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Table of Contents

Analytical and Notation Conventions

Values

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

Definitions of Aggregates and Indices

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

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

New Economy – Enterprises formed through private initiative

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

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

Notations

CPI – Consumer Price Index

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

H – Primary money (high-powered money)

IPPI – Industrial Producers Price Index

M1 – Cash in circulation and dinar sight deposits

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

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

NDA – Net Domestic Assets

NFA – Net Foreign Assets

RPI – Retail Price Index

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

Abbreviations

CEFTA – Central European Free Trade Agreement

EU – European Union

FDI – Foreign Direct Investment

FFCD – Frozen Foreign Currency Deposit

FREN – Foundation for the Advancement of Economics

GDP – Gross Domestic Product

GVA – Gross Value Added

IMF – International Monetary Fund

LRS – Loan for the Rebirth of Serbia

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

NES - National Employment Service

NIP – National Investment Plan

NBS – National Bank of Serbia

OECD – Organization for Economic Cooperation and Development

PRO – Public Revenue Office

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

QM – *Quarterly Monitor*

SORS – Statistical Office of the Republic of Serbia

SDF – Serbian Development Fund

SEE – South East Europe

SEPC – Serbian Electric Power Company

SITC – Standard International Trade Classification

SME – Small and Medium Enterprise

VAT – Value Added Tax

From the Editor

In the second half of the year a moderate improvement in Serbia's economic performance continues - economic activity is growing, while fiscal and external deficit are being reduced. Inflation remains low and certain improvements in the labour market probably occurred. In 2016, we expect growth of economic activity to be around 2%, inflation around 2%, while fiscal and external deficit will remain roughly at this year's level. Reforms in the state owned enterprises and the public administration reform are delayed, which may adversely affect the fiscal consolidation in the future but could also affect future economic development.

The fiscal deficit was reduced by almost 3% of GDP in 2015, which is undoubtedly a significant achievement of economic policy. However, even after the reduction the fiscal deficit is around 4% of GDP and Serbia is still among the countries with the highest fiscal deficit in Europe. The fiscal deficit of 4% of GDP is unsustainable in the long run, which makes it necessary, in a relatively short period of time, to bring it down to the level that stops the growth of public debt to GDP ratio (about 3% of GDP), and then, in the medium term, to reduce it to the level which will enable a significant reduction of public debt to GDP ratio (around 1% of GDP).

In 2016 it is planned to keep the fiscal deficit at the same level as in this year, while significant reduction is planned for 2017. However, such a plan of the fiscal deficit reduction is not credible because more difficult measures are left for the distant future, and besides, 2017 is the last year of the current arrangement with the IMF, and it is possible that this will be an election year. If the elections are held in 2018 there is a high probability that salaries and pensions will increase in 2017, which would leave out the planned deficit reduction in that year. Therefore, there is a risk that the fiscal deficit will remain at a high level of more than 3% of GDP in the next few years, which would result in a further increase in public debt to GDP ratio. To achieve a lower deficit in 2016 than the planned 4% of GDP, it would be good for the government and ministries to prepare programs of savings as well as measures to increase tax collection. These savings would represent a kind of reserve which would finance possible extraordinary expenses from financing debts of state owned enterprises.

Serbia's economy has emerged from recession in 2015, achieving growth of about 0.8%, which can be assessed as a solid performance considering that in this year, due to fiscal consolidation, domestic demand fell by around 2% of GDP. We estimate that in the next year economic growth in Serbia will amount to around 2%, which will finally allow reaching the pre-crisis level of 2008. It is estimated that the main drivers of growth in the coming year, similar as in the current, will be the growth of investment and exports.

The growth of economic activity in 2016 will also be affect by the increase of production capacity on the basis of investments that were implemented in this year. Progress in macroeconomic stabilization and reform (Labour law, building permits, inspection services,..) which affected the growth of investment and GDP in this year, are a good indicator in which direction should the Serbian economic policy take in the coming years. The growth of bank lending activity, which began in mid-2015, and the decline in real interest rates could provide additional stimulus for the growth of the Serbian economy, provided that they continue in the coming year. We expect that the growth of export will continue in 2016, which will be contributed by this year's investments as well as the moderate growth of European economies. Favorable impact on exports, and thus also on economic growth, could also be provided by a moderate real depreciation of the dinar. Finally, restoring agricultural production to the long-term average level would generate the growth of economic activity of 0.7 percentage points of GDP.

International circumstances provide moderate incentives for the growth of the Serbian economy - while on the one hand there is plenty of cheap capital that favourably impact growth of foreign direct investment and lending activities in Serbia, on the other hand there is a relatively slow recovery of European economies.

Serbia's economic growth of about 2% in the coming year will continue to be slower than expected growth in the other Central and Eastern Europe countries, but also significantly slower than the growth which would allow gradual catching up with the developed countries. So the question is what must Serbia do to increase the average growth rate to at least 4% per year? In the short term the most powerful stimulus for growth can be generated from further strengthening of macroeconomic stability and the increase in public investments. Stronger macroeconomic stability can be achieved by keeping inflation low, with low variability of inflation and exchange rates, as well as reduction of the fiscal deficit. Increase in public investment for 1-2% of GDP would, through demand, have impact on the acceleration of economic growth in the short term, while the infrastructure, built with public investments, would increase a long-term economic growth rate.

However, the growth of private investments is crucial for the growth of the economy which, apart from macroeconomic stability and good infrastructure demands well-organized institutions and a strong financial sector. According to a variety of studies on the quality of institutions Serbia is at the very bottom among the European countries, and by some indicators at the very bottom in the world. The protection of property rights is weak, independence of the judiciary is low, and corruption level is high, while the economy is burdened by complicated, unclear and unnecessary regulations… Although the estimates of the World Economic Forum in the case of Serbia are probably biased downward, it is, however, certain that Serbian institutions are functioning poorly. Weak institutions discourage people from investing in education, innovation and entrepreneurial activities which create jobs and create additional value. Poor institutions direct people towards enrichment through corruption, which redistributes existing income and wealth, but does not increase employment nor social wealth. Weak institutions encourage people to enter the gray economy, which undermines the equality of business conditions, while the entrepreneurs who pay their taxes are being burden with high tax rates.

Without improving the work of the institutions, a long-term sustainable economic and social development of Serbia is not possible. In order to achieve a progress in the functioning of the institutions it is essential for important areas (justice, cadastre, tax administration, statistics, other segments of the administration) to adopt annual plans of reform, as well as to define the responsibility for their implementation. In addition to sectorial plans it is necessary to conduct general reforms which would stop irregular employment (political, etc.), including the employment of people with suspicious diplomas. Instead of the current practice the public sector should systematically attract the best students from the best universities. Also, it is necessary to redefine the advancement policy in order to reverse the long trend of negative selection in the public sector. Systematic and non-selective fight against corruption is also crucial for economic progress. Only when enrichment through corruption is disabled businessmen will turn to adoption of technological and market innovation, and bureaucrats to improving expertise and dedicated work.

In the second half of 2015 lending to the economy by the banks is increasing, but for now it is not possible to judge whether this is a longer-term trend or a temporary recovery as are the action to the credit expansion of the ECB. Given that credit growth is not driven by subsidies and that is accompanied by a decline in interest rates, reduction of non-performing loans and the recovery of the economy, it is possible that this is a long-term trend.

A good educational system is one of the crucial factors for economic growth, which has a direct impact on productivity and the ability to create and adopt innovations. In Serbia, there is an educational system which is characterized by a relatively wide comprehensiveness of the young generation, but according to research from different sources the quality of education at all levels is low, while the educational profiles created by the educational system are poorly aligned with market needs. Also, Serbia is ranked on one of a few last places in the world according to the number of patents in relation to the population or its ability to retain talent in the country. There are many educational reforms and they depend on the level of education, but some of them are common for all levels. One of these reforms is related to the gradual introduction of the measurement of the results of all educational institutions, and the conditioning, at least in part, the amount of financial resources that educational institutions receive from the State, with the quality of education and research. Another important reform relates to the concentration of scarce resources available to the state to fund education, and this includes rationalization of the network of educational institutions while maintaining access to education. In the case of university education the State, as a regulator, should tighten the criteria for accreditation, in order to prevent waste of social resources for producing low-quality degrees.

In order for educational reforms to lead to an increase in social welfare it is essential that the public and private sector use and reward knowledge and skills acquired in the educational process. The condition for this is to create an institutional environment in which the conditions for profit in the private sector would be the adoption and creation of technical, financial and market innovations, and not privileged business arrangements through political connections. Similarly, in the public sector, requirements for recruitment and promotion should be the ability and expertise, rather than political and other irregular connections.

TRENDS

1. Review

The year 2015 is coming to an end, and from the perspective of macroeconomic trends we can assess it as favourable. Economic growth of about 0.8% will be achieved, although at the beginning of the year a slight decline in GDP was expected, throughout the year inflation was low and stable at the average level of about 1.5% and the current account deficit was reduced to below 5% of GDP. The two most favourable trends in 2015, which we particularly point out, are: 1) reduction of the fiscal deficit from unsustainable levels of 6.7% of GDP in 2014 to around 4% of GDP and 2) increase in investment activity in the private sector, which after two years of relatively deep fall finally started to recover. The results that are achieved and established trends represent a turnover in relation to the adverse macroeconomic developments in previous years, but in fact are only the announcement of possible more significant improvements in the following years - and that is why they are good, but not sufficient. Because, how would we generally rate the economy which is growing less than 1% a year, with a current account deficit of around 5% of GDP and the fiscal deficit of around 4% of GDP? Therefore, 2015 should be interpreted as the first step towards achieving medium-term objectives of high, sustainable and balanced economic growth, without internal and external imbalances and without large fiscal deficit. For achieving these objectives, grater part of problems and challenges will be met in the years ahead, compared to the obstacles and challenges that were successfully crossed in 2015.

Economic policies that were implemented in 2015 have produced results and because of that the initiative in implementing the key measures should not be lost, and those reforms that were late in 2015 should start more decisively or accelerate. The policies that we consider necessary in 2016 and subsequent years include: the continuation of fiscal consolidation, reforms of the public sector including state owned enterprises, consistent completion of privatization, improvement of the business environment, implementation of credible monetary policy and more. At this time last year the debate was whether the reduction of pensions and salaries in the public sector was practical and *QM* took a clear position that such measure was effective and necessary. Many opponents of this policy then argued that this will further deepen the recession (in which the Serbian economy was back then), and that expected reduction of the deficit will not happen because with the deepening decline of the economy tax revenues will be reduced. None of this, however, has happened. The fiscal deficit is strongly reduced and the negative impact on economic activity was almost negligible. In 2015 there was a beginning of the resolution of the situation of companies still in privatization process which for years represented a burden for the State and the private sector. The most problematic of these companies, however, are exempted from this process and resolution of their situation was postponed for 2016. The reform of state owned enterprises has also started, but also more was expected from them. Also, some organizational changes in EPS and Železnici (Railways) were made, while Srbija Gas has yet to comply with European directives. The main problems of state owned enterprises: surplus of employees, prices, low collectability for provided services and other; are far from resolved even though there was some progress (EPS has received only a small portion of the increase in electricity prices, Srbija Gas has increased the collectability for supplied gas, but primarily due to the decline in gas prices and not the successful restructuring of the largest debtor). The improvement of the business environment in 2015 also achieved mixed results. On the list of the World Economic Forum Serbia has maintained, poor, 94 place, and a solid rise of nine places (based on a comparable methodology) was recorded on the list of the World Bank (Doing Business), on which Serbia is now at 59th position.

Economic activity in Q3 temporarily stopped its recovery and seasonally adjusted GDP recorded a decline compared to the previous quarter of 0.4%. We still do not consider this delay worrying because it was expected, and came after an unusually high (and unsustainable) seasonally-adjusted growth of about 2% in Q2. When we look at these two quarters together, Q2 and Q3, the results of the economy are still satisfactory. What is positive is that the investment component of GDP in Q3 leads over all others, and investment growth is actually the most important for establishing high and sustainable economic growth in the coming years - investments not only directly increase GDP when executed, but also increase the capacity of the economy for future growth of production and exports. Investment growth in 2015 is a result of the growth of private investments, since the State this year almost did not increase the low efficiency in the execution of public investments. Although it is still early to talk about the causes of the increase in private investment in Q3 and throughout 2015, it is possible that it was affected by the improvement of the business environment in the past year. Some reform laws were adopted, such as the amendment of the Labour Law, the Law on Planning and Construction, there has been a global decline in interest rates, credit expansion of the ECB, economic recovery of the EU and neighbouring countries started, and other. Perhaps the crucial change in 2015 which, we believe, could affect the growing trend of investment in this year is the fiscal consolidation - because it is very difficult to expect an increase in investment in the country where there is a danger of the outbreak of a public debt crisis. In 2015 we expect overall growth of GDP of around 0.8%, which incorporates our expectation that in Q4 the re-acceleration of economic growth will occur, after a temporary halt in Q3. If this acceleration is absent, GDP growth in 2015 could be about 0.5%. In 2016, we expect improving economic trends to continue and the growth rate of GDP of about 2%. The growth of the economy in 2016 should be based on increased investment, for which we expect to be around 8% (which is similar to 2015). In addition, we expect further slight real decrease of state and private consumption (up 0.5%) primarily due to continuation of the fiscal consolidation, while net exports could give a slight contribution to GDP growth, which would not be greater than 1 percentage point.

Balance of payments trend were favourable in Q3 from the standpoint of the current account on the balance of payments, as well as from the perspective of the financing account (see. Section 4 “Balance of Payments and Foreign Trade”). Current account deficit in Q3 was reduced to about 300 million euros, which represents a reduction compared to the same period of the last year when it stood at 380 million euros. An even better result was achieved on the capital side of the balance of payments, because of a relatively strong increase of inflow of foreign direct investments (FDI), which were at the beginning of the year very low. In Q3 a net 470 million euros entered into Serbia, and in the same period last year the inflow was about 250 million euros. It is important to point out that the FDI inflow in Q3 was higher than the current account deficit and that such relationship between FDI and the current account deficit is likely to be achieved at the level of the year. This means that in 2015 the deficit in international transactions is covered by the more favourable structure of capital inflow than in previous years, all of that achieved with an increase in foreign exchange reserves.

Throughout the whole year, we expect the current account deficit to be at around 4.8% of GDP, which is a substantial reduction compared to 2014 when it stood at 6% of GDP. The reduction of the current account deficit in 2015 was positively influenced by: the fiscal consolidation, very low oil prices, economic recovery of the Eurozone as well as extremely favourable value of the terms of trade index. In 2016, we expect a mild decrease in the current account deficit compared to 2015. On the one hand it is likely that the current trend of export growth will continue, which may be somewhat lower because of the dry agricultural season in 2015, while the imports could have some increase due to the expected economic recovery and the growth in imports of equipment. Also, further acceleration of FDI in 2016 will hopefully continue in the financing account, and hopefully they will be primarily directed to tradable sectors of the economy.

Inflation has remained, for Serbia, very low and at the end of November stood at 1.3% compared to the same period of the last year. The increase in prices is, for almost more than two years, below the lower limit of the NBS target corridor of 4 ± 1.5% (excluding the two months immediately following the increase in the lower VAT rate), and it is not certain that it will return within that target band soon. The low inflation in 2015 was influenced by external and internal factors. On the one hand, low world prices of primary agricultural products and the low price of oil, and on the other - low aggregate demand and slow growth of regulated prices (see. Section 5 “Prices and the Exchange Rate”). The dinar exchange rate was stable and almost unchanged until the end of the year, which also influenced the low inflation.

Low level of inflation has allowed the NBS to continue to gradually ease the monetary policy with further reduction of the key policy rate, which after the last correction in October decreased to 4.5% (see. Section 7 “Monetary Flows and Policy”). Additional relaxation has been launched in mid-September when the NBS began reducing the rate of foreign currency reserve requirements by one percentage point, which will last the next six months. The banking sector records an increase in net loans to individuals but also to the economy. Lending activity thus recorded its highest level since mid-2012, which can represent a signal of its more substantial recovery. The encouraging fact is that the share of bad loans in total loans began to decrease in all categories of debtors (legal entities, entrepreneurs, private individuals). At the end of September, the share of non-performing loans has been reduced to about 20% compared to 23% from the end of Q2. Preliminary data for October and November suggest that the level of non-performing loans from the end of Q3 will probably not change until the end of the year. In 2016 we expect a continuation of the reduction trend of bad loans share in total loans, because in August 2015 the NBS adopted measures (with technical assistance from the IMF) which should accelerate the resolution of this problem, which will be fully implemented in the first half of 2016.

In the analysis of employment trends the biggest problem is still inconclusive and unreliable data published by the Statistical Office. However, there are indications that in the middle of the year certain methodological changes happened, which could ultimately improve the quality of the data (see. Section 3 “Employment and Wages”). First, the data from the Labour Force Survey (LFS) for 2014 were revised, so that, with this change employment growth in 2015 looks more credible. However, it would be good for SORS, with the revision of the data for 2014, to revise also all data from the LFS published since 2009, and possibly earlier. Because they indicate an unlikely decline in employment in the period 2009-2012, which was significantly higher than the fall of economic activity, and the increase in employment in the period 2012-2015 of almost 15% (300,000 more employees), although in the same period economic activity was at a standstill. In Q3 a methodology for monitoring formal employment (administrative data) was also changed by including data from the Central Registry of Compulsory Social Insurance (CROCSI). However, the quality of the obtained data for 2015 is still bad, because they show an unlikely growth of formal employment during the year of about 5%, which is not in accordance with the payment of employment contributions. Also, these data show a considerable increase in employment in the state sector in which we know for certain that during 2015 employment decreased. Statistical Office announced that at the beginning of 2016 it will make corrections of data on formal employment from 2015, as well as the revision of the time series for a period of at least ten years.

Fiscal trends are much improved compared to the previous year, and this is primarily reflected in a large reduction of the state deficit - which in 2015 could amount to 3.5-4% of GDP, compared to 6.7% of GDP from 2014 (see. Section 6 “Fiscal Flows and Policy”). The interpretation of these results, however, should be thoughtful, because one part of the deficit reduction in 2015 is a consequence of one-off factors, and so a permanent, structural, deficit reduction is slightly lower. Thus, the reduction of the deficit in 2015 was significantly contributed by large one-off payments in the budget from the state owned enterprises (EPS, EMS, Telekom), for which we believe are not fully economically justified and should not be repeated in a similar amount in the coming years. The second part of the temporary reduction of the deficit is related to inefficient implementation of public investments, and lower severance payments than planned, due to the delays in the implementation of the rationalization of the number of employees in the general state, but slightly slower resolving of the situation in the companies in privatization. But when we exclude these temporary factors, there is no doubt that in 2015 a great and lasting reduction of the deficit was achieved, on the basis of: cuts in pensions and public sector wages, improved tax collection and the introduction of excise duty on electricity - all of which together accounted for over 2% of GDP.

To successfully complete fiscal consolidation, i.e. halt the growth of public debt in relation to GDP, the fiscal deficit would have to be reduced to around 2.5% of GDP in the next two years - and that means that there is still need for very large fiscal adjustment, despite good first results in 2015. Even greater challenge for reduction of the deficit will be that in the coming years there are no plans for further cuts in pensions and public sector wages, as well as the significant increase in taxes, which means that savings will largely have to be achieved through structural reforms in late 2015. The original plan of fiscal consolidation estimated that the main savings in 2016 and 2017 will come from the reduction of employees in general state, and the other strong planned measure was the freezing of salaries and pensions. However: 1) the rationalization of the number of employees has not been successfully implemented in 2015 and there is a risk that it will not be successfully implemented in the following years, and 2) freezing pensions and salaries in the public sector was abandoned already in 2016 and there will certainly be a great pressure for a new increase in 2017. Certain guarantee that the fiscal consolidation will not be abandoned too early is a three-year arrangement with the IMF, which should prevent unjustified fiscal easing in the coming years. However, we believe that it is very dangerous to exaggerate undeniably good fiscal results from 2015, because a very large and risky path to healing of public finances in Serbia is still ahead.

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	Q2	Q3
Economic Growth							y-o-y, real growth[1]										
GDP (in billions of dinars)	1,751.4	2,055.2	2,355.1	2,744.9	2,880.1	3,067.2	3407.6	3584.2	3876.4	3884.0	…	…	…	…	…	…	…
GDP	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1	2.6	-1.8	0.4	-1.0	-4.5	-2	-1.8	0.9	2.2
Non-agricultural GVA	6.2	5.1	6.9	4.4	-3.3	0.2	1.5	1.1	1.6	-2.5	0.6	-1.5	-5.8	-2.8	-1.7	2.5	3.9
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	-6.5	2.1	-4.8	-13.9	-9.5	-2.0	11.1	13.2
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	-1.4	3.6	-2.0	-5.6	-2.8	4.2	7.3	6.4
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	44717	…
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	1.750	1.728	1.715	1.702	1.696	1.701	1.706	1.706	1.934	1.965	2.003
Fiscal data							in % of GDP										
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	4.2	4.5
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	-2.9	-1.3
							in billions of dinars										
Overall fiscal balance (GFS definition)[3]	14.8	-33.5	-58.2	-68.9	-121.8	-136.4	-158.2	-217.4	-178.7	-257.5	-68.1	-45.0	-39.8	-105.2	-21.2	-14.2	-15.8
Balance of Payments							in millions of euros, flows[1]										
Imports of goods[4]	-8,286	-10,093	-12,858	-15,917	-11,096	-12,176	-13,758	-14,028	-14,693	-13,393	-3,415	-3,762	-3,740	-3,834	-3,643	-3,864	-3,771
Exports of goods[4]	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,394	10,540	9,732	2,512	2,767	2,664	2,698	2,601	2,987	2,879
Current account5)	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,639	-2,092	-1,857	-496	-541	-384	-563	-521	-258	-304
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*	*-6.3*	*-4.5*	*-6.9*	*-7.0*	*-3.1*	*-3.6*
Capital account[5]	3,863	7,635	6,126	7,133	2,207	1,986	2,694	3,486	1,917	1,517	478	414	217	596	399	70	186
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	669	1,229	1,210	271	435	244	286	349	412	470
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	-1,332	-800	-370	509	-1,136	110	-32	300
Monetary data							in millions of dinars, e.o.p. stock[1]										
NBS net own reserves[6]	175,288	302,783	400,195	475,110	578,791	489,847	606,834	656,347	757,689	788,293	696,802	756,996	787,778	788,293	854,636	858,972	902526
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	7,125	7,509
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	1,925,584	1,919,958	1,918,917	1929573
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909912	933,839	998,277	937,875	949,418	976,865	998,277	1,004,948	1,010,179	995123
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	5.8	2.6
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	1.2	-8.3	-5.7	-3.3	1.1	3.7	2	0.7
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	49.7	47.9	47.6	47.6
Prices and the Exchange Rate							Y-o-y growth[1]										
Consumer Prices Index[7]	16.5	6.5	11.3	8.6	6.6	10.2	7.0	12.2	2.2	1.8	2.3	1.2	2.1	1.8	1.8	1.9	1.4
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	83.0	82.6
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	120.4	120.2

Source: FREN.

1) Unless indicated otherwise.

2) Data for 2008 represent adjusted figures based on a wider sample for calculating the average wage. Thus, the nominal wages for 2008 are comparable with nominal wages for 2009 and 2010, but are not comparable with previous years.

3) We monitor the overall fiscal result (overall fiscal balance according to GFS 2001) – Consolidated surplus/deficit adjusted for "budgetary lending" (lending minus repayment according to the old GFS).

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

5) The National Bank of Serbia changed its methodology for compiling the balance of payments in Q1 2008. This change in methodology has led to a lower current account deficit, and to a smaller capital account balance. A more detailed explanation is given in QM no. 12, Section 6, "Balance of Payments and Foreign Trade".

6) The NBS net own reserves represent the difference between the NBS net foreign currency reserves and the sum of foreign currency deposits of commercial banks and of the foreign currency deposits of the government. More detailed explanations are given in the Section Monetary Flows and Policy.

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

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

2. Economic Activity

Economic activity will record a slight increase of about 0.8% in 2015. This is the lowest growth in the region, but it should be kept in mind that: 1) the initial forecasts, from a year ago, were that Serbia will have another year of recession in 2015; 2) in 2015 agricultural production fell short significantly due to a drought; but also 3) the economic growth was achieved in a period of a strong fiscal adjustment of over 2 percentage points of GDP. Therefore, the result the economy recorded in 2015 is undoubtedly favourable. In Q3 there was a delay in the recovery of the GDP, which was somewhat expected, and which is probably temporary. The delay in the recovery can also be seen in the data which show that the seasonally adjusted GDP had recorded, not so small, drop of 0.4% compared to the previous quarter. However, despite somewhat unfavourable indicators of the overall economic recovery in Q3, it is encouraging that the investment growth continues to lead in relation to other components of GDP, which is a good basis for a somewhat stronger economic growth in the coming years. GDP growth in 2016 could amount to about 2%, which is in line with the projections of the Government and the IMF (1.75%). This, however, does not represent a significant acceleration of growth compared to 2015, because only the recovery of agricultural season from the drought will contribute to the growth of GDP in 2016 by about 0.7 percentage points, and the trend rate of growth of economic activity would amount to just over 1% (compared to the trend growth of about 0.5% from 2015). If positive trends initiated in 2015 (primarily investment trends) continue and intensify, it is possible that the economic growth in 2016 will be somewhat higher than the current estimate, but, for now, we still did not include this option in the forecasts.

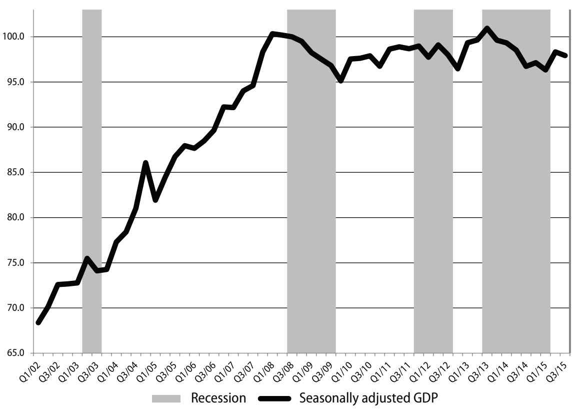
Gross Domestic Product

Real GDP growth in Q3, of 2.2%, is lower than expected

According to the SORS estimates, real year-on-year growth of GDP in Q3 amounted to 2.2%. Although at first sight it seems that GDP growth accelerated in Q3, because the y-o-y growth in Q2 was only 0.9%, the real reason for the higher rate of growth in Q3 is the effect of a very low base from the previous year, and the achieved result of economic activity in Q3 was in fact even slightly worse than in Q2 and our expectations. Namely, in Q3 2014 a deep decline in GDP was recorded (y-o-y for 4.5%), so even with a growth rate of 2.2% in Q3 2015 the level of economic activity from Q3 2013 has not been reached, not even close (more than 2 percentage points of GDP is missing for that). Therefore the y-o-y growth of 2.2%, although a highest since the beginning of the year, cannot be assessed as an acceleration of the economic growth. On the contrary, we expected for Q3 GDP growth to be around 3%.

Seasonally adjusted GDP indicates a fall in Q3 compared to Q2

Graph T2-1. Serbia: Seasonally adjusted GDP growth, 2002-2015 (2008=100)



Source: *QM estimates based on SORS data*

A slightly less favourable trend in economic activity in Q3, compared to Q2, is also indicated by the seasonally adjusted indices of GDP growth (Graph T2-1). Seasonally adjusted GDP in Q3 decreased compared to the previous quarter by 0.4%. Results from Q3 are somewhat less favourable than expected, but we consider them temporary and, still, not too dangerous. First of all, the decline in GDP in Q3 came after an extremely large increase in Q2 when the seasonally adjusted GDP rose by as much as 2% compared to Q1. These two quarters (Q2 and Q3) should be observed together because one part of the high growth of seasonally adjusted GDP in Q2 was caused by temporary factors that are acting in an opposite direction in Q2. For example, after the last drying of the flooded coal mines, electricity production was temporarily unusually high in May and June, even in relation to the period before the floods (about which we wrote in more detail in the previous issue of QM). Therefore, a seasonally adjusted GDP increased in Q2 slightly more than it was sustainable, and so in Q3 this effect was lost and caused a slight decline in a seasonally adjusted GDP. In Graph T2-1 periods in which the Serbian economy was in the recession are shaded (estimated based on the Bry-Boschan procedures). We believe that our assessment that the Serbian economy has emerged from the recession, which we presented in the previous issue of QM and which can be seen in the graph, is undeniable - and that slightly worse results in economic activity in Q3 are temporary and we do not evaluate them as some announcement of new recession.

Investments are growing faster than other GDP components in Q3

Table T2-2 shows the structure of the y-o-y GDP growth in Q3 by expenditure method. As we have repeatedly pointed out, sustainable growth of the Serbian economy in the medium term can only be based on the growth of investment and exports, as the share of private and government consumption in GDP will need to be significantly reduced over the medium term. Investment growth is certainly crucial for an acceleration of the economic growth, because it not only directly increases GDP, but also creates the capacity for future increase in output and exports. Precisely the growth of investments marked the 2015 and we consider that to be the most positive trend of economic activity in that year and to their analysis we gave more attention. In Q3 investments remained the fastest growth compared to all the other components of GDP (Graph T2-2). Among other expenditure components of GDP, solid year growth of nearly 9% was recorded by exports, but the growth of net exports was practically absent, because the imports grew by over 5%. Private consumption is still in the real y-o-y decline, which in Q3 stood at 0.5%, and the growth of government consumption by 0.9% is somewhat surprising, because in the process of fiscal consolidation public sector wages have been reduced by 10% compared to the last year. The growth of government consumption in Q3 was in fact driven by a slightly higher growth of expenditures for procurement of goods and services. Government consumption will have to be reduced in the medium term, therefore its positive y-o-y growth in Q3 is apparently only temporary fluctuation in this trend.

Table T2-3. Serbia: GDP by expenditure method, 2009-2015

	Y-o-y indices													
	2009	2010	2011	2012	2013	2014	2014				2015			Učešće
							Q1	Q2	Q3	Q4	Q1	Q2	Q3	2014
							Međugodišnji indeksi							
GDP	96.9	100.6	101.4	99.0	102.6	98.2	100.4	99.0	95.5	98.0	98.2	100.9	102.2	100.0
Private consumption	99.4	99.4	100.9	98.2	99.4	98.7	98.1	98.9	98.6	99.0	99.7	98.7	99.4	74.9
State consumption	100.6	100.8	101.1	102.4	98.9	99.4	98.6	99.4	97.8	101.6	96.2	97.2	100.8	18.6
Investment	77.5	93.5	104.6	113.2	88.9	96.4	95.2	100.2	91.8	98.6	103.9	108.7	110.1	18.6
Export	93.1	115.0	105.0	100.8	121.3	105.7	119.9	111.3	95.6	100.8	108.7	108.4	108.8	43.4
Import	80.4	104.4	107.9	101.4	105.0	105.6	108.4	108.5	104.0	102.2	111.4	102.0	105.4	56.2

Source: SORS

Investments growth is accelerating and we consider it sustainable

Investments in 2013 and 2014 had a deep decline and were by far a single fastest declining component of GDP (Table T2-2). In 2015, however, and especially since the middle of the year, this trend was reversed. Investment growth in 2015 is widespread by activities and includes both domestic and foreign investments, and is seen in the construction industry but also in the purchase of equipment - and is probably permanent in nature. Foreign direct investments (FDI) have been, until May, very low, lower even than the unsatisfactory level of 2014. However, after May FDI strongly accelerated, and as of September 2015 not only did they caught up with their level from January-September of the last year, but they exceeded it by about 30% (or about 300 million euros). Newly approved loans to the economy from the domestic banking system for investment activities were also on the rise from the middle of the year. Construction activity, after a weak first quarter, achieved a high annual growth of about 15% in the second and third quarter (Table T2-3). Production of capital goods is increasing in 2015 by about 5% compared to 2014, while the imports of capital goods has been increased, compared to the previous year, for around 2%. Growth of total investments in 2015 is a result of the growth of private investment, since the state this year almost did not increase the low efficiency in the execution of public investments.

If public investments were executed as planned in 2015, growth of total investments would be even higher.

Although it is still early to talk about the causes of the increase in private investment in Q3, and throughout 2015, it is possible that it was affected by the improvement of the business environment in the past year. Namely, some reform laws have been adopted, such as the amendment of the Labour Law, the Law on planning and construction, there has been a global decline in interest rates, credit expansion of the ECB, the economic recovery of the EU and the neighbouring countries, and other. Perhaps the crucial change in 2015, which, we believe, could have affected the initiation of the growing trend of investment in this year is the fiscal consolidation - because it is very difficult to expect an increase in investment in the country where there is a danger of the outbreak of a public debt crisis.

Construction growth acceleration continues, and the agriculture in decline due to a drought

Observed by activity (Table T2-3) we see that the trends in Q3 are quite divergent. On the one hand, the largest annual increase of 18.3% was achieved by the construction activity, and a high growth of over 8% was recorded by the industrial production. The growth of construction activity is an encouraging trend which is consistent with the observed increase in investment. The high growth of industrial production was primarily affected by the recovery of electricity production and mining after the floods, but also a solid y-o-y growth has been recorded by the manufacturing industry, to which the floods had no significant impact. On the other hand, the sector of the economy with the biggest decline is the agriculture, which in Q3 recorded a y-o-y decline of 6.5% due to the impact of drought on the autumn crops[1]. Other sectors of GDP are mainly on a similar or somewhat higher level of production compared to Q3 of the last year.

Table T2-3. Serbia: GrossDomesticProductbyActivity, 2008-2015[1]

	2009	2010	2011	2012	2013	2014	2014				2015			Share
							Q1	Q2	Q3	Q4	Q1	Q2	Q3	2014
										Y-o-y indices				
Total	96.9	100.6	101.4	99.0	102.6	98.2	100.4	99.0	95.5	98.0	98.2	100.9	102.2	100.0
Taxes minus subsidies	98.6	99.5	101.1	97.8	98.9	99.4	98.2	99.9	98.9	99.7	100.4	98.7	100.0	16.0
Value Added at basic prices	96.6	100.8	101.5	99.2	103.3	98.0	100.8	98.9	94.9	97.6	97.7	101.3	102.7	84.0
Non agricultural Value Added	96.7	100.2	101.5	101.1	101.6	97.5	100.6	98.5	94.2	97.2	98.3	102.5	103.9	89,8[2)]
Agriculture	95.2	106.4	100.9	82.7	120.9	102.0	103.6	102.1	101.0	101.7	91.2	89.9	93.6	10,2[2)]
Industry	96.8	100.8	103.2	105.6	106.0	92.4	99.9	94.2	86.0	90.0	96.1	108.0	108.3	23,9[2)]
Construction	87.1	97.6	105.9	90.2	96.1	98.5	105.5	102.0	86.1	103.8	97.4	112.6	118.3	5,2[2)]
Trade, transport and tourism	92.9	100.0	99.5	99.3	102.3	101.1	102.6	100.7	101.0	100.2	100.3	100.4	101.2	17,7[2)]
Informations and communications	97.0	103.2	102.6	102.8	99.9	96.1	97.0	95.7	94.9	97.0	96.5	99.5	102.9	5,3[2)]
Financial sector and insurance	102.6	101.9	98.4	92.0	90.5	97.2	97.8	102.2	91.4	97.0	101.6	98.7	105.0	3,2[2)]
Other	99.7	99.8	100.9	101.8	100.2	99.9	99.9	100.2	99.3	100.3	98.4	98.4	100.0	34,6[2)]

Source: SORS
1) In theprevious year'sprices
2) Share in GVA

In 2015 we expect GDP growth of around 0.8%

Although the results of the economy in Q3 were slightly worse than expected, we believe that this delay in the recovery of production was temporary and we keep our forecast of total GDP growth in 2015 of around 0.8%. This assumption implies that the annual GDP growth in Q4 will be over 1%, which only at first glance seems as easily attainable goal, but this is not yet completely certain. In fact, in Q4 2014 certain recovery of production began (Table T2-3), and so for the y-o-y GDP growth in Q4 2015 of more than 1%, the acceleration of the economic activity compared to Q3 is actually needed (although y-o-y growth in Q3 was significantly higher and amounted to 2.2%).

In 2016 GDP will probably record a growth of around 2%

In order to better understand the expected trend of economic activity in 2016 we must „clean" 2016 and 2015 from temporary factors. Thus, the economic activity in 2015 was affected by two one-off factors - the recovery of production of the energy system of Serbia after the floods of 2014 and dry agricultural season. Recovery from the floods temporarily increased economic growth in 2015 by around 1.1 percentage points, while the drought affected its temporary reduction by about 0.7 percentage points. Therefore, the "trend" of economic growth in 2015 (without one-off factors) was only slightly higher than 0%. Similarly, in 2016 the expected recovery of

1 The practice of statistical agencies is to allocate the decrease (or increase) of agriculture to all quartersof the year, although these may occur in only one quarter. In this way, excessive shocks, or decline of agriculture in one quarter for 30-40%, is mitigated.

agriculture after drought (return on average agricultural season) will contribute to GDP growth by about 0.7 percentage points, so the forecasted growth rate of GDP of 1.5% in 2016 actually means economic growth (excluding agriculture) by about 1.3%. So, the estimated real acceleration of economic activity in 2016 compared to 2015 is not significant and amounts to only about 1 percentage point, which we think is a conservative assumption, which will be achievable and it would not be a surprise if the growth of the economy is somewhat higher than 1,5%.

Economic growth in 2016 may be slightly higher than 2%

The composition of the forecasted GDP growth of 2% in 2016 should look like this: a small real decline in public and private consumption (up to 0.5%), investment growth of about 8% and a slight contribution of net exports to GDP growth, which would not be less than 1 percentage point. The Government in its forecasts of GDP trends in 2016 raised the bar to 1.75%, and the difference compared to our projection is that the government expects a small real growth in private and government consumption already in 2016 - which we think is less likely to happen, but it predicted slightly lower growth of investment and net exports. If the existing trend of investment growth is strengthened and extended they could reach an increase of 10% in 2016, and net exports could also be a positive surprise - which would then jointly lead to GDP growth of over 2%, above the Government's current prediction. In this scenario not only would the government's forecast of total GDP growth be exceeded, but also the structure of this growth would be better than expected.

The change in the methodology of the SORS currently prevents calculation of ULC

In this issue of QM our regular review of the ULC trend will be left out, since the Statistical Office form Q3 changed the methodology for calculation of formal employment, which is not comparable with the previous data (and ceased to publish the data under the old methodology). It was announced that in early 2016 they will carry out a reconstruction of all previous data in accordance with the new methodology, which would enable us to follow this important indicator of the competitiveness of domestic economy again from the next issue of QM.

Industrial production

Industrial production records a high y-o-y growth in Q3

Industrial production in Q3 recorded a high y-o-y output growth of over 13% (Table T2-4). Most of this year's growth is a result of a very high growth in mining of 31% and electricity production of 41%. The main reason for a high growth of mining and electricity production is the comparison with the same period of the last year in which the biggest drop in coal mining and electricity production occurred due to the floods. This huge increase in production of the energy sector in Q3 2015, however, is temporary, and from the next quarter (Q4) will start to gradually decline as the results from 2015 will be compared with the higher production of mining and electricity (which in Q4 2014 began to gradually recover as a result of the coal mines drying). Manufacturing, which was not under the major influence of floods, in Q3 had a relatively good results and has achieved annual growth of over 6%. This is a high y-o-y growth, however we expected it to be even higher. In fact, already in Q2 y-o-y growth of over 7% was achieved, and in Q3 manufacturing industry was compared to its long-term minimum from Q3 2014, and we expected the annual growth higher than 8%.

Table T2-4. 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	Q2	Q3	
Total	87.4	102.5	102.2	97.1	105.5	93.5	102.1	95.7	85.8	90.5	98.0	111.1	113.2	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	115.8	130.9	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	107.3	106.4	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	129.0	141.0	17.6

Source: SORS

Somewhat more detailed analysis reveals that, observed by individual sectors of manufacturing industry, the vast majority of sectors is increasing their y-o-y growth in Q3 compared to Q2 (as

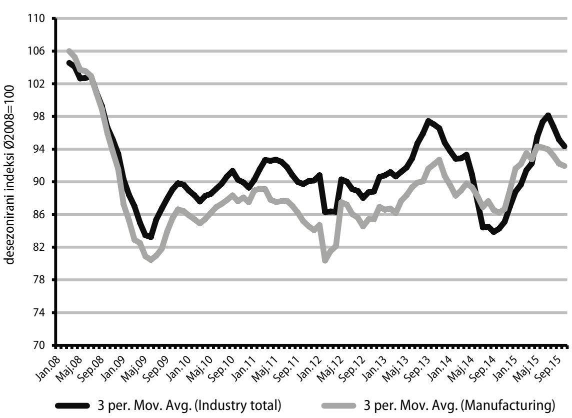
Downward trend of the food industry

expected). However, two sectors of industrial production sharply changed their trends downward. First, and to some extent expected, was the production of machinery and equipment. This sector in the first half of the year had a growth index of over 200 (production was twice higher than in the first half of 2014). We expected this growth to stop at some point, but we did not know when and at what level. Actually, the question we asked is whether this twice higher level of production of machinery and equipment is its new permanent level, or is it a temporary boom, and the production will return to its prior (before this temporary increase) level? Data from Q3 point to this second option, but we will monitor what is happening in this area in the future. Another area that has reversed its rising trend is the food industry, which after a growth of about 5% in the first half of the year, by September entered a relatively deep y-o-y decline, which then continued in October. Likely explanation for this trend is a dry 2015 and we find it hard to believe the explanation that (just) this sector was affected by the closure of the border with Croatian (which could be heard in public).

Seasonally adjusted indices revers their trend – we hope temporary

Graph T2-5 shows seasonally adjusted index of total industry production and particularly manufacturing industry with the last available data for October 2015. The graph immediately indicates a strong reversal in the rising trajectory of industrial production, which we announced in the previous issue of QM. First, expected, reason for this is that the achieved high growth in the seasonally adjusted production in Q2 was temporary because of abnormally high production of electricity and coal. Electricity production and mining in Q2 were 10 to 15% higher than their usual levels for this time of year. In fact, in Q2, after the end of the heating season, overhauls of production facilities are being carried out as a rule, and production temporarily seasonally decreases. This year that scenario didn't happe**n**, and production took place at full capacity, which led to a temporary increase in the overall industrial production, which was already in the next quarter diminished[2]. Second reason for the reversal of the trend of seasonally adjusted industrial production growth was abovementioned trend of certain areas of manufacturing. Graph T2-5 shows that for the reduction of the overall industrial production in Q3 cannot be responsible only electricity production and mining, because manufacturing also had reversal of the trend (lighter line on the chart) independently from electricity production and mining. This shift in manufacturing is much milder than in the case of total industrial production and we believe that it is primarily affected by the production trends in the food industry and the production of machinery and equipment. Since our analysis shows that the seasonally adjusted decline in Q3 was limited to a small number of sectors of industrial production and that was largely exhausted by the beginning of Q4, the decline in the seasonally adjusted industrial production is assessed as temporary.

Graph T2-5. Serbia: Seasonally Adjusted Industrial Production Indices, 2008-2015



Source: SORS

We lower our forecast of industrial production in 2015 from around 9% to around 7.5%

Although we believe that the seasonally adjusted fall of industrial production in Q3 was temporary, it still influenced us to lower our forecast of industrial production in 2015 from around 9% to around 7.5%. This growth seems high at first sight, but it is mainly a consequence of the recovery of production of the energy system of Serbia after the floods. When we take into account that in 2014 industrial production fell by 6.5%, we get somewhat more realistic context of the relatively high growth of the industrial production in 2015.

Observed by use (Table T2-6), we notice that in Q3 energy production maintained (and increased) high y-o-y indices of production, that the production of investment goods entered the

2 It is possible that the reason why the regular overhaulswere not carried out this time in EPS is the fact that the plants for producing electricity worked with significantly reduced capacity in the past 12 months, but perhaps there are some other reasons.

Production of most special purpose groups is slowing down

y-o-y decline, and that the remaining product groups maintained similar trends as in Q2. It is interesting to note that the production of energy, in spite of a very high growth of over 40% in Q3, is actually in seasonally adjusted decline compared to Q2, which can be intuitively seen by comparison with the level of production of this product group in 2013. Namely, in Q2 2014, a 10% decrease in production of this product was recorded, while in Q2 2015 there was a growth of about 25% - which means that in Q2 2015 about 10% more energy was produced than the same period in 2013 (Table T2-6). Similarly, in Q3 2014 production of this product group recorded a decrease of 35%, so even with a high y-o-y growth of over 40% in Q3 2015, it didn't actually reached even its level from Q3 2013. Production of capital goods entered the y-o-y decline due to a sharp turnaround in the trend of production of machinery and equipment. For now we are not concerned about the impact of this data on the movement of total investment, as construction continues with a dynamic growth, and also import of equipment is increasing (however we think that imported equipment is generally a better indicator of investment trends than domestic production).

Table T2-6. Serbia: Components of Industrial Production by use, 2009-2015

	Y-o-y indices												
	2009	2010	2011	2012	2013	2014	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2	2015 Q3
Total	87.4	102.5	102.1	97.1	105.5	93.5	102.5	95.7	85.8	90.5	98.0	111.1	113.2
Energy	98.8	97.7	106.2	93.6	113.2	82.6	101.1	89.3	65.1	75.9	88.5	124.1	141.7
Investment goods	79.3	93.6	103.2	103.8	127.6	95.9	107.4	97.5	89.5	88.6	112.1	109.1	94.5
Intermediate goods	78.4	109.2	102.2	91.2	99.0	96.8	105.7	95.4	94.2	91.4	99.3	107.8	104.8
Consumer goods	86.8	102.1	95.4	103.2	100.7	100.7	100.2	99.6	97.5	105.6	99.4	105.6	106.9

Source: SORS

Construction

High growth of construction continues in Q3

In Q3 construction achieved high y-o-y growth which we estimate to be between 10-15%. The indicators that describe the construction trend were not completely consistent, and so an unambiguous assessment of the trend of this sector of the economy cannot be given, but it is evident that the construction in Q3, as throughout the whole construction season, recorded a high growth. The SORS estimate is that the added value of construction in Q2 increased by 18% compared to the same period of the last year, while the index of completed construction works increased y-o-y by as much as 30% in constant prices. In addition, the measurement of the number of employees in the construction industry indicates a growth of the total number of employees in this sector by about 5%.[3] Finally, an independent indicator that QM uses as additional and probably the most reliable indicator of rough trends in construction activity - the cement production index - in Q3 recorded a growth of 4,5% compared to the same period of the last year (Table T2-7).The cement production index shows that some indicators (especially the value of completed construction

Table T2-7. 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	112.4	104.5	-	-

Source: SORS

3 These are only data on formal employment, since the Labour Force Survey does not publish data on employment at the level of individual sectors

works) probably overestimates the growth in construction activity in Q3, but even this index is not sufficiently reliable in the short term. Based on all of these indicators, we conclude that the construction activity in Q3 most probably achieved high annual growth of between 10-15%.

The analysis of the movement of construction is very important bearing in mind that the movement of construction activity is a good indication of the movement of investments (construction accounts for about 50% of total investments), and we consider the growth of investments to be critical for the sustainable economic growth of Serbia in the medium term. We believe that the noticed positive trends in construction are sustainable, and that they were influenced by the changes to the Law on planning and construction, improved credit conditions (including low interest rates on housing loans), the fall in prices of construction materials and energy, and other. It would be good if the State would, in the coming period, increase efficiency in the execution of public investments, which would be an additional and necessary stimulus to this important sector of the economy.

3. Employment and Wages

The third quarter of 2015 was characterized by methodological changes in both Labour Force Survey (LFS) and formal employment data (administrative figures). The Statistical Office of the Republic of Serbia (SORS) published revised data for 2014. Those revised figures on the activity rate, employment and unemployment were higher in every quarter compared to non-revised figures for the same quarter while the level of informal employment is lower compared to the non-revised figures. In the third quarter of 2015 compared to the same quarter of the previous year, a drop was registered in the unemployment rate and the rate of informal employment as well as a drop in the activities rate (that is a rise in the inactivity rate). The employment rate is rising. Estimates of the number of employed by sector are not reliable according to the latest SORS statement. Since Q3 2015, the data on the number of employed has been published for three basic sectors – agriculture, industry and services – and due to the low number of small subsamples data at activity branches will no longer be published. Estimates of the overall employment show a more realistic image of the actual state on the labor market compared to the initially published data. The rate of growth of the total number of the employed in Q2 2015, compared to the same quarter of the previous year stood at 1.4% while the unrevised data stood at an impressive but very doubtful 6.6%. The SORS changed to the new methodology of monitoring the formally employed as of September 2015 using figures from the Central Register of Mandatory Social Security and the Statistical Business Register. The administrative data on employment will be more precise and will include the employed who do not have permanent contracts such as employees under contract on temporary and occasional jobs. That will allow a harmonization of the statistics of employment with the methodology of short-term statistics used by the European statistics system. This is a completely justified change but there is no justified reason why it was not introduced much earlier. The data base will be revised in January 2016. The average monthly gross wages continue to follow a downwards trend both nominally and in real terms. The biggest drop in wages was registered in the sectors of the state administration and defense, mandatory social security, education and health care. Most of those sectors registered a year on year growth of seasonally adjusted net wages in real terms. The biggest growth was registered in the construction industry of 11% which is less that the real growth rate of the Gross Value Added (GVA) of 18% in the same period.

Employment

Improvements of the basic indicators of the labor market continued in the third quarter of 2015. The SORS revised its data for 2014.

The revised data indicates that improvements do exist on the labor market but that they are significantly lower than the initial indicators showed.

The LFS is characterized by significant changes in the methodology in 2015. In 2014, the observation period was one week in a quarter. Starting from 2015, the observation period covered all the weeks in a quarter (transfer to continued periodic research). The SORS revised its data for 2014, removing the effects of the changes in the evaluation system. On the other hand, the effects of changes in survey period and manner of gathering data could not be removed. That further implies that the changes in the evaluation of the workforce contingent cannot be viewed as reliable or precise[1]. It is important to note that the public statements for the first and second quarter did not mention that the figures for 2015 are not comparable to the figures for the previous year. On the contrary, the figures for the first and second quarters were compared to both the previous quarter and to the same quarters of the previous year[2]. Also, the last statement stresses that care should be taken about the size of the statistical error in year on year changes for the activities branches, besides the changes in period and system of evaluation. The year on year growth rate in the number of employed in Q1 and Q2 2015 stood at 1.7% and 1.4% respectively which is more realistic than the initial 6.5% and 6.6% (non-revised figures). The revision of the figures on the labor market confirm that our criticism in the previous issues of QM were

1 See Statement, Labour Force Survey , revised figures for 2014, 23,10,2015.
2 See Statement, Labour Force Survey , 29,05,2015 and 31,08,2015.

justified. However, we continue to believe that a revision is necessary of the figures for the labor market for the entire 2009-2014 period because of serious discrepancies in data with macroeconomic and fiscal figures while changes in certain sectors are dubious[3]. The publication of a series of comparable figures is important primarily because of the creating of labor market policies but also because of a restoration of credibility in the statistical institutions of Serbia. In that context introducing any political aspect into the debate on statistical figures would be very damaging.

However, as the statement said, the assessments of the number of employed by activity are not reliable which now prevents us from analyzing the dynamics of employment by activity. According to data from the LFS for Q3 2015, the number of employed was 2.6 million while the sector structure of the employed was as follows: 20%, 25% and 56% for agriculture, industry and services[4], respectively. We believe that the SORS should provide figures on the number of employed by activity because that is the statistical practice of EUROSTAT. If the subsamples for certain sectors are not big enough to provide a reliable assessment, that can be resolved by aggregating those activities, that is through the collective figures for several activities. We propose that the activities branches follow the activities branches for GVA in the employment figures. We recall that the figures on employment were disaggregated for 21 activities while the GVA figures were de-aggregated for 10 activities[5]. The publication of figures aggregated on three sectors – agriculture, industry and construction – hides important information on trends on the labor market.

Table T3-1 shows the basic indicators on the labor market in 2014, initial figures and revised figures, as well as figures for the first three quarters of 2015.

Table T3-1. Trends in activity rates, employment, unemployment and informal employment, Q1 2014- Q3 2015.

	2014 – first data				2014 - revised data				2015		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Activity rate (15+)	48.4	49.5	49.3	48.5	51.0	52.4	52.3	51.3	50.8	51.4	51.9
Unemployment rate (15+)	20.8	20.3	17.6	16.8	21.3	20.9	18.1	17.3	19.2	17.9	16.7
Employment rate (15+)	38.4	39.5	40.6	40.4	40.2	41.5	42.8	42.4	41.0	42.3	43.2
Informal employment rate (15+)	20.5	21.2	23.4	24.2	19.7	20.5	22.5	23.2	19.4	18.5	20.4

Source: SORS

The revision of the figures showed that the activity rates, rates of unemployment and employment were higher than the previous results showed while the rate of informal employment is lower. When we compare the figures for 2015 to the same quarters of the previous year (the revised figures) we see improvements in the basic indicators for the labor market (except for the activities rate trend). The unemployment rate dropped in Q3 2015 compared to the same quarter of the previous year by 1.4 percentage points, and that it dropped by 1.2 percentage points compared to the previous quarter. The rate of informal employment is lower compared to the same quarter of the previous year by 2.1 percentage points.

In 2015 (the average on the basis of the first three quarters) compared to 2014 (revised figures) we have a growth of the overall employment of 0.6% while the year on year rise in Q3 2015 stands at 0.2%. Formal employment rose by 2.8% while the number of informally employed dropped by 7.7%. If we look at the structure of the informal employment according to professional status, we see that the trend of growth in employment is continuing while the number of self-employed without employees and helping households' members as staff is dropping (Table T3-2).

3 We cited only highly dubious figures on the labor market (even though there are many more examples of this) such as the high drop in employment in agriculture in 2009 and the allegedly high growth of employment in activities in which the state was dominant in 2015.
4 The agriculture sector includes farming, forestry and fisheries, the industry sector includes mining, the processing industry, the supply of electricity, gas and steam, water supply and waste water management and construction, the services sector includes the wholesale and retail trade, traffic and storage, accommodation and food providing services, information and communication, financial activities and insurance activities, real estate business, expert, scientific and technical activities, administrative and secondary service activities, state administration and mandatory social security, education, health care and social security, the arts, entertainment and recreation, other service activitie, , the activities of households as employers, the activities of extraterritorial organizations and bodies.
5 Activities: A- agfriculture, forestry and fisheries, B-E – processing industry, mining and other industries, F- construction, G-I – wholesale and retail trade, traffic and storage and accommodation and food providing services, J- information and communication, K- financial activities and insurance activities, L-real estate business, M-N- expert, scientific, technical and other secondary activities, O-Q – state administration, defense, education and activities in health care and social security, R-T – other service activities

Trends

Table T3-2. Formally employed persons and structure of informally employed persons, according to professional status, 2014-Q3 2015.

	2014	Q1 2015	Q2 2015	Q3 2015	Index 2015/2014
Number of employed (total)	2,544,188	2,494,346	2,565,712	2,615,221	100.6
Formal employment	2,004,581	2,010,551	2,089,996	2,080,692	102.8
Informal employment	539,607	483,795	475,716	534,530	92.3
Informal employment by professional status					
Employed	101,005	108,179	127,950	145,816	126.0
Self-employed with employees	(2833)	*	*	*	
Self-employed without employees	221,462	170,853	143,452	167,546	72.5
Helping households' members	214,306	202,258	202,216	216,676	96.6

Note: *A small number of occurrences, assessments not published, ( ) less precise assessment – use with caution, figures for 2015 are average values for first three quarters.
Source: SORS

In its European Economic Forecast (published in November 2015), the European Commission gave the following predictions for the coming period using LFS data: employment in 2015/2014 will stand at 5%, growth in 2016/2015 will stand at 0%, while in 2017/2016 employment will rise by 1.9%. The unemployment rate in 2015, 2016 and 2017 is assessed to stand at: 17.7%, 17.7% and 16.6%, respectively. The untimely announcement of changes in the LFS methodology and publication of non-comparable figures[6], creates a bad reputation for Serbian state institutions in international organizations which use SORS figures while at the same time causing misapprehension among state representatives. Year on year growth in employment in Q2 2015, according to initial SORS figures, stood at 6.6%. On the other hand the International Monetary Fund gave an estimate of the unemployment rate of 20.7%, 21.96% and 22.36% in 2015, 2016 and 2017. The unemployment rate will probably rise as a consequence of the rationalization of employees in the public sector.

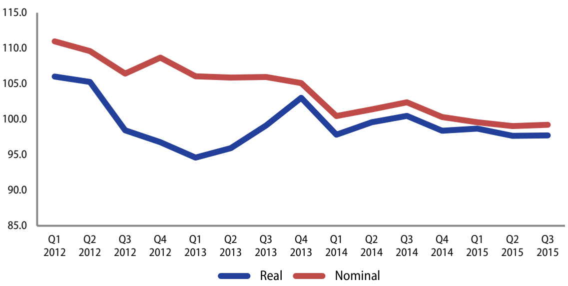
To create adequate policies, and make fiscal projections, it is important to secure reliable figures on the labor market. Instead of a constructive, argumented debate which would contribute to improving the data on the labor market, a political aspect is being introduced to the figures in the public.

Wages

The average monthly gross wages continued their downwards trend both nominally and in real terms.

In the third quarter of 2015, compared to the same quarter of the previous year, the average monthly gross wages were nominally lower by 0.8% and by 2.3% in real terms. The average net salary in Q3 2015 stood at 47,719 Dinars. The year on year indexes (nominal and in real terms) stood at below 100 in the first three quarters. The downwards trend in real gross wages carried over from 2014 into 2015 (Graph T3-1).

Graph T3-1. Average monthly gross wages, year on year indexes, 2012-2015.



Source: SORS

Impressive growth of wages in the construction industry continued in Q3 2015.

The trends in wages by sector continued in the third quarter of 2015. A majority of the sectors registered a year on year growth of seasonally adjusted net wages in real terms. The sectors which dominantly belong to the state sector registered a drop in real net

6 It is unusual that SORS representatives denied in public that the methodology had been changed on several occasions in the first half of 2015.

wages[7]. The biggest drop in wages was registered in the sectors of state administration and defense; mandatory social security and stood at 12%. A big drop in wages was registered also in education and health care and stood at 9%. The biggest rise in real net wages was registered in the construction industry sector and stood at 10.9%. That is in line with a real growth of the GVA in the same period by an impressive 18.3%. That is probably the consequence of the speeding up of the realization of capital expenses in Q3 (see section Fiscal Trends and Policy). Changes to the law, which allowed a faster and easier issuing of construction permits, contributed to the growth in the construction industry. The average prices of new housing in 2012-2015 period fall into the interval of 1100-1200[8] EUR/m2. In the first half of 2015, compared to the same period of 2011, average prices were 9% lower. The effective interest rate of banks for housing loans to the population and the non-financial sector stood at 4.07%[9] (average for 2015), which is the lowest value in the past five years. The drop in interest rates on housing loans has a great positive effect on the construction industry sector. The sector of accommodation and food providing services also achieved a significant growth in wages which stood at 8.8% while the GVA in the sector of wholesale and retail trade, traffic and storage and accommodation and food providing services saw a rise in real terms of 1.2% in the observed period. The processing industry sector registered a growth of real net wages of 4.2%. The seasonally adjusted index of industrial production in September 2015, compared to the average for 2014, showed a growth of 3.9% for the processing industry. Wages in the processing industry rose higher than those in production in Q3 2015 while the opposite happened in the previous quarter (year on year growth of wages stood at 4.2% while production rose by 7.2% in Q2 2015).

Considering that the SORS no longer publishes figures on employment by activity sector, we cannot analyze the weighted average wages in the public and private sector nor can we use the same manner as to date to monitor the relationship between wages in the public and private sectors using LFS data on the structure of employment by activity.

7 Year on year drop in seasonaly adjusted real net wages registered in following sectors: D – supply of electricity, gas, steam and air conditioning, E – Water supply, waste water management, controlling waste removal process and similar activities, O – State administration and defense, mandatory social security, P – Education, Q – Health Care and Social Security, R – Arts, entertainment and recreation, S – Other service activities

8 SORS figure transferred into Euro according to the average daily exchange rate (NBS).

9 NBS

4. Balance of Payments and Foreign Trade

In Q3 2015 current account deficit amounted to 3.6% of GDP and was below the level of Q3 2014, but slightly above the level of Q2 2015. Considering relatively low values of the current deficit since the beginning of the year, we estimate that in 2015 it will be considerably below the last year's value, that is 4.8% of GDP. The reason behind a lower deficit in Q3 is the reduction of trade deficit and foreign trade deficit, as well as a certain increase on the account of services and secondary income, while the net outflow of funds on the primary income account affected its increase. Year-on-year growth of export of goods was 8.1% and was significantly above the growth of imports, which recorded an increase of 0.8% in the same period, while seasonally adjusted values indicate their reduction compared to Q2 2015 by 3.8% and 1.9%, respectively. Recorded trends in exports and imports, as well as the trade deficit, were positively affected by: fiscal consolidation, still very low prices of oil, recovery of eurozone's economic activity, as well the extremely favourable terms of trade index value in Q3. These values were negatively affected by the decline of exports in the automobile industry, as well as the delayed effects of real appreciation of the local currency, which was recorded at the beginning of 2015. In October, exports decelerated, while the imports accelerated their growth. During Q3, an increase in the inflow of capital was recorded as the consequence of a high inflow of FDI. In this way, the favourable structure of the capital inflow in this quarter covered the current deficit and increased the foreign reserves. It is especially positive that FDI inflow of 1.6 billion euros is expected at the annual level, which will fully cover the expected current deficit. Actually, the positive result is the fact that the current deficit in Q3 2015, as well as for the entire 2015, had a relatively low value which is sustainable, because it is fully covered by the inflow of FDI. We feel it is important that this level continues to be maintained with a tendency to even realise a surplus in the coming period.

Current deficit still on a relatively low level in Q3 2015

During Q3 2015, the current deficit was lower compared to Q3 2014, but its level slightly increased compared to the previous quarter of 2015. Current deficit levels in the first three quarters of 2015 indicate that their annual amounts will be much below the last year's, i.e. around 4.8% of GDP. At the same time, a growth in the capital inflow was recorded, which is primarily the result of a high inflow of FDI. Thus, the current deficit was covered by a more favourable structure of capital inflow in Q3, and forex reserves were increased. Exports had a considerably faster growth than imports, so trade and foreign trade deficit recorded a decrease. Inflow of secondary income was relatively high (primarily from remittances), while there was an increase in the net outflow at the primary income account.

At the annual level, current deficit level is significantly below last year's

In Q3 2015, current account deficit was 304 million euros, i.e. 3.6% of GDP. Year-on-year reduction in current deficit by one pp of GDP (from 4.5% of GDP in Q3 2014 to 3.6% of GDP in Q3 2015) was primarily the result of a reduction in trade deficit (which was lower by 2.2 pp of GDP) and a certain increase on the services and secondary income accounts – 0.8 and 0.7 pp of GDP, respectively. On the other hand, net outflow of funds on the primary income account during Q3 was significantly above the one from the same period last year (by 2.7 pp of GDP). Compared to the previous quarter, current account deficit slightly increased – from 3.1% to 3.6% of GDP. Seasonally adjusted values of current deficit also indicate a certain quarterly growth in Q3 compared to Q2 by 15%.

Exports had a significantly faster growth than imports, so trade and foreign trade deficits recorded a slight decrease...

…which is mostly due to an extremely favourable trade ratio

In the observed three-month period, trade deficit was 829 million euros and was 10.5% of the quarterly value of GDP. Such a share of GDP was by 2 pp lower than the share recorded one year before. Goods in the value of 2,879 million euros were exported, which was 33.9% of the GDP value. Imports were 3,771 million euros, which expressed in relative terms (as a share of GDP) was 44.4%. This made the coverage of imports by exports in Q3 at a significant level and was 76%. Even though the coverage was by 1 pp below the level from Q2 2015, it was by 5 pp above the one realised in Q3 2014. The recorded trends of exports and imports were also influenced by extremely favourable terms of trade ratio index in Q3 – yoy index was 113.9. This was considerably above otherwise favourable trade ratio recorded during the previous two quarters, when yoy indices were 102.9 in Q1 and 103.4 in Q2 2015, as well as during the quarterly values in 2014 (Q1:102.0; Q2: 104.2; Q3: 102.1; Q4: 103.6). High depreciation of the euro against the dollar during 2015 contributed to very big differences in the growth rates of exports, imports and trade deficit depending on the currency in which they were expressed. Exports of goods in euro recorded a year-on-year growth in all three quarters since the beginning of the year: 3.6% in Q1, 8.0% in Q2, and 8.1% in Q3, while year-on-year changes in values of exports expressed in dollars were negative: -14.9% in Q1, -12.8% in Q2, and -9.5% in Q3. A similar situation was with imports as well, which realised year-on-year growth if we observe values in euros (6.7% in Q1, 2.7% in Q2, and 0.8% in Q3), and a year-on-year reduction if imports were expressed in dollars (-12.3% in Q1, -17.1% in Q2, and -15.6% in Q3). So, exports and imports in euros in the first nine months of 2015 were by 6.6% and 3.3% above last year's, respectively, while trade deficit was by 5.5% lower for the same period, and dollar values in this period indicate a year-on-year decline of exports, imports and trade deficit by 12.4%, 15.1% and 22.3%, respectively.

Inflow from secondary income was above the one from the same quarter the previous year, but slightly below the inflow from the previous quarter.

Net inflow from secondary income during Q3 2015 was 827 million euro (9.7% of GDP). Out of that amount, 418 million was inflow from remittances. Since the beginning of the year, the net inflow of funds from remittances was 1.57 billion euro. Inflow from remittances during Q3 was 6.2% of GDP and by 0.6 pp of GDP above the inflow from the same quarter of the previous year. And even though the levels of remittances and secondary income in Q3 were high, compared to the previous quarter they were somewhat lower (by 1.0 and 1.4 pp of GDP, respectively). This conclusion is also backed by seasonally adjusted data, which indicate a decline in the inflow from remittances in Q3 compared to Q2. Lower inflow from secondary income in Q3 compared to Q2 is the main reason of a slight increase in value of the current deficit in these two consecutive quarters (because the deficit of goods and services was reduced by 1 pp of GDP: from 9% to 8% of GDP). During Q3 2015, a surplus of 215 million euro was realised on the services account. On the primary income account the net outflow was relatively high and was 454 million euro, out of which net expenditures from dividends were 121 million euro, and from interests 22 million euro.

Current deficit is lower by one fifth, observed year-on-year

Observed year-on-year, current deficit in Q3 2015 was by one fifth (80 million euro) lower than the deficit realised in Q3 2014 (Table T4-1). Exports of goods were by 8.1% and imports by 0.8% above the values recorded in Q3 2014. This reduced the trade deficit by 17% compared to the deficit realised in the same period last year, while the surplus on the services account increased – reduction of foreign trade deficit was as much as 27.3%. Seasonally adjusted values of exports and imports indicate a reduction of their values compared to Q2 2015 by 3.8% and 1.9%, respectively. The recorded trends in exports and imports, as well as their difference, were positively affected by: fiscal consolidation, still very low price of oil, economic recovery of the eurozone, as well as extremely favourable value of trade index ratio in Q3. These values were negatively affected by the decline of exports in the automobile industry. Additionally, negative contribution was also the result of the delayed effect of real appreciation of the dinar against the euro which has been recorded since the beginning of 2015, as well as the decline of global prices of metal and cereal. Net inflow from secondary income was by 13.6% above the last year's inflow recorded in Q3. In this quarter, a year-on-year increase of 11.5% in the inflow of remittances was recorded.

Considerable inflow of capital, primarily as a result of realised inflow from FDI...

…was enough to cover the current deficit and lead to the growth of forex reserves

In Q3 a considerable net inflow of capital of 485 million euro was recorded (Table T4-1)[1]. This inflow of capital was primarily due to a high inflow of FDI – 470 million euro. Thus, FDI covered the current deficit in Q3 and even exceeded it by 166 million euro. As the inflow of FDI since the beginning of the year was 1,231 million euro, we estimate the FDI inflow at the level of 2015 to be around 1.6 million euro (around 4.9% of GDP), which will ensure full coverage of the current deficit. It is quite positive that most of the FDI inflow since the beginning of the year has been directed toward the tradable goods sector, where FDI were more widely disbursed in the processing industry[2].

1 Errors and Omissions account was 118 million euro.
2 http://www.nbs.rs/export/sites/default/internet/latinica/18/18_3/prezentacija_invest.pdf

During Q3 there was a capital inflow on the *Other Investments* account (due to borrowing of financial loans, as well as the increase in the *Cash and Deposit* account, while there was net deleveraging of trade loans). Net inflow on the *Other Investments* account was 113 million euro, out of which there was a 70 million euro net outflow of trade loans, positive balance on the financial loans account (50 million euro), as well as a net increase on the *Cash and Deposit* account (133 million euro). Additional borrowing by means of a financial loan of 50 million euro net was the result of an increased borrowing of the banks (11 million euro net) on the one hand, and on the other of public sector borrowing (71 million euro net), while NBS and the private sector recorded a net deleveraging in the amount of 26 and 6 million euro, respectively. Recorded net deleveraging of portfolio investments in the previous quarter (341 million euro) continued in Q3 as well, albeit in a slightly lower amount. Net deleveraging of 105 million euro on this basis was recorded in Q3.

Growth of forex reserves during Q3 (300 million euro) continued in October as well

Due to the recorded inflow of capital during Q3 and relatively low current deficit, cumulative growth of forex reserves during these three months was 300 million euro. An especially high increase of forex reserves was realised in July (291 million euro). Increase of forex reserves in July was followed by a somewhat lower growth in August (97 million euro), only to decline in September (89 million euro). In October, forex reserves had additionally increased by 163 million euro[3].

Table T4-1 Serbia: Balance of Payments

	2013	2014	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2	2015 Q3
					mil. euros				
CURRENT ACCOUNT	-2,098	-1,985	-496	-541	-384	-563	-521	-258	-304
Goods	-4,159	-4,111	-904	-995	-1,076	-1,136	-1,042	-877	-892
Credit	10,515	10,641	2,512	2,767	2,664	2,698	2,601	2,987	2,879
Debit	14,674	14,752	3,415	3,762	3,740	3,834	3,643	3,864	3,771
Services	313	465	69	73	145	179	137	114	215
Credit	3,422	3,810	793	887	1,044	1,085	927	1,004	1,167
Debit	3,109	3,344	724	814	900	906	791	890	952
Primary income	-1,419	-1,343	-283	-462	-221	-377	-307	-439	-454
Credit	607	642	125	168	181	168	120	186	128
Debit	2,025	1,985	407	631	402	545	426	625	582
Secondary income	3,166	3,003	622	843	768	771	692	944	827
Credit	3,537	3,400	707	934	875	884	785	1,056	944
Debit	372	397	85	91	108	113	93	112	117
Personal transfers, net 1)	2,701	2,442	511	697	618	617	568	758	665
Of which: Workers' remittances	2,160	1,863	378	547	469	469	437	605	523
CAPITAL ACCOUNT - NET	15	7	2	2	3	0	4	-1	1
FINANCIAL ACCOUNT	-1,630	-1,705	-478	-414	-217	-596	-399	-70	-186
Direct investment - net	-1,298	-1,236	-271	-435	-244	-286	-349	-412	-470
Portfolio investment	-1,883	-369	7	-150	-151	-75	-474	341	105
Financial derivatives	-1	-6	0	-3	1	-5	2	4	-7
Other investment	855	1,703	586	543	-332	906	312	28	-113
Other equity	0	0	0	0	0	0	0	0	0
Currency and deposits	-228	830	121	141	246	322	69	79	-133
Loans	1,286	757	373	386	-443	441	235	-34	-50
Central banks	657	574	189	186	100	99	57	55	26
Deposit-taking corporations,	675	795	214	89	197	296	95	101	-11
General government	-434	-728	29	30	-676	-111	67	-216	-71
Other sectors	389	115	-59	80	-64	157	15	25	6
Insurance, pension, and standardized	0	0	0	0	0	0	0	0	0
Trade credit and advances	-204	116	92	16	-134	143	8	-17	70
Other accounts receivable/payable	0	0	0	0	0	0	0	0	0
SDR (Net incurrence of liabilities)	0	0	0	0	0	0	0	0	0
Reserve assets	697	-1,797	-800	-370	509	-1,136	110	-32	300
ERRORS AND OMISSIONS, net	453	273	16	124	165	-32	118	188	118
PRO MEMORIA					in % of GDP				
Current account	-6.1	-6.0	-6.3	-6.3	-4.5	-6.9	-7.0	-3.1	-3.6
Balance of goods	-12.1	-12.4	-11.5	-11.7	-12.7	-13.9	-14.0	-10.4	-10.5
Exports of goods	30.7	32.2	31.9	32.5	31.5	32.9	34.9	35.4	33.9
Imports of goods	42.8	44.6	43.3	44.1	44.3	46.8	48.9	45.8	44.4
Balance of goods and services	-11.2	-11.0	-10.6	-10.8	-11.0	-11.7	-12.2	-9.0	-8.0
Personal transfers, net	7.9	7.4	6.5	8.2	7.3	7.5	7.6	9.0	7.8
GDP in euros 2)	34,268	33,060	7,881	8,527	8,452	8,200	7,451	8,441	8,486

Note: Balance of Payments of the Republic of Serbia is aligned with international guidelines outlined in the Balance of Payment Manual no. 6 of the IMF (BPM6).
Source: NBS
1) Personal transfers present current transfers between resident and non-resident households.

3 http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=8967&konverzija=no

Exports

During Q3 exports continued to record a fast year-on-year growth, even though they slightly decelerated compared to Q2

During Q3 exports were 3,032 million euro (Table T4-2) with a continued fast year-on-year growth, which amounted to 8.8% in this quarter. Still, compared to the growth of the previous quarter, there was a certain deceleration of growth of exports, as indicated by seasonally adjusted values (decline of exports by 3.8% between Q2 and Q3 2015, i.e. 14.3% annualised). According to October data, exports decelerated growth, i.e. by 6.4% above last year's.

Decline in the global price of energy is still reflected in the value of *Energy* exports. Exported value of *Energy* was only slightly below last year's, despite the significantly lower prices (which in Q3 2015 expressed in dollars were almost twice as low as the prices from Q3 2014, and by 40% when expressed in euro). Therefore, after excluding the effect of decreased prices, the exports of *Energy* recorded a growth of 62.6%. This was probably the result of a somewhat lower level of exports of these products in Q3 2014 after the floods. In the coming period, low energy prices are expected and, therefore, relatively low levels of exports of these products. Still, as the exports of these products make only 3.7% of total exports, it will not significantly impact the dynamic of total exports in the coming period.

During Q3, deceleration of the so-called *Other Exports* was recorded. *Capital Goods* and capital goods excluding road vehicles slightly accelerated their growth, which in Q3 was 5.4% and 26.2% year-on-year, respectively. Year-on-year growth of *Intermediate Goods* is slightly lower than the one realised in the previous quarter, but is still high and amounts to 12.8%. Such a high year-on-year growth of intermediate goods in this and previous quarter is especially important because the value of these products makes one third of the total exported value, so their trends considerably affect the export results of our national economy.

Growth of exports during Q3 were positively affected by the economic recovery of European countries, while it was negatively affected by the delayed effect of real appreciation of dinar since the beginning of 2015. Growth of exports were also negatively affected by the reduction in the exports of automobiles. Actually, exports of road vehicles recorded a significant decline during Q3, which was as much as 16% year-on-year.

That is why the value of total exports in Q3 after excluding road vehicles was by 12.1% above the value from the same period last year. Also, global prices of cereal (especially wheat) and metal were significantly lower than last year's, which also had a negative impact on the realised value of exports in Q3.

Table T4-2 Serbia: Exports, Year-on-Year Growth Rate, 2013–2015

	Exports share in 2014	2013	2014	2015			2014			2015		
				Q1	Q2	Q3	Q1	Q2	Q3	Q1	Q2	Q3
	in %	in mil. euros					in %					
Total	100.0	10,996	11,159	2,771	3,183	3,032	17.9	6.6	-10.4	5.1	10.7	8.8
Total excluding road vehicles	86.2	9,359	9,621	2,359	2,764	2,765	14.6	5.7	-5.4	5.9	14.8	12.1
Energy	3.7	519	413	62	107	101	3.9	-1.6	-29.4	-36.5	-16.4	-0.9
Intermediate products	33.0	3,678	3,687	920	1,082	1,064	14.5	1.7	-5.7	0.7	13.6	12.8
Capital products	25.8	2,979	2,877	760	834	684	26.1	6.8	-24.4	5.8	3.0	5.4
Capital products excluding road vehicles	12.0	1,342	1,334	348	414	416	11.2	1.5	-7.9	12.7	21.4	26.2
Durable consumer goods	5.2	524	586	133	169	180	23.0	8.1	5.8	8.6	15.2	19.8
Non-durable consumer goods	23.4	2,410	2,614	634	701	763	12.4	10.3	6.2	12.5	13.5	6.5
Other	8.8	886	981	263	291	240	27.7	24.2	-22.2	18.7	30.9	7.2

Source: SORS

Unlike previous years when the growth of exports was predominantly guided by the growth of exports in the automobile industry, in 2015 their year-on-year growth was due to the growth of exports in a wide range of goods, and the decline of car exports decelerated the growth of total exports. Even though it would be extremely important for the exports of Serbia that the growth of exports of FIAT automobiles recovers, it is also good that other goods present and could present a driver of growth of total exports. It is always good not to concentrate on a small number of export goods in order to avoid bigger fluctuations in the value of exports due to changes in the production within certain companies, fluctuations in the global prices and/or changes in the conditions on the foreign markets.

It is important in the coming period to continue the policy of a stimulating foreign exchange rate for the exporters. External factors that will mostly decide the future trends of the domestic exports are certainly the further dynamic of economic growth in eurozone countries, as well as the price of goods on the global market.

Import

Q3 recorded a further deceleration of growth of imports

Imports in Q3 2015 were 4,015 million euro and by 2.2% above the values of Q3 2014 (Table T4-3). Thus continued the decelerated growth of imports since the beginning of the year (growth of 8.3% in Q1 and 5.1% in Q2). Seasonally adjusted data indicate that imports were higher by 1.9% compared to the previous quarter, which is a 7.4% decline on annual level. October data indicate an accelerated growth of imports. Import value in October 2015 was by 5.8% above the value from the same month in 2014.

...primarily as a result of a decreased value of Energy imports due to still quite low prices

Decline in the value of imports was recorded in Energy, Capital Goods, and Non-Durable Consumer Goods. On the other hand, fast year-on-year growth was recorded in Intermediate Goods, Other Imports and Durable Consumer Goods. Considering that the energy prices are 40% below last year's (in euro), import of energy products actually increased year-on-year by 23.7%.

Low energy prices are still expected...

… and together with the effects of fiscal consolidation measures, it will affect a limited growth of imports in the coming period

Low energy prices and effects of fiscal consolidation kept the imports in Q3 on a low level and its recovery quite slow. Growth of imports of intermediate goods continued. On the other hand, the value of imports of Capital Goods was still below last year's. Import of these products points to certain changes in the country's production activity (includes imports of a considerable number of components for the production in the automobile industry), so its growth would be desirable especially from the viewpoint of production.

In the coming period it is expected that the limited growth of imports will still be due to low prices of oil, as well as low domestic demand as a result of measures of fiscal consolidation. Dinar appreciation from the previous period will act toward an increase in imports.

Table T4-3 Serbia: Import, Year-on-Year Growth Rates, 2013–2015

	Imports share	2013	2014	2015			2014			2015		
				Q1	Q2	Q3	Q1	Q2	Q3	Q1	Q2	Q3
	in %	in mil. euros					in %					
Total	100.0	15,469	15,497	3,862	4,155	4,015	1.6	3.5	0.6	8.3	5.1	2.2
Energy	14.1	2,336	2,180	486	454	444	-3.8	4.5	4.7	-4.9	-8.8	-24.6
Intermediate products	33.0	5,169	5,118	1,127	1,365	1,424	0.8	-1.0	-2.2	-3.9	5.3	7.4
Capital products	23.7	3,801	3,678	679	947	838	2.7	3.9	-10.4	-17.1	-6.6	-3.3
Durable consumer goods	2.0	328	317	79	94	89	-3.3	-7.5	1.7	6.0	28.0	15.7
Non-durable consumer goods	15.1	2,281	2,347	481	568	606	0.6	1.9	6.0	-6.4	0.5	-0.2
Other	12.0	1,554	1,858	1,010	728	613	10.4	19.1	25.3	113.7	43.9	32.7
Imports excluding energy	85.9	13,134	13,317	3,376	3,702	3,570	2.5	3.3	-0.1	10.6	7.1	6.9

Source: SORS

Foreign Debt

Foreign debt at the end of June 2015 was 26.53 billion euro

At the end of June 2015, foreign debt of Serbia was 26,529 million euro. It was 81.5% of GDP (Table T4-4). Compared to the situation from the end of March 2015, the foreign debt was lower by 0.4 pp of GDP. The level of foreign debt expressed in euro mostly recorded changes in value due to currency changes – primarily the depreciation of the euro against the dollar.

Decline in net borrowing during Q2 2015.

Decline in net borrowing during Q2 2015 was 190 million euro and is predominantly the result of a reduction of the public sector's foreign debt – by 185 million euro (Table T4-4). The NBS reduced its debt toward IMF in this period by 35 million euro. The growth of private sector's debt during Q2 2015 was 4 million euro, where 23 million euro was an increase of the long-term debt, while the amount of short-term borrowing was reduced by 28 million euro. During Q2 the banks reduced their indebtedness by 47 million euro (from the long-term loan of 20 million euro and short-term loan of 27 million euro), while the business sector increased its debt by 43 million euro (where 44 million euro is the growth of the long-term loan, see Table T4-4).

Compared to last year's level, the foreign debt is by 1.3 billion euro higher

At the end of June 2015, total foreign debt was by 1.3 billion euro higher. In this period, the public sector increased its foreign debt by 2.12 billion euro, while the private sector deleveraged by 816 million euro. Public sector especially borrowed abroad in Q3 2014 and Q1 2015 (see previous issues of *QM*). Part of the changes for the period of one year is owed to the already mentioned differences in the foreign exchange rate. Deleveraging of the private sector's long-term loan in the observed one-year period was 794 million euro. Out of which the banks deleveraged 555 million euro and the business sector 241 million euro. Short-term debt of the banks at the end of June 2015 was lower by 45 million euro, and the business sector's higher by 24 million euro compared to the situation a year before (Table T4-4).

Table T4-4 Serbia: Foreign Debt Structure, 2013–2015

	2013	2014				2015	
		Mar.	Jun	Sep.	Dec.	Mar.	Jun
	stocks, in EUR millions, end of the period						
Total foreign debt	25,747	25,574	25,225	26,263	25,792	26,719	26,529
(in % of GDP) [4]	*75.1*	*74.9*	*74.4*	*78.4*	*78.0*	*81.9*	*81.5*
Public debt[1]	13,166	12,969	12,796	13,878	14,198	15,102	14,916
(in % of GDP)[4]	*38.4*	*38.0*	*37.8*	*41.4*	*42.9*	*46.3*	*45.8*
Long term	13,166	12,969	12,796	13,878	14,193	15,097	14,911
o/w: to IMF	697	515	333	247	152	108	73
o/w: Government obligation under IMF SDR allocation	434	436	439	455	463	498	488
Short term	0	0	0	0	5	5	5
Private debt[2]	12,581	12,606	12,428	12,384	11,594	11,617	11,613
(in % of GDP) [4]	*36.7*	*36.9*	*36.7*	*36.9*	*35.1*	*35.6*	*35.7*
Long term	12,384	12,466	12,275	12,268	11,498	11,458	11,481
o/w: Banks debt	3,228	3,029	2,923	2,767	2,503	2,389	2,368
o/w: Enterprises debt	9,154	9,436	9,350	9,499	8,992	9,066	9,109
o/w: Others	1	2	2	2	3	3	3
Short term	196	139	153	116	97	159	132
o/w: Banks debt	171	115	128	89	57	110	82
o/w: Enterprises debt	25	25	26	27	40	50	49
Foreign debt, net [3], (in% of GDP) [4]	42.5	44.4	44.6	45.9	48.0	49.7	49.9

Note: As of September 2010, the statistics methodology of foreign debt has been changes so that the public sector's foreign debt includes obligations from IMF SDR (466.8 million euro) used in December 2009, as well as capitalised interest toward the Paris Club (50.9 million euro), while the private sector's foreign debt excludes loans concluded before December 20, 2000 which are free from payment (909.3 million euros, out of which 426.3 million euros relates to domestic banks, and 483.0 million euros relates to domestic companies). The foreign debt data showed in the Table are according to the new methodology.
Source: NBS, *QM*
1) Total foreign debt reduced by NBS forex reserves.
2) Sum of GDP values of the observed quarter and GDP values of the previous three quarters are used.

5. Prices and The Exchange Rate

In Q3 and in October, inflation moved below the lower limit of the NBS target band and at the end of October, it amounted to 1.4%. Low cost pressures in food production caused by a low price of primary agricultural products in the global and domestic market, low petroleum prices, low aggregate demand and slow growth in regulated prices are the most significant disinflationary factors that have affected the inflation trend below the target limit for a longer period of time (since March 2014). Underlying inflation (measured by the CPI excluding the prices of food, energy, alcohol and tobacco) also moved below the lower limit of the target band during Q3 and October, and the causes for such a development are low aggregate demand, stable and basically unchanged rate of the dinar against euro until the end of October, as well as a negative imported inflation. The National Bank of Serbia continued to ease the monetary policy and repeatedly reduced its key policy rate (KPR), which through the reduction of the interest rates at the money market contributes to a more favorable credit activity, although the KPR is still well above the inflation rate. It is expected that the inflation will move below the lower limit of the target band until the middle of 2016, with a possible one-off entry within the limits of the target band in January next year. Average inflation in 2015 will amount to 1.5%, which is lower than planned 2.7%, while at the end of the year, inflation will be 2.2%. During Q3, the dinar nominally appreciated by 0.7%, in October and November it depreciated by 0.8% and 0.4%, respectively, while the depreciation trend continued in December. The National Bank started with significant interventions at the interbank foreign exchange market in December and during first two weeks sold 210 million euros. The easing of a more significant depreciation in short term may be more important from the standpoint of the macroeconomic stability, but the trend of a moderate depreciation in a long term (over the following years) would contribute to the improvement of a price competitiveness with an acceptable risk on side of the cost of loan servicing in highly euroized economy of Serbia.

Prices

In Q3 and October inflation continued its trend below the lower limit of the NBS target band

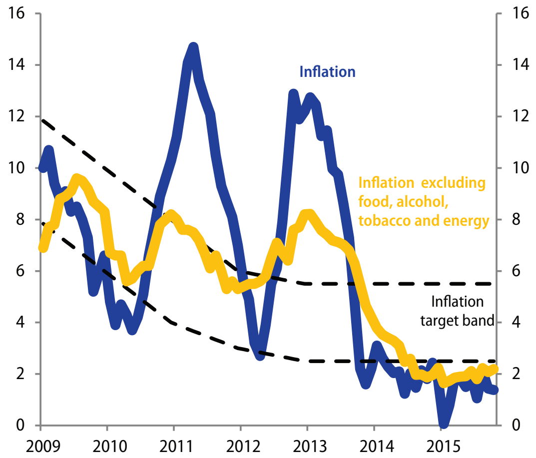
Year-on-year inflation at the end of third quarter of 2015 amounted to 1.4 %, which is below the value at the end of Q1 and Q2 (Table T5-1). When observed on a monthly basis, it can be noticed that the year-on-year inflation rate had a great fall in July (from 1.9% to 1.1%), mostly due to a high monthly deflation in July 2015 caused by a seasonal fall in food products, followed by a growth in August (to 2.1%), due to a relatively high monthly price growth in August 2015 caused by the increase in electricity prices and then a further drop in September (to 1.4%) due to the exclusion from the calculation of high monthly inflation in September 2014. In October, inflation remained unchanged. All these values are below the lower limit of the NBS target tolerance band, below which inflation has remained since March 2014. The movement of the year-on-year inflation was largely influenced by the realized monthly inflation rate in the current year, while the exclusion of the last-year's values from the calculation had a much smaller effect due to a low last-year's monthly changes in the Consumer Price Index (except in September). Underlying inflation (measured by the consumer price index, excluding the prices of food, alcohol, tobacco and energy) was also below the lower limit of the NBS target band, and in September amounted to 2.1%, while in October grew to 2.2%. Year-on-year underlying inflation trend in the period longer than a year is relatively stable (it ranges from 1.6% to 2.2%) and during this year it shows a trend of a slight growth (Graph T5-2). The reduction in pensions and wages in public sector affected the decrease in domestic demand, whose recovery did not happen yet, but it can be expected in coming period (among others, due to a simulating measures of the NBS directed towards the recovery of the credit activity). In addition to low aggregate demand, other domestic factors that had significant impact on inflation are also a relatively unchanged dinar exchange rate that affected the price stabilization, one-off increase in the electricity prices that contributed to a return of contribution to the inflation by the regulated prices from negative (deflationary) to positive (inflationary) area, while a drop in the interest rate had a disinflationary effect. The price of electricity for a domestic consumption is still below the market price, while this does not apply to the price of electricity for industrial consumers. The most important global factors that affected the inflation in Serbia are a fall in global prices of primary agricultural products (measured by Commodity Agricultural Raw Material Index) which results in a low cost pressures in food production in global and domestic market, then the extremely low price of petroleum, that at the end of Q3 stood at the lowest level since the beginning of 2009 and which contributes to further reducing cost pressures in production, low inflation in the international environment and low price of a greater part of a primary products in global market. Synthetic indicator of the impact of global prices to the inflation in Serbia is the index of external prices expressed in dinars, which in Q3 recorded a drop of 2.8%. Taking into consideration abovementioned factors and their impact on a further movement of inflation, NBS in Q3 and October continued to reduce the key policy rate (KPR), in August, September and October by 50 basis points (b.p.), thus from the beginning of Q3 to mid December, KPR was reduced from 6.0% to 4.5% (Graph T5-3). In addition, The Executive Board of the NBS made the decision in September to reduce the foreign exchange required reserves by 1 percentage point in the following six months, which will at the end of a given period result in the reduction of the rate to 20%, i.e. 13% to maturity sources up to two years, i.e. more than two years, respectively.

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					
mar	179.1	2.3	1.2	-0.3	5.1
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
may	182.9	1.5	1.6	-0.3	4.0
jun	183.8	1.9	2.1	0.5	3.1
jul	182.1	1.1	1.2	-0.9	-2.8
aug	183.7	2.1	2.1	0.9	1.8
sep	183.7	1.4	2.1	0.0	-0.2
oct	183.3	1.4	1.8	-0.2	2.7

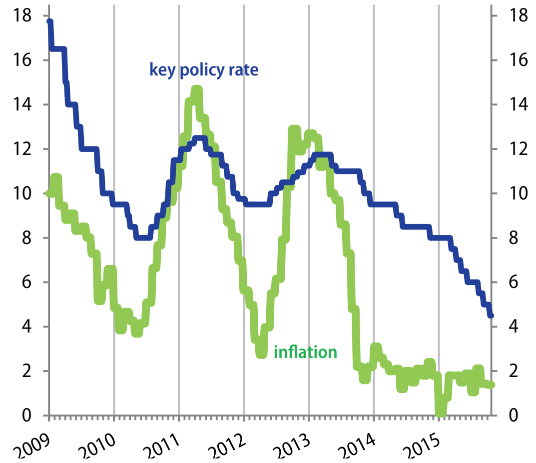
Source: SORS.

Chart T5-2. Serbia: Y-o-y Inflation Rate and Underlying Inflation and the NBS Target Band 2009-2015



Source: NBS and *QM* estimates

Chart T5-3. Serbia: NBS Reference Interest Rate and y-o-y Inflation Rate, in %, 2009-2015



Source: NBS

Deflation in Q3…

Inflation recorded in the third quarter was -0.05% (Table T5-4), or monthly: July recorded a deflation of -0.92%, August recorded inflation of 0.88%, and there were no changes in CPI in September. Total price growth from the beginning of the year until the end of Q3 amounted to 2.1%. Highest contribution to inflation in Q3 was made by the price growth of electricity, tobacco and certain groups of food products (fresh meat, oils and fat), while the fall in the prices of vegetables, petroleum products and to a lesser extent the prices of clothing and footwear had a disinflationary effect. The prices of travel arrangements had approximately neutral effect on the consumer price index (seasonally expected growth in June and July, followed by approximately equal fall in September). In August, the electricity price increased for the consumers at a low voltage network by a total of 12% due to the increase in the producer's price by 4.5% and the introduction of excise duty in the amount of 7.5%, while for the industrial producers that use the electricity at a medium and high voltage, the price increased by the amount of excise duty of 7.5%. This increase contributed to the growth of inflation of about 0.6 percentage points (Table T5-4). Continued growth in the prices of tobacco in July (growth of 3.5%, contribution to inflation of 0.16 p.p.) is a consequence of the increase in excise duty on tobacco products. The growth in the prices of fresh meat, oils and fats partly eased a strong decline in the prices of unprocessed food in Q3, given that there was a strong seasonal fall in the prices of vegetables in the observed period (fall of 15.9%, contribution to inflation of -0.83 p.p.) and slight decline in the prices of fruit. There was also an increase in the prices of drinking water and wastewater disposal in July, thus Q3 saw the increase in the prices of water supply and utility services of approximately 2.0% (contribution to inflation of 0.03%). The prices of travel arrangements followed the trend of the seasonal increase in July and August, whereas there was an expected drop in the prices of these services in September, making the overall effect of these changes neutral. Prices of petroleum products in Q3 dropped by 3.8% (contribution to inflation of -0.22 p.p.), which is the result of the lowest crude oil price on a global market since the beginning of 2009 and a slight weakening of the dollar against the euro during Q3. A decrease in the prices of clothing and footwear due to a reduced demand in the summer month, a drop in the price of the natural gas, as well as a decrease in the price of the use of transport means, in large part due to a decrease in the price of a monthly ticket in Belgrade GSP had a disinflationary effect.

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

	Share in CPI (in %)	price increase in Q3 2015	Contribution to overall CPI increase (in p.p.)	Price increase in October 2015	Contribution to overall CPI increase (in p.p.)
Total	100.0	-0.1	-0.1	-0.2	-0.22
Food and non-alcoholic beverages	32.8	-1.9	-0.6	-1.0	-0.33
Food	29.2	-2.2	-0.6	-1.1	-0.33
Alcoholic beverages and tobacco	7.4	2.2	0.2	0.2	0.02
Tobacco	4.7	3.5	0.2	0.0	0.00
Clothing and footwear	4.5	-1.1	-0.1	1.4	0.06
Housing, water, electricity and other fuels	13.6	4.1	0.6	-0.5	-0.07
Electricity	4.8	12.2	0.6	0.0	0.00
Furniture, household equipment, routine maintenance	4.6	0.4	0.0	0.3	0.01
Health	5.0	0.4	0.0	0.5	0.02
Transport	12.9	-1.5	-0.2	-0.7	-0.09
Oil products	5.8	-3.8	-0.2	-1.1	-0.06
Communications	5.0	-0.4	0.0	1.1	0.05
Other items	14.3		0.1		0.11

Source: SORS and *QM* estimates

…and in October

The largest contribution to October deflation, which amounted to -0.2%, was made by the seasonal drop in the prices of several groups of unprocessed food (mainly fruit), prices of gas and central heating and the prices of petroleum products, while seasonally expected growth in the prices of travel arrangements, vegetables, as well as clothing and footwear had inflationary effect. Within the food price range, fruits cheapened by 14.1% (contribution to inflation of 0.29 p.p.), prices of fresh meat dropped by 0.7% (contribution of 0.05 p.p.), while the vegetable prices increased by 1.5% (contribution to inflation of 0.08 p.p.). The price of natural gas in October was lower by 8.2 % in comparison to September (contribution of -0.05p.p.), the price of central heating was lower by 2.1% (contribution of -0.03 p.p.), while the price of petroleum products was lower by 1.1% (contribution to inflation 0.06 p.p.). A seasonal growth of the prices in the group of recreation and culture (mostly travel arrangements) amounted to 2.5% (contribution of 0.13 p.p.), clothing and footwear 1.4% (contribution of 1.6 p.p.), while the vegetable price increased by 1.5% (contribution to inflation of 0.08p.p.).

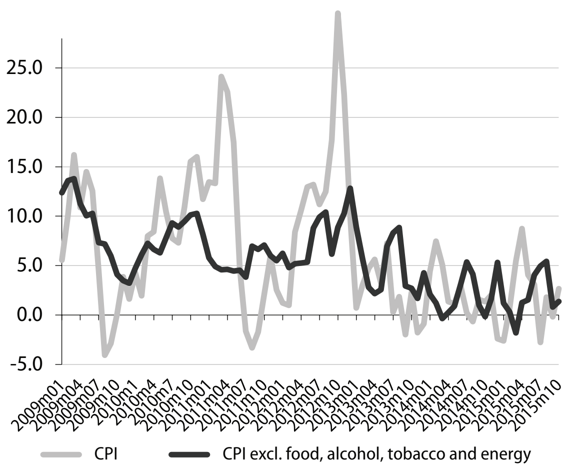
Total and underlying inflation are at a relatively low level

Total inflation, i.e. its three-month annualized average at the end of Q3 amounted to -0.2%, while in October it increased to 2.7%. Underlying inflation (inflation excluding food, alcohol, tobacco and energy products) amounted to 0.8% at the end of Q3, and in October 1.4% (three -month annualized average is also observed in this case). Oscillations in total and underlying inflation (Graph T5-5) result from the absence of stable trend in the movement of monthly value of the prices that define them. Therefore, due to an omission of monthly June inflation of 0.5%, three-month average of total inflation first dropped to -0.8%, only to rise to 2.7% due to an omission of a relatively high July deflation of -0.9%. Underlying inflation had similar oscillations in previous months, so after high monthly June inflation was omitted, at the end of Q3, its three-month average dropped to 0.8% (from 5.4% in August), only to increase slightly in October to 1.4% due to a little higher monthly October underlying inflation. These fluctuations can be explained with the changes in the prices that are one-off in character: October growth of total inflation- exclusion from the calculation of seasonal fall in the prices of food in July, eased seasonal fall in the prices of fruit in October, while somewhat more modest growth in underlying inflation can be explained with the October growth in the prices of clothing and footwear, telephone equipment, and on the other hand, with the exclusion from the calculation of July fall in the prices of clothing and footwear. In addition to the above short-term factors, inflation is also influenced by the factors that determine its dynamics in medium and long term, such as stable dinar exchange rate, low aggregate demand, low cost pressures in manufacturing and others.

Inflation will remain below the lower limit of the target band until the mid 2016

Sustainable return of the inflation within the limits of the target tolerance can be expected only in the second half of the following year. Inflation will be stable below the NBS corridor, while a short-term inflation entry within the target band is possible in January of 2016 due to the omission from the calculation of negative values in December 2014 and January 2015 and the announced increase in excise duties on alcoholic beverages and petroleum products early next year. However, in the coming months, the omission of this year's high February and March values of monthly inflation will again bring down the year-on-year inflation below the lower limit of the NBS target band. Moreover, it is expected that a modest effect of the spillover of the electricity price growth to other prices will disappear, while the extremely low global petroleum prices and the prices of primary agricultural products will continue to act disinflationary. We estimate that at the end of the year inflation will be around 2.2%, i.e. 1.5% on the annual average. Rough agricultural season will be felt next year, but given that it wasn't much worse than previous one, the effect on inflation will be modest. The risks for a faster inflation growth exist if the global petroleum and primary product prices return to normal levels (from the current six-year minimum), but if the petroleum price doesn't increase, it can result in low pressures to additionally increase the price of electricity in the following period. Possible growth in aggregate demand and inflation in international environment can cause the weakening of disinflationary pressures, while they can be increased by the uncertainties in the financial market in international environment, current trend in the prices of primary products in the global market and the growth in regulated prices that could be lower than expected (and that is included in the projection of inflation).

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



Source: SORS and *QM* estimates

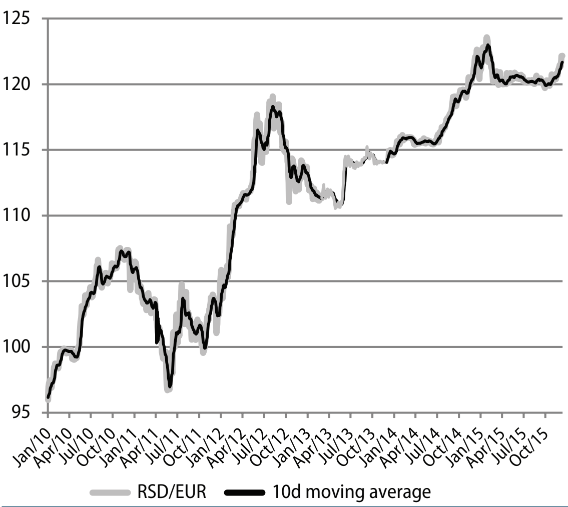
The Exchange Rate

Dinar exchange rate in Q3 is almost fixed, while modest depreciation is recorded in October

During Q3, dinar nominally appreciated against the euro by 0.7%, when observed at the end of the period, i.e. by 0.2% on the quarter average. In relation to the US dollar, dinar strengthened by 1.2% at the end of Q3, i.e. 0.8% on the quarter average. During October and November there was a significant depreciation (Graph T5-6), which can be seen with the dinar weakening at the end of the period against the euro by 0.8% and 0.4% in these months, respectively, i.e. with the strengthening of 0.1% and weakening of 0.5% on a month average. In October and November dinar weakened considerably more against the dollar by 3.2% and 4.2% at the end of the period, i.e. by 0.0% and 5.0% on the month average. Therefore at the end of November when compared to the end of Q2, dinar exchange rate depreciated by 0.5% against the euro, i.e. 6.3% against the dollar. The National Bank, during Q3, intervened at the interbank foreign exchange market mostly in July (IEFM) (by buying 230 million euros), then in August (by buying 140 and selling 10 million euros) and at least in September (by buying 80 million euros at the end of September). Fewer NBS interventions are recorded in October (buying 70 million and selling 10 million euros) and November (purchase of 10 million euros in the beginning and selling of 10 million euros at the end of the month).

Since the beginning of December there have been depreciation pressures, followed by greater NBS interventions for sale of the foreign currency

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

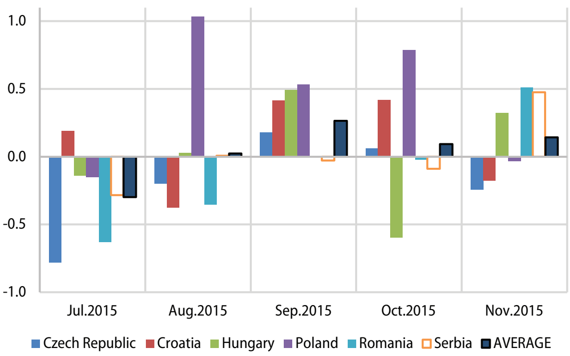


Source: NBS

During the first two weeks of December, dinar nominally depreciated by about 0.8% when compared to late November. Such a weakening was followed by the sale of 210 million euros in the IFEM by the National Bank of Serbia. Larger interventions of the NBS in order to prevent the dinar weakening are not fully justified, since the daily fluctuations from the beginning of October until now have never exceeded ±0.27%, and we believe that the trend of moderate depreciation in the following period (over several years) would be an acceptable compromise between improving the price competitiveness of Serbia and the need to prevent significant fluctuations in highly euroized Serbian economy.

Dinar appreciation in Q3 was slightly higher than average of the region countries, but the depreciation from October and November was also above the average values

Chart T5-7. Nominal Exchange Rate Change (in %) in Selected Countries

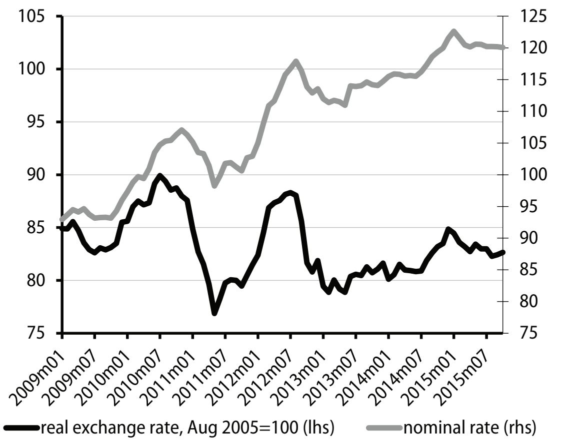


Source: Eurostat, NBS, *QM* estimates

During the third quarter the dinar, after the Romanian leu and the Czech crown, is the currency which mostly strengthened against the euro (compared to selected countries, see Graph T5-7). However, in October and November, the dinar is, after the Polish zloty and Romanian leu, the currency that recorded a biggest drop against the euro. The liquidity growth in the international financial market is one of the most important global factors in the first half of Q3 that had an impact to currency strengthening in the region countries. However, since the news on the slowing down of the Chinese economy appeared, as well as due to the uncertainty in the global financial market, there has been a weakening in most of the observed countries.

Real appreciation in Q3 and depreciation in October

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

The dinar during Q3 really appreciated by 0.65% against the euro, while during October, it recorded a real depreciation of 0.27%. Real appreciation in Q3 is the result of the contribution of nominal dinar appreciation and significantly higher deflation in eurozone than deflation realized in Serbia in the observed period. Real depreciation in October was a consequence of negative inflation in Serbia (of -0.22%) and inflation in eurozone (of 0.14%), while nominal appreciation (of 0.09%) contributed to its moderation. Historically looking, real dinar exchange rate at the end of the October was at a similar value as it was in September of 2014, i.e. in October of 2012 (Graph T5-8).

Trends

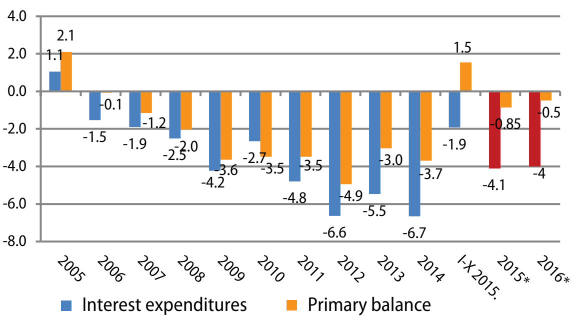
6. Fiscal Flows and Policy

Positive fiscal trends continued in the period July-October, so fiscal results went beyond the expectations again. Accordingly, in the first ten months of 2015 consolidated fiscal deficit (RSD 63.1 billion, or 1.9% of GDP) was smaller than targeted by almost RSD 100 billion because tax revenues exceeded the projected level (primarily VAT, excise tax and contributions), non-tax revenues were collected more aggressively, and some expenditures were postponed or restrained (severance pay and capital expenditures). Although capital expenditures were scaled up in Q3, they will be somewhat lower than budget target for 2015, and much below the CEE average. Continuation of the current trends would result in fiscal deficit at 2.5-3% of GDP at the end of 2015, and the announced settlement of the previously assumed liabilities (towards Gazprom, military pensioners, agricultural producers etc.) would raise this estimate to 3.5-4% of GDP. Fiscal deficit at 4% of GDP at the end of 2015 would mean that it shrank by 2.7% of GDP compared with the last year's level (and would be by 1.9% of GDP below the budget target), and that the structural deficit narrowed by 1.7% of GDP, which would be a notable improvement. However, additional reduction in fiscal deficit down to 2.5% of GDP in the following two years, and to 1% of GDP in the medium term, is necessary to establish sustainable public finance. According to Fiscal Strategy, fiscal deficit for 2016 is expected to remain at the level reached in 2015, and further reduction down to 2.6% of GDP shall be made in 2017. However, this plan is inadequate because the arrangement with the IMF expires in 2017, and 2017 is the election year. Instead, it should be continued with considerable reductions in current spending and a moderate increase in capital expenditures in 2016 and 2017, along with further reduction in fiscal deficit that would be evenly distribute throughout these two years. Public debt (including the debt of local self-governments) totaled 76% of GDP at the end of October, and is expected to reach about 78% of GDP at the end of 2015.

Fiscal tendencies and macroeconomic implications

Fiscal deficit totals RSD 63.1 billion (about 1.9% of GDP) in the first ten months of 2015

Graph T6-1. Serbia: Consolidated fiscal balance and primary balance (% of GDP)[2]



Source: *QM* calculations[3]

In the period July-October 2015 consolidated fiscal deficit totaled RSD 27.7 billion, approximately 2% of the four-month GDP. In the same period, Serbia was running primary surplus of RSD 12.8 billion (1% of the four-month GDP).[1] In the first ten months of 2015 consolidated fiscal deficit totaled RSD 63.1 billion (about 1.9% of GDP), and the budget balance before interest payments showed surplus (primary fiscal surplus) of RSD 50.7 billion (about 1.5% of the ten -month GDP).

In the period July-October fiscal deficit remains below the budget target

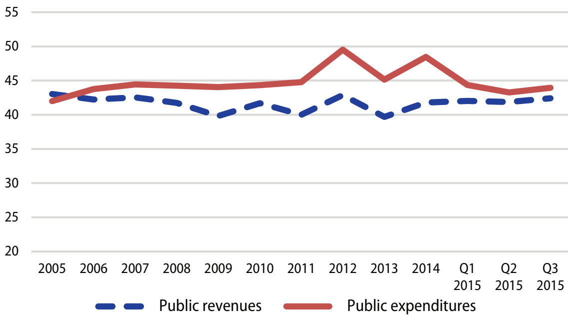
In the period July-October 2015 fiscal deficit accounted for 12% of the annual target, while fiscal deficit in the same period of the preceding years accounted for 24% of the annual deficit. This indicates that fiscal results kept outperforming the projections, as a consequence of growing revenues (primarily revenues from VAT), and a continuous decrease in current spending caused by the measures implemented at the end of 2014, and postponement of some expenditures.

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.
2 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.
3 The data for 2015 and 2016 is based on the projections made by the Ministry of Finance and the IMF.

Fiscal deficit in the first ten months of 2015 is smaller than targeted by almost RSD 100 billion …

Due to improved tax collection (VAT, excise tax and contributions), based on reduction in the shadow economy…

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



Source: *QM* calculations based on the MF data

Accordingly, consolidated fiscal deficit in the first ten months of 2015 is smaller than the budget target by almost RSD 100 billion, due to a much improved revenue collection and a slowdown in expenditures.

In Q3, for the first time, real tax revenues grew faster than the overall public revenues, mainly due to a dynamic real y-o-y rise in excise revenues and revenues from VAT, probably driven by increased efforts against the shadow economy, and the excise on electricity. On the other hand, revenues from corporate income tax suffered the largest drop, probably caused by declining profitability of companies. Q3 saw a strong real y-o-y increase in non-tax revenues, though it was somewhat smaller than in the preceding quarters. In the period January-October 2015 real tax revenues stagnated compared with the same period last year, as a net result of a real rise in revenues from VAT (by 1.8%) and excise revenues (by 5%) and a drop in revenues from social security contributions (by 2.5%). Increase in revenues from VAT, and excise revenues (compared with the last year's level) and in contributions (compared with the targeted level) was to a large extent driven by reduction in the shadow economy, and excise on electricity imposed as of August 2015 was another contributory factor. Revenues from VAT and excise revenues grew somewhat faster in Q3 2015 than in the preceding quarter, which is good because these revenues showed a slower rise in Q2 than in the preceding several quarters. On the basis of the intraannual dynamics of revenues in 2015 and in the preceding years, tax revenues in 2015 are expected to exceed the budget target by RSD 40 billion (1% of GDP). Economic growth outperformed the projections, which had positive impact on tax revenues. However, these effects were offset by lower-than-projected inflation rate and slower-than-expected exchange rate depreciation.

…high-pressure collection of dividend pushes up non-tax revenues…

High-pressure collection of dividend and one-off revenues (from sale of licenses etc.) will push non-tax revenues above the annual target (by around RSD 20 billion, or 0.5% of GDP). However, this is a temporary improvement because it is not possible to continuously use a large share of the profit of state-owned and public enterprises in this manner without impairing the capital base of their business activity, and consequently the quality of the services they provide.

Further reduction in public expenditures, as planned

Real y-o-y decrease in public expenditures continued in the period July-October (by 1.3%), though at somewhat slower pace than in the preceding quarters. Reduction in expenditures on wages and pensions (10.6% and 6% respectively), in accordance with the plan, and a considerable real drop in expenditures on subsidies (by 10.6%) contributed the most to this decrease. There was a considerable real rise in capital expenditures compared with the same period last year (by 32.1%). Finally, the reduction in overall expenditures had good dynamics and structure.

Dynamic rise in capital expenditures in Q3, but they are still low

Thanks to the rise in capital expenditures which started at the beginning of the second quarter and accelerated considerably in Q3, total capital expenditures in the first 10 months of 2015 were by 6.5% higher than in the same period last year. This is especially important from the aspect of economic growth because these expenditures have considerable impact on economic activity. However, capital expenditures accounted for only 2.3% of GDP in the first 10 months of 2015, and are expected to total around 2.5% of GDP at the end of the year. This is below the budget target and insufficient, considering the state of infrastructure in Serbia and the average level of capital expenditures in CEE (about 4.5% of GDP), and the fact that capital expenditures have more favorable impact on economic growth than current spending.

Some expenditures remain postponed (severance pay)

At the same time, in the first ten months of 2015 only a small share of the projected amount was spent on severance pay, because privatization and restructuring of public and state-owned enterprises and the process of public sector downsizing were postponed. Consequently, expenditures in 2015 are RSD 15 billion smaller than projected. However, this will push up expenditures in

2016. Postponement of restructuring and privatization and severance pay is not economically justifiable because it could cause additional costs in the following period (on subsidies to these enterprises etc.). Therefore, the status of the state-owned and socially-owned enterprises should be resolved rapidly (privatization), business and financial restructuring of public enterprises should be done, and the plans for public sector rightsizing should be implemented. In the first ten months of 2015 real expenditures were by 2.8% smaller than in 2014, mainly because expenditures on wages and pensions were reduced in accordance with the plan. Expenditures in the first ten months of 2015 fell more than expected because expenditures on severance pay were postponed and capital expenditures were below the targeted level.

FY 2015 deficit is estimated at 3.5-4% of GDP, which is a considerable improvement…

With the current dynamics of public revenues and public expenditures, consolidated fiscal deficit would narrow to 3% of GDP by the end of 2015. However, the announced settlement of previously assumed liabilities (old debt to Gazprom, debt to military pensioners, unpaid subsidies to agricultural producers etc.) by the end of 2015 raises this estimate to 4% of GDP. It is economically justified and correct from the aspect of accounting to show previously assumed liabilities that are to be settled (paid) in 2015 as expenditures and deficit for 2015, and the assumed liabilities that are to be settled next year should be shown as a part of expenditures and deficit for 2016.

…However, further reduction in fiscal deficit is necessary to establish sustainable public finance

Fiscal adjustment of about 2.7% of GDP achieved in 2015 compared with 2014 is important. However, to establish sustainable public finance, it is necessary to reduce fiscal deficit down to 2.5% of GDP in the following two years, in order to stabilize public debt-to-GDP ratio, and then to further reduce it to 1% of GDP, which is considered to be a long-term sustainable level (see the analysis of the 2016 Budget and the announced fiscal policy in *Highlight 1*). According to Fiscal Strategy, fiscal deficit for 2016 shall remain almost unchanged compared with 2015, and further reduction in fiscal deficit of around 1.5% of GDP shall be made in 2017. However, this plan is inadequate because the arrangement with the IMF expires in 2017, and 2017 is the election year. Instead, further evenly distributed reduction in fiscal deficit of 1% of GDP annually both in 2016 and 2017, and moderate annual increase in capital expenditures of 0.3-0.5% of GDP should be continued.

Trends in public debt

Serbia's public debt totaled EUR 24.3 billion at the end of October (74.8% GDP)...

At the end of October 2015 Serbia's public debt totaled EUR 24.3 billion (74.8% of GDP), and including the debt of local self-governments the percentage goes up to 76% of GDP.

...and including the debt of local self-governments – 76% of GDP

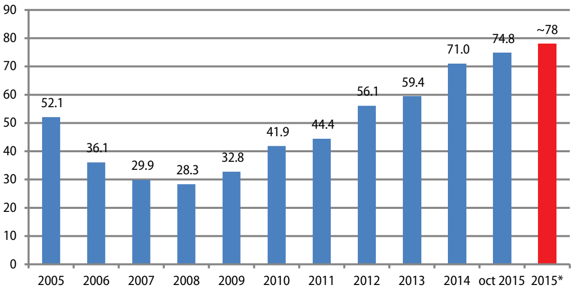
From the end of June to the end of October 2015 public debt grew by EUR 260 million, as a result of the growing direct debt and a slight reduction in indirect debt. The largest share of this increase was used to finance fiscal deficit which totaled EUR 230 million in the period July-October. At the same time, public debt grew by 0.3% of GDP, which is smaller than the absolute amount of growth, because GDP grew slightly. Public debt grew by almost EUR 1.6 billion from the beginning of the year, and a large share of this increase (almost one billion EUR) came from a strong depreciation of dinar against US dollar (by more than 20%), while the remaining amount came from government borrowing needed to finance fiscal deficit. Changes in dinar to dollar exchange rate had negative impact at the beginning of the year, and from the middle of 2015 exchange rate was a neutral factor, because real dinar to euro and dinar to dollar exchange rate remained almost unchanged in the preceding few months

Indirect debt is shrinking slightly

In the period July-October indirect debt shrank slightly (by EUR 50 million), meaning that the downward trend from the preceding period continued, so the overall reduction in indirect debt in the first ten months of 2015 totaled around EUR 110 million. Although this is a good result, we believe that the key drivers of indirect debt have not been eliminated (this was discussed in detail in QM41), and that it might rebound in the following period if privatization and business and financial restructuring of state-owned and socially-owned enterprises are not finished within the established deadlines. There have been many announcements of privatization of some of these enterprises (from the petrochemical complex), but unfortunately none of them was realized.

Public debt will amount to almost 78% of GDP at the end of 2015

Graph T 6-4. Trends in Serbia's public debt (% of GDP)



Source: *QM* calculations

Assuming that real dinar exchange rate remains unchanged, and that borrowing in advance of need remains within the expected level, and that no new government guarantees are issued, and that the government borrowing remains at the level needed to finance the deficit, public debt will reach 77% of GDP, and including the debt of local self-governments it will total 78% of GDP. This is unsustainable in the long term and suggests that the extraordinary fiscal results achieved in 2015 should be used to further reduce fiscal deficit in the following period, instead of increasing current spending.

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	Q2	Q3	jan-oct
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**	**380.5**	**424.7**	**432.5**	**1,377.1**
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	379.5	422.7	430.6	1372.1
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	324.9	368.7	373.3	1188.0
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	35.6	37.6	118.1
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	25.9	11.5	53.8
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	100.1	108.2	345.8
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	57.2	63.8	182.5
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	7.9	8.3	27.2
Social contributions	312.7	318.8	323.0	346.6	378.9	418.3	99.3	109.8	110.7	120.6	440.3	115.6	125.9	126.7	410.3
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	16.0	17.2	50.3
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	54.6	54.1	57.3	184.1
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	1.0	1.9	1.9	5.1
	0.0														
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**	**-401.7**	**-438.9**	**-448.3**	**-1,440.3**
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	-383.8	-406.0	-410.4	-1338.3
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	-98.8	-104.3	-103.1	-339.2
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	-58.8	-65.0	-197.4
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	-32.7	-32.4	-113.8
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	-23.8	-25.3	-80.0
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	-173.8	-174.8	-574.1
o/w: pensions5)	*-331.0*	-556.4	*-394.0*	*-422.8*	-473.7	-498.0	-125.0	-126.9	-128.0	-128.1	-508.1	-121.0	-122.8	-122.1	-407.0
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	-12.5	-9.9	-33.8
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	-23.8	-29.7	-75.5
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	-8.2	-7.5	-24.3
4. Buget lendng	-19.3	-24.0	-30.0	-25.0	-38.2	-35.6	-5.2	-5.8	-0.3	-44.1	-55.4	-0.5	-0.9	-0.7	-2.2
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**	**-21.2**	**-14.2**	**-15.8**	**-63.1**

Source: *QM* calculations based on the MF data

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

	2008	2009	2010	2011	2012	2013	2014					2015			
							Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	jan-oct
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**	**6.9**	**3.5**	**4.5**	**4.1**
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	6.8	3.3	5.3	4.3
Tax revenue	3.7	-8.8	-2.5	-4.1	1.0	-1.7	-1.0	6.4	3.8	4.3	3.5	1.3	-1.1	1.6	0.0
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	-0.3	0.2	-0.7
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	-17.1	-14.5	-20.1	-17.5
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	1.9	1.5	4.7	1.8
Excises	0.7	11.6	4.2	0.6	-1.2	5.1	-1.7	0.8	9.5	-2.4	1.6	7.1	1.9	7.6	5.0
Custom duties	1.8	-32.4	-14.9	-21.5	-14.0	-15.6	-4.4	-7.0	-6.9	-7.3	-6.5	9.1	4.0	4.9	5.5
Social contributions	4.3	-7.0	-6.5	-3.9	1.9	2.6	3.6	29.1	28.1	0.5	3.1	-1.2	-3.0	-2.4	-2.5
Other taxes	-2.3	-4.9	14.5	-15.2	-8.8	-5.2	12.1	8.2	0.8	44.1	29.2	24.1	9.9	12.4	13.3
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	58.8	49.0	37.9	44.3
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	25.3	51.3	-60.0	-31.6
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**	**-5.4**	**-3.8**	**-1.3**	**-2.8**
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	-4.5	-3.0	-2.6	-3.0
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	-12.9	-11.3	-10.6	-11.8
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	-1.0	-0.8	6.3	2.8
Interest payment	-2.8	-5.7	-0.3	17.4	41.9	28.8	82.9	2.2	-3.4	13.6	19.3	13.2	12.2	19.2	12.8
Subsidies	-13.3	19.0	40.6	7.4	29.1	-15.6	-0.8	6.0	-3.8	41.9	13.2	-4.1	-1.4	-10.6	1.4
Social transfers	10.1	-26.0	13.9	5.8	-0.1	-2.1	2.4	-2.2	-1.8	-1.2	-0.7	-3.2	-0.9	-0.4	-1.3
o/w: pensions5)	*9.5*	2.2	-3.9	3.9	*4.4*	*-2.3*	*1.5*	*0.0*	*0.2*	*-2.0*	*-0.1*	*-4.1*	*-4.9*	*-6.0*	*-5.1*
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	-15.8	-2.4	-30.5	-19.3
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	-25.4	-7.4	23.2	6.5
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	34.8	-9.7	23.3
4. Buget lendng	13.3	-24.0	-30.0	-25.0	-38.2	44.2	-36.1	45.5	-97.4	237.4	52.2	-90.9	-85.2	126.3	-81.1

Source: *QM* calculations based on the MF data

7. Monetary Trends and Policy

The Central Bank: balance and monetary policy

In Q3 the y.o.y. inflation rate continued to stand below the target framework for the period while at monthly level, inflation was positive only in August. This allowed the National Bank of Serbia (NBS) to relax its monetary policy by further lowering the key policy rate which, following the previous correction in October, stands at 4.5%. Further relaxation by the NBS was launched in mid-September when it started lowering the rate of foreign exchange (FX) reserve requirement ratio by one percentage point each over a period of six months. A greater inflow of foreign direct investments and remittances created appreciation pressure and caused the NBS to react by buying foreign currency on the inter-banking FX market to the net value of 500 million Euro by the end of October. Thanks to a higher level of interventions in purchase, the NBS net own reserves were increased but in the same period an increased interest by business banks for REPO operations was also registered and that neutralized the positive effect on the growth of primary money. That led to a slowing down of the y.o.y. growth of the money mass M2 in Q3 and a drop in the monetary aggregate compared to the previous quarter. Besides a growth of the placements of business banks in REPO, the banking sector also registered an increase in the net placements of credit to the households and to the enterprises which exceeded the repayments by the enterprises of cross-border loans. Credit activity recorded its highest level since mid-2012 which could be a sign of slight recovery in this segment. The liquidity of the banking sector increased again through the growth of domestic deposits and the net foreign loans by banks. At the same time the participation of bad loans decreased to the level of 20% with the state of bad loans decreasing in all three debtor categories.

Maintaining inflation below target framework allowed relaxation of monetary policy

The maintaining of the y.o.y. inflation rate below the target corridor in Q3 allowed the NBS to continue relaxing monetary policy through an additional lowering of the key policy rate. The first correction came in July by 0.5 percentage points followed in September by a fresh reduction of the key policy rate to 5%. Since deflation at monthly level was registered in October, the NBS once again corrected the key policy rate brining it to the level of 4.5%. Besides the policy of consistent reactive reduction of the key policy rate, the NBS took a decision in September to lower the rate of the FX reserve requirement ratio which will be implemented through six monthly reductions of 1 percentage point each month. Under that decision, the ratio of the FX reserve requirement from mid-February next year will be at the level of 20% for sources with a due date of up to two years and 13% for longer due dates. Freeing up the foreign currency liquidity of business banks should have a positive effect on the trends in interest rates on indexed loans in the coming period. In order to further ease financial burdens on the banking system, activities linked to solving the problem of bad loans need to be speeded up since bad loans are currently one of the obstacles to increasing the growth of credit activity. Despite the reduction of the key policy rate, the virtual lack of inflation in Q3 had a positive effect on the profitability of investments in REPO. That caused business banks to double the amounts of their net placements in REPO bonds compared to the previous quarter.

Trends

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

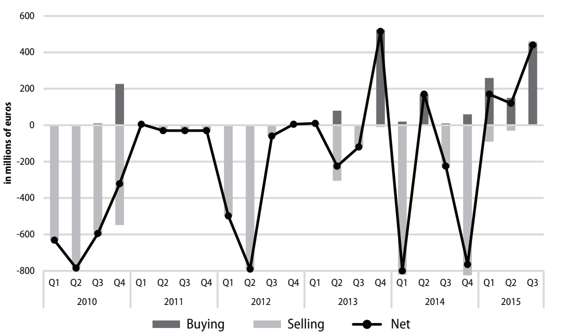
	2013				2014				2015		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
Repo stock (in milions of euros)	678.86	663.82	832.03	966.40	783.96	824.19	387.39	69.48	2.85	168.72	508.19
NBS interest rate	11.75	11.00	11.00	9.50	9.50	8.50	8.50	8.00	7.50	6.00	5.00
NBS interest rate	6.95	3.31	13.24	10.38	4.38	5.09	6.78	10.63	-1.13	3.08	5.00
NBS interest rate	19.25	12.85	12.83	9.25	5.28	7.08	0.03	-1.94	11.33	5.70	6.29
NBS interventions on FX market (in milions of euros)	10.00	-215.00	-140.00	375.00	-800.00	-630.00	-855.00	-1620.00	170.00	290.00	730.00
INCREASE					**cumulative, in % of initial M2[1)]**						
NBS own resreves[2)]	12.5	7.1	17.9	43.2	-31.2	-4.9	2.0	-6.6	33.5	22.5	35.9
NDA	-15.3	-3.9	-16.2	-31.3	12.2	-11.4	-7.6	15.6	-28.4	-16.2	-33.6
Government, dinar deposits[3)]	1.0	-1.2	-4.7	-19.9	3.3	-14.6	-24.3	-9.5	-8.4	-0.5	-10.8
Repo transactions[4)]	-16.0	-14.7	-23.8	-30.7	9.2	6.5	28.9	46.0	3.7	-3.4	-14.5
Other items , net[5)]	-0.3	12.0	12.4	19.3	-0.3	-3.4	-12.2	-20.9	-23.8	-12.3	-8.2
H	-2.8	3.3	1.7	12.0	-19.0	-16.3	-5.6	9.0	5.1	6.3	2.3
o/w: currency in circulation	-3.9	-0.7	1.0	5.4	-5.2	-3.5	0.5	3.7	-7.4	-3.4	-1.4
o/w: excess liquidity	0.6	2.1	-1.4	4.4	-12.1	-11.6	-7.3	-0.6	11.6	8.1	3.7
					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	-216.59	-15.58
Gross foreign reserves	-385.77	-1576.91	-1822.60	240.33	-793.11	-1090.74	-276.23	-1309.69	-671.02	-868.83	-696.40
Foreign liabilities	415.78	584.90	781.10	703.63	184.49	365.52	446.02	531.66	569.35	652.24	680.82
IMF	401.14	568.40	759.83	695.60	182.35	364.90	446.72	539.97	579.34	646.52	669.84
Other liabilities	14.65	16.50	21.27	8.03	2.14	0.61	-0.70	-8.31	-9.98	5.73	10.98
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	-216.59	-15.58
1.1 Commercial banks deposits	911.80	967.01	1058.25	240.42	-125.77	91.72	28.90	610.69	590.01	580.76	676.27
1.2 Government deposits	-811.79	47.05	209.55	-359.83	144.17	541.44	-162.64	48.59	0.60	155.71	243.40
1.3 **NBS own reserves** (1.3 = 1 - 1.1 - 1.2)	130.02	22.06	226.30	824.56	-590.22	-92.05	36.05	-118.75	488.94	519.88	904.10

Source: NBS.
1) "Initial M2" designates the state of the primary money at the start of the current i.e. end of previous year.
2) Definition of net own reserves NBS given in section 8 „Monetary trends and policy", Frame 4, QM5.
3) State includes all levels of government: republic and local government.
4) This category includes NBS Treasury Bondsand repo operations.
5) Other net domestic assets include: domestic loans (net bank debts not including treasury bonds and repo transactions; net debts by the economy) together with other assets (capital and reserves; and items in the balance: other assets) and corrected by changes to the exchange rate.

The NBS prevented excessive exchange rate fluctuations through its interventions on the foreign currency market

In Q3 the NBS intervened to prevent appreciation and in December to prevent depreciation of the Dinar

Graph T7-2. NBS interventions on inter-banking foreign currency market 2010-2015



Source: NBS

The appreciation pressure which were dominant during Q3 caused the NBS to intervene more on the inter-banking FX market on the hard currency purchase side to the extent of 440 million Euro (in Q2, the NBS was a net buyer to the value of 120 million Euro, Graph T7-2). The NBS intervened again in October purchasing foreign currency to the value of 70 million Euro and appearing once on the offer side with 10 million Euro to prevent excessive daily oscillations of the Dinar exchange rate. Pressure to strengthen the Dinar exchange rate are the consequence of a higher inflow of direct foreign investments and remittances in Q3 compared to the other quarters and led to a higher level of NBS interventions. The increased purchases of foreign currency on the inter-banking foreign currency market led to an increase in the NBS own net reserves in Q3 to the extent of 385 million Euro (in Q2 those net own reserves were increased by 31 million Euro, Table T7-1). Although the increase in net own reserves had a positive effect on the growth of primary money due to a reduction in net domestic assets, Q3 registered a reduction o primary money by 3.94% compared to the value at the start of the year. Net domestic assets, on the basis of increased state Dinar deposits and increased placements by business banks in REPO, registered a drop of 17.37% of the value of primary money at the start of the year which completely neutralized the positive effect of the rise in net own reserves. From October to mid-December, the Dinar depreciated against the Euro by about 1.5% which is desirable from a macroeconomic point of view because that improves the competitiveness of the economy and stimulates exports and foreign investments. Although a moderate depreciation of the Dinar is desirable, the NBS interventions in December which prevented a sudden depreciation of the Dinar were justified because in a bi-currency system sudden depreciation leads to huge losses for the economy, the state and the citizens.

Trends

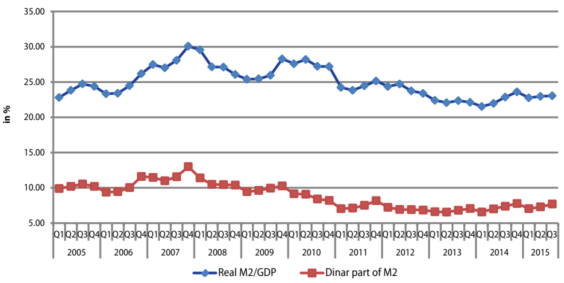
Monetary System: money mass structure and trends

The nominal y.o.y. growth of the money nass slowed down in Q3 ...

... but a slight drop was registered compared to Q2

The money mass M2[1] continued to slow down its nominal growth in Q3 to 4.1% y.o.y. (in Q2 the growth rate of the M2 stood at 7.8% y.o.y., Table T7-4), with the same trend registered in loans to the non-state sector whose nominal growth slowed down to 2.2% year on year. Taking into account y.o.y. inflation, the real y.o.y. growth of the M2 in Q3 stood at 2.6% while in the same period loans to the non-state sector registered a real growth of just 0.7% year on year. Following corrections by the changes to the exchange rate, this growth is even lower and stands at 0.1% year on year. Compared to Q2 the money mass registered a slight drop of 0.2% compared to the value at the start of the year.

Graph T7-3. Money mass trends as percentage of GDP, 2005-2015



Source: *QM* calculation

Table T7-4. Growth of money and contributing aggregates , 2013–2015

	2013				2014				2015		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
					y-o-y, in %						
M2[1)]	8.2	4.5	6.1	4.6	4.2	4.8	6.6	8.7	8.5	7.8	4.1
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	4.2	2.2
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	1.2	1.7
Households	3.0	2.9	2.9	2.6	2.0	2.5	3.0	3.6	5.5	4.9	3.8
Enterprises	0.9	-0.6	-7.6	-8.8	-13.4	-9.7	-7.3	-3.4	1.2	-1.0	0.3
					real y-o-y, in %						
M2[1)]	-2.6	-5	1.2	2.3	1.9	3.5	4.3	6.7	6.4	5.8	2.6
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	2.2	0.7
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	-0.7	0.1
Households	-7.5	-6.1	-1.9	0.4	-0.3	1.2	0.7	1.8	3.4	2.9	2.3
Enterprises	-9.3	-9.3	-11.8	-10.7	-15.4	-10.8	-9.3	-4.9	-0.8	-2.9	-1.1
					in bilions 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	1876.1	1893.8
M2[1)] dinars	478.8	492.5	519.5	547.6	516.4	555.3	587.1	614.5	567.8	595.3	632.4
Fx deposits (enterprise and housholds)	1143.8	1167.3	1186.3	1169.3	1175.0	1185.0	1231.3	1250.2	1267.7	1280.8	1261.4
					cumulative, in % of opening M2[4)]						
M2[1)]	-1.2	1.1	3.9	4.6	-1.5	1.4	5.9	8.6	-1.6	0.6	1.5
NFA, dinar increase	7.2	2.7	5.2	10.6	0.2	-0.1	11.7	11.1	3.2	3.4	3.0
NDA	-8.4	-1.6	-1.3	-6.0	-1.6	1.4	-5.8	-2.4	-4.7	-2.7	-1.3

Source: NBS

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

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

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

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

Greatest effect on growth of money mass based on growth of M1

A dissembling of the nominal growth of the M2 which in Q3 stood at 4.1% y.o.y. reveals that the highest contribution is now owed to the increase of the M1 which is a change compared to the previous quarters. Foreign currency deposits which traditionally caused more than half the growth of M2 now participate with 1.65 percentage points while savings and timed deposits contribute with 0.41 percentage points. The smallest aggregate M1 participated in the growth of primary money with 2.08 percentage points which rose in October to 2.86% (in Q2 the contribution of M1 stood at 1.44 percentage points).

1 The monetary aggregate M2 in the section Monetary trends and policy covers the lesser aggregate M1, savings and timed deposits as well as foreign currency deposits with business banks. That means that the M2 aggregate which we observe is equal to the M3 aggregate in NBS reports.

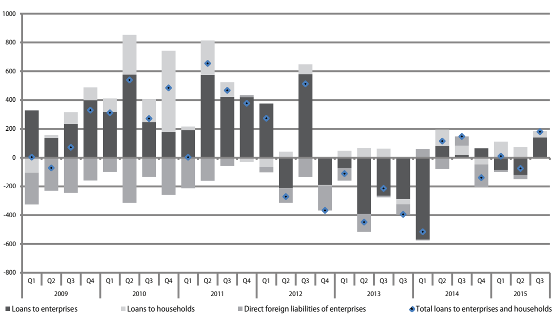
Banking Sector: Placements and Sources of Financing

Positive signals in terms of credit activity were registered in Q3 …

… with the repayment of foreign debts by the enterprises dropping significantly

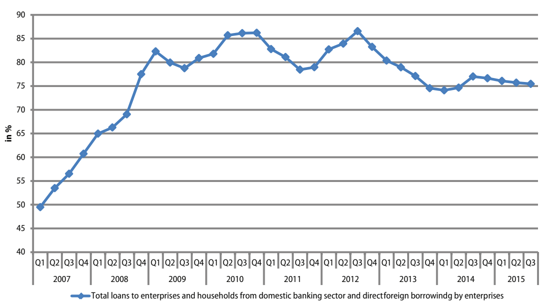
Following the recovery of placements in the previous quarter, mainly thanks to a somewhat higher purchase of REPO bonds, Q3 saw a significant increase of placements by commercial banks by 779 million Euro (Table T7-7). The largest part of the growth was due to the increased placement in REPO bonds which in Q3 stood at 340 million Euro (in Q2 placements in REPO stood at 166 million Euro). Despite the lowering of the key policy rate, the profitability of investing in REPO was high enough thanks to the low and stable inflation and stable Dinar exchange rate, especially bearing in mind that interest rates on the international market for comparable products were almost at zero level. Besides the placements in REPO, banks increased their credits to the enterprises and households in Q3 by 186 million Euro which means a speeding up of the growth started in the previous quarter. The enterprises increased its indebtedness with business banks by 140 million Euro which neutralized its debt repayments in the previous quarter while the growth of loans to the households continued to slow down from the start of the year and in Q3 stood at 45 million Euro (in Q2 placements to the households stood at 75 million Euro, in Q1 they stood at 111 million Euro). In the segment of cross-border loans, debt repayments were almost stopped and in Q3 they stood at just 4,7 million Euro which is significantly lower than in the previous quarters (in Q2 the enterprises repaid debts to the value of 25.5 million Euro, in 2014 a total of 113 million Euro were repaid). The final element in Q3 is the increase in net credit to the state of 225 million Euro which had a positive effect on the overall growth of placements by commercial banks. By observing the segment of yield of the credits placed to the non-state sector from domestic and cross-border loans (Graph T7-5), we see that Q3 registered the highest quarterly yield since Q3 2013. This could be a signal that domestic credit activity is slowly recovering, especially bearing in mind that this yield was achieved without state assistance in the form of subsidized loans. A more certain assessment has to wait for data from at least another two quarters in order to definitely determine whether this is the start of a trend or just a once off increase but what is encouraging is the fact that within the framework of credit to the enterprises a speeding up of the growth of investment loans was registered. Since the start of the year, there has been an evident trend of reduction of real interest rates for Dinar loans for investments and turnover funds (Graph T7-7). A similar trend was registered with indexed loans with interest rates standing at about 5% which is the minimum for interest rates in Serbia over the past 15 years. Interest rates in Serbia continue to stand higher that interest rates in Western economies which stand at 2-3%.

Graph T7-5. Yield for new loans to the economy and population, 2009-2015



Source: *QM* calculation
see footnote in Table T7-4

Graph T7-6. Total credit debt for non-state sector, 2007-2015



Source: *QM* calculation

The participation of bad loans has been reduced in Q3 ...

...whereby the decline has been recorded with all segments of debtors

Table T7-7. Bank operations – sources and structure of placements, corrected[1] trends, 2013-2015

	2013				2014				2015		
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep
	in millions of euros, cumulative from the beginning of the year										
Funding(-, increase in liabilities)	109	341	213	420	578	540	504	678	241	33	-368
Domestic deposits	4	-56	-325	-394	240	-32	-382	-460	47	-118	-324
Households deposits	-87	-132	-252	-423	45	-105	-149	-250	-11	-104	-114
dinar deposits	16	-34	-110	-279	27	-51	-75	-143	96	19	-57
fx deposits	-102	-98	-141	-144	17	-54	-74	-107	-107	-123	-57
Enterprise deposits	91	76	-73	29	195	72	-233	-210	58	-14	-211
dinar deposits	-11	-11	-109	-162	210	45	-159	-273	168	112	-75
fx deposits	102	87	36	191	-15	27	-75	63	-110	-126	-136
Foreign liabilities	357	406	588	806	358	396	610	907	36	150	58
Capital and reserves	-252	-9	-50	8	-20	176	276	232	158	1	-101
Gross foreign reserves(-,decline in assets)	-278	-104	84	-304	193	215	673	1,019	-150	-115	-262
Credits and Investment[1]	123	-169	-67	42	-343	66	-19	-451	-20	149	928
Credit to the non-government sector, total	-23	-348	-551	-875	-577	-382	-300	-296	24	-21	165
Enterprises	-71	-463	-728	-1,018	-570	-488	-471	-410	-86	-207	-67
Households	48	115	177	143	-7	105	171	114	111	186	231
Placements with NBS (Repo transactions and treasury bills)	321	319	492	628	-176	-133	-556	-869	-66	100	439
Government, net[2]	-175	-140	-8	290	411	581	837	713	22	69	324
MEMORANDUM ITEMS											
Required reserves and deposits	-17	-87	-443	-134	-2	-215	-223	-730	444	605	288
Other net claims on NBS[3]	-154	-85	118	44	-136	-135	-4	110	-182	-309	-209
o/w: Excess reserves	-151	-96	60	38	-156	-162	-9	112	-204	-317	-225
Other items[4]	100	50	54	-22	-289	-454	-822	-592	-352	-379	-404
Effective required reserves (in %)[5]	25	24	22	23	23	22	22	19	22	23	20

Source: NBS

1) Calculating yield is done with the assumption that 70% of overall placements are indexed in Euro. Yields for originally Dinar values of deposits are calculated using the average exchange rate for the period. For foreign currency deposits – as the difference calculated by the exchange rate at the ends of the period. Capital and reserves are calculated by the Euro exchange rate at the ends of period and do not include the effects of the change in exchange rate from the calculation of the remaining balance.

2) NBS bonds includes state 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 greater than 14 days.

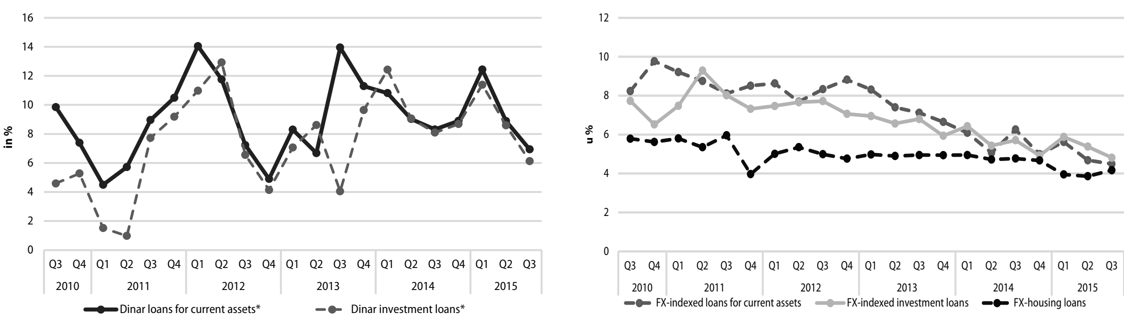
3) Net crediting of the state: loans approved for the state are lowered by the state deposit in business banks ; a negative prefix designates a higher growth of deposits over loans. State includes all levels of government: republic and local government.

4) Other debts by the NBS (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-bank relationships (net) and other assets including capital and reserves.

6) Mandatory cash reserves means the participation of mandatory reserves and deposits in the overall deposits (population and economy) and bank debts abroad. The basis to calculate mandatory reserves does not include subordinate debts because data is unavailable

Graph T7-8. Interest rates on Dinar and indexed loans, 2010–2015



Source: *QM* calculation
* real interest rates

Growth of deposits additionally increases liquidity of banking sector

The liquidity of business banks increased in Q3 by 400 million Euro which is a speedier growth than in the previous quarter (in Q2 sources of funding increased by 208 million Euro, Table T7-7). Half of overall increase was due to the growth of domestic deposits in Q3 while the remainder of the growth of sources for new placements had a positive effect on the increase of foreign indebtedness of domestic banks of 92 million and an increase of capital and reserves of business banks by 102 million Euro. The increase of domestic deposits of 206 million is predominantly the result of increased deposits of the enterprises by 197 million Euro while the rest is owed to a rise in deposits by the population. The households increased their Dinar deposits by 76 million Euro in Q3 thanks to low and long-term stable inflation rates in combination with especially non-stimulating interest rates on savings in foreign currency. That caused the foreign currency deposits by the population to decrease by 66 million Euro which brought down their combined effect on the growth of liquidity in business banks. The economy saw the greatest part of the growth in Dinar deposits of 94% while the remainder of the growth was on foreign currency deposits with commercial banks.

Table T7-9. Participation of bad loans according to debtor type, 2009-2015

	2009	2010	2011	2012	2013				2014				2015		
	Dec	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Q1	Q2	Q3
	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	28.63	25.52
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	34.91	32.03
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	11.60	10.68
Ammount of dept by NPL (in bilions 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	3.96	3.61

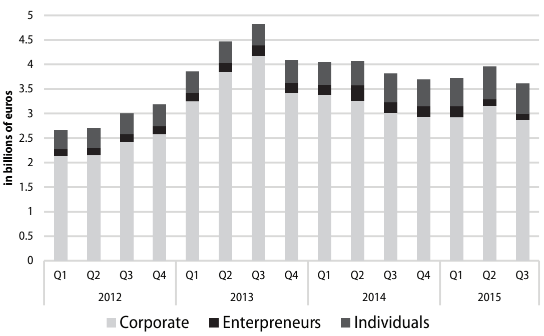
Source: *QM* calculation

The participation of bad loans dropped in Q3 …

… with a drop being registered in all segments of debtor

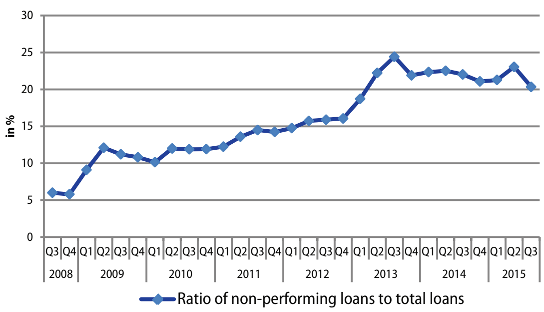
Following the unusually sudden rise in the participation of bad loans at the end of June, the latest data from the Credit Bureau shows that stabilization and decreases have come to this segment. At the end of Q3, the participation of bad loans stood at 20.09% which is a drop compared to the previous quarter of 3 percentage points(Graph T7-11). The greatest contribution to the drop in participation is owed to the decrease in the part of the bad loans placed to corporate sector which stood at 25.5% at the end of Q3 (at the end of Q2 that participation stood at 28.63%). A decrease was also registered in the participation of bad loans placed to entrepreneurs and private individuals by 2.8 and 1 percentage point respectively. Bearing in mind that the growth of bad loans, in both relative and absolute amounts (Graph T7-10) in Q2 was more the consequence of a once-off break in the series than a started trend of slight weakening, we expect that the overall participation in the next quarter will stay at a level of around 20% which is confirmed by preliminary data from October and November. The overall stock of bad loans was reduced in Q3 compared to data at the end of Q1 which along with a slight recovery of credit activity explains the drop in the participation rate of bad loans in overall placements. The set of measures which the NBS adopted in August following negotiations with the International Monetary Fund (IMF) mission should speed up the resolving of the problem of bad loans. Most of their effects will be felt at the end of next year since the framework for their implementation was set in the second half of 2016.

Graph T7-10. Amount of remaining debt on loans which are late with repayment, 2012-2015



Source: *QM* calculation

Graph T7-11. Participation of bad loans in overall placement, 2008-2015



Source: *QM* calculation

HIGHLIGHT

Highlight 1. Analysis and evaluation of Serbian fiscal policy in 2016

Saša Ranđelović [1]

Considerable fiscal adjustment (reduction in fiscal deficit) of about 2.7% of GDP was made in 2015 compared with 2014. This was achieved through implementation of fiscal consolidation measures adopted at the end of 2014, increased efforts against the shadow economy, and the influence of a number of one-off and temporary factors, some of which caused a further reduction in fiscal deficit (high-pressure collection of dividend paid by public and state-owned enterprises, revenues from the sale of licenses, postponed subsidy payments to agricultural producers, and delay in rationalization of the public sector and severance payments). On the other hand, some factors operated to widen the deficit (previously assumed liabilities to military pensioners, Gazprom etc.). Additionally, economic growth in Serbia in 2015, although stronger than targeted, was still below the natural growth rate (estimated at 3-4% annually), which was another factor that pushed down public revenues and hindered reduction in fiscal deficit. In general, all these one-off and temporary factors increased the final amount of fiscal deficit by 1% of GDP, so it stands at 4.1% of GDP.

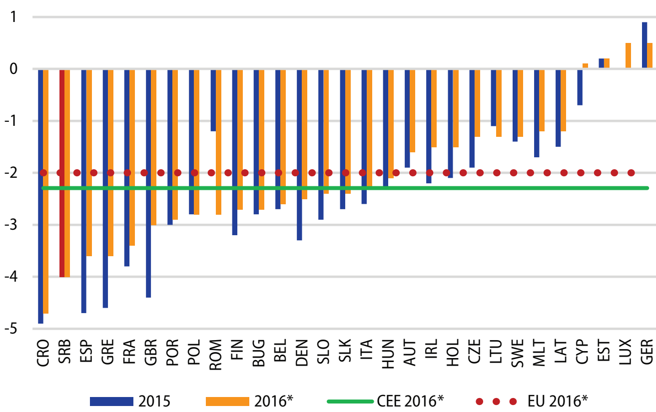
Table 1 Public revenues, public expenditures and fiscal deficit in Serbia, % of GDP

	2015	*2016*	*Change 2016-2015.*
Public revenues	42.2	41.3	-0.9
Public expenditures	46.3	45.3	-1
Fiscal deficit	-4.1	-4	0.1
Structural fiscal deficit	-3.1	-3.4	0.3

Source: *QM* based on the MF data

Fiscal adjustment made in 2015 is considerable and represents a step forward to establishing sustainable public finance. However, for fiscal consolidation to succeed, continued implementation of measures that would provide further reduction in fiscal deficit is necessary. The program of fiscal consolidation is aimed at reducing fiscal deficit to the level that would stabilize public debt-to-GDP ratio, meaning that fiscal deficit needs to be reduced down to 2.5% of GDP in the next two years, and then to 1% of GDP in the medium term. According to the fiscal strategy, fiscal deficit for 2016 shall remain almost unchanged compared with 2015 (4% of GDP), and further reduction of around 1.4% of GDP (down to 2.6% of GDP) shall be made in 2017. Fiscal deficit target set for 2017 is an attainable goal, but the dynamics of further adjustment are inadequate. Credible program of fiscal consolidation is the one that provides a continuous reduction in fiscal deficit down to a sustainable level. Accordingly, the plan to keep the total fiscal deficit in 2016 at the level reached in 2015 (along with a slight widening of structural deficit) is inadequate, regardless of the fact that it is a result of postponed settlement of some of the previously assumed liabilities. This indicates that the pace of fiscal consolidation slowed notably at the end of 2015, after the initial success was achieved in the first year of implementation of the program. Targeted fiscal deficit of 4% of GDP for 2016 will be the second largest deficit in Europe (larger deficit is projected only in Croatia), and will exceed the CEE average (by 2.3% of GDP).

Graph 2 Serbia and EU: fiscal deficit projection for 2015 and 2016 (% of GDP)



Source: *QM* and European Commission

The plan to postpone further reduction in fiscal deficit until 2017 lacks credibility, because 2017 is the election year and the arrangement with the IMF expires in 2017. Accordingly, although purely symbolic, possible increase in wages and pensions is not economically justifiable and will cause a permanent rise in expenditures of about 0.5% of GDP, and elections could additionally increase these expenditures. From the aspect of macroeconomic stability, sustainability of public finance and economic growth, these better-than-expected fiscal results achieved in the first year of fiscal consolidation should be used to reduce fiscal deficit down to 2.5% of GDP by the end of implementation of the program (and then down to 1% of GDP in the following few years).

1 Faculty of Economics, Belgrade University, and *QM*

Further fiscal adjustment (through reduction in current spending) should be evenly distributed in 2016 and 2017 (by 1% of GDP annually), and should be accompanied by an increase in capital expenditures of 0.3-0.5% of GDP each year.

According to revenue projections for 2016, public revenues will fall by 0.9% of GDP mainly because non-tax revenues are expected to go down (by 0.8% of GDP). This is a reasonable forecast because in 2015 there was a high-pressure collection of dividend paid by state-owned and public enterprises, so further continuation of such practice would impair the capital base of their business activity (due to inability to reinvest).

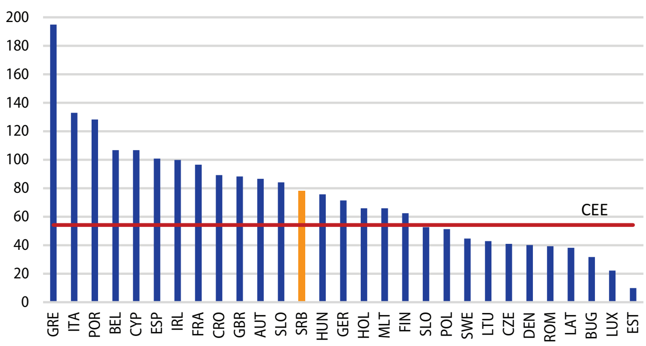
According to expenditure projections for 2016, reduction in total public spending is targeted at 1% of GDP, which is economically justifiable because in 2015 public expenditures in Serbia are by 4% of GDP higher than in comparable CEE countries. The largest cut shall be made in expenditures on subsidies (0.7% of GDP), social expenditures (0.6% of GDP) and expenditures on employees (0.3% of GDP). On the other hand, capital expenditures are expected to go up moderately (by 0.3% of GDP), and expenditures on goods and services, expenditures on interest payments and expenditures on activated guarantees are expected to grow slightly (by 0.1% of GDP each). This new structure of expenditures, taken with a pinch of salt, is considered favorable.

The projected reduction in expenditures on subsidies in 2016, from 3.4% of GDP to 2.7% of GDP, is economically justifiable, especially because they are above the EU average of 1-1.5% of GDP, meaning that further reduction in these expenditures needs to be made in the following years. The largest cut shall be made in agricultural subsidies (abolition of subsidies on farmland with the area over 20 hectares, and for lessees of state land). However, there are some risks that these targets might not be reached because in 2015 the budgeted level of subsidies was not sufficient to pay the envisaged amounts (fragmentation of farmland increased the number of subsidy recipients). Besides, to achieve these savings, social subsidies (per hectare) will have to be halved, and similar earlier attempts to do so show that this will be a tough socio-political task. Total expenditures on agricultural subsidies in Serbia are not much higher than in EU, and it should be mentioned that agricultural producers in EU receive additional money from European funds. Since domestic agricultural producers will not have access to EU funds until Serbia joins EU, larger cuts in agricultural subsidies would impair the competitiveness of domestic agriculture in liberalized agriculture market. Therefore, it would be economically justifiable to keep agricultural subsidies at the previous level but to change the system of distribution so that capital subsidies (for equipment etc.) make a larger share of total subsidies. Additionally, the system of distribution of social subsidies should be modified so that they are granted per unit of production instead of unit of resources used in production. The necessary reduction in subsidies should be made through reduction in non-productive subsidies to public and state-owned enterprises and in subsidies on investments and employment. Additionally, for the sake of transparency, it is very important that all individual subsidy programs (on investments and employment etc.) are stated in the budget.

Projected reduction in expenditures on employees in 2016 is one of the key measures for reducing structural deficit (by 0.3% of GDP), but there is a risk that these savings might not be achieved. The established fiscal framework implies reduction in public sector employees by 29000 in 2016. However, since the reduction in public sector employees in 2015 was way off the targeted 25000, there is a risk that similar could happen in 2016, and that consequently the expected savings might not be achieved.

Further rise in expenditures on interest payments, though slower than in the preceding years, is not welcome. Possible major change in the dinar exchange rate (against euro and dollar) could cause even sharper rise in these expenditures.

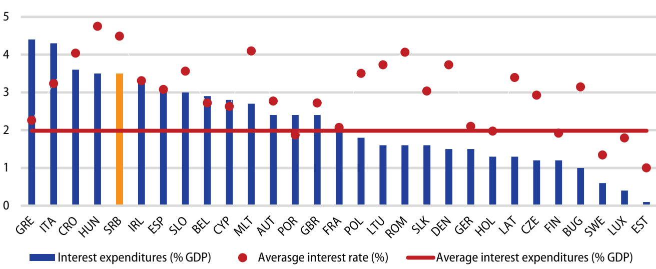
Graph 3 Serbia and EU: Public debt in 2015 (% of GDP)



Source: *QM* calculation based on the MF data

According to the level of public debt-to-GDP ratio Serbia is ranked 13th out of 29 European countries, meaning that it falls into the group of moderately indebted European countries (though it is one of the most indebted countries in CEE), while measured by the relative amount of expenditures on interest payments (as a % of GDP) it is ranked 5th. Expenditures on interest payments account for 3.5% of GDP, far above the CEE average and the EU average (2% of GDP and 2.3% of GDP respectively). Consequently, average interest rate on public debt (the quotient of interest payments and public debt) of 4.6% is the second largest in Europe – only Hungary pays higher average interest rate on public debt (4.7%), while average interest rate on public debt in CEE stands at 3.5%. This is the result of the following factors: *i)* extremely large deficit and years of steep rise in public debt, *ii)* decreasing share of inherited cheap loans, repayment of old foreign currency savings etc., and growing share of new cheaper loans, *iii)* Serbia does not have access to more favorable terms of financing fiscal deficit and public debt that were available to some EU members who financed their deficit in the preceding years on preferential terms. Massive spending on interest payments does not leave much room for financing other productive programs (such as public investments, investments in education etc.). Reduction in expenditures on interest payments down to the CEE average would open up the opportunity to increase public investment and other productive expenditures by around EUR 500 million annually. However, to achieve this, fiscal deficit needs to be reduced considerably in the next two years. Furthermore, a more active public debt management is necessary, and the government should explore the opportunities for refinancing expensive loans with cheaper ones, since the interest rates in financial market are relatively low because fiscal results achieved in 2015 are good and the Fed and ECB are pursuing expansionary monetary policy. Although this cannot be applied to a considerable share of debt due to previously arranged terms of financing, a certain share of debt can be replaced with new cheaper loans, which would slightly reduce expenditures on interest payments. Accordingly, institutional limitations (Law on Public Procurements) that are used as an excuse for a passive approach to public debt management should be adapted to allow the government to take an active approach to this issue.

Graph 4 Serbia and EU: Expenditures on interest payments (% of GDP) and average interest rate (%) in 2015



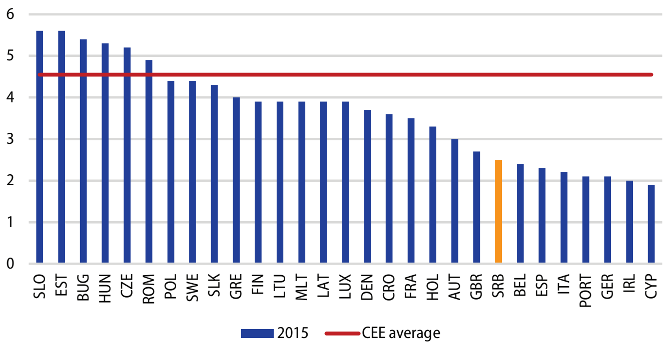
Source: *QM* calculation based on the MF data

Capital expenditures are projected to grow by 0.3% in 2016 compared with 2015, which is good but insufficient to notably improve the quality of infrastructure and accelerate economic growth.[2] According to the Fiscal strategy, the government plans to keep capital expenditures at 3% of GDP in the following three years, explaining that a notable increase in these expenditures will be possible only when economic growth accelerates. This is, however, wrong, because one of the key reasons for low growth rate of Serbian economy is low level of total investment, as a consequence of small public investment (that is the lowest in CEE and by 2% of GDP below the CEE average). On the other hand, the difference between private investment in Serbia and the CEE average is much smaller (around 2% of GDP). Therefore, it would be justifiable to notably increase public investment in the next three years (by 0.3-0.5% of GDP annually), because it would have a double positive effect on economic growth – it would increase demand in the period of their realization, and in the long run it would affect supply, through improved quality of infrastructure.

Capital expenditures (public investment) in EU countries account for 2.9% of GDP on average, and the annual average for 2015 in less developed EU members, from Central and Eastern Europe (CEE), is much higher – 4.5% of GDP. Similarly, in the previous ten years public investment in Serbia was, on average, by 1.5% of GDP lower than in CEE each year, i.e. 15% of GDP (EUR 4.5 billion) in the whole period, which implies a considerable opportunity cost in terms of missed economic growth. Since the infrastructure in Serbia is in poorer condition than in most of these countries, and public investment gives a much stronger stimulus to economic growth than current spending, annual increase in public investment of 0.3-0.5% of GDP is necessary, until it reaches the CEE average. This can be achieved through increased spending on investments and more efficient realization of projects that are financed from the central government budget, and by giving local self-governments systemic incentives to increase the share of public investment in total expenditures. Increase in the share of public investment in total public expenditures of local self-governments from 13% to 20% would imply rise in total public investment of around 0.4% of GDP.

2 It is stated in public that a part of expenditures on subsidies to public enterprises (of about 0.5% of GDP) falls into the category of capital subsidies (funds used by public enterprises to finance investment). Accordingly, these subsidies should be shown separately, as a distinct category. The difference between public investment in Serbia and in other CEE countries would thus be smaller, though they would remain below the CEE level by more than 1% of GDP annually.

Graph 5 Serbia and EU: Capital expenditures in 2015 (% of GDP)



Source: *QM* calculation based on the MF data

Although no major increase in expenditures on direct or indirect subsidies to public, state-owned or socially-owned enterprises that are undergoing privatization (with the exception of capital subsidies to Železnice) is projected in the budget for 2016, there is a certain risk that these expenditures will exceed the targeted level because financial and business restructuring of public enterprises and the process of resolving the status of state-owned and socially owned enterprises (privatization or bankruptcy) are developing much slower than planned. Accordingly, it is necessary to accelerate restructuring of public enterprises (primarily EPS, Srbijagas and Železnice, as the major possible sources of fiscal risks) and heighten the activities directed at resolving the status of state-owned enterprises undergoing privatization (RTB Bor, Azotara, Petrohemija, Železara etc.). RTB Bor is facing EUR 350 million of debt, and it is similar with Petrohemija and other enterprises (though the amount of debt is smaller). If the government takes over these liabilities (as was the case with non-guaranteed debt Srbijagas owed to NIS), fiscal deficit and public debt might widen considerably. Accordingly, the government (i.e. the Ministry of Economy) should take a proactive approach to finding potential buyers for enterprises with market prospects, instead of waiting of for them to appear. Otherwise, if these processes are not finished in the first half of 2016, the government will probably have to subsidize these enterprises or to issue guarantees on loans needed for financing their liquidity, which could impair the whole fiscal consolidation program and the progress that has been achieved in other areas of fiscal policy.

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