

quarterly monitor

OF ECONOMIC TRENDS AND POLICIES IN SERBIA

Issue 40 • January–March 2015

Belgrade, June 2015

PUBLISHER

The Foundation for the Advancement of Economics (FREN)
Kamenička 6, Beograd
Tel/Fax: 011 3021 069
E-mail: office@fren.org.rs
<http://www.fren.org.rs>

EDITORIAL COUNCIL

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

EDITOR IN CHIEF

Milojko Arsić

EXECUTIVE EDITOR

Saša Randelović

AUTHORS

Milojko Arsić
Aleksandra Anić, Employment and Wages
Danko Brčerević, Economic Activity
Mirjana Gligorić, Balance of Payments and Foreign Trade
Milan Pejić, Prices and the Exchange Rate
Saša Randelović, Fiscal Flows and Policy
Svetozar Tanasković, Monetary Flows and Policy

ASSOCIATES IN THIS ISSUE

Slobodan Minić
Pavle Petrović
Mladen Stamenković

TRANSLATION

Darko Popović
Dragica Mihajlović
Marjeta Pevec
Vladica Đukić

DESIGN OF INNER PAGES

Stefan Ignjatović

PRINTING PREPARATION

Maja Tomić

COVER DESIGN

Nikola Drinčić

PRINTING OFFICE

Alta Nova

VOLUME

100 copies

Quarterly Monitor of Economic Trends and Policies in Serbia (*QM*) was created by Kori Udovički, who was the Editor-in-Chief of the first six issues of *QM*. For issues seven to twenty three, the Editor-in-Chief of *QM* was Prof. Pavle Petrović. Diana Dragutinović was the Editor-in-Chief of *QM24*. Since issue *QM25-26* the Editor-in-Chief of *QM* is Milojko Arsić.

Table of Contents

From the Editor 5

TRENDS

1. Review 7

2. Economic Activity 11

3. Employment and Wages 19

4. Balance of Payments and Foreign Trade 26

5. Prices and the Exchange Rate 33

6. Fiscal Flows and Policy 42

7. Monetary Flows and Policy 52

HIGHLIGHTS

Highlights 1

**Highlight 1. Fiscal Consolidation 2012-14
Vs 2015-17: is this Time any Different?** 59

Pavle Petrović i Slobodan Minić

Highlights 2

**Integration of construction land usage fee
into property tax in Serbia:
results and lessons learned** 65

Saša Randelović

Highlights 3

**Demographic trends and the number
of employees in primary and secondary schools** . 67

Mladen Stamenković

Highlights 4

**What is necessary for the sustainable growth
of the Serbian economy?** 71

Milojko Arsić

Analytical and Notation Conventions

Values

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

Definitions of Aggregates and Indices

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

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

New Economy – Enterprises formed through private initiative

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

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

Notations

CPI – Consumer Price Index

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

H – Primary money (high-powered money)

IPPI – Industrial Producers Price Index

M1 – Cash in circulation and dinar sight deposits

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

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

NDA – Net Domestic Assets

NFA – Net Foreign Assets

RPI – Retail Price Index

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

Abbreviations

CEFTA – Central European Free Trade Agreement

EU – European Union

FDI – Foreign Direct Investment

FFCD – Frozen Foreign Currency Deposit

FREN – Foundation for the Advancement of Economics

GDP – Gross Domestic Product

GVA – Gross Value Added

IMF – International Monetary Fund

LRS – Loan for the Rebirth of Serbia

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

NES – National Employment Service

NIP – National Investment Plan

NBS – National Bank of Serbia

OECD – Organization for Economic Cooperation and Development

PRO – Public Revenue Office

Q1, Q2, Q3, Q4 – 1st, 2nd, 3rd, and 4th quarters of the year

QM – *Quarterly Monitor*

SORS – Statistical Office of the Republic of Serbia

SDF – Serbian Development Fund

SEE – South East Europe

SEPC – Serbian Electric Power Company

SITC – Standard International Trade Classification

SME – Small and Medium Enterprise

VAT – Value Added Tax

From the Editor



Fiscal consolidation shows good results because fiscal deficit is much smaller than the last year's and also stands below the annual target for this year. We expect consolidated deficit to narrow to 4.5% of GDP, or RSD 180 billion in 2015, and be 2% of GDP (RSD 80 billion) smaller than the last year's and 1.2% of GDP (RSD 50 billion) below the annual target. This reduction could be even larger, but it would imply harmful decline in public investments or putting off a part of expenditures on severance pay until the next year.

Fiscal deficit was reduced mainly through reduction in oversized public spending, which is welcome from the aspect of correction of macroeconomic imbalances. Increase in tax revenue, achieved through reduction in shadow economy, rather than tax hike, was another significant contributory factor to deficit reduction. Finally, non-tax revenues also considerably contributed to this reduction. However, increase in these revenues was achieved in economically less welcome way, namely through inflow of funds that were taken by different means from financially exhausted public enterprises.

Wage and pension cut produced the largest saving in public spending, and we expect this measure to bring RSD 65 billion by the end of the year. According to the ongoing trends, reduction in shadow economy should push up public revenue by RSD 25 billion. Expected y-o-y increase in non-tax revenues is RSD 20 billion, and 10% reduction in public sector wages is the key generator of their growth.

To establish a sustainable fiscal policy, it is important to determine to what degree this reduction was caused by lasting improvements and to what degree it was driven by temporary factors. We believe that wage and pension cut and reduction in shadow economy can cause lasting saving, if, of course, no wage and pension increase is approved until a more notable GDP growth, which is not expected until 2017, and if the government persists with the efforts to curb shadow economy, relying more on systemic measures. On the other hand, the rise in non-tax revenues is mostly a temporary factor because 10% reduction in public sector wages or intensive dividend payout by public enterprises cannot be observed as permanent measures.

Another important question is due to what factors fiscal deficit fell below the amount projected in the Budget, and later on adopted in the agreement with the IMF. Fiscal deficit will narrow below the annual target because savings in expenditures on public sector wages exceeded the forecasts by about RSD 10 billion, and reduction in shadow economy is expected to bring RSD 25 billion that were not counted on due to a conservative approach to budgeting. On the other hand, annual non-tax revenues will be in line with the forecasts, because the steep rise in the first few months will be offset by a decrease in these revenues in the succeeding months.

Some great imbalances in Serbian economy have been reduced through fiscal consolidation. Reduction in public consumption and state-funded private consumption (wages and pensions) made room for increase in private investments. Furthermore, declining domestic demand will help correct imbalances on the balance of payments. Public sector wage cut narrowed the wage gap between public and private sector employees down to one of the smallest in Europe.

These improvements are just the first step towards the middle-term goal, namely to reduce fiscal deficit to 3% of GDP, which must be done to stop further increase in public debt-to-GDP ratio, and then to further reduce the deficit to 1% of GDP and thus cut the ratio of public debt to GDP to less than 50%. However, additional austerity measures, such as public sector downsizing, rationalization and limited privatization of the network of public institutions, reduction in state subsidies etc., need to be applied to further reduce fiscal deficit from still high 4.5% of GDP. The announced increase in wages and pensions at the end of the year would cause fiscal deficit to widen in 2016 and accelerate government borrowing. Consequently, Serbia would start moving away from a sustainable fiscal position again. The mistake made in the previous episodes of fiscal consolidation of giving up reforms as soon as the first improvements are made would thus be repeated.

Serbian economy shows some signs of recovery at the beginning of 2015. However, this recovery is still fragile and it is mainly driven by recovery in production based on removal of flood effects, and, therefore, should

not be seen as the beginning of a long-term sustainable growth. Contrary to some gloomy prognoses, “neoliberal austerity measures” have not deepened the recession, though they have probably slowed down the recovery.

The goal of economic policy and reforms is to start a long-term sustainable growth that would increase employment and provide steady rise in the standard of living. Economic growth is sustainable if it is achieved without causing large internal and external imbalances, that is to say, without moving into a large fiscal and current account deficit. Sustainable growth also implies considerable investment in physical capital, and continuous improvements in labor force capabilities. Small current account deficit indicates that the investments are financed mostly from the domestic savings, so there is no threat of balance of payment crisis in the following period in Serbia. It is, however, quite certain that a sustainable growth is not underway yet because fiscal deficit and current account deficit are still large, and investments are at a very low level and are financed mostly from foreign savings. Furthermore, business environment in Serbia is not sufficiently stimulating for development of private sector, which should be a cornerstone of future economic growth.

Reduction in fiscal deficit to less than 3% of GDP in the next two years and down to 1% of GDP in the middle term is crucial to correcting the imbalances. Reduction in fiscal deficit accompanied by moderate real depreciation of dinar will help reduce current account deficit to sustainable 3-4% of GDP. Investments can be scaled up from the currently very low level of 20% of GDP to 25% of GDP by making business environment more attractive to private investors and by increasing public investment to about 5% of GDP.

Besides correcting internal and external imbalances, it is necessary to create a business environment that would stimulate private investments and employment. This implies efficient protection of property, financial discipline, adequate competition policy, educated labor force, developed infrastructure, efficient administration, developed financial system, low level of corruption, low inflation, moderate tax rates etc.

The reforms implemented so far, including the ones undertaken as of the middle of 2014, are important but still insufficient to make a stimulating business environment in Serbia. Serbia ranks 91st in the World Bank’s Doing

Business Report, and in the Global Competitiveness Report published by the World Economic Forum the country is ranked 94th in the world. As a result of the aforementioned reforms and reduced macroeconomic risks, Serbia is expected to improve its ranking by 15-20 spots. However, it will still rank 20-30 spots behind the Central European countries. This indicates that additional reforms need to be undertaken to catch up with these countries.

Economic growth could be accelerated temporarily through rise in domestic demand, i.e. through wage and pension increase. However, the results would be negligible, because fiscal multipliers in Serbia are low. Moreover, this slight growth would be unsustainable in the long term because wage and pension increase would widen fiscal deficit and current account deficit, and thus push up public and foreign debt. Consequently, the government would have to apply new austerity measures or to increase taxes, which would have adverse impact on economic growth.

These first signs of recovery can be the beginning of a long-term sustainable growth in Serbian economy provided the government persists with the efforts to correct internal and external imbalances, and speeds up the reforms aimed at improving business environment. In the past, Serbia often gave up at this stage of the process, due to growing resistance to reforms and declining political support. The ruling parties would drop, delay or ease the reforms to gain some short-term political benefits.

This 40th issue of the Quarterly Monitor incorporates four Highlights. Highlight 1 (Petrović, Minić) offers comparative analysis of the failed fiscal consolidation undertaken in the period 2012-2013 and the ongoing consolidation showing good results. Highlight 2 (Ranđelović) deals with the effects of integration of construction land usage fee into property tax. Highlight 3 (Stamenković) gives the analysis of the recent trends in the numbers of primary and secondary school students relative to the trends in teacher numbers. Finally, Highlight 4 (Arsić) considers the necessary conditions for achieving a sustainable growth in Serbian economy.



TRENDS

1. Review

The central economic theme in the first quarter of 2015 was the initiated fiscal consolidation. In Q1 the first results started to show and the assessments of the public were divided and often biased. On the one hand, critics of the adopted measures (above all others reductions in pensions and public sector wages) unfoundedly evaluated them as economically wrong and ineffective. On the other hand, announcements from the Government about the huge government deficit reductions are very frequent and interpretations of the achieved results are optimistic, not only from the standpoint of healing of public finances, but also in a broader economic sense. The data we analysed unquestionably show that the fiscal consolidation in Q1 was implemented successfully. The deficit of the state is significantly lower in comparison with the previous year, even more than it was planned. However, the results are not spectacular and public finances are still far from their permanent healing. Reductions of pensions and wages haven't significantly affected the economic growth, which is good and expected. However, there are still no improvements in economic trends - in Q1 almost unchanged recession trends, started at the end of 2013, continue without reliable signs of the start of a sustained recovery in economic activity. The remaining important macroeconomic indicators are almost unchanged in Q1 compared to the previous quarters: inflation is still low, and the current account deficit of 6% of GDP is identical to that achieved in 2014.

Economic activity in Q1 recorded a relatively high year on year decline of 1.8%, partly as a consequence of the delays in the draining of the coal mines flooded in the May 2014 floods. As a result, mining and electricity production recorded a great y-o-y decline in Q1 of about 15%. However, when we exclude the mining and electricity production from the results of the economy it still has a drop of more than 1%. The movement of the seasonally adjusted GDP further confirms that the essential trends in economic activity, regardless of the impact of floods, were unfavourable in Q1. Seasonally adjusted GDP in Q1 was lower by about 0.5% compared with the quarter that preceded it - which approximates the pace of the decline in economic activity, established back in Q4 2013 (well before the floods, or the beginning of the implementation of the fiscal consolidation). The recession in which the economy of Serbia is already for a year and a half is therefore primarily the result of structural and medium-term problems of the domestic economy: unsustainable fiscal position, multi-year reduction in investments, insufficient export growth, low credit activity of the economy, and more.

The structure of the decline in economic activity in Q1 does not indicate the beginning of a sustainable GDP recovery. Namely, sustainable economic recovery can only be launched by a high growth in (net) exports and investments, while private and government consumption will inevitably decline for a few more years. The results of net exports and investment in Q1, however, were quite unconvincing. Investments did record a solid y-o-y growth of 4.4%, but this growth has not been supported by the proper growth in construction, thus we are not sure that it will continue in the coming quarters. Instead of the expected growth net exports recorded a significant decline in Q1, as imports had higher growth than exports. Private and government consumption, as expected, recorded a drop in Q1 (see Section 2. "Economic Activity").

Since in the data for Q1 we have not yet registered evident and widespread indicators of sustainable economic recovery (although there were some individual positive trends such as the growth of manufacturing industry), for now we keep the forecast of a fall of GDP in 2015 by 0.5-1 % which we presented in previous issues of QM. By the end of the year there are a lot of unknowns that may significantly affect the growth of GDP in 2015. This is primarily related to agriculture, which is affected by unpredictable meteorological factors. If the 2015 agricultural season is very successful, it could contribute to GDP growth by about 1 percentage point, which means that under such circumstances the GDP growth in 2015 could be positive.

The inflation in the first four months of 2015 was still below the lower limit of NBS target band of $4\pm 1.5\%$ and stood at 1.8% (y-o-y) at the end of April. The rise in prices was somewhat accelerated in February, but this acceleration was a result of higher prices of fruits and vegetables and tobacco products and was not widespread to other products and services (see Section 5 “Prices and the Exchange Rate”). Underlying inflation (from which the cost of food, alcohol, tobacco and energy are excluded) was -0,2% since the beginning of the year until the end of April. Therefore, we believe that the recent acceleration in overall inflation is temporary and that it will not continue after the effects of rising prices of certain products are exhausted. Low domestic demand, recession, a stable dinar exchange rate and the lack of growth of regulated prices gave a major contribution to maintaining inflation at a very low level, with an additional contribution of the low oil and unprocessed food world prices. Restoring the inflation into the NBS target band might happen in the second half of 2015 due to the low base effect and the announced increase in the price of electricity, but the decisive easing of monetary policy is certainly necessary - especially as the fiscal risks in 2015 are significantly reduced by the implementation of fiscal consolidation and the conclusion of the arrangement with the IMF.

In March the NBS began a more determined lowering of the key interest rate, which was step by step reduced from 8% to 6% in mid-June (see Section 7 “Monetary Flows and Policy”). It has been also the lowest value of this rate since Serbia introduced inflation targeting. However, the reference interest rate is still high, 4 pp above inflation and we expect its descent to continue in the following period. We believe that it is justified for NBS to continue with the easing of the monetary policy as long as the inflation does not stabilize around the middle of the target band (4%). Reducing the monetary policy restrictiveness also represents an adequate response of the NBS to the expansive policy of the ECB, since the NBS thus prevents harmful economic strengthening of the dinar against the euro.

From the second half of February a relatively stable dinar exchange rate against the euro was established, which ranged from 120 to 121 RSD/EUR and since then until the mid-June the exchange rate was held in this very narrow corridor. At the moment there are market pressures towards the strengthening of the dinar because of the increased supply of foreign currency as a result of the growth of liquidity in international financial markets due to the implementation of the measures of quantitative easing by the ECB and the delays in the increase of the key interest rate by the FED. Also, the approval of the arrangement with the IMF further influenced the reduction of the country risk and the strengthening of the dinar. The NBS reacts to these appreciation pressures by purchasing foreign currency on the interbank foreign exchange market - since the beginning of the year until mid-June the NBS bought 400 million euros and thus prevented excessive strengthening of the dinar. It is a good measure because excessive strengthening of the dinar would be harmful to the national economy and would further increase the gap between the inflation rate and the NBS target band. However, please note that due to the differences in inflation in Serbia and the Eurozone nominally stable foreign exchange rate actually means its real strengthening against the euro. Such movement of the real foreign exchange rate in the long run would not be good, because the Serbian economy still has a huge imbalance in foreign trade and unsustainably high current account deficit of around 6% of GDP.

Current account deficit in Q1 amounted to 6% of GDP, which is the same current account deficit to GDP rate as the one from 2014. By the end of the year, however, we expect that the current account deficit will gradually decrease due to the forecast of faster growth in economic activity of the Eurozone, low prices of oil products and the recovery of production in the flood-damaged facilities of the electric power system of Serbia (see Section 4 “Balance of Payments and Foreign Trade”). While the current part of the capital balance in Q1 had no major changes compared to the previous year in the financial sectors there has been a large increase in the inflow of portfolio investments. Portfolio investments in Q1 reached 475 million euros, which is higher than the amount recorded during the whole 2014 (370 million euros). The high inflow of portfolio investments in the Q1 is a result of the increased interest of foreign investors in government securities in February and March, resulting from the increased liquidity in the international market and the relatively high yield in Serbia. A positive signal to financial investors to invest in Serbia was

also given by the signed arrangement with IMF. Unlike investments in government securities, which are used to finance the fiscal deficit and public debt repayments, in Q1 there are no significant changes in the inflow of more productively directed foreign capital. Net foreign direct investments amounted to 235 million euros, which represents their significant reduction compared to the quarterly FDI inflows from 2014 (when they were also low), and the repayment of the economy and banks abroad continues (although to a lesser extent than during the previous year).

Developments in the labour market are still difficult to estimate reliably since the indicators published by the Statistical Office in the Labour Force Survey (LFS) are rather unconvincing and inconsistent with other economic indicators (see Section 3 “Employment and Wages”). According to the LFS, the unemployment rate in Q1 amounted to around 20% and the employment rate to around 50%. It is possible that these rates reflect current real situation of employment and unemployment in Serbia, but we note that since 2008 the unemployment rate in Serbia had economically rather unlikely trends: first it rose from 14% in April 2008 to over 26% in April 2012, then it decreased to 17.6% ending with October 2014, and it is now back to 20%. Such data on employment and unemployment are inconsistent with the movement of production (whose changes should create or reduce jobs), but also with the consumption of the population (which should be strongly influenced by the growth or decline in the number of employees). Wages in Q1 nominally dropped by 1.3% compared to the same period of the last year, for the first time after the constant growth since 2001 and this is primarily due to the reduction in public sector wages by 10% at the end of last year.

The fiscal deficit in the first four months of 2015 amounted to 22 billion dinars, which is significantly lower than in the same period of the last year, when it reached as much as 87 billion. The strong reduction of the deficit at the beginning of 2015 is attributed to four major factors: 1) lower government spending for pensions and salaries in the public sector, following their reduction at the end of the last year for the 5 and 10% (respectively); 2) slightly better collection of public revenues from excise duties and VAT; 3) one-off factors - aggressive collection of dividends from public enterprises, extraordinary income from the sale of licenses for 4G network and collection of arrearage of EPS through the Deposit Insurance Agency; and 4) extremely inefficient execution of public investment - in the first four months only 15% of the investments planned for 2015 was carried out, and as a rule, during this period of the year, by a third more, between 20 and 25% of annual investment, is being carried out. Economic evaluation of the factors that have led to the reduction of the deficit at the beginning of 2015 is diverse. On the one hand, reduction of government spending on wages and pensions was necessary and leads to the desired reduction of the structural deficit on expenditures that were unsustainably high. In addition, better collection of VAT and excise duties are assessed as fiscally responsible and good. On the other hand, savings that have been made with ineffective execution of capital expenditures are bad and in no way should be included in positive trends of fiscal deficit reduction. Finally, increased collection of revenues from public enterprises (on various grounds) has its good and bad sides. We must say that this kind of deficit reduction is basically not good, because not only does it not represent a permanent, structural, improvement in fiscal flows but it can also do a lot of damage - taking into account the bad situation in which, as a rule, the state and public companies currently are standing.

If current trends continue we estimate that the fiscal deficit in 2015 could be around 4.5% of GDP, which is around 1.5% of GDP better than the plan (see Section 6 “Fiscal Flows and Policy”). However, when taking into account previous analysis, a significant part of this improvement is one-time or temporary, and so a permanent (structural) improvement on the planned high deficit in 2015 of 5.9% of GDP is only about 0.6 % of GDP. Therefore we should be very careful when interpreting the favourable fiscal trends at the beginning of 2015 and the currently very low deficit, because the public finances of Serbia are still very far from their permanent healing. Consideration of possible increase of pensions and salaries in the public sector compared to their current level has no economic justification.

1. Review

Public debt (including the debt of local governments) at the end of April amounted to about 24.5 billion euros, or just over 75% of GDP. Since the beginning of the year until the end of April public debt increased by 1.3 billion euros which is a very large increase, particularly bearing in mind that at the same time, the fiscal deficit was slightly lower than 200 million euros. A much larger public debt growth than the fiscal deficit was a consequence of the strong appreciation of the dollar against the euro (the effect on the growth of public debt of about 700 million euros) and government borrowing in advance (under the current favourable market conditions) in order to finance future deficits and principal repayments of the existing debt. In the remaining months of the year due to an increase in government deposits, public debt will have somewhat slower growth, but we estimate that at the end of the year it will still come close to the level of 80% of GDP.

Serbia: Selected Macroeconomic Indicators, 2005-2015

	Annual Data										Quarterly Data					
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2014				2015	
											Q1	Q2	Q3	Q4	Q1	
Economic Growth																
GDP (in billions of dinars)	1,751.4	2,055.2	2,355.1	2,744.9	2,880.1	3,067.2	3,407.6	3,584.2	3,876.4	3,884.0	...	...	...	...	...	...
GDP	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1	2.6	-1.8	-0.1	-1.2	-4.0	-1.8	-1.8	-1.8
Non-agricultural GVA	6.2	5.1	6.9	4.4	-3.3	0.2	1.5	1.1	1.6	-2.4	-0.3	-1.8	-4.9	-2.4	-1.8	-1.8
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	-6.5	2.1	-4.3	-14.2	-9.5	-2.0	-2.0
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	-1.4	4.2	-1.3	-6.0	-2.8	4.2	4.2
Average net wage (per month, in dinars) ²⁾	17,478	21,745	27,785	29,174	31,758	34,159	37,976	41,377	43,932	44,530	41,825	44,971	44,934	46,371	41,718	41,718
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	...	...	...	...	1,863	1,896	1,895	1,864	1,697	1,697
Fiscal data																
Public Revenues	42.1	42.4	42.1	41.5	38.6	-1.5	-4.6	0.6	-3.0	3.1	-0.8	4.3	3.5	5.4	7.6	7.6
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7	3.3	3.6	-5.7	5.0	4.4	3.7	-3.0	14.8	-5.1	-5.1
Overall fiscal balance (GFS definition) ³⁾	14.8	-33.5	-58.2	-68.9	-121.8	-136.4	-158.2	-217.4	-178.7	-257.5	-68.1	-45.0	-39.8	-105.2	-21.1	-21.1
Balance of Payments																
Imports of goods ⁴⁾	-8,286	-10,093	-12,858	-15,917	-11,096	-12,176	-13,758	-14,028	-14,693	-13,393	3,384	3,759	3,731	-2,476	-3,641	-3,641
Exports of goods ⁴⁾	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,394	10,540	9,732	2,510	2,769	2,656	1,794	2,600	2,600
Current accounts ⁵⁾	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,639	-2,092	-1,857	-503	-495	-502	-312	-450	-450
in % GDP ⁵⁾	-8.6	-12.9	-17.2	-21.6	-7.2	-7.4	-9.1	-12.3	-6.5	-6.1	-6.3	-5.8	-5.9	-6	-6.0	-6.0
Capital account ⁶⁾	3,863	7,635	6,126	7,133	2,207	1,986	2,694	3,486	1,917	1,517	496	372	337	272	366	366
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	669	1,229	1,210	316	397	334	152	235	235
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	-1,332	-800	-370	509	-671	110	110
Monetary data																
NBS net own reserves ⁶⁾	175,288	302,783	400,195	475,110	578,791	489,847	606,834	656,347	757,689	788,293	696,802	756,996	787,778	788,293	854,636	854,636
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	6,486	6,015	6,513	6,641	6,486	7,094	7,094
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	1,927,668	1,815,004	1,842,407	1,888,471	1,927,668	1,919,958	1,919,958
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909,912	933,839	998,277	937,875	949,418	976,865	998,277	1,004,948	1,004,948
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	6.7	1.9	3.5	4.3	6.7	6.4	6.4
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	-8.3	-5.7	-3.3	1.2	3.7	3.7	3.7
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	54.0	52.4	54.7	48.3	49.5	48.5	46.8	48.6	49.5	49.2	49.2
Prices and the Exchange Rate																
Consumer Prices Index ⁷⁾	16.5	6.5	11.3	8.6	6.6	10.2	7.0	12.2	2.2	1.8	2.3	1.2	2.1	1.8	1.8	1.8
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	81.8	80.7	80.9	81.8	83.9	83.8	83.8
Nominal exchange rate dinar/euro ⁸⁾	82.92	84.19	79.97	81.46	93.90	102.90	101.88	113.03	113.09	117.25	115.8	115.6	117.4	120.29	121.6	121.6

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 than the previous one, in order to better adjust to criteria given in the Balance of Payments and the System of National Accounts. A more detailed explanation is given in QM no. 20, Section 4, “Balance of Payments and Foreign Trade”.

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

Recession trends in economic activity continued in the first quarter of 2015. Year-on-year GDP fall amounted to 1.8%, and seasonally adjusted GDP fell by 0.4% compared to the previous quarter. Unlike the unfavourable movements in the overall economic activity, manufacturing industry recorded a solid growth. However, this growth was not spread over the entire manufacturing industry, but was recorded in only few individual sectors, and in addition, it is not yet supported with the growth of exports, which are roughly stagnant - making it questionable whether a similar increase in the manufacturing industry will be sustainable in the coming months. Published data on economic activity in Q1 are in line with our forecast from the previous issues of QM, according to which the fall in GDP in 2015 could be between 0.5 and 1% - and which we will keep for now. A significant factor of change (upward or downward) could be the agriculture, whose results will depend on the meteorological conditions, and revisions of previously published data by the SORS are always possible. However, even if the rate of GDP growth in 2015 is zero, or maybe just a little above zero, it should not be forgotten that this results will include some one-time factors, such as establishing a usual coal and electricity production after last year's floods (with possibly exceptionally good agricultural season). Long-term sustainable growth of the Serbian economy can be based on the significant growth of (net) exports and investments, and in early 2015, there is still no hint of such trends.

Gross domestic product

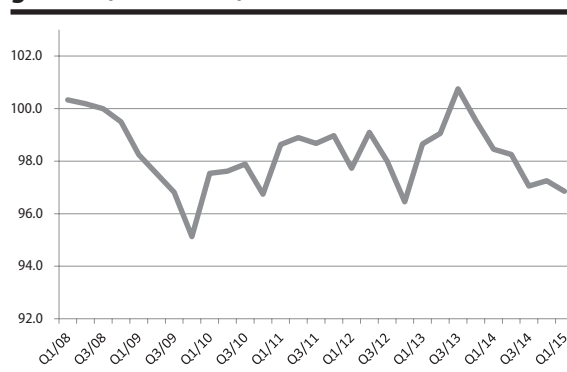
Real GDP drop in Q1 of 1.8%

According to the SORS estimates, real year on year drop of GDP in Q1 amounted to 1.8%. Part of this decrease is the result of a slow draining process of flooded coal mines, due to which the production of coal and electricity in Q1 still had a huge year-on-year decline of about 15%. The decline of the energetic sector of the economy in Q1 is huge, but was cut in half compared to the quarters that preceded it, which means that normal production volume of these sectors is gradually being restored. It is important, however, to point out what we repeated in several previous issues of QM, which is that both floods and inefficient reconstruction after them are not the main reason for the decline in GDP either in 2014 or in Q1 2015. In Q1 relatively strong annual decline in GDP of more than 1% would be achieved even if we exclude the production of electricity and coal. The level of activity of the largest part of the economy is still in similar, if not greater, decline in Q1 than the one from 2014.

Seasonally adjusted GDP indicates a decline in Q1 compared to Q4 2014

Adverse trends of economic activity are also confirmed by the seasonally adjusted indices of GDP growth (Graph T2-1). Seasonally adjusted GDP in Q1 decreased compared to the previous quarter by 0.4%. The chart clearly shows that there has been virtually no significant change in the declining trend of economic activity which started back in Q3 2013, and that a slight increase in the seasonally adjusted GDP, which occurred in Q4 (as we indicated in the previous issue of QM), proved to be brief.

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



Source: QM estimates based on SORS data

Prevaling economic trends in Q1 are even slightly less favourable than those indicated by the seasonally adjusted indices. In fact, as we have already pointed out, flooded coal mines are gradually being drained which is why from quarter to quarter production of coal and electricity is gradually recovering (Table T2-8 and Graph T2-9). Although these sectors of the economy in Q1 still have relatively high y-o-y decline, compared to the previous quarters they are rising, and

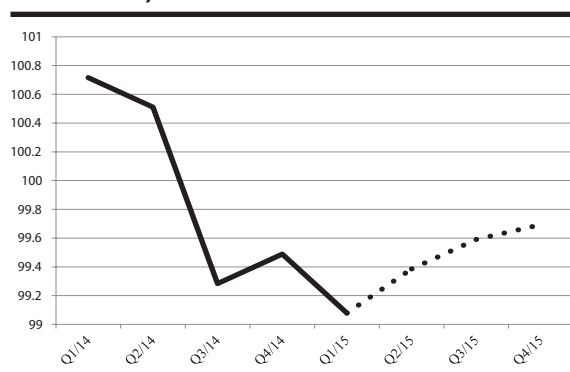
thus contributing to the growth of the seasonally adjusted GDP in Q1. Somewhat higher production of coal and electricity in Q1, compared to Q4 2014, contributed to the positive movement of seasonally adjusted GDP by about 0.2 percentage points. This means that the essential trend of economic activity is its strong quarterly decline of 0.6% (because restoring production after the floods is not an essential and long-term sustainable trend of the economy growth).

We have earlier predicted decline in GDP in 2015 between 0.5 and 1% ...

In two previous issues of QM we predicted a decline in GDP in 2015 of 0.5 to 1%, based on projected trends in private consumption, government spending, net exports and investment. In short, we expect a noticeable drop in government and private consumption due to the implementation of fiscal consolidation, reductions in pensions and salaries in the public sector, but also on the basis of labour market trends of the private sector (wages and employment) and lending activity. These two components (private and government consumption) account for by far the largest part of Serbia's GDP, thus the forecasted growth in net exports and investment according to our analysis would not be sufficient for the growth of economic activity in 2015 to be positive, but only to mitigate the GDP decline. The results achieved in Q1 are generally in line with these expectations. Minor differences are that net exports in Q1 had a decline instead of the forecasted growth, but this was compensated by the fact that the drop in private consumption was slightly lower than expected. Taking all this into account we think that the movement and structure of the fall in economic activity in Q1 approximately matched our expectations and projections of the decline for the entire 2015 of 0.5 to 1%. We can now carry out the forecast of GDP in 2015 also in another way, based on the extrapolation of the trend of seasonally adjusted GDP.

...which is for now confirmed by the current developments in economic activity

Graph T2-2. Serbia: projection of seasonally adjusted GDP by the end of the year (average 2014 = 100)



Source: QM estimates based on SORS data

In Graph T2-2 we presented possible trends of GDP by the end of the year. We used a somewhat optimistic assumption that the main unfavourable trend of the decline in economic activity, which currently stands at about 0.6% per quarter, will gradually reverse by the end of the year, and to this we exogenously added positive effects of establishing a "normal" level of coal and electricity production starting from May and announced gradual increase in production of Smederevo steel plant. The assumptions that we used to project changes in the seasonally adjusted GDP per quarter until the end of the year are presented in Table T2-4.

Table T2-3. Assumptions used for the projection of seasonally adjusted GDP by the end of the year (changes compared to the previous quarter, in percentage points of GDP)

	Underlying trend of seasonally adjusted GDP	Recovery of the electrical power sector after floods	Production growth of Smederevo steelwork	Total changes of seasonally adjusted GDP
Q1	-0.6	0.2	-	-0.4
Q2	-0.4	0.6	0.1	0.3
Q3	-0.2	0.3	0.1	0.2
Q4	0.0	0.0	0.1	0.1

Source: QM estimates based on SORS data

If these (optimistic) forecasts are materialized, GDP in 2015 will decrease by 0.6%, which is completely in line with our previous forecast. It can be visually seen from the chart that despite the optimistic assumptions (upward change of the base trend by the end of the year, a large increase in production of Smederevo steel plant) and the recovery by the end of the year, the average level of seasonally adjusted GDP from 2014 will not be reached. It is interesting to note also that in the second half of the year GDP will probably be in the positive y-o-y growth zone, but that the real reason for this is the comparison to the quarters in which the effects of floods have been most pronounced, and not so significant and sustainable growth in economic activity.

The largest part of the economy is in a recession, even if growth exceeds our forecast

Until the end of the year there is still a lot of unknown one-off factors that may affect the GDP growth in 2015. This is primarily related to agriculture which in the case of an extremely successful season could positively contribute to the annual GDP growth of more than 1 pp (or about 350 million euros). If this happens GDP growth in 2015 could be even slightly positive. However, in case that the agricultural season is poor, the effect could be opposite. What we want to emphasize is that the Serbian economy in 2015, if we exclude the effect of floods remediation, is in recession with the fall pace which (without major changes) is approximately 1.5% per year. The actual decline of GDP will be lower, because of the renewal of the energetic sector of the economy after last year's floods which will increase the growth rate of GDP in 2015 for slightly less than 1 percentage point (and reduce a total decline in GDP in 2015 from 1.5% to 0.5-1%). The establishment of normal levels of electricity and coal production therefore contributes significantly to the increase of GDP in 2015 compared to 2014 - but it is a one-off, rather than lasting, trend that will not continue in 2016.¹

The GDP structure by expenditure method in Q1 close to our expectations

We analysed the structure of the movement of GDP in Q1 by use. Table T2-4 shows the structure of the y-o-y growth of GDP by expenditure method. Private and government consumption are in line with the expectations and recorded a real drop of 0.8% and 3.5% respectively. It is important to note that these are the two largest components, which collectively participate in GDP with over 90%. The fall in private demand was somewhat lower than we expected, taking into account that in Q1 reduction of pensions and salaries in the public sector was effectuated in the full amount. A positive indication is a real growth of investments of 4.4%, which will hopefully be sustainable in the coming quarters (doubts about the sustainability of investment growth is raised by real decrease in construction activity). Net exports was the only unpleasant surprise (foreign trade deficit), which was in decline as imports had higher real growth rate than exports². For sustainable GDP growth in Serbia high, double-digit, growth in exports is necessary, with significantly lower growth of imports. In Q1, unfortunately, there are still no indication that these trends are established.

Table T2-4. Serbia: GDP by expenditure method, 2009-2015

	Y-o-y indices											Share 2013
	2009	2010	2011	2012	2013	2014	2014				2015	
							Q1	Q2	Q3	Q4			Q1
GDP	96.9	100.6	101.4	99.0	102.6	98.2	99.9	98.8	96.0	98.2	98.2	100.0
Private consumption	99.4	99.4	100.9	98.2	99.4	98.7	98.4	99.1	98.7	98.9	99.2	75.3
State consumption	100.6	100.8	101.1	102.4	98.9	100.1	99.3	100.3	98.6	101.9	96.5	17.8
Investment	77.5	93.5	104.6	113.2	88.9	97.3	96.3	99.3	92.7	100.9	104.4	17.6
Export	93.1	115.0	105.0	100.8	121.3	103.9	118.1	108.3	93.4	100.4	109.7	41.2
Import	80.4	104.4	107.9	101.4	105.0	103.3	106.2	105.4	101.1	101.0	111.0	51.9

Source: SORS

In Q1 almost all sectors of the economy in y-o-y decline

Observed by production (Table T2-5) we can see that in Q1 almost all sectors recorded a y-o-y fall which was quite equable across different sectors. Only financial activities and insurance stood out with positive y-o-y growth, but it is possible that this growth was illusory, i.e. that it was (at least partly) a result of exchange rate differences. Among other sectors important positive change compared to the previous quarters was recorded by the industrial production, about which we will discuss in more details in a separate part of this section. At this point, we will only point out that the annual decline in industrial production decreases from quarter to quarter (Table T2-5), and that it is already certain that in Q2 it will cross into the zone of positive y-o-y

¹ Explained and minor correction of forecasts of GDP growth upward from -0.5 to 0% were released by the NBS and the IMF, and these are based on the expectation that low energy prices will have a positive impact on GDP as well as on the expectations of growth in external demand, due to the program of quantitative easing in Eurozone countries. These expectations are possible, but their effects on the Serbian economy so far are not visible in the available data, and therefore we are not including them yet in our forecasts. The change in our forecast could eventually be affected by the revision of previously published SORS data upward, which already happen in the past.

² Published growth rates of exports and imports of 9 and 11% are very suspicious and it is possible that this is some mistake. Real growth rates of exports and imports depend on many variables, different exchange rates, export and import prices, and we have noticed that these were parts of GDP, whose quarterly growth rates SORS is mostly reviewed, even for several quarters backward. Regardless of the possible revision, undoubtedly, net exports in Q1 recorded a negative growth.

2. Economic Activity

growth.³ On the negative side, we could point out the y-o-y decline in construction activity which occurred after a relatively high growth in the previous quarter. Construction, however, is seasonally extremely low in the first quarter, so as a rule we don't use the movement in this part of the year as a reliable indication of the actual movement of construction activity.

Table T2-5. Serbia: Gross Domestic Product by Activity, 2008-2014¹

	2009	2010	2011	2012	2013	2014	2014				2015	Share
							Q1	Q2	Q3	Q4	Q1	2013
Total	96.9	100.6	101.4	99.0	102.6	98.2	99.9	98.8	96.0	98.2	98.2	100.0
Taxes minus subsidies	98.6	99.5	101.1	97.8	98.9	99.4	98.5	100.4	99.3	99.6	100.1	15.8
Value Added at basic prices	96.6	100.8	101.5	99.2	103.3	98.0	100.2	98.5	95.4	97.9	97.9	84.2
Non agricultural Value Added	96.7	100.2	101.5	101.1	101.6	97.6	99.7	98.2	95.1	97.6	98.2	90,6 ²⁾
Agriculture	95.2	106.4	100.9	82.7	120.9	100.8	102.4	100.7	99.9	100.9	95.3	9,4 ²⁾
Industry	96.8	100.8	103.2	105.6	106.0	92.9	99.9	94.8	86.8	90.6	96.0	26,6 ²⁾
Construction	87.1	97.6	105.9	90.2	96.1	100.9	100.2	101.7	93.2	108.0	99.7	5,1 ²⁾
Trade, transport and tourism	92.9	100.0	99.5	99.3	102.3	98.7	100.1	98.0	98.4	98.4	99.6	17,8 ²⁾
Informations and communications	97.0	103.2	102.6	102.8	99.9	101.8	102.2	102.1	101.2	101.5	98.9	5,2 ²⁾
Financial sector and insurance	102.6	101.9	98.4	92.0	90.5	98.4	95.5	98.9	97.2	102.0	104.8	3,1 ²⁾
Other	99.7	99.8	100.9	101.8	100.2	99.7	99.6	99.7	99.6	100.1	99.0	32,8 ²⁾

Source: SORS

1) In the previous year's prices

2) Share in GVA

In the coming quarters we expect the industrial production to start achieving a positive y-o-y growth, while the service sector is likely to record a decline throughout the year. Two unknowns that could significantly affect the growth of GDP in 2015, but also the growth in the coming years, are agriculture and construction. It would certainly be good for the growth of agriculture in 2015 to be solid (in case of good agricultural season). We consider the construction trend, which largely describes the movement of investment activity of the economy (construction accounts for about half of the investment activity) as more important factor for medium-term growth of the economy. Results of construction in Q1 were not convincing, but we hope that the opening of the construction season will lead to the increase in activity of this part of the economy, starting from Q2.

Unit labor costs growing

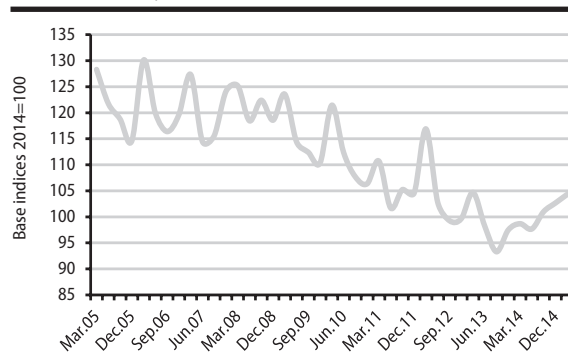
Unit labour costs⁴ (ULC), measured in dinars, continue their growth in Q1 when compared to Q4 2014, but also when compared to the same period of the last year – y-o-y ULC increase amounted to about 6% (Graph T2-6). ULC represent the share of labour costs in the added value and we measure them for total economy from which we excluded the agriculture and public administration sectors so we could assess the real trends in the “market” part of the economy (without public administration sector), and which does not depend essentially on changes of meteorological factors (such as agriculture). We consider the increase of ULC in our sample as inadequate because it indicates that the labour costs are increasing faster than production, which decreases the competitiveness on Serbian economy on international market.

Relatively strong increase in ULC, which takes place from the middle of 2013 (Graph T2-5) however, evidently tells us more about the unreliability of the data from the employment statistics, published by the SORS, than about significantly worsening productivity of the national economy. In fact, according to the Statistical Office, the employment increases although the production decreases which is highly unlikely and in the long term certainly unsustainable trend. Taking the entire observed period from the Graph T2-6 into account, it is possible however, that accelerated reduction of ULC in the period between 2009 and 2013 was also not realistic, which can also be seen in the chart. At that time ULC decreased because employment decreased faster than production in the same period. The trend of significantly greater reduction in employment than in production, in the period 2009-2013, occurred only in Serbia, and not in other countries of Central and Eastern Europe, which is why it is questionable. Most probably, a significant

³ The reason for this is partly the fact that the mining and electricity production from Q2 will be compared with the last year's results, which were bad because of catastrophic floods, but we expect that the manufacturing industry will record y-o-y growth which is confirmed with the available April data.

⁴ Unit Labor Costs in dinars are calculated for the economy (excluding the Agriculture and Public Administration sectors) and industry.

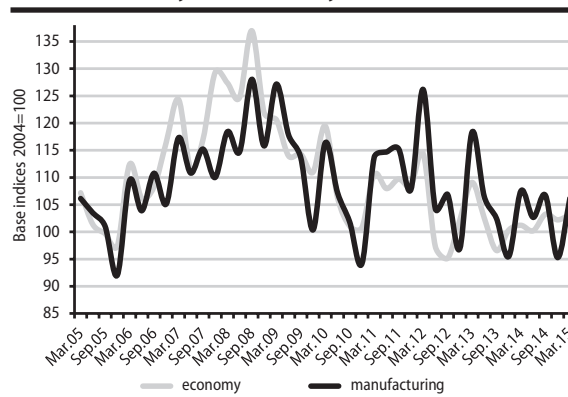
Graph T2-6. Serbia: Real Unit Labor Costs in the Economy, 2005-2015



Source: QM based on SORS and NBS data

Euro-ULC not growing due to a dinar depreciation

Graph T2-7. Serbia: Real Euro - Unit Labor Costs in the Economy and Industry, 2005-2015



Source: QM based on SORS and NBS data

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

drop of ULC did not occur then as a significant increase does not occur even now, and SORS should, in the coming period, pay special attention to the information relating to the labour market, since the signals coming from this part of the statistics are for some time inconsistent with other data.

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 whole⁵, as shown in Graph T2-7. Graph T2-7 shows that the euro-ULC only slightly increased in Q1, compared to the same period of the last year, besides the fact that the dinar-ULC (Graph T2-6) increased considerably. The reason for this is a significant real dinar depreciation throughout 2014 which compensated for this increase of the dinar-ULC. Based on the values of the euro-ULC (Graph T2-6) and the comparison with their historical values, it could be said that the price competitiveness of the domestic economy is currently at the satisfactory level with the dinar exchange rate above 120 dinars per euro, but a moderate real depreciation would even be more favourable.

Industrial production

Industrial production decreases y-o-y drop in Q1

Industrial production in Q1 recorded a y-o-y decline in production volume by 2% (Table T2-8). Compared with the data from the previous quarter, however, we see that the annual decline in industrial production is greatly mitigated, because in Q4 2014 it was about 10%, and in Q3 even higher. The overall y-o-y drop in industrial production in Q1 of 2% is actually the sum of the deep decline of mining and electricity production of about 15% and solid growth of manufacturing industry of over 4%. However, all three sectors of industry respectively improved their results in Q1 compared to the second half of 2014. Mining and electricity production due to the gradual elimination of the consequences of floods halved their decline from the second half of 2014, the manufacturing industry has moved into the zone of positive y-o-y growth (Table T2-8). Therefore, despite the achieved y-o-y fall in industrial production, indices actually point out to significant improvement of industry trends in Q1.

⁵ Excluding the Public Administration and Agriculture sectors.

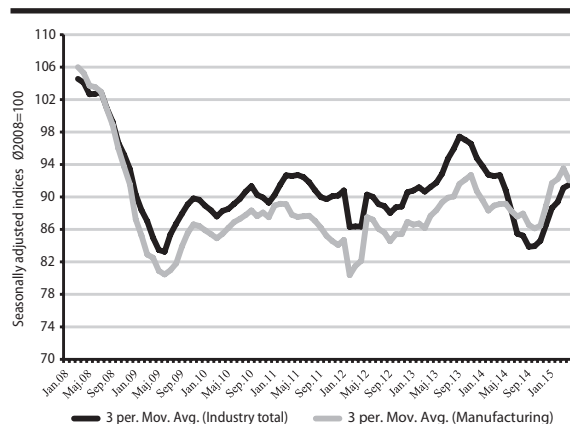
Table T2-8. Serbia: Industrial Production Indices, 2009-2015

	Y-o-y indices											Share	
	2009	2010	2011	2012	2013	2014	2014				2015		2013
							Q1	Q2	Q3	Q4	Q1		
Total	87.4	102.5	102.2	97.1	105.5	93.5	102.1	95.7	85.8	90.5	98.0	100.0	
Mining and quarrying	96.2	105.8	110.4	97.8	105.3	83.3	99.7	87.3	71.6	76.2	84.0	8.5	
Manufacturing	83.9	103.9	99.6	98.2	104.8	98.6	104.2	98.7	94.0	97.2	104.2	73.9	
Electricity, gas, and water supply	100.8	95.6	109.7	92.9	108.1	79.9	99.3	86.2	61.3	72.6	87.0	17.6	

Source: SORS

Seasonally adjusted indices show strong growth of industrial production

Graph T2-9 shows the seasonally adjusted indices of total industry production and manufacturing industry with the last available data for April 2015. The graph confirms the above claim that in Q1 there was a strong recovery of industrial production. This trend of quite strong recovery in industrial production has been actually notable since September 2014 (Graph T2-9). Similar gradients of seasonally adjusted total industrial production and individually manufacturing industry, which can be seen on the graph, actually show that the recovery of the industry was almost equally “dragged” by the manufacturing industry, as well as mining and electricity production (with gradual drying of flooded coal mines).

Graph T2-9. Serbia: Seasonally Adjusted Industrial Production Indices, 2008-2015

Source: SORS

While mining and electricity are expected to extend their seasonally adjusted growth in Q2 (when normal production after the floods will be finally established), forecasts of the movement of manufacturing industry are highly uncertain. Namely, the rapid growth of the manufacturing industry, which lasted from September 2014, was not supported by the same acceleration of the growth of exports or domestic consumption. It is therefore unlikely that a similar pace of growth in manufacturing industry from Q4 2014 and Q1 2015 will extend in the coming quarters. The April data showing seasonally adjusted decline in the manufacturing industry (included in Graph T2-9) are probably

an announcement of a slowdown in the manufacturing industry already from Q2, or stagnation on the already achieved level of production.

In 2015 industrial production growth could be around 7%

Manufacturing in the first four months of 2015 recorded a growth compared to the same period of the last year of 3.6%. By the end of the year we expect that, with some oscillations, similar y-o-y growth will be kept, and eventually increased slightly due to somewhat higher production of base metals, if in the second half of the year second blast furnace in Smederevo steel plant is started up. Manufacturing could therefore have in all of 2015 a growth close to 5%, but probably not beyond that. On the other hand, mining and electricity production will enter the zone of high double-digit y-o-y growth from Q2, since it will be compared to the months of 2014 in which the effects of flooding on the energy system were most pronounced. At the annual level, we expect that in 2015 both electricity and mining production record an increase compared to 2014 of around 20% (where the production of electricity would slightly lead). If such predictions in movements of individual sectors of industrial production are realized, then industrial production could record a growth of between 5 and 10% in 2015. We come to similar findings by observing the seasonally adjusted industrial production indices. In the first four months of the year seasonally adjusted index of industrial production was higher by 4.5% compared to the average from 2014. However with the establishment of normal production of coal and electricity (which we expect to happen in Q2), seasonally adjusted indices of industrial production will further

increase to the level which will be 8–9% above the average from 2014. At the level of the whole year this corresponds to the growth of industrial production in 2015 of about 7%.

In Q1 high growth of production of capital goods

Observed by use (Table T2-10), we see that in Q1 three of four observed product groups recorded y-o-y decline in production, while only the production of investment goods achieved a high, double-digit, y-o-y growth. Looking in more detail, the area “production of machines and equipment not elsewhere specified” which is part of the investment production, and accounts for about 3% in total industrial production, in the first quarter had an annual increase of over 115% so it’s really just due to this area a high growth of production of investment goods was achieved, and other parts of the group had even slight y-o-y decline.⁶ It is interesting to note that such a large increase in production of machines and equipment actually led to the situation that manufacturing industry in Q1 achieved growth of 4.2%, and that without it y-o-y growth of the manufacturing industry would be about 0%. This is a very good indicator of how deceptive some favourable trends in industrial production in Q1 are, as they are not sufficiently widespread in all areas of production, and the question is how sustainable they will be until the end of the year.

Table T2-10. Serbia: Components of Industrial Production by use, 2009-2014

	Y-o-y indices										
	2009						2014				2015
	2009	2010	2011	2012	2013	2014	Q1	Q2	Q3	Q4	Q1
Total	87.4	102.5	102.1	97.1	105.5	93.5	102.5	95.7	85.8	90.5	98.0
Energy	98.8	97.7	106.2	93.6	113.2	82.6	101.1	89.3	65.1	75.9	88.5
Investment goods	79.3	93.6	103.2	103.8	127.6	95.9	107.4	97.5	89.5	88.6	112.1
Intermediate goods	78.4	109.2	102.2	91.2	99.0	96.8	105.7	95.4	94.2	91.4	99.3
Consumer goods	86.8	102.1	95.4	103.2	100.7	100.7	100.2	99.6	97.5	105.6	99.4

Source: SORS

Other special purpose groups of production in decline

Other special purpose groups of industrial production in Q1 had a slightly lower production than in the same period of the last year. This is understandable for energy production, and the reasons for this have been already described several times. We will now describe the movement of the other two special purpose groups of industrial production. Production of intermediate goods in Q1 recorded a slight y-o-y decline, and this was slightly better result than in 2014. This part of the industrial production is strongly influenced by production in the Smederevo Steel plant, so we expect (if the announced increase in the production of this company is realized) that in the coming quarters the annual growth of this group will be positive. On the other hand a slight annual decline in production of consumer goods is apparently more permanent trend. This group of products is strongly influenced by the production of the food industry, which had a large short-lived (and suspicious) boom at the end of the last quarter of 2014. The y-o-y growth in the food industry in December stood at unlikely 21.2%, and we assessed it as temporary even then - which is now confirmed. If in 2015 agricultural season happens to be successful the trend of production of consumer goods could go upward at the end of the year, but for now we estimate that this part of the industry is likely to stagnate in the coming quarters.

Construction

Q1 saw a moderate decline in the construction sector

Construction recorded y-o-y decline of about 5% in Q1. This is our best estimate of trends in the construction sector, given that different indicators which describe this sector of the economy in Q1 were moving very divergently. Number of employees and the average wage in the construction sector recorded a solid y-o-y growth (over 10%), which is however, explained primarily by suppression of the grey economy, as the index value of construction works performed shows that construction in Q1 had a real annual decrease of 7.4%, and y-o-y decline of 22% was recorded in the production of cement, which is the basic building material (Table T2-11). A more detailed

⁶ This is the main reason why in the structure of GDP growth by expenditure investments have an annual increase of 4.4% since the construction and import of investment goods in Q1 have y-o-y fall.

2. Economic Activity

analysis of the construction industry is very important to us given that the movement of construction activity is a good indication of the movement in investments (construction accounts for about 50% of total investments), and growth of investments, we believe, is critical for the sustainable economic growth of Serbia in the medium term.

Table T2-11. Serbia: Cement Production, 2001-2015

	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	104.7	101.5
2015	77.9	-	-	-	-

Source: SORS

some time now very unreliable (see. Section 3 “Employment and Wages”), but this is (in contrast to the production of cement), it seems, more systemic than seasonal problem. It is also possible that the high wage growth in construction activity is a consequence of increased legalization of this part of the economy, which by its nature carries out a substantial part of activities in the informal economy.

Finally, as the most reliable indicator of trends in construction activity in Q1 we must single out the construction activity value index, which indicates the annual decline of construction of over 7%. However, this indicator has its weaknesses, because it monitors large state-owned enterprises better than the rest of the companies in this sector. Knowing that the State failed significantly in the execution of public investment in Q1, and that the construction activity value index is based towards public investments - it is likely that the decline in construction activity was slightly lower than 7.4%, so we estimated it at around 5%. This assessment is still not very reliable, and it does not refer yet to the full period of construction season, so we still do not give it much importance. However, we will carefully monitor the developments in this sector of the economy in the coming quarters, given its importance for the start of the recovery in overall economic activity in Serbia.

Interpreting individually, one by one, (contradictory) information about the construction sector, we concluded that this part of the economy in Q1 probably had y-o-y decline, which is estimated at around 5%. The production of cement is very good indirect indicator of trends in construction activity but it is seasonally very unreliable in Q1. In this quarter, cement production has seasonally very low production levels, and so a small change leads to a large y-o-y growth (or decline) which does not have a major impact on construction activity at an annual level. Therefore, all data for Q1 (Table T2-11) have very large oscillations in Q1⁷. Unfortunately the statistics of employment and wages led by the SORS is for

⁷The best example showing the unreliability of this indicator in Q1 was high growth in Q1 2014 of over 35%, which almost had no effect on the annual growth of this part of the economy.

3. Employment and Wages

The basic indicators on the labor market show an improvement compared to Q1 2014 as well as a deterioration compared to the second half of the previous year. According to the Labor Force Survey (LFS) data, the rates of activity and employment have risen while the unemployment rate has dropped. The extent and structure of employment growth are causing a number of dilemmas. The overall employment growth stands at 6.5% (about 150,000) and it happened over the same period in which economic activity dropped by 1.8% while income from taxes and social security contributions (SSC) dropped by about 1%. According to the LFS, the number of people employed in sectors which are completely or partly within the public sector has risen significantly. According to the LFS, employment rose in the private sector which is hard to explain with the growth of economic activity but can be partly explained with the reduction of the gray economy. However, certain sectors have recorded an extremely high growth of employment and real net wages which are not accompanied with the adequate growth of the extent of activities and Gross Value Added (GVA¹), but it is highly unlikely that this is the consequence of the suppressing of the gray economy. Also, in the real estate business, the y.o.y. growth in the number of people employed stands higher than 100% while the GVA has grown a modest 0.1%. Similarly, the growth of employment and real net wages in the construction industry is not accompanied with the appropriate rise in the GVA and economic activity. Wages in Q1 nominally dropped for the first time following a constant rise in the 2012-2014 period and that is primarily the consequence of a drop in public sector wages by 10% late last year. In the first quarter, wages in real terms dropped by 1.3% as the result of a relatively high drop in the public sector and growth in the private sector. Because of the drop in wages in the public sector, the difference in wages between public and private sector narrowed from about 20% in the first three quarters of 2014 to 14% in Q1, 2015.

Employment

Rates of activity and employment rising, unemployment rate dropping in Q1 2015 compared to same quarter of previous year.

According to the LFS data, we are seeing an improvement in the basic indicators of the labor market in the first quarter of 2015 compared to the first quarter of the previous year. Improvements on the labor market can partly be explained with the reduction of the informal employment from the middle of the previous year but there are dilemmas over the significant discrepancies with other macroeconomic data. Namely, the Gross Domestic Product (GDP), industrial production etc., in the first quarter are still recording significant drops and a recovery of the economy can be expected not before the second quarter while the labor market, according to the LFS data, has recorded continuous improvements since 2012?! Also, the change in unemployment rate usually lags behind the change in economic activity, that means that economic activity rises first and then the unemployment rate drops. However, the opposite holds in Serbia, with the GDP dropping along with the unemployment rate! Table T3-1 shows that the rates of activities (15-64) and employment (15-64) rose by 1.1 and 1.9 percentage points respectively in Q1 2015 compared to the same quarter of the previous year. The unemployment rate (15-64) dropped in the same period by 1.7 percentage points. According to the LFS, the y.o.y. rise in the number of employed stands at 6.5% in Q1 2015 which indicates a strong improvement of the situation on the labor market. However, in the same period we have seen a relatively high drop in the GDP of 1.8%, a drop in the real terms of taxes and SSC which casts doubts on the reliability of the data on a rise in employment.

¹ Source: QM calculation. Note: real growth rates seasonally adjusted data, reference year 2010.

Table T3-1. Trends in rates of activity, employment, unemployment and inactivity, (15-64), 2014-Q1 2015.

	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Change in pp Q1 2015/ Q1 2014
Activity rate (15-64)	61.2	62.5	62.2	61.2	62.3	1.1
Employment rate (15-64)	48.0	49.3	50.8	50.4	49.9	1.9
Unemployment rate (15-64)	21.6	21.2	18.4	17.6	19.9	-1.7
Inactivity rate (15-64)	38.8	37.5	37.8	38.8	37.7	-1.1

Source: Statistical Office of Republic of Serbia

The unemployment rate is higher than in the previous quarter but it has dropped compared to the same quarter of the previous year. The population (15+) has recorded a y.o.y. drop of 0.4% while the number of active persons (15+) has recorded a growth of 4.5%. The active population (15+) increased in Q1 2015 compared to the previous quarter by almost 133,000 people. The structure of the active population (15+) in the first quarter is as follows: employed workers 56.2%, self-employed 18.1%, helping households' members 6.5%, unemployed 19.2%. Compared to the same quarter of the previous year, the participation of the employed increased by 2.7 percentage points while the participation of the unemployed dropped by 1.6 percentage points.

According to the LFS employment is rising in most sectors but it is contradictory to economic activity trends and data from other sources.

Table T3-2 shows the trend in the number of employed by economic activity over the past year. According to it, 13 sectors have recorded growth in the number of employed in Q1 2015. In some sectors (the processing industry for example) the growth of employment is in accord with the economic activity trends while in other sectors, the growth drastically differs from the economic activity trends or Gross Value Added. The most extreme growth of more than 100% was recorded by the real estate sector. The number of people employed in that sector grew from 2,255 to 4,877. That trend is very hard to explain even if we take into consideration the changes to regulations on doing business in this sector because the Gross Value Added shows a modest growth of 0.1% while net wages in real terms dropped by 3% (see part on Wages).

According to the LFS, there is a high growth of the number of employed in most sectors which fall mainly or completely into the public sector which is opposite to reliable data from other state institutions. The problem with the data on employment growth according to the LFS can be illustrated on the example of health care and social security. According to LFS figures, the growth of the number of employed in overall (public and private) health care and social security stands at almost 10% over the past year or about 14,000. However, the public sector dominates health care and social security in Serbia and the number of employees has been reduced in that sector. The conclusion from the LFS is that there was an increase in the number of people employed in private health care and social security by about 100% (which is not very likely). Similar dilemmas exist in regard to the growth in the number of people employed in education, the state administration, defense and mandatory social security of 6.6%!

Table T3-2. Employed people aged 15+ by sector, October 2013-Q1 2015.

	October 2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Index Q4 2014/ October 2013	Index Q1 2015/ Q1 2014
Total	2,394,004	2,342,966	2,407,930	2,475,135	2,459,048	2,494,346	102.7	106.5
Agriculture, forestry and fishing	522,084	469,196	500,302	533,833	538,040	495,660	103.1	105.6
Mining	23,065	27,230	23,941	30,013	29,198	25,883	126.6	95.1
Manufacturing industry	399,654	388,127	386,935	364,053	385,369	398,323	96.4	102.6
Supply of electricity, gas and steam	37,206	31,266	40,114	42,265	37,386	26,816	100.5	85.8
Water supply and wastewater management	36,866	37,139	42,579	34,799	35,548	37,760	96.4	101.7
Construction	126,620	96,744	99,763	113,033	120,476	107,618	95.1	111.2
Wholesale and retail trade, repair of motor vehicles	288,606	300,020	304,649	309,293	305,493	357,183	105.9	119.1
Transportation and warehousing	130,882	141,317	132,088	127,928	121,550	124,578	92.9	88.2
Accommodation and food services	61,973	62,153	59,826	61,707	55,442	83,339	89.5	134.1
Information and communication	50,140	56,796	61,045	51,779	49,253	56,018	98.2	98.6
Financial activities and insurance activities	44,566	44,616	39,275	43,357	40,839	48,654	91.6	109.1
Real estate	2,028	2,255	3,835	2,595	2,467	4,877	121.6	216.3
Professional, scientific and innovation activities	63,185	68,359	73,251	64,795	61,701	57,116	97.7	83.6
Administrative and support service activities	49,175	47,585	46,846	53,186	56,725	56,866	115.4	119.5
Public administration and compulsory social insurance	132,950	135,750	138,316	153,739	138,827	144,684	104.4	106.6
Education	156,867	149,005	150,117	163,450	164,215	158,833	104.7	106.6
Health and social care	136,455	140,776	146,563	141,630	141,713	154,575	103.9	109.8
Arts, entertainment and recreation	44,823	49,158	40,040	39,780	45,794	50,740	102.2	103.2
Other service activities	86,860	95,475	118,443	143,900	129,014	104,825	48.6	148.5

Note: The sectors which fall completely or dominantly into the public sector have been shaded.

Source: Statistical Office of Republic of Serbia

Informal employment rate drops.

Structure of informal employment according to professional status has changed significantly.

The big growth in the number of people employed has also been recorded in the construction, wholesale and retail sectors, motor vehicle repair, accommodation and food services and administrative and auxiliary services. We are expressing doubts about there really being a rise in the number of employees, but that the growth is the consequence of the effects of the suppressing of the gray economy, especially in the construction industry, trade and restaurants, hotels, cafes where the gray economy is most pronounced. That effect is shown in the next table (Table T3-3), where you can note that formal employment figures are rising while informal employment figures have risen by just 0.8%.

Table T3-3. Formally employed people and structure of informally employed according to professional status, 2014-Q1 2015.

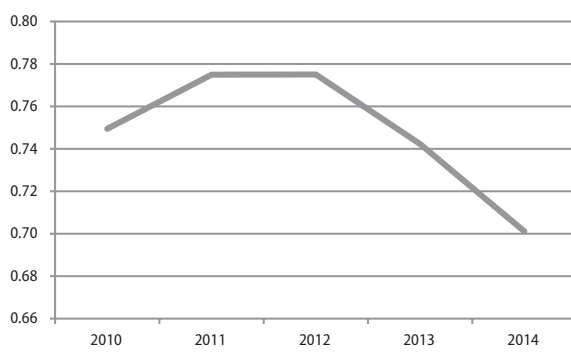
	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Index Q1 2015/ Q1 2014
Number of employed (total)	2,342,966	2,407,930	2,475,136	2,459,048	2,494,346	106.5
Formal employment	1,863,236	1,896,355	1,895,472	1,864,450	2,010,551	107.9
Informal employment	479,730	511,575	579,664	594,598	483,795	100.8
Informal employment by professional status						
Employed	62,352	71,723	118,522	123,737	108,179	173.5
Self-employed with employees	*	*	4.352**	*	*	*
Self-employed without employees	227,955	229,427	226,723	239,872	170,853	75.0
Helping households' members	187,056	209,509	230,068	226,875	202,258	108.1
Informal employment rate	20.5	21.2	23.4	24.2	19.4	

Note: * A small number of observations – estimate not published, ** less precise estimate – use with caution

Source: Statistical Office of Republic of Serbia

The growth of the overall number of people employed (6.5%, that is 151,000) is owed mainly to the growth of formal employment which showed a rise of 7.9% (147,000) in Q1 2015 compared to the same quarter of the previous year. We are recalling that the GDP dropped in the first quarter by 1.8% and that taxes and SSC dropped almost equally to wages in real terms. The question that remains is why the growth of legal employment of 150,000 with approximately unchanged wages in real terms, had no effect on the growth of income from taxes and SSC on wages? We see that there have been changes in the professional status of informally employed people. In the first quarter of 2014, the share of the employed in informal employment stood at 13% and in the first quarter of 2015 it stood at 22%. It is evident that the number of self-employed

Graph T3-1. Ratio of employed according to RAD research and LFS, 2010-2014.



Source: Statistical Office of Republic of Serbia

The overall number of people employed, according to the RAD research, dropped in 2013 and 2014 compared to the previous years (2012 and 2013 respectively) while the number of formally employed, according to the LFS, rose in 2013 and 2014 which caused a reduction of their ratio as seen on Graph T3-1. That indicates the growth of informal employment in 2013 and 2014. The rate of informal employment rose in 2014 (Table T3-3).

We expect an additional reduction in the number of people employed in the public sector considering the announced lay offs in the public sector' employment in 2015 and 2016. It is not realistic to assume that the private sector will employ the entire surplus in the public sector in 2015 at least not in terms of formal employment. Will the private sector increase the overall employment over the next few years depends primarily on investments and economic growth – chances are in general slim that overall employment will rise if the economy does not grow at a rate of 3-4% a year.

Wages

Average gross wages in real terms have dropped over the past two quarters.

Average monthly gross wages dropped nominally by 0.4% in Q1 2015 compared to the same quarter of the previous year while wages in real terms dropped by 1.3%. When we observe the 2012-2014 period we see that wages grew nominally over that entire period (Table T3-4). Following three years of the growth of nominal wages, we have for the first time a drop in nominal wages even though that drop is not significant and stands at less than half a percent. On the other hand, wages in real terms in the observed period mainly recorded a drop and it was spread widely across economic activities. Of the total of 19 sectors, 11 sectors recorded drops in real net wages in Q1 2015, compared to the same quarter of 2014. Considering that wages in the public sector were reduced as of December 2014 (wages for November), the full effects of the reduction were seen in the first quarter of 2015.

Drop in real net wages in public sector in Q1 2015.

Graph T3-2 shows the y.o.y. indexes of real net wages over the past year by selected sectors. The graph on the left shows that sectors with recorded growth of real net wages in Q1 2015 and those are: agriculture, the processing industry, construction industry and retail and wholesale trade, repair of motor vehicles. The graph on the right shows selected sectors with the highest y.o.y. drop in real net wages in Q1 2015. The greatest y.o.y. drop of 7.2% was recorded in the financial operations and insurance sectors as well as in other services. Interestingly, the comparison of wages trends in activities dominated by the state showed that real net wages dropped more in the education sector than in health care with the difference standing at 3.4 percentage points. The smaller drop in real wages in health care is probably the consequence of the fact that this activity relies to a greater extent on own income than was the case with education. The nominal reduction of wages in the public sector means that real wages recorded a drop in all activities which are completely or dominantly in the public sector in the first quarter.

has dropped while the greatest share among the informally employed is recorded by the helping households' members.

The rate of informal employment dropped by 1.1 percentage point in the first quarter of 2015 compared to the same quarter of the previous year.

Graph T3-1 shows an evident drop in the ratio of the number of people employed according to RAD research (formally employed people) and according to the LFS (formal and informal employment figures). That ratio stood at 0.7 in 2014.

Table T3-4 Serbia: Average Monthly Wages and y-o-y indices, 2012-2015

	Average Monthly Wage				Average Gross Monthly Wage Index	
	Total labour costs ¹⁾ , 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
December	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
Q4	75,332	46,371	626	386	100.3	98.4
2015						
Q1	67,730	41,718	557	343	99.6	98.7

Source: SORS

1) 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.

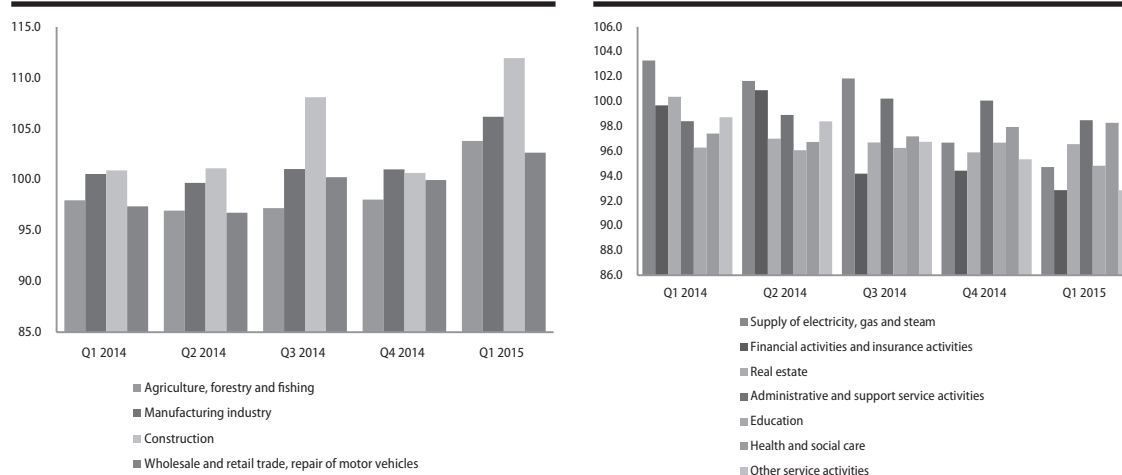
The processing and construction industries recorded a constant growth of real net wages over the past year. The effects of legalization of buildings made without permits are becoming slowly visible in the construction industry.

A big rise in real net wages was recorded in the construction industry in the first quarter of 2015 by almost 12% compared to the same quarter of the previous year. Also, we noted that real net wages in the construction industry rose constantly since the fourth quarter of 2013. On the other hand the Gross Value Added in the construction industry recorded greater oscillations during 2014 with y.o.y. real growth rates standing at -4.9%, 5.6%, -2.4% and 5.9% in Q1, Q2, Q3 and Q4, respectively. The third quarter saw a rise in wages of 8.1% while the Gross Value Added dropped by 2.4%. The growth of real wages is much higher than the value added growth in the first quarter of 2015. The real growth rate of the Gross Value Added stood at 1.2% compared to Q1 2014. The rise in wages is greater than the rise of Gross Value Added by almost 11 percentage points in Q1 2015. It is important to note that from mid-2014, labor inspection in the construction industry sector was stepped up which contributed to the registering of employees who mainly worked as informally employed in the construction industry. We believe that the noted growth of wages is owed mainly to the formalization of wages which were previously paid out informally (in cash) and we express doubts that there was such a large-scale actual growth of the average net salary in the construction industry.

The processing industry has recorded a significant growth in real net wages of 6% in Q1 2015. The processing industry has recorded a production growth of 3.4% in April 2015 compared to the average in 2014 (seasonally adjusted data) while the non-seasonally adjusted y.o.y. growth stood at 1.6% in April 2015. We see that there was a growth of real wages in the processing industry which was higher compared to the growth of production and with employment rising by 2.6% which indicates a modest growth of productivity of 0.8%. A significantly higher growth of wages than of productivity could be at least in part explained with the suppressing of the gray economy. Those salary and productivity trends increase the real unit labor costs in the processing industry which will have a negative effect on the labor market in the long term.

Besides the sectors which are dominant or are completely in the public sector, the sectors which recorded a drop in wages in Q1 2015 are the following: accommodation and food services;

3. Employment and Wages

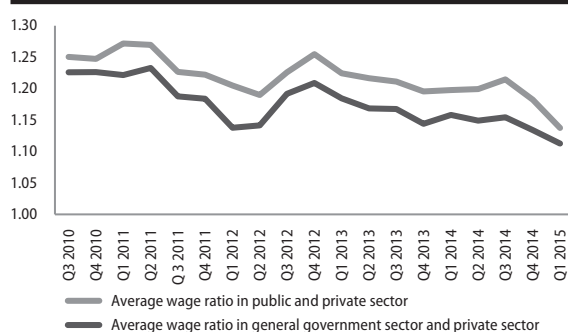
Graph T3-2. Y.o.y. indexes of real net wages, 2014 - Q1 2015.

Source: QM calculation
Note: Seasonally adjusted data

information and communication; financial operations and insurance; real estate and administrative and other service activities.

The differences in wages in the public and private sectors are growing smaller.

The reduction of wages in the public sector contributed to reducing the differences in average wages in the public and private sectors. Graph T3-3 shows the ratio of the average real net wages in the public (overall state and public companies) to private sectors², as well as the ratio of the average wages in the overall state sector³ (state administration, defense and mandatory social security, education, health care and social security) to the private sector. We compared weighted wages in the private and public sectors with the number of employees used as the weights.⁴ This comparison does not take into account the characteristics of the employed such as level of education, years of experience, productivity etc.

Graph T3-3. Ratio of average wages in public to private sectors, 2010-Q1 2015.

Source: QM calculation

and 1.11 respectively in the first quarter of 2015 which is the lowest value in the observed period (2010-2014). In the first three quarters of 2014, wages in the public sector were on average 20% higher compared to wages in the private sector and were 14% higher in the first quarter of 2015. The weighted real net salary in the private sector stood at 23,722 RSD and in the public sector at 26,983 RSD in the first quarter of 2015. If we compare wages in the overall state sector (public sector without public companies), the difference is even smaller and it stands at just over 10%.

2 Public sector includes the following sectors: B – Mining, D – Supplying electricity, gas, steam and air conditioning, E – Supplying water; managing waste waters, controlling the process of removing waste and similar activities, O – State administration and defense; mandatory social security, P – Education, Q – Health care and social security, R – Art; entertainment and recreation. The private sector covers all other sectors.

3 The overall state sector is viewed separately in order to observe those sectors which mainly do not have any commercial activities and do not have income from market activities.

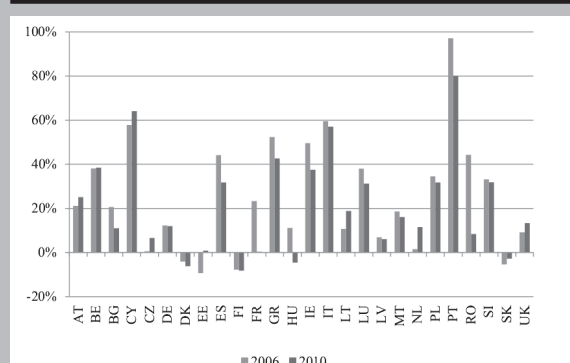
4 S – Other services cover sectors T – Activities of households as employers; activities of households producing goods and services for their own needs and U – Activities by extraterritorial organizations and bodies.

The relevant comparison should take into consideration the differences in characteristics of employees which are not analyzed in this issue of the Quarterly Monitor. We primarily have to take into account the fact that the percentage of employees with university degrees is higher in the public than in the private sector which, as expected, contributed to the higher average salary in the public compared to the private sector.

The ratio of average wages in the public to private sectors and the ratio of average wages in the state to private sector dropped to 1.14

Frame 1. Ratio of wages in public to private sectors in Europe¹

Graph T3-4. Difference in average wages in public and private sectors in % of wage per hour in private sector, EU, 2006 and 2010.



Legend: AT- Austria, BE- Belgium, BG- Bulgaria, CY- Cyprus, CZ- Cyeck Republic, DE- Germany, DK- Denmark, EE- Estonia, ES-Spain, FI-Finkland, FR-France, GR-Greece, HU-Hungary, IE-Ireland, IT-Italia, LT-Lithuania, LU- Luxembourg, LV- Latvia, MT- Malta, NL- Netherlands, PL- Poland, PT- Portugal, RO- Romania, SI- Slovenia, SK- Slovakia, UK- Great Britain
 Source: De Castro, F., Salto, M. and H. Steiner, (2013), The gap between public and private wages: new evidence for the EU, European Commission, European Economy, Economic Papers 508

Wages are higher on average in the public sector than in the private sector in most European Union countries. De Castro et al., (2013), used data from the European Structure of Wages Survey (SES) – survey conducted by Eurostat, to analyze in detail the gap in wages in the public and private sectors of the EU member states in 2006 and 2010.

Higher wages in the private sector have been recorded in Denmark, Finland, Hungary and Slovakia in 2010. Differences in wages were reduced significantly in Bulgaria, Spain, Greece, Ireland, Portugal and Romania. Somewhat smaller reductions were noted in Italy, Luxembourg, Malta, Poland and Slovenia. Reduction of those differences is mainly the consequence of lowering the wages in the overall state sector in order to reduce deficits and public debts.

The graph shows that in 2010 Portugal and Cyprus had the greatest gaps in wages, around 80% and 60%, respectively. Greece and Italy are in the second group of countries by gap size: 40-60%. The difference in average wages is somewhat lower in Austria, Belgium, Spain, Ireland, Poland, Slovakia and Luxembourg and stands at 40-60% of the wage per hour in the private sector. In other countries the difference in wages falls within the 0-20% interval of wages per hour in the private sector.

If we compare Serbia to the EU member states according to differences in wages between the public and private sector, Serbia is within the group of countries in which that gap stands at 0-20% of the average wage in the private sector, but with the reservation that the data is not directly comparable because of methodology differences.

¹ Source: De Castro, F., Salto, M. and H. Steiner, (2013), The gap between public and private wages: new evidence for the EU, European Commission, European Economy, Economic Papers 508

That shows that the reduction of wages by 10%, and their subsequent freezing and the restrictive approval of bonuses (work overtime and etc.) removed a significant part of the difference between wages in the public and private sectors. When making these comparisons we have to bear in mind that this difference is probably somewhat lower because part of the wages in the private sector are paid out in cash (informally). Considering the salary freeze in the public sector, we expect this relationship to be narrowed further in the 2015-2017 period. The reduction of the differences between wages in the public and private sectors is justified not just because of fiscal consolidation but also for promoting competition on the labor market. Still, an excessive reduction of wages in the public sector could be counter-productive because it would lead to the departure of the best personnel from the public sector (doctors, teachers and others) which would bring a drop in the quality of public services. Also, the reduction of wages in the public sector could cause an increase in corruption which means that the private expenses of the population would increase when using public services and would affect the quality of services provided by the public sector.

4. Balance of Payments and Foreign Trade

At the beginning of 2015, there were certain improvements in Serbia's balance of payments, and current and expected events in the country, as well as international circumstances, indicate possible positive trends that will lead to a lower level of current deficit in 2015. Current account deficit in Q1 2015 was 450 million euros, i.e. 6.0% of GDP and it was lower than the one realised in Q1 2014. It was the result of an improvement in the account of services, primary and secondary income, while trade deficit recorded an increase compared to the levels from the same period last year. The beginning of 2015 reversed the trend of year-on-year reduction of exports and imports from the end of 2014 and both components of foreign trade activity recorded a growth. Still, in Q1 the imports recorded a relatively fast recovery, observed year-on-year. The expected faster growth of economic activity in the eurozone countries and still relatively low prices of oil derivatives and the recovery of certain capacities that had been damaged by floods in Serbia, affected the further decline of the current deficit, which probably will not exceed 4.5% of GDP in 2015. During Q1, an inflow of 477 million euros in capital was recorded, which caused an increase of foreign reserves by 110 million euros. The inflow of capital is the result of the inflow of portfolio investments and FDI, while other investments were deleveraged. High inflow of portfolio investments since the beginning of the year was the result of increased interest of foreign investors in investing into government securities due to increased liquidity on the international market – as a result of the ECB programme of quantitative easing. Another positive signal to investors to invest in Serbia was signing of the IMF arrangement and fiscal adjustment. If the government is consistent in implementing the upcoming planned and agreed measures, a continuation of capital inflow can be expected by the end of 2015.

Current account deficit in Q1 2015 was 450 million euros, i.e. 6.0% of GDP and was lower than the one realised in Q1 2014

Balance of payments data from the beginning of 2015 indicates certain improvement and current and expected developments in the country and international circumstances suggest possible positive trends and better balance of payments results for the entire 2015. Current account deficit in Q1 2015 was 450 million euros (Table T4-1) and was by 9.3% lower than in Q1 2014. If we look at the share of current deficit in GDP, the realised deficit was 6.0% of GDP and by 0.3 pp of GDP lower compared to the levels from Q1 of the previous year. Still, the achieved share would have been even lower (5.7% of GDP) if we used the quarterly level of GDP from Q1 2014 as the denominator. That means that the year-on-year reduction of the denominator (GDP) partially compensated for the year-on-year decline in the value of the numerator (current deficit), while keeping the share of current deficit in GDP at the level realised in the previous two years (2013: 6.1% of GDP and 2014: 6.0% of GDP, see Table T4-1). Somewhat lower current deficit in Q1 compared to the same period last year was the result of improvements in the account of services, primary and secondary income, while trade deficit recorded an increase compared to the same period last year.

In the coming period, we can expect a further reduction of external imbalance, i.e. continued reduction of the current deficit

Current international economic policies and circumstances, as well as events in our national economy, indicate that further reduction of the external imbalance can be expected in the coming period, i.e. a decline in current deficit. Expected faster growth of economic activity in the eurozone countries, still low prices of oil derivatives, and continued recovery of capacities damaged by floods in Serbia – and by the same token recovery of energy and mining sectors – will impact the growth of exports and reduction of imports and will contribute to lower levels of current deficit, which in 2015 will probably not exceed 4.5% of GDP.

Trade deficit recorded an increase compared to the levels from the same period last year

Trade deficit is 1,041 million euros, i.e. 14.0% of GDP, which is 2.5 percentage points of GDP higher than the realised share in Q1 2014. During Q1 2015, goods in the value of 2,600 million euros were exported, while the value of imports in this period was 3,641 million euros¹. Share

¹ NBS data for imports and exports of goods, as well as trade balance, differ from the SORS data (which we use in the following sections of the text: Exports and Imports) because they do not include goods being finished-off (see Box 1 on changed methodology of calculating Balance of Payments in QM37).

of imports and exports in GDP in Q1 2015 was slightly above the usual values. In Q1 2015, imports were 48.9% of GDP (after 44.4% in 2012, 42.8% in 2013, and 44.6% in 2014). Compared to Q1 2014 imports and exports expressed as a share of GDP were higher by 5.5 pp and 3.0 pp respectively. Still, for the most part, this year-on-year increase of share is the result of reduced GDP compared to Q1 2014² (around 2/3 of growth can be attributed to the lower denominator – GDP). If we used GDP from Q1 2014 as base, imports would be 33.0%, while exports would be 46.2% of GDP.

For now, contribution of net exports to economic growth is lacking

Foreign trade deficit during Q1 2015 was 905 million euros, which is a year-on-year increase of 8.3%. It is 12.1% of GDP and is by 1.5 pp above the deficit from the same quarter of 2014. This shows that contribution of net exports to economic growth, which is expected this year, is for now still lacking. We expect the foreign trade deficit to keep declining this year, i.e. that the exports will increase significantly faster than imports, which will contribute to mitigating recession tendencies from the first quarter.

Table T4-1 Serbia: Balance of Payments

	2013	2014	2013				2014				2015
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
	mil. euros										
CURRENT ACCOUNT	-2,098	-1,985	-665	-380	-378	-676	-496	-541	-384	-563	-450
Goods	-4,159	-4,111	-1,195	-1,047	-728	-1,189	-904	-995	-1,076	-1,136	-1,041
Credit	10,515	10,641	2,144	2,572	2,973	2,826	2,512	2,767	2,664	2,698	2,600
Debit	14,674	14,752	3,339	3,620	3,701	4,015	3,415	3,762	3,740	3,834	3,641
Services	313	465	29	75	86	124	69	73	145	179	137
Credit	3,422	3,810	697	826	948	951	793	887	1,044	1,085	927
Debit	3,109	3,344	669	751	862	827	724	814	900	906	791
Primary income	-1,419	-1,343	-181	-291	-537	-409	-283	-462	-221	-377	-237
Credit	607	642	113	168	153	173	125	168	181	168	106
Debit	2,025	1,985	295	459	690	582	407	631	402	545	342
Secondary income	3,166	3,003	683	884	801	798	622	843	768	771	692
Credit	3,537	3,400	770	973	899	895	707	934	875	884	785
Debit	372	397	87	89	99	97	85	91	108	113	93
Personal transfers, net ¹⁾	2,701	2,442	581	772	684	664	511	697	618	617	568
Of which: Workers' remittances	2,160	1,863	457	630	554	518	378	547	469	469	437
CAPITAL ACCOUNT - NET	15	7	-1	10	4	2	2	2	3	0	4
FINANCIAL ACCOUNT	-1,630	-1,705	-568	-253	-207	-601	-478	-414	-217	-596	-366
Direct investment - net	-1,298	-1,236	-177	-266	-478	-378	-271	-435	-244	-286	-235
Portfolio investment	-1,883	-369	-1,394	370	124	-983	7	-150	-151	-75	-474
Financial derivatives	-1	-6	2	-2	1	-2	0	-3	1	-5	2
Other investment	855	1,703	141	530	309	-125	586	543	-332	906	230
Other equity	0	0	0	0	0	0	0	0	0	0	0
Currency and deposits	-228	830	-203	165	188	-377	121	141	246	322	62
Loans	1,286	757	383	322	99	482	373	386	-443	441	168
Central banks	657	574	150	148	179	180	189	186	100	99	57
Deposit-taking corporations,	675	795	282	65	156	172	214	89	197	296	25
General government	-434	-728	-145	-36	-274	20	29	30	-676	-111	90
Other sectors	389	115	95	145	38	110	-59	80	-64	157	-4
Insurance, pension, and standardized	0	0	1	0	-2	1	0	0	0	0	0
Trade credit and advances	-204	116	-40	43	24	-231	92	16	-134	143	0
Other accounts receivable/payable	0	0	0	0	0	0	0	0	0	0	0
SDR (Net incurrence of liabilities)	0	0	0	0	0	0	0	0	0	0	0
Reserve assets	697	-1,797	859	-886	-164	887	-800	-370	509	-1,136	110
ERRORS AND OMISSIONS, net	453	273	98	116	167	72	16	124	165	-32	79
	in % of GDP										
PRO MEMORIA	-6.1	-6.0	-8.3	-4.3	-4.3	-7.8	-6.3	-6.3	-4.5	-6.9	-6.0
Current account	-12.1	-12.4	-14.9	-11.9	-8.3	-13.7	-11.5	-11.7	-12.7	-13.9	-14.0
Exports of goods	30.7	32.2	26.8	29.3	33.7	32.6	31.9	32.5	31.5	32.9	34.9
Imports of goods	42.8	44.6	41.7	41.2	42.0	46.4	43.3	44.1	44.3	46.8	48.9
Balance of goods and services	-11.2	-11.0	-14.6	-11.1	-7.3	-12.3	-10.6	-10.8	-11.0	-11.7	-12.1
Personal transfers, net	7.9	7.4	7.3	8.8	7.8	7.7	6.5	8.2	7.3	7.5	7.6
GDP in euros ²⁾	34,268	33,060	8,010	8,779	8,821	8,658	7,881	8,527	8,452	8,200	7,451

Note: Balance of Payments of the Republic of Serbia are aligned with international guidelines cited in IMF's Balance of Payments Manual no. 6 (BPM6).

Source: NBS

1) Personal transfers represent current transfers between the resident and non-resident households.

2) Quarterly values. Conversion of the annual GDP to euro is done according to the average annual exchange rate (average of official daily middle exchange rates of the NBS).

2 On reasons for year-on-year decrease in the value of GDP see section "Economic Activity" in this issue of QM. For GDP in euros, which we use as a denominator, lower value in Q1 2015 compared to the level from Q1 2014 is partially owed to the depreciation of dinar against euro.

4. Balance of Payments and Foreign Trade

Growth of exports in 2015 will be positively affected by the expected recovery of eurozone countries... ..imports will increase at a slower rate due to lower domestic demand, declining import of electricity and lower price of oil

At the beginning of 2015, the trend of year-on-year reduction of exports and imports from the end of 2014 was reversed and both components of foreign trade activity recorded a growth in Q1 2015. Still, imports recorded a relatively fast recovery – year-on-year growth of 6.6%, while exports grew by 3.5% compared to last year's. This caused a year-on-year increase in trade deficit by 15.2%. Coverage of imports by exports was 71.4% and it is at the level of the previous two years (2013: 71.7% and 2014: 72.1%, Table T4-1). By the end of 2015 we expect the recovery of eurozone countries, still low prices of oil, as well as the recovery of our national energy and mining sectors to have a positive effect on the growth of exports and reduction of imports. Delayed effect of real depreciation of dinar from the second half of 2014 will also be acting in the same direction by mid-2015. The risk is associated with uncertainty regarding global energy prices and current appreciation pressures due to foreign capital inflow – as a result of high liquidity in Europe (due to the programme of quantitative easing) and better perception of foreign investors on investing in Serbia (due to the programme of fiscal consolidation and signed arrangement with the IMF).

Box 1

Considerable decline in the value of euro against dollar also affected the large differences in the dynamic of national exports, imports and trade deficit depending on the currency in which they are expressed.

Average of monthly values of euro against dollar indicate that euro is around one fifth weaker compared to dollar in Q1 2015, compared to the exchange rate of these two currencies in Q1 2014. Weakening of euro and strengthening of dollar in this period of one year influenced the value of exports of goods in Q1 2015 expressed in dollars to be by 13.5% lower than the value from Q1 2014, while expressed in euros, this value is higher by 5.2% (Table T4-2). Imports recorded a year-on-year (yoy) reduction of 10.8%, observed in dollars, and a yoy growth of 8.5% if we observe import values in euros. Thus, the trade deficit was reduced by 3.0%, according to values in dollars, while expressed in euros the trade deficit recorded a significant yoy growth of 18.0% (Table T4-2).

Table T4-2 Effects of changes in the dollar-euro exchange rate on the value and year-on-year growth rates of exports, imports and trade deficit in Serbia

	Q1 2015	Q1 2015/ Q1 2014	Q1 2015	Q1 2015/ Q1 2014
	mil. dollars	in %	mil. euros	in %
Export of goods	3,124	-13.5	2,773	5.2
Import of goods	4,359	-10.8	3,868	8.5
Goods deficit	1,235	-3.0	1,095	18.0

Source: SORS, QM

The largest part of Serbia's foreign trade is conducted with the EU countries – according to SORS data for Q1 2015 exports to EU were 68% of total exports, while imports from EU member states were 61% of the total value of imports. Also, significant part of national goods (16.6%) is exported to CEFTA countries, while 11% of total imports are from Russia. Therefore, majority of goods trading is conducted in euros, which contributed to the recorded year-on-year reduction of exports and imports expressed in dollars in the first three months of 2015, even though they recorded a growth when observed in euro values.

Ratios of foreign trade during Q1 2015 compared to Q1 2014 have slightly improved (index 102.9) and so observed year-on-year, they had a positive effect on the foreign trade balance of Serbia. Observed by sectors and areas, trade ratios in Q1 2015 compared to the same period of the previous year improved in *Agriculture, Forestry and Fishery, Mining, Information and Communications, Art, Entertainment and Recreation*, while they decreased in *Processing Industry, Water Supply and Wastewater Management*, as well as in *Unclassified Goods*. However, improvement in the trade ratio in Q1 of this year is smaller than it was in Q4 of the previous year.

Increase in the inflow of remittances is for the most part responsible for the increase in the Secondary Income account

During Q1 2015, share of net inflow on the Secondary Income account was 9.3% of GDP. That makes this inflow by 1.4 pp of GDP above the inflow from the same period of the previous year. This is primarily due to higher remittances.

Inflow of portfolio investments and FDI, while deleveraging of other investments was recorded

In Q1 inflow of capital of 477 million euros³ was recorded, which caused foreign currency reserves to increase by 110 million euros (Table T4-1). Inflow of capital is a consequence of inflow of portfolio investments (474 million euros) and FDI (235 million euros), while other investments were deleveraged (by 230 million euros). High inflow of portfolio investments in Q1 was the result of increased interest of foreign investors in investing into government securities during February and March, which occurred because of the increased liquidity on international market and a relatively high yield in Serbia. In addition, signing of the IMF agreement and the policy of fiscal adjustment also sent positive signals to the investors. In other investments there was an outflow of funds in the amount of 230 million euros – where 168 million euros was net deleveraging of loans, while 62 million euros were a reduction of balance on the *Cash and Deposit* account. Within loan activity, the central bank, banks and the state⁴ had a net deleveraging, while the business sector had a slight net borrowing (Table T4-1). In the coming period, we can expect significant investments due to the increasing liquidity, as well as the effects of measure of ECB monetary policy, which would be additionally stimulated by consistent implementation of plans in Serbia in line with the fiscal strategy and the arrangement with IMF.

Increase in NBS foreign exchange reserves was recorded

Net increase of foreign exchange (forex) reserves in the first quarter of 2015 was 110 million euros. In January, a decrease of foreign reserves by 179 million euros was recorded, which was accompanied by a considerable increase (242 million euros) in February and a more moderate increase (47 million euros) in March. The more significant part of foreign currency inflow from February was the result of NBS intervention at the interbank foreign exchange market and from the sale of RS government securities⁵. NBS intervened in Q1 with the net purchase of foreign currency at the interbank foreign exchange market in the amount of 170.0 million euros (in January NBS sold 90 million euros, while in February and March it purchased 140 and 120 million euros, respectively). The growth trend of forex reserves, which was mainly the result of purchasing securities of NBS continued in April as well⁶. In April, NBS intervened by purchasing 140 million euros and selling 30 million euros, so the sum net result from the beginning of the year until the end of April was the NBS purchase of foreign currencies in the amount of 280 million euros.

Export

During Q1 a recovery of exports was recorded...

In Q1 2015, exports recorded a year-on-year growth, after a yoy decline in value in the second half of 2014. In the first three months exports were 2.77 billion euros, which is by 5.2% above the exported value in Q1 of the previous year (Table T4-3). Part of this recovery of exports is owed to the economic recovery of European countries, consequent recovery of exports in the automobile industry compared to the exports from the second half of 2014, as well as the delayed effects of real depreciation of the local currency.

...as a result of the recovery of exports of all production groups except Energy

Decline in the global energy prices affected the exporting value of energy. Also, in Q1 a year-on-year decline in the production of electricity and mining (coal) was recorded due to delayed flood restoration⁷. Even though energy exports were 36.3% below last year's, exports of these products were only 3.7% of total exports, so this large year-on-year decrease in the value of exported energy products had no significant impact on total exports.

³ 556 million euros including the Errors and Omissions account.

⁴ The state deleveraged in the net amount of 90 million euros (Table T4-1). Out of which, the deleveraging of the state was 157.6 million euros and was accompanied by additional borrowing of 68 million euros. The additional borrowing of the state was created by using the EBRD loan for improvement of public transport and infrastructure in Belgrade and the EIB loan for the construction of the bypass around Belgrade and regional and municipal infrastructure (see Inflation Report, May 2015).

⁵ <http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=8025&konverzija=no>, <http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=8121&konverzija=no>,

<http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=8225&konverzija=no>

⁶ <http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=8318&konverzija=no>

⁷ For more details see section Economic Activity in this issue of QM.

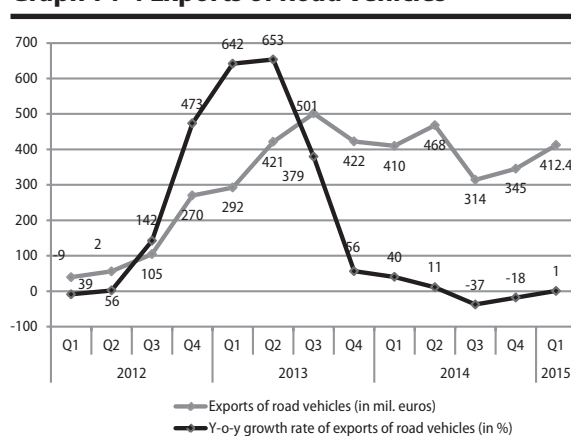
Table T4-3 Serbia: Exports, Year-On-Year Growth Rates, 2013–2015

	Exports share in 2014	2013	2014	2014				2015				2014				2015
				in %		in mil. euros		in %		in %		in %		in %		
				Q1	Q2	Q3	Q4	Q1	Q1	Q2	Q3	Q4	Q1			
Total	100.0	10,997	11,134	2,636	2,873	2,771	2,854	2,773	17.9	6.4	-10.9	-3.4	5.2			
Total excluding road vehicles	86.2	9,360	9,597	2,227	2,405	2,457	2,509	2,361	14.6	5.6	-5.8	-0.9	6.0			
Energy	3.7	519	413	97	129	102	85	62	3.9	-1.2	-29.4	-43.2	-36.3			
Intermediate products	33.1	3,633	3,681	914	949	942	875	921	14.5	1.4	-6.0	-2.4	0.7			
Capital products	25.8	2,979	2,874	719	812	643	700	760	26.1	7.1	-25.1	-11.7	5.8			
Capital products excluding road vehicles	12.0	1,342	1,336	309	344	329	355	348	11.2	2.2	-8.1	-4.2	12.7			
Durable consumer goods	5.3	523	586	122	147	150	167	133	23.0	8.0	5.8	13.9	8.6			
Non-durable consumer goods	23.5	2,410	2,614	563	617	717	717	634	12.4	10.3	6.2	6.3	12.5			
Other	8.7	932	967	221	219	217	310	264	27.7	22.2	-24.6	5.8	19.4			

Source: SORS

Export values of road vehicles were at last year's levels

Automobile exports had no significant impact on year-on-year growth of total exports, since the export value of road vehicles was at the last year's level (410 million euros in Q1 2014 and 412 million euros in Q1 2015). Year-on-year growth of exports after excluding road vehicles was 6.0%. Still, recovery of total exports compared to the second half of 2014 is the result of larger automobile exports since the beginning of 2015, primarily due to the recovery of European economies. Exports of road vehicles in Q1 reached 412 million euros, after 314 and 345 million euros realised from exports of these products in Q3 and Q4 2014 respectively (Graph T4-4). In the coming period, automobile exports could record a growth due to further recovery of European countries and low base in the second half of the year.

Graph T4-4 Exports of Road Vehicles

Source: SORS, QM

our most important export area, but it could also be the result of real depreciation of dinar from the second half of the previous year.

In 2015 we can expect a further recovery of exports due to the expected growth of economic activity in the eurozone countries

In the coming period we can expect further recovery of exports due to the expected growth of economic activity in the eurozone countries. Depreciation recorded in the second half of the previous year should also have a positive effect on exports in the next quarter. Therefore, we feel that the exchange rate in the future should work towards encouraging exports.

Imports

In Q1 a fast recovery of imports was recorded...

Total imports in Q1 2015 were 3.87 billion euros. This import value is significantly above the last year's value – increase of 8.5% (Table T4-5) and is the result of year-on-year growth of values of all imported components, except Energy imports. The significant recovery of imports occurred despite the decrease in energy prices, decline in domestic demand, as well as delayed effects of depreciation of dinar from the previous period. We expect the cited limitations (energy prices, domestic demand and dinar depreciation) will determine the dynamics of import recovery in the next period, probably limiting its growth.

...which was significantly slowed down by lower energy price

Increased value of imports was recorded in all components except in *Energy* imports. Imports of energy products in Q1 were lower by 2.5% compared to the same period last year, which is exclusively the result of extremely low energy price. According to IMF data, global energy price in dollars in Q1 2015 was by as much as 46% below the price of Q1 2014. Due to the depreciation of euro against dollar in this period, the decrease in the energy price expressed in euros in this period was 34%. When we exclude the effects of pricing on year-on-year growth values of energy, we get that energy imports were actually 48% above last year's. The biggest year-on-year growth was recorded in the imports of products classified under *Other*⁸ - which recorded a significant year-on-year increase of 51.1%. These were followed by a fast growth of imports of *Durable Consumer Goods*, while the imports of *Non-Durable Consumer Goods*, *Capital and Intermediate Goods* recorded a slightly lower year-on-year growth rate – 5.0%, 3.5% and 1% respectively (see Table T4-5). Still, this was a significant turn in the dynamics of imports of all import groups, bearing in mind that all except *Other* imports had recorded a year-on-year decline in the second half of 2014.

In the next period, relatively low energy prices, depreciation of dinar from last year and effects of implemented fiscal consolidation measures will limit the growth of imports

In the next period, we expect a slower growth of imports due to the reduced energy imports because of the expected recovery of local capacities damaged by floods, and because of maintaining the energy prices at a low level. In addition, growth of imports will be limited by low domestic demand, as a result of fiscal consolidation measures. Depreciation of dinar from the previous period will also affect the decrease of imports, but it is important that NBS prevents the strengthening of dinar in the next few years.

Table T4-5 Serbia: Imports, Year-On-Year Growth Rates, 2013-2015

	Imports share in 2014	2013	2014	2014				2015				2014				2015
				Q1	Q2	Q3	Q4	Q1	Q1	Q2	Q3	Q4	Q1			
				in mil. euros				in %								
Total	100.0	15,462	15,402	3,565	3,912	3,893	4,032	3,868	1.6	2.4	-0.3	-4.6	8.5			
Energy	13.8	2,325	2,120	511	484	558	567	499	-3.8	1.5	-0.8	-24.9	-2.5			
Intermediate products	32.0	5,130	4,930	1,173	1,255	1,257	1,245	1,185	0.8	-4.2	-7.3	-4.2	1.0			
Capital products	22.1	3,779	3,397	820	958	787	832	849	2.7	-1.8	-18.6	-19.8	3.5			
Durable consumer goods	2.0	324	305	74	73	74	83	83	-3.3	-9.0	-2.2	-8.4	12.0			
Non-durable consumer goods	14.7	2,264	2,259	513	552	579	615	539	0.6	-0.4	1.0	-1.8	5.0			
Other	15.5	1,640	2,391	473	592	638	689	714	10.4	39.3	72.7	64.6	51.1			
Imports excluding energy	86.2	13,137	13,283	3,053	3,429	3,335	3,466	3,370	2.5	2.5	-0.2	-0.2	10.4			

Source: SORS

Foreign Debt

Foreign debt at the end of February was 26.5 billion euros

At the end of February 2015, the foreign debt of Serbia was 26,497 million euros, i.e. 81.2% of GDP⁹ (Table T4-6). In the first two months of 2015, the foreign debt increased by 3.1 pp of GDP. The level of foreign debt expressed in euros for the most part increased due to the currency changes – primarily euro depreciation against dollar (because around one quarter of foreign debt is in dollars). In addition, increased share of debt in GDP was the result of the lower level of GDP which we use in the denominator. Share of foreign debt in GDP would have been around 1 pp lower if it hadn't been for the decreased value of GDP which we use as the denominator¹⁰.

Growth of foreign debt and changes in the state of its components is mostly the result of the changes in the foreign exchange rates

State of foreign debt and its components was significantly impacted by the varying values of foreign currencies. Increase in net borrowing during January and February 2015 was 668 million euros and is predominantly the result of increase in public sector's foreign debt – by 619 million euros (i.e. by 2.5 pp of GDP). To a lesser extent, increase in the value of total foreign debt was due to an increased foreign debt of the private sector – by 48 million euros (0.6 pp of GDP, Table T4-6).

⁸ This group includes mostly goods in stock.

⁹ Since March data is not available yet, in order to calculate share of foreign debt value and its components in GDP, we divided the data related to the end of February 2015 with GDP values for Q1 2015.

¹⁰ Still, share of foreign debt I GDP (and its components) would have been bigger if there hadn't been an increase in GDP value in 2014 due to changed SORS methodology, which we discussed in the previous issues of QM.

4. Balance of Payments and Foreign Trade

Increase in the public sector's foreign debt in January was 550 million euros net, and in February it was 69.3 million euros net. At the same time, NBS continued to reduce its debt toward IMF by 24 million euros. Out of the total growth of foreign debt, growth of private sector's debt during the first two months of 2015 was 48 million euros, where 29 million euros were due to the increase of long-term, while 19 million euros were for short-term debt. In this two month period, banks reduced their indebtedness (for long-term and short-term debt by 2 and 6 million euros respectively, compared to the situation at the end of 2014), while the private sector increased (31 and 25 million euros respectively for additional long-term and short-term borrowing, see Table T4-6).

In the period February 2014 - February 2015 public sector significantly increased and private sector decreased the foreign debt amount

At the end of February 2015, compared to the data from the end of February 2014, total foreign debt was by 988 million euros higher. In this period, the public sector increased its borrowing abroad by 1.7 billion euros, while total deleveraging of the private sector amounted to 719 million euros. Aside from foreign exchange differences – primarily significant weakening of euro against dollar, the reason behind growing public sector's foreign debt is that the state, after deleveraging in the first half of 2014, significantly increased borrowing in the second half of the year – utilising loans during Q3 from UAE (for securing funds for the state budget), as well as loans from the Council of Europe Development Bank, EIB and IBRD, and during Q4 loans from IBRD and EIB¹¹.

On the other hand, in the period February 2014 – February 2015, the private sector significantly decreased the amount of foreign debt. Banks deleveraged their long-term loans by 576 million euros, while businesses deleveraged by 132 million euros. Short-term debt of the banks in the observed period was lower by 60 million euros, while short-term debt of businesses increased by 47 million euros (Table T4-6).

Table T4-6 Serbia: Foreign Debt Structure, 2013–2015

	2013	2014				2015
		Mar.	Jun	Sep.	Dec.	Feb.
stocks, in EUR millions, end of the period						
Total foreign debt	25,747	25,605	25,261	26,301	25,829	26,497
(in % of GDP) ⁴⁾	75.1	75.0	74.5	78.5	78.1	81.2
Public debt ¹⁾	13,166	12,969	12,796	13,878	14,189	14,809
(in % of GDP) ⁴⁾	38	38.0	37.8	41.4	42.9	45.4
Long term	13,166	12,969	12,796	13,878	14,184	14,804
o/w: to IMF	697	515	333	247	152	128
o/w: Government obligation under IMF SDR allocation	434	436	439	455	463	490
Short term	0	0	0	0	5	5
Private debt ²⁾	12,581	12,636	12,465	12,423	11,640	11,688
(in % of GDP) ⁴⁾	37	37.0	36.8	37.1	35.2	35.8
Long term	12,384	12,497	12,312	12,302	11,538	11,568
o/w: Banks debt	3,228	3,028	2,925	2,769	2,509	2,507
o/w: Enterprises debt	9,154	9,467	9,385	9,532	9,026	9,057
o/w: Others	1	2	2	2	3	3
Short term	196	139	153	121	101	120
o/w: Banks debt	171	115	128	89	57	50
o/w: Enterprises debt	25	25	25	32	44	70
Foreign debt, net 3), (in% of GDP) ⁴⁾	42	44.5	44.7	46.0	48.2	49.6

Note: Republic of Serbia's foreign debt is calculated on the principle of "matured debt", which includes the amount of debt from the principle and the amount of calculated interest unpaid at the moment of the agreed maturity.

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 from the loans concluded before the arrival of KFOR mission, unregulated debt toward Libya, and clearing debt toward the former Czechoslovakia), of the National Bank of Serbia, local self-government, funds and agencies founded by the state, and debts for which state guarantee had been issued.

2) Republic of Serbia private sector's foreign debt includes the debt of banks, companies, and other sectors for which no state guarantee had been issued. Private sector's foreign debt does not include loans concluded before December 20, 2000 which are free from payment (943.5 million euros, out of which 423.6 million euros relates to domestic banks, and 519.9 million euros relates to domestic companies).

2) Total foreign debt less NBS forex reserves.

3) Sum of GDP values of the observed quarter and GDP values of the previous three quarters are used. Since March data is not available yet, in order to calculate the share of foreign debt values and their components in GDP, we divided the data related to the end of February 2015 with the GDP values for Q1 2015.

11 See QM 39.

5. Prices and the Exchange Rate

In Q1 and in April, inflation continued to move below the lower limit of the National Bank of Serbia target band and at the end it amounted to 1.8%. Underlying inflation (measured by the consumer price index excluding the prices of food, energy, alcohol and tobacco) was also below the lower limit of the target band and in April, it amounted to 1.9%. During past 14 months inflation was continuously moving below the target band, while underlying inflation was for 9 months consecutively below the lower limit of the NBS. Deflation trend which lasted until January was stopped, and a mild monthly inflation caused by the rising prices of temporary character (above-average seasonal growth in the prices of fruit and vegetables) was recorded from February to April. Low domestic demand, recession, as well as the lack of the growth in the regulated prices were a major contribution to maintaining inflation at a very low level, with an additional contribution of low prices of world oil and unprocessed food. The liquidity growth in international financial market, which influenced the dinar strengthening, made some room for the National Bank of Serbia to begin with greater easing of monetary policy, so in the period March-May, it reduced the key-policy rate by a total of 150 base points (from 8% to 6.5%). However, the return of inflation within the limits of the band would be more certain and desirable with the implementation of the announced, but postponed correction in the regulated prices. Since the growth in regulated prices is taken into account when target inflation is calculated by the NBS, as well as the fact that they significantly contribute to the overall inflation (about 2.0 pp in average), postponing of the increase in these prices (y-o-y decline was even recorded in Q1) impairs the price stability in the medium and long term. Other factors that can act inflationary are the effect of low last-year base and possible overflow of the dinar depreciation realized until February to the prices (this is possible only to a lesser extent, given that the dinar after February significantly strengthened). During Q1 dinar nominally appreciated by about 0.6% against the euro (0.9% at the average period), i.e. depreciated by 12.0% against the dollar (12.7% at the quarter average). Appreciation against the euro continued in April to a lesser extent, while May recorded a slight depreciation. Changes in the exchange rate are largely a consequence of global factors (liquidity growth in the international financial market due to the implementation of the ECB's measures of quantitative easing and the delay of the increase of key policy rate by FED), while domestic factors contributed to the appreciation mitigation and May's dinar depreciation (foreign currency purchases in the IFEM and the reduction in the key policy rate). The approval of the arrangement with the IMF further influenced the reduction of the country risk and the dinar strengthening. Real appreciation in Q1 amounted to about 2% while in April dinar appreciated by additional 0.6% against the euro- dinar strengthening worsens the price competitiveness of Serbia's economy, which affects the maintenance of external deficit at a high level. Real appreciation is driven more by a higher inflation in Serbia than in eurozone, and to a lesser extent, the nominal dinar appreciation.

Prices

In Q1 and in April inflation moves below the lower limit of the NBS

Year-on-year inflation amounted to 1.8 % at the end of first quarter of 2015, which is the same amount in comparison to late 2014 (Table T5-1). The movement of yoy inflation on a monthly basis shows its strong decline in January (mostly due to the leaving from the calculation of a high monthly inflation from January 2014), and its moderate growth in the coming months. Thus, year-on-year inflation amounted to 0.1% in January, 0.8% in February, while in March and April it amounted to 1.8%. These values are below the lower limit of the tolerated target deviation of the NBS, below which inflation stands more than a year (i.e. from March 2014, when the inflation fell below the lower limit of the target band). Underlying inflation (measured by the consumer price index without the prices of food, alcohol, tobacco and energy products) was also in the long run continuously moving below the lower limit of the NBS target and in March it amounted to 1.9%, where it remained in April. Monthly trend of year-on-year underlying infla-

5. Prices and the Exchange Rate

tion is relatively stable, and since falling below the lower limit of the NBS target band in August 2014, it is in range from 1.6% to 2.2% (Graph T5-2), which is consistent with the explanation that the low inflationary pressures are still largely a consequence of low aggregate demand, given that there still hasn't been any significant spillover of dinar depreciation from the period July 2014-February 2015 to the prices. Domestic factors that have affected the inflation movement below the target are: a continuing recession, fiscal consolidation (reduction in pensions and public sector wages), which further reduced aggregate demand, the lack of growth in regulated prices and a weak exchange rate depreciation spillover effect on prices, as well as stabilization and strengthening of the dinar since February 2015. The strong fall in the prices of primary agricultural products on the world market in the past year (observed by Commodity Agricultural Raw Materials Index) has contributed to the low cost pressures in food production (observed by Fuel Commodity Price Index) in the world, as well as the domestic market. Even more expressive fall in the world oil price, from June 2014 to January 2015, affected the drop in the prices of petroleum products and contributed to the reduction of cost pressures in almost the whole economy. The price of oil has stabilized since January, and since March it has a trend of a moderate growth, but it is still far below the maximum price from 2014 (it is currently at about 57% of this value). In addition to domestic and external factors, inflation trend is affected by the NBS measures and the corrections of the regulated prices. Passive attitude of the NBS toward deflation (slow and insufficient mitigation of monetary policy restrictiveness) in the period of the second half of 2014 and January 2015 also did not contribute to the return of the inflation within the target band,

Table T5-1. Serbia: Consumer Price Index, 2009-2015

	Consumer price index				
	Base index (avg. 2006 =100)	Y-o-y growth	Cumulative index	Monthly growth	3m moving average, annualized
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					
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
nov	180.8	2.4	2.2	0.0	2.0
dec	180.0	1.8	1.8	-0.4	-2.4
2015					
jan	179.6	0.1	-0.2	-0.2	-2.6
feb	181.1	0.8	0.6	0.8	0.7
mar	182.4	1.8	1.3	0.7	5.5
apr	183.4	1.8	1.9	0.5	8.7

Source: SORS.

given that the NBS in this period directed its operations exclusively towards the stabilization of dinar exchange rate. However, as the strengthening of the domestic currency started in January, and the liquidity growth in the international financial market appeared in March, it opened the doors for monetary policy easing, and since March, the NBS has repeatedly reduced the key policy rate (KPR) by total of 1.5 percentage points (p.p.). Price trend in Q1 was at the expected level taking into account the absence of the mitigation of the restrictive monetary policy until the mid- March and the absence of the regulated price growth (electricity) which was announced only after the end of the heating season, so Q1 was marked by moderate inflation of 1.3%. The electricity price growth did not even occur at the end of May, while NBS started implementing the measures for monetary policy easing considerably stronger than in the previous period. April recorded the inflation of about 0.5%, but year-on-year inflation (both overall and underlying) remained below the lower limit of the NBS target band,

where it will continue its trend during Q2 and possibly Q3, if the correction of the regulated prices is postponed again. Low aggregate demand will act disinflationary, additionally enhanced by disinflationary effect of the implementation of fiscal consolidation measures and possible implementation of structural reform measures, while the low last-year base effect and the NBS measures directed to returning the inflation within the target band will have inflationary effect.

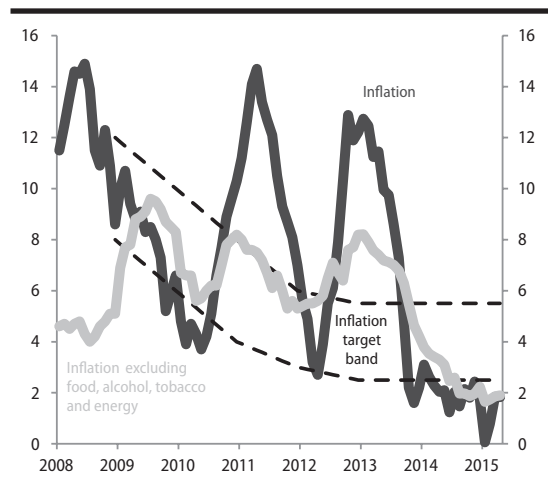
Since mid May, NBS has begun reducing the key policy rate more intensively

The National Bank of Serbia, after a four-month break, has begun reducing the key policy rate since March, so that during March, April and May key policy rate reduced by total of 150 basis points (b.p.), from 8.0% to 6.5% (Graph T5-3). These decisions of the Executive Board of the NBS have been made keeping in mind the long-term inflation trends below the target, and still low inflationary pressures. In addition, important factors were also the stability of the foreign exchange market and a moderate strengthening of the dinar against the euro, as well as favorable developments in the international environment and an increase in global liquidity due to the commencement of the implementation of quantitative easing measures by the European Central Bank (ECB) and postponed increase of the key policy rate by FED. Besides the impact on inflation, the reduction in key policy rate by NBS represents an adequate measure directed towards mitigation of recessionary trends in Serbia, given that the recovery of the economic activity is not expected in this year.

The National Bank of Serbia reduced the required reserve rate in January by 1 p.p. (a reduction from 27% to 26% to the portion of the foreign currency base with maturity up to two years and a reduction from 20% to 19% to the portion of base with maturity over two years) and at the same time increased the percentage of foreign currency reserve requirement that is allocated in dinars by 2 p.p. (from 36% to 38% and from 28% to 30% depending on maturity). By applying this unconventional monetary policy measures- by reducing the reserve requirement rate and increasing the rate of allocation of its dinar portion by twice the percentage, the supply of foreign exchange is indirectly increased and the supply of dinars is reduced. Doing so, the NBS influenced the mitigation of dinar depreciation, but also the consequent reduction in inflationary pressures.

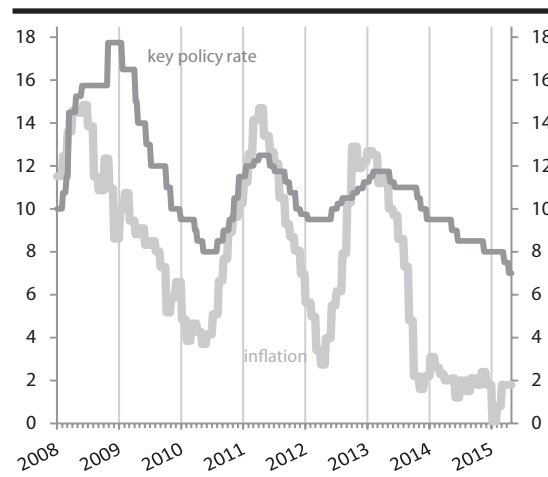
Expansionary monetary policy of the ECB, accompanied by the weakening of the euro against most other world currencies, negative or low inflation in the countries of Central and Eastern Europe, as well as low oil prices have created space for central banks in the region to reduce the key policy rate. Compared with other countries in the region, which also implement the flexible exchange rate regime, at the end of May Serbia had a relatively high key policy rate (a higher key policy rate was only in Turkey, which has a relatively high inflation and volatility of the exchange rate), but in comparison with them, inflation in Serbia was at a much higher level. In Serbia, the key policy rate amounted to 6.5% (while inflation was 1.8%), the Czech Republic 0.05% (infla-

Chart T5-2. Serbia: Y-o-y Inflation Rate and Underlying Inflation and the NBS Target Band 2008-2015



Source: NBS and QM estimates

Chart T5-3. Serbia: NBS Reference Interest Rate and y-o-y Inflation Rate, in %, 2008-2015



Source: NBS

tion of 0.5%), Croatia 5% (inflation -0.1%), Poland 1.5 % (inflation -0.9%), in Romania 1.75% (inflation of 0.6%), Hungary 1.65% (inflation 0.0%) and Turkey 7.5% (inflation 7.9%). In late May, the key policy rate in Serbia was the lowest in recent economic history, but was still higher by 4-5 percentage points than the rate of inflation. Therefore, we estimate that it is necessary that the NBS continues with reductions in key policy rate in the following months.

Regulated price growth is an important component in determining inflation target

Growth in regulated prices is an essential component for determining the medium-term targets of inflation movements by the NBS. These prices in the consumer price index participate with weight of about 20%, and the NBS has so far assessed their growth at about 10% per year, which is in accordance with the historical growth of these prices in recent years and with nominal and real convergence towards price levels in Euro zone. Target CPI growth without regulated prices is determined at the level of the European Union target of 2%. Regulated prices contribute to overall inflation target level of 4% by as much as 2 percentage points, due to a high rate of their growth, while all other prices also contribute by 2 percentage points (equal contribution to inflation is provided by regulated and all other prices). Growth in regulated prices is essential in order to ensure the long term convergence to the European Union prices, while their lack of growth is poor, not only because it keeps inflation at levels below the target band (which is also determined taking into account their growth), but because the price growth, which must certainly continue to grow in the future, is delayed, thus delaying of their corrections would cause a faster pace of the adjustments in the future. It would then cause a higher inflation target and greater instability in dynamics of the overall price index. In addition, the lack of growth of some regulated prices along with increasing the price of other goods or services that serve as their substitutes, distorts a given market. An example that is presently relevant is - the growth in the prices of natural gas and services of central heating that is not accompanied by an increase in electricity prices. This leads to distortion of the consumer choice, resulting in socially undesirable and inefficient outcome - the use of electricity for residential heating, since in this case it is a cheaper option for the consumer.

The uncertainty in the international environment is reduced

After the uncertainty at the beginning of the year, the situation in the international surrounding is calming down - the Fed did not increase its key policy rate, while the ECB started implementing measures of quantitative easing (similar to Fed's measures in the previous years). Expansionary policy of the European Central Bank, the depreciation of the euro against other major world currencies and low oil prices contribute to economic recovery in the euro area (it is expected that growth in the euro zone will be 1.5%, but this is still less than expected growth in the US of 3, 0%), which is gradually spilling over to region of Central and Eastern Europe. From March to September of the current year (and longer, if it is determined that the inflation in the medium term further deviates from the level consistent with the ECB's definition of price stability) ECB will inject over 1,100 billion euros, by purchasing the securities of the Member States of the euro zone. Results of quantitative easing are encouraging and it is estimated that deflation in the euro zone will not be continued, while real interest rates decline, the euro weakens, which should have a stimulating effect on the economy. Financial markets have reacted by reducing the yields on government securities in all member states of the euro zone, with the exception of Greece, where the yields on government securities increased due to investor fears that it could get out of the euro zone or that it will not be able to finance its liabilities. ECB's measures contribute as well to the increased liquidity in the international financial market, despite the expectations that the Federal Reserve System of the United States will start increasing key interest rate in this year, although it is still unknown to what extent and when it will start with its increasing (year-on-year inflation in the United States in April amounted to -0.2%, while core inflation, whose index excludes food and energy, amounts to about 1.8%). Different character of the monetary policy of the ECB and the Fed's announced measures is likely to contribute to further weakening of the euro, which would increase competitiveness and contribute to the recovery of the euro zone and to some extent spill over to other countries in the region, including Serbia.

- Moderate inflation in Q1...** Inflation achieved in the first quarter of 2015 amounted to 1.33% (Table T5-4), or by month: -0.22% (deflation) in January, 0.84% in February and 0.72% in March. After a long period of deflation, in February this trend stopped, and since then, in coming months, consumer price index continued with its moderate growth. The greatest contribution to inflation in Q1 was provided by the price growth of a greater part in the group of unprocessed food (excluding prices of fresh meat, which were lower than in the previous quarter) and in the group of non-alcoholic drinks as well as the increase in prices of gas and central heating of apartments while drop in prices of pharmaceutical products, the fall in prices of social care services and the expected seasonal drop in prices of clothing and footwear had a disinflationary effect. Prices of food and alcoholic beverages recorded the growth of 4.2% in Q1, where the unprocessed food prices provided the greatest contribution: the price of fruit and vegetables was slightly higher than the seasonally expected and amounted to 13.2% (contribution to inflation of 0, 3 pp) and 18.2% (contribution of 1.0 pp) respectively, while the decline in the price of fresh meat of 2.8% (contribution -0.2 pp) acted disinflationary. Prices of processed food also made a positive contribution to inflation, among which the largest contribution came from the increase of prices in the group of alcoholic beverages (rise of 4.1%, the contribution of 0.14 pp). From the products in the regulated price group, natural gas went up in March, while the central heating price increased in January and in March, and their growth at the end of Q1 amounted to 9.7% (contribution to inflation of 0.06 pp) and 3.5% (contribution of 0.05 pp), respectively. The correction of excises increased the prices of alcoholic beverages by 2.0% (contribution of 0.05 percentage points). Prices of pharmaceutical products decreased for the most part in January, and partly in February, so that at the end of Q1 their decline amounted to 2.6% (contribution of -0.08 pp). A significant drop in prices of social care services in January, continued on a smaller scale in February and March, was a consequence of reduced price of services in kindergartens under the jurisdiction of local governments, due to the implementation of the new Rule on the criteria for determining the price of services in kindergartens. The fall in prices of social care services in Q1 was 25.8% and contributed to inflation of -0.07 pp. Seasonal fall in the prices of clothing and footwear by 1.57% (contribution of -0.07 pp) made an additional disinflationary effect in Q1. Car prices in Q1 fell by 1.2% (contribution of -0.03 p.p.) which is a direct consequence of the dinar exchange rate appreciation in this period (similar, the prices of cars, in the previous quarter, recorded a growth due to the depreciation of the dinar exchange rate).
- ... and in April 2015** Increase of prices in the group food and non-alcoholic beverages and increase in prices of tobacco products made a largest contribution to April inflation which amounted to 0.55%. Within food prices, the biggest contribution was given by the continued growth of fruit and vegetable prices from Q1, and it amounted to 6.1% (contribution of 0.12 pp) and 2.1% (contribution of 0.11 percentage points), respectively. Cigarette prices following a drop in Q4 2014 and stagnation in Q1 2015 rose by 4.0% in April (contribution of 0.19 percentage points). Although the excise tax on tobacco products increased several times in the last year (July 2014 and January 2015), it was not accompanied by an increase in the price of cigarettes. The reason for this is a drop in turnover on the market and greater competition between producers, who are struggling to keep their position in declining markets, and the possible dumping by some manufacturers. In Q4 2014, these rates were reduced and in Q1 remained at the same level, so it could not be expected this trend to continue in the long term, which was shown by the April's growth in these prices, whereas in forthcoming period their further growth is expected. The prices of petroleum products slightly increased (in Q1 and in April for a total of 0.5%, giving a contribution to inflation of about 0.03 percentage points) as a result of a slight increase in the price of crude oil and the depreciation of the dinar exchange rate against the dollar. The price of oil type Urals, which Petroleum Industry of Serbia processes in its refineries, fell in Q1 by 2.7% to \$ 55.23 / barrel (at the beginning of 2014 it amounted to \$ 56.75, the lowest was in January - below \$ 47, in February and March increased above \$ 60, only to drop to 55.23 US dollars per barrel at the end of March) in April, then rose to \$ 63.86 in May, moving about 64 dollars for a barrel. In the reporting period, the dinar exchange rate against the dollar depreciated from 99.46 RSD / \$ at the end of 2014 to 108.14 RSD / \$ at the end of April, at times moving above 111 RSD / \$.

Overall inflation is growing, while underlying inflation is still low

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

	Share in CPI (in %)	price increase in Q1 2015	Contribution to overall CPI increase (in p.p.)	Price increase in April 2015	Contribution to overall CPI increase (in p.p.)
Total	100.0	1.3	1.3	0.55	0.55
Food and non-alcoholic beverages	32.8	4.2	1.4	0.67	0.22
Food	29.2	4.2	1.2	0.71	0.21
Alcoholic beverages and tobacco	7.4	0.8	0.1	2.44	0.18
Tobacco	4.7	0.0	0.0	3.99	0.19
Clothing and footwear	4.5	-1.6	-0.1	0.15	0.01
Housing, water, electricity and other fuels	13.6	0.7	0.1	0.00	0.00
Electricity	4.8	0.0	0.0	0.00	0.00
Furniture, household equipment, routine maintenance	4.6	0.4	0.0	0.52	0.02
Health	5.0	-1.8	-0.1	0.12	0.01
Transport	12.9	0.2	0.0	0.06	0.01
Oil products	5.8	0.2	0.0	0.29	0.02
Communications	5.0	1.8	0.1	0.38	0.02
Other items	14.3		-0.2		0.08

Source: SORS and QM estimates

Underlying inflation (inflation without food, alcohol, tobacco and energy products) was at a stable low level during Q1 and in April (Graph T5-5). Insignificant growth recorded in December 2014 was caused by the changes in the prices of one-off character- there was a rise in the prices of products that largely depend on the dinar exchange rate, given that these are almost exclusively imported goods (cars and telephone equipment) and when the amount of December inflation came out from the calculation of the annualized three-month average in March (shown in the

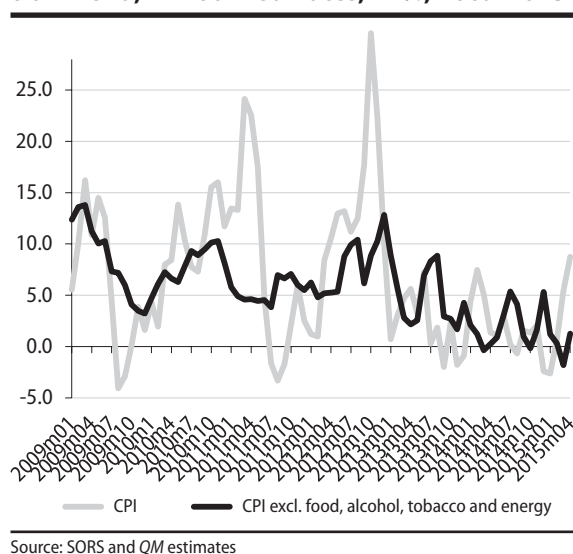
Graph), there was a sharp drop to a negative value of -1.8%. As the period of depreciation of the dinar ended in early February, which was followed by a period of appreciation, it is expected that the future dynamics of underlying inflation in the short term will be stable, without major and lasting changes, especially given the trend of weakening aggregate demand, which significantly affects its movements. Overall inflation (annualized 3m average) during the first two months of Q1 was at a very low level, and in March and April climbed to a moderately high 5.5% and 8.7%, respectively. However, this growth is largely a consequence of the seasonal increase in fruit and vegetable prices in February, March and April, which was slightly higher than expected, which means that it does not reflect the long-term trend in inflation. Also, the share of contribution to the growth in the fruit and vegetable prices in overall inflation in the period January-April was almost 80% (contribution to the rise in the prices of fruits and vegetables was 1.45 percentage points, while the overall inflation during these four months amounted to 1.88%), and as these prices stabilize and fall in the following months, while their high inflation comes out from the calculation of annualized three-months average in the first months of the year, so will the value of 3m average of overall inflation inevitably fall. Regulated prices in Q1 continued to fall (drop of 0.1%, contribution to the CPI from -0.02 pp and this is largely a result of falling prices of medicines and residence of children in kindergarten), although considerably milder than in the previous two quarters. Observed at year-on-year level, regulated prices at the end of March fell by 2.0%, which is happening for the first time since the CPI rate has been measured (the average in previous years is around 10%). The cause of this movement is primarily a fall in the price of cigarettes and medicines and the absence of adjustments in electricity prices throughout 2014 and during 2015. The announced increase in electricity prices of 15% after completion of the heating season did not occur and is unlikely to be realized in Q2, and it is uncertain whether an increase will occur for the announced amount, or some reduced. The National Bank of Serbia currently estimates that an increase in electricity prices will occur in Q3 and by 7.5%, which will have a direct impact on inflation by about 0.35 percentage points.

NBS measures contribute to the return of inflation within the limits of the target band, but the regulated price growth is missing

Starting from March, the NBS has repeatedly reduced its key policy rate (total of 150 bp) and it currently amounts to 6.5% (this is its lowest level in a regime of inflation targeting), which is a good measure to return inflation within the target band. When depreciation pressures ceased to act in February, the NBS instead previously led policy of the exchange rate stabilization started implementing the measures with the aim of inflation targeting. Central projection of the NBS

inflation trends is such that in Q3, inflation should be returned within the limits of the target band and that by the end of 2016 is within that range. The main factors that will influence the return of inflation within the target are the increase in prices of electricity, tobacco and oil products, which in the previous year contributed to the inflation moving below the target. NBS has halved the amount of the expected increase in electricity prices (from the previously announced 15% that did not realize to now expected 7.5%), while even the realization of this increase is uncertain, given that the previously announced price increase did not occur with no explanation whether, in which amount and when it will be implemented. Spillover effect of electricity prices to other prices would be minimal. Another important factor is the increase in the price of cigarettes, which was already recorded in April, and is expected to continue in coming months, as the cost of the excise tax increase in the previous period was fully borne by producers, which even led to price cuts in the conditions of a strong competition and reduced demand and that could not be continued in the long term. Prices of petroleum products are mildly increasing, since the global price of oil increased slightly and the dinar considerably depreciated against the dollar, thus they are expected to increase in the future. As has already been mentioned, the main disinflationary

Chart T5-5. Serbia: CPI and Underlying Inflation Trend, Annualized Rates, in %, 2009-2015



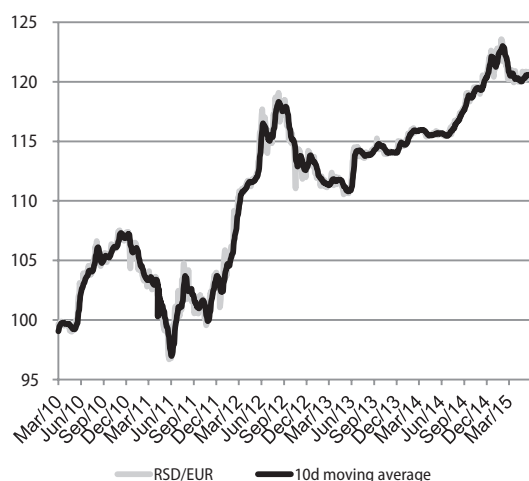
factor in the previous period was the lack of growth in regulated prices (their growth at average historical level of 10% was expected, but, on the contrary, y-o-y decline in Q1 was realized), which endangered adequate monitoring and inflation targeting by the NBS. It is expected that gas prices will decline in the coming quarters, which will have an additional disinflation impact. The spillover of the dinar depreciation realized from the mid 2014 till February 2015 on the prices (which acts with a lag of a few quarters) could boost inflationary pressures to a lesser extent, while the main risks for the inflation projection relate to the movement of primary product prices, deviation from the assumptions on the growth of regulated prices and to a lesser extent the success of this year's agricultural season.

The exchange rate

Appreciation in Q1 and in April 2015

The nominal appreciation of the dinar against the euro in Q1 was 0.6% at the end of the period, or 0.9% on the period average. In comparison to the US dollar, the dinar weakened at the end of Q1 by 12.0%, i.e. 12.7% on the quarter average level, which is almost entirely a consequence of the euro weakening against the dollar. On a monthly basis, there was a strong depreciation in January, which was annulled by even stronger appreciation in February, while stabilization occurred in the coming months (Graph T5-6). January continued with significantly stronger depreciation (started in the mid last year) when the dinar weakened by 2.1% against the euro, i.e. 9.5% against the dollar (0.9% and 7.2% on the level of the period average). Depreciation pressures ended in the early February, (when the dinar exchange rate reached more than 123 dinars per euro), which was followed by a strong appreciation, when the dinar strengthened by 2.6% against the euro, i.e. 1.5% against the dollar, at the end of February. After that, there was a period of stabilization and the exchange rate moved between 120 and 121 RSD/euro, where it currently stands (at the end of May, the dinar strengthened only slightly compared to the end of 2014). Increased liquidity at international financial market has influenced the direction of capital flows towards the emerging markets, including Serbia. Conclusion of the precautionary arrangement with the International Monetary Fund has contributed to a more favorable perception of the risks when investing in Serbia, thus the non-resident investments in government securities were

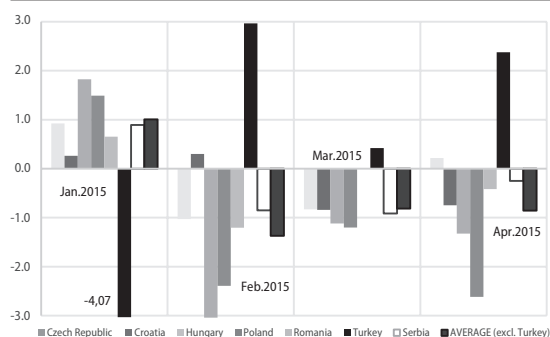
5. Prices and the Exchange Rate

Chart T5-6. Serbia: Daily RSD/EUR Exchange Rate, 2010-2015

Source: NBS

the dinar would negatively affect the export of Serbia, and in the medium term, the growth of economic activity and employment. It is therefore essential that the NBS with various measures of monetary policy (interest rates, required reserves, etc.) prevents strengthening of the dinar against the euro. We estimate that the moderate depreciation in the next few years would be an acceptable compromise between the need to improve the price competitiveness of Serbia with the exchange rate and the need to prevent high exchange rate fluctuation.

The trend of the dinar exchange rate has largely been influenced by global factors (growth of liquidity in the international financial market). The signing of the agreement with the IMF further influenced the decrease in the perception of country risk, exchange rate stabilization and strengthening of the dinar in Q1, while in April, NBS interventions (decrease RKS and purchase of foreign exchange in the IFEM) contributed to the dinar appreciation to be the lowest when compared to other currencies in

Chart T5-7. Nominal exchange rate depreciation (in %) in Period of January - April 2015 in Chosen Central and Eastern European Countries

Source: Eurostat, NBS, QM estimates

high in February and March, which was reflected in their higher demand for dinars and the appearance of the appreciation pressures. The National Bank of Serbia intervened by selling 90 million euros in January, purchasing 140 million euros in February and 120 million euros in March. Then in April, the NBS intervened by net purchasing 110mln euros (purchasing 140 and selling 30 mln euros), while in May there was no NBS interventions at the interbank foreign exchange market. Since the appearance of the appreciation pressures, the NBS intervened by purchasing foreign exchange and mitigating the greater dinar strengthening. Strengthening of the dinar is the result of exogenous, mainly financial factors and is not in accordance with the competitiveness of the Serbian economy. Possible strengthening of

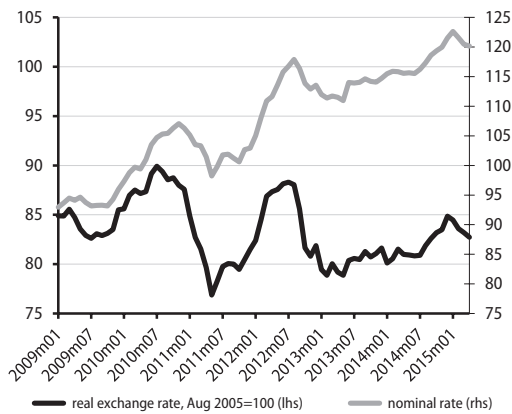
the dinar would negatively affect the export of Serbia, and in the medium term, the growth of economic activity and employment. It is therefore essential that the NBS with various measures of monetary policy (interest rates, required reserves, etc.) prevents strengthening of the dinar against the euro. We estimate that the moderate depreciation in the next few years would be an acceptable compromise between the need to improve the price competitiveness of Serbia with the exchange rate and the need to prevent high exchange rate fluctuation.

The trend of the dinar exchange rate has largely been influenced by global factors (growth of liquidity in the international financial market). The signing of the agreement with the IMF further influenced the decrease in the perception of country risk, exchange rate stabilization and strengthening of the dinar in Q1, while in April, NBS interventions (decrease RKS and purchase of foreign exchange in the IFEM) contributed to the dinar appreciation to be the lowest when compared to other currencies in countries with similar exchange rate regime (with the exception of the Czech Republic, where a slight depreciation was realized, see Graph T5-7). Fluctuations of the exchange rate in Serbia in April were among the lowest compared to other countries of Central and Eastern Europe, and at the same time moderate inflation was achieved, while a number of countries realized deflation or inflation much lower than in Serbia. We estimate that the NBS adequately reacted to prevent the strengthening of the dinar against the euro during April and May, but that it is necessary to continue with such policy in the coming months.

Real appreciation in Q1 and in April

The dinar appreciated in real terms in Q1 by about 2.0%, while in April it appreciated in real terms by an additional 0.56%. Real appreciation in Q1 and in April is the result of (to a slightly lesser extent) the nominal depreciation of the dinar and (mostly) the difference in inflation in Serbia and the Eurozone (inflation in the period January-April in Serbia amounted to 1.89% and the eurozone 0.44%). The trend of real appreciation, that has started in the beginning of the year, halved the real depreciation with which the dinar weakened in real terms by about 5% from the early Q3 to the end of Q4, by which the realized improvement of the economy compe-

Chart T5-8. Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly Averages, 2009-2015



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

titiveness was substantially lost until the end of 2014 (Graph T5-8). In the previous issue of QM, we suggested that the NBS instead of buying euros on the interbank foreign exchange market (IFEM) should have lowered the key policy rate, which at the end happened during May (the NBS did not intervene in the IFEM and continued to lower KPR). In this way both the return of the inflation within the target band and the prevention of the exchange rate (i.e. mitigation of the real appreciation) were affected simultaneously. Historically, the real dinar exchange rate is at a similar level as in October 2012.

6. Fiscal flows and policy

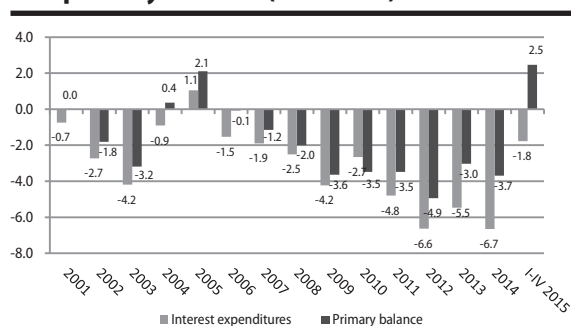
Fiscal deficit in the first four months of 2015 totaled RSD 22 billion (1.8% of GDP), and was much smaller than in the previous year, and below the targeted amount for this period, as well. Y-o-y decrease in fiscal deficit was primarily caused by the wage and pension reduction, and reduction in state subsidies to loss-making public enterprises and banks. On the other hand, it shrank below the targeted level mainly under the influence of one-off and temporary factors – aggressive dividend payments made by public enterprises, one-off revenue payment by the Agency for Insurance of Deposits, extraordinary revenues from the license for 4G network, and low public investments. Additionally, further heightening of actions against shadow economy also contributed to reduction in fiscal deficit. Namely, revenues from VAT continued to grow, and contrary to the preceding quarters, this period saw a considerable rise in revenues from the excise on tobacco, so the overall tax revenues were by 2% higher than planned. As expected, public expenditures went down due to the wage and pension reduction, but also to extremely low public investments, which accounted for only 1.5% of GDP in the first four months of 2015. If the current trends continued, fiscal deficit in 2015 could run at 4.5-4.7% of GDP, and would be by 1.2-1.4% of GDP below the projected level. However, since these are mostly one-off or temporary improvements, structural deficit will more probably shrink below the projected amount by about 0.6% of GDP. Although it is a good result, considering that the initial plan implied substantial fiscal adjustment, this improvement is still quite small, given the total amount of fiscal deficit, and its sustainability is uncertain, because possible revision of the key measures for fiscal consolidation which actually led to deficit reduction has already been announced by Government representatives. These savings should be used to further reduce fiscal deficit and to scale up public investments, because they have much larger impact on economic activity than current consumption. Public debt (including the debt of local self-governments) totaled 76.6% of GDP at the end of April, and is expected to reach about 80% of GDP at the end of 2015.

General trends and macroeconomic implications

Fiscal deficit stands at RSD 22 billion (about 1.8% of GDP) in the first four months of 2015

Fiscal deficit much below the targeted level...

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



Source: QM calculations

Consolidated fiscal deficit stood at RSD 22 billion in the period January-April 2015, which approximates 1.8% of the four-month GDP. Furthermore, Serbia had primary budget surplus of RSD 30 billion (2.5% of the four-month GDP) in this period.¹

In the preceding years, fiscal deficit in the first four months of a year accounted for about 31% of the annual deficit, on average. With such dynamics, consolidated fiscal deficit would have totaled RSD 72 billion in the period January-April 2015, meaning that fiscal performance in this period considerably exceeded the expectations.

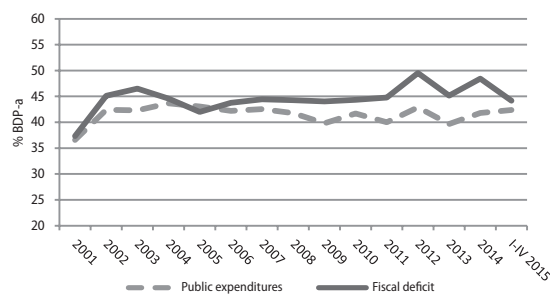
However, this reduction in fiscal deficit was to a large extent caused by numerous one-off or temporary (unsustainable) factors, the most significant being the following: *i*) aggressive dividend payout by public and state-owned enterprises at the beginning of the year worth RSD 17 billion – if this amount was equally distributed over the entire year, revenues from dividend payments in the first four months would decrease by RSD 11 billion, *ii*) a number of large one-off revenues – license for 4G network was granted for RSD 2.5 billion,

¹ Analyses of fiscal trends are based on the Ministry of Finance data on public revenues, public expenditures and public debt, and on other available data on macroeconomic trends.

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

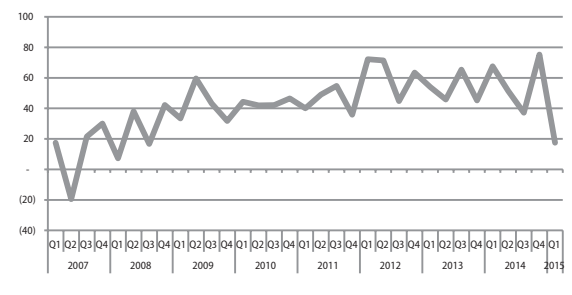
the Agency for Insurance of Deposits paid RSD 7 billion to the budget, *iii*) low public investments – if public investments made in the first four months of 2015 equaled the annual average for the preceding years, capital expenditures in this period would be by RSD 8-10 billion higher (Savings based on reduction in capital expenditures have negative impact on economic growth. Therefore, keeping them at this low level is unsustainable.). Accordingly, if we exclude the influence of the foregoing one-off or temporary/unsustainable factors, fiscal deficit totals more than RSD 50 billion in the first four months of 2015, which is still below the targeted amount. This to a large extent can be attributed to reduction in shadow economy, and to a certain extent to reduction in other expenditures (on goods and services, subsidies etc.).

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



Source: QM calculations based on the MF data

Graph T 6-3. Serbia: Seasonally adjusted fiscal deficit (RSD billion, in 2013 prices)



Source: QM calculations based on the MF data

...due to reduction in the shadow economy and the influence of one-off and temporary factors

Trends in tax revenues show that the government’s increased efforts to curb the shadow economy continued in the first four months of 2015. Consequently, revenues from VAT kept growing notably in this period and the upward trend continued in May, as well. Contrary to the preceding quarter, activities against excise goods smuggling (primarily tobacco products) were heightened in this period, which caused a steep rise in excise revenues. Furthermore, reduction in illegal sale of these goods caused decrease in under the table wage payments, and consequential rise in revenues from social security contributions.

Central government budget deficit smaller than expected, stands at RSD 5.2 billion in May

Data show that the central government had budget deficit of RSD 5.2 billion in May 2015, which is much below the projected level and the deficit recorded in May 2014. This reduction came from further rise in revenues and cut in expenditures. Revenues from VAT and non-tax revenues went up considerably in this period. Namely, non-tax revenues grew by RSD 2.4 million y-o-y. This suggests that the aggressive collection of dividend revenue and other non-tax revenues continued, which is considered unsustainable in the long term. On the other hand, some payments were postponed for the beginning of June, which pushed down the central government expenditures. Thus expenditures on wages and transfers to other government levels, expenditures on interest payments, and capital expenditures in this period were much lower than in the same period last year. If capital investments in May had been executed in accordance with the plan, central government would have run RSD 3 billion larger fiscal deficit. We can, therefore, conclude that moderate improvements in fiscal performance continued in May, but that they were partly caused by one-off and temporary factors.

FY 2015 deficit could narrow to 4.5-4.7% of GDP, which is by 1.2-1.4% of GDP below the forecast, and 2% smaller than in 2014

The aforementioned and some additional factors are expected to push down the deficit below the annual target. If the trends in tax revenues detected in the first four months continue throughout the year, these revenues might exceed the forecasts by 2%, or RSD 25 billion (0.6% of GDP) in 2015. Since capital expenditures in the first four months were much below the projections, and May saw continuation of this trend, real annual rise in capital expenditures is expected to be much below the targeted 20%. With real rise in capital expenditures of 5-10% in 2015, which seems quite ambitious at the moment, overall annual capital expenditures would be by 0.3% of GDP below the projection. Furthermore, the aforementioned extraordinary/one-off revenues and intensified dividend payout by public enterprises will push 2015 revenues above the projected level by 0.3-0.4% of GDP. Accordingly, if the current trends continued and if no extraordinary

Structural deficit is expected to narrow below the projected amount by 0.6% of GDP

events occurred and if no large changes were made in economic policy, 2015 fiscal deficit would outperform the plan by 1.2-1.4% of GDP and shrink to 4.5-4.7% of GDP.

However, since this discrepancy between the actual deficit and the fiscal projections is to a large extent a result of the influence of one-off or temporary factors, lasting (structural) improvement in Serbia's fiscal performance (relative to the projections) will be much smaller, i.e. structural deficit is expected to narrow below the projected amount by 0.6% of GDP. Reduction in shadow economy is expected to push down structural deficit by RSD 20-25 billion (about 0.5% of GDP) relative to the projected level, which would be a good result, because the initial plan also implied relatively strong fiscal adjustment. However, this structural improvement in Serbia's fiscal performance is still uncertain and relatively small given the amount of fiscal deficit (fiscal deficit of 5% of GDP would remain among the largest in Europe). We therefore think that, in spite of the current fiscal trends, there is no room for revision of fiscal consolidation measures (revision of wage and pension reduction etc.) in 2015, especially because there is a risk that some of the adopted measures will not be implemented (excise on electricity, restructuring and privatization of public and state-owned enterprises etc.), which could impair Serbia's fiscal performance in the second half of the year, and in 2016. Additionally, even if the reduction in structural deficit is larger than expected, these savings should be used to further reduce the deficit (fiscal deficit of 4.5% of GDP in 2015 would still be among the largest in Europe) and to finance public investments, because they have more favorable impact on economic activity than current consumption. On the other hand, illusion created in the media that the country's fiscal performance improved considerably in the first few months of 2015 raises people's expectations. Consequently, this puts the government under great pressure to increase expenditures and/or to give up on some of the measures for fiscal consolidation, and lessens the chances of carrying out some of the key structural reforms (employee rightsizing, restructuring and privatization of public and state-owned enterprises etc.).

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

There was a real y-o-y rise in public revenues of 6.7% in the first four months of 2015. It was mainly driven by a considerable increase in non-tax revenues, and somewhat smaller y-o-y increase in tax revenues, caused by notable rise in excise revenues and revenues from VAT.

Public revenues going up due to a steep rise in non-tax revenues...

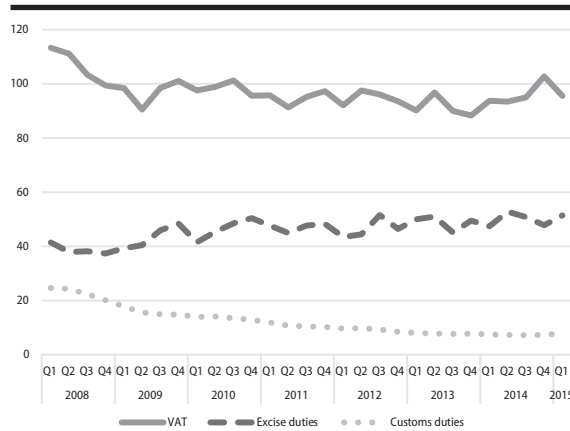
Real y-o-y rise in non-tax revenues of 65.4% in the period January-April contributed most to increase in public revenues in this period. It was driven by the following: *i*) public and state-owned enterprises paid dividends worth RSD 17 billion (in the preceding years dividend payout was usually made in the last quarter of the year), *ii*) one-off payment of about RSD 2.5 billion for the license for 4G network and *iii*) the Agency for Insurance of Deposits (AID) made a one-off payment of RSD 7 billion to the budget, on the basis of a refund received from EPS for settlement of EPS's debts to the Paris and London Club of Creditors in previous years. Since this rise in non-tax revenues is mainly caused by one-off factors, and the foregoing amount of paid dividend is above the long-term sustainable level (the one which would leave the companies sufficient funds to invest in rehabilitation of fixed assets), evaluation of the dynamics in public finance should be based on the dynamics in tax revenues.

...and a much slower rise in tax revenues (0.4%), driven by increase in excise revenues and revenues from VAT

There was a slight real y-o-y rise in tax revenues in the period January-April 2015 (by 0.4%). These revenues, however, suffered a real drop (by 2.1%) compared with the last four months of 2014.² Reduction in shadow economy (which led to rise in revenues from consumption tax) and the wage and pension cut (and consequential reduction in the base for personal income tax and social security contributions) had divergent effect on the dynamics of tax revenues. Tax revenues were by 2% above the projected level in the first four months of the year, primarily because the

² Y-o-y growth rates of public revenues and public expenditures were calculated on the basis of inflation-adjusted absolute amounts (real growth rates). Quarter-on-quarter (qoq) growth rates of public revenues and public expenditures were calculated on the basis of seasonally adjusted and inflation-adjusted absolute amounts.

Graph T 6-4. Serbia: Seasonally adjusted revenues from consumption taxes (RSD billion, in 2014 prices)



Source: QM calculations based on the MF data

Excise revenues going up due to reduction in tobacco smuggling...

government continued and expanded its actions against the shadow economy, especially in the domain of excise goods.

There was a notable real y-o-y rise in excise revenues in the first four months of 2015 (by 7.6%). These revenues were higher than in the last four months of 2014, as well (by 2.4%). This is the result of the governments more decisive actions against illegal distribution of tobacco products, while excise revenues from petroleum products suffered a slight decrease. However, to make a reliable judgment about whether the downward trend in excise revenues on tobacco products has been reversed and a lasting reduction in illegal distribution of tobacco products achieved, it is necessary to observe the trends

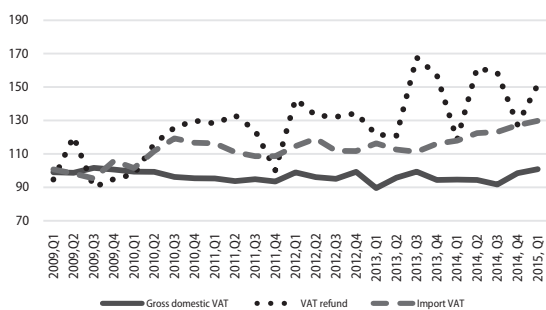
in these revenues in the months to come. Excise revenues slowed down in May compared with the preceding months partly under the influence of seasonal and temporary factors (due date for excise duty payment for the second half of May fell at weekend, and therefore these payments were made on June 1). Slight real y-o-y rise in these revenues of 0.4% speaks in favor of this conclusion.

...but illegal sales of tobacco products are still above the level recorded before 2013

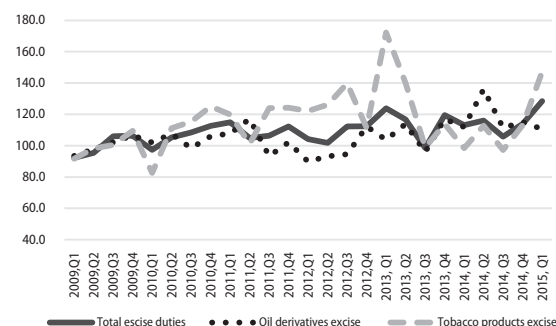
Although seasonally adjusted and inflation-adjusted excise revenues from tobacco products reached the level they were at before 2013, this increase is not as large as it should be considering that in the meanwhile specific excise duty on tobacco products was raised on three occasions. This could mean that illegal sales of these products are still higher than before 2013, though, the number of smokers decreased in the meanwhile, as well. Additionally, somewhat slower y-o-y rise in excise revenues in May, compared with the preceding months, may suggest that a sustainable recovery in these revenues is still uncertain.

Revenues from VAT still going up due to reduction in shadow economy

There was a real y-o-y rise in revenues from VAT in the period January-April (by 0.6%). On the other hand, real seasonally adjusted revenues from VAT in this period decreased compared with the preceding quarter (by 5.9%). Revenues from VAT slowed down in the period January-April 2015 because unpaid VAT refunds from the preceding months, which were subject to delay due to the newly adopted practice by the Tax Administration of investigating almost every VAT refund claim, were paid in this period. This is, however, economically unjustifiable. On the other hand, the upward trend in gross domestic VAT and VAT on imports, first detected in the middle of 2014, continued in the first four months of 2015. This suggests that the government continued its actions against the shadow economy successfully, given that there was no notable recovery in economic activity, and employment, wages, exchange rate and prices remained almost unchanged. Moreover, the ratio between the revenues from VAT collected in the first four months of 2015 and the annual target for 2015 was higher than in the previous years. Revenues from VAT continued growing in May and were 22% (RSD 7.2 billion) higher y-o-y.

Graph T 6-5. Serbia: Seasonally adjusted revenues from VAT, by components (2010=100)

Source: QM calculations based on the MF data

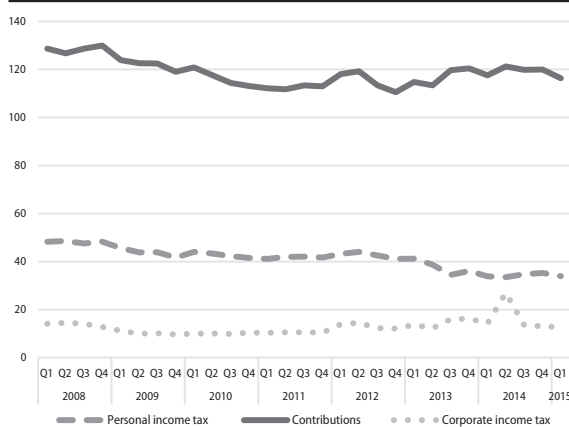
Graph T 6-6. Serbia: Seasonally adjusted excise revenues, by components (2010=100)

Source: QM calculations based on the MF data

Revenues from personal income tax and social security contributions going down, though at a slower pace than expected

Revenues from personal income tax and contributions for mandatory social security insurance went down in the period January–April 2015 compared with the preceding four-month period (real drop of 1.0% and 1.9% respectively). Revenues collected in the first four months of 2015 were lower because the cut to public sector wages (and pensions – from which health care insurance contributions are deducted), which came into effect as of November 2014, affected only the last two months of 2014, while the first four months of 2015 were all hit by this reduction. This reduction in revenues from personal income tax and social security contributions was expected, though somewhat smaller than planned. Namely, the ratio between these revenues collected in the first four months of 2015 and the annual target was higher than in the same period 2014. This could also be a result of reduction in shadow economy, because reduced amount of money circulating in the black market lessens the ability to pay wages outside the legal flows. There was a real drop in revenues from personal income tax in the period January–April 2015 compared with the preceding four-month period and the same period last year, which could be a sign of a decline in profitability of companies.

Steep drop in public expenditures...

Graph T 6-7. Serbia: Seasonally adjusted revenues from taxes on factors of production (RSD billion, in 2014 prices)

Source: QM calculations based on the MF data

...due to wage and pension reduction...

There was a real y-o-y decrease in public expenditures in the first four months of 2015 (by 5.8%). They went down considerably compared with the preceding four-month period (by 10.9%), too. This drop in expenditures was caused by the wage and pension reduction and a considerable decrease in public investments. Furthermore, large one-off net budget borrowings were declared at the end of 2014 (assumed debt of Air Serbia, financial rehabilitation of banks etc.).

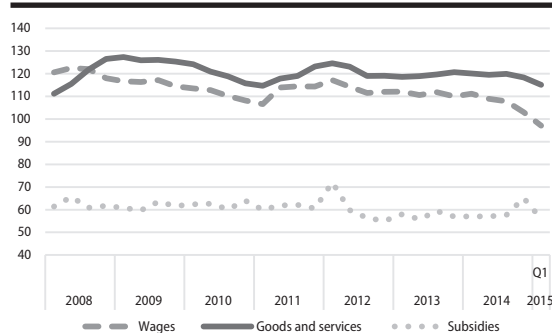
In absolute terms, the wage and pension cut, which produced its full effect in the first four months of 2015, contributed most to the reduction in public expenditures. Namely, real expenditures on wages fell by 12.9% (approximately RSD 17 billion) y-o-y in this period, and real y-o-y decrease in expenditures on pensions was somewhat smaller, but still significant (by 4.3%, or RSD 5.4 billion). Accordingly, reduction in expenditures on wages and pensions brought savings of about RSD 22 billion in the first four months of the year, and the expected annual target is RSD 70 million. This decrease in expenditures on wages considerably exceeds the effects of the 10% wage cut, probably because the number of public sector employees decreased, tighter controls on payment of different bonuses and allowances (for overtime work etc.) were imposed, but also because increased earnings for years of service are no longer calculated for the full years of service but only for the time spent with the last employer.

...and inefficient execution of public investments, which accounted for only 1.5% of GDP

Public investments suffered a real y-o-y decrease in the first four months of 2015 (of 12.3%), and fell compared with the preceding four-month period, as well (by 3.4%). Accordingly, public investments accounted for only 1.5% of GDP in the period January–April 2015. Taking into account the intra-annual dynamics in capital expenditures in previous years and in 2015, and the projected annual rise in capital investments of 20% in 2015, we estimate that in the first four months of 2015 the government spent RSD 8 billion less on public investments than they planned. Inefficient execution of public investments is economically unfavorable because public investments are one of few antirecession measures available to the Government, and should be used especially in times of recession, which is the case of Serbia now.

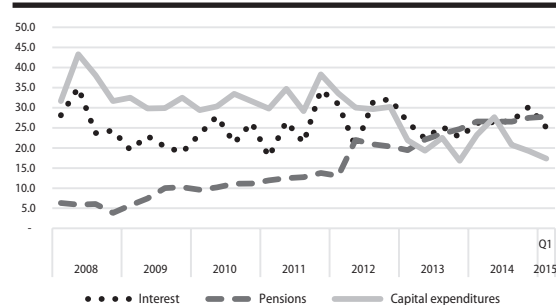
There was a real y-o-y decrease in expenditures on goods and services and expenditures on subsidies (by 4.4% and 4.5% respectively). These expenditures went down compared with the preceding quarter, as well. Reduction in expenditures on goods and services is good so long as it does not jeopardize the proper functioning of the country. On the other hand, the reduction in subsidies is justified, but to some extent, it is a consequence of a high base for comparison.

Graph T 6-8. Serbia: Seasonally adjusted expenditures on wages, pensions and goods and services (RSD billion, in 2014 prices)



Source: QM calculations based on the MF data

Graph T 6-9. Serbia: Seasonally adjusted expenditures on interest payments, subsidies and capital expenditures (RSD billion, in 2014 prices)



Source: QM calculations based on the MF data

Expenditures on interest payments going up, due to growing public debt and dinar (to dollar) depreciation

Expenditures on interest payments went up considerably in the first four months of 2015 compared with the same period last year (by 13.5%), and were higher than in the preceding four-month period, too (by 1.9%). This increase was caused by growing public debt and dinar depreciation (especially against dollar). However, borrowing conditions for Serbia improved because the ECB and Fed loosened their monetary policy, which had favorable impact on expenditures on interest payments, meaning that without the influence of these temporary external factors, rise in these expenditures would be even larger.

Fiscal trends by government level

Central government and Pension and Disability Insurance Fund running budget deficit, other government levels running budget surplus in Q1

In Q1 2015 the central government and Pension and Disability Insurance Fund ran budget deficit (RSD 24.9 billion and RSD 4.2 billion respectively). On the other hand, AP Vojvodina, local self-governments and the Health Insurance Fund of the Republic of Serbia had budget surplus (RSD 1.6 billion, RSD 4.1 billion and RSD 1.95 billion respectively).

The aforementioned rise in consolidated public revenues in Q1 was relatively homogeneous across different government levels, i.e. both the republic budget revenues and revenues collected by local self-governments grew. The first were pushed up by increase in excise revenues and revenues from VAT, and considerable rise in non-tax revenues, and the latter went up due to a strong real y-o-y increase in revenues from property tax in Q1 (by 40.5%).

Republic budget revenues going up – due to increase in non-tax and tax revenues...

Revenues from property tax grew in Q1 because local self-governments increased their efforts to scale up property tax collection and thus make up for the loss of revenue from construction land usage fee, which was abolished in 2014 (see *Highlight 2*). Revenues of the Health Insurance

...revenues of local self-governments growing – due to increase in revenues from property tax

Expenditures of central government and Health Insurance Fund going down, while local self-governments spend more

Local self-governments stretch the rules on public sector wage cut

Fund of the Republic of Serbia suffered a sharp real y-o-y drop in Q1 (by 13.3%), because the contribution rate for health insurance was decreased in the middle of 2014, and the wage and pension cut reduced the contribution assessment basis.

There was a real y-o-y decline in expenditures of the central government and the Health Insurance Fund in Q1 (by 10.7% and 6% respectively), while local self-governments increased their expenses (by 1.2%). Public sector wage cut and reduced capital investments pushed down the re-public budget expenditures. On the other hand, local self-government expenditures on subsidies, welfare and public investments went up y-o-y (by 16.3%, 11.2% and 4.5% respectively), while expenditures on employees and other expenditures declined.

However, real y-o-y decrease in expenditures on employees is more than twice smaller at the local level (7.1%) than at the central level (15.2%). This suggests that the local self-governments have found the ways to stretch the rules regarding the public sector wage limits and cuts, by giving extraordinary pay raise.

Table T6-10. Serbia: Fiscal surplus (deficit) at different levels of government (bn. RSD, current prices)

Year	Budget of Republic	Pension fund	National Employment	Health fund	Vojvodina budget	Local self-government
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
2014	-204.1	3.6	2.0	0.2	1.0	8.5
Q1 2015	-24.9	-4.2	-0.1	2.0	1.6	4.1

Source: QM calculations based on the MF data

Budgets of sub-central government levels remain in surplus...

...indicating vertical imbalance in distribution of competence and revenue

Fiscal trends in the last few years, including 2015, show that there is a notable imbalance between the competence and revenue distributed to different government levels, i.e. sub-central government levels are assigned more revenue than competence. Accordingly, the AP Vojvodina has been running budget surplus of more than RSD 1 billion annually since 2012 (and showed surplus of RSD 1.6 billion in Q1 2015), and the budgets of local self-governments have been in surplus since 2013 (the sum of the budget surpluses in 2013 and 2014 totalled RSD 14.8 billion, and reached as much as RSD 4.1 billion in Q1 2015 alone). On the other hand, there are some indications that local self-governments often fall behind with payments to other government levels and to private sector, which suggests that the economic management at this level is inefficient.

All this leads to conclusion that the system of vertical financial equalization needs to be reformed, to achieve vertical balance between revenues and competencies. Thus, the burden of fiscal consolidation would fall equally on all government levels.

Trends in public debt

Serbia's public debt totaled EUR 24 billion at the end of April (74.6% GDP)...

...and with the debt of local self-governments included – 76.6% of GDP-a

At the end of April 2015 Serbia's public debt totaled EUR 24 billion (74.6% of GDP), and with the debt of local self-governments included it accounted for 76.6% of GDP.

From the end of 2014 to the end of April 2015 public debt grew by EUR 1.3 billion, which is several times larger than fiscal deficit in that period (totaling less than EUR 200 million). This was to a large extent caused by a strong dollar to euro appreciation (which pushed up the debt by EUR 700 billion) and borrowing in advance of need, for financing future deficits and for principal repayments on the current debt.

Table T6-11 Serbia: Public debt dynamics 2000-2015

	Amount at the end of period, in billions EUR											
	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	apr 2015
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	12.36	15.07	17.3	20.2	21.5
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	6.5	7.0	8.2	8.7
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	8.6	10.2	12.0	12.8
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.60	2.81	2.5	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	22.8	24.0
Public debt / GDP²	169.3%	50.2%	36.2%	29.4%	25.6%	31.3%	41.5%	45.1%	59.3%	63.8%	70.9%	72.3%
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%	71.0%	74.6%

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

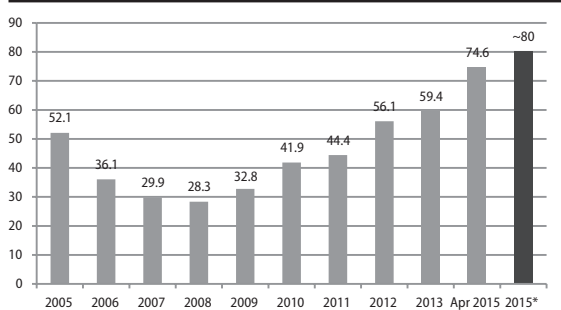
3) QM estimate (Estimated GDP equals the sum of nominal GDP in the current quarter and three previous quarters)

Source: QM calculations based on the MF data

Indirect debt stagnates in 2015, but causes of its earlier growth have not been removed

After the period of strong growth in 2013, and steady decrease in 2014, indirect debt stagnated in the first four months of 2015. However, this stabilization of indirect debt does not mean that its key drivers have been removed but is a consequence of new funding mechanisms and external and temporary factors. State guarantees on loans to public and state-owned enterprises (Srbijagas, EPS, Železara etc.) have been key generator of indirect debt. The key cause of insolvency and illiquidity of Srbijagas, i.e. unpaid receivables for the gas supplied to large customers (Petrohemija, Azotara etc.), has not been removed. However, sharp drop in oil prices in the world market alleviated this problem, but only temporarily. EPS is facing similar problems, which are caused by inefficient organization and management, high losses in electricity transmission, poor collection of receivables, and low price of electricity. Liquidity is maintained through borrowing, but

Graph T6-12: Trends in public debt (% of GDP)



Source: QM calculations

Serbia's public debt will account for 80% GDP at the end of 2015

Debt-to-GDP ratio will continue to rise in 2015 due to poor health of public finance, expected decrease in or stagnation of real GDP, and depreciation of dinar against euro and dollar. Possible issuance of government guarantees on project loans to public companies would contribute to this increase. Accordingly, assuming that dinar depreciates slightly against euro and dollar, and that borrowing in advance of need remains within the expected level, 2015 public debt might reach 78% of GDP, and with the debt of local self-governments included, this figure goes up to 80% of GDP, which is extremely high and unsustainable in the long term.

this is just a temporary solution, which brings new problems and challenges. Inefficient organization of the company is the only issue that has been addressed so far. The company has neither taken any actions against other critical issues, nor adopted a binding plan for their implementation. Similarly, working capital for Železara was provided in 2014 so there was no need for additional borrowing in 2015. However, the problem of financing future operations, after the existing funds are spent, remains unsolved.

Appendices

Annex 1. Serbia: Consolidated General Government Fiscal Operations¹, 2008-2015 (nominal amounts, bn RSD)

	2008	2009	2010	2011	2012	2013	2014				2015		
							Q1	Q2	Q3	Q4	Q1-Q4	Q1	jan-apr
I PUBLIC REVENUES	1,193.5	1,200.8	1,278.4	1,362.6	1,472.1	1,538.1	352.9	403.3	407.6	457.0	1,620.8	365.6	524.8
1. Current revenues	1,143.1	1,139.2	1,215.7	1,297.9	1,393.8	1,461.3	334.9	383.7	385.4	436.8	1,540.8	364.3	523.2
Tax revenue	1,000.4	1,000.3	1,056.5	1,131.0	1,225.9	1,296.4	301.3	348.7	344.8	375.1	1,369.9	309.9	445.9
Personal income taxes	136.5	133.5	139.1	150.8	35.3	156.1	32.2	35.1	36.9	42.2	146.5	32.5	44.7
Corporate income taxes	39.0	31.2	32.6	37.8	54.8	60.7	15.5	29.8	14.2	13.2	72.7	13.0	18.6
VAT and retail sales tax	301.7	296.9	319.4	342.4	367.5	380.6	93.6	97.0	101.7	117.3	409.6	96.2	131.0
Excises	110.1	134.8	152.4	170.9	181.1	204.8	42.9	55.2	58.4	56.0	212.5	46.3	65.3
Custom duties	25.8	48.0	44.3	38.8	35.8	32.5	7.3	7.5	7.8	8.6	31.2	7.9	10.6
Social contributions	312.7	318.8	323.0	346.6	378.9	418.3	99.3	109.8	110.7	120.6	440.3	100.6	159.0
Other taxes	35.6	37.1	46.0	43.5	42.6	43.5	10.7	14.3	15.1	17.2	57.3	13.4	16.7
Non-tax revenue	0.0	138.8	159.2	36.9	37.9	34.9	33.7	35.0	40.5	61.7	170.9	54.3	77.4
2. Capital revenues	1.4	0.9	0.3	2.0	8.7	3.5	0.4	0.6	0.4	0.6	2.0	0.3	
II TOTAL EXPENDITURE	-1,265.5	-1,328	-1,419.5	-1,526.1	-1,717.3	-1,750.2	-421.0	-448.3	-447.4	-562.2	-1,878.9	-379.3	546.8
1. Current expenditures	-1,089.6	-1,155	-1,224.8	-1,324.8	-1,479.9	-1,549.8	-381.7	-393.6	-398.0	-454.7	-1,628.0	-368.9	518.2
Wages and salaries	-293.2	-302.0	-308.1	-342.5	-374.7	-392.7	-95.7	-97.9	-96.4	-98.6	-388.6	-83.8	132.6
Expenditure on goods and services	-181.4	-187.4	-202.5	-23.3	-235.7	-236.9	-50.9	-58.3	-60.2	-87.4	-256.8	-50.9	71.4
Interest payment	-17.2	-187.4	-34.2	-44.8	-68.2	-94.5	-35.5	-28.6	-26.8	-24.2	-115.2	-40.6	52.4
Subsidies	-77.8	-22.4	-77.9	-80.5	-111.5	-101.2	-19.4	-23.7	-27.9	-46.1	-117.0	-18.7	24.7
Social transfers	-496.8	-63.1	-579.2	-609.0	-652.5	-687.6	-170.7	-172.4	-172.8	-181.0	-696.8	-166.7	225.3
o/w: pensions ⁵	-331.0	-556.4	-394.0	-422.8	-473.7	-498.0	-125.0	-126.9	-128.0	-128.1	-508.1	-121.0	162.2
Other current expenditures	-23.5	-387.3	-22.9	-31.7	-37.4	-36.9	-9.6	-12.6	-14.0	-17.5	-53.7	-8.1	11.6
2. Capital expenditures	-106.0	-24.0	-105.1	-111.1	-126.3	-84.0	-13.9	-25.3	-23.7	-33.7	-96.7	-10.5	18.7
3. Called guarantees	-1.6	-2.2	-2.7	-3.3	-3.7	-7.9	-3.4	-5.9	-8.2	-12.1	-29.7	-6.9	9.3
4. Budget lending	-19.3	-24.0	-30.0	-25.0	-38.2	-35.6	-5.2	-5.8	-0.3	-44.1	-55.4	-0.5	0.7
III CONSOLIDATED BALANCE	-72.0	-127.1	-141.0	-163.5	-245.2	-212.1	-68.1	-45.0	-39.8	-105.2	-258.1	-21.1	-22.0

Source: QM

Annex 2. Serbia: Consolidated General Government Fiscal Operations¹, 2008-2015 (real growth rates)

	2008	2009	2010	2011	2012	2013	2014				2015		
							Q1	Q2	Q3	Q4	Q1-Q4	Q1	Jan-Apr
I PUBLIC REVENUES	3.3	-8.9	-1.5	-4.6	0.6	-2.2	-0.8	4.3	3.5	5.4	3.2	7.6	6.7
1. Current revenues	3.5	-9.1	-1.5	-4.4	0.1	-2.6	-0.3	4.3	2.8	5.7	3.3	7.6	6.6
Tax revenue	3.7	-8.8	-2.5	-4.1	1.0	-1.7	-1.0	6.4	3.8	4.3	3.5	1.8	0.4
Personal income taxes	6.3	-10.8	-3.9	-2.9	2.1	-12.2	-17.8	-13.5	0.8	-1.7	-8.1	-0.1	-1.0
Corporate income taxes	18.5	-27.0	-3.6	3.9	35.1	2.9	-18.0	165.3	-9.5	-18.1	17.4	-17.2	-12.9
VAT and retail sales tax	2.5	-10.2	-0.7	-4.0	0.0	-3.8	4.3	-3.6	5.4	15.1	5.4	1.8	0.6
Excises	0.7	11.6	4.2	0.6	-1.2	5.1	-1.7	0.8	9.5	-2.4	1.6	6.9	7.6
Custom duties	1.8	-32.4	-14.9	-21.5	-14.0	-15.6	-4.4	-7.0	-6.9	-7.3	-6.5	8.9	6.4
Social contributions	4.3	-7.0	-6.5	-3.9	1.9	2.6	3.6	29.1	28.1	0.5	3.1	0.3	-1.9
Other taxes	-2.3	-4.9	14.5	-15.2	-8.8	-5.2	12.1	8.2	0.8	44.1	29.2	23.9	13.8
Non-tax revenue	2.6	-11.3	5.8	-6.1	-6.2	-8.7	6.0	-13.1	-5.1	15.1	1.5	59.8	65.4
2. Capital revenues	-76.8	-41.4	-66.8	468.2	304.5	-63.0	-79.6	17.6	-27.7	6.0	-33.3	-19.5	
II TOTAL EXPENDITURE	5.0	-4.8	-1.7	3.3	4.3	-0.3	4.4	3.7	-3.0	14.8	5.2	-5.1	-5.8
1. Current expenditures	6.9	-3.3	-2.2	3.1	4.1	-2.7	6.0	0.4	-1.2	6.5	2.9	-4.4	-5.0
Wages and salaries	10.9	-6.0	-5.9	0.4	2.0	-2.6	-0.6	-2.0	-3.0	-6.5	-3.1	-13.3	-12.9
Expenditure on goods and services		-5.7	-0.3	4.3	1.5	-6.6	-0.1	3.4	-1.6	19.1	6.2	-1.1	-4.4
Interest payment	-2.8	-5.7	-0.3	17.4	41.9	28.8	82.9	2.2	-3.4	13.6	19.3	13.0	13.5
Subsidies	-13.3	19.0	40.6	7.4	29.1	-15.6	-0.8	6.0	-3.8	41.9	13.2	-4.2	-4.5
Social transfers	10.1	-26.0	13.9	5.8	-0.1	-2.1	2.4	-2.2	-1.8	-1.2	-0.7	-3.3	-2.6
o/w: pensions ⁵	9.5	2.2	-3.9	3.9	4.4	-2.3	1.5	0.0	0.2	-2.0	-0.1	-4.3	-4.3
Other current expenditures	14.9	6.7	-6.1	23.9	9.9	-8.4	31.1	36.2	43.1	55.0	42.6	-15.9	-22.7
2. Capital expenditures	-4.3	-6.7	-11.8	5.3	6.0	-38.2	1.4	41.5	-12.8	25.2	12.7	-25.5	-12.3
3. Called guarantees	283.5	-2.2	-2.7	-3.3	-3.7	248.7	40.7	439.8	417.0	310.5	267.8	98.8	82.6
4. Budget lending	13.3	-24.0	-30.0	-25.0	-38.2	44.2	-36.1	45.5	-97.4	237.4	52.2	-90.9	-91.6

Source: QM

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

	Q1 2015/Q1 2014			
	Consolidated budget	Budget of Republic	Health Fund	Local self-governments
A Total public revenues (I)+(II)+(III)+(IV)	7.6	13.3	-13.3	0.9
I Current revenues (1)+(2)	7.6	13.2	-16.1	2.3
1. Tax revenues	1.8	2.2	-17.1	7.1
1.1. Customs	8.9	9.1	-	-
1.2. Personal income tax	-0.1	2.8	-	-1.2
1.3. Corporate income tax	-17.2	-16.3	-	-
1.4. VAT	1.8	1.9	-	-
1.5. Excise duties	6.9	7.1	-	-
1.6. Property taxes	-	-	-	40.5
1.9. Other taxes	23.9	6.8	-	-2.8
1.10. Social security contributions	0.3	-	-17.1	-
2. Non-tax revenues	15.1	104.8	59.6	-18.1
II Capital revenues	59.8	-	-18.0	-21.1
III Transfers from the other levels of government	-	-	-6.9	-4.2
IV Donations	25.3	36.9	-	7.4
B Total public expenditures (I)+(II)+(III)+(IV)	-5.1	-10.7	-6.0	1.2
I Current expenditures	-4.4	-10.8	-5.9	0.6
1.1 Wages	-13.3	-15.2	-11.2	-7.1
1.2. Goods and services	-1.1	-6.3	-1.4	-3.1
1.3 Interest payments	13.0	14.7	557.9	-13.6
1.4 Subsidies	-4.2	-10.5	0.0	16.3
1.5 Social insurance and social assistance	-3.3	-4.0	18.3	11.2
1.6 Transfers to the other levels of government	-	-18.1	-	-
1.7 Other current expenditures	-15.9	-48.9	71.8	6.1
II Capital expenditures	-25.5	-38.4	-84.1	4.5
III Strategic reserves	-	509.6	-	49.9
IV Net lending	-90.9	41.5	-	-36.7

Source: QM

7. Monetary Trends and Policy

Maintaining the y.o.y. inflation rate below the target framework set by the National Bank of Serbia (NBS) and the flow of capital from abroad due to the quantitative easing of the European Central Bank created room to relax monetary policy in Q1. As of March, the NBS started lowering its key policy rate which now stands at 6.5% following corrections in April and May and that is the lowest value of that rate under the targeted inflation regime. The flow of capital from abroad caused an increase in the appreciation pressure of the Dinar exchange rate leading the NBS to intervene in Q1 on the inter-banking foreign currency market with a net purchase of 170 million Euro which continued in April with a net purchase of 110 million Euro. The effect of those factors led to an increase in NBS net own reserves in Q1 of 489 million Euro which had a positive effect on the growth of primary money from the start of the year. The growth of primary money was also caused by the positive effects of the withdrawal of business banks from REPO but net domestic assets still recorded a drop in Q1 due to the lower state spending and drop in the account of net domestic assets. The downwards trend in credit activity continued from the start of the year even though the rise in the Swiss Franc exchange rate seemingly increased placements to the population. Besides the drop in credit activity, the banking sector recorded a drop on the side of the sources of their financing. The percentage of NPLs at the end of April recorded an increase of 0.3 percentage points from the start of the year mainly thanks to a rise in the segment of NPLs placed with companies.

Central Bank: Balances and Monetary Policy

NBS relaxing monetary policy since start of year

The y.o.y. inflation rate continued to stand at values below the NBS target framework in Q1 which created room to further relax monetary policy. The key policy rate was corrected in March for the first time by 0.5 percentage points even though the y.o.y. inflation rate stood at just 0.1% in January and rose to 0.8% y.o.y. in February. Following the correction in March, the NBS made additional corrections in April and in May by 0.5 percentage points and now the key policy rate stands at 6.5% which is also the lowest level of the key policy rate since the NBS started implementing its targeted inflation monetary strategy. In conditions of low and stable inflation which has been present for a long period, there is now a possibility of an additional lowering of the key policy rate in the coming period. The liquidity of the banking sector dropped in the first quarter leading banks to withdraw all their funds placed in NBS REPO bonds. In April and May, the Dinar liquidity of banks rose on the basis of sales of foreign currency to the NBS and the placement in REPO bonds rose again. Following changes to the Decision on Bank's Required Reserves of January which lowered the level of FX reserve requirement and increased the part which is set aside in Dinars, the NBS no longer used this instrument with the aim of further releasing foreign currency liquidity. The most recent session of the NBS Executive Board in May, decided to lower the key policy rate and adopted an amendment to the Decision on Interest Rates which narrowed the corridor of interest rates compared to the key policy rate from +/-2.5% to +/-2%. That change neutralized the latest cut in the key policy rate, at least until the next correction, because the interest rate on deposit facilities has practically been kept at the level of 4.5%.

Table T7-1. Serbia: NBS interventions and foreign currency reserves 2013-2015

	2013				2014				2015
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
Repo stock (in millions of euros)	678.86	663.82	832.03	966.40	783.96	824.19	387.39	69.48	2.85
NBS interest rate	11.75	11.00	11.00	9.50	9.50	8.50	8.50	8.00	7.50
NBS interest rate	6.95	3.31	13.24	10.38	4.38	5.09	6.78	10.63	-1.13
NBS interest rate	19.25	12.85	12.83	9.25	5.28	7.08	0.03	-1.94	11.33
NBS interventions on FX market (in millions of euros)	10.00	-215.00	-140.00	375.00	-800.00	-630.00	-855.00	-1620.00	170.00
INCREASE	cumulative, in % of initial M2¹⁾								
NBS own reserves ²⁾	12.5	7.1	17.9	43.2	-31.2	-4.9	2.0	-6.6	33.5
NDA	-15.3	-3.9	-16.2	-31.3	12.2	-11.4	-7.6	15.6	-28.4
Government, dinar deposits ³⁾	1.0	-1.2	-4.7	-19.9	3.3	-14.6	-24.3	-9.5	-8.4
Repo transactions ⁴⁾	-16.0	-14.7	-23.8	-30.7	9.2	6.5	28.9	46.0	3.7
Other items, net ⁵⁾	-0.3	12.0	12.4	19.3	-0.3	-3.4	-12.2	-20.9	-23.8
H	-2.8	3.3	1.7	12.0	-19.0	-16.3	-5.6	9.0	5.1
o/w: currency in circulation	-3.9	-0.7	1.0	5.4	-5.2	-3.5	0.5	3.7	-7.4
o/w: excess liquidity	0.6	2.1	-1.4	4.4	-12.1	-11.6	-7.3	-0.6	11.6
	in millions of euros, cumulative from the beginning of the year								
NBS, net	30.01	-992.01	-1041.50	943.97	-608.63	-725.22	169.79	-778.03	-101.66
Gross foreign reserves	-385.77	-1576.91	-1822.60	240.33	-793.11	-1090.74	-276.23	-1309.69	-671.02
Foreign liabilities	415.78	584.90	781.10	703.63	184.49	365.52	446.02	531.66	569.35
IMF	401.14	568.40	759.83	695.60	182.35	364.90	446.72	539.97	579.34
Other liabilities	14.65	16.50	21.27	8.03	2.14	0.61	-0.70	-8.31	-9.98
NBS, NET RESERVES-STRUCTURE									
1. NBS, net	30.01	-992.01	-1041.50	943.97	-608.63	-725.22	169.79	-778.03	-101.66
1.1 Commercial banks deposits	911.80	967.01	1058.25	240.42	-125.77	91.72	28.90	610.69	590.01
1.2 Government deposits	-811.79	47.05	209.55	-359.83	144.17	541.44	-162.64	48.59	0.60
1.3 NBS own reserves	130.02	22.06	226.30	824.56	-590.22	-92.05	36.05	-118.75	488.94
	(1.3 = 1 - 1.1 - 1.2)								

Source: NBS.

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

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

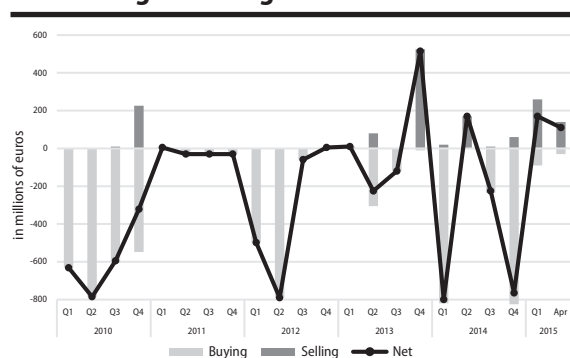
3) State includes all levels of government: republic and local.

4) This category includes Treasury Bonds NBS and repo operations.

5) Other domestic assets net include: domestic loans (net debts of banks, not including treasury bonds and repo transactions; net debts of economy) together with other assets (capital and reserves; and items in balance: other assets) and is corrected by exchange rate changes.

Purchase of foreign currency on interbank FX market has positive effect on growth of net own reserves

Graph T7-2. Serbia: NBS interventions on inter-bank foreign exchange markets 2010-2015



Source: NBS

Following strong depreciation pressure which marked the second half of 2014., the inter-banking foreign exchange FX market saw stabilization from the start of the year and changes in the direction that the NBS intervened to prevent greater appreciation of the Dinar. In Q1, the NBS was a net buyer of foreign currency on the inter-banking FX market to the extent of 170 million Euro in order to neutralize excessive daily exchange rate oscillations (Graph T7-2). Appreciation pressure continued in April when the NBS intervened first selling 30 million Euro and then purchasing 140 million Euro in order to lower pressure towards a strengthening

of the Dinar. Although the NBS interventions over the past few years were mainly aimed at preventing a greater weakening of the Dinar, the goal of interventions this year was to prevent a greater strengthening of the Dinar. We believe that by preventing the strengthening of the Dinar, the NBS continued its adequate policy both because of the high external imbalances and because of the support to long-term economic growth. The strengthening of the Dinar is a double-edged sword because, in the short term, positive effects can be felt very quickly among debtors with indexed loans or imports which become cheaper. Still, the effect in the long term would be highly unfavorable because it would further deteriorate the competitive position of the domestic economy and would hamper economic growth and the opening of new jobs.

The purchase of foreign currency on the interbank FX market increased the NBS own reserves¹ in Q1 by 489 million Euro (in Q4 2014 the sale of foreign currency from net own reserves caused a drop of 155 million Euro, Table T7-1). The growth of net own reserves had a positive effect on the level of primary money which in Q1 was increased by 5% of the value at the start of the year. The higher growth of primary money was prevented by a drop on the side of the net domestic assets which in Q1 stood at -28.4% of the value of primary money at the start of the year. Although the withdrawal of business banks from REPO operations had a positive effect on the creating of primary money, the drop in net domestic assets was the consequence of lower state spending in this period and a drop of -23.8% of the value of primary money at the start of the year which was registered in the account of other net domestic assets.

NBS needs to continue relaxing monetary policy

We believe that the NBS needs to continue relaxing the restrictive monetary policy until the inflation rate stabilizes at around the middle of the target corridor. By reducing the restrictive nature of its monetary policy represents an adequate response by the NBS to the expansionary policy of the European Central Bank. The NBS is preventing the strengthening of the Dinar against the Euro and every strengthening of the Dinar, however popular in the short term, would have a negative effect on the competitiveness of the Serbian economy and on prospects for its growth.

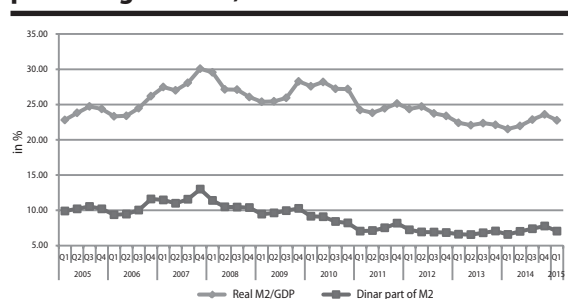
Monetary System: Structure and Trends of Money Mass

The growth of the money mass continued in Q1 ...

In the first three months, the money mass M2² recorded a nominal growth compared to the same period of the previous year of 8.5%. There was also nominal growth in credit to the non-government sector of 5.8% y.o.y. which, following the adjustment for the changes of the exchange rate, stands at 2.8% y.o.y. (Table T7-4). When we include the inflation rate, the real growth of the M2 in Q1 stands at 6.4% y.o.y. while the real growth of credit to the non-government sector dropped by 0.8% y.o.y.³. This was also the first quarter in the past three years which saw a real growth of credit to the non-government sector with the growth owed to the combined effect of the low base from the previous year which was strengthened further by the strengthening of the Swiss Franc exchange rate which caused a once-off increase in the value of credits indexed in this currency which are expressed in Dinars. The effect of those factors in the segment of growth of credit to households in Q1 stood at 3.4% y.o.y. with the rate standing at 1.3% following corrections because of the Swiss Franc exchange rate changes (in Q4 2014 credits to the non-government sector recorded a drop in real terms of -2.6% y.o.y. with households recording a real growth of 1.8% y.o.y.). The customary seasonal reduction of credit activity was strengthened further with the falling due of earlier approved subsidized loans.

... to a lesser extent because of the slight growth of credit activity in the population segment

Graph T7-3. Serbia: money mass trends as percentage of GDP, 2005-2015



Source: QM calculation

Viewed in comparison with the value at the start of the year, the money mass was reduced by -1.6% which represents a customary seasonal fluctuation. The reduction of the money mass since the start of the year was based on the increase in deposits on the account of the state because of the positive effects of fiscal consolidation which led to a drop in the net domestic assets of 1.6% of the initial value of the M2. On the other hand, the net foreign assets had a positive influence on the growth of the money mass primarily on the basis of exchange rate differences which caused a growth of 3.2% of the initial value of the M2.

¹ Repayment of NBS loans to the IMF also caused a drop in the foreign currency reserves (see chapter on Balance of Payments)

² Monetary aggregate M2 in the section Monetary Trends and Policy includes the lesser aggregate M1, savings and timed deposits as well as foreign currency deposits in business banks. Because of that, the M2 aggregate which we observe equally monetary aggregate M3 in NBS report.

³ The real growth of credit to the non-state sector without correction for the exchange rate changes is 3.7% y.o.y..

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

	2013				2014				2015
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
	y-o-y, in %								
M2 ¹⁾	8.2	4.5	6.1	4.6	4.2	4.8	6.6	8.7	8.5
Credit to the non-government sector ²⁾	1.9	-0.5	-4.4	-4.5	-6.1	-4.5	-1.2	2.9	5.8
Credit to the non-government sector ²⁾ , adjusted ³⁾	1.6	0.6	-4.1	-5.0	-8.2	-5.4	-3.7	-0.8	2.8
Households	3.0	2.9	2.9	2.6	2.0	2.5	3.0	3.6	5.5
Enterprises	0.9	-0.6	-7.6	-8.8	-13.4	-9.7	-7.3	-3.4	1.2
	real y-o-y, in %								
M2 ¹⁾	-2.6	-5	1.2	2.3	1.9	3.5	4.3	6.7	6.4
Credit to the non-government sector ²⁾	-8.2	-9.2	-8.9	-6.5	-8.3	-5.7	-3.3	1.1	3.7
Credit to the non-government sector ²⁾ , adjusted ³⁾	-8.7	-8.2	-8.5	-7.0	-10.3	-6.7	-5.8	-2.5	0.8
Households	-7.5	-6.1	-1.9	0.4	-0.3	1.2	0.7	1.8	3.4
Enterprises	-9.3	-9.3	-11.8	-10.7	-15.4	-10.8	-9.3	-4.9	-0.8
	in billions of dinars, end of period								
M2 ¹⁾	1622.7	1659.8	1705.8	1719.3	1691.4	1740.2	1818.4	1864.7	1835.4
M2 ¹⁾ dinars	478.8	492.5	519.5	547.6	516.4	555.3	587.1	614.5	567.8
Fx deposits (enterprise and households)	1143.8	1167.3	1186.3	1169.3	1175.0	1185.0	1231.3	1250.2	1267.7
	cumulative, in % of opening M2⁴⁾								
M2 ¹⁾	-1.2	1.1	3.9	4.6	-1.5	1.4	5.9	8.6	-1.6
NFA, dinar increase	7.2	2.7	5.2	10.6	0.2	-0.1	11.7	11.1	3.2
NDA	-8.4	-1.6	-1.3	-6.0	-1.6	1.4	-5.8	-2.4	-4.7

Source: NBS

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

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

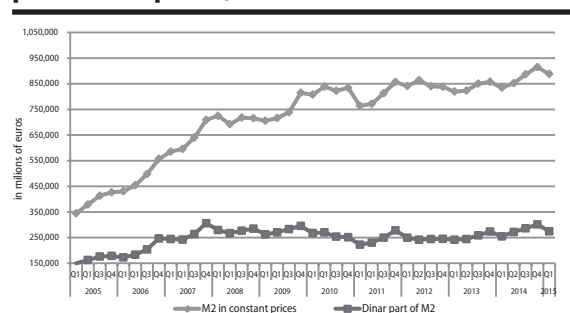
3) Trends are corrected by exchange rate. Corrections were implemented under assumption that 70% of loans to non-state sector (including households and the economy) were indexed against the Euro.

4) Initial M2 designates state of M2 at start of current, ie end of previous year.

All elements contributed positively to growth of M2 ... with foreign currency deposits leading

The structure of the nominal growth of the money mass M2, which in Q1 stood at 8.5% y.o.y., the highest individual contribution came from the growth of foreign currency deposits just as in the previous quarter. The growth of foreign currency deposits rose slightly compared to the end of the previous year with the increase of the money mass contributing with 5.5 percentage points (in Q4 2014 foreign currency deposits contributed to the growth of the M2 with 4.8%). The remaining elements of the money mass M2 also had a positive effect in Q1 with the narrowest aggregate M1 contributing to the growth with 2.2 percentage points while savings and timed deposits reduced their contribution to 0.8 percentage points because of the slower y.o.y. nominal growth (in Q4 2014, savings and timed deposits contributed to the growth of M2 with 1.4 percentage points).

Graph T7-5. State of the money mass in permanent prices, 2005–2015



Source: QM calculation

Banking Sector: Lending and Sources of Financing

Negative trend of drop in credit activity continues in Q1

The net lending of business banks recorded a drop in Q1 which means the negative trend carried over from last year but we should stress that the drop was much lower than in previous quarters. The negative lending in Q1 totaling 20 million Euro is the consequence of the withdrawal of almost all funds which banks had in NBS REPO bonds (in 2014, the drop in overall placements by banks stood at 437 million Euro, Table T7-6). Since banks withdrew 66 million from REPO operations, a slight growth in credit to the government and non-government sector was not sufficient to compensate the drop. Net credit lending to the non-government sector in Q1 stood at 24 million Euro which is a drop compared to the previous quarter when lending stood at 61 million Euro. The growth of lending to the non-government sector in Q1 is the consequence of the recorded growth in accounts of placements to the households of 111 million Euro. The rise

in value of lending to the households was unfortunately not the consequence of any significant recovery of credit activity in this segment but solely of the strengthening of the exchange rate of the Swiss Franc in January. The Dinar depreciated 17.74% against the Franc in January which caused bank balances to rise by the loans indexed in Francs. On this basis alone, the overall lending to the households should have recorded a growth of 137 million Euro but stood at 64 million Euro which de facto shows that the households repaid banks loans indexed in Euro. If we disregard January and view the data for the next three months, we note that there was a moderate recovery of credit activity in the households segment of some 70 million Euro. In the same period, the economy repaid 84 million Euro, further lowering the real level of lending (Graph T7-7). The segment of cross border loans showed no great activities and at Q1 level it showed a minimal indebtedness of the enterprises of 4 million Euro (In Q4 2014, the enterprises repaid 157 million Euro on the basis of cross border credits). The increase of credit activity by business banks had a positive effect only on the growth of net indebtedness of the government which in Q1 stood at 22 million Euro but because the banks withdrew from REPO operations and the fact that the enterprises repaid its debts, overall lending at quarterly level remained negative.

Table T7-6. Serbia: bank operations – sources and structure of lending, adjusted¹⁾ flows, 2013-2015

	2013				2014				2015
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
in millions of euros, cumulative from the beginning of the year									
Funding (-, increase in liabilities)	109	341	213	420	578	540	504	678	241
Domestic deposits	4	-56	-325	-394	240	-32	-382	-460	47
Households deposits	-87	-132	-252	-423	45	-105	-149	-250	-11
dinar deposits	16	-34	-110	-279	27	-51	-75	-143	96
fx deposits	-102	-98	-141	-144	17	-54	-74	-107	-107
Enterprise deposits	91	76	-73	29	195	72	-233	-210	58
dinar deposits	-11	-11	-109	-162	210	45	-159	-273	168
fx deposits	102	87	36	191	-15	27	-75	63	-110
Foreign liabilities	357	406	588	806	358	396	610	907	36
Capital and reserves	-252	-9	-50	8	-20	176	276	232	158
Gross foreign reserves(-, decline in assets)	-278	-104	84	-304	193	215	673	1,019	-150
Credits and Investment¹⁾	123	-169	-67	42	-343	66	-19	-451	-20
Credit to the non-government sector, total	-23	-348	-551	-875	-577	-382	-300	-296	24
Enterprises	-71	-463	-728	-1,018	-570	-488	-471	-410	-86
Households	48	115	177	143	-7	105	171	114	111
Placements with NBS (Repo transactions and treasury bills)	321	319	492	628	-176	-133	-556	-869	-66
Government, net ²⁾	-175	-140	-8	290	411	581	837	713	22
MEMORANDUM ITEMS									
Required reserves and deposits	-17	-87	-443	-134	-2	-215	-223	-730	444
Other net claims on NBS ³⁾	-154	-85	118	44	-136	-135	-4	110	-182
o/w: Excess reserves	-151	-96	60	38	-156	-162	-9	112	-204
Other items ⁴⁾	100	50	54	-22	-289	-454	-822	-592	-352
Effective required reserves (in %) ⁵⁾	25	24	22	23	23	22	22	19	22

Source: NBS

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

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

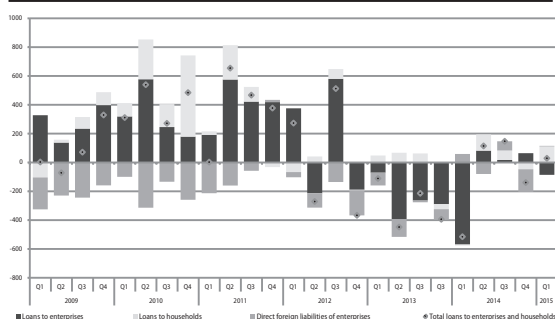
3) Net crediting of the state: credit approved to the state are decreased by the state deposits in business banks; the negative prefix designates a higher growth of deposits over credit. State includes all levels of government: republic and local.

4) Other NBS debts (net): the difference between what the NBS owes banks on the basis of cash and free reserves and debts to the NBS.

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

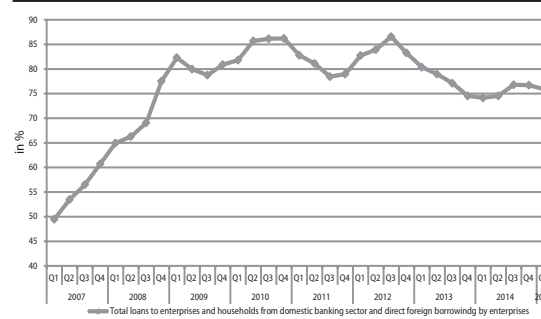
6) Effective mandatory reserve is the participation of the mandatory reserve and deposits in the sum of overall deposits (by the population and economy) and bank debts abroad. The basis to calculate mandatory reserves does not include subordinate debts because they are not available.

Graph T7-7. Serbia: growth of new credit to enterprises and households, 2009-2015



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

Graph T7-8. Serbia: Total loans in % of GDP, 2007-2015



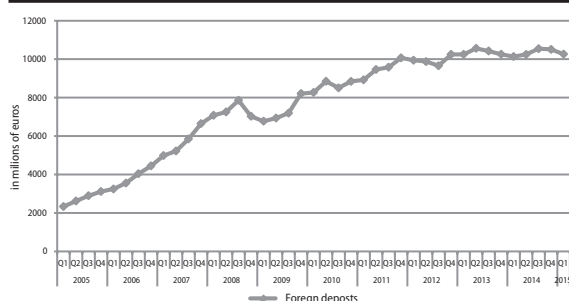
Source: QM calculation.

In Q1 banks increased their Dinar liquidity because of the withdrawal of 66 million Euro from NBS REPO operations but those funds were not used to buy foreign currency as was the case in previous quarters. The higher yield on state bonds led domestic banks and foreign investors, stimulated by the quantitative easing measures by the European Central Bank, placed some 600 million Euro in treasury bonds in Q1⁴. The increased capital from abroad created pressure to strengthen the Dinar leading in turn to appreciation in Q1 which, with the currently low inflation, can have a negative effect on the competitive position of the Serbian economy in the long term. Since the European Central Bank planned to keep the quantitative easing measures in place at least until September 2016, the state and the NBS need to find a mechanism so that the inflow of capital on that basis can be used to increase credit activity which has recorded a negative trend for a long time.

Drop in credit activity accompanied by decrease in foreign sources for new placements

Besides the low level of credit activity which has been present for a long period, negative trends have been noticed in terms of sources which banks use to finance their lending. The overall sources for new placements were reduced in Q1 by 241 million Euro which means the downwards trend from previous years continued (in 2014, sources were reduced by 678 million Euro, in 2013 sources were reduced by 420 million Euro, Table T7-6). By observing the structure of sources for new placements we see that all elements recorded a drop in Q1. The greatest single influence on the drop in sources for new lending was the drop in capital and bank reserves of 158 million Euro (in 2014 capital and bank reserves dropped by 232 million Euro). Domestic deposits recorded a drop of 47 million Euro with that drop being the consequence of a reduction of deposits by the enterprises. In Q1, the enterprises reduced its deposits with business banks by 58 million Euro

Graph T7-9. Serbia: level of foreign currency deposits, 2005-2015



Source: NBS

while the households continued placing surplus liquidity with banks totaling 11 million Euro. In terms of the structure of foreign currency deposits, the households and the enterprises behaved in a similar manner in Q1, with Dinar deposits being reduced while growth was recorded on the side of foreign currency deposits. The drop in sources for new placements was caused by, among other things, the continued repayment of bank debts abroad which in Q1 stood at 36 million Euro (in 2014 and 2013 business banks repaid more than 1.7 billion Euro in funds borrowed abroad).

⁴ Foreign investment portfolio investments in Q1 stood at 477 million Euro, for detailed view see section Balance of Payments and Foreign Trade.

Table T7-10. Serbia: participation of NPLs according to debtor type, 2012-2015

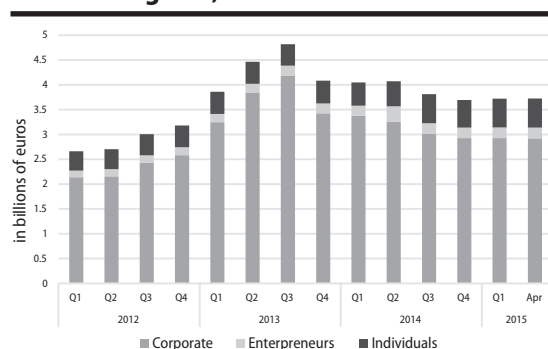
	2009	2010	2011	2012	2013				2014				2015	
	Dec	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Q1	Apr
	balance at the end of period													
Corporate	12.14	14.02	17.07	19.06	22.62	27.77	31.13	27.76	28.67	28.12	26.76	25.5	25.85	28.96
Entrepreneurs	11.21	15.8	17.07	15.92	16.79	18.19	20.86	20.82	21.11	29.77	43.61	43.29	45.19	45.42
Individuals	6.69	6.71	7.24	8.32	8.44	8.37	8.14	8.59	8.7	9.22	11.41	9.97	10.16	10.24
Amount of dept by NPL (in billions of euros)	1.58	1.94	2.63	3.19	3.87	4.47	4.82	4.09	4.05	4.07	3.81	3.70	3.72	3.52

Source: QM calculation.

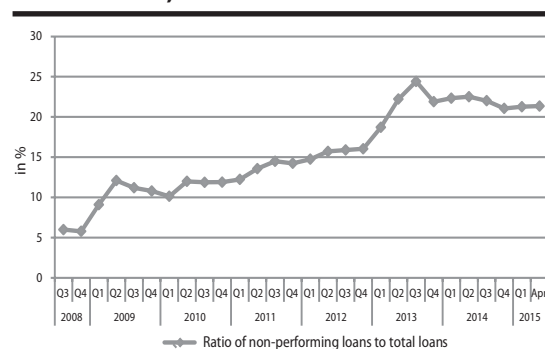
Percentage of NPLs stagnating since start of year

At the end of Q1 the NPL segment showed an evident deterioration compared to the start of the year. Unlike the previous quarter when the slight rise in credit activity reduced participation, the negative placements to the enterprises and households by banks in Q1 caused a slight rise in the participation of NPLs to 21.3% (at the end of 2014, the participation of NPLs was 21%, Table T7-12). Data from the Credit Bureau for April showed that the deterioration continued with the growth recorded mainly in the corporate segment while the remaining two segments recorded changes at the level of 0.1-0,2 percentage points compared to data from March. The participation of NPLs to corporate at the end of April increased to 28.98% which caused the overall participation of NPLs at the end of April to rise to 21.35% which is a growth of 0.3 percentage points over the first four months of 2015. If we observe the stock of NPLs by segment we note that following the drop in the second half of 2013, there was a slight drop primarily in the group of corporate which have the relatively greatest participation in the overall sum of NPLs (Graph T7-11). We should also bear in mind that some 70% of all credits were placed with a foreign currency clause so that this reduction would be more significant if the effects of the depreciation of the Dinar in 2014 were excluded.

During the negotiations with the International Monetary Fund, a significant portion of the talks were devoted to the NPL segment and measures required to reduce them quickly in the future. One of the first steps on that road was the adopted changes and amendments to the law on banks which includes the basic elements to prevent a future growth of NPLs as well as some instruments which could be used in the process of reducing the existing level which is a great obstacle to the speedier recovery of credit activity. One of the positive signals include the conference which the NBS organized in cooperation with the Serbian Finance Ministry and the World Bank devoted to resolving NPLs which saw the participation of representatives of the public and private sector and relevant international institutions. One of the conclusions from the conference was that the public sector can stimulate a speedier resolving of this problems only through stimulative tax and other measures while the burden of financing has to remain in the private sector.

Graph T7-11. Serbia: total remaining debt by loans falling late, 2012-2015

Source: QM calculation.

Graph T7-12. Serbia: participation of NPLs in overall loans, 2008-2015

Source: QM calculation.

HIGHLIGHTS

Highlight 1. Fiscal Consolidation 2012-14 Vs 2015-17: is this Time any Different?

Paule Petrović and Slobodan Minić¹

Introduction

At the end of 2014, a new three-year programme of fiscal consolidation started, which in addition to budgetary savings foresees also comprehensive structural reforms. Previous attempt (2012-14) to return national public finances to a sustainable path did not yield any results despite severe austerity measures, as all realised savings were “eaten up” by unreformed public sector. Primarily due to increased tax indiscipline and huge budgetary expenses for companies and banks owned by the state, measures taken in 2012-13 (such as real reduction of salaries in the public sector and pensions and increase of tax rates) were sacrificed in vain – in 2014 an equally high deficit was recorded as at the beginning of fiscal consolidation in 2012. Used up measures, however, were not the only cost of delaying structural reforms. The starting position now is actually much worse – state debt increased in the meantime from 58% to 73% of GDP and cost of interest on public debt has doubled and will continue to grow, so the upcoming fiscal adjustment will be all the more harder. Even though first positive results of the current programme are already reflected in the budget, we are once again faced with the same structural problems whose lack of solution had condemned the previous attempt at fiscal consolidation to failure. We therefore pose this question: will this time be any different?

1. Fiscal Consolidation 2012-14: Where Did We Go Wrong?

During 2012 it had become certain that public finances in Serbia would not be sustainable in the long-term without a substantial shift in conducting fiscal policy. Government's response to high deficit of 6.8% of GDP and growing public debt which had reached a level of 58% of GDP was an ambitious three-year programme of fiscal consolidation. The plan for reducing budget deficit rested on three pillars: 1) on the side of public expenditures, the key measure was a limited growth of salaries in the public sector and pensions; 2) on the side of public revenues, several tax rates were increased; and

3) planned within structural reforms were the reform of public enterprises, finalisation of the restructuring process, pension reform, strengthening of tax administration, etc. Although this set of budget saving measures was seemingly less drastic than the one implemented today – decrease of public sector salaries and pensions, the size of the planned fiscal adjustment is actually quite comparable. During 2013, the increase of public sector salaries and pensions was limited (instead of adjusting for inflation, a 2% indexation was performed in April and 0.5% in October), which with an average inflation of 7.7% was equivalent to their real reduction by around 5%.² Add to that expected effects of increased tax rates and it becomes clear that the set of measures for reducing deficit in 2012 was at least as ambitious as the one today, which in 2015 actually comes down to real reduction of salary and pension funds by around 8%, observed collectively.

However, instead of the announced strengthening of tax administration and tax discipline, quite the opposite happened in 2013 – a significant decline in collection efficiency and an increase of tax evasion. In the last quarter of 2012, general VAT rate was increased from 18% to 20%, which corresponds to the increase of effective rate by 8.5%. Considering this increase in VAT rate and real value of inflation and domestic demand (which presents a tax basis for VAT), we had expected in 2013 that these revenues would be collected in the amount of around 420 billion dinars. However, real revenue from VAT in that year was around 40 billion lower and was around 380 billion dinars and the main reason for this shortfall was the significant increase of tax indiscipline.³ Graph 1 shows the efficiency of VAT collection in which two sharp declines can be observed: first during 2009 and second during 2013.⁴ The decline in collection efficiency and transfer of the part of economic activity into the grey area at the time of the first strike of economic crisis was somewhat expected, but in 2013, lower collection of VAT was probably the result of numerous organisational weaknesses within the Tax Administration. Analysis shows that out of the total shortfall, as much as 35 billion dinars were due to the weaker tax

² Having in mind that average inflation of around 11% had been foreseen in the planning stage, planned real reduction of these budget expenditures was even higher.

³ Shortfall of VAT revenue compared to that plan was even more pronounced due to objective reasons (real average inflation was lower than the one used for fiscal projections), but also due to optimistic budgeting.

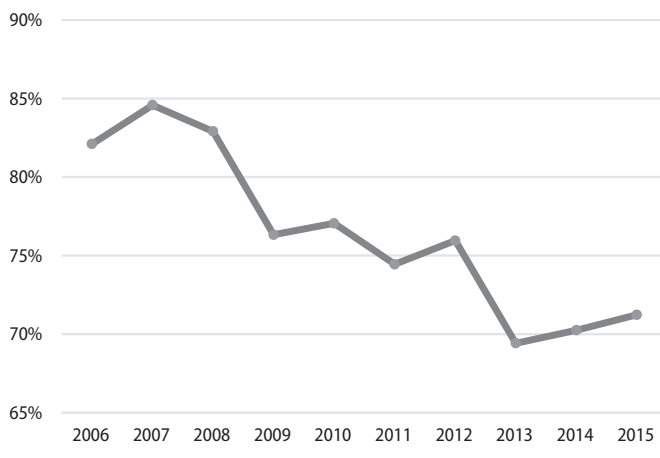
⁴ VAT collection efficiency (the so-called C – efficiency) is calculated according to the following formula: Collection efficiency = Collected VAT revenue / (Domestic nominal spending * VAT rate).

¹ Fiscal Council, Republic of Serbia

Highlights

collection. In other words, had the degree of collection been kept at a level from 2012, VAT revenues would have been higher by 1% of GDP.

Graph 1: VAT Collection Efficiency (C – efficiency)



Increase of tax rates would, therefore, undoubtedly lead to a growth of total state revenue had the work efficiency of the tax authorities at least remained at the (otherwise modest) level from 2012. Therefore, the assessments heard in the public that increase of tax rates is counter-productive, i.e. that instead of consolidating public finances they would lead to a decline of total revenue and consequently growth of deficit (a theoretical concept known as Laffer curve) are not valid. In addition, for the effect of Laffer curve to even show, tax rates would have to be extremely high, which even after their increase certainly wasn't the case in Serbia. On the contrary, with a VAT rate of 20% and corporate income tax of 15%, the tax burden in Serbia was still below the average of European countries.⁵ Current data on collected taxes provide an empirical confirmation that the assumption of the effects of the Laffer curve was wrong: with equally high tax rates, revenue from VAT and excise have been recording a mild growth ever since the second half of 2014. This is most probably a consequence of a slightly better tax collection, which is the result of applied measures for combating grey economy.

Also unfounded were claims that the increase of tax rates would have an extremely negative effect on GDP growth, which would contrary to intentions, lead to an increase of fiscal deficit (so-called *self-defeating* fiscal consolidation). It is indisputable that tax increases have a negative effect on economic growth and the size of that effect is usually expressed through tax multiplier. However, for a country like Serbia, the value of tax

multiplier would have to be quite high in order for the applied increase of tax rates to significantly slow down economic growth and therefore increase the fiscal deficit in percentages of GDP (around 3 according to our calculation). That is, if tax multiplier would indeed be 3, increase of tax revenue by 1% of GDP would decrease the GDP growth rate by 3 percentage points. On the other hand, the reduced growth of GDP would have a direct impact on the decline of tax revenue by 1.05% of GDP (since their share in GDP in Serbia is around 0.35). In this hypothetical example, increase of tax rate would indeed lead to a mild increase of deficit by 0.05% of GDP. Even though there are still no precise assessments of tax multiplier for Serbia, study results for comparative countries indicate that it is probably below 1 – so three times less than what is needed for applied increase of tax rates to be counter-productive.

Negative fiscal trends in 2013, primarily on the side of public revenue, have prompted additional austerity measures with the aim of maintaining fiscal deficit within the limits of the initial plan. Solidarity tax was introduced on public sector salaries above 60,000 dinars, while the lower VAT rate was raised from 8% to 10%. However, already in 2013 a significant growth of state expenditures began due to neglecting and delaying the necessary structural reforms (cost of covering losses of state enterprises and failed banks), so even with additional austerity measures, only a slight reduction of deficit was recorded in 2013 to (still high) 5.5% of GDP.

Huge problems in the operation of numerous state-owned companies were recognised back in 2012 and solution of those problems was an important part of the initial plan of fiscal consolidation. In mid-2013, while conducting a budget rebalancing, the Government explicitly cited problematic companies that needed adequate solutions as soon as possible (Srbijagas, Železara Smederevo, Galenika, Resavica, Dunav osiguranje, and others), but no concrete steps were taken. For example, production in Železara Smederevo (Steelworks) had started again at the beginning of 2013 with the help of a guaranteed loan with the aim of knowing the final status of Železara at the beginning of 2014. However, even after that deadline had expired, the state continued to finance the production of this company which, according to some estimates, cost the state budget 5-10 billion euros (in this regard, in December 2014 Development Fund approved funds for Železara in the amount of over 100 million euros, which is *de facto* a state intervention).

What is especially problematic is constant extension of deadline for finalising the process of restructuring state enterprises, which was supposed to be over in the first half of 2014. Even though direct budget expenditures

⁵ In 2013, average VAT rate in Europe was slightly higher than in Serbia and was around 21%, while the average corporate income tax rate was almost 20%. By comparison, some countries in the region had even higher VAT rates than Serbia, such as Hungary (27%) and Romania (24%).

for this group of companies are not extremely high (the biggest budget subsidy is intended for Resavica in the amount of 4 billion dinars a year), by tolerating their non-payment of taxes, contributions and obligations towards suppliers, the state is indirectly subsidising them quite generously. Not to mention the accumulated debts for consumed gas and supplied electricity of large state systems which have seriously jeopardised operations of public companies, which has already partially spilled over to the state budget. The most obvious example is Srbijagas which has recorded huge losses in the previous years due to, among other reasons, inability to collect receivables from state enterprises such as Azotara, Petrohemija, Železara Smederevo, MSK, and others. Due to chronic illiquidity, Srbijagas is not able to independently pay off loans for which the state provided guarantees in the previous period. So, activated guarantees of this company in 2014 cost the state budget around 150 million euros, and that wasn't even the entire amount of state aid: Srbijagas was approved direct budget loan of around 9 billion dinars, as well as a new guarantee for a 200 million dollar loan. This means that the state in 2014 directly or indirectly aided this public company in the amount that is approximately equal to total savings that will be realised in 2015 from the reduction of pensions and salaries in the public sector (almost 400 million euros).

EPS obligations still have not been a direct cost of the state, but it is important to mention that one of the sources of losses and problems with liquidity of this company are huge debts of companies undergoing restructuring for supplied electricity (in addition to internal issues such as low price of electricity, overstaffing, technical losses in the grid, and others). The debts of seventeen strategically important companies undergoing restructuring alone, for which the Government has extended protection from creditors for another year, amount to 20 billion dinars. In case a strategic partner is found or privatisation of this company conducted, the debts towards EPS will most probably be written off, which will additionally deteriorate the financial bottom line of this company.

Lack of preventive measures in the banking and insurance sector, mainly in the part that is state owned, also led to new budgetary expenditures. Liquidation of Privredna Banka Beograd (Commercial Bank Belgrade) and Univerzal Bank (Universal Bank) have increased the state expenditures since the end of 2013 by almost 200 million euros, including the recapitalisation of Poštanska štedionica (Postal Savings Bank) of around 5 billion dinars, which assumed part of the obligations of these bankrupt banks. An illustrative example of poor management by the state is insurance company “Dunav

osiguranje”. By increasing the number of employees in the period 2007-2012 by around 50% with objectively unchanged scope of work, Dunav which was a relatively profitable company started to record losses. However, even though key issues in business operations were identified, concrete measures were not taken, so in 2014 it was necessary to recapitalise this company from budget funds in the amount of around 5 billion dinars.

Delay of necessary reforms in the sector of state enterprises and banks has completely nullified all previous efforts to heal domestic public finances. In 2014, general deficit of 6.7% of GDP was recorded, equally high as at the beginning of fiscal consolidation in 2012 (6.8%), making the severe measures of budget savings in terms of real reduction of salaries and pensions and increase of tax rates vain sacrifices. Fiscal deficit in 2014 could have been even higher (around 7.7%) and thus show in even more realistic terms the true price of unreformed state sector, had it not been in that year for unplanned large “savings” on capital expenditures (public investments were conducted in the amount of around 300 million euros lower than planned, which made “savings” of 1% of GDP). Starting position before that beginning of the Government's new three-year programme (2015-17) for reducing deficit is only seemingly similar to the previous attempt – public debt has increased in the meantime from 58% of GDP to over 73% of GDP, and budget expenses for interest in 2015 will be twice as high compared to 2012. That fiscal consolidation is much more difficult when the level of indebtedness is higher is confirmed by the fact that cost of interest in the coming years will increase on average by around 20 billion dinars a year, despite the planned reduction of deficit. This means that each following year will require savings of around 0.5% of GDP just to maintain the deficit at the level from previous years (which is almost comparable to the reduction of pensions fund by around 5% which will yield savings in 2015 of around 0.6% of GDP).

In less than three years, Serbia went from averagely indebted country to one of the most indebted countries in the region, and by cost of interest on public debt which will reach 3.5% of GDP this year or over 1.1 billion euros, it is at the very top in Europe. Just how expensive Serbia's public debt is is best demonstrated by comparing it to Greece, debt of which is around 180% of GDP, but it allocates only 0.7 p.p. of GDP more of budget funds to interest (in addition, it is expected that along with the planned severe reduction of deficit, cost of interest in Serbia by 2017 will reach almost 4% of GDP, which would make the gap between us and Greece practically disappear). Defeating fact is also that we are already spending more on interests than on public investments and only slightly less than total expenditure.

Highlights

res on education and science (which along with all other accompanying expenses is enough to pay salaries for over 150,000 employees in this sector).

Having all this in mind, it is quite an irony that one of the important reasons for delaying necessary structural reforms was lack of pressure from international financial markets and relatively cheap borrowing for Serbia in 2013, albeit in dollars. Not only did the state relatively easily finance the current obligations by new borrowing, but the replacement of more expensive loans by cheaper ones was supposed to be an important lever for reducing cost of interests and fiscal deficit, but it did not happen. On the contrary, strengthening of dollar since mid-2014 has increased the cost of all existing dollar obligations and the level of public debt expressed in euros has increased by more than 1 billion euros. This is yet another proof that there are no easy or painless solutions for resolving essential and structural problems of public finances.

2. Such a Severe Fiscal Consolidation Is Possible:

The Case of Romania

Unsuccessful first attempt at consolidating public finances is not a rare occurrence, but there are several countries which managed through responsible and consistent implementation of severe austerity measures and structural reforms to significantly reduce the deficit and thus halt the growth of public debt in a three year period. Romania can serve as an illustrative example as a country that is not only in our region, but whose size and structure of implemented fiscal consolidation is comparable to the challenge Serbia is currently facing. Arrival of the global crisis and deep recession in 2009, as well as deteriorated external conditions of borrowing, brought Romania to the verge of bankruptcy – in order to finance the deficit and matured debt it was necessary to secure almost 20% of GDP.⁶ Severe austerity measures started in mid-2010 and the biggest burden of fiscal adjustment was borne by public sector employees. Salaries were cut by 25% and the number of public sector employees was reduced by around 200,000 within three years (mostly in local self-governments, education, healthcare and police), i.e. by around 15%. Even though a reduction of social expenditures was initially planned, nominal reduction of pensions by 15% was abandoned after the Constitutional Court intervened. However, in order to make up for the lost savings on pensions, Romanian Government was forced to increase the VAT rate by astounding 5 percentage points all at once, from 19%

to 24%. It is important to stress that these draconian measures of budget savings were relatively successfully accompanied by a set of structural reforms whose aim was to improve the business environment and increase public sector efficiency. The end result was impressive – in only three years, the fiscal deficit was reduced from around 9% of GDP to 3% of GDP in 2012, public debt stabilised at the level of around 40% of GDP and Romanian economy is now already achieving remarkable growth rates in the European context.

Analysis of Romanian experience with fiscal consolidation can offer several answers to the question why our first programme of reducing fiscal deficit was unsuccessful and also offer a road map for the current programme. First of all, crucial for the success is the consistent implementation of sufficiently severe austerity measures, but with timely addressing the structural issues which have led to the creation of huge budget deficit in the first place. Probably equally important is the Government's dedication to the fulfilment of the programme: Romania did not have much choice – strong measures were picked as there was no fiscal room for further hesitation and the IMF arrangement had additionally anchored the set goals of fiscal adjustment. There was no similar pressure in the case of Serbia in 2012-2014. Favourable international conditions and consequent easy borrowing during 2013-14 created an illusion that the state of Serbian public finances is not alarmingly bad and that less painful measures were enough to solve the problem, with the support of IMF. By the way, Serbia had two unsuccessful negotiations with IMF about the new arrangement and looking back it seems they were conducted exclusively out of a desire to calm the foreign creditors, but without any real desire to reach an agreement. Perhaps the most important message of the successful consolidation in Romania for us today is that any leeway in implementing fiscal consolidation is not acceptable before the set goals are actually achieved. Romania partially compensated for the initial reduction of public sector salaries only after three years and only because it became certain that despite this salary increase the deficit would still be the planned 3% of GDP. On the other hand, effective reduction of VAT rate, after the drastic increase of tax rate at the beginning of the programme, was done much later, i.e. at the beginning of 2015. Recovery of economic activity and fiscal deficit of below 2% of GDP have enabled the Romanian Government to transfer food products and non-alcoholic beverages from the general rate, which is still 24%, to the lower VAT rate of 9% and thus additionally stimulate private consumption and economic growth without jeopardising fiscal sustainability.

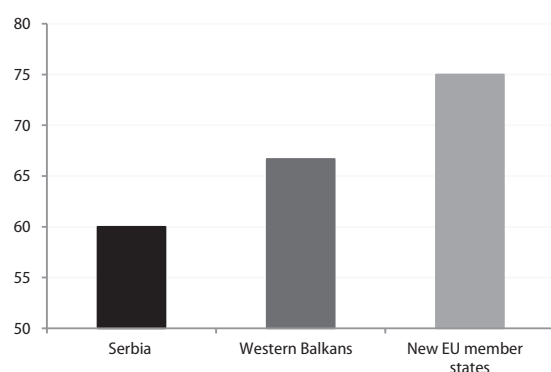
⁶ By comparison, in order to finance the deficit and matured principles of existing debts, Serbia has to borrow around 5.5 billion euros a year, which is a disconcertingly high 17% of GDP.

3. Fiscal Consolidation 2015-17: Where Are We Currently?

New three-year programme of fiscal consolidation started at the end of 2014 and, considering the planned reduction of budget deficit, it is equally ambitious as the previous one from 2012. First results are already reflected in the budget: shortage in the first four months of 2015 was only 22 billion dinars, while in the same period last year, the state deficit was four times higher. Recorded deficit seems to be significantly better compared to the plan due to once-off and out of the ordinary increase of non-tax revenue (primarily unusually high revenue from dividends and profit deposits by public companies and agencies for this period of the year), but also due to a noticeable delay in the execution of public investments. It would seem that part of the reduced deficit is of permanent (structural) nature and is the result of reduction of salaries and pensions at the end of 2014, which is yielding expected and planned savings, as well as mild improvement in the collection of tax revenues.⁷ The biggest challenges, however, are still ahead.

The Government is once again faced with the same wall of structural reforms which was an insurmountable obstacle in the past and the main cause of failure of the first attempt at fiscal consolidation. No matter how difficult and painful the reduction of public sector salaries and pensions was, experiences so far indicate that the main obstacle in achieving set goals was actually unreformed and semi-market economy. According to EBRD data, in Serbia in 2010 still around 40% of total GDP was realised in the public sector, which is considerably higher than in comparable countries (Graph 2). That the situation has not significantly changed in the last five years is confirmed by the fact that even now almost 45% of the formally employed are working in the public sector: state and local administration, education, healthcare, public and state enterprises.

Graph 2: Share of Private Sector in Realised GDP in 2010



Source: EBRD

There are certain reasons why end result of fiscal consolidation now could be different. Part of necessary structural reforms was already concluded in 2014 – with a delay of over a year, pension system reform was finally adopted and Labour Law was harmonised with European standards. Even though pension reform does not yield substantial fiscal savings in the short term, it is of key importance for long term sustainability of national pension system, while changes to the Labour Law present an important improvement of business environment. In addition, fiscal consolidation measures implemented so far are being consistently implemented (reduction of salaries and pensions at the end of 2014) and this is producing planned budgetary savings. However, probably the most important reason is the signing of the three-year IMF arrangement, which is of crucial importance for the credibility of the programme and creditors' trust – without the arrangement, foreign creditors would rate significantly lower the programme that foresees growth of public debt for another three to four years. Agreement with IMF includes pretty detailed plans and deadlines for implementing all foreseen measures (as well as quarterly progress reports by this financial institution), which enables the wider public to easily follow the realisation of goals to which the Government has committed. Additional advantage is expert assistance that can be offered by IMF, World Bank, EBRD and other international institutions included in this programme in solving professionally difficult issues in public and state companies.

On the other hand, plans for the most problematic public enterprises such as EPS, Železnica and Srbijagas are being prepared, so it is still unknown what will be the Government's approach to resolving their core issues (overstaffing, low prices, poor collection, technological obsolescence, and other). Still, even after the plans have been made (plan for financial restructuring of EPS is expected in June), there is still the implementation of these reform measures which is also the most difficult part. Similar applies to rationalisation of public sector employment, which should provide significant budget savings in this and the following two years from the reduction in the number of employees by around 5% a year. What is good is that detailed analyses of the existing state are done, but there is still no concrete plan of layoffs, as well as a plan for the reform/rationalisation of key sectors: healthcare, education, police, judiciary, etc.

Avoiding the solving of the status of companies in restructuring, as we have seen, was one of the main causes of failure of the fiscal consolidation programme 2012-14. However, even though protection from creditors for these companies was due to expire in May 2015 (which would mean for most companies insolvency and ban-

⁷ See monthly report of the Fiscal Council: Fiscal Trends in March 2015.

Highlights

kruptcy), the Government extended this deadline for the group of 17 strategically most important and biggest enterprises for another year. The delay is to a certain extent understandable since it was not realistic to expect privatisation or finding strategic partners for all companies in just a few months – but only if the new deadlines are fully respected (although it is perfectly valid to raise a question of why so little had been done in the previous period). It is important to note that this delay could potentially lead to new budgetary spending. If the state, with the aim of finding strategic partners, took on commercial debts of these companies (which has already been done in the case of JAT in the amount of around 20 billion dinars in 2014), additional spending could in worst case scenario reach as much as 700 million euros, which would be absolutely unsustainable.⁸ In addition, it remains to be seen how this would affect operations of Srbijagas, i.e. whether the companies that are not restructured: Petrohemija and Azotara would still spill over their losses to Srbijagas and thus indirectly to the state budget.

Announcements of the officials about possible increase of public sector salaries and pensions already in 2015 jeopardise (if implemented) the credibility of the entire programme. Abandoning the main measure of fiscal consolidation, which is by far the biggest source of permanent (structural) budgetary savings, even in part, would certainly lead to the new growth of fiscal deficit. Such statements are premature and are the result of exaggerated optimism based on currently better fiscal trends compared to the plan (which is probably only temporary) and expectations of a stronger economic growth which is still not visible through official statistical data (and is therefore unreliable). Creating a false image that crisis is practically behind us is very dange-

rous and could seriously diminish the public's readiness for reforms before they have even started. Any leeway before the main cause of unsustainable state in national public finances is completely removed, and according to our previous experience with fiscal consolidation it is the unreformed public sector, could lead to austerity measures taken so far becoming yet another vain sacrifice.

Whether this time will actually be different basically depends on the success of reforms of three key public sectors: public enterprises, enterprises in restructuring, and public administration. Three-year arrangement with IMF gives credibility to the programme of fiscal consolidation, but it also requires the arranged agreements to be implemented. Even Government officials stress in their public appearances the commitment to the set reform course and the respect of signed agreement with this international institution. On the other hand, plans for the reform of state-owned enterprises and public administration are only in preparation phase (some deadlines are even being postponed), so the implementation of measures, which is the biggest challenge, has not yet started. Having in mind that fiscal consolidation 2012-14 failed precisely because attentions and plans to reform the public sector were abandoned when it came to implementing them, the success of current programme is still uncertain. On the contrary, we can say we are only at the beginning of a three-year period (at best) during which it will be necessary to implement difficult and painful reforms. Therefore, this first, and mostly temporary, reduction of fiscal deficit cannot serve as an excuse to relax (increase of salaries and pensions already at the end of this year?) before the main cause of unsustainable national public finances is removed, and that is the unreformed public sector.

⁸ According to the last available data, in 2013 commercial debts of 17 strategically important enterprises in restructuring amounted to around 700 million euros.

Highlight 2. Integration of construction land usage fee into property tax in Serbia: results and lessons learned

Saša Ranđelović¹

Reasons for integration of construction land usage fee into property tax

Essentially, there were two types of property tax in Serbia for years - property tax (on property right or some other absolute rights related to property owned by any individual or legal entity) and construction land usage fee ("the fee"). Property tax was paid on buildings; construction land was subject to usage fee, while other types of land were *de facto* exempt from taxation. This was inherited from the socialist system in which the state was the only owner of construction land and private individuals had no property right but were just users and paid usage fee. In the Constitution of Serbia adopted in 2007, right of ownership of construction land was extended to private individuals. However, envisaged by the Law on Planning and Construction which was in force at that time, the fee continued to exist parallel to the property tax. The amount of the fee was determined by the area of the land and buildings situated on it, its location, existing utility infrastructure, and its purpose. By its economic essence, this fee was property tax. It is, however, economically unreasonable to deduct two similar taxes from one tax base (double taxation). Furthermore, the fee was more volatile than property tax, because local self-governments had great discretionary power over assessment criteria for the fee, which enabled them to change these criteria in case they needed additional revenue inflow, and, at the same time made business environment less predictable. For all these reasons, decision to abolish the fee and integrate it into the property tax was adopted in 2009, and the amendments to the Law on Property Taxes adopted in 2012 enabled its implementation. Finally, the construction land usage fee was abolished as of January 1, 2014. It took five years to carry out this reform which indicates that it was highly demanding in organizational terms and involved great political risks, because it implied a considerable increase in property tax, which was paid quarterly, while the fee was incorporated into utility bill and was paid monthly.

Table 1. Revenue from property tax and construction land usage fee in 2013

	RSD bn.	% total revenues of local public revenues		
		average	min	maks.
Property tax	16.4	6.9%	0.50%	11.40%
Construction land usage fee	16.0	6.7%	0%	36.50%
Total (tax and fee)	32.4	13.6%	0.80%	39.90%
Total local public revenues	238.2			

Source: The Ministry of Finance of the Republic of Serbia and the author's calculations

The greatest threat involved in abolition of the fee lay in the fact that it was one of the major sources of revenue at the local level. In 2013, the last year of existence of the fee, revenue from property tax and revenue from the fee were almost equal and totaled RSD 16 billion each, or 7% of the total revenue of local self-governments (Table 1). However, revenue from the fee differed widely among municipalities, while there was a much smaller difference in revenue from property tax. Accordingly, revenue from property tax ranged from 0.5% to 11.4% of the total revenue of local self-governments, while revenue from the fee ranged from 0% to 36.5% of the collected revenue. Implementation of this reform without causing any notable loss of local public revenue is one of the main criteria for measuring how successful this reform is. Another criterion is its allocative neutrality, i.e. ensuring that no considerable reallocation of tax burden among certain sectors and groups of taxpayers occurs.

Results of integration of construction land usage fee into property tax

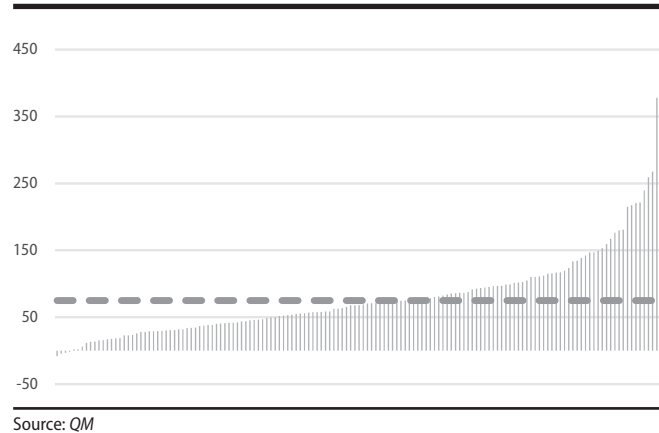
Given the revenue impact of the construction land usage fee, the greatest challenge involved in integration of this fee into property tax was to make up for the loss of revenue through reparametrization of property tax. Previous researches show that there is still much room to increase tax revenue within the current property tax system, because almost 1/5 of buildings have not been entered in tax registers maintained by local self-governments, the tax base is underestimated by 40% on average compared with the market price of buildings, and more than 1/3 of local self-governments do not apply the maximum tax rate on property envisaged by the law (Arsić, et. al. (2014)). Furthermore, agricultural and forest land/ other types of land were *de facto* exempt from taxation for decades, because cadastral income served as the tax base, and not having been indexed for more than two decades, it was negligibly small. However, any of these available ways to increase revenue impact of property tax involves potential political risks, because this tax is assessed and collected by local self-governments and it directly hits the residents/voters. For this reason, there

¹ Faculty of Economics, University of Belgrade and QM

Highlights

was a risk that the abolition of the fee would not be followed by sufficient increase in revenue from property tax and that local self-governments would then demand that the central government make up for the loss of revenue through revenue transfers.

Graph 1. Increase in revenue from property tax in 2014 compared with 2013, by local self-governments (in %)

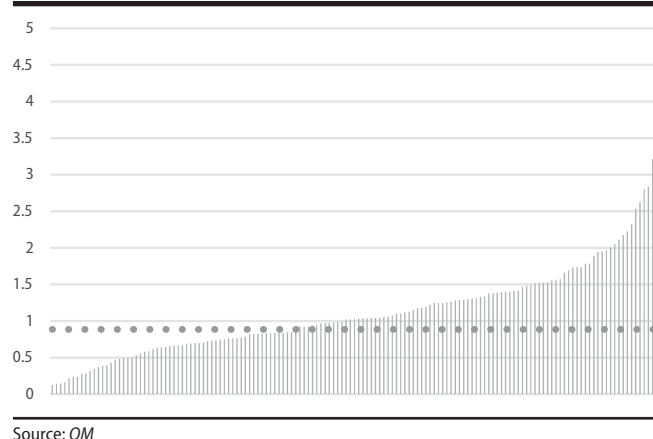


Nevertheless, data show that revenues from property tax grew by 75% in 2014 (from RSD 16.4 billion to RSD 28.7 billion), and that the unweighted average of the increase in revenue from property tax in 2014 compared with 2013 was 80%, while the median was 68.3%. Small difference in value between the weighted and unweighted average and the median indicates that there was a widespread rise in revenue from property tax. Accordingly, analysis by individual local self-governments shows that only four of them failed to increase this revenue. At the same time, some local self-governments increased their revenue from property tax several times in 2014 (revenues of nine local self-governments increased more than twofold), probably because property tax as a source of revenue had not been exploited effectively, and because tax liabilities from previous years were collected.

Data also show that the revenue from property tax collected in 2014 was only 11.4% smaller than the sum of revenue from property tax and revenue from the fee collected in 2013. This indicates that the reform was quite fiscally neutral, that is to say, it did not cause a notable loss of public revenue. Revenues from property tax of more than a half of local self-governments (i.e. 75 out of 145) collected in 2014 exceeded the sum of revenue from property tax and revenue from the fee collected in 2013. However, the fee was an important source of revenue in large cities (in some of them the revenue from the fee exceeded the revenue from property tax). In most of these cities the revenue from property tax collected in 2014 did not exceed the sum of revenue

from property tax and revenue from the fee collected in 2013. Consequently, total public revenue fell slightly.

Graph 2. Ratio between the revenue from property tax collected in 2014 and the sum of revenue from property tax and the construction land usage fee collected in 2013, by local self-governments



Conclusions and lessons learned

According to the results achieved in 2014, integration of construction land usage fee into property tax was carried out successfully, because two basically identical taxes with large revenue impact were integrated into one tax without causing a significant loss of tax revenue or notable distortions (regarding allocation of tax burden). This shows that even the reforms that are technically demanding and involve potential political risk can be carried out successfully if they are adequately prepared in terms of organizational and technical issues and if the public is well informed on their advantages.

This reform caused certain reallocation of tax burden, which was probably inevitable. However, in some cases, there was a disproportionate increase in total tax burden caused primarily by property tax parametrization (zoning, real estate valuation etc.), which should be removed through further fine adjustments to the system. This implies attaining a more adequate and fair valuation of real estate located in different zones, because there was a large number of complaints related to inadequate assessment of tax base and unrealistic difference between the assessed values of real estate located in different zones. Furthermore, a considerable number of buildings have not been registered and therefore are not subject to taxation. Central government should place local self-governments under systemic supervision to determine to what degree they exploit property tax as a source of revenue, and should introduce an incentive system in the form of additional revenue transfer to local self-governments with above-average performance

(the ones that collect more revenue, send more dunning letters, have smaller number of unregistered buildings, apply tax rate closer to the maximum rate etc.). Moral hazard, that is to say, local self-governments not putting enough effort to collect property tax (for political reasons) knowing that the central government will make up for the lacking revenue through revenue transfers, would thus be somewhat reduced. All this leads to conclusion that the reform is justified both from the aspect of allocative neutrality and equity, because most of the tax assessment criteria for property are defined in the law and are more objective than the assessment criteria for the fee (each local self-government established its subjective assessment criteria so the amount of the fee varied).

There are many other examples of parallel existence of two *de facto* very similar taxes (property tax and fee for environmental protection and improvement, corporate income tax and signboard fee), or two identical taxes

levied by both central government and local self-governments (tax on use of motor vehicles). The announced reform in the system of financing local self-governments, and systemic approach to the issue of fees for public goods usage are the opportunity to simplify the tax system (through abolition and/or integration of similar taxes) and make it more predictable (by clearly defining the amounts and the assessment criteria), and thus improve business environment.

Literature:

Arsić, M., Bučić, A., Vasiljević D. and S. Randelović, (2014) „Analiza mogućnosti za kompenzaciju prihoda od naknade za korišćenje građevinskog zemljišta kroz porez na imovinu“. FREN and SKGO, Belgrade

Bilten javnih finansija za februar 2015. godine, Ministarstvo finansija Republike Srbije, Belgrade, 2015.

Highlights 3. Demographic trends and the number of employees in primary and secondary schools¹

Mladen Stamenković²

Abstract: This Highlight focuses on demographic changes which significantly affected the number of pupils in primary and secondary schools in Serbia. During the last 15 years the number of pupils in primary and secondary schools has been significantly reduced, while at the same time, the number of teachers significantly increased. With one of the lowest pupil-teacher ratio Serbia has an oversized system of primary and secondary education, and so the rationalization of the schools network and the reduction of teaching (and non-teaching) staff is one of the necessary steps to reduce public expenditure.

1. Trend in the number of Pupils in primary and secondary schools

Low birth rates and external migrations had impact on the reduction in the number of pupils in primary and secondary schools. The number of children born on the territory of Central Serbia and Vojvodina fell from over 100.000 in the seventies to about 70.000 per year in the period after 2000. In addition to the low birth rates, the decline in the number of births is influenced also by the emigration from Serbia. Stankovic (2014) suggests

that the 2011 Census of population registered 313.411 citizens of Serbia living abroad while the number of returnees from work abroad was 234 932. However, official statistics does not include the permanent migration as well as anonymous stays abroad, and Table 1 clearly shows that it is a far greater number of Serbian citizens.

Internal migrations influenced the making of the discord between the territorial distribution of primary and secondary schools created a few decades ago, and the current territorial distribution of pupils. As a result of large-scale internal migrations there are schools with large classes and on the other side schools with few pupils.

Table 1. Total number of pupils in primary schools.

Total	2000/2001	2010/2011	2014/2015
The Republic of Serbia	711,954	578,978	558,869
Belgrade region	136,891	119,550	124,041
Vojvodina region	-	156,111	150,519
Sumadija and Western Serbia	-	168,824	161,732
Southern and Eastern Serbia	-	134,493	122,577

Source: SORS.

The number of enrolled pupils in the current 2014/15 school year is lower by 22.2% from the number of pupils enrolled in, not so distant, 2000/01 school year. In less than 15 years demographic changes have affected the number of pupils enrolled in schools in such way that this number has been reduced from over 85.000 to slightly more than 65.000 pupils. Tables 1 and 2 show the change in the number of pupils in primary schools during this period, both in the total (Table 1) and in the number of first graders (Table 2).

¹ The author would like to thank Miloško Arsić for helpful comments and suggestions.

² Faculty of Economics University of Belgrade.

Highlights

Table 2. Number of pupils in the first grade of primary school.

The number of pupils - 1st grade	2000/2001	2010/2011	2014/2015
The Republic of Serbia	85,226	74,759	66,276
Belgrade region	16,155	15,654	15,662
Vojvodina region	-	20,536	17,851
Sumadija and Western Serbia	-	22,015	18,743
Southern and Eastern Serbia	-	16,554	14,020

Source: SORS.

Of course, that this trend is not only related to the elementary schools we see from Table 3, which shows the total number of pupils attending secondary schools, today as well as during the 2000/2001 and 2010/2011 school year. Perhaps unexpectedly the greatest reduction in the number of pupils in secondary schools in the last fourteen years happened in the Belgrade region (22.7%), which is for 3.5 percentage points more than in Serbia as a whole (19.3%). However, when we look at the situation from 2010 most significant drop in the number of pupils is present in the region of Southern and Eastern Serbia (9.1% pupils less) and the lowest in the Belgrade region (7.6%).

Table 3. Total number of pupils in secondary schools.

Total	2000/2001	2010/2011	2014/2015
The Republic of Serbia	323,490	285,596	261,156
Belgrade region	79,613	66,665	61,578
Vojvodina region	84,205	73,570	66,372
Sumadija and Western Serbia	91,007	81,754	75,417
Southern and Eastern Serbia	68,665	63,607	57,789

Source: SORS.

The question arises how this important demographic change of population affected the school network, if that is the case. If we look at the number of primary schools in Serbia (Table 4), we might get the impression that the state, in line with the decrease in the number of pupils, also rationalized the network of primary schools. Thus, from 2010/11 school year we have 11% fewer pupils and for about 1.5% fewer schools, while for a period of ten years from starting the 2004/2005, the number of pupils decreased from 656.103 to 558.869, or for 14.8%, while at the same time the number of elementary schools decreased by 4.6%. Of course, these percentages cannot be compared in absolute terms, but from the standpoint of rational management of public

Table 4. Number of primary and secondary schools in Serbia.

Total	Primary Schools			Secondary schools		
	2004/2005	2010/2011	2014/2015	2004/2005	2010/2011	2014/2015
The Republic of Serbia	3,578	3,468	3,414	485	498	506
Belgrade region	-	286	290	-	99	104
Vojvodina region	-	537	535	-	140	139
Sumadija and Western Serbia	-	1,410	1,384	-	136	141
Southern and Eastern Serbia	-	1,235	1,205	-	123	122

Source: SORS.

policy it is to be expected that the trend is identical. On the other hand, the number of secondary schools has slightly increased, so we have an increase in the number of secondary schools of 1% in the last ten years, despite the reduction in the number of pupils of 12.9%.

2. The number of teachers and average class size

Of course, the number of schools and the decision on closure of some school should not be made solely on the basis of negative demographic trends. However, what can be most surprising and even worrying when reviewing Table 5, taken from the Statistical Yearbook for 2006 and 2014, is that the number of teachers, against all rational arguments, increased by 20% in the period of ten years up to 2011 despite the reduction in the number of pupils of 12.3%.

Table 5. Comparison of the total number pupils and teaching staff.

	Pupils	Classes	Teaching staff
2000/2001	1,262,934	43,573	81,419
2010/2011	1,107,215	40,849	97,857
2012/2013	1,101,172	37,636	99,777

Source: SORS.

We can conclude from Table 6, which shows the number of teachers in secondary schools and the total number of teachers, as well as the number of full time teachers that this trend of considerable increase in the number of teaching staff continues, contrary to all demographic trends.

Table 6. Number of teachers in secondary schools.

Total	Total			Full-time	
	2004/2005	2010/2011	2014/2015	2010/2011	2014/2015
The Republic of Serbia	27,298	29,750	29,862	18,876	16,655
Belgrade region	-	6,774	6,821	4,845	4,409
Vojvodina region	-	8,163	8,053	5,188	3,627
Sumadija and Western Serbia	-	8,070	8,226	4,922	5,000
Southern and Eastern Serbia	-	6,743	6,762	3,921	3,619

Source: SORS.

We see that at the secondary school level the number of teachers in the past ten years increased by 9.4% despite the aforementioned decrease in the number pupils of 12.9% in the same period. Of course, a direct consequ-

ence of this is a significantly smaller number of teachers working full-time due to the reduced number of pupils. So in the last four years we have 11.1% fewer full-time teachers, where this change is most pronounced in Vojvodina and amounts to a whopping 30%. The opposite situation compared to all other regions is in Šumadija and western Serbia, where we have an increase in the number of full-time employees by 1.5%. In Vojvodina, the total number of teachers decreased in this period by 1.35%, which is the only change in the number of the teaching staff in the direction of reduction, while the largest increase, 1.9% was recorded in the Šumadija and western Serbia. Similarly, the increase of the teaching staff in primary schools of about 15% indicates that the trend of irrational increase of the educational sector is equally represented in primary and secondary education.

It is interesting to notice that demographic changes and changes in the number of teachers that we have mentioned did not affect, almost at all, the average number of pupils in the classes, which can be seen from Table 7, which is likely to be described by increasing secondary school coverage from 77% according to the Statistical Yearbook for 2006 to 88.5% according to the Statistical Yearbook for 2014.

Table 7. The average class size in Serbia.

	2010/11	2014/15
Primary schools	22.4	22.3
Secondary schools	25.7	24.6

Source: SORS.

The situation with the size of classes in comparison with other countries can be seen from Table 8, where we can note that, on average, there is a larger number of pupils in a class than all other countries in the region, but the difference is not such that we can talk about significantly larger classes in Serbia. This is evident if we compare the data with the average of OECD countries. For comparison, the average number of pupils in Japan is 28.

Due to the harmonization of standards to Eurostat, the average number of classes is shown in accordance with ISCED methodology. ISCED 1 represents the basic education lasting for a period of 6 years and ISCED 2 represents lower secondary education lasting for a period of 3 years. Data for Serbia are adjusted to match these standards. ISCED 3 is an upper secondary education, from tenth to twelfth year of education, and the average class size in Serbia in this category is 24.3. What would be interesting to determine and compare are the variation of class sizes in schools, municipalities and regions in Serbia.

Table 8. The average number of pupils in the class.

	ISCED 1	ISCED 2
Serbia	22.7	22.3
Bulgaria	20.7	22.1
Greece	17.3	21.9
Croatia	16.9	20.8
Hungary	20.9	21.2
Romania	19.4	20.9
Macedonia	17.9	19.4
Finland	19.4	20.3
OECD average	21	24

Source: SORS.

A direct consequence of the identical class sizes and changes in the number of pupils and teachers is a noticeable drop in the number of pupils per teacher. Table 9 shows the pupil-teacher ratio for all levels of education in Serbia, as well as for other countries. Data for Serbia in columns ISCED 1 and ISCED 2 represent the pupil-teacher ratio for primary and secondary education and are not fully comparable with other countries, but show very clearly the existence of surplus labour in the education sector.

Table 9. Pupil-Teacher ratio for all levels of education.

	ISCED 1	ISCED 2	ISCED 3
Serbia	10.8	8.7	
Bulgaria	17.5	12.8	12.3
Croatia	14.2	9.6	9.7
Slovenia	15.9	7.9	14.1
Hungary	10.7	10.6	12.5
Romania	18.1	13	15.9
Macedonia	15.3	9.9	13.8
Sweden	11.8	11.3	13.2
OECD average	15	14	14

Source: SORS.

This ratio, of course, can favourably influence the quality of education although different results on the significance of the impact of class size and pupil-teacher ratio can be found in the literature (see Hanushek et al. (2011) for a detailed review of the literature). It is clear that such a large number of teachers, especially when it comes to basic education, is in no way cost effective because the results of our pupils (which we covered in the previous issue of QM) and their lack of progress in the PISA tests in the last ten years show that positive effects due to the better work with pupils (assuming correlation) are not the equal to economic effects and price of unnecessarily large number of teachers, especially in primary schools. The World Bank came to the same conclusion, and the rationalization of the network of primary schools is considered one of the best ways for significant savings in the public sector (World Bank, 2009). Average class sizes suggest that this may have been too harsh assessment, but the significance of the report is reflected in the fact that for the first time in an argumentative

Highlights

way the existence of a problem is indicated. The average class size that is larger than in other countries shows that it is possible to reduce the excess part of the existing number of teaching staff by creating a larger number of smaller departments. This would increase the number of classes, but still the pupil-teacher ratio at such low level, especially in primary schools, will be an indicator that it is necessary to reduce the number of the teaching staff.

3. Conclusion

Significant demographic changes and the reduction in the number of pupils for over 22% percent between 2000/01 and the current 2014/15 school year has in no way changed the structure of the teaching staff within primary and secondary schools. Moreover, the number of teachers in primary and secondary schools, for example, in the period from 2000 to 2010 has increased by 20%. We showed that this trend wasn't changed even in the past five years, and so in secondary schools the number of teachers increased slightly in this period. This policy in education has led to, for example, increase of 11.8% in the number of teachers who do not have the full number of working hours in secondary schools in the last five years.

We have seen the size of the problem of too large a number of teaching staff, which is certainly not in line with the demographic trends, in the analysis of the average size of classes and pupil-teacher ratios. A significant reduction in the number of pupils did not affect the average class size, because the number of classes was reduced, while the pupil-teacher ratio is significantly lower than in the countries of the region. This low pupil-teacher ratio is a clear indication of excessive teaching staff especially when it comes to basic education and, although painful, reform of school network, the closure of schools with insufficient number of pupils, and the reduction of teaching staff are the steps that at some point we will have to be taken. All this has to be done systematically and carefully because it is important that with the reduction of teaching and non-teaching staff

the quality of education is continually improved. This can be achieved by partial increase in the number of classes, which would consequently lead to a larger number of classes for teachers and moderate necessary reductions in the number of the teaching staff. The second measure, which is justified from the point of adequate preparation of citizens for the labour market, is the introduction of compulsory secondary education. The introduction of compulsory secondary education would increase the number of pupils and classes in secondary schools, which would allow the full engagement of the teaching staff that is now working with incomplete teaching hours. Here we have not made the estimates of non-teaching staff, but its reduction should be equal to or greater than the reduction of the teaching staff.

Literature:

Schwab, K. (Ed.). (2014). *The global competitiveness report 2014-2015*. Geneva: World Economic Forum.

Docquier, F., Lowell, B. L., & Marfouk, A. (2009). A gendered assessment of highly skilled emigration. *Population and Development Review*, 35(2), 297-321.

Hanushek, E. A., Machin, S. J., & Woessmann, L. (Eds.). (2011). *Handbook of the Economics of Education* (Vol. 4). Elsevier.

World Bank. (2009). *How to do more with less. Dealing with the fiscal crisis by increasing productivity in the public sector*. Belgrade: World Bank. Docquier, F., A. Marfouk (2006). *International migration by educational attainment (1990-2000)*.

In: Ozden, C. et M. Schiff (eds), *International migration, remittances and the brain drain*, Chap 5, Palgrave-Macmillan.

Stankovic, V. (2014). *Serbia in the process of international migration*. SORS.

Statistical Yearbook of Serbia - editions from 2001 to 2014, SORS

Highlights 4. What is necessary for the sustainable growth of the Serbian economy?

Milojko Arsić¹

Serbia is in a small group of countries of Central and Eastern Europe² which have failed to reach the pre-crisis level of GDP in 2014. Serbia's economy recorded a growth in the fourth quarter of the last year, but GDP declined again in the first quarter of this year (for more details see Section 2). In the coming quarters of 2015, GDP growth is expected, largely as a result of the recovery of electricity and coal production from the last year's floods. However, flood recovery allows temporary, relatively modest growth of the economy. Therefore, a relevant question is what is needed to put the Serbian economy on the road of the long term sustainable growth. Justification of such analysis comes from the fact that the Serbian economy in recent history had several episodes of rapid growth, which were accompanied by high imbalances, and therefore growth was unsustainable in the long run. Thus, for example, in the period 2001-2008 high growth rates were achieved but with long-term unsustainable level of external deficit and a growing fiscal deficit.

The growth is sustainable in the long run³ if it is achieved without any major internal and external imbalances, and if it is achieved with small fiscal and external deficits. Low deficits do not lead to the growth of public and foreign debt in relation to GDP and so the economic growth can last indefinitely. Sustainable growth implies a relatively high investment in physical capital, as well as a permanent improvement of knowledge and skills of the workforce. Low external deficit implies that the investments are mostly financed by domestic savings and that the country will not enter the balance of payments crisis in the future. It can be concluded that Serbia has not yet moved on the path of sustainable growth, since fiscal and external deficits remain high, while investment are low and largely financed by foreign savings. Besides the economic environment in Serbia is

still not sufficiently encouraging for the development of the private sector, which should be the dominant driving force behind economic growth in the future.

1. Imbalances in the economy

With launching the fiscal consolidation in the second half of the previous year fiscal deficit was reduced to about 2% of GDP, but even after that reduction fiscal deficit in Serbia will amount to about 4.5% of GDP⁴, which is unsustainable in the long run. An additional problem is that a considerable part of the deficit reduction was achieved by applying temporary, long-term unsustainable measures, such as the payment of dividends of public enterprises, taking 10% of wages from employees in the public sector, delayed payments for severances and others. Once these temporary measures cease to make effects this will cause the automatic increase in the fiscal deficit as it was the case in 2011 when measures such as excise duty on mobile phones, a reduction in transfers to local municipalities and others were abolished.

The fiscal deficit, which does not lead to the increase of the public debt in relation to GDP, with the expected growth of the economy and interest rates, is below 3% of GDP, while the long-term sustainable fiscal deficit is at 1% of GDP⁵. Therefore it is necessary to further reduce the fiscal deficit for about 2% of GDP to stop the growth of public debt in relation to GDP in a relatively short period of two years, and then to continue to reduce the fiscal deficit up to 1% of GDP over the medium term. Therefore, to continue reducing the fiscal deficit it is necessary for the Government, already in this year, to prepare measures whose implementation would lead to the fiscal deficit decline in the following years. Instead, representatives of the Government announce the abandonment or postponement of the implementation of such measures, and announce measures that would directly affect the growth of the fiscal deficit (increase in public sector wages and pensions at the end of 2015). This behaviour of the Government representatives is motivated primarily by political factors –with the increase in public spending and reduced savings the government will try to win over voter support.

However, in addition to political reasons, the intention of the Government to mitigate or postpone fiscal con-

¹ Faculty of Economics University of Belgrade.

² Smaller GDP in 2014 compared to 2008, with Serbia had only Croatia, Slovenia and Latvia, but Latvia will already in 2015 reach the pre-crisis level of GDP, while the pre-crisis level in Serbia could be reached in 2016. Although Slovenia, Croatia and Serbia have different starting positions and have implemented different models of transition, they all share the delayed resolution of the fundamental problems of their economies. The inability to solve basic questions in the economy and public finances in particular has become obvious from the beginning of the global economic crisis.

³ In this article we only analyze conditions for economically sustainable growth of a functionally market economy, though the sustainable growth has many other aspects, such as social or environmental sustainability.

⁴ It is possible that the actual fiscal deficit in this year will be smaller, but this will be achieved with temporary savings such as the postponement of the part of severances payment for the coming year, lower public investmentsthanplanned and others.

⁵ Reducing the fiscal deficit to 1% of GDP in the case of Serbia is also necessary to reduce the public debt from about 80% of GDP, where it would be at the end of this year, to below 60% of GDP which is the amount the Maastricht criteria, and then to below 50% which is appropriate to circumstances in which Serbia is.

Highlights

solidation is partly based on optimistic and wrong assessments. Assessment of the Government that Serbia is already on the way to a rapid and long-term sustainable growth is overoptimistic and almost certainly wrong. From this wrong assessment wrong conclusion are made that so far achieved savings measures are sufficient, and perhaps exaggerated, i.e. that it is sufficient to hold consumption at the present level or even slightly to increase it, but that spending and deficit, seen as a percentage of GDP, will decline due to a strong GDP growth.

Moreover, there are suggestions that the GDP growth should be fostered by the increase in government spending or an increase in salaries and pensions. The assumption is that the increase in salaries and pensions would have more impact on GDP growth than on the increase of the fiscal deficit, so as a result the ratio of fiscal deficit to GDP would decline. In Serbia, small and open economy with a flexible exchange rate, fiscal multipliers are low, which besides econometric estimates is confirmed by the recent experience -Serbia during the previous three years had the highest fiscal deficit in Europe, which should potentially represent a strong fiscal stimulus, but its economy was in recession. In contrast, the countries of Central and Eastern Europe which have implemented fiscal consolidation in the previous years are now achieving economic growth. This year's experience, according to which the Serbian economy will stagnate or decline slightly in spite of a strong fiscal consolidation of around 2% of GDP also indicates the small impact of changes in the fiscal policy on economic growth.

Overall, it would be possible to boost economic growth in Serbia temporarily by increasing domestic consumption and increasing salaries and pensions, but such increase would not be significant because the fiscal multipliers in Serbia are low. Moreover, even that small increase in GDP would not be sustainable in the long run because the increase in wages and pensions would lead to the increase of fiscal and external deficits, and thus the public and external debt, which in the future would require spending cuts or tax increases, which would have negative impact on economic growth in the future.

The external imbalance, although much lower than in the pre-crisis period, is still high and unsustainable in the long run. Current account deficit of around 6% of GDP is not sustainable in the long-term, because it affects the growth of foreign debt or more generally deteriorates net assets position of the country⁶. Long-term

⁶ The net assets position is the difference between the foreign exchange reserves, loans granted abroad and investments abroad on the one side and received foreign loans and foreign investment in the country on the other side. With regard to the fact that Serbia does not invest a lot

sustainable current account deficit which does not generate the growth of external debt in relation to GDP, for a country like Serbia, ranges from 3-4% of GDP. This raises the question of what the Government can do to reduce the external deficit to sustainable levels. Anti-market economists often suggest the introduction of import barriers, which would in their view not only reduce the external deficit, but would encourage the growth of the economy. We estimate that measures like this are wrong for most economies, especially economies with small internal market as it is the case with Serbia. In addition it is certain that the introduction of import barriers would lead to countermeasures by other countries, which would result in a reduction of exports from Serbia⁷.

Key measures to reduce the external deficit are reducing the fiscal deficit and a moderate depreciation of the real dinar exchange rate against the euro. Reducing the fiscal deficit directly reduces domestic demand⁸ which has been for almost 15 years considerably higher than the GDP (domestic production), while the depreciation of the dinar will discourage imports and stimulate exports. Moderate depreciation of the real dinar exchange rate is a superior solution compared to the introduction of import barriers, which does not create an arbitrary allocation distortions, nor it creates space for lobbying of interest groups. The reduction in the external deficit will be favourably affected by reforms which improve conditions for investments and increase domestic production oriented towards exports. Serbia's export to GDP ratio is still much lower than in comparable countries of Central Europe, so there is a large space for growth in exports and a reduction of the external deficit on this basis. While in Serbia exports of goods and services in 2014 amounted to 44% of GDP, share of exports in GDP in countries of similar size (Bulgaria, Czech Republic and Hungary) is about 80%. Thus, Serbia has a large space for growth in exports and a reduction of the external deficit on this basis. In addition, growth of exports is a key driver of sustainable growth of the Serbian economy in the coming years, and so the double-digit growth rates of exports would represent a signal that Serbia is on a sustainable growth path.

in foreign countries, as well as that it does not approves loans abroad its net assets position is approximately equal to the difference between the foreign currency reserves and the sum of debts abroad and foreign investments in Serbia.

⁷ Paradoxically, barriers on imports of agricultural products are often suggested because Serbia is a significant net exporter of these products. The introduction of such barriers for EU countries or countries of the region would for sure lead to their countermeasures, which would result in a reduction of exports of agricultural products from Serbia.

⁸ The decrease in domestic demand has a direct impact on the reduction of imports, and indirectly affects the growth of exports because local producers are encouraged to compensate the drop in domestic demand with higher exports.

Investments in physical capital are a direct determinant of economic growth. Although there is no unambiguous relationship between investment and the growth of the economy, it is quite certain that with investments of about 20% of GDP, which is now the case in Serbia, rapid growth of the economy in the future cannot be expected. Based on the experience of similar countries from Central Europe it can be estimated that the rapid economic growth requires investments of around 25% of GDP. In the case of Serbia this implies an annual increase in investment of over 5% of GDP i.e. from 1.5 to 2 billion of euros. It is crucial to increase private investment reforms aimed at creating more favourable conditions for investments, but also fiscal consolidation based on reducing government spending, because it increases assets in the long-term which remain in the private sector⁹. In the mid-term, the state can directly affect the increase in total investment by increasing public investments in infrastructure from the current 3% to 5% of GDP. Infrastructure construction, which reduces the costs of doing business in Serbia would favourably impact the growth of private investment in the long term. From the standpoint of the growth of the economy it is bad that the dividends of public enterprises, which would be largely used for investments, are paid to the Serbian budget, which is largely used for current spending, meaning that the payment of dividends in the budget reduces total investments. In the long term it is important that as a higher percentage of investment is financed by domestic savings.

2. Economic environment

The absence of high internal and external imbalances is a necessary but not sufficient condition for sustainable growth of the economy. In order to grow the economy in the long run numerous additional requirements are needed, such as the effective protection of property rights, financial discipline, adequate competition policy, educated workforce, efficient administration, developed financial system, low corruption, low inflation, moderate taxes and other¹⁰. Reforms, including those that were implemented from the middle of last year, are significant, but still insufficient for the economic environment in Serbia to be characterized as stimulating for the economy growth. According to the business conditions indicator of the World Bank Serbia is ranked 91 in the world, while in the competitiveness ranking of the World Economic Forum is ranked at 94th place. It can

be expected that, as a result of the reforms that have been implemented since the middle of the last year and due to the reduction of macroeconomic risks by implementing fiscal consolidation, Serbia will progress on these lists for 15-20 places, but will still be ranked lower by 20-30 places than the countries of Central Europe. From the above mentioned it can be concluded that in Serbia a number of additional reforms are necessary in order to catch up to Central European¹¹ countries in terms of competitiveness and business conditions. Although in Serbia there are a number of academics (economists, sociologists, philosophers and others.) which blame “neoliberal reforms” from 2001 for all the difficulties Serbian economy is facing with, it is quite obvious that such reforms have not been implemented in Serbia. Specifically, according to the ranking of the Heritage Foundation Serbia is at the 90th place in the world according to the degree of economic freedom.

It is important to decrease state interventions in the economy to improve the business environment in Serbia,, as well as the efficiency of the state in the areas where it is indispensable, or where it has advantages over the private sector. Reduction of the role of the state in the economy would be achieved through the completion of the privatization of former socially-owned enterprises and reducing subsidies from the current level of 2.5% of GDP to a level of around 1.5% of GDP, which is suitable for European market economies.

It is necessary for the growth of market economies that the government effectively perform its core functions such as enforcement of contracts and protection of property. Progress in these areas implies the adoption of laws appropriate to the market economy and improving the work of courts and cadastre. The state has a key role in establishment of discipline in the implementation of legal and contractual obligations, whether it is about transactions in which it is directly involved, such as tax collection or settlement of obligations of the state, or those where the state performs as the guarantor of contract enforcement between private participants. By reducing the tolerance for the grey economy and orderly settlement of liabilities towards the private creditors the state directly contributes to the establishment of financial discipline. In this regard the announcement of another mass rescheduling and tax debts write-offs, as well as the delays of the state enterprises in the settlement of obligations to the private sector, are all the examples of bad signals sent by the state for all participants in the economic life.

⁹ The high fiscal deficit crowds out private investments with government borrowing in the country, i.e. higher taxes in the future to return loans abroad.

¹⁰ The above list of conditions is not complete, and economic science is such that it would be hard to reach an agreement on the conditions for economic growth and their relative importance.

¹¹ We estimate that the countries of Central Europe such as Czech Republic, Hungary and Slovakia may be medium-term objective in terms of business conditions for Serbia.

Highlights

Shortening the time limits for issuing building permits is an important step in removing barriers for investment, but there are still other important activities to remove the barriers for construction, such as the updated records of property rights, resolving uncertainties about the conversion of rights, the use of the property right over municipal building land, solving the restitution, updating urban plans and others.

Fair market competition represents one of the conditions for long-term sustainable growth of the market economy. According to competition policy Serbia is at the average level of the Western Balkans, but is well below the average of the countries of Central and Eastern Europe. Distortion of market competition is achieved through a variety of mechanisms ranging from the abuse of dominant and market position by economic entities, through government subsidies, the privileged position of some private companies in making business with public companies and state institutions, tolerance for the grey economy and the periodic tax debt write-offs. In order to improve competition policy in Serbia it is necessary to establish effective competition policy, abandon the policy of subsidies which distorts the equality of market participants, improve public procurement policies, but also to stop the practice of tolerating informal economy and periodical debtor rewards by writing off debts.

Economic growth requires good infrastructure and an educated work force. The state is usually dominant in the case of transport, energy and public owned infrastructure though not the only participant, while the state role as a regulator is crucial in telecommunications infrastructure. Increase of public investments in infrastructure would directly affect the economic growth in the medium term, while newly built infrastructure would have a positive impact on private investment and growth in the long term. According to the infrastructure conditions, especially transport, Serbia is significantly lagging behind other countries in the region, and the low level of public investments shows that the lag is not being reduced for now.

Educated workforce with physical capital is a direct determinant of economic growth. Based on different studies ranging from the PISA tests to the number of scientific publications and registered patents Serbia lags behind the Central Europe countries. In primary education there are non-productive costs for maintaining the extensive network of primary schools and an excessive number of employees (see Highlights 3), while investments in education of teachers and modern teaching aids is insufficient. Coverage of children with secondary education is insufficient and adaptability of education

to the labour market is low. In primary and secondary education there is no adequate system of evaluating schools, as well as their rewarding depending on the results of education. State university education is characterized by an extensive network of universities and colleges that offer an average low quality of education, while the scientific work in universities is neglected. The State acting as a regulator allowed the accreditation of a large number of non-performing private universities, which further decreased the quality of overall university education in Serbia. An additional problem is that the graduates with bad quality and questionable degrees are employed in public administration and public enterprises in a growing number, which worsens the already low competence of the public sector.

The financial sector in Serbia is underdeveloped except the banking sector, and the banking sector in the past few years is in decline and stagnation. Bank lending is decreasing and without credit growth it is difficult to achieve economic growth. It is necessary to solve the problem of bad loans and establish financial discipline to start the growth of credit activity.

Conclusion

Started recovery may represent the beginning of a long-term sustainable growth of the Serbian economy, provided that it is persisted on the elimination of internal and external imbalances, as well as the reforms to improve the business environment are accelerated. In the past Serbia often dropped the reforms at this stage because the resistance to reforms strengthened and political support for them decreased and the suspension i.e. postponement or mitigation of reforms brought temporary political advantage to the ruling party.

The key role in the elimination of imbalances has a reduction of the fiscal deficit to below 3% of GDP in the next two years, and then its decrease to 1% of GDP over the medium term. Reducing the budget deficit followed by a moderate depreciation of the dinar will affect the reduction of external imbalances to sustainable levels of 3-4% of GDP. Increase of the investment rate from the current, very low, level of around 20% of GDP to around 25% of GDP can be achieved by creating a business environment that is favourable to private investments and with increasing public investments to around 5% of GDP.

In addition to the removal of internal and external imbalances for the long term sustainable economic growth it is necessary to build an enabling environment for private investment and employment. Such an environment includes effective protection of property rights, financial discipline, proper competition policy, an educated

workforce, excellent infrastructure, efficient administration, developed financial system, low corruption, low inflation, moderate taxes and others.

Literature

Arsić Miloško and Saša Ranđelović, 2014., The impact of fiscal policy on economic growth in Serbia, The economic policy of Serbia in 2014: growth opportunities during the reforms and fiscal consolidation, Editors: Miloško Arsić and Dejan Šoškić, NNDE and Faculty of Economics University of Belgrade

Kuzmanović Marija and Peter Sanfey, 2014 Diagnostic growth constraints in south-eastern Europe: The case of Serbia, Working Paper No 167, EBRD

IMF, 2015, The WesternBalkans 15 Year of Economics Transition, Regional Economic Issue, SpecialReport

CIP - Katalogizacija u publikaciji
Narodna biblioteka Srbije, Beograd

33 (497.11)

QUARTERLY monitor of economic trends and policies in Serbia / Editor in Chief Milojko Arsić. - 2011, iss. 1 (january/july)- . - Belgrade (Kamenička 6) : The Foundation for the Advancement of Economics, 2005- (Belgrade : Alta Nova). - 30 cm

Dostupno i na: <http://www.fren.org.yu>. - Tromesečno. - Ima izdanje na drugom jeziku: Kvartalni monitor ekonomskih trendova i politika u Srbiji = ISSN 1452-2624 ISSN 1452-2810 = Quarterly monitor of economic trends and policies in Serbia

COBISS.SR-ID 126940428