quarterly monitor

OF ECONOMIC TRENDS AND POLICIES IN SERBIA

Issue 36 • January–March 2014

Belgrade, June 2014

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VOLUME
100 copies

Quarterly Monitor of Economic Trends and Policies in Serbia (*QM*) was created by Kori Udovički, who was the Editor-in-Chief of the first six issues of *QM*. For issues seven to twenty three, the Editor-in-Chief of *QM* was Prof. Pavle Petrović. Diana Dragutinović was the Editor-in-Chief of *QM*24. Since issue *QM*25-26 the Editor-in-Chief of *QM* is Milojko Arsić.

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Analytical and Notation Conventions

Values

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

Definitions of Aggregates and Indices

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

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

New Economy – Enterprises formed through private initiative

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

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

Notations

CPI – Consumer Price Index

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

H – Primary money (high-powered money)

IPPI – Industrial Producers Price Index

M1 – Cash in circulation and dinar sight deposits

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

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

NDA – Net Domestic Assets

NFA – Net Foreign Assets

RPI – Retail Price Index

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

Abbreviations

CEFTA – Central European Free Trade Agreement

EU – European Union

FDI – Foreign Direct Investment

FFCD – Frozen Foreign Currency Deposit

FREN – Foundation for the Advancement of Economics

GDP – Gross Domestic Product

GVA – Gross Value Added

IMF – International Monetary Fund

LRS – Loan for the Rebirth of Serbia

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

NES - National Employment Service

NIP – National Investment Plan

NBS – National Bank of Serbia

OECD – Organization for Economic Cooperation and Development

PRO – Public Revenue Office

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

QM – Quarterly Monitor

SORS – Statistical Office of the Republic of Serbia

SDF – Serbian Development Fund

SEE – South East Europe

SEPC – Serbian Electric Power Company

SITC – Standard International Trade Classification

SME – Small and Medium Enterprise

VAT – Value Added Tax

From the Editor

In the first months of 2014, negative trends are predominant in Serbian economy, which is in line with our previous forecasts. According to some preliminary estimates, GDP stagnated in the first quarter, while the unemployment slightly increased. Mixed tendencies continued in foreign trade – while the foreign trade balance is improving, the outflow of foreign capital is continuing. Low and stable inflation is maintained by a policy of almost fixed foreign exchange rate. Over the last year, NBS has informally switched to a significantly firmer forex policy, but it is not certain for now whether this is a temporary policy or a long-term commitment.

Prospects of economic recovery are far less favourable than what it seemed a few months ago. Due to the crisis in Ukraine, Serbia's international position has worsened, economic activity will be reduced due to the floods, and it is not certain how firm is the Government's commitment to fiscal consolidation and reforms. First negative consequence of the Ukraine crisis for Serbia is the delay of the construction of South Stream, which should have been the largest single investment in Serbia this year. If the Ukraine crisis does not end soon, Serbia will probably be forced to choose between EU and Russia, and either choice will bring economic losses to it. Disastrous floods in the second half of May have caused property damages which, according to some preliminary estimates, are 2-3% of GDP. The floods will have a negative, but a relatively moderate and short-term effect on the economic growth of Serbia, and the recovery of the damaged property will partially neutralise this effect. It is our estimate that the net effect of floods and recovery will not be more than 0.5% of GDP, as well as that the floods will affect the slower improvement of the foreign trade balance, while the impact on inflation will be negligible. The readiness of the Government to implement firm fiscal consolidation and comprehensive and thorough reforms is now less certain than it seemed right after it was formed. It would seem there is a risk that the Government will repeat the policy from the previous term, which was characterised by announcements of large reforms and cuts, only to gradually give up on them or postpone and mitigate the announced measures. Delay of the visit of the IMF mission indicates that there are still big differences between the Government and IMF with respect to what kind of economic policy and reforms Serbia should implement.

The fiscal deficit in the first four months was significantly higher than planned, and in case the current trends continue in 2014, it will reach around 8% of GDP and even increase due to floods by additional 0.2-0.3% of GDP. Serbia's fiscal deficit this year will be the largest since the hyperinflation of the 90s and it will also be the highest fiscal deficit in Europe. Worsening trends in fiscal policy call into question the Government's credibility, since it was announcing severe measures of fiscal consolidation for the previous and this year, as well as a significant reduction of the fiscal deficit. However, in both years, the fiscal deficit was considerably higher than planned, and this year, the deficit is significantly growing compared to the previous year.

There are many reasons why Serbia has been realising a significantly higher deficit than planned for the second year in a row. Among the more important ones are: delaying solving the problem in the economy, and especially problems in the public and other state companies (Srbijagas, GSP Belgrade, Železara Smederevo and other companies in restructuring), inconsistency in implementing policy (large revenue is planned based on combating grey economy, but no measures are taken to actually fight it), weak coordination between fiscal and monetary policy (inflation is much lower than the one planned by the Government), optimistic planning of macroeconomic aggregates (GDP, domestic spending, employment). Therefore, the Government has to have a much more responsible and thorough approach to solving problems of fiscal deficit, otherwise its not so high credibility will plummet even lower.

Due to unfavourable results in public finances in the previous part of the year, the Government, and with good reason, announced severe and painful austerity measures. However, concrete measures that are certain for now will have a modest reach, which means that the fiscal deficit in this and several coming years will remain at a very high level, and the public debt will continue its accelerated growth. Austerity measures announced by the Government come down to reduction of wages in the public sector by 10% and cuts of unproductive expenses (use of cars, etc.). The Government still hasn't come out with credible plans for preventing the outflow of budgetary funds to cover losses of public and state enterprises, reducing the number of public sector employees and reducing pension expenditures. Additional problem is that the relatively modest savings, as well as possible additional revenue from taxing the grey economy, will for the most part be spent on financing new Government programmes. Even when they are, according to our estimate, justified, as in the case of mass construction of affordable apartments and approving subsidies on loans, the new Government programmes cannot jeopardise the reduction of the fiscal deficit. The Government is still counting on significant revenue from combating grey economy, although no comprehensive operating plan has been presented yet.

The macroeconomic effects of slow consolidation would be unfavourable, since insufficient fiscal consolidation would reduce the public spending, but that reduction would not be enough to gain the trust of private investors and increase their activity. Reduction of public spending would be accompanied by a drop in private investments and private spending through the withdrawal of foreign capital from Serbia and so on, which would mean an additional decline of GDP and employment. In such circumstances, the risk of public debt crisis would be high. Relatively favourable borrowing conditions, which enable the easy financing of the fiscal deficit, represent a sort of a trap similar to the one that the countries of Southern Europe fell into after entering the eurozone.

Fiscal consolidation would have much better chances of success if strong austerity measures would be implemented at its beginning, which would significantly reduce the fiscal deficit in the first year already, with parallel adoption of measures that would guarantee the continuation of the reduction of the fiscal deficit in the following years. In this case too, the GDP at the beginning of the consolidation would drop, while the unemployment would rise, because the private investors would wait a while to make sure the Government is committed to implementing the consolidation. Based on the experience of a large number of countries it would follow that a year or two of consistent implementation of consolidation would be enough to gain investors' trust and to see a growth in private investments, which would be the main driver of GDP and employment growth in the following years.

Inadequate economic system is an important cause of the slow recovery of Serbia's economy, but it is one of the more important generators of the growth of fiscal deficit and public debt. Economic system reforms in Serbia have significantly slowed down in 2006, only to be upstaged by the ensue of the economic crisis. The Government has been trying for years to compensate for the weaknesses of the economic system with generous, but also economically inefficient and fiscally unsustainable subsidies for investments and hiring. Results of that policy were quite modest – investments were low, employment declined, while the economic activity mostly stagnated. Problems of companies under state control (public enterprises, companies in restructuring) were solved with measures that lead to a temporary bridging of problems, while permanent solutions in the form of successful restructuring and privatisation were rare.

In the second half of the previous year, ambitious economic system reforms were announced, which include the reform of labour legislation, building laws, and bankruptcy legislation. In addition, finalisation of the restructuring of former state enterprises was announced, as well as restructuring and partial privatisation of public enterprises. Due to the election in March 2014, the reforms have not been implemented, but after the Government was formed, it was confirmed that the economic reforms are its top priority. Adopting laws that improve the business environment, as well as concrete steps on restructuring public enterprises and finalising the restructuring of former state companies, together with its readiness to adopt additional measures of fiscal consolidation will be the crucial test of the Government's commitment to reforms.

Strong decline of investments, decline of the real scope of lending activity, drop of employment, stagnating overall economy, along with recession in many sectors, justify the implementation of anti-recession measures in Serbia. Even though the economic incentives are justified, it is necessary to bear in mind that these are temporary measures with limited reach, whose aim is to mitigate the recession, but that the long-term perspective of Serbian economy will heavily depend on the economic reforms. Therefore, the temptation of neglecting economic reforms due to anti-recession measures and recovery from flood damages should be avoided.

This issue of Quarterly Monitor, in addition to regular research, contains two Highlights. Highlight 1 (Arsić) analyses first Government measures, as well as options and challenges the Government is facing. Highlight 2 (Arsić, Brčerević) estimates the effects of floods on the trend of GDP and public revenue, and recommends a possible strategy for minimising the negative effects of floods on public finances.

TRENDS

1. Review

Unfavourable macroeconomic trends are continuing. Key problems of domestic economy are related to the low economic growth and unsustainable fiscal position of the country, and these problems have additionally grown in the first half of 2014. The economy is stagnating and it's possible it will again go into a recession – which would be the third time already since 2008. The reasons for unfavourable trends and lack of lasting recovery of economic activity are not the latest floods, but deeper and more lasting economic trends. The fiscal deficit is increasing and by the end of the year, it will probably be more than 8% of GDP and the public debt will be 70% of GDP, so the risk of public debt crisis is growing by the day. For now, there are no measures of economic policy that could mitigate these negative trends – reform measures that will improve the business environment are in the announcement, but not implementation stage, and the Government still refuses to accept as inevitable the reduction of by far the biggest public expenditure – pensions, and NBS is not loosening enough the restrictiveness of the monetary policy.

Economic activity in Q1 entered into stagnation, which we announced in the previous issues of *QM*. The realised year-on-year growth rate of 0.4% in Q1 actually means that the seasonally adjusted GDP remained unchanged compared to Q4 2013 (see Section 2 "Economic Activity"). If a similar trend were to continue until the end of 2014, the entire year would have a growth of economic activity of around 0%. The stagnation of the economic growth is not unexpected, although it was preceded by a solid GDP growth of 2.5% in 2013. However, during 2013, the economy had a large growth of over 20% (as it was compared to an extremely dry 2012), and Fiat Automobiles Serbia (FAS) increased its production in manifold. Without these two factors, the rest of the economy would have been in a decline of around 0.5%. Since the high growth of agriculture ended in 2014, and FAS reached its full production capacity, the stagnating growth of GDP, which began in Q1, revealed the real negative trends of economic activity, which were present but hidden throughout 2013.

The latest floods left behind catastrophic consequences in affected areas. Still, the negative impact of floods on total GDP in 2014 is limited and we estimate (taking also into account the effects of renovation) that it would be 0.5 p.p. of GDP at most (see Highlight 2). It is necessary to separate the effects that the floods have on property (which is currently being estimated at around a billion euros or around 3% of GDP) from the effects that the floods have on GNP and GDP. A flooded house, for example, has a huge property damage, but a very little impact on GNP and GDP. A slightly different example is the flooding of agricultural land. It has a relatively low impact on property, because these lands will be, for the most part, equally usable in the next agricultural season (and some could be used even in the current season), but a relatively high impact on production, because the crops in 2014 were destroyed on them.

The following example probably illustrates best why recent floods will not have a significant impact on GDP. An economic sector that has probably been affected the most by flooding is agriculture. According to currently available data, around 80,000 hectares of agricultural land has been flooded. This, however, represents only 3% of seeded agricultural land in Serbia (Vojvodina was mostly spared). If we take into account that aside from farming, agriculture includes livestock breeding as well (which was affected in a slightly lower percentage), but also that new crops will be planted on certain flooded lands as soon as this year, we can conclude that the decline of agricultural production due to floods should not exceed 2%, and the decline of GDP on this bases should not exceed 0.2 p.p. It is interesting to note that the 2012 drought decreased agricultural production by over 17% and GDP by over 1.5 p.p., which somewhat relativises the claim of extremely large losses of total agriculture in the latest floods. Observed microeconomically, large individual damages on certain farms are undeniable and certain state support is needed in those cases, but with a parallel development of the insurance market for agricultural land.

We have dedicated a bit more space in this Overview to floods in order to additionally stress the real reasons why the economic activity in 2014 will probably stagnate or fall into a mild recession. Those being the dominant negative macroeconomic trends – unsustainable fiscal position (high and growing public debt and high deficit), reduction of foreign and domestic investments, low borrowing activity, deceleration of exports, etc. - and not the floods. *QM* analysis indicates that the floods will have a very limited negative impact on the economy, which, taking into account the effects of renovation, should not exceed 0.5 p.p. of GDP, so the economic growth rate in 2014 will probably be between -0.5% and 0%.

Inflation is quite low and in March and April it was below the lower limit of the NBS target corridor (see Section 5 "Prices and Foreign Exchange Rate"). The year-on-year inflation in April was only 2%, and the prices increased 1.8% from the beginning of the year till end of April. There is no indication that the inflation would accelerate in the coming months. We expect the continuation of stagnating economic activity with a decline of domestic demand, stable dinar exchange rate and seasonal decline in food prices – which will all have a disinflationary effect. The recent floods will not have a significant impact on food prices and inflation either, because they affected a relatively small part of agricultural land, and there is always a possibility of importing deficient agricultural products.

NBS reaction to an inflation lower than the target corridor was quite restrained. The reference interest rate since the beginning of May was kept at the December level of 9.5% and then lowered to 9% (see Section 7 "Monetary Trends and Policy"). There is no doubt that Serbia needs to keep implementing a slightly more restrictive monetary policy than the one that would be appropriate in the circumstances of an extremely low inflation (below the target corridor), because there are issues of large structural imbalances, primarily the fiscal deficit. However, we feel this is not a good enough excuse to have the reference interest rate by as many as seven percentage points higher than the current inflation. Comparisons to reference interest rates in other eurozone countries of Eastern Europe that are implementing the same monetary policy as Serbia (targeting inflation and flexible exchange rate), but also the rate based on which REPO auctions are published and which is by 1-2 p.p. lower than the reference interest rate, clearly indicate a need for reduction of the reference interest rate.

Another argument in favour or reexamining the current restrictiveness of monetary policy is related to the dinar exchange rate. Higher reference interest rate (with NBS interventions) contributes to a pretty stable dinar exchange rate in 2014, which fluctuated in a narrow interval between 115 and 116 dinar to a euro (see Section 5 "Prices and Foreign Exchange Rate"). In case the reference interest rate significantly drops, strengthening of depreciation pressures could be expected and a certain weakening of the dinar. Limited dinar depreciation would have some positive and negative effects. On the positive side, it would have a favourable impact on the price competitiveness of the domestic economy and the growth of exports (see Graph T2-5) – which, in the conditions when domestic demand still surpasses the GDP, would have to be (along with the growth of investments) the main driver of economic growth. On the negative side, depreciation of dinar would additionally worsen the position of foreign currency debtors – and the high level of non-performing loans (over 22%) is growing in 2014, even with the stable dinar exchange rate. It is the stand of *QM* that a moderate real depreciation of dinar (by around 5%) would still have more positive than negative effects on the economy, which is one more valid argument in favour of reducing the NBS reference interest rate.

High unemployment remains one of the biggest structural issues of domestic economy. After the inexplicable and most likely wrongly measured decline of unemployment and increase of employment during 2013, the negative trends on the labour market are visible again in the official statistics in 2014. The number of the unemployed is rising, while the number of the employed is falling, measured both by the Labour Force Survey (LFS) and the RAD survey. The unfavourable trends in economy have reflected in Q1, more than before, on the trend in wages and not only unemployment. The wages have nominally grew in a year only 0.5%, which due to the decelerated inflation did not lead to a large real reduction of wages (2.2% reduction in real terms), but it represents the lowest nominal year-on-year growth of wages since 2000.

The current deficit continues to drop, but at the same time, the trends in capital and financial balance sheet are deteriorating (see Section 4 "Balance of Payments and Foreign Trade"). In Q1, a current deficit of 4.2% of GDP was realised, which is a reduction compared to 5% of GDP from the same period last year. Behind the improvement of the current account balance is a still high growth of exports and a stagnation of imports, but it is questionable how long this growing trend of exports will keep up in the future. What is even more worrying than a possible deceleration of exports is the net capital outflow from Serbia, which was almost half a billion euros in Q1. Business sector and banks are deleveraging abroad, as they are settling their obligations, and there are almost no new projects and the accompanying new borrowing. Foreign direct investments, which are the healthiest part of capital inflow, were extremely low in Q1 and slightly lower than 150 million euros. For now it seems highly unlikely that the officials' announcements about a billion euros of FDI coming into Serbia in 2014 will be realised. It's not because a billion euros is an unattainably ambitious goal for FDI in Serbia (in 2011 it was 1.8 billion euros), but because Serbia in 2014, with bad and unreformed business environment and exposed fiscal risks, is not an attractive investment destination for foreign capital.

Fiscal position of the country at the beginning of 2014 significantly worsened (see Section 6 "Fiscal Trends and Policy"). By April, the fiscal deficit was a staggering 81 billion dinar, which indicates that by the end of the year, the deficit will have exceeded 8% of GDP instead of the planned 7.1% of GDP. The reason for the additional increase of the fiscal deficit in 2014 is lower public revenue compared to the planned, while the public expenditure is under control for now. Public revenue is lower than planned, because the effects of reducing the grey economy are lacking, but also because of the extremely low inflation, which was not expected when budget projections were being made. A fiscal deficit of over 8% of GDP is by far the biggest in Europe and Serbia will not be able to finance it for long.

For now, the huge fiscal deficit is financed mainly on the domestic securities market. From the beginning of the year till end of May, the state borrowed additional 75 billion dinars at the domestic securities market (while renewing all the existing obligations). The conditions of state borrowing, especially for dinar securities, are extremely unfavourable. The weighted average interest rate for dinar bonds, in the first five months of 2014, was as high as 9.6% and its weighted average maturity was slightly less than 2.5 years. These investments are very profitable for investors, as it has become apparent that NBS is prepared, even at the cost of significantly depleting the reserves, to defend the dinar exchange rate against the euro (in Q1, NBS spent over 800 million euros on interventions on the forex market). If such an exchange rate policy is maintained in the future, investors in state securities, who mostly come from abroad, will have huge yields, and the state will have expenses for interests, which will be much higher than those for borrowing in euros. Therefore, the temporarily satisfying liquidity of the state should be observed in the context of how it was secured.

As the result of a high fiscal deficit and increased state borrowing in order to finance it, the public debt continues to grow. At the end of April, the public debt was over 65% of GDP, and by the end of the year, it will exceed even 70% of GDP. In order for the share of public debt in GDP to stop growing, the fiscal deficit has to be reduced to around 2.5% of GDP, which will take Serbia several years, judging by the current level of deficit of over 8% of GDP. We feel that the signing of a new arrangement with IMF is a necessary guarantee for investors in order for them to continue financing the state deficit, until the state get its public finances in order.

Announced fiscal consolidation has not progressed very far. In order to have sustainable public finances in Serbia, it is necessary to make decisive steps on three fronts: 1) improve the business operations of public and state companies, which are currently a huge fiscal expenditure, 2) implement comprehensive reforms (pension reform, reform of the system of wages and employment, etc.), and 3) reduce excessive public spending in the short term. Additional difficulties in reducing the deficit will be the recovery of damages due to recent floods, which will undoubtedly incur a certain fiscal expense (see Highlight 2). Even though the necessity of implementing fiscal consolidation has undoubtedly been recognised as a priority economic policy necessary for avoiding a public debt crisis, its implementation is not going smoothly. The announced 10% cut in public sector wages (and abolishing the solidarity tax) is necessary, but the problems Serbia is facing require far bigger and more decisive measures. The only public expenses that have the necessary volume for a stronger fiscal adjustment are pensions, and their reduction is still, in our opinion, being unnecessarily delayed.

Serbia: Selected Macroeconomic Indicators, 2005 - 2014

	Annual Data									Quarterly Data				
										2013				2014
	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1	Q2	Q3	Q4	Q1
Economic Growth							y-o-y, real growth[1]							
GDP (in billions of dinars)	1,683.5	1,962.1	2,276.9	2,661.4	2,720.1	2,881.9	3208.6	3348.7	3618.2	…	…	…	…	…
GDP	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-1.5	2.5	3.0	0.6	3.7	2.7	0.4
Non-agricultural GVA	5.8	4.9	6.1	4.1	-4.2	1.6	1.5	0.6	0.4	1.3	-1.2	1.0	0.4	…
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	5.2	3.0	10.8	3.3	2.1
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	5.4	3.2	8.8	2.2	3.6
Average net wage (per month, in dinars)[2]	17,478	21,745	27,785	29,174	31,758	34,159	…	…	…	41,419	44,248	43,939	46,185	41.825
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	…	…	…	1.724	1,724	1,720	1,705	1,697
Fiscal data					in % of GDP							y-o-y, real growth		
Public Revenues	42.1	42.4	42.1	41.5	38.6	-1.5	-4.6	0.6	-3.0	-5.8	-3.2	-2.7	0.1	-0.6
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7	3.3	3.6	-5.7	-10.8	-7.0	1.8	-6.2	6.7
							in billions of dinars							
Overall fiscal balance (GFS definition)[3]	14.8	-33.5	-58.2	-68.9	-121.8	-136.4	-158.2	-217.4	-178.7	-37.4	-44.1	-57.1	-40.2	…
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	-14,205	-14,934	-3,386	-3,690	-3,774	-4,084	-3,411
Exports of goods[4]	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,726	10,956	2,235	2,685	3,089	2,946	2,623
Current account5)	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,176	-1,586	-625	-290	-160	-510	-314
in % GDP[5]	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-9.1*	*-10.8*	*-5.0*	*-8.4*	*-3.5*	*-1.9*	*-6.3*	-4.2
Capital account[5]	3,863	7,635	6,126	7,133	2,207	1,986	2,694	3,019	1,395	605	235	62	493	300
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	242	771	158	139	224	250	146
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	859	-886	-164	887	-800
Monetary data							in millions of dinars, e.o.p. stock[1]							
NBS net own reserves[6]	175,288	302,783	400,195	475,110	578,791	489,847	606,834	656,347	757,689	673,147	674,731	701,822	757,689	696,802
NBS net own reserves[6], in mn of euros	2,050	3,833	5,051	5,362	6,030	4,609	5,895	5,781	6,605	6,025	5,917	6,122	6,605	6,015
Credit to the non-government sector	518,298	609,171	842,512	1,126,111	1,306,224	1,660,870	1,784,237	1,958,084	1,870,916	1,933,868	1,929,205	1,911,059	1,870,642	1,815,004
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909912	933,839	907,288	924,684	933,170	933,839	937,875
M2 (y-o-y, real growth, in %)	20.8	30.6	27.8	2.9	9.8	1.3	2.7	-2.2	2.3	-2.6	-4.7	1	2.5	1.9
Credit to the non-government sector (y-o-y, real growth, in %)	28.6	10.3	24.9	25.2	5,2	13.9	0.5	-2.1	-8.3	-8.2	-9.2	-9	-6.5	-8.3
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	53.8	56.2	59.9	50.7	57.3	60.3	53	50.7	48.5
Prices and the Exchange Rate							Y-o-y growth[1]							
Consumer Prices Index[7]	16.5	6.5	11.3	8.6	6.6	10.2	7.0	12.2	2.2	11.2	9.7	4.8	2.2	2.3
Real exchange rate dinar/euro (average 2005=100)[8]	100.0	92.1	83.9	78.5	83.9	88.0	80.43	85.3	80.2	79.5	79.5	80.8	81.2	80.7
Nominal exchange rate dinar/euro[8]	82.92	84.19	79.97	81.46	93.90	102.90	101.88	113.03	113.09	111.69	112.15	114.2	114.3	115.8

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

The main question we will try to answer in this issue of QM is how high growth of GDP can we expect in 2014. Our analysis indicates that the economic activity in 2014 will most probably be in stagnation, or small recession, and that the real reason for this unfavourable movement of the economic activity is not so much the impact of the recent floods, but deeper negative economic trends that have already been present for some time in the Serbian economy. Unfavourable effects these floods could have on GDP will be relatively small - probably around 0.5 pp of GDP, and possibly even less than that. It is necessary to distinguish the two impacts of floods on the economy, which are often perceived as the same by general public: 1) damage on the properties, which is currently estimated at around one billion euros (about 3% of GDP) and 2) the impact that the floods will have on the income in 2014 (i.e. on GDP), which is considerably smaller. The effect of floods on GDP is measured through the reduction of agricultural activities, coal production and electricity, smaller imputed rents due to the damaged buildings and other. We estimate that this impact could be around 0.5 pp of GDP, but we haven't excluded the possibility that, with increased activity for the restoration of damaged facilities, the negative impact of floods on GDP in 2014 could be almost negligible. The fact that the impact of floods on GDP will be small, however, does not mean that the economy will avoid recession in 2014. The first figures for Q1 indicate that the Serbian economy was in stagnation even without the floods, and that increasing slowdown in exports in the last months, the low level of investments and the current unsustainable fiscal position of the state indicate the essential worsening of economic trends which takes place independently of the floods.

Gross domestic product

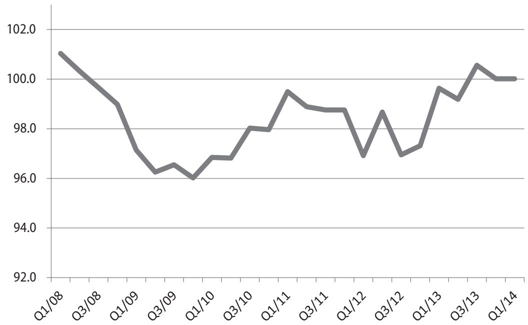
Year-on-year growth of GDP in Q1 of about 0,4%

According to the preliminary, flash, SORS estimate, the real y-o-y GDP growth in Q1 was 0.4%. This growth is significantly lower than the relatively high growth rates (2.7-3.7%) which preceded in the second part of 2013, but it is not unexpected. Namely, in 2013, when the overall GDP growth was 2.5%, agriculture had high growth of more than 20% (because it was compared to extremely dry 2012), and the company Fiat Automobiles Serbia (FAS) increased its production by several times. Without these two factors the rest of the economy would be in a decline of about 0.5%. As in 2014 high growth of agriculture was finished and FAS reached its full production capacity, decline in year-on-year growth rate from Q1 is expected and is a clear indication that the growth of the economy in 2014 (if reached at all) will be significantly lower than in 2013.

Seasonally adjusted data indicate a stagnation

Graph T2-1 shows seasonally adjusted GDP growth indices which provide better illustration of the changes in economic activity on a quarterly basis. Seasonally adjusted indices of GDP growth indicate that GDP in Q1 was in stagnation compared to Q4 2013. If the unchanged trend is maintained until the end of the year, GDP growth in 2014 could amount to about 0%. This is also the rate of growth of the economy in 2014 we predicted in previous editions of QM. However, we note that fully accurate and reliable assessment of GDP trend in 2014 only on the basis of the information from the first quarter is not possible. First of all: 1) Q1 is not so much representative quarter on the basis of which we could derive conclusions for the whole year, 2) preliminary SORS data on the movement of economic activity are not very reliable and are often seriously reviewed already

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



Source: *QM* estimates based on SORS data with the first official estimates and 3) recent floods will have an effect on the movement of GDP, which also cannot be estimated on the basis of the data from Q1. Therefore, for reliable forecast of the possible movement of GDP in 2014 we have conducted a more detailed analysis. First we analysed what would be the economic activity in 2014 if there were no floods, and then tried to estimate what the impact of floods on GDP could be.

Economic growth is driven by net exports, and other GDP components are in decline

First we analysed the GDP structure by use. Table T2-2 shows the GDP structure by expenditure method with last available data for Q4 2013. The table clearly shows that in 2013 only net exports recorded high and positive growth while all other GDP components – private consumption, state consumption and investments – were in decline. The growth structure in 2013 is a first and relatively clear indication that the same growth rate of the economy as in 2013 will not be sustainable in 2014. For example, investments recorded the highest real decline from all other GDP components in 2013 (7.8%), and without new investments further increase of production is not possible. Maybe the best representative of this thesis is trend of exports. Namely, in 2013 exports recorded a growth rate of 26% and in the first month of 2014 y-o-y growth rate is almost halved to about 14% (in April just 5.8%). Without new investments, growth of exports, mainly based on production of companies FAS and NIS, is being exhausted ad so the exports in 2014 will stop contributing to the economic growth to the extent it contributed in 2013.

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

	Y-o-y indices													
	2009	2010	2011	2012	2013	2012				2013				Share
						Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2013
GDP	96.5	101.0	101.6	98.5	102.5	97.4	100.0	98.2	98.3	103.0	100.5	103.8	102.7	100.0
Private consumption	97.2	99.1	98.9	98.2	98.5	100.1	99.9	98.8	94.2	98.1	98.3	97.5	100.3	74.8
State consumption	98.1	100.4	101.0	101.7	98.3	103.9	105.6	100.4	97.5	97.0	93.5	101.9	101.0	19.4
Investment	77.9	94.5	108.4	114.4	92.3	123.8	126.0	117.7	97.4	102.4	83.9	90.6	95.1	19.9
Export	92.0	115.3	103.4	101.8	116.6	95.9	105.1	102.4	103.2	110.6	111.8	126.3	116.7	43.1
Import	80.9	103.1	107.0	101.9	102.0	104.3	105.6	99.4	98.8	97.2	99.4	106.5	104.6	57.6

Source: SORS

Other GDP components won't be able to compensate, already noticed, slowdown of exports with their potential growth. State consumption in 2014 and in the following years will have to be reduced because of a high deficit and a fast growth of the public debt. Private consumption is under the influence of negative trends on the labour market (real decrease of net wage mass due to the further decrease in the number of employees and the slowdown of the growth of the average wage), but also under the influence of real decrease in pensions, so ti will also continue to decrease in real terms. For now there are no signs from the market of the noticeable recovery of investments – financial results of the companies are bad, credit activity low, and the significant FDI inflow is not expected. However, investments could grow in the second half of the year due to the flood damage repairs, which will be discussed in more detail in the following pages. Taking all factors in account, GDP analysis by use suggests certain and considerably worsening of economic trends in 2014, when compared to 2013, because a slowdown in net exports is inevitable and no other GDP component will be able to compensate for this by its growth.

Drivers of the growth in 2013, agriculture and industry, won't have that role in 2014.

We can also complement GDP trend analysis in 2014 with the data, by the production method, which are presented in Table T2-3. The table shows individual sectors growth ending with the last available official data which refer to Q4 2013. Similar to the analysis of GDP trend per use, in this case we can also, based on data for 2013, get enough information based on which we could approximately predict possible economic trends in 2014. Table T2-3 reveals that a sector of agriculture has the largest increase in 2013, of over 20% and that this high growth is the result of comparison of the above-average agricultural production in 2013 with the extremely poor agricultural season from 2012. Another sector that contributes the most to the growth of the economy is the information and communication sector, which recorded a growth of 10% in 2013 and which is on the multi-year growth trend. The third sector that significantly contributed positively to GDP growth in 2013 is manufacturing, which recorded a growth of 5% in 2013. The main drivers of growth in 2013 were agriculture and industrial production, and the sector of information and communication, as a consequence of its low share in GDP and relatively stable growth in long time period, did not contribute significantly to the acceleration of economic growth in 2013 compared to 2012.

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

	Y-o-y indices													
	2009	2010	2011	2012	2013	2012				2013				Share
						Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2013
Total	96.5	101.0	101.6	98.5	102.5	97.4	100.0	98.2	98.3	103.0	100.5	103.8	102.7	100.0
Taxes minus subsidies	98.3	100.9	101.6	98.6	102.4	96.6	100.4	98.1	98.3	103.0	99.5	104.1	102.8	17.4
Value Added at basic prices	96.1	101.0	101.6	98.5	102.5	97.6	99.9	98.2	98.3	103.0	100.7	103.8	102.6	82.6
Non agricultural Value Added	95.8	101.6	101.5	100.6	100.4	99.5	102.0	100.5	100.4	101.3	98.4	101.4	100.4	90,4[2)]
Agriculture	100.8	99.6	100.9	82.7	120.2	81.3	82.9	83.2	82.8	123.2	124.1	117.8	117.8	9,6[2)]
Manufacturing	84.2	100.9	100.6	101.1	104.8	96.3	103.3	99.2	104.9	104.4	103.2	108.7	103.2	16,4[2)]
Construction	80.3	92.9	107.7	99.2	74.3	118.2	110.9	98.7	80.9	78.6	62.8	75.1	82.7	3,7[2)]
Wholesale and retail trade	92.5	101.7	94.5	100.2	98.6	98.2	103.1	101.1	98.3	96.8	96.0	98.5	102.8	9,8[2)]
Transport and storage	90.0	108.2	103.1	100.0	103.2	94.5	103.3	100.1	102.1	105.4	100.0	103.6	104.1	5,6[2)]
Informations and communications	110.0	105.4	108.4	104.8	110.8	106.5	106.2	99.3	107.3	112.4	111.1	113.6	106.4	6,3[2)]
Financial sector and insurance	105.5	107.2	101.0	104.0	98.7	99.8	104.8	106.4	104.9	101.8	99.4	96.9	96.9	3,8[2)]
Other	101.6	100.8	102.0	99.9	100.5	99.1	99.4	100.7	100.5	101.3	99.6	101.5	99.9	44,7[2)]

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

Analysis based on the production method confirms that a significant slowdown of economic activity in 2014 will occur. In 2014 high growth of agriculture and industrial production as in 2013 will not be possible. We already mentioned that the extremely high growth of agriculture in 2013 was incidental because of the comparison with dry 2012, and the industrial production was under the influence of the production in FAS Company. In 2014 we could roughly estimate that agriculture, without the floods, would have almost the same level as in 2013, industrial production would reduce its positive contribution to GDP by two thirds[1], and that all other sectors would have similar growth rates as in 2013.[2] The calculation indicates that under these assumptions GDP growth would be around 0%. So the QM analysis of GDP by use and by production indicate that the economic activity in 2014 would, without floods, be in stagnation, and that the expected growth of 1%, predicted by the Government, would be very hard to accomplish.

In the following pages we have tried to answer the question approximately how high will be the impact of floods on the economic activity in 2014. A more detailed analysis is given in section Highlight 2 of this issue of QM, and here we present its main conclusions and key paragraphs. Please note that a reliable assessment of the impact of floods on GDP is currently not possible, because there are no precise data on all its consequences.

Different impact of floods on assets and GDP

First it is necessary to separate the damage to the property from the impact that the floods have had on income and production, because these are two different things. For example, flooded house has a great damage to property but a very small effect on income and GDP (reduction of income that reduces GDP as a consequence of a flooded residential unit counts as a lost imputed rent). A somewhat different example is the flooding of agricultural areas, which has a relatively small effect on the property, because these areas will be, for the most part, equally usable in the next agricultural season (and some can probably be used in this), but a relatively large impact on the production, because the crops on these areas are ruined for 2014.

We expect reduction of GDP due to the floods of about 0.5 p.p.…

By the last available data, around 80.000 hectares of agriculture areas is flooded, which is less than 3% of total seeded areas. Livestock production is probably less affected than farming (in relation to total livestock population), and also in some parts of agricultural areas it will be possible to seed some agricultural products again in this year. As agriculture has around 10% of the share in GDP because of the impact of floods on agriculture GDP will be reduced by about 0, 2 pp of GDP. Impact on the production of electricity and in mining (due to the flooded coal pits in

1 Based on data for the first four months of 2014 and the analyses of the individual fields of industrial production, which point to a slowdown by the end of the year. FAS has reached its full production capacity in the second half of 2013, so it will have a solid y-o-y growth in the first half of 2014.

2 With the exception of construction, for which we think a decline of 25% in 2013 was incidental and was probably poorly measured. We assumed that the construction activity (without renewal after the floods) in 2014 will be approximately the same as in 2013.

Kolubara) we estimated to about 10% by the end of the year. Reduction in production of electricity and in mining could affect decrease in GDP of about 0.3 p.p. Reduction of imputed rent as a consequence of flooded residential buildings is almost insignificant, because few thousand of residential buildings were damaged by floods (of over 3 million residential units) and probably the largest part of those will be in function already in the next few months. The remaining impact of floods on GDP is even lower and less durable, and so we won't analyse them in more detail, and they refer to temporary reduction in economic activity of small and medium enterprises from the flooded areas, temporary reduction of transports, etc. taking all this into account we conclude that the negative impact of floods on GDP growth in 2014 could amount to slightly over 0.5 p.p of GDP and by no means above 1 p.p. of GDP.

…which can be even lower due to the reconstruction by the end of the year

Reconstruction activities could on the other hand increase the production and in certain extent mitigate negative effects of floods on GPD. Here it should be taken into account whether these are completely new activities to eliminate the consequences of floods and or the resources used would not be otherwise used for some other purpose, or they are redirected from some other activities. Only in the first case there would be the indisputable increase in GDP, while in the second case we would have to look at the difference in added value of eliminating the consequences of floods in relation to the added value these resources would create if they are used for other purposes. Also, the value and the structure of assets which should be reconstructed is not big enough to trigger high growth of economic activity: 1) preliminary damage assessment of a billion euros (3% of GDP) are probably considerably overestimated, 2) all damaged buildings, equipment and infrastructure will not be renewed, and 3) some equipment and assets are mainly imported (machines in Kolubara, technical equipment, cars, etc.), and their re-purchase will not contribute to domestic production. Therefore, we believe that activities taken to fix these damages can in best scenario contribute in a way that a decline of economic activity caused by floods will be slightly smaller than the estimated 0.5 p.p. of GDP, but that they themselves cannot be the drivers of economic growth in 2014 and the coming years.

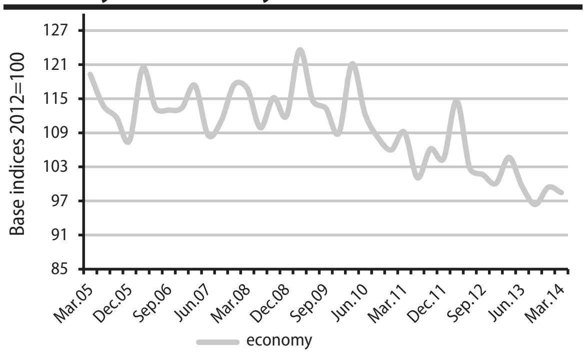
In 2014 recession possible, but because of bad economic fundaments, not floods

Taking all said into account, we conclude that economic activity in 2014 will probably be in stagnation or in mild recession. The most important reasons for this are the dominant macroeconomic trends – unsustainable fiscal position (high and growing public debt and high deficit), fall in investments, low credit activity, reduction in exports and other – and not floods. QM analysis indicates that the floods will have very limited negative impact on the economy which, taking into account the effects of the reconstructions, should not be higher than 0.5 p.p of GDP, and that therefore the growth rate of the economy in 2014 will most probably be between -0,5% and 0%.

Unit Labour Costs in decline

Unit Labour Costs[3] (ULC), measured in dinars, significantly decreased in Q1 (Graph T2-4). Compared to the same period of the last year ULC decreased in Q1 by about 5%. Decrease in ULC is a consequence of a real decrease in wages of above 2% and similar decrease in the number of employed. It is especially important to say that in Q1 nominal growth of wages almost completely stopped, which has never happened since we have analysed the data from the labour market, and which can partially be explained with extremely low inflation. Wages in Q1 recorded y-o-y nominal growth of just 0.5%, which is the lowest y-o-y growth since 2001[4]. Such growth of wages decreases the share of labour costs in production.

Graph T2-4. Serbia: Real Unit Labor Costs in the Economy and Industry, 2005-2014



Source: *QM* based on SORS and NBS data

3 Unit Labor Costs in dinars are calculated for the economy (excluding the Agriculture and Public Administrationsectors) and industry.
4 For more details see „Employment and Wages" in this issue of *QM*

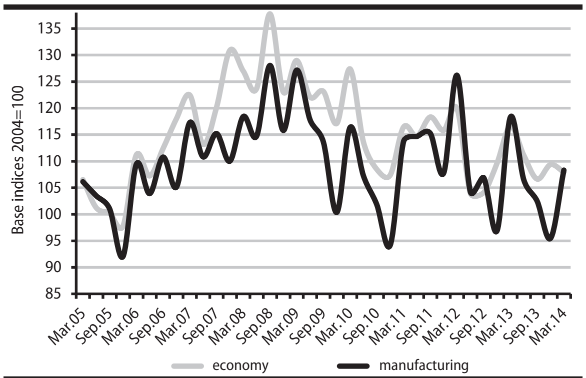
Unit labour costs measured in euros (euro-ULC) are an indicator of the price competitiveness of the Serbian economy as they define the greatest national cost component (labour costs) in relation to the added value. We calculate euro-ULC for the manufacturing sector (which produces by far the greatest share of tradable goods), and for the economy as a whole[5], as shown in Graph T2-5.

The price competitiveness of the economy improved considerably

At first glance Graph T2-5 shows two divergent trends in the movement of the euro-ULC in Q1 in the economy and the manufacturing industry. In fact, it looks as if the euro-ULC is reducing in the economy and increasing in the manufacturing industry. This is however only an illusion, caused by the strong seasonality in the movement of ULC in the manufacturing industry in Q1, when they are seasonally higher compared to other quarters (Graph T2-5). The real measure for assessing trends of euro-ULC would therefore be their comparison with the same period last year (upper peaks of curves from the Graph), and in this way it can be seen that in the case of the manufacturing industry and in the case of the total economy, euro-ULC are reduced for 7% compared to Q1 2013. This is a consequence of a fall in dinar ULC but also of a y-o-y dinar depreciation compared to euro[6]. It is interesting to notice that in Q1 real decline in wages was the main driver of the price competitiveness of the domestic economy, and not the dinar depreciation (which in all previous episodes of improvement of price competitiveness had the main role). Decrease in ULC from the standpoint of international competitiveness is desirable, but the way it happened indicates a difficult situation in the Serbian economy – decrease of ULC is not a consequence of fast growth of the economy and slow growth of real wages but a consequence of stagnation and a decrease in real wages.

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

Graph T2-5. Serbia: Real Unit Labor Costs in the Economy and Industry, 2005-2014



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

Industrial production

Industrial production decreases growth

Industrial production in Q1 recorded year-on-year growth of 2.1% (Table T2-6). Within the industrial production the highest growth of 3.6% was achieved by the manufacturing industry, while the mining and the supply of electricity were at the practically the same level as in the same quarter of the previous year. Year-on-year growth of industrial production has slowed down compared to 2013 and we think this is an indication for the entire 2014, in which the growth rate of industrial production is certain to be less than 5.5% from 2013 - which we announced in the previous QM issues.

5 Excluding the Public Administration and Agriculture sectors.
6 The average exchange rate in Q1 2013 was 111.7 dinars per euro, in Q1 2014 115.7 dinars per euro, the difference in the y-o-y inflation in Serbia and in the Euro zone was only 2 pp due to the slowdown in inflation in Serbia. For more details see section 5 "Prices and Exchange rate" of this issue of *QM*

Table T2-6. Serbia: Industrial Production Indices, 2009-2014

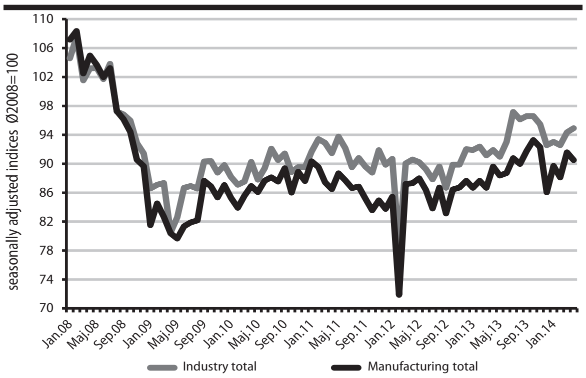
	Y-o-y indices														Share
	2009	2010	2011	2012	2013	2012				2013				2014	2013
						Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	
Total	87.4	102.5	102.2	97.1	105.5	94.5	97.2	96.4	99.4	105.2	103.0	110.8	103.3	102.1	100.0
Mining and quarrying	96.2	105.8	110.4	97.8	105.3	100.2	94.2	100.1	96.3	107.8	102.2	107.6	104.1	99.7	8.5
Manufacturing	83.9	103.9	99.6	98.2	104.8	93.3	100.2	96.2	101.5	105.4	103.2	108.8	102.2	103.6	73.9
Electricity, gas, and water supply	100.8	95.6	109.7	92.9	108.1	96.6	85.4	95.8	93.0	103.7	103.7	120.5	106.8	99.3	17.6

Source: SORS

Seasonally adjusted indices indicate a decline in industrial production in Q1

Graph T2-7 shows seasonally adjusted production indices of total industry and manufacturing. We can immediately notice that the seasonally adjusted data actually indicate a lower level of industrial production in Q1 compared to Q4 2013. However, the trajectory of the seasonally adjusted industrial production may be able to indicate that after the decline in industrial production at the end of 2013 (December), from January its upward trend is re-established, only from the lower basis (Graph T2-7) - which would, despite lower level of production, have positive connotation. We are however still restrained and closer to the interpretation that these are usual monthly fluctuations in industrial production, rather than establishment of a new upward trend.

Graph T2-7. Serbia: Seasonally Adjusted Industrial Production Indices, 2008-2014



Source: SORS

First of all, the decline in industrial production in December of 2013 actually was not permanent in nature, and so the mentioned recovery is only an illusion, and not an essential trend. The most responsible factor for the decline in production in December was a drop in the production of motor vehicles, which is associated with the business policy of the FAS Company. That is why we assessed the decline in industrial production in December as temporary in the previous edition of the QM. Instead of upward trend of industrial production in the last three or four months, we should compare the value of seasonally adjusted indices from March and April of 2014 with the values from September and October of 2013, which, we believe, confirms the decline in industrial production in comparison to its highest level.

The growth of industrial production in 2014 probably around 1%

In the first four months of 2014 industrial production recorded a y-o-y growth of about 2%, but this growth, most probably, cannot be maintained until the end of the year.- because already in Q3 it will be compared to relatively high industrial production from 2013 (Graph T2-7). We expect that the average growth of industrial production in the second part of the year could be around 0%, and so the overall growth of industrial production in 2014 will be about 1%.

Trend analysis of individual areas of industrial production confirms the assessment of relatively low industry growth in 2014. Observed by individual areas, in the first four months of 2014 high year-on-year growth of 24% was achieved by the production of motor vehicles. This growth, though still high, represents actually a slowdown when compared to 2013 when the growth in production of motor vehicles amounted to 240%. The y-o-y growth in in the first four months of 2014 is a consequence of the comparison of the current production at the FAS Company to the production from the same period last year, when the full capacities of the company were not yet been reached. As a consequence this growth will continue to decline by the end of the year. For additional lasting growth in car production FAS needs new large investments. Therefore, we believe that Serbia should enter into negotiations with FIAT about further capacity expansion in Serbia and eventual production of some other car models. We think that in the eventual negotiation process Serbia could offer certain tax breaks and subsidies, but that they would have to be for the order of magnitude lower than those granted in the past.

Another area which gave a significant contribution to the growth of industrial production in the first four months is the production of basic metals, but it is a consequence of production restart in the steel factory Železara Smederevo and its comparison with the previous year when the steel factory was not operating. Since there is a high probability that this unprofitable production will not be maintained during the whole year, we believe that the observed increase in the production of base metals is temporary. Production of food products in the first four months achieved a growth of around 5% for which we believe that is sustainable because it is based on good agricultural production in 2013, and the recent floods by all probability will not have much impact on agricultural production in 2014 (it is maybe possible for the production of food products to have a small temporary drop in May). As a consequence of the floods, it is possible that the production of electricity will record a decline in May and in the next few months.

In Q1 the growth rate of industrial production by purpose relatively even

Observed by purpose (Table T2-8), we notice that in Q1 all specific purpose groups of industrial products achieved y-o-y growth. With somewhat higher growth than others only the production of investment goods stands out – because the production of motor vehicles is classified in this category – and this growth was 7.7%. Other specific purpose groups, production of consumer goods, energy and intermediate goods have smaller y-o-y growth rates spanning from 0.2 to 3.9% (Table T2-8).

Table T2-8. Serbia: Components of Industrial Production by use, 2009-2014

	Y-o-y indices													
	2009	2010	2011	2012	2013	2012				2013				2014
						Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Total	87.4	102.5	102.1	97.1	105.5	94.5	97.2	96.4	99.4	105.2	103.0	110.8	103.3	102.1
Energy	98.8	97.7	106.2	93.6	113.2	95.8	88.3	91.4	98.7	108.6	109.7	131.6	107.7	101.1
Investment goods	79.3	93.6	103.2	103.8	127.6	92.0	105.4	113.7	104.2	132.3	130.2	140.5	104.2	107.7
Intermediate goods	78.4	109.2	102.2	91.2	99.0	89.4	96.3	89.1	90.0	94.7	93.1	101.9	104.8	103.9
Consumer goods	86.8	102.1	95.4	103.2	100.7	97.8	104.5	104.6	106.1	107.0	101.5	97.4	100.0	100.2

Source: SORS

Construction

There are some indications that the decline in construction activity is coming to a halt

Latest construction statistics made available by SORS indicate year-on-year real decline of this sector of the economy in Q1 of 5.1%. This decline, however, represents an improvement compared to the results from 2013 when the official construction statistic recorded a decrease of over 20%. We take the data for Q1 with some reserve, because the construction activity in Q1 is far lower than in Q2 and Q3 due to the seasonal factors - so for the reliable estimation of the construction activity trend we will wait for far more representative data from subsequent quarters. Additional reason why the data from Q1 are not representative for construction activity in the whole 2014 is the fact that in the second part of the year construction activity will most probably increase, as a consequence of floods damage repairs.

Because of the difficulties in monitoring the construction activity, we use cement production index[7] as additional indicator (Table T2-9). Namely, the construction sector comprises of a large number of a small and medium-sized enterprises, whose statistical monitoring is very unreliable and often outside the sight of the official statistics. Therefore, as an additional indicator for monitoring this sector of the economy we use cement production which is easy to monitor and cement is used in almost all construction works. We believe that data obtained this way, although not sufficiently precise, are a good additional indication of an actual state and future trends in construction.

7 Cement consumption would be the most appropriate indicator, but data on cement consumption are not available at the quarterly level. Studies have shown that cement production approximates consumption with relative reliability

Table T2-9. Serbia: Cement Production, 2001-2014

	Y-o-y indices				
	Q1	Q2	Q3	Q4	Total
2001	89.5	103.5	126.9	148.1	114.2
2002	83.6	107.9	115.6	81.6	99.1
2003	51.1	94.4	92.7	94.4	86.6
2004	118.8	107.4	98.5	120.1	108.0
2005	66.1	105.0	105.8	107.4	101.6
2006	136.0	102.7	112.2	120.2	112.7
2007	193.8	108.9	93.1	85.0	104.4
2008	100.1	103.7	108.1	110.1	105.9
2009	34.1	81.4	86.0	75.3	74.4
2010	160.7	96.9	96.0	97.4	101.1
2011	97.7	101.3	96.2	97.7	98.3
2012	107.9	88.3	58.2	84.9	79.6
2013	83.5	78.7	127.6	93.5	94.9
2014	136.2				

Source: SORS

Cement production in Q1 was by 36% higher than in the same period of the last year, (Table T2-9) which is significantly higher than the official estimate of the construction activity trend in Q1 (decrease by 5%). However, for cement production and for the entire construction activity in Q1 we believe that it is not sufficiently reliable for the assessment of actual developments, because it is seasonally quite lower compared to all other quarters. Due to the relatively low value of cement production in Q1 it is often the case that relatively small changes in the quantity of production result in large changes of y-o-y indices which we consider to be the case in Q1 of 2014.

QM methodology is to combine both methods (official data from construction statistic and cement production data) in order to detect the actual trend in construction activity. Based on these data we conclude that it is possible that the value of construction work is finally stabilizing, after the deep fall in the previous two years, and that by the end of the year, due to the flood damage repairs, it could move to the positive growth zone.

3. Employment and Wages

As of this year, Statistical Office of the Republic of Serbia is gathering quarterly data within the Labour Force Survey (LFS). The first quarter survey was conducted at the end of January and beginning of February, when there is usually a negative effect of the winter season. However, comparing the labour market indicators of Q1 and those of October 2013, it would seem that the effect of the season on the labour market is mild and that the labour market situation is not deteriorating significantly. The biggest decline in employment was recorded in construction, while the number of helping household members, who fall into the group of informally employed, is rising. Recently adopted Government incentives for hiring job seekers will contribute to decreasing the grey economy labour only if the incentives are accompanied by a comprehensive and severe punishment policy of the black market labour. Still, we estimated in the Box that the effects of these measures on the increase of formal employment will be modest. At the year-on-year level, the average monthly gross wages are lower in real terms by 2.2%. By sectors, the wages have increased the most in the information and communications sector, which was also the case in the previous three quarters. Compared to the previous quarter, wages are dropping the most in education, healthcare and social protection, which is the result of introducing solidarity tax as of January 1st this year.

Employment

As of this year, the Labour Force Survey will be published quarterly

Labour Force Survey for Q1 2014 was conducted at the end of January and beginning of February. Considering that the survey was done in winter for the first time, it is impossible to compare labour market indicators to the same period last year.

In the previous issue of the Quarterly Monitor, we stressed that it is possible that the employment level in October 2013 (49.2%) was adequately measured within the Labour Force Survey, but it is highly unlikely that the number of employees in the April-October period had increased by 140,000 (Table T3-1). Such large improvements on the labour market in a short period of time of only two quarters happen rarely and in situations when the economic activity is significantly improving, which was not the case in Serbia during 2013. Therefore, we will be comparing LFS results from Q1 and October 2013, even though it should be noted that there is always a seasonal drop in employment in Q1. That is why in the previous years, the survey was conducted in April and October, when the effect of seasonal factors was the smallest.

As can be seen in Table T3-1, there were 4,644,890 individuals in Q1 2014, ages between 15 and 64 (by 29,290 more compared to October 2013). Among these persons:

• 2,805,513 were economically active (by 65,887 less compared to October 2013)

• 2,229,547 were employed (by 38.902 thousand less compared to October 2013)

• 613,787 were unemployed (by 11.136 thousand more compared to October 2013.)

The number of employed individuals in the first quarter is lower compared to October 2013 by almost 40 thousand, which is not surprising considering the weakness of the local economy, as well as the usual seasonal drop in employment in the first quarter.

Trends

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

		Total no. of employed 15-64 2)	Number of employed in agriculture and unpaid family workers 15-64[3]	Employment rate 15-64 15-64 god.			Total number of unemployed 15-64	Unemployment rate 15-64		
				Total	Male	Female		Total	Male	Female
		1	2		3		4		5	
2008	April	2,652,429	..	54.0	62.3	46.0	432,730	14.0	12.4	16.1
	October	2,646,215	443,243	53.3	62.2	44.7	457,204	14.7	12.7	17.3
2009	April	2,486,734	437,957	50.8	58.7	43.3	486,858	16.4	15.0	18.1
	October	2,450,643	411,303	50.0	57.4	42.7	516,990	17.4	16.1	19.1
2010	April	2,278,504	326,623	47.2	54.3	40.3	572,501	20.1	19.4	21.0
	October	2,269,565	352,724	47.1	54.4	39.9	565,880	20.0	19.0	21.2
2011	April	2,191,392	340,528	45.5	52.2	38.8	649,155	22.9	22.7	23.1
	October	2,141,920	329,378	45.3	52.5	37.9	690,782	24.4	23.5	25.6
2012	April	2,083,604	317,879	44.2	51.1	37.1	735,209	26.1	25.6	26.7
	October	2,201,760	345,883	46.4	53.7	39.1	661,698	23.1	22.1	24.5
2013	April	2,127,649	315,109	45.8	53.6	38.1	707,440	25.0	23.1	27.3
	October	2,268,750	349,742	49.2	56.2	42.1	602,651	21.0	20.2	22.0
2014	Q1	2,229,063		48	55.1	41	613,787	21.6	21.0	22.3

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

The biggest decline in employment was in construction

Table T3-2 shows that in the period October-February 2014 (when the first quarter Survey was conducted), the employment dropped the most in construction – by 24%. Decreased employment in construction is largely due to seasonal factors, but also very strong recession tendencies in this field. The largest increase in employment was recorded in the helping household members, which fall into the group of informally employed, and by 25%. According to LFS estimates, the number of helping household members has increased in the past year by as much as 175%, which is probably to some extent reflecting the growth of the grey economy, but it is also due to methodological changes and perhaps even measurement errors. Table T3-2.

Table T3-2. Employment by sectors, LFS

	October 2012	April 2013	October 2013	Oct 2013/ Oct 2012,	Q1 2014	Q1 2014/ Apr 2013,	Q1 2014/ Oct 2013
TOTAL	2,299,038	2,227,432	2,394,004	104.1	2,342,966	105.2	97.9
Agriculture, forestry and fishing	494,700	461,819	522,084	105.5	469,196	101.6	89.9
Mining	25,092	21,173	23,065	91.9	27,230	128.6	118.1
Manufacturing industry	394,992	389,193	399,654	101.2	388,127	99.7	97.1
Supply of electricity, gas and steam	35,159	37,751	37,206	105.8	31,266	82.8	84.0
Water supply and wastewater management	35,203	30,436	36,866	104.7	37,139	122.0	100.7
Construction	121,659	92,977	126,620	104.1	96,744	104.1	76.4
Wholesale and retail trade, repair of motor vehicles	307,136	305,132	288,606	94	300,020	98.3	104.0
Transportation and warehousing	125,748	137,980	130,882	104.1	141,317	102.4	108.0
Accommodation and food services	66,555	55,737	61,973	93.1	62,153	111.5	100.3
Information and communication	35,172	45,266	50,140	142.6	56,796	125.5	113.3
Financial activities and insurance activities	43,676	40,860	44,566	102	44,616	109.2	100.1
Real estate	2,885	3,012	2,028	70.3	*		
Professional, scientific and innovation activities	50,896	61,194	63,185	124.1	68,359	111.7	108.2
Administrative and support service activities	47,076	47,919	49,175	104.5	47,585	99.3	96.8
Public administration and compulsory social insurance	125,469	129,761	132,950	106	135,750	104.6	102.1
Education	146,867	142,490	156,867	106.8	149,005	104.6	95.0
Health and social care	140,297	124,628	136,455	97.3	140,776	113.0	103.2
Arts, entertainment and recreation	36,387	33,040	44,823	123.2	49,158	148.8	109.7
Other service activities	43,722	47,561	45,177	103.3	43,803	92.1	97.0
Activities of households as employers	20,377	18,632	41,003	201.2	51,280	275.2	125.1

Sourcer: ARS. *a small number of occurrences so that it is not possible to have the assessment

According to the RAD survey, formal non-agricultural employment continues to drop

Formal employment (outside the registered agricultural workers, members of the military and the police) according to the RAD survey conducted in March 2014 was 1,697,511 and it has dropped compared to September 2013 by 7 thousand and compared to March last year it dropped by 28 thousand (Table T3-3). This is a disconcerting tendency as it is the highest quality segment of employment, where statistical measurements are most reliable[1].

Table T3-3 Serbia: number of registered employed and unemployed, 2008 - 2014

		Total no. of employed	Employees in legal entities 2)	Entrepreneurs			Total no. of employees	Number of unemployed (NES)
				Total	No. of entrepreneurs	No. of employees with entrepreneurs		
		1 (=2+3)	2	3 (=4+5)	4	5	6 (=2+5)	7
		in thousands						
2008	March	2,006	1,432	574	245	329	1,761	795
	September	1,993	1,425	568	245	323	1,748	726
2009	March	1,911	1,411	500	210	290	1,701	758
	September	1,868	1,383	485	211	274	1,657	737
2010	March	1,817	1,362	455	199	257	1,618	778
	September	1,775	1,348	427	183	244	1,592	721
2011	March	1,755	1,349	405	204	201	1,550	774
	September	1,738	1,337	401	203	198	1,535	743
2012	March	1,730	1,339	391	203	188	1,527	783
	September	1,724	1,343	381	213	168	1,511	751
2013	March	1,725	1,347	378	213	165	1,512	776
	September	1,705	1,329	376	230	146	1,475	759
2014	March	1,697	1,321	376	230	146	1,467	791

Source: SORS – The semi-annual report on employed persons and wages of the employed persons RAD-1/P; the update to the semi-annual survey RAD-1; Semi-annual survey on private entrepreneurs and their employed workers RAD-15; the National Employment Service.
Note: Data from October 2012 are corrected based on the Semiannual research -1/P for September 2012. Individual data on the number of private entrepreneurs and the number of employees are taken from of Monthly Statistical Bulletin 2/2013 of the NES.
Footnotes:
1) By the registered number of employed, we refer to the formal economy, i.e. those employees with employment contracts and for whom social security contributions are being paid.
2) By the registered number of unemployed, we refer to those persons that have registered with the National Employment Service (NES). NES moved from monitoring the number of job seekers to the number of unemployed persons in September 2004. This is why we do not have these data for the previous period (column 7).
3) Figures do not include employees of the Ministry of Defense and Ministry of Interior

The unemployment rate has grown by 0.6 percentage points, and the inactivity rate by 0.8 percentage points

As we stated at the beginning, even though it is difficult to compare October survey and the one conducted in winter, we observed an increased number of the working age unemployed by 11 thousand, so the current unemployment rate is 21.6%. The number of inactive individuals has also increased, i.e. individuals who are out of work and are not actively seeking employment, so the inactivity rate is currently 38.6% (Table T3-1).

The number of the unemployed registered at the National Employment Service has increased

The number of the unemployed registered at the National Employment Service is 791,000 and it has increased compared to March last year by 14 thousand (Table T3-3).

Informal employment increased by 20.5%

Informal employment rate, expressed as a share of informally employed in the total number of employed, is higher by 0.2 percentage points compared to October 2013 and is currently 20.5%. The survey conducted in the first quarter of this year estimates that there are around 480,000 informally employed people in Serbia. This includes those employed in an unregistered business, as well as in a registered company but without a formal employment contract, as well as the unpaid helping household members[2]. This year's survey shows for the first time the structure of the informally employed according to their professional status, which can be seen in Table T3-4. The biggest number of informally employed is among the self-employed who have no other employees, followed by the helping household members. Due to a small number of occurrences, the number of self-employed with employees working in the informal economy is not published.

1 In the case of Serbia, the data on formal employment does not always adequately reflect the level of economic activity due to employers' practice, mostly state companies, keeping on their payroll workers that are not engaged productively. Even though the formal employment, which is not accompanied by work engagement, is gradually decreasing, it is still present especially in the companies undergoing restructuring and in EPS (Kosovo and Metohija workers).
2 Helping household members are persons who are helping another family member run family business or agricultural land, without being paid in money.

Table T3-4. Formal and informal employment by professional status

Formally employed		Informally employed	
Employed	1,518,295	Employed	62.352
Self-employed with employees	86.163	Self-employed with employees	*
Self-employed without employees	258.779	Self-employed without employees	227.955
		Helping household members household	187.056

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

This structure of the informally employed should be kept in mind when planning reforms, which should aim at reducing the number of employees working in the grey economy and transferring them to legal employment. In our opinion, the recently adopted measure for encouraging hiring job seekers has exactly that goal, and we presented the details of the adopted solutions in the Box.

Box no. 1 Incentives for hiring job seekers

In mid-May, the Serbian Government adopted tax reliefs for hiring job seekers. That is, an employer – a legal entity, or an entrepreneur who hires a job seeker will be entitled to a partial refund of the tax paid on wages and of the paid contributions for the mandatory social security, both on the employer's and the employee's side. The incentives will be effective as of July this year and will last until June 2016.

Employer will be entitled to tax and contributions refund as follows:

• 65% if he hired a minimum of 1 and a maximum of 9 job seekers;

• 70% if he hired a minimum of 10 and a maximum of 99 job seekers;

• 75% if he hired a minimum of 100 job seekers.

Job seekers are considered those individuals that have been registered at the National Employment Service as unemployed for at least six months. This category also covers individuals who were interns for at least three months and were not paid for their work engagement.

In order to prevent possible abuse, it is stipulated that the job seeker cannot be any individual that was previously employed by an employer that is affiliated to the employer currently offering employment to the job seeker. The tax relief can also be used by an employer who starts doing business after March 31, 2014, but he has to fulfil the abovementioned conditions related to hiring job seekers.

Introduction of these cancels some earlier tax reliefs, primarily those related to job seekers below 30 and above 45 years of age, on which the employers had tax reliefs on wages.

Although the main goal of this measure is to incite new hirings, the Government has already stressed several times that it expects to encourage the employers who have thus far not offered their employees employment contracts and have not been paying tax and contributions for them, to do so now and legalise them. The LFS data indicates that almost 60% of the informally employed could benefit from this measure, since they are working either for an employer or are self-employed without a formal contract, so they have no paid taxes and contributions. Naturally, the employed workers who have formal contracts, but no taxes or contributions paid for them should also be taken into account. Krstić (2012)[1] uses this extended definition to arrive to informal employment rate that is by 5 percentage points higher than those from the LFS.

The latest research of the Foundation for the Advancement of Economics[2] showed that according to employers surveyed, among factors contributing to grey economy, high taxes are very highly ranked. Average rate of grey economy when it comes to income (ratio of unreported and total real labour income), according to the survey conducted among companies and entrepreneurs, is

1 Krstić, G. (2012). "Labour Force Flows and Informal Economy in Serbia", International Conference From Global Crisis to Economic Growth. Which Way to Take?, The Faculty of Economics, University of Belgrade, September 2012

2 Grey Economy in Serbia: New Findings and Reform Recommendations, March 2013. The project was financed by USAID.

26.2%. On average, it is significantly higher in entrepreneurs, i.e. wages paid by entrepreneurs, than in companies. Observed by sectors, grey economy in the area of employee wages is most expressed in the sectors of construction, hospitality and transportation, quite lower in the manufacturing sector, and the lowest in companies involved in trade.

However, it should be noted that payment of salaries in cash is present the most in micro companies (up to 10 employees) and entrepreneurial shops, and with their growth, the rate of grey economy in the area of wages is dropping. Considering that the capacity of micro companies, given their turnover and revenue, to increase the number of employees (even to register the already employed) is quite small, the question remains to what extent will the adopted measures truly be able to contribute to the increase of employment, as well as to the increase of state tax revenue from wages and contributions.

Additionally, the net effects of the changes should also be kept in mind, considering that the old reliefs that were intended for workers younger than 30 and older than 45 have been abolished. Finally, a question is raised why anyone who hasn't been paying taxes and contributions so far would start doing that now, when the state is tolerating grey economy anyway. If the business environment is not fundamentally changed, measures such as these incentives cannot by themselves lead to a significant and permanent reduction of the grey economy. In addition to improving the business environment, to combat the gray economy, it is crucial to increase the probability of detection of undeclared work and to indiscriminately apply harsh sanctions against employers who hire workers illegally.

Wages

Average monthly gross wages are lower in real terms by 2.2% compared to the same quarter last year

According to the data from the Statistical Office of the Republic of Serbia, at the year-on-year level, the average monthly gross wages in Q1 were nominally higher by 0.5% and in real terms lower by 2.2% (Table T3-5). Average monthly net wages in the first quarter of 2014 were 41,000 dinar or 360 euros. The reduction of wages in real terms reflects the dominating negative tendencies in most of the economy, as well as on the labour market, but also an increasing share of grey economy, which is especially present in the segment of small enterprises and entrepreneurs.

Table T3-5. Serbia: average monthly wages and y-o-y indices, 2008-2014

	Average Monthly Wage[1]				Average Gross Monthly Wage Index[2]	
	Total labour costs[3], in dinars	Net wage, in dinars	Total labour costs, in euros	Net wage, in euros	nominal	real
2012						
Q1	63,846	39,068	591	362	111.0	106.0
Q2	68,140	41,664	600	367	109.6	105.3
Q3	67,457	41,187	577	352	106.4	98.4
Q4	71,452	43,625	630	384	108.7	96.8
Dec	76,830	46,923	677	413	106.6	95.1
2013						
Q1	67,704	41,419	606	371	106.0	94.6
Q2	72,143	44,248	644	395	105.9	95.9
Q3	71,469	43,939	626	385	105.9	99.1
Q4	75,089	46,185	648	399	105.1	103.0
2014						
Q1	68,015	41,825	588	361	100.5	97.8

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

Trends

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

The year-on-year index of net wages shows that the wages realised in Q1 2014, compared to the same period last year, increased in only six out of nineteen sectors. The biggest growth was recorded in the information and communications sector (24.7%), as was the case in the previous three quarters as well. It is followed, in size, by a 6% growth of wages in the accommodation and food sector, which can probably be explained by the winter tourist season. The same growth of wages was recorded in the sector of electricity, gas, steam and air-conditioning. The largest decline of wages in the amount of 15% was recorded in the administration and support services[3] (Table T3-6).

Compared to the previous quarter, the biggest decline of wages was recorded in the healthcare and social protection and education

Table T3-6: Y-o-y indices of nominal net wages

	Informations and communications	Energy supply	Admin. and support service activities
2013,Q1	107.5	96.9	106.1
2013,Q2	105.9	107.1	94.5
2013,Q3	122.6	112.5	94.6
2013,Q4	115.1	103.7	106.8
2014,Q1	124.7	106.3	85.3

Source: *QM*

Observed by business activities, as can be seen in Table T3-7, net wages in Q4 2013, compared to the previous quarter, increased in eight out of nineteen sectors. The highest growth of 2.5% was realised in mining, professional, scientific and technical activities, and service industries. It should be borne in mind that the sector of professional, scientific and technical activities includes legal and accounting business, consulting activities, advertising agencies, photo stores, court interpretors and translators, veterinary institutions, but also research and experimental development in social and natural sciences. The last category includes institutes, which are under the jurisdiction of the Ministry of Science and are financed from the state budget, and are therefore subject to solidarity tax. Even though this category also had a decline of net wages in Q1 2014 compared to the previous quarter, it is impossible to observe it considering the diversity of subjects belonging to this category.

Table T3-7. Real seasonaly adjusted net wages

	Mining	Education	Health and social care
2013,Q2	99.7	101.8	103.3
2013,Q3	100.5	99.9	99.6
2013,Q4	98.9	99.7	100.6
2014,Q1	102.5	98.0	96.8

Source: *QM*

In other sectors, the growth of net wages was between 0% and 1.5%. The highest decline of wages of 3.2% in Q1 2014 compared to the previous quarter was recorded in the sector of healthcare and social protection, which is the result of the implementation of solidarity tax as of January 1, 2014. The same decline of wages was recorded in the financial and insurance sector. The net wages in the sector of education dropped 2% compared to the previous quarter, which can also be explained by the introduction of the solidarity tax.

3 This sector is not connected to the public administration, but rather includes activities of rent and leasing, hiring agencies, private security companies, etc.

4. Balance of Payments and Foreign Trade

In Q1 2014 quarterly current account deficit shrank to very low EUR 314 million, or 4.2% of GDP. Small current account deficit and the downwards trend in it mainly came from reduction in trade deficit driven by favorable trends in its components – steep rise in exports (17.7% y-o-y) accompanied by modest rise in imports (1% y-o-y). Thus foreign trade deficit was by 36% smaller in this quarter than in the same quarter last year, and current account deficit narrowed by a half. Worrying trends in the capital account and financial account of the balance of payments continued. Namely, net outflow of capital reached half a billion euros and was caused by net outflow of other investments, continuation of modest inflow of FDI, and almost zero balance of portfolio investments. Forex reserves of the NBS were by EUR 800 million smaller than at the end of 2013 due to this massive net outflow of capital and the current account deficit. Limited rise capacities in car exports and possible decline in exports of food products and agricultural products (caused by floods) will have adverse effects on current account deficit in the following period. On the other hand, economic recovery in the EU and low domestic demand will affect current account deficit favorably. Serbia's foreign debt stood at EUR 25.5 billion (79.8% of GDP) at the end of March 2014, meaning that it was slightly reduced relative to the amount recorded at the end of 2013 thanks to public sector deleveraging (NBS debt repayment to the IMF) and massive debt repayment by commercial banks. Trends in public debt by the end of 2014 will depend on intensity of fiscal consolidation, sources from which fiscal deficit will be funded and borrowing terms and future trends in net borrowing by banks and companies.

Extremely small current account deficit – EUR 314 million, or 4.2% of GDP

The downwards trend in current account deficit detected in the second half of 2012 continued throughout 2013 and at the beginning of 2014. Quarterly current account deficit in Q1 was especially small and stood at EUR 314 million (4.2% of GDP Table T4-1 and Graph T4-2), which becomes obvious when we compare it with its average values in the preceding years: 9.1% of GDP in 2011, 10.8% of GDP in 2012 and 5.0% of GDP in 2013. This trend suggests that 2014 current account deficit will narrow to less than 4% of GDP. However, extraordinary circumstances in the form of floods that hit Serbia in May will have adverse effects on current account deficit in the second half of the year – exports of agricultural products will fall, and imports of durable consumer goods (appliances, used cars) and electricity will rise. Additionally, slowdown in car and petroleum exports, mainly because the current capacities have been reached, and rise in payments in the income account, caused by increased interest payments, will affect the current account deficit adversely. On the other hand, further recovery in Eurozone and implementation of the announced measures for fiscal consolidation, and possible rise in remittances and foreign donations will exert favorable impact on current account.

...mainly comes from reduced trade deficit

Small current account deficit in Q1 2014 and the downwards trend in it mainly came from reduction in foreign trade deficit driven by favorable trends in its components – steep y-o-y rise in exports, accompanied by modest increase in imports (Graph T4-3), and y-o-y rise in surplus in services account, accompanied by y-o-y decline in current transfers.

Trade deficit in Q1 was record-small, as well – it stood at EUR 788 million, or 10.6% of GDP (by 1.8 pp below the average in 2013, and as much as 6.3 and 8.0 pp below the trade deficits recorded in 2011 and 2012 respectively). Thus, for the first time, exports covered more than ¾ of imports. Exports in Q1 reached EUR 2,623 million (35.3% of GDP), while imports totaled EUR 3,411 million (45.9% of GDP). In this quarter services account was in a small surplus by EUR 74 million. Therefore, foreign trade deficit in Q1 2014 ran at EUR 714 million (9.6% of GDP) and was much below its usual quarterly level. However, in spite of the foregoing reductions in these deficits, they are still large. We therefore think that economic policies (exchange rate policy, control of domestic demand) should work towards further reduction in foreign trade deficit.

Table T4-1. Serbia: Balance of Payments

	2011	2012	2013	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1
				mil. euros				
CURRENT ACCOUNT	-2,870	-3,176	-1,586	-625	-290	-160	-510	-314
Goods	-5,318	-5,480	-3,979	-1,151	-1,005	-685	-1,138	-788
Export f.o.b[1)]	8,440	8,726	10,956	2,235	2,685	3,089	2,946	2,623
Import f.o.b[1)]	-13,758	-14,205	-14,934	-3,386	-3,690	-3,774	-4,084	-3,411
Services	163	156	334	34	79	90	131	74
Export	3,032	3,104	3,423	698	826	948	951	793
Import	-2,869	-2,948	-3,088	-664	-747	-857	-820	-719
Income, net	-758	-799	-1,095	-190	-244	-362	-299	-222
Receipts	428	539	486	102	146	110	128	90
Payments	-1,186	-1,338	-1,580	-291	-389	-472	-427	-312
Current transfers, net	3,043	2,947	3,153	681	879	797	796	623
o/w grants	206	151	131	30	32	30	39	33
o/w private remittances, net	2,065	1,934	2,160	457	630	554	518	378
CAPITAL ACCOUNT	-3	-11	11	-2	9	4	0	2
FINANCIAL ACCOUNT	2,694	3,019	1,395	605	235	62	493	300
Direct investment, net	1,827	242	771	158	139	224	250	146
Portfolio investment, net	1,619	1,720	1,920	1,405	-347	-123	984	-4
Other investments	1,049	-80	-598	-98	-443	-202	145	-642
Trade credits	493	518	401	68	12	39	282	-131
Loans	-413	-442	-1,227	-368	-291	-53	-514	-391
NBS	45	-219	-658	-150	-148	-180	-180	-189
Government	687	209	433	162	42	273	-44	-71
Commercial banks	-729	-475	-714	-308	-43	-169	-194	-210
Long-term	419	-321	-482	-179	-1	-48	-253	-153
Short-term	-1,148	-154	-232	-129	-41	-121	59	-58
Other (enterprises)	-416	43	-288	-72	-142	22	-96	80
Currency and deposits	970	-156	228	203	-165	-188	377	-121
Other assets and liabilities	0	0	0	0	0	0	0	0
Allocation of SDR	0	0	0	0	0	0	0	0
Reserves Assets (- increase)	-1,801	1,137	-697	-859	886	164	-887	800
ERRORS AND OMISSIONS, net	179	168	179	22	46	94	17	12
OVERALL BALANCE	1,801	-1,137	697	859	-886	-164	887	-800
PRO MEMORIA								
				in % of GDP				
Current account	-9.1	-10.8	-5.0	-8.4	-3.5	-1.9	-6.3	-4.2
Balance of goods	-16.9	-18.6	-12.4	-15.4	-12.3	-8.3	-14.1	-10.6
Exports of goods	26.8	29.6	34.3	29.9	32.8	37.5	36.5	35.3
Imports of goods	-43.6	-48.1	-46.7	-45.3	-45.0	-45.8	-50.5	-45.9
Balance of goods and services	-16.3	-18.0	-11.4	-14.9	-11.3	-7.2	-12.5	-9.6
Current transfers, net	9.7	10.0	9.9	9.1	10.7	9.7	9.9	8.4
	31,534	29,516	31,986	7,477	8,195	8,233	8,081	7,439

Source: NBS

1) Exports and imports FOB, according to the NBS methodology adjusted to IMF BOPM-5.

2) Quarterly values. Conversion of annual GDP to euros was done based on average annual exchange rate (average of official daily middle exchange rates of the NBS).

Rise in payments in the income account caused by interest payments

Net outflow of EUR 222 million was recorded in the income account. This considerable net outflow was caused by rise in expenditures on interest payment on portfolio investments and other investments, primarily based on public expenditures. We expect that interest payment will push up expenditures, and consequently widen the income account deficit in the following period.

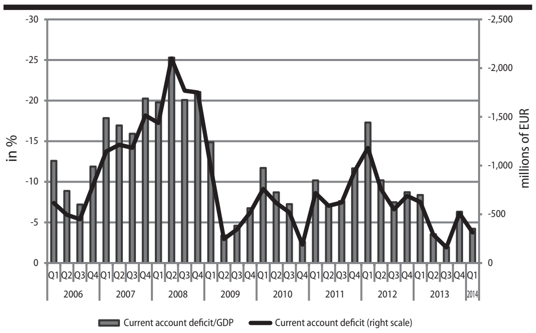
Slight decrease in remittances and current transfers, probably caused by seasonal variations

Net inflow of current transfers stood at EUR 623 million, or 8.4% of GDP in Q1 2014. Remittances accounted for EUR 378 million of this amount. Remittances and current transfers were slightly below their average amounts partly due to a real drop in inflow of these items, and partly due to seasonal variations – which cause a decline in inflow of remittances and current transfers at the beginning of every year (Graph T4-5). Taking into account the *insurance hypothesis* [1](defined in Kapur, 2003), we expect that the flood consequences will push up the inflow of funds

1 The fact that remittances represent a kind of "insurance" to citizens, because under macroeconomic shocks in a country, inflow of remittances rises, for more detail see Kapur, D. "Remittances: the New Development Mantra? ", paper from G-24 Technical Group Meeting, August 2003.

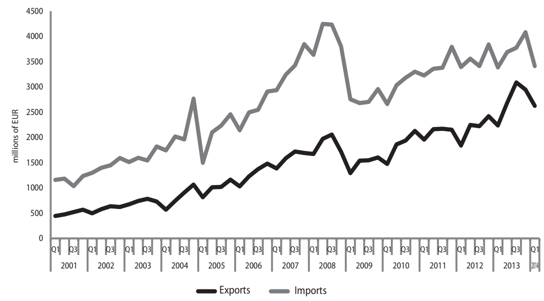
sent by the Serbian diaspora in the following period[2]. Therefore, 2014 remittances will probably be somewhat above its average annual amount.

Graph T4-2. Current account deficit, 2006-2014



Source: NBS, *QM*

Graph T4-3. Imports and exports of goods, 2001-2014

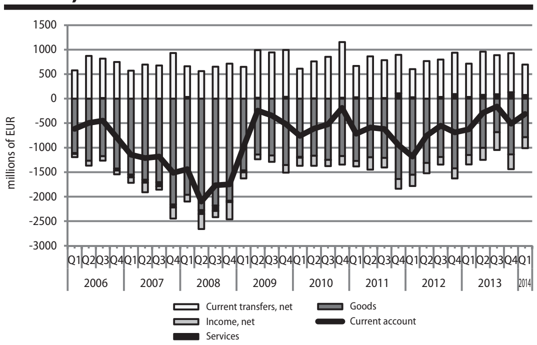


Source: NBS, *QM*

Current account deficit in Q1 2014 by 50% smaller than in Q1 2013

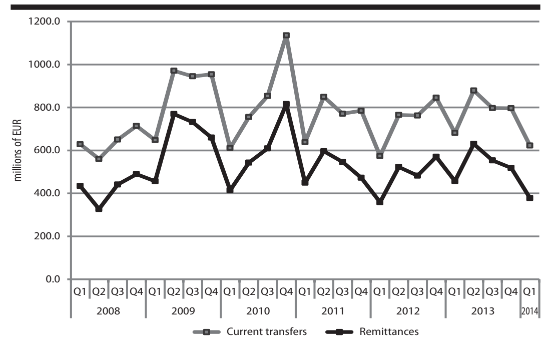
Current account deficit in Q1 2014 narrowed by ½ compared with the same period last year. This primarily came from the continuation of the downwards trend in foreign trade deficit driven by a very small trade deficit. Foreign trade deficit and trade deficit in Q1 were below the last year's level by 36% and 32% respectively. Exports grew by 17% and imports rose by only 1% in the same period. Exports of road vehicles take a small share of the total rise in exports in the analyzed period, meaning that the total exports were primarily driven by exports of other goods (rise in exports excluding road vehicles stands at 14.6%)[3]. Remittances suffered a y-o-y drop of 17%, which caused 9% decrease in current transfers.

Graph T4-4. Current account and its components, 2006-2014



Source: NBS, *QM*

Graph T4-5. Inflow of current transfers and remittances 2008-2014



Source: NBS, *QM*

Net outflow of capital in Q1 stands at half a billion euros

Favorable trends in current account deficit were accompanied by adverse developments in the capital account and financial account of the balance of payments. Namely, net outflow of capital reached EUR 499 in Q1, which is the fourth in a row quarterly capital account deficit from the beginning of 2012 (see Graph T4-6). We therefore think that this is not a one-off decline but a trend driven by adverse developments in international environment, growing risks and absence of reforms in Serbia. To reverse this trend, the Government must adopt and then properly implement a sustainable fiscal consolidation program, and carry out sweeping economic reforms. Massive net outflow of capital and current account deficit pushed down the forex reserves of the NBS by EUR 800 million relative to the amount recorded at the end of 2013 (Table T4-1).

... net outflow of other investments, modest inflow of FDI and zero balance of portfolio investments

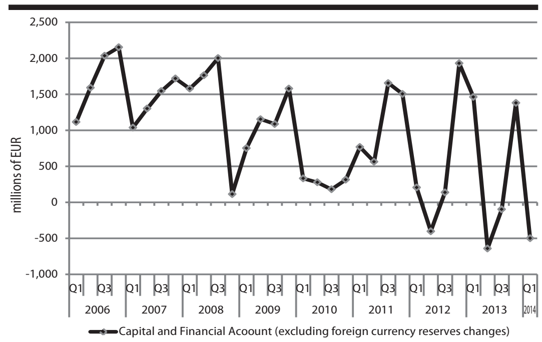
Capital outflow was driven by outflow of other investments, still modest inflow of FDI, and almost zero balance of portfolio investments (net outflow of EUR 4 million). Such developments

2 Increased inflow of remittances to Serbia during the recession caused by the global crisis in 2009 and 2010 supports this hypothesis, for more detail see Janković, I. and M. Gligorić: "The remittance inflows' impact on savings in the Serbian economy", in the forthcoming edition of Journal of Economic and Social Development, Vol.1 No.2, 2014.

3 See the next chapter in this text.

in portfolio investments can be attributed to the Fed's tapering of quantitative easing. Although Serbia's credit rating was downgraded, country risk premium did not increase – it even fell in Q1 (measured by EMBI index), and went up slightly in April[4] - because investors had positive expectations about the new Government and the announced measures for fiscal consolidation. Reforms and fiscal consolidation are therefore necessary to raise this initial confidence. Otherwise, the confidence will be lost. FDIs are still low and stand at EUR 146 million. Taking into account the trends detected in 2013 and 2014 and Ukraine crisis, as a direct cause of the delay in construction of the South Stream pipeline, it is quite reasonable to expect that FDI in 2014 will fall below the last year's level (EUR 771 million, or 2.4% of GDP). Fiscal consolidation measures and economic reforms, even if implemented strongly this year, will have lag effect on FDI. Net outflow of other investments amounted to EUR 642 million. This was caused by negative balance of its all components. There was a net outflow in trade credits of EUR 131 million, net outflow in loans of EUR -391 million and net outflow in *Currency and Deposits* of EUR 121 million.

Graph T4-6. Capital and financial account, 2006-2014



Source: NBS, *QM*

The largest capital outflow comes from repayment of financial loans, primarily repayment of NBS debt and banking sector debt

Data shows that the largest net capital outflow came from repayment of financial loans. The Loan account has been showing negative balance since Q1 2012. The largest net outflow in Q1 2014 was recorded on Commercial banks account, for both long-term and short-term debt repayment. Additionally, the NBS forex reserves fell by EUR 189 million on account of debt repayment to the IMF. Furthermore, public sector debt was reduced by EUR 71 million, which is a net outcome of settlement of due liabilities arising from the old and new loans (loan for Corridor 10 and loan from EIB for development[5]). Business sector net borrowing from foreign creditors stood at EUR 80 million in the analyzed quarter.

Forex reserves fell by EUR 800 million at the end of March relative to the end of preceding quarter

Forex reserves fell by EUR 800 million at the end of March relative to the amount recorded at the end of 2013. Forex reserves fell by EUR 149 million in January, EUR 281.8 million in February and EUR 369.4 in March. April[6] saw a slight rise in the NBS forex reserves of EUR 19.3 million. The National Bank of Serbia intervened in the forex market intensively by selling securities worth EUR 800 million in the first three months of 2014 and by purchasing them in April. A part of forex reserves outflow came from repayment of the foreign debt of the NBS and commercial banks, meaning that their net asset position did not deteriorate. However, unlike the NBS whose deleveraging is desirable, deleveraging of commercial banks is not welcome because it implies reduction in credits to enterprises (see chapter on monetary policy).

Exports

Steep rise in exports continues at the beginning of 2014

Steep rise in exports continues at the beginning of 2014. Export totaled EUR 2.63 billion in Q1 and was by 17.7% higher than in the same period last year (Table T4-7). However, unlike the preceding quarters, rise in exports in Q1 2014 was not driven by rise in car and energy exports, but mainly by increase in exports of other goods. As expected, export of FIAT cars and petroleum products has been quite exhausted, i.e. it probably reached its full capacity. Graph T4-8 shows the exhausted growth in road vehicle exports – export value is steady at EUR 400-500 million, and y-o-y growth rate is very close to a single digit percentage.

4 Inflation report, p. 18 and 19.
5 Inflation Report, NBS, May 2014.
6 http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=7089&konverzija=no http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=7181&konverzija=no http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=7250&konverzija=no http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=7301&konverzija=no

Increasing variety of goods for export

Y-o-y rise in exports excluding road vehicles reached 14.6%. It started in the second half of 2013 and was driven by good agricultural yields and low base for comparison (2012 draught pushed down the exports of these goods to a quite modest level), as well as gradual recovery in the EU, as Serbia's major export partner.

Cars and petroleum products are no longer the drivers of export growth

Rise in *Energy* exports slowed considerably relative to the preceding quarters. This probably indicates that the effects of investments previously made by NIS have been exhausted. Slight slowdown in exports of *Intermediate goods* detected in the mid 2013 continued. Likewise, exports of *Capital products* slowed slightly relative to the preceding quarter, and when compared with the first three quarters of 2013, the slowdown is considerable, because car production reached its full capacity, and its limited contribution to total exports was exhausted.

Recovery in Eurozone has favorable impact on exports, while floods and Ukraine crisis affect it adversely

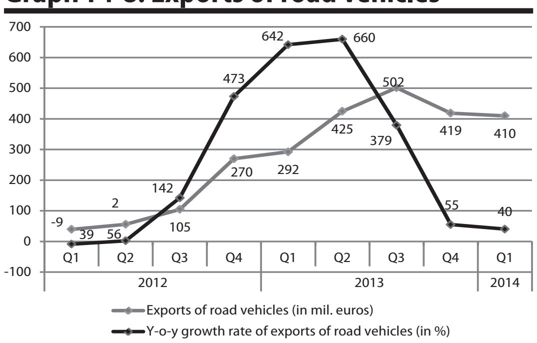
Exports of *Capital products* excluding road vehicles rose in Q1 2014 relative to the preceding quarter, and y-o-y rise reached 11.50%. Additionally, rise in exports of *Non-durable Consumer Goods* in this quarter was steeper than in the preceding one (y-o-y rise of 12.4% in Q1 2014, relative to 10.3% in Q4 2013). On the other hand, rise in exports of *Durable Consumer Goods* was slower than in each individual quarter of 2013 and stood at 22.9%. Although exports of goods classified under *Other exports* fell slightly, its y-o-y growth rate is still high and stands at 25.7%. This is especially important if we take into account a large y-o-y decrease in exports of these goods in the first two quarters of 2013 (Table T4-7). Recovery in Eurozone will boost exports of the foregoing groups of products in the following period, and on the other hand, floods and Ukraine crisis will have adverse but limited impact on them.

Table T4-7. Serbia: exports, y-o-y growth rates, 2011–2014

	Exports share in 2013	2011	2012	2013	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1
	in %	in mil. euros								in %				
Total	100.0	8,441	8,822	11,047	2,236	2,728	3,125	2,958	2,632	20.1	19.5	38.5	22.2	17.7
Total excluding road vehicles	85.2	8,253	8,352	9,410	1,943	2,304	2,623	2,540	2,227	6.6	3.4	22.0	18.0	14.6
Energy	4.7	310	303	521	94	131	145	151	98	47.0	53.6	125.3	68.2	4.8
Intermediate products	33.4	3,980	3,187	3,691	798	981	1,012	901	911	8.0	11.7	24.5	18.8	14.2
Capital products	27.0	1,001	1,667	2,983	570	761	859	793	720	112.8	108.3	109.4	27.2	26.3
Capital products excluding road vehicles	12.2	813	1,197	1,346	278	337	358	374	310	21.6	8.7	17.0	5.9	11.5
Durable consumer goods	4.7	347	395	524	99	136	142	147	122	26.9	35.9	33.8	32.5	22.9
Non-durable consumer goods	21.8	2,118	2,230	2,410	501	560	675	674	564	4.9	3.1	12.8	10.3	12.4
Other	8.3	686	1,039	917	173	160	292	293	218	-26.2	-48.8	10.7	28.0	25.7

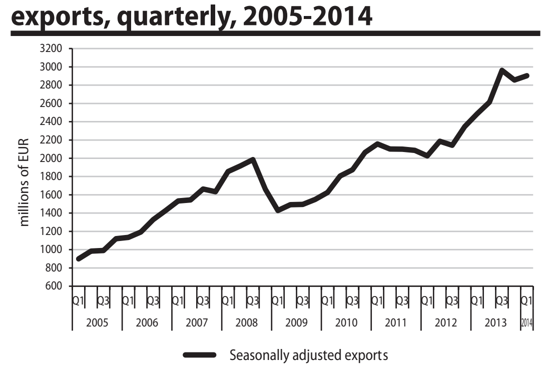
Source: SORS

Graph T4-8. Exports of road vehicles



Source: SORS, *QM*

Graph T4-9. Serbia: seasonally adjusted exports, quarterly, 2005-2014



Source: NBS, SORS, *QM*

Seasonally adjusted values confirm highly favorable trends in exports

Analysis of seasonally adjusted export values confirms the strong rise in exports (Graph T4-9). Analyzed from this aspect, exports grew by 1.7% relative to the preceding quarter, or by 7% annually. This quarterly seasonally adjusted export exceeded its highest value recorded just before the crisis (Q3 2008) by almost a half – it was by 46.3% above the pre-crisis level.

If the growth rate of exports and imports remained unchanged by the end of the year (quarterly rise in exports of 17.7% and quarterly rise in imports of 1%), export would amount to EUR

13.1 billion, and imports would total EUR 16.5 billion. Coverage of imports by exports would thus increase to 83%. However, flood consequences could temporarily stop the rise in this ratio, because exports of agricultural products will fall and imports of durable consumer goods and electricity will increase.

Imports

Q1 saw a modest y-o-y rise in imports of 1%

Imports of goods in Q1 2014 grew by extremely modest 1% y-o-y and totaled EUR 3.54 billion (Table T4-10). This modest rise mainly came from declining domestic demand and stagnant economic activity. Import value of all individual components of imports, excluding *Other imports*, fell compared with Q1 2013. The sharpest drop was detected in imports of *Durable Consumer Goods* (-10.7% y-o-y) and *Energy* (-7.6% y-o-y).

Table T4-10. Serbia: imports, y-o-y growht rates, 2011-2014

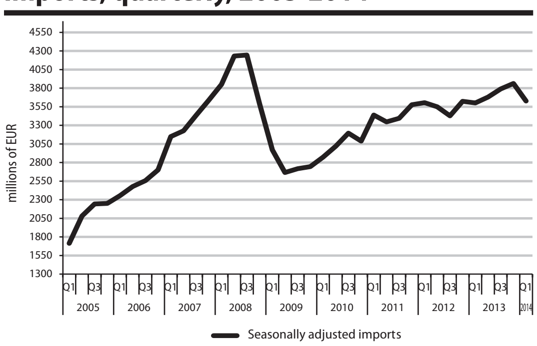
	Imports share in 2013	2011	2012	2013	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1
	in %				in mil. euros							in %		
Total	100.0	14,250	14,771	15,459	3,509	3,822	3,913	4,215	3,543	-0.4	3.2	10.1	5.6	1.0
Energy	15.0	2,846	2,583	2,323	532	485	563	742	491	-34.9	-12.3	5.3	9.5	-7.6
Intermediate products	32.5	5,030	5,131	5,031	1,164	1,292	1,321	1,254	1,145	0.6	-6.5	1.5	-2.9	-1.6
Capital products	23.4	2,812	2,994	3,624	799	931	913	982	790	25.4	25.2	25.7	10.7	-1.0
Durable consumer goods	2.0	320	322	303	77	77	70	79	69	-0.1	-7.0	-12.9	-3.4	-10.7
Non-durable consumer goods	14.3	2,176	2,168	2,206	510	539	558	599	494	7.4	4.1	1.3	-4.1	-3.2
Other	12.8	1,066	1,573	1,972	428	498	489	558	554	18.6	17.2	35.7	30.5	29.4
Imports excluding energy	85.0	11,404	12,189	13,136	2,978	3,336	3,350	3,472	3,052	10.0	5.9	11.0	4.8	2.5

Source: SORS

Import value of all individual components of imports, excluding Other imports, is lower than in Q1 2013

Energy imports are at a very low level as of mid 2012, when domestic capacities were renewed, i.e. when considerable investments in Serbian oil production were made. Consequently, rise in imports exclusive of energy has been much faster than rise in total imports for almost two years. Accordingly, imports excluding energy rose by 2.5% in Q1 2014 relative to Q1 2013.

Graph T4-11. Serbia: Seasonally adjusted imports, quarterly, 2005-2014



Source: NBS, SORS, *QM*

Imports of *Intermediate products* are still low, and by 1.6% below the last year's level. This can be attributed to continuation of modest recovery in domestic production. Y-o-y decline in imports of *Capital Products* by 1% can be attributed to large base for comparison and the fact that car production reached its full capacity. Fall in imports of *Durable* and *Non-durable Consumer Goods* is in accordance with the projected low domestic demand which is not showing signs of recovery. Only imports of products classified under *Other Imports* grew by 29.4% y-o-y.

Seasonally adjusted values indicate a fall in imports

Seasonally adjusted values indicate a fall in imports. Imports in Q1 2014 fell by 6.1% compared with Q4 2013. Graph T4-11 shows that the post-crisis rise in imports value is very modest compared with the steep rise recorded before the crisis. Such trends in imports still keep imports value much below the level reached just before the crisis – it is by as much as 14.5% below its highest value recorded in Q3 2008. Low level of domestic demand is the major cause of a slow recovery in imports after 2008.

Foreign debt

Serbia's foreign debt at the end of March 2014 stood at EUR 25.5 billion, or 79.8%

Serbia's foreign debt at the end of March 2014 stood at EUR 25.5 billion (Table T4-12). It was reduced by EUR 338 million compared with the amount recorded at the end of 2013. However, this reduction is temporary, bearing in mind the expected financial needs of the country and further borrowing in the following period. Foreign debt-to-GDP ratio stands at 79.8%, which is by 1 pp below the level recorded three months ago. This reduction in foreign debt in Q1 came from public and private sector deleveraging (by EUR 198 million, or 0.6 pp, and EUR 140 million, or 0.4 pp respectively).

Reduction in public sector foreign debt is temporary

The NBS debt repayment to the IMF contributed to reduction in foreign debt of the public sector. Reduction in private sector foreign debt in Q1 is a net effect of continuation of banking sector deleveraging (repayment of both long-term and short-term loans), on one hand, and enterprises' borrowing, on the other.

Table T4-12. Serbia: foreign debt structure, 2010–2014

	2010	2011	2012	2013				2014
				Mar.	Jun	Sep.	Dec.	Mar.
	stocks, in EUR millions, end of the period							
Total foreign debt	23,786	24,125	25,721	26,722	26,072	25,686	25,842	25,504
(in % of GDP) 4)	*85.1*	*76.5*	*87.1*	*88.6*	*84.3*	*80.8*	*80.8*	*79.8*
Public debt1)	9,076	10,773	12,187	13,483	12,914	12,786	13,173	12,975
(in % of GDP)4)	*32.5*	*34.2*	*41.3*	*44.7*	*41.8*	*40.2*	*41.2*	*40.6*
Long term	9,076	10,773	12,187	13,483	12,914	12,786	13,173	12,975
o/w: to IMF	1,529	1,618	1,389	1,245	1,079	890	697	515
o/w: Government obligation unc	449	459	452	454	447	441	434	436
Short term	0	0	0	0	0	0	0	0
Private debt2)	14,710	13,352	13,534	13,240	13,158	12,900	12,669	12,529
(in % of GDP) 4)	*52.6*	*42.3*	*45.9*	*43.9*	*42.5*	*40.6*	*39.6*	*39.2*
Long term	12,880	12,704	13,040	12,879	12,849	12,719	12,457	12,377
o/w: Banks debt	3,362	3,782	3,672	3,530	3,511	3,463	3,229	3,021
o/w: Enterprises debt	9,518	8,922	9,369	9,348	9,336	9,255	9,227	9,355
o/w: Others	0	0		1	1	1	1	1
Short term	1,830	648	493	361	309	180	212	152
o/w: Banks debt	1,731	582	428	303	261	135	171	115
o/w: Enterprises debt	100	66	65	58	47	45	41	37
Foreign debt, net 3), (in% of GDP)4)	49.3	38.3	50.2	49.3	49.8	47.9	45.8	47.2

Note: Foreign debt of the Republic of Serbia is calculated on a due-for-payment basis and includes the amount of debt under principal and the amount of accrued interest which is not paid on the agreed due date.
Source: NBS, QM
Foreign debt of the public sector of the Republic of Serbia comprises government debt (including debt of Kosovo and Metohija under loan agreements concluded before the arrival of the KFOR mission, non-regulated debt towards Libya and clearing debt towards former Czechoslovakia), debt of the National Bank of Serbia, local governments, state funds and agencies, and government-guaranteed debt.
Foreign debt of the private sector of the Republic of Serbia comprises debt of banks, enterprises and other sectors which is not government-guaranteed.
Foreign debt of the private sector does not include loan agreements concluded before 20 December 2000 in respect of which no payments are made (EUR 838.8 million, of which EUR 384.7 million relating to domestic banks and EUR 454.1 million to domestic enterprises).
Total foreign debt reduced by NBS forex reserves.
Sum of the GDP value in the analyzed quarter and quarterly GDP values in three preceding quarters is used.

Overall foreign debt reduced by EUR 1.22 billion relative to the same period last year

Overall foreign debt was reduced by EUR 1.22 billion relative to the same period last year (the end of March 2013). This reduction is temporary, bearing in mind the expected financial needs of the country and further borrowing (primarily by public sector) in the following period. The reduction was mainly driven by private sector deleveraging – 58% of reduction in the overall foreign debt came from private sector deleveraging, and the rest came from public sector deleveraging (42%). Private sector foreign debt was reduced by EUR 711 million compared with its amount at the end of March 2013 primarily due to banking sector deleveraging (totaling EUR 698 million of which: EUR 509 million on long-term debt repayment and EUR 188 million on short-term debt repayment), while the enterprises deleveraging totaled only EUR 14 million (EUR 21 million reduction in short-term debt, and a slight increase of EUR 7 million in long--term debt). Public sector foreign debt was reduced by half a billion euros at the end of March 2014 relative to the same period last year. This reduction exclusively came from the NBS debt repayment to the IMF (in the amount of EUR 730 million in this period).

Foreign debt dynamics will depend on fiscal deficit funding and net borrowing by banks and enterprises

Rise in overall foreign debt in the following period will depend on rise in public sector foreign debt through which the fiscal deficit will be funded. However, further borrowing will depend on how persistently the Government will implement the announced fiscal consolidation measures, but also on borrowing conditions, restructuring and possibly privatization of some state-owned companies. Additionally, continuation of the upwards trend in enterprises' borrowing abroad could cause rise in overall foreign debt. On the other hand, further NBS debt repayment to the IMF and continuation of the current trends in banking sector deleveraging will reduce the amount of foreign debt.

5. Prices and the Exchange Rate

In 2014 inflation has moved around the lower limit of the NBS target band and at the end of April amounted to 2%, which is below the range of the corridor of 2.5% to 5.5%. Low domestic demand and a stable exchange rate of the dinar are still the most important factors that influence the maintenance of inflation at an extremely low level in comparison to normal values in Serbia. Relatively high January inflation was of temporary character, given that it was caused by one-off changes in the special VAT rate and excise duties, as well as the seasonal increase in the food prices, and then, this price leap in January was mitigated by low inflation and deflation over the next few months. In the following months it is not expected for inflation to exit the limits of the target band (especially not above the upper limit), taking into account the steady movement of the dinar exchange rate, the expected real decline in wages, pensions and expenditures on goods and services (and the consequent reduction in domestic demand) and a slowdown in economic activity. The movement of the nominal dinar exchange rate, and in particular depreciation pressures at the beginning of the year were, in 2014, partly a consequence of global factors and partly a consequence of economic imbalances and risks, as well as the suspense concerning the parliamentary elections. Bearing in mind the NBS commitment to sustain the foreign exchange rate at a relatively stable level by intervening in the interbank market, as well as the expected inflation movement within the target band, in could be expected that the movement of the nominal and real dinar exchange rate will be stable.

Prices

During Q1 and in April, inflation was around the lower limit of the NBS target band

Slowdown in inflation and its movement within the limits of the target band, which was achieved in late 2013, was continued in the first quarter of 2014. Since inflation reached the target level in September, it has stabilized and its value has moved around the lower limit of the target band, with occasional drops below the target range (table T5-1, Graph T5-2). Such a movement marks the longest period since 2010 during which the inflation moved within (or below) the target limit. However, as the band limits were then at significantly higher values than today, this certainly represents the longest time period with a stable low inflation. Low inflation was contributed by the stable dinar exchange rate, low domestic demand, low imported inflation and further implementation of the restrictive monetary policy, with a very slow mitigation of restrictiveness (even though inflation in April amounted to 2%, the key policy rate was reduced in the

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

	Consumer price index				
	Base index (avg. 2006 =100)	Y-o-y growth	Cumulative index	Monthly growth	3m moving average, annualized
2008					
dec	122.7	8.6	8.6	-0.9	4.4
2009					
dec	130.8	6.6	6.6	-0.3	1.6
2010					
dec	144.2	10.2	10.2	0.3	11.7
2011					
dec	154.3	7.0	7.0	-0.7	2.5
2012					
mar	157.4	3.4	2.0	1.1	8.4
jun	162.4	5.4	5.3	1.2	13.2
sep	169.1	10.3	9.6	2.3	17.7
dec	173.1	12.2	12.2	-0.4	9.9
2013					
mar	175.1	11.2	1.2	0.0	4.7
jun	178.2	9.7	2.9	1.0	7.3
sep	177.3	4.8	2.4	0.0	-2.0
okt	177.6	2.2	2.6	0.2	2.3
nov	176.5	1.6	2.0	-0.6	-1.8
dec	176.9	2.2	2.2	0.2	-0.9
2014					
jan	179.5	3.1	1.5	1.5	4.4
feb	179.7	2.6	1.6	0.1	7.5
mar	179.1	2.3	1.2	-0.3	5.1
apr	180.1	2.0	1.8	0.6	1.4

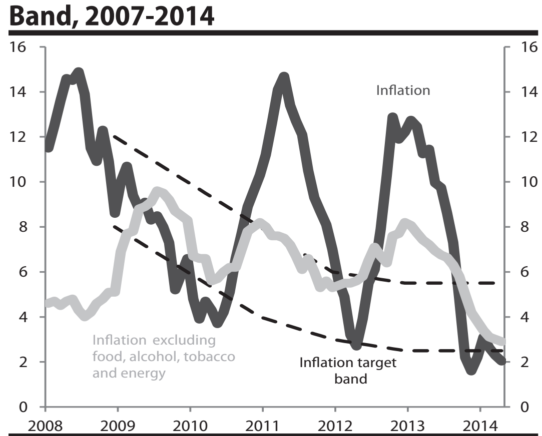
* Three-month moving average of a price growth rose to an annual level. (For example, the March value is obtained by raising the average monthly price growth in January, February and March to an annual level).
Source: SORS.

observed period to still relatively high 9%). Underlying inflation (inflation excluding food, alcohol, tobacco and energy products) is also located within the permissible values and in April, it amounted to 2.9%, which is its lowest level in recent years (Graph T5-2). In the following months inflation is expected to moderately grow and further move within the corridor limits. The inflation growth, in addition to food prices (since last year's base of these prices is at a low level), will be affected by the exit from the account of the last-year's period with relatively high values of monthly inflation, which lasted until June 2013 and the entrance into the period (July--December) when the inflation was on average negative and amounted to around -0.1% on a monthly basis. On the other hand, the expected real drop in the wages and pensions, implementation of fiscal consolidation measures and a slowdown in economic activity will have a disinflationary effect, which will prevent any major price growth.

The gradual relaxation of the monetary policy restrictiveness by the NBS

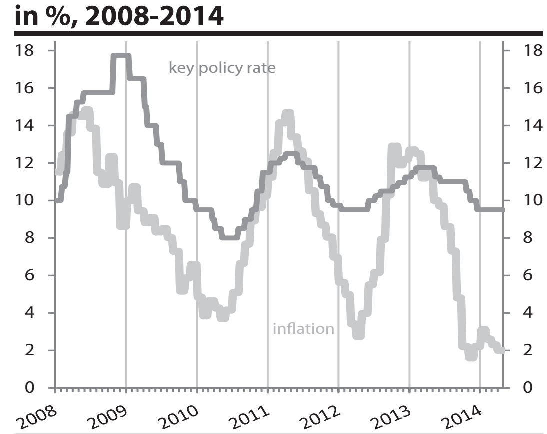
Since the inflation returned within the limits of the target band in September, there was a modest reduction in the key policy rate from a relatively high level of 11%, so at the end of the April it amounted to 9.5% (Graph T5-3), while in early May, it reduced to 9%. Caution of the NBS in keeping the inflation within the limits of the corridor can be explained by the fall of liquidity in the global market (reduction in the volume of quantitative easing by the FED), geopolitical events and Serbia's exposure to movements on the international capital market. In the first quarter of 2014, the key policy rate was kept at the December level of 9.5%, while in May, it decreased to 9%. The current account deficit was significantly reduced and the reduction continued in Q1 (below 4% of GDP), both because of a growth in exports due to the recovery in external demand of major foreign-trade partners, and because of the drop in imports in terms of a drop in domestic demand. The existence of the persistent and growing fiscal deficit and rapid growth of Serbia's public debt, as well as a high level of non-performing loans in the economy continue to create unfavorable conditions for conducting a proper monetary policy of maintaining low inflation, thus more restrictive monetary policy than the one which would be more suitable to the circumstances of such low an inflation must be implemented. Again, it is worth noting that, in order to maintain the macroeconomic stability, a more significant reduction in the restrictiveness of monetary policy by reducing the key policy rate is possible only after solving the problem of structural imbalances- high fiscal and foreign-trade deficit. Until then, we recommend that the NBS, despite present risks, should continue with the cautious reduction of the restrictiveness of monetary policy.

Graph T5-2. Serbia: Y-o-y Inflation Rate and Underlying Inflation and the NBS Target Band, 2007-2014



Source: NBS and *QM* estimates

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



Source: NBS

Low inflation in Q1 and April 2014

After a relatively high inflation in January of about 1.5%, that was, next to seasonal increase in the food price, caused by one-off effects of an increase in a special VAT rate and excise duties, there was a period of a low inflation in February (0.11%) and April (0.56%) and deflation in March of 2014 (-0.33%). Thus, at the end of Q1 inflation stood at relatively low 1.2%, while in April it was 0.6% (Table T5-4). In addition to previously analyzed contributions to inflation in

January (increase in the prices of food, computer equipment, books and other products to which special VAT rate is applied, utilities, as well as petroleum products and tobacco due to an increase in excise duties) in the period January-April a most prominent inflation was in the growth of the prices of fruit (14%, i.e. 0.4pp) and vegetables, whose January growth mitigated March price reduction (overall growth of 13%, or 0.67 percentage points) and the April price increase of postal services (31%, i.e. 0.1pp). Prices of clothes and footwear, after expected seasonal growth at the end of the last year, have continually decreased since the beginning of the year (a total decline of -3.4% and -0.1 percentage points), while a fall in the prices of telephone equipment had a deflationary effect (-9 % and -0.05 pp).

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

	Share in CPI (in %)	price increase in Q1 2014	Contribution to overall CPI increase (in p.p.)	Price increase in April 2014	Contribution to overall CPI increase (in p.p.)
Total	100.0	1.2	1.2	0.6	0.56
Food and non-alcoholic beverages	34.5	1.8	0.6	1.4	0.47
Food	30.9	2.0	0.6	1.4	0.43
Alcoholic beverages and tobacco	7.8	6.5	0.5	-0.1	0.00
Tobacco	4.2	9.6	0.4	0.0	0.00
Clothing and footwear	4.6	-3.2	-0.1	-0.1	-0.01
Housing, water, electricity and other fuels	13.0	0.9	0.1	0.0	0.00
Electricity	5.1	0.0	0.0	0.0	0.00
Furniture, household equipment, routine maintenance	4.1	-0.3	0.0	0.3	0.01
Health	6.4	1.5	0.1	0.8	0.05
Transport	12.3	1.0	0.1	-0.2	-0.02
Oil products	5.1	1.6	0.1	0.0	0.00
Communications	5.0	-1.6	-0.1	1.3	0.06
Other items	12.2		0.0		0.00

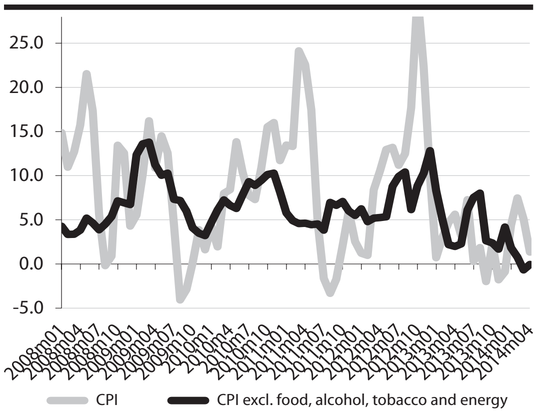
Source: SORS and *QM* estimates

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

Underlying inflation (inflation excluding food, alcohol, tobacco and energy) since the beginning of the year has been held at a steady low level it reached in the late 2013. In April, its three--month average and annualized value amounted to approximately 0% (Graph T5-5). Given that almost the entire inflation growth since the beginning of the year was precisely contributed by the growth in the price of a group of products that are excluded from the underlying inflation, overall inflation was little higher but still relatively low in April (3m average of 1.4%, or 5.5% when annualized). Zero underlying inflation is achieved due to a stable dinar exchange rate and low inflationary expectations of the citizens, economy and the financial sector. The news about decrease in Serbia's credit risk by the Fitch rating agency did not cause the growth of the country risk premium (measured by the EMBI index), since it was compensated by the announcements about the possibility to conclude the arrangement with the IMF and the implementation of fiscal consolidation program following the formation of a new Government of the Republic of Serbia. As a result, the underlying inflation trend hasn't changed and it remained at a low level. After the expected seasonal growth in the prices of fruit and vegetables since the beginning of the year, a seasonal decline in their prices and further disinflationary pressure can be expected in the coming months. The existence of inflationary pressures by the demand isn't expected, since the overall domestic demand will continue to decline due to a planned real fall in government spending (wages, pensions and expenses for goods and services), which would further lead to a decline in demand for goods and services. Extremely high (and still growing) unemployment rate suggests that not even the movement of earnings in private sector will have an inflationary impact, while a one-off effect of the increase in special VAT rates and excise duties, which was relatively modest, is now exhausted. Thus, only the effect of changing the base (exit from the account of last-year's months with relatively high inflation and remain in the account of the months with low and negative inflation) can have the only "inflationary impact" in the future period.

It is not expected that the floods will cause the increase in the prices of agricultural products and overall inflation

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



Source: SORS and *QM* estimates

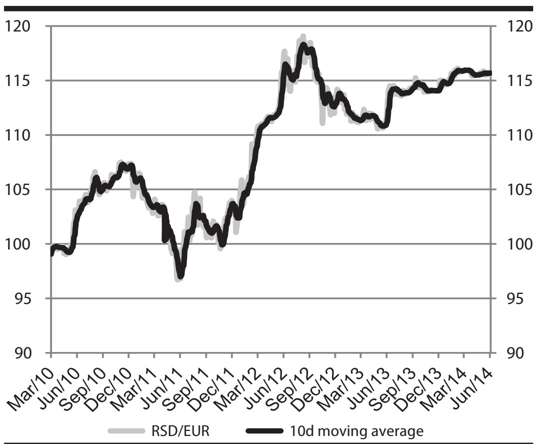
Catastrophic floods that hit Serbia during the second half of May have caused relatively high damage to agricultural production. However, floods have affected a small part of arable land (see Highlight 2), so they will not significantly affect the overall agricultural production in Serbia. In addition, we estimate that the floods will have more influence on the decline in exports than on the growth in the prices of agricultural products. It is possible that the floods will cause the jump in the vegetable prices, but that increase will be limited due to a competitive pressure of imported products.

The Exchange Rate

Relatively stable dinar exchange rate in Q1, April and May of 2014

After a moderate January depreciation, the dinar exchange rate has been relatively stable since the beginning of the year, with minimal fluctuations in the range of 115 to 116 dinars per euro. Such a movement is a continuation of a last year's steady exchange rate movement from September to late 2013 (Graph T5-6), followed by a mild depreciation in January (by about 1.5%) and stabilization with the reacting of NBS (the sale of foreign exchange reserves by mid-March and the purchase from late March to late May of 2014). Since the beginning of the year National Bank of Serbia has continued with the interventions to prevent the excessive daily fluctuations, as well as a mitigation and stopping of a dinar depreciation trend. It, therefore, counting from the beginning of the period of mitigation of depreciation pressures until mid-March 2014, had a sale of total 820 million Euros, and then, by alleviating relatively weak appreciation pressures, it intervened in the interbank market by buying 150 million Euros until the end of May. In this way, it prevented the cancellation of desirable effects of a mild dinar depreciation and additional weakening of the competitiveness of the Serbian economy.

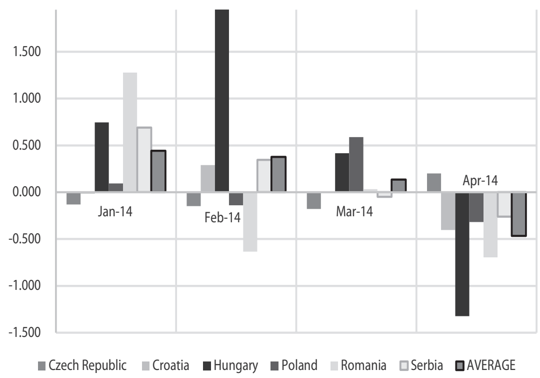
Graph T5-6. Serbia: Daily RSD/EUR Exchange Rate, 2010-2014



Source: NBS

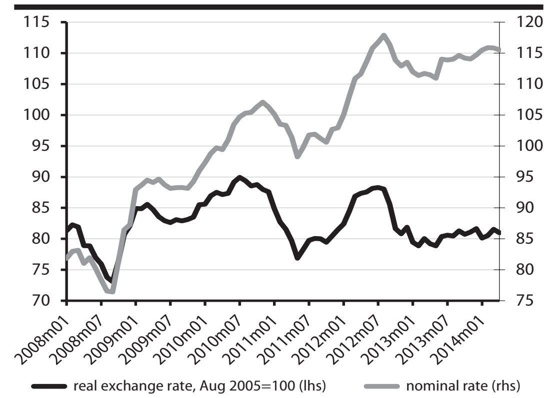
The global factors had the greatest impact on the exchange rate movement since the beginning of the year. The similarity of the exchange rate movement between Serbia and countries of Eastern and Central Europe with a flexible exchange rate regime is especially visible in January and April (see Graph T5-7). Global depreciation pressures in January are largely a consequence of starting a gradual reduction in the volume of quantitative easing by the FED (10 billion dollars per month), which reflected the movement of the exchange rate not only in Serbia, which is due to a large fiscal and moderate external imbalance exposed to impact of the international financial market, but also in most countries with emerging markets. The implementation of FED's decision had only the effect of temporary shock and in the following months the exchange rates stabilized. In April, most countries reported a mild appreciation of the domestic currency, as a result of reduction in the risk premiums in most countries of the region.

Graph T5-7. Nominal Exchange Rate Depreciation in Period of January-April 2014 in Chosen Central and Eastern European Countries



Source: Eurostat, NBS and *QM* estimates

Graph T5-8: Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly Averages, 2008-2014



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

Real exchange rate relatively stable in 2014

Over Q1 the real exchange rate against the euro remained nearly unchanged, mostly as a result of low inflation in Serbia and almost fixed dinar exchanged rate against the euro. The movement of the real dinar exchange rate was mostly influenced by the variations in domestic inflation, which in some months led to a divergent movement of the value of a nominal and real exchange rate, although the changes were not great. Historically looking, the real exchange rate over a longer period (since the late 2012) has had approximately the same index values (Graph T5-8). Bearing in mind the expected future stable movement of the nominal exchange rate (as well as due to a readiness of NBS to maintain the exchange rate at approximately constant level) and relatively low inflation values, one might expect the stable movement of the real exchange rate without large fluctuations in the future.

6. Fiscal flows and policy

Fiscal deficit in Q1 2014 ran at 65.8 billion dinars (about 7.6% of the quarterly GDP), and at the end of April it widened to 81.4 billion dinars, which is above the projections. Fiscal deficit exceeded the projections primarily because the budget revenues fell short of the plan due to a downward revision of the nominal GDP, inflation rate and dinar depreciation below the expected level and failure of the measures against shadow economy to produce the desired effects (there may have even been a rise in shadow economy activities). With the current trends in revenues and announced rise in expenditures, exclusive of flood consequences, and if no fiscal consolidation measures were applied, 2014 fiscal deficit could run at extremely high and unsustainable 8% of GDP. Additionally, flood-caused loss of revenues and rise in expenditures are estimated at about 0.2% of GDP altogether, meaning that without implementation of fiscal consolidation measures 2014 fiscal deficit could grow to 8.2% of GDP. Capital expenditures in Q1 stood at only 1.6% of GDP, meaning that these expenditures take only 1/5 of the fiscal deficit and the rest comes from current public spending. This suggests that the largest share of the current debt burden will be passed on to future generations, which is extremely unfair from the aspect of intergenerational equity. Although the announced fiscal consolidation measures are necessary, they are not sufficient to provide for a sustainable public finance because they will bring savings of 0.3% of GDP at the most, meaning that additional measures aimed at a more dramatic reduction in current expenditures – primarily on pensions and subsidies (including indirect subsidies – below-the-line subsidies) must be implemented. At the end of April 2014 public debt stood at 65.4% of GDP. If no additional measures for fiscal consolidation were implemented, and with other macroeconomic indicators unchanged, public debt could grow to 71-72% of GDP at the end of the year.

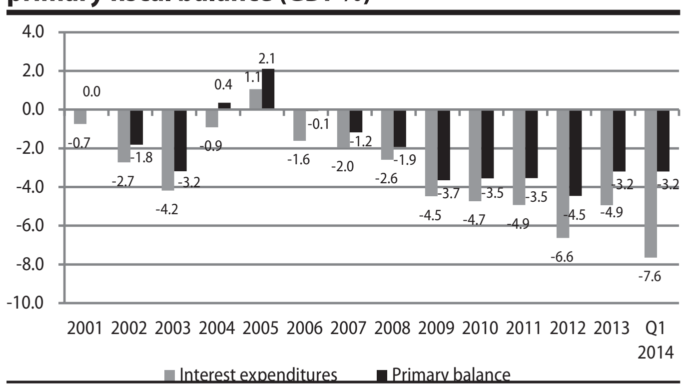
General tendencies and microeconomic implications

In the first four months of 2014 consolidated fiscal deficit exceeded the projections amounting to 81.4 billion dinars

In Q1 2014 consolidated fiscal deficit amounted to 65.8 billion dinars (about 7.6% of the quarterly GDP), and at the end of April it widened to 81.4 billion dinars (about 29% of the projected annual fiscal deficit). This is above the projections, especially because fiscal deficit usually widens more in the last six months under seasonal factors. Fiscal deficit exceeded the targeted level primarily because the consolidated budget revenues in the first four months of 2014 fell short of the plan.

Primary fiscal deficit ran at 3.2% of GDP in Q1 2014

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

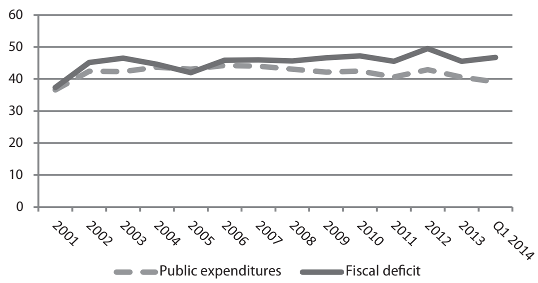


Source: QM calculation

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

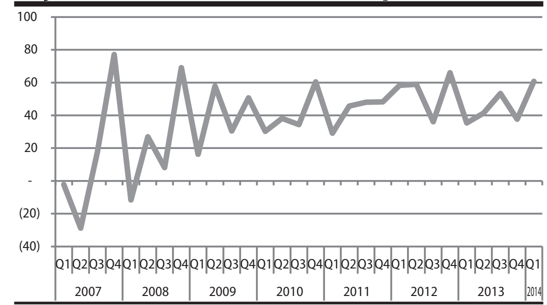
Primary fiscal deficit in Q1 (fiscal deficit exclusive of expenditures on interest payment) stood at 3.2% of GDP, meaning that more than a half of consolidated fiscal deficit came from expenditures on interest payment. Primary deficit in 2013 and in Q1 2014 was somewhat smaller than in the preceding years, but the overall fiscal deficit is growing. This indicates increasing importance of expenditures on interest payment as one of the key drivers of fiscal deficit. If public debt continued growing, fiscal deficit could become self-generating in the future, due to growing indebtedness and consequently tougher borrowing conditions (higher interest rates).

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



Source: QM calculations

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



Source: QM calculations

Without implementation of measures for strong fiscal consolidation, 2014 fiscal deficit will exceed the targeted level considerably – and widen to about 8.2% of GDP

Fiscal trends detected in the first four months show that if other circumstances remained unchanged, public revenues in 2014 could fall short of the plan by about 50-60 billion dinars, due to a number of factors.

...because public revenues fell short of the plan

Public revenues fell short of the projections due to several factors. Firstly, according to the final GDP estimate made by the Statistical Office of the Republic of Serbia (SORS), 2013 nominal GDP is much below the previous estimates. Consequently, 2014 nominal GDP on which the budget projections were based will have to be revised down. Therefore, 2014 public revenues will be by about 0.5% of GDP below the targeted. Systematic disproportion between the SORS's final and preliminary estimates of macroeconomic indicators, reoccurring from year to year, is a large obstacle to good fiscal planning, which suggests an urgent need for improvements in this area of their work. Secondly, inflation slowed significantly in the period January-April - y-o-y inflation was at 2% in April, so it should rise considerably by the end of the year to reach the projected 4.5%, which is quite unlikely. In the third place, nominal dinar depreciation in the period January-April is much below the expected average annual dinar depreciation of 4-5%. And finally, measures against shadow economy failed to produce the desired effects in the period. There may have even been an increase in shadow economy activities and/or tax arrears, due to a growing illiquidity of economy. On the other hand, the announced economic policy (subsidized loans to improve liquidity of economy and similar) will increase expenditures. However, additional savings will be made on some items so the overall expenditures could be somewhat below the targeted. In that case, 2014 consolidated fiscal deficit (exclusive of flood consequences and without implementation of fiscal consolidation measures) is estimated at about 8% of GDP, which is extremely large and unsustainable even in the mid-term.

Flood-caused rise in expenditures and loss of revenues could widen 2014 fiscal deficit by 0.2% of GDP altogether

Flood relief and rehabilitation program that will be funded from the budget and flood-related loss of revenues will widen fiscal deficit even more than expected. Although no accurate flood damage estimates can be made yet, and since large infrastructure rehabilitation projects imply previous preparation of design documentation, selection of contractors etc., it is quite reasonable to expect that these expenditures will be more massive in 2015 than in 2014. A great deal of funds for this purpose can be provided through redistribution of public expenditures, and a part can be raised through donations. A part of tax liabilities shall be written off in the municipalities hit by floods (for example property tax) and the level of economic activity in these areas will go down, which will altogether cause a loss of public revenues. On the other hand, implementation of flood rehabilitation program that will be partly funded from donations could lessen the loss of public revenues. Based on the foregoing, we estimate that floods will widen fiscal deficit by 0.2% of GDP.

The announced fiscal consolidation measures are necessary, but a successful fiscal consolidation requires further reduction in current expenditures – on pensions and subsidies

The announced measures for fiscal consolidation (10% cut in public sector wages, more stringent discretionary expenditures policy (on per diem, official state cars etc.), public sector employee right-sizing, restructuring and privatization of state-owned companies within a reasonable term etc.) are necessary and justifiable but insufficient because they will provide for net savings of only 0.3% of GDP. A package of measures intended to reduce fiscal deficit to the level that would provide for stabilization of public debt-to-GDP ratio in the mid-term (in the next three years) is therefore required. This means that, alongside with the announced measures, additional measures aimed at considerable further, permanent reduction in expenditures – primarily on pensions and financial support to large state-owned and public companies (Srbijagasa, Železare Smederevo and the like), should be applied soon. Without these additional measures, minimum required level of fiscal adjustments to avoid public debt crisis cannot be made.

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

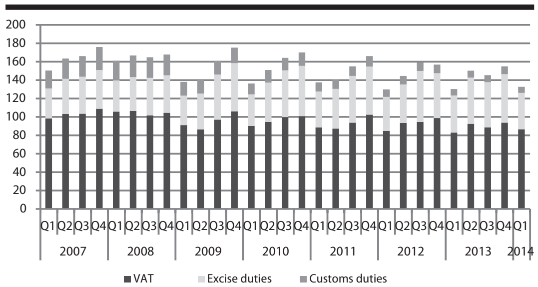
Revenues are going down moderately in the first four months of 2014...

In the period January-April 2014 public revenues went down slightly again – compared with the same period last year they suffered a real drop of 0.9%, and compared with the last four months of 2013 real seasonally adjusted public revenues went up slightly (by 0.7%).

...because revenues from tax on factors of production are falling and growth rate of revenues from consumption tax is below targeted

Drop in public revenues mainly comes from decrease in revenues from tax on factors of production. Additionally, real growth in revenues from consumption tax fell short of projections.

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



Source: QM calculations

Revenues from VAT are below the last year's level

Real seasonally adjusted revenues from VAT collected in the period January-April 2014 rose considerably (by 7.1%) compared with the period September-December 2013. However, compared with the first four months of 2013 these revenues went down (by 1.6%) in spite of VAT rate increase, suggesting continuation (and deepening) of negative trends in these revenues. This is attributed to downward revision of nominal GDP, inflation slow-down, nominal dinar exchange rate depreciation below the targeted, failure of measures against shadow economy, and possible rise in tax arrears.

Excise revenues are going down due to drop in legal sale of excise goods – primarily tobacco products

Seasonally adjusted excise revenues went down moderately in Q1 2014 (by 1.4%) compared with the preceding quarter. However, in the period January-April 2014 real excise revenues went up moderately (by 3.6%) compared with the same period last year, primarily due to somewhat better collection of these revenues in April. Decline in excise revenues, in spite of the regular excise rate increase at the beginning of the year, indicates a drop in legal sales of excise goods caused by real decline in demand for these products (due to lower income and price rise), and possibly by rise in illegal sales of excise goods. Trends in excise revenues by different excise goods show that revenues from excise on petroleum products are rebounding, because the government managed to stamp out illegal sale of base oil, but downward trend in revenues from excise on tobacco products continues, which indicates that the measures against illegal sale of these products were ineffective.

Custom revenues are more stable because the process of foreign trade liberalization is almost finished

In the period January-April 2014 custom revenues went down moderately (by 6%) compared with the same period last year. However, custom revenues (real, seasonally adjusted) went up slightly (by 1.6%) in Q1 (the second quarter in a row) compared with the previous quarter. After years of continuous decline, custom revenues stabilized to some extent, because the tariffs have already been reduced to the level set forth in the Stabilization and Association Agreement with the EU and agreements on avoidance of double taxation signed with other countries, so 2014 saw no significant reduction in tariffs. More stable custom revenues can also be attributed to unchanged dinar exchange rate and moderate real rise in imports (by 1%) compared with Q1 2013.

Real revenues from personal income tax and social security contributions are going down because real income and formal employment are falling

Revenues from personal income tax (real, seasonally adjusted) went down (by 6%) in the period January-April compared with the preceding four-month period, and when compared with the same period last year, there was a sharp real drop in these revenues (by 18.1%). At the same time, real seasonally adjusted revenues from social security contributions went down (by 1.7%) in the first four months of 2013 compared with the preceding four-month period, and when compared with the same period last year, these revenues increased moderately (by 3.9%). This drop in revenues from personal income tax and rise in revenues from social security contributions in the period January-April 2014 compared with the same period last year mainly came from reduction in tax rate for wages and increase in the rate of old-age pension and disability pension contributions in June 2013. Drop in revenues from personal income tax and social security contributions in the first four months of 2014 compared with the last four months of 2013 came from a decline in numbers of formally employed (according to the RAD survey, the number of formally employed in Q1 was by 1% or 17,000 employees below the average in 2013) and reduction in real wages (according to the RAD survey, real wages fell by 2.1% in Q1 2014 compared with the same period last year). Drop in revenues from personal income tax and social security contributions could partly be caused by increase in informal employment.

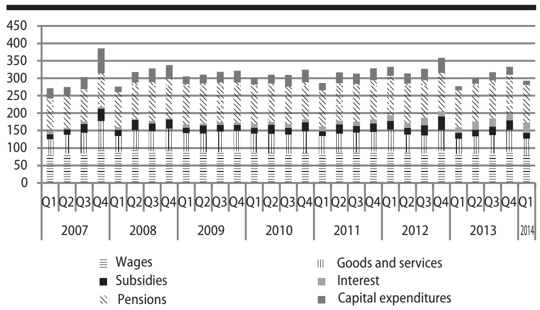
Graph T 6-5. Serbia: Trends in real consolidated seasonally adjusted revenues from tax on factors of production (in 2013 prices)

Source: QM calculation

Revenues from corporate income tax are going down due to change in tax calendar and deteriorating business performance

Real seasonally adjusted revenues from corporate income tax in Q1 went down considerably (by 19.4%) compared with the previous quarter, and in the period January-April these revenues fell slightly (by 1.8%) relative to the same period last year. Drop in revenues from corporate income tax mainly came from changes in tax calendar (as of this year corporate income tax shall be paid in June instead of March), and a much slower y-o-y drop in these revenues confirms this. However, quarter-over-quarter fall in real seasonally adjusted revenues from corporate income tax cannot be attributed to changes in tax calendar, meaning that the drop in revenues from corporate income tax was also caused by deteriorated business performance – decreasing profitability, but also growing illiquidity. Other tax revenues (real) grew considerably (by 16.4%) in the period January-April 2014 compared with the same period last year, primarily thanks to a more efficient use of direct and transferred public revenues by local governments. Non-tax revenues went up slightly (by 2%) during the first four months of 2014 relative to the preceding quarter, primarily due to solidarity tax collection.

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



Source: QM calculations

Public expenditures grew considerably in the period January-April due to rise in expenditures on interest payment, expenditures on goods and services and other current expenditures

Real seasonally adjusted public expenditures went up moderately (by 3.4%) in the period January-April compared with the preceding four-month period, and when compared with the same period last year, rise in these expenditures was somewhat slower (by 2.7%). Increase in public expenditures in this period came from a considerable rise in expenditures on interest payment, goods and services and other current expenditures.

Expenditures on interest payment are growing steeply – because interest on euro-denominated bonds is falling due

Expenditures on interest payment rose considerably (by 24.9%) in the period January-April 2014 compared with the same period last year. These expenditures were much higher than in the last four months of 2013 (exclusive of effects of seasonal factors), as well. Steep rise in expenditures on interest payment came from payment of interest on euro-denominated bonds (falling due in November 2013 and in 2012), with six-month maturity period. Additionally, rising indebtedness of the country and changed interest structure of public debt - share of cheap debt (for example old foreign currency savings) is shrinking in favour of new, expensive loans, are pushing up expenditures on interest payment.

There was a real rise in expenditures on goods and services in the first four months of 2014 (by 6.4%) compared with the same period last year. These expenditures were higher than at the end of 2013, as well (real seasonally adjusted expenditures on goods and services in Q1 2014 went

Expenditures on goods and services are going up – because some previously delayed procurements and payments for procured goods and services have to be executed

up by 4% relative to the preceding quarter). Expenditures on goods and services went up mainly because some procurements and/or payments for procured goods or services that were subject to delay previously had to be done and made in the period, this especially refers to the Health Insurance Fund of the Republic of Serbia. This suggests that fiscal consolidation program cannot count on massive permanent reduction in expenditures on goods and services.

Expenditures on employees are going down slightly, due to public sector hiring freeze and restrictive indexation policy...

There was a real drop in expenditures on employees in the period January-April (by 2.6%) compared with the same period last year. These expenditures went down relative to the preceding quarter, too (real seasonally adjusted expenditures on employees in Q1 were by 3.9% lower than in the last quarter of 2013). This comes from public sector hiring freeze, as of January 2014. Establishment of the register of public sector employees gives the Ministry of Finance a better insight into public sector wage and employment policy, but the mechanisms of direct control (over wage and employment policy in public companies, local self-governments etc.) are still quite poor.

...and expenditures on pensions are higher than in 2013

There was a real rise in expenditures on pensions in the first four months of 2014 (by 0.4%) relative to the same period 2013, primarily due to increase in numbers of pensioners (by about 1%) and strong inflation slowdown. Real seasonally adjusted expenditures on pensions in Q1 2014 were by 1.6% lower than in Q4 2013. This mainly came from abolition of additional payments to pensioners with small pension as of the beginning of 2014.

Capital expenditures are growing because the government is paying off its arrears... but they are still low (only 1.6% of GDP)

Real seasonally adjusted capital expenditures went up steeply in Q1 (by 22.7%) compared with the preceding quarter because the government paid off its arrears. However, capital expenditures in the period January-April 2014 were by 2.1% lower than in the same period last year, meaning that they are still extremely low – these expenditures took only 1.6% of the quarterly GDP in Q1. This means that only 1/5 of fiscal deficit in this period came from expenditures on public investments and 4/5 came from current spending. This suggests that the largest share of the current fiscal deficit burden will be passed on to future generations, which is extremely unfair from the aspect of intergenerational equity and economically inefficient.

Expenditures on subsidies are slowing down, but they could go up in the following period

There was a real drop in expenditures on subsidies in the period January-April 2014 (by 5.9%) relative to the same period last year because some subsidy programs were abolished (investment and employment incentives) and expenditures on subsidies at the local level were reduced. Real seasonally adjusted expenditures on subsidies went up considerably in Q1 (by 11.3%) relative to the preceding quarter, because the ministry of economy of the time almost completely abolished subsidies at the end of 2013, and because some subsidy payments were delayed to keep 2013 fiscal deficit at the targeted level. Revival of certain subsidy programs (on employment, liquidity etc.) suggests that these expenditures could grow in the following period.

Fiscal trends by government levels

Central government runs deficit and other government levels are in surplus, which indicates existence of vertical disequilibrium

Q1 2014 saw continuation of the trend detected in 2013 – central government runs deficit and other government levels (Health Insurance Fund of the Republic of Serbia, Autonomous Province of Vojvodina and local self-governments) are in surplus. Local self-governments had the largest surplus (totalling about RSD 4.6 billion in Q1). This indicates existence of vertical disequilibrium in distribution of funds and competences among different government levels, caused by seasonal factors and remaining effects of 2011 fiscal decentralization. However, to make valid conclusions about the disequilibrium in distribution of revenues and competences among different government levels, effects of abolition of compensation for construction land use and expected flood-caused drop in revenues and rise in expenditures at different government levels must be taken into account.

Table T 6-7. Serbia: Fiscal surplus (deficit) at different levels of government (bn. RSD, current prices)

Year	Budget of Republic	Pension fund	National Employment Service	Health fund	Vojvodina budget	Localself-governments
2010	-108.0	-1.0	-0.1	1.9	-9.6	-11.5
2011	-144.3	0.2	1.3	2.1	-0.7	-15.6
2012	-213.0	-0.4	0.8	4.0	1.1	-0.3
2013	-194.4	-1.2	-0.5	8.7	1.3	6.3
Q1 2014	-78.0	0.3	0.0	4.8	1.8	4.6

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

Central government revenues are rising, and the revenues collected by local self-governments and the Health Insurance Fund of the Republic of Serbia are falling

There was a real rise in central government revenues in Q1 2014 (by 3.3%) relative to the same period last year, and the revenues collected by local self-governmets and the Healt Insurance Fund of the Republic of Serbia fell (by 1.8% and 16.1% respectively). This rise in central government revenues was driven by increase in revenues from VAT and non-tax revenues. The y-o-y decrease in local self-government revenues came from a steep drop in revenues from wage tax (tax rate on wages was reduced in June 2013) and non-tax revenues, cushioned by the rise in revenues from property tax and other tax revenues, which indicates that local self-governments increased their efforts to make up the loss of revenues from wage tax and compensation for construction land use by more efficient collection of own source public revenues.

Rise in central government expenditures, and reduction in local self-governments' spending

Q1 2014 saw a real rise in central government expenditures driven by seasonally massive expenditures on interest payment, increase in expenditures on subsidies, social security and other current expenditures. The Health Insurance Fund of the Republic of Serbia spent more than in the preceding period primarily due to steep rise in expenditures on goods and services, which could be caused by execution of some perviously delayed procurements and payments for procurred goods and services. Sharp drop in local self-government revenues led to a decrease in expenditures at this government level in Q1, primarily through reduction in expenditures on subsidies, capital expenditures, expenditures on state benefits and a slight reduction in expenditures on wages, as a way to adjust to reduced revenues.

The existing system for funding different government levels needs to be reorganized...

Fiscal decentralization made in 2011 is an example of a poorly prepared reform which led to a vertical disequilibrium in distribution of competences and revenues among different government levels and rise in non-productive public spending (on employees, goods and services, subsidies etc.). The disequilibrium in distribution of competences and revenues among different government levels, inconsistent and unpredictable distribution of funds to local self-governments, and the fact that local self-governments do not make full use of their own source revenues and make savings through reduction in local public investments and expenditures on state benefits rather than reduction in other non-productive expenditures (on wages, goods and services and the like) suggest the need for a systemic reorganization of the system for funding different government levels.

...to make all government levels more responsible for collection of public revenues and management of the available funds

This reform in the system for funding different government levels should ensure that all government levels share the burden of the upcoming fiscal consolidation equally and that all government levels are more responsible for collection of their own source revenues and management of the collected funds.

Trends in public debt

Serbia's public debt stood at EUR 20.6 billion (65.4% of GDP) at the end of April 2014

Serbia's public debt grew by EUR 540 million in the first four months of 2014 and stood at EUR 20.6 billion (about 65.4% of GDP) at the end of April 2014. This increase came from the rise in direct debt, while the downwards trend in indirect debt (detected at the end of 2013) continued. Public debt-to-GDP ratio worsened in this period (by 1.7% of GDP) primarily due to rise in absolute amount of public debt, caused by a very small real appreciation of dinar exchange rate in this period, and real GDP growth was too low to improve the ratio. This increase in public debt in the period January-April was smaller than fiscal deficit in the period (which stood at about EUR 700 million) because current fiscal deficit was partly funded from deposits obtained through a massive sale of euro-denominated bonds in November 2013. Decrease in government deposits confirms this (see Monetary flows and policy).

Table T6-8. Serbia: Public debt[1] 2000-2014

	Amount at the end of period, in billions EUR											
	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1 2014	Apr-14
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	12.36	15.07	17.3	17.7	17.8
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	6.5	7.0	7.5	7.6
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	8.6	10.2	10.3	10.2
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.60	2.81	2.8	2.8
III. Total debt (I+II)	**14.17**	**10.28**	**9.38**	**8.88**	**8.78**	**9.85**	**12.17**	**14.47**	**17.67**	**20.1**	**20.5**	20.6
Public debt / GDP[2]	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.6%**	**31.3%**	**41.5%**	**45.1%**	**59.3%**	**61.2%**	**62.3%**	**62.7%**
Public debt / GDP (QM)[3]	**169.3%**	**52.1%**	**37.8%**	**30.9%**	**29.2%**	**34.8%**	**44.6%**	**46.9%**	**60.0%**	**63.7%**	**64.9%**	**65.4%**

Source: Ministry of Finance's data and QM calculations

Portfolio investors are satisfied with the election results... interest rates are going down

Upwards trend in sales of Serbian treasury bills to portfolio investors continued in the period January-May. Additionally, interest rates on treasury bills and bonds fell in April – euro-denominated bonds with maturity period of five years and interest rate of 4.92% were sold at the end of April in the domestic market, which is more than one percentage point lower than the interest rate on euro-denominated bonds sold on international market in November 2013. However, the drop in interest rates and rise in prices of government bonds on secondary market does not indicate that the health of Serbian public finance improved but comes from favourable trends in international capital market (the Fed and European Central Bank's expansionary policy continued), and investors' positive expectations about the new Government, which is, unlike its predecessor, free from political obstacles to reforms.

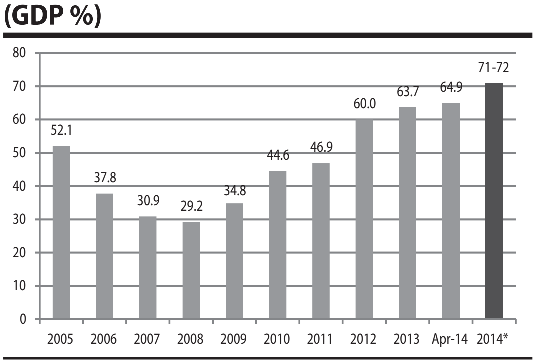
...but without urgent implementation of fiscal consolidation and reforms, interest rates are likely to rebound

However, without strong fiscal consolidation and implementation of the announced structural reforms intended to improve business environment and quality of public services, interest rates will reasonably rebound and/or investors interest in government securities will beging to flag. Interest rates could go up if the Fed and European Central Bank tightened their monetary policy, regardelss of implementation of the announced reforms. However, the rise under this scenario would not be as sharp as under the one first mentioned.

Positive trends in indirect debt are not lasting

Downwards trend in public debt continued in the period January-April. After shrinking by EUR 80 million in Q4 2013, it narrowed by additional EUR 30 million in the period January-April 2014. Although such developments are welcome, because the growth in indirect debt pushed up Serbia's total public debt considerably in the preceding years, this positive trend is temporary because its key drivers (restructuring of Srbijagas, finalization of restructuring of state-owned companies, privatization or closing of Železara etc.) have not been eliminated. Without urgent implementation of measures intended to eliminate the causes of growth in indirect public debt, the savings that will be made through the announced fiscal consolidation will be offset by issuance of additional government guarantees on loans to these companies.

Graph T 6-9: Trends in public debt in Serbia (GDP %)



Source: QM calculations

Public debt will amount to 71-72% of GDP at the end of 2014

If no additional measures for fiscal consolidation are implemented, 2014 fiscal deficit will exceed the projections, and indirect public debt will probably rebound by the end of the year (due to government guarantees on loans to Srbijagas, „soft loans" to Železara Smederevo etc.), and the flood consequences will probably widen fiscal deficit, and with other indicators unchanged (steady GDP, inflation rate at the projected level etc.), public debt could amount to 71-72% of GDP at the end of the year. The announced measures for fiscal consolidation will bring savings of 0.5% of GDP at the most in the current year, and additional measures will not be proposed until October (meaning that they will not produce much effect in 2014). Therefore, fiscal consolidation measures cannot be expected to reduce the public debt below the foregoing level at the end of the year. However, strong fiscal consolidation would produce considerable positive effects on public debt dynamics in the following years.

ANNEX

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

	2008	2009	2010	2011	2012					2013					2014	
					Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Jan-April
I PUBLIC REVENUES	**1,145.9**	**1,146.5**	**1,223.4**	**1,302.5**	**312.6**	**339.7**	**355.1**	**398.0**	**1,405.4**	**330.0**	**362.4**	**369.1**	**406.4**	**1,467.8**	**336.7**	**464.4**
1. Current revenues	1,143.1	1,139.2	1,215.7	1,297.9	311.7	337.7	354.0	390.4	1,393.8	327.3	361.3	367.6	405.0	1,461.3	335.5	461.9
Tax revenue	1,000.4	1,000.3	1,056.5	1,131.0	276.3	298.1	315.6	335.9	1,225.9	296.4	321.8	325.8	352.5	1,296.4	301.9	417.1
Personal income taxes	136.5	133.5	139.1	150.8	35.8	41.2	41.4	46.7	165.3	38.2	39.8	35.9	42.1	156.1	32.2	44.6
Corporate income taxes	39.0	31.2	32.6	37.8	22.9	10.9	10.3	10.7	54.8	18.4	11.0	15.4	15.8	60.7	15.5	21.1
VAT and retail sales tax	301.7	296.9	319.4	342.4	79.7	90.1	94.4	103.3	367.5	87.3	98.7	94.6	99.9	380.6	93.6	128.9
Excises	110.1	134.8	152.2	170.9	34.6	40.6	54.9	51.0	181.1	42.5	53.7	52.3	56.3	204.8	42.9	60.0
Custom duties	64.8	48.0	44.3	38.8	7.7	9.0	9.3	9.8	35.8	7.3	7.9	8.2	9.1	32.5	7.2	9.9
Social contributions	312.7	318.8	323.0	346.6	85.9	94.6	94.5	103.9	378.9	93.4	99.7	107.7	117.6	418.3	99.8	137.9
Other taxes	35.6	37.1	46.0	43.5	9.7	11.7	10.8	10.4	42.6	9.3	10.9	11.6	11.7	43.5	10.7	14.7
Non-tax revenue	142.7	138.8	159.2	166.9	35.4	39.6	38.4	54.5	167.9	30.9	39.6	41.9	52.5	164.9	33.6	44.8
2. Capital revenues	1.4	0.9	0.3	2.0	0.6	1.3	0.8	6.0	8.7	1.9	0.5	0.6	0.5	3.5	0.4	1.5
	0.0															
II TOTAL EXPENDITURE	**-1,195.7**	**-1,248**	**-1,329.9**	**-1,435.9**	**-362.8**	**-391.1**	**-389.2**	**-463.1**	**-1,606.2**	**-364.3**	**-402.6**	**-422.1**	**-445.0**	**-1,633.9**	**-397.2**	**-537.4**
1. Current expenditures	-1,089.6	-1,155	-1,224.8	-1,324.8	-337.5	-368.6	-359.3	-414.6	-1,479.9	-350.9	-385.0	-395.4	-418.6	-1,549.8	-383.4	-517.2
Wages and salaries	-293.2	-302.0	-308.1	-342.5	-85.5	-94.4	-91.2	-103.6	-374.7	-93.8	-98.1	-97.5	-103.4	-392.7	-92.5	-126.9
Expenditure on goods and services	-181.2	-187.4	-202.5	-216.3	-51.2	-62.9	-53.8	-67.7	-235.7	-49.7	-55.3	-60.0	-71.9	-236.9	-55.2	-75.2
Interest payment	-17.2	-187.4	-34.2	-44.8	-15.4	-13.4	-23.3	-16.2	-68.2	-18.9	-27.5	-27.2	-20.9	-94.5	-35.5	-45.7
Subsidies	-77.8	-22.4	-77.9	-80.5	-22.6	-25.2	-19.6	-44.2	-111.5	-19.0	-22.0	-28.4	-31.8	-101.2	-19.4	-25.6
Social transfers	-496.8	-63.1	-579.2	-609.0	-154.9	-161.1	-163.5	-173.0	-652.5	-162.4	-173.0	-172.6	-179.5	-687.6	-170.6	-228.7
o/w: pensions5)	*-331.0*	-556.4	*-394.0*	*-422.8*	*-112.5*	*-117.8*	*-119.2*	-124.1	-473.7	-120.0	-124.6	-125.3	-128.2	-498.0	-125.0	-167.6
Other current expenditures	-23.5	-387.3	-22.9	-31.7	-7.9	-11.7	-8.0	-9.8	-37.4	-7.1	-9.1	-9.6	-11.1	-36.9	-10.2	-15.1
2. Capital expenditures	-106.0	-24.0	-105.1	-111.1	-25.3	-22.5	-30.0	-48.6	-126.3	-13.4	-17.6	-26.7	-26.4	-84.0	-13.8	-20.2
	0															
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**-19.1**	**-20**	**-29.9**	**-24.9**	**-4.7**	**-5.7**	**-2.3**	**-3.9**	**-16.6**	**-3.1**	**-3.9**	**-4.1**	**-1.6**	**-12.7**	**-5.2**	**-8.4**
IV TOTAL EXPENDITURE, GFS (II+III)	**-1,214.8**	**-1,268.3**	**-1,359.8**	**-1,460.8**	**-367.5**	**-396.7**	**-391.6**	**-467.0**	**-1,622.8**	**-367.3**	**-406.5**	**-426.1**	**-446.6**	**-1,646.5**	**-402.5**	**-545.9**

Izvor: QM

Prilog 2. Srbija: međugodišnje realno kretanje konsolidovanog bilansa sektora države[1)], 2008-2014.

	2008	2009	2010	2011	2012					2013					2014	
					Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Jan-Apr
I PUBLIC REVENUES	**3.3**	**-8.7**	**-1.5**	**-4.6**	**1.7**	**4.8**	**-0.8**	**-3.2**	**0.6**	**-5.8**	**-3.2**	**-2.7**	**0.1**	**-3.0**	**-0.6**	**-0.9**
1. Current revenues	3.5	-9.1	-1.5	-4.4	1.7	4.5	-0.9	-4.4	0.1	-6.2	-2.9	-2.8	1.7	-2.6	-0.1	-0.6
Tax revenue	3.7	-8.8	-2.5	-4.1	1.9	5.3	1.9	-4.4	1.0	-4.2	-2.1	-3.4	2.9	-1.7	-0.8	-0.9
Personal income taxes	6.3	-10.8	-3.9	-2.9	4.6	4.6	1.3	-1.6	2.1	-4.9	-12.3	-18.9	-11.6	-12.2	-17.8	-18.1
Corporate income taxes	18.5	-27.0	-3.6	3.9	51.5	39.9	25.4	15.0	35.1	-28.2	-7.9	39.6	44.9	2.9	-18.0	-1.8
VAT and retail sales tax	2.5	-10.2	-0.7	-4.0	-4.0	6.9	0.9	-3.7	0.0	-2.1	-0.6	-6.2	-5.2	-3.8	4.3	-1.6
Excises	0.7	11.6	4.2	0.6	-5.7	-3.0	8.5	-7.0	-1.2	9.5	20.1	-10.9	8.2	5.1	-1.7	3.6
Custom duties	1.8	-32.4	-14.9	-21.5	-18.6	-8.6	-11.4	-17.6	-14.0	-15.3	-20.5	-16.9	-9.3	-15.6	-4.4	-6.0
Social contributions	4.3	-7.0	-6.5	-3.9	4.8	6.1	0.7	-3.4	1.9	-3.0	-4.4	6.7	10.9	2.6	4.2	3.9
Other taxes	-2.3	-4.9	14.5	-15.2	-9.7	7.6	-12.0	-19.2	-8.8	-14.2	-15.6	0.2	10.2	-5.2	12.5	16.4
Non-tax revenue	2.6	-11.3	5.8	-6.1	0.1	-1.1	-19.0	-4.3	-6.2	-22.0	-9.4	2.1	-5.4	-8.7	5.8	2.0
2. Capital revenues	-76.8	-41.4	-66.8	468.2	124.1	259.1	176.7	373.3	304.5	159.4	-63.6	-31.7	-91.3	-63.0	-79.6	-46.1
II TOTAL EXPENDITURE	**4.5**	**-4.8**	**-1.7**	**3.3**	**10.3**	**9.2**	**-2.9**	**1.5**	**4.3**	**-10.4**	**-6.6**	**1.5**	**-5.8**	**-5.5**	**6.2**	**2.7**
1. Current expenditures	6.9	-3.3	-2.2	3.1	8.2	9.3	-1.7	1.4	4.1	-7.2	-5.2	3.0	-1.0	-2.7	6.4	2.1
Wages and salaries	10.9	-6.0	-5.9	0.4	6.6	6.3	-5.7	1.4	2.0	-2.1	-5.7	0.0	-2.1	-2.6	-3.9	-2.6
Expenditure on goods and services		-5.7	-0.3	4.3	9.4	15.0	-2.3	-11.4	1.5	-13.4	-20.3	4.5	4.0	-6.6	8.2	6.4
Interest payment	-2.8	-5.7	-0.3	17.4	48.1	6.6	93.4	23.4	41.9	9.8	86.3	9.5	26.7	28.8	82.9	24.9
Subsidies	-13.3	19.0	40.6	7.4	42.6	56.4	-36.2	82.9	29.1	-24.7	-20.7	35.9	-29.5	-15.6	-0.7	-5.9
Social transfers	10.1	-26.0	13.9	5.8	3.8	2.9	-0.3	-6.1	-0.1	-6.4	-2.5	-1.2	1.7	-2.1	2.3	-0.9
o/w: pensions5)	*9.5*	2.2	-3.9	3.9	*8.4*	*7.4*	*3.1*	*-0.5*	*4.4*	*-4.8*	*-4.1*	*-1.6*	*1.2*	*-2.3*	*1.5*	*0.4*
Other current expenditures	14.9	6.7	-6.1	23.9	-17.1	36.8	12.2	11.8	9.9	-19.6	-29.5	12.4	10.6	-8.4	39.8	38.6
2. Capital expenditures	-4.3	-6.7	-11.8	5.3	48.7	8.3	-14.9	2.3	6.0	-52.9	-29.0	-16.6	-46.7	-38.2	0.9	-2.1
III "OLD" DEBT REPAYMENT, GOVERNMENT NET LENDING AND RECAPITALIZATIONS	**12.3**	**-2.4**	**35.2**	**-25.6**	**-18.3**	**-45.2**	**-54.7**	**-26.3**	**-37.9**	**-41.7**	**-37.6**	**63.2**	**-58.5**	**-29.0**	**66.6**	
IV TOTAL EXPENDITURE, GFS (II+III)	**4.6**	**-4.8**	**-1.1**	**-3.8**	**9.8**	**7.7**	**-3.5**	**1.2**	**3.6**	**-10.8**	**-7.0**	**1.8**	**-6.2**	**-5.7**	**6.7**	

Izvor: QM

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

	Q1 2014/Q1 2013			
	Consolidated budget	Budget of Republic	Health Fund	Local self-governments
A Total public revenues (I)+(II)+(III)+(IV)	**-0.6**	**3.3**	**-1.8**	**-16.1**
I Current revenues (1)+(2)	-0.1	3.3	-2.8	-15.8
1. Tax revenues	-0.8	0.4	-1.7	-13.3
1.1. Customs	-4.4	-3.8	-	-
1.2. Personal income tax	-17.8	-3.6	-	-21.6
1.3. Corporate income tax	-18.0	-16.7	-	-
1.4. VAT	4.3	5.0	-	-
1.5. Excise duties	-1.7	-1.0	-	-
1.6. Property taxes	-	-	-	12.0
1.9.Other taxes	12.5	-3.3	-	31.8
1.10. Social security contributions	4.15	-	-1.7	-
2. Non-tax revenues	5.8	35.8	-51.8	-25.0
II Capital revenues	(79.61)	-	-54.1	-79.6
III Transfers from the other levels of government	-	-	0.6	-5.6
IV Donations	-0.1	-11.0	-	26.5
B Total public expenditures (I)+(II)+(III)+(IV)	**6.2**	**12.3**	**2.8**	**-9.7**
I Current expenditures	6.4	11.3	2.9	-7.9
1.1 Wages	-3.9	2.5	-18.9	-3.6
1.2. Goods and services	8.2	-6.1	30.5	1.1
1.3 Interest payments	82.9	89.2	18.3	4.1
1.4 Subsidies	-0.7	12.3	0.0	-27.7
1.5 Social insurance and social assistance	2.3	18.3	11.0	-17.2
1.6 Transfers to the other levels of government	0.0	1.1	-	-
1.7 Other current expenditures	39.8	67.8	557.8	4.0
II Capital expenditures	0.9	21.1	-57.6	-24.3
III Strategic reserves	0.0	-60.2	-	-39.4
IV Net lending	66.6	66.3	-	-63.5

Source: QM
Indeks potrošačkih cena (Q1/Q1)

7. Monetary Trends and Policy

Inflation has been stable for the past two quarters at about the lower level of the target corridor but the National Bank of Serbia (NBS) is still implementing its restrictive monetary policy. The main elements keeping inflation at a low level are control of the exchange rate and a drop in domestic demand. The strong interventions on the foreign currency market create the impression that the NBS has quietly moved from the model of target inflation and a managed floating exchange rate to a visibly firmer foreign currency exchange regime. There is justification to ask whether it is appropriate to control inflation by keeping the exchange rate almost at a set level in condition of a still high current deficit and outflow of capital? Loans to the economy have continued their two year trend of dropping strongly – at the end of the first quarter the y.o.y. loan drop in real terms stood at –8.3%. The banking sector placement to the enterprises and households saw their greatest quarterly drop of 577 million Euro which was partly caused by the revoking of the license of the Univerzal Bank late in January. Along with the drop in placements to the enterprises and households, domestic banks also recorded a drop in foreign sources for new placements because of the drop in domestic deposits and the repayment of bank debts to their head offices abroad. The negative trends are continuing in the number of bad loans which rose to 22.3% of the overall credit stock in Q1 with all segments of debtors seeing the situation deteriorate.

Centrala Bank: Balance and Monetary Policy

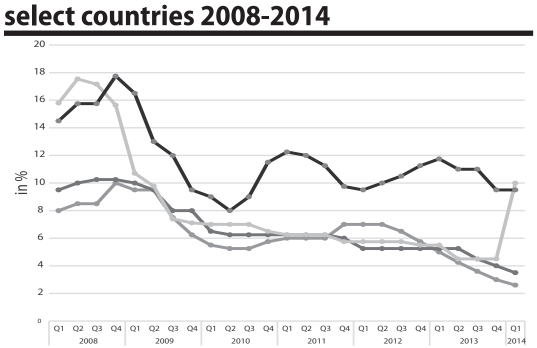
Inflation at low level but monetary policy remains restrictive

Inflationary pressure in the first four months of 2014 was very low, the economy was in stagnation and the credit activities of banks dropped. Despite that the NBS continues to be cautious in relaxing monetary policy. The key policy rate was lowered early in May from 9.5% to 9% and it exceeded the y.o.y. inflation several times over – that inflation rate mainly stood at between 2% and 2.5% in the past six months. Arguments in favor of keeping the restrictive monetary policy in place can be found in the strong depreciation pressure over the first quarter, the high liquidity of banks and worrying tendencies in public finances which the government still has not defined response to. Also, investor confidence in the macroeconomic stability of Serbia is low which is confirmed by the withdrawal of banks from REPO placements in the pre-election period during the first quarter. Business banks lowered their placements in REPO bonds by 183 million Euro in Q1 despite the fact that inflation stood at 2%, the key policy rate at 9.5% and the bank liquidity was high. The funds withdrawn from REPO bonds were used by banks to buy hard currency with the aim of protecting themselves from a possible depreciation of the Dinar. The behavior of the banks showed that their decisions depend of expected trends in the Dinar exchange rate more than on expected inflation and Dinar interest rates.

Despite indisputable risks, a speedier and stronger relaxation of monetary policy is justified

The monetary policy in conditions of high euroization must balance on the sharp edge between inflation control, Dinar exchange rate control and attempts to stimulate credit activities among banks which means economic activity as well. We believe that as long as Serbia has an independent central bank and monetary policy, the NBS besides conducting inflation control, should try to influence credit activity through monetary policy including GDP trends. Considering the fact that inflation has been close to the lower limit of the target corridor with the economy in stagnation and credit activity dropping, we believe that it is justified for the NBS to lower the key policy rate further. It is not certain that a lowering of the key policy rate would

Graph T7-1. Movement of key policy rate in select countries 2008-2014



Source: Central banks of select countries affect the interest rates of business banks but it is fairly certain that it would affect a depreciation of the exchange rate. A moderate depreciation of the exchange rate would cause an increase in inflation within the frameworks of the target interval, deteriorate the balance position of foreign currency debtors but would also caused a delayed improvement of price competitiveness for Serbia and a rise in exports. Given the situation when domestic demand is still significantly greater than the GDP, a rise in exports would be the main stimulator of economic growth on a healthy footing along with a rise in investments. The possibility and need to lower the NBS key policy rate is indicated by comparisons with key policy rates in Euro countries which conduct a policy of target inflation and have a flexible exchange rate (Graph T7-1). Also, the rate used for REPO auctions is 1-2 percentage points lower than the key policy rate which shows that it is possible to lower the key policy rate. Eliminating the difference between the key policy rate and interest rate for auctions would remove the divergent signals the NBS is sending to the market.

Table T7-2. Serbia: NBS interventions and foreign currency reserves 2012-2014

	2012				2013				2014
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
Repo stock (in milions of euros)	1,055.98	111.98	2.29	354.16	678.86	663.82	832.03	966.40	783.96
NBS interest rate	9.50	10.00	10.50	11.25	11.75	11.00	11.00	9.50	9.50
NBS interest rate	1.11	-2.77	-5.74	1.11	6.95	3.31	13.24	10.38	4.38
NBS interest rate	-18.43	-7.27	-6.50	-3.99	19.25	12.85	12.83	9.25	5.28
NBS interventions on FX market (in milions of euros)	-498.50	-1288.80	-1348.30	-1343.30	10.00	-215.00	-140.00	375.00	-800.00
INCREASE					**cumulative, in % of initial M2[1)]**				
NBS own resreves[2)]	-17.6	-45.4	-35.6	-6.0	12.5	7.1	17.9	43.2	-21.4
NDA	2.4	61.3	65.8	41.3	-15.3	-3.9	-16.2	-31.3	1.9
Government, dinar deposits[3)]	-5.1	6.1	4.3	-4.3	1.0	-1.2	-4.7	-19.9	-0.3
Repo transactions[4)]	2.2	53.7	59.3	40.2	-16.0	-14.7	-23.8	-30.7	4.2
Other items , net[5)]	5.3	1.5	2.3	5.4	-0.3	12.0	12.4	19.3	-2.1
H	-15.2	15.9	30.2	35.3	-2.8	3.3	1.7	12.0	-19.5
o/w: currency in circulation	-3.3	-4.0	-1.4	-1.6	-3.9	-0.7	1.0	5.4	-3.6
o/w: excess liquidity	-13.6	-1.6	-1.1	5.4	0.6	2.1	-1.4	4.4	-14.3
					in millions of euros, cumulative from the beginning of the year				
NBS, net	-1070.60	-2087.45	-2383.97	-1050.95	30.01	-992.01	-1041.50	943.97	-230.19
Gross foreign reserves	-1138.11	-2090.09	-2536.57	-1324.15	-385.77	-1576.91	-1822.60	240.33	-344.35
Foreign liabilities	67.51	2.64	152.60	273.20	415.78	584.90	781.10	703.63	114.16
IMF	58.24	-6.44	138.99	258.95	401.14	568.40	759.83	695.60	112.50
Other liabilities	9.27	9.07	13.61	14.25	14.65	16.50	21.27	8.03	1.66
NBS, NET RESERVES-STRUCTURE									
1. NBS, net	-1070.60	-2087.45	-2389.97	-1050.95	30.01	-992.01	-1041.50	943.97	-230.19
1.1 Commercial banks deposits	459.45	740.45	1030.19	907.59	911.80	967.01	1058.25	240.42	-132.58
1.2 Government deposits	263.40	488.43	683.75	28.63	-811.79	47.05	209.55	-359.83	-41.34
1.3 **NBS own reserves**	-347.74	-858.58	-670.03	-114.73	130.02	22.06	226.30	824.56	-404.10
(1.3 = 1 - 1.1 - 1.2)									

Source: NBS.

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

2) Definition of net own reserves NBS is given in section „Monetary trends and policy", Frame 4, *QM* no. 5.

3) Government designates all levels of government: republic level and local government level.

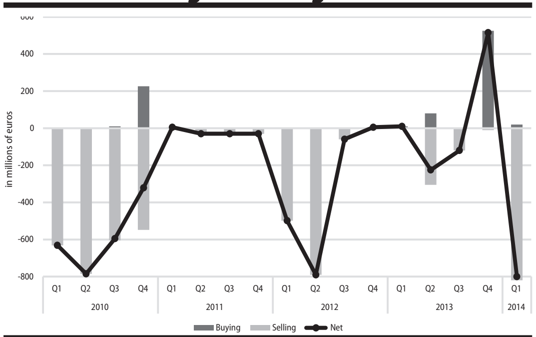
4) This category includes Treasury Bonds NBS (BZ), and repo operations.

5) Other domestic assets net includes: domestic loans (net debts to banks, not including BZ and repo transactions; net debts of enterprises) together with other assets (capital and reserves; and items in balance: other assets) and corrected by exchange rate.

Has NBS informally changed to policy of firmer control of exchange rate?

By observing the inter-bank foreign currency market from the start of this year, we see two periods in which the NBS behaved differently in terms of interventions. In the first period which lasted up to the elections, the NBS intervened strongly by selling hard currency (800 million Euro net) which prevented a weakening of the Dinar. The quick forming of the new government had a positive effect on stopping depreciation pressure and in April the NBS bought 150 million Euro on the inter-bank foreign currency market to decrease the excessive strengthening of the Dinar. Strong interventions on the inter-bank market and a high key policy rate practically blocked the depreciation of the Dinar which indicates that the NBS informally changed from a policy of a managed floating exchange rate to a policy of a stronger control of the exchange rate. In conditions of high euroization, maintaining the exchange rate a an almost fixed level is an efficient way to control inflation but that could prove to be an inadequate policy when that fixed exchange rate is maintained at a level which suits the high deficit in the current account. Persevering with that policy over a longer term means that the NBS is acting in a way similar as the

Graph T7-3. Serbia: NBS interventions on interbank foreign exchange market



Source: NBS

currency board and that monetary policy could have similar advantages and flaws as the ones typical for currency board. The difference lies in the fact that there is no explicit promise to keep the exchange rate at a fixed level which means that the NBS is keeping open the possibility of depreciation, and the price for that possibility is the risk premium for the change in the exchange rate. Bear in mind that in highly euroized economy (as is Serbia's) this risk premium is high even when the possibility of depreciation is not significant.

Due to the extensive interventions aimed at preventing a greater depreciation of the Dinar and the repayment of loans to the International Monetary Fund (IMF), the NBS net own reserves in Q1 recorded a drop of 404 million Euro (in Q4 2013, the net own reserves were increased by 598.26 million Euro). That sale of hard currency on the market caused a drop in primary money levels which in Q1 dropped by 19.55% from the level of the start of the year. That drop was eased minimally by a growth of domestic net assets (NDA) by 1.86% compared to the value of primary money at the start of the year. The growth of the net domestic assets is owed solely to the fact that in Q1 business banks reduced their placements in REPO by 183 million Euro or 4.25% of the primary money at the start of the year.

Monetary System: Structure and Trends of the Money Mass

The money mass M2 has decreased since the start of the year...

... because of a reduction in the Dinar part of the M2

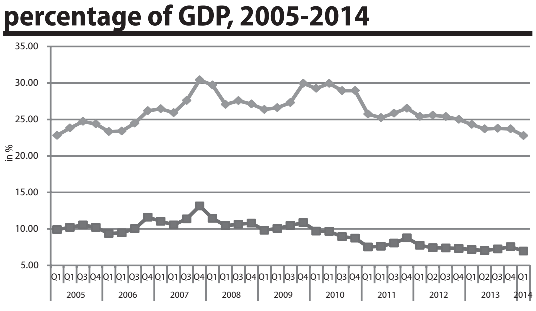
Compared to the level at the start of the year, the money mass M2 recorded a drop of 1.5% in Q1 (a growth of 0.6% was recorded in Q4 2013, Table T7-5), which is due completely to the drop in net domestic assets by 1.6% of the value of M2 at the start of the year. Unlike the previous quarter, the net domestic assets in Q1 recorded a minimal rise of 0.2% which was not enough to compensate fo the drop in the NDS and consequently the M2 money mass. Compared to the same period of the previous year the M2[1] money mass recorded a nominal growth of 4.23% and after a correction by the inflation rate the money mass growth rate stood at a y.o.y. 1.9%. The thing that causes the most concern is the downwards trend in credit to the non-goverment sector which has been evident since mid-2012. That drop has continued without any slowdown and in Q1 it stood at a nominal –6.1% y.o.y. while the real downwards rate is even higher and stands at –8.3% y.o.y. (Table T7-5).

At y.o.y. level the M2 growth rate slowed down to 1.9%...

... while loans to the non-government sector dropped even more to -8.3%

The recorded drop in credit to the non-government sector was caused by the constant drop in credit to the enterprises which in Q1 stood at –15.4% at y.o.y. level. Measures to stimulate credit activity proposed after the new government was formed could partly improve the situation in this segment. We don't know how much these measures can cover all the endangered sectors of the Serbian economy. Namely, to avoid the dominance of political interests over economic logic, decisions to approve subsidized loans will be taken only by business banks on the basis of their own analysis of the credit abilities of potential clients. In terms of efficiency, this is definitely the better option compared to the solution in which the government takes the decision on approving subsidized loans. The government

Graph T7-4. Serbia: money mass trends as percentage of GDP, 2005-2014



Source: *QM* calculation

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

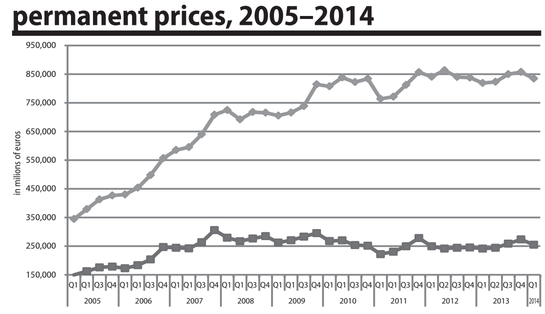
should be included in defining areas where credits should be placed, that is setting the minimum level of funds which have to be placed to small and medium-sized enterprises, investment loans and similar. If that framework is not introduced, business banks could be tempted to approve subsidized loans to big debtors in order to move them to a better category so that their reserves for assessed losses would get lowered. That would mean that favorable subsidized loans would once more go to problematic companies and those loans would not be available to small and medium sized enterprises which are doing health business.

Table T7-5. Serbia: growth of money and contributing aggregates, 2012–2014

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

Source: NBS
1) Money mass: components – see Analytical and Notation Conventions *QM*
2) Loans to non-government sector – loans to enterprises (including local government) and households.
3) Trends corrected by exchange rate changes. Corrections made under assumption that 70% of loans to non-government sector (both households and enterprises) are indexed against the Euro.
4) Initial M2 designates state of M2 at start of this, ie end of previous year.

Graph T7-6. State of money mass in permanent prices, 2005–2014



Source: *QM* calculation

The nominal growth of the M2 of 4.23% at y.o.y. level is due to the growth of M1 by 2.91 percentage points, which explains more than 2/3 growth of the M2. A positive contribution to the growth of M2 came from hard currency deposits with 1.92 percentage points while savings and timed deposits continued their negative influence on the growth of M2 with -.6 percentage points in Q1.

Banking sector: placement and sources of financing

As in the previous year, placements to the enterprises and the households recorded drops which in Q1 stood at 577 million Euro. The overall drop in placements by the banking sector in Q1 is somewhat less and stands at 343 million Euro (in Q1 2013, banks placed 123 million Euro and in the same period of 2012 409 million Table T7-8), and was caused by increased loans to the

The enterprises and households continued repaying off debts in Q1 ...

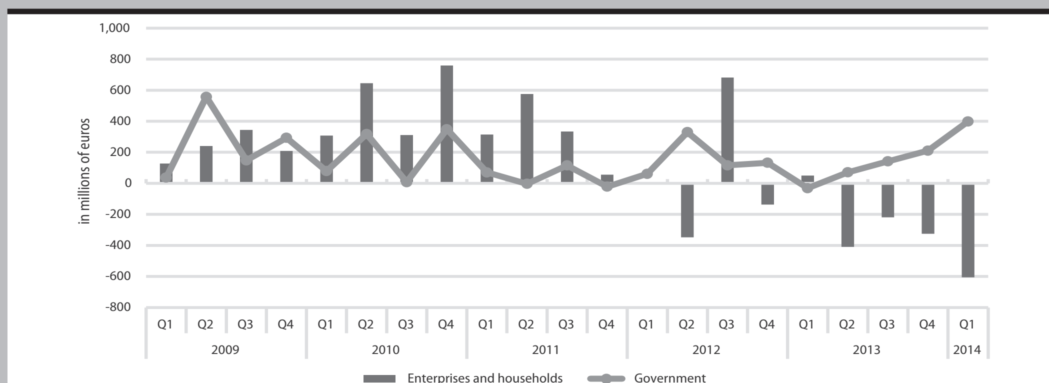
... while the only growth of placement was recorded on the basis of net loans to the government

government in that period. The drop in overall placements is primarily the consequence of the critical state of the enterprises in regard to financial sustainability of operations. Funds to subsidize loans to the enterprises were completely exhausted early in 2013 and the government failed to implement the sorely needed reform of the public sector and regulatory framework to secure conditions for the economy to recover. In virtually unchanged conditions and with no financial injection in the form of subsidized loans for liquidity and turnover funds, the enterprises repaid more than a billion Euro in 2013. That negative trend continued in 2014 when in Q1 alone the enterprises lowered its debts by twice the amount of the average repayments per quarter in the previous year, that is 570 million Euro (in Q4 2013 the enterprises lowered its debts by 312 million Euro which at that moment was a record at quarterly level). The drop in credit activities was due in part to the fact that the Univerzal Bank Belgrade lost its license late in January which meant that its placements were excluded from the balance of the banking sector but even then the rest of the sector recorded a drop in credit activities. Credit placement to the households which increased slightly in 2013 also saw a drop in Q1 by 7 million Euro. At the same time, banks wit-

Frame. Crediting the government and non-government sector

Following the first drop in credit activities due to the effects of the financial crisis in 2008, the Serbian government subsidized loans program quickly showed positive effects in terms of the growth of new placements to the enterprises and the households. However, without reforms in the public sector and a new labor law instead of a return to the old path of economic growth, we only saw a short delay of the inevitable crisis of liquidity. In periods between the end of one and start of a new series of subsidized loans, there was an evident drop in credit activities which shows that the enterprises are unable to take out loans under market conditions and that business banks are not interested in taking some risks and offering better credit conditions (Picture T7-7). The first problems were noticed in 2012 when in Q3 alone the amount of newly approved loans exceeded the debt repayments of the enterprises and households to domestic banks. In 2013, when funds for subsidized loans were completely exhausted, there was a constant negative growth of credit placement. In the past five quarters, the enterprises repaid 1.6 billion Euro more than it took out new loans from business banks.

Picture T7-7. Growth of government loans to the enterprises and households in Serbia 2009-2014.



Source: *QM* calculation

In the same period the net placements to the government were mainly positive. In 2013, placements to the government* increased to reach almost 400 million Euro along with a lowering of the debts of the enterprises in the balance of the domestic banking sector. The increased exposure of the banking sector to the government with a constant growth of bad loans in the economic segment additionally complicated the position of both the state and business banks. Unless the government implements all necessary measures of fiscal consolidation in the coming period there is a latent danger of a public debt crisis which would spill over into the banking sector if the government is unable to service its dues on time.

* Government includes all levels of government: republic level and local government level.

hdrew some 176 million Euro from REPO placements which decreased the overall placement of the banking sector in Q1 even further. Due to the increase of loans to the government by 411 million Euro, the overall drop in credit placements in this period eased significantly but the question is how long the banking sector in Serbia will resist this negative trend in credit withdrawal.

Table T7-8. Serbia: bank operations – sources and structure of placement, corrected[1)] trends, 2012-2014

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

Source: NBS

1) Calculating growth is done under the assumption that 70% of overall placements are indexed against the Euro. Growth for original Dinar deposit values is calculated based on the average exchange rate for the period. For foreign currency deposits – as the difference calculated on the basis of the exchange rate at the ends of periods. Capital and reserves calculated based on Euro exchange rate at ends of periods and do not include effects of exchange rate changes in calculating balance remainder.

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

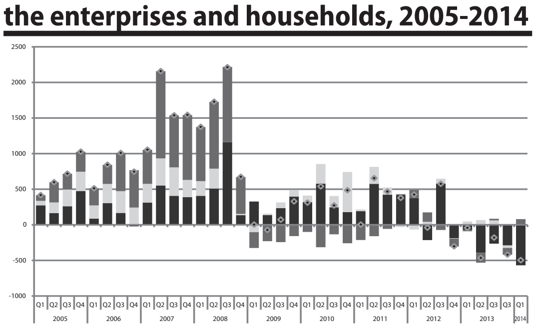
3) Net crediting of the government: credits approved to the government are lowered by the government deposits in business banks; the negative prefix designates a higher growth of deposits over credits. Government includes all levels of government: republic level and local government level.

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

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

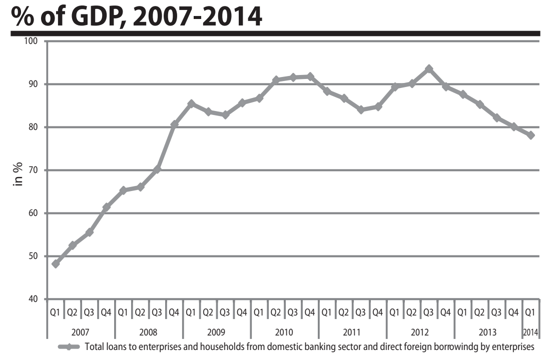
6) Effective mandatory reserve designates participation of mandatory reserve and deposits in sum of overall deposits (households and the enterprises) and bank debts abroad. Basis to calculate mandatory reserves does not include subordinate debt because it is unavailable

Graph T7-9. Serbia: growth of new credit to the enterprises and households, 2005-2014



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

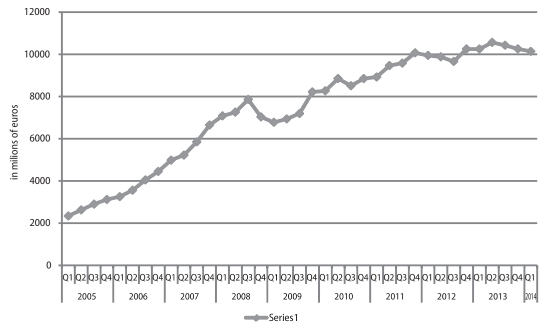
Graph T7-10. Serbia: overall credit debt in % of GDP, 2007-2014



Source: *QM* calculation

The negative trends continued in Q1 in terms of business banks sources for new placements. Although a drop in sources for new placements is characteristic for the start of the year (in Q1 2013 a drop in those sources by 109 million Euro, in Q1 2012 a drop in those sources of 672 million Euro, Table T7-8), there is cause for concern over the fact that in the previous year that trend spread to the entire year. The lowering of sources to finance placement is party due to the drop on the account of domestic deposits by 240 million Euro. That drop was caused by the withdrawal of enterprises deposits totaling 195 million Euro while the remaining 45 million Euro were withdrawn from the accounts of private individuals. In terms of structure, withdrawals were almost completely from Dinar accounts while the foreign currency accounts of the enterprises and households dropped by just 2 million Euro. Sources for new placement in the remaining part were decreased because of the debt repayment of business banks abroad. In 2013, banks lowered their debts to their head offices abroad by 806 million Euro and another 358 million in the first three months of this year. That withdrawal of capital is also an indicator of the confidence of foreign investors who have a much more realistic image of the international position in terms of evaluating the business capacities of the Serbian economy. The decrease in the number of sources for new placements combined with the drop in credit placements means that the domestic banking sector is adapting to a lower level of economic activity and is an additional brake for the already debatable prospects of economic growth in 2014.

Graph T7-11. Serbia: level of foreign currency deposits, 2005-2014



Source: NBS

Table T7-12. Serbia: participation of bad loans by type of debtor, 2011-2014

	2009	2010	2011				2012				2013				2014
	Dec	Mar	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
	balance at the end of period														
Corporate	12.14	14.02	14.39	16.23	17.44	17.07	17.72	19.26	19.04	19.06	22.62	27.77	31.13	27.76	28.67
Entrepreneurs	11.21	15.8	15.66	15.75	16.99	17.07	16.05	18.47	17.56	15.92	16.79	18.19	20.86	20.82	21.11
Individuals	6.69	6.71	6.79	7.1	7.4	7.24	7.57	7.69	8.05	8.32	8.44	8.37	8.14	8.59	8.7
Ammount of dept by NPL (in bilions of euros)	1.58	1.94	2.09	2.46	2.64	2.63	2.67	2.71	2.97	3.19	3.87	4.47	4.82	4.09	4.048

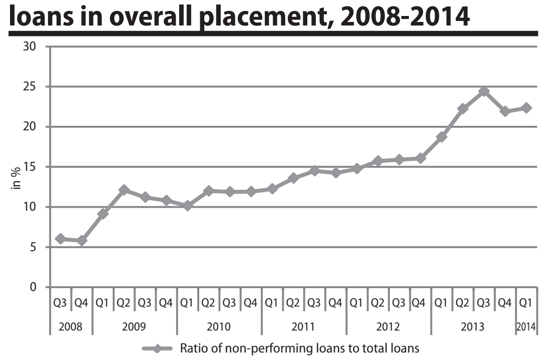
Source: *QM* calculation

Bad loans continue growing …

The revoking of the license of the Univerzal Bank a.d. Belgrade late in January because of the untenable under-capitalization is another indicator of how serious the situation is in the Serbian banking sector and of the problems stemming from bad loans which can no longer be ignored. In Q1 the overall participation of bad loans calculated using QM methodology increased to 22.33% which means that the growth trend which started in 2008 is continuing (Graph T7-13). In the overall structure of bad loans, the greatest contribution came from bad loans to companies which increased by 28.67% (in Q4 2013 that stood at 27,76%, Table T7-12). A somewhat lesser deterioration was noted in the entrepreneur and private individuals segment in which there is no sign that this trend is about to stop. An attempt to decrease the participation of bad loans by relinquishing debts fallen due to persons outside the financial sector obviously was not successful enough. Since there were no better solutions and the Serbian government and NBS were not ready to tackle the problem seriously, it seems that the revoking of the licenses of business banks will become common practice in the Serbian banking system. Solving the problem of bad loans in the banking sector will demand a more active role to be played by the government and NBS not just in creating the regulatory framework but in directly initiating the sale or restructuring of companies which to a large extent generated the rise in bad loans in Serbia.

… with deterioration registered in all three segments

Graph T7-13. Serbia: participation of bad loans in overall placement, 2008-2014



Source: *QM* calculation

8. International Environment

The global recovery is continuing but the developed countries, especially the USA and Eurozone, recorded lower than expected growth in Q1. Financial markets stabilized in developing countries but economic activity continues to be relatively low level. China is implementing structural reforms which have slowed down growth while Russia is probably already in recession because the sanctions imposed by the West. The FED is slowly preparing for the end of its aggressive monetary policy while the European Central Bank (ECB) is doing the opposite and introducing unconventional measures to prevent deflation and a strengthening of the Euro. Inflation is dropping globally. Geopolitical risks are increasing. The US and European Union will probably sign a trans-Altlantic agreement later this year while China and Russia have already signed an energy agreement.

The World

According to the latest International Monetary Fund predictions, the growth rate for the world has dropped slightly (by 0.1 percentage point) for this and the next year. Growth in 2014 should stand at 3.6% and at 3.8% in 2015. There were no changes of predictions for developed countries which should see a growth of 2.2% this year and of 2.3% next year. The predictions for developing countries for 2014 was lowered by 0.2 percentage points to 4.9%. The biggest reduction was for Russia which the IMF says is probably already in recession and instead of the earlier 1.9% it should see a growth of just 0.2% in 2014. The prediction for Eastern Europe was lowered from 2.9% to 2.4%.

The IMF defined the three currently greatest dangers to global growth – possible negative effects on growth of low inflation in developed countries, increased risks in developing countries and a higher level of geopolitical risks. The danger of low inflation (and even deflation) is the highest in the Eurozone while the risk of capital fleeing and slower growth is a trait of developing countries with high current and budget deficits. The geopolitical situation is growing more complicated and the relations of the West with Russia and China are deteriorating. Namely, the trans-Atlantic agreement will probably more deeply integrate the US and EU while Russia and China and have signed an energy agreement. Financial markets in the developing countries have stabilized temporarily and the outflow of capital has been stopped but growth continues to be relatively low level.

East European countries suffered the negative consequences of the continuing crisis in the Ukraine but those were less than expected. There were no higher costs of loans because of the geographic proximity of the Ukraine. Moreover, the opposite happened but for different reasons: since the interest rate on state bonds were lowered on the outskirts of the Eurozone, investors looked for higher income and raised the demand for state bonds in Eastern Europe which caused a drop in the cost of loans in the region. Also, the rise in the GDP in Eastern Europe in the first quarter was higher than predicted. Favorable credit conditions and a faster growth of the GDP meant that many states sold bonds with a longer due date to improve the time structure of their public debt. Risk assessment agencies increased the ratings of several East European countries.

The recovery in Eastern Europe could have a positive effect on Serbia's exports but the continuing crisis in the Ukraine could have a negative effect on the Serbian economy. The first negative effect of that crisis on the Serbian economy is the uncertainty over the construction of the Southern Stream gas pipeline. The construction of the Southern Stream was to have been one of the biggest investments in Serbia this year but the delay will have a negative effect on overall investments and will weaken the already low level of economic activity. If the Ukrainian crisis does not end soon, we can expect rising EU and US pressure on Serbia to impose sanctions on Russia. From the point of view of the economy, choosing one side or the other in the Ukrainian crisis would mean that Serbia faces a choice of two bad options – worsening relations with the EU and US or deteriorating relations with Russia.

The Eurozone

The GDP growth rate in Q1 in the Eurozone was less than expected (0.2%). Growth was slow in Italy (-0.1% q/q), Portugal (-0.7% q/q) and the Netherlands (-1.4% q/q). Germany recorded the fastest growth (0.8% q/q), France stagnated (0% q/q) and Spain recorded a higher rate than expected (0.4%) and continued its recovery. A divergence appeared again in the growth by country but that is most probably temporary. The divergence was caused by the mild winter and in places construction activity was high while energy production was low. That caused the growth in the Netherlands to be low since that country's energy sector is significant while the construction industry showed increased activity in Germany because of the good weather. However, Germany is expected to see a drop in exports because of the slowdown in China and the looming recession in Russia. And it wasn't only the weather that defined results. In Spain, domestic demand was strong and growth speeded up while in France, because of fiscal consolidation, private spending was low. The slowing of growth in the Eurozone, especially in Italy, is a bad signal because it will have a negative effect on Serbia's exports.

The ECB lowered the key policy rate from 0.25% to 0.15% and the rate on bank deposits with the central bank from 0% to –0.1%. Both measures were expected because they had been announced earlier but their effects are uncertain since deposits are at a low level while the key policy rate was already close to zero even before the changes. Cheap credit was offered to commercial banks and the sum will be defined by the amount of credit which commercial banks place with companies. Unlike the FED, the ECB cannot simply implement quantitative easing. First, the choice of country from which bonds will be bought is a political issue and second, the mechanism of quantitative easing would have less effect in the Eurozone because companies are financed through banks and not through the financial market. What is more important than those measures is the fact that the ECB lowered the predicted inflation rates, sending a signal to investors to make realistic assessments of the risk of deflation and that it will react to prevent the consequences. That ECB policy prevents the Euro from growing stronger but for now the ECB is not buying unconventional measures such as buying bonds because that is certainly not necessary yet. Overall inflation in the Eurozone dropped in the first quarter and then rose slightly in April. But, in May it dropped again to just 0.5% at annual level which is far below the 2% target. Services inflation had the highest value (1.1%) while the prices of energy and industrial goods stagnated in May (0%). Base inflation dropped from 0.7% in April to 0% in May.

Unemployment in the Eurozone dropped slightly from the start of the year from 11.8% in January to 11.7% in April. The lowest was in Austria (4.9%) and Germany (5.2%) while the countries on the outskirts saw unemployment start to drop – Greece (26.5%), Spain (25.1%) and Portugal (14.6%). The Eurozone saw the trend of dropping unemployment rates among the working population continue and it dropped from 70.3% at the start of the crisis to 68.3% in 2013 while the unemployment rate for the segment of the population between the ages of 55 and 64 constantly rose. The cause of that is the increasingly low level of youth employment. The European Union 2020 strategy plans to increase the average employment rate to 75%. The lowest employment rate is in Greece (53.2%) and the highest in Sweden (79.8%).

In Q1, the Eurozone trade balance surplus stood at 43.9 billion Euro which is just 0.2 billion less than in Q4. The continued slowing of exports and imports in Q2 lowered predictions of growth in the Eurozone.

The United States

For the first time after three years, the US has recorded a negative quarterly growth rate – 1.0%. Personal spending was at a similar level as in the previous quarter but the drop in supply was significant as did the negative effects of net exports. Private citizens are maintaining their level of spending with lower savings which means that once the labor market recovers and personal income increases, they will have to save more and the recovery will be at a lower level than planned to date. Exports have dropped and imports have risen slightly so that net exports in Q1 lowered the growth rate by 0.9%.

Economists expected weak growth primarily because of low temperatures and accumulated supplies in Q3 but that low level of growth was a surprise. All growth components, except for personal spending, showed negative growth. Cause for concern comes from the slowing down of business investments and the construction sector. Data will show soon whether the slowing down is just temporary as most economy experts thing or if it means a end of the recovery. Unlike economists, investors are fairly skeptical and that is shown by the interest rate on 10 year US bonds which has dropped from 3% to under 2.5%. The difference in perception is easiest to demonstrate with the fact that no economist covered by a Bloomberg poll has predicted that the rate will be under 3% by the end of the year and the fact that the average prediction was 3.25%. Time will tell whether the caution of the investors was justified and if the economists are right in regard to the continuing recovery, the people who have been buying bonds since the start of the year will suffer losses. The US FED continued lowering the monthly amounts of bond purchases in Q1 and is expected to discontinue this unconventional measure by the end of the year. It is uncertain when it will start raising its key policy rate and investors want that to be as late as possible with the market reacting negatively to a statement by the FED chief that the key policy rate could be raised six months after the end of quantitative easing. Overall inflation in the US has started rising and in April it stood at 2% with the same trend present in base inflation which rose from 1.6% in February to 1.8% in April.

Unemployment dropped from 6.6% at the start of the year to 6.3% in April which is the lowest rate in the past five and a half years but the participation of the labor market is the lowest since 1982 for the workforce aged 25 to 54, the age span when they are the most productive. That situation is complicated by the FED policy which can no longer just be defined by unemployment and inflation rates in a situation when participation is at a very low level. Unless there is an increase in participation on the labor market, personal spending will not be able to support the growth of the GDP. It is possible that the raising of the key policy rate will be postponed until participation on the labor market increases.

The trade deficit is growing and in April it stood at 47.2 billion Dollars which is the highest deficit since April 2012. Imports are rising while exports stagnate because of the slowdown in Europe and China.

Central and Eastern Europe

Croatia recorded a negative GDP growth rate (-0.4%) at annual level in the first quarter which is the 10th consecutive quarter in which the Croatian GDP has dropped. Short term indicators show a rise in exports, a drop in imports and continued weakening personal and investment spending. Fiscal consolidation is lowering personal spending, investments are not recovering and export growth is modest with the recent floods cutting down agricultural production. Croatia is also recording a slight deflation during the first quarter (April and March –0.1%, February –0.2%) but no negative effects are expected from the drop in prices because that is probably a passing occurrence since it was caused mainly by the drop in prices of raw materials on the world market. Liquidity is at a sufficient level in Croatia and there will probably be no further lowering of the key policy rate. Structural reforms to raise competitiveness are needed to bring the country out of recession better than stimulation of aggregate demand by lowering the key policy rate. The Fitch and Moody's agencies lowered their prediction ratings into the negative because public finances are in danger due to low growth levels and the lack of reforms. Despite that, a successful auction of 8 year bonds worth 1.25 billion Euro, instead of the planned one billion, was held in May thanks to investor interest.

Hungary had a GDP growth rate of 3.5% at annual level in Q1 primarily because of strong industrial production and construction. The processing industry showed a growth of 9.6% and construction of 25.2%. EU funds eased the realization of infrastructure work. Hungary has no problem with inflation (in that country inflation in Q1 was close to zero), the national currency the Forint has grown stronger, investors are interested in state bonds and since the ECB will lower its key policy rate conditions will be created for the Hungarian Central Bank to continue its aggressive reduction of the key policy rate. The central bank lowered its key policy rate from 2.7% in February to 2.4% in May, cutting it down in several installments. We can expect the key policy rate to be brought down to the level of 2.2% but the aggressive monetary policy will probably be discontinued at the end of the year. The Forint has strengthened against the Euro. The S&P Agency upgraded its prediction rating for Hungary from negative to stable. The unemployment rate is expected to rise by 0.2 – 0.3 percentage points (it stood at 8.1% in April) because the government program of public works, which is an instrument of social policy, is ending.

The GDP growth rate in Romania stood at 3.8% at annual level in Q1 which is the highest growth rate in the European Union. The causes of that high rate are a recovery of personal spending and net exports. The Romanian central bank will probably start lowering the rate of mandatory reserves because of low inflation to stimulate credit for companies in the domestic currency. In April, loans in domestic currency rose by 6.1% at annual level. Romania has managed to successfully place 30 year Eurobonds and has increased the average due date of its debt. The national currency the Leu reached its highest level last summer (4.4 Leu to the Euro). The S&P Agency raised Romania's rating to the level of investment grade and the Moody's Agency changed its prediction rating from negative to stable because the external debt and budget deficit are being reduced. During a visit by US Vice-president Joe Biden, an agreement was reached on wider cooperation with the aim of increasing American investments in the Romanian economy because the US investor presence in the country is very low.

HIGHLIGHTS

Highlight 1. First steps and the announced economic measures of the Government

Milojko Arsić

Elements of the Government's economic program are contained in the expose of the Prime Minister, later statements of the Prime Minister and members of the Government and also in first adopted laws and sub-laws. Announced economic measures can be grouped into four interrelated areas: fiscal consolidation, public sector reform, improving economic environment and antirecession measures. General assessment is that the announced fiscal consolidation is not sufficient and that additional savings measures are needed. Public sector reform, excluding a few exceptions, has not yet been developed and so the evaluation of the Government's plans is not possible. So far, the announced economic reforms are the most ambitious, but these first need to be operationalized through laws and then implemented. When it comes to antirecession measures the authors feel that the announced programs of mass construction of cheap housing and subsidized loans, with certain adjustments, are generally well placed, while the continuation of generous subsidies for employment and investments, as well as tax breaks for new employment, are neither economically efficient nor fiscally sustainable. In order to revers unfavourable economic trends in public finances and the economy of Serbia it is necessary for the Government to adopt additional measures of fiscal consolidation, realize announced economic reforms and prepare, and then implement the public sector reforms.

Postponement of the IMF visit from June to September indicates that there are still significant differences between the Government and the IMF with regard to economic policy and reforms. Considering the scale of problems Serbia is facing, support for the IMF and other international organizations is necessary to avoid a debt crisis, and there are strong arguments in favour of concluding a stronger arrangement with the IMF.

1. Fiscal consolidation

The Government has planned high fiscal deficit of 7.1% of GDP for 2014, which is the highest planned fiscal deficit in Europe. High fiscal deficit and fast-growing public debt present the biggest macroeconomic risks in Serbia, which directly affect growth of interest rates, net outflow of foreign capital from Serbia and thus also insufficient investments and absence of economic growth.

Already in the period of adoption of the budget it was clear that the fiscal deficit could be somewhat higher because there were strong signals that GDP will stagnate instead of a planned growth of 1%, and it was unlikely that the planned additional revenues from combating the grey economy will be realized in the year when the parliamentary elections are held. Lower inflation than planned and growth of tax debts due to the financial problems in companies influenced the additional fall in revenues and via this the growth of deficit in relation to a plan. Based on the trends from the first four months we have estimated that the fiscal deficit in 2014 will amount to around 8% of GDP. Floods which Serbia faced during the second part of May (more detail on effects of floods in Highlight 2) will have direct effect on the decline in tax revenues of about 0.2% of GDP and will also probably influence a rise in total expenditures, and as a consequence the fiscal deficit in 2014, without additional measures of fiscal consolidation, will be over 8.2%.

The Government's representatives, in the first month, have announced the measures for fiscal deficit reduction, but also measures which will affect its growth. The most important measures for fiscal deficit reduction are the reduction of public sector wages, fight against the grey economy and elimination of unproductive spending. Taken as a whole these measures will contribute to the fiscal deficit reduction in 2014 of 25-30 billion dinars (about 0.7-0.8% of GDP). Reduction of public sector wages by 10% starting from the middle of 2014 for now represents the most important measure of savings, which by the end of the year would bring savings of about 12 billion dinars. However, the net effect of these measures will amount to 7-8 billion dinars due to the fact that simultaneously with the reduction of wages a solidarity tax is being abolished. If in the second half of the year decisive measures are taken to combat the grey economy, the increase in revenues on that basis of about 10 billion dinars can be expected. Due to the extension of the deadline for restructuring of the companies certain savings will be achieved in the retirement benefits, but in this case it is merely a transfer of expenditure from this to the coming year.

In the first few months the Government adopted several measures for elimination of unproductive spending in public sector, such as a reduction in costs for company cars, reduction in official travels and other savings on goods and services. Mentioned savings individually observed have more symbolic significance while their cumulative balance significance is modest. However, it

The impact of timing and delays on the effects of fiscal consolidation

In the expose of the Prime Minister and also later statements from the members of the Government it was announced that the savings measures, but also programs which will as a consequence have additional expenditures (different kinds of subsidies, etc.), will be put into effect by the middle of the year. The estimate of the effects of the fiscal policy was done considering this, still not valid, official announcement. However, in early June unofficial information appeared in the media that the planned savings will be delayed for 2-3 months. If this happens the effects of fiscal policy will be proportionally lower than estimated. Also, it is possible that expenditures, and thus the fiscal deficit would be by 0.2-0.4% of GDP lower than the estimated 8.2% of GDP if the perennial practice of State's delays in the settlement of obligations or their transfer to next year continues.

appears that these savings are not conducted in a systematic way, but are ad hoc measures, which are implemented in the short term with the aim of gaining political points. It is estimated that in the best case savings arising from the abolition of unproductive spending will amount to several billion dinars.

In addition to these savings the Government in the second part of the year plans additional expenditures, such as expenditures for subsidized loans (payment of debts but also new subsidies), expenditures for subsidies for employment and investments and also expenditures for reparation of the damages of flooding. In sum, the above mentioned measures will increase total expenditures by about 15-20 billion, which means that they will neutralize the largest part of the so far planned savings. Thus the net effect of government measures in the second half of the year will be a reduction of the fiscal deficit by only 10-15 billion dinars, which is about 0.3-0.4% of GDP. The aforementioned savings are modest, given the size of the deficit Serbia is facing, as well as the necessity for its fast reduction. Such savings will not bring the trust of investors, regardless that these are structural measures whose effect will be transmitted to the following year. Thus, the fiscal deficit needs the additional savings, which includes all expenses, to decrease by at least 1% of GDP in this year.

Based on the aforementioned we conclude that the so far adopted measures of fiscal consolidation are insufficient. Unless the Government implements additional savings measures, the fiscal deficit in the next few years will remain at a very high level, and public debt will continue with its rapid growth. In such circumstances, the risk of a public debt crisis will be high. Macroeconomic effects of slow fiscal consolidation will be unfavourable because the insufficient fiscal consolidation would decrease public spending, but that decrease would not be sufficient to gain the trust of private investors and to increase private investments. Decrease of public spending would be followed by a fall in private investments and private consumption through the withdrawal of foreign capital from Serbia and other, which would mean additional fall in GDP and employment. It could be said that this course of events is already happening in Serbia, because the Government in the last two or three years has been already implementing a certain insufficient measures of fiscal consolidation, whit delays and inconsistency in their implementation.

Fiscal consolidation would have a much greater chance of success if at its beginning a strong austerity measures, which would significantly decrease fiscal deficit already in the first year, would be implemented, with simultaneous adoption of measures that will guarantee continuation of the reduction of fiscal deficit in the coming years. In this scenario also GDP would decrease at the beginning of consolidation process, while unemployment would increase because private investors would wait for a while to be convinced in the persistence of government in the implementation of the consolidation. Based on the experiences of a large number of countries it follows that up to two years of consistent consolidation is needed in order to gain the confidence of investors, which is essential for the growth of private investments which should be the main driver of GDP growth and employment in the coming years.

Large savings needed for significant reduction of fiscal deficit are hardly feasible, if already in this year expenditures for pensions are not reduced, either by making the nominal pension reduction or by taxation of the pension amounts above the minimal level. In addition to reducing pensions and salaries considerable potential for savings in the short term is in the reduction of direct and indirect subsidies paid by the State to cover losses and debts of Srbijagas, Železara Smederevo, GSP Beograd, as well as on the basis of subsidizing companies in restructuring process. Also, it is necessary to reconsider the justification for granting generous subsidies for investments and employment, as well as the granting of tax incentives. Systematic and gradual decrease in the number of employees in the public sector and the application of parametric reforms of pension systems can achieve significant savings in the next few years.

2. Public sector reforms

The objectives of the reform of the public sector are to increase the quality and availability of public services and to eliminate unproductive or fiscally unsustainable spending. Public sector reform should include all functions of the state, but from the point of economic development reforms of the pension system, state and local administration, justice, education and health are especially important.

The government has released the plans for the reform of the pension system, which should take effect in the next year. The most important changes in the pension system are the introduction of actuarial penalties for early retirement in the amount of 4% per year, as well as the increase in retirement age for women from 60 to 63 years. Pension system reforms will contribute to the improvement of its fairness, and in a period of several years they will have a positive impact on the fiscal deficit reduction. However, the pension system reforms will bring significant savings in the long run, so it is necessary to reconsider the one-time reduction of pensions or introduction of taxes on pensions.

Education reforms are crucial for the economic development of Serbia because educated work force could be one of several important comparative advantages of the country. The new Minister of Education in a number of public appearances expressed mainly general and basic views, with some concrete ideas for improving the quality of primary education and some segments of secondary education. Although the effects of changes in the education system are long-term, it is necessary to start with these changes as soon as possible, and it is important that these changes cover all levels of education, from primary to doctoral studies, and that they include both state and private education.

When it comes to primary and secondary education, it is important that the Ministry and the Government propose measures as soon as possible to improve the quality of education, the objectives they want to achieve and the dynamics of their achievement. In addition it is necessary to answers to some key questions within the reform, such as: in which way will the schools be encouraged to educate students for the market demand, when will the rationalization of the school network final begin, whether and when will the secondary education become compulsory, whether and under what circumstances will the state finance the private schools of quality, how to encourage more objective assessment and prevent inflation of excellent students, etc.?

In the case of higher education it is necessary to present a plan to increase the quality of education at state universities, but also to introduce stricter requirements for accreditation in order to prevent overproduction of poor quality diplomas in primary, master's and doctoral students at private universities. In the case of state universities, the state as the owner could initiate changes that would lead to the situation in which basic and doctoral studies in the course of a decade could catch up with the state universities in small European countries such as Austria, Belgium and the Netherlands[1]. Government intervention in the case of private universities is justified because the students and their parents are not sufficiently informed about the quality of educational institutions, and in this case market solutions are not effective, at least in the medium term. An additional problem is that students who complete poor quality universities are massively employed in the public sector, thus reducing the already low quality of state institutions. By hiring graduates of mentioned universities, the State sends a signal to new generations of students that the quality of the university is not important, which is the reason why many students will decide to enrol a less quality but easier universities.

Experience of a large number of countries around the world suggests that the existence of good institutions is crucial for the economic development. Competent, dedicated, uncorrupted and not excessively costly state administration has a key role in making good laws and bylaws and in their consistent implementation. Historically, Serbia has not had much success in the formation of good institutions. Since gaining independence in the second half of the 19th century up until now the state administration was characterized by incompetence, corruption, etc. Creation of good institutions is a necessary condition not only for a long-term sustainable economic development, but also for the stability of a democratic society - poor institutions discredit the democratic system, and citizens often turn to autocracy.[2]

Although institutions are created gradually it is important the society works on their improvement every year. However, regarding Serbia this is not the case, it could be said that there is a zigzag motion where the periods of improvement and decoration are loosely linked to personal characteristics of relevant ministers and other government officials. Improvement of state institutions requires reduction of the influence of political parties on the work of state bodies, change in the employment and advancement policies in order to stop the negative se-

1 In the previous issue of the Quarterly Monitor prof. Branko Urosevic formulated a proposal to elevate doctoral studies at the faculties of economics to the advanced world level with the available modest resources. A similar approach could be applied to other universities in Serbia.

2 In the recent history corruption in Serbia was probably the smallest in the period of socialism.

lection which is in force for many decades, promotion of commitment on the job as one of the core values of the civil servants, introduction of systematic measurement of performance, supress corruption, etc.

3 Economic reforms

The current economic system represents a fundamental limit to the long term sustainable rapid economic growth in Serbia. It imposes unproductive costs and creates high risks on the economy, which impedes the functioning of the economy and discourages investment and employment. Inadequate economic system is an important cause of poor placement of Serbia on international lists of competitiveness and business conditions (list of the World Economic Forum and the World Bank), which even got worse during the last 2-3 years.

Reforms of the economic system in Serbia were significantly slowed down in 2006th and at the beginning of the economic crisis they were pushed aside. Instead of the economic system reform the Government focused on direct incentives to stimulate investment and employment and solving problems of individual companies. Such policy was completely inadequate since Serbia, unlike other countries, entered the crisis without built system of market economy. Weaknesses of the economic system the Government for several years has been trying to compensate with generous, but economically inefficient and fiscally unsustainable subsidies for investments and employment. The results of such policy were very modest - investments were low, employment is decreasing, while economic activity is mainly stagnant. The lack of reforms combined with the prolonged recession has led to the expansion of illiquidity and insolvency of companies and banks, which were threatening the current functioning of the economy and its growth, and secondarily were transferred onto the government through the cost of rehabilitation of the banking system which has so far reached 800 million euros, or about 2.5% of GDP.

During the second half of the previous year ambitious reforms of the economic system have been announced, including the reform of the Labour law, the Construction Law, the Bankruptcy Law, completion of the restructuring of former public companies and restructuring and partial privatization of public companies. Because of the elections held in March 2014 the announced reforms were left out, but after the formation of the Government it was confirmed that economic reforms are at the top of the list of priorities. Adoption of laws which improve economic environment, as well as concrete moves to restructure public companies and completion of restructuring of former public companies, along with the willingness to adopt additional measures of fiscal consolidation, will represent a key test of the Government's reform orientation.

In addition to the adoption of laws it is necessary to develop a new credible plan that would guarantee that the restructuring of the former public companies will be completed within a reasonable time, but not later than the middle of the next year. To ensure continuous movement towards this goal it is necessary to accurately determine the quarterly targets which would determine for how much companies the restructuring process will be completed by the end of October, for how much by the end of the year, etc. From the perspective of the fiscal consolidation,it is particularly important that, no later than by the end of the year, the status of Železara Smederevo Steel plant is resolved, because it is a company that is, with Srbijagas, the single largest user of indirect state aid. By the middle of the next year the privatization of all enterprises that are under the jurisdiction of the Privatization Agency should be put to an end.

Public companies in Serbia for a long period of time have created losses, and some of them have had serious problems with liquidity and solvency. Problems from public enterprises are transferred on the State, which covers part of their losses and repays part of their loans, and on the private companies to which public companies owe. From the standpoint of the budget, priority is the restructuring of the companies which lead to the growth of government expenditure, and here from the standpoint of balance significance the most important company is Srbijagas, followed by Serbian Railways and GSP Belgrade. Also, there are indications that the financial position of EPS is rapidly deteriorating. It is therefore important that the Government gets out as soon as possible with a plan to restructure the public companies, whereby the priority would be on aforementioned companies that bring the highest cost to the environment.

The Government has announced its readiness to privatize some public companies and financial institutions owned by the state, which among other things raises the question how will the revenues from privatization be used? In the period from 2006 to 2008 the state used revenues from privatizations to, in the long term unsustainably, raise pensions and salaries in the public sector, launch a massive program of subsidies and reduce taxes. Irresponsible decisions made at that time created the largest part of the fiscal imbalance Serbia is now facing.

In the current circumstances, it is unlikely that the government will use the revenues from privatization to increase public expenditures and fiscal deficit, but there is a risk that the revenues from privatization are used for disposal and mitigation of fiscal consolidation. Such behaviour of the Government would be myopic and irresponsible, because the problems in public finance would pile up further. It is therefore important that by the middle of this year decisions are made that would ensure that the fiscal deficit is significantly reduced in this and the next few years, regardless of whether the state will earn revenues from privatization or not. If the state strongly decreases fiscal deficit then it would be justified for privatization revenues to be used for its financing because the asset position of the state would not deteriorate –how much the state assets decrease, due to the privatization, that much its debt would be reduced. When evaluating the feasibility of use of privatization revenues to finance the fiscal deficit it is necessary to bear in mind that the average interest rate at which the government borrows are higher than the profit rates that public companies achieve over a longer period.

4. Antirecession measures

Strong drop of investments, a real decline in the volume of lending activity, decline in employment, stagnation of the overall economy followed by a recession in many sectors justify the use of antirecession measures in Serbia. Given that the typical stimulants which are used in large developing countries, such as lowering the interest rates of the Central Bank or fiscal stimulus, in Serbia as a small and open evroized economy, are not effective, it is necessary to use atypical stimulants. The need for government stimulants is further reinforced by recent floods, which have caused a relatively large damage to public and private property. It is therefore necessary to integrate the measures for the flood damage restoration with antirecession measures. Although economic incentives are justified it is necessary to bear in mind that these are temporary measures with limited range, which are intended to mitigate the recession, but that the long-term prospect of Serbian economy depends on economic reforms. Therefore the temptation to push economic reforms aside again due to the antirecession measures and measures for the flood damage restoration should be avoided.

Until now the Government has announced three key antirecession measures, and these are tax and direct budget subsidies for employment and investment, subsidies for lending and mass construction of cheap apartments. State investments, in-kind subsidies and subsidized loans for flood damage restoration could be added to these measures.

The most controversial of these measures are high tax subsidies for new employment, as well as the generous budget subsidies for investments in jobs. Tax subsidies for new employment in Serbia have been applied since 2011, but their effect was more than modest. This type of subsidies was popular around the world, but it proved to be ineffective. Additional problems with the use of these tax incentives are that they create distortions in the tax burden of jobs that create identical incomes, and that they open room for various types of legal tax avoidance and fraud.

Granting generous budget subsidies for investment and employment represents a return to the policy of subsidizing that was implemented until the middle of the last year, with the only difference being that now granting subsidies is limited to two years. These types of subsidies attracted a number of investors in the past, as was very strongly promoted by the media, but the results of these policies at the macro level were weak because total employment and investment declined. Investors who receive budget funds, beside those, use generous tax incentives, such as multi-year exemption from corporate income tax and exemption from some local duties[3], as well as in-kind subsidies in the form of free land. Granting of such subsidies at the macro level is probably counterproductive, because in this way the fiscal deficit increases, and so do the macroeconomic risks, and attracting of several investors with fiscally unsustainable subsidies discourages large number of other investors from investing in Serbia.

Therefore, the policy of encouraging investments should primarily be based on improving the economic environment, while subsidies should be limited to in-kind subsidies and tax incentives. Generous subsidies like arranging of locations and similar would only be granted in the case of large value investments.

Given that the lending activity for more than two years has had a large real decline, granting subsidies for loans represents extorted but reasonable measure. The application of this measure with relatively small government funds (several billion dinars) encourages crediting of about 100 billion dinars. For companies that are in financial problems, state subsidies increase the willingness of banks to offer them once again refinancing of old, hard performing loans. However, in this case, subsidized loans only “buy time”, but the big problems these companies face are not being solved. It is therefore essential that the owners of these companies are further “pressed” to take serious steps to solve the problems they face, such as selling part of the company, recapitalization, etc. - if the owners are not willing to take such steps then the bankruptcy is the only solution. Given that a large part of the subsidized loans in the past was approved precisely to these companies, and

3 In several cases investors were even freed from contributions on salaries.

that in the meantime they did not take any steps to solve the essential problems, it is estimated that it is necessary to reduce the amount of subsidies that are approved for refinancing of old loans and thus further boost pressures on the owners of these companies.

Limiting the percentage of subsidies intended for refinancing of old loans would create space for the increased availability of loans for healthy, especially small and medium enterprises, where high interest rates are the main obstacle for the use of bank loans. With subsidies that reduce interest rates bank loans would become cost-effective for a wider range of companies. In this case also, subsidies are only a temporary measure, and it is essential to eliminate systemic causes of high interest rates in Serbia.

Finally a part of subsidized loans could be focused on the households, entrepreneurs and companies who have suffered from flood damage. In the case of households subsidized loans would be approved for the rehabilitation of damaged houses, purchase of furniture and household appliances and repairs on agricultural mechanization. In the case of entrepreneurs and companies subsidized loans would be used for the rehabilitation of damaged business premises, renewal in inventories, etc. Loans to entrepreneurs who have suffered damage would contribute to the renewal of economic activity and employment in the shortest period possible.

Important antirecession measure announced by the government is the mass construction of cheap apartments. Realization of this program is economically and socially justified because it will enable productive employment of several thousands of workers, and also it will provide the opportunity for several thousands of households to solve their residential issue. Mass construction of apartments with the implementation of at least some of the announced investment programs, and recovery from floods, would help the recovery of the construction industry, which is in a deep recession.

Details of the program of mass construction of apartments contained in the speech of the Prime Minister and later statements by the representatives of the Government largely coincide with the proposals outlined in the last issue of QM[4], but there are some differences. In both proposals, cities and municipalities would provide free construction land, which would significantly affect the reduction in final apartment prices. The difference between the two proposals is that according to our proposal future buyers would bear the minimum costs of construction land, while according to the proposal of the Government those costs would be borne by the local communities. As a result, the final price of apartments according to the proposal of the Government would be about 400 euros, while according to our proposal about 500-600 euros, and in Belgrade perhaps slightly more.

We still think that the free allocation of construction land is sufficient and large subsidy for future buyers of apartments, and that it is not justified for the costs of construction land to be transferred to local governments, i.e. all citizens. Here we remind that the ultimate cost of any subsidy is borne by the citizens, and that the state is only an intermediary in that process. In this particular case, this means that according to the proposal of the Government all people, including the poorest, as well as those who for decades have been saving to buy apartment at a price of 1000 or 1500 euros for m2, would subsidize one part of citizens to buy apartments at a price of 400 euros. There should also be some limits in the case of these subsidies, according to our assessment this means that future buyers should pay the costs of the construction of apartments as well as the minimum cost of construction land. In this case, monthly rate for repayment of the loan would amount to just over 200 euros, which is bearable for a family with the average income. This rate implies much less waiver from that borne by the majority of families who over the past 15 years purchased apartments at market prices. Given that the mass construction of apartments contains a considerable amount of subsidies, it is necessary to give priority to the purchase of apartments to families with unsolved housing issue.

4 See p. 66-67 in QM35

Highlight 2. Impact of floods and damage restoration on property, GDP and fiscal deficit

Milojko Arsić, Danko Brčerević

In this Highlight we have tried to answer the question what will be the impact of damages from the recent floods on economic activity and fiscal deficit in 2014. Reliable assessment of the impact of floods on GDP is currently not possible to give, because there are no precise data on all its consequences. However we think that it is already now possible, and useful, to define the scale of the impact of floods on GDP – not only for GDP forecasts in 2014, but also because in public some arbitrary interpretations of the scale and the impact of this natural disaster appeared[1]. First it is necessary to separate the damage to the property from the impact that floods have on income and production, because these are two different things. For example, flooded house has a great damage to property but a very small effect on income and GDP (reduction of income that reduces GDP as a consequence of a flooded residential unit counts as a lost imputed rent). A somewhat different example is the flooding of agricultural areas, which has a relatively small effect on property, because these areas will be, for the most part, equally usable in the next agricultural season (and some can probably be used already in this), but a relatively large impact on production, because crops for 2014 on these areas are ruined.

International experience shows that the damage on property and fall in production, which are the results of floods, are usually significantly lower in comparison with other natural disasters (for example earthquakes)[2]. That is because floods unlike earthquakes usually affect smaller areas, but also leave less lasting consequences on the assets (with floods the damage is usually easier and faster to repair than with earthquakes). Also, as a rule natural disasters, including floods, have far greater impact on the loss of assets than on decrease in income and production. First estimates of the damages on assets from floods, which could be heard in the public, amounted to around one billion euros or about 3% of GDP. Decrease in GDP from floods should then be for an order of magnitude lower (especially as the first assessments of damages on assets are overestimated), and so already now we exclude the possibility that the economic activity in Serbia will have significant fall as a consequence of floods.

1 For example very arbitrary interpretation is that only in agriculture 500 million of euros is lost.

2 C. Benson, E. J. Clay (2004) „Understanding the Economic and Financial Impact of Natural Disaster", World Bank.

When analysing the impact of floods on individual sectors of the economy we see that the greatest impact could be on agriculture, production of electricity and mining. The largest negative impact of floods on economic activity is through reduction of agricultural production. According to the last available data, around 80.000 hectares of agriculture area has been flooded. In Serbia in total around 3 million hectares is under crops[3], so the floods could directly affect reduction in agricultural production less than 2.5%[4], and, we estimate, on reduction of GDP probably for around 0.2 p.p. Impact on production of electricity is somewhat lower and temporary. Data on relatively low imports of electric energy during the state of emergency and mainly normal supply of electricity in the largest part of Serbia, indicate that the fall in production of electricity probably won't be so high. Under (most probably overestimated) assumption that the production of electricity in the following six months will fall in average by 10% the impact this reduction would have on GDP would be somewhat below 0.2 p.p of GDP. Mining has the share in gross added value of Serbian economy of just 1.9% so the eventual reduction in mining production until the end of the year for about 10% (as a consequence of floods in Kolubara) could affect reduction in GDP by about 0.1 p.p. Reduction in imputed rent due to the flooded residential buildings is almost negligible, because few thousand of residential buildings were damaged by floods (of over 3 million residential units) and probably the largest part of those will be in function already in the next few months. The remaining impact of floods on GDP is even lower and less durable, and so we won't analyse them in more detail, and they refer to temporary reduction in economic activity of small and medium enterprises from the flooded areas, temporary reduction of transports, etc. Taking all this into account we conclude that the negative impact of floods on GDP growth in 2014 could amount to slightly over 0.5 p.p of GDP and by no means above 1 p.p. of GDP.

Reconstruction activities could on the other hand increase production and in certain extent mitigate negative effects of floods on GPD. Here it should be taken into account if these are completely new activities to eliminate the consequences of floods and if the resources used would not be otherwise used for some other purpose, or

3 Data on areas under crops by SORS. According to these data floods did not have significant impact on agriculture production in Vojvodina where there is undoubtedly the largest part of the total area under crops.

4 Taking into account the assumption that the livestock was reduced by slightly less than agricultural land, and that a large part of agricultural land (some estimates from PKS go up to 50%) will be under crops again this year. Share of agriculture in GDP is slightly below 10%. It is interesting to note how the impact of floods on agriculture is lower than the impact of drought in 2012, which reduced agricultural production for about 17% and GDP by 1.5 p.p.

they are redirected from some other activities. Only in the first case would come to the indisputable increase in GDP, while in the second case we would have to look at the difference in added value of eliminating the consequences of floods in relation to the added value these resources would create if they are used for other purposes. Also, the value and the structure of assets which should be reconstructed is not big enough to trigger high growth of economic activity: 1) preliminary damage assessment of a billion euros (3% of GDP) are probably considerably overestimated, 2) all damaged buildings, equipment and infrastructure will not be renewed, and 3) some equipment and assets are mainly imported (machines in Kolubara, technic equipment, cars, etc.), and their re-purchase will not contribute to domestic production. Therefore, we believe that activities taken to fix these damages can in best scenario contribute in a way that a decline of economic activity caused by floods will be slightly smaller than the estimated 0.5 p.p. of GDP, but that they themselves cannot be the drivers of economic growth in 2014 and the coming years.

The economic activity in 2014 will probably be in stagnation or in mild recession.[5] The most important reasons for this are the dominant macroeconomic trends – unsustainable fiscal position (high and growing public debt and high deficit), fall in investments, low credit activity, reduction in exports and other – and not floods. QM analysis indicates that the floods will have very limited negative impact on the economy which, taking into account the effects of the reconstructions, should not be higher than 0.5 p.p of GDP, and that therefore the economic activity in Serbia in 2014 will most probably fall for about 0,5%.

Catastrophic floods which stroked Serbia in the second part of May will have impact on the rise of the fiscal deficit, trough reduction in tax revenues and trough increase in expenditures. Impact of floods on reduction of tax revenues will be mostly realized automatically – because of the decrease in economic activity taxable income and trade will decrease, and thus also tax revenues. Also local communities will free taxpayers of annual taxes on the destroyed and damaged assets. The loss of tax revenues on the basis of floods is proportional to the decline in GDP, so in case GDP falls by 1% loss would amount to nearly 0.4% of GDP. However, the activities of remedial of the consequences of floods could mitigate the decline in GDP and thus the loss of tax revenue. If remedial of consequences of floods starts in time and with power fall in GDP would amount to less than 0.5%, and a loss of tax revenue to about 0.2%, or about 7-8 billion dinars.

Floods inflicted relatively significant damages to private and state property - the level of the damage is roughly estimated between 0.5 and 1 billion euros. Repairing these damages will be done partly by using budget funds, which could lead to an increase in public expenditures and thus to a fiscal deficit. Given the difficult fiscal situation the Government could define such a strategy in which costs arising from repairs of damages caused by floods do not affected the increase in the fiscal deficit or that such impact would be minimal. This would mean that the State provides the largest part of these funds by redistributing existing budget funds, i.e. conversion of approved loans.

Budget funds will partially finance reconstruction of roads, railways and utility infrastructure, one part of the costs would be financed by public companies and one part by foreign donations. We estimate that the State and the local communities should secure almost all funds for reconstruction of the infrastructure through redistribution of total expenditures planned for this year, and also through conversion of so far approved loans. With regard to the scale of damage to the electric power industry it is particularly important that EPS covers these damages without budgetary support, which implies the implementation of significant reforms to increase the efficiency of this company, as well as the conversion of one part of approved loans. Investments in reconstruction of the infrastructure could partially compensate for a fall of economic activity which occurred during and after the floods.

The Republic of Serbia will take part in financing one part of the costs of repairing the damages on the private property, for example reconstruction of destroyed houses, reconstruction of damaged residential units, resowing of crops, livestock renewal, purchases of durable goods, etc. State aid to repair the damages on private property on one hand represents the obligation of states to provide existential minimum for all citizens', while on the other hand represents the obligation of the State to help citizens to deal with damages which occurred because of decades of neglect from government bodies (undeveloped or neglected systems of floods control, tolerance for construction of residential buildings in unsafe areas, etc.). In the case of the aid in repairs of private property the State should carefully look for the balance between the needs to help the citizens which suffered, on one side, and the danger of excessive spending and borrowing for all Serbian citizens - taxpayers. When approving the aid the State should also take care not to stimulate socially irresponsible behaviour, such as the construction of residential buildings in undefended areas, avoiding the insurance of property, etc.

5 For more details see Section 2 „Economic activity" of this issue of *QM*.

The state aid should be the largest in basic existential needs (construction of houses and apartments), while in the case of repairing of other damages the state aid should be partial and indirect. The State should finance the construction of destroyed houses with help from donors, after it is determined that the destroyed houses were used for continuous living not only temporarily. According to the first estimates it is needed to construct around 1500 of houses with costs of construction between 40-45 millions of euro, and until now[6] collected financial donations are enough to cover around half of these costs. Given that the trend of receiving donations is still very dynamic it could be expected that they will be sufficient to cover most of the costs of construction of new houses. Activities of the State and humanitarian organizations on collecting financial and natural donations will directly affect reduction in government expenditures. In the case of rural areas the State could consider as a cheaper solution - purchase of non-damaged houses in which no one lives and their allocation to citizens whose houses are destroyed – this would especially be justified in the case of older households.

In the case of damaged houses and apartments and also destroyed durable goods (furniture, electronics, etc.) the State could transfer one part of subsidized loans, planned for the second part of the year, for this purpose. One part of subsidized loans would be refocused to purchase of agricultural machinery, livestock renewal, while the part of the cost for re-seeding destroyed agricultural crops would be provided through the reallocation of subsidies for agriculture (supply of seeds and fuel). In some cities, and especially in Obrenovac, companies and entrepreneurs whose products were destroyed during the floods suffered significant losses. The State could transfer one part of subsidized loans in order for entrepreneurs to renew their activities through reparation of business premises, furniture and purchase of new stocks of raw materials and finished products. We estimate that it would be justified for the government and humanitarian organizations to launch the campaign in order to secure private donations of used furniture and electronics – this is especially important for households which are not creditworthy. It is estimated that a relatively large number of households possess used goods they don't need and that could be very useful for to households that were damaged by floods.

6 According to the representatives of the State at the beginning of June total donations amounted to about 20 million euros.

CIP - Katalogizacija u publikaciji
Narodna biblioteka Srbije, Beograd

33 (497.11)

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

Dostupno i na: http://www.fren.org.yu. - Tromesečno. - Ima izdanje na drugom jeziku: Kvartalni monitor ekonomskih trendova i politika u Srbiji = ISSN 1452-2624 ISSN 1452-2810 = Quarterly monitor of economic trends and policies in Serbia
COBISS.SR-ID 126940428