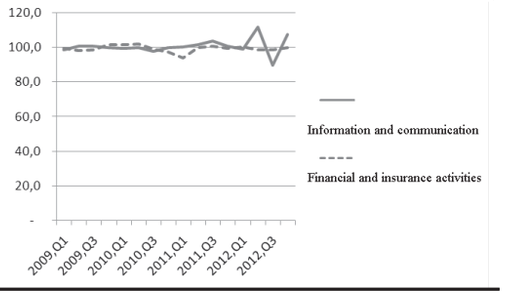
Wages in real estate activities and other service activities noted continuous fall since the beginning of 2012. The situation in manufacturing is even more serious, real wages noted continuous fall from Q3 2011. Similarly, wages in construction noted continuous decline from Q3 2011, noting the sharpest drop at the beginning of 2012 and modest recovery from Q3 last year (Graph T3-4).

Graph T3-4: Real seasonally adjusted average net wages: construction and manufacturing



Source: *QM* calculations

Graph T3-5: Real seasonally adjusted average net wages: information and communication section and financial and insurance activities



Source: *QM* calculations

Wages in information and communication section remained quiet steady from 2009 to the beginning of 2012 when a significant growth occurred, soon after followed by a considerable decrease. However, from Q3 last year wages in this section recovered to the previous level. Nominal net wages in financial and insurance activities had the highest rate and remained steady from the beginning of 2011, in spite of the global economic crisis (Graph T3-5).

Finally, y-o-y real net wages in these sections show that real wages in manufacturing noted in Q4 2012 relative to Q4 2011were decreased by 5.6% and real wages in construction dropped by as much as 14%.

At the same time, real net wages noted in Q4 2012 in information and communication section decreased by 2.1% relative to the same quarter 2011. Only real wages in financial and insurance activities increased by 2% compared with the Q4 2011.

Table T3-7: Year on year real net income indices

2011-2012	Manufacturing	Construction	Information and technologies	Financial and insurance activities
2011Q1	102.0	99.6	97.1	92.8
2011Q2	99.3	99.2	98.1	90.8
2011Q3	102.6	102.0	108.2	94.7
2011Q4	102.1	101.6	107.6	91.3
2012Q1	105.4	105.4	104.3	109.8
2012Q2	105.0	107.2	116.5	100.4
2012Q3	100.0	94.5	97.1	93.1
2012Q4	96.5	87.6	105.5	93.3

Source: *QM* estimates

Table P-5. Serbia: number of emplosees by sectors of economic activity , 2010-2012

	2011												2012											
	Jan.	Feb.	Mar.	Apr	Maj	Jun	Jul	Aug	Sep	Okt.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr	Maj	Jun	Jul	Aug	Sep	Okt.	Nov.	Dec.
Employees in enterprises, institutions and organizations by sectors																								
Agriculture, forestry and fishing	36	36	35	35	35	34	34	34	34	34	34	34	34	34	33	33	33	33	33	33	33	33	33	33
Mining	22	22	22	22	22	22	22	22	22	22	22	22	22	22	22	22	22	22	22	23	23	23	23	23
Manufacturing	296	296	296	296	295	295	294	293	294	294	293	292	292	291	289	290	288	290	289	289	289	289	289	289
Supply of electricity, gas and steam	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28
Water supply and waste water management	32	32	32	32	32	32	32	32	33	33	33	33	33	32	32	32	33	33	33	33	34	34	34	34
Construction	73	73	73	73	72	72	72	72	72	72	72	72	72	72	71	71	71	72	72	72	72	72	72	72
Wholesale and retail trade and repair of motor vehicles	184	185	186	185	185	184	184	183	181	181	182	182	181	182	186	185	185	184	184	183	182	182	182	182
Transport and storage	87	87	86	86	86	86	86	86	86	86	86	86	86	86	84	84	85	85	85	85	85	85	85	85
Accommodation and food services	21	21	21	21	21	21	21	21	20	20	20	20	20	20	20	20	20	20	21	21	21	21	21	21
Information and Communication	37	37	37	38	38	38	38	39	38	38	38	38	38	39	40	40	40	40	40	40	40	40	40	40
Financial activities and insurance activities	39	39	39	39	39	39	39	39	39	39	39	39	39	39	39	39	39	39	39	39	40	40	40	40
Real estate	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3	3
Professional, scientific and technical activities	53	53	53	53	53	53	53	53	51	51	51	51	51	52	52	53	54	54	55	55	56	56	56	56
Administrative and support service activities	31	31	31	30	30	29	28	28	28	28	28	28	28	28	30	29	30	30	30	30	30	30	30	30
Public administration and compulsory social security	70	70	70	70	70	71	71	71	71	71	71	71	72	72	72	72	72	73	73	73	73	73	73	73
Education	138	139	140	139	139	138	138	137	137	138	138	139	139	139	141	141	141	140	139	138	137	137	137	137
Health and social care	160	160	161	161	161	161	161	161	161	161	162	162	162	162	162	162	161	161	161	160	160	160	160	160
Arts, entertainment and recreation	22	22	22	22	22	22	22	23	22	22	22	22	22	22	22	22	22	22	22	23	23	23	23	23
Other service activities	14	14	14	14	14	14	15	15	15	15	15	15	15	15	14	14	14	14	14	14	14	14	14	14

Source: SORS – The semi-annual report on employed persons and wages of the employed persons RAD-1/P; the update to the semi-annual survey RAD-1; Semi-annual survey on private entrepreneurs and their employed workers RAD-15; the National Employment Service.
Notes: The data for September were corrected on the basis of semiannual survey RAD-1 / P of March 2012.

Table TP-6: Nominal net wages by sectors of economic activity

	Nominal net wages																			
2012	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O	P	Q	R	S
2012m01	34,657	62,510	32,127	66,481	35,558	31,901	28,559	44,681	20,585	50,040	70,575	38,808	51,467	30,561	44,602	39,188	28,593	33,636	23,419
2012m02	32,972	66,369	33,181	75,981	36,255	33,130	30,189	42,565	20,386	57,384	75,528	43,868	51,573	28,360	49,150	39,189	40,585	37,043	30,683
2012m03	34,252	68,163	34,092	79,679	37,342	35,010	29,777	43,222	21,358	52,682	77,493	42,843	59,775	29,513	49,945	40,029	40,039	39,848	27,661
2012m04	35,078	65,377	37,080	68,267	37,512	35,352	32,340	42,432	22,595	71,495	79,312	50,207	61,874	29,998	52,866	39,689	40,916	42,119	30,130
2012m05	36,684	63,026	33,799	69,553	37,441	35,021	30,347	43,591	23,686	56,750	67,503	40,411	54,609	31,648	50,074	40,637	42,175	38,391	28,903
2012m06	36,705	62,117	37,068	69,657	37,949	36,780	31,919	43,523	23,428	60,397	84,494	49,772	59,329	31,450	51,186	41,135	42,204	38,433	28,527
2012m07	35,158	56,413	36,780	67,057	38,160	35,011	31,192	42,190	23,672	60,670	70,538	40,188	55,382	31,697	50,835	41,081	41,445	39,373	27,766
2012m08	37,626	64,623	37,323	69,910	39,234	35,341	31,576	43,092	23,660	58,740	77,193	48,963	57,173	31,581	52,008	41,015	41,778	38,252	29,816
2012m09	34,979	59,207	34,950	58,854	37,861	33,263	30,145	42,988	23,195	54,086	75,798	42,005	55,430	32,594	49,184	41,251	41,456	37,145	29,112
2012m10	36,632	64,388	35,262	78,428	38,079	34,170	30,624	42,698	23,728	62,417	75,790	43,395	56,558	32,415	51,806	40,718	41,460	39,882	29,301
2012m11	36,306	66,359	36,626	71,500	38,535	34,851	32,368	43,843	23,117	58,739	76,911	51,571	56,566	31,512	52,018	41,850	42,645	40,768	31,033
2012m12	40,619	66,226	40,853	69,623	41,201	36,899	34,197	46,897	24,740	75,133	83,308	45,509	67,345	33,035	56,015	43,350	54,257	48,362	31,305

KD 2010
A - Agriculture, forestry and fishing
B - Mining
C - Manufacturing
D - Supply of electricity, gas and steam
E - Water supply and waste water management
F - Construction
G - Wholesale and retail trade and repair of motor vehicles
H - Transport and storage
I - Accommodation and food services
J - Information and Communication
K - Financial activities and insurance activities
L - Real estate
M - Professional, scientific and technical activities
N - Administrative and support service activities
O - Public administration and compulsory social security
P - Education
Q - Health and social care
R - Arts, entertainment and recreation
S - Other service activities

Source: SORS

4. Balance of payments and foreign trade

In the period January-November 2012 current account showed a deficit of EUR 2,747 million (10.4% of GDP). In 2012 (from January to November inclusive) current account deficit widened relative to post-crisis years (2009, 2010 and 2011), which can be in large measure ascribed to increased domestic demand due to fiscal expansion during the pre-election period in the first half of the year. However, in 2012, observed quarterly, a downward trend in current account deficit – both in absolute and relative terms (in % of GDP), was detected. Current account deficit narrowed at the end of 2012 primarily because foreign trade deficit shrank due to increased exports and relatively low imports. Automobile production recovery, depreciation of dinar in the preceding period and production of petroleum products exerted positive effects on exports at the end of the year, while slow economic recovery in EU and in the region had negative impact on exports. Time lag effects of exchange rate depreciation in the preceding period led to decrease in domestic demand which resulted in a slowdown in growth of imports at the end of 2012. We expect that in 2013 automobile exports and agricultural exports (due to expected good agricultural yields) will continue to speed up growth of exports, while time lag effects of real appreciation of dinar – which started at the end of 2012 – will reduce it. However, further decrease in foreign trade deficit and consequently in current account deficit in 2013 will in a large measure depend on economic recovery in EU and in the region, and on cessation of further appreciation of dinar.

From January to November 2012 current account showed a deficit of EUR 2,747 million or 10.4% of GDP

In the period January-November 2012 current account showed a deficit of EUR 2,747 million. The current account deficit accounts for 10.4% of GDP[1] which is by 1.4 percentage points larger than in 2011, and by about 3 percentage points larger than in 2009 and 2010. However, observed quarterly, a downward trend in current account deficit – both in absolute and relative terms (in % of GDP), was detected.

Observed quarterly, a downward trend in current account deficit was detected in 2012

In October and November 2012 current account showed a deficit of EUR 286 million or 5.5% of GDP (Table T4-1). The current account deficit was by 3.3 percentage points smaller than in the same period 2011 and made up a much smaller portion of GDP than in Q1, Q2 and Q3 2012 (17.6%, 10.2% and 7.6% respectively). Current account deficit narrowed due to decrease in foreign trade deficit driven by increased exports. At the same time, higher net inflow of current transfers was recorded, as well as a slight decrease in Income account and Services account.

Goods deficit arrowed...

...due to considerable growth in exports

In the first two months of Q4 goods deficit ran at EUR 829 million, or 15.9% of GDP, which is by 2.7 percentage points lower than in October and November 2011. Goods deficit narrowed primarily due to considerable growth in exports. In October and November 2012 the goods to the value of EUR 1,685 million were exported, which is as much as 16.4% higher than in the same period 2011. Relatively strong rise in exports is due to automobile production recovery, time lag effects of depreciation of dinar in the preceding period and production of petroleum products, while recession in EU and in the region, poor agricultural yields and decline in exports of metals exerted negative impact on exports. Imports in October and November 2012 totaled EUR 2,513 million, which is 2.9% y-o-y increase. Since y-o-y increase in exports was much larger relative to y-o-y rise in imports, upward trend in export-import ratio continued – 67% both in October and in November, which has been the highest value recently.

In October and November 2012 exports accounted for 32.4% of GDP, which is 5.3 percentage points larger than in the same period 2011 (27.1% of GDP). However, exports take a substantial share of GDP since Q2 2012 (more than 31%). On the other hand, imports get an increasing share of GDP – 48.4% in October and in November, which is 2.7 percentage points larger than in the same period 2011 (Table T4-1).

1 The data for 2012 in this section of the paper (*Balance of Payments*) are for the period January to November inclusive. Balance of payments items to GDP ratios are calculated on the basis of approximate values of GDP. Namely, 2/3 of GDP value recorded in Q4 is used as a denominator for calculation of the ratios in the period October-November, and sum of GDP values recorded in the first three quarters and 2/3 of the GDP value recorded in Q4 is used as a denominator for calculation of the ratios in the period January-November.

Substantial inflow of current transfers

In October and November 2012 net inflow of current transfers accounted for 11.7% of GDP, which is 1.7 percentage points larger than in the same period 2011. Moreover, this outperforms the inflow recorded in Q1, Q2 and Q3 2012. From January to November 2012 net inflow of current transfers totaled EUR 2.7 billion, which accounts for 10.3% of GDP, the usual and expected inflow. Considerable inflow of current transfers is primarily due to high remittances inflow which totaled EUR 428 million in October and November, relative to EUR 1.8 billion from January to November.

High inflow of capital in October and November – mostly due to sale of government bonds...

In October and November 2012 inflow of capital totaled EUR 1,129 million[2], which was sufficient to make up current account deficit and bring about a substantial rise in foreign exchange reserves (Table T4-1). High inflow of capital is primarily due to net inflow of portfolio investments – sale of government bonds (USD 1 billion in October[3] and USD 750 million in November), and to foreign investors' growing interest in dinar denominated government securities, since risk premium went down starting from September. Inflow of portfolio investments in the first two months of Q4 totaled EUR 1.45 billion. Net FDI are very modest and total EUR 158 million.

...sufficient to make up current account deficit and bring about a substantial rise in foreign exchange reserves

Net outflow of EUR 479 million was recorded in Other investments account. Modest outflow of EUR 44 million was recorded in Trade credits account and net outflow of EUR 94 million was recorded in Loans account. The largest portion of the outflow of loans is recorded in National Bank of Serbia account and was due to debt repayment to the IMF in November (EUR 105 million was paid out from foreign exchange reserves for this purpose[4]). Net drawings of EUR 92 million were recorded in Banks account, whereby short-term net drawings amounted to EUR 139 million and long-term repayments totaled EUR 48 million, while EUR 101 million repayments were recorded in Other sectors account. According to the inflow and outflow of capital recorded in October and November we can conclude that the given structure of capital account is quite disadvantageous – FDI are very small, and capital inflow is achieved mainly through country's borrowing. Further repayments recorded in Other sectors account in the first two months of Q4 have negative short-term effects – they lead to lower liquidity of enterprises, but their long-term effects are positive – they make room for new loans in the future. A net decrease of EUR 341 million was recorded in Currency and deposits account.

Foreign exchange reserves increased in Q4...

Foreign exchange reserves achieved cumulative growth of EUR 890 million in October and November (EUR 394 million and EUR 495 million respectively). This increase is primarily due to sale of Eurobonds in financial market (EUR 806 million and EUR 663 million in October and November respectively). Smaller inflows in both months came from loans and donations, while the outflows were due to debt repayments to the IMF (EUR 105 million in November), withdrawal of excess reserves of banks, covered liabilities to foreign creditors, old foreign currency savings deposits. Minimal interventions in foreign exchange market were made in October (EUR 5 million purchased), and non in November. An increase of EUR 264.8 million in foreign exchange reserves in December mainly came from required foreign exchange reserves allocation. However, in January 2013, in spite of EUR 100 million inflow from sale of securities, foreign exchange reserves declined by EUR 416 million due to higher outflows (withdrawal of excess foreign currency reserves of banks and settlement of due euro-denominated government securities)[5].

... but dropped in January 2013

2 EUR 1,176 million adding up the account *Errors and omissions*.
3 Government of the Republic of Serbia sold USD 1 billion worth of Eurobonds, and the inflow was recorded in October.
4 http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=6189&konverzija=no
5 http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=6277&konverzija=no,
http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=6235&konverzija=no,

Table T4-1. Serbia: Balance of payments

	2009	2010	2011	2011				2012			
				Q1	Q2	Q3	oct-nov	Q1	Q2	Q3	oct-nov
				mil. euros							
CURRENT ACCOUNT	-2,084	-2,082	-2,828	-717	-587	-621	-470	-1177	-738	-546	-286
Goods	-5,118	-4,774	-5,376	-1271	-1196	-1209	-995	-1551	-1293	-1186	-829
Export f.o.b[1)]	5,978	7,402	8,439	1955	2162	2171	1448	1852	2284	2244	1685
Import f.o.b[1)]	-11,096	-12,176	-13,814	-3226	-3358	-3380	-2442	-3403	-3577	-3430	-2513
Services	18	5	162	28	12	13	68	29	1	33	57
Export	2,500	2,667	3,032	631	720	816	544	667	747	839	532
Import	-2,482	-2,662	-2,870	-603	-708	-803	-476	-638	-747	-805	-475
Income, net	-502	-670	-758	-112	-252	-195	-75	-229	-211	-156	-122
Receipts	500	438	428	101	100	101	86	109	134	138	78
Payments	-1,002	-1,108	-1,186	-214	-352	-296	-161	-338	-345	-293	-200
Current transfers, net	3,518	3,356	3,143	638	849	771	531	574	765	762	607
o/w grants	197	193	206	49	41	39	49	26	38	43	26
o/w private remittances, net	2,618	2,383	2,165	450	596	546	325	359	523	483	428
CAPITAL ACCOUNT	2	1	-2	-1	0	-1	0	-3	-4	-1	-1
FINANCIAL ACCOUNT	2,207	1,986	2,610	601	531	579	482	1017	683	490	240
Direct investment, net	1,372	860	1,827	307	259	661	287	-372	234	117	158
Portfolio investment, net	-51	39	1,619	520	246	871	-19	76	58	-37	1450
Other investments	3,249	158	966	-58	58	125	170	397	-708	71	-479
Trade credits	654	83	509	90	89	52	148	117	197	27	-44
Loans	1,414	830	-413	-879	34	226	78	-20	-135	-160	-94
NBS	1,114	341	45	-4	52	-3	0	-4	0	-111	-105
Government	258	735	687	29	275	297	65	18	91	86	20
Commercial banks	894	626	-729	-691	-132	-10	23	-150	-358	-63	92
Long-term	492	619	419	3	10	99	194	-84	-117	-80	-48
Short-term	402	6	-1,148	-694	-142	-109	-171	-66	-241	18	139
Other (enterprises)	-853	-872	-416	-214	-160	-58	-10	115	132	-73	-101
Currency and deposits	760	-754	870	731	-65	-153	-56	300	-770	204	-341
Other assets and liabilities	0	0	0	0	0	0	0	0	0	0	0
Allocation of SDR	422	0	0	0	0	2	0	0	0	3	0
Reserves Assets (- increase)	-2,363	929	-1,801	-168	-33	-1078	44	916	1100	340	-890
ERRORS AND OMISSIONS, net	-124	96	220	118	56	43	-12	163	59	57	47
OVERALL BALANCE	2,363	-929	1,801	168	33	1078	-44	-916	-1100	-340	890
PRO MEMORIA											
				in % of GDP							
Current account	-7.2	-7.4	-9.1	-10.3	-7.2	-7.7	-8.8	-17.6	-10.2	-7.6	-5.5
Balance of goods	-17.7	-17.1	-17.2	-18.2	-14.7	-15.0	-18.6	-23.1	-17.9	-16.5	-15.9
Exports of goods	20.6	26.5	27.0	28.0	26.5	27.0	27.1	27.6	31.5	31.2	32.4
Imports of goods	-38.3	-43.6	-44.3	-46.3	-41.2	-42.0	-45.7	-50.8	-49.4	-47.8	-48.4
Balance of goods and services	-17.6	-17.1	-16.7	-17.8	-14.5	-14.9	-17.3	-22.7	-17.8	-16.0	-14.8
Current transfers, net	12.1	12.0	10.1	9.1	10.4	9.6	9.9	8.6	10.6	10.6	11.7
GDP in euros[2)]	28,966	27,956	31,203	6,976	8,155	8,051	5348	6,701	7,240	7,183	5198

Source: NBS

1) Exports and imports f.o.b, NBS methodology aligned to IMF BOPM-5.

2) Quarterly values. Annual GDP is converted using average annual exchange rate (the average of official daily middle exchange rates).

Exports

In Q4 exports totaled EUR 2,437 million

According to the data obtained from the Statistical Office of the Republic of Serbia exports totaled EUR 2,437 million in Q4, which is 12.6% y-o-y growth. Automobile industry export and time lag effects of dinar depreciation in the first half of 2012 sped up growth in exports at the end of the year.

In 2012 exports totaled EUR 8,835 million, which is 4.7% increase relative to 2011

Total exports in 2012 are valued at EUR 8,835 million, which is 4.7% increase relative to 2011. Dinar depreciation at the end of 2011 and in the larger part of 2012, automobile production recovery, and production of petroleum products exerted positive effects on exports, while slow economic recovery in EU and in the region in the first half of the year and recession in the second half of 2012, poor agricultural yields and decline in production and exports of metals produced negative impact on total exports.

Further rise in total exports through automobile industry exports is expected in 2013...

Continuation of automobile industry exports will produce beneficial effects on Serbia's exports in 2013, while time lag effects of real appreciation of dinar noted at the end of 2012 will unfavorably affect Serbia's competitiveness in foreign markets and consequently Serbia's total exports. However, in 2013 exports will in large measure depend on economic recovery in Eurozone countries and in the region, agricultural yields and world food prices (especially world prices

of cereals and cereal preparations). Additionally, production recovery in "Železara Smederevo" would expand export and speed up its growth.

The largest y-o-y increase in Q4 is seen in Capital goods: 87.8%

Among exports classified by its economic destination the largest y-o-y increase in Q4 was recorded in *Capital goods* 87.8%. Actually, increase in Serbia's exports is primarily due to export of FIAT automobiles. Rise in export of energy products (48.2% y-o-y) due to expanded capacities in Pancevo Oil Refinery which increased export of petroleum products, additionally sped up growth in Serbia's exports. We, therefore, expect that export of automobiles and petroleum products will even more expand Serbia's export in the succeeding quarters, considering expected high volume of production of these products and small volume of production in the last year.

Total exports exclusive of export of road vehicles noted a fairly modest y-o-y growth rate of 2.4%

If we take a look into growth rate of total exports exclusive of the export of road vehicles, we will realize the immense importance of production recovery and export of FIAT automobiles. Actually, Capital goods exclusive of road vehicles noted 18.4% y-o-y growth (relative to 87.8% y-o-y growth in Capital goods inclusive of road vehicles), while total exports exclusive of road vehicles recorded a fairly modest y-o-y increase of 2.4% relative to the growth in total exports recorded in Q4 of, as already mentioned, 12.6% y-o-y (Table T4-2). Generally speaking, we can conclude that export recovery in the second half of 2012 and expected growth speedup in the succeeding period can be in a large measure attributed to automobile industry.

Growth in exports is limited to a small number of products which indicates that the growth is not due to enhanced competitiveness of Serbian economy in general but to specific factors in some sections of economy. High degree of export concentration, only two or three sections of economy, is risky because it makes exports vulnerable to any external shock.

Export of Iron and steel products exert negative impact on total exports

On the other hand, export of *Iron and steel* products exert negative impact on total exports. In each quarter of 2012 export or these products decreased: - 63.0% in Q1, -44.3% in Q2, -62.2% in Q3 and -70.8% in Q4. Although the results are due to the withdrawal of US Steel from Serbia and stopped production in "Železara Smederevo" steel plant, and the restart of production would significantly contribute to the export recovery, we believe that the best solution to this problem is to find a strategic partner and provide sound basis for production, and that maintenance of production through government subsidies is acceptable only in the short run. Since the tender for a strategic partnership failed and government decided to give the mill subsidies to restart the production, an exit strategy is required. The strategy should involve various options: to find a strategic partner, change the structure of production, reduce production etc., but each of these options would have to mean abolition of government's subsidies within a reasonable term.

Y-o-y increase in export of *Durable consumer goods* and *Nondurable consumer goods* was 19.8% and 8.8% respectively. On the other hand, export of *Intermediate goods* dropped by 6.8% and export of *Other goods* fell by 16.3%.

Table T4-2. Serbia: exports, y-o-y growth, 2011–2012

	Exports share in 2012	2011[1)]	2012[1)]	2011			2012			2012		
				Q2	Q3	Q4	Q2	Q3	Q4	Q2	Q3	Q4
	in %			mil. euros						in %		
Total	100.0	8,441	8,835	2,157	2,157	2,163	2,282	2,254	2,437	5.8	4.5	12.6
Total excluding road vehicles	94.7	8,253	8,366	2,102	2,114	2,116	2,226	2,150	2,167	5.9	1.7	2.4
Energy	3.4	310	304	117	69	61	86	65	90	-26.7	-5.8	48.2
Intermediate products	40.7	3,980	3,598	1,071	1,013	910	995	922	848	-7.1	-8.9	-6.8
Capital products	16.5	1,001	1,458	245	250	308	308	354	579	25.5	41.3	87.8
Capital products excluding road vehicles	11.2	813	988	191	207	261	252	249	309	32.2	20.4	18.4
Durable consumer goods	4.5	347	398	90	90	93	101	107	111	12.3	19.7	19.8
Non-durable consumer goods	26.2	2,118	2,318	499	572	581	565	619	633	13.2	8.3	8.8
Other	8.6	686	760	135	164	210	228	187	176	69.3	14.1	-16.3

Source: SORS

1) The amounts in millions of euro, and y-o-y growth rates based on the data obtained from the Statistical Office of the Republic of Serbia calculated using the new methodology. For more detail see QM20, Box 1, Changes to foreign trade methodology used by the Statistical Office of the Republic of Serbia.

Imports

In Q4 imports totaled EUR 3,995 million

In Q4 imports totaled EUR 3,995 million which is 1.6% above the value recorded in the same period 2011. Depreciation of dinar in the first half of 2012 and recession in the second half of the year led to decline in domestic demand and import growth consequently slowed down.

In 2012 imports of goods totaled EUR 14,741 million

In 2012 imports of goods totaled EUR 14,741 million (3.4% y-o-y growth). In the first half of the year imports growth was much faster (5-6% y-o-y growth rate in Q1 and Q2) relative to succeeding quarters (1-2% in Q3 and Q4). This growth dynamics can be attributed to fiscal expansion which marked pre-election period in the first half of 2012, and to decrease in domestic demand in the second half of the year due to real depreciation of dinar and narrowed fiscal deficit in the period May-September. In 2012 y-o-y exports growth thus outperformed y-o-y imports growth, and, observed quarterly, export-import ratio continued to rise due to such growth dynamics.

Y-o-y drop in Energy imports due to increased domestic oil production

Q4 saw a more significant y-o-y drop in *Energy* imports (-20.5%). The decline in the amount of imported energy is much higher than the decline in its value because world prices of energy in Q4 were 5% higher than in the same period 2011[6]. This fall in energy imports is due to increased oil production in Serbia through application of more advanced oil extraction technology by Petroleum Industry of Serbia (NIS). Total imports exclusive of energy thus increased by 7.7% y-o-y in Q4 (Table T4-3).

Table T4-3. Serbia: imports, y-o-y growth rates, 2011–2012

	Imports share in 2012	2011[1)]	2012[1)]	2011			2012			2012		
				Q2	Q3	Q4	Q2	Q3	Q4	Q2	Q3	Q4
	in %			mil. euros						in %		
Total	100.0	14,250	14,741	3,476	3,499	3,934	3,682	3,540	3,995	5.9	1.2	1.6
Energy	17.5	2,846	2,574	626	599	855	546	533	679	-12.9	-10.9	-20.5
Intermediate products	34.7	5,030	5,116	1,354	1,311	1,235	1,364	1,304	1,274	0.7	-0.5	3.1
Capital products	18.7	2,812	2,753	671	687	790	684	651	810	2.0	-5.2	2.6
Durable consumer goods	2.2	320	328	75	80	97	86	81	81	15.0	1.6	-15.9
Non-durable consumer goods	15.4	2,176	2,269	519	579	602	537	581	633	3.5	0.3	5.2
Other	11.5	1,066	1,701	231	244	355	465	389	518	101.2	59.4	45.8
Imports excluding energy	82.5	11,404	12,167	2,850	2,901	3,079	3,137	3,006	3,316	10.1	3.6	7.7

Source: SORS

1) The amounts in millions of euro, and y-o-y growth rates based on the data obtained from the Statistical Office of the Republic of Serbia calculated using the new methodology. For more detail see QM20, Box 1, Changes to foreign trade methodology used by the Statistical Office of the Republic of Serbia.

Additionally, imports of *Durable consumer goods* dropped significantly. This drop indicates that consumers still do not expect their real incomes will grow in the future. On the other hand, imports of *Nondurable consumer goods*, *Intermediate goods* and *Capital goods* slightly outperformed the value recorded in Q4 2011. This structure of imports indicates relatively low domestic demand in the last quarter of 2012, but also low investments, considering quiet modest growth in intermediate and capital goods (probably mostly due to imports for automobile industry purposes).

Foreign debt

Foreign debt of Serbia at the end of December totaled EUR 25.7 billion or 88.9% of GDP...

...this greatly exceeds the bound of sustainability of up to 80%

At the end of December 2012 foreign debt of Serbia totaled EUR 25.7 billion[7], or 88.9% of GDP. In 2012 overall foreign debt increased by EUR 1.6 billion (12 percentage points of GDP). Due to this increase the share of foreign debt in GDP exceeded the bound of sustainability of up to 80% as early as in the first half 2012. After the bound was first exceeded in 2010 (Table T4-4) intensive debt repayment in the private sector (mainly repayments of short-term loans in the banking sector) kept foreign debt to GDP ratio below 80% throughout 2011 and at the beginning of 2012. It is important to point out that foreign debt to GDP ratio above 80% recorded again in 2012 is not the only problem, but also the fact that it is due to the public sector borrowing, which annihilated and significantly exceeded repayments in the private sector in 2011 and 2012.

6 Energy prices in USD recorded in Q4 2012 are 2.5% lower than in the same period 2011, but due to the fact that the euro considerably depreciated against the dollar in the same period, prices are expressed in euro and higher than the last year's.

7 Appreciation of the euro against other currencies resulted in decrease in foreign debt by EUR 130 million (see *Analysis of the Republic of Serbia's Debt*, NBS, February 2013, p. 3).

However, advantageously short-term borrowings in the banking sector decreased significantly relative to 2010, which indicates its reduced vulnerability and good liquidity.

Increase in foreign debt in 2012 is mainly due to rise in foreign debt of the public sector…

Increase in foreign debt in 2012 is mainly due to rise in foreign debt of the public sector – as much as 89% (EUR 1.4 billion). Growth in foreign debt of the private sector takes share of 11% and is exclusively due to increase in long-term borrowing in the enterprise sector in Q3, while in the banking sector both long-term and short-term loans were repaid.

...mainly in Q4

In Q4 overall foreign debt increased by EUR 889 million, or by 4 percentage points of GDP. This is exclusively due to rise in foreign public debt (in Q4 it increased by EUR 1, 244 million, or by 5 percentage point) which is the result of government's borrowing in international financial market – sale of eurobonds. At the same time foreign debt of the private sector decreased by EUR 355 million, whereof as much as EUR 485 million through repayments of long-term foreign loans, while short-term borrowing slightly increased. Foreigndebt of the private sector decreased due to debt conversion into equity (EUR 223 million), larger repayments of the principal of long-term loans (EUR 139 million) and currency and other changes (EUR 124 million)[8]. External debt of enterprises sector decreased by EUR 412 million through repayments of long-term loans, external debt of banking sector decreased by EUR 73 million through repayments of long-term loans, while short-term borrowing in the banking sector increased by EUR 136 million relative to Q3 (Table T4-4).

In the second half of 2012 increase in public debt and looming bankruptcy came into focus. However, increase in external debt is potentially as dangerous to Serbia, because in case of sharp slowdown in inflow of foreign capital Serbia would have to face it since it would be hard to service external debt from foreign exchange reserves in the long run. Because the share of public debt in external debt is rising, threats of external debt crisis and public debt crisis become highly correlated.

Table T4-4. Serbia: structure of foreign debt, 2009–2012

	2009	2010	2011				2012			
			Mar.	Jun	Sep.	Dec.	Mar.	Jun	Sep.	Dec.
	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	24,832	25,705
(in % of GDP) [2]	*77.6*	*85.1*	*79.7*	*77.0*	*78.5*	*77.3*	*77.8*	*80.2*	*85.2*	*88.9*
Public debt	7,764	9,076	8,861	9,138	10,433	10,773	10,655	11,032	10,944	12,239
(in % of GDP)[2]	*26.8*	*32.5*	*31.2*	*30.9*	*34.3*	*34.5*	*34.5*	*36.8*	*37.5*	*42.1*
Long term	7,762	9,076	8,861	9,138	10,433	10,773	10,655	11,032	10,944	12,239
o/w: to IMF	1,110	1,529	1,475	1,506	1,582	1,618	1,581	1,644	1,524	1,408
o/w: Government obligation under IMF SDR allocation	422	449	434	428	449	459	449	467	462	458
Short term	1	0	0	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	13,889	13,466
(in % of GDP) [2]	*51.0*	*52.6*	*48.6*	*46.0*	*44.2*	*42.8*	*43.4*	*43.5*	*47.7*	*46.8*
Long term	12,720	12,880	12,696	12,630	12,569	12,704	12,834	12,712	13,526	12,963
o/w: Banks debt	2,597	3,362	3,347	3,413	3,551	3,782	3,784	3,754	3,745	3,714
o/w: Enterprises debt	10,123	9,518	9,348	9,217	9,018	8,922	9,050	8,958	9,781	9,249
Short term	2,003	1,830	1,116	966	858	648	578	342	363	504
o/w: Banks debt	1,713	1,731	1,036	895	785	582	515	275	292	436
o/w: Enterprises debt	290	100	79	72	73	66	63	67	71	67
Foreign debt, net 1), (in% of GDP)[2]	41.0	49.3	44.8	43.2	41.1	38.7	42.0	46.4	51.5	51.2

Note: In September 2010 the methodology of foreign debt statistics was changed so that the public sector foreign debt now includes obligations under the IMF SDR allocation (€452.3mn), drawn in December 2009, and capitalized interest to Paris Club creditors (€37.5mn), and the private sector foreign debt excludes credits concluded before 20 December 2000 under which payments have not been effected (€872.9mn, of which €405.4mn relating to domestic banks and €467.5mn to domestic enterprises). Foreign debt data presented in the Table have been compiled by the new methodology. "

Source: NBS, *QM*

1) Total foreign debt less NBS currency reserves.

2) The sum of quarterly GDP in the quarter observed and GDP values from the previous three quarters.

8 *Analysis of the Republic of Serbia's Debt*, NBS, February 2013, p. 4

5. Prices and the Exchange rate

After a very high increase in prices from August to October, inflation was abruptly halted in November and December. Although inflation was stopped in November and December, and January realized a moderate price growth, year-on-year inflation is still very high. Year-on-year inflation in December amounted to 12.2%, and in January 12.7%, with the expectation that the growth of y-o-y inflation will continue during the first quarter of the year 2013. A significant difference between y-o-y inflation and inflation during the last three months raises the question of whether y-o-y inflation or the inflation in the last three months are relevant for the decision-making on monetary policy. Even though the overall inflation was slowed down towards the end of the year, underlying inflation (inflation excluding food, alcohol, tobacco and energy) remains relatively high at 8% when annualized. However, it is estimated that the growth in underlying inflation is the result of the one-off factors whose effect is exhausted (depreciation of the exchange rate in the first half of 2012, tax increase in October 2012), thus, its decline is expected in the following months. After a strong nominal appreciation in September and in the first half of October, the exchange rate was mostly stable over the rest of Q4, as well as in January and February of 2013. The real exchange rate of the dinar against euro, at the end of 2012, was approximately at the same level as in 2011, but it should be mentioned that the first half of the year recorded the real exchange rate depreciation of almost 10%, which was then "annulled" with real appreciation in the second part of the year.

Prices

After a record growth from August to October, inflation was sharply brought down.

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					
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					
mar	157.4	3.4	2.0	1.1	8.4
jun	162.4	5.4	5.3	1.2	13.2
jul	162.6	6.2	5.4	0.1	11.2
aug	165.3	8.0	7.1	1.7	12.5
sep	169.1	10.3	9.6	2.3	17.7
oct	173.8	12.9	12.7	2.8	30.5
nov	173.8	11.9	12.7	0.0	22.3
dec	173.1	12.2	12.2	-0.4	9.9
2013					
jan	174.1	12.7	0.6	0.6	0.7

Source: SORS

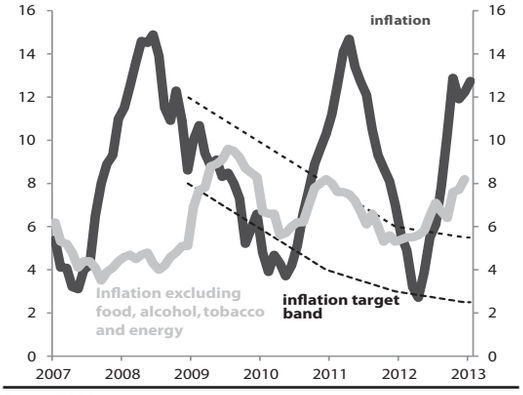
After a high inflation in the first half of the year, and especially after a record growth from August to October, November and December come across a strong decline in the overall inflation rate. Price increase in Q4 was 2.4% (i.e. 9.9% when annualized), a significantly less than 4.1% (i.e. as much as 17.7% when annualized) in the previous quarter (Table T5-1). However, Q4 is a heterogeneous period and includes relatively high inflation in October and deflation in the period from November to December. January of 2013 also recorded relatively low monthly inflation rate of 0.6%. Therefore, the inflation in the period November-December, which cumulatively amounts to a mere 0.2%, is more relevant for the evaluation of recent trends. Although inflation in the last three months varied considerably, it is quite certain that there was an abrupt slowdown in the inflation trend, which is evident in the data for January. While year-on-year inflation in January amounted to 12.7 %, annualized inflation in January was 7.4%.

Overall inflation in 2012 record high

Despite an abrupt slowdown at the end of the year, overall inflation in 2012 reached as much as 12.2%, which is a record annual inflation rate in the last five years since when the consumer price index has been followed. Inflation is high above the upper limit of the NBS target band, which amounted to 2.5%-5.5% at the end of the year 2012 (Chart T5-2). Over Q1 of the year 2013, ye-

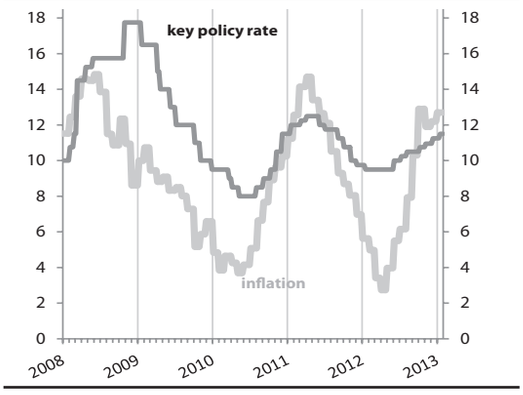
ar-on-year inflation rate will most likely continue to rise slightly, and as of Q2 we might expect a gradual decline in year-on-year inflation rate. Faced with a high inflation rate, NBS continued to raise its reference interest rate in January and February, which now stands at 11.75%. From May 2012 to February 2013, reference interest rate was totally increased by 225 base points (Chart T5-3). Divergent movements in y-o-y inflation and inflation in the last three months raise the question of which inflation indicator is relevant when making decisions on monetary policy? Dilemmas arising in connection with this topic are discussed in more detail in Highlight 1.

Chart T5-2. Serbia: y-o-y inflation rate and underlying inflation and the NBS target band, 2007-2012



Source: SORS

Chart T5-3. Serbia: NBS reference interest rate and y-o-y inflation rate, in %, 2008-2012



Source: SORS

The greatest contribution to inflation in 2012 were increases in the food prices

Increases in the food prices gave the greatest contribution to a record high inflation in the year 2012 (Table T5-4). About a half of a total price increase in the year 2012 is the result of the rise in the prices of food products. High growth in the food prices throughout past year can be partially explained by the reduced supply of agricultural products due to a strong drought. However, this explanation is not sufficient as the drought hit the entire region of Southeast Europe, but the prices of food in other countries have increased less than in Serbia. The reason of above average growth in the food prices in Serbia is probably a low integration of the agricultural market into the world market, as well as the weaknesses in the agricultural policy in Serbia. Low integration of the agricultural market in the world market exists both in imports, as well as exports, causing the prices of these products to strongly grow in bad years, and decrease in good years. As for the other products, a substantial contribution to inflation in 2012 was given by the increase in the prices of cigarettes, as well as the increase in the prices of utility services. It is important to note as well that about 30% of the inflation in 2012 is the consequence of underlying inflation (inflation excluding food, alcohol, tobacco and energy).

Table T5-4. Serbia: Consumer Price Index: Contribution to Growth by Selected Components

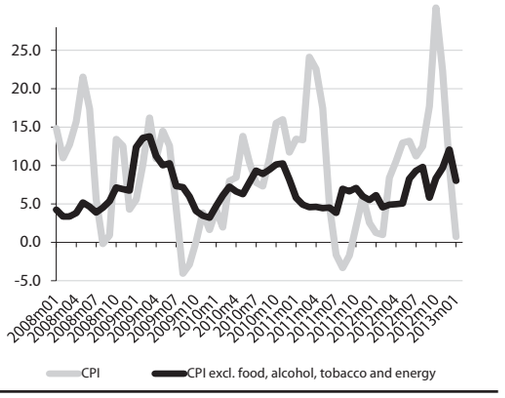
	Share in CPI (in %)	Price increase in Q4	Contribution to overall CPI increase (in p. p.)	Price increase in Q3	Contribution to overall CPI increase (in p. p.)	Price increase in 2012 -total	Contribution to overall CPI increase (in p. p.)
Total	100.0	2.4	2.4	4.1	4.1	12.2	12.2
Food and non–alcoholic beverages	38.8	0.9	0.3	6.0	2.3	15.3	6.2
Food	35.0	0.2	0.1	6.3	2.2	15.5	5.7
Alcoholic beverages and tobacco	5.4	11.6	0.6	11.6	0.6	31.7	1.8
Tobacco	4.0	14.3	0.6	15.6	0.6	39.7	1.6
Clothing and footwear	5.1	3.7	0.2	0.1	0.0	4.1	0.2
Housing, water, electricity, gas and other fu	16.5	3.2	0.5	1.3	0.2	6.9	1.2
Electricity	7.2	1.7	0.1	0.0	0.0	1.7	0.1
Furniture, household equipment, routine m	4.4	4.0	0.2	2.1	0.1	12.7	0.6
Health	4.3	2.0	0.1	1.8	0.1	5.7	0.3
Transport	10.5	-1.2	-0.1	4.6	0.5	11.5	1.3
Oil products	4.8	-4.0	-0.2	9.1	0.4	15.3	0.8
Communications	4.1	4.5	0.2	0.4	0.0	4.5	0.2
Other items	11.0		0.4		0.3		0.6

Source: SORS and *QM* estimates

In Q4, more than half of price growth is the result of underlying inflation...

In Q4 of the year 2012, especially in November and December, the situation is calming down, and then, the food price decreases, which contributed to a sudden halt of inflation by the end of the year. More than a half of the inflation in Q4 is the result of the growth in underlying inflation. Underlying inflation in Q4 amounted to as much as 2.9%, or 12.1% when annualized. Such a high underlying inflation is partly a consequence of the increase in the VAT rate in October (Chart T5-5). However, even when October is excluded, and a three-month period from November to January is observed, underlying inflation stands at 8% when annualized, which is notably above the medium-term trend of about 5%. Relatively high underlying inflation is, among other, the consequence of a strong fiscal expansion in the first half of the year and dinar depreciation in the period from early 2012 to August. Given that the dinar exchange rate has been stable for several months, it is estimated that the effect of exchange rate depreciation on inflation is exhausted. Fiscal expansion in the last quarter of the year 2012 probably had an impact on inflation growth in January, and can be expected to have a certain downward effect on inflation in February and March. In general, if the Government consistently implements the adopted fiscal consolidation program, fiscal policy should not be a generator of inflation in the period March-December 2013.

Chart T5-5. Serbia: CPI and Underlying Inflation Trend, Annualized Rates, in %, 2008-2012



Source: SORS and *QM* estimates

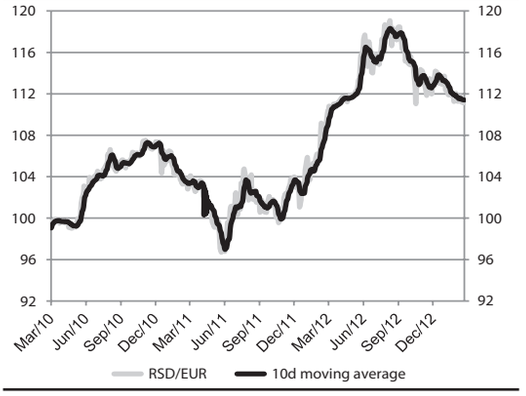
...but the impact of the underlying inflation triggers is getting exhausted

The exchange rate

In Q4 and in early 2013, the nominal exchange rate against the euro is stable

After a strong appreciation of the dinar against the euro in September and in the first half of October, the dinar exchange rate during the rest of Q4, as well as in January and February was stable. When the nominal exchange rate against the euro declined by 12% from early 2012 to late August, it then strengthened by about 6% over the next month and a half. This strengthening of the dinar is the result of several factors, including: NBS's decision to increase the dinar share in the allocation of foreign currency required reserves in August; the increase of NBS reference interest rate from 9.50% in May 2012, to 11.75% in January 2013; the drop of risk premium for Serbia in the last few months (the index EMBI Global for Serbia amounted to 570bps at the end of August, only to fall to a mere 360bps until January, although it subsequently increased again to about 420bps); the inflow of foreign capital through the carry trade. From mid-October until the end of February, the nominal exchange rate of the dinar against the euro was mostly stable, with a slight appreciation (Chart T5-6).

Chart T5-6. Serbia: Daily RSD/EUR Exchange Rate, 2010-2012

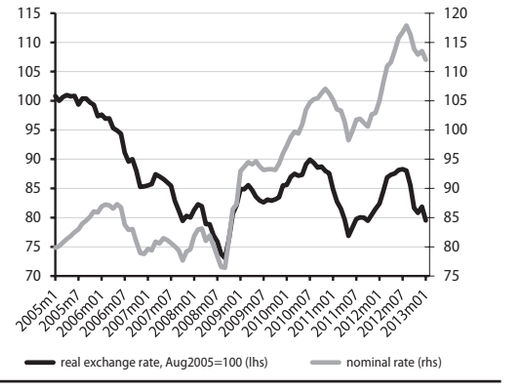


Source: NBS

The real exchange rate against the euro sharply appreciated in Q4 and annulled the real depreciation from first three quarters

The real exchange rate of the dinar against euro sharply appreciated in October and November. The real appreciation resulted from a nominal appreciation and inflation rate in Serbia that is significantly higher than in euro zone. Throughout these two months, the real depreciation from first three months was completely "annulled", thus, at the end of 2012 and in early 2013 the real exchange rate returned to the level where it was in the late 2011. Looking at a longer horizon, the real exchange rate is now at approximately the same level as it was at the end of 2007 and in early 2008, i.e. before the start of the first wave of the global economic crisis. (Chart T5-7)

Chart T5-7: Serbia: Nominal and Real RSD/ EUR Exchange Rate, Monthly Averages, 2005-2012



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

Although the strong appreciation throughout the last few months contributed to a sudden disinflation, it is considered that any continuation of the nominal appreciation in the coming months, viewed in a broader economic context, would be very unfavorable. Further dinar appreciation would worsen already low price competitiveness of products from Serbia, which would be highly unfavorable in the situation where the current account deficit is still very high, while the external debt significantly crossed the limit of 80%. Therefore, in the coming months NBS should lead a policy that would prevent the strengthening of the real value of the dinar, thus, a moderate real depreciation would be welcome from the standpoint of competitiveness and would not have too great an impact on inflation and capital gains and losses. The risks of overvalued dinar in the conditions of a possible reduction in foreign capital income are discussed in more details in Highlight 1.

Generally, the nominal and real exchange rate of the dinar against the euro in 2012, similarly as in the previous years, varied significantly. Although a number of countries in Central and Eastern Europe conduct a flexible exchange rate policy, the dinar in recent years had the highest volatility. Such a movement in the exchange rate reflects inconsistencies in the conduct of macroeconomic policy, high sensitivity of the economy to the external shocks, but also generates additional instability for the economy and citizens. In highly Euroized economy such as Serbian, the exchange rate variations have a much greater impact on the economy and citizens than it is common elsewhere. Exchange rate volatility strongly influences: inflation, the costs of debt service, competitiveness of the economy, but also financial position of the citizens, companies and the state. The impact of the exchange rate on the financial position of the entities in Serbia is the consequence of the fact that loans and part of assets are valued in euro, because of which the exchange rate volatility create high losses/gains.

Proposal of the President of the Democratic Party for the introduction of a fixed dinar exchange rate deserves careful consideration, rather than careless rejection or unconditional acceptance. In a small, open highly Euroized economy such as Serbian, there are strong arguments both in favor of a flexible exchange rate policy and in favor of a fixed exchange rate. In general, both exchange rate policies can generate good results, if well prepared and coherent with other macroeconomic policies, especially monetary, fiscal and wage policy. There are a number of countries that have in the past achieved or are now achieving good economic results (rapid growth, low unemployment, and low inflation) by applying policy of flexible (Poland, Slovakia), or a fixed exchange rate (Austria, Bulgaria, the Baltic countries). There are numerous examples of the countries that have realized poor results (stagnation, high unemployment, and high inflation) by applying policy of flexible (Russia and Bulgaria in the 90's) or a fixed exchange rate (Argentina, African countries, Southern European members of the eurozone). The debate on the optimal exchange rate regime should be especially substantiated in the case of Serbia, where the costs of a flexible exchange rate are high (high interest rates, high and volatile inflation, high capital losses / gains due to change of exchange rate), but the risks of achieving sub-optimal results are also high (price stability, with high unemployment and slow growth). Moreover, in the case that the introduction of a fixed exchange rate is not well prepared or the policies not supporting a fixed exchange rate are led after that, collapse of such a policy is possible (Markovic and Avramović's program, Argentina, etc.).

6. Fiscal Trends and Policy

In the last quarter of 2012, expansionary fiscal policy was led, so a consolidated fiscal deficit of 69 bn dinar (around 7.8% of quarterly GDP) was realised, which is much higher than in the same quarter of previous years. High fiscal deficit realised in Q4 is primarily the result of a considerable increase in spending on subsidies and a mild increase in capital spending, while other categories of public spending and public revenues recorded a mild decline. In the entire 2012, a fiscal deficit of 217 bn dinars (6.6% of GDP) was realised, which is by 0.5% of GDP more compared to the estimated amount in the Fiscal Strategy adopted in November. This deviation of the realised fiscal deficit compared to the estimated one is the result of a slowdown in revenues in November and December, and withdrawal of funds for project loans at the end of the year, and it indicates a need to improve planning and control procedures for executing public revenues and public spending. January fiscal trends indicate a slowdown in public spending, but also continued negative trends in public revenues, so Republic budget deficit of 7 bn dinars was higher than usual for January. Due to risks involved in realising public revenues and expressed variability of certain expense categories, it is necessary to create and publish planned monthly and quarterly trend dynamics of public revenues, public spending and fiscal deficit. This would enable, in case negative trends continue, spotting the need for action already during the year and proposing corrective measures that would ensure that the fiscal deficit in 2013 does not exceed 4% of GDP. Public debt at the end of 2012 was 17.7 bn dinar (61.3% of GDP). The growth of indirect public debt, based on issued state guarantees for loans of public enterprises still continues, threatening to additionally increase the level of country's indebtedness, which is estimated to be economically unjustified. Assuming projected goals for macroeconomic and fiscal trends for 2013 are realised and there are no considerable changes in the real dinar exchange rate, it is estimated that Serbia's public debt at the end of the year would be around 62-63% of GDP.

General Tendencies and Macroeconomic Implications

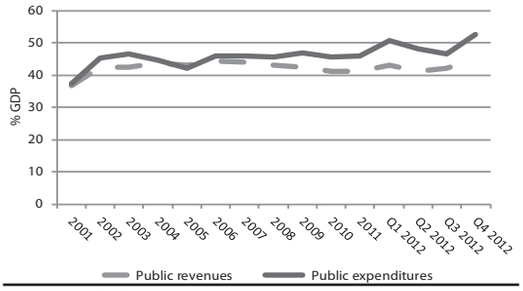
Expansionary fiscal policy was again led in Q4 – consolidated fiscal deficit for that quarter was 69 bn dinar (around 7.8% of quarterly GDP)

Expansionary fiscal policy was led in Q4 2012, in a similar way as in the first two quarters of last year. Consolidated fiscal deficit in Q4 2012 was 69 bn dinar or around 7.8% of quarterly GDP, which is considerably higher compared to the deficits realised in previous quarters, as well as compared to the deficits realised in the last quarter of previous years. So the fiscal deficit realised in Q4 2012 was by 37% higher in real terms compared to the deficit realised in the same period in 2011, and by 9% higher in real terms compared to the deficit realised in Q4 2010. High fiscal deficit in Q4 is the result of the simultaneous growth of public spending and drop in public revenues, where the impact of increased spending was bigger. In addition to seasonal factors, the considerable growth in public spending in Q4 was influenced primarily by the strong growth in spending on subsidies and a moderate growth in capital spending. At the same time, a drop was recorded in public revenues in all categories of tax (fiscal) revenues, where growth was recorded only in non-tax revenues.

...and total fiscal deficit in 2012 was 217 bn dinar (around 6.6% of GDP)

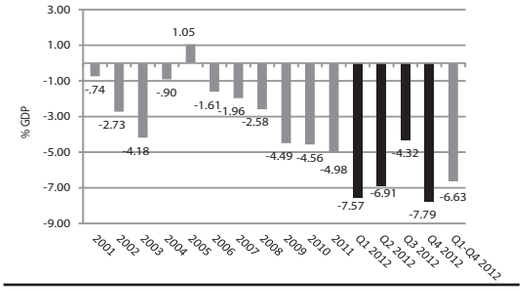
As a result of primarily considerable real growth of public spending (by 4.3% compared to 2011) and to considerably slower real growth of public revenues (by 0.6%), consolidated fiscal deficit in 2012 was 217.4 bn dinar (6.6% of GDP), which is close to the amount planned during the rebalancing of the budget in September 2012. However, according to the Fiscal strategy for 2013 with projections for 2014 and 2015, which was adopted in November, it was estimated that the 2012 fiscal deficit would be lower and amount to around 200.4 bn dinar (6.1% of GDP). The deviation of the realised fiscal deficit from the projected amount in the Fiscal Strategy (by 0.5% of GDP) is the result of a slowdown in excise duties revenues (from cigarettes) and accompanying VAT, as well as non-tax revenues and spending of funds on project loans (from the funds secured by the loan from Azerbaijan) in December. The largest deviation was recorded at the Republic budget level. Having in mind that the Fiscal Strategy was adopted in November, this considerable deviation of the realised consolidated fiscal deficit from the one projected by the Fiscal Strategy indicates a need for improving the process of planning and managing public revenues and public spending.

Graph T6-1 Serbia: Consolidated public revenue and public spending (% GDP)



Source: *QM* calculations

Graph T6-2 Serbia: Consolidated fiscal balance



Source: *QM* calculations

High deficit in Q4 is the result of the slowdown in public revenue, as well as the growth in public spending

After a long time, Q4 2012 recorded a simultaneous growth of public spending and reduction in public revenue, observed in comparison to the previous quarter. The decline in real public revenue recorded in Q4 is widespread and is the result of several factors that were in effect, most important being: continuation of the recession, reduction in foreign trade deficit (absorption gap), mild nominal and moderate real appreciation of dinar against euro. The decline in revenue would be even bigger if there hadn't been an increase in certain taxes since the beginning of October. Even though revenues are dropping in Q4 compared to the previous quarter, they are still mildly growing in relative terms (as % of GDP), which indicates that the effect of fiscal consolidation on the level of public revenue, after excluding effects of recession, is positive. On the other hand, after the slowdown in Q2 and Q3, public spending in Q4 is again considerably growing as a result of a great increase in public spending on subsidies and a moderate increase in capital spending (while all other expense categories recorded a decline).

There has not been any significant recovery in public finances in January either

In January 2013, Republic budget deficit was 7 bn dinar, which is less than average monthly deficit in previous months (which was around 12 bn dinar a month), but at the same time significantly more than the Republic budget deficit realised in January of previous years (which was on average 1 bn dinar). In conditions where there is a slower growth of public revenue (especially excise duties) and higher risk on the expenditure side (e.g. subsidies for Steel Works in Smederevo), it is estimated that there is a risk of planned fiscal deficit for 2013 exceeding 4% of GDP. More precise estimates will be given after reviewing the trends of the following months. Therefore, monitoring of realised goals in respect of trends in public revenue and public spending on quarterly basis (or even better, monthly basis) is necessary for timely taking of fiscal policy measures in order to keep the total fiscal deficit in 2013 within sustainable limits (up to 4% of GDP).

Effects of fiscal consolidation still cannot be estimated reliably

Measures of fiscal consolidation adopted in September 2012 are directed towards reduction of fiscal deficit through equal increase of public revenues and reduction of public spending. Measures on the revenue side (e.g. increase of consumption tax) have been effectively implemented since October 2012, while the measures on the public spending side have started being implemented in January 2013, so it is still too early to give precise estimates of the effects of adopted measures of fiscal consolidation (see more details in Highlight 1).

Success of fiscal consolidation programme depends on the implementation of adopted measures and on the adoption of credible measure for further significant reduction of deficit in 2014

Consistent implementation of adopted fiscal consolidation measures, regular control of the realisation of fiscal effects during 2013, and especially timely defining of the next steps that will secure necessary significant reduction in fiscal deficit in 2014 (by additional 1.7% of GDP, i.e. around 500 million euros) are considered key assumptions for the success of the fiscal consolidation programme and for securing long-term sustainability of public finances in Serbia. Only fiscal consolidation, that will enable further significant reduction in fiscal deficit, which would lead first to the stabilisation of public debt and then to its relative reduction, can create assumptions for sustainable dynamic economic growth. The new studies (for the group of 16 developed countries, over a period of 22 years) show that limited fiscal consolidation of small proportions has negative effects on cost of borrowing for private companies (and consequently on their growth), while strong and sufficiently big fiscal consolidation that enables sustainability of the country's

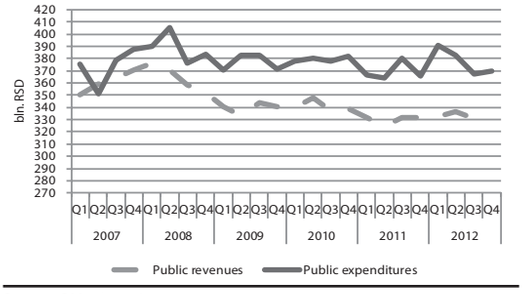
public finances, leads already in the mid-term to a reduction in cost of borrowing for private companies (Agca and Igan (2013)).[1]

These results are explained by the fact that consistency in implementation of adequate fiscal consolidation measures is an indicator of state's credibility, which leads to a reduction in country risk. In line with the foregoing, it is estimated that in order to achieve positive effects of fiscal consolidation on the stabilisation of public finances and future economic growth, it is necessary to realise established general fiscal goals for 2013 and to adopt credible measure for achieving these goals (primarily the amount of fiscal deficit) in 2014. Considering that the first round of fiscal consolidation measures already had tax increases, by which half of the fiscal deficit reduction was achieved, it is not possible to count on measures on the side of public revenues in the context of further reduction of deficit in 2014. Consequently, it is necessary to present already in the first half of 2012 a precise plan for savings on the side of public expenditures, and for measures that would lead to those savings, sufficient for the realisation of fiscal goals in 2014.

Analysis of the Dynamics and Structure of Public Revenues and Public Spending

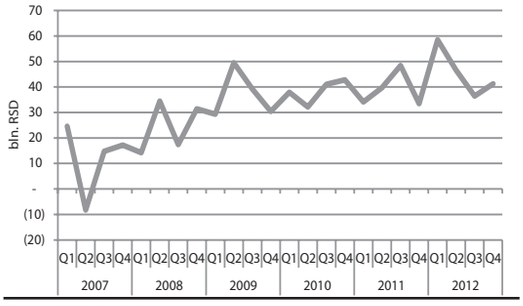
In Q4, a mild decline in real, seasonally adjusted public revenues continued, which were lower by 0.6% in this quarter compared to Q3. Decline in revenue in Q4 was still smaller than the decline in GDP, which led to a mild increase in the relative amount of public revenues (as % of GDP), which means that the effect of negative trends in terms of economic activity was stronger than the effect of increase in taxes. At the same time, public revenues realised in Q4 2012 were lower in real terms by 3.2% compared to the same period last year.[2] Observed at the level of entire 2012, public revenues had a mild increase in real terms (by 0.6%) compared to 2011. Decline in revenue from factors of production is bigger than the decline in revenue from consumption – so the revenues from consumption taxes compared to GDP are growing, while the revenue from taxes on factors of production are falling.

Graph T 6-3 Serbia: Seasonally adjusted, consolidated real public revenue and public spending in bn RSD (in 2012 prices)



Source: *QM* calculations

Graph T 6-4 Serbia: Real, seasonally adjusted fiscal deficit in bn RSD (in 2012 prices)



Source: *QM* calculations

VAT revenue is stagnating, while excise duties revenues are dropping significantly

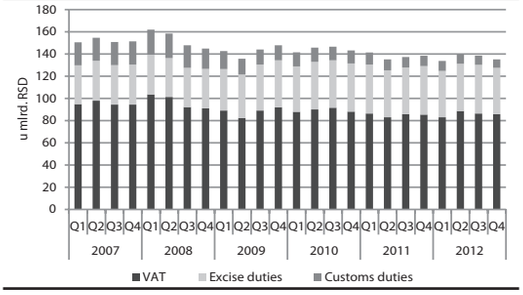
Total real, seasonally adjusted revenues from taxes on consumption realised in Q4 2012 have dropped compared to the previous quarter, where the drop in VAT revenue was mild, drop in excise duties revenue moderate, while the drop in customs revenue was considerable. A decline in revenue from consumption taxes is the result of a slowdown in economic activity, reduction of absorption gap, and moderate appreciation of dinar exchange rate in real terms.

Real, seasonally adjusted revenue from VAT recorded a mild decline in Q4 (0.7%) compared to Q3. Decline in real, seasonally adjusted VAT revenue in Q4 2012, despite the general VAT rate being increased as of October 1, was the result of several factors, most important being: *i)* incre-

1 See: Agca, S. and D. Igan, (2013) „Fiscal Consolidation and the Cost of Credit: Evidence from Syndicated Loans". *IMF Working Paper 13/36.*
2 Data on year-on-year real growth of consolidated public spending, according to an economic classification, is shown in Appendix 1, while the date on absolute amounts of nominal public revenue and public spending is shown in Appendix 2.

ase in the trade of goods and services in September, before the increase of VAT rate (advanced purchase of goods, etc.), which led to a decline in turnover in October and November (i.e. in VAT revenue in November and December), *ii)* reduction of the absorption gap, i.e. slowdown in imports and increase in exports, *iii)* nominal and real appreciation of dinar exchange rate, *iv)* increase of VAT refund for farmers and raising the threshold for entering VAT system. In addition, general slowdown in domestic demand also has a negative effect on the trends in VAT revenue. In the period January-December 2012, VAT revenue stagnated compared to 2011, which is the result of divergent action of several factors. The growth of VAT revenue in 2012 was affected by an increase in foreign trade deficit and the depreciation of dinar in the first half of the year, as well as the increase of VAT rate as of October, while its deceleration was affected by a reduction in the absorption gap and appreciation of dinar in the second half of the year, as well as other, already mentioned, parametric changes in the VAT system.

Graph T 6-5 Serbia: Trend in real, consolidated, seasonally adjusted revenue from consumption taxes (in 2012 prices)



Source: *QM* calculations

In January 2013, a strong increase in VAT revenue was recorded. Thus, the VAT revenue was higher by 9.2% in real terms compared to January 2012, while real, seasonally adjusted VAT revenue in January 2013 was higher by 6.2% compared to the previous month.[3] Increase in VAT revenue in January 2013 was primarily due to an increase in general VAT rate.[4]

Real, seasonally adjusted excise revenue in Q4 recorded a significant fall of 4.7% compared to Q3. Decline in excise revenue in Q4 could also be the result of increased turnover of excise products in September, before the increased excise rate was implemented at the beginning of Q4, which is confirmed by the trend in real, seasonally adjusted excise duties revenue in October (excise duties for second part of September was paid on October 2nd), which was 1.3% higher than in September. Also, the decline in excise duties revenue in Q4 was affected by the reduction in domestic consumption of excise products, and the increased share of export of excise products in their total production, but probably by other factors as well.

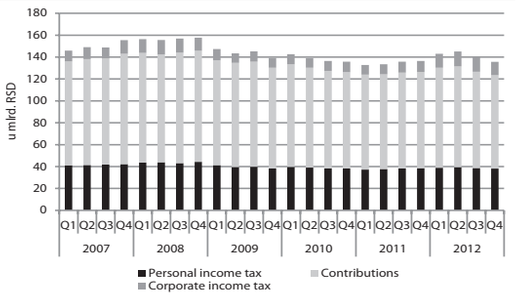
At the level of all four quarters of 2012, excise duties revenues have, despite several increases of excise duties, recorded a real drop of 7% compared to the previous year, which is mostly contributed to the decline in revenues from excise duties on cigarettes. A similar trend continued in January 2013 as well, when state budget revenue from excise duties was lower by 17.7% in real terms, compared to the same month of the previous year.

Considering that the expected growth of GDP in 2013, if realised, will be based primarily on the growth of exports (Fiat, NIS, etc.), with no significant recovery of domestic demand expected and assuming there are no significant changes in real terms in the exchange rate of dinar during the year, it is estimated that the growth of revenue from consumption taxes in 2013 will be moderate, mainly due to the increase of general VAT rate. Increased state activity in fighting shadow economy could contribute to the growth of this type of revenue, but it is estimated that fiscal effects of these measures in 2013 could be relatively limited.

Due to reduced imports and appreciation of dinar, the real seasonally adjusted revenue from customs duties continue to decline, so in Q4 they were by 9.1% lower than in the previous quarter. At the level of entire 2012, customs duties revenues have dropped by 14% in real terms, primarily due to reduced imports, further lowering of customs rate on goods imported from EU,

3 Indicator of the growth of real VAT revenue in January 2013 compared to the previous month is estimated as more relative, since the VAT revenue in January 2012 was by 4 bn dinar lower due to delay in tax refund in the previous month.
4 This is also how an increase in VAT revenue is explained compared to December 2012, because VAT on December turnover is paid in January and, as already stated, there was a significant increase in turnoever prior to the increase in VAT rate in September, which had a negative effect on turnovers in October and November, as well as on the VAT revenues in November and Decembre.

Graph T 6-6 Serbia: Trends of real consolidated, seasonally adjusted revenues from taxes on factors of production (in 2012 prices)



Source: *QM* calculations

Revenue from taxes on factors of production is significantly falling

and appreciation of dinar exchange rate. Since no considerable increase of domestic demand is expected, assuming there is no significant depreciation of dinar and in conditions of further liberalisation of foreign trade (further decrease of customs rates on goods imported from EU at the beginning of 2013, in accordance with the provisions of the Stabilisation and Association Agreement), further decline of this type of revenues can be expected in the current year as well.

Real seasonally adjusted revenues from personal income tax and social security contributions have significantly dropped in Q4 (by 1.4% and 3% respectively) compared to the previous quarter. Decline in revenue from personal income tax and social security contributions is one of many indicators that casts a shadow of doubt on the supposed considerable increase of employment / decrease of unemployment in the period April-October 2012. Decline in real revenue from income tax and contributions in Q4 could be the result of real devaluation of citizens' incomes due to rising inflation, which was partly caused by limiting growth of wages in the public sector, which account for almost half of the total wage bill in Serbia. At the level of entire 2012, revenue from income tax and contributions recorded a real growth (by 2.1% and 1.9% respectively) compared to 2011. Increased revenue from tax on personal income and contributions in 2012 is primarily the result of increased payment of salaries in the public sector in the first half of 2012, which was basically a (pre)election period, during which a strong rise in spending on salaries of public sector employees was recorded. Given that in April 2013 public sector salaries will be again indexed by the amount that will probably be lower than the rate of inflation in the previous six-month period and that no significant increase in formal employment in private or public sector is expected, as well as in citizens' income, it is estimated that in 2013 no significant growth in this kind of revenue can be expected.

In Q4, there was a considerable drop in real, seasonally adjusted revenue from corporate income tax (8.6%) compared to Q3. Decline in revenue from corporate income tax could be a result of general insolvency of companies, which leads to these taxpayers being late with their advance payments for corporate income tax. At the level of entire 2012, revenue from corporate income tax has considerably increased in real terms (by 35.1%) compared to 2011. Increased revenue from corporate income tax in 2012 is primarily the result of paid tax on capital gain from the sale of shares in Maxi retail chain to the Belgian Delhaize, as well as of paid tax on relatively high profit expressed in 2011 financial statements of large public and private companies (e.g. EPS, NIS, etc.). Trends in this type of revenue in 2013 will be negatively affected by the slowdown in economic activity in 2012 (which serves as a basis for payment of this tax in 2013), while it will be positively affected by the appreciation of dinar exchange rate (which leads to generated revenue of companies from positive exchange rate differences), as well as by the increased corporate income tax rate from 10% to 15% (advance payments in 2013 will be paid at the 15% tax rate). On the other hand, factors that led to corporate income tax revenue growth in 2012 were either one-off (large capital gain) or temporary (large profits of EPS), so they cannot be counted on again in 2013. Therefore, it is estimated that there will be a mild increase in this type of revenue in 2013.

Other tax revenues are declining due to abolishing of quasi-fiscal charges

In Q4, further decline in real, seasonally adjusted, other tax revenue continued (by 12.1%) compared to the previous quarter, primarily due to the reform of the system of quasi-fiscal charges, which either abolished or integrated with other duties. In the period January-December 2012, other tax revenues recorded a significant decline in real terms (by 8.8%) compared to the previous year, due to the effect of the stated factors in the second half of the year. Without a simultaneous increase in other non-tax charges or general taxes, abolishing and integrating a large

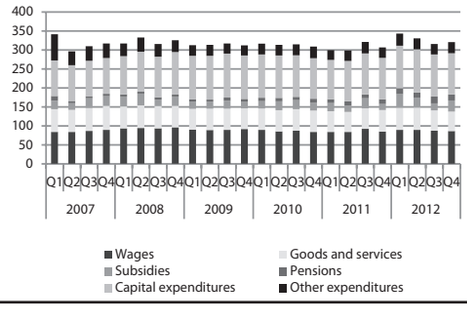
number of quasi-fiscal charges will contribute to the real decline in this type of revenue in 2013 and to the increase of structural fiscal deficit.

…and non-tax and capital revenues are growing

At the same time, real seasonally adjusted non-tax revenues in Q4 recorded a considerable increase (of 9.8%) compared to the previous quarter, while at the annual level, a moderate real decline in non-tax revenue (by 6.2%) was recorded compared to 2011.

Capital revenues have recorded a significant increase during 2012, so the total capital revenue was over three times higher compared to the previous year. The growth of capital revenues is the result of large public companies (EPS, Telecom Serbia, Belgrade Airport, etc.) showing profits in 2011 financial reports, and payments of dividends by some of these companies. In 2013, we can expect a slowdown in this type of revenue, due to lower inflow from dividends paid out by public companies, since they will be lower than in previous years for some companies (e.g. Telecom Serbia), while some public companies in 2012 had negative results, unlike in 2011 when they expressed a profit in their financial statements (e.g. EPS). Increase in NIS profitability and the decision on distribution of part of the profit as dividend will lead to an increased state revenue on this basis, but the growth will be limited. According to preliminary data, the net profit of NIS in 2012 was around 50 bn dinar, and 15% of retained earnings will be distributed as dividend. Since the state owns around 30% of stock (29.87%), the state revenue from received dividend in 2012 will amount to around 2.2 bn dinar.

Graph T 6-7 Serbia: Trends in consolidated, seasonally adjusted public expenditures (in 2012 prices)



Source: *QM* calculations

Real, seasonally adjusted spending of the consolidated state sector slightly increased in Q4 2012 (by 0.8%) compared to the previous quarter, due to a sharp increase in spending on subsidies. Simultaneously, all other categories of public spending recorded a real decline.

Strong growth of spending on subsidies recorded in Q4

Subsidy spending (real, seasonally adjusted) significantly increased in Q4 (by 58.5%) compared to Q3. This increase in subsidy spending is the result of payment of subsidies for agriculture, for mitigating the effects of draught in the amount of 9.5 bn dinar, and payment of subsidies for the Fiat project. In addition, due to budget liquidity problems in Q3, the realisation of certain subsidies was postponed and realised in Q4, which additionally affected the increase in spending for these purposes in the last quarter of 2012. Spending on subsidies (together with interest cost) had the biggest increase in real terms in 2012 (29.1%) compared to the previous year, and it was a significant generator of fiscal deficit growth. Considerable part of additional spending on subsidies introduced in the second half of the year, was one-off in character, which is confirmed by the data from January 2013, which shows that there was a significant drop in state budget spending for these purposes in that month. Still, it is estimated that a certain part of subsidies (around half of subsidies intended for agriculture) will turn into permanent subsidies, which will permanently increase this type of spending. Considering that the spending on subsidies in Serbia is already relatively high compared to other countries, increased subsidies for agriculture are sustainable and justified only if some other forms of subsidies are reduced, which are economically less justifiable (subsidies for investments and employment, for restructuring companies, etc.).

...and a mild increase is recorded in capital expenditures

After its significant fall in previous two quarters, the capital spending (real, seasonally adjusted) has mildly increased in Q4 (by 5.8%) compared to the previous quarter. The growth of capital spending is the result of withdrawal of funds for financing projects from project loans, somewhat lower basis for comparison (due to a decrease in this type of spending in previous quarters), and continuation in the implementation of bigger infrastructure projects (south end of Corridor 10, the loop for the Bridge on Ada, Zemun - Borča bridge, etc.) after adjustment period for new government bodies, and possibly settling of arrears by the state towards construction compa-

nies for work delivered, since after two time emission of Eurobonds the liquidity of the state improved, allowing it to settle previous payables. In entire 2012, the capital spending recorded a mild increase in real terms (6%) compared to the previous year, which is estimated as positive, but still insufficient, since capital spending in 2012 was only 3.9% of GDP, which is by 0.4% of GDP more than in 2011, but still significantly less than the required level for a considerable improvement of the general state of public infrastructure in Serbia. Start of the implementation of infrastructure projects, such as Morava Highway, Belgrade - Čačak Highway, as well as the start of works on the improvement of the of railway infrastructure, could lead to an increase in capital spending in the second part of 2013. However, in order to have a positive effect of increased capital spending on economic growth and social development, it is necessary to make an adequate choice of financing priorities. In that sense, ideas of using the Russian Federation loan for the improvement of railway infrastructure exclusively on the Corridor 10 railroad (and replacing the project of the construction of Loznica - Valjevo railroad with the project of revitalising the Inđija - Novi Sad railroad) are estimated as economically justifiable. In the conditions of overall bad state of railway infrastructure on the busiest routs (such as Corridor 10), construction of a completely new railway infrastructure on the sections where expected traffic is by several times lower, would be economically unjustified. Even though once finalised, the indirect effects of implementing the mentioned projects in the domain of road and rail infrastructure on the conditions of doing business and assumed economic growth will be definitely positive, their direct effects on economic activity and employment (during their realisation) will be limited, since expected participation of Serbian companies and materials is usually below 50%. In that respect, when arranging conditions of this type of loan arrangement, it is necessary to take into account not only the basic elements of the arrangement (interest rate, grace period, payment terms), but also other conditions that include level of engagement of domestic companies and material in its implementation.

Spending on employees and pensions is declining due to slower indexation

As an important part of fiscal consolidation measures, salaries of public sector employees and pensions have increased by 2% in October 2012, which is significantly less than total inflation realised in the period April – September (approx. 9.8%), which led to their decrease in real terms. So the real, seasonally adjusted spending on employees was lower by 0.8% in Q4, while spending on pensions was lower by 2% compared to Q3. Observing entire 2012, the spending on employees has recorded a real growth (2%) compared to 2011, primarily due to a significant increase in spending on employees at the local level, which was the result of increased inflow of funds into local governments' budgets from wage tax and April salary indexation in the public sector.

Spending on pensions (real, seasonally adjusted) in Q4 was lower by 2% compared to Q3, primarily due to the limited growth of pensions, i.e. their indexation in October by 2% instead of by six-month inflation rate. Observing entire 2012, spending on pensions increased in real terms by 4.4% compared to previous year, due to an increase in the number of pensioners, indexation of pensions in April and October, and payment of aid to pensioners whose income is below 15,000 dinar in the amount of 4,000 dinar per pensioner, which was made in September and December 2012.

Considering that in April 2013, salaries in the public sector will be indexed at a fixed rate of 2%, and in October at an inflation rate of previous six months, provided the announced slowdown of inflation during 2013 and a mild real growth of economic activity are realised, it could lead to a mild real and relative decline in this type of spending, which is regarded economically desirable. However, in order to have a considerable decrease in these spending categories to the long-term sustainable level, in addition to limiting the growth of salaries in the public sector and pensions, it is necessary to start the process of determining the optimal number and structure of public sector employees, and implementing measures directed towards achieving the optimal number and structure of employees. It is also necessary to continue the reform of the pensions system, through introducing actuarial penalties, stricter conditions of retirement, and harmonising the retirement conditions for men and women.

After a rise in the first half of the year, the spending on goods and services in Q3 and Q4 dropped, the decline in Q4 being slightly lower than in Q3. Real, seasonally adjusted spending

Spending on goods and services is declining as well

on goods and services decreased by 4.1% in Q4 compared to the previous quarter. After a strong rise in the first part of the year, there was a real drop in this type of spending at the local level in Q4, but this decline was still significantly lower than the decrease recorded at the central state level. If the increased spending for these purposes at the local level in the first half of the year occurred primarily due to settlement of arrears from previous procurements, then the slowdown of these expenditures in Q4 can be partially explained by settlement of these obligations in the previous quarters and estimated as justified. However, high growth rates of local spending on goods and services in most of the quarters indicate a general increase in this type of spending at the local level, which would, in condition of high consolidated deficit be economically unjustifiable. Besides, the reduction of inflows into local budgets from different quasi-fiscal charges in Q4 forced the local self-governments to adjust their spending. Consolidated spending on goods and services for entire 2012 was lower in real terms by 11.4% compared to the previous year. After the announced adoption of the new Law on Public Procurement, as well as the announced centralisation of procurement in the healthcare system in 2013, certain savings can be expected from the procurement of goods and services. Still, having in mind that a large part of procurement of goods and services refers to the procurement of utility and similar services, where possibility of savings through improved system of procurement is limited (since there is one supplier and a fixed price), it is estimated that savings from improvement of the system of public procurement of goods and services on the whole will not exceed 0.5% of GDP in the mid-term, where possible effects in 2013 would be significantly lower, since the implementation of the new rules will at best start in the mid-year.

Interest expenditures in Q4 dropped, but strongly increased at the level of entire 2012

Interest cost (real, seasonally adjusted) in Q4 recorded a significant fall (13.9%) compared to the previous quarter, as a result of maturity of interest payments on public debt, appreciation of dinar, and high base for comparison (since interest expenditures in Q3 significantly increased). Still, at the level of entire 2012, interest cost increased in real terms by 23.4% due to the increased level of country's indebtedness, relatively unfavourable conditions of new borrowings, and depreciation of dinar at the beginning of the year. In the conditions of relatively high fiscal deficit in 2013 of around 3.6-4% of GDP, and further increase of the public debt, it can be expected that interest costs keep increasing in the current year. Interest cost trends will be affected by dinar exchange rate trends as well, so in case of its depreciation, interest costs would rise and vice versa, since the biggest part of Serbia's public debt is denominated in foreign currency. In addition, interest cost trends will be affected by conditions on global financial markets, as well as the consistency in the implementation of adopted fiscal consolidation measures. Achieving the planned fiscal deficit of 3.6% of GDP for 2012 and adopting credible measures for its reduction to the level below 2% of GDP in 2014, would lead to stopping the growth of country's public debt, which would have a positive effect on the interest cost trend, whose growth in 2014 could be slowed down, after which there could even be a reduction in the interest expenditures.

Fiscal Trends Analysis by Government Levels

Trend of significant real growth of revenue for local governments stopped, but imbalance still persists

Q4 saw a mild Republic budget revenue growth in real terms, while revenues of other government levels, primarily Republic Health Insurance Fund (RFZO) and local self-government, saw a moderate decline (by 3.6% and 6.4% respectively). After a strong rise in four consecutive quarters, revenues of local governments recorded a real fall in Q4, because 40% of wage tax revenue was transferred from the Republic budget to the local level in October 2011, so in Q4 2012, for the first time the basis for comparison (same quarter previous year) included this revenue as well. Despite the real year-on-year decline in revenue of local self-government in Q4, caused primarily by the increased basis for comparison, imbalance in allocation of public revenue and spending, caused by the transfer of additional 40% revenue from wage tax to the local level, still remains and is one of the important factors of high consolidated fiscal deficit in 2012. So it can be observed that in 2012, local government revenues increased by 12.8% in real terms, while Republic budget revenues slightly decreased, and consolidated public revenues recorded a slight growth in real terms.

Moderate growth of Republic budget revenue in Q4 was the result of the increase of revenue from personal and corporate income taxes, and capital revenues. The decline in RFZO revenue was primarily caused by a reduction in revenue from social contributions for health insurance. On the other hand, decline in revenue of local self-governments is the result of decreased revenue from wage tax, property tax, and other tax and non-tax revenues. Decline in revenue from property tax is the result of reduced efforts of local communities aimed at establishment and full collection of property tax, which is motivated by increased inflow in local self-government budgets from wage tax in the previous quarters. The decline in other tax and non-tax revenues is the result of the implemented reform of the system of quasi-fiscal charges at the end of Q3 2012, which limited or cancelled certain local taxes (e.g. company signboard fees were cancelled for small companies). The decline in revenue of local self-governments from wage tax, in conditions when same revenue at the Republic level is growing, could be attributed to the significant growth of other revenues from income tax at the state level (e.g. tax on capital income, etc.) or to the delay in transferring part of wage tax revenue to the local government level.

Table T6-8 Serbia: Real, year-on-year growth rate of public revenues and public spending by government levels

	Q4 2012/Q4 2011			Q1-Q4 2012/Q1-Q4 2011		
	Consolidated budget	Budget of the Republic	Local self-governments	Consolidated budget	Budget of the Republic	Local self-governments
A Total public revenues (I)+(II)	**-3.0**	**0.7**	**-6.4**	**0.6**	**-1.3**	**12.8**
I Current revenues (1)+(2)	-4.3	-1.3	-11.6	0.1	-2.0	14.2
1. Tax revenues	-2.0	-1.2	-9.2	1.0	-1.0	25.0
1.1. Customs	-14.6	-17.5	-	-14.0	-14.0	0.0
1.2. Personal income tax	-2.3	6.5	-4.5	2.1	-38.4	40.1
1.3. Corporate income tax	20.9	13.0	-	35.1	33.0	0.0
1.4. VAT	-2.7	-3.6	-	0.0	0.0	0.0
1.5. Excise duties	4.7	3.3	-	-1.2	10.5	0.0
1.6. Property taxes	12.7	-	-12.0	0.0	0.0	-3.1
1.9.Other taxes	-13.2	4.3	-41.4	-8.8	-14.7	-13.9
1.10. Social security contributions	-3.4	-	-	1.9	0.0	0.0
2. Non-tax revenues	-21.9	-1.7	-17.6	-6.2	-9.2	-10.6
II Capital revenues	166.9	369.7	419.5	304.5	283.1	617.8
III Transfers from the other levels of government	0.0	-	26.6	0.0	0.0	4.5
IV Donations	0.0	1.2	16.2	8.2	14.7	-17.1
B Total public expenditures (I)+(II)+(III)	**-5.3**	**6.7**	**-11.9**	**3.6**	**5.0**	**4.6**
I Current expenditures	-3.9	3.5	-2.5	4.1	5.3	9.8
1.1 Wages	-9.2	-1.0	4.4	2.0	3.4	7.9
1.2. Goods and services	-5.9	-28.7	-6.7	1.5	-1.0	11.3
1.3 Interest payments	86.5	25.6	35.2	41.9	46.0	39.6
1.4 Subsidies	-38.5	123.1	6.3	29.1	29.7	19.5
1.5 Social insurance and social assistance	-3.8	-23.7	-12.4	-0.1	-21.9	5.5
1.6 Transfers to the other levels of government	0.0	2.4	-	0.0	7.3	0.0
1.7 Other current expenditures	-4.3	20.3	-8.3	9.9	14.3	-5.1
II Capital expenditures	-17.1	25.5	-36.8	6.0	14.4	-14.1
III Strategic reservs	-56.7	-25.4	-86.6	-37.9	-42.2	-48.8
IV Net lending	0.0	2,445.3	104.4	0.0	552.9	77.8

Source: QM calculations

In Q4 spending on local level is slightly declining, while slightly rising on the central level

In Q4, a real increase in public spending at the Republic level was recorded, primarily due to strong growth of spending on subsidies and moderate growth of spending on interest payments and transfers to other government levels. At the same time, a mild increase in RFZO spending was recorded, primarily in spending on salaries, which is a result of payment dynamic of salaries in the healthcare sector, since these expenditures had a significant decrease in Q3 compared to the same period in 2011. Spending at the local government level had a slight decline in Q4, for the first time after four quarters. In response to the decrease in the inflow of funds, local communities reduced primarily spending on goods and service in Q4, as well as for the social protection and capital spending, while spending on employees and subsidies continued to grow. Similar trends were observed at the level of entire 2012, when in addition to interest expenditure, spending on goods and services, and spending on employees increased the most at the local level. At the same time, local capital spending recorded a significant decline in real terms, while capital

spending at the state level increased. This kind of trend in spending at the local government level indicates a policy of inefficient management of local public finances, since local public funds are being spent unproductively (on salaries of employees, subsidies), especially if we consider that they have been increased significantly in the last year. At the same time, in conditions of reduced inflow of funds, savings are made through reduction in spending on socially vulnerable people, which is estimated as socially unjustified, as well as through reduction in spending on local public investments, which is economically inefficient.

Analysis of Public Debt Trends

Serbia's public debt at the end of 2012 stood at 17.7 billion euro (61.3% of GDP)

According to the official data from the Ministry of Finance and Economy, the total public debt of Serbia at the end of 2012 was 17.7 billion euro (around 61.3% of GDP[5]), which is by around 1.8 billion euro more than at the end of Q3. January 2013 data show that at the end of that month, the public debt dropped by 126 million euro, which combined with the appreciation of dinar against euro by 2% in this month, led to a relative decrease of public debt, to 59.8% of GDP.

Considerable increase of the public debt in Q4 is the result of advance borrowing of the state in order to finance the fiscal deficit in the first half of 2013, since the fiscal deficit in Q4 was around 610 million euro and significantly lower than the public debt increase in the same period. In Q4, the state realised inflow from issuance of Eurobonds issued in two terms (in September and in November 2012) in the total amount of 1.5 billion dollars (around 1.1 bn euro). Atthe same time issuance of treasury bonds continued at the local market, and so did the issuiance of guarantees for the loans of public enterprises.

Even though in Q4, the nominal public debt significantly increased, its relative amount (as % of GDP) increased slowly due to the appreciation of dinar against euro, which was around 1.1% in this quarter. In addition, since there was no significant fall of GDP in real terms in Q4, the GDP trend had no significant influence on the relative amount of the public debt in this period.

Table T6-9 Serbia: Public debt[1] 2000-2012.

	Amount at the end of period, in billions EUR											
	2000	2005	2006	2007	2008	2009	2010	2011	Q1 2012	Q2 2012	Q3 2012	Q4 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	13.40	15.07
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	5.33	5.55	6.10	6.5
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	7.14	7.39	7.30	8.6
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.15	2.34	2.45	2.60
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**	**15.85**	**17.67**
Public debt / GDP[2]	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.6%**	**31.3%**	**41.5%**	**45.07%**			**55.4%**	
Public debt / GDP (QM)[3]	**169.3%**	**52.1%**	**37.8%**	**30.9%**	**29.2%**	**34.8%**	**44.6%**	**46.9%**	**50.9%**	**54.9%**	**56.7%**	**61.4%**

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

Foreign borrowing is dominating again

Growth of Serbia's public debt in Q4 2012 is primarily the result of direct borrowing of the state for financing current and future fiscal deficit and for the settlement of obligations that will mature in the coming period. Unlike in previous periods when borrowing in the country and abroad was equal, and in some periods borrowing on local markets even dominated, in Q4 the borrowing was mostly done abroad, through emission of Eurobonds. State borrowing abroad represents a way of financing current account deficit, which is especially important in times when that deficit is high and inflow of capital from abroad (foreign direct investments and private sector loans) is slow. In addition, government borrowing abroad leaves a bigger opportunity for the private sector to borrow on domestic financial market. However, since borrowing abroad is usually done in foreign currency (euro or US dollar), financing fiscal deficit in this manner leads to a deterioration of currency structure of the country's public debt, and increases the exposure

5 QM estimate, based on comparing the nominal public debt and the sum of GDP in Q4 and previous three quarters.

of public debt sustainability to the exchange rate risk. This is particularly relevant in the case of Serbia, since dinar exchange rate against euro is fluctuating and there is a possibility of dinar depreciation, in case of significant disturbance on the global markets or in the case of increase of deficit of the current account (primarily due to expansionary fiscal policy), which would not be accompanied by a higher capital inflow from abroad from investments and borrowing.

...and the growth trend of state guarantees for public sector borrowing is continuing

In Q4 the trend of considerable growth of indirect government obligations for issuing guarantees for the loans of public enterprises continued. Issued state guarantees in Q4 amounted to around 150 million euro, and in entire 2012 around 490 million euro, which is even higher than in 2011 and 2010, when the growth of indirect government obligations was 400 and 320 million euro respectively. The increase of indirect government debt in Q4 refers mainly to the guarantees issued to Srbijagas for the loan for financing gas import, which means that all taxpayers are financing the consumption of gas by those who use this type of energy. The policy of securing solvency of public enterprises that are essentially insolvent through approving guarantees on loans of these companies continued, since the Parliament of Serbia at the end of December approved guarantees for the loans of Srbijagas, Galenika and JAT Airways in the amount of additional 225 million euro, which will lead to an increase in indirect debt at the beginning of 2013, when these fund are withdrawn. As previous issues of Quarterly Monitor stressed several times, the policy of securing solvency for insolvent public enterprises through issuing state guarantees on commercial loans, in conditions where there are no systematic measures to remove the cause of insolvency, is estimated as economically unjustifiable and risky for the sustainability of public finances. In addition to the lack of control regarding the efficiency and effectiveness of the use of funds that were collected through loans for public enterprises with state guarantees, another shortcoming of this approach lies in the fact that conditions of borrowing for these companies are often unfavourable. So, for example, Srbijagas loan in November was taken from commercial banks with interest rates between 5.98% and 7.25% plus three-month EUROBOR. Therefore, we recommend an urgent creation and implementation of programme of measures directed towards securing solvency of these companies (improving work productivity, increasing efficiency of spending the funds, transferring to the pricing model that covers all costs of production, intensifying activities on privatisation of certain companies, etc.). In that case, state aid can only be justified in the transition phase, for purposes of restructuring these companies, but not for the purposes of continually financing their current operations.

Fall of interest rate on Serbian Government bonds is primarily due to increased solvency on global markets

Considering that conditions on the global financial market are currently better than at the end of 2010 and first part of 2011, and that significant part of old public debt of Serbia also carries relatively high interest rate (e.g. debt towards the London Club), it is estimated that it would be justifiable to consider a possibility of refinancing these debts through possibly more favourable new borrowing and early repayment of the existing, more expensive loans. In this sense, it is necessary to take into account not only the value of the interest rate, but other direct and indirect costs, such as early payment penalties, assessment of the currency risk (especially for US dollar, which is expected to strengthen against euro in the long-term, if structural imbalances are not removed in EU), etc. Before deciding on this type of transaction, it is also necessary to previously examine expected conditions of the new borrowing. In that sense, emission of Eurobonds in the amount of 1.5 bn USD, with maturity of 7 years and interest rate of 5.15% made in February 2013, is estimated as relatively inexpensive. The fall of interest rate on issued Eurobonds was predominantly influenced by improved solvency on global financial markets, due to expansionary measure of monetary policy applied by European Central Bank, US Fed and Central Bank of Japan. In addition, what also affected the fall of interest rates was the implementation of fiscal consolidation measures, but it is estimated that this influence is limited for now and that it will become more significant in case consistent implementation of adopted measure of fiscal consolidation is continued, 2013 fiscal goals are realised and credible measures that would lead to significant further decrease of fiscal deficit in 2014 are adopted.

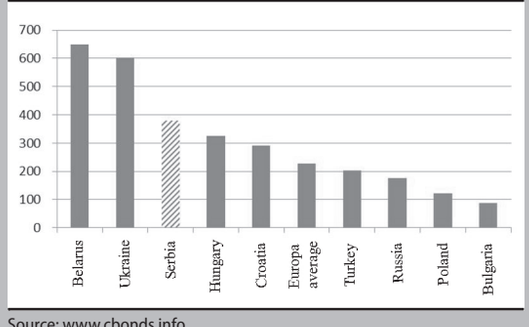
Strategic shift regarding the source of financing of fiscal deficit, from financing through borrowing on local market to financing through emission of Eurobonds on international financial market as of mid 2013, indicates a change in priorities regarding wider economic effects of the deficit

Box 1: Trends in risks of investing in government bonds of Serbia and other countries of Central and Eastern Europe

Fiscal position, primarily level and dynamics of the fiscal deficit and public debt, affects country's borrowing conditions, since the interest rate represents the essential price of risk of borrowing. Therefore, there is a large number of synthetic indicators of investment risk in state securities of certain countries, out of which the one most commonly used in Europe is the *Emerging Markets Bond Index* (EMBI), which indicates the rate of return/range (and implicitly risks as well) on government bonds denominated in US dollars, where the lower value of this index indicates a lower rate of return, i.e. lower country risk.

EMBI for Serbia in the last eight months has significantly dropped (from over 600 base points in May 2012 to around 380 base points in February 2013), primarily due to implementation of the first round of fiscal consolidation measures in September 2012 (consumption taxes increase, limited growth of salaries in the public sector and pensions, inclusion of own revenue into state budget, etc.). After reaching a 12-month minimum at the beginning of January 2013, EMBI for Serbia recorded a slight increase at the end of January and beginning of February 2013 (around 25 base points), which could be the result of publishing data on the consolidated fiscal deficit in 2012 that was higher than planned, political instability, as well as general trends on global financial market.

Graph T6-10 Serbia and selected countries of Central and Eastern Europe: Emerging Markets Bond Index (February 2013)



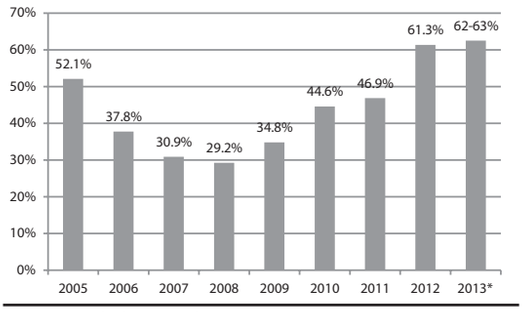
Source: www.cbonds.info

Even though it recorded a decrease in previous months, EMBI for Serbia is still high compared to other countries of Central and Eastern Europe – higher risk/return have the government bonds of Belorussia and Ukraine only, while the risk level of government bonds of other countries in the region is significantly lower (even in countries of similar economic performance, but where fiscal position is more sustainable, such as Bulgaria).

financing policy. Thus, financing of deficit through borrowing on local financial market in dinar was in service of re-dinarisation of economy, whereas now, through borrowing on international markets the focus is on reducing cost of borrowing (interest). In circumstances when the level of euroisation of economy is quite high (over 70%) and level of trust in domestic currency is low, it is estimated that persisting on the process of re-dinarisation would carry relatively high costs with a high degree of uncertainty regarding its effects. Therefore, focusing on reduction of the cost of interest, which in 2012 reached 2.1% of GDP, is considered justified. However, it should be stressed that state borrowing abroad leads to further growth of the country's (public and private) foreign debt, which in Q4 amounted to around 89% of GDP and significantly exceeded the upper limit of high indebtedness, which could have a negative effect on country's external solvency in the coming period.

If the projected macroeconomic trends are realised, it is estimated that the public debt at the end of 2013 would be around 62-63% of GDP

Graph T6-11 Serbia's public debt trends over periods (% of GDP)



Source: QM calculations and projections

Assuming the fiscal deficit in Serbia in 2013 does not exceed 4% of GDP, that other macroeconomic variables are moving in line with official projections (real GDP growth of 2%, inflation rate of 5%) and that there are no significant changes in the real exchange rate of dinar against euro, with expected further increase of indirect obligations of the state for issued guarantees at a dynamic similar to that of previous quarters, it is estimated that country's public debt at the end of 2013 could be around 62-63%

of GDP. In case the growth rate of GDP is lower than planned and/or if there is a significant depreciation of dinar against euro, the relative amount of public debt (as % of GDP) would be higher than the stated amount, while in the opposite case (faster GDP growth, appreciation of dinar) it would be slightly lower.

Appendices

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

	2008	2009	2010	2011	2012					
					Q1	Q2	Q3	Q4	Q1-Q4	Q4/Q3
I PUBLIC REVENUES	**3.3**	**-8.7**	**-1.5**	**-4.6**	**1.7**	**4.8**	**-0.8**	**-3.2**	**0.6**	**7.0**
1. Current revenues	3.5	-9.1	-1.5	-4.4	1.7	4.5	-0.9	-4.4	0.1	5.3
Tax revenue	3.7	-8.8	-2.5	-4.1	1.9	5.3	1.9	-4.4	1.0	1.6
Personal income taxes	6.3	-10.8	-3.9	-2.9	4.6	4.6	1.3	-1.6	2.1	7.6
Corporate income taxes	18.5	-27.0	-3.6	3.9	51.5	39.9	25.4	15.0	35.1	-1.1
VAT and retail sales tax	2.5	-10.2	-0.7	-4.0	-4.0	6.9	0.9	-3.7	0.0	4.5
Excises	0.7	11.6	4.2	0.6	-5.7	-3.0	8.5	-7.0	-1.2	-11.4
Custom duties	1.8	-32.4	-14.9	-21.5	-18.6	-8.6	-11.4	-17.6	-14.0	1.3
Social contributions	4.3	-7.0	-6.5	-3.9	4.8	6.1	0.7	-3.4	1.9	5.0
Other taxes	-2.3	-4.9	14.5	-15.2	-9.7	7.6	-12.0	-19.2	-8.8	-8.1
Non-tax revenue	2.6	-11.3	5.8	-6.1	0.1	-1.1	-19.0	-4.3	-6.2	35.5
2. Capital revenues	-76.8	-41.4	-66.8	468.2	124.1	259.1	176.7	373.3	304.5	636.5
II TOTAL EXPENDITURE	**4.5**	**-4.8**	**-1.7**	**3.3**	**10.3**	**9.2**	**-2.9**	**1.5**	**4.3**	**13.6**
1. Current expenditures	6.9	-3.3	-2.2	3.1	8.2	9.3	-1.7	1.4	4.1	10.1
Wages and salaries	10.9	-6.0	-5.9	0.4	6.6	6.3	-5.7	1.4	2.0	8.4
Expenditure on goods and services		-5.7	-0.3	4.3	9.4	15.0	-2.3	-11.4	1.5	20.2
Interest payment	-2.8	-5.7	-0.3	17.4	48.1	6.6	93.4	23.4	41.9	-33.7
Subsidies	-13.3	19.0	40.6	7.4	42.6	56.4	-36.2	82.9	29.1	115.8
Social transfers	10.1	-26.0	13.9	5.8	3.8	2.9	-0.3	-6.1	-0.1	1.0
o/w: pensions5)	*9.5*	2.2	-3.9	3.9	*8.4*	*7.4*	*3.1*	*-0.5*	*4.4*	*-0.6*
Other current expenditures	14.9	6.7	-6.1	23.9	-17.1	36.8	12.2	11.8	9.9	17.7
2. Capital expenditures	-4.3	-6.7	-11.8	5.3	48.7	8.3	-14.9	2.3	6.0	54.8
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**12.3**	**-2.4**	**35.2**	**-25.6**	**-18.3**	**-45.2**	**-54.7**	**-26.3**	**-37.9**	**59.3**
IV TOTAL EXPENDITURE, GFS (II+III)	**4.6**	**-4.8**	**-1.1**	**-3.8**	**9.8**	**7.7**	**-3.5**	**1.2**	**3.6**	**13.8**

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

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

	2008	2009	2010	2011	2012				
					Q1	Q2	Q3	Q4	Q1-Q4
I PUBLIC REVENUES	**1,145.9**	**1,146.5**	**1,223.4**	**1,302.5**	**312.6**	**339.7**	**355.1**	**398.0**	**1,405.4**
1. Current revenues	1,143.1	1,139.2	1,215.7	1,297.9	311.7	337.7	354.0	390.4	1,393.8
Tax revenue	1,000.4	1,000.3	1,056.5	1,131.0	276.3	298.1	315.6	335.9	1,225.9
Personal income taxes	136.5	133.5	139.1	150.8	35.8	41.2	41.4	46.7	165.3
Corporate income taxes	39.0	31.2	32.6	37.8	22.9	10.9	10.3	10.7	54.8
VAT and retail sales tax	301.7	296.9	319.4	342.4	79.7	90.1	94.4	103.3	367.5
Excises	110.1	134.8	152.2	170.9	34.6	40.6	54.9	51.0	181.1
Custom duties	64.8	48.0	44.3	38.8	7.7	9.0	9.3	9.8	35.8
Social contributions	312.7	318.8	323.0	346.6	85.9	94.6	94.5	103.9	378.9
Other taxes	35.6	37.1	46.0	43.5	9.7	11.7	10.8	10.4	42.6
Non-tax revenue	142.7	138.8	159.2	166.9	35.4	39.6	38.4	54.5	167.9
2. Capital revenues	1.4	0.9	0.3	2.0	0.6	1.3	0.8	6.0	8.7
II TOTAL EXPENDITURE	**-1,195.7**	**-1,248**	**-1,329.9**	**-1,435.9**	**-362.8**	**-391.1**	**-389.2**	**-463.1**	**-1,606.2**
1. Current expenditures	-1,089.6	-1,155	-1,224.8	-1,324.8	-337.5	-368.6	-359.3	-414.6	-1,479.9
Wages and salaries	-293.2	-302.0	-308.1	-342.5	-85.5	-94.4	-91.2	-103.6	-374.7
Expenditure on goods and services	-181.2	-187.4	-202.5	-216.3	-51.2	-62.9	-53.8	-67.7	-235.7
Interest payment	-17.2	-187.4	-34.2	-44.8	-15.4	-13.4	-23.3	-16.2	-68.2
Subsidies	-77.8	-22.4	-77.9	-80.5	-22.6	-25.2	-19.6	-44.2	-111.5
Social transfers	-496.8	-63.1	-579.2	-609.0	-154.9	-161.1	-163.5	-173.0	-652.5
o/w: pensions 5)	*-331.0*	-556.4	*-394.0*	*-422.8*	*-112.5*	*-117.8*	*-119.2*	-124.1	-473.7
Other current expenditures	-23.5	-387.3	-22.9	-31.7	-7.9	-11.7	-8.0	-9.8	-37.4
2. Capital expenditures	-106.0	-24.0	-105.1	-111.1	-25.3	-22.5	-30.0	-48.6	-126.3
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**-19.1**	**-20**	**-29.9**	**-24.9**	**-4.7**	**-5.7**	**-2.3**	**-3.9**	**-16.6**
IV TOTAL EXPENDITURE, GFS (II+III)	**-1,214.8**	**-1,268.3**	**-1,359.8**	**-1,460.8**	**-367.5**	**-396.7**	**-391.6**	**-467.0**	**-1,622.8**

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

7. Monetary trends and policy

Central Bank: balance and monetary policy

Although inflation was lowered suddenly from November 2012, the NBS continued raising its key policy rate. Along with the raising of the key policy rate, in Q4 the NBS turned the direction of REPO operations towards the sterilization of the money mass which was created through the spending of government deposits. The return to the reverse repo was justified at a moment when government spending increased along with the liquidity of the banking sector which did not transfer to new credit placement. The stabilizing of the Dinar exchange rate in the final quarter of 2012 had a positive effect on the growth of NBS net own reserve since there was no need to intervene on the interbank foreign exchange market. In Q4, the economy repaid foreign debts as it had in the previous quarter while the inflow of new credits from domestic sources was lowered compared to the previous quarter. The overall net inflow of new credits for the enterprises and the households was negative in Q4 due to the launch of receivership over the Nova Agrobank and the exclusion of its placements from the banking sector balance. Despite that, the population's confidence in the domestic banking sector remained in place and it increased the level of its deposits in Q4 to 257 million Euro. The overall banking sector increased its sources for new placements in Q4 to 856 million Euro but that surplus in liquidity was primarily placed in REPO which means that credit activity did not support the recovery of the economy despite the launching of the program of subsidized credits. The situation in the NPLs sector essentially did not change but the slight rise in NPLs continued and stood at 16.56% at the end of Q4.

NBS stepping up restrictive monetary policy although inflation drops suddenly

The y.o.y. inflation continued rising in Q4 which caused a stepping up of restrictive monetary policy. The rise in y.o.y. inflation which was caused by a rise in food prices, higher VAT and duties and a growth of regulated prices caused an increase in the key policy rate three times in Q4 by a total of 0.75 percentage points. The key policy rate was raised again in January and February by an added 0.5 percentage points with the aim of acting to prevent the indirect effects of the announced increase in administratively controlled prices at the start of 2013. The key policy rate currently stands at 11.75%. A look at inflation viewed at monthly level shows that the rise in prices was stopped in November with deflation standing at –0.4% in December and a moderate growth of 0.6% recorded in January. The question is whether the stepping up of restrictive monetary policy was justified in conditions of a sudden drop in inflation, strengthening of the real value of the Dinar and economic recession (see more details in Highlights 1).

Increased liquidity in banking sector caused NBS to return to reverse REPO operations

Along with the increase in the key policy rate, the NBS changed the direction of open market operation in December and was again in the position to sterilize the surplus liquidity of the banking sector instead of creating it. In that way, the NBS sterilized some 350 million Euro in the banking sector (Table T7-1) on the basis of REPO transactions. The reason for the re-introduction of reverse repo operations was the need to neutralize the autonomous creation of money which was launched by the government because of increased spending of deposits to cover the budget deficit. The set of implemented monetary policy measures includes changes and amendments to the Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items. Under the new decision, the NBS no longer sets the regulations to determine credit ratings and the level of indebtedness of private individuals with that responsibility transferred to business banks which now independently do those things based on their own criteria on how much clients can be in debt. This is the final form of relaxation in which the limits for new debts are abolished if the banks decided that the clients can service their obligations on time. At first glance, this measure could increase credit activities in the population segment but it is more likely that the measure will not stimulate fresh debts in any great way. Namely, in the previous period the depreciation of the Dinar caused clients who took loans indexed in Euro and received salaries in Dinars to be classified as bad debtors forcing the banks to increase their allocations for

mandatory reserves. Because of the removal of the official debt limit, we expect the number of those clients to drop and a greater expansion of credit placements could happen only if economic activity is increased in the coming period.

Tabela T7-1. Serbia: NBS interventions and foreign currency reserves 2010-2012

	2010				2011				2012			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
Repo stock (in milions of euros)	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	2.29	354.16
NBS interest rate	9.00	8.00	9.00	11.50	12.25	12.00	11.25	9.75	9.50	10.00	10.50	11.25
NBS interest rate	0.65	-2.24	-2.11	0.13	-9.74	6.76	12.59	7.15	1.11	-2.77	-5.74	1.11
NBS interest rate	-6.30	-6.30	1.27	8.01	25.66	28.86	5.17	2.61	-18.43	-7.27	-6.50	-3.99
NBS interventions on FX market (in milions of euros)	-631.50	-785.00	-595.20	-321.50	5.00	-30.00	-30.00	-30.00	-488.50	-1278.80	-1348.30	-1343.30
INCREASE						**cumulative, in % of initialM2[5)]**						
NBS own resreves[2)]	-15.3	-31.2	-57.5	-61.0	-8.9	14.0	26.8	73.9	-17.6	-45.4	-35.6	-6.0
NDA	-0.3	4.5	30.6	33.6	-0.7	-15.5	-28.6	-51.8	2.4	61.3	65.8	41.3
Government, dinar deposits[1)]	2.7	4.8	7.9	3.1	-4.6	-3.3	3.6	2.7	-5.1	6.1	4.3	-4.3
Repo transactions[3)]	4.9	14.2	35.4	42.5	-6.9	-15.3	-32.2	-47.5	2.2	53.7	59.3	40.2
Other items , net[4)]	-7.9	-10.4	-8.6	-7.9	10.9	3.1	0.0	-7.0	5.3	1.5	2.3	5.4
H	-15.6	-26.7	-26.9	-27.3	-9.6	-1.5	-1.8	22.1	-15.2	15.9	30.2	35.3
o/w: currency in circulation	-3.9	-3.2	-2.3	-1.5	-5.8	-4.2	1.3	12.4	-3.3	-4.0	-1.4	-1.6
o/w: excess liquidity	-13.7	-12.5	-8.6	-6.8	-3.8	2.5	-5.5	6.3	-13.6	-1.6	-1.1	5.4
					in millions of euros, cumulative from the beginning of the year							
NBS, net	-183	-389	-990	-1,059	56	282	1,374	2,203	-1,070.60	-2,087.45	-2383.97	-1050.9
Gross foreign reserves	-135	5	-637	-654	16	308	1,426	2,334	-1,138.11	-2,090.09	-2536.57	-1324.2
Foreign liabilities	-49	-393	-353	-405	41	-26	-52	-131	67.51	2.64	152.6	273.2
IMF	-47	-386	-356	-408	37	-32	-59	-132	58.24	-6.44	138.99	259.0
Other liabilities	-2 0	-7	3	3	4	6	7	1	9.27	9.07	13.61	14.2
NBS, NET RESERVES-STRUCTURE	0											
1. NBS, net	-183	-389	-990	-1,059	56	282	1,374	2,203	-1,070.60	-2,087.45	-2389.97	-1050.9
1.1 Commercial banks deposits	-115	-393	-377	-374	22	226	109	-462	459.45	740.45	1030.19	907.6
1.2 Government deposits	-80	39	22	18	-232	-258	-1,009	-455	263.40	488.43	683.75	28.6
1.3 **NBS own reserves** (1.3 = 1 - 1.1 - 1.2)	-378	-743	-1,346	-1,415	-154	250	474	1,286	-347.74	-858.58	-670.03	-114.7

Source: NBS.
1) State includes all levels of government: republic and local.
2) Definition of net own reserves NBS given in section 8 „Monetary trends and policy ", Framer 4, *QM* 5.
3) This category includes NBS bills and repo operations.
4) Remaining domestic net assets include: domestic loans (net debts by banks, not including NBS bills and repo transactions; net debts by economy) together with other assets (capital and reserves; and balance items: other assets) and corrected by exchange rate.
5) "Initial M2" signifies state of primary money at start of current and end of previous year.

In Q4 reserve money records growth …

… thanks to increased government spending…

… which was partly lowered by new growth of REPO placements

The relatively stable nominal Dinar exchange rate in Q4 did not require NBS interventions on the inter-banking foreign exchange market as in previous quarters. The NBS intervened only in October with the purchase of 5 million Euro to ease the Dinar appreciation present from the start of Q4 and continued into 2013. The lack of larger-scale interventions on the inter-banking foreign currency market had a positive effect on the level of net own reserves in Q4. In the last three months of 2012 the NBS net own reserves increased by 555 million Euro, or in relative terms by 29.7% compared to the value of primary money at the start of the year (Table T7-1). A positive effect was exerted on the creating of reserve money and the rise in NBS own foreign currency reserves by the spending by the government which sold part of its foreign currency reserves to the NBS. On the other hand, the rise in primary money was lowered by the withdrawal of REPO placements which had a negative effect of –19% of the level of the initial primary money.

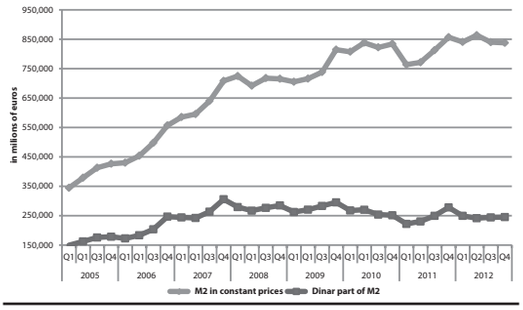
Monetary system: structure and flow of money mass

Nominal growth of money mass slowed at y.o.y. level …

… whil M2 drops in real terms

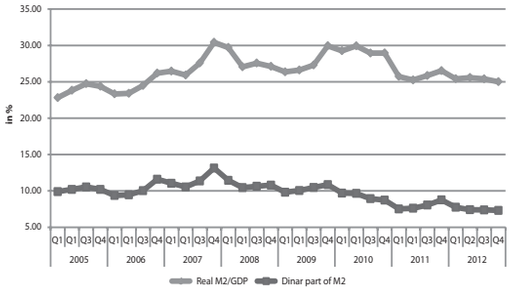
The money mass M2 at the end of 2012 slowed down with the growth which nominally stood at 9.6% y.o.y. (in Q3 a growth of 13.8% y.o.y. while in Q3 growth was 18% y.o.y., Table T7-4). The nominal growth of M2 was almost entirely generated by the growth of foreign currency deposits of 9.99% y.o.y., while a smaller due is owed to the growth of M1 which stood at 1.02% y.o.y. We observe in both elements a slowing down compared to the growth rate in the previous two quarters. This can partly be explained with the fact that the money mass in the same period of 2011 saw a somewhat slighter growth which means that the growth achieved in 2012 was additionally strengthened during the calculation of the y.o.y. rate. The overall nominal growth of M2 in Q4 was negatively affected by savings and time deposits which saw a drop of –1.42% y.o.y. If these rates are corrected by the inflation rate in 2012 we get a real growth rate of M2 which is negative and in Q4 stood at –2.2% (in Q3 real growth of 3.4% y.o.y., in Q2 real growth 10.1% y.o.y.). We

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



Source: *QM* calculation

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



Source: *QM* calculation

observe the same with the real growth rate of credit placements in the non-government sector which in Q4 stood at –2% y.o.y. The real drop in credit placements is unfavorable for economic activity and indicates that, besides several large companies, the majority of the economy still has not gotten out of recession. When additional corrections are made on the money mass by the change of the foreign currency exchange rate at annual level, the growth rate of credits in the non-government sector registers an even greater drop of –8.1% y.o.y. (Table T7-4). The overall cumulative growth of M2 in 2012 which stood at 9.6% is owed solely to the growth of net domestic assets which in the monitored period stood at 9.4%. Within that growth, a negative effect was exerted by credit activity in the non-government sector –1.1% compared to the starting value of M2. On the other hand, increased government spending in this period and the growth of NBS and business bank capital caused the final rate to be positive. Unlike the NDA, the net foreign assets (NSA) saw a minimal growth of 0.2% cumulatively compared to the M2 level at the start of the year. This is primarily the consequence of negative exchange rate which neutralized the growth of the NSA in foreign currency.

Table T7-4. Serbia: growth of money and contributing aggregates, 2010–2012

	2010				2011				2012			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
						y-o-y, in %						
M2[1]	19.9	22.1	20.1	13.1	8.0	3.7	8.1	10.1	14.0	18.1	13.8	9.6
Credit to the non-government sector[2]	14.4	25.0	27.1	27.2	19.3	11.6	8.3	7.7	14.4	14.0	16.6	9.8
Credit to the non-government sector[2], adjusted[3]	10.4	16.2	16.8	19.9	16.7	13.0	11.8	8.1	8.6	4.6	7	3.8
Households	7.9	16.1	18.7	18.9	25.1	20.6	17.8	5.7	5.7	3.3	3	2.5
Enterprises	11.6	16.3	15.8	20.4	12.8	9.4	8.8	9.3	10.1	5.3	9.1	4.4
						real y-o-y, in %						
M2[1]	14.5	17.1	11.4	2.4	-5.4	-8.0	-1.2	2.7	10.1	12.0	3.4	-2.2
Credit to the non-government sector[2]	9.1	19.9	17.9	15.0	4.5	-1.0	-1.1	0.5	10.5	8.1	5.9	-2.0
Credit to the non-government sector[2], adjusted[3]	5.3	11.3	7.8	7.9	1.8	0.2	2.2	0.9	4.9	-1.2	-3.6	-8.1
Households	2.9	11.1	9.6	16.8	9.2	7.0	7.8	-1.3	2.0	-2.4	-7.2	-9.2
Enterprises	6.5	11.3	6.9	3.7	-1.6	-3.0	-0.4	2.1	6.3	-0.5	-1.7	-7.5
						in bilions of dinars, end of period						
M2[1]	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	1,607.6	1,641.7
M2[1] dinars	403.7	417.9	403.0	410.5	382.7	402.0	433.8	486.5	445.0	444.6	467.4	480.6
Fx deposits (enterprise and housholds)	814.0	878.2	903.0	950.3	932.9	942.8	978.3	1,011.5	1,054.7	1,144.0	1,140.2	1,161.1
						cumulative, in % of opening M2[4]						
M2[1]	1.1	7.7	8.5	13.1	-3.3	-1.2	3.8	10.1	0.1	6.1	7.3	9.6
NFA, dinar increase	-0.9	-0.6	-1.7	-5.3	-1.9	-1.4	9.5	11.9	-5.6	-4.5	-7.9	0.2
NDA	2.1	8.3	10.2	18.4	-1.4	0.2	-5.7	-1.8	5.7	10.5	15.2	9.4

Source: NBS

1) Money mass: components – see Analytical and Notation Convetions *QM*.

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

3) Trends are corrected by exchange rate. Correction made under assumption that 70% of credits to non-government sector (both households and economy) indexed against the Euro.

4) Starting M2 is the state of M2 at the start of current, that is end of previous year.

Banking sector: placements and sources of financing

Q4 sees drop in credit activities …

Unlike the previous quarter, the banking sector in Q4 saw a net reduction of credit placements towards the economy and the population. In the last quarter, the economy reduced its debts to the domestic banking sector by 189 million Euro (in Q3 placements rose by 580 million Euro), while the population saw a smaller reduction by 5 million Euro (Table T7-5). The drop in credit placements to the economy is to a large extent the consequence of the launching of receivership over the Nova Agrobank. The withdrawal of its license and launching of receivership meant that most of the debts based on Nova Agrobank loans was transferred to the Deposit Security Agency and those debts were excluded from the banking sector balance. The assessment is that the reduction in the placement of the banking sector because of the excluding of Agrobank credits from the overall placement of the banking sector did not have any significant effect on economic activity. A look at the rest of the banking sector shows that there was a growth of credit placements in this quarter but significantly under the level of Q3. In regard to cross-border credits, the domestic economy reduced its debts in October and November to foreign banks by 101 million Euro. The drop in cross-border credits had a short-term unfavorable effect on economic activity but created space for companies to take loans in the future. This reduction of debt, along with the withdrawal of part of the debts to the Nova Agrobank from the banking sector balance, led to a drop in new placements to the economy and population in Q4 of almost 300 million Euro (Graph T7-6).

... due to exclusion of Nova Agrobank

Subsidized credits rising, but their balance is modest

Compared to the previous quarter, in Q4 almost double the amount of subsidized loans was approved with more than 95% of them to the economy. Of those loans, some 70% were liquidity credits and turnover funds, refinancing credits accounted for some 23% while the rest were export stimulation loans. The funds for the subsidized loans were spent early in December while new funds were approved late in January but only for entrepreneurs, small and medium sized enterprises. Those funds are expected to lead to a rise in credit placements in that segment by about 100 million Euro in the next few months. The expected rise in bank placements on the basis of subsidized loans is modest (about 0.3% GDP), which means it will not have any significant effect on the recovery of the economy but will probably make it easier for small and medium sized enterprises to survive.

REPO stock growing again …

The NBS Executive Board decided at a December 14 session to change the direction of main operations on the open market which actually restored the so-called reverse repo system of selling NBS bonds. The NBS is using the operation to sterilize surplus liquidity in the banking sector instead of creating it. The decision to change the direction of REPO operations can be explained with the fact that the rise of liquidity in the banking sector was not accompanied by a rise in credit placements to the economy and the population. Instead, there was a risk that part of the freed funds could be used for early repayment of loans which domestic banks took from their parent banks abroad. That would exert pressure on the exchange rate and again force the NBS to activate its foreign currency reserves to stabilize the Dinar. In the last two weeks of December when the decision on the direction of main operations was first implemented, banks placed some 350 million Euro in REPO. Bearing in mind the rise in the key policy rate, the stability of the Dinar exchange rate and security of placements in REPO, we can expect the behavior of business banks to continue in the coming period until prospects for economic recovery improve. In Q4 banks used more funds to buy state bonds than in the previous quarter. The market value of the sold bonds in Q4 stood at about 784 million Euro (in Q3 the market value of bonds at day of purchase stood at 620 million Euro), with four auctions of bonds in Euro conducted with a rate ranging from 5.85% to 4.88%. Most of the sold treasury bonds (about 65%) were used by the state to service debts from previously sold bonds which fell due in Q4 so the rise in debts on that basis is about 190 million Euro.

... as consequence of return to reverse repo operations

Table T7-5. Serbia: bank operations– sources and structure of placements, , corrected[1)] trends, 2010-2012

	2010				2011				2012			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
	in millions of euros, cumulative from the beginning of the year											
Funding(-, increase in liabilities)	7	-117	-68	-1,495	603	69	-822	-1,083	672	692	472	-384
Domestic deposits	131	-233	-236	-836	206	-148	-844	-1,169	589	146	15	-459
Households deposits	-137	-323	-500	-1,020	-92	-295	-483	-655	-49	-189	-296	-578
dinar deposits	30	21	25	12	24	13	-68	-182	30	69	36	11
fx deposits	-167	-343	-525	-1,032	-116	-308	-416	-473	-79	-258	-332	-589
Enterprise deposits	268	89	264	184	298	147	-361	-513	638	336	311	120
dinar deposits	213	84	232	151	176	13	-128	-350	362	304	230	99
fx deposits	55	5	32	33	122	134	-233	-164	275	31	81	21
Foreign liabilities	-196	40	90	-563	580	634	678	545	3	345	335	127
Capital and reserves	72	77	78	-96	-183	-416	-656	-459	80	200	123	-52
Gross foreign reserves(-,decline in assets)	53	-120	197	430	-720	-674	-517	-923	-199	371	164	284
Credits and Investment[1)]	397	1,279	1,281	2,285	309	1,270	2,158	2,771	409	-424	201	521
Credit to the non-government sector, total	411	1,264	1,669	2,434	216	1,030	1,554	1,940	309	136	784	589
Enterprises	319	897	1,142	1,756	191	766	1,189	1,607	375	161	741	552
Households	91	368	527	678	25	263	365	333	-36	-25	42	37
Placements with NBS (Repo transactions and treasury bills)	-125	-445	-839	-1,010	86	268	529	720	-28	-944	-1,052	-701
Government, net[2)]	112	460	451	861	7	-28	75	111	128	385	470	632
MEMORANDUM ITEMS												
Required reserves and deposits	54	-182	-188	-115	-157	-429	-210	391	-552	-418	-451	-265
Other net claims on NBS[3)]	-287	-272	-195	-229	17	123	2	110	-199	-20	-42	58
o/w: Excess reserves	-279	-252	-173	-220	22	123	-3	100	-187	45	54	10
Other items[4)]	-147	-331	-692	-565	-136	-195	-246	-601	150	222	56	146
Effective required reserves (in %)[5)]	26	24	24	23	23	21	21	24	22	23	23	23

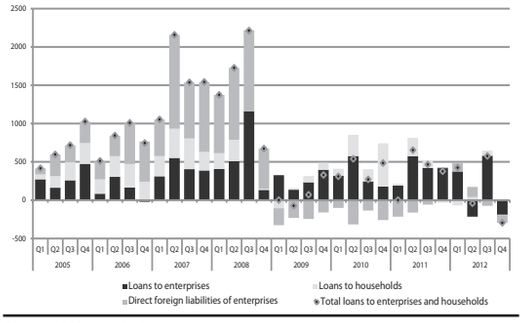
Source: NBS

1) Calculating growth is done with the assumption that 70% of overall placements are indexed against the Euro. Growth for original Dinar deposits was calculated based on the average exchange rate for the period. For foreign currency deposits– as the difference calculated based on the exchange rate at the ends of periods. Capital and reserves are calculated based on the Euro exchange rate at the ends of periods and do not include the effect of changes to the exchange rate from the calculating of the remainder of the balance.

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

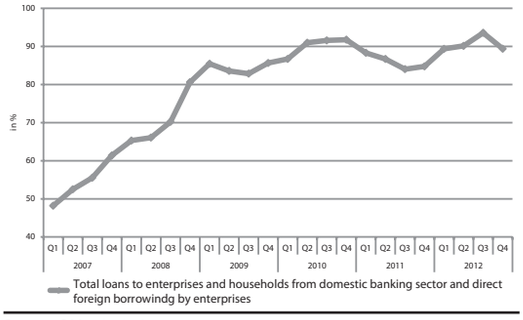
3) Net loans to the state: Loans approved to the state are decreased by the state deposit in business banks; a negative prefix means a higher growth of deposits than credits. The state includes all levels of government: republic and local government levels.

Graph T7-6. Serbia: growth of new loans to the economy and population, 2005-2012



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

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



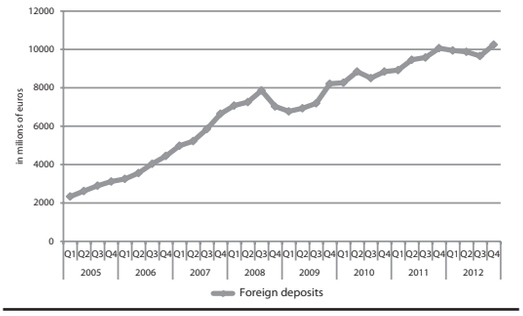
Source: QM calculation

Sources increased for new placements in Q4…

The growth of sources for new placements continued in Q4. After the 220 million Euro that sources rose by in Q3, banks in Q4 increased their sources by another 856 million Euro (Table T7-5). About half of the increase is owed to the growth of deposits by the population and economy. The growth of deposits of the population in Q4 stood at 257 million Euro of which almost the entire amount is in foreign currency while the economy increased its deposits with banks by 191 million Euro. Despite the mini crisis in the banking sector which was initiated by the revoking of the work permit of the Agrobank and the initiating of receivership over the Nova Agrobank, the growth of the deposits by the population in this period shows that the trust of the population in the domestic banking sector continues to be high. Besides the growth of deposits, business banks have increased their indebtedness abroad by 208 million Euro which has additionally caused a rise in the sources for new placements. Still, we should bear in mind that business banks placed 350 million Euro in REPO because of the change in direction of repo operations in just two weeks which means a large part of the earlier rise in sources for new placements

… but banks redirect surplus liquidity into REPO

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



Source: NBS

was redirected in this non-risk form of investment. The decision by banks to place funds in REPO bonds instead of crediting the economy primarily reflects the bad state of the economy whose recovery is still uncertain. The presence of a large number of insolvent and non-liquid companies in the economy obstructs the credit activities of banks and increases the risks and expenses of their operations in Serbia.

Table T7-9. Serbia: participation of NPLs according to 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	Q3	Q4
	balance at the end of period																
Corporate	6.86	11.05	14.86	13.24	12.14	11.62	14.18	13.83	14.02	14.39	16.23	17.44	17.07	17.72	19.26	19.04	19.06
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	18.47	17.56	15.92
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	8.05	8.32

Source: *QM* calculation

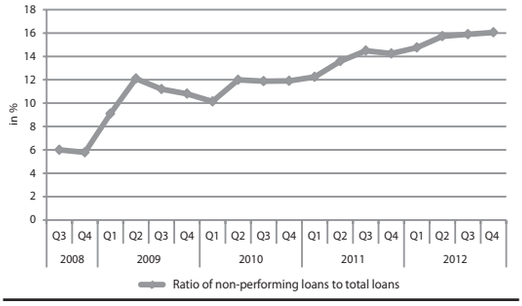
Participation of NPLs continues to rise …

The total participation of NPLs in overall placements rose by the end of the year to 16.05%, which represents a growth compared to the previous quarter of 0.15 percent point (in Q3 that participation stood at 15.89%; Graph T7-10). The launching of a program of subsidized loans had a positive effect on individual debtors in the NPLs segment. There was a lower participation within the NPLs placed to entrepreneurs while a rising trend was recorded among private individuals (Table T7-9).

… due to increase in non-performing loans placed to private individuals

Along with the slight rise in the framework of NPLs placed to companies, the overall participation was increased compared to the previous quarter. The positive effect on the potential drop in participation of NPLs in the next period could come from changes to the Decision on Risk Management of Banks and Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items. The introduced changes cover the possibility of business banks in the coming period relinquishing disputable debts to firms which do not have to be based in Serbia nor do they have to deal primarily in finances. The other set of changes covers the possibility of additional restructuring of debts by companies which are assessed to be able to recover in the coming period.

Graph T7-10. Serbia: participation of NPLs in overall placements, 2008-2012



Source: *QM* calculation

Despite those changes and the combined effect of the appreciation of the Dinars since December and the continued program of subsidized loans (of which a significant part is earmarked for refinancing debts) we do not expect any great reduction in the participation of NPLs in the next quarter. The problem of non-redeemable loans cannot be resolved quickly without improving overall economic activity and these measures are directed more at stabilizing this negative occurrence and we doubt that they will any great effect on reducing it.

8. International Environment

During Q4, this region and the Eurozone were in recession and the United States saw a slight drop in GDP growth while the BRIC countries (with the exception of China) saw their growth slow slightly. At global level we expect to see a rise in the growth rate early this year while the recovery in the Eurozone will come in the second half of 2013. Developed countries are continuing to implement an expansive monetary policy, the Eurozone is continuing its restrictive fiscal policy but somewhat less strict that last year. Inflation is at a standstill at global level but in 2013 we expect a slight rise in inflation in developing countries and a slight drop in inflation in developed countries. The rise of unemployment, drop in living standards, high level of corruption on one side and lack of readiness by the population to save on the other led to the fall of the governments in Slovenia and Bulgaria. The assessment is that trends in the world economy in the first half of 2013 will have a negative effect on the recovery of the Serbian economy while recovery in the second half of the year will make the recovery of our economy easier.

The World

Political decisions at the end of last year lowered the risk of a breakup of the Eurozone and prevented the "fiscal cliff" in the United States but the European Union entered into a recession and the US into stagnation which caused the global growth rate to stand lower than what was predicted. Late in 2012, the cost of debts for the countries on the outskirts of the Eurozone dropped significantly, the value of shares world-wide rose and capital trends towards developing countries remained strong. A rise in the growth rate is predicted in 2013 at global level (3.5%) compared to the previous year but recovery will be weaker than predicted earlier. The main danger to the global growth is the possibility that the drop in state spending in the Eurozone will not be accompanied with the necessary reforms which would bring investments and private spending and the second greatest risk is an excessive contraction of fiscal spending in the United States.

The International Monetary Fund has been constantly lowering the planned growth rates for several quarters in a row both for the world and for eastern Europe for which the latest prediction of GDP growth in 2013 is 2.4%. However, since polls conducted early in 2013 are showing lower results than expected, there will most probably be another reduction in the predicted growth rate for eastern Europe. As was the case earlier in regard to growth rate levels, China leads the developing countries while Brasil, India and Russia have lower growth rates than usual. It is sufficient to compare the predicted growth rate for developing countries which stands at 5.5% and is significantly higher than the predicted growth rate for eastern Europe (2.4%) to see the negative effect of the crisis in the Eurozone on our region. Poland no longer has a high growth rate, Croatia, Slovenia, Hungary, the Czech Republic and Serbia are in recession and Bulgaria and Romania are stagnating.

Japan has fallen into recession but we expect that stimulative fiscal package and expansive monetary policy to help growth. To finally beat deflation and stimulated exports, the new prime minister has decided to introduce aggressive monetary measures whose consequence is a sharp drop of the Yen. Many analysts, in a climate of low growth, see this step by Japan as the first step in a "war of currencies". Gold is loosing its values because investors have increasingly less fear of inflation in the United States and the demand is dropping in China and India. The Euro strengthened in Q4 after the state bond markets on the outskirts of the Eurozone stabilized.

The Eurozone

The recession in the Eurozone deepened in Q4 with the drop in the GDP at annual level standing at 0.9% which is a contraction for the third quarter in a row. The main causes of the slow down are weak domestic demand and a lack of company investments. Both of our main trade partners registered drops in their GDP. Germany saw a drop of 0.6% compared to the previous quarter (primarily due to a drop in exports) and Italy saw a drop of 0.9% q/q (but at annual level -2,7%). The IMF has

predicted that the recession in the Eurozone will continue this year with a drop in the GDP of 0.2%. However, polls early in the year indicated higher activity during Q1 in Germany while the rest of the Eurozone will see the recession continue or have a weak recovery in the first quarter. A positive growth rate at the Eurozone level is expected in the second half of the year. Growth of demand in the United States should help growth in the Eurozone through exports. The main Eurozone exporter Germany should now make use of higher American demand for the placement of its products and help the recovery of the entire Eurozone by importing products from the outskirts. In Q4, Italy registered the greatest drop at quarterly level after Portugal. Italy's problems cannot be solved by stimulating domestic demand because the ratio of debt to GDP is high. The only solution for Italy is to raise the level of competitiveness, productivity and innovation in the economy. Some believe that the Italian economy is more competitive than that of Spain and will recover more quickly. Thanks to austerity measures introduced in mid-2011, fiscal consolidation is going ahead as planned and the 2012 deficit will be under 3%, lower than in 2011 when it stood at 3.9%.

The lack of domestic demand on the outskirts of the Eurozone due to restrictive fiscal policy and a drop in the GDP in Q4 due to the recession led to a growth in the unemployment rate in the Eurozone to 11.7%.

Unemployment in Spain and Greece is especially high (26.1% and 27% respectively), with Italy registering a rise of the unemployment rate to 11.2% in Q4 while Germany saw a drop in the unemployment rate of 5.3%.

Due to weak domestic demand in Q4 and the drop in the price of fuels, inflation in January 2013 dropped to 2%. The drop in inflation was helped partly by a strong Euro because that caused a drop in the price of imported goods. European Central Bank President Mario Draghi said that inflation would be significantly lower than 2% in 2014.

Fiscal policy had a negative effect on demand in Q4 but is expected to be somewhat less restrictive in 2013 which will have a positive effect on the growth rate of the Eurozone. Austerity measures which the poorer levels of society are having a hard time taking are slowly providing results – the current deficits are being lowered in the countries on the outskirts. Labor costs are dropping and exports are recovering slightly and there are indications that austerity measures are starting to raise the level of competitiveness in the countries on the outskirts of the Eurozone.

Monetary expansion in the Eurozone, United States and Japan raised the level of demand for state bonds in the EU states on the outskirts and countries in the process of joining the EU while interest rates dropped significantly. The drop in economic activity in the Eurozone at the end of the previous year lowered demand for Serbian products. The predicted recovery of the Eurozone in the second half of this year will create an opportunity for a growth of Serbian exports and a rise in the inflow of capital into the country which could stimulate economic growth.

The United States

The first assessment of the rate of growth of the GDP in Q4 in the United States was a big surprise because it indicated a stagnation compared to the previous quarter (0% q/q). The main reason is the sharp decrease of state spending (-6.6%), because there was a drastic cut in military spending in Q4 following an increase in expenses for the defense sector in Q3 and that lowered the GDP growth rate by 1.2 percentage points. Personal spending and fixed investments continue showing a solid growth and the financial markets did not react negatively to the unexpected low rate of growth of the GDP. If we exclude state spending, growth is in line with expectations. We expect a quickening of growth in the next quarter because the real estate market is recovering and the capital of the population is increasing and the ratio of their debts to their property is dropping which will have a positive effect on spending. Unemployment rose in January from 7.8% to 7.9%, primarily because of the rise in the unemployment rate among the young and the firing of employees in the public sector.

After the start of last year the FED started formally targeting inflation (within the frameworks of a dual mandate), in December it introduced a precise targeting level of unemployment – the key political rate will not be raised as long as the unemployment rate stands above 6.5% and expected inflation does not rise over 2.5%. The problem will come if the economic situation does not improve significantly since unemployment could perhaps be structural and inflation starts rising. We do not

know if the targets for unemployment or inflation will be changed and it is generally desirable for central bank steps to be as certain as possible. The index of consumer prices in January stood at 1.6% which is significantly lower than average inflation in 2012 of 2.1%. That confirms that the American economy is in a low inflation environment and that fears that "quantitative easing" will cause a sudden rise in inflation are exaggerated for now. The tempo of "quantitative easing" has not changed and will continue with the monthly purchase of mortgage bonds and long-term state bonds to the extent of 85 billion Dollars. Unlike earlier during operation Twist, the purchase of long-term bonds will not be sterilized with the sale of short-term bonds. That will increase the accounts balance of the FED.

The expansive FED monetary policy will cause the consequence of increasing global liquidity which, among other things, leads to a growth in demand for investors to buy the bonds of developing countries. That process has a positive effect on the demand for Serbian state bonds and a reduction of the cost of debts.

Eastern Europe

According to initial assessments, the Croatian GDP dropped by 2.3% at annual level in Q4. The main reasons are low personal spending and weak company investment activities. According to predictions, GDP growth will stagnate this year. The unemployment rate in January rose to 21.9% which is the highest level in the past ten years. The consumer price index rose in January to 5.2% at annual level primarily due to the administrative increase of the prices of electricity and natural gas and the rise in food prices because of the drought. The Croatian national bank will continue to maintain liquidity at a high level to prevent a growth of interests on the inter-banking market. Although the rating of Croatian bonds has been reduced there was no significant change in the cost of loans for Croatia because the effect of increased liquidity on the financial markets would be stronger than the lowering of the country's rating.

The Hungarian GDP dropped in Q4 to 2.8% at annual level while industrial production dropped by 8% in December. Hungary will probably remain in recession in 2013. The unemployment rate rose from 10.5% in October to 11.2% in January. Overall inflation dropped from 5% in December to 3.7% in January because the effects of the low basis caused by a rise in VAT rates ceased in that month. Government economic policy undermines the potential for long-term economic growth. As of the summer of last year, the Hungarian central bank lowered its key policy rate six times, even in periods when inflation was relatively high (more than 5%). Hungary has an unorthodox fiscal policy, it taxes sectors in which the owners are mainly foreign companies – bank taxes, extra profit tax for companies in the energy, retail and telecommunications sector. Following earlier efforts by the authorities in Hungary to control the central bank which were blocked by reactions and measures of the European Commission, IMF, European Central Bank (even though that did not prevent the ruling party from appointing members of the monetary board to cause a lowering of the key policy rate) Prime Minister Viktor Orban has a chance to finally achieve greater influence on monetary policy since the mandate of the current Governor ends in March. The popularity of Orban's party is dropping quickly and the assumption is that just prior to elections, the central bank would be used with non-standards measures.

S&P Rating Agency left in place Bulgaria's rating of debts in foreign currency with a stable prediction, since a responsible policy of fiscal consolidation was conducted despite the low growth with the budget deficit lowered to about 1.4% during last year and the ratio of the public debt to the GDP now stands at just 18%. However, because of the rising dissatisfaction of the population during the crisis period, mass protests broke out and the Bulgarian government fell under that pressure. Besides Bulgaria, Slovenia saw its government fall following demonstrations. In both cases, the governments did not fall only because of rising dissatisfaction because of the recession but the population were dissatisfied with the announced austerity measures and high level of corruption. Corruption increased the already high dissatisfaction of the population caused by a drop in living standards and reduced the readiness of the population to save during the process of fiscal consolidation.

The recession in the region has had a negative effect on the GDP growth rate in Serbia because the countries of the region are important importers of our products. If the countries in Eastern Europe got out of recession, Serbia's economic recovery would be made easier.

HIGHLIGHTS

Highlights 1: Fiscal Consolidation, Monetary Policy and Reform

Milojko Arsić

The most important move of the Government in the area of economics, from its formation to beginning of 2013, was the adoption of the fiscal consolidation programme. The fiscal consolidation programme and 2013 budget temporarily removed the imminent danger of public debt crisis, but not permanently. Consolidation programme is accompanied by a series of additional measures, whose aim is improvement of conditions of doing business (abolishing of quasi-fiscal levies) and putting order into public finances in Serbia (inclusion of own revenue in the budget, etc.). NBS continued to increase the restrictiveness of monetary policy, even though inflation has been low since November, while the economy, with the exception of a few industries, is in recession. Restrictive monetary policy encourages the strengthening of dinar, which slows down the reduction of current account deficit and creates potential problems in case of reduced foreign capital inflow. Among other things, this raises a question of whether it is justified to make decisions on monetary policy based on the trends in year-on-year inflation or if it is necessary, when making a decision on monetary policy, to take into account the trend of inflation in the last few months, as well as the expected trend of inflation. After the initial acceleration, the economic system and public sector reforms have been relatively quickly pushed to the background. Instead of systematic reforms, the Government again started with the implementation of selective and discriminatory measures, such as conditional write-off of interests on tax debts, and it also announced the policy of selective reduction of taxes. Government activities in attracting foreign investments are desirable, but they cannot serve as replacement for implementation of reforms or as an excuse for implementing measures that violate the rules of fair market competition.

1. First results of fiscal consolidation programme

Government's fiscal consolidation programme foresees a reduction of fiscal deficit from 6.6% of GDP in 2012 to 3.6% of GDP in 2013. It is planned that approximately half of the reduction in deficit should be realised through tax increase, while the other half would be realised through savings. In terms of tax increase, the most significant contribution is expected from VAT, which should yield an increase in public revenue of 0.7% of GDP, next from corporate income tax (0.6% of GDP), excise duties (0.2% of GDP), and personal income tax (0.2% of GDP). The largest savings are planned in pensions (0.8% of GDP), salaries (0.6% of GDP) and spending on goods and services (0.6% of GDP).

During the adoption of the consolidation programme and 2013 Budget[1] it was estimated that some expenditures have been underestimated (spending on goods and services), and that there are risks of incurring certain unplanned expenditures (Smederevo Steel Works). That is why at the end of last year, we estimated that despite the macroeconomic forecasts (GDP growth of 1.5-2%, 7% inflation, unchanged exchange rate in real terms), the fiscal deficit would be around 4% of GDP, i.e. around 155 billion dinar instead of the planned 132 billion dinar.

Republic budget deficit in the first two months of 2013 was around 25 billion dinar, and it is estimated that the consolidated government deficit in the first two months was lower, i.e. around 25-30 billion dinar. According to some preliminary estimates based on the first two months, it can be concluded that the trend of consolidated deficit is far above the level planned by the Government (instead of the planned 132 bn dinar, the deficit will be around 170 bn dinar). Since the fiscal deficit will be considerably higher than the officially adopted deficit (by over 1 p.p. of GDP), the fiscal trends in the first months of 2013 can by no means be considered positive. Possible faster growth of economy by 1.5% would not have a significant impact on the reduction of fiscal deficit, because the main factors of growth are industries that do not bring high taxes – export of cars and oil derivatives, as well as the growth of agricultural production. That is why it is necessary, in line with the Fiscal Council recommendations, to quarterly monitor budget execution and, if necessary, adopt additional measures so the fiscal deficit would not exceed 4% of GDP. It is especially worrying that Republic budget deficit in the first two months was as high as 28% of the planned annual deficit and that it was significantly above the usual seasonal dynamic. High Republic budget deficit in the first two months additionally confirms there is an imbalance between the revenue and obligations on different state levels, where the most important one is the vertical imbalance created by the co-called fiscal decentralisation.

1 See Arsić (2012), "Fiscal Consolidation and Recovery of Serbian Economy", Quarterly Monitor no. 30 or Fiscal Council documents published during Q4 2012.

Fiscal consolidation measures on the revenue side were enforced in October 2012, while fiscal consolidation on the spending side did not begin before 2013. That is why now, after four months of implementation, it is possible to give a preliminary estimate of the effects of tax increase. In the analysis we will focus on the effects of VAT and excise duties increase, because they were already supposed to yield results. The effects of coporate and personal income taxes increase will show in the coming months, so they will be analysed in the coming issues of Quarterly Monitor.

At the beginning of October, the standard VAT rate was increased from 18% to 20%, while the lower rate of VAT remained unchanged. In addition to the increase of VAT rate, a series of other measures was adopted as well (raising the limit for entering into VAT system, increase of VAT rate that is subtracted at the buy-out of agricultural products, limited VAT exemption on baby products, etc.), which will result in reduced revenue from VAT. It has been estimated that VAT revenue in 2013, as well as the net results of stated measures, should increase by about 0.7% of GDP. At the same time, some economists and business people have estimated that increase of VAT will result in reduction of VAT revenue instead of its increase. Whether or not the stated increase in VAT revenue will be realised will significantly affect the realisation of the planned reduction of 2013 fiscal deficit.

In order to evaluate the effects of VAT increase on revenue, it is necessary to observe the share of VAT revenue in GDP, because this way, the effects of recession on revenue are excluded. Share of VAT revenue in GDP in the fourth quarter of 2012 was higher by 0.4 p.p. than the average share in the same quarter in the previous four years, while compared to the same quarter last year, the share in GDP was increased by 0.5 p.p. (see the last line of Table 1). Thus, it can be concluded that the increase of VAT rate led to an increase in revenue, but that the effect was somewhat smaller than expected. Still, a more reliable estimate of effects of VAT rate increase will be possible after the data for the first half of 2013 become available, because in parallel to the increase of VAT rate, a series of other changes have been realised, which affected the temporary reduction in VAT revenue (transfer of a portion of taxpayers from monthly to quarterly payments, shortening the time for tax returns, payment upon realisation, limited exemption for baby products, etc.). These changes in the VAT system have certainly lowered the level of revenue in the first months of the change, but this will be offset by higher revenue in the following months.

According to the fiscal consolidation programme, excise duties revenue in 2013 is foreseen to grow by 0.2% of GDP. Excise duties revenue in the fourth quarter of the previous year was by 0.2% of GDP higher than the average share in the fourth quarter of previous four years. However, excise revenue in the fourth quarter of last year was lower by around 0.5 p.p. of GDP than in the same quarter of the previous year (see the last line in Table 1). Generally speaking, the trend of excise duties revenue during previous years expressed a high variability during the year, which cannot be attributed to seasonal factors. Even though it is hard to make a reliable estimate based on the data from last few months on whether or not the planned excise duties revenue will be realised, there are indications that it will be lower than planned by several billion dinars.

Table 1. Share of most important public revenues in GDP, in %

	Public revenue	Income tax	Tax on profit	VAT	Excise duties	Customs duties	Other tax revenues	Contribu-tions	Non-tax revenue	Capital income
2008,Q4	44.1	5.5	1.2	11.0	4.3	2.4	1.3	12.5	5.8	0.0
2009,Q1	42.0	5.0	2.1	11.3	4.0	1.9	1.2	11.9	4.6	0.0
2009,Q2	39.2	4.9	0.8	10.0	4.5	1.7	1.2	11.7	4.3	0.1
2009,Q3	42.4	4.8	0.9	10.9	5.5	1.7	1.5	11.5	5.6	0.0
2009,Q4	44.8	4.9	0.9	11.6	5.7	1.8	1.6	11.7	5.8	0.0
2010,Q1	41.6	4.9	1.8	11.2	4.3	1.5	1.5	11.7	4.7	0.0
2010,Q2	40.9	4.8	0.9	10.8	4.9	1.5	1.7	11.1	5.1	0.0
2010,Q3	41.1	4.6	0.9	11.1	5.7	1.5	1.5	10.6	5.3	0.0
2010,Q4	45.9	5.0	1.0	11.3	6.1	1.6	1.7	11.5	6.8	0.0
2011,Q1	40.5	4.5	2.0	10.9	4.8	1.2	1.4	10.8	4.7	0.0
2011,Q2	38.3	4.7	0.9	9.9	4.9	1.2	1.3	10.5	4.7	0.0
2011,Q3	40.5	4.6	0.9	10.6	5.7	1.2	1.4	10.6	5.4	0.0
2011,Q4	44.7	5.2	1.0	11.2	6.0	1.3	1.4	11.7	6.2	0.1
2012, Q1	43.2	4.9	3.2	11.0	4.8	1.1	1.3	11.9	4.9	0.1
2012, Q2	41.3	5.0	1.3	10.9	4.9	1.1	1.4	11.5	4.8	0.2
2012, Q3	42.1	4.9	1.2	11.2	6.5	1.1	1.3	11.2	4.6	0.1
2012, Q4	44.9	5.3	1.2	11.7	5.8	1.1	1.2	11.7	6.1	0.7
Average Q4*	44.9	5.2	1.0	11.3	5.5	1.8	1.5	11.9	6.2	0.0
Difference**	0.0	0.1	0.2	0.4	0.2	-0.7	-0.3	-0.1	0.0	0.6

*) Average fourth quarter before consolidation (2008-2011)
**) The difference in income in Q4 2012 and the average of the fourth quarter in the previous four years

2. Should the restrictiveness of monetary policy be reduced?

At the end of 2012, the inflation was suddenly stopped; the economy, save for a few industries, is in recession; unemployment is stagnating at a high level; external deficit is slowly decreasing, but is still high, while the foreign debt is close to 90% of GDP. In addition, as of the beginning of 2013, the fiscal consolidation programme has started, which will decrease the fiscal deficit in 2013 by around 2 p.p. of GDP. In such circumstances, NBS still increased the restrictiveness of monetary policy with an explanation that year-on-year inflation is high and that an increase in administratively controlled prices is expected. Below, we will dispute both arguments and then analyse negative consequences of restrictive monetary policy in current macroeconomic circumstances of Serbia.

As one of the main explanations for increasing restrictiveness of monetary policy, the NBS states year-on-year inflation, which is still high and whose growth

is expected in the next month or two. However, it is questionable whether in conditions of high and variable inflation that is characterised by sudden crashes, the year-on-year inflation is the best indicator based on which decisions on monetary policy are made. Year-on-year inflation includes inflation that already happened 10 or 11 months ago and that cannot be affected by any measures, nor can the inflation from 10 or 11 months ago affect the current inflation. So we are faced with a paradox that year-on-year inflation at the end of 2012 and beginning of 2013 is still growing even though the increase of prices since November 2012 has been quite small. In countries with low inflation, this issue is irrelevant, but it is relevant in countries such as Serbia where inflation is over 10%. Maybe it was precisely the decision making on monetary policy based on the year-on-year inflation that caused the monetary policy during 2009 and the second part of 2011 to be restrictive for too long. That is why it would be more adequate to make decisions on monetary policy based on the annual equivalent of average inflation in the last few months and expected inflation in the following months.

The second argument for continuing with restrictive monetary policy is that it prevents or at least decreases the effect of increased administratively controlled prices on inflation. However, this argument can hardly be accepted, because monetary policy can only mitigate the indirect effects of the increase in administratively controlled prices. To be more precise, monetary policy can only make the buyers of products whose prices are administratively controlled (e.g. electricity) absorb part of the cost of administratively controlled prices, i.e. not to transfer them to end consumers. Scope of monetary policy in this segment is very limited due to a lot of factors, such as low level of competition, rigidity of prices, poor state of companies, etc. That is why the level of monetary restriction that would "force" the producers to absorb the cost of increased administratively controlled prices should be very high, and such a monetary policy would probably be pro-recessionary.

One of direct consequences of overly restrictive monetary policy is the strengthening of dinar exchange rate, even though the deficit in current account balance is still quite high (see the chapter on Balance of Payments). Such a policy does not cause problems on foreign currency market as long as there is a considerable inflow of capital, whose value exceeds the deficit in current account balance. In Serbia, that occurred in the second half of 2012 and at the beginning of 2013, when a high inflow of capital was realised through state borrowing on international market. However, such an inflow of capital is unsustainable in the long-term, because it leads to increased growth of foreign and public debt, so the question arises as to what will happen on the foreign currency market once the inflow of capital is reduced. The answer to this question can be found based on the trend on foreign currency market during the first half of 2012, when high inflow of foreign capital suddenly stopped in conditions of high deficit in current account balance. The result of this imbalance was a strong depreciation of dinar and reduction of foreign currency reserves of NBS. It is important to remember that such a policy was preceded by high capital inflow, restrictive monetary policy and strengthening of dinar during 2011. The difference in relation to 2011 lies only in the fact that capital inflow back then was more the result of private investments than state borrowing, while now the inflow of capital is mostly due to state borrowing.

A lesson can be taken from the above that it would be better if NBS gradually reduced restrictiveness of monetary policy and allowed moderate depreciation of dinar that would influence a reduction of deficit in the current account balance. Reduced deficit in current account (that will be affected by other factors as well, such as growth of exports of Fiat and NIS, etc.) would make the country less vulnerable to a reduction in foreign capital inflow, that could happen for many different reasons. Reduction in restrictiveness of monetary policy in the current period would reduce the risk of sudden decrease in foreign currency reserves of NBS and sharp depreciation of dinar in the case of reduced inflow of foreign capital. The result of such a turn of events would be the sudden increase of inflation in the future, and that would require a strong increase of restrictiveness of monetary policy. Reduction of monetary policy restrictiveness would accomplish a gradual, rather than sudden, adjustment and that would decrease the variability of dinar exchange rate and inflation. Increase of fiscal policy restrictiveness, within the fiscal consolidation programme, creates additional room for lower restrictiveness of the monetary policy.

Depreciation of dinar, as a result of reduced monetary policy restrictiveness, should be moderate so as not to significantly worsen the asset position of companies, citizens and the state, who are all mainly indebted in foreign currency. In euroisationed economy, such as Serbia's, strong depreciation increases the cost of servicing the loan and deteriorates the relation between the loan and debtor's assets. That can lead to an increase in non-performing loans, mass bankruptcies, and eventually to a crisis in the banking sector and a recession.

3. Delay in reforms and flourishing of selective incentives

For fiscal consolidation programme to succeed, it is crucial to adopt austerity measures this year, that would contribute to a reduction of fiscal deficit by around 2% of GDP next year. In order for the austerity measures to be realised, public sector reform is necessary, whose implementation should be prepared during the first half of the current year, so that the reforms could be implemented through the 2014 budget.

Public and business sector reforms are necessary not only for the implementation of fiscal consolidation and prevention of a debt crisis, but also to create conditions for long-term sustainable growth. Effective limitations of Serbia's economic growth lie in undeveloped economic system and inefficient public sector and not on the demand side. Removing these obstacles requires large public sector and economic system reforms[2]. Such reforms were announced in the first months of the new Government and some of them have been realised, but after that there was a delay not only in the implementation, but in the preparation of reforms as well.

One of the possible reasons for the delay in reforms is almost constant talk of the possibility of holding new parliamentary elections – such a possibility is often being announced not only by the opposition, but by ruling coalition as well. The possibility of early elections directly affects the delay in the implementation of austerity measures, which are not popular, but are necessary for the reduction of fiscal deficit and removing the risk of public debt crisis (abolishing certain subsidies, introducing actuary penalties for early retirement, extending the age limit on retirement, rationalising the network of schools, firing surplus employees in the public sector, combating shadow economy, etc.).

Political instability manifested in constant possibility of holding early elections shortens the time horizon that politicians have in mind when making decisions. That means they are opting for popular measures that yield visible, short-term results, even when long-term effects of such measures are negative. Accordingly, the Government postpones the implementation of essential reforms that usually require certain sacrifices and savings if their implementation lasts 3-4 years. Thus, it can be concluded that some of the biggest obstacles in implementing economic reforms in Serbia lie in the political system that leads to the establishment of unstable governments with a large number of coalition partners. Systemic solution of this problem is to change the election law, which would enable consolidation of the political scene and forming of stable governments, which would consist of one or a small number of parties.

Delay of reforms for political interests of the ruling coalition is facilitated by the possibility of state borrowing on global financial market under relatively favourable conditions. In doing so, the fact that public and foreign debt of Serbia are already quite high is being ignored, as well as the risk of debt crisis, which has not been removed, but rather temporarily postponed. We should also remember that many debt crisis in the world were preceded by a period of cheap loans – at the end of 1970s, Yugoslavia borrowed in cheap petrodollars, only to get into a debt crisis at the beginning of 1980s.

Instead of systemic reforms, selective government intervention measures are again being applied, which damage the already underdeveloped market environment. Although there are a few of these measures, the analysis will focus on two: conditional write-off of interest on tax debts and announced selective reduction in income tax and social contributions in the IT sector.

Write-off of interests on tax debts is an example of a short-term measure that does not solve the fundamental problems of Serbia's economy, which is mass insolvency of market participants and financial indiscipline. The interest write-off temporarily improves the solvency of tax debtors, whose accounts are thus unblocked, and state revenue is temporarily increased due to regular payment of obligations by the debtors. However, in most cases, the problems of debtors are not solved by interest write-off, which is why the write-off is repeated every three-four years. By nominal interest write-off in conditions of high inflation that exists in Serbia, part of the real value of the principal debt is written off as well. In this way, indisciplined tax payers are being awarded and the disciplined ones punished, because they paid a bigger real tax value for the same transactions. The writing off of real value of the principle through the write-off of interest represents a gross violation of equality among market participants.

Periodic write-off of interest and part of the principle creates an expectation in taxpayers that it will happen in the future as well, which directly encourages a moral hazard – deliberate avoidance of paying tax obligations in order to have them reduced in the future reprogramming. Interest write-off for tax debts would be justified only if it would be realised as part of a wider programme of establishing financial discipline, which would have as a key measure elimination of insolvent companies from the market. Only in that case would the Government promise that there will be no interest write-off in the future be credible and would not encourage financial indiscipline.

2 For more details as to which reforms the Government should implement, see Quarterly Monitor no. 30

As part of the measures of attracting foreign investments, selective reduction of taxes for IT sector employees has been announced. Possible implementation of this measure is quite contrary to basic principles of market economy, because taxpayers (the citizens) would pay different taxes and contributions for the same wages depending on the industry they work in. Attracting investors through selective taxes is an even more damaging and unacceptable form of arbitrary government involvement in market processes than is the case with approving subsidies. If this measure were passed, it would open up doors to new requests for selective tax treatment. Even though such requests are contrary to the rules of equal market competition, they would be equally justified as in the case of IT preferential treatment. There is no economic argument that would allow information technologies to have preferential treatment in relation to, for example, bio technology, food production, clothes manufacture, automobile industry, pharmaceutical industry, etc. Instead of preferential tax treatment, the government should improve the conditions of doing business for all sectors. As far as the IT sector is concerned, it is necessary to increase investments in higher education institutions that would train students for these professions, review the justification for opening new colleges, and enable the return of Serbian engineers from abroad.

Government involvement in attracting large foreign investments is desirable, but it cannot replace economic system reforms or justify the violation of rules of fair market competition by introducing various direct subsidies and tax reliefs. Approval of generous tax and other incentives will probably attract individual investors, but without an economic system reform, there will be no massive investments that would be arranged without Government's direct involvement. Besides, as a condition of investing in Serbia, the new potential investors will request subsidies and tax reliefs similar to those approved in the past. The result is the increased deterioration of market environment, as well as the loss of tax revenue and increase in fiscal deficit.

Highlight 2: Analysis of parametric reform of corporate income tax in Serbia

Saša Ranđelović [1]

In December 2012 a number of amendments to the Corporate Income Tax Law (the Law) were adopted. It is believed that these amendments were driven by two major goals:

• To increase the revenue impact of corporate income tax, within a broader fiscal consolidation program;

• To improve efficiency in implementation of corporate income tax regulations and enhance the business environment (through technical improvements to the law, reduced room for tax evasion and by aligning taxation rules with international best practices).

The analysis and evaluation of the reform of corporate income tax in Serbia thus must be made within the context of the foregoing goals.

1. Fiscal effects of the reform of corporate income tax

Corporate income tax revenues in Serbia make up approximately 1.3% of GDP, which is far below the average of EU 27 member states (2.4% of GDP), and the average of Central and East European states (2% of GDP). Weaker revenue impact of corporate income tax in Serbia is the result of: *i)* lower statutory tax rate, *ii)* wide range of tax reliefs due to which Serbia has by far the lowest effective corporate income tax rate in Europe. Increase in revenue impact of corporate income tax as a goal behind the reform is therefore considered to be justified. Corporate income tax revenues in Serbia will increase chiefly through increased statutory tax rate, and to a lesser extent through abolition of some tax reliefs.

The newly adopted provisions of the Law provide for the increase in standard rate of corporate income tax from 10% to 15%, and abolition of some tax reliefs. When the rights related to the public sector are broadly defined, general taxes should not be low, because that would lead to increase in fiscal deficit and public debt. Corporate income tax rate in Serbia charged at 10%, was one of the lowest in Europe, while the public expenditures (as % of GDP) exceed the EU average and the average of the countries in the region. The adopted increase in corporate income tax rate to 15% is therefore considered justified.[2]Even after being increased, the corporate income tax rate in Serbia is still considerably lower than the EU average (about 25%) and corporate income tax rates in most Central and East European states (about 18%).

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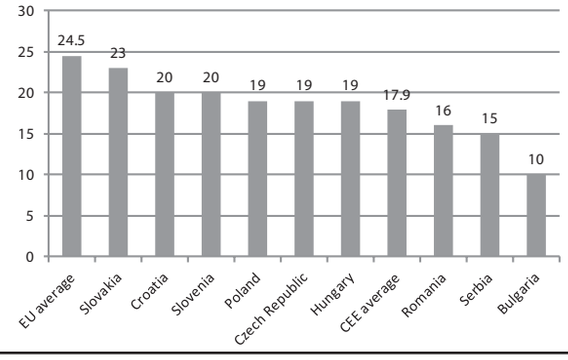
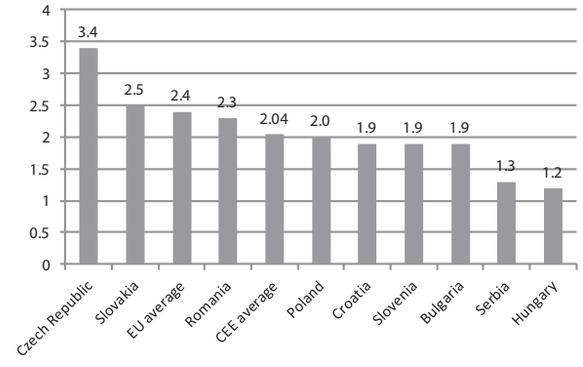
2 Apart from Serbia, in 2013 Slovakia increased corporate income tax rate (from 19% to 23%).

Figure 1. Corporate income tax rates in Serbia and Central and East European countries in 2013 (in %)



Source: Web pages of the national ministries of finance

Figure 2. Corporate income tax revenues in Serbia and Central and East European countries in 2010 (in % of GDP)



Source: Taxation Trends in EU, 2012

It is estimated that the increase in corporate income tax rate will lead to corporate income tax revenues growth in 2013, but that the growth will not be proportional to the tax rate increase due to expected poorer performance of companies in Serbia in 2012 under the global economic crisis.

Under the corporate income tax reform some tax reliefs are abolished: tax reliefs to vocational rehabilitation enterprises, free zone enterprises, enterprises operating in underdeveloped areas, tax credits to enterprises providing services of special interest etc. It is estimated that the abolition of these tax reliefs, under still quiet low tax rate, is justifiable, and that it will help combat tax relief abuse, but will not significantly increase tax revenues due to a small number of enterprises that were entitled to these tax reliefs. At the same time, the most important type of tax reliefs – investment tax credit, is preserved, and the sum it can amount to is reduced from 50% to 33% of the calculated corporate income tax(for medium-sized and large enterprises), which actually only prevents the increase in absolute amount of tax relief under higher corporate income tax rate. Accordingly, this change will not affect Serbia's level of tax expenditure incurred on investment tax credits. Since corporate income tax rate charged at 15% in Serbia will still be considerably lower than in most European countries, further implementation of these tax relief measures is considered unjustifiable and expensive mechanism for attracting foreign direct investments (Serbia suffers revenue losses from these tax reliefs of about 0.5% of GDP, i.e. RSD 15 to 20 billion per year). In addition, empirical analysis of other Central and East European states show that under low tax rates, tax reliefs do not exert significant impact on foreign direct investment inflow.

2. Corporate income taxation efficiency enhancement

Apart from increased revenue impact of corporate income tax, a motive behind the numerous modifications within the system of corporate income taxation in Serbia was more efficient implementation of this form of taxation, via removing ambiguities in certain taxation regulations, reducing the room for tax evasion and aligning corporate income tax rules with international best practices.

2.1 Technical improvements in corporate income tax system and alignment with international best practices

Although the Corporate Income Tax Law has been amended on several occasions in the past 10 years, and thus aligned with corporate income tax assessment principles applied in other European countries, a substantial number of provisions continue to be vague and ambiguous in terms of interpretation and/or administration, and do not follow the international best practices. Consequently, numerous unclear points are referred to the Ministry of Finance for opinion, which breeds legal insecurity, increases operating costs and risks and open up opportunities for rent seeking. Numerous amendments to the Law adopted in December 2012 resolve some of these ambiguities and inconsistencies. However, it is estimated that the institutional framework for corporate income taxation in Serbia can still be further enhanced.

The adopted provisions precisely define expenses that are (are not) recognized as tax deductible, and deductibility threshold for advertisement and promotion expenditures is increased to the level of 10% of taxpayer's total revenue (before 2012 it was charged at 5%). This increase is considered justifiable because advertising and promotion expenditures are business-driven costs and there is no objective reason to limit their deductibility threshold. Moreover, by limiting deductibility threshold for advertisement and promotion expenditu-

res, market oriented enterprises are put in unfavorable position. This leads to distortion of business behavior of taxpayers, since advertisement and promotion is not equally relevant to all enterprises. In this regard, abolition of the deductibility threshold should be considered in the future because tax evasion through this type of expenditures is limited due to anti evasion rules laid down by the Law (non-documentable expenditures shall not be recognized).

The Law also defines the terms under which impairment of receivables expenses are recognized as tax deductible, which reduces room for arbitrariness in case of tax audit. Additionally, under the new system of corporate income taxation in Serbia transfer pricing policy is finally fully aligned with international best practices. The new provisions of the Law allow use of all available methods for "arm's length" price assessment and implementation of rules elaborated in OECD Transfer Pricing Guidelines, which is considered a transfer pricing policy reference guide. Regulatory costs and risks involved in doing business are thus considerably decreased, especially in case of multinational enterprises operating in Serbia that make transfer pricing studies on the global level, but which could not be used in Serbia due to the legal limitations. Besides, this sets the basis for Tax Administration to tighten control on implementation of transfer pricing rules, which should lead to reduced corporate income tax evasion.

It is estimated that the provisions regulating technical improvements and alignment with international best practices will not exert significant impact on corporate income tax revenues in 2013, but that in general they will positively affect business environment and investment climate in Serbia.

2.2 Reduced room for corporate income tax evasion and increased costs of tax evasion

Another set of the adopted provisions provide for different measures intended to reduce room for and increase costs of corporate income tax evasion. The term jurisdiction with preferential tax treatment (so called tax havens) is thus introduced into Serbian corporate income tax system, alongside with general withholding taxes charged at the rate of 25% on the income earned on the basis of delivered services, dividend disbursements, interest etc. by taxpayer registered in these jurisdictions. Although the separate provisions regulating taxation of enterprises registered in jurisdictions with preferential tax treatment is a step in the right direction, disparity between withholding tax rate charged on payments received by these enterprises (25%) and the general withholding tax rate (20%) is estimated insufficient because payments to these enterprises erode the corporate income tax base in Serbia, and often personal income tax base as well, while the sum of corporate income tax rate and personal income tax rate exceed 25%. It is therefore estimated that considerably higher tax rates charged on payments to these enterprises, proposed in draft amendments to the law and discussed at the public hearing, would be economically justifiable.

Compensations for internally delivered services, which often considerably exceed their market price, are a mechanism of corporate income tax and withholding tax evasion in Serbia. Funds transferred abroad via these compensations lead to erosion of corporate income tax base in Serbia and evasion of withholding taxes charged at the rate of 20% on dividend disbursements. In a great number of European countries (and the states in the region) withholding taxes are charged on all compensations for foreign services, assuming that a great proportion of these payments are actually constructive (hidden) dividends. The draft amendment to the Law initially included all compensations for foreign services in the tax base for withholding tax charged at the rate of 20%, but this proposal was rejected and the provision which provides for withholding tax charged only on payments to taxpayers registered in "tax havens" was adopted. From the aspect of fiscal effects, non-discrimination and economic efficiency introduction of general withholding tax on payments for foreign services is believed to be necessary. This would generate about RSD 1 billion tax revenue, and taxpayers who pay taxes on dividend disbursements paid out to foreign owners would be given equal position as the taxpayers who pay out dividend disbursements through compensations for internal services.

3. The impact of corporate income reform on business environment and investment climate in Serbia

In the amended Law some provisions are less vague and ambiguous and some are aligned with international good practices. This decreases regulatory costs incurred on implementation of corporate income taxation in Serbia, as well as uncertainties and risks involved in it. Accordingly, it is estimated that the reforms will exert positive impact on business environment and investment climate in Serbia.

The new provisions of the law intended to reduce room for corporate income tax evasion will affect the enterprises that have been exploiting tax loopholes for tax avoidance and tax evasion purposes. Clearly defined tax treatment of enterprises registered in preferential tax ju-

risdictions reduces room for tax evasion. This affects the enterprises that have been using tax loopholes for tax evasion purposes but also the ones that have not been doing so, because tightening of these loopholes will improve their relative position. However, as mentioned before, if the tax base for assessing withholding tax was increased for the value of all compensations for foreign services (i.e. if they were treated as dividend disbursements) the room for tax evasion would be reduced. This measure would not have harmful effects on business environment, because enterprises from countries that have signed Double Taxation Avoidance Treaty with Serbia (almost all of the countries from which significant investments in Serbia come) would not be affected. Besides, this approach follows the practice used in many European countries, which means that the relative tax competitiveness of Serbia would not be weakened.

In theory, corporate income tax is considered distortionary, and negative from the aspect of economic growth impact. However, empirical analysis show that corporate income tax rate reduction may attract FDI, but the reduction can go only to a certain level, meaning that any further decrease of the rate does not exert positive impact on foreign direct investment inflow, especially when other obstacles to doing business and investing are present, which is the case of Serbia (Bellak, et. al. (2005) i Gorter, et. al. (2004)).

Corporate income tax rate charged at 15% in Serbia is still 10 percentage points lower than EU average, and below the rates charged in most of the states in the region. With preserved tax credits for investment, which reduce tax liability to 1/3, effective tax rate in Serbia will be around 10% and remain among the lowest in Europe. Accordingly, it is estimated that the increase in corporate income tax rate in Serbia will not weaken its tax competitiveness nor impair its investment destination ranking. Moreover, under moderate statutory tax rate, abolition of investment tax credit, resulting in reduction of disparity between the effective and statutory tax rate, would not exert significant impact on business environment and investment climate in Serbia because it is estimated that corporate income rate reduction much below 15% in general produces considerably low effects on FDI inflow.

Literature:

– Bellak, C. and Leibracht, M. (2005) „Do Low Coporate Income Tax Rates Attract FDI? Evidence from Eight Central and East Eauropean Countries“. The University of Nottingham Research paper No. 2005/143

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SPOTLIGHT ON:

Recommendations for Improvement of Competition Policy in Serbia Based on Past Experiences and Comparative Analysis of Several Countries

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The aim of this paper is to offer recommendations for improvement of the system of protection of competition in the Republic of Serbia, which are possible to implement in a relatively short period of time. The recommendations are given based on a comparative analysis of the system of protection of competition of European Union (EU), United States of America (USA), but also the system of protection of competition of individual EU member states with a longer tradition in dealing with competition policy compared to Serbia. The core of the system of protection of competition in an institutional sense consists of the Commission for Protection of Competition, whose duty is to implement the Competition Law, and Administrative Court, which performs judicial review of Commission's decisions. The paper will primarily deal with issues of increasing efficiency and effectiveness in the functioning of the abovementioned core, but also with the connection of the core with other elements of the system. Through seven relatively comprehensive recommendations, the paper will cover issues of strengthening Commission's independence, and strengthening Commission's technical and personnel structure through increasing human resources and reducing the number of cases the Commission processes in a year. Reduction would primarily be related to an excessive number of market concentrations, which unnecessarily burden the low capacity of the Commission and increase companies' cost of doing business. In addition to capacity building and strengthening the Commission's independence, the recommendations will also include capacity building of the Administrative Court, because judges' lack of understanding of the economic content of the competition law can become a stumbling block for Commission's correct decisions. The recommendations will point out the need for more intensive communication and cooperation between the Commission and other government and non-government institutions, whose operations have a significant impact on the conditions of competition on local markets. Finally, the last recommendation will show the importance of informing and educating the general public on the importance of protection of competition.

1. Introduction

Competition is not an end in itself, but it is an irreplaceable element in the functioning of markets. It enables efficient use of limited social resources, technological development and innovation, lower prices, higher quality, diversity of products, and in general a higher productivity of the economy as a whole.[1] The result is the improvement of consumer surplus in different markets allowing them a higher standard of living. More broadly, the promotion and protection of competitive pressure in the markets contributes to a strong and sustainable economic growth, and improves national competitiveness and job creation.

In April 2008, Serbia signed the Stabilisation and Association Agreement (SAA), which is currently in the process of ratification and once it comes into effect, Serbia will have an obligation to implement provisions set by the Agreement in order to enter the EU Accession process. Among other things, SAA outlines instructions for developing a competition policy in Serbia. This primarily refers to Articles 81, 82, 86 and 87 of the Founding Treaty of the

This paper represents a summary of main findings of the study published under the auspices of the Research Forum of the European Movement in Serbia.

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1 European Commission (2012), *DG Competition Management Plan* 2012.

European Community[2] and instruments of their interpretation that were adopted by the institution of the European Union.[3]

Generally speaking, there are four policy areas in competition protection that are considered fundamental, and they are covered by the European Commission at the supranational level. These areas also have to be covered within individual member states, for which the basis are the abovementioned constitutional articles of the EU Founding Treaty: **(1)** Prevention of cartel behaviour (restrictive agreement); **(2)** Prevention of abuse of dominant market position; **(3)** Control of mergers, acquisitions and joint ventures; **(4)** Control of direct and indirect state aid for companies.

The aim of this paper is to offer recommendations for possible improvements in the area of competition policy in Serbia and to present arguments for their importance according to the analysis of circumstances in which this policy is operating in Serbia and other referent countries included in this analysis. The paper will give a limited group of essential recommendations, whose effects can be expected already in the "short" mid-term (from 3 to 4 years), and for whose implementation a foundation already exists, so it will not require considerable capital investments. All recommendations should be taken as a way of doing "fine tuning" of the policy that is already being implemented in Serbia.

Backbone of the competition policy are laws that regulate this sector and institutional bodies that are enforcing these laws. In Serbia, the Law on Protection of Competition (hereinafter LPC) from 2009 is in effect, as well as a number of by-laws that additionally define certain provisions of the law. The law foresees an expert commission whose duty is implementation of the law, it defines its organisational structure and authorities. We are talking about the Commission for Protection of Competition (hereinafter Commission). Also, the Law foresees the Administrative Court to resolve company appeals on decisions that the Commission passes, while the Supreme Court of Cassation is responsible for disputes against Administrative Court decisions.

System of protection and promotion of competition, in a wider sense, in addition to the Commission and the courts, consists of the Ministry responsible for trade, independent regulatory bodies for the control of public procurement and state aid, sector regulators, but also non-government organisations whose aim is to protect the interest of consumers, and last but not least, the wider public for whose benefit this policy exists in the first place (micro-economic entities: companies and consumers). Certainly the high quality work of the independent Commission can be considered an essential link in the protection of competition pressure on partial markets and public promotion of the importance of competition for consumer benefit. In that sense, the Commission for Protection of Competition and Administrative Court can be considered the core of the system. In other words, these two independent bodies form a system in a more narrow sense and that is why the focus of this analysis will be on this core, while fully appreciating the link between the core and other elements.

Through a comparative analysis of the best systems for protection of competition in the world (USA and EU at supranational level), but also of the system of other countries that, much as Serbia, have a short history of dealing with this issue[4], but compared to Serbia have made a more considerable progress (Croatia, Hungary, Czech Republic, Bulgaria, Romania, Slovenia), we will point out its basic flaws and give recommendations for their elimination. The following table shows an overview of basic characteristics of these countries, which is necessary in order to see the circumstances in which the competition policy is being implemented. Here, we primarily have in mind the time of forming the Commission and passing regulations in this field, the size of internal market that is being regulated, and whether or not the country is part of the integral EU market. Country's population and GDP *per capita* are stated in order to illustrate the size of the market.

Important difference within this group of countries is that Serbia and Croatia are not EU member states unlike the rest of the stated countries, although Croatia has made a lot more progress on that front than Serbia. Therefore, it is evident that Serbian Commission for Protection of Competition has a significantly shorter history of operating than all the other stated countries.

2 Following the Lisbon revision of the Treaty, Articles 81, 82, 86 and 87 were renumbered into 101, 102, 106 and 107, respectively. Their content did not change.

3 Article 81 prohibits all forms of cartel behaviour, but also making other formal agreements that can violate conditions of competition on the territory of the EU common market. On the other hand, Article 82 regulates activities of companies that have a dominant position on the market. Any abuse of the dominant position is not in line with Article 82, while the very owning of a dominant, even monopolistic position is not considered criminal. Subject of the remaining two articles include control of state aid, which violates or threatens to violate competition by giving advantage to certain companies or certain products (through a system of state subsidies or by guaranteeing exclusive rights).

4 Characterising the history of competition policy implementation in some countries as "relatively short" is done having in mind that competition policy in USA has already been present for over 120 years, while in Europe this policy has been present in its modern form for over 50 years.

Table 1 Basic characteristics of countries and their markets

Countries	Year of establishment of the Commission	Population (last census) *	GDP per capita (in USD ppp)**	Size of the domestic market (index, 1-7) ***	Size of the domestic market (rank out of 144 countries) ***	EU membership
Serbia	2006	7,120,666	10,528	3.5	67	no
Croatia	1995	4,290,612	14,457	3.4	72	no
Hungary	1991	9,942,000	19,591	3.9	55	yes
Czech Republic	1991	10,512,208	18,337	4.2	45	yes
Bulgaria	1992	7,364,570	7,308	3.6	66	yes
Romania	1997	19,043,767	12,838	4.3	44	yes
Slovenia	1997	2,060,382	28,648	3.1	82	yes

Source: * data from the last official census of countries, **IMF (www.imf.org) , ***WEF (2012).

On the other hand, this is a relatively homogenous group of countries in global terms, when it comes to market size. According to the World Economic Forum methodology, Serbia ranks 67th by internal market size out of 144 countries, with domestic market size index value of 3.5. Except Romania and the Czech Republic who have a significantly higher index value than Serbia, partly due to bigger population and partly due to a higher GDP *per capita*, the other selected countries have recorded a much smaller deviation from Serbia. Since the countries are not identical, the conclusions we make about Serbia based on experiences of other countries will not be observed absolutely, but relatively, taking into account evident specificities of the countries.

All recommendations will be divided into two segments. The first segment will include recommendations whose implementation requires changes in legal regulations, while the second segment will include solutions that do not require changes to current regulations and are in exclusive jurisdiction of institutional entities: the Commission, Administrative Court and the Government.

2. Recommendations that Require Changes in Legislation

Modern history of competition policy in Serbia begins in 2005 with the passing of the Law on Protection of Competition[5] (LPC), which first envisaged the establishment of the Commission for Protection of Competition, independent and competent body in charge of implementing the Law.[6] The Law on Protection of Competition of 2005 was replaced by the Law of the same name in 2009.[7] The new Law provided significant approximation to the EU legislation in the field of protection of competition, but there is always room for improvement. In addition to LPC as the basic legislation on the protection of competition, a number of by-laws are also in effect, foreseen by the Law, which additionally clarify certain articles of the Law.

Law on Protection of Competition places three out of the four stated key areas of competition policy under the jurisdiction of the Commission: **(1)** prevention of restrictive agreements, **(2)** prevention of abusing the dominant market position, and **(3)** control of company mergers (concentration), while the control of state aid is not under the jurisdiction of the Commission, but of a separate regulatory body (Commission for State Aid Control).

In this chapter, we will give recommendations for improvement of existing legislation, which would increase the efficiency and effectiveness of the Commission in the implementation of LPC, which primarily foresees strengthening of institutional capacity and independence of the Commission as the most competent body for implementing the Law.[8]

5 *RS Official Gazette*, issue 79/05.

6 The Commission started operating at the beginning of 2006.

7 *RS Official Gazette*, issue 51/09.

8 Most of the recommendations that will be given in this paper are also present in the expert analysis of UNCTAD from 2011, which was conducted as part of the Peer Review project with the aim of supporting the efforts of Serbia in increasing efficiency and effectiveness in competition policy implementation (see UNCTAD 2011). The way of citing and explaining the recommendations in the form of "theorem followed by proof" that we will use in this paper was taken over from the abovementioned expert analysis, because we feel it represents an efficient and concise way of formulating a document, whose aim is to help understand the necessary changes in a policy. The essential difference from the UNCTAD study is in the "proof" rather than the "theorem", because the set assumptions are confirmed through a comparative analysis of the state in several countries, which gives a foundation for concrete calibration in implementation, wherever possible. This analysis will formulate a lot less recommendations compared to the UNCTAD document, because we feel that certain recommendations, which will not be stated here, although important, are not part of the hard core of the problems that have to be solved in the short mid-term, so they will probably be subject of some future studies, provided the obstacles formulated in this paper are overcome by then.

2.1. Recommendation 1 (Commission's Financial Independence)

Since the Commission's financial independence is crucial to its operational independence in implementing the LPC, it is necessary to secure stable, predictable and sufficient source of financing for the Commission.

2.1.1. Rationale and Way of Implementing Recommendation 1

The current Law foresees (Article 31) the financing of the Commission from its own revenue that the Commission primarily generates through collection of fees from companies that come under the Commission's scrutiny. The amount of fees is set in the Tariff Book[9] that the Commission creates with Government approval. However, it should be noted that the collection of fees from companies that have violated rules of competition is done in favour of the state budget of the Republic of Serbia.

In case of a surplus of revenue over spending in the fiscal year, the Commission is obligated to put the surplus funds in the account of Republic of Serbia's state budget, which *de facto* prevents Commission from creating any reserves (Article 32 of LPC). On the other hand, in case of a deficit, there is a possibility of balancing revenue and spending from the state budget, provided the Government gives its approval (Article 32 of LPC). Even though the Law foresees a possibility of the deficit being covered by the state budget, this option does not obligate the Government to actually do so, which puts the Commission in an unfavourable position when it is not able to cover the realised and justified expenses from its own realised revenues.

The revenue from fees collected from the companies that are the subject of the Commission's review are not as predictable as the expenses. So, the Commission whose capacities do not change significantly on year-on-year level, and by the same token neither do its expenses, is not able to plan with certainty the covering of these expenses by revenues that are inherently variable, because they depend on the Commission's activities that are exogenously determined for it.

It should be noted that the fees companies pay for merger (concentration) notification are the most significant item in total fees, and therefore in revenue as well. The test procedure for approval of concentration is certainly the most analytically demanding and therefore presents the biggest burden to the Commission's capacities, so the fees are greater as well. According to the already mentioned Tariff Book, the concentration fees approved by simplified procedure are up to 25,000 EUR, while for concentrations with full test procedures, where Commission's expert capacities are considerably engaged, the fees can be up to 50,000 EUR. These are prohibitive amounts for companies. Compared to selected group of countries, whose commissions are without exception funded by the state, Serbia leads by far in the value of this kind of fees. The real difference is even bigger if we take into account the fact that Serbia is the least developed country in the focus group.

In circumstances where the Commission is forced to independently finance its own expenses, it is stimulated to maintain a relatively high level of fees, which increases the companies' cost of doing business. On the other hand, since the Commission is unable to control and predict its revenue, the Commission could be forced to reduce its activities, which reduces its expenses, which is an unsatisfactory solution as well. The biggest number of Commission's activities is determined by the companies' activities, which means they are exogenous to it, and any reduction in Commission's activities would indicate a non-enforcement of the existing Law.

The following table shows total amount of revenue of the focus countries' commissions based on the latest available operation reports. Also, the revenue will be stated relative to the number of employees in commissions, which would avoid comparing the differences in countries and regulatory body's capacities.[10]

9 *RS Official Gazette*, issue 49/2011.

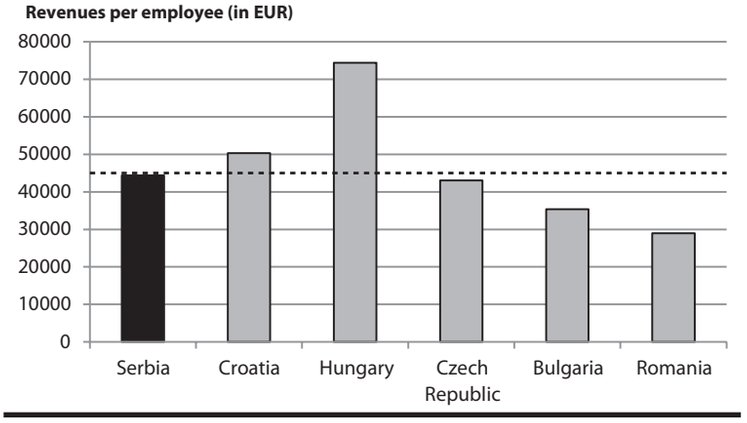
10 It is evident that the control of state aid in Serbia is under the jurisdiction of a separate regulatory body, which is not the case in countries covered by this comparison (where Commissions for Protection of Competition are in charge of this issue).

Table 2 Commissions revenues according to the total number of employees for 2010

Countries*	Number of employees **	Revenues (in EUR)	Revenues (per employee in EUR)	State aid control within the Commission
Serbia	27	1,198,218	44,378	no
Croatia	45	2,265,219	50,338	yes
Hungary	125	9,300,000	74,400	yes
Czech Republic	126	5,420,511	43,020	yes
Bulgaria***	130	4,601,627	35,397	yes
Romania	295	8,551,158	28,987	yes

* Data for Slovenia on revenue and number of employees was not available at the time of writing this paper.
** Total number of employees includes the employees in the expert staff of the Commission, as well as the other administrative staff (Commission's complete payroll)
*** Data for Bulgaria regarding the revenue amount for 2010 is not available, so data for 2011 was used, with an assumption that the amount of revenue did not change considerably, since the Bulgarian Commission is financed from the state budget. In that sense, the authors bear full responsibility for any possible bias of revenue per employee data shown in the table.
Source: Official reports on the commissions' operations are available on their web pages (See: http://www.kzk.org.rs, http://www.aztn.hr, http://www.gvh.hu, http://www.compet.cz/en, http://www.cpc.bg, http://www.consiliulconcurentei.ro)

Graph 1 Revenue per employee compared to the average



According to Table 2 and its illustration in Graph 1, it is evident that Serbia's Commission revenue in absolute amount is significantly lower than revenues in other countries', which refers to total number of employees as well. Having in mind that only Serbian Commission does not have state aid control in its jurisdiction, which is not the case with other selected countries, it is to be expected that that is the reason it is generating lower revenue, as well as employing less people. Based on the revenue per employee data, it is evident that, compared to other countries, Serbia is just below the average (46,087 EUR) of this group of countries.[11]

According to the reports of the RS Commission for Protection of Competition for the last two years (2010 and 2011), it turns out that the Commission in both observed years realised a surplus that was sent to the state budget. It can be thus concluded that through the collection of fees, the Commission managed to secure enough funds to finance its own activities, even beyond its total expenditures, which is also proven by the relatively satisfactory level of revenue per employee compared to the observed group of countries. We should also keep in mind that in Serbia's case, the revenue was generated almost predominantly through the collection of concentration notifications, while other countries' revenues predominantly rely on the state budget.

In addition, the increased exposure of the Commission to the risk of unhindered financing is affected by Article 57 of LPC. This article foresees all financial measures that serve for elimination of the competition violation that the Commission should determine and impose on companies, to be paid into the state budget account. If, however, there is a subsequent abolition or reduction in the imposed measure, the funds are paid out of the state budget only up to the amount of the paid nominal fee, while the cost of interest and other expenses are born by the Commission. The Commission's obligation to compensate for the interest and other expenses exposes the Commission to a significant financial risk. Since it is unable to foresee its own revenue, this potentially prevents the Commission from planning and projecting its own expenses, because it is up to the relevant courts to decide whether or not Commission's decisions will be reversed, which would reduce or annul the imposed measures and the Commission would bear the cost of interest and other expenses related to that transaction.

In general, we propose two options as possible solutions for the implementation of Recommendation 1.

The first option, as in the case of focus countries but also the majority of other European countries not covered by this comparative analysis, foresees securing enough funds from the budget to finance the Commission. The Commission would still charge fees, but in such a way that the amount of those funds is far lower than the funds allocated by the

11 Serbia is included in the group's average.

Republic of Serbia state budget. This way of financing would enable changing the existing Tariff Book, which would primarily reduce the fees for concentration notification. Therefore, this form of company's external growth would become less costly, having in mind that all fees that exceed the cost of providing services have a quasi-fiscal character with a strong distorting effect.[12] The plan for financing the Commission the Government should formulate based on a three-year plan of activities, where the Commission would make a detailed specification of costs for three years in advance, taking into account necessary human and financial resources that are needed for the full enforcement of LPC. Also, the funds allocated to the financing of the Commission should be made an integral part of the budget of the Ministry responsible for trade[13].

Application of this measure would require changes to the existing LPC, i.e. the article regarding the way of financing the Commission (Article 31), which should clearly state which amount of the Commission's expenses is covered by the state budget. This Commission financing option should not jeopardise its independence. In other words, the law should eliminate any possibility of the Government influencing the Commission's plan of activities and their cost specification.

The second option refers to the possibility of providing the Commission with an opportunity to create reserves in case of a realised surplus, from which the Commission would be able, in lack of state budget support, to offset the deficit created in particular years, which would provide a much more stable and predictable financing. The realisation of this measure would require changes to the already mentioned Article 32 of LPC in the part where it foresees the surplus funds to be paid into the state budget. Compared to the possibility of state budget financing, the option of creating reserves could be considered as the second best option.

Naturally, changes to the disputable Article 57 of LPC and abolishing the Commission's obligation to compensate for interest and other costs related to abolishing and reduction of imposed measures by the Administrative Court, should certainly be made, regardless of the financing option that would be selected.

Recommendation 1 should be reviewed by the Commission, the Government and finally the Parliament. The Commission should start an initiative for redefining the means of financing and open a dialogue with the Government, since the existing way of financing is inadequate for the full enforcement of LPC.

2.2. Recommendation 2 (Commission's Organisational Structure and Capacity)

In order for the Commission to do the test procedures prescribed by the Law, it has to optimise its organisational structure and increase its human and therefore professional capacities. That would entail creating new jobs for legal and economic experts specialised in the field of protection of competition, but also for Information and Communication Technology (ICT) experts.

2.2.1. Rationale and Way of Implementing Recommendation 2

Right of competition is specific because its implementation often requires getting into a complex economic analysis, which certainly exceeds the possibility of full legal codification of this area. Combination of law and economy is an essential link in solving the cases in the field of protection of competition, which requires experts of special profiles from the field of law and economy, who would be permanently employed in the Commission.

In addition to the quantity of human resources for implementing the LPC, it is necessary to provide a specific structure of professional profiles of the employees. It is our conclusion that despite the significant progress made in the six years of Commission's operations, its current organisational and personnel structure cannot be considered satisfactory.

We will begin by reviewing the quantitative dimension of human resources that the Serbian Commission has by observing them relative to the number of cases that a regulator faces in a year, and then comparing that data to that of Croatia and the Czech Republic. For comparative reasons, we will focus on the number of employees in three key sectors (Concentration control; Competition violation – cartel behaviour and abuse of dominant position in the market; and Sector analyses), but also on the number of cases that these departments handle in a year. These are key departments for the implementation of competition policy.

12 According to UNCTAD (2011), it is estimated that a reduction of concentration notification fees should be by 50%, which would bring them down to European standards, meaning that at least 80% of revenue would be generated from the state budget.
13 In the current nomenclature of the ministries, the Ministry in charge of trade is named "Ministry of Foreign and Internal Trade and Telecommunications".

Table 3 Structure of cases and employees of three comparative commissions for the protection of competition

Countries		Data	2010	2011
Serbia	Cases (C)***	1(C) Concentration	67	106
		2(C) Competition violation	15	12
		3(C) Se ctor analyses	3	3
		Total 1-3(C)	**85**	**121**
	Employees (E)	1(E) Concentration	5	6
		2(E) Competition violation	7	7
		3(E) Economic analyses	2	3
		Total 1-3 (E)	**14**	**16**
	Relative values	1(C)/1(E)	13.40	17.67
		1-3(C)/1 -3(E)	6.07	7.56
Croatia*	Cases (C)***	1(C) Concentration	15	12
		2(C) Competition violation	2	7
		3(C) Sector analyses	3	2
		Total 1-3(C)	**20**	**21**
	Employees (E)	1(E) Concentration	8	11
		2(E) Competition violation	4	6
		3(E) Economic analyses	3	4
		Total 1-3 (E)	**15**	**21**
	Relative values	1(C)/1(E)	1.88	1.09
		1-3(C)/1 -3(E)	1.33	1.00
Czech Republic**	Cases (C)***	1(C) Concentration	45	
		2(C) Competition violation	1	
		3(C) Sector analyses	1	
		Total 1-3(C)	**47**	
	Employees (E)	1(E) Concentration	31	
		2(E) Competition violation	33	
		3(E) Economic analyses	16	
		Total 1-3 (E)	**80**	
	Relative values	1(C)/1(E)	1.45	
		1-3(C)/1 -3(E)	0.59	

* 2011 data for Croatia on the number of employees per sector was not available, so an approximation was done based on the 2010 data. In the observed three sectors, the number of employees was proportionally increased in relation to the percentage of the total increase of employees engaged in data processing (from 32 to 44 employees).
** At the time of writing this paper, 2011 data for the Czech Republic was not available.
*** The table shows the total number of registered concentrations in the year. This number includes closed cases in that year, as well as cases that are in progress and that are transferred to the next year.
Source: Official reports on the commissions' work are available on their websites (See: http://www.kzk.org.rs, http://www.aztn.hr, http://www.compet.cz/en)

Based on this table, it is evident that in both observed years, Serbian Commission for Protection of Competition had less employees than Croatia, while the difference with the Czech Republic is particularly prominent. However, if we look at the total number of cases, we would see that the situation is quite different. Thanks to a large number of concentration cases in both observed years, the Serbian Commission has almost 6 times more cases in 2010 compared to the Croatian and slightly more cases compared to the Czech Commission. Consequently, this disproportion is reflected in the relative value of the number of cases per employee as well, which best demonstrates the insufficient professional capacity of the Serbian Commission to process cases that are in its jurisdiction.

Number of cases per employees in the concentration control sector especially demonstrates how overburdened the regulatory body is 1(C)/1(E), since the concentration control (company mergers, acquisitions) is analytically the most complex. The 2010 value for Serbia is 13.40, for Croatia 1.88, and for the Czech Republic 1.45. Based on these values, it turns out that the concentration control sector of the Serbian Commission was over 7 times more overloaded with cases than the Croatian Commission, and over 9 times more than the Czech Commission. Comparing Serbia and Croatia for 2011, the focused ratio becomes even more unfavourable for Serbia (over 16 times), primarily due to a major increase in the number of reported concentrations and a minor increase of the concentration control department capacities in Serbia.

By weighting the total number of cases in the stated sectors against the total number of employees in those sectors, 1-3(C)/1-3(E), local Commission's overload can also be observed. In 2010, the case load of one employee compared to Croatia was 4.5 time higher, while compared to the Czech Republic it was over 10 times higher. In that sense, we could expect several times higher productivity of local experts in case processing. Since that is not the case, below we will see how the problem of case overload can be resolved when the local regulator is concerned. For now, it is sufficient to ascertain that there is a significant disproportion between the number of employees and the number of cases they need to process.

In order to reduce this relationship to the standards comparable to European countries, which are obviously lower, it is necessary to increase the number of experts in the Commission, but also to reduce the number of cases, and especially the number of reported concentrations. The professional capacity of the Commission's Expert Department should be strengthened when it comes to case processing. For example, in order to be at the same level as Croatia, it is necessary to increase employee capacity on case processing at least 30% (up to 6 employees). This percentage could be even higher if we take into account that Croatia's internal market is smaller than Serbia's (see Table 1), which also

means a lower scope of activities from the Commission's jurisdiction and, therefore, a lower need for professional staff.[14]

At the same time, in strengthening the expert capacity, special attention should be given to the structure of expert profiles that are being hired, since it is important to have a relatively balanced ratio of legal and economic experts, which is also proven by the experience of countries that Serbia is being compared to in this study. In Serbia, there is a significant dominance of legal experts over economic ones, a disproportion that should be remedied in the future.

Observing the organisational chart of the Commission, it can be observed that it lacks the "Chief Economist" position, which exists for example in Hungary and Croatia, but also at the supranational level of competition protection in the EU, within DG COMP. The role of the Chief Economist is to monitor and control all economic analyses that the Commission would perform, and to form methodology and procedures that the Commission should follow when implementing test procedures that require economic analysis. The Commission Council should respect the opinion of the Chief Economist in cases where economic argumentation is used in the process of proving potential or expressed violation of competition. For example, within DG COMP, the Chief Economist has the right to form his/her own team of economic experts. What we are suggesting is that the opinion of the Chief Economist when selecting economic experts for the work at the Commission should play a major role. When we talk about the position of Chief Economist, a question arises as to what kind of expert profile we are talking about.

When choosing the Chief Economist, it is preferable that the candidate holds the highest academic qualification from the field of economy, PhD in Economic Science and particularly in the field of protection of competition. An expert who should be specialised in game theory and industrial organisation, and within that field, in the protection of competition, which would mean the candidate is an author of a large number of scientific papers from the field, or that he/she has been working for at least 10 years in a developed foreign commission on cases of economic content. Application of econometric tools in the field of protection of competition, as an indispensable factor of test procedures where economic approach is used, should also be part of the knowledge that the Chief Economist brings into the Commission for Protection of Competition. Certainly, the Chief Economist should be a figure that possesses the biggest economic knowledge within the Commission and, therefore, the respectable authority even when the Commission's Council is concerned, in all economic matters on which the Commission is deciding. Also, it is only logical to place the responsibility of forming the economic team of the Commission's Expert Department on the Chief Economist.

That is why the position of the Chief Economist should be defined by Law, which would clarify the qualifications needed for his/her selection. The selection should be done through a public call, through which the best suitable candidate would be chosen. A problem that could ensue regarding this position refers to the possibility of the local Commission financing it, which would currently not be enough for an expert of such a high profile. High fluctuation in the position of Chief Economist is something that should be avoided at all cost, which is impossible to do in a system of compensation and award that is currently implemented at the Commission, which we have already discussed in Recommendation 1.

The Chief Economist position is all the more important to the local Commission if we have in mind that most of the personnel in the Expert Department is of a legal profession, and that the current Commission's Council has five members, all five being legal experts. This last fact about the structure of the Council is particularly disconcerting if we take into account that this is the area of regulation that requires both legal and economic experts. According to that logic, the structure of the Council should be mixed. Let us note that the previous Council could have been considered somewhat mixed, but it was almost entirely replaced after the end of its term. The practice of replacing all members of the Council at the end of the term should be avoided, unless there are objective reasons foreseen by the LPC. In order to enable continuity in work and accumulation of knowledge, and therefore efficiency and effectiveness of the Commission's work, as well as its independence, the Parliament, i.e. the Government should follow the principle where the Commission's Council or at least most of its members would remain in their positions for at least two terms, which the Law does allow.

Discontinuity every five years, connected to the loss of time needed for the new Council to get up to speed, is something that a responsible state that understands the effect of competition on the wellbeing of its citizens should avoid. This practice is standard in most of the EU countries.

14 According to the 2011 regular annual report of the Commission for the Protection of Competition, the total number of employees in the Expert Department should be increased from the current 31 to 54. Respecting the current propotion in the number of employees, it would mean that the number of employees working on cases should increase from the current 20 to 35, which is certainly above 30%. This scenario of increasing the number of employees could be characterised as quite optimistic having in mind the current Commission's revenue with the current system of generating that same revenue.

In the context of the previous discussion on the Commission's Council, we feel that Article 23 of LPC, which refers to the selection of Commission's bodies (President of the Commission and members of the Council) should be changed soon. This article provides for the Council members to be both lawyers and economists, but it does not limit the extreme situations of having solely lawyers or solely economists in the Council. The amendment of Article 23 should eliminate the possibility of extreme solutions. Also, the principles of selecting Council members should be changed as well in order to choose experts whose business careers are tightly tied to law and economy of competition. When it comes to economists, similar principles should be applied as in the case of selecting the Chief Economist, while when it comes to lawyers, people with highest academic qualifications should be selected, whose scientific and professional orientation are related to competition law. If, however, members outside the academic community are selected and without the highest academic qualifications, this can be done exclusively for the candidates who have acquired long years of experience (at least 10) in one of the respectable foreign commissions for protection of competition. Those candidates can be considered professionals in the field of competition protection due to their narrow speciality.

Finally, in the era of rapid development of information and communication technologies, the Commission has to consider hiring experts in this field as well, who are primarily needed for the investigations into cartel agreements. In order to identify a cartel agreement, any proof of its existence can help the Commission solve the case. So, for example, gathering evidence during an unannounced inspection foreseen by Article 53 of LPC, includes collecting data from computer memories from the offices of the companies that are being investigated, but also from physically remote machines that are connected to the company via communication networks. The collected copies of electronic memories are subject to further forensics at the Commission's headquarters with the aim of finding company's correspondence with other market players, which could serve as evidence of illegal cartel agreements. The role of IT experts in this process is indispensable. According to the UNCTAD 2011 analysis, it is stated that the right measure for strengthening IT capacities of the Serbian Commission would be hiring 2 additional experts in this field.

Recommendation 2 should be reviewed by the Commission, the Government, and the Parliament in the segment related to the changes to CPL in order to strengthen the quality of the personnel structure and systematise new positions, such as the one of the Chief Economist. The pre-condition of implementing this recommendation is the implementation of Recommendation 1.

2.3. Recommendation 3 (Reduction in Number of Concentration Cases)

With the aim of reducing the load of the Commission for the Protection of Competition so that the Commission would be able to focus on more important cases for the conditions of competition in partial markets of the Republic of Serbia, it is necessary to reduce the number of reported concentrations.

2.3.1. Rationale and Way of Implementing Recommendation 3

Unnecessarily large number of concentrations (see Table 3) is the result of the fact that prescribed thresholds for reporting concentrations are set too low (Article 61 of LPC), so a large number of minor concentrations fall under the obligation of notification. Low threshold orientation can be explained by the fact that concentration fees represent generous revenue for the Commission and are an essential part of its budget.[15]

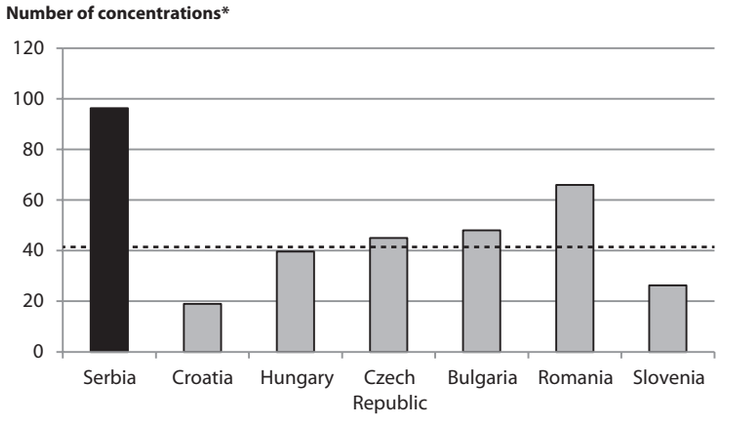
The following graph shows average number of concentrations based on the three last annual reports of regulatory bodies of Serbia and focus group countries.

With an average of 96.33 concentrations a year, Serbia leads significantly compared to the values of observed countries. Dashed horizontal line in Graph 2 shows the average number of concentrations for all stated countries except Serbia (40.67), which Serbia also exceeds by far.

Overload of the Commission by concentrations, out of the need to secure sufficient revenue, forces it to approve most of the cases by simplified procedure, meaning without detailed economic analysis of market structures in which the subjects of the concentration in question operate, which is enabled by Article 37 of LPC. In such circumstances, when the Commission is forced to apply the "rule of thumb", without the accompanying quantitative analysis, in order to approve concentrations, the so-called false positives are significantly increased to approve a concentration that will eventually jeopardise the conditions of competition. In 2011, out of 100 finalised cases, only two were resolved

15 Within Recommendation 1, it was stated that the amounts of fees for local concentrations are among the highest, comparing that amount to EU countries.

Graph 2 Number of reported concentrations (three-year average)



* In the absence of data for Hungary and Slovenia for 2011 regarding the number of reported concentrations, the average value was formed based on the period 2008-2010, while in other countries the average was formed based on the period 2009-2011.
Source: Official reports on the commissions' work are available on their websites (See: http://www.kzk.org.rs, http://www.aztn.hr, http://www.gvh.hu, http://www.compet.cz/en, http://www.cpc.bg, http://www.consiliulconcurentei.ro, http://www.uvk.gov.si/en)

through test procedure (2% of the total number). As an example, compared to Croatia and Czech Republic, this is evidently a too low percentage (10% and 50% respectively).

The damage of such a low threshold for obligated reporting of concentration, and therefore an overly large number of concentrations, is twofold. On the one hand, the Commission is overloaded with cases of minor significance for competition conditions, thus losing the possibility to focus on more significant concentrations that bear a high risk of endangering the free market competition. On the other hand, many companies whose concentrations are of minor importance are faced with an obligation to report the concentration, which increases the uncertainty in planning such a business venture, delays its realisation and increases its cost. By imposing on them the obligation of paying fees, the companies' economic costs of doing business are increased as well.

Implementation of Recommendation 3 should lead to a reduction in the average number of concentrations up to 50%, which would bring Serbia closer to the average of the focus group countries. In order to realise this reduction, it is necessary to raise the threshold of obligated concentration reporting at least to the average level prescribed by comparative European countries. This would also mean changing Article 61 of LPC. With the aim of demonstrating the disproportion in the level of thresholds (Serbia vs. focus group of countries), Table 4 shows one of the threshold components - "Realised revenue of each of at least two participants on the country's territory" - which is comparable at the level of the group countries covered by this analysis, including Serbia.

According to Table 4 it is evident that aside from Slovenia, all other countries have their thresholds set at a significantly higher level, and in certain cases it is several times higher than in Serbia. As an example, Croatia and Hungary have over 10 times higher thresholds than Serbia. The solution we suggest, when it comes to Serbia, is to do an approximation of local thresholds to the average of the focus group. According to one scenario that includes in the average all stated countries except Serbia, the thresholds should be raised over 5 times. According to another, milder and therefore more realistic scenario, where the averages exclude Serbia, Hungary and Croatia as extreme examples, the thresholds should be raised by around 100%.

Table 4 Threshold for obligated reporting of concentration

Countries and averages	Achieved revenues of at least two participants in the territory
Serbia	1,000,000
Croatia*	13,326,395
Hungary*	1,795,848
Czech Republic*	10,050,251
Bulgaria*	1,533,876
Romania	4,000,000
Slovenia	1,000,000
Average (without Serbia)	5,284,395
Average (without Serbia, Croatia and Czech Republic)	2,082,431

* Amounts stated in the law, since they were given in the local currencies of the countries, have been converted to EUR according to the official middle exchange rate of the central banks of those countries on 16.10.2012.
Source: Laws on Protection of Competition of the covered countries

Recommendation 3 is intended, much as the previous two recommendations that require changes to the LPC in certain segments, for the Commission, the Government and the Parliament. It should be stressed that a prerequisite for its realisation is the implementation of Recommendation 1, which refers to redefining the system of financing of the Commission.

3. Recommendations Whose Implementation Does Not Require Changes in Legislation

Implementation of the following recommendations does not require changes to the Law on Protection of Competition and the accompanying by-laws. The dominant factor and initiator of their implementation will turn out to be, among others, the Commission for Protection of Competition.

3.1. Recommendation 4 (Development of the "Guidelines" by the Commission)

In order to increase transparency of the Commission's actions in the cases it processes, and here we primarily mean the cases of company concentrations and abuse of the dominant market position, it is necessary for the Commission to develop Guidelines, which will include practical aspects of the Commission's actions in enforcing the Law. Increased transparency would have a positive effect on the increase of legal certainty in business planning of companies, which is a deficit category in competition law. In that sense, it is essential to create guidelines for the regulation of horizontal mergers of companies and for defining relevant markets, whose presence is a common trait of most of the developed systems for the protection of competition.

3.1.1. Rationale and Way of Implementing Recommendation 4

In addition to the Law and by-laws, the regulation also includes guidelines prescribed by the Commission, which do not have the legal weight of law and regulations, but have a significant role in the functioning of the system for protection of competition. The guidelines define the practical actions of the Commission in the test procedures it performs.

In developed systems of protection of competition, meaning primarily the supranational systems of EU and USA, the role of the guidelines is considered crucial. The guidelines represent a description of practical actions of the Commission in the test procedures it performs[16], for which there is no room in official laws and by-laws that regulate the competition law. Prescription of guidelines by the Commission raises the level of legal certainty in business operations of companies that could come under the Commission's scrutiny, but they also help better understanding of this issue by the courts that are ruling on companies' appeals on the Commission's decisions.

Defining of relevant markets, foreseen by Article 6 of LPC and relevant by-law[17] additionally explaining this article, represents a key step in regulating the horizontal mergers of companies (concentrations) and in determining the dominant market position of a company and a possibility of its abuse. The road to a definition includes primarily the application of quantitative economic-econometric tools and principles of definitions, based on which these are implemented. According to the mentioned article of the Law and the by-law that gives a precise definition of the relevant market, it is impossible to understand what are the definition's criteria and how to define its limits. One of the possible principles of the definition, which is widely applied and has many implementation modalities, is the co-called "Hypothetical Monopolist Test", which should be considered when creating the guidelines.

Please note that the basic problem of the imprecise definition lies in the too broad definition of the market, which carries the danger of diminishing the importance that a particular business endeavour has on the conditions of competition and thus approving it, even though it leads or eventually will lead to violation of competition rules. In a situation where the market is too narrowly defined, it could lead to increased probability of unjustified prohibition of particular business venture, which damages the observed companies, but also the conditions of competition in the industry in which those companies are operating.

Commission's actions in the test procedures regarding horizontal company mergers (concentrations) should also be codified by guidelines, which until now has not been done. The mere interpretation of the current Law does not clarify how the Commission performs the test procedures. Creating guidelines for horizontal mergers would increase the possibility of companies' planning their external growth, i.e. estimating whether or not their venture is in line with the Law. Such guidelines would have to contain a simple quantitative test of concentration, which would be based on the Herfindahl-Hirschman Index. This test offers an extremely useful preliminary indication of potential effects of a concentration on the conditions of competition on the determined relevant market. The test should be aligned with the prevailing levels of concentration on the local markets, in order to achieve optimal restrictiveness

16 Article 41 of CPL defines the test procedure term as evidentiary action directed towards determining the facts.
17 *RS Official Gazette*, issue 89/2009.

in its implementation. In the majority of test procedures performed by the Commission in the field of concentration control, this quantitative test has been applied, so its formalisation within the guidelines will not be difficult.

In creating the guidelines, in addition to its own experiences in enforcing the LPC, the Commission should also take into account the current guidelines of the EU[18] and USA[19] (at supranational level), but also the guidelines of comparative EU member states that have a longer experience in implementing the competition policy than Serbia.

Recommendation 4 is intended exclusively for the Commission for Protection of Competition, because prescription of guidelines is entirely in its jurisdiction. However, until Commission's economic team is formed, including its Chief Economist (foreseen by the implementation of the Recommendation 2), we feel that the proper implementation of this endeavour is not completely feasible.

3.2. Recommendation 5 (Training of Administrative Court Judges on Economics)

In order to improve understanding of competition policy in the area that involves economic-econometric argumentation in proving violation or potential violation of competition, it is necessary to train the Administrative Court judges.

3.2.1. Rationale and Way of Implementing Recommendation 5

Direct control of final decisions of the Commission, pursuant to Article 71 of LPC, is under the jurisdiction of the Administrative Court.[20] So, all possible appeals of companies on the Commission's final decisions are sent for review to the Administrative Court. The Administrative Court has a possibility of confirming the Commission's decision, annulling it or ordering the Commission to repeat the test procedure. The last two possibilities entail the Administrative Court, as an independent body, not agreeing with reached decisions, which means that the Court is competent to understand the argumentation expressed in the Commission's final decision. Difficulties occur mostly when economic argumentation is in question. This issue is not exclusively characteristic of the local system of protection of competition, but also of systems with a much longer tradition. As a rule, systems where commissions are weak and underdeveloped, the courts are at least slightly inferior in understanding these issues. Lack of courts' understanding is especially expressed in cases of concentration control and abuse of dominant market position, where problems occur already at the beginning, in defining relevant markets. Hence the necessity to prescribe the abovementioned guidelines for defining relevant markets (see Recommendation 4).

Parallel to strengthening the professional capacities of the Commission, it is necessary to strengthen the professional capacities of the Administrative Court as well, through permanent education of judges in charge of cases in the field of protection of competition. Acquiring the necessary economic knowledge in the field of industrial organisation theory and econometrics is necessary for the functioning of the Administrative Court in this field. Certainly, it cannot be expected that an Administrative Court judge would get into this kind of economic issues with the precision level and understanding of a specialised Commission, but the judges can be enabled to understand the logic behind the economic argumentation in the Commission's decisions, as well as that of the party submitting the appeal.[21] The Court should be able to rule whose argumentation reflects reality, because absolutely correct solutions cannot be expected in this area of regulation.

In its six-year long history, the Commission has had various experiences with the relevant courts. The point is that most of the major cases handled by the Commission have never been confirmed by the courts (e.g. Delta's concentration in 2006). Last in the series of major cases where Commission's negative decision was overruled by the court refers to the concentration of the Serbian sugar producer "Sunoko" with Greek company "*Hellenic Sugar Industry*". Regarding this decision, the Commission addressed the public with the text entitled "Why Does the Administrative Court Ignore the Public?"[22]

18 For guidelines on defining relevant markets see *Official Journal of the European Union* (OJ C 372) and for Guidelines on the regulation of horizontal mergers see *Official Journal of the European Union* (2004/C 31/03).

19 See Federal Trade Commission and U.S. Department of Justice (2010), *Horizontal Merger Guidelines*.

20 At the highest instance, the decision of the Administrative Court could be overruled by the Supreme Court of Cassation, but in practice, this is quite rare.

21 In addition to appeals to the decision of the Commission for Protection of Competition, the Administrative Court is also in charge of lawsuits against 54 institutions of the government, local self-government, public companies and other government agencies. This demonstrates the case load of Administrative Court judges of various content, and how limited the Court's capacities are when it comes to the protection of competition, which requires much more dedication and expertise in the deliberations before the court.

22 See: http://www.kzk.org.rs/zasto-upravni-sud-ignorise-javnost

Table 5 Cases handled by the relevant court

Countries	Proceedings before the Court	2010	2011
Serbia	Affirmed decisions (of the Commission)	6	17
	Annulled desions (of the Commission)	1	3
	Total	7	20
Croatia	Affirmed decisions (of the Commission)	19	9
	Annulled decions (of the Commission)	0	1
	Total	19	10

Source: Official reports on the commissions' work are available on their websites (See: http://www.kzk.org.rs, http://www.aztn.hr)

Comparing Serbia and Croatia (Table 5), out of the total of 27 Commission's decisions that ended up in court in the period 2010-2011, the Court has annulled Commission's decisions in 4 cases, while in Croatia in the same period only one decision was annulled out of a total of 29 that ended up in court. In principle, numbers in this case bear little significance if we take into account that the cases are not equally important when it comes to competition. In certain cases, wrong decisions could cause significant consequences when it comes to consumer surplus and negatively affect almost entire decade on the market where certain actions occurred in violation of rules of competition.

In addition to permanent education of Administrative Court judges on economic issues in competition, we feel that competition, as highly complex area, deserves establishment of a special department of judges specialised in cases from this domain.

Recommendation 5 is intended for the Administrative Court and the Government, who should make joint effort to find a way of strengthening the professional capacities of the courts in this area. For education of judges, it is necessary to allocate certain financial funds from the state budget, which is significantly less compared to consequences of just one wrong decision of the court. In EU accession funds, there are funds designated for the capacity building in the area of competition protection. Parallel to Serbia's accession to EU, it is necessary to realise in time the significance of competition for the economic growth and development, and living standard of the population, and therefore, possibilities to use those funds in the best way.

In addition to courts, in a wider scope of the system for the promotion and protection of competition, the Government, i.e. the Ministry in charge of trade should fully understand the importance of competition and support the independence of the Commission and the Administrative Court, and understand the need for strengthening professional capacities of these bodies. The Ministry should also form a special working group that would deal with issues of the functioning of the system of promotion and protection of competition, since this Ministry is responsible for establishing the basic government strategy for strengthening the competition on domestic partial markets.

3.3. Recommendation 6 (Commission's Cooperation with Other Elements of the System for Promotion and Protection of Competition)

In order to increase the efficiency of the system of protection of competition, it is necessary to strengthen the communication and cooperation between the Commission for Protection of Competition and institutions that, in addition to the Government and the courts, comprise the system of promotion and protection of competition in a wider sense. By other bodies, we mean all specific sector regulators, but also the bodies for the control of public procurement and state aid, as well as the consumer protection associations.

3.3.1. Rationale and Ways of Implementing Recommendation 6

When we say specific sector regulators, we mean the National Bank of Serbia (NBS), Republic Broadcasting Agency, Stock Exchange Commission, Energy Agency of the Republic of Serbia, and Republic Agency for Electronic Communications (RATEL).[23] Institutional cooperation of the Commission with sector regulators is key to efficient implementation of LPC in the sectors that are in these regulators' jurisdictions. Sector regulators, whose operations are defined by specific laws, should also take care if the functioning of their sectors is in line with Law on Protection of Competition. When this is not the case, sector regulators should notify the Commission for Protection of Competition about the circumstances. On the other hand, many activities of sector regulators within the industry that is subject to regulation could have direct effect on other connected industries, i.e. on other connected markets. Therefore, orchestrated operation of the Commission and sector regulators is an important factor in functioning of the system for the promotion and protection of competition. For example, the Stock Exchange Commission should

23 Civil Aviation Directorate of the Republic of Serbia is also part of the sector regulators. Given that the activities of this regulator are not essential to the application of the Competition Protection Law, it was left out of the list.

notify the Commission of each change of ownership in companies through their merger by purchase of shares of one company by the other, and also warn the parties in the concentration that they need to report their intent to the Commission (Articles 61 and 63 of LPC).

In order for the connection between sector regulators and the Commission to strengthen, it is necessary for the Commission to sign a protocol of mutual cooperation with all the stated regulators, with firm commitment from both sides to fully respect these protocols. So far, protocols of cooperation have been signed with the National Bank of Serbia, Energy Agency, and RATEL. So there are two remaining protocols to be signed in the future. The insistence on signing and implementing the protocols should be initiated by both the Commission and the sector regulators.

In most of European countries, even those that served to us for comparative analysis, the control of the state aid is integrated in current activities of their commissions for protection of competition (shown in Table 2). Also, it is not rare to put the control of public procurement in developed market economies within the scope of the commissions for protection of competition, as is the case in Czech Republic and Slovenia. In Serbia, these activities are performed by special regulatory bodies – for public procurement, we have the Public Procurement Office, and for the control of state aid, there is the Commission for State Aid Control. Both of these areas are regulated by special laws – Law on State Aid Control[24] and Law on Public Procurement[25]. The goals of both these laws almost entirely coincide with the Law on Protection of Competition, which makes their implementation perfectly complementary.

Obviously any attempt to rig a tender procedure presents a direct attempt to eliminate competition between business subjects, tender participants. The importance of public procurement is even bigger if we consider that public procurement makes on average 16.7% of GDP of EU member states, while that percentage is higher in the Balkan countries.[26] Having in mind this fact, as well as the fact that efficient control of public procurement could save up to 30% of public spending, makes it clear how competition protection in this area could have positive effects on the state budget and efficient business operations of suppliers, tender participants.

In order to have a more efficient control of public procurement, a tighter institutional connection is needed between the Commission, as the most competent body for the protection of competition, and Public Procurement Office, as the body in charge of organising and ensuring functioning of the process of public procurement.

State aid control is essential when it comes to conditions of competition. In general, every state aid has a potential of favouring certain market participants, thus putting the others in an unfavourable position. Such government behaviour jeopardises the conditions of competition in the market, but cannot be avoided in some cases. The regulators role in this field is to decide which state aid could be considered allowed and which could not. Large scope of government activities in this field is characteristic for Serbia, hence the big interest of EU to make Serbia reduce this issue to an acceptable level. Currently, the biggest problem of regulating this field is the fact that the Commission for State Aid Control does not have the necessary level of independence, since it is under the patronage of the Ministry of Finance and Economy. Let us note that it is somewhat of a paradox to have the Commission for State Aid Control under the jurisdiction of the Ministry of Finance and Economy, which is a direct donor of state aid. On the other hand, the role of the Commission for Protection of Competition is minor when it comes to the functioning of the Commission for State Aid Control. The only role the Commission for Protection of Competition has is to send a proposal for the selection of one member of the Council of the Commission for State Aid Control, which is not enough for an efficient cooperation of these two bodies on implementing the laws whose goals are identical.

Whether we are talking about state aid or public procurement, one of the solutions for these problems includes a closer cooperation of the Commission for Protection of Competition and relevant regulatory bodies that we mentioned. The other solution would be to put the control of public procurement and state aid under the jurisdiction of Commission for Protection of Competition, which would probably be the most efficient solution when it comes to protection of competition. This last solution certainly would not be possible with current capacities of the Commission for Protection of Competition.

The Law on Consumer Protection[27] has been in effect in Serbia since the beginning of 2011, and it protects the rights of consumers from unscrupulous producers and retailers. This area of law could be considered complementary to the area of protection of competition that the Commission is implementing. Formal regulatory body for enforcing this

24 *RS Official Gazette*, 51/2009.
25 *RS Official Gazette*, 116/2008.
26 UNCTAD (2011), p. 85.
27 *RS Official Gazette*, 73/2010.

law does not exist. The role of the regulator is performed by non-government associations for consumer protection, whose role comes down to sending public appeals when consumer rights are jeopardised. Cooperation between the Commission and these associations could be reflected in a desire to impose issues of importance through joint public appearances when the protection of competition and therefore protection of consumers is at stake.

Recommendation 6 is directed towards the Commission for Protection of Competition, the Government, stated sector regulators, agencies for the control of state aid and public procurement, as well as consumer associations.

3.4. Recommendation 7 (Increasing the Transparency of the Importance of Competition Protection)

Commission and the Government have to put in extra effort to make the importance of protection of competition transparent and understandable to the general public. Public pressure, when protection of competition is concerned, can be a powerful ally to the Commission, so it needs to work on raising public awareness on importance of competition.

3.4.1. Rationale and Ways of Implementing Recommendation 7

As stated in UNCTAD (2011), work on competition advocacy in any country is a never-ending job. Serbia is only at the beginning of this work, since the public is very poorly informed about issues related to the protection of competition. Competition advocacy would demystify the way market games work, which would eliminate public doubt about enforcing the Law and would increase the certainty of doing business.

In implementing this recommendation, Commission's engagement in the field of promoting the results of realised activities over the year would be necessary, because if they are not promoted, an impression is created that the Commission is not doing anything in this area. Regular highlighting of important decisions and events of the Commission has to be transparently placed on the Commission's website, which it is already doing, and also to all relevant media (print and electronic). For these purposes, it would be desirable if the Commission would have at least one person within the Commission permanently doing the so-called public relations (PR). Presence of the Commission's President in the media is also the key to good public promotion of Commission's results.

Recommendation 7 is intended for the Commission for Protection of Competition and the Government.

4. Instead of the Conclusion

Implementation of the recommendations given in this study should improve the functioning of the core system of protection of competition, which is a necessary condition for the system as a whole to work. The recommendations are a connected system of actions that should be done in the "short" mid-term (3-4 years), so that the system of promotion and protection of competition in Serbia would start functioning as the comparative systems with longer traditions and considerable results in the field. The Commission should make sure the implementation of certain recommendations are a prerequisite for the implementation of others. This primarily refers to Recommendation 1, whose adoption solves the chronic problem of unstable Commission's finances.

The paper proposes 7 relatively complex recommendations, which are divided into two homogenous groups, depending on whether their implementation requires changing the Competition Protection Law or not. The paper proposes possible ways of securing stable, predictable and sufficient sources of funding for the Commission, which would turn out to be one of the main conditions of its independence and of forming optimal personnel structure necessary for the enforcement of all elements of the Law. In order to reduce Commission's case overload with cases of minor importance to conditions of competition, it was suggested that a considerable reduction in the number of reported concentrations in a year be reduced by adequate raising of the legal threshold for the obligation of reporting concentrations.

In the section with recommendations that do not require changes in legislation, it was proposed that the Commission prescribes guidelines in the domain of defining relevant markets and concentration control. The guidelines would describe Commission's actions in defining relevant markets and in controlling concentrations, which would reduce the legal uncertainty that accompanies these economic categories of the Law on Protection of Competition.

Training of Administrative Court judges on understanding economic issues in this field was also listed as an extremely important element of implementing the Law, since non-specialised judicial review of Commission's decisions could bring more harm than good when it comes to the benefit of competition.

The recommendations have also covered the cooperation of the Commission with other government and non-government bodies that comprise the system of promotion and protection of competition in a wider sense, as well as the significance of promoting the importance of competition to the general public. The central role in these activities has the independent Commission for Protection of Competition.

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