Economic and fiscal programme of the Republic of Serbia 2012 -2014

Belgrade, January 2012

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ECONOMIC AND FISCAL PROGRAMME OF THE REPUBLIC OF SERBIA FOR 2012

I. Macroeconomic framework for the period 2012 – 2014

1. Economic policy objectives and guidelines in the period 2012 - 2014

1.1. The main economic policy objectives and measures

In the period from 2012 to 2014, macroeconomic policy will be aimed at:

- Macroeconomic stability;
- Dynamic and stable economic growth;
- Increase in employment and living standard.

Economic policy will create conditions for macroeconomic stability through reduction in inflation, fiscal deficit and current account deficit and ensure acceleration of economic growth based on the increase in investment and exports, thus improving the conditions in the labour market and living standard.

Achieving the macroeconomic stability in the next three years requires tight coordination of fiscal and monetary policies. What is particularly important for the strengthening of macroeconomic stability is monetary policy which contributes to the stabilisation of inflationary expectations and reducing inflation, as well as sustainable and foreseeable fiscal policy which contributes to achieving the inflation target.

Acceleration of economic growth becomes the main priority of the economic policy in the next three years. Economic growth in 2011 and 2012 will be more moderate due to a slow recovery of the global economy, especially European economies, lower aggregate demand and delayed labour market adjustment. Faster economic growth is expected in 2013 and 2014, based on the fiscal adjustment and implementation of structural reforms that allow increase in exports, savings, productivity and competitiveness. Economic growth and increase in competitiveness of the economy represent a realistic basis for increase in employment and living standard of the population.

Employment and living standard will grow faster after the end of the economic crisis with further progress of transition and restructuring of the economy, removal of institutional and structural constraints and more efficient economic policy management. Employment and living standard in 2009 and 2010 recorded a sharp drop. In 2011, a mild decrease in employment is expected, whereas employment is likely to rise from 2012. In the process of convergence with the EU, it will be necessary to reduce Serbia’s drastic lagging behind in terms of employment rate of the working age population as one of the key indicators of the national labour market condition, which requires a faster annual economic growth than the EU average, while at the same time ensuring the higher labour intensive growth.

For the accomplishment of the economic policy goals, appropriate measures of fiscal, monetary and structural policy shall be applied in order to mitigate negative effects of the global financial crisis and financial problems in the Euro-area on the Serbian economy.

In the increasingly challenging and uncertain global and regional economic environment, particular attention will be placed on the economic policy measures aimed at the protection against external risks to which the Serbian export is exposed as well as on the external funding opportunities. Special emphasis will be attached to the structural reforms and improvement of the investment climate for attraction of potential investors. Within the economic policy, the implementation of fiscal policy is of particular importance, whereby the main objective is to adjust the fiscal deficit with the adopted rules of fiscal responsibility. In the framework of the structural reforms, main priorities are reforms of public enterprises, reforms in the health and education sectors and reform of the pension system, which should remove major obstacles to economic growth.

Economic policy in the next medium-term period will contribute to the increase in production, export, employment and living standard of citizens through support of the economic activity growth based on tradable goods, higher investment in agricultural production with higher yields and higher level of product finalisation, development of support for export-oriented activities and more efficient guarantee mechanisms for export transactions. A particular challenge for the economic policy in the next medium-term period will be redefinition of the measures to support economy so that the limited room for fiscal incentives should be redirected to those programmes of economic support which would bring, with the available resources, the best results and contribute to the acceleration of the economic growth in the observed period.

The main macroeconomic framework for the next three years foresees, after slow economic growth in 2012, a faster growth in 2013 and 2014, reduction in inflation and current account deficit. To that end, fiscal policy will be further adjusted in line with the defined fiscal responsibility rules, whereas monetary policy will continue total inflation targeting, implementation of the managed floating exchange rate regime and reduction in the financial stability risk. Structural policy will initiate reforms which in the next medium-term period represent the main precondition for a faster economic growth through increasing production capacities of the economy and its competitiveness, savings and export. In order to reduce differences at the level of development, active policy of balanced regional development will be pursued, in line with the long-term plan of the regional development.

1.2. The main fiscal and monetary policy guidelines

The focus of fiscal and monetary policy in the next medium-term period will be to ensure medium-term sustainable economic stability in the country and to create the environment for faster economic growth.

a) The Government will continue to pursue restrictive fiscal policy in line with the principle of fiscal responsibility and fiscal rules defined by the Budget System Law.

Achieving of the macroeconomic stability and economic growth in the next three years requires focusing of the fiscal policy on the credible medium-term adjustment based on the implementation of the defined fiscal rules governing fiscal deficit and public debt.

In the next medium-term period, fiscal policy will be generally focused on the achievement of the following objectives:

- Lower share of public expenditures and fiscal deficit in GDP;
- Relative reduction in public spending will be pursued to the greatest extent possible through reduction in current spending with increase in capital investment level;
- Low and stable tax burden of the economy, with tax discipline strengthening;
- Strengthening of financial discipline in public enterprises at the republic, and local level.

Fiscal framework for the period 2012-2014 foresees the fiscal position of the public sector in accordance with the fiscal rule governing deficit.

The main fiscal policy priority is overall fiscal adjustment in order to reach the level of the targeted deficit by reducing the share of public spending in GDP.

Movements of the major public spending categories, wages and salaries of public sector employees and pensions are determined and limited by implementing specific fiscal rules, the implementation of which gradually leads to the relative reduction in the share of these expenditures.

The remaining required fiscal adjustment was carried out by reduction in discretionary expenditures, i.e. expenditures for purchase of goods and services, subsidies and budget loans. To carry out fiscal adjustment to the required extent, it is necessary to undertake cost-cutting measures at all government levels, both central and local, as well as to ensure more efficient public procurement process, redefine measures of economic support in order to redirect the considerably limited resources for fiscal incentives towards those programmes of economic support that bring the best results from the aspect of fostering economic growth and unemployment reduction.

Fiscal adjustment mainly foresees the measures for reduction in current spending. In addition, room for capital investment remains limited. In the area of public investment, it is necessary to set priorities, taking into account the limited resources and investment in the projects with the most favourable public benefit-cost ratio. Besides the limited domestic, budget sources of funding, it is necessary, considering the level of indebtedness and fiscal rule which limits the debt ratio to 45% of GDP, set investment priorities which will be financed by loans, both from the international financial institutions and through bilateral borrowings.

Structural reforms of the massive and inefficient public sector, especially reforms of the pension system, health sector, education and public enterprises, shall play the key role from the aspect of fiscal sustainability in the medium and long term. A special attention will be attached to the establishment of the efficient, equitable and fiscally sustainable pension system. High contribution rate for the public pension insurance and high budget transfers to the government pension fund in the circumstances of rapid population aging require gradual raise of retirement age and granting higher incentives in the labour market with a view to increasing the number of employees in relation to the number of pensioners, with possibility of introducing an appropriate replacement rate for pensioners who were paying contributions to the state pension fund for 40 years on average.

b) The NBS will retain in the next three years the current monetary regime with the managed floating exchange rate.

According to the Agreement on inflation targeting in the next medium-term period, monetary policy will be focused on the achievement of the inflation rate target. The NBS will use all available instruments within its scope of competence to achieve the medium-term inflation target. In achieving the target, the interest rate applied in the implementation of two-week repo operations and the amount of which will be determined in sustainable and predictable manner, depending on the economic trends and inflation projections, will play a key role.

The National Bank of Serbia will continue to pursue the managed floating exchange rate regime, with the right to intervene in the foreign exchange market in order to mitigate excessive daily exchange rate fluctuations and/or stimulate volume of transactions for smooth functioning of the foreign exchange market, as well as for maintaining stability of the financial system and prices in the local market.

1.3. The main structural policy guidelines

For achieving macroeconomic stability and acceleration of economic growth in the next three years, economic reforms for removal of structural obstacles for economic growth shall be of crucial importance.

Economic crisis has revealed a number of structural weaknesses which still have negative effects on the country's economic development, such as: big state influence on the economy due to slow restructuring and privatisation of the large sector of public enterprises, presence of administrative obstacles which burden business environment and reduce legal security; lack of competition in certain sectors: infrastructure bottlenecks which affect the country's economic potential, structural inflexibility of the labour market, high share of informal economy.

Removal of the structural obstacles for economic growth requires implementation of the active structural policy in the next medium-term period. Structural reforms should accelerate the implementation of reforms that will improve the investment climate and management of public enterprises, increase labour market flexibility, improve education and health care, and establish a fiscally sustainable public pension system.

In order to strengthen the capacity of the economy to respond in the medium-term to the pressures of competition and market forces from the EU, the process of restructuring of economy will be accelerated through improvement of the business environment, strengthening of the rule of law and removal of administrative obstacles, strengthening of competition and role of the private sector, as well as removal of inflexible conditions in the labour market. To achieve this, Serbia will continue to pursue structural reforms aimed at improving the productivity of economy and creating business climate that will allow growth in foreign investment.

Restructuring and privatisation of the rest of socially-owned companies, presently in the portfolio of the Privatisation Agency, will be accelerated, based on the economic feasibility studies of companies and estimates for the survival of the sustainable companies without subsidies from the Republic budget. Furthermore, restructuring and privatisation of large state companies will be accelerated, in order to improve management of state companies and enhance their efficiency and then, to privatise most of such companies by attracting strategic investors. Therefore, the Government will introduce a tighter control and supervision of all state companies, including limitation of the wage volume in all such companies; conversion of all large state companies into joint stock companies will be finished, transparency in state companies' operations will be improved by regular publication of their financial statements and professional competence of managers and operational independence of state companies will be strengthened.

In the next medium-term period, activities for the public sector reform will be intensified, in order to enhance their efficiency. Priority reforms of the public sector, which will be implemented in the next three years, include the pension system, healthcare system, education system, social welfare system and subsidies.

Within the structural reforms, legal and institutional preconditions are created that solve and guarantee property rights in Serbia through the amendment to the Planning and Construction Law and adoption of the Public Property Law and the Law on Restitution of Confiscated Property and Indemnification, implementation of which is of vital importance for reducing investment insecurity of private investors

In order to foster creation of new jobs, additional labour market reforms will be carried out, focusing on the amendment to the Labour Law and allowing better flexibility of the labour market and regulation of the relations between employees and employer. Furthermore, other labour market constraints will be removed and measures to support job seekers and collective bargaining will be re-examined.

Other structural reforms will be further implemented, such as legislative guillotine, regulations governing the area of competition and implementation of the competition protection policy, improvement of Serbia's trade integration, reform of the energy sector in line with the new Energy Law, strengthening of the agricultural sector potential in accordance with the new Strategy for the Development of Serbian Agriculture.

2. Macroeconomic projections for the period 2012-2014

2.1. Macroeconomic trends in 2010 and prospects for 2011

After recession in 2009, Serbian economy achieved in 2010 mild recovery and real GDP growth of 1%, fostered by the recovery of export into the EU countries. All components of the expenditure side of GDP recorded real decline at the year-on-year level, except import and export of goods and services. Export of goods and services was a driver of the economic activity. Current account deficit in 2010 recorded, as in 2009, the level of approximately 8% of GDP, thanks to higher inflow of remittances and lower foreign trade deficit.

Average total employment in 2010 was, after a sharp decline in 2009, reduced by 4.9%, whereas the average number of registered actively unemployed persons, was reduced by 0.1%. Survey-based unemployment rate in October 2010 was 19.2%, i.e. higher by 2.8 percentage points as compared to October 2009.

Year-on-year growth in consumer prices in 2010 was 10.3%. The growth was caused by higher food prices, as well as the effect of the nominal depreciation of dinar.

Real depreciation of dinar in 2010 improved competitiveness of companies in the traded goods sector and led to considerable increase in exports to the EU market. On the other hand, real depreciation had negative effects on the balance sheets of companies which took foreign exchange loans without foreign exchange risk protection.

Table 1. The main economic indicators in 2010 and 2011, in %

	Q1 2010 / Q1 2009	Q2 2010 / Q2 2009	Q3 2010 / Q3 2009	Q4 2010 / Q4 2009	2010 / 2009	Q1 2011 / Q1 2010	Q2 2011 / Q2 2010	Q3 2011 / Q3 1010	I-X 2011 / I-X 2010
GDP, real	-0.2	1.0	1.7	1.2	1.0	3.7*	2.4*	0.7**	
Industrial production, physical volume	1.0	7.2	4.1	-1.6	2.5	5.4	3.6	-1.4	2.0
Turnover in retail trade, real terms	-10.2	-2.0	2.8	4.8	-0.9	-10.5	-19.2	-19.5	-16.8
Tourism, overnight stays	-27.4	-5.8	-0.9	14.9	-5.1	18.1	8.3	0.3	5.4
Construction, constant prices	-20.9	-18.1	-10.8	-1.2	-6.4	-2.3	22.9	23.1	17.0***
Transport, volume of services	5.9	5.2	5.0	15.6	7.8	12.8	11.3	9.2	10.9***
Post activities, volume of services	4.8	3.0	4.5	2.3	3.6	-0.4	2.6	1.6	1.2***
Telecommunications, volume of services	11.9	0.4	8.7	5.2	6.3	8.4	14.0	18.5	13.9***
Export of goods, in EUR, c.i.f.****	15.1	22.5	24.5	32.1	24.0	33.6	15.0	11.7	17.5
Import of goods, in EUR , c.i.f.****	-3.4	13.1	17.6	11.6	9.7	22.8	11.7	7.7	14.1
Average number of employees	-6.1	-4.6	-4.6	-4.6	-4.9	-3.8	-3.2	-2.3	-2.9
Actively unemployed persons, end of period	2.7	-2.1	-2.2	-0.1	-0.1	-0.6	1.3	3.0	2.8
Real average net wages, total	1.6	3.6	2.2	-1.0	0.7	-2.4	-2.2	1.9	-0.5
Real average net wages, public sector	-2.2	-1.6	-3.3	-6.2	-4.1	-6.1	-3.0	0.0	-2.5

* Estimate of the Republic Statistical Office
**Flash estimate of the Republic Statistical Office
*** January-September 2011/January-September 2010
**** Extended coverage – according to the new methodology of the Republic Statistical Office
Source: Republic Statistical Office, NBS, NEA

Serbian economy recorded, after faster growth in the first quarter of 2011, slowdown of the growth caused by production and trade slowdown in the region and EU countries, but also financial problems in the Euro-area, which will represent major risks for the Serbian economy in the coming period, considering strong trade links of Serbia with EU countries and with countries in the region, as well as majority ownership of banks from the Euro-area in the local banking system. Those risks impair Serbia's economic prospects with regard to the economic growth, employment and macroeconomic stability.

Macroeconomic trends in the first ten months of 2011 were characterised by accelerated growth in the economic activity and exports in the first three months, followed by their slowdown, high inflation in the first four months caused by rise in food prices and regulated prices and then, reduction in inflation, slowdown of employment decline, dinar appreciation and risk premium reduction.

In March 2011, the rating agency "Standard & Poor's" increased Serbia's credit rating from (BB-) to (BB). The rating agency "Fitch" confirmed in November the rating (BB-) with stable outlooks.

Economic recovery was accelerated in the first quarter of 2011. In the second quarter of 2011, the economic activity slowed down with achieved annual real GDP growth of 2.4%, primarily due to the reduction in the physical volume of manufacturing industry and drop in retail trade turnover. According to the estimates of the Republic Statistical Office, real annual GDP growth in the first half of the year was 3.0%, whereas GDP growth in the third quarter is estimated at 0.7%. Industrial output recorded in the first ten months annual growth of the physical volume of 2.0%. In this period, retail trade volume recorded real annual drop of 16.8%, whereas the number of tourist overnights showed an increase of 5.4%. From the second quarter of 2011, construction activities started to pick up. The value of the construction works in the first nine months was by 17% higher in real terms than in the same period of 2010.

Acceleration of inflation from the second half of 2010 was continued in the first quarter of 2011. annual increase in consumer prices in March was 14.1%, whereas cumulative increase in consumer prices in the first quarter of 2011, as compared to December 2010, was 5.5%. Increase in CPI was mainly caused by the increase in food prices (4 percentage points). In April, inflation reached its maximum annual level of 14.7%. Monetary policy responded to the threats of spillover of high food price increase on other prices (increase in inflationary expectations) by increasing the reference interest rate as of August 2010. Thank to the undertaken measures and food price stabilisation in the new agricultural season, annual inflation started to fall in May so that in November it was 8.1%. By the end of 2011, annual inflation is expected to continue to fall as a result of further stabilisation of food prices and low aggregate demand, as well as of restrictive monetary policy measures from the previous period.

Export of goods in the first ten months of 2011 recorded annual increase of 17.5%, whereas import of goods recorded increase of 14.1%. Import of goods coverage with export of goods is 59.9%. In the period January-September 2011, current account deficit without donations was EUR 2.2 billion, which represents an annual increase by EUR 209.4 billion. These trends come as a result from the l increase in trade deficit by EUR 207.7 billion. Current account deficit was financed from portfolio investment in the amount of EUR 1.6 billion. Foreign direct investments showed a net inflow of EUR 1.2 billion.

In the period January-October 2011, annual decline of the number of employees in the formal sector was recorded (-2.9%), while the number of actively unemployed persons was increased (2.8%). Average number of employees showed annual decline in Q1 by 3.8%, in Q2 by 3.2%, while in Q3 the decline was 2.3%. In the first ten months, average real net wages recorded decrease of 0.5% compared to the same period of previous year and in the public sector by 2.5%. Average real net wages recorded annual decrease in Q1 of 2.4%, in Q2 of 2.2%, while in Q3 they recorded an increase of 1.9% in real terms. Annual level of average real net wages in the public sector was reduced in Q1 by 6.1% and in Q2 by 3%, while in Q3 this level remained unchanged in real terms.

In the first ten months of 2011 on average dinar appreciated in nominal terms by 0.5%, and in real terms by 9.5%. Strengthening of dinar was supported by high capital inflows, primarily due to foreign direct investment and portfolio investment.

Banks' credit activities towards ecomonic organizations and households recorded decrease of the real growth rate from 15% in January to 9% in October 2011, compared to the same months in the previous year. Real growth rate of credits to households in this period was reduced by 2.9 percentage points and in October it was 6.5%, while at the same time real growth rate of credits to economic orgaizations was reduced by 7.8 percentage points and in October amounted to 10.4%. Credit activities were mainly financed from the domestic sources. Households foreign currency savings rose by 13.9%, compared to October 2010, while cross border borrowing of economic organizations was reduced in comparison to September 2010 by 7.4%. In this period, banks increased their liabilities in NBS securities by 64.9% in nominal terms, whereas liabilities in state-treasury bills nominally rose by 90.2%, due to a higher interest rate (around 13% on average), high security and wider maturity choices. In October 2011, the share of non-performing loans in the total loans was 19.1%, while in the same month previous year it was 17.7%.

Taking into consideration the current macroeconomic trends and planned economic and fiscal policy, a 2% real GDP growth is expected in 2011, based on the growth in investments and net export, whereas final domestic demand will have a negative contribution.

Table 2. Estimates of the main macroeconomic indicators for 2011, in %

	2011
GDP, in billions RSD (current prices)	3,358.8
GDP, real growth	2.0
Investments in fixed capital, real growth	10.5
Export of goods and services	12.6
Import of goods and services	10.3
Current account deficit (with donations), % GDP	7.5
Inflation, end of period	7.7
Number of employees, annual average, in 000 persons	1,745.0
Real average net wages	-0.5

Source: Ministry of Finance

Estimation of GDP from the expenditure side foresees a 10.5% real increase in investments into fixed assets in 2011, after their decline in 2009 and 2010, further reduction in private and government spending of 0.4% respectively and faster growth of export in relation to import growth (in euros) of 14.9% and 11.2% respectively, which will allow reduction in foreign trade deficit and current account deficit at the level of 15.2% and 7.5% of GDP, respectively.

In the labour market, after a sharp decline of the total number of employees in the formal sector in 2009 and in 2010 of 5.5% and 4.9% respectively, it is expected that the decline of the number of employees in 2011 (-2.8%) will slow down. Furthermore, in 2011, average net wages are expected to decline by 0.5%.

After the increase in the annual inflation in the first four months of 2011, from May inflation started to decrease and that trend was continued in the following months as well. Inflation is expected to come down to 7.7% by the end of 2011.

2.2. International environment– Projections of the main economic indicators

The global economic recovery slowed down in the second and third quarter of 2011. According to the Eurostat data, the real GDP growth in the third quarter was 0.6% in the U.S., 0.2% in the Euro area and EU27. Slowing down of the global economic growth, especially the growth in the countries which are Serbia's main foreign trade and investment partners like

Germany and Italy will have negative impact on the recovery of the Serbian economy. In the second quarter of 2011, Italy achieved a low annual GDP growth rate of 0.8% (0.3% seasonally adjusted). Economic recovery is slowing down due to high unemployment and low private consumption, as well as problems of debt refinancing faced by the countries, especially insolvency of some Euro area members. In WEO from September 2011, the IMF downgraded the real GDP growth in the U.S. to 1.5%, in the Euro area to 1.1% and in CEE countries to 4.3%.

Table 3. International environment – The main economic indicators

	2009	2010	2011	2012
Real GDP growth*, %				
- World total	-0.7	5.1	4.0	4.0
- European Union	-4.2	1.8	1.7	1.4
- USA	-3.5	3.0	1.5	1.8
- Emerging and Developing Economies	2.8	7.3	6.4	6.1
- CEE countries	-3.6	4.5	4.3	2.7
World trade volume,%	-10.7	12.8	7.5	5.8
Unemployment rate, %				
- Euro area	9.4	10.1	9.9	9.9
- USA	9.3	9.6	9.1	9.0
Consumer prices, annual changes, %				
- Advanced Economies	0.1	1.6	2.6	1.4
- Emerging and Developing Economies	5.2	6.1	7.5	5.9
Oil price increase, in USD, annual changes, %	-36.3	27.9	30.6	-3.1

* World GDP calculated at purchasing power parity (PPP)
Source: IMF, World Economic Outlook, September 2011

The 2012-2014 period is expected to see the economic growth accompanied by fiscal consolidation, improvement in the financial market conditions, more favourable labour market conditions as well as reduction in the current account disequilibrium. Expectations include considerable improvement of the budget balance, gradual increase in banks' credit activities, along with the private domestic demand as a key economic growth driver. Risks for the achievement of the above-mentioned projections mainly refer to the stability of the European currency due to the increasing sovereign debt in some countries, as well as high unemployment rate in most member states.

The IMF warns in its projections that slowing down of the global growth is aggravating the efforts of EU countries and the USA towards achieving fiscal stabilisation and sustainability of debt and public finance. Furthermore, there are reasonable risks for the banking sector due to the increase in non-performing loans and reduced credit activity of banks. Key levers of the global recovery can be ensured through timely fiscal consolidation and accompanying financial support to the banking sector, as well as external rebalancing of the developed economies towards stimulation of export. By finding an appropriate balance between the fiscal consolidation and structural reforms, on the one hand, and external financial support, on the other hand, sustainable adjustment will be ensured.

The IMF estimates show high unemployment in the developed economies as a result of modest economic growth. The highest unemployment rates will be recorded by Spain (20.7% in 2011) and Greece (16.5%). Thanks to a faster economic growth than in case of advanced economies, emerging economies and developing countries will solve the problems of high unemployment and social consequences of unemployment more quickly.

The IMF estimated the main economic indicators for the regional environment. After a mild economic activity growth in 2010, for all countries in the region, except for Romania (-1.3%) and Croatia (-1.2%), higher growth rates between 1.7% and 5% are anticipated for the period 2012 - 2014.

The IMF forecasts a mild inflation increase in the regional environment in 2011, with inflation increase in the next three years estimated as ranging between 1.8% and 4.3%:

however, inflation trend in Serbia is expected to decrease to around 4% at the end of 2014 after the high level of prices in 2010 and 2011.

Current account deficit will record a higher level measured by the share in GDP in 2011 and in the next three years in relation to the shares in GDP from 2009 and 2010, except for Montenegro and Bosnia and Herzegovina where relative gradual deficit decrease is expected. Current account deficit with donations in the countries in the region in 2014 will range between 2.3% and 7.2% of GDP, except for Montenegro (-15.7%).

In some countries, unemployment has reached historical maximum. The highest unemployment rates will be recorded by Macedonia (32.2%) and Bosnia and Herzegovina (25%), whereas labour market is expected to recover in the coming years.

If excluding Hungary, which has the highest gross debt as percentage of GDP (80.2% in 2011), as well as in the previous years, the IMF forecasts for the countries in the region gradual consolidation and reduction in gross sovereign debt-to-GDP ratio.

Table 4. Regional environment – The main economic indicators

		2011	2012	2013	2014
GDP growth, %	Bulgaria	2.5	3.0	3.7	3.8
	Romania	1.5	3.5	3.8	4.3
	Bosnia and Herzegovina	2.2	3.0	4.0	4.5
	Montenegro	2.0	3.5	3.7	3.7
	Hungary	1.8	1.7	2.9	3.2
	Croatia	0.8	1.8	2.5	2.7
	Macedonia	3.0	3.7	4.2	4.0
	Serbia	2.0	1.5	3.0	4.0
Inflation, period average, %	Bulgaria	3.8	2.9	2.9	3.0
	Romania	6.4	4.3	3.2	3.0
	Bosnia and Herzegovina	4.0	2.5	2.5	2.6
	Montenegro, period average	3.1	2.0	1.8	2.0
	Hungary	3.7	3.0	3.0	3.0
	Croatia	3.2	2.4	2.2	2.5
	Macedonia	4.4	2.0	2.0	2.0
	Serbia	11.2	4.1	3.7	4.0
Current account balance, % GDP	Bulgaria	1.6	0.6	-1.5	-2.3
	Romania	-4.5	-4.6	-4.6	-4.6
	Bosnia and Herzegovina	-6.2	-5.6	-5.3	-5.0
	Montenegro	-24.5	-22.1	-19.2	-15.7
	Hungary	2.0	1.5	1.3	-0.5
	Croatia	-1.8	-2.7	-3.3	-3.4
	Macedonia	-5.5	-6.6	-5.7	-5.4
	Serbia	-7.5	-8.4	-7.7	-7.4
Unemployment rate, in %	Bulgaria	10.2	9.5	8.8	8.4
	Romania	5.0	4.8	4.6	4.5
	Bosnia and Herzegovina	27.6	27.0	26.0	25.0
	Montenegro	-	-	-	-
	Hungary	11.3	11.0	10.5	10.0
	Croatia	12.7	12.2	11.7	11.2
	Macedonia	32.2	32.2	32.2	32.2
	Serbia	23.2	22.9	22.0	20.7
General Government debt, % GDP	Bulgaria	17.8	20.5	20.7	20.4
	Romania	34.4	34.4	34.0	33.6
	Bosnia and Herzegovina	39.6	38.4	35.7	32.3
	Montenegro	43.1	42.2	41.1	39.9
	Hungary	76.1	75.5	75.6	74.4
	Croatia	47.5	50.0	51.9	53.4
	Macedonia	26.3	28.2	27.4	27.3
	Serbia	42.4	44.0	44.9	44.4

Source: MMF, World Economic Outlook, September 2011, Ministry of Finance-estimates for Serbia

The IMF estimated a lower growth rate for the European economies in comparison to other leading world economies and drew attention to the problems in the EU periphery which records low growth, fiscal disequilibrium and financial pressures that altogether may affect other countries. For Serbia, however, economic trends of its major foreign trade partners are particularly important. Serbia's high export in the first quarter of 2011 mainly resulted from the deliveries to Germany and Italy, the economies of which recorded a significant growth in the first quarter of 2011. However, slowing down of the economic activity in the second and third quarter reduced the contribution of the Serbian export to GDP. Slowing down of the GDP growth in the Euro area countries, as well as the risk of spillover of debt crisis to the Western Balkan countries will have negative impact on the recovery of economic and foreign trade activities of Serbia.

The most recent projections of macroeconomic indicators of the European Commission indicate stagnation of the economic recovery of the EU member states with high risk of entering a new recession. The GDP growth in the EU of 0.6% in 2012 and modest recovery in 2013 (1.5%) were projected. Owing to the unfavourable investment trends and the risk from a rapid spread of sovereign debt crisis, projections of economic activity growth for most of the countries in this and next year were downgraded. Gradual economic recovery in the next period will be accompanied by necessary fiscal and foreign trade consolidation, improvement of the financial market conditions, but also with unchanged conditions in the labour market and possible increase in the structural unemployment which may jeopardise potential growth.

Risks for the achievement of the above projections are predominantly related to fiscal sustainability and stability of the European currency due to the increasing sovereign debt in certain countries, as well as due to the high unemployment rate in most member states. Fiscal sustainability remains the major challenge of the EU, but also of the United States. Finally, the global economy contraction, caused by the slowing down of the economic growth, will affect the global demand and net export.

Table 5. Serbia's foreign trade partners – The main economic indicators

		2010	2011	2012	2013
Real GDP growth, in %	Italy	1.5	0.5	0.1	0.7
	Germany	3.7	2.9	0.8	1.5
	Euro area	1.9	1.5	0.5	1.3
	Russia	4.0	3.9	3.8	4.0
Consumer prices, annual change, in %	Italy	1.6	2.7	2.0	1.9
	Germany	1.2	2.4	1.7	1.8
	Euro area	1.6	2.6	1.7	1.6
	Russia	6.9	8.8	7.7	7.4
Current account balance (% GDP)	Italy	-3.5	-3.6	-3.0	-2.3
	Germany	-5.8	-5.1	-4.4	-4.2
	Euro area	-0.4	-0.6	-0.5	-0.3
	Russia	10.2	10.4	8.6	8.4
Consolidated fiscal balance, in % GDP	Italy	-4.6	-4.0	-2.3	-1.2
	Germany	-4.3	-1.3	-0.7	-0.4
	Euro area	-6.2	-4.1	-3.4	-3.0
	Russia	-	-1.3	-1.5	-1.5
Gross debt, in % GDP	Italy	118.4	120.5	120.5	118.7
	Germany	83.2	81.7	81.2	79.9
	Euro area	85.6	88.0	90.4	90.9
	Russia	-	10.0	9.5	8.9
Unemployment rate, in %	Italy	8.4	8.1	8.2	8.2
	Germany	7.1	6.1	5.9	5.8
	Euro area	10.1	10.0	10.1	10.0
	Russia	8.2	7.4	6.9	6.4

Source: European Economic Forecast- Autumn 2011

In the period January-September 2011, EURIBOR varied from 1.22 to 1.83. The IMF downgraded its projection of movements of main interest rates for six-month LIBOR to 0.4% in 2011 and 0.5% in 2012, as well as interest on three-month Euro deposits (1.3% in 2011 and 1.2% in 2012).

Price of crude oil in the first ten months of 2011 varied in the range from 79.32 to 113.93 USD per barrel. As a result of the escalation of the crisis in the African continent, at the end of February 2011, prices of oil derivatives rose. According to the IMF estimates, oil price increase of 30.6% is expected in 2011 and a decrease of 3.1% in 2012. Average oil price is estimated at 103.2 USD per barrel in 2011 and 100 USD per barrel in 2012.

2.3. Projection of the macroeconomic indicators for the Republic of Serbia in the period from 2012 to 2014

Based on the current economic trends in Serbia and in the international environment, as well as on the new estimates of macroeconomic indicators made by the international financial institutions and considering the planned economic policies, the main macroeconomic aggregates and indicators are planned for the Republic of Serbia in the medium term.

Taking into account the slowing down of the global economic recovery from the second quarter of 2011 and lowered forecasts for the global economic growth in 2012, the estimates of the real GDP growth and related indicators for Serbia have been downgraded, primarily due to the stagnation in the Euro area and, consequently, reduction in exports and foreign capital inflow.

Macroeconomic projections for the next medium term from 2012 to 2014 indicate slowing down of the economic growth in 2012 and more rapid growth in 2013 and 2014 to 3% and 4% respectively. The projected average growth rate in the next three years of 2.8% will allow an increase in employment after three-year decrease of the number of employees, productivity growth which will increase the international competitiveness of the Serbian economy, accelerated increase in export and investments as key development drivers, while carrying out the necessary restructuring of the economy towards tradable goods, reduction in internal and external macroeconomic disequilibrium and opening of the space for increase in the living standard on real basis.

The anticipated cumulative GDP growth of 8.7% in the next three years is based on the acceleration of the growth in investments and export of goods and services at average annual real rate of 4.5% and 10.9%, respectively, with mild increase in private (0.8%) and decrease in government spending (-0.7%). On that basis, increase in employment and productivity should be ensured, as well as a change in the economic structure towards increasing the share of industry in GDP.

Medium-term macroeconomic projection anticipates that at the end of 2014, increase in share of fixed investments in GDP should rise to around 21%, reduction in share of government spending in GDP and increase in share of export of goods and services in GDP to 40.2%. Furthermore, in the next three years, an increase in domestic savings in GDP is expected, thanks to the growth in private savings. It is necessary to ensure in the next three years the net inflow of foreign direct investments of around EUR 2 billion p.a., with change of structure towards tradable goods sector. Financing of the balance of payments requires at the same time reduction in share of trade deficit and CAD (with donations) in GDP to 12.6% and 7.4% at the end of 2014, in order to achieve the anticipated GDP growth, external debt sustainability and external liquidity.

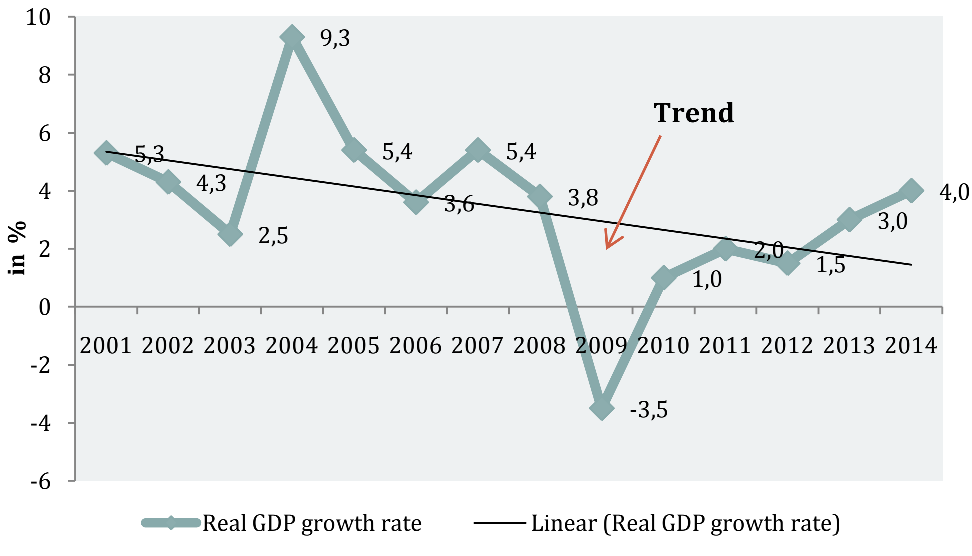
Table 6. Projection of the main macroeconomic indicators of the Republic of Serbia

	Estimate		Projection	
	2011	2012	2013	2014
GDP, in billion RSD (current prices)	3,358,802	3,550,840	3,792,688	4,102,171
GDP per capita, in EUR	4,543.0	4,664.8	4,904.5	5,346.9
GDP, annual real growth, %	2.0	1.5	3.0	4.0
	Real growth of certain GDP components, %			
Personal consumption	-0.4	-0.2	1.1	1.4
Government consumption	-0.4	-1.1	-1.0	0.1
Investments	10.5	2.8	4.4	6.2
Export of goods and services	8.9	8.0	11.3	13.8
Import of goods and services	5.5	3.5	6.0	8.2
Balance of goods and services, in euros, % GDP	-15.2	-14.9	-13.8	-12.6
Current account deficit, with donations, (% GDP)	-7.5	-8.4	-7.7	-7.4
Inflation, end of period, in %	7.7	3.5	4.0	4.0
Number of employees, annual average, in 000	1,745.0	1,755.0	1,782.9	1,825.9
Investment ratio, % GDP	19.0	19.7	20.2	20.8

Source: Ministry of Finance

GDP projection. In 2011, real GDP growth of 2% is expected, while for the next three-year period real GDP growth is expected to grow at the average rate of 2.8%. At the same time, in 2012, economic and foreign trade activities are expected to slow down due to the debt crisis in some EU member states, primarily major foreign trade partners of Serbia. An accelerated GDP growth in 2013 and 2014 to 3% and 4% respectively is based on the net export and gradual recovery of private consumption and investment activity.

Graph 1. Real GDP growth: Achieved rate and long-term trend

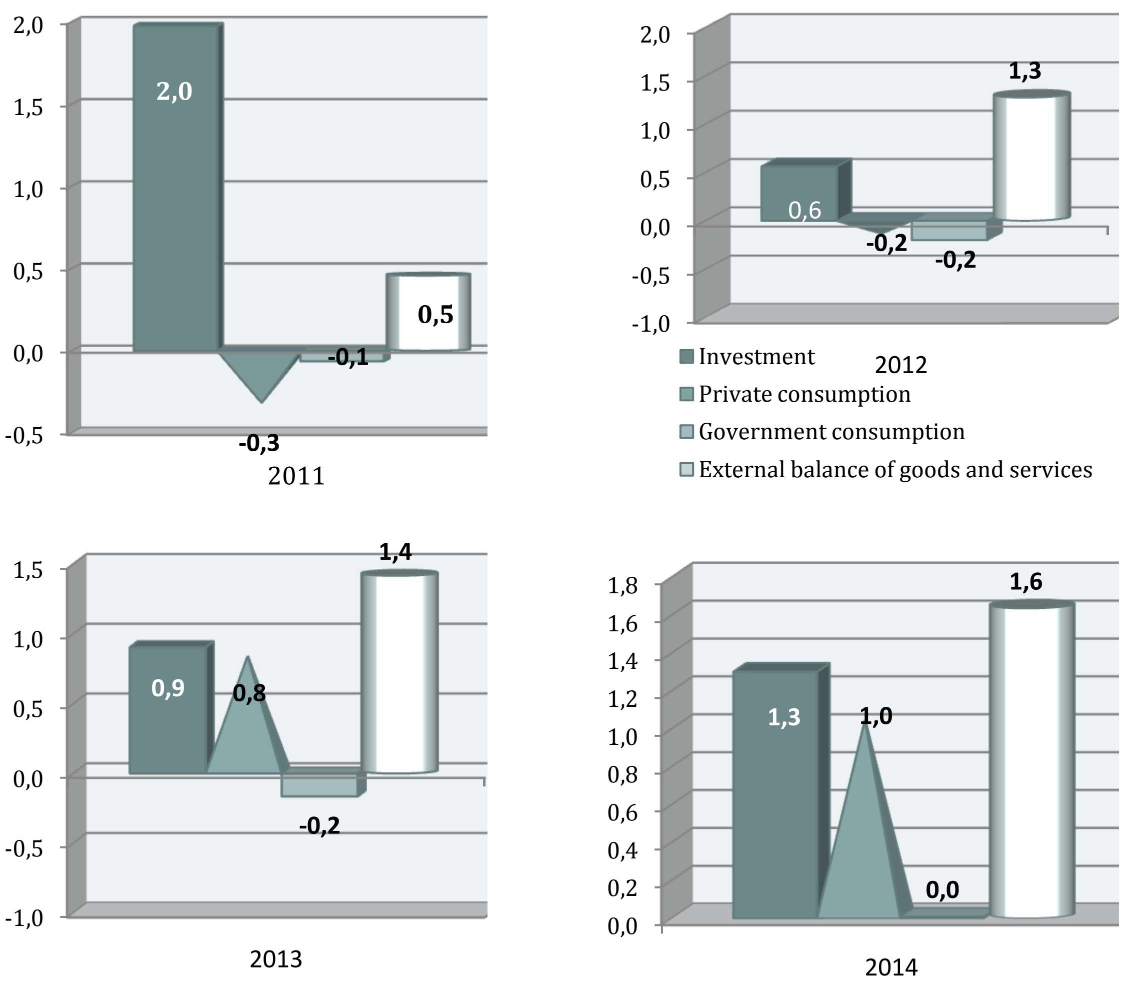


On the production side of GDP, the expectations for the period 2012-2014 include increase in activities in most economic sectors, as well as a recovery in the construction industry after sharp drop in 2009 and 2010. The growth based on the dominant increase in the service sector is not sustainable and economic policy need to be focused on the strengthening of industrial production and export, primarily through stimulating major investments into those sectors that provide tradable goods. Sustainable economic growth implies fostering of significant development of industry, especially export-oriented sectors which will lay a solid basis for economic development.

Production approach to the GDP calculation and GVA anticipates that in the next period agricultural production will contribute to GDP growth approx. 0.4 percentage points on annual basis and will be one of major sources of GDP growth. It is also expected that GVA of the agriculture will grow around 3% p.a. in the period 2012 – 2014, taking into account the fact that agriculture represents one of the most important segments of the Serbian economy, both export-wise and from the aspect of the planned capital investments.

On the expenditure side of the GDP, in the period 2012-2014, major contribution to the growth will come from the net export which will help GDP to grow from 1.4 percentage points, on average annually, while investments will be a component of the domestic demand with the highest contribution to the GDP growth (estimated at 1 ppt). Private consumption growth will be low and limited by the mild increase in real wages, whereas the government consumption will generate negative effects on the GDP growth. Stronger recovery of the domestic demand is expected in 2013 and 2014. The economic activity slowdown in 2012, followed by accelerated GDP growth in the next two years is based on the recovery of investment activity in the second half of 2012, but also on the effects of the fiscal consolidation. Net export is expected to be the main source of growth in 2012, notwithstanding the slowdown of foreign trade activities. The real growth in export and import of goods and services is expected to be at the lower level as compared to 2011, i.e. 8% and 3.5% respectively.

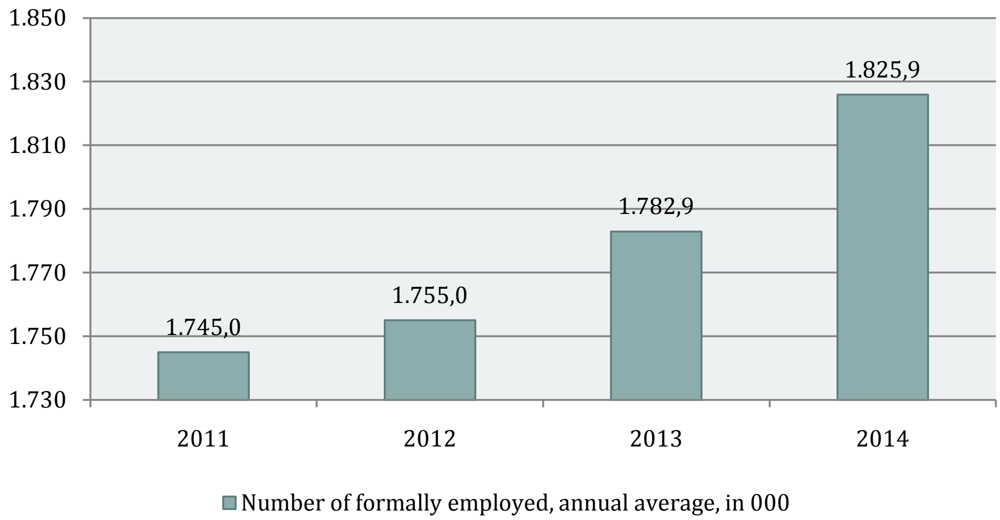
Graph 2. Contributions of the aggregate demand categories to the real GDP growth



The foreseen development scenario indicates the limited opportunities for increase in private and public spending. An increase in spending beyond the planned framework would lead to a rise in consumption and dinar depreciation, as well as to the reduction in foreign currency reserves, along with the problems of external debt servicing. On the other hand, it is expected that the private sector investmenst will significantly contribute to the GDP growth in 2013 and 2014. Insufficient foreign capital inflow represents a major risk for the investment activity pace in the coming period.

Projection of employment and wages. Medium-term employment projection is based on the projected GDP growth and increase in investment. According to the projections, the total employment will mildly grow from 2012, after the sharp drop in 2009 and 2010 and the slowed decline in 2011. In the next three years, cumulative growth in the registered employment of 4.5% is expected. At the same time, the total employment is to record a mild decrease. Harmonisation of employment, education and scientific and technological development policies is of special importance for productive employment in order to ensure higher levels of knowledge and skills and allow employment based on the labour market needs.

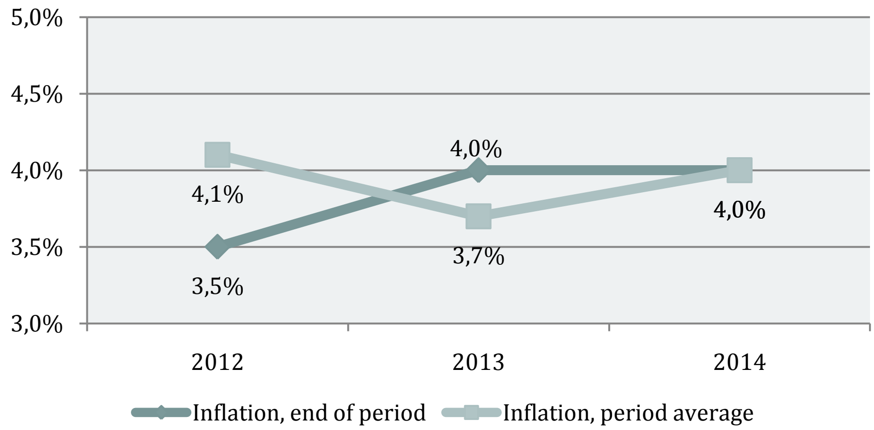
Graph 3. Employment projection



In the next period, the growth in real wages is expected to follow the economic productivity growth. Slower growth in real net wages than the growth in real GDP, as well as the growth in gross wages in line with the productivity growth will lead to the improved competitive position of the country.

Inflation projection. Medium-term inflation projection is based on the increased restrictiveness of the monetary and fiscal policy, especially on the control of public sector wages and pensions in the next three years, more stable food prices, controlled increase in the regulated prices, risk premium reduction, higher capital inflows and foreign exchange stability, as well as reduction in inflationary expectations. Based on the above factors, significant inflation reduction will be ensured in the next three years.

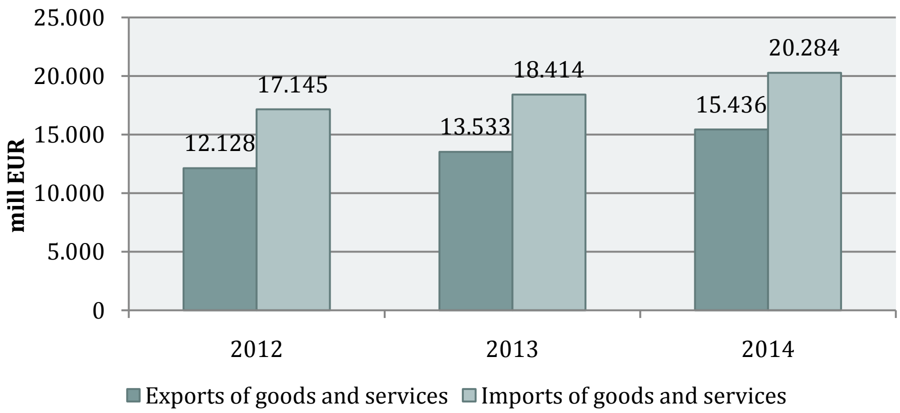
Graph 4. Inflation projection



Key risks for the realisation of the inflation projection come from a possible growth in the regulated prices and prices of food faster than the expected, increase in the fiscal deficit beyond the planned frameworks, as well as possible increase in the risk premium and inflationary expectations.

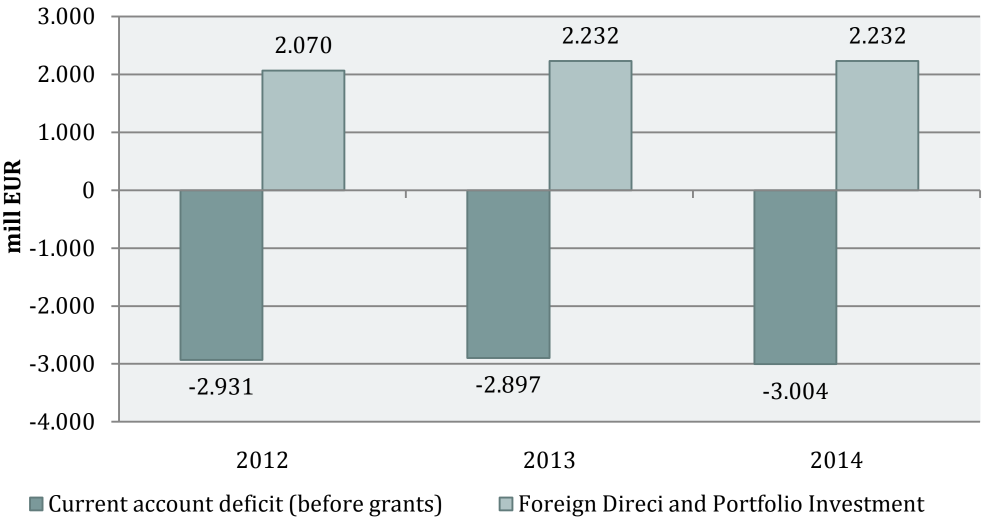
Projection of foreign trade. Slowdown of the foreign trade in the second half of 2011 will also be continued in 2012. In 2012, a 10.2% increase in export of goods and a 5.5% increase in import of goods, expressed in Euros, are expected. In the period 2013-2014, the expectations include achievement of the relatively high rates of increase in export and import of goods of 15.2% and 9.8% on average on annual basis, expressed in EUR. In order to increase investment activity, major portion of import will be oriented to capital and intermediary products, but in 2013 and 2014 recovery of private consumption is expected, as well as acceleration of import. Faster growth in export over import will allow reduction in deficit of goods and services from 16.5% of GDP to 12.6% in 2014. Lower level of current account deficit (with donations) is also expected, with share of 7.4% of GDP at the end of 2014, after the increase in share in 2012 (8.4% of GDP). Reduction in the negative net export of goods and services, especially due to the change of structure of domestic economy in the next period, will allow for the reduction in external disequilibrium and risk of external debt and external liquidity sustainability.

Graph 5. Export and import of goods and services



In the next three-year period, current account of the balance inflow is expected from current transfers, as well as outflow of factor payments. The most important component in the current transfers is income from remittances and household savings, whereas in factor payments the key component is outflows based on interest payments on foreign credits. It is estimated that the net current transfers with non-interest income against factor in the period 2012-2014 will amount on average around EUR 3 billion per annum. It is expected that there will be a negative balance against net interest payments which will reach EUR 1.15 billion in 2014. Net effect of the current transfers and net factor payments in the next three-year period will be positive and stable and it is estimated at around EUR 2 billion per annum. Surplus of the balance of current transfers and net factor payments will cover around 40% of Serbia's foreign trade balance deficit in the period 2012-2014.

Graph 6. Current account deficit and foreign investments



Based on the projected trends of foreign trade, current transfers and net factor income, projections of CAB have been made. Current account balance without donations will be negative, amounting on average EUR 3.0 billion in the period 2012-1014. Current account deficit will be financed from foreign direct investments and foreign credits. According to the expectations, in the period 2012-2014, annual net foreign direct investments and portfolio investments should reach on average around EUR 2 billion.

It is estimated that the total Serbia's external debt in the period 2012-2014 will be increased due to the growth in the external debt of the public sector, while on the other hand, tendency of debt release of the private sector will be continued. In 2011, the public sector had a priority in withdrawing funds from external sources and that tendency is also foreseen for the coming years. Private sector will continue to repay debts and therefore the investment cycle must rely on the direct investments and domestic savings increase. In the next three-year period, the total Serbia's external debt will be reduced and is expected to amount around 70% of GDP. It is estimated that Serbia's foreign exchange reserves in the period 2012-2014 will cover over eight months of import of goods and services.

Assessment of the country's external position sustainability

From the end of 2010, external liquidity recorded improvement, which is indicated by the increase in the NBS foreign exchange reserves, as well as a decrease in short-term borrowing. At the same time, external solvency indicators also show improvement, primarily through reduction in the share of external debt in GDP and in export of goods and services.

Table 7. External position indicators

	2005	2006	2007	2008	2009	2010	Q3 2011
External liquidity indicators (in %)							
Foreign exchange reserves/Import of goods and services (in months)	6.1	9.0	7.2	5.2	9.4	8.1	8.4
Foreign exchange reserves/Short-term debt	519.2	941.7	917.5	380.8	528.8	546.4	1,323.9
Foreign exchange reserves/GDP	24.2	38.7	33.8	25.0	36.7	34.5	36.0
Debt repayment/GDP	4.7	7.0	10.1	10.6	11.5	11.8	12.1
Debt repayment/Export of goods and services	17.7	23.5	33.2	34.0	39.1	34.0	34.3
Debt repayment/Export of goods and services and remittances	-	17.2	25.4	27.6	28.3	26.1	26.4
External solvency indicators (in %)							
External debt/GDP	60.1	60.9	60.2	64.6	77.9	82.1	75.6
Short-term debt/GDP	4.7	4.1	3.7	6.6	6.9	6.3	2.7
External debt/Export of goods and services	228.9	204.1	197.3	207.6	265.3	236.2	210.4
External debt/Export of goods and services and remittances	-	149.1	151.1	168.7	191.8	181.2	164.9

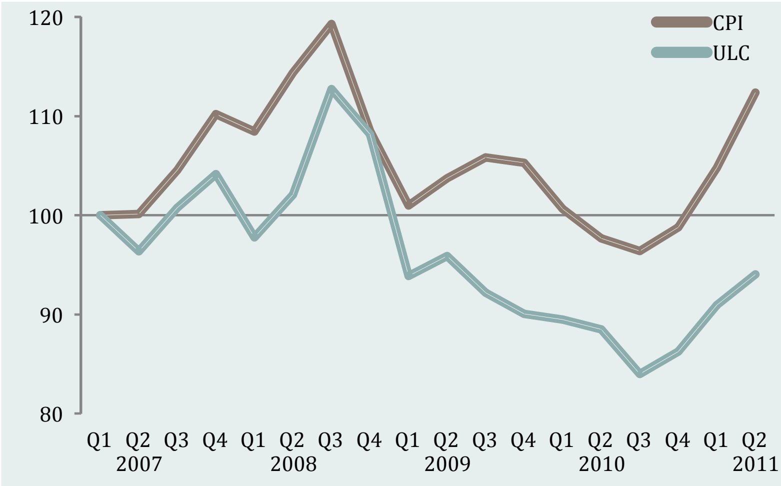
Source: National Bank of Serbia

From the aspect of the country's external position, the level of foreign exchange reserves is at the satisfactory level. Import of goods and services coverage with foreign exchange reserves, in the third quarter of 2011, was over 8 months, whereas the ratio of foreign exchange reserves to short-term debt was considerably improved due to the reduction in short-term borrowing and increase in foreign exchange reserves in this period, amounting to 1,323.9%, which is considerably above the prescribed minimum level of 100%. According to the NBS data on the external debt movements and GDP, share of external debt in GDP in the third quarter was 75.6%, which is below the level of high indebtedness of 80% according to the World Bank criteria. In relation to the end of 2010, this external solvency indicator was improved to 6.5 pp, which was also fuelled by appreciation of dinar in this period. Share of external debt in the export of goods and services in the third quarter was 210.4% and was reduced by 54.9 pp from 2009. Ratio of total repayments against external debt and export of goods and services in the third quarter was at the upper limit of sustainability (35%) and amounted to 34.3%.

In the next period, sustainability of Serbia's external position will depend on the level of the NBS foreign exchange reserves, satisfactory level of liquidity and capitalisation of the banking sector, improved legal framework and measures to be taken in case of problem banks. Implementation of the defined fiscal rules, as well as the new Stand-by Arrangement with the IMF will considerably contribute to the strengthening of Serbia's external position.

For sustainable external position, increase in price and cost competitiveness is of vital importance.

Graph 7. Real foreign exchange rate based on consumer price index (CPI) and unit labour costs (ULC), Q1 2007 = 100, growth marks appreciation



Source: NBS

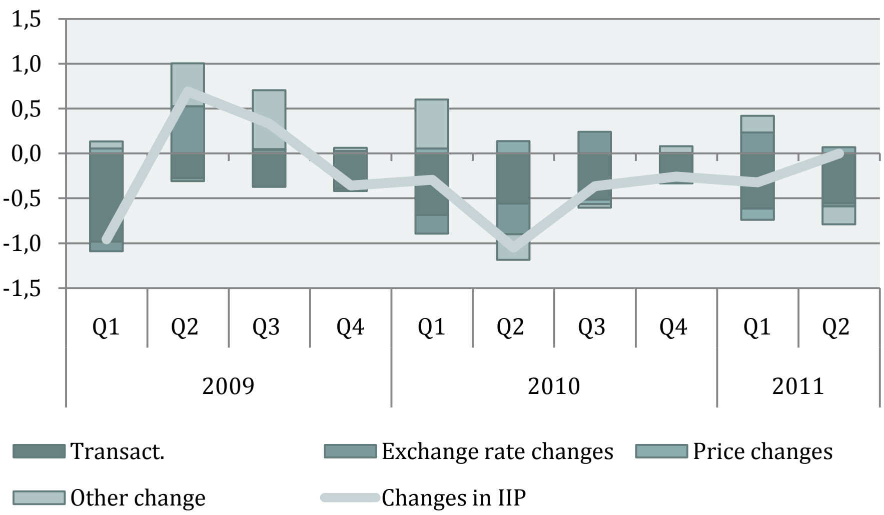
Improvement of competitiveness of the local economy in 2009 and in the first half of 2010 was supported by the real depreciation of dinar. The real appreciation of the foreign exchange rate from the second half of 2010, along with high inflation rates, as well as increase in unit labour costs, indicate reduction in the competitiveness in the mentioned period. From the beginning of 2011 to Q2 2011, the real appreciation of the foreign exchange rate was continued, with the inflation rate above the target, which had negative effects on the competitiveness of the economy.

Price and cost competitiveness of the economy in 2012 and in the next two years will depend on the movements of exchange rate.

Serbia's international investment position

International investment position (IIP), observed from 2009, changed due to the changes of the transactions included in the balance of payments, as well as other changes not resulting from the transactions between non-residents and residents. Balance, structure and changes of Serbia's international investment position are shown in the Graph below.

Graph 8. Change of Serbia's international investment position, in EUR billion



Serbia's international investment position in the second quarter of 2011 was negative as a result of the realised transactions based on withdrawal of domestic capital from abroad and investment of foreign capital in the country, currency changes which additionally caused reduction in the financial assets and financial liabilities, as well as other changes not resulting from the transactions.

In the IIP structure, other net investments have the largest share in the net position (EUR 20.5 billion), then net direct investments (EUR 13.3 billion) and net portfolio investment (EUR 2 billion), while reserve assets are positive (EUR 9,967 billion). At the same time, investment of non-residents in Serbia exceeded the net investments of residents abroad.

IIP represents a basis for assessment of the country's risk exposure in the economic relations with other countries as it contains the overview of the level, sectoral structure and maturity of external liabilities, especially external indebtedness, as well as the overview of volume and structure of receivables from non-residents. Share of IIP in GDP worsened in the past period, so that at the end of 2010 the IIP/GDP ratio was 85.5% and was on average higher by 16.5 pp than at the end of 2008.

Macroeconomic risks

Realisation of the macroeconomic projection is exposed to numerous internal and external risks.

The main global risk for the projection is primarily related to the recovery of the global economy. Sustainability of the initiated economic recovery in Serbia will largely depend on an increase in foreign demand and foreign capital inflow, movements of international interest rates, as well as movements of import prices, food prices and prices of oil derivatives.

Internal risks for the realisation of projection are connected with further delay in implementing economic reforms and economic policy measures, sharp changes in aggregate demand, acceleration of inflation, higher fluctuations of dinar exchange rate against euro and consequent considerable disturbances in the foreign exchange market, considerable fall of foreign direct investment inflow, higher risk premium on international credits granted to domestic entities, political risks, etc.

The main development scenario in the next three years is based on the following factors: increase in share of fixed investments in GDP from 19% in 2011 to nearly 21% in 2014; reduction in shares of public expenditures in GDP from 44% to 41.8%; increase in share of export of goods and services in GDP from 34.4% in 2011 to 40.2% in 2014, along with a mild reduction in share of current account deficit in the balance of payments to 7.4% in 2014; reduction in inflation from 7.7% in 2011 to 4% in 2014.

Key assumptions for the realisation of the planned medium-term development scenario include: harmonisation of the economic system, macroeconomic policy and sectoral policies with the conception of sustainable and stable economic growth, along with strengthening of investments in the distribution of GDP and tradable goods in the economic structure.

Departure from the above assumptions represents a risk for the realisation of the medium-term macroeconomic projection. Lower rates of economic growth than the projected would lead to the deepening of the crisis, while slowdown of recovery of the global economy and especially recession of the European economy would affect recovery of the Serbian economy and economic development of the country that is dependent on the export demand. Slowing down of the economic growth reduces employment, slows down productivity, narrows the room for investment and consumption growth and slows down export and import growth, which results in reduction in public revenues. Such trends would increase macroeconomic disequilibrium through rise in inflation and through increase in foreign trade and current deficit and would cause reduction in foreign exchange reserves, along with problems of external debt repayment. It would also slow down and stop the necessary investment cycle based on the considerable inflow of FDI due to the low domestic savings as well as private and public sector investments. Structural reforms, which create a stimulating economic environment required for the realisation of development objectives and for establishing macroeconomic stability and sustainable economic growth, would also be slowed and stopped.

II. Fiscal framework for the period 2012-2014

1. Medium-term fiscal policy objectives

The objective of the medium-term fiscal policy is gradual reduction in the general government sector deficit towards the medium-term targeted deficit of 1% of GDP.

Deficit reduction will be ensured by the measures on the expenditure side through relative reduction in the current public spending. No significant tax policy change has been foreseen by this fiscal strategy.

General government sector debt in the medium term will be below the upper limit of the sustainable debt-to-GDP ratio of 45%.

Fiscal policy will contribute to the achievement of the defined goals by complying with fiscal responsibility principles and setting the medium-term fiscal framework in line with general and specific fiscal rules.

Deficit will be reduced in the medium term by reducing relative share of current public spending. By applying the specific fiscal rules for adjustment of salaries to public sector workers and pensions, increase in these most important categories of the public spending, considering their size, is limited and their share in GDP is reduced.

Fiscal adjustment will also be carried out by reducing discretionary categories of current spending, i.e. subsidies and budget loans.

The strategy does not foresee fiscal consolidation through increasing the current tax rates. Revenue policy will be directed to further tax system changes with a view to the harmonisation with the EU legislation and tightening of tax administration and discipline.

2. Fiscal framework in the period 2012 - 2014

2.1. Fiscal trends in 2010 and prospects for 2011

Actual fiscal deficit of the general government sector in 2010 was lower than expected. Recovery in revenues in the second half of the year and freezing of the major public spending categories caused that the general government deficit was by 0.2% of GDP lower at the end of 2010 than planned.

Table 8. Planned and actual fiscal result of the general government sector in 2010

in RSD billion

	2010
Public revenues	1,223.4
Public expenditures	1,359.9
Fiscal result	-136.5
Fiscal result (% GDP)	-4.6
Planned fiscal result	-148.0
General Government debt (% GDP)	43.4

Source: Ministry of Finance

In 2010, in addition to regular budget expenditures, public debt was settled in the amount of RSD 255.6 billion, out of which nearly 90% was repaid to domestic creditors.

Table 9. Public debt service in 2010

in RSD billion

	2010
Payment of principal to domestic creditors	229.9
Payment of principal to foreign creditors	25.7
Purchase of financial assets	0.0
Total	255.6

Source: Ministry of Finance

For deficit financing and public debt service the amount of RSD 392.1 billion was needed. Of the total required funds for deficit financing and public debt service in the first half of the year, the largest portion was collected through the issuance of government securities.

The year 2010 did not see an increase in arrears of budgetary beneficiaries and compulsory social insurance organisations.

Table 10. Arrears of from budgetary beneficiaries and organisations of compulsory social insurance in 2010

in RSD billion

	31 December 2009	31 December 2010
Government budget beneficiaries and PE "Roads of Serbia"	11.1	10.9
Compulsory social insurance organisations	16.5	16.4
Total	27.6	27.3

Source: Ministry of Finance

Public revenues in the period January-December 2010 recorded a nominal increase of 6.7%, while in real terms they are nearly at the level of generated revenues in the previous year. Current revenues rose to the level of average inflation, while there was no real growth. The trend of current revenues and/or mild increase in total public revenues was not affected by movements in tax, but non-tax revenues. Tax revenues recorded a real drop of 0.8%, while the real growth in non-tax revenues reached 6.4%. Capital revenues showed considerable growth and for the first time their trend is more relevant for the total revenues.

Table 11. Public revenues in 2009 and 2010

in RSD billion

	2009	2010	growth rate (nominal)	growth rate (real)
PUBLIC REVENUES	1,146.5	1,223.4	6.7	0.2
Current revenues	1,139.8	1,214.5	6.5	0.0
Tax revenues	1,000.3	1,056.5	5.6	99.2
Personal income tax	133.5	139.1	4.2	97.8
Corporate income tax	31.2	32.6	4.4	98.0
Value added tax	296.9	319.4	7.6	1.0
Excise duties	134.8	152.2	12.9	6.0
Customs duties	48.0	44.3	-7.8	-14.4
Other tax revenues	37.1	46.0	24.0	16.5
Contributions	318.8	323.0	1.3	-4.9
Non-tax revenues	139.5	158.0	13.3	6.4
Capital revenues	0.2	1.5	812.0	762.4
Grants	6.5	7.4	14.2	7.2

Source: Ministry of Finance

In terms of tax revenues, indirect taxes, i.e. VAT is growing, as well as excise duties, to a lesser extent, while direct taxes, i.e. individual income tax, corporate profit tax, as well as contributions record a slight nominal growth and a real decrease in comparison to the previous year.

Revenues generated from VAT rose in real terms by 1% in the period January - December 2010, in comparison to the previous year. Gross collection of the local VAT grew in nominal terms by 3.4% relative to the previous year, but export increase consequently led to a considerable growth in VAT Refunds (25.6%). VAT on import, on the other hand, record a nominal increase of 19.8%, and real increase of 12.4%.

Real level of the collected excise duties is higher by 6% compared to the previous year and this trend is a consequence of the increase in nominal amounts of excise duties on oil derivatives and tobacco in mid-2009 and regular adjustment in early 2010. Revenues from excise duties on oil derivatives are in nominal terms higher by 7.7% and in real terms by 1.1%. Revenues from excise duties on tobacco products are in real terms higher by 13.2% and revenues from excise duties on alcoholic beverages by 2.9%, in comparison to the previous year.

Revenues from personal income tax rose in nominal terms by 4.2% in comparison to the previous year, while the real drop in these revenues is 2.2%. Nominal salaries growth in the period January – December 2010, compared to the same period in the previous year, is 7.6%, while nominal growth of personal income tax, in the same period, is 2.4%. Divergent trend in the collected revenues from personal income tax and nominal average salary was mainly caused by the drop in employment in the observed period.

The real level of contributions income in the period January - December 2010 is lower by 4.9% relative to the same period in the previous year. Nominal contributions growth, in the observed period, is 1.3% and is not in accordance with the trend of revenues from personal income tax. The highest deviation is shown in case of payment of contributions for pension and disability insurance, while contributions for health insurance and insurance for unemployment largely follow the trend in personal income tax.

Other tax revenues also showed a significant real growth in comparison to the previous year.

Real growth in public spending in 2010 was 0.7%. An increase in public investment contributed to a modest growth in the total public spending, while current spending was lower in real terms in comparison to the previous year. Real reduction in the current public spending is a consequence of the nominal "freezing" of wages and pensions, which are two major categories of the current public spending. The significant real reduction in these categories of expenditures created a room for an increase in fiscal incentives, i.e. subsidies and "soft" budget loans to economy and citizens.

Public investment increase was driven by investment in road infrastructure. The highest nominal and real growth was seen in PE "Roads of Serbia", capital investments financed from the budget of the Republic of Serbia and from the budget of the Autonomous Province of Vojvodina were in nominal terms higher than in the previous year, while the level of public investments at the local level (cities and municipalities) was slightly lower in nominal terms in comparison to the previous year.

Table 12. Public expenditures in 2009 and 2010

in RSD billion

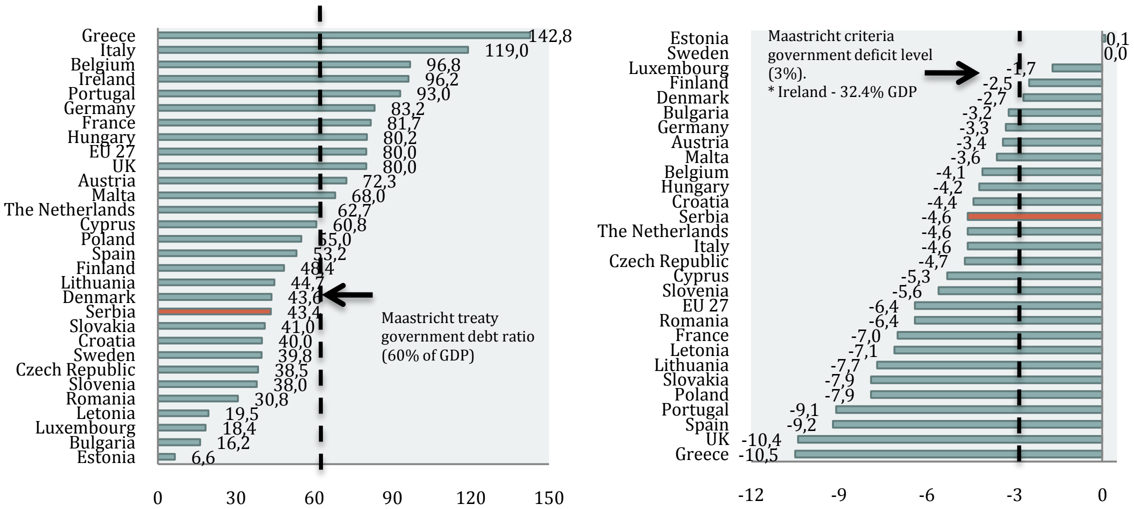
	2009	2010	growth rate (nominal)	growth rate (real)
PUBLIC EXPENDITURES	1,267.9	1,359.9	7.3	0.7
Current expenditures	1,154.2	1,224.8	6.1	-0.4
Wages and salaries	301.8	308.1	2.1	-4.2
Purchase of goods and services	186.4	202.5	8.7	2.0
Interest payment	22.4	34.2	52.8	43.5
Subsidies	63.1	77.9	23.4	15.9
Social benefits and transfers to households	555.6	579.2	4.2	-2.1
Of which pensions	387.3	394.0	1.7	-4.5
Other current expenditures	24.8	22.9	-7.5	-13.2
Capital expenditures	93.3	105.1	12.7	5.8
Net lending	20.5	30.0	46.5	37.5

Source: Ministry of Finance

Public finance in EU countries in 2010

Economic and financial crisis led to a significant impairment of fiscal positions in almost all EU member states. By its discretionary measures (stimulative measures for economic recovery) and automatic stabilizers, fiscal policy played a key role in stabilising EU economies. On the other hand, returning the public finance, deficit and debt into the sustainable frameworks is a challenge for EU countries in the medium and long run.

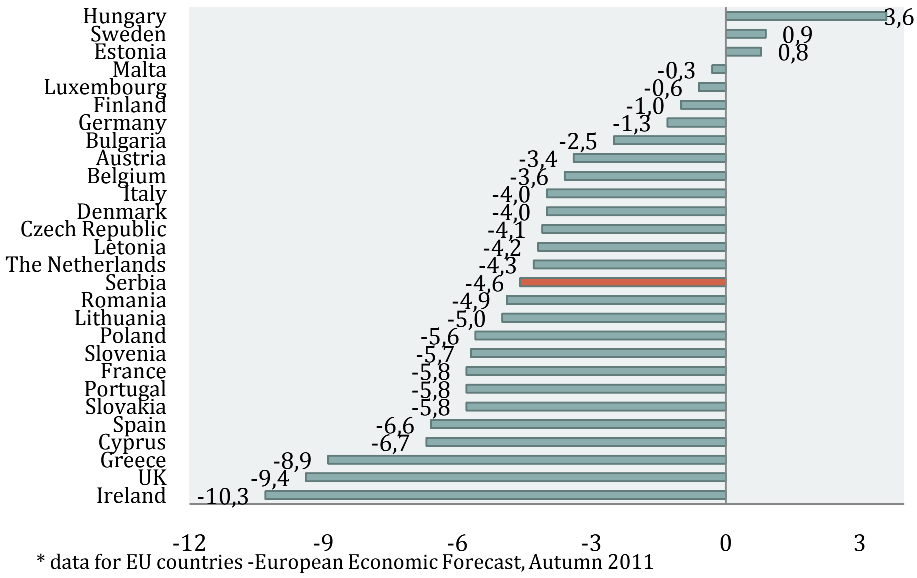
Graph 9. Deficit and debt in Serbia, Croatia and EU countries in % GDP, in 2010



Deficit in EU member states (EU 27) in 2010 was 6.4%, which is in line with the previously projected deficit for 2010[1]. The deficit increase in 2009 and 2010, relative to the previous period, results from the full operation of automatic stabilizers (growth in social benefits, primarily unemployment allowance), generous packages of stimulative measures (for stimulating investment, strengthening purchasing power of private households, assistance for companies and labour market) and considerable decrease in revenues, partly due to the reduction in economic activity, and partly as a result of the discretionary policy, i.e. reduction in interest rates. The projected deficits for 2011 and 2012 are revised to 4.7% and 3.9% respectively.[2]

[1] European Economic Forecast, Autumn 2010
[2] European Economic Forecast, Autumn 2011

Graph 10. Deficits in EU and Serbia in 2011*



* data for EU countries -European Economic Forecast, Autumn 2011

Growing needs for financing of the deficit led to an increase in the share of debt in GDP in almost all EU member states.

Share of debt in GDP (EU 27) in 2010 was 80%. Projections for the next period indicate a further increase in the debt-to-GDP ratio to 82.5% in 2011 and 84.9% in 20122. Such high debt-to-GDP ratio requires return of public finances to a sustainable level, while at the same time acting as an impediment to possible faster growth.

Fiscal trends in Serbia in 2011

General governemt fiscal deficit in the third quarter was RSD 40.1 billion, while from the beginning of the year it reached RSD 108.9 billion. General governemt revenues recorded a nominal growth, but in real terms they decreased by 3.2% in comparison to the same quarter in the previous year. Expenditures also recorded nominal growth and minimum real drop. Nominal growth in expenditures is faster than the growth in revenues in the observed period. Growth in expenditures for wages and pensions in the third quarter has the biggest impact on the trends of the total expenditures.

Table 13. Revenues, expenditures and fiscal result of the general government sector in 2011

in RSD billion

	Q3 2010	Q3 2011	Q1 - Q3 2010	Q1 - Q3 2011
Revenues	309.9	331.8	868.9	936.7
Expenditures	338.2	371.9	953.1	1,045.6
Fiscal result	-28.3	-40.1	-84.1	-108.9

Source: Ministry of Finance

General governemt revenues in the third quarter nominally rose less than the average inflation, whereby tax revenues rose slower than non-tax revenues. In terms of tax revenues, excise duties and corporate profit tax recorded a faster growth, VAT revenues growth has slowed down, while revenues from customs duties continue to fall due to the reduction in customs rates in accordance with the implementation SAA. Social contributions and personal income tax show a recovery in the third quarter.

Growth in total VAT slowed down in the third quarter. Such VAT collection in the observed period was largely influenced by the trends in foreign trade sector. Following the dynamic growth in export and import in the first quarter, as compared to the same period in the previous year, which partly resulted from an extremely low base in the first quarter of 2010, this growth slowed down in the second quarter. The third quarter saw further slowdown of growth in export and import, not expected in such an extent, which affected VAT revenues.

Import VAT growth is slowing down. In the third quarter, annual nominal growth in import VAT is 1.2%, which is considerably lower than the growth recorded in the first two quarters. In the entire observed period, nominal growth of 12.6% was recorded, which is in line with the trends of import (expressed in RSD) in the same period.

The period January – September of the current year saw a nominal increase in VAT refunds of 26.4%, which is in line with the trends of export (expressed in RSD). With slowing down of export in the second, and especially in the third quarter, increase in VAT refunds slowed down as well. A slower increase in refunds caused a slightly faster increase in net domestic VAT.

Nominally higher household revenues in the form of wages, pensions and, to a lesser extent, social benefits, led, along with stricter tax control, to a moderate growth in the collected gross domestic VAT, which caused, together with slower growth in refunds, a slightly faster growth in net domestic VAT.

Revenues from customs duties follow the dynamics of import, but their level also depends on the effects of SAA, which is dependent both on the volume and structure of import from the EU member states. When comparing the comparable quarters, annual drop is 14.5%, while as of the beginning of the year this drop is 11.4%.

After the real increase in the first two quarters of 2011, in the third quarter excise duties recorded a real decrease by 0.3% relative to the same quarter in the previous year. In the period January – September, excise duties nominally rose by 16% (real growth by 3.7%). Such trend in the total revenues from excise duties was mainly influenced by the trends of revenues from excise duties on oil derivatives, while, on the other hand, the trend of moderate growth in revenues from tobacco products was recorded. Usual growth in revenues from oil derivatives, present in summer months, was not this time recorded. Although transit traffic was not notably lower, the reasons should be sought in the price of oil derivatives and/or impossibility to exercise rights to VAT refund by non-residents. In line with these trends, projections of revenues from excise duties are revised by individual items.

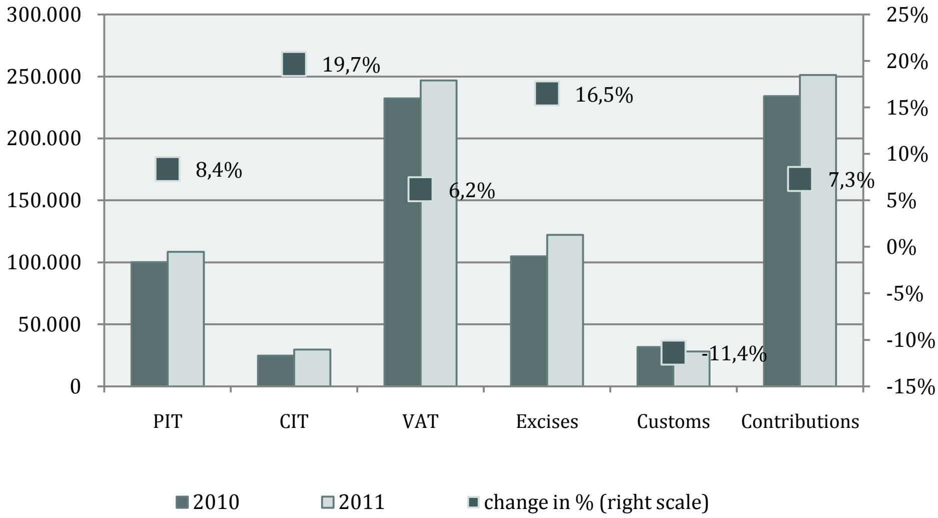
Direct taxes, including contributions, record growth, especially corporate profit tax which shows the fastest growth. Revenues arising from corporate profit tax show real growth in all three quarters. In the period January – September of the current year, the revenues generated on this basis rose in real terms by 6.6% in comparison to the same period in the previous year.

Although showing slightly lower growth rates than corporate income tax, social contributions and personal income tax have much larger effects on the overall level of the collected revenues. Both categories record the lowest real annual drop in the third quarter. These trends of the revenues from personal income tax and contributions result from the trends of wages and employment in the economy. Unfreezing of wages in the public sector had a direct effect on these categories of revenues, as well as an indirect effect through an increase in wages of private sector workers.

Other tax revenues show a sharp real drop, which is largely caused by the abolition of tax on the use of mobile phones, which was included in this category.

The entry into force of the amendment to the Law on Local Self-Government Financing led to the redistribution of the revenues generated from personal income tax between the Republic budget and budgets of local self-government units. Until present, revenues generated from this tax were divided in 60:40 ratio in favour of the Republic budget, while as of 1 October 2011 this ratio is 80:20 in favour of local self-government units. The estimated effect of the redistribution in this year is around RSD 11 billion, which means that the revenue of the Republic budget would be lower by this amount and the budget of local self-government units higher. Effects of these changes will be visible in the fourth quarter of the current year, while the complete effect is yet to be seen in 2012.

Graph 11. Trends of revenues (by categories) in the period January – September 2011



Public spending decreased in real terms by 0.6% in comparison to the same quarter in the previous year. The spending structure shows a qualitative improvement and current expenditures recorded in the third quarter an annual real drop of 0.5%, while capital expenditures showed a real growth of 14.5%, relative to the same quarter in the previous year. In the period January – September, public spending rose less than the average inflation, whereby the real drop in expenditures is slightly lower than the drop in revenues in the same period.

Observing the individual categories, it can be concluded that most current expenditures in relation to the third quarter record a real drop. In the third quarter, wages and pensions achieved, after negative real growth rates in the first two quarters, an annual real growth. In the observed period, wages in the public sector and pensions increased in January by 2%, in April by 5.5%, which is equal to the inflation in the period January – March. October wages and pensions are yet to be adjusted by the inflation recorded in the period April – September and by the half of the real GDP growth rate from 2010. Despite the real growth in the third quarter, both wages and pensions are in the overall period January – September lower in real terms in relation to the same period in the previous year.

General governemt expenditures for purchase of goods and services in the period January – September were in real terms lower by 3.4%, compared to the same period in the previous year. The highest annual drop, observed by quarters, was recorded in the third quarter of the current year.

Other forms of transfers to households, including social welfare benefits, sick leave allowances and compensation for unemployed persons, in the total amount, are lower in real terms than in the same period in the previous year. A slower real drop in certain categories of expenditures in the third quarter may be explained by disinflationary movements. This will help to mitigate or avoid real drop in the expenditures affecting the social position of the population.

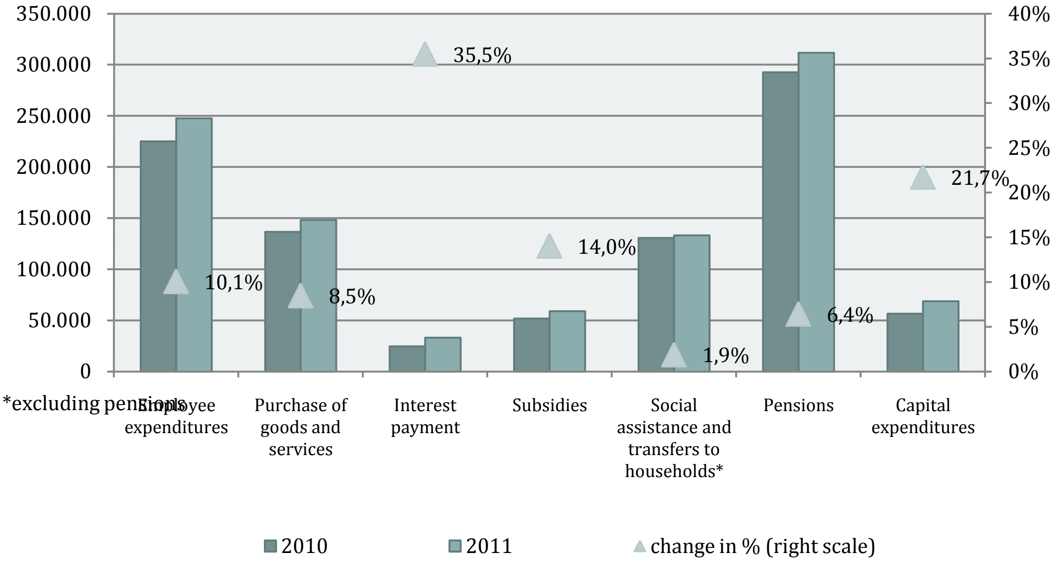
Expenditures for subsidies recorded both nominal and real annual growth, whereby they are throughout the observed period only slightly higher in real terms, compared to the previous year (1.5%). The increase in the third quarter came as a consequence of the farming subsidy payments in the peak of farming season.

Real growth in expenditures arising from interest payments in the overall period is 20.7%. In the third quarter, annual growth was 23.5%.

High real growth in the category of other current expenditures results from one-time payments in the first quarter of this year, based on the judgment of the International Court of Arbitration related to the case of satellite rental.

Budget loans recorded, after real growth in the first and especially in the second quarter, a significant real decrease in the third quarter. Considering that this position includes fiscal incentives to companies, this category of expenditures is expected to rise by the end of the year and to realise the planned level.

Graph 12. Trends of expenditures (by categories) in the period January – September 2011



*excluding pensions

An increase in capital expenditures lies in the faster and more efficient withdrawal of funds within project loans, but also in the realisation of public investments financed from the Republic and local government budgets. Withdrawals of funds within project loans accelerated in the third quarter, but it is obvious that total capital expenditures also accelerated in the second half of the year.

Table 14. General Governemnt revenues and expenditures in the period Jan – Sep 2011

in RSD billion

	Q1	Q2	Q3	Q1-Q3
PUBLIC REVENUES	293.6	311.4	331.8	936.7
Current revenues	292.9	310.5	331.2	934.6
Tax revenues	259.1	272.0	287.3	818.4
Personal income tax	32.7	37.9	37.9	108.5
Corporate income tax	14.4	7.5	7.6	29.5
Value added tax	79.2	80.9	86.6	246.8
Excise duties	32.1	40.2	46.9	122.1
Customs duties	9.0	9.5	9.7	28.2
Other tax revenues	10.2	10.5	11.4	32.1
Contributions	78.3	85.6	87.4	251.3
Non-tax revenues	33.8	38.6	43.9	116.1
Capital revenues	0.3	0.3	0.3	0.9
Grants	0.4	0.5	0.4	1.3
PUBLIC EXPENDITURES	319.9	355.0	371.9	1,045.6
Current expenditures	297.8	324.3	334.6	956.6
Expenditures for employees	76.7	85.3	85.7	247.7
Purchase of goods and services	44.7	52.6	51.0	148.2
Interest payment	9.9	12.1	11.1	33.1
Subsidies	15.1	15.4	28.4	58.9
Social insurance and other transf. to households	143.1	151.3	151.7	444.7
of which pensions	99.2	105.4	107.0	311.6
Other current expenditures	8.3	7.7	6.6	23.9
Capital expenditures	16.7	20.7	32.6	68.7
Net lending	5.5	10.0	4.8	20.2

Source: Ministry of Finance

Table 15. Real growth rates in revenues and expenditures in 2011

in %

	Q1	Q2	Q3	Q1-Q3
PUBLIC REVENUES	-2.3	-6.4	-3.2	-4.2
Current revenues	-2.4	-6.5	-3.1	-4.1
Tax revenues	-2.6	-6.3	-3.5	-4.2
Personal income tax	-6.7	-3.4	-0.5	-3.5
Corporate income tax	9.8	1.6	5.4	6.6
Value added tax	-2.2	-7.8	-5.9	-5.4
Excise duties	14.3	0.8	-0.3	3.7
Customs duties	-15.4	-24.3	-22.7	-21.1
Other tax revenues	-6.9	-22.0	-10.9	-13.7
Contributions	-7.3	-5.1	-1.0	-4.4
Non-tax revenues	-0.4	-7.7	0.1	-30.1
Capital revenues	1,291.5	27.0	-52.7	-50.5
Grants	10.4	43.6	-34.2	-2.5
PUBLIC EXPENDITURES	-2.3	-3.6	-0.6	-2.3
Current expenditures	-3.1	-5.0	-0.5	-2.9
Expenditures for employees	-6.4	-1.2	1.6	-2.0
Purchase of goods and services	-0.2	-3.5	-5.9	-3.4
Interest payment	10.5	27.6	23.5	20.7
Subsidies	19.8	-26.0	16.0	1.5
Social insurance and other transf. to households	-7.4	-7.5	-3.6	-6.5
Of which pensions	-9.3	-4.9	1.4	-5.2
Other current expenditures	88.9	14.1	-2.2	33.6
Capital expenditures	9.5	5.5	14.5	8.4
Net lending	6.9	36.7	-49.5	-7.7

Source: Ministry of Finance

Arrears by budget beneficiaries and organisations of compulsory social insurance at 30 September 2011 increased in comparison to the level of arrears at the end of June 2011. Budget beneficiaries and PE "Roads of Serbia" reduced arrears by RSD 0.7 billion, while organisations of compulsory social insurance increased arrears by RSD 1.6 billion.

Table 16. Arrears of budget beneficiaries and organisations of compulsory social insurance

in RSD billion

	30 June 2011	30 September 2011
Government budget beneficiaries and PE "Roads of Serbia"	12.1	11.4
Organisations of compulsory social insurance	16.9	18.5
Total	29.0	29.9

Source: Ministry of Finance

According to the new regulation, limiting the deadlines for payments by budget beneficiaries, overdue payments are precisely defined so that they mean only unpaid liabilities with more than 60 days past due. Overdue payments in the new Arrangement with the IMF have the same treatment. It is clear that the total level of overdue payments would be lower than the level shown in the Table[3].

Expected fiscal trends in Serbia by the end of 2011

The estimated deficit in 2011 is RSD 153.4 billion. In accordance with the fiscal rule, general government deficit target is 4.6% of GDP. Memorandum on the Budget for 2011 projected the deficit of RSD 140.4 billion, while an increase in deficit target results from the revision (reduction) of the GDP growth rate from the initial 3% to 2%. Effects of the fiscal rule, which regulates deficit target, are basically countercyclical and in this case manifested through an increase in deficit in the conditions of lower growth.

Revised macroeconomic framework, realisation in the first three quarters and changes in the local government financing led to the changes in the projections of revenues for 2011. In order to achieve a deficit target, adjustment was made on the expenditure side in line with the specific fiscal rules governing increase in wages and pensions. The structure of expenditures which influence the living standard of the population and economic growth was maintained as much as possible.

The following Table shows a current projection of revenues, expenditures and fiscal result for 2011. The first column represents a plan of revenues, expenditures and results, adopted in the Memorandum on the Budget for 2011 and reflected in the Law on the Budget for 2011. The second column shows the projection agreed while concluding the new Stand-by Arrangement with the IMF in September 2011 and the basis for the adopted Law Amending the Law on the Budget for 2011. The last column gives the latest estimate, agreed on the first review of the mentioned Arrangement.

[3] According to the methodology of collecting data on arrears at the level of central government, all overdue liabilities were included (outstanding due liabilities), irrespective of the number of days past due. By the end of 2011, a new method of collecting data for the level of central government will be introduced so that it will allow separation of those liabilities with more than 60 overdue.

Table 17. Plan and updated assessment of public revenues and expenditures

in RSD billion

	2011 plan*	2011 estimate**	2011 current estimate
PUBLIC REVENUES	1,325.9	1,315.8	1,313.2
Current revenues	1,324.1	1,314.0	1,311.4
Tax revenues	1,153.3	1,139.4	1,135.0
Personal income tax	147.5	150.8	151.2
Corporate income tax	38.2	38.3	38.7
Value added tax	355.9	341.4	339.6
Excise duties	179.5	180.5	176.5
Customs duties	39.6	39.8	39.0
Other tax revenues	47.9	46.1	44.3
Contributions	344.7	342.6	345.6
Non-tax revenues	170.8	174.6	176.5
Capital revenues	0.0	0.0	0.0
Donations	1.8	1.8	1.8
PUBLIC EXPENDITURES	1,466.3	1,469.2	1,466.6
Current expenditures	1,319.9	1,329.0	1,323.2
Expenditures for employees	328.8	338.6	337.4
Purchase of goods and services	238.3	230.0	227.5
Interest payment	49.9	46.0	46.0
Subsidies	84.2	85.5	85.7
Social insurance and other transf. to households	603.1	612.1	609.8
Of which pensions	416.6	423.1	422.7
Other current expenditures	15.6	16.8	16.8
Capital expenditures	118.7	113.5	116.7
Net budget loans	27.7	26.7	26.7
Result	-140.4	-153.4	-153.4

* According to the Memorandum on Budget for 2011 and Budget Law for 2011
** Estimate prepared when concluding a new Stand-by Arrangement with the IMF in September 2011
Source: Ministry of Finance

In comparison to the initial plan, higher revenues are expected from personal income tax, social contributions and non-tax revenues. A higher projection of certain categories of direct taxes is partly a consequence of the higher nominal growth in public sector wages. That effect is partly directly seen through the payment of tax on wages and contributions of public sector workers, but also through a spillover of such wage increase on the wages in the public sector.

On the other hand, revenue projections for theother categories were lowered, primarily for revenues collected from consumption taxation. Nominal growth in wages and pensions was not, however, sufficient to also ensure a real growth of income, which resulted in a reduced consumption, while import component recorded a more significant decrease. The structure of VAT revenues changed in accordance with above trends. The projection of customs revenues was also reduced to a certain extent.

In the September projection (when concluding the Arrangement with the IMF), the highest growth in comparison to the originally planed amount, on the expenditure side, was recorded in case of employee expenditures and pensions due to a higher indexation of these categories than originally planned[4].

[4] The plan from December 2010 (revised Memorandum on the Budget for 2011) anticipates the indexation of 2% in January, 2.95% in April and 2% in October. In the September projection, expenditures for wages and pensions were calculated based on the following paramteres: 2% in January, 5.5% in April and 1.4% in October. As the achieved inflation in the period April – September was slightly lower than the planned, with an increase by half a rate of the real GDP growth from the previous year, the October indexation was 1.2% instead of the planned 1.4% by half a rate and therefore that indexation was applied in the actual projection of revenues and expenditures by the end of the year.

Adjustments on the expenditure side were mostly made within discretionary categories, primarily expenditures for goods and services. Subsidies are slightly higher, while budget loans remained at the same level. In the September projection, capital expenditures were somewhat lower, but in the last projection they were increased, taking into account faster implementation of capital projects which are financed from the loans granted by the international financial organisations. Relatively considerable savings were also achieved on the expenditure side for interest payments.

On the last revision of projections, during the first review of the Stand-by Arrangement with the IMF, deficit target for 2011 was not changed, considering the fact that the growth projection for 2011 was not changed.

Lower revenue in October and revision of the annual projections downwards, on the one hand, and increased capital expenditures financed from the project loans, on the other hand, created an additional gap which needed to be closed in order to make sure that the fiscal deficit target is not exceeded. Savings are expected on the positions of salaries and pensions (lower indexation of October salaries and pensions than the previously projected), as well as savings on the purchase of goods and services and slightly lower deficit at the local government level due to the increased revenues. On the revenue side, projections is increased, due to the dividen paymentof PE "Electric Power Industry of Serbia", which was not previously planned, as well as due to slightly higher collection of fines charged for currency offences.

Taking into account the risks that may lead to slightly lower revenues compared to the relevant projection, additional savings will be applied, in addition to the anticipated measures, in order to prevent jeopardising the achievement of the deficit target for 2011.

2.2. Fiscal projections in the period 2012 - 2014

Fiscal rules determine medium-term fiscal deficit target, as well as maximum debt-to-GDP ratio, with the view to ensure long-term fiscal policy sustainability in the Republic of Serbia. The following two general fiscal rules are defined:

1) Medium-term annual fiscal deficit target will be 1% of GDP;

2)General government debt, excluding liabilities arising from restitution, will not exceed 45% of GDP.

So as to ensure that the achieved medium-term fiscal deficit is equal to the target as well as to allow implementation of anti-cyclical fiscal policy, the following formula for the calculation of fiscal deficit in the year t shall be applied:

$$d_t = d_{t-1} - a(d_{t-1} - d^*) - b(g_t - g^*)$$

where d_t and d_{t-1} represent deficits in years t and t-1, d^* is fiscal deficit target determined at 1% of GDP, g_t represents real GDP growth rate in year t, while g^* represents potential medium-term GDP growth rate.

Deficit in the formula is expressed as a percentage of GDP, while GDP growth rates are expressed in percents. Coefficient of adjustment "a" shows the speed at which the actual deficit is nearing the deficit target, whereas coefficient "b" shows how much fiscal deficit in year t deviates from target deficit due to the deviation of GDP growth rate in year t from the potential GDP growth rate. Numerical value of coefficients is determined as a=0.3 and b=0.4, while potential GDP growth rate is set as g*=4%.

Table 18. GDP growth and fiscal result trends in the period 2012 – 2014

	2012	2013	2014
Fiscal deficit, in % GDP	4.3%	3.7%	2.9%
Real GDP growth rate	1.5%	3.0%	4.0%

Source: Ministry of Finance

Projections of fiscal aggregates in the period 2012–2014 are based on the projections of macroeconomic indicators for the same period and implementation of the fiscal rules, which leads to reduction in the share of public spending in GDP and reduction in the public sector deficit to 2.9% of GDP at the end of the observed period.

Table 19. The main fiscal aggregates in the period 2011-2014

in % GDP

	estimate		projection	
	2011	2012	2013	2014
Public revenues	39.1	39.9	39.4	39.2
Public expenditures	43.7	44.2	43.1	42.1
Consolidated fiscal result	-4.6	-4.3	-3.7	-2.9

Source: Ministry of Finance

The projected public sector deficit in all years of the observed period maintains the public debt-to-GDP ratio at the upper fiscal constraint limit of 45%.

Table 20. Projected general government debt in GDP in the period 2011 – 2014

in % GDP

	2011	2012	2013	2014
General government debt	42.4	44.0	44.9	44.4

Source: Ministry of Finance

Graph 13. Share of debt and deficit in GDP

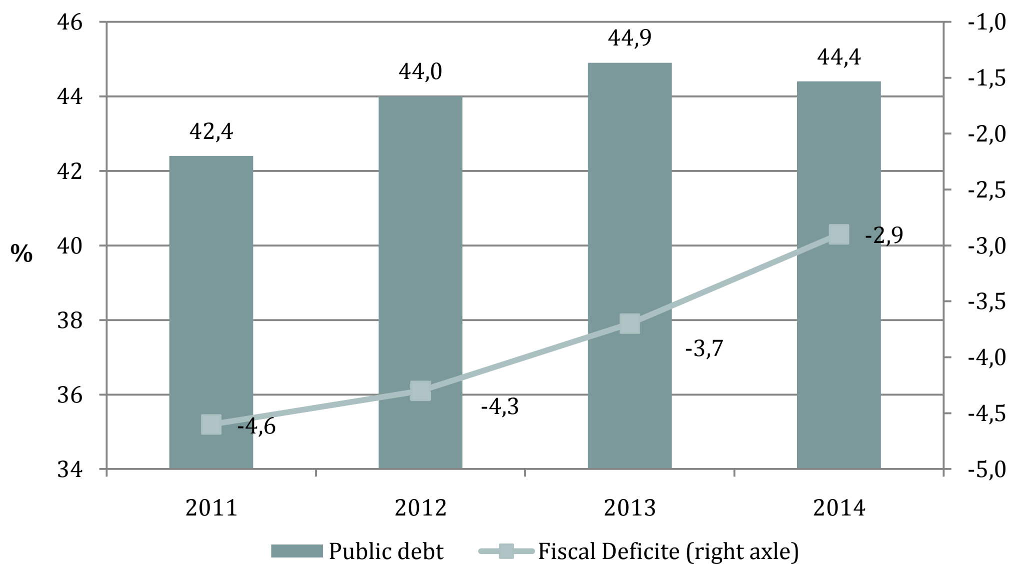


Table 21. Total revenues and donations in the period 2011 – 2014

in % GDP

	Estimate	Projection		
	2011	2012	2013	2014
PUBLIC REVENUES	39.1	39.9	39.4	39.2
Current revenues	39.0	39.8	39.3	39.2
Tax revenues	33.8	34.1	34.1	34.0
Personal income tax	4.5	4.5	4.5	4.5
Corporate profit tax	1.2	1.2	1.2	1.2
Value added tax	10.1	10.2	10.4	10.5
Excise duties	5.3	5.4	5.4	5.4
Customs duties	1.2	1.0	0.8	0.7
Other tax revenues	1.3	1.3	1.3	1.3
Contributions	10.3	10.5	10.5	10.5
Non-tax revenues	5.3	5.7	5.2	5.1
Capital revenues	0.0	0.0	0.0	0.0
Donations	0.1	0.1	0.0	0.0

Source: Ministry of Finance

Personal income tax. Personal income tax is projected at the level of 4.5% of GDP in the following period. The major portion of personal income tax is tax on salaries. Trends of revenues depend on the trends of salaries and employment. As salaries are expected to rise in accordance with the productivity growth as well as a moderate employment rate, it is reasonable to expect that revenues from personal income tax will have a stable share in GDP during the coming period.

Social security contributions. Social contributions represent one of the largest components of public revenues. Share of contributions in GDP is around 10.5% and the trends of this public revenue share have a similar path as a share of taxes on wages. Strengthening of tax discipline and changes in the collection and control systems will allow the realisation of the projected values. The projection of contributions is made according to the assumptions on the trends in wages and employment in the following medium term.

Corporate income tax. Corporate income tax is a form of tax which is considerably affected by the fall in economic activity. The major drop in the share of this tax in GDP was seen in 2009, with the negative trend continued also in 2010. After that, in the period from 2011 to 2014, a mild increase in the share is expected, with the stable rate of 1.2% of GDP.

Value added tax. Value added tax is projected at 10.2% of GDP in 2012, whereas in the next two years a mild increase in the GDP share is expected. VAT includes two components, import and domestic. Value added tax collected from import of goods and services makes around 60% of the total GDP and the projection is based on the trends of import and foreign exchange rate, as well as the assumptions on the effects of the implementation of the SAA. Domestic VAT is projected according to the personal spending trends in the next period and makes approximately 40% of the total revenues collected from value added tax. Increase in VAT share in GDP also results from the faster growth in import in relation to the nominal GDP, as well as from the real growth in household income in the next period. Strengthening of the fiscal discipline is one of the prerequisites based on which this tax form was projected.

Excise duties. Projection of revenues from excise duties was made according to the projected consumption of excise products (oil derivatives, tobacco products, alcohol and coffee) and foreseen changes in the legislation. The total projected excise duties on oil derivatives are planned as the Republic budget revenue, whereas the funds for road maintenance are transferred to PE "Roads of Serbia", in the amount of 10% of the estimated revenues from excise duties on oil derivatives. The excise policy for the next medium term foresees further gradual harmonisation with the EU directives.

Customs duties. Projection of revenues from customs duties is in direct correlation with the import volume and structure. Considering SAA with the EU in place, a further drop in the share of these revenues in GDP is expected, as provided for by the Agreement. Reduction in tax burden on products made in the EU will also reflect the structure and volume of import from this region. Effects on the trends of revenues from customs duties are therefore multiple.

Other tax revenues. These revenues, which include property tax as its major portion, as well as taxes on usage, holding and carrying of goods, are projected in line with the nominal GDP growth. The level of these revenues is relatively stable without notable reactions to the economic activity decrease. Therefore, in the periods of stronger crisis and a slower growth in other tax revenues, this category's share tends to be slightly higher. In the medium term, characterised by the economic growth, share of other tax revenues is stabilised at a lower level.

Non-tax revenues. Fees, fines, and other non-tax revenues in the medium term retain the share at a slightly higher level of 5% of GDP, except in 2012. Non-tax revenues in 2012 also include the funds collected from the acquired receivables from the bankruptcy estate in the amount of 0.04% of GDP. It also caused a slightly higher shae in GDP of these revenues in 2012. In the following years, this amount will be excluded from the base for the projection of non-tax revenues.

Table 22. Total expenditures in the period 2011 – 2014

in % GDP

	Estimate	Projection		
	2011	2012	2013	2014
PUBLIC EXPENDITURES	43.7	44.2	43.1	42.1
Current expenditures	39.4	40.0	38.9	38.0
Expenditures for employees	10.0	10.2	10.0	9.8
Purchase of goods and services	6.8	6.9	6.2	5.9
Interest payment	1.4	1.8	1.9	2.0
Subsidies	2.6	2.7	2.3	2.2
Social insurance and other transf. to households	18.2	18.0	18.2	17.8
Other current expenditures	0.5	0.4	0.4	0.3
Capital expenditures	3.5	4.0	3.8	3.8
Net lending	0.8	0.2	0.3	0.3

Source: Ministry of Finance

Fiscal adjustment on the expenditure side is 1.6 pp in the observed period. The major portion of the adjustment refers to the current spending, thus avoiding the drop in the share of public investment in the next medium term. The specific fiscal rules are meant to make sure that the fiscal deficit reduction in relation to GDP is mostly realised through decrease in current, not capital expenditures.

To implement an appropriate level of fiscal adjustment, it is necessary to carry out savings measures at all government levels, both central and local, as well as to ensure more efficient public procurement process and redefine measures of economic support in order to allocate the extremely limited resources for fiscal incentives towards those programmes of economic support that bring the best results from the aspect of fostering the economic growth and employment.

Expenditures for employees. Public sector wages are re-aligned with the trends of inflation and partly with the GDP growth in the previous year. Considering the projected inflation in the observed period, a solid decrease of the share of expenditures for employees in GDP is expected. Wages are to be aligned according to the specific fiscal rule until the share of these expenditures has reached the level of 8% of GDP.

Purchase of goods and services. This category of expenditures is expected to record a notable decrease of the share in GDP, as these expenditures are mostly dependent on the inflation trends. The major portion of fiscal adjustment on the expenditure side, in order to achieve the planned deficits, will be realised by savings in this type of expenditures.

Interest payment. Expenditures based on interest payment are projected in line with the public debt repayment schedule. The projection also included trends of interest rates paid by the local government. The share of interest payments in GDP is increasing during the period due to the plans for significant infrastructure investments which are to be financed from external loans.

Social insurance and other transfers to households. The major portions of transfers to households are pensions. According to the Budget System Law and the specific fiscal rule governing pensions, in 2011 and 2012 pensions should follow the growth in public sector wages. In the period 2013 – 2015, pensions are aligned with retail price index growth, increased by the portion of a real GDP growth if it is over 4%. The target defined by the fiscal rules is a reduction of the share of pensions in GDP to 10.5%. Other forms of social insurance and transfers to households in the period 2012-2014 are adjusted by applying the prescribed indexation, current and planned policy changes in this field, as well as the projected number of beneficiaries. The share of this expenditure category, by applying the above rules, drops from 18.2% GDP recorded in 2011 to 17.8% in 2014.

Subsidies and budget loans. Fiscal adjustment in the observed period was mainly carried out by reducing the funds for subsidies and budget loans. In the years of crisis, these expenses are considerably increased due to fiscal incentives for households and economy. After the exit from crisis, the funds used for incentives are gradually reduced. Incentives for households (subsidised cash and consumer loans) are first reduced and then abolished. In the following period, incentives for companies are to be gradually reduced and/or the limited resources intended for fiscal incentives to be allocated to more efficient programmes of economic support. Within category of subsidies and budget loans, no reduction of the funds intended for agriculture and subsidies to public enterprises (Public Enterprise "Serbian Railways" and Public Enterprise for Underground Coal Exploitation "Resavica") for payment of salaries is planned. For reduction and final abolishment of subsidies for employees wages in the above public enterprises, these companies need to be restructured in order to be able to ensure financing from their own sources.

Capital expenditures. Reduction in the government spending opens a room for maintaining public investments at the average level of 3.8% in the next medium term. Considering the limited funds, a special emphasis in the planning of medium term investment will be placed on the investments of national importance (Corridor X). An increase in the share in 2012 is explained by the necessity to finance the completion of certain infrastructure projects at the central and local level. For a more considerable increase in the share of capital expenditures, in the circumstances when fiscal rules require gradual fiscal deficit reduction, a stronger and more dynamic economic growth is necessary.

2.3. Potential GDP Growth Estimate and Cyclically Adjusted Budget Deficit by 2014

Potential Growth and Production Gap in Serbia in 2002-2014

Potential GDP is the long-term production capacity of a national economy, and production gap (Output gap) is the differece between the actual and potential GDP.

Potential GDP is not a technical production maximum, but a measure of sustainable growth (GDP growth that does not raise the rate of inflation). It is the best composite indicator of the potential of a national economy to provide for sustainable, non-inflationary growth. Potential GDP and Output gap estimates, offer useful information on actual potential of an economy to generate better outputs using the existing levels of production factors. Basic rule of efficiency and growth through increased productivity is to first use the existing economic capacities with the aim to produce higher quality and quantity of goods, and once these capacities have been used to the fullest, there is a need for additional investments.

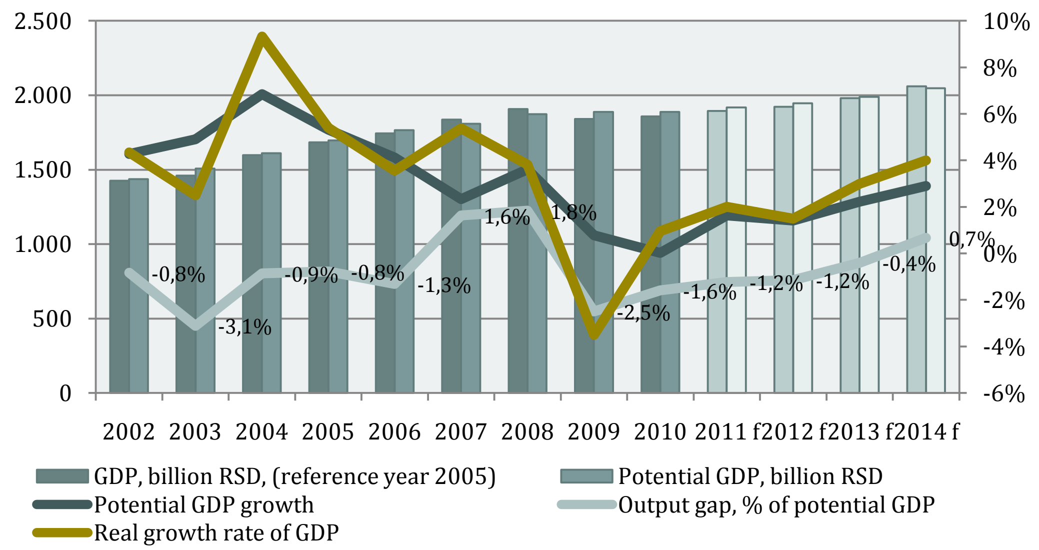
Cobb-Douglas type of utility function[5] is used for calculation of potential GDP and potential gap. The basic idea is to calculate optimum output that an economy can produce providing that the capital and labour[6] are used efficiently. The Cobb-Douglas production function form is as follows[7]:

$$Y = (U_L L E_L)^{\alpha} (U_K K E_K)^{1-\alpha} = TFP \bullet L^{\alpha} \bullet K^{1-\alpha}$$

Average potential GDP growth in 2002 -2008 was 4.5% and the actual GDP growth was 4.9% in the same period. Potential actual growth rate slowed down as of 2004, and the actual rate of real growth begun its downward trend starting from 2008.

The output gap, which is a measure of cyclical character of economic activity, was negative over the observed period, with the only exceptions of 2007 and 2008 (1.6% and 1.8%, respectively), which was led above all by the high levels of domestic demand. In 2002-2006, economy in Serbia achieved high growth rates, but with insufficient levels of output factors' utility, and the potential GDP was on average higher than the actual GDP. The output gap growth in 2007 (by almost 3 p.p. of potential GDP) and high positive output gap in 2008 were a clear signal of an overheated economy (high growth of credit activitiy and growth of nominal wages, as well as of the foreign trade deficit and current account deficit that reached the level of GDP 27.7% and 21.6% in 2008 respectively) and also that the economic growth could not be sustainable in long term. In 2009, due to the slowdown in economic activity, there was even bigger negative output gap and this trend continued in 2010, too. The slowdown of economic output potential growth came as a consequence of combined influence of several factors, and before all of the smaller investments in production capacities, slower financing of current production activity of enterprises and negative trends in labour market.

Graph 14: Potential and actual GDP and output gap in 2002-2014



Potential growth estimate for 2012-2014 was based on gradual economic recovery, and expectation that the output gap in 2014 will be positive after five years of negative correlation between the actual and potential GDP growth rate.

[5] Potential GDP and output gap can be estimated also by using the Hodrick-Prescott filter (λ=1600), where similar and satisfactory results were obtained.

[6] The assumption was that α=0,65, $\alpha+\beta = 1$, β= 1- α

[7] The Cobb-Douglas output function shows potential GDP (Y) as a combination of labour output factor (L) and capital (K), corrected by the level of capacity utilization (U_l , U_k) and adjusted by the efficiency levels (E_l,E_k).

Key determinants of potential growth are the investment ratio (ratio between investments in gross capital assets and potential GDP), natural unemployment rate and participation rate (ratio between active population and population of 15 to 64 years of age).

It has been estimated that the growth of potential GDP over the future period will exert positive influence on strengthening of investment activities and, to a somewhat smaller degree, to the participation rate. It has been expected that the natural rate of unemployment will start to decrease after 2012.

Finding ways to increase the total factor productivity that has showed a downturn trend over the past period as a result of the slowdown of investment efficiency will present a special challenge over the future period. Therefore, it is necessary to implement structural reforms that will provide for long-term and sustainable development of the country based on higher productivity of the economic sector.

Cyclically Adjusted Fiscal Balance

Cyclically adjusted fiscal balance is the fiscal balance that does not include the influence of business cycle. A portion of the fiscal balance that is automatically adjusted to the cyclical fluctuations is called cyclical fiscal balance. Achieved fiscal balance equals the cyclically adjusted fiscal balance in cases when the output gap equals zero, i.e. if the actual GDP growth rate is equal to the potential GDP growth rate.

Estimate of the cyclically adjusted budget deficit is advantageous in several aspects:

- It enables the clear perspective of the budget position and determining of the necessary level of fiscal adjustment over a period, with a potential to easily perceive the improvements achieved by applying certain policies, as opposed to those that came as a result of the effect of the cycle;
- It is used to determine the character of the fiscal policy – whether it is an expansive or a restrictive policy;
- It enables that policies are easily analyzed, including the analysis of the automatic stabilizers' effects;
- It is used for medium-term budget planning and control;
- Cyclically adjusted deficit shows the level of accumulation of cyclically adjusted debt, etc.

To estimate the cyclically adjusted deficit, the OECD approach was used. This approach is used to assess the sensitivity of cyclically sensitive revenues and expenses against the output gap[8]. To estimate the overall elasticity of the total public revenues, individual elasticity of the following categories of revenues are estimated first:

- Personal income tax,
- Corporate income tax,
- Social insurance contributions,
- Indirect taxes (VAT and excise tax).

The estimate is made in two phases, by firstly estimating the elasticity of the individual tax against the tax base (adequate macro economic variable), and in the second phase, the elasticity of the tax base is estimated against the output gap. In the example of the income tax, the procedure is such that the elasticity of the tax is estimated against the citizens' income (total mass of earnings), and after that the elasticity of income is estimated against the output gap. By

[8] The estimate of budget elasticities was made by using the available data for 2001-2010, with the aid of adequate econometric and statistical procedures.

multiplying these two elasticity values, elasticity of a selected tax is obtained against to the output gap, and the same procedure is then repeated for all the categories of taxes listed. The aggregate, i.e, the total tax elasticity equals weighted elasticity average of individual taxes. In this case, it has been estimated that it equals $\varepsilon_{T,Y}$=0.92.

On the expenditure side, this methodology covers only for the estimate of elasticity of the unemployment gap, owing to the assumption that only the unemployment gap component is cyclically sensitive, or influenced by the business cycle. Elasticity of the unemployment gap is then weighted by the share of unemployment-related expenses in the total expenses. The elasticity of primary expenses estimated in this manner is $\varepsilon_{\Gamma,Y}$=-0.03.

In order to determine the sensitivity of the revenues and expenses against the output gap, the aggregate value of individual elasticities is multiplied by the shares of revenues and expenses in GDP. Sensitivities calculated in this manner equal η_T=0,33 for revenues and η_G=-0.01 for expenses.

The fiscal balance sensitivity ratio is equal to the difference between the sensitivity ratios of revenues and expenses: $\eta = \eta_T - \eta_G = 0.33-(-0.01) = 0.34$[9].

Cyclically adjusted balance is calculated by using the following form: CABt = FBt – η(Yt - Yt*)/Yt*[10].

[9] The elasticity of revenues and expenses are to a great degree dependable on the tax system structure and tax bases in the sense of the total tax burden, degree of progressive character of different types of taxes, assistance programmes to the unemployed, and the similar.

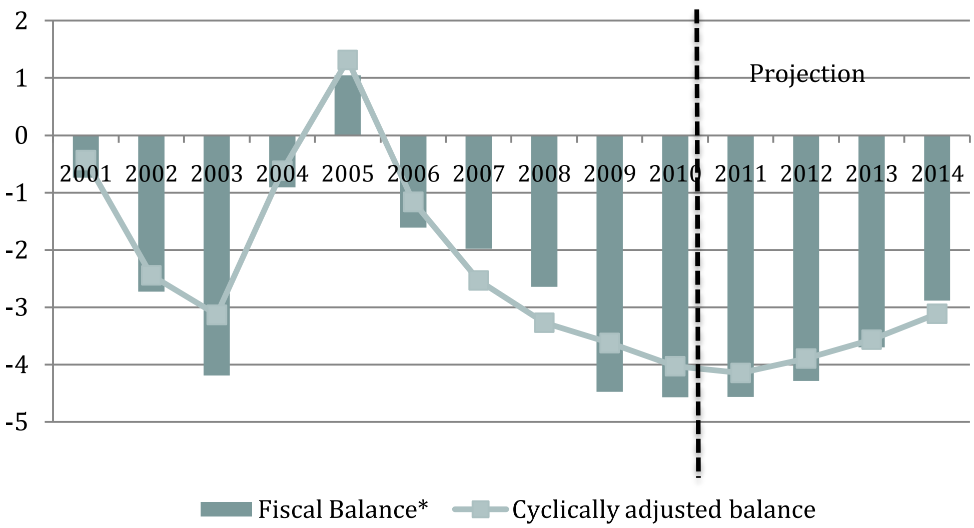
[10] In this formula, CAB_t is the cyclically adjusted balance, FB_t is the actual fiscal balance in the year in question, and the $\eta(Y_t - Y_t^*)/Y_t^*$ part of the form is the cyclic balance. $(Y_t - Y_t^*)/Y_t^*$ is the previously estimated output gap.

Table 23. Fiscal balance and components used in calculation of cyclically adjusted balance in 2001-2014 in GDP %

	Output Gap	Fiscal Balance*	Cyclically adjusted balance	Cyclic Fiscal Balance	Fiscal Policy Character (Fiscal Impulse)
2001	-0.90	-0.74	-0.43	-0.31	/
2002	-0.84	-2.73	-2.44	-0.29	2.01
2003	-3.11	-4.19	-3.13	-1.06	0.69
2004	-0.86	-0.91	-0.62	-0.29	-2.52
2005	-0.78	1.05	1.32	-0.27	-1.93
2006	-1.32	-1.61	-1.16	-0.45	2.48
2007	1.63	-1.98	-2.53	0.55	1.37
2008	1.83	-2.65	-3.27	0.62	0.74
2009	-2.50	-4.47	-3.62	-0.85	0.36
2010	-1.59	-4.57	-4.03	-0.54	0.40
2011	-1.24	-4.57	-4.14	-0.42	0.12
2012	-1.15	-4.29	-3.89	-0.39	-0.25
2013	-0.40	-3.70	-3.56	-0.14	-0.33
2014	0.67	-2.89	-3.11	0.23	-0.45

* For 2011-2014, projected values are presented.

Graph 15. Actual and cyclically adjusted fiscal balance in 2001-2014 in GDP %

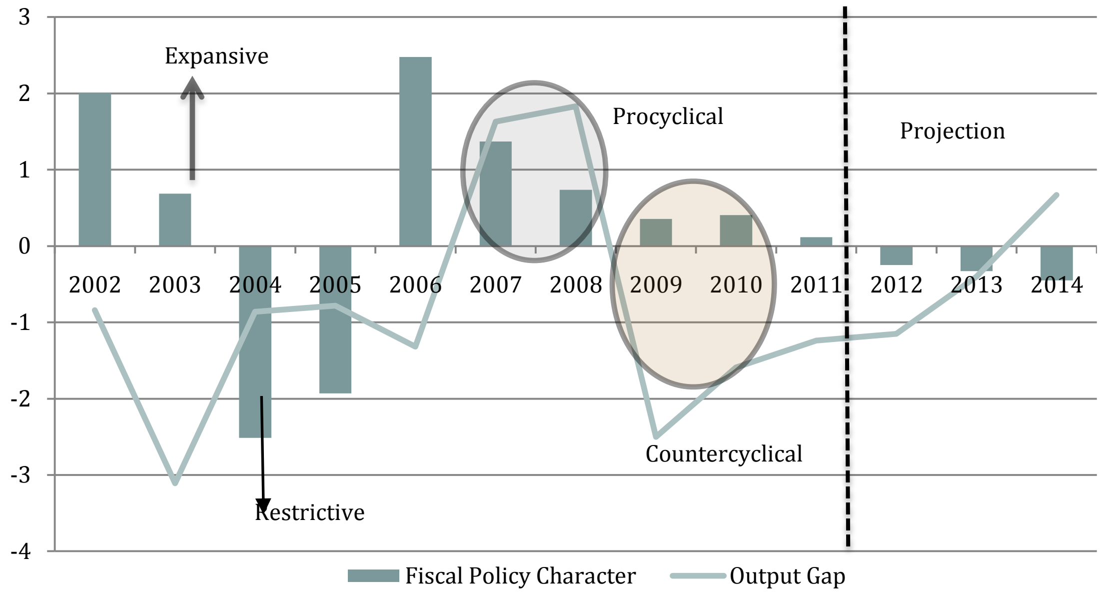


The preceding graph shows actual fiscal and cyclically adjusted fiscal balance in 2001-2010 with forecasts for 2011-2014. Looking at the nearest historical period, the positive effect of the cycle was evident in 2007 and in 2008, which both had a positive output gap. The effect of the cycle was such that it led to the fiscal balance that was smaller than it would have been had the economy taken the road of potential growth. In a reverse case, during the period when the crisis was most evident, or in 2009 and 2010, the influence of the cycle was negative, output gap reached high negative levels, and the actual fiscal balance showed deficit that was much higher than that of the cyclically adjusted fiscal balance.

In 2012-2014, GDP growth rates will be approaching the potential growth rates, output gap will be close to zero and in 2014 it will reach positive value. The consequence of the positive effect of the cycle is reflected in the lower level of actual fiscal deficit when compared with the cyclically adjusted fiscal deficit.

Graph 16. Character and effects of the fiscal policy in 2002-2014

in GDP %



Trends of the cyclically adjusted fiscal deficit are additionally used as an indicator of the fiscal policy character. Table 23 shows the fiscal impulse that was calculated as a difference between the cyclically adjusted fiscal deficit levels in the current and in the previous year. Here, a positive sign is an indicator of expansive, and a negative sign is an indicator of the restrictive character of fiscal policy[11]. In the previous graph, periods of expansive and periods of restrictive fiscal policy are clearly shown, as well as the scope of the impulse itself.

If we include the output gap in the analysis, too, the fiscal policy effect can also be assessed as either pro-cyclical or counter-cyclical. The pro-cyclical fiscal policy is characterized by the presence of expansive fiscal policy in the period of economic growth that exceeds the potential growth (or by the presence of a restrictive fiscal policy in a period of economic recession), and the case is reversed for the counter-cyclical fiscal policy. The main problem with the pro-cyclical fiscal policy is that it does not allow the stabilizers to function automatically. As a result of that, the modifications in expenses follow the GDP trends and it can be said that they do not come as a result of the planned fiscal policy. In case of economic growth that exceeds the potential growth, the cyclical component of revenue growth is used for reduction of taxes or for an increase in expenses, rather than to reduce the fiscal deficit.

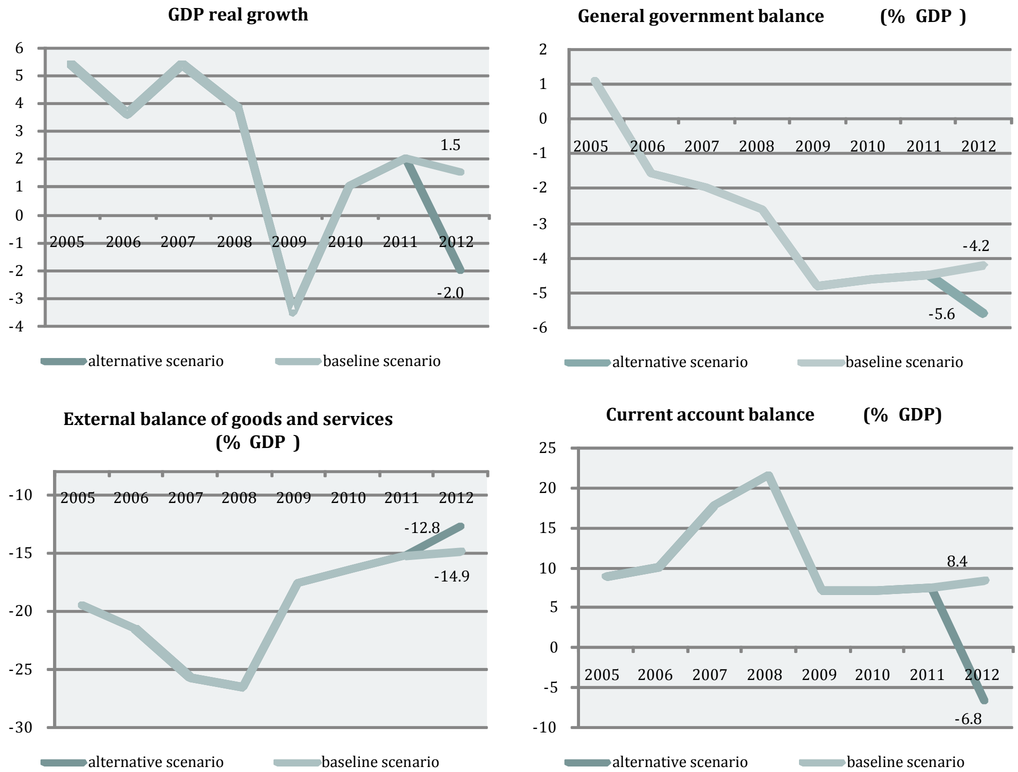
The period of pro-cyclical fiscal policy was evident in 2004-2005 and in 2007-2008. Starting from 2009 and further on, a period of counter-cyclical fiscal policy was initiated, owing to a relatively expansive fiscal policy under the conditions of economic growth that was below the potential growth levels. At the end of the period, in 2014, growth exceeding the potential growth levels is evident, coupled with a positive output gap. Combined with the restrictive fiscal policy, which came as a result of the implementation of fiscal rules, a desired form of counter-cyclical fiscal policy is achieved.

[11] It would be correct, methodology wise, to include the cyclically adjusted primary balance in the analysis as a measure of the fiscal impulse, but the methodology used here also serves to gain an objective picture of the character and influence of the fiscal policy. There are, of course, different limitations to the use of cyclically adjusted fiscal deficit for the estimate of fiscal policy effects in this sense, and it is thus advisable to be careful in reaching of the final estimate.

2.4. Fiscal Risks

Public finances in the Republic of Serbia are facing numerous risks over the next medium-term period, which makes the fiscal position of the state highly unstable. Fiscal risks are circumstances that could, if realized, lead to a significant drop in revenues or increase in expenses. Realization of the foreseen levels of revenues and expenses depends on the success of the fiscal policy in minimizing the probability of risks' realization. Success in managing of fiscal risks depends on the political, macro economic and social circumstances in the country and in its immediate neighbourhood.

Downturn of economic activity. There are significant negative risks in comparison with the forecasts presented in the basic scenario. The negative scenario, according to which a downturn in economic activity was forecast for 2012, could lead to a significant reduction in capital inflow, reduction of the foreign trade exchange, and based on the drop in economic activity, to narrowing of the current account deficit accordingly. Fiscal rule could allow for an increase in the state sector deficit, but the impossibility to finance such a large deficit, coupled with the rule that limits the debt, would not allow for the full counter-cyclical effect of the fiscal policy.



Inflation. Inflation is a significant determining factor in the trends of revenues and expenses. Inflation levels that are higher than the planned ones would exert influence both on the revenues and on the expenses' side of the budget of the state. Since the inflation levels are the main determining factor in the trends of salaries and pensions that account for more than 50% of the expenses in the general state sector, higher inflation levels will lead to higher deficit levels, i.e. the inflation growth above the projected levels for 1 pp would lead to the growth in deficit for 0.2 to 0.3 pp in 2012.

Contributions payment levels. Trends to avoid payment of mandatory social insurance contribution lead to a reduction in revenues of the mandatory social insurance funds, and this deficit of funding is compensated for from the Republic of Serbia Budget. Collection levels that are lower by 1% than the expected, lead to an increase in the deficit of the general state for 0.1pp.

III. Public Debt Management Strategy in 2012 - 2014

Pursuant to the Law on Public Debt (RS Official Gazette, No. 78/11 and 107/09), which provides the legal basis for the debts of the Republic of Serbia, public debt is:

- Debt of the Republic of Serbia incurred on the basis of the agreements concluded by the Republic of Serbia,
- Debt of the Republic of Serbia incurred on the basis of securities,
- Debt of the Republic of Serbia incurred on the basis of contracts, i.e. agreements, concluded to re-programme the liabilities that the Republic of Serbia undertook according to the previously concluded agreements, as well as for the securities that were issued pursuant to some special laws,
- Debt of the Republic of Serbia incurred on the basis of the guarantees provided by the Republic of Serbia, or on the basis of the direct assumption of debts in the capacity of a debtor liable for repayment of debt based on the guarantee issued, or based on a counter-guarantee provided by the Republic of Serbia,
- Debt of the local governments and the debt of the legal entities that were founded by the Republic of Serbia, the guarantees for which were provided by the Republic of Serbia.

The law allows for borrowing in the country and abroad, i.e. in both the domestic and in the foreign market. The Republic may borrow funds in the domestic and in a foreign currency, in order to finance its budget deficit, the current liquidity deficit, outstanding debts' refinancing, to finance the investment projects, as well as to settle the liabilities based on the guarantees that it issued. Pursuant to the Article 9 of the Law on Deposit Insurance Agency (RS Official Gazette, No. 61/05, 116/08 and 91/10), the Republic of Serbia Government may additionally borrow funds to cover the potential losses with commercial banks.

Pursuant to the Article 13 of the Law on Public Debt, public debt is an unconditional and irrevocable obligation of the Republic in relation to the repayment of principal amount, interest and accompanying expenses. Public debt repayment is always included as a separate budget line in the Republic of Serbia Budget, and compared with other public expenditures' established by the law regulating the Republic of Serbia Budget, it is a priority obligation of the Government.

The Law on Budget System (RS Official Gazette, No. 54/09, 73/10 and 101/10) defines the general fiscal rules, according to which the general government debt, excluding the financial obligations based on the restitution process, shall not exceed 45% of the gross domestic product (GDP). This provision of the Law has been approved and accepted by the international financial institutions, since the Republic of Serbia has limited the allowed public debt on a relatively low GDP level. It is important to note here that according to the Maastricht Criteria, the general government debt includes the local government level debt, but not the guarantees issued by the central government. If such methodology were to be applied, the public debt level of the Republic of Serbia would be on a lower level than the debt calculated according to the currently used methodology.

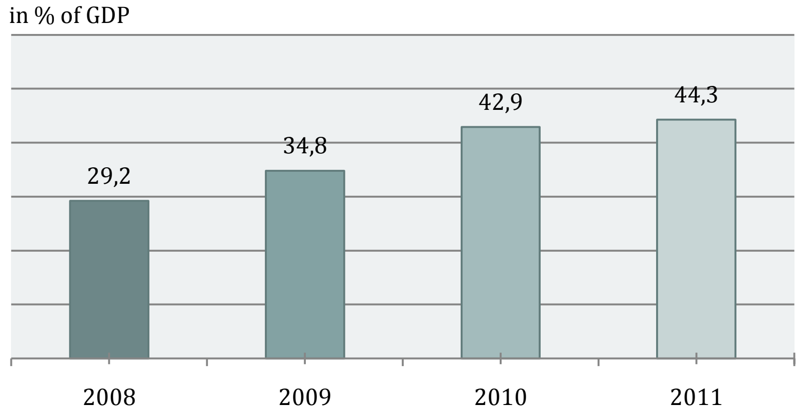
Pursuant to the Law on Public Debt, Directorate for Public Debt was established as an administration body within the Ministry of Finance and its remit and organization were defined with the aim to keep the records of and to manage the public debt of the Republic of Serbia.

1. Public Debt Balance and Structure in 2008-2011

According to the records maintained by the Republic of Serbia Ministry of Finance and its Public Debt Directorate, public debt of the Republic of Serbia is made up of all the direct liabilities of the Republic of Serbia for its debts, as well as of the guarantees issued by the Republic of Serbia Government for the debts of its public enterprises and local governments. The Republic of Serbia public debt consists of direct and indirect liabilities or of the liabilities in the name and for the account of the Republic and of the liabilities based on the guarantees issued by the Republic of Serbia Government, for the benefit of other legal entities. These direct and indirect liabilities can further be divided in the internal and external debt, depending on whether the liabilities were incurred by debts in the domestic or in the international market.

At the end of 2000, total public debt of the Republic of Serbia amounted to GDP 169.3%. As a result of the rise of gross domestic product, regular repayment of the public debt, budget deficit reduction, write-off of a portion of debt by the Paris and London Clubs, as well as owing to some other factors, the public debt to GDP ratio fell to 29.2% in 2008. Owing to the negative effects of the world economic crisis on the domestic economy, the Republic of Serbia increased its debts with the aim to provide funding for its budget deficit in 2009 – 2011.

Graph 17. Trends in public debt-GDP ratio, in 2008-2011



The increase of the budget deficit, modest real GDP growth and depreciation of RSD against foreign currencies in which Serbian public debt was denominated all lead to the increase of public debt level over the last three years, which is now close to the limit envisaged in the RS Law on Budget System. At the end of 2010, total public debt of the Republic of Serbia amounted to RSD 1,282.5 billions, which was a rise from the end of 2009, when the total public debt amounted to RSD 944.4 billions. At the end of 2010, public debt amounted to GDP 42.9%.

Internal public debt grew significantly in 2010. If compared with 2009, it grew from RSD 401.4 billions to RSD 518.2 billions. The external public debt rose from RSD 543.1 billions to RSD 764.4 billions in 2010. In 2009, direct liabilities of the Republic of Serbia Government amounted to RSD 811 billions, and in the following year they grew to RSD 1,102 billions. On the other hand, the indirect liabilities grew, too, from RSD 133.5 billions in 2009 to RSD 180.7 billions in 2010.

At the end of October 2011, total public debt amounted to RSD 1,487 billions, or GDP 44.3 %. Out of that sum, direct liabilities amounted to RSD 1,276 billions, and indirect liabilities accounted for RSD 211 billions. Domestic direct liabilities amounted to RSD 575 billions, and external direct liabilities amounted to RSD 701 billions. In indirect liabilities, the internal debt amounted to RSD 54 billions, and the external debt amounted to RSD 157 billions. If presented in shares of the internal and external public debt, total public debt of the Republic of Serbia is made up of RSD 629 billions and RSD 858 billions respectively.

Table 24. Domestic and external public debt in 2008-2011

	2008	2009	2010	2011/X
		In RSD billions		
Public debt	778.0	944.4	1,282.5	1.487.2
Internal public debt	280.1	401.4	518.2	629.4
External public debt	497.9	543.1	764.4	858.8
		In GDP %		
Public debt	29.2	34.8	42.9	44.3
Internal public debt	10.5	14.8	17.3	18.7
External public debt	18.7	20.0	25.6	25.6

Table 25. Direct and indirect liabilities in 2008-2011

	2008	2009	2010	2011/X
		In RSD billions		
Public debt	778.0	944.4	1,282.5	1,487.2
Direct liabilities, out of which:	695.8	810.9	1,101.9	1,276.2
Internal public debt	280.1	388.4	482.3	575.0
External public debt	415.6	422.5	619.5	701.2
Indirect liabilities, out of which:	82.3	133.5	180.7	211.0
Internal public debt	-	12.9	35.8	54.4
External public debt	82.3	120.5	144.8	156.6
		In GDP %		
Public debt	29.2	34.8	42.9	44.3
Direct liabilities, out of which:	26.1	29.9	36.9	38.0
Internal public debt	10.5	14.3	16.1	17.2
External public debt	15.6	15.6	20.8	20.8
Indirect liabilities, out of which:	3.1	4.9	6.0	6.3
Internal public debt	-	0.5	1.2	1.6
External public debt	3.1	4.4	4.8	4.7

It is important to note here that the public debt of Serbia does not include liabilities on the basis of restitution. Liabilities from restitution will become due as of 2015. The Law on Restitution and Reparation (RS Official Gazette, No. 72/11) regulates deadlines, criteria, methods and procedures that will be implemented by the Restitution Agency in the process of property restitution that was nationalized after the World War II. Property will be restituted in kind, and in cases where this is not possible, compensation will be provided in government bonds and cash. Total amount of compensation must not present a threat to the macro economic stability or economic growth in the Republic of Serbia, and thus the total amount of up to two billions of Euros has been allocated for this purpose, increased by the sum of accompanying interest for all the beneficiaries of the restitution procedure, calculated at the interest rate of 2% annually, for period from January 1, 2015 to the due dates that were specified in this Law. The due date of these bonds will fall within fifteen years with annual repayment instalments, starting from 2015. In certain cases, advance payments of the compensation amount will be made in cash, in the maximum amounts of EUR 10,000.

Internal Public Debt

Pursuant to the Law on Public Debt, internal public debt includes both direct and indirect liabilities of the Republic of Serbia to the domestic investors and creditors. On October 31, 2011, the internal public debt amounted to RSD 629 billions of direct liabilities and RSD 33.1 billions of indirect liabilities.

Table 26. Internal public debt structure in 2008-2011

	2008	2009	2010	2011/X
	In billions of RSD			
Internal public debt	280.1	401.4	518.2	629.4
Government securities	265.5	363.8	430.8	533.7
Treasury bills and government bonds	1.4	100.7	178.2	312.7
Old Foreign Currency Savings Bonds	252.7	251.6	251.8	220.2
Long-term securities (debt to NBS)	10.7	10.7	-	-
Economic regeneration loan	0.7	0.8	0.8	0.8
Other	14.6	37.6	87.4	95.7

For the first time, the Government issued securities in 2003 with three months' and six months' maturity dates. Due to a large influx of money from privatization process in 2005-2008, and also due to a relatively balanced primary fiscal result, the Government did not issue any securities in this period, and thus at the end of 2008, the overall amount of government securities was on a relatively low level. In the last three years, securities were issued with different maturity dates and RSD yield curve was created for securities with maturity date ranging from three months to three years.

Table 27. Public debt structure by different government securities' types (in 2009-2011)

	2009		2010		2011/X	
Financial instrument type		Nominal		Nominal		Nominal
	%	In RSD billions	%	In RSD billions	%	in RSD billions
3 months T-bills	25.8	26.0	12.1	21.5	3.8	12.0
6 months T-bills	56.6	57.0	30.9	55.1	9.5	29.6
6 months T-bills indexed in EUR	-	-	11.8	21.0	-	-
12 months T-bills	17.6	17.7	34.0	60.6	4.2	13.1
53 weeks T-bills	-		-	-	25.1	78.4
53 weeks T-bills in EUR	-		8.4	14.9	6.4	20.1
18 months T-bills	-		2.8	5.0	23.1	72.4
12 months T-bills in EUR					4.8	15.0
24 months T-bills	-			-	12.3	38.5
Government bonds with 3 years maturity date	-			-	4.2	13.2
Government bonds with 3 years maturity date in EUR	-			-	1.9	5.9
Government bonds in EUR, with 15 years' maturity date					4.6	14.5
Total	100.0	100.7	100.0	178.2	100.0	312.7

In the beginning of 2009, and with the aim to provide financing of the budget deficit, the Government issued treasury bills with maturity date of three months, after which they issued 6 months and 12 months treasury bills. The total market value of the issued securities amounted to RSD 202.8 billions in that year, and total treasury bills debt at the end of 2009 amounted to RSD 100.7 billions. As a result of the emission of treasury bills, the share of external public debt, as a portion of the public debt, was reduced to 57.5%, while the share of the internal public debt grew to 42.5% (from 36% at the end of 2008).

In 2010, the debt incurred on the basis of government securities grew and at the end of that year it amounted to RSD 178.2 billions. With the aim to develop the domestic capital market, the Republic of Serbia issued its first treasury bills with the maturity dates of 18 months and 24 months in March 2010. In February 2011, the Republic of Serbia Government issued its coupon bond in Euros with maturity date of 15 years, and the treasury bills denominated in Euros with maturity date of 53 weeks, and in March 2011, the RS Government issued for the first time its RSD denominated coupon bond with maturity date of three years. In June 2011, government bond with coupon and denominated in Euros was issued for the first time in the domestic market with the maturity date of three years, and in July 2011 treasury bills denominated in Euros were issued with maturity date of 18 months.

On October 31, 2011, the debt incurred on the basis of RSD denominated government securities amounted to RSD 257.2 billions, and the government debt on the basis of EUR denominated government securities that were issued in the domestic market amounted to RSD 55.6 billions.

External Public Debt

Pursuant to the Law on Public Debt, the external public debt includes the direct and indirect liabilities towards foreign investors and creditors. The following Table presents the structure of the Republic of Serbia external debt at the end of 2008, 2009 and 2010, and on October 31, 2011:

Table 28. External public debt structure in 2008-2011

	2008	2009	2010	2011/X
	In RSD billions			
Multilateral creditors, and specifically:	405.5	404.0	532.8	501.1
The Paris Club	148.2	153.8	170.6	154.4
IBRD	140.7	118.7	143.3	144.1
EIB	8.4	15.2	38.8	39.5
The London Club	67.7	71.8	79.6	66.9
IDA	40.5	44.5	53.1	51.1
IMF	-	-	47.4	44.5
EBRD	-	-	-	0.6
Others	-	-	-	-
Bilateral creditors, and specifically:	7.6	14.7	63.3	76.6
Switzerland	0.3	0.0	-	-
Italy	2.9	3.2	3.5	4.6
EUУ	4.4	4.7	5.2	15.0
China	-	6.8	8.9	11.3
Russia	-	-	15.9	14.4
Others	-	-	29.8	31.3
Other debts	2.5	3.8	23.5	123.5
Out of which, Euro bonds 2021	-	-	-	71.8
Guaranteed external public debt	82.3	120.6	144.8	156.6
Total external public debt	497.9	543.1	764.4	857.8

Towards the end of 2010, the debt owed to the multilateral creditors amounted to the total of EUR 5.1 billions (RSD 533 billions), i.e. 41.6% of the total public debt, in comparison with EUR 4.2 billions (RSD 404 billions) i.e. 34.6% of the total public debt in 2009. The debt owed to the creditors of the Paris Club at the end of 2010 amounted to EUR 1.6 billions (RSD 170.6 billions) or 13.3% of the total public debt, in comparison with EUR 1.6 billions (RSD 153.8 billions) or 16.3% of the total public debt in 2009. The debt owed to the London Club of creditors amounted to EUR 754 millions (RSD 80 billions) at the end of 2010, or 6.2% of the total public debt, in comparison with EUR 748 millions (RSD 71.8 billions) or 7.6% of the total public debt in 2009.

On October 31, 2011, debt owed to the Paris Club creditors amounted to EUR 1.54 billions (RSD 154.4 billions). Credits granted by the EBRD amounted to EUR 1.43 billions (RSD 144 billions), debt owed to the London Club creditors amounted to EUR 0.7 billions (RSD 67 billions), bilaterally granted loans amounted to EUR 0.8 billions (RSD 76.6 billions). Loans granted by the IDA amounted to EUR 0.5 billions (RSD 51.2 billions), loans granted by the IMF amounted to EUR 0.44 billions (RSD 44.5 billions) and loans granted by the EIB amounted to EUR 0.4 billions (RSD 39.6 billions).

In September 2011, the Republic of Serbia Government issued for the first time its Euro bond in the international financial market of the nominal value of USD 1 billion. Conditions for this issue included the 7.25% coupon and the yield rate by the maturity date of 7.5%. On the issue date, spread to US benchmark bond ratio was 561 basic points, and the bond price from the issue date to the end of November 2011 ranged from 90 to 102. Investment funds from USA bought more than two thirds of the first issue of this government security. With this issue, Serbia has got a liquid bond that will over the next period serve as a benchmark for future issues of Euro bonds in the international financial market.

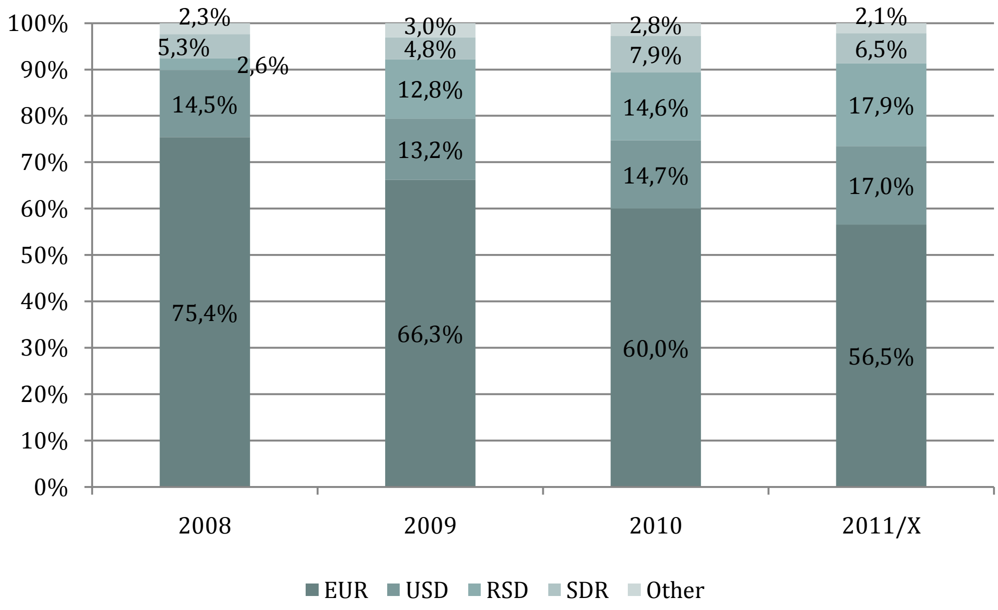
1.1. Structure of the Republic of Serbia Public Debt by Currency Denomination in 2008-2011

At the end of 2008, more than 75% of the public debt of the Republic of Serbia was denominated in Euros, immediately followed by the 14.5% of public debt denominated in US dollars, while the share of debt denominated in the national currency was symbolic only, with 2.6%. With the financing of the budget deficit as of February 2009, issuing of RSD denominated government securities begun and the public debt share denominated in RSD grew to approximately 15% at the end of 2010. On the last day of October 2011, the RSD denominated public debt share amounted to almost 18% of the total public debt of the Republic of Serbia.

Table 29. Public debt structure by currency denomination in 2008 – October 2011

	2008		2009		2010		2011/X	
	(RSD billions)	%	(RSD billions)	%	(RSD billions)	%	(RSD billions)	%
Special drawing rights	40.9	5.3	45.0	4.8	101.4	7.9	96.8	6.5
EUR	586.6	75.4	625.8	66.3	769.9	60.0	840.9	56.5
USD	112.5	14.5	124.5	13.2	188.7	14.7	252.1	16.9
CHF	-	-	18.1	1.9	22.4	1.7	20.1	1.4
RSD	19.8	2.6	120.7	12.8	187.1	14.5	265.6	17.9
Other	18.2	2.3	10.5	1.1	13.0	1.0	11.7	0.8
Total	778.0	100.0	944.4	100.0	1,282.5	100.0	1,487.2	100.0

Graph 18. Public debt structure by currency denomination in 2008 – October 2011

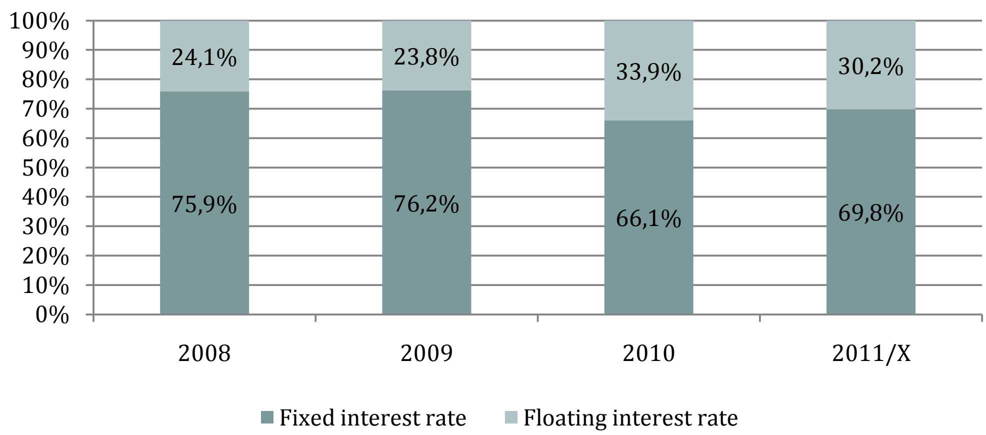


According to data available in October 31, 2011, the biggest share of the public debt of the Republic of Serbia is still denominated in Euros - 56% of the total public debt. The public debt share in EUR is immediately followed by the public debt shares denominated in RSD and USD, with 18% and 17% shares respectively. The remaining portion of the Republic of Serbia debt is denominated in special drawing rights and in other currencies with 6.5% and 2% shares respectively.

1.2. Interest Rate Structure of the Republic of Serbia Public Debt in 2008–2011

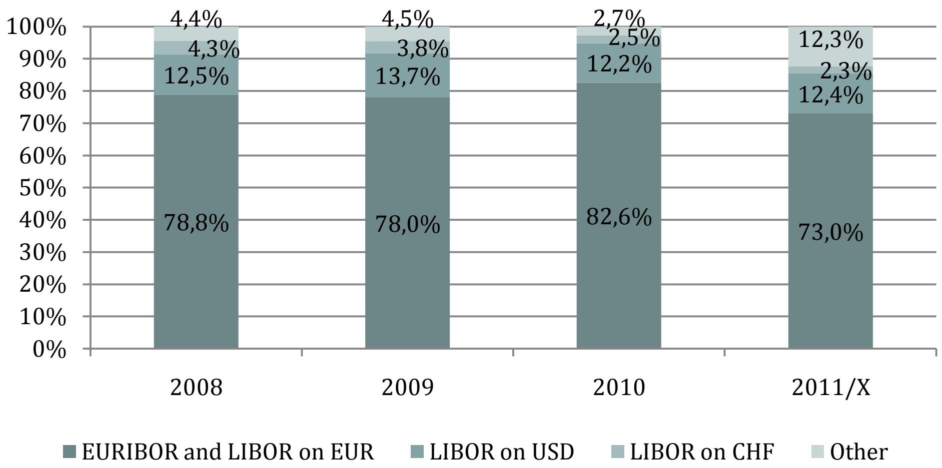
The structure of the public debt of the Republic of Serbia by the interest rates is auspicious, since the majority of debts was granted at fixed interest rates. In 2008, this share was even bigger (with 75%), but in 2010 it has fell significantly, to 66%. According to the data available on October 31, 2011, the fixed interest rates were agreed for a share of 70% of the public debt. On the other hand, the variable interest rates are mostly linked to EURIBOR and LIBOR to EUR.

Graph 19. Public debt interest rates' structure in 2008–2011



The largest portion of the Republic of Serbia public debt of approximately 70% was agreed with fixed interest rate, and some 30% of the total amount of public debt was agreed with the variable interest rates. Among the variable interest rates, a majority of 22.1% of the public debt is linked to EURIBOR, 3.4% to LIBOR to USD and 0.7% to LIBOR to CHF. 0.1% share of the public debt with variable interest rates is linked to LIBOR to GBP and JPY, and the remaining variable interest rates take up 4.7% of the public debt. Interest rates on special drawing rights make up a total of 3.4% of the total public debt.

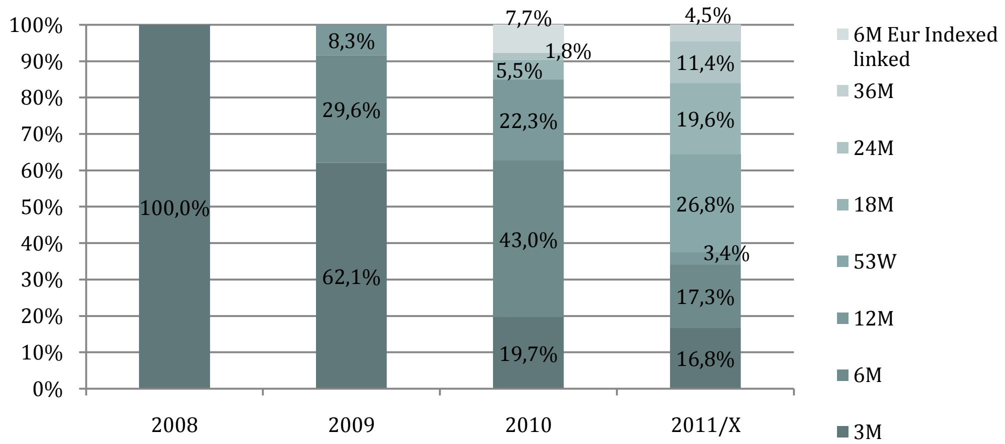
Graph 20. Public debt variable interest rates' structure in 2008–2011



1.3. Government Securities' Structure and Duration in 2008-2011

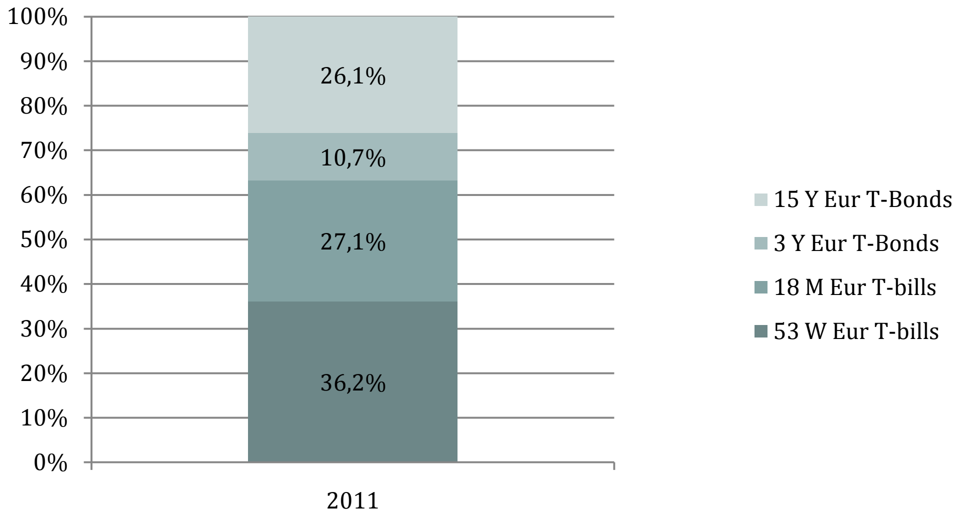
The Republic of Serbia started issuing government securities in 2003. Initially, in 2003-2006, only the short-term securities were issued and after a period of stagnation in the development of the government securities in RSD market, treasury bills were again issued starting from February 2009. Within a three years' period, this debt exceeded the level of RSD 300 billions, or, in other words, the debt exceeded the level of six billions of Euros in absolute debt growth and compared with the end of 2008 one half of this growth was generated in the domestic market through issues of RSD and EUR denominated government securities.

Graph 21. Structure of RSD denominated government securities by maturity at the issue date at the end of the observed period 2008 – October 2011



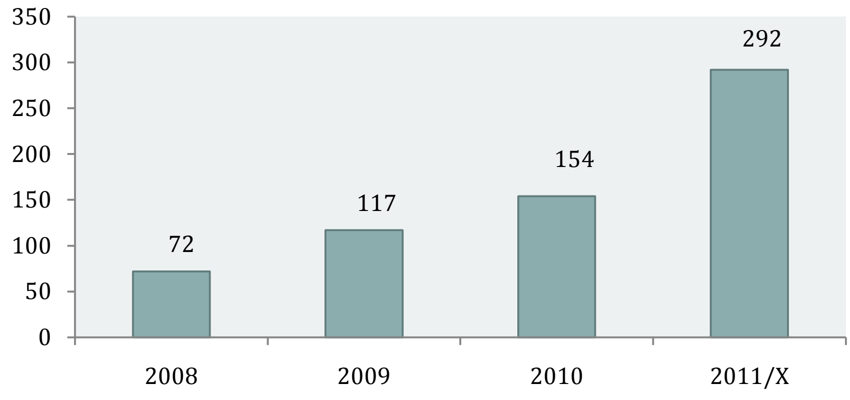
In 2011, the Republic of Serbia issued treasury bills and bonds denominated in Euros for the first time in the domestic securities' market. Treasury bills with 53 weeks and with 18 months' maturity dates were issued, with the total nominal value of EUR 350 millions with weighted interest rate of 4.9%. As for the bonds, 5.85% coupon bonds with 15 years maturity date were issued two times and 5% coupon bonds with 3 years maturity date were issued once, with the total nominal value of approximately EUR 200 millions.

Graph 22. EUR denominated government securities' structure by maturity at the issue date at the end of October 2011



Owing to the fact that in 2008 only the treasury bills with three months' maturity date were issued, the duration, i.e. average number of days till the maturity date was only 72 days. With the introduction of new financial instruments with longer maturity dates and with the reduction of share of the short-term financial instruments in the total balance of RSD denominated securities, duration was extended significantly, and on October 31, 2011, the duration of RSD denominated government securities amounted to 292 days.

Graph 23. Duration of RSD denominated government securities in 2008–2011



2. Republic of Serbia Public Debt Servicing (Central Government Level[12]) in 2012-2014

Data on repayment of interest and principal amounts up to the present is presented, coupled with data on the projections for the future period.

Table 30. Repayment of interest and principal amounts in 2008-2010

	2008	2009	2010
	In RSD billions		
Repayment of principal amounts	38.8	144.2	246.2
Repayment of interest	13.9	20.0	30.1
Total	52.7	164.2	276.3

Table 31. Projections of interest and principal amounts' repayment by 2014

	2011p	2012p	2013p	2014p
	In RSD billions			
Principal amount	312.2	359.0	337.2	340.7
Interest	42.2	61.2	69.5	79.6
Total	354.4	420.2	406.7	420.3
% of public debt as of October 31, 2011	23.8	28.3	27.4	28.3

Table 32. Projections of interest and principal amounts' repayment by 2014 (% share in GDP)

	2011p	2012p	2013p	2014p
	In RSD billions			
GDP	3,358.8	3,550.8	3,792.7	4,102.2
Principal	9.3%	10.1%	8.9%	8.3%
Interest	1.3%	1.7%	1.8%	1.9%
Total	10.6%	11.8%	10.7%	10.2%

3. General Government Debt Forecasts in 2012-2014

Bearing in mind the forecasts for the primary deficit in the Republic of Serbia Budget in 2012-2014, including the loans withdrawn to provide funding for projects of the budget beneficiaries and the effects of the fluctuations of RSD exchange rates for EUR and USD in the basic macro economic scenario, coupled with the plan to provide for most of the Government financing by means of issues of long-term government securities, the balance of the Republic of Serbia public debt excluding the secured financial obligations (except for the debts of the Zeleznice Srbije Public Company and Putevi Srbije Public Company) and including the local governments' debt (both the share that was guaranteed by the Government and the one without guarantees), should not exceed 45% of GDP according to the basic scenario.

[12] The central government level includes the Republic of Serbia Budget, Mandatory Social Insurance Funds and Putevi Srbije Public Company.

Table 33. General government debt, according to the Maastricht Criteria forecast by 2014

	2011p	2012p	2013p	2014p
	In RSD billions			
GDP	3,358.8	3,550.8	3,792.7	4,102.2
Primary deficit	107.4	85.6	68.0	36.0
Interest	46.0	66.6	72.2	82.4
Public debt	1,425.6	1,563.6	1,703.8	1,822.2
Debt-GDP	42.4%	44.0%	44.9%	44.4%

The local government debt will remain on a relative level of 1.5% to 2% of GDP over the next period. Debt incurred for guaranteed liabilities, which are not included in the public debt according to the Maastricht Criteria, is expected to amount to 3.1% to 3.5% of GDP over the next period.

It is expected that the available funds in the accounts of the Republic of Serbia at the end of 2011 should amount to more than EUR 1.2 billions and in the following year, a portion of the funding for the budget expenditures (RSD 50 billions at a maximum) should be provided for from these funds.

4. Analyses Used in Drafting of Public Debt Management Strategy

Directorate for Public Debt used the quantitative approach to formulate the Public Debt Management Strategy, by identifying potential limitations using macro economic indicators, analysis of costs and risks and market conditions that influence public debt management. When analysing costs and risks, all the viable financing alternatives are considered. The share of each instrument in the total required funding in a given year id defined in accordance with the Strategy goals.

For the purpose of analysis, the following instruments available in domestic and international markets were used.

Financing Sources Denominated in Foreign Currencies

- Loans from foreign Governments and international financial institutions were presented as two different instruments denominated in Euros, with fixed and variable interest rates and maturity dates of approximately 20 years and grace period of approximately 3 years;
- Domestic debt denominated in Euros was presented by means of thee financial instruments: loans from domestic commercial banks with variable interest rate, treasury bills and government bonds issued in the domestic financial market;
- Eurobond issued in Euros or US dollars.

Financing Sources in Domestic Currency

- All the government securities denominated in RSD were categorized in several groups, such as the short-term treasury bills (with maturity dates of up to 53 weeks), 2 years government bonds without coupons (with maturity dates ranging from 18 to 24 months) and 3 years government bonds with coupons.
- Issuing of 5 years government bond with coupon has been planned.

Future Market Interest Rates and Analyses-Based Scenarios

On the occasion of drafting of medium-term public debt management strategy for 2012-2014, quantitative analyses of costs and risks based on different scenarios and projections were used.

Basic scenario was the starting point and it is based on the most probable market conditions. Three groups of market variables were then identified: currency risk, reference interest rates on the international market and reference interest rate for RSD. The first variables are broadly available. Future market rates can be derived by analysing the available forecasts for purchasing power parity or by producing forecasts of the interest rates' parity. The assumption was that the RSD depreciation will amount to 1.5%. The other option is to use forward currency exchange ratio of EUR to USD, but in this case external influences ("background noises") are limited and stable EUR:USD exchange rate was kept in order to get a clear picture of the given effect of the applied shock. In that way, market forward rates become a poor basis for interest rates' forecasts. Stable rates were also used here. Effects of market rates' changes were completely tested under the shock conditions.

Interest rates of the debt denominated in RSD cannot be real, nor constant rates or forward rates, owing to the fact that the projected reduction of inflation has not yet caused reductions in the projected interest rates. Among other things, there is also a lack of research works in consumer prices and structural rules that lead to very high real interest rates. Approach used in interest rates in RSD is based on the real interest rates, which reflect the current situation while bearing in mind the expected reduction of inflation rate over the next couple of days.

After having defined the basic scenario, with the aim to perform the stress test, additional four scenario types or shocks were selected. The macro economic shocks or shocks in primary budget are examined separately in the debt sustainability analysis.

1. 25% depreciation of RSD against USD. In this type of shock, all other foreign currency exchange rates will remain the same. Such global scenario cannot be closely linked with the Serbian economy, but it would have significant effect on Serbian debt due to the public debt share that is denominated in USD. According to this scenario, the EUR/USD exchange rate would change from 1.45 to 1.16, which is actually not considered to be an unrealistic outcome. This scenario can easily take place after the recovery of the USA economy, if the European economy remains under the influence of the current debt crisis.
2. 15% depreciation of RSD against all the currencies. According to this scenario, foreign currencies' exchange rates in the entire world would remain stable, and only the RSD would get depreciated against these currencies. The macro economic circumstances necessary for the realization of this scenario would require great current deficit and its adjustments.
3. Interest rates' growth in the international market. The existing interest rates internationally are now historically on a very low level. Central banks keep the interest rates anchored on a low level, enabling the Governments to resolve the issue of debt and enabling the banks to profit from the positive curves of yield and capitalization, until inflation becomes a potential threat. If the world economy recovers, the interest rates will probably be raised by approximately 2 to 3 percentage points.
4. Interest rates' increase in the domestic market by 5%. This scenario would be possible providing that the inflation is kept below the projected level of 4.3%, and providing that it remains on the same level or even get higher. Under such

circumstances, the reduction of interest rate in the basic scenario becomes unrealistic.

Each of the above mentioned stresses or risk scenarios is used in the overview of cost effects of the financial strategy.

5. Alternative Borrowing Strategies for 2012-2014 (Analysis of Risks and Costs of Different Borrowing Strategies)

In cooperation with the World Bank experts, the Republic of Serbia Ministry of Finance and its Directorate for Public Debt, which performs analyses of costs and risks of alternative borrowing strategies, applied the Medium Term Debt Strategy Model (hereinafter: the MTDS) of the World Bank with the aim to make the most of the portfolio and to achieve a more efficacious public debt management.

The most adequate choice that included balancing of costs and risks defined the selection of basic borrowing strategy for the next medium-term period. The analysed options of borrowing strategies are as follows:

The Status Quo Strategy (S1): it is the status quo strategy, which provides for the financing needs by relying mostly on the existing financial instruments for borrowing. The biggest share of new debts is based on the issues of standardized RSD denominated government securities and on issues of USD and EUR denominated Eurobonds.

The Swap Strategy (S2): in contrast to the S1 strategy, the Eurobonds are issued in Euros only.

The Supplementary Dinarization Strategy (S3): this strategy is based on intensified emission of government securities in RSD (approximately 50% gross amount necessary to provide funding by 2014), while maintaining the current block of standardized financial instruments (without extension of the maturity dates of the securities in RSD). This is an illustrative strategy, which is focused on the potential increase in costs related to the goals set for the development of the domestic debt market.

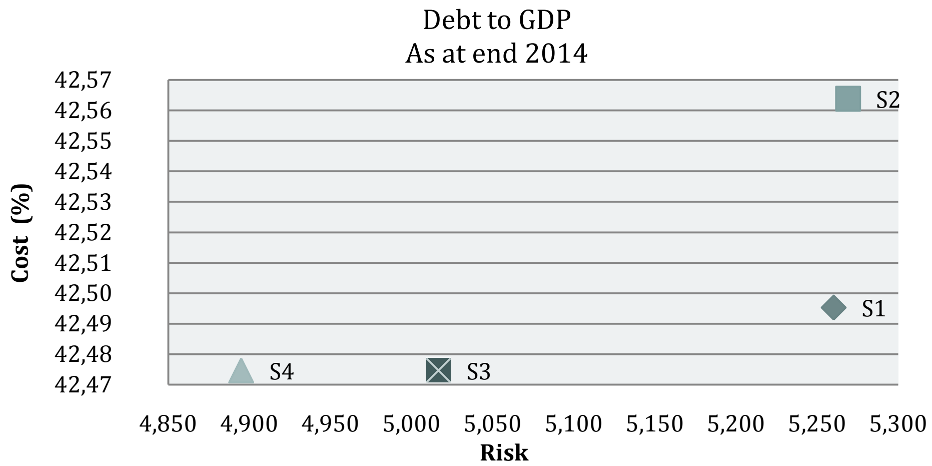
The basic strategy (S4): this is the announced target strategy of debt of the Government of Serbia, which includes a rise in debt levels in RSD and extension of maturity dates of the securities denominated in RSD in 2012-2014.

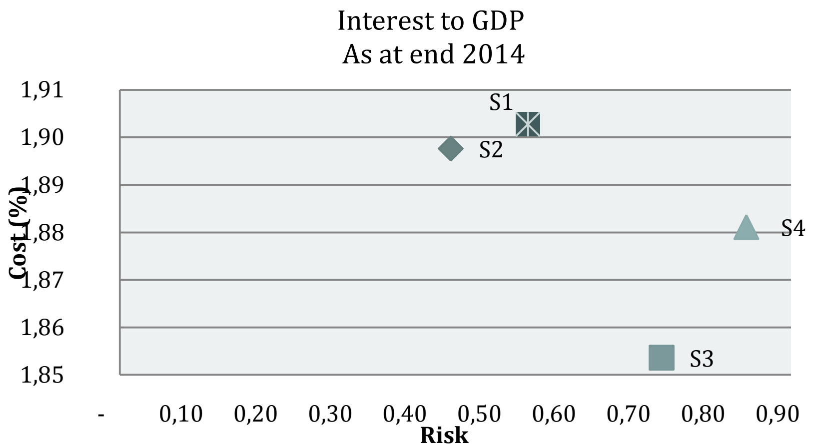
Financing of expenditures in the Republic of Serbia Budget according to all the alternative strategies will mainly be provided for by means of government securities' issues in the international and domestic capital markets. The analysed debt is the debt of the central Government level that is inclusive of the activated guarantees, but not of the local governments' debt, too. The public debt balance as calculated in the above manner at the end of 2011 is estimated to approximately 40.5% of GDP.

5.1. Analysis of Costs and Risks in Alternative Borrowing Strategies

Quantitative analysis includes the performance of each of the four alternative borrowing strategies, with the debt share in GDP within the macro economic framework that is defined in the Report on Fiscal Strategy and that is the basic value of applying a certain borrowing strategy, which is presented on the vertical axis (in Graph 20), and with the potential costs of a selected borrowing strategy presented in the horizontal axis (stress test result). Two measures of costs were applied: debt to GDP ratio and nominal interest as a percentage of GDP. The first coefficient is the indicator of position and the second one is the indicator of a course. For the sake of comparison, the focus of attention is placed on the results of the alternative strategies at the end of 2014.

Graph 24: Alternative Borrowing Strategies - Comparison





In Graph 24, debt to GDP ratio grows to approximately 42.5%, while the share of interest in GDP grows to approximately 1.9% of GDP in 2014 from 1.3% of GDP in 2011.

The increase of debt to GDP ratio comes as a result of a higher rise in financing needs that exceeded the growth of real GDP. The S3 and S4 strategies show relatively lower costs, due to the fact that a portion of financing (borrowing) will be transferred to the securities market in RSD. The S1 strategy involves lower costs than the S2 strategy, due to the lower borrowing costs in USD than the borrowing cots in EUR.

The more expensive S3 strategy of "domestic securities' market development" does not include a significant increase of borrowing costs in comparison with the basic S4 strategy. This implies that the expected reduction of inflation rate in Serbia will help to reduce the differential interest rate between Serbia and the international capital market, as a potential financing source over the medium term. In that sense, relying on an increase in RSD denominated securities' issues will not imply significantly higher borrowing costs.

With respect to the risk-based ranking of the presented strategies, as it has already been assumed, the strategies involving borrowing in foreign currencies (S1 and S2) are the more riskier ones in respect of the debt to GDP ratio, than the strategies based on borrowing denominated in RSD (S3 and S4). The S1 and S2 scenarios can potentially involve the biggest shock to the debt level with an increase in debt to GDP ratio of approximately 5.3% of GDP, which has been based on the assumption of high share of foreign currencies in debt portfolio.

According to the indicators of course, ranking of risks between the S3 strategy of "domestic securities market development" and the strategy of borrowing in foreign currencies are seen as an opposite to the indicators of a position. This can be explained with the fact that this indicator has been defined by interest rates' fluctuation (interest risk in new issues of securities denominated in RSD and in new maturity dates for RSD denominated securities).

Table 34. Public debt to GDP ratio at the end of 2014

Scenario	S1	S2	S3	S4
Basic scenario	42.50	42.56	42.46	42.47
Exchange rate shock (USD 25%)	43.06	42.56	42.94	43.22
Exchange rate shock (15% for all currencies)	47.76	47.83	47.48	47.37
Interest shock	42.81	42.86	42.83	42.96
Combined shock (USD 25% and interest shock)	43.38	42.86	43.31	43.71
Maximum risk	5.26	5.27	5.02	4.90

Table 35. Interest based payment to GDP ratio at the end of 2014

Scenario	S1	S2	S3	S4
Basic scenario	1.90	1.90	1.85	1.88
Exchange rate shock (USD 25%)	2.04	1.90	2.05	2.08
Exchange rate shock (15% for all currencies)	2.22	2.27	2.22	2.23
Interest shock	2.31	2.34	2.38	2.52
Combined shock (USD 25% and interest shock)	2.45	2.34	2.58	2.72
Maximum risk	0.55	0.44	0.73	0.84

The debt refinancing risk in the S4 strategy is the lowest, as well as the risk of interest rates' fluctuations within the basic macro economic framework, and the debt share with fixed interest rate is the highest.

Table 36: Indicators of risk for alternative strategies

Risk indicators		At the end of 2014			
		S1	S2	S3	S4
Nominal debt (% of GDP)		42.5	42.6	42.5	42.5
Net current value (% of GDP)		41.8	41.9	41.8	42.0
Applied interest rate (in %)		4.8	4.7	4.6	4.7
	ATM[13] external portfolio (per years)	8.1	8.1	7.7	8.2
	ATM domestic portfolio (per years)	1.7	1.7	1.7	1.9
Debt refinancing risk	ATM total portfolio (per years)	7.4	7.4	6.8	7.5
	ATR[14] (per years)	6.2	6.2	5.5	6.6
	Re-fixing (% of total debt)	33.4	33.4	37.2	31.5
Interest rates risk	Debt per fixed interest rates (% of total debt)	74.6	74.6	72.3	75.2
Exchange risk	Debt denominated in foreign currencies (% of total debt)	89.4	89.3	82.8	84.0

[13] ATM (*Average Time to Maturity*) – English abbreviation for average time to maturity.

[14] ATP (*Average Time to Refixing*) – English abbreviation for average time to refixing of interest rates.

6. Public Debt Level According to the Domestic Methodology and Maastricht Criteria

It is important to note here that according to the nationally used methodology for debt calculation, the public debt balance includes direct liabilities of the central government level and all the indirect liabilities, i.e. the guaranteed debt incurred by the public enterprises, certain local government levels, state agencies and some other legal entities founded by the Republic of Serbia Government. This debt balance includes all the guarantees, regardless of whether these will be activated or not.

Since one of the main economic political goals of the Republic of Serbia is to achieve the EU accession harmonization of the domestic methodology with the EU standards is a necessary precondition in this area. Due to this reason, the public debt balance is analysed on the basis of the criteria set in the Maastricht Agreement, too, which is a systematized guideline aimed at achieving public debt and fiscal system sustainability, i.e. macro economic stability. According to the Maastricht Criteria, the public debt balance should include, in addition to the direct liabilities of the central government level, the local governments' debt, too. Such public debt balance is called the General Government Debt. Based on this, amendments and addenda to the Law on Public Debt have been planned, with the aim of introducing changes in the scope of public debt, that is, of introducing the local government level debt in the public debt balance, and to exclude the indirect liabilities from the public debt balance, which will not be paid for by the Central Government.

In order to accommodate for the planned modifications, and also to observe the latest recommendations of the World Bank experts to consider only the debt that will actually be repaid by the Central Government, the current Strategy for Public Debt Management is based on the public debt balance according to the Maastricht Criteria.

7. Measures to Improve Market for RSD Denominated Securities in 2012-2014

Market of government securities is a relatively new market that is still developing. In 2009, the Republic of Serbia increased the volume of its issues of RSD denominated short-term securities (3 months and 6 months treasury bills), to start issuing its 18 months and 24 months treasury bills in 2010. In March 2011, the Republic of Serbia issued for the first time its RSD denominated government bond with coupon. In compliance with the medium term strategy of public debt management, the aim is to issue RSD denominated 5 years government bond in 2012, which will then create possibilities for new emissions of RSD denominated government securities with longer maturity dates over the following medium-term period (RSD denominated 7 years and 10 years government bonds). If the planned activities in relation to the issues of RSD denominated government securities with longer maturity dates are realized, the yield curve for RSD would be defined by the end of 2014.

In the period covered by the Strategy, it is also expected that secondary market for government securities is improved, too, which would, coupled with the result of a transparent RSD yield curve, lead to an improvement in the financial market niche for RSD denominated securities and enable the Republic of Serbia Government to finance its expenditures in a more efficient manner with lower exposure to risks.

The plan to extend the maturity dates for RSD denominated securities depends on a series of factors, and primarily from the success of the National Bank of Serbia in the process of dinarization or promotion of bank products in RSD and confidence growth in the monetary and economic policy of the National Bank and of the Government of Republic of Serbia.

From its part, the Republic of Serbia Government will support the development of the domestic market by providing for the following measures:

1. In addition to the annual borrowing plan (an internal document, a part of which is published in the Law on Budget), borrowing plan will be published quarterly, which will serve to achieve consistency, predictability and transparency of government securities' issues;
2. Volume of issues depends on the market capacity and creation of benchmark issues will be based on reopening of the existing issues. The principle of existing issues' re-opening will pertain to all the government securities with maturity dates longer than 18 months, since it is evident that such securities should make up the biggest portion of the secondary trade in securities and that they should have adequate benchmark values;
3. There is the so-called trade-off between creating benchmark values of certain maturity dates and existence of a relatively large number of securities with different maturity dates. An example of such conflict may happen with the planned issues of 7 years and 10 years government bonds in 2013 and 2014. Over the next period, when the RSD yield curve is clearly defined for all the target maturity dates of RSD denominated government securities, consolidation of 18 months and 24 months government securities' issues will be considered, in order to reduce the market segmentation.
4. With the aim to create as large investors' base as possible and to achieve a high level of secondary market development, attempts will be made to provide for an equal tax treatment for domestic and foreign investors and to eliminate all the obstacles for the unobstructed flow of capital. The current structure of the domestic investors is overly homogeneous (investors are mostly from the banking sector) and as such it cannot contribute to development of the secondary market. Pension funds and insurance companies (life insurance) have only a limited potential for placement of funds due to the low level of capital market development. In 2011, a tendency of growth in the share of foreign investors and a change in investor base have been evident, and it is expected that the present investors' structure remains the same over the next three years' period, which could significantly contribute to the development of the secondary market.
5. Bearing in mind that the Republic of Serbia Ministry of Finance, National Bank of Serbia, Central Securities Depository and Clearing House and Securities' Commission have jointly set up a Working Group for improvement of trade in secondary market of RSD denominated securities, the recommendations of the members of this Working Group will be considered by the Ministry of Finance and in case that these are found to be useful, the recommendations will be accepted. Expectations that the Working Group members will make an assessment of potential benefits from the introduction of primary dealers for the liquidity development of the secondary market are especially high.

Amendments to the Regulation on general conditions for issuing and sales of short-term securities contributed to a reduction of the auction process for the government securities in accordance with the expectations and recommendations from the market players. The Ministry of Finance shall, over the future period, modify the tender platform based on the suggestions from the investors, in order to meet the interests of both the sides in the best possible manner that is acceptable for both the sides.

8. Public Debt Management Principles

Pursuant to the Law on Public Debt, the primary aim of the Republic of Serbia borrowing and its public debt management it to provide for funding necessary for budget financing, with minimum financing costs over the medium and long term, with acceptable risk levels. Minimizing long-term public debt servicing costs is limited by the structure of public debt and the cost reduction will be conditioned by a series of various factors and risks. Based on all this, the Strategy of Public Debt Management of the Republic of Serbia defines the following general aims and principles:

- It is necessary to ensure financing of the Republic of Serbia fiscal deficit, in the sense of the short-term deficit (liquidity) and long-term deficit, as a part of the policy of public finances system stability maintenance;
- It is necessary to define an acceptable risk level and it should be defined under conditions of the targeted structure of debt portfolio in the sense of currency debt structure, interest rates' structure, maturity dates' structure and debt structure according to the different financial instruments' types within the public debt;
- It is necessary to support the development of the government securities market issued on the domestic and international market, in order that such a developed market could in turn assist in the reducing the borrowing levels over the medium and long-term, in accordance with the high quality diversification of debt portfolio;
- It is necessary to provide for the transparency and predictability of the borrowing process;
- Public Debt Management Strategy should be supported by, and consistent with, the general Government macro economic framework for the medium-term.

The Republic of Serbia should take into account numerous limitations in considering its financing strategy. As a country with medium levels of income, there are only a limited number of financing sources at its disposal on the domestic and international financial market, and especially so at the moment with the more developed European Union member states face problems in providing for sufficient financing levels for their own fiscal deficits and refinancing of the mature debts. In addition to this, there are some strict public borrowing criteria and conditions for bilateral and multilateral public debts.

While bearing in mind the afore listed limitations and potential risks, it has nevertheless been decided to focus the public debt management strategy over the next medium-term period on financing expenditures of the Republic of Serbia Budget mainly through issues of government securities in the international and domestic capital markets. The current public debt structure is quite heterogeneous, if bearing in mind the inherited debt from the former SFRY, limited character of market instruments over the past period and the specific status in the domain of project financing by the development international financial institutions. The market of government securities is still developing and one of the public debt management principles has been led by the necessity to provide for sufficient flexibility, in order to secure financing of the expenditures of the Republic of Serbia Budget. This flexibility will be evident in the selection of market for borrowing, debt currency and financing instruments. The selection of the financing structure will bear in mind the current position and the development trend of the domestic and international financial markets (interest rates' levels, risk premiums, yield curve, exchange rates for the reference currencies) and the acceptable level of exposure to financial risks.

The aim for the following long-term period is to provide for financing by means of issues of primarily RSD denominated government securities in the domestic securities' market.

However, based on the present situation, it is evident that despite the strong determination to develop the domestic market of government securities, a large portion of financing will have to be provided over the next medium-term period in the international financial market. Guiding principle for providing financing in the international market in foreign currencies will be to provide access to a large number of investors in different parts of the international financial market, to define conditions for borrowing in foreign currencies in accordance with the repayment of debt denominated in foreign currencies including the interest on these debts if possible, and providing that it will be possible to borrow in this market even in a situation when the financial conditions are more auspicious than those in the domestic market and with the aim to stabilize public finances on occasion of fiscal risks' realization.

Borrowing in foreign currencies involves the foreign currency risk caused by the fluctuations in RSD to EUR and EUR to USD exchange rates, which additionally requires active consideration and use of hedging potential in public debt management, providing that funds are not borrowed in RSD or EUR.

Public debt management policy must take into account the long-term perspective, too, but the decision on financing the budget expenditure must be reached each year. Decision on borrowing for a year in question is reached within the Law on Budget for the given fiscal year and in accordance with the changes in basic fiscal aggregates it is possible to change is during the fiscal year of the specific borrowing plan.

9. Financial Risks and Public Debt

Financial and fiscal risks can lead to growth of public debt that can exceed predictions from the basic scenario. Risks that are present and that can lead to debt levels increase and to an increase in debt servicing expenses are as follows:

1) Refinancing risks,
2) Exchange risk,
3) Market risk (interest risk, inflation risk),
4) Liquidity risk,
5) Credit risks,
6) Operational risks,
7) Risks linked to the debt servicing costs' distribution (debt structure, liabilities' concentration).

With the aim to reduce the exposure to financial risks, it is necessary to implement the following measures:

1) Refinancing risk
    - To increase the share of medium-term and long-term financial instruments denominated in RSD in the domestic financial market,
    - Even allocation of public debt liabilities on the annual level in the next long-term period,
    - Extension of average maturity issued securities;
2) Currency risk
    - Effort to reduce the share of debt denominated in foreign currencies while taking into account the costs of the new debt (costs of debt conversion to RSD),

- Use of financial derivatives with the aim to limit the effects of exchange rates' fluctuations for the reference currencies,
- Effort to make the foreign debt denominated in Euros mainly and to use the debt denominated in USD only if financing in the international market in USD is cheaper if used for limiting the financial derivatives' risk;

3) Market risk (interest risk, inflation risk)

- Effort to extend the RSD denominated domestic debt duration,
- Indexed bonds’ issuing (interest rates' indexation),
- risk related to the interest rates on foreign debt is not a threat to the long-term goal to minimize the public debt costs;

4) Liquidity risk

- To constantly maintain sufficient cash levels on the Republic of Serbia accounts to provide for unobstructed payment of financial obligations for a minimum period of four months and also to absorb potentially lower loans' inflow than planned,
- Adequate management of available unemployed cash money in the Republic of Serbia accounts in compliance with the principles of asset-liability management,
- Redefining of agreements with the National Bank of Serbia for placement of RSD and foreign currency funds,
- Automatic execution of orders in the Republic of Serbia Treasury system in order to avoid defaulting (short-term liabilities - debts) in the system and to ensure observance of Rulebook on Budget Execution System,
- In addition to the consolidation of RSD funds, consolidation of foreign currency funds in the next year, too, within the consolidated Treasury system that is maintained by the National Bank of Serbia and employment of foreign currency funds to provide for active management and liquidity of the RSD account for Budget execution;

5) Credit and operational risks

- Transactions involving financial derivatives can only be realized with financial institutions with high credit rating,
- Use of financial instruments that limit the credit risk,
- Guarantees and approval for a new debt to local governments should only be provided in cases where an adequate analysis shows only a low level of probability that the guarantee issued will be realized over a medium-term period,
- Rule on guarantees' issuing will not pertain to the new loans to Putevi Srbije and Zeleznice Srbije Public Companies,
- Introduction of adequate controls in all the business activities in the Public Debt Directorate and strengthening of their employees’ knowledge base,
- Development and use of an adequate information system for public debt monitoring and management;

6) Risks related to the distribution of debt servicing costs

   - Adequate annual borrowing plans and equal distribution of debts over the next years in order to avoid the risk of high concentration of refinancing liabilities,
   - To avoid high concentration of public debt based liabilities on a monthly level, which cannot be absorbed by using the available funds on the Republic of Serbia accounts.

Over the next period, the debt level according to the Maastricht Criteria should remain on the level below 45% of GDP. However, bearing in mind that the biggest share of debt is denominated in foreign currencies (83% of the public debt as of at the end of October 2011 was denominated in foreign currencies), exposure to the currency risk is high.

Each change in RSD to EUR exchange rate of 1% towards depreciation of Serbian dinar as a deviation from the basic scenario will lead to a public debt increase of 9 to 12 billions of RSD, i.e. of 0.25% - 0.30% of GDP in the 2012-2014 period in absolute and in relative terms respectively.

It is also very important for the public debt balance that the EUR to USD exchange rate remains on a basically the same level as that envisaged in the basic scenario. In case of any deviation from the basic scenario, in the form of US dollar appreciation against EUR by 1%, the public debt balance will increase by RSD 1.5 to 5 billions over the next 2012-2014 period, or by 0.05% to 0.12% of GDP.

As for the interest risk, Serbian public debt has a potential advantage based on the fact that approximately 70% of public debt balance on the central government level as of the end of October 2011 was lent at the fixed interest rate. EURIBOR is the most widely used variable interest rate. According to the basic scenario, EURIBOR is expected to remain on the same level as of at the end of 2011 over the following three year's period. In case of a change in EURIBOR for 10 basic points as a deviation from the basic projection, interest will rise by approximately RSD 0.5 billion.

Main risks for Strategy realization in addition to the above listed factors that were quantified here are as follows:

- Stability of the macro economic situation in Serbia (real GDP growth, collection of taxes, unemployment levels, balance of payments current account, interest rates in the domestic market, inflation, RSD to EUR exchange rate, etc.);
- Future development of the economy on the international level and of the Serbian foreign trade partners;
- Needs for additional borrowing in order to repay the debts on other government levels, in the public sector and in the financial system of Serbia;
- Lower tax and non-tax revenues than planned and higher expenses than planned over the budget year;
- Significant depreciation of RSD to EUR (of more than 10%);
- Higher local government borrowing levels than planned in the medium-term macro economic (fiscal) framework;
- Activation of issued guarantees.

IV. Structural reforms in 2012 - 2014

Implementation of the remaining structural reforms of the real, financial and especially of the public sector has the key role to play in acceleration of the economic growth and sustainability of public finances over the next medium-term and long-term periods. By accelerating the reform processes and EU integrations, a more attractive economic environment is created and an additional impetus to the economic development of the country is provided, which will have positive effects on public revenues increase, reduction of fiscal deficit and improvement of overall fiscal position of the country. Such an environment is an incentive for entrepreneurship, business and technological innovativeness and competitiveness of the economic players, and on the other hand, it inhibits searching for rents, redistribution activities and gaining profit through privileged positions and corruption.

Over the past transitional period, Serbia has based its economic growth less on the reforms and more on the growth of consumption that came as a result of revenues made from privatization process and substantial borrowing abroad, primarily by the private sector. In accordance with the new growth model in the post-crisis period, the economic growth will predominantly be based on the growth of investments' and export levels and on reforms that provide incentives and auspicious business climate for the domestic and foreign investors, full legal protection for property and agreements, efficient judiciary, modern tax system, reformed public sector, harmonized fiscal and monetary policies, efficient banking system and development of financial markets, developed private-public partnerships, especially in the infrastructure-related business activities, regulated labour market and regulated relations between the employees and employers, progress achieved in the eradication of grey economy and corruption, which taken all together serves to improve credibility of the country and to reduce risks for investments.

Key economic reforms that will be implemented over the next three years and that will significantly contribute to the macro economic stability, economic growth and consolidation of public finances are as follows:

- Improvements in legislation and strengthening of institutions through adoption and implementation of system laws that are harmonized with EU acquis, which serve to create legal framework and systemic conditions for proper functioning of market economy and democratic society;
- Completion of privatization process of socially-owned enterprises, state-owned banks and insurance companies, including efficacious application of bankruptcy legislation;
- Improvement of regulatory framework for infrastructural and public utility business operations and setting (partial or complete) privatization process in motion for enterprises active in these sectors, in accordance with the development strategy for individual infrastructural sectors and in accordance with the laws regulating these sectors;
- Improvement of business and investment climate and improvements in the protection of competition;
- Restructuring of economy and strengthening of its production and export capacities;
- Continued construction and modernization of infrastructure as a general precondition for development;

- Considering available options for privatization of state-owned agricultural land and privatization of construction land;
- Judiciary reform and institutional and functional modernization of judiciary, especially in its part dedicated to execution of court decisions, as well as in fight against corruption and crime.

Structural reforms are of special importance for fiscal sustainability, since they encourage capacity strengthening in the economic sector that are necessary for increasing production, savings, export and employment levels. Switchover to a more efficient economy with a dominant private sector share shall require implementation of structural reforms that will guarantee property rights, improve management of public enterprises and increase transparency of their business activities, and also improve labour market flexibility in order to boost new jobs' creation in the private sector. By accelerating growth and by improving employment levels based on the implementation of structural reforms, stable growth of public revenues will be ensured, coupled with a balanced budget and sustainability of public debt.

Structural reforms as a whole, and especially the rationalization of large sectors of public spending, will provide for a reduction in fiscal deficit and public debt, as well as for growth of economic activity that in turn leads to creation of new jobs. Reforms of the real sector will additionally contribute to a long-term sustainability of the fiscal policy, and especially to the ending of the privatization process of enterprises with socially-owned capital shares and to acceleration of restructuring and privatization of large public enterprises.

Privatization of the remaining socially-owned enterprises in the portfolio of the Privatization Agency, for those that can survive the test of economic viability without any subsidies and those that can find adequate buyers, will significantly reduce budget expenditures allocated for subsidies to unprofitable socially-owned enterprises. The same effect is expected from successful restructuring and privatization of large public enterprises. It was planned to improve the management of large state-owned enterprises and to improve their performance and transparency of their business operations, and to then privatize those enterprises by attracting strategic investors. With that aim, transformation of all the large state-owned enterprises into joint stock companies will be completed and their management structures' knowledge base will be improved in the area of public companies' management, with strict control of all the state-owned enterprises by the Government. Restructuring and privatization of the large sector of public enterprises will significantly reduce budget expenditures for subsidies for these enterprises, and free up the available fiscal space to increase the capital investments.

The remaining reforms of the financial sector do not have a significant direct influence on public finances and their indirect influence is important in cases where the liquidity of the banking sector contributes to the growth of production, export and employment levels, and consequently to an increase in public revenues.

For strengthening of fiscal sustainability, tax reforms and state administration reforms are of key importance. With that aim, implementation of these reforms will be accelerated, especially in case of the reforms of the biggest beneficiaries of public revenues, such as the pension system, education, medical care and social welfare. The main fiscal effects of the tax reform will be to provide public revenues up to the level that is sustainable from the aspect of the capacity of the economic sector and general population to pay their taxes, and the most important effect of the public administration sector reform will be the reduction in total current public spending, coupled with an increase of volume and effectiveness of public investments.

1. Real Sector Reform

Over the past transitional period, the real sector was restructured and privatized to a significant level. The reform of the entrepreneurial sector over the next medium-term period will be focused on the improvements in the investment and business climate with the aim to reduce costs and risks of business operations in Serbia, and to strengthen the role of the private sector in overall economy.

Serbia has achieved a significant progress in creating an auspicious economic and investment climate. Over the next period, efforts to improve conditions for business and investments in Serbia will continue, and with that aim adoption of system laws and effective legal framework will be faster, as an important precondition of economic growth and social prosperity. By achieving this, better economic climate will be created, legal protection will be improved, and competitiveness' levels within the broader regional and European business environment will be improved.

Strengthening the role of the private sector in the economy will be provided with completion of the privatization process in the remaining companies with socially-owned capital shares and by founding of new privately owned enterprises. The role of the private sector will be grow during corporatization process of large state-owned enterprises, too, and during their complete or partial privatization or through agreements on private management of these enterprises. In addition to this, improved protection of competition, incentives for entrepreneurs and faster development of small and medium-sized companies are all of key importance for private sector strengthening.

The remaining reforms in the real sector over the next three years are primarily related to the improvement of business climate, completion of the privatization process in socially-owned enterprises, more effective implementation of bankruptcy and liquidation procedures in unprofitable enterprises, acceleration of the restructuring process in public enterprises and continued preparations for their privatization, coupled with the liberalization of some infrastrucure activities that these companies pursue.

Improvement of business environment. Improvement of business climate in the country will be achieved through the harmonization of national legal framework with the EU acquis and through the regulatory reforms, as well as through the structural reforms that will eliminate the main obstacles for growth, which requires full accountability and commitment of the relevant state bodies. The national programme for Serbian EU integration (the National EU Integration Programme, NIP), from the aspect of regulations that were planned for adoption in the National Assembly from July 2008 to June 2011 has been realized with 79% success rate. Out of 799 legal regulations that were to be adopted according to the plan, 630 legal regulations were passed, and their application enabled the most important reforms and introduced European rules in different segments of Serbian society. By the end of June 2011, 73% of the obligations according to the plan contained in the Action Plan document for faster achievement of candidate status for EU member state were achieved, including the passing of Law on Public Property and the Law on Restitution, which were important for the candidate status approval in the December meeting of the European Council. In that respect, passing of the Law on Election of Members of Parliament was also important, since the provisions of this Law outlawed the option of blanc resignations and introduced order of presentation in the list of candidates for MPs as a criterion for a deputy to be awarded a seat in the Serbian Parliament, together with the adoption of the Law on Political Activities' Financing.

Within the regulatory guillotine, the existing legislation that regulate the economic sector will be reconsidered with the aim to repeal the unnecessary and outdated regulations, improve the clarity, consistency and precision of meaning in the existing ones and to revoke the provisions that require excessive administrative activity and slow down the economic development of the country. In order to achieve effective implementation of laws and by-laws, efficiency of courts will be increased and deadlines for disputes' resolution will be shortened. Special attention will be paid to revoking of unnecessary regulations that are a burden for the functioning of the economic sector. It has been envisaged for all the Ministries to expedite the termination of unnecessary legislation and procedures within their remit based on the adopted Government recommendations, since only a small number of these recommendations has been implemented. The aim is to simplify the procedures and to reduce costs of operations for the economic sector and to insist on attracting foreign direct investments. Elimination of obstacles for investments and construction is of great importance. With that aim, the procedure of construction permits' issuing will be simplified and maximum allowed time for construction permit issuing will be shortened. Efforts will also be made to eliminate corruption in this sector. By-laws will be adopted to further regulate construction business and to improve the capacity of the local administration for implementation of these regulations, together with stricter controls of law enforcement process and strict fines for corrupt practices. Tax and other incentives will be preserved to attract new investments that can spur production, export and employment levels. Special benefits will be granted to the biggest new investments, especially in exchangeable goods.

During the comprehensive legislative reform, 340 recommendations were made for amendments of legal regulations that unnecessarily complicate business operations in the economic sector. 36 of these recommendations were abandoned. Among the remaining 304 recommendations, 195 recommendations were implemented, 36 recommendations are in the process of implementation, and there are still 73 recommendations that have not yet been implemented. Estimated savings from the implementation of 304 recommendations amount to EUR 183 millions, out of which EUR 121 millions have been saved based on the implementation of 195 recommendations. The biggest number of recommendations that have brought the biggest savings was implemented with the adoption of the Law on Companies and Law on Road Traffic Transportation, as well as with the amendments to the Law on Financial Leasing and Law on Payment Operations. With the adoption and amendments and addenda to these regulations, after setting up of the one stop shop for company registration (TIN issuing through the Business Registers Agency), abolishing of the obligation to submit financial reports to NBS, introduction of one stop shop for registration and de-registration of employees, changes in the area of tax laws, abolishing of obligation to fill out the business trip orders for passenger vehicles for companies and obligation to pay in the daily turnover, and leasing of immovable property was allowed in addition to this. Some of the recommendations have been implemented only partially (in one stop shop system, there are still problems with data exchange in registrations and de-registrations of employees between the Republic Fund for Pension and Disability Insurance and the Republic Fund for Medical Insurance), and the implementation of some of the recommendations will begin as of 2012 (the new Company Law). The adoption of relevant by-laws is of special importance for the implementation of recommendations that have been included in the new legal solutions and for the capacity strengthening of the administration for the implementation of the adopted recommendations. In addition to this, it is important to initiate the adoption of new recommendations for modifications and simplification of legal regulations and administrative procedures, and the implementation of reforms of inspections and elimination of numerous parafiscal burdens, which will bring significant savings and due to which Office for Regulatory Reform and Analysis of Legislative Effects has been established.

Privatization and restructuring of socially-owned enterprises. From 2002 to September 2011, the total of 2,380 socially-owned enterprises was sold through tender procedures, auctions and in the capital market; revenue of EUR 2.6 billions was made and investments worth EUR 1.1 billions were agreed.

Table 37. Privatization process results, from 2002 to September 2011

	2002	2003	2004	2005	2006	2007	2008	2009	2010	I-IX 2011	Total
Number of enterprises sold (T+A+Mc)*	211	637	237	316	272	306	263	93	33	12	2,380
Number of employees (T+A+Mc)	37,320	76,889	38,846	58,893	42,399	40,331	26,211	9,115	1,922	2,195	334,121
											In EUR millions
Selling price (T+A+Mc)	318.8	839.7	154.1	367.8	231.2	398.4	246.4	48.8	18.8	13.1	2,637.1
Investments (T+A+Mc)	320.1	319.8	99.6	98.5	122.2	85.6	61.8	24.6	1.2	4.3	1,137.7
Social programme (T+A+Mc)	145.8	128.3	2.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	276.7

*T=tenders, A=auctions, Mc=capital market
Source: Privatization Agency

From 2003 to September 2011, the total of 638 privatization agreements were terminated due to the defaulting in instalment paying, inability to maintain continuity in production, failure to observe the requirements of the investment and social programme, disposal of property that was contrary to the provisions contained in the sales agreement. With the unwinding of the privatization process, the number of terminated agreements grew, especially in 2009 (90) and 2010 (128). The majority of terminated agreements were the ones concluded with the domestic buyers of privatized companies. The success rate of privatization process that was implemented through tender procedures and auctions was 29% and 28% respectively.

Table 38. Terminated privatization agreements from 2002 to September 2011

	Tenders	Auctions	Total
Number of enterprises sold	127	2.155	2.282
Number of terminated agreements	37	601	638
Success rate in %	29.1	27.9	28.5

Source: Privatization Agency

Out of the remaining number of approximately 500 of the enterprises with socially-owned capital shares that have not been privatized, it is expected that approximately 200 socially-owned enterprises that are being prepared for privatization by the Agency will be sold. Enterprises that the Agency cannot sell will be announced bankrupt or will be liquidated. With that aim, new Law on Bankruptcy was adopted that provides for better compensation to creditors, shorter bankruptcy procedure and lower costs of bankruptcy procedure. It is expected that the some 12,000 unprofitable enterprises the accounts of which were automatically frozen at the end of 2010 will disappear with the automatic bankruptcy procedure and closing down of the fictitious companies. Over the post privatization period, the Privatization Agency will monitor the execution of liabilities undertaken by signing sales agreements for purchase of socialy owned capital and it will resolve the disputable privatization cases.

Special attention will be paid to the privatization of the remaining large socially-owned enterprises undergoing the restructuring process. So far, 35 restructured enterprises have been sold, and successful restructuring and privatization of an additional number of such enterprises is still expected to happen. The Government will continue the restructuring and privatization of parts and/or entire enterprises according to a special programme for special purpose (military) industry and institutions generating revenues for the military.

Restructuring and privatization of public enterprises. Progress has been made in the process of restructuring of the state public enterprises, and there are more delays in the restructuring of the local public enterprises. State public enterprises have improved their economic and financial performance through restructuring process and by means of separation of their auxiliary business operations and reductions in the redundant employees, harmonization of their service prices with the economic principles, establishment of separate enterprises in electrical energy sector with settlement of old debts, modernization of production and technological processes.

The initiated process of restructuring in public enterprises will continue to achieve improvements in their management by the State in order to successfully realize the large public investments, additionally reduce the number of employees, additionally increase the prices of their services and to reduce their subsidies at the same time, and to introduce organizational changes to separate business activities with the character of a natural monopoly from the business activities in which competition is possible.

Over the next medium-term period, financial consolidation of the Zeleznice Srbije a.d. Company will continue parallel with the disuniting of the railroad infrastructure from the transport of passengers and goods activities into separate enterprises; financial consolidation of the Putevi Srbije Public Company; restructuring of the PEU Resavica Public Company as a preparation for its privatization; restructuring of the PTT Srbija Public Company after having cleared the ownership and contractual relations with the Telekom Srbija a.d. Company; restructuring of the JAT Airways a.d. and Galenika a.d. Public Companies to prepare them for the privatization process; followed by further reduction of redundancies in all public enterprises.

Public enterprises owned by the Republic, Provinces and local governments as a significant part of the national economy and despite the reforms that have been implemented, still face the privatization process and liberalization of their business sectors. The liberalization of infrastructural and utility sectors that needs to be carried out before the privatization of public enterprises requires improvements of work of the regulatory bodies and their operational independence, to avoid replacement of the state monopoly with the private one.

In privatization of state enterprises and public utility companies, satisfactory results have not been achieved. In respect of the privatization of enterprises with state owned capital, it is important to transform both the state public companies and public utility companies into closed joint stock companies and that the owners of their capital are strictly identified. In addition to this, the Government will specify the enterprises with strategic national importance, and those that will be privatized if an acceptable offer is made. The Government is, after the unsuccessful international tenders, preparing Galenika a.d., JAT Airways a.d. and Telekom a.d. for sale again, with the aim to find strategic investors that will provide investments for modernization and competitiveness' strengthening in these enterprises, and revenues for the Republic Budget for repayment of international credits and infrastructural investments.

The corporatization process involving the companies with state-owned capital will be accelerated in order to change their legal form and to boost reforms in public enterprises, including the restructuring and privatization if adequate conditions in the market are created. Transformation of public enterprises based on these elements would contribute to a switchover in the Serbian economy to a new growth model that is based on export, domestic savings and strengthening of the domestic currency. The transformed public enterprises would contribute to an increase in the private sector share in the overall economy, losses and prices of public companies' services would be reduced owing to stronger competition and their business efficiency and investments in development would rise. In addition to this, by the end of 2011, public enterprises will be ready for the application of European competition rules, in compliance with the SAA that is effective as of January 1, 2009.

Within a short period, corporatization of large public companies that were founded by the Republic of Serbia will be completed. Transformation of their legal form into joint stock companies will be carried out in the following remaining public enterprises: Elektroprivreda Srbije, Elektromreza Srbije, Transnafta, Srbijagas, PTT saobracaja Srbija, Zeleznice Srbije, Nikola Tesla Airport, Srbijasume and Srbijavode. Deeper organizational and structural transformations will then follow in these enterprises, including their economically profitable privatization. This will reduce the share of the public sector in the overall Serbian economy, and at the same time strengthen the role of the private sector that generates growth in domestic savings and export as key leverages of Serbian economic growth. With the transformation of legal form from a public company into a joint stock company, subscription of capital will be done as net assets' value. In the following phase, through the organizational and business restructuring, efficiency and productivity of these large business systems will be achieved and operational costs and pressure on the Budget of the Republic of Serbia will be reduced. In this respect, it is necessary to introduce norms for the costs and performance of these enterprises and to thus improve the control of their business operations. In order to improve the efficiency of these enterprises, privatization must be carried out in cases where it is necessary and useful, while bearing in mind that different enterprises include different forms of private capital (management agreements, recapitalization, IPO, sales of blocks of shares). Building on such foundations, efforts will be made to transform these enterprises into market oriented and efficient companies.

In order to achieve property, organizational and business transformation of the local public utility companies, strategy for restructuring and privatization of public utility companies will be adopted, together with a law on public utility sector, and amendments and addenda to the Law on Concessions. Local self-governments will reach decisions on privatization of public utility companies while paying attention to protect public interest, relying on the positive experiences of other transition countries. While doing that, the natural monopolies on the local level will not be privatized (electrical energy network, water distribution network, etc.). This basis will be used to provide for improved effectiveness of local public utility companies, and for reduction of losses, surplus workforce and prices of the services they provide.

Liberalization of infrastructural and utility sectors. Privatization of the Republic and local public enterprises involves the liberalization of infrastructural and utility sectors, in which it is possible to introduce competition.

In 2010, liberalization of fixed telephony was achieved, preceded by a rebalancing of the tariff system and technological modernization of the Telekom Srbija a.d. Company and liberalization of oil import. Over the next medium-term period, liberalization will be gradually introduced in the following sectors:

- Electrical energy production and distribution;
- Transportation of passengers and goods by railway;
- Certain post office services;
- Air transportation;
- Certain public utility services.

In sectors with infrastructural character, new enterprises and competition will be introduced in order to improve the functioning of these sectors and to improve the quality of their products and services.

Public enterprises active in the infrastructural sectors with the character of natural monopoly will not undergo majority privatization, such as: the railway infrastructure; electrical energy transmission; international gas lines and oil pipelines.

2. Financial Sector Reform

Main strategic goal of the national financial sector is to further develop the banking industry and to preserve its high growth potential and stability, while increasing competitiveness and reducing costs of banking intermediation. The second basic goal is to develop alternative financial brokerage systems to expand the available range of financial sources for investment financing in the entrepreneurial and public sector. At the same time, establishing of a national development bank is of great importance, to achieve efficient financing of the national infrastructural projects and to develop the private-public partnerships on the implementation of such projects.

Priority reforms of the financial sector over the next medium-term period include the strengthening of the financial system regulations by adopting new and improving the existing legal regulations; liberalization of capital transactions based on the Law on Foreign Exchange Operations; and development of market for foreign currency risk protection instruments and conclusion of privatization process for the financial institutions with state ownership share. Key activities on legal framework improvement in the financial sector are as follows:

- Harmonization of the Law on Banks, Law on National Bank and by-laws passed by the Central Bank with the EU Directives and Basel II Recommendations;
- Improvement of legal regulations in the insurance sector and improvement of by-laws passed by the NBS with the EU Directives;
- Amendments and addenda to the legal regulations in the area of financial leasing and private funds, which will then serve to improve risk management, as well as the prudential monitoring by the NBS.

Banking sector. Serbia has made a significant progress in the banking sector reform in all its different segments. Necessary legal regulations were adopted and privatization of the majority of state-owned banks has been completed. In addition to this, financial sector has been consolidated and an increase in the balance sheet categories has been achieved. Competitiveness has been introduced in the banking sector and quality of banking services has been improved. There are 33 banks in the Republic of Serbia market. Owing to the NBS framework that has so far been restrictive and prudential, the global economic crysis has exerted only a limited negative influence on the banking sector in Serbia, which is reflected in the reduced number of employees in the banking sector, impaired asset quality (the share of non-perfomig loans has increased), as well as in the reduced profit of the banking sector in comparison with the previous years. In 2010, growth was achieved in the banking sector assets, deposits' levels grew, too, together with the capital base (high liquidity of the banking sector), and capital adequacy was maintained significantly above the legally prescribed minimum.

Over the next medium-term period, privatization process of the remaining banks with state ownership share will be completed, in accordance with the prevailing market conditions. Corporate management strengthening will continue, sustainability analysis will be performed to determine the economic viability of merger process of certain state-owned banks and of the recapitalization process in order to improve credit and other risks management procedures; efforts will be continuously applied to resolve the issue of non-performing loans and to improve services to clients. In the final phase, after an improvement in the market conditions, state-owned majority and minority ownership shares in banks will be sold by using different methods (reply to an offer for mergers, stock market sales order, tender sales, association of minority shareholders). Reforms and privatization of the remaining banks with the state share blocks will serve to improve stability, efficiency and competitiveness of the banking sector and will contribute to further strengthening of market mechanisms.

Bearing in mind that the high costs of intermediary banking services are the main issue between the banking sector and real sector, it is necessary to reduce the excessive disparity among the domestic and foreign deposit and loan interest rates, as well as to improve competition levels within the banking sector and among different forms of financial brokerage.

Incentives for speedy development of credit activities are of special importance for the stability and high growth potential maintenance in the banking sector, which will be achieved through reduction of credit risks and share of investments in non-performing loans, which could in turn produce a significant contribution to the improvement of liquidity levels.

Basic goal of the national banking system is also to increase the available domestic and foreign currency savings for investments' financing, owing to the fact that Serbia must found its investment cycle not only on the foreign direct investments and government loans, but also on a significant increase of the share of domestic currency savings in investments' financing.

Risk management will be improved in banking operations, in accordance with the Basel II framework, by means of maintaining the capital adequacy indicators for the banking sector on the level of 12% and by means of keeping the reserves for losses in compliance with the existing international accounting standards.

Adoption of the Basel II Framework is the key priority within the strategy for financial sector monitoring strengthening. With that aim, the NBS adopted bylaws that are harmonized with the Basel II Framework. The NBS will take all the necessary measures to create sound and stable financial institutions and to strengthen confidence in the financial system as a whole. This will increase resilience against financial operational risks and "shocks" from the environment. Diagnostic analyses and stress tests have demonstrated that the banking system in Serbia is solvent and highly capitalized and that it is capable of sustaining stronger macro economic shocks.

Non-banking sector. Over the next period, in addition to the commercial banking, it is necessary to additionally develop the alternative systems for financial intermediary services with the aim to expand the available range of financing sources for the real and public sector, such as the institutional mechanisms based on the development of public and private sectors' debt securities. Government bonds' market is of special importance here, and especially the market for bonds with maturity dates from one to several years, which requires overall market stabilization and low and stable inflation rates.

New, EU acquis-harmonized legal framework will be adopted to regulate the capital market, with the aim to provide for the development of the domestic capital market. In order to improve investor protection, the obligation to provide reliable and truthful information will be regulated in more detail to ensure relevant information about business operations of the company the securities of which are traded in a stock market, and better quality and more transparent financial report will be legally required about all the important facts in relation to the business operations of the entity issuing the securities. Monitoring measures undertaken by the Securities Commission will be strengthened and their scope will be expanded, within the implementation of law regulating the financial markets.

Special attention will be paid to establishing of institutional mechanisms based on the development of public and private sectors' debt securities, in order to provide for financing of investments and for an increase in the available savings. In that respect, establishing of government bonds' market is of special importance, based on clear and effective legal regulations covering the sector of issuing and trade in debt securities. In addition to the government segment of the debt instruments' market, development of the corporate bonds as a form of corporate financing is also important. Similarly, it is very important to develop the market for municipal bonds as debt instruments issued by the local self-government bodies in order to finance the local public activities. Over the next medium-term period, basic preconditions will be created, and primarily the legal framework will be set for establishing and development of the market for debt securities issued by the public and private sector entities.

There are 27 insurance companies operating in the insurance market, 23 of which are dealing in insurance business and 4 in the re-insurance activities. Among the companies active in the insurance business, 7 companies are dealing exclusively with life insurance, 10 companies are dealing exclusively with non-life insurance and six companies are dealing both in life and non-life insurance. The insurance sector in Serbia is still insufficiently developed, if measured by the ratio of total premium against gross domestic product and according to the total premium per capita, and it is still below the average of the EU member states, which is an indicator of its future potential in the insurance market. On the other hand, the insurance market in 2011, if measured by the premium growth, has showed a slow growth, as a consequence of the effects of the international economic crisis. In 2011, the growth trend in the balance sum and technical reserves continued, with complete coverage of technical reserves and of life and non-life insurance, with a slowdown in growth of insurance premium. Growth in the share of life insurances in the total insurance premium has continued, too, but the share of non-life insurances is still prevailing. For the sake of future development of the life insurance, it would be important to consider the option of new issues of treasury bills. The reserves of this insurance type would be placed in the new issues of treasury bills and in the tax reliefs, too.

It has been planned to pass a new insurance law, to further harmonize the legislation in this sector with the European Union acquis, especially in the area of direct insurance and re-insurance, monitoring of groups of insurance companies, insurance companies' financial reports, insurance intermediation services, preparatory activities for the introduction of capital adequacy concept and also for the risk management process in the insurance companies.

Legal framework regulating the leasing will be improved with the aim to provide for better consumer protection, stricter monitoring of financial leasing activities, to include immovable property among the leased assets, while increasing the minimum basic capital of the financial leasing providers.

Legal regulations on investment funds will be improved in order to harmonize them with the new law regulating the capital market, which will create a complete regulatory and institutional framework for legal regulation of establishing and business operations of the investment fund management companies and provide for a comprehensive and efficient legal framework for investment funds and custody banks. This will in turn enable rational and quality monitoring of business activities of these players in the financial market, and also adequate and more effective sanctioning of economic offences and misdemeanours perpetrated by the said players in the implementation of this Law.

Legal framework regulating the voluntary pension funds and pension plans will be improved with the aim to establish a stable, sustainable and effective system for business operations of management companies and funds; broaden potentials for funds' property investments and greater dispersion of investment risks, greater protection of property and interests of the funds' members; as well as to introduce adequate and more effective monitoring by the NBS. Legislative activities in relation to the above mentioned legal regulations will depend on the pension funds' development levels, situation in the domestic financial market and on the dynamics of the Serbian EU accession process.

3. State Administration Sector Reform

Basic goal in the public sector sector reform is to reduce the role of state administration in economy and to improve its efficaciousness in achieving general interests of the society, which would serve to reduce the current expenses of the state administration and to increase public investments.

Key activities in the area of public sector sector reform in the following medium-term period are as follows:

- To reduce the public spending and fiscal deficit levels, to modify the public spending structure, to implement reform in the tax system to introduce tax incentives for employment and economic growth;
- To improve state regulatory function by simplifying administrative procedures, reducing corruption, improving the competitiveness policy, strengthening financial discipline and regulating ownership rights;
- To modernize and build traffic, energy, telecommunications and public utility infrastructure and to reduce operational costs in this area;

- To improve operational efficiency of all the segments of public sector and to improve operational effectiveness of republic and local public enterprises, with liberalization of infrastructural and public utility business activities.

In order to achieve changes in public spending structure to achieve reduction of total public spending, and primarily in current public spending and growth of public investments' share, it is necessary to consolidate public finances based on reforms of the biggest users of public funds. Reforms will be directed to these segments of public spending that can provide for reductions of expenditures through increasing productivity of the public sector. The influence that these reforms will make on the fiscal system will be evident both in the medium and long-term, and their most important effect will be better quality of pension system, education, health care and social welfare. Bearing this in mind, the fiscal policy over the next medium-term period will face strict budget limitations that came as a result of the pro-cyclical fiscal policy that was implemented up to now and also of the global economic crisis.

The reform of the state administration sector pertains primarily to the reform of the retirement pension system, health care system, education system, social welfare system and state subsidies system.

Improvements in pension system. The reform that was initiated in the retirement pension system will continue to achieve long-term financial sustainability of the state-run pension fund. With that aim, it is necessary to reduce expenditures for retirement pensions that are now high due to various mechanisms that serve to encourage early retirement, low average age of the people retiring and smaller number of years during which contributions are paid into the pension fund, and also due to the aging population, which taken all together increases the number of pension beneficiaries as compared to the number of employed persons paying the pension fund contributions. The aim is to reduce the share of expenditures for pensions from approximately 12.5% of GDP to approximately 10% of GDP by applying adequate rules of pension indexation and by implementing a retirement pension system reform that provides for a just and efficacious retirement of persons working under harsh conditions and protection clause on the right to the old age retirement pension for the insured persons who have fully paid in their pension contributions to the retirement pension fund, all in line with the best international practices. Gradual levelling of the age limits for men and for women would result in significant effects on the fiscal system. At the same time, with the reform of the public retirement pension system conditions will be created to achieve faster development of private pension insurance system and other forms of savings.

Improvements in the health care system. Reform that was initiated in the health care system will continue with the aim to preserve and improve the health of Serbian population and to provide for financial sustainability of the health care system. The primary goal of the health care system reform is to improve efficaciousness of the health care system. To achieve this, the existing costs-based financing will be replaced with performance-based financing and considerable rationalization of the health care system will be implemented by means of reduction in the number of non-medical staff and reduction in the number of hospital beds. By doing that, efficiency of the primary health protection and hospital health care will be increased, significant savings will be achieved, and corruption levels in health care system will be reduced, and at the same time funding will be provided for modernization of the health care system. In addition to this, the health care contribution collection system will be improved and planned financing of the health care will be provided for. By improving the collection of all the contributions paid to the health care system from the self-employed persons, savings in the budget could amount to approximately 0.9% of GDP. Priority areas in the development of the health care system in the following three years' period are as follows: preventive health care, improvements of conditions for medical treatment and providing mandatory health care insurance for persons without own income.

Improvements in the education system. Reform that was initiated in the education system will be directed towards improving the quality of knowledge up to the level of knowledge achieved in other European countries. The main purpose of the education system reform is to increase the effectiveness of the education system services based on the existing expenses for education that provides for a higher quality and increased availability of education system services. To achieve this, the network of primary and secondary schools will be significantly rationalized and performance-based financing will be introduced, and significant savings will thus be achieved. Quality improvement of the secondary school education has special importance for active inclusion in labour market together with the improvements of quality of the public and private university level education. The role of the administration is to systematically improve the quality of programmes and teachers in the system of public education and also to exert preventive regulatory function in the case of privately-owned education. The biggest savings can be achieved through rationalization of the network of schools, especially on the level of primary education, providing that the effects of this rationalization do not reflect on the quality of the primary, secondary and higher education. The number of classes and the number of teachers will be harmonized with the enrolment rates of new pupils and students, in primary and secondary schools, and if necessary, classes will be merged in primary schools that do not have sufficient number of pupils. In doing that, it is necessary to have active participation of the local communities. Based on this, savings in budget can achieve up to 0.1% of GDP.

Improvement of the social welfare system. Reform that was initiated in the social welfare system will be continued in compliance with the Social Welfare Development Strategy, Law on Social Welfare and Family Law. With that aim, funding will be provided for the programmes of financial support to families and childcare welfare subsidies and expenditure levels will be increased for social welfare programmes for poverty reduction and assistance to underprivileged social groups. Greater financial support will be provided for the poorest families and vulnerable groups and administrative barriers for obtaining welfare support will be reduced. In a similar manner, expenditures for childcare subsidies for low income families will be increased. The social welfare system reform requires improvements in availability and increases in public expenditures for social welfare programmes up to the levels achieved in the countries in our neighbourhood, as well as the reduction of administrative barriers for social welfare granting in accordance with the income level status of the beneficiaries, which will then contribute to the transfer of social functions from the enterprises to the social welfare institutions. Potential for introduction of checks of income levels of the beneficiaries of maternity leave and war veterans' subsidies will be considered, since those are the most expensive social welfare programmes. If costs for these programmes could be reduced by one half, it would result in savings equalling to 1.2% in the consolidated Republic of Serbia Budget.

Improvements in the subsidies' system. The Law on State Subsidies' Control (RS Official Gazette, No. 51/09) introduced a system of controls for the state subsidies with the aim to protect unobstructed competition in the market, by applying the principles of market economy and incentives to economic development, securing transparency in state subsidies' allocation, as well as by effectuating commitments undertaken based on the signed international agreements containing provisions on state subsidies.

Article 25 of the Law on State Subsidies Control regulates that all the regulations that serve as a basis for state subsidies' allocation should be brought in line with the legal regulations on state subsidies' allocation.

By applying the rules that were envisaged in the Regulation on Rules for State Subsidies' Allocation (RS Official Gazette, No. 13/10), regional, horizontal and sectoral objectives will be achieved in state subsidies' allocation. The above mentioned objectives serve to strengthen the position of small and medium-sized companies, national employment policy objectives are met, and rules for state subsidies' allocation are also regulated for state subsidies' allocation to companies in coal, steel and traffic sectors. In this manner, allocation of state subsidies to companies that are not viable under the prevailing market conditions is discouraged, and the funding, or subsidies, are provided for those companies to which the subsidies can provide greater participation in market activities and greater competitiveness levels.

Table 40. Fiscal implications of the proposed measures in 2012-2014

	% of GDP	% of consolidated Republic of Serbia Budget
Health care system		
Improvement in collection of contributions for health care system from the self-employed	0.9	-
Education system		
Merging of classes in primary schools with insufficient number of enrolled pupils within individual schools	0.1	0.3
Merging of classes in primary schools with insufficient number of enrolled pupils among different schools in one municipality	-	1.0
Social welfare		
Verification of financial standing for beneficiaries of maternity and war veterans' subsidies	-	1.2

Source: IMF ("Options for Expenditure Rationalization: Addressing Symptoms and Causes", 2009) and the World Bank ("How to Do More With The Less", 2009).