Republic of Serbia

Government

REVISED FISCAL STRATEGY

FOR 2023 WITH PROJECTIONS FOR 2024 AND 2025

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Based on Article 27v Paragraph 1 and Article 31 Paragraph 1 Point 1) Subpoints (13) and (14) of the Law on the Budget System ("Official Gazette of the RS", No. 54/09, 73/10, 101/10, 101/11, 93/12, 62/13, 63/13 – correction, 108/13, 142/14, 68/15 - other law, 103/15, 99/16, 113/17, 95/18, 31/19, 72/19, 149/20, 118/21 and 118/21 – other law),

The Government adopts

REVISED FISCAL STRATEGY FOR 2023 WITH PROJECTIONS FOR 2024 AND 2025

I. MACROECONOMIC FRAMEWORK FOR THE PERIOD FROM 2023 TO 2025

1. General Framework and Main Economic Policy Objectives and Guidelines

Economic policy in the following period is shaped by exiting one and entering a new crisis. Coming out of the two-year crisis caused by the pandemic, a calmer period was expected that would allow economic, primarily fiscal policy, a break and enough time to return to a sustainable path. However, the reality is different. The conflict in Ukraine has intensified existing and brought new risks that completely change the international environment and economic policy in the country. Global, growing inflation, intensified energy crisis poses great challenges to economic policymakers.

The Republic of Serbia successfully coped with the health and economic crisis caused by the pandemic. During the two years of the global crisis caused by the coronavirus pandemic, a cumulative growth of the gross domestic product (hereinafter: GDP) of 6.6% was achieved, which represents one of the best results in Europe. The total package of economic measures during the two years of crisis in the amount of 17.3% of GDP contributed to increasing the liquidity of economic entities and facilitating business operations, while through grants to the population it stimulated domestic demand and thus indirectly influenced economic activity. In addition to these temporary factors that positively contributed to GDP growth, there were also structural improvements. They are primarily reflected in the activation of new and expansion of existing export-competitive production capacities, as well as in the further accelerated development of road and railway infrastructure, which permanently increased the potential of the domestic economy.

Geopolitical tensions and the outbreak of the crisis in Ukraine increased uncertainty, which resulted in an additional increase in energy prices, world prices of primary agricultural products and metals, which approached historically high levels. The geopolitical crisis has made short-term inflationary pressures persistent, with a high probability of their long-term presence in the global economy. At the same time, it is expected that increased uncertainty at the global level will have a negative impact on capital flows towards emerging countries, especially if one takes into account the cycle of tightening monetary policies of leading central banks. In addition to temporary factors, economic trends are also characterized by structural changes in the geopolitical and economic environment driven by deglobalization processes, unfavourable demographic trends and accelerated green transition.

Macroeconomic projections have been revised in the conditions of uncertainty, but recession is not expected. Economic activity recorded solid dynamics at the beginning of 2022, but under the influence of events in the international environment, it began to slow down significantly during the third quarter. Slowed investment dynamics and rising inflation, along with increased uncertainty and reduced external demand as a consequence of the economic impact of the conflict in Ukraine, are the main factors influencing the slowdown of domestic economic dynamics. Accordingly, GDP growth in 2022 has been revised downwards compared to previous expectations, to 2.5% each in 2022 and 2023. Growth projections were also lowered in the medium term. The record prices of energy products, along with the increase in imported quantities, will be reflected in the worsening of the balance of payments trends, and under the influence of these factors, a larger current account deficit is expected. The rise in inflation, which was initially expected to be temporary as a result of the gradual fading of the effects of the pandemic, has been further accelerated, primarily due to the rise in food and energy prices caused by the conflict in Ukraine. Under the influence of these factors, according to the current estimate, a higher growth in consumer prices is expected compared to the previous estimate, which should amount to 11.6% in 2022, or 11.1% in 2023.

Fiscal policy has a special role in conditions of growing uncertainty. The role of fiscal policy was crucial in the past two pandemic years. With the outbreak of conflict in Ukraine and increasing global uncertainty, the circumstances in which fiscal policy can operate have completely changed. Countries are now facing conditions of high and rising inflation, slowing growth and tightening of deficit financing conditions. Fiscal policy faces new challenges. Disruptions in the energy sector along with the growing costs of the economy and maintaining the standards of the population require a new set of measures. Expenditures for energy (procurement of energy sources, subsidizing the price of gas, etc.) take up a good part of the fiscal space, incomes of the population (salaries in the public sector and pensions) are adjusted in order to preserve the standard of living. It is necessary to continue to preserve the level of capital investments, which are much needed to support economic growth. Finally, it is extremely important to preserve fiscal discipline in conditions of high uncertainty. The Republic of Serbia submitted a request for a new Precautionary Arrangement with the IMF that will support efforts to preserve macroeconomic and fiscal stability. The directions of the fiscal policy are defined towards the reduction of deficit and debt in the medium term. After exceptional circumstances, which increased the costs of budgetary support to the energy sector in 2022 and partly in 2023, it is expected, after the implemented structural reforms and changes in the international environment, that these costs will be absent, that is, they will not require budgetary intervention in the medium term. In the direction of preserving fiscal stability, the fiscal rules have been redefined, taking on the role of guardians of a sustainable fiscal position in the medium term.

2. Estimates of the International Economic Environment

The global economy is facing a number of turbulent challenges. The highest inflation rate in decades, tightening financial conditions in most regions, the armed conflict in Ukraine and prolonged uncertainty are weighing on the outlook for the global economy. International financial institutions have revised their expectations for the global economic recovery downwards from their previous estimates. The conflict in Ukraine continues to have a negative impact on the region, but also more widely, due to the consequences of sanctions against Russia, which destabilize the energy market, leading to price shocks and interruptions in gas exports to EU countries. The normalization of monetary and fiscal policy that provided unprecedented support during the pandemic is now dampening aggregate demand as policymakers aim to bring inflation under control. The outlook for the global economy depends heavily on the successful implementation of measured monetary policy, the course of the conflict in Ukraine and the potential for further supply disruptions caused by the pandemic. Inflation is expected to peak at the end of 2022 but will take longer than previously expected to stabilize. The priority of fiscal policy should be to protect vulnerable groups through targeted short-term support to ease the burden of the cost-of-living crisis that is being felt around the world. In China, frequent “lockdowns” due to the zero-tolerance policy of COVID have further slowed economic activity, and the real estate sector is facing an accelerated weakening. Given the size of the Chinese economy and its importance to global supply chains, this will have a significant negative impact on global trade and economic activity. In order to mitigate the materialization of greater risks, intensive international cooperation is necessary, finding a peaceful solution to the Ukrainian conflict, harmonizing monetary and fiscal policy, as well as long-term solutions to climate problems.

Macroeconomic Estimates of the International Monetary Fund

In the wake of the pandemic, the global economy continues to face sharp challenges arising from the conflict in Ukraine, the rising cost of living caused by persistent and increasing inflationary pressures, and the slowdown in economic growth in China. According to the October projections of the International Monetary Fund (hereinafter: IMF), global growth in 2022 will amount to 3.2%, which is 0.4 pp less compared to the April projection, while for the year 2023, economic growth was revised down by 0.9 pp and will amount to 2.7%. A significant number of countries, accounting for more than a third of world GDP, are facing a “technical recession” this year or next. The main reasons for revising the projected path of economic recovery are the military conflict in Ukraine and the spill over effects of the crisis on other countries. Persistent and rising inflationary pressures triggered a rapid and synchronized tightening of monetary policy, with the US dollar strongly appreciating against most other currencies. Tightening global monetary and financial conditions will affect economic activity, and by reducing demand it will help to gradually bring inflation under control. The conflict has also raised food prices on world markets, despite the recent Black Sea grain export agreement, causing severe hardship for low-income households around the world, especially in underdeveloped countries.

Risks to the realization of projections are still elevated, while the implementation of appropriate policies to address the accelerated growth in the cost of living has become a serious challenge. At a time when the world economy is extremely vulnerable, the risk of applying the wrong combination of monetary, fiscal and financial policies has risen sharply. Increasing price pressures remain the most immediate threat to the current and future recovery due to the reduction of real incomes and disruption of macroeconomic stability.

Table 1. International environment - macroeconomic indicators

	2021	2022	2023	2024	2025
Real GDP growth[1], %					
World in total	6.0	3.2	2.7	3.2	3.4
Developed economies	5.2	2.4	1.1	1.6	1.9
USA	5.7	1.6	1.0	1.2	1.8
Euro area	5.2	3.1	0.5	1.8	1.9
Emerging countries	6.6	3.7	3.7	4.3	4.3
China	8.1	3.2	4.4	4.5	4.6
Russia	4.7	-3.4	-2.3	1.5	1.0
Growth of world trade, %	10.1	4.3	2.5	3.7	3.7
Unemployment rate, %					
Euro area	7.7	6.8	7.0	6.9	6.8
USA	5.4	3.7	4.6	5.4	5.4
Consumer prices, period average, %					
Euro area	2.6	8.3	5.7	2.7	2.2
Developed economies	3.1	7.2	4.4	2.4	2.0
Emerging countries	5.9	9.9	8.1	5.3	4.6
Exchange rate, euro/dollar, end of period	1.2	1.1	1.0	-	-
Cereal prices, in dollars, annual changes[2]	40.7	22.8	-6.4	-2.9	-5.4
Metal prices, in dollars, annual changes[3]	46.7	-5.5	-12.0	-0.2	-0.1
The price of iron ore, in dollars[4]	158.2	121.0	101.5	101.5	101.5
Oil prices, in dollars, annual changes, %	65.9	41.4	-12.9	-6.2	-4.9

Source: IMF, *World Economic Outlook*, October 2022

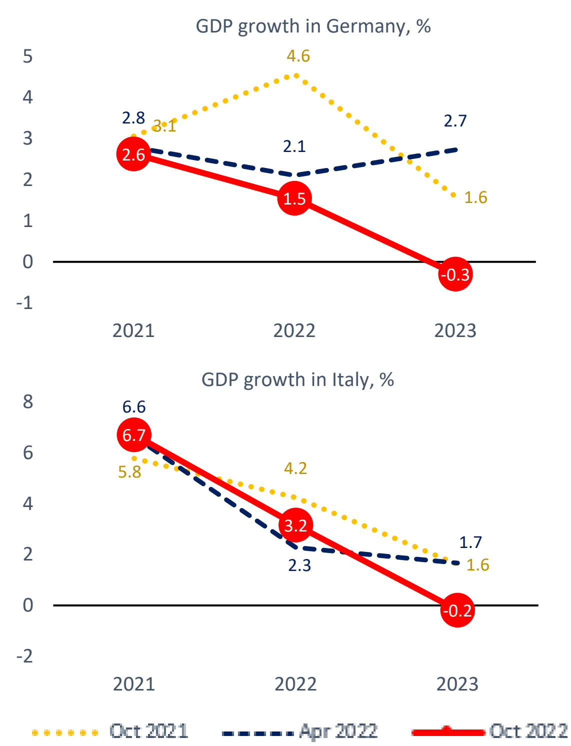
[1] World GDP is calculated according to purchasing power parity.

[2] The price of cereals obtained as a weighted average of the prices of wheat, corn, soybeans, rice and barley.

[3] The price of the metal obtained as a weighted average of the prices of copper, aluminium, iron ore, tin, nickel, zinc, lead and uranium.

[4] Price of iron ore (62% iron content) for import in China, Tian Yan Port, in dollars per metric ton.

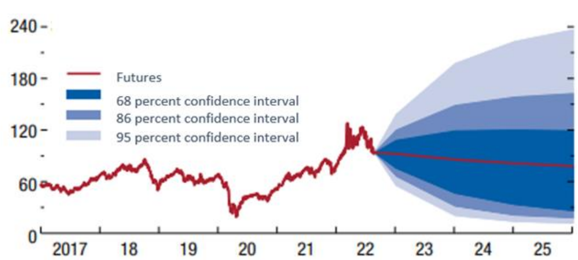
According to the IMF's October estimates, the growth of the group of developed countries for 2022 and 2023 has been revised downwards to 2.4% and 1.1%, respectively. The fall of real disposable income in the US continues to weigh on lower consumer demand, while rising interest rates further limit spending, particularly in the real estate sector. Although in 2022 the slowdown in growth in the euro area is less pronounced than in the USA, due to good results during the first half of the year, in 2023 a significant reduction in growth is expected, to 0.5%. Also, there are pronounced differences in economic activity among the member countries themselves, and the predicted slowdown will hit Germany and Italy particularly hard, which will record a decline of 0.3% and 0.2%, respectively.



Source: IMF, *World Economic Outlook*

In contrast to the growing slowdown in developed economies, growth in emerging economies is expected to reach 3.7% in 2022 and to remain stable through 2023. The decline of the Russian economy is less sharp than previously predicted, due to the redirection of oil exports to Asian markets and the strengthening of domestic demand, which is supported by fiscal and monetary policy, as well as the restoration of confidence in the financial system. The emergence of new virus hotspots and the lockdown of the main economic centres, as well as the crisis in the real estate market, influenced China to record the lowest growth in the last four decades (with the exception of 2020 due to the initial shock caused by the pandemic), while an acceleration of growth is expected in 2023. Middle East and Central Asia growth is forecast at 5.0% in 2022, largely reflecting a favourable outlook for oil exporters and an unexpectedly mild impact from events in Ukraine, but will slow down next year due to an expected drop in oil prices. The growth of the Latin American region has been revised slightly upwards in 2022 due to favourable commodity prices and financing conditions, but due to the slowdown in the economies of the most important foreign trade partners and the tightening of monetary policy, growth is expected to weaken in 2023.

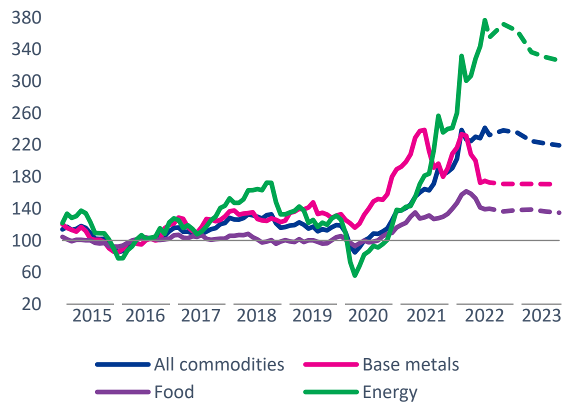
Projection of oil price movements, USD per barrel



Source: IMF, *World Economic Outlook*, October 2022

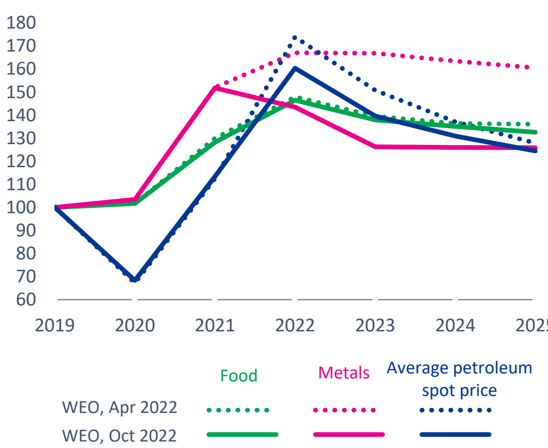
Base metal prices are projected to decline by 5.5% in 2022, while further price declines are expected in the coming period, followed by stabilization. After a sharp jump in the price of iron of almost 50% in 2021, a decrease of 23.5% is expected in 2022, with a further decline in the following year and stagnation in the medium term. Cereal prices are predicted to have a strong growth of 22.8% in 2022, followed by a downward trend. The interest rate on three-month government bonds in the euro area will be -0.2% and 0.8% in 2022 and 2023, while the rate on three-month government bonds in the US will be 1.8% and 4.0%, respectively, for the same period of time.

Commodity prices, indices, 2016=100



Source: IMF, *World Economic Outlook*, October 2022

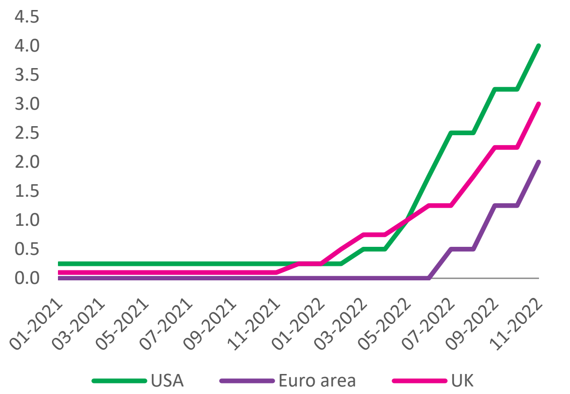
Projection of price trends, indices, 2019=100



Source: IMF, *World Economic Outlook*, October 2022

The US Federal Reserve (hereinafter: FED) has raised interest rates six times since the beginning of the year, and the most recent increase to a range of 3.75% to 4.00% was made in November. This tightening of monetary policy is in line with the strategy of targeting an average inflation of 2% in the long term, with indications that during the rest of 2022 and in 2023 the dynamics of interest rate increases will continue, but in somewhat smaller amounts.

Changes in policy rates by selected countries, %



Source: Central banks of selected countries

Projection risks are asymmetric and remain elevated as a result of increased uncertainty under the influence of the conflict in Ukraine, the danger of applying the wrong measures of monetary and fiscal policy in the fight against rising inflation, with the still present risk of worsening of the epidemiological situation. Although inflation is predicted to decline in the medium term, there is a risk of its prolonged duration caused by price shocks on the food and energy markets, and especially due to the possible further escalation of the conflict. Also, the reappearance of the virus and potential “lockdowns”, the worsening of the real estate crisis in China, the cessation of the delivery of Russian gas to European countries, geopolitical tensions, as well as frequent weather, climate and natural disasters, are some of the present risks to global growth and stability.

Macroeconomic Estimates of the ECB for the euro area

The euro area economy recorded growth in the first half of 2022 above expectations. Growth in the first quarter of 5.6% y-o-y was supported by a strong contribution of net exports, partly related to the activity of multinational companies in Ireland. The second quarter saw the economy expand by 4.2%, with activity in the manufacturing sector benefiting from the gradual resolution of bottlenecks in supply chains, while the services sector was boosted by the lifting of pandemic-related restrictions. However, events in Ukraine led to a severe energy crisis that sharply increased the cost of living and negatively affected economic activity. Eurostat’s preliminary flash estimate indicates a significant slowdown in real GDP growth in the third quarter of 2022 (2.1%). The reason for this is the negative impact of inflation on real incomes, which, along with uncertainty and rising interest rates that slow down investments, defines the ECB’s estimate for the last quarter of the current year (slight drop in GDP of 0.1%). This is also confirmed by the dynamics of high-frequency indicators during the summer months. The euro area PMI index has been below the 50 limit since July, while the estimate for October indicates a significant decrease in activity in both the manufacturing and service sectors.

According to the ECB’s September projections, the euro area economy will record growth of 3.1% in 2022, while an increase of 0.9% is predicted for 2023, which is 1.2 pp less than in the June projection. The weakening of growth across Europe in 2023 reflects the effects of the deepening energy crisis, primarily in the countries that are most exposed to the reduction of Russian gas supplies. At the same time, the tightening of the monetary policy of the ECB by raising the key policy rate will additionally affect the dynamics of economic growth. According to ECB estimates, private consumption will weaken in the next few quarters, but will remain a key driver of growth in the medium term (3.6% and 0.7% in 2022 and 2023, respectively), while investment activity is forecast to grow from 3.1% and 1.6% for the same period. The removal of supply bottlenecks and the depreciation of the euro are expected to support exports outside the euro area in 2022, despite somewhat weaker external demand, so both import and export growth in this period have been revised upwards. However, the slowdown of the global economy will have a negative impact on the growth of trade in the coming year, which caused a downward revision of the expected growth of exports and imports in 2023.

Inflation continues to rise due to large supply-side shocks, which are transmitted to consumer prices at a faster pace than before. The annual inflation rate is expected to remain above 9% until the end of 2022 due to extremely high prices of energy and food products, persistent inflationary pressures, as well as shortages in the supply. The projected decline in inflation from an average of 8.1% in 2022 to 5.5% in 2023 and 2.3% in 2024 mainly reflects the expected decline in energy and food prices as a result of negative base effects and the assumed decline in commodity prices. It is expected that core inflation will remain at high levels until mid-2023, but will decline thereafter due to the fading effects of the reopening of the economy, the removal of supply bottlenecks and the easing of inflationary pressures on energy products.

Table 2. Macroeconomic projections for the euro area, %

	2021	2022	2023	2024
GDP	5.2	3.1	0.9	1.9
Private consumption	3.7	3.6	0.7	1.2
Government consumption	4.2	1.4	-1.3	1.0
Gross fixed capital formation	3.8	3.1	1.6	3.0
Exports	10.5	6.1	3.8	3.8
Imports	8.2	6.5	3.1	3.3
Employment	1.3	2.0	0.2	0.2
Unemployment rate	7.7	6.7	6.9	7.0
Inflation, period average	2.6	8.1	5.5	2.3
Unit labour costs	0.1	2.8	4.1	2.2
General government fiscal result, % of GDP	-5.1	-3.8	-2.9	-2.7
General government gross debt, % of GDP	95.6	92.3	90.7	89.9
Current account balance, % of GDP	2.4	-0.3	-0.5	0.1

Source: Macroeconomic projections of ECB experts for the euro area, September 2022

The ECB's projections are based on assumptions that gas demand will be dampened by energy-saving precautions and high prices, and that more gas rationing than expected will not be needed. However, the uncertainty regarding the realization of the projections is very pronounced, especially in the short term, since inflation trends strongly depend on energy prices, which have been very volatile recently. The key risk for the prospects of the euro area relates to the possibility of more serious disruptions in energy supply, which, in combination with a cold winter, could lead to further jumps in energy prices and a more serious reduction in production.

Overall, no significant deterioration in the labour market is expected, but it is assumed that there will be some adjustments, such as a reduction in the number of working hours and a slight increase in the unemployment rate.

After a particularly expansionary fiscal policy in 2020 and a reduction in support in 2021, a further tightening of fiscal policy is expected in the coming period. The turn in fiscal policy will occur due to the abolition of aid measures introduced as support in the fight against the pandemic and the reduction of support measures due to high energy prices. After a significant fiscal deficit in 2020 and 2021 of 7.1% and 5.1% of GDP, respectively, a gradual improvement of the fiscal balance of the euro area is predicted to -3.8% of GDP in 2022, i.e. -2.9% of GDP in 2023. The debt-to-GDP ratio in the euro area, after growing in 2020, has decreased to 95.6% of GDP in 2021, with an expected downward trajectory in the medium term.

At its meeting in October 2022, the ECB raised the key policy rate to 2.00%, while raising the lending and deposit facility interest rates to 2.25% and 1.50%, respectively. The Governing Council of the ECB is expected to raise key policy rates in the coming months in order to normalize inflation to the target of 2.0% in the medium term.

3. Current Macroeconomic Developments in the Republic of Serbia and Prospects for the Period 2023–2025

Like other countries, Serbia is facing the negative economic consequences of the conflict in Ukraine. Although the macroeconomic trends at the beginning of 2022 were at the expected level, the tightening of international economic and political relations, followed by a sharp jump in energy prices and the resulting reduced global trade and foreign demand, began to spill over into the domestic economy. The materialization of the risks given in the June Fiscal Strategy in terms of longer-term geopolitical tensions, additional financial disruptions and more persistent uncertainty influenced the weaker economic outlook.

Economic activity recorded solid dynamics at the beginning of 2022, but under the influence of events in the international environment, it began to slow down significantly during the third quarter, in which year-on-year GDP growth of 1.1% was achieved, which represents the lowest rate in the post-pandemic period. Slowed investment dynamics and rising inflation, along with increased uncertainty and reduced external demand as a consequence of the economic impact of the conflict in Ukraine are the main factors affecting the slowdown of domestic economic dynamics. Accordingly, GDP growth in 2022 has been revised downwards compared to previous expectations, to 2.5% each in 2022 and 2023.

The rise in inflation, which was initially expected to be temporary as a result of the gradual fading of the effects of the pandemic, has been further accelerated, primarily due to the rise in global food and energy prices caused by the conflict in Ukraine. Under the influence of these factors, according to the current estimate, a higher growth in consumer prices is expected in Serbia as well compared to the previous estimate, which should amount to 11.6% in 2022, i.e. 11.1% in 2023.

The record prices of energy products, along with the growth of imported quantities in order to preserve the security of supply for the domestic economy and the population, were also reflected in the balance of payments trends. In the first nine months of 2022 alone, the import of energy products was EUR 2.5 billion higher than in the same period of the previous year. It is expected that the deficit of the current account of the balance of payments will reach the level of 9% of GDP in 2022, and then with the recovery of external demand and the drop in energy prices, it will gradually decrease.

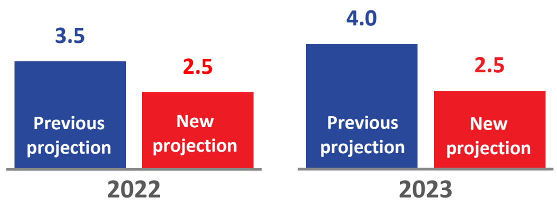
Fiscal intervention, i.e. budget support primarily to the energy sector, did not threaten the sustainability of public finances. Better collection of revenues, primarily tax revenues, was reflected in the preservation of fiscal stability.

Uncertainty in the projections given in this document remains far greater than usual due to the nature and extent of the shocks at the global level. The risks of the macroeconomic framework mostly stem from uncertainty regarding the development of the situation in Ukraine and the impact of new international economic and political relations. Energy price movements, global trade restrictions, as well as greater uncertainty compared to current expectations may have a greater impact on the domestic economy.

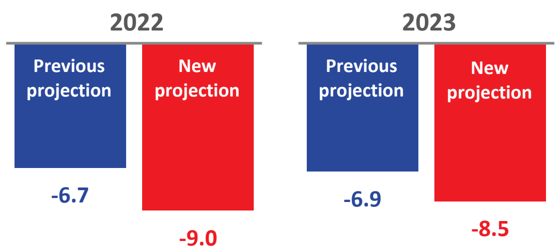
The Government continuously adopts measures aimed at mitigating the consequences of the extremely unfavourable impact of the international environment on the economy and population and preserving energy stability. This orientation will remain the focus of economic policymakers in the coming period and keeping the public debt below 60% will continue to be the basic anchor for conducting fiscal policy. Planned significant investments in energy infrastructure will greatly contribute to stability and the necessity of finding new sources of growth is recognized, so innovation, research and development and creative industries are in constant focus when defining future policies.

Revision of the movement of basic macroeconomic aggregates in relation to the previous Fiscal Strategy

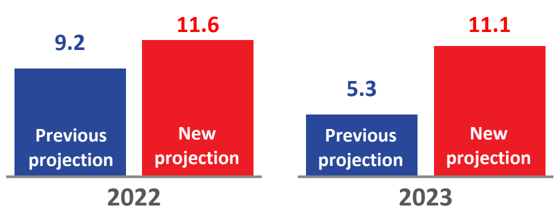
Real GDP growth, %



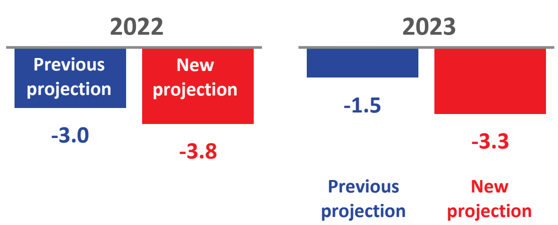
Current account balance, % GDP



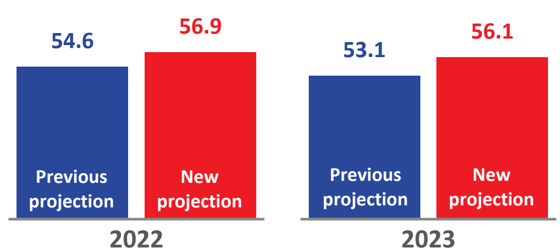
Inflation, period average, %



Fiscal result, % GDP



General government public debt, % GDP



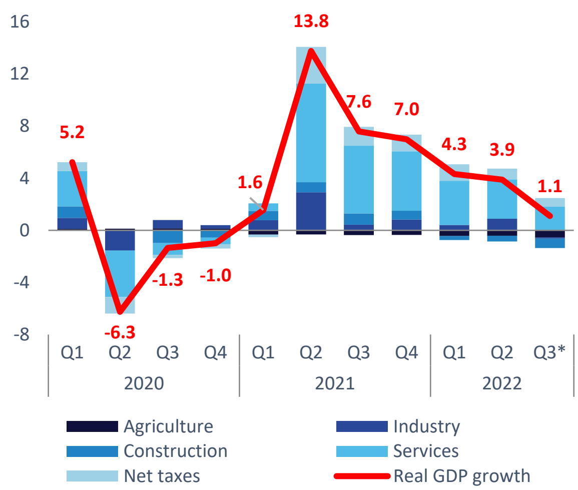
Current Trends in the Real Sector

Macroeconomic developments at the beginning of 2022 were generally at the projected level, but the outlook worsened as a result of the new global shock caused by the conflict in Ukraine and the additional escalation in recent months. Although solid economic growth was achieved in the first two quarters of 2022, in this period there were no significant negative effects of geopolitical events on the dynamics of domestic economic activity. However, the additional escalation of the conflict and the tightening of international economic and political relations, accompanied by record energy prices and consequently reduced global trade and foreign demand, began to reflect on domestic economic activity over time.

According to SORS data, GDP growth in the first quarter of 2022 was 4.3% y-o-y, while an increase of 3.9% y-o-y was recorded in the second quarter, which resulted in an average growth of GDP in the first half of the year of 4.1%.

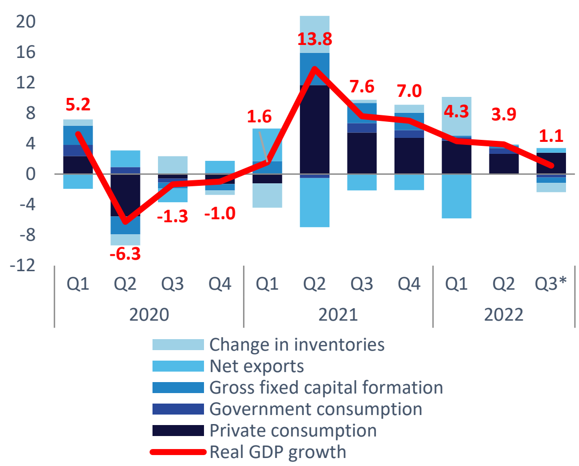
Observed from the production side, economic growth in the first half of 2022 was led by the service sector. The increase in economic activity was recorded in all service activities and the most significant contribution came from trade, transport, tourism and ICT services, which determine about half of the total GDP growth in this period. Despite the significantly lower volume of electricity production, the total industrial production recorded a positive contribution, recording an increase of 3.3% y-o-y, as a result of good developments in the manufacturing sector and mining due to the effect of investments from the previous period. A slight negative contribution to economic growth came from the construction industry, partly due to the high base from the same period of the previous year, but also due to a strong increase in the prices of construction materials. Unfavourable agrometeorological conditions were reflected in the below-average agricultural season, so in the first two quarters a drop of 5.3% was recorded in this sector.

Contributions to the real GDP growth rate, production approach, pp



* Flash estimate of SORS, recalculation by the Ministry of Finance

Contributions to the real GDP growth rate, expenditure approach, pp



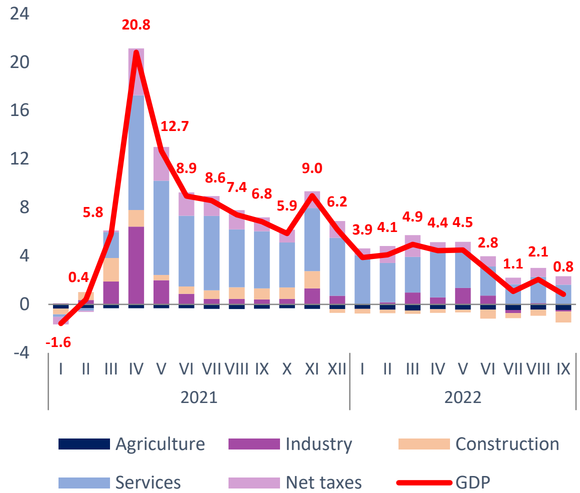
* Flash estimate of SORS, recalculation by the Ministry of Finance

Observed by aggregates of use, GDP growth in the first half of 2022 was entirely driven by domestic demand, while the contribution of net exports was negative. The increase in the disposable income of the population primarily as a result of favourable trends in the labour market, along with significantly better epidemiological conditions, was reflected in the strong growth of private consumption, which amounted to 5.3% y-o-y. Despite the unfavourable developments in the international environment, investments also recorded a positive contribution with a growth of 1.4%. The supply-side effect, with solid external demand in this period, resulted in real export growth of 19.9% y-o-y. At the same time, the import activity recorded a strong growth of about 22.3% due to the increased import of raw materials for the needs of the economy, as well as energy in order to ensure the security of supply to domestic consumers and ensure a certain level of stocks for the winter period. At the same time, this was reflected in the significant positive contribution of inventories to GDP growth.

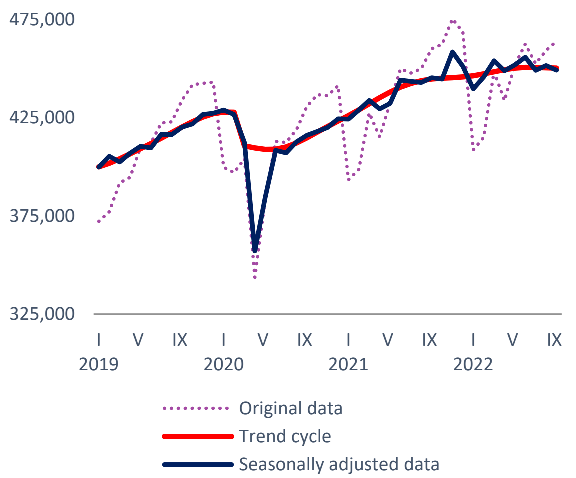
The monthly dynamics of economic activity continued with year-on-year growth during the summer months, but as expected, at lower rates than in the first half of the year, due to the negative impact of the conflict in Ukraine.

This is also confirmed by the Indicator of economic activity (IPAS), which the Ministry of Finance prepares for the purpose of reviewing the monthly dynamics of total economic activity, according to which GDP growth in July, August and September amounted to 1.1% y-o-y, 2.1% y-o-y and 0.8% y-o-y, respectively. The slower dynamics of the economy in this period is a consequence of the smaller volume of industrial production, which recorded a decline of 1.6% y-o-y in July and a modest growth of 0.3% in August, only to enter the negative zone again in September (0.3%), but also with a smaller positive contribution of the service sector due to the slower growth of certain service activities compared to their dynamics during the first half of the year. Construction activity continued in this period with the slowed down dynamics that had started at the beginning of 2022, while bad agrometeorological conditions during the summer additionally influenced an even greater decline in agriculture than originally estimated. Significantly slower economic dynamics in the third quarter of 2022 was also confirmed by the flash estimate of the GDP of the Statistical Office of the Republic of Serbia, according to which economic growth was estimated at 1.1% y-o-y. Thus, in the first nine months, according to the estimate of the Ministry of Finance, economic growth amounted to 3.0%.

Indicator of economic activity in Serbia (IPAS) by sectors (contributions to growth, pp)



Indicator of economic activity of Serbia (IPAS), mil. RSD, chain-linked volume measures



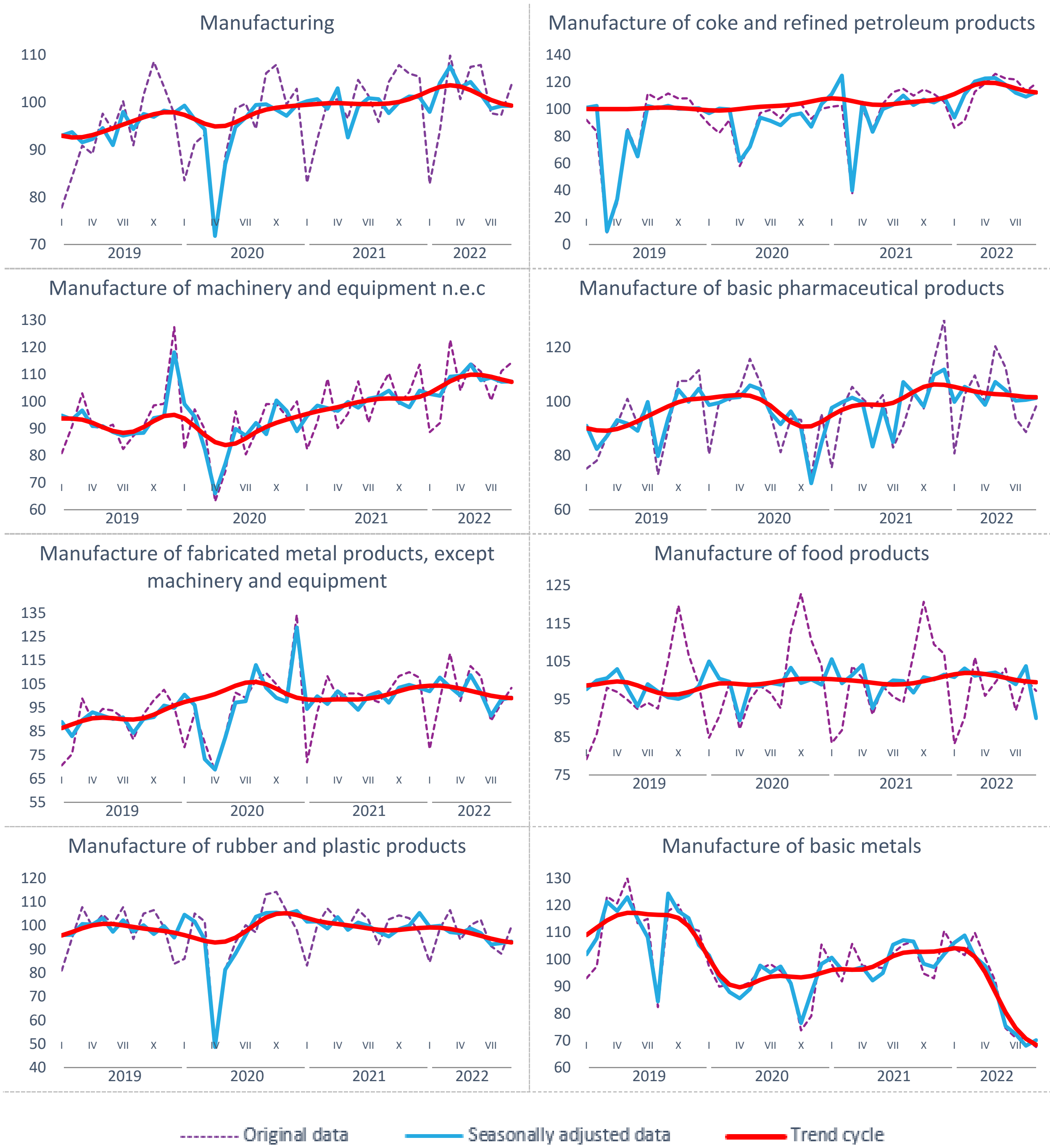
Source: MoF

The solid dynamics of industrial production has continued during the current year, but with a noticeable slowdown in the third quarter. In the first nine months, total industrial production increased by 1.9% y-o-y despite the reduced volume of electricity production of 11.5% y-o-y. This was significantly contributed by the solid growth of the manufacturing industry of 2.7%, as well as the increase in mining production of 25.0%. In these two sectors, there are significant supply-side effects due to the realization of foreign direct investments (hereinafter: FDI) from the previous period and the activation of new production capacities. However, with the tightening of geopolitical relations and the materialization of negative risks from the international environment, during the third quarter industrial activity entered the negative zone achieving a drop of 0.5% y-o-y, followed by a drop in the manufacturing industry of about 1%, but also a smaller positive contribution from mining due to the exhaustion of the influence of the low base from the same period of the previous year. The production of electricity is still year-on-year lower, but it stabilized and during September was at an unchanged level compared to the same month of the previous year.

Observed by divisions of the manufacturing industry, growth was achieved in 14 out of 24 activities in the first nine months. The most significant positive contribution to the year-on-year growth of this sector came from the oil industry (growth of 16.6% y-o-y), accounting for three fifths of the total growth. The activity of other transport equipment achieved growth, whereby the volume of production in the first nine months was higher by 47.4% y-o-y. In the same period, the industry of machinery and equipment recorded a growth of 8.6% y-o-y, while paper production increased by 9.8%. In addition, the physical volume of the pharmaceutical industry increased by 6.4% y-o-y, with significantly slower growth during the third quarter. These four activities provided an approximately equal positive contribution to the movement of the manufacturing industry, accounting for slightly more than half of the total growth of this sector. On the other hand, the activities that experienced a decline in production collectively had a negative impact on the movement of the manufacturing industry of about 1.6 pp. In the first nine months, the metal industry had the most significant negative contribution with a 12.2% decline. After the outbreak of the crisis in Ukraine, the metal industry faced problems in the supply chains of raw materials, which required a reorientation towards new markets for the supply of raw materials. Blast Furnace No. 1 in the Smederevo ironworks was shut down, and the production of the metal industry from June to September was about a third lower, year-on-year. Other activities that experienced a decline in production had a milder negative impact on the movement of the manufacturing industry, whereby the activity of the rubber industry and wood manufacturing, primarily due to reduced external demand, was lower by 3.3% and 15.5% y-o-y, respectively.

Increased uncertainty in the international environment due to geopolitical tensions defines significant negative risks, which, along with reduced external demand from our most important foreign trade partners, as well as disruptions in global supply chains, will have a negative impact on the dynamics of the manufacturing industry in the coming period as well. In addition, the rise in the prices of energy and raw materials has increased cost pressures, and due to the military conflict between Russia and Ukraine, there is a need to find new markets, which can be difficult in the short term.

Indices of physical volume of leading activities of industrial production, 2021=100



Source: Ministry of Finance

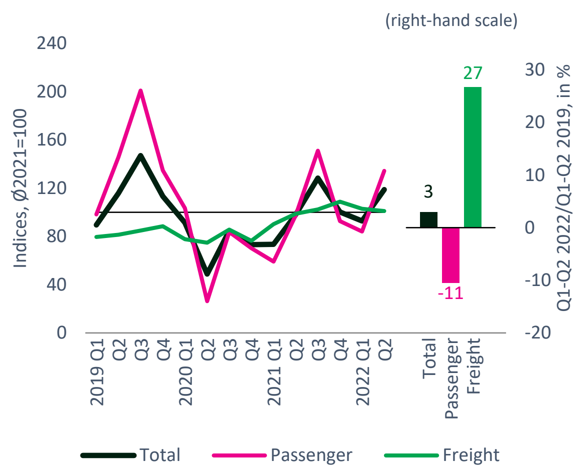
The favourable dynamics of the service sector continued during 2022, but with somewhat slower movements during the third quarter compared to the first half of the year.

In the first nine months, the retail trade turnover increased by 7.1% y-o-y in real terms. This was contributed by the growth of the disposable income of the population, primarily due to the growth of real wages and employment supported by additional benefits to certain categories of the population, but it is also partly a consequence of impulse buying after the outbreak of the conflict in Ukraine. Despite rising prices, there was a noticeable increase in consumer demand for motor fuel and food products (food, beverages and tobacco), so that the turnover of these categories was in real terms higher by 13.4% and 2.8% y-o-y respectively, while the turnover of non-food products increased by 9.0%. During the third quarter, turnover in retail trade in real terms grew slightly slower than in the previous period, due to higher prices, but was still higher on average by a solid 4.6% y-o-y with real growth in all three product categories.

The sector of information and communication technologies, which grew strongly during the two pandemic years, achieving a cumulative growth of gross value added (hereinafter: GVA) of 14.1%, continued with good dynamics in the first half of the year (growth of 5.1% y-o-y). In addition, the export of services is continuously growing, driven by the increasingly significant role of the ICT sector, whereby its export in the first eight months was higher by 43.1% y-o-y.

Transport activity measured by the physical volume index in the first half of 2022 is 23.4% higher year-on-year, with growth in passenger and freight transport by 39.7% and 7.9%, respectively. The total volume of transport exceeded the level from the first half of 2019 by about 3%, primarily due to an increase in the volume of freight transport by about 27%, while the level of passenger transport is still about 11% lower. During 2022, the export of transport services continued to grow and in the first eight months was higher by 45.8% compared to the same period of the previous year.

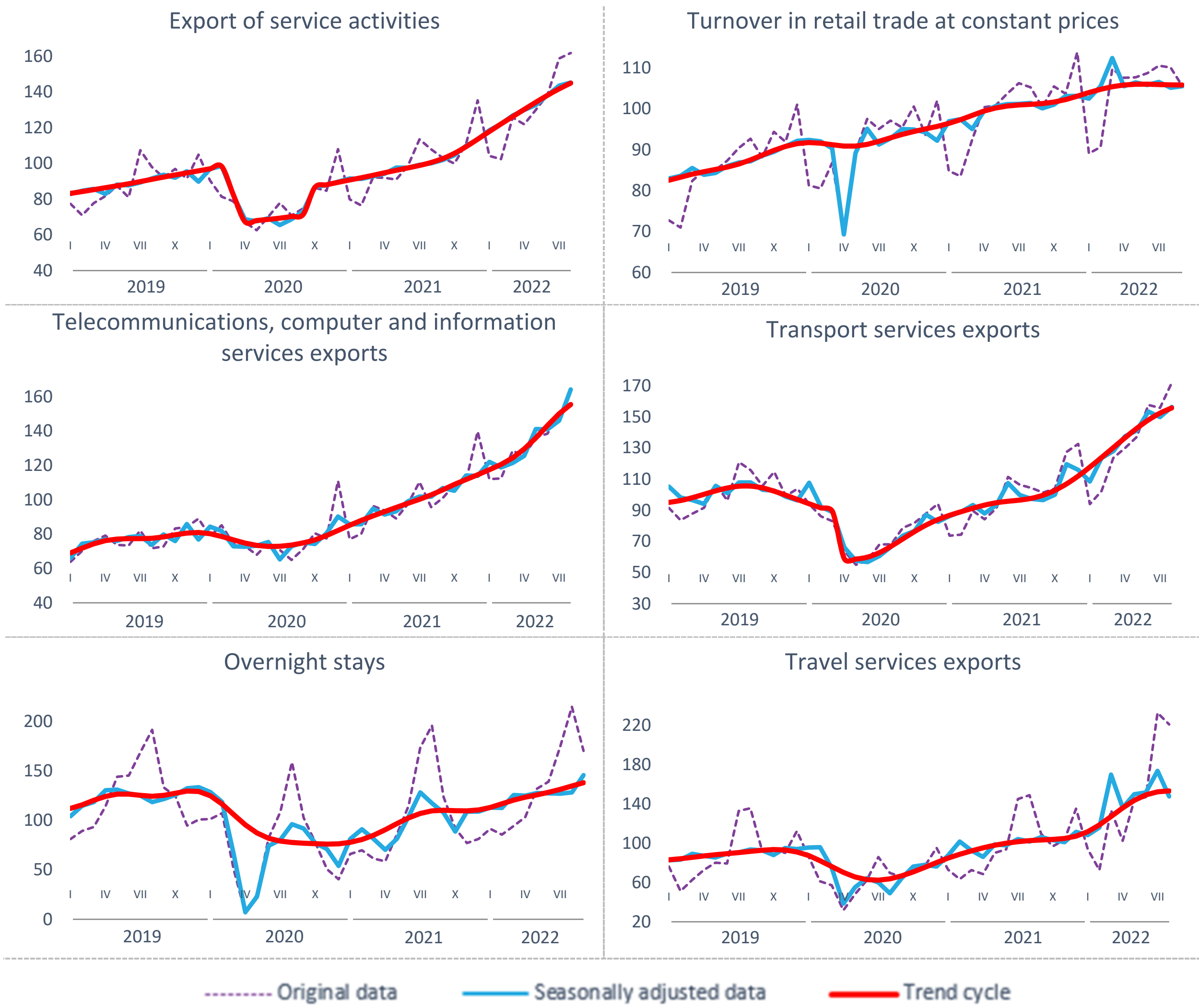
Physical volume index of transport (2021=100)



Source: SORS

After two extremely difficult pandemic years, tourism activity continues to recover in 2022. In the first nine months, the total number of tourist arrivals and overnight stays increased year-on-year by 50.6% and 32.3%, respectively, followed by the growth of activities of domestic and foreign tourists. The foreign currency inflow from tourism also increased, so that in the first eight months of 2022, the export of tourist services was 51.8% higher year-on-year. A strong growth in turnover in the catering trade was recorded during 2021 with the continuation of similar trends during 2022, whereby in the first seven months it was 54.0% y-o-y higher in real terms.

High-frequency indicators of key service industries, 2021=100



Source: Ministry of Finance

Despite the achievements at the beginning of 2022, which were generally at the projected level, the Ministry of Finance revised down the original GDP growth projection for 2022 in the Fiscal Strategy from June 2022 by 1.0 pp, from 4.5% to 3.5%, with the risk matrix rated as asymmetric downwards due to the expected negative impact of growing geopolitical tensions, the energy crisis, as well as increased global uncertainty. Bearing in mind the additional tightening of international economic and political relations, the deepening of the energy crisis, as well as the slower dynamics of high-frequency indicators during the third quarter and a significantly weaker agricultural season than previously expected, the Ministry of Finance further lowered the GDP growth projection for 2022 by 1.0 pp, from 3.5% to 2.5%.

Observed by aggregates of use, economic growth in 2022 and in the new estimate will be entirely driven by domestic demand. The still present favourable trends in the labour market accompanied by the growth of employment and real wages supported by one-time benefits to the population will be reflected in a stable growth of private consumption of almost 4%, while the contribution of government consumption will remain almost neutral. Growing geopolitical tensions and investors' aversion to risk, along with the increase in input prices, affect the slower growth of fixed investments than previously projected, thus instead of the previously estimated growth, stagnant movements are now expected. The realization of FDI from the previous period and the associated significant supply-side effect will result in higher exports by 12.3%, despite slightly lower external demand than previously expected and restrictions on the export of certain products. On the other hand, the increased import of energy and raw materials is reflected in the higher growth of real imports in 2022, which is 12.8% according to the new projection.

Observed from the production side, extremely bad agrometeorological conditions during the summer months were reflected in significantly lower yields of corn, sugar beet and soybeans, so the original estimate of agricultural production, which implied an average season and growth of 0.5%, was corrected downwards to -8.0%. More unfavourable trends than originally expected will also be recorded in the construction industry, primarily as a result of growing global uncertainty and a smaller volume of private investments, but also because of a strong increase in the price of construction materials. Despite weaker external demand, industrial production will provide a positive contribution to GDP growth in 2022, but to a lesser extent compared to previous expectations. The service sector retains its role as the dominant source of economic growth in the new projection, primarily as a result of solid developments in the trade, transport, tourism, as well as ICT and financial services sectors.

Table 3. GDP, real growth rates, %

	2021	Q1 2022	Q2 2022	2022* (estimate from the Fiscal Strategy)	2022* (revised estimate)
GDP	7.5	4.3	3.9	3.5	2.5
Private consumption	7.8	6.9	4.0	3.1	3.9
Government consumption	4.1	2.5	4.5	-0.4	0.4
Gross fixed capital formation	15.9	1.1	1.7	3.0	0.0
Exports of goods and services	19.5	19.7	20.1	9.0	12.3
Imports of goods and services	17.7	28.6	16.9	8.6	12.8
Agriculture	-5.7	-5.2	-5.4	0.5	-8.0
Industry	6.3	1.9	4.6	3.7	1.3
Construction	17.6	-5.5	-7.6	1.4	-8.7
Services	8.3	6.7	5.9	4.0	4.8

Source: SORS

* Ministry of Finance

Projections of Real Sector Developments in the Period 2023–2025

The expected medium-term developments of the real sector take into account current economic trends and prospects for Serbia and the international environment. In the coming period, the Government will lead a responsible and predictable fiscal policy, synchronized with the monetary policy and focused on minimizing the negative economic consequences of increased geopolitical tensions, but also on locating new sources of growth.

The materialization of the risks given in the June Fiscal Strategy in terms of longer-term geopolitical tensions, additional financial disruptions and more persistent uncertainty influenced the weaker economic outlook. The scenario that was then analysed as an alternative, and which implied significantly lower economic growth and higher inflation than those in the basic scenario, especially in 2023, has been largely actualized. Slowed investment dynamics and rising inflation, along with increased uncertainty and reduced external demand as a consequence of the economic impact of the conflict in Ukraine are the main factors affecting the slowdown of domestic economic dynamics. Accordingly, the GDP growth for 2023 was revised down by 1.5 pp, from 4.0% to 2.5%, while the projections for 2024 and 2025 were reduced by 0.5 pp to 3.5% and 4.0%, respectively. In the current scenario, it is assumed that there will be no further escalation of military conflicts and additional tightening of international economic and political relations, that energy prices will remain at a high level in the medium term, but still somewhat lower than in 2022, with the security of domestic supplies preserved producers and consumers, as well as that there will be no additional disruption in external demand, primarily in terms of the sharp decline in the economy of the EU as our most important foreign trade partner. Also, a stable inflow of FDI is expected to continue, which will ensure the transfer of knowledge and technology, as well as new sales channels to domestic producers. The uncertainty in the projections is far greater than usual due to the nature and scale of the shocks at the global level. The channels through which they can potentially affect the domestic economy are numerous, often linked in a chain, and the strength of the potential shocks is such that they can greatly affect medium-term trends.

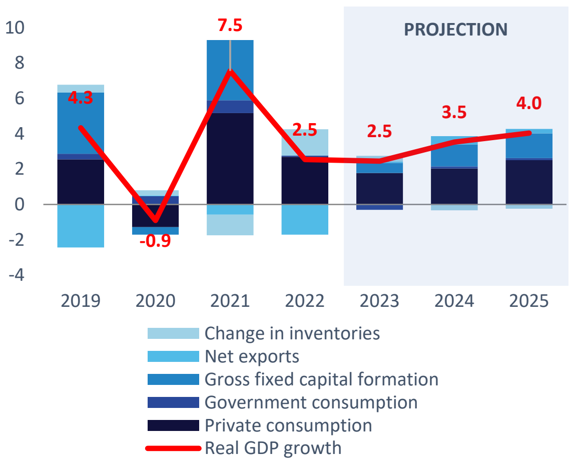
Table 4. Projection of basic macroeconomic indicators of the Republic of Serbia

	Estimate	Projection		
	2022	2023	2024	2025
GDP, billion dinars (current prices)	7,082.5	8,025.1	8,776.3	9,519.4
Real GDP growth, %	2.5	2.5	3.5	4.0
GDP deflator, %	10.2	10.6	5.6	4.3
Private consumption	3.9	2.5	2.9	3.6
Government consumption	0.4	-2.0	0.8	0.8
Gross fixed capital formation	0.0	2.4	5.2	5.8
Exports of goods and services	12.3	4.9	8.8	10.6
Imports of goods and services	12.8	4.0	6.8	8.8
Balance of goods and services, in EUR, % of GDP	-12.2	-10.9	-9.4	-8.4
Current account balance, in EUR, % of GDP	-9.0	-8.5	-6.7	-6.0
Inflation, period average, %	11.6	11.1	5.0	3.5

Source: Ministry of Finance

Observed by aggregates of use, GDP growth in 2023 will also be entirely driven by domestic demand in the revised estimate, while net exports will have an almost neutral contribution. The expected increase in wages, both in the private and public sectors, higher employment and stable growth of pensions, will result in a growth of real personal consumption of 2.5%, which is 1.3 pp less compared to the previous projection, primarily as a result of higher inflationary pressures and somewhat less favourable financing conditions. Geopolitical tensions, weaker external demand and investors' aversion to risk, along with the tightening of the monetary policy of the leading central banks, will result in slower investment dynamics, which caused a downward revision of the investment growth rate, from 6.1% to 2.4%. The dynamics of investment activity will be entirely determined by private investments and the further increase of production capacities of the economy, primarily in sectors that produce tradable goods, while the contribution of public investments will be almost neutral. A slight negative contribution to GDP growth in 2023 of 0.3 pp will come from government consumption. Unlike the previous projection, when a stronger growth of foreign trade flows was expected, in the current projection for 2023, under the influence of the international environment, a slower growth of exports and imports is forecast, which should amount to 4.9% and 4.0%, respectively.

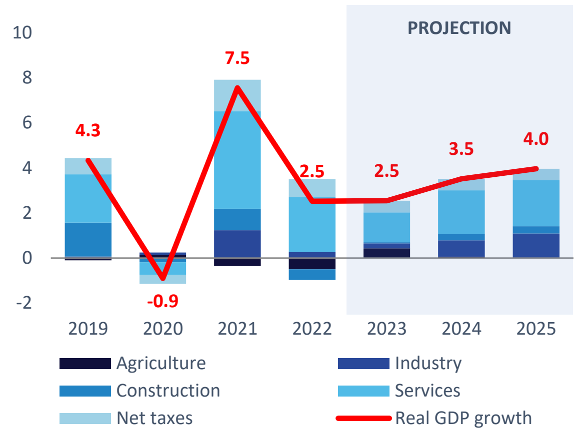
Contributions to the real GDP growth rate, expenditure approach, pp



Source: Ministry of Finance

Observed from the production side, an increase in created GVA is expected in all economic sectors, as in the previous projection, but at a slower pace, except for agriculture due to an extremely low base in 2022. In 2023, the service sector will play a dominant role in the growth of economic activity. Growth should be diversified and achieved in most service industries, and particularly strong in the ICT sector, trade and transport, as well as tourism and catering. Despite weaker external demand than previously expected, the overall industry will continue to grow during 2023 and record an increase of 1.1%, primarily due to the activation of new production capacities, but also the expected recovery of electricity production. It is estimated that construction will also record growth, partly due to a smaller volume of activity in 2022, as a result of growing global uncertainty and a smaller volume of private investments. For the agricultural sector, due to extremely bad weather conditions in 2022 and a low base, and assuming average agrometeorological conditions while maintaining the trend of increasing productivity, a growth of 6.9% in 2023 is projected.

Contributions to the real GDP growth rate, production approach, pp



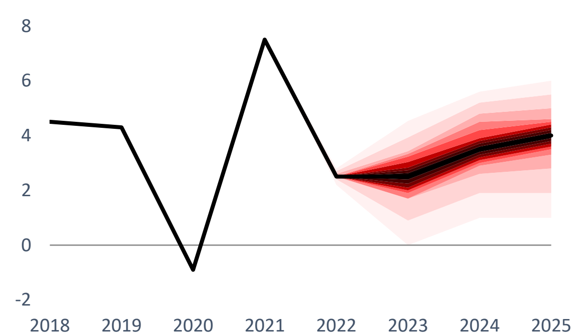
Source: Ministry of Finance

According to the medium-term macroeconomic projection, the cumulative growth rate in the period 2023–2025 will amount to 10.3% and will be driven by the growth of domestic demand, and with the recovery of global trade supported by a slight positive contribution of net exports. This source of growth is determined both by the permanent increase in investments and by the growth of household consumption due to the increase in the living standard of the population. On average per year, the Serbian economy will grow at a rate of 3.3%, which is a downward revision of 0.9 pp in relation to earlier expectations due to the assessed impact of events in the international environment. The increase in real population consumption will follow the growth of economic activity and will amount to 3.0% on average. Stable growth of fixed investments is expected, although slower than previously projected and will amount to 4.5% per year on average. With the activation of new production capacities and the recovery of external demand, the volume of foreign trade will also increase. In addition, the effectiveness of FDI from the previous period will contribute to increased competition and affect the efficiency of domestic producers, while on the other hand, new sales channels will be activated and new market niches will be opened. Exports will grow at an average annual rate of 8.1%, which is faster than the expected annual growth of imports, which will average 6.5%. When it comes to supply, the service sector and industry will maintain their role as dominant sources of growth and increase the created GVA with average annual growth of 3.5% and 3.4%, respectively. A positive contribution will also come from the increase in construction activity, which will amount to 4.0% on average. Reaching European standards and increasing competitiveness in agriculture will reduce the variability of production in this sector caused by agrometeorological conditions.

Even with this three-year scenario, the Government remains committed to preserving the model of economic growth based on investments and exports, which is supported by the growth of private consumption on real and healthy sources. Speeding up all administrative procedures, tax relief for the economy with the aim of increasing its competitiveness, signing agreements that ensure the preservation of existing and opening of new international markets, more intensive and efficient execution of infrastructure works, preservation of energy stability and implementation of projects from the green agenda are just some of the measures that should be taken to provide healthy foundations for GDP growth in conditions of growing geopolitical tensions. Digital transformation and building a digital ecosystem remain the strategic orientation of the Government. More efficient work of the state administration, shortening of procedures for the population and the economy with a focus on digitalisation will accelerate the convergence of our economy towards developed countries. The new system of fiscalization and changes in customs regulations reduces the participation of the grey economy in overall economic flows, ensuring a favourable economic environment. The FDI incentive mechanism will continue to aim at its sectoral and regional dispersion in order to ensure the assumptions of even development and full utilization of comparative advantages.

The medium-term scenario of economic activity in the Republic of Serbia is still under the influence of numerous risks from the international environment. The risks of the macroeconomic framework mostly stem from uncertainty regarding the development of the situation in Ukraine and the impact of new international economic and political relations. Energy price movements, global trade restrictions, as well as greater uncertainty compared to current expectations may have a significantly greater impact on the domestic economy. In accordance with that, an alternative scenario was created, which implies the materialization of risks from the international environment and, consequently, lower rates of economic growth, especially in 2023. In that scenario, the starting point was the assumption of an additional reduction in external demand, due to less production activity in the euro area as a result of insufficient amounts of energy, especially gas, which would cause production interruptions, as well as disruptions in supply chains. In addition, geopolitical tensions would be more acute than in the baseline scenario, leading to additional financial disruptions and deepening uncertainty. The materialization of these risks would result in a lower GDP growth rate of 2.0 pp in 2023 from that in the basic scenario, since the above-mentioned factors would have the greatest impact on export activity, the dynamics of the investment component of GDP, as well as on private consumption. In 2024 and 2025, the differences compared to the original expectations would be smaller due to the gradual recovery of the economy from shocks and a lower base.

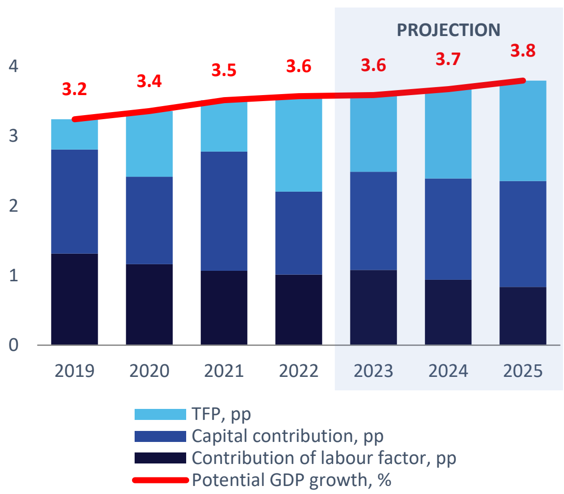
Projection of GDP trends, growth rates, %



Source: Ministry of Finance

According to the central scenario, in the medium term, potential GDP growth is expected to continue, but at a slower pace than in the previous projection as a result of factors from the international environment. Potential GDP in the period 2023–2025 will gradually increase at an average rate of 3.7%. Realization of capital projects and the continuation of the started investment cycle, supported both by a stable inflow of FDI and domestic innovative activities, will ensure an increasingly strong contribution of capital and factor productivity to the growth of potential GDP. Digitalisation will significantly speed up these processes and additionally increase the efficiency of utilization of available capacities. Through significant planned investments in the energy infrastructure, the Government will additionally influence the growth of the economy's potential. Adequate and synchronized monetary policy, further improvements of the financial system, increasing credibility and attractiveness among investors, transfer of knowledge and technology from the most developed countries should ensure a positive impact on both factors of production. On the other hand, strengthening the rule of law, reforming legislation in the field of economy and business, speeding up procedures and raising the efficiency of administration should ensure the maximization of factor productivity in the medium term. Favourable trends in the labour market will also contribute to the growth of potential GDP.

Contributions of production factors to the potential GDP growth rate, pp



Source: Ministry of Finance

Labour Market

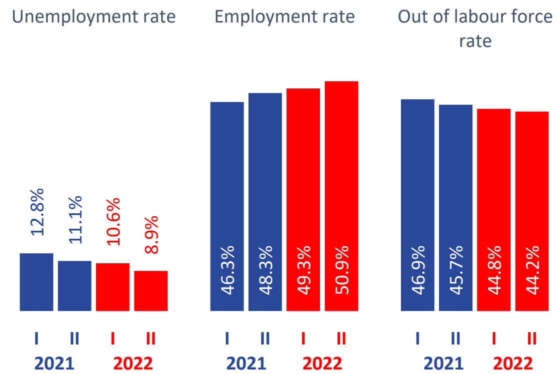
Trends in the labour market largely remained resistant to the slowdown in the dynamics of economic activity, primarily thanks to the macroeconomic stability established in the previous period. Thus, positive developments continued in 2022, which are primarily reflected in the growth of employment and wages, but under the influence of geopolitical tensions, however, at a somewhat slower pace.

According to data from the Labour Force Survey in the second quarter of 2022, the unemployment rate (the age of 15 and over) was 8.9%, which is lower compared to the same period in 2021 when it was 11.1%, while rate of the population outside the labour force decreased by 1.5 pp. At the same time, total employment was higher by 4.3%, with formal employment growing by 74.9 thousand and informal employment by 47.5 thousand. In addition to a significant decrease in the unemployment rate and an increase in the total number of employees, structural improvements in the labour market were also recorded. The position of the more sensitive categories of the population, i.e. the population of young people and women, has improved. Thus, the youth unemployment rate decreased from 22.2% to 18.7%, while the unemployment rate of the female part of the population decreased by 1.6 pp, to 10.2%. Furthermore, the long-term unemployment rate decreased by 0.9 pp, to 4.5%. In the same period, the employment rate in the informal part of the economy increased by 1.1 pp, to 14.3%.

According to the data of the Central Register of Mandatory Social Insurance, in the period January-September, the average number of employees was higher by 1.6%, compared to the same period of the previous year, which was primarily the result of an increase in employment in the private sector by 1.9%, while in the public sector the growth was 0.9%. At the same time, the strongest sectoral contribution to employment growth comes from ICT, administrative-service and scientific-technical activities. According to the data of the National Employment Service, in the same period, the number of people actively looking for employment decreased by 13.0%.

In the period January-August, the average net salary was RSD 73,265, which is a real increase of 3.0%, y-o-y, and represents a slightly slower growth compared to the previous period. The growth of wages was entirely determined by the growth of wages in the private sector, which in the same period amounted to 5.4%, in real terms. The increase in the minimum cost of labour by 9.4% to RSD 201.22 per working hour from 2022 also affected the general increase in wages. Despite the increase in wages in the public sector by the decision of the Government in the range of 7% to 8%, their nominal growth was completely neutralized by the growth of inflation, so that in real terms a decrease of 2.6% was recorded. Observed by activities, the most significant wage growth was in ICT, trade and scientific and technical activities.

Movement of basic labour market indicators



Source: SORS

It is expected that the labour market will maintain a positive trajectory of development, but at a slower pace, primarily due to the weaker growth of economic activity, and as a consequence of great uncertainties due to the conflict in Ukraine. In addition to the above, positive expectations are the result of continuous work on improving working conditions, improving labour market institutions, encouraging employment and inclusion in the labour market of less employable persons, as well as support for regional and local employment policy. Furthermore, continuous efforts are being made to improve the workforce in terms of quality, as well as investing in human capital, all with the aim of facilitating general employment, especially in that part of the economy that has greater added value. The success of these measures so far is confirmed by the data on the increase in the number of employees in the period from 2014 to 2021 in the ICT sector by 31,112 and scientific and technical activities by 26,389 persons. Policies aimed at reducing the number of employees in the grey zone and transferring them to the contingent of formal employees will be continued, which would improve their working conditions, and the positive effect would be reflected in budget revenues. In the medium term, positive results are expected from active measures of training, retraining and support for social entrepreneurship, which will facilitate the availability of jobs for socially vulnerable categories of society and thereby additionally ensure the inclusiveness of economic growth. Also, it is planned to increase the scope of education based on the dual model. Taking into account all of the above, in the medium term, a decrease in the unemployment rate and an increase in wages are projected, but under the influence of the current geopolitical uncertainties caused by the crisis in Ukraine, it is expected to be at a slower pace. For economic sustainability, wage growth should be based on productivity growth. Wage growth in the coming period will be supported by the adopted Government Decision on increasing the minimum cost of labour in 2023 by 14.3%, as well as the announced 12.5% increase in wages in the public sector.

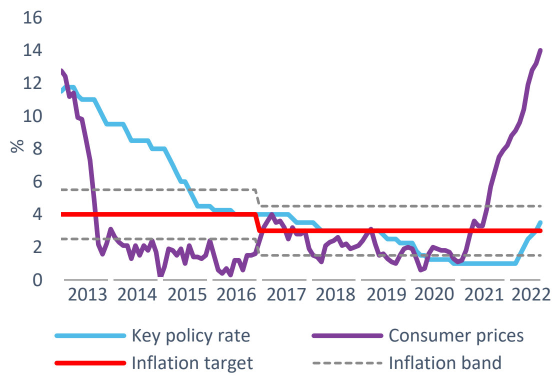
Monetary Developments

Year-on-year inflation in Serbia, as in most other countries, continued to move upward. This trend of inflation was influenced, first of all, by the so-called imported inflation, i.e. external factors on which the NBS does not have a direct influence, such as the increase in world prices of energy and primary agricultural products and disruptions in global supply chains. Additionally, to a certain extent, higher inflation rates were influenced by its low base value. The growth of consumer prices in September was above the upper limit of the permissible deviation from the target inflation and was 14.0% year-on-year. In this period, more than two-thirds of inflation was determined by the increase in food and energy prices. At the same time, base inflation was significantly lower and amounted to 8.6%, which was significantly influenced by the preserved relative stability of the exchange rate and the preserved confidence of the economy and consumers.

In order to mitigate price growth and inflationary expectations, the NBS, in the period from April to October 2022, made a decision on seven occasions to increase the restrictiveness of the monetary policy, by raising the key policy rate by a total of 3.0 percentage points, from 1.0% to 4.0%. Before the increase in the key policy rate, the NBS used the flexibility of its monetary framework, so since October last year it gradually increased the average weighted interest rate on one-week reverse repo auctions and thus started the process of tightening monetary conditions. A significant anti-inflationary effect is also the relative stability of the exchange rate of the dinar against the euro, which was preserved thanks to the timely interventions of the NBS in conditions of strong depreciation pressures that were present from the fourth quarter of 2021, and which were stopped in

April. In addition to influencing the stability of the exchange rate, interventions on the foreign exchange market also had an anti-inflationary effect by withdrawing dinar liquidity from the banking system. In these conditions, financial stability was preserved and additionally strengthened, with further growth in credit activity and a decrease in the share of non-performing loans in the total.

Inflation and key policy rate, %

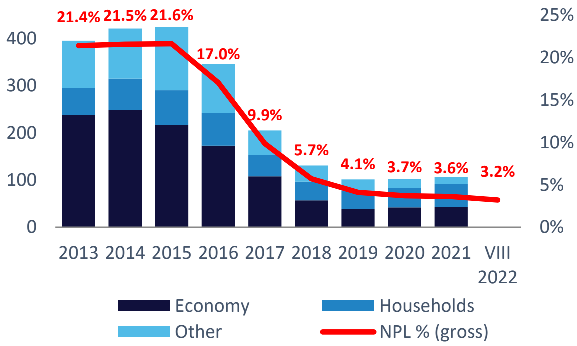


Source: SORS and NBS

With the same goal of calming inflation and the negative social and economic effects of the rise in global food and energy prices, the Government undertook a series of measures to limit administrative prices and to a lesser extent fiscal measures in the form of a reduction in excise duty on oil derivatives. The prices of basic foodstuffs (sugar, sunflower oil, flour type 400 and 500, pork, chicken carcass) are limited. The regulation was last extended until 30 November 2022. The regulation on the temporary measure of gas price restrictions determines the price of gas for further sale and the right to compensation for the difference in the price of gas purchased from imports or produced in the country. The regulation on limiting the price of oil derivatives prescribes the method of calculating the highest prices of oil derivatives in retail, Eurodiesel and Europremium BMB 95. The price of derivatives for farmers is especially limited. Along with this decree, the Government also made a decision to reduce excise duties on oil derivatives. The export of certain basic agricultural products, as well as sunflower oil, was also temporarily prohibited in order to prevent a shortage of these products on the domestic market. The aim of these measures is the reduction of inflationary pressures and inflationary expectations, as well as the regular and uninterrupted supply of food and energy to the market.

Despite the gradual increase in interest rates, both on the domestic and international markets, credit activity continues to record double-digit growth, which has been slowing down since the third quarter. The growth of credit activity is the result of the still favourable financing conditions, which were created in previous years, thanks to the effects of easing the monetary policy, but also the strong drop in the risk premium and the improvement of the credit rating. The growth of credit activity was also influenced by the approval of dinar loans from the guarantee scheme at lower interest rates, then the reduction of the mandatory down payment for the purchase of the first apartment, the reduction of the minimum level of construction of the building whose purchase can be financed with housing loans from banks, and the extension of the repayment period of housing loans. Also, compared to the period before the pandemic, the share of dinar placements has increased significantly, which is the result of the growth of dinar loans to the economy (largely from the guarantee scheme), i.e. the drop in interest rates on dinar loans, as well as measures of the NBS to support the dinarization process. A positive contribution to credit growth comes from loans to the economy and loans to households. Loans to the economy were significantly boosted by the growth of loans for liquidity and working capital, but it is also important to note the growing importance of investment loans, which recorded a recovery and continued growth from the third quarter of 2021. At the same time, as a result of measures to encourage housing loans, their contribution to the growth of total household loans was the most significant. At the end of September 2022, the nominal growth of total loans was registered by 11.2% y-o-y, whereby loans to the economy recorded a growth of 13.9%, while loans to households were higher by 8.1%. The growth of credit activity was not accompanied by an increase in the share of non-performing loans. With the strategy for resolving problem loans, the implementation of which started in the second half of 2015, the share of non-performing loans of the banking sector in total loans was significantly reduced and at the end of August 2022 it was 3.2%. Compared to the period before the implementation of the Strategy, this is a decrease of 19.99 pp. The continued tightening of monetary conditions will inevitably affect the further growth of interest rates, which will be reflected in the slowdown in the growth of credit activity.

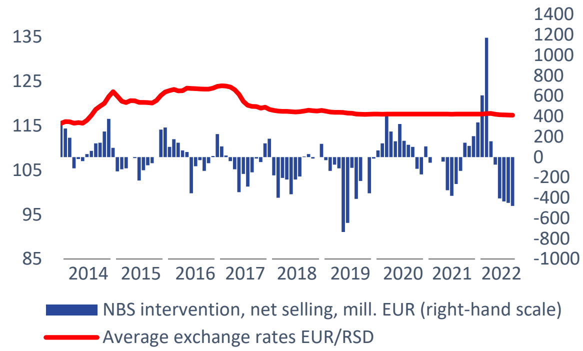
Non-performing loans, billion RSD



Source: NBS

The greater part of 2021 was marked by relatively stable movements on the foreign exchange market, primarily due to good macroeconomic results, acceleration of export growth and a solid inflow of FDI. However, starting from the fourth quarter of 2021, there were significant depreciation pressures on the foreign exchange market and increased demand for foreign exchange as a result of more intensive purchases of foreign currency by energy importers, as well as increased global uncertainty due to the geopolitical crisis in Ukraine. Due to the adequate measures of the NBS, these movements were largely stopped in April, the demand for foreign exchange was calmed, and the ratio of demand and supply of foreign exchange on the foreign exchange market is significantly more balanced, thus preserving the relative stability of the exchange rate even in conditions of increased global uncertainty. Since May, the supply of foreign currency exceeded the demand, so that in the period May-September, the NBS was a net buyer of foreign currency (EUR 1.8 billion). In September 2022, the dinar appreciated on average year-on-year (nominally 0.2%, real 3.9%).

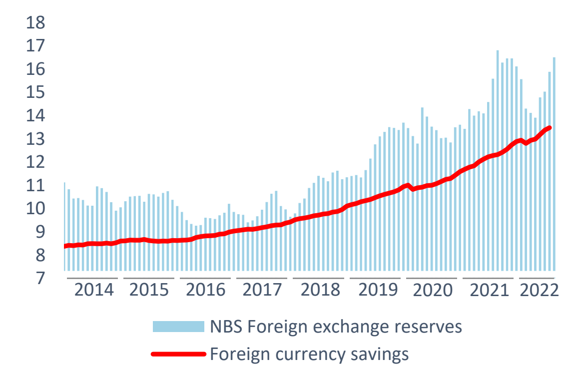
Exchange rate and NBS interventions on the foreign exchange market



Source: NBS

Foreign exchange reserves are kept at a high level, well above what is considered adequate. Thus, in September 2022 they amounted to EUR 16.5 billion, which is the level from the end of 2021, which is also the highest until then. That was enough to cover the M1 money supply of 147.4% and approximately five months of imports of goods and services. The increase in foreign exchange reserves in September is primarily the result of NBS activities on the domestic foreign exchange market.

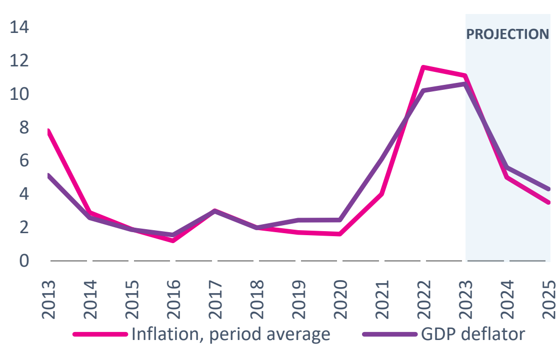
Foreign exchange reserves and foreign currency savings, billion euros



Source: NBS

In the coming period, the trend of inflation will be under the negative influence of external factors, first of all, the rise in world prices of primary products, energy and higher import inflation, and it will move above the upper limit of the goal during the rest of the year, as well as in 2023. With the gradual disappearance of the effects of the mentioned factors, inflation is expected to return to the target values during 2024. The effects of the previous tightening of monetary conditions, as well as the effects of the Government's economic measures aimed at the prices of basic foodstuffs and energy on the domestic market, as well as the expected slowdown in domestic demand will affect inflation. The key risks to the realization of the inflation projection relate to the effects of events in Ukraine on the availability of energy sources and their prices, but also on the prices of other primary products.

Inflation projection, %



Source: Ministry of Finance

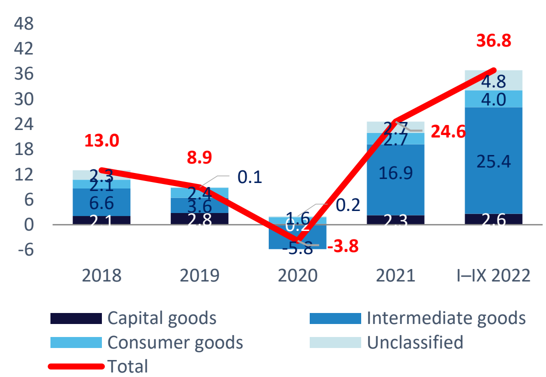
External Sector

After the full recovery of foreign trade goods exchange in 2021 from the shock caused by the pandemic, strong growth continued in 2022. The total volume of foreign trade goods exchange in the first nine months of 2022 was EUR 47.9 billion and was 32.9% higher compared to the same period in 2021. Several factors contributed to this, both on the export and import side.

The high growth of exports is the result of the growth of external demand due to the recovery of the economies of the main foreign trade partners after the implementation of restrictive measures in the fight against the pandemic, the activation of new export-oriented capacities due to the high inflow of FDI from the previous period, as well as the continuation of the trend of growth in export prices. During the first nine months of 2022, goods with a total value of EUR 20.0 billion were exported, which represents an increase of 27.7% compared to the same period last year. The export of the manufacturing industry, which is also the main generator of the growth of the total export, is higher by as much as EUR 3.4 billion or 24.8% compared to the same period in 2021, while within this sector the increase was achieved in all 23 areas. The growth of exports in the food, electronic and chemical industries contributed the most to the higher exports of the manufacturing industry. In addition to the manufacturing industry, a significant contribution to export growth also comes from the exploitation of metal ores. Agriculture, on the other hand, despite the increase in the prices of cereals and primary agricultural products, recorded a drop in exports of 4.5%, due to a weaker agricultural season during the previous and current year.

In addition to the growth of economic activity and the increased import of reproductive goods for the needs of the economy, higher imports in 2022 are primarily a consequence of the strong growth in energy imports. The increased import of gas due to the growing needs of the economy, as well as to fill the Banatski Dvor underground warehouse in order to form strategic reserves of energy, as well as the larger import of oil, electricity and coal, accompanied by a significant increase in their prices, led to a strong increase in total imports. In the period January-September 2022, the import of goods amounted to EUR 27.9 billion, which is a growth of 36.8% compared to the same period of the previous year. Close to 70% of the increase in imports was determined by the higher import of raw materials, which is a growth of 46.3% y-o-y (an increase of EUR 5.2 billion), while the import of consumer goods and equipment increased by 20.4% and 18.2%, respectively.

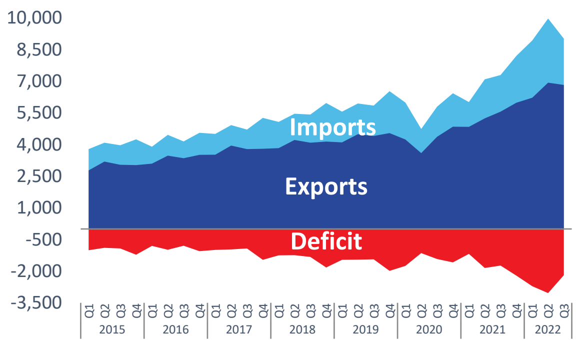
Contributions to the import growth rate, economic destination, pp



Source: SORS

The growth of the deficit in foreign trade in goods in 2022 was also adversely affected by the deterioration of the exchange rate, i.e. stronger growth of import than export prices. Such developments in foreign trade exchange resulted in the growth of the foreign trade deficit during the first nine months of 2022 by EUR 3.2 billion, with a fall in the coverage of imports by exports – from 76.6% in the previous year to 71.5% in the current year.

Merchandise trade, mil. EUR



Source: SORS

The most important foreign trade partners during the first nine months of 2022 are EU countries, which accounted for 64.5% of total exports and 54.5% of total imports. The largest part of total exports (38.4%) in that period was directed to the market of five countries: Germany, Italy, Bosnia and Herzegovina, Hungary and Romania. Imports from China, Germany, Russia, Italy and Hungary accounted for 45.0% of total imports. The foreign trade surplus in this period was achieved with Bosnia and Herzegovina, Montenegro, North Macedonia, Slovakia, Croatia, Romania, United Kingdom, Sweden, Spain, Bulgaria, and to a lesser extent with the Czech Republic. The surplus with these countries in the observed period amounted to EUR 2.5 billion. The biggest deficit occurs in trade with China, Russia, Turkey, Iraq and Hungary.

The Impact of the Energy Crisis on the External Sector

The overall increase in the current account deficit in the first eight months compared to the same period last year is the result of increased energy imports. The growth of energy imports, primarily due to the rise in world energy prices but also the formation of strategic reserves, was reflected in the increase in the current account deficit, which amounted to EUR 2.8 billion. Energy imports in the first eight months of 2022 amounted to EUR 3.9 billion, which is EUR 2.5 billion more than in the first eight months of 2021. Over 80% of the increase in energy imports is the result of rising import prices, while the rest can be attributed to the increase in imported quantities. The effect of a higher import price was most pronounced in the case of gas, accounting for as much as 96.2% of the higher import value, while in the case of oil derivatives (including crude oil) the price effect was somewhat lower and amounted to 78.8%. At the same time, the price effect of coal, coke and briquettes was 57.7%.

The lower volume of coal exploitation at the end of 2021 influenced the reduction of electricity production. This led to an increase in the import of gas for the needs of electricity production, as well as an increase in the import of coal and electricity. The higher import of electricity was also a consequence of the unfavourable hydrological situation and consequently reduced hydrological potential (slightly more than a quarter of the total electricity production comes from hydropower plants). While the import of all energy products increased compared to the same period in 2021, the largest increase was recorded in the import of crude oil and oil derivatives (EUR 2.1 billion against EUR 901.3 million in the first eight months of 2021).

Balance of payments trends during 2022 were characterized by a deepening of the current account deficit from 4.3% in 2021 to an estimated 9.0% of GDP at the end of 2022, i.e. to EUR 5.4 billion. The current account deficit in the first eight months was EUR 2.8 billion. The growth of the current account deficit was largely contributed by the growth of the deficit in the exchange of goods with foreign countries, primarily due to the growth of domestic demand and the increased import of energy products at significantly higher prices. The goods deficit increased by EUR 2.4 billion, while the services account recorded a surplus that was higher by 27.7% and amounted to EUR 1.1 billion. The positive net export of services in the first eight months is largely the result of the higher export of ICT services, which increased by 49.5% year-on-year and amounted to EUR 1.2 billion, as well as the export of other business services, which was higher by 81.8 % and amounted to EUR 605.8 million. The primary income deficit increased by EUR 488.9 million, or by 42.6%, while the surplus of secondary income was 37.4% higher year-on-year and amounted to EUR 3.7 billion, primarily due to the increased inflow of remittances from abroad (a growth of 60.7%).

The net inflow of FDI in the first eight months of 2022 amounted to EUR 2.5 billion, while the total inflow on the basis of FDI amounted to EUR 2.7 billion, which is approximately the level achieved in the previous year. Such developments confirm that the slowdown in inflows in April and May was temporary and caused by the initial shock after the outbreak of the conflict in Ukraine. Observed according to activities, the largest net inflow of FDI in this period was realized in the manufacturing industry, the sector that traditionally attracts the most FDI, with EUR 904.5 million. At the same time, a high inflow of FDI was realized in construction and trade, in the amount of 554.6 and 253.7 million euros, respectively. In addition to product diversity, FDI is also geographically diversified, with a growing share of countries from the Asia-Pacific region. Observed according to geographical origin, the largest part of FDI comes from the European continent. The total inflow of investments from the European Union in the first six months of the current year amounted to EUR 401 million, or 24.9% of the total inflow of FDI, while the share of Switzerland (10.5%) and United Kingdom (8.9%) is also significant. On the other hand, observed by country, the largest net inflow of foreign direct investment comes from China[1], Germany, Switzerland, United Kingdom and Japan, which make up slightly less than three quarters of the total matured investments. The share of FDI inflows from China has grown significantly over the past six years, from 3.1% in 2015 to 30.4% in the first half of 2022. In 2022, China was the single largest investor, with EUR 489.3 million of investment, which amounts to 32.5% of total realized net FDI in the first half of the year. In the first eight months of 2022, a net inflow of portfolio investments was recorded in the amount of EUR 140.1 million.

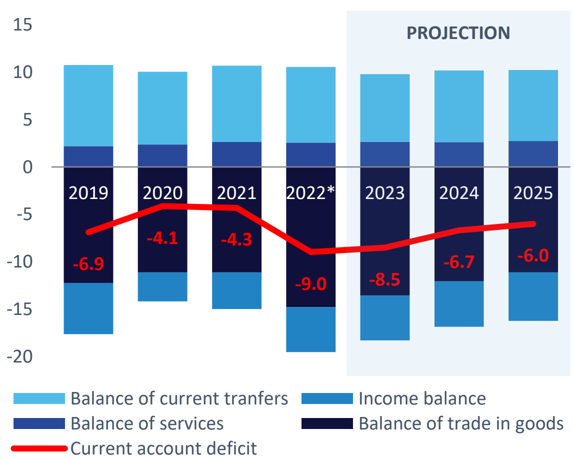
The external position of Serbia in 2022 is characterized by resistance to financial shocks from the international environment. The ratio of foreign exchange reserves and short-term debt at the end of June decreased compared to the end of 2021, due to the simultaneous growth of short-term debt and the reduction of foreign exchange reserves due to the increased demand for foreign exchange necessary for additional energy imports during the first half of the year. On the other hand, the share of external debt in GDP decreased from 68.4% in 2021 to 67.7% at the end of June 2022, with a simultaneous decrease in the share of short-term debt in GDP and the ratio of external debt to exports of goods and services. The share of external debt in the export of goods and services at the end of June 2022 was 116.1%, which is significantly below the World Bank criteria of 220% and is a guarantee of the sustainability of its servicing. Foreign exchange reserves at the end of September of the current year increased by EUR 47.8 million compared to the end of 2021 and amounted to EUR 16.5 billion.

It is expected that the total current account deficit in 2022 will amount to EUR 5.4 billion, i.e. 9.0% of GDP, after which its share in GDP will gradually decrease to the level of 6.0% of GDP in 2025 as a result of the expected positive contribution of net exports and improved terms of trade. The growth of goods exports in euros at an average rate of 11.7% and imports by 9.0% in the projected three-year period

[1] The data refer collectively to the People's Republic of China, Hong Kong and the Chinese Province of Taiwan.

will reduce the foreign trade deficit in goods to 11.1% of GDP in 2025, from this year's 14.8%. The continuation of favourable trends in the services account is predicted, where the surplus in the projected three-year period will amount to an average of EUR 2.0 billion. The inflow based on current transfers will amount to an average of 7.4% of GDP per year, with income from remittances maintaining the role of the dominant component. The net effect of current transfers and net factor payments in the next three-year period will be positive and will amount to around EUR 1.9 billion on average per year, which will significantly alleviate the deficit in the foreign trade balance of goods and services. Such developments, along with the projected dynamics of economic activity, will result in a reduction in the share of the current account deficit of the balance of payments to 6.0% of GDP at the end of the projected period.

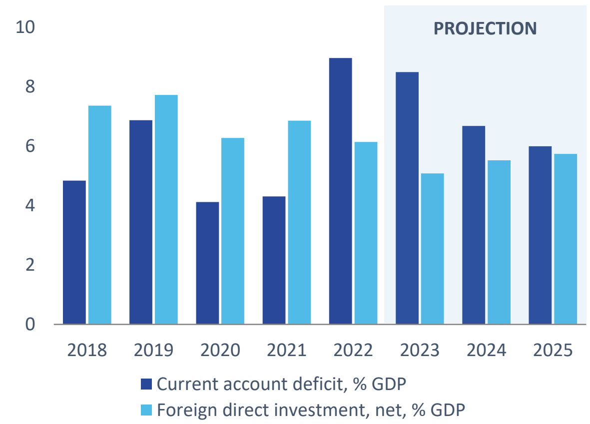
Current account structure, % of GDP



Source: Ministry of Finance, NBS, SORS
* Ministry of Finance estimate.

The structure of the financial account will be dominated by the share of FDI with a participation in GDP of 5.4% on average per year. This inflow will also be the main source of financing the current account deficit. The maintained favourable investment perspective of our country and the expected continuation of the high inflow of FDI, as well as their further diversification towards the tradable goods sector, will contribute to the continuation of export growth and the strengthening of the external and internal macroeconomic balance.

Current account deficit and FDI, % of GDP



Source: NBS and Ministry of Finance

II. FISCAL FRAMEWORK FOR THE PERIOD FROM 2023 TO 2025

1. Medium-Term Goals of Fiscal Policy

The calming of the coronavirus pandemic, high inflation caused by the crisis in the international energy and raw materials markets and the conflict in Ukraine marked the year 2022 in the world, with the danger that uncertainty and crisis will last for a longer period of time. In such a situation, the task of economic and fiscal policy is to ensure the stability of economic flows and preserve the standard of citizens.

During 2022, certain measures have already been initiated in the direction of preventing major shocks that would be caused by the increase in energy and food prices, such as subsidizing the price of gas, temporarily reducing excise duties on oil derivatives and controlling the prices of basic foodstuffs.

The planning of economic and, especially, fiscal policy in the coming period will primarily depend on the estimate of the effects of the Ukrainian crisis on the international environment and domestic circumstances. It is determined that, despite the unfavourable situation, we will balance and stabilize public finances, in order to reduce the share of public debt in GDP and create the basis for stable economic growth. In parallel with that, it is necessary to provide space for a timely reaction of the fiscal policy to economic shocks. Any fiscal intervention of the state in order to minimize the effects of the crisis will certainly be combined with efforts not to stop development programmes and infrastructure projects financed from the budget.

The medium-term fiscal framework envisages a moderate abandonment of the expansive fiscal policy that was present during the pandemic, with the fact that in the coming period, a significant part of the budget funds will be earmarked for alleviating the energy crisis. Considering the uncertain economic situation, the budget will certainly represent a “safety net” in case of escalation of unfavourable trends. On the one hand, the continuity of development and social programmes will be ensured, and on the other hand, the sustainability of public finances and the continuation of the reduction of the level of public debt in terms of participation in GDP. Bearing in mind the expected macroeconomic developments, the predicted annual fiscal deficits enable the reduction of the share of general government debt in GDP in the following period as well.

Fiscal policy will be focused in the coming period, in accordance with the available fiscal space, on the further reduction of the total tax burden on labour, which further relieves the economy, i.e. increases the competitiveness of the private sector. When it comes to expenditure, priority will be given to infrastructure and capital projects, as well as pension and salary policy. In doing so, care will be taken to ensure that the increase in these largest expenditure categories does not go beyond the planned sustainable framework.

The stability of public finances and a sustainable fiscal framework will contribute to the planned changes to the Law on the Budget System, which will, among other things, redesign a set of fiscal rules, general and special, and define special measures and consequences in case of non-compliance. Special emphasis was placed on changing the general rules related to the public debt and deficit of the general government, as well as special rules related to the sustainable level of expenditures for salaries and pensions.

2. Current Fiscal Developments and Prospects for 2022

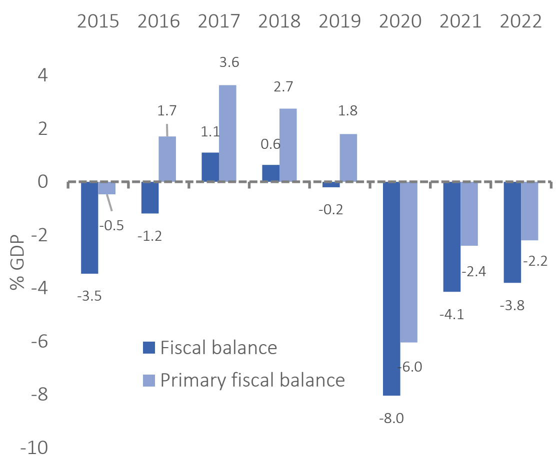
The fiscal framework for 2022 was planned in the circumstances of a gradual exit from the health-economic crisis caused by the coronavirus pandemic. At the end of 2021, good results were achieved in the collection of almost all forms of revenues, which caused significant upward revisions of the projection during the year. Nevertheless, the revenue projection for 2022 was approached cautiously. During 2021, a programme of economic assistance to the citizens and the companies was implemented, and there were also changes in consumer behaviour, and compared to the pre-pandemic period, the cross-border movement of the population was reduced, consumption on the domestic market increased, habits in the use of means of transport changed and the consumption of products where the grey economy is less pronounced increased. The estimated effects of the collection of deferred tax liabilities, as well as the effects of the continuation of the process of reducing the tax burden on wages, were also taken into account. Finally, due to the uncertainty regarding the further course of the COVID-19 pandemic, revenues were conservatively projected so that in the event of negative risks being realized, the downward deviation would be minimal.

The political and economic environment in which the fiscal framework for 2022 was planned has changed significantly. The armed conflict in Ukraine led, among other things, to an increase in uncertainty in business, as well as to the interruption of traditional economic flows, especially in the field of energy supplies. The trend of increasing prices of natural gas, electricity and oil was already present in the second half of 2021, but during 2022 it escalated significantly. Increased uncertainty is also brought in by the irregularity of energy supply, which additionally affects prices. There is a general increase in prices internationally, with monetary authorities deciding to tighten policy and raise general interest rates. In the future, this affects the unfavourable growth prospects of economic activity.

Changes in the international environment affect economic activity and public finances in the Republic of Serbia. The estimate of economic activity growth in 2022 has been revised downwards by 1.5 pp compared to the original plan, and the growth was revised downwards in the medium term. Despite the slowdown in economic activity, there are no pronounced negative tendencies on the labour market, which results in a stable collection of labour taxes. Inflation has immediate effects on the movement of the nominal amount of consumption taxes in terms of their faster growth. At the same time, the growth of revenue collection is also influenced by the much faster growth of the population's income, which is confirmed by the real growth of consumption during the first three quarters of 2022. Budget revenues in 2022 are higher than expected, and the excess revenue was used for the purchase of energy products and curbing price growth with a minimal impact on the standard of living, as well as measures to reduce the excise duty on petroleum products. At the same time, the population policy measures adopted at the beginning of 2022 are operationalized, subsidies in agriculture have been increased as aid paid to certain categories of the population.

The main goal of revised fiscal framework for 2022, is to adapt to the newly emerging negative global economic trends, the world energy crisis unprecedented in the last few decades and the consequent significantly higher price growth. The fiscal deficit of the general government in 2022, according to the latest estimates, will amount to 3.8% of GDP, which is 0.8 pp more than originally planned for the current year. In addition to changes in the amount of the planned result, there are significant changes in the amount and structure of the income and expenditure. It is estimated that the share of public debt in GDP will decrease to 56.9% at the end of 2022. In the coming period, the path of the public debt is expected to be continuously decreasing, due to the planned development of the fiscal result in the medium term.

General government fiscal balance in the period from 2015 to 2022, % of GDP



Source: Ministry of Finance

The pandemic caused by the coronavirus during 2020 and 2021 had extremely negative health, economic and wider social consequences, both globally and in the Republic of Serbia. During these two years, several packages of economic support measures for the companies and the population were implemented to overcome the crisis caused by the pandemic. Measures totalling 15.6% of GDP (planned 17.3% of GDP) were implemented, which significantly mitigated the negative effects of the crisis, a smaller decline in economic activity was recorded compared to other European economies, and turbulence on the labour market was avoided.

At the end of 2021 and the beginning of 2022, the pandemic weakened, and a calmer period was expected that would allow economic, primarily fiscal policy, enough time to return to a sustainable path. However, not all the negative economic consequences caused by the crisis ended with the end of the health crisis. Rapid price surge fuelled by earlier expansionary global monetary and fiscal policy, still damaged supply chains and logistical problems, gradual and then accelerated growth in energy prices are just some of the pressing problems that pose new challenges to economic policymakers. The conflict in Ukraine further intensified existing and brought new challenges, especially in the sphere of energy and food products. Transient inflationary pressures become permanent, while the tightening of monetary policy in the world further complicates the possibilities for financing of growing fiscal deficits. In the near future,it will affect the prospects for the growth of economic activity.

With the adoption of the first Fiscal Strategy during the spring part of the budget cycle, the fiscal framework for 2022 was significantly revised in terms of the amount and structure of revenues and expenditures, while the estimate of the fiscal result in GDP of 3% of GDP was not changed. At that moment, factors that could significantly influence the materialization of negative risks for economic trends in 2022 were emerging. There was a degree of uncertainty regarding the duration and extent of the impact of the emerging crisis on overall fiscal trends, especially on expenditure side. The second revision of fiscal framework for 2022 reflects the overall consequences, but also the responses to the mentioned challenges, and foresees a revised fiscal deficit of 3.8% of GDP. Compared to the originally planned, the revenue estimate has increased by RSD 236.4 billion, while expenditures are higher by RSD 307.4 billion, with significant changes in the structure.

Table 5. Revenues, expenditures and balance of the government sector in 2022, in billion dinars

	budget 2022	estimate April 2022	new estimate 2022	difference new/ budget	% change	2022 new estimate % of GDP
PUBLIC REVENUES	2,804.1	2,901.0	3,040.5	236.4	8.4	42.9
Current revenues	2,778.2	2,875.1	3,018.8	240.6	8.7	42.6
Tax revenues	2,526.7	2,609.4	2,740.5	213.8	8.5	38.7
Personal income tax	274.5	283.4	294.7	20.2	7.4	4.2
Corporate income tax	145.0	145.0	208.5	63.5	43.8	2.9
VAT	684.1	750.7	777.0	92.9	13.6	11.0
Excises	337.6	327.6	336.8	-0.8	-0.2	4.8
Customs	63.3	75.0	79.5	16.2	25.6	1.1
Other tax revenues	96.4	96.2	96.2	-0.2	-0.2	1.4
Contributions	925.8	931.5	947.7	21.9	2.4	13.4
Non-tax revenues	251.5	265.7	278.3	26.8	10.7	3.9
Donations	25.9	25.9	21.7	-4.2	-16.1	0.3
PUBLIC EXPENDITURES	3,004.3	3,107.7	3,311.7	307.4	10.2	46.8
Current expenditures	2,489.9	2,556.8	2,620.8	130.9	5.3	37.0
Expenditures for employees	673.1	674.9	688.4	15.3	2.3	9.7
Purchase of goods and services	511.2	529.9	549.0	37.8	7.4	7.8
Interest repayment	118.6	118.6	115.5	-3.1	-2.6	1.6
Subsidies	165.6	166.9	183.4	17.8	10.7	2.6
Social grants and transfers	914.7	916.1	922.0	7.3	0.8	13.0
of which pensions	645.7	636.1	638.6	-7.1	-1.1	9.0
Other current expenditures	106.7	150.4	162.5	55.8	52.3	2.3
Capital expenditures	485.8	496.8	519.3	33.5	6.9	7.3
Net lending	13.4	38.9	153.4	140.0	1,044.8	2.2
Activated guarantees	15.2	15.2	18.2	3.0	19.7	0.3
Fiscal balance	-200.2	-206.7	-271.2	-71.0		-3.8
Fiscal balance in % of GDP	-3.0	-3.0	-3.8	-0.8		

Source: Ministry of Finance

The most important factors that led to a change in the level and structure of the general government's revenues are:

- base effect (better performance at the end of the previous year) and performance in the period January-September;
- prudent planning of certain categories of tax revenues, primarily value added tax;
- higher consumption of certain excise products;
- collection of unplanned non-tax revenues as well as strong growth of regular non-tax revenues (mineral raw materials and games of chance);
- more favourable trends in the labour market than predicted;
- positive impact of additional population stimulus measures on personal consumption;
- higher inflation growth than predicted, as well as a significant increase in import prices;
- strong nominal growth of foreign trade exchange;
- strong growth in the profitability of the economy in 2021 (corporate income tax);
- adopted measures to mitigate inflationary effects by reducing the excise duty on oil derivatives.

The projected revenue from personal income tax has been increased by RSD 20.2 billion compared to the original amount. The original estimates of the revenue from personal income tax took into account the estimates of average wages and employment, the estimates of the early return of a part of deferred taxes during 2020, as well as the estimates of the effects of reducing the tax burden on wages in 2022. The same assumptions are used for the projection of income from social contributions, which constitute the largest individual income at the level of the general government. The collection of this form of tax at the end of 2021 was somewhat higher than planned, but the main reason for the increase in the wage tax projection is the extremely high growth of wages, primarily in the private sector. The acceleration of wage growth in the private sector began at the end of 2021 and continued throughout 2022. The estimate of deferred taxes and contributions repayment during 2022 was slightly adjusted downwards due to the fact that most of the smaller taxpayers, according to the accelerated dynamics, already settled their obligations on this basis during the previous year. The estimate of revenue from wage tax and social contributions has been revised upward in the total amount of RSD 35.2 billion.

The rest of the personal income tax category consists of other forms such as dividend tax, interest income tax, annual income tax, real estate rental income tax, etc. Revenues from dividends and other forms of income tax usually follow the trend of general economic activity and earnings from the previous year, but they are also significantly influenced by the business decisions of companies regarding dividend and investment policies. The significant increase in the projected amount compared to the original is primarily the result of a strong jump in the collection of the two largest tax forms from this group, namely the annual personal income tax and dividend income tax. Under the effect of the average wages growth and other forms of income in the previous year, as well as the realized profitability and distribution of dividends of companies, there was an increase in tax liabilities on this basis.

The revenues from corporate income tax were relatively the most revised category compared to the original projection (43.8%), and in absolute terms by RSD 63.5 billion. When projecting this tax category, there is uncertainty even under regular circumstances because the final data on profitability are not known at the time of budget preparation. Furthermore, the extremely high collection of this tax form in 2021 led to an increase in the share of this tax form in GDP above the average values recorded in the previous period. Guided by the principle of prudence, during the original projection, it was foreseen to return the share of this tax form in the GDP to the average level. After the payment of the CIT in accordance to the final financial statement for the 2021 (end of June of the current year), the annual estimate of this tax was also revised. The net profit of the economy in 2021, according to the published data of Serbian Business Registers Agency, amounted to RSD 945 billion and is 42% higher than in 2020.

The value added tax is projected at RSD 777 billion, which represents an increase of 92.9 billion compared to the original projection. This significant increase is partly a consequence of conservative planning, due to uncertainty about the trend of personal consumption after a period of strong growth in the previous year, and partly as a consequence of the government's stimulus measures. Another reason for the revision is slightly better execution at the end of 2021 than expected (RSD 5 billion). The most significant reason for the revision of income is the significantly faster nominal growth of private consumption than planned. At the same time, the real component of private consumption growth was also revised upwards. The prices of energy products directly and indirectly affected the rate of inflation (its import component), and to a large extent they spilled over to the market of food products, which make up a significant part of the consumer basket of households. The same applies to oil products whose prices are showing higher growth.

By limiting the prices of certain products, the adverse effects of the increase in import inflation were partially mitigated. The level of disposable income of the population and its faster growth than prices influenced the real growth of trade turnover, which recorded a growth of 7.1% in the first nine months of 2022.

Customs revenues are projected in the amount of RSD 79.5 billion, which represents an increase of RSD 16.2 billion (25.6%) compared to the original projection. These revenues to the greatest extent, although not completely, follow the dynamics of VAT from imports, so in accordance with the change in the structure of VAT, the volume of foreign trade exchange and the movement of customs in the first part of the year, the projection of this form of income was revised. As in the case of VAT, the reasons are the extremely high growth of import prices, but also the procurement of larger quantities of energy due to uncertainty on the global market. During the past part of 2022, foreign trade exchange recorded extremely strong nominal growth, especially in import. In the period January–September, the growth of imports in dinars amounted to 36.8%, of which about three quarters can be attributed to the effect of the increase in import prices.

The projection of excise revenue has been slightly reduced compared to the original projection. At the same time, excise duties on oil derivatives were reduced by RSD 9.2 billion, excise duties on tobacco products were increased by RSD 5 billion, while the projection of revenue from other excise duties was increased by RSD 3.4 billion. In order to prevent an excessive increase in the prices of oil derivatives, the state postponed the regular indexation of excise rates with inflation from the previous year. After that, at the end of the first quarter, the legal possibility of temporarily reducing the excise duty amount was used. In order to limit the growth of derivative prices on the domestic market, due to the rise in oil prices on the world market, this measure was used during the year, ranging from 10% to 20%, which is the legal maximum. In the first quarter, a high level of collection is recorded, partly due to increased demand due to uncertainty of future prices. In the second half of the year, a moderate growth in the consumption of derivatives was recorded, which indicates a lower price elasticity of these products.

The increase in revenues from excise taxes on tobacco is the result of better collection than initially expected during the past part of the year. When creating the original estimate, we assumed a decline trend in consumption that has been present for many years, as well as from the assumption that the market stabilized at the pre-pandemic level in the previous year. Analysing the data on the tobacco products market, it was concluded that reaching previous level of turnover was not achieved in 2021, and that the process of market recovery was carried over to 2022, which was also reflected in the movement of tobacco excise revenue. The projection of revenue from other excise products increased primarily due to the significant growth in electricity consumption, in the commercial supply sector, but also due to the increase in electricity prices with the expected effects in the last quarter of this year. The rest of the increase refers to the payment of arrears due to excise duties on alcohol, collected from bankruptcy proceedings, as well as the continued recovery of the market for these products.

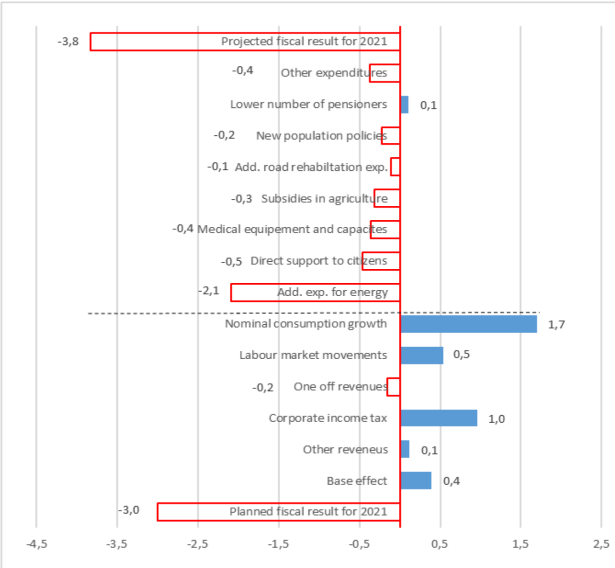
Non-tax revenues increased by RSD 26.8 billion, primarily due to the growth recorded in regular non-tax revenues. These include various taxes, fees, fines, revenues of authorities and organizations and all other revenues that are generated with established dynamics during the year, in approximately similar amounts on a monthly basis with certain seasonal variations.

The first reason for the increase in the projected amount is the better performance at the end of the previous year, while the second reason is the exceptionally good collection during the past part of the year.

Regular non-tax revenues were estimated at a higher amount compared to the original, mostly due to the increase in the collection of revenues from games of chance and fees for the use of mineral resources. The growth of fees for mineral raw materials is the result of higher sales volumes and prices of raw materials on the international market.

Extraordinary non-tax revenues consist of payments of profits of public companies and agencies, budget dividends, revenues from collected claims of the Deposit Insurance Agency, bond issuance premiums, etc. Extraordinary non-tax revenues were adjusted upwards due to the realized payment of revenues that were not included in the original budget plan (NBS profit and budget dividends).

The contribution of individual factors to the fiscal balance adjustment in relation to the 2022 plan, % of GDP



The estimate of general government expenditure in this fiscal framework has increased by RSD 307.4 billion compared to the original plan. The largest part of this increase refers to additional measures for the procurement of energy sources, additional support to the population, and the implementation of new population policy measures. The rest consists of expenditures related to the purchase of goods and services, as well as an increase in capital expenditures.

Expenditures for employees increased by RSD 15.3 billion. The largest part of this increase refers to the higher mass of wages in healthcare (increase in the number of employees and working hours), the judiciary, as well as aid paid to employees in education.

Expenditures for goods and services increased by RSD 37.8 billion. The largest part of the increase refers to the procurement of medicines and medical equipment and funds by the Republic Fund of Health Insurance. The second part of the increase refers to the ongoing maintenance of roads at PE “Roads of Serbia”.

Subsidies were increased compared to the original plan by RSD 17.8 billion, whereby subsidies in agriculture were increased by RSD 10.5 billion, while the rest of the increase refers to subsidies for energy projects.

Expenditures for social protection are higher by RSD 7.3 billion compared to the original plan, but there has been a significant change in their structure. Estimated expenditures for pensions in 2022 will amount to 638.6 billion. Although the original pension indexation plan implied their growth in accordance with the “Swiss formula”, an additional permanent adjustment of pensions by 9% was planned during November.

Within the expenditure intended for social protection, there is also one-time aid paid to pensioners in the amount of about RSD 34 billion. On the other hand, the adopted measures of population policy (increased parental allowance, new subsidies for mothers to buy housing) had an impact on the increase of expenditures within this category. An additional RSD 15 billion are planned for these purposes.

Other current expenditures increased by RSD 55.8 billion compared to the original plan, primarily due to extraordinary payments of direct cash assistance to the population aged 16 to 30, in the total amount of RSD 31 billion.

The intervention procurement of the necessary energy sources influenced the growth of budget expenditures in the amount of RSD 140 billion.

It is estimated that the realization of public investments will be RSD 33.5 billion higher than the original plan. In addition to the increase in expenditures for the construction of the road network, allocations for the strategic stocks of energy sources and other essential goods have also been increased. It is estimated that capital expenditures will reach the level of 7.3% of GDP in 2022.

The estimated fiscal deficit of 3.8% of GDP in 2022 is at the level of the average estimated fiscal result in EU countries. The measures implemented by EU countries to mitigate the energy crisis have significant fiscal implications. The predicted fiscal result enables the implementation of intervention policies aimed at mitigating the crisis, while maintaining the trend of reducing the share of public debt in GDP. Structural analysis of the fiscal result in 2022 identified that around 2.9% of GDP refers to one-time and temporary measures.

Table 6. Revenues, expenditures and balance of the government sector, January–September 2022, in billion dinars

	I–IX 2021	I–IX 2022	I–IX growth rate in %	2022/2021 growth rate in %
PUBLIC REVENUES	1,969.3	2,253.1	14.4	12.1
Current revenues	1,957.4	2,243.3	14.6	12.1
Tax revenues	1,764.5	2,033.6	15.3	13.2
Personal income tax	187.3	219.4	17.2	15.2
Corporate income tax	125.7	166.8	32.7	30.8
VAT	473.9	579.1	22.2	17.9
Excises	243.7	251.2	3.0	2.1
Customs	43.5	57.4	32.0	28.3
Other tax revenues	66.4	72.0	8.4	4.8
Contributions	623.9	687.9	10.2	9.9
Non-tax revenues	192.9	209.7	8.7	2.1
Donations	11.9	9.8	-17.6	12.5
PUBLIC EXPENDITURES	2,037.3	2,204.8	8.2	11.5
Current expenditures	1,755.8	1,874.6	6.8	7.2
Expenditures for employees	466.4	510.4	9.5	9.4
Purchase of goods and services	325.7	360.2	10.6	12.0
Interest repayment	98.1	97.0	-1.1	6.2
Subsidies	142.2	104.2	-26.8	-11.1
Social grants and transfers	633.4	692.8	9.4	8.5
of which pensions	456.7	474.4	3.9	4.9
Other current expenditures	90.0	110.0	22.2	0.8
Capital expenditures	264.5	292.6	10.6	11.3
Net lending	11.6	26.1	125.1	197.9
Activated guarantees*	5.4	11.5	114.5	137.8
Fiscal balance*	-68.0	48.3		

Source: Ministry of Finance

* part of the expenditure on energy is currently shown as part of the financing account, and after the adopted rebalance for 2022, it will be reclassified as an expenditure item.

The state of arrears (over 60 days)* of budget users and mandatory social insurance organizations on the last day of September 2022 amounted to RSD 2.8 billion (about 0.04% of GDP), and it has increased compared to the end of 2021. The users of the budget and PE "Roads of Serbia" created arrears in payment of RSD 1.4 billion, while the balance of arrears of mandatory social insurance organizations is RSD 1.4 billion.

Table 7. The arrears in payments of budget beneficiaries and OOSO, end of 2021 and September 2022, in billion dinars

	31.12.2021.	30.09.2022.
Budget beneficiaries and PE "Roads of Serbia"	1.2	1.4
OOSO	1.3	1.4
TOTAL	2.5	2.8

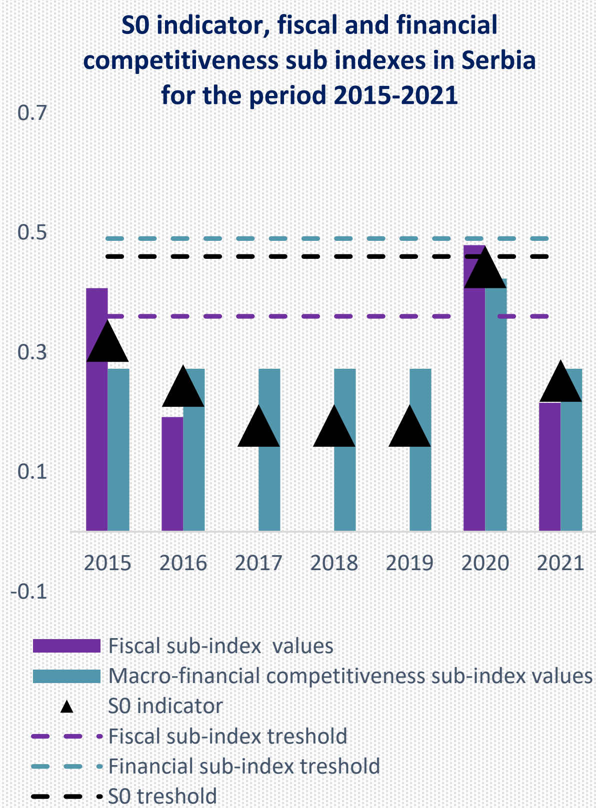
Source: Ministry of Finance

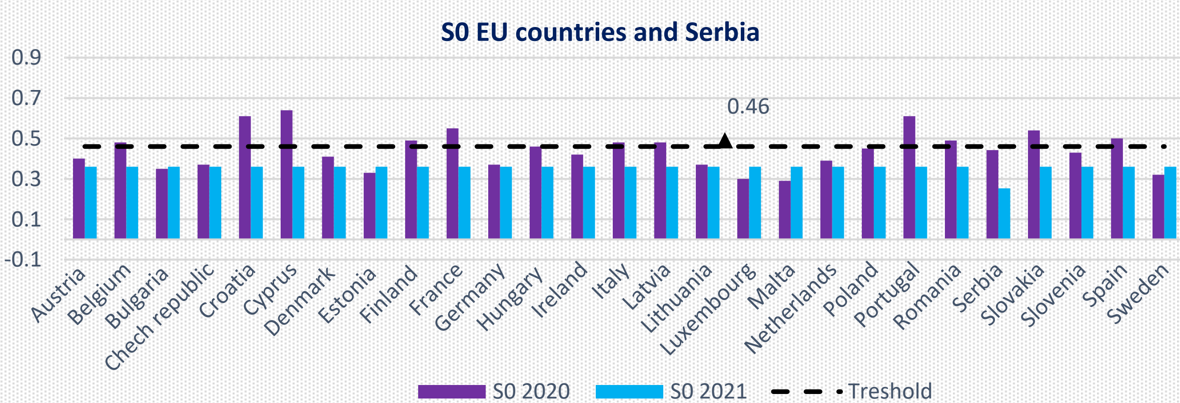
* In accordance with the definition used for monitoring the implementation of the arrangement with the IMF.

S0 Indicator of Short-Term Fiscal Sustainability

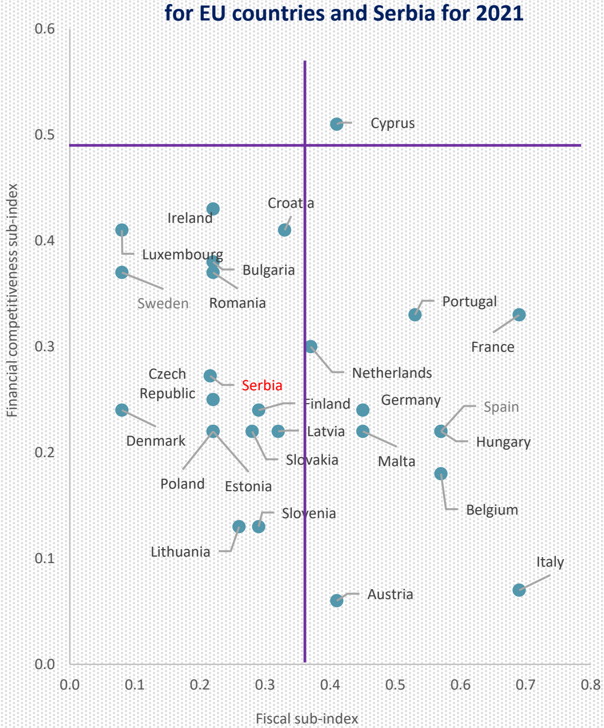
The European Commission has designed a composite indicator S0 for the estimate of short-term fiscal sustainability, which, through the identification of potential short-term risks in the current year, tries to anticipate fiscal stress in the next year. If the value of the S0 indicator exceeds the defined threshold, the country is considered to be at short-term risk of fiscal stress. In addition to the values for the entire indicator, in order to locate the source from which the risk originates, the values of the sub-indices and their components are also considered. The S0 composite indicator consists of two sub-indices, which contain a number of variables of fiscal and macro-financial sustainability. The value of these sub-indices below the defined threshold indicates the absence of short-term fiscal risk.

In 2021, the values of the fiscal (0.22) and financial sub-index (0.27) are within the threshold defined for them, as well as the value of the entire S0 indicator for the Republic of Serbia (0.25), which in principle indicates that there is no danger of macroeconomic instability in the next medium-term period. The successfully preserved macroeconomic and fiscal stability established in the previous period provided space for quick and significant fiscal and monetary policy support measures.





Fiscal and financial competitiveness sub-index for EU countries and Serbia for 2021



The calculation of the S0 indicator for the Republic of Serbia was made by the Ministry of Finance and it is based on the EC methodology.

Based on EC data for EU countries for the year 2021 and the calculations of the Ministry of Finance for the Republic of Serbia, we conclude that most observed countries, as well as Serbia, were not exposed to the short-term risk of realizing fiscal stress, since the value of S0 nowhere exceeds the defined threshold. Minimizing potential risks for the emergence of fiscal stress in the observed countries contributed to the creation of space for the adoption of economic policy measures unprecedented in their scope, and in response to the health crisis that spilled over into all spheres of the economy.

3. Fiscal Projections in the Period 2023–2025

The objectives of fiscal policy are aimed at maintaining fiscal stability and reducing the share of public debt in GDP. The medium-term fiscal framework envisages a gradual reduction of the general government deficit to the level of 1.4% of GDP by 2025 and a decrease in the share of public debt to 54% of GDP. Projections of fiscal aggregates in the period from 2023 to 2025 are based on projections of macroeconomic indicators for the said period, the planned tax policy, which implies further harmonization with EU laws and directives and fiscal and structural measures, including further reform of large public enterprises.

Thanks to fiscal consolidation measures in the previous period, fiscal space was created that enabled rich packages of measures as part of the fight against the effects of the crisis caused by the pandemic during 2020 and 2021. The easing of the pandemic this year led to the creation of fiscal space, which is necessary in the newly emerging unfavourable circumstances. The situation in Ukraine and the international relations that are formed as a reaction to it strongly influence economic trends. In 2022, the measures that should cushion the shocks resulting from this crisis have already begun to be implemented. The reaction of the fiscal policy in the coming period, the created measures and their fiscal implications will be designed so as not to threaten the stability of public finances and the pace of reduction of the public debt, and then to maintain the standard of living of the population and help economic development, but also to ensure the flexibility of the reaction to a possibly stronger impact of the crisis.

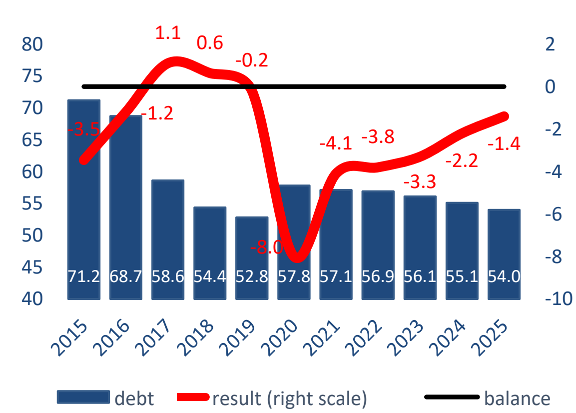
Table 8. Fiscal aggregates in the period 2021–2025, % of GDP

Description	Execution	Estimate	Projection		
	2021	2022	2023	2024	2025
Public revenues	43.3	43.0	40.8	40.3	39.6
Public expenditures	47.4	46.8	44.1	42.5	41.0
Consolidated fiscal result	-4.1	-3.8	-3.3	-2.2	-1.4
Primary consolidated result	-2.4	-2.2	-1.5	-0.1	0.5
General government debt	57.1	56.9	56.1	55.1	54.0
Real GDP growth rate	7.4%	2.5%	2.5%	3.5%	4.0%

Source: Ministry of Finance

The goals of the fiscal policy in the next medium-term period will be to ensure a stable position of public finances and a decreasing path of public debt. The reduction of the debt share is closely related to the reduction of the deficit as the main factor of borrowing, so the dynamics of the reduction of the deficit determines the change in the trend of the debt. The growing costs of borrowing on the international financial market also require caution and restrictive fiscal policy.

Fiscal result and general government debt, % of GDP



The expansionary fiscal policy during 2020 and 2021 reduced the negative economic consequences of the pandemic. In the following medium-term period, a moderate reduction of the deficit of the general government is foreseen in order to ensure the necessary flexibility of the national economy through fiscal policy in order to respond in a timely and efficient manner to possible external shocks. First of all, this refers to expenditure, in the form of an increase in funds intended for energy policy, but still high investment in infrastructure. When it comes to revenue, further reduction of the tax burden on wages and the continuation of the fight against tax evasion and the grey economy will remain the priority.

The revenue projection in the period from 2023 to 2025 was made on the basis of:

- projections of movements of the most important macroeconomic indicators: GDP and its components, inflation, exchange rate, foreign trade exchange, employment and earnings;
- valid and planned tax policy changes;
- estimated effects of fiscal and structural measures in the following period.

Table 9. Total revenues and donations in the period 2021-2025, % of GDP

Description	Execution	Estimate	Projection		
	2021	2022	2023	2024	2025
PUBLIC REVENUES	43.3	43.0	40.9	40.3	39.6
Current revenues	42.9	42.7	40.3	40.0	39.2
Tax revenues	38.6	38.7	36.6	36.4	35.8
Personal income tax	4.1	4.2	4.1	4.0	4.0
Corporate income tax	2.5	2.9	2.6	2.5	2.4
VAT	10.5	11.0	10.8	10.8	10.7
Excises	5.3	4.8	4.1	4.2	4.0
Customs	1.0	1.1	1.1	1.1	1.1
Other tax revenues	1.5	1.4	1.3	1.3	1.2
Contributions	13.7	13.4	12.6	12.5	12.4
Non-tax revenues	4.3	4.0	3.7	3.6	3.4
Donations	0.3	0.3	0.7	0.4	0.4

Source: Ministry of Finance

The declining trend of income in terms of participation in GDP is expected considering the projected structure of medium-term growth of the Serbian economy. The collection of deferred liabilities from 2020 increased the level of income above trend in 2021 and 2022, but it will also amplify the effect of the decline in the share of income in GDP in 2023. The projection of tax revenues implies the maintenance of the current level of collection.

In 2023, it is planned to reduce contributions for pension and disability insurance at the expense of the employer by 1 pp. The effect of this measure is estimated at RSD 30 billion. Additionally, the 12.5% increase in the non-taxable census will have the effect of reducing revenues in the amount of RSD 11 billion.

The prevailing form of income tax is the wage tax, so the movement of the mass of wages and employment are the main factors that influence the movement of this tax form. These revenues were increased in 2022 (as well as in 2021) by the collection of part of the deferred income tax from 2020 as part of the package of measures in the fight against the pandemic. The increase in the minimum wage (14.3%) will have a positive effect on the growth of the total mass of wages in the economy, and therefore on this tax category, and the increase in the tax-free census will reduce income on this basis.

Other forms of income tax (tax on dividends, tax on interest income, annual income tax, etc.) will grow more slowly, i.e. in line with the trend of general economic activity, so a stable level of income based on the total income tax is expected income, in terms of participation in GDP. In the case of wage taxes, the fight against the grey economy is key, given the significant number of unregistered workers and the payment of wages "under the table". In recent years, controls and sanctions have been intensified, which has given results in suppressing the grey economy in the field of work and employment, but it is important to continue with continuous engagement in this field in the coming period.

The movement of the share of contributions in GDP has a similar trajectory as the movement of the share of wage taxes, given that the same assumptions about the movement of wages and employment were used for their projection. Part of the revenue from the collection of deferred contributions from 2020 will not be available in 2023, which, along with the reduction of contributions to pension and disability insurance at the expense of the employer, will contribute to a lower level of these revenues in terms of participation in GDP in the following year.

Revenues from corporate income tax in the period 2023–2025 will depend on the path of economic growth, the relative stability of the dinar exchange rate and the general profitability of the economy. The estimate of income on this basis may be uncertain due to economic factors, as well as the possibility of using a tax credit or refund, as well as differences in accounting and tax balances. The growth in the profitability of the economy in 2021 contributed to a significant upturn in income from profit tax in 2022, considering that the profit tax according to the final calculation is paid in the following year. It is expected that in the period 2023-2025, the collection of profit tax will stabilize in line with the GDP trend.

The main determinant of the VAT movement is domestic demand driven by the disposable income of the population. Disposable income, as the biggest determinant of consumption, depends on the movement of wages in the public sector, pensions, social assistance, the movement of wages in the private sector and other forms of income, including remittances, as well as on the dynamics of banks' lending activities to the population.

As with the personal income tax, the risks for the realization of the VAT projection in the coming period, in addition to the general uncertainty of the international economic environment, also relate to the movement of wages in the private sector, the growth of economic activity, as well as the degree of the grey economy, i.e. the effectiveness in reducing it.

The results of more efficient collection and control of taxpayers were evident in the previous period and it is expected that this trend will continue, with the fact that the effects of the fight against the grey economy are not explicitly included in the medium-term projection of public revenues. The increase in the level of VAT collection in terms of the implementation of independent anti-evasion measures in the area of VAT produced results in the past period. In this segment, room for further improvements will be created by strengthening and modernizing the tax administration.

The excise revenue projection was made on the basis of the current excise policy and the projected consumption of excise products. In 2022, excise taxes were not indexed to the growth of consumer prices in 2021, and excise taxes on oil derivatives were additionally reduced ranging from 10% to 20%. These measures were adopted in order to limit the rise in prices of derivatives on the domestic market, due to the rise in oil prices on the world market. With these assumptions, the estimate of excise revenue for the year 2023 was made. In the following years, due to prudence, no growth in the consumption of oil derivatives is assumed.

As part of the excise policy for tobacco products, further gradual harmonization with EU directives is expected in accordance with the medium-term plan of gradual increase of the excise burden. In the case of cigarettes, it will be directed through a gradual increase in excise duties, in order to reach the EU minimum of EUR 1.8 per pack in the dinar equivalent calculated at the official mid-rate of the NBS within an acceptable time frame. In the following period, for the purposes of projection of excise revenue, due to prudence, a further natural decline of the tobacco product market is predicted, on average of about 3% per year.

Revenues from excise duties on alcoholic beverages, coffee and electricity are projected in accordance with the existing structure of consumption. Harmonization of excise duties on alcoholic beverages in accordance with the EU directive had no significant fiscal effects.

Customs revenues will stabilize at the level of 1.1% of GDP in the coming period. The projection of customs revenue collection was made on the basis of the projected movement of imports, exchange rate and consumption.

Stabilization of the share of other tax revenues in GDP is projected. The most important tax revenue in this category is the property tax, which accounts for about 70%. A nominal increase in this income can be expected based on the expansion of the base. The increase in the level of collection, through the increase in the scope of immovable property on which tax is paid (that is, based on the expansion of the tax base), is not included in the projections in the medium term and represents a positive risk. In addition to property taxes, other tax revenues include taxes on the use, holding and carrying of goods, and other forms of taxes at the local level. They are projected in line with inflation since an inflationary component is built into a significant part of these tax forms.

A decrease in the share of non-tax revenues in GDP is foreseen, from 4.3% of the revenue in 2021 to 3.4%, which is expected to be in 2025. The reason for the reduction of the projected share of non-tax revenues in GDP is the exclusion from the base year of 2022 of all those revenues that are not considered structural, i.e. permanent, and it primarily refers to extraordinary categories of non-tax revenue. Extraordinary non-tax revenues are mostly one-time, to a certain extent uncertain, both regarding the amount and the moment of payment. The largest part of these revenues are extraordinary payments of profits of public companies and agencies, budget dividends, revenues based on collected claims of the Deposit Insurance Agency, emission premiums, etc. Regular non-tax revenues include various fees, charges, fines, revenues of authorities and organizations and all other revenues that are generated with established dynamics during the year. These non-tax revenues are indexed with the realized inflation in the previous year, or they follow the change in the value of the base to which they are applied and are therefore corrected by the projected inflation.

The process of bringing the country closer to EU membership increases the available funds from the IPA and IPARD funds, which make up the predominant part of the income from donations. Funds based on EU sectoral budget support are also included in the projected amounts based on donations. In 2023, exceptionally, an inflow in the amount of RSD 18.4 billion is expected from the EU, based on aid to mitigate the energy crisis. Revenues based on donations are neutral in relation to the result, given that they are equal to expenditures on this basis.

Responsible fiscal policy combined with good macroeconomic performance in the past period ensured the relaxation of the salary and pension policy and a significant increase in capital investments as an essential component of economic development. Special attention is devoted to improving the efficiency of the realization of state capital investments. The social component of the budget was improved by better targeting of social assistance programmes and greater allocation for health and education functions. The method of indexation of pensions was also defined. Salaries and pensions together make up over 40% of expenditures at the level of the general government, and their stabilization is of crucial importance for the sustainability of public finances.

Table 10. Total expenditures in the period 2021–2025, % of GDP

Description	Execution	Estimate	Projection		
	2021	2022	2023	2024	2025
PUBLIC EXPENDITURES	47.4	46.8	44.2	42.5	41.0
Current expenditures	39.0	37.1	35.3	35.2	34.6
Expenditures for employees	10.0	9.7	9.6	9.6	9.6
Purchase of goods and services	7.8	7.8	7.2	6.9	6.7
Interest repayment	1.7	1.6	1.8	2.1	1.9
Subsidies	3.3	2.6	2.7	2.2	2.1
Social grants and transfers	13.6	13.0	13.0	13.2	13.1
of which pensions	*9.7*	*9.0*	*9.6*	*9.9*	*9.9*
Other current expenditures	2.6	2.3	1.4	1.3	1.3
Capital expenditures	7.4	7.3	6.7	6.4	6.1
Net lending	0.8	2.2	1.4	0.7	0.1
Repayment based on guarantees	0.1	0.3	0.3	0.3	0.2

Source: Ministry of Finance

In 2020 and 2021, there was a change in the trend in public expenditure considering the scale of the crisis caused by the pandemic. The measures were significant on the expenditure side, which led to a one-time increase in the share of the expenditure of the budget in GDP.

The increase in expenditures for employees, whose participation in GDP in 2020 was 10.5% of GDP, was influenced by an extraordinary increase in the wages of employees in the health care system, as well as increased payments of other forms of income such as overtime work, awards and an increase in the number of employees in this sector. Given the limited fiscal space in the coming period, wages will increase moderately and in a controlled manner, taking into account their participation in GDP.

Amendments to the Law on the Budget System, as part of the new fiscal rules, will stipulate that the level of total expenditures for employees be harmonized with nominal GDP growth, and not exceed the level of 10% of GDP. The average level of wages at the level of the general government in the EU, before the pandemic, amounted to about 10% of GDP, while during 2020 it was raised to almost 11% of GDP, and in 2021 it amounted to 10.5% of GDP. During 2020, the share of expenditures for employees in GDP increased in Serbia, as in all EU countries.

Expenditures for goods and services will gradually decrease in the medium term in terms of participation in GDP, given that nominal growth is expected to be slower than nominal GDP growth. The high level in 2021 and 2022 is largely the result of higher expenditures in healthcare.

Interest expenses were reduced in the previous period, which is an indicator of a successfully managed fiscal and monetary policy. Good fiscal results in the previous period reduced the need for borrowing, which, along with the easing of monetary policy, led to a drop in interest rates. Bearing in mind the growing cost of borrowing and the need to finance the deficit, it is projected that in the coming period the level of interest expenses will be at the level of around 2% of GDP.

Social grants and transfers to the population represent the largest expenditure category of the general government budget. The largest individual item of this group of expenditures, and at the same time the largest item of all expenditures, are pensions, which in 2020 reached the level of 10.6% of GDP. Since 2020, pensions are adjusted using the “Swiss formula”, in order to simultaneously ensure the growth of pensioners’ living standards and the sustainability of the pension system and the public finance system. The “Swiss formula” implies indexation, i.e. an increase in pensions equal to the sum of half the growth rate of average wages and half the growth rate of consumer prices.

Starting from 2023, a different method of indexation of pensions will be applied, that is, the adjustment of pensions will also take into account the participation of pensions in GDP, in order to additionally protect the living standards of pensioners[2]. Other forms of social benefits and transfers to the population in the coming period will be adjusted by applying the prescribed indexation, current and planned policy changes in this area and with the projected number of beneficiaries. The share of expenditures for social benefits in GDP decreases from 13.6% in 2021 to 13.1% in 2025. In 2022, one-time assistance was paid to all pensioners in the amount of RSD 20,000 each, that is, about RSD 34 billion in total, which was also reflected in the dynamics of the share of social protection expenditures in GDP.

The reduction of subsidies that serve as aid to inefficient segments of the public sector enabled an increase in that part of subsidies that represent real incentives to the economy, primarily agriculture and small and medium-sized enterprises, and that lead to the acceleration of economic activity. The goal is to redirect subsidized funds to development programmes in the economy and agriculture. The high level of subsidies in 2020 and 2021 is the result of the implementation of measures to overcome the problems caused by the pandemic crisis. In 2023, the temporary increase in subsidies in terms of participation in GDP is explained by expenditures intended to overcome the negative effects of rising energy prices, which will be covered by a donation from the European Union.

The categories of other current expenditures consist of various expenditures, such as grants to associations, political parties, religious and sports organizations, fines, compensation for damages, etc. As with subsidies, the one-time increase is caused by the fiscal reaction to the crisis, given that fiscal stimuli were paid to the population from this position, so a reduction of these expenditures in the GDP is expected in the coming period.

During the previous three years, the efficiency of execution of public investments was significantly improved. Capital expenditures increased to 5.3% of GDP in 2020 thanks to the start of a new cycle of infrastructure projects, and in 2021 they reached as much as 7.4% of GDP, despite the problems caused by the pandemic. In the next medium-term period, preservation of the achieved level of investment in public infrastructure is expected. The most significant works are on road, railway, communal and water infrastructure, which are mainly financed by international loans. In addition to transport infrastructure, funds are provided for additional capital investments in health, energy, environmental protection, education, culture, defence and other areas that represent the most important functions of the state. This is all part of the new investment cycle at the national level, which was made possible by the creation of fiscal space and supported by favourable conditions for borrowing on the international financial market in the previous period.

The general determination of fiscal policy in the medium term is to increase investment in infrastructure at all levels of government. When it comes to the local level of government, it primarily refers to investments in water supply and sewerage infrastructure, waste management, local road infrastructure and others. It is expected that the City of Belgrade will begin the metro construction project more seriously next year, with the help of the state.

In the medium-term fiscal framework, until the end of 2025, a balanced overall fiscal position of the local self-government is projected. This means that in total all cities and municipalities have an approximately balanced budget. The projection was made on the basis of trends in the previous period, in which collective local government units were most often in surplus. This situation at the level of all local self-governments is a consequence of debt relief in the previous period. This does not mean that individual local government units cannot run into a deficit,

[2] The method of indexing pensions is explained in more detail in the section Structural measures for improving the stability and sustainability of public finances.

which depends on the fiscal position of each individual municipality and city.

The category of budget loans changes the most compared to previous programmes. The reason is that most of the funds necessary to overcome the negative consequences of the energy crisis are booked here. In 2022, funds in the amount of about 2% of GDP are expected to be disbursed from this category for the aforementioned needs, in 2023, about 1.4% of GDP, and in 2024, 0.7% of GDP of these funds is expected for now.

Repayment on the basis of issued guarantees and payment of guarantees on commercial transactions represent obligations on the basis of the debt of public companies that the state budget took over, considering that these companies could not fulfil them independently. These expenditures represented a great burden on the budget, considering the many years of inefficient operation of a large number of state-owned enterprises and companies. In the previous period, these expenditures were significantly reduced, and the repayment plan predicts that by 2025, these expenditures will fall to the level of 0.2% of GDP.

Comparison with the Previous Programme

The medium-term fiscal framework has been significantly changed compared to the previous document[3] considering the scale of the negative effects brought about by the rise in prices on the international market and the conflict in Ukraine. The funds intended for mitigating these effects have increased the level of expenditures and deficits in the following period to the greatest extent. At the same time, income and expenditure will gradually decrease in terms of participation in GDP, with the fact that, as long as the uncertainties related to the pandemic, the prices of energy, raw materials and food and the conflict in Ukraine, fiscal interventions are possible in order to amortize the negative effects. Planned deficits enable a further reduction in the share of public debt in GDP.

Table 11. Comparison of the fiscal indicators of the two programmes, in % of GDP

	2021	2022	2023	2024	2025
Fiscal strategy 2023–2025					
Revenues	43.3	42.0	41.2	40.7	40.1
Expenditures	47.4	45.0	42.7	41.7	40.6
Balance	-4.1	-3.0	-1.5	-1.0	-0.5
Revised Fiscal Strategy 2023–2025					
Revenues	43.3	43.0	40.8	40.3	39.6
Expenditures	47.4	46.8	44.1	42.5	41.0
Balance	-4.1	-3.8	-3.3	-2.2	-1.4
Difference					
Revenues	0.0	1.0	-0.4	-0.4	-0.5
Expenditures	0.0	1.8	1.4	0.4	0.4
Balance	0.0	-0.8	-1.8	-1.2	-0.9

Source: Ministry of Finance

[3] Fiscal strategy for 2023 with projections for 2024 and 2025.

Structural Measures to Improve the Stability and Sustainability of Public Finances[4]

After the successful conclusion of the arrangement with the IMF at the beginning of last year, the Republic of Serbia concluded a new advisory arrangement with this institution in June 2021. The new cooperation programme - *Policy Coordination Instrument* (PCI) was confirmed on 18 June 2021 and was planned to last until the end of 2023, i.e. 30 months.

The crisis in Ukraine is hitting supply chains hard and creating additional inflationary pressures on the markets for food, energy, raw materials and other goods. The decrease in domestic electricity production increased the need to import energy products at significantly higher prices, along with deteriorating conditions on the financial markets. In such extraordinary circumstances, the Republic of Serbia has decided to request a new arrangement with the IMF, which should be confirmed by the end of this year, for a duration of two years and which will have the character of a precautionary arrangement. The programme aims to: 1) preserve macroeconomic and financial stability by adapting policies to the resulting economic shocks; 2) strengthening the economy's resistance to energy shocks by implementing appropriate energy policies and reforms to face the challenges of the domestic energy sector, while protecting the most vulnerable; 3) providing incentives for faster, green and inclusive sustainable growth in the medium term by implementing comprehensive structural reforms. The goals of the programme are compatible with the aspirations of the Republic of Serbia to join the EU.

In order to ensure the stability and sustainability of public finances in the long term, a functional system of fiscal rules is needed. Fiscal rules were introduced for the first time by the Law on the Budget System in 2010. The Republic of Serbia was one of the first countries to establish national fiscal rules by law and to establish an independent institution, the Fiscal Council, which evaluates the Government's economic and fiscal policy, as well as compliance with the rules. As the rules became valid during the world economic crisis, the numerical rule for debt was violated already in the first year of application. In the meantime, fiscal rules were introduced by more and more countries, in addition to national fiscal rules, EU member states also apply rules defined at the EU and EMU level. European fiscal rules have been changed and redefined on several occasions, taking into account the application and the effects that the application of the rules led to. Bearing in mind that twelve years have passed since the introduction of fiscal rules in the Republic of Serbia, conditions have been created for their change, taking into account the experiences of other countries, the directions in which the fiscal rules of the EU were changed, the consequences and reactions of fiscal policy to the great economic crisis from 2008, but also the experience of the last one, first of all the health but also the economic crisis caused by the coronavirus pandemic, and after that the crisis caused by the conflict in Ukraine.

By the end of the current year, it is expected that the new Law on the Budget System will be adopted, which will define a new set of fiscal rules - a fiscal rule that prescribes the level of the deficit of the general government depending on the level of the public debt of the general government, to be applied from 2025, given that deficit levels prescribed for 2023 and 2024 are at a higher level due to the energy crisis and external factors, and the path of fiscal recovery is determined in accordance with the new arrangement with the IMF and the fiscal rules regulating the level of expenditures for general government salaries and pensions that would enter into force together with the Budget Law for 2023. Deviation from these rules is possible only exceptionally and temporarily, and in cases of natural disasters and external shocks that affect people's health, national security and a significant drop in economic activity.

[4] A more detailed presentation of structural reforms by priority areas is an integral part of the Economic Reforms Programme in the period 2022-2024.

Proposal for a new set of fiscal rules:

General fiscal rules:

- the debt of the government sector, including obligations based on restitution, will not exceed 60% of GDP.
- the target medium-term deficit is 0.5% of GDP.
  If the debt of the government sector is above 60% of GDP, the fiscal position of the government sector must be balanced, so that the deficit is at most 0% of GDP.
  If the debt of the government sector is between 55% and 60% of GDP, the deficit amounts to a maximum of 0.5% of GDP.
  If the debt of the government sector is between 45% and 55% of GDP, the deficit amounts to a maximum of 1.5% of GDP.
  If the debt of the government sector is below 45% of GDP, the deficit will not exceed the amount of 3% of GDP.

Special fiscal rules:

- share of the government sector salaries in GDP up to 10%.
- indexation of pensions depending on their share in GDP.
  If the total expenditure for pensions and the monetary amount as an increase for pension is less than 10% of GDP, the pension will be adjusted according to the change in the average salary without taxes and contributions, in the manner defined by the law governing pension and disability insurance.
  If the total expenditure for pensions and the amount of money as an increase for pension is 10% or more than 10% and less than 10.5% of GDP, the pension will be adjusted to the sum of half of the change in the average salary without taxes and contributions and half of the change in consumer price, in the manner defined by the law governing pension and disability insurance.
  If the total expenditure for pensions and the amount of money as an increase for the pension are equal to or greater than 10.5% of GDP, the pension will be adjusted according to the change in consumer price, in the manner defined by the law governing pension and disability insurance.

In the coming period, the continuation of reforms in the field of employment, personnel management and wage system in the government sector is expected. The goal of the fiscal policy in the medium term is to maintain the expenditure for employees at a sustainable level, with an adequate structure of employees, in order to ensure a higher quality of the services provided. In the next medium-term period, the emphasis will be on structural measures, which through planning the number of employees on the one hand and establishing a new wage system in the government sector on the other hand, would contribute to increasing the efficiency and quality of public services provided.

The existing employment system, which is managed by the Government Commission for granting consent for new employment and additional employment with users of public funds, will continue to function in the transitional period until 2023, that is, until the new system is fully operational. At the end of 2020, amendments to the Law on the Budget System were adopted in order to make it possible for institutions to hire new persons in the transitional period up to the level of 70% of those who leave the institution or retire, while the permission of the Commission is required if the number of new employees exceeds 70%. The purpose of this measure is to ensure greater flexibility in employment at the level of the institutions themselves, in accordance with their needs for new personnel. Also, a limit of 1% was set for the increase of the total number of employees for an indefinite period compared to the level at the end of 2020. The development of the electronic register of employees in the public sector “Iskra”, which should be implemented by the end of 2023, is underway, and the pilot project that includes employees in the Ministry of Finance is already operational. The purpose of this system is better planning, execution and control of expenditures for employee salaries, greater transparency and better management of human resources. The system will cover over 450,000 employees in the public sector, and only employees in the defence, security and internal affairs sectors and institutions of higher education will remain outside the system.

In order to reduce various forms of budgetary support to public and state enterprises, their reforms are continuing. The reduction of budget support to these companies implies: a) limitation of direct and indirect subsidies, b) prohibition of issuing guarantees for liquidity support (except in the case of ensuring uninterrupted supply of energy to the market for PE "Srbijagas" and PE EPS) and c) strengthening of responsibility and transparency in business operations of these companies, including control and reduction of arrears in payments, especially towards PE EPS and PE "Srbijagas" and prevention of their accumulation in the future.

The Government, with the support of the EBRD, adopted the Strategy of State Ownership and Management of Economic Entities Owned by the Republic of Serbia for the period from 2021 to 2027 as a unique act that provides a strategic vision and instructions regarding the goals of ownership management, financial and public goals policy, as well as corporate governance principles and supervisory practices in accordance with international standards and best practices.

For companies that make up strategic companies from the portfolio of the former Privatization Agency, the solution is either through privatization tenders, or through bankruptcy. Companies interested in privatization or strategic partnership will be sought for the transport company "Lasta" JSC Belgrade. With the support of the World Bank, an action plan was defined for PE PEU "Resavica", the implementation of which includes finding a solution for the closure of economically unsustainable mines and a rationalization plan, with the possibility of voluntary departure with provided funds for the social programme and funds for business support in order to avoid accumulation of late payments, especially to PE EPS. For HIP - Petrohemija, the privatization agreement was reached in December 2021 with the company NIS, and the completion of the procedure is planned by the end of this year.

For a certain number of state-owned companies, strategic partners or other models of privatization are sought, i.e. the implementation of pre-pack reorganization plans (UPPR).

Improving the management of public finances is necessary, not only as support for fiscal stabilization measures and structural reforms, but as a process that raises the quality of state administration and ensures an attractive environment for investors. New Public Finance Management Reform Programme for the period 2021-2025 was adopted in June 2021.

The budget execution information system - ISIB, is a part of the public finance management system that includes processes and procedures that are carried out through electronic communication with the Treasury Department within the Ministry of Finance. The development of this system will enable the inclusion of all indirect users of the central level of government. The system includes direct users of public funds, judicial authorities and indirect users of the Ministry of Culture, the Ministry of Labour, Employment, Veterans and Social Policy and the Administration for the Execution of Criminal Sanctions, which were not part of the previous system (FMIS), which was replaced by ISIB at the beginning of 2018. The indirect users of the Ministry of Education are not included in the system, but their inclusion is expected in the coming period. The system is capable of enabling the integration of new users in the future.

The area of public finance management that has received serious attention and is being improved is the management of public investments. By strengthening the public investment management framework, new infrastructure projects are intensified and the quality of the existing infrastructure is raised. In April 2018, the Law on the Planning System of the Republic of Serbia was adopted, which established the national planning framework and defined the Development Plan and the Investment Plan. The public investment management system, which is being developed with the help of the World Bank, includes an integrated database of investment projects, which is currently under development, and an established single list of priority projects (*Single Project Pipeline*). The system will become fully functional at the beginning of 2023 for projects that are in the implementation phase. In the following period, the system will also include projects that are in the phase preceding implementation, and during 2024 and 2025, it will expand its scope to the national level, including local information systems.

Public-Private Partnerships (PPP), as a specific type of cooperation between the government and the private sector, require special attention and caution, therefore the Ministry of Finance will continue to monitor projects of special importance during their implementation and inform the Government about this.

The new Action Plan for the transformation of the Tax Administration for the period 2021-2025 was adopted in May 2021 and it defines strategic guidelines and timelines in which the activities needed for the creatin of the modern tax administration will be implemented, which, with the use of modern electronic processes, will provide a better and more comprehensive service to taxpayers and better control and collection of income, that is, to promote the fight against the grey economy, together with the reform and modernization of inspection supervision. The organizational separation of basic activities from those that are considered secondary was carried out, with the fact that basic activities are now performed in a smaller number of organizational units, that is, their consolidation was carried out. The analysis of business processes and required resources will enable the development of an adequate organizational structure and management, the improvement of project management and the design of an adequate structure of employees. The next phase of reforms is focused on information systems. In May this year, a new fiscalization model (e-fiscalization) was introduced, which will enable real-time control, reduce costs, increase efficiency, and create a better business environment. The system for electronic exchange of invoices is the next step and is expected to be implemented in early 2023. With the adoption of the Law on determining the origin of property and special tax and the creation of a special organizational unit of the Tax Administration, conditions have been created for a cross-analysis of assets and income of persons, and the first audits should begin by the end of the year.

Improving the quality and transparency of national statistics is done through the improvement of comprehensive, timely and automatic data exchange between competent institutions. In April 2018, the list of institutions that make up the general government sector, as well as other sectors, was published in accordance with the European System of Accounts (ESA) 2010 and GFSM 2014, on the basis of which the SORS (in cooperation with the Ministry of Finance and the NBS) started with submitting data to the Enhanced General Data Dissemination System (e-GDDS). These data are published in accordance with the GFSM 2014 methodology. The Sector for Macroeconomic and Fiscal Analysis and Projections of the Ministry of Finance, in cooperation with the IMF, was the first to initiate the process of converting data on public finances from the national methodology to the GFSM 2014 methodology and the preparation of consolidated reports for the level of the general government and by levels of government and their publication via the National Summary Data Page (NSDP), which is available on the SORS website, as well as in the IMF’s Dissemination Standards Bulletin Board (DSBB).

4. Fiscal Risks

Fiscal risks represent the exposure of public finances to certain circumstances that may cause deviations from the projected fiscal framework. There may be deviations in revenues, expenditures, fiscal results, as well as in assets and liabilities of the state, in relation to what was planned and expected. External risks, such as natural disasters or global financial crises, cannot be influenced by the Government, but it is possible to define exit strategies that would mitigate their effects (preserving stability in good days so that in the conditions of a recession or crisis fiscal policy could have room for an adequate response, insurance in case of natural disasters and similar). Internal risks, i.e. their materialization, are the result of activities in the public sector, so that the probability of their realisation may be influenced by decisions and policies of the Government.

The identification of the biggest fiscal risks that can affect state finances in the medium term is the starting point in better fiscal risk management. There are detailed data on certain fiscal risks and it can be easily verified whether and with what probability they will affect fiscal aggregates in the medium term. For others, on the other hand, there are not enough detailed data, but even their identification raises awareness of the possibility that in the coming period they may lead to deviations from the planned fiscal framework.

The Ministry of Finance has a leading role in the management of fiscal risks. As a key institution for medium-term macroeconomic and fiscal planning, budget formulation and management, the Ministry of Finance must also play a leading role in establishing the institutional and legal structure, as well as building the capacities necessary for fiscal risk management. The Department for Fiscal Risk Monitoring, an organizational unit in charge of managing fiscal risks in the Ministry of Finance, was established with the aim of strengthening the legal regulations and methodological framework, building capacity, and developing technical tools and models necessary for monitoring and assessing fiscal risks. It has been intended for the result of these activities to be the identification and assessment of risks and the proposal of exit strategies, as an aid to the Government in preserving the stability of public finances, which is the key objective of the fiscal policy and one of the basic prerequisites for more dynamic economic growth.

In order to implement the aforementioned process of monitoring fiscal risks, in October 2021, a Unified Methodology was adopted, which had been prepared with the help of the World Bank, comprising four basic methodologies, namely: 1) Methodology for monitoring fiscal risks arising from the operations of public companies; 2) Methodology for monitoring fiscal risks to the budget of the Republic of Serbia arising from the exercise of the competence of local self-government units; 3) Methodology for monitoring fiscal risks ensuing from court proceedings; 4) Methodology for monitoring fiscal risks that occur as a result of natural disasters.

During the fall of 2021, disruptions occurred on the energy market in the world. The crisis in the energy sector only built on the already existing crisis caused by the COVID-19 pandemic. Due to the increased demand caused by the post-pandemic economic development and supply problems, i.e. insufficient supply and insufficient inventories, natural gas prices have reached historic highs. This boosted the demand for coal, so its prices rose tremendously. High gas and coal prices, and in Europe reduced production from wind power plants and high prices for CO2 emission permits caused electricity prices to rise, also to historic highs. In such conditions, the production of electricity from coal increased, because it was more favourable than the production from gas.

Until now, it has turned out more than once that the growth of some of the basic energy sources, such as oil and gas, leads to the growth of other prices on the market, and the crisis in Ukraine added to this already difficult situation, so that the question of energy security and European dependence on Russian fossil fuels has emerged as one of the key problems. This sequence of events has caused the prices of electricity and natural gas around the world to reach levels significantly higher than usual in the last few years. The energy crisis inevitably spilled over to Serbia, and energy companies were the most affected, mainly PE “Electric Power Industry of Serbia” and PE “Srbijagas”. Due to the higher prices of electricity, which would threaten the business of economic entities in the RS, as well as energy entities that carry out the activity of transmission, i.e. distribution of electricity (in connection with the procurement of electricity for losses), it has been recommended that PE EPS should supply those entities at prices significantly lower than the market ones, which renders PE EPS exposed to financial risk, i.e. the risk of price increase is completely transferred to PE EPS.

Throughout the year 2022, the Republic of Serbia struggled to secure and ensure the supply of key energy sources, both through financial and strategic measures. In addition, as of September 1, an increase in the price of electricity has been in force, so the effects of such a decision will be visible in the upcoming period. Also, negative economic and hydrological trends influenced the necessity of returning to the production of electricity from coal, and maximum attention was paid to the procurement of this energy source.

As for PE "Srbijagas", the proactive mode of operation provided additional storage capacities for natural gas in Hungary, so that we enter the winter season with more than 650.0 million cubic meters of gas in the warehouse, which is significantly more as compared to the situation in the same quarter of the previous year.

Since, due to unfavourable market trends, the financial position of natural gas distributors has significantly worsened, the Republic of Serbia has financed the procurement of reserved quantities of gas, as well as co-financed regular purchases.

The effects of the energy crisis in the world have not escaped even the PE "Roads of Serbia". This public company has been identified as carrying a high fiscal risk. The fact is that it is not able to cover its high expenses by means of its own income generated primarily from tolls and since the prices of basic energy sources and the main raw materials required to perform the core business activity have a growing trend, this could further worsen the financial position of this public company, and therefore increase its reliance on the budget of the Republic of Serbia for the purpose of further business operation. In addition to the amount of subsidies determined by the 2022 Budget Bill, an additional RSD 12.0 billion has been determined for the Company by the Law on Amendments to the 2022 Budget Bill. The burden on the budget has been reduced when compared to 2021, however, the Company still has high operating costs that it is unable to cover with its own income.

A similar situation was identified at JSC "Corridors of Serbia", due to the high expenditures for capital investments that are the responsibility of this company, and therefore, changes in basic raw materials can significantly increase the costs of implementing projects and increase reliance on the budget of the Republic of Serbia with the aim of continuous project implementation.

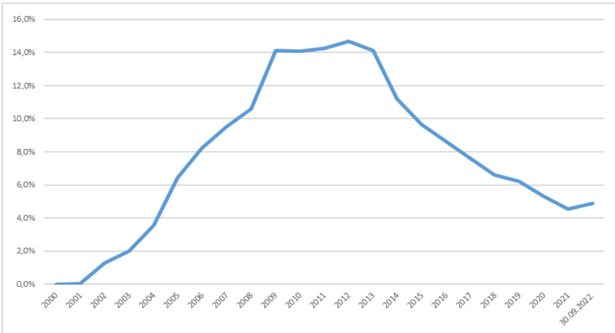
State guarantees

Guarantees issued by the state affect the level of the public debt, but also the level of the deficit, if the repayment of the loan is taken over by the state instead of the original debtor. According to the definition set by the Public Debt Law[5] the issued guarantees are part of indirect obligations and are included in the total amount in the public debt[6]. The restrictions placed on issuing new guarantees have produced results, and the share of indirect obligations in the total public debt is decreasing. Indirect obligations (guarantees issued by the Republic of Serbia) accounted for 4.5% of the total public debt, according to the national methodology, at the end of 2021. The share of these obligations in the public debt is also at approximately the same level in the current year, so that at the end of September 2022 they made up 4.9% of the total public debt. The highest share of these obligations in the public debt, slightly above 14% on average, was recorded between 2009 and 2013.

[5] The Public Debt Law ("Official Gazette of RS", no. 61/05, 107/09, 78/11, 68/15, 95/18, 91/19 and 149/20).

[6] The definition of debt, according to the Maastricht criteria, among other things, treats issued guarantees differently, compared to the definition of public debt pursuant to domestic legislation. According to the Maastricht criteria, only activated guarantees are included in the public debt (General government debt). Domestic legislation has a more conservative approach in this matter and includes all issued guarantees in the public debt.

The share of indirect liabilities in the overall public debt of the Republic of Serbia (in %)



At the end of 2021, the balance of debt based on issued guarantees amounted to EUR 1.4 billion, i.e. 2.6% of GDP. The balance of debt on this basis was reduced by nearly EUR 41 million as compared to the end of 2020. By September of the current year, the balance of debt under guarantees increased by EUR 224.8 million, compared to the end of 2021, and amounted to EUR 1.6 billion as of September 30, 2022.

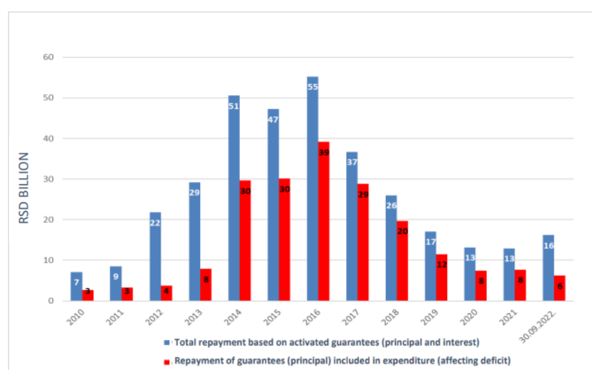
Table 12. Debt balance based on guarantees issued, in millions of euros

Beneficiary	30.09.2022
PE “Srbijagas”	482.5
PE “Roads of Serbia”	225.8
JSC “Serbian Railways”	117.1
JSC “Serbian Railways Infrastructure”	58.1
JSC “Srbija Voz”	93.2
JSC “Serbia Cargo”	31.4
PE “Electric Power Industry of Serbia”	373.5
JSC “Elektromreža Srbije”	35.5
Local self-government units (cities and municipalities)	169.0
PE “Jugoimport-SDPR”	9.7
Serbia and Montenegro Air Traffic Services SMATSA LLC	0.0
JSC “JAT Tehnika”	1.6
PE “Transmitters and Communications”	4.5
PE “Ski resorts of Serbia”	24.5
JSC “Elektrodistribucija Srbije”	0.4
TOTAL	**1,607.0**

Source: Ministry of Finance, Public Debt Administration

The total repayment of principal on the basis of guaranteed loans in 2021 was RSD 11.3 billion, of which RSD 7.7 billion affect the deficit. Until 2014, the accounting methodology did not include in expenditures repayments on the basis of guarantees[7]. Since 2014, a part of these expenditures has been included in the budgetary expenditures[8]. Regardless of the budgetary and accounting presentation, the debt paid by the state instead of the main debtor increases the overall need for borrowing.

Debt repayment based on activated guarantees, billion dinars



[7] Repayment based on guarantees from the republic budget is included in the expenditures on a cash basis. International standards, which are based on an accrual basis, include in expenses the entire amount of the remaining debt at the moment of activation of the guarantee, while the repayment of the debt itself is treated as a financial transaction.

[8] Part of the expenditure based on the repayment of guarantees for PE “Roads of Serbia” is not included in the budget expenditure, because this company is part of the general government sector, so the expenditure financed by guaranteed loans was part of the general government expenditure at the time of spending the funds, while the repayment itself is treated as a financial transaction (“below the line”).

Table 13. Total paid obligations based on guarantees per beneficiary, billion dinars

Beneficiary	2021			2022 (until 30 September)		
	Principal	Interest	Total	Principal	Interest	Total
JSC “Serbian Railways” Belgrade	3.25	0.36	3.62	5.11	0.28	5.38
JSC for the national railway infrastructure asset management “Serbian Railway Infrastructure”, Belgrade	1.45	0.04	1.49	1.47	0.03	1.50
JSC for passenger rail transport “Srbija Voz”Belgrade	0.32	0.03	0.35	0.22	0.04	0.26
JSC for Freight Railway Transport ”Serbia Cargo” Belgrade	1.23	0.03	1.26	0.62	0.01	0.63
PE “Ski resorts of Serbia”Belgrade	0.00	0.05	0.05	0.32	0.09	0.41
PE “Transmitters and Communications”	0.26	0.01	0.27	0.13	0.00	0.13
PE “Roads of Serbia”	3.61	1.13	4.74	3.49	1.00	4.49
PE “Srbijagas”	1.13	0.02	1.15	3.64	0.14	3.78
TOTAL	**11.3**	**1.7**	**12.9**	**15.0**	**1.6**	**16.2**

Source: Ministry of Finance, Public Debt Administration

The repayment plan based on guarantees (total principal and interest) in the rebalancing of the budget of the Republic of Serbia for 2022 amounts to RSD 24 billion, of which RSD 18.2 billion for the repayment of the principal under guarantees are included in the expenses that affect the result.

Indirect debt and the inclusion of part of repayments based on guarantees in budget expenditures as well as the increase in the deficit on that basis, increased awareness of the growing fiscal risks arising from the issued guarantees. Therefore, activities were undertaken that limit the issuance of new guarantees. Amendments to the Law on Public Debt prohibited the issuance of new loan guarantees for liquidity purposes. Amendments to the Law on the Development Fund of the Republic of Serbia made it impossible to further provide counter-guarantees for guarantees issued by the Development Fund of the Republic of Serbia.

In addition to restrictions on the issuance of government guarantees, a key step in reducing and eliminating fiscal risks on these grounds is the reform of state-owned and public companies, beneficiaries of guarantees, in order to be able to repay their loans. A large number of companies, which are also the biggest users of guarantees, are in the process of restructuring, i.e. implementing restructuring plans made in cooperation with international financial institutions.

With the rebalancing of the budget of the Republic of Serbia for 2022, issuing of guarantees of up to RSD 143.1 billion has been planned for loans intended for realisation of infrastructure projects.

Table 14. Plan for the issuance of guarantees in 2022

Ordinal number		Amount in dinars	Original currency	Amount in original currency
I.	**To European Bank for Reconstruction and Development**			
1.	“Srbija Voz” joint-stock company for railway passenger transport, Belgrade - Reconstruction and modernization of regional depots	2,937,500,000	EUR	25,000,000
2.	Joint-stock company for Freight Railway Transport “Serbia Cargo” Belgrade - Procurement and reconstruction of rolling stock	5,052,500,000	EUR	43,000,000
3.	JSC Electricity Distribution of Serbia Belgrade - Smart power meters project	4,700,000,000	EUR	40,000,000
	Total:	**12,690,000,000**	**EUR**	**108,000,000**

Ordinal number		Amount in dinars	Original currency	Amount in original currency
II.	**To German Development Bank (KfW)**			
1.	JSC “Elektromreža Srbije” - Trans-Balkan Corridor, Section 4 - 2x400 kV DV Bajina Bašta (RS) - Pljevlja (ME) - Višegrad (B&H)	3,525,000,000	EUR	30,000,000
	Total:	**3,525,000,000**	**EUR**	**30,000,000**
III.	**To Domestic and foreign commercial banks**			
1.	PE “Srbijagas”- Improving gas pipeline transport capacity in the Republic of Serbia	21,150,000,000	EUR	180,000,000
2.	PE “Electric Power Industry of Serbia” - Buk Bijela hydroelectric power plant construction project in the Republic of Srpska through capital investment	29,375,000,000	EUR	250,000,000
3.	JSC “Electricity Distribution of Serbia” Belgrade - Medium voltage distribution network automation project	11,415,328,040	EUR	97,151,728
4.	Joint-stock company for Freight Railway Transport “Serbia Cargo” Belgrade - Vehicle renewal program	1,762,500,000	EUR	15,000,000
5.	PE “Electric Power Industry of Serbia” - desulphurization of flue gases and construction of wastewater treatment plant at TE Kostolac A	14,100,000,000	EUR	120,000,000
	Total:	**77,802,828,040**	**EUR**	**662,151,728**
IV.	**To Russian Federation (State Development Corporation “VEB.RF”)**			
1.	PE “Electric Power Industry of Serbia” - Revitalization of the hydroelectric power plant “Đerdap 2”	19,975,000,000	EUR	170,000,000
2	PE “Electric Power Industry of Serbia” - Revitalization of blocks TENT A1 and A2	24,440,000,000	EUR	208,000,000
	Total:	**44,415,000,000**	**EUR**	**378,000,000**
V.	**To European Investment Bank**			
1.	JSC “Electricity Distribution of Serbia” Belgrade - Smart power meters project	4,700,000,000	EUR	40,000,000
	Total:	**4,700,000,000**	**EUR**	**40,000,000**
	TOTAL:	**143,132,828,040**	**EUR**	**1,218,151,728**

Source: Ministry of Finance

No significant growth in this category of expenditure is planned in the coming years. The share of these expenditures in GDP is on average around 0.3% of GDP in the medium term.

Structural reforms of public and state-owned enterprises, their coaching in market competition and financial sustainability on the one hand and limited and targeted issuance of new guarantees on the other, will contribute to reducing fiscal risks on this basis and maintaining expenditures in the planned, i.e. projected frameworks in the next medium-term period.

Public enterprises

The operation of public enterprises represents a significant source of fiscal risks, both in terms of budget revenues and expenditures. Public enterprises are faced with numerous problems in their business operations, from the collection of receivables to the regular settlement of obligations to creditors, the state and employees, etc. The state as the founder and their sole owner is responsible for their operation and is their last resort in case of insolvency. There are several channels through which fiscal risks related to the operations of public enterprises can be materialized. The biggest, but not the only risk are the government guarantees given for loans to public enterprises. Sustainability, efficiency and profitability of public enterprises affect budget revenues, that is, the amount of profit they pay into the budget. The quality of products and services provided by public companies affects the efficiency and profitability of the private sector and, ultimately, the level of taxes they pay into the budget.

Public enterprises represent a significant segment of the Serbian economy, employing around 68,000 people. Public enterprises are established as companies to perform activities of general interest. Their work is regulated by the Law on Public Enterprises, which was adopted in February 2016, as well as sub-sectoral laws that define specific areas that are not covered by the Law on Public Enterprises (Law on Energy, Law on Business Companies, etc.).

Key financial indicators of public enterprises business operation

Business results of public enterprises in 2021

The total assets of the republic's public enterprises at the end of 2021 amounted to RSD 3,217 billion, while the net loss in the amount of RSD 12.7 billion was realised as the final result.

Table 15. Main financial performance indicators of public enterprises, in RSD billion

Description	2020	2021
Total assets	2,654	3,217
Equity	1,033	1,140
Total revenues	536.4	776
Net result	15.2	-12.7
Subsidies	66.7	67.3
Subsidies, without PE “Roads of Serbia”	39.8	38.1

Source: Financial statements for 2020 and 2021

In 2021, subsidies, expressed as a percentage of total revenues, were at a lower level as compared to the previous year and made up 8.7% of the total revenues of public enterprises. Certain subsidies have a capital character, such as subsidies for PE “Roads of Serbia”, which are intended for the reconstruction of road infrastructure.

Business results of public enterprises in the first half of 2022

The total net result established in the first half of 2022 is a loss in the amount of RSD 42.9 billion. The result of the current year is overestimated for the amortization costs of PE “Roads of Serbia”, because the company only records these costs at the end of the year in the entire amount for the given year.

Table 16. Key indicators of business performance of public enterprises as of June 30, 2022, in RSD billion

Business performance indicators	2020	2021	01.01–30.06.2022
Operating income	504.5	739.7	447.2
Operating expenses	468.2	740.6	472.7
Business result	36.1	-1.0	-25.5
Net profit	15.2	-12.7	-42.9
Costs of salaries*	110.8	115.0	58.6
Number of PEs which made profit	25	26	24

* Costs of salaries, fringe benefits and other personal expenses

Source: Financial statements for 2020 and 2021 and quarterly reports of the Ministry of Economy for 2022.

In the first half of the current year, 24 companies made a profit in the total amount of RSD 10.4 billion, which is less than planned (the planned value is RSD 19.5 billion). JSC “Elektromreza Srbije” had the greatest influence on the positive net result in the observed period, which achieved a net profit in the amount of RSD 3.8 billion.

Table 17. Public enterprises that achieved a net profit in the period 01.01–30.06.2022 in thousands of dinars

Enterprise	Realisation 2021	Plan 01.01–30.06.2022	Realisation 01.01–30.06.2022
PE “Srbijagas”	3,772,985	6,916,626	1,923,264
PE “Mreža-Most”	7,495	0	4,450
PE “Djerdap National Park”	14,116	4,679	27,854
PE “Ski resorts of Serbia”	244,263	522,273	884,488
PE “Stara planina” Knjaževac	3,776	1,209	1,364
JSC “Metohija”	554	5,500	1,926
JSC “Corridors of Serbia”	0	0	207,977
JSC Transnafta	179,593	13,783	107,656
PE “Post of Serbia”	3,283,600	4,185,374	971,002
JSC “Prosvetni pregled”	19,630	18,308	21,644
PE “Official Gazette”	6,625	49,097	88,705
PE “National Park Fruška Gora”	1,884	5,789	8,009
JSC “Dipos”	132,047	59,321	154,635
JSC “Elektromreža Srbije”	2,320,668	1,475,460	3,803,554
PE “Kopaonik National Park”	20,193	39,687	49,059
JSC “State Lottery of Serbia”	140,574	29,974	197,262
PE “Tara National Park”	9,726	1,460	1,410
PE “Nuclear Facilities of Serbia” VINČA	49,723	630	1,455
JSC “Serbian Railways”	-3,318,393	-116,608	70,032
JSC Nature Park “Mokra Gora”	368	10,800	7,179
PE “Roads of Serbia”	-4,992,801	6,231,622	1,200,940
JSC “Park Palić”	275	0*	4,647
PE “Srbijašume”	871,135	75,857	618,112
JSC “Golubac Fortress”	-2,321	-5,000	5,575
Total	**2,765,715**	**19,525,841**	**10,362,199**

Source: Quarterly reports of the Ministry of Economy for 2022

* The business program was not adopted, therefore there is no planned value

In the first half of the current year, 12 companies realized a net loss in the total amount of RSD 53.3 billion, which is better than the planned negative value of RSD 60.7 billion.

Table 18. Public enterprises which realized a net loss in the period 01.01–30.06.2022, in thousands of dinars

Enterprise	Realisation 2021	Plan 01.01–30.06.2022	Realisation 01.01–30.06.2022
JSC “Uvac Reserve”	2,586	2,616	-183
PE “Electric Power Industry of Serbia”	-14,948,733	-53,695,896	-49,158,919
JSC “Serbian Railway Infrastructure”	-3,457,372	-2,442,269	-1,468,395
JSC “Serbia Cargo”	-162,364	-468,239	-482,372
PE Underground Coal Exploitation, Resavica	2,618,614	-1,171,595	-928,999
JSC “Srbija Voz”	200,830	-937,043	-200,903
PE “Institute for textbooks”	-242,827	-152,315	-151,965
PE “Jugoimport-SDPR”	748,333	-530,389	-561,270
PE Skloništa	-192,347	-41,419	-54,841
PWMC “Srbijavode”	45,539	-67,572	-36,623
PE “Transmitters and communications”	-115,987	-112,681	-31,386
JSC Elektrodistribucija Srbije	33,864	-1,038,542	-174,787
Total	**-15,469,864**	**-60,655,344**	**-53,250,643**

Source: Quarterly reports of the Ministry of Economy for 2022

In order to reduce the fiscal risks associated with the operations of public enterprises, restructuring processes of the largest public enterprises are underway (groups of companies dealing with railway traffic - JSC “Serbian Railways”, JSC “Serbian Railway Infrastructure”, JSC “Srbija Voz”, JSC “Serbia Cargo”, PE EPS and PE “Srbijagas”). The entire process is carried out in cooperation with the world's leading financial institutions - the IMF, the World Bank and the European Bank for Reconstruction and Development (hereinafter: EBRD), in order to provide a sound basis for these companies so that they would start functioning as per the market principle thus reducing potential fiscal costs that may arise from their operations.

Payment of profits

Payment of profit by public enterprises and dividends of corporations in which the state holds ownership constitute an important part of non-tax revenues. The amount of budget revenues on this basis depends on the business results of these enterprises. The payment of regular profits and dividends is a regular budgetary non-tax income, while payments from undistributed profits are treated as income with a one-time character and do not represent a permanent source of income.

Companies founded by the Republic of Serbia or in which the Republic of Serbia has an ownership interest are obliged to pay at least 50% of the proportional part of their profit according to the final account for 2020 to the budget of the Republic of Serbia by November 30 of the current budget year at the latest, which, pursuant to the law governing commercial companies, belongs to the Republic of Serbia as a member of the company.

Exceptionally, with the consent of the Government, an entity that makes a decision to cover a loss or increase capital or use funds to finance investments does not have an obligation based on the payment of profit.

During 2021, on this basis, RSD 7.9 billion were paid into the budget of the Republic.

Mitigation of potential risks, which arise as a consequence of the operations of public enterprises, includes a number of measures related to responsibility, profitability and transparency in the operations of these companies. Restructuring processes have been initiated in PE EPS, PE “Srbijagas” and JSC “Serbian Railways”, where the efficiency of operations in the future will depend on the success of the restructuring process itself and the speed of implementation of the adopted measures..

State-owned Financial Institutions, Banking System and Deposit Insurance

Before the period of fiscal consolidation, the Republic of Serbia had significant fiscal costs in rescuing state-owned banks. The total costs of government interventions in the banking sector in the period 2012–2015 amounted to around EUR 900 million. This is the amount set aside for the recapitalisation of banks, various financial transactions during the merger of unsuccessful banks with more successful ones, including the payment of insured and uninsured deposits (for which funds from the Deposit Insurance Fund were also used).

Today, the Republic of Serbia has a direct stake in the country's banking sector:

- in JSC Postal Savings Bank Belgrade (72.64%),
- JSC Srpska banka Belgrade (76.69%).

In order to consistently implement the exit strategy and reduce fiscal risks on this basis, the reform activities in the area of state financial institutions that began in 2012 and 2015 respectively, are being continued.

Postal Savings Bank. With the support of the World Bank, the implementation of the strategy for Postal Savings Bank will continue with an emphasis on redirecting to retail banking, activities with entrepreneurs, micro-enterprises, small and medium-sized enterprises; improvement of the bank's internal organization, corporate governance and risk management; strengthening the IT infrastructure, as well as the business plan for the period 2021-2025.

In order to facilitate the mitigation of the economic and financial consequences resulting from the pandemic of the disease COVID-19 caused by the virus SARS-CoV-2, the Bank acts in accordance with the Law on the establishment of guarantee scheme as a measure of support to the economy for mitigating the consequences of the SARS-CoV-2 COVID-19 pandemic, by the virus SARS -CoV-2 (“Official Gazette of RS”, no. 153/20 and 40/21) and the Law on establishing another guarantee scheme as a measure of additional support to the economy due to the prolonged negative impact of the pandemic of the disease COVID-19 caused by the SARS-CoV-2 virus (“Official Gazette of the RS”, no. 40/21 and 129/21).

Srpska banka. In accordance with the Government's strategy for state-owned banks, the Expert Working Group for the transformation of the Srpska banka into a specialized financial institution for the provision of all types of financial services and support to the arms industry of the Republic of Serbia was formed on January 21, 2019 and began its formal work in March 2019 when the constituent session was held. Due to the continuation of the COVID-19 pandemic caused by the SARS-CoV-2 virus, as well as the crisis caused by the war in Ukraine and ongoing activities within the Ministry of Finance during the crisis, it is expected that the activities aimed at the transformation of the Srpska banka will continue during 2023.

The reform of the regulations governing the Serbian financial system[9] was carried out in February 2015. One of the features of that reform is the transfer of the responsibility for monitoring the results of operations and the work of management bodies in banks, insurance companies and other financial institutions whose shareholder is the Republic of Serbia, as well as organizing and implementing the procedure for the sale of shares in them, from the DIA to the Ministry of Finance, starting from April 1, 2015. With the regulation reform, the *Bank Recovery and Resolution Directive* (BRRD) was also transposed into domestic legislation and the function of bank restructuring was entrusted to the NBS. In December 2016, a set of regulations was adopted implementing Basel III standards into the domestic regulatory framework, which achieved a significant degree of compliance of domestic regulations with relevant EU regulations in this area, whereas during 2017, activities were continued to improve domestic regulations that govern the operations of banks, with the aim of further harmonising them with EU regulations. The main goals of adopting these regulations are to increase the resilience of the banking sector by increasing the quality of capital and introducing protective layers of capital, better monitoring and control of the bank's exposure to liquidity risk, further strengthening of market discipline and transparency of bank operations in the Republic of Serbia by publishing all relevant information on bank operations, as well as adapting the reporting system to new regulatory solutions.

One of the limiting factors for the growth of lending activity was the relatively high level of non-performing loans. In August 2015, the NPL Resolution Strategy was adopted, which was carried out through the implementation of two three-year action plans, one prepared by the Government and the other prepared by the NBS, with the aim of lowering the level of non-performance loans. The key areas of implementation included strengthening the capacity of banks to resolve non-performing loans, improvement of regulations for assessing the value of collateral, development of the market for non-performing loans, etc.

On the initiative of the National Bank of Serbia, in 2014, a new Law on Insurance was adopted, on the basis of which a regulatory reform was carried out in the insurance sector in 2014 and 2015, which is the second most important segment on the domestic financial market. The regulatory reform created prerequisites for further development of the insurance market through the implementation of modern standards adapted to the needs of the domestic market. The new regulatory framework enabled, among other things, positive results that are reflected in the growth of the total insurance premium on the market of the Republic of Serbia and the further development of the financial market. Likewise, the reform of regulations in this area has made it possible to introduce higher quality services of insurance companies and better protection of citizens and business entities that use these services. In the course of 2021, amendments to the Law on Insurance were adopted, which regulated the change of ownership rights on the social capital in insurance

[9] The National Assembly adopted amendments to the Law on the National Bank of Serbia and the Law on Banks, as well as the new Law on Deposit Insurance Agency, the Law on Deposit Insurance, the Law on Bankruptcy and Liquidation of Banks and Insurance CompaniesWith the amendment of the set of financial laws, the adoption of the amendment to the Law on Ministries was also imposed.

companies. The existing regulations governing the insurance activity in the Republic of Serbia have created preconditions for further convergence of the insurance sector in the Republic of Serbia to the level of development of that sector in the EU. Significant changes in the regulatory framework in the field of supervision of insurance activities are still expected with the full harmonization of regulations with the Directive (EU) 2016/97 — the *Insurance Distribution Directive* - IDD) and applying Solvency II (*Directive 2009/138/EC of the European Parliament and of the Council on taking-up and pursuit of the business of Insurance and Reinsurance*).

Since the adoption of the aforementioned strategy, a large number of regulations and by-laws have been adopted and amended, institutional capacity has been improved, and numerous measures have been implemented to facilitate the write-off and transfer of irrecoverable receivables, namely: with the adoption of the Law on Amendments and Supplements to the Law on Mortgage (2015), the solutions of which enabled the reaffirmation of the out-of-court settlement procedure based on the value obtained from the sale of mortgaged immovable property, but also led to a higher degree of legal and economic security for participants in transactions that involve the establishment of a mortgage, as a means of securing receivables; through the adoption of the Law on Real Estate Value Appraisers (beginning of implementation - June 2017) which, among other things, introduced a new profession - licensed real estate appraisers and prescribed a mandatory appraisal that is carried out in cases related to the Mortgage Law and the Law on bankruptcy, as well as when making assessments for the needs of credit operations that are secured by a mortgage; formation of the Expert Board (a professional body that should contribute to the organization and improvement of the real estate appraiser profession) and the adoption of the National Standards, Code of Ethics and Rules of Professional Conduct of the Licensed Appraiser (in July 2017) which, among other things, define the basics of real estate valuation, the appraisal procedure, assumptions and important facts that must be taken into account when preparing the appraisal report, the minimum content of the valuation report and the rules of professional conduct of the licensed appraiser; adoption of amendments to the Law on Corporate Profit Tax and the Law on Personal Income Tax, which enabled a more relaxed tax policy for the approval and write-off of bank receivables (end of 2017); adoption of amendments to the Bankruptcy Law, which shortened the bankruptcy procedure and improved the position of secured creditors (December 2017); the preparation of a study on the possibilities of introducing bankruptcy of private individuals and entrepreneurs in the Republic of Serbia, the Law on Amendments to the Law on Civil Procedure was adopted and other. Based on the Law on Real Estate Value Appraisers and the Decision on the content, deadlines and method of submitting reports on real estate value appraisals that are the subject of mortgages and loans secured by mortgages, the NBS has maintained a database on real estate value appraisals that are the subject of mortgages since 2015. In accordance with the aforementioned law and decision, banks and licensed appraisers can gain insight into certain data on real estate valuations that are the subject of a mortgage. At the end of 2018, the NBS adopted a set of by-laws reacting proactively to the increasingly frequent non-purpose loans offered to the general public with unreasonably long maturity dates. These regulations aim to contribute to the prevention of non-performing loans in the banking sector and to encourage cautious risk-taking by banks by directing them to sustainable lending and avoiding excessive exposure to certain types of credit products, without disrupting the trend of growth in credit activity and taking into account the rights and interests of users of services provided by banks, all for the sake of preserving and strengthening financial stability in the Republic of Serbia.

On December 27, 2018, the Government adopted the Programme to Resolve Non-performing Loans for the period 2018-2020 (hereinafter: Programme) together with the Action Plan for the implementation of that programme, which successfully fulfilled the reform goal within the cooperation program with the IMF and set the path for further successful work on resolving the issue of non-performing loans.

The main focus of the mentioned public policy document is the resolution of non-performing loans held by insolvent banks and loans in the name and on behalf of the Republic of Serbia, which are managed by DIA. Accordingly, strategic and annual operational plans for DIA, Resolution of the portfolio of non-performing loans were adopted, and internal capacities for their resolution were developed. In June 2019, DIA successfully completed the sale of the first, "pilot portfolio", with a nominal value of approximately EUR 242 million, while on September 30, 2019, it published an advertisement for the assignment of the second, "large portfolio", with a nominal value of EUR 1.82 billion. Due to the limiting factors caused by the COVID-19 pandemic on the ability of investors to carry out the analysis procedure, the opening of binding offers was carried out on September 10, 2020, and a total of five binding offers were received.

After several months of negotiations with the best bidders, in accordance with Government Decision 05 Number: 401-1646/2021 of February 25, 2021, the conclusion of the Provincial Government 127 No. 422-6/2021 of March 3, 2021 and the decisions of the Board of Creditors of all insolvent financial institutions, whose receivables were the subject of assignment, the best offer was selected in the process of assigning the portfolio of receivables for a fee, using the method of public collection of bids through tendering, and the procedure for the assignment of the "large" portfolio was successfully completed on April 19, 2021, with the signing of the Framework Agreements on the assignment of the receivables portfolio and the payment of the assignment fee.

After the successful completion of two claims assignment procedures, activities were started to resolve the remaining portfolio, pursuant to point 2.3.3. of the Programme and Action Plan which defined that, after the implementation of the sale of the pilot and large portfolio, it was necessary to undertake a series of activities regarding the realization of the remaining claims of state creditors.

The portfolio that will be the subject of the assignment will consist of the claims of the Agency in the name and for the account of the Republic of Serbia and seven insolvent financial institutions, with a total nominal value of no less than EUR 300 million. Realisation is expected during 2023.

The implementation of other measures for resolving non-performing loans, both from the NPL Resolution Strategy and from the aforementioned Programme, continues to produce results. The reduction of non-performing loans in the period August 2015 - September 2022 amounts to RSD 320 billion, while the result of the NPL Resolution Strategy is reflected in the historically lowest share of non-performing loans at the end of September 2022 of 3.2%. Compared to that indicator before the implementation of the Strategy (22.25%), an impressive decrease of 19.06 pp is recorded. It is a concrete confirmation that the measures were well defined and that they have produced excellent effects.

The NBS also acted outside the framework of the Strategy, such as the adoption of the Decision on the accounting write-off of the bank's balance sheet assets, which complemented the regulatory activities. And the coverage of non-performing loans with corresponding value adjustments in accordance with international accounting standards, which amounts to 57%, unequivocally, along with all other indicators of the health of the financial system, confirms the stability of our banking sector.

By creating stable business conditions, our economy entered the investment cycle in 2015, and since then investments have represented represent a good part of economic growth in terms of volume. The profitability of the economy grows in conditions of low and stable inflation and a relatively stable exchange rate. Those were all the key factors for a sustainable solution to the issue of non-performing loans. This can be clearly seen from the fact that in the branches that are the bearers of our growth, the biggest drop in non-performing loans was recorded - which is evident in the manufacturing industry and construction.

Deposit insurance is a mechanism that contributes to the preservation of financial stability and ensures the protection of depositors. The deposit insurance system ensures that each protected depositor[10] is paid the entire deposit amount in each bank up to the insured amount of EUR 50,000 in the event of

[10] Protected depositors are: natural persons, entrepreneurs, micro, small and medium-sized legal entities, after the exclusion stipulated by the Deposit Insurance Law.

bankruptcy or liquidation of the bank. Deposit insurance is regulated by the Deposit Insurance Law.

In October 2019, the Law on Amendments to the 2019 Deposit Insurance Law was adopted, which sought to further harmonize the deposit insurance system with the best international practices and standards, as well as the EU legal acquis in terms of: premium calculation method (introducing the possibility of premium calculation based on the level of risk in banks' operations), basis for premium calculation, amount of extraordinary premium, protection of depositors of attached or merged banks, the target amount of the deposit insurance fund, etc., all with the aim of contributing to financial stability through an incentive to reduce risks in bank operations, strengthening public trust in the financial system and increasing the efficiency of the deposit insurance system.

Respecting the provisions of the Law on Amendments to the Deposit Insurance Law, the deposit insurance premium is calculated starting from the collection of the premium for the first quarter of 2020 on the amended basis, i.e. based on the average balance of total insured amounts up to EUR 50,000 (deposit amount covered by insurance) in the bank in the previous quarter, instead of based on the average balance of total insured deposits. With this change, the obligations of the banks based on the payment of the deposit insurance premium were reduced by about 30% on average, which indirectly enabled a greater investment activity of the banks.

As the law also provided for the possibility of calculating the premium based on the level of risk in bank operations, the Agency was required to adopt the Methodology for calculating the deposit insurance premium based on the level of risk in bank operations within one year from the date of entry into force of this law. The Management Board of the Agency adopted the text of the Methodology on October 15, 2020 with the prior consent of the NBS, thus fulfilling the legal obligation within the prescribed period, while a special decision of the Agency's Management Board is to decide on the beginning of implementation of the Methodology.

In the deposit insurance system, the Republic of Serbia is the ultimate guarantor of the payment of insured deposits. In order to provide funds for deposit insurance, DIA collects a deposit insurance premium from banks for the account of the Deposit Insurance Fund, manages the fund's assets and pays deposits up to the insured amount in the event of bank bankruptcy or liquidation. In addition, the resources of the fund can be used to finance the restructuring of banks in the scope and under the conditions established by the law governing banks. In the case of missing funds in the deposit insurance fund, the Republic of Serbia ensures payment either with funds from the budget or by providing a guarantee for DIA borrowing.

On March 24, 2020, the government adopted the Decree on the investment of foreign currency funds managed by the Deposit Insurance Agency during the state of emergency, which stipulated that during the state of emergency due to the disease COVID-19 caused by the SARS-CoV-2 virus, the Agency might invest more than a quarter of the Fund's foreign currency assets in foreign currency debt securities issued by the Republic of Serbia. In accordance with the Regulation, the Agency adjusted the amount of the Fund's foreign currency assets invested in foreign currency debt securities issued by the Republic of Serbia to the level of the legal limit of 1/4 of the Fund's total foreign currency assets.

The guarantee of payment of insured deposits by the state, either directly with funds from the budget, or indirectly by issuing guarantees for DIA borrowing, is a source of fiscal risks and possible fiscal costs. However, thanks to the achieved stability of the banking sector, since 2015 there has been no need to use funds from the deposit insurance fund, nor from the state on the basis of payments of insured deposit amounts.

Reduction of fiscal risks on this basis depends on the stability and sustainability of the banking system. Supervision of the banking system, prudence in the placement of funds and improvement of the quality of bank assets are the basic pillars of a stable banking system.

The achieved results of the banking sector of the Republic of Serbia in 2021 show the increasing profitability of the banks. The banking sector of the Republic of Serbia operated profitably in 2021, with a net profit before taxation in the amount of RSD 53.9 billion, which is 17% more than the positive result achieved in 2020, when the net profit before taxation amounted to RSD 46.1 billion.

The banking sector of the Republic of Serbia is adequately capitalized both from the point of view of the achieved level of capital adequacy indicators and from the point of view of the own funds structure. At the end of 2020, the average value of the capital adequacy indicator at the banking sector level of the Republic of Serbia was 22.42%. Also in the course of 2021, the high capital adequacy of the banking sector was preserved (the capital adequacy indicator was 21.7%), which is significantly above the prescribed regulatory minimum of 8% and more than enough to cover all the risks to which the sector is exposed, as confirmed by the macro prudential stress tests that the NBS regularly conducts.

Bearing in mind the situation created by the declaration of a state of emergency in the Republic of Serbia, in order to facilitate the mitigation of the economic and financial consequences due to the pandemic of the disease COVID-19 caused by the SARS-CoV-2 virus, measures to support the economy were taken, which aimed at increasing the liquidity of economic entities. One of the measures was the adoption of the Regulation on establishing a guarantee scheme as a measure to support the economy to mitigate the consequences of the COVID-19 pandemic caused by the SARS-CoV-2 virus. This regulation constitutes the establishment of the national guarantee scheme. Increasing the liquidity of business entities through the guarantee mechanism of the Republic of Serbia for loans granted by banks to business entities for financing liquidity and working capital, which is made possible by the conclusion of the Agreement on the guarantee of the Republic of Serbia for business lending with the aim of mitigating the negative consequences of the COVID-19 pandemic caused by the SARS-CoV-2 virus, is a measure that in itself sublimates an extremely important and necessary mechanism of effects for all persons based in the Republic of Serbia, including agricultural holdings, which are registered in the Business Registers Agency of the Republic of Serbia and classified as entrepreneurs, or a micro, small and medium-sized company in accordance with the law governing accounting, whose liquidity is a prerequisite for the functioning of the economy of the Republic of Serbia.

Banks can place an amount of up to two billion euros for the realization of loans, whereby the amount of one billion euros, i.e. the amount of the initial maximum insured portfolio per bank, is determined according to the bank's market share according to the NBS report on February 29, 2020.

Considering the fact that by the end of November 2020, around EUR 1.5 billion were placed in the economy through commercial banks, out of a total of EUR 2 (two) billion available, and that the Regulation stipulated that the loan agreement had to be concluded no later than December 31, 2020, as well as that the fact is that the loan agreement must be disbursed no later than January 31, 2021, there was a need to extend the deadline by which the loan agreement had to be concluded, that is until the loan agreement had to be disbursed.

Accordingly, the adoption of the Law on establishing a guarantee scheme as a measure of support to the economy for mitigating the consequences of the COVID-19 pandemic caused by SARS-COV-2 virus was proposed to the National Assembly, which was adopted at the session held on December 17, 2020 and the same was published in the “Official Gazette of the Republic of Serbia” number 153/20 of December 21, 2020. The Republic of Serbia has recognized the need to approve an additional EUR 500 million in aid, in order to maintain liquidity, which will bring the total amount of funds placed through the first guarantee scheme to the amount of EUR 2.5 billion. In this regard, the Law on Amendments to Law on establishing a guarantee scheme as a measure of support to the economy for mitigating the consequences of the COVID-19 pandemic caused by SARS-COV-2 virus was adopted (“Official Gazette of RS”, number 40/21), which among other things, extended deadline for disbursement of loans until July 31, 2022 at the latest.

So far, 24 banks have signed the agreement on the guarantee of the Republic of Serbia for lending to the economy with the aim of mitigating the negative consequences of the pandemic of the disease COVID-19 caused by the SARS-CoV-2 virus with the Republic of Serbia and the NBS. The Republic of Serbia placed the planned EUR 2.5 billion with the Banks, while the Banks, until March 31, 2022, placed about EUR 2.3 billion with the clients. At the same time, the Republic of Serbia recognized the need for additional assistance to the most vulnerable companies that had a drop in business revenues of more than 20% in 2020, compared to the same period in 2019, so that on April 22, 2021 the Law on Establishing the Second Guarantee Scheme was adopted as a measure of additional support for the economy due to the prolonged negative impact of the COVID-19 pandemic caused by the SARS-CoV-2 virus ("Official Gazette of the RS", number 40/21), by which additional EUR 500 million of aid was approved. In December 2021, the Law on Amendments to the Law on Establishing a Second Guarantee Scheme was adopted as a measure of additional support to the economy due to the prolonged negative impact of the COVID-19 pandemic caused by the SARS-CoV-2 virus ("Official Gazette of the RS", number 129/21), which provided for an exception in relation to the loan beneficiaries belonging to entrepreneurs, micro, small and medium-sized enterprises operating in the sectors of passenger transport, catering, travel agencies and hotel industry in cities, that they might be granted a loan secured by a guarantee pursuant to this law, and also when the total amount of the loan approved on the basis of the Law on establishing the first guarantee scheme and the loan approved on the basis of this law was greater than the prescribed thresholds and if the conditions prescribing that the user had prematurely and fully settled the obligations under the loan secured by the guarantee pursuant to the Law on establishing the first guarantee scheme were met, and that the maximum amount of the loan secured by the guarantee was equal to the smaller of the two amounts determined by this law.

Due to the reduced approval of loans within the second guarantee scheme, as well as the evident prolonged negative impact of the pandemic of the disease COVID-19 caused by the SARS-CoV-2 virus, and that, due to the war events in Ukraine, there was a change in circumstances that could not have been predicted by the outbreak of the pandemic COVID-19 disease caused by the SARS-CoV-2 virus, and which in parallel had a negative effect on economic activity, the possibility for refinancing loans from the first guarantee scheme with loans from the second guarantee scheme was provided for business entities that experienced reduced or suspended business activities related to the export and import of goods and services to the markets of Ukraine, Russia or Belarus. The deadline for the use of funds under the second guarantee scheme expired on June 30, 2022, and the possible extension of the prescribed legal deadlines is conditioned by the initiation of the procedure to amend the Law on the establishment of the second guarantee scheme as a measure of additional support to the economy due to the prolonged negative impact of the COVID-19 pandemic.

In accordance with the above, the projections of fiscal gross outflows from the budget of the Republic of Serbia based on the national Guarantee scheme in question amount to EUR 89 million for 2022, EUR 60 million for 2023, EUR 5 million for 2024 and EUR 3 million for 2025. In addition, the projection of the inflow based on the collection of non-performing loans has been made on the basis of the subject Guarantee Scheme of the Republic of Serbia, amounting to EUR 14 million in 2022, EUR 14 million in 2023, EUR 9 million in 2024 and EUR 5 million in 2025. The projection of the fiscal gross outflow of the budget of the Republic of Serbia based on the second Guarantee Scheme amounts to EUR 1.8 million for 2024 and EUR 1.4 million for 2025, and the projected inflow is EUR 10.9 thousand for 2024 and EUR 103 thousand for 2025. On the basis of both guarantee schemes, EUR 2.4 billion of loans were realised, while EUR 39 million were paid out on behalf of the activated guarantees.

As for other financial institutions, the Republic of Serbia has a direct share in the capital of Dunav osiguranje a.d.o. Belgrade (hereinafter: Dunav osiguranje) and Dunav Re a.d.o. Belgrade (hereinafter: Dunav Re), as well as in the National mortgage insurance corporation (hereinafter: Corporation).

Through the successful and efficient implementation of the provisions of the law that was adopted at the end of April 2021 - the Law on Amendments to the Insurance Law ("Official Gazette of the RS", number 44/21), and which was the basis for the change of ownership rights on social capital in insurance companies, the direct equity interest of the Republic of Serbia in Dunav osiguranje increased to 76.70%. Also, as there was a smaller share of social capital in the total capital of Dunav Re, after the change of ownership rights in accordance with the aforementioned law, the Republic of Serbia acquired a direct share of about 4.76% in Dunav Re.

Speaking of which, by the end of 2014, the share of social capital in the total capital of Dunav osiguranje was 94.61%, which had an unfavourable impact on the business of Dunav osiguranje (primarily due to the complicated management structure), as indicated by the audit reports for 2012 and 2013, in which the auditor's qualified opinion was expressed. Bearing in mind the importance of Dunav osiguranje on the insurance market (the largest insurance company), the Republic of Serbia recapitalized Dunav osiguranje with RSD 4.8 billion in December 2014, which reduced the share of social capital to 51.86%. In recent years, the operations of Dunav osiguranje have been stable, with constant improvement of most indicators. There has been a noticeable trend of profit growth year in year out (and regular payment of dividends). Dunav osiguranje had no negative consequences for business operations (judging by the most significant indicators) on account of the COVID-19 disease caused by the SARS-CoV-2 virus. Alignment (in terms of organisation, management, capital, etc.) with the new regulatory standard Solvency 2, which is expected of all participants in the insurance market in the Republic of Serbia, is highlighted as the biggest challenge in the coming period.

The Law on the National mortgage insurance corporation (“Official Gazette of RS”, No. 55/04) established the Corporation as a legal entity specialized in the insurance of claims based on housing loans approved by banks and other financial organizations, which are secured by a mortgage, as well as for performing other tasks related to that insurance. The founder of the Corporation is the Republic of Serbia which has a direct share of 100% in the capital of the Corporation (the law leaves open the possibility for the Corporation to be organized as a joint-stock company, provided that the value of state capital in the total capital of the Corporation may not be less than 51%). The law also prescribes for the total nominal amount of the Corporation's liabilities arising from the performance of the Corporation's activities can be at most up to 16 times higher than the amount of the Corporation's capital, but also that at the reasoned request of the Corporation, the Government can give consent to increase the scope of the Corporation's obligations arising from the performance of the Corporation's activities by more than 16 times the Corporation's capital, for a certain period of time.

Since its foundation, the Corporation has had a significant influence in creating market conditions and lending standards, which was necessary for the mortgage market to develop at all. This led to a reduction in risk and securing the interests of both creditors and borrowers through lowering interest rates, which led to an increase in the demand for residential properties (with a positive effect on the construction industry) and thereby contributed to an increase in the number of apartments purchased on credit.

In the past period, the Corporation was not recapitalised from the funds of the budget of the Republic of Serbia, but instead the capital was increased from the realised gains of the Corporation. However, since the increase in capital did not follow the growth of insured loans, every year the Government, pursuant to the law, gave consent to increase the scope of the Corporation's obligations arising from the performance of the Corporation's activities and by more than 16 times the Corporation's capital. This increase is ever lower year by year (e.g. for the year 2015, the scope of the Corporation's liabilities arising from the performance of the Corporation's activities could be up to 30 times higher than the Corporation's capital, while for the year 2022 it could be up to 20 times higher than the Corporation's capital).

A large number of customer lawsuits against banks in connection with the payment of insurance premiums to the Corporation appears as a potential risk. Although the Corporation is not a sued party, nor does the Republic of Serbia guarantee the obligations of the Corporation (the Corporation guarantees its obligations up to the amount of its capital), the potentially negative outcome of these disputes may result in the eventual need for certain expenditures from the budget. Also, due to changed market conditions, there have been disputes with a certain number of banks (cancellation of the contract with the Corporation by the banks), which leads to a significant decrease in insured loans, and thus to a decrease in the Corporation's income. Taking into account the long-term nature of the potential liabilities assumed by the Corporation (insurance of claims based on housing loans that are approved for a period of up to 30 years), the continuation of the trend of a significant reduction in insured loans may also affect the eventual need for certain expenditures from the budget in the future.

Legal proceedings

Due to numerous court proceedings where the burden of payment is on the Republic of Serbia as the defendant, various fiscal risks have been identified that exist due to uncertainty regarding the processes (litigation, extra-judicial proceedings, enforcement and other proceedings), especially bearing in mind the so-called “mass” actions. The manner in which participants in court proceedings (courts, prosecutors, defendants, etc.) act also affects the length of the proceedings and the value of the amounts awarded on the basis of final judgments. The aforementioned represents a special challenge for monitoring the resulting fiscal risks.

The Republic of Serbia paid a total of RSD 121 billion from the republic's budget in the period 2009–2020 based on fines and penalties according to court decisions (economic classification 483) and compensation for injuries or damage caused by state authorities (economic classification 485), while in 2021, RSD 16.6 billion were paid from the budget of the Republic of Serbia on this basis.

In order to reduce costs in the so-called “budgetary” procedures, during 2019 the Law on Enforcement and Security Interest was amended (“Official Gazette of RS”, no. 106/15, 106/15 - authentic interpretation, 113/17 - authentic interpretation and 54/19), which entered into force on January 1, 2020. Article 300 of the aforementioned law, among other things, stipulates that the enforcement creditor is obliged to notify the ministry in charge of finance of the intention to submit a proposal for enforcement in writing no later than 30 days before submitting the proposal for enforcement, if the Republic of Serbia, an autonomous province, a local self-government unit, a direct or indirect beneficiary of budget funds appears as the executive debtor.

The aforementioned measure encourages voluntary payment of the obligation by the competent authority, in order to avoid the costs of enforced collection. In 2020, 51,757 notifications of the intention to submit a motion for execution were submitted to the Ministry of Finance, Treasury Administration, and in 2021, 54,270 of these notifications were submitted. By the end of the third quarter of 2022, 38,019 notifications were submitted. The debtors with the highest percentage of participation in the number of submitted notifications as of 31.03.2022 were: Commercial Court in Kragujevac with 10.05%, Ministry of Defence with 7.28%, Commercial Court in Leskovac with 6.69%, Misdemeanour Appellate Court Belgrade with 4.98%, Ministry of the Interior with 4.53%, other commercial courts (Zaječar 3.21%, Belgrade 2.97%, Kraljevo 2.30% and others), city budgets (Leskovac with 2.88%, Novi Sad with 2.28%, Belgrade with 1.48%...), budget RS with 2.17% and others.

When it comes to debt enforcement, the largest percentage in these executions on September 30, 2022 was evidenced in: Ministry of Defence 23.3%, Ministry of Justice 8.5% and Ministry of Internal Affairs 7.9%.

In 2022, work continues to improve the system for monitoring fiscal risks based on court proceedings, with the aim of more precisely identifying and assessing risks, as well as suppressing their cause, despite the challenges that arise in connection with the collection of accurate and comprehensive data from the existing records.

Other fiscal risks

In addition to the aforementioned fiscal risks, there are also other circumstances that, if realised, may lead to fiscal costs. Their identification helps to see the possible impacts on the fiscal position of the country within a certain period.

The operations of local self-government units can have fiscal implications for the general government budget. Special fiscal rules for local self-governments set the so-called “golden rule” that deficit is allowable only for realisation of capital investments. There are also rules on the level of indebtedness of local self-government units, the consistent application of which would help maintain the stability of public finances at the local level. What happened in reality was that because of unrealistic planning of both income and expenditure, there was an accumulation of due and undischarged obligations that threatened the functioning of certain cities and municipalities.

In order to avoid the realisation of fiscal risks on this basis, the Ministry of Finance is improving the system of public finance control of local self-governments so that they would comply with the set rules - from planning to the implementation of the budget at the local level.

Based on the Methodology for monitoring fiscal risks to the budget of the Republic of Serbia arising from the exercise of the competences of local self-government units, the Ministry of Finance has developed a working model for the analysis, assessment and monitoring of fiscal risks, the implementation of which is expected in 2023.

The ever-present risk of natural calamities and natural disasters requires investments in prevention programs, in order to reduce the potential fiscal costs for the elimination of damage caused on that basis. Prevention includes the inclusion of a wider range of financial instruments, such as reserve funds, potential credit lines, and insurance is especially important. In 2014, the Republic of Serbia faced the catastrophic consequences of floods, the total consequent damage of which (including losses) was estimated at more than EUR 1.7 billion. In December 2014, the Government of the Republic of Serbia adopted the National Program for Natural Disaster Risk Management, which is implemented in cooperation with the World Bank, the United Nations and the European Union. In line with the aforementioned program, in November 2018, the Law on Disaster Risk Reduction and Emergency Management was adopted ("Official Gazette of RS", No. 87/18). The first meeting of the Special Working Group for the development of the Draft Disaster Risk Reduction and Emergency Management Strategy in the Republic of Serbia for the period 2022-2027 was held in mid-April 2022.

In 2019, the Republic of Serbia paid RSD 4.22 billion from the budget in the name of compensation for injuries or damages caused by natural disasters or other natural causes. In 2020, RSD 2.8 billion were set aside for this purpose (economic classification 484), while in 2021, the amount spent for these purposes amounted to RSD 520.3 million (without intervention funds to mitigate the consequences of the COVID-19 disease). Funds allocated for this purpose in the period from 01.01. until 30.09.2022 amount to RSD 94.2 million (without intervention funds for mitigating the consequences of the COVID-19 disease).

Government Decision No. 05 Number: 40-9575/2021 of October 21, 2021 adopted the Unique Methodology for Monitoring Fiscal Risks in the Republic of Serbia, which, among other things, includes the Methodology for monitoring fiscal risks that occur as a result of natural disasters. Training courses are yet to be organised to master the model for monitoring fiscal risks resulting from natural disasters.

5. Cyclically Adjusted and Structural Fiscal Balance

The cyclically adjusted fiscal balance is defined as the fiscal balance from which the isolated influence of the economic cycle is excluded, and the initial identity is as follows[11]:

$$FB = CB + CAB$$

The part of the fiscal balance (FB) that is not affected by cyclical fluctuations is called the cyclically adjusted fiscal balance (CAB*),* and the aim of this procedure is to isolate the cyclical component of the fiscal balance (CB) which is the result of the effect of the output gap. The actual fiscal balance will be equal to the cyclically adjusted one in case the output gap is equal to zero, i.e. if the real GDP growth rate is equal to the potential growth rate. The structural fiscal balance is further calculated by eliminating one-off effects on the revenue and expenditure side, thus showing the structural (permanent) fiscal position.

The fiscal space created in the previous period and the significantly structurally improved fiscal position of the country made it possible to relax the fiscal policy in times of crisis.

With the outbreak of the COVID-19 pandemic at the beginning of 2020 and the introduction of measures to protect the health of the population, the global economy entered an unprecedented crisis. The impact on the fiscal position was visible through reduced budget revenues, which were the resulte of the slowdown in economic activity due to the pandemic, and dramatically higher expenditures due to higher health care costs and the adoption of an extensive aid package for the economy and citizens. In such a situation, the usual analysis of the economic cycle, quantification of fiscal multipliers and assessment of the elasticity of the fiscal balance in relation to the output gap does not give a completely correct assessment of the country's fiscal position. The fiscal policy response to the complex economic situation caused by the coronavirus pandemic in 2020 and 2021 is represented by an extensive package of measures to help the economy. In the abscence of these measures, modest fall in GDP in 2020 and a strong recovery in 2021 would not have been evidenced, whereas a greater contraction of the economy would have resulted in a significantly slower recovery in the posterior medium-term period.

[11] A more detailed description of the methodology used and the results can be found in the Fiscal Strategy for 2013 with projections for 2014 and 2015 or through the link https://www.mfin.gov.rs//upload/media/jzsbpL_601ab1585ca02.pdf

Table 19. Fiscal balance and components of cyclically adjusted balance in the period 2005–2025, % of GDP*

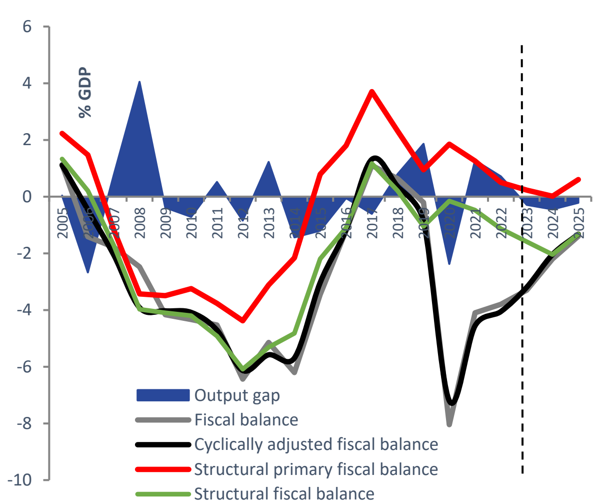
	Output gap	Fiscal balance	Primary fiscal balance	Cyclically adjusted fiscal balance	Cyclically adjusted primary fiscal balance	Structural fiscal balance	Structural primary fiscal balance**	Fiscal impulse
2005	0.0	1.1	2.0	1.1	2.0	1.3	2.2	
2006	-2.7	-1.4	-0.1	-0.5	0.8	0.2	1.5	1.2
2007	0.8	-1.8	-1.2	-2.1	-1.5	-1.7	-1.2	2.3
2008	4.0	-2.5	-1.9	-3.9	-3.4	-4.0	-3.4	1.9
2009	-0.4	-4.2	-3.6	-4.0	-3.4	-4.1	-3.5	0.0
2010	-0.7	-4.3	-3.4	-4.1	-3.1	-4.2	-3.2	-0.3
2011	0.5	-4.5	-3.4	-4.7	-3.6	-4.9	-3.8	0.4
2012	-0.8	-6.4	-4.7	-6.1	-4.4	-6.1	-4.4	0.9
2013	1.2	-5.1	-3.0	-5.6	-3.4	-5.3	-3.1	-1.0
2014	-1.4	-6.2	-3.5	-5.7	-3.0	-4.8	-2.2	-0.4
2015	-1.2	-3.5	-0.5	-3.0	0.0	-2.2	0.8	-3.0
2016	-0.1	-1.2	1.7	-1.2	1.7	-1.1	1.8	-1.8
2017	-0.6	1.1	3.6	1.3	3.8	1.2	3.7	-2.1
2018	0.8	0.6	2.7	0.4	2.5	0.2	2.3	1.4
2019	1.9	-0.2	1.8	-0.9	1.1	-1.0	0.9	1.3
2020	-2.4	-8.0	-6.0	-7.2	-5.2	-0.2	1.8	6.3
2021	1.3	-4.1	-2.4	-4.6	-2.8	-0.5	1.3	-2.4
2022	0.7	-3.8	-2.2	-4.1	-2.4	-1.1	0.5	-0.4
2023	-0.3	-3.3	-1.5	-3.2	-1.4	-1.6	0.2	-1.0
2024	-0.4	-2.2	-0.1	-2.0	0.0	-2.0	0.0	-1.4
2025	-0.2	-1.4	0.5	-1.3	0.6	-1.3	0.6	-0.6

* Projected values are presented for the period 2022–2025.

** The structural primary balance was obtained by excluding estimated one-off revenues and expenses. The results showing the change in the structural primary deficit do not explicitly exclude the effects of increased efficiency in revenue collection, so the assessment of structural adjustment in 2015 and 2016 is in part different from the previously shown effects.

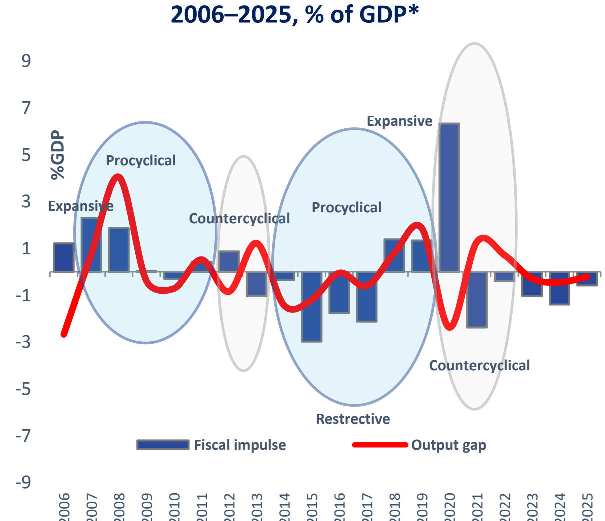
Source: Ministry of Finance

Production gap, cyclic. adjusted and structural fiscal balance in the period 2005–2025, % of GDP*



* Projected values are presented for the period 2022–2025.

Character and effects of fiscal policy in the period 2006–2025, % of GDP*

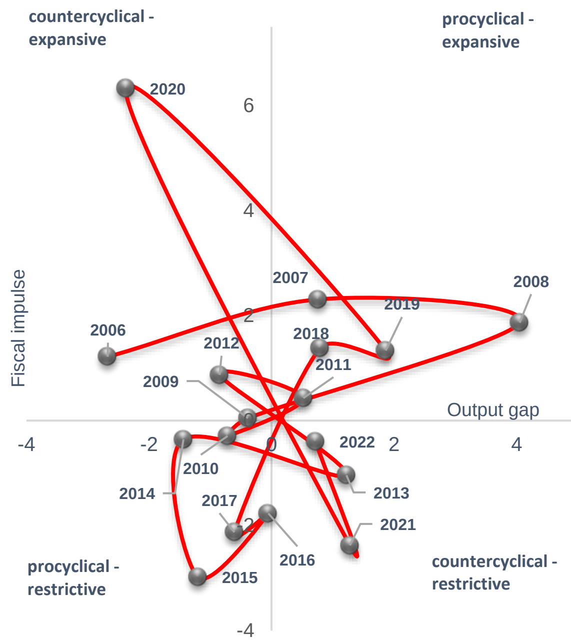


* Projected values are presented for the period 2022–2025.

The structural fiscal position of the country was not significantly impaired in the period between 2020 and 2022, due to the fact that the implemented measures to help the economy from the fiscal policy domain were time-limited. During 2022, a certain amount of funds has been foreseen as a form of assistance to the population, amounting to 0.92% of GDP. Moreover, the energy crisis has caused significant interventions by the state aimed at ensuring energy stability. In addition to the increased expenditures for energy products, assistance to the citizens and the companies was also provided by the reduction of excise duties on oil derivatives.

As the fiscal impulse is defined as the difference between two consecutive cyclically adjusted (primary) results, it is estimated that the fiscal policy during 2020 was extremely expansionary-countercyclical, aimed at mitigating the negative economic cycle. Due to somewhat smaller scope of package of economic support measures in 2021, the fiscal policy was more restrictive than the previous year, and also countercyclical in character. For the period 2022 to 2023, it has been estimated that the fiscal policy will remain slightly restrictive, despite significant allocations to alleviate the energy crisis.

Character and effects of fiscal policy in the period 2006–2022, % of GDP

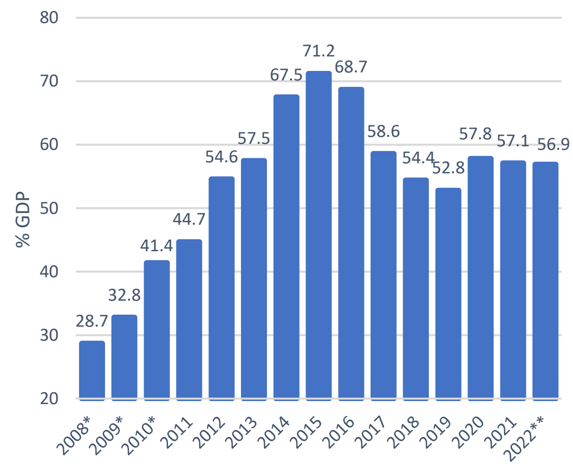


6. Debt Reduction Programme

In accordance with the current provisions of the Budget System Law, if the debt of the general government exceeds 45% of GDP, the Government is obliged to propose measures that will bring the debt closer to the target level and return it to a sustainable framework[12]. By the end of the year, amendments to this law are still to be made in the part related to fiscal rules and principles of fiscal responsibility and sustainability[13]. In accordance with the changes in the general fiscal rules on deficit and debt, the procedure in case of exceeding the debt ceiling has also been changed. Thus, in the event that the debt is above 55%, the Government, within the framework of the Fiscal Strategy and according to the procedure for the adoption of the fiscal strategy, proposes a Debt Reduction Program with specific measures to reduce the debt below the set limit. The program is to be submitted for each year in which the debt remains above 55% of GDP. If the debt is above 60% of GDP, which is the highest allowed upper limit of the debt of the government sector, the Debt reduction program is adopted by the National Assembly at least once a year, within the process of adopting and preparing the budget for the next fiscal year.

In the period from 2008 to 2014, the deficit of the general government increased significantly, while at the same time the public debt grew explosively, with the debt-to-GDP ratio more than doubling. Fiscal consolidation measures adopted at the end of 2012 and during 2013 partly mitigated this trend, but the level of public debt continued to grow significantly. The reduction of the primary deficit in the period 2012-2014 was not enough to stabilize the share of public debt in GDP. The effects of the first wave of fiscal consolidation, which mainly related to the revenue side, were fruitless, due to the increased volume of the shadow economy, typical in the period after the increase in tax rates. On the expenditure side, high interest rates and certain one-off expenses further worsened the fiscal position.

General government public debt in the period 2008–2022, % of GDP



* Local debt approximation
** Estimate for 2022

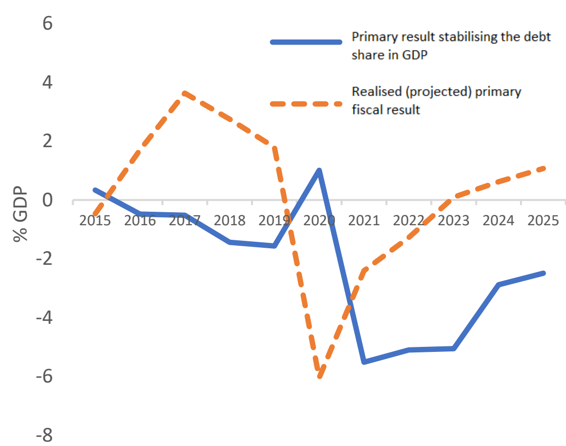
Fiscal consolidation measures adopted at the end of 2014 reduced the primary deficit and slowed down the growth of public debt already in 2015. The reduction of public debt in GDP occurred in 2016, a year earlier than was foreseen by the arrangement with the IMF. In 2016, a primary surplus of 1.7% of GDP was achieved, which finally created the conditions for a decrease in the share of public debt in GDP. After that, in 2017, the achieved primary fiscal surplus of 3.6% of GDP led to an even more significant decline in the debt share, by more than 10 pp of GDP, to 58.6% GDP. During 2018, the trend of reducing the share of public debt in GDP continued being down to 54.4% of GDP. Fiscal relaxation during 2019 did not undermine the downward trajectory of public debt. The positive primary fiscal result in 2019 of 1.8% of GDP led to the further reduction of public debt by another 1.6 pp of GDP.

The period from 2020 on has evidenced one of the biggest health and, consequently, economic crises in the last few decades, caused by the COVID-19 pandemic. The most important factors affecting the debt trends during the mentioned period are the level of the total and primary fiscal deficit, additional financing needs and the repayment of the due part of the debt. The realised fiscal deficit of 8% of GDP (primary deficit of 6% of GDP) in 2020 and a deficit of

[12] Public debt in this regard does not include debt based on restitution in line with the definition of debt set out in the Budget System Law.
[13] See more about the redefined fiscal rules in the section related to structural fiscal reforms.

4.1% of GDP in 2021 had the effect of temporarily reversing the downward trajectory of public debt participation. Despite this, the share of public debt of the general government in GDP in 2021 slightly decreased to 57.1% of GDP. For 2022, the projected level of the primary fiscal result (primary deficit 2.2% of GDP) reduces the share of public debt to 56.9%. The fiscal strategy for the next medium-term period envisages a gradual stabilization of public finances and lower deficit levels, which will bring the public debt back into the downward trend zone.

Primary result stabilising the debt share in GDP and the realised/projected result*, % of GDP



* Projected values are given for the period 2022 to 2025.
Source: Ministry of Finance

By analysing the primary stabilisation gap, which is defined as the difference between the achieved primary result and the primary result that is necessary to stabilise the share of public debt in the current year, it is possible to evaluate the set quantitative fiscal limits. As of 2016, there was a positive primary stabilization gap, and the debt path was reversed. During 2017 and 2018, the positive gap increased, and in that period the biggest reduction in the share of debt in GDP was achieved. The opposite trend was recorded during 2020, when the highest negative value of this indicator was reached. In the period from 2022-2025, in accordance with the fiscal framework given in this document, positive values of this parameter have been projected.

The dynamics of lowering the level of public debt to 45% of GDP have been projected, in accordance with the current fiscal rules, and the basic scenario presented by this fiscal framework foresees a gradual reduction of the fiscal deficit to 1.4% of GDP at the end of 2025.

Management and sustainability of public debt will be additionally ensured:

- by limiting the issuance of new guarantees;
- by limiting the conclusion of new project loans in cases where previously approved loans have not been used effectively;
- by purchasing a part of the expensive debt using funds from more favourable loans or privatisation revenues if possible;
- by identifying and better managing fiscal risks.

The legally stipulated share of public debt in GDP of 45% will be reached during 2030. The success of the previous program of structural fiscal adjustment made it possible to reduce the share of debt from 2015 to 2019 by 18.4 pp GDP. Such circumstances affected the possibility of the Republic of Serbia to provide without difficulty the necessary financing of the fiscal deficit during the duration of the COVID-19 pandemic, as well as the smooth repayment of the due debt. Uncertainty regarding the course and duration of the global economic and energy crisis requires careful management of fiscal policy in the coming period.

As the fiscal rules stipulated debt limit of 45% of GDP is to be reached in 2030, a simulation of the of debt share in the event of a variation of the factors affecting the dynamics of the debt was made.

The assumptions in the basic scenario are:

- after the achieved high level of fiscal deficit in 2020, in the period from 2021 to 2025, the level of the general and primary fiscal result allows for a gradual reduction of the share of public debt in GDP. After that, the fiscal deficit is to be reduced from 1.2% of GDP in 2026 to the level of 0.5% of GDP;
- slower growth of fiscal revenues compared to nominal GDP growth due to changes in the structure of the economy, strengthening of investment activity and export growth. No significant changes in tax policy are foreseen, while maintaining a high level of capital expenditures;
- lack of net increase in issued guarantees after 2025;
- average real GDP growth rate of 4% in the long run;

- a slowdown in inflation and then keeping it at a level of 3% on average in the long term;
- lack of significant inflows from privatization in the period under review. Potentially higher privatization revenues reduce the need for financing and additionally reduce the share of public debt.

Table 20. Total public debt simulation - Baseline Scenario by 2030, % of GDP

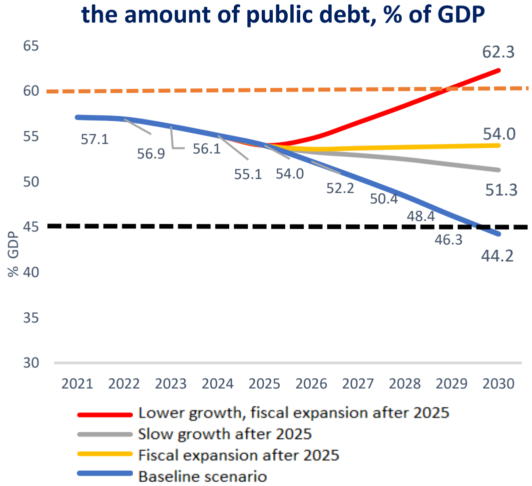
Baseline scenario	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Revenues	43.3	43.0	40.8	40.3	39.6	39.3	39.1	38.9	38.7	38.5
Expenditures	47.4	46.8	44.1	42.5	41.0	40.5	40.1	39.7	39.2	39.0
Decrease in expenditures share		-0.6	-2.7	-1.6	-1.5	-0.4	-0.4	-0.4	-0.5	-0.2
Fiscal result	-4.1	-3.8	-3.3	-2.2	-1.4	-1.2	-1.0	-0.8	-0.5	-0.5
Primary fiscal result	-2.4	-2.2	-1.5	-0.1	0.5	0.7	0.8	0.9	1.2	0.6
Public debt in GDP	57.1	56.9	56.1	55.1	54.0	52.2	50.4	48.4	46.3	44.2
GDP real growth. %	7.5	2.5	2.5	3.5	4.0	4.0	4.0	4.0	4.0	4.0

Source: Ministry of Finance

The baseline scenario envisages a reduction of public debt to around 45% of GDP in 2030. The graph shows simulations of alternative scenarios of public debt trends, depending on the changes in certain assumptions in the baseline scenario. For the purpose of better comparison, only one variable was varied, representing the risk factor that affects the level of debt.

The "slow growth after 2025" scenario implies an average real GDP growth of around 0.7% in the observed period, with the same level of fiscal deficit compared to the baseline scenario. This does not imply the same level of fiscal adjustment, because greater accommodation is needed on the expenditure side in situations where lower economic growth is recorded. At the end of 2030, the public debt according to this scenario reaches the level of 51.3% of GDP.

Comparison of different scenarios and impact on the amount of public debt, % of GDP



The "fiscal expansion after 2025" scenario implies a significant deviation from the currently set medium-term fiscal policy goal and reaching a fiscal deficit of 3%. In this case, the share of public debt in GDP stagnates to the greatest extent, thereafter reaching 54% of GDP in 2030. Public debt does not reach the legal limit of 45% of GDP, and the level below 60% is maintained throughout the observed period. Despite the deterioration of fiscal performance, this scenario implies a still present primary fiscal result which enables the relative stability of the debt share in GDP.

The scenario that combines lower real GDP growth and raising the level of the fiscal deficit to an average of 3% of GDP has the most favourable public debt trajectory. At the same time, only in this scenario the debt has a markedly increasing trajectory in the period after 2025, while the share of public debt reaches the level of 62.3% at the end of the observed period.

III. PUBLIC DEBT MANAGEMENT STRATEGY FROM 2023 TO 2025

Pursuant to the Law on Public Debt, as the legal basis for borrowing on the part of the Republic of Serbia, public debt consists of all direct obligations of the Republic based on borrowing, as well as guarantees issued by the Republic for borrowing by public enterprises and local self-government units, as well as other legal entities. The Republic can borrow in domestic and foreign currency, in order to finance the budget deficit, current liquidity deficit, to refinance an outstanding debt, to finance investment projects, as well as to fulfil obligations under given guarantees. The provisions of the Law on Public Debt indicate that the public debt represents an unconditional and irrevocable obligation of the Republic of Serbia in relation to the repayment of principal, interest and other associated costs.

A quantitative approach was used to formulate the Public Debt Management Strategy, identifying possible limitations through macro-economic indicators, analysis of costs and risks, and market conditions affecting public debt management. For the purpose of the analysis, financing instruments available on the domestic and international financial markets were used. The Public debt management strategy is based on principles that define the need for a transparent and predictable borrowing process, with the permanent development of the government securities market and an acceptable level of exposure to financial risks.

The situation on the international and domestic financial markets, the successful implementation of fiscal consolidation measures with good coordination of fiscal and monetary policy has led to a significant drop in borrowing costs on dinar and euro-denominated securities in the last few years and a reduction in the risk premium for Serbian government securities. During 2022, there will be a significant increase in interest rates caused by external influence.

The fiscal strategy foresees the reduction of the general government debt by the end of 2025 to the level of 54.0% of GDP, whereby a stress- scenario analysis is conducted of the impact of the change in the exchange rate of the domestic currency in relation to the currencies in which the public debt of the Republic of Serbia is denominated in accordance with the public debt management guidelines defined by the World Bank and the IMF and within the framework of the Public Debt Management Strategy.

In the last ten years, significant progress has been made in terms of increasing the average maturity of dinar government securities and reducing financing costs based on this type of borrowing, thereby reducing the exposure to the risk of refinancing. It is important to note that in the mentioned period the average coupon rate of dinar government securities decreased from 13.68%, which was the value at the end of 2012, down to 4.34% at the end of September 2022.

The Public debt management strategy defines the basic measures for further development of the dinar market of government securities. With the development of this market, it is expected that there will be a further increase in internal debt and an increase in its share in the total debt, as well as a reduction in the exposure of public debt to foreign exchange risk, which will positively affect the increase in the credit rating of the Republic of Serbia.

After the successfully implemented measures of fiscal consolidation in 2016 the growing trajectory of public debt and the share of public debt in GDP was reversed, so that the share dropped from 70.0% of GDP, which was at the central government level at the end of 2015, down to 67.7% at the end of 2016. During 2017, there was an even more significant drop to 57.8% of GDP. The trend continued during 2018, when the share of public debt in GDP fell to 53.6%, as at the end of 2019, when the share of public debt in GDP was reduced to 51.9% of GDP. In order to reduce the impact of the crisis caused by the COVID-19 virus pandemic, there was a need to finance measures to support the economy and citizens, which resulted in an increase in the share of debt in GDP to 57.0% at the end of 2020. During 2021, there was a slight decrease in the above indicator, so that the share of public debt in GDP at the end of 2021 was 56.5%. The decline would have been even more intense if significant funds had not been provided during 2021 to finance the debt maturing at the beginning of 2022. For this reason, there was a slightly more pronounced decrease in the share of debt in GDP at the end of September 2022 to 53.7%.

Due to the increased control over the issuance of guarantees in previous years, the guaranteed public debt was almost halved and recorded a drop from EUR 2.8 billion at the end of 2013 to EUR 1.6 billion at the end of September 2022.

The positive fiscal results achieved by the Republic of Serbia are also confirmed by the trend in Serbia's credit rating. In 2019, rating agencies Fitch Ratings and Standard and Poor's increased Serbia's rating to BB+ from BB, while rating agency Moody's improved the outlook for increasing the credit rating of the Republic of Serbia from stable to positive. In 2020, the Republic of Serbia managed to maintain the unchanged credit rating it received in 2019. In March 2021, the rating agency Moody's increased the credit rating of the Republic of Serbia to Ba2 from Ba3 as a result of a very successful response to the crisis caused by the pandemic of the COVID-19 virus and the preservation of macroeconomic stability during the very difficult and challenging year of 2020. In a report published on June 10, 2022, the rating agency Standard and Poor's confirmed the credit rating of the Republic of Serbia at the BB+ level, with stable prospects for its further increase. In its latest report dated August 19, 2022, Fitch Ratings confirmed the credit rating of the Republic of Serbia at the level of BB+, with stable prospects for its further increase.

During 2020, the Republic of Serbia issued Eurobonds on two occasions in order to finance a package of measures to help the economy and citizens in order to minimize the impact of the crisis caused by the COVID-19 virus pandemic and to pay off the previously issued expensive Eurobonds ahead of time. The first issue of Eurobonds was on May 15, 2020, in euros, at the most delicate moment in the first wave of the pandemic, in the total amount of EUR 2.0 billion. The coupon rate was 3.125%, it matures in 2027 and is listed on the London Stock Exchange, one of the largest and most representative markets in the world. The second Eurobond issue was on December 1, 2020, totalling US$1.2 billion due in 2030. The coupon rate amounted to 2.125%, and the final interest rate in euros, after the realisation of the hedging transaction, was 1.066%. The return to the dollar bond market and the new issue denominated in dollars, enabled Serbia to remain present in the emerging market bond index - EMBI Index, which ensured its visibility on the American capital market, as well as on the wider international investment map. The funds from the December 2020 Eurobond issue were used for early repayment of 900 million dollars of Eurobonds issued in 2011, out of a total of 1.6 billion dollars which were due in September 2021. Bonds that were issued at a coupon rate of as much as 7.25% were redeemed ahead of time.

In order to lower financing costs and extend the maturity of the debt, on March 3, 2021, the Republic of Serbia successfully took advantage of the still favourable conditions on the international financial market and for the first time issued twelve-year government securities denominated in euros in the amount of one billion euros at a coupon rate of 1.65%. On September 23, 2021, the Republic of Serbia once again pushed the limits in the choice of financing its investments by entering the international green bond market. The green Eurobond was issued in the amount of EUR 1.0 billion with a maturity of seven years and a coupon rate of 1.00%, the lowest ever achieved on the international market. The Republic of Serbia has become one of the rare European countries that issued green Eurobonds on the international financial market, intended exclusively for financing environmentally friendly projects. At the same time as the emission of the green Eurobond, a 15-year Eurobond with the longest maturity so far was issued in the amount of EUR 750 million, with an annual coupon rate of 2.05%, which additionally increased the maturity of the public debt.

Guided by the best international practice of active public debt management, the Republic of Serbia implemented a hedging transaction for the first time in December 2020, namely the use of financial derivatives for the purpose of protection against foreign exchange and interest rate risk, in accordance with international ISDA standards (*International Swaps and Derivatives Association*), that is, a cross-currency swap transaction by which obligations based on the issued bond were converted from US dollars to euros at a significantly lower final interest rate. Its obligations based on the issued bonds denominated in dollars in the amount of USD 1.2 billion, the Republic of Serbia will pay in euros at a coupon rate of 1.066% on the nominal value of the issue after conversion of EUR 1.016 billion. The favourable exchange rate of euro to US dollar at the given moment was utilised as well as the divergence between the dollar and euro interest rates on the international capital market, and the most favourable borrowing price was achieved, with the optimisation of the currency structure of public debt, all in order to protect against the risk of exchange rate changes. During January 2021, a second swap transaction was carried out, which converted the obligation based on the Agreement on Debt Reprogramming between the Republic of Serbia and the Kuwait Investment Authority from US dollars into euros, at a significantly lower interest rate. Obligations based on the aforementioned reprogrammed loan, contracted in dollars at an interest rate of 1.5%, will be paid by the Republic of Serbia in euros at an interest rate of 0.393%. In March 2021, a new swap transaction was concluded by which the loan from the Export - Import Bank of China for the project to build the bypass around Belgrade on the E70/E75 highway, which had initially been contracted in Chinese yuan in 2018, was converted into euros with a negative interest rate. The said loan, on which a fixed interest rate of 2.50% per annum was paid in Chinese Yuan, was converted into Euros at a fixed negative interest rate of -0.07%. As the negative interest rate was contracted, the Republic of Serbia will have no interest charges in the first five years of the swap arrangement, which is valid until 2030, but will receive instead additional income from the banks with which the transaction was concluded. On November 24, 2021, another swap transaction, the fourth in a row, was carried out in which the obligations based on the loan taken from the Abu Dhabi Development Fund in 2016 and initially contracted in dirhams with payment in US dollars, were converted into euros. The debt and liabilities based on the mentioned loan, on which a fixed interest rate of 2.25% per annum had been paid, were then exchanged into euros at an annual interest rate of 0.96%.

During 2020, the issuance of “benchmark” bonds on the domestic market was continued. Bonds with maturities of 5.5 and 12.5 years were issued in RSD with a nominal value of RSD 100 billion each, the volumes of which were then increased to RSD 150 billion in 2021. On June 30, 2021, dinar benchmark bonds of the Republic of Serbia with maturities of 7, 10 and 12.5 years respectively, were included in J.P. Morgan GBI-EM Index. By being included in the mentioned index, a significant progress was made in strengthening the liquidity of the secondary market of government bonds and the arrival of new international foreign investment funds was ensured, which would result in greater competition and a further decrease in borrowing costs. In October 2021, Clearstream, the international central securities registry, which performs clearing and settlement operations (ICSD), opened a securities account in the domestic registry and through an intermediary - an authorized participant in the local market, enabled foreign investors to settle Serbian bonds in dinars (RSD).

In 2019, the Republic of Serbia made an early repurchase of previously issued government securities on the domestic market through regular auctions at which it bought out government bonds denominated in dinars with high coupon rates of 4.5% on three-year bonds and 10.0% on bonds with a maturity of seven years, in the total amount of RSD 35.1 billion. The same practice continued in 2020, when 10.2 billion RSD bonds with high coupon rates were repurchased early. During 2021, RSD 34.0 billion of government bonds issued in dinars with maturities of 3.7 and 12.5 years respectively were repurchased early.

Through the aforementioned auctions, the active management of public debt continued with the aim of replacing a debt with a shorter maturity and higher interest rates with a debt of a longer maturity and lower borrowing costs. At the same time, investors who actively invest in domestic securities were given the opportunity to extend the maturity of their investments and continue investing in the country, which is of great importance for the further development of the capital market and the issuance of government bonds in the future.

The currency risk was further reduced during the previous years. The share of public debt in local currency in the total public debt of the central level of government was only 2.6% at the end of 2008 and by the end of 2020 it grew to 30.5%, but due to borrowing during 2021 and the beginning of 2022 mainly on the foreign market because of more favourable conditions, there was a decline in the share down to 25.4% at the end of September 2022. The growth of the dinar debt in previous years was mainly contributed by the issuance of dinar government securities on the domestic securities market. During 2019 and 2020, the early redemption of expensive Eurobonds issued in 2011 and 2013 in US dollars took place, and during February 2020, the regular repayment of the dollar bonds issued in 2013 was effected. In December 2020, the first hedging transaction was concluded, in which Eurobonds issued in US dollars were immediately converted into euros. In January 2021, another hedging transaction was concluded by which liabilities in US dollars were converted into euros. Thanks to the transactions in December 2020 and February 2021, as well as due to regular repayments of the dollar debt, its share in the total public debt decreased from 33.9% at the end of 2016 to 12.5% at the end September 2022.

Borrowing costs have also been significantly reduced over the past years. The share of interest costs in GDP fell from 2.9% (central level of government) in 2015 to 1.7% in 2021.

At the end of September 2022, the general government debt level amounted to RSD 3,839.8 billion, i.e. 54.2% of GDP. Of that, RSD 3,614.8 billion related to direct liabilities, RSD 188.5 billion to indirect liabilities, while RSD 31.2 billion referred to the unguaranteed debt of local self-government units and RSD 5.3 billion to the unguaranteed debt of PE "Roads of Serbia" and the company LLC "Corridors of Serbia".

The share of the general government debt level in GDP, %

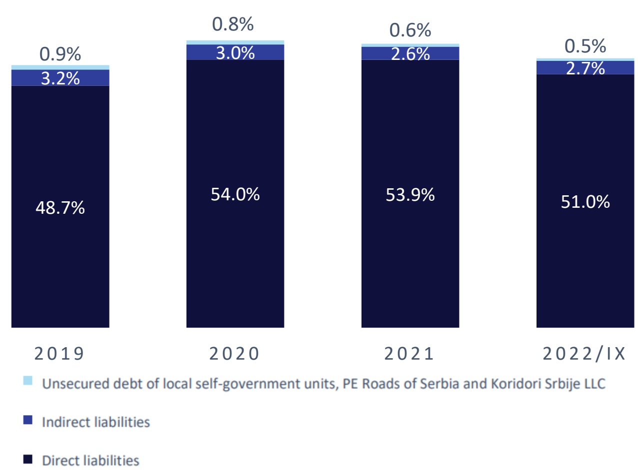


Table 21. General government debt level of the Republic of Serbia in the period from the end of 2019–September 30, 2022

	2019	2020	2021	2022/IX
Public debt (in billion dinars)	2,864.0	3,181.2	3,581.8	3,839.8
Public debt (in millions of euros)	24,354.9	27,055.8	30,461.8	32,730.1
Public debt (in millions of dollars)	27,296.9	33,254.3	34,464.5	32,118.1

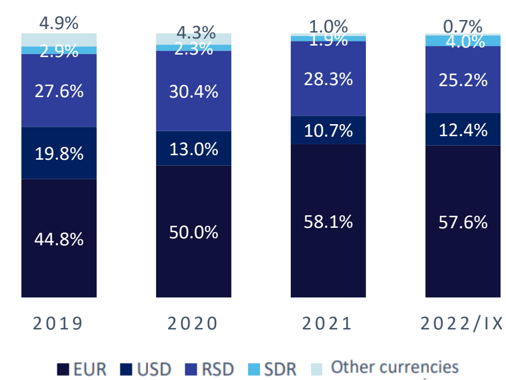
During 2021 and the first nine months of 2022, due to the need to finance measures to support the economy and citizens to combat the pandemic caused by the coronavirus COVID-19, there was a noticeable increase in the public debt of the central level of government in euros. Due to more favourable conditions for borrowing on the foreign market, Eurobonds in euros were issued twice. In addition, part of the debt in US dollars, Chinese yuan and UAE dirhams was converted into euros, due to the much smaller fluctuation of the exchange rate of the euro against the dinar, compared to the mentioned currencies, in order to reduce the currency risk. At the beginning of 2022, there was an increase in debt as per Special Drawing Rights, due to borrowing from the IMF on extremely favourable terms. During 2020 and 2021, the debt in dinars grew due to intensive borrowing in the domestic currency, in order to further stimulate the development of the domestic market, while in 2022 there has been a noticeable decrease, due to the regular repayment of due government bonds. The movement of the exchange rate of US Dollar to Serbian Dinar during 2022 has shown the full justification of the decision to reduce the dollar debt as much as possible and thus minimize the currency risk, as well as that the right moment was chosen to conclude the swap transactions. As a result of concluded swap transactions, and also with the aim of minimizing the currency risk, the debt in other currencies has been reduced significantly.

Table 22. Central government debt balance per original currencies in the period the end of 2019–30 September 2022, in millions

	2019	2020	2021	2022/IX
EUR	10,582.5	13,222.5	17,386.4	18,552.5
USD	5,397.3	4,323.9	3,694.6	3,980.7
RSD	781,250.4	957,952.2	1,010,176.5	965,483.3
CHF	110.5	90.3	73.7	34.2
Special Drawing Rights	570.4	522.7	475.0	1,003.4
Other currencies (in RSD)	128,958.8	127,674.8	27,304.8	28,225.8

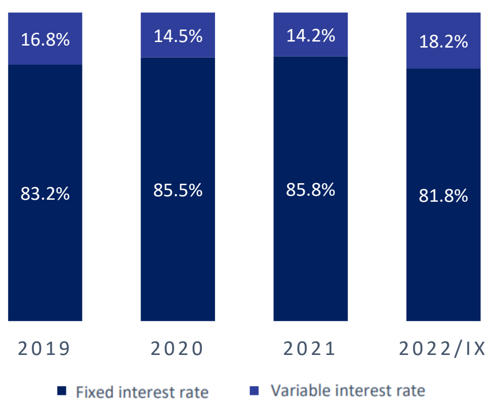
As per the data from September 30, 2022, the largest part of the general government debt of the Republic of Serbia is denominated in euros and amounts to 57.6%. Thereafter, the most prevalent are dinar with 25.2% and the US dollar with 12.4%. The remaining debt is denominated in Special Drawing Rights 4.1% and other currencies 0.7%. Owing to the continuous development of the domestic securities market and the gradual increase in the volume of issues in the domestic currency, there was a notable increase in the share of debt in the domestic currency in previous years, which rose from 16.4% at the end of 2011 to 30.4% in 2020, whereas during 2021 and in the first nine months of 2022 it declined.

Currency structure of the general government debt in the period from 2019 to September 30, 2022



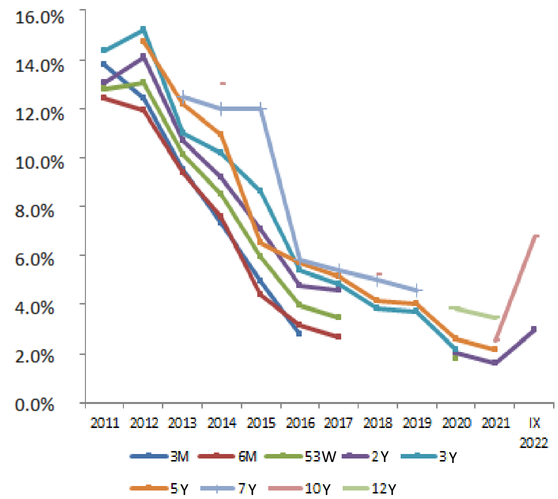
As of September 30, 2022, the largest part of the general government debt of the Republic of Serbia is with a fixed interest rate - 81.8%, while the rest of the debt refers to a variable interest rate - 18.2%. Among the variable interest rates, EURIBOR is the most prevalent with a share of 74.7%, followed by the variable interest rate for Special Drawing Rights 20.9%, BELIBOR 2.6% and LIBOR on the US dollar 1.3%, while the share of liabilities with other interest rates is 0.5%.

Interest rate structure of the government debt in the period from 2019 to September 30, 2022, %

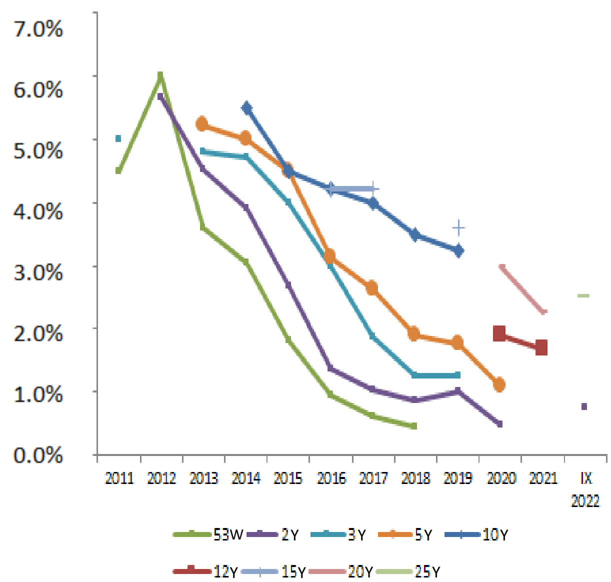


In the last few years, there has been a downward trend in borrowing costs, which is most pronounced in the case of government securities issued on the domestic market. The decline occurred thanks to the development of the capital market of government bonds, the growth of the country's credit rating, i.e. the reduction of the risk premium, the low inflation rate and the reduction of the key policy rate of the NBS. The weighted average interest rate on public debt fell from 5.7% at the end of 2014 to 2.56% at the end of September 2022. In the same period, an even more pronounced decline was observed in dinar government securities, where the average coupon rate decreased from 10.68% at the end of 2014 to 4.34% at the end of September 2022.

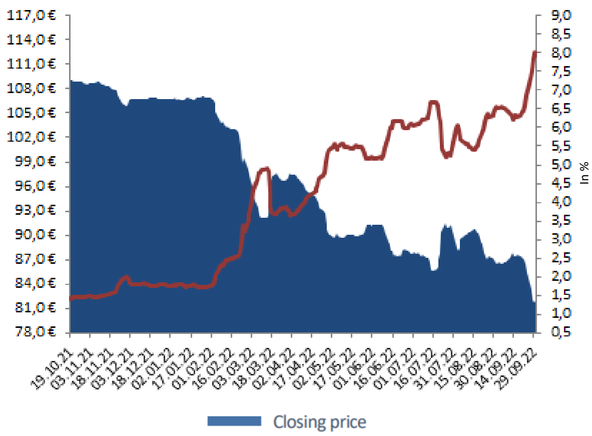
Review of trends in average effective interest rates on dinar government securities in the period 2011–September 30, 2022



Review of trends in average effective interest rates on euro-denominated government securities in the period 2011–September 30, 2022



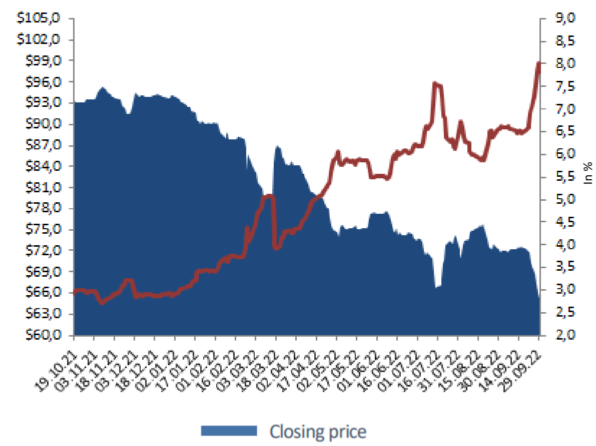
Overview of price and yield trends on Serbia Eurobond 2027



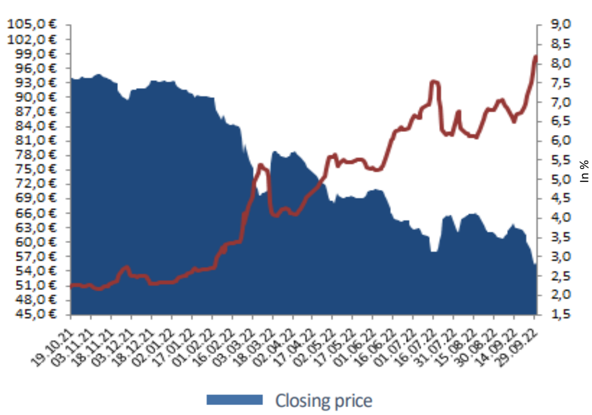
Overview of price and yield trends on Serbia Eurobond 2028

Overview of price and yield trends on Serbia Eurobond 2029

Overview of price and yield trends on Serbia Eurobond 2030



Overview of price and yield trends on Serbia Eurobond 2033



Overview of price and yield trends on Serbia Eurobond 2036

Table 23. Projections of interest and principal repayments until 2025 (billions of dinars)

	2022 p	2023 p	2024 p	2025 p
Principal*	425.0	612.0	645.0	504.0
Interest	113.1	143.3	178.2	180.9
Total	538.1	755.3	823.2	684.9
In relation to the public debt as of 30.9.2022	14.1%	19.9%	21.6%	18.0%

* including funds for buy-back operations

Table 24. Projections of interest and principal repayments until 2025 (%GDP)

	2022 p	2023 p	2024 p	2025 p
Principal	6.0%	7.6%	7.3%	5.3%
Interest	1.6%	1.8%	2.0%	1.9%
Total	7.6%	9.4%	9.4%	7.2%

Planned amounts for repayment of interest and principal, at the central government level, also include funds for buy-back operations, i.e. early debt repayment, in order to replace more expensive debt with a cheaper one, as well as insurance premiums on export loans.

Projection of the general government debt status in the period 2022-2025

Bearing in mind the projected primary result of the budget of the Republic of Serbia for the period 2022-2025, including the volume of withdrawal of credit funds for project financing by the budget beneficiaries, the effects of the exchange rate of Dinar to Euro and US Dollar, in the basic macroeconomic scenario, the state of central government debt should to be at the level of 53.0% of GDP at the end of 2025.

Table 25. Basic projection of general government debt balance by 2025

	2022 p	2023 p	2024 p	2025 p
Public debt (central government level), RSD billion	3,973.9	4,419.1	4,745.1	5,041.1
Central government debt, as % of GDP	56.1%	55.1%	54.1%	53.0%
Non-guaranteed debt of local self-government units*, as % of GDP	0.8%	1.0%	1.0%	1.0%
General government debt, as % of GDP	56.9%	56.1%	55.1%	54.0%

* and other government sectors

At the end of 2022, it is expected that the share of the general government debt in GDP will amount to 56.9%. In the following years, a decrease of ratio is expected, which in the baseline scenario should amount to 56.1% at the end of 2023, 55.1% at the end of 2024, and 54.0% at the end of 2025. In the given period, the implementation of large infrastructure projects is expected, which will be financed mainly from project loans, as well as their more intensive implementation compared to the previous period. This is exactly one of the points where a clear coordination of fiscal and development goals can be observed. Account is taken of the sustainability of public debt and the gradual slight decline of its share in GDP, with simultaneous use of new borrowing to improve infrastructural conditions leading to the growth of GDP, living standards and new investments. It is envisaged that the non-guaranteed debt of the local self-government units and other sectors of the state will be at a relatively stable level of around 1.0% of GDP in the coming period.

Public debt management principles

According to the Public Debt Law, the primary goal of Serbia's borrowing and public debt management is to ensure the funds necessary to finance budget expenditures regularly, under the most favourable conditions, with medium-term and long-term minimal financial costs and acceptable risk level. With this in mind, the Public Debt Management Strategy of the Republic of Serbia defines the following general goals and principles:

1) It is necessary to ensure the financing of the fiscal deficit and the regular servicing of obligations based on the public debt of the Republic of Serbia;

2) It is necessary to define an acceptable risk level that should be defined in terms of a targeted debt portfolio structure, including debt currency structure, interest rate structure, maturity structure and debt structure by the types of instruments;

3) It is necessary to uphold the development of the market of government securities issued both in the domestic and international market, so as to help the reducing of the medium-term and long-term borrowing costs;

4) The borrowing process should be transparent and predictable.

The Public Debt Management Strategy is consistent with the general medium-term macroeconomic and fiscal framework.

The Public Debt Management Strategy shall in the following medium-term period be based on the financing of the deficit and the principal of budget debt of the Republic of Serbia, mainly through the issuance of government securities on the domestic and international capital markets in order to fulfil the regular servicing of obligations. Flexibility will be reflected in the choice of the market on which borrowing will take place, borrowing currency and financing instruments. The choice of financing structure will take into account the current state and development trend of the domestic and international financial market (interest rate level, risk premiums, yield curve, reference foreign currency exchange rates) and an acceptable level of financial risks exposure.

The objective is financing through the issue of mainly dinar-denominated securities on the domestic market in the following long-term period. Part of the financing may also be secured on the international financial market in the medium term. The establishment of the GMTN program in 2020 enabled flexibility in the choice of financing and faster access to financing on the international market.

Borrowing in a foreign currency, such as, e.g. in US dollars, entails the foreign currency risk, due to the changes of the exchange rate EUR-USD, so for that reason the option of hedging will be used.

The public debt management policy must take into account the long-term perspective, but the decision on the financing of budget expenditures must be made annually. The decision on annual borrowing is made within the Budget Law for a specific fiscal year. Depending on the basic fiscal aggregate changes, the correction of the borrowing plan is possible during a fiscal year.

Financial risks and financial risk management measures

The impact of financial and fiscal risks may cause a greater public debt growth than predicted by the baseline scenario. The risks that are present and may cause the debt and public debt servicing costs to increase are: refinancing risks, foreign currency exchange risks, market risk (interest rates risk, inflation risk), liquidity risk, credit and operational risks, and risks related to the servicing costs (debt structure, concentration of obligations).

In order to reduce the exposure to financial risks, the following measures should be taken:

1. Refinancing risk

- Greater share of medium-term and long-term dinar-denominated financial instruments on the domestic financial market;
- Even distribution of obligations based on public debt on an annual basis in the following long-term period:
- Extending the average maturity of debt issued in securities;

2. Foreign currency risk

- An effort to reduce the share of debt denominated in foreign currency while taking into account the costs of new debt (costs of debt dinarization);
- Utilization of financial derivatives in order to limit the effects of changes in exchange rates of reference currencies;
- Striving to have external debt in EUR mainly and to use the US dollar-denominated debt only if financing in dollars in the international market is

less expensive, with the additional use of financial derivatives for limiting the risk;

3. Market risk (interest rate risk, inflation risk)

- striving to extend the average maturity of domestic debt in dinars;
- striving to ensure that risk based on interest rates on external debt does not jeopardize the long-term goal of minimizing public debt cost.

4. Liquidity risk

- continual maintenance of the level of cash assets in the accounts of the Republic of Serbia at a level that enables unhindered financing of obligations for a minimum of four months and at a level that enables the absorption of possible smaller inflows based on borrowing compared to the plan;
- adequate management of free cash assets on the accounts of the Republic of Serbia in accordance with the principles of asset-liability management and in accordance with possibilities;

5. Credit and operational risks

- conducting transactions with financial derivatives only with financial institutions that have a high credit rating;
- use of financial instruments that limit credit risk;
- providing guarantees and approving new debt to local self-government units only if there is an adequate analysis of the relatively low probability that the guarantee will be realized or that the local self-government unit will become insolvent in the medium term;
- introduction of adequate control in all business activities in the Public Debt Administration and improvement of employees' knowledge.

6. Risks related to the distribution of servicing costs

- adequate annual borrowing planning and even distribution in subsequent years and during the fiscal year, in order to avoid the risk of a large concentration of refinancing liabilities;
- avoiding the concentration of liabilities based on public debt on a monthly basis, which could not be amortized by free cash assets on the accounts of the Republic of Serbia.

Thanks to the implementation of defined measures in the past few years, there has been a significant improvement in the structure of public debt in almost all segments – improved currency structure and interest rate structure, significantly increased maturity, reduced borrowing costs, reduced guaranteed public debt, more even distribution of liabilities, maintaining an adequate level of liquidity. For example, at the central government level, the share of public debt in dinars increased from 20.9% at the end of 2016 to 25.4% at the end of September 2022. In the same time period, the share of public debt in US dollars decreased from 33.9% to 12.5%. The share of debt with a fixed interest rate increased from 73.2% to 82.5% in the period from 2013 to September 2022. In the same period, guaranteed debt fell from EUR 2.8 billion to EUR 1.6 billion and the average weighted interest rate on public debt fell from 5.64% to 2.56%.

Analyses used to create the Public Debt Management Strategy

Public Debt Management Strategy was formulated using a quantitative approach in the analysis of costs and risks that affect public debt management.

Having in mind the macroeconomic environment and market conditions, alternative sources of financing were considered in parallel.

For the purpose of the analysis, instruments available on the domestic and international financial markets were used.

Sources of financing denominated in foreign currency:

- Loans from foreign governments and international financial institutions, as well as from domestic commercial banks - presented as concessional instruments denominated in euros or US dollars, with a fixed or variable interest rate;
- Domestic debt denominated in euros expressed through two instruments - treasury bills and government bonds issued on the domestic financial market and the foreign market;
- Eurobond – issued in euros or US dollars on the international financial market.

Sources of financing denominated in domestic currency:

- All government securities denominated in dinars are grouped into treasury bills (with maturities of up to 53 weeks) and government bonds (with maturities of two years and more).

Future market interest rates and analysis scenario

After selecting the appropriate composition of financing sources (selected and comparative financing strategies), a cost-risk analysis is performed starting from the base case (most likely) scenario, followed by stress testing for additional types of scenarios - shocks, to obtain an overview of cost effects of the considered strategies.

The baseline scenario is based on the most probable market conditions for three groups of market variables: exchange rate, international market interest rates, and domestic market interest rates. The approach for dinar and euro interest rates is based on the rates realized during the previous and current year.

After defining the baseline scenario, additional types of scenarios - shocks - were selected for the purpose of stress testing:

- Depreciation of the dinar in relation to all currencies of 15% in 2024. In this scenario, the ratio of the euro to the US dollar would remain stable, while only the dinar would depreciate against both currencies;
- Increase of interest rates on the domestic and international market by about 2 percentage points;
- Increase of interest rates on the international market up to 3 percentage points, and on the domestic market up to 4 percentage points;
- Combined shock related to the depreciation of the dinar against the dollar by 15% in 2024 and the growth of interest rates by about 2 percentage points.

Alternative borrowing strategies for the period 2023–2025

Based on the World Bank model *Medium Term Debt Strategy Model* - MTDS, the following alternative borrowing strategies were examined:

Baseline strategy (S1): under this strategy total financing needs are mostly met by using foreign currency financing sources in 2023 – 81%, 2024 – 82.5% and 2025 - 73.5%. During 2023 and 2024, the budget financing foresees financing mainly in foreign currency (71-72%) through the issuance of government bonds on the foreign market, the issue of

Eurobonds and the use of funds from the arrangement with the International Monetary Fund, while the rest should be provided by issuing government securities in the domestic currency. In 2025, it is planned to establish a balanced financing of budget needs from domestic and foreign currencies through the issuance of government securities on the domestic market and the issuance of Eurobonds on the foreign market. Project financing, as in previous years, is mostly provided by loans denominated in foreign currency from foreign creditors.

Strategy (S2): compared to S1 strategy, total needs for financing are met by issuing USD-denominated Eurobonds, with a maturity of 10 and 15 years.

Strategy (S3): as compared to S1 strategy, under this strategy financing is fully based on the issue of euro denominated Eurobonds with maturities of ten and fifteen years.

Additional Dinarization Strategy (S4): under this strategy financing is fully based on the issue of dinar denominated securities with longer maturity.

Comparing the alternative strategies

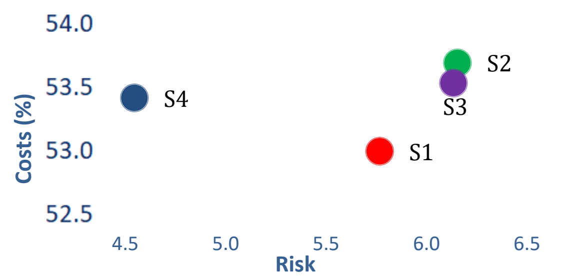
To compare alternative borrowing strategies, two cost measures were applied: the ratio of public debt to GDP and nominal interest as a percentage of GDP. The former is the status indicator, and the latter is the flow indicator. For the purpose of comparison, attention is focused on the results of the strategies examined, at the end of 2025.

Based on the chart, the costs associated with each of the considered strategies are clearly seen. The cost of alternative strategies in the baseline macroeconomic scenario is shown on the vertical axis of the cost chart, while the horizontal axis shows the potential cost of a specific borrowing strategy (stress test result).

In the baseline macroeconomic scenario at the end of 2025, as measured by the share of debt in GDP, strategies with financing entirely from market instruments S2, S3 and S4 are more expensive than strategy S1, which combines financing from market and concessional instruments. On the other hand, in case of deviation from baseline macroeconomic scenario the biggest risk to the debt to-GDP ratio is related to changes in the exchange rate. From the perspective of the impact of exchange rate shocks on the debt-to GDP-ratio, strategy S4 has the best position because the entire financing is effected in dinars, while strategies S2 and S3 have a greater exposure to exchange rate risk because they are entirely based on sources of financing in foreign currency. In terms of exposure to exchange rate risk Strategy S1 has a slightly more favourable position compared to strategies S2 and S3, due to the fact that it combines financing in domestic and foreign currency.

In terms of the share of interest in GDP, the S2 strategy is the most expensive because dollar instruments have the highest rates, being followed by strategies S4 and S3, while the S1 strategy is the most favourable because it combines interest rates for market and concessional instruments. The stress test analysis showed that the greatest risk for changing the ratio of interest to GDP, if the baseline scenario is altered, comes from the shock of changes in interest rates, which is greater on the domestic market than on the international one, which is why strategy S4 features the greatest risk of changes in interest-to-GDP ratio. The strategies S2 and S3 follow, consisting of market instruments that are also subject to the shock of changes in interest rates in the international market, while in S1 such risk is diminished due to the presence of fixed-rate concessional instruments.

Debt-to-GDP ratio at the end of 2025



Interest-to-GDP ratio at the end of 2025

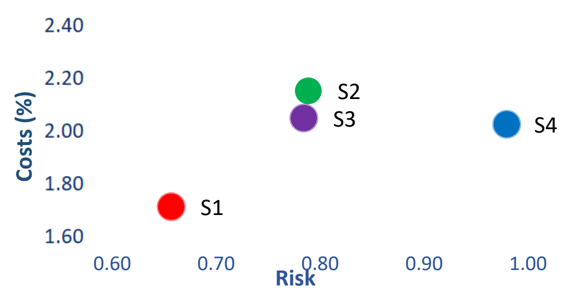


Table 26. Public debt-to-GDP ratio at the end of 2025

Scenarios	S1	S2	S3	S4
Baseline scenario	53.0	53.7	53.5	53.4
Foreign currency exchange rate shock (15% of all the currencies)	58.8	59.9	59.7	58.0
Interest shock (scenario 1)	53.7	54.6	54.4	54.3
Interest shock (scenario 2)	54.1	55.0	54.8	55.0
Combined shock (15% of USD and interest shock 1)	55.3	57.3	55.5	55.4
Maximum risk	5.8	6.2	6.1	4.5

Table 27. Payments based on interest-to-GDP ratio at the end of 2025

Scenarios	S1	S2	S3	S4
Baseline scenario	1.7	2.2	2.1	2.0
Foreign currency exchange rate shock (15% of all the currencies)	1.9	2.4	2.3	2.2
Interest shock (scenario 1)	2.1	2.7	2.6	2.5
Interest shock (scenario 2)	2.4	2.9	2.8	3.0
Combined shock (15% of USD and interest shock 1)	2.2	2.9	2.6	2.6
Maximum risk	0.7	0.8	0.8	1.0

The following table shows trends of the basic public debt parameters in each of the four strategies considered, which reflects the above mentioned characteristics of each of the strategies:

Table 28. Alternative strategies risk indicators at the end of 2025

		S1	S2	S3	S4
Nominal debt (% GDP)		**53.0**	**53.7**	**53.5**	**53.4**
Applied interest rate (%)		**3.5**	**4.4**	**4.2**	**4.2**
Refinancing risk	ATM[14] external portfolio (in years)	**8.3**	**10.0**	**10.3**	**8.4**
	ATM domestic portfolio (in years)	**3.6**	**3.7**	**3.7**	**4.9**
	ATM total portfolio (in years)	**7.3**	**9.5**	**9.8**	**6.4**
Interest rate risk	ATR[15] (in years)	**5.0**	**7.8**	**8.1**	**4.7**
	Refixing (% of total debt)	**30.9**	**15.2**	**15.3**	**18.9**
	Fixed rates debt (% of total debt)	**77.6**	**90.1**	**90.0**	**90.0**
Foreign currency exchange rate risk	Foreign currency debt (% of total debt)	**81.4**	**91.6**	**91.6**	**42.7**

Stress test analysis

The fiscal rule, defined by the Law on Budget System, prescribes that the general government public debt may not exceed 45% of GDP. In case the amount of debt exceeds that level, the Government is obliged to adopt a program for reducing public debt in relation to GDP, i.e. to return the debt into the framework prescribed by the law.

At the end of 2021, the central government debt reached 56.5% of GDP, and the general government debt reached 57.1% of GDP. At the end of September 2022, the public debt-to-GDP ratio of central government and general government were 53.7% of GDP and 54.2% of GDP, respectively. By the end of 2022, a slight increase in the ratio is expected, to about 56.1% of GDP at the central level, or 56.9% of GDP P at the general government level, primarily due to the realization of large infrastructure projects that are financed from project loans and the provision of funds needed to service liabilities in 2023. Due to the high share of foreign currency-denominated debt (74.6%), it is evident that foreign exchange risk will determine changes in the public debt-to-GDP ratio in the coming period, and it will significantly influence the success of fiscal policy measures designed to consolidate public finances and reduce public debt share in GDP.

Based on the planned macroeconomic framework, and in the absence of the impact of possible risks, central, government public debt in 2025 should be at the level of 53.0% of GDP.

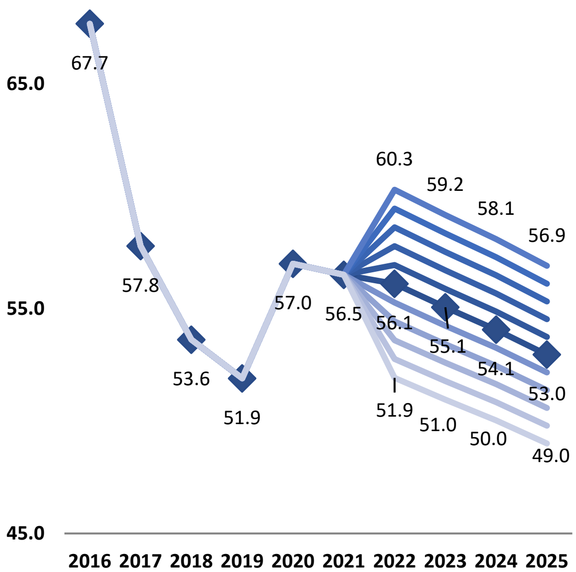
The main factors influencing the stabilization of public debt-to-GDP ratios include GDP growth, positive primary result, dinar exchange rate against foreign currencies and interest rate levels.

Table 29. Contributions from the key macroeconomic variables to the change in the central government public debt-to-GDP ratio, in %

	2020	2021	2022 p	2023 p	2024 p	2025 p
Central government debt-to-GDP	57.0	56.5	56.1	55.1	54.1	53.0
Changes compared to the last year, in% of GDP	5.1	-0.5	-0.4	-1.0	-1.0	-1.1
Contribution of primary fiscal result	6.4	2.9	2.3	1.2	0.1	-0.5
Contribution of interests	2.0	1.7	1.6	1.8	2.0	1.9
Contribution of nominal GDP growth	-0.8	-7.0	-6.5	-6.6	-4.7	-4.2
Contribution of other factors	-2.5	1.9	2.1	2.6	1.5	1.7

[14] ATM (*Average Time to Maturity*) – abbreviation for average maturity time.
[15] ATR (*Average Time to Refixing*) – abbreviation for average time until interest rates change.

Impact of changes in the RSD exchange rate against the basket of currencies from the central government public debt portfolio on the change in public debt-to-GDP ratio



The chart presents the movement of central government public debt–to GDP ratio depending on the change in the dinar exchange rate against a certain basket of currencies. The basic projection is shown with alternative scenarios depending on the appreciation or depreciation of the dinar exchange rate in the range from 10% appreciation to 10% depreciation of the dinar in relation to the currency basket. Applying the above scenarios, it can be seen that the ratio for 2025 would range from 49.0% to 56.9%, while under the baseline scenario it would be at the level of 53.0%.

The main risks for the realization of the Strategy, in addition to the above factors that have been quantified, include the stability of the macroeconomic situation in the Republic of Serbia, the need for additional borrowings to regulate debts at other levels of government, public and financial sector, and the activation of guarantees.

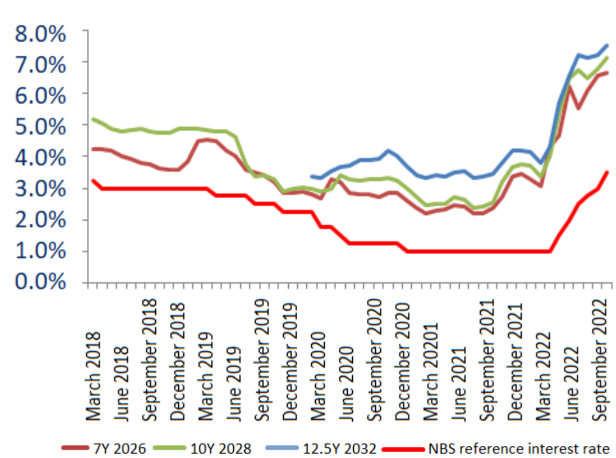
It is important to note that the reduction of public debt in relation to GDP will be enhanced by more adequate control over the issuance of guarantees and improvement of the process of prioritization of investment projects, which are financed from credit lines of multilateral and bilateral creditors.

Long term strategic framework of public debt management

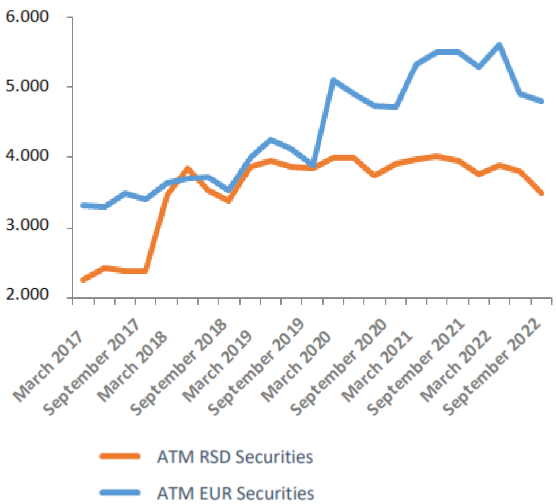
The main strategic goals that need to be pursued in the coming long-term period, in order to minimize the risks of increasing indebtedness and the cost of servicing public debt, include the following:

- the share of dinar-denominated debt is at least 30% of the total public debt in the medium term;
- the share of euro-denominated debt in public debt is at least 65% of foreign currency debt, including future borrowings and transactions;
- the share of debt with a variable interest rate is below 15% in the medium term;
- the average time to refixing (ATR) is maintained at a level of at least 5.0 years, in accordance with the above mentioned measure of gradual decrease of the share of debt with variable interest rates;
- the weighted average interest rate (WAIR) for public debt in local currency does not exceed 6.00%;
- the share of short-term debt (the maturity of which is up to one year) is up to 15% of the total public debt;
- the average maturity time (ATM) of internal debt is at least 5.0 years in the medium term;
- the average maturity time (ATM) of external debt is maintained at the level of 8.0 ± 0.5 years within the same time horizon.

Yield to maturity trends of dinar "benchmark" issues included in GBI-EM Global Diversified Index in the secondary market trading



Average time to maturity (ATM) of government securities issued on the domestic financial market in the period 1 January 2017 - 30 September 2022



Improvement measures for dinar-denominated securities market in the period 2023–2025

The government securities market, in the period from2012 to March 2021, is featured by the fulfilment of the set strategic goals, primarily in terms of financing instruments, as well as in the development and maintenance of the stability of the diversified investor base. The transition from short-term financing sources featuring in the period up to 2010, to medium-term and long-term financing instruments, with a constant reduction of borrowing costs, reduces refinancing risk, as one of the primary risks in the public debt management process. At the end of 2013, the share of long-term dinar-denominated instruments with an original maturity of three years or more amounted to 38.3% in the dinar-denominated securities balance, while at the end of September 2022 it amounted to 90.6%.

Transparent work and reports, as well as the presence on the international capital market, help the non-residents to be informed and therefore interested in investing their capital into debt instruments, primarily into long-term government securities, thereby enabling the growth of a stable investor base. Due to successful realization of benchmark issues during 2014 and 2015, the same practice was continued in 2016. In February and July 2016 there was an issue of a three-year and seven-year benchmark bonds in the amount of RSD 110 billion each. In April 2017, a three-year "benchmark" bond was issued in the amount of RSD 110.0 billion. In January and February 2018 there was an issue of a five-year and ten-year "benchmark" bonds in the amount of RSD 110 billion each. In January 2019 there was an issue of a three-year and seven-year benchmark bonds in the amount of RSD 100.0 and 150.0 billion, respectively. In January and February 2020, five-and-a-half-year and twelve-and-a-half-year bonds with a semi-annual coupon were issued for the first time. In 2021, amendments to the Regulation on General Conditions for Issuance and Sale of Government Securities on the Primary Market ("Official Gazette of RS", No. 100/2014, 78/2017, 66/2018, 78/2018 and 140/2020), made it possible to increase the volume of previously issued bonds, so with the five-and-a-half-year and twelve-and-a-half-year bonds, the volume of the issue was increased by RSD 50 billion each. Also, an increase in the volume of the issue, in the amount of RSD 10 billion, was effected for a ten-year bond originally issued on 6 February 2018.

These issues considerably extended the scope of secondary trading in these instruments, which also considerably contributed to the drop in effective yield rates in the re-opening of the stated issues. The share of foreign investors in dinar-denominated securities at the end of September 2022 amounted to 14.7%.

On June 30, 2021, three dinar benchmark bonds were included in J.P. Morgan Emerging Markets Government Bond Index (GBI-EM Global Diversified Index), maturing on 11 January 2026 (RSMFRSD89592), 6 February 2028 (RSMFRSD55940), and 20 August 2032 (RSMFRSD86176).

In 2022, one-year and two-year dinar bonds were issued, whereas ten-year dinar bonds increased the issue volume by RSD 25 billion. As for the euro-denominated securities, the following were issued: two-year, two-and-a-half-year bonds (with a semi-annual coupon) and twenty-five-year bonds.

In the period covered by this Strategy, the efficiency of the primary market is expected to improve through access to the Euroclear platform and through the concept of primary dealers, as a mechanism for selling government securities that directly, in the long run, contributes to reducing borrowing costs and refinancing risk. The introduction of the system of selling government securities on the domestic financial market through primary dealers will provide a good basis for improving the market efficiency of the secondary market of government securities. With the development of the secondary market, over time, the concept of market efficiency will be established in the process of government securities evaluation. The introduction of the "benchmark" bond issues has had a positive effect on the volume and continuity of secondary trading, as well as on the improvement of market efficiency in the process of selling government securities on the primary market.

The fiscal result, the expected inflation rate and the exchange rate should be highlighted as the key factors that influence the yield curve of government securities. It is important to single out a special group of factors consisting of the macroeconomic trends and expectations, as well as changes in the international financial market, which are reflected in the country's risk premium.

At the end of 2012, the average maturity of dinar denominated securities was 394 days (1.1 years), at the end of 2013 it was 469 days (1.3 years), at the end of 2014 it was 645 days (1.8 years), at the end of 2015, 749 days (2.1 years), at the end of 2016, 789 days (2.2 years), at the end of 2017, 864 days (2.4 years), at the end of 2018, 1,188 days (3.3 years), at the end of 2019 1,403 days (3.8 years), at the end of 2020 1,429 days (3.9 years), at the end of 2021 1,377 days (3.8 years), and at the end of September 2022, 1,273 days (3.5 years).

The development of the domestic securities market has been supported by the following measures of the Republic of Serbia:

- Inclusion of bonds of the Republic of Serbia in J.P. Morgan global index of government bonds in local currencies of developing countries (GBI-EM Global Diversified Index), will significantly increase the investor base and further enhance secondary trading, which will contribute to further reduction of borrowing costs through issues of dinar-denominated government securities;
- In order to create the largest possible investor base and develop the secondary market for securities issued on the domestic market, equal tax treatment of domestic and foreign investors was created at the end of 2011, and in the coming period efforts will be made to remove all possible obstacles to free flow of capital;
- Activities have been undertaken to facilitate the settlement of government securities on the foreign market. Amendments to the Public Debt Law from December 2019 enabled the clearing and settlement of government securities issued on the domestic market, in addition to the Central Register, to be performed by another foreign legal entity that performs clearing and settlement operations;
- During 2022, the harmonization of legal regulations and IT infrastructure has been actively pursued in order to establish an international link (i-Link) between the Central Register, Securities Depository and Clearing and Euroclear Bank, so as to facilitate the settlement transactions of the government benchmark bonds through the Euroclear provider of post trade transactions at the beginning of 2023. The main advantages of joining the Euroclear system are the expansion of the investor base through the easier availability of domestic securities to foreign investors, which further reduces costs in the reduced chain of participants in the purchase of securities, and thus a drop in yields on securities and lower borrowing costs for the issuer. Also, the liquidity of the secondary market increase by expanding the investor base.

IV. FINAL PROVISIONS

Appendix 1 – Projection of the Basic Macroeconomic Indicators and Appendix 2 – Fiscal Framework of the General Government in 2023, printed herewith, constitute an integral part of this revised Fiscal Strategy.

This revised Fiscal Strategy shall be submitted to the National Assembly Committee in charge of finances, republic budget and the control of public funds, as well as to the Ministry of Finance.

This revised Fiscal Strategy shall be published in the "Official Gazette of the Republic of Serbia" and on the website of the Government and the Ministry of Finance.

05 Number: 400-9216/2022
In Belgrade, 17 November 2022

G O V E R N M E N T

THE FIRST VICE-PRESIDENT OF THE GOVERNMENT

Sgd. Ivica Dačić

Appendix 1 – Projection of the Basic Macroeconomic Indicators

	2022	2023	2024	2025
GDP real growth rate, %	2.5	2.5	3.5	4.0
GDP at current market prices (in billion RSD)	7,082.5	8,025.1	8,776.3	9,519.4
Source of growth: percentage changes at constant prices				
Private consumption	3.9	2.5	2.9	3.6
Government consumption	0.4	-2.0	0.8	0.8
Gross fixed capital formation	0.0	2.4	5.2	5.8
Exports of goods and services	12.3	4.9	8.8	10.6
Imports of goods and services	12.8	4.0	6.8	8.8
Contribution to GDP growth, percentage points				
Domestic demand	4.2	2.4	3.1	3.8
Private consumption	2.7	1.8	2.0	2.5
Government consumption	0.1	-0.3	0.1	0.1
Gross fixed capital formation	0.0	0.6	1.2	1.4
Change in inventories	1.5	0.3	-0.3	-0.2
Net export of goods and services	-1.7	0.1	0.5	0.3
GVA growth by sectors and net taxes, %				
Agriculture	-8.0	6.9	0.9	0.0
Industry	1.3	1.1	3.6	5.4
Construction	-8.7	0.9	5.2	5.9
Services	4.8	2.6	3.8	4.0
Net taxes	4.6	3.0	3.0	3.0
Contribution to GDP growth, percentage points				
Agriculture	-0.5	0.4	0.1	0.0
Industry	0.3	0.2	0.7	1.1
Construction	-0.5	0.0	0.3	0.3
Services	2.4	1.3	1.9	2.0
Net taxes	0.8	0.5	0.5	0.5
Price trends, %				
GDP deflator	10.2	10.6	5.6	4.3
Consumer prices (annual average)	11.6	11.1	5.0	3.5
External sector trends, % GDP				
Balance of goods and services	-12.2	-10.9	-9.4	-8.4
Current account balance	-9.0	-8.5	-6.7	-6.0
Fiscal indicators, % GDP				
General government fiscal result	-3.8	-3.3	-2.2	-1.4
Consolidated revenues	43.0	40.8	40.3	39.6
Consolidated expenditures	46.8	44.1	42.5	41.0
Gross debt of the general government sector	56.9	56.1	55.1	54.0

Appendix 2 – Fiscal Framework of the General Government in 2023

	General government*	Republic budget	Local selfgovernment units	Cities and municipalities	AP Vojvodina	PE “Roads of Serbia” and “Koridori Srbije” LLC.	Compulsory Social Insurance Fund	Pension& Disability Insurance Fund	National Health Insurance Fund	National Employment Service	Soc. Insurance Fund for Military Personnel
	1=2+3+6+7	2	3=4+5	4	5	6	7=8+9+10+11	8	9	10	11
Public revenues	**3,283.4**	**1,793.6**	**423.9**	**382.7**	**41.2**	**43.7**	**1,022.2**	**699.1**	**296.4**	**22.7**	**4.0**
Current revenues	3,230.4	1,743.1	421.9	380.7	41.2	43.7	1,021.7	699.1	296.4	22.2	4.0
Tax revenues	2,936.1	1,592.8	334.6	300.1	34.5		1,008.7	698.0	286.4	21.0	3.3
Personal income tax	325.3	107.8	217.4	206.8	10.7						
Social contributions	1,008.7						1,008.7	698.0	286.4	21.0	3.3
Corporate income tax	212.2	188.4	23.8		23.8						
VAT	865.0	865.0									
Excises	332.1	332.1									
Customs	86.0	86.0									
Other tax revenues	106.8	13.5	93.3	93.3							
Non-tax revenues	294.3	150.3	87.3	80.6	6.7	43.7	13.0	1.1	10.0	1.2	0.7
Donations	53.0	50.5	2.0	2.0			0.5			0.5	
Public expenditures	**3,547.4**	**1,637.0**	**551.2**	**460.7**	**90.5**	**62.4**	**1,296.8**	**812.1**	**454.1**	**23.0**	**7.6**
Current expenditures	2,864.8	1,076.4	441.7	357.8	83.9	53.1	1,293.5	811.4	452.1	22.6	7.4
Expenditures for employees	674.5	350.7	117.1	74.8	42.4	3.5	203.3	3.7	197.5	2.0	
Contributions paid by employers	99.3	52.3	17.9	10.3	7.6	0.5	28.5	0.7	27.4	0.4	
Purchase of goods and services	575.9	149.3	165.0	159.1	5.9	45.7	215.9	2.6	207.4	1.1	4.8
Interest repayment	145.9	143.5	2.3	2.0	0.3	0.1					
Subsidies	213.9	168.1	45.8	31.7	14.1						
Social grants and transfers	1,042.0	147.4	52.4	52.2	0.3		842.2	803.3	17.8	18.6	2.5
Of which pensions	770.0						770.0	770.0			
Other current expenditures	113.3	65.1	41.2	27.8	13.4	3.4	3.7	1.1	2.0	0.5	0.1
Capital expenditures	540.8	418.9	109.4	102.9	6.5	9.2	3.2	0.7	2.0	0.4	0.1
Net lending	116.3	116.2									
Activated guarantees	25.5	25.5									
Fiscal result excl. transfers	**-264.0**	**156.6**	**-127.3**	**-78.0**	**-49.3**	**-18.6**	**-274.6**	**-113.0**	**-157.7**	**-0.3**	**-3.5**
Transfers from other levels of government	531.8	7.4	142.4	85.4	57.0	18.7	363.4	193.1	161.8	5.0	3.5
Republic budget	435.2	7.4	134.7	77.7	57.0	18.7	274.6	185.7	83.4	5.0	0.5
Cities and municipalities											
AP Vojvodina	7.7		7.7	7.7							
Pension & Disability Insurance Fund	80.1						80.1		77.0		3.0
National Health Insurance Fund	4.1						4.1	4.1			
National Employment Service	4.7						4.7	3.3	1.4		
Social Insurance Fund for Military Personnel											
Other levels											
Transfers to other levels of government	531.8	427.9	15.1	7.4	7.7	0.0	88.9	80.1	4.1	4.7	
Republic budget	7.4		7.4	7.4							
Cities and municipalities	85.4	77.7	7.7		7.7						
AP Vojvodina	57.0	57.0									
Pension & Disability Insurance Fund	193.1	185.7					7.4	0.0	4.1	3.3	
National Health Insurance Fund	161.8	83.4					78.4	77.0		1.4	
National Employment Service	5.0	5.0									
Social Insurance Fund for Military Personnel	3.5	0.5					3.0	3.0			
Other levels	18.7	18.7									
Net transfers to other levels of government	0.0	-420.5	127.3	78.1	49.3	18.7	274.6	113.0	157.7	0.3	3.5
Fiscal result	**-264.0**	**-264.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

The table shows the approximate amount of revenues and expenditures in 2023, which is based more on the statistical methodology of public finance accounts than on accounting. Since changes in the amount and structure of certain categories may occur during the budget process, these amounts are not legally binding.

* The budget is presented without a part of own revenues of indirect budget beneficiaries and expenditures financed from them, which are not included in the information system of budget execution.