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Table of Contents

Analytical and Notation Conventions

Values

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

Definitions of Aggregates and Indices

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

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

New Economy – Enterprises formed through private initiative

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

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

Notations

CPI – Consumer Price Index

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

H – Primary money (high-powered money)

IPPI – Industrial Producers Price Index

M1 – Cash in circulation and dinar sight deposits

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

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

NDA – Net Domestic Assets

NFA – Net Foreign Assets

RPI – Retail Price Index

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

Abbreviations

CEFTA – Central European Free Trade Agreement

EU – European Union

FDI – Foreign Direct Investment

FFCD – Frozen Foreign Currency Deposit

FREN – Foundation for the Advancement of Economics

GDP – Gross Domestic Product

GVA – Gross Value Added

IMF – International Monetary Fund

LRS – Loan for the Rebirth of Serbia

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

NES - National Employment Service

NIP – National Investment Plan

NBS – National Bank of Serbia

OECD – Organization for Economic Cooperation and Development

PRO – Public Revenue Office

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

QM – *Quarterly Monitor*

SORS – Statistical Office of the Republic of Serbia

SDF – Serbian Development Fund

SEE – South East Europe

SEPC – Serbian Electric Power Company

SITC – Standard International Trade Classification

SME – Small and Medium Enterprise

VAT – Value Added Tax

From the Editor

Over the previous part of the year key indicators of the Serbian economy improved compared to the situation in a couple of previous years. The economy came out of recession during the second quarter of the year, fiscal and external deficits were significantly reduced, the labour market situation is improving, and inflation is low. Although improvements are undisputed, the performance of the Serbian economy in this year, and probably also in the next, will be considerably weaker than in most Central and Eastern Europe Countries: the growth of the economy will be slower, while the unemployment rate, external and fiscal deficits will be among the largest in the above mentioned group of countries. Weaker performances of the Serbian economy in relation to its neighbouring countries are a consequence of delays in the implementation of reforms from one to one and a half decades, as well as delays in the implementation of fiscal consolidation of at least three years. Achieved results represent the first step in creating conditions for long-term sustainable growth of economic activity and employment, so it is therefore necessary to continue with fiscal consolidation, as well as to speed up the reform. There are still no grounds for complacency with the results achieved, nor a space to slow down or delay fiscal consolidation and reforms.

Serbian economy in the second quarter of 2015 came out of the recession which lasted from mid-2013. Previous recession was a consequence of weakness of the economic system and economic policy in Serbia, not the international circumstances, as almost all European countries in the mentioned period recorded economic growth. Previous recession cannot be attributed to the floods, since it started almost a year before them, which means that the floods only deepened the pre-existing recession. Serbia is one of few countries in Europe that even in 2015 has not reached the pre-crisis level of GDP and will do that only in the following year.

Exiting recession in the year when strong fiscal consolidation is being implemented, under which public spending is reduced to about 2% of GDP, is a surprise for most economists (including the authors of QM), international financial organizations, the Government, NBS and others. At the end of last year, according to most forecasts, a fall of GDP of between 0.5 and 1% was anticipated while opponents of the austerity measures argued that the fall will be higher than in the previous year, hence, over 2%. After the end of the first half of the year it is quite certain that the Serbian economy will achieve growth of 0.5-1% of GDP this year, and that without the drought in agriculture this growth would amount to over 1% of GDP. Therefore, it is reasonable to ask the question what factors influenced better than expected results of the economy in this year?

Favourable international circumstances, reforms that have improved business conditions and changes in economic policy have all contributed to exiting from the recession. Favourable international circumstances include improvements in the terms of trade, the recovery of European countries and low interest rates. More favourable terms of trade refer to the decline in oil and gas prices and base metals prices in the international market, which were in growth as a direct result, instead in the expected decline, in production of the petrochemical complex and the metal industry (MKS, processing of aluminium and copper, etc.). The decline in import gas prices influenced the increase in the purchasing power of citizens, resulting in smaller than expected decline of personal consumption. The growth of European economies at a rate of about 2% positively affects the recovery of the Serbian economy because it facilitates the growth of exports, which from the standpoint of demand contributed the most to the achieved growth. Low interest rates are for now influencing the growth of retail lending, thus reducing the drop in private consumption, while for now they are having no effect on the growth of the volume of loans to the economy, but are having a positive effect on operating costs of the economy.

Reform of the labour legislation, acceleration of the approval of construction permits and improvement of macroeconomic stability have positively influenced investments and business operations in Serbia. Improved business conditions have most directly influenced the growth of the construction industry, which was one of the drivers of economic recovery from the recession. Recovery of the construction industry was contributed by the growth of public investments in transport infrastructure, as well as the renewed growth in demand for housing due to the decrease of their prices and the fall of interest rates on housing loans. Also, better business conditions, with already low labour costs, in Serbia directly influenced the relocation of cigarette production from the EU to Serbia - production of cigarettes has been increased by almost 90%. Finally, economic growth in the year when fiscal consolidation is being implemented has confirmed what we argued in the past, and that is that the fiscal multipliers in Serbia are low, which means that an increase in government spending can't be significant to start-up the economy nor the reduction of government spending significantly impacts a drop in the economy.

Unexpected growth of the Serbian economy by 0.5 to 1% in 2015 represents a good result compared to the previous year, but it is still far below what is already achieved by other European countries and what should be a medium-term objective for the Serbian economy. Estimated growth rate in Central and Eastern Europe for the current year is about 2.5% and at the same time all countries, except Croatia, will record a growth of more than 1% while the coming year expects a growth close to 3%. Also, the rate of growth that the Serbian economy will achieve this year is far below the medium-term objective that could be between 3-4% in the next few years, and in somewhat longer term a goal could be the growth of around 5%.

Therefore, the essential question is how Serbia can stimulate economic growth from a modest 0.5% or 1% to 3%-4% per year. The growth of the Serbian economy in 2015, when state and private consumption are reduced, is another confirmation that the growth drivers in our case are not related to domestic demand but to exports and investments. The key condition for acceleration of economic growth in Serbia is to increase the investment rate from the current level of about 20% to over 25% of GDP. At the same time the state can directly contribute to the increase of total investments by increasing the public investments from 3% of GDP to 4-5% of GDP. However, the key role of the state is to create favourable conditions for the growth of private investments, and it includes primarily the improvement of business conditions and the maintenance of macroeconomic stability.

Improvement of business conditions includes reforms of judiciary, cadastre, administration, education, completion of the privatization of former state-owned enterprises, improving the work of public enterprises and others. Improvement of business conditions is not a one-time activity, but a continuous process in which the country's institutions adapt to the changing environment. For secured macroeconomic stability it is necessary to continue with the resolute fiscal consolidation as the fiscal deficit of 3.5-4% of GDP, which will be achieved in this year, still remains one of the biggest in Europe. It is therefore essential to continue reducing the fiscal deficit in the coming years in order to reduce it to around 1% of GDP in the next couple of years. Continuous reduction of the fiscal deficit, and as a result of that the reduction of the public debt to GDP ratio, is a reliable signal that the Serbian economy has avoided the public debt crisis. Therefore, for the credibility of the Government of Serbia it would be very unfavourable for the fiscal deficit to increase in the coming year compared to this year, or to remain above 3% of GDP in the next few years.

Apart from the increase of the GDP growth rate it is important that economic growth is sustainable, i.e. not to create any internal and external imbalances. Fiscal consolidation eliminates the risk of the public debt crisis, but internal risks associated with a high amount of non-performing loans in banks remain. Non-performing loans discourage growth of credit activity without which the investment growth is unlikely, and besides, bad loans are a potential risk for public finances. Removal of external imbalance with the growth of the economy means that export needs to be the main growth driver in the coming years. The condition for this is a relatively high level of investments in sectors whose products are mainly export oriented, which are primarily industry, agriculture and some services. For export growth but also to encourage domestic and foreign investments in export-oriented sectors, it is important that the exchange rate is competitive. In the globalized world, where tariff and non-tariff barriers to trade and the movement of capital are mainly eliminated, policy of moderately undervalued currency is one of the most effective ways to maintain the competitiveness of the economy and encouraging its growth. Slower growth of private and government consumption than the GDP growth in the next few years is an important element of fiscal consolidation, but at the same time in this way domestic enterprises are being directed towards production for export. After stabilizing the fiscal deficit at a low level and a start of the growth of the economy, it would be advisable to reconsider the idea of fiscal devaluation, which was rejected in Serbia in 2010. Fiscal devaluation would reduce fiscal burden on labour, while consumption taxes would be increased, which would have a positive impact on the international competitiveness of the Serbian economy, at the same not deteriorating the situation in public finances.

TRENDS

1. Review

The most important macroeconomic news from the second quarter (Q2) is that the Serbian economy came out of recession in which it was since the second half of 2013. Started economic recovery has been achieved in principle in a healthy way, thanks to the growth of net exports and investments - with no increase in external and internal imbalances. Current account deficit, as an indicator of external imbalance, was actually significantly reduced in Q2, and inflation, as an indicator of internal imbalance is still, for Serbia, extremely low. In addition, the fiscal deficit in Q2 was relatively low and under control. Started improvement of macroeconomic trends is very important, however, it is still at the beginning and therefore very vulnerable. The increase in economic activity of 0.5% which could be achieved in 2015 is better than expected (-0.5%), but even with that growth Serbia is among the European countries with the lowest economic growth and this will not compensate for the decline in GDP in 2014 from 1.8%; fiscal deficit of around 3.5% of GDP is significantly better than 5.9% of GDP, but Serbia is still in the group of European countries with the biggest fiscal problems; current account deficit is significantly reduced, partly because of some temporary circumstances, such as the favourable energy prices, but the financial part of the balance of payments is rather bad, as the inflows of "healthy" foreign capital through foreign direct investments (FDI) in 2015 is even lower than their historically very low levels from 2014.It would therefore be very dangerous for the Government to now overestimate and incorrectly interpret the first favourable economic trends in its mandate and withdraw from the most important fiscal consolidation measures and implementation of urgent reforms.

The economic activity in Q2 recorded a y-o-y growth for the first time since 2013 an it stood at 1%. More convincing indicator of economic recovery in Q2 is seasonally adjusted GDP growth compared to the previous quarter, which stood at 2.2%. Most contribution to the achieved economic growth was made by The increase in production of electricity and mining after the draining of last flooded coal mines in May, but even when we exclude these one-time factors economic trends in Q2 continued to be favourable - seasonally adjusted growth in the rest of the economy compared to Q1 amounted to a solid 0.7%. In addition, started economic recovery is driven by net exports and investments (public and private consumption are in decline), which is a sustainable model of economic growth in the medium term. A preferred structure of the economic recovery which started in Q2 is further confirmed by a solid growth of the manufacturing industry that produces tradable goods and construction, which is a good indicator of overall investments. The size and the structure of the seasonally adjusted GDP growth in Q2 were the key arguments based on which we concluded that the Serbian economy came out of recession in which it was since the second half of 2013, because of which we also corrected our forecast of GDP growth in 2015 up to 0.5% (v. section 2. "Economic Activity").

Although mild growth which can be expected in 2015 is not quantitatively very different from the expected drop of 0.5%, qualitatively, this difference is quite large. The expected duration of the recession has been reduced and another year with the fall of GDP has been avoided, and all of this is being achieved in a year when the implementation of the fiscal consolidation is the strongest. The first good results of economic activity in Q2, however, do not give the Government the right to ignore the major structural problems of the domestic economy which must be removed in order to achieve a significantly higher economic growth of over 4% in the medium term (this is the central theme Review). Otherwise, Serbia could stay "trapped" in the achieved low rates of economic growth for years and further away from the development of the economies of other countries in Central and Eastern Europe which are growing significantly faster. That is why in this edition of QM we are reminding of some sobering data such as that despite the growth in 2015, economic activity will still be lower than in 2013, that almost all countries in the region have higher growth than Serbia, but also that the part of the increase in economic activity in 2015 is based on the production of (problematic) state-owned enterprises (Smederevo Steel Plant, petrochemical complex, and a restart of production in MSK is announced), which can be easily proved to be unjustified and/or unsustainable. Perhaps the best illustration of the fact that Serbia is still structurally insufficiently well organized, commercially unattractive and that the investors are still largely reserved in the interpretation of the achieved macro-economic progress in the first half of 2015, is given by the movement of foreign direct investments. They are in 2015 at a very low level, lower even than in the very poor 2014 - despite the fact that the arrangement with the IMF is being carried out in 2015, fiscal trends are improving and the economies of most EU countries are recovering.

Balance of payments trends in Q2 in their current part have been favourable, because a very low value of the current account deficit of about 200 million euros was recorded (see. Section 4 "Balance of Payments and Foreign Trade"). During the same period of the previous year current account deficit was two and a half times higher (540 million euros). In the financial part of the balance of payments, however, trends were not as good. There was almost no inflow of foreign capital. FDI inflows amounted to only 343 million euros, of which 135 million euros was related to reinvested profit of foreign companies that are already in Serbia, 116 million euros were related to debt instruments, and almost insignificant 92 million euros represented real growth of new investments from abroad. Banks and businesses are still net repaying loans abroad for about 100 million euros, which is not a consequence of the dynamic difference between taking new loans and repayment of old, but it represents repayment of previously taken loans without starting new projects in the country. The State, during Q2, was net returning abroad about 340 million euros on the basis of portfolio investments and net borrowing on the basis of new loans for about 200 million.

Inflation remains very low in Serbia. At the end of August it was 2.1% y-o-y, while the same percentage of the increase in prices was also recorded from the beginning of the year. Inflation in Q2 and in July and August (for which data are available) was below the target corridor of the NBS (see Section 5 "Prices and the Exchange Rate"). August is actually already the eighteenth consecutive month in which NBS does not achieve its primary goal - which is keeping inflation within the target range of 4 ± 1.5%. Since inflation still has not returned to the target corridor, despite the August increase in electricity prices of about 12%, and given that there are no other announcements of major price increases by the end of the year, it is unlikely that inflation will return and remain in the target corridor in the coming months. QM forecast is that the average price increase in 2015 will be around 1.5% instead of the projected 2.7%. Although low inflation has a positive connotation, lower than planned average inflation will influence the correction of nominal GDP downward and the lower growth in tax revenues, which will reduce the expected results of the implementation of fiscal consolidation.

Monetary policy has continued with gradual relaxation (see Section 7 "Monetary Flows and Policy"). National Bank of Serbia in Q2 and in the coming months has repeatedly reduced its key policy rate by 0.5 percentage points bringing it to 5% with the latest reduction in early September. This is also the lowest value of this rate since Serbia introduced inflation targeting. However, inflation in 2015 is at a record low level, so when compared to the current value of the key policy rate it is still 3 percentage points lower, which is why we consider it justified to further lower the key policy rate in the future. Reduction in the restrictiveness of monetary policy is the appropriate response of the NBS on expansive policy of the ECB since the NBS thus prevents harmful economic strengthening of the dinar against the euro. Lending to banks in Q2 was mainly increased by the purchase of REPO securities and rising net loans to households of 75 million euros. However, this growth was almost annulled by the repayment of loans of the economy of 121 million to domestic banks, with additional 31 million euros repayment of cross -border loans. Unfavourable trends continue in the movement of non-performing loans, which in Q2 according to Credit Bureau data have increased to 23% of total loans. Continuing repayment of loans of the economy and a large amount of non-performing loans represent a serious obstacle to future economic growth.

Unreliable and unconvincing statistical data on employment and wages is still the biggest obstacle for a serious analysis of labour market developments. That is why QM once again suggests that the SORS should pay more attention to labour statistics data and to revise them. According to the Labour Force Survey (LFS) in Q2 the number of employees compared to the same period of the last year has increased by more than 150,000 workers, which is not in line with the movements of GDP, consumer consumption, taxes and contributions on salaries and other related indicators (see section 3 "Employment and Wages"). It is particularly interesting that among sectors that recorded a large increase in employment in the past year were those in which the State is the employer. Thus completely state owned sector "Public administration and defence, compulsory social security" increased the number of employees y-o-y for 13,000, and the dominant state sectors, education and health for 24,000 and 15,000 respectively. Therefore, according to this official statistical data the number of public sector employees has increased by 50,000. On the other hand, the other state institutions, the Ministry of State Administration and Local Self-Government, published the data that the number of public administration employees (practically on the same sample) is significantly reduced compared to the previous year (for the more than 20,000). An independent review of the public expenditures for employees in 2015 shows that the number of employees in the public sector actually decreased compared to the previous year - because expenditures for employees decreased by 1.5% more than the average wage reduction in the public sector. This corresponds to the reduction in the number of employees who receive salaries from the state budget by about 10,000 people.

Fiscal deficit in Q2 and in July was relatively low and it is our expectation that in 2015 it could be between 3.5% and 4% of GDP. This is significantly lower than the state deficit of 6.6% of GDP which was recorded in 2014, and the planned deficit for 2015 which was 5.9% of GDP. During Q2 achieved improvements of fiscal trends from the end of 2014 and early 2015 are mainly stabilizing but are also being exhausted. Collection of excise duties and VAT is still slightly above planned, but there is no further strong improvement of their collection that marked the two quarters preceding the Q2 (v. Section 6 "Fiscal Flows and Policy"). In addition, delays in payment to workers who lose their jobs in companies in the privatization process and execution of public investments are gradually recovering (despite somewhat accelerated execution of public investments in recent months the plan for the entire year 2015 will not be reached). The acceleration of the execution of these expenditures increases the deficit, but it is economically justified and desirable. Trends from the previous few months indicate that fiscal consolidation is slowly moving into its second phase when it will be less based on fast individual measures such as cuts in pensions and wages, introduction of excise duty on electricity, police actions aimed at smuggling of tobacco products, and others, and more on systemic reforms (reform of the tax administration, rationalization of the number of employees in the public sector, reform of public enterprises, resolving the fate of the companies in privatization, etc.). This second phase is likely to be the most challenging and professionally the most difficult for implementation.

Deficit of between 3.5% and 4% of GDP, which will be achieved in 2015, represents a success given the state of public finances with which we entered fiscal consolidation and in relation to the original plan for 2015. However this deficit is still very high and there is a small number of countries in Europe that have higher deficit than Serbia. At the European level, a deficit of 3% of GDP is considered as the upper limit of its sustainability, and Serbia is still above that level - and should reduce it significantly in the medium term, to below 1% of GDP. Therefore, the initial success in the implementation of fiscal consolidation is a good basis for faster and more powerful deficit reduction in the coming years, and not the reason for the easing of the fiscal policy. Any extraordinary fiscal space would be economically justified to use only for noticeably increase of public investments, which are currently very low, because they are the only segment of public expenditures that can give a significant boost to business growth. The announced increase of public sector wages and pensions would not contribute to an increase in economic activity (the results of the economy in 2015 clearly show that), and, since these payments are by far the largest share of public expenditures, this could increase the fiscal deficit in 2016 from a (high) level of around 3.5% of GDP in 2015. The increase of fiscal deficit in the second year of implementation of fiscal consolidation, rather than its further reduction, would, we believe, ruin credibility of successfully started healing process of public finances in Serbia.

Public debt (including the debt of local self-governments) at the end of July amounted to 24.4 billion euros (around 75% of GDP) and slightly decreased compared to the end of Q1 when it was around 24.6 billion euros (75.5 % of GDP). The reason for this reduction of the public debt are exchange rate differences, as the dinar (and the euro) since late March to late July has strengthened against the dollar, the currency in which a significant part of Serbia's public debts denominated. On the other hand the fiscal deficit in the same period was relatively low, so that there was no need for new large borrowing from the state and therefore significant growth of public debt on this basis. By the end of the year (without any larger exchange rates fluctuations), we expect that the public debt could amount to about 78% of GDP. This is extremely high (and still growing) level of public debt for the economy at the level of development of Serbia, and further economic argument that better fiscal results than the plan achieved in 2015 should be used for faster deficit reduction and stopping the growth of public debt, not for the increase of pensions and wages in the public sector.

Serbia: Selected Macroeconomic Indicators, 2005 - 2015

	Annual Data										Quarterly Data					
											2014				2015	
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Q1	Q2	Q3	Q4	Q1	Q2
Economic Growth							**y-o-y, real growth[1]**									
GDP (in billions of dinars)	1,751.4	2,055.2	2,355.1	2,744.9	2,880.1	3,067.2	3407.6	3584.2	3876.4	3884.0	…	…	…	…	…	…
GDP	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1	2.6	-1.8	-0.2	-1.3	-3.6	-1.8	-2.0	1.0
Non-agricultural GVA	6.2	5.1	6.9	4.4	-3.3	0.2	1.5	1.1	1.6	-2.4	-0.2	-1.8	-4.7	-2.4	-1.8	2.6
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	-6.5	2.1	-4.8	-13.9	-9.5	-2.0	11.1
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	-1.4	3.6	-2.0	-5.6	-2.8	4.2	7.3
Average net wage (per month, in dinars)[2]	17,478	21,745	27,785	29,174	31,758	34,159	37,976	41,377	43,932	44,530	41,825	44,971	44,934	46,371	41,718	44717
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	1.750	1.728	1.715	1.702	1.696	1.701	1.706	1.706	1.716	1.715
Fiscal data							**in % of GDP**									
Public Revenues	42.1	42.4	42.1	41.5	38.6	-1.5	-4.6	0.6	-3.0	3.1	-0.8	4.3	3.5	5.4	7.6	4.2
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7	3.3	3.6	-5.7	5.0	4.4	3.7	-3.0	14.8	-5.1	-2.9
							in billions of dinars									
Overall fiscal balance (GFS definition)[3]	14.8	-33.5	-58.2	-68.9	-121.8	-136.4	-158.2	-217.4	-178.7	-257.5	-68.1	-45.0	-39.8	-105.2	-21.1	-14.2
Balance of Payments							**in millions of euros, flows[1]**									
Imports of goods[4]	-8,286	-10,093	-12,858	-15,917	-11,096	-12,176	-13,758	-14,028	-14,693	-13,393	-3,415	-3,762	-3,740	-3,834	-3,643	-3,860
Exports of goods[4]	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,394	10,540	9,732	2,512	2,767	2,664	2,698	2,602	2,986
Current account5)	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,639	-2,092	-1,857	-496	-541	-384	-563	-520	-208
in % GDP[5]	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-9.1*	*-12.3*	*-6.5*	*-6.1*	*-6.3*	*-6.3*	*-4.5*	*-6.9*	*-7.0*	*-2.5*
Capital account[5]	3,863	7,635	6,126	7,133	2,207	1,986	2,694	3,486	1,917	1,517	478	414	217	596	377	30
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	669	1,229	1,210	271	435	244	286	332	343
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	-1,332	-800	-370	509	-1,136	110	-32
Monetary data							**in millions of dinars, e.o.p. stock[1]**									
NBS net own reserves[6]	175,288	302,783	400,195	475,110	578,791	489,847	606,834	656,347	757,689	788,293	696,802	756,996	787,778	788,293	854,636	858,972
NBS net own reserves[6], in mn of euros	2,050	3,833	5,051	5,362	6,030	4,609	5,895	5,781	6,605	6,486	6,015	6,513	6,641	6,486	7,094	7,125
Credit to the non-government sector	518,298	609,171	842,512	1,126,111	1,306,224	1,660,870	1,784,237	1,958,084	1,870,916	1,927,668	1,815,004	1,842,407	1,888,471	1,925,584	1,919,958	1,918,917
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909912	933,839	998,277	937,875	949,418	976,865	998,277	1,004,948	1,010,179
M2 (y-o-y, real growth, in %)	20.8	30.6	27.8	2.9	9.8	1.3	2.7	-2.2	2.3	6.7	1.9	3.5	4.3	6.7	6.4	5.8
Credit to the non-government sector (y-o-y, real growth, in %)	28.6	10.3	24.9	25.2	5,2	13.9	0.5	-2.1	-8.3	1.2	-8.3	-5.7	-3.3	1.1	3.7	2.2
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	54.0	52.4	54.7	48.3	49.5	48.5	46.8	48.6	49.7	49.2	48.9
Prices and the Exchange Rate							**Y-o-y growth[1]**									
Consumer Prices Index[7]	16.5	6.5	11.3	8.6	6.6	10.2	7.0	12.2	2.2	1.8	2.3	1.2	2.1	1.8	1.8	1.9
Real exchange rate dinar/euro (average 2005=100)[8]	100.0	92.1	83.9	78.5	83.9	88.0	80.43	85.3	80.2	81.8	80.7	80.9	81.8	83.9	83.8	83.0
Nominal exchange rate dinar/euro[8]	82.92	84.19	79.97	81.46	93.90	102.90	101.88	113.03	113.09	117.25	115.8	115.6	117.4	120.29	121.6	120.4

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

In the second quarter of 2015 economic activity came out of the recession, in which it was since the second half of 2013. The y-o-y GDP growth of 1% was recorded in Q2, while the seasonally adjusted growth, compared to the first quarter of 2015, was as high as 2.2%. Drivers of economic recovery from the production side of GDP were industrial production and construction, and from the expenditure side- net exports and investment. The recovery of industrial production is largely sustained by the recovery of production of coal and electricity to the level before the floods. Due to the achieved level and structure of GDP growth in Q2 we corrected our GDP growth forecast for 2015 by one percentage point upward, from -0.5% to 0.5%. It is good that the growth of the economy is based on the production of tradable goods and increasing investment, but some important indicators of economic activity still suggest caution. Total investments, including foreign direct investments, are still low, and bank lending to businesses is still falling. Without significant and permanent increase in investment it will be hard to sustain and accelerate economic growth.

Gross Domestic Product

Real GDP growth in Q2 of 1%

According to the SORS estimate real y-o-y GDP growth in Q2 stood at 1%. The recovery of electricity production and mining, which not only reached pre-floods production level with draining of the last of the flooded mines in early May, but also exceeded that level by 10-15%, were most responsible for this growth. When we exclude this element from the results of economic activity, which contributed to the y-o-y GDP growth with 1.2-1.4 p.p., we can see that the rest of the economy is still in small y-o-y decline of about 0,3-0,4%. This, however, represents significant improvement in the movement of the largest part of the economy when compared to Q1, in which y-o-y economic decline, with excluded effects of the floods, stood at 1.5%.

Seasonally adjusted GDP indicates a large growth in Q2 compared to Q1

Acceleration of economic activity is also indicated by the seasonally adjusted indices of GDP growth (Graph T2-1). Seasonally adjusted GDP increased in Q2 compared to the previous quarter by as much as 2.2%. The chart clearly shows that in Q2 there was a sharp turn in the movement of economic activity, which has been declining since Q3 2013. The movement of GDP, consumption, employment and others, indicates quite certainly the conclusion that the Serbian economy in Q2 came out from its third recession since 2008. In Graph T2-1 periods in which the Serbian economy was in recession are shaded (estimated based on the Bry-Boschan procedure). Unlike the first two "imported" recessions, which were regional in character since they covered practically the whole of Europe, a third recession, since the second half of 2013, was of local character, and was unique to Serbia.

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

Source: *QM* estimates based on SORS data

The movement of seasonally adjusted GDP in Q2 was also heavily influenced by the recovery of electricity production and mining, which contributed to its growth by 1.5 percentage points compared to Q1. What is not clearly evident from the y-o-y GDP indices, but can be seen with the analysis of seasonally adjusted data, is that the rest of the economy, outside of the energy sector, contributed to the quarterly growth of seasonally adjusted GDP with significant 0.7 pp. This trend, which excludes the effects of floods, is much more important for the future growth of GDP, as the impact of recovery after the floods in seasonally adjusted GDP is one-off and will be exhausted already in Q3 2015. This was also the key parameter on whose basis we estimated the economy in Q2 emerged from recession. Seasonally adjusted economic growth (with excluded effects of floods) in Q2 was the consequence of the growth of just two sectors of the economy: manufacturing industry and construction. However, the fact that this growth is not yet widespread in this case should not be a concern, because these two sectors of GDP are at the same time the most important for the sustainable growth of the economy. Manufacturing industry produces by far the greatest share of tradable products, and its growth is usually associated with the improvement in net exports, while the growth of construction industry is a good indication of the increase in investment.

Investment and net exports are growing in Q2

As we have repeatedly pointed out, sustainable growth of the Serbian economy in the medium term can only be based on the growth of investment and exports, as the share of private and government consumption in GDP over the medium term needs to be significantly reduced. It is necessary that exports grow at a rate close to or greater than 10%, and twice as fast as imports, for the significant growth in net exports which would contribute significantly to GDP growth, as imports are significantly higher than exports. Table T2-2 shows the structure of the y-o-y GDP growth in Q2 by expenditure method, and it generally corresponds to the desired pattern. The two components of GDP in Q2, which have substantial growth, are the investments (y-o-y growth of 8.3%) and net exports (exports increased 8.7% and imports 3%). On the other hand, private and government consumption recorded expected decline of a few percent (Table T2-2).

Table T2-2. Serbia: GDP by expenditure method, 2009-2015

	Y-o-y indices												Share
	2009	2010	2011	2012	2013	2014	2014				2015		2014
							Q1	Q2	Q3	Q4	Q1	Q2	
GDP	96.9	100.6	101.4	99.0	102.6	98.2	99.9	98.8	96.0	98.2	98.0	101.0	100.0
Private consumption	99.4	99.4	100.9	98.2	99.4	98.7	98.4	99.1	98.7	98.9	99.5	98.6	74.9
State consumption	100.6	100.8	101.1	102.4	98.9	100.1	99.3	100.3	98.6	101.9	96.3	97.1	18.6
Investment	77.5	93.5	104.6	113.2	88.9	97.3	96.3	99.3	92.7	100.9	104.3	108.6	18.6
Export	93.1	115.0	105.0	100.8	121.3	103.9	118.1	108.3	93.4	100.4	108.6	108.7	43.4
Import	80.4	104.4	107.9	101.4	105.0	103.3	106.2	105.4	101.1	101.0	111.3	103.0	56.2

Source: SORS

When seasonally adjusted, consumption components of GDP reveal some interesting trends observed by quarters. Private and government consumption, which had a relatively strong seasonally adjusted fall in Q1, due to the implementation of the fiscal consolidation, in Q2 remained at roughly the same level as in the previous quarter. The movement of investments was similar, but only with a different sign. Seasonally adjusted, investments increased relatively high even in Q1, and in Q2 this level of investments was maintained, but not further increased. Practically the only consumption component of GDP, which changed significantly in Q2 in comparison to Q1 and led to a large increase in the seasonally adjusted GDP by 2.2%, is net exports, and within the seasonally adjusted net exports - not so much the increase in exports as seasonally adjusted decrease in imports.

Some important indicators still suggest caution

So, the published data show that the GDP in Q2 grew very strongly, even if we exclude the effects of floods, and that the structure of its growth is generally favourable. It is beyond doubt that the good results from Q2 will influence the rate of GDP growth in 2015 to be higher than expected after Q1 (which will be discussed below), but more detailed analyses suggest an extra caution. In fact, it is still uncertain whether the good economic trends in Q2 will continue in the coming quarters. The growth of net exports such as it was in Q2 is good and desirable, but it would be even better that exports accelerate from quarter to quarter, rather than imports decline (slow down). Second key component of sustainable economic growth, investments, also increases significantly in 2015, but two important indicators do not yet support this growth. These are the foreign direct investments (FDI) and investments loans. Sustainable growth of private sector investments can be launched from abroad (FDI growth) or by starting a new investment cycle of domestic companies. In conditions of low profitability (and profitability in 2014 was smaller than in 2013), starting a new investment cycle would probably reflect the dynamic growth of investment loans. In 2015, however, not only are the FDI and investment loans very low, but they are also considerably lower than in 2014 when they were at historically low levels.

Construction is accelerating, and agriculture declining due to a drought

Observed by use (Table T2-3) we see that the movements in Q2 are very divergent. The highest Y-o-y growth of 12.6% was realized by the construction, and a high growth of almost 8% was recorded by the industrial production. Both these sectors in Q1 were in a solid y-o-y decline and their acceleration led to the GDP increase in Q2, after the fall in Q1. High growth of industrial production was influenced by the recovery of electricity production and mining after the floods, but a high growth was also recorded by the manufacturing sector which was not significantly influenced by the floods. Growth in construction is probably a result of increased public investments in the road infrastructure, but also the recovery of building construction, after simplifying the process of issuing building permits. On the other hand, the sector of the economy that is in the biggest decline is agriculture, recording a y-o-y decline of about 9% in Q2, due to the impact of drought on the autumn crops.[2] Other sectors of GDP are generally at a similar level as in Q2 of the last year.

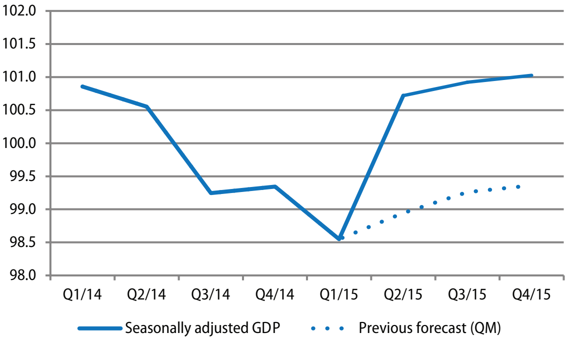
Table T2-3. Serbia: Gross Domestic Product by Activity, 2008-2015[1]

	Y-o-y indices												
	2009	2010	2011	2012	2013	2014	2014				2015		Share
							Q1	Q2	Q3	Q4	Q1	Q2	2013
Total	96.9	100.6	101.4	99.0	102.6	98.2	99.9	98.8	96.0	98.2	98.0	101.0	100.0
Taxes minus subsidies	98.6	99.5	101.1	97.8	98.9	99.4	98.5	100.4	99.3	99.6	100.3	98.6	16.0
Value Added at basic prices	96.6	100.8	101.5	99.2	103.3	98.0	100.2	98.5	95.4	97.9	97.6	101.5	84.0
Non agricultural Value Added	96.7	100.2	101.5	101.1	101.6	97.6	99.7	98.2	95.1	97.6	98.2	102.6	89.8[2)]
Agriculture	95.2	106.4	100.9	82.7	120.9	100.8	102.4	100.7	99.9	100.9	91.4	90.6	10.2[2)]
Industry	96.8	100.8	103.2	105.6	106.0	92.9	99.9	94.8	86.8	90.6	96.2	107.8	23.9[2)]
Construction	87.1	97.6	105.9	90.2	96.1	100.9	100.2	101.7	93.2	108.0	98.0	112.6	5.2[2)]
Trade. transport and tourism	92.9	100.0	99.5	99.3	102.3	98.7	100.1	98.0	98.4	98.4	100.0	102.1	17.7[2)]
Informations and communications	97.0	103.2	102.6	102.8	99.9	101.8	102.2	102.1	101.2	101.5	98.5	99.0	5.3[2)]
Financial sector and insurance	102.6	101.9	98.4	92.0	90.5	98.4	95.5	98.9	97.2	102.0	104.8	100.1	3.2[2)]
Other	99.7	99.8	100.9	101.8	100.2	99.7	99.6	99.7	99.6	100.1	98.1	98.3	34.6[2)]

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

In the coming quarters we expect a similar structure of GDP growth by sectors as in Q2. Industrial production by the end of the year (in the first quarter of 2016) will have high growth rates because it will be compared with the period in which the energy system of the country was working at a reduced capacity. Agriculture by the end of the year will also have a similar decline as in Q2, because the current assessments of the impact of drought on agriculture are probably quite reliable. A mystery that may have limited impact on economic growth in 2015, but much more on economic growth in the coming years is the movement of construction. Its annual growth of over 12% in Q2 represents a major change in the trend, compared to Q1, as well as in relation to several previous years, when construction was in stagnation and decline. The growth of construction in Q2 was supported by a similar increase in the production of building materials (cement) and will hopefully be of more permanent nature, but some additional indicators still suggest caution.[3]

Graph T2-4. Serbia: projection of seasonally adjusted GDP by the end of the year (average 2014 = 100)



Source: *QM* estimates based on SORS data

Due to higher GDP growth in Q2 we correct the growth forecast for 2015 upwards - to 0.5%

In Graph T2-4 we presented the recorded movement of seasonally adjusted GDP in Q2 compared to our forecasts from the pre-

2 The practice of statistical offices is to allocate the decrease (or increase) of Agriculture to all quarters of the year, although this may occur in only one quarter. In this way, excessive shocks of agriculture in one quarter of 30-40% is mitigated.
3 For more details see the last part of this chapter relating to construction

vious issues of QM. The dotted line on the chart represents our forecast of movement of seasonally adjusted GDP by the end of the year, which is consistent with the previously anticipated decline in GDP in 2015 of 0.5%. In the chart, however, it can be seen that the growth of seasonally adjusted GDP in Q2 was much higher than we expected, and the reasons are as follows: 1) we expected that, after drying of the last flooded coal mines, electricity production and mining in Q2 will return to their usual levels, before the floods, and their production instead (temporarily) increased even more, 10-15% above that level; 2) construction achieved very high growth, for which we had hoped[4], but we have not included that in our forecasts before it was achieved.

Much of the difference between our forecast and the results achieved in Q2 are temporary and one-off factors[5]. However, even if a part of that temporary increase in production is lost by the end of the year, the growth rate of the economy in 2015 will still be slightly above zero, due to the large increase in Q2. It should also be noted that after an unusually large increase in the production of EPS and its subsidiaries in Q2, in the coming quarters the continuation of increasing production of a number of other state-owned enterprises (Smederevo Steel Plant, MSK) is announced, which can also affect further increase of GDP. Taking all this into account, the planned increase and the expected reduction in some parts of the production, GDP growth in 2015 so far is estimated at around 0.5%, but because of a large number of unknowns it is not excluded that the growth rate higher than forecasted will be realized.

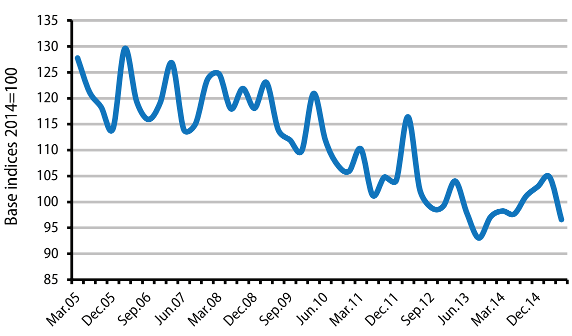
It is good that another recession year has been avoided, but the growth of the economy in 2015 is still very low

The positive growth rate in 2015, which will be likely achieved instead of the planned slight decline of the economy, has a tangible symbolic importance, because there is a vast qualitative difference if the country is not in a recession. It is important to point out that the positive growth rate is being achieved during the implementation of fiscal consolidation, in the year in which the fiscal deficit will be almost halved compared to 2014, which is very good, but it also means that the fiscal multipliers in Serbia are probably even smaller than expectations.[6]However, the results of the economy in 2015 should not be overestimated, because an increase of about 0.5% is very small. There are actually a number of arguments that relativize the results of economic activity in 2015 and should be always kept in mind: 1) even if the growth of 0.5% is achieved economic activity in 2015 would still be significantly lower than in 2013(as in the pre-crisis 2008); 2) countries, not only in the EU, but in the region are growing by an average of 2-3%; 3) a good part of the growth of the economy is the result of one-time and special circumstances (recovery of mining and electricity production after the floods, historically low prices of energy and raw materials that fuelled the increase in production of certain state-owned enterprises, but will not last forever, and others).

Unit labour costs are decreasing

Unit labour costs[7] (ULC), measured in dinars, in Q2 are in decline in relation to Q1 and almost unchanged compared to the same period last year (Graph T2-5). ULC represent the share of labour costs in the added value and we measure them for total economy from which we excluded the agriculture and public administration sectors so we could assess the real trends in the "market" part of the economy (without public administration sector), and which does not depend essentially on changes of meteorological factors (such as agriculture). ULC decline that occurred in Q2 compared to Q1 was a consequence of slightly faster growth of production than labour costs. The Graph also shows that the

Graph T2-5. Serbia: Real Unit Labor Costs in the Economy, 2005-2015



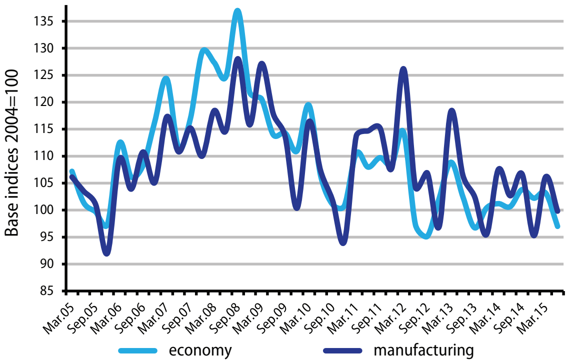
Source: *QM* based on SORS and NBS data

4 See QM40
5 The biggest difference was in the forecast of trends in production of electricity, but it is questionable whether the high growth of construction from Q2will be maintained.
6 Therefore the arguments that eventual increase in public sector wages and pensions could have significantly positive effect on growth are pointless.
7 Unit Labor Costs in dinars are calculated for the economy (excluding the Agriculture and Public Administration sectors) and industry.

long-term trend of ULC is their decline, but also that from the last quarter of 2013 ending with Q1 2015, this long-term trend was reversed and that the ULC relatively strongly increased (Graph T2-5). In Q2, the decline of ULC annulled only a part of this increase from 2013, and so ULC, despite decline, are still at a relatively high level. We believe, however, that trends of increasing ULC in the previous year and a half only partly reflect the real trends in the Serbian economy, and that are partly a consequence of the unreliability of statistics on employment and wages and/or the formalization of employment and some wages which in the past were not paid out in the full amount. Keep in mind that for calculating ULC, QM uses only data on the movement of formal employment and wages, and that (suspicious) ULC increase from 2013 would be even higher if we had used the data of the Statistical Office from the Labour Force Survey instead of the data on the movement of formal employment.[8]

Unit labour costs measured in euros (euro-ULC) are an indicator of the price competitiveness of the Serbian economy, as they define the greatest national cost component (labour costs) in relation to the added value. We calculate euro-ULC for the manufacturing sector (which produces by far the greatest share of tradable goods), and for the economy as a whole[9], as shown in Graph T2-6. From Graph T2-6 we note that the euro-ULC, unlike the dinar-ULC, in the last quarters mainly oscillated around the values achieved in the first half of 2013. Mild real depreciation of the dinar from the mid-2013[10] compensated for the negative impact on the competitiveness of the increase in dinar-ULC (Graph T2-5). Based on the value of the euro-ULC and comparison with their historical values (Graph T2-6) we could say that the pricing competitiveness of the domestic economy with the dinar exchange rate above 120 dinars for euro is currently at a satisfactory level, but moderate real depreciation would be even more favoured.

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



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

Industrial production

Industrial production records a high y-o-y growth in Q2

Industrial production in Q2 recorded a high annual increase in production of 11% (Table T2-7). Most of this y-o-y growth occurred due to a very high growth in mining, by 15.8%, and electricity production, even 29%. The main reason for the high growth of mining and electricity production is the comparison with the same period of the last year in which due to the floods coal mining and electricity production were reduced. It is interesting to notice, however, that mining, and particularly the production of electricity, in Q2 grew even more than their usual levels for this quarter (before the floods). This additional growth in Q2 2015 is however temporary and is the result of a lack of common practice of EPS to seasonally reduce the production and carry out the overhaul of the plant in the summer months when the demand is lower.[11]Instead of this, electricity in Q2 was produced at full capacity and exported. Manufacturing, which was not under the major influence of the floods in Q2 also recorded very good results and has achieved an y-o-y growth of over 7%. The manufacturing industry only once had a similar y-o-y growth in the past five years, in 2013, when production of FAS grew strongly.

8 For more details see Section 3 "Employment and Wages" of this issue of QM
9 Excluding the Public Administration and Agriculture sectors.
10 For more details see Section 3 "Prices and the Exchange Rate" of this issue of QM
11 It is possible that the reason why a full overhaul of the EPS plant was not carried out is the fact that the plants for producing electricity worked with significantly reduced capacity in the past year, but perhaps there are some other reasons.

Table T2-7. Serbia: Industrial Production Indices, 2009-2015

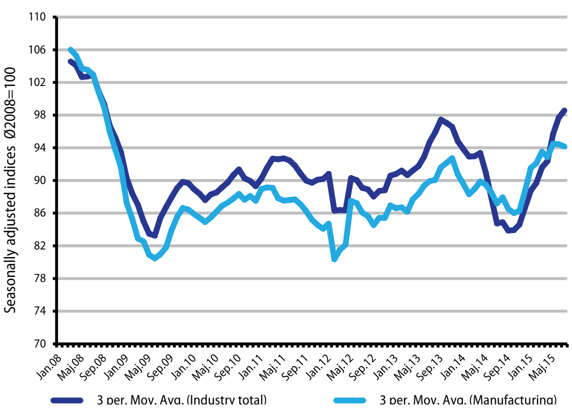
	Y-o-y indices												Share
	2009	2010	2011	2012	2013	2014	2014				2015		2014
							Q1	Q2	Q3	Q4	Q1	Q2	
Total	87.4	102.5	102.2	97.1	105.5	93.5	102.1	95.7	85.8	90.5	98.0	111.1	100.0
Mining and quarrying	96.2	105.8	110.4	97.8	105.3	83.3	99.7	87.3	71.6	76.2	84.0	115.8	6.9
Manufacturing	83.9	103.9	99.6	98.2	104.8	98.6	104.2	98.7	94.0	97.2	104.2	107.3	79.8
Electricity, gas, and water supply	100.8	95.6	109.7	92.9	108.1	79.9	99.3	86.2	61.3	72.6	87.0	129.0	13.3

Source: SORS

Observed by individual sectors of manufacturing industry, sectors, which in Q1 contributed the most to the growth of manufacturing industry, continued with the high growth. The tobacco industry, textile production and the sector "Production of machinery and equipment not elsewhere specified" in the first half of 2015 almost doubled production compared to the previous year and are the main drivers of growth in the manufacturing industry. In Q2 the production of base metals joined to these high growth areas due to increased production of Smederevo Steal Plant, so the y-o-y growth of this sector is now raised to about 30%. Good results in 2015 are also achieved by the pharmaceutical industry with a growth of about 15%, and other sectors of manufacturing industry are achieving results similar to those of the previous year or are slightly declining. Available data for July suggest that the similar structure of growth of manufacturing industry continued in this month, and the only major change is that very high growth in production of other machinery has stopped - which is why the y-o-y index of the manufacturing industry in July decreased to 3.8% (in June it was 9.4%), and the seasonally adjusted decline of that sector of the economy in July was 1.6%.

Seasonally adjusted indices show strong growth of industrial production

Graph T2-8. Serbia: Seasonally Adjusted Industrial Production Indices, 2008-2015



Source: SORS

The Graph T2-8 shows the seasonally adjusted indices of the production of total industry and particularly manufacturing industry with the last available data for July 2015. Although both observed indicators grew in Q2, seasonally adjusted growth of total industry significantly higher (darker line on the Graph) than the manufacturing industry growth (lighter line on the Graph) confirms that the strong growth of industrial production in Q2 was mainly a consequence of the growth of mining and electricity production. In the coming months, the seasonally adjusted index of total industrial production is likely to be reduced. Electricity production will return from September to its normal autumn production levels, and a stoppage in the growth of the manufacturing industry can already be sensed from the Graph T2-8.

Possible industrial production growth in 2015 of about 9%

By the end of the year trends therefore suggest a gradual reduction in seasonally adjusted indices of the industrial production, as well as in the manufacturing industry. The y-o-y indices of industrial production will be very high for some time, as long as the mining and electricity production are compared with the low base, but they will probably start to gradually diminish from autumn. Although carrying trends suggest a slowdown, announced increase of production in some state-owned enterprises can alleviate or even temporarily reverse these trends - launch of the second furnace in Smederevo Steal Plant, restart of production of MSK Company and other. Growth of industrial production in 2015 could be around 9%, but there are still a lot of uncertainties which could further increase or decrease this growth. In comparison to the previous edition we have corrected the forecast growth of industrial production upwards by 2 percentage points, mainly due to a higher than expected growth of electricity production. The expected growth of 9% is very good, but one should keep in mind that in 2014 industrial production fell by 6.5%, so that the industrial production is only slightly higher than in 2013.

Relatively high growth in production of all special purpose groups

Observed by use (Table T2-9), we see that in Q2 all four observed product groups have a relatively high annual growth of production. Energy production was influenced by the recovery of mining and electricity production and recorded a growth of about 24% in Q2. Production of intermediate goods, after stagnation in Q1, in Q2 achieved an increase of 8% due to the increased production in the Smederevo Steel Plant. Capital assets slightly slowed down their growth compared to Q1, but their production is still about 9% higher than in the same period of the last year –which is mostly influenced by the "Production of machinery and equipment not elsewhere specified" sector. Finally, the production of consumer goods was higher than in Q2 by almost 6%, because the tobacco industry in this quarter had a y-o-y increase of about 35%, and the food industry, which has by far the largest share in this group of products in Q2 had a y-o-y growth of 4.5%.

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

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

Source: SORS

Construction

High growth of construction in Q1

In Q2 construction achieved high y-o-y growth of about 12%. Unlike Q1, when the indicators that describe the movement of construction were completely inconsistent and could not give an unambiguous assessment of the movement of this sector of the economy, in Q2 the situation is somewhat different. The SORS estimate is that the added value of construction in Q2 increased by 12.6% compared to the same period of the last year, while the index of completed construction works increased y-o-y by 17.5% in constant prices. The number of formally employed in the construction industry in Q2 increased y-o-y by about 3%, and less reliable measurement of the total number of employees in the construction industry (Labour Force Survey) shows the growth of total employment in this sector by 11%. Finally, an independent indicator that QM uses as additional and probably the most reliable indicator of rough trends in construction activity - the cement production index - in Q2 recorded a growth of 12.4% compared to the same period of the last year (Table T2-10). Based on all of these indicators, we conclude that the construction activity in Q2 actually achieved high annual growth of about 12%.

The analysis of the movement of construction is very important bearing in mind that the movement of construction activity is a good indication of the movement of investments (construction accounts for about 50% of total investments), and we consider the growth of investments to be critical for the sustainable economic growth of Serbia in the medium term. In Q2, the implementation of public investment in the road infrastructure accelerated, which certainly affected the positive trends in construction. This, however, cannot explain the overall growth of construction, as the analyzed data of construction statistics indicate the recovery of construction in the private sector. It is possible that changes to the Law on planning and construction, improved credit conditions (low interest rates on housing loans), the fall in prices of construction materials and energy, and other, influenced the turning point in the trend of construction, but we will wait

Table T2-10. Serbia: Cement Production, 2001-2015

	Y-o-y indices				
	Q1	Q2	Q3	Q4	Total
2001	89.5	103.5	126.9	148.1	114.2
2002	83.6	107.9	115.6	81.6	99.1
2003	51.1	94.4	92.7	94.4	86.6
2004	118.8	107.4	98.5	120.1	108.0
2005	66.1	105.0	105.8	107.4	101.6
2006	136.0	102.7	112.2	120.2	112.7
2007	193.8	108.9	93.1	85.0	104.4
2008	100.1	103.7	108.1	110.1	105.9
2009	34.1	81.4	86.0	75.3	74.4
2010	160.7	96.9	96.0	97.4	101.1
2011	97.7	101.3	96.2	97.7	98.3
2012	107.9	88.3	58.2	84.9	79.6
2013	83.5	78.7	127.6	93.5	94.9
2014	136.2	90.3	96.2	104.7	101.5
2015	77.9	112.4	-	-	-

Source: SORS

a few more quarters for the final confirmation of this assumption.

If it turns out that this recovery in construction activity represents a permanent trend, this would be highly desirable and could represent an announcement of "better days" for the domestic economy. However, once again we note that some other important macroeconomic indicators do not yet support this growth recorded in construction (and investment) of the private sector. These are extremely low levels of FDI and investment loans. In the coming quarters, it would be essential that the recovery of these indicators also occurs, because otherwise it could easily turn out that the recovery of construction in Q2 was only of a short-term.

3. Employment and Wages

According to the data from the Labour Force Survey (LFS), basic labour market indicators improved significantly in Q2 2015. Unemployment rate dropped compared to the previous quarter and to the same quarter of the previous year. Year-on-year growth in the number of the employed was 158 thousand persons (6.6%), while the growth of the employed compared to the previous quarter was 72 thousand (2.9%). Trends in the total and formal employment are not in line with the trends of GDP, consumer spending, and income from taxes and social security contributions (SSC). Certain sectors recorded an extreme growth in the number of the employed, such as, for example, accommodation and food services, financial and insurance activities and administrative and support services activities. According to LFS employment is currently also rising in sectors that are predominantly public sectors, which is contrary to the Ministry's data on the number of employees and labour costs. Average monthly gross wages recorded a year-on-year decline, both in nominal and real terms. As many as 12 sectors recorded a growth in average net wages in real terms, so the total decline of wages is primarily the result of the reduction of salaries in the public sector. Trends in wages and employment in certain sectors are not in line with the trends in economic activity in those sectors. Thus, for example, in Q2 2015, financial and insurance services recorded an increase in the number of the employed of 34% compared to the same quarter last year, and growth of real net earnings of 3%, in the same period when the real growth rate[2] of gross value added (GVA) in this sector was a modest 0.1%. According to LFS, formal employment is growing significantly while informal employment is declining, although data on labour tax and SSC's collection questions whether these changes are so intensive. As a result of wage freeze in the public sector and growth of wages in the private sector, the ratio of average wages in the public and private sectors continued to decline and was 1.08 in Q2 2015.

Employment

According to LFS, in Q2 basic labour market indicators significantly improved…which is not in line with GDP trends, consumer spending and labour tax and SSC.

According to LFS data, improvement trend of labour market indicators continued in Q2 2015 compared to the previous quarter and the same quarter of the previous year. Table T3-1 shows a decline in the unemployment rate compared to the same quarter of the previous year by almost 3 pp. There was a significant year-on-year growth of activity rate and employment rate in Q2 2015, which was 0.8 pp and 2.4 pp, respectively. These kinds of labour market trends deviate from other macroeconomic trends (such as, for example, GDP, consumer spending, labour taxes and SSC). Discrepancy between labour market trends and other macroeconomic aggregates in Serbia can also be seen by comparing them to EU countries. EU countries realised a year-on-year decline in the unemployment rate of 0.7 pp, while estimated GDP growth rate was 1.8%. For example, the Czech Republic recorded a decline in the unemployment rate of 1.1 pp, and its real GDP growth rate in Q2 2015, compared to the same period last year, was as high as 4.4%. Latvia recorded a decline in unemployment rate by 0.9 pp in the period when it realised a GDP growth of 2.7%. Luxembourg, at a GDP growth rate of 1.4% recorded a decline in the unemployment rate of only 0.3 pp. EU countries, in conditions of higher growth rates of economic activity, are recording a relatively small decline in unemployment rate compared to Serbia. Total employment (formal and informal) grew by 6.6% in Q2 2015 compared to the same quarter of the previous year, while GDP grew by only 1%. Change in the unemployment rate in Serbia is significantly higher than the real growth rate of GDP, which is not the case in EU countries. In general, we estimate that certain improvements on the labour market are present, but they are probably smaller than indicated in the LFS.

2 Change compared to the same period of the previous year

Table T3-1. Trends in the rate of activity, employment, unemployment and inactivity (15-64), Q1 2014-Q2 2015

	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015	Change in pp Q2 2015/Q2 2014
Activity rate (15-64)	61.2	62.5	62.2	61.2	62.3	63.3	0.8
Employment rate (15-64)	48.0	49.3	50.8	50.4	49.9	51.7	2.4
Unemployment rate (15-64)	21.6	21.2	18.4	17.6	19.9	18.4	-2.8
Inactivity rate (15-64)	38.8	37.5	37.8	38.8	37.7	36.7	-0.8

Source: SORS

According to LFS the number of the employed is significantly rising in sectors dominated by the state, which is rather strange.

Table T3-2 shows the trend of total employment, as well as the trend in the number of the employed by activities. Activities dominated by the public sector recorded a significant increase in the number of employees. Public administration and defence, mandatory social insurance recorded an increase of 9.5% in the number of employees. Year-on-year growth in the number of employees in education was 6.6% in Q1 2015 and 16% in Q2 2015. The number of employees in the education sector increased by 24,000 persons in Q2 2015 compared to the same quarter of the previous year. Year-on-year growth in the number of employees in healthcare was slightly above 15,000. If we consider the fact that there is currently a ban on public sector employment[3], the entire growth in the number of the employed in the mentioned sectors should be in the private sector, which is highly unlikely, as it would require hundreds of private schools, hospitals and doctor's offices being opened in the last year[4]. Aside from that, it remains unclear how such an increase in the number of the employed is possible if GVA in public administration and mandatory social insurance, education and activities in healthcare and social protection recorded a year-on-year decline of 2.9%.

It is hard to explain extreme growth of employment in parts of private sector

Extremely high growth of 53.9% in the number of employees was recorded in the accommodation and food services sector, 34.4% in the financial and insurance services, and 27.2% in the administrative and support services. Growth in the number of employees in the financial and insurance services significantly deviates from the trends in GVA which recorded a moderate increase of 0.1%. We should take into account the fact that some of these sectors, such as financial services, do not operate in grey economy, so this increase in employment cannot be explained by the influence of legalisation and reduction of grey economy.

Table T3-2. Employed persons, age 15+, by sectors, Q1 2014-Q2 2015

	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015	Index Q1 2015/ Q1 2014	Index Q2 2015/ Q2 2014
Total	2,342,966	2,407,930	2,475,135	2,459,048	2,494,346	2,565,712	106.5	106.6
Agriculture, forestry and fishing	469,196	500,302	533,833	538,040	495,660	479,253	105.6	95.8
Mining	27,230	23,941	30,013	29,198	25,883	27,428	95.1	114.6
Manufacturing industry	388,127	386,935	364,053	385,369	398,323	411,832	102.6	106.4
Supply of electricity, gas and steam	31,266	40,114	42,265	37,386	26,816	27,112	85.8	67.6
Water supply and wastewater management	37,139	42,579	34,799	35,548	37,760	37,390	101.7	87.8
Construction	96,744	99,763	113,033	120,476	107,618	110,849	111.2	111.1
Wholesale and retail trade, repair of motor vehicles	300,020	304,649	309,293	305,493	357,183	352,087	119.1	115.6
Transportation and warehousing	141,317	132,088	127,928	121,550	124,578	132,041	88.2	100.0
Accommodation and food services	62,153	59,826	61,707	55,442	83,339	92,050	134.1	153.9
Information and communication	56,796	61,045	51,779	49,253	56,018	64,365	98.6	105.4
Financial activities and insurance activities	44,616	39,275	43,357	40,839	48,654	52,795	109.1	134.4
Real estate	2,255	3,835	2,595	2,467	4,877	3,841	216.3	100.2
Professional, scientific and innovation activities	68,359	73,251	64,795	61,701	57,116	77,623	83.6	106.0
Administrative and support service activities	47,585	46,846	53,186	56,725	56,866	59,592	119.5	127.2
Public administration and compulsory social insurance	135,750	138,316	153,739	138,827	144,684	151,452	106.6	109.5
Education	149,005	150,117	163,450	164,215	158,833	174,097	106.6	116.0
Health and social care	140,776	146,563	141,630	141,713	154,575	161,790	109.8	110.4
Arts, entertainment and recreation	49,158	40,040	39,780	45,794	50,740	42,544	103.2	106.3
Other service activities	95,475	118,443	143,900	129,014	104,825	107,571	148.5	90.8

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

3 Ministry's data on expenses for wages and on the number of employees indicate that the ban is mostly respected, as well as that the total number of employees has been reduced due to retirement and exiting public sector after wage reductions.
4 Increase in the total number of employees in the stated sectors cannot be explained by registering workers who had previously worked without official registration, as they were included in the overall employment. This type of worker registration only changes the structure of the employed, but not their overall number.

Growth of employment in processing industry is in line with the growth of production

Growth in the number of employees in the processing industry of 6.4% and mining of 14.6% is accompanied by GVA growth of 7.8%[5]. Wholesale and retail trade, repair of motor vehicles and motorcycles recorded an increase in the number of employees of 15.6%. Employment growth in the sectors of wholesale and retail trade, repair of motor vehicles, transport and storage, accommodation and food services is significantly higher than the growth of GVA, having y-o-y real growth of 2.1%. Growth of employment in these sectors can partly be explained by reduction of the grey economy. Employment grows in the sectors of professional, scientific, innovative and technical activities (6%) and administrative and support services (27.2%), while GVA dropped by 1%. Increase in the number of employees in the construction sector is in line with the GVA trends, which increased in construction by 12.6% year-on-year.

Four sectors recorded a decline in the number of employees: agriculture, forestry and fisheries, power, gas and steam supply, air-conditioning, water supply, wastewater management, waste disposal process control, and similar activities and other services.

LFS data indicate intensive registration of workers who had previously worked unregistered

According to LFS data, total employment grew due to the growth of formal employment by 10%, while informal employment declined by 7% in Q2 2015 compared to the same quarter of the previous year. Informal employment rate dropped in Q2 2015 compared to the same quarter of the previous year, but also compared to the previous quarter. Adoption of the Labour Law in the middle of last year and increased control of Labour Inspection and Tax Authority probably caused part of the workers to be registered. However, it is highly unlikely that the number of the formally employed increased by as much as 10.2% (i.e. by 194 thousand), as it would have to reflect on a significant increase of income of labour taxes and SSC, which didn't happen (see the section on Fiscal Policy).

Table T3-3. Formally employed persons and the structure of informally employed persons according to their professional status, Q1 2014-Q2 2015.

	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015	Index Q2 2015/ Q2 2014
Number of employed (total)	2,342,966	2,407,930	2,475,136	2,459,048	2,494,346	2,565,712	106.6
Formal employment	1,863,236	1,896,355	1,895,472	1,864,450	2,010,551	2,089,996	110.2
Informal employment	479,730	511,575	579,664	594,598	483,795	475,716	93.0
Informal employment by professional status							
Employed	62,352	71,723	118,522	123,737	108,179	127,950	178.4
Self-employed with employees	*	*	4.352**	*	*	*	*
Self-employed without employees	227,955	229,427	226,723	239,872	170,853	143,452	62.5
Helping households' members	187,056	209,509	230,068	226,875	202,258	202,216	96.5
Informal employment rate	20.5	21.2	23.4	24.2	19.4	18.5	

Note: * A small number of occurrences – assessment not published, ** less precise assessment – use with caution
Source: Republic Statistics Office

If we look at the structure of the informally employed, we see that even though an extremely high growth of the formally employed has been recorded, who are partly working unregistered - as much as 78% (y-o-y in Q2 2015), the total number of the informally employed is dropping. The reason lies in the fact that the decline in the informal employment in the self-employed without employees (37.5%) and helping household members (3.5%) has a higher weight in the structure of total informal employment – 30% and 43%, respectively.

Wages

Average monthly gross wages are dropping, both in nominal and real terms

Average monthly gross wages have nominally decreased by 1%, while in real terms they declined by 2.3% in Q2 2015 compared to the same quarter of the previous year. The declining trend of nominal and real wages from the first quarter continued in the second quarter as well (Table T3-4).

5 GVA is tracked collectively for the sectors of: mining, processing industry, power, gas and steam supply, wastewater supply and management

Table T3-4. Serbia: Average monthly wages and y-o-y indices, 2012-Q2 2015.

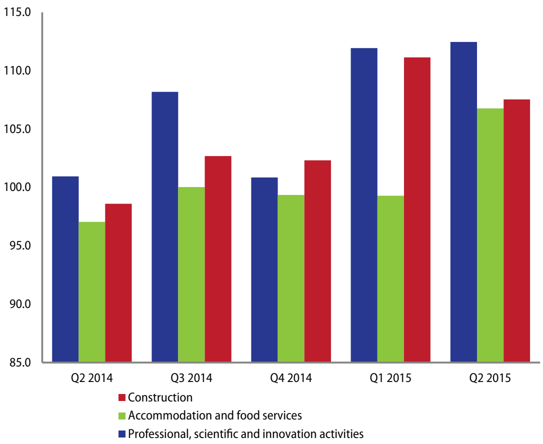
	Average Monthly Wage				Average Gross Monthly Wage Index	
	Total labour costs 1), in dinars	Net wage, in dinars	Total labour costs, in euros	Net wage, in euros	Nominal	Real
2012						
Q1	63,846	39,068	591	362	111.0	106.0
Q2	68,140	41,664	600	367	109.6	105.3
Q3	67,457	41,187	577	352	106.4	98.4
Q4	71,452	43,625	630	384	108.7	96.8
Decembar	76,830	46,923	677	413	106.6	95.1
2013						
Q1	67,704	41,419	606	371	106.0	94.6
Q2	72,143	44,248	644	395	105.9	95.9
Q3	71,469	43,939	626	385	105.9	99.1
Q4	75,089	46,185	648	399	105.1	103.0
2014						
Q1	68,015	41,825	588	361	100.5	97.8
Q2	73,147	44,971	633	389	101.4	99.6
Q3	73,167	44,934	623	383	102.4	100.5
Q4	75,332	46,371	626	386	100.3	98.4
2015						
Q1	67,730	41,718	557	343	99.6	98.7
Q2	72,438	44,717	602	371	99.0	97.7

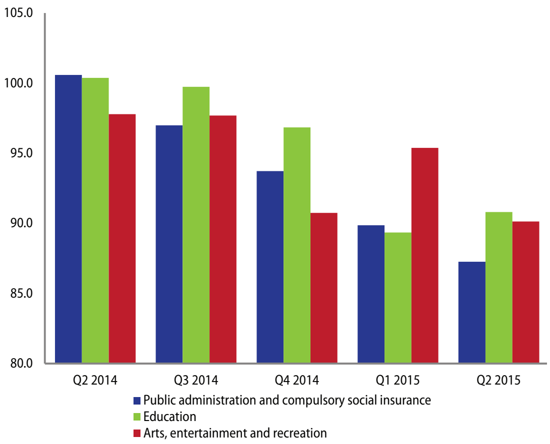
Source: Republic Statistics Office
1) Total labor costs (TLCs) comprise employer's total average expense per worker, including all taxes and social security contributions. TLCs stand at around 164.5% of the net wage. Gross wage growth indices are equal to total labor cost indices, because the average TLC is greater than the average gross wage by a fixed 17.9% of employer based social security contributions."

In most sectors, real wages grew in Q2 2015... sectors that recorded a decline are those which are mostly dominated by the state

Most sectors recorded a year-on-year increase in real net wages. Sectors which are dominated by the state recorded a decline in real net wages, which is the result of the reduction of public sector wages by 10% at the end of last year (Graph T3-1). Significant decrease of real net wages in Q2 2015 of almost 13% was recorded in the public administration and defence, and mandatory social insurance. The smallest decline of real net wages was in the sector of power, gas and steam supply and air-conditioning and was 1%. Continuous declining trend in real net wages was also recorded in the real estate sector. Healthcare sector had a lower year-on-year decrease of real net wages compared to the education sector, although compared to Q1 2015 that difference was reduced by 0.5 pp.

Graph T3-1. Year-on-year indices of real net wages, Q2 2014- Q2 2015.





Note: Right graph – three sectors with the highest y-o-y decrease of wages in Q2 2015, left graph – three sectors with the highest y-o-y growth of wages in Q2 2015
Source: SORS

Real net wages in construction recorded a year-on-year growth of 12.5% in Q2, which was probably the result of this sector's recovery, but also registration of some of the workers who had previously worked unregistered. Year-on-year growth from the first quarter additionally increased in the second quarter.

The growth trend of wages continued in the processing industry, but it was slower than the growth of production, so productivity in this sector is growing. Processing industry sector recorded a year-on-year growth of production of 7.3% in Q2, while year-on-year growth of wages was 4.2% in Q2 2015.

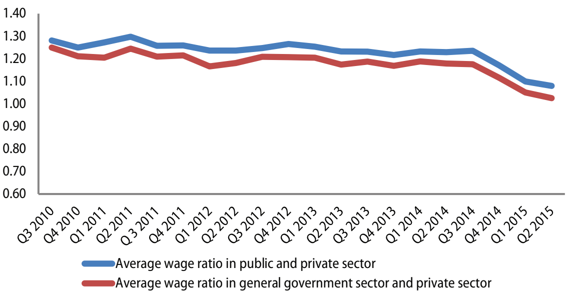
Higher growth of wages than value added adversely affect the real unit labour costs in these sectors, which has negative effects in the long term.

The trend of reducing the difference in wages in the public and private sectors continued in Q2 2015 as well.

The ratio of average wages in the public[6] and private sectors, as well as the ratio of average wages in the general government sector[7] and private sector continued to decline in Q2 2015 (Graph T3-2). The ratio of weighted average wages in the public and private sector was reduced to 1.08, while the same ratio in the general government sector and private sector was reduced by 1.03[8]. Growth of weighted wages in the private sector in Q2 2015 compared to the same quarter of 2014 was 2.9%, while the decline in the public sector and general government sector was significant, 10.6% and 11.9%, respectively. Decrease of wages in the public sector contributed to a significant reduction of differences between average wages in the private and public sectors.

It is difficult to predict the trend of these ratios in the coming period. Wage freeze in the public sector was announced for the period 2015-2017, which should additionally reduce the difference in average wages in the public and private sector. On the other hand, there are constant pressures to abolish this decision, but increase of wages, even if it is realised, will be minimal. Also, rationalisation of public sector was announced, i.e. significant lay-offs due to overstaffing. This will affect a change in weighting and a change in wage ratio as well. As a result of expected growth of wages in the private sector and freezing or minimal increase of wages in the public sector, it is our estimate that the wages in the public sector over the next year will be significantly reduced compared to the wages in the private sector.

Graph T3-2. Ratio of average wages in the public and private sectors, 2010-Q2 2015.



Source: QM calculations
Note: For the weighting we used relative share of the number of employees in each sector compared to the total number of employees in the private sector, public sector and general state sector.

6 We included the following sectors in the public sector: B – Mining, D – Power, gas and steam supply, and air-conditioning, E – Water supply; Wastewater management, Waste disposal process control and similar activities, O – Public administration and defense; Mandatory social insurance, P – Education, Q – Healthcare and social protection, R – Art, entertainment and recreation. Private sector includes all other sectors.
7 General state sector is stated separately in order to separately observe the sectors that mainly don't have any commercial activity and do not generate revenue from market activities.
8 We used seasonally adjusted wages except for sectors D and P, because wages in these sectors have no statistically significant seasonal component, which is why we prefer the use of original series to seasonally adjusted ones. In the previous issue of QM, we used seasonally adjusted data for all sectors.

4. Balance of Payments and Foreign Trade

A relatively low quarterly value of current account deficit was recorded in Q2 2015, of 208 million euros, i.e. 2.5% of GDP. This level of current deficit is mostly the result of reduced foreign trade deficit and high inflow on the Secondary Income account. Observed year -on-year, the exports are accelerating and the imports are decelerating growth, while their seasonally adjusted values indicate that actually there has been a certain deceleration of exports since the beginning of the year, while the imports are slightly below the levels of Q1. The growth of exports have been positively influenced by the beginning of economic restructuring of Serbia towards the sector of exchanging of goods, depreciation of dinar from the second half of the previous year, and the recovery of eurozone. Growth of imports was impeded by low prices of energy, low domestic demand due to the effects of fiscal consolidation, as well as the delayed effects of the weakening dinar from the second half of 2014. During Q2 the outflow of capital was almost equal to its inflow. This was the result of a modest net inflow of FDI and almost equal net outflows of portfolio investments, while other investment and financial derivatives accounts were balanced. There will be quite some uncertainty until the end of the year regarding balance of payments trends – export and import trends and deficit levels, as well as regarding the ways of covering it. Still, it is our assessment that the fast growth of exports will continue, as well as the reduction of current balance deficit, value of which for the entire year could be around 4-5% of GDP.

Relatively low current account deficit in Q2 .....

....208 million euros....

....i.e. 2.5% of GDP...

Q2 2015 recorded a low value of current account deficit of 208 million euro, which is only 2.5% of the estimated value of the quarterly GDP (Table T4-1). Current deficit is by 3.9 pp of GDP lower compared to Q2 2014, when it was 6.3% of GDP. Contributing to this decline in the value of current deficit were all its components, with the biggest contribution coming from the reduced foreign trade deficit (46.3% decline in the value of current deficit is due to a lower foreign trade deficit), followed by the increase in Secondary Income (whose contribution was 33.5%), and to a lesser extent the reduced net expenditure on the Primary Income account (contribution of 20.2%). In Q1 2015, current deficit was 7.0% of GDP which, although considerably higher, is partly due to seasonal factors.

...which is mostly due to lower foreign trade deficit

Foreign trade deficit was 760 million euro, which is 9.0% of GDP (Table T4-1). That is a significantly lower value of this deficit compared to last year when it was 10.8% of GDP in Q2 2014, and compared to Q1 2015 when it was as high as 12.15% of GDP. Still, it should be considered that the relatively high deficit in Q2 2014 was partly due to the first effects of flooding and it is typically higher in Q1 2015 due to seasonal effects. Export of goods and services significantly increased in Q2 and was very close to half of the realised quarterly value of GDP. Share of exported goods and services in GDP in the period Q2 2014-Q2 2015 was higher by 4.4 pp (an increase from 42.9% to 47.3%), while imports increased by 2.6 pp (from 53.7% to 56.3%).

In Q2, goods in the amount of 2,986 million euros were exported, which is 35.4% of GDP. Imports of goods were 3,860 million euros, i.e. 45.7% of GDP. These trends have led to a relatively high coverage of imports by exports, which was 77% in Q2. Reduction of trade deficit was positively affected by the depreciation of dinar in H2 2014, a relatively good last year's agricultural season, recovery of the eurozone, low global energy prices, low domestic demand due to the effects of fiscal consolidation, while it was negatively affected by a relatively weaker export results of the automobile industry. In addition, affecting the recorded trends in exports and imports were also improved ratio of exchange of goods since the beginning of the year – values of year-on-year indices were 102.9 in Q1 and 103.4 in Q2 2015. During Q2, a high surplus was realised in the services trade which was 114 million euro. Revenue from services was a billion euro, while expenditures amounted to 890 million euro.

Inflow of current transfers during Q2 was quite high

Inflow of current transfers during Q2 was quite high – 944 million euro net, i.e. 11.2% of GDP. This income was above one billion euro (1,056 million euro). The largest part of this income were workers' remittances which were 605 million euro net in Q2, which is as much as 7.2% of GDP.

Outflows of net income was slightly lower in Q2 2015 compared to the same period in 2014 and was 392 million euro net. Revenue reduced, but the expenditures were significantly lower as well compared to the same period last year (Table T4-1).

Table T4-1. Serbia: Balance of Payments

	2013	2014	2014				2015	
			Q1	Q2	Q3	Q4	Q1	Q2
			mil. euros					
CURRENT ACCOUNT	-2,098	-1,985	-496	-541	-384	-563	-520	-208
Goods	-4,159	-4,111	-904	-995	-1,076	-1,136	-1,041	-875
Credit	10,515	10,641	2,512	2,767	2,664	2,698	2,602	2,986
Debit	14,674	14,752	3,415	3,762	3,740	3,834	3,643	3,860
Services	313	465	69	73	145	179	137	114
Credit	3,422	3,810	793	887	1,044	1,085	927	1,004
Debit	3,109	3,344	724	814	900	906	791	890
Primary income	-1,419	-1,343	-283	-462	-221	-377	-307	-392
Credit	607	642	125	168	181	168	106	158
Debit	2,025	1,985	407	631	402	545	412	549
Secondary income	3,166	3,003	622	843	768	771	692	944
Credit	3,537	3,400	707	934	875	884	785	1,056
Debit	372	397	85	91	108	113	93	112
Personal transfers, net [1]	2,701	2,442	511	697	618	617	568	758
Of which: Workers'	2,160	1,863	378	547	469	469	437	605
CAPITAL ACCOUNT - NET	15	7	2	2	3	0	4	-1
FINANCIAL ACCOUNT	-1,630	-1,705	-478	-414	-217	-596	-377	-30
Direct investment - net	-1,298	-1,236	-271	-435	-244	-286	-332	-343
Portfolio investment	-1,883	-369	7	-150	-151	-75	-474	341
Financial derivatives	-1	-6	0	-3	1	-5	2	4
Other investment	855	1,703	586	543	-332	906	316	0
Other equity	0	0	0	0	0	0	0	0
Currency and deposits	-228	830	121	141	246	322	69	79
Loans	1,286	757	373	386	-443	441	238	-55
Central banks	657	574	189	186	100	99	57	55
Deposit-taking corporations,	675	795	214	89	197	296	95	63
General government	-434	-728	29	30	-676	-111	70	-204
Other sectors	389	115	-59	80	-64	157	15	31
Insurance, pension, and	0	0	0	0	0	0	0	0
Trade credit and advances	-204	116	92	16	-134	143	9	-24
Other accounts receivable/payable	0	0	0	0	0	0	0	0
SDR (Net incurrence of liabilities)	0	0	0	0	0	0	0	0
Reserve assets	697	-1,797	-800	-370	509	-1,136	110	-32
ERRORS AND OMISSIONS, net	453	273	16	124	165	-32	138	179
PRO MEMORIA				in % of GDP				
Current account	-6.1	-6.0	-6.3	-6.3	-4.5	-6.9	-7.0	-2.5
Balance of goods	-12.1	-12.4	-11.5	-11.7	-12.7	-13.9	-14.0	-10.4
Exports of goods	30.7	32.2	31.9	32.5	31.5	32.9	34.9	35.4
Imports of goods	42.8	44.6	43.3	44.1	44.3	46.8	48.9	45.7
Balance of goods and services	-11.2	-11.0	-10.6	-10.8	-11.0	-11.7	-12.1	-9.0
Personal transfers, net	7.9	7.4	6.5	8.2	7.3	7.5	7.6	9.0
GDP in euros [2]	34,268	33,060	7,881	8,527	8,452	8,200	7,451	8,441

Note: Balance of Payments of the Republic of Serbia is aligned with the international guidelines from the IMF's Balance of Payments Manual no. 6 (BPM6).
Source: NBS
1) Personal transfers are current transfers between resident and non-resident households.
2) Quarterly values. Conversion of the annual GDP to euro was conducted according to the average annual exchange rate (average value of official daily middle exchange rates of NBS).

Year-on-Year improvement of the current balance is mostly due to better results in the exchange of goods and the increase of net inflows from Secondary Income

In Q2 2015, compared to Q2 2014, current account deficit was lower by 61.5%. In the same period, foreign trade deficit declined by 18%. Such a result is due to reduced trade deficit, which was 12.1% in the observed period, and increased surplus on the services account by 56.2%. Exports recorded a very fast year-on-year growth of 7.9%. On the other hand, the imports are by 2.6% above the last year's. Favourable trends in the exchange of goods with foreign countries are additionally emphasised by the fact that there has been an accelerated growth of export of goods since the beginning of the year, while import of goods has decelerated (recorded year-on-year growth rates of exports and imports in Q1 2015 were 3.6% and 6.7%, respectively). Growth of net inflow from the Secondary Income was 12.0% year-on-year, where a year-on-year growth of remittances of 10.6% was recorded.

Change in the exchange rates still plays a large role in indicated amounts and trends of exports and imports of goods

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

	Q2 2015	July 2015	Q2 2015/ Q2 2014	July 2015/ July 2014
	mil. dollars	mil. dollars	in %	in %
Export of goods	3,528	1,204	-10.6	-9.2
Import of gods	4,604	1,518	-15.2	-19.7
Goods deficit	1,076	314	-27.3	-44.4
	mil. dollars	mil. dollars	in %	in %
Export of goods	3,183	1,090	10.7	11.6
Import of gods	4,155	1,374	5.1	-1.3
Goods deficit	972	284	-9.7	-31.7

Source: SORS, *QM*

Change in the exchange rates still plays a large role in indicated amounts and trends of exports and imports of goods, as well as their difference (trade deficit)[2]. According to the SORS data from Q2, imports and trade deficit, if expressed in dollars, were at a significantly lower level compared to the same quarter of 2014. On the other hand, if expressed in euro, both foreign trade components record an increase, while the reduction of trade deficit in euro is significantly smaller than the reduction of its dollar value (Table T4-2).

In the coming period, we expect that the growth of exports will be impacted by the growth of foreign investments into processing industry and the increasing demand in the EU countries, while the exports of agricultural products will decline due to this year's drought. Recovery of economy will affect the increase of imports, while stagnation of private and state spending will affect the decline of imports. Maintaining the current favourable relations of the exchange, which are characterised by low prices of energy and mineral resources, will also have a positive effect on foreign trade balance of Serbia. Moderate depreciation of dinar combined with improving the economic environment would have a stimulating effect on the increase of foreign direct investments into the sector of exchangeable goods, which would increase the export potential of the country.

Outflow of capital is almost equal to its inflow

In Q2, the outflow of capital was almost equal to its inflow, so the net inflow was only two million euro despite the expected increased inflow of capital due to the effects of quantitative easing of ECB. Other Investments account was equal to zero and the inflow from financial derivatives was usually low (four million euro), so the reason behind an almost neutral result on the financial account was the fact that the inflow of net FDI was only slightly above the net outflow of capital from portfolio investments. FDI was 343 million euro, out of which 135 million euro net was from reinvested revenue, 116 million euro net from debt instruments, and only 92 million euro from equity. Outflow of portfolio investments during Q2 was 341 million euro – 169 million euro in April, 91 million in May, and 81 million euro in June. This outflow was partially the result of state deleveraging from matured interests and some of the securities[3] (state deleveraged by 251 million euro). Also, a certain investment of deposit institutions beside the central bank was recorded into the debt securities abroad (91 million euro, see Table T4-1).

Inflows and outflows from other investments have become completely equal in these three months of Q2. On the one hand, a very modest net borrowing was recorded in the sense of financial loans (55 million euro) and a low inflow from trade loans (24 million euro), while an equal amount of the sum of these inflows was recorded on the Cash and Deposit account (79 million euro). Regarding financial loans, only the state borrowed, while central bank, other deposit institutions and other sectors recorded a net deleveraging. The Government borrowed an additional 204 million euro through the loans from the International Bank for Reconstruction and development[4] and EIB[5]. NBS is still reducing its obligations to IMF, so the recorded deleveraging during Q2 amounted to 55 million euro. Net deleveraging of banks was 63 million euro, and 31 million euro of the business sector (Table T4-1).

2 NBS data for import and export of goods, as well as for the trade balance, differ from those of SORS which we use in this table and the following segments of the text: *Exports* and *Imports,* as they do not include unfinished goods (see Box 1 about the changed methodology of calculating Balance of Payments in *QM37*). That is why there is a slight difference in levels of exports and imports and growth rates depending on whether the source of data is NBS or SORS.
3 *Inflation Report*, NBS, August 2015.
4 For the remediation of consequences of floods and rebuilding of roads, *Inflation Report*, NBS, August 2015.
5 For Corridor 10 and research and development of the public sector, *Inflation Report*, NBS, August 2015.

Aside from the neutral financial account, foreign reserves have been reduced due to a relatively low value of the current deficit

Even though, on the one hand, a nearly zero inflow of capital was recorded during Q2 due to the relatively low value of the current deficit, forex reserves have been reduced by only 32 million euro[6]. Reduction of forex reserves was actually recorded only in April (157 million euro), while a growth of 50 and 138 million euro was recorded in May and June, respectively. The largest part of foreign currency inflow was realised through NBS interventions on the interbank foreign exchange market (110 million euro in April), use of loans and donations (88.1 million euro in April, 55.3 million euro in May, and 83.8 million euro in June) and sale of state securities on the domestic financial market. Outflow of funds from the forex reserves was realised through the settlement of obligations of the Republic of Serbia toward the foreign creditors and through old savings in foreign currency, payment of matured securities denominated in euro, using the mandatory foreign currency reserves of the banks, as well as through the payment of NBS debt toward IMF.

In July, forex reserves significantly increased. The biggest amount of inflow was realised primarily through the NBS intervention on the interbank foreign exchange market (by purchasing 230 million euro), as well as through the sale of state securities denominated in euro on the domestic financial market (145 million euro).

During Q2, NBS intervened with a net purchase of foreign currency on the interbank foreign exchange market in the amount of 120.0 million euro (it sold 30 million euro in April, and bought 140 million euro in April and 10 million euro in June), while there were no interventions of the NBS in May. In July, NBS bought 230 million euro[7].

Exports

In Q2 exports grew significantly observed year-on-year...

....although they are decelerating compared to Q1

Exports recorded a high year-on-year growth of 10.1% in Q2 and reached an amount of 3,183 million euro. Still, the effects of floods had reflected on the exports back in Q2 2014, so the high rate is partially the result of a somewhat lower baseline (Table T4-3). Growth of exports was positively affected by the depreciation of dinar from H2 2014, relatively good last year's agricultural season, and the recovery of eurozone, as well as the entry of new large exporters in the processing industry. Growth of exports was realised due to the growth of all export groups (Table T4-3 shows exports divided into products by purpose) except energy. Decline in the exports of energy is for the most part due to the low price of energy products on the global market. Still, export of energy is only 3.7% of total exports, so the price fluctuation and realised decline in value do not significantly reflect on the overall exports. As the exports of road vehicles recorded a year-on-year decline, exports excluding road vehicles recorded a year-on-year increase of 14.8%.

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

	Exports share in 2014	2013	2014	2014		2015		2014		2015	
				Q1	Q2	Q1	Q2	Q1	Q2	Q1	Q2
	in %			in mil. euros					in %		
Total	100.0	10,996	11,159	2,636	2,876	2,771	3,183	17.9	6.6	5.1	10.7
Total excluding road vehicles	86.2	9,359	9,621	2,227	2,408	2,359	2,764	14.6	5.7	5.9	14.8
Energy	3.7	519	413	97	128	62	107	3.9	-1.6	-36.5	-16.4
Intermediate products	33.0	3,678	3,687	914	952	920	1,082	14.5	1.7	0.7	13.6
Capital products	25.8	2,979	2,877	719	809	760	834	26.1	6.8	5.8	3.0
Capital products excluding road vehicles	12.0	1,342	1,334	309	341	348	414	11.2	1.5	12.7	21.4
Durable consumer goods	5.2	524	586	122	147	133	169	23.0	8.1	8.6	15.2
Non-durable consumer goods	23.4	2,410	2,614	563	617	634	701	12.4	10.3	12.5	13.5
Other	8.8	886	981	221	222	263	291	27.7	24.2	18.7	30.9

Source: SORS

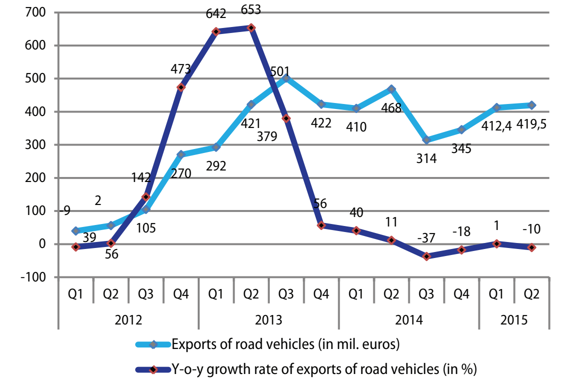
Export of road vehicles below last year's

Export of road vehicles in Q2 was 10.3% below last year's (Graph T4-4), which is partly due to a slightly higher base value recorded in the same quarter of the previous year. Following the

6 Errors and Omissions account was 179 million euro.

7 http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=8318&konverzija=no http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=8437&konverzija=no
http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=8546&konverzija=no
http://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=8641&konverzija=no

Graph T4-4. Export of Road Vehicles



Source: SORS, *QM*

fast growth of production and exports during 2012 and 2013 and reaching of maximum export value of half a billion euro in Q3 2013, export of road vehicles has stabilised between 400 and 500 million euro in the following three quarter. Still, in Q3 and Q4 2014, exported value declined to 314 and 345 million euro, respectively. Since the beginning of 2015, exports again exceeded the level of 400 million euro. As we emphasised in the past[8], in current circumstances, growth of exports of FIAT automobiles has for the most part been exhausted, i.e. the current value is at best expected in the following quarters, and the contribution of road vehicles to the total growth of exports can at best be mildly positive (a mild growth can be expected in the next two quarters due to a lower base in H2 2014). Still, certain, relatively modest results are possible if there are some changes in the tax-free exports to the Russian market – which has been previously announced, but for which there are currently no possibilities, and especially if a new model is introduced.

Growth of exports was realised due to growth of all export groups except Energy

Following the negative year-on-year growth rates from Q3 and Q4 2014, exports recorded a recovery in the first half of 2015. Lower level from H2 2014 compared to the same period in 2013 was the result of reduced exports of automobiles, floods, as well as the decline in prices of energy and agricultural products on the global market. Thus, in the second half of the previous year, decline in value was recorded in Energy, Intermediate Goods, Capital Goods excluding road vehicles, and in Q3 2014 even in other goods as well. Since the beginning of 2015, exports started to increase thanks to the recovery of all stated groups except Energy. Export of *Intermediate Goods* accelerated growth and in Q2 grew at a rate of 13.6% year-on-year. *Capital Goods* after excluding road vehicles had a considerable year-on-year growth of 21.4%. Durable and Non-Durable Consumer Goods recorded a growth during 2014, albeit at somewhat lower rates. These goods have accelerated growth since the beginning of the year and in Q2 recorded the rates of 15.2% and 13.5%, respectively. Unclassified exports (Table T4-3 group *Other*) also accelerated growth and in Q2 2015 was by 30.9% above the same quarter of the previous year.

More realistic view of export recovery trend can be obtained when seasonally adjusted values are observed...

....which indicate that exports have been decelerating since the beginning of the year

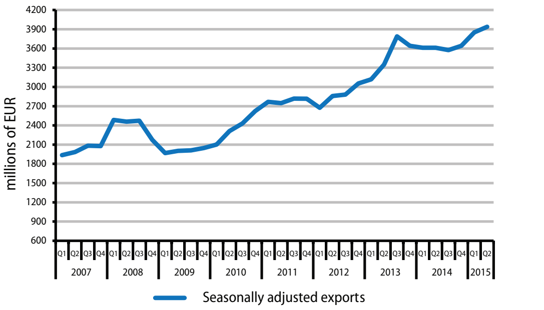
Having in mind that the floods had their first negative effects on exports in Q2 2014, a more realistic view of the export recovery trend can be obtained when its seasonally adjusted values are observed (Graph T4-5 and Graph T4-6). Seasonally adjusted data indicate that exports, after a significant accelerated growth in Q1 2015 (growth of 5.8% compared to Q4 2014), decelerated growth in Q2 2015, i.e. it was 2.2% above the value from the previous quarter. The graphs show that after the accelerated growth of seasonally adjusted export during 2012 and 2013, it reached a significant amount in Q3 2014 only to record deceleration and stagnation after that, and that again growth as of Q4 2014. It is also important to note that its level from Q2 2015 was as much as 59% above the "peak" that was achieved before the crisis, in Q1 2008, and by 4% above the second "peak" achieved more recently, in Q3 2013.

Recorded growth of exports during Q2 presents a good turn. It should be the main driver of growth in the future and that is why we feel it should be supported by all economic policies, especially the policy of mild weakening of dinar. On the other hand, the speed of recovery of EU countries, our biggest export territory, will considerably determine the course of further trend of domestic exports.

In the coming period, new drivers of export growth are needed, because the effects of investments in the automobile industry have been depleted, while this year's drought will affect the reduction of exports of agricultural products in the next year. A more significant growth of exports in the coming years could be generated by new larger investments into the sector of exchangeable goods, primarily processing industry and agriculture.

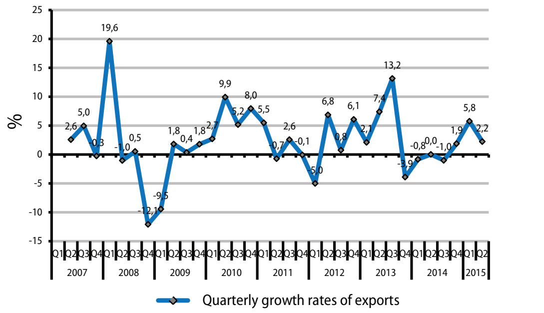
8 See previous issues of *QM*.

Graph T4-5. Serbia: Seasonally Adjusted Exports, quarterly, 2007-2015



Source: NBS, SORS, *QM*

Graph T4-6. Serbia: Growth Rates of Seasonally Adjusted Exports, quarterly, 2007-2015



Source: NBS, SORS, *QM*

Imports

Decelerated growth of imports in Q2

During Q2 2015, trade imports were 4,155 million euro and recorded a decelerated growth (year-on-year increase in value in Q2 was 5.1% compared to 8.3% in Q1, Table T4-7). The growth of domestic imports was impeded by low global energy prices, low domestic demand due to the effects of fiscal consolidation, as well as delayed effects of weakening dinar in H2 of the previous year. Import groups whose value was at a lower level than last year's, i.e. those that had a negative contribution to the value of imports, are *Energy* and *Capital Goods,* while all other groups realised a year-on-year increase. Imports excluding energy also decelerated since the beginning of 2015 – after 10.6% in Q1, their year-on-year growth rate was 7.1% in Q2.

Decline in Energy imports was due to low prices

Energy imports were as much as 8.8% below the value of Q2 2014, which indicates a considerable year-on-year decline from the one recorded in Q1 2015 (4.9%, see Table T4-7). Very low energy prices on the global market affected this trend of imports of energy products. According to IMF data, global price of energy in dollars in Q2 2015 was 42% below the price from the same period last year. When the data is expressed in euro, this decline is lower due to a significant depreciation of euro against dollar recorded in the same period (Q2 2014-Q2 2015) and is 28%.

Except for** Capital Goods, **all other groups realised a year-on-year increase

Capital Goods recorded a smaller decline in value in Q2 (6.6%) than in Q1 2015 (17.1%). Still, reduction of imports in this group of products in the structure of overall imports is the least favourable, because it reflects the production activity (large part of imports of production components for the automobile industry is in this group). Import of *Intermediate Goods,* after four quarters of consecutive year-on-year decline in value (from Q2 2014 to Q1 2015), in Q2 2015 recorded a year-on-year growth of 5.3%. This can be attributed to the certain recovery in the industrial production[9]. Year-on-year growth in Q2 2015 was also realised in *Durable and Non-Durable Consumer Goods* of 28.0% and 0.5%, respectively. Despite the high growth rate of imports of Durable Goods, they only make 2% of total imports, so their considerable growth did not reflect significantly on the overall imports. Also, the non-durable goods didn't make a significant contribution to the growth of overall imports either, because even though these products make 15% of imports, their growth was modest. Still, unlike previous two quarters, they recorded recovery in Q2, i.e. their contribution to the growth of imports was positive. *Other Imports* recorded a year-on-year growth at a rate of 43.9% (Table T4-7).

Seasonally adjusted values indicate a mild decline of imports

In Q2 2015, seasonally adjusted imports were lower by 0.3% compared to the previous quarter. Graphs T4-8 and T4-9 show that after the decline in two consecutive quarters in the second half of 2014, the imported values recorded a significant recovery in Q1 2015 and certain deceleration in Q2. The slow recovery of imports is primarily due to the low level of domestic demand in Serbia, which has been particularly limited by certain measures of fiscal consolidation as of 2014. In the coming period, no significant increase of energy prices is expected, which will maintain for a while the value of imports of these products at a low level. Still, it remains to be seen whether the

9 See section "Economic Activity" in this issue of *QM*.

announced increase of salaries will be implemented, which would certainly affect the increase of domestic demand and imports.

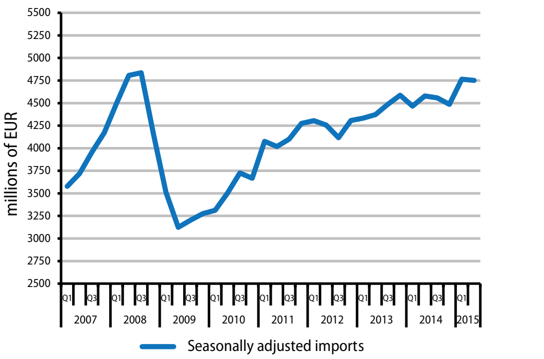
Table T4-7. Serbia: Imports, Year-on-Year Growth Rates, 2013-2015

	Imports share in 2014	2013	2014	2014 Q1	2014 Q2	2015 Q1	2015 Q2	2014 Q1	2014 Q2	2015 Q1	2015 Q2
	in %	in mil. euros						in %			
Total	100.0	15,469	15,497	3,565	3,952	3,862	4,155	1.6	3.5	8.3	5.1
Energy	14.1	2,336	2,180	511	498	486	454	-3.8	4.5	-4.9	-8.8
Intermediate products	33.0	5,169	5,118	1,173	1,297	1,127	1,365	0.8	-1.0	-3.9	5.3
Capital products	23.7	3,801	3,678	820	1,014	679	947	2.7	3.9	-17.1	-6.6
Durable consumer goods	2.0	328	317	74	74	79	94	-3.3	-7.5	6.0	28.0
Non-durable consumer goods	15.1	2,281	2,347	513	565	481	568	0.6	1.9	-6.4	0.5
Other	12.0	1,554	1,858	473	506	1,010	728	10.4	19.1	113.7	43.9
Imports excluding energy	85.9	13,134	13,317	3,053	3,455	3,376	3,702	2.5	3.3	10.6	7.1

Source: SORS

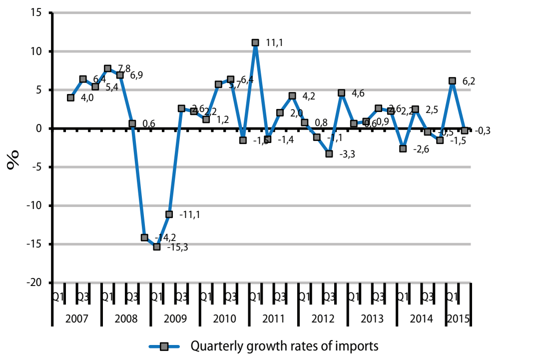
Unlike the exports which were by 60% higher in Q2 2015 than before the crisis, the imports are still 2% below the highest pre-crisis level. This speaks to strong changes in foreign trade that Serbia has had since the beginning of the crisis, which occurred as the result of an inevitable adjustment to new circumstances, due to which it was impossible to continue financing very high pre-crisis deficits.

Graph T4-8. Serbia: Seasonally Adjusted Imports, Quarterly, 2007-2015



Source: NBS, SORS, *QM*

Graph T4-9. Serbia: Growth Rates of Seasonally Adjusted Imports, Quarterly, 2007-2015



Source: NBS, SORS, *QM*

In the following period we expect the low domestic demand to affect the deceleration of imports, while economic recovery will impact the growth of imports.

Foreign Debt

Serbia's foreign debt at the end of March 2015 was 26,735 million euro, i.e. 81.9%

Serbia's foreign debt at the end of March 2015 was 26,735 million euro (Table T4-10). During Q1 2015, growth of foreign debt was 906 million euro. Depreciation of euro against other currencies, especially against dollar – as one quarter of total foreign debt is in dollars – had a significant impact on the growth level of foreign debt expressed in euro. Foreign debt expressed as a percentage of GDP was 81.9% and by 3.8 pp of GDP higher than the value recorded three months earlier. From that increase of share, growth of one pp is owed to the somewhat lower value of quarterly GDP which is used as a denominator.

Expressed level and trend of foreign debt growth is largely due to the changes in the currency ratio

As we have written in the previous issue of *QM*, increase of foreign debt and changes in the state of its components since the beginning of 2015 is for the most part due to the changes in the currency ratios. Out of the total growth of foreign debt of 906 million euro during Q1, the biggest part is the result of an increase in public sector borrowing abroad of 883 million euro, i.e. by 3.3 pp of GDP. Increase in foreign debt of the private sector in Q1 was very modest and amounted to 23 million euro net (from 35.2% of GDP to 35.7% of GDP – a growth of 0.5 pp

Compared to the situation from one year ago, total foreign debt has increased by 1.13 billion euro...

of GDP). This additional private sector borrowing was the result of deleveraging of long-term loans in the amount of 54 million euro on the one hand, and on the other, of the increase in short-term borrowing of 77 million euro. The banks are continuing the trend of deleveraging long-term loans and in the first three months deleveraged a net of 107 million euro. On the other hand, the business sector slightly borrowed on this same basis, another 53 million euro. Banks and companies are slightly increasing the amount of short-term borrowing, by 53 million and 24 million euro, respectively.

...due to public sector borrowing...

Compared to the levels from March 2014, total foreign debt is higher by 1.13 billion euro. Still, we should bear in mind that differences in the foreign exchange rates significantly impacted the amount of foreign debt and its components.

...while the private sector has been decreasing its debts

Table T4-10. Serbia: Foreign Debt Structure, 2013–2015

	2013	2014				2015
		Mar.	Jun	Sep.	Dec.	Mar.
	stocks, in EUR millions, end of the period					
Total foreign debt	25,747	25,605	25,261	26,301	25,829	26,735
(in % of GDP) [4)]	*75.1*	*75.0*	*74.5*	*78.5*	*78.1*	*81.9*
Public debt[1)]	13,166	12,969	12,796	13,878	14,189	15,072
(in % of GDP)[4)]	*38.4*	*38.0*	*37.8*	*41.4*	*42.9*	*46.2*
Long term	13,166	12,969	12,796	13,878	14,184	15,067
o/w: to IMF	697	515	333	247	152	108
o/w: Government obligation under IMF SDR allocation	434	436	439	455	463	498
Short term	0	0	0	0	5	5
Private debt[2)]	12,581	12,636	12,465	12,423	11,640	11,663
(in % of GDP) [4)]	*36.7*	*37.0*	*36.8*	*37.1*	*35.2*	*35.7*
Long term	12,384	12,497	12,312	12,302	11,538	11,484
o/w: Banks debt	3,228	3,028	2,925	2,769	2,509	2,402
o/w: Enterprises debt	9,154	9,467	9,385	9,532	9,026	9,080
o/w: Others	1	2	2	2	3	3
Short term	196	139	153	121	101	178
o/w: Banks debt	171	115	128	89	57	110
o/w: Enterprises debt	25	25	25	32	44	69
Foreign debt, net 3), (in% of GDP)[4)]	42.5	44.5	44.7	46.0	48.2	49.7

Note: Republic of Serbia's foreign debt is calculated on the principle of "matured debt", which includes the amount of debt from the principle and the amount of calculated interest unpaid at the moment of the agreed maturity.
Source: NBS, QM
Republic of Serbia public sector's foreign debt includes the debt of the state (including the debt of Kosovo and Metohija from the loans concluded before the arrival of KFOR mission, unregulated debt toward Libya, and clearing debt toward the former Czechoslovakia), of the National Bank of Serbia, local self-government, funds and agencies founded by the state, and debts for which state guarantee had been issued.
Republic of Serbia private sector's foreign debt includes the debt of banks, companies, and other sectors for which no state guarantee had been issued. Private sector's foreign debt does not include loans concluded before December 20, 2000 which are free from payment (972.3 million euros, out of which 438.4 million euros relates to domestic banks, and 533.8 million euros relates to domestic companies).
Total foreign debt less NBS forex reserves.
Sum of GDP values of the observed quarter and GDP values of the previous three quarters are used. Since March data is not available yet, in order to calculate the share of foreign debt values and their components in GDP, we divided the data related to the end of February 2015 with the GDP values for Q1 2015.

The value of public sector's foreign debt was by 2.1 billion euro higher than last year's. Such an increase in foreign debt is partially mitigated by private sector deleveraging by 974 million euro. As we have written in previous issues of QM, public sector, after deleveraging in the first half of 2014, has significantly borrowed in the second half of the year due to getting the loan from UAE (for the purposes of securing funds for the state budget), a loan from IBRD and EIB[10], as well as due to using a part of the loan from the Council of Europe Development Bank. NBS has significantly reduced the amount of its debt toward IMF – by 407 million euro.

Reduction of private sector's foreign debt compared to the end of March 2014 of 974 million euro has occurred primarily due to the deleveraging trend of the banking sector. In this period, the banks reduced their debt by 626 million euro for long-term loans and five million euro for short-term loans. Companies reduced their long-term debt by 378 million euro, while slightly increasing the short-term one by 44 million euro compared to March 2014.

10 See *QM* 39.

5. Prices and the Exchange rate

During Q2 and July, inflation was below the lower limit of the NBS target band and at the end of July amounted to 1.1%. Low prices of petroleum and primary agricultural products at a world market, the lack of expected regulated price adjustments in a period longer than a year (until the increase in the prices of electricity in August 2015), low aggregate demand and low cost pressures in food production are the most important disinflationary factors affecting the maintenance of inflation at a very low level. The consumer price index (CPI) was mostly affected by the growth in the prices of tobacco products and travel arrangements. Underlying inflation (measured by the CPI excluding the prices of food, energy, alcohol and tobacco) from the beginning of Q2 until the late July was moving also below the lower limit of the target band, mostly due to a low aggregate demand, almost completely unchanged dinar exchange rate against the euro and low imported inflation. Moderate inflation was recorded during April and June, largely as the result of the increase in the prices of cigarettes and unprocessed food, i.e. the prices of travel arrangements and seasonally expected growth in the fruit prices. Deflation in May and July was entirely a consequence of the decrease in the prices of unprocessed food (mainly vegetables). By the end of the year, inflation is expected to move below and around the lower limit of the NBS target band, while its return within the limits of the target band is possible only from the mid 2016. National Bank of Serbia continued to decrease the key policy rate in Q2 and August, but it still at a relatively high level when compared to inflation (5.5% compared to 1.1%). Average inflation in 2015 will amount around 1.6%, which is lower than the planned 2.7%. Low average inflation will affect the downward adjustments in nominal GDP and the lower growth in tax revenues, which will decrease the expected results of the implementation of fiscal consolidation. In Q2 dinar nominally depreciated by 0.3%, in July it appreciated by 0.4%, while in August it weakened by 0.06%. These changes are so small that the exchange rate is almost fixed and ranges between 120.0 and 121 dinars per euro throughout the whole observed period. A slight real appreciation during Q2 of around 0.25% is entirely the result of the difference in inflations in Serbia and in the Eurozone, given that the period realized the modest real depreciation, while July maintained almost unchanged real exchange rate. The increase of inflation to the limits of the target band would affect the more efficient implementation of the fiscal consolidation measures, while the moderate depreciation would have a favourable effect on the growth of the economy competitiveness and employment, with the acceptable costs of loan servicing and costs concerning inflation.

Prices

Inflation continued its trend below the lower limit of the NBS target band in Q2 and July

At the end of the secon quarter year-on-year inflation amounted to 1.9%, which is slightly higher than its value at the end of Q1 (Table T5-1). Exclusion of a January 2014 high inflation from the calculation of the year-on-year inflation affected its strong decline in January of 2015. In the following months, inflation trend was largely influenced by the current monthly inflation, given that in other months in 2014 monthly inflation (i.e. deflation) was usually relatively low. Year-on -year inflation in April stood at 1.8%, in May 1.5%, in June 1.9%, while in July it dropped to 1.1% (mainly due to a strong drop in the vegetable prices). All these values are below the lower limit of the target tolerance of the National Bank of Serbia (NBS), below which inflation has stood since of March 2014. Underlying inflation (measured by the consumer price index, prices of food, alcoholic beverages, tobacco and energy products) was also below the lower limit of the NBS target band, and in June it amounted to 2.1%, while in July, it dropped to 1.8%. The trend of year-on-year underlying inflation in the past year was relatively stable. Since underlying inflation dropped below the lower limit of the NBS target band in August of 2014, there were no major discrepancies in it- it varied in the range from 1.6% to 2.2% (Graph T5-2). The implementation of the fiscal consolidation measures (reduction of public sector wages and pensions) reduces the domestic demand, which is reflected in a low underlying inflation, as well as in the absence of any signi-

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

	Consumer price index				
	Base index (avg. 2006 =100)	Y-o-y growth	Cumulative index	Monthly growth	3m moving average, annualized
2009					
dec	130.8	6.6	6.6	-0.3	1.6
2010					
dec	144.2	10.2	10.2	0.3	11.7
2011					
dec	154.3	7.0	7.0	-0.7	2.5
2012					
dec	173.1	12.2	12.2	-0.4	9.9
2013					
mar	175.1	11.2	1.2	0.0	4.7
jun	178.2	9.7	2.9	1.0	7.3
sep	177.3	4.8	2.4	0.0	-2.0
dec	176.9	2.2	2.2	0.2	-0.9
2014					
jan	179.5	3.1	1.5	1.5	4.4
feb	179.7	2.6	1.6	0.1	7.5
mar	179.1	2.3	1.2	-0.3	5.1
apr	180.1	2.0	1.8	0.6	1.4
may	180.2	2.1	1.9	0.1	1.1
jun	180.4	1.2	2.0	0.1	2.9
jul	180.2	2.0	1.9	-0.1	0.2
aug	179.9	1.5	1.7	-0.2	-0.7
sep	181.2	2.1	2.4	0.7	1.6
oct	180.8	1.8	2.2	-0.2	1.3
nov	180.8	2.4	2.2	0.0	2.0
dec	180.0	1.8	1.8	-0.4	-2.4
2015					
jan	179.6	0.1	-0.2	-0.2	-2.6
feb	181.1	0.8	0.6	0.8	0.7
mar	182.4	1.8	1.3	0.7	5.5
apr	183.4	1.8	1.9	0.5	8.7
may	182.9	1.5	1.6	-0.3	4.0
jun	183.8	1.9	2.1	0.5	3.1
jul	182.1	1.1	1.2	-0.9	-2.8

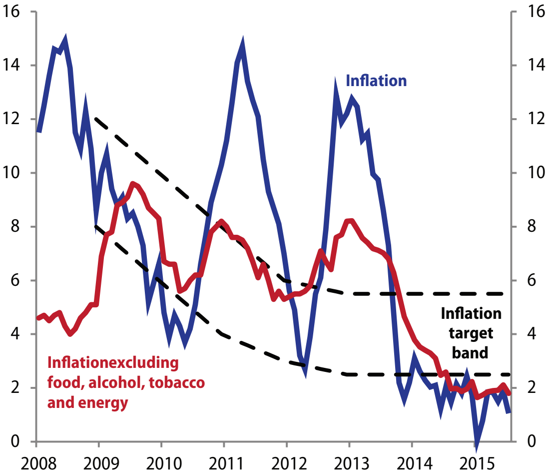
* Pokretne sredine mesečnog porasta cena za tri meseca, dignuto na godišnji nivo. (Na primer, vrednost za mart je dobijena tako što je prosek mesečnog porasta cena u januaru, februaru i martu podignut na godišnji nivo).
Source: SORS.

ficant dinar depreciation spillover from the period July 2014- Feb. 2015 to the prices. The absence of the expected growth in regulated prices in the previous year (until the end of July) also acted disinflationary, while a long-delayed increase in the electricity prices occured in August. The price stability was also affected by the dinar strengthening and stabilization from February. Next to domestic factors, inflationary pressures in Q2 and July remained low and in accordance with low inflation in international environment and low prices in primary products on the world market. The fall in prices of primary agricultural products on the world market (measured by Commodity Agricultural Raw Material Index) has led to a reduction of cost pressures in food production in the world and domestic market. The index of prices of primary agricultural products is at its lowest value in the last five years, which will likely lead to a reduction in cost pressures in food production in the future. The price of petroleum is at a six-year minimum, which will contribute to further reduction of cost pressures in manufacturing. The disappearance of depreciation pressures in the mid Q1, opened the space for National Bank of Serbia to ease monetary policy, so that from March, it has taken a more active role in inflation targeting. Since the beginning of Q2 until the late August, NBS has lowered the key policy rate by a total of 2.0 percentage points, from 7.5% to 5.5%, by 50 base points (b.p.) in April, May, Jun and August (Graph T5-3). Price movements in Q2 and in July were at the expected level, i.e. below the limits of the NBS target band, taking into account the absence of the adjustment in regulated prices, slow economic recovery and a drop in the prices of primary agricultural products in world market and the decline in petroleum prices.

Moderate inflation in Q2

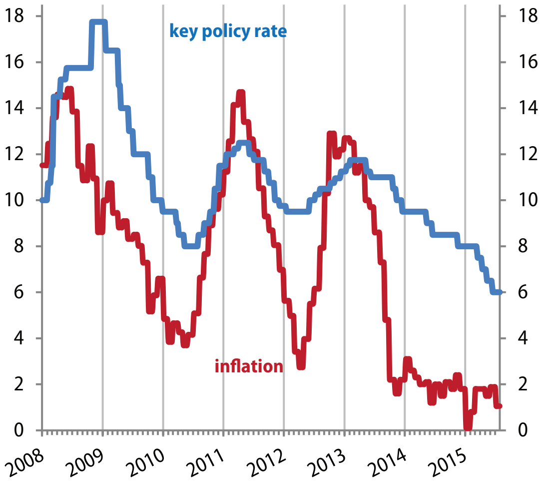
In the second quarter, the growth of the consumer price index amounted to 0.77% (Table T5-4), i.e. by months: in April 0.55%, in May -0.27% (deflation) and in June 0.49%. A total price growth since the beginning of the year until the end of Q2 amounted to 2.1% and it was at an approximately the same level as it was in the same period in 2014.

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



Source: NBS and *QM* estimates

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



Source: NBS

The greatest contribution to inflation in Q2 was made by the rise in the prices of travel arrangements, cigarettes and petroleum products, as well as to a lesser extent rise in the prices of household appliances, tools and equipment for house and garden, telephone equipment, furniture, shoes and products for maintenance. Food prices had an approximately neutral effect to the consumer price index (growth in the fruit prices and a drop in the vegetable prices), while a fall in the prices of natural gas and solid fuels had a disinflationary effect. Due to a seasonal rise in the prices of travel arrangements, the rise in the prices in the group recreation and culture amounted to 5.1% (contribution to inflation of 0.3 p.p.), while the prices of petroleum products rose by 3.1% (contribution of 0.2 p.p.) due to a (short-term) growth in the petroleum world price and the growth of the dinar exchange rate (depreciation) against the dollar at the average level in Q2 compared to Q1. After a long-delayed increase in the cigarette prices, their price increased by 4.0% (contribution of 0.2 p.p.) in Q2, due to the April price rise of 10 dinars per pack of all types of cigarettes. Although excise rose in July 2014 and January of 2015, the prices of cigarettes decreased in the last quarter of 2014, and in early 2015 remained at the same level due to a high competition between the producers whose goal was to maintain their position in the declining market, and shifting the tax burden from producers to consumers occurred only during coordinated rise in the price by all the producers. The increase in the inflation was to a lesser extent influenced by the rise in the price of products and services from the group of house appliances (growth by 1.8%, contribution of 0.02 p.p.), tools and house and garden equipment (growth of 2.1%, contribution of 0.01 p.p.), phone equipment (growth of 4.3%, the contribution of 0.02 percentage points), footwear (growth of 1.5%, the contribution of 0.02 percentage points), furniture and household equipment (growth of 1,0%, the contribution of 0.01 percentage points) and products and services for household maintenance (growth of 0.7%, the contribution of 0.01 percentage points). Prices of products in the group of food and non-alcoholic beverages as a whole influenced the movement of the price index in Q2 to a lesser extent (growth by 0.05%, contribution of 0.02 p.p.). The greatest contribution was made by the prices of unprocessed food, but within this heterogeneous group the prices of fruit and vegetables had divergent movement and to a large extent mutually cancelled the contribution to inflation- the prices of fruit rose by 27.0% (contribution of 0.55 p.p.), while the vegetable prices dropped by 9.5% (contribution of -0.50 p.p.). Significant changes were recorded in the meat prices (growth of 1.8%, the contribution 0,14 p.p.), as well as the prices of milk, cheese and eggs (drop of 3.0%, contribution of -0/16 p.p.), while the other prices in the group of food had relativelly small changes and contribution to inflation. A decline in the prices of natural gas for public supply of 5.0% and solid fuels of 0.8% had a disinflationary effect, which contributed to inflation by -0.03 p.p. or -0.02 p.p. respectively.

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

	Share in CPI (in %)	price increase in Q2 2015	Contribution to overall CPI increase (in p.p.)	Price increase in July 2015	Contribution to overall CPI increase (in p.p.)
Total	100.0	0.8	0.8	-0.9	-0.92
Food and non-alcoholic beverages	32.8	0.1	0.0	-3.7	-1.22
Food	29.2	0.0	0.0	-4.2	-1.22
Alcoholic beverages and tobacco	7.4	2.3	0.2	2.2	0.17
Tobacco	4.7	4.0	0.2	3.5	0.16
Clothing and footwear	4.5	0.2	0.0	-1.1	-0.05
Housing, water, electricity and other fuels	13.6	-0.3	0.0	-0.4	-0.06
Electricity	4.8	0.0	0.0	0.0	0.00
Furniture, household equipment, routine maintenance	4.6	1.1	0.1	0.4	0.02
Health	5.0	0.2	0.0	-0.3	-0.02
Transport	12.9	1.5	0.2	0.2	0.03
Oil products	5.8	3.1	0.2	0.3	0.02
Communications	5.0	0.2	0.0	0.2	0.01
Other items	14.3		0.3		0.19

Source: SORS and *QM* estimates

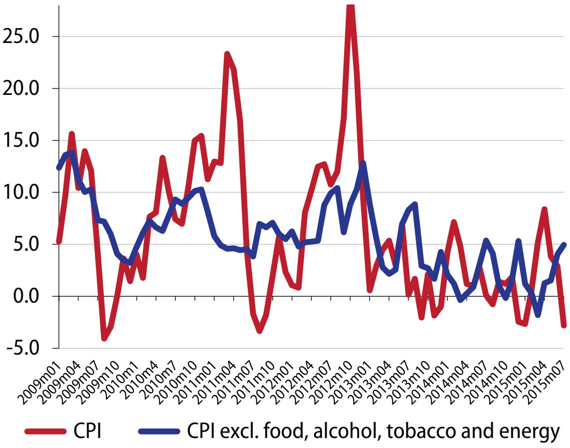
Deflation in July

At a monthly level, July realized relatively high deflation of 0.9%, mostly due to the falling prices of unprocessed food, natural gase and clothing and footwear, while a rise in the prices of tobacco products and travel arrangements had inflationary effect. Within the food prices, the greatest contribution was made by the changes in the unprocessed food prices- a strong drop in the vegetable prices, amounting to -20.5 (contribution of -1.1 p.p.) and significantly more modest drop in the fruit prices of -2.8% (contribution of 0.06 p.p.), while the prices of other categories in the food group (excluding the prices of oil and fat which increased by 4.8%) stagnated. When compared to the prices from a year ago, fruit is more expensive by about 26%, while vegetables are cheaper by about 5%, and the seasonal movement of these prices (the fruit price growth at the end of Q2 and at the beginning of Q3 and vegetable price drop during Q3 are usual) in the following months should have approximately neutral effect. In July, the prices of natural gas further dropped (by 10.2%, contribution of -0.06 p.p.), as well as the prices of solid fuels (by 0.2%, contribution of -0.01 p.p.). Price reduction of footwear and clothes (-1.1%, contribution of 0.05%) and furniture and household equipment by approximately the same amount as the price increase in Q2 was (-1.0%, contribution of -0.01 p.p.), mostly due to the sales in summer months, when the demand decreases, had a disinflationary effect. Deflation was largely mitigated by the continued growth in the prices of tobacco products of 3.5% (contribution of 0.16 p.p.), since there was a new rise in the prices of 10 dinars per pack of cigarettes in July. This price increase is in line with our earlier expectations, given that the decision to increase the excise duties from July was implemented in July, as well as that the price increase could not be delayed in the long term, thus the April and July price increase in cigarettes made the tax burden of excise growth in the previous period largely transfer to consumers. Travel arrangement prices continued to grow in July, so the prices from the group recreation and culture increased by 4.3% (contribution of 0.23 p.p.) which is in accordance with the seasonal growth that is expected from Jun until August, which is followed by a noticeable decline. Prices of petroleum products increased by about 0.3% (contribution of 0.02 p.p.), the water supply price increased by 1.2% (contribution of 0.02 p.p.) and maintenance products price additionally increased by 1.6% (contribution of 0.03 p.p.). In the coming months (observed yoy) August electricity price increase, exclusion from the calculation of the last-year's low prices of tobacco products and somewhat weaker agricultural season in the country than expected will have an inflationary effect, while the most significant disinflationary effect will be caused by an extremely low price of crude oil on the world market.

Overall inflation is at a low level, while underlying inflation is in growth

Overall inflation is in negative zone (3m annualized average is -2.8%), while underlying inflation (inflation excluding food, alcohol, tobacco and energy products) was in a mild growth. However, their short-term trend (Graph T5-5) can be well explained by the changes in the prices of one-off character – by the seasonal drop in the prices of unprocessed food for overall inflation and seasonal growth in the prices of tourist services for underlying inflation, which were the main factors of their movements in the last few months. After a relatively stable trend during Q2 (except in April, when there was an accumulation of the increase in fruit and vegetable prices in the previous three months), the strong decline in the prices of vegetables of more than 20% overthrew 3m annualized average by almost 6 percentage points (from 3.1% to -2.8%). However, as the growth of these prices is uncertain in the following months, this trend is expected to change: inflation is certainly low, but deflationary trend is the result only of temporary factors. The growth of the annualized 3 month-average of the underlying inflation in June and July can in large be explained by the seasonal growth in the prices of travel arrangements, when the prices in the group of recreation and culture increased by 4.1% in June and 4.3% in July. As the prices of unprocessed food momentarily brought down the overall inflation to a very low level, so the seasonal growth in the prices of travel arrangements (which is common for the period June-August) increased the underlying inflation to a much higher level than the one to which it will return in the following months, when the abovementioned prices will stagnate and then drop. In addition to short-term factors, underlying inflation is influenced by the factors that determine its dynamics in the medium and long term, such as the stable dinar exchange rate and a low aggregate demand.

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



Source: SORS and *QM* estimates

NBS Regulated price growth will contribute to approaching the inflation to the NBS target band

Regulated prices in Q2 recorded a growth of 0.8% (contribution to the CPI of 0.1 p.p.) mostly due to the growth in the prices of cigarettes in April, while they are still in decline of -1.5% at a year-on-year level. However, it is uncertain whether this trend will reverse in Q3. Although the announced increase in the electricity price didn't occure during Q2, as well as in July, NBS prediction that it will increase in Q3 was realized. In August, electricity price increased for the consumers at low voltage network (households and the service sectors – trade, catering, financial sector, etc.) by a total of 12% (increase in manufacturing price by 4.5% and introduction of excise in the amount of 7.5%), while the price for industrial producers using the electricity on medium and high voltage increased only by the amount of the excise duty of 7.5%. This increase will have a direct impact on the inflation growth of about 0.6 percentage points and the return of the regulated price growth at a year-on-year level, after a long period of decline. A spillover effect of electricity price to other consumer prices will provide an additional contribution to inflation and contribute to its approaching to the NBS target band.

National Bank of Serbia participates more actively in the inflation targeting, but its return within the target band is not expected in this year

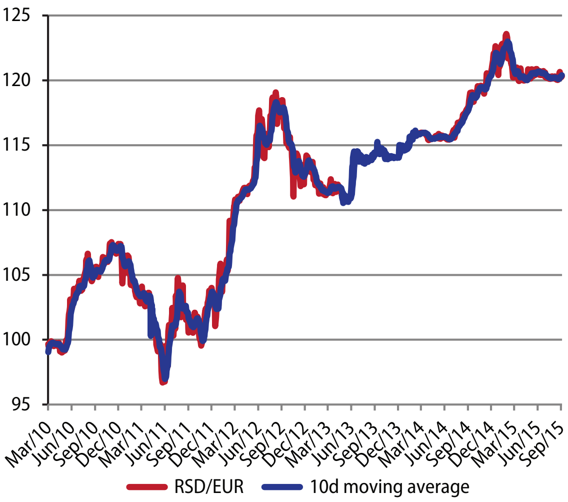
During the second quarter, National Bank of Serbia on several occasions, during April, May and June reduced the key policy rate by 50 basis points each time. In August, the key policy rate was additionally reduced by 50 b.p. and at the end of the month was lower by 2.0 p.p. compared to the beginning of Q2 and amounted to 5.5% (this is its lowest level in the targeting inflation regime), which is a good measure with the goal to return the inflation within the target band. Although the key policy rate is at its lowest level, it is still relatively high, i.e. significantly higher than overall and underlying inflation (1.1% and 1.8% respectively). The decrease of the key policy rate should lead to the reduction in dinar interest rates at the market of money and loans, which should contribute to the economic growth. Despite the easing of monetary policy, the central projection of the NBS in August was lower when compared to May projection, as the world prices of primary products lower than previously expected (they are at a five-year minimum). It is expected that by the mid 2016 inflation will be moving around and below the lower limit of target tolerance, and that only then the inflation entry within the target band can be expected. The main factors that will influence the inflation to return within the target band (in the mid-term) are the growth in the price of electricity, cigarettes and petroleum products, as well as a possible increase in the prices of primary products. It is expected that the spillover effect of the August growth in the electricity price to other prices will not be higher. Inflation will grow according to a low base from the last year, which is largely a consequence of the reduced price of cigarettes and petroleum products. Inflation expectations of the economy and financial sector for the year ahead and in the medium term are within the target band, but the inflation expectations of the citizens are at a much higher level. However, given that the inflation perceived by the citizens is several times higher than realized, it is probable that the inflation projections by citizens are biased. In the following period (in the short term) a low petroleum price, low inflation in the international environment, a continued implementation of the fiscal consolidation measures and low domestic demand will all have a disinflationary effect. Uncertainty regarding the realization of the NBS projections refers to the movement of the prices of primary agricultural products and their impact on the food prices, as well as the impact of the trends in the international environment on the risk premium of the country and the capital influx. Domestic risks are to some extent reduced - arrangement with the IMF and lower fiscal and external deficits contribute to the sustainability of public finances and the improvement of macroeconomic parameters, which in turn contributes to the stability of the foreign exchange market and affects more favourable perception of investors. It is expected that the average inflation in 2015 will be around 1.6%, which is lower than the planned inflation rate of 2.7%. This change will lead to the downward adjustments in nominal GDP by the amount of the difference between planned and achieved inflation (ie. by about 1.1%), which will affect the tax revenues to grow more slowly than planned, the fall of the public expenditure shares in GDP to slow down. Changes like these are most significant in the case of the share of expenditures for salaries and pensions in the GDP, given that, due to the placing their goal in the percentage of the GDP, the slower decline will indicate weaker effects of the fiscal consolidation and necessary extension of the period of its implementation. We estimate that there is room to increase the inflation (within the limits of the target band) in order to increase the nominal GDP, and hence the tax revenues, while the share of public expenditures in GDP would be reduce.

The Exchange rate

Dinar exchange rate is almost flat

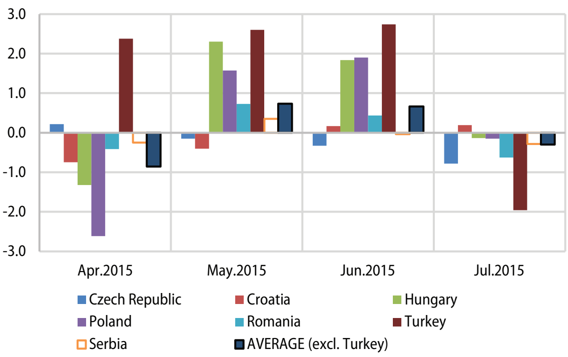
Depreciation in Q2, appreciation in July, and then depreciation in August are extremely small, thus it can be concluded that the exchange rate is almost flat (from the beginning of April until the late August its trend was between 120.0 and 120.9 dinars per euro). During the second quarter dinar nominally depreciated against the euro by 0.3%, observed at the end of the period, i.e. by 0.07% on the level of the period average. Against the US dollar, the dinar at the end of Q2 declined by 3.3%, the same as on the level of the quarter average. For the most part this is a consequence of the continuation of weakening of the euro against the dollar. Minor changes in the exchange rate occurred during April (appreciation of 0.05%) and June (depreciation of 0.03%), when the dinar was relatively stable, while only in May it weakened somewhat more noticeable- by 0.34% (Graph T5-6). However, depreciation realized in Q2 was annulled by the July appreciation of 0.38% at the end of the month, i.e. 0.28% at the level of the month average. Against the dollar, dinar weakened by 1.9% in July (i.e. by 1.6% at the level of the average). Stabilization of the dinar exchange rate against the euro occurred in August- slight depreciation of 0.06% was recorded at the end of the month, i.e. 0.01% at the level of the month average. National Bank of Serbia intervened at the interbank foreign exchange market (IFEM) during Q2 and mostly in April- by buying 140ml euros and selling 30 ml euros, while after that, by the end of Q2, it intervened only on the purchase of foreign exchange in the amount of 10 ml euros (in June). During the time of appreciation pressures, NBS intervened by buying the foreign exchange and eased the further dinar strengthening. However, when there was depreciation pressu-

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



Source: NBS

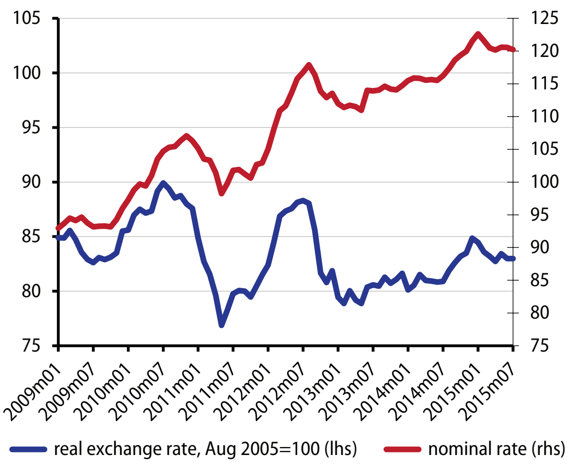
Chart T5-7. Nominal Exchange Rate Change (in %) in Selected Countries



Source: Eurostat, NBS, *QM* estimates

Global factors affect the movement of the dinar exchange rate

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



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

re- from the other half of April till the end of May, NBS didn't intervene and left the exchange rate to the conditions of the market. The National Bank of Serbia intervened in the IFEM by buying 230 million euros in July and net purchase of 130 million euros in August (buying 140 million and selling 10 million euros). This represents a change in comparison to the behaviour of the NBS in the previous period, when the interventions were aimed at the prevention of excessive daily exchange rate oscillations, but mostly when dinar was weakening, while they generally didn't react on the excessive daily dinar strengthening. Strengthening of the dinar is the consequence of exogenous, mainly financial factors (quantitative easing in the Eurozone countries) and not in accordance with the competitiveness of the Serbian economy. Possible future strengthening of the dinar would negatively affect the export of Serbia, and in the medium term, the growth of economic activity and employment. It is therefore essential that the NBS, through various measures of monetary policy (through interest rates, reserve requirements, etc.), prevents the strengthening of the dinar against the euro.

The growth of liquidity in the international financial market (mostly due to the measures of ECB quantitative easing that started to be applied from May) is one of the most important global factors that affect the movement of dinar exchange rate. The reduction in the risk perception of the country (mostly due to the signing of the arrangement with the IMF) and fiscal deficit are additional factors that impact the stabilization of the exchange rate. During April, NBS interventions (key interest rate reduction and purchase of the foreign exchange in the IFEM) contributed the volatility of the exchange rate in Serbia to be among the lowest in the region, when compared to the countries with the similar regime of the foreign exchange rate (Graph T5-7). Given that all chosen countries represent small open economies, their foreign exchange markets are under a strong influence of foreign capital movement. In such way, the Greece crisis of a public debt led to a more cautious behaviour of the investors in most European markets which spurred depreciation pressures. However, after Greece reached the agreement with international creditors, the extreme risks decreased and July was followed by appreciation in most observed countries.

Real dinar value is almost unchanged during Q2 and July

Dinar appreciated in real terms by 0.25% during Q2, while it remained at almost unchanged value of the real exchange rate during July (real depreciation of 0.01% was realized). Real appreciation in Q2 is completely the result of the difference in inflation in Serbia and in Eurozone (inflation in Q2 in Serbia amounts to 0.77%, and in Eurozone 0.45%), given that the period realized the nominal depreciation of the dinar exchange rate of 0.07%. Since the beginning of the year until the late July dinar appreciated in real terms by about 2.2%, which halved the increase of economy competence that was realized in the second part of 2014. (Graph T5-8). However, July maintained the value of the real exchange rate at the June level, because the difference in inflation in Serbia and Eurozone "annulled" nominal appreciation. Real exchange rate at the end of July was at a similar level as in October of 2014. Moderate real depreciation would lead to the improvement of the economy competitiveness, which would then have a favourable impact on the growth of employment in Serbia and on the economic growth, with acceptable costs on the inflation side (especially when we take into account that it is at a historical minimum and below the lower limit of the NBS target band) and the costs of the loan servicing.

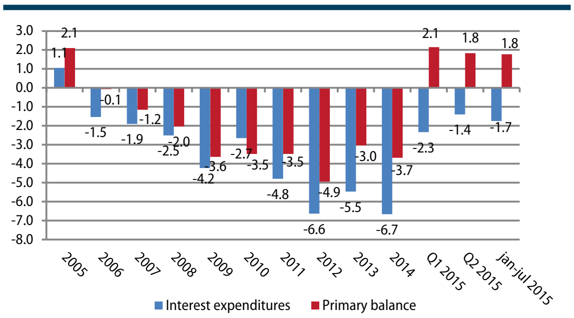
6. Fiscal flows and policy

In the period April-July 2015 consolidated fiscal deficit stood at RSD 18.2 billion, about 1.4% of the four-month GDP, while in the first seven months of 2015 consolidated deficit totaled RSD 39.4 billion (1.7% of GDP) and primary surplus ran at RSD 40 billion (1.8% of GDP). Period January-April saw a slowdown in revenues, but they were still above the targeted level – this mainly refers to excise revenues and social security contributions, while revenues from VAT met the projections. This slowdown in revenues suggests that the government should continue and intensify its efforts to reduce the size of the shadow economy non-selectively and systemically. Otherwise, the initial achievements could be lost. Expenditures continued to fall moderately, due to reduction in wages, pensions and subsidies. After being at a very low level at the beginning of the year, public investments (primarily in infrastructure) increased sharply, but still were below the projected level (2.7% of GDP in the period April-July). Fiscal deficit for 2015 is expected to narrow to 3.5-4% of GDP, and be much smaller than in 2014 and much below the targeted level. This is the result of reduction in the shadow economy, high-pressure collection of non-tax revenues and one-off revenues, and slow pace of certain expenditures (investments and severance pay). On the other hand, positive effects of heightened economic activity on tax revenues were offset by lower-than-projected inflation rate. Excluding the effects of temporary and one-off factors, 2015 fiscal deficit is estimated at 4.5% of GDP. Possible revision of the key consolidation measures (wage and pension reduction) at the end of the year could reverse the downward trend in fiscal deficit in 2016 and thus damage the credibility of the consolidation program. Instead, the initial success should be used to accelerate deficit reduction in the next two years down to much below 3% of GDP, because, by European standards, this is the upper limit of sustainability, meaning that deficits of 3% are considered excessive. Additionally, the extraordinary fiscal room should be used to scale up public investments in 2016 (by 0.5% of GDP), because they act as a much stronger stimulus to economic activity than current consumption. Public debt (including the debt of local self-governments) totaled 75.3% of GDP at the end of July, and is expected to reach about 78% of GDP at the end of 2015.

General tendencies and macroeconomic implications

Fiscal deficit totals RSD 39.4 billion (about 1.7% of GDP) in the first seven months of 2015

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



Source: *QM* calculations

Consolidated fiscal deficit stood at RSD 18.2 billion in the period April-July 2015, which approximates 1.4% of the four-month GDP. In the same period, Serbia had primary surplus of RSD 20 billion (2.6% of the four-month GDP).[2] In the first seven months of 2015 consolidated fiscal deficit totaled RSD 39.4 billion (about 1.7% of GDP), and the budget balance before interest payments was in surplus (primary fiscal surplus) of RSD 40 billion (about 1.8% of the four-month GDP).

Fiscal deficit much below the targeted level in the period April-July

In the period April-July 2015 fiscal deficit accounted for 8% of the annual target, compared with 28% in the preceding years. This indicates that fiscal results continued to outperform the projections, mainly because high-pressure collection of non-tax revenues and one-off revenues continued, tax revenues remained above the projected level, and some spending was delayed or very low (severance pay and public investments).

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

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

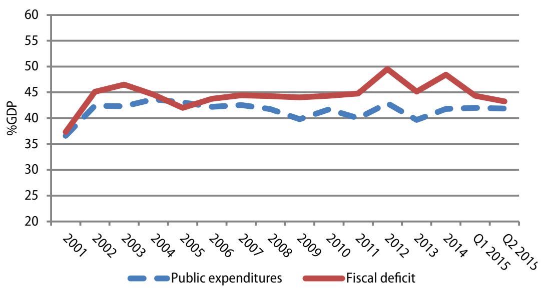
Tax revenues slowing down, but remain above the projected level

In the period April-July rise in excise revenues, revenues from VAT and social security contributions (based on reduction in the shadow economy) slowed down, and some segments even experienced a slight decrease in revenue compared with the preceding period. However, excise revenues and social security contributions remained above the targeted level, while revenues from VAT met the projections. Although tax revenues exceeded the projections in this period, the upward trends detected previously slowed down which suggests that the government should continue with the measures that led to these good results (frequent inspections and penalties for taxpayers engaged in the shadow economy) in order to preserve them. Additional improvements require implementation of additional measures (ban on sale of new industrial products at markets, comprehensive reform in the Tax Administration etc.). Otherwise, the initial results of the government's efforts against the shadow economy could be lost. On the other hand, public investments rose steeply in the period April-July (compared with the preceding four-month period, and the last year's level) primarily because large infrastructure projects were paced up. However, these investments are still below the targeted level.

Consolidated deficit expected to narrow to RSD 140-160 billion (3.5-4% of GDP) in 2015...

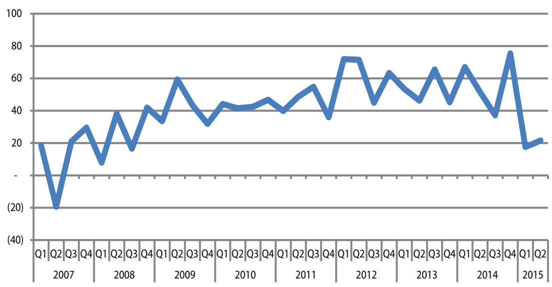
In the previous years, fiscal deficit recorded in the first seven months of a year accounted for around 50% of the annual deficit, on average. However, in the first seven months of 2015 it accounted for around 17% of the annual target. If the trends from the preceding years had continued in 2015, fiscal deficit would have totaled RSD 115 billion in the period January-July 2015. This leads to conclusion that fiscal results were much better than expected. Different dynamics of dividend payout (dividends are now paid at the beginning of a year), considerable one-off revenue inflow (for the license for 4G network, from the Agency for Insurance of Deposits etc.), and delays to and slow pace of some spending (severance pay and public investments) contributed much to such results. However, even if we exclude the effects of these factors, fiscal results achieved in the first seven months are much better than the projections, because reduction in the shadow economy pushed up tax revenues. Namely, effects of the reduction in the shadow economy are estimated at additional RSD 25-30 billion (0.6-0.7% of GDP) of tax revenue. If the current trends continue by the end of the year, consolidated fiscal deficit will stand at RSD 140-160 billion, or 3.5-4% of GDP.

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



Source: *QM* calculations based on the MF data

Graph T6-3. Serbia: Seasonally adjusted fiscal deficit (RSD billion, in 2014 prices)



Source: *QM* calculations based on the MF data

…much below the last year's level and the annual target for 2015

Fiscal deficit of 3.5-4% of GDP would mean a considerable fiscal adjustment compared with the last year's level (by 3-3.2% of GDP), and would be much below the annual target for 2015 (by 2-2.4% of GDP). Wage and pension reduction, more efficient tax collection, and high-pressure collection of non-tax revenues and one-off revenues are the key factors that helped reduce fiscal deficit to below the *last year's level*. Economic activity exceeded the projections and was another factor that pushed up tax revenues. However, inflation rate was below the projected level so the positive effects of real growth on tax revenues were offset. Rising exports and growing investments are the key drivers of growth in 2015. This is good from the aspect of long-term sustainability of growth but does not have large revenue impact because these two components of demand are exempt from VAT and excise duty. Fiscal deficit was smaller *than projected* due to a high-pressure collection of non-tax revenues and one-off revenues, reduction in the shadow economy, low level of public investments, and delays in severance pay. Therefore, excluding the

Credible fiscal consolidation program should secure a steady reduction in fiscal deficit down to a sustainable level…

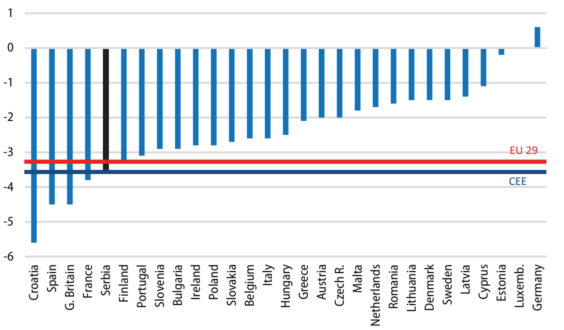
effects of one-off and temporary factors (non-tax revenues, delays in spending on severance pay etc.), fiscal deficit is expected to narrow to 4.5% of GDP in 2015.

Serbia's fiscal performance improved considerably in 2015 compared with the preceding years, and the achieved results are much better than targeted. However, deficit of almost 4% of GDP is still quite large, and therefore it would be economically unjustifiable to loosen the key consolidation measures (wage and pension reduction).

…so it is too early to loosen the key consolidation measures

Credible middle-term consolidation program should secure a steady reduction in fiscal deficit (continuous y-o-y decrease) down to the level much below 3% of GDP, because, by European standards, this percentage is the upper limit of sustainability, and according to Serbia's fiscal rules, this limit is set at 1% of GDP in the middle-term. Even if Serbia's deficit shrinks to 3.5% of GDP in 2015, it will be above the average for EU-29 (2.3% of GDP) and CIE states (2.4% of GDP), and only four European countries will have larger deficits. Possible loosening of some consolidation measures at the end of 2015 (through wage and pension increase), along with uncertain further reduction in the shadow economy, and the risks stemming from serious delays in structural reforms, could push up the deficit in 2016, and Serbia would remain among European countries with the largest fiscal deficits. Economic growth is not expected to contribute much to deficit reduction in the future, because exports and investments as the key drivers of a sustainable economic growth in Serbia do not have large fiscal impact.

Graph T6-4. Serbia and EU: Fiscal deficits in 2015 (% of GDP)



Source: *QM* and European Commission

The extraordinary fiscal room should be used to scale up public investments

Accordingly, more ambitious fiscal goals should be set in the next revision of the arrangement with the IMF (in November 2015), namely, considerable deficit reduction in 2016, and continuation of such trend in 2017, down to much below 3% of GDP. At the same time, the extraordinary fiscal room should be used to scale up public investments, as a strong stimulus to economic activity, because they result in higher fiscal multiplier than current consumption.

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

Public revenues went up moderately (by 2.5%) in the period April-July 2015 compared with the same period last year, primarily because non-tax revenues grew steeply (by 40%), while tax revenues suffered a real drop (by 1.4%). However, public revenues slowed down in the period April-July because real y-o-y increase (by 3.5%) was lower than in the preceding period, and real revenues went down compared with the preceding four months (by 0.7%).

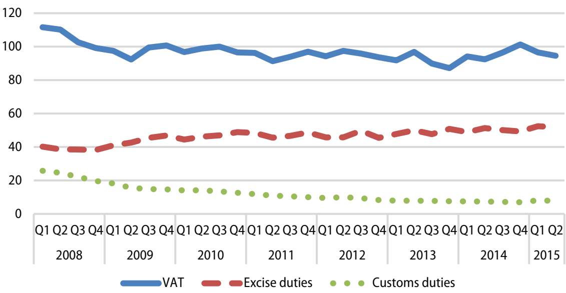
Non-tax revenues slowing down, the largest share collected at the beginning of 2015

Y-o-y increase in non-tax revenues came from an intensive dividend payout by public and state-owned enterprises. However, real drop in these revenues (by 8.3%) in the period April-July compared with the preceding four months suggests that they are slowing down. This increase was based on a high-pressure collection of the total annual dividend at the beginning of the year, which affected the intrannual dynamics of these revenues. However, it is considered to be temporary and unsustainable in the long run, because under such system companies are unable to finance their fixed assets. Furthermore, it will not be possible to permanently keep the system of paying the savings based on the wage reduction into the budget. Analyses of the trends in public finance should therefore be based on the dynamics of tax revenues.

Tax revenues slowing down, but still above the targeted level

Tax revenues suffered a real drop (by 1.4%) in the period April-July compared with the same period last year, which is in accordance with the drop in consumer spending. These revenues fell (by

Graph T6-5. Serbia: Seasonally adjusted revenues from consumption tax (RSD billion, in 2014 prices)



Source: *QM* calculations based on the MF data

0.5%) compared with preceding four-month period, as well.[3] Revenue collection slowed down because revenues from consumption tax slowed down due to reduction in the shadow economy and rise in exports, and revenues from the tax on factors of production decreased due to wage and pension reduction. However, in spite of this slowdown, revenues collected in the period April-July were above the targeted level, primarily due to increase in excise revenues and social security contributions.

Excise revenues stopped growing, but remained above the targeted level

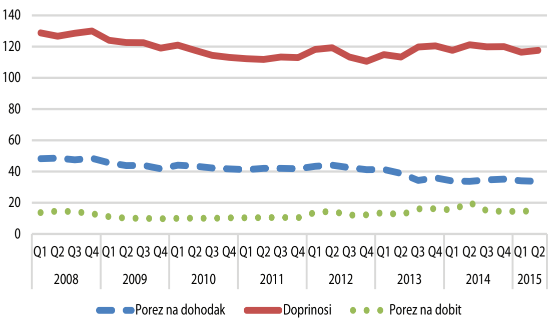
Strong upward trend in excise revenues detected in the first four months of 2015 was halted in the period April-July. Excise revenues collected in this period remained unchanged compared with the same period last year (although excise tax rates were increased), and fell slightly (by1.3%) compared with the preceding four months. Excise revenues stopped growing probably because the effectiveness of the first wave of actions against tobacco products smuggling were exhausted, and sales (legal) of petroleum products decreased (see: Graph T 6-6). In spite of that, excise revenues collected in the period April-July exceeded the targeted level by 4%. Similarly, excise revenues collected in the first seven months of 2015 rose above the targeted level by 5%. Revenues from excise on tobacco products were much lower than before 2013, when illegal sale of these products increased notably, which indicates that there is much room for further actions against the shadow economy in this area.

Revenues from VAT slowed down in the period April-July, but reached the targeted level

Revenues from VAT increased in the period April-July compared with the same period last year (by 0.7%). On the other hand, real seasonally adjusted revenues from VAT fell compared with the preceding four-month period (by 3.1%). Revenues from VAT slowed down in the period April-July due to a slowdown in revenues from gross domestic VAT (2.5% decrease compared with the preceding four-month period), and increase in VAT refund (by 6% compared with the preceding four months), which was probably caused by rise in exports as of May, and previous delays in VAT refund. This slowdown in revenues from gross domestic VAT could mean that the government loosened its efforts to curb the shadow economy. The Tax Administration initially achieved some very promising results, but to make these results permanent, and then further reduce the size of the shadow economy (and there is enough room to do this), it is necessary to maintain tight and systemic controls on tax payers, and to keep punishing defaulters. Otherwise, shadow economy could grow again. Accordingly, many tax offenders who have been punished during the preceding one year's period continue disobeying tax regulations. The government has to make it clear that these are not just temporary actions taken now and then, but that they demonstrate government's continuing commitment to reducing the shadow economy. Although the strong upward trend in revenues from VAT was halted, these revenues reached the targeted level in the period April-July. Revenues from VAT collected in the first seven months of 2015 exceeded the projected amount by 2.5%, mainly due to a large inflow at the beginning of the year. Increase in revenues from VAT, excise revenues and social security contributions, driven by reduction in the shadow economy, contributed much to the recovery in public finance. It is therefore necessary to intensify activities against the shadow economy and make them systemic to preserve the results that have been achieved so far.

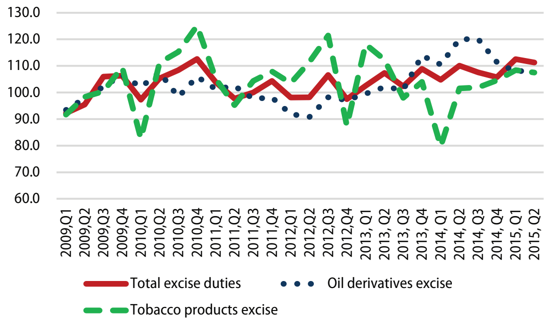
3 Y-o-y growth rates of public revenues and public expenditures were calculated on the basis of inflation-adjusted absolute amounts (real growth rates). Quarter-on-quarter (qoq) growth rates of public revenues and public expenditures were calculated on the basis of seasonally adjusted and inflation-adjusted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

Graph T6-6. Serbia: Seasonally adjusted excise revenues, by components (2010=100)



Source: *QM* calculations based on the MF data

Graph T6-7. Serbia: Seasonally adjusted revenues from VAT, by components (2010=100)



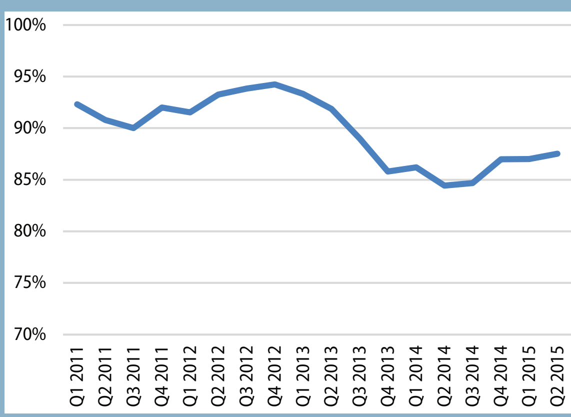
Source: *QM* calculations based on the MF data

Box 1. Collection efficiency of VAT measured by C-efficiency ratio

VAT performance can be roughly measured as a ratio between the collected VAT revenue and perfectly enforced VAT levied at the current effective VAT rate on all consumer consumption. Higher ratio indicates grater collection efficiency, i.e. smaller size of the shadow economy.

Graph T6-8 shows a strong downward trend in VAT performance (growing shadow economy) in 2013, which was reversed as of Q2 2014, so the collection efficiency improved considerably by the end of the year, and continued improving in 2015, but at a much slower pace. However, in spite of these improvements, collection efficiency of VAT, measured by C-efficiency ratio, is far below the level it was at before the sharp decrease in 2013 occurred. This suggests that there is much room to increase collection efficiency. The data also indicate that along with the measures that have been taken so far, some new measures need to be introduced to achieve further improvements, because the effectiveness of the current measures have probably been exhausted.

Graph T6-8. Serbia: Annualized C-efficiency ratio

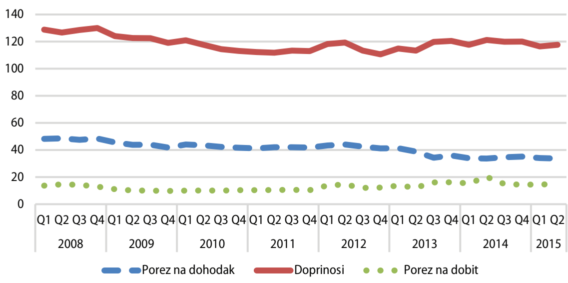


Source: *QM* calculations based on the MF data

Social security contributions exceed the targeted level

Revenues from personal income tax fell (by 1.5%) in the period April-July compared with the preceding four-month period, but went up compared with the same period last year (by 0.5%). This y-o-y increase might have been caused by a more notable reduction in informal employment at the end of 2014 and at the beginning of 2015 (because public sector wage cuts push down the total mass of wages), but the local trend indicates that it was halted in the period April-July. On the other hand, contributions for mandatory social security insurance went up slightly in the period April-July compared with the preceding four-month period (by 0.5%), but suffered a y-o-y decrease (by 2.6%) due to the public sector wage reduction. Real y-o-y decrease in revenues from personal income tax and social security contributions does not match the official data showing 2% drop in average wage, and 10% increase in formal employment, because with such trends in labor market, without changing tax and contribution rates, these revenues should have grown by 8%. However, a reliable method is used to record public revenues (cash principle), meaning that this discrepancy is another indicator of inconsistency between the official data on trends in labor market and other macroeconomic trends. On the basis of intraannual dynamics of revenues from social security contributions in 2015 and in the preceding years, it is estimated that social security contributions collected in the period April-July, and in the period January-July 2015, exceeded the projected level by 5%, mainly because reduction in the shadow economy narrowed the room for wage payments outside the legal flows.

Graph T6-9. Serbia: Seasonally adjusted revenues from tax on factors of production (RSD billion, in 2014 prices)



Source: *QM* calculations based on the MF data

Revenues from corporate income tax went up slightly in the period April-July compared with the preceding period (by 0.5%). On the other hand, these revenues suffered a sharp real y-o-y drop of 18%, which could be a consequence of a notable decline in profitability in 2014.

Considerable decrease in public expenditures…

There was a real y-o-y decrease in public expenditures in the period April-July 2015 (by 2.3%). These expenditures were much lower than in the preceding four-month period (by 7.1%), as well. This decrease was driven by reduction in wages, pensions and subsidies.

…due to wage and pension cut…

Public expenditures fell mainly due to wage and pension reduction. There was a real y-o-y decrease in expenditures on wages of 11.3% in the period April-July. These expenditures fell compared with the preceding four-month period (by around 3%), as well, probably because the number of public sector employees declined and controls on payment of different bonuses and allowances were tightened. There was a y-o-y decrease in expenditures on pensions in the period April-July (by 4.5%). These expenditures went down in this period compared with the preceding four-month period, as well (by 1.3%). In the first seven months of 2015 savings from gross wages amounted to RSD 33 billion, and savings from gross pensions totaled RSD 13 billion.[4] Reduction in wages and pensions is expected to bring annual savings of RSD 70 billion, and its *net effect* on fiscal deficit (taking into account the consequential decrease in revenues from taxes on wages and pensions and social security contributions) is estimated at RSD 55-60 billion. Accordingly, if this measure is abolished, fiscal deficit might widen considerably in 2016.

…and reduction in subsidies

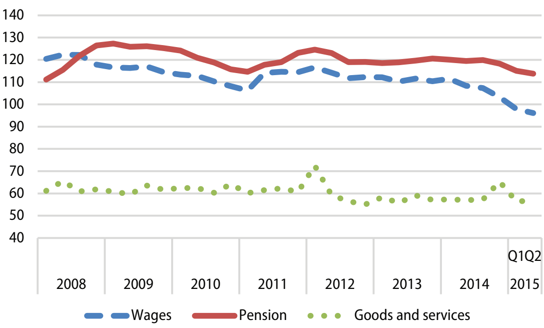
There was a real y-o-y drop in expenditures on subsidies in the period April-July (by 8%). These expenditures fell notably in this period compared with the preceding four-month period (by 15.7%). Expenditures on subsidies in Serbia are much above the sustainable level and above average of comparable countries, so this reduction is welcome. Besides that, their purpose and granting procedure need to be changed to increase their efficiency.

Public investments rise steeply, but fail to reach the target

Extremely slow pace of public investment at the beginning of 2015 was quickened in the period April-July. Namely, public investments (especially in traffic infrastructure) grew notably (by 29.1%) in this period compared with the preceding four-month period. There was a slight y-o-y rise in these investments, as well (by 2.7%). However, public investments accounted for only 2.7% of GDP in this period, which is 15% below the targeted level, and in the first seven months of 2015 only 2.4% of GDP was spent on public investment, i.e. about 25% less than planned. Most probably, only investments in traffic infrastructure will reach the annual target. Public investments are strong stimulus to economic activity, both in the short term (rise in demand) and in the long term (increase in supply), and therefore need to be scaled up, as close as possible to the annual target for 2015. This target should be lifted in 2016 (to at least 3.5% of GDP) and all the necessary preparations for achieving it should be made. After the potential partners abandoned the concession for Corridor XI from Belgrade to Čačak, the remaining sections of the highway, that have not been contracted yet, could be financed from the budget.

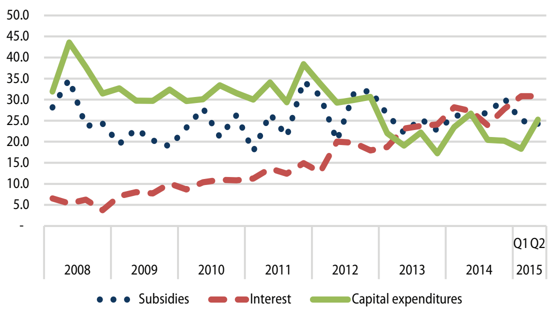
4 Net effect of wage and pension reduction on fiscal deficit is weaker because this reduction pushes down revenues from taxes and contributions deductible from public sector wages.

Graph T6-10. Serbia: Seasonally adjusted expenditures on wages, pensions and goods and services (RSD billion, in 2014 prices)



Source: *QM* calculations based on the MF data

Graph T6-11. Serbia: Seasonally adjusted expenditures on interest payments, subsidies and capital expenditures (RSD billion, in 2014 prices)



Source: *QM* calculations based on the MF data

Expenditures on interest payments going up due to growing indebtedness

Expenditures on interest payments went up considerably in the period April-July 2015 compared with the same period last year (by 16.6%), and were higher than in the preceding four-month period, as well (by 1.9%). Growing indebtedness of the country is the key driver of this increase. However, under the ECB and Fed's expansive monetary policy, borrowing conditions improved, which has favorable impact on expenditures on interest payments, meaning that without the influence of these temporary external factors, rise in these expenditures would be even larger.

Analysis of fiscal trends by government level

Central government and Health Insurance Fund running deficit, other government levels running surplus in Q2

In Q2 2015 the central government and the Health Insurance Fund ran budget deficit (RSD 17.2 billion and RSD 1.8 billion respectively). On the other hand, the Pension and Disability Insurance Fund, AP Vojvodina and local self-governments ran budget surplus (RSD 0.3 billion, RSD 0.9 billion and RSD 1.8 billion respectively).

Revenues of local self-governments went up because revenues from property tax continued to grow

Both central government and local self-governments collected more revenue in Q2. Revenues from VAT, excise revenues and non-tax revenues pushed up the central government revenues. On the other hand, the upward trend in revenues from property tax continued in Q2 (16.3% y-o-y), and pushed up the revenues of local self-governments. This indicates that local self-governments continued with their efforts to increase revenue impact of property tax and thus make up for the loss of revenue from construction land usage fee. Revenues from property tax grew by 75% in 2014, and if they keep growing at the pace detected in Q2 2015, total revenues from property tax in 2015 will equal the sum of revenues from property tax and construction land usage fee collected in 2013, which is justifiable.

Graph T6-12. Serbia: Fiscal surplus (deficit) at different levels of government (bn. RSD, current prices)

Year	*Budget of Republic*	*Pension fund*	*National Employment Service*	*Health fund*	*Vojvodina budget*	*Local self-governments*
2010	-108.0	-1.0	-0.1	1.9	-9.6	-11.5
2011	-144.3	0.2	1.3	2.1	-0.7	-15.6
2012	-213.0	-0.4	0.8	4.0	1.1	-0.3
2013	-194.4	-1.2	-0.5	8.7	1.3	6.3
2014	-204.1	3.6	2.0	0.2	1.0	8.5
Q1 2015	-24.9	-4.2	0.0	2.0	1.6	4.3
Q2 2015	-17.2	0.3	0.1	-1.8	0.9	1.8

Source: *QM* calculations based on the MF data

Local self-governments spend more because they have excessive available funds

Different government levels showed some quite divergent y-o-y trends in expenditures in Q2 – central government (budget of the Republic, Pension and Disability Insurance Fund and Health

Insurance Fund) spent less, and expenditures of local self-governments went up. This reduction in expenditures of the Republic budget was achieved through fiscal consolidation, and consequential reduction in expenditures on wages and transfers to Pension and Disability Insurance Fund, and slow pace of capital expenditures. On the other hand, y-o-y increase in expenditures of local self-governments (by 8.3%) was caused by a steep rise in expenditures on subsidies and welfare, and to a certain extent, by rise in expenditures on goods and services and capital expenditures (see: *Appendix 3*). Rise in expenditures on subsidies and goods and services is justifiable only to the amount used to pay off arrears. Moderate real rise in local public investment (by 15.9%) is economically justifiable and welcome. Total expenditures of local self-governments went up because the funds delegated to local self-governments exceed their competences.

A balance between the assigned competences and revenues should be established

Sub-central government levels have been running large and growing surplus – the budget of AP Vojvodina showed surplus of RSD 1 billion in 2013 and RSD 1.6 billion in 2014, and in the first half of 2015 it totaled RSD 2.5 billion. Similarly, budgets of local self-governments showed surplus of RSD 6.3 billion in 2013 and RSD 8.5 billion in 2014, and in the first half of 2015 it totaled RSD 6.1 billion. On the other hand, the central government runs a quite large deficit. This all leads to conclusion that there is a systemic imbalance in distribution of competences and revenues among different government levels, so that the sub-central government levels have been given more revenue than competences. To improve the management of public finance, it is necessary to correct this imbalance. This can be achieved through a systemic reform in the system for funding sub-central government levels and by bringing distribution of available funds in line with delegated competencies.

Trends in public debt

Serbia's public debt totaled EUR 24 billion at the end of July (74.1% GDP)...

At the end of July 2015 Serbia's public debt totaled EUR 24 billion (74.1% of GDP), and with the debt of local self-governments included it accounted for 75.3% of GDP.

...and with the debt of local self-governments included – 75.3% of GDP

From the end of March to the end of July 2015 public debt remained almost unchanged in nominal terms, because fiscal deficit in this period was small (EUR 150 million), and was mainly financed from previously accumulated government deposits. Additionally, trends in dinar exchange rate had favorable impact on public debt dynamics, i.e. dinar appreciated against dollar by 1.3%, and dinar to euro exchange rate remained unchanged. Although nominal public debt remained unchanged in the period April-July, public debt to GDP ratio fell slightly (by 1.2%), because dinar appreciated against dollar and GDP grew slightly.

Table T6-13. Serbia: Public debt dynamics 2000-2015

	Amount at the end of period, in billions EUR												
	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Q1 2015	July 2015
I. Total direct debt	14.17	9.62	8.58	8.03	7.85	8.46	10.46	12.36	15.07	17.3	20.2	21.6	21.5
Domestic debt	4.11	4.26	3.84	3.41	3.16	4.05	4.57	5.12	6.5	7.0	8.2	8.7	8.5
Foreign debt	10.06	5.36	4.75	4.62	4.69	4.41	5.89	7.24	8.6	10.2	12.0	12.9	13.0
II. Indirect debt	-	0.66	0.80	0.85	0.93	1.39	1.71	2.11	2.60	2.81	2.5	2.6	2.5
III. Total debt (I+II)	**14.2**	**10.3**	**9.4**	**8.9**	**8.8**	**9.8**	**12.2**	**14.5**	**17.7**	**20.1**	**22.8**	**24.2**	**24.0**
Public debt / GDP[2]	**169.3%**	**50.2%**	**36.2%**	**29.4%**	**25.6%**	**31.3%**	**41.5%**	**45.1%**	**59.3%**	**63.8%**	**70.9%**	**73.3%**	**72.3%**
Public debt / GDP (QM)[3]	**169.3%**	**52.1%**	**36.1%**	**29.9%**	**28.3%**	**32.8%**	**41.9%**	**44.4%**	**56.1%**	**59.4%**	**71.0%**	**75.3%**	**74.1%**

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

Indirect debt stagnates in 2015, but it could start growing

Public debt structure did not change much in the period April-July. Direct debt shrank by EUR 150 million due to old foreign currency savings payout and payment of other internal and external debts (EUR 270 million and EUR 120 million respectively). On the other hand, indirect debt remained almost unchanged because the government continued its policy of not granting implicit subsidies to state-owned and public enterprises. Favorable trends in the market (low gas prices and favorable ratio between the price of raw materials and products in steel industry) allowed this, but the factors that could push up the debt in the following period have not been eliminated, i.e. in spite of the announcements that restructuring and privatization of large public and state-owned enterprises, as major users of state guarantees (Srbijagas, Azotara, Petrohemija etc.), would be finished in the first half of 2015, not much progress has been made.

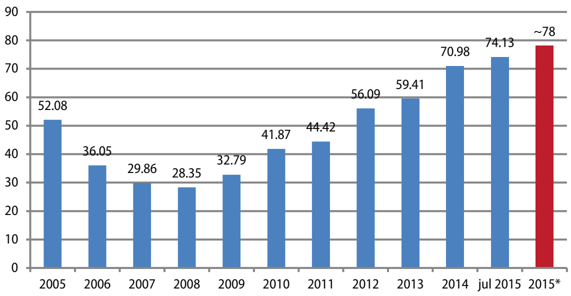
Refinancing of expensive loans by cheaper ones is recommendable under the current trends in the world market

Expenditures on interest payments for 2015 are estimated at around EUR 1.1 billion (3.5% of GDP), y-o-y increase of 0.5% of GDP. This rise is expected to continue in 2016, as well, but at a slower pace. Expenditures on interest payments depend on the amount of debt and the level of interest rates, and the letter are determined by the level of public debt and sustainability of public finance of a country and trends in the global financial market. Persistent implementation of the fiscal consolidation program will slow down the debt in the following period. However, increase in debt-to-GDP ratio is not expected to be halted until 2017 (if the program is implemented consistently). Therefore, expenditures on interest payments can be reduced in the following period through refinancing of some expensive loans, though this option is quite limited because loans that can be refinanced make a relatively small share of the total debt. Borrowing conditions in the global financial market have improved, under the Fed and ECB's expansive monetary policy, and initially good results of fiscal consolidation in Serbia slightly decreased the country risk. Therefore, some of the expensive loans (with interest rates of 4-6%) should be refinanced by cheaper ones. Furthermore, the initiative to use a half of the revenue from privatization of Telekom for early repayment of expensive loans is considered welcome. The foregoing could slightly slow down the overall expenditures on interest payments in the following period (by around EUR 50-100 million annually). Although these savings would not have a notable impact on the health of public finance, this measure should be applied anyway, because it requires relatively small administrative efforts.

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

Debt-to-GDP ratio will continue to rise in 2015, because fiscal deficit is expected to widen in the second half of the year, and some other factors could also push up the debt (exchange rate, issuance of government guarantees etc.). If real dinar exchange rate remains unchanged, and if borrowing in advance of need remains within the expected level, and without new issuance of government guarantees, public debt will probably reach 77% of GDP, and with the non-guaranteed debt of local self-governments included, it will total 78% of GDP, which is unsustainable in the long term and suggests that the extraordinary fiscal results achieved in 2015 should be used to further reduce fiscal deficit in the following period, instead of increasing current spending.

Graph T6-14. Trends in public debt in Serbia (% of GDP



Source: *QM* calculations

Appendices

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

	2008	2009	2010	2011	2012	2013	2014					2015		
							Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	jan-jul
I PUBLIC REVENUES	**1,193.5**	**1,200.8**	**1,278.4**	**1,362.6**	**1,472.1**	**1,538.1**	**352.9**	**403.3**	**407.6**	**457.0**	**1,620.8**	**365.6**	**424.7**	**954.5**
1. Current revenues	1,143.1	1,139.2	1,215.7	1,297.9	1,393.8	1,461.3	334.9	383.7	385.4	436.8	1,540.8	364.3	422.7	951.0
Tax revenue	1,000.4	1,000.3	1,056.5	1,131.0	1,225.9	1,296.4	301.3	348.7	344.8	375.1	1,369.9	309.9	368.7	826.0
Personal income taxes	136.5	133.5	139.1	150.8	35.3	156.1	32.2	35.1	36.9	42.2	146.5	32.5	35.6	81.3
Corporate income taxes	39.0	31.2	32.6	37.8	54.8	60.7	15.5	29.8	14.2	13.2	72.7	13.0	25.9	42.9
VAT and retail sales tax	301.7	296.9	319.4	342.4	367.5	380.6	93.6	97.0	101.7	117.3	409.6	96.2	100.1	235.9
Excises	110.1	134.8	152.4	170.9	181.1	204.8	42.9	55.2	58.4	56.0	212.5	46.3	57.2	128.2
Custom duties	25.8	48.0	44.3	38.8	35.8	32.5	7.3	7.5	7.8	8.6	31.2	7.9	7.9	18.6
Social contributions	312.7	318.8	323.0	346.6	378.9	418.3	99.3	109.8	110.7	120.6	440.3	100.6	125.9	284.8
Other taxes	35.6	37.1	46.0	43.5	42.6	43.5	10.7	14.3	15.1	17.2	57.3	13.4	16.0	34.3
Non-tax revenue	0.0	138.8	159.2	36.9	37.9	34.9	33.7	35.0	40.5	61.7	170.9	54.3	54.1	125.0
2. Capital revenues	1.4	0.9	0.3	2.0	8.7	3.5	0.4	0.6	0.4	0.6	2.0	0.3		3.5
	0.0													
II TOTAL EXPENDITURE	**-1,265.5**	**-1,328**	**-1,419.5**	**-1,526.1**	**-1,717.3**	**-1,750.2**	**-421.0**	**-448.3**	**-447.4**	**-562.2**	**-1,878.9**	**-379.3**	**-438.9**	**-993.9**
1. Current expenditures	-1,089.6	-1,155	-1,224.8	-1,324.8	-1,479.9	-1,549.8	-381.7	-393.6	-398.0	-454.7	-1,628.0	-368.9	-406.0	-926.2
Wages and salaries	-293.2	-302.0	-308.1	-342.5	-374.7	-392.7	-95.7	-97.9	-96.4	-98.6	-388.6	-83.8	-104.3	-236.6
Expenditure on goods and services	-181.4	-187.4	-202.5	-23.3	-235.7	-236.9	-50.9	-58.3	-60.2	-87.4	-256.8	-50.9	-58.8	-132.7
Interest payment	-17.2	-187.4	-34.2	-44.8	-68.2	-94.5	-35.5	-28.6	-26.8	-24.2	-115.2	-40.6	-32.7	-79.3
Subsidies	-77.8	-22.4	-77.9	-80.5	-111.5	-101.2	-19.4	-23.7	-27.9	-46.1	-117.0	-18.7	-23.8	-51.5
Social transfers	-496.8	-63.1	-579.2	-609.0	-652.5	-687.6	-170.7	-172.4	-172.8	-181.0	-696.8	-166.7	-173.8	-401.4
o/w: pensions5)	*-331.0*	-556.4	*-394.0*	*-422.8*	-473.7	-498.0	-125.0	-126.9	-128.0	-128.1	-508.1	-121.0	-122.8	-285.0
Other current expenditures	-23.5	-387.3	-22.9	-31.7	-37.4	-36.9	-9.6	-12.6	-14.0	-17.5	-53.7	-8.1	-12.5	-24.7
2. Capital expenditures	-106.0	-24.0	-105.1	-111.1	-126.3	-84.0	-13.9	-25.3	-23.7	-33.7	-96.7	-10.5	-23.8	-46.7
3. Called guarantees	-1.6	-2.2	-2.7	-3.3	-3.7	-7.9	-3.4	-5.9	-8.2	-12.1	-29.7	-6.9	-8.2	-19.4
4. Buget lendng	-19.3	-24.0	-30.0	-25.0	-38.2	-35.6	-5.2	-5.8	-0.3	-44.1	-55.4	-0.5	-0.9	-1.6
III CONSOLIDATED BALANCE	**-72.0**	**-127.1**	**-141.0**	**-163.5**	**-245.2**	**-212.1**	**-68.1**	**-45.0**	**-39.8**	**-105.2**	**-258.1**	**-21.1**	**-14.2**	**-39.4**

Source: *QM* calculations based on the MF data

Annex 2.

	2008	2009	2010	2011	2012	2013	2014					2015		
							Q1	Q2	Q3	Q4	Q1-Q4	Q1	Q2	jan-jul
I PUBLIC REVENUES	**3.3**	**-8.9**	**-1.5**	**-4.6**	**0.6**	**-2.2**	**-0.8**	**4.3**	**3.5**	**5.4**	**3.2**	**7.6**	**4.2**	**4.2**
1. Current revenues	3.5	-9.1	-1.5	-4.4	0.1	-2.6	-0.3	4.3	2.8	5.7	3.3	7.6	4.1	4.1
Tax revenue	3.7	-8.8	-2.5	-4.1	1.0	-1.7	-1.0	6.4	3.8	4.3	3.5	1.8	-0.6	-0.3
Personal income taxes	6.3	-10.8	-3.9	-2.9	2.1	-12.2	-17.8	-13.5	0.8	-1.7	-8.1	-0.1	-0.4	0.3
Corporate income taxes	18.5	-27.0	-3.6	3.9	35.1	2.9	-18.0	165.3	-9.5	-18.1	17.4	-17.2	-14.5	-17.7
VAT and retail sales tax	2.5	-10.2	-0.7	-4.0	0.0	-3.8	4.3	-3.6	5.4	15.1	5.4	1.8	1.5	1.2
Excises	0.7	11.6	4.2	0.6	-1.2	5.1	-1.7	0.8	9.5	-2.4	1.6	6.9	1.9	2.5
Custom duties	1.8	-32.4	-14.9	-21.5	-14.0	-15.6	-4.4	-7.0	-6.9	-7.3	-6.5	8.9	4.0	7.2
Social contributions	4.3	-7.0	-6.5	-3.9	1.9	2.6	3.6	29.1	28.1	0.5	3.1	0.3	-1.6	-2.0
Other taxes	-2.3	-4.9	14.5	-15.2	-8.8	-5.2	12.1	8.2	0.8	44.1	29.2	23.9	9.9	17.0
Non-tax revenue	2.6	-11.3	5.8	-6.1	-6.2	-8.7	6.0	-13.1	-5.1	15.1	1.5	59.8	50.2	47.3
2. Capital revenues	-76.8	-41.4	-66.8	468.2	304.5	-63.0	-79.6	17.6	-27.7	6.0	-33.3	-19.5	22.9	
II TOTAL EXPENDITURE	**5.0**	**-4.8**	**-1.7**	**3.3**	**4.3**	**-0.3**	**4.4**	**3.7**	**-3.0**	**14.8**	**5.2**	**-5.1**	**-2.9**	**-3.6**
1. Current expenditures	6.9	-3.3	-2.2	3.1	4.1	-2.7	6.0	0.4	-1.2	6.5	2.9	-4.4	-2.6	-3.4
Wages and salaries	10.9	-6.0	-5.9	0.4	2.0	-2.6	-0.6	-2.0	-3.0	-6.5	-3.1	-13.3	-11.3	-12.3
Expenditure on goods and services		-5.7	-0.3	4.3	1.5	-6.6	-0.1	3.4	-1.6	19.1	6.2	-1.1	-0.8	1.4
Interest payment	-2.8	-5.7	-0.3	17.4	41.9	28.8	82.9	2.2	-3.4	13.6	19.3	13.0	12.2	14.8
Subsidies	-13.3	19.0	40.6	7.4	29.1	-15.6	-0.8	6.0	-3.8	41.9	13.2	-4.2	-26.1	-6.6
Social transfers	10.1	-26.0	13.9	5.8	-0.1	-2.1	2.4	-2.2	-1.8	-1.2	-0.7	-3.3	-0.9	-1.3
o/w: pensions5)	*9.5*	2.2	-3.9	3.9	*4.4*	*-2.3*	*1.5*	*0.0*	*0.2*	*-2.0*	*-0.1*	*-4.3*	*-4.7*	*-4.5*
Other current expenditures	14.9	6.7	-6.1	23.9	9.9	-8.4	31.1	36.2	43.1	55.0	42.6	-15.9	-2.4	-8.8
2. Capital expenditures	-4.3	-6.7	-11.8	5.3	6.0	-38.2	1.4	41.5	-12.8	25.2	12.7	-25.5	-7.5	-5.2
3. Called guarantees	283.5	-2.2	-2.7	-3.3	-3.7	248.7	40.7	439.8	417.0	310.5	267.8	98.8	34.8	69.4
4. Buget lendng	13.3	-24.0	-30.0	-25.0	-38.2	44.2	-36.1	45.5	-97.4	237.4	52.2	-90.9	-85.2	-86.3

Source: *QM* calculations based on the MF data

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

	Q2 2015/Q2 2014			
	Consolidated budget	Budget of Republic	Health Fund	Local self-government
A Total public revenues (I)+(II)+(III)+(IV)	***3.5***	**7.3**	**-15.9**	**4.6**
I Current revenues (1)+(2)	*3.3*	7.0	-17.5	4.5
1. Tax revenues	*-1.1*	-0.1	-18.9	4.2
1.1. Customs	*4.0*	4.0	-	-
1.2. Personal income tax	*-0.3*	-0.8	-	0.0
1.3. Corporate income tax	*-14.5*	-11.2	-	-
1.4. VAT	*1.5*	1.5	-	-
1.5. Excise duties	*1.9*	1.9	-	-
1.6. Property taxes	-	-	-	16.3
1.9.Other taxes	*9.9*	-1.3	-	2.6
1.10. Social security contributions	*-3.0*	-	-18.9	-
2. Non-tax revenues	*49.0*	75.7	63.8	6.3
II Capital revenues	*59.8*	-	-71.7	23.4
III Transfers from the other levels of government	-	-	-12.2	4.2
IV Donations	*51.3*	168.8	-	-4.6
B Total public expenditures (I)+(II)+(III)+(IV)	***-3.8***	**-7.2**	**-8.0**	**8.3**
I Current expenditures	*-3.0*	-8.4	-8.1	8.1
1.1 Wages	*-11.3*	-11.1	-13.0	-8.8
1.2. Goods and services	*-0.8*	-11.2	-2.8	11.0
1.3 Interest payments	*12.2*	12.7	230.1	5.2
1.4 Subsidies	*-1.4*	-13.1	0.0	30.5
1.5 Social insurance and social assistance	*-0.9*	9.3	10.3	25.2
1.6 Transfers to the other levels of government	-	-16.0	-	-
1.7 Other current expenditures	*-2.4*	-17.3	-13.0	5.6
II Capital expenditures	*-7.4*	-11.0	155.2	15.9
III Strategic reserves		-22.8	-	-51.6
IV Net lending	*-85.2*	57.4	-	18.2

Source: *QM* calculations based on the MF data

7. Monetary Trends and Policy

Maintaining the y.o.y. inflation rate below the target framework opened room for the NBS to further relax its monetary policy in Q2. Following a series of corrections by 0.5 percentage points, the key policy rate at the end of Q2 was at the level of 6% and was lowered by the NBS in August and September to the current 5%. The monthly inflation rate which was negative in May and July with a stable exchange rate increased the profitability of REPO bonds which showed a growth in Q2. Liquidity of the banking sector which increased on the basis of growing deposits by the enterprises and the households has been transferred into REPO. This led to a reduction of the money mass. The overall money mass was still increased thanks to NBS interventions on the inter-banking foreign exchange (FX) market on which it was a net buyer of hard currency in Q2 to the amount of 120 million Euro. The placements of business banks in Q2 rose mainly on the basis of the purchase of REPO bonds and the rise in net placements to the households of 75 million Euro. This growth was almost annulled with new repayments by the enterprises of 121 million Euro to domestic banks with an additional 31 million Euro on the basis of the repayment of cross-border loans. The continuing debt repayment by the enterprises is a serious obstacle to future economic growth. Confirmation of this is visible through the NPL trend which in Q2 rose to 23% of the overall placements but because of significant oscillations in the data from the Credit Bureau on bad loans we accept this growth with the reservation that their real participation is somewhat lower.

Central Bank: Balance and Monetary Policy

NBS continues to relax monetary policy

Despite expectations by the National Bank of Serbia (NBS) from the end of last year that the y.o.y. inflation rate will fall back into the target framework in mid-2015, it dropped to the level of 1.1% in July. The monthly inflation rate, which is perhaps a better indicator for the implementation of monetary policy, was negative in May and July which suggests that we still cannot talk about the recovery of the aggregate demand in Serbia. Due to the extremely low inflation rate, the NBS acted three times in Q2 to correct the key policy rate. The rate was first lowered to 7% in early April and two more corrections of 0.5 percentage points were undertaken in mid-May and June. In July, the NBS kept the key policy rate at the level of 6% and in mid-August it was lowered to 5.5%. Finally, in first half of September another correction took place after which key policy rate stood at current 5%. This policy reflects the ex-post reactive policy by the NBS rather than an adequate pro-active approach to controlling inflation within the defined corridor. The concluding of the arrangement with the International Monetary Fund and positive trends in public finances contributed to increasing stability in the monetary sector as well. The stability of prices and the exchange rate are good results but we cannot ignore the drop in credit activities by banks since without credit activities we cannot expect a permanent recovery of the economy. Unlike the negative trend in terms of credit placement, the liquidity of the banking sector increased in Q2 due to the growth of deposits by the enterprises and the households as well as an increase of the capital of business banks. The growth of sources did not find its way to new users of credit services but thanks to low and stable inflation and a stable Dinar exchange rate it spilled over to the placements into REPO bonds. Placements in REPO bring certain yields which are relatively high in conditions of a stable Dinar exchange rate and low interest rates on the world market.

Purchase of hard currency on inter-banking FX market affects growth of net own reserves …

and indirectly growth of primary money

There were no greater imbalances between the offer of and demand for hard currency on the inter-banking FX market in May and June, but the NBS was once again a net buy to the amount of 120 million Euro (Graph T7-2) because of appreciation pressure in April at the level of Q2. In July it had to react again with the purchase of 230 million Euro which means that in the first seven months of the year the NBS created Dinar liquidity through the net purchase of hard currency on the inter-banking FX market to the amount of 520 million Euro. Although NBS interventions in the past were mainly aimed at preventing any sudden and greater weakening of the Dinar exchange rate, we believe that the fact that despite the existence of appreciation pressure from the start of the year, the Dinar did not strengthen significantly against the Euro is positive. The current position of the NBS in terms of exchange rate policy is unfortunately caught between a foreign trade imbalance which obviously demands an additional depreciation on the one hand and the problems in the banking sector caused by the high participation of indexed loans which are in constant danger of moving into the segment of bad loans if the Dinar weakens. Because of that the exchange rate policy which is being implemented is more of a forced compromise than it is in the function of developing the economy.

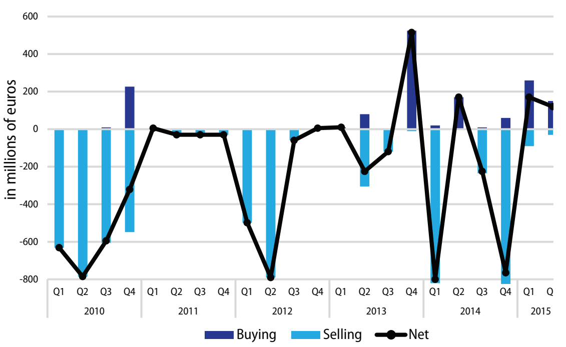
The purchase of hard currency on the inter-banking FX market caused the NBS net own reserves to record an increase in Q2 of 31 million Euro (in Q1 those net own reserves were increased by 489 million Euro, Table T7-1).

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

	2013				2014				2015	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
Repo stock (in milions of euros)	678.86	663.82	832.03	966.40	783.96	824.19	387.39	69.48	2.85	168.72
NBS interest rate	11.75	11.00	11.00	9.50	9.50	8.50	8.50	8.00	7.50	6.00
NBS interest rate	6.95	3.31	13.24	10.38	4.38	5.09	6.78	10.63	-1.13	3.08
NBS interest rate	19.25	12.85	12.83	9.25	5.28	7.08	0.03	-1.94	11.33	5.70
NBS interventions on FX market (in milions of euros)	10.00	-215.00	-140.00	375.00	-800.00	-630.00	-855.00	-1620.00	170.00	290.00
INCREASE	cumulative, in % of initial M2[1]									
NBS own resreves[2]	12.5	7.1	17.9	43.2	-31.2	-4.9	2.0	-6.6	33.5	22.50
NDA	-15.3	-3.9	-16.2	-31.3	12.2	-11.4	-7.6	15.6	-28.4	-16.20
Government, dinar deposits[3]	1.0	-1.2	-4.7	-19.9	3.3	-14.6	-24.3	-9.5	-8.4	-0.50
Repo transactions[4]	-16.0	-14.7	-23.8	-30.7	9.2	6.5	28.9	46.0	3.7	-3.40
Other items , net[5]	-0.3	12.0	12.4	19.3	-0.3	-3.4	-12.2	-20.9	-23.8	-12.30
H	-2.8	3.3	1.7	12.0	-19.0	-16.3	-5.6	9.0	5.1	6.30
o/w: currency in circulation	-3.9	-0.7	1.0	5.4	-5.2	-3.5	0.5	3.7	-7.4	-3.40
o/w: excess liquidity	0.6	2.1	-1.4	4.4	-12.1	-11.6	-7.3	-0.6	11.6	8.10
	in millions of euros, cumulative from the beginning of the year									
NBS, net	30.01	-992.01	-1041.50	943.97	-608.63	-725.22	169.79	-778.03	-101.66	-216.59
Gross foreign reserves	-385.77	-1576.91	-1822.60	240.33	-793.11	-1090.74	-276.23	-1309.69	-671.02	-868.83
Foreign liabilities	415.78	584.90	781.10	703.63	184.49	365.52	446.02	531.66	569.35	652.24
IMF	401.14	568.40	759.83	695.60	182.35	364.90	446.72	539.97	579.34	646.52
Other liabilities	14.65	16.50	21.27	8.03	2.14	0.61	-0.70	-8.31	-9.98	5.73
NBS, NET RESERVES-STRUCTURE										
1. NBS, net	30.01	-992.01	-1041.50	943.97	-608.63	-725.22	169.79	-778.03	-101.66	-216.59
1.1 Commercial banks deposits	911.80	967.01	1058.25	240.42	-125.77	91.72	28.90	610.69	590.01	580.76
1.2 Government deposits	-811.79	47.05	209.55	-359.83	144.17	541.44	-162.64	48.59	0.60	155.71
1.3 **NBS own reserves** (1.3 = 1 - 1.1 - 1.2)	130.02	22.06	226.30	824.56	-590.22	-92.05	36.05	-118.75	488.94	519.88

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

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



Source: NBS

The increase of the net own reserves had a positive effect on the growth of primary money. At the level of Q2, primary money grew by 3.04% compared to the value at the start of the year also thanks to the growth of net domestic assets by 1.94% of the value of the initial primary money. The growth of the net domestic assets was achieved thanks to a decrease of the state deposits in the account at the NBS while business banks acted in the opposite direction by placing surplus liquidity in REPO bonds.

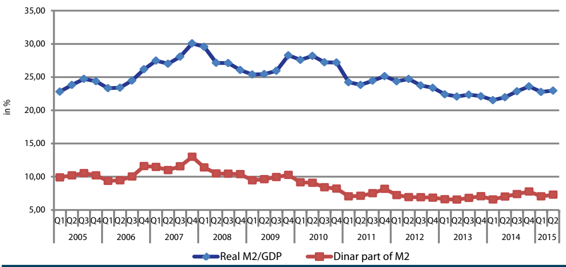
Monetary system: structure and trends of money mass

The money mass continued growing in Q2...

... mainly thanks to growth of net domestic assets

The growth of the money mass M2[2] continued in Q2 with a slight slowing down compared to the start of the year. The money mass recorded a nominal growth of 7.85% y.o.y. (in Q1 the money mass achieved a nominal growth of 8.5%, Table T7-4), while the growth of loans in the non-government sector stood at 4.2% y.o.y. Within this segment, loans to the households grew at a nominal rate of 4.9% y.o.y. while a y.o.y. nominal drop of –1% was recorded with the enterprises. The real y.o.y. growth rate M2 corrected by the level of inflation in the observed period in Q2 stood at 5.8% while the real rate of growth of loans in the non-government sector stood at 2.2% y.o.y. The real growth rate of loans to households in Q2 stood at 2.9% y.o.y. while a drop of –2.9% y.o.y. was recorded with the enterprises. At the quarterly level, the money mass recorded a growth of 2.2% compared to the value at the start of the year. The growth of the money mass had a positive effect on the growth of net domestic assets of 2% compared to the level of the money mass at the start of the year while the net domestic assets had a slight effect on growth with their increase of 0.2% compared to the initial M2. The growth of the net domestic assets at the quarterly level was achieved thanks to an increase of the capital of business banks and the NBS in Q2 while loans to the government and non-government sector had a negative contribution to the overall growth of the net domestic assets.

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



Source: *QM* calculation

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

	2013				2014				2015	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
					y-o-y, in %					
M2[1)]	8.2	4.5	6.1	4.6	4.2	4.8	6.6	8.7	8.5	7.8
Credit to the non-government sector[2)]	1.9	-0.5	-4.4	-4.5	-6.1	-4.5	-1.2	2.9	5.8	4.2
Credit to the non-government sector[2)], adjusted[3)]	1.6	0.6	-4.1	-5.0	-8.2	-5.4	-3.7	-0.8	2.8	1.2
Households	3.0	2.9	2.9	2.6	2.0	2.5	3.0	3.6	5.5	4.9
Enterprises	0.9	-0.6	-7.6	-8.8	-13.4	-9.7	-7.3	-3.4	1.2	-1.0
					real y-o-y, in %					
M2[1)]	-2.6	-5	1.2	2.3	1.9	3.5	4.3	6.7	6.4	5.8
Credit to the non-government sector[2)]	-8.2	-9.2	-8.9	-6.5	-8.3	-5.7	-3.3	1.1	3.7	2.2
Credit to the non-government sector[2)], adjusted[3)]	-8.7	-8.2	-8.5	-7.0	-10.3	-6.7	-5.8	-2.5	0.8	-0.7
Households	-7.5	-6.1	-1.9	0.4	-0.3	1.2	0.7	1.8	3.4	2.9
Enterprises	-9.3	-9.3	-11.8	-10.7	-15.4	-10.8	-9.3	-4.9	-0.8	-2.9
					in bilions of dinars, end of period					
M2[1)]	1622.7	1659.8	1705.8	1719.3	1691.4	1740.2	1818.4	1864.7	1835.4	1876.1
M2[1)] dinars	478.8	492.5	519.5	547.6	516.4	555.3	587.1	614.5	567.8	595.3
Fx deposits (enterprise and housholds)	1143.8	1167.3	1186.3	1169.3	1175.0	1185.0	1231.3	1250.2	1267.7	1280.8
					cumulative, in % of opening M2[4)]					
M2[1)]	-1.2	1.1	3.9	4.6	-1.5	1.4	5.9	8.6	-1.6	0.6
NFA, dinar increase	7.2	2.7	5.2	10.6	0.2	-0.1	11.7	11.1	3.2	3.4
NDA	-8.4	-1.6	-1.3	-6.0	-1.6	1.4	-5.8	-2.4	-4.7	-2.7

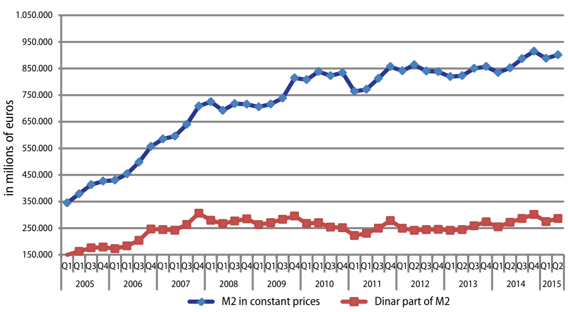
Source: NBS
1) Money mass: components – see Analytical and Notation Conventions QM.
2) Loans to non-governmetn sector – loans to economy (including local government) and households.
3) Trends are corrected by changes to exchange rate. Corrections are implemented under the assumption that 70% of the loans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

All elements of M2 contribute positively in Q2

An analysis of the nominal growth of M2 which in Q2 stood at 7.8% y.o.y., we notice the continuation of the established trend in which all elements make a positive contribution to overall growth. As to date, the single greatest contribution is from foreign currency deposits

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

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



Source: *QM* calculation

which participated with 5.5 percentage points in the growth of M2. Savings and timed deposits participate in the growth of M2 with 0.86 percentage points which, as in the case of foreign currency deposits, is approximately the same level as in the previous quarter. The lowest M1 aggregate participated in the growth of M2 with 1.44 percentage points which is a decrease compared to Q1 because of which the overall nominal growth in this quarter is somewhat lower (in Q1 the M1 contribution stood at 2.22 percentage points).

Banking sector: placements and sources of financing

Placements of banking sector grow in Q2 …

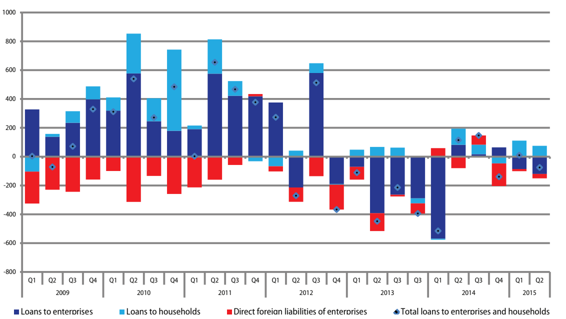
… but mostly thanks to return to REPO bonds

The enterprises are again deleveraging …

... to domestic banks and on the basis of cross-border loans

Following the drop in Q1 business banks recorded a rise in net placements of 169 million Euro in Q2. This growth is still mainly the consequence of the return of banks to REPO placements while the negative trends continued in the economic domain. After business banks withdrew almost all their funds from REPO bonds at the start of the year, in Q2 part of the liquidity of business banks totaling 166 million Euro was once again used for REPO placements (in Q1 66 million Euro were withdrawn from REPO placements, Table T7-6). Besides that, the rise in the balance of net loans to the government of 47 million Euro made a positive contribution to the growth of overall placements in the banking sector. In Q2, the divergent trends from the start of the year continued in the enterprises and the households with the overall effect being negative because of a speedier debt repayment by the enterprises compared to the growth of the indebtedness of the households. A rise of net placements totaling 75 million Euro was recorded with the households in Q2 (in Q1 a growth of 111 million Euro was recorded), with more than half of the new placements being in the form of cash credit while housing loans continue to be at a low level. In the same period, the households repaid debts to domestic banks totaling 121 million Euro which is even more than the amount recorded at the start of the year (in Q1 the enterprises repaid a total of 86 million Euro of its debts). The greater repayment of debts by the enterprises compared to the growth of placements to the households caused the overall net placements of business banks to the non-government sector in Q2 to be negative and stand at –45 million Euro. The negative trend in the repayment of debts by the enterprises continued also in the segment of cross-border loans which recorded a decrease in net placements by 31 million Euro. If we observe the overall placements from domestic and foreign sources at the level of Q2, the non-government sector (the enterprises and the households) reduced its indebtedness by 76 million Euro (in Q1 positive net placements of 9 million Euro were recorded, Graph T7-7).

Graph T7-7. Growth of new loans to the enterprises and households, 2009-2015



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

Table T7-6. Bank operations – sources and structure of placements, corrected[1] trends, 2013-2015

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

Source: NBS

1) Calculating growth is done under the assumption that 70% of overall placements are indexed against the Euro. Growth for original Dinar values of deposits are calculated on the basis of 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 are calculated on the basis of the exchange rate of the Euro at the ends of the period and do not include the effects of the change of the exchange rate from the calculation of the remaining balance.

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

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

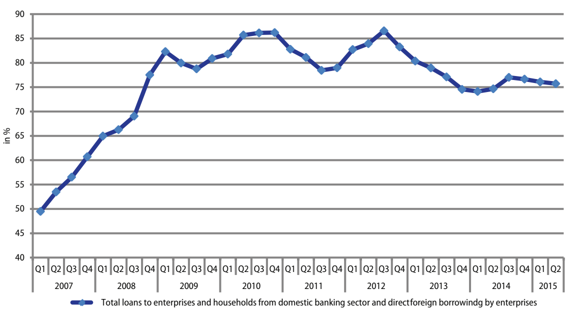
4) Other debts by the NBS (net): the difference between what the NBS owes banks on the basis of cash and free reserves and debts to the NBS.

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

6) The effective mandatory reserve represents the participation of the mandatory reserve and deposits in the total of overall deposits (households and the economy) and bank debts abroad. The basis to calculate mandatory reserves does not include subordinate debts because they are unavailable

Sources for new placements increasing in Q2

Graph T7-8. Overall credit indebtedness by private sector, 2007-2015



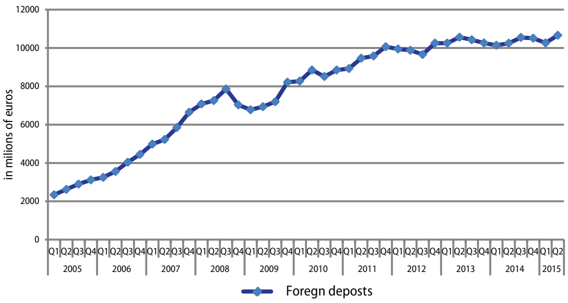
Source: *QM* calculation

The liquidity of banks in Q2, unlike the previous quarter, was increased by 208 million Euro (in Q1 the sources for new placements by bank were decreased by 241 million Euro, Table T7-6). Business banks increased their sources for new placements on the basis of the growth of domestic deposits and an increase of capital while the continuing repayment of debts outside the country neutralized a part of the growth. Following the decrease in Q1, banks recorded an increase of 165 million Euro in domestic deposit accounts with both the enterprises and the households increasing their funds in deposit accounts. Among the households, this increase totaled 93 million Euro with more than 80% in Dinars despite the fact that the payment of this years installment of the old foreign currency savings was paid in June. Something similar was recorded in the deposit accounts of the enterprises which were increased by 72 million Euro of which around 77% was in Dinars. The decrease in the capital and reserve accounts of business banks which was recorded at the start of the year was completely neutralized in Q2 in almost the same amount of 157 million Euro which additionally increased the credit potential of banks. The repayment of borrowed funds to head offices abroad had a negative effect only on the growth of sources for new placements with banks

Participation of bad loans is showing unusual variations …

…but does not drop below the level of 20%

Graph T7-9. Level of foreign currency deposits, 2005-2015



Source: NBS

in Q2 increased their debt repayments to 114 million Euro (in Q1 business banks repaid a total of 36 million Euro in debts outside the country).

According to data from the Credit Bureau, the participation of bad loans was additionally increased in Q2. The participation of bad loans at the end of the month of June reached the level of 23.04% (in Q1 their overall participation stood at 21.27%, Graph T7-12) despite a decrease which was recorded in the entrepreneur sector. The latest figures on bad loans from the end of August show a drop in their participation to 20.75% which is the lowest value over the past two years. Bearing in mind that oscillations have been noticed which are extremely unusual for this time period of several months, we are expressing a reservation towards the reliability of the data on loans whose repayment is late which the Credit Bureau published. The growth of the participation of bad loans in Q2 is due to the segment of companies in which an increase of bad loans of 2.7 percentage points was recorded which had the greatest effect on the growth of the overall participation since bad loans in this segment account for around 80% of the overall bad placements. A deterioration was also recorded among the households whose participation in bad loans grew by 1.7 percentage points which represents the highest value of participation registered to date in the households segment. This deterioration can be explained in part with the delayed reaction to the rise in value of the Swiss Franc at the start of this year. The state of bad loans (stock) by segment shows that following the stabilization of the overall amount of bad loans which started in the middle of last year, a growth of the overall level was recorded once again (Graph T7-11).

Table T7-10. Participation of bad loans according to type of debtor, 2009-2015

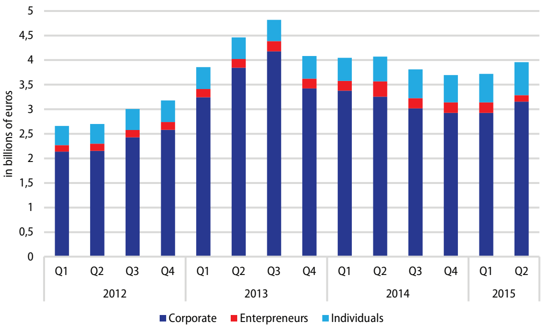
	2009	2010	2011	2012	2013				2014				2015	
	Dec	Dec	Dec	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Q1	Q2
	balance at the end of period													
Corporate	12.14	14.02	17.07	19.06	22.62	27.77	31.13	27.76	28.67	28.12	26.76	25.5	25.85	28.63
Entrepreneurs	11.21	15.8	17.07	15.92	16.79	18.19	20.86	20.82	21.11	29.77	43.61	43.29	45.19	34.91
Individuals	6.69	6.71	7.24	8.32	8.44	8.37	8.14	8.59	8.7	9.22	11.41	9.97	10.16	11.30
Ammount of dept by NPL (in bilions of euros)	1.58	1.94	2.63	3.19	3.87	4.47	4.82	4.09	4.05	4.07	3.81	3.70	3.72	3.96

Source: *QM* calculation

The resolving of the problem of bad loans would remove the risks to public finances and would get credit activity moving

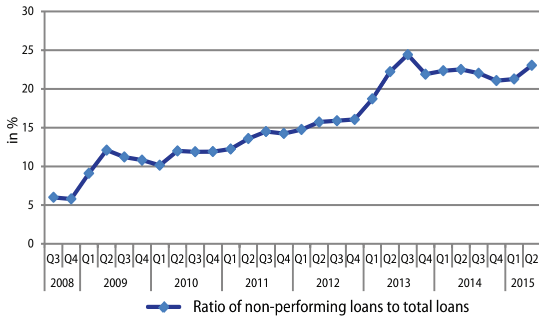
Even though an important part of the talks during the negotiations with the International Monetary Fund were devoted to the segment of bad loans, the set of concrete measures aimed at resolving this problem will be implemented at the start of 2016 at the earliest. Namely, on the basis of the mentioned talks, the NBS adopted its action plan for implementation of the *Strategy To Resolve Problematic Loans* in August. The adopted action plan is for the most part oriented towards creating a new system with prevention mechanisms to prevent the sudden growth of bad loans. A part of those measures are linked to the resolving of the currently high participation of bad loans but the framework for its implementation was moved further to the middle of 2016. Despite the high capitalization level of a majority of business banks in Serbia, we believe that the resolving of the problem of bad loans must not be delayed any longer. Besides the stability of the banking system, the high participation of bad loans is having a negative effect on the level of credit activity in the economy through interest rates on new loans which would be lower if banks did not have to make reserves on that basis.

Graph T7-11. Amount of remaining debt on credits running late, 2012-2015



Source: *QM* calculation

Graph T7-12. Participation of bad loans in overall placement, 2008-2015



Source: *QM* calculation

HIGHLIGHTS

Highlight 1. The Greek Crisis – Causes, Myths and Lessons

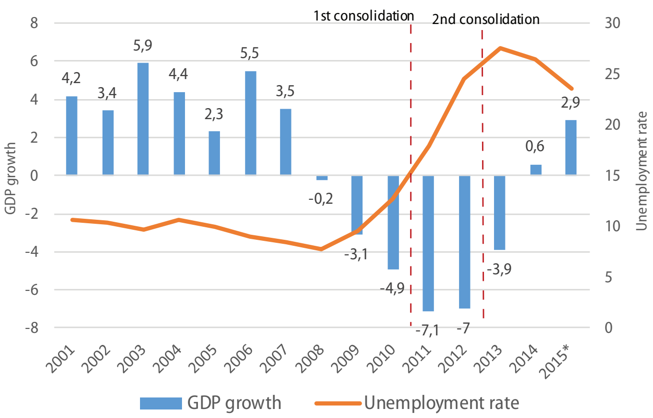
Saša Ranđelović [1], *Milojko Arsić* [2]

Modern Greek state, since the liberation from Turkey (in the first half of the 19th century) until today has *de facto* bankrupted five times. The first bankruptcy occurred right after the liberation from Turkey, because the state could not pay its debt to the British banks, which was taken out in order to purchase weapons for the uprising. The last public debt crisis, which has lasted since 2010, is also in a wider sense a bankruptcy, because the state was not able to service the entire debt under the existing conditions, which is why part of the debt was written off, payment period extended, and interest rates reduced. Frequent public debt crisis in Greece indicate society's high tolerance to borrowing and a low degree of institutional development, which is necessary for ensuring sustainability of public finances.

Causes of Crisis

Since entering Eurozone (in 2001) until the crisis (in 2008), Greek economy was growing at a rate of 4.2% (Graph 1), which is significantly faster that the Eurozone average, primarily due to strong increase of state and personal consumption. As a result, since the beginning of the crisis Greece has had an extremely high current account balance of payments deficit which in 2008 reached almost 15% of GDP, which caused considerable dependency on inflow of foreign capital. High level of foreign deficit in the long term indicates Greek economy's uncompetitiveness, which was mostly caused by the policy of high wages (in relation to productivity) and inability to use currency depreciation as a mechanism of improving international competitiveness. Global financial crisis has caused a significant decline in capital inflow, which in 2009 caused a problem with financing foreign debit and its consequential decline by one third. Decline of foreign capital inflow automatically caused a strong decline of GDP, citizen consumption, and tax revenue, i.e. an increase of fiscal deficit and public debt already in 2009, before Greece applied austerity measures.

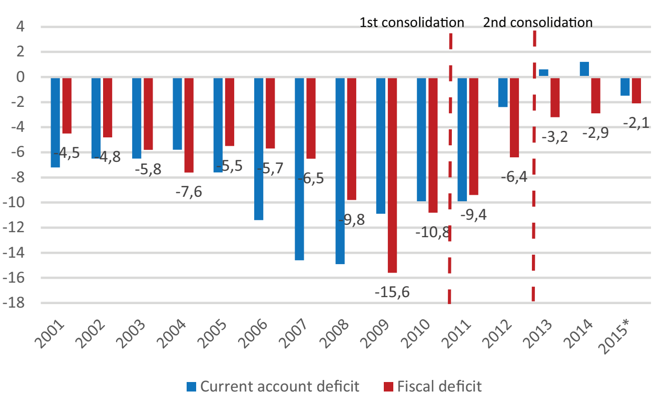
Graph 1. Greece: GDP Growth Rate and Unemployment Rate



Source: Eurostat

Aside from external imbalance, Greece has had a significant internal imbalance as well during the past decades, primarily in the sense of high fiscal deficit. Even in 2001, which was the first year of its membership in Eurozone, Greece's fiscal deficit (4.2% of GDP) was higher that the limit prescribed by the Maastricht Treaty, only to continue growing in the following years. In the period 2001-2008 the fiscal deficit was on average 6.3% of GDP, and from 2009 to 2014 it was around 8% of GDP. Significant contributing factors were the failed implementation of the 2001 pension reform, tax reduction (reducing VAT rate before entering Eurozone in order to meet the inflation requirement), continued policy of uncontrolled public sector hiring, and very broadly defined rights in the public sector (wages, supplements, social contributions, etc.), which made the share of current spending in the overall public spending in Greece significantly above the European average. Also contributing to the high fiscal deficit was the high level of corruption

Graph 2. Greece: Consolidated Fiscal Deficit and Current Account Balance of Payments Deficit (% of GDP)



Source: Eurostat

1 Economic Faculty of the University of Belgrade and *QM*
2 Economic Faculty of the University of Belgrade and *QM*

and tolerance toward grey economy. In addition, high foreign deficit and the resulting high revenue from consumption tax stimulated the continuation of expansive fiscal policy, blurring the true picture of a high deficit.

High current account balance of payments deficit (14.9% of GDP) and high fiscal deficit (9.8% of GDP) in 2008, made Greece very exposed to the shocks caused by global economic crisis – decline in foreign capital inflow made the country's external position unsustainable, and high fiscal deficit and small fiscal multipliers narrowed the country's manoeuvring space to use countercyclical measures of economic policy in order to absorb part of the negative external shocks on economic activity. That is why in 2009 Greece entered into recession. Unlike other European states that managed to stabilise in 2010, recession in Greece was additionally deepened in that year as a result of a strong decline in trust in the sustainability of public finances, due to an extremely high fiscal deficit and very high public debt. Discovery that the real fiscal deficit in the past years was much higher than the officially announced one (thus, the estimated deficit for 2009 was revised from 7% of GDP to 15.6% of GDP) additionally increased investors' distrust in the sustainability of public finances. Thus, access of Greece to international financial market was limited, so the aid of the European Union and IMF was necessary in order to provide liquidity of the state (for servicing matured obligations and financial deficit). The aid arrived as part of the First Programme of Economic Reforms (concluded with EU, ECB and IMF), which included implementation of a strong fiscal consolidation until the end of 2010 and a series of structural reforms. A similar scenario was applied to the Second Programme as well, which included implementation of additional measures of fiscal consolidation until the end of 2012 and further structural reforms (privatisation, public sector reform, etc.). Since Greek fiscal deficit was extremely high and mostly of structural nature, i.e. result of discretionary decisions on reducing taxes and increasing spending, implementation of a strong fiscal consolidation was necessary and justified.

Macroeconomic data for 2014 and preliminary assessments for 2015 (made before the radical left came to power) indicate that implemented measures of fiscal consolidation and other structural reforms started to yield results – fiscal deficit was reduced to 2.9% of GDP, current account balance of payments deficit was eliminated, so in 2014 a surplus of 1.2% of GDP was realised, and after declining for six previous years, GDP in 2014 recorded a real growth of 0.6%, while unemployment rate dropped from 27.5% (in 2013) to 23.5% (in 2015). Stopping reforms and fiscal consolidation in mid-2014, as well as the radical turn with the election of the new Government at the beginning of 2015, caused the trust of investors and consumers to strongly decline, which slowed down or reversed the positive trends from 2014. Slower than planned growth of economic activity and consequently a higher fiscal deficit have led to the need for the Third Programme of reforms, concluded in August 2015, to include even stricter measures of fiscal consolidation than was initially planned in order to achieve originally envisioned fiscal goals. So giving up on reforms in their final stage, when the toughest measures of consolidation had already been implemented and started to yield results, will have a negative impact on economic recovery and macroeconomic stabilisation, because after new fluctuations it will be considerably harder to regain the investors' trust.

Myths

We can often hear in the public here and abroad some unfounded claims regarding the economic crisis in Greece and implemented programmes of fiscal consolidation which often do not correspond to the facts and are only confusing the broader public primarily regarding the need for implementation of fiscal consolidation and its effects.

For example, we often hear a claim that the decline of economic activity in Greece, which between 2008 and 2013 cumulatively amounted to 26.2%, is the result of austerity measures. Data on the growth rate of GDP (Graph 1) show that the strong decline of economic activity in Greece started back in 2008, long before the implementation of fiscal consolidation, which started at the end of 2010. Thus, the decline of GDP before 2011 cannot be ascribed to fiscal consolidation, i.e. to austerity measures, while the decline of GDP after that can for the most part, although not entirely, be ascribed to austerity measures. It can therefore be concluded that the recession in Greece is primarily the result of a low level of the economy's competitiveness and the resulting structural imbalances (high foreign deficit), as well as lack of investors' trust in macroeconomic stability of the country (which reflects on the drop in investments). So, unit labour costs in Greece in the period 2001-2010 increased significantly (by around 12%) while they mildly decreased in the rest of the Eurozone (by around 3%), which undermined the country's competitiveness. This is the consequence of a growth strategy based on domestic demand, financed by borrowing and growth of wages above the growth of productivity, as well as the inability to improve international competitiveness by currency depreciation (due to the membership in the monetary union). Implemented fiscal consolidation also contributed to the decline of GDP, but its influence is smaller than that of factors related to competitiveness and macroeconomic instability, because in a small open economy, with relatively undeveloped industry and significant dependency on export of services (tourism), fiscal multipliers, as a rule, are not very high. On the other hand, it is possible that a different structure and dynamic of fiscal consolidation could have had lesser negative effects on economic growth. In support of this argument is the fact that total reduction of expenditures and increase of revenue due to applied measures of fiscal consolidation is considerably higher than the realised reduction of deficit, and that the difference can be ascribed to the change in economic structure, as well as negative effects of fiscal adjustment to economic activity.

Second claim often heard in public indicates that fiscal consolidation does not contribute to the reduction of fiscal deficit, as the resulting decline of GDP and tax revenue is higher than direct effects of consolidation. Data on the trends of fiscal deficit indicate quite the opposite – that through the implementation of fiscal consolidation measures, the fiscal deficit of Greece in the period 2009-2014 was reduced by 13.5% of GDP, from 15.6% to around 2.1% of GDP. This proves the rule that reduction of fiscal deficit which occurred due to discretionary measures (reduction of taxes/increase of spending) requires an implementation of opposite discretionary measures (increase of taxes/reduction of spending).

Third claim refers to high (usurious) interests imposed on Greece for the public debt significantly contributing to its fiscal deficit. Level of interest rate at which a country borrows funds on the market depends on the sustainability of its public finances, economic growth perspective and conditions of borrowing on the global financial market. Due to the policy of extremely high deficit and resulting growth of public debt, which has continuously been at the level of over 100% of GDP since 1999, interest rates on Greece's loans grew as well. However, the First Programme in 2010 significantly restructured the public debt – debt toward private creditors (primarily banks and investment funds) was mostly paid off through loans to Greece from the EU member states, and the interest rates on loans from EU member states were quite low and the payment period was extended (average maturity of Greek public debt is around 17 years). This way, the EU member states gave a considerable contribution to the fiscal consolidation in Greece through a significant reduction of interest cost in 2011 and the following years. Thus, the effective interest rate of the remaining debt of Greece (interest expenses/public debt) dropped from 4.9% in 2011 to 2.5% in 2014, which on average caused the interest expenses (and total expenses and total fiscal deficit) to be lower by around 4% of GDP annually. Effective interest rate on the country's long-term borrowing of 2.5% is considered quite favourable, even for the countries with a much lower debt level and better macroeconomic performance than Greece. As a comparison, in 2014 Greece had a debt of 170% of GDP and was paying interest of 4.5% of GDP, while Serbia with a debt of around 70% of GDP paid interest of around 3% of GDP (effective interest rate for Serbia is 4.2%). Stated data show that through two programmes Greece received an effective write-off of a significant portion of future obligations (through reduced interest rates and extended period of payment), and that the remaining part of fiscal adjustment should be implemented through other measures. On the other hand, it is often stated that by approving aid to Greece through two programmes, EU countries were practically saving their banks from large losses from potential writing off of Greece's debt. This claim is mostly true, where the argument for implementing such a policy is the need to ensure stability of the banking system, while the unequivocal downside of this decision is the transfer of cost of risky management behaviour of these banks from their shareholders to all tax payers.

Forth claim that is especially widespread in the public is that, unlike some other countries (e.g. Germany in 1953), Greece never had its debt written off. However, the facts are quite different, because in 2012 Greece did have 105 billion euros of its public debt written off by private creditors (mostly banks) which at the time was around 28% of its public debt. In addition, taking over of the biggest part of Greek public debt by non-commercial creditors (EU member states and international organisations), the interest rates on Greek debt were dramatically reduced compared to the market interest rates at which Greece borrowed money, but also compared to the interest rates at which other countries borrow money as well (e.g. Serbia, Croatia, Hungary). Depending on which interest rate is taken as a reference point, it is estimated that the reduction of interest rates indirectly wrote off between 1/3 and ½ of the Greek debt. The misconception that Greece never had its debt written off probably comes from the fact that soon after it was written off, the Greek debt reached an amount very close to the one before it was written off?! There are three main reasons why Greek debt reached its old level soon after it was written off. First, Greece did a recapitalisation of its banks in order to prevent their bankruptcy[3]; second, due to late fiscal consolidation, the fiscal deficit was even after the debt was written off still quite high, so its fi-

3 There is a bit of an absurd claim in the public that Greece saved its banks in order to protect the interests of world powers. Saving of Greek banks is primarily in the interest of the citizens of Greece, because their mass bankruptcy would additionally worsen the crisis in the country. A hypothetical mass bankruptcy of Greek banks would have a negative impact on the countries of South-East Europe where Greek banks are present, while the negative effect on developed countries would be relatively modest.

nancing led to another strong growth of public debt. Sharp decline of GDP in 2012 and 2013 also affected the growth of debt to GDP ratio.

Another widespread misconception is that the banks, especially foreign ones, made a huge profit on loans they approved for Greece. However, the truth is that by writing off a large part of the debt, the banks incurred big losses in 2012 from the Greek public debt. Just what effect business with Greece had on the banks is best described on the example of Cyprus whose banking system was on a verge of bankruptcy after the Greek debt was written off. Big western banks also incurred losses in doing business with Greece, but thanks to their size they were able to withstand those losses. As in previous cases, there is a reason why a superficial observer was misled. During the period when the agreement with the creditors was uncertain, Greece borrowed several billion euros at very high interest rates in order to bridge liquidity. However, the share of those expensive loans in the total loans was pretty insignificant, so they didn't affect the trend of average effective interest rates.

The next misconception concerning the Greek public debt is that it is often claimed that Greece has no prospects for recovering its economy due to the huge cost of servicing the loan. However, the cost of servicing Greece's public debt (as % of GDP) in the next ten years will be lower than the cost of servicing the public debt of many European countries, including Serbia. The reason is that Greek interest rates are quite low and the average maturity is 17 years, which is twice as long as in other countries. Therefore, servicing public debt will not pose a bigger burden on Greece in relation to GDP than in any other European country. However, in this case there are facts that are seemingly supporting this misconception and that is that the Greek public debt under current conditions of financing will stay quite high in the future. If Greece tried to lower the level of its debt from high fiscal surplus, it would probably lead to economic exhaustion of the country. That is why it is pretty certain that Greece's recovery requires part of the public debt to be written off, after Greece stabilises the deficit at a very low level or transfers to the surplus. And Greece's problem are not high costs of servicing the debt in the coming years, but the inability to reduce the absolute level of the debt and its relation to GDP.

Finally, another wrong claim that is stated in European public is based on the stand that Greece is not implementing reforms, but is waiting for the burden of its spending to be permanently financed by tax payers of other European countries. According to the official data, in the period 2009-2014, Greek fiscal deficit was reduced by 13.5% of GDP, while structural fiscal deficit was reduced by as much as 16.7% of GDP (so in 2014 a structural surplus was realised of 2% of GDP). That was a very large fiscal adjustment in a relatively short period of time, which was necessary having in mind the high deficit and the dynamic of the public debt. The First Programme of fiscal consolidation (2010-2011) was evenly distributed between the reduction of spending and increase of taxes, while the Second Programme (2013-2014) was mostly based on the reduction of spending. As a result of recession and fiscal consolidation, average disposable income of households in the last five years has dropped by around 35%, which indicates that great efforts were made in Greece to regain the sustainability of public finances. Besides, significant part of work was done in the domain of structural reforms, also proven by Greece's high ranking on the OECD country list, ranked according to the speed of implementing recommendations for accelerating economic growth.

Lessons

Greek public debt crisis offers an opportunity to draw many lessons, most of which are relevant to Serbia.

It is important that the growth of economy is sustainable in the long term, and growth is sustainable if it is realised with little internal and external imbalances. In the period 2001-2007, Greece was realising high growth rates of GDP and even faster growth of income and consumer spending, but at the same time, it had high deficit in the current balance of payments and high fiscal deficit. Such a growth model means that a large part of investments and spending is financed by foreign loans and foreign direct investments. Problems are even bigger if the foreign loans are used to finance current spending, and bigger part of foreign investments goes to the sector of non-tradable goods.

It is important that the democratic processes used to pass decisions on fiscal and other economic policies are considering the long-term consequences of adopted policies. There is a risk in young democracies of establishing unsustainable arrangement between politicians, who are using the loans to finance high consumer spending, and citizens who are tolerating their corruptive actions and give them support in elections. Politicians, bureaucrats and citizens should resist the temptation to temporarily increase spending at the expense of the citizens of other countries and the expense of future generations of their own country. Increase in spending through taking out foreign loans that cannot be or will not be repaid has limited range, while spending at the expense of future generations is morally questionable.

High deficit in current balance of payments poses a risk not only to the country's growth but to the sustainability of its public finances as well. High deficit can be financed as long as there is a trust of foreign investors, but when it is gone for whatever reason, then that leads to forced reduction of the foreign deficit, but also to the decline of private spending, investments and, consequently, the GDP as well. Decline in GDP automatically leads to a decline in tax revenue, which increases the fiscal deficit and public debt. This is exactly what happened in Greece in 2009-2010, when sudden reduction in the inflow of foreign capital led to the decline of GDP, before the Government applied austerity measures.

It is important that the national currency exchange rate be adjusted to other macroeconomic variables, such as productivity and earnings. If the exchange rate is not aligned to productivity and earnings, then it is possible that the country is realising high growth with foreign deficit, financing of which depends on the moodiness of the global capital market. Countries that have a fixed exchange rate, such as Greece, maintain the macroeconomic balance through adjusting salaries, pensions, etc. with the exchange rate. In case of a country with a flexible exchange rate, such as Serbia, the alignment can be implemented through income policy and control of domestic demand, as well as through the exchange rate policy.

If a country has a high fiscal deficit, it is necessary to start consolidating as soon as possible, and measures of consolidation should be strong enough to reduce the deficit in a short time to a sustainable level. Timely implementation of strong consolidation measures is especially important in the case of small economies which have a low credit rating and have no potential for applying fiscal stimuli which would initiate economic growth through increased state spending. A large number of countries at the beginning of the previous crisis applied such measures of reducing fiscal deficit and they resulted in a deep but short-term decline of GDP, followed by a strong recovery of their economies. The experience of Baltic countries, Romania and even Serbia this year is definitely refuting the claims of some economists that austerity measures only worsen the crisis. Delaying fiscal consolidation and hesitating during its implementation only increase the cost of consolidation. Recovery of Greek economy began in the second year after the decisive measures of fiscal consolidation were applied in 2012.

Experience of Greece, and other countries as well, shows that the success of fiscal consolidation, and sustainable economic growth, requires persistence in its implementation. Even a short detour from fiscal consolidation after initial good results, as Greece has done this year, will only increase the cost of fiscal consolidation and delay the economic recovery. In that sense, the experience of Greece, which (temporarily) gave up on fiscal consolidation and structural reforms in their last stages and then came back to the reform programme but under worse conditions, can be educational for other small open economies which are implementing such reforms (e.g. Serbia) in the sense that the success of reforms requires perseverance in their consistent implementation, so that the initial success in their implementation would not be lost due to losses related to the interruption of reforms. Besides, the recent experience of Greece shows that small and medium countries (in economic sense) cannot affect change in the principles of global economy, because that would only be possible within a wider simultaneous action of a larger number of big and economically strong countries, which is highly unlikely. Instead, small and medium countries at the middle level of development should direct their efforts toward optimising their policies in the given context.

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