

GOVERNMENT OF THE REPUBLIC OF SERBIA

FISCAL STRATEGY PAPER

FOR 2016 WITH PROJECTIONS FOR 2017 AND 2018



FISCAL STRATEGY
FOR 2016 WITH PROJECTIONS FOR 2017 AND 2018

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In accordance with Article 27v paragraph 1 of the Budget System Law ("Official Gazette of the RS", no 54/09, 73/10, 101/10, 101/11, 93/12, 62/13, 63/13 – correction, 108/13, 142/14 и 68/15 – as amended),

The Government adopts

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I. Macroeconomic Framework for the Period 2016 to 2018

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

The Government is strategically oriented towards the European integration process and the acquisition of full EU membership. In that context, the general framework of the economic policy from 2016 to 2018 has been established through Government's developmental documents such as: the Stabilisation and Association Agreement between the European Communities and their Member States, on one hand, and the Republic of Serbia, on the other (hereinafter: SAA), the National Programme for the Adoption of the *Acquis* (2013-2016), National Economic Reform Programme for 2015, as well as general and sectoral national development strategies, including this Fiscal strategy. European integration process requires the fulfilment of economic and political criteria for EU membership, including, among other things, creation of a stable economic and monetary environment, development of market economy and strengthening of its capability to respond to challenges of the competition within EU, with a simultaneous strengthening of administrative capacities and institutions safeguarding democracy, rule of law, respect of human rights and protection of minorities.

In the previous period, the Government of the Republic of Serbia initiated and adopted measures for establishment of stability of public finances and the entire macroeconomic environment. The credible fiscal consolidation programme was confirmed by concluding Precautionary Arrangements with IMF in early 2015. A strong turnaround was made in the fiscal policy, with results higher than expected, already in the first year of the implementation of the programme.

A consistent implementation of fiscal consolidation measures, together with an ambitious programme of structural reforms, has helped establish macroeconomic stability. The economic activity is on the rapid recovery trajectory, and the fiscal deficit has been drastically reduced. The improved fiscal position of the country has reduced the needs for borrowing and the costs of servicing liabilities. At the same time, the improved business and investment environment has created the basis for a revival of investment activity.

The economic policy for the next medium-term period is determined in accordance with the thus defined strategic development framework. The main objectives of the economic policy in the next medium-term period shall be focused on:

- Continuing to implement fiscal consolidation measures, maintaining macroeconomic stability together with stopping further growth of the debt and establishing the trend of its reduction;
- Strengthening the stability and resilience of the financial sector by resolving the issue of non-performing loans; and
- Removing obstacles to the economic growth and to the increase of competitiveness by implementing comprehensive structural reforms, as well as continuing to implement

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structural reforms, especially with regard to public enterprises, and increasing the efficiency of the public sector.

In the next three-year period (2016-2018), the Government will continue to carry out a responsible economic policy with a view to creating a stable and predictable business environment. Reduction of irrational consumption, bureaucracy and unnecessary costs of the government will ensure further growth of the investment activity, with a view to encouraging the economic growth and employment, while preserving the level of social protection of the most disadvantaged sections of society. The key role in it belongs to the fiscal policy and the continued implementation of the comprehensive reform of the economic system.

Special attention will be devoted to the further improvement of the business environment which would be stimulative for the development of the private sector. The implementations of the remaining economic reforms will be accelerated in order to improve the business environment, especially by strengthening the rule of law and removing the already identified structural obstacles to the economic growth.

Good results of the fiscal policy that were achieved during this year have allowed a mild relaxation of the fiscal policy, without endangering the achievement of the objective concerning the deceleration of the growth trend of the public debt and its gradual reduction until 2017. The fiscal policy priorities will be: further strengthening of the tax discipline, increased efficiency of tax collection, and combating the shadow economy. The objective is to establish a stimulative tax policy which shall encourage the economy and employment, as well as a zero tolerance policy for the violation of law, crime and corruption, through reformed institutions of the system. This will simultaneously ensure the improvement of general conditions for economic activities, equal business opportunities and reduction of the total fiscal deficit.

The economic reform programme will continue the restructuring process of the Serbian economy, primarily the public sector, with a view to reducing the irrational public consumption and increasing the efficiency, as well as improving the quality of services. The efficiency of the public sector will be improved by abolishing non-productive jobs and generally rationalising business activities. Rationalisation will be performed on the basis of a comprehensive needs analysis, with a view to increasing the quality of services provided by the government (education, health care, state administration and local self-government, etc.).

Completion of the privatisation process and enterprise restructuring process from the portfolio of the Privatisation Agency is planned for the next period, as well as the continuation of the process of reorganisation and restructuring of large public enterprises. The introduction of professionalisation into the business activities of public enterprises, as well as responsible corporate management in the enterprises which will remain under government control, together with the displacement of the social policy from public enterprises into the social security system, as well as gradual and responsible reduction of the government share in the economy.

The National Bank of Serbia (hereinafter: NBS) has supported the implementation of Government's economic and fiscal policy through measures and instruments of monetary policy. Coordination of macroeconomic policies will continue the revival of the economy, together with further encouraging the credit activity. The adopted Strategy for Addressing Non-Performing Loans (hereinafter: NPL) will remove obstacles to efficiently addressing non-performing loans, and will reduce the possibility of their occurrence, all with a view to reducing the interest and the overall borrowing costs.

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2. Economic Trends and Prospects for the period 2016 to 2018

2.1. Assessments of the International Economic Environment

The recovery of developed economies, deceleration of the Chinese economy, low level of prices of energy and raw materials, reduced capital inflows in developing countries and volatility of foreign currency exchange rates have characterized global economic developments in 2015. The International Monetary Fund (hereinafter: IMF) assessed the basic economic indicators on the global level and on the level of groups of countries in its revised World Economic Outlook in October 2015. The global economic growth was, for the third time this year, revised downwards by 3.1% in 2015, due to uncertainties with regard to future developments in China, uncertainties with regard to the changes of the monetary policy in USA, as well as unfavourable economic developments in Russia and Brazil.

The economic activity of the Eurozone will continue to recover at a slightly slower rate than previously expected. For Eurozone countries, after the year-on-year growth of the gross domestic product (hereinafter: GDP) in the first (1.2%), second (1.5%), third (1.6%) quarter of 2015, IMF retained the forecast of GDP growth by 1.5% in 2015. A favourable business environment within the Eurozone will support the recovery, while the deceleration of largest foreign trade partners of EU will have the opposite effect. The deceleration of the world trade to 3.2% in 2015 is a result of the deceleration of the Chinese economy. Moderate acceleration of trade flows is expected in the next period, resulting in the growth of 4.6% in 2017 and 2018. Inflation is expected to remain very low in 2015, and acceleration during the medium-term period is expected.

Table 1 International Environment - Macroeconomic Indicators

	2015	2016	2017	2018
Real growth of the Gross Domestic Product¹, %				
World Total	3.1	3.6	3.8	3.9
Eurozone	1.5	1.6	1.7	1.6
USA	2.6	2.8	2.8	2.7
Russia	-3.8	-0.6	1.0	1.5
Developing countries	4.0	4.5	4.9	5.1
World trade growth, %	3.2	4.1	4.6	4.6
Unemployment rate, %				
Eurozone	11.0	10.5	10.1	9.7
USA	5.3	4.9	4.8	4.8
Consumer prices, annual changes, %				
Eurozone	0.2	1.0	1.3	1.4
Developed economies	0.3	1.2	1.7	1.9
Developing countries	5.6	5.1	4.7	4.5
Foreign currency exchange rate, EUR/USD, end of period	1.1	1.1	1.1	1.1
Prices of cereals, in USD, annual changes ²	-19.6	-5.9	3.4	1.3
Prices of metals, in USD, annual changes ³	-22.3	-9.4	0.7	1.4
Price of iron ore, in USD ⁴	55.8	44.8	42.9	42.8
Oil price growth, in USD, annual changes, %	-46.4	-2.4	10.1	8.0

¹ World GDP has been calculated on the basis of the Purchasing Power Parity.

² Price of cereals has been calculated as the weighted average of the prices of wheat, maize, soy, rice and barley

³ Price of metals has been calculated as the weighted average of the prices of copper, aluminium, iron ore, tin, nickel, zinc, lead and uranium

⁴ Price of iron ore (iron content 62%) for export in China, port Tianjin, in USD per metric ton.

Source: IMF, World Economic Outlook, October 2015

Disinflationary pressures in Eurozone have compelled the European Central Bank (hereinafter: ECB) to strengthen the expansiveness of the monetary policy since March, through

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programmes of quantitative relief. In December, a meeting of ECB is expected, with a view to deciding whether to increase the range of quantitative relief in the next period. On the other hand, strong growth of economic activity in USA during the first half of 2015, due to the increase of the disposable household income, real estate prices and growth of investments, did not affect the decision of the USA Federal Reserve (hereinafter: FED) to raise the reference interest rate (0.25%) and thus reduce the expansiveness of the monetary policy in the next period. IMF expects the reduction of inflation in developed economies and the growth of inflation in developing countries in 2015.

Movements of prices of metals and energy products in the international market in 2015 had positive effects on the economic activity of countries which are net importers of energy, and the trend of decline of these prices will continue in the next period. The price of Brent type oil (the average price of "Brent", "Dubai Fatex" and "West Texas" type oil) is expected to be 51.6 \$ per barrel in 2015 and 50.4 \$ per barrel in 2016, which constitutes a decline of 2.4%. Due to lower demand in China, prices of metal cumulatively declined by 15% in the period from February to September 2015. These trends will continue until the end of the year and in 2016 (a decline of 9.4%). At the same time, further decline of import prices of iron ore in China is expected (share of 60% in consumption, a 50% in production of steel), from 55.8 \$ per metric ton to 44.8 \$ per metric ton in 2016.

For 2015 and 2016, IMF anticipates 0.2% interest rates on three-month EUR deposits, as well as 0.4% interest rates on six-month LIBOR on USD deposits in 2015, and 1.2% in 2016.

In November 2015, the European Commission (hereinafter: EC) revised the growth of economic activity of the EU and Eurozone upwards compared to the projection from March. The depreciation of euro, low oil price and accommodative monetary policy of ECB are some of the factors which affected the upward revision of the growth. However, the effect of these positive impulses was temporary, and it has been gradually disappearing under the pressure of deceleration of economies of developing countries and the world trade. In the next period, trends in the international economic environment are not expected to significantly destabilize the initiated recovery, which will be supported by the improving labour market conditions, increase of the disposable household income, more favourable lending conditions, and investment growth. For 2015, a 1.6% growth in Eurozone has been forecast, while the next period will see a moderate acceleration of the growth to 1.8% and 1.9% in 2016 and 2017, respectively. The growth projection is based on the recovery of domestic demand, primarily of personal consumption (more favourable labour market developments are anticipated in the circumstances of low inflation) and investments (whose growth will be encouraged by better conditions of business operations and lending to the economy, as well as the rise of consumer confidence). Household consumption expenditure will remain one of the main drivers of the recovery due to the growth of the real disposable income. In the medium term, continued growth of wages and employee fees is expected in circumstances of stable growth of employment. Also, low costs and improving financing conditions along with expansive measures by the ECB, should additionally encourage private consumption.

Global demand movements and acceleration of investment growth will determine the moderate growth of the EU export activities, while strengthening of private consumption will affect the growth of import. The Eurozone economies were resistant to the deceleration of global trade flows in the previous period, due to the depreciation of euro and the decline of oil prices. In spite of weaker prospects for the foreign trade growth, effects of the previous depreciation of effective euro exchange rate and the low interest rate will encourage investment activity, while favourable labour market developments and lower prices of energy will affect the consumption. A weaker external demand, in the circumstances of revised global growth and lower world trade elasticity in relation to the growth, will affect the mild deceleration of export growth - 4.3% in 2016 and 5% in 2017. Import developments will also be uneven, and will accelerate from 4.8% in 2016 to 5.7% in 2017. In the next period, a slight deterioration of current account on the balance of payments and deficit reduction is expected, from 3.7% of GDP in 2015 to 3.4% of GDP in 2017. The intensification of business activities, improvement of professional trust and moderate wage growth will contribute to the slight improvement of labour market conditions (reduction of the unemployment rate from 11% in 2015 to

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10.6% in 2016). Due to a somewhat more favourable cyclical position, fiscal deficit will continue to decrease throughout Eurozone, helped by a further decrease of interest rates.

The disinflation trend in Eurozone countries has continued during 2015 due to low prices of energy and food, and thus 0.1% inflation is expected in 2015. In the next period, growth of energy prices is expected, but also a stronger growth of domestic demand and narrowing of the production gap, which will contribute to the acceleration of the inflation (to 1% in 2016 and 1.6% in 2017).

Table 2 Serbia's foreign trade partners - main economic indicators

		2015	2016	2017
Real growth of GDP, %	Italy	0.9	1.5	1.4
	Germany	1.7	1.9	1.9
	Eurozone	1.6	1.8	1.9
	Russia	-3.7	-0.5	1.0
Inflation, %	Italy	0.2	1.0	1.9
	Germany	0.2	1.0	1.7
	Eurozone	0.1	1.0	1.6
	Russia	15.6	8.0	6.0
Current account balance (BDP %)	Italy	2.2	1.9	1.9
	Germany	8.7	8.6	8.4
	Eurozone	3.7	3.6	3.4
	Russia	4.9	4.7	4.1
Consolidated fiscal balance, BDP %	Italy	-2.6	-2.3	-1.6
	Germany	0.9	0.5	0.4
	Eurozone	-2.0	-1.8	-1.5
	Russia	-2.2	-2.0	-0.8
Gross government debt, BDP %	Italy	133.0	132.2	130.0
	Germany	71.4	68.5	65.6
	Eurozone	94.0	92.9	91.3
	Russia	19.9	21.7	22.2
Unemployment rate, %	Italy	12.2	11.8	11.6
	Germany	4.7	4.9	5.2
	Eurozone	11.0	10.6	10.3
	Russia	5.4	5.5	5.5

Source: European Commission, Autumn Forecast, November 2015

In the circumstances of reduced demand of developing countries, Germany's economic growth in 2015 (1.7%) is based on the rise in domestic demand, due to more favourable labour market developments and better lending conditions. Improvement of macroeconomic indicators is expected in the next period. A 2.6% growth of investments has been forecast for 2015, followed by 3.1% and 3.6% growth in the next two years respectively, especially investments in equipment, due to the growth of businesses trust and more favourable lending conditions. Although it's possible that negative risks from automotive industry will spill over into the real sector, investment activity will continue to recover. The foreign trade surplus will be slightly reduced due to the weakened effect of the depreciation of euro. At the same time, the surplus of current account on the balance of payments (8.7% of GDP in 2015) will be somewhat lower in 2016 and 2017 due to the decrease of global demand. Effects of low oil prices on the inflation will disappear by the end of the next year, and inflation is expected to accelerate by 1% in 2016 and 1.7% in 2017.

The recovery of the Italian economy, initiated during 2015, encouraged by low oil prices and intensification of private consumption, should be accelerated in 2016 and 2017 (from 0.9% in 2015 to 1.5% and 1.4%, respectively). In the next years, domestic demand will contribute most to the growth of Italian GDP, while net export will contribute neutrally in 2015, and negatively in 2016. The

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deceleration of global demand will have an unfavourable effect on the export activity in 2016 (deceleration of import growth from 4.4% in 2015 to 3.3% in 2016). Import will show a stable growth of approximately 5% on average in the next three-year period. Inflation will show moderate growth due to the possible increase of tax rate on the added value and a mild increase of unit labour costs. Stronger economic growth and favourable developments in the international financial market (lower interest rates) will improve the fiscal position of the country and reverse the public debt trajectory.

Although growth forecasts have been improved for most countries, growth will not be uniform and sufficient to initiate stronger convergence between the EU Member States. The Eurozone economy will be burdened with insufficient investments and structural weaknesses of the economy, which narrows the space for a stronger growth of employment. On the other hand, high level of private and public debt will require additional fiscal efforts, especially in the light of the uncertainty of the global economy in 2016.

Risks to the global economic recovery are strongly connected to the decrease of global demand due to the deceleration of the Chinese economy, which affects the increase of currency risks, deterioration of the balance position of banks and diversion of capital flows away from developing countries. Uncertainty in the international environment is also connected to the normalisation of the monetary policy in the USA. Market expectations of short-term interest rates in the USA, which constitute the basic technical assumption in projections, are currently indicating very gradual growth of short-term interest rates. Sudden changes in capital flows toward developing countries are increasing the uncertainty in the international environment and the loss of investors' trust. Growth of long-term interest rates in USA may condition the outflow of capital from developing countries, stricter financing conditions and, thus, result in deceleration of the global growth.

In case there is materialisation of external shocks, the growth of investments and business activity in Europe may be endangered. On the other hand, effects of the structural reforms which were previously implemented and the implementation of the Investment Plan for Europe, together with the acceleration of the global trade, may give an additional impulse to the growth of the economic and export activity.

2.2. Current Macroeconomic Developments and Prospects for 2015

The Government initiated the implementation of the programme of strong fiscal consolidation and structural reforms in 2014, and continued it in 2015. The programme of fiscal and structural adjustment was adopted in difficult macroeconomic conditions, after disastrous floods and in the circumstances of high geopolitical tensions.

Fiscal measures undertaken in 2015 had good results. Successful coordination of the monetary and fiscal policy, during the implementation of fiscal consolidation measures, has enabled the relaxation of the monetary policy by gradually reducing the reference interest rate while preserving the stability of the exchange rate. Economic activity is additionally stimulated by the implementation of structural reforms concerning labour legislation and construction, which has considerably improved the business environment and additionally encouraged growth.

Current developments indicate that macroeconomic prospects of the country have been improved, and that the recovery of the economic activity has been intensified. Internal and external macroeconomic imbalances have been reduced, and the inflow of investments has been increased. Consistent implementation of fiscal consolidation, together with the initiated structural adjustment, has favourably affected the investment environment. The favourable structure of the initiated recovery is additionally confirmed by positive labour market trends. The balance of payment deficit, as an indicator of the external imbalance, has been notably reduced, and inflation, an indication of internal imbalances, is extremely low. Also, the recovery of our foreign trade partners, in the circumstances of an expansive monetary policy by ECB and decline of oil prices, has additionally affected favourable economic developments during most of 2015.

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According to the data of the Statistical Office of the Republic of Serbia (hereinafter: SORS), GDP, after a decline in the first quarter of 2015, was increased by 2.2% in the second quarter, seasonally adjusted, while the year-on-year growth was 1% compared to the second quarter of 2014. During the third quarter, positive economic developments continued, and year-on-year GDP growth was 2.0% (flash estimate by SORS). The initiated recovery was achieved in a healthy manner, due to the growth of the export and investment activity. Reforms of the business environment, together with the improvement of the financial position of enterprises, mostly due to the decline in oil prices and lower costs of borrowing, have had a positive impact on the investment growth. Decline of oil prices, lower costs of borrowing and increased inflow of remittances have reduced the short-term negative effects of the fiscal consolidation on the final consumption.

Table 3 Main indicators of current economic developments

	2014	Jan.- Sept. 2015
Industrial production, physical volume	-6.5	7.6
Real turnover in retail trade	2.0	1.8
Export of goods denominated in EUR	1.5	8.5
Import of goods denominated in EUR, CIF	0.2	5.3
Consumer prices, period average	2.9	1.4*
Actively unemployed persons, period average	-1.0	-3.3
Average net wage in real terms, total	-1.5	-1.8
Average net wage in real terms, public sector	-1.8	-7.6
Average pensions in real terms	-2.1	-5.5
In mill. EUR		
	2014	Jan.- Sept. 2015
Trade deficit, CIF	-4,338.1	-3,051.5
Current account deficit	-1,984.7	-1,082.5
Net FDI inflow	1,236.3	1,231.4
NBS foreign exchange reserves, end of period	9,907	10,674.4*
Foreign currency savings, end of period	8,525	8,590

* Data refer to the period January-October

Source: SORS, NBS, NEA, PF

The favourable structure of the initiated recovery of the economy is additionally confirmed by the industry growth, which produces exchangeable goods, and construction, which is a good indicator of the developments of total investment. The recovery of the mining and energy sector, together with the continued growth of the processing industry, determined the strong growth of the industrial production by 7.6% in the first nine months of 2015. Mining and production of electrical energy reached their 2013 level and affected the growth of energy production by 39.3% in the third quarter. Production of intermediary goods also continued its year-to-year growth in the third quarter (4.9%) due to the increase of production in Zelezara Smederevo (Smederevo Steel mill). Production of investment goods was guided by the growth of machine production, and has experienced a growth of 5% YoY since the beginning of the year, in spite of negative trends in production of automotive industry. Positive trends from the beginning of the year were also present in the production of consumer goods, and during the third quarter, the growth was accelerated (growth of 8.4% YoY) due to the growth of the tobacco industry (90.4%) and the growth of production of basic pharmaceutical products (23.8%), in spite of the deceleration of growth of the food industry. The production growth of the pharmaceutical and tobacco industry and production of basic metals determined the growth of the processing sector of 6.1%. At the same time, there was a visible recovery of the construction sector, as a result of the acceleration of public investments in the transport infrastructure, as well as the recovery of high rise building construction after the acceleration of the procedure of issuance of construction permits. The growth of activities in this sector is indicated, primarily, by the real growth of values of executed works by 22.5% YoY (in the second quarter) and hours worked on construction sites by 5.8% YoY. In addition, the issuance of construction permits was considerably accelerated through the application of new regulations, and in third quarter it reached the record growth of 26.5%

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YoY. On the other hand, the summer months drought caused a crop yields decline of maize and industrial crops, which resulted in a downward correction of agricultural production. The fiscal consolidation had effects on the economic activity of the service sector (state administration, education, health care and social security sectors), which recorded a reduction of the gross value added (GVA). Nevertheless, positive developments were achieved in certain parts of the service sector (slight turnover growth in retail trade, growth of the physical volume of transport services and increased number of tourists' overnight stays). It is expected that the growth structure in the fourth quarter will be similar as in the previous part of the year. Continuation of positive developments in industry and construction, together with the recovery of certain service sectors, should result in an acceleration of GDP growth, which, according to our revised assessment, should be about 0.8% in 2015. In spite of negative effects that the drought had on the agricultural production, acceleration of growth of activities is expected in the last quarter, on the basis of the increased production and the activation of capacities of Zelezara and parts of the chemical industrial complex.

The labour market situation is characterized by the growth of employment in the circumstances of an increased participation rate, while fiscal consolidation measures have affected the decline of actual net wages, due to the actual decline of public sector wages. Labour market indicators from the Labour Force Survey indicate a continued reduction of unemployment, which is confirmed by National Employment Service data. According to the Labour Force Survey data, the labour market situation was improved in the second quarter of 2015 compared to the same period the previous year, due to the increased employment within the service sector, especially in respect of retail trade and wholesale trade, accommodation and food and processing industry. The unemployment rate was reduced by 3 p.p. to 17.9%, while the employment rate was increased by 0.8 p.p., with a simultaneous decrease of the informal employment rate by 2 p.p. to 18.5%. The average net wage paid during the first nine months of 2015, compared to the same period in 2015, was actually reduced by 1.8%. Fiscal consolidation measures affected the decline of actual net wages in the public sector, which were actually reduced by 7.6%, especially in respect of health care, education and state administration, while the processing industry positively contributed to movements of total wages. A new law on the salary system in the public sector is expected to be adopted by the end of the year, ensuring a unique and transparent method of determination and more effective control of employee salaries in the public sector. During 2015, the competitiveness of the economy was additionally improved, in the circumstances of a strong growth of industrial production and mild reduction of unit labour costs. By the end of the year, a mild increase of unemployment rate is expected, while actual wages in the private sector will continue to grow.

Low prices of commodities on the world market, low inflation in the international environment, improvement of fiscal consolidation, favourable external financial conditions and stabilized inflation expectations are the factors that have affected the relaxation of the monetary policy. In the first ten months of 2015, the average inflation was 1.4% YoY, which is below the lower limit of allowed deviation from the target ($4 \pm 1.5\%$). In late October, compared to December 2014, inflation was 1.8%, which was mostly caused by increased prices of electrical energy, cigarettes, holidays package, coffee and edible oil. Prices of unprocessed food, particularly vegetables, negatively contributed to price movements. During 2015, NBS gradually mitigated its monetary policy, reducing the reference interest rate, which was kept at 4.5% during November. The tighter fiscal policy confirmed the commitment of the creators of the economic policy to strengthening public finances, and helped reduce inflationary pressures. In 2015, inflation is expected to remain under the lower limit of allowed deviation from the target of NBS, where the low aggregate demand and low prices in the international environment will be the main reasons why inflation will be 2.1% by the end of the year.

The decline of world oil price and gradual economic recovery of our main foreign trade partners have had a favourable impact on the foreign trade, characterized by an increased volume of trade and a significant reduction of the foreign trade deficit. The balance-of-payments position of the country was considerably improved during the first nine months of 2015. The current account deficit in this period was 1,082.5 million EUR, and was almost by a quarter (23.8%) lower than in the same period in 2014. The foreign trade deficit of goods and services was reduced by 12.8% due to the faster

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export growth. In this period, goods were exported (CIF) in the amount of 9 billion EUR, and imported in the amount of 12.1 billion EUR, which constitutes an increase of 8.5% and 5.3%, respectively, compared to the same period in 2014. Growth of export of goods in this period was achieved due to the export of agricultural products, foodstuffs and tobacco. The relaunch of production in the Smederevo steel mill affected the increase of exports and the partial substitution of the import of iron and steel. Positive effects to the improvement of the foreign trade imbalance were continued to be contributed by the export of chemical and pharmaceutical products and rubber and plastic products. On the other hand, the export of motor vehicles was reduced due to the lower external demand. Also, the decline of oil prices and consequent lower prices of oil derivatives affected the lower amount of export, while the recovery of the energy sector from the last year floods affected the growth of export of electrical energy (38.5% YoY). Import developments in this period are characterized by the growth of import of metal ores, coke and hard coal due to the increased production of basic metals. The most important contribution of the foreign trade deficit comes from the lower amount of import of crude oil and oil derivatives due to the decline of price on the world market. The euro-denominated coverage of import by export in the first nine months was 74.7%. The largest foreign trade partner in the period January - September 2015 were EU countries, which constituted 66.0% of the total export and 62.5% of the total import. Almost half of the total export in that period was targeted to the markets of the following five countries: Italy, Germany, Bosnia and Herzegovina, Romania and Russian Federation. Import from Germany, Italy, Russian Federation, China and Hungary constituted 46.2% of the total import. The trade with Bosnia and Herzegovina, Montenegro, Italy, Macedonia, Romania and Bulgaria resulted in the surplus in the amount of 1.6 billion EUR.

The recovery of the external demand, primarily of our largest foreign trade partners, will positively affect our export. However, the investment growth has caused the increased import, primarily of capital equipment, since our economy is import-dependent, and thus the contribution of the net export in 2015 is expected to be neutral.

Capital inflow in the first nine months is a result of the inflow of foreign direct investment in the amount of 1,231.4 million EUR (which is an increase by 281.6 million EUR or 29.6% compared to the same period in 2014). The largest inflow of FDI in the first half of the year was recorded in the processing industry (310.1 million EUR), financial activities and insurance (183.9 million EUR) and construction (84 million EUR). Total FDI from EU in the same period were 614 million EUR, which constitutes 80.4% of the total net FDI. Net inflow of portfolio investments in the first nine months of 2015 was 27.6 million EUR and was lower than in the same period in 2014 by 265.8 million EUR. This decrease was mostly affected by the reduced government borrowing on the basis of debtor securities. Net borrowing from abroad by residents, on the basis of financial loans, was 150.6 million EUR. Net government debt on the basis of financial loans was reduced by 398.6 million EUR, to the amount of 220.2 million EUR. On the basis of due liabilities, NBS made payments in the amount of 138.7 million EUR, out of which the largest part (130.3 million EUR) concerned amounts payable to IMF. Banks continued to discharge their foreign debts in 2015 (184.8 million EUR), while at the same time enterprises discharged their debts in the amount of 47.1 million EUR. The total current account deficit in 2015 is expected to be approximately 1.6 billion EUR or 4.7% of GDP, which is lower compared to 2014 by 1.3 p.p., with the almost full coverage of FDI. Continued implementation of structural reforms with a view to improving the business climate, preserving macroeconomic stability and consolidating public finances should ensure further inflow of foreign direct investment in sectors of exchangeable goods, which will improve the productive potential and ensure the sustainable growth in the medium term and long term.

Foreign exchange market developments in the period January to October 2015, compared to the same period the previous year, were characterized by the nominal depreciation of the dinar in relation to euro in the amount of 3.3% and the actual depreciation of 2%. The real effective exchange rate in this period depreciated by 5.7%, which affected the improvement of the international competitiveness of the economy. The foreign currency market in 2015 recorded appreciation pressures, which were mitigated by NBS through the purchase of foreign currency on the interbank foreign exchange market in the net amount of 790 million EUR, by October. Foreign reserves of NBS

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in late October were 10.7 billion EUR, which is higher than the amount at the end of 2014 by 7.7%, and ensures the coverage of almost seven months of import of goods and services.

After the intensification of the credit activity in 2014, as a result of the subsidised loan programme, the credit activity of banks towards the private sector has remained low. The deceleration of the credit activity is also negatively affected by the high share of non-performing loans in total loans, which was 22% in the third quarter of 2015. Compared to the third quarter of 2014, the share of non-performing loans granted to retail clients was increased by 0.9 p.p to 11.15%, while the share of non-performing loans granted to corporate clients was reduced by 3.2 p.p. to 24.14%. Key contribution to the expected recovery of the credit activity in the next period will be provided by the mitigation of the monetary policy, since it has caused a considerable decrease of interest rates on loans. The credit activity of banks in September 2015 on an annual level is characterized by a slight recovery of the growth in lending to corporate clients (2.3%) and deceleration of the growth of lending to retail clients (4.3%). In terms of purpose, the credit activity of retail clients was most affected by the growth of residential loans, which have experienced a deceleration of growth since June. At the same time, the growth of credit activity towards corporate clients was determined by the growth of investment loans, which have recorded an acceleration of growth for the fourth consecutive month. The high growth of investment loans confirms the wider recovery of the total investment activity. In this period, in terms of the currency structure, the share of foreign currency sources of financing has been reduced, together with sources of borrowed funds and external sources of funding. Efforts on the resolution of non-performing loans have been intensified by the adoption of the NPL Resolution Strategy, which was adopted by the Government in August 2015. The main objective of the Strategy is to ensure incentives and remove obstacles identified in the system, which are preventing a timely resolution of NPL and the establishment of a system which would prevent the accumulation of NPL to the level which may have negative effects on the credit activity, endangering the potential economic growth. With a view to achieving the above mentioned objective, measures will be undertaken to resolve problems of state-owned enterprises undergoing restructuring or insolvency, strengthen capacities of banks, create conditions for development of NPL market, improve and encourage out-of-court debt restructuring and sale of immovable property.

According to the data of the NBS, the total external debt at the end of September 2015 was 26,308 million EUR, which constitutes an increase of 516 million EUR compared to the end of 2014 and a 204 million EUR decrease compared to the end of the previous quarter. Even with the increase of the external debt, the external solvency ratio of the external debt to the export of goods and services has been slightly improved, by being reduced from 178.5% in 2014 to 171.4% in the third quarter of 2015, which was affected by the growth of import which was higher than the growth of external debt. Improvement of the external solvency was also noticed in the relation between the short-term debt and BDP, while deterioration was noticed in the external debt-to-BDP ratio with an increase of 2.8 p.p. The external liquidity ratio has registered an improvement in the share of debt repayment in the import of goods and services, with a decrease from 32.7% in 2014 to 24.2% in the third quarter of 2015.

2.3. Projection of Macroeconomic Indicators for the period 2016-2018

On the basis of current economic developments and prospects in Serbia and international environment, having in mind the planned economic policies and the concluded Precautionary Arrangements with IMF, main macroeconomic aggregates and indicators for the Republic of Serbia in the period 2016-2018 have been projected.

Successfully implemented fiscal policy measures and improved conditions of the business environment and investment environment during 2015 have enabled the creation of the basis for a stable and sustainable growth in next years. Implementation of harsh fiscal consolidation measures in the circumstances of favourable economic developments in the international environment did not cause a significant decrease of domestic demand, contrary to the previous estimation.

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Projections of GDP and related indicators in the next medium-term period have been adjusted upward. Systematic improvement of the corporate environment will allow the growth of foreign and domestic investments, while the acceleration of the economy restructuring will create conditions for new employment and increase of productivity and competitive position of the country. GDP growth in 2016 was revised upward from 1.5% to 1.8%, and will be led by the growth of investment consumption. In addition, a timid growth of the standard of living is expected in 2016. Fiscal space, ensured by a strong structural adjustment, has enabled a slight adjustment upward of the government consumption in 2016.

Macroeconomic projections for the period from 2016 to 2018 indicate an accelerated recovery trajectory. The projected cumulative growth rate of real GDP for the next three years of 7.7% is based on the growth of domestic demand, primarily the recovery of the investment activity and growth of the standard of living. The initiated investment cycle during 2015 and in the next years will be the leading development factor which will, together with restructuring of the economy, enable the further reduction of internal and external imbalances. Further implementation of the public sector reform and improvement of the business environment and investment environment will enable creation of the basis for growth acceleration.

The medium-term macroeconomic projection anticipates the average real GDP growth of 2.5%. Growth of investments and private consumption is expected, at the annual average real rates of 6.1% and 1.1%, respectively, with the annual average real growth of export and import of goods and services (7.2% and 4.9%, respectively). The continued implementation of the credible fiscal consolidation plan will affect the reduction of government consumption (at an annual average of -0.5%). The adopted plans of structural adjustment of the economy continue to reduce the irrational consumption, bureaucracy and unnecessary public sector costs, with the simultaneous improvement of the investment environment. At the same time, protection will be provided for the most socially vulnerable strata.

The initiated recovery trajectory will make it possible to ensure the increase of GDP investment share by 2 p.p. in late 2018, reduction of the share of government consumption from 18.2% in 2014 to 14.4% of GDP and the increase of the share of import of goods and services in GDP to over 50%. Net inflow of foreign investments in the annual average amount of 1.5 billion EUR, together with the change of investment structure towards the exchangeable goods sector. Financing the balance of payments implies the simultaneous reduction of the share of deficit of goods and services of current transactions in GDP to 7.9% and 4.2%, respectively, at the end of 2018, in order to ensure the sustainability of the foreign debt, external liquidity and solvency.

Table 4 Projection of main macroeconomic indicators of the Republic of Serbia

	Estimated	Projected		
	2015	2016	2017	2018
GDP, billion RSD (current prices)	3,964.4	4,137.7	4,377.2	4,711.6
Real growth of GDP	0.8	1.8	2.2	3.5
GDP deflator	1.5	2.6	3.5	4.0
<i>Real growth of individual components of GDP, %</i>				
Personal consumption	-0.5	0.2	1.0	2.0
Government consumption	-2.2	0.9	-2.8	0.3
Investment	8.2	6.6	6.2	5.5
Export of goods and services	7.8	7.7	7.0	6.7
Import of goods and services	6.0	5.8	4.4	4.3
Balance of goods and services, in EUR, GDP %	-9.8	-9.0	-8.6	-7.9
Current account balance, BDP %	-4.7	-4.6	-4.3	-4.2
Inflation, period average, %	1.5	2.8	3.9	3.9
Investment ratio, BDP %	16.4	16.8	17.7	18.4

Source: MoF

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Real Sector

Medium-term prospects for the real sector enable an analysis of the cyclical position of the economy and consideration of expected sources of the real GDP growth in terms of changes of factors of production and aggregate demand.

Current developments indicate that macroeconomic prospects of the country have been improved, and that the recovery of the economic activity has been intensified. GDP growth rate in 2015 has been revised upward by 1.25 p.p. compared to the last year Fiscal Strategy, and by 0.3 p.p. compared to the August estimation, due to the favourable impact of the international environment on the investment and import activity. In addition to this, consistent fiscal adjustment, followed by implementation of structural reforms, has resulted in larger investments and import, while household consumption and government consumption will contribute negatively to the 2015 GDP due to the implementation of the fiscal consolidation. Decline of prices of oil derivatives on the world market has affected the disposable household's income and the low and stable inflation, and as a result, the real decline of household's consumption is lower than expected. Investments growth resulted in the increase of imports, since Serbia is an import-dependent economy, and as a result, net export is contributing neutrally this year. From the production perspective, fiscal consolidation will negatively affect the activity of the service sector. In addition, agricultural sector will also negatively contribute to GDP. On the other hand, industrial production will contribute positively, both by virtue of the processing industry, and by virtue of the recovery of the economic sector. Construction activity is expected to record strong growth in 2015, after many years of poor results.

Economic developments and prospects in Serbia in 2016 will largely depend on developments in the international economic environment, as well as further implementation of real sector and public sector reforms. Results of reforms that have been implemented so far will ensure the growth of investment activities in 2016 (contribution to GDP growth of 1.3 p.p.). However, since Serbian economy is import-dependent, an increase of import is expected, primarily the import of investment goods, which will influence the contribution of net export to GDP growth, making it only mildly positive.

After a seven-year stagnation and actual reduction of household consumption, a slight growth of the standard of living is expected in 2016 (0.2%). Fiscal space, ensured by strong structural adjustment of 2.5% of GDP in 2015, will enable a slight real growth of government consumption of 0.9% in 2016. Fiscal results which are better than planned will be partially used for the targeted increase of salaries and pensions and narrowing of the salary gap in the government sector.

Stopping the growth of the public debt remains the main objective of the fiscal policy, which requires further implementation of fiscal consolidation measures in 2016 and 2017. The necessary adjustment in 2016 compared to 2015 requires further structural fiscal adjustment of 0.75% of GDP. Fiscal consolidation measures in the next two years will affect domestic demand, primarily government consumption (reduction of salary mass in the public sector by 3% through the rationalization of the number of employees and natural outflow and continued implementation of rules, pursuant to which one new person may be employed in the government sector per five job vacant job placements). The projected reduction of the number of employees by 5% in the public sector during 2017 will affect the reduction of government consumption and its real decline of 2.8%.

Graph 1 Real growth of GDP: actual and projected rate and the long-term trend, in %



The output gap measuring the cyclical nature of the economic activity in the period of economic boom during 2007 and 2008 was positive (1.4% and 3.8%, respectively), guided primarily by the high domestic demand. In 2009, due to the decline of the economic activity, caused by the economic and financial crisis, the negative output gap was deepened until 2013. Positive trends of the cyclical component during 2013 are a result of activating new capacities in the automotive and oil industry. During 2014, there were recession trends in the economy, again. Consequences of floods significantly affected the potential GDP due to damaging and temporary decommissioning of public and private infrastructure facilities, and as a result, the productive potential of the economy was considerably reduced. The downward trend of the potential growth of productive potential of the economy in the previous ten-year period is, primarily, the result of the reduced investments in productive capacities, difficult financing of current productive activities, and negative trends in the labour market.

Assessment of the potential growth is based on the accelerated economic recovery, where the output gap is expected to be closed late in the projection period, after many years of the negative relation between the real and potential growth rate of GDP growth.

Graph 2 Contribution of the factors of production to the potential growth rate, in p.p.

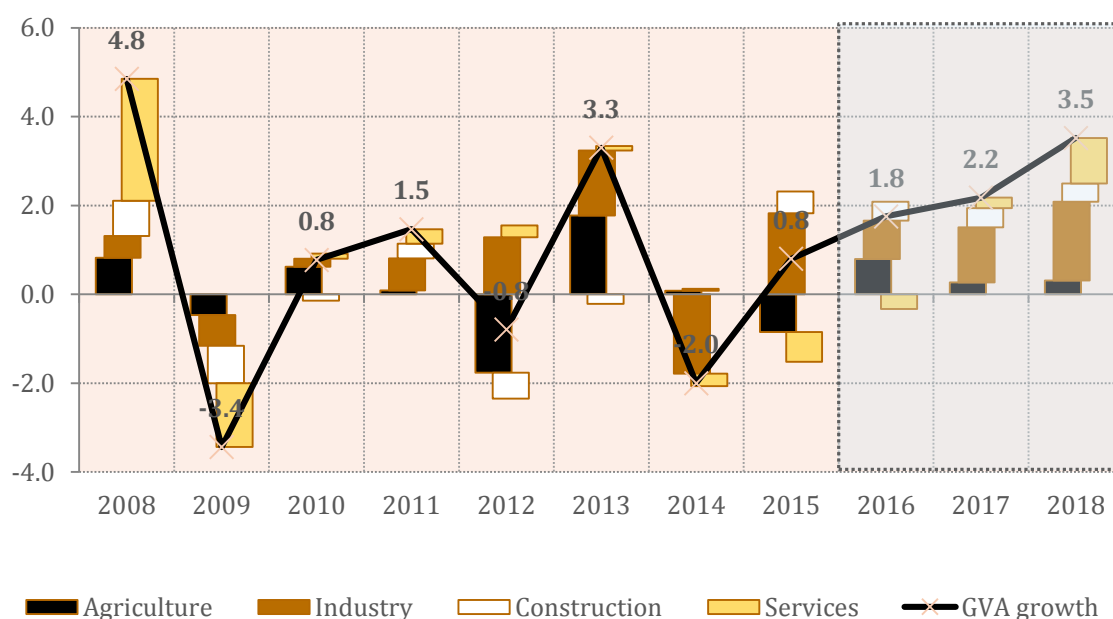


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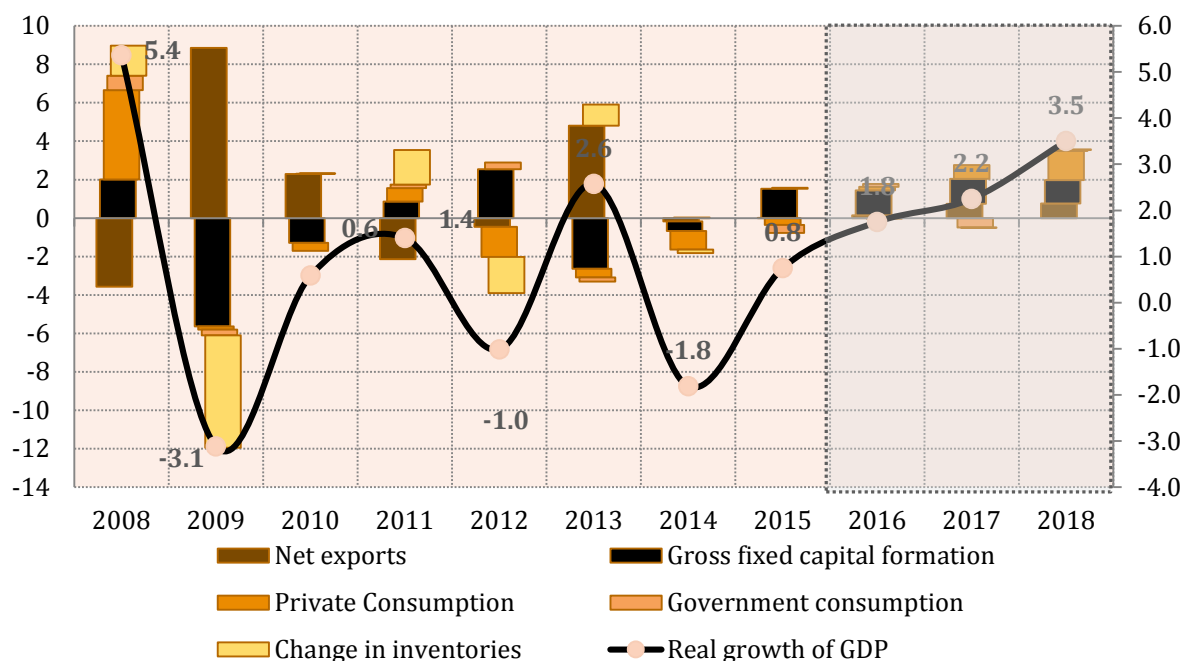
It is estimated that the growth of potential GDP in next years will positively affect the strengthening of investment activity and favourable labour market developments. More favourable financing conditions and stronger investment activity in transport, energy and agricultural sector will increase the potential of the economy. The expected increase of unemployment due to the rationalization in the public sector and the completion of the state-controlled enterprise restructuring process will be mitigated by the increase of net employment in the private sector. Having in mind the current cyclical position of the Republic of Serbia and structural disturbances inherited from the previous period, as well as the extent of current unused capacities, it will be especially important to find ways to increase the total factor productivity and improve the efficiency of investments. For that purpose, it is necessary to continue reforms which will permanently increase productive potentials of the country.

Graph 3 Sectoral contributions to the growth of GDP activities, in p.p.



In terms of production, in the period 2016 - 2018, the largest contribution to the GDP growth is expected from the growth of industrial production and the recovery of the construction sector (contribution at an annual average of 1.3 and 0.4 p.p.). The continued implementation of savings measures in the government sector will have a negative impact on the service sector in 2016 as well, after which a gradual growth is expected (contribution at an annual average of 0.6 p.p. in 2017 and 2018). The main driver of growth in 2016 will be industrial production, as well as agriculture, as a result of the recovery from this year's drought.

Graph 4 Contributions of aggregate demand categories to the real growth of GDP, p.p.



On the expenditure side of GDP, in the period 2016 - 2018, the largest contribution is expected from investment consumption (contribution at an annual average of 1.3 p.p.). Government consumption will make a positive contribution to the GDP growth in 2016 due to the slight growth of salaries in parts of the public sector. The continuation of structural adjustment of the state budget in 2017 will affect the decline of government consumption. Personal consumption will positively affect GDP movements during the entire projection period. The growth of consumption will be guided by the recovery on the labour market, primarily acceleration of the growth of wages and employment in the private sector, and growth of the credit activity of banks targeted to retail clients.

Net export will also contribute to the GDP growth in the next three years, although at a slower rate than expected (contribution of 0.1 p.p. in 2016, 0.7 p.p. in 2017 and 0.8 p.p. in 2018). High growth of export is a result of the recovery of main foreign trade partners of the Republic of Serbia, while the rate of import (growth at an annual average of 4.9%) will be determined by the recovery of domestic demand.

Macroeconomic projection anticipates that the real growth of investments will be 6.6% in 2016, and 6.2% and 5.5% in 2017 and 2018, respectively, which will be generated by launching a new investment cycle. Growth of private investments is crucial, having in mind that the decline of economic activity in the previous period, which was a crisis period, affected the decrease of the potential GDP through the loss of economic capacities and considerable deterioration of labour market conditions.

The projected development scenario indicates the strategic orientation of the Government towards structural adjustment of the economy, in order to ensure the sustainable growth trajectory, primarily based on the increase of the total investment activity through encouragement of investments of the private sector and export, as key factors of achieving macroeconomic stability. The Government will carry out a responsible and predictable fiscal policy with a view to stabilizing public finances through the reduction of the consolidated state budget deficit and stopping the growth of the public debt.

Employment and wages

It is expected that total employment will continue its growth in 2016, guided by the growth of employment in the private sector. The medium-term employment projection is based on the projected growth of GDP and the increase of investments. Due to the improvement of regulation on labour relations and employment, continuation of positive trends on the labour market is expected, in spite of the scheduled rationalization in the public sector and state-controlled enterprise restructuring process. At the same time, trends of increasing the employment rate are expected due to the improvement of regulation on labour relations. Amendments to the Law on Labour have removed the employment obstacles, increased the labour market flexibility and created the basis for reduction of work in the shadow economy.

Graph 5 Actual and projected employment rate and unemployment rate, in %



In the next period, the growth of actual net wages in the private sector is expected to follow the growth of productivity in the economy.

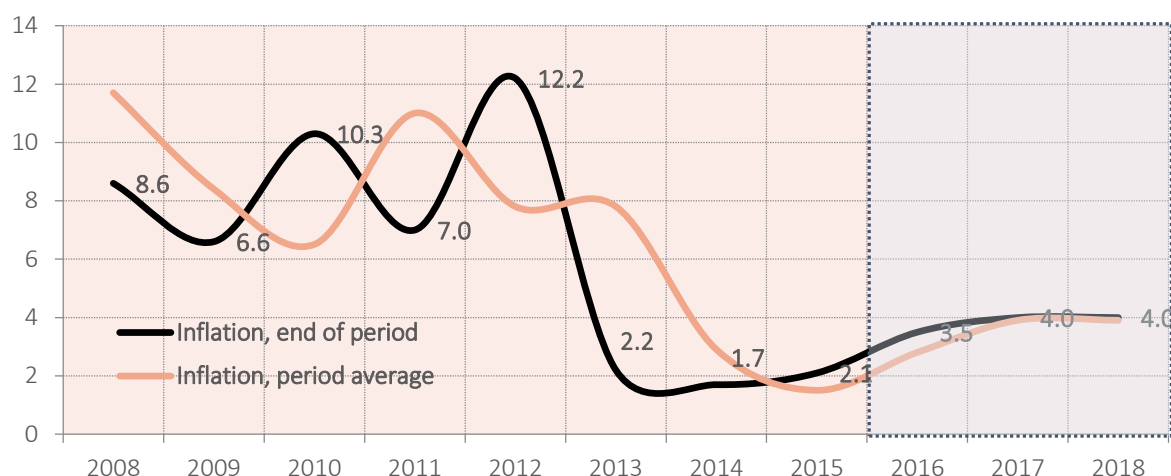
Inflation

Annual inflation since March 2014 moved under the lower bound of allowed deviation from the NBS target. Inflation should return within the bounds of allowed deviation from the target midway through 2016, which will mostly be affected by depletion of effects of this year's low oil prices, weakening of disinflationary pressures by virtue of gradual growth of aggregate demand, and narrowing of the output gap, as well as acceleration of the growth of prices in the international environment.

The medium-term projection of inflation is based on the planned fiscal and monetary policy in the next medium-term period, and anchoring of inflation expectations on the level of the medium-term inflation target. In addition, NBS will adjust its monetary policy in order to make inflation move within the limits of the target in the medium-term period.

Also, the stabilization of inflation will also be affected by the stability of the exchange rate, as well as the weakening of the short-term transfer effect of the exchange rate to prices, which decreases the potential inflation volatility thereby.

Graph 6 Inflation projection, %



Key risks of fulfilment of the projection of inflation concern developments in the international environment, especially price movements of primary products and uncertainties with regard to monetary policies of central banks of leading countries.

Projection of the balance of payment

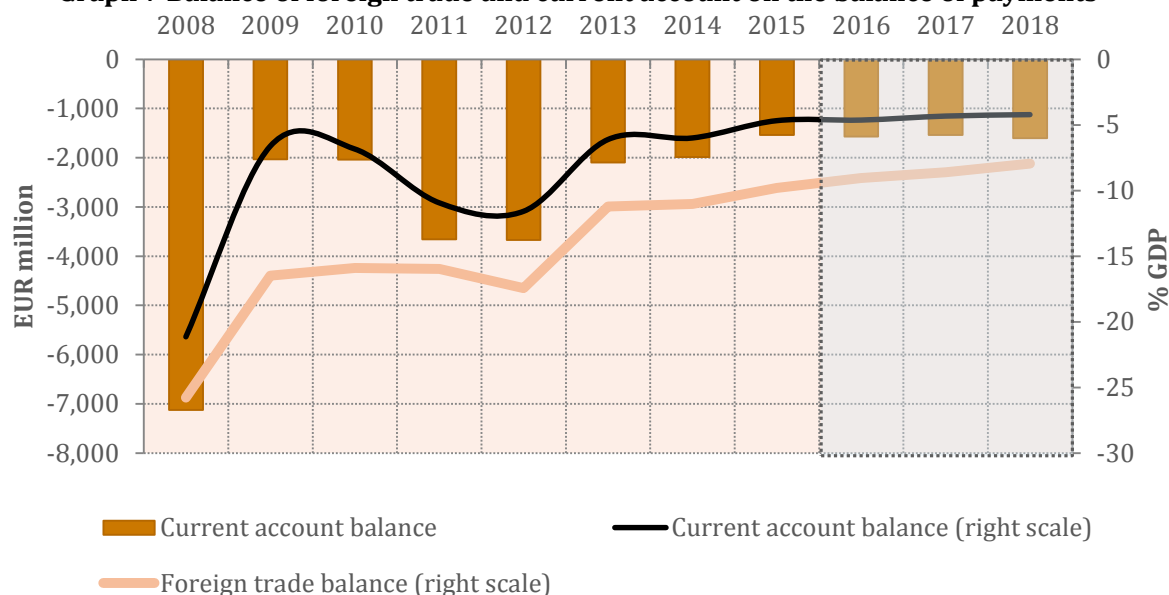
Data from the balance of payment indicate that in 2015 so far there have been favourable developments in foreign trade and balance of payment of the country as a result of favourable impulses from the international environment (decline in oil prices and recovery of main foreign trade partners), larger inflow of remittances from abroad, as well as positive effects of fiscal consolidation on the balance of payment position of the country. The estimated current account deficit in 2015 of 4.7% of GDP has been reduced compared to the last year, and fully covered by net inflow of foreign direct investment, which has positively affected the external position of the country.

The medium-term macroeconomic projection anticipates a continuation of the growth of import and FDI inflow, together with strengthening of cost competitiveness and price competitiveness. The projected real growth trajectory of import of goods and services is based on the strengthening of the external demand for domestic products, which will enable the growth of the market share on export markets, together with strengthening of cost competitiveness and price competitiveness. Faster growth of export of goods and services compared to the import will allow the foreign trade deficit to be reduced from 12.4% of GDP in 2014 to 11.4% of GDP in 2016. The balance of current payments will be negative and it will be 1.6 billion EUR (4.6% of GDP). In addition, the structure of capital inflow will be dominated by the share of foreign direct investment, which will be the main source of funding the current account deficit.

It is expected that, in the period from 2017 to 2018, real growth of export of goods and services (at an annual average of 6.9%) will continue to be faster than the import of goods and services - at an annual average of 4.4%. With a view to increasing the investment activity, the largest part of the import will be targeted to capital goods and intermediate goods.

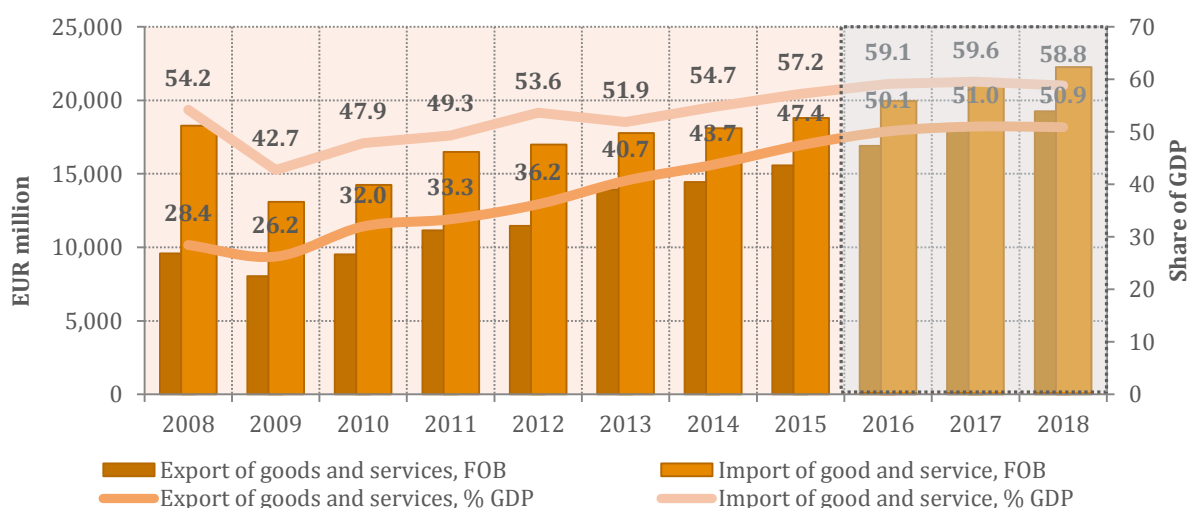
The medium-term and long-term sustainability of the current account balance will depend on the implementation of structural reforms and increase of competitiveness of the import of goods and services, as well as interest costs, which would, in case of a drastic deterioration of financing conditions on foreign markets, put strong pressure on the growth of current account deficit. In that regard, sustainable fiscal position and reduction of internal macroeconomic imbalances play an important role. Continuation of fiscal consolidation measures are expected to affect the gradual reduction of current account deficit, through the reduction of government consumption.

Graph 7 Balance of foreign trade and current account on the balance of payments



Faster growth of export of goods and services compared to the import will allow the deficit of goods and services to be reduced to approximately 8% of GDP in 2018. Also, the balance of services will be positive, and is estimated to be 2.6% of GDP, which constitutes an increase of 1.2 p.p. of GDP compared to the 2014 surplus. Reduction of the negative net export of goods and services, primarily as a result of the changed structure of the domestic economy, will contribute to the reduction of the external imbalance and the risk of sustainability of the external debt and external liquidity. The lower level of current account deficit, with the share of 4.2% of GDP at the end of 2018, will be fully covered by foreign direct investment.

Graph 8 Export and import of goods and services



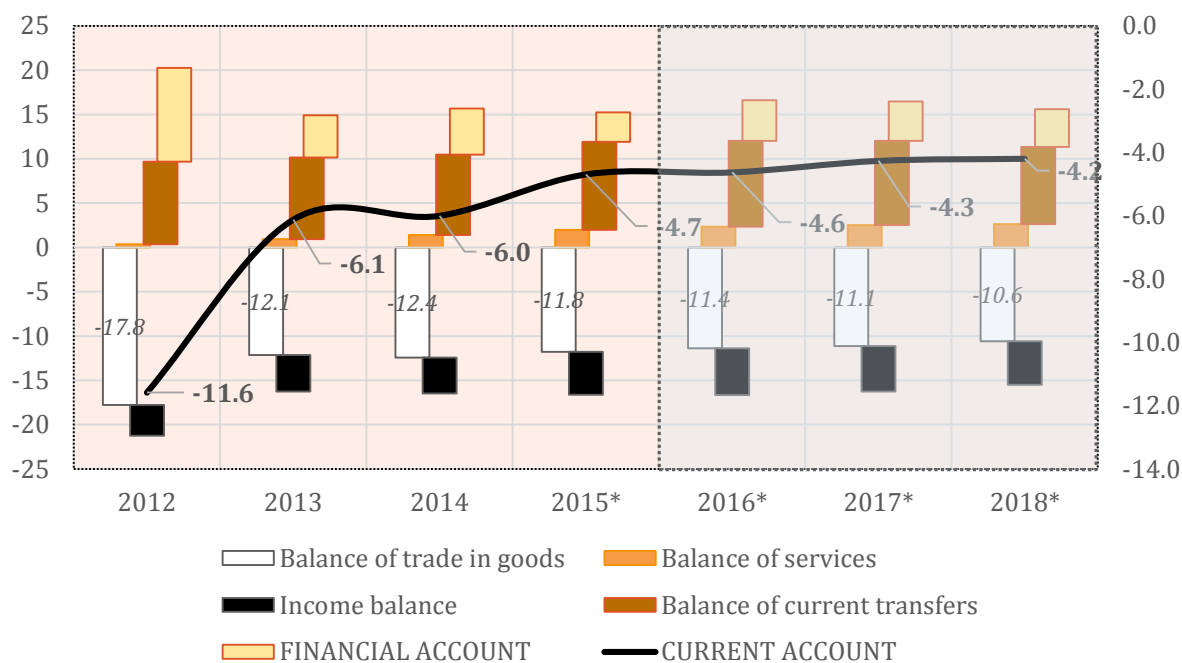
In the next three year period, an inflow to the current account on the balance of payments on the basis of current transfers is expected, as well as an outflow on the basis of factor payments. Inflows to the current transfer account are expected to remain stable (at an annual average of 9.3% of GDP). The most important component in current transfers is income from remittances, while outflows on the basis of payments of foreign loan interest are crucial for factor payments. It is estimated that net current transfers with non-interest income on the basis of factors in the period 2016-2018 will be at an annual average of 2.5 billion EUR. The negative balance on the basis of net interest payments will reach 1.0 billion EUR in 2018. Net effect of current transfers and net factor payments in the next three-

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year period will be positive, and it is estimated that it will be at an annual average of 1.5 billion EUR. The surplus of the balance of current transfers and net factor payments will cover, on average, approximately 48% of the deficit of the foreign trade balance of the Republic of Serbia in the period 2016-2018.

Graph 9 Current account deficit and its financing, % of GDP



Projections of the balance of current payments have been made on the basis of projected foreign trade developments, current transfers and net factor income. The balance of current payments will be negative and it will be at an average of 1.6 billion EUR in the period 2016-2018. In addition, the structure of capital inflow will be dominated by the share of foreign direct investments (at an annual average of 4.3% of GDP), which will be the main source of funding the current account deficit, and will be at an annual average of 1.5 billion EUR in 2017 and 2018. The growth of FDI, primarily towards the government exchangeable goods sectors will contribute to the growth of export and improvement of the external position of the country.

It is estimated that the total external debt of the Republic of Serbia by the end of 2017 will show a downward trend, mostly due to the stabilization and reduction of the public external debt. Foreign currency reserves of the Republic of Serbia in the period 2016-2018, according to the assessment, will cover the six-month import of goods and services.

2.4. Risks for the Realisation of Projections

The fulfilment of the macroeconomic scenario is exposed to certain external and internal risks.

The uncertainty on the international capital market in terms of the continued reduction of expansiveness of the monetary policy of FED, and uncertainty with regard to the effects of ECB measures, contribute to the increase of the risk with regard to the recovery of the global and European economy. The global economic recovery is decelerating, with considerable differences in growth rates between groups of countries. One of the risks to the economic growth of the Eurozone, which is our largest foreign trade partner, concerns the deceleration of growth of countries on the rise, primarily China. Turbulences on the Chinese financial market and their spilling over into the real economy may affect the deceleration of the global foreign trade market. The reduction of demand from China will affect its largest foreign trade partners, and may endanger the initiated recovery of the EU by reducing the demand for its export. In addition to the expectations with regard to the economic growth, the

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exchange rate of the US dollar is one of the factors that investors are monitoring when assessing country risk. A possible strengthening of dollar may make it more difficult for many countries to service their debt. Also, the crucial external risk of fulfilment of the projection is linked to the further deterioration of geopolitical tensions and their strong effect on financial, foreign trade and energy flows. The recovery of the economy of the Republic of Serbia will largely depend on the rate of recovery of Eurozone and the economies of the region, and the increase of foreign demand thereby and the inflow of foreign capital, foreign interest rate movement, import prices movement, prices of food and oil derivatives.

Downward risks are also linked to steel price trends on the world market, considering the fact that further decline of prices may endanger the performance of the domestic steel industry. On the other hand, keeping the prices of oil and gas on a low level would encourage the economic activity through a higher consumption and more favourable financial position of the economy (the petrochemical complex, etc.).

The resistance of the domestic economy to the above mentioned risks from the international environment is affected by fiscal consolidation measures, prospects of economic growth that are more favourable than expected, reduction of the external imbalance, and consistent implementation of arrangements with IMF.

Internal risks of the fulfilment of projection are relatively lower than the risks identified in the previous Fiscal Strategy, considering the fact that the planned structural fiscal adjustment in 2016 is on a considerably lower level.

The main development scenario in the next three years is based on the increase of a part of fixed investment in GDP, reduction of the share of public expenditure in GDP, increase of the share of export of goods and services in GDP, together with the reduction of the share of deficit of current transactions in GDP.

The main preconditions for the fulfilment of the prescribed medium-term scenario are the continuation of the implementation of fiscal consolidation measures and restructuring of economy, especially public sector reforms, maintaining the continuity in approaching EU, stabilization of the public debt and sustainability of the external debt.

Any deviation from the above mentioned preconditions is a risk to the fulfilment of the medium-term macroeconomic projection. A lack of investment and comprehensive structural measures ensuring a stimulative natural environment would cause a deterioration of the macroeconomic position of the country. Such developments would increase macroeconomic imbalances through the instability of the foreign currency market, reduction of foreign currency reserves and problems in debt repayment. In addition, the necessary inflow of foreign capital would be decelerated and stopped.

II. Fiscal framework for the period 2016-2018

1. Medium-term fiscal policy objectives

The objective of the medium-term fiscal policy is to stop the government debt growth and to achieve its relative decrease in the long run, i.e. to lower the debt to GDP ratio to about 45%, in line with the general fiscal rules.

The general government debt has doubled in the past few years, and it is estimated that by the end of 2015 it will stand at around 76.6% of GDP. Fiscal policy is focused on stopping the upward trend in government debt, stabilisation and lowering of debt to GDP ratio until 2018. The debt stock increase is the consequence of long-term high deficits, but also strong growth of repayment of the publicly guaranteed debt and costs needed for stabilization of the financial system. Further delay to limit the growth of debt brings into question the sustainability of public finances, i.e. the possibility of financing expenditures, especially such expenditures as salaries, pensions and social benefits, which amount to more than 60% of the total public spending, but also further debt service liabilities.

Significant fiscal consolidation measures were adopted along with the adoption of the budget revision already in 2012, and the measures continued to be implemented in the 2013 budget. These measures were primarily on the revenue side and related to change in numerous tax rates and abolishing a considerable number of quasi-fiscal burdens. On the expenditure side, the most significant measure was to limit salaries in the public sector and pensions. During 2014, the key instruments of fiscal consolidation were the reduction of salaries in the public sector for the employees with net income above RSD 60,000 and a hiring freeze. The fiscal consolidation measures yielded different results. The restrictive fiscal policy approach influenced certain macroeconomic aggregates; thus, during 2013 and 2014, there was an actual drop in private consumption, government expenditures and investment spending, as well as growth in illicit trade, particularly when tobacco products are in question. In the second half of 2014, there was a positive trend, when the effects of the measures undertaken finally began to show as reduced fiscal deficit compared to the year before. At the same time, the recovery of the economic activity has begun and started to show a long-term trend of economic growth. Furthermore, growth of current expenditures was stopped, and stability and revenue growth were achieved, although the growth of interest, expenditures for repayment of guaranteed debt and coverage of losses of public enterprises and state-owned banks have caused new deficit and debt growth.

In 2015, the fiscal consolidation measures have continued, bearing in mind the current unsustainable position and burden, which the high deficit, debt level and its future necessary repayments represent for the citizens and economy. Significant support to the recovery of public finance has begun with the IMF arrangement of the Serbian Government. The arrangement with this institution has additionally strengthened the credibility of the policy implemented by the Government in the public finance domain, and ensured more favourable status and investors' perception in the international finance market. In order to avoid additional burdening of economy through increasing taxation, decrease in deficit is mainly based on adjustment of the expenditure side of the budget. The main fiscal consolidation measures are reduced salaries in public sector and pensions, and rationalisation in public sector, with simultaneous resolving the issues in reorganisation of huge state-owned economic systems, primarily through business processes improvement and corporatisation. On the revenue side, the priority is combating shadow economy, with obvious results this year, particularly in the domain of collecting income tax and contributions, control of sales of products subject to excise and sales in general.

The mentioned measures in 2015 have led to strong structural adjustment of 2.5% of GDP.

The expenditure policy has been primarily directed, through the measures reducing salaries and pensions, in accordance with specific fiscal rules relating to the indexation of salaries and pensions, in accordance with the last Amendments to the Budget System Law; but also towards further relative decrease in current expenditures, particularly expenditures for subsidies, activated guarantees and budget loans to economy, on the basis of the expected completion of the process of

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restructuring and privatisation of state-owned enterprises and raising the efficiency of public enterprises.

The medium-term fiscal framework accompanied by the proposed measures of fiscal consolidation provides a significant reduction of the general government deficit to 1.8% of GDP by 2018. Nominal deficit reduction by 2018 corresponds to additional structural adjustment of 2.3% of GDP in the period 2016-2018. As the consequence of structural adjustment and deficit reduction, stabilisation of government debt at the 79% of GDP level in 2017, and further reduction to 75.9% of GDP in 2018 will occur.

2. Fiscal framework for the period 2016-2018

2.1. Fiscal developments in 2015

At the end of 2012, the first important package of fiscal consolidation measures was adopted. These measures were mainly related to the revenue side, bearing in mind the increasing tax rates. On the expenditure side, the measures concerned limiting salaries and pensions, abolishing own revenues of budget beneficiaries, rationalisation of expenditures for purchase of goods and services and subsidies. The development aspect of this package related to attracting investments and overcoming liquidity problems in the economy. The plan was ambitious bearing in mind that decrease in deficit by approximately 2.5% of GDP in the first year was envisaged. Although the growth of GDP was greater than expected (2.6% instead of 2.0%), the revenue projections were not carried out. The main growth components were exports and agriculture, which in the short term are not generous regarding revenue collection. On the other hand, numerous changes in tax policy negatively affected the consumption, provoking, inter alia, strengthening of the shadow economy influence. However, deficit was nevertheless decreased by 1.7% of GDP, and some of the then introduced measures showed their full effect in the second half of 2014. During 2013, pension and disability insurance contribution rates and income tax rates were changed; thus, part of the funds was redirected from the budget of local self-governments units to the Budget of the Republic of Serbia. This measure was introduced with the goal to settle the unequal revenue distribution, i.e. surplus of funds at the local level compared to the high deficit of the Budget of the Republic of Serbia.

The restrictive fiscal policy approach was continued in the 2014 Budget of the Republic of Serbia. On the revenue side special VAT rate was increased from 8% to 10%, although the low purchasing power and decrease in domestic production due to floods, resulted in VAT revenues less than expected. Furthermore, changes in the consumption structure occurred, because the demand for domestic products was substituted by imported goods, which reflected on the collection of VAT from imports, while the reduced domestic production influenced lower domestic gross and net VAT collection. Significant results were expected from combating shadow economy, particularly when sales of tobacco products are in question, although they have begun to fulfil only in the second half of the year. On the revenue side numerous restrictive measures have been implemented, beginning from the decrease in salaries to the employees whose net income is more than RSD 60,000, and the amount of this decrease was paid in the budget as non-tax revenues. Strict control over hiring freeze was introduced in order to reduce the number of employees through natural outflow. Besides, rationalisation of discretionary spending, particularly goods and services and subsidies, continued. On the other hand, interest repayments, resolving problems in public enterprises and financial sector are of utmost importance. During 2014, due to extraordinary parliamentary elections and consequences of the floods in May, expenditures significantly increased; also, additional funds were allocated for financing troubled parts of the public sector, and were paid at the end of the year, which is the reason why 2014 ended with deficit of the general government of 6.7% of GDP.

The Programme of economic reforms that began at the end of 2014 was completed by signing a three-year stand-by arrangement with IMF in February 2015. The 2015 budget was adopted in order to ensure basis for sound economic growth, macroeconomic stability and sustainable fiscal system.

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The fiscal consolidation measures, whose implementation began at the end of 2014, continue to give effect during 2015 as well.

In the period of three years 4% structural fiscal adjustment is planned, and the major part of 2.5% is expected already by the end of this year. The measures are mostly implemented on the expenditure side – through lowering salaries and pensions as well as through reducing financial support to state-owned enterprises, when either subsidies or debt assumption and/or stricter control of issuing new guarantees are in question. The measure of 10% linear decrease from the net salary of the employees in the public sector with salary threshold above RSD 25,000, covers the entire public sector, including all budget beneficiaries, public enterprises, local self-government units and other entities included in the public sector. The effects of this measure could be seen on the expenditure side, due to lower salaries paid from the Republic Budget, but also on the revenue side, since the revenues from lowering of employee salaries at other government levels are recorded as the budget non-tax revenues. At the same time, progressive decrease of pensions for all pensioners with income above RSD 25,000 has been introduced. Pensions between RSD 25,000 and RSD 40,000 were lowered by 22% for amounts above RSD 25,000, while all other pensions over RSD 40,000 were additionally lowered by 25% for amounts above RSD 40,000. Furthermore, rationalisation of the number of employees is underway (according to 5:1 attrition rule concerning the ratio of the number of employees leaving on the basis of natural outflow and new employment), as well as suspension of indexation of salaries in the public sector and pensions. Furthermore, within the reform of public administration, legal solutions concerning the public sector wages system, grades, improvement of the Register of employees in the public sector, cataloguing jobs, determining the maximum number of employees and the plan for decreasing, i.e. optimisation of the structure of employees in the public sector, will be introduced. On the revenue side – there was a natural gas transport system price increase, thus providing to the Public Enterprise “Srbijagas” EUR 60 million on a yearly basis, and allocations from the budget will be reduced by this amount; excise on electricity for final consumption has been introduced, paid ad valorem in the amount of 7.5%, as well as excise for electronic cigarettes. Furthermore, a fee for compulsory stock of crude oil and petroleum products, paid by the litre or kilogram of petroleum products, and considered to be non-tax revenue, has been introduced as well.

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Table 5 General government revenues, expenditures and fiscal balance in 2015 – Budget and estimate based on the third revision of arrangement with IMF, in billion RSD:

	Budget	Current estimate
PUBLIC REVENUES	1,598.7	1,672.6
Current revenues	1,589.5	1,662.8
Tax revenues	1,399.9	1,451.6
Personal income tax	141.3	143.6
Corporate income tax	76.0	63.0
Value added tax	399.4	412.0
Excise	215.7	230.3
Customs	29.2	33.0
Other tax revenues	54.3	65.0
Contributions	484.1	504.8
Non-tax revenues	189.6	211.3
Grants	9.2	9.7
PUBLIC EXPENDITURES	1,830.8	1,834.7
Current expenditures	1,674.6	1,701.0
Expenditures for employees	423.7	423.7
Purchase of goods and services	255.9	253.1
Interest payment	137.5	134.3
Subsidies	104.2	136.4
Social assistance and transfers	706.0	709.9
<i>of which pensions</i>	<i>491.4</i>	<i>491.6</i>
Other current expenditures	47.3	43.6
Capital expenditures	122.9	103.2
Net lending	2.6	2.5
Activated guarantees	30.7	28.0
Fiscal balance	-232.1	-162.2
Fiscal balance (% GDP)	-5.8	-4.1

Source: MoF

At the end of the third quarter 2015, the general government deficit amounted to RSD 51.1 billion, which is far below the planned limit of RSD 143.6 billion, determined in the programme with IMF, which is the result of both conservative planning and better revenue collection (80%), on the one hand, and expenditure shortfall (20%), primarily when capital expenditure is in question. It has been planned that the general government deficit at the end of 2015 is RSD 162.2 billion, i.e. 4.1% of GDP, which is considerably less compared to deficit of RSD 232.1 billion, i.e. 5.8% of GDP, which has been included in the 2015 budget. The reasons for this could be found both on the revenue and the expenditure side.

Within tax revenues the most significant positive deviation is when VAT, excise duties and contributions are in question. VAT revenue collection in 2015 will be greater than originally planned, partly due to better performance at the end of 2014, which serves as a basis. The other reasons are as follows: absence of the estimated drop in economic activity and growth of salaries in the private sector; slower pace of rationalisation of the number of employees than planned; increased inflow on the basis of remittances from abroad; stronger credit activities of banks; and enhanced measures for preventing shadow economy, particularly when products subject to excise are in question. Excise on oil derivatives records positive deviation relative to the plan due to growth of consumption, better control of transactions thanks to product marking, but also due to changes in the structure of domestic production (domestic and export components), which have led to the drop of the level of return of excise to domestic producers. The increase in the amount of specific excise and recorded growth of legal trade of tobacco products, have not had the same effects on the growth of revenues from excise on tobacco products. It could be partly explained with the pricing policy, with which the producers

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have tried to mitigate the growth in excise, and partly due to the consumer switch towards cheaper cigarette types. There is a certain positive risk regarding the projection implementation in 2015; however, bearing in mind the possibility that the very producers could influence with their stock policy the payment schedule at the end of the year, conservative estimate on this basis was made. Income tax (the majority of which make taxes on salaries) and contributions record positive deviation compared to the plan, partly due to recovery of the private sector and growth of employment, and partly due to successful control measures in the labour market. Corporate income tax records negative deviation during the whole year 2015 due to general drop in profitability in 2014, when actual 1.8% drop in GDP was recorded (mostly as the consequence of the floods in May), unfavourable foreign exchange rate movement as well as effects of oil prices on operations of the domestic oil processing company. Other tax revenues were higher than planned mainly due to the increased collection of property tax, changes in the manner of calculation of the tax basis, increase in tax rates, but also better collection of this tax.

Non-tax revenues record significant positive deviation in relation to the budget mostly because of extraordinary non-tax revenues, consisting of as follows: payment of profit of public enterprises and agencies, budget dividends, revenues on the basis of collected claims of the Deposit Insurance Agency, emission premium, revenues from sale of 4G license, etc. These are mostly one-off revenues, and in certain sense uncertain, both as regards the amount and the moment of payment.

On the expenditure side the biggest deviation was recorded when subsidies were in question. Subsidies were increased in relation to the budget amount because of the assumption of the Public Enterprise "Srbijagas" debt from the previous years in the amount of RSD 24 billion, and due to major agricultural subsidies in the amount of RSD 8 billion. It is the consequence of regulatory and administrative shortcomings because of which this year predicted savings, relating to abolishment of agricultural subsidies for surface areas above 20 hectares and for leased land owned by the Republic, have not been achieved. Amendments to the legal solutions will provide the implementation of the measures planned during 2016.

The Government will take over the obligations related to the debt owed to military pensioners that has occurred due to the failure to adjust military pensions in 2008. The assessed amount of obligations on this basis, which will be included in the government debt, is RSD 10 billion.

As regards capital expenditure, there is still a shortfall when budget resources are in question, which is a long-term problem and an obstacle for potential growth. Regulations are being drafted in order to enable better and more efficient management of public investment.

Part of the fiscal consolidation measures have not been implemented or are implemented in a slow manner; thus, part of the expenditures planned for their implementation have not been carried out. This relates, first of all, to the payment of severance pay within the rationalisation of the public sector, and, to a lesser extent, in the restructuring process. More resources were planned for unemployment benefits. According to the performance estimate, there will be no considerable deviations till the end of the year when expenditure for the employees is in question, although the structure of implemented expenditures will be somewhat different than the planned one (lower severance pay for the rationalisation was compensated with somewhat higher expenditure for salaries exactly because of the lack of rationalisation in the planned volume). No considerable deviations have been planned when social security benefits are in question, but also with a changed structure compared to the planned one. Lower realisation rate is expected when severance pay for restructuring enterprises and unemployment benefits is in question, which has been compensated with unplanned expenditures for the settlement of debt to military pensioners.

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The estimate of deficit for 2015 was done in close cooperation with the IMF within the third revision of the arrangement. The fiscal trends from November and expectations for December show that the general government deficit will be significantly lower than the expected one, and that it will reach the level of 4.1% of GDP. More effective collection of tax revenues, greater extraordinary non-tax revenues, but also lower capital expenditures than the initially planned are the main factors influencing the fiscal position of the country during 2015.

The arrears of budget beneficiaries and the compulsory social insurance organisations (CSIO) were lower on the last days of September 2015 compared to 2014, which is one of the conditions of the IMF arrangement. The budget beneficiaries and Public Enterprise "Putevi Srbije" (Roads of Serbia) reduced the amount of arrears by RSD 0.8 billion, while the CSIO reduced the amount of arrears by RSD 0.2 billion.

Table 6. Payment in arrears of budget beneficiaries and CSIO

in billion RSD

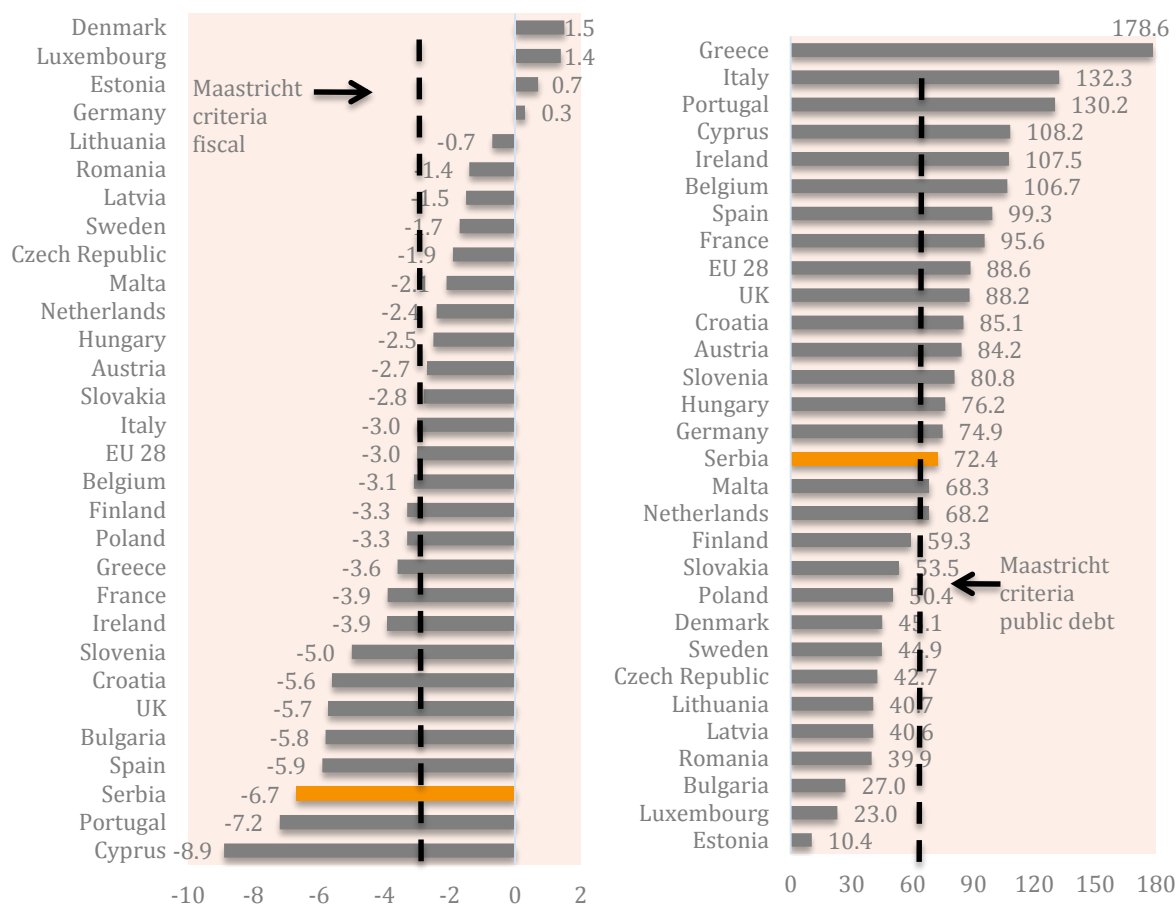
	31.12.2014	30.9.2015
Budget beneficiaries and PE "Putevi Srbije"	6.2	5.4
CSIO	3.2	3.0
Total	9.4	8.4

Source: MoF

Public finances in EU countries in 2014 and 2015

The economic recovery of the euro zone and EU continues at a moderate pace, aided with favourable circumstances, such as low price for oil and raw materials, relatively weak euro and monetary policy measures (including quantitative easing by ECB). On the other hand, there are also negative impacts induced by foreign factors, primarily global trade slowdown, and economies of China and other developing countries. Uncertainty on the international level is related to the possible reference interest rate increase in U.S.A. However, international factors should not considerably slow down the expected recovery of the EU countries, primarily led by private consumption and investments. The European Union GDP growth is estimated at 1.9% in 2015, and in the next two years at 2% and 2.1%.

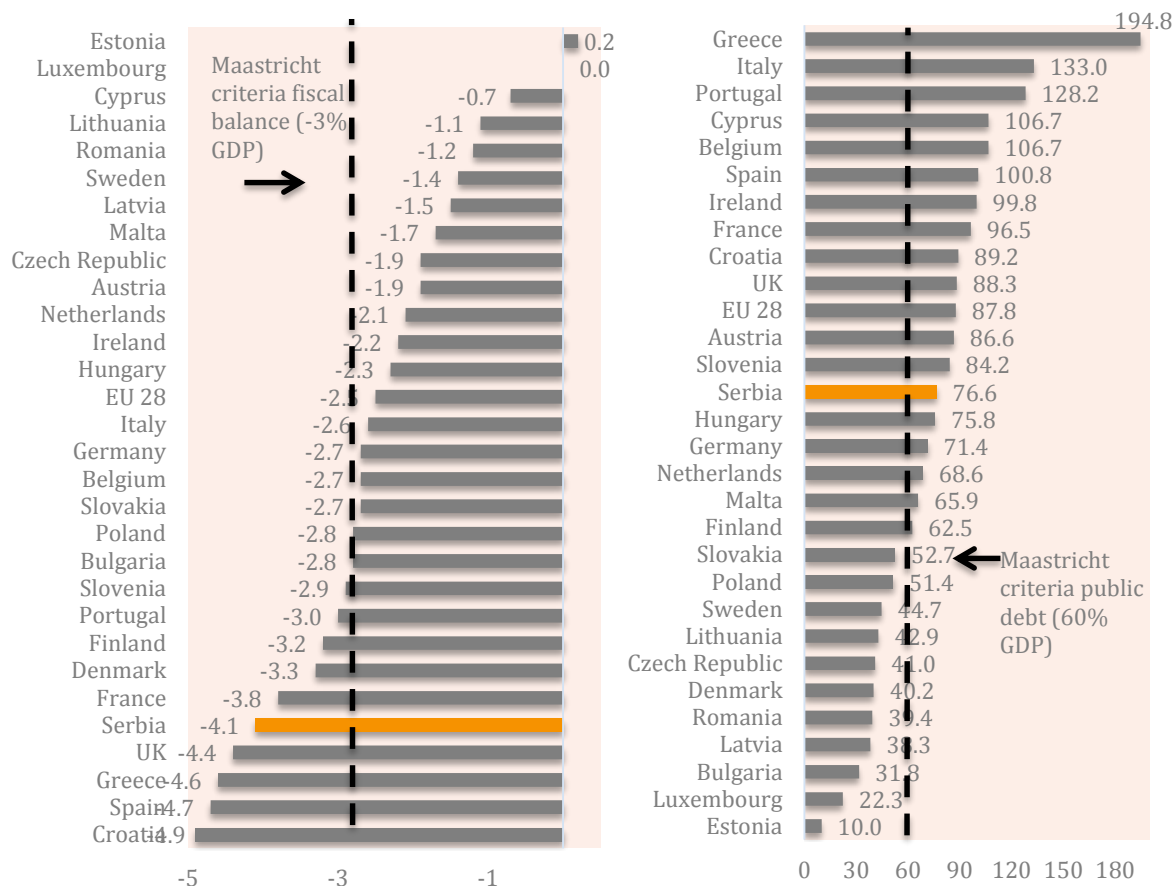
Graph 10. Deficit and government debt in Serbia and EU countries in 2014, in % of GDP



Deficit in the EU countries (EU 28) in 2014 amounted on an average 3% of GDP, which is in compliance with the previously projected deficit. On the basis of the fiscal consolidation measures, together with the expected gradual economic recovery, further decrease in deficit in the EU countries (EU 28) in 2015 and 2016, at the level of 2.5% and 2% of GDP, respectively, is expected.

The reduced needs for deficit financing influenced lowering debt to GDP ratio in almost all EU countries. Debt to GDP ratio (EU 28) in 2014 was 88.6%. The projection for the next period indicates minimum drop of debt to GDP ratio to 87.8% in 2015 and 87.1% in 2016. The deficit will continue to fall in the next period, resulting in lower debt to GDP ratio.

Graph 11. Deficit and government debt in Serbia and EU countries in 2015, in % of GDP



2.2. Fiscal projection for the period 2016-2018

In the next medium-term period fiscal consolidation will continue. The medium-term fiscal framework with proposed fiscal consolidation measures estimates considerable general government deficit lowering to 1.8% of GDP by 2018, along with stabilizing the government debt and its trend reversal (75.9% of GDP in 2018). This means nominal deficit reduction of 5% of GDP in the period 2014–2018, i.e. structural adjustment of around 4.8% of GDP.

The fiscal framework in this document is harmonised with Draft Memorandum on Economic and Financial Policies, agreed between the Government of the Republic of Serbia and the International Monetary Fund. Bearing in mind that the Fiscal Strategy comes before the 2016 Budget Law, during the budget process, certain deviations in certain categories of revenues and expenditures are possible.

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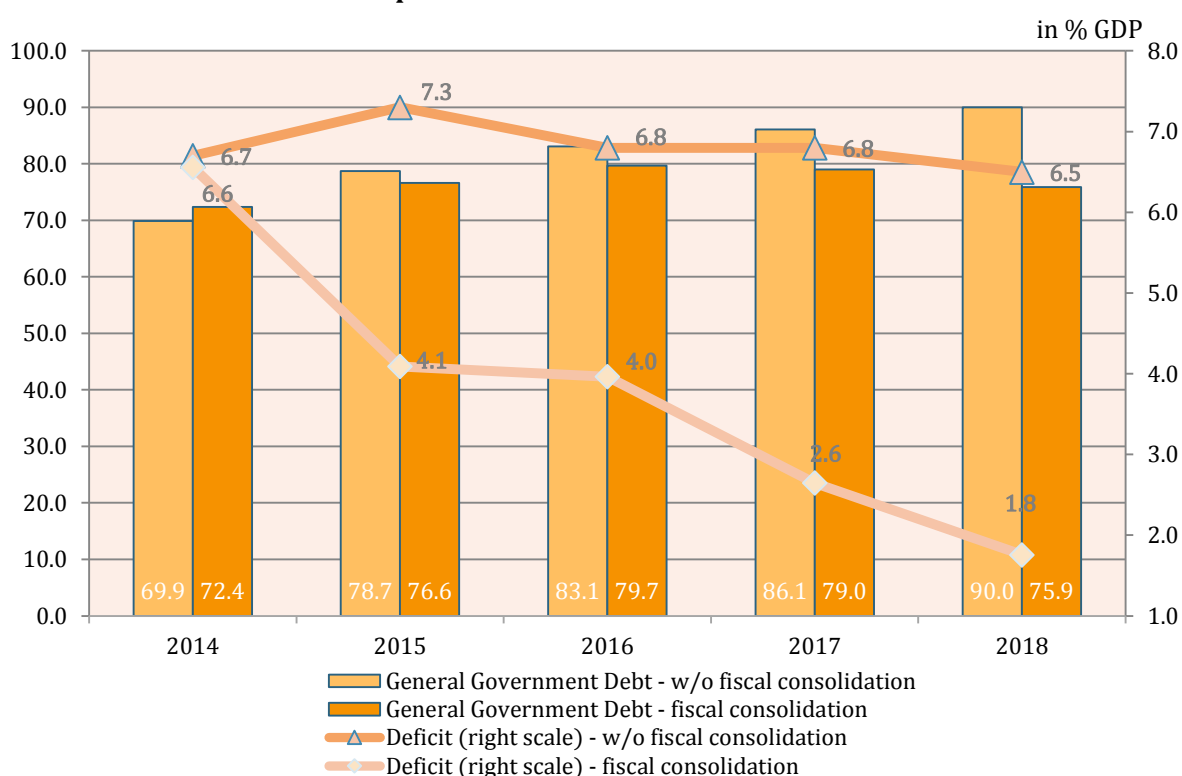
Table 7. Fiscal aggregates in the period 2015-2018, in % of GDP

	estimate	projection		
	2015	2016	2017	2018
Public revenues	42.2	41.3	40.3	39.0
Public expenditures	46.3	45.2	42.9	40.8
Consolidated fiscal balance	-4.1	-4.0	-2.6	-1.8
Primary consolidated fiscal balance	-0.8	-0.5	0.9	1.6
General government debt	76.6	79.7	79.0	75.9
Real GDP growth rate	0.8%	1.8%	2.2%	3.5%

Source: MoF

Target deficit in 2018 is 1.8% of GDP. After strong deficit reduction in 2015 of around 2.6% of GDP, in the remaining three years cumulative 2.3% deficit reduction is expected. The projections of fiscal aggregates in the period 2016-2018 are based on projections of macroeconomic indicators for the mentioned period, planned tax policy that means further harmonising with the EU laws and directives and adequate measures on the revenue and expenditure side, including reforms of major public enterprises. When the primary result, such as the difference of the fiscal result and net interest payment, is in question, a growing trend is noted and primary surplus is expected already in 2017.

Graph 12. Debt and deficit in % of GDP



Bearing in mind the tax revenue to GDP ratio, total revenues in the government sector, without indirect beneficiaries, are decreasing, since the nominal GDP growth is faster than the revenue growth. The reason for this trend lies in the fact that tax revenues depend mostly on the movement in private consumption, which in the observed period grows more slowly than the nominal GDP. GDP growth in the period 2016-2018 will be determined in the first place by gentle recovery of private consumption and stronger growth of investments, which in the short term are not generous regarding revenue collection. In case of higher growth rates over a long term, more dynamic adjustment and employment and salaries movement, which would lead to a significant increase in demand, could be expected. In

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addition, the revenue trend will also depend on success in combating shadow economy and tax evasion.

Table 8. Total revenues and grants in the period 2015–2018, in % of GDP

	estimate	projection		
	2015	2016	2017	2018
PUBLIC REVENUES	42.2	41.3	40.3	39.0
Current revenues	41.9	41.0	40.0	38.8
Tax revenues	36.6	36.6	35.7	34.7
Personal income tax	3.6	3.6	3.5	3.4
Corporate income tax	1.6	1.6	1.6	1.5
Value added tax	10.4	10.3	10.1	9.8
Excise	5.8	6.1	6.0	5.8
Customs	0.8	0.8	0.8	0.8
Other tax revenues	1.6	1.6	1.5	1.5
Contributions	12.7	12.5	12.2	11.8
Non-tax revenues	5.3	4.5	4.3	4.1
Grants	0.2	0.3	0.3	0.3

Source: MoF

The projection of revenues in the period 2016-2018 is based on the following:

- projections of movement of major macroeconomic indicators: GDP and its components, inflation, foreign exchange rate, movement of foreign trade exchange, estimates of employment and salary movements in 2016;
- estimate of further effects of fiscal consolidation measures in 2016, indirectly, through influence on the macroeconomic framework, and, directly, through influence on the movement of certain categories of revenues due to changes in the tax policy.

The combination of measures, when employment and the nominal wage amount in the public sector are in question, determines the movement of the total wage bill. For certain employee categories, increase in the nominal wage amount compared to 2015 is expected. On the other hand, continuation and speed-up of the rationalisation process in the public sector is necessary, in such a manner that the projected total wage bill shall decrease during the entire observed period. Finally, during the rationalisation process, severance payments needed for the rightsizing are planned. These three processes occurring at the same time will influence the total wage bill and salary movement of employees in the public sector. Employment and salaries trends in the private sector as the result of the planned speeding up of the economic growth rate will show a mild positive effect when the movements in actual private consumption are in question:

- the projected inflation level, together with the actual movement in private consumption, will lead to moderate growth of the nominal consumption level, as determinant of the collection of indirect taxes;
- salary movement in the public sector (without severance payments) directly affects the trend of the level of direct taxes, such as salary taxes and social contributions. Salary movement in parts of the public sector not financed directly from the Budget of the Republic of Serbia (local self-government units and public enterprises) will affect the revenue side as a part of non-tax revenues;
- the assumption is that the consumption of excise goods is inelastic in income terms and that the expressed consumption trend is to some extent autonomous in relation to the overall level of spending. On the other hand, the trend of prices of these products directly and largely affects the volume of the shadow economy. When part of products subject to excise, such as oil derivatives, are in question, excise policy changes are planned; the projection of revenues now includes revenue from excise on electricity as well, while changes in the amount of excise

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on tobacco products are performed according to dynamics determined in applicable regulations;

- the increase in the profitability of certain parts of the public sector will cause a higher payment received from public enterprises in the future. When projection of the total level of these revenues is in question, precautionary principle was applied as well as the standing that the projection of revenues on this basis should include only the structural and permanent part of these revenues. In 2015, a new category of specific-purpose revenues was introduced, a fee for compulsory stock of crude oil, which in accordance with the consumption of derivatives, influences the amount of total non-tax revenues.

The projection of revenues for 2015, both by amount and structure, provides the basis for the projection of revenues in the coming years. At this moment, except the excise duties on the oil derivatives, no significant change in the amount of other tax rates or in the tax policy in general has been expected. On the one hand, it enables greater reliability of the revenue estimates, since a certain time period is always necessary for the full effect of the new tax rates and to enable to the entities within the tax system to adapt their behaviour. Essential aspect of the process of projecting revenues is the assessment of quality and sustainability of the tax collecting level as well as taking into account only structural forms and parts of revenues. In order to continue structural adjustments determined in the arrangement with the IMF, and within its third revision, additional measures on the revenue and expenditure side have been agreed. Additional resources that need to be realised with the changes in the tax policy on the revenue side have been determined in the amount of RSD 6 billion. Additional revenue will be provided by increasing excise duties on oil derivatives up to 3 dinars, depending on the type of derivative, in relation to the amounts that would be valid by applying the regular indexation. The reasons that led to the decision to perform structural adjustments by increasing the excise duties on oil derivatives are as follows: (1) greater certainty when tax collection is in question in relation to other products subject to excise, (2) current and expected favourable movements in the world oil market regarding future prices, and (3) smaller effect of this measure on the poor layers of population compared to the alternative solution - increasing the VAT rate. On the other hand, there will be a certain risk when full estimate of the effects of the continuation of fiscal consolidation on the private consumption and actual growth are in question, as well as further changes in the shadow economy size and efficiency of measures for its preventing.

Personal income tax. The personal income tax is projected at around 3.4% of GDP at the end of the period. The reason for the gradual decline of this tax is reduction in wage bill and the public sector employment rightsizing. The projected amounts are in compliance with changes of the salary policy in the public sector, planned level of rationalisation of the number of employees with the beneficiaries of public funds and positive predicted movements of employment and average salaries in the private sector, in accordance with the expected recovery of the economic activity. The predominant form of income tax is the tax on salary, and therefore the trend of the wage bill and employment are the main factors affecting the trend of revenues from income tax. The other part of the total income tax consists of other forms, such as tax on dividends, interest income tax, annual income tax. Over several recent periods, drop or stagnation of certain categories of this tax form were recorded, although in the second half of 2014, stabilisation of the trend and mild recovery of revenues on this basis occurred. One of the reasons for decline in this category are lower revenues from interest income tax, caused by general decrease in interest rates and a consequential decline in income based on savings. Revenues from dividends and other forms of income tax follow general economic activities and salaries trend. For this reason, in 2016, very mild growth of this group of taxes is expected. There is a certain level of risk as regards collecting of this revenue in case of absence of nominal salary growth in the private sector or if it is lower than the estimated one.

Contributions for compulsory social insurance. Contributions for CSI represent the largest single type of public revenues. Contributions share in GDP was 12.7% in 2014 and dropped to 11.8% by the end of the period. The trend of the share of this public revenue in GDP has a similar trajectory as the trend of the share of tax on salary, given that for their projection the same assumptions on salaries and employment were used for the coming medium term. There is a difference only when

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contributions collected on the basis of insurance of farmers and entrepreneurs are in question. Contributions are a tax category in which the tax indiscipline is the most prominent and where the largest debt of taxpayers is recorded. In the recent period there have been significant changes in the levels of the rates at which social contributions are calculated and collected, revenues from this tax form have been projected in accordance with them. In 2013, the rate for pension contributions was increased from 22% to 24%, while the rates for tax on salary were reduced from 12% to 10%. In 2014, the rate for pension contributions was increased from 24% to 26%, while the rate for health insurance contributions was reduced from 12.3% to 10.3%. In the projected coming period, further changes as regards increasing rates are not planned. The future reform of the system of salary taxation both in terms of structure and amount will mainly rely to changes in the contribution rates and rates of the taxes on salary.

Corporate income tax. By Amendments to the Law on Corporate Income Tax in 2013 the corporate income tax rate was increased from 10% to 15%, and the full effect of these changes was recorded in 2014 for the first time. After excellent results in the collection of this tax form in 2014, which was the consequence of the mentioned changes in tax rates and favourable trends as regards company profitability (real GDP growth of 2.6% in 2013), during 2015, a significant inflow decline on this basis was recorded. The factors influencing such a trend were as follows: general profitability decline as the consequence of the real GDP decrease of 1.8% (mostly as the consequence of the floods in May); unfavourable movement of the foreign exchange rate; as well as the price influence of the domestic oil processing company. The amendments to the regulations on the collection of the corporate income tax in 2013 determine significant abolishment of tax relief, while the greatest additional positive effect on this basis was predicted for 2015. In spite of this, corporate income tax collection declined, which proves how strong the mentioned negative impacts are. In the coming period, no significant nominal growth of this tax form has been planned, given the great uncertainty appearing during the projection of this tax form. The share in GDP is mildly decreasing at the end of the period due to the strong GDP nominal growth in 2018. After that, the growth should positively reflect on the increased profitability of business entities and tax collection on this basis.

Value added tax. The VAT revenues are characterized by a slight decline in the share of GDP, given that a slower growth in private consumption in relation to nominal GDP growth has been projected. The investment activities and exports show the same trend. The main determinant of VAT trend is private consumption led by disposable income of the population. Disposable income as a determinant of consumption depends on salaries trends in the public sector, as well as pensions, social assistance and the trends of the wage bill in the private sector and other forms of income, including remittances, as well as the bank credit activity level. The reason for the better VAT collection than the expected in the previous period are as follows: absence of the estimated decline in economic activity and growth of salaries in the private sector, slower pace of rationalisation of the number of employees than the planned one, increased inflow on the basis of remittances from abroad, strengthened bank credit activity and enhanced measures for the prevention of shadow economy, particularly when products subject to excise are in question. The relaxation of fiscal consolidation measures in the domain of salaries in the public sector and pensions will contribute to growth of the available income of the population, although, on the other hand, completion of the restructuring and rationalisation process that diminishes these effects is underway. On the other hand, a higher level of allocations through various forms of social protection at the level of general government, moderate nominal salaries and employment growth in the private sector, due to the predicted acceleration of the economic activity, movement of remittances and credit activity, will finally result in the nominal growth of private consumption in the coming year.

VAT rates were twice increased, first the general one in 2012, and the special VAT rate in 2014. Any change in tax rates introduces some distortion in the structure and in the level of consumption, as well as the size of the shadow economy, thus affecting the efficiency of collection of all forms of consumption tax. In the initial period, the collection rate usually gets worse and there are no full effects of applying the new rates; although, after a certain period of time, balance is established and the consumption and collection stabilised. The results of more efficient collection and control of taxpayers are notable and it is expected that this trend will continue in the coming year, but the effects of the

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fight against the shadow economy are not explicitly given in the projected values for reasons of caution. The projected growth in export in the coming period will lead to growth of VAT return, and if there is a greater increase in export demand that may affect the overall level of collected VAT. Risks to the realization of VAT projections in the projected period are similar to those related to taxes on personal income and lie in the trends of salaries in the private sector, the overall growth of the economy as well as in the size of the shadow economy, i.e. the efficiency in reducing its size.

Excise. The share of excise revenue in GDP in 2016 will grow in comparison with the previous year due to amendments to the excise policy that year, and then slowly decline since new amendments are not planned at the moment. The projection of excise revenue is made on the basis of the planned changes in the excise policy, projected consumption of products subject to excise (oil derivatives, tobacco products, alcoholic beverages, coffee and electricity), and regular harmonisation of the nominal amount of excise on individual products. Within the fiscal consolidation measures and achieving the necessary level of structural fiscal adjustment, increase in excise on oil derivatives above the amount prescribed in the current regulations is planned. Within the excise policy and when tobacco products are in question, gradual harmonisation with EU directives is expected to continue in the following medium term. This includes the adoption of a medium-term plan for the gradual adjustment of the excise burden. For cigarettes, it will be directed through a gradual increase in excise duties, so that the EU minimum of 1.8 euros per pack could be reached in an acceptable timeframe. It is essential that these changes are carefully designed so that the changes in the structure and volume of consumption that may threaten revenues could be avoided, but also so as not to be opposed to the objectives of the public health policy.

The legal market of tobacco products (cigarette packs) decreased by 20%, expressed quantitatively, in 2013, and in the first half of 2014, compared to the first half of 2013, it dropped by 15%. In the second half of 2014, a recovery of revenues from excise duties, which mitigated to a certain extent the total value of the drop of sales in the legal market at the beginning of the year, was achieved. Measures in combating illicit trade in this type of excise products began to yield results during 2014 and 2015. According to available data, at the end of the first half of 2015, the growth in sales volume is about 17.8%, representing the first sales increase in the legal market in years. However, this increase had no effect on the excise revenue growth. Namely, in spite of increase in specific duty tax per pack by over 4 dinars, the revenue growth was the same or lower than the sales volume increase during the year. It suggests that the tobacco products producers mitigated with their pricing policy the increase in excise duties, while the consumers re-oriented themselves and started to buy cheaper cigarette types. There is a certain positive risk for the implementation of the projection for 2015, because of the possibility that the producers may influence with their stock policy the payment dynamics, which is another reason for a more cautious estimate. For the coming period of three years, no amendments to regulations are planned, thus the last adjusted amounts of excise duties for 2016, stipulated by law, are being adjusted with the inflation in 2015. It should be noted that before 2013, the average annual drop in consumption was rather uniform, and amounted to about 2 - 4%, and can be attributed to "natural" drop in consumption due to the trend of the rise of prices of tobacco products and the global campaign against the consumption of tobacco products. Beside the volume, it is a very delicate task to predict the legal market structure, reaction of producers regarding the price and other factors. In the coming period, for the projection of the excise revenue, due to cautiousness, further decline of the legal tobacco market by approx. 3% on a yearly basis is expected. If tobacco market conditions continue to improve along with the reduction of the size of shadow economy, there is a certain positive risk regarding the collection of this type of revenue.

Unlike tobacco products, the situation in the market of oil derivatives is much less volatile. After several years, in 2014 and 2015, the trend of decrease in the volume of the legal market of motor gasoline, has been stopped and reversed. The reasons for this are multiple: better control and the effects of oil derivatives marking, weakening of effects of substitution of gasoline by liquefied petroleum gas and convergence of motor gasoline prices to the prices in the region. Consumption of diesel fuel is continuously growing, and this is happening, inter alia, due to the measures for combating illicit trade and the introduction of various substitutes of this fuel for use in agriculture, under the category of products subject to excise. On the other hand, the consumption of liquefied petroleum gas

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is mostly stagnant after reaching the level of consumption of motor gasoline in the previous period. In 2015, the achieved excise collection results are better than the initially projected ones, partly because of better implementation at the end of 2014, and partly due to changes in the structure of domestic production (domestic and import component), which have led to decline in the level of excise recovery to the domestic producer. In the future, due to caution, a continued growth in consumption of motor gasoline and diesel fuel has not been assumed, but the expected amount of consumption in 2015 has been used for the projection. However, the increase in private consumption and speed-up of economic activities will contribute to the consumption growth. In accordance with the decision to increase, within the continuation of the implementation of fiscal consolidation measures, the nominal excise amount, the following amounts per oil derivative unit have been proposed: 54 dinars per litre for diesel and 52.5 dinars per litre for motor gasoline. It has been assessed that this measure will ensure the required effect of RSD 6 billion in relation to the previous solution, and an increase of RSD 9 billion in relation to 2015. In this case as well, there is a chance of certain positive risk regarding revenue collection, if the growing trend of the legal market of oil derivatives continues.

Revenues from excise duties on alcoholic beverages and coffee have been projected in accordance with the existing structure of consumption, although the current nominal excise amounts are adjusted with the expected inflation rates in the medium-term period. In 2015, 7.5% ad valorem excise has been introduced for the value of electricity consumption. For 2016, this excise revenue has been planned in the amount of RSD 14 billion, taking into account the current annual consumption and applicable prices.

Customs. The main determinants for the projection of revenues from customs are import and foreign exchange rate trends. However, in the previous period, customs revenues have nominally declined each year as of 2009 due to the implementation of the Stabilisation and Association Agreement with the EU, Free Trade Agreement with EFTA and Free Trade Agreement with Turkey, as well as gradual reduction and abolishment of certain customs rates. Adjustment of customs rates was completed in 2014. In 2015, because of this, for the first time, and in accordance with the import level and structure trends, nominal customs revenue growth has been recorded. It could be assumed that a change in the very structure and origin of the imported goods from the areas less burdened with customs is still present. Revenues from customs duties in 2016 make 0.8% of GDP and it could be expected that they will remain at this level in the future after several years of decline.

Other tax revenues. The projection of these revenues, the majority of which consists of property tax, and taxes on the use, possession and carrying of goods, other forms of taxes at the local self-government level, etc., is in accordance with the inflation trend, since the inflation component has been embedded in a significant part of these tax forms. The level of these revenues is relatively stable and reactions to economic downturn have not largely been expressed. This is the reason that in times of major crisis and slower growth in other tax revenues, the share of this category to some extent increases. In the upcoming medium term the share of other tax revenues is stabilizing. These tax revenues have increased significantly in 2014 due to changes to regulations concerning property taxes in the part relating to the property tax of legal entities, i.e. including fees for the use of land in property tax. It should be expected that the local self-government units, due to the loss of other incomes and reduction in transfers from the central budget, will improve the collection of property taxes, which is one of the most significant revenues that they independently dispose of.

Non-tax revenues. The share of non-tax revenues in GDP has been reduced over the medium term, after the jump in 2015. This jump is the result of the expected payment of funds based on the reduction of salaries in the public sector (public enterprises and local self-government units), higher revenues from dividends and income of public enterprises, as well as the introduction of fees for compulsory oil stocks. The reasons for decline of the projected share in the coming period are the exemption from the basic (2015) year of all products not considered to be structural, i.e. permanent part of these revenues, which mostly relates to extraordinary categories of non-tax revenues; namely, a level which has proven stable in the past few years has been taken into consideration. Non-tax

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revenues are a category of a very heterogonous character with different trends and movements according to certain forms. Individual non-tax revenues are indexed with the inflation of the past year, while the others follow the changes in the value of the basis to which they apply; because of this, they are adjusted for the projected inflation, while part of them are one-time payments to the budget (extraordinary non-tax revenues). Regular non-tax revenues are different fees, charges, penalties, revenues of agencies and organisations and all other revenues realised according to regular dynamics during the year, in approximately similar amounts on monthly level with certain seasonal variations. The extraordinary non-tax revenues are mostly one-off and less certain, both when the amount and the moment of payment are in question. Most of these revenues consist of payments of profits of public enterprises and agencies, budget dividends, revenues on the basis of collected claims of the Deposit Insurance Agency, emission premium, etc.

Grants. With the developing process of approaching membership in the EU, IPA funds which can be used, have increased, and therefore these funds make up the predominant part of the revenues obtained from grants. Besides, annual payment in the total amount of EUR 55 million for 3 years sector budget support of EU is planned.

Table 9. Total expenditures in the period 2015 – 2018, in % of GDP

	estimate	projection		
	2015	2016	2017	2018
PUBLIC EXPENDITURES	46.3	45.3	42.9	40.8
Current expenditures	42.9	41.6	39.2	37.2
Expenditures for employees	10.7	10.4	9.3	8.3
Purchase of goods and services	6.4	6.5	6.3	6.1
Interest payment	3.4	3.5	3.6	3.4
Subsidies	3.4	2.7	2.5	2.4
Social assistance and transfers	17.9	17.3	16.6	15.9
of which pensions	12.4	12.3	11.8	11.2
Other current expenditures	1.1	1.1	1.0	1.0
Capital expenditures	2.6	2.9	2.9	3.1
Net lending	0.1	0.1	0.1	0.1
Activated guarantees	0.7	0.8	0.7	0.4

Source: MoF

Fiscal adjustment on the expenditure side of general government during the observed period was 5.5% of GDP. Including 2014, adjustment was 7.6% of GDP. The largest part of the adjustment relates to the expenditures for employees and pensions as these two items make up more than 50% of total expenditures. In addition, the completion of the restructuring process of socially-owned enterprises, addressing issues of inefficient public enterprises and the stabilisation of the financial sector should contribute to the reduction of expenditures. On the expenditure side, investments in infrastructure represent the priority in the future, so that in case of creating additional fiscal space available funds would be focused in that direction.

Expenditures for employees. The reduction of the wage bill will take place on two grounds. On the one hand, all public sector employees who receive more than RSD 25,000 will have their salaries reduced by 10%, and, on the other hand, it is planned to rationalise the number of employees. In addition, in accordance with the new fiscal rule for indexation, growth of this category has not been envisaged. In 2016 there will be less relative reduction, bearing in mind the increase in salaries of part of the general government employees. The 4% salary increase will be given to the employees in primary and secondary schools; 3% increase to the employees in healthcare institutions and institutions for social protection; 2% increase to the employees in the universities and other tertiary education institutions; while the wage bill for the military and police will increase by 1%. The effect of this measure on deficit increase will be somewhat above 0.1% of GDP.

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The reform of the public sector is essential for the consolidation of public finances and establishing a healthy business environment. The surplus and unfavourable employee structure are issues that cause inefficiency of the public sector and are a burden for the overall economy. In 2015, comprehensive analyses on surplus of employees in the public sector were made. Except the hiring freeze in the public sector and natural outflow of the employees, there were no dismissals; thus, the predicted results failed. In 2016, decrease in the number of employees by about 35,000 is planned (of which, 14,000 already in January) compared to December 2014. The wage bill will be decreased by 3% in 2016 compared to 2015, while in 2017 it is planned that the number of employees will be reduced by 5% more.

In 2018, no additional decrease in the number of employees is expected, although the effect of rightsizing from 2017 will be carried over to 2018. Furthermore, in 2018, no severance pay is planned as opposed to the previous years, which is also the reason for drop in nominal expenditures for the employees. During 2016, a comprehensive reform of the salary system is envisaged with the goal to ensure fairness and reduce differences between the employees in the public sector, although this should not considerably affect the total wage bill.

Purchase of goods and services. For this category of expenditure a relatively stable share in GDP until 2017 has been predicted. In 2017, a new Law on Local Self-Government Financing will come into effect, which will enable to the greatest extent savings on this expenditure item.

Interest payment. Extremely high level of public debt and high fiscal deficits have caused interest to become one of the most important expenditure items, and undoubtedly the fastest growing one. It is expected that interest growth will reach its climax in 2017; after this, their share in GDP should decrease. Good results in 2015 drastically slowed down the interest growth bearing in mind the initial estimate that the interest share in GDP would be 4.0%, while the current projection is 3.6%.

Social assistance and transfers to households. The largest category within transfers to households are pensions. Reducing the amount of pensions and the pension system reform will contribute to a significant reduction in the share of pension expenditure in GDP. Their share in GDP should fall from 13.1% in 2014 to 11.2% in 2018. In addition to the nominal pension cuts, the lack of indexation in accordance with the new rules and amendments to the pension system adopted during 2014 will also contribute to such a trend. The increase in pensions by 1.25% in 2016 and increase in the number of new pensioners due to employment restructuring and rationalisation will reduce the effects of the measures applied. Other forms of social benefits and transfers to households in the coming period will be adjusted by applying the prescribed indexation of current and planned changes of policies in this area and the projected number of beneficiaries. In addition, an increase in funds required for certain types of social assistance is expected due to sharp fiscal consolidation measures in the future. This includes increased funding for severance pay and unemployment compensation. Social welfare expenditure share will decline from 18.1% of GDP, which was the share percentage in 2014, to 15.9% in 2018.

Subsidies. Fiscal adjustment in the observed period will largely be implemented by reducing the total amount of funds for subsidies. The most important measure in this regard is the abolition of subsidies for land area larger than 20 hectares, as well as state-owned land that is leased, which is expected in 2016. The reduction of subsidies for JSC "Železnice Srbije" a.d. (Serbian Railways) and public broadcasting services has also been envisaged based on the reduction of operational costs; bearing in mind the restructuring process, subsidies will be reduced on this basis as well. Subsidies to public broadcasting services are going to be reduced to RSD 4 billion along with introducing compulsory public subscription.

Other current expenditures. This category is represented by different expenditures, such as grants to NGOs, political parties, religious and sports organizations, penalties, compensation for damage, etc. In the previous period, the level of this category was around 1% of GDP, only in 2014 the share of these expenditures in GDP increased to 1.6% due to compensation for damage caused by catastrophic floods. The effects of the Law on Local Self-Government Financing should show to a greater extent when this expenditure category is in question as well.

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Capital expenditures. Priority area on the expenditure side is represented by capital investments. By reducing the current consumption of the government sector, space is created for maintaining the level of public investments at around 3% of GDP in the upcoming medium term. Bearing in mind the limited resources, investments of national importance will be especially significant in investment planning in the medium term (Corridors X and XI). To significantly increase the share of capital expenditure in terms of fiscal adjustment, a stronger and more dynamic economic growth is necessary.

Net lending. This category represents (among others) funds that are given to ensure liquidity and recapitalization of state-owned enterprises and banks. These expenditures have particularly been evident in the period from 2012, when several state-owned banks found themselves in difficulties because of bad credit policy. The assumption of debt of the airline company JAT and providing liquidity of PE "Srbijagas" should be added to this. Since new problematic cases are not expected in the banking sector and given that one of the priorities in the upcoming period is the reform of public enterprises, stabilisation of these expenditures is expected at 0.05% of GDP.

Activated guarantees. Activated guarantees and payment of guarantees on commercial transactions are debt obligations of public enterprises, which the central budget took upon itself, given that these companies are not able to fulfil them. The largest expenditure on this account are related to JSC "Železnice Srbije" a.d. (Serbian Railways), "Železara Smederevo" (Smederevo Steelworks), JAT and Galenika. It should be noted that significant resources on this basis are paid for PE "Putevi Srbije" (Roads of Serbia), but that these expenditures are classified as classical debt repayment, considering that the enterprise is part of the general government. Similar to the budget loans, these expenditures will be significantly reduced if the problems of inefficient public enterprises are properly solved.

2.3. Debt Reduction Programme

In accordance with the principle of fiscal responsibility, if the general government debt exceeds 45% of GDP, the Government is obliged to propose measures that will bring debt level closer to the target, i.e. return it to a sustainable path¹.

The economic crisis that started at the end of 2008 resulted in a cyclical decline or budget revenue growth slowdown and expenditure growth to mitigate the effects of the crisis on the population, under the effect of automatic stabilizers. In the absence or insufficient level of structural measures, there was an increase in the annual level of fiscal deficit. In the period from 2008 to 2014, the general government deficit increased from 2.6% to 6.6% of GDP, while the public debt entered into an explosive growth path, wherein the debt-to-GDP ratio more than doubled. The public debt with around 30% of GDP at the end of 2008 reached 72.4% of GDP at the end of 2014, with around 3.4 pp increase in debt level compared to the previous year.

Fiscal consolidation measures adopted in late 2012 and throughout 2013 impeded this trend to a certain extent but the level of public debt continued to grow significantly. The fact that previously adopted fiscal consolidation measures have yielded certain results can be viewed from the structure of recorded fiscal results. This is supported by the constant decline in the primary deficit ratio since 2012, but it is not enough to stabilize the public debt-to-GDP ratio due to a significant increase in interest expense. The level of public debt, especially its dynamics in the previous period, were not fiscally sustainable in the follow-up period. A new wave of fiscal consolidation measures in 2015, as described in this document, gives a significant momentum to stopping the growth of public debt.

¹ Public debt within the meaning of this document does not include liabilities arising from restitution in accordance with the definition of debt from the Budget System Law.

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The envisaged measures, previously described in this document, to achieve cumulative adjustment on the expenditure side of around 7.6% of GDP for the period 2014-2018, are leading to lowering of the general government deficit to 1.8% of GDP in 2018. In the same period, stabilization of the debt at 75.9% of GDP is to be accomplished, which is still high compared to the international standards.

The fiscal deficit, although crucial, is not the only factor that affects the level of public debt; therefore, it is necessary to fully implement measures that should additionally improve management and sustainability of public debt:

- limitation on issuance of new guarantees, in particular guarantees to public enterprises for the current liquidity and guarantees to local governments;
- restriction on signing new project loans in cases when the previously approved loans have not been used efficiently;
- refinancing of an expensive portion of debt by using funds from soft loans and privatization proceeds, if there are options to do so;
- improvement and identification of fiscal risks and their management.

The programme of measures to reduce the fiscal deficit and fiscal framework for the period 2016-2018, which is scheduled to decrease the consolidated fiscal deficit to 1.8% in 2018, represents the basic scenario and an integral part of the public debt reduction programme.

According to the fiscal rules, it is necessary to predict the dynamics of reducing the public debt level to 45% of GDP. This programme provides scenario for reducing the debt level to the legally prescribed level by 2028 with the assumptions on which it is based. Such a long period of adjustment is based on the assumption that the annual adjustment of the deficit larger than 1 pp of GDP is not feasible in the long term and in the conditions of slow or moderate growth, without provoking major consequences for the population and the economy. For the same reason, the fiscal result trajectory, which implies achieving a fiscal surplus, has not been envisaged, so the public debt ratio declines after a certain period of time only due to the growth of GDP.

The assumptions in the baseline scenario are:

- fiscal adjustment in the post-2018 period is at a slightly lower level than the one anticipated during the period from 2015 -2018;
- slower growth of fiscal revenues in relation to nominal GDP due to changes in the structure of the economy, strengthening of investment activity and export demand; this is true provided that there are no significant changes in the tax policy;
- achieving fiscal balance in 2024 and its maintenance in the period thereafter;
- a net gain of guarantees issued on average around zero after 2018;
- real GDP growth of 3% in the long run, which implies an average growth to an extent greater than the potential;
- annual inflation rate of about 4% on average in the observed period, which corresponds to the conditions of the higher real growth rates;
- the average change in the nominal exchange rate of 2% per year in the observed period (assumption of actually unchanged exchange rate solely for the purpose of this scenario);
- no significant adverse effects on interest rates;
- no significant privatization proceeds in the period 2019-2028.

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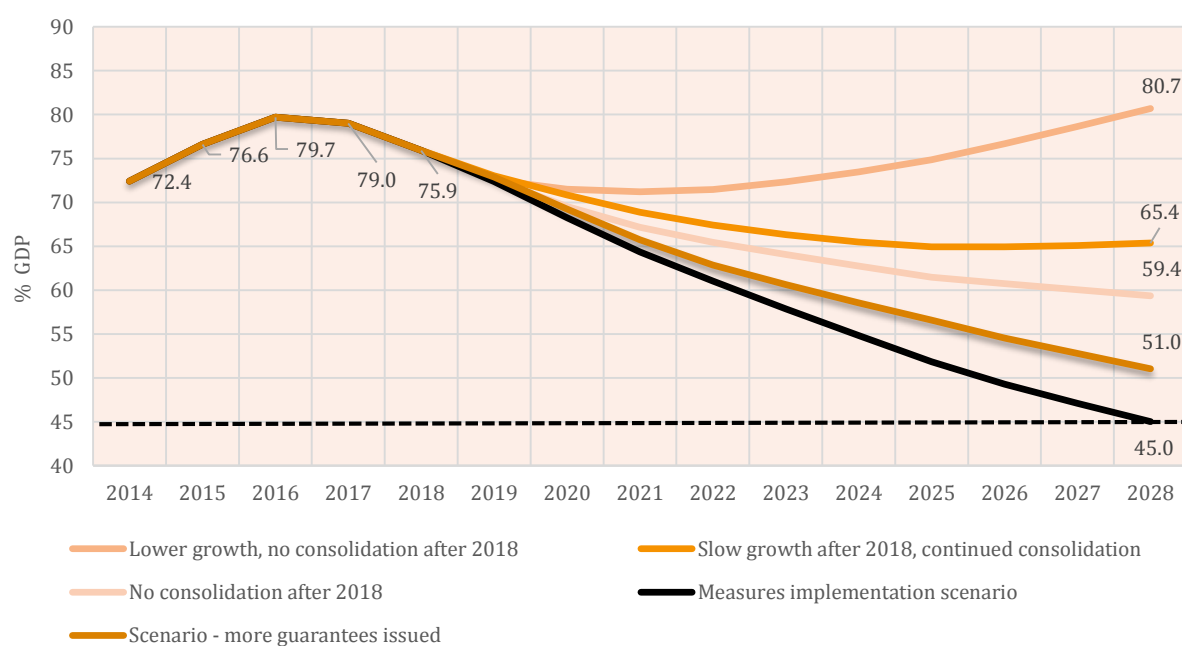
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Table 10. 2028 Total Public Debt Simulation - Baseline Scenario

Measures implementation scenario	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Revenues	41.8	42.2	41.3	40.3	39.0	38.3	37.5	36.9	36.3	35.8	35.3	34.8	34.4	33.9	33.5
Expenditures	48.4	46.3	45.3	42.9	40.8	39.4	38.0	37.1	36.5	35.9	35.2	34.6	34.4	34.0	33.7
adjustment of expenditures		-2.1	-1.1	-2.3	-2.2	-1.3	-1.3	-1.0	-0.6	-0.6	-0.6	-0.6	-0.3	-0.3	-0.3
Fiscal balance	-6.7	-4.1	-4.0	-2.6	-1.8	-1.1	-0.5	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Public debt-to-GDP ratio	72.4	76.6	79.7	79.0	75.9	72.4	68.3	64.3	61.0	57.9	54.8	51.9	49.3	47.1	45.0
GDP real growth rate, in%	-1.8	0.8	1.8	2.2	3.5	4.0	4.0	3.5	3.0	3.0	3.0	3.0	2.5	2.5	2.5

The results of this simulation clearly show that even after 2018, it is necessary to take further measures to reduce the fiscal deficit, because otherwise there would be no decline in public debt-to-GDP ratio. The greatest burden of fiscal adjustment is at the beginning of the observed period with a gradual decline. Total cumulative adjustment in the period from 2019 to 2028, on the expenditure side, is about 7 pp or about 0.7 pp per year on average. The experience so far indicates that in the long run this level of consolidation is at the upper limit of possibilities, but feasible. Significant contribution to reducing expenditures in a later period, due to a gradual decrease in the debt level, would be accomplished by the reduced interest expense, which is a positive change in the structure of expenditures. Movements in interest expenditures in the period 2015-2018, significantly reduce the effects of the savings achieved on other positions, and their reduction, as the most unproductive expenditures, should be a priority. This will be enabled by changes in the structure of debt, and the consolidation itself will, after a certain period of time, have a positive impact on this type of expenditure. Accelerated economic growth in the forthcoming period, increase in employment and private consumption growth, will have an important role in the process of reducing public debt-to-GDP ratio, which will altogether have a positive impact on the trend of public revenues.

Graph 13. Comparison of Different Scenarios and Their Impact on Public Debt Level



The Graph shows the simulation of alternative public debt scenarios, according to changes in certain assumptions in the baseline scenario. For a better comparison, a variation of one variable was

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made as the risk factor that affects the level of debt. In reality, there are many combinations of possible movements of different factors that affect the public debt.

Scenario "*slower growth*" means the average real GDP growth of about 1.6% in the observed period with the same level of fiscal deficit, which does not mean the same level of fiscal adjustment. At the end of the period, public debt would reach the level of 65.2%. The risk implied by this scenario of prolonged slow growth (which in the circumstances of extended crisis does not look so modest), is that despite the same level of fiscal adjustment on the deficit side, public debt is not falling fast enough. On the other hand, slow growth does produce higher levels of fiscal deficit by itself, so that there is even bigger need for greater reduction in expenditures in order to maintain the path that is already unfavourable as it is. There is a risk of entering in the spiral of slow growth due to high deficit and necessity for austerity measures.

Scenario "*no consolidation after 2018*" implies the absence of further measures to reduce the fiscal deficit, while in the observed period it does not fall below 1.8% of GDP. In this case there is no significantly slower reduction in the public debt ratio, despite the previously implemented measures of fiscal adjustment in the period 2015-2017. In the case of a combination of this and the previous scenario, the level of debt would take on even more unfavourable trajectory and the debt would enter into an explosive growth path. In that case, at the end of the period it would reach over 80% of GDP.

Scenario "*more guarantees issued*" implies the abandonment of the measure relating to the level of net growth of guarantees issued. In this case the assumption of an annual net growth of about 0.7% on average has been introduced, which is somewhat lower than the level of net growth of guarantees issued, which is present in the period before 2014. At the end of the observed period, public debt would increase by about 6% of GDP. It is evident that a number of positive effects can be achieved through better control and the introduction of stricter criteria for issuing new guarantees.

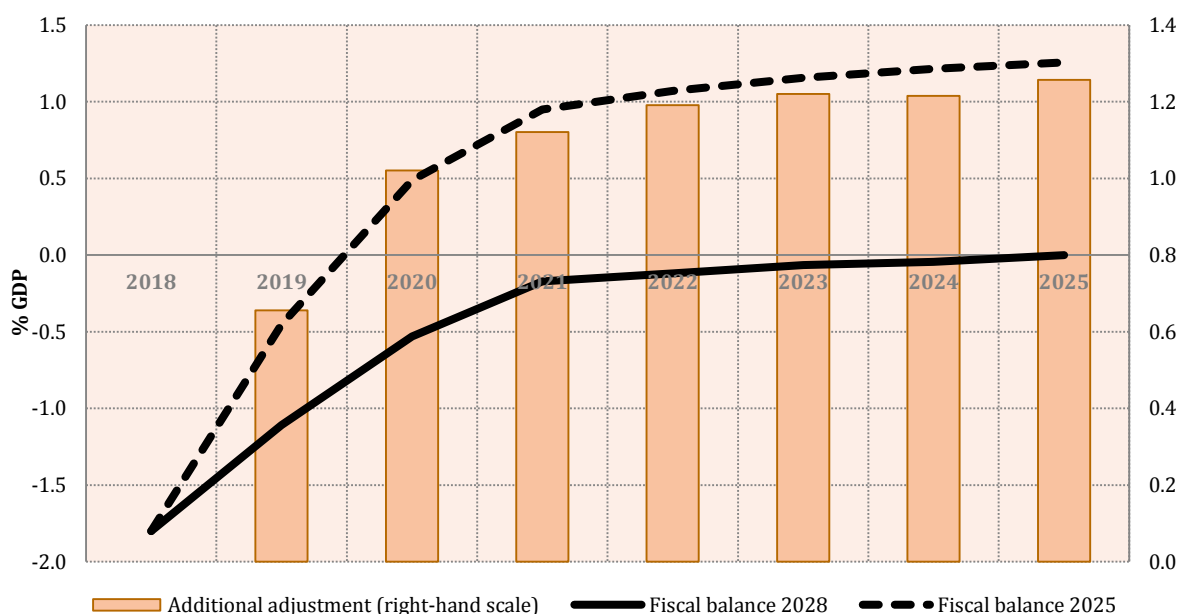
The assumptions of the baseline scenario are quite rigorous, involving a significant reduction in public expenditures to GDP ratio, the absence of net growth of guarantees but also significant constant GDP growth rates. In spite of that, reducing the debt-to-GDP ratio to the legal level is slow and time consuming process.

By comparison, if the goal was to reduce the level of debt to 45% of GDP in 2025 (3 years earlier), it would take a stronger fiscal adjustment and achieving a fiscal surplus of around 0.25% of GDP as of 2020. The following Graph shows the projected fiscal results in two variants, the baseline scenario in accordance with the programme for debt reduction and alternative scenario involving lowering the debt to 45% of GDP in 2025. For this to be achieved much greater fiscal adjustment is required, on the average adjustment on the deficit side of 1% of GDP is required in the period 2019-2025, which is about RSD 64 billion per year, and a total of over RSD 510 billion of cumulative adjustment in the same period. For that amount, it would be necessary to increase the revenues, reduce expenditures or create a combination of measures on the revenue and expenditure sides. Even after 2021, it would be necessary to slightly raise the achieved fiscal surplus.

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Graph 14. Fiscal Outcome and Additional Adjustment Depending on Public Debt Reduction Dynamics



For this reason, the fiscal policy after 2018 must be focused on further debt growth slowdown, by reducing the relative deficit-to-GDP ratio and by means of the fiscal adjustment on the expenditure side. It is important to note that the successful implementation of the programme will be aided by adequate control and monitoring of the issuance of new guarantees. Retention of guarantees issued at the level determined by this programme has as a prerequisite improving of the process of monitoring, risk assessment and prioritization of investment projects.

A scenario in which the government would deviate from the fiscal framework established by this strategy which includes, in addition to measures of fiscal adjustment, the continuation of structural reforms, could lead to a public debt crisis and macroeconomic instability. Preventing debt crisis and slowing its growth can be achieved only by reducing the deficit in the whole period. It should be done through the implementation of austerity measures and expenditure growth control, as well as through continued implementation of structural reforms in the medium term leading to the recovery of public finances.

2.4. Fiscal Risks

Fiscal risks are deemed to be circumstances which, if implemented, could result in significantly lower revenues or increased expenditures and the factors that otherwise affect the size of deficit and public debt. The envisaged volume of revenues, expenditures and fiscal balance is dependent upon the success of fiscal policy to minimize the probability of risk. The success of fiscal risks management depends on political, macroeconomic and social conditions in the country and the region. If the implementation and realisation of medium-term macro-fiscal framework is based on a comprehensive programme of fiscal consolidation, the risks associated with its implementation, of any kind, represent a significant source of fiscal risk.

Decline in economic activity. The negative scenario that in the future means economic decline and lower growth would lead to a significant capital drying up, reduction in foreign trade, and due to the reduced activity to the narrowing of the current account deficit. In this case, there would be less revenue, and consequently a larger deficit, if it would not work on additional adjustment on the expenditure side. According to the estimates of sensitivity of the fiscal balance, any change in the real growth by 1 pp of GDP leads to a change in the fiscal balance of around 0.4% of GDP. In the event that

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in the next three years lower rates of real GDP growth are realized (1 pp less on average per year) than planned, the cumulative increase in the fiscal deficit would be over RSD 50 billion.

Inflation. Inflation is the major determinant of the overall macroeconomic stability. Due to the modification of fiscal rules on indexation of salaries and pensions in the forthcoming period, inflation will to a lesser extent influence the trend of the overall level of expenditure than it was the case in the past. As far as the revenue side is concerned, the impact of inflation on indirect taxes can be beneficial in a short term, but due to the inevitable adjustment of the real level of spending, this effect would be lost if the level of income is limited. Exchange rate changes have a similar short-term effect. Some revenue items are adjusted annually for inflation (mainly nontax revenues and the level of specific excise rates), so from that side there is a certain risk, but due to the low value of the projected inflation, it is not high. Inflation on the other hand, can indirectly affect the size of the deficit and public debt. In case it goes significantly above targeted levels, during the process of adjustment of relevant interest rates an increase in interest rates on public debt may happen. On the other hand, the consumer price index largely affects the movements of the total GDP deflator, and therefore the level of nominal GDP, as the denominator of the deficit-to-GDP and public debt-to-GDP ratios.

Interest. Interest expense, apart from the amount and structure of the public debt, are affected also by other factors, such as exchange rate and interest on the international and domestic markets. Given the unpredictability of the movement of certain variables, it can increase the required funds for interest repayments in the future. Interest rate policy run by certain international institutions (FED, ECB, etc.) can influence the general level of interest rates in the international market, so that the Republic of Serbia as a small open economy poses additional fiscal risk. A significant part of the public debt (and fiscal deficit as well) belongs to activated guarantees issued for the loans of public companies. If the companies can meet their obligations, these guarantees initially increase the public debt level, but they do not require additional funding. If the companies cannot meet their liabilities these guarantees would be activated and additional resources for repayment of both principal and interest payments would be needed.

International environment. Numerous factors from the international environment can affect the level of economic activity and indirectly the level of fiscal risk in the country but also directly on the expenditure side of the budget. Economic activity of the most important trading partners is certainly the most important factor. Interest rate movement has already been described as a potential risk factor. Current favourable market developments of primary products and raw materials in the field of petrochemistry have a favourable impact on the business of the domestic petrochemical complex. In the event of significant changes in this market, difficulties that companies operating in this field may encounter are not excluded. This may lead to potential risks on the expenditure side of the budget.

Shadow economy. Programme of fiscal consolidation measures is aimed at further efforts to combat tax evasion and the shadow economy. Although these effects are not explicitly included in the revenues projected by this fiscal framework, if there is a deterioration in the current extent of the shadow economy, there may be some shortfalls on the revenue side. Fight against the shadow economy in particular must include the reduction of illicit trade in tobacco products, reduction of the shadow economy in the area of labour and employment and continued good results in the field of trade in petroleum products.

Rationalization of the number of employees. Slowing down the natural employee attrition rate during 2016 and 2017 requires pretty ambitious programme of targeted rationalization in the future, especially in the systems with large number of employees. Expected resistance to this process can slow down the pace and scope that are essential for achieving the planned savings in public sector wages. On the other hand it is essential that this process be carefully designed and transparent in order to avoid the potential long-term negative effects on the efficiency of services provided by the public sector. These are at first glance the two conflicting objectives that must be met during the implementation of the measure.

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Unspent funds from previous years. In the previous period, significant unspent funds were formed at some levels of government at the approximate amount carried over to the next period and so they do not distort the fiscal balance. However, if a decline in liquidity and weaker collection of current revenues would occur, it may have caused accelerated spending of these funds and increased fiscal deficit. Although thus generated part of fiscal deficit does not affect the public debt level at the time of its creation, it can have negative impact on the level of liquidity in the future and to some extent can create a misleading picture of the state of public finances.

Project loans. Project loans are a key source of funding for major infrastructure projects. These loans funding is included in the calculation of the fiscal balance, mostly as capital expenditures. Although faster withdrawal of these funds is not adverse from the standpoint of economic activity trends and can be the basis for more dynamic development in the future, it increases the expenditure side of the budget, fiscal deficit and public debt. Assessment and analysis of costs, dynamics and volume of the withdrawal of funds in the past are key factors for the assessment of justification of individual project loans planning.

Public enterprises. The revenue projection for the next three years provides for considerable proceeds from the payment of public enterprise profit. It has been planned to have on average 0.3% of GDP from this source in the next three years. Many of the decisions related to public enterprises have significant potential or actual fiscal implications. Public enterprises also have a direct connection with the budget, both on the income side (dividends, taxes, etc.) and on the expenditure side (subsidies, loans, etc.) as well as through the creation of contingent liabilities (guarantees, losses, etc.). In order to prevent the emergence of new and realisation of the existing fiscal risks, better control and monitoring of public enterprises have been introduced and the restructuring of the three large public enterprises (EPS, Srbijagas and Serbian Railways) commenced. In order to succeed in implementing the restructuring process, it is necessary in the forthcoming period to implement the measures agreed upon in individual corporate and financial restructuring plans.

Public-Private Partnership (PPP). Although Serbia has no major PPP projects that are ongoing, there is growing pressure to implement them, primarily because of dissatisfaction with the current capacity for the implementation of infrastructure projects as well as the more stringent fiscal conditions. As there would be no unpredicted effects on the budget, it is important at an early stage of consideration of PPP projects to understand, assess and report on the fiscal implications, risks and benefits of the project itself.

2.5. Cyclically Adjusted Fiscal Balance

Cyclically adjusted fiscal balance is the fiscal balance from which isolated impact of the economic cycle is excluded, assuming the following identity²:

$$B = CB + CAB$$

Part of the fiscal balance (B) that automatically adjusts to cyclical fluctuations is called cyclical fiscal balance (CAB), the aim of the procedure is isolating the cyclical component of the fiscal balance (CB), as a result of the presence of the output gap. Actual fiscal balance will be equal to the cyclically adjusted if the output gap is zero, i.e. if the growth rate of real GDP equals potential.

² A detailed description of the methodology and results is available in the Fiscal Strategy for 2013 with projections for 2014 and 2015 or via link http://www.mfin.gov.rs/UserFiles/File/dokumenti/2012/Fiskalna%20strategija%20za%202013_%20godinu%20sa%20projekcijama%20za%202014_%20i%202015_%20godinu.pdf

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For evaluating cyclically adjusted deficit, the OECD disaggregated approach was used, involving the evaluation of the elasticity of individual categories of cyclically sensitive revenues and expenditures. Unlike the previous analyses of the cyclical balance now there is included assessment of the structural primary balance, which was obtained by correcting cyclically adjusted primary balance of revenues and expenses that were assessed as one-time and non-structural ones.³

The results and their interpretation are largely dependent on the length of the series used in elasticity econometric evaluation, the reliability of the statistical data, the existence of structural breaks in the series, changes in methodology and coverage.

Table 11. 2005 – 2018 Fiscal Balance and Cyclically Adjusted Fiscal Balance Calculation Components as % of GDP*

	Output gap	Fiscal balance	Primary fiscal balance	Cyclical component of the fiscal balance	Cyclically adjusted fiscal balance	Cyclically adjusted primary fiscal balance	Structural primary fiscal balance	Nature of fiscal policy – fiscal impulse
2005	0.2	1.1	2.0	0.1	1.0	1.9	2.2	
2006	-0.2	-1.5	-0.2	-0.1	-1.4	-0.1	0.6	2.0
2007	1.4	-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	1.7
2009	-0.9	-4.4	-3.8	-0.4	-4.0	-3.4	-3.5	-0.1
2010	-1.1	-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	-6.4	-4.6	-4.6	1.0
2013	1.4	-5.5	-3.1	0.5	-6.0	-3.7	-3.4	-1.0
2014	-0.9	-6.7	-3.8	-0.3	-6.3	-3.5	-2.5	-0.2
2015	-1.0	-4.1	-0.8	-0.4	-3.7	-0.4	0.0	-3.1
2016	-0.8	-4.0	-0.5	-0.3	-3.7	-0.2	0.4	-0.2
2017	-0.9	-2.6	0.9	-0.3	-2.3	1.2	1.5	-1.4
2018	-0.3	-1.8	1.6	-0.1	-1.7	1.7	1.7	-0.5

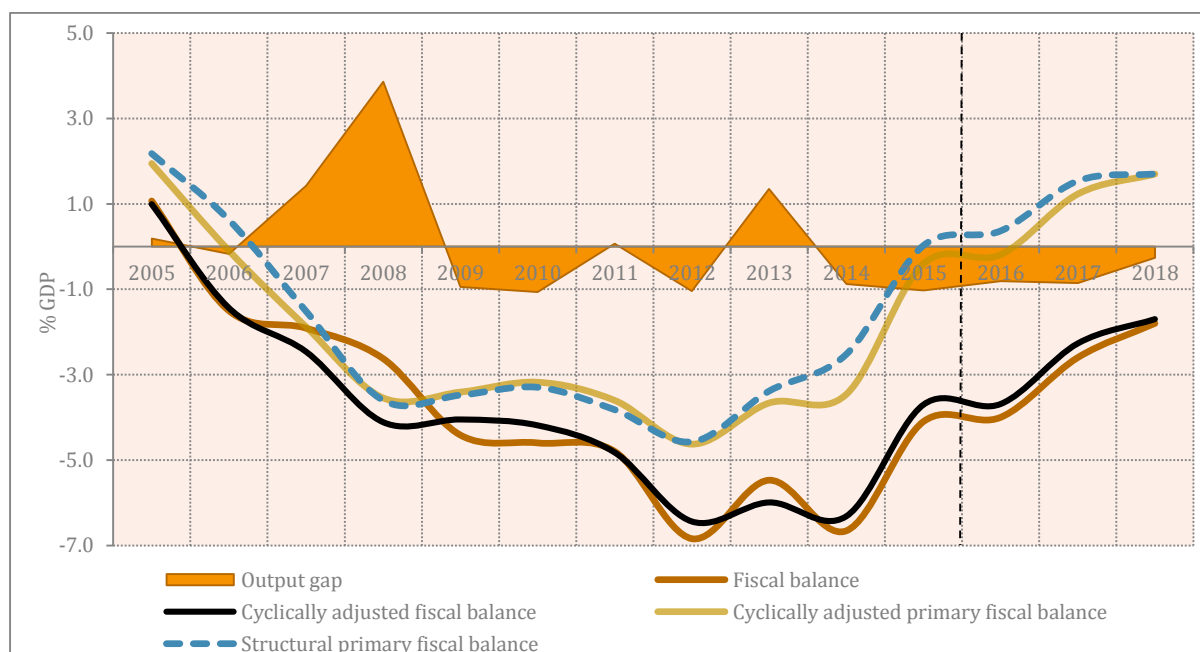
* For the period from 2015 - 2018 projected values are given.

** The structural primary balance is obtained by excluding the estimated one-time revenues and expenses.

The following graph shows the actual fiscal and cyclically adjusted fiscal balance, as well as the output gap in the period 2005-2014 with projections for the period 2015-2018. Looking at the past few years, the positive effect of the cycle is visible in 2007, 2008 and 2013, where there is a positive output gap. The effect of the cycle is such that it leads to fiscal balance that is lower than it would be if the economy was on a potential growth path. Conversely, in the period of the biggest crisis from 2009 to 2012, the impact of the cycle is negative, the output gap reaches negative values, and the actual fiscal balance is higher than the cyclically adjusted fiscal balance. In 2015, due to the projected decline, output gap reaches a high negative value, to be closed in 2018.

³ This method of analysis is still in its infancy and in cooperation with relevant national and international institutions the assessment of value of one-time revenues and expenses will certainly be modified.

Graph 15. 2005 – 2018 Real, Cyclically Adjusted, Structural and Cyclically Adjusted Primary Balance, as % of GDP



* For the period from 2015 - 2018 projected values are given.

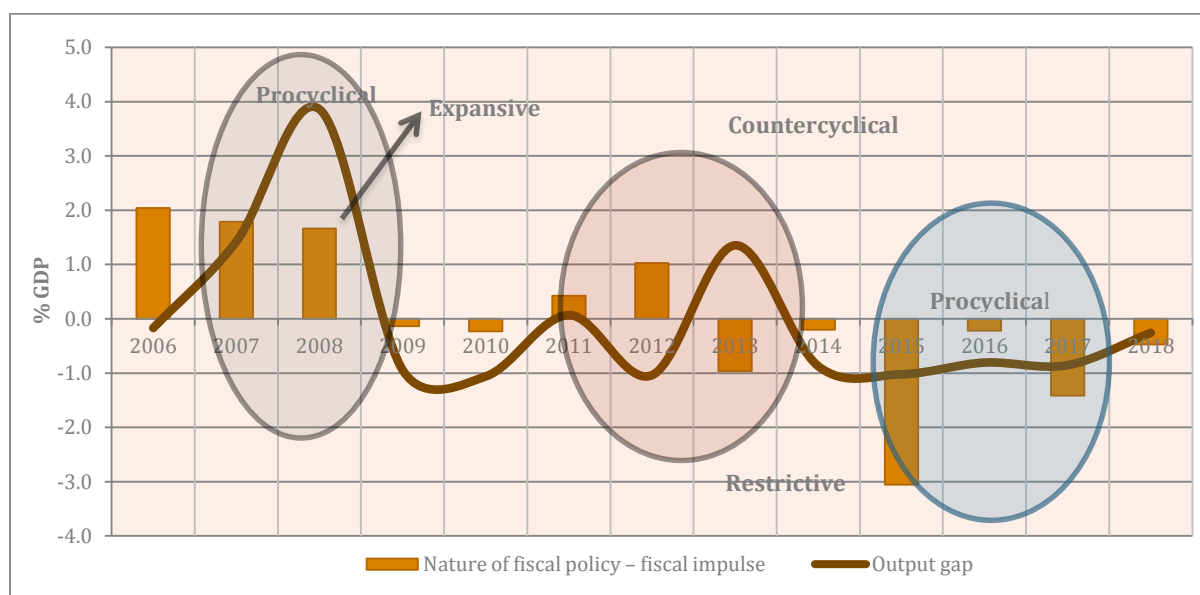
Significant structural changes can be seen from the cyclically adjusted, structural trends and in particular from cyclical adjusted primary balance. Although the influence of the cycle is not completely excluded, one can see a certain trend change. Since 2012, there was an apparent stagnation and then in projected period after 2015, there has been decline in the cyclically adjusted primary balance. This primarily means that certain structural changes in the tax and expenditure system began to yield results and that the fiscal consolidation process effectively began to unfold. This primarily refers to measures taken on the revenue side in 2012 and 2013, and particularly to the measures within the expenditure side in 2015. Full effects of these measures began to be realized in 2014 when dramatic slowdown of public revenues-to-GDP ratio occurred. Expenditures for salaries and pensions were largely limited even before passing the decision on their reduction, which contributed to the stabilization of the primary balance. After their nominal reduction, conditions were created for the implementation of significant fiscal consolidation, which is reflected in the reduction of all aggregates expressing the fiscal balance. On the other hand there has been a much stronger decline in the primary balance as a result of growth in interest expense and the level of public debt in the previous period. The first prerequisite for the decrease in interest rates is the previous contraction of the primary balance. When the analysis includes structural primary balance, it is possible to see, first of all, one-time effects on the expenditure side. The structural primary balance estimated in this way is an effective tool for making a final assessment of the fiscal position, and in 2014, in particular, it was evident that the fiscal position was much better than suggested by the initial results. Implementation of consolidation measures requires a certain level of one-time expenses in the form of severance payments to employees and the full effect on the deficit can be seen only in the later period.

Cyclically adjusted primary balance movement is used as an indicator of the nature of fiscal policy. The last column in Table 14 shows the fiscal impulse, obtained as the difference between cyclically adjusted primary balance in the current year and the previous year. In addition, a positive prefix indicates an expansive fiscal policy, while a negative prefix indicates a restrictive fiscal policy. Graph 16 shows periods of expansive and restrictive fiscal policy, as well as the size of the impulse itself. Fiscal impulse is the relative change in balance, and aims to analyze the effects of fiscal policy on the trend of the output gap. The primary fiscal balance has been taken into account because it excludes interest expenses as a form of unproductive expenditure without any real effect on the trends in the economy. The volume of interest expense in practice has more counter-cyclical effect due to the

effect of crowding out the private sector. Nevertheless. The absolute assessment of the nature of fiscal policy should be sought at the level of cyclically adjusted fiscal balance.

When the output gap is included in the analysis, it is possible to evaluate the effects of fiscal policy in terms of its pro-cyclicality or counter-cyclicality. Pro-cyclical policy is characterized by the presence of an expansionary fiscal policy in periods of growth above the potential level (or restrictive policy in a recession), and vice versa applies for the counter-cyclical policy. As a result of the pro-cyclical fiscal policy, changes in expenditures follow the movements of nominal GDP, and the cyclically created component of the revenue growth is then used for reducing the tax burden, or in most cases for an increase in expenditures, rather than for a decrease in the fiscal deficit.

Graph 16. 2006 – 2018 Fiscal Policy Nature and Effects



* For the period from 2015 - 2018 projected values are given.

Counter-cyclical policy was implemented between 2009 and 2012, during the crisis, given the relatively expansionary fiscal opportunity to start serious reform of the tax system and the stabilization of public finances. Such behaviour appears economically logical at first glance, whether it is done deliberately or as a result of the structure of the tax system and public expenditures policy in terms of high negative output gap and *vice versa* in 2013.⁴ Favourable trends in 2013 provided an system, i.e. influenced by the effects of the automatic stabilizers. However, as a result of an expansionary policy, which has not resulted in faster growth, and in situations when fiscal policy measures alone cannot eliminate the structural reasons for the negative output gap, the real and cyclically adjusted balance will deepen and public debt will enter a phase an expansion stage.

From the graph above, it can be seen that a relatively significant structural adjustments made during the 2013 were due to changes in tax policy at the end of 2012. The full effects of the measures were not manifested in 2013, but a part of the effects was transferred to the next period, which gave some impulse to restrictive fiscal policy. In 2014, fiscal consolidation impulse was not interrupted, but it is not reflected in the presented figures, due to significant sums allocated for the rehabilitation of

⁴ In 2013, there was a growth above the potential, primarily as a result of the opening of new production facilities in the automotive and petroleum industry. This year is also characterised by intention, due to revenue shortfalls, to make better savings on cutting the expenditures which resulted in lower real deficit and primary deficit.

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the financial sector and individual companies in the real sector. Measures adopted in the previous period, as well as fiscal consolidation measures relating to the period (primarily nominal reduction of pensions and salaries in the public sector), represent structural changes in public finances. These measures were strongly continued in 2015 with certain relaxation in the domain of salaries and pensions policy in 2016. The negative fiscal impulse in 2016 was further mitigated by the planned payment of substantial funds for severance pay and in the process of rationalization of public administration. After this, the effect of the negative impulse increases one-time due to reduced volume of these funds. A combination of measures envisaged by the programme of fiscal consolidation in the period 2015 - 2018 should show the greatest structural effects in 2015. In the period from 2016 to 2018, the effects of public sector reform, the completion of the restructuring process and the abolition of certain subsidies start to produce results in terms of savings on the expenditure side, thus prolonging the effects of fiscal consolidation. In the period from 2015 to 2018, fiscal policy is procyclical in character, to a greater extent due to fiscal consolidation and to a lesser extent because of the negative output gap. Yet the effects of such policies weaken over time after the strongest impact in 2015, primarily due to the fact that the additional measures in the area of consolidation are not expected, and gradual closing of the output gap as a result of higher rates of real GDP growth has also been envisaged.

In the period 2016-2018, the specific effects of fiscal adjustment and the contribution of fiscal policy restrictiveness is legally provided for an increase in excise on tobacco products and petroleum products, as well as certain degree of increased efficiency in revenue collection at central and local levels.

Approaching the actual growth rate potential level reduces, to a certain extent, the need for restrictive fiscal policy. In the context of stabilization of the public debt, the effects of cost-saving measures in the observed period lead to its stagnation and a slight decrease, but for a serious reduction in the public debt-to-GDP ratio it is necessary to continue with fiscal consolidation measures after 2018. Real, above the potential, GDP growth would enable the process to be facilitated in the long term.

III. Public Debt Management Strategy for the Period 2016 to 2018

According to the Public Debt Law, the legal basis for the borrowing of the Republic of Serbia, the public debt shall include all the direct liabilities of the Republic, based on borrowings, as well as on the guarantee issued by the Republic of Serbia for public enterprises' and local governments' borrowings.

The Republic may borrow in domestic or foreign currency, in order to finance budget deficit, current liquidity ratio deficit, to refinance an outstanding debt, to finance investment projects, and to assume liabilities based on the issued guarantees.

The provisions of the Public Debt Law indicate that the public debt shall be an unconditional and an irrevocable obligation of the Republic of Serbia with regard to the repayment of the principal, the interest and the remaining costs.

The basic principle of public debt management is the provision of regular servicing of the budgetary needs at the lowest possible costs and an acceptable level of risk.

The development of the Public Debt Management Strategy used a quantitative approach by identifying possible restrictions through macroeconomic indicators, analysis of costs and risks and market conditions which affect the management of public debt. The analysis involved the use of financing instruments available in the domestic and international financial market.

The Public Debt Management Strategy is based on the principles that define the need for transparent and predictable process of borrowing with the permanent development of the government securities market and acceptable level of exposure to financial risks.

By analysing possible borrowing strategies, the World Bank model MTDS indicates that the borrowing structure that is based on dinar-denominated and euro-denominated securities issue represents the best option in terms of costs (risks). The model in which borrowing strategies were analysed indicates that, in situations when concessional financing sources may be ensured, these funds should be used, because in this way, financing costs are reduced with an acceptable risk, which achieves the primary objective of public debt management.

The fiscal strategy envisages that the public debt trend in the next period until 2018 shall stay below the level of 80% of GDP, with a clear tendency to decrease after 2016 to the level of 75.9% of GDP in the end of 2018, whereas, in accordance with the IMF-World Bank Guidelines for Public Debt Management, within the Public Debt Strategy was conducted the stress testing and scenario analysis of the effect of the foreign currency exchange rate of RSD against the currencies in which the public debt of the Republic of Serbia is denominated.

Significant progress has been made in the last four years in terms of increase in the average maturity of dinar-denominated securities and reduction of the costs of financing on the basis of this form of borrowing, which reduced the exposure to the refinancing risk. The Public Debt Management Strategy defines basic measures for further development of dinar-denominated securities market, because the development of this market shall create one of the necessary preconditions for raising the credit rating of the Republic of Serbia and reducing the exposure of the public debt to the foreign exchange risk.

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1. Public Debt Balance and Structure from the End of 2012 to October 31, 2015

At the end of October 2015, the total public debt was RSD 2,988.9 billion, i.e. 75.4% of GDP. That includes RSD 2,643.7 billion of direct liabilities, and RSD 294.3 billion of indirect liabilities, RSD 49.3 billion of non-guaranteed local government units' debt and RSD 1.6 billion of non-guaranteed debt of the Development Fund of the Republic of Serbia (hereinafter referred to as the Development Fund) and of public enterprise "Putevi Srbije".

Graph 17. Public debt as a share of GDP in percentage

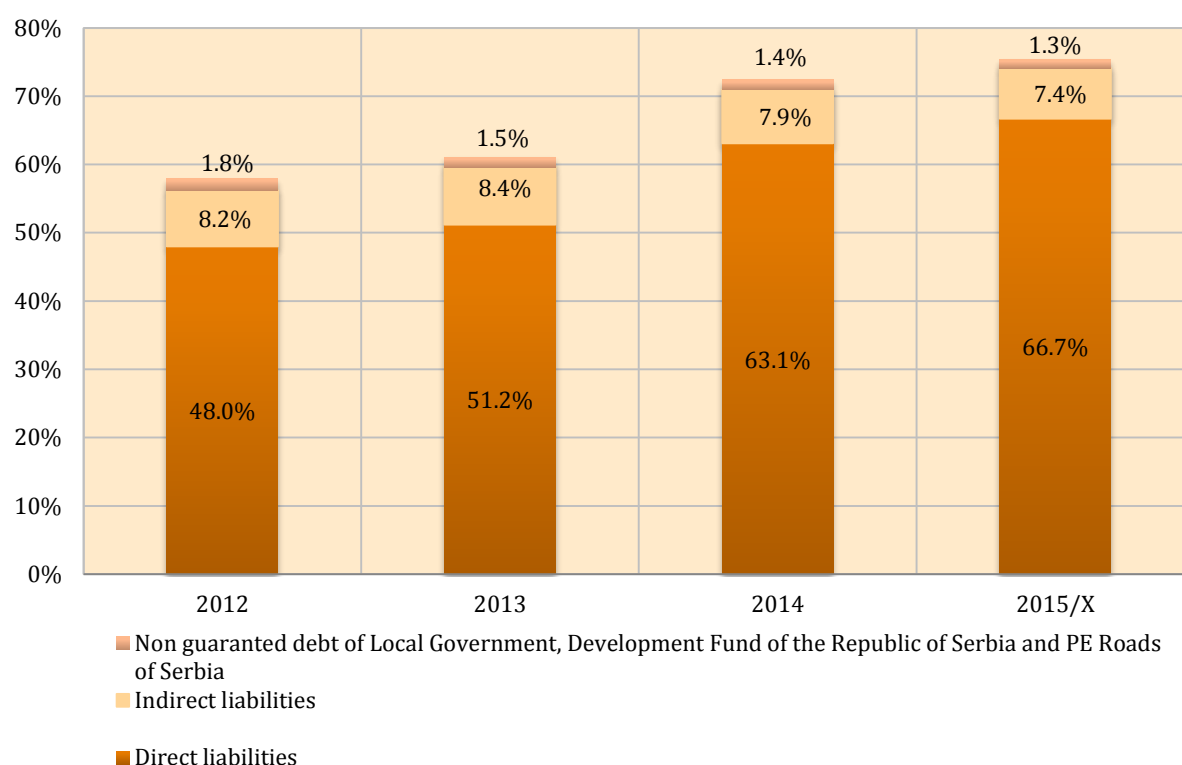


Table 12. Public debt of the Republic of Serbia in the period from the end of 2012 to October 31, 2015

	2012	2013	2014	2015/X
Public debt (in billion RSD)	2,073.9	2,369.0	2,808.2	2,988.9
Public debt (in billion EUR)	18,236.8	20,664.5	23,216.0	24,750.3
Public debt (in billion USD)	24,065.3	28,498.4	28,233.0	27,185.7

If growth of the public debt in the currencies in which it was initially denominated is observed in 2015, the largest growth may be noticed in the dinar-denominated part of the public debt, which was the main source of budget deficit financing. The dollar-denominated public debt increased by only USD 100 mill. in the first ten months of 2015, entirely on the basis of project loans, whereas the euro-denominated public debt increased in slightly more than EUR 170 mil.

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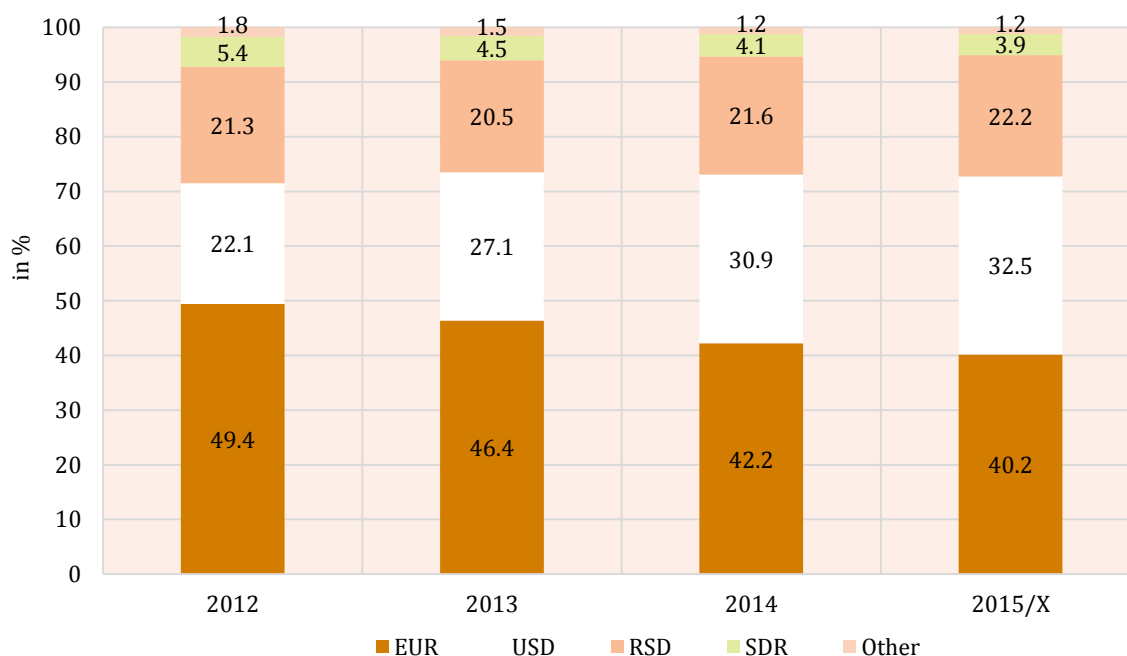
Table 13. Central government debt balance per initial currencies in the period 2012 - October 31, 2015

	2012	2013	2014	2015/X
<i>In million</i>				
Special drawing rights	849.2	832.9	801.2	763.3
EUR	8,992.1	9,226.2	9,493.4	9,666.6
USD	5,307.8	7,675.6	8,717.8	8,824.0
CHF	253.5	225.7	199.1	173.2
RSD	380,519.9	466,366.6	588,570.0	648,832.5
Other currencies (in RSD)	12,686.1	13,142.8	13,776.4	15,427.8

The main source of financing in the period 2012–2015 are dinar-denominated securities issue, which increased the share of dinar-denominated public debt from 19.5% at the end of 2012 to 21.6% of the public debt of the Republic of Serbia at the end of 2014. The tendency to drop the currency risk effects, to expand maturity and develop new borrowing instruments in the domestic financial market, and the trend of national currency share increase in the public debt portfolio continues in 2015, and on October 31, 2015, that share was 22.2% of the total public debt portfolio.

According to data from October 31, 2015, the largest part of the public debt of the Republic of Serbia is still euro-denominated debt and it amounts to 40.2%. It is followed by dollar-denominated debt whose part is 32.5% and dinar-denominated debt in the amount of 22.2%. The remaining debt is denominated in special drawing rights (3.9%) and other currencies (1.2%).

Graph 18 Currency structure of the government public debt state in the period 2012 – October 31, 2015



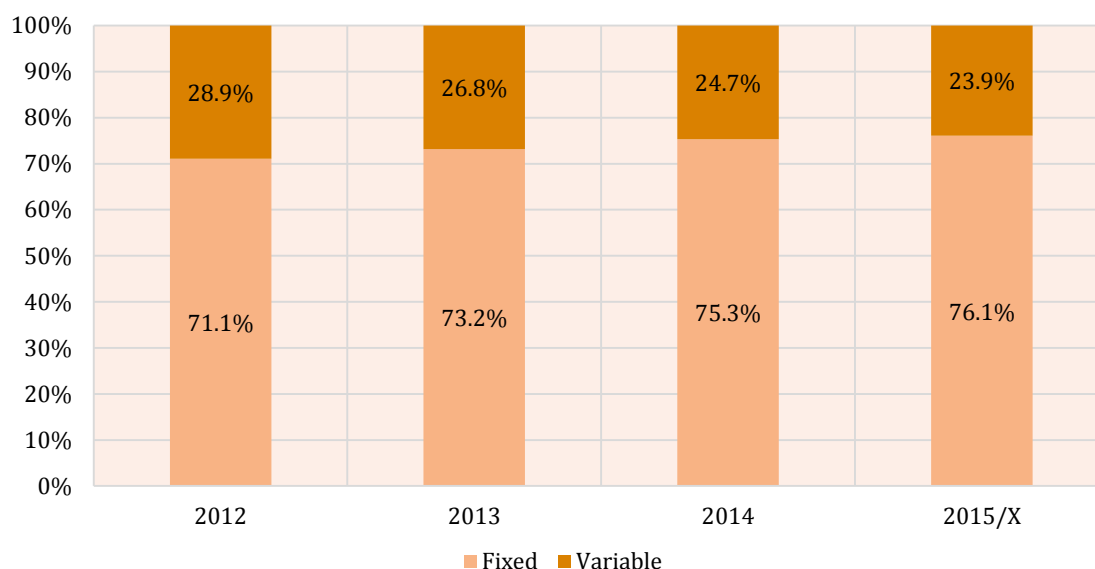
As of October 31, 2015, the majority of Serbia's public debt 76.1% is with the fixed interest rate, whereas the public debt with the floating interest rate makes 23.9% of the public debt. Among the floating interest rates, the highest share hold Euribor and Libor interest rates in EUR, which in total make 63.7% of the total public debt tied to floating interest rates, whereas 12.1% refers to the

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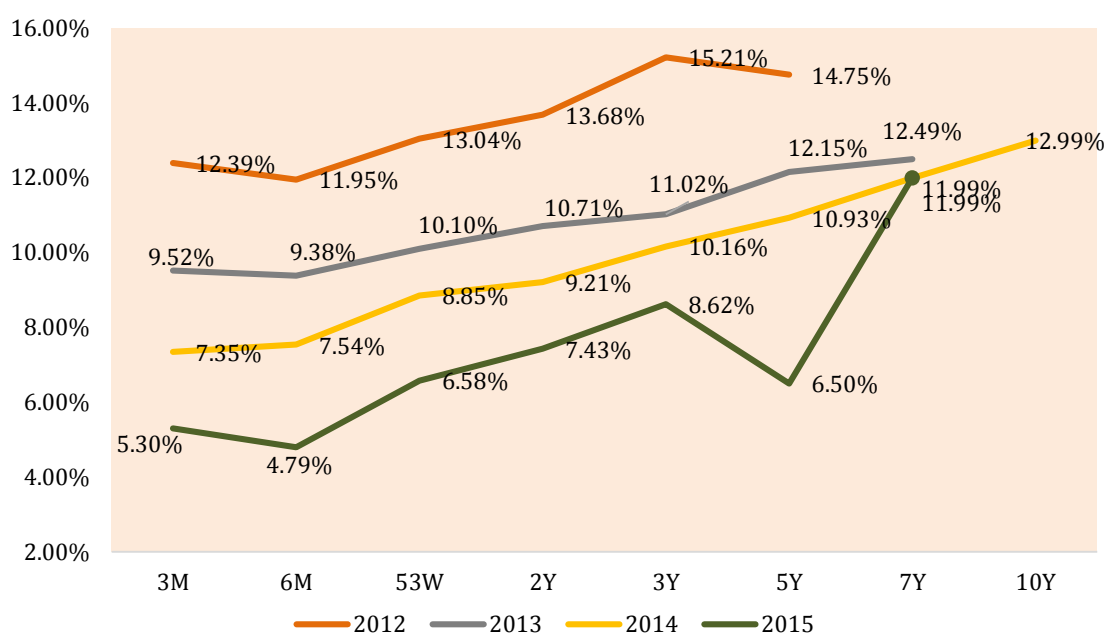
liabilities tied to the reference interest rate of the NBS, 11.5% to the Libor interest rates in USD, and the rest of the liabilities tied to other types of floating interest rates have the share of 12.6% (mainly the floating interest rate for special drawings rights).

Graph 19. Interest rate structure of the government public debt in the period 2012 – October 31, 2015



Further drop of borrowing costs of the Republic of Serbia in terms of dinar- and euro-denominated securities occurred in 2015 due to the reduced credit risk in the country i.e. reduced risk premium, inflation rate and reference NBS interest rate, which continued the trend that began in 2012.

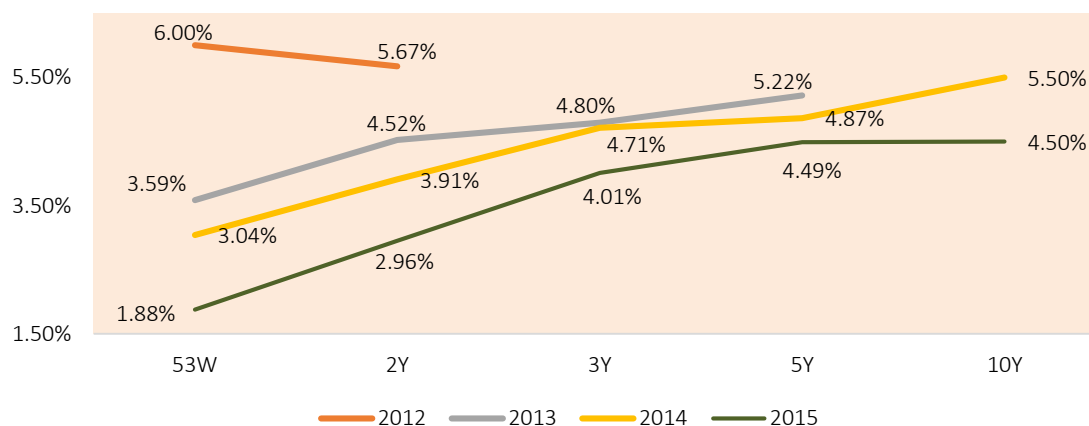
Graph 20. Overview of the trend of average effective interest rates in dinar-denominated securities in the period 2012–2015



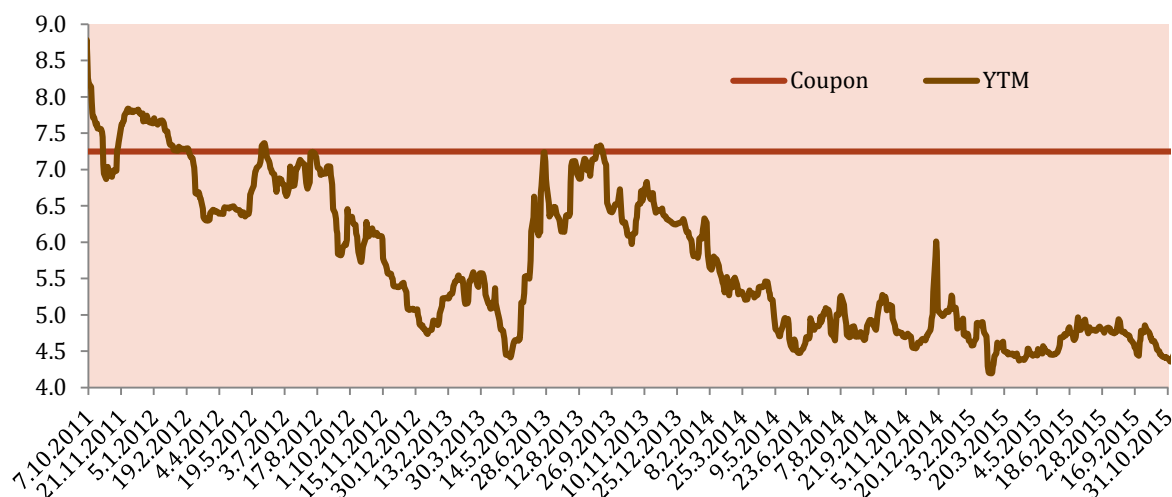
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Graph 21. Overview of average effective interest rates for euro-denominated securities in the period 2012–2015



Graph 22. Overview of yield rate trend for Serbian Eurobond 2021



Servicing the public debt of the Republic of Serbia (central government⁵) in the period 2015 - 2018

Table 14. Interests and principals repayment projections by 2018

	2015p	2016p	2017p	2018p
	In RSD billion			
Principal	525.7	567.6	702.7	668.6
Interest	128.0	139.6	151.6	157.0
Total	653.7	707.2	854.3	825.6
Share in the public debt as of 31 October 2015	22.3%	24.1%	29.1%	28.1%

⁵ Central government includes the budget of the Republic of Serbia, mandatory social security funds and PE "Putevi Srbije".

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Table 15. Interests and principals repayment projections by 2018 (as a % of GDP)

	2015p	2016p	2017p	2018p
	In RSD billion			
GDP	3,964.4	4,137.7	4,377.2	4,711.6
Principal	13.3%	13.7%	16.1%	14.2%
Interest	3.2%	3.4%	3.5%	3.3%
Total	16.5%	17.1%	19.5%	17.5%

2. Projection of General Government public debt balance in the period 2015-2018

Considering the projected primary budget deficit of the Republic of Serbia for the period 2015-2018, and including the withdrawal of loan instruments for project financing of budget beneficiaries, effects of foreign currency exchange rate of RSD against EUR and USD in the basic macroeconomic scenario, the central government debt balance at the end of 2018 should amount to 74.5% of GDP.

Table 16. Basic projection of general government public debt balance by 2018

	2015p	2016p	2017p	2018p
	In RSD billion			
GDP	3,964.4	4,137.7	4,377.2	4,711.6
Primary deficit (central government)	33.0	23.0	-35.9	-77.4
Interests (central government)	128.0	139.6	151.6	157.0
Public debt (central government)	2,980.1	3,239.0	3,396.1	3,510.5
Central government debt, as % of GDP	75.2%	78.3%	77.6%	74.5%
Non-guaranteed local government - GDP	1.4%	1.4%	1.4%	1.4%
General government debt, as % of GDP	76.6%	79.7%	79.0%	75.9%

The ratio indicating the share of the general government public debt in GDP in 2016 is expected to rise to 76.6% from 79.7% in comparison to 2015, whereas in 2017, it is expected to stabilise and slightly drop to 79.%, and the full effect of fiscal consolidation and measures taken will give a result in 2018 when the ratio is expected to drop to 75.9%. The local government public debt is predicted at the relatively same level at about 2.1% of GDP in the following period.

The public debt stock according to the Maastricht criteria

It is important to mention that, according to the national methodology, public debt stock includes direct liabilities of central government as well as all indirect liabilities, i.e. guaranteed debt for public enterprises, local governments and other legal entities founded by the Republic of Serbia. This stock encompasses all the guarantees regardless of whether payment they will be activated in the following period or not.

Considering the fact that one of the major economic and political objectives of the Republic of Serbia is EU accession, compliance of domestic methodology and European standards arises as a prerequisite. For that reason, the public debt stock is regularly analysed based on the criteria of the Maastricht Treaty, which are the systematic guidelines with the goal to maintain the public debt and the fiscal system, i.e. macroeconomic stability. According to these criteria, apart from the direct liabilities of central government, the public debt stock should also include non-guaranteed debt of local government, and exclude the debt based on direct and indirect liabilities that the Republic of Serbia (central government) does not pay for.

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This debt is measured at the nominal value equal to the agreed amount of debt the Government must repay the creditors at maturity. That means that public debt is not influenced by the market yield changes and it excludes the unpaid accrued interest.

Table 17. Public debt structure and projection until 2018 according to the Maastricht criterion

	2014	Oct 31, 2015	2015p	2016p	2017p	2018p
			In RSD billion			
Total direct liabilities	2,368.6	2,562.1	2,628.6	2,914.0	3,054.7	3,171.5
Guaranteed debt	199.7	189.2	186.5	169.6	153.7	132.8
Remaining debt of the government sector	2.2	1.6	1.3	0.7	0.4	0.4
Local government debt	82.2	79.0	85.1	88.3	90.8	93.7
Social insurance institutions debt	0	0	0	0	0	0
Public debt of the Republic of Serbia	2,652.8	2,831.9	2,901.6	3,172.6	3,299.7	3,398.4
Public debt of the Republic of Serbia/GDP	68.4%	71.4%	73.2%	76.7%	75.4%	72.1%

Public debt management principles

According to the Public Debt Law, the primary goal of Serbia's borrowing and public debt management is to ensure the funds necessary to finance budget expenditures, with medium-term and long-term minimal financial costs and acceptable risk level. Reduction of long-term public debt servicing costs to a minimum is restricted by the debt structure and costs reduction will be influenced by a number of factors and risks. With this in mind, the Public Debt Management Strategy of the Republic of Serbia defines the following general objectives and principles:

- 1) It is necessary to ensure the financing of the fiscal deficit and regular financing of liabilities based on the public debt of the Republic of Serbia;
- 2) It is necessary to define an acceptable risk level that should be defined in terms of a targeted debt portfolio structure, including debt currency structure, interest rate structure, maturity structure and debt structure by types of instruments;
- 3) It is necessary to uphold the development of a market of government securities issued in the domestic and international market, so as to have a developed market which would reduce the medium-term and long-term borrowing costs;
- 4) The borrowing process should be transparent and predictable.

The Public Debt Strategy should be supported by, and consistent with, the government's general medium-term macroeconomic and fiscal framework.

The Public Debt Management Strategy shall in the following medium-term period be based on the financing of the budget costs of the Republic of Serbia, mainly through the issue of government securities in the international and domestic capital market. The government securities market is still developing and one of the principles of public debt management is the necessary flexibility in order to secure the financing of Serbia's budget expenditures. Flexibility shall be reflected in the choice of the market for borrowings, borrowing currency and financing instruments. The choice of the financing structure will be made considering the domestic and international financial market current balance and development (interest rate level, risk premiums, yield curve, reference foreign currency exchange rates) and an acceptable level of financial risks exposure.

The objective is financing through the issue of mainly dinar-denominated securities in the domestic market in the following long-term period although the current situation indicates that, despite the firm decision to develop domestic securities market, in the following medium-term period, the financing must be carried out in the international financial market. Guidelines for financing in the

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international market in foreign currency will be to secure access to a greater number of investors in different parts of the international financial market, if possible, to define the borrowings in foreign currency according to the repayment of the foreign currency-denominated debt.

Borrowing in a foreign currency, such as, e.g. in US dollars, includes the foreign currency risk, due to the changes of the exchange rate RSD-EUR and EUR-USD, indicating that the public debt management is faced with the task of actively considering and using the possibility of hedging, if borrowing is not in RSD.

The public debt management policy must take into account the long-term perspective, and still make a decision about financing budget expenditures once a year. Decision on annual borrowing is made within the Budget Law for a certain fiscal year and depending on the basic fiscal aggregate changes correction of the borrowing plan is possible during a fiscal year.

Financial risks and financial risk management measures

Financial and fiscal risks can cause a greater public debt growth than predicted by the basic scenario. The risks that are present and may cause the debt and public debt servicing costs increase are: refinancing risks, foreign currency exchange risks, market risk (interest rates risk, inflation risk), liquidity risk, credit and operative risks, and risks tied to the servicing costs distribution (debt structure, liabilities concentration).

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

1. Refinancing risks

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

2. Foreign currency risk

- Tendency to reduce the foreign currency-denominated debt share regarding the new debt costs (cost of debt dinarisation);
- Utilisation of financial derivatives to limit the effects of the reference currencies exchange rates changes;
- Tendency to have external debt in EUR mainly and to use the US dollar-denominated debt only if financing in dollars in the international market is less expensive, with the additional use of limiting the financial derivatives risk;

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

- Tendency to extend the duration of the internal dinar-denominated debt;
- Issue of indexed bonds (interest rates indexation);
- Risk based on external debt interest rate does not jeopardise the long-term objective of minimising public debt costs;

4. Liquidity risk

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

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- Consolidation of foreign currency assets, apart from dinar assets, in the consolidated Treasury system at the NBS, and the use of foreign currency assets to actively manage liquidity of the dinar account of the budget execution;

5. Credit and operative risks

- Financial derivatives transactions can only be carried out with the financial institution of high credit rating;
- The use of financial instruments that limit the credit risk;
- Granting guarantees and new loans to local government only if there has been an adequate analysis of a relatively low possibility of realizing the guaranty in the medium-term period;
- Introduction of adequate control in all the business activities in the Public Debt Administration and expanding the employees' knowledge, which requires expanding limit of the number of employees and approving adequate budget funds;
- Upgrade and improve the existing information system that monitors the public debt and the operations related to it;

6. Risks tied to the servicing costs distribution

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

Analyses used to create the Public Debt Management Strategy

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

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

Financing sources denominated in foreign currency

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

Financing sources denominated in domestic currency

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

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Future market interest rates and analysis scenario

In the process of creating the medium-term public debt management strategy for the period 2016-2018, quantitative costs and risks analyses based on various scenarios and projections were used.

The first step is the basic scenario based on the most likely market conditions. Then three groups of market variables are identified: foreign currency exchange rates, interest rates in the international market and RSD reference interest rates. Future market rates can be deducted through the analysis of the available predictions of the purchasing power parities or through the prediction of the interest rate parities. The trend of RSD depreciation against EUR and USD is assumed, according to the macroeconomic framework in the period observed, and the constant relation between EUR and USD remains in order to provide a clear picture of the effect of the shock applied. The shocks test the effects of the market interest rates changes. Approach to dinar-denominated interest rates is based on current yield rates realised in 2015.

Having defined the basic scenario, three more scenarios – shocks were chosen to conduct the stress test.

Dinar depreciation against US dollar by 25%. In this type of shock the EUR-RSD ratio in projection remains unchanged. This scenario has large influence on the Serbian debt due to the US-denominated debt share (which was 33% of central government public debt at the end of October 2015).

Depreciation of dinar against all the currencies by 25%. In this scenario, the EUR-USD ratio would remain stable, whereas dinar would be depreciated against both currencies. Macroeconomic conditions for such scenario would refer to the increased current deficit of balance of payments and to the low direct and portfolio foreign investments inflow.

International market interest rates increase. The current interest rates in the world are historically low. If the world economy recovers, the interest rates will probably increase for about 2-3 percentage points in the medium-term period.

Domestic market interest rates increase by up to 4 percentage points. This scenario would be possible if the inflation were to rise again (over 10%) as in the period until 2012, and high volatility of RSD-EUR exchange rate due to the country's risk premium increase.

Each of the above mentioned stress tests or risk scenarios were used to outline the effects of the costs of the strategies examined.

Alternative borrowing strategies for the period 2016-2018

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

Basic Strategy (S1): it is the strategy that covers the need to finance government securities issue in domestic and foreign currency in the domestic financial market, and the euro-denominated five-year and ten-year Eurobonds issue.

Secured Concessionary Loan Strategy (S2): as opposed to S1 strategy, euro-denominated five-year and ten-year Eurobond is issued, more favourable long-term loan and fixed interest rate of 2% in US dollars is ensured, whereas the additional domestic market financing is primarily based on dinar-denominated securities in a structure similar to S1. This strategy, compared to S1 strategy, has a greater share of external sources of financing.

Eurobonds Issue-Based Strategy (S3): S3 strategy, as compared to S1 strategy predicts the issue of US dollar-denominated Eurobonds with five and ten-year maturity, whereas the structure and amount of dinar-denominated securities remain as in S1 strategy.

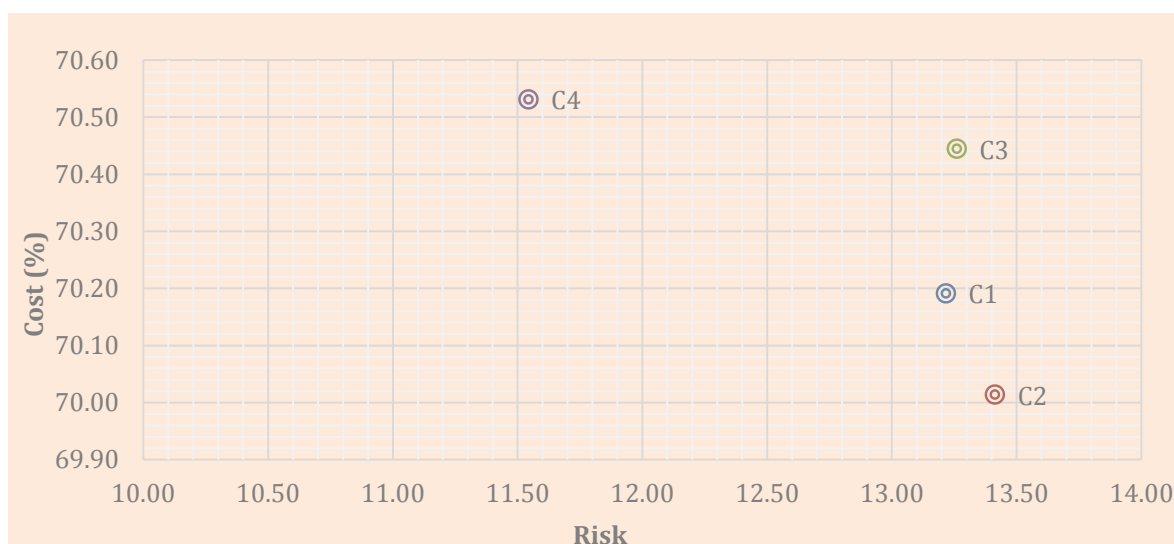
Additional Dinarisation Strategy (S4): this is a strategy in which the total financing is based on dinar-denominated securities issues.

Financing Serbia's budget expenditures following these strategies will be executed mainly through the issue of government securities in the international and domestic capital market, except in the strategy S2, when a greater share of concessionary loans is predicted.

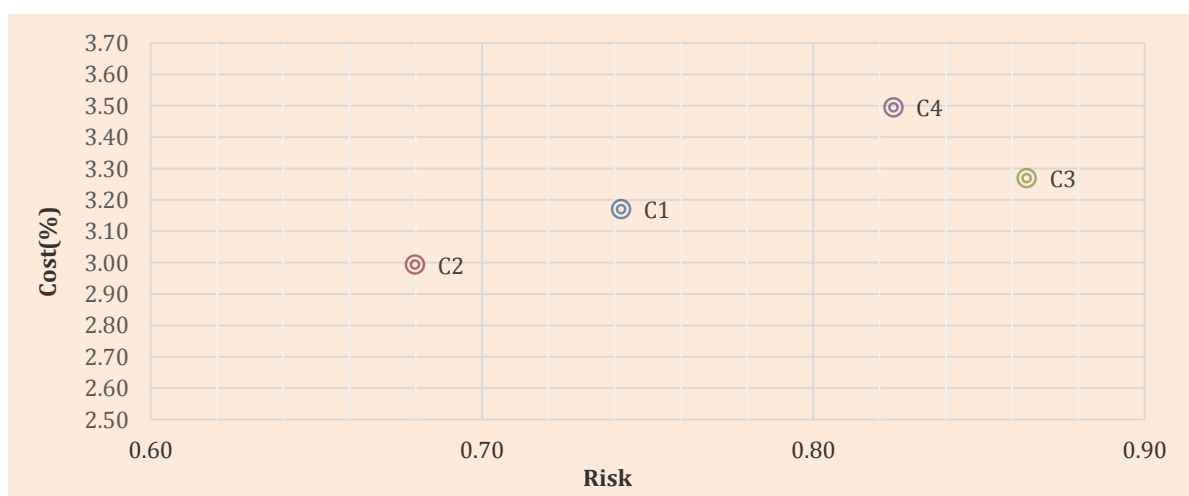
Comparing the alternative strategies

Quantitative analysis represents the performance of each of the four alternative borrowing strategies. The vertical axis represents the debt share in GDP and interest in GDP costs in the basic macroeconomic framework whereas the horizontal axis represents the potential cost of a certain borrowing strategy (stress test result). Two cost ratios are implemented: public debt to GDP and nominal interest to GDP. The former is the balance indicator, and the latter the course indicator. For the sake of comparison, the attention is focused on the results of the strategies examined, at the end of 2018.

Graph 23. Debt-to-GDP ratio at the end of 2018



Graph 24. Interest-to-GDP ratio at the end of 2018



The Graphs clearly show the costs brought by each of the considered strategies – strategies S2 and S3 have relatively higher foreign currency exchange rate risk exposure. As it combines securities denominated in RSD and EUR, strategy S1 is currently highly exposed to the possible dinar-denominated interest rates for government securities volatility, and the risk is higher in the strategy S4, where the complete additional financing plan is based on the issue of dinar-denominated securities. On the other hand, strategy S4 in the basic macroeconomic framework has relatively higher share of dinar, and therefore has more stable ratio of debt share in GDP. Strategy S2, which is partially based on a long-term concession loan in US dollars, has the lowest risk in terms of interest rates, out of the four strategies examined, due to low fixed costs of the concessionary loan. Strategy S3 appears to be of relatively high risk regarding the debt-to-GDP ratio, since additional financing is based on the issue of US dollar-denominated bonds, whereas strategy S4 appears to be relatively expensive, considering the high share of dinar-denominated securities in this strategy.

The analysis of public debt-to-GDP ratio graded strategy S2 as the one of the highest risk. The basic strategy S1 has relatively higher expenditures of interest, compared to S2 strategy, due to the significant share of dinar-denominated securities. In the basic macroeconomic framework strategy S2 has lower interest costs, since a part is financed out of the concessionary loan. Based on the analyses, it is evident that in the following medium-term period, basic borrowing operations will be based on strategies S1 and S2, and with clearly indicated preference to, if there is a possibility of borrowing in greater amount according to the concessionary conditions, base the borrowing operations on strategy S2, considering that further reduction of interest rates for dinar-denominated securities would lead to the preference of S1 strategy. Application of discount prices that maintain limit borrowing costs of the Republic of Serbia in the financial market would result in the most optimal S1 and S2 borrowing strategies and from the aspect of net present value.

Table 18. Public debt-to-GRP ratio at the end of 2018

Scenarios	S1	S2	S3	S4
Basic scenario	70.2	70.0	70.4	70.5
Foreign currency exchange rate shock (25% of all the currencies)	83.4	83.4	83.7	82.1
Interest shock (scenario 1)	70.6	70.4	71.0	71.0
Interest shock (scenario 2)	70.8	70.6	71.1	71.2
Combined shock (25% of USD and interest shock 1)	77.0	77.2	78.2	77.4
Maximum risk	13.2	13.4	13.3	11.5

Table 19. Payment ratio based on interest and GDP at the end of 2018

Scenarios	S1	S2	S3	S4
Basic scenario	3.2	3.0	3.3	3.5
Foreign currency exchange rate shock (25% of all the currencies)	3.7	3.5	3.8	3.9
Interest shock (scenario 1)	3.6	3.4	3.8	4.0
Interest shock (scenario 2)	3.8	3.5	4.0	4.2
Combined shock (25% of USD and interest shock 1)	3.9	3.7	4.1	4.3
Maximum risk	0.7	0.7	0.9	0.8

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

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Table 20. Alternative strategies risk indicators

Risk indicators		At the end of 2018			
		S1	S2	S3	S4
Nominal debt (% of GDP)		70.2	70.0	70.4	70.5
Net present value (% of GDP)*		62.8	60.1	67.7	67.8
Applied interest rate (%)		4.7	4.4	4.8	5.1
Refinancing risk	ATM ⁶ external portfolio (in years)	6.5	7.6	6.5	6.8
	ATM domestic portfolio (in years)	3.2	3.2	3.2	3.8
	ATM total portfolio (in years)	5.2	6.1	5.2	4.7
Interest rate risk	ATR ⁷ (in years)	4.7	5.6	4.7	4.2
	Refixing (% of total debt)	23.4	22.3	23.4	25.5
	Fixed rates debt (% of total debt)	84.4	85.1	84.4	83.5
Foreign currency exchange rate risk	Foreign currency debt (% of total debt)	68.3	71.4	68.3	43.8

* Application of discount prices reflects the limit borrowing cost of the Republic of Serbia in the financial market.

Stress test analysis

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

At the end of 2014 central government debt reached 71.0% of GDP, and general government debt reached 72.4% of GDP. The public debt-GDP ratio of Central Government was 74.1% of GDP at the end of October 2015. Rising trend is expected to continue until the end of 2015, and to reach a share of about 75.2% of GDP at central government level, and 76.6% of GDP at general government level

Due to high share of foreign currency-denominated debt (about 78%), it is clear that the foreign currency risk will determine the behaviour of public debt-GDP ratio in the following period, and it will significantly influence the success of the fiscal policy measures designed to consolidate public finances and reduce the debt share in GDP

Based on the planned macroeconomic framework, providing that there is no possible risk influence (foreign currency risk primarily), public debt, excluding the non-guaranteed debt of local government, would be at the level of 74.5% of GDP, until 2018.

The key factors that influence the stabilization of public debt-GDP ratio include GDP growth, primary deficit, dinar exchange rate against foreign currency rates, and interest level. The planned measures of fiscal policy define the reduction of primary deficit, which reduces the key factor of debt growth.

⁶ ATM - Average Time to Maturity

⁷ ATR - Average Time to Refixing

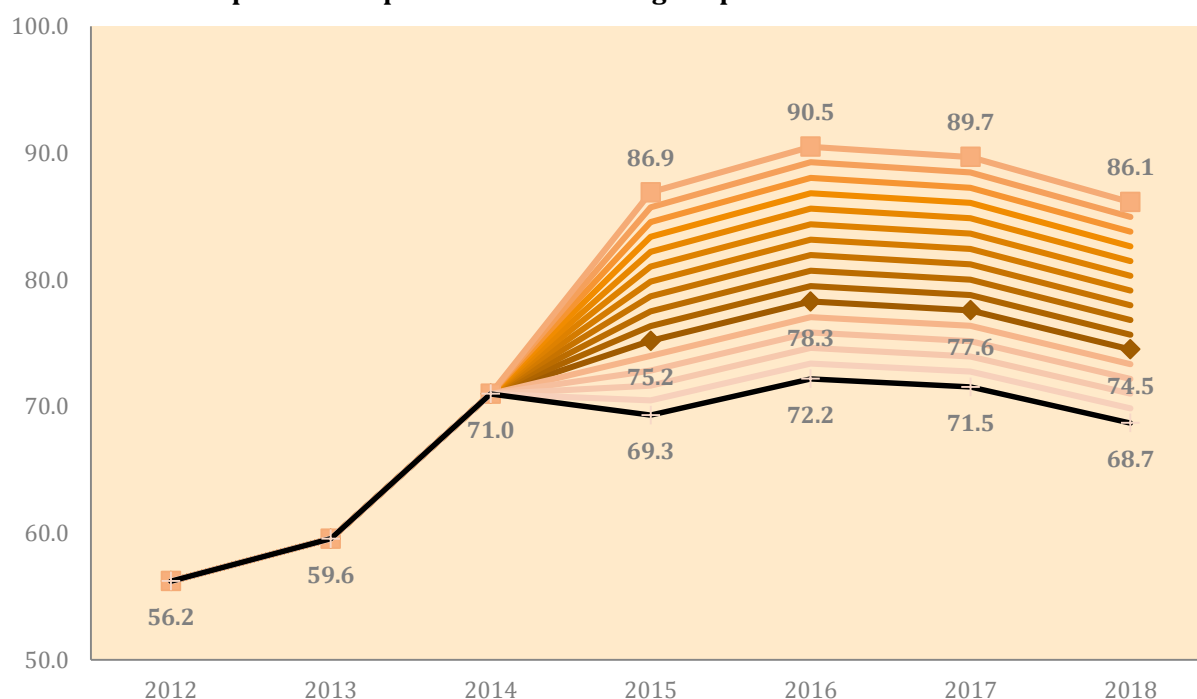
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Table 21. Basic macroeconomic variables' contributions to the changes in the central government debt-to-GDP ratio

	2013	2014	2015p	2016p	2017p	2018p
	In percentage					
Central government debt/GDP	59.6	71.0	75.2	78.3	77.6	74.5
Changes compared to the last year	3.4	11.4	4.2	3.1	-0.7	-3.1
Primary deficit influence	2.9	3.6	0.8	0.6	-0.8	-1.6
Interest	2.3	2.8	3.2	3.4	3.5	3.3
Nominal GDP growth	-4.2	0.0	-1.5	-3.1	-4.3	-5.5
Other factors affecting the ratio	2.4	5.0	1.7	2.3	0.9	0.7

Graph 25. Impact of changes in the RSD exchange rate against the basket of currencies from the public debt portfolio on the change in public debt-to-GDP ratio



Graph 25 represents the public debt-to-GDP ratio trends depending on the dinar exchange rate against a certain currency basket. It shows the basic projection with alternative scenarios depending on the appreciation or depreciation of dinar exchange rate, in the range of 10% appreciation to 20% depreciation of dinar against a currency basket. Implementation of the scenarios in question shows that in 2018 the ratio would range from 68.7% to 86.1%, whereas in the basic scenario it would be at 74.5%

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

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

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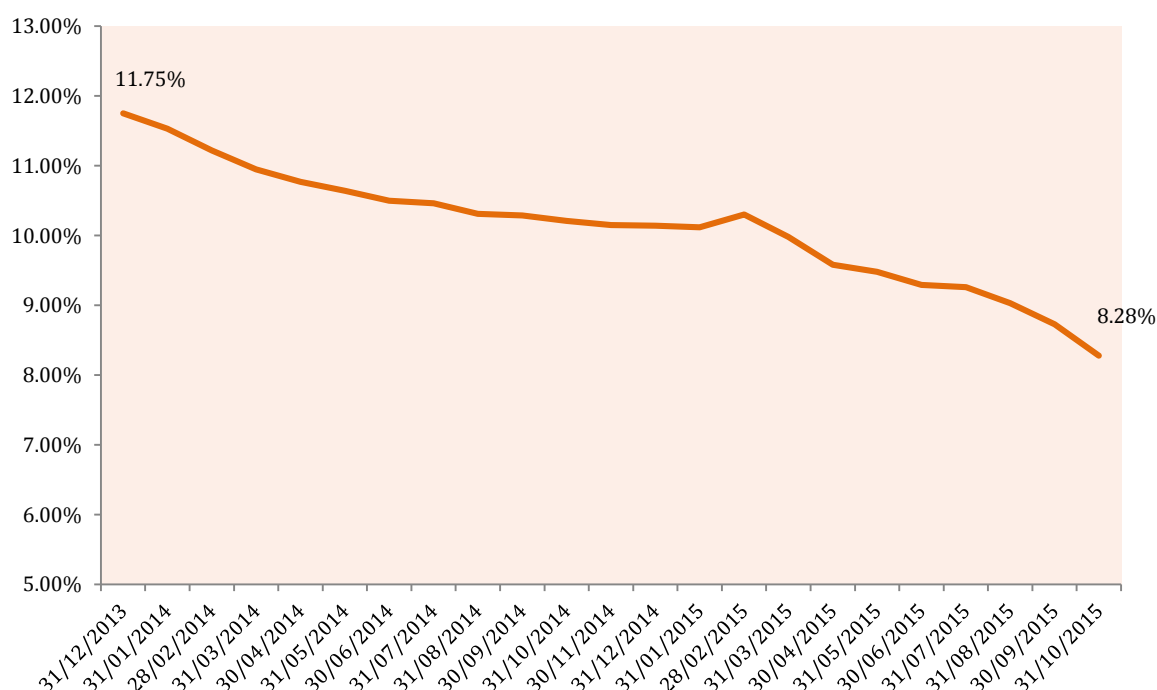
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Long-term strategic framework of public debt management

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

- The share of dinar-denominated debt should be about 20-25% of the overall public debt in the medium-term period;
- The share of euro-denominated debt in the public debt should be at least 60% of the foreign currency debt, including future borrowings and transactions;
- The share of floating interest rate should drop to below 20% in the mid-term period;
- Average time to refixing (ATR) should remain at a level of at least 4.5 years, in accordance with the above mentioned measure of gradual decrease of floating interest rate debt share;
- Weighted average interest rate (WAIR) for internal public debt shall not exceed 10% in short-term and mid-term debts;
- The share of the short-term debt (whose maturity is up to a year) shall be up to 15% of the overall public debt;
- The average maturity time (ATM) of internal debt shall be at a level of at least 4 years in mid-term;
- The average maturity time (ATM) of external debt shall remain at a level of from 6 ± 0.5 years in the same time framework.

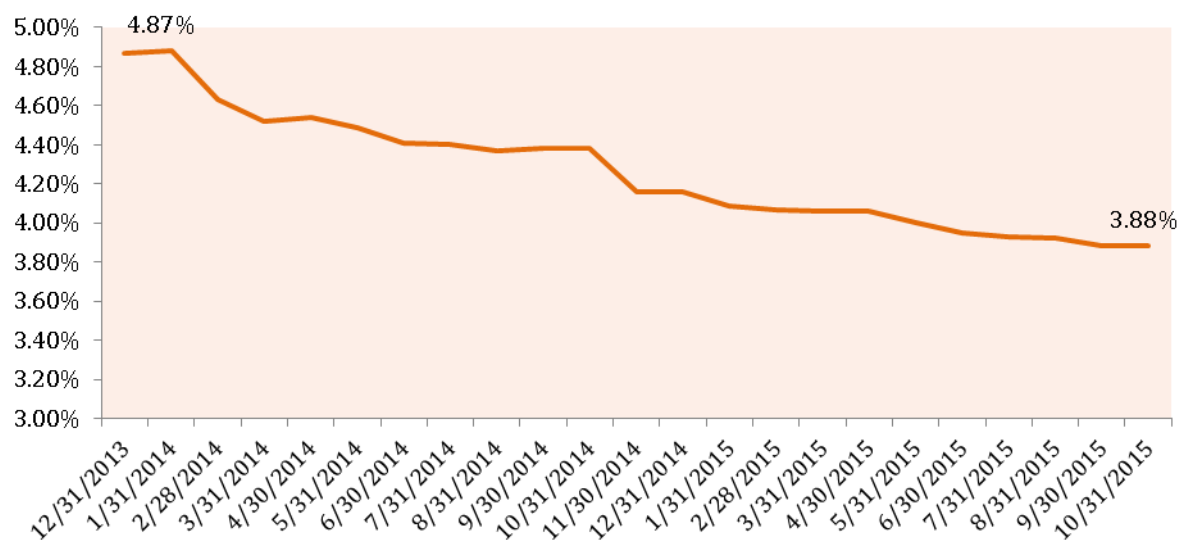
Graph 26. Average weighted interest rate for dinar-denominated securities in the period from the end of 2013 to October 31, 2015



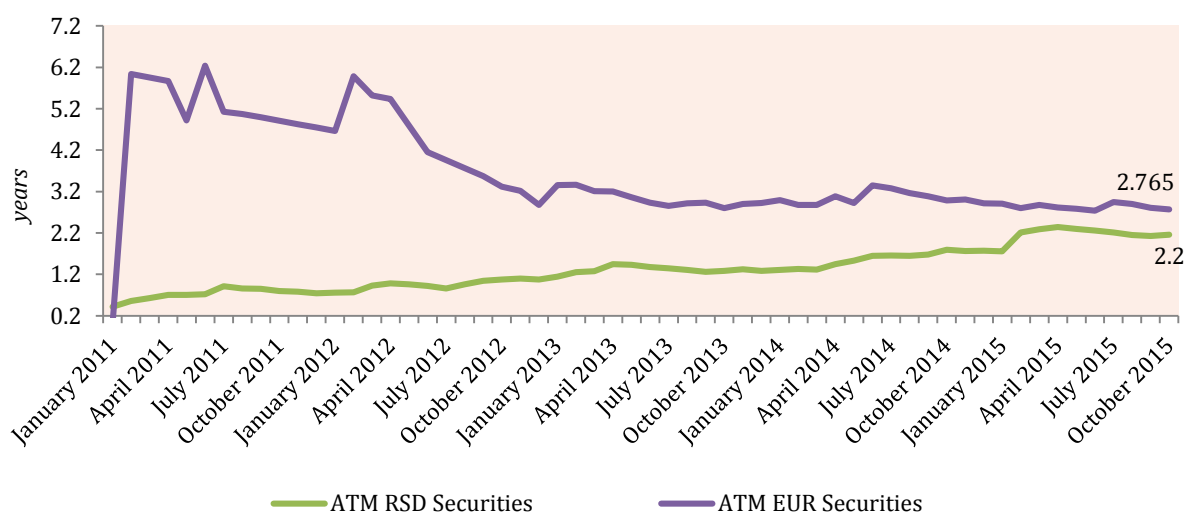
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Graph 24. Average weighted interest rate for euro-denominated securities in the period from the end of 2013 to October 31, 2015



Graph 28. Average time to maturity (ATM) of securities issued in the domestic financial market in the period from the beginning of 2011 to October 31, 2015



Improvement measures for dinar-denominated securities market in the period 2015-2018

In the period of 2012–October 2015, the securities market has achieved the set strategic objectives, primarily regarding the financing instruments, but also when it comes to maintaining stability of diversified investor base. The development policy of the domestic market of securities has enabled the continuity of Serbia's budget financing, as well as broadening the amount that will be financed from the issue of long-term dinar-denominated securities in the domestic financial market. Transferring from short term financing resources, which were used in the period up to 2010, to the mid-term and long-term financing instruments, and the constant drop in borrowing costs, have influenced the reduction of refinancing risk, as one of the primary risks in the public debt management process. At the end of 2013, the share of long-term dinar-denominated instruments in initial maturity

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of three or more years amounted to 37% in dinar-denominated securities balance, whereas at the end of October 2015, the amount was 57%.

Transparent work and reports, as well as presence on the international capital market, helps the non-residents to be informed and therefore interested to invest their capital into borrowing instruments, primarily into long-term government securities, which enhances the development of a stable investor base. In 2014 were for the first time issued ten-year bonds which concluded the maturity development on the yield curve, of both dinar and euro denominated government securities. In February 2015 was for the first time established benchmark issue in the domestic financial market with the 7-year maturity in the amount of RSD 50 billion. In 2015, there was an issue of two three-year bonds in the amount of RSD 50 billion each. This issue considerably extended the scope of secondary trade in these instruments which considerably contributed to the drop in effective yield rates in the re-opening of the stated issues.

Trade in long-term government securities was enabled at Belgrade stock exchange to ensure further development of the secondary market of government securities from November 12, 2015.

The period to which this strategy applies is expected to improve the efficiency of the primary market through the concept of primary dealers, as a mechanism of selling government securities which can, in the long run, directly contribute to the reduction of borrowing costs and refinancing risk. Introduction of the selling system for the government securities in the domestic financial market through primary dealers is a solid base for the improvement of the market efficiency of the secondary market of government securities. In time, the development of the secondary market will establish the concept of market efficiency in the process of government securities evaluation. Introduction of the benchmark issue of bonds will have a positive effect on the amount and continuity of secondary trade, as well as on the improvement of market efficiency in the process of selling government securities in the primary market.

We should highlight the fiscal result, expected inflation rate and foreign currency exchange rate as the key factors that influence the yield curve of government securities. A special group of factors are the macroeconomic trends and expectations, as well as changes in the international financial market, which reflects the premium risk of the country.

The plan to extend the average maturity of the dinar-denominated securities depends on a series of factors, primarily on the success of Government and the NBS in the process of dinarization and maintenance of the set inflation framework, along with the growth of confidence in the monetary and economic policy of the Government and the NBS, as well as the stability of the dinar exchange rate.

At the end of 2011 the average maturity of dinar-denominated securities was 272 days (0.75 years), at the end of 2012 it was 394 days (1.1 year), at the end of 2013 it was 469 days (1.3 years), at the end of 2014 it was 645 days (1.8 years) and as of October 31, 2015, it was 788 days (2.2 years). The maturity has grown over the years and during 2015 there was the most significant improvement, due to successful issue of bonds of three, five, seven and ten years. Bearing in mind that during 2018 the planned average maturity should be ranging from 2 to 3 years. Development of the domestic securities market will be supported by the Republic of Serbia with the following measures:

- Considering to increase the amount of benchmark issue in the following period;
- Including domestic currency-denominated securities in one of a Global Currency Government Bond Emerging Market Indexes. Including Serbia's bonds in a global index would considerably increase the database of investors and support secondary trade, which would contribute to further reduction of costs by borrowing issues of securities;
- In order to create a base of investors as large as possible and to develop the secondary market for securities issued in domestic market, the Government created an equal tax treatment for the domestic and foreign investors at the end of 2011, and in the following period, efforts will be made to remove all the obstacles to a free capital flow. During the last three years there has been a noticeable trend of increased share of foreign investors, and a change in the base of

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investor and the current investors structure is expected to remain in the following three-year period, which could contribute to the development of secondary market;

- The possibility of clearing and settling the domestic securities transactions through the international clearing system is to be considered in the following period;
- The possibility of introducing the primary dealers will be considered in the following period;
- In order to increase the investments of domestic natural persons, there will be additional efforts in the domain of educating the citizens of the Republic of Serbia and consider the issue of retail bonds.

In the following period, the Ministry of Finance will modify the auction platform, based on the suggestions from the investors, in order to satisfy the interests of both parties in the best and the most acceptable manner.

IV. Structural Reforms in the Period 2016-2018

The Government and Ministry of Finance are committed to achieving the objectives of economic policy set by three-year fiscal strategy and the Memorandum of Economic and Financial Policies, agreed with the IMF. Credible medium-term plan of structural reforms, together with measures of fiscal consolidation, is a key basis for (1) achieving stabilization of public finances by reducing the fiscal deficit and public debt, (2) initiation of economic activities based on the increase in investments, exports and employment. The objectives of economic program of reforms are compatible with the objectives of the candidate countries for EU membership. Structural adjustment of the economy creates a lasting basis for faster economic growth, increasing employment and standard of living.

In this regard, in 2015, a number of reforms has been implemented, aimed at the elimination of structural obstacles, improving the business environment and competitiveness of the economy:

- With a view to removing obstacles to realisation of the investments, the Law on Investment has been adopted which replaced and extended the scope of the Law on Foreign Investments, including domestic investments. A reform and rationalization of programs and institutions for promotion of investments have started, particularly the Development Fund, the National Agency for Regional Development and agencies that deliver programs of investment incentives and export financing (Serbian Export Credit and Insurance Agency - AOFI, Serbia Investment and Export Promotion Agency - SIEPA). Adoption of this law allowed the reorganization of existing agencies into a new Serbian Development Agency to be made by the end of 2015, which will be aimed at linking foreign direct investment (FDI) and regional development;
- A working group was formed for implementation of the Action Plan for improving the business environment for small and medium-sized enterprises based on the Strategy for supporting small and medium enterprises, entrepreneurship and competitiveness for the period from 2015 to 2020;
- With a view to achieving greater predictability and transparency in business operations, as well as harmonization with EU regulations, amendments to the following laws have been adopted: the Law on Republic Administrative Fees, the Law on Value Added Tax and the Mortgage Law;
- To increase business predictability and reduce corruption and grey economy, the new Law on Inspection Control was adopted, and improved labour inspection has already started to contribute to reduction of informal employment and increasing the collection of contributions;
- The Tax Administration Transformation Program (hereinafter: TA) for the period 2015-2020 has been adopted. Introduction of electronic services has made possible for taxpayers to carry out electronically a larger number of procedures for preparation and payment of taxes, thereby contributing to a more transparent work of the tax authorities, and simplification of tax procedures, especially in terms of reducing the number of tax returns, optimization of deadlines for submitting and verifying the correctness of the calculated and paid taxes;
- In order to improve bankruptcy procedures, amendments to the Law on the Bankruptcy Supervision Agency have been adopted, and amendments to the Law on Consensual Financial Restructuring have been adopted with the aim of restructuring the debt of the economy;
- A comprehensive NPL Resolution Strategy has been adopted;
- Amendments to the Law on Conversion of the Right of Use into the Right to Property on Construction Land with a Fee have been adopted, which will end the ownership transformation of the construction land and allow the intensification of construction activity;

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- Amendments to the Law on State Survey and Cadastre have been adopted, which has simplified the procedure and shortened the time for registration in the cadastre to seven days;
- The Government has elaborated the Program of reforms of employment policy and social policy, which will act as the main mechanism for dialogue on priorities in the areas of social policy and employment to monitor the process of European integration, structured on the model of the Europe 2020 strategy;
- A Draft Strategy of Scientific and Technological Development of the Republic of Serbia for the period from 2016 to 2020 - "Research for Innovation" has been prepared, which aims to establish an effective national research system integrated into the European Research Area, which, through the development of innovation contributes to economic growth, social and cultural progress, raising the standard of living and quality of life;
- In order to improve the existing legal framework of employment policy, amendments to the following laws have been adopted: the Law on Employment and Unemployment Insurance, the Law on Safety and Health at Work, and the Law on Conditions for Assignment of Workers to Temporary Work Abroad and Their Protection has also been adopted;
- National Employment Action Plan for 2016 has been adopted;
- A comprehensive process is in progress with respect to changes in the salary system, rationalisation of number of employees and strengthening control of the salary system in the public sector.

The World Bank has evaluated the process of structural reforms, so that the Republic of Serbia is ranked at the 59th place on the Doing Business 2016 list, which has been made according to the criteria of ease of doing business.

1. Structural Reforms of the Real Sector

In order to strengthen the private sector, improvement of business and investment climate will be provided in order to reduce costs and risks of doing business and investing in the Republic of Serbia, as well as completion of the process of restructuring the state-owned enterprises. It will also ensure greater protection of competition, encouraging faster development of small and medium-sized enterprises and entrepreneurship, the removal of rigidity in the labour market and more efficient implementation of bankruptcy. Special attention will be paid to structural reforms that encourage the strengthening of capacity of the economy to increase production and efficiency, exports and employment, which will result in improved economy competitiveness.

Structural Reforms that Improve Business Environment

In order to improve competitiveness and business environment of the Republic of Serbia, a comprehensive program for supporting investment, job openings and the private sector development will be developed. The program will ensure that the policies supporting the growth are well coordinated and targeted. Specific actions will focus on the following areas:

- Encouragement of development of small and medium-sized enterprises will be continued through implementation of the Strategy for supporting small and medium-sized enterprises, competitiveness and entrepreneurship;
- Improvement of efficiency in the management of bankruptcy proceedings will be continued by centralizing all the procedures and processes within the jurisdiction of a single agency;
- Activities on the introduction process of corporate governance in public enterprises will be continued, in order to ensure impartiality, transparency and accountability in corporate behaviour. The Government will introduce a new Law on Public Enterprises by the end of December 2015, and in 2016 a new Law on Companies will be adopted, in order to improve the efficiency of public enterprises and better monitoring;

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- Preparation of a legislative framework will be continued that will allow the formation of a unified public register of administrative procedures and other conditions for doing business, so as to provide for business entities and citizens timely planning of the cost of providing certain services of public administration;
- Improvement of capacity of the Tax Administration will continue through implementation of the program for the transformation of TA, in order to prepare connection to European information systems in the EU accession process;
- In the coming period, implementation of the NPL Resolution Strategy will be carried out, which seeks to reduce the trend of high and growing share of these loans, so as not to burden the banking sector in the country and limit economic activity and development of domestic economy. Legislative activity will be focused on introduction of the profession of assessors and the change of the Bankruptcy Law for the purpose of better protection of creditors.

Structural Reforms that Improve Labour Market

In line with the overall aim of employment policy until 2020, by means of the established National Employment Strategy for the period 2011-2020, implementation of activities will be continued aimed at establishing an efficient, stable and sustainable employment growth trend until 2020. In this regard we will work on improving the existing legal framework of employment policy, better implementation of existing and introduction of new measures of active employment policy, encouraging employment in the less developed regions with development of regional and local employment policies, improving the quality of human capital, development of institutional capacity and reduction of duality in the labour market.

- In the coming period, realization of the following activities has been planned:
- Implementation of the reform of the National Employment Service, which will be supported by the Competitiveness and Employment Project, with the aim of improving the quality of programs and services provided to the unemployed and employers;
- Adoption of the National Qualifications Framework (NQF), which is one of the instruments for determining questions of qualifications required on the market;
- As a part of the initiative for the opening of new jobs, improvement and expansion of the scope of active employment measures will be continued, depending on the situation in the labour market and results of analysis of the impact of the measures taken.

Financial Stability

In order to preserve financial stability and support the ability of the banking sector to cope with the shocks from the environment, special attention will be paid to the following issues: resolving the issue of non-performing loans (NPL), strengthening the supervisory and regulatory framework of the banking sector in line with EU standards, implementation of measures in accordance with the framework for recovery and restructuring of financial institutions (in accordance with the EU Directive - Directive 2014/59/EC establishing a framework for the recovery and resolution of credit institutions and investment firms) and implementation of a strategy to regulate the operations of state-owned banks.

The Strategy for Resolving Non-Performing Loans (NPL) was adopted in August 2015 on the basis of joint work of the Ministry of Finance, Ministry of Economy, Ministry of Justice, National Bank of Serbia (NBS), and the Deposit Insurance Agency (DIA), with the support of experts from international financial institutions, which was followed by its implementation.

Drafting of specific diagnostic studies (SDS) has been completed, which establishes the status and quality of bank assets. It is expected that bank management and the external auditors will consider the results of studies and accordingly take action in the future.

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The NBS is preparing a series of draft amendments to the existing regulatory framework in order gradually to begin with implementation of the international regulatory framework - Basel III. Systemically important banks have been identified based on internal methodological framework, in accordance with the guidelines of the European Banking Authority (EBA). Also, the Sector for restructuring the banks has started working, where banks submit their data and initial recovery plans, in order to draft plans for restructuring the systemically important banks.

Implementation of the strategy for state-owned banks is in progress. The aim of this process is to strengthen supervision of the banks business operations, which are partially or majority state-owned and finding solutions for their continued business operations, whether it is about improving business performance through new business strategies, improved risk management, in line with international best practices or through the privatization process.

Reform of the Construction Permit Issuance System

Based on the report of the World Bank in Doing Business Report 2016, the Republic of Serbia has advanced 39 places on the list ranked on the basis of the length of waiting for a construction permit. Issuance of construction permits will continue to accelerate, so, by the beginning of 2016 the electronic issuance of construction permits will be implemented.

Transport Infrastructure Improvement

Investment in transport infrastructure by various transport modes and priorities are defined in the document Transport Master Plan up to 2027, which was prepared in cooperation with the EU. The main objective of the master plan for transport in Serbia is to contribute to the pursuit of a better and safer transport networks, which will attract investments in poorer areas, improve the quality of life in these areas and improve trade.

In order to develop the transport infrastructure, there will be a focus on development of logistic centres of regional and local character on the multimodal Corridors X and VII, in large regional economic hubs and their gravitational zones. At the same time, the works have been continued on the highway E-80, the bypass around Belgrade, the road E-763 Belgrade - South Adriatic and highway E-75. The City Assembly of Belgrade adopted a Draft of detailed regulatory plan for the Intermodal terminal and logistics centre "Batajnica" and its completion is planned for July 2017, which will allow reduction of the share of logistics costs in the product price, and products and goods to end customers will arrive in a faster, better and more economical way. Prerequisites for attracting investments and opening new jobs will also be created.

The works on railroad Oriental / Eastern-Mediterranean primary corridors are in progress. In the field of trans-European energy networks, Serbia continues to provide support for the implementation of the gas ring project in Southeast Europe. Preparatory work on the construction of the gas interconnections between Serbia and Bulgaria will be intensified in order to increase security of gas supply. Also, construction on the interconnection between Romania and Serbia has started, in the framework of Trans-Balkan corridor for transmission of electricity.

By adopting a law on broadband Internet access, harmonization of national legislative framework in the field of electronic communications will be carried out with the EU framework and conditions and manner of development of broadband Internet access (Directive 2014/61 / EU) will be regulated. The structural reform includes consolidation of the broadband network owned by the public sector, linking public institutions to the national network, as well as construction of broadband communication infrastructure to the access network in residential areas. With the construction of broadband infrastructure in all regions of the Republic of Serbia, conditions will be created to reduce the economic gap, i.e. for balanced regional development, GDP growth, employment growth, productivity growth and improved efficiency, intersectoral synergy which reduces the need for civil works for the installation of electronic communications networks, as well as maximizing the positive effects of construction works financed by public funds.

Energy Infrastructure Improvement

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Key obstacles that characterize the electric power system of the Republic of Serbia relate to the outdated, inefficient production capacities, and the lack of new power capacities, low investment in the system of preventive protection of electric power systems against natural disasters and high import dependence.

To make PE "Electric Power Industry of Serbia" (*EPS*) satisfy the increased demand for electricity, construction of a new block B3 in TPP Kostolac (350 MW) is planned within the second phase of the package TPP Kostolac B. Also, construction of a new thermal block TEK0 B3 is planned in the second phase of the project. The new block TEK0 B3 will be a replacement production capacity for the old blocks TEK0 A1 and A2 in order to ensure security of supply of electricity and heat.

In order to increase the security of gas supply and the establishment of conditions for reliable, safe operation and sustainable development of the gas system, energy system and the energy sector in general, and in accordance with the Law on Spatial Plan of the Republic of Serbia from 2010 to 2020, in the sector of the gas industry, construction of new gas pipelines, underground storage and compressed gas stations is planned, and, among the priority directions of strategic projects of the gas industry, the main gas pipeline Niš – Dimitrovgrad is scheduled.

Draft Energy Development Strategy of the Republic of Serbia until 2025 with projections to 2030 which relates to development of transmission capacities, points out strengthening the internal transmission capacities and capacities of regional corridors through the transmission network, 400 kV voltage level of the Republic of Serbia in the northeast – southwest direction. Measures taken relate to the construction and modernization of the network of overhead power lines to Romania, Montenegro and Bosnia and Herzegovina within the Trans-Balkan Corridor.

With a view to increasing security of supply and the establishment of conditions for reliable, safe operation and sustainable development of the energy sector in general, and in accordance with the Law on Commodity Reserves and international obligations, and set out criteria for opening negotiations on Chapter 15 – Energy, construction of new storage capacities in public ownership is planned for storage of the minimum reserves of oil and oil derivatives.

In the framework of the Draft Energy Development Strategy of the Republic of Serbia until 2025 with projections to 2030, energy efficiency is recognized as "a new energy source." Energy efficiency can significantly contribute to meeting the energy security of the country, but also to enable the launch of the local economy and to lead to reduction of energy costs and energy generating products.

Development of the Agriculture Sector

The Agriculture Sector is characterized by technical and technological obsolescence of the whole sector, especially the food industry, as well as unfavourable farm structure (the largest number of farms is small or medium sized), which can be a limiting factor of development, taking into account the favourable conditions for development of agriculture in the Republic of Serbia. Accordingly, the Republic of Serbia is making steps to improve agricultural production, as one of the key sectors in the economic structure.

By amendments to the Law on Incentives for Agriculture and Rural Development in December 2014, beneficiaries of subsidies may be the registered farms for reported and sown or planted areas under the appropriate culture to a maximum of 20 hectares. Also, amendments to this Law do not provide for the right to subsidies for state-owned land leased or in use. As this measure has not fully given the expected results in 2015, introduction of accompanying by-law measures is in progress, so as not to have this situation repeated in 2016.

The main directions of development of agriculture are defined in the adopted Strategy for Agriculture and Rural Development of the Republic of Serbia for the period 2014-2024, and the National Program for Agriculture for the period 2015-2020 and the National Rural Development Program for the period 2015-2020 have been prepared, representing medium-term documents, and are based on the aforementioned strategy, the Law on Agriculture and Rural Development, the Law

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on Incentives for Agriculture and Rural Development, as well as the National Program for acceptance of the acquis. Adoption of such documents is expected in the coming period.

Reform of the System of Support to Promotion of Investments and Exports

The reform is a combination of legislative and administrative measures and activities and includes: prioritization of industrial branches with the greatest potential for growth and development and creation of action plans for their implementation, drafting and adoption of laws and bylaws for implementation of the new action plans of priority industrial branches, reform of the work of agencies under the competence of the Ministry of Economy for implementation of the programs oriented to support investments and exports and development of monitoring and evaluation system. This reform will help creation of a focused and better coordinated policy for development of the industrial sector, as well as improving the efficiency of public institutions involved in its implementation. Reforms in the industrial sector are essential, primarily the reform of investment and exports support system, which is defined by the Strategy and Industrial Development Policy of the Republic of Serbia from 2011 to 2020. Encouraging the private and public investments and acceleration of implementation of public infrastructure projects will be performed in line with the EC recommendations.

Package of Measures for Enhancement of Tourism Revenue

Within the services sector, the priority will be to stimulate tourism through investments in infrastructure and superstructure in tourist destinations, in the projects of promotion, education and training in tourism, improving tourist traffic of domestic tourists (allocation of vouchers to certain categories of the population) and attracting the organized groups of foreign tourists. Proposed measures are planned within incentive measures under the Law on Tourism. Progress in implementation of the measure will depend on the funds provided in the budget of the Republic of Serbia and the Government will adopt acts which will more closely define the conditions, method of allocation and use of these funds.

2. Structural Reforms of the Public Sector

High level of the public debt, far above the sustainable, which was set by the Law on Budget System and a growing deficit in the government sector in the previous period, have seriously endangered the sustainability of public finances. Return of public finances to a sustainable path required a serious shift in fiscal policy, strong adjustment on the public expenditure and consequent reduction in deficit and debt. The planned fiscal consolidation is supported by a precautionary agreement with the IMF.

The Republic of Serbia expects to continue fiscal consolidation in the next medium term. Fiscal consolidation in the period 2016-2018 means further structural adjustment of 2.3% of GDP. For further adjustment of public expenditure, it is crucial to implement structural reforms to redefine the role of the government and size of the state's influence in certain segments.

Major challenges of fiscal consolidation in the coming period are:

1. *The number and structure of employees in the government sector.* Objective of the fiscal policy in the medium term is to reduce expenditures for employees on a sustainable level of 7% of GDP, as defined by the Law on Budget System. Reduction of salaries in public sector by nominal amount of 10%, starting from 2015, and then freezing them (notwithstanding the targeted increase of individual sectors in 2016) is a key measure of fiscal consolidation and has given the expected results. The mass of paid salaries in the government sector was reduced from 10% of GDP in 2014 to 9.1% of GDP in 2015. As the rationalization process was delayed, compared to the planned dynamics in 2015, this reduction in the share of salaries in GDP is almost entirely owing to nominal reduction and freeze of salaries. The next task is to reform the system of salaries in the government sector in order to reduce inequalities in salaries, and creating equity through introduction of the principle of equal pay for equal work, to strengthen control of the budget and to establish handling of the salary mass, as well as to

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increase transparency of the system⁸. Another component that affects the level of the salary mass in the government sector is a number of employees. Bearing in mind earlier, less successful attempts of problem solving by linear reduction in the number of employees, addressing this issue requires a different approach. To answer the question about the optimal number and structure of employees, it is necessary to carry out in-depth analyses by sectors, bearing in mind the scope and quality of services that the state is expected to provide.

2. *Budgetary support to public and state-owned enterprises.* In the previous period, large budget allocations referred to support to state-owned and public enterprises. Besides the classic subsidies mainly for current operations (PE for underground coal mining Resavica and Serbian Railways) and earmarked subsidies (e.g. for maintenance of roads), there was a large increase in expenditure on the basis of budget loans and payments on the ground of the guaranteed loans to public enterprises. Expenses for budget loans and payments on the ground of the activated guarantees reached the share of 2.2% of GDP in 2014. The plan is to reduce share of these expenses, so that in 2018 it does not exceed 0.5% of GDP.

3. *Improving the management of public finances.* For successful implementation of the fiscal consolidation program besides structural fiscal measures, on the revenue side as well as on the expenditure side, that result in reduction of deficit and public debt, it is necessary to improve the procedures of the budget process from the stage of medium-term planning, to control and audit of budget spending. Improving the procedures in planning, execution and control, on the one hand, and increasing the efficiency of institutions which task is to charge for revenue, on the other hand contribute to and support the fiscal consolidation program.

The most important structural reforms envisaged in the medium term to support the process of fiscal consolidation relate to:

1. Reforms continued in the areas of employment and salary system in the government sector. After short-term measures, reducing the nominal value of salaries in the government sector, which was necessary for the start of fiscal consolidation, in the following medium term the emphasis is on structural measures, which would, by lowering the number of employees on the one hand, and the establishment of a new system of salaries in the government sector on the other hand, contribute to the movement of the wage bill to a sustainable level of 7% of GDP.

Law on the Register of Persons Employed, Elected, Nominated, Appointed and Persons Engaged in Public Funds, which was adopted at the end of July 2015, created a legal basis for the precise determination of the number of employees in the broader public sector to whom the law applies (in addition to the government sector - direct and indirect budget beneficiaries at all levels of government and organizations for mandatory social insurance, the law applies to public companies, NBS, public agencies and companies in majority state ownership). Determining a precise number of employees within the various coverage of public sector is a necessary starting point, so as to determine the optimal number of employees in certain sectors in the next step. So established register will be able to solve doubts that have arisen about a total number of employees in the public sector, or narrow government sector that were present in the previous period.

Number of employees in the government sector at the end of 2014 amounted to 500,038.⁹ Analysis of the Public Administration conducted by the Ministry of State Administration and Local Self-Government has shown that Serbia does not deviate significantly from the EU average according

⁸ Draft Law on the Public Sector Employees' Salary System - a guide.

⁹ Data on the number of employees and relevant indicators for Serbia and the EU taken from the document: "The modern state-rational state. Analysis of Public Administration, Ministry of Public Administration and Local Self-Government." http://www.mduls.gov.rs/doc/Brosura%20CIR_bleed%203%20mm.pdf

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to the number of employees in the government sector compared to 100 inhabitants. In Serbia, according to data for 2014, this indicator was 7.0% while the average EU level (28) 7.2%. Yet the costs required to finance the number of employees are high when you take into account that in Serbia, in the economy, there are employed only 34.2% of the population, while the percentage in the EU is 45.2.

Law on the Method of Determining the Maximum Number of Employees in the Public Sector, which was adopted in July 2015 is a legal basis for determining the maximum annual number of employees in the period 2015-2018 by individual institutions, in line with the expected improvement of their productivity to which should come after the reorganization. The Government will adopt a decision on the maximum number of employees for each institution within the government sector to which the maximized number of permanent employees will relate. Total number of employees in the government sector, after implementation of this decision, will be reduced by 14,500 employees in relation to the data from the Register at the end of December 2014. Measures will also be taken to allow reduction in temporary employment within the allowable (10% of the total number of full-time employees).

Adopting the new Law on the Public Sector Employees' Salary System, a comprehensive reform of the salary system in the public sector has begun. Salaries in various segments of the public sector are regulated by different regulations, thus hindering comparability, control and handling the salary system in public sector. The umbrella law on salaries of the public sector employees, which adoption is planned by the end of 2015, creates a legal basis for harmonization of the tax base, reducing the number of coefficients and their simplification, which ultimately should result in equal pay for equal work, regardless of a segment of the public sector an employee works in. General objectives of the reform of the salary system in the public sector are as follows: reduction in the inequality of salaries, and creation of equity through introduction of the principle of equal pay for equal work, strengthening the budget control and handling of the wage bill and increasing the transparency of the system. In addition, the broader objective of the reform of public administration in which context the salary reform is placed, is also strengthening the impact and effectiveness of public administration.

By the end of February 2016, it is expected that the data in the Register of Employees are supplemented by titles and job descriptions in the catalogue of jobs and professions in the public sector (by area). Catalogues constitute a list, classification and evaluation of jobs, which is one of the most important steps in implementation of the reform of the payment system. In addition to job titles or professions in which the jobs are performed in the workplace, the catalogue also contains a typical job description, required qualifications, additional skills and exams / certificates, as well as the required experience to work on such jobs. Subsystems of the public sector, by which the catalogues have been designed are as follows: state authorities, autonomous province authorities and local self-government units, health care system, education system, social protection system, culture and sports. Generic jobs that appear throughout the system have been separated for the purpose of comparability.

2. Aimed at reducing different forms of budgetary support to public and state-owned enterprises, reforms of the largest public and state-owned enterprises were launched. Reducing budgetary support to such enterprises includes the following: a) restriction of direct and indirect subsidies, b) strictly limited issuance of guarantees for new loans and c) strengthening accountability and transparency in the operations of these enterprises. Reforms related to two large groups of public and state-owned enterprises.

The first group of enterprises includes enterprises in the portfolio of the Privatisation Agency, whose status will be settled either by bankruptcy or by privatization. In early February 2015, the action plan was adopted for the bankruptcy procedure for 188 enterprises. By October 2015, the bankruptcy was instituted in 160 enterprises with weak prospects for privatization, while public calls for privatization were announced for 160 enterprises. As regards a group of 17 enterprises in this category, the deadline for final resolution of their status has been extended to May 2016, and final resolution for seven enterprises is expected by the end of this year.

The second group includes public enterprises and state-owned enterprises in the energy, rail transport and road infrastructure. During 2015, in cooperation with international financial

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institutions, the process of their restructuring started, especially: PE "Electric Power Industry of Serbia", "Serbian Railways", PE "Srbijagas" and PE "Roads of Serbia". The process will be continued in 2016.

1) *PE "Electric Power Industry of Serbia".* In July 2015, the Plan of Corporate Restructuring was adopted with focus on simplifying the organizational structure and management and rationalization of the number of employees in order to avoid the need for state aid in the future. In June 2015, the Financial Restructuring Plan was adopted, which was prepared in cooperation with the World Bank and the European Bank for Reconstruction and Development (EBRD). The basic elements of the Plan are as follows: increase in revenues through improved collection and decrease in costs through increased efficiency, optimization of the procurement process and reducing the number of employees. It is necessary to implement a number of measures, so that PE "Electric Power Industry of Serbia" (*EPS*) could do business financially viable. The first steps involve an increase in electricity prices for the final customers in total amount of 12%, which has included an excise tax of 7.5% since August 2015. Also, by the end of 2015, changes to the collective agreement will be adopted so as to define optimization of the number of employees in a five-year period. The Plan of the New Management Structure was also adopted, which abolished the single level of management in all three business areas - mining, manufacturing and distribution. By July 2016, the plan is to get *EPS* transformed into a joint stock company in order to search for minority private partner who could further enhance the performance of the enterprise and provide professional management.

2) *PE "Srbijagas".* Organizational restructuring plan, adopted in December 2014, started to be implemented in June 2015. The plan includes the sale of assets that are not used for performing basic activity and resolving collection of receivables from the largest debtors, including enterprises: HIP Azotara Fertilizer Co, HIP Petrohemija and MSK Kikinda. In the area of financial restructuring, which is prepared with the support of the World Bank, and which will be adopted in the first half of 2016, the emphasis is on achieving long-term financial sustainability and competitiveness. Also, in cooperation with the Ministry of Mining and Energy, defining the conditions for hiring an independent auditing firm is under way, so as to view the real financial condition of the enterprise and define a restructuring plan, or measures that can be undertaken in 2016. The aim of these measures is to stop further deterioration of the financial position of PE "Srbijagas" and eliminating the need for additional state aid in line with the fiscal program.

3) *"Serbian Railways" JSC* The plan of corporate and financial reorganization, which began in 2015, involves the organizational and statutory changes. The company has been divided, in accordance with the experiences from the EU countries, into the companies in the field of passenger transport, cargo transport, a company that will deal with infrastructure and the holding company. Changes will be accompanied by the reorganization of management. The restructuring plan includes changes to disposal of property, transport networks and rationalization of number of the employees. The Freight Transport Sector shall not receive subsidies from the budget and shall operate according to the market principles from January 2018, in accordance with the recommendations of the World Bank. In January 2016, fees for the use of railway infrastructure will be introduced, as part of the opening of the market for rail transport. Reorganization and improvement of business plans of companies for passenger traffic and infrastructure will also be continued, with the aim of strictly limiting state aid in the medium term. In October 2015, in cooperation with independent consultants and with the assistance of the World Bank, the EBRD and the European Union, the plan was prepared and adopted covering the overall corporate and financial restructuring. The plan provides for a reduction of staff in the next five years. The inventory of assets and liabilities of the company is in progress, with a view to completing their allocation to the newly established companies by January 2016, while the process of independent audit of assets and separation process will be completed by June 2016. It has also been agreed that the new companies take full responsibility for the payment of their liabilities toward *EPS* and do not increase days of default in payments to *EPS*. Also, the election process will continue regarding the management of the newly formed company within the "Serbian Railways" JSC, in accordance with the restructuring program.

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4) *PE "Roads of Serbia"*. Tolls will be discussed, and efforts will also be made to improve road maintenance contracts and eliminating administrative barriers. The aim is to save money and increase efficiency of the system and thus reduce the need for subsidies from the budget. Options for construction and maintenance of roads through concessions will be considered. Plans of corporate and financial restructuring will be developed during 2016 in collaboration with the World Bank.

To ensure cost savings arising from the corporate and financial restructuring of the largest state-owned/public enterprises, at the same time a set of reforms has been implemented in the area of public finance management in the segment of business operations of the government with public and state-owned enterprises.

In order to strengthen financial discipline in the public sector, the effect of the Law on Payment Deadlines in Commercial Transactions was extended by amendments to the Law in July 2015, so that it also applies to transactions among public sector institutions. Amended provisions of the Law shall apply as of 1 January 2016. The Law establishes monitoring and control mechanisms of applying the provisions relating to payments between units of the public sector. The mechanisms that enable consistent implementation of the Law relate to, among other things, reduction in transfers from the budget, where the measure may be applied, or in case that the state-owned or public enterprise receives some form of budget support from the budget, as well as penalties for the responsible persons determined in accordance with the Law.

Considering the height and impact on the deficit payments based on activated guarantees, since the beginning of 2015, the government has limited the issuance of new guarantees for state-owned enterprises. Issuing the guarantees for loans for liquidity has been entirely suspended. Possibility of issuing guarantees was left only in case of capital project loans, with respect to the limit that is determined by the objective of public debt sustainability. With a view to implementing these structural measures, the Public Debt Law was amended in July 2015 by introducing provisions that do not allow the issuance of guarantees for loans for liquidity.

At the beginning of 2015, the Law on the Development Fund of the Republic of Serbia was also amended by deleting provisions which stipulated that the guarantees issued by the Development Fund were guaranteed by the Republic of Serbia as well.

3. In accordance with the adopted strategic documents and systemic laws in the health sector, the reforms will continue ensuring increase the health system efficiency, increasing the financial sustainability of the health care system, improving the health of the population and improving the quality of health care. These objectives can be achieved by strengthening the preventive medicine, as well as improving the system of accreditation and certification of the health institutions, with the establishment of a system of mandatory certification of minimum standards (e.g. patient safety). As part of fiscal consolidation, rationalization of the health system will be implemented primarily through the reduction of non-medical staff, improving the mechanisms for selecting priorities in procurement of new equipment and better control of expenditures for medical services. Thus, the efficiency of the health institutions will be increased, evaluation of their actual effects provided and quality of the health care increased.

- Improving the financing of the health system through introduction of a system for establishing the National Health Accounts (NHA) - which provides reliable information on the financial resources allocated to health care and ways of their use. For a better inspection of the flows of money in the health service (budget allocations for the health service, private health service, donations in the health service, etc.), the National Health Accounts will be created. The National Health Accounts is an instrument for monitoring the flow of money through the health system of the country, increasing the efficiency of health services and equitable distribution of available resources in the health system of the Republic of Serbia.
- Continuing the computerization of the health system - consists of connecting the health institutions into a single data systems, which started in 2015.

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- Improvement of the staff base in the Health Institutions Network Plan for the purpose of reviewing staffing in accordance with the norms and standards.
- Defining the role of the private sector in providing health services to the population.

4. Reform activities within different sub-systems of the public finance management (PFM) are included in the Draft Program of Public Finance Management Reform from 2016 to 2020 (the Program PFMR). The Program PFMR objective is to provide a comprehensive and integrated framework for the planning, coordination, implementation and monitoring of progress in the implementation of sustainable activities so as to improve macroeconomic stability, ensure efficient and purposeful deployment and use of public resources for realization of the national priorities and improve the services provided by the government administration in the Republic of Serbia, while increasing transparency and the overall functionality of the public finance management and fulfilment of the necessary conditions for accession to the European Union (EU). Also, Draft Strategy for Development of Internal Financial Control in the Public Sector from 2015 to 2019 has been prepared, and a Draft Anti-Fraud Strategy is in preparation.

High level of the grey economy, which negatively affects the budget deficit and conditions of business operations and investments, to a large extent is a consequence of the inefficient mechanism of control, assessment and collection of taxes and other public revenues. Inadequate organization of work of the Tax Administration and its processes, with inadequate scope and structure of human resources and the lack of a proper system for risk assessment precluded the limited resources from diverting to taxpayers who are most likely to violate tax regulations. On the other hand, the way of functioning of the Tax Administration carried out so far often had negative effects on the taxpayers who fully and timely perform their obligations to the state, through the unequal practice of interpretation of tax regulations, complicated administrative procedures, all leading to an increase in the risk and cost of doing business in Serbia.

The *Program of Transformation of the Tax Administration for the Period 2015-2020* was adopted in June 2015 and includes quarterly indicators of the work success relating to assessment of compliance with the targets. New, well-equipped data centre has become fully operational this year. Introduction of electronic services has made possible for taxpayers to carry out electronically a larger number of procedures for preparation and payment of taxes, thereby contributing to a more transparent work of the tax authorities, and simplification of tax procedures, especially in terms of reducing the number of tax returns, optimization of deadlines for submitting and verifying the correctness of the calculated and paid taxes. In this way, costs have been reduced regarding fulfilment of tax obligations and tax collection improved. However, maintaining the number of employees in the information technology department has become a challenge due to salary competition from the private sector. The European Commission has confirmed that there has been progress in the field of taxation and recommended further simplifying and integrating of tax procedures and better training of staff, as well as improvement of operational activities against the grey economy.

It is necessary for the branch offices of the Tax Administration to improve their way of working with taxpayers. The Draft Program PFMR and Program of Transformation of TA provide for creation of separate organizational units for the provision of services to taxpayers in order to improve communication and interaction with taxpayers, including timely provision of updated information on changes in laws and regulations.

5. Structural reforms of the public sector include measures concerning reforms of the defence system arising from the Strategic Defence Review of the Republic of Serbia and relate primarily to:

- contribution to protection of the defence interests of the Republic of Serbia and active participation in building and maintaining peace in the region and the world;
- implementation of the defence policy in order to create conditions for preservation and protection of the defence interests of the Republic of Serbia;

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- maintaining the operational and functional capabilities of the Serbian Armed Forces to carry out missions and tasks defined by the Defence Strategy of the Republic of Serbia;
- optimization of the organization and rationalization of the staffing of the Ministry of Defence and the Serbian Armed Forces;
- provision of projected level of war material reserves;
- preparation of defence entities in order to create conditions for defence of the Republic of Serbia.

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Appendix 1: Projection of the Basic Macroeconomic Indicators

<i>In percentages</i>	2015	2016	2017	2018
GDP growth at constant market prices	0.8	1.8	2.2	3.5
GDP level at current market prices (billion dinars)	3,964.4	4,137.7	4,377.2	4,711.6
Sources of growth: percentage changes at constant prices				
Private consumption expenditure	-0.5	0.2	1.0	2.0
Government consumption expenditure	-2.2	0.9	-2.8	0.3
Gross fixed capital formation	8.2	6.6	6.2	5.5
Changes in inventories and net acquisition of variables as a % of GDP	0.0	0.0	0.0	0.0
Exports of goods and services real growth	7.8	7.7	7.0	6.7
Imports of goods and services real growth	6.0	5.8	4.4	4.3
Contribution to GDP growth				
Final domestic demand	0.8	1.6	1.5	2.7
Investment	1.5	1.3	1.3	1.2
Private consumption	-0.4	0.1	0.7	1.5
Government consumption	-0.4	0.2	-0.5	0.0
Change in inventories and net acquisition of valuables	0.0	0.0	0.0	0.0
External balance of goods and services	0.0	0.1	0.7	0.8
Growth of Gross Value Added				
Agriculture	-8.3	8.5	2.7	3.1
Industry	7.6	3.4	4.8	6.7
Construction	9.5	7.6	7.2	6.6
Services	-1.1	-0.6	0.4	1.8
Contribution to Gross Value Added growth				
Gross Value Added growth	0.8	1.8	2.2	3.5
Agriculture	-0.8	0.8	0.3	0.3
Industry	1.8	0.9	1.2	1.8
Construction	0.5	0.4	0.4	0.4
Services	-0.7	-0.3	0.2	1.0
Prices				
GDP deflator	1.5	2.6	3.5	4.0
CPI change (annual average)	1.5	2.8	3.9	3.9
External sector developments				
Export of goods in mill EUR	11,381	12,347	13,201	14,058
Import of goods in mill EUR	15,254	16,192	17,135	18,053
Trade balance (EUR)	-3,873	-3,845	-3,934	-3,994
Exports of goods and services (% of GDP)	47.4	50.1	51.0	50.9
Imports of goods and services (% of GDP)	57.2	59.1	59.6	58.8
Net exports of goods and services (% of GDP)	-9.8	-9.0	-8.6	-7.9
Current account balance (% of GDP)	-4.7	-4.6	-4.3	-4.2
Fiscal indicators				
Consolidate fiscal balance (% of GDP)	-4.1	-4.0	-2.6	-1.8
Consolidate public revenue (% of GDP)	42.2	41.3	40.3	39.0
Consolidate public expenditure (% GDP)	46.3	45.2	42.9	40.8
General government debt (% GDP)	76.6	79.7	79.0	75.9

Appendix 2. Fiscal framework of the general government in 2016

	General Government	Republic Budget (incl project loans)	Republic Budget	Project Loans	Local Government	Cities and Municipalities	AP Vojvodina	Road Fund	SSO	Pension Insurance Fund	Health Fund	Unemployment Fund	Military Health Fund
1	2=3+6+9+10	3=4+5	4	5	6=7+8	7	8	9	10=11+12+13+14	11	12	13	14
Public revenues	1.709,7	953,1	953,1	0,0	213,3	195,7	17,6	19,9	523,5	361,4	138,9	21,0	2,1
Current revenues	1.697,1	943,4	943,4	0,0	210,9	193,6	17,3	19,9	523,0	361,4	138,9	20,5	2,1
Tax revenues	1.513,0	829,6	829,6	0,0	166,0	154,8	11,2	0,0	517,4	360,7	135,1	19,8	1,7
Personal income tax	149,5	45,4	45,4		104,1	99,1	5,0						
Social contributions	517,4								517,4	360,7	135,1	19,8	1,7
Corporate income tax	64,4	58,3	58,3		6,1		6,1						
VAT	427,0	427,0	427,0										
Excises	254,3	254,3	254,3										
Customs	34,8	34,8	34,8										
Other tax revenue	65,5	9,8	9,8		55,8	55,8							
Non-tax revenue	184,2	113,8	113,8	0,0	44,9	38,8	6,1	19,9	5,6	0,7	3,8	0,7	0,4
Grants	12,6	9,7	9,7	0,0	2,4	2,1	0,3	0,0	0,5	0,0	0,0	0,5	0,0
Public Expenditures	1.873,2	753,7	740,7	13,1	283,4	237,7	45,7	51,6	784,6	537,9	216,4	24,4	5,8
Current expenditures	1.720,8	669,0	669,0	0,0	246,5	203,0	43,6	21,8	783,5	537,7	216,2	24,2	5,4
Expenditures for employees	371,5	202,2	202,2		70,0	45,9	24,2	1,0	98,2	3,1	93,5	1,6	0,0
Social contributions	60,5	33,5	33,5		11,5	7,0	4,5	0,2	15,3	0,4	14,6	0,3	0,0
Purchase of goods and services	267,8	74,0	74,0		68,4	65,8	2,6	20,4	104,9	2,2	98,3	1,1	3,4
Interest repayment	144,9	139,9	139,9		4,8	4,8		0,2					
Subsidies	112,5	79,4	79,4		33,1	26,5	6,6						
Social assistance and transfers	716,2	114,0	114,0		38,6	38,0	0,6		563,5	531,7	9,0	20,9	1,8
of which pensions	507,9								507,9	507,9			
Other current expenditures	47,5	25,8	25,8		20,1	14,9	5,1		1,5	0,3	0,8	0,4	0,1
Capital expenditures	118,0	50,9	37,8	13,1	36,2	34,4	1,8	29,8	1,1	0,3	0,2	0,2	0,4
Net lending	2,4	1,8	1,8		0,6	0,3	0,3		0,0	0,0	0,0	0,0	0,0
Activated guarantees	32,0	32,0	32,0										
Fiscal balance excl. transfers from/to other levels	-163,5	199,4	212,4	-13,1	-70,1	-42,0	-28,1	-31,7	-261,1	-176,5	-77,4	-3,4	-3,7
Transfers from other levels of government	397,9	0,0	0,0	0,0	68,7	41,5	27,3	7,5	321,7	228,8	80,6	9,6	2,7
Republic Budget	334,3				68,7	41,5	27,3	7,5	258,1	219,8	28,2	9,6	0,5
Cities and Municipalities	0,0								0,0	0,0	0,0	0,0	0,0
AP Vojvodina	0,0								0,0	0,0	0,0	0,0	0,0
Pension Insurance Fund	52,3								52,3	0,0	50,1	0,0	2,2
Health Fund	3,2								3,2	3,2	0,0	0,0	0,0
Unemployment Fund	8,2								8,2	5,8	2,4	0,0	0,0
Military Health Fund	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
Transfers to other levels of government	397,9	334,3	334,3	0,0	0,0	0,0	0,0	0,0	63,6	52,3	3,2	8,2	0,0
Republic Budget	0,0								0,0	0,0	0,0	0,0	0,0
Cities and Municipalities	41,5	41,5	41,5						0,0	0,0	0,0	0,0	0,0
AP Vojvodina	27,3	27,3	27,3						0,0	0,0	0,0	0,0	0,0
Pension Insurance Fund	228,8	219,8	219,8						9,0	0,0	3,2	5,8	0,0
Health Fund	80,6	28,2	28,2						52,5	50,1	0,0	2,4	0,0
Unemployment Fund	9,6	9,6	9,6						0,0	0,0	0,0	0,0	0,0
Military Health Fund	2,7	0,5	0,5						2,2	2,2	0,0	0,0	0,0
Road Fund	7,5	7,5	7,5						0,0	0,0	0,0	0,0	0,0
Net transfers to other levels	0,0	-334,3	-334,3	0,0	68,7	41,5	27,3	7,5	258,1	176,5	77,4	1,4	2,7
Fiscal balance	-163,5	-134,9	-121,9	-13,1	-1,3	-0,5	-0,8	-24,2	-3,0	0,0	0,0	-2,0	-1,0

The table shows the approximate amount of revenue and expenditures in 2016, which is largely based on the statistical methodology of the public finance accounts rather than on the accounting methodology. Considering that there may come to changes in the amount and structure of certain categories during the budget process, these amounts are not legally binding.