

GOVERNMENT OF THE REPUBLIC OF SERBIA

FISCAL STRATEGY

FOR 2017 WITH PROJECTIONS FOR 2018 AND 2019



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Pursuant to Article 27v paragraph 1 of the Budget System Law (*Official Gazette of RS* Nos. 54/09, 73/10, 101/10, 101/11, 93/12, 62/13, 63/13-corrigendum, 108/13, 142/14, 68/15-new law and 103/15),

the Government adopts this

FISCAL STRATEGY FOR 2017 WITH PROJECTIONS FOR 2018 AND 2019

I. MACROECONOMIC FRAMEWORK FOR THE PERIOD 2017 TO 2019

1. General Framework and Main Objectives and Guidelines of Economic Policy

The Government's strategic commitment to attaining full membership in the European Union (hereinafter referred to as "EU") and the progress made towards this goal to date have been reaffirmed with the opening of two new negotiation chapters in 2016. Regular political and economic dialogue about open issues under the Stabilization and Association Agreement between the European Communities and their Member States of the one part and the Republic of Serbia of the other part (hereinafter referred to as "SAA"), adoption of the Economic Reform Program for the Period 2016–2018, the Employment and Social Reform Program and the revised National Program for the Adoption of the EU Acquis, implementation of the Public Financial Management Reform Program for the Period 2016–2020, harmonization of national legislation and passing of general and sector-specific development strategies, including this Strategy, all have the aim of helping Serbia meet within the shortest possible period the economic requirements for membership set out in *acquis communautaire*.

In addition to the establishment of an institutional framework and administrative capacity building, which should ensure and guarantee democracy and rule of law, the EU integration process also means Serbia will have to build a stable macroeconomic environment, develop a market economy and strengthen its ability to respond to the challenges of the EU competition forces. In recent months, the Government has initiated, adopted and implemented key measures for stabilizing public finance and the overall economic environment. In April 2016, the Stabilization and Association Committee welcomed the strengthening of Serbian economy and underscored the importance of a reduced fiscal deficit. Successful attainment of the objectives set by the fiscal consolidation program has been officially confirmed through six successful revisions of the Precautionary Stands-by Arrangement with the International Monetary Fund (hereinafter referred to as "IMF"), with an observation that the achieved results have significantly exceeded expectations.

Serbia's economy has continued improving across all macroeconomic indicators in 2016. Economic growth projection for this year has been revised upward for the third time (from the initial 1.8% to the current 2.7%), with an improved medium-term outlook. The fact that economic growth has been achieved in circumstances of strict fiscal consolidation is proof that policy makers have chosen appropriate instruments. The three-year objectives set under the fiscal consolidation program, which pertain to the level of structural adjustment of the fiscal deficit and the ratio of public debt to gross domestic product (hereinafter referred to as GDP), have been achieved a whole year ahead of schedule. Consistent implementation of fiscal consolidation and structural reforms has been essential in boosting the resilience of the Serbian economy, while the carefully weighed and fully coordinated fiscal and monetary policy measures have been instrumental in keeping inflation at a low and stable level in the past three years, which allowed the National Bank of Serbia (hereinafter referred to as "NBS"), in

cooperation with the Government, to lower the target inflation rate. This will further reduce uncertainty for the economy as a whole in the coming medium-term period, thus providing an impetus to further improvement of the investment climate and lowering of long-term financing costs for the economy, the state and citizens. Economic and fiscal policies in the next medium-term period will focus on attaining the following objectives:

- Maintaining macroeconomic stability, coupled with further reduction of public debt and its return to a sustainable level;
- Continued implementation of structural reforms, especially in public enterprises, and improved efficiency of the public sector.

The Government will continue improving the business climate in the next three years through active measures. The achieved fiscal stability will bring about improved macroeconomic performance across the board. The growth model that has been established is based on increased investment and exports. Additional impetus to long-term sustainability of growth should come from complex and comprehensive reform processes, which the Government will continue implementing in order to eliminate existing barriers and risks. This will encourage private initiative, promote entrepreneurship and innovation and affirm growth based on knowledge and technological development, which in turn will generate new jobs and help reduce unemployment.

Fiscal consolidation measures have created scope for an increase in pensions and salaries in a part of the public sector, which will enable growth of disposable income and standard of living of the population, but without jeopardizing the planned budget deficit and the achieved downward trend in public debt. A continuing priority goal of fiscal policy is to establish a tax system that fosters economic activity and employment, ensures greater efficiency of tax collection and reduces the shadow economy.

Fiscal consolidation in the coming period will be supported by continued implementation of structural reforms, with special focus on organizational and financial restructuring of public enterprises to prepare them to operate according to market principles. Rebalancing of the economy will give an additional boost to growth and lay a key foundation for maintaining stable public finance.

Attainment of the Government's ambitious objectives will increase the standard of living by achieving sustainable, smart and inclusive growth, which will imply promotion of competitiveness and more efficient use of resources and development of a knowledge- and innovation-based economy, coupled with increased participation in the labor market, poverty reduction and social cohesion.

2. Assessments of the International Economic Environment

Global economic recovery has been taking place in an environment fraught with instability in financial and commodity markets, economic slowdown in developed economies and a mildly improved macroeconomic outlook for emerging economies, divergent monetary policies of leading central banks and growing geopolitical tensions. Frequent revisions of growth rates of the largest economies and emerging economies have additionally increased uncertainty in the global market, thus diverting capital flows to “safe harbors”. The response by leading central banks and the gradual normalization of monetary policy applied by the United States Federal Reserve System (hereinafter referred to as Fed) may lead to greater risk aversion among investors, which could affect capital inflows into emerging economies, including Serbia. Low prices of oil and other primary products have continued contributing to deflationary pressures. The slowdown and rebalancing of the Chinese economy, in view of the growing geopolitical tensions, has been adversely affecting trade flows, especially with Serbia’s largest economic partners (EU Member States). The rising political uncertainty caused by the decision of the United Kingdom (hereinafter referred to as “UK”) to exit the EU and the delay in reaching a final free trade agreement with the United States of America (hereinafter referred to as “US”), threaten an increase in protectionism, which will continue to affect the direction of the flow of goods, capital, and labor. In an unstable global environment, the small and open Serbian economy, has reduced internal and external imbalances by improving domestic macroeconomic fundamentals, thus strengthening its resilience to external shocks and reducing the risks associated with the international environment.

Macroeconomic Estimates by the International Monetary Fund

The second half of 2015 was characterized by a global economic slowdown, continued decline in the prices of primary products and volatility in international financial markets. Developed economies experienced a slowdown, while growth was based on growing domestic demand due to favorable monetary policies in the USA and the Eurozone, while export activity stagnated. China’s slower economic growth and recession in Russia and Brazil resulted in an economic slowdown in emerging economies, which had adverse effects on global economic growth and global trade growth at 3.2% and 2.6% respectively. Net energy export countries felt the most severe effects of weakening export demand, which, coupled with reduced capital inflow, resulted in worsened macroeconomic performance. The increasingly difficult global geopolitical situation also contributed to slower growth in 2015, with the recession trends in Ukraine, Libya and Yemen alone account for a 0.1 p.p. decline in the global GDP.

The factors that drove global economic growth in 2015 continued contributing positively in early 2016: according to preliminary IMF estimates, growth in the first half of 2016 reached 2.9%. In parallel with this, negative risks associated with the slowdown of the Chinese economy and the uncertainty of UK’s final status in the EU contributed to slowed global trade and financial flows. Eurozone growth remained stable and driven primarily by increased private consumption and investment. Even with increased private spending, the US has seen slower growth due to a decline in gross investment in the export-oriented sectors, as a result of negative effects of appreciation of the dollar. Emerging economies, as net exporters of commodities, have seen sound growth notwithstanding the declining costs of raw materials, even if this growth has been rather heterogeneous across this group. India and China have experienced robust growth, while Latin America has seen recessionary trends due to the drought in Brazil and the low costs of primary products.

Table 1. International environment – macroeconomic indicators

	2015	2016	2017	2018
Real gross domestic product growth¹, %				
World	3.2	3.1	3.4	3.6
Eurozone	2.0	1.7	1.5	1.6
USA	2.6	1.6	2.2	2.1
Russia	-3.7	-0.8	1.1	1.2
Emerging economies	4.0	4.2	4.6	4.8
Global trade growth, %	2.6	2.3	3.8	4.2
Unemployment rate, %				
Eurozone	10.9	10.0	9.7	9.3
USA	5.3	4.9	4.8	4.7
Consumer prices, period average, %				
Eurozone	0.0	0.3	1.1	1.3
Developed economies	0.3	0.8	1.7	1.9
Emerging economies	4.7	4.5	4.4	4.2
Euro/dollar exchange rate, end-of-period	1.1	1.1	1.1	/
Grain prices, in dollars, annual changes²	-17.3	-8.5	6.2	6.3
Metals prices, in dollars, annual changes³	-23.1	-7.5	1.7	-1.0
Iron ore price, in dollars⁴	55.2	53.9	48.4	42.8
Oil price, in dollars, annual changes, %	-47.2	-15.4	17.9	4.8

¹ Global GDP is calculated on the basis of purchase power parity

² Grain price is calculated as the weighted average price of wheat, maize, soy, rice and barley

³ Metal price is calculated as the weighted average price of copper, aluminum, iron ore, tin, nickel, zinc, lead and uranium

⁴ Iron ore price (iron content of 62%) for import to China, Tianjin port, in dollars per metric tons.

Source: IMF, World Economic Outlook, October 2016

The IMF retained July's global economic growth estimates in its **World Economic Outlook for October**, namely **3.1% in 2016 and 3.4% in 2017**. This forecast takes into account the effects of the slowdown of the Chinese economy, which adversely affects investment activity and trade flows, low oil prices which reduce revenue for exporting countries, slowdown in the US and the uncertainty associated with the UK's negotiation of its EU exit. As a consequence of these circumstances, growth in developed countries has been revised downward, while the outlook for emerging countries has improved. In the medium-term perspective, it is expected that most Eurozone economies and the US will experience a tepid slowdown; Russia is expected to exit recession; while emerging economies are set to see sound growth, all of which combined could lead to global economic growth taking off in 2017 and 2018 by 3.4% and 3.6% respectively. Eurozone will grow at a rate of 1.7% in 2016, a 0.1 p.p. improvement over July projections, but still slower than 2015. Continued increase in of domestic demand within the Eurozone, low oil prices, moderate fiscal expansion, and an accommodative monetary policy will support economic recovery, which is forecasted at 1.5% in 2017, while weakened business confidence after the UK referendum will have the opposite effect. Spain and Germany are expected to see growth at a slightly higher rate than originally forecasted for 2016 and 2017, while Italy's outlook has been slightly worsened compared with the July projection. Worsening economic developments in the international environment and contraction of the energy sector have resulted in a downward revision of US growth to 1.6% in 2016 and 2.2% in 2017, which is lower by 0.6 p.p. and 0.3 p.p. respectively than the previous projection. Employment growth and the resulting increase in private consumption and private investment will remain the main drivers of growth in the coming period, while net exports will negatively contribute to the appreciation of the USD and weakening of international trade. After the contraction of the Russian economy by 3.7% in 2015, the IMF expects the recession to continue due to continued effects of falling oil prices, EU sanctions, and the existing structural imbalances in the economy. As environmental factors will remain unchanged, the Russian economy is expected to see a moderate recovery in 2017 and 2018.

According to the IMF's estimates, inflation is expected to remain low in 2016, with a

timid increase in the medium term. Price growth in developed countries is expected to increase from 0.8% in 2016 to 1.9% in 2018, while inflation in emerging economies is projected to drop from 4.5% to 4.2% in the same period. The trends in metals and energy prices at the international market since the beginning of 2016 have had positive effects on the economic activity of net importers of commodities, albeit slightly lower than in 2015. The price of Brent Crude oil (the average price of Brent, Dubai Fateh and West Texas) in 2016 is expected to be US\$ 43.0/barrel, 15.4% lower than in 2015, followed by an increase to US\$ 50.6/barrel in 2017. Due to weaker investment demand in China, metals prices have declined cumulatively by approximately 50% since 2011. These trends are expected to continue until the end of the year (7.5% decline), with prices stabilizing in the medium-term perspective. In parallel with this, China, which accounts for 50% of world's steel production and 60% of iron ore consumption, is expected to see a drop in the price of this ore from US\$ 53.9 to US\$ 48.4/metric ton. Grain prices will continue falling in 2016, but in 2017 and 2018 will see moderate recovery.

Deflationary pressures in the Eurozone have caused the European Central Bank (hereinafter referred to as "ECB") to pursue a more expansionary monetary policy, while the Fed has indicated it will gradually be reducing the expansiveness of US monetary policy in the coming period. The ECB's Governing Council decided in October 2016 to keep the key policy rate at 0.00%. It also reaffirmed the negative interest rate of 0.4% on bank deposits, with the aim of encouraging lenders to increase lending to companies and households. The scope of quantitative easing (QE) has been kept at EUR 80 bn per month (until the end of 2017), and has expanded since June 2015 through purchase of corporate debt securities in the secondary market in order to encourage companies to increase investment. According to the most recent statements by ECB officials, QE measures could be extended to achieve an inflation target of slightly below 2%. On the other hand, in September 2016 the Fed decided to keep its key policy rate within the 0.25%-0.50% range due to uncertainty regarding future developments in global economic activity, notwithstanding sound reports about improvements in the labor market and increased private spending, mild growth in gross investment and low inflationary expectations in the US. For 2016 and 2017, the IMF has forecast interest rates on 3M euro deposits to be -0.3% and -0.4% respectively. At the same time, the projected interest rates on 6M deposits in US dollars are 1.0% and 1.3% respectively.

According to the IMF's recommendations, a policy conducive to growth will be crucial for the global economy. Leading economies must continue structural reforms, accommodative monetary policies, and increased public spending on education, technology, and innovation, while reforms to ensure resilience to external shocks and increase productivity will be essential for emerging economies. Many countries will have to put in place employment policies that would focus on increasing labor market flexibility, i.e. increasing the rate of activity, in view of the global migration trends and the unfavorable demographic trends. Furthermore, due to the global economic slowdown there is a need to globally coordinate economic policies, continue strengthening financial stability and limit spillover effects from tax havens and offshore companies on fiscal policy.

European Commission's Macroeconomic Estimates for the EU

In November, the European Commission (hereinafter referred to as "EC") kept its May estimate for EU economic growth in 2016 at 1.8% due to extended effects of growth levers for 2015, while the projection for 2017 has been revised downward to 1.6% to account for increased uncertainty. Depreciation of the euro, low oil price, accommodative monetary policy of the ECB, increased public expenditures and inflow of migrants to some Member States are among the factors that contributed to acceleration of growth in 2015. However, the effects of these positive factors are temporary in nature and are gradually disappearing under pressure from the economic slowdown in developed countries and deceleration in global trade. Domestic demand is expected to remain the main driver of GDP growth in the coming period, supported in particular by adaptive monetary policy

and favorable fiscal policy in 2016. The positive developments in the labor market coming from employment and wage growth will increase the disposable income of households and make private consumption the main driver of growth. Investment growth will be boosted by improved business conditions, access to cheaper borrowing for businesses, increased public spending and implementation of the EC's Investment Plan for Europe. While a tepid increase in exports has been forecasted, it will still not cover imports; however, the negative contribution of net exports will gradually diminish and will become mildly positive in 2018.

In the medium-term, economic growth is expected to be accompanied by employment growth. Labor market reforms implemented in some Eurozone members, as well as fiscal policy measures, will have positive effects on new employment. An indirect positive impact on the labor market is also expected to come from a recovery in domestic demand, while expected wage growth should increase the economic activity rate. Although the unemployment rate will remain uneven among the member states, total unemployment in the EU in 2016 is expected to drop to 8.6%, which is 0.8 p.p. lower than in 2015. The downward trend of the unemployment rate will continue to below 8% at the end of the projected period, the lowest it has been since 2008, but still higher than the pre-crisis level.

Average inflation in 2016 is forecast at 0.3% - a timid increase compared with 2015. The first half of 2016 was marked by low inflation due to declining energy prices, while Q3 saw inflation accelerated due to the base effect of last year's price levels. Core inflation, which excludes the highly volatile prices of energy and food, has remained at approximately 2015 levels throughout 2016, and, for now, there are no indications of an upward trend. However, wage growth, coupled with a reduced production gap, is expected to accelerate core inflation in the coming period. In addition, a positive contribution to inflation growth is also expected to come from external price pressures, with import price inflation becoming positive in 2017 after having remained negative for four years. Accordingly, the inflation rates forecast for 2017 and 2018 are 1.6% and 1.7% respectively.

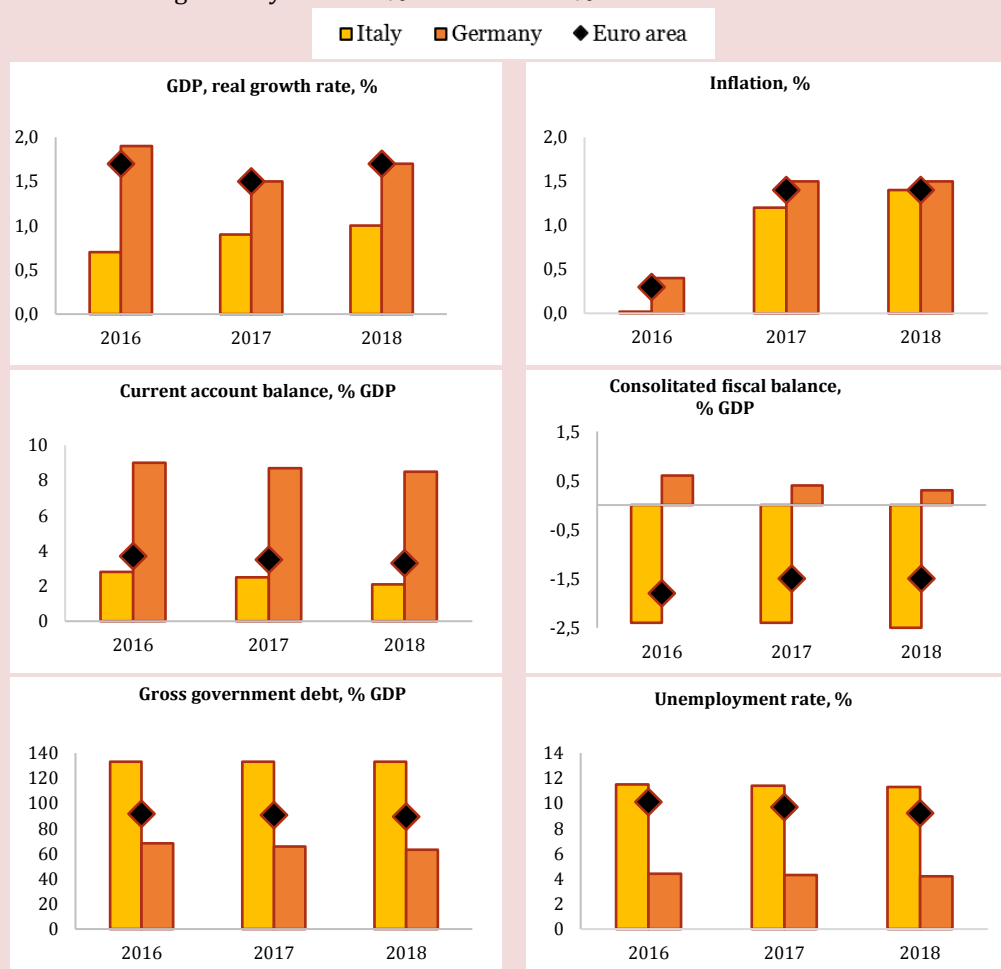
Growth of the EU's export activity will be moderate due to falling global demand and the global investment slowdown, while increased private spending will contribute to higher imports. The Eurozone economies have been resilient to the global trade slowdown in recent years due to positive effects on competitiveness of the euro's depreciation. Even with the reduction in labor unit costs, due to the global economic slowdown and appreciation of the euro in early 2016, EU exports will see only a tepid increase in the coming period, from 3.0% in 2016 to 3.5% in 2017. Due to growing domestic demand, imports will increase at a somewhat higher rate than exports, at 3.6% in 2016 and 3.9% in 2017. The current account on the balance of payments is expected to improve moderately in the coming period, with a slight increase in the surplus from 2.1% of GDP in 2017 to 2.2% of GDP in 2018.

The fiscal outlook has improved. The reduced general government deficit can be attributed mostly to increased economic activity and declining interest rates. The general government fiscal deficit in 2016 is expected to be 2%, which is 0.4 p.p. lower than last year. Employment growth will contribute to lower unemployment benefits; coupled with modest public sector salary growth and a stable share of capital expenditures, this will reduce public expenditures as a share of GDP. Public revenues as a share of GDP have continued declining, mostly as a result of the reduced tax burden on labor, but their increase has been lower than the decline in revenues as a share of GDP. Lower interest expenses will continue contributing positively to the structural fiscal result, albeit at a slower rate as the base effect is exhausted. Coupled with further improvement of the cyclical component and the primary fiscal balance in 2017 and 2018, this will reduce the deficit to 1.7% and 1.6%, respectively. Public debt as a share of GDP in 2016 is estimated at around 86%, with gradual reduction projected for the next two years, to 85.1% in 2017 and 83.9% in 2018. This contribution will come primarily from favorable economic developments and the projected primary surplus.

Macroeconomic Developments of Serbia's Main Trading partners

Employment growth and the resulting increase in private spending are expected to ensure growth of the German economy in the coming period, with a mild slowdown in growth in 2017.

The resilience of exports to the slowdown in global trade and growing construction activity will give additional impetus to growth in the medium-term. Even with the anticipated mild decline, the current account surplus will remain high, while lower borrowing costs, coupled with growing government revenue, are expected to generate a budget surplus. Growth in the first two quarters was 1.8% and 1.7%, respectively. Business climate indicator, the Purchasing Managers' index and the level of industrial output all seem to indicate a moderate growth in Q3; as a result, a mild improvement in macroeconomic indicators is expected in the coming period. With import demand falling in emerging economies reduced, Germany's estimated economic growth of 1.9% in 2016 is based on growing domestic demand as a result of higher disposable income, which is due to favorable labor market developments, lower borrowing costs and low energy prices. Increase in private spending will remain the main generator of growth, coupled with a sound contribution from investment, which will be boosted by a strong increase in construction activity. Total investment growth is forecast at 2.5% in 2016 and 1.9% in 2017. The planned increase in social spending, as a result of increased tax-exempt income and child allowance, will slightly increase public expenditures, while lower expenditures on migrants will have the opposite effect. A mild decline is forecast in the budget surplus, from 0.6% of GDP to 0.4% of GDP in 2017. The foreign trade surplus will be slightly lower, due to weakening effect of low energy prices and due to the rapid imports growth caused by rising domestic demand. The effects of low oil prices on inflation will be exhausted by the end of next year and price growth is expected to increase gradually from 0.4% in 2016 to 1.5% in 2017.



The recovery of the Italian economy, which has begun in 2015, boosted by low oil prices and increasing private spending, should continue in the coming period, from 0.7% in 2016 to 0.9% in 2017 and 1.0% in 2018. Domestic spending will be the main contributor to growth in the coming years, while the contribution of net exports will be negative. Low inflation and employment

and wage growth will boost private consumption, while the high share of non-performing loans will have the opposite effect. The lower labor tax burden for new employment will result in a tepid reduction of the unemployment rate, from 11.5% in 2016 to 11.4% in 2017. The recovery of external demand will increase the need for expansion of the manufacturing industry, with additional impetus coming from legislative changes (e.g. lower income tax), so strong investment growth has been forecast for the coming period. The forecasts also indicate that the construction sector will be further strengthened due to activities launched under the Investment Plan for Europe, which funds eight infrastructure projects with EUR 1.4 billion. The current account surplus on the balance of payments will be 0.3 p.p. lower in 2017 compared with 2016, at 2.5% as a share of GDP. With energy prices and companies' profits rising, inflation will increase from 0% in 2016 to 1.2% in 2017. The fiscal deficit in 2016 will be 0.2 p.p. lower than last year at 2.4%, owing to the higher primary surplus and lower interest expenses. Higher spending on pensions, coupled with a modest public sector wage growth, will bring about to an increase in primary current expenditures, which will be offset by further reduction of borrowing costs, so deficit is expected to remain unchanged in 2017. Public debt will stagnate at 133.1% as a share of GDP until 2018 due to lower interest rates and higher nominal GDP.

The recovery of EU Member States' economies is fraught with heightened internal and external risks. Growth among the EU Member States will be uneven and will not be sufficient to promote convergence. The risks include the possibility of the economic slowdown in emerging economies, especially China, spilling over into the Eurozone through trade and investment flows, as well as the uncertainty in future trends in the prices of raw materials and sources of energy in the international market. On the other hand, faster than projected global growth could result in increased demand for oil, while lower investment into the capacities of the oil sector due to unfavorable price trends could cut the supply of this energy source, which could combine to push the increase in oil prices above the estimated level. Political factors will also affect growth in EU Member States in 2017, in view of the UK's exit negotiations, which may hamper the free flow of goods, capital, and labor within the EU. Geopolitical tensions will also be a contributing factor and these will increase investors' risk aversion and lead to lower investment.

3. Current Macroeconomic Developments in Serbia and Outlook for the Period 2017 to 2019

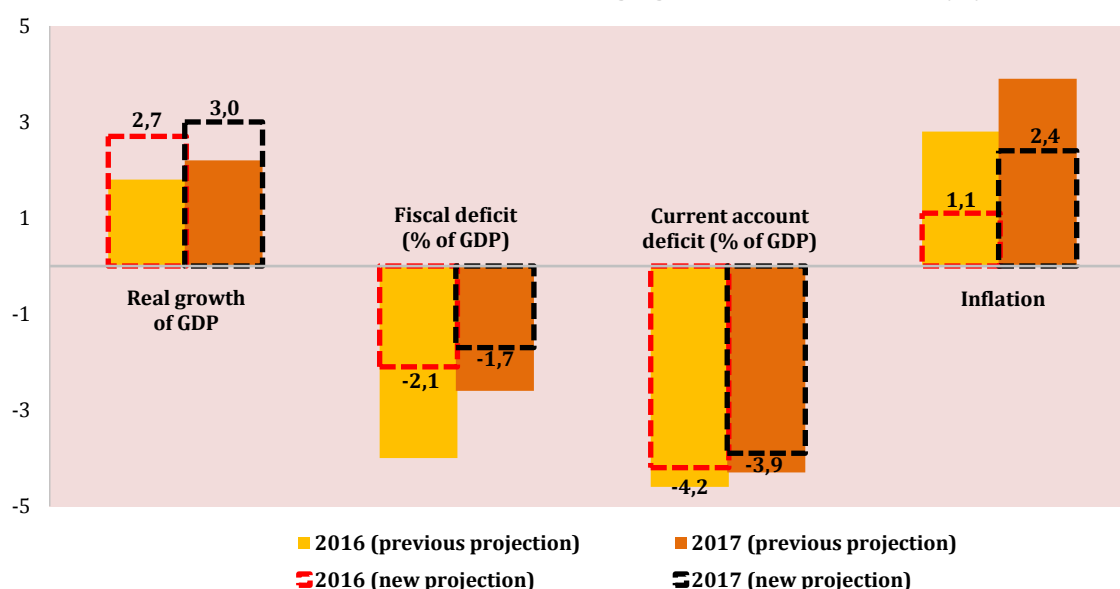
The successfully implemented fiscal policy measures and creation of a favorable business and investment climate in 2015 resulted in a significant improvement across all economic indicators in 2016. Economic activity is taking off, the fiscal deficit and the trade deficit are declining, the labor market situation is improved and inflation remains low and stable. The macroeconomic stability that has been achieved, coupled with systemic reforms of the economy, has boosted investment activity and increased the competitiveness of the Serbian economy in the international market; together with improved trade conditions, this has enabled exports to grow. Furthermore, the recovery in Serbia's main trading partners, given an expansive ECB monetary policy and falling oil prices, has provided additional impetus to favorable economic trends. Macroeconomic stability has been solidified, as reflected in reduced internal and external imbalances and increased investment, while fiscal consolidation has failed to yield the anticipated positive effects. The systemic approach in addressing issues of enterprises undergoing restructuring, coupled with implementation of structural reforms of labor legislation and construction, has benefited the business climate and resulted in Serbia advancing in international competitiveness rankings and improving its credit rating. The successful coordination of monetary and fiscal policies has enabled further relaxation of the

monetary policy, at the same time preserving exchange rate stability, which was also partly due to lower imbalances.

Economic Activity

The growth in economic activity is macroeconomically sustainable. Drivers of economic growth include investment and exports on the demand side and services and industrial production on the supply side. The current indicators and the medium-term outlook of the real sector point to economic growth. Due to improved trends, all macroeconomic indicators for the next medium-term period have been revised. The primary growth scenario for the next three years is based on an increase in investment as a share of GDP, a reduction of public expenditures as a share of GDP, an increase in exports of goods and services as a share of GDP and a reduction of the current account deficit as a share of GDP. Key assumptions for the attainment of the forecast medium-term scenario include maintenance of fiscal stability; continued restructuring of the economy (especially the public sector); further improvement of the business climate; expansion and modernization of production capacities; primarily in the sector of tradable goods; and maintaining momentum in the EU accession process.

Revision of the main macroeconomic aggregates for 2016 and 2017 (%)



Real Sector

According to the data of the Statistical Office of the Republic of Serbia (hereinafter referred to as "SORS"), in 2015 Serbia's GDP increased by 0.8%, in spite of strong fiscal adjustment, growing international uncertainty and slow recovery among the country's main trading partners. Furthermore, a severe drought over the summer months resulted in a drop of 7.7% gross value added (hereinafter referred to as "GVA") in the agriculture sector, which adversely affected the year's overall economic growth. GDP growth was built on an economically sound foundation, and was based on greater investment and exports, both necessary for sustainable growth. Reforms of the business environment, along with improved financial performance of companies, have had positive effects on investment growth, which reached 5.6%. The negative effects of fiscal consolidation on final consumption were mitigated by falling oil prices, lower borrowing costs and increased inflow of remittances. The favorable structure of the economic recovery which began in 2015 is further confirmed by robust growth of industrial production by 3.2%, driven primarily by a recovering electricity sector, as well as by continued growth of manufacturing. After three years in decline, construction grew by 2.7%, as a result of intensified investment activity, with an added boost from

expedited permitting procedures. Fiscal consolidation measures led to a decline in GVA in a small segment of the service sector (public administration, education, health care and social security), while most service industry branches saw positive developments (tourism, trade, transport, telecommunications and financial services).

Table 2. Gross domestic product, real growth rates, %

	estimate	estimate	estimate	
	2015	Q1 2016*	Q2 2016*	2016
Gross domestic product	0.8	3.8	2.0	2.7
Expenditure approach				
Private consumption	0.5	0.9	1.3	0.6
Government consumption	-1.5	3.3	4.6	3.9
Investment	5.6	8.4	4.9	6.4
Exports of goods and services	10.2	11.6	10.0	9.2
Imports of goods and services	9.3	4.7	12.3	6.2
Production approach				
Agriculture	-7.7	7.1	4.3	8.4
Industry	3.2	6.4	-0.6	3.1
Construction	2.7	15.1	6.1	8.9
Services	0.8	2.4	2.4	1.7

* According to the regular SORS calendar, the above figures will undergo minor adjustments on 30 November 2016

Source: SORS and MoF

The positive economic developments which began in 2015 have continued through 2016. After year-on-year growth of 3.8% in Q1 and 2.0% in Q2, according to a SORS flash estimate, GDP growth in Q3 was 2.5%, which means GDP growth in the first nine months was 2.7%.

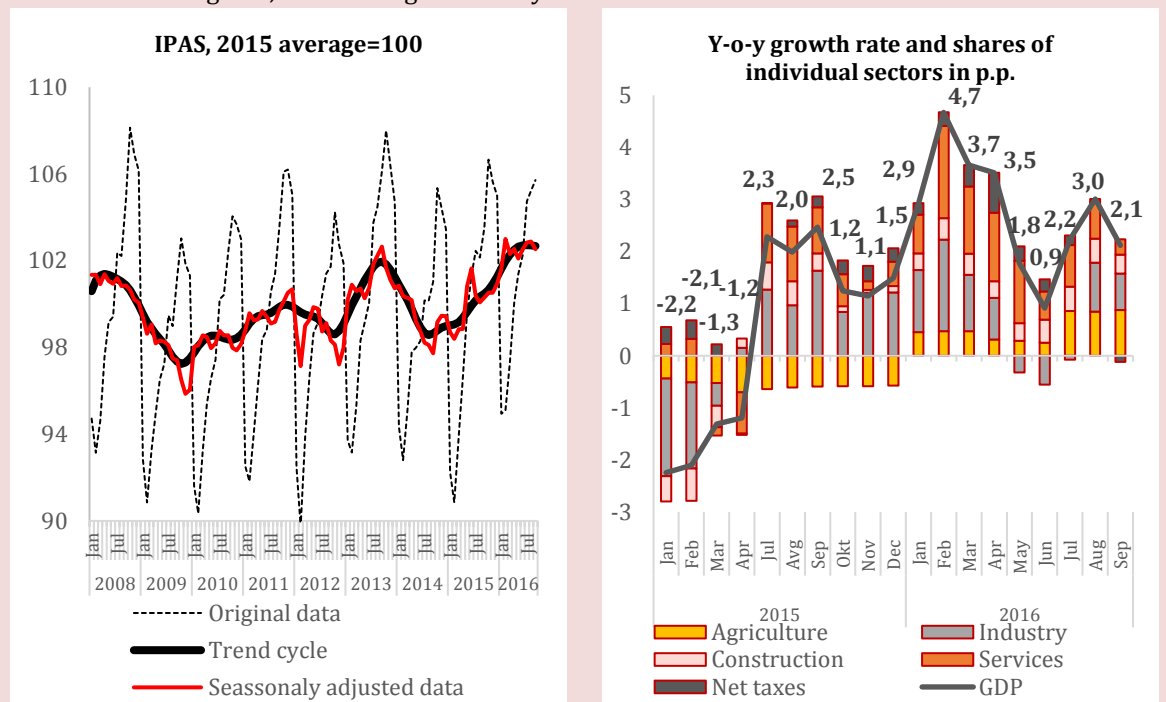
Broken down by aggregates of use, net exports and investment accounted for the largest shares of year-on-year GDP growth in Q1 (2.7 p.p. and 1.3 p.p. respectively). In Q2, investment activity remained an important generator of growth, but private spending accounted for the highest share at 1.0 p.p., while in Q3, according to an estimate of the Ministry of Finance, all aggregates except inventories had a positive contribution. Successful fiscal consolidation, reform of labor law, and more efficient public administration have created an environment conducive to greater economic activity. Growth of employment and salaries, lower cost of financing and higher volume of new lending, especially cash loans, as well as favorable price trends, have all boosted spending, which resulted in an increase in final consumption by 1.4%. In parallel, lower borrowing costs and low oil prices have positively affected on companies' portfolios, thus intensifying private sector investment. This has, together with the greater volume of infrastructure works, resulted in an increase in total investment by approximately 5.5%. Higher export demand, new market niches and improved competitive position with favorable trading conditions have resulted in rapid export growth of about 11%. Diversification of investment in a large number of activities that produce tradable goods has ensured wide dispersion of exports, thus reducing the risk of exports slowing down in the medium term. Import activity is driven by the economy's demand for investment goods and raw materials, which resulted in import growth; however, it was outpaced by exports making the net contribution of exports positive.

On the supply side, all production sectors have had a positive contribution to growth. The Q1 increase in GDP was driven by the growth of industry and services by 1.4 p.p. and 1.2 p.p., respectively, and in Q2 services took over as the leading source of growth (at 1.2 p.p.), while industry saw negative developments due to the lower volume of electricity generation. This decline is in part due to the capital overhaul of generation capacities, but it can also in part be attributed to the nature of billing, taking into account the all-time high output generated by this sector in the same period last year in order to offset the losses caused by floods, which resulted in a very high base for comparison very high. The structure of growth in the first semester remained the same in Q3, but with a higher

share of agriculture, as a result of the record yields of some crops.

Indicator of the economic activity of Serbia (IPAS)

Indicator of the economic activity of Serbia is an indicator calculated by the Ministry of Finance for the purpose of monitoring overall economic activity on a monthly basis. It is a coincident composite indicator based on the Chow-Lin regression method for temporal disaggregation of time series. Unlike official quarterly GDP statistics, the IPAS is able to assess economic activity to a more frequent schedule. On the one side, it shows monthly fluctuations in economic activity that remain hidden in official quarterly data, while, on the other hand, as it is available much sooner than the official GDP figures, also serving as a timely indicator of current economic trends.



The development of economic activity measured by this indicator is consistent with all official statistical figures on GDP trends. According to the IPAS, economic activity has been on a continual upward path since September 2014, with strong growth until February 2016, followed thereafter by moderate growth. Monthly rates of economic activity in 2016 have been uneven. The highest year-on-year increase was seen in February, when the economy grew at the rate of 4.7% - the highest rate of monthly economic activity since April 2008. The growth in that month was the result of a strong increase in economic activity in industry and services, which accounted for the bulk of total economic growth. The relatively high economic growth continued in the following month, with the lowest economic growth rate of 0.9% y-o-y reported in June, primarily as a result of lower industrial output due to an overhaul of electricity generation capacities, the negative effects of which continued into July. In August, overall economic activity grew at a rate of 3.0%, while September saw somewhat slower growth at 2.1% due to the one-off effect of the total halt in oil industry production.

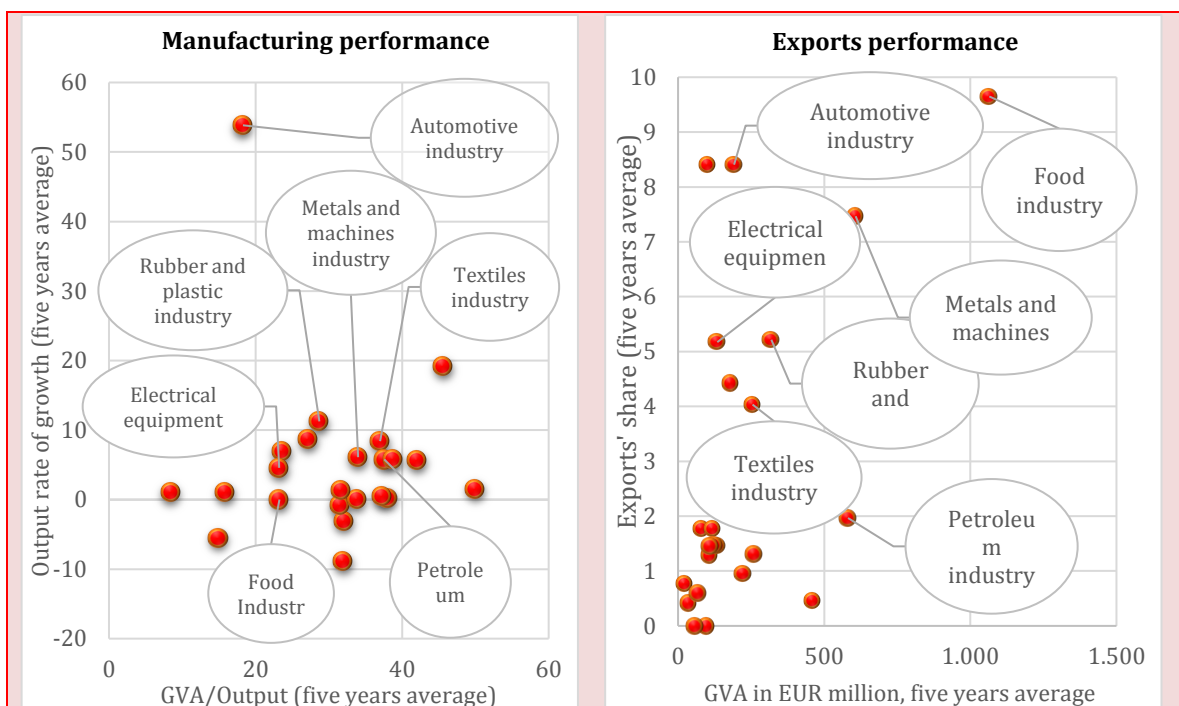
The value of the IPAS in the first nine months and its expected evolution until the end of the year, together with the emergence of certain positive risks, indicate that annual GDP growth could be even higher than the currently estimated 2.7%.

The growth of GVA has also been confirmed by the trends in high-frequency indicators across all production activities. The physical volume of industrial production in the first nine months of 2016 has increased by 5.2% compared with the same period in 2015, with widely dispersed generators of growth, which is confirmed by the fact that 20 out of the total of 29 activities have had a positive contribution. Mining has grown 5.4% y-o-y, while electricity generation has grown 4.5% y-o-y. The 5.5% y-o-y growth of the manufacturing industry was driven by export-oriented industries (food, chemicals and tobacco industries, production of rubber and plastic goods, and production of

electrical equipment). When industries are disaggregated by type of product, the largest growth compared with the same period last year can be seen in durable industrial goods (10.7% y-o-y), the result of increased output of electrical appliances and furniture. A significant increase has also been observed in the intermediary product segment (9.9% y-o-y), driven by the growth of chemical and rubber and plastic industries, due to which this product group made the greatest contribution to the growth of total industrial production at 2.7 p.p. The output of non-durable industrial goods has increased by more than 3.9% y-o-y, with tobacco and food industries accounting for the largest share of the growth, while production of capital goods has remained at approximately the same level as in January-September 2015, with continuing negative trends in vehicle production. Changes in the legislative framework and simplification of administrative procedures have buoyed the investment cycle in construction, which resulted in an increase in the value of construction works in the first nine months by 9.3% y-o-y and an increase in the number of issued building permits by 16.8% y-o-y. Construction activity has intensified for both building construction segment and investment into infrastructure. Wage increases and favorable price trends have increased the household's disposable income, which generated growth in the services sector notwithstanding pessimistic expectations due to fiscal consolidation measures. Real retail sales have increased by 8.0% y-o-y, with the highest increase of 9.7% y-o-y reported in sales of foodstuffs, followed by sales of food, beverages and tobacco, which increased by 7.6% y-o-y, while engine fuel sales increased by 6.8% y-o-y. The Government's strategic commitment to developing tourism services has resulted in an increase in the number of tourists to approximately 2.1 million, 12.3% more compared with the same period last year, with more than six million nights spent at tourist accommodation establishments. According to current estimates, yields of main crops will be far above the multiannual average. The yield of maize, as the most important crop, is 36.6% higher than last year's, while wheat yield has increased by 18.8%. Apart from grains, the yields of industrial crops have also increased, including sunflower by 43.6%, soybean by 29.2% and sugar beet by 17.2%.

Manufacturing Industry – Performance and Potential

The manufacturing industry is the leading sector of the Serbian economy, accounting for approximately 15% of GDP and employing about 20% of the workforce. At lower levels of aggregation, the most important segment is the food industry, as evidenced by its share in Serbia's GDP of 3.5% far above the EU28 average. This industry is also among the most attractive ones for foreign direct investment, which, together with expansion of production capacities, enables modernization, enhances know-how, and increases productivity. It is also the leading exporting industry, accounting for approximately 9.6% of total Serbian exports during the observed period. Nevertheless, detailed analyses have shown that, notwithstanding its sound indicators, the potential of this industry remains underutilized, especially given the strong raw material base provided by agricultural production and the special terms of trade with major food importing countries. The average annual growth rate of the food industry in the past fifteen years has been modest, with insufficient production and market diversification. In view of the outstanding performance of this sector in terms of its high competitiveness and comparative advantages, it is necessary to eliminate all obstacles to rapid growth as soon as possible, promote the development of small and medium-sized enterprises and encourage specialization and production of complex products at higher levels of processing and with high added value.



The automotive and oil industries also account for high shares in GDP. In the past decade, these activities achieved high rates of production, productivity and export growth. However, they are characterized by a high level of concentration, with output dominated by a single company or a small number of firms, which poses certain risks. Development of entrepreneurship and small and medium-sized enterprises should therefore be promoted, primarily in the automotive component segments, as should outsourcing, to reap the full benefits of production synergies.

The machine industry and metalworking, textile industry, electronic goods and electrical equipment industry, and rubber and plastics industry have recently positioned themselves as Serbia's leading industries. The noticeable recovery in these industries was certainly driven by the large pool of qualified workforce, as well as foreign direct investment (hereinafter referred to as "FDI"), which ensured technology transfers and boosted competitiveness. Even though these industries have long-standing traditions in the Serbian economy, at present they should be seen as "infant industries" and their performance should be preserved and improved by creating a conducive environment, primarily by removing any barriers that the free market has failed to eliminate. In the medium term, they should be made less reliant on imports for raw materials and inputs, which will positively impact on the foreign trade balance and provide an impetus to other related activities. Furthermore, in addition to these general measures, it is also necessary to adopt tailored solutions to address any specific issues associated with the sectors concerned.

The reindustrialization process is complex and demands synchronized efforts from all economic policymakers, coupled with harmonized reforms of the judiciary and education, support to infrastructural projects, and passage of relevant environmental legislation. These efforts will be boosted by the formation of an industrial zone and by implementation of the *Strategy for the Development of Small and Medium-Sized Enterprises, Entrepreneurship and Competition in the Period 2015-2020*. According to forecasts, successful implementation of this process and strengthening of activities with untapped potential could increase the manufacturing industry's share in GDP to about 20% in five to seven years, which would additionally contribute to dynamic and sustainable economic growth.

Significant improvements across all macroeconomic indicators at the beginning of the year and the sustainable nature of the ongoing positive trends have improved the outlook for the coming period and resulted in an upward revision of the GDP growth rate in 2016 from 1.8% to 2.7% (by 0.9 p.p.). Competitiveness of the Serbian economy is expected to increase and, coupled

with better utilization and expansion of production capacities, result in high real growth of imports of goods and services in 2016 (9.2% y-o-y). In parallel, a more favorable investment climate and planned investment into infrastructure will ensure a high investment growth rate (6.4% y-o-y), which will be a key contributor to economic growth in 2016 together with net exports, at 1.2 p.p. and 0.6 p.p., respectively. The short-term negative effect of fiscal consolidation on private spending has been offset by the increase in private sector employment and wages, as well as by the increased disposable income of households due to favorable price trends and lower borrowing costs. In keeping with this, private spending is expected to recover further, which will contribute to GDP growth by 0.5 p.p. Continued upward trends on the supply side are also expected to continue, with every sector contributing positively to continued acceleration of economic activity and with services and industrial production accounting for a slightly higher share. Strengthening of trade, tourism, hospitality and IT services on the one hand and growing external demand, new market niches and recovery of domestic spending on the other will contribute positively to growth of the services and industrial sectors by 0.9 p.p. and 0.7 p.p., respectively. A significant positive contribution to GDP growth will also come from the agriculture sector, which will see year-on-year growth of 8.4% due to low production in 2015 and favorable weather in 2016. The improved institutional framework, lower costs of finance, and a more efficient construction permitting procedure have laid the foundations for dynamic growth of construction, estimated at 8.9% y-o-y. As construction is associated with a large number of other economic activities, this growth is expected to have a multiplier effect on overall economic growth. Furthermore, taking into account the strategic commitment of economic policy makers to strengthening SMEs, the entrepreneurial sector can be expected to boost all segments of economic activity in the coming period.

Based on current economic indicators and outlook for Serbia and the international environment, taking into account the economic policies that have been either launched or planned and the Precautionary Standby Arrangement with the IMF, we have projected the key macroeconomic aggregates and indicators for the Republic of Serbia from 2017 to 2019. Macroeconomic stability that has been achieved, along with regulatory and structural reforms, has been promoting economic activity, while the increased competitiveness of the Serbian economy in the international market, coupled with improved trade conditions, has helped achieve export growth. The increase in private spending will be boosted by positive developments in the labor market and increased lending. The Government will implement a responsible and predictable fiscal policy aimed at stabilizing public finances by lowering the consolidated government budget deficit and reducing public debt to a sustainable level.

Table 3. Projection of key macroeconomic indicators for the Republic of Serbia

	Estimate	Projection		
	2016	2017	2018	2019
GDP, billion RSD (current prices)	4,203.5	4,396.7	4,678.1	4,987.5
Real GDP growth, %	2.7	3.0	3.5	3.5
GDP deflator, %	1.3	1.6	2.8	3.0
Real growth of specific components of GDP, %				
Private consumption	0.6	1.4	2.2	2.9
Government consumption	3.9	1.6	2.6	2.3
Gross fixed capital formation	6.4	5.7	5.7	4.9
Exports of goods and services	9.2	7.7	7.7	7.6
Imports of goods and services	6.2	5.3	5.8	6.3
Balance on goods and services, in EUR, % of GDP	-7.9	-7.7	-7.0	-6.4
Current account balance, in EUR, % of GDP	-4.2	-3.9	-3.9	-3.9
Inflation, period average, %	1.1	2.4	3.0	3.0
Investment ratio, % of GDP	18.5	19.0	19.3	19.4

Source: MoF

Projected GDP growth in 2017 has been adjusted upward by 0.8 p.p. (from 2.2% to 3.0%). The systemic improvements that have created a business enabling environment will allow

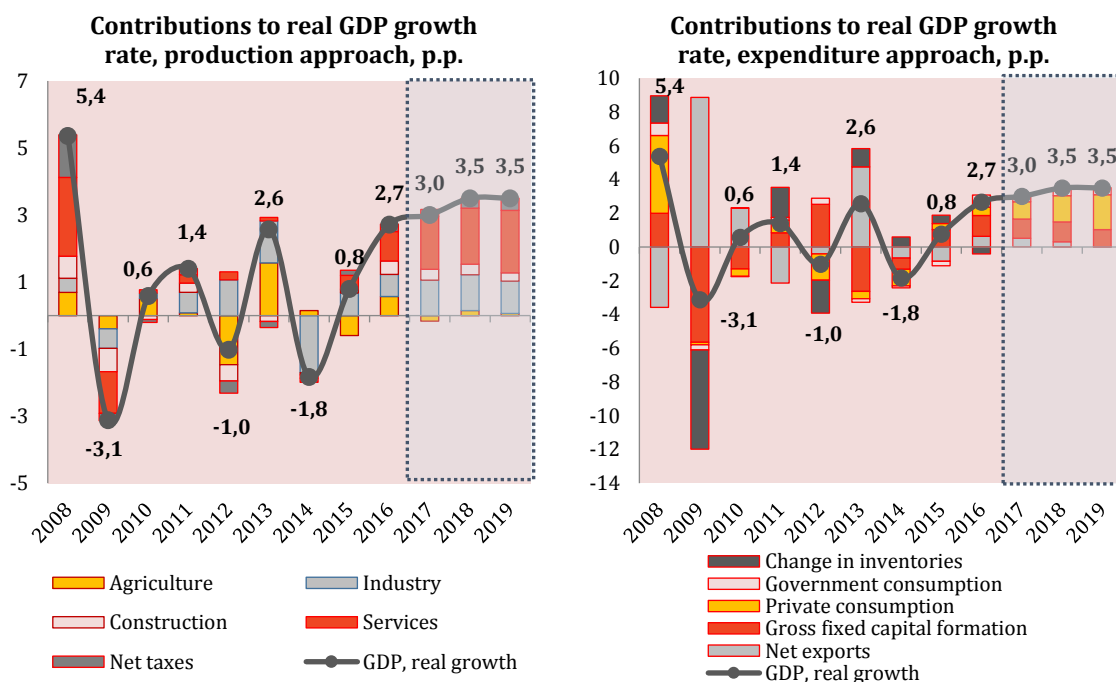
growth of foreign and domestic investment, while faster restructuring of the economy will facilitate new employment and contribute to increased productiveness and enhance the country's competitive position. The results of the reforms implemented to date will ensure a 5.7% increase in investment activity, which will be the most significant generator of economic growth in 2017 with a share of 1.2 p.p. After the mild recovery of in the previous year, private spending is expected to increase in 2017 as a result of improved standard of living and is forecast to contribute 1.0 p.p. to GDP growth. High export growth will be accompanied by an increase in imports due to greater demand for investment goods and inputs, which will put the positive contribution of net exports at approximately 0.6 p.p. On the production side, the rising living standards are expected to provide significant impetus to the service sector, while the execution of investments made in recent months will lead to an increase in industrial production. A positive contribution to GDP growth will also come from the construction sector as the current investment cycle continues, while the contribution of agriculture is likely to be slightly negative, assuming the agricultural season results in average crop yields.

The projected cumulative GDP growth rate from 2017 to 2019 of 10.3% is indicative of a path of rapid development and is based on growth of domestic demand through intensification of investment and recovery of private spending. Economic trends in Serbia and the country's outlook will to a large extent be influenced by global economic developments, as well as by Serbia's success in implementing reforms in the real and public sectors. Reform laws and increased efficiency of public administration have created a favorable business climate, which will enable the current investment cycle to continue as a key development factor. The increase in foreign direct investment will enable transfer of technologies and know-how and will boost the overall competitiveness of the economy. On the other hand, economic policy makers are focusing on the SME and entrepreneurs, which is expected to contribute significantly to the growth of domestic investment, increased employment and higher living standards in the medium term. Sound and sustainable growth, with balanced regional development ensured through the establishment of industrial zones, will help further reduce internal and external imbalances.

The medium-term macroeconomic projection envisages average real GDP growth of 3.3%. Investment is expected to see dynamic growth at an average annual rate of 5.4%, with similar high growth of imports of goods and services, at 7.7% and 5.8%, respectively. Private and government spending will also increase, but at a rate far lower than GDP growth. This structure of economic growth is desirable in terms of sustainability. Plans have been adopted for structural adjustments of the economy; these will continue cutting wasteful spending, red tape, and unnecessary public sector expenditures, whilst simultaneously increasing in the quality of organizational, functional, and technical linkages between various public authorities. In addition, appropriate re-training and self-employment programs will be offered to the part of the working-age population affected by the rightsizing process, together with protection for the most socially vulnerable segments of the population. On the production side, the largest contribution to GDP growth in the period 2017 - 2019 is expected to come from the service sector and industrial production. Growth of private sector investment and accelerated implementation of infrastructure projects will result in a positive contribution of the construction sector, along with a mildly positive contribution from the agriculture sector.

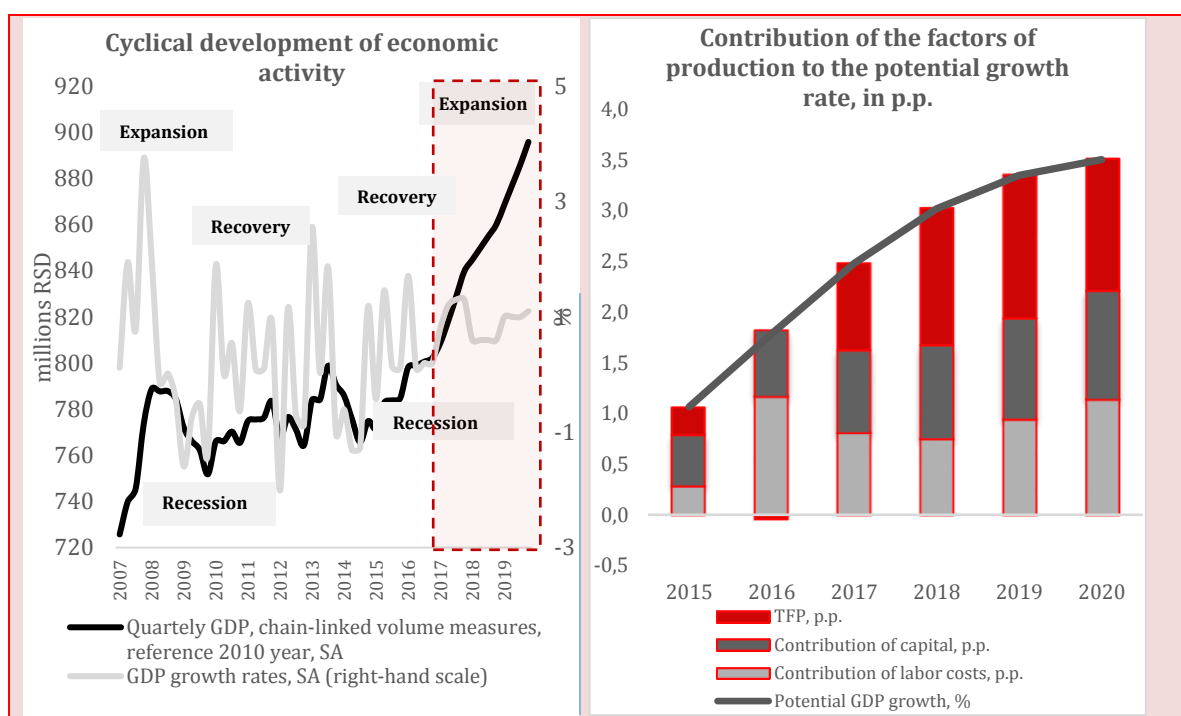
The envisaged development scenario reflects the Government's strategic focus on structural adjustment of the economy in order to maintain a sustainable growth path, based primarily on an increase in overall investment activity through encouragement of private sector investment and exports as key factors for improving macroeconomic performance. At the end of 2019, investment as a share of GDP will stand at some 2 p.p. higher than in 2014, the share of government spending will decline from 17.7% to 15.8% in the same period, while exports of goods and services as a share of GDP will reach approximately 55%. An average net annual inflow of approximately EUR 1.7 billion in FDIs will be necessary, along with greater dispersion towards the tradable commodity sector. Financing the balance of payments deficit will also require a reduction in the goods and services deficit and the current account deficit to 6.4% and 3.9% of GDP, respectively, at

the end of 2019, so as to ensure sustainability of external debt, external liquidity and solvency.



Analysis of Cyclical Development of Economic Activity and Potential GDP Rates

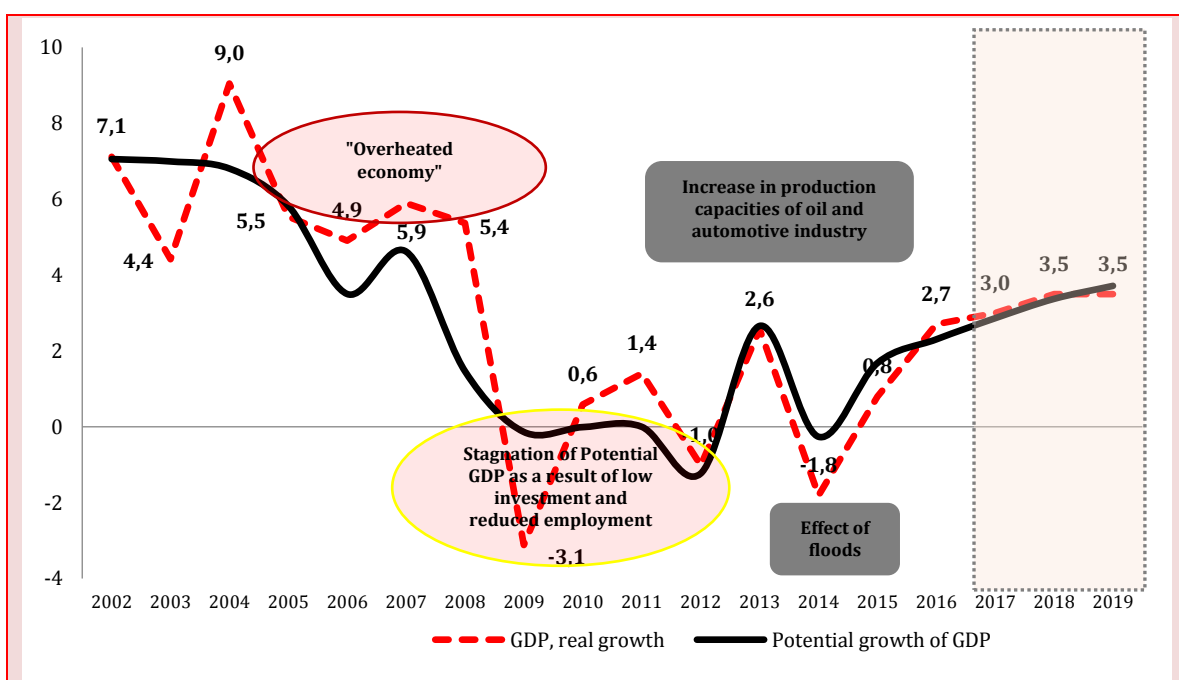
The current rate of economic activity and the medium-term outlook of the real sector are indicators of acceleration of economic activity and the onset of an economic expansion phase. After the deep recession in the second half of 2008 and during 2009 caused by the global economic crisis, the economy saw a mild recovery beginning in 2013. The positive developments in the cyclical component in 2013 were the result of the activation of new capacities in the automotive and oil industries. In 2014 the economy once again displayed signs of recession, mostly as a result of devastating flooding that occurred that year, and in particular due to severe damage to production capacities, especially in the electricity sector. The devastated production capacities were put to use in 2015 enabling economic activity to recover, while the initiated fiscal consolidation, along with a set of reform laws, helped Serbia reach pre-crisis GDP levels in early 2016. The business enabling environment created by the systemic reforms implemented by economic policy makers is expected to set the stage for and facilitate expansionary developments in the medium term.



Potential economic activity growth is a measure of maximum sustainable GDP growth.

An analysis of long-term potential GDP trends determines the maximum sustainable level of economic activity that does not generate macroeconomic imbalances (high inflation, unsustainable foreign trade position, high fiscal deficit, etc.). Taking into account the current cyclical position of the national economy and the inherited structural disturbances, as well as the extent to which existing capacities are under-utilized, in the near term it will be crucial to improve the efficiency of investment and increase total-factor productivity. To that end, it will be necessary to continue with reforms that can permanently increase the country's production potential.

An assessment of the production gap and the relationship between real and potential GDP is significant for economic policy-making. The effectiveness of an economic policy can be judged by its measures designed to reduce the gap between the economy's potential and actual GDP growth. Thus, as production capacities are under-utilized production capacities, monetary and fiscal policy measures directly affect real GDP growth. In cases where real GDP matches the long-term sustainable level, economic policy measures cannot directly increase real GDP without undermining macroeconomic stability; instead, this can only be done by increasing available production factors in real terms (including investment into physical capital and human resources and technology transfer).



Potential GDP growth has slowed down significantly over the past six years. The average annual growth of potential GDP had been above 5% in the pre-crisis period, while since the onset of the global economic crisis its average growth has stood at about 0.6%. The strong contribution of the capital factor to potential GDP growth in the pre-crisis period, which came from growing investment, has dropped significantly since the beginning of the crisis. The positive contribution of multi-factor productivity, which used to be modest in the pre-crisis period, has also dwindled. The labor factor has also contributed negatively to potential GDP growth throughout the crisis period, as a result of lower employment and, to a lesser extent, an upward unemployment rate trend.

In the medium term, potential GDP growth is expected to take off. In 2016, potential GDP is expected to grow at a rate of about 2%. The largest contribution to its growth is expected to come from the capital factor due to a rebound of investment, with a slightly lower contribution from the labor factor on the back of an increased labor participation rate, while multi-factor productivity will have a neutral contribution. The expected increase in unemployment due to public sector rightsizing and completion of restructuring of state-controlled enterprises has been offset by the increase in net private sector employment. Estimated potential medium-term growth is based on the assumption of rapid economic recovery, along with the expected closing of the production gap by the end of 2017. According to the forecasts, rising investment and favorable labor market developments are expected to contribute positively to potential GDP growth in the coming years. More advantageous financing conditions and stronger investment activity in the transport, energy, and agriculture sectors will increase the economy's potential. Continued reforms aimed at creating an environment conducive to investment and employment will also enable more efficient use of currently under-utilized production capacities.

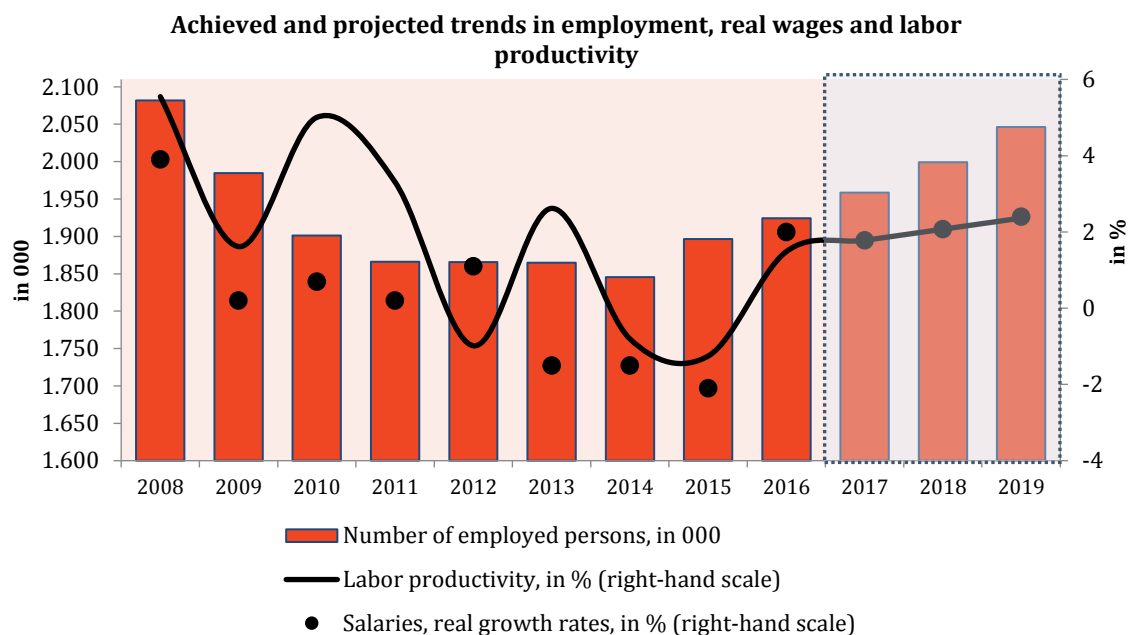
Employment and Wages

Growth of economic activity, coupled with amendments to labor legislation and supported by appropriate retraining programs and self-employment incentives, has resulted in favorable developments across all labor market indicators. According to the Labor Force Survey ("LFS"), after a year-on-year increase in total employment by 2.7% in Q1 2016, positive developments have continued. Total employment in Q2 was 6.7% higher, while the unemployment rate was 2.1 p.p. lower compared with the same period last year at 15.2%. The increase in employment was reported across all production sectors, with the greatest improvements seen in services and industry. The

number of employees increased both in formal and in informal employment. The share of formal jobs in total employment rose by 2.7% on the back of economic growth and the inspectorates' intensified efforts to stem out the shadow economy. The strong increase in informal employment in Q2 was for the most part due to greater engagement of seasonal workers in agricultural production owing to good crop yields. Employment growth and promotion and expansion of active employment measures, with additional impetus coming from wage growth, contributed to a year-on-year increase in the activity rate in the first two quarters by 1.8 p.p. and 2.6 p.p., respectively. These positive developments in the labor market been confirmed are also borne out by the data available in the Central Registry of Compulsory Social Insurance, which show that the total number of formally employed persons in the period January-September 2016 increased by 1.2% y-o-y, due entirely to greater employment in the private sector (2.6%). Furthermore, employment has increased in the manufacturing industry, mining, trade etc., which is in line with the favorable economic trends in these sectors.

As a result of faster wage growth in the private sector, wage differences between the public and the private sector have been reduced significantly. The real and nominal wage decline in the public sector in 2015 brought down the difference between the average public-sector and non-public-sector wage from about 15% in November 2014 to 5.3% in the period January-September 2016. The real average net monthly wage increased by 2.8%, y-o-y in the period January-September 2016, due mostly to private sector wage growth (3.9%). In terms of individual industries, manufacturing and trade made the largest contributions to this wage increase. At the same time, the real average net monthly wage in the public sector increased by 0.9% y-o-y, due in part to the weakening base effect of public sector wage cuts made in 2015, as well as to nominal wage increases in certain segments of the public sector in early 2016. In view of the continued growth of GDP and investment forecast for the future, and the developments in the labor market to date, employment is expected to see a mild increase by the end of 2016, while wages will match the rate of increase in labor productivity, with private sector wages increasing at a higher rate than those in the public sector.

The mid-term projection of employment and wage trends is based on projected GDP growth and increase in investment. It is expected that total employment will continue growing in 2017 on the back of increased employment in the private sector. Improved employment legislation has eliminated structural obstacles to employment, boosted labor market flexibility, and laid the foundations for curbing shadow employment, which will ensure continued positive trends, notwithstanding the ongoing rightsizing of the public sector. Increased gainful employment could particularly benefit from harmonization of employment, education, and research and development policies so as to adapt skills, knowledge, and staffing levels to labor market demands. In this context, the coming medium-term period will see reforms to the labor market and education system, in particular through the introduction of dual education, which will provide a qualified workforce to match the demands of the labor market. Growth of real net wages in the private sector is expected to be accompanied by increased productivity of the economy. The slower growth of real net wages compared with real GDP growth and the fact that wage growth will match the increase in productivity, will result in lower unit labor costs and improve the country's competitive position. Real wage growth will also be supported by the increase in the minimum cost of labor from RSD 121 to RSD 130 as of 1 January 2017, which will have positive effects on aggregate demand and will also produce a positive fiscal effect.



Inflation

Similarly as in the previous period, inflationary pressures in 2016 were low, on account of both most domestic factors and low cost pressures from the international environment. Inflation has remained low and stable this year. October saw a year-on-year increase of 1.5%, which was still below the lower edge of the target tolerance band applicable until the end of 2016 ($4\% \pm 1.5$ p.p.). The largest positive contribution to year-on-year inflation came from increased prices of tobacco, package holidays, fresh meat, electricity and medicines. Compared with October 2015, regulated prices have increased, driven primarily by increased tobacco prices and, to a lesser extent, rising prices of electricity and medicines. Continued implementation of a credible fiscal policy is a testament to the commitment of economic policy makers to further strengthening of public finance, which will help keep inflationary pressures low. Inflation is expected to remain below the current lower edge of the target tolerance band of the NBS by the end of 2016. Inflation trends to the end of the year will be influenced primarily by the low base in prices of oil products and food products on the one hand and the high base in prices of cigarettes on the other.

In the course of 2016, the NBS relaxed its monetary policy twice by cutting the key policy rate, first in February to 4.25% and then in July to an all-time low of 4.00%, which resulted in a further decline in interest rates on dinar-denominated loans. Interest on total newly-granted loans in September was 3.1 p.p. lower compared with the same month last year. After a stagnation in Q1 of the current year, corporate loans has increased due to an increase in current assets loans and investment loans.

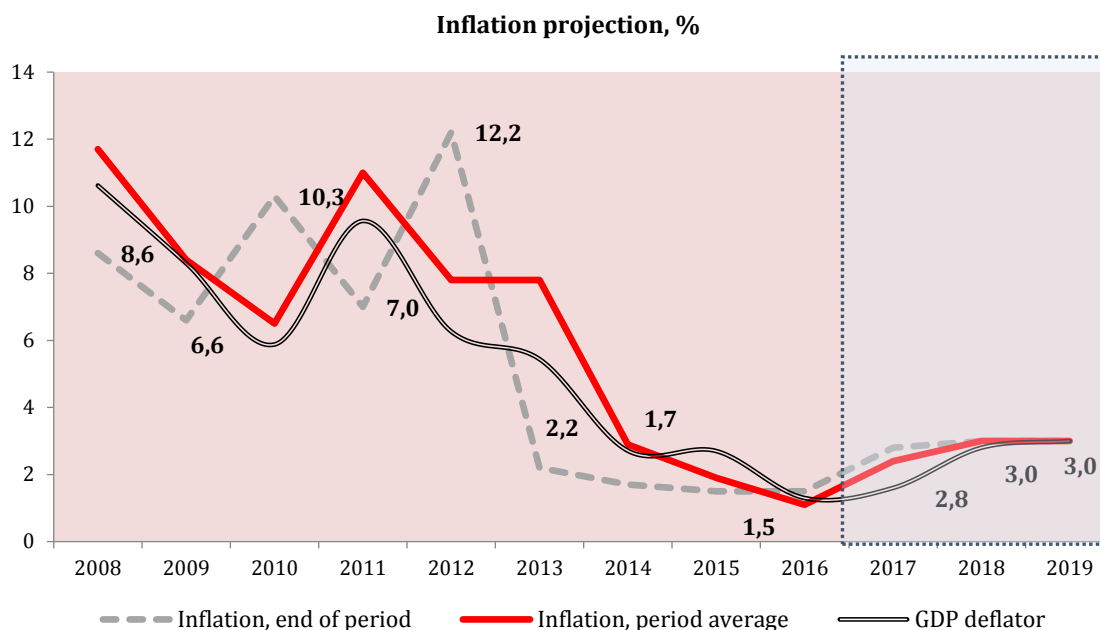
Positive developments have also been seen in new loans. The amount of new loans granted in the first nine months of 2016 was higher by approximately one-quarter than in the same period last year, while new current assets loans increased by around 50%. September saw a high year-on-year increase in lending activity, including a 10.5% increase in household lending and a 3.0% increase in corporate lending. In terms of the intended use of these loans, household lending rose in September almost entirely due to increased cash loans. The growth in corporate loans was spearheaded by an increase in liquidity and current assets loans and investment loans. Banks relied mostly on domestic sources of finance for their lending activity, including in particular dinar and foreign exchange corporate and household deposits. Additional impetus to increased lending came from the funds released as the NBS reduced the foreign exchange reserve requirement. Implementation of the adopted NPL Resolution Strategy has continued contributing positively to the efforts to address this issue. Thus,

the share of NPLs in total loans has fallen in 2016 for both corporate and household loans. At 19.5%, the share of NPLs in total loans in the banking sector in Q3 2016 was 2.1 p.p. lower than at the end of the previous year. Relaxation of monetary policy and the resulting decrease in interest rates, coupled with the anticipated acceleration of economic growth, will drive a further increase in lending.

The first half of the year was characterized by depreciation pressures, amidst growing uncertainty in the international financial market and the relatively high demand for foreign exchange in the domestic market due to a seasonal spike in payments for energy imports and servicing of foreign loans. Appreciation pressures have been felt since the beginning of the second semester, which the NBS mitigated by purchasing foreign exchange in the interbank foreign exchange market (hereinafter referred to as "IFEM"). Trends in the foreign exchange market from January to October 2016 compared with the same period last year were characterized by nominal and real depreciation of the dinar against the euro, by of 2.0% and 1.1%, respectively. The real effective exchange rate depreciated by 1.3% during this period, which had positive effects on the country's external price competitiveness. To counter any excessive short-term fluctuations of the exchange rate, the NBS intervened during this period in the IFEM by selling foreign exchange in the amount of EUR 870 million and by purchasing EUR 660 million. Foreign exchange reserves of the NBS at the end of October amounted to EUR 9.71 billion, which was EUR 671 million lower than at the end of 2015 and was sufficient to cover six months' worth of imports of goods and services.

In cooperation with the Government, the NBS has reduced the inflation target as from 2017 from 4%±1.5 p.p. to 3%±1.5 p.p. to reflect macroeconomic stability and improved economic outlook for the coming period. The lower inflation target for 2017 and 2018 is also justified by inflationary expectations that have remained low and stable for quite some time. Consistent implementation of fiscal consolidation and structural reforms has been crucial for improved resilience of the Serbian economy to shocks, while carefully weighed and fully coordinated fiscal and monetary policy measures have kept inflation low and stable over the past three years at a level comparable to that of developed economies and consistent with the new target. Lowering of the inflation target in the medium term will further reduce uncertainty for the overall economy, which will contribute to further improvement of the business environment and reduce the cost of meeting the economy's needs for finance.

Medium-term projected inflation is based on expected developments in the domestic and international environments. The new inflation target for 2017 will be determined by the exhaustion of the effects of this year's low prices of oil and primary agricultural products in the short term, and increasing domestic aggregate demand and faster price increases in the international environment in the medium term. On the other hand, the low costs of raw materials used in food production will have deflationary effects. Furthermore, stabilization of inflation is supported by the relative stability of the exchange rate. According to inflation projections for 2018 and 2019, the exchange rate will remain stable and low and will not deviate from the target. Key risks for projected inflation include trends in the international environment, in particular uncertainties concerning monetary policies implemented by the central banks of the leading economies.



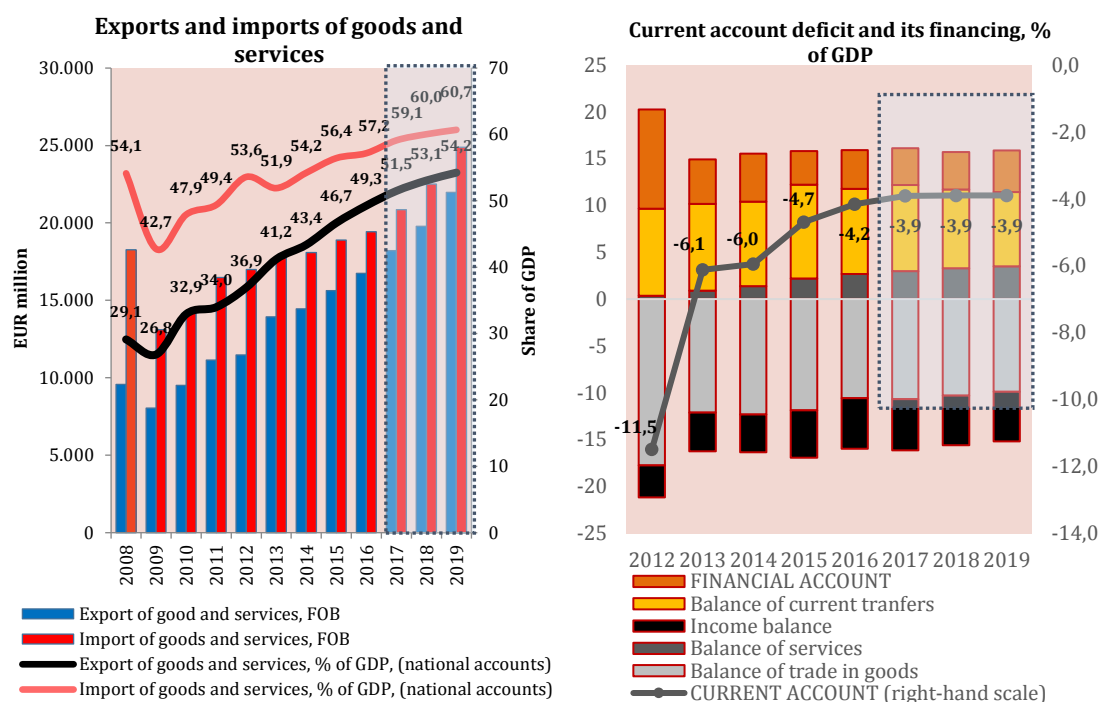
External Sector

Low oil prices in the international market, gradual economic recovery of Serbia's main trading partners, and effects of earlier FDIs in the manufacturing industry have had favorable effects on foreign trade, which has been characterized by an increased volume and a significant reduction in the foreign trade deficit. Between January and September, exports (c.i.f) were worth EUR 9.9 billion, while imports of goods were worth EUR 12.7 billion, which was an increase of 10.1% and 5.7% respectively compared to the same period in 2015. The increase in exports of goods in this period was primarily due to the exports of power-generating machinery and equipment, as well as electrical apparatus and appliances. Positive contribution to the improvements in foreign trade have continued to come from exports of chemical products, tobacco and vegetables and fruits. On the other hand, the value of exports of iron and steel is reduced in the first half of the year due to low costs of raw materials in the international market. However, after the arrival of the Chinese company Hesteel in Q3, exports took off by one-third year-on-year, thus offsetting the negative effects seen at the beginning of the year. Furthermore, the low price of oil and resulting low prices of oil products had an impact to the lower value of exports, while the recovery of the energy sector from the 2014 floods provided a strong boost to the exports of other sources of energy (electricity and gas by 31.6% and 12.6% y-o-y, respectively). Export trends in exports in this period were characterized by increased imports of power-generating machinery and equipment, electrical equipment and fertilizers, while the most significant negative contribution to import growth came from the lower value of imported gas, crude oil and oil products. Coverage of the imports by exports in euros in the first nine months was 77.9%. Serbia's largest trading partners in the period January - September 2016 were EU member states, which accounted for 66.4% of total exports and 63.4% of total imports. In this period almost one-half of the total exports (47.3%) were related to the trade with: Italy, Germany, Bosnia and Herzegovina, Romania and Russian Federation. Imports from Germany, Italy, China, the Russian Federation and Hungary accounted for 44.1% of total imports. Serbia had a trade surplus of more than EUR 1.7 billion with Bosnia and Herzegovina, Montenegro, Macedonia, Romania, Italy, Bulgaria, the UK, Slovakia, and Croatia. The recovery of external demand, primarily among Serbia's main trading partners, will have positive effects on the country's exports. Even though the increase in investment has resulted in higher imports as Serbia is an import-dependent economy, the contribution of net exports in 2016 is expected to be positive, as evident from foreign trade trends, that have exceeded expectations.

Balance of payments trends are characterized by an increase in exports of goods and services at a faster rate than the corresponding increase in imports of goods and services, which resulted in reduction of the current account deficit in the first nine months to a level that was more than one fifth lower compared to the same period last year and was fully covered by FDI. The current account deficit between January and September was EUR 880.9 million, as opposed to EUR 1,132.6 million in the first nine months of 2015. This improvement can partly be attributed to favorable terms of trade, but was mostly due to improved international competitiveness of Serbia's industrial production. Furthermore, FDI inflows remained significant at EUR 1.3 billion. The mild year-on-year decline of 1.4% was a consequence of unfavorable developments in September: as these can be considered transient, total inflows at the end of the year are expected to amount to EUR 1.8 billion, translating to 5.2% of GDP and more than sufficient to cover the current account deficit. The highest FDI inflows in the first half of 2016 were recorded in the manufacturing industry (EUR 314.1 million), the financial sector (EUR 223.6 million) and construction (EUR 94.1 million). Total net FDI from the EU in the same period amounted to EUR 674.5 million, which accounted for 81.7% of total net FDI. In the first nine months of 2016 it was recorded an outflow of portfolio investment in the amount of EUR 683.7 million net, compared to a net inflow of EUR 27.6 million in the same period last year. This trend in portfolio investment has created depreciation pressures and adversely affected foreign exchange reserves; it has mostly been due to uncertainties associated with the effects of monetary measures implemented by the ECB and the Fed, as well as uncertainties surrounding the procedure and pace of the UK's exit from the EU. As regards financial loans, net foreign deleveraging by residents in the first nine months of 2016 was EUR 602.5 million. The government repaid EUR 56.7 million in net liabilities over the same period. On the basis of due liabilities, NBS made payments of EUR 23.2 million, among which payments to the IMF accounted for the largest share (EUR 14.7 million). Companies have continued deleveraging by repaying their foreign debt since the beginning of the year (153.2 million), while banks repaid EUR 369.4 million.

The total current account deficit in 2016 is expected to be around EUR 1.5 billion, or 4.2% GDP, which was 0.5 p.p. lower than in 2015, with the deficit fully covered by FDI. The wide dispersion of foreign direct investment into different fields of the manufacturing industry resulted in faster than expected growth of exports, which, combined with improved terms of trade, contributed to a balance of payments deficit that was 0.4 p.p. lower than the projected figure. Continuing structural reforms aimed to improve the business environment, maintain macroeconomic stability, and consolidate public finance should ensure continued FDI inflows into tradable goods sectors, which should improve the production potential in the medium- and long-term perspective and ensure sustainable growth.

According to macroeconomic projections, in 2017 exports will continue growing at a faster rate than imports, with further improvement in international competitiveness. The projected real growth curve of goods and services exports is based on expansion of domestic production capacities and greater external demand for Serbian products, which will lead to the country capturing greater shares of export markets and enhancing its cost and price competitiveness. The faster growth of exports relative to imports will help reduce the goods trade deficit from 11.9% of GDP in 2015 to 10.7% of GDP in 2017, while the current account deficit as a share of GDP will be reduced from 4.7% to 3.9% in the same period. Capital inflows will be dominated by foreign direct investment, which will be the main source of finance for the current account deficit.



Medium and long-term sustainability of the current account balance will depend on continuing structural reforms and increasing export competitiveness, as well as interest expenses, which could exert upwards strong pressure the current account deficit in the event of a drastic worsening of financing terms in foreign markets. In this context, it is essential to have a sustainable fiscal position and reduce internal macroeconomic imbalances. Reduction of government spending as a share of GDP in 2017 is expected to lead to a gradual reduction of the current account deficit. In 2018 to 2019, real growth of exports of goods and services is expected to continue increasing at a faster rate than imports of goods and services (7.7% per annum on average vs. 6.1% per annum on average). Due to increased investment activity, capital and intermediate products will account for a significant share of imports. The faster growth of exports compared with imports will help reduce the goods and services trade deficit to 6.4% of GDP in 2019. Furthermore, the balance of the services account will be positive and is forecast to reach 3.5% of GDP, which will be an increase of 1.3 p.p. of GDP compared with the surplus generated in 2015. The more favorable developments in net exports of goods and services, primarily as a result of changes in the structure of the Serbian economy, will help reduce the external imbalance and risks to the sustainability of external debt and external liquidity. The reduced current account deficit, which will reach 3.9% of GDP at the end of 2019, will be fully covered by foreign direct investment. The current account on the balance of payments is expected to see inflow from current transfers amounting to 8.5% of GDP on average per annum. Revenue from remittances is the most important component of current transfers, while expenditures arising from FDI will be a key element of factor income. The net effect of current transfers and net transfer payments will be positive in the next three years and is forecast to reach approximately EUR 1.2 billion on average per annum, which will be sufficient to cover, on average, about 45% of the balance of trade deficit. Projections of the current account payment balance are based on projected trends in foreign trade, current transfers, and net factor income. The current account payments balance will be negative, averaging EUR 1.5 billion between 2017 and 2019. Capital inflows will be dominated by foreign direct investment (4.4% of GDP on average per annum), which will be the main source of finance for the current account deficit. Growth of FDI and its further diversification towards the sector of tradable goods will contribute to further growth of exports and improvement of the country's external position.

The solvency ratio, measured as the ratio of external debt to GDP, improved in the first half of 2016 compared with the end of the previous year. External solvency improved in terms of both the ratio of short-term debt to GDP and the ratio of external debt to GDP. With regard to external liquidity indicators, debt servicing improved measured as the percentage of exports of goods and

services. According to the NBS, external debt at the end of the first half 2016 was EUR 25.8 billion, EUR 474 million lower than at the end of 2015. The reduction in external debt in this period was the result of lower indebtedness of banks and the public sector, as repayments were higher than withdrawals; another contributing factor was the weakening of the US dollar against the euro. Furthermore, the share of private sector debt in external debt was EUR 208.9 million lower at EUR 10.8 billion, while public sector debt was EUR 265.1 million lower and stood at approximately EUR 15 billion. Total external debt is expected to be on a downward trajectory, primarily due to stabilization and reduction of public external debt. According to the World Bank's criteria, a "low indebted" country is one with a ratio of external debt to exports of goods and services of below 132%, while for a "heavily indebted" country the ratio stands at 220%. Furthermore, a low indebted country has an external debt-to-GDP ratio below 48%, while the same ratio for a heavily indebted country is above 80%. According to these criteria, Serbia is categorized as a "medium indebted" country. External solvency indicators have been improving since 2013. The external debt-to-exports ratio has declined significantly, while public debt as a percentage of GDP has stabilized, and the beginning of a slight downward trend has been observed.



4. Risks to Realization of Serbia's Macroeconomic Projections

External risks are determined by economic growth of leading economies, volume of global trade, volatility of international financial and commodity markets, and political risks, including geopolitical tensions and the pace and outcome of negotiations between the EU and UK on the country's exit from the bloc. Recovery of the Serbian economy will depend to a large extent on the speed at which the Eurozone and regional economies are able to recover and the resulting increase in foreign demand and foreign capital inflows, trends in foreign interest rates, and trends in import prices and prices of food, oil products, and iron ore in the international market. The Eurozone, Serbia's largest trading partner, faces the risk of growth slowing down in emerging economies, China in particular. Any further decline in Chinese demand would affect its largest trading partners and could jeopardize further recovery of the EU's economy due to lower demand for its exports. Furthermore, rebalancing of the Chinese economy could exacerbate the continuing slowdown in global trade by reducing global demand and continuing the trend of low prices of primary products in the global market. Growth in developed countries could be additionally affected by unfavorable demographic trends and an investment slowdown. In such circumstances, private spending could fall, which could prolong slow growth and low inflation. The risks faced by global and European economies are to a large

extent due to markets' uncertainty about decisions of leading central banks. If the Fed brings its monetary policy back into its usual framework and increases its key policy rate, this could reduce capital inflows to emerging economies; in Serbia's case, this would increase depreciation pressures on the dinar. Additionally, it is not known whether the ECB will extend its quantitative easing program and what the ultimate effects of these measures could be. The oil prices could deviate from projected values in both directions. An increase above the expected level could result in lower spending and worsening of the economy's financial position (in the petrochemical industry etc.), which could slow down economic activity. Furthermore, trends in the prices of primary agricultural products and base metals, which account for a high share of Serbian exports, pose symmetrical risks to the realization of macroeconomic projections.

Given the low trading volume and weak links between the economies of Serbia and the UK, any direct effect of Brexit on the Serbian economy is expected to be relatively minor. However, there is a risk associated with the effects of this process (the transition period is expected to be over in 2019) on the economies of our major trading partners in the Eurozone and the possibility of an indirect spillover. Changes in the trade regime owing to the UK's exit from the EU could slow down economic flows. The negotiation process itself will add to uncertainty in the global markets in the coming months, both in terms of price parities and exchange rates and by lowering the credit ratings of developed countries and, indirectly, of emerging economies as well. The course of these negotiations will contribute to institutional, economic and political uncertainty in the EU, which could spill over into global trading and financial flows. If the unfavorable risks materialize, capital flight from emerging economies will continue and their credit ratings will be downgraded. Another long-term risk for the EU is the potential loss of pluralism in the decision-making process on EU policies once the UK leaves the Union, especially with regard to regulation of financial markets and the banking sector.

In addition to external risks, the macroeconomic scenario will also be affected by internal uncertainties. The effects of these internal risks could be less pronounced due to the consistent fiscal consolidation, better-than-expected outlook for economic growth, reduction of external imbalances, and consistent implementation of the IMF arrangement. The baseline scenario for development in the next three years is based on increased investment and exports of goods and services and reduced public expenditures and deficit as a percentage of GDP. The key assumption for the envisaged medium-term scenario is that structural reforms will intensify whilst fiscal stability will be maintained. The pace of structural reforms will determine the rate of economic growth in the medium-term perspective. Any deviation from these assumptions could pose a risk to the medium-term macroeconomic projections. Any slowdown in the implementation of structural measures designed to improve the business environment could worsen the country's macroeconomic position. Such developments could increase external and internal macroeconomic imbalances, and could also constrain or prevent inflows of necessary foreign capital.

II. FISCAL FRAMEWORK FOR THE PERIOD 2017 TO 2019

1. Medium-term Fiscal Policy Objectives

The medium-term objective of fiscal policy is a deficit of 1% of GDP, which will be achieved in 2019. This will fully restore public finance to a sustainable path and reduce public debt to 67% of GDP. A fiscal deficit within the range of 0.5% to 1% of GDP in the coming period will enable a reduction of the share of public debt to under 60% after 2021.

The high level of public debt and its continued growth at an increasing rate, as well as the high interest expenditures in the budget in 2014, were a clear signal that a serious fiscal consolidation program was due. At the time, debt stood at 71.8% of GDP, annual interest expenditures were 3% of GDP, while the general government deficit was 6.6% of GDP¹. A sound fiscal consolidation program was prepared and garnered support from the IMF. It was formalized in the Precautionary Standby Arrangement entered into in 2015. It was determined that a structural adjustment of approximately 4% of GDP would be needed in the period 2015–2017 to stop public debt growth and reduce the debt to GDP ratio.

The structural (permanent) deficit reduction achieved in the first two years of the fiscal consolidation program surpassed the initial expectations. In 2015, the structural deficit reduction was 2.6% of GDP, while in 2016 the adjustment is expected to be around 1.3% of GDP. A key contribution to the structural adjustment came from lower expenditures (wages and pensions), while the favorable macroeconomic environment, along with stronger tax and financial discipline, enabled a strong increase in revenue. The objective of the fiscal consolidation program was structural adjustment of 4% of GDP, with a turnaround in the public debt trend. Due to consistent implementation of the fiscal consolidation measures and the expected macroeconomic recovery, public debt was reduced already in 2016. The rightsizing and restructuring process is also due for completion and is expected to result in sustainability on the expenditure side of the budget, while the favorable macroeconomic environment and the fight against shadow economy will speed up revenue growth. These two processes combined will create a fiscal leeway for economic policy makers to have multiple options for their decisions. Once the structural adjustment has been completed, a second wave of fiscal deficit reduction will follow as a result of lower interest expenditures, which offset the effects of the implemented measures in the past.

Restoring the fiscal deficit and public debt to a sustainable path will facilitate Serbia's access to the international financial market. Lower interest rates and restored creditor trust will enable access to cheaper loans, which would replace the most expensive existing ones in subsequent transactions and thus additionally improve the fiscal position. The government needs affordable loan facilities for further investment infrastructure and the private sector also needs them to increase its investment activity. Together, this would guarantee continued stable and sustainable growth.

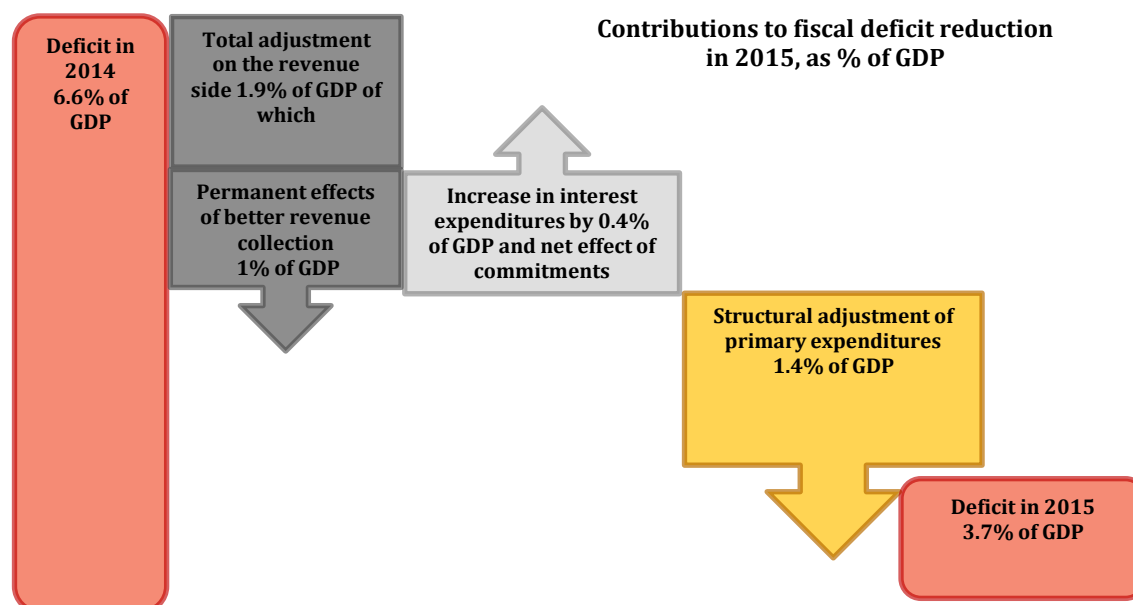
Fiscal Developments in 2015

The economic reform program launched in late 2014 was completed with the signing of the three-year Standby Arrangement with the IMF in February 2015. The high and increasing general government debt at 71.8% of GDP at the end of 2014 and the general government deficit of 6.6% of GDP in 2014 were clear signals that new fiscal consolidation measures were needed. To give credibility to these

¹ The fiscal figures presented in this document do not include own-source revenue of indirect budget spending units and the relevant expenses associated with them.

measures, to achieve stability and resilience of the financial sector and to increase competitiveness and support growth, in February 2015 the Republic of Serbia entered into a three-year Standby Arrangement with the IMF for approximately EUR 1.2 billion or 200% quota (SDR 935.4 million). The 2015 budget was designed to lay the foundations for sound economic growth, achieve macroeconomic stability and ensure a sustainable fiscal system. This is a continuation of the fiscal consolidation measures initially implemented in late 2014. The arrangement provided for a structural fiscal adjustment of 4% during the three-year period, but most of it – about 2.6% – was already achieved by the end of 2015.

After many years of unsuccessful attempts to eliminate the structural deficit, Serbia finally implemented a program that would permanently eliminate fiscal imbalances. General government deficit was reduced from 6.6% of GDP in 2014 to 3.7% of GDP at the end of 2015. General government deficit in 2015 was RSD 149.1 billion, which was far lower than the RSD 232 billion planned in that year's budget and the RSD 258.1 billion recorded in 2014. Furthermore, interest expenditures accounted for a substantial share of the deficit (more than 85%), which meant primary deficit was only 0.5% of GDP. The reduction of total deficit by 2.9% of GDP was a significant result. However, in order to fully understand the scale of this structural adjustment, we must exclude the net effect of temporary factors both on the revenue side and on the expenditure side. In this way, we arrive at a figure of 2.6% of GDP for the structural primary fiscal adjustment made in the first year of consolidation.



The key measures in the fiscal consolidation program were designed to adjust the expenditure side of the general government budget, while fight against the shadow economy and tax evasion was identified as a priority on the revenue side. The primary fiscal consolidation measures included public sector wage and pension cuts, which had the total effect of about 1.7% of GDP. The linear 10% cut in the net wages of employees who earn more than RSD 25,000 a month was applied to the entire public sector, including all budget spending units, public enterprises, local administration and other entities categorized as public sector. The effects of this measure can be seen both on the expenditure side, as a result of lower wages paid from the national budget, and on the revenue side, because the wages' cuts for employees at other levels of government are recorded as non-tax budget revenue. In parallel with this, the pensions of all retirees who receive more than RSD 25,000 a month have been cut progressively. Pensions between RSD 25,000 and 40,000 have been cut by 22% on the amount in excess of RSD 25,000, while all pensions higher than RSD 40,000 were cut by a further 25% on the amount in excess of RSD 40,000. Certain improvements have also been made in public sector rightsizing and reform. Although the planned scale has not been reached, the number of employees in the public sector has nevertheless declined, primarily as a result of natural employee turnover (through application of the 5:1 attrition rule regarding the ratio of the

employees who leave through natural employee turnover and new employment). Indexation of public sector wages and pensions was suspended during the year. A large-scale public administration reform process has also been initiated, which includes legislative arrangements that govern the government sector wage system, the pay grade system, improvement of the public sector employee registry, job and title catalogue, maximum employment thresholds for individual institutions and a plan to reduce/optimize employee structure in the government sector.

A number of tax bases had already been changed before 2015, which limited the scope for tax policy changes. The cost of connecting to the natural gas transport system was increased in 2015, which provided funding for the gas public utility PE "Srbijagas", thus reducing the need for budget funding. The same year saw the imposition on excise on end consumption of electricity, which is payable *ad valorem* at the rate of 7.5%, as well as excise on e-cigarettes. Another new levy introduced the same year was the fee on mandatory reserves of oil and oil products payable per liter or kilogram of oil products, which is posted to non-tax income.

A favorable macroeconomic environment, sound results in the fight against shadow economy and tax evasion and improved financial discipline among budget spending units were the main contributing factors to the good fiscal performance in 2015.

General government revenue in 2015 was higher than the previous year by RSD 74.1 billion, or 4.6% in nominal terms. The difference is even higher when compared to the amount planned in the budget – approximately RSD 96 RSD billion (2.4% of GDP). Non-tax revenue contributed the most to the increase in public revenue in 2015, with a nominal growth of about 30%, or RSD 51.2 billion. This revenue is mostly of a one-off nature and somewhat uncertain, both in terms of its amount and in terms of the time of its payment, so it is expected to deviate from the budget. The largest increase in this revenue compared with 2014 (by more than RSD 41 billion) was seen in extraordinary non-tax revenue, which includes: profit payments by public enterprises and agencies, budget dividends, revenue from collected claims of the Deposit Insurance Agency, issue premiums etc. Just how difficult it is to plan this heterogeneous revenue can best be seen from the fact that the amount actually generated exceeded the planned amount by more than RSD 20 billion, or about 0.5% of GDP. The main reason for this excess was the higher amount of dividends and profits from earlier years paid to the budget by public enterprises and state-owned companies, as a result of stronger financial discipline in the public sector.

The increase in public revenue is mostly attributable to the increase in excise and VAT revenues. Excise revenues increased by RSD 23.3 billion or 11% in nominal terms compared with 2014. This was primarily the result of a successful fight against the illegal market for goods subject to excise, which was achieved by stomping out the illegal market for tobacco products and improved control of oil product sales through the introduction of a fuel marking system. Measures to eliminate illegal trading in tobacco products yielded their first results in late 2014 and during 2015. Measured by quantity, the legal market for tobacco products (cigarette packs) shrank in 2013 and 2014 by 20% and 15% respectively. The recovery seen in the second half of 2014 offset to a certain extent the declining sales in the legal market at the beginning of the year. According to the available data, sales growth at the end of 2015 was about 11.4%, which was the first case of growth of the legal market in recent years. It should be noted that the average annual decline in consumption had been rather even before 2013 at 2–4% and could be attributed to a "natural" decline in consumption due to higher tobacco product prices and the global campaign against the use of tobacco products. Indeed, it is rather difficult to forecast not only the sales volume, but also the structure of the legal market, the manufacturers' price reduction and other factors. The increase in excise revenue in 2014 was in part due to the imposition of excise on electricity and regular statutory adjustment of excise rates. The collected VAT revenue exceeded the plan and increased compared with 2014. In 2015, VAT collection was better than expected as a result of acceleration of economic activity and private sector wage growth, lesser effects of fiscal consolidation measures on trends in private spending and income, higher inflow from international remittances, increased lending by banks and increased efforts to stomp out the shadow economy, especially for goods subject to excise. Compared with 2014, this revenue increased nominally by 1.6%, or RSD 6.5 billion.

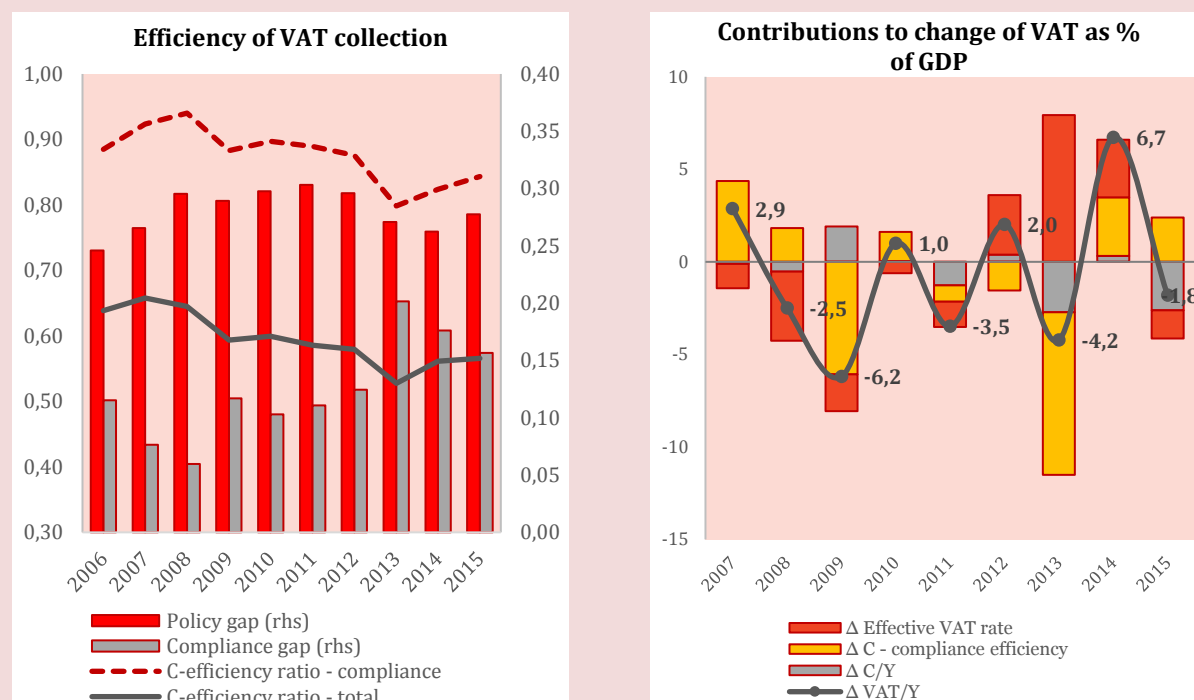
Efficiency of VAT Collection and Estimate of Tax Evasion

More efficient collection and control of taxpayers has produced visible results and this trend is expected to continue in the coming period. The decline in tax discipline observed in 2013 was reversed in 2014 and the trends observed so far seem to indicate that tax collection has improved. The decline in tax discipline was stabilized in the first half of 2014, while 2015 saw increased tax collection. These conclusions

were confirmed by an analysis and assessment of the so-called VAT gap. This indicator was developed to assess the efficiency of VAT collection and determine the scale of tax evasion (compliance gap), as well as to determine the tax system yield (policy gap). This analytical indicator had been in a constant decline since 2008 and reached the all-time low of approximately 80% in 2013. The decline in 2013 was primarily a result of the increased general VAT rate and the “flight” of sales to the shadow economy. Any change in tax rates creates a certain level of distortion, both in terms of the structure and level of consumption and in terms of the scale of the shadow market, thus affecting the efficiency of collection of all forms of consumption taxes. VAT rates were increased on two occasions: the general rate was increased in 2012, followed by an increase in special rates in 2014. The new rates initially failed to generate the full anticipated effects due to lower levels of tax collection. However, after a certain time, both consumption and tax collection stabilized.

VAT collection improved in 2014 and in 2015 the VAT gap was reduced by 4 percentage points from the all-time low. This reaffirmed the first important steps in the fight against the shadow economy. The improved VAT collection in late 2014 and during 2015 was also helped by the collection of excise on tobacco products and oil products, which in turn also boosted the collection of value added tax on those goods subject to excise.

There is much scope for additional improvements in tax collection in the coming period. Notwithstanding the improved tax discipline in recent months, tax administration will be further strengthened through consistent implementation of the Tax Administration Transformation Program, in order to increase revenue collection. It is estimated that the so-called VAT gap was around 15% in 2015. The aim is to increase this indicator of tax collection efficiency to about 10% by 2020. This improvement in tax collection would result in an increase in VAT revenue by 1.8% as a percentage of GDP during the observed period.



* Efficiency of collection was calculated on the basis of the estimated effective VAT rates obtained from VAT returns and relevant customs data about the structure of imports. The results may be subject to change once the calculation becomes standardized.

Revenue from compulsory social insurance contributions exceeded the amount envisaged in the budget by RSD 21.6 billion, or more than 0.5% of GDP. This was the result of improved macroeconomic performance of the economy, which enabled the private sector wage growth to offset to a

large extent the wage cuts in the public sector, so the total wage bill shrank less than initially expected. Also, the effects of staff rightsizing in the public sector were not felt. Successful labor market control measures were another contributing factor to the successful generation of this revenue. In addition, the factors which contributed to the higher collection of contributions also influenced the trends in personal income tax collection, which was approximately RSD 5.5 billion higher than planned, or slightly more than 0.1% of GDP.

A nominal increase in customs revenue was observed in 2015, for the first time since the completion of the customs rate harmonization process in late 2014. As had been the case before the implementation of the SAA, a new, relatively stable relationship was established between VAT charged on imports and customs duty. Customs revenue had been dwindling constantly since 2009 due to implementation of the EU Stabilization and Association Agreement, the Free Trade Agreement with the EFTA and the Free Trade Agreement with Turkey, as well as the gradual reduction and elimination of certain customs rates. It can reasonably be assumed that the structure and origin of goods imported from the regions with lower customs burden are continuing to change.

The economic slowdown in 2014 and the lower profitability of the economy resulted in lower collection of corporate income tax. Although 2014 saw improved collection of this tax form as a result of amendments to the Law on Corporate Income Tax (2013), which increased the income tax rate from 10% to 15%, and the favorable developments in terms of profitability of companies (real GDP growth of 2.6% in 2013), this revenue declined sharply in 2015. The recession in 2014 (decrease in real GDP of 1.8%, mainly as a result of the floods in May that year), the reduced profitability of the economy, the unfavorable exchange rate trends, changes in the accounting standards used in the calculation of exchange gains/losses on the financial statements of economic operators etc. are just some of the factors that led to the lower collection of this tax. Furthermore, the effects of amendments to the regulations governing the collection of corporate income tax in 2013 (revocation of tax incentives) partly offset the underperformance of tax collection in 2015. The planned increase in revenue from this source failed to materialize, as the revenue declined by RSD 10 billion compared with 2014, which was a nominal decline of 13.9%. The amount of underperformance compared with the plan was around RSD 13.3 billion, or about 0.3% of GDP. Other tax revenues increased compared with 2014 by approximately RSD 6 billion (10.4%), exceeding the planned collection by about 9 billion RSD (0.2% of GDP), mostly due to increased collection of property tax as a result of changes in tax base calculation.

General government expenditure was about RSD 34.9 billion, or 1.9%, lower than in 2014; however, it exceeded the planned amount by approximately RSD 13.2 billion, or about 0.3% of GDP. On the expenditure side, the largest deviation was seen in subsidies, which were RSD 17.7 billion RSD (15.2%) higher than in 2014 and which exceeded the planned amount by RSD 30.5 billion, or 0.8% of GDP. Subsidies exceeded the planned amount due to assumption of the debt of PE "Srbijagas" from earlier years in the amount of RSD 23.4 billion RSD. In addition, agricultural subsidies were increased by RSD 10.1 billion because of regulatory and administrative deficiencies due to which savings from revocation of agricultural subsidies on arable areas of more than 20 hectares and on leased land owned by the Republic of Serbia failed to materialize in 2015.

Growing public debt leads to ever-increasing interest expense year after year. Interest expense increased by 12.8% compared with the previous year. However, due to improved financial performance and better borrowing terms, the actual interest expense was lower than planned. Other expenditures saw minor positive or negative deviations from the plan, which offset one another in the sum total, except the expenditure for goods and services, which exceeded the planned amount primarily due to exceeded expenditure limits at the local self-government level.

Capital expenditures were lower than planned in the budget. This has been a problem for many years and constrains potential growth. Although this expenditure increased by RSD 17.9 billion RSD or 18.5% compared with 2014 (2.8% of GDP), it failed to reach the level envisaged in the budget (3.1%

of GDP). Due to the underperformance of capital expenditures in recent years, it is necessary to draft regulations which would enable better and more efficient management of public investments and increase the share of capital expenditure in the future.

Some of the fiscal consolidation measures were not implemented or were implemented at a slow rate, which meant that part of the expenditures planned for their execution failed to materialize. Unemployment benefits were expected to be higher. The lower amount of severance payments in the rightsizing process was partly offset by increased wage expenditures, exactly because the rightsizing process was not fully implemented. The structure of social allowances also deviated from the plan. The lower amount of severance payments in the enterprises in restructuring and of unemployment benefits was offset by unplanned expenditures for the settlement of debt to military pensioners in the amount of RSD 10 billion. The total unplanned one-off expenditures paid in 2015 amounted to approximately RSD 43 billion, or 1.1% of GDP.

Table 4. General government revenue, expenditure and fiscal balance in 2014 and 2015, as a % of GDP

	Achieved in 2014	Planned for 2015	Achieved in 2015
PUBLIC REVENUE	41.5	39.5	41.9
Current revenue	41.2	39.3	41.7
Tax revenue	36.8	34.6	36.2
Personal income tax	3.7	3.5	3.6
Corporate income tax	1.9	1.9	1.5
Value added tax	10.5	9.9	10.3
Excise duty	5.4	5.3	5.8
Customs duty	0.8	0.7	0.8
Other tax revenue	1.5	1.3	1.6
Contributions	13.0	12.0	12.5
Non-tax revenue	4.4	4.7	5.5
Grants	0.2	0.2	0.2
PUBLIC EXPENDITURE	48.1	45.3	45.6
Current expenditure	43.4	41.4	42.0
Employee expenditure	11.7	10.5	10.4
Purchase of goods and services	6.6	6.3	6.4
Interest repayment	2.9	3.4	3.2
Subsidies	3.0	2.6	3.3
Social allowances and transfers	17.8	17.5	17.6
<i>out of which, pensions</i>	<i>13.0</i>	<i>12.2</i>	<i>12.1</i>
Other current expenditure	1.4	1.2	1.1
Capital expenditure	2.5	3.0	2.8
Net lending	1.4	0.1	0.1
Repayment of guarantees	0.8	0.8	0.7
RESULT	-6.6	-5.8	-3.7

Source: MoF

The amount of arrears of budget beneficiaries and compulsory social insurance organizations as at the last day of 2015 was RSD 6.8 billion (around 0.2% of GDP), which was RSD 2.6 billion lower than at the end of 2014. Budget beneficiaries and PE "Putevi Srbije" reduced their arrears by RSD 0.8 billion, while compulsory social insurance organizations reduced their arrears by RSD 1.8 billion.

Table 5. Balance of past-due debt of budget spending units and CSIO, in RSD billion

	31 Dec 2014	31 Dec 2015
Budget spending units and PE "Putevi Srbije"	6.2	5.4
CSIO	3.2	1.4
Total	9.4	6.8

2. Current Fiscal Developments and Outlook for 2016

Implementation of the fiscal consolidation program under the IMF arrangement has continued successfully in 2016. The estimated structural adjustment in 2016 will be 1.3% of GDP. After a very successful 2015, which saw structural fiscal adjustment of 2.6% of GDP, based on the most recent estimates it is expected that the adjustment in 2016 would reach an additional 1.3% of GDP. A total structural adjustment of 3.9% over the course of two years under the fiscal consolidation program would enable Serbia to achieve the target envisaged by the IMF arrangement, which is an adjustment of 4.1% of GDP over a three-year period. The economic reform program has been implemented in 2016 with minor changes. The wage and pension policy was slightly relaxed at the end of 2015, which was offset on the revenue side by higher excise on oil products. Measures have been adopted to achieve significant savings on subsidies. Another aspect of structural adjustment that has continued in 2016 is rightsizing of the public sector, although some of the ultimate goals have been scaled down after thorough analysis. The increase in the number of pensioners has noticeably slowed down, which can in part be attributed to the implemented parametric pension system reform. As regards the revenue side of the budget, the trend of increased efficiency in tax revenue collection has continued.

Table 6. Estimated elements of structural adjustment in 2016, as a % of GDP

Excise duty on oil products – increased rates and higher consumption	0.28
Excise duty on tobacco	0.10
Excise duty on electricity – additional effects compared with 2015	0.27
Dividends of Telekom Srbija a.d.	0.21
Agricultural subsidies – savings under new regulations	0.24
Staff rightsizing in 2015 – effect carried forward (approximation)	0.12
Slowdown in the increase of the number of retirees (approximation)	0.15
Wage and pension increase – net effects	-0.29
Other (efficiency of collection, reduction of shadow economy)	0.24
Total structural adjustment	1.32

Source: MoF

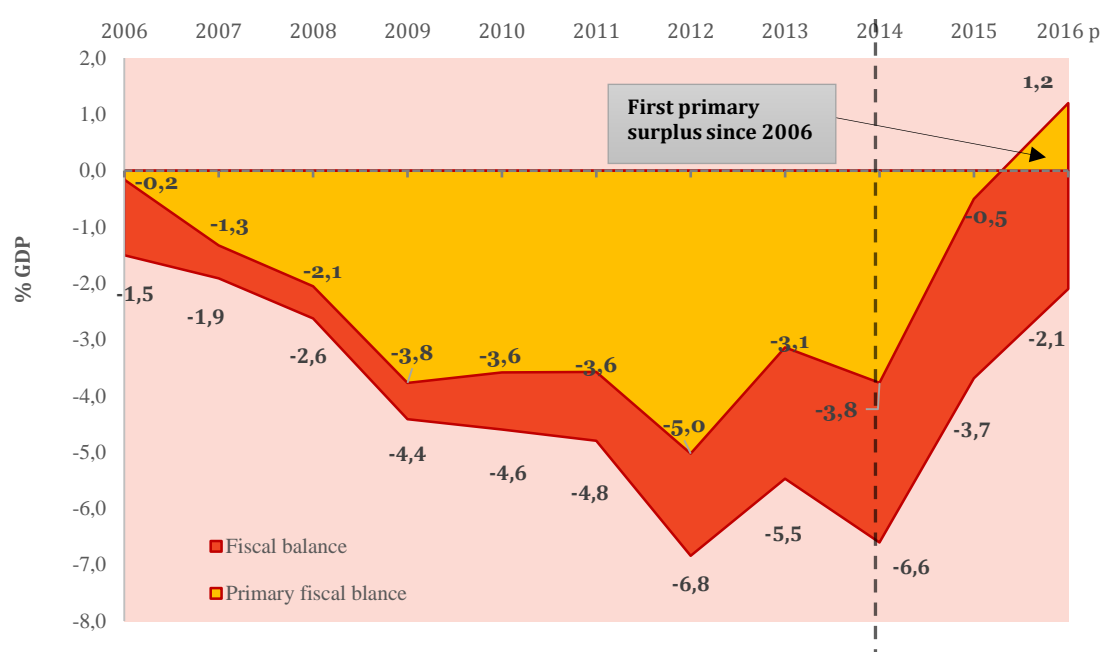
According to the most recent estimates, general government fiscal deficit in 2016 will be below the planned level by 1.8% of GDP, although it is possible that it could be even lower. A new macroeconomic and fiscal framework, which is presented in this Fiscal Strategy, was agreed during the sixth revision of the IMF arrangement. It sets out a new estimate of revenue, expenditure and general government deficit, with the fiscal deficit RSD 74.3 billion lower than planned. These estimates take into account the latest macroeconomic trends and estimates, the fiscal trends since the beginning of 2016 and the expected realization of certain one-off expenditure categories that had not been included in the plan. As it is possible that realization of certain expenditure categories would be lower than planned, the fiscal balance in 2016 could be more favorable than the one planned in this framework.

Primary fiscal surplus will be achieved for the first time since 2005, as both an indicator of success of fiscal consolidation and an assumption for reducing public debt as a percentage of GDP. It is estimated that primary fiscal surplus in 2016 would be minimum 1.2% of GDP. This result shows that the fiscal consolidation measures have achieved their results and public spending has been sufficiently reduced. On the other hand, favorable fiscal developments and an improved interest structure of debt will lead to stabilization of the absolute amount of interest expenditures and their reduction as a percentage of GDP. This would create scope for a certain extent of fiscal relaxation, without jeopardizing the main objectives of the program.

Stopping the increase of public debt to GDP ratio is the primary goal of the fiscal consolidation program and it has been achieved one year ahead of schedule. The trend of public debt to GDP ratio will be reversed in 2016, after years of moving upward. It is estimated that public debt in 2016 would be 74.6% of GDP, as opposed to 76% of GDP at the end of 2015. Lower fiscal deficit and the primary

surplus generated in 2016 are the main contributing factors to the downward trend of public debt to GDP ratio. Faster economic growth and higher real growth rates and nominal GDP than originally planned also had positive effects on the ratio. While these factors should have structural effects on share of public debt in GDP, other factors which materialized in 2016 had only temporary effects on the trend of public debt. Similarly as in the case of interest expenditures, favorable developments in the international exchange market (including in particular the exchange rate of the US dollar) resulted in a lower public debt expressed in dinars in 2016. Furthermore, due to a satisfactory level of liquidity, it was possible to avoid issuing certain short-term securities. Although there are risks of unfavorable effects on the trend of public debt in the coming period due to developments in the international foreign exchange market, the projected fiscal balance trajectory will enable the positive trend initiated in 2016 to continue. On the other hand, withdrawals for project loan financing have intensified, which is seen as a positive trend because this segment of public debt certainly incorporates a development component.

Primary and total fiscal balance, as a percentage of GDP



The improved fiscal position, i.e. lower deficit in 2016, will be supported by better-than-planned collection of public revenue. The projected has been revised upward by RSD 108.2 billion, boosted by both tax and non-tax revenue. The projected expenditure has also been revised slightly upward, but with significant changes in its structure. The changes in the structure of expenditure are a result of modifications to specific categories of expenditure due to changed scope and execution timeframe of expenditure at certain levels of government and due to the inclusion of certain one-off expenditures that had not been initially planned.

Table 7. Government revenue, expenditure and fiscal balance in 2016 – budget and estimate based on the sixth revision of the IMF arrangement, in RSD billion

	2016 budget	New estimate 2016	Difference	Change, %	New estimate, as a % of GDP
PUBLIC REVENUE	1,711.5	1,819.7	108.2	6.3	43.3
Current revenue	1,697.2	1,809.3	112.1	6.6	43.0
Tax revenue	1,513.0	1,572.8	59.8	3.9	37.4
Personal income tax	149.5	155.1	5.6	3.7	3.7
Corporate income tax	64.5	78.5	14.0	21.7	1.9
Value added tax	427.0	447.6	20.6	4.8	10.6

FISCAL STRATEGY FOR 2017 WITH PROJECTIONS FOR 2018 AND 2019

	2016 budget	New estimate 2016	Difference	Change, %	New estimate, as a % of GDP
Excise duty	254.3	265.2	10.9	4.3	6.3
Customs duty	34.8	36.3	1.5	4.3	0.9
Other tax revenue	65.5	64.2	-1.3	-2.0	1.5
Contributions	517.4	525.9	8.5	1.6	12.5
Non-tax revenue	184.2	236.6	52.4	28.4	5.6
Grants	14.3	10.4	-3.9	-27.3	0.2
PUBLIC EXPENDITURE	1,875.0	1,908.9	33.9	1.8	45.4
Current expenditure	1,719.9	1,736.2	16.2	0.9	41.3
Employee expenditure	432.0	422.60	-9.4	-2.2	10.1
Purchase of goods and services	271.3	286.86	15.5	5.7	6.8
Interest repayment	144.9	138.60	-6.3	-4.4	3.3
Subsidies	111.6	120.40	8.8	7.9	2.9
Social allowances and transfers	715.7	716.30	0.6	0.1	17.0
<i>out of which, pensions</i>	507.9	496.30	-11.6	-2.3	11.8
Other current expenditure	44.3	51.40	7.1	15.9	1.2
Capital expenditure	120.8	130.20	9.4	7.7	3.1
Net lending	2.2	3.50	1.3	59.1	0.1
Repayment of guarantees	32.0	39.00	7.0	21.9	0.9
Result	-163.5	-89.1	74.3		-2.1
Result as a % of GDP	-3.9	-2.1	1.8		

Source: MoF

The projected fiscal framework was agreed and determined during the most recent revision of the IMF arrangement in October 2016, with both sides insisting on the precautionary principle. It was acknowledged there were "positive risks" and the parties agreed there was scope for an improved final result in terms of realization of the fiscal deficit.

Fiscal developments in the period January-September 2016 reflected to a large extent the positive macroeconomic developments and faster economic growth, as well as other factors that contributed to improved collection of public revenue. The general government deficit of only RSD 4.5 billion during the observed period was significantly lower than both the planned deficit and the deficit realized in the same period last year. It is necessary to identify the (permanent and temporary) effects which contributed to the downward revision of the deficit. Public revenue is significantly influenced by macroeconomic trends and its development tends to be stable, except in the event of tax policy changes. Reasons for deviation can be found in the rate of payment and amounts of extraordinary non-tax revenue, certain methodological changes in the scope of public revenue, improved tax discipline (efficiency of collection) etc. On the other hand, public expenditure can be influenced by changes in the schedule of realization (discretionary component), execution and implementation of adopted measures, execution of one-off expenditure etc. The new estimate of expected realization until the end of 2016 takes into account the base effect, i.e. the difference between the achieved and planned values at the end of the previous year.

The macroeconomic developments in 2016, in the shape of increases in average wages, employment and spending, have strongly influenced fiscal trends through the effects they had on the collection of personal income tax and VAT. The 3.9% increase in the average wage in the first nine months of 2016 was matched by a corresponding increase in revenue from social security contributions and wage taxes. The increase in revenue from wage tax and social security contributions was due primarily to wage developments in the private sector. Although monthly growth rates were heavily influenced by seasonal factors, especially in Q2, they were subsequently stabilized. It is expected that total collection by the end of 2016 would be slightly higher than originally planned, owing in part to the improved revenue generation at the end of 2015. The trends in these forms can serve as a crucial early indicator of overall economic trends.

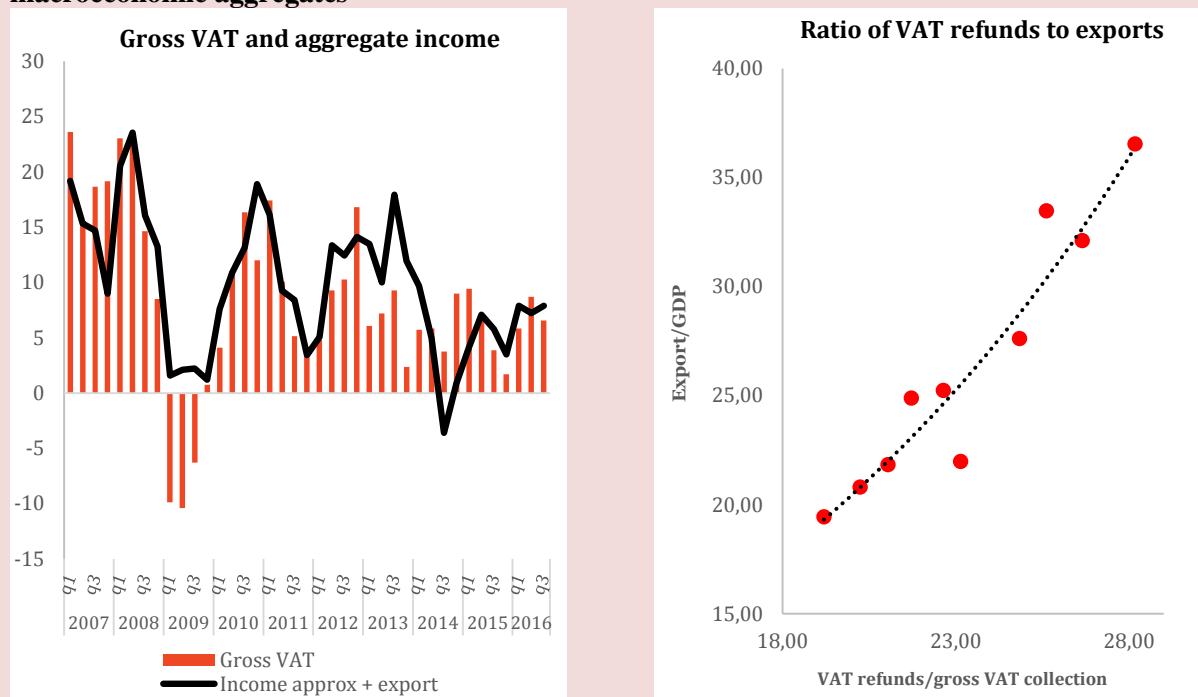
Excellent results were achieved with regard to control and improved efficiency of VAT collection, especially in 2015, with a similar trend continuing in 2016. The key determinants of

improved VAT collection are total consumption (C), effective tax rate and collection efficiency (*C-efficiency*). VAT is the second-largest tax form in total public revenue and its trends are influenced by factors such as credit activity, trends in other sources of revenue, collection efficiency and scale of the shadow economy, structure of consumption and foreign trade trends. To project and conduct short-term analyses of this tax form, trends in gross VAT collection should be examined separately from trends in VAT refunds.

Gross VAT collection saw a sharp increase of 7%, which was higher than the increase in average wages and total disposable income. The reason for this deviation is seen in the fact that wages are not the only source of disposable income (other potential sources include pensions, loans, remittances, savings, social security benefits etc.). The trends in gross collection are also largely driven by export demand through the domestic and import component in the realized exports. Increased consumption of goods subject to excise (primarily oil products) also contributed to the increase in VAT collection. The last group of facts which influence gross collection includes the structure of consumption (effective tax rate) and improved collection efficiency (*C-efficiency*). The increase in gross collection compared with 2015 was also in part due to the increased excise burden (excise is included in the VAT base), which had been planned, and increased consumption of this type of goods. In terms of structure of collected VAT, domestic gross collection grew at a higher rate than import VAT. Apart from increased efforts to stomp out the shadow economy, this was also due to changes in the taxation of natural gas and electricity (abolishment of VAT on imports of these goods).

Net VAT collection in the first nine months of 2016 increased at a much faster rate than gross collection, primarily due to a slower increase in VAT refunds compared with the previous year. A close link between trends in refunds and exports has been observed for several years; however, this dynamic has been changed this year, as VAT refunds saw a lower increase. The volume of refunds had not increased in the first half of the year, but it has been rising gradually since then. It is not always possible to determine the main cause of such trends at a macro level. They can be attributed to improved control of taxpayers who are not predominantly exporters or to changes in the rate and volume of purchases and realization of production by certain large recipients of refunds (for example, Smederevo Ironworks saw the sharpest decline in VAT refunds at the beginning of the year). After some time has passed and refund trends have stabilized, it will be possible to determine the cause with greater accuracy. The current net VAT increase rate is also significantly above the level that could be attributed to trends in household income and other macroeconomic aggregates, although some of it can be attributed to increased collection of excise and more efficient control of collection. The trends in the first nine months of 2016 indicate that the original plan would be exceeded by more than RSD 20 billion RSD, while the estimate set out in the new plan is seen as the mean expected collection.

Analysis of trends in gross VAT collection and refunds compared with different macroeconomic aggregates



Aggregate income (for the purposes of this analysis) is an approximation of trends in private spending based on total estimated wages and disbursed pensions, social support and other household income (excluding loans, remittances and the like). The strong relation between aggregate income and gross VAT collection is even stronger if exports expressed in dinars are added to the equation. Trends in refunds (as a share of gross collection) largely reflect changes in the structure of exports and their share in GDP. Thus, trends in refunds can be taken as an early indicator of export activity. This ratio (refunds/gross VAT) is at a level comparable to that of countries with a similar economic structure and at a similar level of development.

Source: MoF

Excise revenue saw a higher increase as a result of increased consumption of certain goods subject to excise, and partly due to the reduced shadow market. Excise revenue includes four main categories: oil products, tobacco, electricity and other goods subject to excise (alcohol and coffee). The budget projection of revenue in 2016 did not take into account increased consumption of goods subject to excise; instead, it was based on regular adjustment of the excise burden. Due to large annual oscillations in the consumption of certain goods subject to excise, in particular tobacco products, caution must be exercised when making estimates for this tax form. A drastic decline in the legal market for tobacco was seen in 2013 and 2014, followed by a certain degree of recovery in 2015 (11.4% growth). In addition, the tobacco product market has been declining naturally to a certain extent for years now, which must be taken into account when projecting consumption. The market for oil products is also subject to changes in the volume of consumption, albeit to a slightly lesser extent, both due to the shadow economy and due to price differences between countries of the region. Sales of alcoholic beverages have been unstable in recent years, while excise on electricity was introduced in the second half of 2015.

The revised projection of excise revenue was mainly a result of increased consumption of oil products, as well as higher excise revenue compared with the previous year. The estimated level of excise revenue from oil products was based on the 2015 level of consumption, at new, higher specific excise rates. The figures showing excise collection in the period January-September can implicitly reveal trends in consumption, although they are partly distorted due to the overhaul of NIS oil refineries. However, at the macro level it is difficult to reliably distinguish the effects of the actual increase in consumption (price elasticity and the effect of economic growth) from those that stemmed from changes in the size of the shadow economy. It can reasonably be assumed that the real increase in consumption levels was also due to favorable price trends in the oil product market. The new estimate of excise revenue for 2016 is based on figures on current realization and on the assumed 4.5% increase in consumption by the end of the year.

The estimates for electricity and alcohol excise collection have also been revised upward as a result of more reliable data on monthly trends in electricity consumption and increased consumption of alcohol. A clearer perspective on the direction of trends in the tobacco market can usually be gleaned after July, which is traditionally the month with the highest collection of excise on tobacco. However, in 2016 the revenue from these goods subject to excise saw a significant change in this dynamic, with alternating periods of high growth and decline compared with the relevant periods in 2015. A contributing factor to this behavior was the price and stock-keeping policy of tobacco manufacturers. Due to this stock-keeping policy, in recent years the bulk of excise on tobacco products was paid in the period immediately before any planned changes to excise rates. All this adds a degree of uncertainty to the projection of this tax form, which has seen an increase in the projected amount compared with the amount planned in the budget. The increased revenue from this tax form can mostly be attributed to better collection at the end of 2015, which seems to suggest a significant recovery of consumption, while measures to stomp out the shadow market also played a part. The total excise revenue has been revised upward by RSD 10.9 billion.

Customs revenue has increased at a faster rate than originally planned and, subject to certain specificities, has followed a pattern similar to the trends of value added tax. Barring any changes in tariff rates, customs revenue normally tends to reflect import trends and exchange rate changes. Certain amendments were made to tax regulations in 2016, including the abolishment of import VAT on certain goods which account for a significant share of total imports (natural gas and electricity). As a result, the increase in customs revenue at the beginning of the year was double the amount of increase in import VAT. However, this difference declined as the year progressed. Based on the trends in the first nine months, the projected customs revenue has been revised upward by RSD 1.5 billion.

The projected revenue from corporate income tax has been revised significantly upward from the originally planned amount, with an increase of approximately RSD 14 billion in the collection of this tax form. Corporate income tax is the most volatile item of public revenue and economic growth is not always the most reliable indicator of its collection. As final profitability figures are not available at the time when projections for the next year are made, the common practice is to assume that it would remain unchanged, while accepting a certain level of risk associated with the generation of this form of revenue. The trends observed in collection in the first half 2016 did not indicate it was necessary to revise the budget projection, although preliminary profitability figures seemed to suggest that. According to the data of the Business Registers Agency, total gross profits in 2015 were RSD 467 billion and were 14.6% higher than in 2014. It became obvious from the payment of corporate income tax in June, after the final assessment of this tax, that the annual revenue would be much higher than planned and also much higher than the previous year. The deviation of the rate of gross profits increase from the projected increase in corporate income tax revenue was a result of high corporate income tax refunds in 2015.

Non-tax revenue has been revised upward more than any other revenue category, both as an absolute amount and as a percentage. Non-tax revenue in the national budget has been revised upward by RSD 52.4 billion. The reasons for this deviation are mostly methodological in nature; however, a contribution factor was that certain potential revenue was excluded from the budget plan for precautionary reasons. At the time when the final projection of 2016 revenue was made, it was agreed with the IMF to include in the revenue plan only the assumed structural (permanent) part of non-tax revenue, which includes dividends for the budget, profit of public enterprises and other similar forms of one-off revenue. This amount was set at RSD 9.6 billion and it was agreed that any surplus above that amount would not be treated as part of the structural adjustment. Thus, for example, the budget plan did not include RSD 12.8 billion in revenue from the 4G mobile network license, although it was known that this revenue would be paid in early 2016. Since Telekom Srbija was undergoing a privatization process at the time, which has since been suspended, the amount of revenue for the national budget from this company's dividends was not included in the plan (the proceeds were RSD 8.9 billion). The total increase in estimated non-tax revenue for the national budget is RSD 28 billion RSD, while the remaining amount included payments that had already been made by the national electricity company Public Enterprise "Elektroprivreda Srbije" (PE EPS) and the Deposit Insurance Agency, payments from premiums for bonds reissue etc. The projection of regular non-tax revenue has not been significantly revised. Out of the total amount of general government non-tax revenue of RSD 236.6 billion, the structural (permanent) part accounts for RSD 216.6 billion. The difference of RSD 20 billion includes revenue from the 4G license fee in the amount of RSD 12.8 billion, RSD 4 billion in revenue from land sales at the local level and a minor share of other payments.

Local-level non-tax revenue will be RSD 21 billion higher than planned. However, the increase in this revenue is mostly due to changes in methodology. Dividends from local public enterprises account for a part of this increase. The payments on this basis were made at the end of 2015,

which was why they were not included in the base used in the estimation of this revenue in 2016. The remainder of this increase was due to changes in the reporting methodology at the local level. Namely, at the end of 2015 and in 2016, data on total revenue and expenditure of preschool institutions and the Integrated Tariff System (public transport fare collection system) became an integral part of the budget execution reports of the City of Belgrade. This expanded the coverage of local budgets² and ensured a methodologically sounder approach, with the resulting change affecting the total level of revenue and expenditure. It should be noted that this change is mostly neutral with regard to the amount of deficit at the local level, since approximately the same amounts are also posted on the expenditure side. On the other hand, the annual trends of this revenue are still unknown, which means its amount may be subject to change. In addition, sales of building land worth RSD 4 billion are also treated as non-tax revenue and were of a one-off nature.

According to the new estimate of public expenditure, the total amount should be higher by RSD 33.9 billion, or 1.8%, with a significant change in structure compared with the budget plan for 2016. Between January and September, public expenditure increased at the rate of 5.3%; for the remainder of 2016, this increase is expected to slow down to 3.5%. The reasons for this slowing down by the end of the year include significant changes in the execution schedule for specific items of expenditure compared with previous years, as well as execution of the so-called one-off expenditure at the end of 2015 in the form of debt assumption and addressing the long-term issues that had accumulated in the public sector in earlier years. Certain one-off expenditure items have also been planned for 2016, including assumption of outstanding debt for supplied natural gas of the company HIP Petrohemija (12.9 billion) and its conversion to public debt and payment of one-off assistance to retirees (8.6 billion), although the total amount will be lower than last year. Execution of one-off (non-structural) expenditure in 2015 was RSD 43.5 billion, or 1.1% of GDP, while the projections for 2016 total RSD 31 billion, or 0.64% of GDP. This figure includes severance pays and certain expenditure items of local governments of a one-off nature. Unlike current expenditure, capital expenditure will see sharper growth compared with 2015 according to the most recent estimate.

There is scope for cutting total public expenditure to below the projected figure. Excluding the amount of one-off expenditure, the remaining planned part of expenditure is virtually unchanged as a total amount compared to the figure planned in the budget. The last quarter of the year is traditionally a season of highest spending (especially on the side of capital expenditure), so the estimate of total public expenditure in 2016 was based on the maximum possible level. It is possible that the full projected amount of current expenditure will not be reached (goods and services, interest and subsidies), which could result in a more favorable fiscal balance than the one envisaged by this framework.

The estimated expenditure for employees is 2.2% lower than in the 2016 budget, primarily due to the lower amount needed for severance payments. Expenditures for employees saw a minor increase in the first part of the year, some of which was attributable to expenditures associated with the general and local elections. The following three elements were key for the projection of this expenditure in the 2016 budget: 1) nominal wage increase for certain categories of employees, 2) the scale and timeframe of staff rightsizing, and 3) the scale and timeframe of severance payments to the employees laid off in this process. The wage increase at the beginning of 2016 was generally supposed to be offset by the planned staff cuts, while the amount of severance payments was expected to ultimately determine the total wage bill. However, significant changes have been made in the rightsizing process, which have lasting effects on the trends of this expenditure category. The lower amount of severance payments will partly reduce the total amount of employee expenditure, while changes in the execution timeframe will result in slightly higher wage expenditure (excluding severance payments) than originally planned.

According to the rightsizing plan, the number of public sector employees was supposed to be cut by 75,000 by the end of 2017. After an analysis of the number and structure of employees by relevant national and international institutions, the rightsizing plan was revised to 25,000-30,000 persons. According to the most recent available figures, as of Q4 2016, the number of employees is about 22,000 lower than at the end of 2014. The volume and dynamics of severance payments was also influenced by increased natural staff turnover through retirement. Savings on this basis were made due to slower recruitment of replacements to the vacant posts. It is estimated that there will be no structural increase in pension expenditure on this basis, because the employees concerned are already eligible for retirement and the existing penalty system includes deterrents from early retirement. By the end of 2016, employee

² This revenue and expenditure was treated as own-source revenue and was included in the plan, but was not covered by regular monthly reporting by the Treasury of the City of Belgrade.

expenditure will be reduced to 10.1% as a percentage of GDP, which is within the EU average and contributes to achievement of the goals set by the existing fiscal rules (7% of GDP). However, the existing arrangements in this field should be reviewed for effectiveness in the coming period and the amount of employee expenditure as a percentage of GDP should be revised as appropriate to a level that would be more socially and economically acceptable.

Expenditure for the purchase of goods and services has seen the greatest change compared with the budget plan for 2016. The new estimate of expenditure for goods and services is RSD 15.5 billion (5.7%) higher than originally planned, while the current rate of increase stands at 16.5%. The greatest increase in this expenditure is seen at the local level, where the changes in the planned amount are essentially due to execution of the expenditure to date. The main reason for the increased execution of expenditure at the local level is of a methodological nature and is due to the expanded scope of local budget execution reports. Namely, the expanded coverage of local government revenue has for the most part resulted in an increase in spending presented under this expenditure category.

Interest expenditure is a category expected to yield significant savings compared with the amount planned in the budget. The trends in the overall fiscal balance indirectly influence also the trends in interest expenditure. Apart from the amount of deficit, the interest amount is also influenced by the interest rate risk and the foreign exchange risk for liabilities presented in foreign currency. All this risks were taken into account in the planning of interest expenditure. Almost all of these factors have been favorable in 2016. The significantly lower fiscal deficit influenced the overall level of new borrowing, due to a satisfactory level of budget liquidity, it was possible to avoid issuing certain short-term securities. On the other hand, favorable trends of the US dollar and a stable exchange rate of the euro offset any foreign exchange risk, which, coupled with lower interest rates in the international market, contributed to lower interest expenditure.

Trends in pension expenditure in 2016: the revised objectives of staff rightsizing in the general government sector and the lower-than-planned increase in the number of pensioners contributed to a downward revision of pension expenditure. The projection for this expenditure category made at the end of 2015 included a provision to accommodate an expected faster inflow of new pensioners from the public sector rightsizing process (which included public enterprises) and completion of restructuring of the remaining enterprises undergoing privatization. In addition, it also included a provision for an increase in the number of pensioners in those categories of workers that had received coverage for years of service during which their employers failed to make social security contributions. Other factors that influenced the total estimate of pension expenditure included the linear increase in the nominal pension amount and the increase in the amount due to military pensioners pursuant to a decision of the Constitutional Court. The plan for 2016 envisaged an increase in the number of pension beneficiaries by more than 1%, which was in line with the trends seen in earlier years.

After ten years in which the number of pensioners increased, 2015 saw for the first time a reduction in the total number of pensioners by 0.2% or 3,200 persons. This trend has continued in 2016. In addition to the mild reduction in the total number of pension beneficiaries, the structure of various forms of pensions has been changed, with a reduction in the number of disability pension beneficiaries and a slightly lower reduction in the number of family pension beneficiaries. The measures put in place to prevent abuse in this field also contributed to this. While the number of old-age pensions continues increasing, but at a noticeably lower rate. Such trends are also a result of parametric measures, including phased-in increase in the retirement age and penalties for early retirement. Based on these trends, the estimated total pension expenditure was revised downward by 2.3% from the planned amount. It should be noted that the one-off assistance payments to pensioners are not presented as part of the overall pension expenditure; instead, they are treated as a form of other transfers to households.

Expenditure for social security benefits and other transfers to households will exceed the planned amount, primarily due to the one-off assistance to pensioners. Every pension beneficiary has received RSD 5,000 regardless of the amount of his/her pension. The total effect of this one-off benefit is RSD 8.6 billion. Certain forms of expenditure for social security benefits and other transfers to households will be lower than originally planned. Only half of the total planned amount for severance payments to the workers of the enterprises in restructuring will be spent in 2016, while the remainder of RSD 3 billion is planned for 2017, when the restructuring process is expected to be completed. Due to the expected higher inflow of beneficiaries of the National Employment Service (as a result of completion of restructuring and rightsizing in the public sector), a slightly higher amount of unemployment benefits had been planned. So far in 2016, execution of this expenditure has been significantly below the planned level. On the other hand,

social security benefits at the local level have increased as a result of increased coverage of certain funds, as already explained above. The amount of debt payments to military retirees pursuant to court judgments has also been increasing. Namely, some of the beneficiaries refused to settle out of court, opting instead to collect their claims through enforced collection pursuant to individual court judgments.

Due to the planned one-off expenditures, subsidy expenditure is a category in which execution under the new framework is expected to be higher than the budgeted amount. A sharp reduction in the total amount of subsidies had been envisaged for 2016. Subsidies for arable areas of more than 20 hectares and for leased land owned by the Republic of Serbia have been abolished. Subsidies for public broadcasting services have been cut from RSD 8 billion to RSD 4 billion. Execution at the end of the year will be higher than planned due to the assumption of Petrohemija's debt in the amount of RSD 12.9 billion, which is categorized as a subsidy. Local subsidies have been reduced compared with 2015; however, this is a result of the abovementioned methodological changes in the coverage of beneficiaries, which led to changed classification on the expenditure side.

Repayment of guarantees and subsidies will deviate significantly from the amounts planned in the 2016 budget. Execution of the budget for this expenditure reached the planned level in September. The reason for this trend is positive in its nature and is associated with prepayment of the guaranteed amount of debt (debt owed by companies "Galenika" a.d. and PE "Srbijagas"), which will bring significant savings on the side of interest expenditure in the coming period. According to the plan, PE "Srbijagas" was supposed to repay independently a portion of the debt to its creditors; however, this has not been fully achieved. Even with the improved liquidity position, this company is still unable to alone fully service its debt.

Other current expenditure has been increased compared with the budget plan. This increase is in part due to the general and local election and the transfers made to political parties. The increase in this expenditure at the national level is also due to the development of expenditures for penalties paid under court judgments and in enforced collection procedures, which is a form of expenditure that is impossible to forecast. There is a risk that the total amount of this expenditure may exceed the currently planned level.

Execution of public investment has improved considerably from comparable periods in earlier years. Capital expenditure has seen the largest increase of all expenditure categories in the period January–September 2016. By the end of September, capital expenditure reached more than RSD 86 billion, which was an increase of more than 35% compared with the same period last year.

Table 8. Execution of capital expenditure by government levels, in RSD billion

	Jan - Sept 2015	Jan - Sept 2016	Δ
National budget	15.0	18.5	3.5
Project loans	12.5	18.4	5.9
Local self-governments and P Vojvodina	20.0	25.5	5.5
PE "Putevi Srbije" and "Koridori Srbije" d.o.o.	15.9	23.4	7.5
CSIO funds	0.5	0.6	0.1
TOTAL	64.0	86.3	22.3

Source: MoF

The highest increase in capital expenditure was the result of withdrawal of project loans used for the construction of road and railway infrastructure, along with a noticeable intensification of project execution at the local level. These are undeniably positive results of execution of public investment, as the expenditure was made for the construction of Corridors 10 and 11 and revitalization of the railway infrastructure. On the other hand, the increase in capital expenditure at the national budget level has been lower and approximately RSD 1.9 billion was paid in order to replenish strategic oil reserves, i.e. it was not an investment in infrastructure. In the past, execution of capital expenditure at the local level had been characterized by a spike in execution in the last quarter of the year, followed by a traditional slump in the first months of the next year; however, 2016 saw a reversal of these trends. As a rule, execution of capital expenditure at the national level tends to spike in the second half of the year, so 2016 can be expected to end with a sound increase in total capital expenditure. This undoubtedly positive tendency will bring about to a mild increase in public investment as a percentage GDP, which has been extremely low in recent years.

Table 9. General government revenue, expenditure and fiscal balance, in RSD billion

	Jan-Sept 2015	Jan-Sept 2016	Jan-Sept % of increase	2016/2015 % of increase
PUBLIC REVENUE	1,237.7	1,352.4	9.3	7.4
Current revenue	1,232.8	1,344.6	9.1	7.2
Tax revenue	1,066.9	1,163.6	9.1	7.5
Personal income tax	105.7	112.7	6.6	5.7
Corporate income tax	50.4	62.6	24.1	25.3
Value added tax	304.5	331.5	8.9	7.6
Excise duty	167.3	198.1	18.4	12.5
Customs duty	24.1	26.6	10.2	8.9
Other tax revenue	46.7	48.2	3.4	1.4
Contributions	368.2	383.9	4.3	4.0
Non-tax revenue	166.0	181.0	9.1	5.6
Grants	4.9	7.8	59.8	44.1
PUBLIC EXPENDITURE	1,288.8	1,356.9	5.3	3.5
Current expenditure	1,200.3	1,239.7	3.3	2.3
Employee expenditure	306.2	308.1	0.6	0.8
Purchase of goods and services	174.7	193.0	10.5	11.4
Interest repayment	105.7	109.6	3.7	6.7
Subsidies	67.8	62.5	-7.8	-10.6
Social allowances and transfers	515.4	526.5	2.2	0.9
<i>out of which, pensions</i>	365.9	369.1	0.9	1.2
Other current expenditure	30.5	40.0	31.1	13.4
Capital expenditure	64.0	86.3	34.9	13.7
Net lending	2.0	2.6	30.9	28.3
Repayment of guarantees	22.6	28.1	24.7	29.5
RESULT	-51.1	-4.5		

Source: MoF

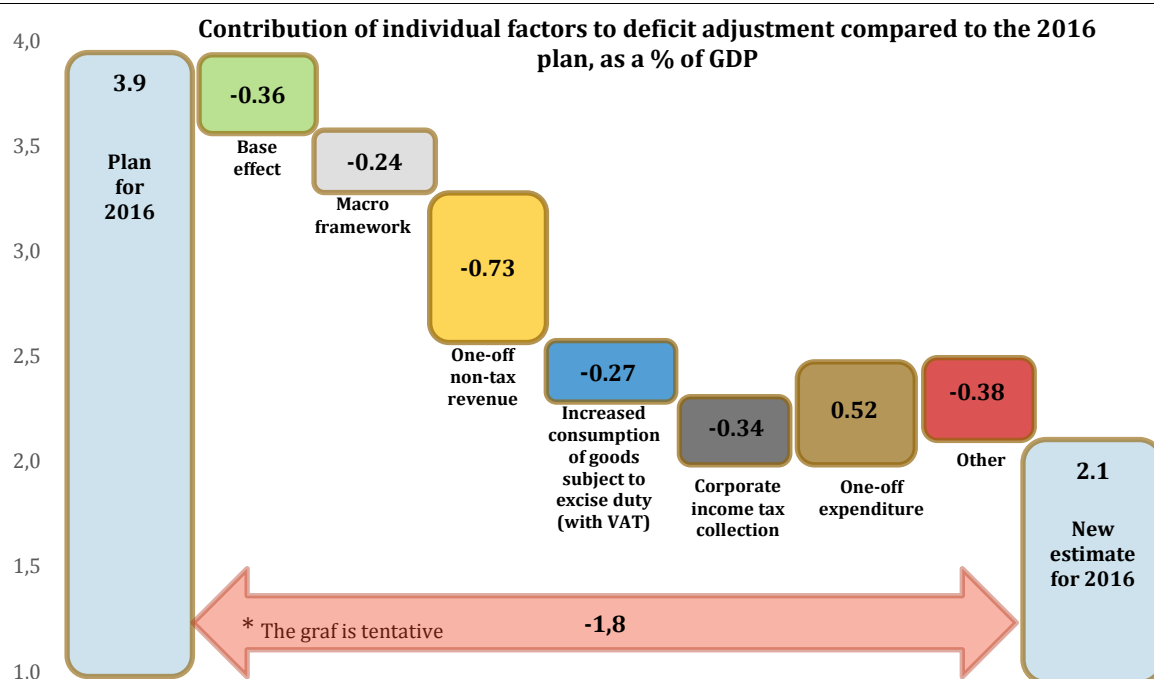
The amount of arrears of budget beneficiaries and compulsory social insurance organizations as at the last day of September 2016 was RSD 5.2 billion (about 0.1% of GDP), which was RSD 1.6 billion lower than at the end of 2015. Budget beneficiaries and PE "Putevi Srbije" reduced their arrears by RSD 1.6 billion, while the arrears of compulsory social insurance organizations remained unchanged.

Table 10. Balance of past-due debt of budget spending units and CSIO, in RSD billion

	31.12.2015.	30.9.2016.
Budget beneficiaries and PE "Putevi Srbije"	5.4	3.8
CSIO	1.4	1.4
Total	6.8	5.2

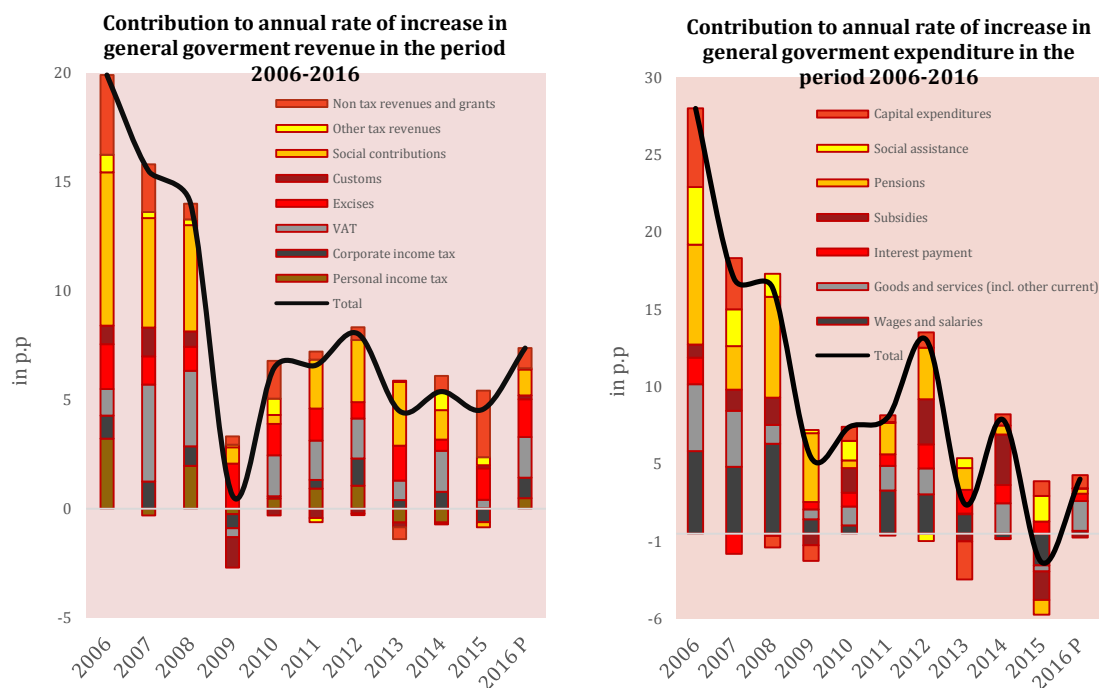
Source: MoF

The more favorable fiscal position in 2016 was mostly due to improved revenue collection. The factors that contributed to the downward revision of the fiscal deficit in 2016 can be categorized in the following groups: the effect of the base value (execution in 2015), the effects of the revised macroeconomic framework, the estimated collection of one-off non-tax revenue, trends in the consumption of goods subject to excise, significantly improved collection of corporate income tax etc. These factors and their effects have been identified primarily for analytical purposes. The total effect of all identified factors on the estimated deficit in 2016 is 1.8%.



Total revenue collection in 2015 was RSD 19 billion higher than the estimate which served as the basis for the 2016 plan. Out of that amount, RSD 4 billion had no effect on the deficit, so the identified base effect which contributed to the lower deficit was RSD 15 billion, or 0.36% of GDP.

The effect of the revised macroeconomic framework in terms of a lower fiscal deficit is estimated at 0.24% of GDP. The effects of faster economic growth (revised from 1.8% to 2.7%) on individual types of tax have already been discussed. The estimate of the overall effect obtained in this analysis is based on the concept of sensitivity of public revenue relative to the real GDP growth rate. A stronger growth of economic activity is reflected primarily in increased social security contributions and personal income tax, as well as other forms of revenue. Some forms of non-tax revenue are also influenced by the level of economic activities. The macro effects on VAT trends are somewhat lower due to the effect of lower inflation on nominal consumption, as well as due to other factors, including increased lending, trends in other forms of disposable household income and collection efficiency. It should be noted that the effect thus calculated does not include consumption of goods subject to excise, which is identified separately (and is certainly influenced by the macro environment), because it was assumed that consumption would remain constant in the original projection of excise revenue. Furthermore, a minor share of the effect of the improved macroeconomic framework on lower fiscal deficit as a percentage of GDP may be attributed to the higher-than-planned nominal GDP.



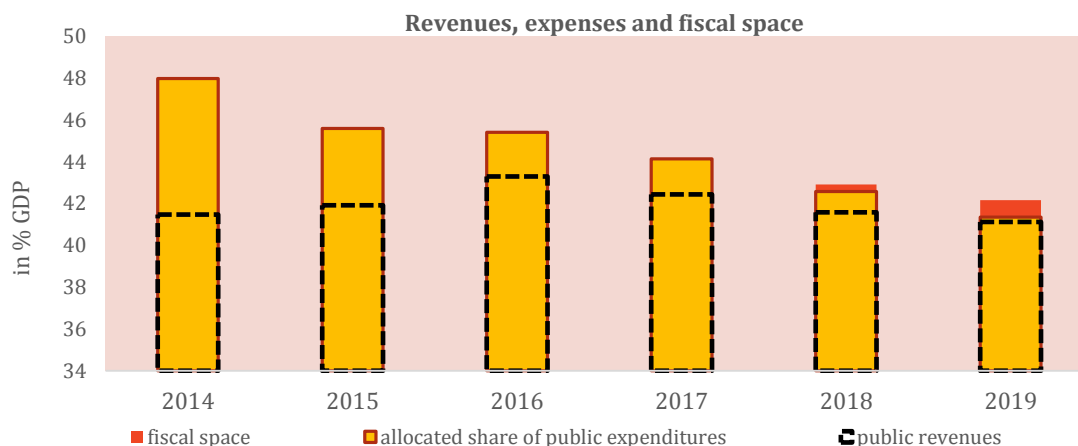
Other factors which contributed to Serbia's improved fiscal position include continued increase in overall tax collection efficiency, trends of VAT refund amounts and timeframe compared with the originally planned levels, significantly improved collection of corporate income tax, payment of extraordinary non-tax revenue and underperformance of specific categories of expenditure. A factor that will have negative effects on the deficit level in 2016 is the assumption of debt of HIP Petrohemija and its conversion to public debt. The payment of one-off assistance to pensioners will also increase the deficit.

3. Fiscal projections for the period 2017 to 2019

In the upcoming mid-term period the goals of fiscal policy will be further reduction of fiscal deficit and public debt. The mid-term fiscal framework envisages a decrease in the general government deficit to 1% GDP by 2019 and the share of public debt to below 70% GDP. This calls for structural fiscal adjustment of approx. 4% GDP, of which an adjustment of 2.6% was done already in 2015, and of approx. 1.3% of GDP in 2016. Structural deficit is the level of deficit that does not depend on the economic cycle and which excludes one-off revenues and expenditures. The primary result, as a difference between the fiscal result and net repayment of interest, has a rising trend and we are expecting, already this year, to have primary surplus. Fiscal aggregate projections for the period 2017 to 2019 are based on projections of macroeconomic indicators for this period, planned tax policy which necessitates further compliance with the EU laws and directives and appropriate measures on both the revenue and expenditure side, including also the reforms of large state-owned enterprises.

Thanks to fiscal consolidation measures, fiscal space has been created for new policies. Fiscal space is a positive difference between the targeted and expected deficit i.e. these are the available funds that are created as a difference between the expected revenue and distributed expenditure. Decrease in deficit, primarily through adjustments on the expense side of the budget, and favourable macroeconomic trends that resulted in better results on the revenue side, brought about a result that is better than expected. Accordingly, in the upcoming period, the level of deficit, in case of unchanged policy, will be lower than the targeted deficit, which will enable the adoption and implementation of new policies. Fiscal space allows fiscal policy makers greater freedom in choosing the manner in which the funds are distributed, given that they have a greater number of options at their disposal. Fiscal space can be used on both the

expense and revenue side by reducing the tax rates or by abolishing certain levies. If fiscal space were to be used for prepayment of debts or for increase in deposits, the deficit would go even further down. In the assumed mid-term fiscal frame, the fiscal space is shown as undistributed portion of expenditures.



Fiscal space in 2017 will be used to increase pensions and salaries in one part of the public sector. Thanks to excellent fiscal results in 2015 and 2016 a partial increase in salaries and a slight increase in pensions for all pensioners will be possible. Salary increase in one part of the public sector, in the amount of 3-6% and an increase in pensions of 1.5% will increase the deficit by approx. 0.4% of GDP. These measures and their amounts have been designed so as not to endanger the intensity of fiscal consolidation and the pace at which public debt is reduced, and on the other hand to raise the standard of living for one part of the population and to stimulate personal consumption.

Table 11. Fiscal aggregates in the period 2015–2019, % of GDP

description	performance	estimate	projection		
	2015	2016	2017	2018	2019
Public revenue	41.9	43.3	42.4	41.6	41.1
Public expenditure	45.6	45.4	44.1	42.9	42.1
of which fiscal space				0.3	0.8
Consolidated fiscal result	-3.7	-2.1	-1.7	-1.3	-1.0
Primary consolidated result	-0.5	1.2	1.4	1.6	1.7
General government debt	76.0	74.6	73.9	70.7	67.0
Real GDP growth rate	0.8%	2.7%	3.0%	3.5%	3.5%

Source: MoF

Public debt trajectory was reversed and already as of 2016 the share of public debt in GDP has begun to go down. In the last two years, thanks to fiscal and structural measures, the growth in debt was first slowed down and this year, for the first time, there has been a decline in the share of public debt in GDP. Decrease in debt is closely related to the reduction of deficit as the key factor of indebtedness, so the speed of reducing the deficit determines also the change in the trend of debt. It is estimated that optimum fiscal deficit for a long-term reduction in debt is approx. 1% of GDP, but the lower the long-term deficit, the faster the reduction of public debt. Financial transactions, such as a replacement of an expensive debt with a cheaper one, as well as better position of the government in the international financial market, will also contribute to further reduction of debt.



Public finance consolidation will continue in 2017. In the process of reducing the number of employees in the general government approx. five thousand people are expected to be made redundant. The process of restructuring state-owned enterprises and the former socially-owned companies will continue in order to reduce the burden that these companies currently place on public finance and on the whole economy. In accordance with the Law on Municipality Financing the revenue from salary tax has been redistributed into the budget of the state, in the amount of approx. RSD 5 billion. Apart from reducing the general government deficit, the aim of this measure is also to encourage municipalities to improve the collection of revenue from their area of competence, primarily property tax, and to improve their finances.

Stronger growth of economic activity will result in the recovery of the revenue aspect of the budget. Observed by the share of GDP, total government's revenues, excluding indirect beneficiaries, are on the decline, given that the nominal GDP growth is faster than the growth in revenues. Namely, tax revenues mostly depend on the trends in personal consumption, whose pace of growth is slower than the projected growth rate of nominal GDP. Higher GDP growth rates in the period 2017 to 2019 will contribute to more dynamic growth in tax revenues compared to the past period. Recovery of the labour market, as well as the growth in the population's available income and personal consumption, together with continued combat against grey economy and tax evasion will be the factors that will decisively boost revenues.

Table 12. Total revenue and donations in the period 2015–2019, % of GDP

description	actual	estimate	projection		
	2015	2016	2017	2018	2019
PUBLIC REVENUE	41.9	43.3	42.4	41.6	41.1
Current revenue	41.7	43.0	42.1	41.3	40.9
Tax revenue	36.2	37.4	37.3	36.7	36.5
Personal income tax	3.6	3.7	3.7	3.7	3.7
Corporate income tax	1.6	1.9	1.8	1.8	1.8
VAT	10.3	10.6	10.6	10.4	10.3
Excises	5.8	6.3	6.2	6.0	5.7
Customs	0.8	0.9	0.9	0.9	0.9
Other tax revenue	1.6	1.5	1.5	1.4	1.3
Contributions	12.5	12.5	12.6	12.6	12.7
Non-tax revenue	5.5	5.6	4.8	4.6	4.4
Donations	0.2	0.2	0.3	0.2	0.2

Source: MoF

Revenue projection for the period 2017 to 2019 was based on:

- the current tax policy;
- projected trends for the most important macroeconomic indicators: GDP and its

components, inflation, exchange rate, trends in foreign trade, estimate of trends in employment and salaries;

- estimated effects of the remaining fiscal consolidation measures, specifically the reduction in the number of employees in the public sector and restructuring of state-owned enterprises and former socially-owned companies.

No major changes are planned in the tax policy and the level of the existing tax rates. This allows for greater reliability of revenue assessment, as it always takes for a certain time for the new rates to become fully effective and for the entities in the tax system to adjust their behaviour. Revenue projection also includes the maintaining of the existing level of collection of all structural forms of total revenue.

Personal income tax reflects the trends in salaries and the level of employment in the economy. Personal income tax has been projected at about 3.7% of GDP throughout the mid-term period. Projected amounts are in line with the salary policy in the public sector, the planned reduction of the number of employees in entities that are the beneficiaries of public funds and the anticipated positive trends in employment and average salaries in the private sector, in accordance with the recovery of the economic activity. The prevailing form of personal income tax is the wage tax. Therefore, the trends in the wage bill and employment are the key factors that affect the trends in this tax form. The second part of the total personal income tax is the dividend tax, interest income tax, annual personal income tax, etc. One of the reasons for a decrease in this category is the lower revenue from interest tax caused by the general reduction in interest rates and the consequent decrease in income from savings. Income from dividends and other forms of income tax is consistent with the trend in general economic activity and salaries. A certain level of risk in collection of tax on wages is present if a nominal increase in wages in the private sector fails to materialize or if that increase is lower than planned. In this tax category the key factor is the fight against grey economy, given the large number of unregistered employees and “cash in hand” payment of salaries. During 2015 and 2016 controls and sanctions were intensified, which returned great results in combating grey economy in labour and employment field, but it is very important to continue with this kind of efforts in the upcoming period as well.

It has been projected that the share of contributions for obligatory social security in GDP will be stable in the mid-term period. Trends in the share of this public revenue in GDP has a trajectory similar to the share of wage tax, given that their projection was based on the same assumptions about the trends in wages and employment in the upcoming mid-term period. The only difference is the contributions that are collected for insurance of farmers and entrepreneurs. Contributions are a tax category where the lack of tax discipline is the highest and where the tax payers have the largest debt. Although there have been changes over the past period in the rates at which social contributions are calculated and collected (during 2013 the rate for pension and disability contributions increased from 22% to 24%, with a reduction in the tax rate for salaries from 12% to 10%, whereas in 2014 the rate of pension and disability contribution increased from 24% to 26%. At the same time, the rate of contributions for health insurance went down from 12.3% to 10.3%). No further changes have been planned in the level of rates for the upcoming period.

Stable revenue from corporate income tax has been planned for the period 2017-2019 (1.8%). Collection of corporate income tax in the upcoming three-year period will depend on the expected economic recovery, stability of the dinar exchange rate and on the overall profitability of the economy. Estimate of the revenue from this source is characterized by high uncertainty during the projection phase, due to both the economic factors and the possibility of using tax credit or a refund. Mid-term projection does not envisage more significant changes in the legislation and the prudential approach resulted in a very conservative projection of future collection of this tax form. This is supported also by the fact that the effects of abolishing tax reliefs from 2013, due to the transitory period of several years, were not included in the projection and there is a possibility that this tax revenue will be higher.

Trends in revenue from value added tax is characterized by a slight decrease in the share of GDP, given that a slower growth in personal consumption has been projected against the nominal GDP growth. The key factor in the VAT trend is the local demand determined by the population's available

income. The available income as a determining factor of consumption depends on the trends of wages in the public sector, pensions, welfare benefits, trends in the wage bill in private sector and other forms of income, including remittances, as well as the lending activity of banks towards the population. Relaxation of fiscal consolidation measures in the domain of public sector salaries and pensions will contribute to the increase in the population's available income, but on the other hand, a process of restructuring and reducing the number of employees in the public sector is being finalized and it will weaken these effects. Nominal growth of wages and employment in the private sector, due the anticipated acceleration of the economic activity, trends in remittances and lending activity will have, as a final result, quicker nominal growth in personal consumption in the upcoming period. However, due to reorientation of the economy, a gradual decrease in the share of revenue from VAT in GDP is planned from 10.6% of GDP in 2016 to the expected 10.3% in 2019. Also, the projected growth in exports in the upcoming period will result in an increase in VAT refund and will increase the level of collected VAT. Risks for the achievement of projected VAT in the upcoming period are similar to those of the personal income tax and relate to the trends in salaries in the private sector, increase in economic activity as well as the degree of grey economy i.e. the effectiveness of reducing it. Additional revenue coming from the measures to combat grey economy was not included in the projection, which leaves open a possibility for the current revenue estimate to be exceeded.

Results of more efficient collection and control of tax payers are evident and it is expected that this trend will continue in the upcoming period. However, the effects of combating grey economy are not explicitly included in the mid-term projection of public revenue. Increased level of VAT collection, in terms of implementing independent anti-evasion measures in the field of value added tax has yielded certain results over the past period. In this segment there is room for improvement. Strengthening tax administration will be continued with consistent implementation of the transformation program for the Tax Administration, with the aim of improving the collection of revenue. It is estimated that the improvement of the efficiency of collection, over the following four year period, might increase VAT revenue by 1.8% of GDP.

Projection of revenue from excise tax has been made on the basis of the existing excise policy and the projected consumption of excise goods (petroleum products, tobacco products, alcohol, coffee and electricity). Within the excise tax policy for tobacco products, in the upcoming mid-term period we expect further gradual compliance with the EU directives. This means adopting a mid-term plan of a gradual increase in excise burden. For cigarettes it will be done through gradual increase in excise tax in order to reach the EU minimum, within an acceptable period, of 1.8 euros per pack. It is necessary for these changes to be carefully designed in order to avoid changes in the structure and volume of consumption that would threaten budget revenue, but also to avoid them going against the goals of the public health policy. In the upcoming period, for the purpose of projecting the revenue from excise tax, and for the sake of caution, further decline in the legal tobacco market is anticipated at about 3% on average, per year. If the improvement of conditions in the tobacco market continues and if grey economy goes down, there is certain "positive risk" regarding the collection of this form of revenue.

Unlike tobacco, the situation in the oil derivatives market is considerably less volatile. Better control and effects of marking oil derivatives and adjustment of the derivative price to that in the region have eradicated the possibility and profitability of illegal activities. In the upcoming years, for the sake of caution, continued increase in consumption of oil derivatives is not planned. However, we can expect that the growth in personal consumption and acceleration of economic activity will contribute to the increase in consumption, which is already attested by the data on collection of excise taxes in 2016. In this case also there is certain "positive risk" when it comes to collection of revenue if the rising trend in the oil derivative market continues.

Revenue from excise tax on alcoholic beverages, coffee and electricity has been projected in accordance with the existing consumption strategy. The current nominal amounts of excise on alcoholic beverages and coffee have been adjusted with the expected level of mid-term inflation rate. During 2015 an ad valorem excise was introduced of 7.5% for the consumption of electricity. For the period 2017 – 2019

the revenue from this excise per annum was planned in the amount or approx. RSD 15 billion, bearing in mind the current annual consumption and the current prices.

Key determining factors for projection of revenues from customs are the trends in export and exchange rate. Revenue from duties in 2016 accounted for 0.9% of GDP and it can be expected that they will remain at this level in the future. Bearing in mind the expected trends in consumption, exchange rate, as well as completion of the process of complying duty tariffs as a result of implementation of the Stabilization and Association Agreement, it has been planned to gradually increase these revenues in nominal terms, while no change in the share of revenue from customs in GDP is planned for the upcoming period.

The most significant tax form among other tax revenues is the property tax, whose share is 70% in this group of tax revenues. These revenues, which include also the tax on use, possession and transport of goods, other forms of tax on the local level, etc. have been projected in accordance with the trends in inflation, given that the inflationary component has been incorporated into a significant portion of these tax forms. The level of these revenues is relatively stable and reactions to the decrease in economic activity are not significantly pronounced. In the upcoming mid-term period the share of other tax revenues is being stabilized.

Non-tax revenues are a very heterogeneous category with various trends in different forms. Non-tax revenues have reduced their mid-term share in GDP, after a surge in 2015 and 2016. This surge came as a result of receiving the funds from a reduction in public sector salaries (state-owned enterprises and municipalities), higher revenue from dividends and profit from state-owned enterprises, as well as introduction of a surcharge for obligatory oil reserves. A reduction in the share of non-tax revenues in GDP is planned, from the expected 5.6% of GDP in 2016 to the expected figure of 4.4% in 2019. Reason for the decrease in the projected share in the upcoming period is the exclusion from the baseline 2016 of all the revenues that are not considered structural i.e. permanent, which mostly relates to extraordinary categories of non-tax revenue. Certain non-tax revenues are indexed by the inflation realized in the previous year, while other are dependent on the change in the value of the basis they apply to and are, therefore, adjusted to the projected inflation, whereas one portion is made up of one-off payments to the budget (extraordinary non-tax revenue). Regular non-tax revenue includes different taxes, charges, fines, revenue of various bodies and organizations and all other revenues that are generated in the established cycle during the year in roughly similar amounts per month, with certain seasonal variations. Extraordinary non-tax revenues are mostly one-off in nature and are uncertain to some extent, both in terms of amount and the moment of payment. The greatest portion of these revenues are payments from the profit of state-owned enterprises and agencies, budget dividends, revenues from collected receivables of the Deposit Insurance Agency, issuance premiums, etc.

With the process of EU accession the funds from IPA funds have increased and these funds form the largest part of revenue from donations. The projected amounts for donations include also the funds from the EU for budget support.

Restrictive fiscal policy in combination with good macroeconomic performance created fiscal space in the period 2017 to 2019 that could be used, among other things, also for new policies on the expenditure side. The key fiscal consolidation element was the correction in the expenditures. The largest part of adjusting is related to the expenditures for employees and for pensions, given that these two items make up more than 50% of total expenditure. Good results of consolidation are seen in the reduction of interest expenditures, given the lower need for borrowing. Apart from this, the reduction in expenditure will be contributed by the completion of the restructuring process of socially-owned companies, resolution of the issue of inefficient government-owned enterprises and stabilization of the financial sector. Significant effect would certainly come if a portion of the available funds was used for increase in capital investments, as an important component for the development of the economy.

Fiscal trends over the past two years and the prospect for the upcoming period allow for a change in the structure of expenditure in favour of the development aspect of the budget, primarily

the increase in capital expenditure. The structure of expenditure is currently unfavourable, given that a significant portion are liabilities arising from inefficient operation of some segments of the public sector, such as subsidies and activated guarantees, high interest, while the realization of capital investments is insufficient. Social component of the budget can be improved with better targeting of the welfare benefit programs and greater transfers for healthcare and education. Until 2019 the salaries and pensions will stabilize their share in the GDP, which will be another factor that will allow for a more fair allocation of revenue with a decreased pressure on public finance.

Table 13. Total expenditure for the period 2015 – 2019, % of GDP

description	performance	estimate	projection		
	2015	2016	2017	2018	2019
PUBLIC EXPENDITURE	45.6	45.4	44.1	42.9	42.1
Current expenses	41.9	41.3	40.0	38.5	37.4
Expenses for employees	10.4	10.1	9.9	9.3	9.2
Purchase of goods and services	6.4	6.8	6.8	6.8	6.8
Repayment of interest	3.2	3.3	3.1	3.0	2.7
Subsidies	3.3	2.9	2.4	2.3	2.2
Welfare benefits and transfers	17.6	17.0	16.5	15.8	15.4
<i>of which pensions</i>	<i>12.2</i>	<i>11.8</i>	<i>11.6</i>	<i>11.1</i>	<i>10.8</i>
Other current expenses	1.1	1.2	1.2	1.2	1.2
Capital expenditure	2.8	3.1	3.3	3.5	3.6
Net budget loans	0.1	0.1	0.1	0.1	0.1
Repayment of guarantees	0.7	0.9	0.8	0.5	0.3
Fiscal space	0.0	0.0	0.0	0.3	0.8

Source: MOF

Reduction in wages, employment freezing and reduction of the number of employees in the public sector are the measures that contributed most to the reduction in expenditures and to the success of fiscal consolidation. Implementation of these measures led to a decrease in the share of wage bill in GDP from approx. 12% in 2014 to 10% in 2016 and in the upcoming period to almost 9% of GDP. The Law on Budget System plans for a decrease in the level of salaries to 7% of GDP. However, it seems that such targeted wage bill level is too low. The average level of general government wage bill in the EU is about 10% of GDP, and the lowest one is 8%, so the adequate share of salaries for Serbia would be 9-9.5% of GDP, which would be achieved as early as in 2018.

Redundancy and unfavourable structure of employees are the problems that have been causing inefficiency of the public sector for a long time and placed a burden on the whole economy. The initial plan for reduction in the number of employees in the public sector called for a decrease in employees of 75,000 in 2017. After extensive analyses of the number and structure of employees in each public sector segment, the plan was revised to 25,000 – 30,000. The final data is that the number of employees has been reduced by approx. 22,000 compared to the end of 2014. For 2017. It is planned that the number of employees be reduced by additional approx. 5,000. For 2018 no additional decrease in the number of employees has been planned, but the effects of the redundancies made in 2017 will be felt. During 2016 a comprehensive reform of the salary system was started and it is aimed at ensuring the fairness and reduction of differences between the employees in the public sector, but this should not have a significant effect on the overall bill of wages. Salaries for some employees in the public sector will increase by 3-6% in 2017. These are the employees in health care, education, the military, police, culture and some employees in the judiciary. The effect of this measure is approx. 0.2% of GDP to the general government deficit.

Share of expenditure for goods and services has been between 6.3 % and 6.8% of GDP for years now. In 2016 the high level of these expenditures was a result of methodological changes on the level of municipalities whose scope for a portion of revenue and the relevant expenditure had been expanded. For this expenditure category, stabilization of share to 6.8% of GDP until 2019 has been planned. New Law on Financing Local Self-government will facilitate the achieving of this goal as it will enable savings exactly

on this expenditure item, starting from 2017.

Reduction in interest expenditures is one of the best indicators of the success of fiscal consolidation. Extremely high public debt and high fiscal deficit led to interest becoming one of the most important expense items and certainly an item with the fastest growth. It is expected that the interests will reach a peak this year and after that their share in the GDP will start decreasing gradually. In 2019 the level of interest expenditures will go down below 3% of GDP. Good results in 2015 and 2016 i.e. lower deficit, have allowed for lower need for borrowing. The trend in interest has been reversed and as early as in 2017 we can expect also nominal decrease in interest expenditures. Improvement of Serbia's position in the international financial market will result in further decline in the amount of interest expenditures.

Social benefits and transfers to the citizens form the largest category in the general government's budget. Reduction in the amount of pensions and a reform of the pension system have greatly contributed to a decrease in the share of pension expenditure in GDP. Their share of GDP will drop from 13% in 2014 to approx. 10.8% in 2019. Apart from the nominal decrease in pensions, what contributed to this trajectory is also the absence of indexation, as well as the changes to the pension system that were adopted in 2014. In 2016 pensions increased by 1.25% and in 2017 they will be 1.5% higher. The effect of increase in pensions in 2017 is about 0.2% of GDP. As of 2018 pensions will be indexed in accordance with the Law on Budgetary System. According to this law, the pensions should be at the level of 11% of GDP, which is confirmed in this fiscal framework as well. Other forms of benefits and transfers to the population in the upcoming period will be adjusted with the implementation of prescribed indexation, current and planned changes to the policies that govern this area and with a projected number of beneficiaries. During 2015 and 2016 there was increased spending for certain forms of benefits, bearing in mind the implementation of fiscal consolidation measures. This means money for severance pays, higher unemployment benefits and possibly higher amounts for pensions. A portion of funds has been allocated for these purposes also. Share of expenditures for benefits is falling from 17.6% of GDP, in 2015, to 15.4% in 2019.

Fiscal adjustment in the observed period will be implemented, to a large extent by reducing the funds for subsidies. In 2016 subsidies have been discontinued for land exceeding the size of 20 ha, as well as for leased government land. In the upcoming three-year period it is planned to reduce subsidies for „Železnice Srbije a.d., Infrastruktura železnice Srbije a.d.“ and for „Srbija Voz a.d.“ as part of restructuring of these companies and reduction in the number of employees. In 2017 it is expected that a number of mines that operate as part of PEU Resavica will be closed, and this will result in the reduced number of employees in this company. This company will receive subsidies next year in the amount of 5.1 bn RSD, of which RSD 0.6 bn are the costs of closing the mine. After that, the subsidies will be reduced, and in case an adequate solution is found for this company, subsidies will be fully abolished. Given the process of restructuring state-owned enterprises and the former socially-owned companies, there will be a reduction in subsidies for this also. Reduction in subsidies that provide assistance to inefficient segment of the public sector would enable an increase in the part of subsidies that would act as true incentives for the economy and which would speed up the economic activity.

The categories of other current expenditure are made up of different outlays such as support to NGOs, political parties, religious and sports organizations, fines, damages, etc. Over the past period the level of this category was approx. 1% of GDP and it was only in 2014 that the share of this expenditure in GDP increased to 1.4% due to the damages caused by the devastating floods. The effect of the Law on Financing Municipalities should have more effect on this expenditure category. By 2019 this expenditure will be at the level of 1.2% GDP.

Capital investments are a category of expenditure that has the greatest effect on the economic activity and is a priority. The share of capital investments in the GDP, which has so far been about 3%, is considered insufficient and it is desirable to raise it to at least 4%. Reduction in the current spending of the government sector has created fiscal space that should be used, at least partially, for increase in investments. Use of funds from the signed international loans is inefficient and insufficient in

capital expenditure. The most important infrastructure works are the ones on Corridors 10 and 11 which are mostly financed from international loans. With the use of a portion of the fiscal space for capital investments, their level could be even higher than 3.6% of GDP, which is the figure currently planned for 2019.

Budget loans are the funds that are mostly given for liquidity and capital increase in state-owned companies and banks. This expenditure increased considerably between 2012 and 2014 as a result of resolving the issue of state-owned banks. We should add to this the takeover of the debt of the JAT company and supplying liquidity to PE Srbijagas. What is new in 2017 is the expenditure for current liquidity in RTB Bor in the amount of RSD 2 bn. Given that no new problems are expected in the banking sector and that one of the priorities in the future is the reform of state-owned enterprises, we expect this expenditure to stabilize at 0.05% of GDP.

Repayments of activated guarantees and payment of guarantees for commercial transactions are the liabilities arising from the debt of the state-owned enterprises which were taken on by the state budget, as these companies could not settle them. These expenditures are a great burden for the budget, given the long-term inefficient operation of a large number of state-owned enterprises and companies. The greatest amounts paid for this purpose were given to PE Srbijagas, Železnice Srbije a.d., Železara Smederevo a.d., JAT and Galenika a.d. It should be noted that considerable funds for this purpose are paid also to PE Putevi Srbije, but this expenditure is classified as standard debt repayment, given that this company is part of the general government. Similarly to the plan for budgetary lending, the importance of this expenditure will also be reduced if the problems with inefficiency in the state-owned enterprises are resolved in the right manner. According to the repayment plan, there will be a considerable reduction already in 2017, whereas in 2019 this expenditure will amount to as little as approx. 0.3% of GDP.

4. Fiscal risks

Over the past years Serbia has faced significant expenditures that resulted from materialized fiscal risks. This primarily means repayments arising from guarantees, court decisions, resolving the issue of state financial institutions, taking over the unguaranteed debts of the state-owned enterprises and their transfer into public debt, etc.

Fiscal risks are an exposure of public finance to certain circumstances that might cause short-term and mid-term deviations from the projected fiscal framework. The departure may arise in revenues, expenditures, fiscal result and as well as government's property and liabilities, compared to what has been planned and expected.

Identification of the greatest fiscal risks that might affect mid-term public finances is the starting point for better management of fiscal risks. There is detailed data about certain fiscal risks and it can be easily determined whether, and with what probability, they will affect the fiscal aggregates in the mid-term. On the other hand, there are not sufficiently detailed data, but even their recognition alone will raise awareness of the possibility that they might lead to deviation from the planned fiscal framework in the upcoming period.

Macroeconomic assumptions and sensitivity of fiscal aggregates

Deviations of macroeconomic assumptions from the baseline scenario might lead to deviation of fiscal aggregates from the projected level.

Negative scenario, which means a decrease in economic activity or lower growth in the upcoming period, would result in significant reduction of the capital inflow and a decrease in foreign trade. In that case, revenues would be lower and deficit would be higher, unless additional adjustments were made on the expenditure side. In accordance with the estimates of the sensitivity of the fiscal balance, each change in the real growth of 1pp of GDP will result in a change in fiscal result of approx. 0.36% GDP. In case that the future three-year period achieved real GDP growth rates are lower (by 1pp lower per year, on average) than planned, the cumulative increase in fiscal deficit would amount to over RSD 40 bn.

Inflation is the key determining factor of the overall macroeconomic stability. Due to modification of fiscal rules on indexation of salaries and pensions, in the upcoming period, inflation will have a lesser effect on the overall level of expenditure than has been the case so far. As for the revenue side, the effect of inflation on indirect taxation can be favourable, in the short run, but due to the inevitable adjustment of the real level of spending, that effect will be lost if the level of revenue is limited. Exchange rate has a similar short-term effect. Certain revenue items are adjusted for inflation, on a yearly basis (mostly non-tax revenues and the level of certain excise rates), so there is certain risk from that side, but due to low projected inflation, that risk is not high. Inflation, on the other hand, may indirectly affect the deficit and public debt. In case it ranges significantly above the targeted values, during the process of adjusting the relevant interest rates, there might be an increase in interest on public debt. On the other hand, the consumer price index significantly affects the trends in the overall GDP deflator and also the level of the nominal GDP, as denominator of the share of deficit and the public debt in GDP.

Apart from the level and the structure of public debt, what also affects the interest expenses are the factors such as the exchange rate and the interest rates in the international and local market. Given the unpredictability of the trends in certain variables, it is possible that there will be increase in the funds required for interest payments in the

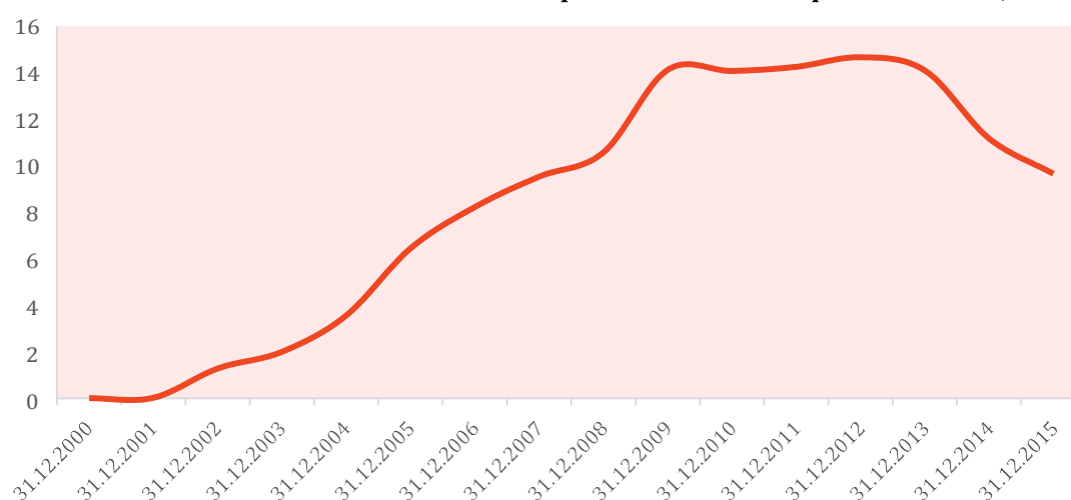
upcoming period. Interest policy of certain international institutions (the FED, ECB, etc.) might affect the overall level of interest rates in the international market, which is additional fiscal risk for a small and open economy like the Republic of Serbia.

State guarantees

Guarantees issued by the state affect the level of public debt, but also the level of deficit, if the repayment of the loan is assumed by the state, instead of the original debtor.

Issued guarantees, according to the definition in the Law on Public Debt³ are a portion of indirect liabilities and are included in the public debt⁴ in the full amount. Indirect liabilities (guarantees issued by the Republic of Serbia) accounted for 9.7% in the total public debt, according to the national methodology, at the end of 2015. The greatest share of these liabilities in the public debt, slightly above 14% on average, was recorded between 2009 and 2013.

Share of indirect liabilities in the public debt of the Republic of Serbia, %



At the end of 2015 the stock of debt for issued guarantees was EUR 2.4 bn i.e. 7.2% of GDP. The stock of debt for this was reduced by a little more than EUR 300 million.

Table 14 the stock of debt for issued guarantees in EUR million

Beneficiary	31.12.2015.	30.09.2016
JP Srbijagas	644.8	480.5
JP Putevi Srbije	456.8	433.9
Železnice Srbije a.d.	346.0	311.3
Air Serbia a.d. Beograd	32.7	27.0
Galenika a.d.	57.5	44.8
JP EMS	45.7	42.1
JP EPS	172.7	179.0
Građevinska direkcija Srbije	0.0	0.0
RTB Bor	140.6	122.8
Flight Control Agency of Serbia and Montenegro	25.9	18.7
JP Jugimport - SDPR	38.0	33.5
FIAT doo	127.3	111.7
Nikola Tesla Airport	7.3	6.8
JAT Tehnika d.o.o.	4.8	4.8
JP Emisiona tehnika i veze	12.8	16.6
Local self-governance (cities and municipalities)	243.5	244.1
Development Funds	21.3	5.9

³ Law on Public Debt "RS Official Gazette" No. 61/2005, 107/2009, 78/2011 and 68/2015.

⁴ Definition of debt, according to the Maastricht Criteria treats issued guarantees differently compared to the definition of public debt in the local legislation. According to the Maastricht Criteria, only activated guarantees are included in public debt (general government debt). Local legislation has a more conservative approach to this issue and all issued guarantees are included in the public debt.

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Export Credit and Insurance Agency	19.6	7.8
TOTAL	2,397.1	2,091.2

Source: MOF, Public Debt Administration

Total planned repayment for this in 2016 is RSD 61 bn. Accounting methodology used until 2014 did not include into the expenditure the repayments of guarantees⁵. As of 2014 a portion of these expenditures is included in the budget expenditure⁶. Independently of the budget and accounting presentation, the debt that the government pays instead of the main debtor increases the overall need for borrowing.

Repayment of debt from guarantees in RSD bn

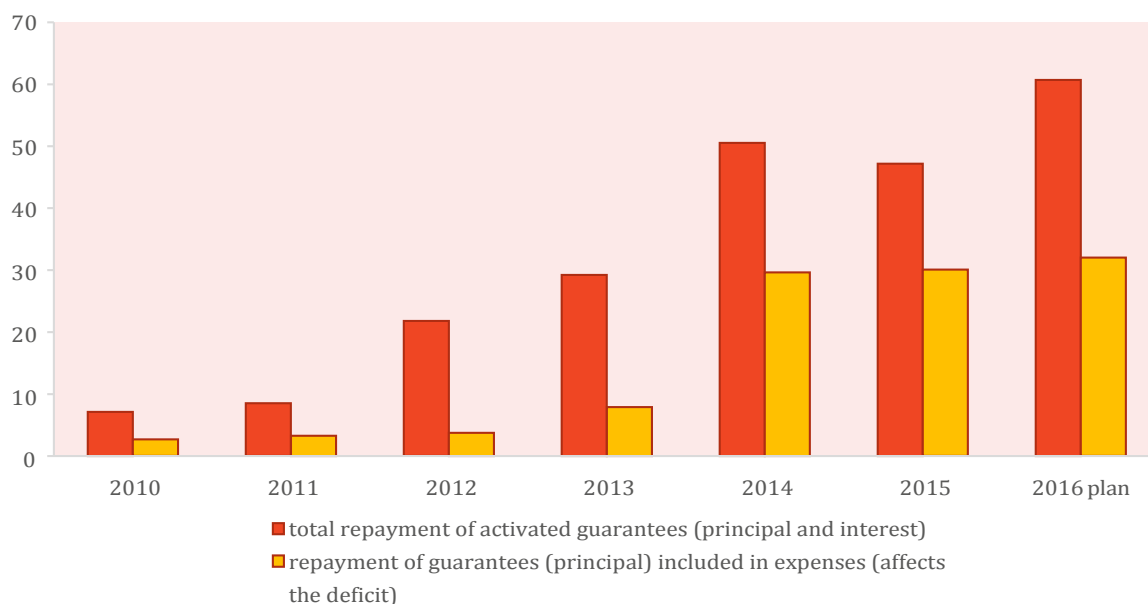


Table 15. Total settled liabilities from guarantees, by beneficiaries, in RSD bn

Beneficiary	2015			2016 (until 30.9.)		
	Principal	Interest	Total	Principal	Interest	Total
JP Srbijagas	17.6	3.7	21.3	17.8	2.5	20.3
JP Putevi Srbije	4.0	1.8	5.8	3.9	1.7	5.6
Železnice Srbije a.d.	5.5	0.9	6.4	5.2	0.6	5.8
JAT	1.2	0.2	1.5	0.7	0.1	0.8
Galenika a.d.	2.1	0.5	2.6	1.6	0.3	1.9
Local self-governance	0.2	0	0.3	0.2	0.0	0.2
Železara Smederevo	3.3	0	3.3	2.8	0.0	2.8
RTB Bor	0.4	0.2	0.6	0.0	0.0	0.0
Other beneficiaries	5.4	0	5.4	0.0	0.0	0.0
TOTAL	39.8	7.4	47.2	32.2	5.3	37.4

Source: MOF, Public Debt Administration

Rising indirect debt and inclusion of a portion of repayments for guarantees in the budget expenditure, and the consequent increase in deficit, have raised awareness of the growing fiscal risks that arise from issued guarantees. Therefore, activities have been undertaken which limit the issue of new guarantees. Changes in the Law on Public Debt prohibit the issue of new guarantees for loans for liquidity purposes. Changes in the Law on the

⁵ Repayments arising from guarantees from the national budget are included in the expenditure on cash basis. International standards that are based on accrual basis, include in the expenditure the whole amount of the remaining debt, at the moment the guarantee is activated, while the very repayment of debt is treated as a financial transaction.

⁶ A portion of expenditure arising from repayment of guarantees for the JP Putevi Srbije is not included in the budget expenditure, as this company is part of the general government sector and the expenditures that were financed by guaranteed loans were part of the general government expenditure at the moment the money was spent, whereas the repayment itself is treated as a financial transaction ("below the line").

Development Fund of the Republic of Serbia prevented further issue of counter-guarantees for guarantees issued by the Development Fund of the Republic of Serbia.

Apart from the limitation in the issue of government guarantees, the key step in reducing and eliminating fiscal risks arising from this is the reform of state-owned and government companies, the guarantee beneficiaries, in order for them to become capable of repaying their loans. A large number of companies that are also the greatest guarantee beneficiaries are in the restructuring process i.e. the process of implementing the restructuring plans prepared in cooperation with the international financial institutions. New guarantees in 2015 were issued to a limited extent, only for loans that serve the purpose of public investments. Guarantees were issued to the company JP Srbijagas, for the construction of the gas pipeline Aleksandrovac – Tutin, in the amount of EUR 20 million and to JP EPS for financial restructuring in the amount of EUR 200 million⁷. Annual budget for 2016 calls for an issue of guarantees up to EUR 140 million for infrastructure projects⁸.

Table 16. Plan for issuing guarantees in 2016

No.		Amount in dinars	Original currency	Amount in original currency
To German Development Bank (KfW)				
1.	JP Elektroprivreda Srbije – Changing the system for transporting ash and slag, TENTA	5,512,500,000	EUR	45,000,000
2.	JP Elektroprivreda Srbije – Renewable energy program – Wind farm Kostolac	9,800,000,000	EUR	80,000,000
3.	JP Elektromreža Srbije a.d. – Energy in transport systems (stage I – Transbalkans Corridor)	1,837,500,000	EUR	15,000,000
TOTAL:		17,150,000,00	EUR	140,000,000

SOURCE: MoF

Repayment plan for guarantees (total principal and interest) in 2016 is RSD 61 bn, of which RSD 32 bn is included into the expenditure that affects the deficit, for repayment of principal for guarantees. The structure of the outlay for the repayment of principal from guarantees that are included into the budget expenditure is shown in the following table.

Table 17. Repayment plan for guarantees in 2016 (portion included into budget expenditures) in RSD bn

Beneficiary	amount
RS Development Fund (Železara Smederevo)	3.9
JAT	1.2
Galenika a.d.	2.1
Železnice Srbije a.d.	7.0
JP Srbijagas	17.8

⁷ New indirect liabilities of the Republic of Serbia for the guarantees issued in 2015 are regulated by the following laws: 1) Law on Confirming the Guarantee Contract (project of restructuring JP EPS) between the Republic of Serbia and the European bank for Reconstruction and Development, in the amount of up to EUR 200,000,000.00, published in the Official Gazette of the Republic of Serbia – International Contracts, No. 23/2015 2) Law on Issuing the Guarantees of the Republic of Serbia in favour of Societe Generale Bank Srbija a.d. Beograd, for the settlement of the liabilities of the state-owned enterprise Srbijagas Novi Sad with reference to the contract on long-term loan for the construction of the pipeline Aleksandrovac – Brus – Kopaonik – Raška – Novi Pazar – Tutin in the amount of up to EUR 20,000,000.00, published in the Official Gazette RS, No. 112/2015

⁸ Total amount of guarantees planned in the Law on Budget amounts to EUR 360 million and includes also EUR 220 million for issuing the guarantees for JP EPS and JP Srbijagas issued in 2015.

Other beneficiaries	0.4
TOTAL	32.3

Source: MOF, Public Debt Administration, Law on Budget for 2016

Repayment of guarantees will depart from the amount planned in the 2016 budget. The performance of the budget in this regard reached the planned amount in September. The cause for this trend is positive in nature and refers to the prepayment of the guaranteed amount of debt (debts of the companies Galenika a.d. and JP Srbijagas) which enabled considerable savings on the expenditure side for interest in the upcoming period. According to the plan, JP Srbijagas will repay, on its own, a portion of debt to its creditors, which did not fully materialize. Apart from this company's improved liquidity position, it is still not capable of settling its liabilities in a fully independent manner.

The balance and the structure of public debt arising from indirect liabilities and rising budgetary expenditures for guarantees point out that there are significant fiscal risks that might materialize in the next couple of years. In the upcoming years repayment of guarantees is also planned, but with a decreasing trend, so their share in the GDP will go down from 0.9% of GDP in 2016 to 0.3% of GDP in 2019. Thanks to the measures undertaken over the past period, as well as the negotiations with the local commercial banks, where interest rates were reduced for the guarantees liabilities of JP Srbijagas and Galenika a.d., the exposure of Serbian public finance to this risk was reduced.⁹

Structural reforms of state-owned enterprises and government companies, making them capable to compete in the market and making them financially sustainable, on the one hand, and limited and targeted issue of new guarantees, on another, will contribute to reduced fiscal risks arising from this and will help maintain expenditures within the planned i.e. projected limits in the upcoming mid-term period.

Transferring liabilities into the public debt of the Republic of Serbia

Assuming the liabilities of the state-owned enterprises and government companies is a significant source of risks for public finance and directly increases public debt and government deficit. Over the past period, on several occasions, the liabilities of state-owned enterprises and government companies were assumed. Assuming liabilities directly increases public debt in the amount of the liabilities assumed from the borrower. At the same time, this amount becomes a budget expenditure and, therefore, increases the general government deficit.

Apart from assuming the liabilities of the state-owned enterprises and government companies, what also increases the public debt and deficit are the court decisions, but also inadequate planning of certain expenditure (subsidies). In the past year the increase in the debt and deficit was affected also by the decision of the Constitutional Court on increase in pensions to the military pensioners and inadequate planning of subsidies to farmers, which resulted in including this debt into the public debt and paying it to farmers.

Table 18 Assumption of liabilities into public debt, RSD bn

description	2015
JP Srbijagas	23.4
Military pensioners	10.0
Subsidies for agriculture	10.1
TOTAL	43.5

Source: MoF

⁹ As of 2016 euro denominated loans with residual maturity of under two years have an interest rate of 1.75% + three-month Euribor; Euro denominated loans with residual maturity of over two years have an interest rate of 2.75% + three-month Euribor as of 18.11.2016; as of 18.11.2016 loans denominated in US dollars have an interest rate of 3.00 + three-month USD Libor.

Until the end of 2016, as part of the financial restructuring of HIP Petrohemija, it is planned that the liabilities of this company will be assumed and transferred into public debt in the amount of EUR 105 million, which was agreed as part of the program with the IMF. Assuming the debts along with the financial restructuring of the company will eliminate the possible fiscal risks and the future budget expenditures for support to this company.

State-owned enterprises (SOE)

The operation of SOEs is a significant source of fiscal risks, both on the budget revenue side and on the expenditure side. SOEs are facing numerous problems in their operation, from collection of receivables to the regular settlement of their liabilities to creditors, the state, the employees, etc. The state, as their founder and the only owner is responsible for the operation and is their protector of last resort in case of illiquidity. There are several channels through which fiscal risks related to the operation of SOE might materialize. The biggest, but not the only risk, is the government guarantees issued for the loans to SOEs. Sustainability, efficiency and profitability of SOEs affect the budget revenues i.e. the amount of profit they pay into the budget. The quality of products and services they provide affects the efficiency and profitability of the private sector and ultimately the level of tax paid into the budget.

SOEs are a significant segment of the Serbian economy which employs nearly 79 thousand people. SOEs are set up as companies that perform activities of general interest. Their operation is governed by the new Law on State-Owned Enterprises, adopted in February 2016, as well as sub-sectoral laws that regulate special areas not covered by the Law on State-Owned Enterprises (Energy Law, Company Law, etc.)

With the aim of reducing the fiscal risks related to the operation of SOEs, a restructuring process has been initiated for the largest SOEs (Železnice Srbije, JP EPS and JP Srbijagas). The whole process is performed in cooperation with the leading world financial institutions – IMF, World bank and EBRD, in order to set these companies on solid ground, so that they can start functioning on market principles which will reduce the potential fiscal expenditures that might arise from their operation.

Key financial indicators for SOEs

Operating results of SOEs in 2015

Total capital of SOEs on national level¹⁰ at the end of 2015 amounted to RSD 1,530 bn, while net loss in 2015 amounted to RSD 3.6 bn.

Table 19 Key financial indicators of SOEs*, RSD bn

description	2014	2015
Total assets	2,400.0	2,487.1
Own capital	1,557.0	1,530.2
Total revenue	465.9	498.8
Net profit (loss)	-65.3	-3.6
Subsidies	26.4	23.6

¹⁰ Financial indicators shown in the table were obtained from the quarterly reports that SOE's submit to the Ministry of the Economy.

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description	2014	2015
Subsidies, excl JP Putevi Srbije	19.0	16.7
ROE in %	-4.2%	-0.2%
ROA in %	-2.7%	-0.1%
Subsidies, as a % of total revenue	5.7%	4.7%

Source: Official financial statements published on the Business Registers Agency's website

*summary data relate to the companies stated in table 20.

Operation of the SOE's on the national level improved significantly in 2015.

Although the realized net loss is RSD 3.6 bn, it is significantly lower than in the previous year, when it amounted to RSD 65.3 bn.

The number of companies that are receiving subsidies went down from 21 to 20. Received subsidies reduced their share in the structure of revenue of SOEs, and in 2015 account for 4.7% of the total revenue. Certain subsidies have a capital nature, such as the subsidies for PE Putevi Srbije in the amount of RSD 6.9 bn intended for reconstruction of road infrastructure.

Table 20 Overview of certain items in the financial statements for 2015

SOE	Net result, RSD 000	Total assets, RSD 000	Capital, RSD 000	RoA, %	RoE, %
PE EPS (group)	6,986,344	1,091,126,511	781,376,116	0.7	0.9
PE SRBIJAGAS	2,963,854	128,958,465	-68,559,132	2.4	-
Srbija kargo a.d.	63,223	26,570,817	18,882,612	0.2	0.3
Srbija voz a.d.	-876,158	32,575,413	27,518,264	-2.7	-3.2
Infrastruktura ŽS a.d.	-1,975,962	241,383,339	216,471,307	-0.8	-0.9
Železnica Srbije a.d.*	-8,483,272	24,673,946	-55,672,075	-5.1	-
PE putevi Srbije	-9,597,720	528,624,223	404,150,235	-1.8	-2.3
Коридори Србије д.о.о.	0	90,943,731	500	0.0	0.0
PE Elektromreža Srbije	2,846,912	92,927,409	58,912,336	3.1	4.8
PE PEU Resavica	-1,435,652	8,368,833	-5,353,310	-17.8	-
PE Pošta Srbije	3,128,267	34,115,664	25,825,335	9.1	12.2
PE Jugoiimport SDPR	2,008,291	32,447,664	7,986,711	6.8	27.1
PE Transnafta	125,528	4,714,235	4,483,276	2.7	2.8
PE Srbijašume	384,596	64,618,535	60,595,448	0.6	0.6
PE Srbijavode	14,368	18,703,079	5,229,832	0.1	0.3
PE Skijališta Srbije	54,329	10,281,839	2,578,563	0.5	2.1
Državna lutrija Srbije d.o.o.	40,116	2,130,965	1,106,092	1.9	3.6
DIPOS d.o.o.	168,427	895,315	721,352	20.2	24.6
PE Službeni glasnik	11,623	3,043,958	2,507,104	0.4	0.5
PE Zavod za udžbenike	2,533	3,221,962	3,021,313	0.1	0.1
PE Emisiona tehnika i veze	2,222	5,169,717	1,867,336	0.1	0.1
JAT Tehnika d.o.o.	18,411	2,507,750	937,483	0.7	2.0
PE za skloništa	-180,452	14,505,322	13,390,228	-1.2	-1.3
PE Stara planina	26,989	4,587,861	3,195,548	0.6	0.8
PE Nuklearni objekti Srbije	274	374,862	201,202	0.1	0.1
PE NP Tara	14,854	8,158,041	8,031,044	0.2	0.2
PE NP Fruška Gora	3,159	2,381,181	2,190,497	0.1	0.1
PE NP Đerdap	6,444	4,784,235	4,691,254	0.1	0.1
PE NP Kopaonik	7,955	3,655,518	3,615,207	0.2	0.2
Park prirode Mokra gora d.o.o.	288	191,879	9,962	0.2	5.8
Rezervat Uvac d.o.o.	278	41,871	12,404	0.7	2.3
Prosvetni pregled d.o.o.	19,050	61,693	52,135	35.9	43.1
PE Mreža most	8,344	29,959	13,334	29.0	78.8
Park Palić d.o.o.	2,110	152,516	2,781	1.4	104.9
NIPE Panorama Priština	42	1,248	60	1.2	1.9
Tvrđava Golubački grad d.o.o.	-1	4,648	550	-0.0	-0.2
Metohija d.o.o.	1,491	14,486	5,486	16.1	31.5

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SOE	Net result, RSD 000	Total assets, RSD 000	Capital, RSD 000	RoA, %	RoE, %
PE Tanjug	34,119	179,975	158,252	19.1	25.9
Total	-3,604,648	2,487,128,665	1,530,156,632	-0.1	-0.2

* Net result of the Serbian Railways contains the net result of the joint company until 10 August 2015 and the net result of the separated fourth company Serbian railways from 10 August 2015 to 31 December 2015.

Source: Official financial statements published on the BRA's website

Operating results of SOEs in 2016

In 2016 the positive trend in the operation of the national SOEs continued, if observed on summary basis.

The next table shows the preliminary operating results for the first 9 months of 2016.

Table 21. Preliminary operating results of SOEs* for the first nine months of 2016, RSD bn

Operating results	30.09.2016 realized
Operating revenue	317.9
Operating expenses	229.3
EBITDA	88.6
Depreciation	40.8
EBIT	47.8
results before tax	31.1
Net result	22.5
Received subsidies	18.7

*summary results relate to the companies stated in table 20

Realized operating results are considerably better, both compared to the plan and compared to the same period the previous year. Net result for the first nine months is a profit of RSD 22.5 bn. The greatest effect on all observed values came from JP Elektroprivreda Srbije, as the largest SOE by all criteria. In the first nine months this company realized a profit of RSD 15.3 bn.

Payment of profit into the state budget

Payment of profit by SOEs and dividends from equity companies where the state has ownership account for a large portion of non-tax revenue. The business success of these companies determines the amount of revenue in the budget from this source. Payment of regular profit and dividends is a regular non-tax budget revenue, whereas payments from retained earnings are considered one-off revenue and are not a permanent source of revenue.

Budget revenue coming from SOEs profit, both regular profit and retained earnings from previous years, amounted 1.1% of total budget revenue in 2015¹¹. The budget for 2015 specifies that the SOEs are obliged to pay into the budget 59% of realized profit from previous year. The equity companies are obliged to do the same i.e. pay the relevant portion of profit to the state, as one of the owners. Apart from regular profit, the Government demanded the payment of retained earnings coming from the period before 2013, up to the amount that would not endanger the operation of SOEs. From this (SOEs profit) approx. RSD 6.5bn was paid into the budget in 2015.

¹¹ Total paid profit of SOEs, public agencies and dividends from equity companies, where the state has ownership, amounted to RSD 24.8bn in 2015. Here we are limiting to the profit of SOEs from the aspect of fiscal risks.

Table 22. Net profit of SOEs paid into the budget, in RSD bn

	2014	2015
Payment of current profit	4.9	4.1
payment of retained earnings	-	6.5
Total	4.9	10.6
% of total budget revenue	0.5	1.1
% of GDP	0.1	0.3

Source: MoF

The SOE's obligation to pay at least 50% of their profit realised in the previous year is prescribed in the Law on the Budget of the Republic of Serbia for 2016. The budget for 2016 is planned to receive approx. RSD 5 bn from this source alone. The initial plan has been exceeded and as of September RSD 5.5 bn has been paid into the budget.

Mitigation of potential risks that arise as a consequence of operation of SOE's includes a range of measures related to responsibility, profitability and transparency in the operation of these companies. Namely, in early 2016 a new law on SOEs was passed that will strengthen the management structure and responsibility of SOEs. The restructuring processes have been initiated in JP EPS, JP Srbijagas and Serbian Railways. The efficiency of operation in the future will depend on the success of the restructuring process and the speed of implementing the adopted measures.

Banking system and deposit insurance

Deposit insurance is a mechanism for ensuring financial stability and protection of depositors. The deposit insurance system ensures that each insured depositor¹² is paid the full amount of deposit in every bank up to the insured amount of EUR 50,000 in case of bankruptcy or liquidation of the bank. Deposit insurance is regulated by the Law on Deposit Insurance.

In the deposit insurance system the Republic of Serbia is the ultimate guarantor for the payment of insured deposits. For the purpose of securing the funds for insurance of deposits, the Agency charges a premium for deposit insurance from banks for the account of the Deposit Insurance Fund, manages the fund's assets and pays the deposits up to the insured amount in case of bankruptcy or liquidation of the Bank. In case there is a shortfall in the deposit insurance fund, the Republic of Serbia will ensure the payment is made, either with funds from the budget or by issuing guarantees for the borrowing of the Deposit Insurance Agency.

Guaranteed payment of insured deposits by the state, either directly from the budget or indirectly by issuing guarantees for Deposit Insurance Agency's borrowings, is a source of fiscal risks and possible fiscal expense. In 2014 such a fiscal risk materialized when the state provided the shortfall cash for the payment of insured deposits of Univerzal bank.

Reduction of fiscal risks arising from this depends on the stability and sustainability of the banking system. Supervision over banking system, conservative approach in investing the funds and improvement of the quality of banks' assets are key pillars of a stable banking system.

Reform of regulations that govern the Serbian financial system¹³ was carried out in February 2015. One of the features of this reform is the transfer of duty for monitoring the operating results and the operation of the management bodies in banks, insurance companies

¹² Protected depositors are: private individuals (resident and non-resident), sole traders (resident, micro, small and medium-sized legal entities (residents).

¹³ The National Parliament adopted the amendments and supplements to the Law on the National Bank of Serbia and the Law on Banks, as well as the new Law on the deposit Insurance Agency, law on deposit Insurance, Law on Bankruptcy and Liquidation of Banks and Insurance Companies. With the change in a set of financial laws, adoption of the supplement to the Law on Ministries was required.

and other financial institutions whose shareholder is the Republic of Serbia, as well as organizing and implementing the process of selling shares in them, from the Deposit Insurance Agency to the Finance Ministry as of 1 April 2015. Also, the reform of regulations transposed into the local legislation also the Directive on Bank restructuring (Bank Recovery and Resolution Directive – BRRD) and the restructuring function was delegated to NBS.

Realized results of the Serbian banking sector at the end of the fourth quarter 2015 show a trend of moderate recovery of bank profitability. At the end of 2015, at the level of the banking sector in Serbia, a positive net financial effect before tax was realized in the amount of RSD 9.7 bn, which is RSD 6.2bn more than the net profit before tax realized in the previous year¹⁴.

Banking sector in Serbia is adequately capitalized, from the perspective of realized capital adequacy ratio and the perspective of the structure of regulatory capital. At the end of the fourth quarter 2015 the capital adequacy ratio for the Serbian banking sector was 20.89%, which is far above the regulatory minimum (12%), and the minimum set by Basel standards (8%).¹⁵

Realized profit of the Serbian banking sector at the end of the second quarter 2016 point to a continued trend towards improvement of banks' profitability. As of 30 June 2016, at the level of the Serbian banking sector a positive net financial result before tax was realized in the amount of RSD 20.4bn, which is RSD 3.5bn more than the amount of net profit before tax realized in the same period the previous year.¹⁶

One of the limiting factors for the growth in lending activity is a relatively high level of non-performing loans. In August 2015 a Strategy for Resolving Non-Performing Loans was adopted and is being implemented through two action plans, one prepared by the Government and another by NBS, with the aim of lowering the level of NPLs. Key areas of implementation include strengthening the capacity of banks for resolving NPLs, improvement of regulations for collateral valuation, development of NPL market, etc.

Implementation of measures for resolving the issue of NPLs is yielding results. The total gross NPLs in the banking sector went down by RSD 2.2 bn during the second quarter of 2016 and at the end of June amounted to RSD 404.3 bn. Gross reduction from collection amounted to RSD 19.0bn and RSD 5.1bn from transfer.¹⁷ Implementation of measures from the Strategy for resolving NPLs considerably affected the change in the profile of NPL transfer transactions. The volume of transferred NPLs is relatively higher and it has been noticed that the structure of persons these loans are being transferred to has changed (transfer from the banking sector).

Reduced risk and fiscal expenses associated with the deposit insurance scheme meant gradual compliance with the European standards in this area.

Other fiscal risks

Apart from the stated fiscal risks, there are also other circumstances that might lead to fiscal expenses, if materialized. For certain risks there are no systematic data but, bearing in mind that certain risks have materialized in recent past, we can see the magnitude of their effect on public finance. Even their identification only helps to see the possible effect on the fiscal position of a country in the upcoming period.

¹⁴ Banking Sector in Serbia – Report for the IV quarter of 2015, NBS

¹⁵ Banking Sector in Serbia – Report for the IV quarter of 2015, NBS

¹⁶ Banking Sector in Serbia – Report for the II quarter of 2015, NBS

¹⁷ Banking Sector in Serbia – Report for the II quarter of 2015, NBS

There are considerable fiscal risks from court decisions by local and international courts, fines, damage compensation by the government bodies. In the period 2009 – 2015 the Republic of Serbia paid from the budget RSD 47 bn¹⁸. The debt to military pensioners, which was assumed in 2015 in the amount of RSD 10 bn, although, according to the court decision it had not been recorded in these accounts, in terms of accounting it was treated as repayment of debt, whereas in reports on fiscal aggregates of the general government it was allocated as expenditure for welfare benefits (pensions). Independently of the manner of recording, this expenditure is a materialized fiscal risk from court decisions. Potential liabilities may arise also from the decisions of the international court in Strasbourg as a result of legal action initiated by the employees of the former socially-owned companies (for unpaid salaries and contributions), for payment of old FX savings to the citizens of Bosnia and Herzegovina, etc.

Permanently present risk of natural disasters necessitates investment into prevention programs in order to reduce the potential fiscal expenses for elimination of damage occurred as a result of this. In 2014 Serbia faced the consequences of a disastrous flood. The total damage (with losses) was estimated at more than EUR 1.7 bn¹⁹. In accordance with the Law on eliminating the consequences of floods in the Republic of Serbia, the funds for recovery came from the budget, on all levels of government, donations, grants and presents, borrowing, financial assistance from the EU, etc. Grants were secured for the recovery in the amount of EUR 220.7 million and approx. USD 300 million from the World Bank. Bearing in mind the constantly present risks of natural disasters, reduction in fiscal risks that might arise from this means investment in prevention programs. In December 2014 the Government adopted a National Program for managing Risks of Natural Disasters that will be implemented in cooperation with the World Bank, UN and EU. For implementation of the prevention program EUR 70 million has been secured so far.

5. Cyclically adjusted fiscal balance

Cyclically adjusted fiscal balance is a fiscal balance from which an isolated effect of the economic cycle has been excluded, and the starting identity is the following²⁰:

$$B = CB + CAB$$

Portion of the fiscal balance (B) that automatically adjust to cyclical fluctuations is called the cyclically adjusted fiscal balance (CAB), and the goal of this procedure is to isolate the cyclical component of the fiscal balance (CB) which is the result of the effect of production gap. **The real fiscal balance will be equal to the cyclically adjusted one in case the production gap is zero i.e. if the growth rate of the real GDP is equal to potential growth rate.**

For assessment of the cyclically adjusted deficit we have used the OECD approach i.e. disaggregated approach, which means assessment of the resilience of individual categories of cyclically sensitive revenues and expenditures. We included in the analysis the estimate of the structural primary balance obtained through correction of cyclically adjusted primary balance for revenues and expenditures that were assessed as one-off and non-structural revenues and expenditures.²¹ The obtained results and their interpretation depend, to a large extend, on the length of the used series in the econometrical assessment of resilience, reliability

¹⁸ Expenditures in the following accounts were included: fines and penalties upon decisions by court and court bodies and compensation for injuries or damage caused by the government bodies

¹⁹ <http://www.obnova.gov.rs/uploads/useruploads/Documents/Kancelarija-za-pomoc-poplavljenih-podrucja-infograf-15-04-2016-srb.pdf>

²⁰ More detailed description of the methodology used and of the results can be found in the Fiscal Strategy for 2013 with projections for 2014 and 2015 or on the link <http://www.MoF.gov.rs/pages/article.php?id=8626>

²¹ This method of analysis is still in its infancy and in cooperation with the relevant local and international institutions the valuation of one-off revenues and expenditures will certainly be modified.

of statistical data, existence of structural breaks in the series, change in the scope and methodology. In practice, various tools are used for assessment of the production gap, theoretical methods (*Cobb-Douglas* production function) various econometric filters (*Hodrick-Prescott*, *Band-Pass*, *Kalman*, etc.). The choice of certain method depends on availability, quality and length of the data series, etc. Each of these methods may produce, to either greater or lesser extent, different results, both in terms of size, timeline and the very character of production gap. At any rate, the production gap is not a value that can be calculated objectively, but only estimated. For an accurate analysis, apart from these methods, it is necessary to use the principles of economic theory and the available information on economic trends. The estimate of the cyclical fiscal result is, therefore, under a great influence of the choice of methods and the manner used to assess the production gap. Despite this, the cyclically adjusted fiscal balance is an indispensable tool in the economic analysis and assessment of the permanent fiscal position of a county. For the purpose of this analysis we have used the production gap obtained using the *Hodrick-Prescott* filter.

The cyclically adjusted i.e. structural fiscal result is the best measure for the assessment of the overall fiscal position of a county. The effect of the cycle on fiscal trends cannot be fully excluded, and it has been said, each of the implemented methods for the assessment of a production gap gives somewhat different results. However, it is only in this manner that we can see how the tax system and the expenditure policy permanently affect the fiscal position of the country. An analysis of cycle provides for a possibility to objectively see the current fiscal positions of the country and allows the economic policy makers to react in a timely manner.

Primary fiscal balance excludes interest expenditures as a form of non-productive expenditure with no effect on the trends in the real sector, and trends in cyclically adjusted primary balance is used for the assessment of the character of fiscal policy. The size of the interest expenditures often has a countercyclical effect in practice due to the effect of squeezing out the private sector from the capital market. Fiscal impulse is obtained as difference between the cyclically adjusted primary balance in the current and the previous year.

In this process, the positive sign means an expansive, and the negative one means restrictive character of fiscal policy. The graph Character and Effects of Fiscal Policy in the Period 2006-2009 shows the periods of expansionary and restrictive fiscal policy, as well as the size of the impulse. Fiscal impulse means relative change in the balance and its aim is to analyse the effect of fiscal policy on the trends in production gap and the assessment of fiscal multipliers.

Table 23. Fiscal balance and components for calculation of cyclically adjusted balance in the period 2005 – 2019, % of GDP

	Production gap	Fiscal balance	Primary fiscal balance	Cyclical component of fiscal balance	Cyclically adjusted fiscal balance	Cyclically adjusted primary fiscal balance	Structural primary fiscal balance**	Character of fiscal policy - fiscal impulse
2005	0.2	1.1	2.0	0.1	1.0	1.9	2.2	
2006	-0.1	-1.5	-0.2	0.0	-1.5	-0.1	0.6	2.0
2007	1.5	-1.9	-1.3	0.5	-2.5	-1.9	-1.5	1.8
2008	3.9	-2.6	-2.1	1.5	-4.1	-3.5	-3.6	1.6
2009	-0.9	-4.4	-3.8	-0.3	-4.1	-3.4	-3.5	-0.1
2010	-1.0	-4.6	-3.6	-0.4	-4.2	-3.2	-3.3	-0.2
2011	0.1	-4.8	-3.6	0.0	-4.8	-3.6	-3.8	0.4
2012	-1.0	-6.8	-5.0	-0.4	-6.5	-4.6	-4.6	1.0
2013	1.3	-5.5	-3.1	0.5	-6.0	-3.6	-3.4	-1.0
2014	-1.1	-6.6	-3.7	-0.4	-6.2	-3.3	-2.3	-0.4
2015	-1.4	-3.7	-0.5	-0.5	-3.2	0.0	0.4	-3.3
2016	-0.5	-2.1	1.2	-0.2	-1.9	1.4	1.6	-1.4
2017	-0.2	-1.7	1.4	-0.1	-1.6	1.5	1.6	-0.1
2018	0.2	-1.3	1.7	0.1	-1.4	1.6	1.6	-0.1
2019	0.4	-1.0	1.7	0.1	-1.1	1.6	1.6	0.0

*Projected values were shown for the period 2016 - 2019.

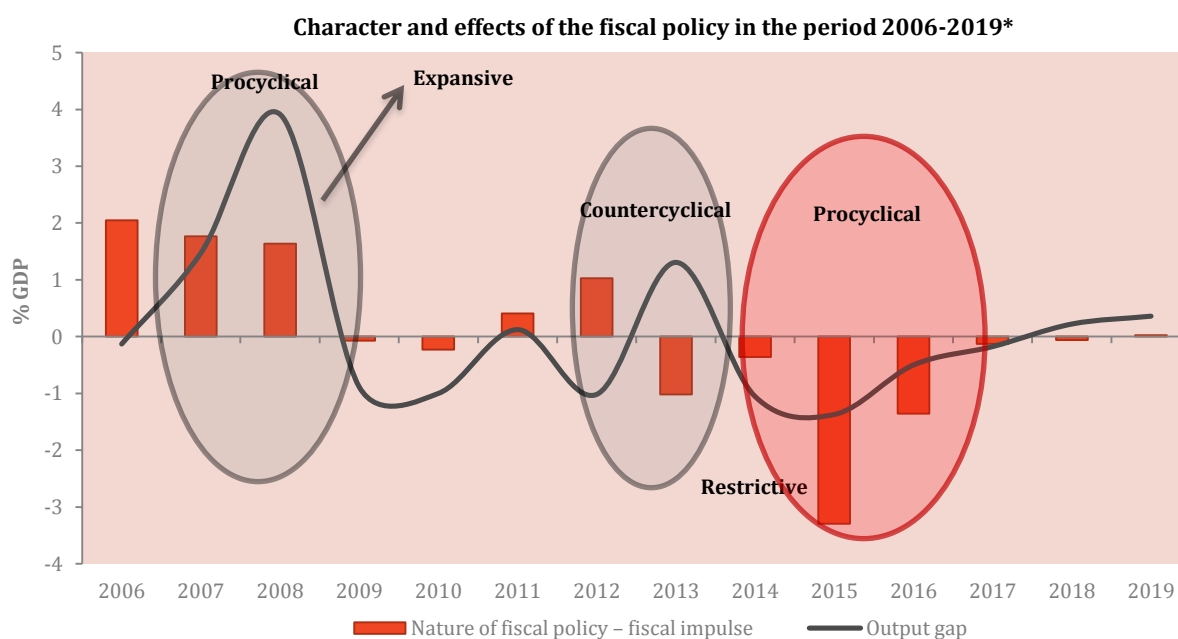
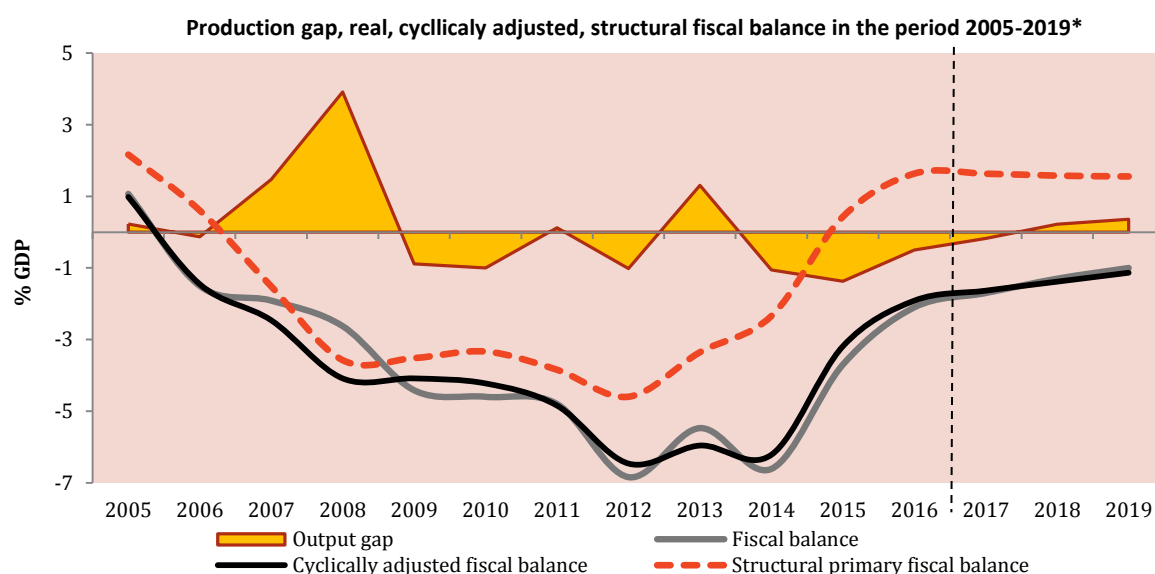
** Structural primary balance was obtained by excluding the estimated one-off revenues and expenditures. The results that show the change in the structural primary deficit do not exclude explicitly the effects of an increase in the efficiency of collection of revenue and the estimate of structural adjustment in 2015 and 2016 partially differs from the previously shown effects.

Source: MOF

A positive effect of the economic cycle was seen in 2007, 2008 and 2013 where a positive production gap is present. The effect of the cycle is such that it leads to the fiscal result that is better than it would have been if the economy had been on the course of potential growth,²² contrary to this, at the height of the crisis between 2009 and 2012 the effect of the cycle was negative, production gap recorded negative values and the actual fiscal gap was higher than the cyclically adjusted one. In 2014 and 2015 the production gap reached relatively high negative values that went down afterwards, and after 2017 the production gap will be closed.

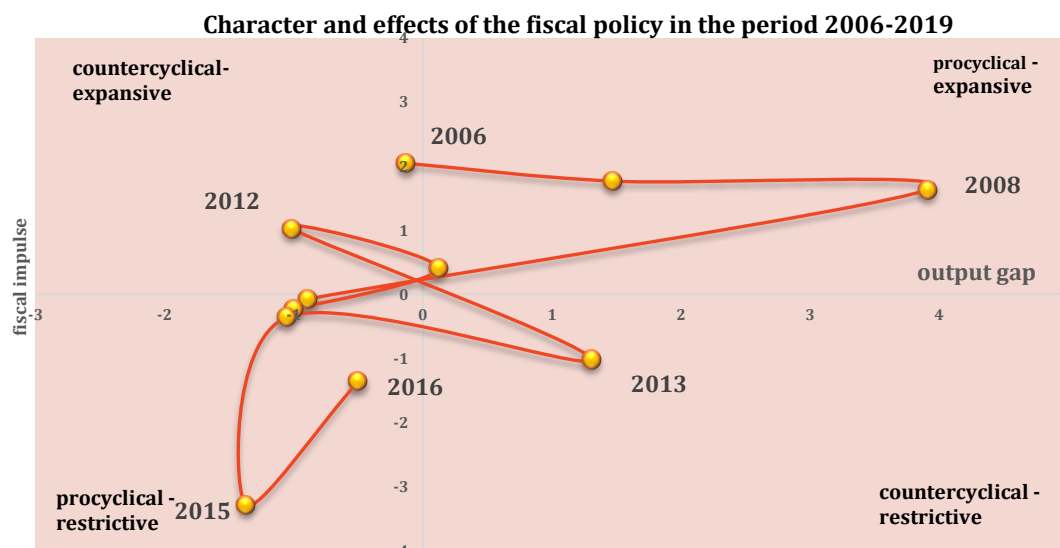
Cyclically adjusted primary deficit has reduced since 2012. In 2015 the fiscal balance reached the lowest value in the past several years and finally, in 2016, primary surplus will materialize. The structural changes in the tax system and the expenditure system during 2012 and 2013 started yielding results and the process of fiscal consolidation started, in effect, at that moment. Fiscal consolidation measures passed during 2015 considerably improved the country's fiscal position. When we factor into the analysis the structural primary balance, we can isolate, primarily, one-off effects on the expenditure side, although in certain years the one-off effect on the revenue side was not so insignificant either. Structural primary balance estimated in this manner makes for an efficient tool for the final assessment of the fiscal position, especially in the period between 2014 and 2016 when the fiscal position improved considerably.

²² With the inclusion of production gap we can estimate the effect of fiscal policy in terms of its procyclical or countercyclical nature. Procyclical policy is characterised by the presence of expansionary fiscal policy in the period of above potential growth (or restrictive policy in the environment of recession) and the contrary holds true for the counter cyclical. As a result of procyclical fiscal policy, the changes in public revenues follow the trends in the nominal GDP. Cyclically created growth component is then used either for the reduction in the tax burden or, in most cases, for increasing expenditure, rather than for the reduction of fiscal deficit.



Countercyclical policy was implemented in 2012, during the crisis, bearing in mind the relatively expansionary fiscal policy in the environment of high negative production gap and the contrary situation in 2013.²³ At first glance, the logic of economics calls for this kind of behaviour, although it is mostly the consequence of the structure of tax system and the public expenditure system i.e. is under the influence of automatic stabilizers. However, although expansionary policy does not result in accelerated growth, and when fiscal policy measures alone cannot eliminate the deep reasons for the negative production gap, the real and cyclically adjusted balance is deepened, and the public debt enters the expansion stated. This is a frequent case in situations when the values of fiscal multipliers are low, as is the case in Serbia.

²³ In 2013 there was a growth above that exceeded the potential one, primarily as a consequence of opening new capacities in the automobile and oil processing industry. That year is characterised also by an intention to make greater saving in the expenditure, due to a shortfall on the revenue side, which resulted in a decrease in real and primary deficit.



Measures adopted over the past period, as well as fiscal consolidation measures implemented during 2015 led to a structural improvement of fiscal position of the country. Negative fiscal impulse in 2016 was partly mitigated by the relaxation of fiscal policy in the form of increasing pensions and a portion of salaries in the public sector. In the period since 2016 to 2019 the effect of the reforms in the public sector, completion of the restructuring and abolishing of certain subsidies will result in permanent savings on the expense side. At the same time, space will open for further relaxation of fiscal policy, first on the expenditure and then on revenue side also.

Negative production gap did not prevent the successful implementation of fiscal consolidation in the period between 2014 and 2016. Certain internal and external factors mitigated the effects of fiscal consolidation. The most important factors are: 1) considerable improvement in efficiency of collection of tax revenue, 2) collection of one-off non-tax revenues that greatly neutralized the amounts for one-off expenditures, 3) favourable international environment (oil price, economic growth among foreign trade partners, ECB policy), 4) accommodating NBS monetary policy, 5) relatively low values of fiscal multipliers.

In the period between 2017 and 2019 the fiscal impulse was practically neutral. Certain minimal degree of restrictiveness comes from improved efficiency of collection on the central and local level. The fact that realized growth rates are getting closer to the potential ones considerably reduced the need for restrictive fiscal policy. In the context of stabilisation of public debt, the effects of measures in the observed period resulted in the stagnation and slight decrease in public debt, but for a more significant decrease of the share of public debt in GDP it is necessary to maintain the achieved effects of fiscal consolidation even after 2018. Real growth in GDP above the potential one in the long run will facilitate that process.

6. Debt reduction program

In accordance with the fiscal responsibility principle, if the general government debt exceeds 45% of GDP, the Government must propose measures that will bring the debt closer to the targeted level and bring it back into the sustainable range²⁴. At the same time,

²⁴ In the context of this document, public debt does not include the debt for restitution, in accordance with the definition of debt from the Law on Budgetary System

the Stability and Growth Pact sets the upper limit for the share of public debt in GDP at 60%, as well as an obligation of an EU country to present, in an official document, a credible plan for achieving the set level at the satisfactory speed, if such a limit is exceeded.

In the period between 2008 and 2014 the general government deficit went up from 2.6% to 6.6% of GDP while at the same time public debt entered an explosive growth spiral, with the debt to GDP ratio more than doubling. Economic crisis that started at the end of 2008 resulted in a decrease or slow-down of the growth of budget revenues and a growth in expenses that mitigate the consequences of crisis. In the environment of absence or insufficient level of structural measures, there was an increase in the annual fiscal deficit. Public debt at approx. 30% of GDP at the end of 2008 reached 71.8% of GDP at the end of 2014. Fiscal consolidation measures adopted at the end of 2012 and during 2013 partially mitigated this trend, but the level of public debt still grew considerably.

Decrease in primary deficit in the period between 2012 and 2014 was not sufficient to stabilize the share of public debt in the GDP. The effects of the first wave of fiscal consolidation that related mostly to the revenue side did not materialize due to increased volume of the shadow economy. Public debt, particularly its trend over the past period was not sustainable in fiscal terms. On the expenditure side, high interest and certain one-off expenditures still deteriorate the fiscal position.

Fiscal consolidation measures initiated during 2015 reduced the primary deficit to 0.5% of GDP and slowed down the growth in public debt. Primary surplus will be realized in 2016 and the public debt trajectory will be reversed.

Decrease in the share of public debt in GDP, which is the primary goal of the fiscal consolidation program, will be realized one year earlier than was originally planned in the arrangement with the IMF. It is planned that the share of public debt will reach 74.6% of GDP in 2016 compared to 76% of GDP at the end of 2015. Apart from the primary surplus, acceleration of economic growth will have a positive effect on the trend in the share of public debt in GDP.

Fiscal deficit, although of decisive effect, is not the only factor that influences public debt and it is therefore necessary to implement measures that additionally improve the management and sustainability of public debt:

- Limitation on issuing new guarantees;
- Limitation on taking out new project loans in case where previously approved loans were not used efficiently;
- Repurchase of a portion of expensive debt by using the funds from more favorable loans or privatization revenue in case there is possibility for that;
- Identification and better management of fiscal risks.

In accordance with the fiscal rules, it is necessary to specify in the program the timeline for reducing the public debt to 45% of GDP. Apart from this, the program of measures for reducing fiscal deficit and fiscal framework for the period 2017 – 2019, which plans for a decrease in consolidated fiscal deficit to 1% in 2019, are the baseline scenario and constitute an integral part of this program for decrease in public debt. This program gives a simulation of reducing the debt to the lawful level by 2027, the timeline for reaching the borderline of 60% and the assumptions it is based on.

Assumptions in the baseline scenario are:

- Fiscal adjustment in the period after 2019 is at a lower level compared to the period 2015-2019;
- Achieving fiscal deficit of 0.5% of GDP in 2020 and its slight reduction in the period

afterwards;

- Slower growth in fiscal revenues compared to the nominal GDP due to a change in the structure of the economy, increased investment activities and growth in export. All this is assumed on condition that there are no significant changes in the tax policy and that the volume of grey economy has not deteriorated to a major extent;
- No net increase in issued guarantees after 2019;
- Average real GDP growth of 3.5% in the long run;
- Annual inflation of approx. 3% on average in the observed period;
- Unchanged dinar exchange rate in real terms;
- No significant receipts from privatization in the period 2020 – 2027.

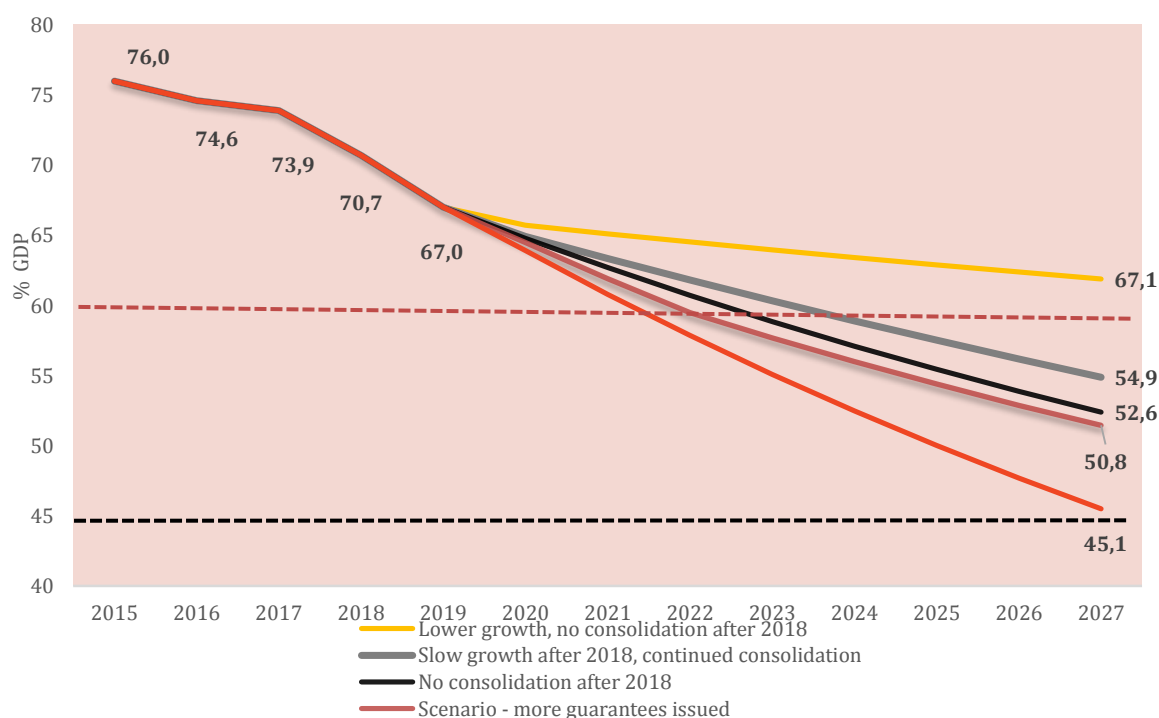
Table 24. Simulation of the level of total debt in the baseline scenario until 2027, % of GDP

Baseline scenario	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Revenues	41.9	43.3	42.4	41.6	41.1	41.0	40.9	40.8	40.7	40.6	40.5	40.4	40.3
Expenditure	45.6	45.4	44.1	42.9	42.1	41.5	41.4	41.2	41.1	40.9	40.8	40.7	40.8
decrease in the		-0.2	-1.3	-1.2	-0.8	-0.6	-0.1	-0.2	-0.1	-0.2	-0.1	-0.1	0.1
Fiscal result	-3.7	-2.1	-1.7	-1.3	-1.0	-0.5	-0.5	-0.4	-0.4	-0.3	-0.3	-0.3	-0.5
Public debt in GDP	76.0	74.6	73.9	70.7	67.0	63.8	60.8	57.8	55.0	52.2	49.7	47.2	45.1
Real GDP growth %	0.8	2.7	3.0	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5

Source: MOF

The baseline scenario assumes that the level of public debt be decreased to approx. 60% of GDP by the end of 2021. Legal borderline of 45% of GDP will be reached in 2027, under these assumptions.

Comparasion of different scenarios and effect on public debt



The graph shows the simulations of alternative scenarios for the trends in public debt, depending on the changes in certain assumptions in the baseline scenario. For the purpose of better comparison, variation of only one variable was carried out, as a risk factor that affects the level of debt. In reality numerous combinations of trend in different factors that affect the public debt is possible.

The “*slowed-down growth after 2019*” scenario means average real GDP growth of approx. 0.9% in the observed period, with the same level of fiscal deficit compared to the baseline scenario. This does not mean the same level of fiscal adjustment as greater accommodation is required on the expenditure side in situations of lower economic growth. At the end of the period, public debt, according to this scenario, will reach 54.9% of GDP. One danger that the scenario of extended slow growth might bring along is that despite certain level of fiscal adjustment on the deficit side, the public debt is not decreasing fast enough. On the other hand, slow growth produces higher levels of fiscal deficit through automatic stabilizers, which requires greater reduction in expenses in order to maintain the decreasing trajectory of the share of public debt. There is risk of entering a spiral of slow growth due to high deficit and the necessity of savings measures. Despite these risks, the scenario enables gradual reduction in the share of public debt and reaching the level of 60% in 2024, if other assumptions remain the same.

The scenario of “*no further consolidation after 2019*” means relaxation of measures aimed at decreasing the fiscal deficit so that it does not go below 1.5% of GDP in the observed period. In this case the reduction in the share of public debt is somewhat slower despite the previously implemented fiscal adjustment measures in the period 2015-2019. Public debt is not reaching the legal limit of 45% in the observed period although its trajectory is decreasing. In this scenario, the limit of 60% of share is achieved two years later, compared to the baseline scenario.

Scenario “*higher issued guarantees*” means abandoning the measures related to the increase in net issued guarantees. In this case an assumption is introduced on the annual net increase in issued guarantees of approx. 0.7% of GDP. At the end of the observed period the public debt is higher by approx. 6.8% of GDP compared to the baseline scenario. It is evident that the numerous positive effects can be achieved by better control and introduction of stricter criteria for issuing new guarantees.

Scenario that combines a lower real growth and keeping the level of fiscal deficit to 1.5% of GDP has the most adverse public debt trajectory. This is the only scenario where the debt does not go below 60% in the observed period. The share of public debt is almost constant during the observed period.

III. PUBLIC DEBT MANAGEMENT STRATEGY FROM 2017 TO 2019

According to the Law on Public Debt, as the legal grounds for the borrowing of the Republic of Serbia, the public debt includes all direct liabilities of the Republic from borrowing, as well as guarantees issued by the Republic for debt settlement by state-owned enterprises and local self-governance. The Republic may borrow in local and foreign currency for the purpose of financing the budget deficit, current liquidity deficit, refinancing the unsettled debt, for financing investment projects as well as for repayment of liabilities for issued guarantees. The provisions of the Law on Public Debt state that the public debt is an unconditional and irrevocable liability of the Republic of Serbia for repayment of principal, interest and other relevant expenses.

The key principle of managing public debt is to secure regular servicing of budgetary needs at the lowest possible expense and at an acceptable level of risk.

In order to formulate the Public Debt Management Strategy a quantitative approach was used which identifies possible limitations through macroeconomic indicators, analysis of expenses and risks and the market conditions that affect the management of public debt. For the purpose of analysis, financing instruments available at the local and international financial market were used. Public Debt Management Strategy is based on the principles that define the need for a transparent and predictable process of borrowing, with permanent development of the government securities market and an acceptable level of exposure to financial risks.

Having analyzed the possible borrowing strategies, the model proposed by the World Bank *Medium Term Debt Strategy Model* – MTDS points out that the borrowing structure that is based on securities issued in dinars and Euros is the best option from the aspect of expenses (risks). The model in which the borrowing strategies are analysed show that in situations where it is not possible to secure concessional sources of funding, such funds should be used, as the cost of funding is therefore reduced at an acceptable risk which achieves the basic goal of public debt management.

Fiscal strategy anticipates a trend in public debt of the general government in the upcoming period until 2019 below 70% of GDP with a clear decreasing tendency after 2016, where, in accordance with the guidelines for managing public debt formulated by the World Bank and the International Monetary Fund, stress testing within the Public Debt Management Strategy is performed to analyse the effect of a change in exchange rate for the local currency against the currency in which the public debt of the Republic of Serbia is denominated.

Over the past four years great progress has been made in increasing the average maturity of RSD government securities and reduction of the cost of funding from this lending source, which reduced the exposure to the refinancing risk. Public Debt Management Strategy defines the key measures for further continuation of development of the market for government securities in dinars, since the development of this market will create one of the necessary preconditions for increasing the credit rating of the Republic of Serbia and decreasing the exposure of public debt to FX risk.

1. Balance and Structure of Public Debt in the Period 2013 – 30 September 2016

At the end of September 2016 the total balance of public debt of the general government was RSD 3,022.8bn or 72% of GDP. Of this amount, direct liabilities account for RSD 2,718.2 bn and indirect liabilities RSD 257.8 bn, while RSD 45.8bn is the unguaranteed debt of municipalities and RSD 1 bn is the unguaranteed debt of JP Putevi Srbije.

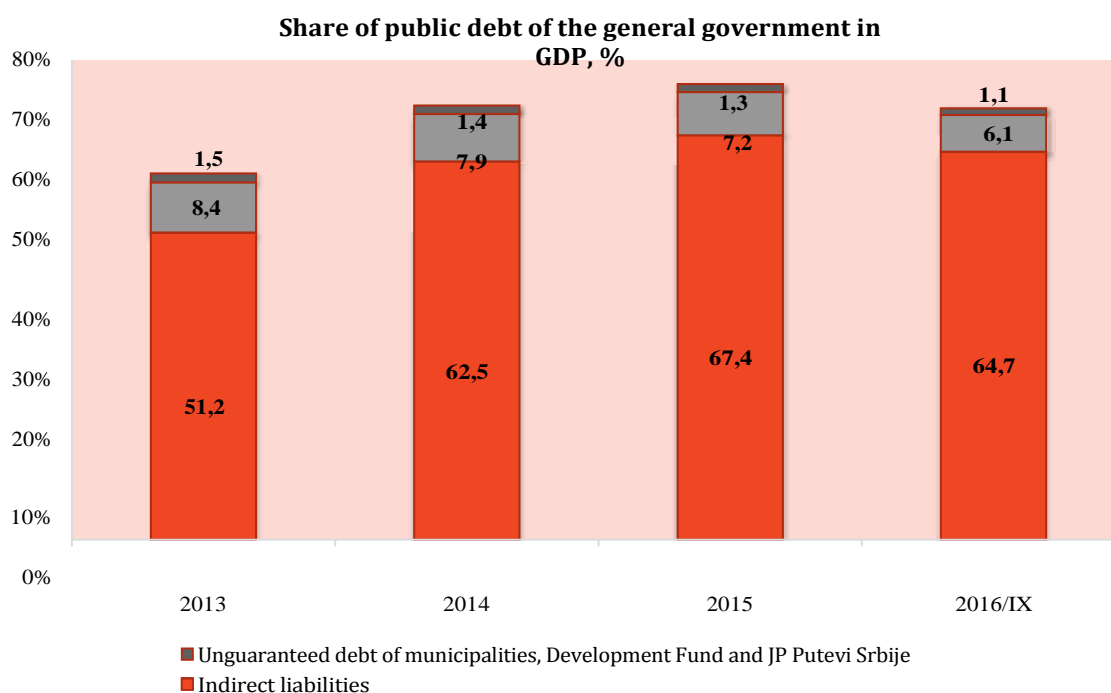


Table 25. Public debt of the general government of the Republic of Serbia in the period end of 2013 – 30 September 2016

	2013	2014	2015	2016/IX
Public debt (in RSD bn)	2.369,0	2.808,2	3.072,3	3.022,8
Public debt (in EUR million)	20.664,5	23.216,0	25.260,1	24.517,6
Public Debt (in USD million)	28.498,4	28.233,0	27.616,9	27.506,3

Source: MOF, Public Debt Administration

In the first nine months of 2016 there was a noticeable decrease in public debt of the central government for almost all currencies in which it had been originally denominated. The public debt denominated in US dollars went down in the first nine months of 2016 by 0.9 US dollars, whereas the public debt denominated in Euros went down by EUR 38.9 million and the public debt denominated in dinars went down by RSD 33.5 bn compared to the end of 2015.

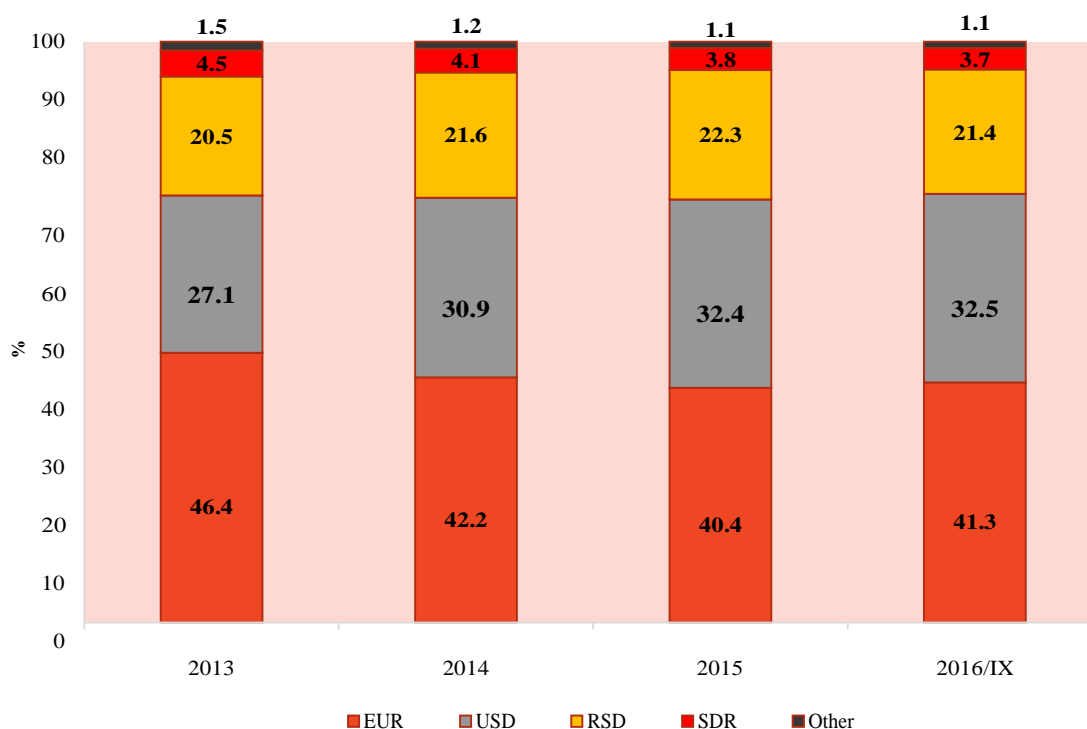
Table 26. The balance of public debt of the central government by original currency in the period 2013 – 30 September 2016, in million

	2013	2014	2015	2016/IX
EUR	9,226.2	9,493.4	9,885.4	9,846.5
USD	7,675.6	8,717.8	8,934.6	8,933.7
CHF	225.7	199.1	173.2	146.4
RSD	466,366.6	588,570.0	668,939.4	635,473.8
other currencies (in RSD)	13,142.8	13,776.4	16,613.5	17,335.1

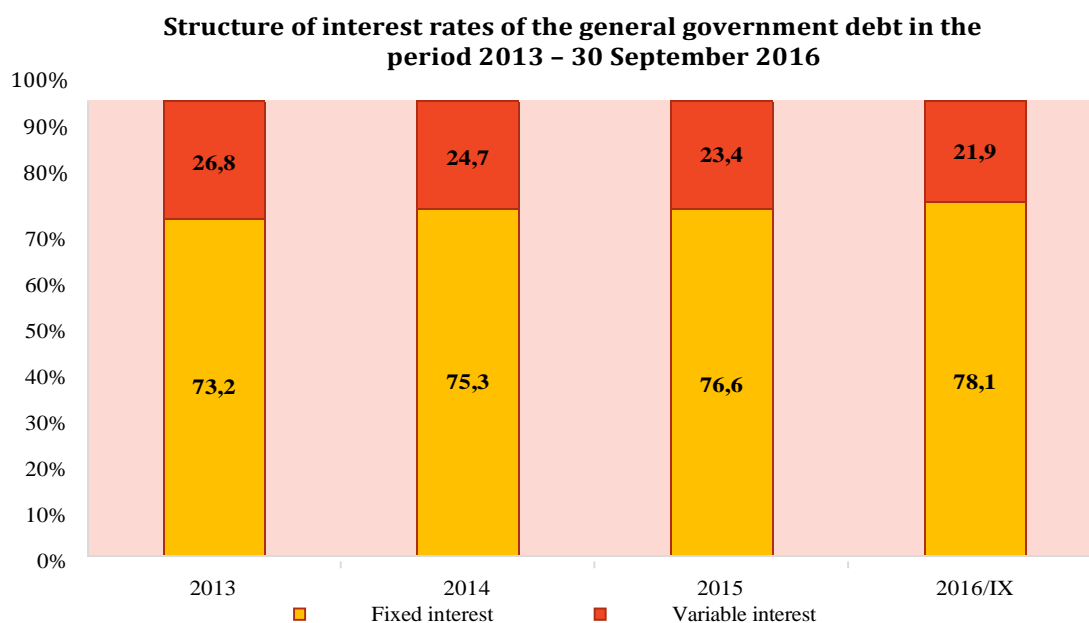
Source: MOF, Public Debt Administration

In line with the orientation toward decreasing the exposure to currency risk, extending the maturity and continuing with the development of new borrowing instruments in the local financial market, the key source of funding in the period 2013 – 2016 was the issuing of dinar securities, which resulted in an increase in the share of public debt in dinars from 20.5% at the end of 2013 to 21.4% of the public debt of the Republic of Serbia at the end of September 2016 i.e. from 469.1 bn dinars, which was the amount of the public debt in dinars from the end of 2013 to RSD 635.5 bn at the end of September 2016.

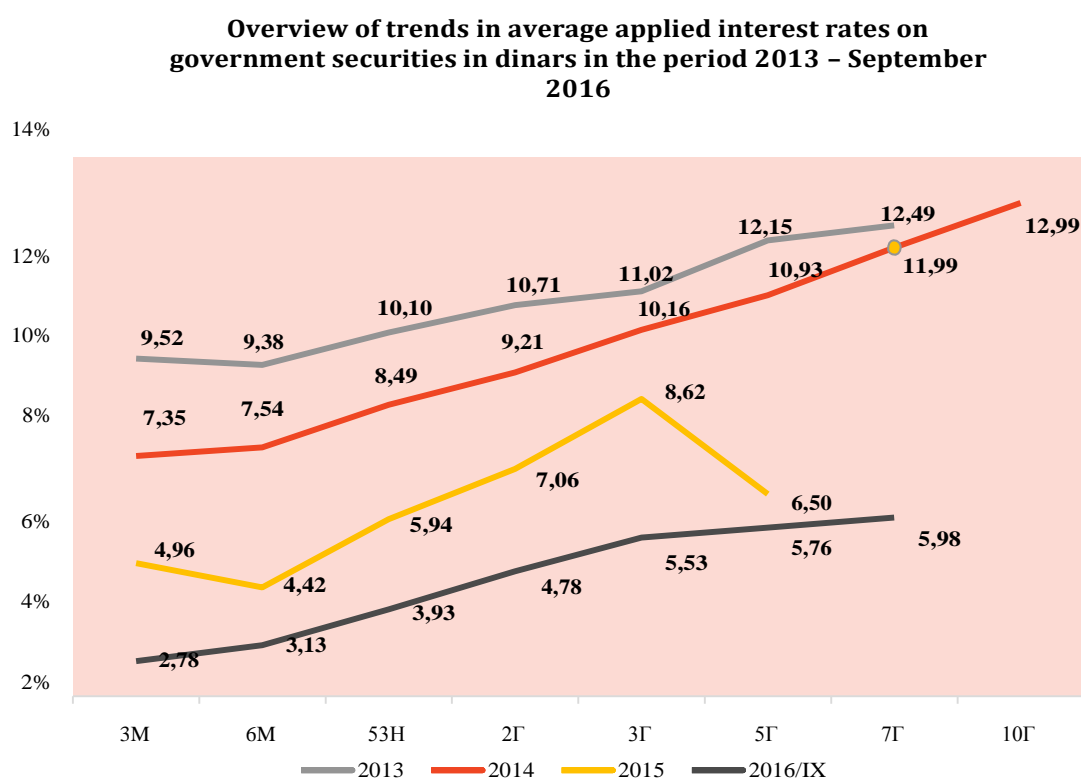
According to the data as of 30 September 2016, the largest portion of public debt of the general government of the Republic of Serbia is still denominated in Euros and amounts to 41.3%. US dollars follow with 32.5% and dinars with 21.4%. The rest of the debt is denominated in special drawdown rights 3.7% and other currencies 1.1%.

Currency structure of the general government's debt between 2013 and 30 September 2016

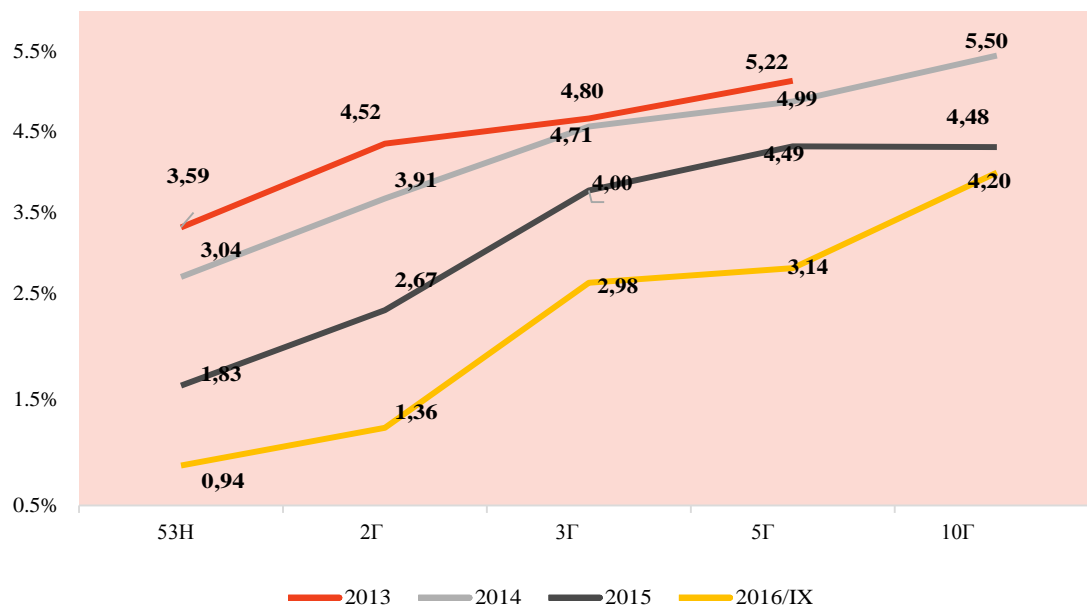
As of 30 September 2016 the greatest portion of public debt of the general government of the Republic of Serbia had a fixed interest rate – 78.1%, while the public debt with variable interest accounted for 21.9% of total public debt. Of the variable interest rates, the most common ones are EURIBOR and LIBOR for euro, which account for 68.4%, then LIBOR for US dollar which accounts for 10.8%, while liabilities linked to the NBS key-policy rate account for 7.2% and other liabilities 13.6%, mostly variable interest rate for special drawdown rights).



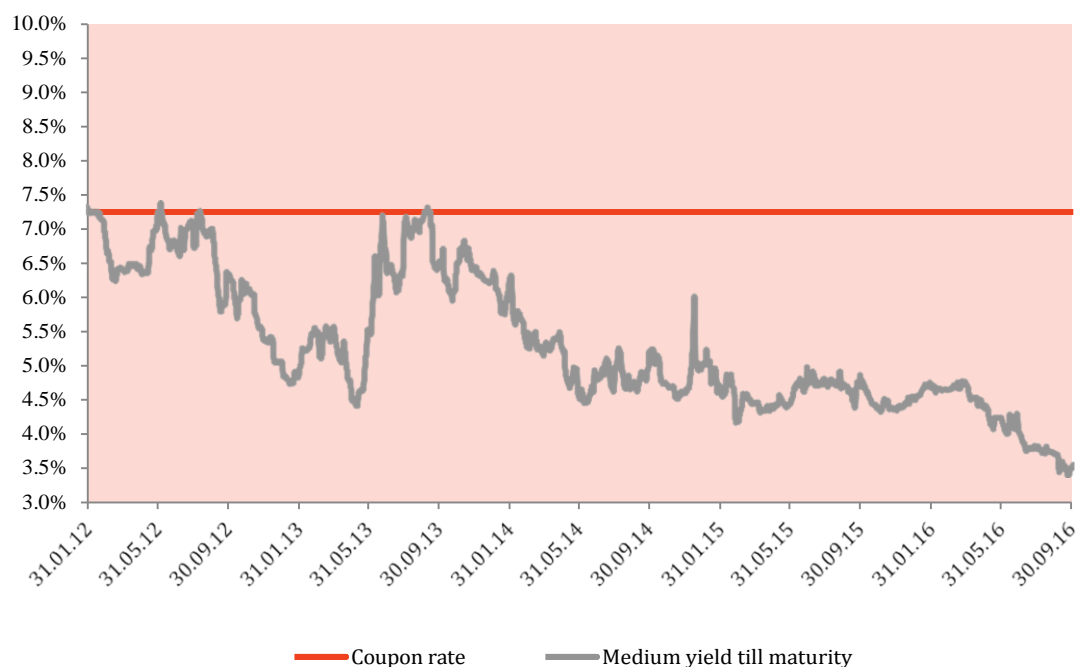
During 2016 there was further decline in the cost of borrowing for the Republic of Serbia from dinar and euro denominated securities, thanks to a decrease in the country's credit risk i.e. the decreased risk premium, low inflation and a decrease in the NBS key-policy rate that is currently 4%, which continued the trend started in the final quarter of 2012.



Overview of trends in average applied interest rates to euro denominated government securities in the period 2013 – September 2016



Overview of trends in the yield rate for Eurobonds - Serbia 2021



Servicing public debt of the Republic of Serbia (central government level) in the period 2016 - 2019²⁵

Table 27. Projections for repayment of interest and principal by 2019, in RSD bn

	2016п	2017п	2018п	2019п
Interest	129,0	134,0	132,5	127,7
Total	666,5	820,3	740,4	708,1
Compared to the public debt as of 30.09.2016, %	22,4	27,6	24,9	23,8

Source: MOF, Public Debt Administration

Table 28. Projected repayment of interest and principals by 2019

	2016п	2017п	2018п	2019п
Principal % of GDP	12,8	15,6	13,0	11,6
Interest, % of GDP	3,1	3,0	2,8	2,6
Total, % of GDP	15,9	18,7	15,8	14,2

Source: MOF, Public Debt Administration

Projected balance of general government debt for the period 2016 - 2019

Bearing in mind the projected primary deficit of the budget of the Republic of Serbia for the period 2016 – 2019, including also the volume of loans drawn down for project financing from budget beneficiaries, the effects of change in the exchange rate of dinar to the euro and US dollar, in the baseline macroeconomic scenario, the balance of debt of the central government should be at approx. 65.9% of GDP at the end of 2019.

Table 29. baseline projection of the balance of the general government public debt by 2019

	2016п	2017п	2018п	2019п
GDPP, bn dinars	4.203,5	4.396,7	4.678,1	4.987,5
Primary surplus (central government), bn dinars	54,6	64,9	83,1	91,9
Interests (central government), bn dinars	129,0	134,0	132,5	127,7
Public debt (central government), bn dinars	3.089,2	3.201,8	3.256,4	3.287,2
Central government's debt, % of GDP	73,5	72,8	69,6	65,9
Unguaranteed debt of local self-governments, % of GDP	1,1	1,1	1,1	1,1
General government debt, % of GDP	74,6	73,9	70,7	67,0

Source: MOF, Public Debt Administration

It is expected that in 2016 the ratio showing the share of central government's public debt in GDP will fall to 74.6% while in 2017 a fall to 73.9% is expected. Full effects of the fiscal consolidation and the undertaken measures will be felt in 2019 when a decrease in ratio is expected to reach 67%. It is estimated that in the upcoming period the unguaranteed debt of the local government level will be at approx. 1.1% of GDP in relative terms.

Balance of debt according to the Maastricht criteria

It is important to note that, according to the national methodology, the balance of public debt includes central government's direct liabilities, as well as all indirect liabilities i.e. guaranteed debt in favour of state-owned enterprises, local self-governments and other legal entities whose founder is the Republic of Serbia. This balance includes also all guarantees, regardless of whether they will be paid in the upcoming period.

²⁵ Central government level includes the budget of the Republic of Serbia, obligatory social security funds and JP Putevi Srbije.

Given that one of the key economic and political goals of the Republic of Serbia is accession to the EU, a precondition that is being imposed is the compliance of local methodology with EU standards. Therefore, the balance of public debt is regularly analysed also on the basis of the criteria set in the Maastricht agreement which contains systematic guidelines aimed at making the public debt and the fiscal system sustainable and preserving macroeconomic stability. According to these criteria, the balance of public debt should include, apart from direct liabilities of the central government, also the unguaranteed debt of local self-governments, but exclude the debt from direct and indirect liabilities that the Republic (the central government) is not paying for.

This debt is measured at nominal value equal to the agreed amounts of debt that the Government should repay to the creditors within maturity, which means that the public debt is not under the influence of changes in market yields and excludes the unpaid accrued interest.

Table 30. Structure and projection of the balance of public debt according to Maastricht criteria by 2019, in RSD bn

	2015	IX 2016.	2016π	2017π	2018π	2019π
Total direct liabilities	2.626,5	2.615,0	2.707,5	2.828,4	2.869,0	2.898,9
Guaranteed debt	187,1	161,4	149,0	116,2	91,2	73,0
Other debt of the state sector	1,4	1,0	0,7	0,4	0,4	0,4
Debt of local self-governance	81,9	75,9	77,1	78,5	80,0	81,7
Debt of the social security institutions	0,0	0,0	0,0	0,0	0,0	0,0
Public debt of the Republic of Serbia	2.896,9	2.853,2	2.934,3	3.023,5	3.040,7	3.054,0
Public debt of the Republic of Serbia as % of	71,6	67,9	69,8	68,8	65,0	61,2

Source: MoF, Public Debt Administration

Principles of public debt management

According to the Law on Public Debt, the primary aim of borrowing by the Republic of Serbia and public debt management is to secure the funds needed for financing budget outlays, at minimum cost of financing in the medium and long run and at an acceptable risk level. Minimizing the long-term expenses of servicing a public debt is limited by the debt structure while achieving the goal of reducing the expenses will be conditioned on a range of factors and risks. On the basis of that, the Public Debt Strategy of the Republic of Serbia defines the following general targets and principles:

- 1) It is necessary to secure the financing for the fiscal deficit and regular servicing of liabilities from the public debt of the Republic of Serbia;
- 2) It is necessary to define an acceptable level of risks that should be determined in the environment of targeted debt portfolio structure in terms of currency clause of the debt, the structure of interest rates, maturity structure and the debt structure by instruments;
- 3) It is necessary to develop the market for securities that are issued in the local and international market, so that the developed market could help bring down the cost of borrowing in the medium and long run;
- 4) It is necessary to allow for transparency and predictability of the borrowing process.

Public debt management strategy should be supported by and consistent with the overall Government's mid-term macroeconomic and fiscal framework.

Public debt management strategy will be based in the upcoming mid-term period on financing the outlays from the budget of the Republic of Serbia mostly through the issue of government securities in the local and international capital market. The market for the government securities is still developing and one of the principles of managing public debt is the necessity for flexibility in order for the financing of outlays from the budget of the Republic of Serbia to be secured. Flexibility will apply to the choice of markets where borrowing will be made, the borrowing currency and financing instruments. The choice of financing structure will take into consideration the current condition and the trend in development of local and international financial market (interest rates, risk premiums, yield curve, exchange rates of the reference currencies) and an acceptable level of exposure to financial risks.

The aim is for financing to be done in the upcoming long-term period primarily through issuing of dinar securities in the local market. The current situation shows that, despite firm determination towards developing the local securities market, a portion of financing must be secured in the international financial market in the medium run. The guidelines for financing in the international market in a foreign currency, securing access to a large number of investors in various parts of the international financial market and borrowing in foreign currency (to the extent possible) are defined in accordance with the repayments of debt denominated in a foreign currency.

Borrowing in a foreign currency, e.g. in the US dollars carries also FX risk due to changes in the exchange rates for the dinar – euro and euro - US dollar. Therefore, it is necessary to consider the use of hedging if borrowing is not in dinars.

Public debt management policy must take into consideration the long-term perspective, but the decision on financing budget outlays must be made per year. The decision on the annual borrowing is made in compliance with the Law on Budget for a particular fiscal year. Depending on the change in the key fiscal aggregates, it is possible to correct the plan of borrowing during a fiscal year.

Financial risks and measures for managing financial risks

Financial and fiscal risks may lead to higher growth in public debt than predicted in the baseline scenario. The risks that are present and which might result in the increase in indebtedness and in the cost of servicing the public debt are: refinancing risk, FX risk, market risk (interest rate risk, inflation risk), liquidity risk, credit and operational risks and risks related to the distribution of servicing costs (debt structure, concentration of liabilities).

In the aim of reducing the exposure to financial risks, it is necessary to undertake the following measures:

1. refinancing risk
 - increase the share of medium term and long-term financial instruments denominated in dinars in the local financial market;
 - balanced distribution of liabilities from public debt on a yearly level and during a fiscal year in the future long-term period;
 - extending the average maturity of the debt that is issued as securities;
2. FX risk
 - striving towards reducing the debt denominated in foreign currency, while taking into consideration the cost of a new debt (cost of debt dinarization);
 - use of financial derivatives with the aim of limiting the effects of change in the exchange rates of reference currencies;
 - effort to have the foreign debt mostly in euros and that the US debt be used only if

financing in the international market in US dollars is cheaper with the use of financial derivatives for limiting the risk;

3. market risk (risk of interest rates, risk of inflation)
 - effort to extend the average maturity of the domestic debt in dinars;
 - issuing indexed bonds (indexation of interest rates);
 - effort to prevent the risk from interest rates on foreign debt from threatening the long-term goal of minimizing the cost of public debt;
4. liquidity risk
 - permanently maintaining the level of cash in accounts of the Republic of Serbia at the level that enables unhindered financing of liabilities for at least four months and at the level that enables an absorption of possible lower than planned inflows from borrowing;
 - adequate management of free cash in the accounts of the Republic of Serbia, in accordance with the principles of asset-liability management, in line with the capacity;
 - consolidation of FX assets, apart from dinar ones, within consolidated treasury system that is kept at the NBS and the use of FX funds to actively manage liquidity also on the FX budget execution account;
5. credit and operational risks
 - implementation of transactions with financial derivatives only with financial institutions that have high credit rating;
 - use of financial instruments that limit credit risk;
 - issuing guarantees and approving new debt to local self-governments and to state-owned enterprises only if there is adequate analysis of a relatively low degree of probability that the guarantee will be activated in the medium term.
 - introducing adequate control in all business activities in the Public Debt Administration and improvement of the knowledge of employees, for which the limit to the number of employees will have to be increased and adequate budget funds will have to be granted;
 - creating new information system for monitoring public debt and its operations;
6. risks related to the distribution of the servicing costs
 - adequate planning of indebtedness on an annual level and equal distribution in the upcoming years and during the fiscal year in order to avoid the risk of high concentration of liabilities to be refinanced;
 - avoiding concentration of liabilities for one public debt on a monthly level, which could not be cushioned by the cash available in the accounts of the Republic of Serbia.

Analyses used when preparing the Public Debt Management Strategy

Public Debt Administration used quantitative approach to formulate the Public Debt Management Strategy, having identified possible limitations through macroeconomic indicators, analysis of costs and risks and market conditions that affect public debt management. When analysing the cost and risk, all feasible financing alternatives are considered. The share of each instrument in the total financing needs in a given year is determined in accordance with the Strategy goals.

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

Funding sources denominated in a foreign currency

- Loans from foreign governments and international financial institutions – shown as instruments denominated in euros or US dollars, with fixed or variable interest;
- Domestic debt denominated in euros is expressed through two instruments – government T-bills and government bonds issued in the local financial market;
- Eurobonds – issued in euros or US dollars in the international financial market.

Funding sources in local currency

All government securities denominated in dinars are grouped in several groups, into short-term government bills (with maturity of up to 53 weeks), two-year, three-year and long-term (five-year, seven-year and ten-year) government bonds.

Future market interest rates and analysis scenario

When preparing the long-term public debt strategy for the period 2017 – 2019 quantitative cost and risk analyses were used that were based on different scenarios and projections.

The starting point is the baseline scenario that is based on the most likely market conditions. Three groups of market variables were identified: exchange rate, interest rates in the international market and interest rates on dinars. Future market rates can be obtained from analysing the available prediction of the purchasing power parity or by predicting the interest rate parity. It is assumed that the trends in the exchange rate for the dinar against the euro or against the US dollar, in accordance with the macroeconomic framework in the observed period, and a relatively stable exchange rate of the euro to the dollar was retained in order to obtain a clear picture of the effect of applied shock. The effect of changes in market interest rates was tested in shocks. The approach for dinar interest rates is based on the current rates of return realized during 2016.

After defining the baseline scenario, with the aim of stress testing, another three types of scenarios – shocks were selected.

Dinar depreciation against the US dollar of 15%. At this type of shock the exchange rate of the euro to the dinar is not changed in this projection. This scenario has a great effect on the public debt of the republic of Serbia due to the share of the debt denominated in US dollar, which, at the end of September 2016, accounted for 33% of the central government debt of the Republic of Serbia

Dinar depreciation of 15% against all currencies. In this scenario the exchange rate of the euro against US dollar is stable, while only dinar would depreciate against both currencies. macroeconomic circumstance for such a scenario would include large current balance of payments deficit and low level of FDI and portfolio investments.

Rise in interest rates in the international market. Currently, interest rates in the world are at a historic low. If the world economy recovers, interest rates will probably increase by approx. 2pp in the medium term.

Increase in interest rates in the local market up to 4pp. Such a scenario would be possible if inflation is above the allowed departure compared to the targeted inflation, as was the case until 2012 and if there is high volatility of the exchange rate of the dinar against the euro due to an increase in the country's risk premium.

Each of the stress tests listed above or the risk scenario has been used for the overview of the cost effects of the strategies that have been considered.

Alternative borrowing strategies for the period 2017-2019

Optimum choice between the cost and risk, on the basis of the World bank's model MTDS has defined the choice of the basic borrowing strategy for the future medium term period. The alternative borrowing strategies that were analysed include:

Basic strategy (S1): is a strategy that covers the needs to finance the issues of government securities in the local and foreign currency in the local financial market and the issues of Eurobonds in euros with a maturity of five and ten years.

Strategy with secured concessional loan (S2): compared to strategy S1, a Eurobond in euros is issued to ten years, favourable long-term loan is secured with a fixed interest rate of approx. 2% in US dollars, while additional financing in the local market is based mostly on dinar securities in the structure, similar to S1. Compared to the S1 strategy, this strategy has higher share of external funding sources.

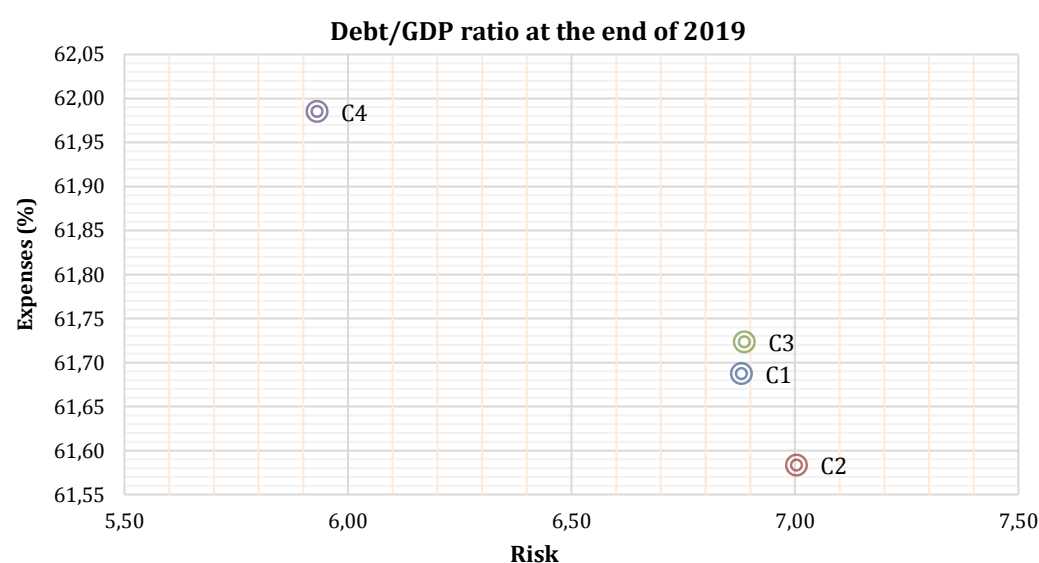
Strategy based on Eurobond issues (S3): strategy S3, compared to strategy S1, anticipates that the Eurobonds with a maturity of five and ten years be issued in US dollars, while the structure and volume of issues of dinar securities should remain as in strategy C1.

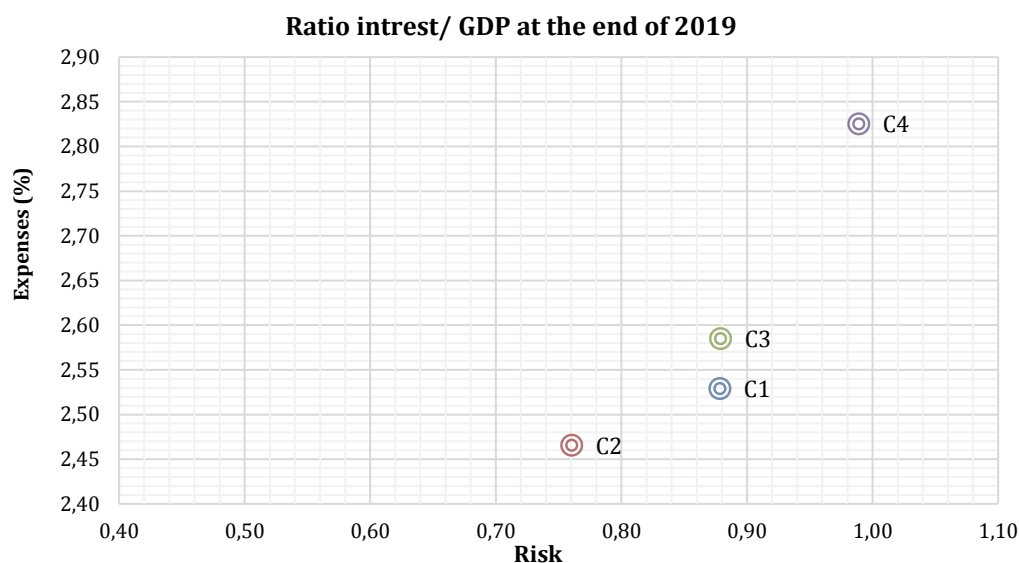
Additional dinarization strategy (S4): is a strategy that bases the whole financing on the issues of dinar securities.

In all these strategies, the financing of budget outlays will be performed mostly through issue of government securities in the international and local capital market, except for strategy S2 where a more considerable share of concessional loans is anticipated.

Comparison of alternative strategies

Quantitative analysis presents the effects of each of the four alternative borrowing strategies where the share of debt in GDP i.e. the cost of interest in GDP in the basic macroeconomic framework is placed on the vertical axis, while the horizontal axis contains the potential cost of a certain borrowing strategy (result of stress testing). Two cost measures were applied: the ratio of public debt to GDP and the nominal interest as percentage of GDP. The first ratio is the indicator of balance and the second is the flow indicator. For the sake of comparison, the focus is on the results of considered strategies at the end of 2019.





On the basis of the graphs one can clearly see the costs that each of the considered strategies implies - strategies S2 and S3 have a relatively higher exposure to the exchange rate risk. Strategy S1, due to combining dinar and euro denominated securities, has high exposure to possible oscillations in dinar interest on government bonds, in the current proportions, while this level of exposure in Strategy S4 increases considerably, as the total additional financing is secured by issuing dinar securities. On the other hand, S4 strategy, given the basic macroeconomic framework, has a more stable ratio of debt share in GDP, due to a relatively higher share of dinars. In strategy S2, which is partially based on the long-term concessional loan in US dollars, the interest rate is the lowest compared to all four observed strategies due to low fixed cost of concessional loan. Strategy S3 is shown as quite risky when it comes to the debt/GDP ratio, because additional financing is based on an issue of bonds denominated in US dollars, while strategy S4 turns out to be relatively expensive, given the high share of dinar securities in this strategy.

When analysing the ratio of public debt to GDP, it was estimated that the strategy S2 is the one that carries the highest risk. Basic S1 strategy has somewhat higher interest expenses compared to S2 strategy, due to higher share of dinar securities. At the basic macroeconomic framework, strategy S2 has low interest expenses, as one part of the funding needs is secured from concessional loan. On the basis of these analyses, it is evident that in the future, medium-term period the key borrowing operations will be based around strategies S1 and S2, but with a clear preference that, in case an opportunity arises for borrowing on concessional terms and in a greater volume, borrowing operations will be based on strategy S2, but further decrease in interest rates on long-term dinar securities will lead towards preference for strategy S1. By applying discounted rates that reflect the borderline (marginal) cost of borrowing for the Republic of Serbia in the financial market, we can see that, from the aspect of net present value as well, the most optimum borrowing strategies are S1 and S2.

Table 31 Ratio of public debt to GDP at the end of 2019

Scenarios	C1	C2	C3	C4
Baseline scenario	61,7	61,6	61,7	62,0
Exchange rate shock(15% all currencies)	68,6	68,6	68,6	67,9
Interest shock (scenario 1)	62,4	62,2	62,4	62,8
Interest shock (scenario 2)	63,1	62,8	63,1	63,5
Combined shock (15% USD and interest shock 1)	65,4	65,5	65,9	65,8
Maximum risk	6,9	7,0	6,9	5,9

Source: MOF, Public Debt Administration

Table 32. Ratio of payments for interest to GDP at the end of 2019

Scenarios	C1	C2	C3	C4
Baseline scenario	2,5	2,5	2,6	2,8
Exchange rate shock (15% all currencies)	2,8	2,7	2,8	3,0
Interest shock (scenario 1)	3,0	2,8	3,0	3,3
Interest shock (scenario 2)	3,4	3,2	3,5	3,8
Combined shock (15% USD and interest shock 1)	3,1	3,0	3,2	3,5
Maximum risk	0,9	0,8	0,9	1,0

Source: MOF, Public Debt Administration

The table below shows the trends in key public debt parameters for all four considered strategies, which depicts the above-mentioned features of each strategy:

Table 33. Risk indicators for alternative strategies

Risk indicator		at the end of 2019			
		C1	C2	C3	C4
Nominal debt (% of GDP)		61,7	61,6	61,7	62,0
Net present value (% of GDP)*		55,2	53,8	59,2	59,4
Applied interest (%)		4,2	4,1	4,3	4,7
Refinancing risk	ATM ²⁶ external portfolio (in years)	6,3	7,4	6,3	6,5
	ATM domestic portfolio (in years)	3,3	3,3	3,3	3,8
	ATM total portfolio (in years)	5,1	6,0	5,1	4,6
Interest rate risk	ATR ²⁷ (in years)	4,6	5,4	4,6	4,1
	Refixing (% of total debt)	29,3	28,2	29,3	31,3
	Debt at fixed rates (% of total debt)	84,6	85,2	84,6	83,7
Exchange rate risk	Foreign currency debt (% of total debt)	68,6	71,6	68,5	45,2

* Applied discount rate reflects the borderline cost of borrowing in the financial market for the Republic of Serbia.

Source: MOF, Public Debt Administration

Stress-test analysis

Fiscal rule, specified in the Law on Budget System, prescribes an obligation that the general government public debt may not exceed 45% of GDP. In case the debt exceeds that level, the Government is obliged to adopt a program for reducing the ratio of public debt to GDP i.e. for bringing the debt back within the lawful range.

At the end of 2015 the balance of the central government's debt reached 74.7% of GDP and the general government's debt reached 76% of GDP. Ratio of public debt to GDP for the central government level was 70.8% of GDP at the end of September 2016 and for the general government this ratio stood at 72%. A slight increase is expected until the end of 2016 and the share will reach approx. 73.5% of GDP on the central level and 74.6% of GDP on the general government level.

Due to high share of the debt denominated in a foreign currency (78.4%), it is evident that FX risk will determine the behavior of the public debt/GDP ratio in the upcoming period and will significantly condition the success of the fiscal policy measures aimed at consolidating public finances and reducing the share of public debt in GDP.

On the basis of the planned macroeconomic framework, in case the possible risks (primarily FX risk) do not materialize, the public debt, excluding the unguaranteed debt of the local self-governance, should be at 65.9% of GDP by 2019.

The key factor that affects the stabilization of the public debt/GDP ratio are the GDP growth, primary deficit, dinar exchange rate against foreign currencies and the level of interest.

²⁶ ATM (Average Time to Maturity)

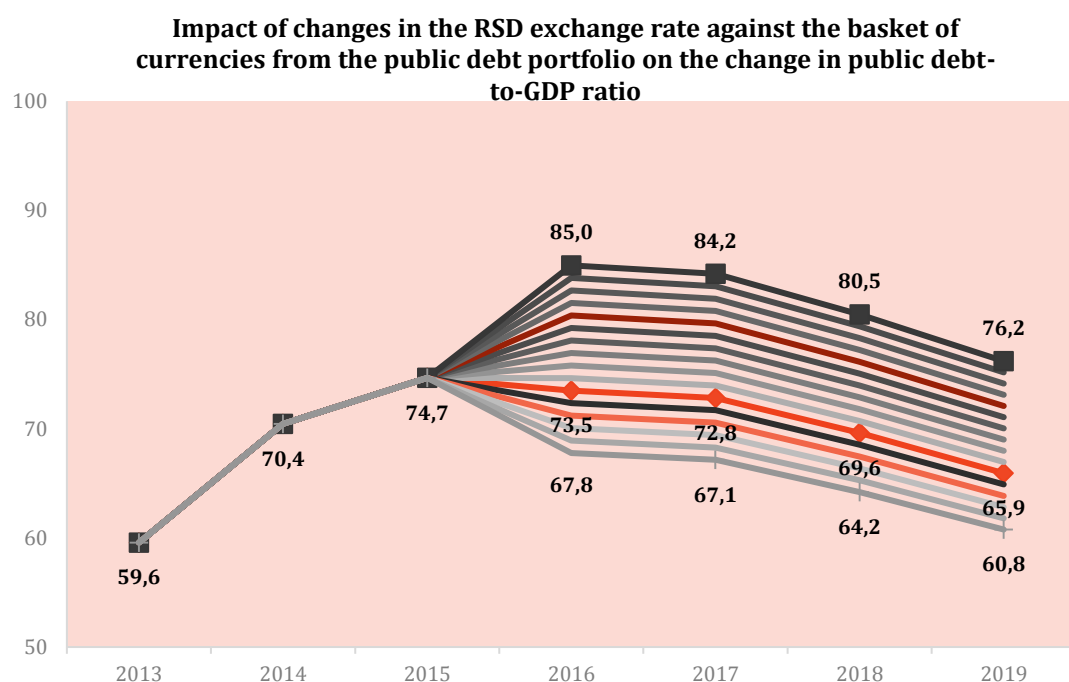
²⁷ ATR (Average Time to Refixing)

The planned fiscal policy measures also call for a reduction in the primary deficit which reduces the key factor of debt growth.

Table 34. Contributions from the key macroeconomic variables to the change in the public debt (central government)/GDP ratio, in %

	2014	2015	2016 π	2017 π	2018 π	2019 π
Central government debt as % of GDP	70,4	74,7	73,5	72,8	69,6	65,9
Change compared to the previous year	10,8	4,3	-1,2	-0,7	-3,2	-3,7
Effect of primary deficit	3,6	-0,3	-1,3	-1,5	-1,8	-1,8
Interest	2,8	3,1	3,1	3,0	2,8	2,6
Nominal GDP growth	-0,5	-2,3	-2,8	-3,2	-4,4	-4,3
Other factors that affect the ratio	4,9	3,8	-0,1	1,0	0,1	-0,1

Source: MoF, Public Debt Administration



The graph shows the trend in the ratio of public debt of the central government /GDP, depending on the change in the dinar exchange rate against a certain currency bucket. Basic projection is shown with alternative scenarios, depending on appreciation or depreciation of the dinar exchange rate in the range between 10% of appreciation to 20% of depreciation of dinar against the currency bucket. Implementation of these scenarios will show that the ratio for 2019 would range between 60.8% and 76.2%, while for the baseline scenario this ratio would be 65.9%.

Key risks for realization of Strategy, apart from the above listed factors that have been quantified, are also the stability of the macroeconomic situation in the Republic of Serbia, the need for additional borrowing in order to settle the debts in other levels of government, public sector and the financial sector of the republic of Serbia and issued guarantees.

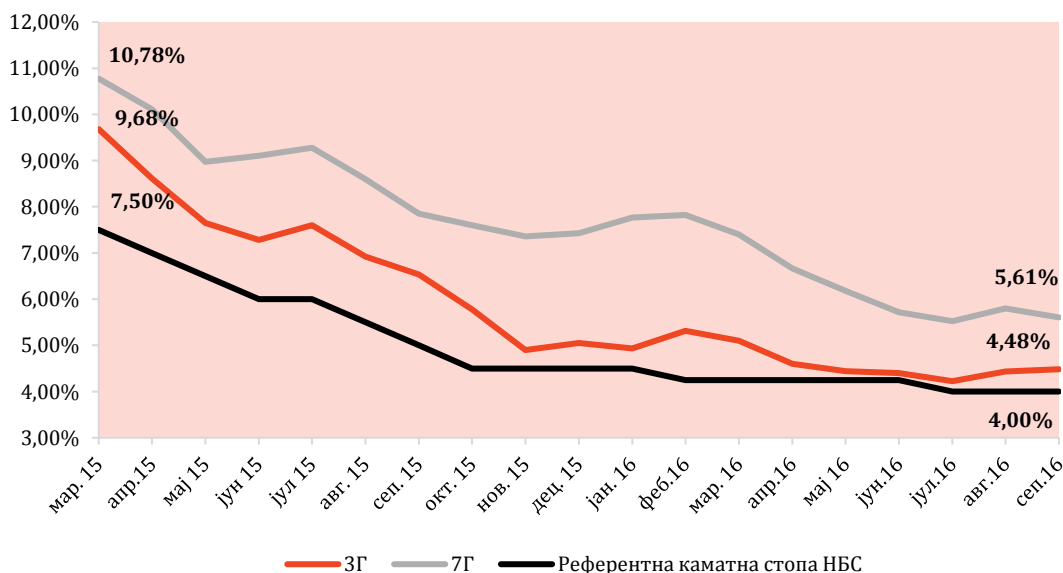
It is important to mention that the reduction of public debt against the GDP is contributed also by the adequate control of issuing guarantees and improvement of the process of prioritizing investment projects that are financed from credit lines of multilateral and bilateral creditors. As of 2015 the guarantees are issued only for project (investment) loans i.e. issuing of guarantees for loans for current liquidity of state-owned enterprises has been halted, which in 2015 and 2016 noticeably reduced the balance of the guaranteed public debt.

Long-term strategic framework for public debt management

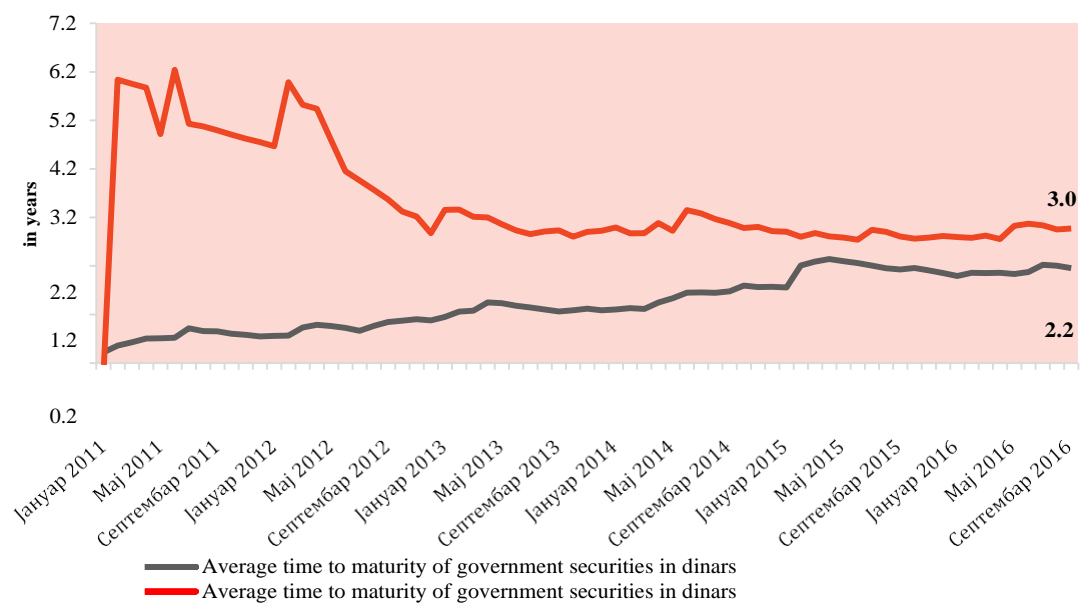
The key strategic goals that we should strive for in the upcoming long-term period, in order to minimize the risk of increasing the indebtedness and the cost of servicing public debt are:

- that the share of debt denominated in dinars amounts to approx. 20-25% of the total public debt in the medium run;
- that the share of debt denominated in euros in the public debt amount to no less than 60% of the debt in foreign currency, including future borrowings and transactions;
- that the share of debt with variable interest rate decreases to below 20% in the medium term;
- that the average time to refixing (ATR) is maintained at the level of at least 4.5 years, in accordance with the above-stated measure for gradual decrease in the share of debt with variable interest rates;
- that the weighted average interest rate (WAIR) for the internal public debt does not exceed 10% for mid-term and medium-term borrowing;
- that the share of short-term debt (whose maturity is up to one year) amounts up to 15% of the total public debt;
- that the average time to maturity (ATM) of the internal debt is at the level of at least 4 years for medium term;
- that the average time to maturity (ATM) of the external debt is maintained at the level of 6 ± 0.5 years in the same time horizon.

Trends in yield to maturity of three-year and seven-year dinar benchmark issues in secondary trade



Average time to maturity (ATM) of the government securities issued in the local financial market in the period 2011 – 30 September 2016



Measures for improving the market for dinar securities in the period 2016–2019

The market for government securities in the period from 2012 to September 2016 is characterized by fulfilling the set strategic targets, primarily regarding the financing instruments, and by developing and maintaining the stability of diversified investor base. Thanks to pursuing a development policy for the local market of government securities, continuity has been enabled in financing the budget of the Republic of Serbia, as well as improvement of the volume of financing by issuing long-term dinar government securities in the local financial market. Transfer from short-term funding sources, which are related to the period until 2010, to mid-term and long-term instruments of finance, with constant decrease in the cost of borrowing, reduces the 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 instruments at original maturity of three and more years amounted to 37% in the balance of dinar securities and 67% at the end of September.

Transparency in operation and in reporting, as well as presence in the international capital market influences how well informed and, by extension, interested the non-residents are in investing their capital into debenture instruments, primarily into government long-term dinar securities, which generates the growth of stable investor base. In 2014, ten-year bonds were issued for the first time, which completed the development of maturity in the yield curve for both dinar and euro denominated government securities. In February 2015 a benchmark issue was issued for the first time in the local financial market with seven-year maturity in the amount of RSD 50 million. During 2015 two three-year bonds were also issued in the amount of RSD 50bn each. Due to successful realization of benchmark issues during 2015, the same practice was continued during 2016. In February 2016 three-year and seven-year bonds were issued at the volume of issue of RSD 110 bn. With these issues the volume of secondary trade in these instruments increased considerably, which contributed also to the decrease in applicable rates of return for reopening of these issues.

For the purpose of developing the secondary market for government securities, as of 12 November 2015 it has been allowed to trade in long-term government securities on Belgrade Stock Exchange.

In the period this Strategy applies to we expect to see improvement in the efficiency of primary market through the concept of primary dealers, as a mechanism for selling government securities that directly, over a long period, contribute to a reduction in the cost of borrowing, and the reduction of refinancing risk. Introduction of the system for selling government securities in the local financial market via primary dealers provides good basis for improvement of market efficiency of the secondary market for government securities. With the development of secondary market, over time, the concept of market efficiency will be established in the process of valuing government securities. Introduction of benchmark bond issues would have a positive effect on the volume and continuity of secondary trading, as well as improvement of market efficiency in the process of selling government securities in the primary markets.

The leading factor that affect the yield curve of the government securities and that should be singled out is the fiscal result, the expected inflation rate and exchange rate. Macroeconomic trends and expectations should be singled out as a special group of factors, as well as changes in the international financial market that affect the country's risk premium.

At the end of 2011 the average maturity of dinar securities amounted to 272 days (0.75 years), at the end of 2012 amounted to 394 days (1.1 years), at the end of 2013 amounted to 469 days (1.3 years), at the end of 2014 amounted to 645 days (1.8 years), at the end of 2015 amounted to 749 days (2.1 years), while on 30 September 2016 it amounted to 789 days (2.2 years).

In the period until 2018 it is estimated that the average maturity will range between 2 to 3 years. The development of the local market for government securities will be supported by the Republic of Serbia through the following measures:

- Including the government securities denominated in local currency into one of the global indices of government bonds of countries in the emerging markets (Local Currency Government Bond Emerging Market Index). Including the bonds of the Republic of Serbia into one of the global indices will considerably increase the investor base and promote secondary trade, which will contribute to further decrease in the cost of borrowing from issue of government securities;
- With the aim of creating the biggest possible investor database and with the aim of developing the secondary market for securities issued in the local market, an equal tax treatment was created for both local and foreign investors at the end of 2011 and in the upcoming period the tendency will be to eliminate all possible obstacles for free flow of capital. An option of using the international clearing system to clear and net the transactions with domestic securities will be considered in the upcoming period;
- Activities will be undertaken in the upcoming period on the introduction of the primary dealer systems;
- With the aim of increasing investments by local private individuals, additional efforts will be made in the domain of educating the population of the Republic of Serbia and the issue of the so called retail bonds will be considered.

The Finance Ministry will modify the auction platform in the upcoming period on the basis of proposals from investors in order to satisfy the interests of both sides in the best possible manner and in the manner acceptable for both sides.

IV. STRUCTURAL REFORMS FROM 2017 TO 2019

The Government and the Ministry of Finance are dedicated to the accomplishment of the economic policy goals laid down by the three-year Fiscal Strategy and Memorandum on Economic and Financial Policies agreed upon with the IMF. A credible medium-term plan of structural reforms implemented along with fiscal consolidation measures aimed to attract foreign investments, supporting the growth and rebalancing of the economy intended to accelerate the EU integration, a key precondition for: (1) stabilizing public finances by reducing of the fiscal deficit and public debt, and (2) fostering economic activity based on increased investments, exports and employment. Structural adjustment of the economy creates a more lasting basis for a faster and sustainable economic growth, job creation, and higher living standards.

In this regard, at the close of 2015 and in the course of 2016 numerous reforms were carried out with the aim of developing the private sector and creating new jobs, improving the business environment and promoting competitiveness:

- A comprehensive reform of state- and socially-owned enterprises has been initiated in order to improve their operational sustainability and address fiscal risks, as well as to reduce state aid and accumulation of arrears;

- The Serbian Development Agency (hereinafter: RAS) was established pursuant to the newly-adopted Law on Investments. The RAS is the product of the merger of the Serbia Investment and Export Promotion Agency and the National Agency for Regional Development designed to enhance the efficiency of the combined entity. The RAS offers a wide range of services, including support for direct investment and export promotion, but also implementation of the projects intended to improve competitiveness, regional development, and reputation of Serbia. The Law on Investments also established the Council for Economic Development, which is together with the RAS tasked with creating conditions for a clearer division of responsibilities when it comes to proposing, implementing, and monitoring Government policies;

- In February 2016, the Government adopted a program of activities entitled “Year of Entrepreneurship 2016” to encourage entrepreneurial spirit and facilitate access to credit finance for small and medium-sized enterprises. The program “Year of Entrepreneurship 2016” is based on three main pillars: improvement of the business climate, direct support to companies, and development of the entrepreneurial spirit. The Program’s outcomes are still being accessed; according to the data from November 2016 data, however, more than seven thousand companies, start-ups, local governments and clusters have taken part in the Program. Continuation of the Program has also been planned in the coming years;

- In late 2015, the Republic of Serbia and the EU signed an agreement confirming the country’s participation in the EU COSME program for small and medium-sized enterprises, which provides support to small- and medium-sized businesses by facilitating access to finance, aiding internationalization and access to foreign markets, creating a more business-friendly environment and encouraging competitiveness, and fostering entrepreneurship;

- The Ministry of Economy is implementing in cooperation with RAS, selected business banks and leasing companies the Program of Support to Small-Sized enterprises for purchase of equipment in 2016, in order to strengthen the competitiveness of businesses, improve their operations and internationalization, as well as creating new job posts;

- Since the beginning of 2016, the Ministry of Economy has been implementing the Program Supporting Improvement of economic climate intended to attract investments and enable job creation. The Program’s involves assistance in providing infrastructure for business zones in

order to attract investments by participation in the financing of the projects of infrastructural equipping of the business zones, and/or the construction of new facilities, reconstruction refurbishment of existing amenities, construction of auxiliary facilities to support business zones, and financial assistance for construction of access infrastructure and utility, electric power and other infrastructure facilities;

- Under the European Investment Bank's Municipal and Regional Infrastructure Loan, the Ministry of Economy has since early 2016 been pursuing infrastructure projects for local and regional development in support of local governments. The objective of these programs is to enhance capacity of local authorities by improving infrastructure and living standards. The Ministry of Economy provides funding of up to 50% of project value, excluding VAT;

- In December 2015 was adopted the National Program for Countering the Shadow Economy, intended to reduce the share of the shadow economy in GDP, and enable more efficient control over the informal economy, improve operation of the fiscal system, decrease the administrative and quasi-fiscal burden imposed on businesses and the general public, raise awareness of the importance of tackling the shadow economy, and encourage compliance;

- The range of active labor market policies has been broadened; in addition, World Bank assistance has been secured for ongoing reform of the National Employment Service aimed at increasing the efficiency of its programs and improving the quality of its services for the unemployed and employers;

- National employment action plan for 2017 has been adopted;

- The Employment and Social Reform Programme was adopted in June; this is the chief mechanism for dialogue on social and employment policy priorities in the course of EU accession negotiations;

- The „Research for Innovation” Serbia Scientific and Technological Development Strategy, 2016 to 2020, has been adopted. Its objective is to establish an effective national research system integrated into the European research framework that is able to contribute, through development of innovation, to economic growth, social and cultural progress, greater living standards, and better quality of life for the general public;

- The Information Technology Industry Development Strategy, 2017 to 2020, has been adopted; it includes measures to enhance productivity of the sector and so make an indirect impact on overall economic growth, as well as to reduce the economic development gap between urban and rural areas;

- A Central Inventory of Planning Documents came online in May 2016. Its purpose is to simplify the registration of real property and reduce the associated costs. The Central Inventory, which is part of the electronic construction permitting system, contributes to the creation of an investor-friendly environment by expediting construction permitting and making it easier to identify potential locations for investment. The Inventory allows online tracking of property titles to facilitate registration and reduce cost;

- The Tourism Development Strategy for the period from 2016 to 2025 has been adopted. Its implementation is expected to result in a significant increase of tourism revenues and creation of new jobs in the tourism sector;

- The Strategy for Trade Development to 2020 has been adopted; the Strategy envisages the foundation of a National Trade Council and establishment of a database on to trade and trade network of the Republic of Serbia. The database will facilitate market analysis by potential investors;

- The Program for Harmonizing National Legislation with the EU Services Directive (Directive 2006/123/EC), with accompanying Action Plan and Appendix, has been adopted; the

Program envisages improvement of the business environment and removal of undue restrictions for the performance of certain services, as well as the ability to provide cross-border services. Services have to date been governed in Serbia by a large number of sectoral regulations. The Program will help regulate the service industry in an integrated and unified manner, and will create preconditions for application of the EU Services Directive;

- The overall legal framework has been improved to promote economic growth and create a more business-friendly environment intended to increase investment and employment and ensure more balanced regional development. The Investment Law, adopted at the close of 2015, ensures equal treatment of foreign and domestic investors and enhances the environment for investment. The Law stipulates special treatment for investments of particular significance in underdeveloped municipalities. A new Government Order on incentives for balanced regional development in 2016 has been adopted; this regulatory instrument governs support for balanced regional and local development, strengthening of regional institutional capacities, increased competitiveness of regions, districts, and local governments, and strengthened inter-municipal, inter-regional, cross-border, and international cooperation. A separate Government Order was also adopted to regulate investment promotion; this instrument sets out criteria for designation of investments of particular and local significance and governs schemes designed to attract direct investment in Serbia. Among other issues, the Order regulates monitoring and oversight of investment projects awarded incentives under the Order, as well as the procedure for awarding incentives, incentive amounts, and periods in which any incentives and exemption from payment of customs and other duties on importation of a foreign investor's equipment can be exercised.

The business environment has benefited from systemic resolution of difficulties faced by firms in restructuring, as well as from structural reforms to labor legislation and construction. These have also resulted in Serbia improving its position in international competitiveness rankings. Serbia rose by four positions in the World Economic Forum's Global Competitiveness Index (from 94th to 90th place) of a total of 138 countries. The greatest progress was seen in the country's macroeconomic environment. The World Bank has recognized Serbia's structural reforms, placing the country 47th in its Doing Business 2017 rankings. Serbia is one of the countries that have made the most progress on the World Bank's ease of doing business list, including a leap of 116 positions due to construction permitting reforms.

1. Structural Reforms of the Real Sector

Reforms designed to improve the business and investment climate and promote growth of the private sector will resume so as to reduce the cost and risk of doing business and investing in Serbia. These efforts will ensure better protection of competition, faster growth of small-and medium-sized enterprises and entrepreneurship, greater flexibility of the labor market, and more efficient resolution of bankruptcies. Special attention will be paid to structural reforms that strengthen productivity and efficiency, exports, and employment, which will result in greater competitiveness. Particular attention will be paid to the completion of restructuring of state-owned enterprises.

Structural Reforms Promoting the Business Environment

To improve competitiveness and business environment of the Republic of Serbia, a comprehensive program will be instituted to support to investment, new jobs creation and development of the private sector. This Programme will ensure that pro-growth policies are well coordinated and targeted. Concrete actions will focus on the following areas:

- Promotion of small-and medium-sized enterprises growth will continue through implementation of the Strategy for Supporting Development of Small and Medium-Sized

Enterprises, Entrepreneurship and Competitiveness;

- Following the success of the program entitled „Year of Entrepreneurship 2016“, the activities that promote the business environment and provision of direct financial and non-financial support to the sector of small-and medium-sized enterprises and entrepreneurs will continue;

- Taking into account the importance of small-and-medium-sized enterprises for the Serbian economy and the limited access of this sector to finance, a framework will be introduced to allow operation of non-deposit financial institutions and credit support to small-and-medium-sized enterprises through credit lines of the European Investment Bank („Apex Loans“). Guidelines for allocation of Apex funds have been developed in accordance with EIB criteria to improve the efficiency of the Apex Program;

- Efforts to tackle the shadow economy will continue, with 2017 and 2018 designated as “Years of Addressing the Shadow Economy”;

- In the course of 2017, an independent consultant will carry out a diagnostic analysis of the Republic of Serbia Development Fund and the Export Credit and Insurance Agency, and will develop proposals to improve their management and operating procedures;

- The newly-established Inter-Ministerial Council for Information Technology will in the forthcoming medium-term period implement a number of initiatives designed to increase exports of the IT sector, which will contribute to job creation posts and promote the innovation environment;

- A Law on Fees is being drafted that will replace existing laws and bylaws and regulate fees at all government levels so as to enable greater predictability and transparency. The Law is planned to be adopted in 2017;

- Efficiency of bankruptcy procedures will continue to be improved, including through amendment of the Bankruptcy Law;

- Bylaws to the Law on Public Enterprises are being drafted to improve the efficiency of public enterprises and create a robust framework for supervising their operation. Introduction of corporate governance in public enterprises will continue so as to ensure impartiality, transparency, and accountability in corporate behavior;

- Development will continue of a single public register of administrative procedures and other conditions for doing business; this is intended to allow businesses and members of the public to know in advance the cost of any service provided by public administration.

Structural Reforms Promoting the Labor Market

In conformity with the overall objective of employment policy to 2020, laid down by the 2011–2020 National Employment Strategy, activities will continue with the aim of establishing an efficient, stable, and sustainable trend of employment growth by the year 2020.

The following activities are planned for the forthcoming period:

- The current employment policy framework will be improved; existing active labor market policies will be implemented more thoroughly, and new ones will be introduced. Establishment will continue of the National Qualifications Network (NQN), an instrument to ensure the education system meets the real needs of the labor market;

- Improvement of conditions in the labor market will continue, as will the effectiveness of labor market institutions. This will encourage the hiring of those who are hard to employ and their inclusion into the labor market, provide support for local and regional employment policies, enhance quality of the labor force, and promote investment in human capital;

- Job creation efforts will continue, with special focus on agriculture, information technology, SMEs, start-up entrepreneurs, and better access to finance;

- Employment in underdeveloped regions will be promoted, with simultaneous development of regional and local employment policies, enhancement of human capital,

institutional capacity-building, and reduction of undue differences between participants in the labor market;

- Active employment measures will continue to be pursued with reference to the state of the labor market and results of policies implemented to date, with special focus on the young and long-term unemployed.

Financial Stability

To preserve financial stability and promote the ability of the banking sector to respond readily to possible shocks from the external environment, and at the same time enhance financial intermediation, special attention will be paid to the resolution of non-performing loans (NPLs), provisioning policy, and enhancement of the oversight and regulatory framework in accordance with EU standards.

Progress has been achieved in implementing the NPL Resolution Strategy. The National Bank of Serbia (NBS) has to date implemented all measures envisaged under the NPL Resolution Action Plan, thus demonstrating its dedication and commitment to resolution of this complex issue in conformity with best international practice, and carrying out its responsibilities so as to preserve the stability of the banking and financial system as a whole and enhance its efficiency. The NBS's new regulatory requirements will enhance banks' reporting of NPLs, treatment of restructured loans in accordance with EU requirements, and the regulator's expectations regarding management of non-performing assets. In addition, 2016 saw the completion of guidelines for disclosure of banks' asset quality information. It is worth noting that the findings of the special bank asset quality review, carried out on the ECB model, confirmed that all banks tested were adequately capitalized. Moreover, a database of appraised values of mortgaged real property and loans secured by mortgage has been established, with banks required to provide this data to the NBS on a monthly basis. Adoption of the Law on Real Property Value Appraisers is underway in parallel. As a result of all these activities, the share of NPLs in total bank loans fell in September to 19.5%, 2.1 percentage points lower than at year-end 2015, and 2.5 percentage points lower at annual level.

Basel III standards will be introduced into national regulation by the end of June 2017. Minimum capital requirements will decrease thereafter, and new capital requirement tiers will be introduced to limit systemic risks. Loan-loss provisioning requirements will remain in force until 2019; however, recently adopted bylaws allow banks to reduce reserve requirements if they are able to bring NPLs down to prescribed levels.

To preserve financial stability, the NBS and the Government will continue implementing the "Dinarization" Strategy. The Strategy's activities can be grouped into three interconnected pillars: 1) maintenance of macroeconomic stability, at once the key pillar of the Strategy and the primary metric according to which the success of dinarization will be measured; 2) promotion of a market in dinar-denominated instruments, and 3) promotion of instruments to protect against existing FX risks in the non-banking sector. The Strategy has already yielded visible results, with both retail lending and deposits recording a rising trend as the result of low inflation, a relatively stable exchange rate, and significantly lower interest rates on dinar loans relative to three years ago.

Improvement of Transport Infrastructure

The document Master Transport Plan until 2027, made in cooperation with the European Union, defines and prioritizes the investment into the transport infrastructure for various modes of transport and by priorities. The basic target of the Master Transport Plan for Serbia is to contribute to the creation of a better and safer transport network that will attract investments in underdeveloped regions, improve the quality of life of the population living there, and improve trade. The Spatial Plan of the Republic of Serbia to 2020 defines the organization, arrangement, use, and protection of spatial resources of the Republic of Serbia to ensure that economic and social development reflect natural potentials.

Efforts will be invested into the development of local and regional logistics centers along multimodal Corridors X and VII, as well as in large economic regional hubs and their gravitational areas, with the aim of developing transport infrastructure. At the same time, work has resumed on the E-80 motorway (in the direction of the Bulgarian border, the *Istok* ("East") Project), as well as on the Belgrade bypass, and on the E-75 motorway (in the direction of the Macedonian border; the *Jug* ("South") project). Work is also progressing on the so-called "Corridor XI", the E-763 Belgrade–South Adriatic motorway, while project documentation is under preparation for the Niš–Priština highway (to connect Corridor X with the Adriatic via the Albanian city of Durrës). The design project for the Novi Sad – Ruma dual carriageway (the "Fruška Gora Corridor") has been finalized, and detailed planning documents are under preparation. Technical documentation for the Batajnica intermodal terminal and logistics center has been completed, with construction slated to begin by late 2016. Once built, this terminal will reduce the impact of logistics costs on the price of products, and allow goods to reach customers more quickly and cheaply, so contributing to greater investment and job creation.

Works on the railways Oriental/East Mediterranean Basic Corridor, involving the reconstruction and modernization of the railway line are underway. The project of Belgrade–Budapest railway line reconstruction is a key infrastructure projects in the next period, along with the construction of the Žeželj Bridge in Novi Sad and modernization and rehabilitation of the Niš–Preševo, Niš–Dimitrovgrad railway lines, and reconstruction of the Belgrade–Bar railway line. The Belgrade Railway Node – Belgrade Center Phase 1 Project has been completed. Serbia continues to provide support for implementation of the South-East Europe Gas Ring Project. Preparatory works for the Niš to Dimitrovgrad gas interconnector between Serbia and Bulgaria will be intensified to enhance security of gas supply. Construction of electricity interconnection facilities between Romania and Serbia will commence as part of the Trans-Balkan Electricity Corridor.

Under preparation is the law on broadband approach to Internet which, when adopted, will make the national legislative framework in the area of electronic communications compliant with EU framework, and regulate the conditions for, and the mode of, development of the broadband access to Internet (Directive 2014/61/EU). Structural reform also includes the consolidation of the broadband network in ownership of the public sector, connecting the public institutions to the national network, as well as the construction of the broadband communication infrastructure with an access network in the settlements. The construction of broadband access infrastructure in all regions of the Republic of Serbia will create the conditions for a decrease of the economic gap, i.e. for a uniform regional development, growth of GDP, employment and productivity, and for the accomplishment of inter-sector synergy that reduces the need for the construction works that would be needed for installing the electronic communication networks.

Improvement of Energy Infrastructure

Strategy of Energy Development of the Republic of Serbia until 2025 with projections until 2030, growth of the electric power sector is the key link in the development of the energy system of the Republic of Serbia as a whole. The Strategy also presents an overview of production capacities and electric energy systems.

Average age of the entire installed production capacity is over 25 years in the thermal power and hydropower electric plants of the Public Enterprise „Elektroprivreda Srbije“. While existing electric energy producing capacities need refurbishment, new capacities are also required to ensure end-users can benefit from a reliable supply of electricity. Existing transmission capacity also requires refurbishment, and new such capacity ought to be constructed to ensure the transmission system is able to develop in a balanced, sustainable, and timely manner and to connect new conventional and renewable sources of electricity. Development of the distribution network entails construction of missing sub-stations,

transmission lines, and low-voltage networks, and reconstruction and modernization of existing facilities. These measures will help reduce the currently very large losses encountered by the distribution systems and increase their efficiency, so making the system more reliable and providing better service to clients. Modernization and promotion of energy efficiency will contribute to satisfying the country's energy needs.

To allow Elektroprivreda Srbije PE to respond to and satisfy the increased need for electricity, construction of a new 350-megawatt B3 Block at the Kostolac coal-fired power plant has been planned as part of Phase 2 of the Kostolac B Package Project. The new B3 Block will replace the old A1 and A2 Blocks and so ensure reliable supply of electricity and heat. Plans also call for some power generation capacity to be phased out as Serbia aligns its system with the EU's environmental policy framework, and as Elektroprivreda Srbije downsizes and cuts operating costs.

New gas pipelines, underground storage facilities, and compressed gas stations have also been planned, with the aim of ensuring reliable supply of gas and promoting robust, safe, and sustainable operation and development of the gas system, energy system, and energy sector in general, in accordance with the Law on the Spatial Plan of the Republic of Serbia, 2010 to 2020. The Niš to Dimitrovgrad trunk gas pipeline is a priority project in this regard.

As envisaged under the Law on Commodity Reserves, and in accordance with Serbia's international obligations and Chapter 15 (Energy) of the EU *acquis*, construction has been planned of new public warehousing capacities to enable the storage of mandatory reserves of oil and oil products.

The Program to Implementing the Energy Development Strategy to 2025, with projections to 2030, is under development. Pursuant to Articles 5 and 6 of the Law on Energy (*Official Gazette of the Republic of Serbia*, No. 145/14), the Program will define the measures, projects, and activities to be implemented between 2017 and 2023, in all energy-related areas, including electricity, heating, renewable energy, coal, oil, natural gas, and energy efficiency.

Agricultural Sector Development

The agriculture sector is characterized by technological obsolescence and an unfavorable structure of agricultural holdings (most holdings are of small or medium sized), which could constrain development, taking into account the favorable conditions for agricultural development in the Republic of Serbia. By liberalizing the agricultural sector, the government has lost its ability to influence farm size. To counteract these issues, the government will endeavor to lower the cost of production inputs and encourage the association of small- and medium-sized farmers. By doing so the government will help smallholders increase their competitiveness.

Under the amended Credit Support Regulation, which has made it easier to access credit, in 2016 the Ministry of Agriculture and Environmental Protection has continued to facilitate borrowing by the agricultural sector, with the ultimate aim of advancing agricultural production. Individuals, sole traders, and businesses can access loans of up to RSD 5 million, whilst farm co-operatives can borrow up to RSD 15 million.

Competitiveness in agriculture will be promoted through the establishment of an institutional framework to implement the 2015-2020 IPARD Program, the 2016-2020 National Agriculture Program, and the 2016-2020 National Rural Development Program, which define medium-term policies designed to improve farm competitiveness. For the time being, the Republic of Serbia does not meet the requirements for using IPA Rural Development (IPARD) funds. Serbia must reform the Directorate of Agrarian Payments before it is granted access to IPARD funds. In November 2016, the Ministry of Agriculture and Environmental Protection and the European Commission's Directorate-General for Agriculture and Rural Development agreed on the details of the IPARD accreditation procedure, and an Action Plan was also developed to ensure that issues identified in the

European Commission's auditor's reports are addressed. In the course of 2017 the European Commission is expected to finalize accreditation of all structures in the Republic of Serbia that are necessary for implementing reforms to improve the competitiveness and position of agricultural holdings.

Together with international financial institutions (the IMF and the World Bank) an analysis was made of existing agricultural and rural development policies. New development-oriented policies, focusing on investment and competitiveness, will be implemented in the 2017 budget.

Package of Measures to Improve Tourism Revenues

One of the priorities in the services sector will be the promotion of tourism through investment into the development of infrastructure and superstructure at tourist destinations; tourism education and training projects; domestic tourism; and organized visits by foreign tourist groups. These measures are supported through loans for investments designed to enhance the tourist offering, subsidies and grants earmarked for tourism development projects, vouchers for subsidized accommodation for domestic tourists, as well as through other incentives under the Tourism Law. Spas and specialized treatment facilities are expected to be privatized in the near future, which will likely promote the growth and development of this segment of the tourist industry.

2. Structural Reforms of the Public Sector

The high level of public debt, exceeding the limit set by the Law on the Budget System and the rising deficit in the government sector endangered seriously the sustainability of public finance in the past period. Returning public finance to a sustainable path required a serious turnaround in the fiscal policy, strong adjustment on the side of public expenditures and consequent decrease of the deficit and debt. The envisaged fiscal consolidation is also supported by the precautionary arrangement with the IMF. The results of fiscal consolidation and decrease of the deficit and debt were achieved one year ahead of the deadline set by the arrangement with the IMF.

In the upcoming medium-term period, the Republic of Serbia is to bring to end the process of consolidation and maintain steady public finance. Of key importance for this process is the implementation of the structural reforms that would redefine the role of the government and the size of the government's impact in certain segments.

Basic Challenges for Sustainable Fiscal Position

1. **Number and structure of employees in the government sector.** The fiscal policy goal over the medium-term is to bring down the expenditures for employees to a sustainable level. The level of 7% of GDP, as defined by the Law on the Budget System, needs to be revised and adjusted so as to ensure the maximum quality of rendered services and a sustainable level of expenditures needed therefore. Average wage level of general government in EU is around 10% of GDP, and the lowest is 8%; accordingly, the share of wages of 9-9.5% of GDP is adequate for the Republic of Serbia. According to the fiscal schedule presented in this document, this level will be reached in 2018. The World Bank's functional analysis has identified the surpluses smaller than initially assumed which, coupled with structural improvements in the collection of tax revenues reduces the need for drastic cuts in the number of employees. In lieu of linear dismissals which often affect the quality of rendered services, it is necessary to finalize the in-depth analysis per each sector of the public administration, in order for the rationalization process to ensure, despite reduced costs,

preservation of the structure in terms of quality of the staff. Nominal 10% decrease of wages in the public sector starting from 2015, followed by their freeze (with the exception of targeted increases for certain sectors in 2016 and 2017) was the key measure of fiscal consolidation, and produced the expected results. The wage bill paid in the government sector dropped from 11.7% of GDP in 2014 to 10.4% of GDP in 2015, being the estimate for 2016 the level of 10.1% of GDP. As the rationalization process has been amended against the dynamics envisaged for 2015, this decrease of the share of wages in GDP is mainly due to their nominal decrease and freeze. Based on the data as of end of September 2016, it was found that the number of employees in the public sector dropped by about 22,000 persons against the 2014-end, which is in line with the latest review of the arrangement with the IMF.

2. **Budgetary support to public and state enterprises.** In the previous period, large amounts were allocated from the budget as a financial assistance to state and public enterprises. Apart from classic subsidies mainly for current operation (JP PEU „Resavica” and „Železnice Srbije” a.d), and the specifically targeted subsidies (for example, for the maintenance of roads), sizeable assets were allocated in the form of budget loans and payments under guaranteed loans approved to public enterprises. Expenditures for budget loans and payments based on the guarantees reached a share of 2.2% of GDP in 2014, to drop in 2015 to the level of 0.8% of GDP, which is in conformity with the plan for the reduction of their share. The target set in this sense for 2019 is up to 0.4% of GDP.

3. **Improvement in public finance management.** Successful implementation of the program of fiscal consolidation also requires, in addition to structural fiscal measures both on the revenues and expenditures sides, which result in the decrease of the deficit and public debt, an improvement of the procedures of the entire budget process, from the stage of the medium-term planning to the control and audit of spending of budget resources. Improved procedures in the planning, implementation and control on one side and, on the other, increased efficiency of the institutions whose task is to collect revenues, contribute and support the program of fiscal consolidation.

Management of public investments is one of the areas of public finance management to which serious attention is paid and the improvement of which has been worked on. Lack of efficiency in implementing the planned public investments for which the funding is provided and which are economically justified represents an obstacle to the improvement of competitiveness, i.e. to raising the infrastructure capacities and other positive effects of these projects' implementation. Majority of individual projects were implemented under the burden of numerous difficulties: from inadequate project documentation to difficulties in the land expropriation, to insufficiently appropriate control over the contractors that had led not only to non-observance of the contracted deadlines but also to increased price of the works, slow issue of permits, etc.

In order to improve the management of public investments, a regulatory framework will be created for regulation of this area. Capacity development, both in the Ministry of Finance and in all budget users, is one of the priorities, while implementation and updating of a single information base of capital projects, assessment of the capital projects by budget users and Ministry of Finance will start in the course of 2017, and will be carried out continuously in the upcoming period. Improved management of capital investments' implementation will provide for, *inter alia*, positive effects on the budget based on savings and lower amount of spending for paying the penalties as a result of non-disbursement of the approved loans and additional subsequent non-envisaged spending for execution of the works.

The most important structural reforms planned in the upcoming medium-term period as support to the fiscal consolidation process refer to:

1. **Resumption of the reforms in the area of employment and the wage system in the government sector.** After the short-term measures, decrease of the nominal

amount of wages in the government sector, which had been indispensable for the beginning of the fiscal consolidation, in the upcoming medium-term period accent will be placed on structural measures that would give their contribution through rationalization of the number of employed persons on one side, and establishment of a new salary system in the government sector, on the other, to the wage bill movement towards a sustainable level.

The Law on the Register of Employed, Elected, Designated, Appointed and Retained Persons with the users of public funds, which was adopted at the end of July 2015, has created a legal basis for a precise establishment of the number of employees in broader public sector to which the Law relates (apart from the government sector – direct and indirect budget beneficiaries at all government levels and organizations of obligatory social insurance, the Law also refers to public enterprises, the National Bank of Serbia (NBS), public agencies, and the companies in majority state ownership). Establishing the precise number of the employed within different coverage of the public sector is the necessary starting base that will enable establish in the next step the optimal number of employees in certain sectors. The register established in this way will be able to dispel dilemmas that had emerged in the previous period with regard to the total number of employees in the public sector, and/or in the narrower government sector. Moreover, free declaration of ethnic affiliation of the employees and entry thereof in the Register is possible, which will enable conducting of a proactive policy of employment of those belonging to national minorities in the Republic of Serbia. An inter-ministerial Working Group has been set up in 2016 based on the Government decision. The task of the Working Group will be to integrate the said Register in the CROSI (Central Register of Obligatory Social Insurance), which will enable further development, a higher level of reliability and verification of data.

At the close of 2014, the government sector employed 500.038²⁸ persons. The analysis of the public administration, carried out by the Ministry of State Administration and Local Self-Government, showed that Serbia does not dissent significantly from the EU average when one takes the number of employees in the government sector in relation to the number of inhabitants. According to the data for 2014, this ratio is 7.0% in Serbia, while the average at EU level (28) is 7.2%. If we talk exclusively about the general government in Serbia, it is not oversized. It is even smaller than the case is in EU countries. Namely, Serbia is at the level of about 6.5 employees in central administration per 100 inhabitants, while this parameter is higher in EU member states – around 8.5. The problematic issue for our country is the fact that the costs needed to finance this number of employees are high when one takes into account that only 34.2% of inhabitants are employed in the economic sector in Serbia, while this percentage is 45.2 in EU.

The Law on the Manner of Setting Maximum Number of Employees in the Public Sector, adopted in July 2015, represents a legal basis for determining the maximum annual number of employees in the period from 2015 to 2018 per individual institutions, but in accordance, however, with the expected improvement of their productivity to materialize after the reorganization. Since January 2016, the entities to which the Law on the Manner of Setting the Maximum Number of Employees in the Public Sector applies, will be allowed to renew the contracts for temporary or ad hoc operations only if that will be in accordance with the limits envisaged by the Law and if the share of employees on that basis is below 10% of the number of permanently employed, or in other exceptional cases envisaged by the Law. The ban on employment in the public sector will be in force also in 2017, with the exceptions to be analyzed by the Employment Commission by taking into consideration the limits set for the number of employees, the budget, as well as the needs for expert personnel of a concrete institution.

²⁸ Data about the number of employees and relevant indicators for Serbia and EU were taken over from the document entitled: „Modern State – rational state. Public administration analysis, Ministry of Public Administration and Local Self-Government. www.mduls.gov.rs/doc/Brosura%20CIR_bleed%203%20mm.pdf

The General Statute on the System of Wages of Public Sector Employees, which establishes the key principles of the new system and sets the deadlines for gradual implementation, was adopted in February 2016. The Government is expected to adopt at end-December 2016 the draft Law on Wages of Employees in the Autonomous Province and Local Self-Government Units, and to also adopt thereafter, by June 2017, the Draft Law on the Labor-Legal Status and Wages of Employees in public services. Until 1 January 2018, the Government will adopt the draft laws harmonizing the salaries of civil servants and employees, and harmonizing the salaries in the Army and Police with the system law on salaries. This system law will create a legal basis for making uniform the base, the number of coefficients and their simplification, strengthening the budget control and the wage bill manageability, and a higher level of transparency of the system, the final result of which is equal salary for equal work, regardless of the public sector segment where an employee is working. Moreover, a broader objective of the public administration reform, in the context of which the salary reform is included, is also the strengthening of the performance and effectiveness of the public administration.

In February 2016, the Government adopted the By-Law on Job Code in order to be enabled a better analysis and comparability of salaries of the general government employees. Upon adoption of the Code by the Government, all users of public assets (11,000 institutions, including public enterprises) started entering data in the Register in accordance with the new Job Code. The Register contains the data about the work posts and titles that are compliant with the Job Code and the working version of the job catalogue. Catalogues represent a list, classification and valuation of the work posts, which is one of the most important steps in the implementation of the salary system reform. Apart from the work posts' name, and/or titles under which works are performed at the work posts, the catalogue also includes a typical job description, the required education, additional knowledge and examinations/certificates, as well as the required experience for working at such jobs. Public sector's sub-systems, according to which the catalogues are designed, are: government authorities, authorities of the autonomous province and local self-government unit, health care, education, social protection, culture and sports. Generic jobs appearing in the entire system are specifically singled out for the purpose of comparability.

The Ministry of Public Administration and Local Self-Government has launched activities relating to the improvement of the areas of advanced training in the system of public administration. Underway is the preparation of the law that will regulate all issues relevant for the accomplishment of this objective. Plus, National Academy for Advanced Training in Public Administration is expected to be established in the mentioned period. For the purpose of implementing the provisions governing the advanced training of civil servants, in this area will also be established the record of established and implemented programs of general advanced training and of established and implemented programs of advanced training of civil servants. Moreover, continuity will be ensured in operations of the public administration, which relate to tenure vocational ability examination, a special professional ability examination for registrars, and advanced training of registrars. Key results in the establishment of the entire system of civil servants in the bodies of the autonomous provinces and local self-government units are expected through further implementation of the Strategy for Advanced Training of Employees in Local Self-government Units in the Republic of Serbia, and full application of the Law on Employees in Autonomous Provinces and Local Self-Government Units. Establishment is envisaged of a unique system of advanced training of employees in local self-government units by taking into account the specificities existing relative to the system of public administration, primarily in terms of differentiation between general and special programs of advanced training and the specific needs of the local government units. New legal solution will introduce through application of the Law on Employees in Autonomous Provinces and Local Self-Government Units significant changes in the sphere of career development, promotion at work, and advanced training of employees in autonomous provinces and local self-government units. The legal basis for the reform of the system of civil servants in

autonomous provinces and local self-government units is the Law on Employees in Autonomous Provinces and Local Self-Government Units for whose application a Council for Advanced Training will be set up and which is currently in the phase of establishment.

During the term of office of the preceding Government, the Ministry of Public Administration and Local Self-Government had prepared a package of laws relating to local self-government: Draft Law Amending the Law on Local Self-Government and Bill on Communal Police. Preparation of a Law amending the Law on the Capital City and of a Law amending the Law on Communal Police has been planned for the coming period. The Strategy for the Reform of Public Administration in the Republic of Serbia laid down, as one of the key reform objectives, the need for further decentralization (and de-concentration), the primary result of which would be an improved system of local self-government and a more efficient distribution of competences between certain government levels. Activities from the Action Plan have been carried out to enable implementation of the Strategy for public administration reform, necessary for preparing the starting bases of a Strategy for Decentralization to be worked on in the coming period.

The objective of introducing electronic administration is to increase the effectiveness, efficiency and cost-effectiveness domestically, all for the purpose of increasing the quality of public services. The Ministry proposes the policies and strategies for the development of electronic administration. Enactment of the law on electronic administration will regulate general acting of the basic registers that are established, data classification and the mode of electronic data exchange between and among the public administration authorities, and use of the electronic administration's portal by government authorities, the authorities of territorial autonomies, local self-governments, public enterprises, and anyone else entrusted with public administration operations. Electronic administration will identify in the best way the needs of public administration users by monitoring systematically the results of administrative procedures and by analyzing the existing statistics intended to detect the deficiencies in the existing procedures.

Reform of inspection supervision is one of the key elements for the public administration reform. The goals include establishment of a foreseeable and transparent business ambiance, improvement in the application of regulations, reduction of direct and indirect operating costs of both the corporate and government sectors, reduction of the scope of the shadow economy and unfair competition, as well as bringing down the corruption risk to minimum. Priority in the upcoming period will be full application and harmonization of the special laws with the newly adopted Law on Inspection Oversight whose application will encompass: expert support to the work of the coordination body, investing in the provision of information to the business community, citizens and the public about the solution offered by the law, the training of inspectors, establishment of a unique information system, and equipping the inspection teams in the field for enforcement of the law. Investments in IT infrastructure, logistics and training of the inspection teams represent a fundament for improving the application of the law, reducing the costs of doing business, increasing foreseeability of operation, and reducing the unfair competition and corruption. An analysis of the effects of the regulations has been made, and an action plan was defined for the application of the law over a three-year period. The Law application will be in phases, while preparation for the creation of a unique information system has already started.

2. **For the purpose of reducing different form of budget support to public and state enterprises, reforms of the biggest enterprise of these two categories are presently underway.** Reduction of budget support to these enterprises involves: a) limitation of direct and indirect subsidies, b) strict limitation on the issue of guarantees for new loans, and c) strengthening of accountability and transparency in the operation of these enterprises. The reforms relating to three large groups of public and state enterprises have already been launched.

3. The first group of companies includes those that were in the portfolio of the

former Privatization Agency, the status of which will be solved either by bankruptcy or privatization. Solution has been found in this way for 330 companies until the end of October 2016. Severance payments were received by 24,474 employees. Solution is pending for 172 companies employing around 45,000 workers. Some of these companies are strategically important, such as PKB, RTB Bor, JP PEU „Resavica“, Petrohemija, etc., either through Pre-Prepared Plans of Reorganization (PPPR) or through regular bankruptcy procedures in accordance with law.

The second group of companies could include those for which searching of a strategic partner is planned and whose business activity would resume through various forms of concessions. For Komercijalna banka, the second largest bank in Serbia, a privatization adviser has been selected in order for the privatization to be carried out in the course of 2017. Privatization of the Steel Works Smederevo was finalized in June of this year. In this way has been ensured the Steel Works' operation without the budget support in the future and further debt accumulation was prevented. Consulting companies have been simultaneously hired in order to consider the options for granting concession for the „Nikola Tesla“ Airport, and for further construction of Corridor 11.

The third group includes the public and state enterprises in the areas of energy, railway transport and road infrastructure. They have been under the process of restructuring during 2016 which started in cooperation with international financial institutions in 2015. Concretely, such enterprises are: JP „Elektroprivreda Srbije“, „Železnice Srbije“ a.d, JP „Srbijagas“, and JP „Putevi Srbije“:

1) **JP „Elektroprivreda Srbije“.** The Program of Reorganization and the Plan of Fiscal Consolidation, agreed upon with the World Bank and EBRD were adopted in the previous period. The basic elements of the plan are: increase of revenues thanks to better collection rate and reduction of costs based on increased efficiency, optimization of the procurement process, and decrease of the number of employees. Numerous measures need to be implemented in order for JP EPS to operate in a financially sustainable manner and for the difference in the electricity price to go down in the domestic market and in the region. In this regard, one of the first steps was the increase of electric power tariff for end users by a total amount of 12% in the course of August of 2015. Out of this increase, the price was raised by 4.5%, while 7.5% related to excise tax, and the additional price increase of 3.8% was in October 2016. Within the Plan for Financial Consolidation was defined the Plan for Optimizing the Number of Employees for the period to 2019. Until end of October 2016, the number of employees who voluntarily applied for severance payment was 1,900. A plan was also made for additional decreases in the number of employed staff until 2019. It has been planned for JP EPS to transform to a share-holding company by the end of the first half of 2017, and to analyze other possibilities for further development of the company with a view to having its performance improved and a professional management ensured.

2) **JP „Srbijagas“.** Since August 2015, a changed organizational structure of this company has been in place. Namely, the parts dealing with transport and distribution of gas have been founded as separate units. The plan envisaging the sale of assets that are not used for the performance of the core activity is under implementation, while efforts continue to be invested in the resolution of the issue relating to the recovery of the receivables due from the biggest debtors, including the enterprises such as: HIP Azotara, HIP Petrohemija and MSK Kikinda. Upon adoption of the financial restructuring plan in March 2016, prepared with the support of the World Bank, recovery of the receivables registered improvement. A debt restructuring plan will be adopted in the course of 2016 to enable avoid in the future the conversions of receivables into equity. Other objectives of the plan are: a higher level of discipline in the recovery of receivables, assessment of the existing and future investment plans in cooperation with the World Bank. These measures are intended to stop further worsening of the financial position of JP „Srbijagas“, and elimination of the need for additional government aid in accordance with the fiscal framework.

3) **„Železnice Srbije” a.d.** The Plan of Corporate and Financial Reorganization launched in 2015, involves organizational and status changes. Since August 2015, three new companies have been spun off from the unique enterprise „Železnice Srbije” a.d., in accordance with the experience from EU countries - „Srbija voz” a.d, „Infrastruktura železnice Srbije” a.d. and „Srbija Kargo” a.d. the changes were also accompanied by the management reorganization. The restructuring plan includes modifications with respect to disposal of assets, the transport network, and rationalization of the number of employees. Starting from August 2015, cargo transportation is not receiving subsidies from the budget and is operating based on market principles, in accordance with the World Bank recommendations. In January 2016, a fee was introduced for the use of the railways infrastructure as part of the market opening for railways transport, and the first private railways operator was granted in June of this year the approval for using the route of public railways infrastructure. Moreover, reorganization and improvement will continue of the business plans of the companies „Srbija voz” a.d, „Infrastruktura železnice Srbije” a.d., and „Železnice Srbije” a.d. aimed at strict limitation of the government aid in the medium term. In October 2015 was prepared and adopted the plan of overall corporate and financial restructuring. The plan was prepared in cooperation with independent consultants and with the assistance of the World Bank, EBRD and EU. Inventory-taking of the company’s assets and liabilities was finalized in 2016, as was also their allocation to the newly-formed companies. The plans defining the rationalization of the number of employees to 2020 were adopted by railway companies in September 2016, which involve reduction of around 3,000 employees in 2016, including natural outflow. In October 2016 was rendered the decision suspending transport on the lines either not in use or marked as non-profitable, which will exert material impact on the company’s financial performances. The newly-formed enterprises have assumed full liability for the payment of their liabilities to JP EPS, which also involves their commitment not to increase defaults in the payments to JP EPS. The process of selecting the management for the newly-formed companies within „Železnice Srbije” a.d continues in accordance with the program of restructuring.

4) **JP „Putevi Srbije”.** In order to ensure adequate maintenance of the infrastructure, starting from 1 January 2017 the tolls will go up by ten percent. Further increases of the toll amount will take place in phases, and the estimate of adequate rates will be prepared in cooperation with the World Bank. The plan for improvement of the contracts for road maintenance and removal of administrative obstacles has been adopted. The purpose is to create savings and increase efficiency of the system and thus reduce the need for subsidies from the budget. Options for road construction and maintenance by way of concessions will be considered. Plans of corporate and financial restructuring will also be developed in cooperation with the Word Bank.

With a view to ensuring the savings that arise from corporate and financial restructuring of the biggest state/public enterprises, a set of reforms is at the same time being implemented in the area of public finance management, in the segment of government operation with public and state enterprises.

For the purpose of making financial discipline more austere, the effect of the Law on the Terms for Settlement of cash liabilities in commercial transactions has been expanded by the Law Amendments in July 2015, so that it also relates to transactions between the public sector institutions. Amended provisions of the Law apply starting from 1 January 2016.

Taking into account the amount and impact that guarantee payments exert on the fiscal deficit, issue of government guarantees has been strictly limited since 1 January 2015. In that regard, new government guarantees cannot be issued for liquidity support, and/or for any company from the portfolio of the former Privatization Agency. Guarantee issue is only possible in the case of capital project loans; provided, however, that the limit set for the purpose of public debt sustainability must be observed.

3. **In accordance with the adopted strategic documents and system laws in the area of health protection, reforms will continue that ensure increased efficiency of the health protection system, increased financial sustainability thereof, improved health condition of the population, and a better quality level of the health care.**

- Improvement of the law and of corresponding by-laws for the benefit of planned reform of the health system of the Republic of Serbia – adoption of the strategic document – Health Protection Development Plan from 2017 to 2021, which defines the health protection and health insurance policy, and/or adoption of the system laws, the Law on Health Protection and the Law on Health Insurance, and other laws in the area of health care and corresponding by-laws.

- Upgrading the quality in the provision of health protection for the needs of a sustainable health system by promoting the primary, secondary and tertiary health protection – enhancing the primary health protection by improving the work in the domain of prevention and early detection as well as by treating chronic non-infectious diseases that affect most the health of the population in Serbia. Speaking of secondary and tertiary health protection, accent is on the introduction of new, highly developed health technologies based on the purchase of the equipment necessary for the treatment of patients suffering from malignant diseases, and for improving the work of health care institutions in this field of health protection.

- Upgrading of the health system financing through introduction of a system that will enable establishment of the National Health Account (NHA) – which provides reliable information about the financial assets allocated for health protection and modes of their utilization. National Health Account will be made for the sake of having a better insight in the money flows in the health care sector (allocations from the budget for health care, private health care, donations in health care, etc.). National Health Account is an instrument for tracking the money flow through the health care system of a country, for increasing the efficiency of health care services, and for equal distribution of available assets in the health care system of the Republic of Serbia.

- Resumption of computerization of the health care system – consists of connecting all health care institutions in a single information system, commenced in 2015

- Upgrading of the personnel base from the Plan of Health Care Institutions Network for the purpose of checking availability of necessary personnel in accordance with the prescribed norms and standards

- Defining the role of the private sector in providing health services to the population

Rationalization of the health care system will be carried out within the fiscal consolidation through decrease of the number of non-medical staff, improved mechanisms for priority selection in terms of purchase of new equipment and better control of spending for medical services. These measures will ensure: increased efficiency of health care institutions, valuation of their actual performances, and a higher quality level of health protection.

4. **Reform driven activities in the framework of various sub-systems of public finance management (PFM) are encompassed by the Program of Public Finance Management Reform (PFMR Program) from 2016 to 2020.** The objective of the PFMR Program is to provide a comprehensive and integrated framework for the planning, coordination, implementation and follow-up of the progress in implementing sustainable activities enabling to improve the macroeconomic stability, ensure efficient and appropriate allocation and utilization of public resources for the materialization of national priorities, and upgrading of services rendered by public administration in the Republic of Serbia, with simultaneous increase of transparency and overall functionality of the public finance management and the meeting of the conditions for accession to the European Union. Also, a Draft Strategy for Development of Internal Financial Control in the Public Sector from 2017 to 2019 has been prepared, and under preparation is also a Draft Anti-Fraud Strategy.

High level of the shadow economy that has a negative impact on the budget deficit and operation and investment conditions results to a considerable extent from the inefficient mechanism of control, establishment and collection of taxes and other public revenues. Inadequate work organization of the Tax Administration and its processes, with inappropriate volume and structure of human resources and non-existence of an adequate system for risk assessment have disallowed directing the limited resources to the taxpayers maximally inclined not to observe their tax liabilities. On the other hand, the hitherto manner of the Tax Administration functioning frequently had negative effects on the taxpayers who meet their liabilities to the state fully and on time. This was due to non-uniform practice of interpretation of the tax regulations, complicated administrative procedure, which altogether leads to the rise of the operating risk and costs in Serbia.

Program of transformation of the Tax Administration for the period 2015 to 2020 was adopted in June 2015. The priorities in further implementation of the Program are: enhancing the Tax Administration management, simplification of the organizational structure in the head office and branches and/or branch offices, including reduction of the number of main branches, implementation of the contemporaneous approach to risk management, tightening default management including the write-off procedures, modernization of information technologies and business processes, and improved coordination and exchange of information with other state authorities.

PA branches need to upgrade their mode of operation with the taxpayers. The RFMR Program and the Program for PA transformation envisage formation separate organizational parts for rendering services to taxpayers, which would improve communication and interaction with the taxpayers, including timely provision of updated information about the changes in the laws and regulations.

5. Structural reforms of the public sector also include the measures concerning the defense system reform. In accordance with the defense planning documents and system laws in the defense area, the reforms that need to ensure a more effective and more efficient functioning of the defense system will continue.

Basic structural reforms to be implemented in the area of defense relate to:

- establishment and application of a new strategic framework in the field of defense security for the needs of protecting the national and defensive interests of the Republic of Serbia;
- maintenance and partial improvement of operative and functional capabilities of the Serbian Armed Forces of for execution of the missions and tasks laid down by the Strategy of the Republic of Serbia Defense;
- optimization of the organization and functioning of the Ministry of Defense and the Armed Forces of Serbia;
- ensuring the projected level of required war material reserves;
- improvement of international military-economic and military-technical cooperation;
- preparation of the forces for participation in EU Combat Group;
- improvement of the industrial and technological bases of the Republic of Serbia of interest for the defense and in accordance with the needs of development of operating capabilities of the Armed Forces of Serbia.

The priority of structural reforms of the Ministry of Defense in 2017 will be to ensure security of the administrative line with the AP Kosovo and Metohija, permanent control and protection of the air space of the Republic of Serbia, upgrading the response capability of the Serbian armed force, support to civil authorities in countering the non-military threats to security, preparation for participation in multinational operations and other activities and tasks, as determined by the Minister's confidential Instruction for 2017.

In accordance with the results of the work performed in drafting the Long-Term Plan for Defense System Development of the Republic of Serbia for a sustainable development and functioning of the Ministry of Defense and the Armed Forces of Serbia, it is necessary to provide approximately 1.5% of gross domestic product. Once the economic possibilities of the Republic of Serbia improve, it will be necessary to gradually increase the allocations from the gross domestic product for the needs of the defense in order to reach the amount of about 2% of gross domestic product.

FISCAL STRATEGY FOR 2017 WITH PROJECTIONS FOR 2018 AND 2019

Appendix 1: Projection of the Basic Macroeconomic Indicators

<i>In percentages</i>	<i>2016</i>	<i>2017</i>	<i>2018</i>	<i>2019</i>
GDP growth at constant market prices	2,7	3,0	3,5	3,5
GDP level at current market prices (billion dinars)	4.203,5	4.396,7	4.678,1	4.987,5
<i>Sources of growth: percentage changes at constant prices</i>				
Private consumption expenditure	0,6	1,4	2,2	2,9
Government consumption expenditure	3,9	1,6	2,6	2,3
Gross fixed capital formation	6,4	5,7	5,7	4,9
Changes in inventories and net acquisition of variables as a % of GDP	-0,4	0,0	0,0	0,0
Exports of goods and services real growth	9,2	7,7	7,7	7,6
Imports of goods and services real growth	6,2	5,3	5,8	6,3
<i>Contribution to GDP growth</i>				
Final domestic demand	2,0	2,5	3,2	3,5
Investment	1,2	1,1	1,2	1,0
Private consumption	0,5	1,0	1,6	2,1
Government consumption	0,7	0,3	0,5	0,4
Change in inventories and net acquisition of valuables	-0,4	0,0	0,0	0,0
External balance of goods and services	0,6	0,5	0,3	0,0
<i>Growth of Gross Value Added</i>				
Agriculture	8,4	-2,0	2,6	3,0
Industry	3,1	5,2	5,4	5,4
Construction	8,9	7,6	7,1	6,1
Services	1,7	3,3	3,6	3,7
<i>Contribution to Gross Value Added growth</i>				
<i>Gross Value Added growth</i>	2,7	3,0	3,5	3,5
Agriculture	0,6	-0,1	0,2	0,2
Industry	0,7	1,1	1,2	1,2
Construction	0,4	0,3	0,3	0,3
Services	0,9	1,7	1,8	1,9
<i>Prices</i>				
GDP deflator	1,3	1,6	2,8	3,0
CPI change (annual average)	1,1	2,4	3,0	3,0
<i>External sector developments</i>				
Export of goods in mill EUR	35,9	37,9	39,1	40,1
Import of goods in mill EUR	46,5	48,5	49,4	50,1
Net exports of goods and services (% of GDP)	-10,6	-10,7	-10,3	-9,9
Current account balance (% of GDP)	-4,2	-3,9	-3,9	-3,9
<i>Fiscal indicators</i>				
Consolidate fiscal balance (% of GDP)	-2,1	-1,7	-1,3	-1,0
Consolidate public revenue (% of GDP)	43,3	42,4	41,6	41,1
Consolidate public expenditure (% GDP)	45,4	44,1	42,9	42,1
General government debt (% GDP)	74,6	73,9	70,7	67,0

Appendix 2. Fiscal framework of the general government in 2016*

	General Government	Republic Budget (incl. Projects loans)	Local Government	Cities and Municipalities	Vojvodina	Road Fund	CSIO	Pension Insurance Fund	Health Fund	Unemployment Fund	Military Health Fund
1	2=3+6+9+10	3	6=7+8	7	8	9	10=11+12+13+14	11	12	13	14
Public revenues	1.865,8	1.049,8	231,0	213,5	17,5	21,1	564,0	387,7	151,8	22,3	2,2
Current revenues	1.850,9	1.036,3	230,0	212,5	17,5	21,1	563,5	387,7	151,8	21,8	2,2
Tax revenues	1.638,5	916,8	167,9	156,1	11,8	0,0	553,7	386,7	144,0	21,1	1,9
Personal income tax	162,7	56,0	106,7	101,5	5,2	0,0	0,0	0,0	0,0	0,0	0,0
Social contributions	553,7	0,0	0,0	0,0	0,0	0,0	553,7	386,7	144,0	21,1	1,9
Corporate income tax	81,0	74,4	6,5	0,0	6,5	0,0	0,0	0,0	0,0	0,0	0,0
VAT	466,0	466,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Excises	271,4	271,4	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Customs	38,6	38,6	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Other tax revenues	65,1	10,4	54,7	54,7	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Non tax revenues	212,4	119,5	62,1	56,3	5,8	21,1	9,8	1,0	7,7	0,7	0,3
Donations	15,0	13,5	1,0	1,0	0,0	0,0	0,5	0,0	0,0	0,5	0,0
Public expenditures	1.941,0	808,1	304,2	256,1	48,1	33,4	795,3	543,5	225,0	21,9	4,8
Current expenditures	1.756,6	677,4	262,5	216,4	46,1	22,9	793,7	542,8	224,6	21,7	4,6
Expenditures for employees	368,8	200,5	70,4	44,1	26,2	1,3	96,7	3,0	92,1	1,6	0,0
Contributions paid by employer	65,7	36,9	12,2	7,2	5,0	0,2	16,4	0,5	15,6	0,3	0,0
Purchase of goods and services	300,7	84,6	82,0	79,9	2,1	20,7	113,4	2,2	107,9	1,1	2,3
Interest payment	138,4	134,0	4,3	3,8	0,5	0,1	0,0	0,0	0,0	0,0	0,0
Subsidies	107,0	78,2	28,9	22,2	6,7	0,0	0,0	0,0	0,0	0,0	0,0
Social grants and transfers	724,9	112,7	46,1	45,5	0,6	0,0	566,0	537,1	8,3	18,4	2,2
<i>of which: Pensions</i>	510,0	0,0	0,0	0,0	0,0	0,0	510,0	510,0	0,0	0,0	0,0
Other current expenditures	51,1	30,5	18,7	13,7	5,0	0,6	1,3	0,0	0,8	0,4	0,1
Capital expenditures	144,9	91,9	40,9	39,0	2,0	10,5	1,5	0,7	0,4	0,2	0,2
Net lending	4,7	4,0	0,7	0,7	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Activated guarantees	34,8	34,8	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Fiscal balance excl. transfers	-75,2	241,6	-73,2	-42,6	-30,6	-12,3	-231,3	-155,9	-73,2	0,5	-2,6
Transfers from other levels of government	372,6	0,0	73,2	45,2	28,0	6,3	293,1	208,9	76,7	4,9	2,6
Republic Budget	310,7	0,0	73,2	45,2	28,0	6,3	231,3	201,6	24,3	4,9	0,4
Cities and Municipalities	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Vojvodina	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Pension Insurance Fund	53,0	0,0	0,0	0,0	0,0	0,0	53,0	0,0	50,8	0,0	2,2
Health Fund	3,5	0,0	0,0	0,0	0,0	0,0	3,5	3,5	0,0	0,0	0,0
Unemployment Fund	5,4	0,0	0,0	0,0	0,0	0,0	5,4	3,8	1,5	0,0	0,0
Military Health Fund	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Other levels	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Transfers to other levels of government	372,6	310,7	0,0	0,0	0,0	0,0	61,9	53,0	3,5	5,4	0,0
Republic Budget	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Cities and Municipalities	45,2	45,2	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Vojvodina	28,0	28,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Pension Insurance Fund	208,9	201,6	0,0	0,0	0,0	0,0	7,3	0,0	3,5	3,8	0,0
Health Fund	76,7	24,3	0,0	0,0	0,0	0,0	52,4	50,8	0,0	1,5	0,0
Unemployment Fund	4,9	4,9	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Military Health Fund	2,6	0,4	0,0	0,0	0,0	0,0	2,2	2,2	0,0	0,0	0,0
Other levels	6,3	6,3	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Net transfers	0,0	-310,7	73,2	45,2	28,0	6,3	231,3	155,9	73,2	-0,5	2,6
Fiscal balance	-75,2	-69,1	0,0	2,6	-2,6	-6,1	0,0	0,0	0,0	0,0	0,0

*The table shows the approximate amount of revenue and expenses in 2017, which is largely based on the statistical methodology account the public finances than on accounting. Because during the budget process can lead to changes in the amount and structure of individual categories, these amounts are not legally binding.