

Government  
of the Republic of Serbia

---

# FISCAL STRATEGY

FOR 2021 WITH PROJECTIONS  
FOR 2022 AND 2023

---



## CONTENTS

<b>I. MACROECONOMIC FRAMEWORK FOR THE PERIOD 2021 - 2023 .....</b>	<b>1</b>
1. General framework and main economic policy objectives and guidelines .....	1
2. Estimates of the international economic environment .....	3
3. Current macroeconomic developments in the Republic of Serbia and prospects for the period 2021–2023.....	9
4. Risks involved with achieving the projection of GDP trends in the Republic of Serbia in the period 2021–2023 .....	28
<b>II. FISCAL FRAMEWORK FOR THE PERIOD FROM 2021 TO 2023 .....</b>	<b>30</b>
1. Medium-term goals of fiscal policy .....	30
2. Fiscal trends in 2019 .....	31
3. Current fiscal trends and the outlook for 2020 .....	32
4. Fiscal projections for the period 2021-2023 .....	42
5. Fiscal risks.....	53
6. Cyclically Adjusted and Structural Fiscal Balance .....	67
7. Debt reduction program.....	70
<b>III. PUBLIC DEBT MANAGEMENT STRATEGY FOR THE PERIOD 2021 TO 2023 .....</b>	<b>73</b>
<b>IV. FINAL PROVISIONS .....</b>	<b>87</b>
<b>Appendix 1 – Projection of the Basic Macroeconomic Indicators .....</b>	<b>88</b>
<b>Appendix 2 – Fiscal framework of the general government in 2021 .....</b>	<b>89</b>
<b>Appendix 3 – Statement on the Fiscal Council Assessment.....</b>	<b>90</b>

Pursuant to Article 27v paragraph 1 and Article 31 paragraph 1 item 1) sub-item. (13) and (14) of the Budget System Law “Official Gazette of RS”, No. 54/09, 73/10, 101/10, 101/11, 93/12, 62/13, 63/13-correction, 108 / 13, 142/14, 68/15-state law, 103/15, 99/16, 113/17, 95/18, 31/19 and 72/19),

The Government hereby adopts

## **FISCAL STRATEGY FOR 2021 WITH PROJECTIONS FOR 2022 AND 2023**

### **I. MACROECONOMIC FRAMEWORK FOR THE PERIOD 2021 - 2023**

#### **1. General framework and main economic policy objectives and guidelines**

**In 2020, the world faced the severe economic consequences of the global health crisis caused by the coronavirus pandemic.** Since March 2020, when the first case of the virus was confirmed in the Republic of Serbia, epidemiological measures of varying degrees of restriction have been in force. From complete “lockdown” in the first month and a half of the pandemic, to the relatively normal functioning of the economy in compliance with preventive measures in order to slow down the spread of the pandemic.

**The Republic of Serbia responded in a timely manner to the challenges posed to the economic but primarily fiscal policy by the public health crisis.** The first and most important task of the state treasury was sufficient and unhindered financing of the fight to preserve the health and lives of the people. The health system that is on the first line of defence has all the necessary support through unhindered financing and providing the necessary additional funds. Additional financing has been provided for the purchase of consumables, medical equipment, etc. The construction of two completely new COVID hospitals has begun in order to provide the necessary capacity for patients whose condition requires hospital treatment.

**The main objectives set by the adopted Programme of Economic Measures to Support the Serbian Economy have been met. Economic capacities have been preserved and support has been provided in maintaining the liquidity of the economy during these extraordinary circumstances.** It was the second, none the less important task of public

finances. Thanks to the macroeconomic and fiscal stability achieved in the previous period, the Republic of Serbia had enough space to help the economy with monetary and fiscal measures to mitigate the negative effects of the coronavirus pandemic. Fiscal policy has envisaged a comprehensive package of measures that provided assistance to the economy the positive effects of which were reflected in macroeconomic indicators (unemployment, lower decline in economic activity, etc.). The planned value of the total package of measures to assist the economy and the population is estimated at 12.5% of gross domestic product (hereinafter: GDP).

**The fiscal strategy in the medium term envisages a gradual stabilization of public finances and the focus of fiscal space on the growth of public investment with an aim at recovery and growth of the economy.** The basic scenario of economic trends presented in this document presumes the end of the health crisis and economic recovery. Under these assumptions, the medium-term deficit trajectory is declining and close to the sustainable level at the end of the observed period. Exceptionally, the increased share of public debt in GDP in 2020, having in mind the projected fiscal results, as of 2021 onwards has been decreasing and returning to sustainable limits. Experience in the previous period shows us that stable public finances are necessary not only as a precondition for sustainable growth, but above all, as a prerequisite for an adequate response of the state in extraordinary circumstances such as this caused by the coronavirus pandemic. The available fiscal space in the next medium-term period is focused on public

investments with a slight increase in their share in GDP, and then maintaining the achieved level of public investment. Public investment is a key factor in faster economic recovery and creating the basis for dynamic economic growth.

**Macroeconomic and fiscal risks to the presented baseline scenario are significant and predominantly**

**negative.** There are uncertainties regarding the course and duration of the pandemic, the way and speed with which economies will recover, the need for additional economic assistance, as well as numerous obligations that may arise from implicit and explicit state guarantees given to support the economy during the pandemic.

## 2. Estimates of the international economic environment

The global economy has been hit by the most devastating public health crisis and is in the deepest recession in decades. The virus pandemic, which has claimed more than a million lives, and the consequent economic crisis that has gripped the world, are a common challenge faced by almost all countries. However, the latest projections point to a slightly better situation than previously expected: an increase in the number of tests, more effective therapy, faster vaccine development, stronger international solidarity, faster opening of economies and recovery after the “lockdown” period have led to somewhat moderate predictions of an impending recession. The upward revision for 2020 was also supported by the results from the second quarter, which were not as negative as originally expected, as well as stronger growth in China, and indications of a faster recovery during the third quarter. Macroeconomic performance would have been significantly weaker had it not been for fiscal, monetary and regulatory reactions that were significant, rapid and unprecedented, thus preventing a financial catastrophe. International financial institutions expect the global economic recovery to be long and

uneven, while the resspreading of the virus and the introduction of restrictive epidemiological measures will slow the return of economic activity to pre-crisis levels. Most countries face unusually high negative risks arising from the further course and duration of the pandemic and the response thereto. The main challenges will be the preservation of existing production capacities and the implementation of structural changes aimed at creating stronger, fairer and more sustainable growth. The priority of the social and economic system is the timely provision of resources for the functioning of the health system and limiting economic damage. To achieve this, is necessary to have a significant international cooperation and support to health systems, financial support to severely affected countries, support to countries in the process of normalization after the fight against the virus, but also the implementation of policies and economic measures to address public and corporate debt the growth of which is expected in the future. Global cooperation is also necessary due to the long-term problem of climate change and possible future health crises.

### Macroeconomic estimates of the International Monetary Fund

The global economy is recovering from the shock caused by the “Great Lockdown”. Although, after the initial phase of the pandemic, a gradual easing of health measures and a recovery in economic activity have followed globally since May, there is still a high degree of uncertainty regarding the speed of global economic recovery, reflecting international commodity and financial market developments. According to the autumn projections of relevant international institutions, the crisis will be less intense than expected, with an uneven global recovery. In addition to the challenges of the crisis, the current projections also indicate certain reasons for optimism. Recovery in developed countries and China has been faster than estimated, but the expected return of the global economy to pre-pandemic levels remains uncertain and prone to high risks.

As the pandemic continues to spread many countries have slowed the opening of their economies, and some are re-establishing preventive epidemiological measures to protect the population.

Risks to the realization of projections continue to be accompanied by unusually high uncertainty. The negative risks to the projection are significant and are mainly related to the re-emergence of the virus in the areas that “recovered” from it. Slower-than-expected development of the vaccine or its uneven accessibility could also result in slower virus suppression. Premature withdrawal of support measures introduced due to the crisis caused by the pandemic or their ineffective implementation also pose a risk, which, with less favourable financing conditions, could lead to a drop in liquidity and, in the long run, to insolvency. On the other hand, a milder recession than originally anticipated, continued implementation of fiscal measures in 2021 and faster productivity growth would contribute to accelerating global recovery and normalizing economic activity.

**Table 1. International environment - macroeconomic indicators**

	2020	2021	2022	2023
<b>Real GDP growth, %</b>				
World total	-4.4	5.2	4.2	3.8
Advanced economies	-5.8	3.9	2.9	2.2
USA	-4.3	3.1	2.9	2.3
Euro area	-8.3	5.2	3.1	2.2
Developing economies	-3.3	6.0	5.1	4.9
China	1.9	8.2	5.8	5.7
Russia	-4.1	2.8	2.3	2.1
World trade growth, %	-10.4	8.3	5.4	4.3
<b>Unemployment rate, %</b>				
Euro area	8.9	9.1	8.4	7.9
USA	8.9	7.3	5.7	5.1
<b>Consumer prices, period average, %</b>				
Euro area	0.4	0.9	1.2	1.4
Advanced economies	0.8	1.6	1.6	1.7
Developing economies	5.0	4.7	4.3	4.2
Exchange rate, euro/dollar, end of period	1.1	1.1	–	–
Cereal prices, in dollars, annual changes <sup>2</sup>	1.0	1.8	3.4	0.0
Metal prices, in dollars, annual changes <sup>3</sup>	0.8	3.0	0.6	0.7
Price of iron ore, in dollars <sup>4</sup>	104.2	99.1	99.1	99.1
Oil prices, in dollars, annual changes, %	-32.1	12.0	3.0	2.3

Source: International Monetary Fund (hereinafter: IMF), *World Economic Outlook*, October, 2020.

<sup>1</sup> World GDP is calculated according to purchasing power parity.

<sup>2</sup> The cereal price obtained as the weighted average price of wheat, corn, soya, rice and barley.

<sup>3</sup> The metal price obtained as the weighted average price of copper, aluminium, iron ore, tin, nickel, zinc, lead and uranium.

<sup>4</sup> 4 Iron ore price (of 62% iron content) for imports into China, Tian Jan port, in dollars per metric ton.

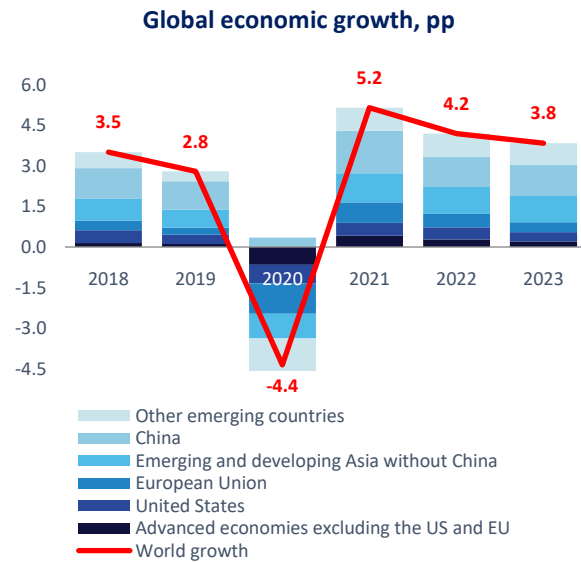
According to the October IMF forecasts, the revision of global economic growth upwards for 2020, compared to the June projection, reflects the results achieved in the second quarter, as well as the movements of high-frequency indicators from July and August, which are better than previously expected. This improvement is mainly the result of a better economic situation in developed countries, where the decline in GDP is projected at 5.8% instead of the previously expected 8.0%. The US economy will record a contraction of 4.3% in 2020, which is almost twice less than expected in June, and the outlook for the Eurozone has improved despite the sharp decline that is still expected. On the other hand, the outlook for developing economies has remained almost unchanged. Accordingly, the estimate of global economic growth in 2020 was adjusted to -4.4%, which represents a revision up by 0.8 percentage points as compared to -5.2% of June, but it is still a worse result than expected in April. The improvement in the outlook for 2020 inevitably, due to the base effect, was reflected in the revision of the downward

projection of global economic growth in 2021 by 0.2 percentage points to 5.2%. Growth is expected to slow down in the medium term, which is in line with projected trends in most countries.

The outlook for Asian developing countries (excluding China) remains uncertain as major economies such as India and Indonesia continue to struggle to curb the spread of the virus. The positive outlook for China is confirmed by estimates that cumulative GDP growth in the period 2020-2021 will amount to about 10%, as the easing of health measures and the normalization of economic flows took place faster than expected, and economic growth was already recorded in the second quarter. Although the forecasts for Russia have been revised upwards, this country continues to face a deep decline of 4.1% in 2020, and expectations for the next medium-term period are similar to those of other countries, and a slight weakening of economic activity is expected. Many Latin American countries have been severely affected by the pandemic and are facing serious decline in economic activity. A big drop is expected in the Middle East and



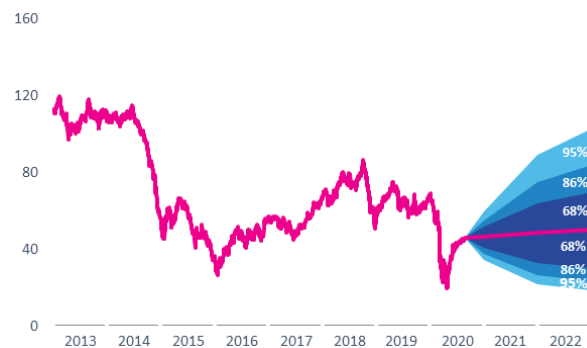
Central Asia as well as in oil-exporting countries in sub-Saharan Africa, which are further affected by low oil prices and civil conflicts.



Source: IMF, *World Economic Outlook*, October, 2020.

The outlook for inflation reflects mainly indicated growth prospects and expected movements in commodity prices. In developed economies, inflation will rise slightly from 0.8% in 2020 to 1.6% in 2021, after which stagnation is predicted in the medium term period. Emerging countries will, after the price increase of 5% in 2020, record a slight decrease in inflation in the coming years. According to the October IMF projections, the price of oil in 2020 is expected to be \$ 41.7/barrel, a decrease of 32.1% compared to 2019, after which a gradual increase is expected.

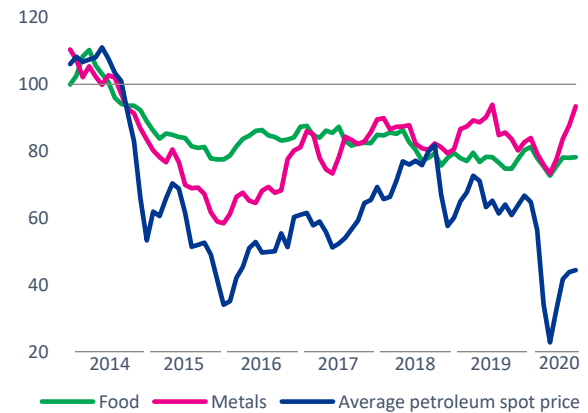
#### Projection of oil price movements, USD per barrel



Source: IMF, *World Economic Outlook*, October, 2020.

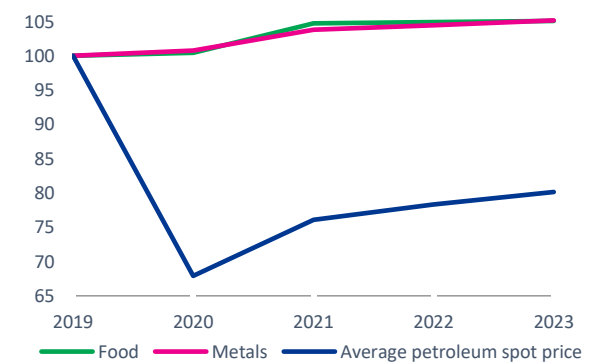
It is projected that the prices of base metals will be higher by 0.8% in 2020 and their growth will continue in the coming period. After the growth of iron prices of about 11% in 2020, their decline over the next year and stagnation in the medium term are projected. Cereal prices in 2020 are expected to grow slightly, and then will gradually accelerate in the medium term. The three-month euro deposit rate will decrease from -0.4% in 2020 to -0.5% in 2021, while the six-month rate on US dollar deposits will amount to 0.7% and 0.4%, respectively.

#### Price movements, indices, 2014=100



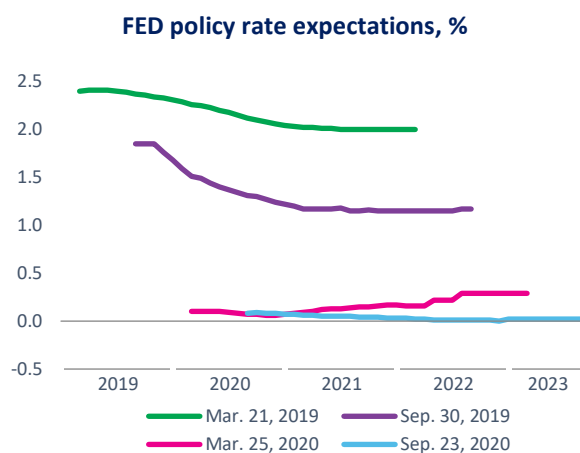
Source: IMF, *World Economic Outlook*, October, 2020.

#### Projection of price trends, indices, 2019=100



Source: IMF, *World Economic Outlook*, October, 2020.

US Federal Reserve System (hereinafter referred to as FED) on two occasions in March 2020 decreased policy rate, which is now at the level of approximately 0% and is in line with the announcement of a change in monetary policy strategy to target average inflation rate of 2%, which in turn signals that the base interest rate will remain low. The focus remains on achieving full employment and supporting economic growth.



Source: IMF, World Economic Outlook, October, 2020.

Since the uncertainty about further developments in the pandemic persists, forecasts are unusually uncertain and accompanied by significant downside risks. Geopolitical tensions and the volatile market of petroleum products, shaky global trade, failure to reach a trade agreement between the European Union (hereinafter: the EU) and the United Kingdom, as well as frequent weather, climate and natural disasters, continue to be risks to global growth and stability. On the other hand, a milder recession than originally anticipated, continued implementation of fiscal measures in 2021 and faster productivity growth would contribute to accelerating global recovery and normalizing economic activity. Also, finding a safe and effective vaccine and advancing in the treatment of patients would have a positive impact on limiting the pandemic and relieving health care systems.

#### Overview of economic measures taken in selected countries

The spillover of the health crisis to all spheres of society has initiated the undertaking of various economic policy measures to alleviate the crisis. The governments of most countries have provided a wide range of fiscal support that is reflected in tax deferrals, measures to preserve living standards and employment, support to the unemployed, subsidies to the most vulnerable industries or companies of national importance, and extensive government guarantee and credit support. The European Central Bank (hereinafter: the ECB), the Fed and other national central banks have used the available monetary instruments: lowering key policy rates,

introducing a moratorium, repurchasing government bonds. Significant support, especially to less developed countries, was provided by international organizations such as the IMF and the World Bank. The European Commission presented a new recovery instrument called the EU Next Generation worth EUR 750 billion and proposed “full flexibility” in the application of fiscal rules, i.e. the suspension of fiscal rules that limit the amount of debt and deficit, for the first time since they were introduced. The United States has in effect an economic stimulus, unprecedented in American history, worth about USD 3,000 billion of direct aid. The value of the support package is presented in Table 2.

**Table 2. Economic measures in selected countries**

	billion euros	% of GDP
Albania	0.36	2.8
BIH	0.6	2.74
Bulgaria	7.3	13
Czech Republic	29.4	13.7
Montenegro	1.54	0.03
Greece	24	14
Croatia	4	7
Hungary	30	18-22
Romania	7.5	3.7
North Macedonia	0.55	5.5
Slovenia	7.3	16.4
Slovakia	6.64	7.1

Source: IMF, Policy Tracker and EBRD, Coronavirus policy response

#### ECB macroeconomic projections for the euro area

According to ECB estimates from September, economic activity in the euro area will decline in 2020, with a recovery in 2021, and then continue to grow at a slightly lower rate. The collapse of economic activity was caused by strict measures to curb the spread of the virus, and the negative effects slowly began to subside with the relaxation of the introduced measures, so some high-frequency indicators began to show signs of recovery during the third quarter. The gradual economic recovery of the euro area has been aided by favourable financial conditions and expansionary fiscal policy, as well as the resumption of productive activity in Europe and the world, the speed of which nevertheless remains in question in the context of the global spread of the virus. According to the projections of ECB, which are based on the assumption of a gradual lifting of restrictive



measures, a recovery in demand and a fall in global uncertainty, after the expected -8.0% in 2020, the euro area economy will record a growth of 5.0% in 2021. A similar trend in the euro area will be recorded in private consumption (a decline of 8.0% in 2020, followed by an increase of 5.9% in 2021), as well as investment (a decrease of 12.3% in 2020 and a recovery of 6.3% in 2021). Export activity of the euro area has been strongly affected by the pandemic, due to the global collapse in the sectors where the euro area is particularly exposed. Both exports and imports are anticipated to record a recovery in 2021 after falling in 2020, while only government consumption will achieve a slight growth of 1.7% in both years.

The euro area saw a sharp drop in private consumption in the first half of 2020, with the automotive and tourism industry being the most affected sectors. Although the losses in real disposable income were largely mitigated by fiscal incentives and higher public transfers, the decline in consumption was affected by forced savings and increase in the precautionary savings. Private consumption is expected to recover strongly in the second half of the year, as significant fiscal transfers will preserve disposable income and jobs.

**Table 3. Macroeconomic projections for the euro area, changes in comparison to the same period last year, %**

	2019	2020	2021	2022
GDP	1.3	-8.0	5.0	3.2
Private consumption	1.3	-8.0	5.9	3.4
Government consumption	1.8	1.7	1.7	1.0
Gross fixed capital formation	5.0	-12.3	6.3	6.1
Exports	2.5	-13.7	7.4	4.5
Imports	3.9	-11.7	7.0	5.0
Employment	1.2	-2.3	0.1	1.3
Unemployment rate	7.6	8.5	9.5	8.8
Inflation	1.2	0.3	1.0	1.3
Unit labour costs	1.9	4.3	-1.7	0.1
General government fiscal result, % GDP	-0.6	-8.8	-4.9	-3.6
General government gross debt, % GDP	84.0	100.7	100.0	98.9
Balance of current account, % GDP	2.7	2.0	2.6	2.6

Source: Macroeconomic projections of ECB experts in the euro area, September 2020.

Although the unemployment rate in recent months has increased less than predicted by the June projections, the situation in the labour market is expected to deteriorate significantly. The unemployment rate is projected to increase from 7.3% in the first quarter of 2020 to 9.5% in 2021, followed by a decrease to 8.8% in 2022, as economic activity gradually returns to normal. Although the decline in employment in terms of the number of employees has been mitigated by extensive recourse to reducing hours of work in many countries, the total number of working hours is expected to drop significantly, reflecting the fact that many people were employed but effectively worked far fewer hours. This will be reflected in labour productivity, which is forecast to decline in 2020, while since mid-2021, productivity is expected the return to previous levels. In the same period, a similar trend will be observed in the salaries of employees.

Short-term expectations relative to inflation are close to zero, due to falling oil prices, the appreciation of the euro and a temporary reduction in the value added tax rate (hereinafter: VAT) in Germany. However, inflation may rise in 2021 due to the repeal of the decision to reduce VAT, as well as the expected rise in oil prices and the recovery in demand. Inflation is expected to rise from 0.3% in 2020 to 1.0% in 2021, while core inflation will remain low and stable, and will record a slight increase from 0.8% to 0.9% over the same period.

Fiscal policy during 2020 was assessed as extremely expansionary, as extraordinary fiscal measures were necessary to mitigate the negative effects of the pandemic. Most of the measures are expected to apply until the end of 2020, so the fiscal policy in 2021 is projected to be more restrictive. As a result of extraordinary fiscal measures and the negative

economic cycle in the euro area, 2020 will end with a dramatic rise in the budget deficit and the share of debt in GDP. The fiscal position will be improved in 2021 and 2022, both due to the expiration of the planned one-off measures to help the economy and population, and also because of the normalization of economic activity and its return to the pre-crisis level.

At its meeting in October 2020, the ECB decided to keep the key policy rate at a record low of 0.00%, while keeping the interest rate on lending and deposit facilities at 0.25% and -0.50%, respectively. The Governing Council of the ECB expects the key policy rates to remain at the current or lower levels until the projection indicates that inflation will approach or reach 2.0%.

### 3. Current macroeconomic developments in the Republic of Serbia and prospects for the period 2021–2023

Serbia, as a small and open economy, shares the fate of other countries in terms of fighting the economic consequences of the pandemic. The shock that hit the global economy, according to the first estimates, is the biggest since the Second World War. The EU, which is our most important foreign trade partner, but also the group of countries from which most foreign direct investments come (hereinafter: FDI), will record in 2020 the worst economic results since its establishment, while only a moderate recovery is forecast for 2021.

Reduced external demand and the introduction of a state of emergency on March 15, 2020, inevitably affected the domestic economy. Although under the influence of these factors the initially projected economic growth in 2020 will not be achieved, the economic decline of only 1.0% will be one of the best results in Europe. This was largely due to the achieved fiscal balance, price and financial stability in the previous period, which enabled the creation of a comprehensive economic package of support to the economy and the population, thus preserving macroeconomic stability. The value of the support programme amounted to about 12.5% of GDP and without its implementation the decline in economic activity would be about 5% and would be accompanied by a significant loss of production and labour resources. Also, the absence of the mentioned measures would slow down the recovery of the economy in the next year.

The recovery of economic activity was supported by the measures adopted by the Government and the National Bank of Serbia (hereinafter: the NBS), the gradual recovery of external demand due to the opening of economies and the mitigation of health measures. Timely implementation of economic assistance package to the economy and population affected the country's fiscal position, which, along

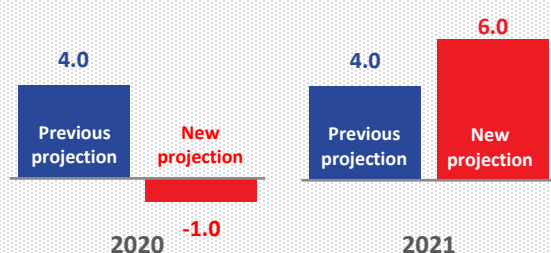
with reduced budget revenues due to the slowdown in economic activity caused by the pandemic, resulted in an increase in the fiscal deficit up to 8.9% of GDP and a temporary increase in public debt up to about 59% of GDP. Increased expansionary fiscal policy has not undermined the sustainability of public finances. At the same time, an adequate and timely monetary policy response provided sufficient liquidity to households and the economy, with stable and predictable inflation trends and relative exchange rate stability.

The success of the economic package was verified by the absence of negative effects of the pandemic on the labour market, jobs and wages were preserved, both in the private and public sectors. At the same time, the planned increase in pensions and salaries in the public sector in 2021 will not jeopardize the established macroeconomic balance and will contribute to a faster recovery of domestic demand. In addition, active participation in socio-economic dialogue has increased the minimum cost of labour in a way that will not further burden the economy or negatively affect its competitiveness, with the intention to ensure inclusive economic growth and create an environment of social cohesion.

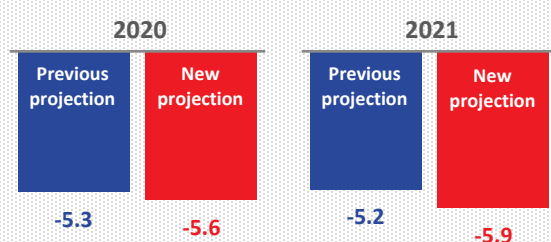
Measures that focus on mitigating the consequences of the pandemic remain a priority for economic policy makers in the coming period. In addition, efforts are focused on intensifying reform processes, to ensure the continuity of improving the economic environment, progress on international competitiveness lists and further raising the country's credit rating. The need to find new sources of growth has been recognized, so innovation, research and development, renewable energy sources, creative industries and eco-investments are in constant focus when defining future activities.

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

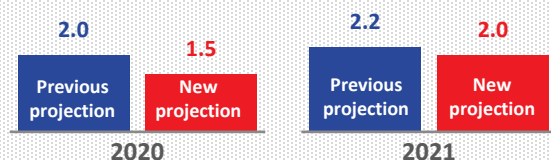
#### Real GDP growth, %



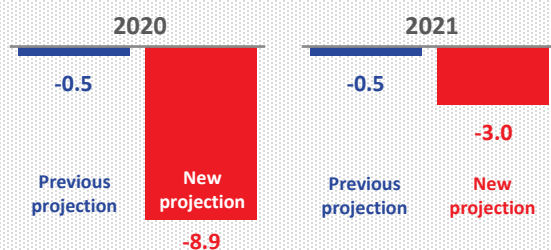
#### Current account balance, % of GDP



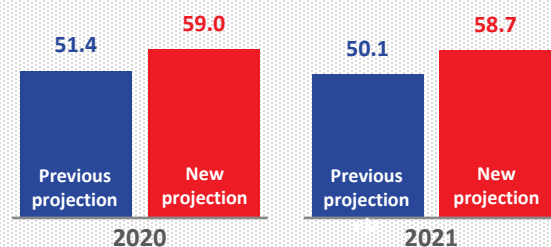
#### Inflation, period average, %



#### Fiscal result, % of GDP



#### General government public debt, % of GDP



### Current trends in the real sector in 2020

Economic activity growth of 4.2% in 2019 was higher than the initial projection by 0.7 percentage points, thus placing Serbia among a small group of European countries whose dynamics of economic activity was better than expected. A higher rate than projected is the result of the materialization of positive risks related to the dynamics of agricultural production and construction industry. Economic growth combined with a favourable investment environment had a positive impact on the labour market with a record low unemployment rate of 10.4% and real growth in average wages of 8.5% in 2019. Inflation throughout 2019 was low and stable and generally moved close to the lower limit of the allowed deviation from the target value. At the same time, there was an extremely high net FDI inflow of EUR 3.6 billion, which was more than enough to fully cover the balance of payments current account deficit.

Macroeconomic developments at the beginning of 2020 were fully in line with the projections from the Fiscal Strategy and the Budget Law for 2020, adopted at the end of last year. According to the data of the Statistical Office of the Republic of Serbia (hereinafter: SORS), GDP growth in the first quarter amounted to 5.1% y-o-y and was accompanied by positive developments in all economic sectors. Growth was driven by service industries, which in total contributed with 2.6 percentage points to GDP, primarily as a result of growth in the sector of information and communication technologies, as well as trade, transport and tourism. During the first quarter, industrial production recorded positive trends that began in the second half of the previous year, providing a contribution of 0.9 percentage points to GDP. A solid pace of construction activity in the first quarter is the result of continuing work on the implementation of infrastructure projects, and activities of private construction companies. Observed from the expenditure side, economic growth was driven by domestic demand. The most significant contribution to GDP growth came from private consumption (2.2 percentage points), which is primarily the result of improvements in the labour market. Economic activity was also supported by an increase in investments and government spending with an equal contribution to the overall growth of

2.0 percentage points each. Negative contribution of net exports of 3.3 percentage points is due to the increased imports of capital and intermediate goods for the needs of the economy, but also a somewhat slower dynamics of exports in March because of the effects of the coronavirus pandemic on the economies of our most important foreign trade partners.

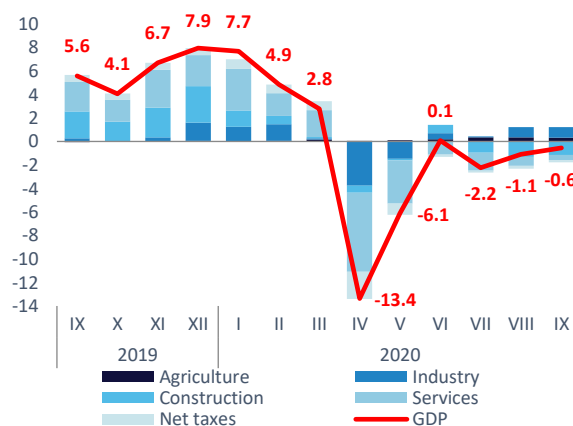
Although economic activity growth was solid during the first quarter, the onset of a slight slowdown in economic activity was observed in March as a result of dramatic changes in the international environment caused by the coronavirus pandemic. This was also indicated by the data of the Indicators of the Economic Activity of Serbia (IPAS)<sup>1</sup> which is prepared by the Ministry of Finance for the purpose of reviewing economic activity in monthly dynamics. After the growth of the economy in January and February of 7.7% y-o-y and 4.9% y-o-y, respectively, in March, according to this indicator, economic dynamics achieved significantly lower growth, of only 2.8%.

The economic activity of our most important foreign trade partners very quickly took on a recessionary character and began to spill over into the Serbian economy. In addition to dramatic changes in the international environment, the implementation of health measures at home, as well as the introduction of a state of emergency on March 15, 2020, further affected the Serbian economy, so that in April there was a sharp drop in economic activity of 13.4% y-o-y. The first to be hit were the sectors of tourism, transport, recreation and entertainment, since the health care measures taken directly affected them, but also companies from the manufacturing. Export-oriented activities such as the automotive and metal industries, production of electrical equipment, rubber and plastics were particularly affected, and significant negative effects were also manifested in the sector of micro and small enterprises and entrepreneurs. Companies in industries featuring a significant import component also faced major problems due to disrupted supply chains. Numerous companies, if not having stopped completely their production, significantly reduced the activities during this period. Some activities of the manufacturing on which the

influence of external factors is somewhat smaller, such as the food industry, were in a slightly more favourable position, while the pharmaceutical and parts of the chemical industry significantly increased production due to increased demand.

Thanks to the gradual “unlocking” of the economy and the improvement of the epidemiological situation, the economic decline in May more than halved year on year, while in June economic activity fully stabilized. The gradual recovery of economic activity was significantly contributed by the implementation of a timely and comprehensive programme of support to the businesses and households, which was jointly adopted by the Government and the NBS.

**Indicator of economic activity of Serbia (IPAS) by sectors (contributes to growth, pp)**



According to the SORS, GDP fell in the second quarter to 6.4% y-o-y. The contraction of the economy in the second quarter is entirely the result of effected implementation of health measures due to coronavirus pandemic. The economic support package for the economy and the population has significantly contributed to mitigating the shock and resulted in a smaller economic downturn, particularly in comparison with other European economies and the turbulence in the labour market was avoided as well.

Observed from the production side, the dominant negative contribution to the GDP growth rate in the second quarter of 2020 came from the service sector (-3.8 percentage points), due to a drop in trade, transport and tourism sectors, as well as professional

<sup>1</sup> Detailed methodological explanations at <https://www.mfin.gov.rs/wp-content/uploads/2019/12/Model-za-procenu-mesecnog-BDP.pdf>

and technical services and activities related to arts, entertainment and recreation. At the same time industrial production with a drop of 7.7% y-o-y negatively contributed to economic growth with -1.5 percentage points, while the contribution of construction was neutral. Favourable agrometeorological conditions resulted in an increase in agricultural production, but its contribution was slightly positive due to comparisons with the high base from the same period last year.

Observed from the expenditure side, in the second quarter of 2020, the effects of the pandemic had the greatest impact on private consumption, which negatively contributed to the GDP growth with 5.6 percentage points. Although the real incomes of the population have been preserved, the decline in personal consumption of households is a consequence of the temporary drop in demand for consumer durable goods as well as reduced reliance on tourist, catering and transport services. Investments as the component of GDP that are most sensitive to global uncertainty recorded a decrease of 11.9% y-o-y and affected the decline in GDP by 2.5 percentage points. The alleviation of the sharp fall in GDP during the second quarter was affected by increased health care expenditures expressed through the growth of government consumption for these purposes. The shock in foreign trade resulted in a significant decline in export-import activity, but the contribution of net exports was still slightly positive and amounted to 0.9 percentage points.

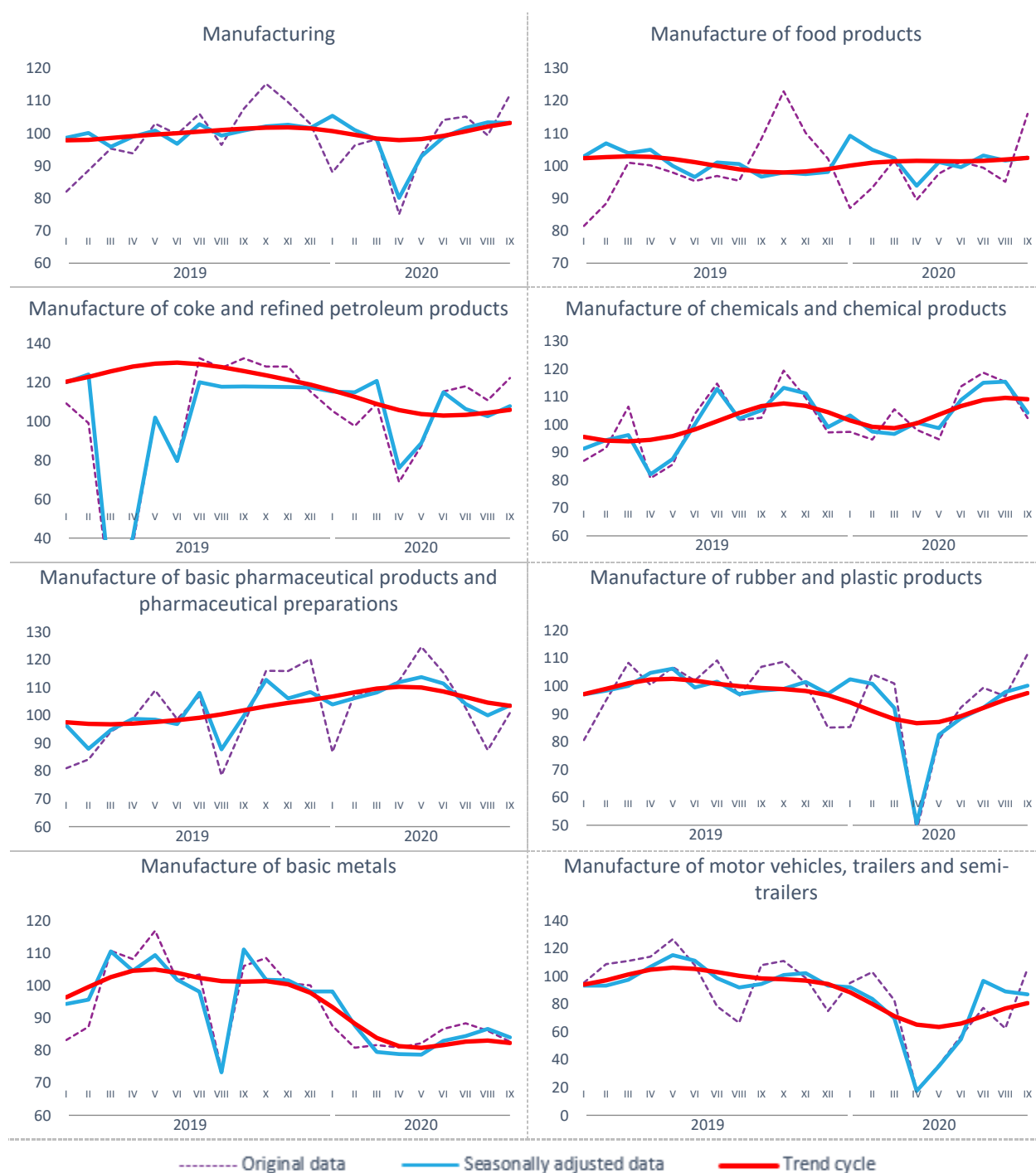
The gradual recovery of economic activity was also confirmed by the flash assessment of the SORS, according to which a real decline of 1.3% y-o-y was achieved in the third quarter. This is a good result, especially considering the extremely high base from the same period in 2019. According to the estimate of the Ministry of Finance, in the third quarter industrial production fully recovered from the shock caused by the coronavirus pandemic and achieved a growth of gross value added (hereinafter: GVA) of 3.1%. A positive contribution also came from agricultural production, which recorded an increase of about 5%

with record yields of individual plants and crops. However, the positive developments in these two sectors failed to fully compensate for the negative contribution that came from construction and services. Extremely high last year's growth in the construction sector due to the base effect influenced the year-on-year decline in the third quarter of 2020 of about 17%. A moderate recovery in economic activity in the services sector was not enough to avoid a slight decline of 1.5% y-o-y.

High-frequency indicators of economic activity also point to a solid economic recovery. The physical volume of total industrial production in September, after eliminating the seasonal and calendar effect, was 2.7% higher compared to the pre-crisis level in February 2020, although some divergent trends were recorded by activities. Certain divisions of industry, especially those that are predominantly export-oriented, have been affected by the crisis to a greater extent. This primarily refers to the automotive industry, the production of basic metals, the rubber and plastics industry, as well as oil production. In April 2020, the level of production in these divisions was halved compared to the previous month, while the decline in the automotive industry was over 80%. However, it should be noted that production in these divisions gradually increased with the recovery of external demand, while in some, such as the automotive and rubber industries, the recovery was also contributed by the activation of new production facilities as a result of FDI from the previous period. In contrast to these activities, in divisions where domestic demand is more significant and the structure of production is such that the goods necessary to meet basic living needs are produced, such as the food industry, recessionary trends were avoided, or the impact of the crisis was far lower. On the other hand, the pharmaceutical and chemical industries, because of the increased need for the resources for health care due to the pandemic, recorded a significant increase in production, which in the first nine months amounted to 11.6% and 7.6%, respectively.



### Indices of physical volume of leading activities of industrial production, 2019=100

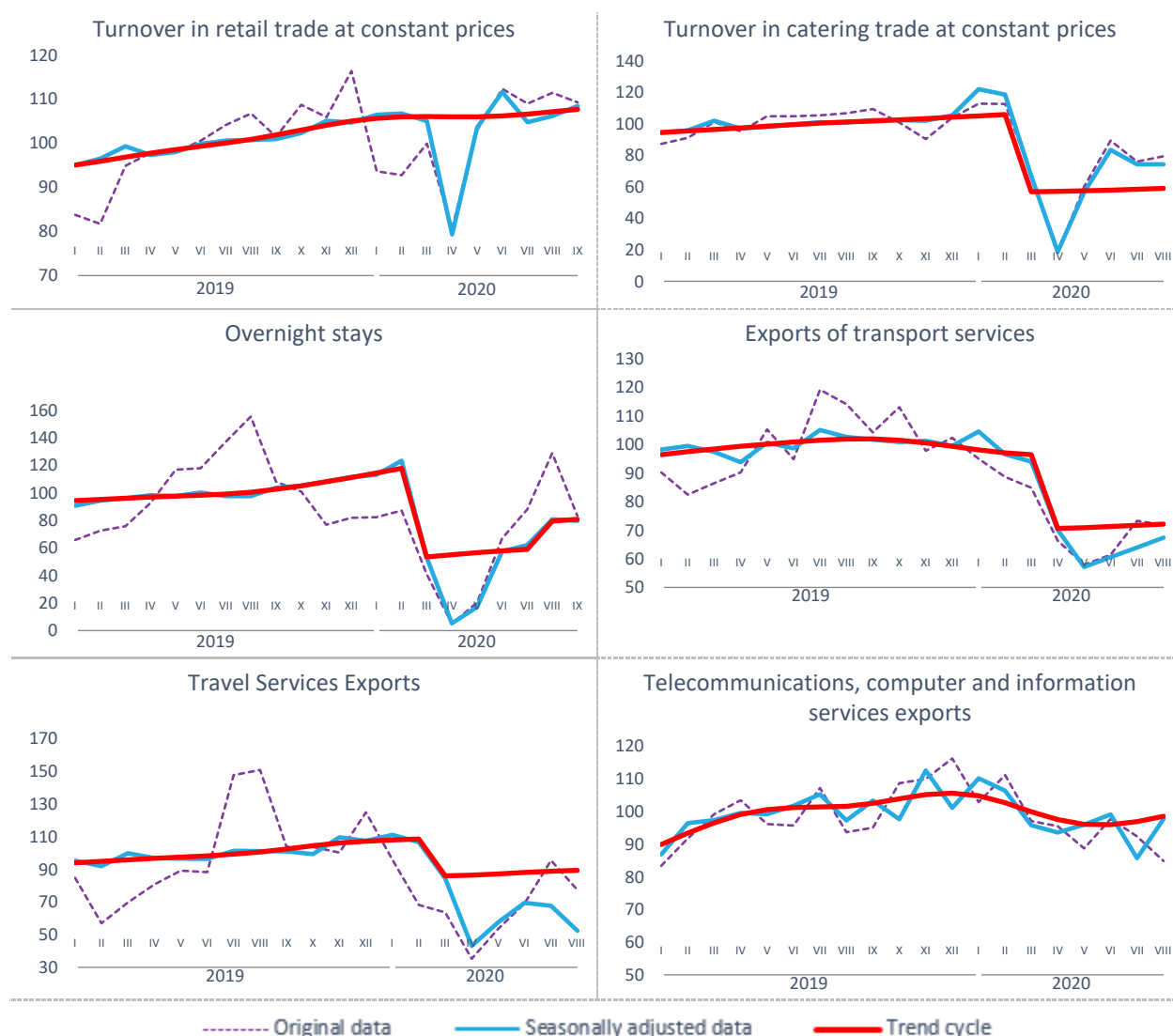


Source: Ministry of Finance

The services sector is the part of the economy that is most affected by the coronavirus pandemic due to its structure. Although some service industries such as trade and financial sector continued with positive trends, certain activities, such as tourism, catering trade, transport, arts, entertainment and recreation recorded a dramatic drop. Turnover in retail trade, after a drop of 18.6% y-o-y in April, fully recovered in the following month and continued with positive trends, so that in the period January-September

2020, a real growth of 4.9% was achieved. On the other hand, the tourism and catering trade has suffered enormous implications. The number of overnight stays of foreign tourists in the first nine months decreased by 68%, while the foreign currency inflow from tourism in the period January-August decreased by 27.3% with a drop in turnover in the catering trade by 22.7%. Reduced external demand due to lower economic activity was also reflected in a slowdown in exports of ICT services.

### High-frequency indicators of the most important service industries, 2019=100



Source: Ministry of Finance

On the basis of available indicators, the observed trends and the nature of the crisis, the Ministry of Finance has already in March revised downwards GDP growth projection for 2020 by 5.8 percentage points from 4% to -1.8%. However, a faster-than-expected recovery after the lifting of the state of emergency, with a record good agricultural season, projection of GDP growth for 2020 was revised slightly upwards to -1.0% in October, which will be one of the best results in Europe.

Compared to the March projection, a slightly higher negative contribution of private consumption is expected due to the drop in demand for durable consumer goods, as well as a reduction in expenditures for some service needs due to the extended pandemic. Nevertheless, the measures taken by economic policy makers continue to ensure that these adverse effects are mitigated as they are largely aimed at preserving employment and income of the population during the pandemic. Under the influence of these factors, in the October estimate, the expected decline in private consumption was revised downwards by 1.0 percentage points as compared to the March projection and amounts to -1.9%. Given the significant government spending on goods and services needed to combat the coronavirus pandemic, government consumption growth has been revised upwards from 2.1% to 5.8%.

When it comes to investment activity, according to the new estimate, the decline in 2020 will be about 5%, which is a better result than the March projection, primarily due to the recovery of implementation of infrastructure projects, significant imports of equipment for the health care system, but also a somewhat more dynamic recovery of private investments. A smaller decline in investments was also significantly due to the programme of support to the economy and the population implemented by the Government and the NBS during the pandemic, which preserved macroeconomic stability and greatly mitigated the increased investors' aversion to risk.

World trade contraction, significantly lower foreign demand, but also supply-side constraints continue to have a negative impact on foreign trade developments. However, with the gradual unlocking of economies, this shock is smaller than originally expected, which resulted in a revision of export-import activity, which is now expected to decline slightly, while maintaining a positive contribution of net exports to GDP growth. Such foreign trade trends with positive trade relations will contribute to the reduction of the balance of payments deficit compared to 2019, despite the lower expected inflow based on remittances.

Observed from the production side, economic activity in the services and construction sectors is still expected to decline in 2020, while agriculture will record positive trends. The dynamic recovery of the industry after the "unlocking of the economy" will result in this sector, instead of the expected decline, still achieving stagnant trends. From the aspect of contribution to GDP, the service sector will continue to have the most significant negative impact, recording a decline of about 1.5% due to the continued negative effects of the coronavirus pandemic on tourism and transport, but also on entertainment and recreation services, as well as some professional and technical services. Construction activity is expected to decline slightly primarily due to the base effect, namely due to extremely high value of construction works done during, and especially in the second half of 2019, and a negative contribution is also expected from net taxes due to lower household consumption. Good agrometeorological conditions have favoured agricultural production, which will achieve a growth of about 5%, with record yields of individual plants and crops. Industrial production will have a neutral impact on GDP due to the faster recovery of certain activities after the lifting of the state of emergency, both those export-oriented and those mainly focused on the domestic market, but also as a result of a significant increase in production of the electricity sector commenced in July.

**Table 4. GDP, real growth rates, %**

	2019	Q1 2020	Q2 2020	2020* (original projection)	2020* (March revision)	2020* (October revision)
GDP	4.2	5.1	-6.4	4.0	-1.8	-1.0
Private consumption	3.6	3.2	-7.9	3.9	-0.9	-1.9
Government consumption	2.0	11.8	8.9	1.5	2.1	5.8
Gross fixed capital formation	17.2	10.8	-11.9	6.4	-13.2	-4.8
Exports of goods and services	7.7	3.0	-20.7	8.1	-9.1	-6.9
Imports of goods and services	10.7	8.1	-19.3	7.4	-10.3	-6.5
Agriculture	-1.6	1.7	2.2	-2.8	-2.3	4.9
Industry	0.4	4.3	-7.7	4.3	-5.5	0.0
Construction	33.7	20.4	0.1	9.1	-1.2	-6.0
Services	4.2	5.0	-6.6	4.3	-1.3	-1.5

Source: SORS

\* Ministry of Finance

### Projections of real sector developments in the period 2021–2023

The medium-term projection of real sector developments is based on a realistic approach, so that fiscal policy is adequately set and so as not to jeopardize the achievements so far. The developments of basic macroeconomic aggregates and indicators for the Republic of Serbia in the period 2021–2023 have been projected on the basis of current economic trends and prospects for the Republic of Serbia and the international environment, as well as on the basis of the assessed effects of the planned measures of economic policy. Preserved stability of public finances provided fiscal space for the implementation of a comprehensive programme of support to the economy and the population during

the pandemic, but also for increasing capital investments. In this period, the Government will pursue a responsible and predictable fiscal policy, synchronized with the monetary authorities and focused on remediating all the consequences of the coronavirus pandemic, but also on locating new sources of growth. Continued FDI inflows will provide knowledge and technology transfers, increase competitiveness and provide new sales channels to domestic producers. The incentive mechanism aims at their sectorial and regional dispersion in order to ensure the preconditions for balanced development and full use of competitive advantages. Achieving this projection, in conditions of high uncertainty, is subject to risks, which are primarily of exogenous origin. The projection risk matrix exists and is described in detail in this document.

**Table 5. Projection of the basic macroeconomic indicators in the Republic of Serbia**

	Estimate 2020	Projection		
		2021	2022	2023
GDP, billions of dinars (current prices)	5,517.3	5,997.7	6,408.1	6,871.3
Real growth of GDP, %	-1.0	6.0	4.0	4.0
GDP deflator, %	2.9	2.6	2.7	3.1
Private consumption	-1.9	5.4	2.8	2.9
Government consumption	5.8	0.4	2.5	1.8
Gross fixed capital formation	-4.8	13.3	7.1	7.8
Exports of goods and services	-6.9	9.6	9.1	9.3
Imports of goods and services	-6.5	9.3	7.7	7.8
Balance of goods and services in EUR, % GDP	-8.5	-8.9	-8.6	-8.0
Current account balance, in EUR, % GDP	-5.6	-5.9	-5.5	-5.2
Inflation, period average, %	1.5	2.0	2.2	3.0

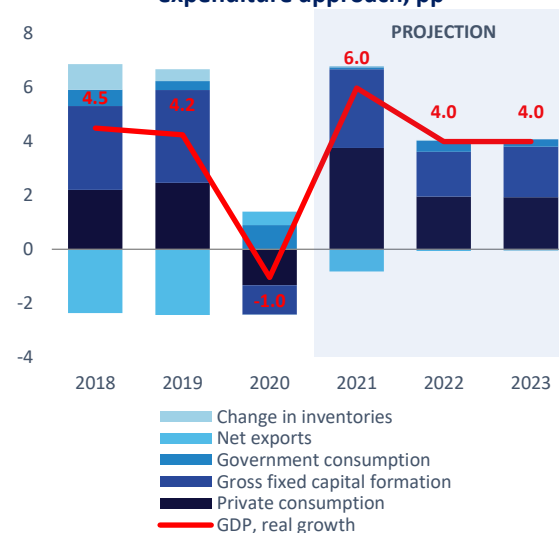
Source: Ministry of Finance

Real GDP growth of 6.0% has been projected for 2021, which means that the initial projection from the previous Fiscal Strategy was revised upwards by 2.0 percentage points. The main reason for this revision is the lower base in 2020 due to the impact of the pandemic on all components of GDP.

Observed by expenditure aggregates, growth will be entirely driven by domestic demand, while the contribution of net exports will be negative. All three components of domestic demand will positively contribute to the growth of economic activity. Preserved stability in the labour market and the expected real increase in wages, both in the private and public sectors, with the recovery of consumption in the segment of services that were most affected by the pandemic in 2020, supported by favourable financing conditions, will result in private consumption growth of 5.4% and consequently as this aggregate has the largest share in GDP, will contribute to the growth of economic activity with 3.8 percentage points. It should be noted that the increase in consumption is based on healthy sources, will be lower than real GDP growth and will not generate internal and external imbalances. In 2021, investments will be the second most important component in terms of a positive contribution to GDP growth, which is very important from the point of view of its sustainability. A year-on-year increase of 13.3% is expected, i.e. a contribution to GDP growth of 3.0 percentage points. The dynamics of investment activity will be determined by a further increase in the production capacity of the economy, primarily in sectors that produce tradable goods, but also by continuing the implementation of infrastructure projects for which in 2021 a record share in GDP of 5.5% is estimated. In contrast to these two components of domestic demand, government consumption will grow slightly by 0.4% in 2021, primarily due to the high base from the previous year caused by a significant increase in expenditures for health care. The expected recovery of external demand, with the activation of new production capacities as a result of effecting FDIs from the previous period, accompanied by the expected increase in exports of certain agricultural products, will result in export growth of 9.6%. On the other hand, solid growth of private consumption with strong growth of investments will result in growth of

imports of 9.3%. Although faster growth of exports than imports is expected, a higher share of imports in GDP will result in the fact that the contribution of net exports to GDP growth will still be negative amounting to -0.8 percentage points.

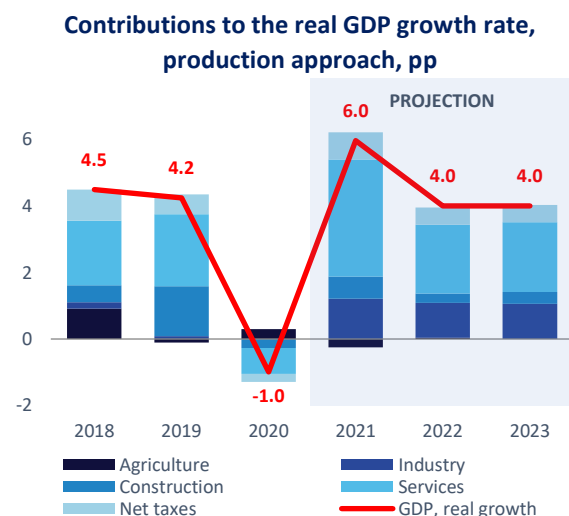
**Contributions to the real GDP growth rate, expenditure approach, pp**



Source: Ministry of Finance

Observed from the production side, an increase in the generated GVA is expected in all sectors, except for agriculture, which is based on the assumption of the average season. The service sector, which was most affected by the pandemic in 2020, will play the role of the dominant growth driver in 2021 with a contribution of 3.5 percentage points. Growth should be diversified and achieved in most service activities and it should be especially strong in the ICT sector, trade and transport, while a moderate recovery is expected in tourism and catering as well as recreation and entertainment services. With the recovery of external demand and the activation of new production capacities, but also due to the base effect, the total industry will accelerate in 2021 and contribute to GDP growth of 1.2 percentage points. Construction activity should achieve solid growth in 2021 due to further acceleration of the implementation of infrastructure projects, but also a strong recovery of private construction works, which would result in a contribution to GDP growth of 0.4 percentage points in 2021. As for the agricultural sector, assuming average agrometeorological conditions with the continued trend of increasing productivity, and under the influence of an extremely

high base from 2020, a drop in GVA of about 4% in 2021 is projected.



According to the medium-term macroeconomic projection, the cumulative growth rate in the period 2021–2023 will amount to 14.6% and will be determined by the growth in domestic demand. This source of growth is determined by both the permanent increase in investment and the growth of household consumption due to rising living standards of the population. On average per year, the Serbian economy will grow at a rate of 4.7%. The increase in private consumption is projected at a lower rate than the acceleration of economic activity and will average 3.7%. In the first year of the projection, slightly higher than average increase of household consumption is expected, primarily due to the base effect, and then a gradual slowdown in growth is to follow. This increase does not contain disruptive elements, it is based on sound sources, primarily on increasing employment, but also on the favourable impact of price and credit developments on disposable income. A steady growth of investments is expected, an average of about 10% per year, which will gradually raise their share in the GDP structure, amounting at the end of the projection period to nearly 25%. With the recovery of foreign demand and the activation of new production capacities, the volume of foreign trade will increase. In addition, effecting of FDIs 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 9.3%, which is faster than the expected annual growth of imports, which will average 8.3%. This dynamics of foreign trade flows will improve the current account balance in the medium term and provide a slight reduction in the balance of payments deficit from 6.9% in 2019 to 5.2% in 2023. As for the supply side, the services sector and industry will retain the role of dominant sources of growth and increase the generated GVA by an average of 5.0% and 5.2% per year, respectively. A positive contribution will be also provided by the growth of construction activity, which will average 9.6%. Achieving European standards and raising competitiveness in agriculture, by meeting the conditions for opening Chapter 11 and through the use of EU IPARD II programmes, will reduce the variability of production in this sector caused by agrometeorological conditions.

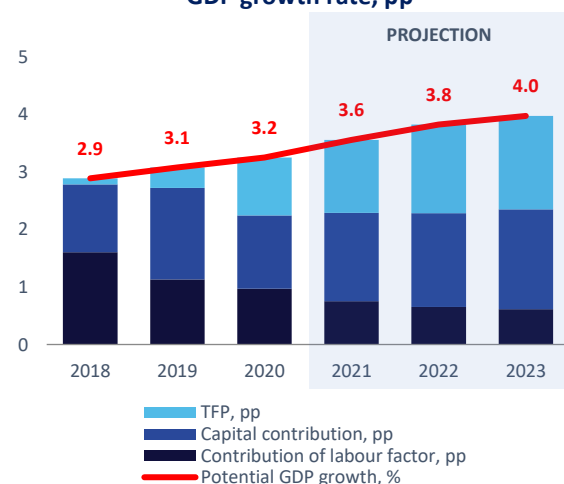
With this three-year scenario, the Government remains committed to maintaining a model of economic growth based on investments and exports, which is supported by the growth of private consumption on realistic and sound sources. The share of gross fixed capital formation in GDP will be 24.6% at the end of 2023, which is about 2.1 percentage points higher compared to the pre-crisis year 2019, while at the same time the share of exports of goods and services will increase by 1.9 percentage points. After the jump in 2020, government consumption will gradually reduce its share in GDP, so that at the end of the projection period it will come close to the 2019 level.

Through its activities and measures, the Government is trying to strengthen the investment and export component of GDP. Acceleration of all administrative procedures that accompany these activities, tax relief in order to stimulate competitiveness of the economy, signing agreements to ensure the preservation of the existing and entering new foreign markets, more intensive and efficient execution of infrastructure works are just some of the measures which should provide sound foundations for growth of the potential GDP. Consistency in preserving fiscal stability prevents generation of imbalances and creation of uncertainty, whereas reform processes should enable stronger positive dynamics of the basic macroeconomic variables. The digital transformation



and construction of the digital ecosystem remains the strategic orientation of the Government. More efficient work of the state administration, shortening of procedures for the citizens and businesses with a focus on digitalization will accelerate the convergence of our economy towards developed countries. The new system of fiscalization and changes in customs regulations will reduce the share of the grey economy in total economic flows, provide affirmative competition and improve the cost-effectiveness and efficiency of procedures.

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



Source: Ministry of Finance

According to the central scenario, potential GDP growth is expected to accelerate in the medium term. After an increase of 3.2% in 2020, potential GDP will

gradually increase and reach a rate of 4% at the end of the projection period. Slower growth of potential GDP, than expected in the previous Fiscal Strategy, is a consequence of the negative effects caused by the coronavirus pandemic. Nevertheless, an adequate economic policy has preserved the production potentials of the economy. Accelerating the implementation of capital projects and the continuation of the ongoing investment cycle, supported by both a stable inflow of FDI and domestic innovative activities, will provide an increasingly strong contribution of capital and factor productivity to potential GDP growth. Digitization will significantly speed up these processes and further increase the efficiency of the utilization of available capacities. Adequate and synchronized monetary policy, further improvements of the financial system, raising credibility and attractiveness for the investors, a radical reform of the education system and its adaptation to suit the needs of economy, as well as modernization of educational programmes and transfer of knowledge and technology from the most developed countries should provide a positive impact on both factors of production. On the other hand, strengthening the rule of law, reform of the legislation in the field of economy and business, speeding up procedures and raising the efficiency of the administration should ensure maximization of the factor productivity in the medium term. Favourable developments in the labour market will also contribute to the growth of potential GDP but at a slower pace than in the previous period.

## Labour market

The labour market situation is characterized by relatively favourable developments despite the negative effects of the coronavirus pandemic. The package of economic measures of the Government, which was devised primarily to ensure the maintenance of the production capacities of the economy, significantly contributed to this, especially in terms of preserving jobs. With the same goal, the

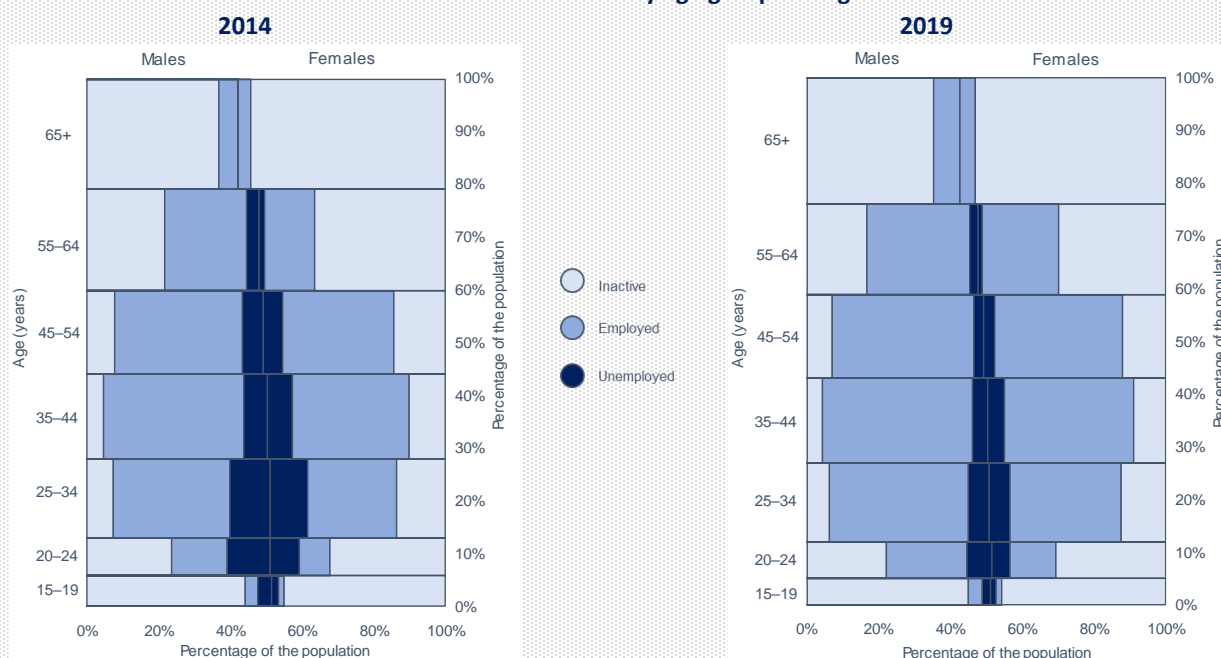
legal framework for the implementation of the second package of economic measures was adopted in July. After completion of the first set of measures, and prolonged duration of the complex epidemiological situation, the Government decided to provide direct assistance to micro, small and medium enterprises in the amount of 60% of the minimum wage for another two months (in August and September), and to extend tax and contributions deferral for another month.

### Structural improvements in the labour market in the period from 2014 to 2019

According to the Labour Force Survey in 2019, the unemployment rate reached a record low level and amounted to 10.4%, which is by 2.3 percentage points less compared to the year before and by as much as 8.8 percentage points less than five years ago. From 2014 to 2019, employment increased by 13.3%, and amounted to 2,901.0 thousand, with an increase in the number of permanent and temporary contracted workers, as well as full-time employees. In this period, the employment rate reached the level of 49.0%, which is its highest level since comparable data are available. In addition to a significant reduction in the

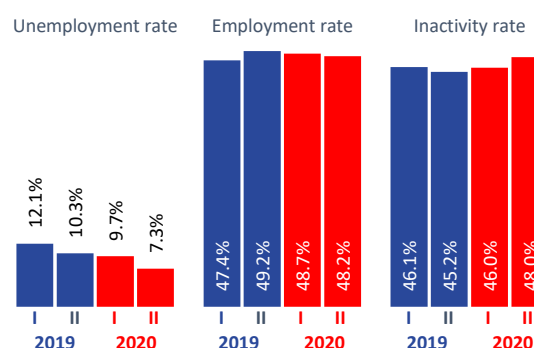
unemployment rate, structural improvements in the labour market have also been noted. In the last five years, there has been a decrease in the youth unemployment rate from 47.5% to 27.5%. The decrease in unemployment has been registered in all age groups. In addition to the category of young people (15–24 years), a significant decrease in unemployment was also recorded in the age group of 25–34 years. Also, there is a noticeable progress in the position of women in the labour market as well as an increase in the activity rate for both sexes of all ages.

### Labour market indicators by age groups and gender



Despite the difficult conditions on both the international and domestic markets, favourable trends in the labour market are to be recorded in 2020. According to LFS data, the year-on-year unemployment rate in the first quarter decreased by 2.4 percentage points, to 9.7%. In the second quarter, the unemployment rate decreased by 3.0 pp, y-o-y, to a record low level of 7.3%. Also, in the second quarter there was a decrease in the employment rate from 49.2% in Q2 2019 to 48.2% in Q2 2020. Simultaneous decrease in the unemployment rate and the employment rate is a consequence of the increase in the number of inactive population by 153.8 thousand persons, i.e. the decrease in the activity rate by 2.8 percentage points. The total number of employees decreased by 2.5%, with an increase in formal employment by 60.1 thousand and a decrease in informal employment by 132.4 thousand persons, as a result. In addition to a significant reduction in the unemployment rate and a reduction in informal employment, improvements were also noted with other indicators. The situation has improved among the more vulnerable categories of the population, namely young people and women. Thus, at the year-on-year level, the youth unemployment rate decreased from 24.4% to 20.7%, while among women it decreased from 11.0% to 7.6%. Also, the long-term unemployment rate was reduced by 2.0 pp to 4.1%, and the employment rate in the informal part of the economy by 4.1 pp to 15.2%. Favourable developments in the labour market are also confirmed by CROSO data, according to which in the period January-September the number of employees y-o-y increased by 45.1 thousand persons, i.e. by 2.2%. This is almost entirely the result of growth in the number of employees in the private sector. In terms of sectors, the manufacturing industry leads in terms of employment with 15.4 thousand newly employed workers, followed by construction with 10.2 thousand and the information sector with 6.2 thousand. Also, another confirmation of good results on the labour market are the data of the National Employment Service (hereinafter: NES), according to which in the period January-September 2020 the number of unemployed persons decreased by 23.9 thousand, or 4.4%, y-o-y.

### Movement of basic labour market indicators



Source: SORS

The average net salary in 2019 was driven primarily by strong economic growth, and increased in nominal terms by 10.6% and in real terms by 8.5% compared to 2018 and amounted to RSD 54,919. Salary growth was driven, primarily by salary growth in the private sector. Observed by activities, the growth of salaries was primarily contributed by the manufacturing and trade. Positive trends spilled over into 2020, despite the negative effects of the coronavirus pandemic. In order to mitigate as much as possible the negative effects on the movement in salaries, the Government has adopted packages of economic measures in two occasions. Also, the growth of the average salaries was influenced by the decision of the Government at the end of 2019 to increase salaries in the range from eight percent in the state administration to 15 percent for nurses, but also the decision to permanently increase salaries of health workers by 10% starting from April 2020. In addition to this, the growth of salaries was also influenced by the decision to increase the minimum labour cost to 172.54 per working hour in 2020 from RSD 155.3 in 2019. Thus, in the period January-August, the average net salary increased by 9.2% in nominal terms and by 7.6% in real terms, y-o-y and amounted to RSD 59,234. An increase in average net salaries was recorded in all regions, with the largest being in the Belgrade region. Real salary growth in the public sector was 9.3%, while in the private sector real salary growth was 6.8%. In terms of sectors, the largest contribution to the growth of average salaries was made by health care system, trade and manufacturing industry. The coronavirus pandemic will inevitably be reflected in the labour market. However, timely measures of economic policy makers, whose focus is primarily on maintaining employment, significantly mitigate the

negative effects caused by the pandemic, so that in 2020 no significant turbulence is expected in the labour market, neither in the number of employees, nor in the amount of earnings. Although the unemployment rate was at a record low in the second quarter, primarily due to a decrease in the number of people actively looking for work, it is expected to increase slightly by the end of the year, remaining at an annual level below 10%. The favourable developments so far, the Government's commitment to increase the number of employees, as one of the priority goals of economic policy, as well as the expected economic growth have defined the projection for the medium term. Positive developments are expected to continue, through the improvement of all labour market indicators, particularly through further reductions in the unemployment rate. Such expectations are the result of continuous efforts to improve conditions in the labour market, improving labour market institutions, fostering employment and labour market inclusion of less employable individuals, and providing support to regional and local employment policy. Also, continuous work is being done to improve the workforce in terms of quality, as well as to invest in human capital, all with the aim of facilitating overall employment, especially in the part of the economy featuring higher added value. Also, with the intensified work of inspection services, and after the improvements in labour legislation and measures adopted to enable corporate tax relief, the reduction of the number of employees in the grey zone and their transfer to the contingent of formally employed will be continued. These measures will improve working conditions, in terms of workers' rights and insurance, and will have a positive effect on budget revenues. At the end of the medium term, complex reforms of the education system and an adequate response to the needs of the economy are expected to take effect, while active training, retraining and support for social entrepreneurship will facilitate the availability of jobs for socially vulnerable categories of society and thus ensure inclusiveness of economic growth. In the medium term, the growth of average salaries is expected to continue. For the sake of economic sustainability, salary growth in the medium and especially long term should be based on productivity growth. This will require the continued creation of favourable conditions for economic

growth, primarily through growth of consumption and attracting and increase of private investments.

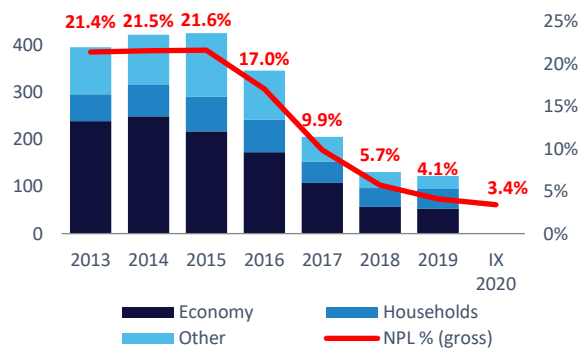
### Monetary developments

Due to the increased uncertainty caused by the virus pandemic, and in the conditions of previously preserved full price and financial stability, the NBS has eased monetary policy in 2020 in order to alleviate the negative effects of the pandemic on economic activity. First of all, the NBS lowered the key policy rate on three occasions, in March by 0.50 percentage points, in April by 0.25 pp and in June by another 0.25 pp, to a historical low of 1.25%. The easing of monetary policy has also led to a fall in interest rates on dinar loans, which, in addition to encouraging the granting of loans from the Guarantee Scheme, has contributed to the growth of lending activity. At the same time, in the conditions of a pandemic, and as a result of the undertaken measures and full coordination of the Government and the NBS, the overall macroeconomic, financial and fiscal stability has been preserved. In addition, a moratorium on repayment of loans and other similar obligations of debtors was introduced on two occasions, and significant funds were provided for liquidity of the banking sector through repo operations, foreign exchange swap auctions, as well as bilateral purchases of dinar securities (government and corporate ones) from banks in the secondary market.

In conditions of heightened uncertainty in the global market, caused by the coronavirus pandemic, credit activity recorded double-digit growth rates, while at the same time further reducing non-performing loans. The growth of credit activity was achieved thanks to the accelerated growth of loans at the beginning of the year, then due to the relaxation of monetary policy, the effects of two moratoriums on loan repayment, favourable borrowing conditions, and since May the positive contribution of loans from the guarantee scheme. Also, the Dinar share of placements has significantly increased, which is a result of the growth of Dinar loans to the businesses (largely from the guarantee scheme), i.e. the fall in interest rates on Dinar loans. Last but not least, low and stable inflation, as well as NBS measures to support the dinarization process, contributed to the growth of lending activity. Corporate loans and household loans also made a positive contribution to

credit growth, while the favourable structure of loans was maintained, primarily in the economy, where the share of investment loans was higher than loans for working capital. At the end of September 2020, the nominal growth of 14.4% y-o-y of total loans was registered, by which percentage loans to businesses also increased, while loans to households were higher by 14.3%. In line with the strategy for resolving non-performing loans, the implementation of which began in the second half of 2015, the share of non-performing loans of the banking sector in total loans was reduced by four times and at the end of September 2020 amounted to 3.4%, which is the lowest level since their monitoring begun. Compared to the period before the implementation of the said Strategy this indicator has decreased by as much as 18.82 pp.

#### Non-performing loans, billion RSD

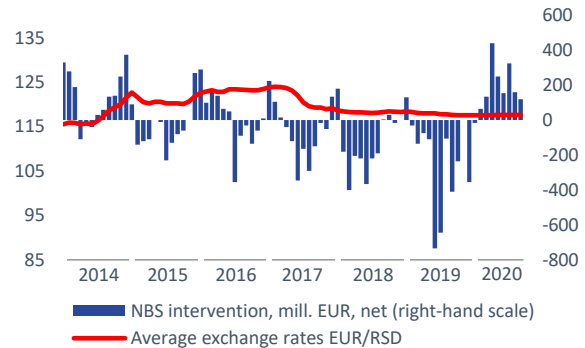


Source: NBS

Developments in the foreign exchange market in 2019 were marked by relative exchange rate stability, with prevailing appreciation pressures, due to stable macroeconomic trends, economic growth, high FDI inflows, as well as increased investments of non-residents in the domestic securities market. Developments in the foreign exchange market are characterized by exchange rate stability during 2020, despite depreciation pressures fuelled by uncertainty in the international financial market. The exchange rate stability was contributed, first of all, by the measures of the NBS, which intervened in the foreign exchange market by selling foreign currency. In the period January-September, the exchange rate nominally appreciated on average by 0.3% year on year. In order to ease the excessive short-term

exchange rate fluctuations, the NBS intervened in the interbank foreign exchange market in the period January-September with net sales of EUR 1.6 billion.

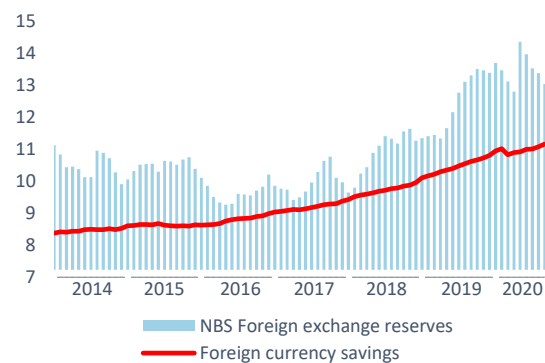
#### Exchange rate and NBS interventions in the foreign exchange market



Source: NBS

At the end of September 2020, foreign exchange reserves were reduced y-o-y by EUR 265.1 mil. and amounted to EUR 13.0 billion. This was sufficient for the coverage of the money supply M1 of 136% and for six months of imports of goods and services. The reduction of foreign exchange reserves was largely influenced by the activities of the NBS in the domestic foreign exchange market implying the sale of foreign currency in the amount of EUR 1.6 billion in the period January-September, undertaken to maintain stability, i.e. to mitigate the effects of the coronavirus pandemic crisis on the domestic economy and financial system.

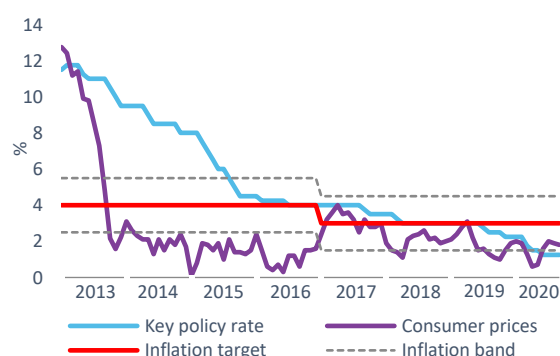
#### Foreign exchange reserves and foreign currency savings, billion euros



Source: NBS

Inflation in 2019 was low, mainly within the limits of the NBS target corridor, except for August, September and October, when under the influence of the base effect it was slightly below the lower limit. As a result of still present low inflationary pressures and stable developments in the foreign exchange market, year-on-year inflation in the period January-September 2020 was at a low level and averaged 1.6%. The fact that inflation is low and stable is also indicated by the data on core inflation, namely consumer price growth rates excluding food, energy, alcohol and cigarette prices. Core inflation in the period from January to September 2020 ranged from a minimum of 1.0% to a maximum of 1.9% y-o-y. Year-on-year inflation stood at 1.8% in September. The biggest impact on inflation in this period was primarily due to the increase in prices of fruits, vegetables, tobacco, meat products, telephone services, electricity and tourist arrangements. On the other hand, in the direction of slowing down the growth of inflation, the fall in the prices of oil derivatives had a strong effect.

#### Inflation and reference interest rate, %

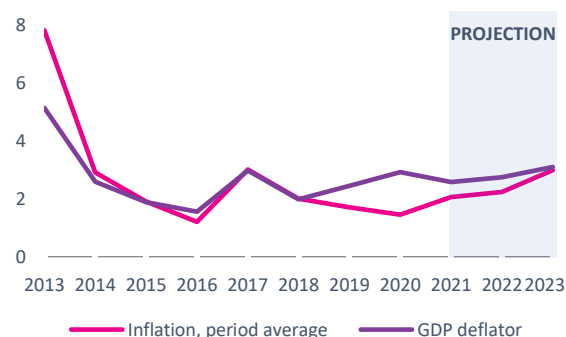


Source: NBS

The presence of continued low inflationary pressures, reduced aggregate demand, low base in vegetable prices, as well as disinflationary effects due to the prices of oil derivatives will cause inflation to move at a low and stable level in the short term. In the medium term, inflation is expected to move around the central value of the target, primarily due to the gradual recovery of domestic and foreign demand, but also the expected gradual neutralization of the disinflationary effect of reduced prices of oil derivatives. Key risks to the realization of the inflation

projection relate to developments in the international environment, and in particular to uncertainties regarding trends in the world market of primary products and the financial market. In the forthcoming period, positive trends in lending activity are expected to continue, as a result of the measures taken so far to encourage lending, low interest rates in the euro area, as well as the expected recovery of economic activity.

#### Inflation projection, %



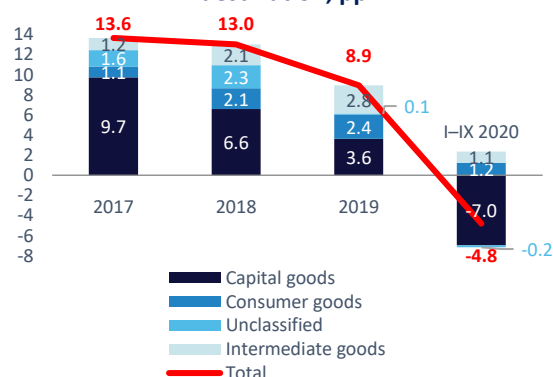
Source: NBS and Ministry of Finance

#### External sector

In 2019, the volume of foreign trade increased and was higher by EUR 3.2 billion year on year. The expansion of foreign trade activity was followed by faster growth of merchandise imports, which increased by 8.9%, while exports grew by 7.7%. With such dynamics of export-import flows, the foreign trade deficit increased by 12.5%. However, this increase was largely determined by the higher needs of the economy for raw materials and equipment, which were imported more by EUR 1.4 billion, while imports of consumer goods were higher by half a billion euros. In terms of structure, the import activity determined by the production needs of the economy contributed to the growth with 6.4 percentage points, while the contribution of the consumption-oriented component was 2.4 pp. The growth of exports of goods in this period was driven by exports of electrical equipment, machinery and agriculture. Also, the rubber and food industries made a significant contribution to the growth of exports. These five activities determine about three quarters of export growth in 2019 and is yet another confirmation of the importance of FDIs for our economy.



### Contributions to import growth rates, economic destination, pp



Source: SORS

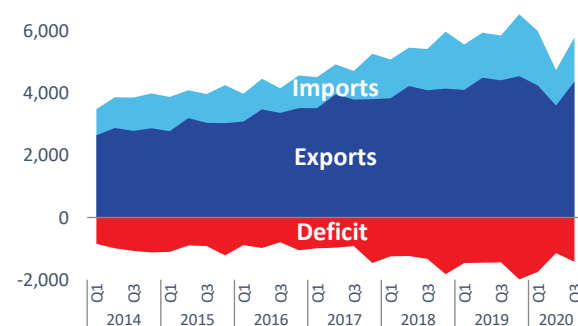
Significant changes in the international environment as a result of the economic shutdowns, consequent changes in global supply chains and reduced economic activity of the most important foreign trade partner countries have had a negative impact on foreign trade activity in 2020. During the first nine months of 2020, the volume of foreign trade decreased, while year on year it was lower by EUR 1.6 billion. Goods were exported (FOB) for EUR 12.2 billion, and imported for EUR 16.5 billion (CIF), which is a decrease of 6.1% y-o-y and 4.8% y-o-y, respectively. Wide diversification of exports by industrial sectors conditioned the decline in exports to be relatively small, while in September already the recovery was materialized through year-on-year growth in export activity. The manufacturing industry continued to be the dominant sector of export activity during the first nine months of 2020. Within this sector, the biggest shock was suffered by the automotive industry, due to reduced demand and dependence of this branch on global supply chains, and lower exports of basic metals and the rubber industry had a decisive negative impact. These three activities together determined lower exports by 5.6 percentage points. On the other hand, the increase in exports of the tobacco industry, food and pharmaceutical industry, provided for the mitigation of the decline in total merchandise exports. Also, a good agricultural season provided a positive contribution of the agricultural sector to export growth.

Imports of goods slowed in the first nine months as a result of lower imports of raw materials due to reduced economic capacity and lower oil prices, while

imports of consumer goods and equipment are recovering and growing. Within the manufacturing industry, the most significant surplus in this period was recorded by the food industry, the production of motor vehicles, the production of rubber and plastic products, the production of furniture and the tobacco industry. The larger absolute decline in imports than exports in the first nine months resulted in a slight reduction in the foreign trade deficit by EUR 35.9 million compared to the same period last year. In the period January-September 2020, the coverage of imports by exports, expressed in euros, amounted to 73.9%.

The most important foreign trade partners in the period January-September 2020 were EU countries, which accounted for 64.3% of total exports and 58.3% of total imports. The largest share of total exports (39.5%) in that period was directed to the markets of five countries: Germany, Italy, BiH, Romania and the Russian Federation. Imports from Germany, China, Italy, the Russian Federation and Hungary accounted for 45.6% of total imports. The surplus was realized in exchange with BiH, Montenegro, Northern Macedonia, Romania, Algeria, Bulgaria, the Czech Republic, Croatia, Slovakia, Great Britain, Sweden and Moldova and amounted to almost EUR 2.1 billion.

### Merchandise trade, mil. EUR



Source: SORS

According to the NBS, the share of the balance of payments current account deficit in 2019 in GDP amounted to 6.9% and increased compared to 2018 by 2.1 percentage points. The increase of the current deficit is a result of a higher deficit in goods (by 10.6% due to faster growth of imports than exports), where higher imports are largely the result of growth in equipment imports due to faster growth of fixed investments. In addition, the increase in the current account deficit in 2019 is a result of a higher deficit of

the primary income account (by 13.6% due to higher expenditures on direct investments) and a lower surplus of secondary income. In the opposite direction, there was a slightly higher surplus in the exchange of services.

Balance of payments trends in the first nine months of 2020 are characterized by a significant reduction in the current account deficit. In the observed period, the current account deficit amounted to EUR 1.7 billion and was lower by 14.9% compared to the same period last year. The lower current account deficit is the result of an improvement in the services account, which recorded a higher surplus of EUR 119.3 mil. and reduction of the deficit on the primary income account by EUR 635.1 mil. The deficit on the goods account is almost unchanged due to the steady decline in exports and imports of goods, as a result of the fall in external demand and disruptions in global supply chains. The services account recorded an increase in the surplus, which was determined by a higher surplus in ICT services, but also a smaller decline in exports of tourist services than imports. The primary income deficit is lower due to lower FDI expenditures. In the opposite direction, there was a lower surplus of secondary income by EUR 423.2 mil., as a result of decreased remittances due to lower labour flow. Reduction of the current deficit since the beginning of the year is the result of developments in the period from April to September. After the current deficit of EUR 956.6 mil. in the first quarter, the current account deficit in the next six months amounted to only EUR 757.3 mil., or slightly more than EUR 125 mil. per month, which is a decrease of 39% compared to the period April-September 2019.

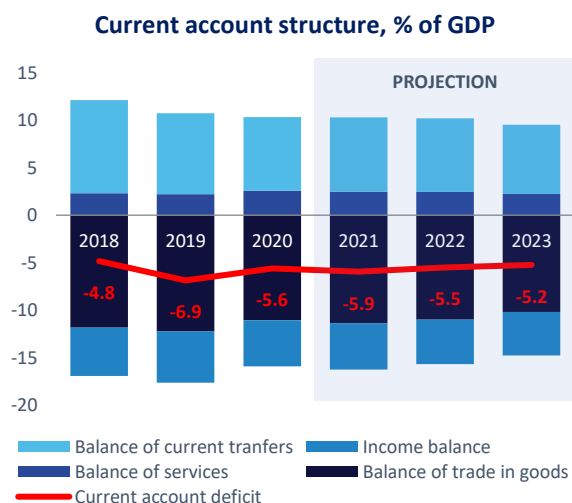
At the same time, FDI inflows remained high despite the adverse effects of the pandemic. FDI inflows provide full coverage of the current account deficit. Also, FDI dispersion provides the desired distribution by sectors that produce tradable goods. Net FDI inflows amounted to EUR 1.7 billion and were lower by 33.1% compared to record inflows last year. According to the structure of net FDIs in the first half of 2020, the largest inflow was recorded by the manufacturing industry - 32.3% and land transport and pipeline transport - 23.8%. Significant inflows were also registered in construction industry, financial sector and trade. Observed by geographical

origin, 67.5% of total investments arrived from the EU in this period, and broken down by country the most significant investments came from the Netherlands, China, Germany, Great Britain and Hong Kong. In the period January-September 2020, there was an inflow based on portfolio investments in the amount of EUR 1.3 billion and an outflow based on other investments in the amount of EUR 1.2 billion, due to a net increase in commercial loans and an increase in net financial assets.

The total current account deficit in 2020 is expected to be around EUR 2.6 billion, or 5.6% of GDP. Having in mind the realized current deficit during nine months, there is a possibility for a better outcome. Also, a stable inflow of FDIs is expected to continue, which in the net amount should amount to around EUR 2.2 billion or 4.7% of GDP.

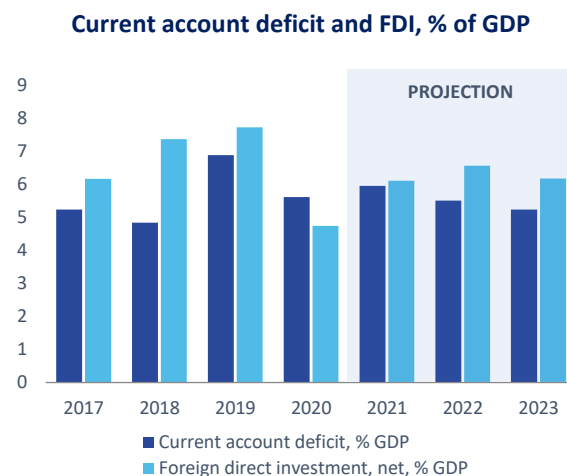
By the medium-term macroeconomic framework for the period 2021-2023, it is planned to improve foreign trade flows compared to 2020 when flows deteriorated due to the global recession and return to previous growth path already in 2021, as well as continuation of modernization and expansion of production and export capacities in the activities of tradable goods, strengthening of competitiveness on the international market and conquest of new market niches.

The growth of merchandise exports in euros at an average rate of 9.8% and imports by 8.6% in the projected three-year period will reduce the foreign trade deficit of goods to 10.2% of GDP in 2023, from this year's 11.1%. The continuation of favourable developments in the services account is envisaged, where the surplus in the projected three-year period will average 1.3 billion euros. The inflow from current transfers will average 7.6% of GDP per year, with remittance revenues retaining the dominant component. The net effect of current transfers and net factor payments in the next three years will be positive and will amount to about EUR 2.5 billion on average per year, which will be enough to cover almost half of the deficit of 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 balance of payments current account deficit to 5.2% of GDP at the end of the projection period.



Source: Ministry of Finance, NBS, SORS

It is important to point out that the structure of the financial account will be dominated by the share of FDI with a share in GDP of 6.3% 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 growth of FDIs, as well as their further diversification towards the tradable goods sector, will contribute to the continuation of export growth and the strengthening of external and internal macroeconomic balance.



Source: NBS, Ministry of Finance

Some indicators of Serbia's external position have deteriorated slightly, but still reflect satisfactory resistance of the Serbian economy to financial shocks from the international environment. The ratio of external debt to exports and external debt to GDP have increased. The sale of government bonds on the international financial market in the amount of two billion euros, with the aim of helping the economy during the pandemic, had the greatest impact on the increase of these external solvency indicators. The share of external debt in exports of goods and services in the first half of 2020 is 138%, which is significantly below the World Bank criteria of 220% and is a guarantee of sustainable debt servicing.

#### **4. Risks involved with achieving the projection of GDP trends in the Republic of Serbia in the period 2021–2023**

The medium-term scenario of economic activity in the Republic of Serbia is accompanied by numerous risks both from the international environment and on the basis of domestic factors.

The risks of the macroeconomic framework are unusually high and arise from the further course and duration of the pandemic and the response to it, particularly after the re-escalation of the epidemiological situation in the world and in our country, and partial or complete closure of certain countries.

The baseline macroeconomic scenario assumes that the impact of the pandemic will weaken during 2021 as progress is made in finding and using vaccines, limiting virus transmission and implementing more effective therapies in treatment. Otherwise, the deterioration of the epidemiological situation and the introduction of additional restrictive measures would lead to further recessionary trends. The recovery of the Eurozone and the region of Central and Southeast Europe, our most important foreign trade partners, in the coming period will depend on the efficiency of health measures, but also on the possibility of using fiscal and monetary incentives and the reach they may have.

In the short term, exogenous risks are asymmetric downwards based on multiple factors. Uncertainty in the international commodity and financial market, trade tensions and collapsed business confidence would have a negative impact on capital flows. Also, the slowdown in external demand and the stagnation in supply chains have a negative impact on export activity, cause a reduction in capital inflows to Serbia, and thus lower industrial production. As for the commodity market, the collapse of primary commodity prices could have a twofold impact on Serbia's economic growth. The movement of oil prices above the projected would have a negative impact on production costs, but would also change the structure of household consumption by increasing the share of imported goods, which would jointly slow down economic growth. Serbia has maintained its role as a net exporter of basic metals despite declining exports, so that faster growth in

their prices would positively affect economic activity and somewhat neutralize the effects of EU measures. The activation of new and expansion of existing export capacities, more favourable trade relations, but also the abolition of 100% tax on products delivered to Kosovo and Metohija will contribute to the mitigation of negative risks.

Endogenous risks are identified as more pronounced upwards. Although the deterioration of the epidemiological situation and the temporary closure of the economy during 2020 resulted in refrain from spending, its full recovery is expected in 2021. On the other hand, the package of economic measures of the Government and the NBS preserved the disposable income of the households and existing jobs, thus providing a recovery faster than expected.

The course of the pandemic will determine developments in the service sector, especially in the transport, catering and tourism sectors. The damage caused by the pandemic in these sectors can spill over to other branches of industry.

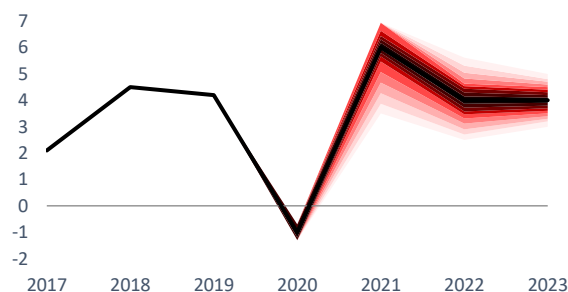
Other factors from the domestic environment relate to the volatility of agricultural production, efficiency in the delivery of public projects and the dynamics of the implementation of the initiated reforms. Continuation of structural reforms and further improvement of the business environment should contribute to faster growth. Despite the improvement and modernization of the agricultural sector, the production of major crops is still significantly dependent on agrometeorological conditions, which may lead to significant deviations from the multi-year average agricultural production on the basis of which the movement of this sector is projected. The baseline scenario assumes a negative contribution of agriculture to GDP given this year's excellent season. The growth of construction industry in the coming period is based on trend developments in this activity, predictive indicators and announced investments of the state. Dynamics and efficiency in the implementation of public projects, after the relaxation of health measures, as well as activities in the segment of construction of buildings and production facilities bring along symmetrical risks.

The movement of industrial production is largely determined by external factors. Nevertheless, the electricity segment could contribute to growth above expectations, if the reform processes were intensified, and investments from the previous period effectuated in the coming period. Also, the reform of public companies is the basis for raising the level of productivity and efficiency, which would reduce the cost of production processes, increase competitiveness and expand investment capacities. The dynamics of the implementation of these reforms is clearly reflected in the dynamics of overall economic growth by influencing it in the same direction, namely faster implementation of reforms brings faster economic growth and vice versa.

Although neutralizing internal and external imbalances in the previous period increased resistance of the Serbian economy to external shocks, we should not lose sight of the fact that we are a small and open economy, which is significantly exposed to them.

Auspicious macroeconomic prospects of the country, improved business environment, maintaining favourable financial conditions and planned investment projects of the state will reduce the uncertainty which is present in terms of the readiness for investments and expansion of production capacity.

**Projection of GDP trends, year-on-year growth rates, %**



Source: Ministry of Finance

## II. FISCAL FRAMEWORK FOR THE PERIOD FROM 2021 TO 2023

### 1. Medium-term goals of fiscal policy

The good state of public finances and the relatively favourable debt levels enabled a generous and timely response of the state to the crisis caused by the pandemic. A package of measures of around 12.5% of GDP, combined with monetary measures, alleviated the negative effects of the crisis and stabilized macroeconomic developments.

The fiscal deficit is expected to reach 8.9% of GDP in 2020, while general government debt will amount to 59% of GDP. The one-time increase in debt and deficit is an inevitable consequence of intervention measures aimed at neutralizing the effects of the crisis. The fiscal package consisted of three components. The first component was assistance to businesses in the form of deferred payment of tax liabilities, direct financial assistance and easier access to credits. Another aspect of the package of measures was the fiscal stimulus to the population with the aim of preserving the standard of living. Finally, a significant part of the funds was invested in the health care system in order to strengthen human resources and procure the necessary medical equipment, supplies and medicines. At the same time, efforts were made not to stop development programmes and infrastructure projects financed from the budget, so that capital expenditures are expected to significantly exceed the plan from the beginning of the year.

The global pandemic is not over yet, so the upcoming period is full of uncertainty. Planning of the economic and, in particular, fiscal policy will primarily depend on controlling and suppression of the pandemic and its completion. The general commitment is to enable a gradual balancing and stabilization of public finances in the period after the pandemic-caused crisis, in order to reduce the share of public debt in GDP and create the basis for stable economic growth. Until then, it is necessary to ensure the possibility of

a timely response of fiscal policy in the event of a deepening crisis.

The medium-term fiscal framework envisages a moderate abandonment of expansionary fiscal policy. Given the uncertain economic situation, the budget will certainly be a “safety net” in case of escalation of unfavourable developments. 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 continued reduction of public debt levels in terms of participation in GDP will be ensured. Bearing in mind the expected macroeconomic developments, the anticipated annual fiscal deficits allow for reduction of the share of general government debt of GDP in the coming period.

Fiscal policy in the coming period will continue to focus on reduction of the overall tax burden on labour, which will further relieve the economy, i.e. increase the competitiveness of the private sector. On the expenditure side, priority will be given to infrastructure and capital projects, as well as pension and wage and salary policies. In doing so, care will be taken not to go beyond the planned sustainable framework by increasing these two, the largest, categories of expenditures. In addition, the stability of public finances and a sustainable fiscal framework will be contributed to by the planned amendments to the Budget System Law, which will, among other things, redesign a set of fiscal rules, both general and special, and define special measures and consequences in case of non-compliance. Special emphasis will be placed on amending the general rules related to public debt and the general government deficit, as well as special rules related to the sustainable level of expenditures for salaries and pensions.



## 2. Fiscal trends in 2019

At the end of 2019, at the level of the general government, the fiscal deficit amounted to 11.1 billion dinars, or 0.2% of GDP, which is by 0.3% of GDP better than planned, given that the budget had planned fiscal deficit of 0.5% of GDP. In the same period, the primary fiscal surplus of 1.8% of GDP was realized. Positive fiscal developments had a favourable effect on the debt trajectory, so the downward trend in general government debt continued in 2019. The debt decreased by about 1.5 percentage points, from 54.4% of GDP at the end of 2018 to 52.9% of GDP at the end of 2019.

Better fiscal result was influenced by the collection of public revenues, which exceeded the plan by as much as 116.9 billion dinars, or 5.4%. Tax revenues were higher by RSD 78.1 billion than planned, or 4.1%. Non-tax revenues exceeded plan by RSD 39.4 billion, or 17.1%. In the category of tax revenues, significantly better performance compared to the plan was recorded in social contributions and income taxes, as well as indirect taxes (especially excise duties). More favourable trends in the labour market, i.e. faster growth of wages and employment, affected the collection of revenue from contributions and personal income tax, where the plan was exceeded by about 0.7% of GDP. Indirect taxes exceeded the plan by about 0.5% of GDP, mostly due to the growth of excise duties (higher by 0.3% of GDP), due to increased consumption of excise products (mostly petroleum products). Significantly better collection of non-tax revenues compared to the plan was the result of unplanned one-off payments. Non-tax revenues were better than planned by 0.4% of GDP. When preparing the revenue projection for 2019, in accordance with the precautionary principle, only the assumed structural, i.e. permanent amounts of non-tax revenues were included in the planned amount of non-tax revenues. The plan did not include one-off payments such as the payment of NBS profit in the amount of RSD 9.3 billion, payments of the Deposit Insurance Agency (hereinafter: AOD) of RSD 1.8 billion, bond reissuing premium, etc. The plan did not include revenues and expenditures of Institutions of

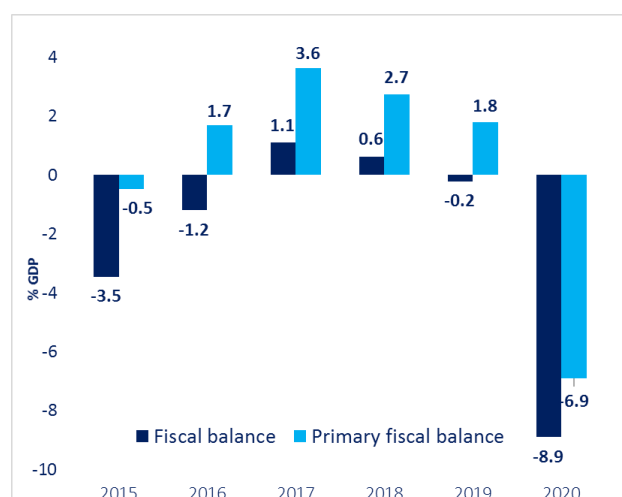
Social Welfare, as indirect budget beneficiaries, which have been included in the budget execution system since 2019.

Total general government expenditures were higher than planned by RSD 99.3 billion, or 4.5%. The largest deviation from the plan was recorded in the realization of capital expenditures, payroll expenditures, expenditures for goods and services and other current expenditures. More efficient withdrawal of project loans and execution of funds on that basis are the main reason why capital expenditures significantly exceeded the planned amount. They were higher by 0.9% of GDP than planned and in 2019 they reached 4.9% of GDP, which was a record level in the last ten years. Higher execution of expenditures for employees compared to the plan (about 0.3% of GDP) was the result of several factors. The inclusion of Institutions of Social Welfare fully covered the salaries of employees of these indirect budget beneficiaries. Another factor that contributed to the increase in expenditures for employees compared to the original amount was the adopted increase of salaries in the public sector ranging from 8% to 15%, starting from November salaries, paid out in December. Expenditures for the purchase of goods and services were higher by 0.3% of GDP than planned. This can be explained by stronger spending at the local level and by the PE "Roads of Serbia" (maintenance of the road network), and part of it came from the previously mentioned inclusion of Institutions of Social Welfare in the budget execution system. Other current expenditures were higher than the budget plan by 0.4% of GDP, partly due to increased execution at the PE "Roads of Serbia", and partly due to the payment of obligations based on the court ruling in connection with the company "Energo-zelena". As for the subsidies, funds were allocated for solving the problems of citizens who had taken loans in Swiss francs, but despite this, the total subsidies were made in accordance with the plan. Other categories of expenditures (social welfare, interests, etc.) were carried out in accordance with the budget plan.

### 3. Current fiscal trends and the outlook for 2020

The general government fiscal deficit in 2020, according to the latest estimates, will amount to 8.9% of GDP. Compared to the result envisaged by the original budget for 2020, the deficit is higher by 8.4 percentage points of GDP. Such a significant revision of the general government fiscal deficit is primarily the result of the impacts of the COVID-19 pandemic on the global and domestic economic developments. The downward trend in the share of public debt in GDP, present since 2016, has been temporarily suspended. In the forthcoming period, due to the stabilization of economic trends and economic recovery, the public debt trajectory is expected to decline again.

#### General government fiscal result in the period from 2015 to 2020, % of GDP



Source: Ministry of Finance

Throughout 2020, the coronavirus pandemic have had extremely negative wider consequences for public health, societies, national economies, both worldwide and in the Republic of Serbia. Ever since March, when the first case of the disease was registered in the Republic of Serbia, epidemiological measures of varying intensity have been in force in order to preserve the health of citizens and reduce the pressure on public health. The COVID-19 pandemic posed enormous challenges to the country's economic policy which is coping to preserve economic activity, jobs and living standards.

At the beginning of April 2020, the Government adopted the "Program of economic measures to reduce the negative effects caused by the COVID-19 virus pandemic and support the Serbian economy", which formulated a set of measures to help the economy in order to preserve liquidity and alleviate employment decline, and the preservation of the living standards of the population and liquidity of households. The program of measures presented the macroeconomic framework which quantified the negative impact of the pandemic on both global and economic developments in our country. The macroeconomic assumptions which served to devise the programme included a revision of real GDP growth by about 6 percentage points (from + 4% to - 1.8%).

The total volume of the package of measures to help the economy and the population was then estimated at over 608 billion dinars (11% of GDP), whereby it was assumed that all economic entities which qualified to apply specific measures would take advantage of this opportunity. As for the effects of the adopted measures, direct reduction of the expected revenues of the general government accounted for 177 billion dinars (160 billion dinars of deferral and rescheduling of tax liabilities based on income taxes and advance payment of corporate taxes).

The first group of tax policy measures referred to the postponement of the payment of taxes and contributions on salaries and income taxes for the private sector, initially for a period of three months, with the subsequent repayment of liabilities incurred in instalments as of 2021 at the earliest. In addition, the postponement measure was extended for another month. All companies (regardless of sector / activity) are entitled to this assistance, provided that they have not reduced the number of employees by more than 10%. The aim of this measure was to preserve jobs and increase the liquidity of economic entities.

The second set of measures included the payment of direct aid in the amount of the minimum wage for entrepreneurs, micro, small and medium enterprises,

namely subsidies of 50% of the minimum wage to large enterprises, whose employees were sent to a compulsory leave due to reduced business volume or complete work stoppage.

The aim of the third set of measures was to preserve the liquidity of economic entities in the conditions of economic crisis expected during and after the end of the emergency situation caused by the COVID-19 virus pandemic. The financial support program referred to the loans that the state would give to companies directly through the Development Fund of the Republic of Serbia, and were intended for entrepreneurs, micro, small and medium-sized enterprises, as well as farms. The second part of the financial support to the economy referred to lending through commercial banks with state guarantees for these loans.

In addition to these measures aimed at the economy, the payment of a sum of money to all adult citizens of the Republic of Serbia in the amount of 100 euros in dinars, calculated at the official middle exchange rate of the NBS, was carried out in order to help the population, preserve living standards and stimulate domestic demand. As part of the package of measures, additional support to health professionals was provided by increasing their salaries by 10% from April this year, as well as one-off aid to pensioners in the amount of 4,000 dinars.

Having reviewed economic developments during the second and third quarter, the situation on the labour market, the effects of the implemented set of measures, all under the conditions of prolonged duration of the complex epidemiological situation, the Government decided to extend the duration of economic support measures. It was decided to

provide direct assistance to micro, small and medium enterprises in the amount of 60% of the minimum wage for another two months (August and September), and to extend the deferral of payment of taxes and contributions for another month. The aim of these measures was to strengthen the economy in Serbia, but also to provide additional time for entrepreneurs to adapt to existing circumstances. Also, a programme of assistance to a segment of economic entities in the field of tourism and catering was additionally prepared and adopted. The total volume of economic assistance measures to the economy and the population in 2020 thus reached 12.5% of GDP (around 690 billion dinars), including guarantee schemes for easier access of the economy to corporate credit funds.

Additional expenditures to support the public health system in the fight against the coronavirus pandemic have been estimated at over 60 billion dinars, or 1.1% of GDP.

The package of economic measures aimed at preserving the productive capacity of the entire economy, maintaining the living standards of the population and ensuring the liquidity of economic entities. In this way, the Government and the NBS have significantly helped to mitigate the immediate economic damage from the shock caused by the pandemic, but also to create conditions for faster economic recovery in the coming period.

The implementation of the package of measures to support the economy, until September 2020 inclusive, is estimated at about 10% of GDP. It is estimated that in the absence of measures to support the economy and the population, the decline in GDP in 2020 would be greater, amounting to about 5%.

## Review of the package of measures to support the economy and the population

	Plan		Realization until 30.09.2020	
	in billion dinars	in% of GDP	in billion dinars	in% of GDP
<b>Tax policy measures</b>				
Deferred payment of payroll taxes and contributions for the private sector during the state of emergency and for one additional month; private companies will repay these obligations in instalments, but not before January 2021	168.0	3.0	97.3	1.8
Deferred advance payment for the second quarter of 2020 of corporate income tax	21.0	0.4	13.5	0.2
Exemption from VAT for all donors	–	–	–	–
<b>Total</b>	<b>189.0</b>	<b>3.4</b>	<b>110.8</b>	<b>2.0</b>
<b>Direct support to the private sector</b>				
Direct support to entrepreneurs who pay a flat tax and entrepreneurs who pay tax on the actual income, and to micro, small and medium-sized enterprises in the private sector - three months payment of net minimum wage and two additional months payment of 60% net minimum wage	128.8	2.3	130.1	2.4
Direct support to large private companies - support in the amount of 50% of the net minimum wage (during a state of emergency) to employees who have received a decision on termination of employment (based on Articles 116 and 117 of the Labour Law).	4.5	0.1	1.6	0.0
Direct support to Hospitality sector - € 350 per bed, 150 € per room, in dinar equivalent calculated at the official middle exchange rate of NBS	2.0	0.0	1.2	0.0
<b>Total</b>	<b>135.3</b>	<b>2.4</b>	<b>132.9</b>	<b>2.4</b>
<b>Measures to preserve private sector liquidity</b>				
Financial support programme during COVID-19 crisis through the Development Fund of the Republic of Serbia	24.0	0.4	14.6	0.3
Guarantee schemes to support the economy during the COVID-19 crisis	240.0	4.4	145.1	2.6
<b>Total</b>	<b>264.0</b>	<b>4.8</b>	<b>159.7</b>	<b>2.9</b>
<b>Other measures</b>				
Dividend moratorium until the end of the year, excluding public companies and loss of revenue arising from dividends	16.0	0.3	–	–
Salary increase measures and other direct financial assistance (10% increase in salaries of health workers, direct financial assistance of RSD 4,000 to all pensioners, support to agricultural producers)	16.0	0.3	16.0	0.3
Fiscal incentive - payment of 100 EUR to all adult citizens	70.0	1.3	72.0	1.3
<b>Total</b>	<b>102.0</b>	<b>1.9</b>	<b>88.0</b>	<b>1.6</b>
<b>Fiscal Impact Assessment of measures</b>	<b>450.3</b>	<b>8.1</b>	<b>346.3</b>	<b>6.3</b>
<b>Overall package of measures</b>	<b>690.3</b>	<b>12.5</b>	<b>491.4</b>	<b>8.9</b>
<b>Other costs associated with COVID-19 (medical equipment and medicines)</b>	<b>–</b>	<b>–</b>	<b>60</b>	<b>1.1</b>
<b>Overall costs related to COVID-19 until 30.09.2020 inclusive</b>	<b>690.3</b>	<b>12.5</b>	<b>551.4</b>	<b>10.0</b>

In principle, the impact of the COVID-19 pandemic on the movement of the fiscal result can be divided into several categories:

- impact on the decline in revenue through automatic stabilizers caused by the fall in GDP;
- additional decline in income caused by measures of epidemiological protection of the population. This is reflected in the restriction of movement, the inability to consume certain services, performing administrative tasks in a certain period, the decline in transit and tourism revenues;
- increase in expenditures for additional health and epidemiological protection of the population, including the construction of additional health facilities and purchase of equipment;
- losses in revenues and increased expenses for the implementation of the package of economic measures to help the economy and population.

During April, the first rebalance of the budget for 2020 was adopted. This budget rebalancing enabled the operationalization of the Programme of Economic Measures, unhindered financing of the fight to preserve health care and lives of people and the reduction of the negative economic consequences of the pandemic for the economy and citizens. The revenue side of the budget was changed taking into account the new projections of economic trends, as well as the estimated effects of the adopted fiscal measures. Changes in the volume and structure of public spending were identified, in order to further adapt it to new economic circumstances, adopted measures and the needs of unhindered and sufficient financing of the country's health system in the circumstances caused by the pandemic. This rebalance planned for the general government budget deficit to be at the level of 7.2% of GDP.

Estimated general government revenues were then revised downwards by 230 billion dinars, and expenditures increased by about 136 billion dinars. Due to high uncertainty regarding epidemiological and economic developments, another budget revision was expected by the end of the year.

In November 2020, the Government adopted the proposal of the second budget rebalance, which, compared to the previous one, increased the estimate of general government revenues by 113 billion dinars, while the increase on the expenditure side amounted to about 210 billion dinars. The general government fiscal deficit of RSD 492.3 billion (8.9% of GDP) was anticipated. The most important reasons for revising the assessment of revenues, expenditures and results in relation to the previous budget rebalance are:

- shorter and milder effects of the most severe epidemiological measures (restricting and prohibiting movement and performance of certain activities) and faster establishment of domestic and, to a certain extent, international economic flows;
- slighter decline in total economic activity than projected, with significant changes in the structure of GDP;
- prolonged impact of the pandemic on economic trends at the international level in relation to the originally planned;
- lack of transit traffic and a drastic drop in the number of foreign tourists;
- conservative planning of certain categories of tax revenues (income tax and dividend taxes) and payment of originally unplanned non-tax revenues;
- cautious approach in assessing the use of economic assistance programmes by economic entities;
- positive impact of a part of the programme of economic measures on labour market trends;
- an additional package of economic assistance measures in the form of tax deferrals and direct assistance to companies;
- additional expenditures for the implementation of health care measures and within the procurement of goods and services and capital investments;
- increasing investments in road infrastructure and accelerating the execution of capital investments.

**Table 6. Revenues, expenditures and result of the government sector in 2020, in billion dinars**

	Budget 2020	Estimate April 2020	New estimate 2020	Difference new/budget	Change, %	2020 New estimate, % GDP
<b>PUBLIC REVENUES</b>	<b>2,340.8</b>	<b>2,110.7</b>	<b>2,223.5</b>	<b>-117.3</b>	<b>-5.0</b>	<b>40.3</b>
Current revenues	2,324.3	2,094.2	2,207.5	-116.8	-5.0	40.0
Tax revenues	2,084.5	1,867.8	1,962.3	-122.2	-5.9	35.6
Personal income tax	215.8	180.0	202.1	-13.7	-6.3	3.7
Corporate income tax	114.4	98.6	122.3	7.9	6.9	2.2
Value added tax	582.0	565.8	547.5	-34.5	-5.9	9.9
Excises	311.1	296.1	299.7	-11.4	-3.7	5.4
Customs Duties	52.0	44.4	51.0	-1.0	-1.9	0.9
Other tax revenues	84.0	82.8	79.6	-4.4	-5.2	1.4
Contributions	725.2	600.0	660.0	-65.2	-9.0	12.0
Non-tax revenues	239.8	226.4	245.2	5.4	2.3	4.4
Grants	16.5	16.5	16.0	-0.5	-3.0	0.3
<b>PUBLIC EXPENDITURES</b>	<b>2,369.8</b>	<b>2,505.5</b>	<b>2,715.8</b>	<b>346.0</b>	<b>14.6</b>	<b>49.2</b>
Current expenditures	2,090.0	2,262.1	2,379.4	289.4	13.8	43.1
Expenditure for employees	554.8	565.2	575.9	21.1	3.8	10.4
Purchase of goods and services	394.7	412.2	453.6	58.9	14.9	8.2
Interest Repayment	113.6	109.1	110.5	-3.1	-2.7	2.0
Subsidies	114.2	206.3	258.3	144.1	126.2	4.7
Social benefits and transfers	824.8	827.3	814.1	-10.7	-1.3	14.8
of which pensions	594.2	588.2	586.2	-8.0	-1.3	10.6
Other current expenditures	87.8	142.0	167.0	79.2	90.2	3.0
Capital expenditures	260.0	207.5	286.7	26.7	10.3	5.2
Net lending	13.1	27.1	41.9	28.8	219.8	0.8
Activated guarantees	6.7	8.8	7.8	1.1	16.4	0.1
<b>Result</b>	<b>-29.0</b>	<b>-394.8</b>	<b>-492.3</b>	<b>-463.4</b>		<b>-8.9</b>
<b>Result in % GDP</b>	<b>-0.5</b>	<b>-7.2</b>	<b>-8.9</b>	<b>-8.4</b>		

Source: Ministry of Finance

The updated fiscal framework for 2020 envisages a fiscal deficit of 8.9% of GDP. In relation to the budgetary planned fiscal framework, the revenue estimate was reduced by 117 billion dinars. On the expenditure side, there was an increase of 346 billion dinars, with significant changes in their structure.

The revenue side of the general government budget was largely affected by the movement of overall economic activity, measures of epidemiological nature, as well as the adopted measures concerning the postponement of tax liabilities. There is also a certain positive effect of better realization of total revenues at the end of 2019, which serves as the base year for the projection.

Estimated VAT collection decreased by RSD 34.5 billion due to nominal decline in personal consumption since the beginning of the pandemic and accompanying negative economic trends. Although the normalization of economic flows started

earlier than expected, there was no recovery in the services sector, partly due to the reduced inflow from tourism and transit. A more detailed analysis of trade in goods and services confirms these conclusions. Namely, the decline in total taxable turnover in the first nine months of 2020 amounted to about 1.5%, with the turnover in retail trade growing, while the taxable turnover in other service activities decreased. Although the disposable income of the population is not significantly reduced (except when it comes to remittances), the inability to consume certain types of services, as well as the caution of the population in uncertain epidemiological conditions, has resulted in the decline in personal consumption.

Revenues from excises decreased by 11.4 billion dinars compared to the original budget. This category of revenues, in addition to a general slowdown in personal consumption, for the most part was influenced by the measures of restriction of movement of the population and the lack of transit



traffic during the summer months. Therefore, the largest decrease was recorded in revenues from excises on petroleum products. The first estimates of losses were higher, but due to the shorter duration of the most severe epidemiological measures, they did not materialize. Revenues from excise duties on tobacco were minimally reduced.

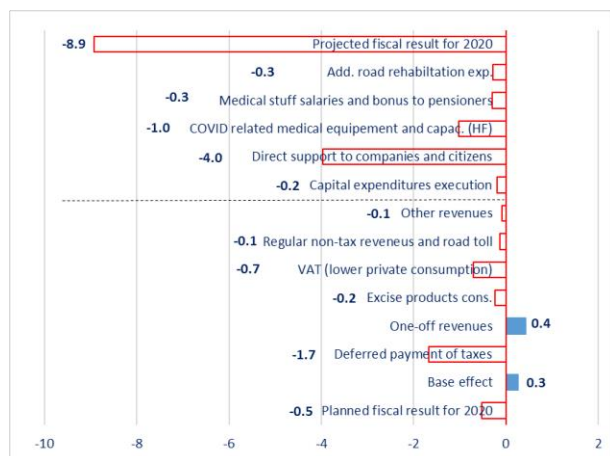
The estimate of personal income tax was reduced by 13.6 billion dinars. Within this category, the largest part constitutes the payroll tax for which the programme of measures provided for the postponement of the tax liability for the next two years. According to the latest available data, a total of around 15.2 billion dinars of net liabilities on this basis have been deferred. A similar explanation can be applied to the movement of social security contributions. According to the latest data, the total net delay in the payment of social contributions amounts to 77.8 billion dinars. It can be expected that a portion of taxpayers will partially make payments of their deferred liabilities by the end of the year. After the period in which there was a possibility to defer payment of obligations, social contributions recorded high growth rates (more than planned in the original budget), compared to the previous year, which testifies to the positive effects of the package of measures to preserve employment. If the effects of tax deferral were excluded on the positions of payroll taxes and social security contributions, it can be concluded that the collection of these two tax forms would significantly exceed the values given by the original projections. Within other income taxes, there is a significant increase in payments based on annual income tax, primarily due to a notably higher number of tax returns compared to the previous period.

Corporate income tax is a tax category whose assessment was revised upwards. When drafting the budget for 2020, the assumption of moderate growth

in profitability of the economy in the Republic of Serbia was used, because the final business results were still unknown. Due to the precautionary principle, the initial budget estimate was slightly underestimated.

The estimate of total non-tax revenues was increased in relation to the original budget by 5.4 billion dinars. Non-tax revenues are a heterogeneous category of revenues with different movements by individual forms. Regular non-tax revenues are various fees, charges, penalties, revenues of bodies and organizations and all other revenues that are generated at a steady pace during the year in approximately similar amounts on a monthly basis with certain seasonal variations. Extraordinary non-tax revenues include payments of profits of public companies and agencies, budget dividends, claims collected by the AOD, bond issuing premiums, etc. Regular non-tax revenues were significantly affected by the economic and epidemiological situation in the country. A special example of this are toll revenues. The cessation of certain economic activities, as well as the inability of certain legal and administrative activities to take place, had the greatest impact on the reduction of revenues from court and administrative fees, revenues of bodies and organizations and revenues from fees. Due to the decrease in activity, there was a drop in the collection of fines. However, after more favourable epidemiological conditions, shorter duration of the state of emergency and faster normalization of activities, the decline in this category of income slowed down. Extraordinary non-tax revenues were adjusted upwards due to the payment of previously unplanned amounts of profit belonging to the budget of the Republic as well as other forms of extraordinary income (NBS, Komercijalna banka, Road Traffic Safety Agency, Medicines and Medical Devices Agency of Serbia, etc.).

**The contribution of individual factors to the correction of the fiscal result in relation to the plan for 2020, % of GDP**



The estimate of general government expenditures has increased by 346 billion dinars in relation to the original budget. The largest part of this increase relates to the implementation of packages to help the economy and the population. The rest consists of expenditures related to the direct fight against the pandemic and the improvement of the country's health capacities. In the period January-September, public expenditures grew at a rate of 21.7% compared to the same period in 2019, and by the end of the year it is expected that the total growth of expenditures will slow down to some extent and reach 18.3%.

Expenditures for employees increased by 21.1 billion dinars compared to the originally planned. Most of this growth is the result of a 10% salary increase in health care system as of April. The rest refers to the increase in the number of people engaged in the health system, increased engagement and the number of working hours in other sectors that participated in the control of the epidemiological situation. One part of the increase is a consequence of a slightly larger execution at the end of 2019.

Expenditures for goods and services increased significantly by almost 60 billion dinars. The largest part of the increase refers to the increase in expenditures for the purchase of medical equipment and supplies by the NHIF in the amount of 47.5 billion dinars, and the growth in expenditures for current road maintenance at PE "Roads of Serbia" of 16.7 billion dinars. At other levels of government, there was a minimal reduction in this category of expenditures.

Subsidies were also significantly increased compared to the original plan, by over 144 billion dinars. From this category of expenditures, direct aid was paid to companies and entrepreneurs to overcome the crisis caused by the pandemic. According to the latest available data, by the end of September, about 133 billion dinars was paid out for these purposes, with direct assistance being used monthly by an average of about 237,000 employers with over a million employees. The rest of the increase in expenditures for subsidies is for the most part made up of increased subsidies in agriculture.

Expenditures for social welfare are lower by 10.7 billion dinars compared to the original plan. The major part of the reduction refers to lower expenditures for pensions of 8 billion dinars. Pensions in 2020 had been indexed according to the "Swiss formula", the parameters of which were known during the planning of pension expenditures. However, due to conservatism in the planning process, a certain increase in the number of retirees had been assumed, which did not materialize during 2020. Pension expenditures temporarily slightly increase their share in GDP to 10.6%, as a result of slower nominal GDP growth caused by the current economic situation. In addition to these expenditures, certain categories of social assistance were less executed as compared to the budget plan.

Other current expenditures increased by 79.2 billion dinars compared to the original plan, primarily due to the payment of direct financial assistance to the population (100 euros to all adult citizens in dinar equivalent converted at the official middle exchange rate of the NBS) in the total amount of 72 billion dinars. The rest of the increase refers to a larger allocation for the payment of old foreign currency savings to the citizens of the former Yugoslav republics. At the time of planning these funds, not all decision-making processes on the submitted claims were completed, so the amount was increased compared to the originally planned.

The item of net budget loans increased by 28.8 billion dinars. Within this category of expenditures, funds for credit assistance to the economy were transferred through the Development Fund of the Republic of Serbia.

The realization of public investments to a greater extent than planned by 26.7 billion dinars is expected. Execution of capital expenditures in the period January-September 2020 compared to the same period last year increased by 14.6%. Capital expenditures reached for now a record level of 5.2% of GDP in 2020. One part of the larger execution is based on investments in new health facilities, as well as equipment that has a longer service life. These expenses are part of the total expenditure for epidemiological protection of population from COVID-19, as well as for the improvement of the health care system in the future. It is also significant that there is an increase in allocations for new and existing infrastructure projects, primarily road and railway infrastructure. In this way, to a certain extent, through the growth of investments, there is a positive

effect on the current movement of GDP, but also preconditions are created for accelerating its growth in the future. In earlier times of crisis, there was most often a decrease in capital expenditures, but this was not the case now, which is a qualitative positive change in public finance management.

The estimated fiscal deficit of 8.9% of GDP is significant, but is comparable to the results that will be achieved in EU countries and the region. On the other hand the analysis of the structural fiscal position, shows that it was not considerably disturbed. On both the revenue and expenditure sides, about 7% of GDP of one-off effects have been identified, which in the case of realization of assumptions from the basic macroeconomic scenario will not be realized again.

**Table 7. Revenues, expenditures and result of the government sector, January-September, in billion dinars**

	I-IX 2019	I-IX 2020	I-IX growth/decline rate %	2020/2019 growth/decline rate in %
<b>PUBLIC REVENUES</b>	<b>1,646.4</b>	<b>1,599.6</b>	<b>-2.8</b>	<b>-2.5</b>
Current revenues	1,639.0	1,591.6	-2.9	-2.6
Tax revenues	1,454.2	1,418.9	-2.4	-1.6
Personal income tax	146.4	143.8	-1.8	-0.8
Corporate income tax	102.7	95.8	-6.7	-3.5
Value added tax	395.1	398.8	0.9	-0.6
Excises	225.5	221.8	-1.6	-2.2
Customs Duties	34.3	37.3	8.9	6.0
Other tax revenues	60.8	58.2	-4.3	-3.1
Contributions	489.4	463.2	-5.4	-2.3
Non-tax revenues	184.8	172.7	-6.6	-10.2
Grants	7.4	8.0	8.3	7.6
<b>PUBLIC EXPENDITURES</b>	<b>1,611.3</b>	<b>1,960.4</b>	<b>21.7</b>	<b>18.3</b>
Current expenditures	1,445.7	1,757.6	21.6	18.5
Expenditure for employees	380.0	426.1	12.1	11.5
Purchase of goods and services	260.4	304.8	17.0	17.3
Interest Repayment	97.4	87.0	-10.6	1.9
Subsidies	69.5	209.1	201.1	113.2
Social benefits and transfers	577.8	593.8	2.8	3.9
of which pensions	419.9	437.3	4.2	4.8
Other current expenditure	60.7	136.7	125.1	80.6
Capital expenditures	152.4	174.7	14.6	7.6
Net lending	4.6	22.5	386.9	284.8
Activated guarantees	8.6	5.7	-34.2	-27.7
<b>Fiscal result</b>	<b>35.1</b>	<b>-360.8</b>		

Source: Ministry of Finance

The stock of arrears (over 60 days of delay) \* of budget beneficiaries and organizations of compulsory social insurance on the last day of September 2020 amounted to 6.7 billion dinars (about 0.05% of GDP), and increased compared to the end of 2019 by 0.9 billion dinars.

Budget beneficiaries and PE "Roads of Serbia" created the arrears in payment of 5.3 billion dinars, while the state of the delay in payments in the organization of compulsory social insurance was 1.4 billion dinars.

**Table 8. The arrears in payments of budget beneficiaries and OCSI in 2019 and January-September 2020, in billions of dinars**

	31.12.2019	30.09.2020
Budget beneficiaries and PE "Roads of Serbia"	4.4	5.3
OCSI	1.4	1.4
<b>TOTAL</b>	<b>5.8</b>	<b>6.7</b>

Source: Ministry of Finance

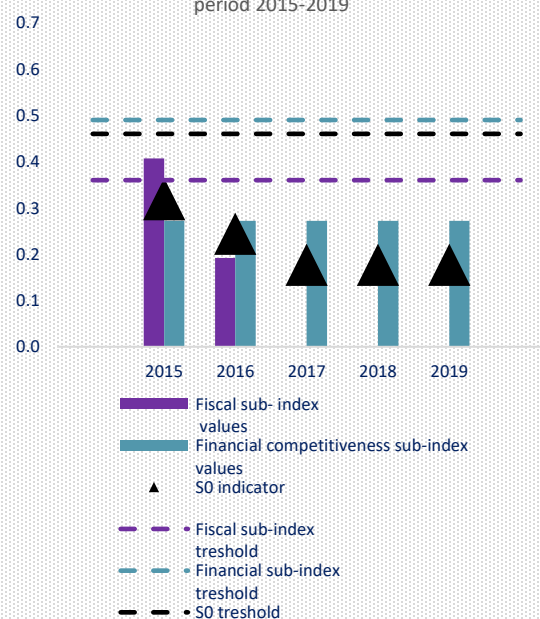
\* Pursuant to the definition used to monitor the implementation of the arrangement with the IMF.

### S0 indicator of short-term fiscal sustainability

To assess short-term fiscal sustainability, the European Commission has designed a composite S0 indicator which, by identifying potential short-term risks in the current year, seeks to anticipate fiscal stress in the coming year. If the S0 indicator value exceeds the defined threshold, it is considered that the country is in a short-term risk of fiscal stress. Along with the value of entire indicator, for the purpose of locating the source of risk, the values of sub-index and their components are considered as well. 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 2019, the values of S0 indicators, as well as both sub-indices for the Republic of Serbia were below the defined thresholds, which in principle indicates that there was no short-term danger of any macroeconomic instability, and that there were no risks arising from the areas covered by sub-indices. The recession in 2020 was not caused by economic factors, and the successfully preserved macroeconomic and fiscal stability established in the previous period provided space for rapid and significant fiscal and monetary support measures.

S0 indicator with fiscal sub-index and financial competitiveness sub-index for Serbia for the period 2015-2019

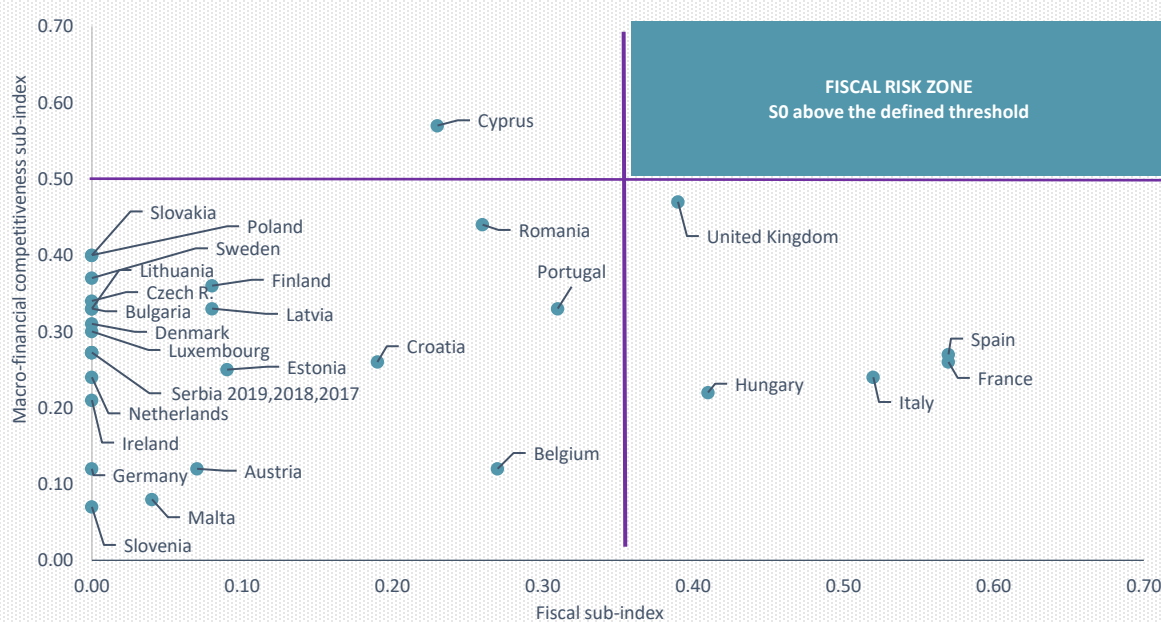


Based on the data of EC for EU countries for 2019 and the calculation of the Ministry of Finance for the Republic of Serbia, for the period from 2016-2019, we may conclude that none of the observed countries was exposed to short-term risk of fiscal stress, since the value of S0 nowhere exceeded the defined threshold. Some countries were faced with fiscal and macro-financial challenges, while the Republic of Serbia, together with most EU countries, was still within the defined thresholds of the S0 indicator.

Minimizing the potential risks of fiscal stress in the observed countries contributed to the creation of space for the adoption of unprecedented economic policy measures in its scope, in response to the health crisis that spilled over into all spheres of the economy.

The calculation of S0 indicator for the Republic of Serbia was done by the Ministry of Finance and is based on the EC methodology.<sup>2</sup>

#### Fiscal sub-index and macro-financial competitiveness sub-index for EU countries for 2019 and Serbia for 2017, 2018 and 2019



Source: Calculation of the Ministry of Finance

<sup>2</sup> A more detailed definition of S0 indicator as well as a description of the methodology and results used can be found in the Fiscal Strategy for 2018 with projections for 2019 and 2020 via the link <http://www.mfin.gov.rs/pages/issue.php?id=8382> and the EC Report "Fiscal Sustainability report 2015" 25, January 2016, 157–158.

#### 4. Fiscal projections for the period 2021-2023

In the next medium-term period, economic and fiscal policy will depend on the development of the pandemic and success in the fight against it. Fiscal policy objectives are certainly 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 1.0% of GDP by 2023 and a decline in the share of public debt to 56.0% of GDP. Projections of fiscal aggregates in the period from 2020 to 2023 are based on projections of macroeconomic indicators for that period, 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, a fiscal space was created enabling

an extensive package of measures to be provided as part of the fight against the effects of the crisis caused by the pandemic during 2020. The same impact of the pandemic which would require a similar package of measures is not expected in the next year, but certain reserves will be provided in case of a new deterioration of economic trends. Fiscal space in 2021 will be used to increase capital investment, additional investment in the health system, a moderate increase in pensions and salaries in the public sector, and to relieve the tax burden on the economy. These measures and their fiscal implications are designed so as not to endanger the stability of public finances and the pace of public debt reduction, then to maintain the living standards of the citizens and help economic development, but also to ensure flexibility to respond to potential new crisis shocks.

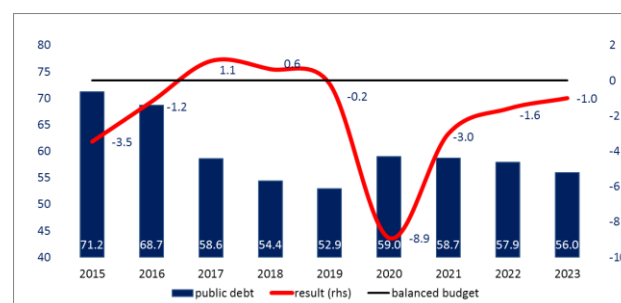
**Table 9. Fiscal aggregates in the period 2019–2023, in % of GDP**

Description	Realization	Estimate	Projection		
	2019	2020	2021	2022	2023
Public revenues	42.1	40.3	40.4	40.5	39.7
Public expenditures	42.3	49.2	43.4	42.1	40.7
Consolidated fiscal balance	-0.2	-8.9	-3.0	-1.6	-1.0
Primary consolidated balance	1.8	-6.9	-1.1	0.1	0.6
General government debt	52.9	59.0	58.7	57.9	56.0
Real GDP growth rate	4.4%	-1.0%	6.0%	4.0%	4.0%

Source: Ministry of Finance

The goals of fiscal policy in the next medium-term period will be the stabilization of public finances and the return of public debt on a downward path. Reducing the share of debt is closely related to the reduction of the deficit as the main factor of borrowing, so that the dynamics of reducing the deficit also determines the change in the movement of debt. Financial transactions, such as swapping expensive debt for cheap debt, as well as a better position of the state in the international financial market, will contribute to further debt reduction.

**Fiscal result and general government debt, % of GDP**





Expansionary fiscal policy in 2020 reduced the negative economic impact of the pandemic. In the next medium-term period, a moderate reduction of the general government deficit has been envisaged in order to ensure the necessary flexibility of the national economy to face potential external shocks through fiscal policy. This primarily refers to the expenditure side, in the form of an increase in public investment, as well as additional investments in health care system. On the revenue side, the priority will remain to further reduce the tax burden on wages.

The projection of revenues in the period from 2021 to 2023 was made on the basis of:

- projections of major macroeconomic indicators: GDP and its components, inflation, exchange rate, foreign trade, employment and wages;
- existing and planned changes in tax policy;
- estimated effects of fiscal and structural measures in the forthcoming period.

**Table 10. Total revenues and grants in the period 2019-2023, in % of GDP**

Description	Realization	Estimate	Projection		
	2019	2020	2021	2022	2023
PUBLIC REVENUES	42.1	40.3	40.4	40.5	39.7
Current revenues	41.8	40.0	40.1	40.2	39.4
Tax revenues	36.8	35.6	36.2	36.3	35.6
Personal income tax	3.8	3.7	3.8	3.8	3.7
Corporate income tax	2.3	2.2	1.8	1.8	1.8
Value added tax	10.2	9.9	10.0	10.1	10.1
Excises	5.7	5.4	5.3	5.1	4.8
Customs Duties	0.9	0.9	0.9	0.9	0.9
Other tax revenues	1.5	1.4	1.4	1.4	1.3
Contributions	12.5	12.0	13.1	13.2	12.8
Non-tax revenues	5.0	4.4	3.9	3.9	3.9
Grants	0.3	0.3	0.3	0.3	0.3

Source: Ministry of Finance

The most significant measures of the tax policy in 2021 will be the increase of the non-taxable threshold from 16,300 dinars to 18,300 dinars and the collection of part of the deferred taxes and contributions from 2020. Collection of deferred liabilities from 2020 will increase the level of revenues above the expected one in 2021 and 2022, which will significantly strengthen the fiscal position. The projection of tax revenues implies maintaining the existing level of collection of tax levies.

The predominant form of income tax is the payroll tax, so the trends in the wage bill and employment are the main factors influencing the movement of this tax form. The increase in the non-taxable threshold will have a negative effect of around 5.5 billion dinars on income tax revenues, but it is expected that the increase in earnings and employment growth will fully compensate for this loss. In addition, these revenues

will be increased by the collection of part of the deferred salary tax from 2020 as part of the package of measures in the fight against the pandemic in the amount of about 7 billion dinars. In the coming period, the wage bill is expected to grow faster than nominal GDP as a result of continued favourable developments in the labour market, so that the salary tax revenues will grow as well in terms of their share in GDP. An increase in the minimum wage will also affect the growth of the total wage bill in the economy, and therefore this tax category.

Other forms of income tax (dividend tax, interest income tax, annual income tax, etc.) will grow more slowly, namely in line with the movement of general economic activity, so that a stable level of income tax income is expected, in terms of its share in GDP. As far as the payroll taxes are concerned, the fight against the shadow economy is crucial, considering

the substantial number of undocumented workers and undocumented payment of earnings. In recent years, the controls have been intensified and sanctions have been tightened, which resulted in reducing the shadow economy in the area of work and employment, but it is very important to proceed with continuous engagement in this area in the following period as well.

Reducing the tax burden on wages will have a negative effect of about 2.5 billion dinars on revenues from contributions. Wage bill growth is expected to be higher than nominal GDP growth, so this loss will be fully offset. The movement of the share of this tax form in GDP has a similar trajectory as the movement of the share of the payroll tax, considering that the same assumptions on the movement of salaries and employment were used for their projection. Part of the revenue will be collected from the payment of deferred contributions from 2020 in the amount of about 32 billion dinars. Contributions are a tax category in which the tax indiscipline is the most prominent and where the largest debt of taxpayers is recorded, so that the consequences of a possible increase in fiscal indiscipline are most visible in this form of taxation.

Revenues from corporate income tax in the period 2021-2023 will depend on trajectory of economic growth, relative stability of RSD exchange rate and general profitability of economy. Assessment of income on this basis may be uncertain due to economic factors, as well as due to the possibility of using a tax credit or refund, as well as differences in accounting and tax balances. The decline in 2021 represents the expectation that the effects of this year's crisis will affect the profitability and income tax collection. Revenue projection on this basis is conservative in the period after 2021 and assumes the collection of income tax in accordance with GDP trends.

The movement of VAT revenues is characterized by a stable share in GDP. The main determinant of VAT trends is domestic demand driven by disposable income of the population. Disposable income as the largest determinant of consumption depends on the movement of salaries in the public sector, pensions, social benefits, the movement of the wage bill in the

private sector and other forms of income, including remittances, as well as the dynamics of banks' lending to households. As with personal income tax, the risks for the realization of the VAT projection in the coming period, in addition to the uncertainty regarding the pandemic, relate to the movement of wages in the private sector, growth of economic activity and the degree of shadow economy, i.e. the efficiency in reducing its size.

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, although the effects of the fight against shadow economy have not been explicitly included in the medium-term projection of public revenues. The increase in the amount of VAT collection in terms of implementing independent anti-evasive measures in the VAT area gave certain results in the previous period. In this segment there is still the room for further improvements, through consolidation and modernisation of tax administration.

The projection of excise revenues is made on the basis of the current excise policy and projected consumption of products subject to excise. Within 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 1.8 euros per pack in dinar equivalent, calculated at the official middle exchange rate of the NBS, within a reasonable time. In the coming period, for the needs of the projection of excise revenues, due to caution, a further natural decline in the market of tobacco products has been anticipated, on average of about 3% per year. Unlike tobacco products, the situation on the market of petroleum products is much less volatile. Better control and labelling effects of petroleum products have reduced the possibility and profit of illegal activities. In the coming years, for cautionary purposes, the growth of consumption of petroleum products has not been envisaged to continue, although it may be expected that the acceleration of economic activity could contribute to

the growth of consumption. Revenues from excise duties on alcoholic beverages, coffee and electricity have been projected in accordance with the existing consumption structure. Current nominal excise amounts on alcohol beverages and coffee are adjusted with the expected inflation rates in the medium-term period. Collection of revenues from excise duty on electricity in the period 2021-2023 has been planned to amount to about 18 billion dinars annually, taking into account the trend of annual consumption and current prices.

Customs revenues will stabilize at 0.9% of GDP in the coming period. The projection of the collection of customs revenues 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 has also been projected. The most significant tax revenue in this category is the property tax, the share of which accounts for about 70%. A nominal increase in this income can be expected based on the expansion of its base. An increase in the level of collection, through an increase in the coverage of taxable real estate (i.e. on the basis of expanding the tax base), has not been included in the medium-term projections and poses a positive risk. In addition to property taxes, other tax revenues include taxes on the use, possession and carrying of goods, as well as other tax forms on the local level. They are projected in line with inflation trends, as the inflation component is incorporated within a significant proportion of these tax forms.

The share of non-tax revenues in GDP is projected to decrease, from 5.0% which was earned in 2019 to 3.9% which is expected to amount to in 2023. In 2019, payment obligations were reduced based on the reduction of salaries for a part of the public sector, while in 2020 this measure was completely abolished. Another reason for reducing the projected share of non-tax revenues in GDP is the exclusion from the base 2020 of all those revenues that are not

considered structural, i.e. permanent, and this primarily refers to extraordinary categories of non-tax revenues. Extraordinary non-tax revenues are mostly one-off, to some extent uncertain, both in terms of their amount, and in terms of the time of payment. The largest part of these revenues are extraordinary payments of profits of public companies and agencies, budget dividends, revenues based on collected receivables of AOD, bond issuing premiums, etc. Regular non-tax revenues include various fees, charges, penalties, revenues of agencies and organizations and all other revenues that are generated at a steady pace in the course of the year. These non-tax revenues are indexed to the realized inflation in the previous year, or follow the changes in the value of the basis to which they apply and as a result are adjusted to the projected inflation.

The process of joining and accession to the European Union membership increases the available funds from IPA and IPARD funds, which make up the predominant part of grant revenues. The projected amounts based on donations also include funds based on EU sector budget support. Revenues from donations are neutral in relation to the result, since they are equal to expenditures on the same ground.

Responsible fiscal policy in combination with good macroeconomic performance in the next medium term will ensure the relaxation of wages and pension policy and a significant increase in capital investment as an important component of economic development. Special attention will be paid to improving the efficiency of delivery of capital investments of the state. Social component of the budget has been improved by better targeting of social welfare programmes and greater allocation of funds for health and education functions. The method of indexation of pensions has also been defined. Salaries and pensions together account for over 50% of general government expenditures and their stabilization is crucial for the sustainability of public finances.

**Table 11. Total expenditures in the period 2019–2023 in % of GDP**

Description	Realization	Estimate	Projection		
	2019	2020	2021	2022	2023
PUBLIC EXPENDITURES	42.3	49.2	43.4	42.1	40.7
Current expenditures	36.9	43.1	37.4	36.1	34.8
Expenditures for employees	9.5	10.4	10.0	9.8	9.6
Purchase of goods and services	7.0	8.2	7.6	7.4	7.1
Interest Repayment	2.0	2.0	1.9	1.7	1.6
Subsidies	2.2	4.7	2.3	1.8	1.7
Social assistance and transfers	14.5	14.8	14.1	14.0	13.7
<i>to pensions</i>	<i>10.3</i>	<i>10.6</i>	<i>10.4</i>	<i>10.3</i>	<i>10.1</i>
Other current expenditures	1.7	3.0	1.4	1.3	1.2
Capital expenditures	4.9	5.2	5,5	5,6	5,7
Net lending	0.2	0.8	0.4	0.2	0.1
Activated guarantees	0.2	0.1	0.2	0.2	0.1

Source: Ministry of Finance

In 2020 there was a change of trend in public spending due to the need to respond to the crisis caused by the pandemic. Measures were significant on the expenditure side, which led to a high, albeit one-off, jump in the share of the expenditure side of the budget in GDP.

Such is the case with expenditures for employees that reached the level of 10.4% of GDP in 2020, thanks, among other things, to the extraordinary salary increase for employees in the health care system. Given the limited fiscal space in the next period earnings will grow moderately, along with the control and reduction of their share in GDP.

Salary reduction, employment control and streamlining the number of employees in the public sector were the measures that contributed most to downsizing expenditures and attaining success in fiscal consolidation. Budget System Law stipulates lowering the level of wages without contributions at the expense of the employer to 7% of GDP, however, it seems that the targeted level of wages is set quite low. Currently, the share of such defined wages in GDP is around 10.4%. The average level of wages at the level of general government in EU is about 10% of GDP. In the previous period, a comprehensive reform of the public sector wage system was initiated, which aimed at ensuring fairness and reducing the risk of discrepancies between the salaries of public sector

employees. The implementation of the new reformed salary system in the public sector should start in 2022.

During the consolidation process, a ban on employment in the public sector was in force. On the one hand, this enabled control of the level of salaries, but on the other hand, the number of fixed-term employment contracts increased, as well as the lack of staff in certain parts of the public administration. A more flexible way of controlling employment is now in place, based on medium-term staffing plan in all areas of the public sector in line with budget constraints.

Expenditures for purchase of goods and services will gradually decrease in the medium term with regard to their share in GDP and return to 7.1%, as their nominal growth is anticipated to be slower than nominal GDP growth. The surge in 2020 was largely the result of higher expenditures in health care system.

The reduction of interest expenditures is one of the best indicators of a successful fiscal and monetary policy, as well as their full coordination in the previous period. Good fiscal results in the previous period reduced the need for borrowing, which, together with the easing of monetary policy, led to a fall in interest rates. In 2023, the level of interest expenditures will decrease to 1.6% of GDP.

Social assistance and transfers to the population represent the largest expenditure category of the general government budget. The largest single item of this group of expenditures, and at the same time the largest item of all expenditures, are pensions, which in 2020 will reach the level of 10.6% of GDP. As of 2020, pensions have been harmonized with the so-called “Swiss formula”, in order to simultaneously ensure the growth of the living standard of pensioners 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. It is estimated that in the coming period the indexation would be between 5 and 6%, and in 2021, specifically, it will amount to 5.9%. 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 field and with the projected number of beneficiaries. The share of expenditures for social benefits in GDP shall decrease from 14.8% in 2020 to 13.7% in 2023.

The reduction of subsidies that serve to help inefficient segments of the public sector enables an increase in the portion of subsidies that represent real incentives to the economy, primarily agriculture and small and medium-sized enterprises, leading to the acceleration of economic activity. The aim is to redirect subsidized funds over to development programmes in the economy and agriculture. The growth of subsidies in 2020 is the result of the implementation of measures to overcome the problems caused by the pandemic crisis.

Categories of other current expenditures consist of various expenses, such as grants to associations, political parties, religious and sports organizations, penalties, compensation for damages, etc. As with subsidies, the one-time growth was caused by the fiscal response to the crisis, and a reduction of these expenditures in GDP is expected in the coming period.

During 2018 and 2019, the efficiency of execution of public investment was significantly improved. Capital expenditures increased to 4.9% of GDP in 2019 due to

the commencement of a new cycle of infrastructure projects, and in 2020 they are expected to reach the level of 5.2% of GDP, despite the problems caused by the pandemic. In the next medium-term period, further growth of investments in public infrastructure is expected. Reducing the current expenditure of the government sector has provided fiscal space that will be partly used to increase investments. The most significant infrastructure works are carried out on road, railway and water infrastructure, which are mainly financed from international loans. In addition to transport infrastructure, funds have been provided for additional capital investments in health care, education, culture, defence and other areas that represent the most important functions of the state. This is all part of a new investment cycle at the national level that has been made possible by the creation of fiscal space and supported by favourable conditions for borrowing in the international financial market.

The general commitment of fiscal policy in the medium term is to increase investment in infrastructure at all levels of government. According to the estimates of the Fiscal Council, investments of the local self-government in the medium term should be increased by at least 75% compared to their current level, i.e. by about 250 million euros. These are primarily investments in water supply and sewerage infrastructure, waste management, local road infrastructure and more.

In the medium-term fiscal framework, by the end of 2023, a balanced overall fiscal position of local self-government has been 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 collectively, local self-government units were usually in surplus. This situation at the level of all local governments is a consequence of deleveraging in the previous period. This does not mean that individual LGUs cannot go into deficit. It primarily depends on the fiscal position of each individual municipality and city.

The level of budget loans and debt repayment on the basis of guarantees is a good indicator of the success

of fiscal consolidation. The total share of these two categories in GDP was reduced to 0.4% of GDP in 2019 with temporary growth in this and next year. By the end of 2023, these expenditures will be minimal, with a share of up to 0.2% of GDP.

Activated guarantees and payment of guarantees on commercial transactions are liabilities based on the debt of public companies assumed by the state budget, since these companies could not perform them on their own. These expenditures were a great burden on the budget given the long-term 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 envisages that from 2020 on, these expenditures will amount to only about 0.1% of GDP.

### **Structural measures to improve the stability and sustainability of public finances<sup>3</sup>**

At the time of writing this paper, in conditions unprecedented in recent world history caused by the COVID-19 pandemic, creation of the Policy Coordination Instrument (PCI) is nearing its completion – arrangement concluded by the Republic of Serbia with the IMF in July 2018, for a period of 30 months, which provided for the continuation of institutional and structural reforms, after successfully implemented fiscal consolidation and the previous precautionary arrangement with the IMF.

The program has helped to preserve macroeconomic and fiscal stability, but in the current year, in accordance with the new circumstances, the program has been redefined and aimed at mitigating the negative consequences caused by the COVID-19 pandemic. The shock caused by the pandemic had a particularly negative effect on the economy of the Republic of Serbia, export demand, FDI, remittances and supply chains, especially during the second quarter of 2020, after which a significant economic recovery began. Owing to the responsible fiscal policy in the previous period, in response to the crisis caused by the pandemic, a significant package of fiscal and

monetary measures was implemented, which supported the businesses and citizens, preserved jobs, equipped the health care system and provided assistance to the most vulnerable groups. All these measures, with a simultaneous shock on the revenue side, resulted in a considerable increase of the fiscal deficit and public debt. Stabilization and return of these categories to a sustainable path are expected in the next year and in the medium term. Monetary policy has supported the economic recovery, with low and stable inflation and maintaining the relative stability of the exchange rate, while further strengthening the dinarization process. In the financial sector, where the share of non-performing loans decreased to 3.4% in September, which is the lowest amount since they were monitored, activities will continue to reduce them, with the continuation of reforms of financial institutions (state-owned banks, state development agencies, etc.), in accordance with the Programme. Structural and institutional reforms in the next medium term will aim to improve the business environment, which contributes to a more successful EU accession process. These reforms will focus on restructuring state-owned enterprises, financial institutions and public administration, as well as further reducing the grey economy.

A functional system of fiscal rules is needed in order to ensure the stability and sustainability of public finances in the long run. The fiscal rules currently in force were introduced in 2010, but have not managed to help stop the growth of the deficit and public debt. Due to the pandemic, the adoption of a new set of fiscal rules has been postponed this year. As of this year, the indexation of pensions has been reintroduced, where pensions are adjusted using the “Swiss formula”, while respecting the limit of 11% of GDP for total pension expenditures. Next year, a fiscal rule should be adopted, which would be in use from 2022, which defines the level of deficit and which ensures that the level of public debt is set on a downward trajectory. In defining a new set of fiscal

---

<sup>3</sup> A more detailed overview of structural reforms by priority areas is an integral part of the Economic Reform Programme in the period 2020-2022.



rules, in addition to the Ministry of Finance, the IMF and the Fiscal Council will take an active part.

In the coming period, the reforms in the field of employment, human resources management and payroll system in the general government are expected to continue. The goal of fiscal policy in the medium term is to keep expenditures for employees at a sustainable level, with an adequate structure of employees, in order to ensure higher quality of services provided. In the next medium-term period, the emphasis is on structural measures, which through optimization of the number of employees on the one hand, and the establishment of a new salary system in the government sector, on the other hand, would contribute to increasing the efficiency and quality of public services.

In recent years, laws and bylaws have been adopted to pinpoint the coverage and number of public sector employees. Act of 31 July 2015 on means of determining the maximum number of public sector employees, which defined the maximum number of full-time employees at the institutional level, was in force as a *lex specialis* until December 31, 2019. It was planned that a new system of pay grades for all employees in the public sector (including the army and police), i.e. a new Law on Salaries of Civil Servants and Employees and amendments to the Regulation on the Catalogue of Jobs in Public Service and Other Public Sector Organizations, would be drafted this year, in order to be ready for implementation with the budget for 2021. Due to the known circumstances that influenced the formation of new authorities, which would then participate in the negotiations on a new system of salaries and coefficients with the trade unions, the entire process was postponed for the next year. The new pay grade system should be implemented from 2022 on.

The existing system of recruitment, managed by the Government Commission giving approval for new employment and further hiring of employees by the beneficiaries of public funds had its shortcomings and led to problems in a timely and adequate human resources management. Therefore, it is necessary to replace the existing solution with a new one, where

staffing would be managed at the level of each public sector organization in the medium term and in accordance with budget constraints. During the transition period, it is possible for institutions to hire new persons up to the level of 80% of those who leave the institution or retire, while the permission of the Commission is required if the number of new employees exceeds 80%. Also, limits will be set for the total number of employees in relation to their number at the end of 2020. The development of an electronic register of public sector employees is underway, which should be completed by 2023, and a pilot project involving employees in the Ministry of Finance is already operational.

In order to reduce various forms of budget support to public and state-owned enterprises, reforms of the largest public and state-owned enterprises are continuing. Reduction of budget support to these companies implies: a) limitation of direct and indirect subsidies, b) a strict limitation on issuing guarantees for new loans and c) strengthening accountability and transparency in the operations of these companies, including control and reduction of arrears in payments, especially to PE "Elektroprivreda Srbije" (hereinafter: EPS) and PE "Srbijagas". In the forthcoming period, a plan will be drawn up to repay the accumulated arrears caused by the pandemic and new measures will be adopted to prevent their accumulation in the future.

The status of a company from the portfolio of the former Privatization Agency is resolved through bankruptcy or privatization proceedings. By September 2020, the bankruptcy was declared in over 300 companies, while 67 had been privatized since the end of 2014. About 35,600 employees from 355 companies accepted the social programme. Intensive work is being done to find solutions for another 72 companies with almost 29,000 employees.

As for the enterprises representing strategic companies from the portfolio of the Privatization Agency, the solution is to be found either through privatization tenders, or through bankruptcy. Privatization advisor was appointed for the transport company "Lasta" JSC Belgrade last year, but the

privatization process was postponed due to the crisis. With the support of the World Bank, the Action Plan for PE PEU “Resavica” was defined, which includes finding a solution for closing economically unsustainable mines and a rationalization plan, with the option of voluntary leave and provided funds for social programmes and resources to support business in order to avoid the accumulation of arrears in payments, especially to PE EPS. Talks with potential investors are underway for HIP Petrohemija, after which a tender procedure will be announced. For HIP Azotara, after unsuccessful attempts to find a strategic partner, bankruptcy was declared, while for MSK Kikinda, a solution is being sought in finding strategic partners or investors.

For a number of state-owned companies, strategic partners or other models of privatization are required, namely the implementation of pre-pack reorganization plans (PRPs).

Improving public financial management is necessary not only to support fiscal consolidation measures and structural reforms, but as a process that raises the quality of public administration and provides an environment that is attractive and desirable ground for investors. Reform activities within the various subsystems of public financial management (PFM) are covered by the revised Public Financial Management Reform Programme 2016–2020 (PFMR Programme). The Ministry of Finance has started drafting a new Public Financial Management Reform Programme for the period 2021-2025.

The Budget Execution Information System - ISIB - is part of the public financial management system that includes processes and procedures carried out by electronic communication with the Treasury Department within the Ministry of Finance. The development of this system will enable tracking of all indirect beneficiaries from the central government level. The system includes direct beneficiaries of public funds, judicial authorities, and since last year also indirect beneficiaries of the Ministry of Culture and Information and the Directorate for the Execution of Criminal Sanctions, which were not part of the previous system (FMIS). Since 2019, social

welfare institutions have also been included, so that only indirect beneficiaries of the Ministry of Education, Science and Technological Development are still not covered by the system. The system is capable of enabling the integration of new users in the future. The financial plans of Social Insurance Funds will continue to contain data on their indirect beneficiaries.

The area of public financial management to which serious attention has been paid and which is being improved is public investment management. Strengthening the public investment management framework intensifies new infrastructure projects and raises the quality of existing infrastructure. Capital projects, i.e. project loans have become an integral part of the budget. 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. In order to improve the framework for public investment management, in line with the recommendations of technical assistance of the IMF and World Bank, and based on the Decree on the content, preparation method and assessment, monitoring the implementation and reporting on the capital projects, by the end of the year a rulebook should be adopted which will contain a brief overview of feasibility studies for large and strategic infrastructure projects. The public investment management system includes an integrated database of investment projects, which is currently being developed, and a single list of priority projects (*Single Project Pipeline*) has been established, in order for the system to start functioning during 2021 and become fully operational during 2022.

*Public-Private Partnerships* (PPP), as a specific type of cooperation between the state and the private sector, require special attention and caution, so the Ministry of Finance will in the future evaluate all proposals in terms of cost-benefit analysis and risk sharing.

Action plan for the transformation of the Tax Administration for the period 2018-2023 adopted in

December 2017 defines strategic guidelines and deadlines in which the activities necessary for the creation of a modern tax administration will be carried out, which will, with the use of modern electronic processes provide better and more comprehensive service to taxpayers and better control and collection of revenues, stepping up the fight against the grey economy, together with the reform and modernization of inspection supervision. In 2019, the organizational separation of core activities from those considered secondary was carried out, with the main activities now being performed in a smaller number of organizational units, i.e. their consolidation was performed. Analysis of business processes and necessary resources will enable the development of an adequate organizational structure and management, improvement of project management and design of an adequate structure of employees. The next phase of reforms is focused on information systems, and a tender to replace the existing system with a new one is expected next year. The implementation of measures aimed at reducing the average time for VAT refunds, i.e. compliance with the prescribed deadlines, continues, with the application of the precautionary principle, in order to minimize the possibility of fraud, and for low-risk taxpayers to be reimbursed as early as possible. The Centre for Large Taxpayers (CVPO) will expand its scope, i.e. the number of entities that settle their tax liabilities through this system will be increased, at the same time, the capacity of this very important organizational unit within the Tax Administration is being strengthened. With the adoption of the Law on Determining the Origin of Property and on the Special Tax and the formation of a special organizational unit of the Tax Administration, conditions were created for cross-analysis of assets and income of individuals,

in order to investigate cases of unjust enrichment and determine a special tax accordingly. The procedure has been initiated for appointment of an external consultant to review existing business processes and manage the process of their re-engineering and modernization. The Tax Administration has played a significant role in implementing some of the measures taken in response to the COVID-19 crisis: deferral of payment of taxes on salaries and contributions and their payment in 24 instalments, starting from next year, postponement of advance payment of corporate income tax for the second quarter of 2020, a three-month moratorium on forced collection and reduction of interest on tax debt.

Improving the quality and transparency of national statistics is done through the promotion of comprehensive, timely and automatic data exchange between competent institutions. In April 2018, a 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, based on the basis of which SORS (in cooperation with the Ministry of Finance and NBS) will start submitting data to the Extended General Data Dissemination System (e-GDDS) as of 2021. This data will be in accordance with the GFSM 2014 methodology. Department 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 public finance data from the national methodology to the GFSM 2014 methodology and their consolidation, covering all levels of the general government in order to enable a complete transition to the new methodology in terms of coverage, planning and reporting in the future.

### Comparison with the previous programme

The medium-term fiscal framework has changed significantly compared to the previous document<sup>4</sup> bearing in mind the negative effects of the pandemic on economic trends. The decline in revenues and the growth of expenditures and deficits are the main differences compared to the previous document. In 2020, the decline in revenues was caused partly by the application of measures to stabilize the economy, and partly by unfavourable macroeconomic trends. In the coming period, revenue performance is expected to improve, but still lower than it would be under normal circumstances. On the expenditure side, the

implementation of measures caused an increase, primarily through significant investment in the health care system, and then through subsidies and other fiscal stimuli in order to mitigate the effects of the crisis in the economy and the population. In the coming period, expenditures will gradually decrease in terms of their share in GDP. In the future, as long as the uncertainty related to the pandemic lasts, a somewhat more expansionary fiscal policy will be pursued. Planned deficits enable the reduction of the share of public debt in GDP, and in the long run it is planned to return to the annual deficit of 0.5% of GDP.

**Table 12. Comparison of fiscal indicators of the two programmes, in% of GDP**

	2019	2020	2021	2022	2023
Fiscal strategy 2020–2022 <sup>5</sup>					
Revenues	41.4	42.4	41.1	40.7	–
Expenditures	41.9	42.9	41.7	41.3	–
Result	-0.5	-0.5	-0.6	-0.6	–
Fiscal strategy 2021–2023					
Revenues	42.1	40.3	40.4	40.5	39.7
Expenditures	42.3	49.2	43.4	42.1	40.7
Result	-0.2	-8.9	-3.0	-1.6	-1.0
Difference					
Revenues	0.7	-2.1	-0.7	-0.2	–
Expenditures	0.4	6.3	1.7	0.8	–
Result	0.3	-8.4	-2.4	-1.0	–

Source: Ministry of Finance

<sup>4</sup> Fiscal strategy for 2019 with projections for 2020 and 2021.

<sup>5</sup> The amounts were recalculated based on the revision of the GDP series data from 2018 to 2021.

## 5. Fiscal risks

As most of the countries in the world, in 2020, the Republic of Serbia has been affected by health and economic crisis caused by the SARS-CoV-2 pandemic. In a very short period of time, the economic crisis has affected the global aggregate supply and demand, inter alia due to the high level of interdependence of the global economy. Some sectors, such as catering, tourism, air transport, as well as a range of various services, were forced to suspend their operation almost overnight, in order to reduce, i.e. to slow down the spreading of the virus. The pandemic has limited or stopped the production, either due to the disrupted supply chains and the lack of raw material, or due to the failure to organize the production in a safe way, from epidemiological point of view.

In response to the economic crisis caused by the SARS-CoV-2 pandemic, the Republic of Serbia implemented strong intervention measures. With a view of eliminating harmful consequences caused by COVID-19, a comprehensive package of economic measures was adopted aimed at reducing the unemployment and preserving the liquidity of companies, maintaining investments, enabling the survival of certain sectors (tourism, agriculture etc.). The assistance has been provided to certain categories of the population (pensioners, healthcare workers), as well as the payment of one-off financial assistance to all adult citizens.

The Government has defined a low and sustainable deficit of 0.5% of GDP as the medium-term objective of the fiscal policy, which shall ensure further reduction of the public debt. In the previous period, the fiscal consolidation program has been successfully implemented, the stability of public finances was provided, and the maintenance of fiscal stability was defined as the goal in the following period, along with the implementation of measures supporting the economic growth. In these uncertain circumstances, special attention needs to be paid to management of fiscal risks, whose realization may endanger the realization of the set medium-term goals of the fiscal policy. This year, primarily due to providing support and required capacities for the functioning of the public healthcare system, and to

eliminate adverse economic consequences of the pandemic, a drastic one-off deviation from the targeted medium-term deficit by about 8.4 p.p occurred.

In the next period, after the one-off deviation, a gradual return to the sustainable level of deficit is expected, as well as the continuation of the declining trajectory of public debt to GDP.

Fiscal risks represent the exposure of public finances to certain circumstances which may cause deviations from the projected fiscal framework. Deviation may occur in revenues, expenditures, fiscal result, as well as in state assets and liabilities, compared to what is planned and expected. The Government cannot influence the external risks, such as natural disasters or global financial crisis; however, it is possible to define exit strategies that could mitigate their effect (maintaining stability in good times, so as to make room for the adequate response of fiscal policy in times of recession or crisis, insurance in case of natural disasters etc.). Internal risks, i.e. their materialization, are the consequence of the public sector activities, hence the probability of their realization might be influenced by the Government decisions and policies.

In the previous decade, the Republic of Serbia has faced the realization of numerous risks which seriously jeopardized its fiscal position. The financial crisis and recession negatively impacted the public finances, causing high deficits and the accelerated increase of public debt. The global financial crisis, as an external factor, has also activated internal risks, so the payments on the basis of guaranteed loans, executions of court decisions, and resolvment of state financial institutions issues and an incorporation of public enterprises liabilities into public debt, have further worsened the fiscal position. In 2014, the Republic of Serbia also faced the catastrophic consequences caused by the floods. The total damage (losses included) was estimated at more than EUR 1.7 billion<sup>6</sup>. Given the previous experience and the significant deterioration of fiscal position caused by the materialization of mentioned fiscal risks, it is

---

<sup>6</sup> <http://www.obnova.gov.rs/uploads/useruploads/Documents/Kancelarija-za-pomoc-poplavljenih-podrucja-infograf-15-04-2016-srb.pdf>

crucial to return to the sustainable level of deficit, after the crisis caused by the pandemic.

The Ministry of Finance has the leading role in managing fiscal risks. As a key institution for medium-term macro-economic and fiscal planning, budget formulation and management, the Ministry of Finance shall also have a leading role in the establishment of institutional and legal structure, as well as building the capacities necessary for fiscal risk management. The organizational unit for fiscal risk management in the Ministry of Finance has been established with the aim of working towards strengthening legislative regulation and methodological framework, building capacities and development of technical tools and models necessary for monitoring and assessment of fiscal risks. The intention of these activities is to identify and assess the risks and to propose exit strategies, as an assistance to the Government in preserving the stability of public finances, which is the key goal of fiscal policy and one of the prerequisites for more dynamic economic growth.

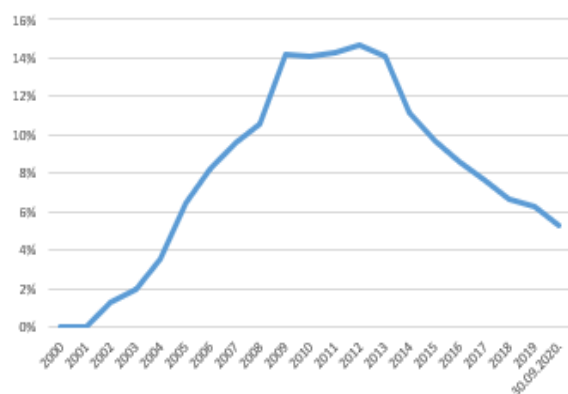
### State guarantees

Guarantees issued by the state affect the height of public debt, as well as the height of deficit, if the states take over the repayment of credit instead of the original debtor. Issued guarantees, according to the definition in the Public Debt Law, are part of the indirect liabilities and included in the public debt<sup>7</sup> in their total amount. The limitations set for issuing new guarantees were successful, so that the share of indirect liabilities in the overall public debt is

reducing. Indirect liabilities (guarantees issued by the Republic of Serbia) participated with 6.2% in the overall public debt, according to the national methodology, at the end of 2019. The share of these liabilities in the public debt keeps declining in the current year as well, so at the end of September 2020, the share of these liabilities was 5.3 % of the overall public debt. The biggest share of these liabilities in the public debt, slightly above 14% on average was recorded between 2009 and 2013.

### The share of indirect liabilities in the overall public debt of the Republic of Serbia

At the end of 2019, the debt balance on the basis of issued guarantees was EUR 1.488 billion, i.e. 3.2% of GDP. The balance of debt on this basis was reduced for about EUR 36 million, compared to the end of 2018. By September this year, the debt balance was reduced for additional EUR 79 million, compared to the end of 2019 and amounts to EUR 1.409 billion, on 30 September 2020.



<sup>7</sup> Definition of debt, according to the criteria from Maastricht, among others, treats differently given guarantees, when compared to the definition of public debt according to the domestic legislation. The public debt (debt of the general government) includes, according to the criteria from Maastricht, only activated guarantees. Domestic legislation has more conservative approach to this issue, and incorporates all given guarantees into the public debt.

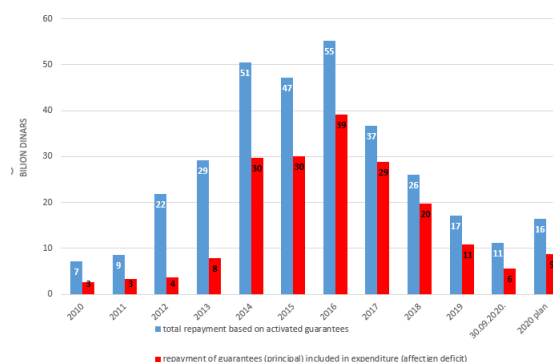


**Table 13. Debt balance based on guarantees issued in millions of euros**

Beneficiary	30/9/2020
PE "Srbijagas"	180.5
PE "Roads of Serbia"	286.6
"Serbian Railways" JSC	166.6
"Infrastruktura železnice Srbije" JSC	58.8
"Srbija Voz" JSC	21.2
"Serbia Cargo" JSC	52.2
PE "EPS"	380.4
"EMS" JSC	32.2
Local self-government units (cities and municipalities)	200.8
"FIAT Automobiles Serbia" LLC	6.3
PE "Jugoimport - SDPR"	10.7
Serbia and Montenegro Air Traffic Services SMATSA LLC	1.3
"JAT Tehnika" LLC	2.8
PE "Emisiona tehnika i veze"	8.9
<b>TOTAL</b>	<b>1,409.4</b>

Source: Ministry of Finance, Public Debt Administration

Total planned repayment on the basis of guaranteed loans in 2019 is RSD 15 billion, of which 11 billion affect the deficit. The accounting methodology, until 2014, did not include repayments based on guarantees into expenditures<sup>8</sup>. Since 2014, part of these expenditures has been included in the budget expenditures<sup>9</sup>. Independently from budget and accounting presentation, the debt paid by the state instead of the main debtor increases overall needs for borrowing.

**Debt repayment based on activated guarantees, RSD billion**

<sup>8</sup> Repayment based on the guarantees from the republic budget is included into the expenditures on the cash basis. International standards, based on the accounting basis, include the entire amount of the remaining debt in the expenditures, at the moment of activating guarantees, whereas the very repayment of debt on that basis is treated as the financial transaction.

<sup>9</sup> Part of the expenditures on the basis of repayment according to the guarantees for PE „Roads of Serbia“ is not considered as the part of the budget expenditures, because this enterprise is the part of the general government sector, so the expenditures financed with guaranteed credits were part of the general government expenditure at the moment of resources consuming, whereas the very repayment is treated as the financial transaction („below the line“).

**Table 14. Total paid liabilities on the basis of guarantees per beneficiaries, in billions of dinars**

Beneficiary	2019			2020 (until 30/9)		
	Principal	Interest	Total	Principal	Interest	Total
PE "Srbijagas"	4.6	0.1	4.7	0.3	0.0	0.3
PE "Roads of Serbia"	4.2	1.4	5.6	3.9	1.2	5.1
"Serbian Railways" JSC	4.7	0.6	5.3	3.6	0.4	4.0
JAT	0.2	0.0	0.2	-	-	-
"Galenika" JSC	0.5	0.0	0.5	-	0.0	0.0
Belgrade Nikola Tesla Airport	0.5	0.0	0.5	-	-	-
PE "Emisiona tehnika i veze"	0.3	0.0	0.3	0.1	0.0	0.1
"Infrastruktura železnice Srbije" JSC	-	-	-	1.0	0.0	1.0
"Srbija Voz" JSC	-	-	-	0.1	0.0	0.1
"Serbia Cargo" JSC	-	-	-	0.6	0.0	0.6
<b>TOTAL</b>	<b>15.0</b>	<b>2.1</b>	<b>17.1</b>	<b>9.6</b>	<b>1.6</b>	<b>11.2</b>

Source: Ministry of Finance

Repayment plan on the basis of the guarantees (the total of principal and interest) in the budget for 2020 is RSD 16.4 billion, of which RSD 8.8 billion used for repayment of principal amount under guarantees participate in the expenditures which affect the result. As of 30 September, the total repayment on the basis of the guaranteed loans was RSD 11.2 billion.

Growing indirect debt, as well as including one part of repayment on the basis of guarantees into the budget expenditures and increasing of deficit on that basis arose the awareness of growing fiscal risks resulting from the issued guarantees. Therefore some activities, which limit issuance of new guarantees are undertaken. The amendments on the Public Debt Law forbid issuance of new guarantees for credits issued for the purpose of liquidity. The amendments of the Law on Development Fund of the Republic of Serbia

prevent further issuance of counter-guarantees for guarantees issued by the Development Fund of the Republic of Serbia.

Along with the limitations in issuing state guarantees, the key step in reducing and eliminating of fiscal risks on this basis lies in the reform of state-owned and public enterprises, the beneficiaries of the guarantees, in order to be capable of repaying their own credits. Most of enterprises, which are the greatest beneficiaries of the guarantees, are currently in the process of restructuring, i.e. implementation of restructuring plans, made in compliance with international financial institutions.

The issuance of guarantees up to RSD 108 billion was foreseen in the rebalance of the budget for 2020, for the loans intended for the realization of infrastructure projects.

**Table 15. Issuance of guarantees plan in 2020**

No.		Amount in RSD	Original currency	Amount in the original currency
I.	European Bank for Reconstruction and Development			
1.	Joint-stock company for railway passenger transportation Srbija Voz, Belgrade – (Procurement of railway vehicles for Srbija Voz)	11,830,000,000	EUR	100,000,000
2.	PE “EPS” – Smart power meters project	4,732,000,000	EUR	40,000,000
	Total:	16,562,000,000	EUR	140,000,000
II.	To German Development Bank (KfW)			
1.	“EMS” JSC Trans Balkan Corridor section 3-2x400KV Obrenovac–Bajina Bašta and raising TC Bajina Bašta to 400KV	4,732,000,000	EUR	40,000,000
	Total:	4,732,000,000	EUR	40,000,000
III.	To European Investment Bank			
1.	Joint stock company for managing public railway infrastructure “Infrastruktura železnice Srbije”, Belgrade – The reconstruction and construction project of the second track on the railway Belgrade-Mladenovac-Niš-Preševo-state border, section Stalač-Đunis	20,702,500,000	EUR	175,000,000
	Total:	20,702,500,000	EUR	175,000,000
IV.	To commercial banks			
1.	PE “Srbijagas” – Construction of distribution gas line on the territory of the Republic of Serbia from the border with the Republic of Bulgaria to the border with Hungary and other neighbouring countries to the Republic of Serbia through the investment in the capital of the joint stock company South Stream Serbia AG, Zug, Switzerland	8,281,000,000	EUR	70,000,000
2.	PE “Srbijagas” – Construction of distribution gas line on the territory of the Republic of Serbia from the border with the Republic of Bulgaria to the border with Hungary and other neighbouring countries to the Republic of Serbia through the investment in the capital of the joint stock company South Stream Serbia AG, Zug, Switzerland	6,506,500,000	EUR	55,000,000
3.	PE “Srbijagas” – Construction of distribution gas line on the territory of the Republic of Serbia - Gas interconnection Serbia - Bulgaria	2,957,500,000	EUR	25,000,000
4.	PE “Skijališta Srbije” - the construction of the gondola Brzeće - Mali Karaman	3,194,100,000	EUR	27,000,000
	Total:	20,939,100,000	EUR	177,000,000
V.	Kuwait Fund for Arabic Economic Development			
1.	Joint stock company for managing public railway infrastructure “Infrastruktura železnice Srbije” – The construction of the railway station building Belgrade Centre - Phase II	6,378,022,800	KWD	18,000,000
	Total:	6,378,022,800	KWD	18,000,000
VI.	To the Russian Federation (National Development Corporation „VEB.RF”)			
1.	PE “EPS” - Revitalization of hydropower plant “Đerdap 2”	23,660,000,000	EUR	200,000,000
	Total:	23,660,000,000	EUR	200,000,000
VII.	To the Republic of France (Treasury)			
1.	PE “EPS” - Mid-voltage distribution network automation project	15,024,100,000	EUR	127,000,000
	Total:	15,024,100,000	EUR	127,000,000
	TOTAL:	107,997,722,800	EUR	859,000,000
			KWD	18,000,000

Source: Ministry of Finance

Repayment on the basis of the guarantees is also planned in the following years, but with the declining

trend, so that their share in GDP decreases from 0.2% of GDP in 2019 to 0.1% of GDP in 2023.

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

### Public enterprises

Business performance of public enterprises represents a significant source of fiscal risks, both on budget revenues side and budget expenditures side. In the process of business performance, public enterprises face with numerous problems, such as the claim collection and regular payment to creditors, state and employees etc. The state, as the founder and the sole owner, is responsible for their business performance and it is their last shelter in case of insolvency. There are several channels through which fiscal risks related to business performance of public enterprises may be materialized. The greatest, but not the only risk is state guarantees issued for the public enterprises loans. Sustainability, efficiency and profitability of public enterprises affect the budget revenues, i.e. the amount of profit to be paid into the budget. The quality of products and services provided by public enterprises affect the efficiency and profitability of the private sector, and ultimately the level of tax paid into the budget.

Public enterprises represent a significant segment of Serbian economy, which employs more than 81 thousand people. Public enterprises are established as the companies performing activities of public

interest. Their business performance is regulated by the Law on Public Enterprises, adopted in February 2016, as well as by subsector laws which define specific areas not covered by the Law on Public Enterprises (Energy Law, Company Law etc.).

### Key financial indicators of public enterprises business operations

#### Results of business performance of public enterprises in 2019

Total capital of state public enterprises at the end of 2019 was RSD 1,751 billion, whereas the net profit in the amount of RSD 18.1 billion was realized as the final result.

**Table 16. Key financial indicators of business performance of public enterprises, in RSD billion**

Description	2018	2019
Total assets	2,805	2,854
Equity	1,795	1,751
Total revenues	509.9	524.3
Net profit	-1.9	-18.1
Subsidies	30.8	33.4
Subsidies, PE "Roads of Serbia" excluded	23.0	24.3
Subsidies, % of total revenues	5.9%	6.4%

Source: Financial reports for 2018 and 2019

In 2019, the subsidies, expressed in the percentage of the total revenues, were at slightly higher level compared to the previous year, and make 6.4% of total revenues of public companies. Certain subsidies have capital character, such as subsidies for PE "Roads of Serbia", which are allocated for the reconstruction of the road infrastructure.

### Results of business performance of public enterprises in the first half of 2020

The total net result determined in the first half is the profit in the amount of RSD 8.9 billion. The result of

the current year is overestimated for the amortization expenses of PE "Roads of Serbia", because the enterprise records these costs at the end of the year in total amount for the given year.

**Table 17. Key indicators of business performance of public enterprises on 30 June, 2020, in RSD billion**

Business performance indicators	2018	2019	1/1–30/6/2020
Business income	469.1	496.7	243.4
Business expenses	454.1	490.9	223.9
Business profit	15	6	20
Net profit	-1.9	-18.1	8.9
Wage costs*	113.3	111.9	54.4
Number of PE which made profit	28	25	22

\*Wage costs, wage compensations and other personal expenses

Source: Financial reports for 2018 and 2019 and quarterly reports of the Ministry of Economy for 2020

In the first part of the year, 22 companies made profit in the total amount of RSD 11.5 billion. This result exceeds the plan for this period (RSD 5.5 billion). PE „EPS“, which made profit in the amount of RSD 7.9

billion, has the greatest influence to the positive net result in the observed period. PE "Roads of Serbia" is in the second place, with the profit of RSD 1.4 billion.

**Table 18. Public enterprises which made net profit in the period 1/1–30/6/2020, in thousands of dinars**

Enterprise	Realization 2019	Plan 1/1–30/6/2020	Realization 1/1–30/6/2020
PE "Srbijagas"	4,771,689	1,066,980	145,616
PE Mreža most	9,902	0	7,036
PE "National Park Đerdap"	9,759	4,814	11,084
PE "Skijališta Srbije"	313,961	402,249	580,636
"Transnafta JSC"	245,477	53,326	118,844
"Koridori Srbije" LLC	0	0	0
"Uvac Reserve" LLC	960	1,800	2,758
"Prosvetni pregled" LLC	10,735	25,480	23,847
PE "Official Gazette"	58,160	55,486	94,856
PE "NP Fruška Gora"	18,710	1,713	3,811
"Dipos" LLC	97,832	-62,009	122,019
"EMS" JSC	1,092,542	251,330	647,552
PE "National Park Kopaonik"	21,935	36,758	41,227
PE "EPS"	-5,786,923	678,741	7,898,456
State Lottery of Serbia LLC	113,357	7,010	60,468
PE "National Park Tara"	17,007	120	4,590
PE "Nuclear Facilities of Serbia" VINČA	902	109	11,700
"Infrastruktura železnice Srbije" JSC	-780,149	-1,206,098	79,978
Serbian Railways JSC	-539,035	-198,037	29,809
PE Srbijašume	756,158	121,974	156,690
PE "Emisiona tehnika i veze"	36,856	-55,570	40,846
PE "Roads of Serbia"	-16,852,957	4,333,830	1,376,944
Total	-16,383,122	5,520,006	11,458,767

Source: Financial reports for 2019 and quarterly reports of the Ministry of Economy for 2020

In the first half of the current year, thirteen companies suffered net loss in the total amount of RSD 2.6 billion,

which is a worse result than the planned one (RSD 2.3 billion).

**Table 19. Public enterprises which suffered net loss in the period 1/1–30/6/2020, in thousands of dinars**

Enterprise	Realization 2019	Plan 1/1–30/6/2020	Realization 1/1–30/6/2020
PE UCE "Resavica"	-1,452,706	-727,304	-525,592
"Srbija Voz" JSC	-2,391,846	-779,584	-172,397
PWE "Srbijavode"	41,667	-16,721	-88,808
PE "Zavod za udžbenike"	-296,405	-181,178	-200,892
"Mokra gora" LLC	212	7,299	-5,778
PE "Stara planina"	-13,447	-	-22,655
"Tvrđava Golubački grad" LLC	12,081	-	-8,006
"Serbia Cargo" JSC	-1,223,791	-881,028	-826,018
PE "Post of Serbia"	1,932,322	92,496	-198,241
"Metohija" LLC	795	950	-1,149
"Park Palić" LLC	2,461	3,097	-2,311
PE Skloništa	-141,449	-53,718	-59,430
PE "Jugoimport - SDPR"	1,781,932	273,612	-495,940
<b>Total</b>	<b>-1,748,174</b>	<b>-2,262,079</b>	<b>-2,607,217</b>

Source: Financial reports for 2019 and quarterly reports of the Ministry of Economy for 2020

In order to reduce fiscal risks related to the business performance of public enterprises the reconstructing processes of largest public enterprises are in progress (a group of companies engaged in railway traffic - "Serbian Railways" JSC, "Srbija Voz" JSC, "Serbia Cargo" JSC, PE EPS and PE "Srbijagas"). The entire process is being 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 put these companies on a sound footing and start operating on a market basis, as well as to reduce potential fiscal costs that may arise from their operations.

**PE "EPS".** Employee Optimization plan for the period 2016–2019, developed with the help of the World Bank, is being successfully implemented. With the help of the World Bank and EBRD the possibilities of further improvement of the corporate management in terms of management, planning system and procurement are being considered. The Action Plan for improvement corporate management, drawn up on the basis of EBRD recommendations, and adopted by the government in February 2019, is being successfully implemented.

It is foreseen that during 2021, EPS will change its legal status and register as a joint stock company, which is in compliance with the current process of restructuring and financial consolidation of the

company, with the aim of improving the profitability and professionalize the management of the company. In this regard, during the last quarter of 2020, a public call was published to assess the value of the company's fixed assets. Also, during 2020, the analysis of the tariff system was conducted, which would enable the company to be able to service the entire operating costs from regular operations, as well as the costs arising from the increased volume of expenditures caused by the production from renewable energy sources, and the need for additional capital investments in existing and new production capacities.

Due to the necessity of adequate collection of its receivables, EPS regularly updates the list of 20 largest debtor companies on the website. It is also envisaged to implement all necessary measures for the collection of overdue receivables, which arose during the state of emergency.

**PE "Srbijagas".** The pandemic and the introduction of the state of emergency partially affected the level of collection of receivables in that period. The company regularly updates the list of 20 largest debtors on its website, with the intention of taking all necessary measures to collect overdue receivables. The intention of the company is to be able to independently service the financial obligations incurred in the period 2008-2012 by the end of 2020.



## Payment of Profits into the State Budget

Payment of profit by state enterprises and dividends of capital companies in which the state has ownership represent a significant part of non-tax revenues. The level of budget revenues on this basis depends on the successful performance of these enterprises. Payments of regular profit and dividends represent regular budget non-tax revenue, whereas the payments from undistributed profit are treated as one-time revenue, and do not represent permanent source of revenue.

Budget revenues on the basis of payment of profit by public enterprises, both regular and undistributed profit from previous years, at the end of 2019 amounted to RSD 2.8 billion, whereas in the first part of 2020 those revenues amounted to RSD 187.8 million. Higher revenue on this basis is expected in the second part of the year.

Public enterprises are obliged to pay at least 50% of profit realized in the previous year, which is also prescribed by the Budget System Law of the Republic of Serbia for 2020. Mitigation of potential risks, resulting from the business performance of public enterprises, includes series of measures related to responsibility, profitability and transparency in business performance of these enterprises. Namely, at the beginning of 2016, a new Law on Public Enterprises was adopted, with the aim of strengthening the structure of management and the responsibility of public enterprises. Restructuring processes were initiated in PE EPS, PE "Srbijagas" and "Serbian Railways" JSC, whereby the efficiency of the business performance itself will depend on the successfulness of the restructuring process and the speed of enforcement of adopted measures.

## State Financial Institutions, Bank System and Deposit Insurance

Prior to the fiscal consolidation period, the Republic of Serbia had significant fiscal expenditures related to saving national banks. Total expenditures of government interventions in the bank sector in the period 2012-2015 amounted to about EUR 900 million. That is the amount set aside for the recapitalization of banks, various financial transactions when merging unsuccessful banks with

the successful ones, including the repayment of insured and uninsured deposits (for which the funds from the Deposit Insurance Fund were also used).

Currently, in the bank sector of the country, the Republic of Serbia has a direct share in the capital of:

- Banka Poštanska štedionica JSC Belgrade (79.01%),
- Komercijalna banka JSC Belgrade (83.23%),
- Srpska banka JSC Belgrade (76.68%).

In order to consistently implement the exit strategies and the reduction of fiscal risks on this basis, the reform activities in the field of government financial institutions started in 2012, i.e. 2015, will continue.

„Banka Poštanska štedionica“. With the support of the World Bank, the implementation of the strategy for „Banka Poštanska štedionica“ will continue, with the emphasis of redirecting business performance to population, entrepreneurs, micro- and small enterprises; the improvement of internal organization of banks, corporate governance and risk management; strengthening the IT infrastructure, as well as the business plan for the period 2020-2022.

In order to enable the mitigation of economic and financial consequences due to the pandemic of COVID-19, caused by SARS-CoV-2 virus, the bank was enabled to fully implement the Regulation on Establishing the Guarantee Schemes as a support measure to the commercial sector in mitigating the impact of COVID-19 pandemic caused by SARS-CoV-2 virus, to invest funds in local self-government units, and the limitations of exposure to companies that until that moment existed in case of Banka Poštanska štedionica.

Komercijalna banka. The privatization process of Komercijalna banka is in progress and is expected to be completed by the end of December, 2020. The public invitation by which The Republic of Serbia announces the sale of the shares of this bank in the direct ownership of the Republic of Serbia, and invites qualified investors to submit the Letter of Expression of Interest to participate in a tender published on 31 May 2019. The deadline for submitting the Letter of Expression of Interest was 21 June 2019 and six Letters of Interest were received. The deadline for submitting a non-binding bid was 6 September, 2019.

The public opening of non-binding bids was conducted on 10 September 2019, and the Ministry of Finance received four valid non-binding bids. All four tenderers were invited to participate in the second phase of the tender procedure. In the second phase of the tender procedure, three valid binding bids were received. At the session of the Tender Commission of the Ministry of Finance, held on 16 December 2019, three received bids were opened. On 23 December, 2019, the Commission, along with the financial advisor, evaluated the binding bids and Nova Ljubljanska banka d.d. Ljubljana, as the highest ranked bidder, was invited to start negotiations on conclusion of the purchase and sale contract. On 26 February 2020 the representatives of the Ministry of Finance of the Republic of Serbia and Nova Ljubljanska banka d.d. Ljubljana signed the Share Purchase Agreement of this bank owned by the Republic of Serbia, according to which 83.23% of regular shares of the bank were sold for EUR 387 million. The privatization process of Komercijalna banka should be completed by the end of December 2020.

Srpska banka. In compliance with the Government strategy for national banks, the expert working group for the transformation of Srpska banka into a specialized financial institution for providing all kinds of financial services and support to the defence industry of the Republic of Serbia was formed on 21 January 2019 and the formal operation began in March 2019, when the constitutional session was held.

Regulatory reform governing the financial system in Serbia<sup>10</sup>, was carried out in February 2015. One of the characteristics of that reform is the transfer of competence for monitoring the results of business performance 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 implementation of the procedure of selling the shares in them, from the Deposit Insurance Agency to the Ministry of Finance, starting from 1 April 2015. Also, through this regulatory reform, Bank Recovery and Resolution

Directive – BRRD was transposed into the domestic regulation and the function of bank restructuring was entrusted to NBS. In December 2016 the set of regulations was adopted, implementing Basel III standards into the domestic regulatory framework, thus achieving a significant level of compatibility between domestic regulations and relevant European Union regulations in this area, whereas during 2017 the activities in improvement of domestic regulations continued, governing the bank operation, with the aim of further compatibility with EU regulations. Basic objectives of adopting these regulations are increasing the resilience of banking sector through the increase of the quality of capital and introduction of protective layers of capital, better monitoring and the control of the bank exposure to the liquidity risk, further strengthening of market discipline and operating transparency of the banks in the Republic of Serbia, by publishing all relevant information on bank operations, as well as adaptation of the reporting system to the new regulatory solutions.

Relatively high level of problematic credits was one of the limiting factors for credit activity growth. In August 2015, the Strategy for Problematic Credit Settlement was adopted, carried out through implementation of two three-year action plans, one prepared by the Government and the other by the NBS, with the aim of lowering the level of problematic credits. Key areas of implementation included strengthening of bank capacity for settlement of problematic credits, improvement of regulation for assessment of the securities value, problematic credits market development etc.

Since the adoption of the mentioned strategy, a lot of laws and by-laws have been adopted as well, the institutional capacity has been improved, and a lot of measures for mitigation of the write-off and the transfer of uncollectable accounts have been implemented through the adoption of the Law on Real Estate Appraisers (the beginning of the application of the law - June 2017) which, among other things, introduced a new profession - licenced real estate appraisers and prescribed a mandatory assessment to be conducted in cases related to the

---

<sup>10</sup> The National Assembly adopted amendments to the Law on the NBS and the Law on Banks, as well as the new Law on AOD, the Law on Deposit Insurance, and the Law on Bankruptcy and Liquidation of Banks and Insurance Companies. The amendment of the set of financial laws also led to adoption of the amendment to the Law on Ministries.

Mortgage Law and the Law on Bankruptcy, as well as while making assessments for the purpose of credit operations provided by a mortgage, education of the professional board (the expert body which should contribute to the regulation and the improvement of the profession of real estate appraisers), and adoption of National Standards, Code of Ethics and the rule of professional conduct of real estate appraisers (July 2017), which, among other things, define the basics of the real estate appraisal, the appraisal procedure, important assumptions and facts that have to be taken into consideration when preparing the appraisal report, the minimum content of the appraisal report and the rules for professional conduct of licenced appraisers; adoption of the amendments to the Corporate Income Tax Law and the Individual Income Tax Law, which enabled more relaxed tax policy for approval and write-off of bank claims (the end of 2017); adopting the amendment to the Law on Bankruptcy, which shortened the bankruptcy procedure and improved the position of insured creditors (December 2017); the preparation of the study on the possibilities of introducing the bankruptcy for private individuals and entrepreneurs in the Republic of Serbia, the Law on Amendments to the Law on Civil Procedures was adopted etc. At the end of 2018, NBS adopted a set of by-laws, reacting proactively to increasingly frequent occurrence of the non-purpose loan of population at the unjustifiably long deadlines. The aim of these regulations is to prevent the problem loan emergence in bank sector, and to encourage prudent risk-taking by the banks, directing them to sustainable lending and avoiding excessive exposure to certain types of credit products, without disrupting the growth trend of credit activity, and taking into account the rights and interests of beneficiaries of services provided by banks, all for the purpose of preserving and strengthening the financial stability in the Republic of Serbia.

On 27 December 2018, the Government adopted the Program for Problematic Credit Settlement for the period 2018-2020 (hereinafter: the Program), along with the Action Plan for implementation of that program, thus successfully meeting the reform goal within the IMF cooperation program, and the further successful work on resolving issues of problematic claims was determined.

The main focus of the mentioned public policy document is resolving issues related to problematic insolvent bank placement, and the placement on behalf and on the account of the Republic of Serbia, managed by AOD. In compliance with that, strategic and annual operation plans were adopted for AOD, Resolution of portfolio of problematic placement, and the internal capacities for their solving were developed. In June 2019, AOD successfully completed the sale of the first, so-called "pilot portfolio", of the nominal value of about EUR 242 million, whereas on 30 September it published the announcement for assignment of the second, so-called large portfolio, of the nominal value of about EUR 1.82 billion. Due to limiting factors caused by the COVID-19 pandemic to the capacity of the investors to carry out the analysis, opening of binding bids was conducted on 10 September 2020, and the total of five binding bids were received.

Implementation of other measures for solving the issue of problematic credits, both from the Strategy for Problematic Credit Settlement and the abovementioned Program, continues to give significantly good results. The reduction of problematic credits in the period August 2015 - September 2020 amounted for RSD 333.0 billion, whereas the results of the Strategy for Problematic Credit Settlement reflect in historically the lowest share of problematic credits at the end of September 2020 of 3.4%. In comparison to the same indicator prior to the implementation of the Strategy (22.25%) the impressive decline of 18.82 pp is recorded. This definitely confirms that the measures are well-defined and that they provided excellent results.

NBS also acted outside the framework of the Strategy, such as the adoption of the Decision on the Accounting Write-off of Bank Balance Sheet Assets, which complemented the regulatory activities. The coverage of problematic credits with related value adjustments in compliance with the international accounting standards, which is at the level of 62%, 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 in terms of volume have represented a

The profitability of the economy is growing in the conditions of low and stable inflation and a relatively stable exchange rate. All of these were key factors for the sustainable resolution of problematic credits. This is clearly seen from the fact that in the branches that are also the bearers of our growth, the biggest decline in problematic credits was recorded - which is evident in the manufacturing and construction.

Deposit insurance is a mechanism that contributes to preserving financial stability and it provides protection for depositors. The deposit insurance system ensures that each protected depositor<sup>11</sup> is paid the full amount of deposits in each bank up to the insured amount of EUR 50,000 in the event of bankruptcy or liquidation of the bank. The deposit insurance is regulated by the Law on Deposit Insurance.

In October 2019, the Law on Amendments to the Law on Deposit Insurance from 2019 was adopted, which sought to further harmonize the deposit insurance system with the best international practice and standards, as well as the *acquis communautaire*, in terms of: methods of premium calculation (introduction of premium calculation based on the level of risk in bank operations, the basis for premium calculation, the amount of extraordinary premium, the protection of depositors of merged or joined banks, target amount of deposit insurance fund, etc., all with the aim of contributing to financial stability through the incentives for the reduction of risks in bank operations, strengthening public confidence in the financial system and increasing the efficiency of the deposit insurance system.

In the deposit insurance system, the Republic of Serbia is the ultimate guarantor of the payment of insured deposits. For the purpose of providing deposit insurance funds, AOD collects deposit insurance premiums from banks for the account of the Deposit Insurance Fund, manages the fund assets and pays deposits up to the insured amount in case of bankruptcy or liquidation of the bank. In addition, the resources of the fund can be used to finance the process of bank restructuring to the extent and under the conditions established by the law governing

banks. In case of missing resources in the deposit insurance fund, the Republic of Serbia provides payment either from the budget funds or by issuing a debt guarantee to AOD.

The guaranteed payment of insured deposits by the state, either directly from the budget, or indirectly by issuing debt guarantees for AOD, 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 the funds from the Deposit Insurance Fund, nor from the state on the basis of payments of insured deposit amounts.

The reduction of fiscal risks on this basis depends on the stability and sustainability of the banking system. The 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 sector.

The results achieved by the banking sector of the Republic of Serbia at the end of 2018 and 2019 show a stable bank profitability. The banking sector of the Republic of Serbia operated profitably in 2019, with the net profit before tax in the amount of RSD 67.7 billion, which is 10.6% less than the result achieved at the end of 2018, when the net profit before tax was RSD 75.7 billion.

Banking sector of the Republic of Serbia is adequately capitalized, both from the viewpoint of the achieved level of capital adequacy indicator, and the structure of regulatory capital. At the end of 2019, the average value of the capital adequacy indicator at the level of the banking sector of the Republic of Serbia was 23.39% (22.26% at the end of 2018), which significantly exceeds the prescribed regulatory minimum of 8%, and is more than enough to cover all the risks the sector is exposed to, which is also confirmed by macro prudential stress tests that NBS regularly conducts.

Having in mind the situation caused by declaring the state of emergency in the Republic of Serbia, in order to enable mitigation of economic and financial consequences triggered by the COVID-19 pandemic caused by SARS-CoV-2 virus, the measures were

---

<sup>11</sup> Protected depositors are: natural persons, entrepreneurs, micro, small and medium-sized legal entities, as defined by the Law on Deposit Insurance.

taken to support the economy, aimed at increasing liquidity of business entities. One of the measures was the adoption of the Decree Establishing a Guarantee Scheme as a measure of support to the economy for mitigating the consequences of the pandemic of the COVID-19 disease caused by the SARS-CoV-2 virus.

This Decree regulates the establishment of national guarantee scheme. The increase of the liquidity of business entities through the guarantee mechanism of the Republic of Serbia for the loans granted to business entities by the banks for financing liquidity and current assets, enabled by concluding the Guarantee Agreement of the Republic of Serbia for crediting economy with the aim of mitigation the adverse consequences of the COVID-19 pandemic caused by SARS-CoV-2 virus, is the measure which sublimates an extremely important and necessary mechanism of effects for all persons situated in the Republic of Serbia, including farm households, registered in the Serbian Business Register Agency (APR) and classified as entrepreneurs, or micro, small or medium-sized enterprises in compliance with the law governing the accounting, whose liquidity is a pre-requisite for functioning of the economy of the Republic of Serbia.

Banks can place up to two billion euros for the realization of the loan, with the amount of one billion euros, i.e. the amount of the initial maximum insured portfolio at banks, determined in accordance with the market share of the bank, according to the NBS report on 29 February 2020. Once the bank reaches 90% of utilization of maximum insured portfolio, it can apply for the increase of its limit from the remaining amount of guarantee scheme funds, under the same conditions for increasing the maximum insured portfolio unlimited number of times, provided that each individual request cannot be less than five million euros or more than 25 million euros.

So far, 25 banks has signed the Guarantee Agreement of the Republic of Serbia for crediting economy with the aim of mitigation the adverse consequences of the COVID-19 pandemic caused by SARS-CoV-2 virus with the Republic of Serbia and NBS, and the Government has approved 22 requests the increase of the maximum insured portfolio in the amount of EUR 502.5 million.

In compliance with the abovementioned, the projections of fiscal gross outflows of the budget of the Republic of Serbia on the basis of the National Guarantee Scheme for 2021 amount to EUR 24 million for 2021, EUR 112 million for 2022 and EUR 34 million for 2023. Also, the inflow projection was made based on the collection of problematic claims on the basis of the Guarantee Scheme of the Republic of Serbia, amounting to EUR 14 million for 2022 and EUR 23 million for 2023.

### Other fiscal risks

Along with the mentioned fiscal risks, there are other circumstances as well, which if realized, may lead to fiscal expenditures. For certain risks there are no systematized data, but having regard to the fact that certain risks were realized in the recent past, the magnitude of their impacts to public finances may be perceived. Their identification helps perceiving possible impacts on fiscal position of the country in the following period.

Business performance of local self-government may have fiscal implications on the budget of the general government budget. Special fiscal rules for local self-governments set up so-called "golden rule", i.e. deficit is only possible for the realization of capital investments. There are also the rules regarding the level of indebtedness of local self-government units, which would maintain the stability of public finances on the local level, if implemented consistently. In practice there were cases of unrealistic planning of both revenue and expenditures causing the accumulation of due, yet unsettled obligations that threaten the functioning of certain cities and municipalities.

In order to avoid the realization of fiscal risks on this basis, in the next period, the Ministry of Finance will significantly improve the control system of public finances of local self-governments for the purpose of following the set rules, from planning to the realization of the budget on the local level.

There are certain fiscal risks based on court decisions, made both by domestic and international courts, fines, indemnities by state authorities. In the period 2009 - 2018, the Republic of Serbia paid RSD 80.5



billion<sup>12</sup> from its budget on the basis of court decisions. In 2019, the amount of RSD 17.6 billion was paid from the budget of the Republic of Serbia on the basis of court decision, whereas in the first half of 2020 on the same basis RSD 17.4 billion was paid from the budget of the Republic of Serbia. The Republic of Serbia was bound by the Decision of the European Court for Human Rights to pay the public debt on the basis of unpaid foreign currency savings which the citizens of the former republics in SFRY, as well as the citizens of the Republic of Serbia deposited in the banks seated on the territory of the Republic of Serbia and their branch offices on the territories of the former republics of SFRY. Also, possible liabilities may result from the decisions issued by the Constitutional Court on the basis of the submitted constitutional appeals and the decisions issued by the European Court Human Rights on the basis of lawsuits of the employees in former state enterprises (for unpaid wages and compulsory social security contributions, default interests, costs of proceedings, claims on the basis of business transactions).

Constantly present risk of natural disasters and catastrophes demands investments into the prevention programs in order to reduce the potential fiscal expenditures for removing the damage arose therefrom. The Republic of Serbia in 2014 faced the disastrous consequences of the flood. Total damage (with losses) was estimated at over EUR 1.7 billion<sup>13</sup>. Having regard to the constantly present risks of natural disasters, reducing fiscal risks which may originate therefrom includes investment into the preventive programs. In December 2014, the Government adopted the National Program for Risk Management in case of Natural Disasters, which will be realized in cooperation with the World Bank, United Nations and EU. Within the National Program, another umbrella law was adopted in November 2018, governing the problems of natural disasters and catastrophes, i.e. the Law on Disaster Risk Reduction and Emergency Management. In 2019, the Republic of Serbia paid RSD 4.22 billion from the budget for the

compensations for injuries or damaged caused by natural disasters. In the first half of 2020, the Republic of Serbia was affected with a large number of disasters caused by floods. According to the data obtained from the Public Investment Management Office, the floods damaged 1,200 residential facilities in 27 municipalities in Serbia.

The fact that since the beginning of 2020, the world has been under the enormous negative influence and the consequences of yet another form of catastrophic effect of pandemic caused by SARS-Cov-2, leading to the enormous pressure on healthcare systems, the paralysis of the world economy and large economic losses, affected the changes of fiscal positions of monetary, fiscal and real sector in the Republic of Serbia. With a view of eliminating harmful consequences of COVID-19 disease caused by the virus SARS-CoV-2, the Republic of Serbia adopts the comprehensive package of economic measures, whose value is estimated at 12.5% of GDP.

Measures refer to:

- deferral of payment of tax and contributions liabilities,
- direct aid for payment of salary (micro, small and medium) enterprises, in order to maintain employment,
- additional aid to economic entities provided through the Fund for Development, by granting loans (for investments and liquidity),
- provided loans guarantees for the economy via the Guarantee Scheme,
- providing support for catering sector etc.

Given the uncertainty regarding the duration of unfavourable epidemiological situation, particularly in 2021, its negative impact on economic activities, there are risks related to the foreseen scenario of fiscal developments in medium term. This is particularly evident knowing that the fiscal space for possible new measures is limited.

<sup>12</sup> Expenditures on accounts are included: fines and penalties according to the decision of courts and judicial bodies, and compensations for injuries or damage caused by government authorities.

<sup>13</sup> <http://www.obnova.gov.rs/uploads/useruploads/Documents/Kancelarija-za-pomoc-poplavljenih-podrucja-infograf-15-04-2016-srb.pdf>



## 6. Cyclically Adjusted and Structural Fiscal Balance

Cyclically Adjusted Fiscal Balance is the fiscal balance from which isolated impact of the economic cycle is excluded, assuming the following identity<sup>14</sup>:

$$FB = CB + CAB$$

Part of the fiscal balance (FB) that is not under the influence of cyclical fluctuations is called cyclically adjusted fiscal balance (CAB), whereas the aim of this procedure is isolating the cyclical component of fiscal balance (CB) which is the result of the presence of the output gap. Actual fiscal balance will be equal to the cyclically adjusted one if the output gap is zero, i.e. if the growth rate of real GDP equals the potential one. Structural fiscal balance is further calculated by eliminating one-off effects on both the revenue expenditure side, thus showing structural (permanent) fiscal position.

Cyclically adjusted primary deficit has been declining rapidly since 2014, along with the movement of the general fiscal result, and in 2017 it entered into the surplus zone. Structural primary balance freed from one-off factors recorded an impressive positive value

in 2017. Structural changes in tax and expenditure system during 2012 and 2013 started to give results in the following period and the process of fiscal consolidation effectively began. The next phase of fiscal consolidation, carried out during the arrangement with IMF, but this time with the focus on structural adjustment on expenditure side, significantly improved the fiscal position of the country. One-off effects on the expenditure side may be isolated through the analysis and quantification of structural primary balance, although in certain years they are not insignificant, as well as the one-off effects on the revenue side. Structural primary balance analysis evaluated the fiscal position of the country. In the period 2014 - 2019, the fiscal position was significantly improved, confirming the assessment of the success of the fiscal consolidation program.

The fiscal space, created in the previous period, as well as significantly structurally improved fiscal position of the country enabled the relaxation of the fiscal policy in times of crisis.

---

<sup>14</sup> More detailed description of the used methodology and the results can be found in the Fiscal Strategy for 2013 with projections for 2014 and 2015. or via the link <http://www.mfin.gov.rs/pages/article.php?id=8626>

**Table 20. Fiscal Balance and Cyclically Adjusted Fiscal Balance Calculation Components in the period 2005-2023, as % of GDP\***

	Output gap	Fiscal balance	Primary fiscal balance	Cyclical component of the fiscal balance	Cyclically adjusted fiscal balance	Structural fiscal balance	Structural primary fiscal balance**	Nature of fiscal policy - fiscal impulse
2005	0.0	1.1	2.0	0.0	1.1	1.3	2.2	
2006	-2.9	-1.4	-0.1	-1.0	-0.4	0.3	1.6	1.1
2007	1.4	-1.8	-1.2	0.5	-2.3	-1.9	-1.4	2.6
2008	4.5	-2.5	-1.9	1.6	-4.1	-4.1	-3.6	1.8
2009	0.0	-4.2	-3.6	0.0	-4.2	-4.2	-3.6	0.0
2010	-0.6	-4.3	-3.4	-0.2	-4.1	-4.2	-3.3	-0.4
2011	0.1	-4.5	-3.4	0.0	-4.6	-4.8	-3.6	0.2
2012	-2.0	-6.4	-4.7	-0.7	-5.7	-5.7	-4.0	0.6
2013	0.5	-5.1	-3.0	0.2	-5.3	-5.1	-2.9	-0.9
2014	-1.9	-6.2	-3.5	-0.7	-5.5	-4.7	-2.0	-0.3
2015	-1.4	-3.5	-0.5	-0.5	-3.0	-2.3	0.6	-2.9
2016	0.0	-1.2	1.7	0.0	-1.2	-1.1	1.8	-1.7
2017	-0.3	1.1	3.6	-0.1	1.2	1.1	3.6	-2.1
2018	1.1	0.6	2.7	0.4	0.2	0.1	2.2	1.4
2019	2.1	-0.2	1.8	0.8	-1.0	-1.1	0.9	1.3
2020	-2.1	-8.9	-6.9	-0.8	-8.2	-1.2	0.8	7.2
2021	0.2	-3.0	-1.1	0.1	-3.1	-3.7	-1.8	-5.0
2022	0.4	-1.5	0.3	0.1	-1.6	-2.3	-0.5	-1.3
2023	0.4	-1.0	0.6	0.2	-1.2	-1.2	0.4	-0.3

\* The projected values are shown for the period 2020–2023.

\*\* Structural primary fiscal balance is obtained by excluding estimated one-off revenues and expenditures. The results showing the change of the structural primary deficit do not explicitly exclude the effects of increasing in revenue collection, so the assessment of structural adjustment in 2015 and 2016 partially differs from previously presented effects.

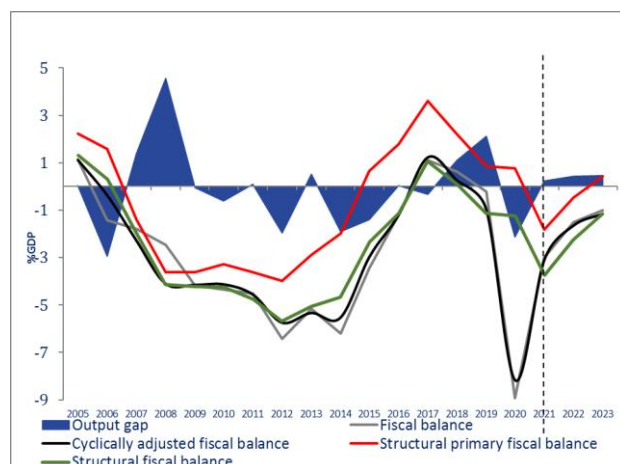
Source: Ministry of Finance

With the outbreak of the pandemic and the introduction of measures for the health protection of the population, the global economy has entered the unprecedented crisis. The specificity of the crisis is reflected in the cause itself, which is not the economic, but health in nature, with the way of combat in containing the spread of the virus causes additional adverse economic effects. The impact on the fiscal position is visible through reduced budget revenues, which are the consequences of decelerating the economic activity due to pandemic, and a dramatic increase of expenditures due to the increased healthcare costs, and the adoption of an extensive aid package to economy and citizens. In such a situation, the usual analysis of economic cycle, the quantification of fiscal multipliers and the assessment of elasticity of the fiscal balance in comparison to the output gap do not provide completely correct assessments of the fiscal position of the country.

The fiscal policy response to the complex economic situation caused by the pandemic of the COVID-19 is represented by the large-scale package of economic measures, estimated at 12.5% of GDP. It is estimated that the direct impact of the economic package on the country's cyclical position amounts to around 10% of GDP, with a negative output gap of around 2.1 % of GDP. In the absence of measures aimed at providing support to the economy and the population, the decline of GDP in 2020 would be significantly higher, and it would reach around 5%, due to greater economic concentration and slower recovery, and the output gap would reach around 6% of GDP.

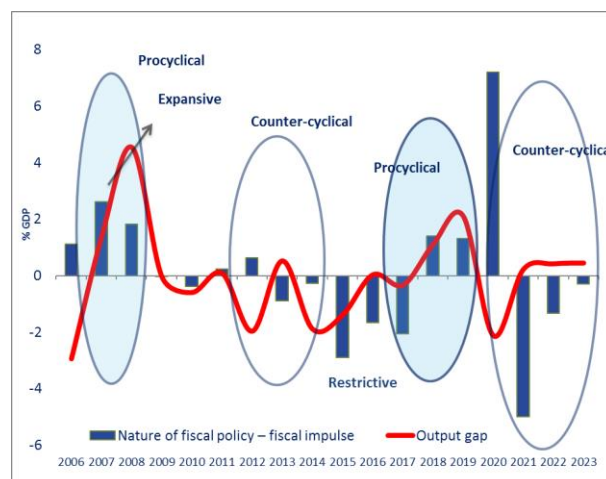
The estimated negative cyclical component of the fiscal result in 2020 is only 0.8% of the GDP. Although the cyclical analysis of the fiscal result suggests that the savings resulting from non-implementation of package of measures would outweigh fiscal losses due to larger decline of GDP, long-term adverse effects of the loss of productive potential and human resources would be immeasurably greater.

**Output gap, real cyclically adjusted and structural fiscal balance in the period 2005-2023, % GDP**



Source: Ministry of Finance

**Nature and effects of fiscal policy in the period 2006-2023, % GDP**



\*Projected values are shown for the period 2021–2023

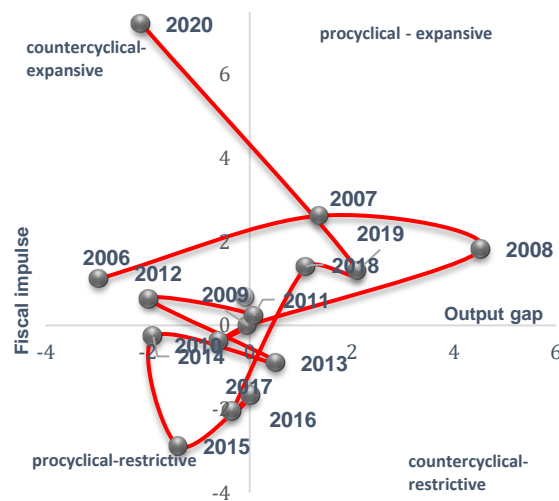
Source: Ministry of Finance

The structural fiscal position of the country has not been impaired because the economic aid measures have been implemented in the field of temporary fiscal policy. However, in the next medium-term period, the trend of the structural fiscal result will be influenced by tax liabilities transferred from 2020 to 2021 and 2022. The payment of revenues based on the tax and contributions deferral in 2020 will have temporary (non-structural) effect on the structural balance in 2021 and 2022.

As the fiscal impulse is defined as the difference between two successive cyclically adjusted (primary) results, it can be estimated that during 2018 and 2019, in the conditions of the positive output gap, fiscal policy had a pro-cyclical character. On the other hand, the fiscal policy during 2020 has been expansive-countercyclical, aimed at mitigation of the negative economic cycle. In the period 2021 - 2023, the fiscal policy will generally have counter-cyclical

character, reflected in the set goal of rapid balancing and stabilization of public finances.

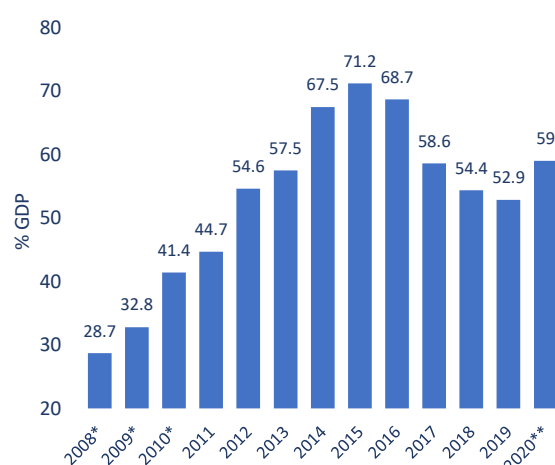
**The nature and the effects of fiscal policy in the period 2006 - 2020**



## 7. Debt reduction program

In accordance with the principle of fiscal responsibility, if the general government debt exceeds 45% of GDP, the Government is obliged to propose measures that will bring debt level closer to the target, i.e. return it to a sustainable path<sup>15</sup>. Simultaneously, Stability and Growth Pact defined the highest limit of the public debt share in GDP of 60%, as well as the liability of the EU member countries to issue an official document in order to present a credible plan for reaching the given level at satisfactory pace, if the given limit was exceeded.

### Public debt of the general government in the period 2008–2020, % GDP



\* Local debt approximation

\*\* Assessment for 2020

In the period from 2008 to 2014, the general government deficit was significantly increased, whereas at the same time public debt entered into the explosive growth path, with the ratio between the debt and GDP more than doubled. Fiscal consolidation measures adopted at the end of 2012 and during 2013 partially mitigated this trend, but the level of public debt was still significantly increasing. Reduction of primary deficit in the period 2012 - 2014 was not sufficient to stabilize the share of public debt in GDP. The effects of the first round of fiscal consolidation, which mostly referred to revenue side lacked, due to increased volume of shadow economy, characteristic for the period after the increase of tax rates. On the

expenditure side, high interests and determined one-off expenditures made the financial position even worse.

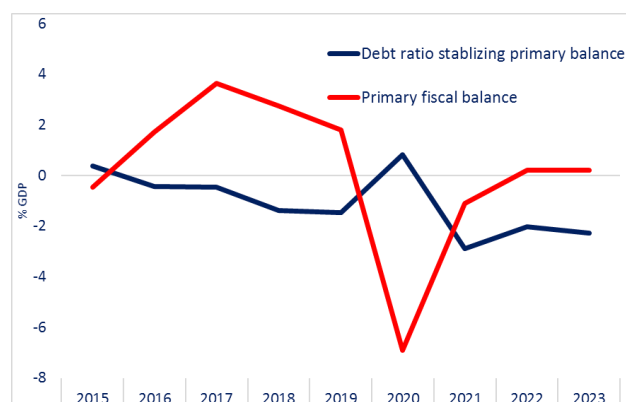
Fiscal consolidation measures adopted at the end of 2014 reduced the primary deficit and decelerated the growth of public debt during 2015. The decrease of public debt occurred in 2016, a year before it was predicted by the arrangement with IMF. In 2016, the primary surplus of 1.7% of GDP was realized, finally creating the conditions for the decline in the share of the public debt in GDP. After that, in 2017, primary fiscal surplus of 3.6% of GDP was achieved, leading to even more significant decline in share of public debt in GDP, for more than 10 pp of GDP to 58.6% of GDP. During 2018, the trend of the reduction of public debt share in GDP continued and reached 54.4%. Fiscal relaxation during 2019 did not threaten the declining public debt trajectory. Positive primary fiscal result in 2019 of 1.8% of GDP affected further reduction of public debt for additional 1.5 pp of GDP.

As stated in the previous part of this document, the year 2020 will be marked by one of the greatest health, and consequently economic crisis in the last few decades, caused by the COVID-19 pandemic. The direct consequences on the country's economy, as well as the measures taken to mitigate both economic and health consequences for the population and the economy, have already been discussed in the previous part of the text. The most important factors affecting the trend of debt during 2020 are the level of total and primary fiscal deficit, additional financing needs and the repayment of the due part of the debt. The estimated one-off increase of the fiscal deficit to 8.9% of GDP (primary deficit of 6.9% of GDP) will influence the declining trajectory of public debt to reverse. The share of general government public debt in GDP will reach 59% at the end of 2020. The fiscal strategy for the next medium-term period envisages the stabilization of public finances and significantly lower levels of deficit that will revert public debt to a declining trend zone. The stabilization process of public finances will be gradual and steady, so that too

<sup>15</sup> Public debt in this document does not include the debt on the basis of the restitution in compliance with the definition of the debt from the Budget System Law.

restrictive policies would not undermine the assumptions of accelerated economic growth.

**Primary result stabilizing the share of debt in GDP  
and achieved/projected result \*,  
% GDP**



\* Projected values are given for the period 2021–2023

Source: Ministry of Finance

By analysing the primary stabilization gap, defined as the difference between the achieved primary result and the primary result necessary for stabilization of the share of public debt in the current year, it is possible to assess the set quantitative fiscal limits. Since 2016 there has been a positive primary stabilization gap, and the debt trajectory has been reversed. During 2017 and 2018 the positive gap increased and in that period the largest reduction of the share of debt in GDP was achieved. The opposite trend was recorded during 2020, when the highest negative value of this indicator was achieved. For the period 2021–2023, in compliance with the fiscal framework given in this document, positive values of this indicator are envisaged.

The dynamics of reducing the level of public debt to 45% of GDP, in compliance with the current fiscal rules is projected, and the baseline scenario presented by this fiscal framework envisages gradual reduction of the fiscal deficit to 1% of GDP at the end of 2023.

Management and sustainability of the public debt will be additionally provided by:

- limitation on issuance of new guarantees;

- restriction on signing new project loans in cases where the previously approved loans have not been used efficiently;
- refinancing of an expensive portion of debt by using funds from soft loans and privatization proceeds, if there are options to do so;
- identification of fiscal risks and improvement of their management.

Legally envisaged share of the public debt to 45% of GDP will be achieved in 2028. The success of the previous program of structural fiscal adjustment enabled the reduction of the debt from 2015 to 2019 for 18.3 pp of GDP. Such circumstances affected the ability of the Republic of Serbia to provide for the unhindered financing of the fiscal deficit during 2020, as well as the unhindered repayment of due debts.

Uncertainty regarding the course and duration of the global pandemic, as well as the health measures taken, requires careful fiscal policy in the upcoming period.

As the fiscal rules envisage a debt limit of 45% of GDP to be reached during 2028, a simulation of the movement of the share in the case of variation of factors influencing the debt dynamics was done.

**The assumptions in the baseline scenario are:**

- after reaching a surplus in 2020, in the period 2021–2023 the level of general and primary fiscal result enables gradual reduction of the public debt share in GDP. After that, fiscal deficit was corrected to 0.5% of GDP;
- slower growth of fiscal revenues in relation to nominal GDP due to changes in the structure of the economy, strengthening of investment activity and export demand. No significant changes in the tax policy are envisaged, with retaining the existing effort in the fight against the shadow economy;
- the absence of net gain of issued guarantees after 2022;
- the average rate of real GDP growth of 4% in the long run;
- annual inflation rate of about 3% on average in the observed period;
- no significant privatization proceeds in the period 2024–2028. Possibly increased privatization proceeds will reduce the need for financing, and will additionally reduce the share of public debt.

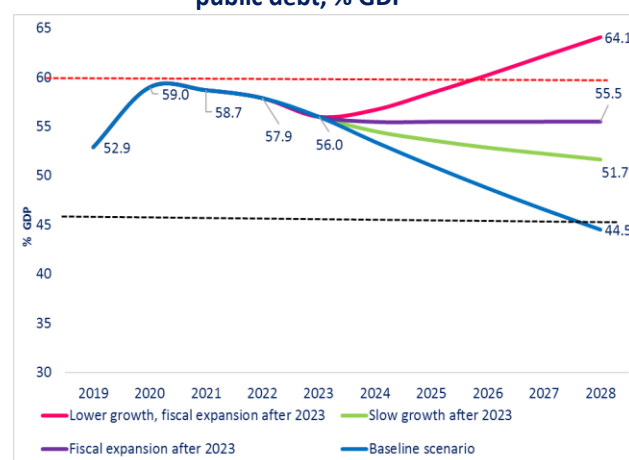
**Table 21. Total public debt simulation - Baseline Scenario by 2028, % GDP**

Baseline scenario	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Revenues	42.1	40.3	40.4	40.5	39.7	39.5	39.3	39.1	38.9	38.7
Expenditures	42.3	49.2	43.4	42.1	40.7	40.0	39.8	39.6	39.4	39.2
Decline of expenditure share		6.9	-5.8	-1.3	-1.4	-0.7	-0.2	-0.2	-0.2	-0.2
Fiscal result	-0.2	-8.9	-3.0	-1.6	-1.0	-0.5	-0.5	-0.5	-0.5	-0.5
Primary fiscal result	1.8	-6.9	-1.1	0.2	0.6	1.0	0.9	0.8	0.7	0.6
Public debt in GDP	52.9	59.0	58.7	57.9	56.0	53.4	51.0	48.7	46.5	44.5
GDP real growth rate, %	4.2	-1.0	6.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0

Source: Ministry of Finance

Baseline scenario assumes that the level of public debt is to be reduced at about 45% of GDP in 2028. The Graph shows the simulation of alternative public debt scenarios, according to changes in certain assumptions in the baseline scenario. For a better comparison, a variation of one variable was made as the risk factor that affects the level of debt.

Scenario “slower growth after 2023” refers to the average real GDP growth of about 0.7% in the observed period with the same level of fiscal deficit in comparison to the baseline scenario. This does not mean the same level of fiscal adjustment, since bigger accommodation is required on the expenditure side in the situations when the lower economic growth is recorded. According to this scenario, at the end of 2028, public debt would reach the level of 51.7% of GDP. One of the risks implied by this scenario of prolonged slow growth is that despite the maintaining of the same low level of fiscal deficit, public debt is not falling fast enough. On the other hand, slow growth, by automatic stabilizers, does produce higher levels of fiscal deficit, so that there is even bigger need for greater reduction in expenditures in order to maintain the declining trajectory of public debt share. There is a risk of entering the spiral of slow growth and the necessity for additional austerity measures. Despite all these risks, this scenario enables gradual reduction of public debt share, but not reaching the level of 45% in the observed period, in other given assumptions.

**Comparison of different scenarios and effect on public debt, % GDP**

Source: Ministry of Finance

Scenario “Fiscal expansion after 2023” implies significant deviation from the currently set medium-term goal of fiscal policy and the achievement of the fiscal deficit of 3%. In this case the share of public debt in GDP mostly stagnates, so that in 2028 it could reach 55.5% of GDP. The public debt does not reach the legal limit of 45% of GDP, and the level below 60% is present during the entire observed period. Despite the significant worsening of fiscal performance, primary fiscal result is still present, enabling the relative stability of debt share under the given growth rates of GDP.

Scenario which combines lower real growth of GDP and raising the level of fiscal deficit to 3% of GDP on average has the least favourable public debt path. Only in this scenario does public debt have a growing path in the period after 2023, and the share of public debt is getting close to the level of significantly above 60% at the end of observed period.



### III. PUBLIC DEBT MANAGEMENT STRATEGY FOR THE PERIOD 2021 TO 2023

According to the Public Debt Law, the legal basis for the borrowing of the Republic of Serbia, the public debt shall include all the direct liabilities of the Republic, based on borrowings, as well as the guarantees issued by the Republic of Serbia for public enterprises', local governments' and other legal persons' borrowings. The Republic may borrow in domestic or foreign currency, in order to finance budget deficit, current liquidity ratio deficit, to refinance an outstanding debt, to finance investment projects, and to assume liabilities based on the issued guarantees. The provisions of the Public Debt Law indicate that the public debt shall be an unconditional and irrevocable liability of the Republic of Serbia with regard to the repayment of the principal, the interest and the remaining costs.

For the purpose of formulation of the Public Debt Management Strategy a quantitative approach was used, by identifying possible restrictions through macroeconomic indicators, analysis of costs and risks and market conditions which affect the management of public debt. The analysis involved the use of financing instruments available in the domestic and international financial markets. The Public Debt Management Strategy is based on the principles that define the need for transparent and predictable process of borrowing with the permanent development of the government securities market and acceptable level of exposure to financial risks.

By analysing possible borrowing strategies, the World Bank model MTDS indicates that the borrowing structure based on dinar-denominated and euro-denominated securities issue represents the best option in terms of costs (risks). The borrowing strategy of the Republic of Serbia, applied in the last five years and based on the combination of financing from current resources and funds, mostly or partially from concessionary financing sources, showed that in situations when concessionary financing sources may be ensured, these funds should be used, because in this way, financing costs are reduced with an acceptable risk, thus achieving the primary objective of public debt management. The situation on domestic and international financial market, successful implementation of fiscal consolidation

measures, along with good coordination between fiscal and monetary policy in the last few years led to the significant decline in the borrowing in dinar-denominated and euro-denominated securities, as well as to the reduction of the risk premium for Serbian securities to the historical minimum. New framework of the analysis of possible borrowing strategies is based on the comparison between the strategy applied during the last five years and the strategies exclusively based on the market financial instruments denominated in dinars and in euros.

The fiscal strategy envisages the reduction of public debt of the general government level by the end of 2023 at the level of 56.% of GDP, in which case, in accordance with the Public Debt Management Guidelines defined by the World Bank and IMF, within the Public Debt Management Strategy, the stress-scenario analysis of the effects of the foreign currency exchange rate of the domestic currency (RSD) against the currencies in which the public debt of the Republic of Serbia is denominated, was conducted.

Significant progress has been made in the last seven years in terms of increase in the average maturity of dinar-denominated securities and reduction of the costs of financing on the basis of this form of borrowing, which reduced the exposure to the refinancing risk. It is important to emphasize that the Public Debt Management Strategy in the mentioned period the average coupon rate of dinar-denominated securities was reduced from 12.4% at the end of September 2012, to 4.8% at the end of September 2020.

Public Debt Management Strategy defines basic measures for further development of dinar-denominated securities market. The development of this market will lead to the growth of the internal debt and its share in the overall debt, as well as the exposure of the public debt to the foreign exchange risk, which will have a positive effect on the credit rating increase of the Republic of Serbia.

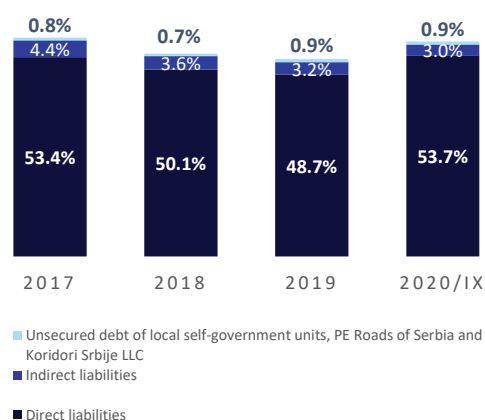
In 2019, after a few years of absence, the Republic of Serbia appeared as the issuer on the international financial market, with the desire to take advantage of favourable circumstances and a great interest of

investors, as well as with the intention of replacing the more expensive dollar-denominated debt with the cheaper, euro-denominated one. A ten-year Eurobond in EUR Serbia 2029 worth EUR 1 billion was issued, with the coupon rate of 1.5% and the yield rate of 1.619%, and the funds were used for early redemption of a dollar-denominated Serbian Eurobonds 2020 and 2021, in the total value of USD 1.1 billion, with coupon rates 4.875% and 7.25%. At the reopening of this issue of Eurobonds, in November 2019, the Republic of Serbia sold an additional 550 million euros of bonds with a yield of 1.25%, which is lower by as much as 37 basis points compared to the initial rate of return on bonds issued in June this year, and at the same time the lowest yield ever achieved on bonds of the Republic of Serbia issued on the international financial market; the funds were used for additional early redemption of the Serbian dollar-denominated Eurobond 2020. On May 7 2020, in order to finance the measures aimed at supporting economy and population in the fight against the COVID-19, the Republic of Serbia courageously stepped into the international financial market, among the first in the group of countries whose rating is just below the investment, attracted a lot of attention from investors and successfully sold its government bond denominated in euros in the total amount of EUR 2.0

billion with a coupon rate 3.125%, maturing in 2027 and listed on the London Stock Exchange.

At the end of September 2020 the total public debt at the general level of the state was RSD 3,175.5 billion, i.e. 57.6% of GDP. Of this, the direct liabilities amounted to RSD 2,962 billion, and the indirect ones RSD 165.7 billion, whereas RSD 37.3 billion referred to the non-guaranteed debt of local self-government units, and RSD 10.0 billion to unsecured debt of PE „Roads of Serbia“ and „Koridori Srbije“ LLC.

#### General government public debt share in GDP, %



**Table 22. General government public debt of the Republic of Serbia in the period from the end of 2017 to 30 September 2020**

	2017	2018	2019	2020/IX
Public debt (in billion RSD)	2,790.5	2,757.3	2,864.0	3,175.5
Public debt (in million EUR)	23,554.0	23,328.4	24,354.9	27,007.3
Public debt (in million USD)	28,154.0	26,669.1	27,296.9	31,701.2

In the first nine months of 2020, due to the necessity to finance the measures to support economy and citizens to fight the pandemic caused by COVID-19, there is a noticeable increase in general government public debt in the currencies with the largest share in public debt, i.e. in euros and dinars. Due to borrowing on the domestic security market, which in 2020 was predominantly performed in RSD, there was an

increase of the public debt in dinars of RSD 138.3 billion. In euros, there was the increase of EUR 1,961.7 million, due to the issuance of Serbian Eurobond 2027. In February 2020, the remaining amount of USD 210.3 million of the Serbian Eurobond 2020 was repaid. This transaction led to the further decline in USD-denominated debt in the first nine months of 2020 for USD 210.5 million.

**Table 23. Central government debt balance per original currencies in the period the end of 2017 - 30 September, 2020, in millions**

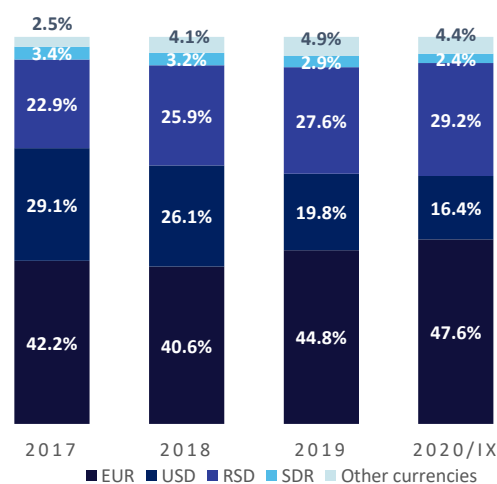
	2017	2018	2019	2020/IX
EUR	9,656.4	9,216.7	10,582.5	12,544.2
USD	8,181.3	6,963.9	5,397.3	5,186.8
RSD	632,485.6	708,389.1	781,250.4	919,504.9
CHF	129.6	120.7	110.5	92.0
Special drawing rights	665.8	618.1	570.4	530.7
Other currencies (in RSD)	56,843.9	100,910.4	128,958.8	129,347.9

In accordance with the tendency to drop the exposure to currency risk, to expand maturity and continue development of new borrowing instruments in the domestic financial market, the basic source of financing in the period 2017 - 2020 is issues of dinar-denominated securities, which affected the increase of public debt share in dinars from 23.0 % at the end of 2017 to 29.4% of public debt of the Republic of Serbia at the end of September 2020, i.e. from RSD 632.5 billion, which was the amount of public debt at the end of 2017, to RSD 919.5 billion at the end of September 2020.

According to data from 30 September, 2020, the largest part of the public debt of the Republic of Serbia is still euro-denominated debt and it amounts to 47.6%. It is followed by dinar-denominated debt in the amount of 29.2% and dollar-denominated debt in the amount of 16.4%. The remaining debt is denominated in special drawing rights (2.4%) and other currencies (4.4%). During 2020 there was a further reduce of dollar-denominated public debt share due to the issuance of new Serbian Eurobond 2027 in euros, in the international financial market for financing the measures of support to the economy and citizens to fight the consequences of the pandemic caused by the COVID-19, and due to the regular maturity of the remaining amount of Serbian Eurobond 2020. During 2019, the Serbian Eurobond 2029 was issued, and there was an early redemption of the dollar-denominated Serbian Eurobond 2020 in the amount of USD 1.3 billion, and 2021 in the amount of USD 400 million. These transactions led to a significant growth of public debt share in euros in the last two years, and on the other side they also led to the reduction of dollar-denominated debt and the risk of exposure to dollar exchange rate, which is one of the goals defined by this strategy. The mentioned

transactions also cause the reduction of borrowing costs due to the replacement of more expensive debt with the cheaper one, considering that the coupon of the new Serbian Eurobond 2029, issued in euros, amounted 1.5%, whereas the coupons of early redeemed dollar Eurobonds amount to 4.875% and 7.25%. The coupon for issued Serbian Eurobond 2027 is 3.125%. Also, due to the operations on the domestic security market, there was a growth of dinar-denominated public debt share, so additional shift was made in the process of dinarization. Year after year, the share of dinar-denominated government securities has been increasing, in compliance with the strategically defined objectives. Hence, their share in the realization of government bonds issued in the domestic market during the first nine months of 2020 amounted even to 85.0%.

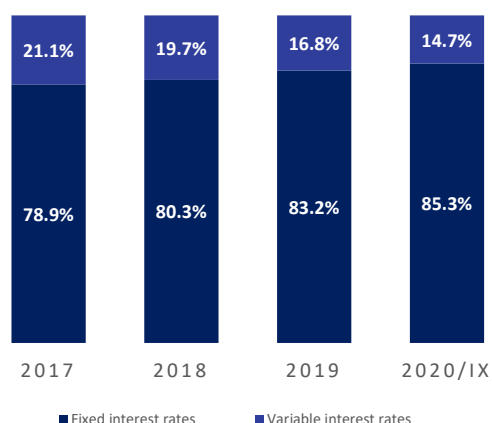
#### Currency structure of the general government public debt in the period 2017 – 30 September 2020



On 30 September 2020, the majority of the general level public debt of the Republic of Serbia was with the fixed interest rate - 85.3%, whereas the public

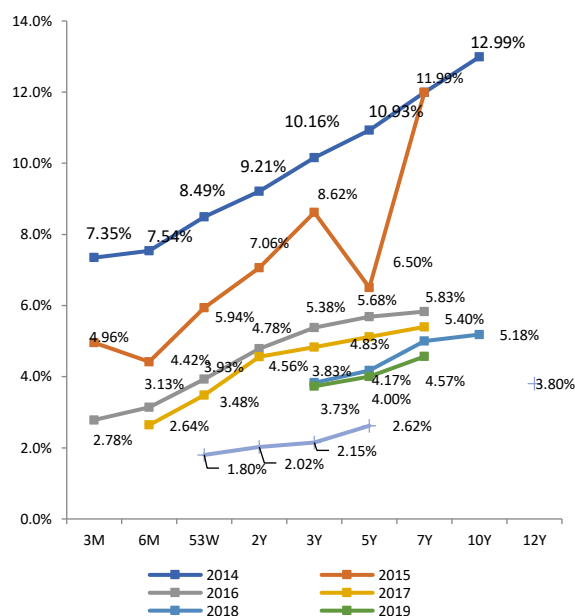
debt with the floating interest rate made 14.7% of the total public debt. Among the floating interest rates, the highest share hold EURIBOR and LIBOR interest rates in EUR which in total make 82.8%, then floating interest rate for special drawing rights 11.7% and LIBOR interest rates in USD which made 3.3%, whereas the share of liabilities with other interest rates was 2.1%.

### Interest rate structure of the government public debt in the period 2017 - 30 September 2020, %

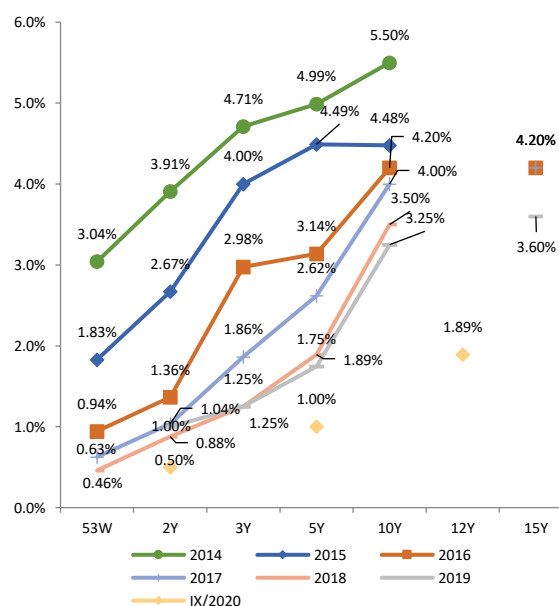


In the last couple of years, there was the drop of borrowing costs, mostly in case of government securities issued in the domestic market. During 2019 and 2020 the further drop of borrowing costs of the Republic of Serbia in terms of dinar- and euro-denominated securities occurred due to the credit rating growth of the country, i.e. reduced risk premium, low inflation rate and the drop of the reference interest rate of the NBS, which is currently 1.25%, thus continuing the trend that began in the last quarter in 2012. During 2020, thanks to the achieved results among which the most significant one was public debt management, and despite the pandemic caused by COVID-19, all rating agencies confirmed the credit rating of the Republic of Serbia, with the stable outlook for further increase.

### Overview of the trend of average effective interest rates in dinar-denominated securities in the period 2014 - 30 September 2020



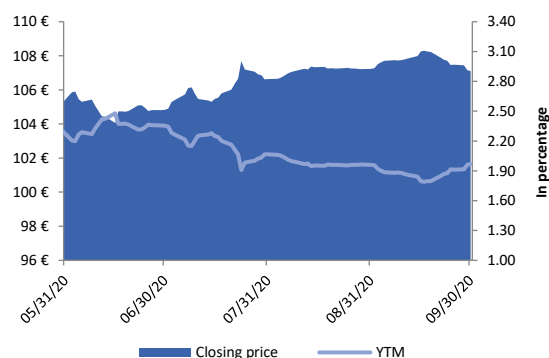
### Overview of the trend of average effective interest rates in euro-denominated securities in the period 2014 - 30 September 2020



Overview of price trend and yield rates trend for Serbian Eurobond 2021



Overview of price trend and yield rates trend for Serbian Eurobond 2027



Overview of price trend and yield rates trend for Serbian Eurobond 2029

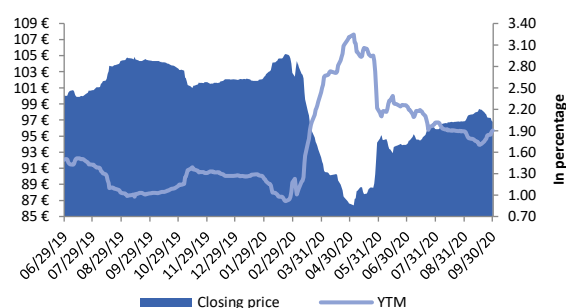


Table 24. Interests and principals repayment projections by 2023, in RSD billion

	2020 p	2021 p	2022 p	2023 p
Principal	400.2	471.5	430.2	458.8
Interest	108.9	110.8	109.5	108.8
Total	509.1	582.3	539.7	567.6
Share in the public debt on 30 September 2020	16.3%	18.6%	17.3%	18.1%

\* With planned *buy-back* operations

Table 25. Interests and principals repayment projections by 2023 (% GDP)

	2020 p	2021 p	2022 p	2023 p
Principal	7.3%	7.9%	6.7%	6.7%
Interest	2.0%	1.9%	1.7%	1.6%
Total	9.2%	9.7%	8.4%	8.3%

Planned amounts for interests and principals repayment in 2020, at the central government level, also include the funds for *buy-back* operations, i.e. early debt redemption, so that more expensive debt could be exchanged for the cheaper one.

### Projection of General Government public debt balance in the period 2020 - 2023

Considering the projected primary budget deficit of the Republic of Serbia for the period 2020 - 2023, including the withdrawal of loan instruments for project financing of budget beneficiaries, the effects

of foreign currency exchange rate of RSD against EUR and USD in the basic macroeconomic scenario, the

central government debt balance at the end of 2023 should amount to 55.0 % of GDP.

**Table 26. Basic projection of general government public debt balance by 2023**

	2020 p	2021 p	2022 p	2023 p
Public debt (central government level), in RSD billion	3,193.8	3,447.8	3,639.0	3,781.1
Central government debt, as % of GDP	57.9%	57.5%	56.8%	55.0%
Non-guaranteed local self-government debt, as % of GDP	1.1%	1.2%	1.1%	1.0%
General government debt, as % of GDP	59.0%	58.7%	57.9%	56.0%

In 2020, the growth of ratio is expected, which shows the share of public debt of the general government level in GDP to 59.0% due to the need to finance measures to support the economy and citizens affected by the pandemic caused by COVID-19. After that, in the upcoming years, the stabilization of the situation is expected, as well as the return of the ratio to the downward trajectory, so at the end of 2021 it is expected to be 58.7%, at the end of 2022 57.9%, and at the end of 2023 56.0%. In the given period, the realization of large infrastructure projects is expected, which will be financed mainly from project loans, as well as their more intensive realization compared to the previous period. If it were not for that, the drop in raids would be more pronounced. However, 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 in its share of GDP, with simultaneous use of new borrowing to improve infrastructural conditions leading to the growth of GDP, living standards and new investments. The non-guaranteed debt of the local self-government units is envisaged to remain at the relatively stable level of about 1.0% to 1.2% of GDP in the period from 2021 to 2023.

### 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. Reduction of financing costs, with the acceptable risk level. With this in mind, the Public Debt Management Strategy of the Republic of Serbia defines the following general objectives and principles:

1) It is necessary to ensure the financing of the fiscal deficit and regular financing of liabilities 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

Public Debt Management Strategy must be 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 issue of government securities in the international and domestic capital market. The government securities market is still developing and one of the principles of public debt management is the flexibility in order to secure the regular financing of liabilities. Flexibility shall be reflected in the choice of the market for borrowings, borrowing currency and financing instruments. The choice of the financing structure will be made considering the domestic and international financial market current balance and development (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 in the domestic market in the following long-term period. However, the current situation indicates that, despite the firm decision to develop domestic securities market, in the following medium-term period, one part of the financing must be carried out in the international financial market, through the establishment of *GMTN* program.

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

The public debt management policy must take into account the long-term perspective, and still make a decision about financing budget expenditures annually. Decision on annual borrowing is made within the Budget Law for a certain 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**

Financial and fiscal risks can 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 increase are: refinancing risks, foreign currency exchange risks, market risk (interest rates risk, inflation risk), liquidity risk, credit and operative risks, and risks related to the servicing costs distribution (debt structure, liabilities concentration).

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

#### **1. Refinancing risks**

- Greater share of medium-term and long-term dinar-denominated financial instruments on the domestic financial market;
- Equal liabilities distribution based on public debt on an annual level in the following long-term period;
- Extension of average debt maturity issued in securities;

#### **2. Foreign currency risk**

- Tendency to reduce the foreign currency-denominated debt share regarding the new debt costs (cost of debt dinarization);
- Utilization of financial derivatives to limit the effects of the reference currencies exchange rates changes;
- Tendency 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)**

- Tendency to extend the duration of the internal dinar-denominated debt;
- Tendency to ensure that the risk based on external debt interest rate does not jeopardize the long-term objective of minimizing public debt costs;

#### **4. Liquidity risk**

- Permanent sustainability of cash on Serbia's accounts at the level that enables smooth liabilities financing for at least four months, as well as the amortization of possible minor inflows based on borrowing according to the plan;
- Adequate management of free cash assets available on the accounts of the Republic of Serbia, in compliance with the asset-liability management principles, as well as in compliance with the possibilities;

#### **5. Credit and operative risks**

- Financial derivatives transactions can only be carried out with the financial institution of high credit rating;
- The use of financial instruments that limit the credit risk;
- Granting guarantees and new loans to local self-government only if there has been an adequate analysis of a relatively low possibility of realizing the guaranty in the medium-term period or the local self-government becoming insolvent in the medium-term period;
- Introduction of adequate control in all the business activities in the Public Debt Administration and expanding the employees' knowledge;

#### 6. Risks tied to the servicing costs distribution

- Adequately planned annual borrowing and equal distribution for the following years and during the fiscal year in order to avoid the risk of high concentration of refinancing liabilities;
- Avoiding the obligations concentration based on the public debt on a monthly level, which could not be amortized by free cash assets on the accounts of the Republic of Serbia.

Due to the implementation of the defined measures, in the previous few years there was a significant improvement of the public debt structure in almost all segments - currency structure and interest rates structure, significantly increased maturity, reduced borrowing costs, reduced guaranteed public debt, even distribution of liabilities along with permanent maintenance of adequate level of liquidity. For example, at the central level of government the share of public debt in RSD increased from 20.9%, at the end of 2016, to 29.4% at the end of September 2020. In the same time period, the share of public debt in USD decreased from 33.9% to 16.6%. The share of the debt with the fixed interest rate in the period from 2013 to September 2020 increased from 73.2% to 86.1%. In the same period, there was a decrease of the guaranteed debt from EUR 2.8 billion to EUR 1.4 billion, as well as the decrease of the weighted average interest rate to public debt from 5.64% to 3.10%.

#### **Analyses used to create the Public Debt Management Strategy**

Public Debt Administration used the quantitative approach to formulate the Public Debt Management Strategy, identifying the possible restrictions through the macroeconomic indicators, and the analysis of costs, risks and market conditions which affect the public debt management. During the analysis of costs and risks, all the feasible financing alternatives are considered. The share of each instrument in the overall financing needs in the given year is determined according to the objectives of the Strategy.

For the purpose of analysis, the following instruments described below, available in the domestic and international financial market, were used.

#### **Financing sources denominated in foreign currency**

Eurobond denominated in EUR and USD issued in the international financial market.

- Foreign governments and international financial institutions loans are shown as concessionary instruments denominated in EUR and USD, with fixed and floating interest rate;
- Internal, euro-denominated debt is presented through two instruments – government bills and government bonds issued in the domestic financial market;
- Eurobond denominated in EUR and USD issued in the international financial market.

#### **Financing sources denominated in domestic currency**

All of the dinar-denominated government securities are categorized into several groups: short-term government bills (with maturity dates up to 53 weeks), and long-term government bills. (with maturity dates from 2 to 15 years).

#### **Future market interest rates and analysis scenario**

In the process of creating the medium-term public debt management strategy for the period 2021-2023, quantitative costs and risks analyses based on various scenarios and projections were used.

The first step is the baseline scenario based on the most likely market conditions. Then three groups of market variables are identified: foreign currency exchange rates, interest rates in the international market and interest rates in the domestic market. The trend of RSD depreciation against EUR and USD is assumed, according to the macroeconomic framework in the period observed, and the relatively stable constant relation between EUR and USD remains, in order to provide a clear picture of the effect of the shock applied. The shocks test the effects of the market interest rates changes. The approach to dinar- and euro-denominated interest rates is based on the current yield rates realized during the previous and the current year.

Having defined the basic scenario, additional types of scenarios – shocks were chosen to conduct the stress test:

- Depreciation of dinar against all the currencies by 15% in 2022. In this scenario, the EUR-USD ratio would remain stable, whereas dinar would be depreciated against both currencies;
- The increase of interest rates in both international and domestic market for about 2 pp;
- The increase of interest rates in the international market up to 3 pp, and in the domestic market up to 4 pp;
- Combined shock concerning the depreciation of dinar against the USD of 15% in 2022, and the increase of interest rates for about 2 pp;
- Each of the above mentioned stress tests or risk scenarios were used to outline the effects of the costs of the strategies examined.

### **Alternative borrowing strategies for the period 2021-2023**

The optimal choice between costs and risks, on the basis of the World Bank model *Medium Term Debt Strategy Model* - MTDS, defined the basic borrowing strategy choice for the next medium-term period. The analysed alternative borrowing strategies are the following:

Basic Strategy (S1): it is the strategy that covers the financing needs mostly (about 60%) by using foreign currency financing sources (issue of securities in both the domestic and international market, as well as credit borrowing from foreign creditors ), and to the

lesser extent (about 40%) by using financing sources in domestic currency (issue of securities in the domestic market).

Strategy (S2): compared to S1 strategy, the needs for financing are met through issuing the state securities in the domestic market, in the domestic currency (50%) and in the foreign currency (50%).

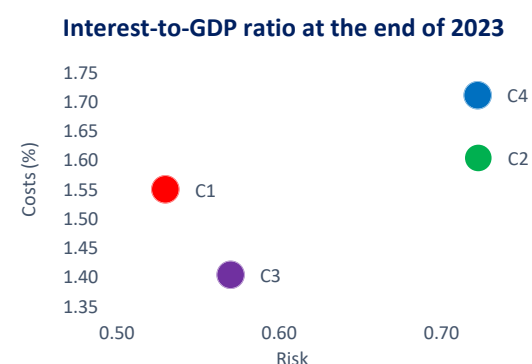
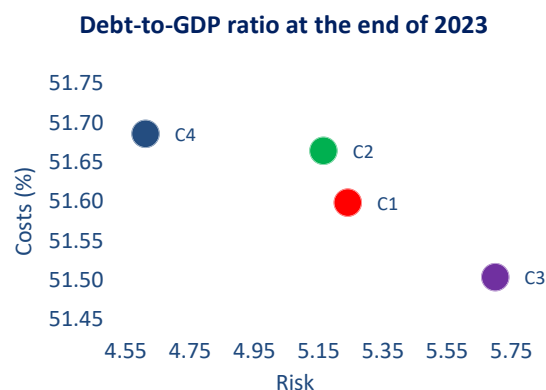
Eurobonds Issue-Based Strategy (S3): S3 strategy, as compared to S1 strategy, is the strategy in which the total financing is based on the issue of euro-denominated Eurobonds with seven and fifteen-year maturity.

Additional Dinarization Strategy (S4): this is a strategy in which the total financing is based on dinar-denominated securities issues.

Financing Serbia's budget expenditures following these strategies will be executed mainly through the issue of government securities in the international and domestic capital market.

### **Comparing the alternative strategies**

Quantitative analysis represents the performance of each of the four alternative borrowing strategies. The vertical axis represents the debt share in GDP, i.e. interest in GDP costs in the basic macroeconomic framework whereas the horizontal axis represents the potential cost of a certain borrowing strategy (stress test result). Two cost ratios are implemented: public debt to GDP and nominal interest as % in GDP. The former is the balance indicator, and the latter the course indicator. For the purpose of comparison, the attention is focused on the results of the strategies examined, at the end of 2023.



The Graphs clearly show the costs brought by each of the considered strategies - strategy S3 has relatively highest foreign currency exchange rate risk exposure. Strategies S4 and S2 have the highest exposure to

possible oscillations of dinar-denominated interest rates, due to issuance of dinar-denominated securities. Strategies S1 and S3 in the basic macroeconomic framework will have the lowest debt in GDP ratio at the end of 2023. Strategy S1 has the lowest risk in terms of interest rates out of the four strategies examined, due to low fixed costs of euro-denominated Eurobonds; however, it turns out to be rather risky in terms of debt-GDP ratio. Strategy S4 appears to be relatively expensive from the aspect of foreign currency interest share in GDP, but at the same time the least risky from the aspect of foreign currency risk, considering that the budget financing on this ground is performed by issuance of dinar-denominated securities.

The analysis of public debt-to-GDP ratio concluded that strategies S1 and S2 have approximately similar debt-to-GDP ratio within the baseline scenario, with the risk of increasing the ratio lower than S3 and higher than S4. Strategy S4 has the highest interest costs due to the significant share of dinar-denominated securities, as well as the risk caused by possible increase of domestic interest rates. Based on these analyses, it is evident that in the following medium-term period basic borrowing operations will be based on strategy S1.

**Table 27. Public debt-to-GDP ratio at the end of 2023**

Scenarios	C1	C2	C3	C4
Basic scenario	51.6	51.7	51.5	51.7
Foreign currency exchange rate shock (15% of all the currencies)	56.8	56.8	57.2	56.3
Interest shock (Scenario 1)	52.1	52.3	52.1	52.3
Interest shock (Scenario 2)	52.5	52.8	52.4	52.8
Combined shock (15% of USD and interest shock 1)	53.4	53.5	53.3	53.5
Maximum risk	5.2	5.2	5.7	4.6

**Table 28. Payment ratio based on interest and GDP at the end of 2023**

Scenarios	C1	C2	C3	C4
Basic scenario	1.6	1.6	1.4	1.7
Foreign currency exchange rate shock (15% of all the currencies)	1.7	1.7	1.5	1.8
Interest shock (Scenario 1)	1.9	2.0	1.8	2.1
Interest shock (Scenario 2)	2.1	2.3	2.0	2.4
Combined shock (15% of USD and interest shock 1)	1.9	2.0	1.8	2.1
Maximum risk	0.5	0.7	0.6	0.7

The following table shows the basic public debt parameters trends in each of the four strategies

considered, which outlines the abovementioned characteristics of each strategy:

**Table 29. Alternative strategies risk indicators at the end of 2023**

		C1	C2	C3	C4
Nominal debt (% of GDP)		51.6	51.7	51.5	51.7
Applied interest rate (%)		3.1	3.2	2.8	3.4
Refinancing risk	ATM <sup>16</sup> external portfolio (in years)	8.3	8.6	8.2	6.7
	ATM domestic portfolio (in years)	5.9	5.4	4.1	6.7
	ATM total portfolio (in years)	7.7	7.6	7.7	6.7
Interest rate risk	ATR <sup>17</sup> (in years)	7.3	7.2	7.3	6.3
	Refixing (% of total debt)	15.4	15.5	14.2	16.8
	Fixed rates debt (% of total debt)	92.8	92.8	92.8	92.8
Foreign currency exchange rate risk	Foreign currency debt (% of total debt)	72.9	68.4	88.3	48.1

### Stress test analysis

Fiscal rule, defined by the Law on Budget System, imposes that the General Government public debt must not exceed 45% of GDP. Should the debt exceed that level, the Government's duty is to implement a program to reduce the debt share in GDP, i.e. to have the debt within the legal framework again.

At the end of 2019 the central government debt reached 52% of GDP, and the general government debt reached 52.9% of GDP. The public debt-GDP ratio of Central Government was 56.7% of GDP at the end of September 2020, and the general government 57.6%. By the end of 2020 the slight increase of the ratio is expected at the level of about 57.9% of GDP at central government level, i.e. 59.0% of GDP at general government level, due to the necessity of further financing of measures for preventing

the effects of the pandemic caused by COVID-19. Due to high share of foreign currency-denominated debt (about 70.6%), it is clear that the foreign currency risk will determine the behaviour of public debt-GDP ratio in the following period, and it will significantly influence the success of the fiscal policy measures designed to consolidate public finances and reduce the debt share in GDP.

Based on the planned macroeconomic framework, providing that there is no possible risk, central government public debt should be at the level of 55.0% of GDP, until 2023.

The key factors that influence the stabilization of public debt-GDP ratio include GDP growth, primary deficit, dinar exchange rate against foreign currency rates, and interest level.

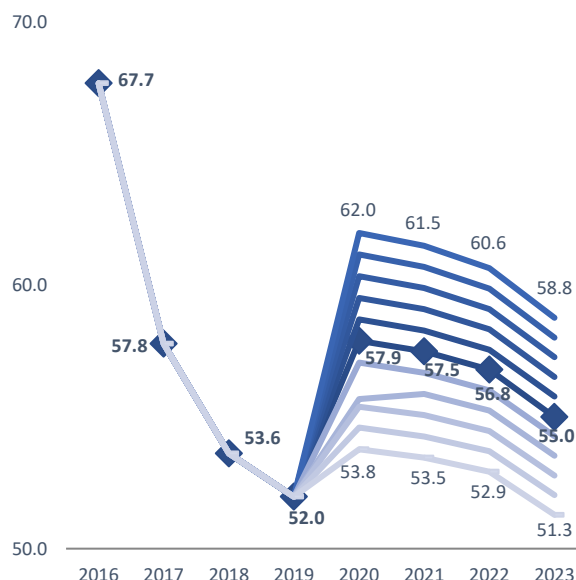
**Table 30. Contributions from the key macroeconomic variables to the change in the central government public debt-to-GDP ratio, in %**

	2018	2019	2020 p	2021 p	2022 p	2023
Central government debt/GDP	53.6	52.0	57.9	57.5	56.8	55.0
Changes compared to the last year. in % of GDP	-4.2	-1.7	5.9	-0.4	-0.7	-1.8
Contribution of primary fiscal deficit	-2.7	-2.2	6.6	1.1	-0.2	-0.5
Contribution of interests	2.1	2.0	2.0	1.9	1.7	1.6
Contribution of nominal GDP growth	-3.6	-3.4	-0.9	-4.6	-3.7	-3.8
Contribution of other factors	0.0	2.0	-1.7	1.3	1.5	1.0

<sup>16</sup> ATM (Average Time to Maturity) – abbreviation for average maturity time.

<sup>17</sup> ATR (Average Time to Refixing) – abbreviation for average interest rates change time.

### 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



Graph represents the public debt-to-GDP ratio trends depending on the dinar exchange rate against a certain currency basket. It shows the basic projection with alternative scenarios depending on the appreciation or depreciation of dinar exchange rate, in the range of 10% appreciation to 10% depreciation of dinar against a currency basket. Implementation of the scenarios in question shows that in 2023 the ratio would range from 51.3% to 58.8%, whereas in the basic scenario it would be at 55.0%.

Major risks to the Strategy implementation, apart from the abovementioned quantified factors, include the following: stability of macroeconomic situation in the Republic of Serbia, the need for additional borrowing in order to regulate debts at other government levels, the public sector and the financial sector of the Republic of Serbia and the activation of provided guarantees.

It is important to mention that the reduction of the public debt in relation to GDP will be enhanced by the more adequate control of guarantees issuance and the improvement of the process of investments projects prioritization, financed from the loan lines of multilateral and bilateral creditors. Starting from 2015, the guarantees shall be issued only for the project (investment) loans, i.e. no more guarantees for current liquidity loans to public enterprises, which

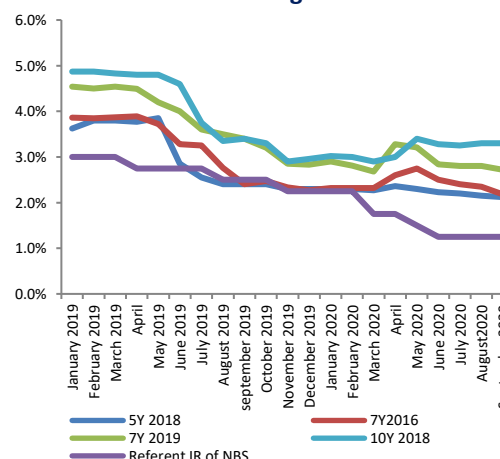
already significantly influenced the reduction of the guaranteed public debt balance in the last five years.

### Long-term strategic framework of public debt management

The basic strategic objectives which are to be acquired in the following long-term period, in order to minimize the risk of increased debt and public debt servicing costs are the following:

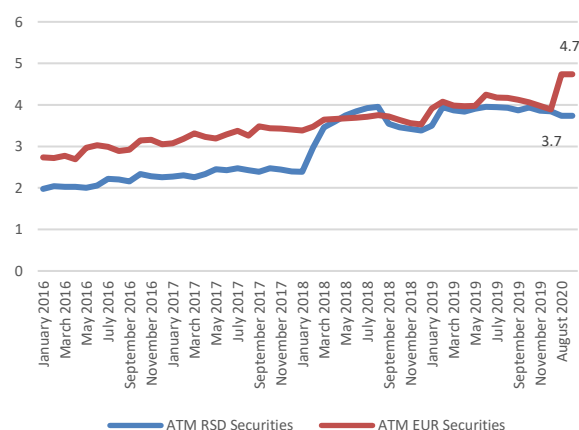
- The share of dinar-denominated debt should be above 30% of the overall public debt in the medium-term period;
- The share of euro-denominated debt in the public debt should be at least 65% of the foreign currency debt, including future borrowings and transactions;
- The share of floating interest rate should drop to below 15% in the mid-term period;
- Average time to refixing (ATR) should remain at a level of at least 5.0 years, in accordance with the abovementioned measure of gradual decrease of floating interest rate debt share;
- Weighted average interest rate (WAIR) for public debt in domestic currency shall not exceed 5.00%;
- The share of the short-term debt (whose maturity is up to a year) shall be up to 15% of the overall public debt;
- The average maturity time (ATM) of internal debt shall be at a level of at least 5.0 years in mid-term;
- The average maturity time (ATM) of external debt shall remain at a level of from 7.0 ± 0.5 years in the same time framework.

### Yield to maturity trends of three-year and seven-year dinar benchmark issues on the secondary market trading





### Average time to maturity (ATM) of securities issued in the domestic financial market in the period from 1 January 2016 – 30 September 2020



### Improvement measures for dinar-denominated securities market in the period 2021–2023

In the period of 2012–September 2020, the securities market achieved the set strategic objectives, primarily regarding the financing instruments, but also when it comes to the development and maintaining the stability of diversified investor base. Transferring from short-term financing resources, which were used in the period up to 2010, to the mid-term and long-term financing instruments, and the constant drop in borrowing costs, have influenced the reduction of 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 in initial maturity of three or more years amounted to 38.3% in dinar-denominated securities balance, whereas at the end of September 2020, the amount was 91.1%.

Transparent work and reports, as well as the presence on the international capital market, help the non-residents to be informed and therefore interested to invest their capital into borrowing instruments, primarily into long-term government securities, which enhances the development of a stable investor base. Due to successful realization of benchmark issues during 2014 and 2015, the same practice continued during 2016. In February and July 2016 there was an issue of a three-year and seven-year benchmark bond in the amount of RSD 110 billion each. In April 2017 there was an issue of a three-year benchmark bond in the amount of RSD 110 billion. In January and February

2018 there was an issue of a five-year and ten-year benchmark bond in the amount of RSD 110 billion each. This issue considerably extended the scope of secondary trading in these instruments which considerably contributed to the drop in effective yield rates in the re-opening of the stated issues. In January 2019 there was an issue of a three-year and seven-year benchmark bond in the amount of RSD 100.0 and 150.0 billion. In January and February 2020 for the first time there was an issue of a five-and-a-half-year, i.e. twelve-and-a-half-year bond with a six-month coupon.

These issues considerably extended the scope of secondary trading in these instruments, which considerably contributed to the drop in effective yield rates in the re-opening of the stated issues. "Benchmark" issues also increased the share of foreign investors in dinar-denominated securities, which at the end of September 2020 amounted to 24.9%. A seven-year bond, whose development and realization were followed by *J.P. Morgan* in 2019, was put in the *Index Watch Positive* list, with the positive chances for inclusion in *J.P. Morgan GBI-EM* index.

Starting from November 12, 2015, trading in long-term government securities was enabled at Belgrade stock exchange to ensure further development of the secondary market of government securities. The period to which this strategy applies is expected to improve the efficiency of the primary market through the concept of primary dealers, as a mechanism of selling government securities which can, in the long run, directly contribute to the reduction of borrowing costs and refinancing risk. The introduction of the selling system for the government securities in the domestic financial market through primary dealers is a solid base for the improvement of the market efficiency of the secondary market of government securities. In time, the development of the secondary market will establish the concept of market efficiency in the process of government securities evaluation. The introduction of the "benchmark" issue of bonds will have a positive effect on the amount and continuity of secondary trading, as well as on the improvement of market efficiency in the process of selling government securities in the primary market.

The fiscal result, expected inflation rate and foreign currency exchange rate should be highlighted as the key factors that influence the yield curve of

government securities. It is important to emphasize a special group of factors consisting of the macroeconomic trends and expectations, as well as changes in the international financial market, reflecting the premium risk of the country.

At the end of 2012 the average maturity of dinar-denominated securities was 394 days (1.1 year), 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, it was 749 days (2.1 years), at the end of 2016 it was 789 days (2.2 years), at the end of 2017 it was 864 days (2.4 years), at the end of 2018 it was 1,188 days (3.3 years), at the end of 2019 it was 1,403 days (3.8 years) and at the end of September 2020 it was 1,365 days (3.7 years). The development of the domestic securities market will be supported by the Republic of Serbia with the following measures:

- Including Serbia's bonds in the *Index Watch Positive* list, with the positive chances for the inclusion in a global index considerably increased the database of investors and supported secondary trading, which contributed to further reduction of borrowing costs by issues of dinar-denominated securities;
- In order to create a base of investors as large as possible and to develop the secondary market for securities issued in domestic market, the Government created an equal tax treatment for the domestic and foreign investors at the end of 2011, and in the

following period, efforts will be made to remove all the obstacles to a free capital flow. The preparations of legal and technical frameworks for enabling the clearing system and the offsetting of the domestic securities transactions through the international clearing system are ongoing;

- The possibility of introducing the primary dealers will be considered in the following period. Namely, the Law on Amendments to the Public Debt Law from December 2018 envisages the introduction of primary dealers to the domestic capital market as the incentive for the liquidity of the secondary securities market and the reduction of the debt refinancing risk. The mentioned amendments to the Law also envisage the operation with financial derivatives, which would be used for performing the transactions for the purpose of the risk management, including the reduction or elimination of the exchange rate change, interest rate change, as well as other risks.
- Activities have been undertaken to enable the settlement of government securities in the foreign market. Amendments to the Public Debt Law from December 2019 enable that the clearing and settlement of government securities issued in the domestic market, in addition to the Central Register, shall be performed by another foreign legal entity in charge of performing clearing and settlement operations.

#### **IV. FINAL PROVISIONS**

The integral part of this Fiscal Strategy are: Appendix 1 - Projection of the Basic Macroeconomic Indicators, Appendix 2 – Fiscal framework of the general government in 2021 and Appendix 3 – Statement on the Fiscal Council Assessment, printed in addition of this Fiscal Strategy.

This 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 Fiscal Strategy shall be published in the „Official Gazette of the Republic of Serbia“, and on the website of the Ministry of Finance.

05 No.: 400-9123/2020-1

In Belgrade, 20 November 2020

**G O V E R N M E N T**

**PRIME MINISTER**

Ana Brnabić, sgd.

## Appendix 1 – Projection of the Basic Macroeconomic Indicators

	2020	2021	2022	2023
GDP real growth rate, %	-1.0	6.0	4.0	4.0
GDP at current market prices (in billion RSD)	5,517.3	5,997.7	6,408.1	6,871.3
Sources of growth: percentage changes at constant prices				
Private consumption	-1.9	5,4	2,8	2.9
Government consumption	5.8	0,4	2,5	1.8
Gross fixed capital formation	-4.8	13,3	7,1	7.8
Changes in inventories as % of GDP	0.0	0,0	0,0	0.0
Exports of goods and services	-6.9	9,6	9,1	9.3
Imports of goods and services	-6.5	9,3	7,7	7.8
Contribution to GDP growth, percentage points				
Domestic demand	-1.5	6.8	4.1	4.0
Investment consumption	-1.1	3.0	1.7	1.8
Private consumption	-1.3	3.8	1.9	1.9
Government consumption	0.9	0.1	0.4	0.3
Change in inventories	0.0	0.0	0.0	0.0
Net export of goods and services	0.5	-0.8	-0.1	0.0
GVA growth, %				
Agriculture	4.9	-4.0	0.6	0.0
Industry	0.0	5.7	4.9	5.0
Construction	-6.0	14.6	6.2	7.9
Services	-1.5	6.9	4.0	4.1
Contributions to GDP growth, percentage points				
Agriculture	0.3	-0.2	0.0	0.0
Industry	0.0	1.2	1.1	1.1
Construction	-0.3	0.7	0.3	0.4
Services	-0.8	3.5	2.1	2.1
Net taxes	-0.2	0.8	0.5	0.5
Price trends, %				
GDP deflator	2.9	2.6	2.7	3.1
Consumer prices (annual average)	1.5	2.0	2.2	3.0
External sector trends, % GDP				
Balance of goods	-11.1	-11.4	-11.0	-10.2
Balance of services	2.6	2.5	2.4	2.2
Current account balance	-5.6	-5.9	-5.5	-5.2
Fiscal indicators, % GDP				
General government fiscal result	-8.9	-3.0	-1.6	-1.0
Consolidated revenues	40.3	40.4	40.5	39.7
Consolidated expenditures	49.2	43.4	42.1	40.7
Gross debt of the general government sector	59.0	58.7	57.9	56.0

## Appendix 2 – Fiscal framework of the general government in 2021\*

	General government	Republic budget	Local self-government units	Cities and municipalities	AP Vojvodina	PE "Roads of Serbia" and „Koridori Srbije“ LLC	OOCO	Pension Insurance Fund	National Health Ins.Fund	National Unemployment Service	Military Health Fund SOVO
	1=2+3+6+7	2	3=4+5	4	5	6	7=8+9+10+11	8	9	10	11
<b>Public revenues</b>	<b>2,424.0</b>	<b>1,285.9</b>	<b>311.4</b>	<b>288.7</b>	<b>22.8</b>	<b>29.9</b>	<b>796.7</b>	<b>557.9</b>	<b>218.4</b>	<b>17.3</b>	<b>3.1</b>
Current revenues	2,404.5	1,268.4	309.9	287.2	22.8	29.9	796.2	557.9	218.4	16.8	3.1
Tax revenues	2,171.2	1,154.6	232.0	215.6	16.4		784.5	556.9	209.4	15.7	2.5
Personal income tax	225.4	73.3	152.2	143.7	8.5						
Social contributions	784.5						784.5	556.9	209.4	15.7	2.5
Corporate income tax	107.1	99.1	8.0		8.0						
VAT	600.4	600.4									
Excises	315.8	315.8									
Customs	53.1	53.1									
Other tax revenues	84.9	13.0	71.9	71.9							
Non-tax revenues	233.3	113.8	77.9	71.6	6.3	29.9	11.7	1.0	9.0	1.1	0.6
Donations	19.5	17.5	1.5	1.5			0.5			0.5	
<b>Public expenditures</b>	<b>2,603.1</b>	<b>1,132.5</b>	<b>390.9</b>	<b>330.6</b>	<b>60.3</b>	<b>51.0</b>	<b>1,028.6</b>	<b>654.4</b>	<b>347.1</b>	<b>21.0</b>	<b>6.1</b>
Current expenditures	2,241.1	834.6	341.5	281.6	59.9	41.5	1,023.4	653.7	343.1	20.6	5.9
Expenditures for employees	513.6	272.5	93.9	59.4	34.6	2.9	144.3	3.1	139.5	1.6	
Contributions paid by employers	88.9	48.2	15.8	9.1	6.8	0.4	24.4	0.6	23.5	0.4	
Purchase of goods and services	456.9	124.3	126.0	123.7	2.3	35.2	171.4	2.3	164.8	0.9	3.3
Interest repayment	113.6	111.2	2.3	2.0	0.3	0.1					
Subsidies	136.8	109.7	27.1	19.2	7.9						
<b>Social assistance and transfers</b>	<b>848.1</b>	<b>120.0</b>	<b>47.8</b>	<b>47.6</b>	<b>0.2</b>	<b>0.0</b>	<b>680.3</b>	<b>646.7</b>	<b>14.3</b>	<b>16.8</b>	<b>2.5</b>
of which pensions	621.0						621.0	621.0			
Other current expenditures	83.2	48.7	28.5	20.8	7.8	3.0	3.0	1.1	1.0	0.8	0.1
Capital expenditures	327.1	266.6	45.8	45.3	0.5	9.5	5.2	0.7	4.0	0.4	0.1
Net lending	23.2	19.6	3.6	3.6							
Activated guarantees	11.7	11.7									
<b>Fiscal result excl. transfers</b>	<b>-179.1</b>	<b>153.4</b>	<b>-79.5</b>	<b>-41.9</b>	<b>-37.5</b>	<b>-21.1</b>	<b>-231.9</b>	<b>-96.5</b>	<b>-128.7</b>	<b>-3.7</b>	<b>-2.9</b>
Transfers from other levels of government	418.2	7.0	88.1	50.1	38.0	17.7	305.4	161.1	132.8	8.6	2.9
Republic budget	344.7	7.0	88.1	50.1	38.0	17.7	231.9	153.6	69.2	8.6	0.5
Cities and municipalities											
AP Vojvodina											
Pension Insurance Fund	64.6						64.6		62.2		2.4
National Health Insurance Fund	4.1						4.1	4.1			
National Unemployment Service	4.9						4.9	3.5	1.4		
Military Health Fund SOVO											
Other levels											
Transfers to other levels of government	418.2	337.7	7.0	7.0			73.5	64.6	4.1	4.9	
Republic budget	7.0		7.0	7.0							
Cities and municipalities	50.1	50.1									
AP Vojvodina	38.0	38.0									
Pension Insurance Fund	161.1	153.6					7.5		4.1	3.5	
National Health Insurance Fund	132.8	69.2					63.6	62.2		1.4	
National Unemployment Service	8.6	8.6									
Military Health Fund SOVO	2.9	0.5					2.4	2.4			
Other levels	17.7	17.7									
Net transfers to other levels of government		-330.7	81.1	43.1	38.0	17.7	231.9	96.5	128.7	3.7	2.9
<b>Fiscal balance</b>	<b>-179.1</b>	<b>-177.3</b>	<b>1.6</b>	<b>1.2</b>	<b>0.5</b>	<b>-3.4</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>

The table shows approximate amount of revenue and expenditures in 2021, which is largely based on statistical methodology of the public finance accounts than on the accounting methodology. Considering that there may be changes in the amount and structure of certain categories, these amounts are not legally binding.

\* The budget is shown without indirect budget beneficiaries and expenditures financed from them, which are not included in the budget execution information system.

## Appendix 3 – Statement on the Fiscal Council Assessment

Having regard to the opinion of the Fiscal Council on the Fiscal Strategy Draft, we shall present statements on the most important assessments of the Fiscal Strategy.

The mid-term projection of real sector development is based on the realistic approach, so that the fiscal policy is adequately set and not jeopardizing the achievements so far. The trends in basic macroeconomic aggregates and indicators for the Republic of Serbia in the period 2021-2023 have been projected on the basis of current economic trends and prospects for the Republic of Serbia and the international environment, as well as on the basis of the assessment of effects of planned economic policy measures.

A real GDP growth of 6.0% has been projected for 2021, making the initial projection from the previous Fiscal Strategy revised upwards by 2.0 pp. The main reason for this revision is the lower base in 2020, due to the effects of the pandemic on all GDP components<sup>18</sup>. Mid-term macroeconomic and fiscal scenario is complied with IMF, within the fifth revision of the program.

In the baseline macroeconomic scenario, the fiscal deficit of 3% will return the debt to the declining path in 2021. The estimated one-off increase of the fiscal deficit to 8.9% of GDP in 2020 (the primary deficit of 6.9% of GDP) will have the effect on reversing so-far declining path of public debt share in GDP. The share of general government public debt in GDP will reach 59% at the end of 2020. The fiscal strategy for the next period envisages the stabilization of public finances and significantly lower levels of deficit, which will revert the public debt in the declining trend zone. The process of stabilization of public finances will be gradual and steady so that over-restrictive policies would not undermine the assumptions of accelerated economic growth.

However, aware of the fact that the central growth scenario is based on the assumption of curbing the health crisis and unusually high uncertainty in this regard, the Fiscal Strategy also states negative risks to the macroeconomic scenario<sup>19</sup>.

The existence of uncertainty regarding the stabilization of firstly health, and consequently economic crisis, and the frequent revisions of macroeconomic projections in these conditions, the changes in the baseline scenario are possible, if certain assumptions it is based on are not met. The projections of the Ministry of Finance, in compliance with the international methodology and practice, also contain risks that may be positively and negatively symmetrical, and upon their activation the projections will be revised. The Government has shown that it is capable of implementing consolidation measures when needed, so it is unreasonable to assess that an excessive deficit will lead to the further increase of public debt.

Employee expenditures shall drop from 10.4% of GDP in 2020 to 10.0% of GDP in 2021, and by the end of the observed period, to 9.6% of GDP. Average wage expenditures in EU amount to about 10% of GDP. Given the limited fiscal space, in the next period, the wages will increase gradually, with the control and reducing of their share in GDP. The argument that the wages in public sector are 20% higher than in the private sector has to be perceived in the light of the fact that the public sector includes both public enterprises and public agencies. It was the rigid wage control in the public sector, primarily in the public administration, which has led to the tendency to form numerous bodies and organizations established in the form of public agencies outside the government sector, so that the wages are not under the strict and rigid control, as is the case in state and local administration. Also, in the previous period, it was planned for a new payment class system for all public sector employees (including the army and the police), i.e. the new Law on Public Servants' and Public Employees' Wages and the Amendments to the Decree on the Catalogue of Job Posts in the Public Sector and other Public Sector Organizations, to be drafted this year, so

---

<sup>18</sup> More detailed explanation on the projection in the chapter: „Projections of real sector developments in the period 2021–2023”, p. 16.

<sup>19</sup> More detailed explanation on the risks in the chapter: „4. Risks involved with achieving the projection of GDP trends in the Republic of Serbia in the period 2021–2023”, p. 28.



that it would be ready for implementation along with the budget for 2021. Due to well-known circumstances that affected the formation of new authorities, which would subsequently participate in the negotiations with the unions regarding new wage and coefficient system, the entire process was postponed for the next year. New payment class system should be implemented as of 2022.

The Fiscal Strategy states the Government's determination to strengthen fiscal rules in order to stabilize public finances. The functional system of fiscal rules is required in order to ensure stability and sustainability of public finances over a long period. The current fiscal rules were introduced in 2010. As of this year, the pension indexation was reintroduced, with the pensions being adjusted by using the "Swiss formula", while respecting the limit of 11% of GDP for total pension expenditures. The amendment of the Budget System Law, which would, inter alia, strengthen the fiscal rules, was planned for 2021, with the implementation starting from 2022, defining the level of deficit and ensuring the downward path of the public debt level. Apart from the Ministry of Finance, IMF and Fiscal Council shall also actively participate in the defining of the new set of fiscal rules.