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TRIP NOTES: SERBIA

Trip Notes: Serbia

Key notes from our recent trip to Belgrade: October 3rd- 4th

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On October 3-4th we traveled to Belgrade, where we met with prominent officials from the IMF, the World Bank, the Central Bank, the Fiscal Council, Research Institutes as well as several prestigious politicians and market participants. The main focus of our discussions was the rapid deterioration of public finances and the urgent need for comprehensive fiscal consolidation visa vie the government's response to the fiscal crisis. In addition, we discussed the multiple challenges that the Serbian economy is confronted with. Finally, we identified the key constraints to long-term growth. From that point of view, we concluded that removing bottlenecks in the labor and product markets and improving the business environment is essential to mitigate the impact of fiscal consolidation.

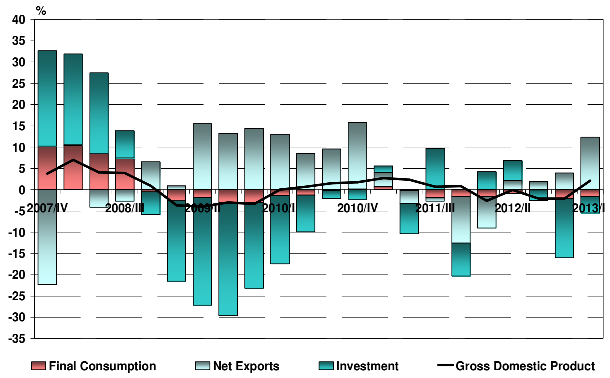
Key points

- Driven by robust net exports, the economy is expected to grow by approximately 2% in 2013. The negative base effects from net exports plus the fiscal drag from the implementation of the austerity package will make such a growth rate harder to repeat in 2014.
- The probability of early parliamentary elections in the spring has increased despite the successful reshuffling of the government coalition
- The new package of fiscal consolidation is a welcoming first step to fix public finances; Additional spending cuts will be required in 2014 to stabilize public debt in the medium-term
- Serbia is a country of high upside pontential. It has key comparative advantages in its geostrategic position, in education, in technological readiness, in agribusiness
- The key policy priorities in revamping the economic model of Serbia should focus on:
    - ➢ Fixing public finances so as to avoid a painful financial markets shut out
    - ➢ Reducing the size of the government - pushing the privatization agenda
    - ➢ Removing bottlenecks from the labor and products markets
    - ➢ Abolishing bureaucratic red tape in order to improve the business environment

The economy turned the corner on automotives industry and agriculture sector boost in 2013. The sustainability of the net exports boom puts output recovery at risk in 2014.

The economy has recently emerged from a double dip recession. After a lackluster growth recovery in 2010–11, the economy again slipped into recession in 2012 due to severe weather conditions, recession in the main trade partner euro area and weak domestic demand dynamics (Figure 1). Economic activity rebounded by 2.7% yoy in Q1, 0.3% yoy in Q2 and skyrocked to 3.2% yoy in Q3 according to the flash estimate. Factoring in a weaker Q4, full year growth is expected to average 1.8% in 2013.

Figure 1
GDP growth drivers



Source: National Statistics, Eurobank Research

Yet, our discussants pointed out that output recovery is uneven and fragile. Growth is entirely driven by net exports on the demand side. On the supply side, this is a a reflection of the robust performance of three key sectors: agriculture, automobiles and petroleum products industry. After a steep decline last year, agriculture has performed better than expected in 2013. More importantly, the manufacturing output from large-scale investments in the NIS refinery and FIAT automotive factories is now driving exports growth. On the other hand, domestic demand remains depressed and unable to support growth. Domestic demand is constrained by declining public and private consumption dynamics, negative real incomes, labor market inefficiencies, private sector deleveraging and fiscal adjustment.

The sustainability of the net exports boom puts the growth recovery at risk next year. In our view, the growth record of this year will be more difficult to achieve in 2014 because of the negative base effects from automotive exports and the robust performance of agriculture this year. On the positive side, the recovery of Euroarea, the main trade partner and main source of capital flows of Serbia may help exports performance. In addition, the fiscal drag from the austerity measures already announced. plus the urgent need for further fiscal adjustment will weigh negatively on domestic demand. All in, we have penciled in a growth forecast at 1.2% in 2014, that reflects the the diverse performance of those two GDP components.

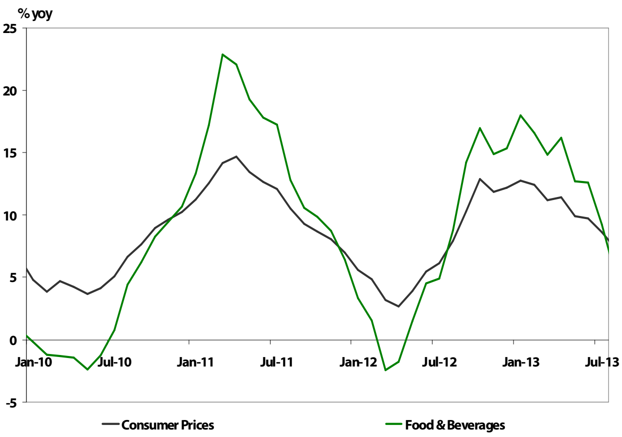
Serbia: Eurobank EFG Forecasts

	2011	2012	2013	2014
Real GDP (yoy%)	1.6	-1.7	1.8	1.2
Inflation (yoy%)				
CPI (annual average)	11.1	7.3	8.3	5.0
CPI (end of period)	7.0	12.2	5.0	4.5
Fiscal Accounts (%GDP)				
General Government Balance	-4.9	-6.4	-6.5	-5.4
Gross Public Debt	48.2	59.3	62.7	68.8
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	23.0	23.9	24.0	23.0
Wage Growth *(total economy)*	11.1	8.9	-5.5	-3.5
External Accounts				
Current Account (% GDP)	-9.1	-10.5	-6.0	-5.0
Net FDI (EUR bn)	1.8	0.2	0.5	1.0
FDI / Current Account (%)	63.7	7.4	45.0	60.0
FX Reserves (EUR bn)	12.1	10.9	10.5	10.0
Domestic Credit	**2011**	**2012**	**2012**	**Q2 2013**
Total Credit (%GDP)	72.2	66.2	66.2	62.7
Credit to Enterprises (%GDP)	40.5	36.1	36.1	33.3
Credit to Households (%GDP)	22.0	19.3	19.3	18.9
Private Sector Credit (yoy%)	5.9	9.7	9.7	-0.6
Loans to Deposits (%)	141.9	144.6	144.6	140.7
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	10.00	10.00	9.75	9.50
EUR/RSD	114.10	115.00	115.00	117.00

Source: National Sources, IMF, Eurobank Research & Forecasting

The good news is that external imbalances and inflation concerns are declining. Headine inflation-4.9% in September vs. 12.2% in last December- has returned within the central bank target range for the first time since July 2012 (Figure 2). Inflation is now seen at 5% by the end of 2013, thus providing some breathing space for consumers. Easing inflationary pressures have allowed NBS to pursue an accommodating monetary policy despite high fiscal risks. NBS has delivered a cumulative of 175bps cuts since February -from 11.75% to 10% but now is expected to leave rates unchanged until year end until fiscal side risks have subside.

Figure 2
Easing inflation measures in Serbia



Source: National Statistics, Eurobank Research

External imbalances have decreased but are still a source of concern. The current account deficit is expected to decline to 6% of GDP in 2013 and further improve to 5% in 2014 vs. 10.5% in 2012. The high level of international reserves coverage provides also some comfort against potential BoP pressures. The high level of capital adequacy in the banking sector is also another mitigating factor.

Serbia is a country of high upside potential. The country has unmatched comparative advantages in education, in technological readiness, in agribusiness. The population of Serbia has the highest English speaking proficiency in Emerging Europe. A big part of the comparative advantage lies also in its geostrategic position at the crossroads of Pan-European Corridors 7 and 10 that can turn it to a transportation and logistics hub. Serbia is the only country outside of the Commonwealth of Independent States that enjoys a Free Trade Agreement with Russia. Last but not least, Serbia has one of the lowest corporate and income tax rates across Emerging Eurpe and an attractive set of tax incentives for foreign investments.

Multiple domestic macroeconomic challenges require urgent policy response

The Serbian economy is confronted with multiple economic challenges. Those include a weak growth environment, unwinding macroeconomic imbalances, an unsustainably high primary deficit, rising public debt sustainability concerns, a high unemployment rate, a rigid business environment, a food prices driven volatile inflation, a high level of Euroization, political uncertainty to name a few. Without the shield of a new IMF agreement, Serbia could find itself in a vulnerable position in case markets or economic stress in emerging Europe reemerges.

In order to capture this potential, Serbia ought to revamp its economic model. A necessary precondition to start with, is fixing its public finances so as to avoid a painful shut out of international markets. More importantly, Serbia ought to institute a wide range of reforms in product and labor markets, in its pension system, simplify bureaucracy and push the privatization agenda. Improving the business environment will help attract more FDI inflows in the tradables sector, improve the share of private investment in output, help mitigate the impact of fiscal consolidation and finally accelerate convergence with EU living standards. In any case, a difficult adjustment with no grace period and with no easy choices and tough decisions lies ahead for the country.

The probability of early parliamentary elections in spring has increased. The reshuffling of the government coalition has averted early parliamentary elections only for the moment.

The parliamentary elections held in May 2012 led to a change of administration in the country. The change in administration culminated in the participation of the Serbian Progressive Party (SNS) in the formation of a multi party coalition government together with the Socialist Party (SPS) and its allies (PUPS and SPO-DHSS group), as well as the the party of the regions (URS) (Table 1). However, the tensions between the minor coalition partners Socialist Party of Serbia (SPS) and the party of the regions (URS) culminated in a cabinet reshuffle which was completed on Sep 3rd. In the aftermath of the reshuffle, the ministers nominated by the party of the regions (URS) departed from the cabinet.

Table 1
Parliamentary elections results, 6th May 2012

Parties	% Vote	Seats
1) Let's Get Serbia Moving-Serbian Progressive party (SPS)-Tomislav Nikolic	24.0	73
2) Choice For A Better Life- Democratic Party (DS)- B.Tadic	22.1	67
3) Ivica Dacic-Socialist Party of Serbia (SPS), Party of United Pensioners (PUPS), United Serbia (US)	14.5	44
4) Democratic Party of Serbia-DSS-Voislav Kostunica	7.0	21
5) Turnaround-Liberal Democratic Party (LDP)- Čedomir Jovanović	6.5	20
6) United Regions of Serbia (URS)-Mr. Mladan Dinkic	5.5	16
7) Alliance of Vojvodina Hungarians-István Pásztor	1.8	5
8) Party of Democratic Action of Sandzak-Dr Sulejman Ugljanin	0.7	2
9) All together-(BDU, CAH, DUC, DFVH, Slovak Party)- Emir Elfić	0.6	1
10) Albanian Coalition From Presevo Valley	0.3	1
All Other Candidates & Parties not represented in the Parliament	12.5	-
Invalid Vote	4.4	-
TOTAL	**100**	**250**

Source: National Media, Eurobank Research

The resignation of the URS leader, Mr. Mladan Dinkic, from the post of Minister of Finance & Economy led to the split of the Ministry into two individual posts and another minister without portfolio was added. The post of Minister of Finance was assumed by Mr. Lazar Krstic nominated by the SNS (Serbian Progressive Party).

The departure of the URS and its leader, former Minister of Finance Mr. Mladan Dinkic, from the government coalition has decreased parliamentary backing to a slim and fragile majority increasing worries over the stability of the current government. The new cabinet received support from the parliament members of the two biggest coalition parties (SPS and SNS) plus two minor parties (PUPS and SPO-DHSS group) and various independent MPs. As a result, the cabinet was endorsed by 134 MPs out of a total 250 MPs, 65 were against while 51 abstained.

The stability of the current government is at stake for one more reason. The agenda of the reshuffled government includes also the implementation of a new fiscal consolidation and structural reforms package in the areas of public enterprises and pension system with an eye on negotiations about a new IMF agreement.

Inevitably, the tensions between coalition partners may rise again in the near future. Implementing spending cuts in pensions and public wages may again be a point of confrontation between the coalition partners. Spending cuts in pensions are strongly opposed by PUPS which controls 12 seats in the parliament.

On the other hand, the popularity of the main ruling party, the Serbian Progressive Party (SNS) which collected 24% of the vote in May 2012, is still very high. The recent opinion polling suggests that SNS might be able to win a victory with a sizeable margin to be able to rule without its current coalition partner. The popularity of the SNS leader, Mr Aleksandar Vucic who succeeded the current President of the Republic, Mr. Tomislav Nikolic, in the leadership of the party is the highest among politicians. His popularity is supported by the anticorruption campaign that culminated in the arrest of the wealthiest man, Mr. Miroslav Miskovic, in last December.

Further on, early parliamentary elections could depend upon two more issues: The beginning of accession talks with the EU authorities and the forthcoming early municipal elections of Belgrade in next spring. The repercussions of those events could create a political momentum that would lead to early parliamentary elections held at the same period.

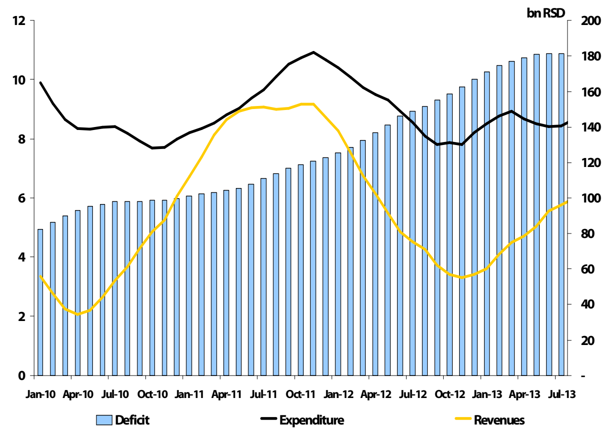
This government can claim credit for the improvement in the EU accession project. Serbia was awarded EU candidate status only in March 2012 while the EU council decided in late June 2013 that accession negotiations could begin by the end of January 2014. The prospects for EU accession talks could be made easier by the progress recorded in the implementation of the landmark agreement reached in last April with Kosovo authorities in order to normalize relationships. If the turn-out of the ethnic Serbs in the forthcoming municipal elections of Kosovo (held in early November) and their co-operation with the new institutions is good enough to support the case of visible and sustainable progress in the normalization of relationships, then EU accession could receive another boost.

The forthcoming municipal elections of Belgrade next spring are another issue that could trigger early parliamentary elections. This is an extremely high profile case because of the large size of the electorate of the capital city and the circumstances under which elections were provoked. Socialists and Progressives in the city assembly voted to dismiss the mayor of Belgrade, Mr Djilas. Mr Djilas, the outgoing mayor of Belgrade took over the leadership of the Democrats from the outgoing President, Mr Tadic. Socialists, which had been part of the city's governing coalition together with the Democrats, turned against him.

The rapid deterioration of the public finances in 2008-2012 calls for the adoption of a sizeable and comprehensive fiscal consolidation plan

The highly expansive and untargeted fiscal policy followed by the previous administrations led to an unsustainable widening of the consolidated government deficit in 2008-2012. The consolidated government deficit widened from 2.6% of GDP in 2008 to 4.9% in 2011 and further on to 6.4% in 2012 (or 7.6% of GDP in 2012, including the resolution costs of state-owned banks which the government treats as items below the line). Despite supplementary fiscal consolidation measures introduced by the incoming government in September 2012 and June 2013, the fiscal position of the country showed no visible signs of improvement. Significant post-election current expenditures fiscal slippage, lower than projected nominal growth, the losses of the subsidized public sector companies, the lack of adequate budget execution plus the recapitalization costs of non-viable state-owned banks weighed further negatively on the fiscal results of 2012-2013 (Figure 4).

Figure 4:
Twelve month rolling fiscal deficit

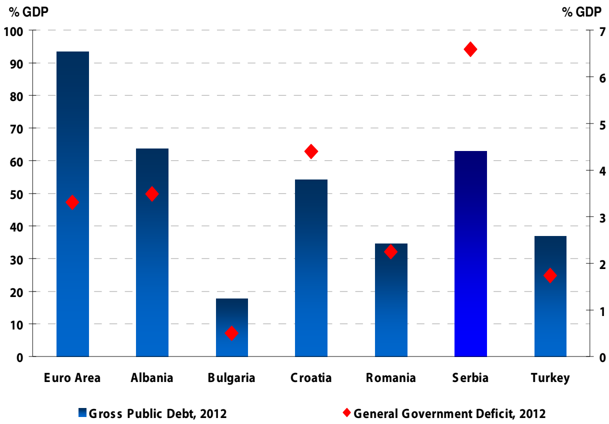


Source: Ministry of Finance, Eurobank Research

The budget implementation throughout the first nine months of 2013 has shown some improvement but also illustrated that the achievement of the revised fiscal target at the consolidated government level (5.2% of GDP vs. 3.6% of GDP initially) will be very challenging if not already out of reach. The consolidated government deficit came at RSD 139.6bn in 9M-2013 vs. 148.3bn in Jan-Sep2012. In terms of projected GDP, the consolidated government deficit stood already at 3.7% in 9M-2013 down from 4.4% in 9M-2012.

The deterioration in the fiscal position is also reflected in the rapid rise of the debt. The public debt to GDP ratio is expected to reach 62.7% of GDP in 2013 (IMF latest forecast: 67.5% including below the line items) up from 59.3% of GDP in 2012. This stands significantly above the 45% threshold of the fiscal rule compared to 48.2% in 2011 and only 29.2% in 2008. Those metrics put Serbia among the most indebted countries in the region (Figure 5). The deterioration in the fiscal position requires a sustained, consistent and sizeable consolidation effort to restore fiscal position soundness and improve investors' confidence.

Figure 5
Public Debt & Fiscal Deficits in Euro area & New Europe



Source: IMF WEO, Eurobank Research

The new package of fiscal consolidation is a first welcoming step towards fixing public finances of Serbia, but doesnot put enough emphasis on mandatory spending cuts

On October 8th, the new Minister of Finance Mr. Lazar Krstic announced a new package of fiscal consolidation measures (Appendix). The consolidation package envisages a cumulative adjustment of 4.5%-5% of GDP in 2014-2017 aiming to stabilize public debt below 75% of GDP.

More than half of the savings are expected to materialize in 2014. The Ministry of Finance anticipates a total of €600-800 mn savings (1.5-2%) in 2014 only. The fiscal strategy of the Ministry envisages that the consolidated government fiscal deficit will be contained to 5.4% of GDP in 2014 from an expected 6-6.5% of GDP in 2013. If items below the line are included in the fiscal result, the consolidated government deficit is expected to reach 7.1% in 2014, then decline to 5.2% in 2015 and further to 3.2% in 2016

In our view, the new package is a welcome and necessary first step towards fiscal consolidation. Having said that, some of the content of this package (particularly on the areas of fighting tax evasion and improving the business environment) has to be further identified and quantified.

However, the package doesnot address the fundamental drivers behind the deterioration in public finances. The package doesn't put enough emphasis on expenditure consolidation. Emphasis on expenditure consolidation is even more important in the case of Serbia because the room to increase revenues is relatively constrained by the poor domestic demand and limited by the tax rate competition in the region.

The consolidation and rationalisation of public expenditure ought to be an integral part of a sustainable fiscal consolidation plan. Public expenditures had already reached a historic high at 49.2% of GDP in 2012 up from 42.2% in 2005. From a qualitative point of view, mandatory spending represents two thirds of total government spending. The largest items of public spending are pensions and public wages. The wage bill in terms of GDP stood above the emerging markets average and close to that of the advanced economies in 2012. The level of pension expenditure in terms of GDP stood significantly above those in the emerging markets and the advanced economies.

On the other hand, there are important implementation risks surrounding the fiscal consolidation package. The authorities have not established a credible record of commitment to fiscal discipline. Moreover, the adopted measures are a compromise between the different factions within the coalition government. Some of the minor coalition partners, upon which the current government depends for its survival, are opposing deeper spending cuts.

The reaction of the official sector is also different this time compared to the first package announced in September 2012. The reaction of the IMF mission towards the fiscal package is a positive one. The IMF mission statement points out that the measures are appropriate urging that the steadfast implementation of those measures in 2014 would be an important step in the right direction. In addition, the IMF mission has pointed out that additional fiscal consolidation would be needed to reverse the rising trend of public debt.

The reaction of the Fiscal Council, an independent institution, is also supportive. However, the head of the Council, Professor Pavle Petrovic described this package as the first step in a three-year adjustment process, and recommended to include more categories of pensioners and public employees in the wage and pension cuts. Moreover, the Fiscal Council argued that some of the measures identified may not provide the anticipated result. In turn, additional measures may be required as early as in the beginning of 2014.

Reliance on foreign financing has increased sovereign funding and debt servicing costs. Bilateral loans can provide no substitute for a new IMF agreement

The vast majority of the public debt (more than 80%) is denominated in foreign currency which makes it sensitive to exchange rate fluctuations. The favorable funding conditions in emerging Europe markets and the lack of a Dinar denominated liquid bond market has favored foreign financing.

As a result, the re-financing of the public debt has become an issue of greater attention. The rapid rise in public debt has increased both servicing and funding costs. Debt servicing is projected to account for approximately 6% of the total government spending in 2013 vs. only 1.3% in 2008. Debt servicing has climbed to 2.6% of GDP in 2013 vs. only 0.7% of GDP in 2008.

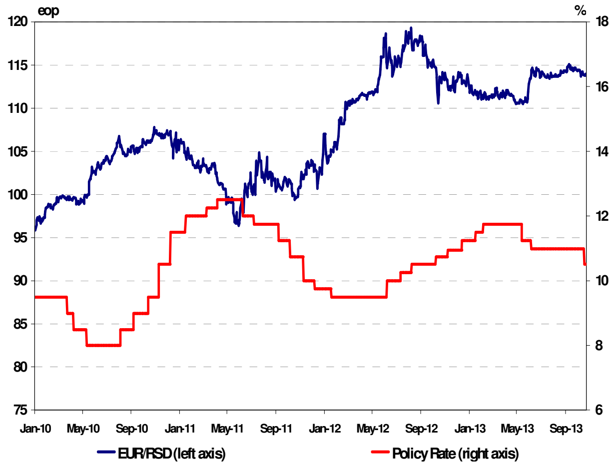
The rise in emerging markets' yields has made reliance on foreign refinancing more costly and hard to find. After two successful Eurobond issuances in late 2012, political uncertainty, the lack of a coherent fiscal consolidation plan plus the deterioration in the financing conditions in emerging markets led yields to unsustainably high levels in May-June2013. The pressure on domestic yields peaked after the replacement of the outgoing Minister of Finance Mr. Mladan Dinkic in late August.

The successful reshuffling of the government and the introduction of the new fiscal consolidation package provided a temporary relief to market worries and improved appetite for Serbian debt. The initial reaction of the financial markets was further reinforced by the decision of the FED to continue the QE program in mid September. The yields of the domestic 10Y Eurobond declined further to 6.6% on October 8th vs. a year high at 7.2% recorded after the resignation of Minister Dinkic. EMBIG spreads an illustration of the country risk premium, declined from 450bps on October 7th to 380 bps in mid October. The depreciation trend of the domestic currency stopped in October. After depreciating as much as 115.2/€ on September 10, Dinar recouped some of its losses trading below 114/€ in late October (Figure 6).

In any case, the original plan provided for tapping the Eurobond market in the last quarter of the year in order to meet the gross financing requirement in 2013. However, Serbian authorities have decided to recourse to bilateral loans as a means of reducing sovereign funding costs. In that direction, they have announced that they are going to hold negotiations with United Arab Emirates (UAE) in order to secure a USD2-3bn bilateral loan of a maturity 20-30 years at very favorable cost (0.5%-1%).

The proceeds from this loan would be utilised in order to refinance more expensive borrowing and also utilize some of the funds for public investments. UAE has already been involved in a number of investment projects that are not limited to the restructuring and rebranding of the national airliner Air Serbia (JAT Airways). Although securing such a loan would be a catalyst for driving yields lower, it is still not substitute for a new IMF agreement.

Figure 6
FX & Policy rate



Source: NBS, Bloomberg, Eurobank Research

We delved into the necessity of a new IMF agreement as a real policy option in order to restore investors' confidence and act as a driver for the implementation of so much needed structural reforms in the domestic economy.

An ambitious reform agenda is essential to remove competitiveness bottlenecks in order to unlock the growth potential and mitigate the impact of fiscal drag in the medium term

This part aims to summarize our findings from our discussions on the competitiveness bottlenecks in Serbia. All our discussants identified the lack of competitiveness as one of the binding constraints to long term growth. From that point of view, they recognized the need to improve the business environment as a means of attracting more FDI inflows in the tradables sector.

The country has had a delayed transition from a central planning to a market based economy in late 2000. Despite significant progress in transition in the first half of the past decade, reforms in number of areas remained incomplete. Reforms fatigue had led to a relatively weak business environment, structural bottlenecks which in turn magnified fiscal vulnerabilities. The brisk growth in 2004-2008 masqued some of these issues, preventing the economy from attracting more FDI investment in the tradables sector. Despite reintegration in the world economy, the overall level of competitiveness in Serbia is still low not only by international comparison but also than some of its regional peers. This is reflected in the surveys of the World Economic Forum and the World Bank:

Table 2
The Global Competitiveness Index 2013- 2014

	Rank (out of 148)	Score (1–7)
GCI 2013–2014	**101**	**3.8**
GCI 2012–2013 (out of 144)	95	3.9
GCI 2011–2012 (out of 142)	95	3.9
Basic requirements (40.0%)	**106**	**4.0**
Institutions	126	3.2
Infrastructure	90	3.5
Macroeconomic environment	136	3.4
Health and primary education	69	5.7
Efficiency enhancers (50.0%)	**92**	**3.8**
Higher education and training	83	4.0
Goods market efficiency	132	3.6
Labor market efficiency	119	3.9
Financial market development	115	3.5
Technological readiness	60	3.9
Market size	69	3.7
Innovation and sophistication factors (10.0%)	**125**	**3.0**
Business sophistication	137	3.2
Innovation	112	2.9

Source: World Economic Forum, The Global Competitiveness Report 2013-2014

Table 3
Ease of Doing Business: Two opposite examples

Year of Report	Starting a Business					Dealing with Construction Permits			
	Rank	Procedures (number)	Time (days)	Cost (% of income per capita)	Paid-in Min. Capital (% of income per capita)	Rank	Procedures (number)	Time (days)	Cost (% of income per capita)
2004	..	12	56	15.9	113.4	..	..	..	..
2005	..	12	56	15	101.6	..	..	..	..
2006	..	11	23	12	7.6	..	19	205	3,896.00
2007	..	11	23	10.2	7.6	..	18	204	3,055.30
2008	..	11	23	8.9	8	..	18	204	2,513.60
2009	..	11	23	7.6	6.9	..	18	279	2,017.50
2010	..	7	13	7.1	6.1	..	18	279	1,767.20
2011	..	7	13	7.9	6	..	18	279	1,690.00
2012	91	7	13	7.8	6	178	18	279	1,603.80
2013	42	6	12	7.7	0	179	18	269	1,427.20

Source: World Bank Doing Business Reports 2004-2013

- **World Economic Forum rankings**: Serbia scores relatively low in terms of competitiveness based on the rankings of the World Economic Forum (101st out of 148) with a slight deterioration over the last two years. The areas which carry the lowest rankings and require immediate attention are: Macro-environment, business sophistication, goods market efficiency, institutions, labor market efficiency, financial market development (Table 2).
- **World Bank Doing Business rankings**: According to the World Bank cross country surveys there is a lot of room for improvement in the business environment. Although Serbia has made a lot of progress in starting a business and registering property, it still has deteriorated across others so that the overall ranking score has remained almost the same in 2008-2012.

Yet, fostering an ambitious reform agenda to promote competitiveness is absolutely necessary at this point. First of all, improved competitiveness will act as a catalyst in creating new jobs in the tradables sector. Thus, it will ease the burden of the fiscal consolidation on the corporate and household balance sheets. Eventually, the long term growth potential of the country is conditioned on adopting an ambitious structural reforms agenda. Identifying the key issues and priorities was a focal point in our discussions:

- **Inflexible labor market**: Serbia has one of the highest unemployment rates and one of the lowest participation rates across Emerging Europe. Both are symptoms of an inflexible labor market. Removing disincentives in the labor market ought to be the first priority of the new labor law. The strongest disincentives to be addressed are the revision of the severance payment to include only the last employment period and the reduction of the wedge between total labor cost and net wage.
- **Rigid business environment**: a complicated system of regulations and laws creates distortions and disincentives for investors. Our discussants pointed out the issuing of construction permits as an example of an area that requires remedial. Dealing with a construction permit requires more time in 2013 (269 days) than in 2006 (205 days), while the number of procedures is almost the same (18 vs. 19 procedures) (Table 3).
- **Quality of institutions:** Solid quality of institutions matters for growth. In the case of Serbia, perceptions of corruption appear to be relatively high while scores in government efficiency-rule of law lie below EU average and regional peers.
- **Public enterprises**: Heavily subsidized losses making state-owned enterprises put pressure on the state balance sheet and deprive the economy from an efficient allocation of resources.
- **Price Competitiveness**: Overall, the price competitiveness of the country has deteriorated in the post-transition period.

The Real Effective Exchange Rate (REER) has been one of the most volatile in the region. The REER appears to have appreciated cumulatively by 26% in November 2002- August 2013.

Appendix

The Ministry of Finance announced a set of measures aimed to stabilize public finances and stimulate growth

1. **Decrease of the public wage bill (an estimated impact of around €100-150mn or approximately 0.3% of projected GDP):** The structure of this measure is twice fold:
   a. Decrease of 20% on net income above 60,000 RSD threshold
   b. Decrease of 25% on net income above 100,000 RSD threshold

Based on the assessment that that public wages are on average 30% higher than in the private sector, the purpose of this measure is to align public wages with private sector wages. In addition, the Ministry of Finance considers imperative to abolish the compensations for participation in the boards of the state-owned enterprises.

2. **Revenue raising initiatives**
   a. **Increase of the minimum VAT rate from 8% to 10% for essential goods. A reclassification of some goods from the lower VAT to the standard VAT rate will also partially help boost VAT revenue (an estimated impact of around €200mn or approximately 0.6% of projected GDP).** In practice, this means that the average consumer basket will increase by 450RSD from an overall basket value of 65,000 RSD.
   b. **Fight against tax evasion and shadow economy (an estimated impact of around €150mn or approximately 0.4% of projected GDP):** Along the same lines, an effort to fight to reduce shadow economy and tax evasion will be made through additional measures:
      - Reorganization of the Tax Authority
      - On line control of fiscal bills
      - Increase in inspections
      - Fight against excise duties smuggling
3. **Reduction of subsidies for State owned Enterprises (SOEs) (an estimated impact of €300-400mn or 1% of GDP realized in the medium-term)**

   The government has agreed with the World Bank on an action plan for the disposition of enterprises in restructuring. The plan envisages the resolution by sale or bankruptcy of 179 State owned Enterprises (SOEs). The Ministry of Finance anticipates the benefits of the plan to materialize in the medium term. The problem of the SOEs is primarily rooted in the legacy of socially owned enterprises[1] in the Former Yugoslavia. According to the Ministry of Finance, subsidies for SOEs are twice as much in other European countries, while the criteria for allocation are not transparent and optimal. The fiscal burden from SOEs is indirect and direct. The total direct subsidy for SOEs averaged 2.5% of GDP in 2009-2011, while the debt guarantees issued combined with the arrears amounted to 12% of GDP in 2011.

4. **Savings on expenditure of goods and services (an estimated impact of €30-40mn or around 0.1% of projected GDP in 2014):** All ministries were asked to cut their next year budget by 10% vs. their supplementary 2013 budget. The Ministry of Finance plan calls for a better monitoring and forecasting of expenditures through the reorganization of the public sector and the implementation of a budgetary plan system. In practice, each Ministry will define its priorities but will also be held accountable for the assigned savings.
5. **Savings on interest rates (an estimated impact of €150 mn on a 3 year time horizon for each €1bn used for refinancing):** This is based on the assumption that the Ministry of Finance will seek cheaper sources of re-financing the old debt stock. Replacing more expensive debt will allow savings on debt servicing that would pan out in a three year horizon depending upon the financial market conditions. Moreover, the Ministry of Finance intends to use private investors financing in infrastructure projects
6. **Improvement of business environment (the benefits accrued are indirect for the economy):** The government intends to push structural reforms in a number of areas in 2014 with the visible impact seen in 2015 (social security, pension, public administration, tax system, healthcare and education etc)

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