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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

Serbian economy produced heterogeneous results in 2013. Preliminary data shows that GDP increased by more than 2%, current account deficit is halved, and inflation reached its all-time minimum. However, the main drivers of the growth in GDP and reduction in the current account deficit are wearing out gradually, so economic growth and rise in exports slowed down in the last quarter of 2013. Besides the foregoing positive results, numerous worrying trends in Serbian economy have been detected. There is a rising illiquidity and insolvency of companies, the share or bad loans is increasing, loans to enterprises are decreasing, a number of small banks have been wound up, and tax arrears of companies are accumulating. The implemented fiscal consolidation measures have not produced the desired results because the effects of savings and tax increase were offset by new expenditures on financial support to enterprises and banks and decline in tax revenues. Low foreign investments and pressures on dinar exchange rate, stability of which has been preserved in the first quarter of 2014 only thanks to the interventions of the NBS, indicate that foreign investors place fragile trust in Serbian economy.

Prospects for Serbian economy in 2014 are quite poor. It is however possible to boost economic activity and employment in the years to come through a determined fiscal consolidation, and reforms in public sector and economic system. It is quiet certain that economic activity in 2014 will stagnate, and a mild recession cannot be ruled out. Real drop in private and public consumption will probably be sharper than it seemed two or three months ago, because additional austerity measures will be needed in the second half of the year. Investments will fall in the first half of 2014, and after the recovery expected in the second half of the year, there will be, at the best, a modest rise in total investments in 2014. Sharp drop in credit activity of banks and financial difficulties in many companies will not only cause a fall in domestic investments but also present a threat to the existing level of production. Foreign direct investments will be modest and, unless a large enterprise is privatized, their level will not exceed the last year's EUR 700 million. Real rise in exports will continue in 2014 but at a much slower rate than in 2013, so it will not be sufficient to make up the decline in other components of demand.

The official data on the employment trends in 2013 published in the October 2013 Labour Force Survey raise serious doubts about its credibility. There is a large deviation of the aggregate data from other macroeconomic indicators, such as GDP, private consumption etc. Employment growth structure is even more questionable – informal employment increased, number of supporting household members doubled over a six-month period, and the number of construction employees grew, although statistical data shows that activity in construction industry fell by 20%!? We think that the data on formal employment trends, although incomplete, reflect the trends in labour market in 2013 more accurately than the Labour Force survey. We expect a moderate fall in employment numbers in 2014 due to public sector rightsizing, and stagnation in private sector employment numbers.

Inflation in 2013 was down to its lowest level in Serbia's recent history, and we expect it to edge up in 2014 – closer to the upper boundary of the targeted interval. There has been a slight depreciation in dinar exchange rate, and it would be stronger if there were not for the NBS's frequent and decisive interventions in the forex market. The total amount of interventions made from the beginning of 2014 to mid March is EUR 820 million, or 2.5% of GDP. There are probably some pre-election motives behind keeping the exchange rate at almost fixed level. The NBS should slow down its interventions and thus allow for a moderate depreciation of dinar exchange rate, which would stimulate reduction in the current account deficit, while its negative effects on foreign currency debtors and inflation would be moderate.

Some segments of Serbia's balance of payments improved considerably in 2013, but some are deteriorating. Current account deficit has been halved, but it still stands at 5% of GDP, which is unsustainable in the long run. Increase in exports should remain one of the major priorities of economic policy in the following period. Trends in the financial account and capital account are adverse. Foreign direct investments are low, private foreign debt is going down, and public foreign borrowing is increasing, mainly for the purpose of current consumption funding.

The newly elected Government will have to get to grips with many problems arising from the decades of unfavourable conditions Serbia has been in, the world economic crisis but also from postponement of reforms and diluted effectiveness of the planned reforms over the last 3-4 years. The Government should therefore attack these problems vigorously, persistently and with a multidimensional approach. Multidimensional approach to problems means simultaneous work on fiscal consolidation, reforms in public sector and economic system and implementation of certain anti-recession measures. Vigorous response means that the Government has to adopt the necessary, often unpopular, measures rather than procrastinate or implement partial solutions. Finally, the Government should persist with the reforms, in spite of resistance or difficulties. We will see if the new Government is willing and able to carry out the necessary reforms already few months after its formation. An important test that will show whether the Government (SNS) is reform-oriented will be their readiness to enter into a binding long-term arrangement with the IMF in the second half of the year.

Although fiscal consolidation will be achieved in 3-4 years, it is necessary to make about EUR 400 million savings already in the second half of 2014. This requires reduction in public sector wages, but also reduction in or taxation on pensions. To achieve fiscal consolidation, laws and binding plans that would guarantee additional savings and more efficient tax collection in the years to come must be adopted already in 2014. This implies pension reform, plan for public sector rightsizing, plans for reduction in the republic and local administration expenditures, plans for education reform, health care reform etc. Certain reductions in fiscal deficit can be made through a more efficient tax collection, meaning that shadow economy should be curbed and that the existing tax arrears should be paid and their further accumulation prevented. Additional tax revenues must not be a substitute for austerity measures but a supplement to them.

Reforms in public sector and economic system are necessary for both a long-term sustainable economic and social development in Serbia and fiscal consolidation. Reforms in public sector should improve the quality of administrative, judicial, educational and other services of government bodies, and to bring in certain savings. Reforms in public and state-owned enterprises mean that these enterprises should be professionalized, that they should not serve social and quasi-fiscal functions, and that the process of privatization and restructuring in former public companies should be finalized. Public companies should not serve social and quasi-fiscal function, meaning that they should charge market price for their service and deliver it only to regular payers, number and structure of employees should be optimized, and buoyant sponsorship deals should be abandoned. These reforms would reduce expenditures on financial support to state-owned companies and thus help achieve fiscal consolidation.

The goal of the reform in economic system is to create a more favourable investment climate and encourage employment. This can be achieved through reduction in costs and risks involved in doing business in Serbia. Improvements in business environment mean financial discipline tightening, deregulation, labour market reform, privatization process finalization, improved competitiveness policy etc. Reforms in economic system would have positive impact on public finance because some subsidies would be abolished, rise in employment and consumption would boost public revenues, and tax collection would be more efficient (reduction in shadow economy and tax arrears).

Tax reform whereby tax burden on employment (primarily contributions) would be eased, and tax burden on consumption increased would encourage investments and employment, and indirectly improve international competitiveness of Serbian economy. However, the tax reform should be postponed until the major problems in Serbian public finance, i.e. large fiscal deficit and growing public debt, are overcome.

This issue of QM, besides the usual analysis, offers three *Highlights*. *Highlight 1* (Arsić) deals with economic policy and reforms waiting for the new Government. *Highlight 2* (Urošević) gives a review on doctoral studies in Serbia and offers suggestions on how to reach the world standard in this segment of education with modest funds. *Highlight 3* (Brčerević, Arsić) deals with certain shortcomings in statistical data and their influence on economic policy.

TRENDS

1. Review

Serbian economy is not in a good shape and its recovery will take a long time. Economic activity is stagnating, which is one of the causes of a low inflation and large reduction of the current deficit. Extremely low investments, domestic and foreign, are probably the best indicator of currently very poor prospects of the local economy. Without new investments, it will be impossible to initiate economic activity, increase employment, and increasingly hard to maintain the dinar exchange rate. The first major challenge of the new Government after the elections will be to implement fiscal consolidation and make an arrangement with IMF. This would be a guarantee of macroeconomic stability and, along with other measures, the first necessary precondition for starting a new investment cycle. However, even if a decisive fiscal consolidation would start immediately after the new Government is formed, as well as the implementation of reforms and changes of most important laws for improving the business environment, the first positive results of such a policy would be seen in mid-2015 at the earliest.

In 2013, the economic activity had a solid growth of 2.4%. However, the truth behind this growth is that agriculture had a growth rate of over 20%, mostly due to the comparison with a dry season of 2012, and the fact that Fiat Automobiles Serbia (FAS) increased its production by two and a half times compared to 2012. But if we were to remove these two factors from GDP realised in 2013, the rest of the economy would have had a decline of around 0.5%. What is even worse, the GDP component that had the biggest decline in real terms of around 10% in 2013 were investments. And investments hold double importance for GDP, because when they are realised they directly increase GDP, but they also create preconditions for future production increase.

In 2014, we expect the economic activity to stagnate, i.e. for the GDP growth rate to be close to 0%. The effects of the increased production of FAS will wear off in 2014, and agriculture will not be able to achieve high growth rates as in 2013. Therefore, the real trend of economic activity will be revealed, which is close to stagnation. The stagnation in 2014 is also confirmed by GDP component analysis. Private and state spending will undoubtedly decline, and investments and net exports will be able to somewhat compensate for this decline, but they won't be able to ensure positive growth rates (see Section 2 "Economic Activity").

The inflation was almost completely stopped and in 2013, from January to end of December, it was only 2.2%. The main reasons for stopping the inflation were low domestic demand, stable dinar exchange rate and drop of prices of agricultural products (see Section 5 "Prices and the Exchange Rate"). Similar trends are continuing in 2014 as well. In the fist two months of 2014, the inflation was 1.5% mainly due to a single increase of administrative prices in January and the increase of lower VAT rate from 8% to 10%. Therefore, market prices are still calm and we expect this trend to continue during 2014. Only in the case of considerable depreciation of dinar in the following months could there be a certain inflation acceleration.

Dinar exchange rate is currently under strong depreciation pressures, and we estimate the NBS policy, that is maintaining at any cost an unchanged value of dinar during 2014, to be expensive and not very useful. From the beginning of the year until mid-March, NBS spent as much as 820 million euros on interbank market interventions. We do not consider the sale of such a large amount of euros for the purposes of defending the dinar value a good economic policy for many reasons: 1) country's forex reserves are being significantly depleted; 2) the flip side of selling large amounts of euros from foreign reserves is the purchase and sterilisation of the relevant amount of dinar, which is a bad policy in conditions of increased insolvency of businesses and low inflation; 3) sale of euros from foreign reserves treats only the consequence, but not the essential cause of weakening of the dinar, and it cannot be justified if the depreciation pressures on dinar are not temporary. The *QM* analysis indicates that aside from temporary there are essential reasons for the weakening of dinar. And 4) a moderate depreciation of dinar would be beneficial and not detrimental to the economic activity, because it would increase its price competitiveness (Graph T2-5). For all these reasons, we believe that NBS should decrease its interventions on the foreign exchange market and allow a certain depreciation of dinar.

Pressure on the dinar exchange rate and (perhaps economically hasty) sale of over 800 million euros of foreign reserves in less than three months, could also be a good indication of how unstable the macroeconomic balance of Serbia was during 2013 and even now. That is, the stable dinar exchange rate during 2013 was realised in an environment of low economic growth, low FDI, huge unemployment, public debt and fiscal deficit. Unless these imbalances and weaknesses of the domestic economy are systematically removed, the negative results could very quickly take over and the current fragile macroeconomic stability could very easily be ruined.

The current deficit in 2013 was around 5% of GDP, which is half of what it was in 2012, when it was 10.1% of GDP. The reasons for such a large reduction of current deficit are: 1) high growth of exports, which is partly due to increased exports of automobiles, and 2) low growth of imports, which was influenced by the reduction of domestic demand (see Section 4 “Balance of Payments and Foreign Trade”). Despite the large reduction compared to the previous year, the current deficit of 5% of GDP is unsustainable in conditions of low foreign direct investments and weak economic growth. Capital account in 2013 managed to stay positive mostly due to state borrowing, and on the other side, the FDI was low and the banks and businesses were deleveraging their foreign debt. Since the state cannot keep borrowing indefinitely, such a capital account structure cannot be a permanent counterweight, not even to this reduced current deficit of around 5% of GDP.

In 2014, we expect a similar structure of balance of payments as it was in 2013. The current deficit will probably continue to drop, but not as much as it did in 2013, because the potentials of the automobile industry have been depleted and there are no new large exporters in sight. The imports will either stagnate or decrease due to the further decline of domestic demand. FDI will remain low, because Serbia with its economic problems is not an attractive destination for investments, and it is also highly unlikely that by the end of the year there will be some large foreign investment that would come out of direct negotiations between the state and investors.

Low employment remains one of the biggest economic issues of Serbia, even though the latest data from the Labour Force Survey (LFS) indicate a strong growth of employment and a reduction of unemployment. However, our analyses indicate that in the macroeconomic environment of Serbia there could not have been a significant increase in employment during 2013 (see Section 3 “Employment and Wages” and Highlight 3). In our view, the latest data from the Labour Force Survey on the one hand sends a wrong signal to the decision makers, while on the other hand they raise doubts about the reliability of statistical data on Serbia’s economy with many investors and analysts following the trends in Serbia’s economy.

The monetary policy during 2013 and the beginning of 2014 was led too carefully, perhaps even to the detriment of businesses. Keeping the reference rate at a level of 9.5%, with the y-o-y inflation rate of around 3%, could reflect an intention by NBS to use the repo rate to mitigate strong depreciation pressures on the foreign exchange market, that have been present since the beginning of 2014. At the same time, problems in the banking sector continue to grow. Since the last issue of *QM,* two banks had their licenses revoked – Belgrade Commercial Bank (Privredna banka Beograd) and Universal Bank (Univerzal banka). The high drop of around 10% y-o-y in the real value of loans approved to the business sector continues, and even the registered decline of share of bad credits in the past few months cannot be interpreted positively, as it is a temporary result of license revoking from problematic banks. Therefore, it is our opinion that NBS should strengthen its preventive and controlling role on the market, so the list of banks being shut down wouldn’t expand any further, but that it should also loosen its monetary policy and together with the Government seek mechanisms for resolving the insolvency issues of the business sector, which are the main threat to the banking sector.

Even though the challenges facing the monetary policy are big, we believe there are even bigger issues with the fiscal policy. The realised deficit of 5.7% of GDP in 2013 was slightly lower than was expected at the end of the year, but it is still the highest deficit in Central and Eastern Europe (see Section 6 "Fiscal Trends and Policy"). A more detailed analysis of the realised fiscal deficit of 2013 additionally raises concerns. Public revenue continues to underperform, while the deficit stayed at the planned level through large savings in discretionary spending (primarily reduction of capital investments, but also purchase of goods and services, and subsidies). The problem is that the reduction of revenues is a systematic problem and it cannot always be offset by *ad hoc* savings, especially since part of those savings at the end of 2013 was realised by state's delay in settling its obligations – which means that last year's fiscal deficit was somewhat artificially reduced, and the unsettled obligations of 2013 become obligations of 2014.

That is why we expect the deficit in 2014 to be even higher than the planned 7.1% of GDP, i.e. at least 8% of GDP, unless severe measures of fiscal consolidation are passed immediately after the formation of the new Government. It is almost certain that the public revenues in 2014 will underperform compared to the plan, and there are numerous obligations and risks on expenditure side that were not foreseen by the budget, such as the debt towards the banks for subsidised loans of 7.5 billion dinars. In addition to all that, the budget foresees funds allocated to the Smederevo steel factory (Železara Smederevo) just for the first half of the year, and it is already clear that the fate of this company will not be resolved in such a short time. Additional risk could be incurred by Srbijagas operations during 2014, because we do not know how far the restructuring of the company has come along and the planned enabling of the company to operate without the (implicit) state subsidies.

Even the foreseen fiscal deficit of 7.1% of GDP is unsustainable and it would require additional austerity measures during 2014. Further deterioration of fiscal trends that we observed requires those savings to be even bigger and more comprehensive. In the short-term, the economic policy does not have many options for curbing the growing deficit. The biggest budgetary expenses are public sector wages and pensions, but let us also stress that these are at the same time the biggest economic imbalances of our public finances, because a state such as Serbia should be spending around 10% instead of the current 13% of GDP on pensions, and around 8% instead of the current 10.5% of GDP on wages.

Public debt at the end of 2013 reached a level of at least 63.5% of GDP (including total debt of local self-government), and it will continue to grow during 2014 as well. In order to overturn the growing trend of public debt and thus avoid a crisis, it is necessary to reduce the fiscal deficit from current 8% of GDP to around 2.5% of GDP, which will be possible in 2017 at the earliest. Such a large reduction of deficit will require a sharp short-term reduction of deficit in 2014 and the first half of 2015, but also a start of the reforms that are being announced for several years now, and which will yield savings in the mid-term – pension reform, public sector wages and employment reforms, reforms of the public enterprises, financing of local self-governments, system of subsidies, etc.

In order for investors to keep financing the fiscal deficit and other state obligations in the coming years as well, it is necessary for the deficit reduction plan by 2017 to be credible. That is why the new Government needs to adopt all necessary reform laws in the first year of its mandate, as well as make an arrangement with IMF. Without that, it will be difficult to secure investors' trust and their financing of large state obligations at moderate interest rates – and this will be crucial in the multi-year transition period of transferring from a record-high and unsustainable fiscal deficit to a sustainable deficit, which reduces the share of public debt in GDP.

Fiscal consolidation is a precondition to any economic growth, because otherwise, a crisis and macroeconomic instability could ensue very quickly. However, fiscal consolidation alone will not be able to initiate economic growth (which is not its goal anyway). Let us stress again that from the standpoint of economic growth, the year 2014 is probably a lost year, because its foundation was poorly set during 2013. For the economic growth as of 2015, the work of another ministry, the Ministry of Economy, will be crucial, which will have to write a set of laws towards improvement of the business environment, as well as to improve Serbia's position on all relevant competitiveness lists (WEF, World Bank). In the short-term, until the business environment has improved, the state should probably consider the possibility of direct negotiations with some of the large foreign investors.

Serbia: Selected Macroeconomic Indicators, 2005-2013

	Annual Data								Quarterly Data							
									2012				2013			
	2005	2006	2007	2008	2009	2010	2011	2012	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Economic Growth							y-o-y, real growth[1]									
GDP (in billions of dinars)	1,683.5	1,962.1	2,276.9	2,661.4	2,720.1	2,881.9	3208.6	3347.1	…	…	…	…	…	…	…	…
GDP	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-1.5	-2.6	0.0	-1.8	-1.7	3.0	0.6	3.7	2.6
Non-agricultural GVA	5.8	4.9	6.1	4.1	-4.2	1.6	1.5	0.6	-0.5	2.0	0.5	0.4	1.3	-1.2	1.0	…
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	3.0	10.8	3.3
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	8.8	2.2
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	43,939	46,185
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	1,720	1,705
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	-2.7	0.1
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7			9.8	7.7	-3.5	1.5	-10.8	-7.0	1.8	-6.2
							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	-37.4	-44.1	-57.1	-40.2
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	-3,392	-3,559	-3,412	-3,849	-3,386	-3,690	-3,774	-2,700
Exports of goods[4]	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,822	1,838	2,247	2,221	2,426	2,235	2,685	3,089	2,049
Current account5)	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,155	-1,180	-757	-551	-697	-625	-290	-160	-172
in % GDP[5]	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-9.1*	*-10.6*	*-17.3*	*-10.2*	*-7.5*	*-8.7*	*-8.2*	*-3.5*	*-1.9*	*-3.1*
Capital account[5]	3,863	7,635	6,126	7,133	2,207	1,986	2,694	2,988	1,124	702	479	693	602	235	62	187
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	242	-362	234	117	253	155	139	224	125
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	-164	-24
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	701,822	757,689
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	6,122	6,605
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	1,911,059	1,870,642
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	933,170	933,839
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	1	2.5
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	-9	-6.5
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	53	50.7
Prices and the Exchange Rate							Y-o-y growth[1]									
Consumer Prices Index[7]	16.5	6.5	11.3	8.6	6.6	10.2	7.0	12.2	3.4	5.4	10.3	12.2	11.2	9.7	4.8	2.2
Real exchange rate dinar/euro (average 2005=100)[8]	100.0	92.1	83.9	78.5	83.9	88.0	80.43	85.3	84.6	87.7	87.3	81.5	79.5	79.5	80.8	81.2
Nominal exchange rate dinar/euro[8]	82.92	84.19	79.97	81.46	93.90	102.90	101.88	113.03	108.01	113.67	117.02	113.44	111.69	112.15	114.2	114.3

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.

7) Data for 2004, 2005 and 2006 are based on the Retail Prices Index. SORS has transferred to the calculation of the Consumer Price Index from 2007.

8) The calculation is based on 12-m averages for annual data, and the quarterly averages for quarterly data

2. Economic activity

According to the last SORS estimate, economic activity in 2013 recorded a solid growth of 2.4%. Circumstances in Serbia's economy in 2013 are less favorable than the rate of growth itself indicates. The biggest part of the economy is in recession, and the overall growth is the result of a one-time increase in agricultural production, by over 20% (due to a recovery from the drought from 2012), and a strong growth in production of several companies (Fiat, NIS). Therefore, foundations for economic growth in 2014 are not well positioned, as the drivers of economic growth from 2013 will exhaust - and the new ones have not been established. From the standpoint of growth perspective in 2014 the fall in investments of about 10% worries. Without new investments it is difficult to expect that the high growth of net exports will continue (which was the most favorable trend in 2013). State and personal consumption will continue to decrease in real terms, as the government plans to implement fiscal consolidation and reduce pensions and wages in real terms, and the wage mass in the private sector is still under the influence of unfavorable trends on the labor market. As a consequence in 2014 we expect stagnation of the economic activity and the growth rate of about 0%. In the last quarter of 2013 SORS estimated that the year on year growth of GDP was 2.6% but compared to Q3 there was a decrease of seasonally adjusted economic activity – due to a significant fall in industrial production. Price competitiveness of the domestic economy is at a satisfactory level, but a slight depreciation could further improve it.

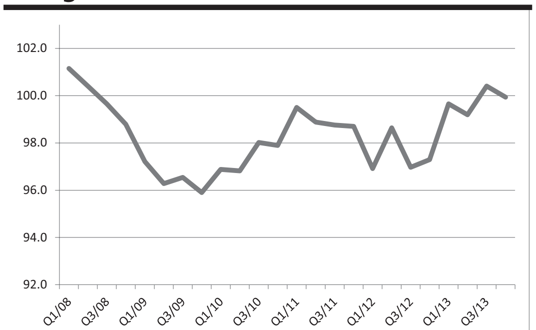
Gross domestic product

Y-o-y GDP growth of 2.6% in Q4

According to the preliminary, flash, SORS estimate, the real y-o-y GDP growth in Q4 was 2.6%. This growth is solid but still slightly lower than the one achieved in Q3 (3.7%) which indicates a slowdown in economic activity. Confirmation for this is seasonally adjusted GDP (Table T2-1) which shows that the value of the seasonally adjusted GDP in Q4 is 0.5% lower than the one from Q3.

Decrease in Q4 consequence of the reduction in industrial production

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



Source: *QM* estimates based on SORS data

The reason for the decrease in economic activity in Q4 compared to Q3 is seasonally adjusted decline in industrial production. Industrial production has contributed to the reduction of seasonally adjusted GDP in Q4 compared to Q3 by 0.6 percentage points, while the total decline in GDP stood at 0.5%. We therefore conclude that, except for industrial production, the Serbian economy in Q4 remained at almost unchanged level of economic activity from Q3 - that is, its overall decline is consequence of the reduction in industrial production.

In 2013 growth of GDP of 2.4%

If official statistic confirms preliminary assessment of GDP in Q4, it would mean that in 2013 a real GDP growth of 2.4% was achieved. We could call this a positive surprise since in the previous issue of QM we expected that the GDP growth will be below 2%. Reason for higher growth of GDP than expected, however, is not the acceleration of economic activity in Q4. On the contrary, economic activity slowed down in Q4 compared to Q3. Higher growth than expected was a result of data revision SORS performed for previous three quarters. Growth of GDP in all three quarters of 2013 was increased by about 0.5% through this revision, and so instead of expected growth of 1.9%, at the end growth of 2.4% was achieved. QM redaction is however very reserved towards the most current revisions of national accounts performed by SORS.[1]

1 For more details se Highlight 1 of this issue of *QM*

Pre-crisis level of production reached

It is interesting to note that, after the upward revision of the data for the first three quarters of 2013 GDP now surpassed its pre-crisis value (Graph T2-1). This pre-crisis value we defined as the average quarterly value of GDP in 2008. Recent SORS data indicate that GDP in Q3 was 0.4% higher than before the crisis, which means that the pre-crisis level of production was achieved five years after its outbreak.

It is important to point out, however, that with reaching pre-crisis levels of production the structure of GDP in the past five years has changed significantly. Growth of the economy is no longer based on domestic demand but on the growth of net exports. Private consumption is reduced in real terms compared to its value in 2008 by 7%, government spending (expenditures for salaries in the public sector and purchases of goods and services by the state) is almost unchanged (increased by about 1%), and investments are reduced by 16%. The decline in domestic demand was compensated by growth in net exports, as exports grew by 26% in real terms compared to 2008, while imports decreased by about 10%. The expenditure side of GDP is shown in Table T2-2, with the most recent available data for Q3 2013. Observed from the perspective of long-term sustainable growth of the economy, some changes in aggregate demand can be assessed as positive. The high growth of exports and the decline of imports is probably the most positive trend, which has contributed to reducing the unsustainably high deficit in the current balance of payments which existed in Serbia before the outbreak of the crisis. Reduction in personal consumption, although very unpopular, is part of a necessary process of harmonization of consumption and disposable income. However, the large real decline in investments is not very satisfactory from the standpoint of long-term growth of the economy, and also it is bad that the real decrease in government spending, which is oversized in relation to the possibility of the country, has been absent until now,

Table T2-2. Serbia: GDP by expenditure method, 2009-2013

	Y-o-y indices										
	2009	2010	2011	2012	2012				2013		
					Q1	Q2	Q3	Q4	Q1	Q2	Q3
GDP	96.5	101.0	101.6	98.5	97.4	100.0	98.2	98.3	103.0	100.6	103.7
Private consumption	97.2	99.1	98.9	98.2	100.1	99.9	98.8	94.2	98.2	98.3	97.9
State consumption	98.1	100.4	101.0	101.7	103.9	105.6	100.4	97.5	97.1	95.6	101.8
Investment	77.9	94.5	108.4	114.4	123.8	126.0	117.7	97.4	102.7	83.6	89.7
Export	92.0	115.3	103.4	101.8	95.9	105.1	102.4	103.2	111.4	112.6	126.7
Import	80.9	103.1	107.0	101.9	104.3	105.6	99.4	98.8	97.8	99.8	106.9

Source: SORS

In 2013 economy is driven by net exports while investments decline strongly

Table T2-2 shows that in 2013 similar structure of GDP growth as in the previous five years was achieved. Exports is the only aggregate with strong positive real growth and that growth in 2013 amounted to just over 17% (data for the first three quarters). On the other hand, private and government consumption had almost equal real decline of 1.9%, and investment decline of almost 10%. The decline in investments is particularly worrisome, because its strong reduction, which was already certain in 2013, will have a very negative impact on the economic growth in 2014. Companies invest little because they do not have enough of their own funds, and because of financial problems domestic and foreign banks are not willing to credit them. In addition, relatively low level of foreign direct investment, that will amount to about 700 million in 2013, did not significantly influenced the growth of total investments.

In general, investments in Serbia are low and in 2013 will by all accounts be below 20% of GDP, and for the growth of the economy of 4-5% annually investment of around 25% of GDP are needed. In the short term of one to two years, a significant increase in investments can be achieved primarily on the basis of the growth of foreign and public investments. Increasing foreign investments from 2.2% of GDP to 4-5% of GDP, as well as public investment from 2.5% to 4-5% of GDP would create momentum for the start of long-term growth of the economy. Although in the short term we cannot count on significant growth of domestic private investments, in the medium and long term these investments should become the main driver of growth of the Serbian economy. For the growth of domestic private investments to happen it is crucial to solve the accumulated financial problems in private companies, as well as to improve the business environment through the reform of the economic system.

Net exports are increasing due to the expansion of production in several companies

Growth of net exports is mostly a consequence of operations in only a few companies, of which the most important are Fiat Automobiles Serbia (FAS) and NIS. Of the total increase in net exports of around 1.5 billion euros in 2013, a half is a consequence of operations in only these two companies. This is, however, the specificity of 2013 and these trends will not continue in 2014. In fact, both of these companies have already reached almost full utilization of existing capacity, so the increase in their production and exports, as the one from 2013, is unlikely in 2014. More investments in 2013 were needed for a similar pace of exports growth to continue in 2014 - much like the increase in investments in 2011 and 2012 (Table T2-2) preceded a strong growth in net exports. As this did not happen, but the investments in 2013 were in decline, it is hard to expect that the unchanged rate of growth of exports can be lasting.

High growth of agriculture and deep fall of construction

GDP trend analysis in Q3 and in 2013 can be complimented with the data by the production method which is presented in Table T2-3. The table shows individual sectors growth ending with the last available official data which refer to Q3. Similar to the analysis of GDP trend per use, in this case we also believe that, based on data for the first three quarters of the year, we can show basic trends in individual sectors of the economy in the entire 2013. Table T2-3 reveals that a sector of agriculture has the largest increase in 2013, of over 20% and that this high growth is the result of comparison of the above-average agricultural production in 2013 with the extremely poor agricultural season from 2012. Another sector that contributes the most to the growth of the economy is the information and communication, which is on the multi-year trend of a steady growth. The third sector that significantly contributes positively to GDP growth in 2013 is manufacturing which in the first three quarters of 2013 achieved growth of 5.5%. On the other hand, the most unfavourable trend of all sectors of the economy has construction, which, according to data for the first three quarters of 2013, recorded a decline of as much as 30%, compared to the same period last year. Construction trend confirms worrisome decline in investment, which we have already observed when analysing GDP by use.

Table T2-3. Serbia: Gross Domestic Product by Activity, 2009-2013[1]

	Y-o-y indices											Share
	2009	2010	2011	2012	2012				2013			2012
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	
Total	96.5	101.0	101.6	98.5	97.4	100.0	98.2	98.3	103.0	100.6	103.7	100.0
Taxes minus subsidies	98.3	100.9	101.6	98.6	96.6	100.4	98.1	98.3	103.1	99.7	104.3	17.4
Value Added at basic prices	96.1	101.0	101.6	98.5	97.6	99.9	98.2	98.3	103.0	100.7	103.5	82.6
Non agricultural Value Added	95.8	101.6	101.5	100.6	99.5	102.0	100.5	100.4	101.3	98.8	101.0	91,1[2)]
Agriculture	100.8	99.6	100.9	82.7	81.3	82.9	83.2	82.8	122.9	121.0	118.7	8,9[2)]
Manufacturing	84.2	100.9	100.6	101.1	96.3	103.3	99.2	104.9	104.4	103.2	108.7	14,4[2)]
Construction	80.3	92.9	107.7	99.2	118.2	110.9	98.7	80.9	78.9	62.4	74.0	3,9[2)]
Wholesale and retail trade	92.5	101.7	94.5	100.2	98.2	103.1	101.1	98.3	96.8	95.9	98.6	13,0[2)]
Transport and storage	90.0	108.2	103.1	100.0	94.5	103.3	100.1	102.1	105.4	100.0	96.5	5,5[2)]
Informations and communications	110.0	105.4	108.4	104.8	106.5	106.2	99.3	107.3	111.4	109.9	112.5	9,6[2)]
Financial sector and insurance	105.5	107.2	101.0	104.0	99.8	104.8	106.4	104.9	101.8	99.5	97.3	4,1[2)]
Other	101.6	100.8	102.0	99.9	99.1	99.4	100.7	100.5	101.5	100.6	101.7	41,1[2)]

Source: SORS
1) In the previousyear'sprices
2) Share in GVA

No major changes in Q4, except for the reduction in industrial production

Based on the available monthly data we estimate that in Q4 there will be small changes in the structure of production growth by sector, compared to Q3. Monthly indicators of industrial production trend point to a strong y-o-y decrease in the manufacturing industry – which, we think, is the main reason for the slowdown in overall GDP growth in Q4 compared to Q3. On the other side, from the Announcements on construction activity in Q4, we conclude that there will be some recovery of construction, which, however, due to the lower share of construction in GDP (especially in Q4), will not significantly affect the overall GDP. Other sectors of the economy in Q4 will likely have similar growth rates as in Q3 (Table T2-3).

In 2014 zero growth rate probable

In the previous, December, issue of QM we gave a forecast of zero GDP growth rate in 2014, which we will not correct in this QM. Other institutions which forecast GDP growth in Serbia have similar forecasts. The government forecasts economic growth of 1%, as the NBS, which in the February issue of Report on inflation downgraded its initial assessment of the growth in 2014 from 1.5% to 1%. We do not exclude that in 2014 GDP growth of 1% will be achieved, but we are in somewhat conservative our forecasts (as usual).

Stagnation in 2014 is in fact not a derogation compared to 2013

First we must clarify that stagnation, i.e. zero economic growth in 2014 does not mean the essential worsening of trends compared to 2013. Namely, if we excluded the results of agriculture and companies FAS and NIS from the economic activity, the remaining part of the economy would record a fall of at least 0.5% in 2013. As we cannot expect the similar growth of agriculture in the following year, and FAS and NIS will contribute less to the growth because they came close to their full production capacity –we enter 2014 with a recession, not with growth. Therefore, even the stagnation in 2014 would represent a positive shift in relation to a hidden, but real, trend that exists in a large part of the economy.

Private consumption will record a real fall, and net exports growth

In the previous issue of QM we gave a detailed overview of the basic components of GDP for 2014 which indicate the overall stagnation of economic activity, and so we will now only repeat the main thesis. Private consumption trend we estimated on the basis of the assessment of the components' trend from which the consumption is financed – wages, pensions, social assistance, consumer loans, remittances and other – and came to the conclusion that in 2014 it will record a real decline of about 1.7%. Based on the data from the Fiscal strategy we concluded that the government spending in 2014 will reduce in real terms by 2.3%, and any additional austerity measures to reduce the fiscal deficit would also affect the decline in government spending. Further, we expect a modest increase in investments of 3-4%, which will not be sufficient to compensate their decline of about 10% from 2013. Finally, we assess that net exports will have a smaller positive contribution to growth in the economy in 2014, compared to 2013 - which in the aggregate would result in the maintenance of zero growth rate of the economy, despite the decline of state and private consumption and weak investment growth.

Low investments are the main problem

The investments are of the utmost importance for a high and sustainable economic growth. Investments are important for two reasons, first because they directly increase economic growth, and second because they create preconditions for growth in production after their completion. Therefore, we point out the decline in investment in 2013 as the most unfavorable trend and also the limiting factor for the potential growth in 2014. Economic policy should therefore pay special attention to increasing investments in the coming years. The healthiest way to achieve this is to improve the business environment and political stability, and the state could offer further help by increasing public investment. As a consequence of the low state efficiency in improving the business environment the past practice has been to facilitate the arrival of the investors, through direct negotiations with investors and/or through direct subsidizing. In 2014, however, it will be very hard to achieve a significant increase in investment on any basis: 1) relevant research (WEF, World Bank) do not indicate the improvement of business environment in recent years, 2) although some increase in public investments, compared to 2013, is planned, the question is to what extent it will be achieved, and 3) there are no reliable information that negotiations with any large strategic investor are brought to an end, which would result in the beginning of a major investment project in 2014[2]. Although 2014 is probably lost from the perspective of increasing investment activity in Serbia, attracting investments and especially improving the business environment must be priorities of economic policy in the following years.

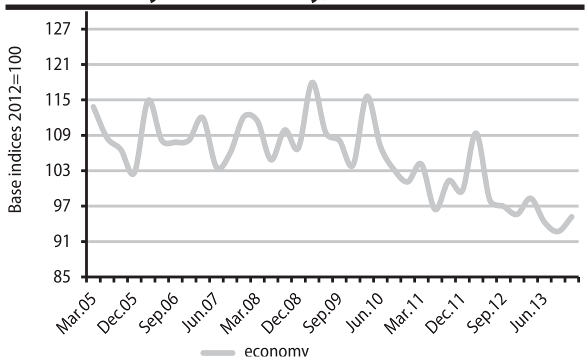
Unit Labour Costs are temporarily increasing

Unit Labour Costs[3] (ULC), measured in dinars, are increasing in Q4 when compared to Q3 (Graph T2-4). In comparison with the same period of the previous year ULC are still lower in

2 It is still not certain how high will be the investments in connection with, in public frequently mentioned, plans of realization of projects "South Stream" and "Belgrade on the water." It is our assessment that in best case these investments will begin to be implemented at the end of the year, so that the total foreign investment will not exceed the planned amount of billion euros. If some of these investments are to be postponed for the next year, the total foreign investment, including the possible privatization revenues, will likely be lower than one billion euros.

3 UnitLabor Costs in dinars are calculated for the economy (excluding the Agriculture and Public Administration sectors) and industry.

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



Source: *QM* based on SORS and NBS data

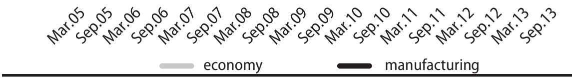
Q4, but this decrease is no longer as great as in the first three quarters of 2013. We believe, however, that the increase in ULC in Q4 is temporary in nature, and that the actual trend in the movement of ULC is still declining. The reason for the slightly higher ULC in Q4 is slowdown in inflation rather than growth in nominal wages (see chapter on employment and wages). Due to less elasticity of nominal wages to inflation, the real reduction in wages in Q4 was considerably lower than in all other quarters of 2013, which is then reflected in somewhat higher ULC.

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 (which produces by far the greatest share of tradable goods), and for the economy as a whole[4], as shown in Graph T2-5).

Price competitiveness of the economy in Q4 same as a year ago

Graph T2-5 shows at first glance two divergent trends in the movement of the euro-ULC in Q4 in the economy and the manufacturing industry. In fact, it looks as if the euro-ULC in the economy is increasing, and reducing in the manufacturing industry. This is however only an illusion, caused by the strong seasonality in the movement of ULC in the manufacturing industry in Q4, when they are seasonally very low. The real measure for assessing trends of euro-ULC would therefore be their comparison with the same period last year, and in this way it can be seen that in the case of the manufacturing industry and in the case of the total economy, euro-ULC are almost unchanged.

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

The Graph shows that the price competitiveness of the domestic economy is still 5-10% lower than in 2005, indicating that a slight real depreciation of the dinar would be desirable from the standpoint of the price competitiveness of the domestic economy. We chose the 2005 as a benchmark year because it is a year before the beginning of strong capital inflows, the enormous increase in wages and pensions (period 2006-2008), a sharp real appreciation of the dinar and the deterioration in the competitiveness of the domestic economy. All this has resulted in the huge and unsustainable deterioration in the balance of current payments, with which Serbia entered the crisis. An additional argument for controlled depreciation of the dinar is the fact that the economic growth in 2014, but also in the coming years, will crucially depend on the trend of exports, because the space for the growth of domestic demand is limited.

Therefore, we believe that there is room for a gradual depreciation of the dinar, because: 1) price competitiveness the domestic economy had under "normal" circumstances has not yet been achieved, and 2) exports (alongside investments) is the only possible source of sustainable growth in the coming years, and it should be also encouraged through monetary policy. In this regard, we think that the last NBS interventions in the foreign exchange market, which are aimed at

4 Excluding the Public Administration and Agriculture sectors.

preventing the depreciation of the dinar, are too expensive, and economically not fully justified. Allowing a moderate depreciation of a few percent would not affect the growth of the inflation over the target corridor, it would moderate to worsen the balance of enterprises and banks, but it would be very stimulating for export growth, and a slowdown in imports.

Industrial production

Industrial production decreases growth

Industrial production in Q4 recorded a high year-on-year growth of 3.3% (Table T2-6). Within the industrial production, the highest growth of 6.8%, was achieved by the supply of electricity, while the mining and manufacturing industry recorded a growth of 4.1% and 2.2%. The y-o-y growth of electricity production in Q4 is short term event, and it is the result of a comparison with the very low level of production in 2012, when as a consequence of the drought hydroelectric plants worked on a minimum. Table T2-3 shows that the achieved growth in Q4 represents a significant decline in the y-o-y growth when compared to Q3.

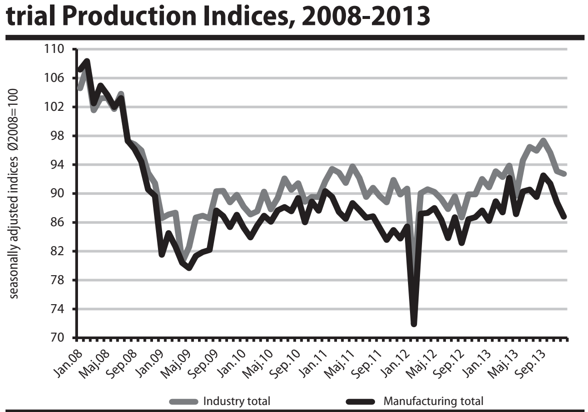
Table T2-6. Serbia: Industrial Production Indices, 2009-2013

	Y-o-y indices													Share
	2009	2010	2011	2012	2013	2012				2013				2012
						Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Total	87.4	102.5	102.2	97.1	105.5	94.5	97.2	96.4	99.4	105.2	103.0	110.8	103.3	100.0
Mining and quarrying	96.2	105.8	110.4	97.8	105.3	100.2	94.2	100.1	96.3	107.8	102.2	107.6	104.1	9.8
Manufacturing	83.9	103.9	99.6	98.2	104.8	93.3	100.2	96.2	101.5	105.4	103.2	108.8	102.2	74.3
Electricity, gas, and water supply	100.8	95.6	109.7	92.9	108.1	96.6	85.4	95.8	93.0	103.7	103.7	120.5	106.8	15.9

Source: SORS

Seasonally adjusted indices confirm decline in industrial production in Q4

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



Source: SORS

Graph T2-7 shows seasonally adjusted production indices of total industry and manufacturing. We immediately notice that the seasonally adjusted data indicate quite strong downward trend in industrial production, which began in September 2013, i.e. seasonally adjusted decline in industrial production in Q4 compared to Q3 for almost 3%. This decline has reversed the largest share of the achieved growth of industrial production in 2013, and so we enter 2014 with the level of industrial production which is only slightly larger than the one whit which we entered 2013 (Graph T2-7).

We estimate that a good part of the fall in industrial production in Q4 was not permanent in nature, but there are still some worrying fundamental trends that will continue in 2014. The decline in production in Q4 is mostly a consequence of a fall in production of motor vehicles, which is associated with the business policy of the company FAS. This decline we basically evaluate as temporary. Car production at the company FAS will probably increase again from January, but undoubtedly the results will oscillate around their values in the second half of 2013, and will no longer be able to maintain relatively high growth rate of the total industry. For additional lasting increase in car production in FIAT major new investments are required. Therefore, we believe that Serbia should enter into negotiations with FAIT about a further expansion of FAS capacities in Serbia.

We estimate that in the eventual negotiations Serbia could offer certain tax breaks and subsidies, but that they will have to be lower than those granted in the past. Among other industrial areas, in 2014 we expect solid growth in the food industry due to a better agricultural season and the occasional (unsustainable) advances in the field of industrial production, which are basically subsidized - such as the production of other motor vehicles (Ikarbus) and basic metals (Steal Plant Smederevo). The largest part of industrial production, however, is in a very unfavorable situation and we do not expect that in 2014 it will have positive growth rates.

In Q4 consistent growth rates of industrial production by purpose

Observed by purpose (Table T2-8), we notice that in Q4 divergent trends of growth in industrial production, which were present in the first three quarters, were not continued. On the one hand the growth in production of capital goods (already mentioned decrease in production of FAS) and energy production strongly slowed down. On the other hand, due to the increase in production in the food industry there has been a recovery in food production, and stable growth rates of production of intermediate goods are largely a consequence of subsidizing production in Steal Plant Smederevo.

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

	2009	2010	2011	2012	2013	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4
						Y-o-y indices							
Total	87.4	102.5	102.1	97.1	105.5	94.5	97.2	96.4	99.4	105.2	103.0	110.8	103.3
Energy	98.8	97.7	106.2	93.6	113.2	95.8	88.3	91.4	98.7	108.6	109.7	131.6	107.7
Investment goods	79.3	93.6	103.2	103.8	127.6	92.0	105.4	113.7	104.2	132.3	130.2	140.5	104.2
Intermediate goods	78.4	109.2	102.2	91.2	99.0	89.4	96.3	89.1	90.0	94.7	93.1	101.9	104.8
Consumer goods	86.8	102.1	95.4	103.2	100.7	97.8	104.5	104.6	106.1	107.0	101.5	97.4	100.0

Source: SORS

In Q4 lower growth rate of industrial production

Since the seasonally adjusted fall in the industrial production in Q4 was under great influence of some temporary trends, we expect a recovery in Q1 2014. How high will be the growth rate of industrial production in 2014 is still quite uncertain. We expect that it will be slightly positive, mainly due to the expected growth of the food industry, which has the largest share of industrial production. Manufacture of motor vehicles will also have an increase in production compared to 2013, but this increase will not be particularly high. Energy production will likely remain at the same level as in 2013, because we expect that NIS continues to positively contribute to the growth of this area (less than in 2013) , but also that electricity production will be lower than in 2013 due to a warmer winter and probably somewhat less favorable hydrological situation . What will be the total industrial production growth will depend on the developments in the rest of the industry, which was not favorable in 2013 either. If the decline in the rest of the industry remains the same as in 2013 the total growth rate of the food industry and the production of motor vehicles will probably remain slightly positive. If the decline in the rest of the industry further deepens, which is not excluded, it is possible that the total industrial production in 2014 stagnates or perhaps even achieves a smaller decline.

Construction

Construction is in crisis...

...but the results for Q4 are however slightly better than those from the rest of 2013

Latest construction statistics made available by SORS indicate year-on-year decline in this part of the economy in Q4 of 8.5%. This decline, however, represents an improvement when compared to the results from Q3, when the official construction statistics recorded a decrease of over 20%. Data for Q4 we take with some reserve, because construction activity, due to the seasonal factors, is in Q4 (as in Q1) lower than in Q2 and Q3. Data for the entire 2013 indicate an indisputable high decline in construction activity.

Because of the difficulties in monitoring the construction activity, we use cement production index[5] as additional indicator (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

5 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

Trends

Cement production confirms the decline in construction...

…but indicates that it is lower than the official statistics is showing

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	127.6	93.5	94.9

Source: SORS

not sufficiently precise, are a good additional indication of an actual state and future trends in construction.

Cement production in Q4 was by 6.5% lower than in the same period last year, (Table T2-9) which is in line with the official estimate of the construction activity trend in Q4. Observed at the level of the entire 2013 we notice that the cement production was by only 5% lower than in 2012, which indicates a smaller decline in construction from the one official statistics indicates. Therefore, to detect the actual trend in construction activity we combine both methods and concluded that the construction activity in 2013 undoubtedly recorded a big decline, but that this decline was probably not greater than 20% (which is indicated by the official statistics) - but maybe about 10%.

3. Employment and Wages

Official statistics on the labour market trends during 2013 are extremely divergent – according to the data of the October Labour Force Survey (LFS), the situation on the labour market is significantly improving, while according to the data from monthly reports, the formal employment is slightly declining. The data from the October LFS are not in line with other macroeconomic data. According to the LFS data, employment in October 2013 has increased by 3.4 percentage points, while unemployment has declined by 4 percentage points compared to April of the same year. The growth of employment, according to LFS, occurred in the grey economy, with helping household members in agriculture and with the self-employed. Although improvements like these are in principle possible on the labour market, it is our assessment that they are highly unlikely and we therefore express certain reservation towards them. Such large improvements on the labour market in a short period of time happen rarely and during times when there is an accompanying surge in economy, which is not the case in Serbia. Additional doubts about the LFS data are brought about the data on the growth of employment by business activities. So, for example, according to LFS, the employment in construction in October 2013 was higher by 4% than in October of the previous year, while all other data indicate that the business activity in construction has fallen between 15% and 25%?! Similarly, high growth of the number of employees in healthcare, education and public administration in a short period is difficult to explain. Therefore, it is our opinion that even if there were certain improvements during 2013 in certain segments of the labour market (self-employment, helping household members, grey economy), those improvements are significantly smaller than indicated by LFS. At the year-on-year level, average monthly gross wages are higher in real terms by 3%. When it comes to business activities, the wages have increased the most in the sectors of professional, scientific and technical activities, information and communications, compared both to the previous quarter and Q4 2012.

Employment

According to LFS, employment rate in October 2013 was 49.2%

According to the data from the October Labour Force Survey (LFS), employment rate in October was 49.2%, while the number of employees compared to April 2013 increased by 140,000 and the employment rate by 3.4 percentage points. Even though it is possible that the level of employment in October (49.2%) was adequately recorded by LFS, it is our assessment that it is highly unlikely that the number of employees in the period April-October increased by 140,000 (Table T3-1). High employment rise in a relatively short time is not in line with other macroeconomic data (economic activity, spending), and the estimated growth of employment by business activities and labour market segments further raises doubts about the LFS data. Such large improvements on the labour market in a short period of only two quarters happen rarely and only in situations when economic activity significantly improves. One of the rare historical examples of employment growth was in the Baltic countries during 2010, which coincided with strong recovery of their economies after a deep fall of GDP at the beginning of the crisis. There had been no such growth of economic activity in Serbia during 2013, and the business activities that had some economic growth (agriculture, automobile industry) had a modest rise in employment.

Trends

Table T3-1. Serbia: Employment and Unemployment According to the Labour Force Survey, 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
	October	2,268,750	349,742	49.2	56.2	42.1	602,651	21.00	20.2	22.00

Source: Labour Force Survey (LFS), SORS

Employment trends in business activities additionally undermine the validity of published data

Employment trends data by business activities additionally undermine the validity of the data on total employment. Data on employment trends in certain activities drastically deviate from the trends in economic activity – according to LFS data, employment in construction has increased by 4% in October 2013 compared to the same month last year, while the data on business activity trends in construction and production of construction materials indicate a decline in activities of about 20%?! The number of helping household members was doubled compared to the same period last year, and more than doubled compared to April 2013. Also, it is difficult to believe that the number of employees in education was increased by almost 7% over the past year. Employment in healthcare and social protection shows unusual fluctuations, as these are not sectors with expressed seasonal component – in April 2013 the number of employees in this sector dropped by 12% compared to October 2012, only to rise again in October 2013 by 9.5% compared to April.

Table T3-2. Employment Trends by Business Activities

	October 2012	April 2013	October 2013	Oct 2013/ Oct 2012, index
TOTAL	2.299.038	2.227.432	2.394.004	104,1
Agriculture, forestry and fishery	494.700	461.819	522.084	105,5
Mining	25.092	21.173	23.065	91,9
Processing industry	394.992	389.193	399.654	101,2
Electricity, gas and steam supply	35.159	37.751	37.206	105,8
Water supply and waste water management	35.203	30.436	36.866	104,7
Construction	121.659	92.977	126.620	104,1
Wholesale and retail, Repair of motor vehicles	307.136	305.132	288.606	94,0
Transport and warehousing	125.748	137.980	130.882	104,1
Accommodation and food services	66.555	55.737	61.973	93,1
Information and communications	35.172	45.266	50.140	142,6
Financial and insurance activities	43.676	40.860	44.566	102,0
Real-estate business	2.885	3.012	2.028	70,3
Professional, scientific and innovation activities	50.896	61.194	63.185	124,1
Administrative and support services	47.076	47.919	49.175	104,5

Public administration and mandatory social security	125.469	129.761	132.950	106,0
Education	146.867	142.490	156.867	106,8
Healthcare and social protection	140.297	124.628	136.455	97,3
Art, entertainment and recreation	36.387	33.040	44.823	123,2
Other services	43.722	47.561	45.177	103,3
Activities of households as employers	20.377	18.632	41.003	201,2

According to the Survey, employment is growing mostly due to increased number of self-employed persons and helping household members…, while employment by employers is dropping

According to the Labour Force Survey during 2013, the structure of employment by professional status has changed considerably (Table T3-2). According to LFS, the percentage of the self-employed and helping household members has been increasing since October 2012. At the same time, the percentage of the employed has been dropping, i.e. persons working for a salary with an employer. This change of employment structure could be observed from the standpoint of reliability of measuring, as well as from the standpoint of job quality. Measuring the number of self-employed and helping household members is in principle less reliable than measuring employment by employers, which implies that the growth of total employment, which is the result of an increase in the number of the self-employed and helping household members, is also less reliable. Also, the quality of employment, especially in the case of helping household members, is weak as a rule, because they are usually less productive jobs.

Table T3-3. Employment Structure by Professional Status

	2012, oct.	2013, apr.	2013, oct.
Self-employed	24	24.1	25.4
Assisting household members	7.3	7.3	8.1
Employed workers	68.7	68.6	66.5

… positive progress in the segment of self-employed and helping household members could only partially maintain changes on the labour supply side

To the extent that the mentioned trends are real, it could be concluded that the main drivers of positive progress in employment are the result of trends on the labour supply side. Numerous factors can influence an increase in labour supply, and one of the most important ones are trends in unearned income, such as pensions, unemployment remittances or benefits. Benefits data published by the National Bank of Serbia show a continuous decline since 2009. Furthermore, according to the data from the Ministry of Finance, after 2009, which was the last year that pensions were significantly increased by 12%, the pensions started to decline as well in real terms. Finally, the declining state funds for unemployment benefits as of 2010, with a simultaneous growth of the number of users, has led to a decline in average real benefit. In short, according to the Labour Force Survey, there are indicative data that drying up the sources of unearned income has encouraged labour supply, i.e. there is an increased willingness of people to fend for themselves and accept any job. However, this explanation can be accepted with certain reservation as well, because the decline in unearned income started a lot sooner and was the highest in 2009-2010, while the supposed changes on labour market occurred during 2013 and in a time period of only two quarters.

The share of private sector is increasing in the employment structure…, but only in grey economy employment

According to the Labour Force Survey, the share of state in total employment is dropping, while the share of private sector is rising, which is generally good. However, growth of share of the private sector in the overall employment is generated exclusively by the growth of grey economy employment. Even though these tendencies are in line with other observations on the growth of grey economy, it is highly unlikely that they occurred in such a short time period. Still, the survey results could indicate a deterioration of business conditions in the regular private sector, but also a relatively high tolerance of the state towards grey economy.

Table T3-4. Employment Structure by Type of Ownership, in %

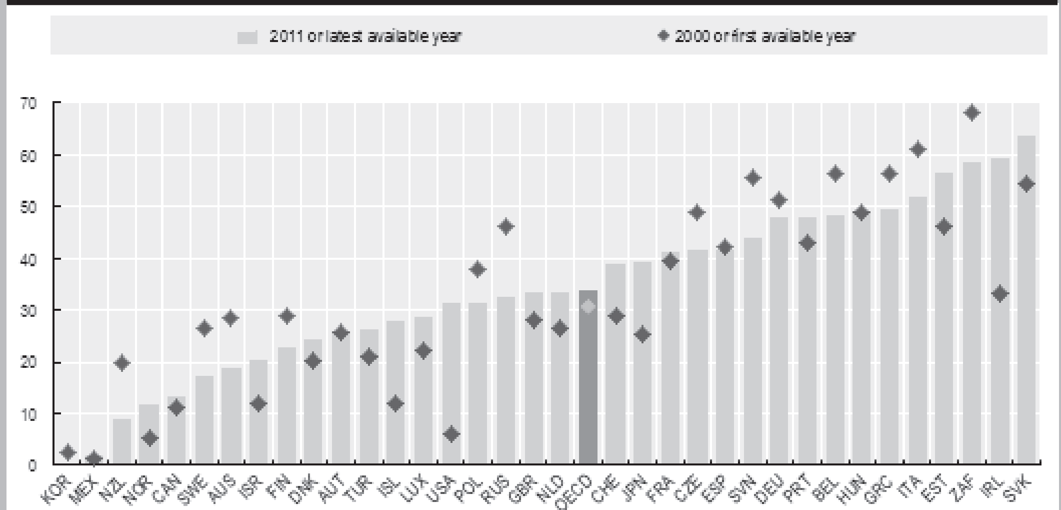
	2012, oct	2013, april	2013 octr
Registered private property	54.6	53.9	53.9
Unregistered private property	11	12.3	13.6
State property	31.7	31.6	30.3
Other forms of ownership	1.9	2.2	2.2

Source: LFS

Box 1. Share of Long-term Unemployment in Total Unemployment

Share of long-term unemployment represents a percentage of those who have been unemployed for one year or longer in the total number of unemployed population. This rate is mostly lower in countries that have had a high rate of economic growth for several consecutive years. However, long-term unemployment can also drop at the beginning of an economic crisis due to increased inflow of newly unemployed individuals and then again grow with the deepening of the crisis, as is the case with most OECD countries (Graph T3-3).

Graph T3-1. Share of long-term unemployment, OECD countries



The Graph shows that more than half of the countries had a share of long-term unemployment around or above the OECD average. For countries such as Estonia, Ireland, Italy and Slovakia, the rates go even above 50%. It is interesting that in Germany, the share of long-term unemployment persists at a high level of 48% despite the growing trend of the employment rate since 2005. This could be a consequence of generous unemployment benefits available for a longer period of time, which reduces an incentive to look for work.

In Serbia, share of long-term unemployment is quite high – 75.7%, which is significantly higher than any OECD country, but still the lowest compared to the countries in the region. Based on the data from the national Labour Force Surveys, this rate is 82% in Macedonia and Bosnia and Herzegovina, and 84% in Montenegro.

High share of long-term unemployment in the total unemployment speaks to the inefficient functioning of the labour market. But it is quite certain that other policies also affect long unemployment status. Generous unemployment benefits are not one of the factors influencing the high share of unemployment in Serbia because, as we said, the state on average is allocating fewer and fewer funds for these purposes. Also, the maximum duration of benefits is 12 months, and as can be seen in Graph T3-4, among the unemployed persons looking for work over a year, most of them have been looking for jobs between two and six years, and even longer than 10 years, which is considerably longer than the maximum duration of benefits. In other words, among the long-term unemployed there aren't many who are receiving unemployment benefits.

Graph T3-4. Unemployment Structure by Duration of Job Search

Source: LFS, October 2013

The above would suggest that income earned in the informal economy is most probably the source of income for those who are long-term unemployed. High share of long-term unemployment and growing informal economy are related to the incentives for accepting (formal) work in Serbia. That is, high tax burden of work income and sudden reduction of social benefits after an individual realises even a minimum income, contribute to the high opportunity cost of finding formal employment.

According to the Labour Force Survey, the unemployment rate is 21% and has dropped compared to April 2013 by as much as 4 percentage points, … it is highly unlikely that such a change in unemployment actually occurred

According to the Labour Force Survey, the unemployment in October 2013 was 21% and it was by as much as 4% lower than in April the same year, and 2% lower than in the same period of 2012. The survey indicates that the unemployment rate in October 2013 was the lowest since October 2010, and that it is related to the growth of employment in grey economy, in the self-employed and helping household members. All of the earlier mentioned reservations about the high growth of employment during 2013 can also be applied to the registered reduction of unemployment.

Wages

Average monthly gross wages higher in real terms by 3% compared to the same quarter of the previous year

According to the data from the Statistical Office of the Republic of Serbia, average monthly gross wages at the year-on-year level were nominally higher by 5.1% in Q4 and by 3% in real terms (Table T3-5). Average monthly net wages in the last quarter of 2013 were 46,000 RSD or 399 EUR. In the entire 2013, average wages in Serbia grew nominally by 5.7%, while they dropped in real terms by 1.9%. Reduction of real wages during 2013 reflect the dominating negative tendencies in most of the economy, as well as on the labour market, but also an increasing share of grey economy, which is especially present in small companies and entrepreneurs.

Table T3-5. Serbia: Real Seasonally Adjusted Net Wages, by business sectors

	Average Monthly Wage[1)]				Average Gross Monthly Wage Index (SORS) [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
Q3	71,469	43,939	626	385	105.9	99.1
Q4	75,089	46,185	648	399	105.1	103.0

Source: SORS

It is interesting that the year-on-year quarterly indices of nominal wages were relatively stable during 2013, while real indices recorded a significant drop during the year. It can thus be concluded that the growth of year-on-year real wages can mostly be explained by a sudden reduction of inflation during 2013 – stable indices of nominal wages were divided by decreasing indices of prices. Therefore, the real wages during 2013 didn't grow because the nominal wages increased, but because the inflation dropped.

At the year-on-year level, the highest growth of wages was recorded in the information and communications sector

The year-on-year index of net wages indicates that the wages realised in Q4 2013 increased in all twelve sectors compared to the same period last year. The highest growth was recorded in the sectors of information and communications (12.8%), other service industries (10.9%), and professional, scientific and technical sector (10.3%). Other sectors had no more than 5% increase (Table T3-6).

Table T3-6. Year-on-Year Index of Net Wages in Real Terms

2011-2013	Professional, scientific and engineering activities	Other services	Information and comunication
2012,Q1	108.6	106.6	104.3
2012,Q2	114.4	108.2	116.5
2012,Q3	105.0	99.6	97.1
2012,Q4	102.7	96.3	105.5
2013,Q1	91.5	97.2	95.8
2013,Q2	105.5	103.4	95.9
2013,Q3	102.5	103.5	114.6
2013,Q4	110.3	110.9	112.8

Wages increased the most in professional, scientific and technical sector

Observed by business activities, as can be seen in Table T3-7, the net wages in Q4 2013 increased the most in professional, scientific and technical business activities by 17.5%. A 5.3% growth of wages was recorded in the sector of information and communications, while other sectors had up to one percent growth. The biggest decline in wages of 7.2% was recorded in the sector of real-estate, followed by a 4% decrease in finance and insurance sector. Other sectors had a decline in wages between 0.5% and 1.1%.

Table T3-7. Year-on-Year Index of Net Wages

	Professional, scientific and engineering activities	Information and Communication	Real estate	Financial and insurance activities
2012, Q1	106,89201	103,061046	104,541566	106,639936
2012, Q2	102,94142	104,4022938	103,560818	95,366857
2012, Q3	95,962883	91,93509773	91,9229062	94,5908223
2012, Q4	97,333157	103,7359959	97,7051048	97,6902022
2013, Q1	94,310793	99,12122665	105,745097	101,473767
2013, Q2	100,95682	101,3764895	97,1591386	99,2037039
2013, Q3	100,73621	98,08931379	104,05263	102,452746
2013, Q4	117,45046	103,272816	96,8143905	98,4490083

Source: *QM* calculations

4. Balance of Payments and Foreign Trade

In 2013, the current account deficit was significantly reduced – according to the NBS estimates, current deficit in 2013 was 1.6 billion euros (5.1% of GDP), which is two times less than in 2012. The significant reduction of current deficit in 2013 is primarily due to favourable foreign trade trends – expansion of exports with moderate growth of imports. Still, the fast trend of deficit reduction recorded in the first three quarters of 2013 (8.2% of GDP, 3.5% of GDP, and 1.9% of GDP respectively) was interrupted in Q4 when the deficit reached a level of 6.3% of GDP. The higher level of deficit at the end of 2013 is the result of a noticeable deceleration of exports due to decelerated growth of car exports – considering that the possibility of growth in the exports of these products has mostly been exhausted. Capital inflow during 2013 was quite modest and insufficient for covering still high, although reduced, current deficit. This was a result of a very high outflow on Other Investments account due to an intensive deleveraging of banks and the business sector, as well as a modest inflow of FDI despite a more significant inflow of portfolio investments (mostly due to state borrowing). In 2014, the trends indicate the deficit staying at approximately the same level of around 5% of GDP, having in mind the limited possibility of growth of exports and imports. Also, the still existent political and macroeconomic uncertainty and instability will have a great negative impact on foreign investments in the first half of the year, while a continuation of EU accession negotiations and possible new arrangement with IMF would send a positive signal to the investors. Therefore, unless something considerably changes, it is our opinion that there is a big possibility of same modest results in capital inflow repeating in 2014 as well.

In 2013, the current account deficit was significantly reduced due to favourable foreign trade trends – expansion of exports and modest growth of imports

In 2013, a relatively low current account deficit was realised. In the period January-November[1] 2013 the current account balance of payments deficit was 1,247 million euros. The current deficit was 4.2% of GDP and by 6.6 percentage points lower than the deficit realised in 2012. For the entire 2013, NBS estimates that the current deficit was 5% of GDP. Although two times lower than the current deficit realised in 2012, the 5% of GDP deficit is still quite high and probably not sustainable in the long term. Deficit at this level would be sustainable in the long term only with high FDI and high GDP growth, but none of these conditions can be counted on. Most of the improvement of deficit in 2013 can be attributed to the growth of net exports, primarily to the expansion of exports in automobile industry.

Current deficit in 2014 will remain around 5% of GDP, which is still a high foreign deficit

NBS estimates that the share of current deficit will be at the level of 5% of GDP in 2014. That is, the growth of exports in the coming period will, on the one hand, be negatively influenced by depleting the growth of exports in the automobile industry, and on the other hand, the expected recovery of eurozone countries will have a positive impact.

Capital inflow was quite modest and insufficient for covering the current deficit

Capital inflow in 2013 was quite modest and insufficient for covering the current deficit. Total net inflow of capital from January to November was 873 million euros and is the result of a modest inflow of FDI (643 million euros), a significant inflow of portfolio investments (1,134 million euros – mostly due to state borrowing), and outflow on Other Investments account (due to intensive deleveraging of banks and businesses). In 2014, the still present political and, therefore, macroeconomic uncertainty and instability in the first half of the year will have a negative impact on foreign investments, while the continuation of EU accession negotiations and possible renewal of IMF arrangement would send a positive signal to investors. Still, unless in 2014 something significantly changes, we believe that there is a great possibility of modest results in capital inflow from 2013 repeating this year as well.

Current deficit in October and November on a slight rise...

Current account deficit in October and November 2013 was 172 million euros, i.e. 3.1% of GDP (Table T4-1). The realised deficit was by 2.4 pp lower compared to the same period of the previous year (October-November 2012) and significantly lower compared to the quarterly share of

1 At the moment of submitting QM to printing, the data on the current account for 2013 haven't been published yet, but the data on some of its elements (trade balance) have. Therefore, this chapter analyses balance of payments for the period January-November 2013 and gives estimates for entire 2013.

deficit in GDP in 2012 and in Q1 2013. Still, compared to Q3, the realised deficit is on a slight rise (1.2 pp of GDP). Most of the improvement of the current deficit is still the result of reduced foreign trade deficit due to increased exports, while the inflow of current transfers remained unchanged.

Exports recorded a significant increase during 2013, reaching at the end of the year ¾ of import value

Trade deficit was 651 million euros, i.e. 11.9% of GDP, which is 4.0 pp of GDP lower than the realised share in October and November 2012. Reduction of the trade deficit is the result of a fast growth of exports, accompanied by a modest growth of imports. During October and November 2013, goods in the value of 2,049 million euros were exported. So the exports in this period were higher by almost ¼ of the value realised in the same period of the previous year. In the observed two month period of 2013, the imports were 2,700 million euros, which is by 7.9% above the value realised in the same period of 2012.

In order for the foreign trade deficit to continue its reduction in 2014, the exports need to record a growth at a rate at least a third higher than the growth rate of imports

Share of exports in GDP has been at a high level of around 37% of GDP since mid 2013, which is high compared to historical data for Serbia, but still lower than in small open economies in the region[2]. In the observed two month period (October-November 2013), it reached 37.3% of GDP. That is 5.6 pp above the realised share in the same period of 2012. Share of imports in GDP was 49.1%, which is just one pp above the recorded value from the same period in 2012 (Table T4-1). Even though the coverage of imports by exports was significantly higher at the end of 2013, the exports are still by ¼ higher than the value of imports. Therefore, in order for the foreign trade deficit to continue its reduction in 2014, the exports should record a growth at a rate that is at least one third higher than the growth rate of imports.

Constant inflow of current transfers and remittances

During October and November 2013, the share of net inflow of current transfers was 10.0% of GDP. So this share has been very stable at a level of 10% of GDP since 2011.

Remittances in October and November, as well as in 2012 and 2013, were around 7% of GDP. This confirms that in Serbia, as well as other developing countries, there is a dominant inflow of remittances and current transfers and stable inflow of foreign capital. This also confirms, as stated in economic literature, that these inflows are considerably less sensitive to economic cycles and shocks than Foreign Direct Investments and other private and state flows of capital. Having this in mind, Serbia should influence more heavily directing them to savings and investments, in order to secure, in addition to their direct impact that these inflows have on current spending, that redirecting them to more productive purposes would contribute to the economic growth and development of the country in the long term.

Low capital inflow is the result of a modest net inflow of FDI and portfolio investments, with net outflow of other investments

From January to November, the net capital inflow was 873 million euros and it was enough to cover the current deficit in the same period, causing the foreign reserves to drop by 214 million euros. Net FDI inflow was 643 million euros (2.2% of GDP). At the same time, the net outflow of other investments was quite high in the amount of 905 million euros. In addition, the portfolio investments were quite unstable (see Table T4-1).

October and November recorded a capital inflow of 158 million euros. Therefore, despite the extremely reduced value of the current deficit, the realised capital inflow was not enough to cover it, which caused a reduction of foreign reserves by 24 million euros (Table T4-1). The low capital inflow is the result of a modest net inflow of FDI and portfolio investments, with a net outflow of other investments. Portfolio investment inflow in October and November was 202 million euros and it was mostly due to the slightly increased interest of the foreign investors in investing into dinar state (NBS and treasury) bonds (see the section on Monetary Policy), because of the external factors – FED decision in September on delaying the reduction of quantitative reliefs, as much as the internal factors – high dinar interest rate with a credible NBS policy of preventing a sudden depreciation of dinar. FDI is still low in the amount of 125 million euros, while the recorded net outflow on Other Investments account was 169 million euros. Within other investments there was a modest inflow on the Trade Loans account, accompanied by an outflow for financial loans on the Cash and Deposits account.

2 See previous issue of *QM*.

Negative balance of net financial loans are predominantly the result of NBS deleveraging the IMF debt

Negative balance of net financial loans of 177 million euros is mostly due to the deleveraging of the National Bank of Serbia for the purpose of repaying the loan to IMF (122 million euros were paid from foreign reserves for these purposes). The banks had a net borrowing of 17 million euros, with recorded borrowing of short-term loans (45 million euros), and deleveraging of short--term loans (28 million euros). The business sector deleveraged 64 million euros net. The Cash and Deposits account recorded a reduction of 146 million euros net.

During 2013, the foreign reserves increased by 274 million euros

From January to November, the NBS foreign reserves were reduced by 214 million euros (Table T4-1), while at the annual level they increased by 274 million euros[3] (primarily due to additional state borrowing in December). Despite the fact that during 2013 there was a considerably higher deleveraging of other investments than in 2012 (by November, the deleveraging of other investments amounted to 905 million euros – nine times higher than in 2012), the significantly lower current deficit, as well as somewhat higher FDI inflow than in 2012 together with cumulatively high inflow of portfolio investments (primarily as a result of state borrowing), contributed to the recorded increase of foreign reserves in 2013.

Table T4-1 Serbia: Balance of Payments

	2011	2012	Jan-Nov	2012		2013			
			2013	Q3	Oct-Nov	Q1	Q2	Q3	Oct-Nov
	mil. euros								
CURRENT ACCOUNT	-2,870	-3,185	-1,247	-551	-291	-625	-290	-160	-172
Goods	-5,318	-5,480	-3,492	-1,191	-834	-1,151	-1,005	-685	-651
Export f.o.b[1)]	8,440	8,732	10,058	2,221	1,669	2,235	2,685	3,089	2,049
Import f.o.b[1)]	-13,758	-14,212	-13,551	-3,412	-2,503	-3,386	-3,690	-3,774	-2,700
Services	163	152	271	34	57	34	79	90	68
Export	3,032	3,090	3,061	839	532	698	826	948	590
Import	-2,869	-2,938	-2,790	-805	-475	-664	-747	-857	-522
Income, net	-758	-798	-932	-156	-121	-190	-244	-362	-137
Receipts	428	548	436	138	78	102	146	110	79
Payments	-1,186	-1,346	-1,368	-293	-200	-291	-389	-472	-215
Current transfers, net	3,043	2,941	2,906	762	607	681	879	797	549
o/w grants	206	144	111	43	26	30	32	30	18
o/w private remittances, net	2,065	1,934	2,008	483	428	457	630	554	367
CAPITAL ACCOUNT	-3	-11	11	-1	-1	-2	9	4	0
FINANCIAL ACCOUNT	2,694	2,999	1,087	479	245	602	235	62	187
Direct investment, net	1,827	242	643	117	158	155	139	224	125
Portfolio investment, net	1,619	1,720	1,134	-37	1,450	1,402	-347	-123	202
Other investments	1,049	-101	-905	60	-474	-95	-443	-202	-164
Trade credits	493	506	278	16	-42	68	12	39	159
Loans	-413	-434	-887	-160	-91	-366	-291	-53	-177
NBS	45	-219	-600	-111	-105	-150	-148	-180	-122
Government	687	261	469	86	20	162	42	273	-8
Commercial banks	-729	-476	-503	-28	102	-308	-43	-169	17
Long-term	419	-323	-256	-46	-37	-179	-1	-48	-28
Short-term	-1,148	-154	-246	18	139	-129	-41	-121	45
Other (enterprises)	-416	0	-253	-108	-109	-70	-142	22	-64
Currency and deposits	970	-172	-295	204	-341	203	-165	-188	-146
Other assets and liabilities	0	0	0	0	0	0	0	0	0
Allocation of SDR	0	0	0	0	0	0	0	0	0
Reserves Assets (- increase)	-1,801	1,137	214	340	-890	-859	886	164	24
ERRORS AND OMISSIONS, net	179	197	149	73	47	25	46	94	-16
OVERALL BALANCE	1,801	-1,137	-214	-340	890	859	-886	-164	-24
PRO MEMORIA									
	in % of GDP								
Current account	-9.1	-10.8	-4.2	-7.5	-5.5	-8.2	-3.5	-1.9	-3.1
Balance of goods	-16.9	-18.6	-11.7	-16.2	-15.9	-15.1	-12.0	-8.2	-11.9
Exports of goods	26.8	29.6	33.6	30.2	31.7	29.3	32.1	36.8	37.3
Imports of goods	-43.6	-48.2	-45.3	-46.3	-47.6	-44.4	-44.1	-45.0	-49.2
Balance of goods and services	-16.3	-18.1	-10.8	-15.7	-14.8	-14.6	-11.1	-7.1	-10.6
Current transfers, net	9.7	10.0	9.7	10.3	11.5	8.9	10.5	9.5	10.0

Source: NBS
1) FOB exports, according to the NBS methodology adjusted to the IMF BOPM-5.
2) Quarterly values. Conversion of annual GDP to euro was done by average annual exchange rate (average of official daily NBS exchange rates).

3 NBS, with cross-currency changes – current exchange rate.

Only in Q1 of entire 2013 was there an increase of foreign reserves as a result of a considerable state borrowing in February. Otherwise, if the state hadn't increased its debt in February by selling state bonds in the value of 1,165 million euros, the decline of forex reserves during 2013 would have amounted to 1.38 billion euros by November. In the period from Q2 to November, the foreign reserves were reduced by 1.1 billion euros. Cumulative reduction of foreign reserves during October and November was 24 million euros. In these two months, the largest outflow of foreign reserves was created due to the withdrawal of the higher mandatory bank reserves for the payment of matured euro-denominated RS state bonds, settling of obligations towards foreign creditors, and debt repayment towards IMF. Significant inflow of foreign currency was the result of the sale of euro and dinar denominated RS state bonds[4] on the domestic financial market. In October, dinar nominally appreciated, while in November it kept an almost unchanged value towards the euro. In order to maintain the stability of the exchange rate, NBS started intervening heavily since mid-2013 by buying and selling foreign currency at the interbank foreign exchange market.

Exports

Exports still recorded a significant y-o-y growth in Q4, even though they decelerated compared to Q3

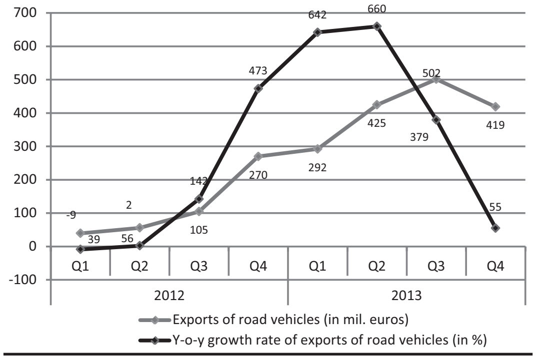
According to the data from the Statistical Office of the Republic of Serbia (SORS), during Q4 exports amounted to 2,958 million euros, i.e. they recorded a year-on-year growth of 22.2%. Thus, after a strong growth of exports in the previous quarter (38.5% y-o-y), the exports have decelerated their growth in Q4 (Table T4-2). In Q4, as in entire 2013, the main driver of exports growth was the automobile industry's export. Besides automobiles, the high growth of exports in 2013 was also the result of the effects of previous investments in oil industry. In addition to that, a relatively good agricultural season and the resulting increased exports of these products had a favourable impact on the growth of total exports in the second half of 2013.

Table T4-2 Serbia: Exports, y-o-y growth rates, 2011–2013

	Exports share in 2013	2011	2012	2013	2012		2013		2012		2013	
					Q3	Q4	Q3	Q4	Q3	Q4	Q3	Q4
	in %	in mil. euros							in %			
Total	100.0	8,441	8,822	11,076	2,255	2,422	3,125	2,958	4.5	11.9	38.5	22.2
Total excluding road vehicles	85.2	8,253	8,352	9,439	2,151	2,152	2,623	2,540	1.7	1.7	22.0	18.0
Energy	4.7	310	303	523	65	90	145	151	-6.0	48.2	125.3	68.2
Intermediate products	33.7	3,980	3,187	3,731	812	758	1,012	901	-19.8	-16.7	24.5	18.8
Capital products	26.9	1,001	1,667	2,983	410	623	859	793	63.9	102.1	109.4	27.2
Capital products excluding road vehicles	12.2	813	1,197	1,346	306	353	358	374	47.9	35.2	17.0	5.9
Durable consumer goods	4.8	347	395	529	106	111	142	147	18.5	19.1	33.8	32.5
Non-durable consumer goods	21.8	2,118	2,230	2,412	598	611	675	674	4.6	5.2	12.8	10.3
Other	8.1	686	1,039	898	264	229	292	293	60.6	8.8	10.7	28.0

Source: SORS

Graph T4-3 Exports of road vehicles, 2012-2013



Source: SORS

Exports of road vehicles began a sudden growth during 2012 (Graph T4-3). In Q2 and Q3 2013 these exports reached a very high level, only to slightly drop in Q4. Therefore, after an extremely high year-on-year growth rates in the first half of 2013, the growth slowed down in Q3 and was almost entirely exhausted in Q4 (due to including Q4 2012 exports as a high base). Therefore, as the growth has been exhausted, the most we can expect in the coming period is a stagnation in the exports of these products.

Still, the exports after excluding road vehicles slightly decelerated their growth (18.0% in Q4

4 Part of the investors are bringing foreign currency into Serbia and selling them at the foreign exchange market in order to obtain dinars to buy NBS and Treasury securities. This investors' behaviour indicates that they expect the interest rates on dinar securities to be (considerably) higher than the sum of interest rates at the global market and expected dinar depreciation.

compared to 22.0% in Q3), despite the favourable impact of the moderate real appreciation of the domestic currency at the beginning of 2013. This was primarily a consequence of economic activity and industrial production slowing down in Q4, as well as a very slow recovery of the eurozone. Economic activity of the eurozone countries is expected to recover in 2014, which will have a positive impact on the domestic exports. On the other hand, exhausted potential of the automobile industry and lack of new large exporters will significantly reduce the overall export results.

Exports of all export groups, with the exception of exports of Other Products, decelerated growth compared to the previous quarter

Exports of Capital Products are suddenly decelerating their growth. After the year-on-year growth of over 100% for four consecutive quarters, in Q4 2013 the y-o-y growth was 27%. Exports of *Capital Products* after excluding road vehicles recorded a y-o-y growth at a rate of 5.9%. This means a decelerated growth compared to the previous quarter, but also to the growth recorded in the first two quarters of 2013. Exports of *Intermediary Products,* after a year-on-year growth of 24.5% in Q3, recorded a growth of 18.8% in Q4.

Exports of *Non-durable Consumer Goods* also decelerated compared to Q3, although they are accelerating compared to the first half of the year. Growth of exports of *Durable Consumer Goods* is still high at 32.5%.

Exports of products classified under *Other Exports* recorded a significantly accelerated growth. That is, exports of products in this group was higher by 28.0% in Q4 compared to the Q4 2012 values.

In 2013, the foreign trade deficit was significantly reduced, and coverage of imports by exports reached 72%

At the annual level, a much faster growth of exports was recorded than of imports, which significantly increased the coverage of imports by exports and reduced the current deficit. Exports in 2013 were 11,076 million euros, which is a 25.6% growth compared to the exports realised during 2012. At the same time, imports were 15,478 million euros (y-o-y growth of 4.8%). Thus, the coverage of imports by exports increased: from 60% in 2012 to 72% in 2013. This is the biggest coverage of imports by exports in the recent period, but additional improvement is needed, because the current balance deficit of 5% of GDP is still high. Foreign trade deficit in 2013 was by a quarter (i.e. 1.55 billion euros) below the one from 2012.

Imports

In Q4 2013 y-o-y growth of imports was 5.6%...

Imports in Q4 were 4,215 million euros, which is 5.6% above the Q4 2012 values (Table T4-4). After the accelerated growth recorded in the first three quarters of 2013, imports decelerated their growth in Q4. The main reason is the continuing low domestic demand, which is the result of the fiscal consolidation measures taken so far.

....which will be significantly limited in the coming period

We believe that the growth of imports in 2014 will be, on the one hand, limited by a low domestic demand due to decelerated growth of production in the automobile industry, which will manifest through a decelerated growth of imports of car components. Low (even negative)[5] credit activity will have the same impact on imports, if it continues in 2014. In addition, private and state spending will drop and this will decelerate the growth of imports[6].

Energy imports are accelerating growth

The period of year-on-year reduction of Energy imports ended in Q3 2013, when the import of energy recorded a 5.3% growth and accelerated towards the end of the year. The imports of these products in Q4 were 9.5% above the Q4 2012 values. This can be explained by the fact that the effects of earlier investments in oil industry have been mostly depleted and that Q4 2013 is being compared to a low last year's base. Therefore, the imports excluding energy recorded a y-o-y growth of 4.8%, which is an expressed deceleration of growth of thus observed imports compared to the growth from the previous quarter.

5 See the section on Monetary trends and policy.
6 See the section on Economic activity and the section on Fiscal trends and policy.

Table T4-4 Serbia: Imports, y-o-y growth rates, 2011–2013

	Imports share in 2013	2011	2012	2013	2012 Q3	2012 Q4	2013 Q3	2013 Q4	2012 Q3	2012 Q4	2013 Q3	2013 Q4
	in %	in mil. euros							in %			
Total	100.0	14,250	14,771	15,478	3,554	3,990	3,913	4,215	1.6	1.4	10.1	5.6
Energy	15.1	2,846	2,583	2,339	535	678	563	742	-10.6	-20.7	5.3	9.5
Intermediate products	32.4	5,030	5,131	5,010	1,301	1,291	1,321	1,254	-0.7	4.5	1.5	-2.9
Capital products	23.3	2,812	2,994	3,600	726	887	913	982	5.8	12.4	25.7	10.7
Durable consumer goods	1.9	320	322	301	80	82	70	79	0.5	-15.0	-12.9	-3.4
Non-durable consumer goods	14.2	2,176	2,168	2,197	551	625	558	599	-5.0	3.7	1.3	-4.1
Other	13.1	1,066	1,573	2,031	360	427	489	558	47.6	20.3	35.7	30.5
Imports excluding energy	84.9	11,404	12,189	13,139	3,019	3,312	3,350	3,472	4.1	7.6	11.0	4.8

Source: SORS

Imports were reduced in as many as three categories

Observed year-on-year, in as many as three categories – Intermediary Products, as well as Durable and Non-durable Consumer Goods – the imports have been reduced (Table T4-4). Decrease of imports of Intermediary Products could indicate a decelerated production in the coming period. Capital products are increasing at a y-o-y rate of 10.7%. It is still a decelerated growth compared to the previous quarters. This deceleration is owed to the reduced imports of components for the production of cars, as well as to the fact that Q4 is being compared to a high base.

Products classified under Other Imports still have a significant growth

Still, products classified under Other Imports still have a significant y-o-y growth of 30.5%. As mentioned in previous issues of QM, in addition to Capital Products, components for the production of FIAT automobiles are also classified in this group.

Foreign debt

Serbia's foreign debt at the end of December was 25.8 billion euros, i.e. 79.2% of GDP

At the end of December 2013, Serbia's foreign debt amounted to 25.8 billion euros, i.e. 79.2% of GDP[7].

Increase of foreign debt in 2013 is due to the increase in public sector's foreign debt...

During 2013, the total foreign debt increased by 121 million euros net, where public sector's foreign debt increased by 986 million euros, while private sector's decreased by 865 million euros. Therefore, the growth of country's foreign debt in 2013 is exclusively the result of the growth of public sector's foreign debt. Private sector, banks and companies, have reduced the amount of their foreign debt from both long-term and short-term loans.

...mostly realised during Q1 …

while the private sector has been deleveraging its debt

Long-term foreign debt of the private sector was reduced by 584 million euros, out of which the highest reduction was due to the deleveraging of the banking sector (which in 2013 deleveraged 443 million euros). The business sector reduced the amount of its long term foreign debt by 142 million euros. Compared to 2012, the level of short-term borrowing is quite lower for both banks (by 257 million euros) and businesses (by 25 million euros).

Increase of foreign debt during Q4 was exclusively due to the growth of public sector's foreign debt

During Q4, total foreign debt increased by 156 million euros, i.e. by 0.4 pp of GDP. This growth was exclusively due to the increase in public sector's foreign debt (a growth of 387 million euros, i.e. 0.8 pp). On the one hand, this net increase is the result of inflow of funds from the sale of 845 million euros of RS state bonds in December at the international and domestic financial markets, which in turn was reduced by the outflow of funds for the repayment of debt on matured securities and deleveraging of NBS toward IMF. At the same time, the private sector reduced its foreign debt by 231 million euros, out of which 263 million euros were long-term borrowing, while short-term borrowing slightly increased. Banks deleveraged its long-term loans by 234 million euros, and the business sector by 29 million euros. Banks' short-term borrowing increased by 34 million euros, while the business sector's slightly decreased - by 5 million euros, compared to Q3 (Table T4-5).

Having in mind the planned level of fiscal deficit, it is estimated that in 2014 the growth of public sector's debt will continue. It will be accompanied by a reduction of private sector's debt, if the

7 With the latest revision of the statistics, the data on nominal GDP have been adjusted downward, which caused an increase in the share of all macroeconomic variables in GDP. Considering that the GDP revision was published just before QM went to printing, this issue uses old unadjusted GDP data.

recent trend of intense bank and private sector deleveraging is continued. Even though private sector deleveraging will mostly compensate for the increase of public sector's debt, the unfavourable structure of the total debt in favour of public sector's debt will be expressed even more in 2014. Therefore, the right measure of risk in Serbia in the coming period is not the mere level of foreign debt, but its structure, which reflects the unfavourable state of economy – a relative inactivity of the private sector for a long time, which is giving no signs of a potential recovery or a more significant activity, large and growing needs of the public sector, which in absence of activity in other parts of the economy tend to become unsustainably se lf-generating.

Table T4-5 Serbia: Foreign debt structure, 2010–2013

	2010	2011	2012	2013			
				Mar.	Jun	Sep.	Dec.
	stocks, in EUR millions, end of the period						
Total foreign debt	23,786	24,125	25,721	26,722	26,072	25,686	25,842
(in % of GDP) 4)	*85.1*	*76.5*	*87.1*	*88.1*	*83.4*	*79.6*	*79.2*
Public debt1)	9,076	10,773	12,187	13,483	12,914	12,786	13,173
(in % of GDP)4)	*32.5*	*34.2*	*41.3*	*44.5*	*41.3*	*39.6*	*40.4*
Long term	9,076	10,773	12,187	13,483	12,914	12,786	13,173
o/w: to IMF	1,529	1,618	1,389	1,245	1,079	890	697
o/w: Government obligation under IMF SDR allocation	449	459	452	454	447	441	434
Short term	0	0	0	0	0	0	0
Private debt2)	14,710	13,352	13,534	13,240	13,158	12,900	12,669
(in % of GDP) 4)	*52.6*	*42.3*	*45.9*	*43.7*	*42.1*	*40.0*	*38.8*
Long term	12,880	12,704	13,040	12,879	12,849	12,719	12,457
o/w: Banks debt	3,362	3,782	3,672	3,530	3,511	3,463	3,229
o/w: Enterprises debt	9,518	8,922	9,369	9,348	9,336	9,255	9,227
o/w: Others	0	0		1	1	1	1
Short term	1,830	648	493	361	309	180	212
o/w: Banks debt	1,731	582	428	303	261	135	171
o/w: Enterprises debt	100	66	65	58	47	45	41
Foreign debt, net 3), (in% of GDP)4)	49.3	38.3	50.2	49.1	49.3	47.2	44.9

NOTE: External debt of the Republic of Serbia is calculated on a due-for-payment basis and includes the amount of debt under principal and the amount of accrued interest which is not paid at the agreed due date.
Source: NBS, QM
1) External debt of the public sector of the Republic of Serbia comprises government debt (including debt of Kosovo&Metohija under loans concluded before the arrival of the KFOR mission, non-regulated debt towards Libya and clearing debt towards former Czechoslovakia), debt of the National Bank of Serbia, local governments, state funds and agencies, and government-guaranteed debt.
2) External debt of the private sector of the Republic of Serbia comprises debt of banks, enterprises and other sectors which is not government-guaranteed. External debt of the private sector does not include loans concluded before 20 December 2000 in respect of which no payments are made (EUR 836.3 million, of which EUR 383.2 million relating to domestic banks and EUR 453.1 million to domestic enterprises).
3) Total foreign debt minus NBS forex reserves.
4) Uses the sum value of GDP of the observed quarter and previous three quarterly values of GDP.

5. Prices and the exchange rate

Since the beginning of 2013, the inflation in Serbia was exceptionally low; this trend continued until the end of the year, when the inflation stood at record low 2.2%, which is slightly below the NBS target band. The slowdown in inflation and its drop to a historically lowest level were mostly affected by a low domestic demand as well as the relative stability of the dinar. Although inflation in January 2014 amounted to a relatively high 1.5%, it is estimated that this leap is of a temporary nature, given that it was caused by a seasonal increase in the prices of food, as well as one-off growth in the prices of energy and utilities and in a small part, by an increase in special VAT rate and excise duties. Primarily due to a low domestic demand, caused by a realistically lower planned public spending on wages, pensions, goods and services, as well as the stagnation in wages caused by high unemployment, it can be expected that there will be no releasing of the inflation outside the permitted NBS target band in the following period. The nominal exchange rate was relatively stable until December, whereas, since then, the depreciation trend that has lasted in the last three months is noticed. Strong depreciation pressures are largely driven by global factors, but they are to some extent influenced by unfavorable movements in the balance of payments in Serbia. Therefore, it is not obvious whether the dinar weakening is only temporary or that trend will continue in the following months, which could then affect the inflation on a long run. Although in comparison to December dinar temporarily really appreciated in January, in real terms it is weaker by about 0.8% when compared to its value in January 2013, while February expects its further mild depreciation.

Prices

The Q4 inflation fell below the lower limit of the NBS target band

… while it returned within the target band in January

Table T5-1. Serbia: Consumer Price Index, 2008-2014

	Consumer price index				
	Base index (avg. 2006 =100)	Y-o-y growth	Cumulative index	Monthly growth	3m moving average, annualized
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					
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					
mar	175.1	11.2	1.2	0.0	4.7
jun	178.2	9.7	2.9	1.0	7.3
sep	177.3	4.8	2.4	0.0	-2.0
oct	177.6	2.2	2.6	0.2	2.3
nov	176.5	1.6	2.0	-0.6	-1.8
dec	176.9	2.2	2.2	0.2	-0.9
2014					
jan	179.5	3.1	1.5	1.5	4.4

* Moving average of the monthly price growth in three months, raised to an annual basis. (For example, the March value was obtained by increasing the average of monthly price growth in January, February and March to an annual level).
Source: SORS.

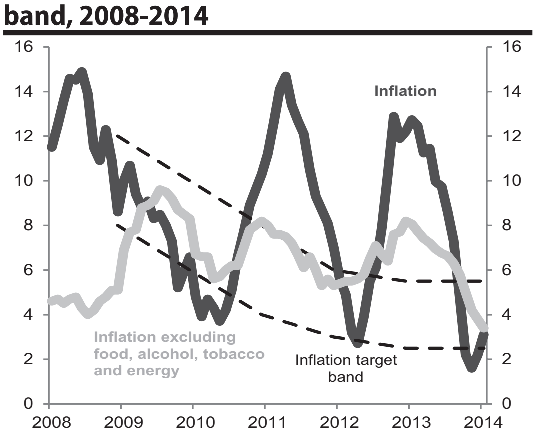
The inflation slowdown continued in Q4 and at the end of the year stood at 2.2%. After inflation reached its targeted level in September, it fell below the target tolerance band (4 ± 1.5%) in October and it stayed there until the end of 2013 (Table T5-1). Various things contributed to such a low inflation: low domestic demand, relative stability of the dinar exchange rate, negative imported inflation in Q3 and Q4, drop in the prices of primary agricultural products due to a good agricultural season in the country and the world, as well as cautious and relatively slow mitigation of the restrictiveness of monetary policy during 2013.

After reaching a record low value of 1.6% in November 2013, year-on-year inflation stabilized around the lower limit of the target corridor and stood at 3.1% in January. Underlying inflation (inflation excluding food, alcohol, tobacco and energy products) is also located within the acceptable values and in January it amounted to 3.4%, which is its lowest level in recent years (Graph T5-2). In the coming months, we can expect further moderate growth of the overall inflation and stabilization of underlying inflation and their movement within the corridor. Inflation growth could be affected by further (seasonally expected) growth in the food prices, spillover effect due to a dinar depreciation in the period from December to February and due to an increase in specific VAT rate and excise duty, which were mostly manifested in January. On the other hand, low domestic demand can influence this effect, as happened during the previous year, not to manifest completely in the following period.

NBS continues with a gradual moderation in restrictiveness of monetary policy

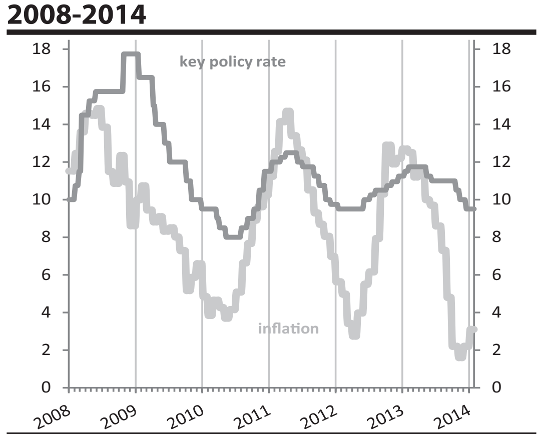
Relatively modest reduction in the key policy rate in recent months and its retention at the level of 9.5% (Graph T5-3) suggest the cautiousness of the NBS in keeping the inflation within the target band, given that there are still significant risks related to a credible implementation of fiscal adjustment measures, the decline of liquidity in the international financial market, as well as a further existence of the external imbalance and the need for external financing. Moreover, there is a risk that high imbalances existing in Serbian economy destabilize the dinar exchange rate, which would further, due to a high euroization, soon spread to inflation. Throughout Q4 the key interest rate was reduced three times by 50 base points in October, November and December, while since the beginning of 2014 until the end of February, it remained at the December level of 9.5%. The external deficit has been significantly reduced, primarily due to the growth in exports (but the possibility of the export growth on the basis of the existing capacities is largely exhausted), while the existence of multy-year high fiscal deficit and the rapid growth in Serbia's public debt, as well as the growth in the share of non-performing loans in total loans, create unfavorable conditions for the maintenance of low inflation in the economy. In these conditions, the restrictive monetary policy must be implemented even when the inflation is at its record low level, which has negative consequences for the long-term economic growth. In order to preserve macroeconomic stability, a further reduction in the restrictiveness of monetary policy by decreasing the key interest rate and the rate of required reserves would have to be accompanied by a resolution of the problem of structural imbalances- primarily by reducing the excessively high fiscal deficit and mitigating the external imbalances.

Graph T5-2. Serbia: y-o-y inflation rate and underlying inflation and the NBS target band, 2008-2014



Source: NBS and *QM* calculation

Table T5-3. Serbia: NBS reference interest rate and y-o-y inflation rate, in %, 2008-2014



Source: NBS

During the period when the NBS implements the regime of targeted inflation, one can notice high variability in inflation. For the most of this period, inflation moved outside the target band (see Graph T5-2), while the underlying inflation also moved outside this target band in a significant period of time (most of the 2012 and 2013). The main source of the inflation variability were variations in the exchange rate, and occasionally the variations in the prices of food and energy, whose growth spilled over to the prices of a substantial part of other products, thus making underlying inflation grow as well.

Deflation in Q4 and high monthly inflation in January 2014

A total price drop of about 0.2% in Q4 was followed by a relatively high inflation in January of about 1.5%, thus the three-month inflation amounted to 4.4% when annualized. During Q4, the largest disinflationary contribution came from the fall in the prices of food and non-alcoholic beverages (Table T5-4), mainly in November. In December, food prices began to rise, which continued during January, so the total reduction of these prices in Q4 was annulled with the increase in January (contribution to inflation of -0.7 percentage points in Q4 and +0.8 pp in January). Similar effect was made by the changes in the prices of petroleum products, whose drop of about 1.5% in Q4 had a disinflationary effect with about 0.1 percentage points, while January growth of about 1.4% increased the inflation for the same amount of 0.1pp. Seasonal growth in the prices of clothing and footwear of about 2.8% (0.1pp) had a significant effect on inflation in Q4. Next to the growth in the food prices (inflationary effect of the rise in prices of vegetables by around 12%, or 0.6 percentage points is especially pronounced) and petroleum products, a significant inflationary contribution was given by the rise in the prices of tobacco (9.5%, or 0.4pp) and other products that were affected by an increase in specific VAT rates and excise duties. The prices of computers, computer equipment, audio-visual and photographic equipment increased in January by 4.1%, and a similar growth was recorded by the prices of books (4.7%), while the utility prices also increased, giving a total contribution to inflation by about 0.1pp.

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

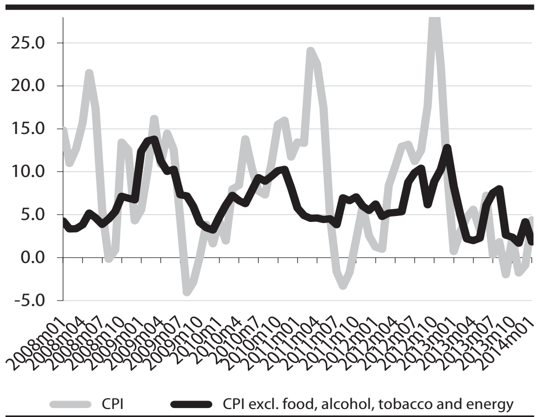
	Share in CPI (in %)	price increase in Q4 2013	Contribution to overall CPI increase (in p.p.)	Price increase in January 2014	Contribution to overall CPI increase (in p.p.)
Total	100.0	-0.2	-0.2	1.5	1.5
Food and non-alcoholic beverages	34.5	-2.0	-0.7	2.3	0.8
Food	30.9	-2.0	-0.6	2.5	0.8
Alcoholic beverages and tobacco	7.8	1.2	0.1	5.9	0.5
Tobacco	4.2	1.1	0.0	9.6	0.4
Clothing and footwear	4.6	2.8	0.1	-1.1	0.0
Housing, water, electricity and other fuels	13.0	0.3	0.0	0.8	0.1
Electricity	5.1	0.0	0.0	0.0	0.0
Furniture, household equipment, routine maintenance	4.1	0.8	0.0	-0.4	0.0
Health	6.4	0.1	0.0	1.2	0.1
Transport	12.3	-0.8	-0.1	1.0	0.1
Oil products	5.1	-1.5	-0.1	1.4	0.1
Communications	5.0	0.7	0.0	-0.5	0.0
Other items	12.2		0.2		0.0

Source: NBS and *QM* calculation

Overall, as well as underlying inflation are at a relatively low level

Underlying inflation (inflation excluding food, alcohol, tobacco and energy) stabilized at a relatively low level from November, thus the three-month average in January amounted to 0.46%, or 1.8% when annualized (Graph T5-5), while the overall inflation amounted to 1.08%, or about 4.4% when annualized. Such a low underlying inflation was affected by a relatively stable dinar exchange rate, as well as a fall in inflationary expectations of the citizens, economy and financial sector in recent months of 2013. However, the dinar exchange rate has moderately depreciated since the beginning of 2014, and the inflationary expectations of all three sectors have grown, both because of the reduction in Serbia's credit rating by Fitch agency, and the growth in the risk premium for Serbia (measured by the EMBI index), thus in the coming months we could expect a moderate growth in underlying inflation, which would still stay within the target band. Inflationary pressures could slightly increase in February due to the expected seasonal rise in the prices of the unprocessed food (vegetables), but this would be followed by similar disinflationary pressures in the coming months, when the prices of the same products would decrease. On

Graph T5-5. Serbia: CPI and Underlying Inflation Trend, Annualized Rates, in %, 2008-2014



Source: NBS and *QM* calculation

the other hand, it is almost certain that there won't be stronger inflationary pressures from the demand side, given that the overall domestic demand will decline in real terms due to a planned real decline in government spending that affects the demand for goods and services (salaries, pensions, spending on goods and services). In addition, the movement of wages in the private sector will not have inflationary effect since they are expected to stagnate due to a high rate of unemployment. The increase in the special VAT rate from 8% to 10%, as well as an increase in administratively controlled prices (utilities and natural gas) has influenced the rise of inflation in January, but their overall effect was modest.

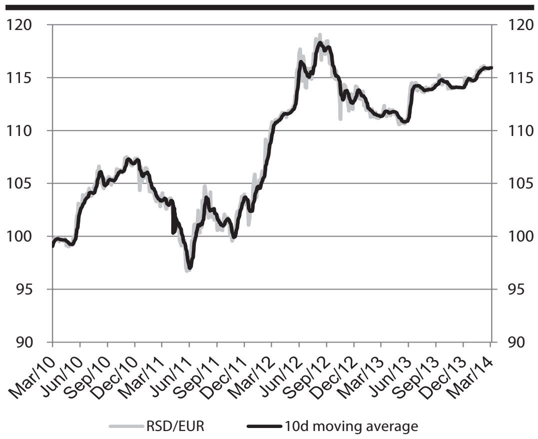
Control of inflation in Serbia is predominantly managed by using the foreign exchange rate

A strong correlation between the exchange rate movements and inflation suggests that in the conditions of a high euroization, it is not possible to apply a clean model of a targeted inflation in Serbia. A model of the targeted inflation implies that the central bank, primarily through the key policy rate, affects the interest rates of commercial banks, and the interest rates of commercial banks affect the movement of the domestic demand (investments, personal consumption) and inflation. In the conditions of a high euroization, the NBS impact on inflation is achieved indirectly- interest rates and interventions in the foreign exchange market influence the exchange rate movement, and the exchange rate movement has a crucial influence on inflation. In such circumstances, the exchange rate variations are transmitted on the inflation variations to a large extent, thus making this impact asymmetric- the dinar weakening (depreciation) transfers to inflation in a much higher level than its strengthening (appreciation). With regard to the impact of the exchange rate on the inflation, the NBS has intervened in the foreign exchange market more frequently and intensively than the other central banks do, particularly more frequent than those implementing a model of targeted inflation. The intensity of the NBS interventions in the foreign exchange market significantly exceeds the volume that could be explained by the intention to prevent the excessive daily volatilities of the exchange rate. It is obvious that the NBS, with strong interventions, has repeatedly tried, and more or less managed to influence the long-term exchange rate movement, and not only to alleviate the daily volatilities.

The Exchange Rate

Moderate dinar depreciation from December

Graph T5-6. Serbia: Daily RSD/EUR Exchange Rate, 2010-2014



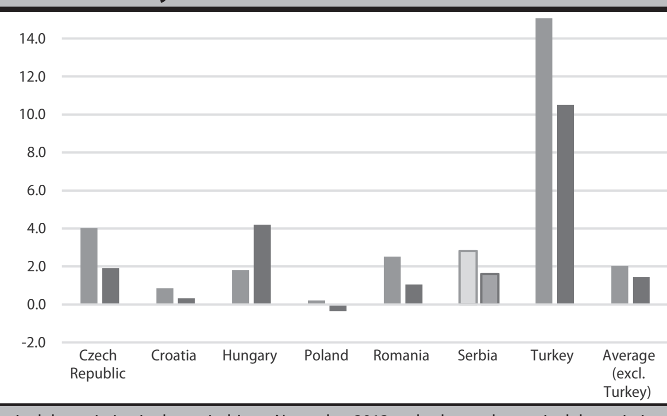
Source: NBS

The dinar exchange rate from July to the end of November was relatively stable, but the early December has shown the depreciation pressures that still persist. Since the exchange rate was sharply brought down in September and October of 2012, a moderate appreciation continued until the first significant shock in June 2013, when it came to depreciation of about 3%. Since then up until December, the exchange rate was relatively stable, at the level of about 114 dinars per euro. However, in early December a slight depreciation trend can be noticed, in January, the level of 115 dinars per euro was exceeded, and by the end of February in comparison to the early December, dinar depreciated by about 1.6% (Graph T5-6). NBS responded to appre-

Box 1. The exchange rate in the countries of Central and Eastern Europe

By observing the exchange rate in the countries of Central and Eastern Europe which conduct a flexible exchange rate policy, one can notice, on average, the trend of a mild depreciation (an exception is Turkey, where the strong depreciation of the lira has started since June 2013) and when observed in individual countries the exchange rate varies depending on the specific factors- discrete measures and circumstances in the economy of the specific country. In the observed group of countries (the Czech Republic, Croatia, Hungary, Poland, Romania, Turkey, see Graph T5-7), the highest depreciation occurred in Turkey- after the outbreak of social riots in Istanbul last summer, political instability and corruption affairs within the members of Turkish government, as well as due to the inadequate and non-credible measures of the central bank (the first decision not to raise the key interest rate, but to increase only a part of the required reserves in foreign currencies, and then making a necessary decision to nevertheless increase the reference rate by a significant amount) the lira has continued to weaken rapidly up until now. In other, politically stable, selected countries, the significant depreciation occurred in the Czech Republic at the end of 2013 and in Hungary in February of 2014. In addition to developments in the global financial market (reduced volume of quantitative easing by the FED), in both countries, depreciation was highly influenced by the implementation of the central bank measures: in Czech Republic, increased offers of domestic currency in order to stimulate economic growth and avoid expected deflation; and in Hungary, reduction in the key interest rate to a record low value, although the forint weakening was affected by the crisis in the neighboring Ukraine. On the other hand, the exchange rate in Poland was relatively stable and there was a record of a slight appreciation in the period of December 2013- February 2014. The stability of the exchange rate in Poland is the result of a high economic growth, low inflation and improvement in the foreign trade balance compared to the previous year, and is probably in part a result of transferring the interest of foreign investors to the markets of more stable Eastern Europe countries from the increasingly unstable Russian market (due to the crisis of political relations between Russia and the U.S. and EU, which has already led to a withdrawal of capital from Russia and drop of Ruble)

Graph T5-7. Nominal exchange reate depreciation (in%) in the period June-November 2013 and December-February 2014, in selected countries of Central and Eastern Europe



Note: blue color marks nominal depreciation in the period June-November 2013; red color marks nominal depreciation in the period December 2013- February 2014.
Source: Eurostat, NBS

When we exclude the extreme case of depreciation in Turkey (due to specific factors that have contributed to the instability in the country), we get the average moderate depreciation trend in both observed periods in the countries of Central and Eastern Europe. Serbia is slightly above this average, so it could be concluded that the dinar depreciation is largely a consequence of general international movements, and only to a minor part is the result of the specific factors related to Serbia. The improvement of the factors that negatively affect the stability of the financial market in Serbia, such as the poor state of public finances, (rapidly growing public debt, and high fiscal deficit), a low credit rating, low economic growth and others, could, as in the case of Poland, compensate for the impact of global trends and result in a stable exchange rate of the domestic currency.

ciation pressures that acted until December by purchasing a total of 525 million Euros. In this way, the NBS prevented the weakening of the competitiveness of the Serbian economy, alleviated the future depreciation pressures, and formed the foreign exchange reserves for the prevention of a sudden depreciation in the future. The depreciation pressures, "defense"of the dinar exchange rate and the sale of the foreign exchange rate have ensued from December. The NBS interventions in the interbank market intensified in February, so from December 2014 to the end of February, NBS has sold over 600 million Euros, while the exchange rate reached the level of about 116 dinars per euro.

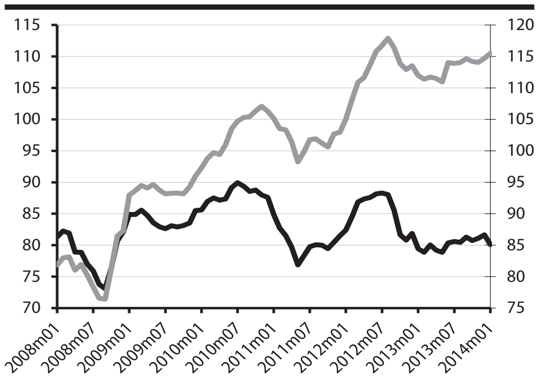
Global factors had the most impact on the exchange rate trend during the period appreciation and depreciation of the exchange rate. Following the FED decision on the postponement of reducing the volume of quantitative easing, appreciation pressures appeared as a result of calming down the reaction of financial market. Since January, FED has begun with gradual reduction in the volume of quantitative easing, which led to depreciation pressures not only in Serbia but also in most countries with emerging markets. Serbia is particularly exposed to the effects of FED's monetary policy due to a high fiscal imbalances and the fact that a large part of government securities is held by non-residents.

The excessively giving the importance to daily monitoring of the dinar exchange rate against the euro by all kinds of media and dramatized reporting which insists on changing the rate by a few tenths of per mile, can only have the purpose to fill a free media space, and usually does not contain any relevant information that would be of use for local businessmen, foreign investors and citizens in general. In contrast to the arbitrary assessment of the dinar exchange rate, based only on daily changes in its value, a certain amount of intention could be given to a long-term analysis of the exchange rate movement by economic experts, which certainly cannot be changed and communicated on a daily basis, and a serious economic journalism should be based on such an analysis.

Real depreciation reached its maximum at the end of Q4

The dinar really depreciated against the euro by 0.3% during Q4 and at the end of December, it was at approximately the same level as at the end of 2012 (Graph T5-8). However, since the beginning of 2014, not only due to a slightly higher inflation in Serbia, but also because of high deflation in the eurozone, the dinar really depreciated by about 2% in January. It is expected that this strengthening of the dinar will be only temporary, given that Serbia expects the reduction in the monthly rate of inflation, while further disinflationary trend in the eurozone would be unsustainable (January monthly deflation was 1.15%). Moreover, dinar continued to nominally depreciate during February, and a significant „drop"of the exchange rate has been prevented by a substantial NBS interventions in the interbank market. The continuation of the trend of moderate real dinar depreciation would improve the competitiveness of the economy with eligible costs of the foreign inflation and the costs of the loans.

Graph T5-8: Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly Averages, 2008-2013



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

6. Fiscal Flows and Policy

Fiscal deficit in 2013 ran at RSD 211 billion, or 5.7% of GDP, which is the largest fiscal deficit in the Central and Eastern Europe. Fiscal deficit widened although discretional expenditures (on subsidies, goods and services and capital investments) fell in the second half of 2013, because public revenues went down considerably, both real and as a GDP percent. Indications suggest that the savings partly came from the government's arrears, meaning that FY 2013 deficit is not real but artificially decreased (probably by 0.5% of GDP), and that FY 2014 deficit will be higher by equal percent. Real drop in revenues came from recession, illiquid companies, growing shadow economy, and numerous tax exemptions, granted in the previous years. At the end of January 2014 public debt stood at 63.5% of GDP. Without additional fiscal consolidation measures, and with other macroeconomic indicators unchanged, FY 2014 deficit could exceed projected 7.1% of GDP, in which case the public debt would amount to more than 70% of GDP by the end of the year. Recovery in public finance and economic growth are pre-conditioned by additional permanent savings of about 1% of GDP, which cannot be made without reduction in large items of current public expenditures (on pensions and wages in the public sector), urgent financial and business consolidation of public and state-owned companies and more efficient banking system monitoring by the NBS.

General tendencies and microeconomic implications

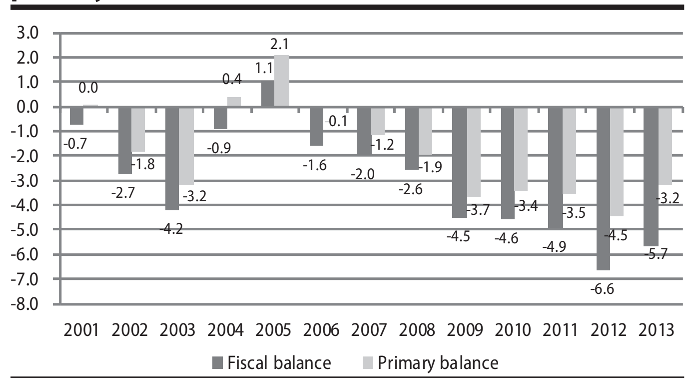
Fiscal deficit in Q4 runs at 4.3% of the quarterly GDP

Consolidated fiscal deficit in Q4 2013 ran at RSD 40.2 billion (about 4.3% of the quarterly GDP), which is below the planned. This partly came from a temporary slowdown in loss of revenues and a considerable reduction in discretional expenditures (on subsidies, goods and services, public investments) as of September 2013, intended to keep the annual fiscal deficit within projections. Reduction in subsidies is economically justifiable, but it should be gradual and accompanied by a sweeping reform in business environment. Likewise, reduction in expenditures on goods and services is justifiable, but it should be made strategically so that it does not cause shortages in the public sector (e.g. in the healthcare system) or the government does not fall into arrears on its liabilities. Reduction in capital expenditures is economically unjustifiable because they are already low (3.4% of GDP) and Serbia's infrastructure is neglected and poor, which adversely affects business environment and economic growth.

Increase in arrears on government liabilities casts a shadow on the reduction in expenditures

Increase in arrears on government liabilities casts a shadow on the reduction in expenditures achieved in Q4 2013. Government in arrears is a blatant example of financial indiscipline, which is unacceptable in an organized market economy, because a government should cover its liabilities on time and thus set an example to all market participants. Under crisis, arrears additionally impair liquidity and plunge the state into deeper recession. Savings based on arrears are temporary, similar to reduction in public investments which fell considerably after the change of local governments in large cities. Payment of the arrears, and rise in local investments, which could occur in the second half of 2014, will widen 2014 fiscal deficit, provided that other conditions remain unchanged.

Graph T6-1. Serbia: Consolidated fiscal balance and primary fiscal balance (% of GDP)[1]



Source: *QM* calculation

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.

Consolidated fiscal deficit in 2013 ran at 5.7% of GDP, or 6.2% inclusive of arrears

Consolidated fiscal deficit in 2013 amounted to RSD 211 billion, or 5.7% of GDP[1], and if the government covered all its contractual obligations and legal liabilities it would run at 6.2% of GDP. Expenditures on financial rehabilitation of banks and losses incurred by public and state--owned companies (repayment of state-guaranteed loans etc.) take up a considerable portion of the fiscal deficit (0.9% of GDP). Central government ran the largest deficit, while the Health Insurance Fund and local self-governments were in surplus. Central budget deficit is closely related to the pension fund deficit because financial transfers from the central budget to the pension fund in 2013 exceeded consolidated fiscal deficit. Local government budgets were in surplus partly because local public investments fell due to the change of government in several large cities, so this can be taken as temporary.

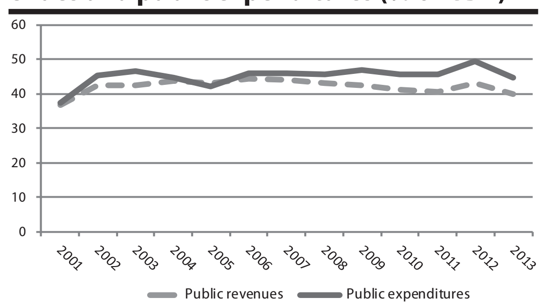
Primary fiscal deficit in 2013 runs at 3.2% of GDP, and inclusive of arrears it rises to 3.7% of GDP

Overall fiscal deficit can be divided into two components: primary fiscal deficit and interest payment. Primary fiscal deficit is a valuable indication of fiscal position of a country because it shows how large the deficit is when subtracted by interest payments. Primary fiscal deficit in 2013 ran at 3.2% of GDP, and inclusive of arrears it rises to 3.7% of GDP. This indicates a large imbalance between revenues and expenditures which is not public debt driven. Primary fiscal deficit shows how large fiscal deficit would be if Serbia's public debt equalled zero. Large primary fiscal deficit suggests that fiscal consolidation in Serbia, and in other countries, must be based primarily on reduction in non-interest expenses (salaries, pensions, subsidies, expenditures on goods and services).

Expenditures on interest payment ran at 2.5% of GDP – without reduction in primary fiscal deficit, Serbia could be faced with a self-generating public debt

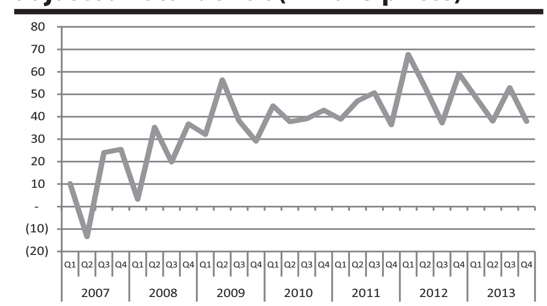
Expenditures on interest payment in 2013 ran at 2.5% of GDP, relative to only 0.7% of GDP in 2008, a pre-crisis year. Increase in these expenditures primarily came from the rise in public debt and interest rates[2]. This means that in order to slow down the growth in expenditures on interest payment it is crucial to curb public debt, which can be achieved through a sharp reduction in primary fiscal deficit. Otherwise, expenditures on interest payment will continue to grow, which could lead to a self-generating public debt, i.e. government borrows to pay interest on the existing debt.

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



Source: *QM* calculations

Graph T6-3. Serbia: Real seasonally adjusted fiscal deficit (in 2013 prices)



Source: *QM* calculations

To ensure public finance viability, additional permanent savings of 1% of GDP must be made in 2014

Public finance sustainability of a country is assessed according to the level and trends in public debt. Recent empirical research shows that consistency in public debt trends is more important for long-term economic growth and steady pace of economic activity than the debt level.[3] To improve viability of Serbia's public finance and set the basis for a long-term economic growth, reduction in fiscal deficit which would curb public debt in the mid-term (within three years), and reduce it afterwards, is necessary.

1 In the Ministry of Finance's official data, expenditures on financial rehabilitation of banks and companies are not included in the total expenditures. Consequently, official fiscal deficit stands at 4.8% of GDP. We think that for the purpose of transparency and credibility of Serbia's fiscal policy all expenditures should be recognized according to the international accounting standards.

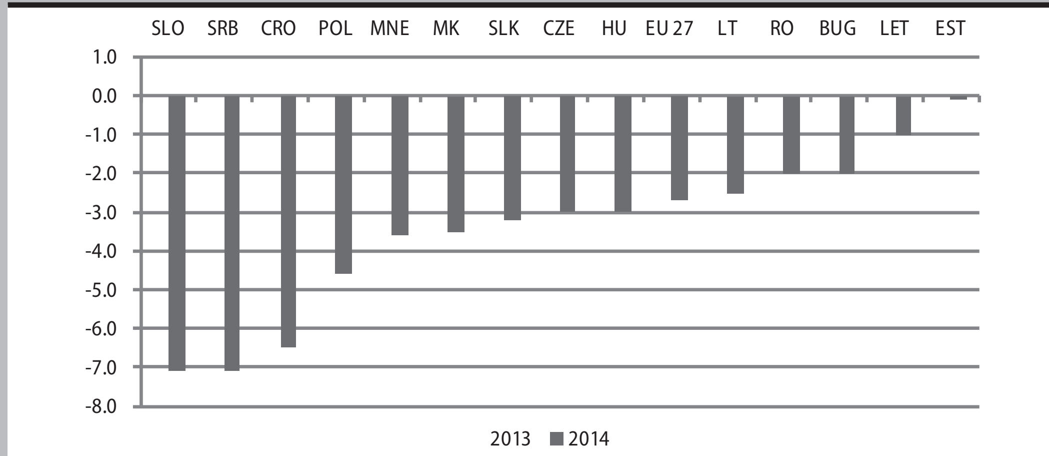
2 Although expenditures on interest payment to GDP ratio also depends on trends in GDP and real dinar exchange rate (about 80% of public debt is in foreign currency), influence of these factors was not big.

3 Pescatori, A., Sandri, D. and J. Simon (2014) „Debt and Growth: Is there a Magic Threshold?". *IMF Working Paper 14/34*

Box 1. Fiscal deficits in the Central and Eastern European countries in 2013 and 2014.

In 2013, two times in a row, Serbia ran the largest fiscal deficit among all Central and Eastern European countries. FY 2014 deficit is projected at 7.1% of GDP, which is twice as large as the average of fiscal deficits in other Central and Eastern European countries. Besides Serbia, only Slovenia and Croatia's fiscal deficits are projected to be this large. However, Slovenia's fiscal deficit mainly comes from the need to intervene in the banking sector, and Serbia and Croatia's fiscal deficits are driven by systemic causes, rather than short-term factors. Additionally, 2014 fiscal deficit is projected to widen relative to 2013 deficit, which is considered bad. There is a risk that without additional fiscal consolidation measures Serbia's 2014 fiscal deficit would be above the projected (failure to restructure the public and state-owned companies etc.). Serbia's 2014 fiscal deficit and its increase rate would thus rank among the largest in Europe.

Graph T6-4. Serbia and other Central and Eastern European countries: Fiscal deficit in 2013 and 2014 (% of GDP)



Source: European Economic Forecasts (2013) and the Ministry of Finance of the Republic of Serbia

...through reduction in salaries, pensions, state-owned companies consolidation and a more efficient banking sector monitoring system

For this purpose, reduction (permanent) in structural fiscal deficit by about 1% of GDP relative to the projections already in 2014 is necessary. This can be achieved only through massive reductions in major current expenditures (on salaries and pensions) in the second half of the year, urgent financial and business restructuring of public and state-owned companies as major state-guaranteed loan users, and more efficient banking sector monitoring by the NBS.

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

In 2013 revenues are going down... the drop in revenues slows down in Q4, but temporarily

After a continuous decline in previous quarters, Q4 2013 saw stabilization in public revenues. There was a slight real (seasonally adjusted) rise in public revenues (by 0.3%) in this quarter relative to Q3, and relative to the same period last year, the drop in public revenues slowed down to 0.1%. There was a real drop in annual public revenues by 3%, so 2013 public revenues were by one billion euro bellow the projected (in the Budget 2013). This drop in public revenues relative to the previous year and the projections is driven by recession, insolvency and illiquidity of economy in general, and growing shadow economy.

...and continues in January 2014

In January 2014 real seasonally adjusted public revenues fell by 0.4% relative to December 2013, primarily because revenues from personal income tax, social security contributions, and other tax and non-tax revenues went down.

Downwards trend in revenues from VAT continues...

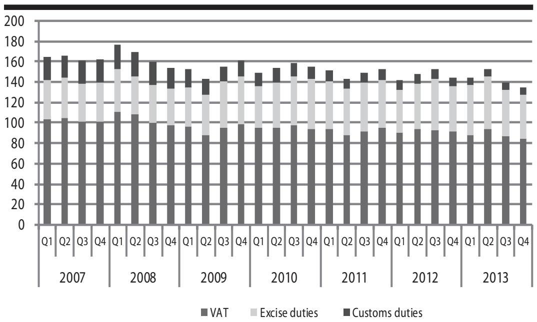
Real seasonally adjusted revenues from VAT went up in Q4 relative to Q3 (by 5.8%), mainly due to the VAT refund done in September, so they were compared against a much lower base (Q3 average). It is therefore more appropriate to make a y-o-y comparison of revenues from VAT in Q4. The data shows that there was a real drop in revenues from VAT in Q4 2013 by 5.2% relative to the same period 2012.

...mainly due to growing shadow economy and tax arrears

Continuation of the downwards trend in revenues from VAT in Q4 under a slight increase in economic activity, almost unchanged real dinar exchange rate, and real and relative (% of GDP) rise in imports suggests that the drop in these revenues was largely driven by growing shadow economy, and financial indiscipline in general. Total revenues from VAT in 2013 suffered a real drop (by 3.8%) relative to 2012, due to decline in domestic demand, slight real appreciation of dinar exchange rate, rise in shadow economy and financial indiscipline, and consequential increase in current tax arrears (tax return has been filed but tax has not been paid). Decline in domestic demand comes from drop in real income and loans, and cannot be attributed to the rise in VAT rate in 2012 (VAT rate increase from 18% to 20% could have caused a drop in domestic demand by 0.3% at the most, which is 1/10 of the total decline in demand).

Excise revenues are going up

Graph T6-5. Serbia: Trends in real consolidated seasonally adjusted revenues from consumption taxes (in 2013 prices)



Source: *QM* calculations

Real seasonally adjusted excise revenues went up slightly in Q4 2013 (by 0.4%) relative to Q3, and when compared to the same period 2012, these revenues grew considerably (by 8.2%). Since there is no indication of a rise in demand for excise goods, or systematic actions against shadow economy in this sector, this increase in excise revenues in Q4 relative to Q3 probably comes from a low base for comparison. There was a real rise in annual excise revenues (by 5.1%) driven by increase in excise rates and high inflation in 2012 (and consequently high indexation of excise duties) which went down in 2013.

Downwards trend in customs revenues continues

Customs revenues (real, seasonally adjusted) went down slightly in Q4 (by 1.8%) relative to the preceding quarter, and suffered a large real drop (by 9.3%) relative to the same period 2012, which is a continuation of a multi-year trend in these revenues. Under a stable real dinar exchange rate and a moderate rise in imports, continuation of the downwards trend in customs revenues (relative to Q3) could be driven by a change in the structure of imports (by commodity and country of origin) to a larger share of commodities with lower tariffs and commodities imported from countries which entered into free trade agreements with Serbia. Annual customs revenues in 2013 suffered a real drop of 15.6% due to a slowdown in imports (domestic demand), slight real appreciation of dinar exchange rate and continuation of a gradual reduction in tariffs on commodities imported from the EU (in accordance with the Stabilization and Association Agreement).

Revenues from personal income tax and social security contributions are rising...

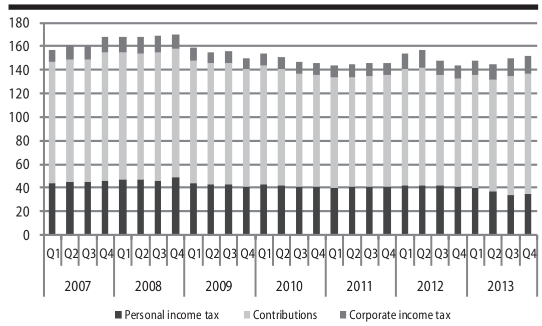
Revenues from personal income tax (real, seasonally adjusted) went up (by 4.9%) in Q4 relative to Q3, but relative to the same quarter 2012, these revenues suffered a large drop (by 11.6%). Revenues from social security contributions (real, seasonally adjusted) went up in Q4 relative to Q3 2013 and Q4 2012 (by 3.1% and 10.9% respectively), primarily due to increase in the rate of pension and disability insurance contributions.

...due to increase in expenditures on wages in the public sector, and probably to good agricultural yields

Rise in revenues from personal income tax and social security contributions in Q4 relative to Q3 was driven by a moderate real increase in public sector wages (due to nominal increase in wages by 0.5% and deflation in the period), growth in the numbers of employees in public sector, pre-term wage payment in the public sector in December (before the solidarity tax came into force) and probably a slight growth in wage payments to private sector agricultural workers, due to good agricultural yields. Rise in revenues from social security contributions and decline in revenues from personal income tax in Q4 2013 relative to the same period 2012. Besides this, increase in social contributions revenues is consequence of the reduction in wage tax rate (and increase in non-taxable part of wage) and rise in social security contributions rate, as of June 2013. Annual revenues from personal income tax in 2013 suffered a large real drop (by 12.2%), and revenues from social security contributions went up moderately (by 2.6%) relative to 2012. This is the net effect of the decline in formal employment and real personal income, and redistribution of tax burden from personal income tax to social security contributions.

Slight fall in revenues from corporate income tax in Q4 could indicate deterioration of business performance

Graph T6-6. Serbia: Trends in consolidated seasonally adjusted revenues from taxes on production factors (in 2013 prices)



Source: *QM* calculation

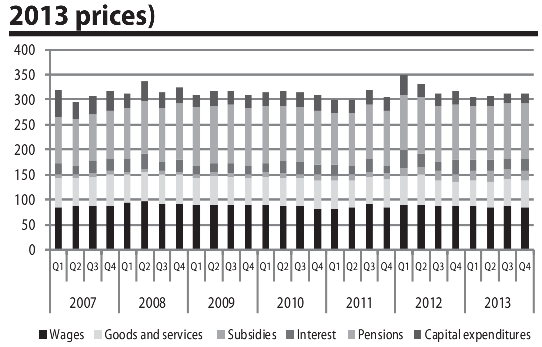
There was a moderate fall in revenues from corporate income tax in Q4 relative to Q3 (by 0.9%), but when compared with the same period 2012, these revenues went up considerably (by 44.9%). Annual (real) revenues from corporate income tax in 2013 went up moderately (by 2.9%). The fall in corporate income tax in Q4 relative to Q3 comes from illiquidity of Serbian economy, and could be an indicator of continuous deterioration of business performance, based on which companies estimated that the overall profit in 2013 would fall short of the projections and revised (down) their corporate income tax advances. Rise in revenues from corporate income tax in 2013 relative to 2012 primarily came from the increase in corporate income tax rate, as of January 2013. Rise in revenues from corporate income tax mainly came from the increase in corporate income tax rate from 10% to 15%, which affects the amount of corporate income tax advances paid in 2013.

Other tax revenues (real seasonally adjusted) went up slightly in Q4 relative to Q3 (by 0.8%), which could indicate a more efficient use of direct and transferred public revenues by local governments, due to loss of revenues from wage tax and other quasi-fiscal charges. Non-tax revenues (real seasonally adjusted) suffered a slight drop in Q4 (by 0.6%), because some companies failed to pay dividends to the government. Observed annually, other tax revenues and non-tax revenues suffered a moderate fall (by 5.2% and 8.7% respectively) in 2013 relative to 2012 due to abolition of quasi-fiscal charges at the end of 2012 and deteriorated business performance of public and state-owned companies (and consequential drop in revenues from dividend).

There is a moderate drop in public expenditures in Q4, driven by reduction i discretional expenditures ... however, arrears are going up

Real seasonally adjusted public expenditures went down moderately (by 3.5%) in Q4 relative to Q3, and suffered a considerable real drop (by 5.8%) relative to the same period last year.

Graph T6-7. Serbia: Trends in consolidated seasonally adjusted public expenditures (in 2013 prices)



Source: *QM* calculations

Real annual public expenditures in 2013 went down by 5.5% relative to 2012. Reduction in overall expenditures in Q4 came from a massive reduction in subsidies, reduction in capital investments and slight reduction in expenditures on goods and services and expenditures on employees. Discretionary expenditures went down partly because some projects were justifiably cancelled, and partly because some projects were delayed or payments for procured goods and services were postponed (arrears). All savings based on postponement of vital projects or delayed payments for procured goods and services could widen 2014 deficit.

Reduction in subsidies came from abolition of investment and employment incentives and reduction in subsidies to municipal public companies

To keep the fiscal deficit within projections, the government reduced discretionary expenditures in Q4. Accordingly, real seasonally adjusted expenditures on subsidies went down in Q4 relative to Q3 (by 11%), and the drop was even larger when compared with the same period 2012 (by 29.5%). Due to a considerable reduction in subsidies at the end of the year, total expenditures on subsidies in 2013 went down by 15.6% relative to 2012. Reduction in expenditures on subsidies was made through abolition of investment and employment incentives, reduction in incentives to tourism and similar, and through reduction in local government subsidies to municipal public companies. Some of these savings are temporary, because some incentive programmes were abolished in Q4 (investment and employment incentives etc.), but similar incentive schemes have been announced.

Reduction in subsidies is desirable, but it should be gradual and accompanied by reforms in business environment

Reduction in massive, fiscally unviable subsidies was necessary, but, for the purpose of predictability of business environment and to prevent a sharp drop in foreign direct investments, it should have been made gradually and accompanied by sweeping reforms in business environment.

Capital expenditures went down in Q4, which is economically unjustifiable

Reduction in public expenditures in Q4 came from reduction in capital expenditures. Real seasonally adjusted capital expenditures in this quarter were much lower than in Q3 (by 24.2%), and by 46.7% lower than in the same quarter 2012. Total capital expenditures in 2013 went down by 38.2% relative to 2012, and amounted to only 3.4% of GDP, which is much below the necessary level. Reduction in expenditures aimed at keeping fiscal deficit within the projected levels is justifiable, but it should not be made through reduction in investments in physical and human capital (public investments and education), as these are drivers of long-term economic growth.

Expenditures on goods and services went down, too

Expenditures on goods and services (real seasonally adjusted) went down in Q4 relative to Q3 by 4.7%, and when compared with the same period 2012, they grew by 4%. Total expenditures on goods and services in 2013 fell by 6.6%, which is in nominal amount (RSD 1.3 billion) much below the savings from the new public procurement system (tens of billions of dinars) announced earlier. These expenditures fell in Q4 relative to Q3 because procurement of goods and services that are not crucial for the functioning of public sector was suspended and/or reduced to keep fiscal deficit at the projected level. Reduction in these expenditures was also made through pooled procurement of medicines and other medical supplies. Reductions in expenditures on goods and services are welcome, as long as they do not jeopardize functioning of the public sector, or cause accumulation of arrears.

Expenditures on employees fell slightly

Real seasonally adjusted expenditures on employees in Q4 were by 2.5% lower than in Q3, and by 2.1% lower than in Q4 2012. Trends in expenditures on employees in Q4 were divergently affected by the wage increase of 0.5% in October, on one hand, and specific dynamics of wage payments in healthcare system, and government's greater caution about hiring new employees and wages, driven by establishment of the register of public sector employees which allows greater control in this area, on the other.

Expenditures on pensions went up slightly in Q4, due to indexation of the nominal amount of pensions and deflation

Expenditures on pensions (real seasonally adjusted) in Q4 were by 0.5% higher than in Q3, and by 1.2% higher than in Q4 2012. Rise in expenditures on pensions in Q4 is driven by the increase in numbers of pensioners and pension indexation in October (by 0.5%). Under a slight deflation, these factors caused a considerable real rise in these expenditures. There was a real drop in total expenditures on pensions in 2013 of 2.3%, because indexation did not keep pace with inflation. Amendments to the Budget System Law adopted at the end of December provide that the low indexation of pensions and wages will continue in 2014 and 2015 (by 0.5% in October and April). However, under low inflation this restrictive indexation policy will not bring the necessary real and relative savings. Therefore, a credible fiscal consolidation requires nominal reduction in pensions and wages.

Expenditures on interest payment went up because semi-annual coupons fell due

Real seasonally adjusted expenditures on interest payment in Q4 rose by 10% relative to Q3, and by 26.7% relative to the same quarter 2012, because semi-annual coupons on euro-denominated bonds fell due.

...total expenditures on interest payment in 2013 increased sharply due to increase in Serbia's public debt and tougher borrowing conditions

Total expenditures on interest payment went up in 2013 relative to 2012 by 28.8%. This increase came from rise in the absolute amount of public debt, change in public debt structure (share of cheap debt, such as old foreign currency savings, is shrinking in favour of new, expensive loans), and tougher borrowing conditions (due to large fiscal deficit, and to a smaller extant, to turmoil in the world financial markets).

Fiscal trends by government levels

Central government (exclusive of the Health Insurance Fund) runs deficit, and sub-central governments are in surplus

In 2013 central government (exclusive of the Health Insurance Fund of the Republic of Serbia) ran deficit, and sub-central governments (Autonomous Province of Vojvodina and local self--governments) were in surplus. Central government budget deficit in 2013 was within the levels projected in the Budget rebalance. The same goes for the Pension and Disability Insurance Fund and National Employment Service.

The Health Insurance Fund was in large surplus in 2013 due to specific dynamics of wage payment and reduction in expenditures on medicines

On the other hand, the Health Insurance Fund posted surplus of almost RSD 9 billion in 2013, which is much larger than planned. This is due to a specific dynamics of wage payment and reduction in expenditures through pooled procurement of medicines and other medical supplies. These savings came from the new procurement system, but indications show that it also caused a shortage in some items and led to arrears.

Effects of 2011 fiscal decentralization have not worn off... further redistribution of revenues/expenditures of 0.1-0.2% is possible

Budget of the Autonomous Province of Vojvodina was in surplus because some capital projects were slowed down. Local self-governments were in surplus of RSD 6.3 billion in 2013, although they were expected to run deficit. This could indicate that the vertical imbalance caused by 2011 fiscal decentralization has not been corrected. However, given the scope of local self-government competencies, real amount of the surplus revenues could deviate from the achieved budget surplus, because according to the State Audit Institution local self-governments are obliged to accumulate the full amount of funds for any capital project before inviting tenders for it. On the other hand, aware of the risk of further redistribution of funds from local to central government, local self-governments probably increased expenditures in Q4 to reduce the nominal amount of their budget surplus. However, taking all this into account, we believe that further redistribution of revenues (from local to central government) or competencies (from the central to the local level) of 0.1-0.2% of GDP (RSD 4-8 billion) is possible, without jeopardizing the functioning of local governments or accumulating arrears.

Table T6-8. Serbia: Fiscal surplus (deficit) at different levels of government (bn. RSD, current prices)

Year	*Budget of Republic*	*Pension fund*	*National Employment Service*	*Health fund*	*Vojvodina budget*	*Localself-governments*
2010	-108.0	-1.0	-0.1	1.9	-9.6	-11.5
2011	-144.3	0.2	1.3	2.1	-0.7	-15.6
2012	-213.0	-0.4	0.8	4.0	1.1	-0.3
2013	-194.4	-1.2	-0.5	8.7	1.3	6.3

Source: *QM* calculations based on the Ministry of Finance's data

Central government and local self-governments budget revenues are going down, and social security funds revenues are rising

Central government and local self-government budget revenues suffered a real drop (by 2.5% and 5.5% respectively) in Q4 2013 relative to the same period 2012. On the other hand, the Health Insurance Fund and Pension and Disability Insurance Fund's revenues went up, based on social security contributions. This decline in central government and local self-government budget revenues and rise in the Pension and Disability Insurance Fund's revenues mainly came from reduction in tax rate on wages and increase in pension and disability pension contributions as of June 2013. Additionally, a downwards trend in local budget non-tax revenues continues, as a consequence of the reform in quasi-fiscal charges system carried out in 2012. Revenues from property tax went up slightly (by 5.5%), which could indicate that local governments increased their efforts to collect this tax more efficiently, and thus make up the loss of revenues.

There was a real drop in expenitures at all government levels in Q4, due to fall in revenues...

There was a real drop in expenditures at all government levels in Q4 2013 relative to the same period 2012. Central government and loacal self-governments made the largest reduction in expenditures (12.8% and 6.2% respectively). Cut in central government expenditures came from reduction in direct subsidies, slowdown in public investments, and reduction in other discretionary expenditures intended to keep the fiscal deficit at the projected level.

...reduction in local government expenditures primarily comes from a cut in subsidies and capital investments

Local self-governments tried to make up the loss of revenues through a cut in subsidies, which is justifiable, but also through reduction in capital investments, which is not good from the aspect of local economic development. On the other hand, reduction in the largest (unproductive) current expenditures at the local level – expenditures on wages and goods and services – was negligible (expenditures on goods and services even went up slightly). Reduction in capital expenditures is the least economically justifiable way of saving, but under large deficit it is reasonable to postpone some capital projects and prioritize them.

The foregoing fiscal trends indicate that local self-government and the Autonomous Province of Vojvodina funding systems need to be (re)organized, meaning that the funding should be predictable (primarily the amount of transfers), and allocation of funds should be in proportion with the efforts local self-governments make to collect its tax revenues, and the efficiency in revenue use, intended to encourage them to increase local public investments, rather than expenditures on employees, goods and services and subsidies.

Public debt dynamics

In January 2014 Serbia's public debt stood at EUR 20.2 billion (63.5% of GDP)

According to the Ministry of Finance's official data, Serbia's public debt stood at EUR 20.2 billion (63.5% of GDP) at the end of January 2014, which is by EUR 1.3 billion larger than at the end of Q3 2013. This increase came from the rise in direct debt. Public debt-to-GDP ratio worsened in this period (by 3.6% of GDP) primarily due to rise in absolute amount of public debt, and small real appreciation of dinar exchange rate in this period, while real GDP growth was too low to improve it. Increase in public debt in the period October-January was much larger than fiscal deficit in this period (EUR 350 million), because the government issued a large amount of euro-denominated bonds in November to obtain the funds needed to finance the deficit in the following quarters. Increase in government deposits in the period October-January confirms this (see Monetary flows and policy).

Table T6-9. Serbia: Public debt[1] 2000-2014.

	Amount at the end of period, in billions EUR										
	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013	Jan-14
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	12.36	15.07	17.3	17.4
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	6.5	7.0	7.1
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	8.6	10.2	10.4
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.60	2.8	2.8
III. Total debt (I+II)	**14.17**	**10.28**	**9.38**	**8.88**	**8.78**	**9.85**	**12.17**	**14.47**	**17.67**	**20.1**	**20.2**
Public debt / GDP[2]	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.6%**	**31.3%**	**41.5%**	**45.1%**	**59.3%**	**61.2%**	**62.3%**
Public debt / GDP (QM)[3]	**169.3%**	**52.1%**	**37.8%**	**30.9%**	**29.2%**	**34.8%**	**44.6%**	**46.9%**	**60.0%**	**62.4%**	**63.5%**

Source: Ministry of Finance's data and *QM* calculations

There is a growing interest among portfolio investors in Serbian treasury bills due to high real yields...

Direct public debt rose by EUR 1.3 billion in the period October 2013-January 2014. More than a half of this amount comes from borrowing with international financial institutions (about EUR 750 million), and the rest comes from domestic borrowing (about EUR 500 million). Quite large increase in domestic borrowing, primarily driven by issuance of treasury bills, is a continuation of the trend detected in Q3 and comes from quite stable dinar exchange rate and high interest rate on treasury bills, which provides high yields.

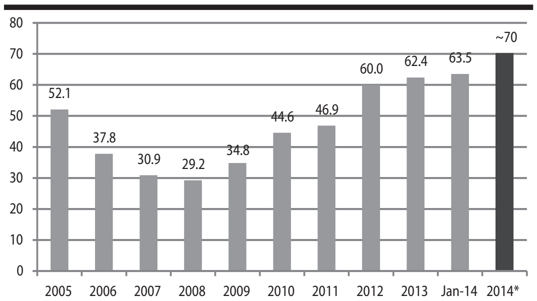
...but there is a risk that they could withdraw suddenly, so alternative sources of funds must be provided

However, there is a risk that portfolio investors could withdraw suddenly due to a growing uncertainty in the world financial markets (caused by the Fed's less expansionary monetary policy) and lack of a strong fiscal consolidation in Serbia. Alternative sources of funds must therefore be provided, to secure budget liquidity.

Indirect debt is going down, but the key drivers of its long-term growth have not been eliminated

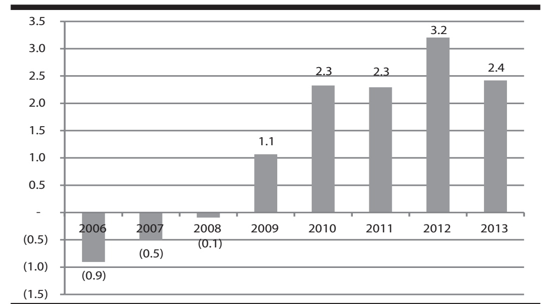
After stagnation in Q3, indirect public debt went down slightly (by EUR 100 million) in the period October 2013-January 2014. This is good because the upwards trend in indirect debt has been reversed after many years. However, this stagnation and decrease is temporary because the key drivers of the growth in public debt have not been eliminated. The continuous growth in public debt is mainly driven by government guaranteed borrowing by public and state-owned enterprises (Srbijagas, Železara, Galenika, EPS etc.). Quite large amount of government guarantees on loans to these companies was issued in the first half of 2013, which enabled them finance their operations (primarily Srbijagas and Železara) by the end of 2013 and at the beginning of 2014. According to the Budget of the Republic of Serbia for 2014, government will issue guarantees on loans to these enterprises with which they will be able to fund their operations by mid 2014, the deadline for their restructuring which should lead to their long-term financial viability (Srbijagas) and privatization (Železara, Galenika). Since the restructuring plans have not been developed yet, it is quiet unlikely that these companies will be enabled to function on their own by mid 2014, meaning that further issuance of state guarantees will be needed. Annual expenditures on financial support to these enterprises in consolidated budget are growing and have amounted to hundreds of millions of euros per year. Financial and business consolidation of these enterprises is therefore crucial for a comprehensive fiscal consolidation in Serbia. Otherwise, reduction in expenditures on other items will be offset by growing expenditures on financial support to these enterprises.

Graph T6-10. Trends in public debt in Serbia (% of GDP)



Source: *QM* calculations

Graph T6-11. Growth in public debt in Serbia (Euro bn)



Source: *QM* calculations

Public debt dynamics are highly unfavourable. Four years in a row, Serbia's public debt increased by more than EUR 2.3 billion annually (average annual growth in public debt in the period 2010-2013 was EUR 2.6 billion), and the increase was larger in 2012 and 2013 than in the preceding years. Relative growth in public debt (as GDP percentage point) was somewhat slower, due to a moderate real appreciation of dinar-to-euro exchange rate and modest cumulative growth in GDP.

Public debt will amount to 70% of GDP at the end of 2014

With 2014 fiscal deficit at the projected level (around 7% of GDP), and with steady dynamics in indirect debt, with inflation at the projected level, and with unchanged real dinar exchange rate and steady real GDP, Serbia's public debt will amount to 70% of GDP at the end of 2014. Potential arrangement with the IMF is conditional on the additional reduction in 2014 fiscal deficit, by 1% of GDP. In that case, public debt could be slightly below 70% of GDP at the end of the year. On the other hand, with notable depreciation of dinar exchange rate, decline in economic activity or increase in indirect debt (financial support to state-owned companies, banks etc.), public debt could be larger than projected.

Appendices

Annex 1. Serbia: Consolidated General Government Fiscal Operations[1)], 2008-2013 (nominal amounts, bn RSD)

	2008	2009	2010	2011	2012					2013				
					Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4
I PUBLIC REVENUES	**1,145.9**	**1,146.5**	**1,223.4**	**1,302.5**	**312.6**	**339.7**	**355.1**	**398.0**	**1,405.4**	**330.0**	**362.4**	**369.1**	**406.4**	**1,467.8**
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	367.6	405.0	1,461.3
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	325.8	352.5	1,296.4
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	35.9	42.1	156.1
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	15.4	15.8	60.7
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	94.6	99.9	380.6
Excises	110.1	134.8	152.2	170.9	34.6	40.6	54.9	51.0	181.1	42.5	53.7	52.3	56.3	204.8
Custom duties	64.8	48.0	44.3	38.8	7.7	9.0	9.3	9.8	35.8	7.3	7.9	8.2	9.1	32.5
Social contributions	312.7	318.8	323.0	346.6	85.9	94.6	94.5	103.9	378.9	93.4	99.7	107.7	117.6	418.3
Other taxes	35.6	37.1	46.0	43.5	9.7	11.7	10.8	10.4	42.6	9.3	10.9	11.6	11.7	43.5
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	41.9	52.5	164.9
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	0.6	0.5	3.5
	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**	**-364.3**	**-402.6**	**-422.1**	**-445.0**	**-1,633.9**
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	-350.9	-385.0	-395.4	-418.6	-1,549.8
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	-97.5	-103.4	-392.7
Expenditure on goods and services	-181.2	-187.4	-202.5	-216.3	-51.2	-62.9	-53.8	-67.7	-235.7	-49.7	-55.3	-60.0	-71.9	-236.9
Interest payment	-17.2	-187.4	-34.2	-44.8	-15.4	-13.4	-23.3	-16.2	-68.2	-18.9	-27.5	-27.2	-20.9	-94.5
Subsidies	-77.8	-22.4	-77.9	-80.5	-22.6	-25.2	-19.6	-44.2	-111.5	-19.0	-22.0	-28.4	-31.8	-101.2
Social transfers	-496.8	-63.1	-579.2	-609.0	-154.9	-161.1	-163.5	-173.0	-652.5	-162.4	-173.0	-172.6	-179.5	-687.6
o/w: pensions [5)]	*-331.0*	-556.4	*-394.0*	*-422.8*	*-112.5*	*-117.8*	*-119.2*	-124.1	-473.7	-120.0	-124.6	-125.3	-128.2	-498.0
Other current expenditures	-23.5	-387.3	-22.9	-31.7	-7.9	-11.7	-8.0	-9.8	-37.4	-7.1	-9.1	-9.6	-11.1	-36.9
2. Capital expenditures	-106.0	-24.0	-105.1	-111.1	-25.3	-22.5	-30.0	-48.6	-126.3	-13.4	-17.6	-26.7	-26.4	-84.0
	0													
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND	**-19.1**	**-20**	**-29.9**	**-24.9**	**-4.7**	**-5.7**	**-2.3**	**-3.9**	**-16.6**	**-3.1**	**-3.9**	**-4.1**	**-1.6**	**-12.7**
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**	**-367.3**	**-406.5**	**-426.1**	**-446.6**	**-1,646.5**

Source*: QM*

Annex 2. 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	Q3	Q4	Q1-Q4
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**	**-2.7**	**0.1**	**-3.0**
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	-2.8	1.7	-2.6
Tax revenue	3.7	-8.8	-2.5	-4.1	1.9	5.3	1.9	-4.4	1.0	-4.2	-2.1	-3.4	2.9	-1.7
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	-18.9	-11.6	-12.2
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	39.6	44.9	2.9
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	-6.2	-5.2	-3.8
Excises	0.7	11.6	4.2	0.6	-5.7	-3.0	8.5	-7.0	-1.2	9.5	20.1	-10.9	8.2	5.1
Custom duties	1.8	-32.4	-14.9	-21.5	-18.6	-8.6	-11.4	-17.6	-14.0	-15.3	-20.5	-16.9	-9.3	-15.6
Social contributions	4.3	-7.0	-6.5	-3.9	4.8	6.1	0.7	-3.4	1.9	-3.0	-4.4	6.7	10.9	2.6
Other taxes	-2.3	-4.9	14.5	-15.2	-9.7	7.6	-12.0	-19.2	-8.8	-14.2	-15.6	0.2	10.2	-5.2
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	2.1	-5.4	-8.7
2. Capital revenues	-76.8	-41.4	-66.8	468.2	124.1	259.1	176.7	373.3	304.5	159.4	-63.6	-31.7	-91.3	-63.0
II TOTAL EXPENDITURE	**4.5**	**-4.8**	**-1.7**	**3.3**	**10.3**	**9.2**	**-2.9**	**1.5**	**4.3**	**-10.4**	**-6.6**	**1.5**	**-5.8**	**-5.5**
1. Current expenditures	6.9	-3.3	-2.2	3.1	8.2	9.3	-1.7	1.4	4.1	-7.2	-5.2	3.0	-1.0	-2.7
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	0.0	-2.1	-2.6
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	4.5	4.0	-6.6
Interest payment	-2.8	-5.7	-0.3	17.4	48.1	6.6	93.4	23.4	41.9	9.8	86.3	9.5	26.7	28.8
Subsidies	-13.3	19.0	40.6	7.4	42.6	56.4	-36.2	82.9	29.1	-24.7	-20.7	35.9	-29.5	-15.6
Social transfers	10.1	-26.0	13.9	5.8	3.8	2.9	-0.3	-6.1	-0.1	-6.4	-2.5	-1.2	1.7	-2.1
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*	*-1.6*	*1.2*	*-2.3*
Other current expenditures	14.9	6.7	-6.1	23.9	-17.1	36.8	12.2	11.8	9.9	-19.6	-29.5	12.4	10.6	-8.4
2. Capital expenditures	-4.3	-6.7	-11.8	5.3	48.7	8.3	-14.9	2.3	6.0	-52.9	-29.0	-16.6	-46.7	-38.2
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**	**-41.7**	**-37.6**	**63.2**	**-58.5**	**-29.0**
IV TOTAL EXPENDITURE, GFS (II+III)	**4.6**	**-4.8**	**-1.1**	**-3.8**	**9.8**	**7.7**	**-3.5**	**1.2**	**3.6**	**-10.8**	**-7.0**	**1.8**	**-6.2**	**-5.7**

Source: *QM*

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

	Q4 2013/Q4 2012			
	Consolidated budget	Budget of Republic	Health Fund	Local self-governments
A Total public revenues (I)+(II)+(III)+(IV)	**0.1**	**-2.5**	**0.9**	**-5.5**
I Current revenues (1)+(2)	1.7	0.4	1.4	-8.7
1. Tax revenues	2.9	0.2	2.3	-5.9
1.1. Customs	-9.3	-9.3	-	-
1.2. Personal income tax	-11.6	-13.3	-	-10.6
1.3. Corporate income tax	44.9	43.9	-	-
1.4. VAT	-5.2	-5.2	-	-
1.5. Excise duties	8.2	8.2	-	-
1.6. Property taxes	5.5	-	-	5.5
1.9.Other taxes	10.2	4.4	-	26.3
1.10. Social security contributions	10.9	-	2.3	-
2. Non-tax revenues	-5.4	1.4	-26.4	-16.2
II Capital revenues	-91.3	-	-66.3	-3.3
III Transfers from the other levels of government	-	-	-0.3	8.0
IV Donations	-49.4	-80.1	-	184.9
B Total public expenditures (I)+(II)+(III)+(IV)	**-5.8**	**-12.8**	**-1.0**	**-6.2**
I Current expenditures	-1.0	-7.6	-1.0	-1.1
1.1 Wages	-2.1	-3.0	-1.6	-0.3
1.2. Goods and services	4.0	6.2	-0.6	1.2
1.3 Interest payments	4.0	27.9	-91.7	-0.2
1.4 Subsidies	26.7	-37.1	0.0	-14.4
1.5 Social insurance and social assistance	-29.5	11.6	6.6	-5.4
1.6 Transfers to the other levels of government	1.7	-13.9	-	-
1.7 Other current expenditures	10.6	-11.2	-36.4	31.7
II Capital expenditures	-46.7	-41.1	-18.6	-26.2
III Strategic reserves		-99.0	-	-9.2
IV Net lending	-20.7	-61.0	-	665.0

Source: *QM*

7. Monetary trends and policy

The fourth quarter of 2013 saw the continuing of the trend of extremely low inflation which was temporarily stopped with a single leap of prices in January 2014. The foreign currency market saw depreciation and appreciation pressure from mid-2013 but the Dinar exchange rate was relatively stable because of the strong interventions by the National Bank of Serbia (NBS) on that market. Following the lowering of the key policy rate by 1.5 percentage points in Q4 , there were no additional drops in NBS interest rates at the start of 2014. That fact that the key policy rate was kept at the level of 9.5% with a y.o.y. inflation rate of about 3% reflects the intention of the NBS to ease the strong depreciation pressure on the foreign currency market, which has been in place since early 2014, through the REPO rate. The NBS policy of high interest rates in conditions of low inflation shows that the pure model of target inflation is not being implemented in Serbia – instead of through interest rates, the NBS influences inflation predominantly through the exchange rate. As part of the existing model of monetary policy, the NBS does not have an opportunity to stimulate the credit activities of banks, even in periods when it drops significantly, and the question that is raised legitimately is whether the existing model of monetary policy is optimal for Serbia. The high drop in the real value of loans to the economy of about 10% y.o.y. increases the problem of lack of liquidity of companies and deepens recession tendencies in a significant part of the economy. Financial problems in a group of large private companies carries over to banks and the NBS revoked the licenses of two small banks late last year and early this year. The drop in the participation of bad loans in Q4 is the consequence of the revoking of the licenses of problematic banks and we believe it is temporary. If the state does not create the appropriate mechanisms to solve the lack of liquidity and insolvency problems more efficiently we expect the trend of growth of bad loans to continue and that will result in a drop in production and employment as well as serious problems in the banking sector. Financial problems in companies will have a negative effect on public finances because insolvent companies do not pay taxes and when the problems are carried over to banks, the state will have significantly expenses on the basis of payment of insured deposits.

Central Bank: Balance and Monetary Policy

Low inflation rates in Q4 allowed easing of monetary policy …

The positive trends in lowering inflation continued in Q4 causing a gradual relaxation of monetary policy in the form of lower NBS key reference rates. The combination of a good agriculture season at home and abroad, lower domestic demand and a drop in the price of crude oil in Q4 brought y.o.y. inflation rates to levels below the target of 4±1.5% by the end of the year. That caused the NBS to correct the key policy rate three times for a total of 1.5 percentage points (PP) after which it was at the level of 9.5% at the end of the year (Table Tabela T7-1). Although inflation at the start of 2014 was closer to the lower target framework value, NBS did not continue relaxing its monetary policy. The restrictive policy can be explained with the intention of the NBS to redirect the excess liquidity of banks from demand for hard currency to REPO NBS bonds. By keeping the key policy rate at a relatively high level, the NBS de facto controls the exchange rate at its current level by sterilizing a part of the liquidity of the banking sector which would otherwise by used to buy foreign currency. If we bear in mind the fact that a large part of the transactions in the economy are Euro-based (more than 70%) we get the impression that the NBS started implementing its key policy rate to support the target exchange rate rather than the target inflation. That is confirmed by the state of the REPO stock which was increased by 134 million Euro in Q4. The Dinar exchange rate in Q4 moved towards strengthening which led the NBS to intervene by purchasing hard currency to the value of 525 million Euro with one intervention when it sold 10 million Euro which was in December. We feel that the preventing of the strengthening of the Dinar in a situation when the population supports its strengthening is responsible behavior by the NBS since the Dinar exchange rate would otherwise have additionally distanced itself from its balanced value and would endanger the long-term position of

… but the NBS indirectly targeted the course level which meant that there was no great lowering of the key policy rate

the economy. Interventions on the inter-banking foreign currency market in Q4 led the NBS to become a net buyer of hard currency to the value of 180 million Euro over the entire year for the first time in the previous five years although the NBS intervened on that market selling 610 million Euro in January and February because of significantly stronger depreciation pressure (Graph T7-2). The high variation in demand on the foreign currency market in part reflect the changes on the inter-banking capital market while at the same time reflecting the specificity of Serbia – a high deficit in the current accounts balance combined with a very high inflow of capital, uncertainty over the kind of economic policy which will conducted after the elections etc.

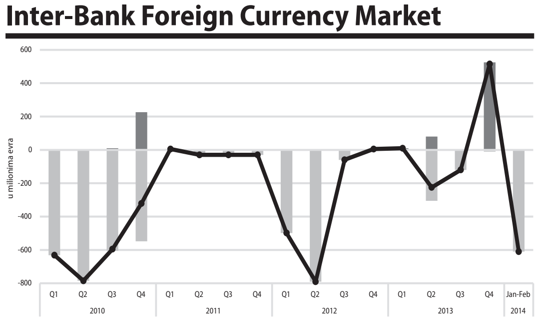
Table T7-1. Serbia: NBS Interventions and Foreign Currency Reserves 2011-2013

	2011				2012				2013			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
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	832.03	966.40
NBS interest rate	12.25	12.00	11.25	9.75	9.50	10.00	10.50	11.25	11.75	11.00	11.00	9.50
NBS interest rate	-9.74	6.76	12.59	7.15	1.11	-2.77	-5.74	1.11	6.95	3.31	13.24	10.38
NBS interest rate	25.66	28.86	5.17	2.61	-18.43	-7.27	-6.50	-3.99	19.25	12.85	12.83	9.25
NBS interventions on FX market (in milions of euros)	5.00	-30.00	-30.00	-30.00	-498.50	-1,288.80	-1,348.30	-1,343.30	10.00	-215.00	-140.00	375.00
INCREASE					**cumulative, in % of initial M2[1]**							
NBS own resreves[2]	-8.9	14.0	26.8	73.9	-17.6	-45.4	-35.6	-6.0	12.5	7.1	17.9	43.2
NDA	-0.7	-15.5	-28.6	-51.8	2.4	61.3	65.8	41.3	-15.3	-3.9	-16.2	-31.3
Government, dinar deposits[3]	-4.6	-3.3	3.6	2.7	-5.1	6.1	4.3	-4.3	1.0	-1.2	-4.7	-19.9
Repo transactions[4]	-6.9	-15.3	-32.2	-47.5	2.2	53.7	59.3	40.2	-16.0	-14.7	-23.8	-30.7
Other items , net[5]	10.9	3.1	0.0	-7.0	5.3	1.5	2.3	5.4	-0.3	12.0	12.4	19.3
H	-9.6	-1.5	-1.8	22.1	-15.2	15.9	30.2	35.3	-2.8	3.3	1.7	12.0
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	1.0	5.4
o/w: excess liquidity	-3.8	2.5	-5.5	6.3	-13.6	-1.6	-1.1	5.4	0.6	2.1	-1.4	4.4
					in millions of euros, cumulative from the beginning of the year							
NBS, net	56.41	281.69	1,374.46	2,203.13	-1,070.60	-2,087.45	-2,383.97	-1,050.95	30.01	-992.01	-1,041.50	-106.98
Gross foreign reserves	15.50	308.18	1,426.15	2,333.77	-1,138.11	-2,090.09	-2,536.57	-1,324.15	-385.77	-1,576.91	-1,822.60	-1,083.82
Foreign liabilities	40.91	-26.49	-51.69	-130.63	67.51	2.64	152.60	273.20	415.78	584.90	781.10	976.83
IMF	36.90	-32.40	-58.53	-131.88	58.24	-6.44	138.99	258.95	401.14	568.40	759.83	954.55
Other liabilities	4.01	5.90	6.85	1.24	9.27	9.07	13.61	14.25	14.65	16.50	21.27	22.28
NBS, NET RESERVES-STRUCTURE												
1. NBS, net	56.41	281.69	1,374.46	2,203.13	-1,070.60	-2,087.45	-2,383.97	-1,050.95	30.01	-992.01	-1,041.50	-106.98
1.1 Commercial banks deposits	21.84	226.33	108.59	-461.78	459.45	740.45	1,030.19	907.59	911.80	967.01	1,058.25	1,148.01
1.2 Government deposits	-232.50	-257.55	-1,009.24	-455.09	263.40	488.43	683.75	28.63	-811.79	47.05	209.55	-331.19
1.3 **NBS own reserves** (1.3 = 1 - 1.1 - 1.2)	-154.25	250.47	473.81	1,286.27	-347.74	-858.58	-670.03	-114.73	130.02	22.06	226.30	709.84

Source: NBS.
1) "Initial M2" is used to designate the state of primary money at the start of the year, or the end of the previous year.
2) Definition of net own reserves NBS given in section 8 „Monetary Trends and Policy", Frame 4, *QM* no. 5.
3) State includes all levels of government: republici and other levels.
4) This category includes NBS (BZ) Treasury Bonds and REPO operations.
5) Other domestic net assets include: domestic loans (net debts of banks including BZ and REPO transactions; net debts by the economy) along with other assets (capital and reserves; and balance items: other assets) and corrected by changes in the exchange rate.

NBS own reserves rise in Q4 because of foreign currency purchases, ..., but drop from start of 2014

Graph T7-2. Serbia: NBS Interventions on Inter-Bank Foreign Currency Market



Source: NBS

The purchase of foreign currency on the inter--bank foreign currency market had a positive effect on the level of NBS own reserves which rose by 484 million Euro in Q4 (in Q3 the net own reserves increased by 104 million Euro). The NBS foreign currency reserves have decreased since the start of the year. On the other hand, the state has kept most of the money collected from the sale of treasury bonds and Euro bonds in NBS accounts which led to an increase in the state deposits by some 540 million Euro. The growth of the state deposit combined with added placement by business banks in REPO had a negative effect on net domestic assets which recorded a drop of 15.1% of the value of primary money at the start of the year. The overall effect in creating primary money in Q4 was positive due to a higher growth of net own reserves which led to the level of primary money at the end of the year growing by 12% of its value at the start of the year.

Monetary System: Structure and Trends of the Money Mass

The money mass recorded a slight growth at the end of the year...

The money mass M2 increased in Q4 by 0.8% compared to the level at the start of the year (in Q3 a growth of 2.8% was recorded, Table T7-4). The overall growth of the money was generated on the basis of the growth of net foreign assets which also recorded a quarterly growth of 5.4% at

Trends

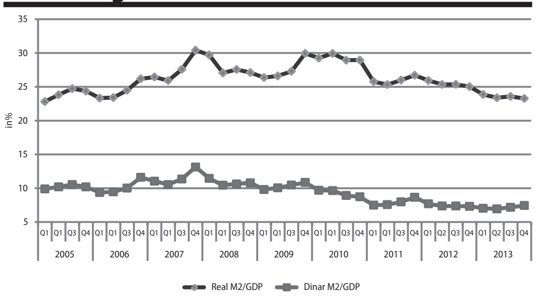
… thanks solely to an increase in NSA

the end of the year and 10.6% at the level of the entire year. On the other hand, the net domestic assets recorded a significant drop which stood at –4.6% in Q4.

A growth of the money mass at y.o.y. level was registered in Q4 …

… but the loans to the private sector dropped constantly and significantly

Graph T7-3. Serbia: Money Mass Trends as Percentage of GDP, 2005-2013



Source: *QM* calculation

The y.o.y. nominal growth rate of the money mass M2[1] stood at 4.7% in Q4 despite the fact that loans to the private (non-state) sector in Q4 saw a drop of –5% compared to the same period a year earlier (Table 7-4). Take into account the level of inflation in Q4 and the real M2 growth rate is 2.5% y.o.y. while in credits to the non--state sector it recorded a drop of –6.5%. The overall drop in credit activity covers the credit placements to the economy which recorded a drop of 10.7% y.o.y. in Q4 with the situation remaining unchanged with the population. The drop in credit to the private sector in Q4 is a continued trend from early 2012 with no indications yet that it will end soon if we know that the 2014 budget does not include funds to continue the program of subsidized interest on new loans.

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	Sep	Dec
	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	6.1	4.7
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	-4.4	-4.5
Credit to the non-government sector[2)], adjusted[3)]	16.7	13.0	11.7	8.1	8.6	4.6	7.0	3.8	1.6	0.6	-4.1	-5.0
Households	25.1	20.6	17.8	5.7	5.7	3.3	3.0	2.5	3.0	2.9	2.9	2.6
Enterprises	12.8	9.4	8.8	9.3	10.1	5.3	9.1	4.4	0.9	-0.6	-7.6	-8.8
	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	1.2	2.5
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	-8.9	-6.5
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	-8.2	-8.5	-7.0
Households	9.2	7.0	7.8	-1.3	2.0	-2.4	-7.2	-9.2	-7.5	-6.1	-1.9	0.4
Enterprises	-1.6	-3.0	-0.5	2.1	6.3	-0.5	-1.7	-7.5	-9.3	-9.3	-11.8	-10.7
	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	1,622.7	1,659.8	1,705.8	1,719.3
M2[1)] dinars	382.7	402.0	433.8	486.5	445.0	444.6	467.4	480.6	478.8	492.5	519.5	550.0
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	1,143.8	1,167.3	1,186.3	1,169.3
	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	3.9	4.7
NFA, dinar increase	-1.9	-1.4	9.5	11.9	-5.6	-4.5	-7.9	0.2	7.2	2.7	5.2	10.6
NDA	-1.4	0.2	-5.7	-1.8	5.7	10.5	15.2	9.4	-8.4	-1.6	-1.3	-5.9

Source: NBS

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

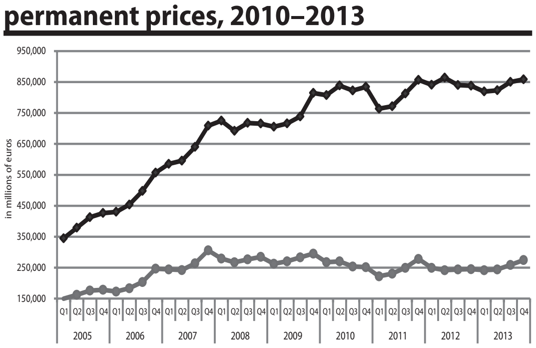
2) Credits to non-state sector – credit to the economy (including local government) and households.

3) Trends are corrected by exchange rate changes. Corrections are done with the assumption that 70% of credits to the non-state sector (households and the economy) are indexed in Euro.

4) Initial M2 designates the state of the M2 at the start of this ie the end of the previous year.

The greatest contribution to the growth of the nominal M2 at y.o.y. level of 4.72% came from the growth of M1 which in Q4 stood at 4.87 percentage points. The growth of the M1 was caused by an intervention of the NBS which bought foreign currency on the inter-banking foreign currency market in Q4 due to the appreciation of pressure on the Dinar exchange rate and the increased demand for cash which is characteristic for the end of the year. On the other hand there was no rise in the foreign currency deposits which could have been expected during savings week which led to this element contributing to the growth of M2 by just 0.5 percentage points while Dinar savings and timed savings had a negative effect on the growth of M2 of –0.65 percentage points.

Graph T7-5. State of money mass in permanent prices, 2010–2013



Source: *QM* calculation

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 aggregaeu M3 in NBS reports.

Banking Sector: Placements and Sources of Financing

Debt repayment by the economy continues …

… with record 312 million Euro in Q4

The placements by the banking sector in Q4 recorded a slight rise of 87 million Euro which is just under the amount which business banks placed in the previous quarter (in Q3 they placed 102 million Euro, Table T7-6). The structure of the bank placements continues to be unfavorable because the economy is continuing to get rid of its debts and bank placements are growing solely on the basis of investments in REPO bonds and treasury bonds. The negative trend of debt repayment by companies which started in 2012 continued in 2013 with companies getting rid of 1,040 million Euro of debts including 312 million Euro in Q4 which is also a quarterly record. The high drop in credit in Q4 is owed partly to the fact that the Privredna Banka Beograd lost its licence in October which means that its placements were not included in the balance of the banking sector but the continued debt repayment is present even when we observe the other banks in the system. According to figures for October and November, there was a debt repayment by the economy on the basis of cross-border credits to the amount of 64 million Euro. An analysis of the domestic banking sector in Q4 shows that besides the economy, the population also got rid of 34 million Euro of its debts which can be explained partly with the seasonal effect while the placement at annual level is positive and stands at 143 million Euro.

Table T7-6. Serbia: bank operations – sources and structure of placements, corrected1) trends, 2011-2013

	2011				2012				2013			
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec
	in millions of euros, cumulative from the beginning of the year											
Funding(-, increase in liabilities)	603	69	-822	-1,083	672	692	472	-384	109	341	213	420
Domestic deposits	206	-148	-844	-1,169	589	146	15	-459	4	-56	-325	-394
Households deposits	-92	-295	-483	-655	-49	-189	-296	-578	-87	-132	-252	-423
dinar deposits	24	13	-68	-182	30	69	36	11	16	-34	-110	-279
fx deposits	-116	-308	-416	-473	-79	-258	-332	-589	-102	-98	-141	-144
Enterprise deposits	298	147	-361	-513	638	336	311	120	91	76	-73	29
dinar deposits	176	13	-128	-350	362	304	230	99	-11	-11	-109	-162
fx deposits	122	134	-233	-164	275	31	81	21	102	87	36	191
Foreign liabilities	580	634	678	545	3	345	335	127	357	406	588	806
Capital and reserves	-183	-416	-656	-459	80	200	123	-52	-252	-9	-50	8
Gross foreign reserves(-,decline in assets)	-720	-674	-517	-923	-199	371	164	284	-278	-104	84	-304
Credits and Investment1)	309	1,270	2,158	2,771	409	-424	201	521	123	-169	-67	20
Credit to the non-government sector, total	216	1,030	1,554	1,940	309	136	784	589	-23	-348	-551	-897
Enterprises	191	766	1,189	1,607	375	161	741	552	-71	-463	-728	-1,040
Households	25	263	365	333	-67	-25	42	37	48	115	177	143
Placements with NBS (Repo transactions and treasury bills)2)	86	268	529	720	-28	-944	-1,052	-701	321	319	492	628
Government, net3)	7	-28	75	111	128	385	470	632	-175	-140	-8	290
MEMORANDUM ITEMS												
Required reserves and deposits	-157	-429	-210	391	-552	-418	-451	-265	-17	-87	-443	-399
Other net claims on NBS4)	17	123	2	110	-199	-20	-42	58	-154	-85	118	102
o/w: Excess reserves	22	123	-3	100	-187	45	54	*10*	-151	-96	60	48
Other items5)	-136	-195	-246	-601	150	222	56	146	100	50	54	124
Effective required reserves (in %)6)	23	21	21	24	22	23	23	23	25	24	22	23

Source: NBS

1) Calculating revenue is done with the assumption that 70% if the overall placements are indexed in Euro. Revenu for original Dinar values of deposits is calculated using the average exchange rate for the period. For foreign currency deposits – as the difference in the state calculated by the exchange rate at the ends of the period. Capital and reserves calculated by Euro exchange rate at ends of period and do not include effects of exchange rate changes after calculation of remainder of balance.

2) NBS bonds include state bonds and NBS treasury bonds which are sold at repo rates and rates set by the market in regard to permanent auction sales with a due date of 14 days.

3) Net crediting of state: credit approved to state decreased by state deposits in business banks; negative prefix designates higher growth of deposits over credit. State includes all levels of government: republic and local.

4) Other debts to NBS (net): difference between NBS debts to banks on the basis of cash and dues to the NBS.

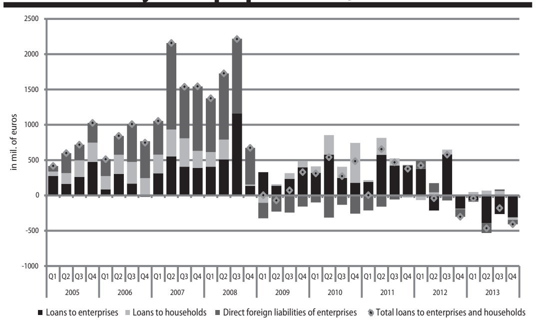
5) Items in bank balances: other assets, deposits by companies in bankruptcy, inter-banking relations (net) and other assets not including capital and reserves.

6) Effective mandatory reserve designates participation of mandatory reserves and deposits in overall deposits (population and economy) and bank debts abroad. The basis for mandatory reserves does not include subordinate debts which are not available.

Stability of the exchange rate and prices in Q4, in combination with the bad state of the economy motivated banks to increase their placement in REPO and treasury bonds

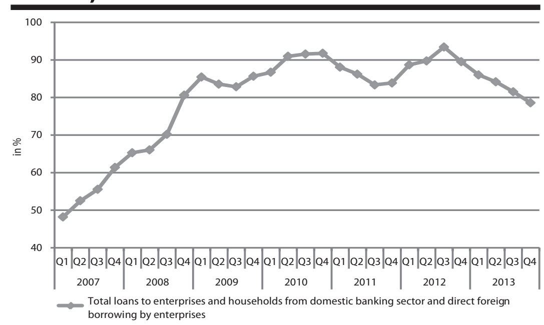
The increased liquidity was placed in Q4 in REPO to the amount of 136 million Euro which means that the REPO stock increased at annual level by 628 million Euro. Using strong interventions on the foreign currency market in the third quarter the NBS sent investors the message that it would prevent a sudden depreciation of the Dinar. The announced stability of the Dinar in combination with high Dinar interest rates made the placement in REPO bonds and treasury bonds risk-free (in relation to the changes of the exchange rate) and very profitable. We feel that the maintaining of the key policy rate at 9.5%, in combination with strong interventions on the foreign currency market, sends a signal to investors that the Dinar exchange rate will be stable at least in the short term. Also, a part of the liquidity of banks spilled over into the purchase of treasury bonds – in Q4 the value of sold treasury bonds issued in Dinars stood at 1.052 billion Euro including 600 million which is income from investments in treasury bonds. Also, bonds were issued in the same period denominated in Euro amounting to 334.7 million Euro, including some 247 million Euro used to pay earlier issue Euro bonds while the revenue from investments in treasury bonds stood at 88 million Euro. Add all that up and the conclusion is that banks in Q4 of last year increased their investments in Dinar and foreign currency treasury bonds by about 700 million Euro.

Graph T7-7. Serbia: growth of new credit for economy and population, 2005-2013



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

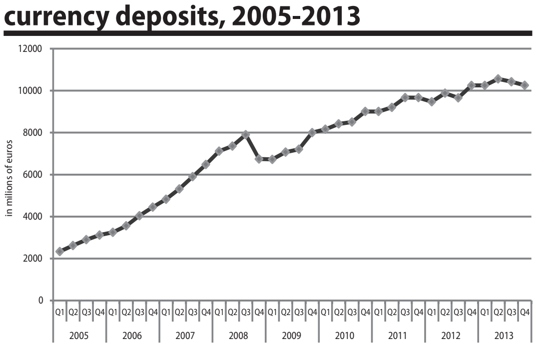
Graph T7-8. Serbia: overall credit debt in % of GDP, 2007-2013



Source: *QM* calculation

Business banks recorded a drop in foreign sources for new placements in Q4 besides the drop in placement to the economy and the population. In the last three months of 2013, sources for new placement were reduced by 207 million Euro and by 420 million Euro for the entire year, Table T7-6. Sources for placement were reduced because domestic banks reduced their dues in foreign currency on the basis of loans taken from their head offices abroad by 218 million Euro and also reduced the capital and reserves of banks by 58 million Euro. In regard to domestic sources, deposits by the population increased in Q4 by 171 million Euro which were almost entirely in Dinars while just three million were deposited in foreign currency. Although that period, because of savings week in previous years, was characterized by a growth of foreign currency deposits, interest rates on savings in Euro were significantly lower than savings in Dinars which, along with the expected stability of the exchange rate and high interest on Dinar savings, caused the population to choose savings in Dinars. We feel that this is a positive change in the behavior of the population which up until now regularly laid their trust in foreign currency savings despite the fact that Dinar savings were more profitable over the past five years. The reduction in new placements was also caused by the withdrawal of deposits by the economy which appears regularly at the end of the year and which stood at 102 million Euro in Q4. If we consider the data on sources and placements in 2013, we can conclude that the high growth in REPO and state bonds, combined with the bad financial situation in companies, turned business banks towards crediting of the state and not the economy. This situation in which the state takes out loans and the economy reduces its debts is not tenable for long. That is why measures are needed to reduce the fiscal deficit so that the state will take out less loans in future and measures to resolve the financial problems in the company sector to stimulate growth in banks crediting companies and subsequently see a growth in investments and employment.

Graph T7-9. Serbia: level of foreign currency deposits, 2005-2013



Source: NBS

If we know that, based on current performances, most of the Serbian economy still has not pulled out of the recession and is late in repay-

Active state participation is necessary in resolving the problem of excessive debts in big companies

ing loans, the question that arises is whether there is room for new credit lines with the existing level of debt at current interest rates. The answer to that question is negative and was given by banks over the past two years. On the other hand, if the state does not participate actively in resolving the financial problems of large private companies, much deeper problems will be generated and that will result in much higher losses for the state in the future. Also, interventions by the state should be focused on improving regulations (bankruptcy and other) with the aim of motivating company owners and banks as creditors to take timely measures to restructure companies or launch receivership if that is not possible. The state as a creditor on the basis of unpaid taxes should play a significant role in the process of restructuring or company receivership.

Table T7-10. Serbia: particpation of bad loans according to debt or type, 2009-2013

	2009	2010	2011				2012				2013				
	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Feb
	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	31.13	27.76	29.08
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	20.86	20.82	21.47
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	8.14	8.59	8.77
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	4.82	4.09	4.20

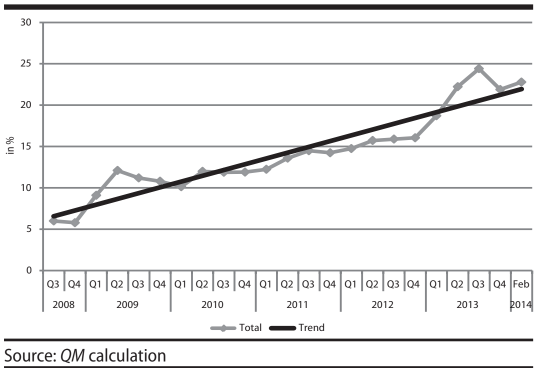
Source: *QM* calculation

Revoking the licence of the UBB caused a drop in the participation of bad loans …

… but the negative trend was not stopped according to figures for January and February

Following the strong increase in bad loans in Q3, an improvement was recorded in this segment to the end of 2013 in the form of a decrease in the overall participation to 21.89% (participation in Q3 stood at 24.41%, Graph T7-11). This is also the first time since 2010 that a significant reduction in participation in this segment was recorded but data from January and February 2014 showed that there were just short-term changes in level but not in the trend. The drop in the participation of bad loans was not the consequence of an improvement of the situation in the economy but of the fact that in October 2013, a third foreign-owned bank the Privredna Banka Beograd (PBB) lost its license following the Agrobanka and Razvojna Banka Vojvodina (RBV). The revoking of the license meant that the PBB balance position was excluded from the balance of the banking sector which gives us a clear picture of the level of bad loans in this bank even though we are bearing in mind the fact that the participation of bad loans in the entire banking sector was reduced by some 2.5 percentage points following the exclusion of this bank. The biggest individual reduction was recorded in bad loans to companies which stood at 27.76% at the end of Q4 (at the end of Q3 the participation of bad loans with companies stood at 31.13%, Table T7-10), while the participation of bad loans placed with private individuals continued to rise following a drop in Q3 and stood at 8.59% at the end of Q4. In January, the Univerzal Bank Beograd (UBB) also lost its license which shows the gravity of the problem of bad management in domestic banks and the danger of negative effects spilling over to the rest of the banking sector. The NBS revoked the UBB license as a measure of prevention to avoid a repeat of the scenario with the first three banks whose recovery cost some 800 million Euro but despite that public finances will continue to be exposed because of the fact that deposits of up to 50,000 Euro are guaranteed by the state. Despite the fact that the UBB lost its license in January, figures from the end of February back up our view expressed in previous issues that bad loans are a problem for the entire banking sector and that the real situation is probably even worse than statistics are showing. Although the NBS has taken certain measures to reduce the participation of bad loans[2], the effects to date are far below the level that would indicate that we could expect significant reductions in the amount of bad loans in the Serbian banking sector in the medium term. On the basis of the stable trend of growth of bad loans, it seems that an active engagement by the state as regulator and creditor is needed to resolve problems in companies whether by restructuring or by change of owner.

Graph T7-11. Serbia: participation of bad loans in overall placement, 2008-2014



Source: *QM* calculation

2 By changing regulations in December 2012, the NBS enabled the passing of debts due to banks to persons outside the financial sector with the consequence of increasing the credit ability of banks thanks to the freeing of previously formed reservations for credit losses.

8. International environment

Global recovery continues. Advanced economies, particularly the USA and the euro area, are growing more rapidly. On the other hand, many developing countries are suffering the consequences of capital outflow. The Fed and the ECB tightened their expansionary monetary policy, and central banks in many developing countries are raising the interest rates to prevent depreciation of the national currencies. Budget deal between Republicans and Democrats would increase consumer demand in the USA, and the fiscal deficit in the euro area is narrowing to an acceptable level. There is a dichotomy between the price rise in developed and developing economies – the former keep the inflation down at a quiet low level while the latter are facing high inflation. Inflation is going down in the Eastern Europe and in developed countries. Macroeconomic crisis and lower growth in developing countries and escalation in Ukraine crisis are the major threats to global economic growth. Developing economies are facing increased political instability.

World

According to the IMF's forecasts from January, global growth is projected to increase slightly in 2014, to 3.7%, while the growth rate in 2015 remains at the level anticipated in the previous report, i.e. 3.9%. Growth in advanced economies in 2014 is targeted at 2.2% and in developing economies at 5.1%. Growth rates in Russia and Brazil have been revised downward, from 3.0% to 2% and from 2.5% to 2.3% respectively, while the growth rates in China and India have been revised upward, from 7.2% to 7.5% and from 5.2% to 5.4% respectively. The IMF advises that structural reforms be made both in developing and advanced economies, that expansionary monetary policy continue to be pursued in advanced economies until the recovery, and that measures intended to increase financial and macroeconomic stability be implemented in developing countries.

The Fed decided to tighten its monetary policy in December. Consequently, investors started to withdraw the "hot money" from developing countries causing increase in borrowing costs, drop in stock values and depreciation of national currencies. However, the Fed should not be held solely responsible for this. As of the last summer, after the Fed announced their plan to follow a less expansionary monetary policy, the turmoil in developing markets started, and the phrase "fragile five"[1] (Brazil, India, Turkey, South Africa and Indonesia) became popular among economists. These five countries are faced with some common problems – high inflation and current account deficit, growth slowdown, and big political risks in some of them. More rapid growth in the USA and the euro area, and consequently capital outflow from developing to these markets driven by higher risk premiums, exacerbated the situation. However, GDP growth in advanced economies boosts demand for products from developing economies and thus helps them expand. Growth in advanced economies, therefore, affects developing countries in two opposite ways – capital outflow and increased demand for products from these economies. Short-term net effect could be negative, but in the long run, growth in advanced economies will probably boost developing economies.

Many developing countries are experiencing increased political instability, often in the form of mass demonstrations, which undermines financial stability and hinders economic growth. The IMF emphasizes that structural reforms in most of developing countries are needed to overcome the macroeconomic weaknesses, and that some forms of control over the volatile flow of foreign capital can be useful.

Similar like earlier when the IMF and ECB had different opinions on the intensity of austerity measures across the Euro zone, these two institutions now disagree on how to avoid deflation.

1 The term BRIK was coined by Goldman Sachs' economists, and similarly the phrase "fragile five"was coined by the Morgan Stanley. The acronym BIITS is also used for these five countries. The "fragile five" take up 7% of the world economy.

The ECB economists take a more conservative approach to this issue and do not perceive deflation as such a serious threat as the IMF economist do. The IMF says that the recovery in the Euro area has just started and that further drop in prices should be prevented in time because it could be harmful if the euro-zone economy slowed down again.

The Eastern European states have not been exposed to such intense pressures as the "fragile five" have been due to the Fed's exit strategy. However, escalation in Ukraine crisis could cause a large capital outflow. Investors are not adequately informed about the Eastern European countries so, out of precaution, they could withdraw their capital from these countries only because they are geographically close to Ukraine. This happened in Poland and Hungary at the beginning of Ukraine crisis. If the armed conflict arose or if the West imposed sanctions against Russia, the growth in Euro area would slow down, capital outflow from Eastern Europe would occur and the oil prices would rise, which would produce synergistic harmful effect on the Eastern European economies. We must emphasize that Serbia and the "fragile five" have many macroeconomic weaknesses in common. Therefore, if the Ukraine crisis deepened, Serbia could find itself among the most seriously affected countries, and its borrowing costs would increase, as well as dinar depreciation risks.

Euro area

Since the recovery is speeding up, GDP growth in the euro area in 2014 has been revised upward by the European Commission, from 1.1% to 1.4%. Quarterly growth increased from 0.1% q/q in Q3 to 0.3% q/q in Q4. GDP growth was negative in 2013 (-0.4%). Growth across the euro area is more balanced and the recovery is now underway in countries at the periphery of the euro area – quarterly growth in Spain in Q4 was 0.2%, in Italy 0.1% and in Portugal as much as 0.5%. Growth achieved in Germany and France was beyond expectations (0.4% q/q and 0.3% q/q respectively). The growth in the euro area was mainly driven by exports and investments, while stocks and public consumption produced adverse effects (public consumption went down for the first time since Q3 2012). Surveys show that the growth will speed up in Q1 2014.

Since the rate of inflation was much below the targeted (0.8% instead of 2.0%), the ECB's intervention was expected by many economists. However, the ECB neither reduced its refi rate[2] nor used any other instrument of monetary policy to halt the drop in prices or stimulate growth. Consequently, euro has strengthened against dollar considerably. They are not planning to change the monetary policy in the foreseeable future. Faster economic growth is expected to push up the prices, so the unchanged monetary policy will increase economic activity because the real refi rate will go down as the inflation goes up. Not until 2016 will the inflation reach the targeted rate. Credit growth is still low, and public debt and private debt are large, which slows down the process of "cleaning up" the Euro zone corporate and state balance sheets.

Inflation in the euro area remains low, though it was stable in February and stood at the January rate (0.8%). Monthly inflation rate continued to fall in Germany, Spain and Italy. The euro area core inflation rose slightly, to 1%. Inflation will remain low due to low domestic demand. Not until the next year will the inflation increase to 1.5% thanks to faster economic growth.

After an aggressive fiscal consolidation in the euro area during the previous years, fiscal deficits should continue to narrow, but at a slower pace. Austerity measures helped reduce the euro area fiscal deficit in 2013 by 0.6 p.p. to 3.1%. Fiscal deficit in 2014 is projected to shrink to 2.6% and remain at that level afterwards. Greece primary budget surplus of EUR 1.5 billion exceeded the expectations, and allowed debt rescheduling and rise in social spending on austerity-hit citizens.

Unemployment in the euro area stands at 12% as of October. Austria and Germany have the lowest unemployment rates (4.9% and 5% respectively), while Greece and Spain have the largest number of the unemployed (28% and 25.8% respectively).

2 Refi rate stands at only 0.25% so there is not much room for its further reduction.

The euro area current account surplus increased to EUR 66.8 billion in Q4, which is by EUR 24 billion larger than in Q3. This increase primarily came from the trade surplus. Faster growth in the euro area stimulates economic growth in Serbia, especially because the recovery in Italy, as the major importer of Serbian products, continues.

U.S.

U.S. growth in Q4 fell to 3.2%[3] relative to 4.1% in Q3 2013. However, if we take a closer look at the growth structure we will see that the slowdown is not a bad news. Growth rate in Q3 primarily came from sharp increase in stocks, so it was reasonable to expect the growth to slowdown in the following quarter due to decrease in stocks. Stocks had minimum impact on growth rate this time. However, investments in fixed capital, having been quite small for a while, finally showed a considerable increase (6.9%), and exports growth rate shot up to 11.4%. Domestic demand remains sluggish. Additionally, residential investments, public spending and investments in business facilities slowed significantly in Q4.

The Fed tapered the monthly securities purchase by USD 10 billion both in December and February, and thus tightened its monetary policy. The Fed still faces communication problems. Their decision not to scale down quantitative easing made in September came as a big surprise. It was equally surprising when they reversed the decision in December. Economists predict Fed's interest rate hike in the first half of the next year. Tighter monetary policy and the expected interest rate stabilization prompted capital outflow from developing countries to the USA, and consequently destabilized many financial markets, pushed down stock and bond prices, and weakened developing countries' currencies. Rise in the overall US inflation rate started in October (1%) and reached 1.6% in February. Core inflation is quite steady (1.6% in February).

In his budget for 2015, President Obama proposes tax breaks for people on a low income and elimination of tax loopholes that the rich exploit to pay lower effective tax rates, often lower than those paid by the people on average income. Additionally, investments in infrastructure, technology innovations and training of the unemployed, intended to overcome the structural problems in US economy, are planned. This budget proposal is also intended to energize the voters because the Congress and House of Representatives elections will be held this year. Furthermore, budget deficit forecasts have been revised downward so the deficit is projected to narrow to 1.6% by 2024. Democrats emphasize that the budget deficit has been almost halved since President Obama's first term in office, which proves the effectiveness of their fiscal consolidation, and therefore believe that more aggressive austerity measures proposed by Republicans are not necessary.

Unemployment stands at 6.7% and it is close to the Fed's unemployment goal, but the problem is low labour force participation rate. Labour reports from December and January are quite adverse, but it is not clear why – due to low temperatures and bad weather during the winter, or because economy slowed down.

Central and Eastern Europe

Eastern European countries were not hit by the Fed's decision to tighten its monetary policy as seriously as other developing economies, primarily because the inflow of "hot money" into these countries was much lower than into other developing markets, while the inflow of EU funds often covers the current account deficit, and they have substantial foreign exchange reserves. Yields on bonds issued by some Eastern European countries, such as Slovakia and Czech Republic, are getting closer to the yields on German bonds. This indicates that the gap between the Eastern European countries is widening. Regarding public debt and fiscal deficit, Serbia, Slovenia and Croatia are the most vulnerable countries in the region. Many countries cut inflation which then allows them reduce reference rate and thus stimulate economy. Agricultural production boosted economic growth in the region.

3 SAAR – seasonally adjusted annualized quarterly growth rate used in the USA

Eastern European countries do not have close trade relations with Ukraine, so escalation in Ukraine crisis would not affect these countries considerably in that respect. Foreign investors could however withdraw their capital from the region due to small geographical distance from Ukraine. They often perceive geographical distance as a significant geopolitical risk factor, especially in countries they are not properly informed about. Escalation in crisis, which is quite unlikely, would have multiple negative effects on the Central and Eastern European countries: it would affect energy supply, capital inflow would decline etc.

Croatia experienced decrease in GDP by 1.2% in Q4, primarily due to low domestic demand. Private consumption declined by 1.8% and investments fell by 3.3% annually. Public consumption and net exports show annual growth of 1.8% and 3.3% respectively. Croatian economy is expected to stagnate in 2014. Low demand pushes the inflation down. Monthly inflation rate in January was negative (-0.1%), while annual inflation rate was slightly above zero (0.1%). If pressures on kuna increase, low liquidity, huge public debt and large fiscal deficit will push up borrowing costs. Croatia has the second highest public debt-to-GDP ratio in Eastern Europe, after Hungary, and the second largest fiscal deficit, after Serbia. Due to these risks and pressures from the European Commission, Croatian Government had to rebalance the budget to reduce 2014 fiscal deficit to 4.5%. To increase public revenues, they are considering relocation of payment for people with reduced service years for retirement from second-pillar pension fund to the state pension fund (European Commission does not object), or increase in health contributions rate to 15%.

Hungary experienced an unexpected annual GDP growth of 2.7%, while the quarterly GDP rose by 0.5%. Private consumption showed annual increase of 1% after a longer period. Investments, public consumption and exports also went up. Similar to many other Eastern European countries, Hungary experienced a marked increase in agricultural production. GDP growth in 2014 is projected at 2%. Inflation rate reached its 40-year minimum falling from 0.9% in October to 0% in January, primarily due to administrative price control. Unorthodox monetary policy was undertaken to reduce reference rate from 3.4% in October to 2.7% in February and thus stimulate economy. However, many economists believe that such a sharp reduction in reference rate can be dangerous because the effects of administrative price control will soon wear off, and the inflation rate will probably rise to about 1% at the end of the year. Borrowing costs are quite stable thanks to a quite large share of domestic borrowing. However, large foreign debt and its short average maturity could increase interest rates on government bonds. Unemployment declined to 8.9%, primarily due to increase in numbers of public work employees, as an instrument of social policy.

Romania experienced an unexpected growth in Q4 (1.5% q/q) and annually (5.2%). This came from large volume of exports, rise in stocks and increase in agricultural production. GDP is projected to grow by 2% in 2014. The National Bank of Romania is planning to reduce reserve requirements and thus boost demand for domestic bonds. Inflation rate dropped from 1.9% in October to 1.1% in February. This allowed for several reductions in the reference rate from 4.25% in October to 3.5% in February. Liberals brought down the Government because they failed to get support for their programme. Social Democrats won 60% of the vote in the Parliament to form the new Government. Investors reacted positively to this because borrowing costs went down and leu appreciated.

HIGHLIGHTS

Highlight 1. Solving problems or delay and dilution

Milojko Arsić [1]

1. Key problems and challenges

Government will face big challenges in the economy: a) a fiscal deficit in Serbia has been for two years the largest among the Central and Eastern Europe countries, and this will probably be the case in this year, b) the public sector is oversized and inefficient c) functional system of market economy has not been established. The economy of Serbia in the late 2013 and at the beginning of 2014 faces slowing growth and high unemployment, so it is necessary, alongside fiscal consolidation and reforms, for some antirecession stimulants to be implemented. Most problems the new government will face are rather old, but they increased in the previous year and so the maneuver space to further postpone their solving is exhausted[2].

Reasons for postponing the solution of economic problems are numerous, but probably the most important obstacle was the existence of heterogeneous governments which were not been able to reach the agreement about the necessary reforms. Measures on which members of the ruling coalition reached the agreement were not sufficient to solve the problems, and problems grew over time. In the case of fiscal consolidation some parties have blocked the savings measures on salaries and pensions, other savings on subsidies, and that meant that there was no sufficient savings on positions that are the most oversized in relation to the possibilities of the country. The problem of heterogeneity will probably not exist in the new government, and the implementation of reforms will essentially depend on the determination and the ability of the dominant party (SNS) to implement them. Whether SNS will implement the decisive reforms, as announced, or choose a strategy of delay and dilution will be clear just a few months after the formation of the new government.

Fiscal deficit in Serbia in 2012 and 2013[3] was over 6% of GDP, which is at the same time the largest fiscal deficit in the Central and Eastern Europe countries, while the fiscal deficit of 7,1% of GDP is planned for 2014, with the possibility of being even larger (see details in Section 6). A direct consequence of a high fiscal deficit is the growth of the public debt in the past two years for 5.6 billion euros, i.e. increase of its share in GDP from 46.9 % at the end of 2011 to 63.5 % at the end of 2013. If a fiscal deficit of around 7.5% of GDP is achieved in this year the public debt at the end of 2014 would reach 23-24 billion of euros, i.e. it would be close to 70 % of GDP. As a consequence of a growing public debt, but also rising interest rates, interest expenditures increased from 0.8% of GDP in the pre-crisis 2008 to 2.5 % of GDP in 2013, in order to reach 3 % of GDP in this year. It is evident that these tendencies are not sustainable and that their continuation could, in the short term, lead to self-generated growth of the public debt, i.e. state could increasingly borrow just to pay its interest expenditures. In such circumstances, a crisis of public debt is highly possible, and its postponement with help of bilateral loans, which are motivated by non-market (probably internationally - political) reasons, has a limited duration. Therefore, a sharp fiscal consolidation, which would decrease the fiscal deficit to 2.5 - 3 % of GDP in the next three years, is urgent task of the new government.

Second priority of the Serbian government, which is important both for successful fiscal consolidation and for creation of a good economic environment, should be the improvement of the efficiency of the public sector. The efficiency of the public sector in Serbia is generally low, but the problems are especially concentrated in the functioning of the judiciary, land registry and town planning, i.e. the state institutions that are responsible for solving property and contractual relations in the economy. The quality of services of the state administration is low, which is manifested in low capacity for creation and implementation of economic and other public policies. The negative selection, the party hiring, and nepotism have become a widespread practice. Large space for the improvement of state performance exists in the field of education, where the state is acting as a regulator, financier and provider. Long-term economic and social development of Serbia is not feasible without raising the quality of education at all levels, from elementary school to doctoral studies. In the area of health care Serbia has made some progress over the last decade, but it is necessary to improve the availability and quality of health services in the following period, with existing relatively modest funds. There is a high degree of ineffi-

1 FREN and Faculty of Economics University of Belgrade

2 For more details see the Quarterly Monitor No. 28, which was released shortly after the elections of 2012, and before the formation of the government.

3 According to the official data the fiscal deficit in 2013 amounted to 5.7% of GDP, but the lags in settling the obligations of the state of around 0.5% of GDP are created, which is why it is necessary to correct the fiscal deficit to 6.2% of GDP. This correction is justified even though the budget accounting in Serbia is based on the principle of cash flow, because in a developed market economy it is unthinkable that the state is late in settling its obligations.

ciency in the performance of some public enterprises, which is manifested through high costs and low quality of their services.

Third priority of the Serbian government is the reform of the economy, i.e. improvement of the economic environment. The Serbia's economic system in many aspects significantly differs from the characteristics of a well regulated market economy, which increases costs and risks of doing business in Serbia. Some of the major differences are: financial indiscipline, predatory regulations and corruption (building permits, some elements of the Labor law, high tolerance for gray economy), excessive distortive state intervention in the economy, frequent and unpredictable changes in regulations, underdeveloped protection of competition, etc. The consequences of inadequate economic system are low investments, high unemployment, but also government expenditures for covering the losses in companies and banks, high tax debts and gray economy.

The lack of financial discipline, i.e. hard budget constraint, is probably the biggest deviation from the principles of the market economy. Financial indiscipline means that there are many market participants (companies, government institutions, etc.) in Serbia which do not settle their obligations in contractual and statutory deadlines. In the absence of financial discipline mechanisms of market selection don't work, so the survival in the market is possible for participants which are insolvent for years, some even for decades. Losses which occur in insolvent enterprises are transferred through market transactions to other market participants: banks, other enterprises, state and employees, and this leads to the spread of illiquidity and insolvency, and then to a decrease in economic activity.[4]

2. Fiscal consolidation: necessity, dynamic, content

Although most economists in Serbia estimate that fiscal consolidation is necessary, there are still economists who argue that it is not necessary, or that it is of a secondary importance compared to other policies and reforms. Representatives of the idea that fiscal consolidation is not necessary often refer to the practice of the developed countries of Europe and the U.S. that allegedly gave up on fiscal consolidation. However, data on trends of fiscal deficit in Serbia, European countries and the United States suggest that the reality was quite different.[5] The developed members of the EU and the U.S. have reduced the fiscal deficit in the period between 2009 and 2013, on average, from 6.8% of GDP to 4.1% of GDP, and in 2014 plan to reduce the fiscal deficit to 3.1% of GDP. Similarly, the countries of Central and Eastern Europe have reduced the fiscal deficit from 6.8% of GDP in 2009 to 3.8% of GDP in 2013. Even the United States, a country that is commonly cited as an example of an expansionary fiscal policy, in the current crisis reduced the fiscal deficit from 11.5% of GDP in 2009 to 6.2% 2013.

Contrary to the developments in the EU and the U.S. fiscal deficit in Serbia in the period of crisis, viewed as a percentage of GDP, was growing. In the first two years of crisis, the fiscal deficit in Serbia amounted to around 4.5% of GDP, and reached over 6% of GDP in 2012 and 2013. All countries that have had high fiscal deficits in 2013, including Greece, the United States and Britain, plan to reduce it in 2014. The only exception is Serbia, which is planning to increase the fiscal deficit in 2014, so the projected fiscal deficit of Serbia in 2014 is the largest among 29 countries observed. An unequivocal conclusion from the previous follows: the stand that Serbia conducts the policy of austerity, while other countries are giving up on austerity, stimulating consumption and increasing their fiscal deficits, is simply not true.

Other critics of implementing fiscal consolidation in Serbia state theoretical arguments, according to which reduction of consumption leads toward even bigger fall of GDP, consequently tax revenues fall even faster, fiscal deficit increases and the share of public debt in GDP increases. Based on this theoretical and empirical research follows that this sequence of events is possible, but it is unlikely that it will last for a long time (Berti et al, 2013). Reducing government spending will lead to an increase in the fiscal deficit to GDP ratio only if the fiscal multipliers are very high and/or if investors do not believe in a certain persistence of the Government in the implementation of the fiscal consolidation. The critical value of the multiplier, after which the state savings would affect the growth of deficit in Serbia is around 1, while empirical studies suggest that the consumption multipliers in countries such as Serbia are considerably smaller (Petrović et al, 2014).

A second reason government savings could affect the increase in the fiscal deficit and growth of public debt share to GDP is the distrust of investors in the persistence of the government in the implementation of fiscal consolidation. In this case the government savings can affect the reduction of private investments, because investors believe that the government will soon give up on savings, and that after that the country will enter the debt crisis. Empirical research show that even if investors do not initially believe a government, that it is enough for one to two years of consistent fiscal consolidation to pass in order to gain trust. In this period, while the

4 Udovički, K. (2014)

5 Data on movements of fiscal deficit in the countries of EU and SAD can be found on the website of the Eurostat.

trust is not gained, GDP may decline, the fiscal deficit and public debt may grow, but that is a necessary price that must be paid for prior history of inconsistencies in the implementation of fiscal policy. Thus, although it is possible that savings measures could lead to a temporary fall in GDP, and the deterioration of the fiscal position of the country, their use is necessary because the lack of savings would lead to continuing rapid growth of public debt, and that would be a sure way to a debt crisis.

Although a fiscal consolidation is necessary, in circumstances in which Serbia currently stands (fiscal deficit of 7.5% of GDP, public debt of about 65% of GDP), questions are raised about the dynamics of its implementation and the way it should be implemented? Given the level of the fiscal deficit and the public debt, as well as the former failures in their reduction, we estimate that for the credibility of fiscal consolidation it is important in the first step to take measures which would reduce fiscal deficit in 2014 by at least 1% of GDP[6]. As the additional measures of fiscal consolidation will probably be implemented in a half a year period, these savings are equivalent to annual savings of 2% of GDP, which means that these are very strong fiscal consolidation measures. It is important for the adopted measures to be permanent, not short term, because this would allow the transfer of its effects on the following years.

Parallel with these savings it is necessary to adopt plans, in the form of law, which would ensure additional permanent savings of about 1% of GDP a year, in the period between 2015 and 2017. As a result of these savings, fiscal deficit would decline from a level of about 7.5% in 2014 to about 3% in 2017. Although this represents a very significant reduction in the fiscal deficit, it ensures that Serbia in 2017 finds itself in a fiscal position in which the CIE countries are, in average, in 2014.

An important question with regard to fiscal consolidation is in what way is it possible to reduce fiscal deficit? Reduction of fiscal deficit is possible through reduction of expenditures (savings), increase in taxes or combination of these measures. Given that the public spending amounts to about 45% of GDP, which is high for a country at the level of development as Serbia, it is necessary that the largest part of fiscal consolidation is achieved through reduction of expenditures, i.e. through savings. Reduction of expenditures of about 5 percentage points of GDP in the following three years is possible only if significant savings on the biggest expenditure positions are realized, and these are salaries and pensions. These two expenditure positions are oversized in relation to the economic possibilities of the country - Serbia for pensions spends over 13% of GDP, while other countries at similar levels of development spend around 10% of GDP. Similarly, in the case of wages Serbia spends about 2% of GDP more than the countries on a similar level of development.

The savings on salaries and pensions will probably have to be implemented in a two steps process. In the first step nominal reduction of salaries and pensions during 2014 will be necessary, not lower than 10 %. Reducing salaries and pensions by 10 % would result in savings of just under 2 % of GDP annually, which represents 40% of needed savings in these two positions. If the reduction of pensions is illegal, or if it is politically unacceptable, then an alternate measure, which is often applied in the world, could be implemented and that is taxing pensions. If pensions would be taxed in the same manner as wages that would bring the country additional income/ expense decrease of about 0.6% of GDP. However, if neither reduction nor taxation of pensions are realized that would require that the public sector wages fall for about 25%. We estimate that such a reduction of wages would not be socially acceptable, and also it would be dissimulative for the functioning of the public sector - would lead to a further deterioration in the expertise of employees, reduction of efforts, encourage petty corruption, etc.

Second step towards savings on salaries and pensions would start with the adoption of legal changes in 2014, and continue with their implementation in the following years. In the case of pensions, legal changes would encompass introduction of actuary penalties for each year of pensioning before standard age limit, increment of age limit for pensioning of women and increasing of age limit for pensioning of both men and women. These reforms would not bring great savings in the first few years of their implementation, but their effect would gradually accumulate, and so they would give significant effects in a 10 year period. Additional savings on labor costs in the public sector can be achieved by rationalizing the number of employees. In the next few years, the number of employees in the public sector, which is financed with fiscal revenues, could be reduced by 5-10%, and in doing so not jeopardize the quality and accessibility of government services (health, education, justice, security, etc.). Reducing the number of employees in the public sector needs to be systematic, which means that the smaller part is achieved through natural outflow (retirement, leaving the public sector), and the larger part by laying off workers who are working on non-productive workplaces. The savings on salaries and pensions are not sufficient to place state expenditures on a sustainable path and create additional

6 Reduction in relation to the previous year is difficult, as through the lags part of the expenditures is transferred from the last in this year (see the section on the fiscal policy).

space for growth of investments within the reduced expenditures.

Additional savings which can be realized in the short term relate to the reduction of costs arising from the coverage of losses of enterprises and banks, and the reduction of subsidies for investment and employment. Besides, some savings can be achieved through reform of state administration at central and local level, as well as the reform of public services (health, education, social protection, etc.), about which we write in the third point of this Highlight.

In the course of the past two years the state has had high expenses to cover the losses of some enterprises, primarily Srbijagas, as well as expenditures for the recapitalization of banks that later went bankrupt and the payment of the insured (but also other) deposits from banks in bankruptcy. Behind the losses of Srbijagas[7], lay mostly: a) long-term sales of gas at prices lower than its cost, b) the sale of gas to insolvent companies, such as Petrohemija, Azotara, Železara Smederevo, companies in restructuring, etc., c) tolerance towards nonpayment of gas by public institutions and citizens, etc. A problem of poor management lies behind the bankruptcy of several local banks, which includes party involvement in bank management, but also the growing problem of illiquidity and probably insolvency of large private enterprises. Therefore, the reduction in government expenditures on the basis of covering losses in enterprises and banks can be solved only by the reform of the economic system, which is the topic of the third point of this Highlight.

Until the middle of 2013 Serbia was approving very extensive programs of direct and indirect subsidies for encouraging investments and employment, while in the second half of 2013 Serbia fully suspended approval of new subsidies for these purposes. However, during the election campaign representatives of the largest party (SNS) have announced extensive subsidies for investments and employment, which would be approved in a time-limited period of two years. We estimate that instead of returning to the extensive subsidies, the adequate thing, in 2014, would be to reduce these subsidies in relation to the amounts that were granted by the middle of 2013, as well as to legally determine the trajectory of their additional reduction in order to be fully repealed by the end of 2015.

Subsidies would be further reduced by limiting purposes for which these subsidies are granted - they could be obtained only for large scale investments, which have positive effects for the economy of a region or the entire country. In addition to budgetary subsidies, it is necessary to reduce the tax exemptions and deductions, which are granted through income tax, because the income tax is still low compared to other countries.

7 Although, there were irrational operations in Srbjiagas they are of secondary importance in terms of the balance sheet and in comparison to the above mentioned causes of the losses.

Box 1. How European countries reduced fiscal deficits in the period of crisis – lessons for Serbia

Given that the majority of European countries, both developed and developing countries, managed to significantly reduce the fiscal deficit in the period of crisis, in the process of drafting the program of fiscal consolidation in Serbia it is useful to have in mind the way in which deficits in other countries were reduced. The study Kichert at. al (2013) shows an overview of the measures that have been applied in 13 European countries in order to reduce the fiscal deficit. Almost all analyzed countries have taken significant measures to reduce labor costs, although labor costs in these countries, in relation to GDP, were lower than in Serbia. In as many as 11 countries hiring was frozen and measures to reduce the number of employees in the public sector had been taken. Salaries have been reduced in six countries, while in 11 countries they have been frozen. Almost all countries have proceeded with the reform of the public sector (health, education, pension system, administration) with the aim to reduce government expenditures. In as many as 11 countries excise duties were increased, VAT was increased in nine countries, income tax in nine countries, and the tax on profit in five countries. Tax cuts have been rare and used in developed countries that had good fiscal position, and in which tax rates are very high (Belgium, Denmark).

The experience of European countries in reducing the fiscal deficit is important particularly in the case of Serbia, because our country meets very strange and unrealistic proposals to reduce the fiscal deficit, which as a rule do not require any renouncement. According to some of these proposals the key measure to reduce the fiscal deficit is to reduce interest costs by replacement of expensive loans with the cheap ones. In the previous issue of QM we wrote about how relatively modest savings could be achieved this way, even in the hypothetical case in which Serbia would get favorable loan in the amount of three billion euros from the UAE. In the present circumstances when the contract was signed on the loan of one billion euros it is practically not possible to achieve savings by preterm return of one part of expensive loans. If the state would use this loan to repay part of the expensive loans, it would not achieve any savings because in few months, the state would again borrow at interest rates of 6-7%.

An alternative proposal implies that the fiscal deficit should be reduced in relation to GDP without saving, that is, through expansionary policy of expenditures or through reducing the taxes on labor, encouraging the strong GDP growth that would lead to an increase in tax revenues, which would further result in a reduction of the fiscal deficit relative to GDP. Such dynamics of fiscal and macroeconomic variables is generally very unlikely, and in circumstances Serbia is it is practically impossible. Furthermore, it could be argued that Serbia in the last two and a half years carried out the moderate variant of this policy, and its result was the growth of the fiscal deficit and a stagnation of the economy.

From the foregoing it follows that successful fiscal consolidation in Serbia, as in other countries, have to rely on very specific saving measures: such as reducing of expenditures for salaries and pensions, reform of state-owned enterprises, reform of health care, education, etc. Furthermore, due to the delays in implementation of austerity measures Serbia will have to implement tougher measures than most other European countries.

Fiscal deficit may be partly reduced by improving tax collection, which implies combating the shadow economy but also improving tax discipline by reducing the tax debts. In doing so it is important that additional tax revenues do not represent a replacement for the previously described measures of austerity, but rather a supplement to them. According to a detailed study[8], the shadow economy in Serbia in 2012 amounted to around 30% of GDP, and was alongside those in Bulgaria and Romania the largest in Europe. There are numerous indications that the extent of the shadow economy in 2013 was further increased. Along with the growth of the shadow economy, in 2013 tax debts were intensively growing, which occurs in situations where the tax payers register their obligations but are unable to pay them. The growth of tax debts, with a growth percentage of non-performing loans, represents a strong deterioration in financial performance in the large number of companies in Serbia, including some large private companies.

For repressing the shadow economy it is crucial to reduce government tolerance towards it, while for the reduction of tax debts it necessary to establish a financial discipline. It is estimated that Serbia within 2-3 years could reduce the shadow economy to the level of the countries of Central Europe, which would increase tax revenue for about 1% of GDP. When it comes to the tax debts collection, it is quite uncertain to what extent the chargeable tax debts occurred in large private companies over the past few years, but we estimate that the revenue will be lower if the solving of problems is delayed. The possibility to collect the old tax debts which largely relate to the companies in the process of restructuring is practically negligible.

3. Public sector reforms and improvement of the economic environment

The main objective of the reform of the public sector is improving its efficiency and this may be done by reducing costs and/or increasing the quality and the range of its services. Reducing the cost of the public sector is important for the success of the fiscal consolidation, and this, apart from the above mentioned measures (reduction of salaries and pensions, downsizing and parametric pension reform) should encompass reforms to reduce the costs of goods and services in the sectors of major consumers (local and the national administration, the judiciary, health, education, social services, etc.). In certain sectors improving cost efficiency can be achieved by changing the funding method - in the case of primary and secondary schools funding would be based on the number of students in the municipality, not on the number of employees. Reducing the cost of the public sector can be achieved through the rigorous prioritization of investment projects, which would postpone some projects, while permanently reject others. Prioritization would for example imply that the construction of Morava corridor, highway Novi Sad – Sabac, or the highway towards the Romanian border is postponed until the end of construction of Corridors 10 and 11. In addition, it is necessary to establish mechanisms for the cost efficiency control of investment projects.

Improvement of the quality of services of the public sector is equally important as reduction of its costs. Public sector reform is of key importance for improvement of the economic environment because without efficient judiciary and administrative services, quality education services, etc., economic and social development is not possible. It is therefore important for all major areas (administration, judiciary, education, health care, local communities, etc.) to define criteria for measurement of the quality of services, target dynamics to improve the quality and responsibility of authorities and individuals for achieving the defined goals. Improving the quality of services requires the introduction of the system of financial rewards and penalties for government institutions, depending on the results of work (primary and secondary schools). In the case of universities it would be justified for government funding to depend on the quality of the University, which is measured according to standard international criteria. In the area of doctoral studies modest resources available to the government could be concentrated in a way that from every scientific

8 Krstić et al. (2013)

field doctoral studies are organized at one university in Serbia, but that these studies are at the top international level (see Highlights 2). In this case improved efficiency would be two-fold, because society would receive better education with less money spent.

Reduction of public expenditures on the basis of covering the losses and financing the credits of public companies requires implementation of numerous measures starting from improvement of the management of these companies, reduction of unnecessary costs which are a consequence of the excess employment, elimination of suspicious agreements with private companies which are owned by people close to the ruling parties, liberation of public companies from quasi fiscal obligations such as all kinds of sponsorships, etc. In order to improve the revenues of public companies it is necessary for public companies to be liberated from the social function, and this implies: to form the prices for their products in accordance with the market principles, to prevent the usage of services to customers who do not pay them regularly, regardless of whether they are companies, government institutions or citizens. The example of NIS, after privatization, is a confirmation of how much the operations of a company can be improved by abolishing unnecessary costs and improving revenue collection[9].

The overall goal of the public sector reform is creation of favorable conditions for investment and employment in Serbia and the way to achieve this is through reduction of expenditures and risks of doing business in Serbia. Reform of the economy is important also for fiscal consolidation as it would directly affect the reduction of expenditures, such as the expenditures for covering the losses of public companies and banks, and the expenditures for subsidies used to compensate for the weak economic system. Reforms of the economy would also favorably influence public revenues as the tax capacity of the economy would increase through the growing employment, consumption, etc., and the collection of taxes would also be improved (reduction of the shadow economy and tax debts).

Establishing a financial discipline, i.e. hard budget constraint, represents the most important reform in harmonizing the economic system of Serbia with the principles of the market economy. A key role in this process has the adoption of adequate bankruptcy laws that would encourage creditors and owners of companies to promptly take measures to solve the financial problems in companies, including bankruptcy procedure. Adequate bankruptcy legislation should in future put to an end the accumulation of financial problems in companies, which is then transferred to the banks and the state. To establish financial discipline it is important to, within a reasonable time period which should not be longer than one year, definitely resolve the status of all companies in restructuring, either through privatization or bankruptcy. Establishing financial discipline requires removing the social functions from public companies, which we have previously discussed. In order to establish financial discipline it is essential that the government regularly settles its legal and contractual obligations and to drastically reduce the tolerance of the shadow economy and the accumulation of tax debts.

Improvement of the economic environment requires, besides fiscal discipline, realization of numerous other reforms, such as abolition of unnecessary and simplification of other regulations, labor market reform, ending of the privatization process, improvement of the competition policies, reduction of the shadow economy, and other. Overly complicated, unclear and mutually inconsistent regulations introduce risks, increase operating costs and represent a powerful source of corruption. It is therefore necessary to re-start the “guillotine of regulations”, which was quickly abandoned after the initial momentum. Guillotine of regulations should be a continuous process because the tendency of the state to make unnecessary and complicated regulations is fairly stable. Among the many regulations that hinder business operations for many years, complicated, costly and time-consuming procedures for the construction of buildings stand out. Thus, the legislative simplification of these procedures and the introduction of mechanisms for their effective implementation should represent one of the priorities of the new government.

Tax system reform, which would reduce the fiscal burden on labor (primarily contributions) and increase fiscal burden on consumption, would be stimulating for investments and employment, and indirectly would improve the international competitiveness of the Serbian economy. However, it is estimated that the tax system reform should be postponed until the most important problems in public finances in Serbia are solved, and these are high fiscal deficit and growing public debt.

Besides solving the accumulated fiscal and structural problems there are strong reasons to re-examine whether the current monetary policy regime is optimal for Serbia (Šoškić, 2014). Due to the fact that for a long time it is not certain whether in Serbia the benefits or costs of an independent central bank are higher, introducing currency council is a legitimate alternative that should be seriously considered. In this sense, it would be desirable that the Government conducts consultations

9 Improvement in NIS operations is also a result of relatively high investments Gazprom realized after taking the control over the company, and not only as a result of eliminating unnecessary costs and better collection.

with the IMF, the ECB and the leading world economists in this field.

4. Antirecession stimulants and sectorial policies

While the realization of the fiscal consolidation and reforms is necessary, justification for implementing antirecession stimulants is not entirely certain, especially having in mind that in Serbia it is not possible to apply standard stimulants which are applied in market economies. While it is possible to put forward many arguments against anti-recession stimulants, it is estimated that arguments in support of their application are prevailing.

Standard stimulants refer to the reduction of the key policy rates of the central banks, which encourage commercial banks to lower their interest rates which affects increase in credit activity and then increase in investments, consumption and economic activity. In Serbia such policy cannot be implemented because high euroization prevents impact of NBS interest rate reduction on interest rates of commercial banks, consequently preventing the impact on their credit activity. Instead, the interest rates have more effect on the exchange rate and the demand for foreign currency, and so their reduction encourages the demand for foreign currency and depreciation of the dinar. Therefore, the NBS is forced to implement the policy of high interest rates even in the conditions of falling lending activity, recession and low inflation.

However, problem of a substantial drop in the level of bank lending activities, increase of the percentage of non-performing loans and the consequential decline in economic activity cannot be ignored. It is therefore justified to encourage bank lending in a different way, if this is not possible by lowering interest rates of NBS. One of the relatively efficient ways to stimulate bank lending activity during the crisis in Serbia was a program of subsidized interest rates on bank loans. Through the implementation of this program, states with relatively low resources (4-5 billion of dinars) encouraged an increase in bank lending activity for several dozens of billions of dinars. Therefore, we estimate that it would be justified for the government to continue with a program of granting subsidized loans in 2014 and the following year. Parallel with the extension of the program of subsidized loans, the government would implement reforms to systematically tackled the problem of illiquidity and insolvency of companies (bankruptcy law, etc.), which would increase the number of creditworthy companies.

In the part on fiscal consolidation, arguments are given against total abandoning of subsidies for investments and employment, but also against the continuation with generous subsidies in the following two years. Instead of this, we propose granting lower subsidies which would gradually reduce with the aim to be completely abandoned by the end of 2015.

Besides general subsidies which would refer to all economic activities we estimate that in some sectors special sectorial subsidies are justified. In this part we lay down possible subsidies for construction and agriculture, although sectorial incentives are possible even for some other activities.

The main goal of subsidies in construction is to mitigate dramatic fall in this sector (see 2. Economic Activity) and related sectors. The second goal is to provide solution for housing problem of members of the middle class, through encouraging construction of apartments at prices that are affordable to families with average income, and this is income of family members in the interval from 80 to 100,000 dinars per month. The program would be implemented in such a way that local communities would provide free land for housing construction, and so the price of apartments would consist of two components, costs of construction of apartments and minimum cost of arranging of the construction land. Apartments built under these conditions would cost about 500-600 euros per m^2 outside Belgrade, i.e.600-800 euro per m^2 in Belgrade. Funds to finance the construction would be granted by commercial banks, which would credit the customers and these loans would be secured by the National Mortgage Insurance Corporation.

The cost of the state for the realization of this project would consist of two components: the value of the ceded construction land and insurance costs of housing loans. Ceded construction land represents a capital transfer, which would be a cost of local communities on whose territory apartments would be built, while insurance costs would be borne by the Republic. Economic motivation of local communities to join this project is the increase in employment, income and consumption in their territory during the period of construction of apartments and the realization of future tax revenues arising from property tax. The project would be launched in Belgrade and several major cities in Serbia which during the previous decade achieved a certain economic progress, so that they have enough households that could buy apartments under these conditions. Given that the whole project would have a social component, certain restrictions would be placed in order to provide a buying advantage to families that do not have a solved housing problem.

In contrast to construction industry, where subsidies are under antirecession, incentives for agriculture would be systemic, and would aim to increase the productivity of agricultural production, growth of exports of agricultural products, etc. Incentives would partly be aimed at individual farm households and would refer to the education of producers, approving of co-financed subsidies for the purchase of agricultural machinery, procurement of more productive plants and breeds of animals, hail protection, irrigation, etc. In all cases the state would provide a smaller amount of funds while the greater part of the funds would be provided by farmers.

Second type of subsidies would refer to the support of modern cooperative production as already exists in European countries. The state would, in this case through subsidies, participate with a certain percentage in the construction of cooperative facilities, such as cold storages, warehouses, modern machinery, etc.

In addition to subsidies the state would also apply other measures for improving the productivity of agricultural production, particularly important are incentives for the enlargement of agricultural properties. Introducing tax on agricultural land in 2014 would be one such measure, which should increase the cost of unused agricultural land, and thus to encourage the sale of smaller properties that are not used or are used unproductively. For the enlargement of agricultural properties, especially south of the Sava and Danube rivers, it is necessary to solve the unregulated property relations that now prevent the purchase transaction.

Next to fundamental questions which appear always when incentives are applied and subsidies granted, and those are the questions which refer to economic justification and fairness, another important question is how to secure the funds for antirecession and sectorial incentives in the conditions when it is needed to reduce the expenditures of the stare drastically? Also, it is relevant that the total state expenditures for all forms of the above mentioned incentives (subsidizing interest on loans, subsidizing housing loans, subsidies for new employment, and subsidies for agriculture) could not be larger than 0.5% of GDP, which means it would amount to between 15 and 20 billion dinars annually. For 2014 financial resources would be secured through redirection of funds intended for the guarantee fund and a joint venture fund. As it is clear that the process of layoffs in companies in restructuring will extend on the next year, funds intended for severance pay in this year would be refocused on simulative measures.

To ensure the fiscal sustainability the total stimulation funds for specified purposes in the future would not exceed 0.5% of GDP, but their structure would change significantly over time. While subsidies for interest would be one of the biggest incentives in this and the next year this sort of incentive would be completely abolished in a 2-3 year period. Also, subsidies for job creation would be reduced so that they are completely abolished by the end of 2015. Subsidies for housing credits in 2014 would be were very low but would probably grow in the next 2-3 years and after that period would decline. Subsidies for improving agricultural production would gradually grow and they would by applied in a longer period. Abolishing antirecession measures would create space for startup grants for activities that generate positive external effects, such as the development and introduction of innovations and similar activities.

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Highlight 2. Reform in higher education in Serbia: on doctoral studies

Prof. Branko Urošević [1]

This is the first in a series of short reviews of issues relating to the reform in higher education in Serbia. We will begin with the issue of doctoral studies for three reasons. **The first one** is the importance of quality doctoral studies to social development. Doctoral studies are the crown of educational process and a foundation stone for development of scientists and university lecturers in any field of science. **The second reason** is that the quality of doctoral studies in Serbia in some fields of science is much below the highest international standards. One of the main consequences of such state is, on one hand, overproduction of personnel with doctor's degree who are not properly trained for scientific work. On the other hand, the most talented young people are leaving the country increasingly to take up quality doctoral studies abroad. They often do not come back, either because they do not want to, or because they cannot find employment at universities or research institutions in Serbia. This affects universities and research institutes adversely, and could have a catastrophic long-term consequence for society. **The third important reason** why the reform is necessary and why we are writing this paper is the need to use the scarce government funds (getting even scarcer) for higher education and scientific work as efficiently as possible.

Although much of the following can be more or less applied in any field of science, for the purpose of concreteness and regarding the obvious importance of economics for the society, we will focus on development and funding of high quality doctoral studies in economics.

1. What the doctoral studies in economics in Serbia are and what they should be

Not a small number of institutions in Serbia offer doctoral programmes and award doctor's diplomas in economics and related branches (business management, for instance). The key reason for this is existence of a number of public and private faculties which provide education in these fields and which are obliged by the valid law to formally round up its educational process and obtain appropriate accreditation. Another important reason why doctoral programmes are offered, the way they are today, is that they allow faculties increase their profits. Both of these reasons are far from the primary purpose of doctoral studies - to be the crown of educational process and to create quality researchers.

Since all faculties in Serbia, even the public ones, charge fees for doctoral studies in economics, and since no adequate fellowships that would enable the prospective PhDs focus on studies and scientific research over the period of 4 to 5 years (this is necessary to write a quality PhD thesis) are awarded, most of the students have to work simultaneously. Lecturers are often people with little or no experience in writing scientific papers that can be published in high quality international journals in the SSCI list, which is the international research quality standard in economics. To attract students who do not have too much time to study, to facilitate the work of lecturers, and to attract a mass of students necessary for profitability of these programmes, teaching materials used in undergraduate studies and, to a certain extent, in master studies are employed.

All this make doctoral studies in economics in Serbia inadequate for its main purpose. It is therefore important to mention some of the essential characteristics of quality doctoral studies in economics and their social function.

Firstly, being the crown of educational process, domestic doctoral studies, both by its form and its essence, must keep pace with the high quality and structure of the best international doctoral programmes as much as possible. The goal is to enable talented young people become top-class economists-researchers without having to go abroad. It is important to mention that in economics and business management, probably more than in any other social science, clear international quality standards of doctoral studies have been established. Leading American universities and business schools set these standards and the rest of the world adopted them. Lecturers at doctoral studies are typically people who have proved their ability and willingness to do internationally-valuated research work. Classes are typically in English. Doctoral programmes thus can compete for students and lecturers from all around the world, and students are enabled to study in language which is de facto the official language of economics. Applicants have to satisfy objective and stringent initial selection criteria. Students are usually awarded fellowships with which they can pay the fee and live modestly. This allows them focus on studies and research. In return, prospective PhDs are to a certain extent involved in the teaching process and/or research. The objective of teaching process at quality doctoral studies is to achieve a high level of competence to understand and independently develop models used in scientific works in top-class international journals on economics and business management, and to provide high-quality

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training in empirical research. These programmes therefore, without exception, reached a high quantitative level. Textbooks on main subjects, primarily on microeconomics, macroeconomics and econometrics, and the mathematical apparatus students are expected to handle, have been standardized. Doctoral students also have access to standardized databases and can attend quality research seminars where they become acquainted with works of the leading international researchers and make personal contacts with them.

Thanks to the knowledge and skills they acquire, students completing doctoral degree at prestigious universities are in great demand both in university circles and outside of them. For example, besides the leading multinational companies and international institutions (IMF, World Bank, EBRD etc.), ministries of finance, central banks and fiscal councils in many countries increasingly employ top-class PhDs. Similar goes for private sector – banks, insurance companies, large enterprises. Quality doctoral studies in economics are therefore a very important factor which contributes to increase in institutional capacities and modernization of the society.

Another very important thing that people in Serbia know very little about is that there is a superbly organized formal world labour market for the people who successfully complete quality doctoral studies in economics or some other social sciences. Several **thousands** of fledgling PhDs from all around the world go to the first round of interviews with potential employers at several large world conferences, primarily the Allied Social Sciences Association (ASSA) conferences held every year early in January in North America. At this well organized labour market for economists-researchers wherein leading American, European, Asian, Russian, Australian and Latin-American universities, institutes, companies and international organizations participate, doctor's degrees, and consequently, universities awarding them are valorized. This encourages institutions and countries willing to participate in this market to open up and hire doctoral students at the top-class programmes as lecturers and researchers, and to establish an upwards trend in the quality of their own doctoral studies. Serbia can either try to follow these trends, or continue falling behind not only the leading countries, but also the contries that have until recently been far behind us, at least in these fields.

2. One, but valuable

The foregoing clearly shows that quality doctoral studies in economics are very important and useful but also a quite complex undertaking. The question is what Serbia, given the current state of affairs, can do. We could learn from some European countries' experience. Some of the problems European countries, especially the continental ones, are faced with are quite scarce funds for research work, very heterogeneous quality of the existing researchers in the field of economics, and that quality researchers are hired in a number of institutions. To establish a competitive high-quality doctoral programme, joint doctoral programmes in English have been developed in a growing number of countries, by a group of institutions or at the national level. These are some examples:

The Humboldt University and Freie University and two more universities from Berlin (one of them is a top-quality private business school) in cooperation with more than 20 institutes established a joint PhD programme in economics in English. Only top-class researchers hired with these institutions hold the classes which satisfy the highest world standards. Besides the professors from Germany, lecturers come from other countries, too. Maximum annual number of students is 20 (for all fields of economics and related branches). All students are awarded fellowships and come from Germany, Europe and other parts of the world.

There is another example in Spain. Two leading universities from Barcelona, the Pompeu Fabra University and Autonomous University of Barcelona (previously bitter rivals) established the Barcelona Graduate School in Economics. All of their master's and PhD programmes, which are among the best in the world, with top-class world lecturers, and classes held in English, are jointly organized at this school. Although they pay quite modest salaries (which are comparable with salaries received at Serbian faculties of economics), these two schools are able to hire top-class young talented academic economists from all around the world, primarily thanks to the quality research work and students.

The third example is especially interesting. Even Switzerland and Austria, rich countries, implement austerity measures and concentrate their resource (primarily human resources). Swiss Finance Institute is an umbrella organization which organizes joint doctoral studies in finance in English for the whole of Switzerland. In Vienna, consortium of two leading public universities and the private university Vienna Institute for Advanced Studies offer joint doctoral studies in economics and finance. These are all quality programmes.

The fourth example is closer to us, geographically and by mentality. There is only one PhD programme in physics in Croatia. All Croatian universities and institutes engaged in physics participate in it. The number of similar examples is large and growing.

3. How to develop quality doctoral studies in economics in Serbia?

Clearly, quality, and especially top-class, doctoral studies in Serbia cannot be developed overnight. We however think that it is necessary, for the foregoing reasons, to work on it. These are the steps that, in our opinion, should be taken if we want to achieve it in the foreseeable future.

The current structure of teaching personnel and funds the government allocates for higher education and science dictate extremely rational use of scarce human and material resources. Quality researchers are employed with different institutions in Serbia, such as universities, institutes, but also the National Bank of Serbia. The success of the International Masters in Quantitative Finance (IMQF) programme established at the Faculty of Economics in Belgrade shows that, through cooperation between the leading domestic and foreign lecturers and with top-class standardized programmes, it is possible to develop both cheap and quality educational programmes in Serbia.

On the other hand, none of the institutions has adequate human resources to carry out a quality doctoral programme on its own. We therefore suggest that the country take an active part in development of a **single** PhD programme in economics and business management that would gather the leading economists-researchers in Serbia and from Serbia, regardless of where they are currently employed, as lecturers, and also attract high-quality lecturers from abroad.

Entire programme should be in English, though a combination of English and Serbian would be possible during a transitional period. The structure and quality of the programme should be monitored by an **international council for the programme** made up of some of the leading world academic economists with a wealth of experience in establishment of similar programmes.

The idea is to establish a programme that would be up to world standards regarding its goals, content and the quality of lecturers, and the quality of PhD thesis and working conditions. Only the number of students for which it is possible to provide quality mentoring and fellowships that would allow them commit to studying and research over a period of 4 to 5 years should be enrolled on the programme. It cannot be a large number on national level (about twenty students annually for the entire field of economics).

It is important to point out that all quality human resources should be included in the process and that all regulatory, organisational, interest-related and psychological barriers must therefore be removed to make it possible. Additionally, top-class seminars organized by the National Bank of Serbia should be a backbone of research seminars at which doctoral students and, of course, lecturers would be active participants.

Experience teaches us that spontaneous association and socially responsible behaviour of domestic academic institutions cannot be expected as long as majority wants to maintain the status quo.

The state therefore plays the key role, at least at the beginning. It is in charge of two important issues: it allocates funds to most productive activities and grants accreditations only to those programmes, especially doctoral programmes, which reach certain quality standards. We therefore suggest that, regarding economic research funding, the government give top priority to funding for these elite doctoral programmes and everything that helps establish and develop such programmes. Some funds should be spent on researchers hired as teachers at these courses. Additionally, fellowships and access to appropriate databases should be given to all students, and study visits at partner institutions and programmes abroad should be arranged. However, probably the most important role the government should serve could be to find the mechanisms to remove all barriers to return and employment of our young people who completed top-class PhD studies abroad and wish to come back, and to open up to international labour market for economists-researchers. With possible considerable savings, these measures would produce more profound effects than buying peace by preserving the (unsustainable) status quo.

Highlight 3. The Impact of Unreliable Statistical Data on Creating Economic Policy in Serbia

Danko Brčerević [1], Milojko Arsić [2]

For a successful economic policy, as well as economic analyses (as the ones conducted in QM), reliable and timely statistical data is essential. It is our opinion, however, that SORS in some important cases does not provide such data. The latest revisions and newly published data by SORS related to the statistics of the national account and employment opened up numerous dilemmas in users of these data, which deserve a broader expert discussion due to their importance.

Revision of the national account for 2012, adjusted the real growth of investments for that year from -3.4% to 14.4%, i.e. almost 18 percentage points. Economic policy makers and economic analysts were therefore signalled a year ago that investments in Serbia are experiencing a considerable decline, but we now learned that investments in 2012 not only did not decline, but actually had a high growth (provided this new data is correct as well). Let us note here that revision of data is not uncommon in statistical systems and, as stated on SORS website, they are the result of improved methodologies, changes in calculating methods, corrections of errors in data, etc. So, there is no doubt that revision of data is necessary and common, and it achieves fine tuning of data, often quite important in more complex statistical research. However, when the revision changes one of the most important macroeconomic aggregates, investments, by 18 percentage points with one year delay, a question is raised whether SORS is giving us in real time even the most basic insight into main economic trends in Serbia?

After the last revision, GDP in 2012 had a 1.5% decline instead of the previously assessed decline of 1.7%, which presents a usual adjustment done all over the world. The huge adjustment in investments in 2012 was accompanied by other changes on national accounts, so its impact on GDP was mostly offset. The biggest change was in the share of imports and exports in GDP, so net imports' contribution to GDP growth in 2012 was reduced by around 3.5 percentage points (despite almost unchanged growth rates of imports and exports). Total GDP growth in 2012 therefore changed by only 0.2 percentage points upward, despite the extremely high changes of individual aggregates that comprise it.

At the end of December, SORS also published a new, official value of nominal GDP for 2012, which compared to the previous estimate was lower by 1.1%. That means that realised GDP in 2012 was by 320 million euros lower than we thought at the time. Let us remember that at the same time when nominal GDP was adjusted downward by 1.1%, the real GDP growth in 2012 was adjusted in the opposite direction – by 0.2 pp upward. It follows that the GDP deflator for 2012 was adjusted by as much as 1.3 percentage points. GDP deflator adjustment of 1.3 pp is considered high and unexpected, because its most important components – inflation and dinar exchange rate for 2012 – have long been known.

With the new 2012 GDP value, the values of all other indicators that are calculated in relation to GDP change as well. For example, the new value of share of public debt in GDP at the end of 2012 is now almost 62% of GDP.[3] Since the value of nominal GDP for 2012 is at the same time the basis for calculating GDP for 2013, the nominal GDP in 2013 will be reduced and the share of public debt in GDP in 2013 will probably be close to 65% of GDP.

Another problem is the existing bias in preliminary estimates of GDP compared to its final value. Since 2009, each time the final nominal value of GDP was lower than the preliminary one by 1%-3%. If errors are accidental, their average should be zero, i.e. sometimes preliminary data would be higher than the final one, and other times it would be lower, but on average the preliminary data would be equal to the final one. However, in the case of nominal GDP of Serbia, the final data is almost always lower than the preliminary data, which indicates a systemic error rather than an accidental one. Preliminary estimates of nominal GDP are calculated based on preliminary estimates of the real GDP growth and deflator. Final GDP estimates could differ either due to changes in real GDP growth rates or due to changes in the deflator. Even in this case, we would expect sometimes deflators to change and other times real growth rates. In practice, however, in the past four years, after each final announcement of the nominal GDP (which is lower than the preliminary one), real growth rate of GDP for that year remained unchanged, while the deflator always decreased. It is our opinion that it is highly unlikely that there were errors four years in a row in calculating preliminary deflator, while the real GDP growth was always calculated correctly.

1 FREN
2 The Faculty of Economics and FREN

3 Based on the public debt value from 2012 published by the State Audit Institution

Large reduction of unemployment indicated by October Labour Force Survey (LFS) is also questionable.[4] According to LFS data, the number of employees in October 2013 compared to April of the same year increased by as much as 7.5% (from 2.23 million employees to 2.39 million), while the unemployment rate was reduced from 25% to 21%. According to LFS, high improvements on the labour market are also confirmed at the year-on-year level[5]. The highest growth of employment was recorded in the grey economy, in helping household members in agriculture and in the self-employed, which is basically difficult to verify, because there are no reliable statistics about these economic sectors. For example, the number of helping household members doubled from April to October 2013 (see the Section on Labour Market). Even though this cannot be directly verified, it is not difficult to show based on indirect indicators that such a growth of employment, even in the informal economy, is highly unlikely.

The significant increase in employment in 2013 was in line with the trends in other macroeconomic parameters. First of all, large improvements on the labour market require a strong economic recovery and vice versa, large improvements on the labour market should influence the growth of GDP, as was the case with Baltic countries in 2010. However, there was no such recovery in the second part of 2013, and we could even say that most of Serbia's economy was in recession in 2013.[6] Low economic growth rate with a large increase in employment would also imply a significant decline in productivity, which is highly unlikely. The impact of 150,000 newly employed people, from April to October, would have to manifest in the increase in trade and population's standard of living, which based on the trends in private consumption published by SORS did not happen.

The inconsistency in employment growth in 2013 compared to other statistical indicators can be shown even more directly by analysing employment trends by sectors. According to LFS, the number of employees in construction increased by over 4% from October 2012 to October 2013. On the other hand, at the time of publishing LFS, SORS also published another piece of data – that construction in 2013 had around 20% decline. We used as an additional indicator for trends in construction activities the production of cement. Cement production is easy to monitor and cement is used in all construction works. In this way, we wanted to include in the assessment of construction activities the part of construction that is perhaps out of sight of this sector's official statistics. However, cement production also confirmed that construction activities in 2013 suffered a large decline, which means that the data on the growth of employment in construction is probably wrong, even if we include informal employment in that growth.

According to our estimate, the latest data from the Labour Force Survey on the one hand sent wrong signals to decision makers about improvements on the labour market, while on the other they raised doubt about the reliability of statistical data in many investors and analysts who are monitoring economic trends in Serbia.

In all its analyses, QM mostly uses SORS data. That is why we support every improvement in the work of this institution and the adoption of improved methodologies, which is currently in progress.[7] Still, it is hard to believe that the mere change in methodology could explain the 18 pp adjustment in investment growth, the discrepancy between the real GDP growth and its nominal value, as well as the strong growth of employment in conditions of slow economic recovery. That is why we feel that SORS would have to establish a practice with each bigger change (such as this investment one, for example) whereby it would provide an explanation why the change occurred, why the new value is so different from the previous one, and whether they expect similar adjustments to happen in the future.

4 Let us also recall that this is not the first time that highly unusual data was published in the Labour Force Survey about the changes in employment, which we wrote about in previous issues of QM. One of those very unlikely changes was the sudden drop in the number of employees in agricultural households during 2009.

5 We additionally verified this in order to exclude any seasonal influence on the growth of employment in October. Growth of employment really was slightly lower at the year-on-year level than at the last year's level, but both indicators imply large improvements on the labour market.

6 For more details, see section 2 "Economic activity" in this issue of QM.

7 On SORS website it is published that the process of harmonization with the methodology of ESA 2010 is currently in progress.

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