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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

Tendencies from the beginning of the year continue in the second quarter as well. Economic activity makes slow growth, which will be between 1.5% and 2% on an annual level, the inflation is slowing down and will probably be 4-5%by the end of the year,while the current deficit is also on the decline and will be 6-7% of GDP in 2013. Most of the economy is still in recession, economic activity and employment are dropping in most industries, and the recovery is focused on a few business activities, including agriculture which is returning to its average level. Financial performance of the economy is rapidly deteriorating. Mass inability of companies to settle regularly their reprogrammed tax obligations indicates the scope of the illiquidity and insolvency problem in the economy. State of banks is deteriorating as well, because real values of loans are decreasing, and the percentage of bad loans is increasing. Unemployment is stagnating at a very high level of 25%, with half of the young generation being out of work.

Domination of negative trends in Serbia's economy is confirmed by unfavourable assessment of the economic policy by IMF and deteriorating placement of Serbia in competitiveness rankings published by the World Economic Forum. Lower placement on the list of the World Economic Forum indicates that the growing macroeconomic risks have completely neutralised the implemented reforms, such as abolishing numerous quasi-fiscal levies. EU's economic recovery, which is very much tied into Serbia's economy, is still very slow and its longevity is uncertain.

Fiscal deficit this year will be 5.5-6% of GDP (i.e. over 7% according to IMF definition) and will be the highest in Central and Eastern Europe, while the public debt in the previous year has grown by 3.6 billion euros, i.e. by 23% - growth of public debt accelerated over the past year. The structure of public spending is deteriorating, because reduction of the share of public investments is realised through it, and as a result, around 2/3 of state borrowing this year was intended for financing current spending (salaries, pensions, interests, subsidies, etc.).

Public debt will reach 63-64% of GDP by the end of the year, cost of interest is rising, so there is a risk of growth of public debt becoming self-generating, i.e. that growth of cost of interest becomes higher than the savings realised by the state in other budget lines. Unfavourable conditions in Serbia's public finances, as well as worsening conditions of borrowing on the international financial market, for now exclude the possibility of replacing expensive loans with cheaper ones with market arrangements. That possibility perhaps exists within politically motivated inter-governmental arrangements, but based on past experience, the chances of something like that being realised are very small. That is why the state will be forced in the coming period to borrow at higher interest rates than was the case over the past year.

Key measures for slowing down the growth of public debt are reduction of the fiscal deficit by 2-2.5% of GDP in 2014, limiting the growth of state guarantees, and minimisation of the fiscal effects on the issues of the banking sector. Fiscal measures from May and June this year, as well as the announced savings of the Government provide about half of the necessary savings in the next year. For the remaining savings of around 1% of GDP the Government has to accept the proposal of the Fiscal Council on taxation of above average salaries and pensions, or to come out with an alternative solution.

Acceleration of the recovery of Serbian economy cannot be expected in the following year, because the effects of investments of FIAT and NIS are diminishing, while the new investments in this year are quite low. In the first half of the year, public investments, as well as foreign direct investments, are far below the multi-year average. Decline of production and imports of investment equipment, as well as reduction of the real scope of loans indicate that private investments are declining as well.

In the next year, a real reduction of state and private spending is expected, so the potential sources of growth boil down to investments and exports. Any considerable growth of investments is highly unlikely for now, and it will happen only if some of the announced large foreign investments are realised. General, high dispersed increase of investments, as a result of improving business environment, can be expected only after a year or two after the implementation of such reforms. We expect the growth of exports to slow down, because the

biggest exporters (FIAT, NIS) are gradually reaching their maximum, and new major exporters are nowhere in sight. Therefore, sources of growth for the following year are quite limited on the demand side as well as on the supply side. Additional obstacle to economic growth is bad financial situations in companies, which is decreasing borrowing activity, without which there are no investments or growth.

Unemployment rate is still on a very high level of around 25%. Statistically recorded modest growth of employment compared to the previous year is not healthy, because the employment in the private sector is growing only in the grey zone, while the registered (legal) employment is only rising in areas dominated by the state.

Strong growth of exports and reduction of deficit in the current balance of payments represent the most favourable tendency in the Serbian economy. While in the previous years the reduction of deficit was mainly a result of the reduction of domestic demand and depreciation of dinar, in this year the deficit is significantly reduced by factors on the supply side, generated by the growth of exports. Still, the deficit in the current balance of payments, although significantly reduced, is still high, so it has to be additionally reduced in the coming years. Reduction of fiscal deficit, with moderate depreciation of dinar, should be the key contributor to the reduction of current balance deficit. While the current balance deficit is being reduced at a satisfactory rate, the trends in capital balance are alarming, foreign direct investments are low, and companies and banks are deleveraging. Although similar trends have been recorded in other countries in Central and Eastern Europe, Serbia is in the group of countries where trends in the capital balance are the least favourable.

Strong reduction of inflation is another positive result of Serbia's economy. Average monthly inflation in the first seven months was 0.3%, which is 3.7% at the annual level. Reducing inflation creates a space for the reduction of restrictiveness of monetary policy, but the risks, which are the consequence of external and internal imbalances, call for a gradual and careful approach. First precondition for reducing the restrictiveness of monetary policy is adopting a credible budget for the next year, which would contain a significantly lower deficit. Depreciation of dinar during May and June reflects primarily unfavourable trends in the capital balance of Serbia, and to a lesser extent, general deterioration of capital flows in the countries of Central and Eastern Europe. Observing the wider economic picture, moderate increase of inflation, brought about by depreciation, is an acceptable price to pay for the reduction of external imbalances and growth of competitiveness of Serbia's economy.

After Government restructuring, as was the case after its formation a year ago, there were announcements of comprehensive and fundamental reforms of the economic system and public sector. Reforms of the pension system were announced, resolving of the status of companies in restructuring, liberalisation of legislation, improvement of business environment, reform of the tax system, reform of public administration, etc. and all this in a very short period of time. Some of these reforms (reform of the pension system, reform of the labour market, improvement of the business environment) have been in preparation for a relatively long time, they are pretty undisputable from an economic viewpoint, and are not excessively administratively complicated, so they should be realised quickly. However, it is uncertain whether political consensus will be reached on this issue, because parties that were blocking these reforms in the past are still in the Government. Other reforms, such as tax reform or public sector reform should be prepared more thoroughly and a more favourable economic and political moment found for their implementation. Generally speaking, a good preparation of reforms, their adoption and consistent implementation would require a relatively solid arrangement with IMF.

Recession in most of the economy requires implementation of certain short-term stimulating measures, in order to prevent mass bankruptcy of companies and banks. Although space for implementation of fiscal and monetary stimuli is quite limited in Serbia, it does not mean there should be no anti-recession measures taken. Short term anti-recession measures could include re-activating of the programme for subsidised loans, acceleration of the realisation of public investments and settling of state debts towards businesses. Additional stimuli could be created by approving loans to small and medium enterprises by international financial institutions.

This issue of Quarterly Monitor contains, aside from regular research, four Higlights as well. Higlights 1 (Arsić) analyses short-term stimuli and possible reforms, Higlights 2 (Glišić) analyses financial performance of large companies controlled by the state, Higlights 3 (Žarković-Rakić) analyses possible measures for employment of young people in EU and Serbia, while Higlights 4 (Arsić) disputes some popular proposals for jump-starting the economy and resolving the issues in public finances.

TRENDS

1. Review

Most of the important macroeconomics trends did not significantly change in Q2 when compared to Q1. Economic activity continues with its low growth which will amount to between 1.5 and 2% on an annual level, inflation is slowing down and until the end of the year will most probably be between 4 and 5%, while current account deficit is also in decline and in 2013 will amount to about 6% of GDP. Macroeconomic picture of Serbia, however, is somewhat less favourable than that indicated by aforementioned numbers. The growth of the economy in Q2, and throughout the entire 2013, comes from the recovery of agriculture after a drought in 2012 and a strong increase in the production of a small number of successful companies (Fiat, NIS). The largest part of the Serbian economy is actually in recession, and that recession is one of the factors that influence a somewhat faster reduction in inflation and the current account deficit. We therefore believe that this growth of the economy is not sustainable (because it is made of only few sectors of the economy, and the total investment is very low, which threatens the growth in the coming year), but also that two basic imbalances of the domestic economy (external – current account deficit and internal - inflation), although considerably reduced, are not yet fully mastered.

Therefore, one of the questions we ask in this issue of QM is: will the growth of GDP continue in 2014 when its current growth sources dry out? Namely, high growth of agriculture in 2013 is specific and one-off, and Fiat and NIS are approaching their full capacity employment, which means that they will no more be able to contribute to the overall growth of the economy – now, for example, production of motor vehicles is growing by about 3.5 times compared to the previous year. Answer to this question is worrying, because our analysis shows that all macroeconomic indicators which refer to the drivers of the further economic growth are very bad. Private investments, as well as loans to the private sector, are in Q2, in a large decline, similar to Q. In addition, foreign direct investments (FDI) are almost two years on, for Serbia, a extremely low level, and state investments in first seven months of 2013 are for one third lower than in the same period of the previous year. In addition to all this, it should be mentioned that the economic recovery of the Eurozone, to which the economy of Serbia is closely linked, is still weak and uncertain. As it is still not too late for these observed negative trends of the domestic economy to be turned around or at least to be mitigated, it is now necessary to turn attention to them and implement appropriate economic policies on time.

Individual analyses from Trends section therefore indicate that in addition to some irrefutably good results of the economy – such as a high growth of exports – economic policy is facing great challenges. The situation is further complicated by the fact that it is necessary to achieve large number of different goals at the same time: 1) mitigate negative tendencies in the greater part of the economy, 2) lay healthy foundations for a future economic growth and growth of employment with structure reforms, improvement of business environment and attraction of FDI, and 3) reduce high fiscal deficit and avoid possible public debt crisis. Fiscal policy undoubtedly has the greatest part of responsibility in those processes, but the monetary policy could also contribute to the revival of the credit activity with gradual relaxation. This is somewhat related to the issue of appropriate dinar exchange rate, where the moderate depreciation of the dinar would be useful to the increase in the price competitiveness of the domestic economy, at the cost of moderate increase of inflation. Implementation of all necessary reforms would not be painless, but neither fast nor un-risky process, so we think that it is in need for international institutional support, which could be provided by new arrangement with the IMF.

GDP in Q2 recorded year-on-year growth of only 0.7% but it should be noted that the quarter to which the economic activity is compared, Q2 2012, was somewhat better than other quarters in that year (see section 2 „Economic activity"). Because of that we conclude that the economic activity trends in Q2 were quite similar to those from Q1 and despite somewhat lower y-o-y growth in Q2, the estimated growth rate in 2013 of between 1.5 and 2% will most probably be achieved. The structure of the achieved growth in Q2, but also in the entire first half of the year, shows us that three out

of four basic components of GDP (investments, personal and state consumption) are in decline, but that the decline is compensated by the high growth of net exports. Of all mentioned trends, the most worrying is the fall in investments which decreases a potential for the future growth of the economy.

High unemployment remains perhaps the biggest structural problem of the domestic economy. The employment rate in April stood at about 45.8% of the working age population, and the unemployment rate about 25%. Youth unemployment is particularly high and stands for about 50%. There has already been some discussion in the general public about the April data which indicate some increase in employment and fall of unemployment. We interpret this data very cautiously. First of all, noted increase in employment is small, and statistics measuring it is insufficiently reliable so that such small changes could be considered as relevant. Further, if the increase in employment is actually achieved, this information is somewhat neutralized by the fact that the sectors in which the increase was achieved are mainly "non-production" and / or under the direct control of the state. These are: administrative and supporting services, public administration and obligatory social security, water supply and water waste management. On the other hand, the production and market-oriented parts of the economy (construction, manufacturing, financial services) also according to the official April data, record a drop in employment (see section 3 "Employment and Wages"). We also note that high unemployment is a problem of the domestic economy which in the future cannot be eliminated without significant increase of the economic growth. Since the acceleration of economic growth is unlikely in the coming year, ambitiously set goals of the new government to reduce the unemployment rate below 20% in the next year - are not realistic.

Current account deficit in Q2 was, for Serbia, extremely low and amounted to only 3.3% of quarterly GDP (see Section 4: "Balance of Payments and Foreign Trade"). Such a low current account deficit is a result of permanent and temporary trends. By permanent trends we mean improvements in the foreign trade, i.e. fall of the foreign trade deficit. This is the result of high growth of exports (mostly contributed by Fiat) accompanied by the stagnation of imports – mostly contributed by the fall in domestic demand. High growth of exports and stagnation of imports led to the fact that over 70% of imports in Q2 were covered by exports, which is the most favourable relationship between exports and imports since 2001. Temporary factor that led to a record-low current account deficit in Q2 was slightly higher than the usual current transfers – more precisely remittances. These inflows often have fluctuations during the year, but on an annual basis, they are rather stable, so that their growth in Q2 is evaluated as a temporary. Taking all aforementioned into account, we expect that by the end of the year the current account deficit could amount to 6-7% of GDP, which means that it could almost reduce for about 40% compared to the 2012, when it amounted to 10.5% of GDP.

And while the situation in the current part of the balance of payments is considerably improving, its capital part is very unfavorable. Net FDI in Q2 amounted to only 140 million euros, which is a continuation of a bad trend that lasts for already a year and a half. In this period, total net FDI inflow was only 520 million euros (230 million euros in 2012 and 290 million euros in the first half of 2013). We note that FDI in the period between 2007 and 2011 were, on average, over 1.5 billion a year, and that in 2011 they were 1.83 billion euros. Alongside the FDI reduction, we notice a continuation of the trend of debt repayment of the domestic economy towards foreign countries. But this repayment is not the effect of strengthening in the domestic economy, but rather the opposite – of a recession in the majority of the economy stands and doubts of the creditors about the solvency of the debtors. Simply speaking, previously taken loans from abroad are now being returned and new projects are not being started.

Shortage of capital inflows is reflected in the weakening of the dinar exchange rate. By intervening in the interbank market, NBS influenced this weakening not to be large, but this was achieved at the cost of significant reduction of foreign exchange reserves. In Q2, currency reserves were reduced by as much as 866 million euros, out of which, over 300 million euros was spent on the defence of the exchange rate (in Q2 from the foreign exchange reserves part of the IMF loan in the amount of 140 million euros was also repaid). QM supports the view that it is necessary to prevent any potential source of macroeconomic instability and the related NBS interventions may be useful mechanism to prevent the risk of uncontrolled fall of the dinar exchange rate. On the other hand, we believe that moderate and controlled depreciation of the dinar would be beneficial for the economy of Serbia, which is justified by the relatively unfavourable trend of its price competitiveness, which we measure by unit labor costs in Euros (Graph T2-5). We remind that a low current account deficit in 2013 is

largely the consequence of the recession in which the greater part of the Serbian economy stands and that there is still large structural imbalance between exports and imports. Therefore, the NBS interventions aimed at defending the dinar exchange rate would have to be very balanced and primarily implemented when the shocks which affect the decrease in the value of the dinar are undoubtedly temporary.

The increase in the prices in Q2 was relatively low 1.7%. July even recoded a significant deflation of 0.9%, so that the total increase in the price amounted to only 2% since the beginning of the year until the end of July (see section 5 "Prices and the Exchange Rate"). A near halt in inflation in 2013 is a consequence of many different factors. First of all, the recessions, in which the majority of the Serbian economy stands, and the decline in real household consumption prevent large price growth. In addition, the dinar exchange rate is relatively stable, global food prices are falling, while oil prices remained stable until July - but already in August strongly increased due to the escalation of the crisis in Egypt and the Middle East. By the end of the year increase in the price of energy is likely, but we do not expect any other major changes, and so the annual inflation could amount to around 4%, i.e. be within the target corridor of the NBS.

Despite inflation which currently stands at about 4%, NBS reference rate is high 11%. The formal reason for this level of reference rate is a still high year on year inflation which, at the end of July, stood at 8.6%. We believe, however, that the y-o-y inflation is not the best indicator on the basis of which decisions on monetary policy should be made in conditions of high and variable inflation characterized by sudden breaks, as it is the case today in Serbia. Annualized inflation in the past few months would be a better parameter for the management of monetary policy, and a response based on it could lead to faster responses of NBS than in the case of using the y-o-y rate. In essence, the QM analysis provides support for the conduct of somewhat more cautious monetary policy, because the government deficit is very high and there are serious risks of macroeconomic instability. This however does not mean that the NBS should go to the extreme, which is perhaps the case now, and to completely ignore other targets for preserving the price stability (the primary objective of NBS). Because, it is already more than obvious that the actual inflation rate since the end of 2012 is within the NBS target band, and this is not seen just due to the observing of the y-o-y inflation which itself includes the high inflation in September and October of 2012 (when, among other things consumption taxes were increased).

Unfavourable trends in the major part of the economy are confirmed by the movements in credit activities (see Section 7 "Monetary Flows and Policy"). The annual real decline in credit lending to the private sector stood at 9.2%, which is the biggest drop since QM follows this series of data. We presume that the part of the decline in credit activities is a consequence of a halt in subsidized loans program, since the funds planed for its financing were exhausted already in March, and according to the new revised budget new funds are not planned. In addition, growth of non-performing loans rapidly increases. Participation of non-performing loans in total (calculated with QM methodology) from the beginning of the year increased from about 16% to over 22% in late July. These data indicate that the NBS in collaboration with the Government had to think about a gradual reduction in the restrictiveness of monetary policy in the future.

Fiscal policy could also mitigate the negative trends in the economy. Although the possibility of a serious fiscal stimulus in conditions of a high deficit, rising public debt and low fiscal multiplier is almost excluded, the priorities of economic policy could certainly be re-examined. Namely, in 2013 almost common practice repeats in which most cuts in the necessary reduction of public expenditures are the cuts in public investments rather than in the current expenditures. Public investments in the first seven months of 2013 are actually lower by 33% compared to the same period of the last year. In Q2 they were particularly low, only 1.8% of GDP and for the level of development of Serbia we believe that these should be at about 5% of GDP. Poor choices in priorities the Government also made by abolishment of subsidized loans, which of all stimulus to the economy we considered the most efficient.

Fiscal deficit in Q2 amounted to 4.6% of GDP and slightly decreased compared to Q1, but this is not the consequence of systematic efforts of the Government, but forced savings on a discretionary expenditures - public investments, procurement of goods and services and subsidies - after public revenues significantly underperformed (see Section 6 "Fiscal Flows and Policy"). Despite some reduction of the fiscal deficit in Q2, current fiscal policy is actually completely unsustainable. Deficit

will amount to about 6% of GDP in 2013, while public debt will reach the level of about 63-64% of GDP. It is obvious that the partial fiscal consolidation from October 2012 (in which, in addition to tax increase and control of the growth of pensions and public sector wages, the most important structural reforms were left out) did not produce the desired results

Therefore, a second round of fiscal consolidation must start now, in order to reduce the fiscal deficit and thus avoid a public debt crisis. Since the pensions and wages of public sector employees are by far the largest part of government spending, without their correction, a powerful deficit reduction will hardly be feasible.

It is particularly important that the mistakes from October 2012 are not repeated this time and that along with the expected short-term measure, serious reforms are finally implemented. Good indication for this are the announcements coming from the Government about pension reform, reform of labour legislation, creation of a central registry of employees in public administration, reform of public enterprises, as well as the first steps that have been made in resolving the fate of companies still under the umbrella of the Agency for privatization. There are, however, more important areas of public sector which need reforms. Above all, creating and implementing serious reform plans for the two largest state systems - health and education. We note that the failure in the previous implementations of the reforms, however, has never been the consequence of a lack of plans and skills, but the lack of political will for their implementation. So, once again the key question is whether the initial enthusiasm and commitment to reforms will survive when painful and politically unpopular measures begin to be implemented?

Serbia: Selected Macroeconomic Indicators, 2004 - 2013

	Annual Data								Quarterly Data					
	2005	2006	2007	2008	2009	2010	2011	2012	2012				2013	
									Q1	Q2	Q3	Q4	Q1	Q2
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	…	…	99.99	102.4203236	100.724764	100.88941	…	…
GDP	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-1.7	-2.6	-0.1	-2.1	-2.1	2.1	0.7
Non-agricultural GVA	5.8	4.9	6.1	4.1	-4.2	1.6	1.5	1	0	2.6	0.7	0.7	1.2	…
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	-5.5	-2.8	-3.6	-0.6	5.2	3
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	-6.7	0.2	-3.8	1.5	5.4	3.2
Average net wage (per month, in dinars)[2]	17,478	21,745	27,785	29,174	31,758	34,159	…	…	39,068	41,664	41,187	43,625	41,419	44,248
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	…	…	1.734	1.7300	1.7260	1.7240	1.724	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			1.7	4.8	-0.8	-3.2	-5.8	-3.2
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7			10.3	9.2	-2.9	1.5	-10.8	-6.6
							in billions of dinars							
Overall fiscal balance (GFS definition)[3]	14.8	-33.5	-58.2	-68.9	-121.8	-136.4			-54.9	-57.0	-36.5	-69.0	-37.0	-44.1
Balance of Payments							in millions of euros, flows[1]							
Imports of goods[4]	-8,286	-10,093	-12,858	-15,917	-11,096	-12,176	-13,758	-14,272	-3,403	-3,577	-3,430	-3,862	-3,413	-3,701
Exports of goods[4]	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,822	1,854	2,282	2,244	2,442	2,260	2,711
Current account[5]	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,155	-1,176	-740	-546	-694	-627	-276
in % GDP[5]	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-9.1*	*-10.6*	*-17.0*	*-9.8*	*-7.3*	*-8.7*	*-8.2*	*-3.3*
Capital account[5]	3,863	7,635	6,126	7,133	2,207	1,986	2,694	2,988	1,120	685	490	692	612	220
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	242	-362	234	117	253	155	139
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	-916	-1,100	-340	1,218	859	-886
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	606,834	656,347	615,234	583,121	608,235	656,347	673,147	674,731
NBS net own reserves[6], in mn of euros	2,050	3,833	5,051	5,362	6,030	4,609	5,895	5,781	5,376	5,037	5,225	5,781	6,025	5,917
Credit to the non-government sector	518,298	609,171	842,512	1,126,111	1,306,224	1,660,870	1,784,237	1,958,084	1,897,034	1,938,662	1,999,697	1,958,084	1,933,868	1,929,205
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909912	834,253	888,372	890,782	909,912	907,288	924,684
M2 (y-o-y, real growth, in %)	20.8	30.6	27.8	2.9	9.8	1.3	2.7	-2.2	10.1	12.0	3.4	-2.2	-2.6	-4.7
Credit to the non-government sector (y-o-y, real growth, in %)	28.6	10.3	24.9	25.2	5,2	13.9	0.5	-2.1	10.5	8.1	5.9	-2.1	-8.2	-9.2
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	53.8	56.2	59.9	59.3	60.2	61.6	59.9	57.3	60.3

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 estimate from the Statistical Office of the Republic of Serbia – SORS indicates year-on-year GDP growth of about 0.7% in Q2. Although the achieved growth seems modest at first sight (in Q1 it was 2.1%), it must be considered that Q2 2012, with which this economic activity is compared, was significantly more successful than all other quarters of 2012. Seasonally adjusted indices indicate that the GDP in Q2 is at the similar level as in Q1, which we interpreted as a continuation of a trend started in Q1, not as a possible beginning of stagnation. The economy in Q2, as in Q1, is driven by the net exports, while domestic demand is in a decline. However, when compared to Q1, there is a certain slowdown in net exports but also a decrease in the fall of domestic demand. Observed by production method, trends, we wrote about in previous editions of QM, are clearly seen – growth is driven by agriculture and only few successful companies (Fiat, NIS) while by far the largest part of the Serbian economy is still in recession. For the entire 2013 we still hold unchanged estimate of GDP growth of 1.5% - 2% which we first expressed at the end of 2012. The estimate is still not completely reliable because there are some unknowns about the real rate of the economy growth, but also certain exogenous factors which may influence changes in GDP in the second half of the year (the risks coming from fiscal policy, drought in August). Milder depreciation of the Dinar that occurred in Q2 has a positive impact on the price competitiveness of the domestic economy, but the euro-ULC indicate that the price competitiveness in Q2 is significantly lower compared to the same period last year.

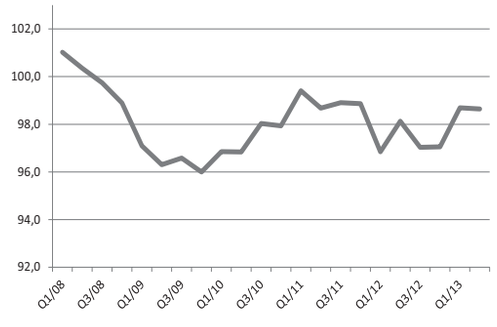
Gross domestic product

Year-on-year growth of GDP in Q2 of about 0.7%

According to the preliminary, flash, SORS estimate, the real y-o-y GDP growth in Q2 was about 0.7%. This y-o-y growth is significantly lower than the 2.1% achieved in Q1, but the main reason for considerable decrease in the y-o-y growth is a comparison with the different bases from the previous year and not the changes in the trend of the economic activity. Namely, GDP in Q2 2012 was higher than in any other quarter of 2012 and therefore the comparison with this quarter gives lower y-o-y growth rate. This could be explained illustratively if we would compare the realized value of economic activity with that of 2011. Thus in Q1 2013, despite the y-o-y growth of 2.1%, the real GDP level from Q1 2011 had not been overhauled yet, as the decline in 2012 was 2.6%. However Q2, despite the lower rate in GDP growth of 0.7%, exceeded the real GDP level from Q2 2011 because the decline in 2012 was only 0.1%.

Seasonally adjusted data indicate a possible stagnation ...

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



Source: *QM* estimates based on SORS data

... but we are still cautiously interpreting the data

Graph T2-1 shows seasonally adjusted GDP growth indices which provide better illustration of the changes in economic activity on a quarterly basis. Seasonally adjusted indices of GDP growth suggest that Q2 retained almost unchanged level of economic activity when compared to Q1 (Graph T2-1). This may suggest a possible stagnation of production in Q2, but we ought to be very careful with this conclusion. Namely, 2012 and 2013 are quite irregular years, mainly due to the collapse and then recovery of agriculture, and these fractures affect the reliability of the seasonal adjustment procedures. If we were to use X-12 seasonal adjustment methodology[1] instead tramo/seats methodology which is used

1 In our country and most other European countries tramo/seats seasonal adjustment methodology is in use but the use of X-12 seasonal adjustment methodology is not uncommon and is used in the statistical bureaus of individual European countries. The European Commission accepts both methodologies as relevant.

for seasonal adjustment of GDP in Serbia, the result would be totally different and seasonally adjusted GDP in Q2 would be much higher than in Q1. Because of this, as well as the already mentioned data that the real GDP in Q2 exceeded its value from the 2011 (which was not the case for Q1), it is our conclusion that in Q2 there were no essential changes in the trend of economic activity. Finally, we note that the assessment of an annual GDP growth of 0.7% in Q2 is still only preliminary and that SORS will give a more reliable assessment at the end of September.

Increase in net exports, domestic demand falling....

The structure of the GDP growth can be analyzed on the basis of the data on the use of GDP. Table T2-2 shows the official data on the movement of the main components of GDP ending with the latest available data for Q1 2013. Based on data for Q1, adopted policies and expected trends, we can approximately estimate the pattern of GDP growth in Q2 which will probably continue until the end of the year. That is: 1) real decline in investment, private and government consumption, and 2) high growth in net exports. Thus, the growth of the economy in 2013 is therefore the result of the sum of two completely divergent trends - a significant increase in exports and a fall in domestic demand. Exports grows primarily due to the operations of individual companies like Fiat Automobiles Serbia (FAS) and to a smaller extent some other (such as NIS), while the domestic demand declines due to a real reduction of the earnings mass (real reduction in earnings and decrease in the number of employees) and pensions, but also due to very negative trends in investment.

Table T2-2. Serbia: GDP by expenditure method, 2008-2013

	Y-o-y indices								
	2009	2010	2011	2012	2012				2013
					Q1	Q2	Q3	Q4	Q1
GDP	96.5	101.0	101.6	98.3	97.4	99.9	97.9	97.9	102.1
Private consumption	97.2	99.1	98.9	98.1	97.1	97.3	99.8	98.1	98.9
State consumption	98.1	100.4	101.0	101.8	103.8	105.9	100.5	97.4	96.8
Investment	77.9	94.5	108.4	96.6	102.8	104.3	97.7	85.5	96.1
Export	92.0	115.3	103.4	104.5	94.9	111.5	105.5	105.8	113.5
Import	80.9	103.1	107.0	104.2	102.2	109.4	103.7	101.9	101.2

Source: SORS

In Q2 growth of net exports is slowing down

Since we have no official data on the movement of expenditure components of GDP in Q2 we estimate them through indirect indicators. Based on the data on foreign trade, which are available for Q2, we conclude that net exports in Q2 continued quarterly growth when compared to Q1, but that the growth is already significantly slower than it was in the previous quarter. This is expected[2], because the company which had most effect on the growth of net exports - FAS - by the end of Q1, practically reached the value of exports of cars that will be common in the next few months and it can no longer generate such fast growth of exports as in recent quarters. In the forthcoming period we could still maybe expect acceleration in net exports due to the expected increase in export of this year's agricultural products.

...but the real growth of domestic demand is slowing down also

We can approximately estimate the movement of the domestic demand in Q2 based on the officially released preliminary estimates of GDP and data on net. This way we come to the assessment that the domestic demand slowed down the decline in Q2. We reach the same conclusion when we estimate the domestic demand based on the movement of its components - private consumption, government consumption and investments. Q2 saw significantly slower decline in private consumption due to the increase of pensions and salaries in the public sector by 2% in May (the April salaries and pensions are paid at that time). Nominal increase in salaries and pensions, in the period when inflation was low, resulted in a slowdown of the real decline in private consumption. The other two components of domestic demand (government consumption and investments) accelerated the decline during the second quarter, but the decline in domestic demand slowed down due to a slowdown in the biggest position - private consumption.We do

2 For more detalis see Section 2 „Economic activity" of *QM32*

not expect that there will be significant changes in the trend of real domestic demand by the end of the year, so the fall which it realizes will be similar to that of Q2. Additional confirmation of this assessment (of moderate real decline of domestic demand by the end of the year) is provided by the inflation trend, which will likely continue to slow down in the future - which will prevent the deepening of the real fall in the domestic demand, even in the circumstances where its sources of funding are to a large measure frozen on the nominal level.

Growth structure that is based on the growth of net exports and decrease of domestic demand is in general favourable for Serbia. Private consumption is still disproportionately high in relation to production and thus, its gradual reduction leads to a reduction of macroeconomic imbalances. Reduction of government spending is undoubtedly good and it is essential for the sustainability of public finances. What we are really most concerned about in this structure of GDP growth is a sharp reduction of investments that decreases the opportunities for a future growth of the economy.

Agriculture is the sector with the highest growth in 2013

Analysis of GDP movement in Q2 and in entire 2013 can be supplemented with the data by the production method which are shown in the Table T2-3. Table shows growth of individual sectors of the economy ending with last official data which refer to Q1. Similarly to the GDP trend analysis by use, in this case we also believe that Q1 is sufficiently representative so that we can show basic trends of individual sectors of the economy in Q2, but also in the entire 2013. Table T2-3 reveals that agricultural sector has the largest increase in 2013 and this growth is the result of comparisons with extremely poor agricultural season from 2012. Second sector that provides the largest contribution to the growth of the economy is the information and communication sector which records multi-annual trend of steady growth. Manufacturing in Q1 moved from negative to positive growth zone (Table T2-3), where it is expected to remain throughout the 2013. On the negative side the massive drop in construction activity and the decline in trade stand out.

Table T2-3. Serbia: Gross Domestic Product by Activity, 2008-2013[1]

	Y-o-y indices									
	2009	2010	2011	2012	2012				2013	Share
					Q1	Q2	Q3	Q4	Q1	2012
Total	96.5	101.0	101.6	98.3	97.4	99.9	97.9	97.9	102.1	100.0
Taxes minus subsidies	98.3	100.9	101.6	97.2	95.4	99.5	96.9	96.8	102.7	17.4
Value Added at basic prices	96.1	101.0	101.6	98.5	95.4	99.5	96.9	96.8	102.7	82.6
Non agricultural Value Added	95.8	101.6	101.5	101.0	100.0	102.6	100.7	100.7	101.2	91,1[2]
Agriculture	100.8	99.6	100.9	82.9	81.5	83.2	83.4	83.0	116.7	8,9[2]
Manufacturing	84.2	100.9	100.6	101.1	96.3	103.3	99.2	104.9	102.4	14,4[2]
Construction	80.3	92.9	107.7	92.5	111.2	103.5	91.3	75.3	75.3	3,9[2]
Wholesale and retail trade	92.5	101.7	94.5	99.6	97.9	102.7	100.5	97.6	96.0	13,0[2]
Transport and storage	90.0	108.2	103.1	100.6	95.1	104.0	100.8	102.6	105.4	5,5[2]
Informations and communications	110.0	105.4	108.4	110.3	112.0	113.0	105.2	111.4	108.1	9,6[2]
Financial sector and insurance	105.5	107.2	101.0	104.4	100.0	105.1	106.8	105.9	105.2	4,1[2]
Other	101.6	100.8	102.0	100.0	99.2	99.6	100.8	100.4	101.9	41,1[2]

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

Based on the available monthly data for Q2 we estimate that only the minor changes will occur in the structure of production growth by sector, compared to Q1. We expect a slightly lower drop in wholesale and retail in Q2 compared to Q1 which is indicated by the monthly data on movements in retail sales, as well as our analysis of the movements in the private consumption. Construction will probably have a deeper decline in Q2 than in Q1, which is indicated by the index value of construction activity, while the financial sector and insurance activities are likely to have a slightly lower growth which is indicated by the movement of deposits and loans. Other sectors will probably have similar growth rates in Q1.

In 2013 we expect growth of 1.5 to 2%

The very fact that this is the fourth successful edition of the QM-a in which we retain practically invariable forecast of GDP growth in 2013, indicates that in the previous quarters there were not many surprises. This however does not mean that they cannot happen by the end of the year.

Risk for achieving the anticipated growth may by the fiscal policy which is being, for a long time now, led in the danger zone from which it can threaten macroeconomic stability. It is also possible that the agricultural season will not be as successful as expected because the drought from the first half of August will have impact on a smaller-than-expected growth of corn and other autumn crops. On the other hand, it can easily turn out that the real growth rate of the economy in Q2 is somewhat higher than that indicated by the seasonal adjustment tramo/seats method, but it is closer to that indicated by the seasonal adjustment X-12 methodology, which could then indicate even a slightly higher growth rate of 2% in 2013. Finally, it should not be forgotten that SORS is prone to the frequent and substantial revisions of the published data on economic activity, even a few quarters back, and we have based all our analysis on these data - which than can significantly influence the growth forecast in 2013. For now, however, as the most probable outcome, we believe that the real GDP growth in 2013 will be between 1.5 and 2%.

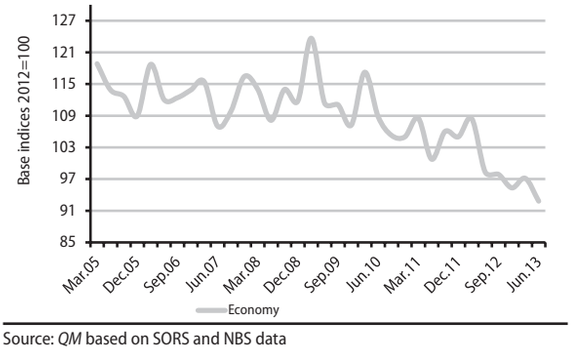
There are no indications of the growth acceleration in 2014 and in the medium term

As in previous issues, also in this issue of QM, we draw attention to the fact that most of the Serbian economy is still in recession because the strong growth in production is concentrated in the agriculture and only a few large companies. A very important question is: how will the GDP of Serbia move when its current sources of growth are exhausted? All macroeconomic indicators that describe the future growth of the economy are very bad. Private investments, as well as loans to the nongovernmental sector, were in large decline in Q2. In addition, foreign direct investments (FDI) for almost two years are, for Serbia, on an extremely low level, and state investments in the first seven months of 2013 were almost halved in real terms compared to the same period last year.[3] In addition to all this, it should be mentioned that the economic recovery of the eurozone, to which the Serbian economy is closely linked, is still very weak and uncertain.

Reforms are essential, but short-term focused stimulants are also necessary

Fiscal consolidation is a necessary, but not sufficient condition for a sustainable economic growth in the medium and long term. Along with the fiscal consolidation, there is a necessity for broad reforms, but also for short-term incentives to mitigate the negative tendencies in the larger part of the economy. First of all, a nearly common practice that proportionally largest savings are realized in the capital expenditures when it comes to the budget reduction must be stopped, while the current budget spending are less adapted. Also, one of the priorities of economic policy management should be to enhance the business environment - as a condition for the increase in domestic and foreign investments. Improving the economic environment is becoming more urgent, after the reduction of economically inefficient and fiscally unsustainable subsidies for investment and employment has started. Reduction and then elimination of such subsidies is necessary, but if decisive reforms of the economic system are absent, it will further reduce investments and employment. A sharp drop in credit activity of companies indicates that it would probably be useful to continue with the program of state subsidized loans, because with little investment, a considerable impact on the economy is achieved. Finally, in terms of almost completely stopped inflation, the monetary policy should probably also take part in the responsibility and with the gradual relaxation contribute to the revival of lending activities of the Serbian economy. The question about the appropriate exchange rate of the dinar is somewhat related to this, which will be discussed in the analysis of the price competitiveness of the domestic economy.

Graph T2-4. Serbia: Real Unit Labor Costs in the Economy and Industry, 2005-2013



Source: *QM* based on SORS and NBS data

Unit Labour Costs measured in dinars decrease

Unit Labour Costs[4] (ULC), measured in dinars continue to decrease in Q2. The trend can be easily seen in Graph 4. When we compare ULC with the same quarter of the previous year - we see that they are in

3 For more details about loans, foreign direct investment and government sections see sections 7: "Monetary Flows and Policy", 4 "Balance of Payments and Foreign Trade" and 6 "Fiscal Flows and Policy" of this edition of *QM*

4 UnitLaborCosts in dinarsarecalculated for the economy (excluding the Agriculture and Public Administration sectors) andindustry.

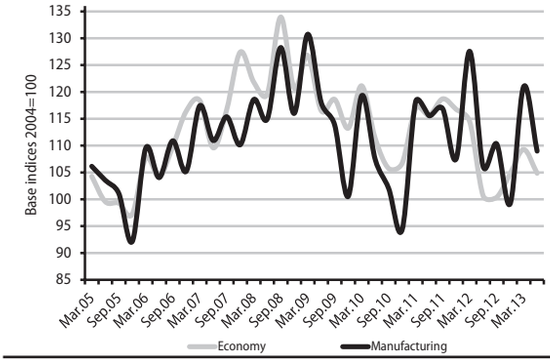
decline of over 5%. ULC indicate the quantity of the labour costs participating in the production unit and whether the productivity is growing faster or slower than the growth of real wages. In the case of Serbia, however, we can conclude that the medium-term productivity growth is faster than wages (and hence implied decline in ULC) mostly due to the reduction in employment, which cannot be seen as a positive trend.

Appreciation of the dinar lovers the price competitiveness of the economy

Unit labour costs measured in euros (euro-ULC) are an indicator of the price competitiveness of the Serbian economy as they define the greatest national cost component (labour costs) in relation to the 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 whole5, as shown in Graph T2-5).

In Graph T2-5, we see that the euro-ULC oscillate a lot by quarters. They are lower in Q2 than in Q1, which is not only attributed to seasonal factors but also to observed real reduction in dinar-ULC, with a certain depreciation of the dinar. Observed on the y-o-y basis euro-ULC are still higher in Q2 than in the same period last year, because then, the dinar value was lower than it is now. Something we want to draw attention to in this issue of QM is that euro-ULC in the medium term don't have pronounced downward trend as the dinar-ULC have (Graphs T2-4 and T2-5). This means that despite a significant increase in productivity and reduction in real wages-there was no significant increase in price competitiveness of the domestic economy. The reason for this is the strong real appreciation of the dinar throughout all period of 2005 (with some fluctuations) which has overruled the effects of the dinar-ULC reduction[6]. Although strong dinar affects slowing down in inflation and temporary rises consumer's consumption, we believe that the impact it has on the competitiveness of the economy, balance of payments disequilibrium, employment and sustainable growth of the economy - which can be based only on the growth of net exports, should be taken into consideration.

Graph T2-5. Serbia: Real Unit Labor Costs in the Economy and Industry, 2005-2013



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

Industrial production

Industrial production rose by about 3% in Q2

Industrial production in Q2 recorded year-on-year growth of 3% (Table T2-6). Within the industrial production, all three sectors (mining, manufacturing and supply of electricity) had positive and approximately equal growth rates that ranged from 2.2% to 3.7%. Unlike in Q1, when an annual growth of over 5% was achieved mostly as the consequence of a comparison with a low base from 2012 (then due to extraordinary weather conditions there was a temporary deep fall) - industrial production growth of 3% is evaluated much more favourably, because it is sustainable above all.

5 Excluding the Public Administration and Agriculture sectors.
6 For mor details see section 5 „Prices and Excange rate" of this issue of *QM*

Table T2-6. Serbia: Industrial Production Indices, 2009-2013

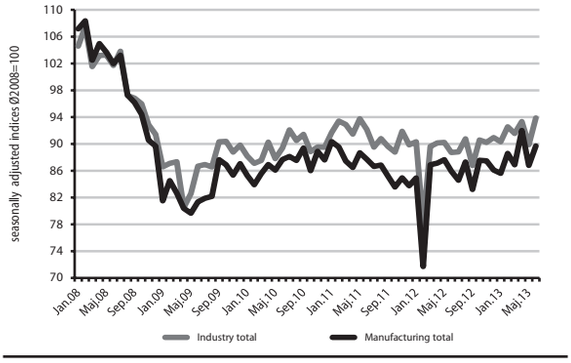
	Y-o-y indices										Share
	2009	2010	2011	2012	2012				2013		2012
					Q1	Q2	Q3	Q4	Q1	Q2	
Total	87.4	102.5	102.2	97.1	94.5	97.2	96.4	99.4	105.2	103.0	100.0
Mining and quarrying	96.2	105.8	110.4	97.8	100.2	94.2	100.1	96.3	107.8	102.2	9.8
Manufacturing	83.9	103.9	99.6	98.2	93.3	100.2	96.2	101.5	105.4	103.2	74.3
Electricity, gas, and water supply	100.8	95.6	109.7	92.9	96.6	85.4	95.8	93.0	103.7	103.7	15.9

Source: SORS

Seasonally adjusted indices in Q2 indicate growth when compared to Q1

Graph T2-7 shows seasonally adjusted production indices of total industry and manufacturing. Seasonally adjusted data indicate that, particularly manufacturing, in Q2 recorded solid growth compared to Q1. Seasonally adjusted total industrial production is higher in Q2 compared to Q1 by about 1%, and manufacturing, which best describes the essential trends of the domestic industry, by as much as 2.8%. We draw attention to the fact that large fluctuations in industrial production (and manufacturing) in April and May were the result of an unusual schedule of holidays (Easter, which was in May and usually falls in April), and the usual "linking" of non-working days. Because of that the seasonally adjusted values of industrial production in April were significantly above the trend (because of the absence of formal and informal non-working days), but then in May seasonally adjusted indices of industrial production and manufacturing were significantly below the trend (Graph T2-7).

Table T2-7. Serbia: Seasonally Adjusted Industrial Production Indices, 2008-2013



Source: SORS

Only three sectors power growth

We announced in the previous issue of QM seasonally adjusted growth of manufacturing industry in Q2, among others things, because the production in Smederevo Steelworks was launched in this quarter.[7] Seasonally adjusted index of base metals production in Q2 recorder a growth which slightly raised overall industry growth in Q2, but it still was not crucial. Production of basic metals is now at a much lower level than it was several years ago and the changes that are now occurring in this area in fact were not so large so they could significantly affect the general trends. For industrial production growth in Q2, but also for its recovery throughout 2013, three other areas are much more deserving: 1) the production of motor vehicles (FAS), 2) the production of petroleum products (NIS), and 3) the pharmaceutical industry. All three areas have unusually high rates of growth in 2013 in relation to 2012. Thus, the pharmaceutical industry in the first half of 2013 was by 35% higher than in the same period of 2012, production of petroleum products by 42% , and the production of motor vehicles three times higher than in the first half of 2012. What is disturbing is that without these three areas industrial production in 2013 would be considerably decreasing. Particularly poor results were recorded by the food industry and the areas of industrial production which are directly linked to the investments (production of non-metallic minerals, for example).

By the end of the year we expect industrial production to continue its growth

Probably by the end of the year certain changes in the structure of industrial production growth will occur, but we expect that this growth will continue. The growth of production in the production of motor vehicles and manufacture of petroleum products will probably soon slow down, as the companies behind this growth are slowly approaching full employment capacity. As the contributions of these areas to the overall growth weaken, we expect that probably already in Q3, and almost certainly in Q4, a solid recovery of the food industry will occur, since the agricultural production in 2013 is much better than in the previous year.

7 For more details see section „Economic Activity" *QM32*

2014 should already be considered

We believe that there are serious reasons for concern in terms of not only the present but also the future trends of industrial production in Serbia. Primary reason is that, despite the overall growth, most of the industry for a longer period of time is in a decline - without showing signs of improvement. This then raises the question of what will happen when, though limited, sources of growth of industrial production are exhausted, which is no longer a matter of a distant future. Not only the trends of the largest part of the production, but also a very low level of investment are disturbing - which can be seen from the trends in imports of capital goods and construction activity – and investments are supposed to enable future growth in industrial production. At the beginning of 2014 the recovery of food industry will probably still maintain a positive overall growth rate, but if this recovery is not joined by some other sector, already in the second half of 2014 the actual negative trends of the majority of domestic companies will be discovered.Until then, there is still plenty of time to reverse the negative trends, with combination of focused stimulation and acceleration of reforms, but this should be already seriously considered.

Dynamics of industrial products production differ significantly by purposes

A breakdown by use (Table T2-8) shows that in Q2 production of most intermediate product groups recorded y-o-y growth, while only production of intermediate goods was in a decline. Intermediate product groups are also heavily influenced by individual production companies, so the production of investment goods (which includes the manufacture of motor vehicles) recorded an increase of as much as 30%. Once again we note that despite the high growth in production of capital goods level of investment in Serbia in Q2 was very low. Next in line, measured by the level of y-o-y increase (10%) is the production of energy, which was influenced by the production in the company NIS.

Table T2-8. Serbia: Components of Industrial Production , 2009-2013

	Y-o-y indices									
	2009	2010	2011	2012	2012				2013	
					Q1	Q2	Q3	Q4	Q1	Q2
Total	87.4	102.5	102.1	97.1	94.5	97.2	96.4	99.4	105.2	103.0
Energy	98.8	97.7	106.2	93.6	95.8	88.3	91.4	98.7	108.6	109.7
Investment goods	79.3	93.6	103.2	103.8	92.0	105.4	113.7	104.2	132.3	130.2
Intermediate goods	78.4	109.2	102.2	91.2	89.4	96.3	89.1	90.0	94.7	93.1
Consumer goods	86.8	102.1	95.4	103.2	97.8	104.5	104.6	106.1	107.0	101.5

Source: SORS

Construction

Construction is in deep decline in Q1 ...

Latest construction statistics made available by SORS indicate deep year-on-year decline in this part of the economy of about 45.7%. Unlike Q1, which due to seasonally low construction activity, is not very suitable for giving qualitative assessments - a deep decline in construction activity in Q2 gives us an undoubted confirmation that the construction industry is in big crisis. Observing the official reports for several quarters back we notice that this crisis of the construction activity is deepening from one quarter to another. And so from Q2 2012 when the index value of construction works performed was positive and pointed to an annual increase in construction activity of 6%, already in Q3 a year on year decline of 10% was recorded, which gradually deepened and in Q2 2013 reached almost incredible 45%.

Cement production index, which we use as an additional indicator of the construction industry trends[8] (Table T2-9). 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 an actual state and future trends in construction.

8 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.

Low cement production confirms deep decline in construction activity

Table T2-9. Serbia: Cement Production, 2001-2013

	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
2013	83.5	78.7			

Source: SORS

Cement production in Q2 was by 21% lower than in the same period last year. This drop is high but still smaller than the decline in the index value of construction activity. This data gives us confirmation that the construction activity is in deep decline, but it seems that the decline is deeper when it comes to large construction works and companies (which are better covered by the official statistics). Indirectly we conclude that the construction activity of small and medium enterprises is somewhat more resistant to the crisis, in which undoubtedly this sector of the economy is.

Thoughtfully designed economic policy measures could help the construction industry

There are several ways in which the state could help the construction activity. First of all it should finally solve the problems and administrative barriers that lead to the slow issuance of building permits. This would not only have a broad and non-selective positive impact on construction, but it would be the cheapest thing to do for the country. Public investment would also have to be increased. In Q2, their level was a record low (only 1.8% of GDP) and for the country at the Serbia's development level, the optimum would be that the level of public investment is about 5%. With all this, the amount of the costs and benefits of large state housing projects should be analyzed (such as building settlements Vojvode Stepe in Belgrade). If possible, the key weaknesses of these and similar projects should be removed, and perhaps the possibility of their re-launch considered.

3. Employment and Wages

According to the April Labour Force Survey (LFS), the condition at the labour market is still unfavourable with certain signs of improvement. The signs are modest and it is not certain whether they are sustainable having in mind the recession in most of the economy. The employment rate, even though it grew by 1.1 percentage points compared to April 2012, is on an alarmingly low level of 45.8%. The unemployment rate has been reduced by 1.1 percentage point, but it is still considerably high and is 25%. The unemployment rate in youth (age 15-24), although it has been reduced within a year by 1.2 pp, is currently almost twice as high compared to the unemployment of the entire population and is 49.7%. Observed by regions, only Belgrade has unemployment rate below the total one and it is 19.2%. Compared to April 2012, unemployment rate has mostly fallen in the Belgrade region, by 3.6 percentage points, followed by Vojvodina by 2.4 percentage points. With respect to level of education, the highest unemployment rate is recorded in persons who haven't finished school and it is twice as high compared to individuals with high education. Their unemployment rate has increased the most in the observed period, which could be the result of reduced funds for public works in the last year, having in mind that these activities are mostly performed by low-qualified labour force. Net wages at the level of entire economy continued to drop in real terms in Q2 of this year. Observed by regions, net wages in the first half of 2013 compared to the same period last year have mostly increased in the sector of Professional, Scientific and Technical activities, compared to previous quarter as well as compared to Q2 of previous year.

Employment

Employment rate in April 2013 is still on a considerably low level of 45.8%

Even though the number of employees based on the date of the April Labour Force Survey (LFS) grew compared to the same period last year, by almost 45,000 persons, and employment rate grew by 1.6 percentage points, it is still at an alarmingly low level of 45.8% (Table T3-1). It is now certain that projections from the National Employment Strategy for 2011-2020, which foresaw total employment reaching its minimum in 2010 and returning to the pre-crisis level in 2013, will not be realised. As things now stand, the employment has reached its minimum in April 2012 and has been increasing very slowly since then, but it is still uncertain how sustainable these upward changes are and how much time it would take for the employment to return to the levels before the start of the crisis.

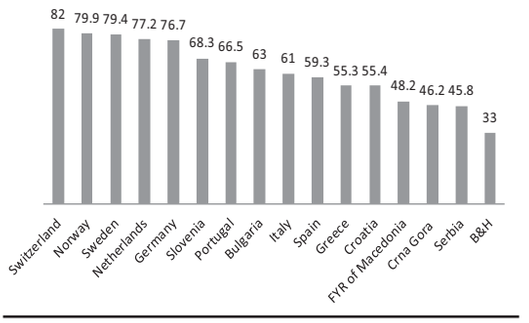
Table T3-1 Serbia: Employment and Unemployment according to the Labour Force Survey[1], 2008-2013

		Total no. of employed 15-64 [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
2013	April	2,127,649	315,109	45.8	53.6	38.1	707,440	25.0	23.1	27.3

Source: Labour Force Survey (LFS), RZS.
Note:
1) Labour Force Survey has been conducted since 2008, twice a year – in October and April.
2) Persons between the age of 15 and 64 are considered to be of working age.
3) Until October 2008, LFS did not have the 15-64 classification for the number of employees in agriculture and helping members

Just how alarming the situation in Serbia's employment rate really is, is demonstrated by comparative data. The graph shows employment rates for a certain number of European countries, starting with those who recorded the highest rates in 2012, through the countries of South Europe where the situation in the labour market drastically deteriorated with the start of the crisis. Finally, at the very bottom of the scale is Serbia and surrounding countries.

Graph T3-1 Employment Rates for Selected Number of European Countries, 2012



Source: Eurostat

The percentage of employees in the grey economy is rising in the private sector, while registered employment is dropping

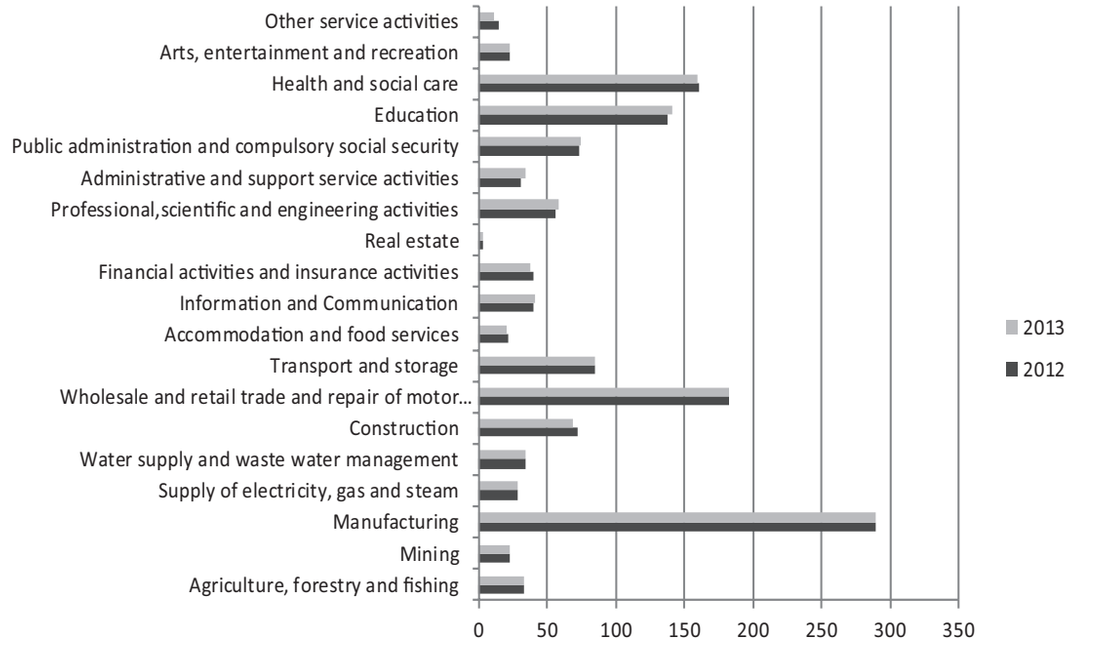
Percentage of employees in registered private economy in the total number of employees has dropped from 55.4% to 53.9% between April of this and previous year. Share of employees in private non-registered economy in the total number of employees has grown from 11% to 12.3%. A modest growth of share in total employment of 0.3 percentage points was recorded in other forms of ownership, while the share of employees in state-owned companies remained almost unchanged, 31.6% this year and 31.7% last year (Table T3-2).

Table T3-2 Employee structure by form of ownership, in %

	2012, april	2013, april
Registered private property	55.4	53.9
Unregistered private property	11	12.3
State property	31.7	31.6
Other forms of ownership	1.9	2.2

Source: LFS, April 2012. LFS, April 2013.

Graph G3-1 Employees by activities, data expressed in thousands



Source: RAD survey, SORS.

Formal employment in Q2 2013 unchanged compared to the same period last year; growth in only 5 out of 19 sectors

According to the data from the RAD survey, we can observe that the total formal employment in the second quarter of this year has remained unchanged compared to Q2 2012 (Table TP-4). Observed by sectors, number of employees has increased in only five out of a total of nineteen sectors. Growth has been recorded in the sector of Water Supply and Wastewater Management

- 5%, in Professional, Scientific and Technical Activities - 5.8%, in Administrative and Support Service Activities - 14.7%, in Public Administration and mandatory social security - 2%, and in the sector of Arts, Entertainment and Recreation - 2%. From the standpoint of healthy growth of employment, an unfavourable circumstance is that out of five sectors showing growth in formal employment, three are extremely dominated by the state, while significantly present in the other two. The biggest decline in employment has been recorded in the sector of Other Service Activities[1] by 20%, in Construction and in Financial and Insurance Activities by 3.5% each (Graph G3-1).

Unemployment rate is 25% and has dropped compared to April 2012 by 1.1 percentage point

According to the Labour Force Survey, the number of unemployed between April last year and this year has dropped by about 30,000 people. Unemployment decline is more expressed in men and is 2.5 percentage points, while in women the unemployment dropped by only 0.6 percentage points (Table T3-1).

Youth unemployment (age 15–24) is still alarmingly high

Youth unemployment, ages 15 to 24, is twice as high compared to the unemployment rate of the entire population. Although it dropped by 1.2 percentage points (pp) compared to April last year, it is still extremely high and is 49.7% (Table T3-3). In Highlights, we talk more about new measures, the so-called *guarantees for young people* which are applied in European Union and here, with the aim of resolving this priority social and economic problem.

In other age groups, unemployment has dropped by 1.5 percentage points, and the smallest decline was in persons ages 45-54 (0.9 percentage points).

Unemployment rate has dropped the most in the Belgrade region and is currently 19.2%

Over the last year the unemployment rate has dropped in all four regions, but the highest decline was in Belgrade – 3.6 and Vojvodina – 2.4 percentage points. The smallest decline of unemployment was recorded in the region of South and East Serbia – only 0.3 pp (Table T3-3).

Observed by educational level, unemployment of persons who haven't finished school has increased the most

Observed by educational level, the unemployment has only dropped for persons who have mid-level education and by 2.3 pp (Table T3-3). Compared to April last year, unemployment in persons without any education has increased by 15% (1,800 people). This could be a consequence of decreased funding of public works, where mainly workers of a lower educational profile are engaged, as well as a decreasing participation of workers with lower education in public works. In other countries, in addition to public works, measures that are used to improve the position of unskilled labour force are programmes of functional adult literacy and general training. Programme of functional adult literacy was introduced in 2004 on trial basis, but it didn't last. Then in 2011, a new programme started, financed by the European Union, entitled "Second Chance". It is planned that by the end of 2013, 4000 adults over the age of 15, without primary education or professional competence, pass through this concept of functional literacy.

Another programme that potentially could have benefited the most persons with low education is "Training for the Known Employer", but provided it is improved and directed more towards people with low educational profile, which currently isn't the case.

Table T3-3 Unemployment rate by age groups and educational level

	Age groups					Educational level			
	15-24	25-34	35-44	45-54	55-64	withouth	lower	midle	higher
Unemployment rate, April 2012	50.9	33.2	22.2	20.7	19.1	25.2	26.6	28.7	18
Unemployment rate, April 2013	49.7	32.6	20.7	19.8	17.6	40.2	26.5	26.4	19.4

Source: LFS, April 2012 and April 2013.

Percentage of unemployed people seeking employment for more than a year is 76.3%

According to LFS of April this year, 76.3% of the unemployed fall into the category of long-term unemployed, i.e. have been looking for a job over a year. This percentage has considerably increased since the beginning of the crisis, i.e. 2008, when it was 71.6% (LFS April 2008). The fact that almost 40% of the unemployed have been waiting for work for more than four years is

1 This sector (as a residual category) includes activities of organisations based on membership, computer maintenance, maintenance of objects for personal and home use, and various personal services.

extremely alarming. In addition, the fact that as much as 17% of the unemployed have been looking for work longer than 10 years indicates there is a considerable number of discouraged people, most probably transition losers, who the economic crisis additionally pushed to the margins of the labour market.

Share of long-term unemployed in the total number of unemployed people does not differ by gender, but there are some differences by regions. So for example, in Šumadija region and West Serbia, as much as 81.6% of unemployed women have been looking for work for over a year, while the lowest number of unemployed women is in Vojvodina – 71.3%. Observed by educational level, the biggest number of long-term unemployed is among the population between 55 and 64 years of age, as much as 86.4%. Finally, the smallest number of unemployed people looking for work for over a year is among those who are highly educated (69.4%), while the biggest number is among those without formal education (83%).

Wages

Average monthly gross wages lower by 4.1% compared to the same quarter of previous year

According to the data from the Statistical Office of the Republic of Serbia (RZS), at the year-on-year level, average monthly gross wages are nominally higher by 5.9%, and in real terms they are lower by 4.1% (Table T3-4). Average monthly gross wages in the second quarter of this year were 44,248 dinar or 395 euro, and it was lower in real terms by 3.5% (Table TP-5).

Table T3-4 Serbia: Average Monthly Wages and Year-on-Year Indices, 2008-2013

	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
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
2013						
Q1	67,704	41,419	606	371	106.0	94.6
Q2	72,143	44,248	644	395	105.9	95.9

Source: RZS

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

According to the National Statistical Office data, average monthly net wages in the surrounding countries, for the first half of 2013, were 740 EUR in Croatia, 480 EUR in Montenegro, 420 EUR in Bosnia and Herzegovina, and 330 EUR in Macedonia.

Highlights : Effects of changes in tax regulation on the labour market

Through amendments to the Law on Income Tax and Law on Social Security Contributions, the following novelties have been introduced as of June this year:

• Tax rate on wages has been reduced from 12% to 10%;

• Non-taxable part of the wages has been increased from 8,776 RSD to 11,000 RSD;

• Contribution rate for pension and disability (PIO) on the employee's side has been increased from 11% to 13% (while the rate for PIO on employer's side has remained the same – 11%);

• Rate of PIO contributions for other wages (temporary service contracts, etc.) has been increased from 22% to 24%.

The goal of these changes was to reallocate tax revenue from local self-governments to the state, and they probably won't have any impact on the labour market, since the unburdening of the wages was minimal. Even though the expert public has discussed several times the necessity of reducing the fiscal burden on labour[1] in order to increase demand for labour, before this kind of measure is introduced, research data from other countries should be taken into account, where similar policies have already been implemented. Different research shows that fiscal unburdening of labour leads to a reduction in the cost of labour and an increase in employment only if it is well prepared and supported by other measures of economic policy. Otherwise, there is a possibility of most of the fiscal unburdening being used for the growth of net salaries, in which case the cost of labour does not change and there is no increase in the demand for labour force.

1 Labour taxes (or labour tax burdens) represent a sum of contributions for social security at the burden of the employee, contributions at the burden of the employer and tax on salaries. Total cost of labour includes gross salary increased by social security contributions at the burden of the employer. Net salary increased by the tax on salaries and contributions at the burden of the employee make the gross salary.

In the first half of the year, compared to the same period in 2012, wages have increased the most in the regions of Šumadija and West Serbia

Observed by regions, average net wages in the first half of the year, compared to the same period in 2012, have increased the most in the regions of Šumadija and West Serbia by 8.7%. The smallest growth was recorded in the Belgrade region – 4%.

Wages increased the most in Professional, Scientific and Technical Activities

Observed by activities, as can be seen in Table T3-5, in Q2 2013 compared to the previous quarter, the net wages increased the most in Professional, Scientific and Technical Activities, and Administrative and Support Services by 6.7% each. In other sector, growth ranged from 0.5% to 1.1%. The biggest decline in wages in the amount of 3% was in the field of Finance and Insurance. As in the growth of employment, in this case as well the biggest growth of wages was realised in the activities dominated by the public sector.

T3-5 Real, seasonally adjusted net wages, by activity sectors

	Professional scientific and engineering activities	Administrative and support service activities	Financial and insurance activities
Q1, 2012	106.35	106.35	106.77
Q2, 2012	103.3	103.3	95.26
Q3, 2012	95.19	95.19	94.65
Q4, 2012	98.6	98.6	97.6
Q1, 2013	93.69	93.69	101.89
Q2, 2013	100.43	100.43	98.62

Source: *QM* calculations

Table P-6 Serbia: Average Monthly Wages and Year-on-Year Indices, 2012-2013

	Average Monthly Wage (SORS)			Average Monthly Wage (SORS)	
	Total labor costs in rsd	Gross in rsd	Net in rsd	Y-o-y real indices, gross	Y-o-y real indices net
2012					
January	59,927	50,829	36,639	101.5	101.9
February	65,440	55,505	40,003	107.1	107.3
March	66,171	56,125	40,562	109.3	109.6
April	68,930	58,465	42,215	104.1	104.3
May	66,267	56,206	40,442	110.2	110.0
Jun	69,221	58,712	42,335	102.0	102.1
July	67,486	57,240	41,180	99.6	99.2
August	68,975	58,503	42,122	101.7	101.7
September	65,910	55,903	40,258	94.2	94.2
October	68,067	57,733	41,558	96.6	96.5
November	69,460	58,914	42,395	98.9	98.8
December	76,830	65,165	46,923	95.1	95.3
2013					
January	64,193	54,447	39,197	95.0	94.9
February	70,975	60,199	43,371	96.5	96.4
March	67,943	57,628	41,689	91.4	91.5
April	75,750	64,249	46,530	98.6	98.9
May	68,289	57,921	41,821	94.7	95.0
Jun	72,389	61,399	44,394	95.3	95.6

Source: RZS

Note: 2008 data represents corrected data based on expanded scope of the sample for calculating average wages. Thus, the nominal values of wages for 2008 are comparable to the nominal values for 2009, but not to previous years.

4. Balance of payments and foreign trade

During Q2 2013, tendency in reduction of current account deficit continued. The low deficit of 276 million euros (3.3% of GDP) partly reflects a long-term tendency, while it is partly the result of temporary factors. Trade deficit in Q2 was 990 million euros (11.7% of GDP), which is significantly below the previous quarterly values. Reduction of foreign trade and by the same token current account deficit is the result of fast growth of exports, accompanied by modest growth of imports (18.8% compared to 3.5%). This continues the growth of coverage of imports by exports and reaches the record value; almost ¾ of imports are covered by exports. In addition to good foreign trade results, what also contributed to the reduction of current deficit was a higher amount of current transfers, whose growth is probably temporary. It is our estimate that the current deficit in 2013 will be 6-7% of GDP, which means it will be significantly lower than in previous years, but still above the sustainable level in the long term. Trends in capital balance during 2013, including Q2, have negative macroeconomic implications. Companies and banks are lowering their debts, while the inflow of foreign direct investments is extremely low. Payment of business debts is jeopardising their liquidity and deepening the recession, while low foreign direct investments reduce the chances of accelerated growth of economy in the following year. During Q2, due to the financing of current account deficit and net outflows of capital, foreign currency reserves have been reduced by 886 million euros. Decline of foreign debt, which was realised in Q2, is primarily a consequence of settling part of the public sector debt, and to a smaller extent of settling debts of the private sector. In the following period, we expect a growth of foreign debt, which will primarily be determined by additional foreign borrowing of the public sector.

Balance of payments current account deficit dropped significantly in Q2 2013 ...partly due to temporary factors

Reduction of balance of payments current account deficit that started at the end of 2012, accelerated in the first half of 2013. Current account deficit in Q2 2013 recorded an extremely low value for Serbia, i.e. 276 million euros, which is 3.3% of GDP (Table T4-1 and Graph T4-2). Favourable decline trend, as well as currently unusually low level of current deficit are primarily the result of improved results in foreign trade (fast growth of exports, followed by modest growth of imports). Also, this reduction is the consequence of currently relatively high inflow of current transfers, which is at least partially the result of temporary factors.

At the beginning of the crisis, the deficit was reduced due to a decline in domestic demand and depreciation of dinar

Seasonally adjusted current account deficit presented in Graph T4-2 indicates that it is reaching one of the minimal values in the past several years. In the first wave, at the beginning of the global crisis, the current deficit was reduced due to the drop in domestic demand and depreciation of dinar. As of the second half of previous year, the reduction in deficit is not only the result of the reduction in domestic demand[1], but also of the factors on the supply side, which generate growth of exports.

...this year, factors on the supply side have had significant contribution

In the first half of 2013, the current deficit was 903 million euros (5.6% of GDP). If the achieved favourable results in foreign trade hold, together with other unchanged conditions, the value of the current deficit will be 6% of GDP in 2013[2]. If this value is realised in 2013, it will be significantly lower compared to previous years, but still quite high.

Current deficit in 2013, although lower compared to previous years, is still high

During the first six months of 2013, the value of the current account deficit was 52.9% below the realised value in the same period last year. This decline, although mostly the result of a reduction in deficit in real terms, is partly due to a high base. That is, considering that previous year was an election year, high public spending was recorded that caused a high growth of domestic demand and, by the same token, an unusually high current deficit. A much smaller decline of

1 New recession wave was recorded at the beginning of 2012. Even though since the beginning of 2013 there has been a year-on-year growth of GDP, the growth is initiated by agriculture and only a few successful companies (FIAT, NIS), while the biggest part of Serbian economy is still in recession, see section 2: „Economic Activity" of this issue of *QM*.

2 For calculation, we used in the denominator the estimated GDP of the Ministry of Finance and Economy, and in the numerator the usual annual values on the accounts of Services, Income and Current Transfers (whose annual values don't vary significantly) and double value of the trade deficit realised in the first half of 2013. That means that if there are no further reductions in trade deficit in the second half of 2013, ceteris paribus, the current deficit could be even below 6% of GDP.

current deficit is reached if it is compared to the first half of 2010 or 2011 (34% and 31% respectively) – comparison to 2010 and 2011 probably reflects better the real improvement of the current balance.

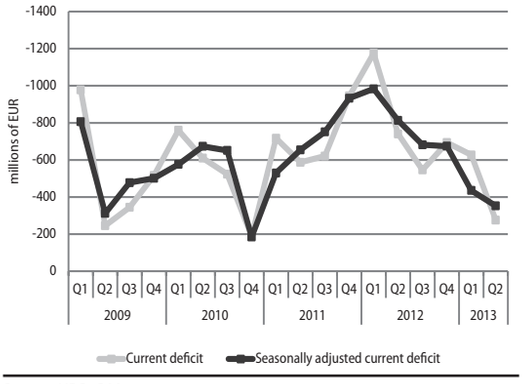
Table T4-1 Serbia: Balance of Payments

	2010	2011	2012	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1
				mil. euros				
CURRENT ACCOUNT	-2,082	-2,870	-3,155	-1,176	-740	-546	-694	-627
Goods	-4,774	-5,318	-5,450	-1,549	-1,294	-1,186	-1,420	-1,152
Export f.o.b[1)]	7,402	8,440	8,822	1,854	2,282	2,244	2,442	2,260
Import f.o.b[1)]	-12,176	-13,758	-14,272	-3,403	-3,577	-3,430	-3,862	-3,413
Services	5	163	152	29	1	33	90	34
Export	2,667	3,032	3,091	667	747	839	838	698
Import	-2,662	-2,869	-2,939	-638	-747	-805	-749	-664
Income, net	-670	-758	-798	-229	-211	-156	-203	-190
Receipts	438	428	547	109	134	138	167	102
Payments	-1,108	-1,186	-1,346	-338	-345	-293	-369	-291
Current transfers, net	3,356	3,043	2,941	574	765	762	839	681
o/w grants	193	206	144	26	38	43	38	30
o/w private remittances, net	2,383	2,065	1,934	359	523	483	570	457
CAPITAL ACCOUNT	1	-3	-11	-3	-4	-1	-2	-2
FINANCIAL ACCOUNT	1,986	2,694	2,988	1,120	685	490	692	612
Direct investment, net	860	1,827	242	-362	234	117	253	155
Portfolio investment, net	39	1,619	1,720	130	58	-37	1,569	1,402
Other investments	158	1,049	-112	436	-707	71	88	-85
Trade credits	83	493	498	164	199	27	108	78
Loans	830	-413	-437	-29	-135	-160	-113	-366
NBS	341	45	-219	-4	0	-111	-105	-150
Government	735	687	261	18	91	86	65	162
Commercial banks	626	-729	-521	-146	-348	-63	35	-308
Long-term	619	419	-368	-80	-107	-80	-100	-179
Short-term	6	-1,148	-154	-66	-241	18	135	-129
Other (enterprises)	-872	-416	42	102	122	-73	-109	-70
Currency and deposits	-754	970	-172	300	-770	204	93	203
Other assets and liabilities	0	0	0	0	0	0	0	0
Allocation of SDR	0	0	0	0	0	0	0	0
Reserves Assets (- increase)	929	-1,801	1,137	916	1,100	340	-1,218	-859
ERRORS AND OMISSIONS, net	96	179	178	59	60	57	3	17
OVERALL BALANCE	-929	1,801	-1,137 0	-916	-1,100	-340	1,218	859
PRO MEMORIA				in % of GDP				
Current account	-7.4	-9.1	-10.6	-17.0	-9.8	-7.3	-8.7	-8.2
Balance of goods	-17.1	-16.9	-18.2	-22.5	-17.2	-15.9	-17.7	-15.0
Exports of goods	26.5	26.8	29.5	26.9	30.4	30.1	30.5	29.5
Imports of goods	-43.6	-43.6	-47.8	-49.3	-47.6	-46.0	-48.2	-44.5
Balance of goods and services	-17.1	-16.3	-17.7	-22.0	-17.2	-15.5	-16.6	-14.6
Current transfers, net	12.0	9.7	9.8	8.3	10.2	10.2	10.5	8.9
GDP in euros[2)]	27,956	31,534	29,870	6,900	7,516	7,449	8,004	7,664

Source: NBS.
1) Exports and imports FOB, according to NBS methodology adjusted to IMF BOPM-5.
2) Quarterly values. Conversion of the annual GDP to euros was done based on average annual exchange rate (average of official daily middle exchange rates of NBS).

Trade deficit visibly below previous quarterly values

Graph T4-2 Current Deficit and Seasonally Adjusted Current Deficit, quarterly, 2009-2013



Source: NBS, *QM*.

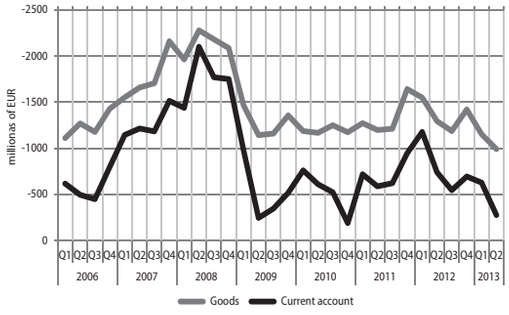
Trade deficit is 990 million euros, i.e. 11.7% of GDP. This level of trade deficit is both in absolute and relative terms (as share of GDP) significantly below the previous quarterly values recorded in the observed period (since 2006, Graph T4-3 and T4-4). During Q2, exports were 2,711 million euros and have reached 32.0% of GDP. This share of exports in GDP is above previous values of this indicator (2008: 22.7% of GDP, 2009: 20.6% of GDP, 2010: 26.5% of GDP, 2011: 26.8% of GDP, and 2012: 29.5%, see Table T4-1). Exports will probably reach in 2013 the historic maximum, both in euros and in relative terms (in % of GDP). Such value of exports is still relatively low compared

to other countries. In 2012, with exports of goods and services of 39.9% of GDP, Serbia was behind the countries in the region: Hungary 94.8% of GDP, Slovenia 76.1% of GDP, Bulgaria 66.6% of GDP, Macedonia 53.1% of GDP, Croatia 43.4% of GDP, Montenegro 40.3% of GDP, and Romania 40.0% of GDP[3]. In 2013, exports of goods and services will be increased as % of GDP, but it will still be among the lowest in the region. Due to real appreciation of dinar, GDP in euros has significantly increased in 2013, so the share of exports of goods and services in GDP will modestly grow – by around 1 percentage point (pp). If it were not for real appreciation of dinar, the share of exports of goods and services in GDP would have grown by 4-5 pp.

On the other hand, imports are recording modest results. During Q2, 3,701 million euros worth of goods were imported, which is 43.7% of realised quarterly value of GDP. Thus, the share of imports compared to Q1 has been decreased by almost 1 pp, while significantly below the quarterly levels of previous year (especially compared to Q1 and Q2 of 2012, when the growth of domestic demand due to election period reflected on the growth of imports).

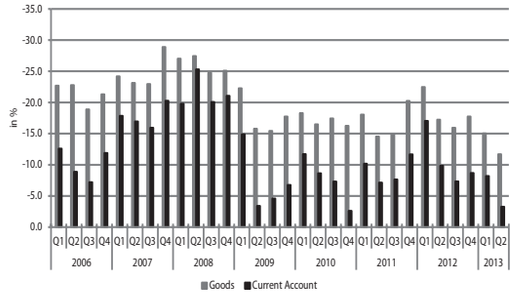
A mild surplus on the account of services was realised, i.e. 79 million euros. So the foreign trade deficit in Q2 was 911 million euros, which was only 10.8% of GDP.

Graph T4-3 Current and Trade Deficit, 2006-2013



Source: NBS, *QM*.

Graph T4-4 Current and Trade Deficit in % of GDP, 2006-2013

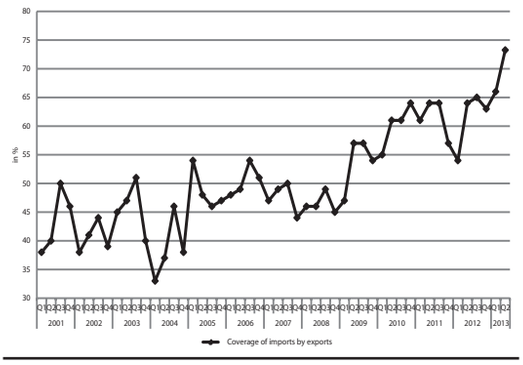


Source: NBS, *QM*.

Reduction of foreign trade and consequentially current account deficit is the result of very fast growth of exports, accompanied by modest growth of imports

Reduction of external imbalances: foreign trade and consequentially balance of payments current account deficit, is the result of very fast growth of exports, accompanied by a modest growth of imports. Exports are by 18.8% above the value recorded in Q2 2012, while imports have a year-on-year growth of 3.5%. Thus the growth of exports-covered imports is continued. This indicator has reached record high value, where almost ¾ of imports are covered by exports (Graph T4-5). This kind of dynamic of imports and exports evidently contributes to the desirable change of structure in foreign trade in favour of exports, which we emphasised as a necessary road to achieving a balanced level of current deficit. Still, a negative fact is that the acceleration of exports is for the largest part due to starting production in one factory (FIAT), considering that increase of exports excluding road vehicles has recorded an annual growth of 3.4%[4]. When export results of one country depend on the business operations of a single company, it is not a strategically good solution and bears a lot of risk (which was already the case in Serbia in the years up to 2012, when most of exports depended on the business of US Steel, and when exports were significantly reduced after its withdrawal from the market). On the other hand, the example of FIAT should indicate the importance of creating business environment for attracting foreign

Graph T4-5 Serbia: Coverage of Imports by Exports, quarterly, 2001-2013



Source: SORS, NBS, *QM*.

3 Source: Eurostat.

4 See section *Exports* further down in the text.

investments in Serbia, especially in the environment of low employment and poor inflow of foreign capital.

Aside from motor vehicles (FIAT Automobiles Serbia - FAS), high contribution to growth of total exports was also realised by the exports of oil derivatives (NIS) and the pharmaceutical industry. Additionally, what also contributed to growth of exports were companies that produce auto-parts, as well as other industries: production of rubber and plastic products, and production of electrical equipment[5].

Low imports are the result of low domestic demand, due to the first series of applied measures of fiscal consolidation and their effect on the reduction of private and state spending, but also due to a fall in investments. Even though the drop of imports of investment goods reduces the foreign trade balance, the associated drop of investments jeopardises the growth of economy in the future. Improvement of trade balance in the future will be negatively affected by real appreciation of the domestic currency in the previous year and the slow recovery of eurozone. Observed year-on-year, trade deficit in Q2 2013 is lower by almost ¼ of the value realised in the same quarter of the previous year.

By end of 2013, we expect the main factors of the reduction in value of current account deficit to still be continued favourable trends in foreign trade. Primarily, high positive effect of export growth of motor vehicle, oil derivatives and chemical industry. Also, the additional factor on the side of reduction of current deficit will be the reduction of imports due to halted domestic demand – as the result of current and planned modest increase of salaries and pensions, as well as the still existing recession in the large part of domestic economy. Also, better agricultural season will lead to increased exports of agricultural and food products in the second half of 2013. Additionally, expected although modest recovery of EU, which is our biggest export area, will again affect export value and export structure.

In 2014, we expect the same effect of these factors, with anticipated slowdown in the growth of total exports led by the growth of exports of oil derivatives and cars. Also, as the recession played in favour of reducing the imbalance on foreign trade and current accounts, the exit out of recession in the future will bring the danger of these deficits increasing. Preventing the possible growth of foreign trade/current deficit, after the recession is over, could be realised through gradual real depreciation of dinar and reduction of domestic demand, which would be realised by continued reduction of the fiscal deficit.

In addition to good foreign trade results, higher value of current transfers also contributed to the reduction of current deficit, which is probably just a temporary improvement

Net inflow of current transfers is 879 million euros (10.4% of GDP). Of that amount, 630 million (7.4% of GDP) is inflow of remittances. These kinds of values of current transfers and remittances are above Q2 2012 and average of 2012, and by 1.5 percentage points of GDP above the values recorded in Q1 2013. So, in addition to good foreign trade results, what also contributed to the reduction of current deficit was a somewhat higher value of current transfers. Inflow of current transfers during Q2 2013 was higher by 15% compared to Q2 2012, due to growth of remittances by 20% in the same period. Still, this growth of inflows of remittances (and current transfers) is probably only one-time occurrence, so it is hard to count on it staying on such a high level in the coming period.

On the income account, a net outflow of 244 million euros was recorded, and it is on the rise compared to previous quarters. Income on expenditure side includes payments of interests on short-term and long-term loans and borrowings, dividends, etc. of the private and public sector. Having in mind that public sector obligations will increase on this basis in the coming period, we expect that such a result on the income account will be relatively permanent unfavourable tendency.

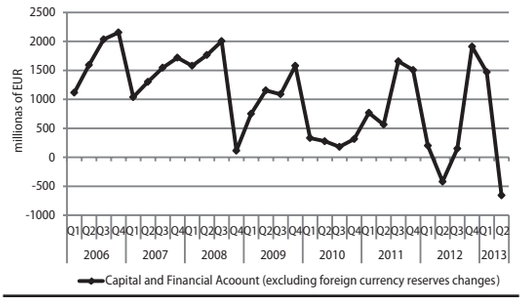
Net outflow of capital realised in Q2...

Realised favourable trends in the current part of balance of payments are accompanied by unfavourable trends in its financial part. That is, Q2 recorded a net outflow of capital of 666[6] million euros (Table T4-1 and Graph T4-6). Stated outflow of capital is primarily the consequence

5 See Text box 3 in *NBS Inflation Report*, August 2013, p. 31

6 619 million euros with a correction of the account *Errors and Ommissions*.

Graph T4-6 Capital and Financial Account, 2006-2013



Source: NBS, *QM*.

...primarily due to settling part of the state's debt...

of state's debt payment to the London Club executed at the end of April, and other debts that have matured for payment, repayment of financial loans of the banks and businesses, and modest inflows of FDIs. Therefore, net foreign assets haven't significantly changed.

During Q2, there has been a net outflow of portfolio investments of 347 million euros. This result is primarily the consequence of an early repayment of part of the debt, but to a certain extent of increased risk premium of the country. Still, this reduction of debt is temporary, because it is expected that by the end of the year, the public sector debt will grow in order to finance the fiscal deficit. At the end of April, the state settled almost half of the remaining debt towards the London Club – 400 million dollars out of the remaining 860 million dollars. Settling part of the debt was enabled thanks to the increased budget liquidity due to previously accumulated funds collected by the emission of eurobonds and other borrowings in the previous months, as well as through positive starting effects of the implementation of fiscal consolidation. As a reaction to Fed's announcements, there has been an increase in the risk premium of surrounding countries as of end of May and a general withdrawal from and avoiding of further investments in risky markets by investors. Increased risk premium in Serbia was additionally caused by poorer than expected results of fiscal adjustment.

and modest inflow of FDIs

Net FDIs are still low and they were 139 million euros in Q2, which is cumulatively since the beginning of the year a modest inflow of 294 million euros. Even though the inflow is above the one realised in the same period of 2012, it cannot be considered a good result, considering the record low last year's inflow due to specific circumstances (increased instability of the country because of the election year and a long period of forming the Government, which had a counter-stimulating effect on investors, as well as the once-off withdrawal of capital in telecommunications at the beginning of the year)[7]. What sends a positive signal to foreign investors in 2013 is the beginning of fiscal reform, stabilisation of the foreign exchange rate, and lowering inflation towards its goal, as well as indications of recovery of the eurozone. Still, it is our estimate that foreign investments in 2013 will be relatively modest and that they will at best reach a billion euros (around 3% of GDP). Such low foreign direct investment in this year, with low local investments, indicate that no considerable acceleration of the economic growth can be expected in the following year (for more details see section 2: "Economic Activity" in this issue of QM).

Foreign direct investments in Serbia in 2012 and first half of 2013 are among the lowest in the countries of Central and Eastern Europe

With the start of the crisis, there has been a decline in foreign direct investments in all countries of Central and Eastern Europe (the Region). In the period 2009-2011, the decline of foreign investments in Serbia was lower than in other countries of the Region, primarily due to high investments of FIAT and NIS. However, during 2012 and in the first half of 2013, foreign direct investments in Serbia were extremely low – among the lowest compared to the countries of the Region.

Net borrowing of NBS, the banks and companies for financial loans

During Q2, there was a net outflow on the account of other investments of 458 million euros. That was primarily the result of net borrowings of the banks and companies for financial loans (291 million euros), net outflow on the account *Cash and Deposits* of 165 million euros, while the account of trade loans was almost balanced (a slight net outflow in the net amount of 2 million euros was recorded, Table T4-1).

Deleveraging of financial loans is the result of NBS settling their obligations towards IMF (148 million euros were paid for these purposes), deleveraging of companies towards foreign creditors (in the net amount of 142 million euros – which is almost entirely long-term borrowing), and reduction of the banking sector's debt (43 million euros, out of which the biggest part – 41

7 For details see *QM28* & *QM29*, section "Balance of Payment and Foreign Trade"

million euros was towards repayment of short-term loans). On the other hand, the public sector increased its obligations towards foreign creditors by 42 million euros for financial loans.

Considerable reduction of forex reserves realised during Q2

In Q2, NBS forex reserves decreased by 886 million euros. Out of that amount, the biggest reduction was recorded in April – 543 million euros, primarily due to early repayment of part of the state debt (305 million euros) and withdrawal of the surplus of mandatory reserves deposited in the past by the banking sector (274 million euros)[8]. During April and May, NBS intervened with a smaller amount in order to mitigate excessive daily fluctuations of the foreign exchange rate, while in June it sold 270 million euros for the same purposes.

Exports

Trend of fast growth of exports continued in Q2

In Q2, exports continued fast growth started at the end of the previous and especially at the beginning of the current year. Goods in the value of 2,738 million euros were exported, which represents 19.5% year-on-year growth[9]. Achieved growth of exports is primarily due to exports of the automobile industry (FAS), as well as exports of oil derivatives (NIS) and the chemical industry. Also, companies producing car components, as well as other branches (production of rubber and plastic products and production of the electrical equipment) have made a significant contribution to the increase of exports in Q2.

Exports excluding road vehicles have recorded a much more modest growth

After excluding exports of road vehicles, the value of exports record a significantly lower growth of 3.4% year-on-year (thus observed exports recorded a year-on-year growth of 8.2% in Q1 2013, see Table T4-7). We feel that the acceleration of exports excluding road vehicles realised in Q1 2013 is partly due to the delayed effect of real foreign exchange rate – depreciation of dinar recorded in the first three quarters of last year, while the recorded slowdown in Q2 2013 is the result of appreciation of the domestic currency, which started at the end of 2012 and continued at the beginning of 2013.

In 2013, the exports will probably reach a historic maximum, both nominally and in real terms (in % of GDP). Still, compared to other countries, not just the developed ones, but transitional European countries as well, such export values are still relatively low.

Energy exports continue to accelerate growth thanks to the exports of oil derivatives

Energy exports are accelerating growth. In Q2 2013, the year-on-year growth of exports in Energy was 53.6% (after 48.2% in Q4 2012 and 49.4% in Q1 2013). High export growth rates of energy products were realised thanks to the investments undertaken during 2012 and the improvement of NIS production capacities, which led to the expansion of oil derivatives exports since the beginning of 2013.

Year-on-year growth of exports of *Intermediary Products* is 11.7%. It is a continuation of the growth trend of exports of these products, which started in 2013, after the negative year-on-year growth rates realised during all four quarters of 2012. *Capital Products* recorded an increase of 108.3% year-on-year, which is predominantly owed to the exports of the automobile industry. After the category of road vehicles is excluded, the growth of exports of capital products is 8.7% and is significantly slower compared to the previous quarter (when the export of capital products excluding road vehicles grew by 21.5% year-on-year).

Growth of exports of *Durable Consumer Goods* continued to accelerate during Q2. So the exports of this group of products were by 25.9% above the one realised in Q2 of last year. On the other hand, exports of *Non-durable Consumer Goods* continued to slow down and in Q2 they grew by 3.1% year-on-year. Exported value of products in the group *Other Exports* was by 48.8% lower compared to the one realised in Q2 2012 (Table T4-7).

8 http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=6442&konverzija=no

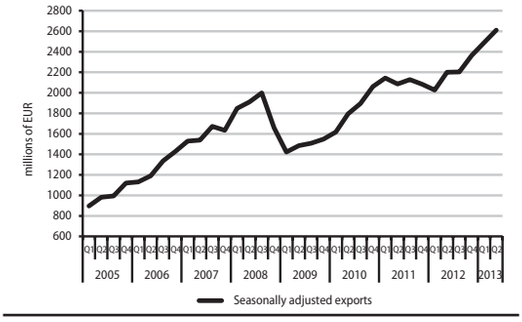
9 Part of the text dealing wih the analysis of balance of payments uses the adjusted data for imports and exports (FOB) published by NBS and calculated according to the IMF methodology ("Balance of Payments Manual", fifth edition, IMF; http://www.imf.org/external/np/sta/bop/BOPman.pdf.). Part of the text dealing wih the analysis of imports and exports uses RZS data, which are methodologically different than NBS data. That is why there is a difference in the presented imports and exports, as well as in growth rates.

Table T4-7 Serbia: Exports, year-on-year growth rates, 2011–2013

	Exports share in 2012	2011[1)]	2012[1)]	2012		2013		2012		2013	
				Q1	Q2	Q1	Q2	Q1	Q2	Q1	Q2
	in %			mil. euros				in %			
Total	100.0	8,441	8,836	1,862	2,283	2,265	2,728	-5.2	5.8	21.7	19.5
Total excluding road vehicles	94.7	8,253	8,366	1,822	2,228	1,972	2,304	-5.2	5.9	8.2	3.4
Energy	3.4	310	304	64	86	95	131	1.1	-26.7	49.4	53.6
Intermediate products	38.3	3,980	3,387	739	878	838	981	-25.0	-7.1	13.5	11.7
Capital products	17.7	1,001	1,566	268	365	570	761	35.6	25.5	112.8	108.3
Capital products excluding road vehi	12.4	813	1,096	228	310	278	337	48.0	32.2	21.6	8.7
Durable consumer goods	4.5	347	397	78	100	104	136	5.0	12.3	32.9	35.9
Non-durable consumer goods	25.7	2,118	2,272	478	543	503	560	2.5	13.2	5.3	3.1
Other	10.3	686	910	235	312	154	160	32.6	69.3	-34.3	-48.8

Source: SORS.
1) data in millions of euros, as well as year-on-year growth rates, were calculated based on the data from the Statistical Office of the Republic of Serbia (RZS) according to a new methodology. For details, see QM no.20, Box1 "Change of Foreign Trade Methodology of the Statistical Office of the Republic of Serbia".

Graph T4-8 Serbia: Seasonally Adjusted Exports, quarterly, 2005-2013



Source: NBS, SORS, *QM*.

Seasonally adjusted data also shows sudden growth of exported value

Seasonally adjusted data also shows fast growth of total exports (Graph T4-8). Thus observed exports were by 4.9% higher in Q2 than they were in the previous quarter (which is a growth of 21.2% at the year-on-year level). Also, seasonally adjusted data indicate that exports in Q2 2013 were by 31% above the maximum value that domestic exports recorded before the start of the global economic crisis.

Imports

In Q2, imports recorded a modest growth, although they slightly accelerated compared to previous quarters

Imports in Q2 were 3,822 million euros, which was 3.2% above the values from Q2 2012. Even though such a growth of imports is pretty modest, it is still higher compared to previous year-on-year growth rates recorded as of the middle of the previous year: 1.2% in Q3 2012, 1.6% in Q4 2012 and 0.1% in Q1 2013 (Table T4-9).

It should be noted that the growth of imports in Q1 and Q2 2013 was calculated against a high base (Q2 2012). That is, at the beginning of 2012, imports were at an irregularly higher level due to the fiscal expansion in the pre-election period. Therefore, if we took 2011 as comparison basis, the imports would have been higher in Q1 2013 by 4.2% and in Q2 2013 by 11.3%.

Aside from the high base, the reason for the slow growth of imports is low domestic demand, which is primarily the result of the effects of certain measures of fiscal consolidation applied so far. So during Q2, there was a significant drop in all components of the domestic demand: private and public spending, but also lack of larger investments. On the other hand, real appreciation of dinar from the previous period (started at the end of 2012)[10] had a stimulating effect on the import demand.

The effects of decline in the imports of Energy on total imports might possibly lessen soon

Reduction in the imports of *Energy,* started in the first half of 2012, continued in Q2 2013 as well. As we have already written in previous issues of QM, reduction of *Energy* imports is the result of increased exploitation of oil in Serbia due to the renewal of production capacities of the Serbian Oil Industry (NIS). So, the imports excluding energy recorded a year-on-year growth of 5.6% in Q2 (Table T4-9).

10 For details see section 5: "Prices and Foreign Exchange Rate" in this issue of *QM*.

At a first glance, the structure of imports is favourable, but the picture changes once we exclude the imports of components for FAS

Capital Products, Other Imports and *Non-durable Consumer Goods* recorded a year-on-year growth at a rate of 25.2%, 17.2% and 4.1%, respectively (Table T4-9). Still, the picture changes once we exclude components for motor vehicles that statistics record within imports of Capital Products and Other Imports. So, these two groups of products together had a year-on-year growth of 19.8% in Q2. When we exclude the imports of road vehicles, these groups realise imports as much as 8.1% below last year's. Therefore, we can conclude that by far, the biggest part of the year-on-year growth of imports in capital products is owed to FIAT. Just how important these components are in total imports is demonstrated by the fact that once their values are excluded, the total imports in Q2 are by 4.6% below last year's.

Year-on-year reduction of import value was recorded in *Intermediary Products* (-6.5%) and in *Durable Consumer Goods* (-7%). Such an import structure has to be tagged as unfavourable, because it reflects activities in one area, i.e. it is primarily the result of imports of components for the production of motor vehicles, low economic activity in other areas, as well as lack of considerable production investments.

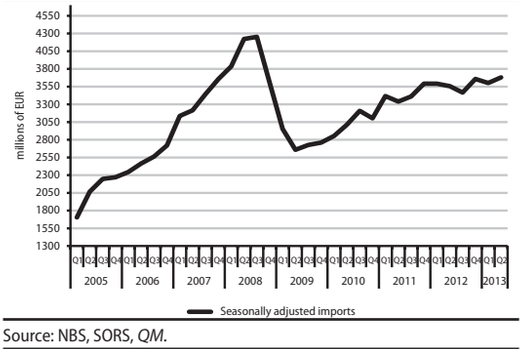
Table T4-9 Serbia: Imports, Year-on-Year Growth Rates, 2011-2013

	Imports share 2012	2011[1)]	2012[1)]	2012		2013		2012		2013	
				Q1	Q2	Q1	Q2	Q1	Q2	Q1	Q2
	in %			mil. euros				in %			
	100.0	14,250	14,762	3,524	3,704	3,528	3,822	5.5	5.9	0.1	3.2
Total	17.5	2,846	2,582	817	553	548	485	6.4	-12.9	-32.9	-12.3
Energy	34.8	5,030	5,134	1,157	1,382	1,144	1,292	3.9	0.7	-1.2	-6.5
Intermediate products	19.4	2,812	2,865	637	744	774	931	-8.5	2.0	21.5	25.2
Capital products	2.2	320	323	77	83	75	77	15.2	15.0	-2.9	-7.0
Durable consumer goods	15.0	2,176	2,215	475	518	502	539	8.8	3.5	5.6	4.1
Non-durable consumer goods	11.1	1,066	1,644	361	425	486	498	39.8	101.2	34.8	17.2
Imports excluding energy	82.5	11,404	12,180	2,707	3,151	2,981	3,336	5.2	10.1	10.1	5.9

Source: SORS.
1) data in millions of euros, as well as year-on-year growth rates, were calculated based on the data from the Statistical Office of the Republic of Serbia (RZS) according to a new methodology. For details, see QM no.20 Box 1 "Change of Foreign Trade Methodology of the Statistical Office of the Republic of Serbia".

Seasonally adjusted imports in Q2 slightly above the values from the previous quarter

Graph T4-10 Serbia: Seasonally Adjusted Imports, quarterly, 2005-2013



Source: NBS, SORS, *QM*.

Seasonally adjusted data shows that imports in Q2 were slightly above the values from the previous quarter (2.2%, i.e. 9.0% annualised, Graph T4-10). The graph clearly indicates a very slow recovery of imports after the crisis, which is especially expressed as of mid-2012. So the imports are still by 13.5% below the values achieved in Q3 2008.

Foreign Debt

Foreign debt was reduced during Q2, but it is expected to grow again by the end of 2013

At the end of June, foreign debt was 26,072 million euros, i.e. 82.5% of GDP (Table T4-11). Compared to the situation three months ago, foreign indebtedness has been reduced by 651 million euros, i.e. by 4.7 percentage points of GDP. Realised reduction of the foreign debt is primarily the consequence of public sector deleveraging (due to settling part of the debt), and to a lesser extent of the private sector deleveraging. Considering that the state still has a high fiscal deficit, this drop is temporary, so there will be a rise in foreign debt by the end of 2013.

... as the result of settling part of the public sector's foreign debt...

Foreign debt of the public sector at the end of Q2 was 12,914 million euros[11] which was 40.9% of GDP. In Q2, public sector reduced the debt by 569 million euros. Out of this amount, the biggest part was early repayment of part of the principle towards the London Club, payment of matured state bonds, as well as settling of obligations towards local and foreign banks. Also, part of this amount is due to NBS debt settlement towards IMF (during Q2, 167 million euros were paid for these purposes).

...and to a lesser extent due to deleveraging of the private sector

Private sector – both banks and companies – settled 82 million euros of foreign debt (30 million for long-term and 52 million for short-term debts, see Table T4-11). Such a tendency of deleveraging foreign debt represents an additional mechanism of exhausting the economy, i.e. it deteriorates its liquidity and deepens the recession in the most parts of economy.

Decline of foreign debt is predominantly the result of a reduction of public debt, because in the first half of the year, the state settled part of the expensive loans based on relatively favourable loans it withdrew at the end of the previous and in the first quarter of the current year. Still, we expect further growth in public sector borrowing in net amount in the coming period, having in mind that previously collected funds from borrowing are almost depleted, and that fiscal deficit is still high. On the other hand, private sector hasn't changed its level of foreign debt in a while. So, if this trend continues, in 2013 – as was the case in 2011 and 2012 – the level and dynamic of the foreign debt will primarily be determined by the level and dynamic of public sector borrowing, which in turn will be determined by the level of the fiscal deficit and approved guarantees.

Table T4-11 Serbia: Foreign Debt Structure, 2010–2013

	2010	2011	2012				2013	
			Mar	Jun	Sep	Dec	Mar	Jun
	stocks, in EUR millions, end of the period							
Total foreign debt	23,786	24,125	24,068	24,086	24,832	25,721	26,722	26,072
(in % of GDP) [2]	*85.1*	*76.5*	*76.7*	*78.6*	*82.9*	*86.1*	*87.2*	*82.5*
Public debt	9,076	10,773	10,655	11,032	10,944	12,187	13,483	12,914
(in % of GDP)[2]	*32.5*	*34.2*	*34.0*	*36.0*	*36.5*	*40.8*	*44.0*	*40.9*
Long term	9,076	10,773	10,655	11,032	10,944	12,187	13,483	12,914
o/w: to IMF	1,529	1,618	1,581	1,644	1,524	1,389	1,245	1,079
o/w: Government obligation under IMF SDR allocation	449	459	449	467	462	452	454	447
Short term	0	0	0	0	0	0	0	0
Private debt	14,710	13,352	13,412	13,054	13,889	13,534	13,240	13,158
(in % of GDP) [2]	*52.6*	*42.3*	*42.7*	*42.6*	*46.3*	*45.3*	*43.2*	*41.6*
Long term	12,880	12,704	12,834	12,712	13,526	13,040	12,879	12,849
o/w: Banks debt	3,362	3,782	3,784	3,754	3,745	3,672	3,530	3,511
o/w: Enterprises debt	9,518	8,922	9,050	8,958	9,781	9,369	9,348	9,336
o/w: Others	0	0	0	0	0	0	1	1
Short term	1,830	648	578	342	363	493	361	309
o/w: Banks debt	1,731	582	515	275	292	428	303	261
o/w: Enterprises debt	100	66	63	67	71	65	58	47
Foreign debt, net 1), (in% of GDP)[2]	49.3	38.3	41.4	45.4	50.0	49.6	48.6	48.7

Note: As of September 2010, the methodology of the foreign debt statistics has been changed, so public sector foreign debt includes obligations as per SPV IMF allocations (447.1 million euros), used in December 2009, as well as capitalised interest towards the Paris Club (24.9 million euros), while the private sector foreign debt excludes loans concluded prior to December 20, 2000, for which no payments are made (872.1 million euros, out of which 403.1 million is related to local banks, and 469.0 million euros to local companies). Foreign debt data shown in the Table were calculated according to the new methodology.
Source: NBS, *QM*.
1) Total foreign debt decreased by NBS foreign reserves.
2) Sum of GDP values of the observed quarter and GDP values of the previous three quarters is used.

11 In part of the text dealing with the analysis of the Public debt in section 6: "Fiscal Trends and Policy", public foreign debt significantly differs from the one stated and is 9.5 billion euros. The difference of around 3.4 billion euros is the result of different scope of NBS and the Ministry of Finance, from which we take the data (in section 6, Ministry of Finance data is used, while in this text we use NBS data). The definition of public debt according to the Ministry of Finance doesn't include the debt of the National Bank of Serbia, unsettled obligations (debt for which payments are not made, and part of the debt of local governments and state agencies without state guarantees). On the other hand, the scope of National Bank of Serbia includes all the stated obligations, i.e. the entire foreign debt of the public sector is monitored (as part of the total foreign debt).

5. Prices and the Exchange Rate

Since the beginning of the year, inflation in Serbia has been extremely low, the cumulative growth rate in the first seven months is 2%. The key contribution to the rapid disinflation comes from the stability/appreciation of the dinar and reduced domestic demand. Another contribution to disinflation was the absence of supply shocks (energy prices, agricultural products, taxes etc.) that, in recent years had a strong impact on the inflation growth in Serbia. Occasional inflation leaps in the previous part of the year are mostly the result of the increase in administratively controlled prices, and temporary weakening of the dinar. Throughout this year, the inflation is expected to be among the lowest in the last few years and around the upper limit of the target interval. The nominal exchange rate was generally stable during the first five months, only to depreciate by 3% in June, after which it stabilized again. The real exchange rate appreciated by 4% from the beginning of the year to the end of July, while compared to the same period last year, the dinar strengthened in real terms by over 10%. A real dinar appreciation favors the reduction in inflation, improves the balance sheets of the companies and other, but at the same time has a negative effect on the price competitiveness of the Serbian economy, which slows down the improvement of the reduced, but still high deficit in the current account balance.

Prices

The trend of reducing inflation is continued

The downward trend in inflation, started in Q1, continued in the second quarter. Although the price growth in Q2 amounted to 1.7% (i.e. 7.3% when annualized), July deflation of -0.9% indicates that these were one-off adjustments in the price level, rather than accelerating inflation (Table T5-1). Overall inflation since the beginning of the year amounts to about 2%, i.e. 3.5% per annum. After reaching a maximum value of 12.7% in January, year-on-year inflation rate started to decline, and in July, it amounted to 8.6%. Year-on-year inflation is still above the upper limit of the NBS target band, amounting to 2.5%-5.5% (Graph T5-2), but its sharp drop towards the upper limit of the corridor is expected in the following months. Year-on-year inflation will continue to decline till the end of the year, both for the expected low inflation rate in the following months, and high inflation in the second part of the year 2012, (in the period August-October of 2012, inflation amounted to 6.7%). Underlying inflation (y-o-y) declines as well, although its fall is slightly milder than the overall inflation, as the decline of overall inflation was more affected by the lower growth in the prices of food, alcohol, tobacco and energy than the prices of other goods and services.

Table T5-1. Serbia: Consumer Price Index, 2007-2013

	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
sep	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
sep	169.1	10.3	9.6	2.3	17.7
dec	173.1	12.2	12.2	-0.4	9.9
2013					
jan	174.1	12.7	0.6	0.6	0.7
feb	175.1	12.5	1.2	0.6	3.0
mar	175.1	11.2	1.2	0.0	4.7
apr	176.5	11.5	2.0	0.8	5.6
maj	176.5	10.0	2.0	0.0	3.2
jun	178.2	9.7	2.9	1.0	7.3
lul	176.6	8.6	2.0	-0.9	0.3

Source: NBS

Excuse for a restrictive monetary policy cannot be found in the current inflation

Although inflation has been very low since the beginning of the year, NBS continues to implement restrictive monetary policy. Cumulative inflation in the first seven months amounted to 2%, i.e. 3.5% when annualized, while the reference rate was 11%. It is obvious that the excuse for a high reference rate cannot be found in this year's inflation. In previous QM issues we wrote about the fact that the y-o-y inflation is not a good indicator for making decisions on monetary policy in conditions of high and variable inflation characterized by sudden breaks, which is the presently the case in Serbia. High year-on-year inflation in the previous part of 2013 is the consequence of a high inflation in the previous year, which cannot be influenced by the current monetary policy.

… but can in the risks resulting from high imbalances

Although inflation was low in the last part of the year, there are high imbalances in Serbian economy that could destabilize the exchange rate in a short term, which would shortly after transfer to inflation in highly euroized Serbian economy. Fiscal and foreign deficit, as well as the public and foreign debt are high, and bad loans reached alarming proportions (see Chapters 4,6 and 7). Under such circumstances, restrictive monetary policy attracts foreign capital into the country, including the speculative, and contributes to the stabilization of the exchange rate, which has a significant impact on inflation. On a long run, such a policy isn't sustainable, therefore it is necessary to significantly reduce the fiscal deficit already in the next year and take measures to minimize the negative fiscal implications of possible problems in the banking sector. NBS should adopt measures for encouraging banks to actively solve the problem of bad loans.

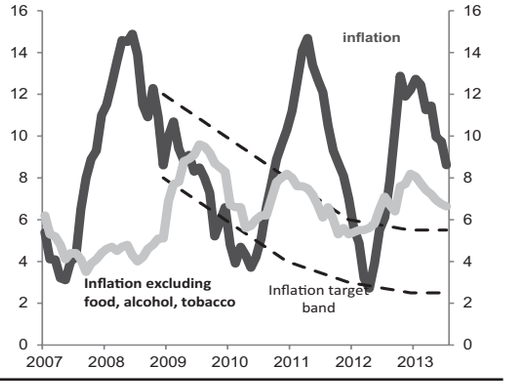
…if a restrictive budget is adopted for the next year, it is possible to reduce the monetary policy restrictiveness

Adoption of the budget for the next year with the deficit lower by 2.5% to 3% of GDP would allow the reduction of monetary policy restrictiveness. Reduced restrictiveness of monetary policy would not directly influence the growth of a bank credit activity, although certain, relatively modest effect would likely exist. The reasons for a low impact of monetary policy to a credit activity and economic trends are numerous and include factors such as: high economy euroization, absence of a clear separation between illiquidity and insolvency of companies and others. However, less restrictive monetary policy would contribute to the reduction of a foreign deficit and economy growth on a long run through the influence on the real exchange rate trend, but the price for that would be a slightly higher inflation. The reduction in the monetary policy restrictiveness would affect a moderate real dinar depreciation, which would contribute to the export growth and reduction of a still high deficit in the current account balance. Depreciated exchange rate would also make the domestic demand more competitive, which would, apart from export growth, contribute to an increase in employment and economic activity in Serbia.

… reduction in the restrictiveness has to be gradual and moderate

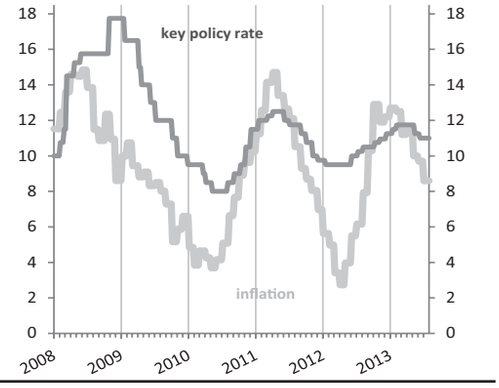
The reduction in the monetary policy restrictiveness, through the reduction of the reference rate and required reserve rate should be gradual and moderate, in order to preserve macroeconomic stability. In highly euroized economy with high internal and external imbalances, a sharp reduction in monetary policy restrictiveness may lead to a strong dinar depreciation, which would

Table T5-2. Serbia: y-o-y inflation rate and underlying inflation and the NBS target band, 2007-2013



Source: NBS

Table T5-3. Serbia: NBS reference interest rate and y-o-y inflation rate, in %, 2008-2013



Source: NBS

again accelerate the inflation and generate high capital losses for the economy, the state and the citizens on the basis of so-called exchange rate differences. Monetary policy needs to balance between inflation, as its primary objective, and other objectives (reduction of external imbalances, employment, etc.), and the result of that „balancing" in any case should be a one-digit inflation.

Low price growth in Q2 and deflation in July 2013

In Q2 and July of 2013, the overall price growth was slightly below 0.9%, i.e. 2.6% when annualized. The largest contribution to the growth of consumer price index was given by the growth in the prices of some food products (fruit and meat prices accounted for 93%, i.e. 0.8 pp in the increase of CPI), tobacco (share of 16%, i.e. 0.14 pp, Table T5-4), housing, water and electricity (17%, i.e. 0.16 percentage points), medical products and health services (21%, i.e. 0.19 pp) and culture and recreation (share of 53%, i.e. 0.5 pp). Fall in the prices of other food products excluding fruit and meat (0.99 pp) and services related to the use of means of transportation (0.1 pp) had a disinflationary impact. The prices in Q1 2013, as well as in 2012, significantly contributed to the growth of the consumer price index, while their overall effect in Q2 and in July was disinflationary. A considerable impact of the growth in the prices of vegetables in the first quarter, as well as their decline in the second quarter on the consumer price index is most likely the result of using the same weights for the consumption throughout the year. This means that the growth in the prices of fruit and vegetables that are yet to emerge on the market significantly affect the consumer price index (as was the case in April), although these products are bought to a much lesser extent than the average annual weight shows. When the prices of these products fall significantly (as has already happened with the prices of vegetables, and in the coming months can be expected with the prices of vegetables), it then leads to deflationary trends, although the real jumps and falls never occured.

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

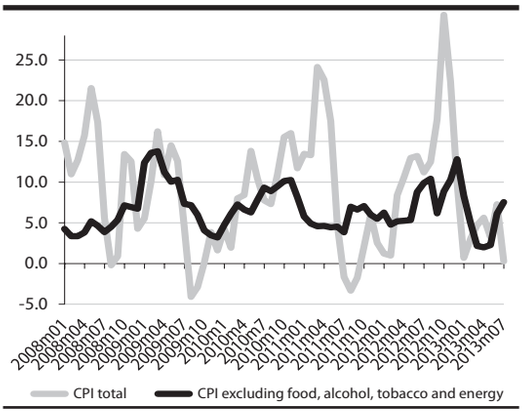
	Share in CPI (in %)	Price increase in Q2 and july 2013	Contribution to overall CPI increase (in p.p.)	Price increase in Q1 2013	Contribution to overall CPI increase (in p.p.)	Price increase in August-December 2012.	Contribution to overall CPI increase (in p.p.)
Total	100.0	0.9	0.9	1.2	1.1	6.5	6.4
Food and non-alcoholic beverages	34.5	-0.7	-0.2	1.5	0.5	8.3	3.2
Food	30.9	-0.7	-0.2	1.6	0.5	8.2	2.9
Alcoholic beverages and tobacco	7.8	2.2	0.2	4.1	0.3	16.9	0.9
Tobacco	4.2	3.4	0.1	5.7	0.2	21.5	0.9
Clothing and footwear	4.6	0.4	0.0	-2.3	-0.1	3.7	0.2
Housing, water, electricity and other fuels	13.0	1.2	0.2	1.2	0.2	4.5	0.7
Electricity	5.1	0.0	0.0	0.0	0.0	1.7	0.1
Furniture, household equipment, routine maintenance	4.1	1.2	0.0	1.6	0.1	5.6	0.2
Health	6.4	3.0	0.2	3.0	0.2	3.3	0.1
Transport	12.3	-0.3	0.0	-1.0	-0.1	3.8	0.4
Oil products	5.1	-1.6	-0.1	-2.4	-0.1	5.0	0.2
Communications	5.0	0.4	0.0	4.1	0.2	5.2	0.2
Other items	12.2		0.6		-0.1		0.4

Source: SORS and *QM* estimate

While overall inflation is decreasing, the underlying inflation is increasing significantly

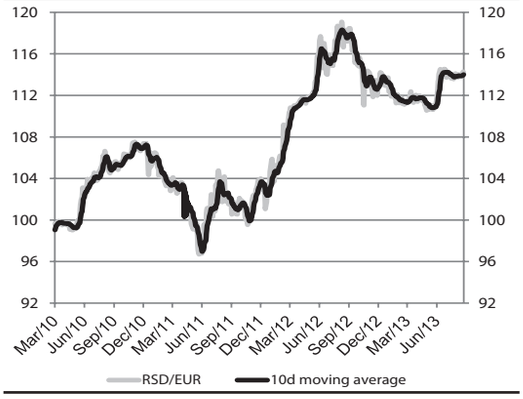
Underlying inflation (inflation excluding food, alcohol, tobacco and energy), has started to decrease since January 2013 and in April it amounted to 0.49%, or 2% when annualized, which was a record low level of underlying inflation rate (Graph T5-5). This was after followed by its significant growth, and in July it amounted to 1.84%, i.e. 7.5% when annualized. The underlying inflation movement largely reflects the impact of systematic factors on the inflation, and in the case of Serbia, the movement of the exchange rate and wages crucially influence the inflation. As from May to July, the exchange rate of the dinar against the euro grew from about 110 to about 114 dinars per euro, one can concluded that it was precisely the change in the exchange rate that had the greatest impact to the underlying inflation trend. For low and stable inflation, in the

Graph T5-5. Serbia: CPI and Underlying Inflation Trend, Annualized Rates, in %, 2008-2013



Source: SORS and *QM* estimate

Graph T5-6. Serbia: Daily RSD/EUR Exchange Rate, 2010-2013



Source: NBS

conditions of highly euroized economy such as Serbian, it is important that strong exchange rate changes are absent in the future, and such changes would be less probable if the real exchange rate is near the equilibrium level.

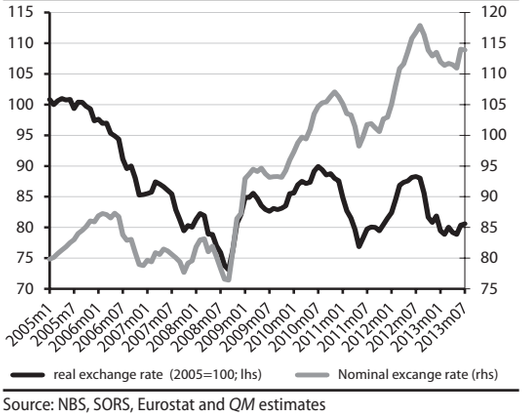
The Exchange Rate

Dinar depreciation in June

The dinar exchange rate was relatively stable from the beginning of the year to May, but in the first half of June it sharply depreciated (in June dinar against the euro nominally weakened by nearly 3%), and throughout following months it stabilized at the level of about 114 dinars per euro (Graph T5-6). The National Bank of Serbia for the first time in 2013 intervened in the foreign exchange market on May 30th, and in the next few weeks sold 275 million Euros in total to mitigate the excessive daily volatility of the exchange rate, but also stopped dinar depreciation trend.

Real dinar appreciation stopped

Graph T5-7: Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly Averages, 2005-2013



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

During Q2 and July, the real dinar exchange rate against euro depreciated by 0.7%. From the beginning of the year to May, dinar appreciated by nearly 4% compared to December 2012, only to stabilize, after depreciation in June, at a real level that is about 1.5% stronger than the one in December. In addition to depreciation, low inflation rate over previous three months also contributed to a stabilization of the real exchange rate. Historically, the real exchange rate is roughly at the same level as in the late 2011, prior to the strong depreciation in the early 2012 (Graph T5-7).

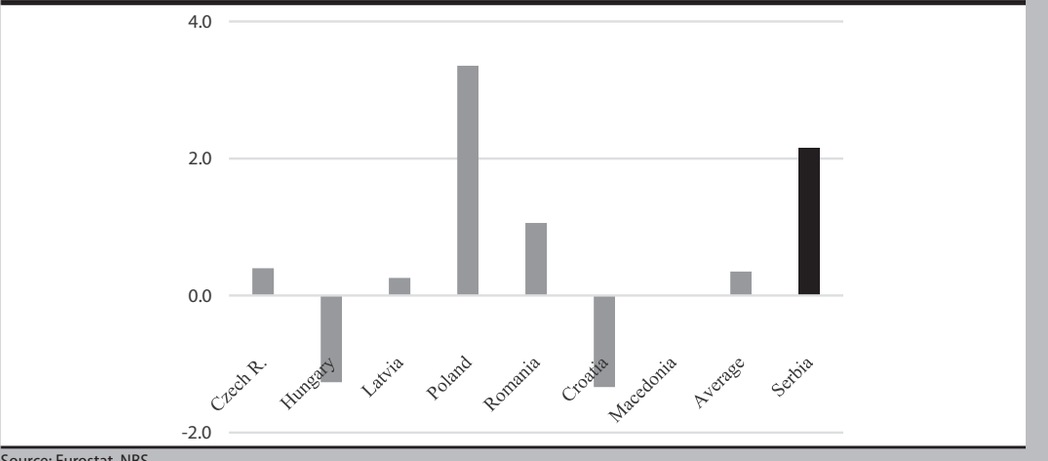
Strengthening of the dinar was the result of government borrowing and was not sustainable on a long-term

Strengthening of the dinar in the first five months of 2013 was the result of a high government borrowing, and not the result of a surplus growth in a foreign trade balance or the increase in the competitiveness of the Serbian economy. As a high borrowing is not sustainable on a long run, the real exchange rate could be sustainable only if the foreign currency inflow from the government borrowing is replaced with either the inflow of foreign investments or the current account surplus. Because there was no significant inflow of foreign investments, even though the current account deficit is reduced, a current account surplus cannot be expected in the mid-term (in the next few years). Therefore, real depreciation is more probable than dinar appreciation in the future period.

Box 1. Exchange rates in the countries of Central and Eastern Europe

When observing the exchange rate in the countries of Central and Eastern Europe which implement flexible exchange rate policy, one can see, on average, a trend of a mild depreciation (Graph T5-8), but looking at the countries individually, the exchange rate varies depending on specific factors- the discrete measures and circumstances in the economy of a given country. Thus, in the studied group of countries (Czech Republic, Hungary, Latvia, Poland, Romania, Croatia and Macedonia), the highest depreciation occurred in Poland, which was the consequence of a reduced reference rate to a record low level of 2.75% in June. National Bank of Poland cut the referent rate so to stimulate the economic growth, as the country is in a period of a biggest slowdown of economic activity in the last four years. Unlike Poland, national currency in Croatia has strengthened, primarily due to the country's entry into the European Union, while appreciation occurred in Hungary due to a large inflow of foreign investments in the second quarter of this year.

Graph T5-8. Nominal exchange rate depreciation in July in relation to April 2013 (in %) in Central and Eastern Europe



Source: Eurostat, NBS

By excluding the extreme cases of exchange rate depreciation and appreciation in aforementioned countries, a similar, almost neutral exchange rate trend is obtained in the countries of Central and Eastern Europe. As there isn't a global trend in these countries, and the exchange rate moves according to the discrete measures and circumstances in individual countries, the same conclusion could be drawn for Serbia, that depreciation of the dinar exchange rate in the period April-July 2013 is not the consequence of a general international movements, but the cause for dinar weakening is the result of specific factors related to Serbia. The most important negative factors affecting the dinar exchange rate in this period are the poor state of public finances (record-high public debt and extremely high fiscal deficit), as well as negative reviews by IMF and other relevant institutions.

6. Fiscal flows and policy

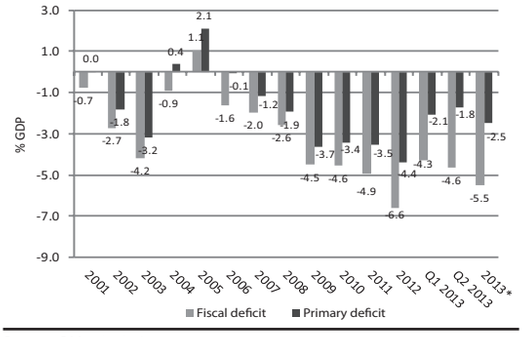
Fiscal deficit in Q2 2013 amounted to RSD 44.2 billion (4.6% of the quarterly GDP), while in the first two quarters of the year it totaled RSD 80.9 billion, (4.5% of GDP). Although public revenues went up slightly in Q2 relative to Q1, they are still below the targeted, and suffered a considerable real drop (by 3.2%) compared with the same period last year, so a more substantial and steadier rise in public revenues does not seem to be on the way. Real public expenditures in Q2 went down considerably compared with the same period last year, but when compared with non-election years, without high election spending, they are still heavy. Furthermore, expenditures in Q2 slightly went up compared with Q1, primarily due to a considerable rise in expenditures on interest payments and a slight increase in expenditures on pensions. Measures intended to reduce the deficit by the end of 2013, on average by 2.5-3 billion dinars per month, or by around 0.5-0.6% of GDP annually, were adopted at the end of May and in June. However, since seasonal expenditures are extremely high in the last quarter, fiscal deficit in 2013 is expected to run at 5.5-6% of GDP according to domestic methodology, or at 7-7.5% of GDP according to international GFS methodology, if other variables remain unchanged. A stronger slowdown in public debt growth in 2014 requires reduction in fiscal deficit by at least 2-2.5% of GDP (down to 3.5-4% of GDP according to domestic methodology). The measures that have been implemented, and the announced measures agreed on by the Government, will not suffice to achieve the desired fiscal deficit reduction – additional measures that would secure a reduction of 1-1.5% of GDP are necessary. Adoption of a credible 2014 Budget is therefore critical to the success of the overall fiscal consolidation. Public debt stood at 60.5% of GDP at the end of July, but this slight drop in public debt compared with Q1 is short-lived. Public debt is expected to total 63-64% of GDP at the end of the year, on the assumption that macroeconomic and fiscal projections would fulfill.

General tendencies and macroeconomic implications

Fiscal deficit in Q2 runs at 4.6% of GDP

Consolidated fiscal deficit in Q2 2013 ran at 44.2 billion dinars (about 4.6% of the quarterly GDP), while the fiscal deficit in the first two quarters of the year totaled RSD 80.9 billion, 4.5% of the semi-annual GDP. Considerable real y-o-y drop in public revenues continued in Q2 and they came below projections, although seasonally adjusted data indicates a slight real growth compared with Q1. This growth is primarily due to the new dynamics of revenues from consumption tax caused by VAT system reform and a slight real depreciation of the dinar exchange rate. Furthermore, a moderate recovery in economic activity and a slight rise in imports stimulated the growth in public revenues in Q2. However, the growth in revenues in Q2 is not seen as a sign of a lasting recovery in public revenues because it is mostly caused by specific and one-off factors. Additionally, the Tax Administration took a new approach to tax collection as of May 2013, switching from announcements of future reforms and implementation of ad hoc measures, to actual enhancement of fiscal discipline, which is considered encouraging. However, these activities have not yet produced the desired effects, and, apart from the improved performance of the Tax Administration, a marked reduction in shadow economy and tax evasion requires a greater overall financial discipline in the state. Public expenditures in Q2

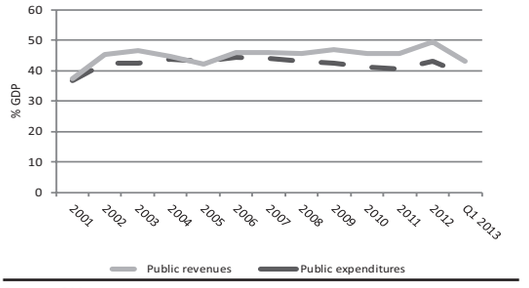
Graph T6-1. Serbia: Consolidated fiscal balance and primary fiscal balance[1]



Source: QM calculations.
1) Primary deficit (deficit without interests) is the difference between the total public revenues and the overall public expenditures subtracted by expenditures on interest payments.

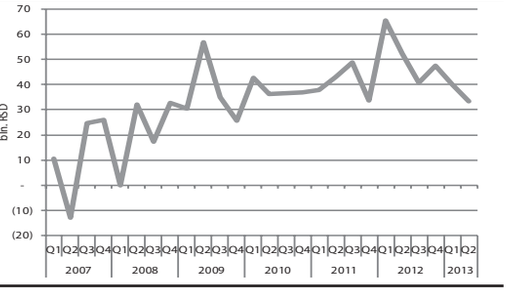
went down moderately compared with the same period last year, but when compared with non-election years without high election spending (2012 was the election year), they are still heavy. Additionally, Q2 saw a slight (real seasonally adjusted) rise in public expenditures compared to Q1 2013. Overall public expenditures went up (relative to Q1) due to a slight rise in expenditures on pensions caused by indexation, and the strong rise in expenditures on interest payments because euro-denominated bonds issued in November 2012 fell due. The difference between the fiscal deficit and the primary deficit widens, which indicates the relative rise in expenditures on interest payments. More rapid rise in expenditures on interest payments detected in the preceding quarters, which will probably continue in the following period, suggests the need for a massive reduction in fiscal deficit in order to prevent public debt become self-generating, i.e. to prevent further borrowing to pay interest on the existing debt.

Graph T6-2. Serbia: Consolidated public revenues and public expenditures (% GDP)



Source: *QM* calculations

Graph T 6-3. Serbia: Real seasonally adjusted fiscal deficit (in prices in 2012)



Source: *QM* calculations

Fiscal deficit in 2013 will run at 5.5-6% of GDP, according to domestic methodology

In the 2013 Budget rebalance adopted in July, consolidated fiscal deficit in 2013 is projected at 5.2% of GDP. The measures adopted mid 2013 should cut the deficit, on average, by about 2.5-3 billion dinars per month by the end of the year (abut 0.5-0.6% of GDP annually). However, fiscal trends detected in Q1 and Q2, and the expected macroeconomic trends by the end of 2013 (inflation slowdown, quite stable dinar exchange rate, no significant change in the dynamics of economic activity and income) suggest that the public revenues (primarily from contributions) projected in the budget rebalance might be below the target. The same goes for certain savings that have been projected in the budget rebalance. On the basis of the trends detected in Q1 and Q2, and macroeconomic and fiscal projections for the rest of the year, and without implementation of additional measures, 2013 fiscal deficit to GDP is projected at 5.5-6% (according to domestic methodology).

...or 7-7.5% of GDP, according to international methodology

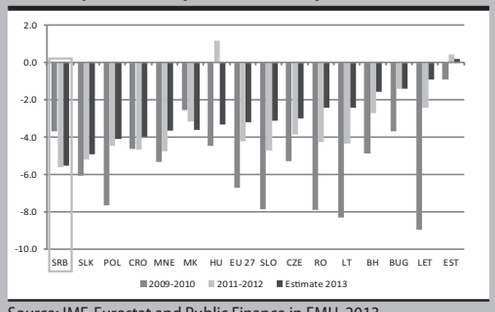
Expenditures on financial rehabilitation of banks, expenditures on principal repayment of government guaranteed public enterprise debt etc., totalling about 1.5% of GDP, are not recognized as expenditures in the Law on the Budget, although international (GFS) methodology recognizes them as budget expenditures. If these expenses were treated as budget expenditures, total consolidated fiscal deficit in 2013 could run at extremely large 7-7.5% of GDP.

Box 1. Fiscal performance of Central and East European states (2008-2013)

At the beginning of the world economic crisis Serbia ran fiscal deficit at 2% of GDP (in 2008), which was much smaller than in most Central and East European Countries (CEE). During the first two years of the crisis (2009 and 2010) Serbia's fiscal deficit widened due to the crisis and the discretion measures adopted at the beginning of the crisis (extraordinary increase in pensions in 2008), but it was still around the average in CEE states (nominal salary and pension freeze in 2009-2010 prevented its larger rise). However, while almost all CEE countries managed to cut their fiscal deficits considerably in 2011 and 2012, Serbia's fiscal deficit continued to rise during this period,

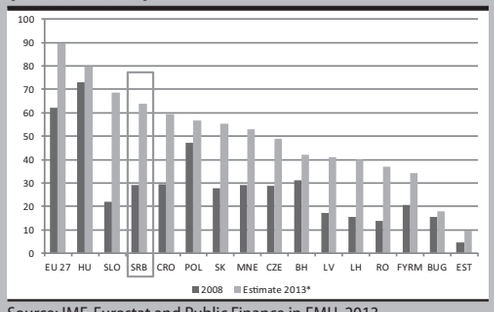
and was the largest among the analyzed countries. Projections for 2013 are similar – almost all CEE states will continue cutting their fiscal deficit, and fiscal deficit in Serbia will be somewhat smaller than in 2012. In 2013 Serbia will run the largest fiscal deficit among all CEE states (according to both domestic and international methodology).

Graph T6-4. Serbia and Central and East European states: Consolidated fiscal deficit, % BDP (2008-2013)



Source: IMF, Eurostat and Public Finance in EMU, 2013

Graph T6-5. Serbia and Central and East European states: Public debt, % GDP (2008-2013)



Source: IMF, Eurostat and Public Finance in EMU, 2013

Consequently, from a country with a moderate public debt level in 2008, around the average in CEE states, in 2013 Serbia became a country with the third highest public debt (% GDP) in CEE, after Hungary and Slovenia. From 2009 to 2013 Serbia experienced the second largest relative increase in public debt in CEE countries (after Slovenia).

The foregoing data show that most CEE countries managed to achieve a moderate or considerable fiscal deficit reduction, and that Serbia's fiscal deficit is still high and growing. This indicates that the probability of debt crisis in Serbia is much higher than in other CEE countries, so the measures aimed at substantial reduction in fiscal deficit as early as in 2014 must be adopted already in 2013.

Major fiscal adjustments, not only through curbing shadow economy, but also through additional savings of 1-1.5% of GDP, are required in 2014

Slowdown in public debt growth and its reduction require a massive cut in fiscal deficit as early as in 2014. As announced, fiscal deficit is targeted at around 4% of GDP in 2014, though it is not clear whether the projection was based on international methodology or the methodology envisaged in the Law on the Budget. If domestic methodology was employed, fiscal deficit targeted at 3.5-4% of GDP would be more appropriate, i.e. it would be reduced by 2-2.5% of GDP compared with 2013. If international methodology was used, fiscal deficit reduction could be larger (3-3.5% of GDP), and the fiscal deficit could be targeted at 3.5-4% of GDP. Larger reduction in fiscal deficit according to international methodology implies that expenditures on payment of guaranteed loans would be cut, and that no further expenditures would arise from the financial rehabilitation of banks in the following year.

Box 2. Tackling shadow economy – possible fiscal effects

As announced, fight against shadow economy will be one of the key instruments for fiscal consolidation in the following period. Shadow economy rate in Serbia is among the highest in the region (with the rate of about 31% of GDP Serbia is ranked second, after Bulgaria), so a fight against it is necessary, both from the aspect of fiscal consolidation and fair market competition.

Empirical studies show that even if all recommended measures against shadow economy were effectively implemented, rise in public revenues would not exceed 1% of GDP in the mid-term (the following 2-3 years), and it would probably be even smaller in the following year (about 0.5% of GDP).[1] Accordingly, further implementation of stringent policy on tax evasion is critical for bringing

1 More detailed analysis of the causes, mechanisams and effects of shadow economy, and possible measures against it is presented in the study, Krstić, G., et. al. (2013) „ Shadow economy in Serbia – new findings and recommended reforms ", FREN and USAID; Belgrade, 2013

order in tax system and increase in revenues. Quality of service delivered by the inspection bodies (primarily the Tax Administration and Labor Inspection) must be improved in order to identify informal business activities more efficiently, and thus produce the foregoing fiscal effects. Reform in the penalty system for tax evasion (regarding the amount and structure) should be considered. However, a more efficient tax collection also requires implementation of measures designed to tighten overall financial discipline in Serbia (more efficient bankruptcy proceedings etc.), and measures intended to increase labor market flexibility.

Lag effect of the measures adopted mid 2013 (restrictive salary and pension indexation) will be reduction in fiscal deficit by about 1% of GDP in 2014. On the other hand, rise in public debt and tougher loan conditions are expected to increase expenditures on interest payments by about 0.4% of GDP[1], which will take up almost a half of the projected savings from reduction in expenditures on salaries and pensions. Effective implementation of strategic measures intended to curb shadow economy could reduce fiscal deficit by about 0.5% of GDP. The targeted 2-2.5% of GDP reduction in fiscal deficit in 2014 can thus be achieved only through additional savings of about 1-1.5% of GDP. If great problems arose in the banking sector, requiring government's intervention, reduction in other current expenditures would have to be even larger in 2014. Accordingly, structural reforms in public enterprises, pension system, education, health insurance, public administration etc. aimed at reduction in expenditures (in 2014 and the succeeding years) and improved efficiency and quality of service in these fields, must be undertaken as early as in 2013. Additionally, greater coordination between the Government and the National Bank of Serbia regarding control and management of the risks involved in banking sector is necessary due to a possibility that the government's intervention in banking sector may be needed in the next year, which would considerably increase budget expenditures.

Numerous studies and strategies, based on contemporary methodology and good comparative practices, providing strategic framework for implementation of structural reforms (tax reforms, curbing shadow economy, labor market reforms, reforms in education and healthcare system etc.) were made in the previous years in Serbia, as well as a number of practical measures that should be taken accordingly. These studies and strategies are a solid base for planning and introduction of the needed reforms, so the government should not spend more time and resources on reanalyzing and redesigning them, but should focus on their implementation.

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

Public revenues in Q2 still much lower than in the same period last year, but showing signs of a modest recovery

Public revenues continued to fall in Q2 2013 compared with the same period last year (by 3.2%). Although real seasonally adjusted public revenues went up in Q2 relative to Q1 (by 3.3%), this rise is not a sign of lasting recovery, but mainly a consequence of specific and one-off factors. These factors are: continuation of a modest recovery in economic activity, slight real depreciation of the dinar exchange rate, and time allocation of revenues (for example revenues from VAT) from Q1 to Q2 due to the new tax collection system.

Revenues from VAT are much lower than in the same period last year, but much higher than in Q1 2013 – a consequence of one-off factors

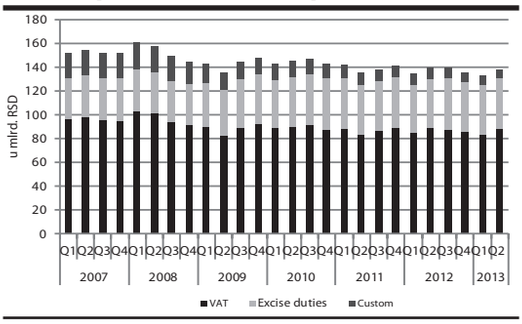
Real revenues from VAT in Q2 went down slightly (by 0.6%) compared with the same period last year, but relative to Q1 2013 real seasonally adjusted VAT revenues went up (by 6%). Revenues from VAT fell because a switch from domestic demand to exports was made in national economy (see Chapter 2 on economic activity). Economic restructuring is favorable from the aspect of macroeconomy, but it has negative impact on tax collection. Restructuring of national economy will probably continue in the future, because growth in domestic demand is slower than GDP growth[2]. Another cause of lower revenues from VAT is strong real appreciation of the

1 See the Fiscal Council analysis and estimates.

2 In several issues of QM, in the previous years, we wrote that decrease in domestic demand and rise in exports would cause drop in revenues from VAT. Since this process was inevitable (otherwise, balance of payment crisis would arise), the drop in revenues from VAT was predictable.

dinar exchange rate in the first half of 2013 compared with the same period last year – this effect is very important since about 2/3 of VAT is collected from imports. Economic policy-makers should bear in mind that large drops in inflation and appreciation of the dinar exchange rate reduce tax revenues, so fiscal deficit can be reduced only through cuts in nominal expenditures. This is an important change in Serbia because in the past fiscal consolidation was often achieved through high inflation which brought in high tax revenues but reduced the value of real expenditures. Revenues from VAT in Q2 went up relative to Q1 due to changed administration and collection of VAT, slight real depreciation of the dinar exchange rate in Q2 and a modest growth in economic activity. Administration and collection of VAT has been changed considerably from January, so most VAT payments were postponed from March to April. Modest growth in domestic demand in Q2 (see the chapter on economic activity) exerted positive effects on revenues from VAT in this quarter. Although the Tax Administration announced strong actions on identifying and sanctioning tax evasion (inspection of fiscal receipt issuance was announced), higher level of tax collection produced modest effects on overall tax revenues, including revenues from VAT in Q2. Nevertheless, growth in revenues from VAT continued in July (real seasonally adjusted revenues went up by 1.1% compared with Jun), which suggests that the Tax Administration's efforts to increase the level of tax collection might have paid off in July, though a more precise estimation requires the data on the following few months.

Graph T 6-6. Serbia: Trends in real consolidated seasonally adjusted revenues from consumption tax (in 2012 prices)



Source: *QM* calculations

Excise revenues went up considerably

Real seasonally adjusted excise revenues in Q2 2013 went up both relative to Q1 and the same period 2012 (by 2.1% and 20.1% respectively). Excise revenues in this quarter were higher than in the same period last year due to increase in excise. The growth in excise revenues in Q2 relative to Q1 is caused by slight real depreciation of the dinar to euro exchange rate, earlier than usual payment of some excise duties, but can also indicate that illegal sale of some excise goods (shredded tobacco etc.) has been curbed.

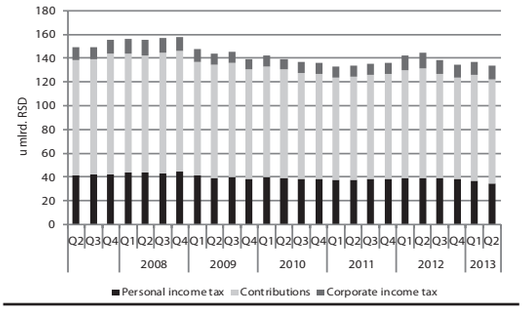
...while customs revenues keep dropping

Customs revenues (real, seasonally adjusted) dropped considerably (by 6.1%) in Q2 relative to Q1, which is a continuation of the trend detected in the previous years. This drop is due to further reduction in tariffs on goods imported from EU (additional reduction according to the Stabilization and Association Agreement was made in February 2013 and comprised last two months of Q1 and the whole Q2 2013). This drop in customs revenues would have been even larger if there had not been for a slight depreciation of the dinar exchange rate in Q2 and continuation of the upwards trend in production in car and petroleum industry, wherein a great portion of raw materials and other inputs is imported.

...as well as revenues from personal income tax and social security contributions, due to reduction in real income

Revenues from personal income tax (real seasonally adjusted) fell considerably in Q2 (by 6.8%) relative to Q1, and revenues from social security contributions went down slightly (by 1%). Compared with the same period 2012, real revenues from personal income tax dropped significantly (by 12.3%), and revenues from social security contributions fell less sharply (by 4.4%). Revenues from personal income tax and social security contributions in Q2 were affected by further real drop in income, reformed wage taxation system, and possibly by further rise in informal employment. The dynamics of revenues from personal income tax and social security contributions is primarily caused by reforms in wage taxation system. Reduction in tax rate for wages by 2 percentage points, and increase in non-taxable part of wage, starting from 1 June 2013, decreased revenues from personal income tax considerably. On the other hand, although the contribution rate for pension and disability insurance was increased by 2 percentage points starting from June 2013, revenues from social contributions in Q2 went down relative to Q1. This is due to further drop in real income (Real public-sector wage bill, taking up almost a half of the total wage bill

Graph T 6-7. Serbia: Trends in real consolidated seasonally adjusted revenues from taxes on factors of production (in 2012 prices)



Source: *QM* calculations

Revenues from corporate income tax in Q2 much lower than in 2012

in Serbia, was reduced by 2.9% in Q2 relative to Q1. Similar trends were detected in private sector). Such trends in revenues from personal income tax and social security contributions also suggest that the Tax Administration's announced activities towards more efficient collection of taxes and social security contributions failed to produce detectible effects.

Real seasonally adjusted revenues from corporate income tax in Q2 2013 are lower than in the same period last year by 7.9%, but relative to Q1 2013 they went up by 5.4%. These revenues dropped relative to the previous year primarily because the level of economic activity fell and financial performance of Serbian economy in 2012 was poor. Revenues from corporate income tax in Q2, when the final tax liability for 2012 is paid, possibly went up due to use of accruals and deferrals to boost the profit declared in 2012, taxable at the rate of 10%, and lower the profit in 2013, taxable at the rate of 15%. Additionally, maturity of interest and dividend payments from Serbian companies to foreign creditors and investors might have increased revenues from withholding tax on these payments. Since most sections of economy suffer from recession, increase in operating profitability cannot be expected. However, real appreciation of the dinar exchange rate will mainly bring accrued gains, rather than real foreign exchange rate gains, which will considerably increase the overall profit in 2013 – if the appreciated exchange rate remains unchanged by the end of the year.

Other tax revenues (real seasonally adjusted) went up slightly in Q2 (by 2.6%) relative to Q1. This could be due to local communities' increased efforts towards collection of local public revenues, by expanding the scope of property taxation and by exploiting legal possibilities for property taxation more fully, since they lost a part of revenues from wage tax and other quasi-fiscal charges. Non-tax revenues (real seasonally adjusted) went up considerably (by 13.5%) in Q2 relative to Q1, because the government collected some outstanding debts, and because non-tax revenues fell sharply in Q1.

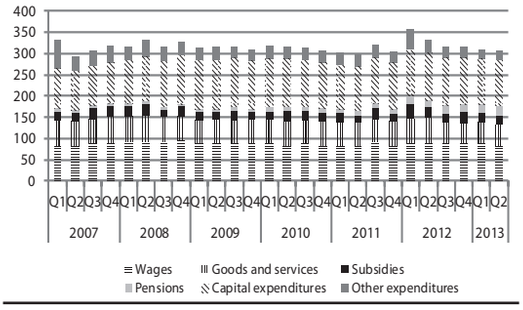
Public expenditures in Q2 fell steeply relative to the same period last year, but when compared with non-election years and Q1 2013, they slightly went up

Public expenditures in Q2 fell by 6.6% relative to the same period last year, but when compared with Q1 this year, real seasonally adjusted public expenditures went up. They are lower than the last year's because: 1) public expenditures in Q2 2012 were extremely high due to high election spending (elections were held in May 2012) and 2) modest nominal rise in most public expenditures was projected in 2013 Budget, but with high y-o-y inflation rate real expenditures went down considerably (see chapter 5). Real public expenditures in Q2 will be occasionally benchmarked against the data for 2011 because the level of public expenditures in 2012 is not usual due to high election spending. So, real public expenditures in Q2 2013 went up (by 1.9%) relative to Q2 2011, and similar rise in expenditures (by 1.1%) was recorded relative to Q1 2013. Overall public expenditures in Q2 slightly went up relative to Q1 due to a sharp increase in expenditures on interest payments and modest increase in expenditures on pensions, while all other public expenditures went down.

…due to a strong rise in expenditures on interest payments…

Q2 saw a strong rise in real seasonally adjusted expenditures on interest payments (27.1%) relative to Q1, and when compared with the same quarter 2012 the rise is even stronger (86.3%). Expenditures on interest payments went up due to increase in public debt and country risk, and one-off factors. Accordingly, interest payments on debt to Paris and London Club creditors and semi-annual coupons on euro-denominated bonds issued in November 2012 fell due in April 2013, which caused the rise in expenditures on interest payments in Q2. Another cause of the rise in expenditures on interest payments (projected at about 0.4% of GDP annually) is the increase in Serbia's public debt. Rise in expenditures on interest payments was also caused by a slight real depreciation of the dinar exchange rate in Q2, and tougher borrowing conditions

Graph T 6-8. Serbia: Trends in consolidated seasonally adjusted public expenditures (in 2012 prices)



Source: *QM* calculations

…and a small rise in expenditures on pensions...

(indicated by the increase in EMBI index and the rate of yield on euro-denominated bonds of the Republic of Serbia).

Expenditures on pensions (real seasonally adjusted) in Q2 went up slightly (by 0.8%) relative to Q1, but when compared with Q2 2012, a modest real drop (by 4.1%) is detected. Expenditures on pensions in Q2 were higher than in Q1 due to regular indexation of pensions by 2% in April. Real expenditures on pensions are expected to go down slightly because the rate of the next indexation, in October, will be lower (0.5%), and reduction in these expenditures is one of the key instruments for curbing fiscal deficit. A noticeable rise in expenditures on pensions in Q2 2013 relative to the same period 2011 is due to increase in numbers of pensioners (due to population aging), one-off aid to pensioners, and the pension indexation.

…while all other public expenditures go down moderately

Q2 saw a moderate reduction in real seasonally adjusted expenditures on employees relative to Q1 2013 and to Q2 2012 (by 2.9% and 5.7% respectively). Announced slower wage indexation in October 2013 and in the next year will cause a slight reduction in expenditures on employees in real (and relative) terms. However, massive cuts in these expenditures, necessary for substantial reduction in fiscal deficit, can be made only through implementation of strategic measures aimed at public sector employee right sizing (primarily in education and health care system and public administration) and reform in the public sector wage system.

Real seasonally adjusted expenditures on goods and services in Q2 fell moderately relative to Q1 (by 3.9%), and expenditures on subsidies went down considerably (by 7.5%). Expenditures on goods and services went down partly due to reduction in some discretionary expenditures, which is considered reasonable as long as delivery of public services is not jeopardized. However, savings from cuts in discretionary expenditures are limited and temporary, so certain strategic savings from reduction in expenditures on goods and services can be made only through a more efficient system of public procurement and procurement prioritization. Trends in expenditures on goods and services detected in Q2 confirm QM and the Fiscal Council's forecasts that enforcement of the new Law on Public Procurements will bring in savings much below EUR 600 million per year.

Slowdown in expenditures on subsidies was caused by reduction in subsidies on investments and employment and to some public enterprises. Cut in expenditures on subsidies is one of the Government's key instruments for achieving fiscal consolidation in 2013, which is considered economically reasonable, but requires simultaneous implementation of reforms aimed at economic consolidation in public sector and improved business environment.

Capital expenditures (real, seasonally adjusted) in Q2 continued to fall moderately (by 4.2%), because some projects were put off due to a slowdown in government revenues. Real capital expenditures went down by as much as 30.2% relative to Q2 2012. Capital expenditures in Q2 2012 ran at 1.8% of the quarterly GDP, which is much below the quarterly fiscal deficit. This indicates further deterioration in the net asset position of Serbia in Q2, because current expenditures take up almost 2/3 of the fiscal deficit, meaning that the future generations will have to shoulder the burden of the current expenditures. Since capital expenditures stimulate economic growth more greatly than any other type of public expenditures, and the basic infrastructure in the country is undeveloped, increase in these expenditures, followed by massive reduction in current expenditures, would be economically reasonable in the following period. However, financial decisions should be prioritized more efficient to produce the maximum output out of limited resources.

Fiscal trends by government levels

Local government revenues suffered the largest drop due to wage tax reduction and quasi-fiscal charges reform

Although real revenues on all government levels went down in Q2 2013 (relative to the same period last year), local governments suffered the largest drop due to reduction in tax rate for wages from 12% to 10% and increase in non-taxable part of wage, as of June, and quasi-fiscal charges reform in Q3 2012 (see Appendix 3)[3]. Reduction in tax rate for wages took effects only in one month of Q2, so local governments can expect further fall in these revenues in the future. Reduction in tax rate for wages has *de facto* cushioned the negative effects of fiscal decentralization carried out in 2011. Additionally, other local tax revenues fell due to the reform in quasi-fiscal charges. Since this reform was carried out in Q3 2012, the data show that its effects on local revenues have worn off (Q2 saw a real rise in these revenues relative to Q1 this year). The drop in local revenues is substantial so local communities will probably increase their efforts towards a more effective exploitation of property tax, as an instrument for local revenue collection, primarily through expanding the scope of property taxation and enhanced tax collection system. However, reforms in wage taxation and quasi-fiscal charges will probably widen local government fiscal deficit in 2013, and even jeopardize functioning of some local municipalities, because the liabilities taken on at the beginning of 2013 were proportional to the projected budget revenues, which will probably fall short of the plan.

... so did the local government expenditures

Reduction in public revenues caused reduction in public expenditures on all government levels in Q2, and the largest cut was made on the local level due to fall in local government revenues. Distribution of some local revenues to the central budget is considered economically reasonable incentive to local governments to cut their expenditures. However, the largest reductions were made in capital expenditures (real drop of 40.4% in Q2 relative to the same period last year), while the cuts in less productive expenditures (expenditures on employees etc.) were much smaller, which is considered unfavorable. This is in line with QM forecasts about the 2011 fiscal decentralization measures that the local governments would use additional funds primarily to increase current expenditures, rather than to invest, and that it will cause rise in local government current expenditures, which will be difficult to reduce afterwards. Accordingly, closer control of the purpose of local government revenue spending, through conditioning redistribution of funds from the central level by full exploitation of property taxation and other local government revenues and the dynamics of local government expenditures on wages in line with the dynamics of these expenditures on the central level, is recommended.

Analysis of trends in public debt

Public debt in Serbia amounted to EUR 19.08 billion (60,5% of GDP)

According to the official data released by the Ministry of Finance and Economy, at the end of July 2013 Serbia ran up public debt of EUR 19.8 billion (around 60,5% GDP[4]), EUR 310 million lower than in Q1. When compared with the same period last year, public debt went up by EUR 3.6 billion, or by 4.6% of GDP.[5] This rapid growth in public debt in the previous 12 months is caused by large fiscal deficit in the second half of 2012 and the first half of 2013, government guaranteed loans to public enterprises and financial rehabilitation of banks. Public debt during the new Government's first few months in power went up considerably because the liabilities inherited from their predecessors had to be covered. In the period April-July 2013 public debt went down because accumulated funds were used to finance fiscal deficit and for principal repayment of loans that fell due in this period.

Decrease in public debt in the period April-July was short-lived

Public debt in the period April-July went down because funds collected through issuance of euro-denominated bonds and other borrowing in the previous months were used to cover fiscal

3 Primary deficit (deficit without interests) is the difference between the total public revenues and the overall public expenditures subtracted by expenditures on interest payments.

4 *QM* estimate is based on comperison between the nominal public debt and the sum of GDP in Q2 2013 and the previous three quarters (which is in line with the international methodology), and the Ministry of Finance and Econoy estimate is based on comparison between nominal public debt and the projected GDP for 2013, which is incorrect from the aspect of economics, and is not in line with international methodology.

5 The amount of EUR 3.6 billion approximately equals 12% of GDP. However, relative increase in public debt (in Q2 2013 relative to Q2 2012) was much lower due to a strong appreciation of the dinar-euro exchange rate in that period (more than 10%).

deficit and principal payments on loans and cannot be perceived as a sign of recovery in public finance or the beginning of a downwards trend in public debt. Since a considerable portion of the funds collected through issuance of euro-denominated bonds has already been spent in the previous quarters, the government will have to provide for additional funds in the following period (either through issuance of euro-denominated bonds or through direct borrowing from financial institutions or other countries) to cover fiscal deficit and liabilities in the following quarters. Additional borrowing will cause detectible rise in public debt, in nominal and relative terms, as a % GDP.

Because fiscal deficit is made up through borrowing (revenues from privatization are low and a long-term growth in these revenues is not expected in the following period), the relationship between fiscal deficit and public debt is strong. To slow down and then to curb public debt, the government must reduce fiscal deficit, put limits on issuance of government guarantees and minimize the risks stemming from the problems in banking sector.

Table T6-9. Serbia: Public debt[1] 2000-2013

Amount at the end of period, in billions EUR

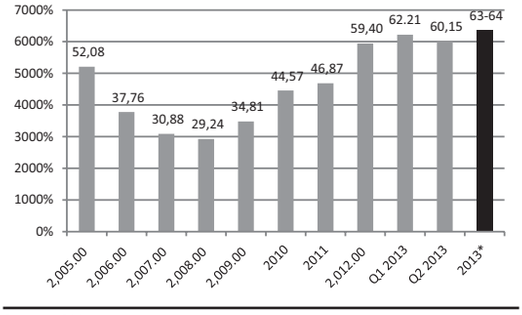
	2000	2005	2006	2007	2008	2009	2010	2011	2012	Q1 2013	Q2 2013	July 2013
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	12.36	15.07	16.61	16.05	16.22
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	6.45	6.67	6.54	6.54
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	8.62	9.94	9.51	9.68
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.60	2.78	2.85	2.85
III. Total debt (I+II)	**14.17**	**10.28**	**9.38**	**8.88**	**8.78**	**9.85**	**12.17**	**14.47**	**17.67**	**19.39**	**18.90**	**19.08**
Public debt / GDP[2]	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.6%**	**31.3%**	**41.5%**	**45.07%**		**57.70%**	**57.4%**	**57.7%**
Public debt / GDP (QM)[3]	**169.3%**	**52.1%**	**37.8%**	**30.9%**	**29.2%**	**34.8%**	**44.6%**	**46.9%**	**61.4%**	**62.2%**	**60.2%**	**60.5%**

Source: Ministry of Finance and Economy data and *QM* estimate

Growth in indirect debt continues as of April, and direct debt goes down temporarily

The overall public debt went down in the period April-July due to decrease in the direct debt (by EUR 390 million) and further increase in indirect debt (by EUR 80 million). Although the growth in indirect (guaranteed) public debt slowed down in the period April-July, the average growth was EUR 20 million per month relative to EUR 50 million per month in the previous quarters, it is still considered quite high because if this trend continues, annual growth in public debt will run at around 1% of GDP. The Government therefore must obey the limitations on issuance of government guarantees, set in 2013, and the maximum annual government guarantee threshold should be set (for example 0.5% of GDP). The agreement on strategic partnership between the JAT Airways and Etihad Airways that should provide for successful future operating of the national airline without direct or indirect government subsidies is a step in the right direction. According to this agreement the government has to make large investments (purchase of airplanes), which will be funded through additional borrowing, so this type of partnership is not desirable in case of other public enterprises because it would lead to further increase in public debt. Therefore, the government should not make heavy commitments when resolving the problems in public enterprises. Besides, government borrowing to invest in sectors that can be privatized, such as electricity sector, is unreasonable.

Graph T 6-10: Serbia - trends in public debt (% GDP)



Source: *QM* calculations

Chances that the expensive loans will be replaced by the cheap ones are still slim

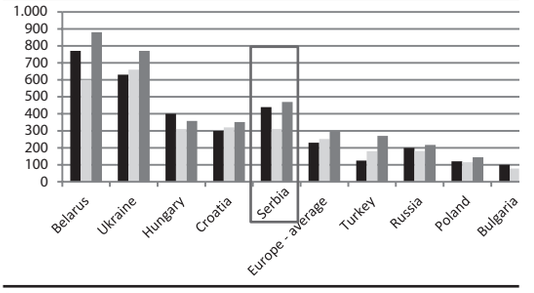
One of the announced measures aimed at more efficient public finance management after the reconstruction of Serbian Government is replacement of the existing expensive loans with new loans offering better terms. However, we believe that this is quite unlikely because the situation in the international financial market has worsened and the state of Serbian public finance is unfavorable (large fiscal deficit and public debt). Speaking from experience, it is quiet unlikely to achieve this through some non-commercial interstate arrangement, as

well. We believe that a comprehensive debt rescheduling program would be possible under the patronage of IMF, preceded by strong fiscal consolidation and arrangement with IMF. However, this would be reasonable just in case of emergency, because implicit declaration of bankruptcy goes without saying with this program. Serbia should therefore improve its fiscal position and reduce risk premiums, and then replace expensive loans with loans offering better terms, and short-term loans with long-term loans.

Risk premiums on the Government Bonds of the Republic of Serbia go up due to unfavorable fiscal trends

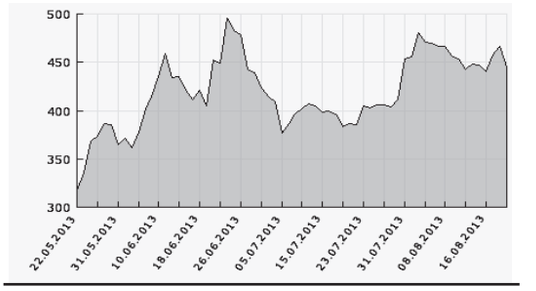
In the period April-August 2013 yield/risk on the Government Bonds of the Republic of Serbia, measured by *Emerging Markets Bond Index* (EMBI), increased from 310 basis points (at the beginning of May) to more than 470 basis points (in August). Although EMBI went up in all other Central and East European countries (on average by 25%), increase in EMBI for Serbia was among the largest in relative terms (about 52%). The rise in risk/yield on government bonds is mainly assigned to negative fiscal trends and the absence of a comprehensive fiscal consolidation program, and to a certain extent to general trends in the global market.

Graph T6-11. Serbia and the selected Central and East European countries: EMBI



Source: web page www.cbonds.info

Graph T6-12. Serbia: Trends in MBI in the period May-August 2013



Source: web page www.cbonds.info

If macroeconomic and fiscal flows remain unchanged, public debt at the end of 2013 will amount to 63-64% of GDP

With fiscal deficit at about 5.5-6% of GDP in 2013, and without further advance borrowing, and with other macroeconomic variables in line with official projections (2% growth in real GDP, average inflation rate in 2013 relative to 2012 at about 10%, y-o-y inflation rate at the end of the year at 5-6%), with steady real dinar-euro exchange rate, and with unchanged dynamics of the indirect public debt, Serbia's public debt at the end of 2013 could amount to about 63-64% of GDP. Deviation of any of these variables from the projected values would cause the deviation of the level of public debt. Public debt could exceed the projections due to: *i)* the risk of a larger fluctuation in the dinar exchange rate at the end of the year, *ii)* risk that the government's intervention in banking sector may be needed again, *iii)* risk of further deterioration in fiscal flows caused by inadequate implementation of the plan envisaged in the Budget Rebalance, *iv)* risk of increase in government guarantees on loans granted to some public enterprise, *v)* government's decision to significantly increase the level of advance borrowing to cover 2014 fiscal deficit. Exchange rate risk management is quite limited in the short term. However, other foregoing risks can be managed, so the government should monitor them systematically in the following period and adopt measures that can be taken aginst these risks soon after they arise.

Appendices

Appendix 1. Serbia: Consolidated General Government Fiscal Operations[1)], 2008-2013 (real growth in %)

	2008	2009	2010	2011	2012					2013			
					Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q1 - Q2	Q2 2013-Q2 2011
I PUBLIC REVENUES	**3.3**	**-8.7**	**-1.5**	**-4.6**	**1.7**	**4.8**	**-0.8**	**-3.2**	**0.6**	**-5.8**	**-3.2**	**-4.5**	**1.3**
1. Current revenues	3.5	-9.1	-1.5	-4.4	1.7	4.5	-0.9	-4.4	0.1	-6.2	-2.9	-4.6	1.3
Tax revenue	3.7	-8.8	-2.5	-4.1	1.9	5.3	1.9	-4.4	1.0	-4.2	-2.1	-3.1	3.0
Personal income taxes	6.3	-10.8	-3.9	-2.9	4.6	4.6	1.3	-1.6	2.1	-4.9	-12.3	-8.9	-8.4
Corporate income taxes	18.5	-27.0	-3.6	3.9	51.5	39.9	25.4	15.0	35.1	-28.2	-7.9	-21.5	28.7
VAT and retail sales tax	2.5	-10.2	-0.7	-4.0	-4.0	6.9	0.9	-3.7	0.0	-2.1	-0.6	-1.4	6.1
Excises	0.7	11.6	4.2	0.6	-5.7	-3.0	8.5	-7.0	-1.2	9.5	20.1	15.2	16.4
Custom duties	1.8	-32.4	-14.9	-21.5	-18.6	-8.6	-11.4	-17.6	-14.0	-15.3	-20.5	-18.1	-27.4
Social contributions	4.3	-7.0	-6.5	-3.9	4.8	6.1	0.7	-3.4	1.9	-3.0	-4.4	-3.7	1.3
Other taxes	-2.3	-4.9	14.5	-15.2	-9.7	7.6	-12.0	-19.2	-8.8	-14.2	-15.6	-15.0	-9.4
Non-tax revenue	2.6	-11.3	5.8	-6.1	0.1	-1.1	-19.0	-4.3	-6.2	-22.0	-9.4	-15.4	-10.5
2. Capital revenues	-76.8	-41.4	-66.8	468.2	124.1	259.1	176.7	373.3	304.5	159.3	-63.5	11.0	30.9
II TOTAL EXPENDITURE	**4.5**	**-4.8**	**-1.7**	**3.3**	**10.3**	**9.2**	**-2.9**	**1.5**	**4.3**	**-10.5**	**-6.6**	**-8.5**	**1.9**
1. Current expenditures	6.9	-3.3	-2.2	3.1	8.2	9.3	-1.7	1.4	4.1	-7.3	-5.1	-6.2	3.5
Wages and salaries	10.9	-6.0	-5.9	0.4	6.6	6.3	-5.7	1.4	2.0	-2.1	-5.7	-4.0	0.1
Expenditure on goods and services		-5.7	-0.3	4.3	9.4	15.0	-2.3	-11.4	1.5	-13.4	-20.3	-17.2	-8.4
Interest payment	-2.8	-5.7	-0.3	17.4	48.1	6.6	93.4	23.4	41.9	9.8	86.3	45.2	98.3
Subsidies	-13.3	19.0	40.6	7.4	42.6	56.4	-36.2	82.9	29.1	-24.6	-20.6	-22.6	24.0
Social transfers	10.1	-26.0	13.9	5.8	3.8	2.9	-0.3	-6.1	-0.1	-6.4	-2.6	-4.4	0.1
o/w: pensions5)	*9.5*	2.2	-3.9	3.9	*8.4*	*7.4*	*3.1*	*-0.5*	*4.4*	*-4.8*	*-4.1*	*-4.5*	*2.8*
Other current expenditures	14.9	6.7	-6.1	23.9	-17.1	36.8	12.2	11.8	9.9	-24.1	-26.5	-25.6	0.4
2. Capital expenditures	-4.3	-6.7	-11.8	5.3	48.7	8.3	-14.9	2.3	6.0	-53.6	-30.2	-42.7	-24.5
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**	**-41.9**	**-37.6**	**-39.6**	
IV TOTAL EXPENDITURE, GFS (II+III)	**4.6**	**-4.8**	**-1.1**	**-3.8**	**9.8**	**7.7**	**-3.5**	**1.2**	**3.6**	**-10.9**	**-7.0**	**-8.9**	

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

Appendix 2. Serbia: Consolidated General Government Fiscal Operations[1)], 2008-2013 (nominal amounts)

	2008	2009	2010	2011	2012					2013		
					Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q1-Q2
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**	**330.0**	**362.4**	**692.4**
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	327.3	361.3	688.6
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	296.4	321.8	618.1
Personal income taxes	136.5	133.5	139.1	150.8	35.8	41.2	41.4	46.7	165.3	38.2	39.8	78.0
Corporate income taxes	39.0	31.2	32.6	37.8	22.9	10.9	10.3	10.7	54.8	18.4	11.0	29.4
VAT and retail sales tax	301.7	296.9	319.4	342.4	79.7	90.1	94.4	103.3	367.5	87.3	98.7	186.1
Excises	110.1	134.8	152.2	170.9	34.6	40.6	54.9	51.0	181.1	42.5	53.7	96.2
Custom duties	64.8	48.0	44.3	38.8	7.7	9.0	9.3	9.8	35.8	7.3	7.9	15.2
Social contributions	312.7	318.8	323.0	346.6	85.9	94.6	94.5	103.9	378.9	93.4	99.7	193.0
Other taxes	35.6	37.1	46.0	43.5	9.7	11.7	10.8	10.4	42.6	9.3	10.9	20.2
Non-tax revenue	142.7	138.8	159.2	166.9	35.4	39.6	38.4	54.5	167.9	30.9	39.6	70.5
2. Capital revenues	1.4	0.9	0.3	2.0	0.6	1.3	0.8	6.0	8.7	1.9	0.5	2.4
	0.0											
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**	**-363.7**	**-402.7**	**-766.4**
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	-350.5	-385.4	-735.9
Wages and salaries	-293.2	-302.0	-308.1	-342.5	-85.5	-94.4	-91.2	-103.6	-374.7	-93.8	-98.1	-191.9
Expenditure on goods and services	-181.2	-187.4	-202.5	-216.3	-51.2	-62.9	-53.8	-67.7	-235.7	-49.6	-55.3	-104.9
Interest payment	-17.2	-187.4	-34.2	-44.8	-15.4	-13.4	-23.3	-16.2	-68.2	-18.9	-27.5	-46.4
Subsidies	-77.8	-22.4	-77.9	-80.5	-22.6	-25.2	-19.6	-44.2	-111.5	-19.0	-22.0	-41.1
Social transfers	-496.8	-63.1	-579.2	-609.0	-154.9	-161.1	-163.5	-173.0	-652.5	-162.4	-173.0	-335.4
o/w: pensions[5)]	*-331.0*	-556.4	*-394.0*	*-422.8*	*-112.5*	*-117.8*	*-119.2*	-124.1	-473.7	-119.9	-124.5	-244.4
Other current expenditures	-23.5	-387.3	-22.9	-31.7	-7.9	-11.7	-8.0	-9.8	-37.4	-6.7	-9.5	-16.2
2. Capital expenditures	-106.0	-24.0	-105.1	-111.1	-25.3	-22.5	-30.0	-48.6	-126.3	-13.2	-17.3	-30.4
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**	**-3.1**	**-3.9**	**-6.9**
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**	**-366.7**	**-406.6**	**-773.3**

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
Realni rast dobijen je primenom prosečnog baznog indeksa cena na malo (baza decembar 2003) na kvartalne podatke.

Appendix 3. Serbia: Real annual rates of growth in public revenues and public expenditures, by the levels of government

	Q2 2013/Q2 2012			
	Consolidated budget	Budget of Republic	Health Fund	Local self-governments
A Total public revenues (I)+(II)	**-3.2**	**-0.3**	**-4.3**	**-15.0**
I Current revenues (1)+(2)	-2.9	0.1	-5.2	-15.1
1. Tax revenues	-2.1	2.3	-6.4	-15.8
1.1. Customs	-20.5	-20.6	-	-
1.2. Personal income tax	-12.3	-9.6	-	-13.7
1.3. Corporate income tax	-7.9	-10.9	-	-
1.4. VAT	-0.6	-0.8	-	-
1.5. Excise duties	20.1	20.0	-	-
1.6. Property taxes	-9.9	-	-	-9.9
1.9.Other taxes	-15.6	13.7	-	-40.3
1.10. Social security contributions	-4.4	0.0	-6.4	-
2. Non-tax revenues	-9.4	-16.5	142.6	-12.9
II Capital revenues	-63.5	-	11.6	12.4
III Transfers from the other levels of government	-	-	-2.2	-16.9
IV Donations	-33.5	-61.7	-	88.2
B Total public expenditures (I)+(II)+(III)	**-6.6**	**-5.2**	**-7.0**	**-15.2**
I Current expenditures	-5.1	-4.6	-7.1	-9.7
1.1 Wages	-5.7	-5.3	-7.8	-3.4
1.2. Goods and services	-20.3	-38.1	-5.9	-15.5
1.3 Interest payments	86.3	94.3	60.8	-7.1
1.4 Subsidies	-20.6	-27.0	-	-12.9
1.5 Social insurance and social assistance	-6.4	15.3	-10.5	-4.4
1.6 Transfers to the other levels of government	-	-7.4	-	-
1.7 Other current expenditures	-24.1	-41.4	59.3	-14.2
II Capital expenditures	-53.6	-6.6	98.9	-40.4
IV Net lending	-41.9	-30.3	-	293.7

Source: *QM* calculations

7. Monetary Trends and Policy

The lowering of the y.o.y. inflation rate from the start of the year and the relatively stable exchange rate along with the announced reform of public finances created a positive environment to continue relaxing monetary policy. If expectations in regard to the public finances deficit come true in the coming period, the National Bank of Serbia (NBS) will have more space to maneuver for an additional cut in the key policy rate which would, by influencing the interest rates of business banks, at least partly improve new credit placements. Although the repo stock was decreased in Q2, Dinar liquidity in the system was cut down through NBS interventions on the inter-banking foreign currency market. The real growth rate of the money mass M2 at y.o.y. level is negative which caused by the worrying trend of debt repayments by the enterprises to foreign creditors and domestic banks. Enterprises have lowered their debts to domestic banks for the third quarter running which can turn into a serious problem unless a solution is found to move new credit placements. One of the elements that caused the debt payments of the enterprises was the end of a program of subsidized loans which allowed the economy to finance the purchase of working capital and current account liquidity. An additional deterioration was registered in the segment of bad credits whose participation continues to grow in Q2 with the speed of growth growing compared to Q1. The drop in credit activity and rise in bad loans demand a quick response by the state to ease recession tendencies in the greater part of the economy and minimize fiscal risks due to problems in the banking sector.

Central Bank: Balance and Monetary Policy

NBS lowers key policy rate …

The NBS key policy rate was lowered by 0.5 percentage points in May to 11.25% and that was followed in June by another correction to bring it to 11% (Table T7-1). The easing of monetary policy could have come earlier due to the fact that the monthly inflation rate in November indicated a significant drop in inflationary pressure which continued through the first half of 2013. A somewhat higher rise in prices in June which was seasonal was practically neutralized by deflation of –0.9% which appeared in July continuing the trend of bringing the annual inflation rate to the target framework for this year. Unlike the previous quarter when Dinar liquidity in the system was lowered through REPO placements, in Q2 the drop in Dinar liquidity was affected by NBS net interventions on the inter-banking foreign currency market totaling 225 million Euro aimed at cutting the weakening of the value of the Dinar. (In Q1 the NBS bought hard currency for a total of 10 million Euro, Table T7-1). Following the weakening of depreciation pressure, interventions on the inter-banking foreign currency market in July were directed at easing the strengthening of the Dinar which caused the NBS to buy 30 million Euro. Despite the constant presence of the deficit in the trade segment of the balance of payments which would require a depreciation of the exchange rate, the Serbian economy has seen a real appreciation of the Dinar since mid-2012 which caused an additional deterioration in Serbia's long-term export position.

… due to weakening inflationary pressure

In the highly eurorized economy with a constant growth of bad loans, the depreciation of the domestic currency caused a deterioration of the property position of the economy, state and the population because of which the NBS is intervening on the inter-banking forex market to prevent a sudden weakening of the value of the domestic currency. This problem is often described as the impossible trinity of the open economy in which it is unsustainable to have a stable exchange rate in combination with free movement of capital and an independent monetary policy which should secure price stability. In that case, the adapting of all imbalances in the current segment of the balance of payments is done through a change in the exchange rate. We believe that the lowering of the y.o.y. inflation rate in the period to the end of the year opens the door to a gradual depreciation of the Dinar exchange rate which would have a positive effect on the foreign trade balance while a new program of subsidized loans by the state would neutralize the negative effects of the rise of the cost of financing loans to the economy and the population.

Table T7-1. Serbia: NBS interventions and foreign currency reserves 2010-2013

	2011				2012				2013	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
Repo stock (in milions of euros)	549.77	746.09	1,000.42	1,174.84	1,055.98	111.98	2.29	354.16	678.86	663.82
NBS interest rate	12.25	12.00	11.25	9.75	9.50	10.00	10.50	11.25	11.75	11.00
NBS interest rate	-9.74	6.76	12.59	7.15	1.11	-2.77	-5.74	1.11	6.95	3.31
NBS interest rate	25.66	28.86	5.17	2.61	-18.43	-7.27	-6.50	-3.99	19.25	12.85
NBS interventions on FX market (in milions of euros)	5.00	-30.00	-30.00	-30.00	-498.50	-1288.80	-1348.30	-1343.30	10.00	-215.00
INCREASE					**cumulative, in % of initial M2[5)]**					
NBS own resreves[2)]	-8.9	14.0	26.8	73.9	-17.6	-45.4	-35.6	-6.0	12.5	7.1
NDA	-0.7	-15.5	-28.6	-51.8	2.4	61.3	65.8	41.3	-15.3	-3.9
Government, dinar deposits[1)]	-4.6	-3.3	3.6	2.7	-5.1	6.1	4.3	-4.3	1.0	-1.2
Repo transactions[3)]	-6.9	-15.3	-32.2	-47.5	2.2	53.7	59.3	40.2	-16.0	-14.7
Other items , net[4)]	10.9	3.1	0.0	-7.0	5.3	1.5	2.3	5.4	-0.3	12.0
H	-9.6	-1.5	-1.8	22.1	-15.2	15.9	30.2	35.3	-2.8	3.3
o/w: currency in circulation	-5.8	-4.2	1.3	12.4	-3.3	-4.0	-1.4	-1.6	-3.9	-0.7
o/w: excess liquidity	-3.8	2.5	-5.5	6.3	-13.6	-1.6	-1.1	5.4	0.6	2.1
					in millions of euros, cumulative from the beginning of the year					
NBS, net	56	282	1,374	2,203	-1,070.60	-2,087.45	-2383.97	-1050.9	30.0	-992.0
Gross foreign reserves	16	308	1,426	2,334	-1,138.11	-2,090.09	-2536.57	-1324.2	-385.8	-1576.9
Foreign liabilities	41	-26	-52	-131	67.51	2.64	152.6	273.2	415.8	584.9
IMF	37	-32	-59	-132	58.24	-6.44	138.99	259.0	401.1	568.4
Other liabilities	4	6	7	1	9.27	9.07	13.61	14.2	14.6	16.5
NBS, NET RESERVES-STRUCTURE										
1. NBS, net	56	282	1,374	2,203	-1,070.60	-2,087.45	-2389.97	-1050.9	30.0	-992.0
1.1 Commercial banks deposits	22	226	109	-462	459.45	740.45	1030.19	907.6	911.8	967.0
1.2 Government deposits	-232	-258	-1,009	-455	263.40	488.43	683.75	28.6	-811.8	47.1
1.3 **NBS own reserves** (1.3 = 1 - 1.1 - 1.2)	-154	250	474	1,286	-347.74	-858.58	-670.03	-114.7	130.0	22.1

Source: NBS.

1) State includes all levels of government from republic to local.

2) Definition of net own reserves NBS is given in section 8 „Monetary Trends and Policy", frame 4, *QM* 5.

3) This category includes NBS Bills and repo operations.

4) Other domestic assets net include: domestic loans (net debts to banks, not including NBS Bills and repo transactions; net debts of economy) together with other assets (capital and reserves; and balance items: other assets) and corrected by exchange rate.

5) "Initial M2" signifies the state of primary money at the start of the current ie end of previous year.

Interventions on Inter-Banking Forex Market influence drop in own reserves

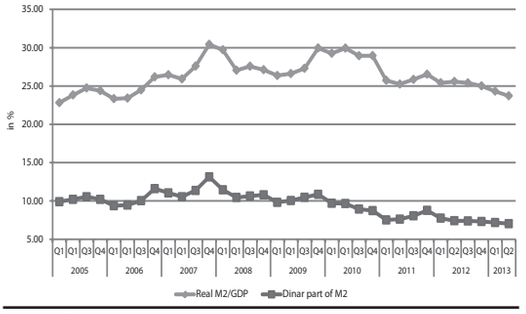
Interventions on the inter-banking forex market in Q2 caused a drop in NBS net own reserves compared to the previous quarter by about 109 million Euro. A greater drop was prevented somewhat by the purchase of foreign currency from the state which converted a part of the hard currency deposits from its NBS account to finance spending in Q2. State spending in Q2, together with the withdrawal of funds from repo operations unlike the previous quarter when banks aggressively invested funds in REPO, caused a positive growth of the net domestic assets (NDA) of 11.5%. The recorded rise in net domestic assets was enough to compensate the drop in NBS net own reserves which finally caused a growth in primary money in Q2 of 6.1% compared to the previous quarter.

Monetary System: Money Supply Structure and Trends

Rise of NDA from start of year due to increased state spending

From the start of the year, the M2 money mass increased by 1.1% with the growth of the money mass in Q2 standing at 2.3% which neutralized the drop in the first three months of –1.2%. The nominal growth of the money mass in Q2 was due to the increase of the NDA of 6.8% while the net foreign assets (NFA) were lowered by 4.5% on the basis of exchange rate differences. Bear in mind that the increase of the NDA was achieved thanks to higher state spending in this period while credits in the private sector which should be the main moving force for economic growth saw an insignificant rise in this period compared to the previous quarter and a significant drop at y.o.y. level.

Graph T7-2. Serbia: money mass trend as percentage of GDP, 2005-2013



Source: *QM* calculation

Real y.o.y. M2 growth rate negative …

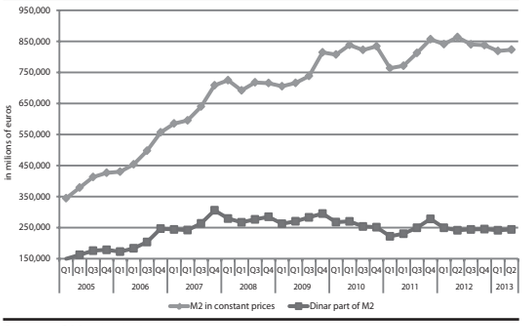
The nominal money mass M2[1] in Q2 slowed its growth to 4.5% y.o.y., mainly thanks to the

1 Monetary aggregate M2 in section Monetary Trends and Policy includes the lesser aggregate M1,savings and timed deposits as well as foreign currency deposits in business banks. Because of that, aggregate M2 which we are observing is equal to monetary aggregate M3 in NBS reports.

negative trend established in credit placement to the enterprises (in Q4 2012, the M2 growth rate stood at 9.6% y.o.y. Table T7-4). Following corrections to allow for inflation we see that the negative trend of a decrease of the real value of the money mass has continued. The drop in the money mass in Q2 stood at –4.7% at y.o.y. level which is a speedier drop compared to the previous two quarters which also saw the negative trend (in Q1 the drop of the M2 was 2.6% y.o.y., in Q4 2012 the M2 drop was –2.2 y.o.y.). That mentioned drop was mainly caused by the drop in credit placements to the private sector whose real rate showed a decrease of –9.2% which is the greatest relative drop since QM has monitored that data. Following the correction for the exchange rate, the drop in credit to the private sector was somewhat lesser and stood at –6.8% y.o.y. (in Q1 the drop stood at –8.7% and in Q4 2012 at –7.6% y.o.y.). The overall drop was caused by a drop in credit placements to both the population and the economy with a decrease of –7.9% y.o.y. Part of the drop in credit activity was caused by the end of the program of subsidized loans since the financing funds were exhausted in March of the current year and according to the amended budget and measures to cut expenses no additional funds were planned for this year. We believe that it would be necessary to restart the program of subsidized loans since it is obvious that the largest part of the economy is still failing to resolve the problem of current financing and is actually still in recession.

… as consequence of worrying debt repayment of enterprises

Graph T7-3. State of money mass in permanent prices, 2005–2013



Source: *QM* calculation

The nominal growth of the M2 money mass of 4.5% y.o.y. in Q2 was mainly caused by the increase of the lesser monetary aggregate M1 of 3.71 percentage points. This is an exception compared to the previous quarters when foreign currency deposits had the dominant influence on the growth of M2. The contribution to the growth of M2 in Q2 by foreign currency deposits stood at 1.47 percentage points (in Q1 the rise of the foreign currency deposits was 5.94 percentage points) which was cited to explain the 25% rise in the M2 monetary aggregate. Savings and timed deposits continued their negative contribution of 0.7 percentage points in Q2 which marks one year since that element of the money mass having a negative effect on the overall nominal growth of M2.

Table T7-4. Serbia: growth of money and contributing aggregates 2011–2013

	2011				2012				2013	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
					y-o-y, in %					
M2[1]	8.0	3.7	8.1	10.1	14.0	18.1	13.8	9.6	8.2	4.5
Credit to the non-government sector[2]	19.3	11.6	8.3	7.7	14.4	14.0	16.6	9.8	1.9	-0.5
Credit to the non-government sector[2], adjusted[3]	16.7	13.0	11.8	8.1	8.6	4.6	7	3.8	1.6	2.2
Households	25.1	20.6	17.8	5.7	5.7	3.3	3	2.5	3.0	4.5
Enterprises	12.8	9.4	8.8	9.3	10.1	5.3	9.1	4.4	0.9	1.0
					real y-o-y, in %					
M2[1]	-5.4	-8.0	-1.2	2.7	10.1	12.0	3.4	-2.2	-2.6	-4.7
Credit to the non-government sector[2]	4.5	-1.0	-1.1	0.5	10.5	8.1	5.9	-2.0	-8.2	-9.2
Credit to the non-government sector[2], adjusted[3]	1.8	0.2	2.2	0.9	4.9	-1.2	-3.6	-8.1	-8.7	-6.8
Households	9.2	7.0	7.8	-1.3	2.0	-2.4	-7.2	-9.2	-7.5	-4.6
Enterprises	-1.6	-3.0	-0.4	2.1	6.3	-0.5	-1.7	-7.5	-9.3	-7.9
					in bilions of dinars, end of period					
M2[1]	1,315.6	1,344.8	1,412.2	1,498.0	1,499.7	1,588.6	1,607.6	1,641.7	1622.7	1659.8
M2[1] dinars	382.7	402.0	433.8	486.5	445.0	444.6	467.4	480.6	478.8	492.5
Fx deposits (enterprise and housholds)	932.9	942.8	978.3	1,011.5	1,054.7	1,144.0	1,140.2	1,161.1	1143.8	1167.3
					cumulative, in % of opening M2[4]					
M2[1]	-3.3	-1.2	3.8	10.1	0.1	6.1	7.3	9.6	-1.2	1.1
NFA, dinar increase	-1.9	-1.4	9.5	11.9	-5.6	-4.5	-7.9	0.2	7.2	2.7
NDA	-1.4	0.2	-5.7	-1.8	5.7	10.5	15.2	9.4	-8.4	-1.6

Source: NBS

1) Money mass: components – see Analytical and Notational Conventions *QM*.

2) Credits to private sector – credit to the economy (including local government) and households.

3) Trends corrected by exchange rate changes. Corrections conducted under assumption that 70% of loans to private sector (both households and the economy) indexed against the Euro.

4) Initial M2 means the state of the M2 at start of current ie end of previous year.

Banking Sector: Placements and Sources of Financing

Repayment of enterprises debts continued in Q2...

The banking sector in Q2 continued in its unchanged position on the overall placements of funds compared to the start of the year. In the segment of the enterprises and the households, placements dropped by 46 million Euro as the consequence of the drop in credit to the economy while the placement to the population increased in Q2. The households increased its debts in this quarter by 184 million Euro (Table T7-5) which is a significant growth of credit activity compared to the growth in previous quarters of about 40 million Euro. On the other hand, the net placement to the enterprises has been negative for the third quarter running which means that repayments of loans taken earlier is higher that the amount of new loans. The drop in the placement to the enterprises in Q2 stood at 230 million Euro (about 0.7% of the GDP). Including the debt repayments in the previous two quarters the total repayment amount has increased to about half a billion Euro. We should mention that the drop in credit activity in Q2 was also influenced by the fact that the Razvojna Banka Vojvodine lost its work permit. As in the case of bankruptcy proceedings at the Nova Agrobanka, most of the debts were automatically transferred to the Deposit Insurance Agency which means those debts were taken out of the overall balance of the banking sector. Despite that, if we look at the rest of the banking sector we see that the drop in the placements to the enterprises was present in Q2 and stood at around 100 million Euro.

… towards both local and foreign banks

Besides the repayment of debts to local banks, the enterprises have reduced its debts to foreign creditors by 140 million Euro in Q2 (in Q1 the debt repayments stood at 70 million Euro). The net repayment of debts by the enterprises to foreign creditors intensified following the start of the crisis which caused a contraction on the international financial market and the negative trend was overturned late in 2011. However, as of Q3 2012, there has been a constant debt repayment to foreign creditors which has caused an added deterioration of the economy in regard to sources of financing. Debt repayment to local and foreign banks can have very negative consequences for the Serbian economy because if the current financing problem is not solved there is a danger of the still present recession becoming the prevailing trend.

End to program of subsidized loans one of causes of drop in credit activity

The negative trend of debt repayment in combination with the growth of bad loans and reduced investments reflects the fact that a large part of the economy still has not found a solution to finance current business operations and investments. The drop in credit activity is largely due to the discontinuing of subsidized loans since the budget funds for that purpose were spent and no new subsidized loans were likely to be approved to the end of the year bearing in mind the current situation in terms of the deficit of public finances. It would be useful for stimulating credit activity if the possible budget amendment for 2013 and the budget for 2014 secured funds to continue the program since subsidized loans, despite all their shortcomings, have proved to be one of the rare effective stimulation measures for the Serbian economy in the period of recession.

In Q2 REPO stock stagnated and grew significantly in July …

Business banks kept their placement amounts in REPO papers at almost unchanged level in Q2 while moderately increasing placement in treasury bonds. In Q2 the placements in REPO were reduced by just two million Euro while on the other hand activity increased at auctions of state bonds in Q2. As to date, the majority (about 94%) of the funds collected at treasury bond auctions was used to repay debts fallen due from previous auctions and the net withdrawal of funds from the economy on that basis was relatively modest. Since there were no large-scale investments by business banks in REPO and the purchase of treasury bonds in Q2, liquidity accumulated in the banking sector was not used for the placement of new loans to the economy. Part of the surplus liquidity of banks was used in July to increase placement in REPO stock by about 15 billion Dinars. We could say that this formed the covert problem of the sustainability of the macroeconomic position when economic growth was created through the increase of agricultural production and export oriented production within several large companies while the rest of the economy which is still in recession saw credit placement drop.

… placements in treasury bonds also stagnated

Table T7-5. Serbia: bank operations – sources and structure of placement corrected[1] trends, 2011-2013

	2011				2012				2013	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
	in millions of euros, cumulative from the beginning of the year									
Funding(-, increase in liabilities)	603	69	-822	-1,083	672	692	472	-384	109	-125
Domestic deposits	206	-148	-844	-1,169	589	146	15	-459	4	-289
Households deposits	-92	-295	-483	-655	-49	-189	-296	-578	-87	-318
dinar deposits	24	13	-68	-182	30	69	36	11	16	-34
fx deposits	-116	-308	-416	-473	-79	-258	-332	-589	-102	-283
Enterprise deposits	298	147	-361	-513	638	336	311	120	91	29
dinar deposits	176	13	-128	-350	362	304	230	99	-11	-11
fx deposits	122	134	-233	-164	275	31	81	21	102	39
Foreign liabilities	580	634	678	545	3	345	335	127	357	299
Capital and reserves	-183	-416	-656	-459	80	200	123	-52	-252	-134
Gross foreign reserves(-,decline in assets)	-720	-674	-517	-923	-199	371	164	284	-278	-73
Credits and Investment[1]	309	1,270	2,158	2,771	409	-424	201	521	123	128
Credit to the non-government sector, total	216	1,030	1,554	1,940	309	136	784	589	-23	-69
Enterprises	191	766	1,189	1,607	375	161	741	552	-71	-301
Households	25	263	365	333	-36	-25	42	37	48	232
Placements with NBS (Repo transactions and treasury bills)	86	268	529	720	-28	-944	-1,052	-701	321	319
Government, net[2]	7	-28	75	111	128	385	470	632	-175	-122
MEMORANDUM ITEMS										
Required reserves and deposits	-157	-429	-210	391	-552	-418	-451	-265	-17	277
Other net claims on NBS[3]	17	123	2	110	-199	-20	-42	58	-154	-140
o/w: Excess reserves	22	123	-3	100	-187	45	54	10	-151	-108
Other items[4]	-136	-195	-246	-601	150	222	56	146	100	-140
Effective required reserves (in %)[5]	23	21	21	24	22	23	23	23	25	24

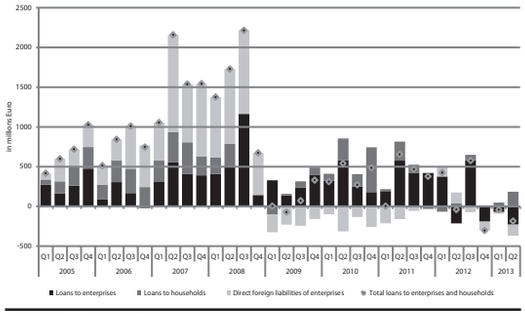
Source: NBS

1) Calculating growth is done under the assumption that 70% of overall placement is indexed against the Euro. Growth for original Dinar values of deposits are calculated on the average exchange rate for the period. For foreign currency deposits – the difference of the situation calculated under the exchange rate at the ends of the period. Capital and reserves calculated under Euro exchange rate at the ends of the period and does not include the effects of changes in the exchange rate from the calculation of the remaining balance.

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

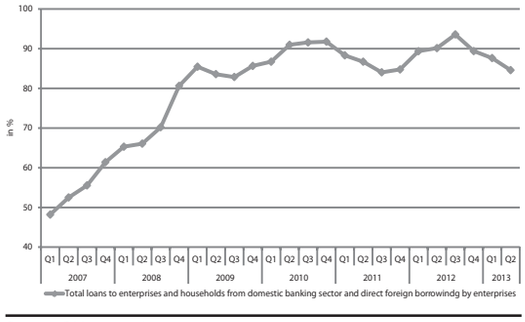
3) Net crediting of the state: loans approved to the state are decreased by the deposits of the state in business banks; a negative prefix marks a higher growth of deposits than of credit. The state includes all levels of government; republic to local.

Graph T7-6. Serbia: growth of new credits to economy and population, 2005-2013



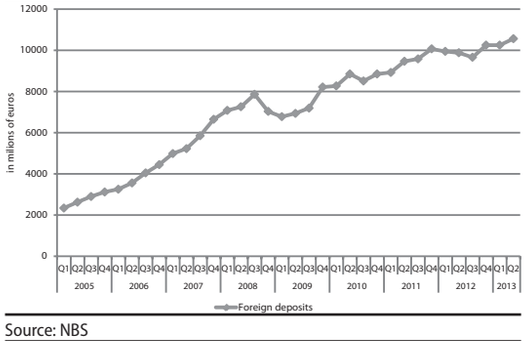
Source: *QM* calculation
See footnote 1 in Table T7-5.

Graph T7-7. Serbia: overall credit debts in % of GDP, 2007-2013



Source: *QM* calculation

Graph T7-8. Serbia: level of foreign currency deposits, 2005-2013



Source: NBS

Following the seasonal reduction of sources for new placements at the start of the year, the banking sector in Q2 saw a growth in this segment totaling 234 million Euro (in Q1 the drop in sources for new placements was 109 million Euro, Table T7-5). Sources for new placements increased thanks to a growth in the deposits of the population mainly in foreign currency of 181 million Euro while Dinar deposits increased by 50 million Euro. Growth was recorded to a lesser extent with deposits by the economy in foreign currency which increased

by 62 million Euro in Q2. Growth of sources for new placements which did not turn into new credits to the economy nor into investments in REPO showed that there were significant unused liquidity reserves in the banking sector.

Growth of bad credit speeds up in Q2 …

… mainly thanks to a rise in bad credits to corporate sector

The growth of bad credits in the banking sector in Serbia speeded up throughout Q2. The participation of bad credits calculated using the QM methodology[2] show a worrying jump of 2.6 percentage points in Q1, a growth in Q2 of 3.5 percentage points which continued in July at a somewhat slower pace (Graph T7-10). In the structure of bad credit according to type of debtor the largest contribution to the increase came from the growth of bad loans to corporate sector. The latest data for July show that the participation of bad credits in just one month for corporate sector increased by an added 0.47 percentage points. If a similar trend continues to the end of the year, the banking sector in Serbia would see practically one fourth of the credit placements fall in to the category of bad!

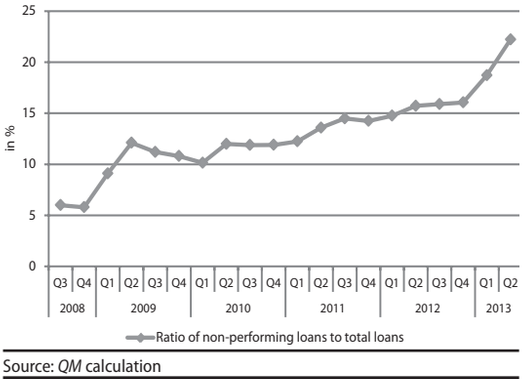
Table T7-9. Serbia: participation of bad credits by type of debtor, 2009-2013

	2009	2010	2011				2012				2013	
	Q4	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	May
	balance at the end of period											
Corporate	12.14	14.02	14.39	16.23	17.44	17.07	17.72	19.26	19.04	19.06	22.62	27.77
Entrepreneurs	11.21	15.8	15.66	15.75	16.99	17.07	16.05	18.47	17.56	15.92	16.79	18.19
Individuals	6.69	6.71	6.79	7.1	7.4	7.24	7.57	7.69	8.05	8.32	8.44	8.37
Ammount of dept by NPL (in milions of euros)	1.58	1.94	2.09	2.46	2.64	2.63	2.67	2.71	2.97	3.19	3.87	4.47

Source: *QM* calculation

A short-term reduction of the participation of bad credits to the individuals was recorded compared to the previous quarter but in July it increased again to 8.5% which is a new quarterly maximum. Still, the fact that the overall growth of bad loans in this segment from the start of the crisis stood at more than 4 percentage points because of which the loans to private individuals represents the part of the market which is the most regular in meeting its credit dues.

Graph T7-10. Serbia: participation of bad loans in overall placement, 2008-2013



Source: *QM* calculation

Bearing in mid the fact that the growth of bad loans continued despite the slight economic recovery in the previous and this year, we come to the conclusion that the greatest generators of this growth are companies for which the recession has not been stopped id est. those which are not export oriented. Large-scale investments in local companies such as those by FIAT, ETIHAD and NIS are highly desirable and necessary to the Serbian economy but will not have any great effect on the level of bad loans at least not directly since those companies use foreign sources of finance and do not have any great influence on the domestic banking system (for more details on bad loans see QM 32, Review 3).

2 Manner of calculation in more detail in *QM*.6, Under the Microscope: NPLs in Serbia – what is the right measure?

The International Environment

Global recovery continued somewhat more quickly in developed countries (primarily because the Eurozone got out of the recession) but developing countries slowed down. Financial markets are preparing for the quantitative easing by the US FED and capital is being withdrawn from developing countries which raised the cost of their debts, devalued currencies and lowered the value of shares. Quick growth of GDP in Q2 in most eastern European countries. The main risks in continuing global growth are the further slowing down of developing countries and the negative effects of military intervention in Syria. The United States and the Eurozone continued fiscal consolidation. Developed countries are still implementing expansive monetary policies but the FED will start gradually decreasing the amount for monthly purchases of stocks and bonds. Inflation in developed countries is still low and there is a danger of increased inflation in the developing countries. The continued recovery of the Eurozone will have a positive effect on Serbia's economic growth.

The World

According to the International Monetary Fund (IMF) predictions in July, global growth will continue in 2013 and will reach about 3%. In expectation of a less expansive FED policy, long-term interest rates have rise in developed countries. That along with the slowdown in developing countries led to a drop in prices on the stock markets of developing countries, a rise in the cost of their debts, outflow of capital and devaluation of their currencies. Growth in the USA was partially hampered by the restrictive fiscal policy (the IMF predicted a growth of 1.7% in 2013) while Japan achieved a higher than expected growth because of the rise of its net exports and domestic consumption. Although the Eurozone officially got out of the recession in Q2 there is still no confirmation of a definite recovery of the Eurozone because Spain and Italy have seen a drop in GDP and many risks which could slow growth are still present (primarily because of the insufficient speed in implementing institutional reforms and structural changes). The IMF predicted a drop of 0.6% in the Eurozone in 2013 but an upwards revision of that prediction is expected because of the higher than expected growth in Q2. The difference in the growth rate in developing and developed countries is growing smaller because the predicted growth rate for developing countries has dropped from 5.3% to 5% for 2015 and from 5.7% to 5.4% for 2014. There was no change in the predicted growth rates for eastern Europe. The growth rate for China for this year was reduced from 8.1% to 7.8% and for next year from 8.3% to 7.7%. The greatest negative correction of growth rates was for Brazil, Russia and South Africa. The risks of a fiscal cliff in the US and financial crisis in the Eurozone have been drastically reduced and now the main risks to global recovery are the slowdown of growth in developing countries and the negative consequences of military intervention in Syria. Capital has started withdrawing from developing countries because of the confusion over the FED exit strategy (and its timing) which could lead to a macroeconomic imbalance and additional slowdown of growth in those countries, especially those with high current deficits. The deepening of the crisis in developing countries could have a negative effect on the level of the cost of debts in Serbia.

The Eurozone

The Eurozone achieved a y.o.y. drop of 0.7% in Q2 but compared to the previous quarter it achieved a growth of 0.3%[1], (more than the expected 0.2%) and the official view is that the recession is over. However, Italy and Spain are still in recession (negative quarterly growth) while the population of the Eurozone has not felt the exit from the recession since unemployment continues to be high (12.1%) and the effect of low base is still present since growth in Q1 was fairly low. In Germany, quarterly growth stood at 0.7% after growth slowed down in the previous quarter primarily due to bad weather. The construction and processing industries saw strong

1 Seasonally adjusted growth compared to previous quarter

and fast growth in Q2 in Germany and the business environment improved. The biggest surprise was France which had a quarterly growth of 0.5% which was higher than the expected growth of 0.2%. That country saw its automobile and aircraft industries recover the most. Portugal recorded a positive growth of the GDP at quarterly level after a long time. Fiscal policy continues to be restrictive in the Eurozone which prevented a significant recovery of personal spending in the Eurozone.

The European Central Bank (ECB) did not change its key policy rate since May (0.5%) but the novelty is that it started using the phrase "the key policy rate will be low in the long term" similarly to what the FED is telling the public. Analysts believe that the low rate will stay in place probably to the end of 2014. The ECB chairman said that the low rate will remain in place to support economic recovery as long as inflation does not pose a threat.

Overall inflation dropped again following the recovery in Q2. Overall inflation in June stood at 1.6% and at 1.3% in August while base inflation in June stood at 1.2% and at 1.1% in August.

Unemployment in the Eurozone has been stable since April and is at a historic high of 12.1%. The lowest unemployment was in Austria (4.8%) and Germany (5.3%) and the highest was in Greece (27.6%) and in Spain (26.3%).

The trade balance in the Eurozone was positive in Q2, standing at 43.7 billion Euro which is more than the surplus in Q1 which stood at 39.1 billion Euro. While Eurozone exports recorded growth, imports saw a drop and the trade surplus increased. Germany had the biggest surplus in the first five months of this year (8.1 billion Euro) and the biggest deficits were recorded in France (32.9 billion Euro), Great Britain (26.1 billion Euro) and Greece (8 billion Euro). If the recovery results in a rise in imports Serbia's economic growth could be stimulated.

The United States

The United States achieved a GDP growth of 1.6% at annual level in Q2. As in the previous quarter, personal spending contributed the most to growth and the reduction of public spending had a negative effect because fiscal consolidation is underway because of the high public debt of the US. Companies recorded growth of investments and supply levels while imports rose. The construction industry continued its recovery. After tax exemptions were abolished for the poor and middle class and higher taxes were introduced for the rich, personal spending continued to grow at a similar pace as before.

The fiscal deficit will stand at less than 4% this year with a downward trend which is a significant success. For example, in 2009 the deficit stood at 10.8%. Congress needs to take a fresh decision on the extent of budget expenses when the risk of a fiscal cliff could resurface although that scenario is less probable than before. The planned deficit for next year is 3.3% and 2.1% in 2015 but the Republicans will probably demand an even lower deficit rate.

The FED did not change its key policy rate nor did it correct existing interventions on the open market but it is expected to slowly decrease the amount of stocks and bonds which the FED buys every month which is part of the third stage of quantitative easing. However, since no specific date has been announced, there is confusion about when the easing of the intensity of the interventions on the open market will begin. Because of that, long-term interest rates have risen (early in May the rate for 10 year US state bonds stood at around 1.6% and now it is almost 3%) as well as the return of capital from developing countries to the US. There is a danger that if the growth of long-term interest rates continue it could block the recovery of the real estate market.

Overall inflation, following the drop in March and April to 1.1%, rose and now stands at 2% while base inflation stands at 1.7% at annual level which is a drop compared to March when it stood at 1.9%.

The situation on the labor market is improving and the unemployment rate fell from 7.6% in March to 7.4% in July. The US economy will probably continue creating some 200,000 jobs a month but

that is not enough to normalize the situation on the labor market completely. That trend will gradually decrease the unemployment rate but the pace will slow down unless the level of participation of the workforce increases on the labor market and it is currently at a fairly low level. The growth of wages will not speed up unless there is a significant drop in unemployment rates.

Central and Eastern Europe

Fears of the FED easing its expansive monetary policy led to a rise in the cost of debts and a devaluation of currencies in Eastern Europe but to a lesser extent than in Brazil, India and Russia. As in the Eurozone, the growth of the GDP speeded up slightly in many east European countries and polls show that this trend could continue over the next quarters. The possible increase of imports into the countries of eastern Europe increase could have a positive effect on exports from Serbia.

Hungary achieved a growth of its GDP of 0.2% at annual level in Q2. The main contributions to that growth came from agriculture and the construction industry while industrial production and services stagnated. Helped by EU funds, capital investments (state) also recovered while personal spending saw a modest growth following 8 quarters of decline. Net exports had a saw negative effect on growth (exports rose 3% and imports rose 4.7%) but automobile production is expected to increase the level of production in the autumn. Fiscal policy was slightly expansive but the government continued its unorthodox taxes on companies and as a result capital investments by companies remained at a low level. The IMF predicted zero growth this year with inflation at 3.2%. There are plans to convert loans in foreign currency into Forints under favorable conditions. The central bank continued its sharp reduction of the key policy rate which was lowered several times from the 5% level in March to 3.8% now. In conditions of relatively low inflation and weak domestic demand, the key policy rate is aimed at stimulating economic activity and exports by weakening the Forint. From the start of the year, overall inflation dropped and stood at just 1.8% in July which is much lower than the target of 3%. Hungary has managed to reduce its budget deficit to a level below 3% and help from EU funds will not be withheld.

Romania achieved a GDP growth of 0.5% q/q (y.o.y. growth of 1.4%) in Q2. Industrial production rose by 1.4%, agriculture by 0.6% while the construction industry saw a drop of 0.5%. Net exports saw a growth of 6%. The trade deficit was cut in half in the first six months and, together with very successful agricultural production, Romania recorded a surplus in its current account in the first six months of the year. A new stand-by arrangement will be signed with the IMF as a measure of caution and the focus of that agreement will be raising the competitiveness of the Romanian economy. The IMF predicted a growth of 2% this year with a budget deficit of 2.3% (somewhat larger than the earlier plan of 2.1% because of additional expenses in health care and regional development). The plan is to reduce VAT on bread to 9% (the standard VAT is 24%) and raise duties on alcoholic beverages along with a new tax on luxury cars, gold, jewelry and weapons. In order to reform the economy and raise competitiveness, Romania plans to sell shares in several public companies.

Croatia recorded a GDP drop of 0.7% at annual level in Q2 which is somewhat better than expected and is the least bad result over the past six quarters. Most probably, personal spending was somewhat higher than earlier with a solid tourist season but the fact that Croatia quit CEFTA and the restructuring of the shipbuilding industry had a bad effect on industry. Most investments were financed by the state and the level of private investments continues to be low. The prediction is that the GDP would see a negative growth of 0.8% in 2013. In August, the S&P agency lowered its predicted rating for Croatia from stable to negative. The autumn is expected to see a new government economic plan as well as a budget plan for 2014 which will be important for budget income due to weak economic activity and the servicing of the public debt (which is approaching the level of 60% of the GDP with a budget deficit of more than 4% this year) is increasingly expensive. Because of that the new economic plan must include a reduction of budget expenses and structural reforms.

HIGHLIGHTS

Highlight 1. Economic policy and reforms – a trade-off between rapid and carefully planned reforms

Milojko Arsić

Beginning of the world economic crisis caused more rapid deterioration in the financial health of enterprises, banks and the state. Most sectors of economy are still in recession (see Chapter 2), and financial health is deteriorating – illiquidity, closely related with insolvency, goes up. Financial health of banks is failing because real value of loans is going down, and the percentage of bad loans is rising (se Chapter 7). Drop in real value of loans to enterprises weakens their liquidity and worsens recession. Foreign exchange gains on large foreign currency loans give a false impression of recovery in their business performance[1], just like the upwards trend in production in several companies and agricultural production back on the average level create an illusion that Serbian economy came out of recession. Unemployment stagnates at very high 25%, and a half of the young population is jobless.

This year's fiscal deficit is projected at 5.5-6% of GDP (or more than 7% according to IMF methodology), the first largest fiscal deficit in Central and East European states. During the previous 12 months public debt went up more rapidly, by EUR 3.6 billion, or by 23%. Recovery in Serbian economy is modest and limited to the rapid growth in exports, reduction in the current account deficit and low inflation. Serbia's economic policy received negative evaluation from the IMF and Serbia slipped down the ranks of global competitiveness according to the report published by the World Economic Forum, which confirms that the negative trends in Serbian economy still prevail.

The government must get to grips with the growing problems determinately to prevent the country go bankrupt, slow down recession, curb the rise in bad loans etc. However, during the previous years, including 2013, they failed to do that. Stronger measures were taken only when the country was on the brink of bankruptcy, but soon after the danger would pass they were abandoned. This summer Deputy Prime Minister Vučić spoke about sweeping, radical reforms, but no further steps in that direction were made. Implementation of rapid and drastic reforms in economic system and public sector, after the Government reconstruction, was announced. However, a question as to is it reasonable to adopt fundamental reforms in a short term, without previous expert and public debate arises.

With complicated political structure of the Government, rapid adoption of major reforms could be a way to outmaneuver the opponents of reforms, and the wider public, often not willing to accept reforms. However, adoption of insufficiently planned reforms cannot be justified with high macroeconomic risks and unfavorable political environment. Implementation of such reforms can cause serious damage and compromise the idea of reforms. There are many examples of hasty adoption of insufficiently planned reforms and policies in Serbia, starting from National Investment Plan, over extraordinary increase in pensions at the beginning of the crisis, judicial reform, to fiscal decentralization. To avoid this, all reforms affecting long-term economic development should be open to an in-depth expert and public discussion, and consulted on with the IMF, World Bank and EU.

Accordingly, a line should be drawn between the policy and reforms intended to slow down recession and prevent public debt crisis, which therefore must be adopted urgently, and the policies and reforms that affect long-term economic development and therefore should be carefully planned rather than rapid. The first refers to anti-recession measures designed to enhance liquidity, stop the rise in bad loans and provide for reduction in fiscal deficit. The second refers to pension or tax reform, public administration reform, reforms in education and healthcare system, measures intended to tighten financial discipline etc. Selective approach to reforms is possible, meaning that the reforms that have already been carefully planned reforms (pension system reforms, strategies for enterprises undergoing restructuring, Labor Law reform, issuance of construction permits) would be implemented in the short-term, and insufficiently planned reforms (reform in public administration, tax reform, social security reform etc.) would be postponed.

As written in the previous issues of QM, effects of anti-recession measures in Serbia are modest due to low fiscal multipliers and inefficient monetary policy under a dual-currency system. However, this does not imply that anti-recession measures should be abandoned altogether, and that the state should take no measures against the drop in credit activity, liquidity weakening and fall in economic activity in most sectors of economy.

1 Foreign exchange gains are especially big in public enterprises, which, as a rule, have large foreign currency loans.

On the contrary, the Government should take measures against the negative trends in Serbian economy rapidly, by as early as the end of the year.

Extension of the program of state-subsidized loans has proved effective, because credit activity increased considerably through small government subsidies (subsidies worth several billion dinars brought in an increase in credit activity of several hundred billion euros), and increased credit activity leads to increase in economic activity with a certain lag. Funds for state-subsidized loans would be provided through reallocation of the budget expenditures, so the total amount of expenditures would remain unchanged. Another way to enhance liquidity of Serbian economy is to encourage small and medium-sized enterprises take loans at international financial organizations. Both measures are intended to reduce the drop in credit ability which pushes most sectors of economy in deeper recession.

Increase in government investments, which reached its lowest level of only 1.8% of GDP in the first seven months, could act as a stimulus to economic activity. Since the loans for the construction of the corridor 10 and 11 and many other projects have been arranged, there is no practical reason for the slowdown in government investments. Inefficient management of large infrastructure projects has been the major obstacle to increase in government investment. Additionally, if the government settled its outstanding debt to companies, some anti-recession effects would be achieved, but on the other hand, it would reveal that the actual fiscal deficit assessed on the basis of cash flows is higher than the official data shows.

Adoption of a credible 2014 Budget, with fiscal deficit projected at 2-2.5% of GDP below this year's, is another problem that requires speedy solution. Next year's deficit is targeted at 4% of GDP, which is acceptable only if the projection was based on international methodology, which recognizes all expenses as budget expenditures. If the projection was based on domestic methodology, which does not recognize some expenses as budget expenditures, the targeted reduction is insufficient.

The measures that have been adopted so far and the measures that (probably) have been agreed on in the Government provide for a half of the necessary reduction in fiscal deficit. This year the Fiscal Council proposed introduction of solidarity tax, as a means of indirect reduction in public sector wages and pensions that are above the average, that would provide for a large portion of the necessary savings. However, the Government, before the reconstruction, flatly rejected this proposal without offering any alternative plan for fiscal deficit reduction. The reconstructed Government must therefore come up with an alternative plan or accept the Fiscal Council's proposal. Because the 2013 Budget fell short of projections, the next year's Budget plans should be as realistic as possible, otherwise Serbian budget plans will not be taken seriously in the future. Accordingly, over-optimistic expectations about savings through implementation of the Law on Public Procurement or reduction in shadow economy should be pointed out. Best practice used in developed countries (Germany, Great Britain etc.) shows that the government should establish an institutional framework for macroeconomic forecasting (on which budget projections are based) - this year's budget revenues fell short of the plan partly due to deviation of some economic variables from the values on which the projections were based. One of the possible solutions could be mandatory harmonization of macroeconomic forecasts issued by relevant government bodies (the Ministry of Finance, Fiscal Council and National Bank of Serbia), on which Ministry of Finance's projections would be based.

Alongside with short-term measures intended to slow down recession and prevent the bankruptcy of many companies and the state, a package of reforms aimed at establishing an efficient system of market economy and improving public sector efficiency is needed. One of the key economic reforms is financial discipline tightening, meaning that all market participants must meet their liabilities within the legal and contractual terms. This is closely related to other reforms such as abolition of legal protection of companies undergoing restructuring, enhancing efficiency of bankruptcy proceedings, abolition of extensive social welfare function of public companies and public utility companies, harmonization of state aid policy with EU standards, intended to prevent some companies get preferential treatment (the case of Simpo). Tax discipline is a part of a wider financial discipline and cannot be enforced unless payment discipline among private entities is strong.

Other economic reforms necessary for enhancing business environment and investment climate are liberalization of labor regulations, regulatory guillotine, shorter construction permit issuance period etc. Most of these reforms have been discussed over years, some have been formally adopted, but the process of their implementation is very slow. Reasons behind this are many, from lack of political consensus in the ruling coalition (labor market reform), to obstruction on reforms by interest groups and bureaucracy (regulatory guillotine, building permits etc.). Implementation of these reforms is neither administratively complex nor expensive, but it would lead to loss of different rents, and the ratings of political parties that build their position on providing short-term employee benefits could fall.

Expensive loans and limited availability of loans to companies are among the greatest problems Serbian economy is faced with. By this criterion, Serbia is among the countries at the bottom of the world rankings. Reduction in interest rates on loans requires reduction in business risks in Serbia, but also dissolution of insolvent companies. Reduction in interest rates on loans requires reduction in reserve requirement ratio, which will be possible only under more relaxed monetary policy. Terms of financing in the sector of small enterprises and entrepreneurs are especially unfavorable. Legal framework for setting up micro-finance organizations, through which financial sources would be more easily available to small enterprises and entrepreneurs, should therefore be established. Small enterprises and entrepreneurs, lacking access to bank loans, would thus be able to borrow under more favorable conditions.

Serbian business environment could be improved through tax reform aimed at creating more favorable employment and investment climate. If tax burden on labor was lightened and tax burden on consumption (VAT) increased, employment rate would go up and international competitiveness of Serbian economy would improve. Tax reform through which tax burden on labor would be shifted onto capital would produce negative effects on investments, and the goal behind the reduction in labor tax is to attract investments and thus stimulate economic growth and rise in employment. Many empirical studies show that high capital taxes have severe impact on economic growth. High capital taxes lead to lower investments, and consequently to slower long-term growth, and this effect becomes more detectible with increase in international mobility of capital.

High property taxes are desirable from the aspect of economic growth, but they are difficult to collect, especially in Serbia with large portion of unused or inefficiently used property (agricultural land). Similarly, taxation on residential property is limited due to a weak correlation between the owner's income and the value of the property. Property taxes can to a certain extant direct taxpayers adjust the value and the structure of their property to their current income, but must not lead to massive confiscations. High taxation on property of legal entities are not desirable from the aspect of international competitiveness because they are built-in in the price of exported goods – high taxation on agricultural land would increase the price of agricultural products, so if a part of tax burden was shifted from labor onto property, fiscal devaluation would not be achieved.

If the aim behind high taxation on capital and non-labor income is to increase tax burden on the rich, there is no guarantee that this would be achieved. It is quite unlikely that the whole burden of high taxation on capital and property would fall on the owners. The owners would more probably try to shift a part of the burden onto employees and consumers by changing wage policy and prices of their products, in which case distributive goals behind the increase in tax on capital would not be achieved. However, if the owners failed to do that, they would transfer abroad at least a part of their business operations. Similarly, owners of commercial property would probably increase rents and thus in the long run shift a part of tax burden onto tenants – usually citizens or entrepreneurs with lower income.

Tax reforms should therefore be carefully planned, rather than rapid. Carefully planned tax reform should be at least revenue neutral, and under large fiscal deficit a revenue-producing tax reform is desirable. From the aspect of economic growth, heavy tax burden on labor should be shifted onto consumption and to a smaller extant onto property, instead of shifting it from one factor of production (labor) onto another (capital) already carrying tax burden. Predictable and stable business environment is one of the key indicators of an efficient economic system – it is therefore not advisable to sharply increase tax rates. Besides, final result of tax reforms should be a simpler and cheaper tax system. Implementation of a complex tax system, with conditional tax relieves, is expensive and suitable for tax fraud and corruption. Workable tax system must make a good trade-off between efficiency and equity, and in a country trying to speed up its economic growth, advantage should be given to efficiency.

Government must reform public sector to reduce public expenditures, and achieve budget balance in the following few years. Another important goal behind these reforms is more efficient public sector, i.e. delivery of better and more available service. Reforms in public sector should comprise pension system, healthcare system, system of education and public administration (including judicial system). Besides, to improve public sector efficiency, and to establish fair market competition, it is necessary to develop a new government subsidy policy harmonized with EU state aid standards. Reforms in pension system are critical to public finance consolidation in Serbia[1], and the key measures are offered in the studies made by the Fiscal Council, IMF and individual researchers. These reforms should be implemented rapidly, otherwise problems will continue to pile up and soon it will be difficult to handle them. While pension

1 Pension insurance reform which comprises raise in the retirement age, introduction of actuarially fair penalty and similar, is carried out in almost all European countries. Lack of political consensus on pension system reform is one of the key reasons for the public finance crisis in Slovenia. Given the health of Serbian public finance, further delay in pension system reforms would produce more serious effects.

system reforms are aimed at reduction in expenditures, the main goal behind the reforms in healthcare system, education system and public administration is better efficiency. This means that better quality of these services is as important as reduction in expenditures.

It is still unclear to what extant is the government willing to carry out the reforms. Government structure remained almost unchanged after the reconstruction, so it is uncertain whether it will be possible to implement pension system reforms, change the Labor Law, improve efficiency of the bankruptcy proceedings, cut budget expenditures etc. Regarding system of education, it is uncertain whether the primary school network rationalization plan will be implemented, whether accreditation requirements for higher education institutions and programs will be tightened, or whether labor market will be liberalized to increase the quality of doctoral studies. Political parties that blocked these reforms and opposed the arrangement with IMF are still in the Government.

Highlight 2. Financial performance of companies owned by the Republic of Serbia

Milan Glisic

There is no doubt that state-owned enterprises, regardless of whether they are legally organized as public sector companies or joint stock companies, play an important role in the economic life of the Republic of Serbia. Those companies usually carry out activities of common interest, such as production, transmission and distribution of electricity; production and processing of coal; research, production, processing, transportation and distribution of oil and natural and liquid gas; railway, postal and air traffic; telecommunications; utilization, management and protection of the property of the public interest (such as water, roads, minerals, forests, etc.); production, marketing and transportation of arms and military equipment, and so on.[1]Many of these activities have a strategic importance for the development of the Serbian economy. Also, we have to mention the results of some studies indicating that public sector companies hired, on average, 10.7% of total employed workers, engaged even 17.7% of total assets and had 29.3% of the owners' equity in the domestic economy in the period from 2006 to 2011.[2]Despite all the above, a system of regular and comprehensive monitoring and control of their performance is still not established, although we are witnessing the fact that the significant resources, that they use, are being spent irrationally and inefficiently. The most valuable information about the state of public sector companies, their problems, and possible solutions to these problems are contained in the studies of international financial institutions, consulting companies and individual researchers. However, these in-depth and, by nature, one-off analyses cannot be a substitute for regular monitoring of the operations of these companies. The aim of this analysis is to examine the financial position and profitability of the key state-owned enterprises in an integral and comprehensive manner, which could result in useful guidelines for improving their performance in the future, both for their management and policy makers.

Basic financial information on the companies included in the analysis is given in Table 1. These are state-owned companies whose functioning is under the jurisdiction of the Republic. Local public enterprises were not the subjects of this analysis. It should be noted right at the beginning that these ten enterprises in 2012 recorded a cumulative net loss of 69.5 billion RSD. Only four of companies earned profits and two companies lost the entire owners' equity through previous operations and generated losses above their equity.

Without going further into the explanation of individual results we will briefly mention that the basis for assessing the performance of selected public sector companies and other state-owned enterprises were cumulative financial statements obtained by adding up the positions of separate and consolidated financial statements of these companies.[3]These are presented in Tables 2 and 3. For the purpose of assessing liquidity, solvency and profitability of these companies, standard financial analysis techniqueswere used: ratio analysis combined with an analysis of net working capital (NWC) and cash flows.[4]

1 See: Law on Public Companies,"Official Gazette of the Republic of Serbia", no. 119/2012.

2 Malinic, D. "Financial power (weakness) of public sector companies", Proceedings: Accounting regulatory environment: stimulus or restriction for economic growth, 44th Symposium of Accounting and Corporate Finance in modern business environment, Zlatibor, 2013, p. 131-154.

3 Separate and consolidated financial statements of companies included in the analysis were taken from the website of the Serbian Business Registers Agency.

4 For more see: Malinic, D., Milicevic, V., Stevanovic, N. (2012) *Management Accounting*, The Publishing Centre of the Faculty of Economics in Belgrade, p. 83-188, White, GI, Sondhi, AC, Fried, D. (2003) *The Analysis and Use of Financial Statements*, John Wiley & Sons, Inc., P. 110-163.

Table1. Basic financial indicators of analyzed companies owned by the Republic of Serbia, in 2012 (in thousands of RSD)

Company	Financial statements	Total assets 12/31/2012
Elektroprivreda Srbije	Consolidated	1,074,223,552
Putevi Srbije	Separate	462,502,726
Zeleznice Srbije	Consolidated	282,264,431
Telekom Srbija	Consolidated	255,525,154
Srbijagas	Consolidated	135,541,442
Elektromreza Srbije	Consolidated	68,652,536
Srbijasume	Separate	62,137,758
PTT Srbija	Separate	34,214,120
Galenika	Consolidated	21,338,997
JAT Airways	Separate	15,612,800
	Total	**2,412,013,516**

Company	Operating revenues 2012
Elektroprivreda Srbije	190,405,822
Telekom Srbija	119,422,935
Srbijagas	74,396,641
Putevi Srbije	28,714,657
Zeleznice Srbije	27,348,241
PTT Srbija	21,781,921
Elektromreza Srbije	16,096,599
JAT Airways	13,574,085
Srbijasume	6,049,486
Galenika	5,025,443
Total	**502,815,830**

Company	Owners' equity 12/31/2012
Elektroprivreda Srbije	780,953,152
Putevi Srbije	347,387,297
Zeleznice Srbije	210,964,887
Telekom Srbija	136,553,429
Srbijasume	58,760,531
Elektromreza Srbije	46,862,131
PTT Srbija	24,058,356
Srbijagas	2,956,388
Galenika	0
JAT Airways	0
Total	**1,608,496,171**

Company	Net earnings 2012
Telekom Srbija	10,710,275
Elektromreza Srbije	1,489,856
PTT Srbija	1,243,341
Srbijasume	51,326
JAT Airways	(3,680,760)
Galenika	(5,657,471)
Putevi Srbije	(7,851,362)
Elektroprivreda Srbije	(11,747,314)
Zeleznice Srbije	(16,656,917)
Srbijagas	(37,364,724)
Total	**(69,463,750)**

Source: The Serbian Business Registers Agency

Before we move on to the aforementioned assessment of the most important aspects of performance of the observed state-owned enterprises, we will briefly comment on the key positions and trends in the cumulative balance sheet presented in Table 2 and cumulative income statement in Table 3. Based on the data in Table 2 we note that the total assets of all observed companies have increased significantly in the period from the end of 2009 until the end of 2012 (by even 48.79%). This growth was mostly caused by an increase in non-current assets of 52.20%, within which the value of property, plant and equipment rose by 60.97% mainly due to a conducted revaluation. The increase in current assets in the analyzed four-year period was 25.76%, which was largely result of the increase in other receivables of 69.08% and an increase in accounts receivable of 28.73%. On the financing side, equity rose by 52.87% in this period, while the long-term and short-term liabilities increased by 54.20% and 31.70%, respectively. Within equity, the biggest growth was registered by reserves, whose value was more than doubled. Revaluation reserves, which have increased due to the revaluation of property, plant and equipment, accounted for the most of the reserves in recent years. Due to the additional credit borrowing, a long-term and short-term financial liabilities increased by 34.46% and 14%, respectively. We note a significant increase in accounts payable of 40.06%. The data in Table 3 indicate a sales growth of 17.81% in the period from 2009 to 2012, but also a significant increase in operating expenses that caused a decrease in EBITDA and EBIT of 21.71% and 106.55%, respectively. A heavy net loss was observed in three of the four analyzed years and its amount increased 23 times from 2009 to 2012. Deeper investigation of all these trends will be conductedin the following analysis of liquidity, solvency and profitability of key state-owned enterprises.

1. Liquidity analysis

It is very often said that the liquidity crisis seriously shakes domestic economy and that many state-owned enterprises are part of the group of major illiquidity generators. The results of the performed analysis, which are presented in Table 4 and shown in Graph 1, indicate that there is a basis for such an opinion. Certain problems in the paying short-term liabilities and managing liquidity of these companies can be identified on a superficial examination of static liquidity ratio values. The current ratio, which compares the current assets and current liabilities, and a quick ratio, which is the quotient of the sum of accounts receivable, short-term financial investments, cash and cash equivalents, on the one hand and short-term liabilities, on the other hand, take values, in all analyzed years, significantly lower-than desirable for these indicators(2 for the current ratio and 1 for the quick ratio).At the end of 2012 the current ratio of the observed state-owned enterprises had a 64% lower value than 2, while the amount of quick ratio was 48% lower than 1.

The amounts of these indicators at the end of 2012 were far below their values recorded by the private sector companies in the real economy whose shares are constituents

Table 2. Cumulative Balance Sheet (in thousands of RSD)

Elements	12/31/2009	12/31/2010	12/31/2011	12/31/2012
Goodwill	30,528,110	33,587,447	33,827,395	36,717,363
Intangible assets, net	37,680,807	36,010,674	34,028,584	31,939,910
Property, plant and equipment, net	1,264,916,226	1,283,991,915	2,203,412,751	2,036,088,720
Long-term investments	77,749,434	15,283,972	38,429,213	41,393,891
Deferred income tax assets	1,145,917	1,389,348	1,625,772	2,956,381
Total noncurrent assets	**1,412,020,494**	**1,370,263,356**	**2,311,323,715**	**2,149,096,265**
Merchandise	10,356,571	11,641,520	8,517,577	8,454,100
Materials	32,660,625	36,500,501	38,278,305	36,020,444
Work-in-process	1,224,442	1,467,690	1,151,538	942,481
Finished goods	2,451,411	5,611,955	4,940,447	4,148,537
Other	4,642,262	4,741,174	5,105,030	5,380,623
Inventories	*51,335,311*	*59,962,840*	*57,992,897*	*54,946,185*
Accounts receivable, net	65,278,954	79,045,542	80,241,773	84,031,790
Other receivables, net	27,556,204	32,487,187	37,567,190	46,591,147
Short-term investments	24,384,506	35,134,218	38,034,668	23,854,611
Cash and equivalents	32,422,910	27,692,177	30,051,377	35,427,704
Other current assets	8,090,789	10,700,177	9,527,153	18,065,814
Total current assets	**209,068,674**	**245,022,141**	**253,415,058**	**262,917,251**
TOTAL ASSETS	**1,621,089,168**	**1,615,285,497**	**2,564,738,773**	**2,412,013,516**
Losses above owners' equity	**-**	**245,283**	**3,509,711**	**11,110,380**
Share capital	109,956,902	109,956,902	364,107,810	410,091,919
Treasury stock	-	-	-	(16,502,510)
State capital	885,733,370	844,742,626	596,613,204	596,414,991
Other paid-in capital	8,636,406	6,991,998	11,279,384	7,747,026
Reserves	298,851,306	300,837,392	1,129,245,658	928,434,349
Retained earnings (accumulated losses)	(268,917,016)	(294,678,741)	(249,996,131)	(336,818,289)
Accumulated other comprehensive income	(163,202)	(167,712)	(790,020)	(829,963)
Equity attributable to non-controlling interests	18,090,166	19,619,923	19,052,318	19,958,648
Owner's equity	**1,052,187,932**	**987,302,388**	**1,869,512,223**	**1,608,496,171**
Provisions	18,205,609	18,665,121	20,806,777	23,832,613
Long-term debt	225,115,514	269,115,145	226,695,743	302,699,734
Other noncurrent liabilities	17,006,520	14,339,386	10,839,974	11,684,912
Deferred income tax liabilities	30,317,489	29,591,499	94,019,709	109,949,611
Total noncurrent liabilities	**290,645,132**	**331,711,151**	**352,362,203**	**448,166,870**
Short-term debt	101,641,961	110,181,610	134,392,485	115,873,048
Accounts payable	69,037,055	61,177,107	73,665,482	96,695,624
Other current liabilities	107,577,088	125,158,524	138,316,091	153,892,183
Total current liabilities	**278,256,104**	**296,517,241**	**346,374,058**	**366,460,855**
OWNERS' EQUITY AND LIABILITIES	**1,621,089,168**	**1,615,530,780**	**2,568,248,484**	**2,423,123,896**

Source: The Serbian Business Registers Agency

Current ratio observed in a group of state-owned enterprises ranged from 0.02 (PuteviSrbije) to 2.98 (PTT Srbija). Besides PTT Srbija, the level over 2for this ratio was also achieved by Elektromreza Srbije (2.20). The values of the current ratio greater than its cumulative value (0.72), calculated on the basis of cumulative balance sheet, were also recorded by Elektroprivreda Srbije (0.94), Srbijagas (0.82) and Telekom Srbija (0.80). Similar to the aforementioned, the levels of quick ratio above its preferred value were achieved by PTT Srbija (2.73) and Elektromreza Srbije (1.67).The amounts of this ratio greater than its cumulative value also generated Elektroprivreda Srbije (0.72), Telekom Srbija (0.58) and Srbijagas (0.56). The lowest value of quick ratio at the end of 2012 was recorded by Putevi Srbija (0.02).

of the Belgrade Stock Exchange index BELEX 15 (amount of current ratio was 56% lower and the amount of quick ratio 44% lower).[5] The similar conclusions yield the values of cash ratio signalling that at the end of 2012 only 10% of the observed short-term liabilities of state-owned enterprises were covered by cash and cash equivalents, as the most liquid assets. This was again below the coverage that was recorded by the private sector companies, constituents of the BELEX15 index basket. Finally, the defensive interval ratio shows that

5 Private sector companies from the BELEX 15 basket included in this analysis are: Naftna industrija Srbije a.d. Novi Sad, Imlek a.d. Beograd, Energoprojekt holding a.d. Beograd, Sojaprotein a.d. Becej, Galenika Fitofarmacija a.d. Zemun, Metalac a.d. Gornji Milanovac, Jedinstvo a.d. Sevojno, Alfa plam a.d. Vranje, Gosa montaza a.d. Velika Plana, Veterinarski zavod a.d. Subotica and Tigar a.d. Pirot.

Table 3. Cumulative Income Statement (in thousands of RSD)

Elements	2009	2010	2011	2012
Sales, net	371,145,782	411,120,675	437,888,811	437,260,441
Own work capitalized	6,501,203	7,563,457	8,840,832	7,689,484
Changes in inventory of work-in-process and finished goods	(1,039,000)	1,780,122	(838,817)	(410,493)
Other operating revenues	56,694,725	58,850,265	66,506,508	58,276,398
Operating revenues	**433,302,710**	**479,314,519**	**512,397,334**	**502,815,830**
Cost of merchandise sold	45,472,759	67,115,934	74,101,089	73,653,099
Material costs	55,144,161	68,354,303	79,213,189	84,847,607
Labor costs	99,083,406	103,108,984	113,423,180	119,748,904
Other operating expenses	118,999,917	122,456,909	125,635,031	134,848,576
EBITDA	**114,602,467**	**118,278,389**	**120,024,845**	**89,717,644**
Depreciation and amortization	76,783,683	76,677,750	96,156,787	92,195,795
EBIT (Operating earnings)	**37,818,784**	**41,600,639**	**23,868,058**	**(2,478,151)**
Financial revenues	24,343,182	30,268,468	32,753,023	30,255,563
Interest expenses	14,512,103	15,018,043	15,520,227	21,502,583
Other financial expenses	28,375,284	45,171,471	13,222,997	35,365,873
Other revenues	27,619,738	22,651,624	90,706,256	24,600,755
Other expenses	47,473,445	43,898,322	68,112,749	90,547,638
Earnings from continuing operations	**(579,128)**	**(9,567,105)**	**50,471,364**	**(95,037,927)**
Earnings from discontinued operations	(136,260)	(260,660)	(573,982)	(2,258,592)
Earnings before provision for income taxes	**(715,388)**	**(9,827,765)**	**49,897,382**	**(97,296,519)**
Provision for income taxes	947,404	1,206,042	4,713,436	(29,408,094)
Earnings before non-controlling interests	**(1,662,792)**	**(11,033,807)**	**45,183,946**	**(67,888,425)**
Non-controlling interests	1,336,158	1,839,366	1,367,260	1,575,325
Net earnings	**(2,998,950)**	**(12,873,173)**	**43,816,686**	**(69,463,750)**
Foreign currency gains[1]	5,159,168	6,449,334	11,581,226	6,928,822
Foreign currency losses[2]	23,174,252	42,463,692	9,916,381	31,431,726
Net currency gains	**(18,015,084)**	**(36,014,358)**	**1,664,845**	**(24,502,904)**

[1] Element of item: Financial revenues
[2] Element of item: Other financial expenses

Source: The Serbian Business Registers Agency

state-owned enterprises were able to pay cash operating expenses with the existing monetary assets (quickly convertible into cash) at the end of 2012, for about half a year. We have to notice that the values of all static liquidity ratios for analyzed state-owned enterprises were fairly stable in the observed four-year period, which tells us that there were no signs of improvement in their already disturbed liquidity position from the end of 2009 until the end of 2012.

Similar results were obtained from the cash flow analysis. The fact that the cash flow from operating activities (CFO), which essentially determines the liquidity of companies, was positive in all of the observed years and recorded a growing trend, should be interpreted with reserve for at least two reasons. First, although the CFO was positive, some ratios tell us that it was not large enough. Thus, the values of coverage ratio of short-term liabilities with CFO, which compares CFO and average short-term liabilities during the year, were twice as lover than the desirable valueof this indicator from the standpoint of preserving the liquidity of 0.40. The ratio of CFO to average short-term financial liabilities shows that in 2012 state-owned enterprises on average needed two years to repay short-term loans and other short-term interest-bearing debt with the excess cash generated by operating activities.

The highest value of CFO to average short-term liabilities ratio in 2012 was achieved by Telekom Srbija (0.62) and the lowest by Galenika (-0.43). Besides Telekom Srbija, the level of this indicator above the desired value of 0.40 was generated by Elektromreza Srbije (0.42), while the ratio values above cumulative value of 0.17 were also recorded by PTT Srbija (0.35) and Elektroprivreda Srbije (0.25).

Also, the relationship between the CFO and the average amount of total capital of public sector companies and other state-owned enterprises in 2012 was much worse than that achieved by private sector firms, members of the BELEX 15 index basket, which, among other things, indicates an inefficient use of this capital in the public sector. Finally, except in 2011 the CFO was not sufficient to cover capital expenditures. This has forced the state-owned enterprises to further increase their debt and thus expose themselves to both long-term and short-term financial risks, which will be thoroughly discussed later in the analysis of solvency.

Another reason for a caution in the interpretation of the growing trend of CFO lies in the fact that this growth was not the result of increasing business profitability or faster collection of receivables in the analyzed companies. In fact, it emerged as a consequence of the significant slowdown in payments of accounts payable and

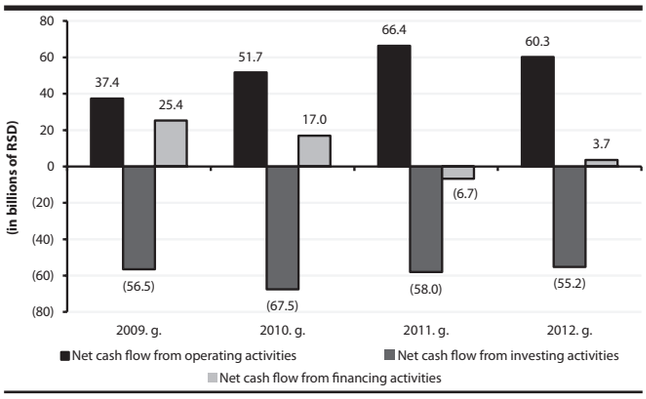
Table 4. Liquidity ratios of theobserved state-owned companies

Ratios	State-owned companies				BELEX 15[1]
	2009	2010	2011	2012	2012
Static liquidity analysis					
Current ratio	0.75	0.83	0.73	0.72	1.63
Quick ratio	0.54	0.59	0.54	0.52	0.93
Cash ratio	0.12	0.09	0.09	0.10	0.17
Defensive interval (days)	171	177	173	168	146
Cash flow analysis					
CFO[2] / Average current liabilities	n/a	0.18	0.21	0.17	0.46
CFO[2] / Average short-term debt	n/a	0.49	0.54	0.48	1.85
CFO[2] / Average value of total capital[3]	n/a	3.77%	3.69%	2.84%	19.15%
CFO[2] / Capital expenditures	0.65	0.75	1.08	0.85	0.86
Analysis of operating cycle and cash conversion cycle					
Days of inventory on hand	n/a	43	42	41	64
Days of sales outstanding	n/a	56	58	60	57
Operating cycle (days)	**n/a**	**99**	**100**	**101**	**122**
Days of payable outstanding	n/a	169	162	199	82
Cash conversion cycle (days)	**n/a**	**(70)**	**(62)**	**(98)**	**40**

[1] BELEX 15 excluding financial institutions and Aerodrom Nikola Tesla which is majority owned by the state
[2] Net cash flow from operating activities
[3] Total capital is the sum of owners' equity and debt (long-term and short-term debt)

other current liabilities, which cannot be characterized as positive trend, since this tendency is not financially sustainable in the long term and at the same time creates liquidity problems in the economy. This is clearly indicated by the cumulative financial statements shown in Table 2 and Table 3, as well as by the analysis of the operating cycle and cash conversion cycle in Table 4. The operating cycle of the observed state-owned companies, which represents the average time that elapses from the moment of purchase of materials from suppliers, through the production and sales of products, to the moment of collection of receivables from the buyers, was fairly stable in the period from 2010 to 2012 and slightly fluctuated around the level of 100 days. On the other hand, in the same period, the number of days of accounts payable was significantly longer and increased from 169 days in 2010 to 199 days in 2012. As a consequence a negative cash conversion cycle emerged indicating that the analyzed public sector companies and other state-owned enterprises did not rely on short-term debt in financing the operating cycle. In fact, the entire burden of financing the operating cycle was shifted onto suppliers. They were paid irregularly and because of that they were not able to regularly pay liabilities to their own suppliers, thereby laying the foundations for the chain expansion of the liquidity crisis in the economy.[6]

Graph 1. Cash flows of the observed state-owned companies



Souce: Author. Based on the data from Business Registers Agency

2. Solvency analysis

Liquidity crisis can be an introduction to a solvency crisis, especially in the case in which the liquidity problems are present for a long period of time.[7]Solvency indicators are set out in Table 5. We can already notice some signs signalling this crisis as well, whereby under no circumstances we should allow ourselves to be deceived by a superficial overview of the structure of the total capital and funding sources of the analyzed state-owned companies. Namely, although all debt ratios in Table 5 (total liabilities / equity, debt / equity, debt / total capital, debt / total assets and financial leverage[8]) clearly show that owner's equity dominates the total capital and funding sources of the observed companies,

6 See more: Malinic, D. "Financial power (weakness) of public sector companies", Proceedings: Accounting regulatory environment: stimulus or restriction for economic growth, 44th Symposium of Accounting and Corporate Finance in modern business environment, Zlatibor, 2013, p. 131-154.

7 Same.

8 Financial leverage ratio is the ratio of average assets to average owners' equity.

this information should be considered with caution in the evaluation of long-term financial stability of these company for at least two reasons. First, most of the assets of these companies are fixed assets (see the cumulative balance sheet in Table 2).Their share in total assets was as much as 94.74% at the end of 2012. It is well known that fixed assets present the most risky part of the company's assets, and hence, from the standpoint of preserving solvency, it is desirable that they are completely funded by the capital of highest quality, which is the owners' equity.[9]Despite the high values of equity of the analyzed state-owned companies, this requirement was not met, which is indicated by the values of fixed assets coverage ratio that were lower than 1, and negative values of own net working capital (ONWC) in all observed years (see indicators ONWC/ current assets and ONWC / inventories).[10]The solvency position of these companies was especially jeopardised by the fact that a portion of their fixed assets was financed by short-term liabilities indicating the maturity mismatch of assets and funding sources. This conclusion is derived from the negative net working capital values (NWC)[11] in the period from 2009 to 2012 (see the indicators NWC / current assets and NWC / inventories).

In the group of observed state-owned enterprises the highest value of NWC to inventory ratio, at the end of 2012, was recorded by PTT Srbija (13.14). This figure shows that the company had positive NWC, which was about 13 times higher than the value of the inventory, indicating the existence of a good matching between the asset structure and the structure of funding sources, and consequently the good preconditions for maintaining a liquidity and solvency. High value of NWC to inventory ratio at the end of 2012 also generated Elektromreza Srbije (9.79). In other observed state-owned enterprises the value of this indicator was negative.The amounts above the cumulative value of the ratio (-1.88) also recorded Elektroprivreda Srbije (-0.27), Srbijagas (-1.11), Galenika (-1.11), Srbijasume (-1.70) and Telekom Srbija (-1.76). The lowest value of NWC to inventory ratio at the end of 2012 was achieved by Putevi Srbije (-184.38).

Contrary to the previously stated, it is evident that private sector companies, constituents of the BELEX 15 index basket, funded total fixed assets, total inventory and part of the receivables by the long-term financing sources at the end of 2012. The second reason why we should not give special importance to the high values of equity in the solvency assessment of the observed state-owned companies is the significant level of revaluation reserves that increased the value of equity, although there was no actual cash inflow of owners' capital into these companies in the previous period. Namely, in 2011, Elektroprivreda Srbije, Putevi Srbije and Zeleznice Srbije conducted a comprehensive revaluation of their property, plant and equipment and as a result of that noticeably raised the value of revaluation reserves and equity in their books. This led to a significant increase in the share of equity in the financing sources of state-owned companies included in the analysis, and consequently to a substantial reduction of the value of all debt ratios. Having all said in mind, it is clear why the decline in the values of debt ratios of the analyzed companies in the four year period, from the end of 2009 to the end of 2012, shouldn't be interpreted as a sign of their indebtedness reduction. In fact, during this period indebtedness increased, since the financial and total liabilities of these companies increased, which is clearly indicated by the figures in the cumulative balance sheet in Table 2.

What caused aforementioned increase in financial and total liabilities of the observed companies? The contours of the answer to this question have already been drawn in the previously performed liquidity analysis. It showed that increase in financial liabilities was not caused by the need to finance the operating cycle. In fact, this need has caused the growth of operating liabilities, specifically accounts payable. Debt was primarily used to finance capital expenditures. We have already indicated that in the previous period the CFO was not sufficient to cover the capital expenditures. If we also consider the fact that in this period the paid-in capital was not significantly changed, which can be clearly seen from the cumulative balance sheet in Table 2, we quickly come to the conclusion that the missing funds to finance the investments into intangible assets and property, plant and equipment were provided from the debt sources.[12] Understandably, this has increased the exposure of state-owned enterprises to both the short-term and long-term financial risks.

Additional reasons for the concern regarding the ability of the observed companies to smoothly pay their long-term obligations, without the help of state, are found

9 The financial accounting theory states that total assets of a company are convertible into cash.Some assets need lesstime for this conversion, and some need more time. Of course, as the time required for the cash conversion of assets increases, the uncertainty whether such a conversion will fullyoccur also increases, and assets are seen as riskier. Since fixed assets need more than one year for conversion into cash, they are considered riskier than the current assets whose period of cash conversion lasts less than one year. Hence, it is desirable to finance the fixed assets by the corporate capital of highest quality, which is the equity, due to the fact that it matures at the time of company liquidation.
10 Fixed assets coverage ratio is the ratio of equity to fixed assets, while own net working capital represents the difference between equity and fixed assets.
11 Net working capital is the difference between long term funding sources (sum of equity and long term liabilities) and fixed assets.
12 Paid-in capital consists of share capital, state capital and other paid-in capital in the cumulative balance sheet in Table 2.

Table 5. Solvency ratios of the observed state-owned companies

Ratios	State-owned companies				BELEX 15[1]
	2009	2010	2011	2012	2012
Equity / Noncurrent assets	0.75	0.72	0.81	0.74	0.82
ONWC[2] / Current assets	(1.72)	(1.56)	(1.76)	(2.10)	(0.24)
ONWC[2] / Invetories	(7.01)	(6.39)	(7.68)	(10.04)	(0.66)
NWC[3] / Current assets	(0.33)	(0.21)	(0.37)	(0.39)	0.39
NWC[3] / Invetories	(1.35)	(0.86)	(1.60)	(1.88)	1.07
Liabilities / Owners' equity	0.54	0.64	0.37	0.51	1.14
Debt[4] / Owners' equity	0.31	0.38	0.19	0.26	0.37
Debt[4] / Total capital[5]	0.24	0.28	0.16	0.21	0.27
Debt[4] / Assets	0.20	0.23	0.14	0.17	0.17
Financial leverage	n/a	1.59	1.47	1.44	2.23
Interest coverage	2.61	2.77	1.54	(0.12)	19.54
CFO[6] / Average liabilities	n/a	0.09	0.10	0.08	0.22
CFO[6] / Average debt[4]	n/a	0.15	0.18	0.15	0.69
Average debt[4] / CFO[6] (years)	n/a	6.83	5.58	6.47	1.44
Debt[4] / EBITDA (years)	2.85	3.21	3.01	4.67	0.86

[1] BELEX 15 excluding financial institutions and Aerodrom Nikola Tesla which is majority owned by the state
[2] Own net working capital
[3] Net working capital
[4] Debt is the sum of long-term and short-term debt
[5] Total capital is the sum of owners' equity and debt (long-term and short-term debt)
[6] Net cash flow from operating activities

in low values of CFO to average liabilities ratio in the previous period. In 2012, the value of this indicator was only 0.08, which was significantly lower than its desired value from the standpoint of preserving the long-term financial stability of the company in the amount of 0.20 and also significantly lower than its value for private sector companies, members of the BELEX 15 index basket, of 0.22. We should also add, not so encouraging, information that the state-owned enterprises in 2012 needed about 6.5 years to pay all their debts from internally generated cash, as indicated by CFO to average financial liabilities ratio and its reciprocal value. The values of these indicators for private sector companies, constituents of the BELEX 15 index basket, in 2012 were more favourable. Finally, at the end of 2012 debt of public sector companies and other state-owned enterprises was 4.67 times higher than the EBITDA, an approximation of the CFO, which was above the desirable range of values for this indictor (from 0 to 4).[13]

Previous remarks on jeopardised solvency position of state-owned companies are reinforced by low values of interest coverage ratio and declining profitability of these companies in the observed four-year period.[14]Interest coverage ratio, expressed as a ratio of earnings before interest and taxes (EBIT) to interest expenses, recorded significantly lower values than those desirable, which are in the range between 5 and 7, during the covered period. In 2012, the value of this ratio wasnegative,becausethe analysed state-owned companies generated cumulative operating loss in the amount of almost 2.5 billion RSD.

In 2012, in the group of analyzed state-owned companies interest coverage ratio ranged from -8.46 (JAT Airways) to 5.90 (PTT Srbija). Besides PTT Srbija, an acceptable value of this ratio was achieved also by Elektromreza Srbije (5.12). Values of interest coverage ratio greater than its cumulative value (-0.12) were recorded also by Srbijasume (0.62) and Putevi Srbije (0.28).

At the same time, operating earnings of private sector companies, members of the BELEX 15 index basket,were 19.54 times higher than their interest expenses. Reductionof the interest coverage ratio in the period from 2009 to 2012was the result of two very unfavourable trendsregarding a long-term financial stability of the observed companies: the increase in theinterest expensesas a consequence of growing debts of these companies and the decline in their profitability. Acrisis of profitabilityofstate-owned enterprises will bediscussed in more detailin the following section.

13 Acceptable values of this indicator were recorded by Srbijasume (0.61), Telekom Srbija (1.63), Elektroprivreda Srbije (2.34), PTT Srbija (2.51) and Elektomreze Srbije (3.12).
14 According to modern concepts of solvency, profitability is its primary determinant.

3. Profitability analysis

Profitability is not the only measure of a success of public sector companies and their managers. However, it is also known that the accumulation of losses over an extended period is financially unsustainable and leads to huge distortions of the total capital structure, which seriously impedes the ability of companies to sustain their liquidity and solvency. Bearing in mind the size and importance of the state-owned companies and their business connections with other entities in the economy, it is clear what implications such a financially irresponsible way of doing business has for the rest of the economy.

Profitability indicators of the analysed state-owned companies are presented in Table 6. Their values signal several alarming occurrences and trends. First, the EBITDA margin, as the ratio of EBITDA to operating revenues,[15] had a downward trend during the observed four-year period, despite the growth of the operating revenues. This indicates that the costs of merchandise sold, material costs, labour costs and other operating expenses in total grew faster than operating revenues during this period. We can see that the EBITDA in 2012 was insufficient to cover the high costs of depreciation and amortization, whose level was dictated by the significant tangible and intangible fixed assets of state-owned companies. As a result negative operating earnings (EBIT) margin was recorded in this year. Our judgment that the EBITDA margin of the observed companies in 2012 was unsatisfactory is also supported by the fact that it was considerably lower than the EBITDA margin of private sector companies (members of the BELEX 15 index basket), although the depreciation and amortization costs of these private entities were significantly lower in the previous period. What are the causes of unsatisfactory level of the EBITDA margin? Inadequate pricing policy of state-owned companies that has elements of social policy is certainly one of them. We must add the problem of insufficient cost control. Costs must be carefully managed. This primarily refers to the individually largest components of operating expenses, as well as to the components that had the fastest growth in the previous period, because within them exists the greatest potential for savings. These are the labour costs, material costs and costs of merchandise sold.

The decline in the EBIT margin caused by the drop in the EBITDA margin and growth of depreciation and amortization costs in 2011, due to the revaluation of property, plant and equipment in somestate-owned companies, is also alarming. Negative value of EBIT margin in 2012 fully reflects the crisis of operating result with which some of the observed companies were faced. Mitigating factors were high quality of operating earnings in the period between 2009 and 2012, as well as the fact that in 2012, despite the operating loss, a net cash inflow from operating activities was recorded, which is indicated by a negative value of quality of (operating) earnings (CFO /EBIT). However, as we already mentioned, this relationship is not financially sustainable in the long term.

The downward trend of net earnings margin is also disturbing and it completes the picture of declining revenue profitability of the analyzed state-owned companies.[16]It is noticeable that the net earnings margin was positive only in 2011 thanks to the significant foreign currency gains and other revenues, which were dominated by the transitory items, such as revenues from valuation adjustments of property, plant and equipment of Elektroprivreda Srbije and revenues from reduction of liabilities of Zeleznica Srbije. In other years massive foreign currency losses and even higher other expenses (much greater than the other revenues) were recorded, which is clearly indicated by the figures in the cumulative income statement in Table 3. As a result negative net earnings margin was generated. The structure of other expenses confirmed again the fact that public sector companies served as a convenient instrument to relevant political structures for pursuing the social policy goals in the previous period. Thus within these expenses a significant part were write-offs of accounts receivable, wages paid to employees in public sector companies on the territory of Kosovo and Metohija and expenses of sponsorships and donations.

A particularly alarming signal, in addition to all aforementioned signals, is the decline in the efficiency of the asset management in the analyzed state-owned companies. This tendency, combined with a decrease in a revenue profitability, contributed to a considerable lowering of the pre-tax return on total capital, after-tax return on assets and after-tax return on equity (attributable to owners of the parent company) in the previous period. All three rates of return ended the year 2012 with negative values. Deeper analysis shows that the deterioration of the efficiency of asset management, indicated by the downtrend of asset turnover ratio, was the result of a decrease in turnover of property, plant and equipment (PPE), as well as a decrease in working capital turnover. The reduction of the level of PPE turnover in 2011 compared to 2010 was partly caused by

15 More precisely, we refer to the amount of operating revenues excluding the changes in inventory of work-in-process and finished goods.

16 The net earnings margin reflects the profitability of revenues solely from the perspective of the owners of the parent company and is calculated by dividing net earnings and operating revenues excluding changes in inventory of work-in-process and finished goods.

Table 6. Profitability ratios of the observed state-owned companies

Ratios		State-owned companies				BELEX 15[1]
		2009	2010	2011	2012	2012
EBITDA margin		26.39%	24.77%	23.39%	17.83%	24.70%
EBIT margin	(Operating earnings margin)	8.71%	8.71%	4.65%	-0.49%	21.73%
Net cash flow from operating activities / EBIT		0.99	1.24	2.78	(24.31)	0.61
Earnings attributable to equity and debt holders margin		7.38%	1.22%	11.54%	-10.51%	16.41%
Net earnings margin		-0.69%	-2.70%	8.54%	-13.80%	15.25%
$ROTC_{pre\text{-}tax}$	(Pre-tax return on total capital[2])	n/a	3.03%	1.33%	-0.12%	31.62%
$ROA_{after\text{-}tax}$	(After-tax return on assets)	n/a	0.36%	2.83%	-2.13%	14.81%
$ROE1_{after\text{-}tax}$	(After-tax return on equity attributable to owners of parent)	n/a	-1.29%	3.11%	-4.06%	32.07%
DU PONT analysis	Net earnings margin	n/a	-2.70%	8.54%	-13.80%	15.25%
	Asset turnover	n/a	0.30	0.25	0.20	0.90
	Property, plant and equipment turnover	n/a	0.37	0.29	0.24	1.80
	Working capital turnover	n/a	2.10	2.06	1.95	2.09
	Financial leverage	n/a	1.59	1.47	1.44	2.23
	Average equity / Average equity attributable to owners of parent	n/a	1.02	1.01	1.01	1.05

[1] BELEX 15 excluding financial institutions and Aerodrom Nikola Tesla which is majority owned by the state
[2] Total capital is the sum of owners' equity and debt (long-term and short-term debt)

the performed revaluations of PPE, which were already discussed in the previous paragraphs. This fact has to be taken into account as a mitigating factor. However, it does not change our conclusion that the efficiency of employing these assets in state-owned companies was extremely low in the previous period, as evidenced by four and a half times lower value of PPE turnover in 2012 for state-owned companies than for private sector companies, constituents of the BELEX 15 index basket.[17]Decline in the working capital turnover ratio, on the other hand, was primarily caused by the decrease in the tempo of collection of accounts receivables, which is implied by a gradual increase in the number of days of sales outstanding in Table 4, in the liquidity analysis. All of this clearly indicates the need for professionalization of the management of public sector companies and other state-owned enterprises and rightly raises the question of appropriateness of criteria used for electing managers and recruiting staff in these firms.

In 2012, the after-tax return on assets of observed state-owned companies recorded values in the range between -22.35% (Srbijagas) and 23.98% (PTT Srbija). In addition to PTT Srbija, positive values of this indicator were generated by Telekom Srbija (6.61%), Elektromreza Srbije (2.73%) and Srbijasume (0.13%). Negative values of this ratio, which were, however, greater than its cumulative value (-2.13%), have been achieved by Elektroprivreda Srbije (-0.92%) and Putevi Srbije (-1.31%).Significant losses of assets, and therefore extremely negative values of this indicator, in addition to Srbijagas, were recorded by JAT Airways (-20.59%), Galenika (-19.41%) and Zeleznice Srbije (-5.32%). On the other hand, the highest value of the after-tax return on equity (attributable to owners of the parent company) in the group of observed state-owned companies was achieved by PTT Srbija (35.08%) and the lowest value by Galenika (-506.95%). In addition to PTT Srbija, positive values of this indicator achieved Telekom Srbija (8.28%), Elektromreza Srbije (3.16%) and Srbijasume (0.09%).Negative values of this rate generated Elektroprivreda Srbije (-1.31%), Putevi Srbije (-2.32%), Zeleznice Srbije (-8.11%), and especially Galenika, Srbijagas (-229.93%) and JAT Airways (indicator was not defined because of the zero value of the average equity in 2012), which recorded a loss above equity. Distribution of the values of the pre-tax return on total capital in 2012 closely corresponded to the presented distributions of the after-tax return on assets and the after-tax return on equity.

Presented stances are best illustrated using Du Pont analysis of the after-tax return on equity, which undoubtedly implies that the decline in the value of this rate in the previous period was the result of a decrease in net earnings margin, a slowdown in turnover and a slight lowering of financial leverage.[18] Net earnings margin and turnover have been thoroughly examined in the previous paragraphs, so we will take a closer look at the financial leverage now. Mentioned lowering of

17 Stated conclusion remains valid despite the fact that the observed state-owned companies operate in capital-intensive industries. This factnaturally lowers the value of PPE turnover ratio. However, supporting evidence for our judgment provides the value of PPE turnover ratio of Naftna industrija Srbije (NIS) in 2012, which was 6.8 times greater than the value of the same indicatorforthe analyzed state-owned companies and amounted to 1.61. We must note that NIS also operates ina capital intensive industry and until recently it was in state hands.

18 There are different versions of the Du Pont analysis of profitability in the literature. However, the most common one defines the return on equity (ROE) as the product of three components: net earnings margin, asset turnover and financial leverage. This idea forms the basis for the Du Pont analysis presented in Table 6, except in it, the forth component was also taken into account: the ratio of the average equity attributable to all owners and average equity attributable to owners of the parent company. This component was included in the analysis due to a specificity of definition of the after-tax return on equity (attributable to owners of the parent company), according to which this rate is defined as the ratio of net earnings to average equity attributable to owners of the parent company.

Table 7. Financial leverage effect analysis in the observed stare-owned companies

Ratios	State-owned companies				BELEX 15[1]
	2009	2010	2011	2012	2012
$ROTC_{after\text{-}tax}$ (After-tax return on total capital[2])	n/a	0.42%	3.30%	-2.49%	23.87%
- After-tax cost of debt	n/a	4.78%	3.80%	3.85%	5.59%
equals	**n/a**	**-4.35%**	**-0.50%**	**-6.34%**	**18.29%**
x Average debt[3] / Average equity	n/a	0.35	0.26	0.23	0.38
equals	**n/a**	**-1.51%**	**-0.13%**	**-1.43%**	**6.97%**
+ $ROTC_{after\text{-}tax}$ (After-tax return on total capital[2])	n/a	0.42%	3.30%	-2.49%	23.87%
equals	**n/a**	**-1.08%**	**3.17%**	**-3.92%**	**30.84%**
$ROE2_{after\text{-}tax}$ (After-tax return on equity attributable to all owners)	n/a	-1.08%	3.17%	-3.92%	30.84%
Effect of financial leverage	**n/a**	**Negative**	**Negative**	**Negative**	**Positive**

[1] BELEX 15 excluding financial institutions and Aerodrom Nikola Tesla which is majority owned by the state
[2] Total capital is the sum of owners' equity and debt (long-term and short-term debt)
[3] Debt is the sum of long-term and short-term debt

financial leverage ratio for the covered companies, however, should not be interpreted as a sign of decrease in their financial risk exposure, as we already indicated in the solvency analysis. The analysis of the financial leverage effect shown in Table 7 also confirms this finding.

The negative effect of financial leverage, which has been recorded by state-owned companies in 2010, 2011 and 2012, complements our earlier impressions of seriously violated profitability and solvency position of these companies.[19]Rates of return earned on invested capital, obtained from debt sources, were not high enough to cover the costs of that capital in the analyzed period. This conclusion is derived from the difference between the after-tax return on total capital and the after-tax interest expense.[20]Specifically, the after-tax return on total capital was lower than the after-tax interest expense in all observed years (e.g. in 2012: -2.49% < 3.85%), which had a negative impact on the after-tax return on equity (attributable to all owners), lowering the return on equity below the level of the return on total capital (e.g. in 2012: -3.92% <-2.49%).[21]Completely opposite relations between these two rates and the positive effect of financial leverage were recorded in 2012 by private sector companies, members of the BELEX 15 index basket. These companies profitably invested the capital acquired by lending and as a result they managed to raise the profitability of equity above the profitability of total capital (30.84% > 23.87%).

Conclusion

The main conclusions of our analysis are the following. The financial position and performance of the most important public sector firms and other state-owned companies are seriously wounded, and these companies, collectively speaking, are faced with the liquidity crisis, solvency crisis and profitability crisis. Of course, liquidity, solvency and profitability differ from one company to another, but the general assessment is that the overall financial shape of all companies together is weak. Taking into account the aforementioned specific financial position and profitability of individual companies, in the near future, it is necessary to conduct a detailed screening of their operations, so that in each case the appropriate measures to improve performance are determined. However, it is already possible to identify some general measures that would ensure stabilization of the financial position and improvement of profitability of the state-owned companies: the professionalization of management, limitation of the abuse of political influence on the business activities, correction of pricing policy in the cases where this strategy is feasible, tightening control of operating costs (especially labour and material costs), insisting on public procurement, raising the efficiency of collection of receivables, etc. In addition to all of this, it is legitimate to raise one important question: Does the state still needs to be (the only) owner of the companies it currently possess? Many other equally complex questions can be derived from this question. They all require a response from the reconstructed government in the near future.

19 Observed individually, positive effect of financial leverage in 2012 generated only PTT Srbija, Elektromreza Srbije and Telekom Srbija.

20 The after-tax return on total capital is the quotient of the sum of earnings before non-controlling interests and after-tax interest expense, on the one hand, and the average value of the total capital, on the other hand, while the after-tax interest expense is defined as the ratio of after-tax interest expense to average debt. Again, we emphasize that the total capital consists of equity and debt (i.e. short-term and long-term financial obligations).

21 The after-tax return on equity (attributable to all owners) is the quotient of earnings before non-controlling interests and the average equity.

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Highlights 3. Extreme youth unemployment in Serbia and the EU: consequences and possible solutions

Jelena Žarković Rakić

In Serbia, the unemployment rate for young people (aged 15-24) reached 50% two years ago. Since the start of the recession, the deterioration of the circumstances on the labour market for this particular age group has also been noted in EU countries, where one out of five people under the age of 25 is unemployed, the situation being even graver in southern Europe. The graph below shows the European countries in which the situation is particularly worrying.

When economies face difficult periods, such as the current recession, young people are the first to lose their jobs, due to insufficient working experience and skills that are irreplaceable to their employers. So, for an example, in 2008, the youth unemployment rate in EU-27 was twice the unemployment rate for the whole population, as the recession affected the youth more than any other age group. Since early 2009, the gap between the youth unemployment rate and the rate for the whole population has been constantly increasing, reaching the 2,6 ratio by the end of 2012.

Substantial youth unemployment creates significant expenses on both the individual and social level. For the state, this means decreased revenues from income tax, higher budget expenditures for benefits, such as unemployment benefits, but above all, unused labour potential. So, for example, a study[1] in the UK assesses that productivity losses attributed to youth unemployment could be measured in ten million pounds on a daily level.

Studies carried out mostly in developed countries indicate that, on the individual plan, long periods of unemployment have a negative effect on the individual's future income (the so-called "wage scar"). A widely cited study in the UK[2] points out that young people enduring long periods of uneployment at the start of their careers, receive income decreased by 9 - 21% for as long as twenty years. For the USA, Mroz and Savage (2006)[3] find that the effect of decreased income may linger for about ten years. On the other hand, the results of measuring the magnitude of the "scar" in poorer countries vary significantly from case to case. A large-scale study carried out for China, indicates that any effect of unemployment on future income for young people dissapears after merely three years[4]. However, a research conducted for Argentina and Brazil[5] shows that the effect the scar has on young people who have not only been unemployed for a long time, but have worked in the informal economy, lasts up to ten years, and is especially prominent with underqualified individuals.

Apart from being unemployed, a large number of young people is excluded from education and training programmes. It is estimated that there are nearly 8 million

1 McNally,S. and Telha, S.*The Cost of Exclusion: Counting the cost of youth disadvantage in the UK* (2007). Centre for Economic Performance, London School of Economics, Prince's Trust, http://www.princestrust.org.uk/PDF/Princes%20Trust%20Research%20Cost%20of%20Exclusion%20apr07.pdf

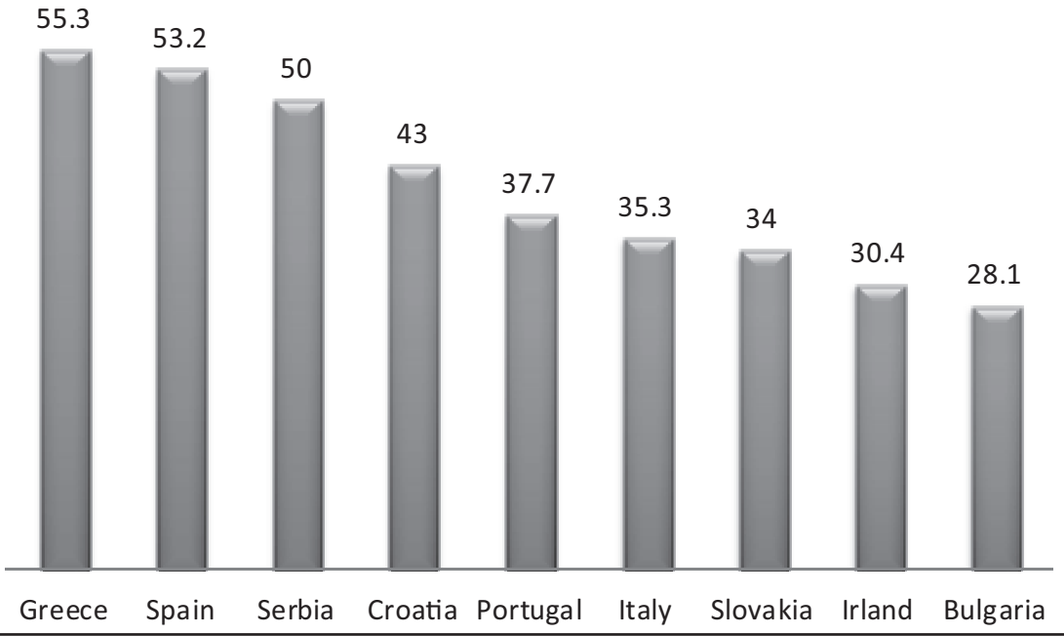
2 Gregg, P. and Tominey, E. (2005) "The wage scar from male youth unemployment". Labour Economics, 12(4), pp. 487-509.

3 Mroz, T.A. and Savage, T.H. (2006). "The long-term effects of youth unemployment". Journal of Human Resources, 41(2), pp. 259-293.

4 Adjusting to Really Big Changes: The Labor Market in China, 1989-2009 Wei Chi, Richard B. Freeman, and Hongbin Li NBER Working Paper No. 17721, January 2012

5 Scarring effects of youth unemployment and informality Evidence from Argentina and Brazil* Guillermo Cruces,
Andrés Ham, Mariana Viollaz, 2012. http://publish.illinois.edu/andresham/files/2012/12/CRUCES-HAM-VIOLLAZ-Scarring-effects-of-youth-unemployment-and-informality.pdf

Graph G3-2. Youth unemployment rate (age group 15-24), 2012



Source: Eurostat

young people in Europe who belong to the so-called NEET (*not in employment, education or training*) category. At the same time, 30% of unemployed people under the age of 25 have been unemployed for more than 12 months.[6] The European Commission has, therefore, recently proposed the introduction of the Youth Employment Package, a program focusing on:

1. Easier school-to-work transition through guarantees for persons under the age of 25, enabling them to obtain new jobs, continue their education or enter internship programs 4 months upon finishing their education or losing their jobs;

2. Improving the quality and range of internship programs and training courses;

3. Providing options for young people to work and develop their skills abroad (through an exchange program similar to Erasmus)

For the Package, the European Union intends to spend 8 billion euros over the next two years, assigning the largest part to the countries most severely affected by the recession, such as the southern economies. In addition to this, the European Investment Bank should help small businesses employ and train young people.

According to the Survey on labour force issued in April 2013, there are almost 200,000 young people in Serbia pertaining to the NEET category (i.e. 25% of the total number of young people aged 15-24). Taking into account the findings regarding the impact of long-term unemployment on the future income of young people, one is very alarmed by the fact that as many as 60% of unemployed people under the age of 25 seek jobs for more than 12 months.

In Serbia, the National Employment Action Plan (NEAP)[7], an instrument for the operationalization of the goals set in the National Employment Strategy 2010-2020, provides a so-called package of services for young people in the current year. The package stipulates that in the first three months following a young person's application to be registered as unemployed, the National Employment Agency shall: 1) assess the person's employability; 2) establish the individual employment plan and set the most suitable measures for activating and enhancing the employability of young people; 3) offer a job or some other active employment policy measure that may assist in employment (counceling, training courses, self-employment subventions, support for the development of youth entrepreneurship and so on).

Content-wise, the youth package of services, as well as the EU youth guarantees, resemble the programs initially introduced in Scandinavian countries (1984 in Sweden, 1993 in Norway and Denmark and, finally, Finland in 1996). Due to the intense debate in European circles over the success of these programs, results of the evaluations of former measures have emerged. So,

6 http://ec.europa.eu/social/main.jsp?catId=1036

7 http://www.minrzs.gov.rs/doc/zaposljavanje/NAPZ%202013.pdf

for example, in the Eurofond's research for Sweden and Finland[8], these programs are evaluated as positive for trying to avoid the aforementioned effect of the scar. However, the research also emphasises the fact that the guarantees are beneficial for work eligible young people who have just entered the labour market, and less beneficial for long-term unemployed individuals. Furthermore, the success of these measures also depends on other public policies (e.g. NEA infrastructure and capacities, university availability, offer of internship programs and trainings). In conditions of high youth unemployment rate, one may tempted to reach for quick solutions that may not necessarily bring about long-term benefits for this population. For example, by way of guarantees, a young person may be offered a job, a position in the education system, or traning with low expenses in a relatively short amount of time, without solving the structural problem of this target group, which is the lack of skills and qualifications. Finally, it is considered that the moment of intervention is crucial, and that the three-month period (available to the National Employment Agencies in Finland and Sweden) is too long, and that the Agencies should be obliged to aid unemployed youths upon entering the unemployment register.

Taking into account the fact that in Serbia, the youth package has only been introduced this year, it is too early to predict its effect. However, when planing the 2014 NEAP (which has not been adopted, most likely due to the Government reconstruction) these and similar evaluations should be taken into account so that the available NEA capacities may be used in the best possible manner in order to reduce the number of unemployed youths.

Apart from specific programs aimed at young people which should be developed and enhanced, it is necessary to work on changes in the education and training systems, in order to reduce the gap between skills offered and sought on the labour market.

Since 2003, the European Union has used various projects to help the reform and modernization of the secondary vocational education system, in order to respond to future needs of the economy, the companies' needs for trained labour force, simultaneously increasing the employability of individuals with the secondary level of education. However, the quality of vocational education in Serbia is still low, as the areas are too specialized and the system generally unpopular among students. This year's cancellation of numerous classes attests to this fact.

In the domain of university education, there has been a small number of graduates in Serbia. This, however, is not due to an insufficient number of enrolled students, but because of the fact that many students quit their studies or study for too long. Undoubtedly, one of the causes of this problem is the fact that the university programs are much more shaped by the supply, rather than the demand for particular knowledge.

As assessed in the latest study on the role of labour market skills in the future economic growth of the Western Balkans[9], in order to solve the structural problems of young people in Serbia – mainly the lack of skills and qualifications – it is necessary to finally initialize the institutional cooperation between education and employment policies. To begin with, it would be sufficient to create a body that would assemble experts in thses two fields, who would then initialize a strategic debate on the reform of the education system. Until then, measures such as youth guarantees can only ease the current situation for young people, but cannot offer a long-term solution to their problems on the labour market.

8 http://www.eurofound.europa.eu/pubdocs/2012/42/en/1/EF1242EN.pdf

9 *Labour Market and Skills in the Western Balkans*, ed. Mihail Arandarenko and Will Bartlett, FREN and LSE Research on South Eastern Europe, 2012.

Highlight 4. Review of some of the proposed measures for recovery in Serbian economy and public finance

Milojko Arsić

Deteriorating health of Serbian economy and public finance encouraged a number of non-standard recovery proposals. In this Highlight we will analyze three such proposals that have been long present in the media, and that we find unsuitable and harmful to Serbian economy and public finance[1]. More precisely, we think that the effects of the proposal to fund economic development through base money creation can be fatal, and that the proposals to clear up the problems in public finance through government pension fund capitalization and state crackdown on shadow economy are unrealistic.

Investment advisor Nebojša Katić brought forward a proposal to employ base money creation as an instrument for solving Serbia's current economic problems and for boosting economic development. Possible implementation of this plan would be fatal to Serbian economy and citizens[2] because it would cause a sharp depreciation in the dinar, and almost immediate rise in inflation, and finally a steep drop in economic activity. Serbia has experienced this scenario several times (within SFRY and FRY), and under the present circumstances it would unfold more quickly.

The main reason why Serbian government cannot stimulate economy through monetary policy[3] is a continuous abuse of base money creation, starting from as early as 1970s up to 2001, with short breaks during the implementation of stabilization programs developed by Ante Marković and Dragoslav Avramović. This abuse resulted in a dual-currency system with about 70% of financial assets in euros, i.e. with dinar inferior to euro. Real demand for Serbian dinar is low, and even a modest increase in supply of dinars (base money creation) would increase demand for foreign currency, instead of increasing credit activity of banks. For this reason the National Bank of Serbia is unable to follow an expansionary monetary policy like other central banks do, even during recession. With low real demand for dinar, the National Bank of Serbia mostly has had no other option but to follow restrictive monetary policy during the ongoing crisis.

We remind that base money creation through loans to government made by central banks is almost abandoned - interest rates are typically used as a monetary policy instrument. In recent period, base money is created through so called quantitative easing, used only when economy is in recession, interest rates are close to zero and inflation is very low. However, only one out of the three conditions is satisfied in Serbia - economy is in recession, but interest rates and inflation are high.

Miladin Kovačević and Mahmut Bušatlija's proposal to make up the pension fund deficit by pension fund capitalization through local property also deserves attention. The deficit pension fund runs is somewhat larger than Serbia's overall fiscal deficit so its elimination would considerably improve the health of the public finance. However, two questions arise. The first one is how much property is needed and what return should it produce to make up the pension fund deficit. Let us assume that the capitalized fund would yield a return equal to the 3% average for Central and Eastern Europe, recorded before the crisis. With this rate of return, the capitalized fund would have to have property worth 67 billion euros on disposal to provide for the funds needed to make up a deficit of 2 billion euros (about 2.4 billion euros in the previous years). The foregoing value of property is several times higher than the total revenues that have been raised through privatization since 2001 (including Mobtel and the banks), and about 30 times as big as the assessed value of Telekom Srbija.

The largest portion of local property is made up of local public goods (streets, parks, sports and recreation facilities and courts etc.), natural monopolies (water supply, sewage, heating etc.) and social institutions (nursery schools). Clearly, none of these categories of property can be used to capitalize the pension fund. Possible pension fund capitalization could therefore be done through use of urban construction land or commercial space. However, this property brings in considerable tax or rental revenues to local governments, so if it was transferred into the pension fund, local government deficits would widen significantly. Consolidated deficit would remain almost unchanged – reduction in pension fund deficit would be proportionate to increase in local government deficit.

Most of the construction land and commercial space owned by local municipalities is to be privatized in the

1 Academic community and politicians mostly ignore these proposals. However, we believe they should be discussed, to avoid the impression that there are easy solutions to difficult problems but that for some reasons they are not being adopted.

2 Mr. Katić's proposals are not in accordance with the Law on the National Bank of Serbia, meaning that for now they cannot be implemented.

3 The National Bank of Serbia cannot even use interest rates, as an anti-recession instrument, in the same way as other central banks do.

future. However, revenues from local property privatization are usually used for funding local infrastructure, already in a very bad state in Serbia. If this property was transferred to the pension fund, local governments would be forced either to borrow or to increase the currently levied, or some other, taxes. In the long run, it comes down to one thing – tax increase. This would not improve Serbia's consolidated balance sheet either, unless the local taxes are increased.

This leads to conclusion that a possible transfer of local property into the government pension fund would fail to provide the funds needed to make up the pension fund deficit. Possible decrease in the pension fund deficit would cause approximately equal increase in the local government deficit. Apart from the foregoing shortcomings, the proposal to capitalize government pension fund through local property suggests that perhaps there is no need for radical reforms in the pension system or that the reforms are of secondary importance, which is completely wrong and leads to more serious problems.

The third debatable proposal is based on the estimation that state crackdown on shadow economy can drastically reduce fiscal deficit – the most ardent advocate of this idea is Milan Knežević, president of the Association of Small and Medium-sized enterprises. Serbia's shadow economy is very large (around 30% of GDP) and the government can certainly collect additional revenues through tackling it. However, a more in-depth analysis shows that in the mid-term public revenues collected through shadow economy curbing can total around 1% of GDP, which is much below Serbia's fiscal deficit (around 6% of GDP). This is based on the estimation that, for example, in a three-year period the size of Serbia's shadow economy, in the best case scenario, could be reduced to the level of the Central European states, from the current 30% to around 25% of GDP. A 5 percentage point reduction in the size of shadow economy would bring in additional public revenues of about 1.5% of GDP, but only under assumption that by stamping out shadow economy the government would not stamp out activities that go with it. However, this is quite unlikely because only some informal activities can be legalized, and the acquisition of the abandoned activities by entrepreneurs and employers operating legally is a gradual process. We therefore believe that in the mid-term additional public revenues collected through shadow economy curbing could total around 1% of GDP, rather than 1.5%. On the other hand, the ideas to eliminate fiscal deficit by halving the size of shadow economy are substantially unrealistic, because it means that the size of shadow economy should be reduced to 15% of GDP, which is much smaller than in most developed European countries or in the USA. Under inefficient institutions and poor tax morale this is estimated impossible.

Undoubtedly, shadow economy should be tackled for the purpose of establishing fair market competition and increasing public revenues. However, from the aspect of public finance, revenue impact of the reduction in the size of shadow economy must not be overestimated. Overestimated revenue impact could lead the government to abandon some austerity measures or even reduce some taxes. Under any of these scenarios, fiscal deficit reduction would slow down and the public debt growth would speed up.

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