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OF ECONOMIC TRENDS AND POLICIES IN SERBIA

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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

Adverse trends in Serbian economy prevailed in Q3 – economic activity weakened, and foreign trade deficit increased. Our estimates show that in 2014 GDP will shrink by about 2%, and current account deficit will widen to 6% of GDP. Inflation remained below the targeted level, with relatively frequent months of deflation, and dinar depreciated in nominal terms against euro by 6-7%, and the real exchange rate depreciated by 4%. Official figures show strong and continuing improvements in labor market, which is inconsistent with all other macroeconomic trends, and therefore raises reasonable doubts about their credibility. Fiscal deficit will be somewhat smaller than projected and will probably run at 7.5% of GDP by the end of year. However, Serbia will still have the largest fiscal deficit in Europe in 2014.

Laws on public sector wage cuts and pension reduction were adopted at the end of October, as one of key measures for fiscal consolidation. The amended Law on Planning and Construction adopted in Q4, which dramatically simplifies the issuing procedure and shortens the time needed to obtain building permit, is the most important reform bill. However, a number of obstacles to construction, such as outdated records of ownership of land, or the unresolved issue of restitution and conversion of building land, still remain.

In 2015, economic activity will be strongly affected by numerous factors acting in opposite directions. Fiscal consolidation, liquidation of insolvent companies, and low credit activity of banks, will weaken economic activity. However, this decrease in economic activity will be cushioned by rise in electricity and coal production back to the multiple-year average, renewal of production in some enterprises after their privatization, and expected reform-driven rise in investments. According to mid-term projections, GDP will shrink by about 1% in 2015. This decrease will be somewhat larger if the announced successful privatizations (of Železara, FAP etc.) fail, or if some over-indebted private firms stop the production. Analysis by components of demand shows that public and private consumption will suffer the sharpest drop (by -6% and -3% respectively), and investments will increase by 5%. Net export is expected to rise by 1.5 percentage point of GDP, due to drop in domestic demand and real dinar depreciation. The National Bank of Serbia should try more actively to bring the inflation back to the middle of the targeted corridor in the next year.

Government representatives and the IMF reached a three-year agreement on economic policy and reforms. This agreement is not available to the public yet, but according to what could be heard from the Government it contains a relatively comprehensive package of economic policies and reforms. The main goal of economic policy is to reduce fiscal deficit by about 4% of GDP in the following three years. Furthermore, this agreement contains crucial reforms such as completion of privatization of socially-owned enterprises, reforms in public enterprises and enhancement of business environment.

Although the measures contained in this agreement are sometimes described as draconic in public, they are actually the minimum of what Serbia needs to do to put public finance in order and prevent public debt crisis. Sustainable economic growth requires further reforms, such as reforms in judiciary, in cadastre, in tax administration, in government and municipal administration, in education system etc. However, to make progress in any of these fields, it is crucial to eliminate negative selection when hiring or promoting public sector employees.

Delays in budget approving and in signing the agreement with the IMF indicate political and social gravity of the required measures, but also suggest that the government still dithers over their implementation. This brings up the question as to whether the Government is willing and able to carry out the announced reforms. In the preceding months, the Government has embarked on some unpopular reforms and measures, such as pension reform, and wage and pension reduction, which confirms their willingness to act. Besides, there is no room for further delays and procrastination. However, it is not certain whether the Government has political will to carry out the reforms. On one hand, it is a long way to new elections and the Government has huge parliamentary majority, which should make the job easier. On the other hand, it is uncertain whether the Government will persevere with reforms in spite of the resistance from unions, bureaucratic obstruction, or a possible drop in approval rating. Limited administrative capaci-

ties are another obstacle to some complex reforms, such as reforms in judiciary, tax administration, cadastre, government administration, education etc.

Serbia is in recession and faces dinar depreciation. However, recession does not seem to have attracted much public attention, while the effects of depreciation have been overemphasized. At the same time, an extremely biased and simplified approach to both phenomena has been used.

Serbia moved into recession in the first half of 2014, and May floods deepened it. Furthermore, there is a tendency to blame the floods and unfavorable international developments for the drop in economic activity. However, economic activity started to weaken almost six months prior to the floods, which disproves the forgoing thesis. Downwards trends are detected in almost all components of aggregate demand and in almost all sectors, which indicates the impact of systemic factors on recession. In the current year, private consumption, public consumption and investments went down, and the second half of the year saw decrease in exports, as well. Almost all sectors were hit by a drop in economic activity, including those that are neither directly nor indirectly related to the floods, such as car industry or petrochemical industry. A quite reliable estimate obtained through a detailed analysis by sector shows that even if Serbia had not been hit by floods, its GDP would have shrunk by 0.8%.

Unlike the previous two, the ongoing recession was not caused by unfavorable international developments. In 2009 and 2012 Serbian economy was pushed into recession by the first and the second wave of crisis in EU. Currently, only 4 out of 28 member states are in recession, and the average growth in EU countries in 2014 is estimated at 1.3%. Drop in economic activity in Serbia cannot be attributed to Ukraine crisis either, because Eastern European economies that have closer economic ties with Russia and Ukraine than Serbia does will grow in 2014.

The foregoing leads to conclusion that the recession in Serbia was caused by internal fundamental factors, such as unfavorable business environment and growing macroeconomic risks. Economic reforms and fiscal consolidation are therefore necessary to make a sustained economic recovery.

Dinar depreciation was in line with the usual exchange rate fluctuations in countries with flexible exchange rate regime – euro and yen fell against dollar more than dinar did against euro. There are estimates of the short-term negative effects of depreciation, but its positive effects on Serbian economy are completely neglected. Short-term negative effects are direct and visible, and come down to increase in expenditures on foreign currency loans. On the other hand, favorable effects are produced in the mid and long term, and are not that apparent. In case of Serbia, deflationary tendencies that reversibly deepen recession can be eliminated through dinar depreciation. Under recession, the impact of depreciation on inflation is weakened. Somewhat deeper depreciation is therefore needed to bring the annual inflation back to the targeted corridor of 4-5%. Depreciation is needed to enhance international price competitiveness of Serbian economy and to reduce still very large trade deficit. Additionally, dinar depreciation stimulates exports and inflow of FDI, as the key generators of future economic growth. Depreciation is also a means of diversion of investments from the sector of non-tradable goods (trade and other services) to the sector of tradable goods (industrial and agricultural products). In general, devaluation of domestic currency by several percents annually through moderate depreciation is a good strategy for a small open economy such as Serbian. Systematic devaluation of domestic currency proved successful in many emerging economies. We therefore believe that it would be good to employ this strategy in Serbia, as well. Overvalued currency hinders economic growth and decreases employment. Overvaluation of dinar before the crisis is partly attributed to a large inflow of capital, and partly to a short-sighted and opportunist policy and influence of certain interest groups (importers and foreign currency debtors). To the extent to which it was caused by economic policy, whose aim was to win political favor with citizens through an unsustainable rise in the standard of living based on imports of cheap goods, and to protect the interests of importers and foreign currency debtors, overvaluation of dinar was one of the biggest mistakes made by Serbian economic policy makers after 2000.

TRENDS

1. Review

Unfavorable macroeconomic trends continued and worsen in Q3: economic activity increases its decline, inflation is still considerably below the target corridor of the NBS, and the current account deficit is starting to increase noticeably. Only on the labor market economic indicators consistently show improvement - reduction of unemployment and employment growth - but they are in all probability poorly measured (such movements are impossible in the current macroeconomic environment). We believe that economic policy is not coping well enough with these problems. Not only that the reactions on the rapid worsening of economic trends are very late, although all signals pointing to it have been visible for a long time, but are also completely wrong and unfounded assessments of the impermanence of the current problems and high economic growth in the medium term are being sent to the public. We believe that the first correct step of economic policy would be to finally objectively perceive and recognize how bad is the situation in which the Serbian economy is at the moment, but also to say the real reasons behind it, and not only to place the blame on floods or unfavorable international environment. After that it will be much easier to make the right comprehensive measures, but also to assess the real possibilities of the economy and required number of years for healing.

The economic activity is already now in deep recession. Year on year fall of GDP in Q3 amounted to nearly 3.6%, which is partly a consequence of floods and inefficient repairs from floods, but also of much more durable and therefore more dangerous trends (see Section 2 „Economic activity"). Within the bad result in economic activity in Q3 most worrying is the fact that of all the components of GDP in the largest decline were the ones that are most important for future growth - net exports, and particularly investments. In order to come to the turning point of the unfavorable trend in economic activity, the first component of GDP that must start to record positive results are investments, because in the coming years reduction of domestic demand is inevitable, and the growth of net exports must be preceded by the investment growth. Therefore, we estimate that such structure of GDP fall in Q3 clearly indicates further continuation of worsening economic trends.

We estimate that the fall of economic activity in 2014 could amount to around 2%. Approximately 1.2% of this fall we can attribute to floods (but also to inefficient repairs from floods), which are onetime problems, while the durable trend of bad economic activity accounts to around 0.8% annually. Our estimates indicate that this durable and essential trend of economic activity will further worsen and deepen its fall in 2015 to around 2%. Overall fall of economic activity in 2015 will however be somewhat lower, and we currently estimate it to be around 1%. The reason for seemingly lower fall than the actual trends of the economy is the expected restoration of normal production of coal and electricity in the year following the floods, which will contribute to GDP growth in 2015 by about 1 pp of GDP.

Inflation remains very low and at the end of November its annual level was 2.4%. The actual level of inflation is, however, even lower, because this index also contains the increase of the lower VAT rate from 8 to 10% in January 2014. Therefore, somewhat better measure, which more clearly indicates stagnation in the increase of the prices, is inflation in the last six months of only 0.3%. Reasons for low inflation are recession, in which the economy is, accompanied by a decrease in domestic demand, low growth of food prices, low imported inflation, and still restrictive monetary policy (see Section 5 "Prices and the Exchange Rate"). It is interesting to note that the recent depreciation of the dinar has not been significantly affected by the rise in prices. The dinar in the last six months (June-November) depreciated against the euro by about 4%, and in relation to the dollar by as much as 13%, while the inflation in Serbia in the same period was only 0.3%.

Since October 2013 when inflation fell below the NBS target corridor of 4±1,5% it returned to that corridor just twice (January and February) and that was immediately after the aforementioned increase of the lower VAT rate. The NBS, however, reacted to that failure to meet its primary objective rather passive, and held on to the restrictive monetary policy. The reference interest rate, besides the last reduction from 8.5 to 8%, is still about 6 pp greater than inflation. Although this is a sort of curiosity, the impact of the interest rate channel on inflation in Serbia is quite limited, and the real restrictiveness of monetary policy is better reflected in the NBS attempts to prevent the depreciation of the dinar. Since the beginning of the year up to this review, NBS intervened with almost 1.7 billion euro of foreign exchange reserves to defend the dinar's value. In addition, the NBS changed the rules on the amount and the structure of bank reserve requirements in an attempt to increase the offer of euros with less negative impacts on the offer of dinars. By defending the dinar's value not only that the inflation was slowed down, because a larger increase in the prices of imported products was prevented, but also a great amount of dinars was sterilized (primarily the one the NBS bought on the interbank market). Therefore, this seems like the NBS changed its priority from inflation targeting to maintaining exchange rate stability, because otherwise it would allow depreciation of the dinar, at least until inflation returns to the target corridor.

From the beginning of the year to the end of November dinar nominally depreciated against the euro by 4.5%, and in real terms for just over 2%, which is not much. Attention this topic is given in the public, but also costly interventions of the NBS, we therefore do not see as fully justified. It is true that the depreciation of the dinar has a negative impact on the foreign currency liabilities of debtors, but it positively affects the price competitiveness of the domestic economy, which in the next step contributes to the growth of net exports and employment. We believe that the NBS should use the current depreciation pressures and allow controlled dinar depreciation, and that a good measure of the level to which the NBS should allow the depreciation is - the return of inflation to the middle of the target corridor of 4%. Such NBS policy would meet multiple objectives (other than its primary objective to return inflation in the target corridor): 1) the level of inflation of about 4% would be desirable to ease the recession and more efficiently implement fiscal consolidation measures 2) depreciation of the dinar of 5-10% would improve the competitiveness of the economy at an acceptable increase in the cost of servicing loans and 3) reduction of foreign exchange reserves, which is especially accelerated in the last months of 2014, would be slowed down.

Depreciation pressures from the previous months have been caused by different factors, and we as essentially the most important single out sudden and adverse changes in the current part of the balance of payments occurring from mid-2014 (see Section 4, "Balance of Payments and Foreign Trade"). The middle of the year saw completion of a two-year period of strong growth in exports and reduction of the current account deficit, for what was largely responsible car production in the FAS Company. But in the past two years, investments were in the significant decline, and with no new investments, continued high export growth, after completed expansion of exports of cars, could not be expected. Therefore, the deterioration export trend in Q3 was somewhat expected, and we have already announced it in previous issues of QM. In Q3 export not only stopped the growth but it passed in deep y-o-y decline of about 10%, which now leads to a considerable growth of the current account deficit. By the end of the year we expect the current account deficit to reach a level of about 7% of GDP, which is by 1 percentage point of GDP higher than in the previous year. While at first glance this does not seem much, we note that this relatively small change compared to the previous year is the result of two different trends in the first and second half of the year. In the first half of the year exports still had high growth and the current account deficit were reducing, and in the second half of the year the situation reversed and now not only that the reduction of the current account deficit was canceled but the overall result will annually be an increase in the current account deficit compared to 2013.

Capital and financial inflows in Serbia in 2014 are not sufficient to finance the current account deficit, which is particularly evident from the increase in the current account deficit in the second half of the year (depreciation pressures on the dinar and foreign exchange reserves decline).

Capital inflows from FDI are relatively low, the economy and the banks are returning loans abroad and the only large and stable inflows of funds are the result of government borrowing to finance the huge deficit. However, even that large and unsustainable government borrowing in 2014 was not enough for the balance of payments to be in equilibrium (for the inflows from abroad to be similar to the current account deficit), so the NBS foreign exchange reserves since the beginning of the year until the end of November fell by over 900 million euros.

In the next year we do not expect major changes in the balance of payments in relation to 2014. The capital and the financial part of the current account will probably be similarly reduced - on the one hand the implementation of fiscal consolidation will reduce net government borrowing abroad, and on the other hand we expect that the expected decline in domestic demand will affect certain reduction of the current account deficit (primarily due to the decrease in imports, and not due to the growth of exports). For now there are no suggestions of any significant increase in FDI in 2015, but it is possible that there will be certain improvements. Arrangement with the IMF could have a positive impact on investors, but probably only from the second half of the year, when not only conditions of the arrangement but also the first results of its implementation will be known. The successful privatization of enterprises in the restructuring could also lead to a certain increase in FDI in 2015.

Large fiscal deficit and associated fast-growing public debt remain the biggest problems of economic policy. The fiscal deficit in 2014 (with expenditures below the line included) we estimate at 7-7.5% of GDP, which is slightly smaller deficit than the one planned by the budget revision, but it is still very high (see Section 6 "Fiscal Flows and Policy"). The share of public debt to GDP will exceed 70% by the end of the year, which is an increase of almost 10 pp of GDP compared to the beginning of the year. The continuation of these trends would inevitably led to a public debt crisis, and the government was forced to adopt unpopular measures to reduce pensions and salaries in the public sector, but also to enter into negotiations on a new arrangement with the IMF. We will write in more details on this arrangement and the medium-term fiscal adjustment in future releases of QM, when all the details of the agreement with the IMF are known, and now we will briefly give a preliminary analysis of the published contours of fiscal consolidation.

Based on the available data about the fiscal consolidation plan in the next three years and the arrangement with the IMF (which are very limited) we conclude that the government has opted for the strategy of multi annual gradual reduction of the fiscal deficit – instead of a strong adjustment in the first year of the implementation of consolidation and some minor corrections in the coming years, which was the plan of the previous Minister of Finance. The announced fiscal deficit in 2015 of about 6% of GDP is actually a decrease compared to 2014 for only 1-1.5% of GDP (because the deficit in 2014 will be 7-7.5% of GDP). It is planned to gradually reduce the deficit in the next two years at the approximately same pace, so in 2017 it with be lowered to the level of just over 3.5% of GDP (with expenditures below the line included).

The implementation of such gradual reduction of the deficit is practically made possible by the arrangement with the IMF, without which it would hardly be sufficiently credible and therefore possible. The advantage of this approach is that it buys time in which the quality of a number of fiscal consolidation measures can be improved, whose largest effect is shifted to the medium term, such as, for example, dismissal of employees in the public administration - for which it will now be possible to perform detailed analysis and prepare good plans. In addition, a negative short-term impact of fiscal consolidation on the economy will be more evenly distributed throughout the years, which can also help and facilitate its implementation (we remind you of our analysis by which the Serbian economy in 2015 will be in a relatively deep recession). This approach, however, has some disadvantages which may not be sufficiently clearly shown, and which would be useful to point out to the professional and general public, but also to policymakers if they are not fully aware of them.

First, fiscal consolidation will practically have to be prolonged on to 2018. Preliminary QM analysis show that the planned overall fiscal deficit of more than 3.5% of GDP in 2017 (which would correspond to a deficit of between 3 and 3.5% of GDP without expenditures below the line), will

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just be enough to slow down the growth of public debt to GDP in that year, but insufficient to stop it. For the reversal of rising trajectory of the public debt and avoidance of the crisis it will therefore be necessary that fiscal consolidation takes longer than three years, and that in 2018 similar (unpopular) measures to reduce the deficit are conducted, as in 2016 and 2017. Second, total savings will actually have to be greater than that the ones if faster (front loading) fiscal consolidation was implemented. This is because the prolonged fiscal consolidation will allow longer and higher growth of public debt to GDP ratio - preliminary analysis suggests that public debt at the end of 2017 could easily come to as much as 85% of GDP. Such high public debt will cause the allocations for interest in public expenditure to rise from around 3% of GDP in 2014 to almost 4.5% of GDP in 2017, which would then have to be compensated by the additional savings elsewhere.

Serbia: Selected Macroeconomic Indicators, 2005 - 2014

| | Annual Data | | | | | | | | | Quarterly Data | | | | | | |
| | | | | | | | | | | 2013 | | | | 2014 | | |
	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Economic Growth									y-o-y, real growth[1]							
GDP (in billions of dinars)	1,751.4	2,055.2	2,355.1	2,744.9	2,880.1	3,067.2	3407.6	3584.2	3876.4	...	...	...	...	...	...	...
GDP	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1	2.6	2.4	1.1	3.4	3.3	-0.2	-1.3	-3.6
Non-agricultural GVA	6.2	5.1	6.9	4.4	-3.3	0.2	1.521677838	1.1	1.6	2.2	-0.3	2.4	2.3	-0.2	-1.8	-4.7
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	5.2	3.0	10.8	3.3	2.1	-4.8	-13.9
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	5.4	3.2	8.8	2.2	3.6	-2.0	-5.6
Average net wage (per month, in dinars)[2]	17,478	21,745	27,785	29,174	31,758	34,159	...	...	...	41,419	44,248	43,939	46,185	41.825	44.971	...
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	...	...	...	1.724	1.724	1.720	1.705	1.697	1.697	...
Fiscal data						in % of GDP								y-o-y, real growth		
Public Revenues	42.1	42.4	42.1	41.5	38.6	-1.5	-4.6	0.6	-3.0	-5.8	-3.2	-2.7	0.1	-0.8	4.5	3.8
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7	3.3	3.6	-5.7	-10.8	-7.0	1.8	-6.2	5.8	2.2	-2.0
								in billions of dinars								
Overall fiscal balance (GFS definition)[3]	14.8	-33.5	-58.2	-68.9	-121.8	-136.4	-158.2	-217.4	-178.7	-37.4	-44.1	-57.1	-40.2	-64.7	-39.1	-31.5
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	-14,028	-14,693	3,341	3,623	3,712	4,017	3,384	3,759	3,731
Exports of goods[4]	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,394	10,540	2,151	2,578	2,979	2,832	2,510	2,769	2,656
Current account[5]	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,639	-2,092	-668	-387	-381	-671	-503	-495	-502
in % GDP[5]	-8.6	-12.9	-17.2	-21.6	-7.2	-7.4	-9.1	-12.3	-6.5	-8.3	-4.4	-4.3	-7.8	-6.3	-5.8	-5.9
Capital account[5]	3,863	7,635	6,126	7,133	2,207	1,986	2,694	3,486	1,917	612	356	277	671	496	372	337
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	669	1,229	171	264	446	347	316	397	334
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	859	-886	-164	887	-800	-370	509
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	757,689	673,147	674,731	701,822	757,689	696,802	756,996	787,778
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	6,605	6,025	5,917	6,122	6,605	6,015	6,513	6,641
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	1,870,916	1,933,868	1,929,205	1,911,059	1,870,642	1,815,004	1,842,407	1,888,471
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909912	933,839	907,288	924,684	933,170	933,839	937,875	949,418	976,865
M2 (y-o-y, real growth, in %)	20.8	30.6	27.8	2.9	9.8	1.3	2.7	-2.2	2.3	-2.6	-4.7	1	2.5	1.9	3.510531203	4.3
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	-8.3	-8.2	-9.2	-9	-6.5	-8.3	-5.7	-3.3
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	53.8	56.2	59.9	50.7	57.3	60.3	53	50.7	48.5	48.7	48.2
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	2.2	11.2	9.7	4.8	2.2	2.3	1.2	2.1
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	80.2	79.5	79.5	80.8	81.2	80.7	80.9	81.8
Nominal exchange rate dinar/euro[8]	82.92	84.19	79.97	81.46	93.90	102.90	101.88	113.03	113.09	111.69	112.15	114.2	114.3	115.8	115.6	117.4

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

Economic activity in Q3 recorded a deep year-on-year fall estimated at 3.6%. Reasons for such a deep fall in economic activity in Q3 are inefficient recovery from floods (mining and production of electricity), but also negative trends in the rest of the economy for which there are no indication that will soon be reversed. We expect that the cumulative fall of GDP in 2014 will amount to around 2% while in 2015 we expect a fall of 0.5%. Slowdown of GDP fall in 20145 is a result of temporary factors while the long-term trends will further deteriorate in the next year. The decline in economic activity in 2014 of about 2% includes large temporary reduction in the production of electricity and coal inflicted by the May floods and delays in restoring production. Conversely, reduction in the rate of decline in 2015 is the result of restoring production of EPS Company to multi-annual average, which will make a positive contribution to economic activity in 2015 of more than one percentage point of GDP. Therefore, carrying trend of economic activity (with effects of floods excluded) in 2014 would be a decrease of approximately 0.8%, and in 2015 (with effects of recovery from floods excluded) of 1.7%, which means that economic trends are worsening. Among many reasons for the noticed worsening economic trends, as a key on we single out several years of strong decrease of investments. Unless significant increase of investments occur already in 2015, the decline of economic activity in 2015 may be even deeper than expected 0.5%, but, what is worse, the perspective of the Serbian economy even in the medium term would not be optimistic.

Gross domestic product

Large y-o-y GDP decline in Q3 of 3.6%

According to the SORS estimate real y-o-y GDP decline in Q3 was very deep and amounted to 3.6%. Almost half of this decline is a consequence of temporary halt in the production of electricity and coal (floods), and without the effects of floods the decline of economic activity would amount to around 1.9%. May floods therefore had significant effect on the decline of economic activity in Q3 also, but the economic activity would be in significant decline even if there were no floods. Data on movement of economic activity in the first nine months indicate that the economic activity will record a drop in 2014 compared to 2013 by about 2%, which is significantly larger drop then the one we expected in the previous issue of QM (then we estimated that the GDP will drop by about 1% in 2014). Two most important reasons for which we changed our estimate are: 1) SORS has revised downward previously announced estimates of GDP trend in Q1 and Q2 2014 and 2) delays in eliminating the negative effects of floods on EPS production.[1]

Seasonally adjusted GDP confirms large drop of the economy in Q3

Graph T2-1. Serbia: Seasonally adjusted GDP growth (2008=100)
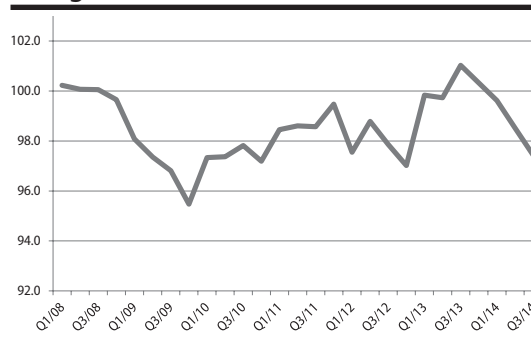
Source: *QM* estimates based on SORS data

Seasonally adjusted GDP growth indices (Graph T2-1) confirm negative trends in the movement of economic activity and its extremely large drop in Q3. Graph also shows that Q3 is the fourth consecutive quarter in which seasonally adjusted GDP decreases. Pace of GDP reduction is very similar to that after the first wave of the crisis in late 2008, which is very worrying and can be clearly seen in Graph T2-1. However, in contrast to the end of 2008 and throughout 2009, when the decline in economic activity was the central theme and had great attention of professional, but also the general public, this time it seems that this is not the case.

1 In the last issue of QM we assumed that already in Q3 one part of flooded coal mines will be drained and enabled and that the production of coal and electricity will begin to gradually increase, and in Q4 production will be fully normalized. Draining the water from the largest submerged pit "Tamnava West" began, however, only in the second half of September, four months after the floods, and normalization of production by all accounts will not be possible before 2015.

Trends

Negative economic trends are somewhat marginalized, and in the public unjustified estimates of higher economic growth in the medium term or unreliable and probably poorly measured data about strong employment growth prevail (impossible in conditions of deep recession).

Even when we exclude negative effects of May floods economic activity is falling

Graph T2-2. Serbia: Seasonally adjusted GDP growth excluding effects of floods (2008=100)
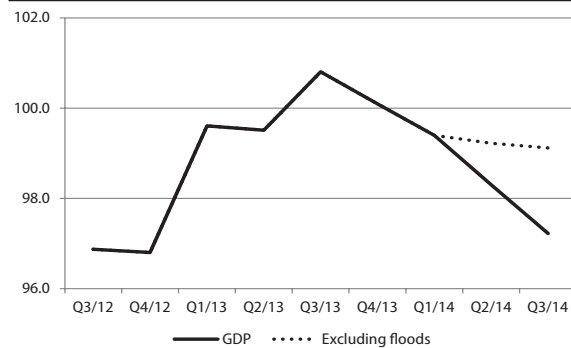
Source: *QM* estimate based on SORS data

For more detailed analysis of economic activity trends it is necessary to exclude from the result of economic activity in Q3 those areas that were most affected by the floods. In this way we can separate the bearing, durable, economic trends from the temporary impact of floods that will end in 2015. When we exclude those affected areas, we see that the decline in economic activity in 2014 would still exist, but it would be much lower (Graph T2-2). Based on this analysis (assuming that the GDP in Q4 will be at a similar level as in Q3), we can conclude that the economic activity in 2014 will decrease by approximately 2%, and that if there were no floods, this decrease would be by around 0.8% (dashed line in Graph T2-2).

Effects of reconstruction after the floods cannot be seen in the movement of GDP, which may indicate that the reconstruction is inefficient

It is interesting to notice some other interesting indications related to the reconstruction from floods indicated by the Graph T2-2. First, the negative impact of floods on the production of coal and electricity (and through that on seasonally adjusted GDP) was approximately twice as high in Q3 as in Q2. It actually directly shows that by the end of Q3 there was no significant recovery of production in the affected areas (because floods occurred in mid-May and affected only half of Q2). Second, it shows that the downward trend of seasonally adjusted economic activity without floods (dashed line) is virtually unchanged in Q3 compared to Q2 - which indicates the absence of a positive impact of reconstruction from floods on production.[2] Both of these indications suggest that the reconstruction after the May floods is quite inefficient, because of which our estimates of negative impact of floods on GDP from the previous issue of QM proved to be optimistic.[3]

The analysis separating the temporary effects of floods from the leading trends in economic activity is important for the prognosis of possible developments in economic activity in 2015. Namely, in 2015 usual coal and electricity production will be established which will increase their production for about 20% when compared to 2014. This will make a positive contribution to the growth of the economy for over one percentage point of GDP - which we will use as an exogenous component in forecasting GDP in the next year.

All components of demand falling in Q3

We have analyzed the structure of GDP trend in Q3 by use. Table T2-3 shows the structure of GDP growth by use. Table clearly shows that throughout 2013, up to Q1 2014, net exports (difference between exports and imports) had high and positive growth, while all other components of GDP - private consumption, government consumption and investment - were in decline or at best in stagnation. In Q2 and Q3 2014 bad trends of most GDP components were accompanied by net exports, which first stopped its high growth in Q2, and already in Q3 was in large decline. Slowing down, and then a fall in net exports, however, is not a big surprise and in QM we have indicated such trend of net exports a year ago.

Namely, high growth of net exports (as well as a solid growth of GDP) in 2013 was driven by the results of only several companies (FAS and NIS) and was therefore limited by production

2 Of course, this cannot be argued with complete certainty, since it is possible, for example, that the economic activity in Q3 would be even lower if there were not positive contribution of the reconstruction from floods. However deepening decline in total investment and construction in Q3 are additional indicators that suggest that the renewal is not implemented efficiently enough
3 In the June issue of QM, we estimated that the negative impact of floods (with the effects of restoration) may be around 0.5-0.6 pp of GDP, in the previous issue of QM, because of delays in restoration, we increased the negative impact floods on GDP in 2014 to around 0.8 pp of GDP, and the current trend of coal and electricity production suggests that it might be somewhat greater than 1 pp of GDP

capacities of these companies. In the meantime since 2012 investments are in deep decline[4], and without investments it is impossible to sustain such high growth of exports, and therefore GDP growth in general. We claim this because the remaining components of GDP, private and government consumption, despite a gradually decrease for several years, are still disproportionately high in relation to the possibilities of the national economy and must continue to decrease in the medium term. So, the key to sustainable economic growth in Serbia in the coming period is relatively high growth of investments and net exports, which should have a greater positive contribution to GDP growth than the inevitable reduction in private and government consumption.

Table T2-3. Serbia: GDP by expenditure method, 2009-2013

	Y-o-y indices												Share
						2013				2014			
	2009	**2010**	**2011**	**2012**	**2013**	Q1	Q2	Q3	Q4	Q1	Q2	Q3	**2013**
GDP	96.9	100.6	101.4	99.0	102.6	102.4	101.1	103.4	103.3	99.8	98.7	96.4	100.0
Private consumption	99.4	99.4	100.9	98.2	99.5	98.1	100.1	100.0	100.1	98.3	98.9	98.8	75.3
State consumption	100.6	100.8	101.1	102.4	98.7	96.7	94.2	102.5	101.6	99.4	100.2	98.4	17.8
Investment	77.5	93.5	104.6	113.2	89.9	97.0	81.9	90.4	90.2	97.6	99.4	92.4	17.6
Export	93.1	115.0	105.0	100.8	120.9	113.8	115.6	131.7	122.4	114.7	109.5	94.3	41.2
Import	80.4	104.4	107.9	101.4	104.9	99.4	102.5	109.6	108.2	103.0	106.3	101.9	51.9

Source: SORS

Most worrying is deep fall of investments

Precisely because the sustainable growth of the Serbian economy can be based only on the growth of investments and net exports, the result of economic activity in Q3 is more disturbing. So relatively deep decline in overall economic activity in Q3 is not the only problem, but also that the biggest drop was recorded by two components of GDP that are most important for future growth - net exports and investments (Table T2-3).In order for unfavorable trend in economic activity to make the turning point the first component of GDP that must start to record positive results (which will precede all others) are investments, and investments in Q3 additionally deepened its decline. This result is disappointing partly because we expected that in Q3 a slight recovery of investments will occur, as a consequence of reparations from floods. So far there is no indication that in the short term a significant recovery of investments will occur - financial performances of companies are bad, lending activity is low and FDI are low despite announcements. All things considered, the analysis of GDP by use confirms and suggests the further continuation of worsening economic trends.

In 2014 industrial production recorded a largest drop

Started analysis of GDP trends may be complemented with the last available data by activity which are shown in in Table T2-4. SORS with the latest published data and the transition to the new methodology (SNA 2008 / ESA 2010), changed the way of presenting the data by sector of economic activity so that instead of publishing the data for all of the individual sectors, some of them are grouped in one category[5]. Table T2-4 shows that the largest decline in 2014 was recorded in industrial production, partly due to the May floods (mining, energy), but partly due to the permanent negative trends in the manufacturing industry, on which more will be discussed in a separate chapter devoted to industrial production. Other sectors do not have so pronounced changes in production compared to the previous year. Service industries, which now integrated trade, transport and tourism, recorded a decline of a few percent compared to the previous year, and financial activities also recorded a drop. Agricultural production is approximately at the same level as in 2013, and only, but not excessively high increase, is recorded in the sector of information and communication.

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4 SORS data presented in Table T2-3 that investments in 2012 had real growth of even 13% is at least suspicious and occurred with the revision of previously published fall of investments in 2012 of 4%.
5 Manufacturing, mining and electricity production are grouped in industrial production, trade, transportation and storing, and tourism are also now presented together, etc.

Trends

Table T2-4. Serbia: Gross Domestic Product by Activity, 2013-2014

	2013				2014			Share
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	**2013**
Total	102.4	101.1	103.4	103.3	99.8	98.7	96.4	100.0
Taxes minus subsidies	95.9	98.4	100.2	101.0	98.6	100.1	99.6	15.8
Value Added at basic prices	103.7	101.6	104.0	103.8	100.1	98.4	95.8	84.2
Non agricultural Value Added	101.7	99.2	102.4	102.3	99.9	98.2	95.4	90,6[2]
Agriculture	122.8	125.0	119.1	118.3	102.3	100.7	100.0	9,4[2]
Industry	107.3	105.8	107.0	104.0	99.7	94.6	88.1	26,6[2]
Construction	103.0	82.2	98.6	102.7	100.6	104.1	93.6	5,1[2]
Trade, transport and tourism	101.0	99.9	102.7	105.4	99.6	97.7	98.2	17,8[2]
Informations and communications	99.9	96.6	100.9	102.3	104.7	105.1	103.2	5,2[2]
Financial sector and insurance	89.2	90.1	89.6	93.4	96.1	99.7	97.0	3,1[2]

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

GDP drop by 0.5% in 2015

We presented estimate of the GDP growth in 2015 in more detail in Spotlight On 1 of this issue of QM. Here we will briefly present only the main results of the estimate. In 2015 we expect a decline in economic activity of 0.5%, but this estimate could be changed depending on a number of factors that are not yet fully known: solving the fate of the companies in the restructuring, privatization of Smederevo Steel Plant, the fate of large private concerns (Farmakom), the size of fiscal consolidation and more.

We expect deep decline in private and government consumption as well as solid growth of investments

Observed by GDP components, we expect that in 2015 private consumption will record a real decline of about 3%, and government spending by over 6%. Net exports will make a positive contribution to GDP, but not because of growth in exports (we expect exports to stagnate), but because of the decline in imports. The component of GDP which is especially interesting to us, and which we consider to be crucial for the sustainable growth of the Serbian economy is investments. Real growth of investments in 2015 is estimated at 5% due to the growth of both public and private investments.

Unit Labor Costs in a temporary increase

Unit labor costs[6] (ULC), measured in dinars, in Q3 increased when compared to Q2, but also when compared to the same period of the last year (Graph T2-5). ULC actually represent the share of labor cost in the added value. This share in Q3 has been increased because of a temporary decrease of production in mining and production of electricity which was not followed by the layoffs of employees or reduction of their salaries. If we would exclude this temporary effect, ULC in Q3 would be at approximately the same level as in Q2. When a usual production in these sectors of the economy is established, the ULC will automatically return to its lower level.

In the medium term ULC in Serbia are decreasing which is generally a positive trend. We emphasize, however, that this results appeared by us using data on formal employment as information about the employment, which is in decline and in line with developments in economic activity (and our expectations) - but that the result would be totally different if we used data from the Labor force Survey (LFS). Namely, according to LFS, which includes informal employment, in Serbia there is a pronounced increase in the number of employees. If we used this data we would have a situation that the ULC trend is strongly growing, because employment is growing rapidly in conditions when economic activity is falling and slightly realistic reduced net earnings. If such large increase in ULC is really happening, it would lead the domestic economy to the enormous loss of competitiveness and a collapse (as with all the challenges that the Serbian economy is facing is not likely to happen, certainly not because of unsustainable growth in expenditure on employees). That is why we once again call on SORS to review the credibility of a strong increase in employment measured by the LFS in the past two years.

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6 Unit Labor Costs in dinars are calculated for the economy (excluding the Agriculture and Public Administrationsectors) and industry.

Graph T2-5. Serbia: Real UnitLaborCosts in theEconomyandIndustry, 2005-2014
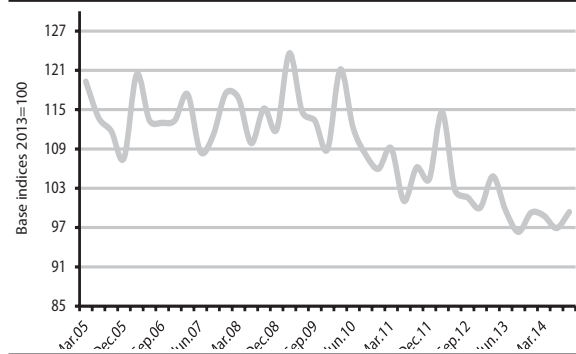
Source: QM based on SORS and NBS data

Price competitiveness of the economy is improving with real depreciation of the dinar

Graph T2-6. Serbia: Real Euro - Unit Labor Costs in the Economy and Industry, 2005-2014
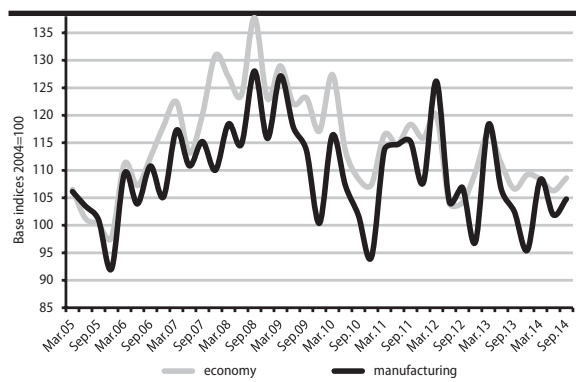
Source: QM based on SORS and NBS data
Note: the growth of euro-ULC on the graph represents the decline in price competitiveness

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[7], as shown in Graph T2-6.

Graph T2-5 shows that the euro-ULC in Q3 were on the rise despite a mild depreciation of the dinar. As in the case of dinar-ULC this is also a result of temporary trends that will end until the beginning of 2015. With all that, in Q4, there was somewhat more significant depreciation of the dinar, and so we expect that the euro-ULCs in 2015 are likely to be somewhat lower than in 2014. Competitive dinar exchange rate at which smaller euro-ULC point out is desirable for future sustainable growth of the economy based on the growth of net exports and investment. Please note, however, that this is a necessary, but not sufficient, condition for the increase in FDI, exports and production, and that for this to happen it will be necessary to remove many other obstacles (unsustainable fiscal policy, unfavorable and unpredictable business environment, poor ranking on competitiveness lists, etc.)

Box 1. September revisions of GDP

Since September 2014 SORS introduced two changes into the GDP calculation. The first was introduction of a new methodology of national accounts SNA 2008 / ESA 2014 in line with the recommendations from the European Union, and the second was increase of GDP coverage through better incorporation of the grey economy. These changes led to the increase of nominal GDP but also the increase of real growth rates in entire series of GDP data. Nominal GDP value in 2013 was increased by about 7% and in the preceding years in average for around 6%. Real GDP growth rates in the period 2001-2013 increased in average by 0.6 p.p We point out the fact that the increase in nominal GDP directly influenced the reduction of the relative value of all macroeconomic aggregates that are measured in relation to GDP (current account deficit, external debt, public debt, fiscal deficit, etc.), which is why there has been a change in data in almost all sections of this issue of QM.

Methodological changes in national accounts were not unexpected and already took place in previous years in all statistical institutes of EU countries. In countries in the region it led to an increase of nominal GDP for 5 - 10% (primarily due to a better incorporation of the grey economy in GDP, and less due to the implementation of the SNA 2008 / ESA 2010). Change of nominal GDP in Serbia also occurred primarily due to a better incorporation of the grey and illegal economy

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7 Excluding the Public Administration and Agriculture sectors.

and its size is consistent with the changes made by other statistical institutes in the region - and it is apparently justified and probably well implemented. The specificity for Serbia is, however, that recent methodological changes have led to great changes in real growth of GDP. Real GDP growth rates have been increased from 2001 in average by 0.6 pp. per year, while fro EU28 and Eurozone changes of real growth rates with introduction of new methodology were between ±0.1 p.p per year approximately symmetrically distributed on the positive and negative side[1]. This last fact raises some questions related to the latest revision.

In order for implemented revisions to be consistent GDP deflator had to suffer serious change, which is not mentioned anywhere. Namely, nominal GDP increased by about 7% in 2013 within the revision and by about 7.7% in 2001, which implicitly means that the growth of nominal GDP in the observed period was revised slightly downward. On the other hand, growth of real GDP in the period 2001-2013 was adjusted upward and not insignificant (on average by 0.6 percentage points per year, cumulatively for 8 pp). This means that at the same time with the revision of data on GDP a serious change in the GDP deflator happened. This change, we believe, would have to be explained in detail by the SORS.

Real growth rates by individual sectors are also oddly changed within the last revision – in some areas upward and in some downward. Thus, in the 2008-2012 period the growth rate of construction sector for each year changed for an average of about 7 percentage points. The average change in the annual growth of financial sector is more than 5 percentage points, which is about the same as average revised annual growth rates in the sector of information and communication. The recorder is still accommodation and food services sector whose previously published growth rates for each year are corrected on average by almost 9 pp.

QM redaction fully supports every improvement and harmonization of local statistics with the latest international guidelines, such as the last switch to the SNA 2008 / ESA 2010 methodology and increase of GDP coverage. Well explained quality data revisions improve the quality of our analysis. However, we're constantly encountering the unusually frequent and large adjustments made by the SORS, and constant publishing of official data of suspicious quality. GDP revisions in the previous ten years (since we follow them in QM) were far more frequent and greater in Serbia than in all other countries in the region[2], and some specific adjustments it is impossible to rationally explain (for example revision of real investment growth in 2012 from a decline of 4% to a growth of 13% - for which we know did not happen). When we add to all this the lack of logic which statistical data on employment and wages, construction and other sectorial statistics often have, we conclude that in front of SORS are major challenges to improve the quality of its work and reliability of the data it publishes.

1 Source: Eurostat news release: „ESA 2010 shifts level of EU and euro area GDP upward, growth rates almost unaffected", 17. October 2014. Available data for individual countries indicate that on the national level those oscillations were higher that ±0,1 p.p. per year, but nowhere we encountered the case that in the long run they systematically increased or decreased (as in Serbia).
2 For more details, see Review: "Reliability of official data on gross domestic product in Serbia", QM24

Industrial production

Industrial production continues strong decline

Industrial production in Q3 recorded a y-o-y fall of even 414% (Table T2-7). Within the industrial production large fall of even 28% and 39% was recorded by the mining industry and production of electricity, while the manufacturing industry also recorded a fall which was somewhat lower and amounted to around 5.5%. The reason for large fall of mining and production of electricity is May floods, which flooded the most important coal mines consequently influencing large fall in production of electricity and total industrial production. This deep fall in mining industry and production of electricity is temporary.

The trend of manufacturing industry, however, is much more important for the analysis. The decline of manufacturing industry in Q3 was also partly the result of one-off factors, of which certainly the most significant was halt in production in NIS company in September due to the plant maintenance and occasional stoppages in the production in FAS company (which for now we interpret as a one-off, but it is possible that they announce a gradual decrease in demand for

cars that are being produced in this company)[8]. Taking into account the aforementioned temporary factors, analysis of QM, however, shows that even with their exclusion manufacturing industry in Q3 was on a downward path, which is very worrying trend.

Table T2-7. Serbia: Industrial Production Indices, 2009-2014

	Y-o-y indices												Share
	2009	**2010**	**2011**	**2012**	**2013**	**2013**				**2014**			**2013**
						Q1	Q2	Q3	Q4	Q1	Q2	Q3	
Total	87.4	102.5	102.2	97.1	105.5	105.2	103.0	110.8	103.3	102.1	95.2	86.1	100.0
Mining and quarrying	96.2	105.8	110.4	97.8	105.3	107.8	102.2	107.6	104.1	99.7	87.0	71.6	8.5
Manufacturing	83.9	103.9	99.6	98.2	104.8	105.4	103.2	108.8	102.2	103.6	98.0	94.4	73.9
Electricity, gas, and water supply	100.8	95.6	109.7	92.9	108.1	103.7	103.7	120.5	106.8	99.3	86.2	61.3	17.6

Source: SORS

In 2014 drop in industrial production around 7%

In 2014 total industrial production will undoubtedly record a significant fall which we currently estimate to about 7%. Manufacturing will also record a fall, which will be lower and around 2.5%. Perhaps even more important than the annual decrease in total and manufacturing industry are bad trends that whit which we end 2014 and enter 2015. This worsening of trends can be sensed by only observing y-o-y growth of industry by quarters (Table T2-7), which from positive y-o-y growth of 3.6% in Q1 came to a fall of 5.5 in Q3 – and it can be even more clearly seen in seasonally adjusted indices.

Seasonally adjusted indices show a reduction in industrial production

Graph T2-8 shows seasonally adjusted production indices of total industry and manufacturing. Seasonally adjusted indices of total industry (lighter line in Graph T2-8) confirms already mentioned sharp fall in production from May under the influence of floods, which there is no need to further analyze. Darker line on Graph T2-8 refers only to the manufacturing which was not under such influence of floods and which we will analyze. Manufacturing started its slowdown even before the floods and its downward trend in 2014 is undeniable besides some oscillations by months[9]. Graph T2-8 shows that the manufacturing recorded its peak in October 2013 and started to fall since then, which coincides with a slowdown in net exports and the beginning of fall of seasonally adjusted GDP. Unfortunately there is still no indication of any change in these trends.

In Q3 most special purpose groups of industry deepened their decline

Graph T2-8. Serbia: Seasonally Adjusted Industrial Production Indices, 2008-2014
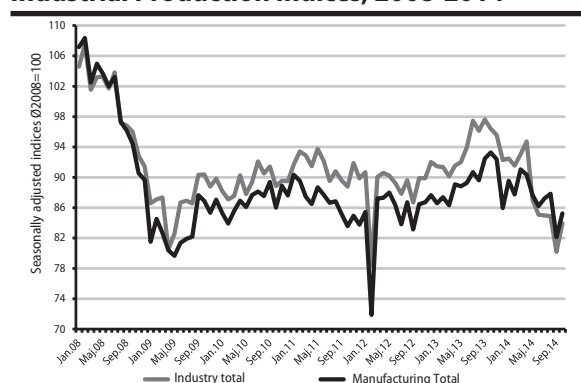
Source: SORS

Observed by use (Table T2-9) we see that in Q3 all specific groups of products are in a y-o-y decline and that almost all of them are deepening their decline compared to Q2 (only the production of intermediate goods kept approximately unchanged y-o-y decline). This division of industrial production from yet another angle shows the different effects of permanent and temporary factors on production. Energy production and investments in Q3 were under the dominant influence of temporary factors (energy - the consequences of floods and maintenance in NIS company, and investment - production shut in FAS company), while the trend of

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8 The lack of investment in capacity expansion in the FAS, as well as the announcements by the leaderships of FIAT, that for now they do not plan to start production of the new car models in the FAS, pointing to an assessment that production in FAS in the coming years could be stabilized at around 100 000 cars.

9 For example last two data in Graph T2-8 refer to September and October where the seasonaly adjusted manufacturing production in October is significantly higher than the one from September. This, however, is by no means an indication of recovery but a consequence of completion of plant maintenance of NIS company started in September when the production almost completely stopped for a month. When the value of the manufacturing production in October is compared with the data for August they show that manufacturing is on a downward trend.

production of intermediate and durable consumer goods reflects more permanent trends of in-dustrial production - which from the zone of mild growth in Q1 crossed toa decrease of a few percent in Q3 (Table T2-9).

Table T2-9. Serbia: Components of Industrial Production by Use, 2009-2014

						Y-o-y indices										
						2012				2013				2014		
	2009	**2010**	**2011**	**2012**	**2013**	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
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	102.1	95.2	86.1
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	101.1	89.1	65.1
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	107.7	97.0	91.1
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	103.9	94.3	94.8
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	100.2	99.6	97.5

Source: SORS

Construction

Estimated fall of about 5% in construction activity in 2014

The construction sector has been in a continuous decline for three years in a row and undoub-tedly this decline continues in Q3. Latest SORS construction data indicate a year-on-year real decline of this sector of economy in Q3 of even 20.7%, but this we consider unlikely. Previous two data from the construction statistics for Q1 and Q2 showed that the cost of construction works in both these quarters had approximately the same real y-o-y fall of about 5%, and the change in Q3 consider simply too big to be possible.

As a control analysis of the construction trend we use cement production index which, because of the difficulties in monitoring the construction sector, we use as additional indicator of its movement (T2-10).Cement production in Q3 was for 3.8% lower than the one from the same period of the last year.[10] Taking into consideration the inaccuracy of this indicator, we believe that this is however a good confirmation of the previously exposed estimates that it is unlikely that the construction sector in Q3 recorded extremely deep fall – as indi-cated by the construction cost index. Our best current estimate is that construction activity in Q3, as in the entire 2014, recor-ded a real decline of about 5%.

The main reason for the fall in the con-struction sector in 2014 is low level of investments of a private, but also public sector about which we spoke in detail in previous issues of QM. What is specific for Q3 is that in the previous version of QM we expected that there will be a tem-porary increase in construction activity due to the elimination of the consequen-ces of the May floods. Available data on cement production, and especially on the cost of per-formed construction works, however, do not indicate noticeable positive changes in construction activity compared to Q2 and previous quarters.

Table T2-10. Serbia: Cement Production, 2001-2014

	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
2014	136.2	90.3	96.2		

Source: SORS

3. Employment and Wages

According to the official statistical data from the Labour Force Survey (LFS), the strong trend of improving the most important indicators on the Serbian labour market continues – unemployment rate is significantly dropping, while the employment rate is rising. However, for almost two years, trends of labour market indicators have drastically differed from the trends of other macroeconomic indicators, such as GDP, personal consumption, labour tax revenue, etc. According to official data, the unemployment rate in the third quarter of 2014 has declined by 1/3 compared to April 2012, while the employment rate in the same period increased by over 10%?! Observed in absolute amounts, the number of the unemployed in this period decreased by around 200 thousand, while the number of the employed increased by around 250 thousand?! In the same period, GDP, which according to the new methodology includes grey economy and illegal activities, has remained almost unchanged. Since large improvements like these on the labour market in a short period of time do not happen to the most prosperous of economies, it is highly unlikely that they happened in Serbia's economy in a period alternating between stagnation and recession. Therefore, it can be concluded with some certainty that the official data in the last two years does not reflect the real changes on the labour market. So the question is, what is the reason behind bad data on the changes on the labour market in the last two years? One possibility is that the state of the labour market is now measured more precisely than in the past, which would mean that the unemployment rate in 2012 was not 25-26%, but probably closer to the current one. If that is the case, SORS would have to correct its wrong data for the period 2008-2012. Another less likely possibility is that mistakes in measurements have been made in recent years, i.e. that the unemployment rate is around 25% now as well, in which case SORS would have to correct the newer data. Unlike the employment data, the ones on the wages trends are consistent with other economic trends. On the year-on-year level, wages in real terms have increased by only 0.5%. Information and Communication sector is still recording the highest growth of wages – 12.8% in Q3 of this year.

Employment

With some reservations concerning the dynamic of the labour market indicators for the period 2008-2014, in this article we will focus on the trends during 2014. Even though changes on the labour market in 2014 deviate from trends in GDP, personal consumption and labour tax, these deviations are possible due to differences and seasonality of various macroeconomic variables.

Probably under the influence of the summer season, the employment is growing by 1.3 percentage points

As of this year, the Labour Force Survey is being conducted quarterly. For the third quarter of 2014, the Survey was conducted at the end of July and beginning of August, while in previous years there were only April and October surveys. Therefore, we cannot compare the data from Q3 of this year with the ones from the same period in 2013. Additionally, we cannot establish what is the contribution of the seasonal factors to the improvement of labour market conditions, since we do not have a long enough series for seasonal adjustment of data.

In Q3 2014, there were 4,605,403 individuals ages between 15 and 64 (by 14,938 less than in Q2 2014). Among these persons 2,865,922 were economically active (by 22,621 less than in Q2 2014):

- 2,337,424 were employed, which is by 60,011 more compared to Q2 2014. The increase in the number of the employed, but also the decrease in the number of individuals ages 15 to 64 has contributed to the rise of the employment rate by 1.3 percentage points.

- 529,953 were unemployed, i.e. by 82,181 less compared to Q2 2014.

- 1,739,481 was inactive, i.e. by 7,683 less than in Q2 2014. Decline of the inactivity rate from 37.8% to 37.5% is predominantly due to the reduction of the overall working population and, to a lesser extent, to the reduced number of the inactive (Table T3-1).

Trends

Table T3-1. Serbia: Employment and Unemployment According to the Labour Force Survey[1], 2008-2014

		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	21.0	20.2	22.0
2014	Q1	2,229,063		48	55.1	41	613,787	21.6	21.0	22.3
	Q2	2,277,413		49.3	56.3	42.5	612,134	21.2	20.4	22.1
	Q3	2,337,424		50.8	57.5	44.2	529,953	18.4	17.9	19.1

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

The biggest growth of employment was among the helping household members

Employment increased in eleven out of twenty business activities between Q3 and Q2 of this year. The biggest employment growth was recorded in helping household members, which fall into the category of informally employed, by 22.2%, followed by "other services"[1] by 18%. There was a significant growth of employment in construction as well, i.e. 13%, which was expected due to the summer season. Considering the ban on new employment in the public sector, the data on the growth of employment by more than 15 thousand in the state administration and mandatory social insurance funds was surprising. Also, the Survey recorded 13 thousand newly employed workers in education. The 25% growth of employment in the mining sector should be taken with caution, since SORS noted in its announcement that the estimate was not reliable (Table T3-2).

Table T3-2. Employed by Sectors (LFS)

	Q1 2014	Q2 2014	Q3, 2014	Q3/Q2 index
TOTAL	2,342,966	2407930		
Agriculture, forestry and fishing	469,196	500302	533833	106.70
Mining	27,230	23941	30013	125.36
Manufacturing industry	388,127	386935	364053	94.09
Supply of electricity, gas and steam	31,266	40114	42265	105.36
Water supply and wastewater management	37,139	42579	34799	81.73
Construction	96,744	99763	113033	113.30
Wholesale and retail trade, repair of motor vehicles	300,020	304649	309923	101.73
Transportation and warehousing	141,317	132088	127928	96.85
Accommodation and food services	62,153	59826	61707	103.14
Information and communication	56,796	61045	51779	84.82
Financial activities and insurance activities	44,616	39275	43357	110.39
Real estate	*	*	*	*
Professional, scientific and innovation activities	68,359	73251	64795	88.46
Administrative and support service activities	47,585	46846	53186	113.53
Public administration and compulsory social insurance	135,750	138316	153739	111.15
Education	149,005	150117	163450	108.88
Health and social care	140,776	146563	141630	96.63
Arts, entertainment and recreation	49,158	40040	39780	99.35
Other service activities	43,803	42157	50027	118.67
Activities of households as employers	51,280	75690	92502	122.21

Source: LFS
Note: *small number of occurrences, so an estimate was impossible.

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1 Other services include associations (of employers and unions); repair of computers and object for personal use, as well as services of hairdressers and undertakers.

Informal employment is still rising and is currently 23.4%

Informal employment rate, expressed as a share of the number of informally employed in the total number of the employed, is higher by 2.2 percentage points compared to Q2 2014. Survey from the third quarter of this year estimates that there are 579,664 informally employed people in Serbia or by around 70 thousand more than in the previous quarter. This includes those employed in unregistered companies, those working in registered companies but without a formal contract, as well as the unpaid helping household members[2]. Since the Survey, ever since it is being published quarterly, shows the structure of the informally employed according to their professional status, it can be observed that among the workers in the informal sector, the number of those with the status of employed or helping household members grew the most. Due to a small number of occurrences, the number of self-employed with workers working in the informal economy has not been published so far, while the Q3 estimate is unreliable (Table T3-3).

Table T3-3. Formally and Informally Employed According to Professional Status, Q1 & Q2 2014

	Q1	Q2	Q3
Employed	62.352	71.723	118552
Self-employed with employees	*	*	4352
Self-employed without employees	227.955	229.427	226.723
Helping household members household	187.056	209.509	230.068

Source: ARS, Q1 2014. *a small number of occurrences so the evaluation was not published

Box 1 Employment of welfare beneficiaries

A regulation[1] was recently passed by the Ministry of Labour the aim of which is to encourage those welfare beneficiaries who are capable of working to join the labour market. The reason for adopting this regulation, as emphasised many times by the Ministry, was the fact that out of the total number of welfare beneficiaries (270 thousand), 50% or more precisely 147 thousand are individuals capable of working.

The regulation foresees the Centre for Social Work, as the body deciding the allocation of social welfare, concluding an agreement with the beneficiary who is capable of working on "actively overcoming his unfavourable social situation". Forms of activation include: directing the beneficiary to further education; acquiring knowledge and skills; treatment, community service, and finding employment.

 The part of the regulation related to employment brings nothing new. That is, the Law on Social Protection already foresees an obligation of an unemployed welfare beneficiary who is capable of working to register with the National Employment Service (NES). The Service is supposed to offer the beneficiary work or direct him to one of the programmes of further education, training, acquiring new knowledge and skills. If the beneficiary refuses to accept the job or NES training, the Centre for Social Work has the right to suspend the welfare payments.

In this regard, there are some opinions in the public that low NES capacities are to blame for the unemployment of welfare beneficiaries, as well as the bad economic situation regarding the number of available jobs. However, we should bear in mind that the category of welfare beneficiaries who are capable of working is dominated by individuals with low level of education and/or little working experience, so they tend to find work mainly on the so-called secondary sector of the labour market[2]. In this market segment, the level and structure of the employment

1 http://www.minrzs.gov.rs/lat/aktuelno/item/1320-uredba-o-merama-socijalne-ukljucenosti-korisnika-novcane-pomoci
2 Secondary labour market includes the employed with "flexible" contracts (e.g. temporary or service contracts), majority of those employed in the private sector, self-employed, those employed in traditional services, most of the industry and agriculture. For instance, if someone has a formal labour contract, but part of his wages are paid "off the books", he would also be classified as the secondary segment of the market. Jobs on the secondary market are usually insecure and poorly paid. On the other hand, the primary segment of the labour market includes the public sector, modern services (such as banking and finance, IT and marketing), and a small number of large privatised companies with foreign ownership. This market segment is characterised by employment security, good working conditions and above-average earnings.

2 Helping household members are persons who were helping another family member in managing family business or agricultural land without being paid.

Trends

is determined by the supply of labour, much more than by the trends in gross domestic product. While labour supply, on the other hand, depends on availability of various sources of non-working income, such as welfare financial aid.

If we take for example a single parent with two children, the non-working income of this family (the sum of welfare financial aid of 14,592 dinars, and two child benefits of 6,742 dinars) according to current regulation would be 21,334 dinars. If the parent found minimum wage employment (at around 20,000 net), this family would lose all rights to welfare, while keeping the child benefits. Their total income, in that case, would be only 5 thousand dinars higher compared to the income before finding a job. In case the parent accepts the same job but only part-time, for example (because of their obligations regarding children), the total income of this family would be even lower than with welfare[3]. In other words, the current design and amounts of welfare do not provide good enough incentives for seeking employment, so potential reforms should be headed in that direction. If welfare beneficiaries who are capable of working would be able to keep a part of their welfare financial aid, together with their working income, it would increase their motivation to seek and accept employment.

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3 Similar is valid for single parent families with one child, as well as families with one or two children when one of the parents manages to find a minimum-wage job.

Wages

Average monthly gross salary higher in real terms by 0.5% compared to the same quarter last year

According to the data from the Statistical Office of the Republic of Serbia, at the year-on-year level, the average monthly gross salary in Q3 was nominally higher by 2.4%, and in real terms by 0.5% (Table T3-5). Average monthly net wages in the third quarter of 2014 were almost 45 thousand dinar or 383 euro.

Table T3-4. Serbia: Average Monthly Wages and year-on-year indices, 2012-2014

	Average Monthly Wage[1]				Average Gross Monthly Wage Index[2]	
	Total labour costs[3], in dinars	Net wage, in dinars	Total labour costs, in euros	Net wage, in euros	nominal	real
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
2014						
Q1	68,015	41,825	588	361	100.5	97.8
Q2	73,147	44,971	633	389	101.4	99.6
Q3	73,167	44,934	623	383	102.4	100.5

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

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

Table T3-5. Y-o-y real net wages indices

	Information and communication	Admin. and support service	Construction
2013Q1	95.8	94.6	89.7
2013Q2	95.9	85.6	89.2
2013Q3	114.6	88.5	94.5
2013Q4	112.8	104.7	109.7
2014Q1	123.3	89.1	100.8
2014Q2	119.1	112.4	101.0
2014Q3	112.8	109.2	108.2

Source: *QM*

Year-on-year index of net wages in real terms shows that the wages realised in Q3 2014 grew in ten out of twelve sectors compared to the same period last year. The biggest growth was recorded in the Information and Communication sector (12.8%), which was the case in the last four quarters as well. They are followed by the growth of wages in the sector of administrative and service activities[3] in the amount of 9.2%, which could probably be explained by summer tourist season. The situation is similar in construction as well where the wages grew 8.2%, while other service activities realised a growth in net wages of 5.9%. Growth in the rest of the sectors did not exceed 2% (Table T3-6).

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3 This sector is not related to public administration, but rather includes activities of renting and leasing, hiring agencies, private security, etc.

Trends

4. Balance of Payments and Foreign Trade

During the third quarter, the current account deteriorated and this trend will most likely continue in the last three months of 2014. During Q3, current account deficit was 502 million euros (5.9% of GDP). Compared to Q3 2013, this level of deficit represents a substantial increase. Year-on-year growth of the current account is primarily the result of growing foreign trade deficit due to pronounced reduction of exports with almost unchanged levels of imports. The main dilemma is whether this deterioration is the result of temporary factors (floods, short delay in the production of FIAT cars, etc.) or a more permanent issue (oversaturation of foreign markets with current model of FIAT). Furthermore, the inflow of remittances is lower compared to the same period last year. At the same time, high capital inflow during Q3 (primarily due to the loan that the state took from the United Arab Emirates) was enough to cover the current deficit and to lead to an increase of NBS foreign reserves by 509 million euros. During October, the declining trend in exports continued (although at a slightly lower rate than in Q3), and even the imports were lower than last year's. Given current trends, we expect the current deficit in 2014 to be 7% of GDP. In 2015, we are anticipating lower levels of current deficit, 5-6% of GDP, bearing in mind the expected effects of fiscal consolidation measures, renewal of production in the energy sector, likely recovery of the Eurozone countries, as well as favourable impact of dinar depreciation on foreign trade trends. It remains uncertain whether the following year will see a significant recovery of exports, to what extent the plans for fiscal consolidation will be enough to secure a low level of domestic demand and contribute to long-term sustainability of Serbia's public and foreign debt, as well as whether it will, together with the new IMF arrangement, help increase the trust of investors. On the other hand, the cancellation of the South Stream construction, as was recently announced, is for many reasons not favourable for Serbia's economy.

Increased current account deficit during Q3....

In Q3 2014, current account deficit was 502 million euros (5.9% of GDP). This represents a growth of 1.6 pp compared to the same period in 2013. This share of deficit in GDP, although it is above the last year's value realised in Q3, is at the level of the previous quarter and even slightly below the value realised in 2013 (6.1%). We expect further growth of current deficit by the end of the year, which will cause the deficit in 2014 to reach 7% of GDP. During Q4 2014, the increase of foreign trade and current deficit could be influenced primarily by seasonal factors, increased demand for energy imports as a result of the floods, as well as a possible further delay in production and exports of the automobile industry. In 2015, we expect the current deficit to be 5-6% of GDP, taking into account the expected effects of fiscal consolidation measures, expected production increase in the energy sector, possible recovery of the Eurozone countries, and a favourable impact of dinar depreciation on foreign trade trends.

...primarily due to decreased exports with almost unchanged imports

Trade deficit was 1,075 million euros, i.e. 12.6% of GDP. Share of trade deficit in GDP in Q3 2014 is considerably above the level of Q3 2013 – by 4.3 pp, above the level of Q1 and Q2 2014 (by 1.6 pp and 1.1 pp respectively), while only slightly above the trade deficit recorded in 2013 (by 0.5 pp). Exports were 2,656 million euros, which is 31.2% of GDP. On the other hand, goods in the value of 3,731 million euros were imported (43.9% of GDP).

Surplus on the Services account, net outflow of Primary Income...

...and inflow of Secondary Income (Current Transfers) slightly below the last year's

Realised surplus in the services trade was 145 million euros, and significantly above the previous values. Services revenues amounted to 1,044 million euros, while expenditures were 899 million euros. Net outflow from Primary Income was lower in Q3 2014 compared to the same period in 2013, primarily due to somewhat lower expenditures from income. Secondary Income (net Current Transfers) was 768 million euros (9.0% of GDP). Realised inflow was slightly below the last year's. This is mostly due to lower net Personal Transfers, primarily remittances. In Q3, inflow of remittances amounted to 469 million euros, which is by 0.8 pp of GDP below the inflow in Q3 of last year.

Year-on-year increase of current deficit as much as 32%

In Q3 2014, there was a 32% increase in the current account deficit compared to Q3 2013. Increase of the current deficit is primarily the result of the growth in foreign trade exchange

(year-on-year growth of 44%) due to a pronounced reduction of exports with almost unchanged levels of imports. In addition, during Q3 the inflow of remittances was lower compared to the same period last year.

Realised trade deficit was by 47% higher than the deficit of the same quarter in 2013. Growth of trade deficit is the result of declining exports with almost unchanged imports. Exports recorded a significant year-on-year decline of 11%. At the same time, the growth of imports is very low and is 1% y-o-y. Such trends led to a reduced coverage of imports by exports by 9 pp (from 80% in Q3 2013 to 71% in Q3 2014).

We do not expect the following year to bring a significant growth of imports, due to already implemented and announced measures of fiscal consolidation. Imports in October declined by as much as 2.3%, observed year-on-year. Uncertainty in the coming period lies with exports, i.e. it will depend on the character of the current reduction of exports in the automobile industry (whether the decline in production and exports in FIAT Serbia factory is temporary or there are more permanent limitations at play, such as for example low foreign demand for car models currently manufactured in Serbia). Depreciation of dinar, which started in July 2014, will have a favourable impact on the trends in foreign trade.

Surplus on the financial account...

Surplus on the financial account is 846 million euros and is primarily due to the recorded net inflow on the Other Investments account, i.e. a large amount of net borrowing of financial loans, which is primarily the result of the state loan taken from the United Arab Emirates (UAE).

.... primarily the result of the state loan from UAE

FDI are 334 million euros. Since the beginning of the year, the recorded inflow from FDI has been 1,047 million euros. If the FDI inflow in Q4 is at the average level of the first three quarters, the total FDI inflow in 2014 will amount to 1.4 billion euros. A positive impact of the concluded IMF arrangement is expected on the investors' trust. It is estimated that most of FDI in 2014 will be in manufacturing, trade and financial sector[1]. Also, EMBI for Serbia has dropped significantly as the result of general trends on the global market, while its relative growth compared to other countries indicates an increase in specific risks related to Serbia. However, if the announced cancellation of the South Stream project is realised, it would have a negative impact on the level of FDI in the coming period. Portfolio investments during Q3 were 163 million euros, i.e. at the level of investment value realised in the previous quarter.

For the first time this year, Other Investments account recorded a net inflow. This inflow was 350 million euros, mostly due to state borrowing. The financial loan borrowed was 459 million euros. NBS borrowed additional 100 million euros, most of which was for NBS repayments of the IMF loan. The state borrowed additional 674 million euros net, most of which was the loan approved by UAE for the state budget of the Republic of Serbia. Financial institutions continued to deleverage their foreign debts and the net deleveraging of these institutions in Q3 was 183 million euros. The business sector had a slight borrowing of 68 million euros net. During Q3, net inflow of trade loan was realised in the amount of 137 million euros. Inflow on the Cash and Deposit account was 246 million euros.

Increased NBS foreign reserves

High capital inflow (primarily from state borrowing) in Q3 2014 was enough to cover the current deficit and lead to an increase of NBS foreign reserves by 509 million euros.

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1 Source: NBS.

Table T4-1. Serbia: Balance of Payments

	2012	2013	2013 Q1	2013 Q2	2013 Q3	2014 Q1	2014 Q2	2014 Q3
					mil. euros			
CURRENT ACCOUNT	-3,639	-2,107	-668	-387	-381	-503	-495	-502
Goods	-5,634	-4,152	-1,190	-1,045	-732	-874	-990	-1,075
Credit	8,394	10,540	2,151	2,578	2,979	2,510	2,769	2,656
Debit	14,028	14,693	3,341	3,623	3,712	3,384	3,759	3,731
Services	139	319	30	75	86	68	72	145
Credit	3,104	3,423	698	826	948	793	887	1,044
Debit	2,965	3,103	668	751	861	725	815	899
Primary income	-1,091	-1,428	-189	-297	-532	-320	-418	-340
Credit	657	617	113	168	164	122	176	151
Debit	1,748	2,045	302	465	695	442	595	492
Secondary income	2,947	3,153	681	879	797	623	842	768
Credit	3,286	3,523	768	968	895	708	933	876
Debit	339	369	87	89	98	85	91	108
Personal transfers, net [1]	2,459	2,701	581	772	684	510	695	618
Of which: Workers' remittances	1,934	2,160	457	630	554	378	547	469
CAPITAL ACCOUNT - NET	-11	13	-1	10	4	2	-1	3
FINANCIAL ACCOUNT	-3,486	-1,917	-612	-356	-277	-496	-372	-337
Direct investment - net	-669	-1,229	-171	-264	-446	-316	-397	-334
Portfolio investment	-1,722	-1,916	-1,404	348	122	4	-150	-163
Financial derivatives	2	-1	2	-2	1	0	-3	1
Other investment	41	532	101	446	210	616	548	-350
Other equity	0	0	0	0	0	0	0	0
Currency and deposits	156	-228	-203	165	188	121	141	246
Loans	574	1,185	375	295	67	374	388	-459
Central banks	219	657	150	148	179	189	186	100
Deposit-taking corporations, except central bank	377	682	286	67	155	214	89	183
General government	-467	-449	-150	-43	-278	29	30	-674
Other sectors	444	296	89	124	12	-58	82	-68
Insurance, pension, and standardized guarantee schemes, net	3	0	1	0	-2	0	0	0
Trade credit and advances	-692	-426	-72	-14	-43	121	19	-137
Other accounts receivable/payable	0	0	0	0	0	0	0	0
SDR (Net incurrence of liabilities)	0	0	0	0	0	0	0	0
Reserve assets	-1,137	697	859	-886	-164	-800	-370	509
ERRORS AND OMISSIONS, net	164	177	57	21	99	5	123	162
PRO MEMORIA					in % of GDP			
Current account	-11.5	-6.1	-8.3	-4.4	-4.3	-6.3	-5.8	-5.9
Balance of goods	-17.8	-12.1	-14.9	-11.9	-8.3	-11.0	-11.5	-12.6
Exports of goods	26.6	30.8	26.9	29.4	33.8	31.6	32.3	31.2
Imports of goods	44.4	42.9	41.7	41.3	42.1	42.6	43.8	43.9
Balance of goods and services	-17.4	-11.2	-14.5	-11.0	-7.3	-10.1	-10.7	-10.9
Personal transfers, net	7.8	7.9	7.3	8.8	7.8	6.4	8.1	7.3
GDP in euros[2]	31,592	34,268	8,010	8,779	8,821	7,946	8,580	8,505

Note: Balance of Payments of the Republic ofSerbia is in line with the international guidelines laid out in IMF's Balance of Payments Manual no. 6 (BPM6).
Source: NBS
1) Personal Transfers represent current transfers between resident and non-resident households.

Exports

Table T4-2. Serbia: Exports, Year-on-Year Growth Rates, 2012–2014

	Exports share in 2013	2012	2013	2013			2014			2013			2014		
				Q1	Q2	Q3	Q1	Q2	Q3	Q1	Q2	Q3	Q1	Q2	Q3
	in %			in mil. euros						in %					
Total	100.0	8,739	11,003	2,236	2,699	3,110	2,632	2,873	2,771	20.1	18.2	37.9	17.7	6.4	-10.9
Total excluding road vehicles	85.1	8,269	9,366	1,943	2,277	2,608	2,223	2,405	2,457	6.6	2.2	21.3	14.4	5.6	-5.8
Energy	4.7	303	519	94	130	145	98	129	102	47.0	52.3	124.8	4.8	-1.2	-29.4
Intermediate products	33.1	3,126	3,638	798	937	1,002	911	949	942	8.0	6.7	23.3	14.2	1.4	-6.0
Capital products	27.1	1,667	2,980	570	758	859	720	812	643	112.8	107.3	109.4	26.3	7.1	-25.1
Capital products excluding road vehicles	12.2	1,197	1,342	278	336	358	310	344	329	21.5	8.7	17.0	11.6	2.2	-8.1
Durable consumer goods	4.8	395	523	99	136	142	122	147	150	26.9	35.7	33.6	22.9	8.0	5.8
Non-durable consumer goods	21.9	2,224	2,410	501	560	675	564	617	717	4.9	3.1	12.8	12.4	10.3	6.2
Other	8.5	1,025	933	173	179	287	218	219	217	-26.2	-42.5	9.0	25.7	22.2	-24.6

Source: SORS

Exports recorded a significant y-o-y decline of 10.9%...

...which is mostly (55.2%) due to the decline in car and energy exports

In Q3, exports amounted to 2,771 million euros. This export value is significantly below the level of Q3 2013 - by 10.9%. After an exceptionally fast year-on-year growth in 2013 at a rate of 26.0%, exports since the beginning of 2014 had started to decelerate their growth – in Q1 they grew at a rate of 17.1%, while in Q2 their year-on-year growth was only 6.4%. The year-on-year decline of exports recorded in Q3 continued in October as well, but at a slightly lower rate (-6.6%).

Graph T4-3. Exports of Road Vehicles

Source: SORS, *QM*

The year-on-year reduction of exported value during Q3 is mostly due to the decline of exports in the automobile industry, which can also be observed in Table T4-2 as a significant decline of exports of capital products (year-on-year decline of 25.1%). In 2013, Serbia exported 159,250 passenger vehicles, out of which 65% was exported to Italy, one fifth to USA, 5% to Germany, 2% to Poland, 1% to Montenegro, and around 6% to other countries.

In Q3 2014, contribution of the reduced exports of road vehicles to the reduction of overall exports was 55.2%. After a level that since Q2 2013 has been around 400-500 million euros (the highest level was reached in Q3 2013 of 501.4 million euros), exports of road vehicles dropped to 314 million euros in Q3 2014, i.e. by around 40% compared to Q3 2013 (Graph T4-3). Monthly values of road products exports indicate that a year-on-year decline was first recorded in June 2014 (drop rate of -9.4%), increased in July (-28.7%), peaked in August (-67.4%), dropped again in September (-27.3%), and continued further and even slightly increased in October (-34.1%). This declining trend in exports of road vehicles is very troubling, having in mind that the reduction of exports, that has been going on for almost half a year, could suggest some more serious problems that FIAT automobile factory is currently facing (market saturation with the current model produced in Kragujevac, i.e. the need to place new models), and not just a temporary slow-down in production.

Decline of exports excluding road vehicles was 5.8%...

...result of flooding...

...and the decline of global prices of energy and agricultural products

Still, exports after excluding road vehicles recorded a year-on-year decline of 5.8%. This was greatly influenced by the decline of energy exports, which was almost one third below the last year's values (Table T4-2). The floods reflected on the reduction of production and exports of electricity during Q3 (Table T4-4). Reduction of energy exports was partly the consequence of the decline of energy prices on the global market, which in Q3 were by 6.3% below the last year's prices in the same quarter. Still, after excluding the impact of prices, the decline of energy export value is due to lower exported quantities (by about one forth less than in the same quarter of the previous year). The price of metals in dollars is also below the last year's by about 12% (where the biggest decline of global prices in dollars was recorded in iron – prices in November 2014 were by almost 50% lower than in the same month in 2013). On the other hand, despite of the global price decline, Oil exports grew by 17.7% year-on-year (Table T4-4).

Trends

Table T4-4 shows export values of selected products, which have a more significant share in the total exports. Export of food products was by 4.6% higher in Q3 2014 than in Q3 of the previous year. The same period saw a considerable decline in export values of agricultural products. That is, the export of products classified under Agricultural Products, Hunting and Services was by 30.6% lower in Q3 than last year. On the one hand, there was a reduction of global prices of certain agricultural products. For example, grain prices in dollars are lower by 13% than last year's. Therefore, high year-on-year decline of exports of grain and grain products of 33.0% recorded in Q3 was partially due to flooding and partially due to price components. According to SORS data, wheat crops were 2,164 million tons and by around 19.4% below the last year's production due to unfavourable weather conditions[2]. Additionally, good wheat crops in other countries affected negatively the advance export contracts, which led to reduced quantity exports during Q3 2014, observed year-on-year[3]. On the other hand, corn exports significantly increased, observed year-on-year, due to the low last year's base[4]. Even though there were projections that the floods would affect the fruit and vegetable crops, exports of these products in Q3 2014 were by 3.9% above the Q3 2013 values. It is possible that larger consequences will be visible in the coming period.

Table T4-4. Serbia: Exports, Year-on-Year Growth Rates, Q3 2013-Q3 2014

	Exports share, jan-sep 2014	2013 Q3	2014 Q3	2014 Q3
	in %	in mil. euros		in %
Total exports	100.0			
Manufacture of food products	11.4	345	361	4.6
Crop and animal production, hunting and related service activities	5.9	225	156	-30.6
Vegetables and fruit	4.9	166	172	3.9
Cereals and cereal preparations	4.7	161	108	-33.0
Non-ferrous metals	4.2	127	116	-8.1
Iron and steel	3.1	98	89	-9.8
Petroleum, petroleum products and related materials	3.0	76	89	17.7
Electric current	0.7	68	4	-93.8
Gas,natural and manufactured	0.3	6	9	41.9

Source: SORS

Table T4-2 clearly shows a reduction of exports of all individual components except consumer goods. Year-on-year growth of exports of durable and non-durable consumer goods was 5.8% and 6.2%, respectively. The value of other exports in Q3 2014 was by 25% lower than in Q3 2013.

Growth of exports in 2015 will be positively affected by the delayed effects of dinar depreciation and a possible economic recovery of EU countries.

Imports

Year-on-year decline of imports in Q3 0.3%

Total imports in Q3 2014 were 3.9 billion euros and, according to SORS data, by 0.3% below the values from the same quarter last year (Table T4-5).

Decline recorded in all components except in products classified under Other

Decline of imports was recorded in all components except in products classified under *Other*, which recorded a considerable growth of 72.7% year-on-year. The biggest decline in import values was realised in Capital Products (18.6% year-on-year) due to the reduced production in the automobile industry and, therefore, lower imports of components. Also, low business investments

2 http://webrzs.stat.gov.rs/WebSite/repository/documents/00/01/43/06/PO13_174_srb_2014.pdf
3 Inflation report, NBS, p. 31.
4 Inflation report, NBS, p. 31.

and lack of significant investments in increasing production capacities affected the low imports of capital products. Decline in economic activity, especially industrial production, affected the reduction of imports of Intermediate Goods, due to reduced demand for importing production components. Gas imports increased as well by 15.5%, probably in order to create stock for the upcoming winter season. Low domestic demand affected the low imports of consumer goods, due to the announced measures of fiscal consolidation.

Growth of energy imports after excluding effects of global price decline

Even though a year-on-year decline of energy imports was realised in Q3 2014 (Table T4-5), it is due to the reduction in energy prices on the global market. That is, energy prices in Q3 were lower by 6.3% compared to Q3 2013 prices. After excluding effects of price reduction, we find that the quantity of imported energy is by 5.9% above the last year's. This increase in energy imports is the result of the fact that certain domestic plants were damaged during the May floods. Thus, electricity imports increased by 81.7% year-on-year.

According to SORS data, there was a reduction of imports in October by 2.3%. All factors indicate that Q4 2014 and 2015 will not see significant changes in current levels/trends, since the reduction of imports will be affected by low domestic demand as the result of consolidation, recovery of electricity production with renewed damaged capacities during May floods, provided the energy prices and depreciation of dinar, which had started in the second half of 2014 and has recently intensified, continue.

Table T4-5. Serbia: Imports, Year-on-Year Growth Rates, 2012-2014

	Imports share in 2013	2012	2013	2013			2014			2013			2014		
				Q1	Q2	Q3	Q1	Q2	Q3	Q1	Q2	Q3	Q1	Q2	Q3
	in %			in mil. euros						in %					
Total	100.0	14,717	15,449	3,509	3,820	3,904	3,543	3,912	3,893	-0.4	3.1	9.9	1.0	2.4	-0.3
Energy	15.0	2,570	2,316	532	476	563	491	484	558	-34.9	-13.9	5.1	-7.6	1.5	-0.8
Intermediate products	33.0	5,132	5,104	1,164	1,310	1,357	1,145	1,255	1,257	0.6	-5.2	4.3	-1.6	-4.2	-7.3
Capital products	24.3	2,996	3,748	799	975	967	790	958	787	25.4	31.2	33.2	-1.0	-1.8	-18.6
Durable consumer goods	2.1	323	317	77	80	76	69	73	74	-0.1	-3.4	-5.6	-10.7	-9.0	-2.2
Non-durable consumer goods	14.5	2,175	2,247	510	554	573	494	552	579	7.4	7.1	4.0	-3.2	-0.4	1.0
Other	11.1	1,520	1,717	428	425	369	554	592	638	18.6	0.0	2.4	29.4	39.3	72.7
Imports excluding energy	85.0	12,147	13,133	2,978	3,344	3,342	3,052	3,429	3,335	10.0	6.1	10.7	2.5	2.5	-0.2

Source: SORS

Foreign Debt

Foreign debt of 26,361, i.e. 78% of GDP...

Foreign debt at the end of September 2014 was 26,361 million euros (78% of GDP, Table T4-6). Foreign debt is by 1.05 billion euros higher than the recorded value three months earlier. This is exclusively due to public sector borrowing, while the private sector slightly deleveraged its debt. Still, we should bear in mind that the share of foreign debt (and its components) in GDP would be higher if it were not for increased value of GDP due to the changed methodology of SORS.

...the result of public sector borrowing

According to the NBS methodology, foreign debt is calculated according to the "matured debt" principle. Data from 2013 is preliminary and is updated quarterly. Foreign debt includes the principle and the amount of accrued unpaid interest.

Public sector foreign debt at the end of Q3 accounts for more than half of the total foreign debt

Trends from previous quarters continue – the state is still increasing the level of its foreign debt, while the private sector is gradually decreasing it. Thus, public sector foreign debt at the end of September accounted for 53% of total foreign debt. Over Q3, the state borrowed additional 1.08 billion euros. This is primarily the consequence of the UAE loan for the purposes of securing funds for the state budget. In addition, part of the increase of public sector's debt was due to withdrawing several loans taken from Council of Europe Development Bank, EIB and EBRD[5].

On the other hand, the private sector is slowly decreasing its foreign debt (Table T4-6). The banks have deleveraged their foreign long-term debts by 150 million euros, while companies additionally borrowed almost the same amount (147 million euros). The level of short-term loan additionally decreased compared to the previous quarterly level.

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5 Inflation report, NBS.

Key for sustainability of foreign debt are investments and tightly implemented fiscal consolidation

What could have a negative affect on the level of the debt is the announced cancellation of the South Stream. If this cancellation turns out to be definite, it could have multiple negative effects on the level of investments, production and employment. Positive effects on the growth of investments and sustainability of Serbia's public and foreign debt are expected in the coming period from the new arrangement with IMF, as well as the fiscal consolidation.

Table T4-6. Serbia: Foreign Debt Structure, 2011–2014

	2011	2012	2013				2014		
			Mar.	Jun	Sep.	Dec.	Mar.	Jun	Sep.
Total foreign debt	24,123	25,645	26,593	25,889	25,632	25,764	25,650	25,310	26,361
(in % of GDP) [4]	*72.0*	*81.2*	*82.3*	*78.2*	*75.3*	*75.2*	*75.0*	*74.4*	*78.2*
Public debt [1]	10,800	12,185	13,478	12,892	12,790	13,166	12,969	12,796	13,876
(in % of GDP) [4]	*32.2*	*38.6*	*41.7*	*38.9*	*37.6*	*38.4*	*37.9*	*37.6*	*41.2*
Long term	10,800	12,185	13,478	12,892	12,790	13,166	12,969	12,796	13,876
o/w: to IMF	1,618	1,389	1,245	1,079	890	697	515	333	247
o/w: Government obligation under IMF SDR allocation	459	452	454	447	441	434	436	439	455
Short term	0	0	0	0	0	0	0	0	0
Private debt [2]	13,323	13,460	13,115	12,997	12,843	12,598	12,681	12,514	12,485
(in % of GDP) [4]	*39.8*	*42.6*	*40.6*	*39.2*	*37.7*	*36.8*	*37.1*	*36.8*	*37.1*
Long term	12,722	13,005	12,783	12,711	12,683	12,401	12,540	12,359	12,356
o/w: Banks debt	3,869	3,722	3,535	3,503	3,457	3,231	3,038	2,935	2,785
o/w: Enterprises debt	8,854	9,283	9,247	9,207	9,225	9,168	9,501	9,422	9,569
o/w: Others			1	1	1	1	2	2	2
Short term	601	455	332	286	160	197	141	155	129
o/w: Banks debt	582	428	303	261	135	171	115	128	89
o/w: Enterprises debt	19	27	29	24	25	26	26	27	40
Foreign debt, net 3), (in% of GDP) [4]	36.0	46.6	45.7	45.9	44.6	42.5	44.5	44.7	46.0

Note: The foreign debt of the Republic of Serbia is calculated according to the "matured debt" principle, which includes the principle amount of the debt and the amount of calculated interest unpaid at the time of the agreed maturity date.
Source: NBS, *QM*
1) Republic of Serbia public sector's foreign debt includes the debt of the state (including the debt of Kosovo and Metohija for the loans concluded before the arrival of KFOR, unregulated debt toward Libya, and the clearing debt toward the former Czechoslovakia), National Bank of Serbia, local self-government, funds and agencies formed by the state, as well as debts for which state guarantees had been issued.
2) Republic of Serbia private sector's foreign debt includes the debt of the banks, companies and other sectors for which state guarantee had been issued. Private sector foreign debt does not include loans concluded before December 20, 2000 for which no payments are being made (859.6 million euros, out of which 382.0 million euros is related to domestic banks, and 477.6 million euros to domestic companies).
3) Total foreign debt less the NBS foreign reserves.
4) Sum of values of the observed quarter's GDP and previous three quarterly values of GDP.

5. Prices and the Exchange rate

During Q3 and October, inflation was moving below the lower limit of the NBS target band and at the end of October it stood at 1.8%. Low domestic demand and reduced costs in food production are most significant factors that affect the maintenance of inflation at a very low level compared to normal value in Serbia. Since the beginning of Q3 and up to late October underlying inflation (Measured by CPI excuding food, energy, alcohol and tobacco) was also at an extremely low level and it stood below the lower limit of NBS target band, mostly due to a low aggregate demand and low imported inflation. Poor deflation was recorded during three out of four previous months (July, August, October), while only September had a positive inflation at a relatively high level, mainly due to the seasonal increase in the prices of food (mostly fruits and vegetables). In the folling year fiscal policy and macroeconomic trends will act deflationary- salaries and pensions will decline, while the economy will be in recession. If the NBS does not allow the dinar depreciation, the inflation will remain below the lower limit of the corridor by the middle of 2015. Troughout Q3, dinar nominally depreciated by about 2.6%, and a moderate depreciation occurred in October and November (additional dinar weakening by about 1.4%). Depreciation pressures are influenced by the global factors (uncertainty in international financial market, the reactions of the Fed and ECB), as well as specific factors related to Serbia (deterioration of the external balance, high fiscal deficit, high and growing public debt, as well as country's low credit rating). The real depreciation of about 2.2% in Q3 and 0.7% in October (total of 1.9% since the beginning of the year), as well as the expected continuation of the real depreciation in November could influence the improvement of the economy competitiveness with an acceptable increase in the costs of credit servicing and inflation costs. Moderate inflation is even desirable in order to mitigate the recession and efficiently implement a fiscal consolidation measures.

Prices

Inflation moves below the lower limit of the NBS target throughout Q3 and October

During third quarter the year-on-year inflation ranged below the lower limit of the tolerated target deviation, and it continued such a trend in October (Table T5-1). Underlying inflation (measured by the consumer price index excluding the prices of food, alcohol, tobacco and energy) is also below the lower limit, which is a consequence of a fall in a domestic demand and recession. Due to a strong recession and a fall in domestic demand, the effect of dinar depreciation on inflation is reduced. Reduced costs in food production due to a good agricultural season on a world and domestic demand, low pressures arising from umport prices, as well as the absence of mitigation of the monetary policy restrictiveness (key interest rate remained at a relatively high 8.5% during October and Q3) have also had a significant disinflationary effect. The price growth in Q3 was lower than expected and amounted to a mere 0.4%, mostly because the correction of the regulated prices was absent- increasing prices of electricity, because of a fall in world oil prices and, consequently, only a slight growth in the prices of the petroleum products (due to the weakening of the dinar against the dollar) and because of almost neutral trends in the food prices- rising prices of food and declining vegetable prices in Q3. October was marked by a slow deflation of about -0.2%, mainly due to the falling prices of unprocessed foods- fruit and fresh meat. Low inflation, next to the long-term impact factors (such as low aggregate demand) was contributed by the one-off factors- low growth of the regulated prices (due to price adjustments of the electricity that, although planned, were missing and are not going to be implemented until the end of the this year), low growth in the prices of primary commodities in the country and the world market. Factors with a long-term impact in the following period will further have an enhanced disinflationary effect because of the reduction of wages in the public sector and pensions, as well as other measures of fiscal consolidation. The declin of the expenses in the food production was above the NBS expectations, which in addition to aforementioned, stands out as being the main reason for the failure to return the inflation within the limits of the target band

NBS reduced the key interest rate in November

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
dec	176.9	2.2	2.2	0.2	-0.9
2014					
jan	179.5	3.1	1.5	1.5	4.4
feb	179.7	2.6	1.6	0.1	7.5
mar	179.1	2.3	1.2	-0.3	5.1
apr	180.1	2.0	1.8	0.6	1.4
may	180.2	2.1	1.9	0.1	1.1
jun	180.4	1.2	2.0	0.1	2.9
jul	180.2	2.0	1.9	-0.1	0.2
aug	179.9	1.5	1.7	-0.2	-0.7
sep	181.2	2.1	2.4	0.7	1.6
oct	180.8	1.8	2.2	-0.2	1.3

* Three-month moving average of a price growth rose to an annual level. (For example, the March value is obtained by raising the average monthly price growth in January, February and March to an annual level).
Source: SORS.

in Q3. However, central bank should not only passively observe the realization of its projections, but should implement the measures which would help inflation return within the frames of the target band. Next to extremely low total inflation, underlying inflation is also at a record low level- the lowest since the inflation is measured by CPI (Graph T5-2)

The executive board of the National Bank of Serbia did not change the key interest rate until mid-November, when it was reduced by 50 base points and since when it has amounted to 8%. Although NBS measures aren't quite synchronized with the movement of inflation, caution in the conduct of monetary policy, despite strong disinflationary effect of low aggregate demand and entering into recession, can be partially justified by domestic risks- the existence of structural imbalances in the economy of Serbia (high fiscal and foreign trade deficit, high level of NPLs in the economy) and the risks concerning the uncertainties in international environment (geopolitical tensions related to the crisis in Ukraine, a slow recovery of the economy in the euro zone countries and the reduction in the expansiveness of Fed's monetary policy). It is possible that not even greater easing of monetary policy would have a more significant effect on inflation in the conditions of a low and falling aggregate demand, but it would be an adequate response of the central bank to the economy's entering the recession. The reduction of pensions and wages in the public sector in the following period will contribute to an additional reduction in domestic demand and consequent growth of deflationary pressures, while the implementation of fiscal consolidation measures and structural reforms at the same time should reduce the risks in Serbia's economy, which would create space for additional easing of monetary policy.

More restrictive monetary policy of the Fed and ECB's monetary policy easing

The reduction in the expansiveness of Fed's monetary policy continued in Q3, so that the downsizing of the quantitive easing program ended in accordance with the planned schedule. However, it is uncertain when exactly the increase of the Fed's base rate will be initiated and to what extent it will be increased. These uncertainties regarding the implementation of monetary policy in the United States have contributed to the moderate turbulence in financial markets in the countries with emerging markets, and thus in Serbia (see the text on Exchnge rates). Contrary to Fed's measures, ECB has additionally eased monetary policy due to the existence of strong deflationary pressures in the euro zone. The fall in global economic activity below the predicted valued in Q2 and Q3 reduces chances of global economic growth in 2014 and 2015. The consequence of this is also a drop in the world oil prices and primary agricultural products1.

Chart T5-2. Serbia: Y-o-y Inflation Rate and Underlying Inflation and the NBS Target Band 2008-2014

Source: NBS and *QM* estimates

Chart T5-3. Serbia: NBS Reference Interest Rate and y-o-y Inflation Rate, in %, 2008-2014

Source: NBS

Low inflation in Q3 and deflation in October 2014

The growth in consumer prices in Q3 and in October amounted to 0.2% (individually: 0.4% in Q3 and -0.2% in October). Having that, contrary to expectations, the usual seasonal higher drop in the prices of fruit and vegetable was absent, the prices of food and non-alcoholic beverages increased in Q3, which put forward the total inflation as well. While it is common for the prices of fruit and vegetable to drop in Q3, this year fruit went up by 17% (mostly due to the shortages of citrus in Europe), but then, in October, the fruit got cheaper by about 12%. The prices of vegetable were lower by about 8% in October when compared to the prices in June. The growth in the prices of fresh meat is seasonally expected and it's slightly higher due to a rising prices in the world market and domestic producer prices. Highest positive contribution to the inflation in Q2 and in October, next to the rise in the prices of fruit (an increase of 3%, the contribution of 0.8pp), was the rise in the prices of milk and dairy products (an increase of 2.3%, contribution of 0.11pp), growth in the prices of solid fuels (growth of 4.7%, the contribution 0.13pp), growth in the prices of vehicle insurance (an increase of 26%, the contribution 0.16pp) and transport services (an increase of 1.6%, the contribution 0.19pp). The largest negative contributions to inflation in Q2 and October were the fall in prices of vegetables (a decrease of 8.4%, the contribution -0,42pp), the fall in prices in fixed telephony (a decrease of 6.1%, the contribution -0,14pp) and the fall in prices clothing and footwear (down 1.5%, the contribution -0.07pp) (see Table T5-4). The September increase in the prices of food and non-alcoholic beverages was particularly expressed when a positive contribution to inflation of about 0.8pp was noted for the first time after a year. The prices of industrial products excluding food and energy decreased in Q3 due to a low aggregate demand. Clothing and footwear got cheaper, while passenger cars got more expensive (mostly due to dinar exchange rate depreciation, since these prices are, as a rule, stated in euros). The

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

	Share in CPI (in %)	price increase in Q3 2014	Contribution to overall CPI increase (in p.p.)	Price increase in October 2014	Contribution to overall CPI increase (in p.p.)
Total	100.0	0.4	0.4	-0.2	-0.2
Food and non-alcoholic beverages	34.5	0.4	0.1	-1.4	-0.5
Food	30.9	0.4	0.1	-1.6	-0.5
Alcoholic beverages and tobacco	7.8	-0.5	0.0	-0.1	0.0
Tobacco	4.2	0.0	0.0	0.0	0.0
Clothing and footwear	4.6	-1.8	-0.1	0.4	0.0
Housing, water, electricity and other fuels	13.0	0.8	0.1	1.0	0.1
Electricity	5.1	0.0	0.0	0.0	0.0
Furniture, household equipment, routine maintenance	4.1	-1.2	0.0	-0.5	0.0
Health	6.4	-0.4	0.0	0.6	0.0
Transport	12.3	1.4	0.2	0.1	0.0
Oil products	5.1	1.8	0.1	-0.3	0.0
Communications	5.0	-1.3	-0.1	-0.4	0.0
Other items	12.2		0.2		0.2

Source: SORS and *QM* estimates

Trends

growth of minimum excise tax on tobacco products has not reflected to the rise in the prices of cigarettes (in the conditions of the fall in these products's turnover, the burden fully transferred to the producers). The growth in the prices of energy has mostly occurred due to the increase in the prices of petroleum products. Although the world price of oil fell, due to a dinar weakening against the dollar (oil prices are expressed in dollars), the prices of petroleum products increased by 1.4% (prices in October compared to prices in June). Due to a drop in the prices of oil and food on a world market, import prices expressed in dinars in Q3 slowed down the quarterly growth to 0.6%. The possibility of duty-free import of most agricultural products from EU since of this year reduces the pressures on food prices in the conditions of reduced supply in domestic market. The decline in imported inflation was mitigated by the dinar depreciation in the mentioned period. The growth of import prices on a year-on-year basis amounted to 0.7% at the end of Q3, which reduced the inflationary pressures in the domestic market.

Total and underlying inflation are low

During Q3 and in October, underlying inflation (inflation excluding food, alcohol, tobacco and energy products) is at a stable low level, as it was in the previous two quarters. Its slight growth was recorded in July 2014, when three-month average amounted to 1.2%, i.e. 4.9% when annualized (Graph T5-5). However, as this leap was caused by the sudden changes in the prices of one-off character (increase in the prices of insuarance and services from the group of recreation and culture), whose effect disappeared, underlying inflation soon returned within this year's stable low framework and in October three-month average amounted to 0.1%, i.e. -0.4% when annualized. The decline in underlying inflation in August was largely a consequence of cheapening of the fixed telephony services (one-off effect), and in September was a consequence of the exected fall in the prices of tourist packages at the end of summer tourist season. Total inflation in September inceased slightly mostly due to a rise in the prices of food, when the annualized three-month average rose to 1.6% from -0.7% in August, while in October, it amounted to 1.3%. Regulated prices recorded a drop in Q3 (quarterly, this has been the first time the inflation was measured by the IPC changes) - mainly due to a falling prices of telephone services, as well as the drop in the prices of medicines and the abolition of TV subscription. The largest part of the reduction has a one-off character. Also, the absence of correction, i.e. growth in the prices of electricity has influenced this decline, but it is certain that this correction will occure in the next period (most likely after completion of the heating season 2014/2015). NBS's recommendation is that the correction of the regulated prices should take place at a pre-planned schedule and in a planned amount, which would undoubtedly contribute to a more certain inflation prediction and more adequate responses of NBS to its movement. The year-on-year growth of regulated prices in Q3 amounted to 3.5% (of which 2.6% since the beginning of the year).

Inflation trends below the lower limit of the target band is expected in Q4 and in early 2015

In Q4 year-on-year inflation will most likely move below the NBS target band. Given that the low aggregate demand will remain the main disinflationary factor in the long term, the return of y-o-y inflation within the limits of the target band is not even expected in Q4 (temporary entry in the target band is possible in November), nor during the first quarter, but only in the second quarter of 2015, when the disinflationary pressures based on food prices are expected to disappear, with the continuing and enhancing of the low base effect functioning. A slowdown in economic activity has a disinflationary effect, while measures of fiscal adjustment will further affect the reduction in aggregate demand, and thus the stability of the prices, while dinar depreciation could have a inflationary effect in the following period, but it's unlikely that a moderate depreciation could to a large extent transfer to a price growth in the conditions of a low and faling domestic demand and economic activity slowdown. The growth of general government deficit to 7% of GDP and public debt to over 70% suggests the poor state of the public finances. Consistent implementation of fiscal consolidation measures and structural reforms, together with the signing the arrangement with the IMF is necessary and would have a positive impact to the decisions of foreign investors on investing in Serbia, contribute to the improvement of credit rating in the competitiveness rating lists. NBS inflation projection in November is lower than in August due to a larger than supposed fall in the prices of raw material, as well as due to the absence of a planned increase in the prices of electricity. Thus, due to aforementioned factors, and primarily due to a low aggregate demand, in the first quarter of 2015 inflation will also continue

to move below the lower limit of the target band (also due to the exit from the accounting of high monthly inflation of 1.5% in January 2014). However, their effect is one-off and from the mid-2015 inflation is expected to return within the limits of the target band, and its approaching to the goal of 4% by the end of 2015. The main inflationary pressures will be the growth of regulated prices (the same as in previous years) and a probable growth in the food prices after next agricultural season. Inflationary trend in Q4 will be affected by the low base effect and dinar weakening during Q3 and in early Q4, but will most probably be neutralized by the effect of a low domestic demand and the fall in the prices of primary agricultural products. It is expected that the core inflation will remain below the limits of the target band even during Q4.

Dinar depreciation will affect inflation gowth, but due to the recession it will be a modest one

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

Source: SORS and *QM* estimates
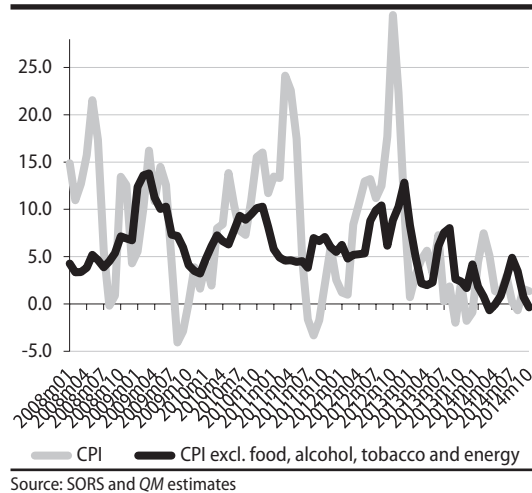
Due to a dinar weaking (in Q3 and continuing in Q4), a positive contribution to inflation could be expected from the rising prices of industrial products excluding food and energy. Highest deviation from the expectations could appear in the trends of food and vegetable prices, as well as the extent to which the realized depreciation will transfer to the prices in the conditions of a low aggregate demand. Further easing of monetary policy will depend on the effects of undertaken monetary and fiscal policy measures (fiscal consolidation and structural reforms) and on the trends in the international environment. Inflationary expectations of the economy and financial sector in the short and long term are within the target band of National Bank of Serbia. Stable inflation expectations suggest that significant inflationary pressures shouldn't be expected even in the following period (a year and two in advance). Inflation expectations of the financial sector for a period of one year amount to 4.5% in advance according to the *Bloomberg* survey, i.e. 4.0% according to Ipsos survey, and there is a similar sitiation with the economy expectations. Inflation expectation of the population are at a high 10%, but are largely caused by the lack of knowledge among the population on the macroeconomic trends, given that the citizens evaluate the perceived inflation as several times higher than the actual one

The Exchange rate

Depreciation in Q3, October and November 2014

At the end of Q3 when compared to Q2, dinar weakened against the euro by 2.6^, ie.e 1.5% at the level of average period. Against the dollar, dinar weakened by 9.4% at the end of Q3 (much of this depreciation is the result of euro wekening against the dollar). Slightly weaker depreciation continued in October, when dinar weakened by additional 0.2%, but more significant weakening occurred in November (Graph T5-6). Since the beginning of Q3, there has been a record of constant depreciation pressures, while by the end of November, NBS intervened by selling foreign currency in the amount of 605 million euros. Since the beginning of the year until the end of November, NBS intervened by selling foreign currency in the amount of 1.445 billion euros and buying 200 million euros, while the dinar exchange rate against the euro nominally depreciated from 114.69 to 120.55 RSD/eur, i.e. by 5.1%. Global factors that have contributed to dinar weakening are the uncertainty in the international financial market concerning Ucraine crisis, reduction in the expansiveness of Fed's monetary policy and the uncertainties concerning the effects of ECB's undertaken measures. Domestic factors are unfavorable news on the worsening of the foreign trade balance, reduced inflows of foreign capital, and investor's doubt in the sustainability of public finances and Government willingness in the implementation of structural reforms. The consequence of the aforementioned factors was a modest capital inflow in Q3 and outflow of foreign exchange for payment of dividends t foreign companies, but there was also a greater deleveraging of banks to abroad, thus making non-residents, again as in Q2, the net buyers of foreign exchange in the domestic market. Companies also increased their demand for

foreign exchange due to increased energy imports after May floods. Global factors have contributed to depreciation pressures strengthening during July and August even in other countries in the region with a similar exchange rate regime, only to completely disappear in September and appear again in October, but in a much lesser extent (Graph T5-7). However, the dinar exchange rate when compared to other currencies depreciated considerably more, and the pressures did not stop even during the period when other currencies appreciated (similar happened in January and May 2014). It can be concluded that dinar depreciation is to a certain extent the result of global factors, but that the factors specific for Serbia (worsening of a foreign trade balance and distrust of investors) also have a great influence on the exchange rate trend. Risk premium mo-

Chart T5-6. Serbia: Daily RSD/EUR Exchange Rate, 2010-2014
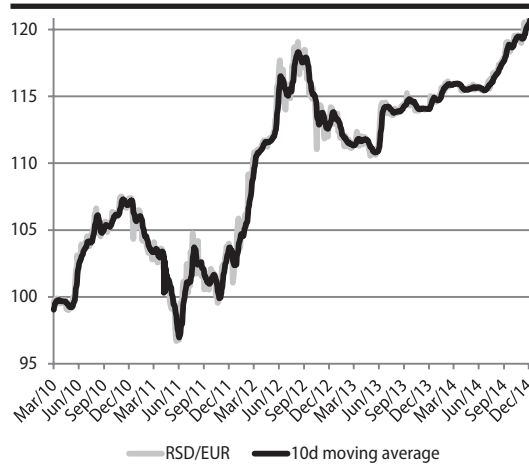
Source: NBS

Chart T5-7. Nominal exchange rate depreciation (in %) in Period of July-October 2014 in Chosen Central and Eastern European Countries
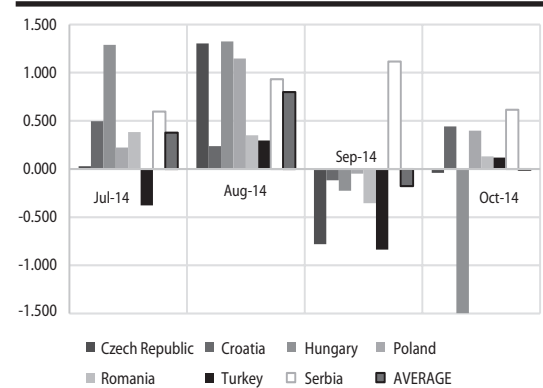
Source: Eurostat, NBS, *QM* estimates

Chart T5-8. Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly Averages, 2008-2014
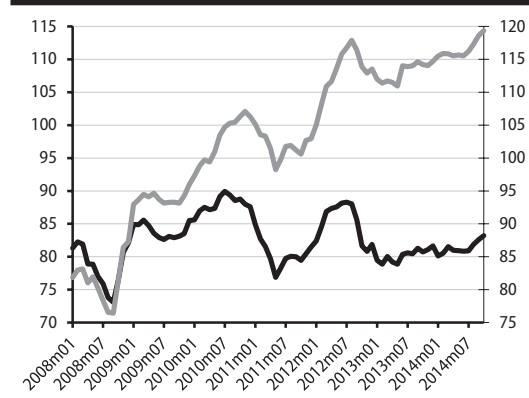
Source: NBS, SORS, Eurostat and *QM* estimates
Note: an increase represents depreciation

vement of the countries in the reion (measured by the EMBI index) was relatively stable during Q3. At the end of Q3, EMBI index value for Serbia was increased by 32bp when compared to the late Q2, while the average level was higher only by 1bp when compared to an average of Q2. In addition to global factors which influenced the movement of EMBI index of the countries in the region, above-average index growth for Serbia occurred due to a poor assessment of the situation in the public finances by investors and rating agencies.

During Q3 there was real dinar depreciation by about 2.2% and 0.7% in October. Total real depreciation since the beginning of 2014 until the end of October was 1.9%. The movement of the real dinar exchange rate during Q3 was mostly affected by the changes in the nominal exchange rate and to a lesser extent, the ratio of the domestic and euro zone inflation (while inflation in Serbia was 0.2%, in the euro area during the same period it amounted to -0.2%). Real exchange rate in the previous period (about two years back), was relatively stable, but since the beginning of Q3, a period of a moderate real depreciation began, and it could lead to the improvement of the economy competitiveness at an acceptable cost at the side of inflation (which is located below the lower limit of the target band) and loan servicing costs. Historically observed, the real dinar value at the end of the October was by 4% higher than in a first half of 2012, so the additonal depreciation would be welcome in order to spur export as one of the main drivers of the growth in the coming years (Graph T5-8).

6. Fiscal flows and policy

Fiscal deficit, excluding "below-the-line" expenditures, ran at 29.7 billion dinars in the period July-October (about 2.3% of quarterly GDP), and totaled 137.2 billion dinars in the first ten months of 2014 (about 4.2% of GDP), while inclusive of "below-the-line" expenditures it ran at 5.5-6% of GDP. Relatively small fiscal deficit in the period July-October came as a consequence of multiple factors, the most important being a slowdown in expenditures on goods and services and capital expenditures, the impact of seasonal factors on revenues, and depreciation of dinar exchange rate, and, to a certain extent, intensified activities against shadow economy. Moderate fiscal deficit in November suggests that consolidated fiscal deficit in 2014, including "below-the-line" expenditures, will be by RSD 25-30 billion smaller than projected in the Budget Revision Bill adopted in October, and will reach about 7% of GDP. This deviation is extremely large, given the fact that it will occur in only two months. It is attributed to much lower spending on goods and services and public investments than planned. However, these expenditures are absolutely controllable, which suggests that the government lacks the capacities to make macro fiscal projections and carry out the adopted projects. Public debt totaled EUR 22.1 billion (67.7% of GDP) at the end of October, and inclusive of the debt of local governments it reached 69.7% of GDP. Estimations show that if other circumstances remain unchanged, public debt (including the debt of local governments) will reach 72% of GDP at the end of the year.

General tendencies and macroeconomic implications

Fiscal deficit for the period July-October, excluding "below-the-line" expenditures, totals RSD 29.7 billion (about 2.3% of the quarterly GDP)

Consolidated fiscal deficit in the period July-October 2014 totaled RSD 29.7 billion (about 2.3% of GDP[1]) due to a slight rise in public revenues and a moderate decrease in expenditures. This rise in public revenues was mainly based on revenues from VAT and personal income tax. On the other hand, expenditures went down moderately due to a slowdown in capital expenditures and expenditures on goods and services, and decrease in expenditures on interest payments driven by a specific payment schedule.

Relatively small deficit in the period July-October is not, however, a sign of a continuing and notable recovery in public finance

Relatively small deficit in the period is mainly attributed to seasonal factors (VAT payments by small VAT payers in July and October etc.), dinar depreciation, temporary reduction in expenditures on goods and services and public investments (which are often postponed or canceled due to complicated procurement procedures), and to a certain extent, intensified activities against shadow economy. Accordingly, it cannot be observed as a sign of continuing and significant recovery in public finance because it is based on temporary postponement of some procurements rather than systematic rationalization. Furthermore, considerable reduction in public investments produces negative impact on economic growth and social development in the long term, so, in spite of being technically accomplishable, it is extremely economically unjustified.

Graph T6-1. Serbia: Consolidated fiscal balance and primary fiscal balance (% BDP)[1]
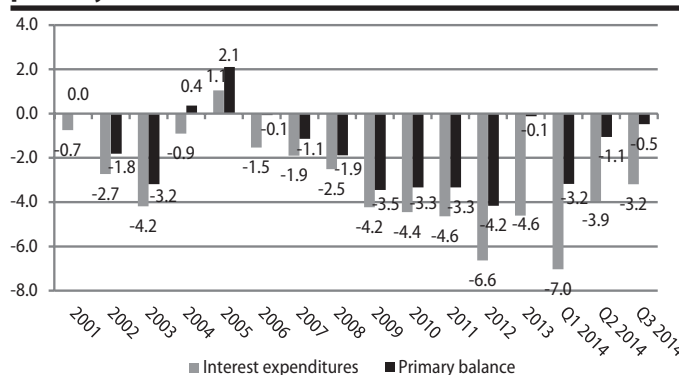
Source: *QM* calculation
1 Primary fiscal deficit (deficit without interests) is the difference between the total public revenues and the overall public expenditures subtracted by expenditures on interest payments.

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1 SORS' upwards revision of the data on nominal GDP also pushed down fiscal variables (revenues, expenditures, deficit and public debt) as a GDP %. More detail on GDP revision can be found in the section on economic activity.

Fiscal deficit, excluding „below-the-line" expenditures, amounts to RSD 137.2 billion (about 4.2% of GDP) in the first ten months of 2014... and inclusive of these expenditures it stands at 5.5-6% of GDP

To October inclusive, consolidated fiscal deficit excluding "below-the-line" expenditures (activated guarantees on loans to public enterprises etc.) amounted to RSD 137.2 billion, which equals 4.2% of the GDP achieved in this period. With these expenditures added, this percentage goes up to 5.5-6% of GDP.

Fiscal deficit excluding expenditures on interest payments stands at 1.2% of GDP in the first ten months of 2014

Primary fiscal deficit (deficit without expenditures on interest payments) amounted to 1.2% of GDP in the period January-October 2014, meaning that expenditures on interest payments make almost three quarters of consolidated fiscal deficit. Primary fiscal deficit is narrowing and the overall fiscal deficit is growing, which indicates that expenditures on interest payments are becoming one of the main drivers of fiscal deficit. Consequently, fiscal deficit could become self--generating in the future.

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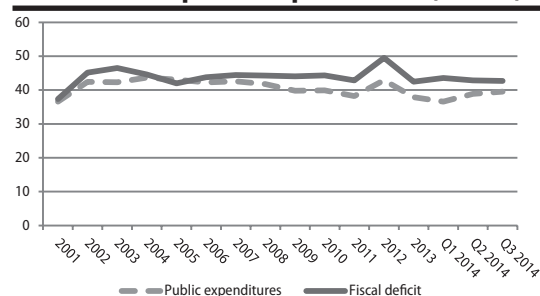
Source: *QM* calculation

Graph T 6-3. Serbia: Real seasonally adjusted fiscal deficit (in 2013 prices)
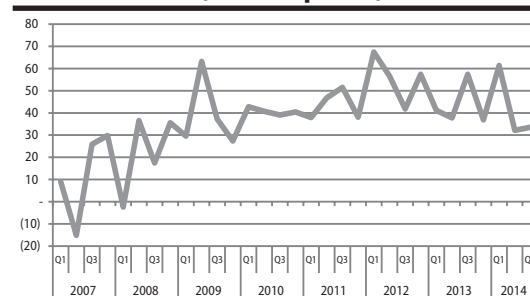
Source: *QM* calculation

Consolidated fiscal deficit in 2014 will be by 25-30 billion dinars smaller than projected in the Budget Revision Bill adopted in October...

In the Budget Revision Bill adopted in October central government budget deficit is projected at RSD 225 billion, and consolidated fiscal deficit excluding "below-the-line" expenditures is targeted at RSD 240 billion (about 6% of GDP), while inclusive of these expenditures it goes up to about RSD 300 billion (about 8.5% of GDP). However, trends in fiscal deficit detected in the first three quarters and in October and November suggest that consolidated fiscal deficit could be much below the projections. In the period January-October consolidated fiscal deficit amounted to RSD 137 billion and preliminary data show that the central government budget deficit in November was below RSD 10 billion (consolidated deficit could be somewhat larger). Under the influence of seasonal factors, fiscal deficit and public expenditures usually go up steeply in December relative to other months. However, December fiscal deficits recorded in the last five years have never exceeded the amount of RSD 45 billion.

...and will total 7% of GDP

Accordingly, and taking into account the dynamics in public revenues and public expenditures in the preceding months, consolidated fiscal deficit in 2014 is expected to be by 25-30 billion dinars smaller than projected in the budget revision, and inclusive of "below-the-line" expenditures it is expected to total 7% of GDP.

Deviation from the projected amount of fiscal deficit is attributed to much lower spending on goods and services and capital investments than planned...

Deviation from the projected amount of fiscal deficit came from a much lower spending on goods and services and capital investments than planned, rather than a notable recovery on the revenue side. This deviation is extremely large, given the fact that it will occur in only two months, because public expenditures will be more than 7% below the projections made at the end of October. Complicated public procurement procedure and demanding requirements stipulated by the new Public Procurement Law (obligation to provide the amount that equals total value of procurement in advance) are often cited as reasons for this deviation. These are not permanent rationalization-driven savings, but temporary reductions in expenditures on goods and services which are based on postponed procurements.

...which shows that the government is lacking capacity...

However, the Public Procurement Law has been in force for more than a year and a half, and most of the foregoing public expenditures are completely controllable. Therefore, large discrepancy between realized expenditures and the targeted level suggests that the relevant gover-

...to make macro fiscal projections and to carry out the adopted projects

Unreliable statistical data and macro fiscal estimates pose a large obstacle to economic policy makers

nment bodies lack the capacity to plan expenditures and budget, and carry out the planned projects on time.

Large discrepancy between preliminary and final estimates of macroeconomic variables made by the Statistical Office of the Republic of Serbia that are often subject to considerable revisions (GDP revisions), and relatively unreliable projections of fiscal trends (public revenues and expenditures) made by the state institutions pose a large obstacle to economic policy makers. Therefore, the quality and reliability of statistical data and fiscal projections need to be improved considerably in a relatively short term to enhance Serbian economic policy.

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

Public revenues are going up slightly in Q3

Real seasonally adjusted consolidated public revenues went down moderately (by 2.6%) in Q3 2014 relative to the preceding quarter, primarily due to a considerable drop in revenues from corporate income tax, caused by changes in tax calendar in 2014, and a slight decrease in excise revenues. Without revenues from corporate income tax, public revenues (real seasonally adjusted) rose by 1.9% in Q3 relative to Q2. Slight real (seasonally adjusted) rise in these revenues continued in October relative to the preceding month (by 0.8%). Total public revenues in Q3 were by 3.8% higher than in the same quarter last year.[2]

Revenues from VAT are rising slightly due to dinar depreciation and reduction in shadow economy

Graph T 6-4. Serbia: Trends in real consolidated seasonally adjusted revenues from consumption tax (in 2013 prices)
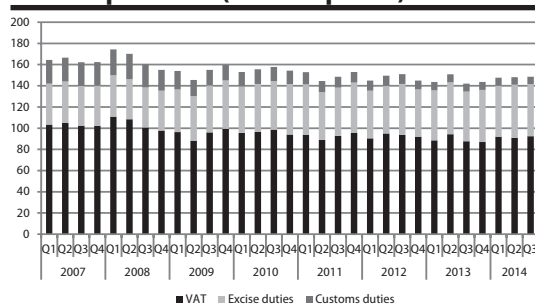
Source: *QM* calculations

Real seasonally adjusted revenues from VAT went up slightly (by 1.6%) in Q3 relative to the preceding quarter. There was a real y-o-y rise in these revenues (by 5.4%), as well. Revenues from VAT continued to rise in October and were by 7.4% higher than in September. Taking into account recession and import stagnation, somewhat steeper rise in revenues from VAT in the second half of the year could be attributed to real dinar depreciation (by 2.6%) and intensified activities against illegal sales of goods and services, mainly through tighter controls on retailers and cafes and restaurants[3].

...and excise revenues show no sign of recovery

Real seasonally adjusted excise revenues went down in Q3 relative to the preceding quarter (by 1.8%), but were higher (by 9.5%) than in the same period last year (due to tax rate increase). Revenue dynamics in Q3 were affected by dinar depreciation, decrease in world oil price, trends in real domestic demand, and intensified activities against illegal sale of excise goods. Illegal sale of petroleum products has been reduced notably, while in the area of tobacco products only small steps forward have been made.

Drop in custom revenues slows down

Custom revenues (real seasonally adjusted) fell slightly in Q3 relative to Q2 (by 1.6%), while y-o-y decrease was somewhat larger (6.9%). With almost completely liberalized foreign trade (with EU) and stagnant imports, this drop in custom revenues can be attributed to a shift in the structure of imported goods, regarding their type and country of origin, towards goods that are subject to lower custom duties and the goods imported from the signatory countries to free trade agreement with Serbia.

Activities against informal employment have not produced noticeable effects on revenues from personal income tax and social security contributions yet

Seasonally adjusted revenues from personal income tax went up considerably in Q3 relative to the preceding quarter (by 3.7%). These revenues increased slightly relative to the same period last year (by 0.8%), although the tax rate for wages was reduced mid Q3 2013, which increased the base for comparison. On the other hand, revenues from social security contributions (real seaso-

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2 Although flood relief donations amounted to RSD 4.7 billion in Q3, which exceeds the total annual donation received in 2013 by more than 50%, these are one-off revenues and therefore were excluded from the economic analysis of public revenue dynamics.

3 It is possible that the rise in revenues was partly driven by a slowdown in VAT refund, but there are no official data that would confirm this.

nally adjusted) went down in Q3 relative to Q2 (by 0.8%). However, these revenues were higher than in the same period last year (by 28.1%), because contribution rate for pension and disability insurance was increased by 2 percentage points. Divergent trends in revenues from personal income tax and revenues from social security contributions could be caused by increase in registered income from capital, which is subject to taxation but not to social security deductions. This also suggests that the activities against informal employment failed to produce notable results.

Revenues from corporate income tax are going down, due to changes in tax calendar, and possibly to decreasing profitability and illiquidity of companies

Graph T 6-5. Serbia: Trends in real consolidated seasonally adjusted revenues from tax on factors of production (in 2013 prices)

Source: *QM* calculation

Real seasonally adjusted revenues from corporate income tax were halved in Q3 relative to Q2. This was caused by changes in tax calendar as of this year and cannot be offset by standard methods for seasonal adjustment. Q3 saw a considerable y-o-y drop in these revenues (by 9.5%). This can be attributed to decreasing profitability of companies, leading to downwards revisions in tax advances, or to illiquidity (and consequently, increase in tax arrears).

Other tax revenues are going up slightly due to increase in property tax rate…

There was a slight real rise in other tax revenues in Q3 relative to the same period last year (by 0.8%) due to increase in property tax rate, after abolition of compensation for building land use.

…and solidarity tax pushes up non-tax revenues

Non-tax revenues (real seasonally adjusted) rose in Q3 relative to the preceding quarter (by 4.8%) thanks to effective solidarity tax collection as of Q2. However, Q3 saw a real y-o-y drop in these revenues (by 5%). This is attributed to abolition of compensation for building land use, and high base for comparison, because dividend payments made by NIS in Q3 2013 considerably increased these revenues.

Public expenditures are going down moderately

Graph T 6-6. Serbia: Trends in consolidated seasonally adjusted public expenditures (in 2013 prices)
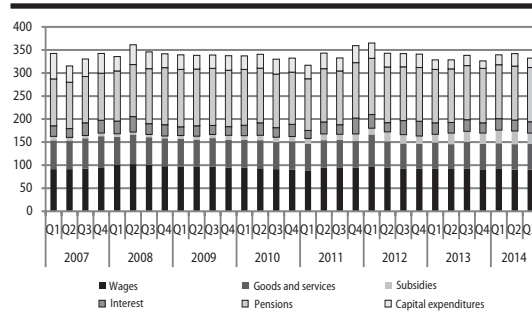
Source: *QM* calculations

Real seasonally adjusted public expenditures went down moderately in Q3 2014 relative to the preceding quarter by 2%, which equaled its y-o-y drop. This reduction in public expenditures was primarily driven by reduction in capital expenditures and decrease in expenditures on interest payments (due to payment schedule for coupons on euro-denominated bonds).

Expenditures on wages are stagnant… and hiring freeze fails to produce desired effects

Expenditures on public sector employees (real seasonally adjusted) remained almost unchanged in Q3 relative to the preceding quarter. This quarter saw a moderate real y-o-y drop in these expenditures (by 3%). Such dynamics in expenditures on employees came from nominal wage freeze, and to a certain extent, from public sector hiring freeze as of January 2014. Stabilized expenditures on employees suggest that the government have brought them under control. However, hiring freeze failed to produce notable results, which suggests inconsistent implementation of this measure. Therefore, without additional institutional and organizational guarantees that the rule will be obeyed, it would be risky to include savings from hiring freeze in future fiscal projections.

Expenditures on pensions are growing slightly… due to increase in the numbers of pensioners

Expenditures on pensions (real seasonally adjusted) grew slightly in Q3 relative to Q2 (by 0.7%), and were somewhat higher than in the same period last year (by 0.2%). Expenditures on pensions increased in Q3 relative to the preceding quarter due to increase in the numbers of pensioners, which will probably continue to grow by the end of 2014 because future pensioners will have to meet more stringent retirement requirements as of January 2015.

Expenditures on goods and services are going up slightly relative to the preceding quarter

Real seasonally adjusted expenditures on goods and services went up slightly in Q3 relative to the preceding quarter (by 1.5%), but were lower than in the same period last year (by 1.6%). Spending on goods and services, mainly from the local government budgets and Health Insurance Fund of the Republic of Serbia, rose slightly probably because of additional expenditures on flood relief, and partly because some previously postponed procurements had to be done and procurement arrears had to be cleared. Data show that these expenditures slowed down again in October and December because some procurements were postponed, delayed or canceled.

Implementation of new subsidy programs slightly pushes up expenditures on subsidies

Real seasonally adjusted expenditures on subsidies increased moderately in Q3 relative to the preceding quarter (by 2.3%) due to a specific agricultural subsidy payment schedule, and approval of direct budget support to Srbijagas (instead of former state guarantees on loans to this company). Q3 saw a real y-o-y drop in these expenditures (by 3.8%), caused by abolition of some subsidy programs (on housing loans, investment and employment subsidies – although these subsidies have been reintroduced *ad hoc*).

Expenditures on interest payments are falling slightly thanks to payment schedule for coupons on euro-denominated bonds, but the long-term upwards trend in these expenditures will continue

Expenditures on interest payments fell considerably in Q3 relative to Q2 (by 18,5%), because large amount of euro-denominated bonds fell due in April. Q3 saw a real y-o-y drop in these expenditures (by 3.4%). However, such dynamics cannot be observed as a beginning of a continuing downwards trend in expenditures on interest payments. Actually, it is quite the opposite – growing public debt, tougher borrowing conditions (due to growing debt, and possibly because the Fed and ECB will tighten their monetary policy in the following period) and dinar depreciation are expected to push these expenditures upwards again.

Capital expenditures are falling steeply, because they are the easiest to cut

Capital expenditures (real seasonally adjusted) fell sharply in Q3 2014 relative to the preceding quarter (by 25.4%), and were much lower than in the same period last year (by 12.8%), as well. This decrease would be even sharper if RSD 3 billion were not spent on goods for Commodity reserves in September. Such dynamics of capital expenditures are attributed to high base for comparison (large interim payments in Q2), demanding procurement requirements (amount that equals total value of procurement has to be provided in advance), and the fact that the easiest way to reduce public expenditures is to cancel or postpone public investments. Overall capital expenditures in the first three quarters of 2014 accounted for only 2.2% of GDP. This indicates that more than a half of fiscal deficit in that period (4.7% of GDP) came from current consumption. Since fiscal deficit is funded through borrowing, future generations will have to shoulder part of this burden. At the same time, such a low level of capital expenditures is unacceptable from the aspect of economic efficiency, as well, because they have affect economic growth more than any other public expenditure. Additionally, insufficient investments in public infrastructure hinder possible future economic.

Fiscal trends by government levels

Central government, the Autonomous Province of Vojvodina, local self-governments and the Health Insurance Fund of the Republic of Serbia are overspending their budget in Q3

In Q3 2014 central government overspent its budget by RSD 159.4 billion, and after a long period of budget surplus, both the Autonomous Province of Vojvodina and local municipalities slipped into deficit (RSD 0.4 billion each).

However, in the first three quarters of 2014 Vojvodina and local self-governments were in budget surplus of RSD 3.5 billion and RSD 7.6 billion respectively. Even with usual seasonal rise in expenditures in Q4 (assuming there will be no extraordinary spending) these two government levels will probably be in surplus.

In the first three quarters of 2014 sub-central government levels were in budget surplus of about RSD 11 billion, which indicates existence of vertical fiscal imbalance

After a long period, the Health Insurance Fund of the Republic of Serbia moved into deficit of RSD 2.1 billion because the rate for health insurance contributions was reduced in July.

Q3 2014 saw a real y-o-y rise in central government revenues (by 5.4%). It was driven by increase in revenues from VAT (based on VAT rate increase), rise in excise revenues, and increase in non-tax revenues (based on solidarity tax) and donations (for flood relief). Health Insurance Fund revenues suffered a considerable real drop in Q3 relative to the same quarter last year (by 9.3%) because the rate for health insurance contributions was reduced by 2 percentage points in

Health Insurance Fund of the Republic of Serbia slipped into deficit because the rate for health insurance contributions was reduced in July

Central government revenues are growing, and the Health Insurance Fund revenues and local government revenues are falling

Central government expenditures are going down moderately, and local government expenditures are growing

July (from 12.3% to 10.3%), and the rate for pension and disability insurance contributions was increased by 2 percentage points. Additionally, transfers between the central government budget and the Health Insurance Fund have been introduced. This way, savings from wage reduction can be transferred from the Health Insurance Fund to the central government budget, and used to make up consolidated fiscal deficit. Q3 saw a moderate real y-o-y decrease in local government revenues (by 2.5%). It was caused by a decrease in wage tax rate (lag effect of wage tax rate reduction from 12% to 10% in July 2013), a sharp drop in non-tax revenues (by 22.7%), due to abolition of compensation for building land use, and reduction in transfers from the central government budget (by 14.8%). At the same time, revenues from property tax increased considerably (by 57.9%). However, this rise is insufficient to offset the loss of revenues from compensation for building land use (these revenues were almost equal to revenues from property tax). It is therefore necessary to increase revenue impact of this tax in the next year.

Table T 6-7. 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	Local self-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
Q1 2014	-77.5	0.3	0.0	6.1	1.8	4.5
Q2 2014	-51.5	0.9	1.2	3.0	2.1	3.5
Q3 2014	-30.4	0.0	0.8	-2.1	-0.4	-0.4
Q1-Q3 2014	-159.4	1.2	1.9	7.0	3.5	7.6

Source: *QM*

Q3 saw a real y-o-y drop in central government expenditures (by 7.7%) driven by considerable reduction in expenditures on goods and services, in capital expenditures and in expenditures on welfare. The Health Insurance Fund also spent less in Q3 than in the same period last year (by 1%), primarily due to considerable cuts in capital expenditures. This could be attributed to redistribution of income between the Health Insurance Fund and the central government budget, due to which the Health Insurance Fund suspended payments for some capital projects until the transfer from the central budget was made. Q3 saw a real y-o-y rise in local government expenditures (by 1%) driven by increase in expenditures on welfare and goods and services. On the other hand, capital expenditures fell moderately, which is considered unfavorable. Such revenue dynamics at different government levels (sub-central government levels are in surplus and the central government is running large deficit), and unfavorable trends regarding the level and structure of local government expenditures indicate the need for strategic approach to distribution of revenue among different government levels, that would redress vertical imbalance and encourage rational and productive spending.

Trends in public debt

Serbia's public debt totals EUR 22.1 billion (67.7% of GDP) at the end of October 2014...

...and including the debt of local municipalities it goes up to 69.7% GDP

Serbia's public debt totaled EUR 22.1 billion (about 67.7% of GDP) at the end of October 2014, and was by EUR 1.43 billion larger than at the end of Q2.

Including the debt of local municipalities, public debt amounted to 69.7% of GDP. Growth in public debt in the period July-October considerably exceeded consolidated fiscal deficit in the period (about EUR 0.25 billion). The loan received from the UAE in August, rise in domestic borrowing, needed to fund liabilities in the following period, and depreciation of euro-dollar exchange rate were the key generators of debt. In the same period, public debt-to-GDP ratio increased by 6.5% of GDP, which exceeded its absolute growth. This is attributed to real depreciation of dinar exchange rate in the period (by 2.6%), and GDP shrinking in Q2 and Q3. Relative growth would be even larger if the data on GDP were not revised upwards in the meanwhile.

Table T 6-8. Serbia: Public debt dynamics 2000-2014

	Amount at the end of period, in billions EUR													
	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1 2014	Q2 2014	Q3 2014	X 2014
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	12.36	15.07	17.3	17.7	18.0	19.5	19.5
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	6.5	7.0	7.5	7.7	8.0	8.1
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	8.6	10.2	10.3	10.3	11.5	11.6
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.60	2.81	2.8	2.7	2.6	2.5
III. Total debt (I+II)	**14.2**	**10.3**	**9.4**	**8.9**	**8.8**	**9.8**	**12.2**	**14.5**	**17.7**	**20.1**	**20.5**	**20.7**	**22.1**	**22.1**
Public debt / GDP²	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.6%**	**31.3%**	**41.5%**	**45.1%**	**59.3%**	**63.8%**	**62.3%**	**63.0%**	**66.8%**	**67.2%**
Public debt / GDP (QM)³	**169.3%**	**52.1%**	**36.1%**	**29.9%**	**28.3%**	**32.8%**	**41.9%**	**44.4%**	**56.1%**	**59.4%**	**60.6%**	**61.2%**	**67.6%**	**67.7%**

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

Downwards trend in indirect debt continues, but it is expected to rebound

The downwards trend in indirect public debt detected in the preceding two quarters continued in Q3, when it decreased by EUR 130 million, because a part of state-guaranteed loans to Srbijagas was repaid (about EUR 100 million), and direct budget support to this company was approved (of about EUR 75 million) instead of issuing new government guarantees. However, key generators of indirect public debt (guarantees on loans to Srbijagas and other public/state companies) have not been eliminated. Therefore, if other circumstances remain unchanged, public debt will probably rebound, and the announced issuance of guarantees to Srbijagas worth EUR 200 million by the end of 2014 confirms this. To reverse the long-term upwards trend in indirect debt, large recipients of state guarantees need to be restructured/privatized/declare bankruptcy as soon as possible.

Public debt will amount to 72% of GDP at the end of 2014

Graph T 6-9: Trends in public debt in Serbia (GDP %)
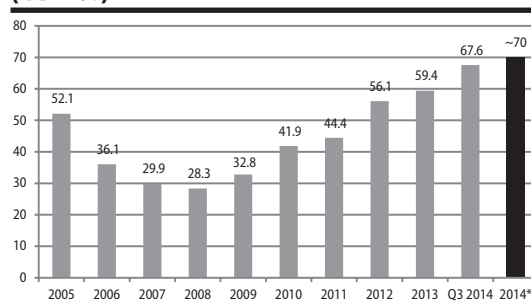
Source: *QM* calculations

Public debt as GDP percent will rise both in Q4 and on annual basis. This is due to poor health of public finance, and real GDP shrinking in 2014. Taking into account its level at the end of October, expected dynamics in fiscal deficit by the end of the year, announced issuance of state guarantees to Srbijagas, realization of the flood relief loan worth EUR 300 million granted by the World Bank in October, expected continuation of a slight dinar-to-euro depreciation, and assuming that borrowing in advance (to obtain funds for the next year) will remain within the expected level, 2014 public debt is estimated at 70% of GDP, and with the debt of local municipalities it is targeted at 72% of GDP.

Appendices

Annex 1. Serbia: Consolidated General Government Fiscal Operations[1], 2008-2014 (nominal amounts, bn RSD)

	2008	2009	2010	2011	2012	2013					2014			
						Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q1-Q3
I PUBLIC REVENUES	**1,145.9**	**1,146.5**	**1,223.4**	**1,302.5**	**1,405.4**	**330.0**	**362.4**	**369.1**	**406.4**	**1,467.8**	**336.1**	**385.6**	**390.5**	**1,112.2**
1. Current revenues	1,143.1	1,139.2	1,215.7	1,297.9	1,393.8	327.3	361.3	367.6	405.0	1,461.3	334.9	383.7	385.4	1,104.0
Tax revenue	1,000.4	1,000.3	1,056.5	1,131.0	1,225.9	296.4	321.3	325.8	352.5	1,296.4	301.3	348.7	344.8	994.8
Personal income taxes	136.5	133.5	139.1	150.8	165.3	38.2	39.8	35.9	42.1	156.1	32.2	35.1	36.9	104.3
Corporate income taxes	39.0	31.2	32.6	37.8	54.8	18.4	11.0	15.4	15.8	60.7	15.5	29.8	14.2	59.5
VAT and retail sales tax	301.7	296.9	319.4	342.4	367.5	87.3	98.7	94.6	99.9	380.6	93.6	97.0	101.7	292.2
Excises	110.1	134.8	152.2	170.9	181.1	42.5	53.7	52.3	56.3	204.8	42.9	55.2	58.4	156.4
Custom duties	64.8	48.0	44.3	38.8	35.8	7.3	7.9	8.2	9.1	32.5	7.2	7.5	7.8	22.4
Social contributions	312.7	318.8	323.0	346.6	378.9	93.4	99.7	107.7	117.6	418.3	99.3	109.8	110.7	319.7
Other taxes	35.6	37.1	46.0	43.5	42.6	9.3	10.9	11.6	11.7	43.5	10.7	14.3	15.1	40.1
Non-tax revenue	142.7	138.8	159.2	166.9	167.9	30.9	39.6	41.9	52.5	164.9	33.7	35.0	40.5	109.2
2. Capital revenues	1.4	0.9	0.3	2.0	8.7	1.9	0.5	0.6	0.5	3.5	0.4	0.6	0.4	1.4
	0.0													
II TOTAL EXPENDITURE	**-1,195.7**	**-1,248**	**-1,329.9**	**-1,435.9**	**-1,606.2**	**-364.3**	**-402.6**	**-422.1**	**-445.0**	**-1,633.9**	**-395.6**	**-418.9**	**-421.8**	**-1,236.3**
1. Current expenditures	-1,089.6	-1,155	-1,224.8	-1,324.8	-1,479.9	-350.9	-385.0	-395.4	-418.6	-1,549.8	-381.7	-393.6	-398.0	-1,173.3
Wages and salaries	-293.2	-302.0	-308.1	-342.5	-374.7	-93.8	-98.1	-97.5	-103.4	-392.7	-95.7	-97.9	-96.4	-290.0
Expenditure on goods and services	-181.2	-187.4	-202.5	-216.3	-235.7	-49.7	-55.3	-60.0	-71.9	-236.9	-50.9	-58.3	-60.2	-169.4
Interest payment	-17.2	-187.4	-34.2	-44.8	-68.2	-18.9	-27.5	-27.2	-20.9	-94.5	-35.5	-28.6	-26.8	-91.0
Subsidies	-77.8	-22.4	-77.9	-80.5	-111.5	-19.0	-22.0	-28.4	-31.8	-101.2	-19.4	-23.7	-27.9	-70.9
Social transfers	-496.8	-63.1	-579.2	-609.0	-652.5	-162.4	-173.0	-172.6	-179.5	-687.6	-170.7	-172.4	-172.8	-515.8
o/w: pensions5)	*-331.0*	*-556.4*	*-394.0*	*-422.8*	*-473.7*	*-120.0*	*-124.6*	*-125.3*	*-128.2*	*-498.0*	*-125.0*	*-126.9*	*-128.0*	*-379.9*
Other current expenditures	-23.5	-387.3	-22.9	-31.7	-37.4	-7.1	-9.1	-9.6	-11.1	-36.9	-9.6	-12.6	-14.0	-36.1
2. Capital expenditures	-106.0	-24.0	-105.1	-111.1	-126.3	-13.4	-17.6	-26.7	-26.4	-84.0	-13.9	-25.3	-23.7	-63.0
	0													
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**-19.1**	**-20**	**-29.9**	**-24.9**	**-16.6**	**-3.1**	**-3.9**	**-4.1**	**-1.6**	**-12.7**	**-5.2**	**-5.8**	**-0.3**	**-11.3**
IV TOTAL EXPENDITURE, GFS (II+III)	**-1,214.8**	**-1,268.3**	**-1,359.8**	**-1,460.8**	**-1,622.8**	**-367.3**	**-406.5**	**-426.1**	**-446.6**	**-1,646.5**	**-400.8**	**-424.7**	**-422.0**	**-1,247.5**

Source: *QM*

Annex 2. Serbia: Consolidated General Government Fiscal Operations[1], 2008-2014 (real growth rates)

	2008	2009	2010	2011	2012	2013					2014			
						Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q1-Q3
I PUBLIC REVENUES	**3.3**	**-8.7**	**-1.5**	**-4.6**	**0.6**	**-5.8**	**-3.2**	**-2.7**	**0.1**	**-3.0**	**-0.8**	**4.5**	**3.8**	**2.6**
1. Current revenues	3.5	-9.1	-1.5	-4.4	0.1	-6.2	-2.9	-2.8	1.7	-2.6	-0.3	4.3	2.8	2.3
Tax revenue	3.7	-8.8	-2.5	-4.1	1.0	-4.2	-2.1	-3.4	2.9	-1.7	-1.0	6.4	3.8	3.2
Personal income taxes	6.3	-10.8	-3.9	-2.9	2.1	-4.9	-12.3	-18.9	-11.6	-12.2	-17.8	-13.5	0.8	-10.4
Corporate income taxes	18.5	-27.0	-3.6	3.9	35.1	-28.2	-7.9	39.6	44.9	2.9	-18.0	165.3	-9.5	29.9
VAT and retail sales tax	2.5	-10.2	-0.7	-4.0	0.0	-2.1	-0.6	-6.2	-5.2	-3.8	4.3	-3.6	5.4	1.9
Excises	0.7	11.6	4.2	0.6	-1.2	9.5	20.1	-10.9	8.2	5.1	-1.7	0.8	9.5	3.1
Custom duties	1.8	-32.4	-14.9	-21.5	-14.0	-15.3	-20.5	-16.9	-9.3	-15.6	-4.4	-7.0	-6.9	-6.2
Social contributions	4.3	-7.0	-6.5	-3.9	1.9	-3.0	-4.4	6.7	10.9	2.6	3.6	29.1	28.1	23.7
Other taxes	-2.3	-4.9	14.5	-15.2	-8.8	-14.2	-15.6	0.2	10.2	-5.2	12.1	8.2	0.8	4.1
Non-tax revenue	2.6	-11.3	5.8	-6.1	-6.2	-22.0	-9.4	2.1	-5.4	-8.7	6.0	-13.0	-5.0	-4.8
2. Capital revenues	-76.8	-41.4	-66.8	468.2	304.5	159.4	-63.6	-31.7	-91.3	-63.0	-79.6	17.6	-27.7	-52.5
II TOTAL EXPENDITURE	**4.5**	**-4.8**	**-1.7**	**3.3**	**4.3**	**-10.4**	**-6.6**	**1.5**	**-5.8**	**-5.5**	**5.8**	**2.2**	**-2.0**	**1.8**
1. Current expenditures	6.9	-3.3	-2.2	3.1	4.1	-7.2	-5.2	3.0	-1.0	-2.6	6.0	0.4	-1.2	1.5
Wages and salaries	10.9	-6.0	-5.9	0.4	2.0	-2.1	-5.7	0.0	-2.1	-2.6	-0.6	-2.0	-3.0	-1.9
Expenditure on goods and services		-5.7	-0.3	4.3	1.5	-13.4	-20.3	4.5	4.0	-6.6	-0.1	3.4	-1.6	0.5
Interest payment	-2.8	-5.7	-0.3	17.4	41.9	9.8	86.3	9.5	26.7	28.8	82.9	2.2	-3.4	20.9
Subsidies	-13.3	19.0	40.6	7.4	29.1	-24.7	-20.7	35.9	-29.5	-15.6	-0.8	6.0	-3.8	0.1
Social transfers	10.1	-26.0	13.9	5.8	-0.1	-6.4	-2.5	-1.2	1.7	-2.1	2.4	-2.2	-1.8	-0.6
o/w: pensions5)	*9.5*	*2.2*	*-3.9*	*3.9*	*4.4*	*-4.8*	*-4.1*	*-1.6*	*1.2*	*-2.3*	*1.5*	*0.0*	*0.2*	*0.6*
Other current expenditures	14.9	6.7	-6.1	23.9	9.9	-19.6	-29.5	12.4	10.6	-8.4	31.1	36.2	43.1	37.3
2. Capital expenditures	-4.3	-6.7	-11.8	5.3	6.0	-52.9	-29.0	-16.6	-46.7	-38.2	1.4	41.5	-12.8	7.0
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**12.3**	**-2.4**	**35.2**	**-25.6**	**-37.9**	**-41.7**	**-37.6**	**63.2**	**-58.5**	**-29.0**	**66.6**	**45.4**	**-93.1**	**0.2**
IV TOTAL EXPENDITURE, GFS (II+III)	**4.6**	**-4.8**	**-1.1**	**-3.8**	**3.6**	**-10.8**	**-7.0**	**1.8**	**-6.2**	**-5.7**	**6.3**	**2.6**	**-2.8**	**1.8**

Source: *QM*

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

	Q3 2014/Q3 2013			
	Consolidated budget	Budget of Republic	Health Fund	Local self-governments
A Total public revenues (I)+(II)+(III)+(IV)	**3.8**	**6.5**	**-9.1**	**-2.5**
I Current revenues (1)+(2)	2.8	4.7	-8.9	1.0
1. Tax revenues	3.8	4.8	-9.3	9.4
1.1. Customs	-6.9	-6.9	-	-
1.2. Personal income tax	0.9	5.7	-	-1.2
1.3. Corporate income tax	-9.5	-10.1	-	-
1.4. VAT	5.4	5.5	-	-
1.5. Excise duties	9.5	9.6	-	-
1.6. Property taxes	57.9	-	-	57.9
1.9.Other taxes	28.1	-7.6	-	-0.1
1.10. Social security contributions	0.87	-	-9.3	-
2. Non-tax revenues	-5.0	4.0	14.9	-22.7
II Capital revenues	(27.65)	-	-100.0	-27.6
III Transfers from the other levels of government	-	-	-9.7	-14.8
IV Donations	424.8	1,554.9	-	-35.4
B Total public expenditures (I)+(II)+(III)+(IV)	**-2.0**	**-7.7**	**-1.0**	**1.1**
I Current expenditures	-1.2	-6.0	-0.9	3.0
1.1 Wages	-3.0	-2.7	-3.9	-1.3
1.2. Goods and services	-1.6	-16.4	3.6	5.0
1.3 Interest payments	-3.4	-3.1	373.8	-9.1
1.4 Subsidies	-3.8	-8.1	0.0	-1.6
1.5 Social insurance and social assistance	-1.8	-14.7	16.5	12.4
1.6 Transfers to the other levels of government	0.0	-7.6	-	-
1.7 Other current expenditures	43.1	64.3	-0.9	8.3
II Capital expenditures	-12.8	-27.5	-71.7	-7.7
III Strategic reserves	0.0	209.9	-	-40.5
IV Net lending	-93.1	-94.8	-	-63.5

Source: *QM*

7. Monetary Trends and Policy

Monetary policy in Q3 remained unchanged which is a compromise between the extremely low monthly inflation rate and occasional deflation on the one hand and strong depreciation pressure on the other. The NBS lowered its key policy rate from 8.5% to 8% in mid-November when it was obvious that the drop in aggregate demand based on the rebalancing of the budget and trends in the prices of fuels and food meant that inflation in the coming period would remain at a similar level. In the same period, depreciation pressure caused an increased level of interventions on the inter-banking market and the NBS used 225 million Euro and an additional 140 million Euro in October. The weakening of the exchange rate caused a withdrawal of business banks from REPO bonds which continued to the end of October reaching a value of 600 million Euro. We suggest that in conditions of recession and occasional deflation, the NBS should have allowed a moderate depreciation of the Dinar until inflation draws closer to middle of the target corridor. Credit activities continued to drop with the real change at y.o.y. level stood at –5.8% while the money mass recorded a drop in real growth of 4.3% y.o.y. thanks to a monetization of foreign currency deposits which the state implemented in this period. The economy in Q3 raised its debts minimally with domestic business banks but there was a somewhat higher level of cross-border credits of 82 million Euro. On the side of sources for new placements, there was a significant increase of domestic deposits in the accounts of the economy and the population but those funds were used in the majority of cases for banks to repay foreign debts. The slight improvement was noted in terms of the participation of bad loans in the overall credit placements. In Q3 the segment of bad loans placed with companies recorded a drop of participation of 1.5 percentage points while a similar trend was noted in the nominal amount of those credits since the end of last year.

Central Bank: balance and monetary policy

Despite inflation trends over the target framework...

Despite the fact that y.o.y. inflation continued to move below the lower limit of the target corridor because of strong depreciation pressure, the NBS in Q3 was not prepared to relax its monetary policy. The lowering of the key policy rate came in mid-November when it became obvious that inflation would by the end of the year stand below the level of 2% except in the case of some greater external shocks. Deflation which was present in several months in the second half of the year reflects strong recession trends which justifies the easing of the restrictive nature of the monetary policy. Strong interventions on the foreign currency market which are aimed at preventing a depreciation of the Dinar give the impression that the NBS is occasionally giving preference to the stability of the exchange rate over target inflation and anti-recession policy. In November the NBS lowered its key policy rate from 8.5% to 8% which gave justification, although probably late, to its decision to ease its restrictive monetary policy. Along with the lowering of the key policy rate, the NBS also decided to change the mandatory reserves in order to lower depreciation pressure. The NBS lowered the mandatory foreign currency reserves in order to increase the offer of hard currency but raised part of the foreign currency reserves which are in Dinars to lower the quantity of Dinars and consequently the demand for foreign currency. Because of a drop in domestic demand and strong recession, we can expect that inflation will remain at its current level of 1.8–2% to the end of the year which leaves room for the NBS to further relax monetary policy. More room for relaxation of monetary policy is created with the launching of the program of fiscal consolidation which will significantly lower domestic demand.

... the NBS did not change its monetary policy in Q3 because of strong depreciation pressure

NBS strongly intervening on foreign currency market since mid-year but Dinar depreciates by about 5%

Trends on the inter-banking foreign currency market in Q3 were directed towards a weakening of the Dinar exchange rate which influenced the direction of the interventions by the NBS. Unlike Q2 when the NBS was a net buyer of foreign currency on the inter-banking foreign currency market, Q3 was dominated by depreciation pressure due to which the NBS intervened with 225 million Euro (Graph T7-2). Those interventions continued in October when the NBS sold an additional 140 million Euro to ease excessive daily exchange rate oscillations.

Table T7-1. Serbia: NBS interventions and foreign currency reserves 2012-2014

	2012				2013				2014		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
Repo stock (in milions of euros)	1,055.98	111.98	2.29	354.16	678.86	663.82	832.03	966.40	783.96	824.19	387.39
NBS interest rate	9.50	10.00	10.50	11.25	11.75	11.00	11.00	9.50	9.50	8.50	8.50
NBS interest rate	1.11	-2.77	-5.74	1.11	6.95	3.31	13.24	10.38	4.38	5.09	6.78
NBS interest rate	-18.43	-7.27	-6.50	-3.99	19.25	12.85	12.83	9.25	5.28	7.08	0.03
NBS interventions on FX market (in milions of euros)	-498.50	-1288.80	-1348.30	-1343.30	10.00	-215.00	-140.00	375.00	-800.00	-630.00	-855.00
INCREASE				cumulative, in % of initial M2[1]							
NBS own resreves[2]	-17.6	-45.4	-35.6	-6.0	12.5	7.1	17.9	43.2	-31.2	-4.9	2.0
NDA	2.4	61.3	65.8	41.3	-15.3	-3.9	-16.2	-31.3	12.2	-11.4	-7.6
Government, dinar deposits[3]	-5.1	6.1	4.3	-4.3	1.0	-1.2	-4.7	-19.9	3.3	-14.6	-24.3
Repo transactions[4]	2.2	53.7	59.3	40.2	-16.0	-14.7	-23.8	-30.7	9.2	6.5	28.9
Other items , net[5]	5.3	1.5	2.3	5.4	-0.3	12.0	12.4	19.3	-0.3	-3.4	-12.2
H	-15.2	15.9	30.2	35.3	-2.8	3.3	1.7	12.0	-19.0	-16.3	-5.6
o/w: currency in circulation	-3.3	-4.0	-1.4	-1.6	-3.9	-0.7	1.0	5.4	-5.2	-3.5	0.5
o/w: excess liquidity	-13.6	-1.6	-1.1	5.4	0.6	2.1	-1.4	4.4	-12.1	-11.6	-7.3
				in millions of euros, cumulative from the beginning of the year							
NBS, net	-1070.60	-2087.45	-2383.97	-1050.95	30.01	-992.01	-1041.50	943.97	-608.63	-725.22	169.79
Gross foreign reserves	-1138.11	-2090.09	-2536.57	-1324.15	-385.77	-1576.91	-1822.60	240.33	-793.11	-1090.74	-276.23
Foreign liabilities	67.51	2.64	152.60	273.20	415.78	584.90	781.10	703.63	184.49	365.52	446.02
IMF	58.24	-6.44	138.99	258.95	401.14	568.40	759.83	695.60	182.35	364.90	446.72
Other liabilities	9.27	9.07	13.61	14.25	14.65	16.50	21.27	8.03	2.14	0.61	-0.70
NBS, NET RESERVES-STRUCTURE											
1. NBS, net	-1070.60	-2087.45	-2389.97	-1050.95	30.01	-992.01	-1041.50	943.97	-608.63	-725.22	169.79
1.1 Commercial banks deposits	459.45	740.45	1030.19	907.59	911.80	967.01	1058.25	240.42	-125.77	91.72	28.90
1.2 Government deposits	263.40	488.43	683.75	28.63	-811.79	47.05	209.55	-359.83	144.17	541.44	-162.64
1.3 **NBS own reserves**	-347.74	-858.58	-670.03	-114.73	130.02	22.06	226.30	824.56	-590.22	-92.05	36.05
(1.3 = 1 - 1.1 - 1.2)											

Source: NBS.
1) "Initial M2" designates the state of primary money at the start of the current year, ie the end of the previous.
2) The definition of net own reserves NBS is given in section 8 „Monetary Trends and Policy", frame 4, QM no. 5.
3) State includes all levels of government: republic and local.
4) This category includes Treasury Bonds NBS (BZ), and repo operations.
5) Other domestic net assets include: domestic loans (net debts of banks, not including BZ and repo transactions; net debts of economy) together with other assets (capital and reserves; and items in the balance, all other assets) and corrected by changes in the exchange rate.

Graph T7-2. Serbia: NBS interventions on inter-banking foreign currency market 2010-2014
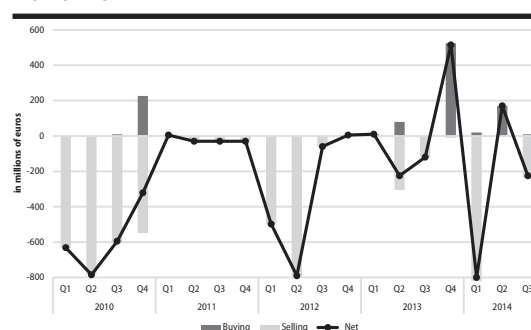
Source: NBS

In mid-October, the NBS Executive Board adopted changes to the rate of mandatory foreign currency reserves and the mandatory part of the foreign currency reserves that are earmarked in Dinars. The lowering of the foreign currency reserves by one percentage point each in both categories of due date on one side should increase the credit potentials of the banking sector but it seems that the primary reason behind this measure is lowering depreciation pressure because of the increase in the amount of free foreign currency with business banks. That view gets added confirmation from the increase in the mandatory part of the foreign currency reserves which are set aside in Dinars from 32% to 34% and from 24% to 26% depending on the due date. Although the overall amount of mandatory foreign currency reserves was lowered, the increase in the mandatory Dinar part of the mandatory foreign currency reserve is relatively higher and now less Euro but more Dinars are earmarked for the same deposit by business banks. In that way, the NBS is trying by increasing the foreign currency and lowering Dinar liquidity to influence the Dinar and Euro exchange rates. Despite the sale of foreign currency on the inter-banking foreign currency market, Q3 saw the NBS own reserves grow by 128 million Euro (in Q2 the new own reserves were increased by 498 million Euro). Although the sale of foreign currency on the inter-banking foreign currency market meant that primary money was withdrawn, it was increased in Q3 by 10.69% compared to the value at the start of the year (in Q2 there was a rise in primary money of 2.72%, Table T7-1). The growth of primary money was achieved on the basis of the growth of domestic net assets of 3.58% of the value at the start of the year (in Q2 there was a drop in net domestic assets of 23.64% of the value at the start of the year). The increase in net domestic assets in Q4 is the consequence primarily of a lowering of REPO

placements by 437 million Euro or 22.34% of the value at the start of the year while the rise in net domestic assets was caused by the positive effect of increased state spending in the period.

In conditions of recession and frequent deflation ...

Because of the high Euro-isation the Dinar exchange rate is one of the key determining factors of inflation in Serbia. Besides the exchange rate, determining factors of inflation include earnings and domestic demand[1]. Of all the determining factors on inflation, the NBS has the greatest influence on exchange rate trends. The influence of the NBS on the credit activities of banks, and on domestic demand, is very modest because of the high level of Euro-isation. In conditions of a drop in domestic demand and lower earnings within the fiscal consolidation, the depreciation of the exchange rate is the key lever to bring inflation back into the target framework. Besides, the depreciation of the Dinar has a favorable effect on exports and foreign direct investments (once--off working expenses in Euro are dropping), which represent basic potential movers of economic growth in the next years (see section on economic activity). All that leads us to believe that the NBS should conduct a policy of moderate intervention on the foreign currency market until the depreciation of the Dinar raises inflation to the middle of the target interval. When creating exchange rate policy it is necessary to bear in mind that in conditions of relatively deep recession and a drop in domestic demand the effect of the deprecation of the Dinar on inflation is reduced. It is necessary to bear in mind the time frame between depreciation and inflation when creating policy so that the effect of depreciation on inflation is not underestimated.

... a moderate depreciation of the Dinar is desirable

Monetary System: structure and money mass trends

Growth of money mass M2 compared to start of year ...

The money mass M2[2] at y.o.y. level rose in Q3 viewed nominally. That growth of 6.6%, including credits to the non-state sector, continue to drop by –1.2% y.o.y. and now stand at –3.7% following exchange rate corrections (in Q2 credits to the non-state sector recorded a drop of –5.4% y.o.y. following a correction of the exchange rate, Table T7-4). After including inflation over the past period, the real growth of the M2 is 4.3% y.o.y. with the drop in credit to the economy and population raised additionally to –5.8% y.o.y. following exchange rate changes. If we view the trends in the money mass compared to the value at the start of the year, an increase of 4.5% was achieved in Q3 (in Q2 a growth of 2.9% was recorded of the value of the M2 at the start of the year, Table T7-4). The registered growth of M2 at quarterly level is due solely to the extremely high growth of net foreign assets (NSA) which registered a growth of 11.6% compared to the situation at the start of the year. At the same time, the net domestic assets (NDA) were reduced by 7.2% of the initial value of M2 which prevented a higher growth of primary money in Q3.

Graph T7-3. Serbia: money mass trends as percentage of GDP, 2005-2014
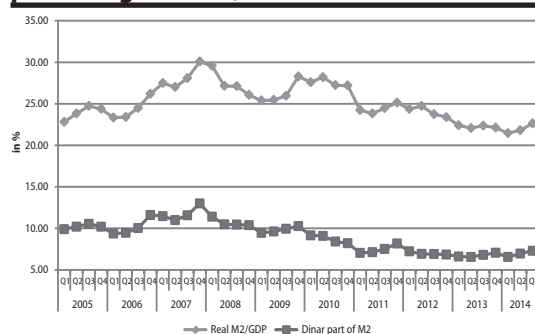
Source: Calculation *QM*

... was achieved thanks to growth of net foreign assets (NSA) of 11,6%

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1 There is a large number of econometric research which showed that the exchange rate and earnings were the main determining factors of inflation in Serbia.
2 Monetary aggregate M2 in the section Monetary Trends and Policy cover the more narrow aggregate M1, savings and timed deposits as well as foreign currency deposits in business banks. Because of that the aggregate M2 which we observe is equal to the monetary aggregate M3 in NBS reports.

Table T7-4. Serbia: growth of money and contributing aggregates, 2012–2014

	2012				2013				2014		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
							y-o-y, in %				
M2[1]	14.0	18.1	13.8	9.6	8.2	4.5	6.1	4.6	4.2	4.8	6.6
Credit to the non-government sector[2]	14.4	14.0	16.6	9.8	1.9	-0.5	-4.4	-4.5	-6.1	-4.5	-1.2
Credit to the non-government sector[2], adjusted[3]	8.6	4.6	7	3.8	1.6	0.6	-4.1	-5.0	-8.2	-5.4	-3.7
Households	5.7	3.3	3	2.5	3.0	2.9	2.9	2.6	2.0	2.5	3.0
Enterprises	10.1	5.3	9.1	4.4	0.9	-0.6	-7.6	-8.8	-13.4	-9.7	-7.3
							real y-o-y, in %				
M2[1]	10.1	12.0	3.4	-2.2	-2.6	-5	1.2	2.3	1.9	3.5	4.3
Credit to the non-government sector[2]	10.5	8.1	5.9	-2.0	-8.2	-9.2	-8.9	-6.5	-8.3	-5.7	-3.3
Credit to the non-government sector[2], adjusted[3]	4.9	-1.2	-3.6	-8.1	-8.7	-8.2	-8.5	-7.0	-10.3	-6.7	-5.8
Households	2.0	-2.4	-7.2	-9.2	-7.5	-6.1	-1.9	0.4	-0.3	1.2	0.7
Enterprises	6.3	-0.5	-1.7	-7.5	-9.3	-9.3	-11.8	-10.7	-15.4	-10.8	-9.3
						in bilions of dinars, end of period					
M2[1]	1,499.7	1,588.6	1,607.6	1,641.7	1622.7	1659.8	1705.8	1719.3	1691.4	1740.2	1818.4
M2[1] dinars	445.0	444.6	467.4	480.6	478.8	492.5	519.5	547.6	516.4	555.3	587.1
Fx deposits (enterprise and housholds)	1,054.7	1,144.0	1,140.2	1,161.1	1143.8	1167.3	1186.3	1169.3	1175.0	1185.0	1231.3
						cumulative, in % of opening M2[4]					
M2[1]	0.1	6.1	7.3	9.6	-1.2	1.1	3.9	4.6	-1.5	1.4	5.9
NFA, dinar increase	-5.6	-4.5	-7.9	0.2	7.2	2.7	5.2	10.6	0.2	-0.1	11.7
NDA	5.7	10.5	15.2	9.4	-8.4	-1.6	-1.3	-6.0	-1.6	1.4	-5.8

Source: NBS
1) Money mass components – see Analytical and Notation Conventions QM.
2) Credits to non-state sector – credits to economy (not including local government) and households.
3) Trends are corrected by exchange rate changes. Corrections are conducted under assumption that 70% of credit to non-state sector (and households and the economy) indexed against the Euro.
4) Initial M2 designates the state of the M2 at the start of current, ie end of previous year.

Credit to non-state sector in Q3 continue to drop –5.3% y.o.y.

Graph T7-5. State of money mass in permanent prices, 2005–2014
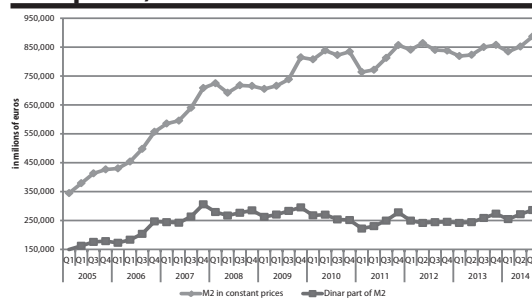
Source: *QM* calculation

While observing the structure of the nominal growth of M2 we noted that the negative effect of savings and timed deposits in Q3 was stopped. In the overall growth of M2 of 6.6% y.o.y., savings and timed deposits accounted for 0.6 percentage points which is a positive change following more than six quarters in which those deposits had a negative effect on the growth of M2. The narrowest observed aggregate M1 once again recorded the highest individual contribution to growth of 3.4 percentage points while the rise in foreign currency deposits explains the remaining 2.6 percentage points of M2 growth. The recorded contribution of foreign currency deposits is somewhat higher compared to the previous quarters (in Q2 the foreign currency deposits participated with 1.06 percentage points in the growth of M2 while in Q1 it contributed with 1.92 percentage points).

Banking Sector: placement and sources of financing

Credit activity by domestic banks is stagnating …

… while a slight rise is expected in cross-border credits

Following a growth in placement in the previous quarter, business banks recorded lower placements by 85 million Euro in Q3. The drop in placements is the consequence of the withdrawal of banks from REPO bonds which dropped by 423 million Euro in Q3, a drop continuing into October with another 175 million Euro. The overall drop in placements was eased through an increase in crediting of the state in this period and a slight recovery of credit activity within the non-state sector. In Q3, the placement of credit to the economy and population grew by 82 million Euro with 66 million of that placed to the population while the economy increased its debts by 16 million Euro (Table T7-6). The growth of placements to the economy was launched during Q2 thanks to the new program of subsidized loans intended to maintain liquidity and finance permanent turnover funds. In Q3 the growth of placements in this segment slowed down compared to the previous quarter because of somewhat stricter standards which business banks started implementing when approving loans to the economy. The economy managed to draw part of the necessary funds from foreign sources which is shown by the inflow of cross-border loans totaling 68 million Euro in Q3 (in Q2 the economy repaid 82 million Euro of its foreign debt while in Q1 a rise in cross-border loans of 58 million Euro was recorded Graph T7-7).

Low credit activity will represent a serious limitation to the economy in the next year

In the next year, economic activity is expected to drop by about 0.5% despite the significant recovery of activities affected by the floods (see section on economic activities). The increase in credit activities by banks could ease the recession but the chances of that happening in the next year are slim. One thing making the situation more difficult is the fact that the government and NBS do not have any significant instruments within monetary and fiscal policy to stimulate credit activity. It is necessary for state activities to be directed to ordering the economic environment which would reduce credit risks. Some of the more important activities in that direction include a more efficient elimination of insolvent companies from the market, increased transparency of business operations, sanctioning the founders of fraudulent companies, introducing added stimulation to resolve problems of bad credit and other things. Because of the lack of banking credits to micro and small companies and entrepreneurs, we believe that it is necessary to once again create legal possibilities to form non-banking credit institutions.

Table T7-6. Sebia: bank operations – sources and structure of placements, corrected[1] trends, 2012-2014

	2012				2013				2014		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
	in millions of euros, cumulative from the beginning of the year										
Funding(-, increase in liabilities)	672	692	472	-384	109	341	213	420	578	540	504
Domestic deposits	589	146	15	-459	4	-56	-325	-394	240	-32	-382
Households deposits	-49	-189	-296	-578	-87	-132	-252	-423	45	-105	-149
dinar deposits	30	69	36	11	16	-34	-110	-279	27	-51	-75
fx deposits	-79	-258	-332	-589	-102	-98	-141	-144	17	-54	-74
Enterprise deposits	638	336	311	120	91	76	-73	29	195	72	-233
dinar deposits	362	304	230	99	-11	-11	-109	-162	210	45	-159
fx deposits	275	31	81	21	102	87	36	191	-15	27	-75
Foreign liabilities	3	345	335	127	357	406	588	806	358	396	610
Capital and reserves	80	200	123	-52	-252	-9	-50	8	-20	176	276
Gross foreign reserves(-,decline in assets)	-199	371	164	284	-278	-104	84	-304	193	215	673
Credits and Investment[1]	409	-424	201	521	123	-169	-67	42	-343	66	-19
Credit to the non-government sector, total	309	136	784	589	-23	-348	-551	-875	-577	-382	-300
Enterprises	375	161	741	552	-71	-463	-728	-1,018	-570	-488	-471
Households	-36	-25	42	37	48	115	177	143	-7	105	171
Placements with NBS (Repo transactions and treasury bills)	-28	-944	-1,052	-701	321	319	492	628	-176	-133	-556
Government, net[2]	128	385	470	632	-175	-140	-8	290	411	581	837
MEMORANDUM ITEMS											
Required reserves and deposits	-552	-418	-451	-265	-17	-87	-443	-134	-2	-215	-223
Other net claims on NBS[3]	-199	-20	-42	58	-154	-85	118	44	-136	-135	-4
o/w: Excess reserves	-187	45	54	10	-151	-96	60	38	-156	-162	-9
Other items[4]	150	222	56	146	100	50	54	-22	-289	-454	-822
Effective required reserves (in %)[5]	22	23	23	23	25	24	22	23	23	22	22

Source: NBS

1) Calculating the growth is done under the assumption that 70% of the overall placements indexed against the Euro. Growth for original Dinar deposits are calculated by the average exchange rate for the period. For foreign currency deposits – as the difference calculated by the exchange rate at the ends of period. Capital and reserves calculated based on the Euro exchange rate at the ends of the period and do not include the effects of changes in the exchange rate from the calculation of the remainder of the balance.
2) NBS bonds include state bonds and treasury bonds NBS which are sold at repo rate and at rates set on the market for permanent auction sale with a due date greater than 14 days.
3) Net crediting of the state: loans are approved to the state lowered by the state deposit in business banks: a negative designation marks the higher growth of deposits over loans. The state includes all levels of government: republic to local government.
4) Other NBS debts (net): the difference between NBS debts to banks on the basis of cash and free reserves and dues to the NBS.
5) Items in bank balances: other assets, deposits by companies in receivership, inter-banking relations (net) and other assets not including capital and reserves.
6) Effective mandatory reserve represents the participation of mandatory reserves and deposits in the sum total of overall deposits (population and economy) and bank debts abroad. The basis to calculate mandatory reserves does not include subordinate debts because that was not available.

Graph T7-7. Serbia: growth of new loans to economy and population, 2005-2014
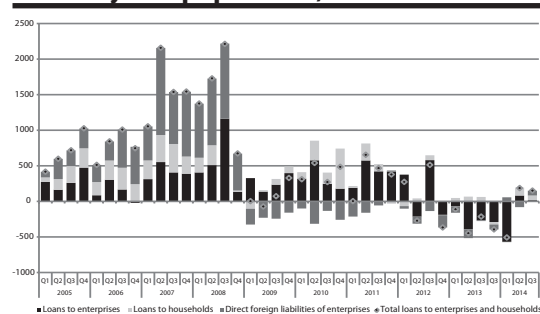
Source: *QM* calculation
See footnote 1 in Table T7-5.

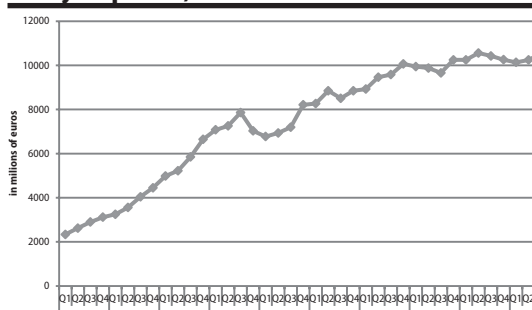**Graph T7-8. Serbia: overall credit debts in % of GDP, 2007-2014**
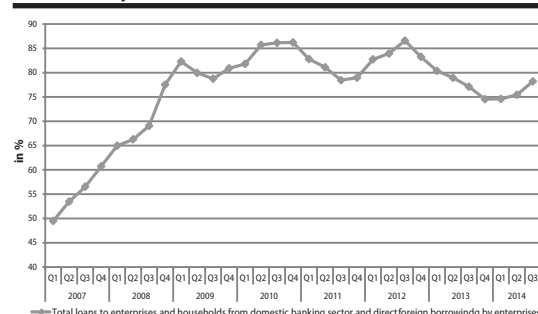
Source: *QM* calculation

Significant rise in domestic deposits …

Graph T7-9. Serbia: level of foreign currency deposits, 2005-2014

Source: NBS

… used by banks to repay foreign debts instead of for loans

Business banks recorded a slight rise in sources for new placements which in Q3 stood at 36 million Euro, similar to the increase in the previous quarter (in Q1 sources for new placements were increased by 38 million Euro, Table T7-6). As one of the elements on the side of the rise in sources, we have domestic deposits which recorded a significant rise of 350 million Euro. The growth of domestic deposits is mainly the consequence of increases in the accounts for deposits by the economy of 305 million Euro while the population increased its deposits by 44 million Euro in Q3. Of the overall increase of deposits by the economy and population, 228 million Euro are Dinar deposits while 122 million Euro were deposited in other currencies. Since the rise in domestic deposits was not accompanied by a significant rise in credit placement to the economy and population, business banks used their surplus liquidity in this period to repay loans taken abroad to the value of 214 million Euro. Counting from 2012 onwards, business banks lowered their foreign debts by 1.42 billion Euro which shows that there is no quality demand for credit arrangements on the Serbian capital market. Besides paying the foreign debts, business banks also lowered the amount of funds on capital and reserve accounts by 100 million Euro in Q3 which had an added negative effect on the overall growth of sources for new placements.

Table T7-10. Serbia: participation of bad loans according to type of debtor, 2011-2014

	2009	2010	2011	2012				2013				2014		
	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
							balance at the end of period							
Corporate	12.14	14.02	17.07	17.72	19.26	19.04	19.06	22.62	27.77	31.13	27.76	28.67	28.12	26.76
Entrepreneurs	11.21	15.8	17.07	16.05	18.47	17.56	15.92	16.79	18.19	20.86	20.82	21.11	29.77	43.61
Individuals	6.69	6.71	7.24	7.57	7.69	8.05	8.32	8.44	8.37	8.14	8.59	8.7	9.22	11.41
Ammount of dept by NPL (in bilions of euros)	1.58	1.94	2.63	2.67	2.71	2.97	3.19	3.87	4.47	4.82	4.09	4.05	4.07	3.81

Source: *QM* calculation

The growth of bad loans was stopped in Q3…

After almost constant growth over the past four years, the participation of bad loans in the overall placement dropped slightly in Q3 to 22.02% (in Q2 the participation of bad loans stood at 22.51% Table T7-10). The biggest positive change was achieved in the segment of bad loans placed with companies which dropped by 1.36 percentage points compared to the previous quarter which dragged down the percentage of overall bad loans because of the relatively highest participation. The negative trend of speedier growth of bad loans with entrepreneurs continued and in Q3 their participation was increased by 13.84 percentage points while a similar trend was noted with bad loans in the segment of private individuals which increased their participation by 2.19

… thanks to the lesser participation in the company sector

Graph T7-11. Serbia: amount of loan falling late, 2012-2014
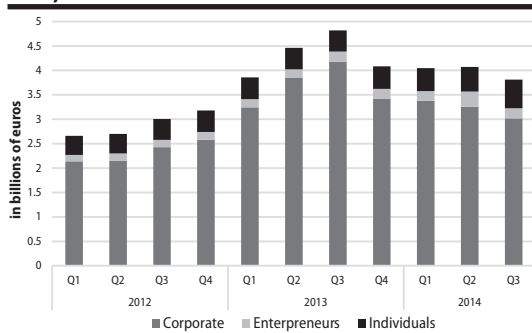
Source: *QM* calculation

Graph T7-12. Serbia: participation of bad loans in overall placement, 2008-2014
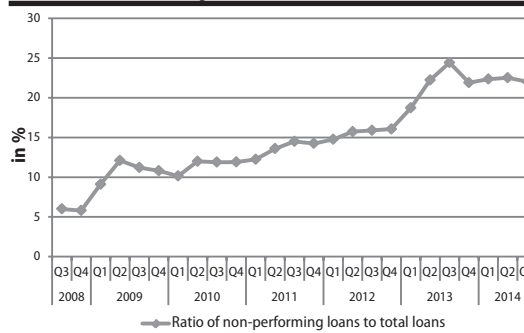
Source: *QM* calculation

percentage points. By viewing the nominal amount of the remainder of the credit debts which were late by the end of 2013, we see a stabilization of the negative trend of increasing the overall amount of debts based on bad loans (Graph T7-11). The stabilization and consequent drop was caused by the fact that the NBS changed certain regulations and allowed the purchase of bad debts by companies and persons outside the financial sector. Along with the reduction of overall amount of bad loans to companies, the individuals sector is seeing a speedier rise in the participation of bad loans in both nominal value and the relative participation in the overall amount of loans placed. Bad loans to private individuals and entrepreneurs, account for about 20% of all bad loans which means that the growth is cause for concern in terms of the stability of the banking sector. The change shows a drop in income at household level and the small company sector which will reflect on the remainder of the economy through the drop in aggregate demand.

8. International Environment

Global growth has slowed down in most of the largest economies with the exception of the United States where recovery is continuing. That is why there has been a divergence in monetary policy where the central banks of China, the Eurozone and Japan have strengthened their expansive monetary policies while the US FED has finished its quantitative easing and will probably raise its key policy rate next summer. The G20 has announced investments in structural reforms which should raise the GDP of those countries from 2.1% by 2018 while the European commission announced a five year investment plan. Inflation is dropping because of a drop in oil prices. In eastern Europe, growth was somewhat higher than expected and low inflation provides room to lower key policy rates while the costs of debts are mainly falling as the consequence of the new measures introduced by the European Central Bank (ECB).

The World

The International Monetary Fund (IMF) has once again lowered its prediction for the world--wide growth rate for 2014 but minimally from 3.4% to 3.3%. The prediction for next year has been lowered from 4% to 3.8%. The reason for the lowered prediction for this year is the slowing down in the Eurozone: Germany (from 1.9% to 1.4%), Italy which is in recession (from 0.3% to −0.2%) and France while the prediction for Spain was slightly raised. The difference between the countries on the outskirts of the Eurozone and the central countries is narrowing. Besides the Eurozone, Japan is also slowing down (from 1.6% to 0.9%) as is Brasil while Russia has entered a recession. The drops would be even greater if the prediction for the United States had not been raised (from 1.7% to 2.2%) and India (by 0.2 percentage points). For China there were no changes in prediction this time although the latest data indicate that growth is also slowing down in China. The growth rate dropped in developing countries as well from 4.5% to 4.4% this year and from 5.2% to 5% for next year. It is important to bear in mind that the IMF report early in October also did not include the latest slowdown in the Eurozone and the very bad results recorded by Japan in Q3.

The two biggest economies of the Far East are slowing down and are continuing their expansive monetary policy because of that. The growth of the Chinese GDP in Q3 stood at 7.3% which is the lowest results in the past five years. The central bank is trying to slow down the excessive growth of the construction industry and direct additional credit to sectors which will stimulate personal spending and employment. Also, in order to stimulate the economy which is slowing down, the key policy rate was lowered from 6% to 5.6%. Unexpectedly, Japan recorded the second negative quarter in a row in Q3 and technically it is in recession. Because of the slowing down of growth and the risk of a drop in inflation, the Central Bank of Japan announced a new wave of quantitative easing with an additional 720 million Dollars and the state pension fund announced more purchases of company stocks.

Besides the mentioned monetary measures, the G20 summit also announced structural reforms and investments in infrastructure. The member state accepted the obligation of increasing the growth of the GDP by an additional 2.1% by 2018 and submitted a list of 800 new measures which they intend to implement. They also drafted an agreement on lowering gas emmissions which cause the greenhouse effect. However, there were agreements on structural reforms earlier and even though the member states seem to be more serious about their implementation this time, economists are skeptical about the realization of those measures.

Structural reforms and fresh investments continued in the European Union. European Commission President Jean Claude Juncker announced a five year investment plan worth 315 billion Euro whose mainstay is a fund for infrastructure projects financed by governments while the remaining funds should be invested by commercial banks with the help of the European Invest-

ment Bank. That plan should secure 1.3 million new jobs. As with the G20 agreement, we do not know how successful the plan will turn out to be primarily because it is uncertain whether the banks will support the projects that the European Commission views as priorities.

The Eurozone

The new European Commission started working on November 1 this year. Its main economic priorities are increasing growth and investments (mainly in the production of energy, transport infrastructure, investments in education, research and investments which will help young people find jobs). The idea is to improve the situation on the labor market without any significant added expenses. For example, the unification of the digital market will stimulate growth of employment and offer new business opportunities and the new trade agreement with the United States will open new markets. The announced investments will have a small share of state funding in order to prevent a growth of public debts. There are also plans to decrease the energy dependency on natural gas (because of the crisis with Russia) and set up an Energy Union which will buy natural gas for all European Union countries, dispose of reserves and use a common network. The EU should become the world leader in renewable sources of energy under that plan.

The growth of GDP in Q3 in the Eurozone stood at 0.2% compared to the previous quarter, that is at 0.8% at annual level. In Germany that growth was low standing at just 0.1% compared to the previous quarter while Italy recorded negative growth of −0.1%, the second quarter in a row that this country has technically been in recession. Unlike the situation earlier, the difference between the peripheral and central countries of the Eurozone narrowed and in Q3 compared to previous quarters Greece recorded a growth of 0.7% and Spain of 0.5%. The slowdown in Italy and Germany had a negative effect on Serbia's exports and on the inflow of direct investments. Polls indicate a stagnation or slight drop in industrial production in Q4 which means a speedy recovery is not expected in the Eurozone.

Overall inflation, although below the targetted 2% continues to drop in the Eurozone and it stood at 0.3% in November compared to 0.9% in the same month of 2013. Base inflation also dropped and stood at 0.9% in August and 0.7% in November. Since demand was low, base inflation will not recover significantly in the next quarters. The overall drop in inflation was influenced by the drop in oil prices of 30% in the past few months and if that trend continues, the low level of inflation of 0.3% could become negative. Also, even if there is no further drop in oil prices, the danger lies in the fact that inflationary expectations have been dropping for some time, in both the short and medium term. Inflationary expectations could affect real inflation and launch a so-called self-generating spiral. Due to the low inflationary expectations and danger of a further drop in oil prices leading to deflation, the European Central Bank will have to use the instruments it has available to prevent the negative effects of possible deflation in the period of slow growth.

Due to the danger of deflation the European Central Bank in September lowered the key policy rate from 0.15% to 0.05%. Since political resistance meant that it could not expand its program of purchasing bonds, it implemented the heterodox mechanism which all the large central banks avoided – the rate on deposits was lowered to below zero. Now that all instruments have been activated and the risk of deflation is rising, political resistance has dropped and the European Central Bank will enter into some form of quantitative easing. Most probably it will purchase different types of bonds to the value of about 1,000 billion Euro. Unfortunately, the effects of the quantitative easing will be far less than those in the United States because the decision was delayed, the European banking system operates differently and the European Central Bank cannot be an adequate replacement for the lack of a consensus on fiscal policy within the EU. The program will most probably include a significant purchase of state bonds, including those of the peripheral countries, and there is a risk of politicians in those countries loosing their motivation to adhere to their own consolidation programs. The European Central Bank's announced quantitative easing will increase the demand for Eurozone member state bonds which will lower

the costs of those countries' debts. Investors will be interested in bonds with higher yields and Serbia will benefit since the demand for its bonds will be higher. The escalation of the war in the Ukraine and accompanying new EU sanctions imposed on Russia could have a negative effect on the demand for Serbia's bonds since investors will purchase the safest Eurozone bonds because of the increasing geo-political risks.

The risk of deflation, high public debt of many states, low economic growth and bad demography has led some economists to believe that the Eurozone is similar to Japan and that it now faces a "lost decade" as well. Structural reforms and new regulations for the banking sector are needed to avoid that scenario.

The unemployment rate in the Eurozone has not changed since June and in September it continued to stand at 11.5%. Over the past year, the biggest drop in the unemployment rates was recorded in Hungary where it dropped from 10% to 7.6% and in Spain from 26.1% to 24% as well as Portugal from 15.7% to 13.6%. Youth unemployment stood at 23.3% in September and was highest in Spain (53.7%) and Greece (50.7%). In Italy unemployment rose from 12.9% in September to 13.2% in October which is the highest rise since 1977.

The United States

The growth of the GDP in Q3 was above expectations (3.5%) primarily due to the growth of public spending and exports. However, the question is whether that growth can continue at this pace in the same manner because the rest of the world economy is slowing down which will decrease exports and fiscal policy will be in a position to support that growth to any significant degree only in 2016. A cause for concern lies in the fact that domestic demand has slowed down, especially private investments. This indicates that the private sector is not fully confident of the recovery.

In October the FED ended its biggest program of purchasing bonds in its history, known as quantitative easing. The placement of the central bank increased because of that by 3,500 billion Dollars (the size of the German economy). Practically, the program was not fully completed because the FED will reinvest in new bonds on the basis of income from old bonds that have fallen due. Economists still do not agree on whether the program was ended too soon or too late or even whether it should have been launched at all. The influence of this program was huge on developing countries because global liquidity was increased significantly and last year when its end was announced many of the currencies in those countries were devalued. This time when the program finally did end, the effects were minimal but the next risky stage will be raising the key policy rate. The key policy rate was left at its old level at a meeting in October and its increase is expected in June next year. However, if China and the Eurozone continue to slow down, this decision could be postponed so that it would not have a negative effect on global growth.

Consumer prices have been stagnating for three months at the level of 1.7% which is a slight drop compared to the summer when the average was about 2%. It is important to bear in mind that although inflation is stagnating, that is happening despite the drop in oil prices and inflationary pressure has appeared which some economists are citing as confirmation that the key policy rate needs to be raised in June 2015. Base inflation rose slightly in October (1.8%) compared to the previous two months (1.7%) but it is still lower than the level of last summer. If base and overall inflation rise over the next few months, the FED will have to raise the key policy rate according to expectations.

For nine months in a row, employers have been taking on more than 200,000 new employees which is a significant improvement compared to the previous year. The unemployment rate dropped from 6.7% in March to 5.8% in October but the workforce participation rate has been stagnating for some time and the rise of real salaries has not exceeded 2%. The low growth of salaries is caused primarily by the low productivity growth. That is why the impression of an increase in employment does not paint the complete picture of the state of the American economy. About

70% of new jobs created in October are temporary jobs in health care and the restaurant and hotel business while industry and processing are not recording higher employment because of slow productivity growth.

Eastern Europe

Hungary

The annual growth of the GDP slowed down from 4% in Q2 to 3.2% in Q3 and the quarterly from 0.8% to 0.5%. That growth was achieved thanks mainly to industrial production which increased its exports and agriculture thanks to favorable weather conditions. Next year a growth of some 2% is expected because of a slowing down of investments but that growth could be higher if personal spending recovers because of an increase in available income. In October, annual inflation continued to be negative (-0,4%) but it could draw closer to the target (3%) next year due to an increase in tax rates, the end of the effects of base because of an administrative lowering of fuel prices and relatively high economic growth compared to other EU member states. The Hungarian currency, the Forint, strengthened thanks to expectations of a monetary stimulation in the Eurozone and a surplus of the Hungarian trade balance.

Despite the depreciation of the Forint the central bank did not lower its key policy rate (2.1%) and it will probably remain unchanged to the end of 2015. A more active approach to the exchange rate policy is expected next year when interventions on the foreign currency market would stop appreciation and fill the foreign currency reserves which are at lower levels than they were earlier. Also, the interventions would secure a profit and they are a better solution than the lowering of the key policy rate. Interest on 10 year state bonds brought a yield of just 3.6% which is the historic minimum.

Prime Minister Orban's government, following the victory at parliamentary and local elections, has huge support and can continue the heterodox economic policy. The government introduced several taxes as of the start of 2015. The public debt will be lowered in the next few years from 50% to 45% and the budget deficit will be cut down to below 3% by 2016. Also, the population will be allowed to convert housing loans in foreign currency into the domestic currency to eliminate currency risks.

Hungary is under pressure from the West because it is refusing to abandon its economic plans with Russia. The plans include the construction of a nuclear power plant in cooperation with a Russian company and the Hungarian government is planning to sell MOL shares in Croatia's INA oil company to a Russian company. Hungary was subjected to criticism from the European Commission because of that and 10 of Prime Minister Orban's associates have been placed on a US sanctions list. The Hungarian government will bow down under pressure to some extent since new elections are not coming for another 3 years.

Romania

Romania's GDP grew 3.2% at annual level in Q3 which is faster compared to Q2 when it stood at 1.2%. The growth was higher than expected because the level of investments dropped less than predicted while the growth of personal spending is higher than expected. Current demand is reflected only in personal spending while investments, both public and private, are very low. The European Commission predicted growth this year of 2.3% and if 2.5% in the next year.

Inflation at annual level in October stood at 1.4% while base inflation stood at around 1% which indicates a drop in demand. Because of the low inflation which now stands below the target, the central bank lowered its key policy rate from 3% to 2.75% in November. Another reduction to 2.5% is expected early next year. Also, the level of mandatory reserves in foreign currency was lowered from 16% to 14% to free up funds for bank loans. A lowering of the mandatory reserve to bring them closer to the European Central Bank level.

Presidential election favorite Ponta was unexpectedly defeated by Johanis, a candidate of the center right. A reshuffle of the government is possible if they disagree over the budget for next year. Measures need to be adopted to neutralize the growth of public spending prior to next year's budget. Measures need to be imposed to neutralize the growth of public spending prior to the elections, The IMF and European Comission.

Croatia

Croatia recorded a GDP drop of −0.5% at annual level. Personal spending and investments continuo to be low but services and net exports primarily due to the drop in imports. The recession will probably continue in Croatia into next year when the GDP will drop by −0.5%. The shortage of private investments is compensated insufficiently by EU funds and exports will be under pressure from the slowdown in the Eurozone.

The Croatian government has put forward a budget for 2015, with a deficit of 3.8% GDP (this year's plans 5%). Despite expectations, there were no small expenses for salary costs and the Croatian government probably will not be in a position to maintain the deficit at planned level. That led to the attitude towards the GDP and will start from 90% %. Because of the lack of structural reform and measures to improve the business climate, we are expecting a growth of the cost of debts.

Croatia is preparing for presidential elections late this December and they are not all that important in regard to setting policy but they will influence the balance of power among the main parties at next year's elections.

After nine months of deflation, inflation was achieved in October standing at annual level at 0.4% but the increase of 70% was caused by a rise in electricity prices which last year recorded a drop following a liberalization of the market. The unemployment rate rose from 1 percentage point to 18.7% in October because the positive effects of the previous season is dropping.

SPOTLIGHT ON:

Economic Policy in Serbia - Retrospective, Reforms and Medium Term Perspective

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In mid 2014, Serbian economy officially entered recession again, since it recorded a decline in real terms for two consecutive quarters, which deteriorated even further in the third quarter. Therefore, it is estimated that the decline of GDP in real terms in 2014 will be around -2% (while initially a 1% increase had been planned). The recession that Serbia entered in 2014 is the third one since the beginning of the global economic crisis in 2008, so Serbia's GDP in 2014 will be lower in real terms by 1.5% compared to the period before the crisis (2008), while the GDP in EU countries in the same period, regardless of two phases of recession, had cumulatively grown by 0.7% in real terms. The first two recession cycles in Serbia (in 2008 and 2011) were considerably related to unfavourable economic trends in Europe and beyond, since the European Union countries, where most of Serbia's exports are going, also recorded negative economic growth rates in 2008 and 2011. However, after this period, there was a gradual recovery in EU countries, so in 2014 an economic growth rate of 1.6% in real terms is expected, which indicates that the third wave of recession in Serbia is caused primarily by internal factors. Unlike the pre-crisis model of economic growth, which was based on strong growth of private and state consumption, which have been financed by revenues from privatisations and borrowing, the economic growth episodes since 2008 (in 2010-2011 and 2013) have mostly been fuelled by investment growth and net exports, since the private consumption has been steadily declining since 2009 (due to the decline in real income and loans), while the growth of state consumption has slowed down, which is seen as desirable rebalancing. Still, the strong growth of investments in 2011 and 2012 was focused on several projects/companies (FIAT and NIS), while no new significant investment projects had been agreed in the meantime. Also, the strong growth of exports in the previous years is mostly related to the automobile and oil industries, which, bearing in mind their current product range and capacity, cannot be expected to considerably increase production and exports in the coming period. Observed by business activities, it can be noted that since 2008, the biggest decline was recorded in the construction sector, which is the result of the decline of income/employment and loans, as well as limitations on the supply side (issuing construction permits, registering property in the cadastre, etc.). In the second half of 2014, there was a significant deceleration in the manufacturing industry, which is mostly associated with negative trends in the automobile industry and lack of new investments. Accordingly, it can be concluded that the negative trends in economic activity are the consequence of differences related to extremely high fiscal deficit and fast growing public debt, which discourage private investments and inflow of loans, as well as unfavourable business and investment conditions and, to a lesser extent, unfavourable international environment (slower growth of economic activity than expected in the countries that are Serbia's key trade partners – Italy, Germany, Russia).

1. Macroeconomic Trends 2008-2014 – from one crisis to another

According to the official data of the Statistical Office of the Republic of Serbia (SORS), based on data from the Labour Force Survey, the unemployment rate in Serbia in the third quarter of 2014 was 17.6%, which is by 7.9 pp less than in April 2012, where the unemployment rate in the third quarter of 2014 alone dropped by as much as 2.7 pp. Since Serbia's GDP in the period 2012-2014 cumulatively dropped by around 0.7% in real terms, and that the

third quarter of 2014 recorded a 3.4% decline of GDP, which was mostly caused by a decreased activity in labour intensive sectors (such as construction), a reduction of the unemployment rate by almost a third in a two year period, i.e. by over 10% in one quarter, would be unexpected and difficult to explain with economic reasons. Data on the trends of employment and unemployment structure show that in the first two years of the crisis (2009 and 2010), the biggest decline of employment was recorded in agriculture, which was unexpected given that agriculture did not record a significant decline in production and the elasticity of employment with respect to production in this sector is relatively low (since these are mostly family households). Similarly, the reduction of unemployment rate in the period 2012-2014 is explained by a considerable increase in the number of helping farming household members, while the number of wage workers is declining. Accordingly, the reliability of measuring trends on the labour market is questioned, since the acquired results/trends are contradictory to other macroeconomic trends. Given that the unemployment rate from 2008 to 2014 increased cumulatively by 3.6 pp, which could be consistent with other macroeconomic developments in this period, it is possible that the new results on the level of unemployment reflect the actual state, but then it is unlikely that the unemployment rate in the previous years increased so much (exceeding 25%), but rather that in the conditions of recession, it drastically declined (by one third) in short term. Regardless of whether the data on unemployment level or its variation reflect the real situation, the problem of unreliable statistical data presents one of the more significant limitations for efficient implementation of economic policy.

Table 1. Macroeconomic Trends in Serbia from 2008 to 2014

	2008	2009	2010	2011	2012	2013	2014
GDP growth rate (%)	5.4	-3.1	0.6	1.4	-1	2.6	-2
GDP growth rate in EU (%)	0.4	-4.3	2.1	1.5	-0.3	0.1	1.6
Unemployment rate in 15-64 age group (%)	14	16.6	19.2	23.7	22.4	20.1	17.6
Deficit of the current account balance of payments (% of GDP)	-20.9	-6.2	-6.3	-8.6	-10	-4.6	-6
Foreign Direct Investment (% of GDP)	5.4	4.5	2.9	5.5	2.1	3.6	4.1
Foreign Debt (% of GDP)	64.6	77.7	85	76.7	86.9	80.8	80
Rate of inflation (%)	8.6	6.6	10.3	7	12.2	2.2	2
Dinar exchange rate against euro (end of year)	88.6	95.9	105.5	104.6	113.7	114.6	121.2
Rate of real depreciation of dinar exchange rate against euro [1]	3	1.5	-0.3	-7.3	-3.1	-1.4	3.6
Growth of corporate and personal loans (in millions of euros)	1.125	1.306	1.657	1.784	589	-875	-300
Rate of non-performing loans (%)	5.79	10.8	11.9	14.2	16.5	21.9	22
Fiscal deficit according to domestic methodology (% of GDP)[2]	-2.5	-4.2	-4.4	-4.6	-6.6	-4.6	-5
Fiscal deficit according to international methodology (% of GDP)[3]	-2.5	-4.2	-4.4	-4.6	-6.6	-5.6	-7
Public debt (% of GDP)	28.3	32.8	41.9	44.4	56.1	59.4	70

1) Negative sign marks the real appreciation of the exchange rate, while the positive sign marks the depreciation
2) Fiscal deficit without the "below the line" spending (for the bail-out of banks, payments for activated guarantees issued to public and state enterprises for bank loans, etc.)
3) Fiscal deficit expressed according to the international GFS methodology, including the "below the line" spending ("below the line" spending data available only for 2013 and 2014).
4) Some of the 2014 data are related to the end of the year estimate (GDP growth rate, fiscal deficit and public debt), while others refer to the end of the third quarter.

In the period since 2009, there has been a significant deceleration of imports, caused by the decline of real income and loan activity, while exports, after the significant drop in 2009, have been growing strongly since 2010 and were by around 51% higher in real terms in 2014 than in 2008, which led to increased coverage of imports by exports, from 46% in 2008 to 73% in the first three quarters of 2014. Growth of exports, which was especially dynamic in 2010 and 2013, was caused by launching a large number of investment projects agreed in the period before the crisis, and by the recovery of the demand in EU countries (this explains the growth of exports in 2010), as well as the start of operations in the FIAT factory and other cooperating companies in the automobile industry, and significant growth of exports of oil derivatives in the region from the renewed NIS facilities (which explains the growth of exports in 2013), while in 2014 there was a significant reduction of the export growth rate, since export potential of the aforementioned projects were mostly depleted, without any significant new investments. It is estimated that the results of the net exports until 2013 would have been even better if it had not been for the significant appreciation of dinar exchange rate in real terms (by almost 12%) in the period between 2011 and 2013, which had a negative impact on the international competitiveness of Serbia's economy. In line with the aforementioned trends, the current account balance of payments deficit was significantly reduced compared to the period before the crisis (even though it grew in 2010, due to a significant growth of capital equipment imports for FIAT and NIS), but it was still relatively high in 2014 (around 6% of GDP), which is unsustainable in the long term in the conditions of relatively small inflow of investments and deceleration of foreign borrowing. High current account balance of payments deficit until 2008, its

moderate value in 2009 and 2010, decelerated inflow of foreign direct investments, considerable decline of GDP in 2009 and moderate depreciation of dinar exchange rate, affected the significant growth of the country's foreign debt from 64.6% of GDP in 2008 to 85% of GDP in 2011. Reduction of balance of payments deficit, strong real appreciation of dinar exchange rate, and a mild recovery of economic activity in 2013, affected the moderate decline of the country's foreign debt to around 80% of GDP at the end of 2014, which is considered an upper limit of the long-term sustainable level of foreign debt. At the same time, there was a considerable increase in the share of public debt (from 29% to almost 54% of total foreign debt), and the reduced share of private debt (from 71% to 46%), which was the result of state borrowing in order to finance the fiscal deficit, and net foreign deleveraging of the business sector. Structure of the country's foreign debt according to maturity dates indicates that in the following three years, and especially in 2017 and 2018, a considerable share of foreign debt will be up for payment, which is why it is necessary to take timely action (during 2015) to prevent issues with country's foreign liquidity, even though foreign reserves are relatively high, which could include long-term refinancing of certain larger short-term and medium term obligations.

Inflation rate in 2013 and 2014 was quite low (around 2%), which is the result of the decline in domestic demand, fall of oil prices, as well as relatively restrictive monetary policy of NBS. Even though low inflation and recession tendencies in the economy indicate a need for reducing the restrictiveness of the monetary policy, high degree of euroisation reduces the potential effectiveness of monetary policy in inciting economic activity and makes the effects of reducing its restrictiveness on the foreign exchange rate even bigger. Still, a very low inflation rate, which was below the planned target in 2014 (4+/-1,5%), and which was used to make fiscal projections, complicates the implementation of fiscal policy making the revenue from tax on consumption lower than expected, which is why it would be necessary for the monetary policy measures to be used more intensively with the aim of reaching an inflation rate that is closer to the middle of the target corridor.

From 2010 to 2013, the dinar exchange rate against euro continuously appreciated in real terms (by 12.1% in total), due to reduced current account balance of payments deficit, moderate level of foreign direct investments, and considerable inflow of portfolio investments (primarily into state bonds). In 2014 this trend stopped, and (from the beginning of the year until the end of the first week of December) a real appreciation of the exchange rate was recorded by 3.6%, but the real value of dinar is still higher than in 2010. Considerable real appreciation from 2010 to 2013 had a negative impact on international competitiveness of domestic economy, so the real depreciation which happened in the second half of 2014 only partially removed the effects of appreciation from the previous years. The dynamic and intensity of NBS interventions on the forex market indicate that the principle of interventions for the purpose of preventing extreme daily fluctuations of the exchange rate has mostly been abandoned and instead, interventions are used to influence the trend, which can also be concluded from public appearances of the NBS top management. Depreciation of the dinar exchange rate had a positive effect on the economy's international competitiveness, but it had negative effects on balances of banks and net assets of the citizens and business that have foreign currency loans. Since it is desirable to use the depreciation of the exchange rate to offer an incentive to exports, and that the inflation rate is very low, but at the same bearing in mind the fact that the rate of non-performing loans is high and that real income of the citizens is declining, it is estimated that continued mild depreciation of dinar presents an optimal outcome.

Signing of the "Viennese Initiative" caused the banks not to withdraw funds at the beginning of the crisis from Central and Eastern Europe, so until 2011, loan activity toward citizens and businesses grew. Expiration of this agreement, which coincided with the big crisis in the Eurozone, caused by the public debt crisis in Greece and fiscal problems of other countries of the South Europe, with growing macroeconomic (primarily fiscal) risks in Serbia, affected the sudden deceleration of credit activity in 2012 (approved loans to citizens and businesses were by 1.1 billion euros lower than in 2011), and the negative tendencies increased considerably in 2013, when there was a significant net deleveraging of the citizens and businesses. Credit activity in 2014 continued to drop, even though that decline was somewhat slower than in the previous year. Introduction of the programme of subsidising loans for business sector liquidity in May 2014 affected the temporary halt of credit activity, but without resolving the issue of non-performing loans, removing other limitations (financial indiscipline, etc.) and reduction of (macroeconomic and microeconomic) risks and cost of doing business in Serbia, and therefore interest rates as well, no significant growth of credit activity can be expected. In the conditions of shallow financial market, revival of micro-loan organisations combined with measures of resolving issues of non-performing loans, could contribute to growing credit activity in the coming period.

Due to the economic downturn, acute problems of the business sector with liquidity and solvency, inefficient bankruptcy procedures and change of property ownership, abuse of loan approvals within state banks, and a considerable decline of real income and employment, the rate of non-performing loans in Serbia grew almost four times in the period 2008-2014, reaching the level of around 22%, where the credit default of the businesses was much larger than that of the citizens. As such, the rate of non-performing loans is among the highest in Central and Eastern Europe (along with Montenegro, Albania and Romania). Still, it can be observed that during 2014, there has been a certain slow-down in the non-performing loans growth rate compared to previous years, since the growth in the first three quarters amounted to 0.1 pp, and in the previous three years it was on average 2.6 pp annually. This was partially due to closing down of four banks with large amounts of non-performing loans and excluding their portfolio from the calculation of non-performing loans growth rate. The high rate of non-performing loans was considerably influenced by abuse in loan approval to private companies, often by the state banks, which led to four banks losing their licenses in the past four years and declaring bankruptcy, creating budget spending of around 3% of GDP for the purposes of deposit payments. Those expenditures could have been lower if the state had paid only the guaranteed deposit amounts (up to 50,000 euro per depositor), but at the cost of increasing lack of trust in the stability of the banking system. That is why state's exit from bank ownership, with a possibility of keeping a minority share in Komercijalna Bank, is estimated as economically justified, which should, together with a significant improvement of the control function of the NBS, prevent these types of risks and budget expenditures in the future. High rate of non-performing loans significantly increases the costs of the banks and thus has a large impact on the value of the interest rates, as well as on the readiness/caution of the banks to approve new loans. Given the importance and magnitude of this problem, it is necessary for the state (NBS and the Government) to create an appropriate institutional framework for its solution through facilitating trading of bank receivables (and encouraging the entry of large international companies dealing with these matters), and through improving the bankruptcy procedure (adopting the amendments to the Law on Bankruptcy during the summer of 2014 represents an important step in this direction) and settlement of state obligations in full and on time. Taking over obligations of private companies or bank receivables by the state is not an economically justifiable solution, because it would encourage moral hazard and at the same time jeopardise the sustainability of public finances.

Serbia entered the crisis period with a relatively low fiscal deficit and public debt, where the structural deficit in 2008 was higher than the actual one due to high economic growth and large absorption gap. Discretionary measures of fiscal policy (increase of wages in the public sector and reduction of taxes in 2006-2007, out of turn pension increase by 22% in 2008, fiscal decentralisation in 2011, increase in the number of public sector employees, the need for state intervention in the banking system bail-out, and a considerable growth of subsidies for public and state enterprises, etc.), have made the fiscal deficit in Serbia grow steadily since the beginning of the crisis, while in other European countries it had started to decline as of 2011. Therefore, it is estimated that consolidated fiscal deficit in 2014, according to the internationally comparable methodology which includes "below the line" spending as well, will be around 7% of GDP and, as such, one of the highest in Europe. As the result of continuously high and growing fiscal deficit since 2008, the public debt has increased by over 40% of GDP, and it is estimated that it will be around 70% of GDP by the end of 2014. This level and trend of public debt for a country with a low level of development and low credit rating is estimated as unsustainable in the long term. Considering the fact that most of the fiscal deficit in Serbia is of structural nature and that economic growth will not lead to its considerable reduction, it is necessary to reduce the fiscal deficit by 4-5% of GDP to below 3% of GDP in the medium term (the next four years) by measures of fiscal consolidation. In the conditions of low values of fiscal multipliers, which is characteristic of small open economies with flexible exchange rate, it can be achieved primarily through lowering current public spending.

Since 2007, Serbia has stagnated or regressed on international lists of competitiveness, business conditions and economic freedoms. In 2007, Serbia was ranked 91st on the competitiveness list of the World Economic Forum and in 2014, it was ranked 94th, where among the countries of Central and Eastern Europe (CIE) only Albania had a lower rating. According to the ranking of countries by the degree of economic freedom, published by the Heritage Foundation, Serbia is ranked 91st, which is the worst result among the CIE countries. Given this result and that fact the public spending accounts for about 44% of Serbia's GDP (while the CIE average is around 42% of GDP), that spending on subsidies is over 3% of GDP (while EU average is around 1.5% of GDP), and that almost 32% of the employed are working in the public sector, it can be concluded that the degree of state intervention in Serbia's economy is extremely high. This refutes the argument that poor economic situation in Serbia is the result of liberalism, as a paradigm of economic policy since 2001.

Three recession episodes since 2008, high long-term unemployment, relatively high current account balance of payments deficit and foreign debt, extremely high fiscal deficit and unsustainable tendencies in public debt development, bad business environment (compared to other CIE countries), conditions of declining credit activity, high rate of non-performing loans and relatively low investments, economically and politically unstable international environment, indicate that Serbia's unfavourable economic position is the result of accumulated large number of structural problems, some of which have been inherited from previous years, while some are newly created. Causes of this unfavourable situation lie in high macroeconomic risks (primarily due to unsustainable public finances), poor business environment, which is reflected in inefficient public sector and low quality of public services (public administration, healthcare and education), widely spread financial indiscipline, and in unpredictable conditions of doing business, which makes risks and costs of investing and doing business in Serbia quite high. So, in order to significantly increase prospects for a faster economic growth in the medium term, it is necessary to relatively quickly (practically by the end of 2015) and in synchronised and coordinated manner implement a series of structural reforms with the aim of completing the process of transition to a market economy. Such reforms do not guarantee accelerated economic growth, because it depends on a number of external factors that are not under the state control, but they represent a necessary condition for growth, because without their implementation, even in conditions of positive tendencies in the international environment, faster economic growth of Serbia would be highly unlikely.

2. Economic Policy and Reforms

The main weakness of economic policy as of 2000 was in the fact that Government representatives, when making decisions, gave priority to short-term rather than long-term effects of economic policy and reforms. Examples of such policies are numerous, some of the more important ones being giving priority to growth of current consumption rather than growth of investments, considerably faster growth of domestic demand than growth of production, assessment of the dinar exchange rate, attracting investment with fiscally unsustainable subsidies, subsidising citizens and businesses through low prices of infrastructure services, taking dividends from public enterprises and using them for state current spending, etc. The reforms that were implemented in Serbia after 2000 were slow, partial and insufficient to establish functional market economy that exists in continental European states. The role of the state in the economy is exaggerated, which in combination with inefficient state is the main cause of problems in the economy. That is why it is necessary to accelerate reforms in Serbia toward market economy, reduce the scope of state interventions, and make the state more efficient.

Resolving accumulated problems in Serbia's economy, as well as creating conditions for long-term sustainable growth, requires a decisive change of course in economic policy and faster reforms. The need for such a change has existed for several years, but now there are conditions for its realisation, while the possibilities for its delay have been almost completely exhausted. The current Government has a stable majority in the Parliament and a relatively long horizon until the next elections, which is an important political precondition for accelerating reforms and changing course in economic policy. In addition, the Government reached an agreement with IMF on economic policy and reforms for the next three year period, and the obligation of implementing certain reforms stems also from the process of EU accession. It is our estimate that the reforms that Serbia is implementing within the IMF arrangement and EU accession represents the minimum of what Serbia needs to do in the coming years. Probability of implementing announced economic policies and reforms has increased compared to the previous years (and the decade), but certain difficulties and problems in their implementation should be expected as well.

2.1 Fiscal Consolidation and Improving the Public Sector Efficiency

The key change in economic policy should be implemented through the announced fiscal consolidation, which would reduce the fiscal deficit from the current level of around 7% to around 3.5-4% of GDP in the period of three years, which is the lower limit of sustainability, because this would only slow down the growth of relative public debt in 2017, but it would not stop it, without creating a space for more significant increase of public investments and investments into education, which have a considerable impact on future economic growth. Reduction of spending on wages and pensions will bring permanent savings of around 400 million euros, i.e. a bit over 1% of GDP. Detailed content and dynamic of applying other measure for reducing the fiscal deficit still have not been represented to the general public, but it is quite certain that, in addition to already realised reductions of wages and pensions, large additional savings will be needed as well. The biggest savings potential lies in the reduction of subsidies and spending

on servicing guaranteed loans. Implementation of fiscal consolidation requires that spending for these purposes, at the level of consolidated state sector, is reduced from the current level of around 3-3.5% of GDP to about 1.5% of GDP in 2017. Savings of 1% of GDP could be realised by reducing the number of employees in the public sector, not including public and other state enterprises, by around 10%, which is around 50 thousand. Greater reduction of the number of public sector employees will be difficult without jeopardising the quality and accessibility of public sector services.

Implementation of fiscal consolidation will create a space for a gradual reduction of the restrictiveness of monetary policy. Central Bank should reduce the restrictiveness of monetary policy until inflation is back to the middle of the target corridor. In conditions of high euroisation, this practically means that NBS should allow a mild depreciation of dinar until it starts jeopardising keeping the inflation within the targeted scope, while taking care of the effects of depreciation on non-performance of bank loans.

Fiscal consolidation implementation is tightly related to public sector reforms, including public enterprises, but also business sector/economic reforms. In order to realise savings from reducing subsidies and servicing guaranteed loans, it is necessary to adopt quickly key measures for restructuring public enterprises. In almost all state-owned companies, there is significant room for a reduction of costs, such as cost of labour, but also to stop the overflow of resources to privileged private companies. In addition, in some public enterprises such as EPS, Srbijagas and some utility companies, it is necessary to increase the price of their products as well. However, it is our estimate that the most important individual measure in restructuring public enterprises is to stop delivering products (gas, electricity, utility services) to buyers who do not pay for these services. This measure should be applied as soon as possible and by the middle of next year at the latest, and it should be applied unconditionally, regardless of whether they are applied to companies in restructuring, local self-governments or state institutions. If this measure is delayed, it can be expected that the public enterprises will again ask for state's help, and this means that the necessary reduction of subsidies and spending for guaranteed loans will not be realised. Additional requirement for reducing subsidies is giving up on generous subsidies granted to investors. Reforms of the economic system which would reduce the costs and risks of doing business (construction permits, efficient protection of contracts and property, lower cost of paying taxes, etc.), building of infrastructure, etc. should attract more investments than is currently managed with subsidies.

Reduction of number of public sector employees by around 10% over the next three years should be implemented together with reforms which would lead to increased quality of public sector services, from justice and security to infrastructure, education and healthcare. Reduction of the number of employees can only partially (around 50%) be achieved by natural outflow[4] (retirement, transferring to private sector), which means that a substantial part would have to be achieved through targeted firing of employees who hold unproductive job posts.

Some of the announced measures of reducing fiscal deficit, such as taking dividends from public enterprises or introducing excise duty on electricity, are highly problematic. Reducing deficit by taking dividends from public enterprises is an unreliable measure (if the enterprise does not realise profit, there are no dividends either), which is also quite damaging to the reliability and quality of its services, as it would considerably decrease investments in replacing worn out infrastructure (of power plans, electricity grids, etc.). Some of the public enterprises, such as Telekom, do business in competitive conditions, so taking dividends and reducing investments could lead to a decline in the enterprise's value – what the state gains from taking dividends, it would lose from the sale of Telekom. Constant taking of dividends by the state would also have a negative impact on the overall economy, because the profit of these enterprises is used for investments, while the state would use dividends almost entirely for financing current spending, which decreases investments at the level of society approximately by the same amount of dividends taken by the state.

In line with the above, it is estimated that a considerable improvement in managing public enterprises is needed, as well as of the supervisory function of the state over them, in order to improve their profitability in the medium term, and the additional profit created in such a way should be used to reinvest in those enterprises and raise the quality and reliability of their services. Possible introduction of excise duty on electricity could secure steady and relatively significant revenues for the budget. However, introducing excise duty on electricity in conditions where more than half of the produced quantity of electricity is sold at a price that is by around 30% below the costing price, would be highly unfavourable for the operation and development of EPS, and it could even cause problems in the medium term for Serbia's budget. Introducing excise duty on electricity over the next year would almost certainly delay the

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4 Given that in the first 11 months of this year, natural outflow did not lead to a reduction of public sector employees, there is some doubt as to the efficiency of this measure of employee reduction.

increase of electricity production price, which would mean that EPS in the coming years would have insufficient funds for current operations and capital repairs, which would cause its problems with liquidity to accumulate. With low electricity prices and, for now, very foggy plans for improving cost efficiency of the company, there is a considerable risk that EPS liquidity problems would escalate in the coming years to a level where the company would need help from the state, which would mean additional spending from Serbia's budget.

Aside from fiscal consolidation, the Government also announced numerous reforms, such as: finalisation of privatisations of former state enterprises during 2015, restructuring of public enterprises and privatisation of some of them, improvement of business environment, and public sector reform. The mentioned reforms are mutually connected, which means the improvement in one area has a positive impact on the functioning of other areas. Implementation of these reforms is a necessary requirement for starting a long-term sustainable economic growth and for fiscal consolidation. Fiscal consolidation, finalisation of privatisation and restructuring of public enterprises will contribute to the improvement of business environment.

Privatisation of public enterprises in Serbia started almost two and half decades ago and it still has not been finalised. The deadline for finalising privatisation of state enterprises, which are now mostly state-owned, has been pushed several times. The latest plan for privatisation, adopted by the Government at the end of 2013, foresaw all ex social enterprises to be privatised by mid 2014 or start bankruptcy proceedings in case privatisation is not possible. However, not one enterprise has been privatised in this period nor have any bankruptcy procedures started, which seriously questions Government's credibility. Prospects for successful privatisation of most of these companies are quite small, because almost all companies that have not been privatised until now have gone through one or more unsuccessful privatisations. Therefore, the finalisation of privatisation greatly depends on Government's readiness to quickly implement bankruptcy procedures in case these companies cannot be privatised. Finalisation of the privatisation of former socially-owned enterprises is of great importance in order to stop the overflow of losses from these enterprises to other enterprises and the state, but also to put in operation valuable assets that these enterprises are using unproductively. In order to prevent establishment of new state enterprises, it is necessary, in case of unsuccessful privatisations, to sell these companies automatically to another private owner instead of being taken over the by the state, as has been the case so far.

Restructuring of public enterprises is a necessary requirement for reducing state spending on subsidies and services of guaranteed loans, and thereby for the success of fiscal consolidation. Privatisation of certain public enterprises that are operating in competitive conditions, with the finalisation of privatisation of former socially-owned enterprises and state-owned banks would enable the state ownership in Serbia's economy to be reduced to a level closer to European economies. Reducing state ownership in economy is important not only from the standpoint of economic efficiency and economic growth, but also from the standpoint of sustainability of public finances. Huge state budget losses incurred from relatively small and ruined banks and enterprises that have not been privatised are the price of excessive state intervention in Serbia's economy.

2.2 Businesses Environment Reform

Changes to the business environment, together with public sector reform, are probably the most complex task that the Government of Serbia is facing. Over the past few years, very little progress has been made in this area, as confirmed by Serbia's modest placement in international rankings on competitiveness and business conditions. Improvement of the business environment could be achieved by a government who cares about long-term implications of the policies it implements. In mid-2014, the current Government implemented certain important reforms, which improve the business environment, such as amendments to the Labour Law, Bankruptcy Law and Law on Privatisation. Amendments to the Labour Law are by nature such that they will have a positive impact the labour market, while the effects of amendments to the Bankruptcy Law and Law on Privatisation will critically depend on the efficiency of their implementation. In December, amendments to the Law on Planning and Construction were adopted, whose main goal was to reduce the time needed to issue construction permits to one month and as of second half of 2015, cut down the regulatory costs as well through introducing a system of electronic submission of requests and issuing construction permits. By cutting down the time needed for issuing construction permits, one of the biggest obstacles for construction and for investments will be removed, but there would still be obstacles related to inadequate records of property rights in the cadastre. The way of solving the problem of conversion of city construction land in privatised companies is not regulated by these amendments to the Law, which creates uncertainty with respect to property rights and hampers business transactions.

In addition to the announced reforms for improving business environment, many others are needed, for which it is now uncertain when they will be implemented, among which the most important being introduction of firm budgetary restrictions, improvement of the protection of property rights and contract enforcement, construction of modern transportation, energy, utility and telecommunications infrastructure, and removal of administrative barriers.

Improvement of the quality of state services is equally important, as well as reduction of its costs. For the functioning of economy, as well as the total social progress, it is necessary to improve the operations of all state institutions, from justice and cadastre, security services, through state and local administration to education and healthcare. For each of these areas it is necessary to adopt plans for improving efficiency, as well as define measurable criteria for checking progress in realising those plans, as well as the responsibility in case of no progress. One of the key areas for improving public sector efficiency is creating competent, dedicated and honest public administration. A necessary requirement for achieving this goal is to change the policy of recruiting, promoting and awarding all public sector employees, including the top management. Instead of the currently dominant partisan, family, regional and other channels of recruitment and promotion, which lead to negative selection, it is necessary to strictly apply competitive procedures, which would favour the best candidate in each step of the process.

2.3. Institutional and Organisational Assumptions/Premise of Economic Reforms

For the first time since 2000, one party has a parliamentary majority which eliminates the risk of a smaller party blocking some reforms or imposing anti-reforming measures and populist economic policy, as was often the case over the past few years. Even though the current Government is homogenous, proportional election system is still applied in Serbia, so there is a big chance that future governments will be again formed with many parties. That is why a change in the election system, which would reduce political fragmentation, is a necessary precondition for political stability, and it would increase the chances of implementing a long-term sustainable economic policy and the necessary reforms. Still, that is not a sufficient condition for strong fiscal consolidation and implementation of reforms – that would require Government's readiness to implement unpopular measures, which could have negative short-term effects on its rating.

Low administrative capacities are an important limitation to implementing complex reforms, such as the reform of the justice system, cadastre, local and state administration, tax authority, public enterprises, etc. The problem of low capacities in the public sector is a permanent problem in Serbia, which has additionally escalated during the current Government's mandate by mass recruitment and promotion of people with inadequate degrees. Instead of capability and results, the key channels of promotion in the public sector are party affiliation and informal contacts (family, native, etc.). Long term negative selection has led to creation of a network of incompetent and partially corrupt staff. As the result, there is a large number of managers in the public sector who are not capable of improving the capacity of the institutions they run. Furthermore, reforms are not even in their interest, as they would directly jeopardise their positions. Therefore, instead of the real reforms, we can expect their staging and a latent obstruction by these officials. The problem of insufficient capacity for public sector reforms in Serbia could be mitigated through direct involvement of the representatives of international financial institutions and EU in the implementation of the reforms. Generally speaking, their engagement will have a positive impact, although there is a risk in certain situations of imposing templated, less than optimal solutions.

Fiscal consolidation and reforms will most probably be implemented in unfavourable international circumstances, which will make the negative effects on economic growth, employment and living standard even bigger and longer lasting. EU economy, which is crucial for Serbia in the coming years, will probably stagnate or recover slowly, so we cannot count on high growth of demand or a strong inflow of foreign direct investments in Serbia. In such circumstances, what Serbia can do is attract as much of the scarce capital as possible through the exchange policy and improvement of the business environment. Additionally difficulty from the international surroundings could occur if the Ukraine crisis is not resolved relatively soon. Deepening and possible escalation of the crisis will almost certainly exacerbate pressures on Serbia from the USA and EU on the one hand, and Russia on the other. In such circumstances, the neutrality policy may no longer be possible, while siding with either party would additionally worsen Serbia's economic position. Perseverance in maintaining good relations with Russia in those circumstances would probably result in some form of sanctions from the EU, while supporting EU policy toward Russia would jeopardise the agreement on duty-free trade with Russia.

Economic Perspectives in the Period 2015-2017

Forecasts of economic growth in 2015 are quite unreliable for now, as there is an unusually high number of still unpredictable factors, which could significantly affect the growth. For example, it is not yet quite clear what fiscal consolidation planned for 2015 will look like, what will be the fate of the biggest companies undergoing restructuring, but also of the large private companies such as Farmakom, Interkomerc, Beohemija, etc. On top of that, there is a problem with a great unreliability of SORS data, which change often, for several years back and to such an extent that it completely changes the trend assessments for economic activities and the conclusions reached based on analyses.

For the GDP trend forecast for 2015, two different approaches were used, which do not yield the same results: 1) through analysis and projection of trends of seasonally adjusted GDP, we estimated that the GDP in 2015 could drop 0 to 0.5%, and 2) through analysis of possible trends in individual GDP components (private consumption, state spending, investments and net exports), we found that the decline of economic activity in the following year could amount to around 1%. Given that the second method takes into account all currently available information on effects of planned measures of economic policy and reforms (which is not the case with the first method), we believe it is more reliable and conclude that economic activity in 2015 could have a decline of around 1%.

Based on the analysis of possible trends in the most important determinants of citizen income (wages and employment, pensions, consumer loans, remittances, welfare, etc.), it is estimated that private consumption in 2015 will have an over 3% decline in real terms. At the same time, given the projected trends in public sector earnings in 2015, it is estimated that state spending in 2015 will decline by over 6% in real terms. Net exports in 2015 will make a positive contribution to GDP growth by around 1.5 pp of GDP, which will be due to reduction of imports, caused by a reduction in domestic demand and depreciation of dinar, and by stagnation of exports, due to previously analysed reasons – slow economic growth in EU and lack of large new investments in the previous year, etc. Forecasting the investment trends is related to the bigger uncertainties than projecting other GDP components. Still, given the expected growth of public investments (by 0.3-0.5% of GDP) and private investments, we estimate the total investments in 2015 could increase by over 5%. The risk of this growth being smaller is primarily related to inefficient realisation of public investments. Public investments in 2014 were planned at an approximately the same level as they are now being planned for 2015, but significantly less were realised. Moderate growth of private investments could occur due to the finalisation of the process of privatisation and strengthening of investors' trust due to the signed IMF agreement.

The Government of the Republic of Serbia has already announced that it expects the real GDP growth rate in 2016 to be 1.5% and then 2% in 2017 (and that these are very conservative estimates). Our analysis, however, shows that GDP growth rate of 1.5% in 2016 will be hard to achieve, and that any positive growth that year would be a good result. Simply speaking, current economic difficulties of both the private and the public sector are too great to end in only one year and enable a more significant economic growth already in 2016. Real GDP growth in 2017 of 2% is possible, but it too will not be achieved if key issues that Serbian economy is currently facing are not resolved.

Economic growth in the medium term will greatly depend on the still unknown and uncontrolled factors, such as the outcome of privatisations of large state companies or the speed of medium term economic recovery of the EU. It should be noted that the estimate of GDP growth in 2016 and 2017 cannot be made with the simplest method, which would include forecasting GDP trends so that its growth gradually approaches the potential medium term growth rate. In 2016 and 2017, there will still be dangerous imbalances, which will cause the GDP trends to deviate from the medium term trend – such as the implementation of the three-year fiscal consolidation agreed by the IMF arrangement. Let us stress that it is also uncertain what the new potential medium term GDP growth rate in Serbia will amount to, as it has been quite atypical in the past ten years – first because of the enormous influx of foreign capital in the country from 2005 to 2008, and then because of the global economic crisis. That is why the forecast of possible trends in economic activity in 2016 and 2017 requires a more detailed analysis of the existing and expected trends and the announced economic policies.

Year 2016 will be entered from the recession of 2015. Even though the total decline of GDP in 2015 will probably be only 1%, it will contain large growth rates (around 20%) of mining and electricity production – because of the comparison with the deep temporary decline in 2014 due to the floods. If it were not for this temporary growth, the economic activity in 2015 would decline by around 1.7% and that is actually the main unfavourable trend in economic activity after which a sharp turn is expected together with a 1.5% GDP growth in 2016. So, in order to achieve

the 1.5% economic growth in 2016, it is necessary to accelerate the trend of economic activity by over 3 pp compared to 2015, which is a considerable change that is not likely to happen that quickly. Such acceleration of economic activity (of over 3 pp) in one year has happened three times since 2001: *first time* in 2004, when the GDP growth rate increased from 3% in 2003 to 9% in 2004, *second time* in 2010, when after a real decline of 3.1% in 2009, a positive growth of 0.6% was achieved, and *third time* in 2013, when GDP went from a 1% drop in 2012 to 2.6% rise. We only consider the second episode (from 2010) to be relevant for the analysis, since the other two cases of fast acceleration of economic activity were under a great influence of large year-on-year changes in agricultural production caused by climate factors.[5] Additional advantage of analysing the second episode (2009-2010) is that the recovery of economic activity came after a relatively deep recession, which would also be the case in 2016. Analysis of the shift in the growth of economic activity that happened in 2010 quite clearly shows why it is highly unlikely that a similar shift will occur again in 2016. In 2010, the state and private consumption had remained approximately unchanged compared to 2009 and the exports had a high real growth rate of 15%. In 2016, these parameters will be quite different. State spending will be in great decline in real terms due to the inevitable implementation of the fiscal consolidation (the alternative would mean a public debt crisis), private consumption will have a real decline which also cannot be avoided, and the growth of exports will not be able to be that high.

Due to the continuation of fiscal consolidation, the state spending in 2016 will have a real decline of around 5% (frozen wages and downsizing of the public sector). Private consumption will also be in a real decline, which we estimate to be between 1 and 1.5%, as the sources of its financing will continue to decrease in real amounts (mild growth of mass wages in the private sector, which is also uncertain, would not be enough to compensate for the considerable decline of pensions and wages in the public sector, and a considerable increase of loans cannot be expected either). So, private and state consumption in 2016 will jointly contribute to the decline of total economic activity by around 2 pp, which means that achieving the planned economic growth of 1.5% in 2016 would require a growth of net exports and investments to first compensate this decline and then additionally contribute to GDP growth by another 1.5 pp of GDP. In other words, in order to realise a GDP growth of 1.5% in 2016, net exports and investments would have to jointly contribute to the growth of GDP by as much as 3.5 pp of GDP, i.e. over 1.2 billion euros – which is very unlikely (there has not been a comparable example since 2001).

However, what is possible is to use good economic policies and secure a sufficient growth of net exports and investments, which would help avoid an extended recession and set good foundations for a solid and sustainable growth in 2017 and the coming years. We feel that any positive growth in 2016 would be a great success, but still achievable, provided the Government implements an adequate economic policy in 2015 and 2016. It is also interesting to note that the trends in private consumption are quite inert, as it considerably depends on slowly changing trends on the labour market (mass wages is by far the biggest source of funds for private consumption), and reduction of state spending is practically already defined by the three-year arrangement with IMF, so the key difference between the extended recession and economic recovery in the medium term will depend on the growth of net exports and especially investments. Government's economic policy could have a deciding effect on both of these GDP components. The growth of net exports in 2016 is possible, but it will be limited in that year by objective circumstances. It is our estimate that the most the foreign trade deficit could decrease in 2016 is probably by 1-1.5% of GDP (around 400 million euros). There are no preconditions for a bigger growth of net exports, neither on the demand nor on the supply side. Relatively speedy recovery of EU economies, which accounts for most of Serbia's exports, is currently not projected, so it will probably be no great incentive for the growth of exports. Also, the high growth of exports in 2016 would have to be preceded by a high growth of investments in previous years, which is currently not happening and it is highly unlikely that during 2015 there will be a dramatic change.[6] Possible inflow of an individual large private investment directed to exports (such as the FIAT investment) during 2015 is still not certain (although there are many announcements), and if it did happen, it probably could not have a large impact on the growth of exports in 2016.[7] A possible successful privatisation of Železare Smederevo (Steelworks) would significantly impact the growth of exports, but this company is also one of the biggest importers, so its contribution to net exports would be relatively small. On the imports side, it is unrealistic to expect its significant decline in 2016, because domestic consumption will not continue falling as much as in 2015, and a slightly stronger growth of investments which could be expected

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5 It is possible, of course, for a similar scenario in trends of agricultural activity to occur in 2015 and 2016, but it would mean a bigger decline of GDP in 2015 than the forecasted one.

6 We projected the real investment growth in 2015 of around 5%

7 Implementation of individual projects of that size would require time for preparation, investment, achievement of full production capacity, which means that if negotiations on an investment like that are started at the beginning of 2015, the full effect on net exports would be visible in 2017 at best.

during 2016 would push a certain growth of imports. Realisation of the growth of net exports would also depend on the trends in the real dinar exchange rate, to which economic policy makers should pay special attention. QM analyses show that at the end of 2014, the dinar exchange rate is coming closer to its competitive level, from which it would probably be possible to realise the forecasts from the previous paragraph.8 Allowing again stronger real appreciation (as was in the period 2010-2013) would be damaging to net exports and sustainable economic growth in the medium term, which should be kept in mind when implementing monetary policy.[9] As far as trends in investments in 2016 are concerned, after a relatively deep recession in 2015, it is hard to expect that there are capacities of the domestic economy for a significant market growth of investments. The public sector could contribute to investment growth in 2016, although it has its own limitations as well – it is limited by the size of the fiscal deficit and a high public debt.[10] As of 2016, even public enterprises could start increasing their investments, but first the biggest part of the huge problems in their operations would have to be resolved during 2015. A certain growth of foreign investments is possible and it would largely depend on business environment reforms in 2015 (a good indicator for it would be advancement on the relevant competitiveness lists). If the Government manages to secure during 2015 arrival of some of the big global companies, it could also have a positive impact on the investment trends. Still, a precondition for a considerable growth of investments is a decisive implementation of economic reforms, which we have already discussed in this text. If these policies are not implemented, the growth of investments will probably not be enough for the economic activity in 2016 to have a positive growth rate, so Serbia's economy would stay in a prolonged recession.11

Laying solid foundation for sustainable economic growth during 2015 and 2016 and a solid investment growth in 2016, would make the real GDP growth of 2% in 2017 possible. If, for example, in 2016 the real GDP growth was around 0.5%, the 2% increase in 2017 would be possible, as an acceleration of GDP growth b 1.5-2 pp is achievable (which has already happened several times in the past 15 years). However, if the growth in 2016 fails and Serbia ends that year in recession (which, simply put, means that the Government has not led good enough policies and has not been successful in their implementation), it would jeopardise any GDP growth in 2017, while the planned 2% growth would probably be unattainable.

In case the projected rates of economic growth (0.5% in 2016 and 2% in 2017) are achieved, this would create conditions for improving trends on the labour market in 2017. If there is the projected growth of investments, the private sector could probably compensate for further reduction of the number of employees planned for the public sector, which would cause private consumption in 2017 to no longer be in a real decline. The state spending would still have a real decline, but this decline would gradually decrease in relation to 2016. It is our estimate that the decline of state spending together with unchanged private spending in real terms could make a negative contribution to GDP growth in 2017 by around 0.5 pp. A positive contribution that net exports and investments could then make to overall GDP growth of 2% would be around 2.5 pp, which is still quite optimistic, but possible. Compared to 2016, there should be some mitigating circumstances in 2017 as well, which would support it, such as a slightly higher growth in EU. Also, a good fiscal policy would be encouraging due to country's risk reductions, and a successful reform of public enterprises, which would start in 2015, could enable them to increase their investments more an more.

Taking into account all conducted analyses of medium term trends, we can see that the official forecast for the movement in economic activity in Serbia in the medium term is quite optimistic and not conservative (where the one for 2016 can hardly even be possible). Current options that Serbia's economy has are long-term (maybe even deep) recession or painful treatment for many years, whose first tangible results the economy and private citizens would see only in several years. That is why we feel that the Government should redefine its medium term projections and goals, responsibly present to the public the real difficult state that the economy is currently in, and start immediately with implementing decisive and credible measure for getting out of the crisis.

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8 Current level of unit costs of labour measured in euro are indicating this.
9 Exaggerated depreciation of dinar would not be useful either, due to balances of the state and companies burdened with foreign currency obligations.
10 It is possible that the public sector would influence the increase of investments without these limitations through concessions and public private partnerships, but these are usually atypical and perhaps even risky projects with an uncertain impact on GDP (for e.g. if the material and workers are from abroad)
11 We have an example in the region (Croatia) where the recession has lasted six years.