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

Table of Contents

Analytical and Notation Conventions

Values

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

Definitions of Aggregates and Indices

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

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

New Economy – Enterprises formed through private initiative

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

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

Notations

CPI – Consumer Price Index

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

H – Primary money (high-powered money)

IPPI – Industrial Producers Price Index

M1 – Cash in circulation and dinar sight deposits

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

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

NDA – Net Domestic Assets

NFA – Net Foreign Assets

RPI – Retail Price Index

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

Abbreviations

CEFTA – Central European Free Trade Agreement

EU – European Union

FDI – Foreign Direct Investment

FFCD – Frozen Foreign Currency Deposit

FREN – Foundation for the Advancement of Economics

GDP – Gross Domestic Product

GVA – Gross Value Added

IMF – International Monetary Fund

LRS – Loan for the Rebirth of Serbia

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

NES - National Employment Service

NIP – National Investment Plan

NBS – National Bank of Serbia

OECD – Organization for Economic Cooperation and Development

PRO – Public Revenue Office

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

QM – *Quarterly Monitor*

SORS – Statistical Office of the Republic of Serbia

SDF – Serbian Development Fund

SEE – South East Europe

SEPC – Serbian Electric Power Company

SITC – Standard International Trade Classification

SME – Small and Medium Enterprise

VAT – Value Added Tax

From the Editor

Unfavourable trends in Serbia's economy additionally deteriorated in the second quarter, and there are signals that negative trends will continue in the third quarter as well. In the second quarter, the economy entered recession for the third time since 2008, while the two-year improvement in the foreign trade balance came to a halt. Inflation has been below the target for several months now, while the months with deflation are getting more frequent. The three month period of dinar exchange rate stability was interrupted at the beginning of July, and depreciation pressures were strong during August and September. Mid-year, the Government adopted reform laws on labour and retirement, which are important for improving the business environment and long-term sustainability of public finances. Growing macroeconomic risks, stemming from a high fiscal deficit and fast growing public debt, now present basic threat to the economy's stability and growth. Government's responses to macroeconomic risks have been slow so far, indecisive and insufficient.

Economic activity declined in the second quarter by 1% compared to the same period last year, while seasonally adjusted GDP is dropping for the third consecutive quarter, which leads to an undoubtable conclusion that Serbia's economy has entered recession for the third time since the beginning of the crisis. Worrying data on the trends in industrial production and exports in July are for the most part incidental, but they still confirm the deepening of recession trends. The main causes of the decline in economic activity have deeper roots located in poor business environment, while catastrophic floods only intensified the negative trends. Poor business environment, now dominated by macroeconomic risks related to the fiscal deficit and public debt, directly influences the decline of economic activity by discouraging investments and lending activity. Recession was present even last year in most of the economic sectors, but it was masked by the high growth in only a few sectors – automobile and oil industry and agriculture. However, due to the lack of new investments, the growth in the stated sectors has declined during this year.

Catastrophic floods uncovered another problem, which is the drastic inefficiency of the state, proven by inability to repair the damages to the electrical grid, transport infrastructure and residential buildings within a reasonable time frame. Compliance to the procedures and prevention of corruption are important, but they cannot serve as an excuse for state's inefficiency. The inability to repair flood damages raises an important question: is the state capable of implementing complex programmes such as mass construction of affordable housing, combating grey economy, improvement of education, public administration reform, etc.?

The fall of GDP in 2014 will be at least 1% of GDP, out of which the decline of 0.3% is the result of fundamental factors, while the decline of around 0.7% is the result of temporary factors (floods). In the following 2015, we expect GDP to drop by around 1%, because fundamental weaknesses of the economy will not be eliminated by then, and the austerity measures by the state, as well as shutting down the loser state enterprises will additionally increase the decline of GDP. The statistical data on the labour market trends are still disturbing. Formal employment is declining, which is in line with the trends in economic activity, but total employment is rising as a result of growth in informal economy?!

Another unfavourable tendency we have also predicted is the strong slow-down in Serbia's exports this year. In the previous two years, high growth of exports was the main driver of otherwise modest GDP growth, and it compensated for the decline in investments, private and public spending. The slow-down in export growth stopped the further improvement in the current account balance, which was stabilised at a high level of around 5% of GDP. Current account deficit of 5% of GDP is unsustainably high for a country facing low inflow of foreign capital, which mostly relies on government borrowing. Therefore, it is necessary to use economic policy and reforms to encourage export growth and import reduction in order to prevent potential balance of payments problems. In the short term, the key instruments are decreasing domestic demand and moderate depreciation of dinar, while in the long term, the measures for encouraging development of export oriented economy are crucial.

Based on the trends in the first seven months, it is estimated that Serbia's fiscal deficit this year will amount to around 8% of GDP, which will be the highest deficit in Europe, as well as the highest fiscal deficit that Serbia has had since 2000. As the result of the deficit, the public debt this year will increase by around 2.5 billion euros and will reach 70% of GDP by the end of the year. The state will spend around a billion euros this year on paying interests, which is more than expenditures for the military or the police, and equal to half of the total public expenditures for healthcare. Unless the fiscal deficit is reduced, the public debt next year will reach close to 80% of GDP, and 1.15 billion euros will go toward paying off the interests.

Procrastination and indecision of the Government in implementing fiscal consolidation have launched a torrent of proposals which challenge the need for fiscal consolidation or suggest "lighter" measures for its implementation. Challenging fiscal consolidation is nothing new, it exists in other countries as well and it is the result of effects of political factors on economy. Challenging consolidation justifiably raises a question of whether we as a society will regulate public finances in an organised fashion or will we leave it to chance, i.e. bankruptcy? In a democratic society, both choices are legitimate, although we believe the former is better.

Representatives of various interest groups are trying to avoid, postpone or at least decrease the savings related directly to them. To this end, there are estimates in the public that the situation is not that serious, so no big savings are necessary. Alternatively, austerity measures are proposed which should be realised anyway within the fiscal consolidation, but their effects are over-exaggerated in order to prove that cuts in wages and pensions are not necessary. For example, there are claims that the public sector employs twice as many people per 100 inhabitants than in other countries, which is the result of hiring 200 or 300 thousand party activists after 2000?! This leads to a conclusion that the fiscal deficit could be eliminated by firing public servants employed through partisan hiring. There is no doubt that the public sector has too many employees and that it is partly due to partisan hiring, but their number is significantly lower and is measured in tens, rather than hundreds of thousands.

Claims of enormous number of employees in Serbia's public sector are based on subjective observations, while the use of comparable statistical data is rare. These exaggerated estimates of the surplus of employees in the public sector find fertile ground in the public opinion, who does not have a good understanding of the state functions. Forming of this public opinion was also influenced by irresponsible statements by politicians, usually during election campaigns, according to who Serbia has an enormous surplus of public sector employees. Furthermore, it is paradoxical that these claims often came from parties who lead in partisan hiring.

That is why we will show here statistical data on the number of employees in Serbia's public sector and other countries, not including public and other state companies. In Serbia, in the state and local government, education, healthcare, police, military, social protection, agencies, etc. there are around 550-570 thousand workers, which is 7.7 employees per 100 inhabitants. Number of employees in the public sector is slightly higher than the average in European countries, which have 7 employees working in the public sector per 100 inhabitants. In European countries who have predominantly state education and state healthcare, the number of public sector employees varies in a narrow interval between 6 and 8 employees per 100 inhabitants. Similar number of employees per 100 inhabitants across countries is the result of the fact that availability of state education implies a certain number of teaching staff per 100 kids, while the availability of healthcare requires a certain number of medical staff per 100 inhabitants. Similarly, there are standards as to how many policemen, firemen, taxmen, judges are needed per 100 inhabitants. Comparison of Serbia to the countries of Central and Eastern Europe is relevant – the number of public sector employees in Serbia per 100 inhabitants is similar to that of Romania, but higher than in Bulgaria, while it is lower than in Hungary, the Czech Republic, Slovakia or Poland.

Comparative data convincingly show that there is no enormous surplus of public sector employees in Serbia (e.g. surplus of 30 or 50%), but it is quite certain that, through better organisation, the number of employees could be reduced by 10-15%, which is not negligible. However, the 30-50% reduction in the number of employees that is daily suggested by the public is possible only if state functions employing the largest percentage of the employees are abolished or significantly reduced, and these include education, healthcare, police, military, etc. That is why it would be good if those proposing reduction of public sector employees by a third or a half, come out with concrete proposals as to how many employees should be cut in each sector. Unsubstantiated claims of enormous surplus of public sector employees are upstaging other more important issues, such as: irregular hiring in the public sector, negative selection in promotions, no dedication to work, insufficient education of the employees, corruption, etc.

Aside from regular research, this issue of the Quarterly Monitor contains also a Highlight (Arsić), which analyses the reasons behind fiscal consolidation, possible alternatives, as well as consequences of various choices.

TRENDS

1. Review

Q2 saw continuation and further deterioration of the adverse macroeconomic trends we have been warning about in the preceding quarters. Economic activity is in recession, inflation is almost at zero, and the positive trends in the current account of the balance of payments have been halted as exports stopped growing. In addition, fiscal position of Serbia is completely unsustainable, and the huge deficit and fast growing public debt pose a threat of public debt crisis. Signs indicating deterioration in macroeconomic trends have appeared few quarters ago, and some of them more than a year ago, and we have pointed them out clearly in previous issues of QM - but economic policies have failed to address them properly. Work of two key government ministries, the Ministry of Economy and the Ministry of Finance, was almost completely halted during the preceding year by a large number of organizational, personnel and even conceptual changes. Monetary policy makers, on the other hand, "play it safe" and carrying out an extremely cautious and restrictive policy. Therefore, ultimately it fails to meet its goals - because inflation has been below the target level for two successive quarters already.

Economic activity is in recession. Decline in economic activity can only partly be attributed to devastating May floods, because Serbia slipped into recession even before the floods (see Section 2 "Economic activity"). The key reasons for the decline in economic activity are unsustainable fiscal position (high and growing public debt and large deficit), years of decrease in investments, and decline in credit activity, joined by a sharp slowdown in exports in Q2. In the preceding period, it was a steep rise in exports that counterbalanced decline in other components of GDP (investment, consumption), so the unfavourable economic trends were not so evident. With the slowdown in exports these negative trends became more prominent and the total GDP shrank. QM analysis shows that the slowdown in exports is lasting because the export of motor vehicles reached its full capacity (FAS), no new investments that would boost exports have been made, and international environment is unfavourable - therefore we do not expect this period of negative economic growth in Serbia to end soon.

On the basis of somewhat less favourable economic trends detected in Q2, we revised the projected decrease in GDP in 2014 up to 1%, instead of the expected 0-0.5%. This issue of QM also offers the first forecasts of a possible level of economic activity in 2015, which we projected at -1%. Since the real causes of recession are fundamental rather than temporary (such as floods), and therefore more difficult to eliminate, we do not expect that these unfavourable trends in economic activity will be reversed sharply in 2015. Additionally, fiscal consolidation will have to be implemented in 2015 (otherwise Serbia will slip into public debt crisis), which will affect medium term economic growth favourably, but will have limited and temporary negative impact on production in 2015. Due to all this, we expect 2015 to be another year of recession with a drop in GDP now estimated at 1%, but it could easily be higher.

Inflation is very low and its y-o-y level was only 1.5% in August. We should however take into account that the y-o-y index incorporates increase in the reduced VAT rate from 8 to 10% in January 2014, and that without that inflation would fall below 1%. In addition, there was no rise in prices in the past six months - meaning that in the period March-August inflation stood at 0%. Causes of low inflation are economic recession accompanied by decline in domestic demand, quite stable exchange rate, low rise in food prices, low imported inflation, and restrictive monetary policy keeping the reference rate at high 8.5% (see Section 5 "Prices and exchange rate").

Although the NBS have been expecting and announcing rebound in inflation to the targeted corridor (4 ± 1.5%), nothing has changed for the last six months, and the NBS, nevertheless, keeps pursuing restrictive monetary policy. We have understanding for this kind of monetary policy to some extent - the last recorded depreciation of dinar exchange rate in early September was not large, but it once again reminded us of how fragile the macroeconomic equilibrium in Serbia is, and that monetary policy makers need to be very cautious. However, we must emphasize that the NBS has not achieved its objectives for 2014, which contributed considerably to deterioration of other macroeconomic aggregates. We also remind that it is the NBS who often and reasonably points out the unsustainability of fiscal policy as the major threat to macroeconomic stability in Serbia, exchange rate and prices. However, we should add, free from bias, that fiscal policy in 2014 would have been much more effective if the NBS had achieved its goals.

Positive trends in the current account of the balance of payments have been halted by a slowdown in exports in Q2 (see Section 4 “Balance of payments and foreign trade”). Current account deficit now stands at about 5% of GDP, which is much lower than two or three years ago when it stood at about 10% of GDP, and we remind you that before the 2008 crisis it reached more than 20% of GDP. However, the circumstances are now much different to those before the crisis, so in spite of being considerably reduced in 2014 this current account deficit is no longer sustainable. There is no large inflow of foreign capital any longer, and there certainly will not be any in the medium term. Companies are discharging their foreign debt, foreign direct investments are small, and the only source of considerable inflow of foreign capital is – huge government borrowing. One such inflow of about EUR 750 million (loan for budget support granted by the United Arab Emirates) was recorded in August solely. So, when we draw the line, in 2014, current account deficit stands at around 5% of GDP, capital inflows (despite the large government borrowing) are slightly below this percentage - which led to a slight decrease in foreign exchange reserves of about EUR 250 million (from the beginning of January to end of August).

Large government borrowing abroad will, however, have to be gradually reduced already in 2015; otherwise public debt crisis will arise. Reduction in government borrowing in 2015 will most probably push down the overall inflow of foreign capital relative to 2014, since it is quite unlikely that any of the other items in financial account will increase notably in the period ahead - FDI or foreign loans to domestic companies and banks. This is exactly why we believe that the existing current account deficit of 5% of GDP is not sustainable. It is, however, the task of economic policy to anticipate such or similar future trends on time and try to find the optimum combination of monetary policy, exchange rate, and acceptable reduction in foreign exchange reserves in the years ahead, taking into account the balances of foreign currency debtors and that fiscal consolidation leads to reduction in inflow of foreign capital and pushes down domestic demand. We think that it would probably be beneficial to use current depreciation pressures to allow limited and controlled depreciation of dinar - especially because inflation stands below the NBS’s targeted corridor.

Labour market statistics continues to show some quite contradictory trends that we find hardly possible. Y-o-y formal employment fell by about 2% in Q2, which is in line with other macroeconomic indicators (primarily recession), and we think that this data is most probably accurate. What, however, does not cease to surprise us is that according to the Labour Force Survey (now carried out quarterly, as well), rise in employment and decline in unemployment continued in Q2. This time, it can be attributed to seasonal and temporary factors (temporary informal hiring for the purpose of flood protection, for example), but we emphasise once again that under the recession Serbian economy is currently facing, the rise in employment that Labour Force Surveys have been showing since 2013 is not possible.

Corporate borrowing is still low and below the last year’s level, but it shows some signs of recovery in Q2, thanks to the new cycle of subsidized loans for liquidity and working capital (see Section 7 “Monetary flows and policy”). We think that this programme is currently justifiable because corporate borrowing is declining sharply and, by providing subsidies on interest, the government makes great and favourable impact on overall credit activity using relatively small funds. On the other hand, amount of nonperforming loans continues to grow gradually in Q2, so the following three institutions should jointly address this problem to find the optimum solution: banks, the NBS and the Ministry of finance. The government should however ensure that solution to this problem does not become fiscal expenditure.

Unsustainability of fiscal policy is the major problem national economy is facing currently. Perhaps our estimate that they far exceed recession, price stagnation, high unemployment, unsustainable current account deficit and large and growing share of nonperforming loans best illustrates how enormous the problems confronting fiscal policy are. Fiscal deficit (inclusive of below-the-line expenditures) will exceed 8% of GDP in 2014. Fast growing public debt will amount to more than 70% of GDP at the end of the year and will continue to grow in the years ahead. Although the government has provided sufficient funds to cover its liabilities in the following six months (until the loan for budget support granted by the United Arab Emirates is spent), they need to start implementation of a determined fiscal consolidation programme during that period. Otherwise they run the risk of public debt crisis in the following years – steep drop in GDP, dinar depreciation and macroeconomic instability.

Fiscal deficit will exceed 8% of GDP in 2014 instead of the projected 7.1% of GDP (see Section 6 “Fiscal flows and policy”). This large fiscal deficit is not driven by rise in expenditures, which will probably be somewhat below the projections. It is above the expected level because public expenditures fell short of the projections. Public revenues went down because macroeconomic circumstances worsened – recession instead of economic growth projected at 1%, inflation rate at only 2% instead of the projected 5% and trends in labour market somewhat below the expected. In addition, extra revenues from reduction in shadow economy that have been projected in the budget will fall short of projections. Large savings will be made on expenditure side through reduction in public investments (which is not a good way to reduce public expenditures), while expenditures on subsidies will exceed the targeted level.

Public debt (including the debt of local self-governments) amounted to EUR 22 billion at the end of August (when the loan from the UAE was received). With exchange rate at 119 dinars for one euro, public debt already exceeds 70% of GDP. We estimate that public debt will reach about 72% of GDP by the end of the year, but some events would push it even higher. One such event would be issuance of a large amount of government guarantees on loans to EPS, needed to finance import of electricity and its current operations. This would hit severely not only public debt but overall public finance in Serbia, so we think that it would be much better to raise the price of electricity instead.

Finally, we arrive to the central issue of economic policy during the preceding months – fiscal consolidation. Under current fiscal flows, the only way to achieve fiscal consolidation is strong reduction in the largest public expenditures – pensions and public sector wages. However, this will not be sufficient unless the government put in order operations of public companies because otherwise all savings will be used to make up for their poor performance. This time fiscal consolidation needs to be carried out in a way that would really reverse negative trends in public finance, instead of adopting insufficient measures that only put off crisis and make things even worse in the following year (calling for more radical measures afterwards). Without sufficient cuts, government will maybe escape public debt crisis in 2015, but the health of public finance will deteriorate further.

Under poor economic indicators, Serbia will almost certainly remain in recession in 2015, even if no measures for fiscal consolidation are taken. Fiscal consolidation will deepen recession. The Government and NBS should therefore start coordinated implementation of fiscal consolidation and relevant anti-recession measures. The Government’s task would be to increase efficiency of public investments, improve business environment, and negotiate with and bring in large foreign investors (with minimum fiscal spending). The NBS’s task would be to ease monetary policy and to prevent deflation and rise in illiquidity of companies (recession and deflation are the largest obstacles to fiscal consolidation). The NBS should also, in coordination with the Government, try to find out how to increase corporate borrowing and solve the problem of nonperforming debt.

Serbia: Selected Macroeconomic Indicators, 2005 - 2014

	Annual Data									Quarterly Data					
										2013				2014	
	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1	Q2	Q3	Q4	Q1	Q2
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	0.1	-1.1
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	0.1	…
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	5.2	3.0	10.8	3.3	2.1	-4.8
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	5.4	3.2	8.8	2.2	3.6	-2.0
Average net wage (per month, in dinars)[2]	17,478	21,745	27,785	29,174	31,758	34,159	…	…	…	41,419	44,248	43,939	46,185	41.825	44.971
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	…	…	…	1.724	1,724	1,720	1,705	1,697	1,697
Fiscal data					in % of GDP							y-o-y, real growth			
Public Revenues	42.1	42.4	42.1	41.5	38.6	-1.5	-4.6	0.6	-3.0	-5.8	-3.2	-2.7	0.1	-0.6	4.5
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	2.2
							in billions of dinars								
Overall fiscal balance (GFS definition)[3]	14.8	-33.5	-58.2	-68.9	-121.8	-136.4	-158.2	-217.4	-178.7	-37.4	-44.1	-57.1	-40.2	-64.7	-39.1
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	3,384	3,747
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	2,512	2,768
Current account5)	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,176	-1,586	-625	-290	-160	-510	-483	-383
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*	*-6.5*	*-4.8*
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	533	361
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	242	771	158	139	224	250	289	251
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	859	-886	-164	887	-800	-370
Monetary data							in millions of dinars, e.o.p. stock[1]								
NBS net own reserves[6]	175,288	302,783	400,195	475,110	578,791	489,847	606,834	656,347	757,689	673,147	674,731	701,822	757,689	696,802	756,996
NBS net own reserves[6], in mn of euros	2,050	3,833	5,051	5,362	6,030	4,609	5,895	5,781	6,605	6,025	5,917	6,122	6,605	6,015	6,513
Credit to the non-government sector	518,298	609,171	842,512	1,126,111	1,306,224	1,660,870	1,784,237	1,958,084	1,870,916	1,933,868	1,929,205	1,911,059	1,870,642	1,815,004	1,842,407
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909912	933,839	907,288	924,684	933,170	933,839	937,875	949,418
M2 (y-o-y, real growth, in %)	20.8	30.6	27.8	2.9	9.8	1.3	2.7	-2.2	2.3	-2.6	-4.7	1	2.5	1.9	3.5
Credit to the non-government sector (y-o-y, real growth, in %)	28.6	10.3	24.9	25.2	5,2	13.9	0.5	-2.1	-8.3	-8.2	-9.2	-9	-6.5	-8.3	-5.7
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	53.8	56.2	59.9	50.7	57.3	60.3	53	50.7	48.5	48.7
Prices and the Exchange Rate							Y-o-y growth[1]								
Consumer Prices Index[7]	16.5	6.5	11.3	8.6	6.6	10.2	7.0	12.2	2.2	11.2	9.7	4.8	2.2	2.3	1.2
Real exchange rate dinar/euro (average 2005=100)[8]	100.0	92.1	83.9	78.5	83.9	88.0	80.43	85.3	80.2	79.5	79.5	80.8	81.2	80.7	80.9
Nominal exchange rate dinar/euro[8]	82.92	84.19	79.97	81.46	93.90	102.90	101.88	113.03	113.09	111.69	112.15	114.2	114.3	115.8	115.6

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

Worrying trends in the movement of economic activity continued in the second quarter and it is unlikely that there will be a turning point by the end of the year. Year-on-year decline of economic activity in Q2 was over 1%. This fall is only partly a consequence of May floods because even if we exclude negative effects of floods – GDP would be in decline. This is already third successive quarter in which seasonally adjusted GDP has decreased, which is why we estimate that the Serbian economy is without a doubt once again in a recession, for the third time since 2008. Because of additional deterioration trends, we corrected downward the estimation of GDP decline from the previous QM. At that time we expected that GDP will achieve a drop of between 0 and 0.5% in 2014, and now we estimate that GDP in 2014 will have a real decline of about 1%, and possibly somewhat higher than that. Exports, which is the only factor that had positive and strong contribution to the growth in the previous two years and which represented counterbalances to the decline in domestic demand, halted its growth in Q2 – primarily because full capacity in exports of motor vehicles (Fiat) has been reached, and nothing new happened that could extend this growth. Domestic demand is a multi-year decline, in which unfortunately drop in investment is the most significant, which also reduces the potential for future recovery and growth. Economic policy should be much more determined in response to worsening economic trends. This means an adjustment of excessive government expenditure to the actual strength of the economy, improving the business environment, solving the fate of companies in restructuring, and then to see which antirecession measures are available to mitigate the increasing decline in economic activity. Based on the current information, we expect that the GDP in the coming year will fall probably by about 1%.

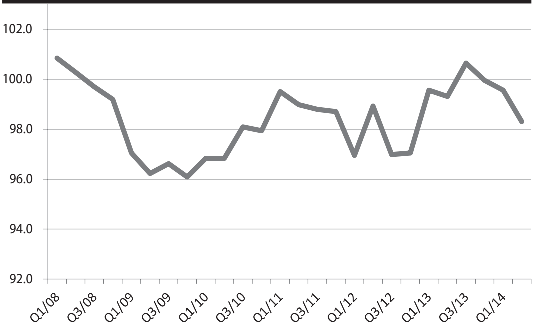
Gross domestic product

Year-on-year fall in Q2 of 1.1%

According to the preliminary, flash, SORS estimate, the real y-o-y GDP fall in Q2 was 1.1%, and this is the first y-o-y GDP fall since 2012. However, this fall was expected considering bad trends of the economic activity, which started at the end of the last year and which we described in the previous issue of QM. The May floods only further contribute to the fall of economic activity in Q2. Also, in the period between two issues of QM SORS published final assessments of GDP trend in Q1, which are somewhat lower than previous flash estimates. According to a new data GDP in Q1 recorded a y-o-y growth of only 0.1%, not 0.4% as previously published. Data on economic activity trend in the first half of the year indicate that in 2014 economic activity will almost certainly record a fall compared to 2013, and for now we estimate that this fall will be around 1%, which will be further discussed in the following paragraphs.

Seasonally adjusted GDP indicates a strong fall in economic activity in Q2

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

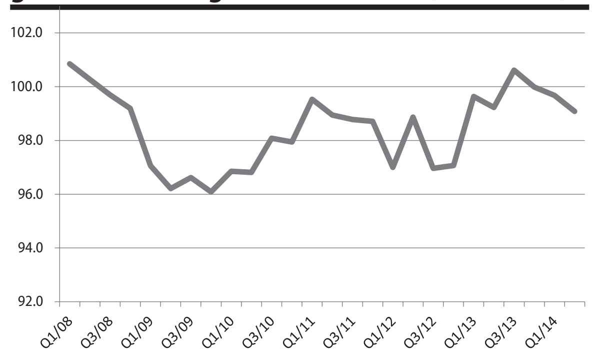


Source: *QM* estimates based on SORS data

Seasonally adjusted GDP growth index (Graph T2-1) confirms negative trends in the movement of economic activity and its relatively strong fall in Q2. Graph also shows that Q2 is a third successive quarter in which seasonally adjusted GDP decreases, which is a definite confirmation that the Serbian economy is in a recession. GDP level, after a last, strong fall (Graph T2-1), is once again significantly lower than the one before the crisis (2008) which means that the economy has not reached that level of production even six years after the outbreak of the crisis. Even the most pessimistic estimates from that period did not indicated that its negative impact on the economy and its duration will be so significant.

Even when we exclude the negative impacts of May floods economic activity is in a decline

Graph T2-2. Serbia: Seasonally adjusted GDP growth excluding effects of floods (2008=100)



Source: *QM* estimate based on SORS data

To separate long-term economic trends and a temporary effects of floods from the results of the economic activity in Q2 we excluded those sectors which were the most affected by floods – such as mining and production of electricity. When we exclude these sectors we see that the y-o-y fall in economic activity would still exist, but it would be significantly lower and would be 0.2-0.3% instead of 1.1%. Somewhat more relevant for the analysis of economic activity trend without the effects of floods is seasonally adjusted GDP which we presented in Graph T2-2.

Graph shows that the economic activity, even when we exclude effects of floods, is on a downward path and its declining trend started and practically remained unchanged since Q3 2013. One of the important reasons for the declining trend of economic activity since Q3 2013 is the fact that at that time the FAS Company reached its full production capacity and stopped its positive contribution to the growth of total economic activity. Without that contribution, prevailing unfavourable GDP trends were revealed, and they were undoubtedly present before Q3 2013, but were concealed with strong short-term growth of FAS Company production as well as by good agriculture season.

Net exports is slowing down while other GDP components have been in decline for a long time

We have analysed the GDP growth structure by use. Table T2-3 shows the GDP structure by expenditure method with last available data for Q1. The table clearly shows that in the last year, including also Q1 2014 only net export had high and significant growth, while all other GDP components – private consumption, state consumption and investments – were in decline or in the best case stagnant. Such structure of economic growth explains above stated assessment that a positive rate of growth of economic activity won't be possible in 2014. We state this because the growth of exports in the last several months is slowing down, and there are no signs that other components of GDP will compensate that with its own growth in short term. The slowdown in exports will clearly be seen as soon as the detailed data for Q2 become available. Namely, exports of goods in 2013 had a growth rate of about 26% in Q1 2014 y-o-y growth rate of exports was reduced to 17.4% in Q2 to 6.4%, and the last data show that exports in July recorded a y-o-y decrease of 11%.

Even deeper explanation for the slowdown in exports and thus the total production is found in the movement of investments. Namely, investments for some time have the largest real decline of all GDP components (7.7% in 2013), and without new investments it is not possible to continue further increase in exports and total production. Large investments from FAS and NIS in 2011 and 2012 led to a high growth of exports in the last two years but now they are exhausted, and there are no new similar investments. Therefore, exports in 2014 can no longer give a great contribution to the growth of the economy as it was the case in 2013, and the big question is whether it will have a positive effect on economic growth in 2015. We believe that for the future growth of the economy sharp increase in investments in the next period will be crucial and that this will have to be one of the main objectives of economic policy in Serbia.

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

	Y-o-y indices										
	2009	2010	2011	2012	2013	2013				2014	Share
						Q1	Q2	Q3	Q4	Q1	2013
GDP	96.5	101.0	101.6	98.5	102.5	102.8	100.4	103.8	103.0	100.1	100.0
Private consumption	97.2	99.1	98.9	98.2	98.5	98.0	98.1	97.4	100.6	98.0	74.8
State consumption	98.1	100.4	101.0	101.7	98.3	96.7	93.5	101.9	101.3	97.9	19.4
Investment	77.9	94.5	108.4	114.4	92.3	102.4	83.3	90.4	96.0	93.7	19.9
Export	92.0	115.3	103.4	101.8	116.6	110.6	111.8	126.3	116.7	114.2	43.1
Import	80.9	103.1	107.0	101.9	102.0	97.1	99.5	106.5	104.5	103.2	57.6

Source: SORS

As we already mentioned, other GDP components won't be able to compensate already noted slowdown of net exports in 2014 for eventual growth. State consumption will have to be reduced due to a high deficit and fast growth of public debt. Private consumption is under the influence of bad trends on the labor market (real decrease of wage mass due to a further decrease in the number of employed and low growth of average wage), but also a real fall of pensions, so it will also continue to decrease in real terms. For now there are no indications that the significant recovery in investments will happen – financial results of companies are poor, credit activity is low and there are no reliable announcements of large FDI. Investments could temporarily rise in the second part of the year due to repairs of floods consequences. Taking all said into consideration GDP analysis by use confirms and suggests continuation of worsening economic trends by the end of the year.

In 2014 there are no strong drivers of economic growth as agriculture and industry were in 2013

GDP trend analysis in the first half of 2014 can be complemented by the last available data on the level of economic activity by sectors in Q2 which are still not published, but based on partial data it is evident that trends in this quarter worsened. Therefore Table T2-4 shows growth of individual sectors of the economy ending with last complete official data which refer to Q1. It can be noticed that in 2014 growth rates of individual sectors are much more equable than they were in 2013. Preliminary and incomplete indicators for Q2 indicate that most sectors will continue with similar trends as in Q1– with the exception of the industrial production (especially mining and production of electric energy) that will record a strong fall, and this is mostly explained by flood consequences, and the trade which will record a growth. For that growth, until recently, we thought that it was a consequence of floods (buying of stocks, help for endangered, buying of necessary objects and electronics which were ruined in floods), but July data show even higher growth than in May and June indicating some other explanation. These data are not in line with the movement of domestic demand so we will analyze trade movements in more detail in the next issue of QM, when more data for the analysis will be available.

Table T2-4. Serbia: Gross Domestic Product by Activity, 2009-2013[1]

	Y-o-y indices										
	2009	2010	2011	2012	2013	2013				2014	Share
						Q1	Q2	Q3	Q4	Q1	2013
Total	96.5	101.0	101.6	98.5	102.5	102.8	100.4	103.8	103.0	100.1	100.0
Taxes minus subsidies	98.3	100.9	101.6	98.6	102.4	102.7	99.4	104.1	103.2	99.9	17.4
Value Added at basic prices	96.1	101.0	101.6	98.5	102.5	102.8	100.5	103.6	102.7	100.0	82.6
Non agricultural Value Added	95.8	101.6	101.5	100.6	100.4	101.1	98.2	101.4	100.8	100.1	90,4[2)]
Agriculture	100.8	99.6	100.9	82.7	120.2	123.2	124.1	117.8	117.8	97.0	9,6[2)]
Manufacturing	84.2	100.9	100.6	101.1	104.8	104.5	103.1	108.7	103.2	101.6	16,4[2)]
Construction	80.3	92.9	107.7	99.2	74.3	78.6	62.8	75.1	82.7	92.2	3,7[2)]
Wholesale and retail trade	92.5	101.7	94.5	100.2	98.6	96.8	96.0	98.5	102.8	98.0	9,8[2)]
Transport and storage	90.0	108.2	103.1	100.0	103.2	105.4	100.0	103.6	104.1	102.7	5,6[2)]
Informations and communications	110.0	105.4	108.4	104.8	110.8	110.0	109.8	113.3	110.3	105.1	6,3[2)]
Financial sector and insurance	105.5	107.2	101.0	104.0	98.7	101.8	99.4	96.9	96.8	96.3	3,8[2)]
Other	101.6	100.8	102.0	99.9	100.5	101.2	99.5	101.4	100.1	99.9	44,7[2)]

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

We expect GDP fall in 2014 of about 1%

With gradual arrival of new data economic activity trend is getting clearer, but also the impact floods had on GDP which give us more reliable estimates for this year. In the previous issue of QM we estimated that the economy is in stagnation and that the negative impact of floods with positive effects of the reconstruction) could be up to 0.5% of GDP. Because of that we estimated that the fall of GDP in 2014 could be around 0 and 0.5%. Last available data[1] and information however indicate that the impact of floods on the mining and production of electricity will be somewhat higher than we expected (partially because of the delay in the drying of coalmine Tamnava). According to the first indications the reconstruction from floods is for now very inefficient – the announced recovery of the railway infrastructure still did not happen (railroad

1 Data on industrial production trend, which includes mining and production of electric energy, are available ending with June so we ae are able to predict more accurately impacts of floods on GDP.

Belgrade – Bar) although already four months have passed. Instead of the expected 0.5 p.p negative impact could therefore be higher, around 0.7%. Besides that, even the economic trend without floods is not stagnation but recession, therefore we expect that the total fall of GDP in 2014 will be around 1% instead of expected 0.5%. For now we will hold on to the estimate that the fall of GDP in 2014 will be around 1%, although it could be easily somewhat higher.

Real reasons for recession are bad economic fundaments and not floods – stronger reaction of economic policy is needed

For almost two years we have indicated in QM that long-term trend of economic activity is negative. This was not so obvious in 2013 because the negative trend of the largest part of the economy was overshadowed by a high growth of agriculture (due to the comparison with the droughty 2012) and a high growth in production of FAS. Thoughtful and decisive economic policy response to poor economic trends, however, is still pending, although in 2014 unfavorable economic trends became stripped and apparently and even worse[2]. Real reasons for reduction of economic activity are essential and not temporary – unsustainable fiscal position (high and growing public debt and high deficit), reduction of investments, low credit activity, slowdown of exports and other. Economic policy should therefore have to react more decisively and begin to implement stronger antirecession measures, but also begin to eliminate core problems the Serbian economy is facing.

Growth in conditions of fiscal consolidation and restructuring of enterprises.

Growth of Serbian economy in the long term will crucially depend on the economic environment, thus its improvement represents a key driver of investment and economic growth. At the middle of this year labour market reforms were implemented in Serbia, the bankruptcy procedure was improved, and significant simplification of construction procedures was announced by the end of the year. Progress in other elements of economic environment remains very slow. Construction of infrastructure is still very inefficient and in the work of state bodies there were no systematic improvements for years. Even in the best case scenario, if in the coming years systematic improvement in the economic environment is achieved, it will take few years for it to affect the growth of the economy.

Macroeconomic stability represents one of the important elements of economic environment, and it rapidly deteriorated in Serbia in the last few years. High fiscal deficit and strong public debt growth which it generates represent the main sources of macroeconomic instability, and therefore the mid-term growth of the economy will largely depend on the planned fiscal consolidation. If in 2015 the most difficult part of the fiscal consolidation is implemented, the public debt crisis is avoided, and steps are taken towards the recovery of public finances – this could have negative effects on economic activity in the short term, but in the mid-term, faster and sustainable growth could be expected. With incomplete consolidation of public finances (which now seems possible, because it indicates less severe reduction in pensions and public sector wages than required) – crisis in 2015 will most likely be avoided, but the Serbian economy will be doomed to recession or stagnation, not only in 2015 but most likely in the medium term. Simply put, it is not realistic to expect high economic growth and investments in the environment which is threatened by the outbreak of the public debt crisis and macroeconomic instability, and this risk with incomplete fiscal consolidation will not be avoided. Finally, if necessary measures are not taken and savings in 2015 are significantly lower compared to the magnitude of the problem in public finances, than a drop in GDP of 1% will prove to be optimistic, because crisis of public debt with GDP fall of over 5% will be very probable.

The growth of Serbian economy in the coming year will be under the dominant influence of a number of specific factors. Although there is a number of unknowns due to which it is still impossible to give a reliable assessment of trends in the economic activity in 2015, it is almost certain that it will be another year of recession. We highlight some of the many reasons for this: 1) a multi-year decline in investment has reduced the potential for future growth in production, 2) solving the fate of the companies in restructuring is expected and a shutdown in the largest number of companies from this group in 2015, which is good for Serbian economy, but in the

2 Occasionally some ad hoc antirecession measures appear, such as the extension of subsidized loans, but comprehensive and thoughtful policy responses to the recession is still lacking.

short term will affect the temporary reduction of GDP 3) fiscal consolidation, which will also have a temporary negative impact on the economy, but which is essential for avoiding public debt crisis and 4) an unfavorable international environment - stagnation in the EU and possible further escalation of its relations with Russia with negative economic consequences. Factors which could enhance economic growth in 2015 are mostly limited. It could be heard in public that after Russia imposed sanctions for goods from the EU, Serbia's export to Russia is a great chance for economic growth. However, Serbia's export is almost marginally tied to Russia, only about 6% of total exports. Even if it would increase within a year by 50%, it could contribute to the overall growth in exports of around 3%, which is insufficient, especially considering that a possible recession or stagnation in the EU at the same time would reduce the demand on the market where we export more than two-thirds of all products. Somewhat more realistic opportunity for mitigation of expected negative trends in economic activity could be a growth in investments, but it requires appropriate, good and decisive economic policy. We believe that during the implementation of fiscal consolidation, public investments must not only be efficiently executed but also that the room for their increase must be left. Attracting large FDI and eventual privatization of a number of companies in restructuring, accompanied by investments of new owners, are also areas in which the economic policy could play a crucial role. Besides all this subsidies for loans should be retained or possibly increased, and the introduction of some other limited antirecession measures should be considered. Taking all this into account, we believe that the negative trends will prevail in 2015, which will be another year of recession with a possible drop in GDP of around 1%.

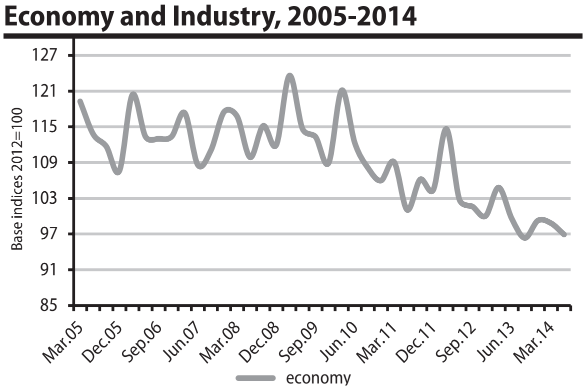
In 2015 fall of economic activity is probable, maybe about 1%

Although there are many uncertainties due to which it is still impossible to give reliable estimate of the economic activity trend in 2015, it is almost evident that it will be another recession year. We estimate that the factors which will have an impact on the fall of economic activity in the next year, will be dominant compared to the ones which could start its growth (see Highlight 2). When creating fiscal policies and reforms first step is to recognize the trends in the local economy, instead of emphasizing unreliable and probably poorly measured data on employment growth.

Unit Labour Costs continue to fall

Unit labour costs[3] (ULC), measured in dinars, continue to fall in Q2 (Graph T2-5). This tempo of decrease is somewhat slower in Q2 than in Q1, because y-o-y ULC decrease in Q2 was about 3% while in Q1 it was about 5%. ULC decrease is a consequence of unfavourable trends on the labour market and unfavourable trends of economic activity – because of which wage mass is falling not only in real terms but also in nominal terms. Because the real labour costs are declining slightly faster than the economic activity - ULC decrease. It is interesting to note that based on the data on formal employment by sectors of the economy, based on which we calculate the movement of the ULC, employment in the economy decreased in Q2 by about 2% (in the manufacturing industry for over 4%), while the data from the Labour Force Survey which include informal employment show growth of employment.

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



Source: *QM* based on SORS and NBS data

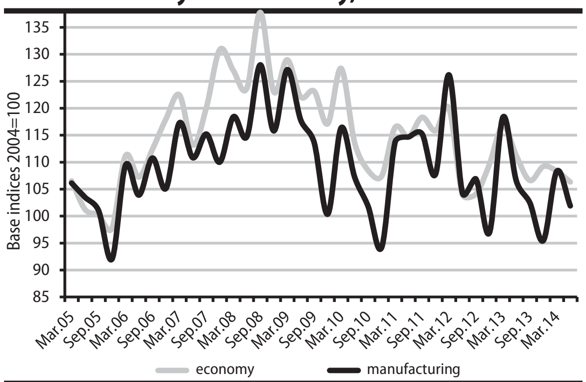
Unit labour costs measured in euros (euro-ULC) are an indicator of the price competitiveness of the Serbian economy, as they define the greatest national cost component (labour costs) in relation to the added value. We calculate euro-ULC for the manufacturing sector (which produces by far the greatest share of tradable goods), and for the economy as a whole4, as shown in Graph T2-6.

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

The price competitiveness of the economy is improving with real dinar depreciation

Graph T2-5 shows, despite strong seasonality, a trend of gradual reduction of the euro-ULC. Euro ULC in Q2 decreased y-o-y slightly more than the dinar ULC, because there was a mild y-o-y dinar depreciation. Last, slightly higher, dinar depreciation from August and the beginning of September still has not been included in the data, and in the future will (if lasting) additionally influence euro ULC to decrease further and come roughly to the level of 2005. We use this year as 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. Strong growth of euro – ULC after 2005 due to the real dinar appreciation was one of the main reasons why in the pre-crisis period Serbian economy was on unsustainable path which was based on the growth of domestic demand, instead of production of tradable goods and exports. After the outbreak of crisis and relatively strong dinar depreciation at the end of 2008, there was a rebalancing of the domestic economy– imports decreased and exports increased compared to their pre-crisis level. It is interesting to notice that in 2014 relatively favourable and competitive labour costs seem to have no influence on increase of FDI, exports and production. This short analysis points out that the price competitiveness is required, but not sufficient, for the growth of investments and exports, and that the sustainable growth of the economy depends on some other factors such as stabile macroeconomic environment (now there is a risk of public debt crisis), favourable business environment and other.

Graph T2-6. Serbia: Real Euro - Unit Labor Costs in the Economy and Industry, 2005-2014



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

Industrial production

Industrial production recorded strong fall

Industrial production in Q2 recorded a y-o-y fall of 4.8% (Table T2-7). Within the industrial production large fall of even 13 or 14% was recorded by the mining industry and production of electricity, while the manufacturing industry also recorded a fall which was somewhat lower and amounted to around 2%. The reason for large fall of mining and production of electricity is May floods, which flooded the most important coal mines consequently influencing large fall in production of electricity. Besides this strong, but temporary fall, a drop in production industry is worrisome (although significantly lower) because it was not under the influence of temporary factors but probably under the influence of deeper negative trends.

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

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

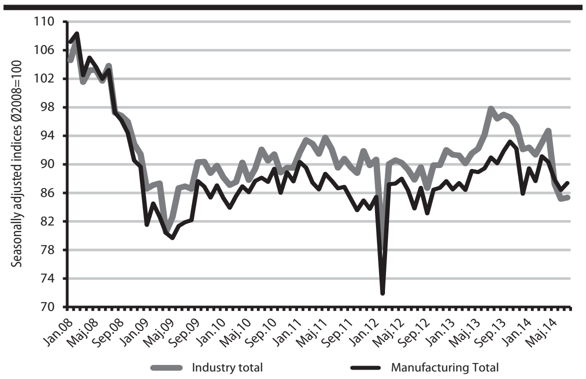
Source: SORS

In 2014 industrial production will undoubtedly record a fall. Mining and production of electricity will have even somewhat higher fall in Q3 compared to Q2, as Q2 includes relatively good April and the first half of May – period before floods – which won't be the case in Q3. These sectors of industrial production will gradually recover as flooded coal mines get drained, but on the annual level will undoubtedly be in deep fall. On the other hand manufacturing industry won't be able to compensate this fall with eventual growth in two sectors influenced by floods in order for total industrial production to be positive - all the more so because the manufacturing industry is currently in decline, and its noticeable growth by the end of the year we don't even expect.

Seasonally adjusted indices show big fall in May

Graph T2-8 shows seasonally adjusted production indices of total industry and manufacturing. We can immediately notice that the seasonally adjusted data confirm already mentioned large fall of production by about 10% since May under the influence of floods, but also a fall of manufacturing by about 4%, for which a more detailed analysis shows that it occurred regardless of floods. Namely, sectors of the manufacturing industry which recorded a fall in Q2 were motor vehicles production, oil derivatives, food processing, chemical products and other. These movements will be closely followed in the future issues of QM because by then we will have a final confirmation of whether the decline in the manufacturing industry from Q2 is temporary or permanent in nature. One of the assumptions which we will examine in more detail is whether the slowdown in manufacturing industry may be caused by falling export demand as exports in July recorded a very strong decline. For now, available industrial production data for July show that only decline in the production of oil derivatives in Q2 was temporary, because already in that month there was a sharp increase in production, while the drop in other areas is generally confirmed and probably more durable. We will also follow future trends in the production of motor vehicles (FAS) with special attention, which in July had a huge temporary decline due to the collective holidays. Occasional suspension of production in FAS in September could indicate that the plant is reaching its peak in production and that is now entering a phase of gradual decline, but also provide an additional argument that the drop in export demand is the main cause of the fall in manufacturing industry.

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



Source: SORS

In Q2 massive drop in energy production due to the floods

Observed by use (Table T2-9) we see that in Q2 all specific groups of industrial products recorded a y-o-y decline. This decline was particularly pronounced in the production of energy and it is explained with negative impact of floods. Production of capital goods moved from the zone of high y-o-y increase from Q1 to the 3% decrease. This is primarily a result of a slowdown in production of the FAS Company - because motor vehicles are classified into this category - but negative y-o-y growth of capital goods implicitly points to the low investment activity in Serbia[5]. Production of consumer goods is currently stagnating, while the production of intermediate goods decreases, but we note that it is subject to slightly larger oscillations, which are mostly caused by occasional production of Železara Smederevo (Table T2-9).

Table T2-9. 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	Q2
Total	87.4	102.5	102.1	97.1	105.5	94.5	97.2	96.4	99.4	105.2	103.0	110.8	103.3	102.1	95.2
Energy	98.8	97.7	106.2	93.6	113.2	95.8	88.3	91.4	98.7	108.6	109.7	131.6	107.7	101.1	89.1
Investment goods	79.3	93.6	103.2	103.8	127.6	92.0	105.4	113.7	104.2	132.3	130.2	140.5	104.2	107.7	97.0
Intermediate goods	78.4	109.2	102.2	91.2	99.0	89.4	96.3	89.1	90.0	94.7	93.1	101.9	104.8	103.9	94.3
Consumer goods	86.8	102.1	95.4	103.2	100.7	97.8	104.5	104.6	106.1	107.0	101.5	97.4	100.0	100.2	99.6

Source: SORS

5 Motor vehicles production in spite of a slowdown recorded an annual increase of about 5%, which means that the rest of the production of capital goods declined by about 5%.

Construction

The construction sector has been in a continuous decline for three years in a row (Table T2-4 and T2-10). Latest SORS construction data indicate a year-on-year real decline of this sector of economy in Q2 of 5.7%. This decline is quite similar to the one measured in Q1 (5.1%) and we believe that despite the insufficient reliability of the construction indicators from the official statistics – this time they describe real trends in the construction activity well.

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

	Y-o-y indices				
	Q1	Q2	Q3	Q4	Total
2001	89.5	103.5	126.9	148.1	114.2
2002	83.6	107.9	115.6	81.6	99.1
2003	51.1	94.4	92.7	94.4	86.6
2004	118.8	107.4	98.5	120.1	108.0
2005	66.1	105.0	105.8	107.4	101.6
2006	136.0	102.7	112.2	120.2	112.7
2007	193.8	108.9	93.1	85.0	104.4
2008	100.1	103.7	108.1	110.1	105.9
2009	34.1	81.4	86.0	75.3	74.4
2010	160.7	96.9	96.0	97.4	101.1
2011	97.7	101.3	96.2	97.7	98.3
2012	107.9	88.3	58.2	84.9	79.6
2013	83.5	78.7	127.6	93.5	94.9
2014	136.2	90.3			

Source: SORS

Confirmation of similar movements in the construction sector is given by the cement production index which, because of the difficulties in monitoring the construction sector, we use as additional indicator of its movement (T2-10). Cement production in Q2 was for 9.7% lower than the one from the same period of the last year[6]. Taking into consideration the inaccuracy of this indicator, we believe that this is however a good confirmation of the previously exposed estimates from the official construction statistics that the construction sector in Q2 was in a moderate decline of somewhat over 5%.

The main reason for the fall of the construction sector was low level of investments of a private, but also public sector. We already discussed the fall of private investments and the main reason for that was a low level of FDI, bad financial results of domestic companies and low credit activity of companies and citizens (mortgage loans). On the other hand there are not many convincing explanations for large underperformance in the execution of public investments, which will in 2014 be for even 30% lower than planned at the beginning of the year. Those investments are not only planned by the budget but also the financial funds for them are secured and so the only remaining explanation why they are not executed is - inefficiency of the State.

It is possible that there will be a recovery due to the remediation from floods

By the end of the year we can expect a moderate recovery of the construction sector due to remediation of the consequences of floods, so the construction sector could enter the area of positive growth. That growth could hardly be strong, in part because we have already noted the government's inefficiency in sanitation of the consequences of floods (draining coal mines, restoration of railway infrastructure, etc.). Also, even if the growth of the construction sector happens by the end of the year, without reversal of the essential trends of economic activity, growth of private investments and increase in efficiency in the execution of public investments, this eventual recovery will likely prove to be temporary.

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). Survey for the second quarter was conducted at the end of March. The data shows that the negative effect of the winter season has passed, because the employment slightly rose by 1.3 percentage points, and the inactivity was reduced by the same percentage. Considering the almost unchanged rate of unemployment, it would seem that the labour market trends went from inactivity to employment. As of this year, the LFS is publishing the structure of the inactive according to their subjective status. According to this data, more than 700,000 individuals are not actively seeking employment, and not because of retirement or education or training, which are the most usual reasons for inactivity. While the formal employment is dropping, informal employment continues to grow, especially among the employed workers and helping household members. Observed by sectors, employment has increased the most in helping household members, followed by companies dealing in supply of electricity, gas and steam. As a result of growth of informal employment, total employment is growing as well, which is not in line with the recession trends in the economy.

Employment

After the negative effects of the winter season had passed, employment grew slightly, while inactivity declined

As of this year, the Labour Force Survey is published quarterly. For the second quarter of 2014, the Survey was conducted at the end of March, while in previous years the April surveys were conducted at the end of April and beginning of May. Therefore, these two surveys are not completely comparable. Additionally, data from Q2 2014 is not compared to the April survey of 2013 because, as we stated earlier, we believe that the level of employment in October 2013 (49.2%) is the real one, because it is highly unlikely that the number of the employed in the period April--October had increased by 140,000 (Table T3-1).

In Q2 2014, there were 4,620,341 individuals between the ages of 15 and 64 (by 24,549 less compared to Q1 2014). Among these persons 2,888,543 were economically active (by 46,632 more compared to Q1 2014), namely:

- 2,277,413 were employed, which is by 48,350 more compared to Q1 2014. The rising number of the employed, but also the declining number of individuals between the ages of 15 and 64, contributed to the increase of the employment rate from 48 to 49.3%.
- 612,134 were unemployed, i.e. by 1,653 less compared to Q1 2014. However, the decline of the unemployment rate from 21.6 to 21.2% is mostly due to the growing number of economically active individuals compared to Q1.
- 1,731,798 were inactive, i.e. by 71,181 less compared to Q1 2014. The decline of the inactivity rate from 38.8% to 37.5% is partly due to the decrease in total working age population, but certainly mostly due to the decreased number of the inactive.

The number of the employed individuals in the second quarter of this year is higher compared to Q1 by almost 50,000, but only slightly higher than the number of the employed in October 2013, which indicates that the negative effect of the winter season, which is usually present at the beginning of the year, has passed. The number of the unemployed is almost unchanged compared to the first quarter of this year, and it increased by 10,000 compared to October 2013 (Table T3-1).

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

		Total no. of employed 15-64 2)	Number of employed in agriculture and unpaid family workers 15-64 3)	Employment rate 15-64 15-64 god.			Total number of unemployed 15-64	Unemployment rate 15-64		
				Total	Male	Female		Total	Male	Female
		1	2	3			4	5		
2008	April	2,652,429	..	54.0	62.3	46.0	432,730	14.0	12.4	16.1
	October	2,646,215	443,243	53.3	62.2	44.7	457,204	14.7	12.7	17.3
2009	April	2,486,734	437,957	50.8	58.7	43.3	486,858	16.4	15.0	18.1
	October	2,450,643	411,303	50.0	57.4	42.7	516,990	17.4	16.1	19.1
2010	April	2,278,504	326,623	47.2	54.3	40.3	572,501	20.1	19.4	21.0
	October	2,269,565	352,724	47.1	54.4	39.9	565,880	20.0	19.0	21.2
2011	April	2,191,392	340,528	45.5	52.2	38.8	649,155	22.9	22.7	23.1
	October	2,141,920	329,378	45.3	52.5	37.9	690,782	24.4	23.5	25.6
2012	April	2,083,604	317,879	44.2	51.1	37.1	735,209	26.1	25.6	26.7
	October	2,201,760	345,883	46.4	53.7	39.1	661,698	23.1	22.1	24.5
2013	April	2,127,649	315,109	45.8	53.6	38.1	707,440	25.0	23.1	27.3
	October	2,268,750	349,742	49.2	56.2	42.1	602,651	21.0	20.2	22.0
2014	Q1	2,229,063		48	55.1	41	613,787	21.6	21.0	22.3
	Q2	2,277,413		49.3	56.3	42.5	612,134	21.2	20.4	22.1

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 highest decline in employment in the financial and insurance sectors

Employment grew in ten out of a total of twenty sectors between the two quarters of this year. The highest increase in employment was realised in helping household members, who fall in the category of informally employed, by 47%, followed by companies dealing with supply of electricity, gas and steam by 28%. Employment declined the most in finance and insurance by 12%, as well as the sectors dealing with art, entertainment and recreation by 19%[1]. (Table T3-2).

Table T3-2. Employed by Sectors (LFS)

	October 2012	April 2013	October 2013	Oct 2013/ oct 2012, index	Q1 2014	Q1 2014/ Apr 2013, index	Q1 2014/ Oct 2013	Q2 2014	Q2/Q1 2014
TOTAL	2,299,038	2,227,432	2,394,004	104.1	2,342,966	105.2	97.9	2407930	102.7727248
Agriculture, forestry and fishing	494,700	461,819	522,084	105.5	469,196	101.6	89.9	500302	106.6296388
Mining	25,092	21,173	23,065	91.9	27,230	128.6	118.1	23941	87.92141021
Manufacturing industry	394,992	389,193	399,654	101.2	388,127	99.7	97.1	386935	99.69288403
Supply of electricity, gas and steam	35,159	37,751	37,206	105.8	31,266	82.8	84.0	40114	128.2991109
Water supply and wastewater management	35,203	30,436	36,866	104.7	37,139	122.0	100.7	42579	114.647675
Construction	121,659	92,977	126,620	104.1	96,744	104.1	76.4	99763	103.120607
Wholesale and retail trade, repair of motor vehicles	307,136	305,132	288,606	94	300,020	98.3	104.0	304649	101.5428971
Transportation and warehousing	125,748	137,980	130,882	104.1	141,317	102.4	108.0	132088	93.46929244
Accommodation and food services	66,555	55,737	61,973	93.1	62,153	111.5	100.3	59826	96.25601339
Information and communication	35,172	45,266	50,140	142.6	56,796	125.5	113.3	61045	107.4811606
Financial activities and insurance activities	43,676	40,860	44,566	102	44,616	109.2	100.1	39275	88.02895822
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	73251	107.1563364
Administrative and support service activities	47,076	47,919	49,175	104.5	47,585	99.3	96.8	46846	98.4469896
Public administration and compulsory social insurance	125,469	129,761	132,950	106	135,750	104.6	102.1	138316	101.8902394
Education	146,867	142,490	156,867	106.8	149,005	104.6	95.0	150117	100.7462837
Health and social care	140,297	124,628	136,455	97.3	140,776	113.0	103.2	146563	104.1107859
Arts, entertainment and recreation	36,387	33,040	44,823	123.2	49,158	148.8	109.7	40040	81.45164571
Other service activities	43,722	47,561	45,177	103.3	43,803	92.1	97.0	42157	96.24226651
Activities of households as employers	20,377	18,632	41,003	201.2	51,280	275.2	125.1	75690	147.6014041

Source: LFS
Note: *small number of occurrences so it is impossible to estimate. Q2/Q1 2014 mining index should be taken with caution because the score for the second quarter is less accurate.

1 Includes activities that satisfy various cultural, entertainment and recreational needs and interests, including music and stage performances, the work of museums, galleries and collections, protection of monuments, games of chance (gambling and betting), sports and recreation.

Informal employment grew to 21.2%

Informal employment rate, expressed as a share of the informally employed in the total number of the employed, is higher by 0.7 percentage points compared to Q1 2014, and is currently 21.2%. Survey from the second quarter of this year estimates that there are 511,575 informally employed people in Serbia. This includes those employed in unregistered companies, registered ones but without a formal labour contract, as well as helping household members[2]. Considering the fact that the Survey, ever since it started being published quarterly, shows the structure of the informally employed according to their professional status, we can observe that the highest increase among the informally employed is in those who have the status of the employed and helping household members, by 15% and 12% respectively. Due to a small number of occurrences, the number of the self-employed and those working in an informal economy has not been published (Table T3-3).

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

	Q1	Q2
Employed	62.352	71.723
Self-employed with employees	*	*
Self-employed without employees	227.955	229.427
Helping household members household	187.056	209.509

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

The structure of inactive persons is disconcerting

As of this year, Labour Force Survey is publishing more detailed results about the reasons of inactivity of the working age population. Even though we have repeatedly pointed out the extremely high inactivity rate, the more detailed representation of this category's structure in the labour market is additionally worrying. That is, out of a total of 3 million people who are out of work and are not actively looking for it, over 700,000 does not claim this is due to retirement or still being in school, since these are the most common reasons of inactivity. As can be seen in Table T3-4, among them is almost the same number of homemakers and persons who are categorised as unemployed, but it can be clearly seen through other questions in the Survey that they are not actively seeking employment.

Table T3-4. Inactive persons according to subjective status

Pensioners	1.699.271
Pupil, student, graduate student, person on mandatory unpaid practice	542.165
An unemployed person	361.797
Houseworker	358.076
Person with long-term disability who is not working	80.503
Other inactive person	40.827

Source: LFS, Q2 2014

"From Inactivity to Employment"[3] study deals in detail with the reasons behind the inactivity of each individual group, as well as possibilities for their activation on the labour market. We have shown that, with the right incentives, the possibilities of activating the inactive, who call themselves unemployed, are significantly higher compared to other categories. Inactive "unemployed" show significantly higher desire to work (especially those up to 55 years of age), and the basic cause of their inactivity is discouragement regarding the possibilities of finding work. In those older than 55, who became inactive after they lost their job in the process of transition, discouragement is stronger and is related to the initial failure of finding work again after years of secure employment, but also to the low estimate of their own abilities, which includes poor health. Older women (homemakers) are in the toughest position, as they are stuck in a 'sandwich' – taking care of children and elderly parents and relatives. Inactivity is additionally higher in persons with low education, and in those who can rely on income from social transfers or on income from other family members. Separate analysis of the effects of the two most significant social transfers, which are conditioned by activity on

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

3 Arandarenko, M., Žarković-Rakić, J., Vladisavljević, M. 2012. From Inactivity to Employment. Analysis of the Impact of Public Policy and Factors Influencing the Inactivity: Possibilities of Growth in Activity and Employment in Serbia. Foundation for the Advancement of Economics for the Social Inclusion and Poverty Reduction Team of the Government of the Republic of Serbia.

the labour market – unemployment benefits and financial social assistance – has shown that their beneficiaries are not especially motivated to be active or are even less active on the labour market than persons with similar characteristics. While on the one hand, beneficiaries of unemployment benefits have higher inactivity than other persons registered at the National Employment Service, on the other hand, even though one of the formal requirements for accessing financial social assistance is for the working-age people to actively seek employment, most of them do not comply. Our analysis of parameter characteristics of these transfers indicates that the main problem is not in their excessive generosity, but in lack of incentives for activating and in deficiencies in monitoring the behaviour of their beneficiaries.

Box no. 1 New Labour Law Adopted

In mid July, Serbian National Assembly adopted the new Labour Law, which was a subject of debate for a long time among the expert public, as well as source of disagreements between the Government, unions and employers' associations.

Amendments to the Labour Law present a significant progress in labour market regulations in Serbia. Some of the most important provisions that we have suggested on several occasions in the Quarterly Monitor have been adopted. This includes severance pays which, according to the new law, will be paid exclusively for the years of employment spent with the last employer and not for the entire working age of the employee, as was in the past, and in the amount of at least one third of earnings per year of employment. Severance pay due to retirement will be two average wages of the employee, instead of the previously foreseen three. Since severance pays previously had a negative impact on the supply and demand for the older workers, the adoption of this solution, according to our estimate, is a positive one.

The maximum duration of fixed-term contracts has been changed from one year to two, or to three in exceptional circumstances. Also, the age limit of 30 years for concluding contracts for temporary employment through youth organisations has been abolished.

Part-time employment and remote employment, as well as flexible forms of employment, are regulated in more detail by the new law. The new law prescribes providing better information to workers by their employers and unions on the availability of part-time jobs. However, it is our opinion that that alone is not enough to encourage this type of employment, since the tax regulation has not been changed in the part related to the part-time employment. Namely, the minimum contribution base, which is 35% of average gross earnings, is currently around 20,000 dinars, and for someone working part-time with a gross earnings of around 13,000 dinars, the contributions are calculated to a higher amount, i.e. the minimum base. Because of this, part-time employment does not pay off for the employers.

In other words, expectations that the mere change in the Labour Law would improve the situation on the labour market are unrealistic. The law itself presents a problem when it is too rigid or too liberal, which was not the case with the previous solution. In two separate researches, the World Bank[1] and OECD[2] concluded that the previous labour market regulations in Serbia was not particularly rigid compared to other countries in the region of Southeast Europe or OECD countries. Relatively high employment in grey economy and limited inspection capacity in the formal sector contribute, without a doubt, to a decreased influence of the formal rules on labour market performances, thus additionally improving Serbia's relative position. Therefore, without changes in other areas, the efficiency of the law cannot be completely realised, even if on paper it presents a better solution than the previous law.

1 World Bank (2005b). Doing Business 2006. Washington, DC.
2 OECD, 2008. Serbia: A Labour Market in Transition, Paris: OECD

Wages

Average monthly gross wages were lower by 0.4% in real terms compared to the same quarter last year

According to the data of the Statistical Office of the Republic of Serbia, at year-on-year level, the average monthly gross wages in Q2 were nominally higher by 1.4%, and lower by 0.4% in real terms (Table T3-5). Average monthly net wages in the first quarter of 2014 were slightly lower than 45,000 dinars or 389 euros. Reduction of real wages continues to reflect the negative tendencies in most of the economy, as well as the labour market, but also a bigger share of the grey economy.

Table T3-5. Serbia: Average Monthly Wages and year-on-year indices, 2012-2014

	Average Monthly Wage[1)]				Average Gross Monthly Wage Index[2)]	
	Total labour costs[3)], in dinars	Net wage, in dinars	Total labour costs, in euros	Net wage, in euros	nominal	real
2012						
Q1	63,846	39,068	591	362	111.0	106.0
Q2	68,140	41,664	600	367	109.6	105.3
Q3	67,457	41,187	577	352	106.4	98.4
Q4	71,452	43,625	630	384	108.7	96.8
Dec	76,830	46,923	677	413	106.6	95.1
2013						
Q1	67,704	41,419	606	371	106.0	94.6
Q2	72,143	44,248	644	395	105.9	95.9
Q3	71,469	43,939	626	385	105.9	99.1
Q4	75,089	46,185	648	399	105.1	103.0
2014						
Q1	68,015	41,825	588	361	100.5	97.8
Q2	73,147	44,971	633	389	101.4	99.6

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

At the year-on-year level, the highest growth in wages in Q2 was still in the sector of information and communication

Year-on-year index of net wages shows that the wages realised in Q2 2014, compared to the same period last year, have increased in only six out of nineteen sectors. The biggest growth was recorded in the sector of information and communication (19.1%), which was also the case in the previous three quarters. They are followed by the growth of wages in the sector of administrative and auxiliary services by 12.4%[4]. In other sectors, the growth of wages was not higher than 1%.

Table T3-6. Year-On-Year Index of Real Net Wages

	Information and communication	Financial and insurance activities	Admin. and support service	Wholesale and retail trade
2012Q1	104.3	109.8	105.4	103.0
2012Q2	116.5	100.4	106.1	110.4
2012Q3	97.1	93.1	102.0	96.0
2012Q4	105.5	93.3	96.6	97.8
2013Q1	95.8	91.3	94.6	97.5
2013Q2	95.9	91.1	85.6	100.4
2013Q3	114.6	101.0	88.5	99.9
2013Q4	112.8	103.0	104.7	104.2
2014Q1	123.3	90.5	89.1	96.8
2014Q2	119.1	95.9	112.4	96.4

Source: *QM*

The biggest decline in wages in the amount of 4% was recorded in the financial and insurance sector, followed by wholesale and retail where the wages in Q2 dropped by 3.6% compared to the same period last year (Table T3-6).

Compared to the previous quarter, the wages have increased the most in mining

Observed by sectors, as can be seen in Table T3-7, the net wages in Q4 2013 compared to the previous quarter have increased in ten out of nineteen sectors. The highest increase in the amount of 3.6% was realised in mining. In other

4 This sector is not related to public administration, but rather includes sectors of rental and leasing, hiring agencies, private security, etc.

Table T3-7. Real Seasonally Adjusted Net Wages

	Mining	Construction	Financial and insurance activities
2012,Q1	113.50	102.83	106.30
2012,Q2	91.85	100.16	95.23
2012,Q3	96.11	91.22	94.56
2012,Q4	102.59	93.42	98.16
2013, Q1	99.18	101.35	101.63
2013, Q2	100.16	101.57	98.54
2013,Q3	98.62	102.06	103.72
2013,Q4	102.05	101.22	97.61
2014, Q1	98.50	99.47	99.70
2014, Q2	103.56	98.92	97.32

Source: *QM*

sectors, the growth was insignificant, from 0.1% to 1.5%.

The highest decline in wages of 2.7% in Q2 2014 compared to the previous quarters was realised in the financial and insurance sector. In other sectors, the decline of wages was up to one percent at the most.

4. Balance of Payments and Foreign Trade

In the months passed in 2014, including Q2, the improvement in the current balance of payments has stopped. The deficit has stabilised at around 5% of GDP, which is considerably less than two or three years ago, but the realised deficit was still higher than long-term sustainable levels. The trends in current account balance of payments are predominantly determined by the foreign trade trends. As we already predicted, in 2014, the exports are decelerating their growth, while the growth of imports is slightly accelerating. We do not expect significant improvements in the second part of the year in foreign economic relations, because the factors influencing the increase and decrease of foreign deficit will mostly cancel each other out. Depreciation of dinar and the announced austerity measures will influence the improvement of foreign trade balance, while the stagnation in EU and growth of energy imports will worsen the foreign trade balance. Received billion dollar loan in August from the United Arab Emirates intended for the budget of the Republic of Serbia led to an increased level of public sector's foreign debt and total foreign debt.

In Q2 the current account deficit was 383 million euros, i.e. 4.8% of GDP

According to NBS data, and in line with the new balance of payments methodology[1], the current account deficit in Q2 was 383 million euros (4.8% of GDP, Table T4-1). This value of the current account deficit is equal to the one recorded in the same period last year. However, there have been certain changes within the current account in realised values on its individual accounts: goods and services deficit is below and primary income deficit (Income according to BPM5) is above the last year's values. The secondary income (current transfers according to BPM5) is slightly lower compared to Q2 2013.

In 2014 we expect the current account deficit to stay at around 5% of GDP

Having in mind the past trends and expected changes, we estimate that the current account deficit will stay at an approximately the same level as last year. The 5% of GDP deficit that is expected this year is significantly lower than the realised deficit in the last several years, but it is still higher than the long-term sustainable level. The reduction of the current account deficit in the second half of 2014 could be influenced by measures of fiscal consolidation, but the weak demand in EU will present an obstacle for the export growth. Dinar depreciation from July and August will have a positive effect on foreign trade trends in this year's final quarter, while the growth of electricity imports will cause a deterioration in foreign trade trends. Recession trends, which began even before the floods, probably contributed to the current export trend (which decelerated its growth in Q2 and in July recorded a year-on-year decline of 10.9%), but at the same time, set limitations on the import growth (after a gradual acceleration of growth in Q2, imports are again decelerating in July – year-on-year growth at a rate of 1.8%).

Growth of exports are still faster than the growth of imports...

…Still, exports are decelerating their growth, while imports are slightly accelerating

In Q2, trade deficit was 980 million euros (12.2% of GDP), which is 0.5 p.p. of GDP below the deficit realised in the same period last year, as a result of still faster growth of exports than imports. Goods and services deficit was at a level of 908 million euros (11.3% of GDP) and by 0.5 p.p. of GDP lower than the last year's. Goods in the value of 2.768 million euros were exported (34.6% of GDP). Imports during Q2 were 3.747 million euros (46.8% of GDP). Exports are decelerating their growth, while imports are slightly accelerating. Still, the rate of exports is sufficiently higher than the rate of imports, which led to further decline of the trade deficit. Exports were by 7.3% above the values recorded in Q2 2013. Imports recorded a year-on-year growth of 3.4%[2]. During Q2, the services account had a slight surplus of 72 million euros. Strengthening of the dinar's real value in the first half of the year had a negative effect on the foreign trade trends, while the depreciation of dinar that started mid-year will have a positive impact on the foreign trade at the end of current and beginning of next year.

Higher outflow of the Primary Income (Income) and lower inflow of the Secondary Income (Current Transfers) compared to Q2 of last year

On the primary income account (Income), a net outflow of 317 million euros was recorded. Secondary income (Net inflow of current transfers) in Q2 was 842 million euros (10.5% of

1 For more details on the changes in methodology, see Box 1 in this article.
2 The data differs from the SORS data as it excludes goods in processing (see Box 1 on methodology changes in calculating Balance of Payments).

GDP). Out of that amount, 695 million euros were Personal Transfers (8.7% of GDP), out of which 547 million euros were inflows from remittances (6.8% of GDP).

Box 1. Methodology Change in the Balance of Payments Statistics

In April, the statistics methodology of the balance of payments was changed and is now in line with the methodology applied by all EU member states, and which is also expected of the accession countries[1]. From the methodology of the International Monetary Fund, contained in the *Balance of Payments Manual (BPM5)*[2] we moved to the calculation according to the sixth edition of the Manual (BPM6)[3].

The transition to the new methodology has resulted in changes in the significant number of balance of payments items. Above all terminology changes along with numerous technical changes (additional allocation, i.e. separate disclosure of certain positions, which were formerly a part of the larger accounts, as well as the change in signs convention) and substantial changes (e.g. changes in scope of certain items).

We primarily highlight some terminology changes in items (former and current terms in Table 1) of the balance of payments account:

1) Within the current account of the balance of payments

- Account *Income* is now *Primary Incom*e
- Account *Current Transfers* is now *Secondary Income*

2) Within the financial part of the balance of payments

- Account *Financial Loans* is now *Loans*. And within this account:
  - *NBS* is now *Central Bank*
  - Instead of *Bank loans*, it is now borrowing of the *Deposit-taking corporations except the Central Bank*
  - *Government* is now referred to as *General Government*
- *Trade Loan*s from the old methodology are now *Trade Credit and Advances*
- *Other Asset*s *and Liabilities* are now *Other accounts receivable/payable*

Items that were not expressed in the former version of the balance of payments and which are now part of the Table 1 are:

1) Within the current account, as a part of *Secondary Income* (*Current Transfers* according to old methodology) a new item is recorded and published – *Personal Transfers*.

2) Within the financial account (aside from standard accounts: *Foreign Direct Investments, Portfolio Investments and Other Investments*) there is a new item called *Financial Derivative*s.

- Under *Other Investments* two new items have been added: 1. *Insurance and Pension and Standardised Guarantee Schemes* and 2. *Other Equity*

There has also been a change in signs convention: Within the current and capital part of the balance of payments, both revenues and expenditures have a positive sign, and the net value is their difference (in the old methodology, expenditures were shown as negative values, so the net value was a sum of revenues and expenditures). Within the financial part of the Balance of Payments, every increase in assets and liabilities has a positive sign, while every decrease has a negative one, so the net value is their difference.

As key substantial changes, we highlight the following:

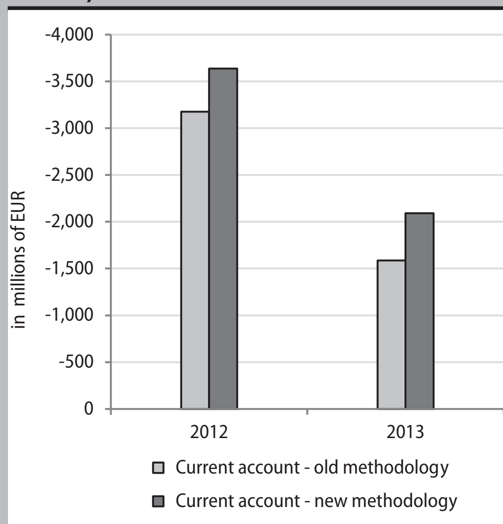
1) Balance of payments current account deficit is adjusted upward due to:

1 http://www.nbs.rs/export/sites/default/internet/latinica/80/obrazlozenje_BOP_IIP.pdf
2 Balance of Payments Manual (BPM5), 1993, http://www.imf.org/external/pubs/ft/bopman/bopman.pdf
3 Sixth Edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6), 2009, http://www.imf.org/external/pubs/ft/bop/2007/pdf/bpm6.pdf

- Higher deficit in the *Income account* (which is now called *Primary Income*) due to the inclusion of reinvested profit (expressing the entire profit). Still, this change is neutral for the balance of payments, since FDI is increased by this amount.

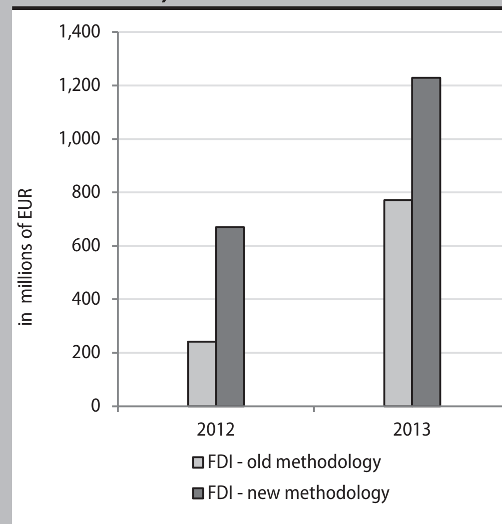
- Higher *Trade Deficit*, due to the exclusion of all transactions related to exports and imports of goods for further processing. Further processing services, according to the new methodology, will be recorded on the services account.

Graph T4-2. Serbia: Current Account Deficit, 2012-2013



Source: NBS, *QM*

Graph T4-3. Serbia: Foreign Direct Investments, 2012-2013



Source: NBS, *QM*

Current account balance in 2013 is now 6.5% of GDP, while calculated by the former methodology it was 5.0% of GDP (Graph T4-2).

2) Financial account deficit of the balance of payments is adjusted upward due to higher FDI (Graph T4-3), which were increased due to the inclusion of reinvested profit, as well as the improved scope of data caused by transferring to direct reporting. Wider scope of inter-company loans and their reclassification from *Other Investments* to FDI have led to the amount changes of these two items.

Inflow of FDI and portfolio investments, with a modest inflow of financial derivatives…

In Q2, there was a modest outflow of capital of 9 million euros (Table T4-1). This was the result of the recorded inflow of FDI (251 million euros net) and portfolio investments (149 million euros) on the one hand, and outflow of other investments (419 million euros) on the other. In addition, the financial derivatives account recorded a low inflow of 9 million euros.

…while outflow of other investments was recorded, mostly due to loan deleveraging

The recorded net outflow on the other investments account is mostly due to deleveraging of loans (319 million euros). Out of this amount, the largest portion is deleveraging of NBS towards IMF for earlier borrowed loans (in Q2, the deleveraging of the Central Bank was 186 million euros). Other deposit institutions additionally deleveraged 91 million euros, and the public sector 33 million euros, while the businesses moderately borrowed 9 million euros. Net inflow from trade loans was 41 million euros, while the net outflow on the Currency and Deposits account was 141 million euros.

In the coming period, the capital inflow will largely depend on the trust in the Government's economic policy and the situation in the international surroundings

In the coming period, the capital inflow will largely depend on the investors' trust in the Government's economic policy, and the trust will essentially depend on the Government's readiness to decisively implement the fiscal consolidation programme, as well as on the economic implementation of the reforms. Investors will observe relations with IMF as key indicators of the Government's readiness to implement austerity measures and economic system reforms. Still, the current geopolitical tensions will probably have a negative impact on investors' readiness to invest, which would affect Serbia as well.

Decline of forex reserves in Q2 by 370 million euros

Cumulative decline of forex reserves during Q2 was 370 million euros. During these three months (April-June), NBS intervened by purchasing 170 million euros at the interbank foreign exchange market[3]. Foreign currency reserves were slightly increased in April (38 million euros), while there was a considerable reduction in May and June (166 and 273 million euros, respectively).

Table T4-1. Serbia: Balance of Payments

	2012	2013	2013		2014	
			Q1	Q2	Q1	Q2
			mil. euros			
CURRENT ACCOUNT	-3,639	-2,092	-662	-382	-483	-383
Goods	-5,634	-4,152	-1,190	-1,045	-872	-980
Credit	8,394	10,540	2,151	2,578	2,512	2,768
Debit	14,028	14,693	3,341	3,623	3,384	3,747
Services	139	319	30	75	68	72
Credit	3,104	3,423	698	826	793	887
Debit	2,965	3,103	668	751	725	815
Primary income	-1,091	-1,412	-184	-292	-301	-317
Credit	657	617	113	168	104	140
Debit	1,748	2,030	297	459	405	457
Secondary income	2,947	3,153	681	879	623	842
Credit	3,286	3,523	768	968	708	933
Debit	339	369	87	89	85	91
Personal transfers, net [1)]	2,459	2,701	581	772	510	695
Of which: Workers' remittances	1,934	2,160	457	630	378	547
CAPITAL ACCOUNT - NET	-11	11	-2	9	2	-1
FINANCIAL ACCOUNT	-3,486	-1,917	-612	-356	-533	-361
Direct investment - net	-669	-1,229	-171	-264	-289	-251
Portfolio investment	-1,722	-1,916	-1,404	348	4	-149
Financial derivatives	2	-1	2	-2	0	-9
Other investment	41	532	101	446	552	419
Other equity	0	0	0	0	0	0
Currency and deposits	156	-228	-203	165	121	141
Loans	574	1,185	375	295	362	319
Central banks	219	657	150	148	189	186
Deposit-taking corporations, except central bank	377	682	286	67	212	91
General government	-467	-449	-150	-43	29	33
Other sectors	444	296	89	124	-68	9
Insurance, pension, and standardized guarantee schemes, net	3	0	1	0	0	0
Trade credit and advances	-692	-426	-72	-14	70	-41
Other accounts receivable/payable	0	0	0	0	0	0
SDR (Net incurrence of liabilities)	0	0	0	0	0	0
Reserve assets	-1,137	697	859	-886	-800	-370
ERRORS AND OMISSIONS, net	164	164	52	17	-51	23
PRO MEMORIA						
			in % of GDP			
Current account	-12.3	-6.5	-8.9	-4.7	-6.5	-4.8
Balance of goods	-19.1	-13.0	-15.9	-12.7	-11.8	-12.2
Exports of goods	28.4	33.0	28.8	31.5	33.9	34.6
Imports of goods	47.5	45.9	44.7	44.2	45.6	46.8
Balance of goods and services	-18.6	-12.0	-15.5	-11.8	-10.8	-11.3
Personal transfers, net	8.3	8.4	7.8	9.4	6.9	8.7
GDP in euros[2)]	29,516	31,986	7,477	8,195	7,417	8,009

Note: The presentation of the balance of payments is in line with the guidelines contained in the sixth edition of the IMF Balance of Payments Manual, 2009 (BPM6).
Source: NBS
1) Personal transfers represent current transfers between resident and non-resident households.
2) Quarterly values. Conversion of annual GDP into euro is done according to average annual exchange rate (average of official NBS middle exchange rates).

3 http://www.nbs.rs/internet/latinica/90/90_5/prezentacije_ioi/prezentacija_ioi_08_2014.pdf

Exports

In Q2 exports significantly decelerated growth...

...due to considerable decelerated growth of exports of road vehicles, as well as due to the consequences of floods.

According to the SORS data, exports in Q2 significantly decelerated growth. On the one hand, this is due to a considerable decelerated growth of road vehicle exports. On the other hand, the May floods also impacted this export growth trend, as they had a negative effect on production (and therefore exports) primarily in the energy, mining and agricultural sectors[4]. In addition, this could also have been affected by a moderate appreciation of dinar, as well as recession trends from the first half of the year. Thus, the year-on-year export growth rate excluding road vehicles was lower compared to the previous quarterly rate. The nature of exports decline of as much as 10.9% in July this year compared to the same month of the previous year is still unclear. For now, it is our estimate that it is a temporary once-off decline and we expect that in the coming months the exports will return to positive, albeit low growth rates.

During Q2 2014, a total of 2.873 million euros worth of goods were exported. Compared to Q2 2013, this represents an increase of 6.4%. Realised year-on-year growth of total exports was significantly below the growth realised in all quarters of 2013 (Q1: 20.1%, Q2: 18.2%, Q3: 38.5% and Q4: 22.2%) and in Q1 2014 (17.7%) (Table T4-4).

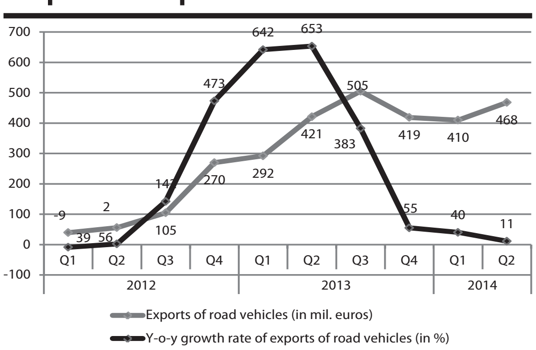
Table T4-4. Serbia: Exports, Year-on-Year Growth Rates, 2011–2014

	Exports share in 2013	2011	2012	2013	2013		2014		2013		2014	
					Q1	Q2	Q1	Q2	Q1	Q2	Q1	Q2
	in %			in mil. euros						in %		
Total	100.0	8,441	8,739	10,997	2,236	2,699	2,632	2,873	20.1	18.2	17.7	6.4
Total excluding road vehicles	85.1	8,253	8,269	9,360	1,943	2,277	2,223	2,405	6.6	2.2	14.4	5.6
Energy	4.7	310	303	519	94	130	98	129	47.0	52.3	4.8	-1.2
Intermediate products	33.4	3,980	3,126	3,678	798	937	911	949	8.0	6.7	14.2	1.4
Capital products	27.1	1,001	1,667	2,979	570	758	720	812	112.8	107.3	26.3	7.1
Capital products excluding road vehicles	12.2	813	1,197	1,342	278	336	310	344	21.5	8.7	11.6	2.2
Durable consumer goods	4.8	347	395	524	99	136	122	147	26.9	35.7	22.9	8.0
Non-durable consumer goods	21.9	2,118	2,224	2,410	501	560	564	617	4.9	3.1	12.4	10.3
Other	8.1	686	1,025	887	173	179	218	219	-26.2	-42.5	25.7	22.2

Source: SORS

Graph T4-5 indicates that since the end of the previous year, a "ceiling" has been reached in the exports of road vehicles. That is, even though the recorded value of exports of these products in Q2 2014 exceeds the level from the same quarter last year (11% year-on-year growth), it is a considerably lower increase compared to the results realised at the beginning of the production and exports of the automobile industry (at the end of 2012 and in the first 9 months of 2013).

Graph T4-5. Exports of Road Vehicles



Source: SORS, *QM*

Decelerated growth of production and exports of automobiles is reflected on the values of Capital Goods exports. After the year-on-year growth of 26.3% in Q1 2014, exports of this group of products recorded a 7.1% growth in Q2 2014.

Values of Energy exports were 1.2% below the values from Q2 of last year. This is the result of damaged energy capacities and reduced energy production due to flooding. Decline of Energy exports is thus expected in the coming period as well.

Exported value of all other individual groups of products, classified by purpose, recorded a decelerated growth compared to the previous period (Table T4-4). Exports of durable consumer goods was by 8.0% above the last year's, while the exports of non-durable consumer goods recorded a year-on-year growth at a 10.3% rate, which is a lower growth than the one realised in the previous quarter (Table T4-4). In 2014, the year-on--year export growth rate of Intermediate Goods, after 14.4% from Q1, dropped to 1.4% in Q2.

4 From the presentation of the latest Inflation Report.

The highest year-on-year export growth values were recorded in products classified in the Other group (22.2% year-on-year). Still, even such a growth is below the realised year-on-year rates from the previous two quarters (Q4 2013 and Q1 2014).

We expect the deceleration of exports to continue

In the coming period, we expect that the May floods and current recession will have a negative impact on exports. The expected EU recovery might have a positive impact. We estimate that potential growth of Serbia's exports to the Russian market is quite modest, and that the possibility of growth in substituting EU member's exports will not have a significant impact on the growth of Serbia's total exports. Also, current depreciation wave would affect the export growth as early as end of 2014 and beginning of next year.

Imports

Imports have been gradually accelerating growth since the beginning of the year

Imports have been gradually accelerating growth since the beginning of the year (Table T4-6). Import of goods in Q2 2014 was 3.912 million euros, which is by 2.4% higher compared to the same period last year (Table T4-6). Save for Other Imports and Energy, a year-on-year decline of imports was recorded in all other groups of products. Year-on-year Energy import growth was 1.5%. After a long period of year-on-year decline of imports of energy products, the growth in Q2 is due to reduced domestic production, which is the result of flooding. Also, in the coming period, we can expect further growth in Energy imports and thus, growth of total imports as well.

Decline in imports of Intermediate, Capital and Consumer Goods and growth of Other imports

On the other hand, imports of Intermediate Goods and Capital Goods were by 4.2% and 1.8% below the last year's values. That indicates a certain decrease in demand for products that partially determine further domestic production. Imported values of Durable Consumer Goods were by 9.0% below last year's, while imports of Non-Durable Consumer Goods were almost at the last year's level. Significant increase in imports was recorded in goods classified under Other, where imported value in Q2 2014 was by 40% above the values from Q2 of last year (Table T4-6).

On the one hand, we expect in the coming period a reduction of imports due to the decline of domestic demand, caused by the announced measures of fiscal consolidation, as well as the current recession wave. On the other hand, growth of imports could be affected by imports of construction material and equipment (for the repair of buildings damaged by floods) and energy (due to the expected production reduction due to damages on power plants).

Table T4-6. Serbia: Imports, Year-on-Year Growth Rates, 2011-2014

	Imports share in 2013	2011	2012	2013	2013		2014		2013		2014	
					Q1	Q2	Q1	Q2	Q1	Q2	Q1	Q2
	in %	in mil. euros							in %			
Total	100.0	14,250	14,717	15,469	3,509	3,820	3,543	3,912	-0.4	3.1	1.0	2.4
Energy	15.1	2,846	2,570	2,336	532	476	491	484	-34.9	-13.9	-7.6	1.5
Intermediate products	33.4	5,030	5,132	5,166	1,164	1,310	1,145	1,255	0.6	-5.2	-1.6	-4.2
Capital products	24.6	2,812	2,996	3,800	799	975	790	958	25.4	31.2	-1.0	-1.8
Durable consumer goods	2.1	320	323	328	77	80	69	73	-0.1	-3.4	-10.7	-9.0
Non-durable consumer goods	14.7	2,176	2,175	2,276	510	554	494	552	7.4	7.1	-3.2	-0.4
Other	10.1	1,066	1,520	1,563	428	425	554	592	18.6	0.0	29.4	39.3
Imports excluding energy	84.9	11,404	12,147	13,134	2,978	3,344	3,052	3,429	10.0	6.1	2.5	2.5

Source: SORS

Foreign Debt

Foreign debt is 25.384 million euros, i.e. 80.0% of GDP

Foreign debt at the end of June 2014 was 25.384 million euros (80.0% of GDP, Table T4-7). Public sector's foreign debt was in both absolute and relative terms (as part of GDP) slightly above the private sector's foreign debt after September 2013, which was the case at the end of June 2014 as well. Public sector's foreign debt was 12.795 million euros (40.3% of GDP), while the private sector's foreign debt was 12.589 million euros (39.7% of GDP, Table T4-7). A billion dollar loan received from the United Arab Emirates in August, intended for the budget of the

Republic of Serbia, will lead to an increased foreign debt. We estimate that this additional borrowing will affect the growth of public sector's foreign debt and thus the growth of total foreign debt as well by around 2.5 p.p. of GDP.

In the first half of the year, the foreign debt was temporarily reduced, but it was again raised in August due to state borrowing

Compared to the situation at the end of the previous year, foreign debt is lower by 404 million euros. This is the result of reduced borrowing of the public sector, primarily for paying off the National Bank of Serbia's debt toward the IMF. On the other hand, in the first six months of 2014, the private sector deleveraged moderately by 32 million euros. The banks deleveraged 293 million euros of their long-term debt, while the businesses borrowed 305 million euros. Short-term debt was reduced compared to December by 44 million euros, solely as the result of lower short-term borrowing of the banks. Compared to end of March, foreign debt is lower by 291 million euros, part of which is due to public sector deleveraging (NBS toward IMF), and partly due to additional deleveraging of long-term loans of the private sector. However, reduction of state's foreign debt was temporary, as the state received in August a loan of around 800 million euros from the United Arab Emirates, which has led to the new increase of foreign debt.

Fiscal consolidation and international environment will determine further borrowing

In the coming period, the foreign borrowing dynamic will greatly depend on consistency in implementing announced measures of fiscal consolidation, as well as the global market situation. Positive trends on global financial market could affect additional public sector borrowing in order to create reserves for 2015[5]. Arrangement with the IMF would also have a positive impact.

Table T4-7. Serbia: Foreign Debt Structure, 2011–2014

	2011	2012	2013				2014	
			Mar.	Jun	Sep.	Dec.	Mar.	Jun
			stocks, in EUR millions, end of the period					
Total foreign debt	24,123	25,645	26,596	25,890	25,637	25,788	25,675	25,384
(in % of GDP) [4]	*76.5*	*86.9*	*88.2*	*83.7*	*80.6*	*80.6*	*80.4*	*80.0*
Public debt[1]	10,800	12,185	13,478	12,892	12,790	13,167	12,970	12,795
(in % of GDP)[4]	*34.2*	*41.3*	*44.7*	*41.7*	*40.2*	*41.2*	*40.6*	*40.3*
Long term	10,800	12,185	13,478	12,892	12,790	13,167	12,970	12,795
o/w: to IMF	1,618	1,389	1,245	1,079	890	697	515	333
o/w: Government obligation under IMF SDR allocation	459	452	454	447	441	434	436	439
Short term	0	0	0	0	0	0	0	0
Private debt[2]	13,323	13,460	13,118	12,998	12,846	12,621	12,705	12,589
(in % of GDP) [4]	*42.2*	*45.6*	*43.5*	*42.0*	*40.4*	*39.5*	*39.8*	*39.7*
Long term	12,722	13,005	12,786	12,713	12,683	12,420	12,561	12,433
o/w: Banks debt	3,869	3,722	3,535	3,503	3,457	3,232	3,036	2,939
o/w: Enterprises debt	8,854	9,283	9,250	9,208	9,224	9,187	9,523	9,492
o/w: Others			1	1	1	1	2	2
Short term	601	455	332	286	164	201	144	157
o/w: Banks debt	582	428	303	261	135	171	115	128
o/w: Enterprises debt	19	27	29	24	28	30	30	29
Foreign debt, net 3), (in% of GDP)[4]	38.3	49.9	48.9	49.2	47.8	45.6	47.8	48.1

Note: External debt of the Republic of Serbia is calculated on a due-for-payment basis and includes the amount of debt under principal and the amount of accrued interest which is not paid at the agreed due date.
Source: NBS, QM
1) External debt of the public sector of the Republic of Serbia comprises government debt (including debt of Kosovo&Metohija under loans concluded before the arrival of the KFOR mission, non-regulated debt towards Libya and clearing debt towards former Czechoslovakia), debt of the National Bank of Serbia, local governments, state funds and agencies, and government-guaranteed debt.
2) External debt of the private sector of the Republic of Serbia comprises debt of banks, enterprises and other sectors which is not government-guaranteed. External debt of the private sector does not include loans concluded before 20 December 2000 in respect of which no payments are made (EUR 844.4 million, of which EUR 387.8 million relating to domestic banks and EUR 456.6 million to domestic enterprises).
3) Total foreign debt minus NBS forex reserves.
4) Uses the sum value of GDP of the observed quarter and previous three quarterly values of GDP.

5 See section "Fiscal Trends and Policy" of this issue of QM.

5. Prices and the exchange rate

In Q2 and July inflation ranged below the lower limit of the NBS target band and at the end of July it stood at 2%. The growth in the prices of food lower than expected (largely due to a drop in the prices of unprocessed food that has affected the prices of processed food), as well as a low domestic demand were the main contribution to a low inflation until the end of Q2. July recorded weak inflation, which was largely affected by the fall in the prices of raw material in the food industry, although there was a mild dinar exchange rate depreciation which mostly affects the growth in the underlying inflation (which excludes the prices of food, energy, alcohol and tobacco). By the end of the year it is expected that the inflation will return within the target band, largely due to a low base effect from the previous year. There will be no significant changes in inflation, since it is expected that the factors influencing the inflation change the most will be under control. The exchange rate, as one of the most influential factors, already depreciated (in July and August) but we estimate that the NBS will not allow it to change to a greater extent, given that in the past it showed willingness to intervene considerably in order to prevent greater depreciation of the exchange rate. Another significant factor that will affect the stability of inflation is a low domestic demand, the reduction of which is expected in the following period as a result of fiscal consolidation measures (reduction in salaries and pensions in the public sector). Entering into recession will also have a disinflationary effect. The dinar exchange rate movement during Q2 and July and August is to a large extent influenced by global factors, although throughout the entire period the dinar exchange rate depreciated significantly more than the currencies of other countries in the region with similar exchange rate regimes. The growth in investors' distrust in the Government's economic policy has significantly contributed to the weakening of the dinar. Real depreciation in July and August annulled the appreciation from the beginning of the year and such moderate dinar depreciation affects the improvement of the competitiveness of the economy with the acceptable costs at the inflation side (which is already low) and the costs of credit servicing.

Prices

Inflation extremely low and in Q2 and July ranges below the lower limit of the NBS target band

From the beginning of the year y-o-y inflation has been at a low level, and since March it fell below the lower limit of the NBS target band, where it continued to move throughout Q2 and in July (Table T5-1). Relatively long period of low inflation for the situation in Serbia was followed by a lowest year-on-year inflation (1.2%) over the past five decades recorded in June. Price growth in Q2 is lower than expected (mostly because of a low growth in the prices of unprocessed food), while July was marked by weak deflation (due to a fall in the prices of unprocessed food, especially vegetables). A contribution to a low inflation was made by the lack of higher pressures in production, low aggregate demand, the decline in inflationary expectation and a relative stability of the dinar exchange rate (until July), low imported inflation, as well as a slow mitigation of monetary policy restrictiveness (key interest rate is relatively high 8.5%). For the same period, from May to July, underlying inflation (measured by the consumer price index excluding the prices of food, alcohol, tobacco and energy) revolved around lower limit of the NBS target band, with occasional egresses below the limit value, where it is currently located (data for July). Underlying inflation is also at the lowest level for a long period of time (Graph T5-2). The return of year-on-year inflation within the limits of the target band is expected in Q4, when the disinflationary pressures on food prices should disappear, although a low aggregate demand will remain the main disinflationary factor. Dinar depreciation as well as a possible increase in the prices of energy (gas and electricity) will affect the growth of inflation with a lag of 1-2 months. The period with relatively high values of monthly inflation lasted until Jun, whereas from July to December an average monthly inflation was negative and amounted to -0.1%. A slowdown in economic activity will have a disinflationary effect, while the measures of fiscal adjustment will

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

	Consumer price index				
	Base index (avg. 2006 =100)	Y-o-y growth	Cumulative index	Monthly growth	3m moving average, annualized
2008					
dec	122.7	8.6	8.6	-0.9	4.4
2009					
dec	130.8	6.6	6.6	-0.3	1.6
2010					
dec	144.2	10.2	10.2	0.3	11.7
2011					
dec	154.3	7.0	7.0	-0.7	2.5
2012					
mar	157.4	3.4	2.0	1.1	8.4
jun	162.4	5.4	5.3	1.2	13.2
sep	169.1	10.3	9.6	2.3	17.7
dec	173.1	12.2	12.2	-0.4	9.9
2013					
mar	175.1	11.2	1.2	0.0	4.7
jun	178.2	9.7	2.9	1.0	7.3
sep	177.3	4.8	2.4	0.0	-2.0
dec	176.9	2.2	2.2	0.2	-0.9
2014					
jan	179.5	3.1	1.5	1.5	4.4
feb	179.7	2.6	1.6	0.1	7.5
mar	179.1	2.3	1.2	-0.3	5.1
apr	180.1	2.0	1.8	0.6	1.4
maj	180.2	2.1	1.9	0.1	1.1
jun	180.4	1.2	2.0	0.1	2.9
jul	180.2	2.0	1.9	-0.1	0.2

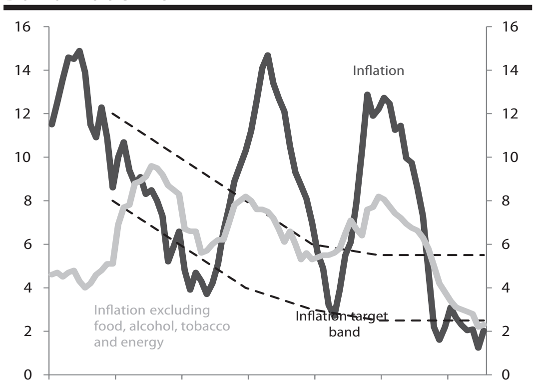
* Three-month moving average of a price growth rose to an annual level. (For example, the March value is obtained by raising the average monthly price growth in January, February and March to an annual level).
Source: SORS

additionally affect the aggregate demand reduction and price stability; it is expected that July and August dinar depreciation will have inflationary effect in the following period. Significant changes in inflation are not expected to occur by the end of the year. Factors that could affect the changes in the price growth rate to a largest extent are: the exchange rate, which already depreciated, but in the previous period National Bank of Serbia showed the willingness to "defend" the exchange rate from the excessive deviation, even at the cost of considerable reduction in foreign exchange reserves; second factor that largely affects the inflation is the reduction in domestic demand, which is likely to occur due to anticipated cuts in wages and pensions (fiscal consolidation measures).

The gradual restrictiveness mitigation of the monetary policy by the NBS

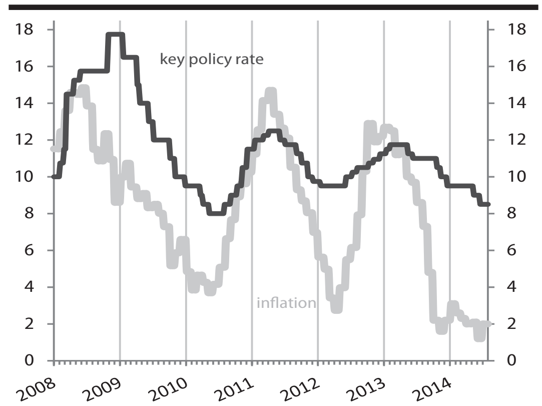
The measures of the National Bank of Serbia were not synchronized with inflation movement to the best extent in the past year. Since the inflation returned within the limits of the target band in September 2013, there was a modest reduction in the key interest rate, from a high level of 11%, which in previous years corresponded to the periods with inflation of over 10% (Graph T5-3) to a still high 8.5% in June 2014, even though the inflation is at a record low level, with no prospects for a significant growth, and the economy is stagnant or on the verge of recession. During Q2, there were two reductions in key interest rate by 50 basis points at the meetings of the NBS' Executive Board in May and June (to 9% and 8.5% respectively). The current account deficit is stabilized at a high level of around 5%, and the strengthening of the real dinar value has certainly contributed to a slowdown of the export growth and acceleration of the import

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



Source: NBS and *QM* estimates

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



Source: NBS

growth. The explanation for the implementation of more restrictive monetary policy than the one more suitable to the conditions of a current low inflation could be found in the structural imbalances in the economy of Serbia (high fiscal and foreign-trade deficit, high level of bad loans in economy) that can threaten macroeconomic stability. The indecisiveness of the Government to implement stricter measures of fiscal consolidations and the delay of the announced measures causes a distrust of investors which is primarily expressed in the foreign exchange market, only to later transfer to inflation as well.

Low inflation in Q2 and deflation in July 2014

Overall inflation in Q2 and July amounted to 0.6% (individually: 0.8% in Q2 and -0.1% in July). Observed from the beginning of the year- after a one-off inflation increase in January (conditional seasonal increase in the prices of food and an increase in specific VAT rate and excise duties), there was a period of a low monthly inflation in Q1 and Q2, as well as the occasional low deflation- in March and July (Table T5-1). Inflation in Q2 was mostly contributed by the price growth of food (growth of 1.5%, i.e. contribution of 0.5pp) and telecommunication services (growth of 0.1%. i.e. contribution of 0.1pp) (Table T5-4), and in April the decline in the prices of food (-1.8%, i.e. contribution -0,6pp) and the increase in the fuel prices (1.2%, the contribution of 0.1pp). Unprocessed food prices increased in Q2 by 4.9%, out of which prices of fruit contributed the inflation by 0.4 pp, and the prices of fresh meat by 0.3%. Due to a good agricultural season in the country and abroad, seasonally expected increase in the prices of vegetables was absent, and its price continued to drop during July. Processed food prices, due to a fall in the prices of raw material, were in a decline in Q2 (all product categories except for milk and dairy products), and similar trend continued in July. The growth in the prices of industrial products excluding food and energy in Q2 did not occur as a result of low aggregate demand. None of the price categories from this group made a significant contribution (positive or negative) to overall inflation in Q2 and July. Service prices in Q2 increased by 1.6%, whereas the largest contribution to overall inflation has come from the rise in prices of package tours and to a less extent, from the changes in the prices of housing and utility services and vocational services. Regulated prices increased by 0.2% in Q2 (housing and communal services and medicaments), and observed from year-on-year standpoint, the growth of these prices is slowing down month by month and is currently standing at around 10%. Since the beginning of the year these prices have increased by 3.2 % (a consequence of adjusting to a higher VAT rate and an increase in the excise duties), while the higher growth in this price group is expected in the second half of the year, primarily on the basis of the expected rise in the energy prices, which has already begun in July. Also, the impact of the increase in the prices of telecommunication services on the inflation growth is expected the coming months (from September). Floods in May haven't largely contributed to the prices, which is a result of a low demand but also fall in the prices of primary agricultural products in the global market, which will condition the cost pressures in food production remain low until the end of the year. Possibility of duty-free imports of most agricultural products from the EU as of this year also reduces the pressures on the growth in the food price in terms of reduced supply in the domestic market.

Overall and underlying inflation are relatively low

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

	Share in CPI (in %)	price increase in Q2 2014	Contribution to overall CPI increase (in p.p.)	Price increase in July 2014	Contribution to overall CPI increase (in p.p.)
Total	100.0	0.7	0.7	-0.1	-0.1
Food and non-alcoholic beverages	34.5	1.5	0.5	-1.6	-0.6
Food	30.9	1.7	0.5	-1.8	-0.6
Alcoholic beverages and tobacco	7.8	-0.2	0.0	-0.2	0.0
Tobacco	4.2	0.0	0.0	0.0	0.0
Clothing and footwear	4.6	0.4	0.0	-0.7	0.0
Housing, water, electricity and other fuels	13.0	0.2	0.0	0.3	0.0
Electricity	5.1	0.0	0.0	0.0	0.0
Furniture, household equipment, routine maintenance	4.1	-0.6	0.0	-0.7	0.0
Health	6.4	0.7	0.0	-0.1	0.0
Transport	12.3	-0.4	0.0	0.8	0.1
Oil products	5.1	-1.0	0.0	1.2	0.1
Communications	5.0	1.3	0.1	-0.1	0.0
Other items	12.2		0.1		0.4

Source: SORS and *QM* estimates

Underlying inflation (inflation excluding food, alcohol, tobacco, and energy) has been at a stable low level since the beginning of the year. Its slight growth was recorded in July 2014, when the three-month average was 1.2%, i.e. 4.9% when annualized (Graph T5-5). This leap is caused by the July's one-off increase in the prices of insurance and the prices of services from the group of recreations and culture (which doesn't need to be a one-off character). Overall inflation was slightly lower, since the growth of the prices in the group of products that are included into measuring the underlying inflation was offset by the fall in the prices of food and not too excessive an energy growth, thus annualized three-months average of the overall inflation amounted to a mere 0.2%. The growth of underlying inflation was affected by the unstable dinar exchange rate (July depreciation that continued in August and September), while the fall of the country risk premium had a disinflationary effect in Q2 and July (measured by EMBI index; the decline in risk premium is related to the global trend- the decline occurred in other countries in the region as well). However, uncertainty regarding the scope and the beginning of the fiscal reforms could threaten the exchange rate stability and thus affect underlying and overall inflation.

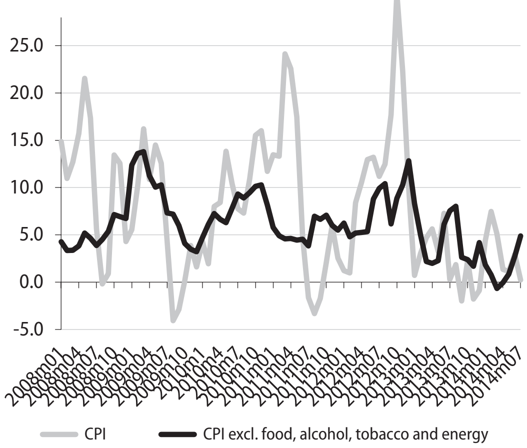
Moderate inflation increase and its return within the target band is expected by the end of the year

In Q3 year-on-year inflation will most likely stagnate and continue to move below the lower limit of the NBS target band. However, in the last quarter of the year2014 we expect a moderate acceleration of inflation and its movement toward the center of the target band. The main drivers of the accelerating inflation will be dinar depreciation during the third quarter, and the prices of electricity and gas are expected to increase. The expected decrease of wages in public sector and pensions will impact the slowing down of inflation, thus the overall inflation in the fourth quarter will be relatively modest.

Entrepreneurs expect the inflation to reach the middle of the target band

Short-term inflationary expectations (in the next year) for the economy and financial sector are within the limits of the NBS target band, both in the short and medium term. Thus, the estimates of the inflationary expectations for the financial sector in the coming year range from 3.75% to 4.5%. Inflationary expectations for the economy revolved around 5% in July. Expectations of the population are at a high 10%, but they are caused by the population's lack of information on the macroeconomic trends, and thus the current inflation rate, which is estimated to be at a high level of 10-15% as well (perceived inflation). Medium-term inflation expectation (for two years in advance) for the financial sector and economy are also within the limits of the NBS target band (4.6% and 6% respectively), while the expectations of the population are at the level of 10%. The biggest uncertainty in the estimates of the inflation trends in the following period refers to whether and in what amount will the price of the electricity and solid fuels be adjusted. There are risks to a less extent in the trends of agricultural product prices and regarding the current geopolitical tensions.

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



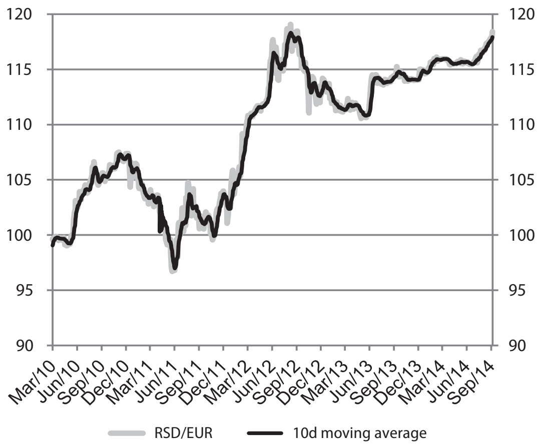
Source: SORS and *QM* estimates

The exchange rate

Relatively stable dinar exchange rate in Q2, depreciation in July and August

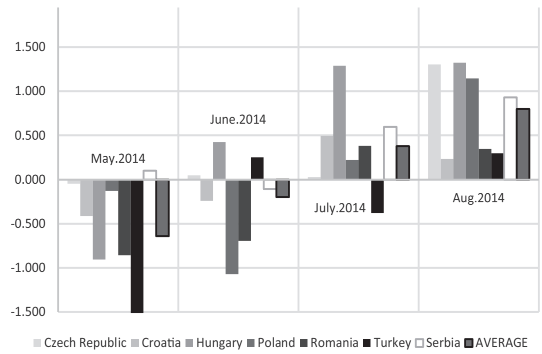
After a period of depreciation in January, the dinar exchange rate against the euro was relatively stable until the end of Q2. At the end of the period, dinar in Q2 nominally depreciated by 0.3%, while the average level rose slightly (0.2%) when compared to Q1. In July and August, however, there was a period of dinar depreciation which continued in the early September. From the level of less than 115 dinars per euro at the beginning of the year, the exchange rate moved around 119 dinars per euro in the early September (Graph T5-6). During Q2 the exchange rate was mostly stable with moderate appreciation pressures, which is consistent with the trend in the countries of

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



Source: NBS

Graph T5-7. Nominal exchange rate depreciation (in %) in Period of May-August 2014 in Chosen Central and Eastern European Countries



Source: Eurostat, NBS, *QM* estimates

the region that implement the fiscal exchange rate regime. To a large extent it was contributed by the fal in the risk premium and enlarged investing of foreign investors into the securities. Unlike Q1, when NBS intervened by selling foreign currencies, during Q2 it intervened by foreign currencies purchases of 170 million euros (mostly in the first half of April). Depreciation pressures caused by the escalation of geopolitical tensions concerning Ukraine crisis emerged at the beginning of Q3. Furthermore, the resignation of the Minister of Finance has led to an occurrence of unfavorable news about the scope and pace of fiscal consolidation in the following period. The risks relating to implementation of fiscal consolidation are reflected in insufficient scope of measures that are implemented and in a lack of confidence in their implementation, in the conditions of constantly growing macroeconomic risks. Since July, the nonresidents in the foreign exchange market again emerged in the role of net customers. Thus, the NBS in July and August intervened on MDT mainly by selling foreign currency (since the beginning of the year until the beginning of September NBS bought 200 million euros and sold more than 900 million euros). Most of the currencies of the countries in the region with the similar exchange rate regime strengthened in Q2, while since of July depreciation pressures start to occur (Graph T5-7). Although the dinar exchange rate movement was mostly in the line with the average trend of this group of countries, dinar depreciated during the period when the currencies in other countries substantially appreciated (January and May 2014), while dinar depreciation in the periods of depreciation of regional currencies was stronger. It can be concluded that the movement of the dinar exchange rate was in part the result of global factors, but a slightly higher depreciation than average was affected by the political situation and uncertainty regarding fiscal reforms in the country (election of the Government of Serbia at the beginning of the year, the change of the Minister of Finance and the risks related to the implementation of fiscal consolidation).

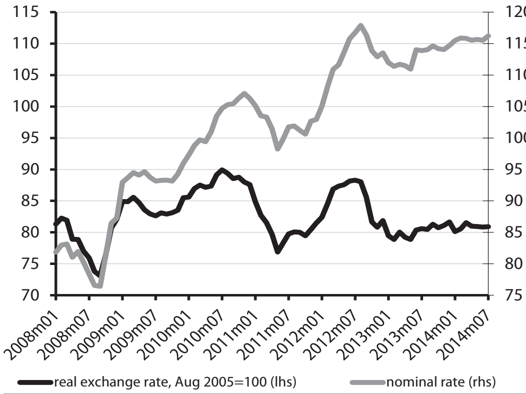
Moderate real appreciation in Q2 and depreciation in the period July-September

After a real appreciation in Q1 of about 0.1%, the dinar appreciated in real terms during Q2 by additional 0.8% (mostly in April), only to depreciate in real terms by a relatively modest 0.05%. Overall real appreciation since the beginning of 2014 until the end of July was 0.9%. NBS interventions in the second quarter prevented a considerable appreciation of the dinar. We estimate that in a highly euroized economy such as Serbian it is desirable for the central bank to prevent large exchange rate fluctuations. In the euroized economy exchange rate fluctuations transfer to a large extent onto inflation and intermittently create large capital gains and losses, thus reinforcing macroeconomic stability.

The real exchange rate has mainly followed the movement of the nominal exchange rate

The movement of the real exchange rate in Q2 was mostly influenced by the ratio of domestic inflation and inflation in the eurozone countries, which in some months led to divergent trends in nominal value and the real exchange rate (Grpah T5-8). At the beginning of Q3, the main cause of the movement of the real exchange rate is the nominal value of the exchange rate, and then the value of inflation in Serbia and the Eurozone. Nominal depreciation in August was signifi-

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

cantly higher than the July, so it can be expected that the real depreciation will be higher (which will be known when the data on inflation become available). The real exchange rate in the past two years has been relatively stable, but in the future, with an expected slight increase in inflation in Q3 and Q4 and a similar trend of the exchange rate as in July and August, it can be expected the trend to change towards a mild real depreciation. Real depreciation in July and August practically annulled the appreciation from the beginning of the year. Moderate depreciation affects the improvement of the economy competitiveness, and if the depreciation continues in September as well (which is likely to happen, given that the exchange rate reached the value of around 119 dinars per euro in the early September), any significant improvement of competitiveness would occur with the acceptable costs on the side of inflation (which is extremely low) and the costs of loan servicing.

Trends

6. Fiscal flows and policy

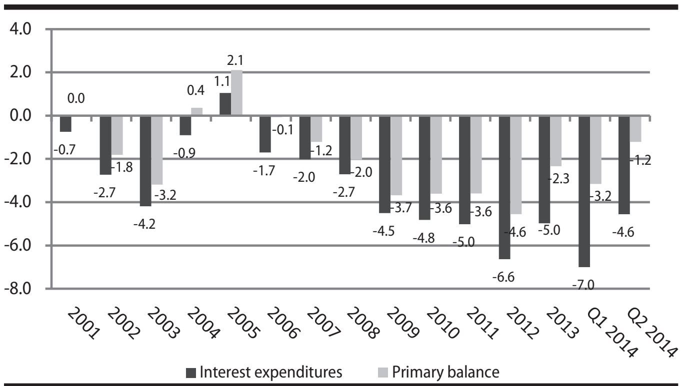
Fiscal deficit, exclusive of below-the-line expenses, stood at RSD 39 billion (about 4.6% of the quarterly GDP) in Q2 2014, and reached RSD 103.7 billion, or about 5% of GDP, in the period January-July. Inclusive of below-the-line expenses, fiscal deficit ran at 6.5-7% of GDP in the period January-July. June and July saw a small surplus in the budget caused by seasonal factors, changes in tax calendar and the change at the post of the Minister of Finance which implies suspension of non-urgent expenses. Therefore, these developments do not reflect a continuing improvement in the health of public finance. Although public expenditures in Q2 remained at the level reached in the preceding quarter, real rise in these expenditures continued relative to the same period last year and they ran at 49.5% of GDP. Without a broad fiscal consolidation, below-the-line fiscal deficit will run at more than 6.5% of GDP in 2014 (and inclusive of below-the-line expenses it will widen to more than 8% of GDP), which is much above the projections, and is primarily driven by decrease in revenues. Public debt totaled EUR 20.9 billion (67.1% of GDP) at the end of July, and, under other circumstances unchanged, it could reach 70-72% of GDP by the end of the year, or even exceed this projection. Extremely large and growing fiscal deficit involves a high risk of public debt crisis. Strong fiscal consolidation, primarily through reduction in current expenditures, that would provide for fiscal deficit shrinking to 3% of GDP by 2017, i.e. EUR 1.5-2 billion reduction in expenditures and rise in revenues, is therefore necessary.

General tendencies and macroeconomic implications.

Official consolidated fiscal deficit in the first seven months of 2014 stands at RSD 103.8 billion (about 5% of GDP)

To July inclusive, consolidated fiscal deficit, excluding below-the-line expenses (such as payments for activated guarantees granted to public companies), ran at RSD 103.7 billion or 5% of GDP, and inclusive of these expenses it ran at 6.5-7% of GDP.[1] Fiscal deficit in the period January--July 2014 accounted for 42.2% of the total projected annual deficit, which is somewhat below the relative amount of deficits recorded in the first seven months of the preceding years. This primarily came from a considerable reduction in fiscal deficit in June and July caused by seasonal factors, changes in tax calendar and the Minister of Finance's resignation (during the change at the post of Minister of Finance fiscal deficit is usually small because the outgoing minister most often approves only the most urgent expenditures, while his successor needs some time to familiarize himself with fiscal flows). The foregoing developments were driven by a slight rise in public revenues and unchanged public expenditures relative to the preceding four months. However, when compared with the preceding year, a moderate real rise in public expenditures continued so they ran at 49.5% of GDP in Q2, which is extremely high relative to other Central and Eastern European countries.

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



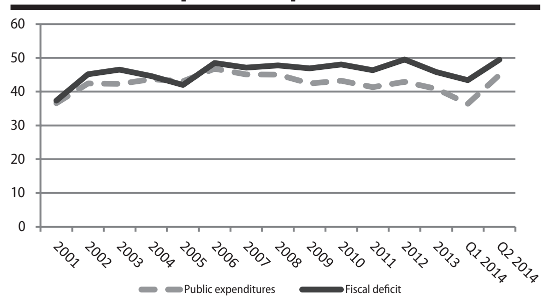
Source: *QM* calculation.
1 Primary fiscal deficit (deficit without interests) is the difference between the total public revenues and the overall public expenditures subtracted by expenditures on interest payments.

1 Below-the-line expenditures, recognized as a part of consolidated public expenditures according to international (GFS) methodology, while domestic methodology does not recognize them as such, include budget expenditures on activated guarantees granted to public companies (e.g. Srbijagas), budget expenditures on financial rehabilitation of banks, and similar. To achieve greater transparency of data on fiscal flows and to obtain internationally comparable data on public expenditures and fiscal deficit in Serbia, Ministry of Finance must start making regular monthly reports on these expenditures, and recognize them as a part of consolidated public expenditures (see Highlight 1).

Primary fiscal deficit runs at 0.5% of GDP in the period April-July 2014 … and inclusive of below-the-line expenditures it reaches 1.5% of GDP

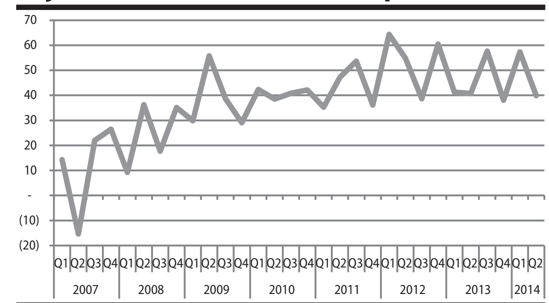
Primary fiscal deficit (fiscal deficit without expenditures on interest payment) ran at 0.5% of GDP in the period April-July 2014. In the first seven months of 2014 official primary fiscal deficit stood at 1.7% of GDP, while primary fiscal deficit inclusive of below-the-line expenditures ran at 3% of GDP, meaning that expenditures on interest payment make more than a half of consolidated fiscal deficit. Expenditures on interest payment are becoming one of the main generators of fiscal deficit. Consequently, fiscal deficit could become self-generating in the future.

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



Source: *QM* calculation

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



Source: *QM* calculation

...due to decrease in revenues caused by unfavorable macroeconomic circumstances

Fiscal trends detected in the first seven months suggest that if other circumstances remained unchanged, in spite of the positive developments in June and July, public revenues in 2014 could fall short of the plan by about RSD 50 billion primarily due to changed macroeconomic circumstances. Public revenues were below the targeted due to several factors: i) downward revision of the nominal GDP carried out by the Statistical Office of the Republic of Serbia (SORS); ii) GDP slowdown (instead of the projected 1% growth rate, GDP will fall by 1%); iii) inflation rate below the expected (the budget was drawn up on the basis of the projected average inflation rate of 5.5%, but it now stands at 2% annually), which has negative impact on revenues from consumption taxes; iv) dinar depreciation below the expected level (which will have negative impact on revenues from VAT and customs duty, but will affect expenditures on interest payments favorably); v) downwards trends in labor market, leading to loss of revenues from personal income tax and social security contributions; vi) negative effect of floods on economic activity and tax revenues in flooded areas. By imposing a tougher spending control, and limiting or delaying certain expenditures, the government will manage to make a limited reduction in the overall expenditures.

Growth of shadow economy is slowing down ... some measures against it taken during the summer ... but there is still a great deal of room for maneuver

Growing shadow economy was an important cause of the decrease in public revenues in 2013 and at the beginning of 2014. Fiscal trends detected in the succeeding months, primarily in terms of domestic VAT and excise duties on certain goods, indicate a slight stabilization in this area, and a slower growth rate or even a slight reduction in shadow economy activities in some segments (trade in petroleum products etc.). Additionally, amendments to the Law on Tax Procedre and Tax Administrationm,introducing tougher penalties for tax evasion or failure to file tax return were adopted in June, and in July Tax Administration embarked on intensive control of illegal retail trade of goods and services, which resulted in closing down of a number of restaurants and retail shops. Measures against shadow economy to be fully effective (EUR 100 million annually in the following three years), the Tax Administration must continue and intensify their control on taxpayers and a number of state institutions must coordinated their actions to close the channels of illegal wholesale of goods (primarily excise goods). Intensified control by the Tax Administration should be given proper media coverage to make taxpayers aware of the increased possibility of being caught and fined.

Without strong fiscal consolidation, fiscal deficit in 2014 (exclusive of below-the-line expenditures) will widen to 6.5% of GDP...

Slight improvement in the state of public finance detected in June and July was driven by seasonal factors (larger turnover during the summer), changes in tax calendar (corporate income tax falls due in June instead of March), and onetime factors, such as change at the post of the Minister of Finance, which usually implies delay of non-urgent expenditures. Taking into account the foregoing effects, and the fact that revenue collection in the period January-July was below the projections, and that certain reductions in expenditures were made, and since fiscal deficit in the second half of a year is larger than in the first six months, consolidated fiscal deficit in 2014 (exclusive of below-the-line expenditures) is estimated at 6.5% of GDP, which is much above the expected level (5.5% of GDP).

...and inclusive of below-the-line expenditures it will exceed 8% of GDP

Fiscal deficit inclusive of below-the-line expenditures, recognized as a part of consolidated expenditures according to internationally comparable methodology, will exceed 8% of GDP in 2014, and will be one of the largest in Europe. Since capital expenditures take less than 3% of GDP, the largest share of fiscal deficit comes from current spending, which is unjust from the aspect of intergenerational equity.

Urgent implementation of fiscal consolidation program aimed at reduction in current expenditures that would provide EUR 1.5-2 billion reduction in fiscal deficit is necessary to prevent bankruptcy

Fiscal deficit above 8% of GDP, mostly structural deficit, is unsustainable even in the mid-term. Urgent implementation of a credible fiscal consolidation program designed to reduce fiscal deficit to 3% of GDP by 2017, which implies EUR 1.5-2 billion reduction in expenditures and rise in revenues, is therefore necessary to prevent public debt crisis. Fiscal consolidation should be based on reduction in current expenditures rather than tax increase, because large fiscal deficit in Serbia does not come from low taxes but from high public spending. Sale of state-owned property would not eliminate the need for fiscal consolidation (although privatization of certain public and state-owned companies is economically justifiable) but only delay it for a while, and subsequently, measures for fiscal consolidation would be even more drastic, and Serbia's asset, economic and political position would weaken.

Box 1. Evaluation of parametric reform of the pension system

After years of announcements, amendments to the Law on Pension and Disability Insurance were adopted in July, introducing substantial parametric reform of the pension system. Among other things, the amendments envisage that the statutory retirement age for women shall be raised gradually from 60 to 65 years, pension payments for early retirement shall be reduced by 4.08% for every year shy of statutory retirement age, minimum early retirement age shall be increased to 60 at a faster pace, and the persons doing administrative jobs will be ineligible for accelerated retirement scheme. Additionally, following the best practices in developed countries (such as Germany), women with children are entitled to register additional months of service. This measure is intended to valorize additional effort women put in giving birth to children and bringing them up, often deployed as an argument against equation of statutory retirement age for men and women.

This reform of pension system is considered appropriate and necessary, and represents a big step forward in reforms made by the new Government (together with the Labor Law). This reform aims at long term sustainability of pension system, because the foregoing changes are expected to provide for reduction in expenditures on pensions of more than 1% of GDP annually, in the long run. Reform parameters are economically justifiable and in accordance with the practices adopted in almost all EU states (in most EU states statutory retirement age for women is 65 years, all EU states impose penalties for early retirement, etc.). Although the reform of pension system is appropriate and justifiable, it will produce quite modest effects in the mid-term (the following 2-3 years), meaning that a single reduction in expenditures on pensions is still necessary.

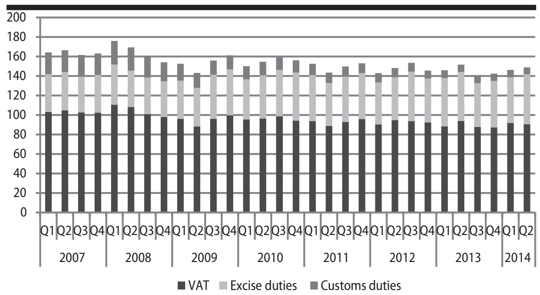
Analysis of the dynamics and structure of public revenues and public expenditures

Public revenues are going up slightly in the period January-July

Public revenues went up slightly in the period April-January 2014 - compared with both the same period last year and the preceding four months real seasonally adjusted public revenues went up by 3.9%. This rise in public revenues primarily came from a steep rise in revenues from corporate income tax (due to changes in tax calendar) and excise revenues and moderate rise in revenues from social security contributions. Other public revenues either remained unchanged or went down.

There is a slight rise in revenues from VAT, but they are still below the last year's level

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



Source: *QM* calculations

Real seasonally adjusted revenues from VAT collected in the period April-July went up slightly (by 0.6%) compared with the preceding four months. However, compared with the same period 2013 these revenues went down (by 3.9%), in spite of VAT rate increase. June and July saw a moderate rise in revenues from VAT driven by slight depreciation of dinar exchange rate, and possibly by modest reduction in shadow economy activities which came from tougher punitive measures and intensified control on fiscal receipt issuing. Tax Administration and other inspection authorities need to intensify their actions against shadow economy and increase efficiency in tax collection to maintain and boost the rise in revenues from VAT.

Excise revenues are going up considerably because illegal trade in petroleum products has been curbed

Real seasonally adjusted excise revenues collected in the period April-July went up (by 9.9%) compared with the preceding four months, and when compared with the same period 2013 these revenues increased considerably (by 6.4%). Excise revenues rose mainly because illegal trade in diesel fuel and other petroleum products (through the process of fuel marking) had been curbed successfully. On the other hand, collection of excise revenues from tobacco products proved inefficient, although this could be a rich source of tax revenue if illegal trade in these products was curbed.

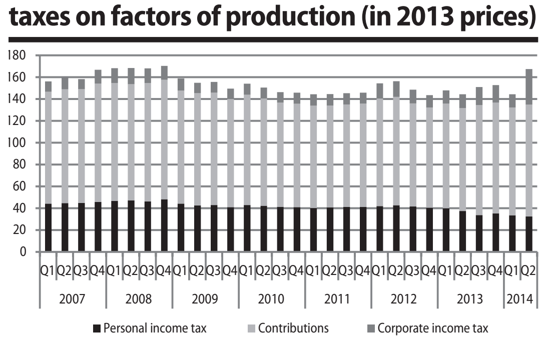
Drop in custom revenues continues

In the period April-July 2014 real custom revenues went down moderately (by 7.7%) compared with the same period last year, and the same decline is posted when compared to April-July 2013. This decrease in custom revenues can be attributed to slowdown in exports, liberalization of foreign trade, and possibly changes in the structure of imported goods regarding its type and country of origin, meaning that goods that are subject to lower custom duties and the goods imported from the signatory countries to free trade agreement with Serbia predominate.

Revenues from personal income tax are going down, and revenues from social security contributions are rising slightly

Revenues from personal income tax (real, seasonally adjusted) went down slightly (by 3.1%) in the period April-July compared with the preceding four-month period, and when compared with the same period last year, these revenues suffered a considerable drop (by 10.9%). This drop in revenues from personal income tax in the period April-July 2014 compared with the same period last year can be attributed to reduction in tax rate for wages as of June 2013. Decrease in revenues from personal income tax in this period compared with the preceding four-month period can be attributed to fall in real wages and increase in informal employment. Additionally, steep real drop in tax revenues from outside of employment income (income from capital, royalties, self--employment etc.) of 11.5% in Q2 relative to the same period last year, pushed down revenues from personal income tax.

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



Source: *QM* calculation

Seasonally adjusted revenues from social security contributions went up moderately (by 2.7%) in the period April-July compared with the preceding four-month period, and when compared with the same period last year, real rise in these revenues was stronger (by 7.1%). This rise in revenues from social security contributions in the period April-July 2014 compared with the same period last year came from increase in the rate of old-age pension and disability pension contributions. Rise in revenues from social security contributions in this period compared with the preceding four-month period could indicate that the state embarked on a more intensive collection of outstanding social security contributions.

Revenues from corporate income tax are going up steeply due to changes in tax calendar

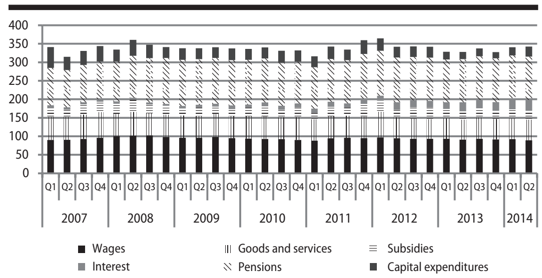
Real seasonally adjusted revenues from corporate income tax collected in the period April-July were much higher than in the preceding four months, or in the same period last year (by 122.1% and 113.9% respectively). Steep rise in revenues from corporate income tax in this period compared with the preceding quarter can be attributed to changes in tax calendar, according to which corporate income tax for 2013 falls due in June 2014, and not in March as was previously the case. Strong real rise in revenues from this tax in the first seven months of 2014 relative to the same period last year (47.3%) came from the increase in corporate income tax rate from 10% to 15%, which influenced only advance tax payments in 2013, but in 2014 it affected the final tax liability, as well. Additionally, rise in revenues from corporate income tax can partly be attributed to greater profitability of companies in 2013 relative to 2012. According to the data released by the Serbian Business Registers Agency, companies in Serbia generated cumulative profit of almost RSD 27 billion in 2013, and suffered cumulative loss of RSD 78.5 billion in 2012.

Other tax revenues are rising considerably, and non-tax revenues are going down, due to the reforms in property taxation

Other tax revenues grew considerably (by 12.4%) in the period April-July 2014 compared with the preceding four months, and when compared with the same period last year this real rise is even steeper (by 23.7%). At the same time, non-tax revenues (real, seasonally adjusted) went down (by 8.5%) in this period relative to the preceding for months, and when compared with the same period 2013, real drop in these revenues was 11.1%. This rise in other tax revenues is the result of changes to property tax calculation method, and the drop in non-tax revenues was caused by abolition of building land use fee, which has been integrated into property tax as of 2014.

Public expenditures remained unchanged in the period April-July

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



Source: *QM* calculation

Real seasonally adjusted public expenditures remained almost unchanged in the period April-July (0.1% rise) compared with the preceding four-month period, and when compared with the same period last year, real rise in these expenditures was somewhat higher (1.9%). Under falling GDP, this resulted in relative rise in public expenditures (to 49.5% of GDP in Q2).

Expenditures on subsidies are rising slightly due to implementation of new subsidy programs

After a period of a slowdown, real seasonally adjusted expenditures on subsidies increased slightly (by 1.8%) in the period April-July relative to the preceding four months, and when compared with the same period 2013 this rise is stronger (by 12.1%). Rise in expenditures on subsidies entirely came from the increase in subsidies paid from the central government budget (while the level of subsidies paid from the local budgets fell considerably), which was driven by specific dynamics in subsidy payments to agricultural producers, and adoption of new subsidy scheme for RTS (national broadcasting company of Serbia), which is considered fiscally, economically and socially unjustifiable. Announced reintroduction of subsidies for investments and employment, realization of subsidies for liquidity loans and similar will result in further rise in these expenditures in the following period. Subsidies for investments and employment are justifiable if their amount is limited, if they are granted in a limited number of cases (for large investments that result in inflow of a number of small investments) and during a very limited time period, and cannot make up for reform in business environment.

Capital expenditures are going up but they are still low

Real seasonally adjusted capital expenditures went up steeply in the period April-July 2014 (by 31%) compared with the preceding four months, and when compared with the same period last year, they increased by 35.3%. Capital expenditures went up mainly because the government discharged its liabilities for performed infrastructure works. The upwards trend in capital expenditures detected in Q1 2014 continued, so these expenditures accounted for 3% of GDP in Q2, which is higher than in the preceding periods but still below the necessary level (about 5% of GDP), and much below the quarterly fiscal deficit (by 1.6% of GDP). This suggests that the future generations will have to shoulder 1/3 of the current fiscal deficit burden, which is unjust from the aspect of intergenerational equity.

Expenditures on goods and services are going up slightly

There was a slight real rise in expenditures on goods and services in the period April-July 2014 (by 1%) compared with the preceding quarter, and when compared with the same period last year, the rise was somewhat higher (3.8%). This slight rise in these expenditures, primarily at the level of central government and Health Insurance Fund of the Republic of Serbia, is the result of floods, and partly of procurements and payments for procured goods or services that were subject to delay previously.

There was a slight temporary decrease in expenditures on interest payments in the period April-July

After a steep rise in expenditures on interest payments in Q1, driven by payment of due coupons on euro-denominated bonds, these expenditures went down slightly (by 1.8%) in the period April-July 2014. They were somewhat lower (by 2.9%) than in the same period 2013. Decrease in expenditures on interest payments is the result of a high base for comparison. They will probably rebound in the following period due to growing public debt (and consequential increase in principal, but also rise in interest rates caused by higher country risk) and changed structure of public debt (share of cheap debt – e.g. old foreign currency savings) is shrinking in favor of new expensive loans. Government bonds of the Republic of Serbia are traded at quite favorable prices on the secondary market, primarily due to high availability of capital in international market, but also because investors have certain expectations about the announced economic reforms. However, strong real rise in expenditures on interest payments (by 28.3%) in the first seven months of 2014 relative to the same period 2013 indicate a continuing upwards trend in these expenditures driven by growing debt and consequently tougher borrowing conditions.

Slight decrease in expenditures on employees continues, due to public sector hiring freeze

Real seasonally adjusted expenditures on employees went down in the period April-July (by 3%) compared with the preceding four-month period, and were by 3.1% lower than in the same period 2013. This is the result of public sector hiring freeze as of January 2014, which generally proved effective, although the Government often derogates from this rule via special decisions. Register of public sector employees gives the Ministry of Finance better insight into dynamics of these expenditures, which also contributed to their reduction. Low wage indexation in April (by 0.5%) did not result in significant real savings because inflation was extremely low (cumulative inflation in the period April-July was at 0.6%).

Expenditures on pension remained unchanged

Expenditures on pensions (real seasonally adjusted) in the period April-July remained unchanged relative to the preceding four-month period and to the same period last year. This is the result of low pension indexation (which pushed down expenditures on pensions by 0.1%) and a slight increase in the numbers of pensioners.

Fiscal trends by government levels

Central government runs budget deficit and other government levels are in surplus – probably seasonally

Q2 2014 saw continuation of the trend detected in 2013 – central government ran budget deficit and other government levels (Health Insurance Fund of the Republic of Serbia, Autonomous Province of Vojvodina and local self-governments) were running surplus. Local self-governments posted the largest budget surplus (totalling about RSD 3.5 billion in Q2, and RSD 8 billion in the first six months), partly because great investments in large cities (Belgrade, Novi Sad etc.) were stopped. However, we think that this disequilibrium is mainly caused by seasonal factors, and that this surplus will vanish in the second half of the year.

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

Central government revenues and revenues collected by the Healt Insurance Fund of the Republic of Serbia went up moderately in Q2 2014 relative to the same period last year (by 6% and 2.3% respectively), while revenues collected by local self-governmets fell considerably (by 9.7%). This rise in central government revenues came from a steep increase in revenues from corporate income tax caused by changes in tax calendar. The y-o-y decrease in local government revenues occurred because revenues from wage tax (tax rate on wages was reduced in June 2013) and non-tax revenues (construction land use fee was abolished since January 2014) fell sharply, revenues from property tax rose due to new calculation method, and possibly because local self-governments increased their efforts towards more efficient collection of own source public revenues.

Table T6-7. 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	6.1	1.8	4.5
Q2 2014	-51.9	0.9	0.8	3.0	2.1	3.5

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

Moderate rise in central government expenditures, and considerable reduction in expenditures at the local level

Q2 2014 saw a real y-o-y rise in central government expenditures (by 2.7%) driven by increase in expenditures on goods and services, subsidies and capital expenditures. The Health Insurance Fund of the Republic of Serbia spent more than in Q2 2013 (by 2.7%) due to rise in expenditures on goods and services. Sharp drop in local self-government revenues led to consequential decrease in expenditures at this government level by 26.1% in Q2 2014 relative to the same period last year. Reductions were recorded on all items on expenditure side. However, capital expenditures suffered the largest cut, while expenditures on wages were reduced slightly, which is economically unjustifiable. Reduction in expenditures on goods and services (by 20.4%) and subsidies (by 31.7%) at the local level is necessary and justifiable so long as it does not jeopardize functioning of local self-governments.

Trends in public debt

Serbia's public debt stood at EUR 20.9 billion (67.1% of GDP) at the end of July 2014

Serbia's public debt grew by EUR 430 million in the period April-July 2014 and stood at EUR 20.9 billion (about 67.1% of GDP). 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 and small real appreciation of dinar exchange rate (by 0.5%), and GDP shrinking. Increase in public debt in the period April-July exceeded fiscal deficit in this period (EUR 320 million). Loan worth EUR 800 million (about 2.6% of GDP) received from the United Arab Emirates in August considerably increased public debt at the end of the month relative to the preceding month, and pushed up government deposits (see: Monetary flows and policy).

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

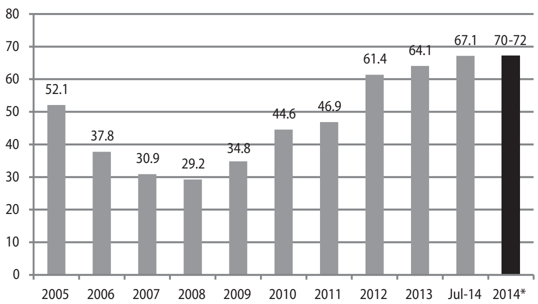
	Amount at the end of period, in billions EUR												
	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1 2014	Q2 2014	Jul-14
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	12.36	15.07	17.3	17.7	18.0	18.3
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	6.5	7.0	7.5	7.7	7.8
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	8.6	10.2	10.3	10.3	10.5
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.60	2.81	2.8	2.7	2.7
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**	20.7	20.9
Public debt / GDP[2]	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.6%**	**31.3%**	**41.5%**	**45.1%**	**59.3%**	**63.8%**	**62.3%**	**63.0%**	**64.3%**
Public debt / GDP (QM)[3]	**169.3%**	**52.1%**	**37.8%**	**30.9%**	**29.2%**	**34.8%**	**44.6%**	**46.9%**	**61.4%**	**64.1%**	**65.4%**	**65.7%**	**67.1%**

Source: Ministry of Finance's data and QM calculations

Reduction in government guarantees, but they are expected to rebound in the second half of the year

Downwards trend in indirect debt continued and at the end of July it was by EUR 140 million smaller than in Q2, which is considered favorable. However, indirect public debt decreased because government guaranteed loans granted to large borrowers (Srbijagas, Železara, etc.) in 2013 were sufficient to cover their operations in the first half of 2014. Since in the meanwhile no measures intended to eliminate key generators of debt in these companies (financial and business consolidation of Srbijagas, privatization or closing down of Železare, etc.) have been taken, it is likely that indirect debt will rebound by the end of the year because these companies will have to borrow further to cover their current operations, meaning that the government will have to issue guarantees to enable them to do so. This suggests that urgent financial and business con-

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



Source: *QM* calculations

solidation of state-owned and public companies is one of the crucial measures for fiscal consolidation. This primarily means that a firm budget constraint based on the principle „user pays" has to be set, cost efficiency should be achieved through increased labor productivity (reduction in the numbers of employees), management should be professionalized (Srbijagas, Železnice, EPS), and some of these companies should be privatized or declare bankruptcy (Železara Smederevo, Rudnik Resavica, etc.).

Public debt will amount to 70-72% of GDP at the end of 2014, or even more

Based on the projection of 2014 fiscal deficit at more than 8% of GDP, and with other indicators unchanged (slight decrease in GDP, inflation rate below the projected level, real dinar exchange rate unchanged), 2014 public debt is estimated at 70-72% of GDP. Some events could even push public debt above this projection. One such event would be issuance of a large amount of government guarantees on loans to EPS needed to finance import of electricity and its current operations. Additionally, if positive developments in international financial market continue during the autumn and interest rates on Serbian bonds remain quite low, like during the summer, it will be reasonable to issue euro-denominated bonds to obtain funds that would be used to finance fiscal deficit by the end of 2014 and in the first half of 2015. This would also push up the level of public debt by the end of the year.

Prilozi

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

	2008	2009	2010	2011	2012					2013					2014	
					Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2
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
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**

Source: *QM*

Trends

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

	2008	2009	2010	2011	2012					2013					2014		
					Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	Q1-Q2
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**	**4.5**	**1.9**
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	4.3	2.1
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	6.4	2.8
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	-13.5	-15.6
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	165.3	50.5
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	-3.6	0.1
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	0.8	-0.3
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	-7.0	-5.8
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	29.1	21.2
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	8.2	5.9
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	-13.0	-4.7
2. Capital revenues	-76.8	-41.4	-66.8	468.2	124.1	259.1	176.7	373.3	304.5	159.4	-63.6	-31.7	-91.3	-63.0	-79.6	17.6	-58.5
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**	**2.2**	**3.9**
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	0.4	3.0
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	-2.0	-1.3
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	3.4	1.7
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	2.2	35.2
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	6.0	2.8
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	-2.2	0.0
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*	*0.0*	*0.8*
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	36.2	33.9
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	41.5	24.1
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**	**45.4**	**54.7**
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**	**2.6**	**4.3**

Source: *QM*

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

	Q2 2014/Q2 2013			
	Consolidated budget	Budget of Republic	Health Fund	Local self-governments
A Total public revenues (I)+(II)+(III)+(IV)	**4.5**	**6.0**	**2.3**	**-9.7**
I Current revenues (1)+(2)	4.3	6.0	2.4	-10.8
1. Tax revenues	6.5	6.4	2.8	-2.8
1.1. Customs	-7.0	-7.0	-	-
1.2. Personal income tax	-13.4	-12.0	-	-14.2
1.3. Corporate income tax	165.5	172.1	-	-
1.4. VAT	-3.5	-3.5	-	-
1.5. Excise duties	0.9	0.9	-	-
1.6. Property taxes	42.9	-	-	42.9
1.9.Other taxes	29.2	12.6	-	14.3
1.10. Social security contributions	8.23	-	2.8	-
2. Non-tax revenues	-13.0	3.1	-12.9	-36.1
II Capital revenues	17.64	-	63.6	16.7
III Transfers from the other levels of government	-	-	2.1	-7.4
IV Donations	117.7	72.1	-	47.9
B Total public expenditures (I)+(II)+(III)+(IV)	**2.2**	**5.5**	**2.7**	**-26.1**
I Current expenditures	0.4	0.8	2.9	-19.8
1.1 Wages	-2.0	-2.3	-0.9	-12.2
1.2. Goods and services	3.5	20.7	5.9	-20.4
1.3 Interest payments	2.3	3.1	-88.6	-1.7
1.4 Subsidies	6.0	32.0	0.0	-31.7
1.5 Social insurance and social assistance	-2.1	-7.9	30.5	-23.2
1.6 Transfers to the other levels of government	0.0	-4.9	-	-
1.7 Other current expenditures	36.3	35.4	86.7	-21.8
II Capital expenditures	41.6	148.7	-88.9	-59.3
III Strategic reserves	0.0	2223.4	-	-72.6
IV Net lending	45.5	50.8	-	-5.7

Source: *QM*

7. Monetary trends and policy

Inflation has stood at the lower end of the target corridor since March but we expect it to draw close to the middle of the target corridor in the fourth quarter. The main movers of the moderate increase of inflation in the coming period are the depreciation of the Dinar and expected rise in fuel prices. Monetary policy remains restrictive but an easing of that restrictive nature is possible only once macro-economic risks are lowered and that primarily means once a credible plan of fiscal consolidation is adopted. Following a lengthy period when credit activity dropped, that activity increased at the end of the second and start of the third quarter with the launching of the program of subsidized credits was launched. The rise in the number of bad loans continued but at a slower pace. The extent of bad loans reached a level which made in necessary for the government and National Bank of Serbia (NBS) to announce a program to resolve the problem.

Central Bank: Balance and Monetary Policy

Monetary policy demands a balance between extremely low inflation and high macro-economic risks

In Q2 the annual rate of growth of consumer prices continued to stand below the lower level of the target corridor. Viewed at monthly level, inflation was extremely low with deflation registered in March and July. Contrary to the expectations of the NBS, inflation at the end of July was under the lower level of the target corridor for four consecutive months. The policy of very cautious and gradual lowering of the key policy rate continued in Q2 with the NBS lowering the key policy rate by 0.5 percentage points in May and again in June. The key policy rate now stands at 8.5% and it is significantly higher than the y.o.y. inflation which stands at around 2%. The high key policy rate has the basic goal of redirecting the surplus Dinar liquidity of banks to NBS REPO bonds. In that way, the NBS is preventing greater fluctuations of the exchange rate since they affect inflation to a great degree in the highly Euro-ized economy but with some tardiness. However, the high NBS interest rates in conditions of low inflation carry a price which is the lowering of bank credit activity and a rise in the cost of loans.

NBS easing depreciation pressure through high interest rates

Despite that we do not expect any significant correction of the key policy rate downwards to the end of the year because of the stronger depreciation pressure in July and August. By keeping the rate at this level, the NBS is trying to prevent business banks from drawing funds out of REPO placement and converting them to foreign currency which exerts pressure on the exchange rate. This is confirmed by data on REPO placements in July when business banks withdraw from REPO placement 215 million Euro which was felt quickly as the Dinar weakened. A significant weakening of the Dinar, although justified from the point of view of the competitiveness of the economy would seriously shake the financial position of the state, companies and the population.

Easing of restrictive monetary policy requires reduced macro-economic risks

Although inflation this year was low with deflation occasionally present, macro-economic risks were extremely high. The postponing of fiscal consolidation, replacement of the finance minister, delay in the arrival of the IMF mission and other things caused doubts among investors in the government economic policy which is manifested through a withdrawal of Dinar placements, rise in demand for foreign currency and withdrawal of capital from Serbia. As a result of those processes, strong depreciation pressure appeared mid-year and the NBS intervened on the foreign currency market to prevent a depreciation of the Dinar. The maintaining NBS interest rates at high level is aimed at preventing a high depreciation of the Dinar because it would affect inflation. Besides internal risks, Serbia, like other countries in the region, is facing the negative effects of the Ukrainian crisis. We feel that a significant easing of the restrictive monetary policy is possible only once macro-economic risks are reduced.

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

	2012				2013				2014	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
Repo stock (in milions of euros)	1,055.98	111.98	2.29	354.16	678.86	663.82	832.03	966.40	783.96	824.18
NBS interest rate	9.50	10.00	10.50	11.25	11.75	11.00	11.00	9.50	9.50	8.50
NBS interest rate	1.11	-2.77	-5.74	1.11	6.95	3.31	13.24	10.38	4.38	5.09
NBS interest rate	-18.43	-7.27	-6.50	-3.99	19.25	12.85	12.83	9.25	5.28	7.08
NBS interventions on FX market (in milions of euros)	-498.50	-1288.80	-1348.30	-1343.30	10.00	-215.00	-140.00	375.00	-800.00	-630.00
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	-13.3
NDA	2.4	61.3	65.8	41.3	-15.3	-3.9	-16.2	-31.3	1.9	6.4
Government, dinar deposits[3]	-5.1	6.1	4.3	-4.3	1.0	-1.2	-4.7	-19.9	-0.3	5.0
Repo transactions[4]	2.2	53.7	59.3	40.2	-16.0	-14.7	-23.8	-30.7	4.2	4.4
Other items , net[5]	5.3	1.5	2.3	5.4	-0.3	12.0	12.4	19.3	-2.1	-3.0
H	-15.2	15.9	30.2	35.3	-2.8	3.3	1.7	12.0	-19.5	-6.9
o/w: currency in circulation	-3.3	-4.0	-1.4	-1.6	-3.9	-0.7	1.0	5.4	-3.6	-2.8
o/w: excess liquidity	-13.6	-1.6	-1.1	5.4	0.6	2.1	-1.4	4.4	-14.3	-2.8
					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	-497.57
Gross foreign reserves	-1138.11	-2090.09	-2536.57	-1324.15	-385.77	-1576.91	-1822.60	240.33	-344.35	-797.81
Foreign liabilities	67.51	2.64	152.60	273.20	415.78	584.90	781.10	703.63	114.16	300.24
IMF	58.24	-6.44	138.99	258.95	401.14	568.40	759.83	695.60	112.50	298.78
Other liabilities	9.27	9.07	13.61	14.25	14.65	16.50	21.27	8.03	1.66	1.45
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	-497.57
1.1 Commercial banks deposits	459.45	740.45	1030.19	907.59	911.80	967.01	1058.25	240.42	-132.58	-18.15
1.2 Government deposits	263.40	488.43	683.75	28.63	-811.79	47.05	209.55	-359.83	-41.34	264.53
1.3 NBS own reserves (1.3 = 1 - 1.1 - 1.2)	-347.74	-858.58	-670.03	-114.73	130.02	22.06	226.30	824.56	-404.10	-251.20

Source: NBS.

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

2) The definition of NBS own reserves is given in section 8 „Monetary trends and policy", Frame 4, *QM* no. 5.

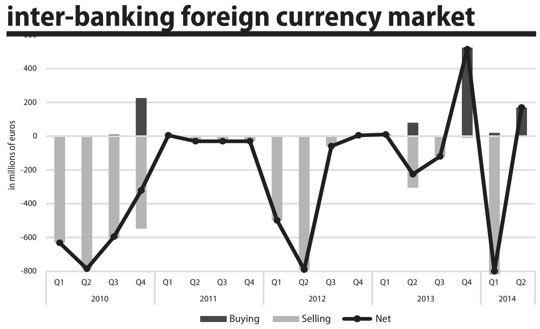
3) „State" includes all levels of power: republic level and local government level.

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

5) Other domestic net assets includes: domestic credits (net bank debts excluding BZ and repo transactions; net debts by the economy) together with other assets (capital and reserves; and items in the balance: other assets) and corrected by changes in the exchange rate.

During Q2 the NBS prevented the appreciation of the Dinar and in Q3 it eased its depreciation

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



Source: NBS

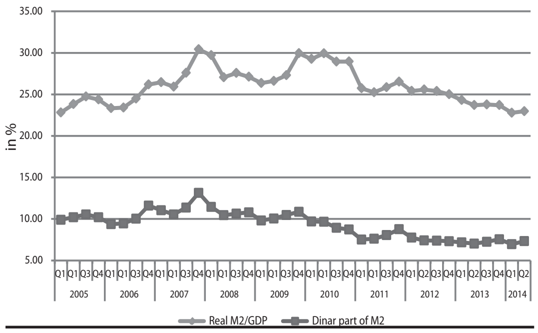
Due to the greately more stable Dinar exchange rate, NBS interventions in Q2 were significantly lower compared to the first quarter. Since appreciation pressure was dominant in this period, the NBS bought foreign currency on the inter-banking foreign currency market to the value of 170 million Euro (Graph T7-2). That caused an increase in the level of NBS net own reserves in Q2 to the value of 150 million Euro which partly neutralized the significant drop in the first quarter (in Q1 those net own reserves decreased by 404 million Euro). By buying foreign currency the NBS positively affected an increase in Dinar liquidity in the system and the primary money in Q2 increased by 12.7% of its value at the start of the year (Table T7-1). Part of the primary money growth is due to the conversion of state foreign currency deposits which led to an increase of 5.36% of the primary money level at the start of the year. On the other hand, business banks in Q2 increased their REPO placements by some 45 million Euro which, along with the drop in account of other domestic assets, led to a decrease in Dinar liquidity. The NBS changed the direction of its interventions from mid-year, selling foreign currency on the foreign currency market to slow down the depreciation of the Dinar.

The Monetary System: Money Mass Structure and Trends

M2 money mass growth of 2.9% of value at start of year in Q2

The M2[1] registered a slight increase in the y.o.y. growth rate in Q2 which nominally stood at 4.8%. The trend of decreasing credits in the private sector continued with credits standing nominally lower by 4.5% y.o.y. while, following a correction by changes in the exchange rate, the drop rate stood higher at –5.4% (Table T7-4). Thanks to low and stable inflation, the real y.o.y. growth rate stood at 3,5% but the greatest cause for concern are loans to the economy which registered a drop of –10.8% y.o.y. Compared to the level at the start of the year, the M2 money mass in Q2 recorded a growth of 2.9% (in Q1 the drop was 1.5%, Table T7-4). The increase in the money mass in this period was solely thanks to the growth of the net domestic assets of 3% compared to the value of M2 at the start of the year while the net side of the net foreign assets was slightly lower in the same period.

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



Spurce: *QM* calculation

Real growth of money mass increases in Q2 ...

... while loans to the private sector continue to drop

The drop in loans to the private sector, primarily to the economy, was partly reduced in June and July thanks to the launching of a new cycle of measures to stimulate credit activities in the form of subsidized loans to maintain liquidity and finance permanent turnover funds. As part of the new program of subsidized loans, a limit was imposed of 15% of the total loans being used to refinance loans with the loan issuing bank. In that way the state tried to affect the system of distributing loans so that they would dominantly be used to finance production and not cover debts based on earlier loans which would profit only banks. Also, a limit was imposed of 20% on total approved credits on loans to large companies which is a positive movement of focus to financing small and medium sized companies which proved to have the most problems in financing production in the previous period.

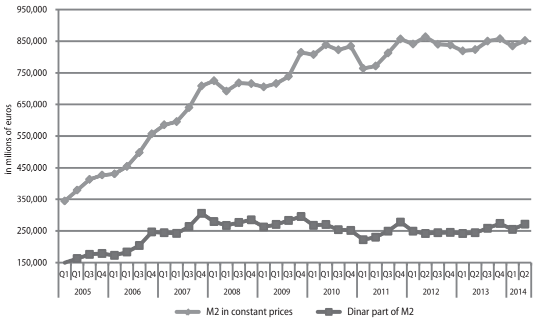
Table T7-4. Serbia: growth of money and contributing aggregates, 2012–2014

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

Source: NBS
1) Money mass: components – see Analytical and Notation Conventions QM.
2) Credits to private sector – credits to the economy (including local government) and households.
3) Trends are corrected by exchange rate changes. Corrections are undertaken under assumption that 70% of loans in private sector (both households and the economy) are indexed against the Euro.
4) Initial M2 designates state of M2 at start of current and end of previous year.

1 Monetary aggregate M2 in section Monetary Trends and Policy includes less aggregate M1, savings and timed deposits in business banks. Because of that the M2 aggregate which we observe is equal to M3 aggregate in NBS reports.

Graph T7-5. State of the money mass in permanent prices, 2010–2014



Source: *QM* calculation

The greatest contribution to the 4.8% nominal growth of the M2 is owed to the growth of the narrowest monetary aggregate M1 which in Q2 contributed 4.33 percentage points to the growth of the M2. The remainder of the growth was achieved thanks to an increase in foreign currency deposits which participated with 1.06 percentage points in the overall growth of the M2 bearing in mind that this was one of the lowest contributions recorded in the past two years. Savings and timed deposits in Q2 made a negative contribution to the growth of the M2 of –0.55 percentage points but that was not enough to endanger the overall y.o.y. growth rate of the M2.

Banking sector: placements and sources of financing

Placements to economy positive again...

... thanks to launching of new program of subsidized credit

The placements of business banks following the significant drop at the start of the year, recorded an increase of 409 million Euro in Q2 (in Q1 the bank placements were negative to the amount of –343 million Euro, Table T7-6). That growth is the result of the combined effect of the growth of placements to the economy and the populaton and increased state crediting in Q2. The negative trend in repaying the debts of the economy recorded over a period of more than one year was ended late in Q2 thanks to the new program of subsidized loans. The placements to the economy at Q2 level increased by 88 million Euro with business banks increasing their placement by 230 million in July when the subsidized loans began. A growth of credit placements of 98 million Euro was recorded among the population in Q2 even though the new program of subsidized loans did not include funds for housing loans which were dominant for the population in previous cycles. The fact that the state increased its debts to business banks in Q2 contributed to the rise in overall credit placements and led to a rise in the net crediting of the state by 170 million Euro. Besides the fact that the crediting of the state and private sector in Q2 increased, the rise in the placement of business banks was also caused by the positive effects of the rise in purchase of REPO NBS bonds with REPO stock in Q2 increasing by 43 million Euro. In July, banks once again withdrew funds from REPO bonds to the value of 215 million Euro. Following the positive increase in cross-border credits in the previous quarter, business banks in Q2 once again lowered their foreign debts by 9 million Euro (in Q1 the increase in cross-border loans stood at 68 million Euro, Table T7-6).

Trends

Table T7-6. Serbia: bank operations – source and structure of placement, corrected[1)] trends, 2011-2014

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

Source: NBS

1) Calucalting increase is done under the assumption that 70% of overall placements are indexed in Euro. Increases for original Dinar values of deposits are calculated based on the average exchange rate for the period. For foreign currency deposits – as the difference of the state calculated based on the exchange rate at the ends of the period. Capital and reserves calculated based on exchange rate of Euro at the ends of the period and do not include the effects of the exchange rate calculated for remainder of balance.

2) NBS bonds includes state bonds and NBS treasury bonds sold at repo rate and at rate set by market for permanent auction sales with a due date of more than 14 days.

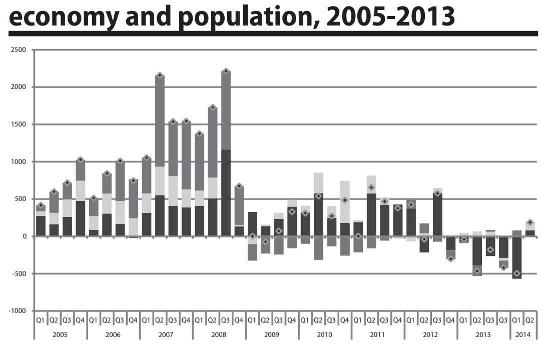
3) Net crediting of the state: credits approved to the state lowered by the state deposits in business banks; the negative prefix designates a higher growth of deposits over credits. The state includes all levels of power: republic and local government level.

4) Other NBS debts (net): difference between NBS debts to banks based on cash and free reserves and debts to the NBS.

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

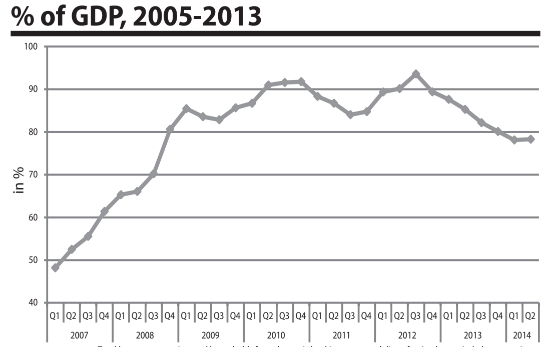
6) Effective mandatory reserves represents the participation of mandatory reserves and deposits in the total overall deposits (for the economy and population) and bank debts abroad. The basis for calculating mandatory reserves does not include subordinate debts because that data is not available.

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



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

Graph T7-8. Serbia: overall credit debts in % of GDP, 2005-2013



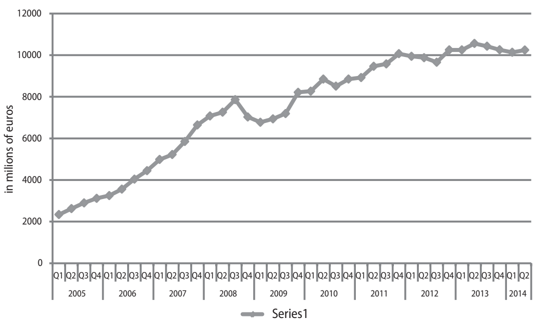
Source: *QM* calculation

Sources for new placements increased in Q2 ...

... but surplus liquidity redirecte into REPO and treasury bonds

In terms of sources of financing for new placements, business banks recorded a slight increase of 38 million Euro in Q2 which is several times lower than the recorded drop at the start of the year (in Q1 sources for new placements dropped by 578 million Euro, Table T7-6). Unlike the previous quarter, domestic deposits contributed to the growth of sources for new placements with 272 million Euro. Within the growth of domestic deposits, a rise was recorded in Q2 in both the economy sector and the population sector with the population contributing to the overall growth with 150 million Euro while the economy increased its deposits by 120 million Euro. Due to the low inflation rate, the population increased its participation in Dinar deposits

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



Source: NBS

in Q2 which is a continuing of the trend from the previous year. In the same period, business banks lowered their foreign debts by 38 million Euro (in Q1 business banks repaid 358 million Euro of debts abroad) which, along with the reduction on the capital and reserves accounts of 196 million Euro, helped neutralize to a great extent the positive effect of the growth on the side of domestic deposits. The surplus liquidity freed in Q2 was redirected by business banks to the purchase of treasury bonds to the value of 505 million Euro of which 2/3 represents a rise in debts on the basis of Dinar bonds while the rest was tied to bonds issued in Euro.

Table T7-10. Serbia: participation of bad loans according to type of debtors, 2008-2013

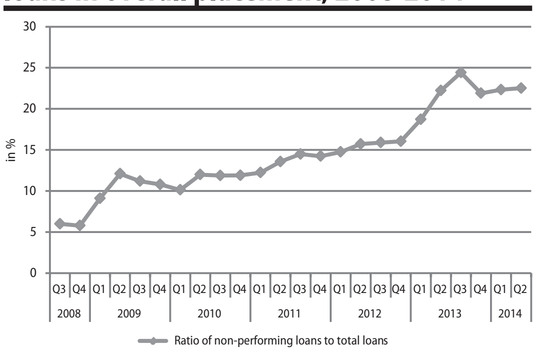
	2009	2010	2011	2012				2013				2014	
	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
	balance at the end of period												
Corporate	12.14	14.02	17.07	17.72	19.26	19.04	19.06	22.62	27.77	31.13	27.76	28.67	28.12
Entrepreneurs	11.21	15.80	17.07	16.05	18.47	17.56	15.92	16.79	18.19	20.86	20.82	21.11	29.77
Individuals	6.69	6.71	7.24	7.57	7.69	8.05	8.32	8.44	8.37	8.14	8.59	8.70	9.22
Ammount of dept by NPL (in bilions of euros)	1.58	1.94	2.63	2.67	2.71	2.97	3.19	3.87	4.47	4.82	4.09	4.05	4.07

Source: QM calculation

The rise of bad loans continued in Q2 …

… primarily because of a deterioration of the situation among entrepreneurs and private individuals

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



Source: *QM* calculation

Q2 saw a slight rise in the participation of NPLs in the overall placement which stood at 22.5% in June (Graph T7-11). The percentage of bad loans in the private individual segment which participated with some 65% in the overall sum of placed credit dropped slightly and in Q2 the bad loans placed with private individuals stood at 28.1% of the sum placed. Unlike them, the credits placed with entrepreneurs saw a slight deterioration at quarterly level and a rise in bad loans to 29.8%. There was also a rise in the participation of bad loans among private individuals which is slightly lower and stood at 9.2% of the overall placement at the end of Q2 but was relatively more dangerous bearing in mind that this segment accounts for about 30% of the overall funds placed.

8. International Environment

Although the global recovery is continuing, it is below expectations, primarily because of the slowing down in the United States, the Eurozone and China. The European Central Bank (ECB) announced new measures of HOV purchase to stimulate credit growth while the FED is drawing closer to the end of its "quantitative easing" although it is still uncertain when the key policy rate will be raised depending on indicators on the labor market. A new European Commission President has been named and he laid out a plan to stimulate the European Union economy while China also announced a program of measures to stimulate growth which includes a fiscal package. The main risks to global recovery are geopolitical – the crises in the Ukraine and the Middle East could slow growth and cause oil prices to rise. In Eastern Europe, the main risks continue to be the slowing down of the Eurozone and negative effects of the impending raising of the FED key policy rate which could raise the cost of debts and a drop in currency value especially in countries which have a high level of public debt and current account deficit.

The World

The International Monetary Fund (IMF) reduced its prediction for the world growth rate for 2014 from 3.7% to 3.4%. That prediction was lowered because of the slower growth in the US and China whose growth slowed because of a drop in domestic demand. The sanctions imposed against Russia affect not only domestic growth but also the economy of the Eurozone. The predicted growth rate for the US in 2014 was lowered from 2.8% to 1.7%, for China from 7.6% to 7.4% and from Russia from 1.3% to 0.2%. The growth rates for Japan, Germany, Spain and Great Britain were increased and lowered for France, Italy, Brazil and South Africa. The growth rate for the Eurozone was not changed (1.1%) and was raised for eastern Europe from 2.4% to 2.8%.

Since bank interest rates have been lowered in developed countries due to expectations that the expansive monetary policy would be longer lasting, capital has been placed in bonds of developing countries for the sake of higher income and the conditions of financing for those countries have improved and their currencies have grown stronger. In response to the slowing of growth, China has announced a fiscal package, reduced taxes for small and medium sized companies, started infrastructure projects and reduced the mandatory reserves in banks which, taken all together, will stimulate growth. The ECB has expanded its program of purchasing HOV to motivate banks to offer credit to companies and the new president of the European Commission has announced new measures to stimulate the economy. The new risks to global growth are geopolitical – a possible escalation of the conflicts in the Ukraine and the Middle East which could result in higher oil prices. The risk to developing countries is a possible growth of the cost of debts if the interest rates in the US rise quicker than predicted.

Besides the slowing down in the Eurozone, the sanctions which the EU imposed against Russia have had a negative effect on the growth of the Eurozone and will have a similar effect on growth in Serbia unless the Serbian economy increases its exports to Russia as an alternative to European companies but the chances of that happening are relatively small. Also, the sanctions are having a negative effect on growth in Russia and Russian demand for Serbian goods is dropping.

The Eurozone

The European Parliament elected Jean Claude Junker as the new President of the European Commission. His agenda includes a number of economic and institutional reforms. A total of 300 billion Euro have been earmarked for public and private investments in economic infrastructure in the next three years. Small and medium sized companies are faced with complicated bureaucratic procedures and a simplification of those procedures will stimulate entrepreneurship. In order to cut down dependency on Russia, the New Energy Union will include new countries from which fuels will be imported and domestic production will focus on renewable sources. Industrial policy is aimed at increasing the industry share of the GDP in the EU from the current 16% to the 20% of earlier years by the year 2020. Stricter control of banks has been announced as well as an integrating of the capital market along with support for TTIP arrangements with the US. Junker's statement that no country will become a full EU member in the next five years indicates that the anti-European block is exerting pressure over further expansion even though negotiations are underway with 6 countries, including Serbia. The agenda includes greater democratization in the EU with a greater role to be played by the European Parliament and influence on decisions by the European Commission.

The growth of the GDP in the Eurozone during Q2 stagnated at quarterly level while the growth rate at annual level stood at 0.7% which is below what economists expected. Personal spending showed a growth of 0.3% q/q, but investment spending dropped –0.3% q/q and state spending showed a slight growth of 0.2% q/q. Imports showed a lower growth (0.3% q/q) than exports (0.5%q/q), and the net exports had a positive effect on growth. Economic activity is still under the influence of fiscal consolidation and the plan is for the budget deficit to be lower in 2014 and 2015 by 0.5 percentage points each year. The Eurozone cannot be expected to have a growth higher than 1% this year and since the economy is slowing down some countries might get a free pass if they do not meet the budget consolidation plans. Spain and Portugal recorded GDP growth in Q2 of 0.6% q/q and Greece recorded the first positive quarterly growth following 16 negative quarters which indicates that the consolidation and structural measures probably had a positive effect on competitiveness. The GDP in Germany dropped by –0.2% q/q because of lower external demand due to the conflict in the Ukraine and a drop in business sentiment and partly because of the high growth in Q1. The growth in Germany in 2014 will probably stand at around 2%. Italy also recorded growth in Q2 – 0.2% q/q, but that is the second consecutive negative quarterly result which technically puts Italy back in recession. Growth in Italy will probably not be higher than 0.2% this year. The slowing down of growth in Italy and Germany will have a negative effect on Serbia's exports.

Although the ECB lowered its refinancing rate to 0.15% in June with the aim of stimulating the growth of credit and lowering real interest rates, the growth of bank credits continues to be slow, just slightly higher than in Q1. The lowering of the refi rates and other ECB measures did not have any great influence on the cost of credit for companies but did have an effect on the cost of credit for states. Interest on bonds from peripheral countries were lowered. In order to increase the influence of monetary policy on the economy through monetary channels and reduce the risk of deflation, the ECB lowered the refi rate in September to 0.05% and the rate on deposits to -.2%. Also, to stimulate banks to give credit, the purchase of ABS bonds was announced but a detailed plan will be revealed in October. The announced measures were partly unexpected and the Euro dropped to below 1.3 to the Dollar. Since the political situation in the Eurozone is complex there is not quantitative easing of the kind implemented by the FED but if growth slows down further and inflation continues to fall, the ECB will have no choice but to start a comprehensive purchase of Eurozone state bonds.

Overall inflation in the Eurozone dropped in Q2 from 0.7% in April at annual level to 0.3% in August. Base inflation is relatively stable – oscillating at around 0.8%. Low inflation has a positive effect on the purchasing power of consumers, especially since salaries are stagnating, but the negative effect is the fact that it makes it harder for the population and the state to repay their debts. Low inflation is caused by low personal spending and lower food prices. Negative inflation in July was recorded in Bulgaria (-1.1%), Greece (-0.8%), Portugal (-0.7%), Spain (-0.4%) and Slovakia (-0.2%). The highest inflation in July was in Austria (1.7%) and Romania (1.5%).

The unemployment rate in the Eurozone dropped slightly from 11.6% in April to 11.5% in June which is a reduction of about 450,000 people. The lowest unemployment rate was in Austria (5%), Germany (5.1%) and the highest in Greece (27.3%) and Spain (24.5%). The unemployment rate is dropping in the peripheral countries – Spain, Portugal and Ireland which is another sign that fiscal consolidation and structural reforms are probably starting to show positive effects.

The United States

In Q2, the US achieved a growth of 1% q/q and 2.4% at annual level, which is a speeding up compared to Q1 when growth stood at 0.5% q/q.

Final spending was higher than expected which indicates that the lower unemployment rates are starting to affect demand slowly and the level of available income is higher for the population. However, the rise in income is having an influence on increasing savings more than on spending and the continued rise in spending will depend on how sure the population is that the economy is recovering. State spending in Q2 contributed to higher than expected growth because the growth rate was higher than in Q3 2012, primarily at local level. Unlike demand which is seeing improvement, the situation is different with demand. Companies are investing less than expected into fixed investments and they have downgraded their profit predictions.

The FED has lowered its monthly purchases of HOV from 35 to 25 billion Dollars as expected and the quantitative easing will be finished in October. There were no changes in interest rates. Since the earlier target for the unemployment rate has already been achieved (6.5%), the question now is what will make the FED decide to start raising the key policy rate. Since a further drop in unemployment is expected and the recovery is not yet certain, the FED will start using other target activities on the labor market to base its decision on when to start raising the key policy rate. That will most probably bee a rise in real salaries. The FED board members do not agree on whether the incomplete capacities of the economy have been caused by lower domestic demand or whether the reason lies in the structural difference between offer and demand on the labor market. The market expects a higher key policy rate in mid-2015.

The unemployment rate in August stood at 6.1% but that figure does not make it simple to draw conclusions on the situation on the labor market. That low unemployment rate is caused to a great extent by the low participation on the labor market. Although the unemployment rate is dropping, there is no significant increase in wages rates which means that there is no significant inflationary pressure on the labor market. Those will most probably appear once the unemployment rate drops to around 5.5%.

Eastern Europe

Growth in Eastern Europe will be higher than last year on the average but the situation is different in each country. The crisis in the Ukraine and the slowing down in the Eurozone have had a negative effect on growth in Eastern Europe. The lowering of interest rates in developed EU countries has increased demand for state bonds in Eastern Europe and most countries have secured financing for this year. However, despite that the greatest challenges in terms of public debt are facing the countries of the former Yugoslavia which are mainly late in implementing structural reforms. Possible risks to the level of cost of credit and stability of their currency can appear once the FED specifies when it will start raising the key policy rate. The countries which will be especially vulnerable will be those with high levels of public debt and current account deficits. It is possible that the negative effects of the FED decision can be eased if the ECB starts a massive purchase of state bonds which would increase the demand for the bonds of Eastern European countries and reduce the cost of credit. Inflation is low in Eastern Europe and many central banks are using this by lowering their key policy rates to stimulate the economy.

Romania

Romania has achieved a growth in Q2 of 1.2% at annual level but its quarterly growth was negative –1% q/q. The main reason for the low growth are disappointingly low investments (-4.4% q/q) and investments in equipment at annual level dropped by 16%. State projects stalled and companies are postponing new investments because they are repaying old credits in foreign currency. Imports and exports also showed a negative quarterly growth. The GDP is predicted to grow in 2014 by about 3%.

Prime Minister Ponta ended his cohabitation with President Basescu and elections are due to be held in November. After the dues paid by employers were lowered by 5 percentage points, the risk rose that the goal of a budget deficit below 3% appeared because, despite criticism from the IMF, the government did not specify how the lower income (200 million Euro) caused by those measures would be compensated. The government has no intention of lowering salaries and pensions prior to the elections and the cost of credit could possibly rise while the "silent war" with the IMF is ongoing. A temporary exceeding of the planned budget deficit level will most probably be short-term and Romania's public debt will not go over 40% of the GDP in the next few years.

Work over the winter which the government organized as a kind of social measure were completed in Q2 and the unemployment rate is expected to rise slightly (7.1% in June) in the second half of the year. The central bank has kept its key policy rate at the level of 3.5% but has lowered the rate of mandatory reserves for foreign currency from 18% to 16% which will release some 300 million Euro in the banking system. This surplus of funds will be used to pay dues to the head offices of foreign banks, invest in companies and state bonds. Overall annual inflation in June stood 0.7% and a drop in prices was registered at monthly level primarily because of a drop in food prices. That was the sixth month that overall inflation stood under the target of the central bank of 2.5% +/-1%. If inflation continues to be below the target, the central bank will probably continue to lower its key policy rate.

Croatia

Croatia recorded negative GDP growth at annual level (-0.8%) in Q2 once again. Domestic demand continued to be low, personal spending is under pressure from high unemployment while fiscal consolidation has a negative effect on investments. The tourist season had a positive effect on the current account balance but foreign direct investments are still low and Croatia is not making sufficient use of EU funds. The GDP growth rate will be negative again this year (about – 0.5%). The central bank's monetary policy is still accommodative to raise liquidity and credit growth. The main risk to monetary policy is higher volatility of the exchange rate. Croatia had deflation during Q2 with inflation in June standing at –0.4% at annual level. Inflation will start to rise in the second half of the year because the effects of the low base will be gone. According to Eurostat data, the unemployment rate is dropping and has gone from 17% in April to 16.3% in June but we won't know until the end of the tourist season whether the drop in unemployment is just temporary. The Fitch credit agency lowered the rating level for Croatian bonds to BB because the budget deficit will be higher than planned, structural reforms are not being implemented and the GDP growth rate continues to be negative. Health care dues will be increased following a reduction and there are plans to raise property taxes. Ways of filling the budget through the income side have been exhausted because Croatia has higher tax rates than most countries in the region. Structural reforms are necessary to increase the flexibility of the labor market, restructuring and the privatization of public companies.

Hungary

The GDP growth rate in Q2 stood at 3.9% at annual level and 0.8% at quarterly level which is higher than expected. Although Hungary has significant economic ties with Russia and the Ukraine, the Hungarian economy has managed to annul the negative effects. Primarily the production of automobiles was stimulated by increased capacities of Audi and Mercedes and the construction industry was helped by state infrastructure projects. Better results in almost all sectors caused the prediction of the growth rate for 2014 to rise to above 3%.

The Hngarian central bank ended the cycle of lowering the key policy rate which it started in August 2012 when that rate stood at 7% and it was reduced in July to 2.1%. That level secures the desired inflation and stimulates growth. The European Commission warned Hungary that the insufficient reduction of the public debt requires added fiscal consolidation. Finance Minister

Varga then announced a new package of austerity measures worth 110 billion Foring (0.35% of the GDP) to keep the deficit at the level of 2.9%.

Hungary has kept its budget deficit below 3% for years but that is not enough to reduce the debt to GDP ratio. The debt will increase because of plans to build a nuclear power plant through Hungarian-Russian cooperation and that will cost 10% of the GDP. That continues Hungary's economic policy which differs from the desires of the European Commission. But, the Hungarian government proved determined to resolve deficit problems which gives it credibility despite the disagreements with the EU. An example of the government's unorthodox economic policy is the decision aimed at reducing expenses for the population that banks should bear part of the cost of housing loans because of the rise of the Swiss Franc against the Forint. Banks will have to convert mortgage loans into the domestic currency at exchange rates which are not market rates which means a burden on banks of about one billion Euro.

The consumer price index dropped 0.3% in June at annual level but there is no great risk of deflation since monthly inflation was positive and the base inflation stood at 2.6% at annual level. The main causes of the drop in consumer prices was the administrative reduction of expenses for households and low food prices because of the successful agriculture season but since their effects are fading inflation is expected to stand at 1% by the end of the year.

The unemployment rate in July stood at 7.9% which is the lowest in the previous six years. However, even though the private sector contributed to the reduction of the unemployment rate, the cause lies primarily in the state programs of temporary employment without which unemployment would stand at 11.2%.

HIGHLIGHTS

Highlight 1. Fiscal consolidation – alternatives and consequences

Milojko Arsić

Based on the trend in the last seven months it is estimated that Serbia's fiscal deficit in this year will amount to about 8% of GDP, which will be the largest deficit in Europe as well as the largest deficit Serbia recorded since 2000. As a result of this deficit public debt is going to rise in this year for about 2.5 billion euros, and will reach 70% of GDP by the end of the year. In this year the state will spend around one billion euros on credit interest, which is more than the expenditure for the army or the police, and as half of the total healthcare expenditures. If the fiscal deficit is not reduced public debt will reach close to 80% in 2015, and credit interest will be 1.15 billion euros.

Despite extremely worrisome trends in the movement of the fiscal deficit and public debt, the public still debates whether it is necessary to take measures of savings. There are opinions that the problem of fiscal deficit can be solved with the economic growth. Representatives of such views argue that the growth of the economy would increase employment and consumption, which would automatically increase tax revenues, thus with keeping public spending at the current level the fiscal deficit would be reduced. According to even more extreme standpoint, not only that Serbia should not reduce consumption, but it should even increase it considering that the economy is still in recession. Increased government spending, according to these proposals, would launch the economic growth, which would then solve the problem of the fiscal deficit. Representatives of this viewpoint often adduce to the fiscal policies of large developed countries, like the United States, and the statements by economists like Krugman and Stiglitz. Also, it is occasionally argued that Serbia's public debt of 70% of GDP is not a big problem, because most EU member states have debt which is greater than 80% of GDP. From the abovementioned it is concluded that due to the fact that public debt is not a big problem sharp fiscal consolidation is not necessary. We will try to challenge previous stances below.

1. Why is the fiscal deficit reduction necessary?

Statement that the problem of high fiscal deficit and public debt can be solved with the GDP growth can be challenged with the fact that this did not happen in some other countries and so chances for this to happen in Serbia are low. Other countries implemented harsh austerity measures and increased taxes[1] instead of waiting for GDP growth to solve the problem of fiscal deficit. The reason that the problem of a high fiscal deficit cannot be solved with GDP growth is that high fiscal deficits negatively impact the economy in many ways.

Reduction of a high fiscal deficit is necessary in order to reduce high macroeconomic risks, and this is one of the prerequisites for starting up the economic growth. To what extent macroeconomic risks have become serious constraint to the growth of the economy is indicated by the ranking list of the World Economic Forum for 2013-2014, according to which Serbia is on a 136th place ranked by the macroeconomic environment, which is far below the overall ranking of Serbia's competitiveness (101th place). Of course, fiscal consolidation is not sufficient to trigger Serbia's economic growth, but if not implemented it is almost certain that there will be no growth. In addition to fiscal consolidation, a number of reforms are necessary for the growth of the economy, such as the improvement of the economic environment, public sector reform, and in the period of crisis some fiscal and monetary stimulus are justified.

Proposition that Serbia, in times of recession, should increase consumption in order to start the economy would mean that, in addition to all existing taxes, the state should further increase the fiscal deficit. In doing so, representatives of such proposals neglect that Serbia de-facto has been conducting such policy since 2011 – public consumption and fiscal deficit were raised faster than taxes, but the result of such policy was not growth of the economic activity, but its fall. Even in this year, in which Serbia has a largest fiscal deficit in Europe, the economy would, without floods, in best case be stagnant, while its decline would be more likely (see section on economic activity). Problems of Serbian economy which limit its growth are not primarily on the demand side as domestic demand continues to exceed supply. Representatives of such proposals manipulate the statements of leading world economists like Krugman and Stiglitz which refer to big countries (USA, Germany, and China) whose economies have significantly different characteristics from Serbian, while their fiscal position is much more favorable. Moreover, the explicitly Krugman's statement which he gave during his visit to Serbia is ignored, according to which his advices proposed for the USA, Germany and others do not apply for Serbia as a small and open economy.

1 We wrote about this in more detail in QM35

Justification of implementation of the savings measures is challenged with statements that with savings the fiscal deficit cannot be reduced, not just as a percentage of GDP, but even nominally?! According to this opinion savings reduce domestic demand, and this leads to a higher fall in public revenues than a reduction in spending, and so the deficit rises. Though this kind of a development is generally (ie. mathematically) possible, it is highly unlikely, and it is even less likely to be lasting.[2] Savings can affect the growth of the fiscal deficit as a percentage of GDP when private investors do not believe in the persistence of the Government in the implementation of the austerity measures, and therefore parallel with the state savings private investments decline. However, if the Government is consistent in the implementation of fiscal consolidation measures, investors' confidence will be received, even if it did not exist at the beginning of the program implementation.

The argument that the level of a public debt of 70% of GDP is not alarming in case of Serbia, because the majority of EU member states have public debt which exceeds 80% of GDP ignores differences between Serbia and the EU member states. EU member states have better credit rating than Serbia, and therefore they are borrowing at much lower interest rates than Serbia.[3] As a result interest costs for Serbia at a debt of around 70% of GDP are approximately equal to the costs developed countries have with a public debt of over 100% of GDP. When it comes to the relation of the public debt to GDP, in case of Serbia, an additional problem is that about 80% of the debt is in euros so each euro depreciation by 1% leads to an increase in the share of debt in GDP by about 0.6 percentage points of GDP. The risk of the public debt of Serbia is also higher because over 60% of the debt[4] is related to foreign creditors, increasing the risk of a sudden stop of Serbia's funding.

2. How would fiscal deficit reduction affect the economy?

Critics of fiscal consolidation as its huge flaw suggest that it will lead to a further decline in economic activity, employment and income of citizens. Although this estimate is correct, it ignores the negative effects that a lack of fiscal consolidation would have on the economy.

2 Formal requirement for savings measure to affect the growth of the fiscal deficit is that the fiscal multiplier is greater than its critical value which is for Serbia is about 1.

3 Serbia occasionally borrows at low interest rates, as is the case with the Arabian loan, but this should not to blur the fact that the average interest rate at which Serbia borrows, as in the period of previous also during this government, is high and are in averaging around 5% annually, in euros.

4 Besides, one part of the public debt refers to domestic banks which are in foreign ownership.

Box 1. Credibility of fiscal policy and transparency of public finances in Serbia

Official data which are being published every month by the Ministry of Finance do not include all expenditures, which should be included according to the international public sector accounting standards. The consequence of this is that announced expenditures are lower, and this also means that the announced deficit is lower than the actual one. This problem in Serbia exists in for a long period, but it is more and more pronounced because the expenditures which were not included in the monthly reports (so called "below the line expenditures") are growing fast. Expenditures "below the line" include different positions, such as credits to state owned companies for which there is a minimal chance that they will be returned by the company (hence these "credits" are de facto subsidies, e.g. Železara Smederevo), state guarantees for credits of the public companies (Srbijagas, etc.) which are almost certain to be returned by the state, and other. While the expenditures "below the line" 3-4 years ago were about 05-1% of GDP, now they are close to 2% of GDP. As a result it is possible at the same time to find data in the Government documents that confirm the public debt in this year is around 6% of GDP or 8% of GDP depending weather the expenditures "below the line" are included or not.

The lack of transparency in public finances is particularly concerning due to the fact that the representatives of the Government at the end of the previous year announced that during 2014 data on public finances will, for the first time, include all income and expenses. It is confusing that the representatives of the Government claim that the data on expenditures include the below line positions, although the data on the website of the Ministry and in the Newsletter of public finances still do not include the data "below the line". The Ministry and the Government certainly have up to date and complete data on revenues and expenditures, but transparency means that these data are available on a monthly basis to all interested: investors, analysts, citizens.

Data on public debt of Serbia are not fully reported according to the international public sector accounting standards. There are differences in the scope of the public debt as well as in the method of calculation of its relation to GDP. Therefore, representatives of international financial institutions, private investors and analysts usually correct the official data on public debt, and as a result in different publications there are different data on the extent of the public debt of Serbia in euros and its share in GDP. It is relevant that the Fiscal Council more than two years ago published a document in which it suggested how to adjust the statistics of the public debt of Serbia with the international practice.

A lack of transparency about public finances causes the lack of trust from investors, international financial organizations and other, in the economic policy of the Government. The sensitivity about the problem of the lack of transparency in the world is particularly increased after a negative experience with Greece. It is therefore important to include "below the line" expenditures, in the shortest period possible, in the monthly data on revenues and that the data on public debt is entirely published in accordance with international accounting standards.

Fiscal deficit reduction almost always leads to the reduction in the economic activity. The mechanism is relatively simple – reduction in government spending cannot be compensated in the short term with the growth of other components of demand (private investments, private consumption and exports), thus total demand and GDP decline. Exceptions are very rare and they happen in situations when some country implements savings measures together with other reforms which improve economic environment, and at the same time countries, its most important economic partners are in expansion. In such circumstances economic activity does not fall because a fall in state consumption is compensated with the growth of private investments, private consumption and exports. However, this set of circumstances, which leads to a so called expansive fiscal contraction, happens relatively rarely, and in recent economic history Ireland and Slovakia are the most famous examples.

The possibility that expansive fiscal contraction happens in Serbia is practically non-existent, even if along with fiscal consolidation other reforms would be implemented, because its relevant environment is far away from the expansion. Therefore fiscal consolidation in Serbia will, as it was the case with most other countries, lead to certain fall in economic activity. How big this fall will be and how long will it last largely depends on Serbia, i.e. the intensity and structure of fiscal consolidation, and the content of policies and reforms. If fiscal consolidation would be strong and if alongside it the reforms of the economy and antirecession measures would be implemented, fall in economic activity could be relatively short-lived and moderate, and would last one to two years.[5]

5 The effects of fiscal consolidation and reforms depend on circumstances that are not controlled by the government, as trends in the international environment, particularly in the EU. The recovery of the EU would favorably influence the growth of foreign investments and credits, as well as the growth in demand for products from Serbia, which would mitigate the impact of the fall in government expenditure on GDP. In contrast, possible new recession in the EU would additional boost negative effects of fiscal consolidation on GDP growth.

The lack of fiscal consolidation would basically mean a continuation of the fiscal policy from the last few years, i.e. the continuation of the policy of high fiscal deficit and rapid growth of public debt. The result of such policy is the stagnation of the economy with stronger tendencies towards recession, and such policy could, in a relatively short period of time, end with the bankruptcy of the state. It is estimated that the delay of fiscal consolidation would result in a drop of GDP of about 1-2%, with the growing probability that the state goes bankrupt, which would lead to a drop of GDP of 5-10%.

Possible bankruptcy of the state would negatively affect the Serbian economy and public finances in a longer period of time. The State would not have access to commercial borrowing for many years, and the due debts and future deficits would had to be financed by the loans from uncommercial creditors (international financial organizations and other states) and the sale of state assets. It is certain that the amount of uncommercial credits would not be high which would mean that the fiscal deficit, and thus the expenditures of the state, would have to decrease significantly in real term. In this case, the state would simply have no choice - it would have to decrease the salaries, pensions, subsidies etc., to the level of available resources, and the available resources would be more modest than in the case of application of fiscal consolidation.

3. Consequences of alternative dynamics and structure of fiscal consolidation.

From the standpoint of recovery of the Serbian economy it is more favorable to carry out decisive fiscal consolidation, in parallel with the reform of the economic system. Implementation of a strong fiscal consolidation, which would in the next 3-4 years stop the growth of public debt to GDP ratio, alongside the reform of the economy, poses a condition for the growth of private investments, and hence employment and wages in the private sector. Strong fiscal consolidation with which savings of about 2.5% of GDP in the first year would be achieved, and then continuation with austerity measures in the next 2-3 years until the fiscal deficit is reduced to below 3% of GDP, would lead to moderate and short-term drop of GDP, after which the GDP would begin to grow.

However, such fiscal consolidation is politically unpopular because it implies that Government decisions will in the next few years reduce real incomes of a large number of citizens (public sector workers, pensioners, recipients of subsidies, etc.) which are financed by the state. People whose income depends on the state, along with family members, represent a large percent of voters[6], and the reduction of their incomes would certainly influence the decline in popularity of the Government. Therefore, the Government is reluctant to take necessary measures, mitigates the announced measures, and adopted measures are not implemented consistently.

Partial fiscal consolidation would basically mean a continuation of a policy which has been carried out for several years, and such policy has less and less confidence of investors. Investors have been somewhat understanding for delays of consolidation in the period of the previous coalition government, but they expected that after the formation of the new government strong fiscal consolidation will be implemented. Furthermore, such consolidation was announced by the Prime Minister, and its delay brings into question the credibility of the Government. Because of a long history of delays and mitigation of announced measures policy of uniform consolidation would probably not quickly gain the confidence of investors. Therefore, in the case of slower fiscal consolidation we would at the same time have a moderate drop in government spending but also the decline in private investments, because investors would be restrained.

Delaying or mitigation of fiscal consolidation is probably a short-sighted policy, even from the standpoint of political interests of parties forming the actual government. Delays in fiscal consolidation lead to the accumulation of problems and this can lead to a public debt crisis, followed by a decline in GDP, employment and income of citizens, including pensioners and public sector employees. In that case, it is almost certain that it will lead to a significant drop of support for the actual government. Therefore, from the standpoint of political interests of the members of the Government it would be better that unpopular measures are being implemented from the beginning of its mandate, in order to provide positive results in the second half of the mandate, and be capitalized in the election.

Besides the dynamics of fiscal consolidation an important issue is the structure of savings within fiscal consolidation. Savings of 5% of GDP can be achieved using different methods, and each of these methods has different effects on the growth of the economy, functionality of the public sector, economic inequality and political popularity of the government. The structure of fiscal consolidation will reveal to what extent each of these goals are taken into account during the process of creation of the savings measures.

From the standpoint of the economic growth it is important that savings are not being made on the account of public investments, which are already low, and also not to reduce the investments in the activities which are crucial for the economic growth, such as modest investments in education and science. For the growth of the economy it would be good to achieve savings mainly on current expenditures which are oversized in relation to the strength of the economy, and these are expenses for employees in the public sector, pensions, subsidies and other forms of assistance to state owned companies. It would be good to create certain space for implementation of incentive antirecession measures through savings on current expenditure. Suppressing the gray economy could contribute to the reduction of the fiscal deficit, while it would also affect the improvement of economic conditions. Abolition/reduction of subsidies which distort equal conditions for doing business would also be good for economic recovery.

From the standpoint of the functioning of the public sector the most favorable savings are the ones which refer to unproductive spending, starting from the abolition of unnecessary jobs, savings on public procurements, to abolition of unnecessary institutions. Certain savings could be made through privatization of some state institutions, as well as through exclusion from the state financing of institutions which offer low quality services. Certain savings, such as announced highly progressive reduction of wages, are not good from the standpoint of efficiency of the labor market and the functioning of the public sector. Such savings would further foster negative selection, which exists in the public sector for decades, reduce the quality of services and encourage corruption. Well regulated state is crucial for the progress of the economy and society, and this cannot be achieved with egalitarianism. Therefore, from the standpoint of the public sector operation it would be most appropriate that wages within fiscal consolidation decrease linearly, with the protection of the minimum wage, and that the change in relative wage relations are achieved in a systematic way through salary ranges.

Saving measures as part of the fiscal consolidation should be designed so that through them the poorest class of population is protected, and this means that recipients of minimum pensions and minimum wages, as well as social assistance recipients, should be exempted from savings. However it is not justified that the fiscal consolidation introduces progressive reduction of salaries and pensions, because it would mean de facto redistribution from middle class (doctors, judges, professors, senior officers and others.) to poorer citizens.

6 The number of pensioners is 1.7 million while the number of employed in the public sector, including the employees in other state companies, is about 750 thousands.

From the standpoint of the Government popularity, savings which affect a small number of citizens - potential voters are desirable. Undoubtedly the best example of such savings is a substitute of expensive loans with cheap ones, but more than once we wrote in the Quarterly Monitor that the potentials of this undoubtedly good saving measure is more than modest - by replacing a billion euros of expensive loans with cheap loans savings of 30-40 million euros per year would be achieved. All measures which abolish unnecessary spending (excessive use of expensive cars, buying unnecessary goods and services, and others.) are politically profitable. Some savings which affect a small number of people, such as the solution of the status of loss-making state owned industrial companies, are good from the standpoint of the economy and the public sector also, but their influence on the popularity of the Government is uncertain because of possible strikes. Savings which would be achieved through high progressive reduction of public sector wages and pensions are appropriate from the standpoint of the popularity of the government, because in this way most employees/pensioners, who are also voters, are protected, but this would have a negative impact on the overall functioning of the public sector.

Conclusion

Stalling and indecisiveness of the Government in the implementation of fiscal consolidation has launched a flood of proposals challenging the need for fiscal consolidation or proposing "light" measures for its implementation. Contesting fiscal consolidation is not new, it exists in other countries also and it is a consequence of the effects of political factors on the economy. Representatives of interest groups are trying to avoid, postpone, or at least reduce the savings which refer to them. For that purpose assessments that the situation is not so serious, and thus big savings are not necessary are released in public. Savings measures, which should normally be realized within fiscal consolidation, are proposed, but their effects are being extremely overestimated in order to prove that the reduction of wages and pensions is not necessary. Thus, for examples, it is argued that in Serbia's government sector has twice as many employees per 100 citizens than other countries, and that this is a consequence of employing of 200 or 300 thousands party activists after 2000. From the above mentioned it can be concluded that the fiscal deficit can be eliminated with the lay-off of the party-employed clerks. There is no doubt that there is a surplus of employees in the public sector and that this is partly a consequence of party-employment, but it is for an order of magnitude smaller and measured by tens, not hundreds of thousands. There are also claims that the fiscal deficit can be eliminated with a more efficient suppressing of the gray economy. In this case also, there is an extreme overestimation of the potential of the gray economy suppressing - possible additional revenues amount to about 1% of GDP, and the deficit should be reduced for 5% of GDP. In a similar way savings which could be realized based on the replacement of expensive loans with the cheap ones, abolition of unnecessary agencies or reduction of subsidies to state owned companies were extremely overestimated. Mutual characteristic of previous proposal is that they would lead to insufficient fiscal consolidation, and then to prolonged recession, with the possibility of bankruptcy of the State.

Disposal of consolidation reasonably raises the question of whether we as a society will in an organized way regulate Public Finances, or will we leave it to disorganization i.e. bankruptcy? Both choices are legit, although we believe that the first option is better.

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