Government

of the Republic of Serbia

FISCAL STRATEGY

FOR 2022 WITH PROJECTIONS FOR 2023 AND 2024

CONTENTS

Pursuant to Article 27v paragraph 1 and Article 31 paragraph 1 item 1) sub/item (8) of the Budget System Law (“Official Gazette of RS”, nos. 54/09, 73/10, 101/10, 101/11, 93/12, 62/13, 63/13-corrigendum, 108/13, 142/14, 68/15-other law, 103/15, 99/16, 113/17, 95/18, 31/19, 72/19 and 149/20),

The Government hereby adopts

FISCAL STRATEGY FOR 2022 WITH PROJECTIONS FOR 2023 AND 2024

I. MACROECONOMIC FRAMEWORK FOR THE PERIOD 2022 - 2024

1. General framework and main economic policy objectives and guidelines

The economic policy in the Republic of Serbia has provided an adequate response to a crisis triggered by the coronavirus pandemic. Two years of struggle in the health and economic field have given satisfactory results. Thanks to the previously achieved macroeconomic stability, space has been created for the economic policy response to be adequate both in terms of its scope and structure. Fiscal policy has envisaged a comprehensive package of measures that has provided assistance to the economy and the households and its positive effects are reflected in macroeconomic indicators. The provided value of the package of measures to assist the economy and the households in 2020 is estimated at 12.9% of the gross domestic product (hereinafter: GDP). The prolonged duration of the adverse epidemic situation in 2021 impelled another, high volume support to the economy and the households, aimed at providing conditions for full economic recovery and growth, along with mass vaccination of the population and bringing the epidemic under control. The aid package provided in 2021 is estimated at 4.5% of GDP.

The main objectives set by the adopted Program of Economic Measures to Support the Serbian Economy have been met. Economic capacities have been preserved and support has been provided in maintaining the liquidity of the economy during these extraordinary circumstances. Thanks to the adequate response, the economy of the Republic of Serbia achieved good results even in 2020, despite unprecedented limiting factors for economic growth. In 2021, a complete economic recovery and growth is expected. Economic developments are also underpinned by the successful immunization of the population, which creates conditions for the full opening of the economy and the recovery of those activities that have been hit the hardest by the pandemic.

The fiscal strategy in the medium term envisages a gradual stabilization of public finances and fiscal space focusing on public investments to enable economic recovery and growth. The fight against the pandemic and its economic consequences has temporarily worsened country's fiscal position. The baseline scenario of economic trends in the medium term presumes the end of the health crisis and economic recovery. Under these assumptions, the medium-term deficit trajectory is declining and will be close to a sustainable level at the end of the observed period. Exceptionally, the increased share of public debt in GDP in 2020 and 2021, having in mind the projected fiscal results, as of 2022 onwards is decreasing and will return to sustainable limits. Experience in the previous period shows that stable public finances are necessary not only as a precondition for sustainable growth, but above all, as a prerequisite for an adequate response of the state in extraordinary circumstances such as those caused by the coronavirus pandemic. In the next medium-term period, the available fiscal space is focused on maintaining the achieved level of public investments. Public investments are key to faster economic recovery and creating the basis for dynamic economic growth.

Under the presented baseline scenario macroeconomic and fiscal risks are significant. Uncertainties remain regarding the path and duration of the pandemic, the rate of mass immunization, the way and speed with which economies will recover, the need for additional economic assistance, as well as numerous obligations that may arise from implicit and explicit state guarantees given to support the economy during the pandemic.

2. Estimates of the international economic environment

The global outlook remains very uncertain a year after the pandemic began. Although the vaccination process is progressing and has a positive effect on the general social mood, new mutations in the virus and lost lives continue to cause concern. Economic recovery varies by country and sector, reflecting variations in pandemic-related disturbances and varying volumes of economic support packages. The prospects depend not only on the outcome of the battle between viruses and vaccines, but also on the effectiveness of economic policies implemented in conditions of huge uncertainty, with the aim to mitigate the long-term consequences of this unprecedented crisis. The upward revision of global growth for 2020, based on the results from the second half of the year which were better than expected, pushed the projections for 2021 and 2022 in the direction of faster recovery than previously predicted. The macroeconomic performance would have been significantly weaker had it not been for a significant fiscal response, and it is therefore expected that this crisis caused by the pandemic will have less consequences than the Great Recession of 2008. However, as developing and low-income countries are hit harder by the crisis, they are expected to suffer significant medium-term losses. Most countries face unusually high uncertainty arising from the further course and duration of the pandemic and the response to it. The main challenges will be focused on the process of normalization and the creation of appropriate policies corresponding to the specific situation in individual countries. In order to achieve that, significant international cooperation and support to health systems is necessary, as well as the coordination of monetary and fiscal policy in order to combat possible long-term consequences of the crisis. Global cooperation is also necessary in solving the long-term problem of climate change and possible future health crises.

Macroeconomic estimates of the International Monetary Fund

One year after the start of the pandemic, the global economy is recovering from the shock caused by the “Great Lockdown”. The contraction in economic activity in 2020 was unprecedented in its speed, and estimates by the International Monetary Fund (hereinafter: the IMF) suggest that the economic downturn could have been up to three times greater had it not been for emergency support measures. According to the spring projections of relevant international institutions, the prospects for global recovery have improved. The current projections of global growth for 2021 and 2022 have been revised upwards and amount to 6.0% and 4.4%, respectively, while in the medium term the growth rate will slow down. Different rates of recovery are noticeable, both between developed and developing countries, and within the groups themselves, which could lead to a certain gap in the living standard of the population.

Risks to the realization of projections continue to be accompanied by unusually high uncertainty. Future developments will depend on the path of the health crisis and the progress of vaccination, the effectiveness of policies in repairing long-term consequences for the economy, the movement of prices of primary products and conditions on the financial market. Although the current situation varies between countries, the primary focus should be on tackling the effects of the crisis and strengthening the health system, well-targeted fiscal support and the continuation of accommodative monetary policy. Achieving these goals requires strong international cooperation, especially in the production and distribution of vaccines, but also in access to the global financial market.

Table 1. International environment – macroeconomic indicators

	2020	2021	2022	2023
Real GDP growth[1], %				
World total	-3.3	6.0	4.4	3.5
Advanced economies	-4.7	5.1	3.6	1.8
USA	-3.5	6.4	3.5	1.4
Euro area	-6.6	4.4	3.8	1.9
Developing economies	-2.2	6.7	5.0	4.7
China	2.3	8.4	5.6	5.4
Russia	-3.1	3.8	3.8	2.1
World trade growth, %	-8.5	8.4	6.5	4.2
Unemployment rate, %				
Euro area	7.9	8.7	8.5	8.2
USA	8.1	5.8	4.2	3.7
Consumer prices, period average, %				
Euro area	0.3	1.4	1.2	1.4
Advanced economies	0.7	1.6	1.7	1.8
Developing economies	5.1	4.9	4.4	4.0
Exchange rate, euro/dollar, end of period	1.1	1.2	1.2	–
Cereal prices, in dollars, annual changes[2]	8.4	25.2	-4.4	-2.4
Metal prices, in dollars, annual changes[3]	3.5	32.1	-4.5	-0.4
Price of iron ore, in dollars[4]	108.1	146.5	130.5	130.5
Oil prices, in dollars, annual changes, %	-32.7	41.7	-6.3	4.2

Source: IMF, *World Economic Outlook*, April 2021

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

[2] The cereal price obtained as the weighted average price of wheat, corn, soya, rice and barley.

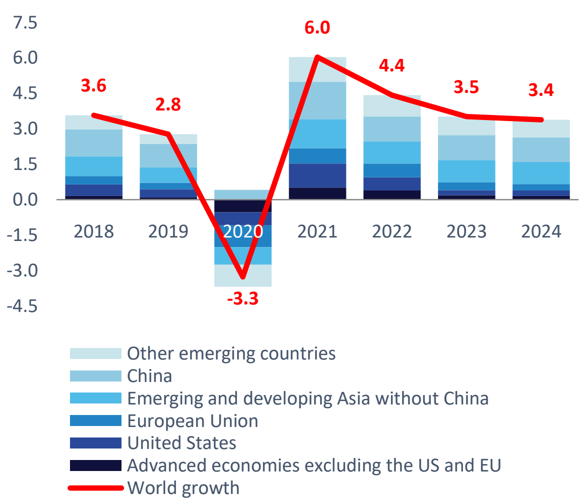
[3] The metal price obtained as the weighted average price of copper, aluminium, iron ore, tin, nickel, zinc, lead and uranium.

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

According to the IMF's April estimates, the contraction of the global economy in 2020 is estimated at -3.3%, which is an upward revision by 1.1 percentage points compared to the October estimate. The improved outlook is the result of higher-than-expected growth in the second half of the year, due to the easing of the restrictive measures introduced in response to the pandemic. Compared to the October IMF report, the growth projections for 2021 and 2022 were also revised upwards by 0.8 pp. and 0.2 pp. respectively, reflecting the additional fiscal support of some major economies and the expected recovery in the second half of 2021 as a result of vaccination. In the group of developed countries, the speed of recovery of economic activity will vary between countries due to differences in the health sector response to the pandemic, flexibility and adaptability of economic activity and country's pre-crisis situation. The US economy will reach the 2019 pre-crisis level in the first half of 2021, and the announced $ 1.9 trillion Rescue Plan will give an additional impetus to growth in the next two years. The Eurozone and UK economic growth projections for 2021 have been revised downwards due to the reintroduction of restrictive measures at the end of 2020, and the pre-crisis level is expected to be reached only in 2022. On the other hand, for the developing economies the outlook has been revised upwards for 2021; however vaccine procurement data indicate that the majority of the population will not be protected during 2021, thus more frequent introduction of restrictive measures could affect these countries' growth in the medium term. Also, a slowdown in global growth is expected in the medium term, which is in line with projected trends in most countries.

The outlook for Asian developing countries has been revised upwards for 2021, due to a higher than expected growth after the restrictive measures were lifted in some countries, while the high number of infected citizens in other countries (Indonesia and Malaysia) represents a limiting factor for the recovery. On the other hand, China reached the pre-crisis level of growth already in 2020, thanks to effective pandemic control measures and central bank and fiscal policy support, so that the growth projection for 2021 has been slightly revised upwards. Although the forecasts for Russia have been revised upwards for 2021, the expectations for the next medium-term period are similar to those in other countries, and a slight weakening of economic activity is expected. For Latin American countries, after a sharp decline in 2020, growth has been revised upwards for 2021–2022, however, but the insufficient number of purchased vaccines may be an obstacle to growth in the medium term. Projections for the Middle East and Central Asia are largely unchanged, but the recovery path will vary depending on the situation in individual countries, on the oil prices as well as on the evolution of the pandemic and progress of vaccination.

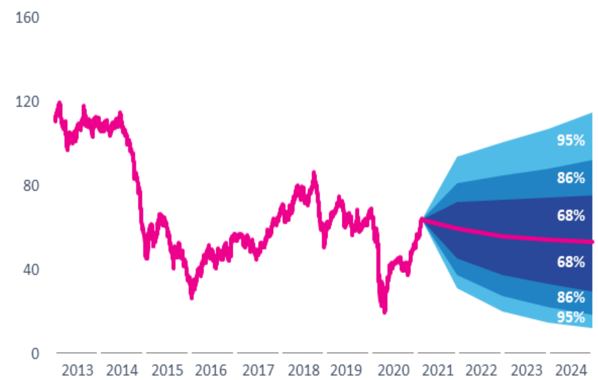
Global economic growth, pp



Source: IMF, *World Economic Outlook*, April 2021

The outlook for inflation reflects mainly indicated growth prospects and expected movements in commodity prices. In developed economies, inflation will rise slightly from 1.6% in 2021 to 1.7% in 2022, after which it is expected to continue slightly growing in the medium term. Emerging countries will, after the price increase of 4.9% in 2021, record a slight slowdown in inflation in the coming years. According to the April IMF projections, the price of oil in 2021 is expected to be $ 58.5/barrel, an increase of 41.7% compared to 2020, after which a gradual decline is expected.

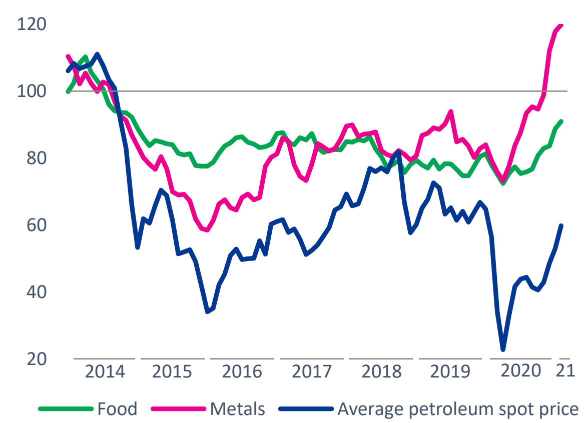
Projection of oil price movements, USD per barrel



Source: IMF, *World Economic Outlook*, April 2021

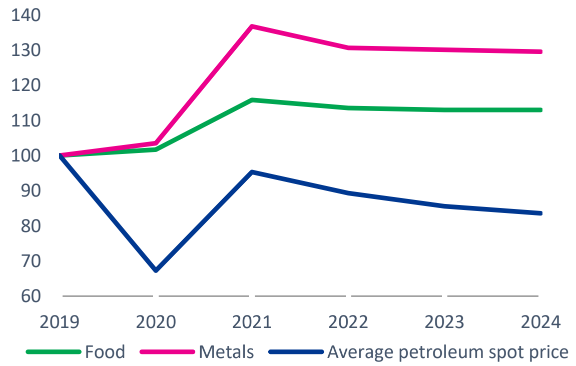
The prices of base metals are projected to record a strong growth of 32.1% in 2021, led by the recovery of China, while the forecast for the following period envisions their stabilization and a moderate decline. After the growth of iron prices by over one third in 2021, their decline over the next year and stagnation in the medium term are projected. Cereal prices are expected to rise strongly in 2021, and then to decline in 2022 and stagnate in the medium term. The three-month euro deposit rate will remain unchanged at -0.5% in 2021 and 2022, while the six-month rate on US dollar deposits will amount to 0.3% and 0.4%, respectively.

Price movements, indices, 2014=100



Source: IMF, *World Economic Outlook*, April 2021

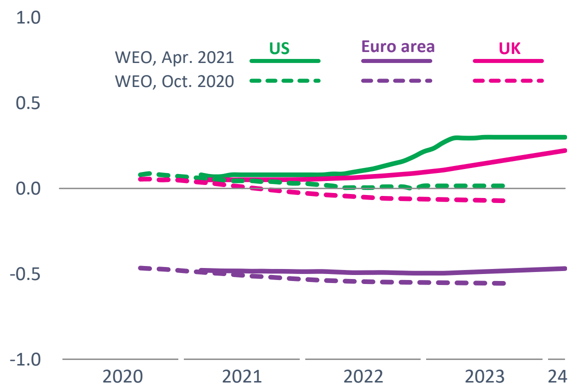
Projection of price trends, indices, 2019=100



Source: IMF, *World Economic Outlook*, April 2021

The US Federal Reserve System (hereinafter: FED) maintained the target interest rate range of 0% to 0.25% in April, in line with the change in monetary policy strategy to target average inflation rate of 2%, which signals that the base interest rate will remain low, until the growth outlook improves.

Expected movements in the reference interest rate, %



Source: IMF, *World Economic Outlook*, April 2021

The uncertainty regarding the evolution of the pandemic is the biggest risk to IMF's growth projection. The emergence of new virus strains, unfavourable financing conditions, the prolonged negative impact of the crisis, social unrest, geopolitical tensions as well as frequent weather, climate and natural disasters, are still present as risks to global growth and stability. On the other hand, faster vaccine production, distribution and implementation, positive effects of the applied fiscal measures and the timely coordinated implementation of economic policies would contribute to accelerating global recovery and normalization of economic activity.

ECB macroeconomic projections for the euro area

According to European Central Bank's March estimates, economic activity in the Eurozone is expected to decline in the first quarter of 2021, due to the introduction of stringent containment measures to curb the spread of the virus, with a slight recovery in the second quarter and strong growth in the second half of the year. The expected recovery path rests on the assumptions of a gradual relaxation of containment measures, with the simultaneous implementation of mass vaccination. The recovery will be aided by foreign demand growth, as well as by additional support packages adopted by fiscal and monetary authorities, and real GDP is expected to exceed its pre-crisis level in the second quarter of 2022.

According to ECB projections, after a 6.9% decline in 2020, the Eurozone economy will grow by 4.0% and 4.1% in 2021 and 2022, respectively. After a sharp drop of 8.0% in 2020, private consumption will grow by 3.0% and 5.9% in 2021 and 2022, respectively, due to a gradual uncertainty decline, and a shift from the current trend of household savings to consumption. The expected demand growth, favourable financing conditions and disposable income rise will push both corporate and housing investments, so total investments will record a growth of 5.5% and 5.9% in 2021 and 2022, respectively. Owing to foreign demand increase, foreign trade will also recover over the next two years, but after the positive impact of the net export on GDP in 2021, its contribution will be mostly neutral.

With the normalization of the labour market and the withdrawal of employee support schemes, the unemployment rate is projected to peak in the second quarter of 2021, after which it will fall to 7.6% at the end of 2023 as the economy gradually recovers. By the end of the projection horizon, the unemployment rate and the number of persons employed are expected to converge towards, but not reach, the pre-crisis levels. Also, a somewhat faster recovery in labour productivity is projected in the first half of 2021, before gradually moderating over the remainder of the projection horizon.

Significant fluctuations in inflation are expected in the coming quarters, but over the medium term, underlying price pressures are expected to remain subdued due to weak demand, and to strengthen only gradually in line with the economic recovery. The combined upward impact from the recent surge in oil prices and the end of the temporary VAT rate reduction in Germany, imply a temporary jump in inflation in 2021, which has been revised up by 0.5 percentage points compared with the December 2020 projections. Overall, inflation is expected to rebound sharply from 0.3% in 2020 to 1.5% in 2021, and then to drop to 1.2% in 2022.

After the highly expansionary fiscal policy in 2020, continued fiscal support is expected to mitigate the macroeconomic impact of the pandemic crisis, and further underpin the recovery in 2021. Most of the additional measures are temporary and are expected to be reversed in 2022. After the substantial fiscal deficit in 2020 of -7.2% of GDP, the euro area fiscal result is projected to recover somewhat in 2021, to -6.1% of GDP, and then to further improve to -3.1% and -2.4% of GDP in 2022 and 2023, respectively. Euro area debt-to-GDP ratio is projected to peak in 2021 (at 98%), after which it will begin to decline slightly as a result of favourable interest-growth differentials, which more than offset the continuing, albeit decreasing, primary deficit.

At its meeting in April 2021, the ECB decided to keep the key policy rate at a record low of 0.00%, while keeping the interest rate on lending and deposit facilities at 0.25% and -0.50%, respectively. The Governing Council of the ECB expects the key policy rates to remain at the current or lower levels until the inflation reaches the target level of 2.0%.

Table 2. Macroeconomic projections for the euro area, changes in comparison to the same period last year, %

	2020	2021	2022	2023
GDP	-6.9	4.0	4.1	2.1
Private consumption	-8.0	3.0	5.9	2.1
Government consumption	1.0	2.9	0.1	1.1
Gross fixed capital formation	-8.4	5.5	5.9	3.3
Exports	-10.5	7.5	5.5	3.4
Imports	-10.0	6.6	6.4	3.6
Employment	-1.7	-0.2	1.3	1.0
Unemployment rate	7.8	8.6	8.1	7.6
Inflation	0.3	1.5	1.2	1.4
Unit labour costs	4.7	-0.3	-0.6	1.2
General government fiscal result, % GDP	-7.2	-6.1	-3.1	-2.4
General government gross debt, % GDP	96.9	98.2	96.1	95.1
Balance of current account, % GDP	2.2	2.0	1.7	1.7

Source: Macroeconomic projections of ECB experts in the euro area, March 2021

3. Current macroeconomic developments in the Republic of Serbia and prospects for the period 2022–2024

The global crisis that has hit world economy in consequence of the coronavirus pandemic inevitably affected the Serbian economy. However, the achieved fiscal balance and price and financial stability in the previous period enabled the creation of a comprehensive economic package of support to the economy and population in 2020, worth 12.9% of GDP, which preserved macroeconomic stability and created the basis for accelerated recovery. The scenario of a dramatic fall in GDP, faced by many countries, has been avoided. Thus, in 2020, a contraction of the economy of only 1.0% was recorded, which is one of the best results in Europe, and in the first quarter of 2021, economic activity reached the pre-pandemic level.

The success of the economic package was verified by the absence of negative effects of the pandemic on the labour market. Jobs and wages have been preserved, both in the private and public sectors, and the scenario of increasing unemployment at the end of 2020 and the beginning of 2021 has been avoided. At the same time, the increase in salaries and pensions did not jeopardize the established macroeconomic balance and contributed to a faster recovery of domestic demand. In addition, active participation in socio-economic dialogue has increased the minimum cost of labour in a way that does not further burden the economy and does not jeopardize its competitiveness, and with the intention to ensure inclusive economic growth and create an environment of social cohesion.

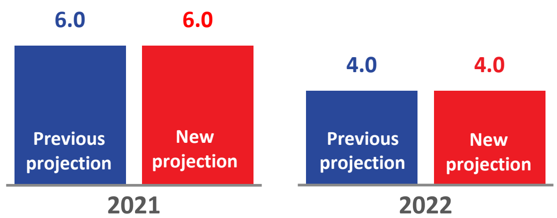
At the beginning of 2021, the Government created an additional fiscal package of support to the economy and population, worth 4.5% of GDP, and provided additional fiscal space for sizeable capital investments. At the same time, the successful process of immunization of the population, with the availability of vaccines for all age groups, has significantly contributed to the improvement of the epidemiological situation and the gradual relaxation of restrictive measures. In this way, preconditions have been created for the full recovery of certain service activities that were hit the hardest by the epidemic, such as tourism, catering, entertainment and recreational services, but also for additional acceleration of growth of other economy sectors, especially industry and construction.

The timely implementation of the economic assistance package to firms and households influenced country's fiscal position and the temporary increase in the fiscal deficit and public debt. However, the increased expansiveness of fiscal policy has not undermined the sustainability of public finances. At the same time, an adequate and timely monetary policy response provided sufficient liquidity to households and firms, with stable and predictable inflation trends and relative exchange rate stability.

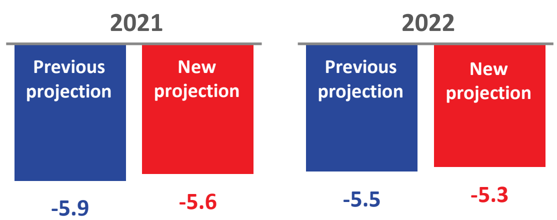
Measures that focus on mitigating the consequences of the epidemic remain a priority for economic policy makers in the coming period. In addition, efforts are focused on intensifying reform processes, to ensure the continuity of improving the economic environment, progress on international competitiveness lists and further raising country's credit rating. The need to find new sources of growth has been recognized, so innovation, research and development and creative industries are in constant focus when defining future policies. In order to support economic growth and ensure more sustainable and environmentally friendly development, one of the Government's priorities will be the implementation of green projects and support for the green growth program.

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

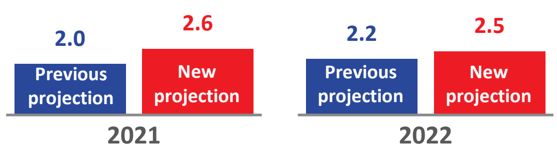
Real GDP growth, %



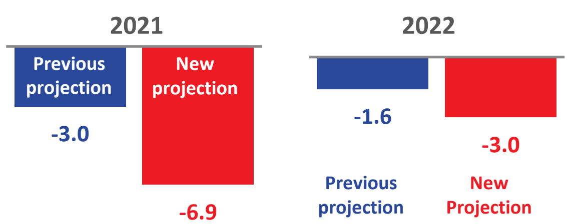
Current account balance, % of GDP



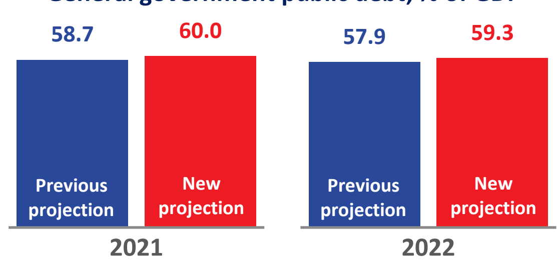
Inflataion, period average %



Fiscal result, % of GDP



General government public debt, % of GDP



Current trends in the real sector

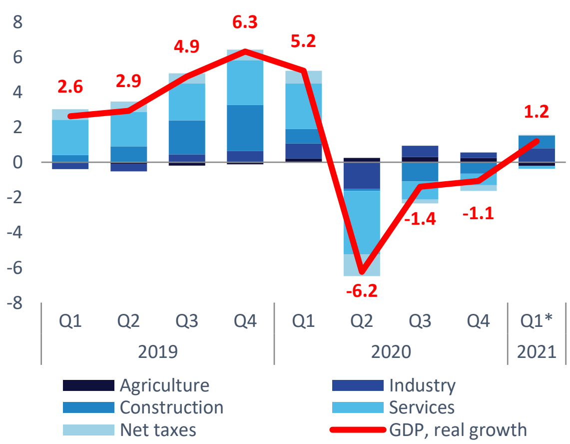
According to preliminary data of the Statistical Office of the Republic of Serbia (hereinafter: SORS) obtained on the basis of quarterly calculations, economic decline in 2020 was 1.0%. The shock in the second quarter of 2020 caused by the coronavirus epidemic was followed by a strong recovery in the third and fourth quarters. In addition to state-of-emergency lifting and "unlocking" of the economy, the businesses and households support program, jointly adopted by the Government and the National Bank of Serbia (hereinafter: NBS), have largely contributed to GDP recovery. The adopted package of measures has preserved macroeconomic stability, additionally ensured businesses and households liquidity, and largely prevented distortions in the labour market.

In such circumstances, already in the third quarter, after eliminating the seasonal effect, GDP growth compared to the previous quarter amounted to 7.2%, while in the fourth quarter an additional recovery of 2.2% followed. Thus, at the end of 2020, the overall economic dynamics was lower by only 0.6% compared to the pre-pandemic level from the first quarter of 2020. However, it should be noted that economic activity in certain sectors, such as industry, ICT and financial services, has already fully recovered during the second half of the year and reached record high levels in the last quarter of 2020. At the same time, a moderate recovery was recorded in tourism, transport, art, entertainment and recreation sectors, which were most affected by the pandemic, but their level of gross value added (hereinafter: GVA) at the end of 2020 was still significantly lower compared to the pre-pandemic level.

Macroeconomic developments at the beginning of 2021 are better than expected. According to SORS flash estimate, GDP growth stood at 1.2% y-o-y, which is by 2.5 pp better result compared to the initial projection for this period, which implied an annual growth path of 6%.

Observed from the production side, according to the Ministry of Finance estimate, economic growth in the first quarter of 2021 was driven by industrial production, which achieved an increase of 3.7% y-o-y, thus contributing to GDP growth with 0.8 pp. The intensification of infrastructure works along with the recovery of private construction operations have resulted in a vigorous construction growth, so that with a 0.7 pp contribution this sector was the second most important in terms of the impact on GDP growth. Service activities record divergent movements. Trade, ICT and financial services continue to grow, while tourism, catering and transport continue to contribute negatively to economic developments. Overall, the contribution of the service sector in the first quarter of 2021 was slightly negative and amounted to -0.2 pp. The estimate of economic developments in the first quarter also included the assumption of the average agricultural season, which implied a slightly negative contribution of agriculture to GVA.

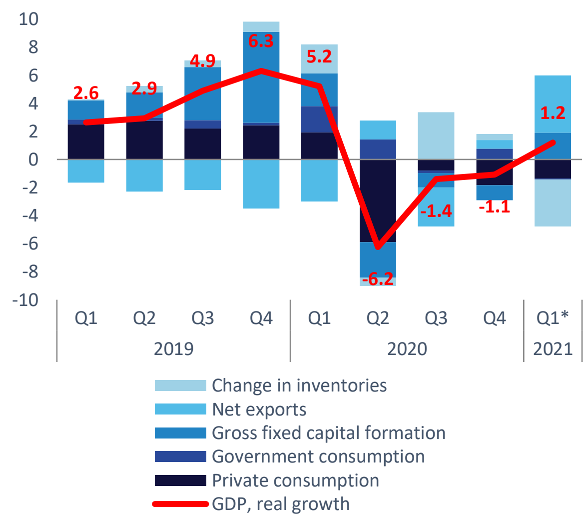
Contributions to real GDP growth rate, production approach, pp



* Estimate of the Ministry of Finance

Observed by aggregates of GDP use, the effects of the pandemic had the strongest impact on private consumption, despite the growth of citizens' real income, due to the present constraints and applied health measures, and consequently lower use of tourist, catering and transport services. Investments as the most significant development component of GDP recorded an increase in the first quarter of about 10% y-o-y, contributing 2.0 pp to GDP growth. Activation of new export-oriented capacities, as a result of the materialisation of FDIs from the previous period, along with the recovery of external demand and increase in exports of agricultural products, influenced the strong growth of real exports in the first quarter of 2021. At the same time, import activity recorded a moderate increase, so that with a 4.1 pp contribution, net export was the main generator of economic growth in the first quarter of 2021.

Contributions to real GDP growth rate, expenditure approach, pp

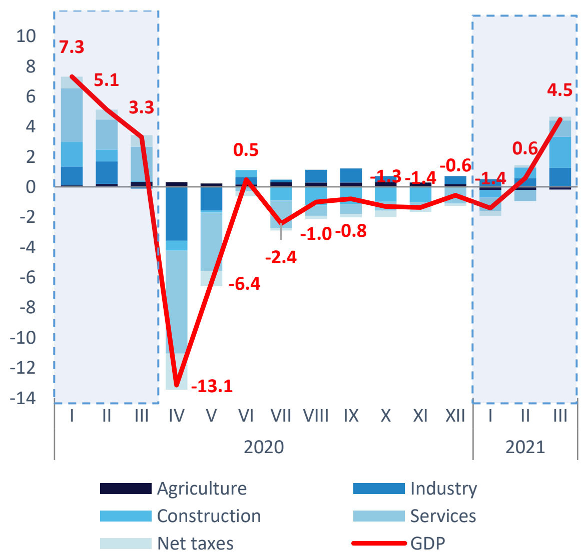


* Estimate of the Ministry of Finance

High-frequency indicators of economic activity also indicate positive macroeconomic trends at the beginning of 2021. This is confirmed by the Economic Activity Indicator (IPAS)[1], which the Ministry of Finance prepares for the needs of reviewing the monthly dynamics of the total economic activity. Despite the high baseline from January of the previous year, IPAS value in January 2021 was lower by only 1.4% y-o-y, in February y-o-y growth rate turned positive, and in March there was a strong growth of 4.5% y-o-y.

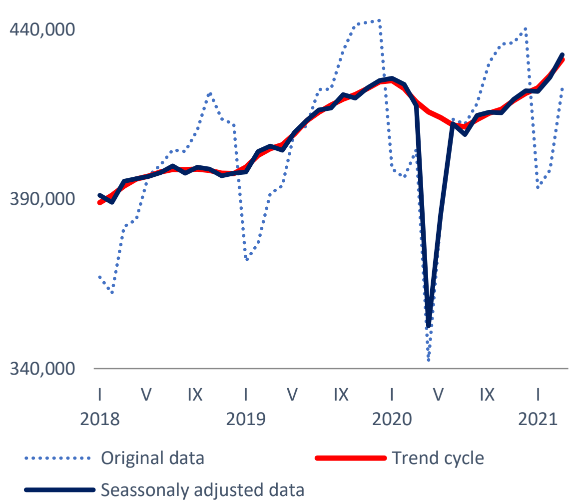
[1] For detailed methodological explanations visit https://www.mfin.gov.rs//upload/media/ZzkTpV_601696edb3a9a.pdf

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



If seasonally adjusted data are observed, the IPAS dynamics indicates that overall economic activity recovered very quickly from the shock caused by the lockdown and introduction of the state of emergency, and that in March 2021 it was at a historically highest level since data measuring this indicator are available, i.e. since January 1995.

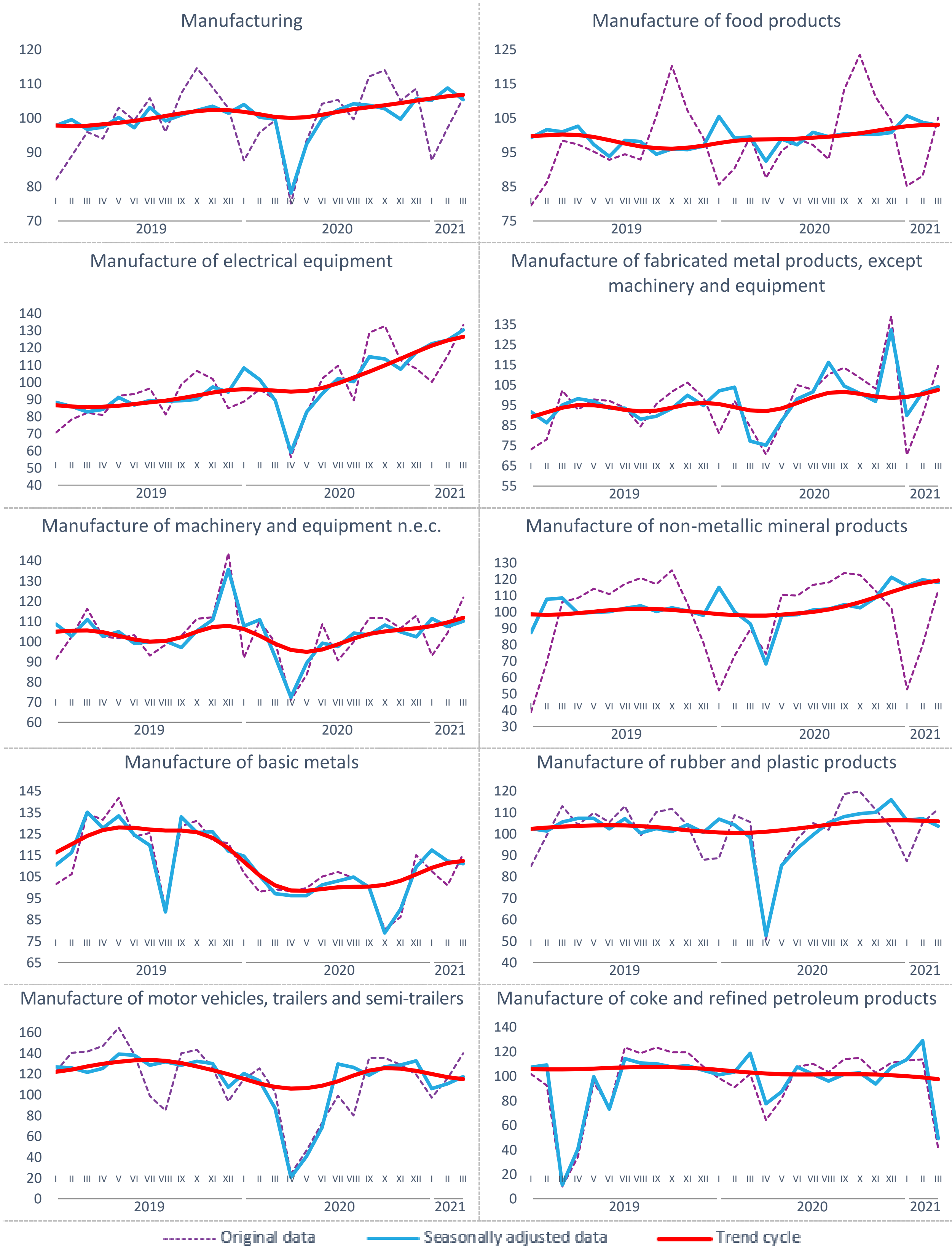
Indicator of economic activity of Serbia (IPAS), mil. RSD, chain-linked volume measures



The physical volume of total industrial production in the first three months of 2021 was higher by 3.8% y-o-y. In this period, the manufacturing industry and electricity production with a growth of 2.5% y-o-y and 9.1% y-o-y, respectively, determined the movement of the overall industry, while the mining sector with an increase of 1.0% produced a slightly positive impact.

The favourable dynamics of industrial production is also confirmed by monthly data. After growth in January and February, of 2.5% y-o-y and 2.6% y-o-y, in March, the physical volume of industrial production was higher by as much as 6.1% y-o-y, despite the overhaul of production capacities in NIS. At the same time, the growth of the manufacturing industry has been diversified and achieved in as many as 20 out of a total of 24 activities. This dynamic is primarily the result of the activation of new production capacities, but also of the gradual recovery of external demand. Among the activities that recorded the most significant production increase in March, the dominant positive impact was produced by the metal industry, with a growth of 35.9% y-o-y, and the production of electrical equipment, which recorded 48.1% y-o-y physical volume increase. A significant positive contribution also came from food industry with y-o-y growth of 5.6%, and higher production volume of the automotive and machinery industry, of 36.4% and 22.7%, respectively. Despite the halt in production in the second half of March in some plants of HIP Petrohemija, due to overhaul and investment activities, the chemical industry recorded a production growth of 6.3% y-o-y in March. On the other hand, suspended production at the oil refinery in Pancevo, due to works on cleaning, revision and rehabilitation of equipment, and the implementation of investment works, affected the year-on-year decline of the oil industry of 59.6%, producing a significant negative contribution of 5.5 percentage points to manufacturing industry. However, this is a temporary suspension, so that production in NIS is expected to return to normal levels as early as April.

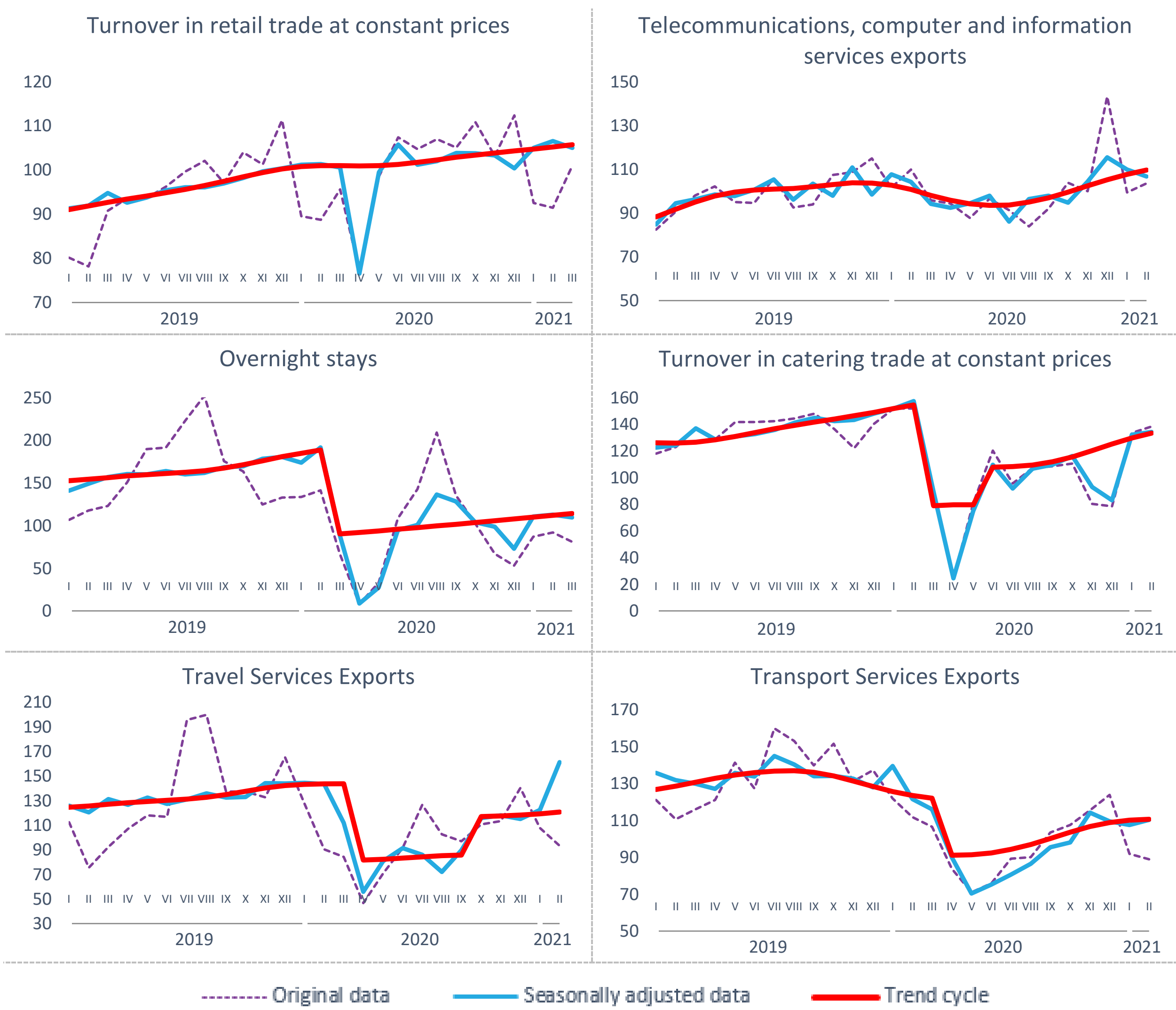
Indices of physical volume of leading activities of industrial production, 2020=100



Source: Ministry of Finance

The service sector is the part of the economy that has been most affected by the coronavirus epidemic due to its structure, both in terms of the strength of that impact and in terms of duration. Some activities such as tourism, catering, transport, art, entertainment and recreation recorded a dramatic decline, especially in the second quarter of last year. However, with the gradual relaxation of measures and the improvement of the epidemiological situation, a moderate recovery is registered in these activities, but a return to pre-pandemic levels is expected not earlier than in 2022. However, some service activities such as trade, ICT and financial services have maintained positive trends despite the unfavourable conditions of the previous year, and growth is accelerating also at the beginning of 2021.

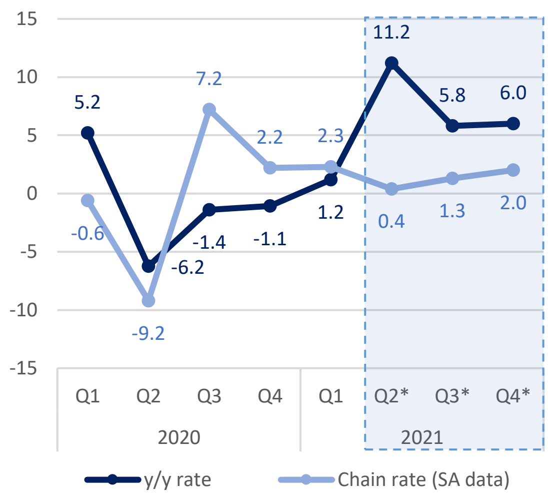
High-frequency indicators of key service industries, 2020=100



Source: Ministry of Finance

Despite better-than-projected performance in the first quarter of 2021, due to the still high uncertainty and respecting the precautionary principle, the Ministry of Finance maintains 6% GDP growth estimate for 2021, with a slightly changed structure of growth sources compared to previous projection from the Fiscal Strategy for 2021. However, if the growth dynamics of economic activity from previous months continues, supported by the adopted package of economic measures, progress in the vaccination process and further recovery of external demand, GDP growth could be higher in 2021, thus the risk matrix is assessed as slightly upward asymmetric. A 6% growth path would imply GDP growth of about 11% y-o-y in the second quarter, given the low baseline from the same period last year, while in the third and fourth quarters economic growth should stand at 5.8% y-o-y and 6.0% y-o-y, respectively.

Real GDP growth rate, %



* Estimates of the Ministry of Finance

Observed by expenditure aggregates, economic growth in 2021 will be entirely driven by domestic demand, while the expected contribution of net export will be negative. Support to households within this year's Government economic support package, along with preserved stability in the labour market and expected increase in wages in the private and public sector, backed by favourable financing conditions, will result in more dynamic growth of personal consumption than previously projected and its greater contribution to GDP growth. Increased government expenditures will also accelerate collective consumption, which will grow by 3.0%. Stronger investment growth is also expected as a result of increased government spending on infrastructure projects and other investment needs, which will more than offset the somewhat slower dynamics of private investment due to the prolonged effects of the pandemic. The increase in investment activity should amount to 14.3%, instead of the previously planned 13.3%. The gradual recovery of external demand, with the activation of new production capacities as a result of the materialization of foreign direct investment from the previous period, supported by an increase in exports of certain agricultural products, will result in total exports real growth of 13.8%. On the other hand, the expected trends in private and government consumption, as well as investment, will result in a significant increase in imports, which should record a real increase of 13.4%.

Observed from the production side, no significant changes in the growth dynamics of economic sectors are expected, compared to the previous projection. Thanks to continued growth in trade, information and communication and financial activities, with the recovery of certain areas worst hit by the epidemic in the previous year (such as tourism, passenger transport and recreational services), the service sector will continue to play a role of the dominant source of economic growth, and will record a 6.0% increase. This is a slight downward revision compared to the previous projection of 6.9%, due to the epidemic extended impact on the service sector. As regards industrial production, good results from the beginning of the year, activation of new production capacities, along with the further recovery of external demand, will result in a slightly higher growth than initially planned, which according to the new projection should amount to 6.4%. Owing to better performance in the first quarter of 2021, trends in construction have been revised slightly upwards, and an increase of 16.1% is expected. In the current assessment of economic trends as well, the assumption of the average agricultural season is maintained, so that the projected decline in this sector amounts to about 4.0%.

Table 3. GDP, real growth rates %

	2020	Q1 2021*	2021* (original projection)	2021* (current estimate)
GDP	-1.0	1.2	6.0	6.0
Private consumption	-2.5	-2.0	5.4	5.8
Government consumption	5.6	-0.4	0.4	3.0
Gross fixed capital formation	-2.8	9.2	13.3	14.3
Exports of goods and services	-5.9	9.8	9.6	13.8
Imports of goods and services	-3.5	1.8	9.3	13.4
Agriculture	4.2	-3.9	-4.0	-4.0
Industry	0.4	3.7	5.7	6.4
Construction	-5.1	17.6	14.6	16.1
Services	-1.4	0.3	6.9	6.0

Source: SORS

* Estimate of the Ministry of Finance

Projections of real sector developments in the period 2022–2024

The medium-term projection of real sector developments is based on a realistic approach, in order to have fiscal policy adequately set out and not to jeopardize earlier achievements. The developments of basic macroeconomic aggregates and indicators for the Republic of Serbia in the period 2022–2024 have been projected on the basis of current economic trends and prospects for the Republic of Serbia and the international environment, as well as on the basis of assessed effects of planned economic policy measures. In this period, the Government will further pursue a responsible and predictable fiscal policy, synchronized with the monetary authorities and focused on remediating all the consequences of the coronavirus pandemic, but also on locating new sources of growth. Continued FDI inflows will provide knowledge and technology transfers, increase competitiveness and provide new sales channels to domestic producers. The incentive mechanism aims at their sectoral and regional dispersion in order to ensure the preconditions for balanced development and full use of competitive advantages. Achieving this projection, in conditions of high uncertainty, is subject to risks, which are primarily of exogenous origin. The projection risk matrix has been made and it is described in detail in this document.

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

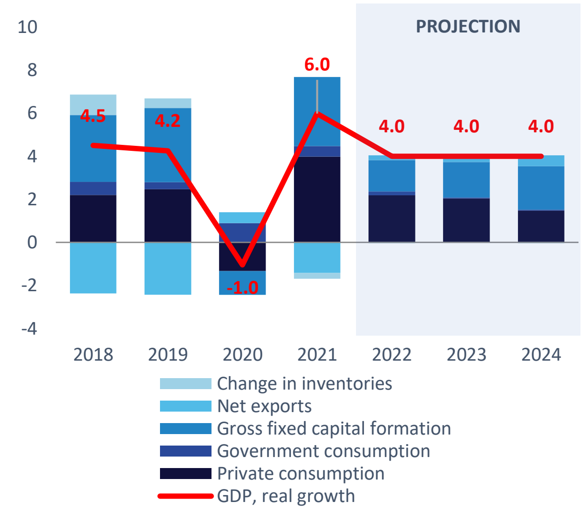
	Estimate	Projection		
	2021	2022	2023	2024
GDP, billions of dinars (current prices)	5,938.1	6,342.1	6,792.2	7,287.7
Real growth of GDP, %	6.0	4.0	4.0	4.0
GDP deflator, %	2.6	2.7	3.0	3.2
Private consumption	5.8	3.2	3.0	2.2
Government consumption	3.0	1.1	0.3	0.3
Gross fixed capital formation	14.3	6.0	6.7	8.1
Exports of goods and services	13.8	9.5	9.9	10.0
Imports of goods and services	13.4	7.4	7.8	7.8
Balance of goods and services, in EUR, % GDP	-9.7	-9.1	-8.1	-7.0
Current account balance, in EUR, % GDP	-5.6	-5.3	-4.9	-4.4
Inflation, period average, %	2.6	2.5	2.9	2.9

Source: Ministry of Finance

Real GDP growth of 4% has been projected for 2022, which means that the initial projection from the previous Fiscal Strategy was maintained, with almost unchanged structure of basic sources of growth.

Observed by GDP expenditure aggregates, growth will be driven by domestic demand, which will provide a contribution of 3.8 pp, while net exports will also produce a positive effect of 0.2 pp. All three components of domestic demand will positively contribute to the growth of economic activity. Favourable trends in the labour market and the expected real increase in wages, both in the private and public sectors, stable growth of pensions and continued favourable financing conditions, will result in personal consumption growth of 3.2% and consequently, as this aggregate has the largest share in GDP, will contribute to the growth of economic activity with 2.2 pp. In 2022, investments will be the second most important component in terms of a positive contribution to GDP growth, which is very important from the point of view of its sustainability. A year-on-year increase of 6.0% is expected, i.e. a contribution to GDP growth of 1.4 percentage points. The dynamics of investment activity will be entirely determined by private investments and further expansion of production capacities, primarily in sectors that produce tradable goods, while the contribution of public investments will be neutral due to the high baseline from 2021 and record GDP share of 7.2%. In contrast to two components of domestic demand, in 2022 government consumption will record a slower growth than in previous years, primarily due to a gradual reduction in health expenditures. The expected recovery of external demand, with the activation of new production capacities as a result of effecting FDIs from the previous period, will result in export growth of 9.5%. On the other hand, a moderate increase in private consumption as well as investment will result in growth of imports of 7.4%. Such dynamics of foreign trade will result in net exports positive contribution to GDP growth, of 0.2 percentage points.

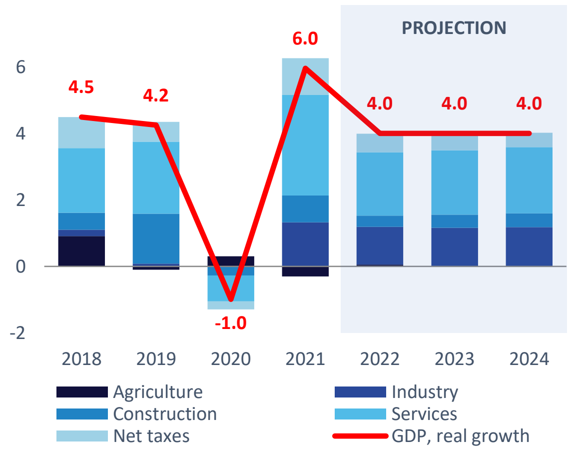
Contributions to the real GDP growth rate, expenditure approach, pp



Source: Ministry of Finance

Observed from the production side, an increase in the generated GVA is expected in all sectors. In 2022, the service sector will play the role of the dominant growth driver with a contribution of 1.9 percentage points. Growth should be diversified and achieved in most service industries and it should be especially strong in the ICT sector, trade and transport, while a return to pre-pandemic levels is expected in tourism and catering, as well as in recreation and entertainment services. With the further recovery of external demand and the activation of new production capacities, the total industry will continue to grow in 2022 and contribute to GDP growth with 1.1 percentage points. Construction activity should achieve solid growth in 2022, primarily due to the acceleration of private construction operations, but also the continuation of the implementation of infrastructure projects, which would result in a contribution to GDP growth of 0.3 percentage points in 2022. As for the agricultural sector, assuming average agrometeorological conditions with the continued trend of increasing productivity, a slight positive contribution of 0.1 percentage points in 2022 is projected.

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



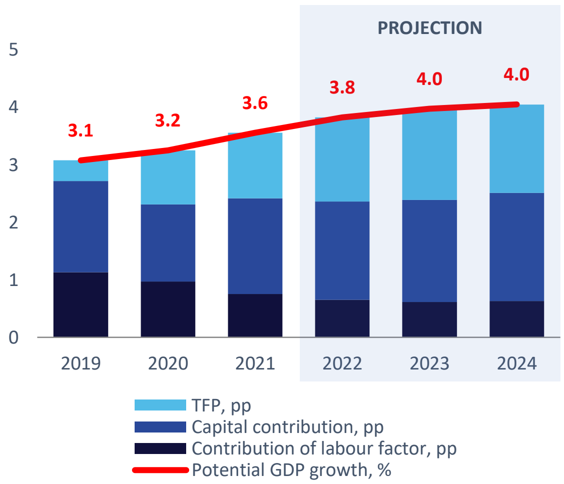
Source: Ministry of Finance

According to the medium-term macroeconomic projection, the cumulative growth rate in the period 2022–2024 will amount to 12.5% and will be driven by the growth in domestic demand and the recovery of global trade, additionally supported by a slight positive contribution of net exports. This source of growth is influenced by both continuous increase in investments and growth of household consumption due to rising living standards. On average per year, the Serbian economy will grow at a rate of 4.0%. The increase in private consumption is projected at a lower rate than the acceleration of economic activity and will average 2.8%. This increase does not include disruptive elements, it is based on sound sources, primarily on increasing employment, but also on the favourable impact of price and credit movements on disposable income. A steady growth of investments is expected, on average of about 7% per year, which will gradually increase their share in the GDP structure, which at the end of the projection horizon should come close to 25%. With the recovery of foreign demand and the activation of new production capacities, the volume of foreign trade will increase. In addition, realization of FDIs from the previous period will contribute to increased competition and affect the efficiency of domestic producers, while on the other hand, new sales channels will be activated and new market niches will be opened. Exports will grow at an average annual rate of 9.8%, which is faster than the expected annual growth of imports, which will average 7.7%. This dynamics of foreign trade flows will improve the current account balance, which should amount to 4.4% of GDP at the end of the projection horizon. Observed on the supply side, the services sector and the industry will retain the role of dominant sources of growth and increase generated GVA by an average of 3.8% and 5.9% per year, respectively. A positive contribution will be also provided by the growth of construction activity, which will average 7.3%. Attainment of European standards and raising competitiveness in agriculture, by meeting the conditions for opening Chapter 11 and through the use of EU IPARD programs, will reduce the variability of production in this sector caused by agrometeorological conditions.

With this three-year scenario, the Government remains committed to maintaining a model of economic growth based on investment and exports, which is supported by the private consumption growth on realistic and sound sources. The share of gross fixed capital formation in GDP will be 24.5% at the end of 2024, which is about 2 percentage points higher compared to the pre-pandemic level, while at the same time the share of exports of goods and services will increase by 7.1 percentage points. After the jump in 2020, the share of government consumption in GDP will gradually decrease, so that at the end of the projection horizon it will come close to the 2019 level.

The Government strives to strengthen the investment and export component of GDP by undertaking certain activities and measures. Measures designed to provide sound foundations for potential GDP growth include acceleration of all administrative procedures that accompany these activities, reducing tax burden with a view of increasing economic competitiveness, signing agreements that ensure maintaining existing presence on foreign markets or entering new ones, more intensive and efficient execution of infrastructure works. Consistency in preserving fiscal stability prevents generation of imbalances and creation of uncertainty, whereas reform processes should enable stronger positive dynamics of the key macroeconomic variables. The digital transformation and construction of the digital ecosystem remains the strategic orientation of the Government. More efficient work of the state administration, shortening of administrative procedures for citizens and businesses with a focus on digitalization will accelerate the convergence of Serbian economy towards developed countries. The new system of fiscalization and changes in customs regulations will reduce the share of the grey economy in total economic flows, provide affirmative competition and improve the cost-effectiveness and efficiency of procedures.

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



Source: Ministry of Finance

According to the central scenario, potential GDP growth is expected to accelerate in the medium term. After an increase of 3.6% in 2021, potential GDP will gradually increase and reach a rate of 4%. Accelerated implementation of capital projects and continuation of the ongoing investment cycle, supported by both stable FDI inflows and domestic innovative activities, will provide an increasingly stronger contribution of capital and factor productivity to potential GDP growth. Digitization will significantly speed up these processes and further increase the efficiency of the utilization of available capacities. The Government will implement a comprehensive structural and institutional reform agenda to stimulate high, green, inclusive and sustainable growth in the medium term. Adequate and synchronized monetary policy, further improvements of the financial system, raising credibility and attractiveness for the investors, reform of the education system and its adjustment to the needs of the economy, as well as modernization of educational programs, transfer of knowledge and technology from the most developed countries should provide a positive impact on both factors of production. On the other hand, strengthening the rule of law, reform of the legislation in the field of economy and business, speeding up procedures and raising the efficiency of the administration should ensure maximization of the factor productivity in the medium term. Favourable labour market developments will also contribute to potential GDP growth but at a slower pace than in the previous period.

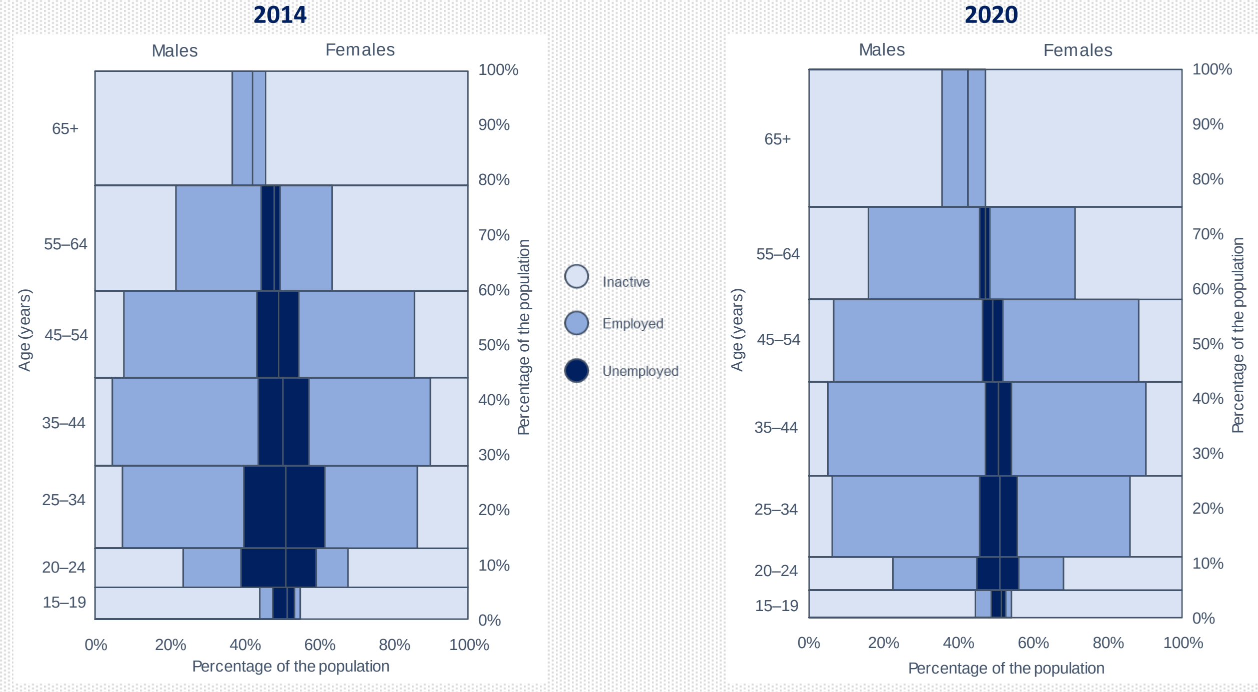
Labour market

Preservation of employment is one of the greatest achievements of the joint measures introduced by the Government and the NBS in the conditions of high uncertainty caused by the pandemic. According to the Labour Force Survey, the unemployment rate in 2020 decreased by 1.4 percentage points, compared to the previous year and stood at 9.0%. In addition to well-balanced measures, the positive developments were also influenced by the dynamics of economic activity, whose contraction was not of such extent to significantly affect the labour market, especially in the segment of formal employment where the impact of adopted economic aid packages was the strongest. Thanks to the mentioned measures, there was an improvement in the employees structure, including increase in the number of formally employed by 49.3 thousand, and decrease in the number of informally employed, which was reduced by 55.5 thousand. Other indicators are also improving. The female unemployment rate was reduced by 1.7 percentage points, to 9.4%, the youth unemployment rate by 0.9 pp, to 26.6%, and the long-term unemployment rate by 1.2 percentage points, to 4.9%. Positive trends in the labour market are confirmed by data from the Central Register of Compulsory Social Insurance, according to which the average number of formally employed was higher by 2.3%, y-o-y. The good situation on the labour market is also reflected in the growth of wages. The average net salary in 2020 was higher by 9.4% in nominal terms, or 7.7% in real terms, and amounted to RSD 60,073. In this period, the average net salary in the private sector was higher by 7.2%, and in the public sector by 8.9%.

Structural improvements in the labour market in the period from 2014 to 2020

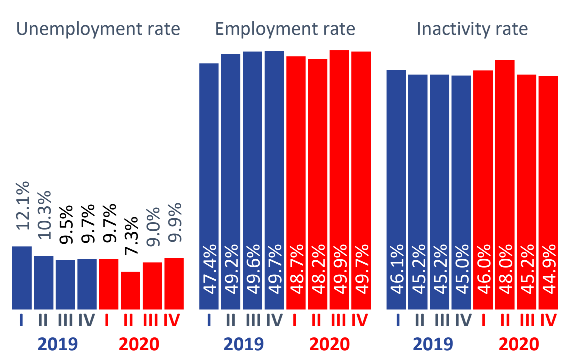
According to the Labour Force Survey, in 2020 the unemployment rate reached a record low level and amounted to 9.0%, which is lower by as much as 10.2 percentage points than six years ago. From 2014 to 2020, employment increased by 13.1%, and amounted to 2,894.8 thousand, with an increase in the number of permanent and temporary contracted workers, as well as full-time employees. In this period, the employment rate reached the level of 49.1%, which is its highest level since comparable data are available. In addition to a significant reduction in the unemployment rate, structural improvements in the labour market have also been noted. In the last six years, a significant decrease in the youth unemployment rate has been registered, from 47.5% to 26.6%. Also, there has been a noticeable progress in the position of women in the labour market, while long-term unemployment and informal employment have decreased. The decrease in unemployment has been registered in all age groups. In addition to the category of young people (15–24 years), the most significant decrease in unemployment was recorded in the age groups 25–34, as well as in 45–54. Also, noticeable progress in the position of women in the labour market is reflected in the reduction of the unemployment rate, as well as in a significantly higher growth in the number of active status holders compared to the male population.

Labour market indicators by age groups and gender



Despite the expiration of the effects of the previously adopted package of measures, the beginning of 2021 features the continuation of good trends on the labour market, which is primarily the result of higher economic growth than expected, which was backed by the started mass vaccination of the population. Thus, in the first quarter, according to the data of the Central Register of Compulsory Social Insurance (CROSO), the average number of employees was higher by 3.2% y-o-y. This growth is almost entirely the result of employment growth in the private sector, of 4.3%, while in the public sector the growth was only 0.3%. The strongest sectoral contribution to employment growth in this period was given by the manufacturing industry, trade and ICT. According to the data of the National Employment Service, the number of active job seekers was higher by 1.0%, which is estimated as a temporary increase due to the influence of one-off factors. Economic growth coupled with the overall stability of the economy has resulted in wage growth. In the first two months, the average net salary was higher by 5.0% y-o-y in real terms, and amounted to RSD 62,693. In this period, private sector's contribution to the general wage growth was more than twice larger than the contribution of the public sector. The general growth of wages was influenced by the decision to increase the 2020 minimum price of labour of RSD 172.54 per working hour, to RSD 183.93 in 2021. In addition, the growth of salaries in the public sector was influenced by the decision of the Government to permanently increase the salaries of health workers by 10% starting from April 2020. Observed by sectors, more than half of the total wage growth was influenced by the growth of wages in health, manufacturing, trade and ICT sectors. Within the public sector, in the first two months wages year-on-year increase was the highest in the health sector (19.2% in nominal terms or 17.9% in real terms).

Development of main labour market indicators



Source: SORS

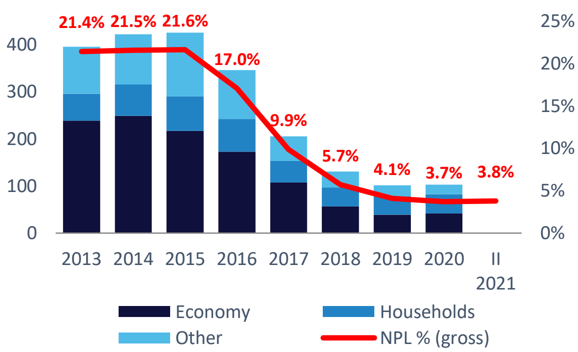
Well-balanced measures of economic policy makers, in response to the pandemic, which were aimed primarily at maintaining economic growth and preserving employment, created a strong basis for the continuation of positive trends in the labour market. Additionally, the improvement of the epidemiological situation, through the immunization of the population, is a sure way to full opening of the economy which, along with the positive trends so far, the expected high economic growth and further commitment of the Government to increase the number of employees, will result in a further reduction in the unemployment rate and wage growth. Furthermore, positive expectations are the result of continuous work on improving working conditions, improving labour market institutions, stimulating employment and inclusion in the labour market of hard-to-employ persons, as well as support to regional and local employment policy. Also, continuous efforts towards improving the quality of workforce are made, along with investments in human capital, all with the aim of enabling easier general employment, especially in the economy segment that features a greater added value. Also, through the intensified work of inspection services, after the improvement of labour legislation and adopted measures to reduce the tax burden on labour, decline in the number of employees in the grey zone and their transition to the contingent of formally employed will be continued. These measures will improve working conditions, in terms of workers' rights and insurance, and the positive effects will be reflected in budget revenues as well. At the end of the medium term, complex reforms of the education system are expected to take effect ensuring an adequate response to the needs of the economy, while active measures of training, retraining and support for social entrepreneurship will facilitate job availability for socially vulnerable categories of society and thus ensure inclusive economic growth. To ensure economic sustainability, wage growth in the medium and especially longer term should be based on productivity growth. This will require the continued creation of favourable conditions for economic growth, primarily through the growth of consumption and the attraction and growth of private investments.

Monetary developments

After the uncertainty on the domestic and global market induced by the coronavirus pandemic, the beginning of 2021 was featured by the complete restoration of trust in all the areas of economic life. As a result, above all of well-coordinated and balanced economic measures of the Government and the NBS, macroeconomic, financial and fiscal stability has been preserved. In addition to this, the good macroeconomic results during the pandemic were influenced by the previous economic growth, the created fiscal space, but also the favourable structure of the economy, which proved to be quite resistant to shocks of such nature. In addition to the measures taken, the started mass vaccination of the population in Serbia and in the international environment has also contributed to the positive economic environment. Good results were recognized by the rating agencies, thus in March, Moody's upgraded Serbia's credit rating to Ba2 with a stable outlook, and Fitch confirmed the BB+ credit rating. Banking stability has been preserved and further consolidated, with a significantly reduced share of non-performing loans.

Lending activity recorded a high growth, boosted by reduced financing costs, due to the effects of the monetary policy easing, but also to a sharp decline in risk premia, improved credit ratings, and easing of the ECB's monetary policy. The growth of lending activity was also influenced by the approval of dinar loans at a lower interest rate under the Guarantee Scheme, reduced mandatory participation for the purchase of the first apartment, reduced minimum built portion of property whose purchase can be financed with housing loans and extension of repayment period for housing loans. High credit growth rates were accompanied by a further decline in the share of non-performing loans. Also, the share of dinar placements has significantly increased, which is a result of the growth of dinar loans in the corporate sector, underpinned by low interest rates on dinar loans, as well as by favourable corporate financing under the Guarantee Scheme. The growth of lending activity was also boosted by low and stable inflation rate, and the NBS measures to support the process of dinarization. The positive contribution to the growth of loans is also provided by corporate and household loans, where the share of investment loans in the corporate sector has increased and approximately corresponds to the share of loans for working capital. At the same time, largely as a result of encouraging housing loans, their contribution to the growth of total household loans has increased significantly and is almost equal to the contribution of cash loans. At the end of March 2021, an 8.9% y-o-y nominal growth of total loans was registered, where corporate loans recorded a growth of 6.4%, while household loans were higher by 11.9%. Under the Strategy for NPLs Resolution, the implementation of which began in the second half of 2015, the share of NPLs in total loans in the banking sector was significantly reduced and at the end of February 2021 amounted to 3.8%. This is a decrease of 18.41 percentage points compared to the period before the implementation of the Strategy.

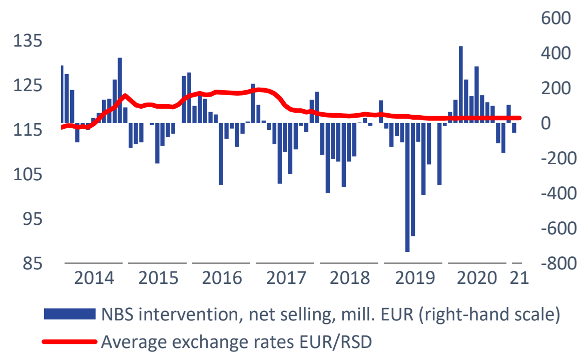
Non-performing loans, billion RSD



Source: NBS

As a result of low inflationary pressures, associated with the falling domestic demand and significantly cut oil prices on the international market, but also with stable movements in the foreign exchange market, inflation in 2020 hovered at a low level, despite the negative effects of coronavirus. Thus, at the end of 2020, inflation stood slightly below the lower limit of deviation from the target, at 1.3% y-o-y. The rise in the prices of tobacco, telephone services, travel packages, meat products, telephone equipment and edible oils was significantly mitigated by a sharp fall in the prices of petroleum products. At the beginning of 2021, inflation continued moving at a low level. Thus, in March, the growth of consumer prices on a year-on-year basis was 1.8%. The biggest contributor to the rise in prices in this period was the increase in the prices of electricity, tobacco, meat products, utility services and telephone equipment. On the other hand, the fall in the prices of vegetables and meat was a contributor in the opposite direction, towards slowing down the growth of inflation. Low inflationary pressures are indicated by the movement of core inflation, which stood at 1.8% y-o-y in March.

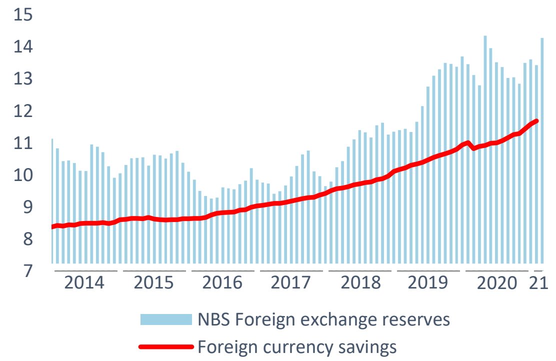
Exchange rate and NBS interventions in the foreign exchange market



Source: NBS

Developments in the foreign exchange market in 2020 were marked by relative exchange rate stability, despite depreciation pressures, fuelled by uncertainty in the international financial market regarding the evolution of the pandemic. The relative stability of the exchange rate was supported, first of all, by the measures of the NBS, which intervened in the interbank foreign exchange market mainly by selling foreign currency. As a result of the maintained stability on the foreign exchange market, the confidence of international investors has been preserved. Due to good macroeconomic trends, economic growth above the expected and solid FDI inflows, the beginning of 2021 has featured continued stable trends in the foreign exchange market. Thus, in the first quarter, the dinar recorded a slight y-o-y real appreciation (averaging 0.3%), while it was nominally unchanged. In the first quarter, the NBS intervened in the interbank foreign exchange market with a net sale of EUR 50 million.

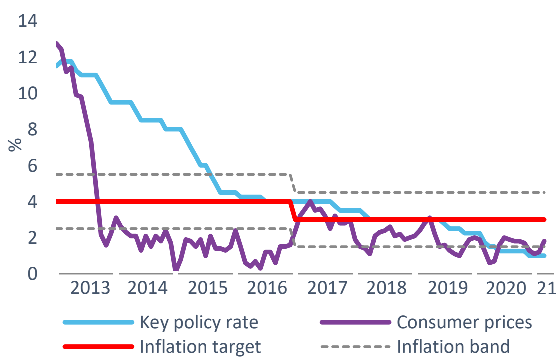
Foreign exchange reserves and foreign currency savings, billion euros



Source: NBS

In March 2021, foreign exchange reserves were increased by EUR 852.7 million and amounted to EUR 14.3 billion, which was sufficient for the coverage of the money supply M1 of 141% and for more than six months of imports of goods and services. The increase in the foreign exchange reserves of the NBS is primarily the result of the Republic of Serbia issue of a twelve-year Eurobond in the nominal amount of EUR 1.0 billion on the international financial market. Compared to March 2020, the NBS's foreign exchange reserves increased by EUR 1.2 billion.

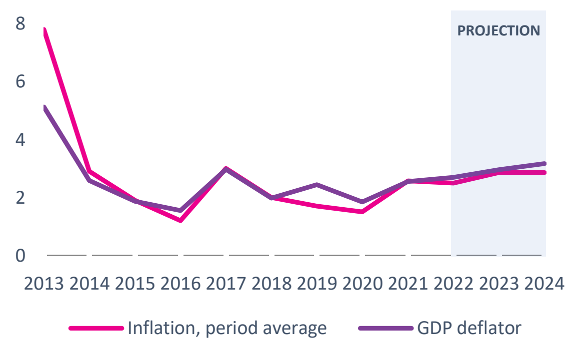
Inflation and reference interest rate, %



Source: SORS and NBS

As a consequence of rising electricity prices and global oil prices, inflation is expected to rise in the short term. However, due to the expected continuation of low and stable inflation trends, as well as the negative production gap and low import inflation, disinflationary pressures are expected to prevail in the medium term. Inflation will be in the lower half of the target band, and such movements will also depend on the speed of recovery of domestic and foreign demand, domestic food prices and movements in regulated prices. The key risks to the inflation projection relate to developments in the international environment, primarily to the speed of the euro area recovery, then to uncertainties regarding developments in the global commodity market, as well as capital flows to emerging markets. In the forthcoming period, positive trends in lending activity are expected to continue, as a result of the measures taken so far to encourage lending, low interest rates in the euro area, as well as the expected strong growth of economic activity.

Inflation projection, %



Source: SORS and Ministry of Finance

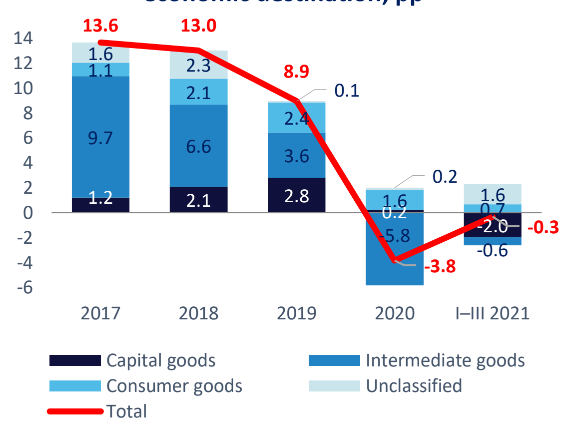
External sector

The pandemic that hit the global economy, as well as the consequences of the economy "lockdown", largely affected foreign trade trends during the previous year, especially in the second quarter. However, the recovery of foreign trade activity began already during the third quarter owing to the improvement of the epidemiological situation, easing of the measures, as well as the gradual opening of economies. In such circumstances, the volume of foreign trade in 2020 decreased by only 3.4%, with a decline in exports of 2.8% and in imports of 3.8%.

Diversification of products and markets in which domestic products are placed, along with the recovery of external demand, played a significant role in improving export activity in the second half of 2020. After a sharp fall in the second quarter of almost 20%, exports recorded stagnant y-o-y trends in the following quarter, and then returned to the growth path in the fourth quarter, being by 6.8% higher with double-digit growth rates in certain key manufacturing industries. However, such dynamics was not sufficient to prevent a 5% drop in the manufacturing sector exports on an annual basis. The most significant negative contribution was recorded by the metal and automobile industries, but also by the reduced export of petroleum products. On the other hand, the mitigation of the decline in total export activity was influenced by the agricultural sector, which recorded an increase in exports of 20.0%, as well as mining, whose export value more than doubled.

The decline in merchandise imports in 2020 is a consequence of the reduced needs of the economy for raw and production materials due to the smaller volume of economic activity, but also lower oil prices. In the opposite direction, there was an increase in imports of consumer goods and capital goods, of 8.3% and 1.6%, respectively, primarily as a result of huge government expenditures for the procurement of materials and equipment necessary for health care needs, but also slightly smaller private sector investments. Such export-import dynamics resulted in a reduction of the trade deficit by 6.9% compared to 2019, while the coverage of imports by exports was higher by 0.8 percentage points and amounted to 74.3%.

Contributions to import growth rates, economic destination, pp

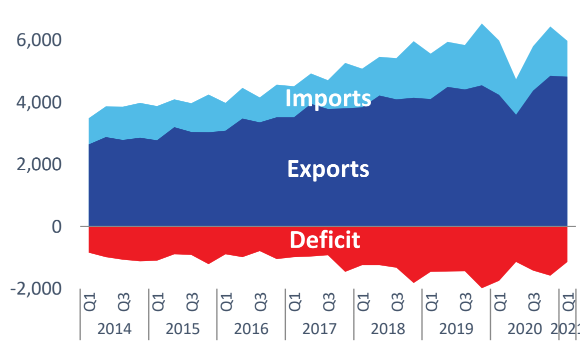


Source: SORS

In the first quarter of 2021, foreign trade maintained its positive trends. Further recovery of external demand with the activation of new production capacities resulted in an increase in merchandise exports of 13.8% y-o-y. The high growth in the first quarter is partly a consequence of the base effect, since some industries have already significantly reduced export activity in March 2020. The manufacturing industry continued to be the main driver of export growth in the first three months, providing a contribution of 10.3 percentage points, which was also supported by higher exports of the agriculture and mining sectors. Within the manufacturing industry, almost all activities recorded higher values of exports, and the largest increases were registered in exports of electrical equipment (35.3%), chemical (24.5%) and metal industry (17.3%), as well as in food (12.3%) and rubber industries (10.6%). At the same time, merchandise imports recorded a slight decline of 0.3% y-o-y as a consequence of somewhat smaller imports of equipment and intermediate goods. The import of consumer goods took the opposite direction, and was increased by 3.4% y-o-y due to the recovery of household personal consumption. Such trends in foreign trade during the first quarter of 2021 resulted in a reduction in the trade deficit by 34.6% y-o-y, as well as in an increase in the coverage of imports by exports, from 70.8% to 80.8%.

The most important foreign trade partners during the first three months of 2021 are still the EU countries, which accounted for 67.3% of total exports and 60.4% of total imports. The largest share of total exports (41%) in that period was directed to the markets of five countries: Germany, Italy, Romania, Bosnia and Herzegovina and Hungary. Imports from Germany, China, Italy, Hungary and Turkey accounted for 44.7% of total imports.

Merchandise trade, mil. EUR



Source: SORS

Balance of payments trends in 2020 are characterized by a significantly lower current account deficit, which was 37.3% lower than in the previous year. The trade deficit amounted to EUR 5.2 billion and was lower by almost EUR 400 million, while the surplus in the trade in services amounted to EUR 1.1 billion and was higher by EUR 62.9 million, primarily owing to a more favourable balance of net exports of tourist services. Lower expenditures on investment income resulted in a 43.4% reduction in the primary income deficit, while the secondary income surplus was lower by 9.1%, due to lower remittance inflow. Such developments resulted in a reduction in the share of the current account deficit in GDP to 4.3%, which is 2.6 percentage points less than in 2019.

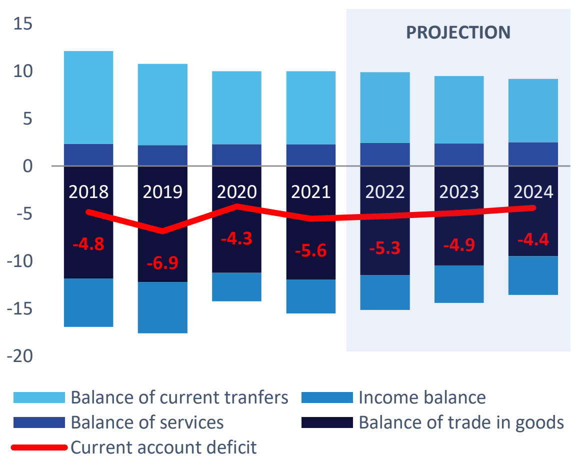
The net inflow of foreign direct investments in 2020 remained high despite the unfavourable impact of the pandemic, and amounted to EUR 2.9 billion, or 6.2% of GDP, which was more than sufficient for full coverage of the current account deficit. Observed by activities, the largest share in total net FDI is still recorded by the manufacturing industry, but also by the financial sector, mostly due to the privatization of *Komercijalna Banka*. Observed by geographical origin, 67.9% of total investments in this period arrived from the EU, while observed by countries, the largest net inflow of foreign direct investments comes from the Netherlands, Slovenia, China, Germany and Austria, which account for slightly less than three quarters of total due investments. At the end of 2020, an inflow of portfolio investments in the amount of EUR 1.6 billion was registered, mostly due to the issuance of a 7Y Eurobond (EUR 2 billion) in May, which was used to support the economy in the fight against coronavirus. On the other hand, the second issue of Eurobonds ($ 1.2 billion) was mostly used for early redemption of part of the debt under the bonds issued in 2011.

Favourable balance of payments movements have continued in the beginning of 2021. In the first two months, the trade deficit was lower by 43.2% due to the growth of exports and drop in imports, while the surplus on the services account increased by 70.3%, primarily as a result of a larger decline in our tourists spending abroad compared to the decline in foreign tourists spending in Serbia. There was a lower primary income deficit of 48.3% y-o-y primarily due to lower expenditures on direct investment income. The secondary income account recorded a surplus in the amount of EUR 578.2 million, which was higher by 6.7% y-o-y, mostly due to increased remittances inflow. The total current account deficit in 2021 is expected to be around EUR 2.8 billion, or 5.6% of GDP. With the recovery of the economy, the inflow of FDIs is expected to accelerate, which will provide full coverage of the current account deficit this year as well.

Medium-term macroeconomic framework for the period 2022–2024 envisages further improvement of foreign trade flows, based on the modernization and expansion of production and export capacities in tradable sectors, strengthening of competitiveness on the international market and conquering new market niches. This will be supported by further mitigation of the effects of the pandemic in the external environment, as well as intensification of domestic investment activity.

The growth of merchandise exports in euros at an average rate of 11.5% and imports by 9.0% in the projected three-year period will reduce the deficit in foreign trade in goods to 9.5% of GDP in 2024, from this year's 12.0%. It is foreseen that the favourable developments in the services account will continue, where the surplus will average EUR 1.4 billion in the projected three-year period. The inflow from current transfers will average 7.1% of GDP per year, with remittance revenues retaining the dominant component role. The net effect of current transfers and net factor payments in the next three-year period will be positive and will amount to around EUR 1.8 billion on average per year, which will significantly alleviate the deficit in the balance of foreign trade in goods and services. Such developments, along with the projected dynamics of economic activity, will result in a reduction in the share of the current account deficit to 4.4% of GDP at the end of the projection period.

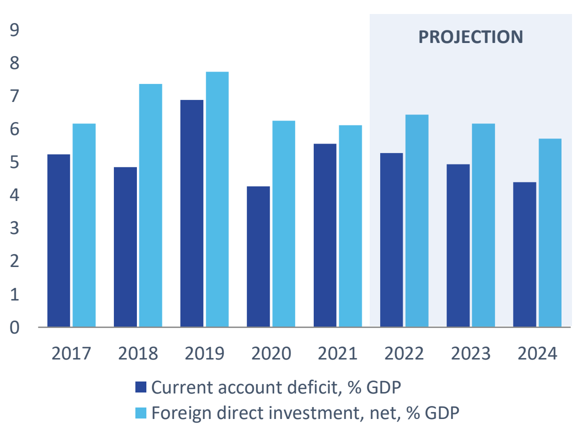
Current account structure, % GDP



Source: Ministry of Finance, NBS, SORS

It is important to note that the structure of current account will be dominated by the share of FDIs, amounting to 6.1% of GDP on average per year. This inflow will also be the main source of financing the current account deficit. The maintained favourable investment outlook of our country and the growth of FDIs, as well as their further diversification towards the tradable goods sector, will contribute to the continuation of export growth and the strengthening of external and internal macroeconomic balance.

Current account deficit and FDI, % GDP



Source: NBS and Ministry of Finance

Some indicators of Serbia's external position deteriorated slightly in 2020, but still reflect the satisfactory resilience of the Serbian economy to financial shocks from the international environment. The ratio of external debt to exports and external debt to GDP increased. The increase in these external solvency indicators was mostly due to the sale of government bonds on the international financial market, in the amount of two billion euros, with the aim of helping the economy during the pandemic, while the proceeds from the second issue of Eurobonds in 2020 in the amount of $ 1.2 billion were mostly used for early redemption of part of the debt under the bonds issued in 2011. The share of external debt in exports of goods and services in 2020 is 138.8%, which is significantly below the World Bank criteria of 220% and is a guarantee of sustainable servicing.

4. Risks involved with achieving the projection of GDP trends in the Republic of Serbia in the period 2022–2024

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

The macroeconomic framework risks largely arise from uncertainty about the evolution and efficiency in curbing global pandemic.

The baseline macroeconomic scenario assumes that the impact of the pandemic will weaken during 2021 along with the weakening of virus transmission and increase in vaccination coverage. If otherwise, the deterioration of the epidemiological situation and the introduction of additional restrictive measures would lead to further recessionary trends. In the upcoming period, the recovery of the Eurozone and the region of Central and Southeast Europe, Serbia’s most important foreign trade partners, will depend on the efficiency of health measures, but also on the margins for monetary and fiscal stimuli which are narrow for countercyclical actions in many countries.

In the short run, exogenous risks are assessed as symmetrical. Greater production and distribution of the vaccine should reduce the pandemic to acceptable levels and stimulate a faster-than-expected recovery of consumers’ and investors’ confidence, and thus faster economic growth. On the other hand, difficulties in the process of vaccine production and distribution, already faced by some developed countries, and the emergence of new strains of the virus, which spread faster, could extend application of restrictive health measures and thus slow down recovery. Uncertainty in the international commodity and financial markets, trade tensions and collapsed business confidence would have a negative impact on capital flows. As for the commodity market, the collapse of primary commodity prices could have a twofold impact on Serbia's economic growth. The movement of oil prices above the projected values would have a negative impact on production costs, but would also change the structure of household consumption by increasing the share of imported goods, which would jointly slow down economic growth. Serbia has maintained its role of a net exporter of basic metals despite declining exports, so that faster growth in their prices would positively affect economic activity and to some extent neutralize the effects of EU measures. The activation of new and expansion of existing export capacities, and more favourable trade relations will contribute to mitigating negative risks. Thanks to investments from the previous period, primarily in tradable sectors, Serbia's total exports were less affected by reduced external demand from the euro area, and the industrial sector remained relatively resistant to shocks from the global environment.

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

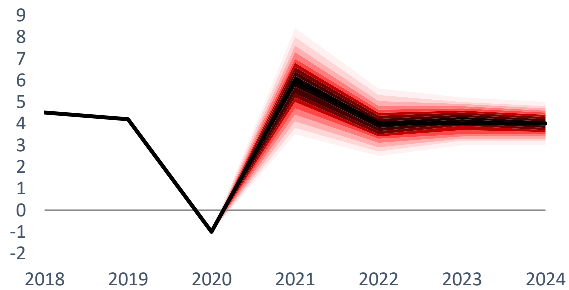
The path of the pandemic will determine developments in the service sector, especially in the transport, catering and tourism sectors. The damage caused by the pandemic in these sectors can spill over to other branches of industry.

Other factors from the domestic environment relate to the volatility of agricultural production, efficiency in the delivery of public projects and the dynamics of the implementation of the initiated reforms. Continuation of structural reforms and further improvement of the business environment should contribute to faster growth. Despite the improvement and modernization of the agricultural sector, the production of major crops is still significantly dependent on agrometeorological conditions, which may lead to significant deviations from the multi-year average agricultural production on the basis of which the movement of this sector is projected. The baseline scenario assumes a negative contribution of agriculture to GDP, taking into consideration that the last year’s season was excellent. The growth of construction in the coming period is based on trend developments in this sector, predictive indicators and the announced government investments. Dynamics and efficiency in the implementation of public projects, after the relaxation of health measures, as well as activities in the segment of construction of buildings and production facilities bring along symmetrical risks. The movement of industrial production is largely determined by external factors. Nevertheless, the electricity segment could contribute to growth above expectations, if the reform processes were intensified, and investments from the previous period effectuated in the coming period. Also, the reform of public enterprises is the basis for raising the level of productivity and efficiency, which would reduce the cost of production processes, increase competitiveness and expand investment capacities. The dynamics of the implementation of these reforms is clearly reflected in the dynamics of overall economic growth by influencing it in the same direction, namely faster implementation of reforms brings faster economic growth and vice versa.

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

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

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



Source: Ministry of Finance

II. FISCAL FRAMEWORK FOR THE PERIOD FROM 2022 TO 2024

1. Medium-terms goals of fiscal policy

Serbia ended 2020 with a fiscal deficit of 8.1% of GDP and a debt level of 58.2% of GDP. The good state of public finances and the relatively favourable debt levels enabled a generous and timely response of the state to the crisis caused by the pandemic. The package of measures, planned in the amount of about 12.9% of GDP, and implemented in the amount of about 11.6% of GDP, according to preliminary data, combined with monetary measures, alleviated the negative effects of the crisis and stabilized macroeconomic trends.

The fight against the coronavirus pandemic has continued in 2021. With a view of reducing the negative effects on economic activity, a new package of measures to support businesses and households was adopted. The package of measures amounts to about 4.5% of GDP and includes general assistance to businesses and citizens, in the form of direct assistance, but also additional measures for sectors whose operations are most restrained by epidemic-control measures (hospitality, bus transport, hotel and tourism sectors). In addition to direct assistance, this package of measures provides additional funds for maintaining the liquidity of business entities and extends the deadline for the use of this form of assistance, and increases the amount of funds allocated to the health sector.

Given the huge effect that the package of measures will produce upon the fiscal position of the state, Republic budget rebalance was prepared. The budget revision plans a deficit of 6.9% of GDP and a debt level of 60% of GDP. As in the previous year, state's fiscal intervention to minimize the effects of the crisis was combined with efforts not to suspend development programs and infrastructure projects financed from the budget.

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

The medium-term fiscal framework envisages a moderate abandoning of expansionary fiscal policy. Given the uncertain economic situation, the budget will certainly be a "safety net" in case of escalation of unfavourable developments. On the one hand, the continuity of development and welfare programs will be ensured, and on the other hand, the sustainability of public finances and the continued reduction of public debt levels in terms of their share in GDP will be ensured. Bearing in mind the expected macroeconomic developments, the envisaged annual fiscal deficits allow for reduction of the share of general government debt of GDP in the coming period.

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

2. Fiscal trends in 2020

At the end of 2020, at the level of the general government, the fiscal deficit amounted to 442.8 billion dinars, or 8.1% of GDP, which is by 0.8% of GDP better than planned, given that the revised budget planned fiscal deficit of 8.9% of GDP. In the same period, the primary fiscal deficit of 6.1% of GDP was realized. In the original budget plan, the deficit was 0.5% of GDP. Debt increased by 5.3 percentage points, from 52.9% of GDP at the end of 2019 to 58.2% of GDP at the end of 2020. Such unfavourable fiscal developments are due to the crisis caused by the COVID-19 pandemic, and corresponding efforts made by the Republic of Serbia to mitigate its impact on economic and social flows by significant investments in the health system and procurement of necessary medical supplies. The total package of measures planned for 2020 amounted to 704.4 billion dinars, or 12.9% of GDP, of which 564.1 billion dinars were released under the measures to support the economy and the population (10.3% of GDP) which, summed up with the purchase of medical equipment and medicines in the amount of about 72 billion dinars (1.3% of GDP), produces a total cost of COVID-19 response of 636.1 billion dinars, or 11.6% of GDP.

In relation to the original budget plan, revenues and expenditures were realized with significant deviations, both in nominal amounts and in terms of their structure.

Public revenues were realized in the amount lower by 85.8 billion dinars (1.6% of GDP) compared to the amount planned in the original budget, while compared to 2019 they are nominally lower by 1%. The biggest deviation in relation to the plan was recorded in tax revenues, i.e. contributions, personal income tax and VAT. Contributions and personal income tax are lower than envisaged in the plan by 1.2% of GDP, which is a consequence of the measures under which tax liabilities on this basis are deferred and paid in instalments, starting from January 2021. After the period in which the measures were in force, these categories recorded a higher growth than envisaged in the initial plan, partly due to the fact that some taxpayers have already started settling part of their deferred liabilities. Indirect taxes (mostly VAT) are lower by 0.7% of GDP compared to the plan, which is a consequence of the fall in personal consumption, population movement restriction measures, reduced volume of transit traffic, and the like. Corporate income tax was realized in the amount higher than planned by about 0.2% of GDP, despite deferral of advance payments for the second quarter, due to a conservative approach applied in the planning of this category, based on moderate growth of economic profitability. Non-tax revenues are higher by 0.2% of GDP compared to the plan, owing to payments of extraordinary non-tax revenues, which are not included in the plan (profit, dividends, premiums, etc.), while regular non-tax revenues were significantly reduced due to the pandemic (tolls, fines, court and administrative fees and charges, etc.).

Public expenditures were higher than the original plan, in the amount of RSD 327.9 billion (6% of GDP). Compared to 2019, they recorded a growth of 13.8%. The largest deviation was registered in subsidies (2.5% of GDP), equal to the amount of direct support to the private sector paid out from the subsidies account. Payment of direct financial assistance to the population from the other current expenditures account caused these expenditures to be higher by 1.4% of GDP compared to the plan. Expenditures for goods and services are higher than planned by about 0.8% of GDP due to increased expenditures for the purchase of medicines and medical equipment, but also increased expenditures for road network maintenance at PE “Roads of Serbia”, while expenditures for employees are higher by 0.4% of GDP mostly due to salary increases in the health sector. The realization of public investments in 2020 exceeded all previous years, reaching the level of 5.4% of GDP and exceeding the plan by 0.6% of GDP. Investments have been made in both transport infrastructure and new health facilities, which represents a significant qualitative shift in public financial management in times of crisis and an incentive for further economic growth. The net budget loans item increased by 0.6% of GDP compared to the original budget plan. Within this category of expenditures, assets for credit assistance to the economy were transferred through the Development Fund of the Republic of Serbia.

Table 5. Review of the packages of measures to support the economy and the population in 2020

	Plan		Realization	
	in billion dinars	**in % of GDP**	**in billion dinars**	**in % of GDP**
Tax policy measures				
Deferred payment of payroll taxes and contributions for the private sector during the state of emergency and for one additional month; private companies will repay these obligations in instalments, but not before January 2021	168.0	3.1	119.8	2.2
Deferred advance payment for the second quarter of 2020 of corporate income tax	21.0	0.4	13.5	0.2
Exemption from VAT for all donors	–	–	–	–
Total	**189.0**	**3.5**	**133.3**	**2.4**
Direct support to the private sector				
Direct support to entrepreneurs who pay a flat tax and entrepreneurs who pay tax on the actual income, and to micro, small and medium-sized enterprises in the private sector – three months payment of net minimum wage and two additional months payment of 60% net minimum wage	128.8	2.4	130.1	2.4
Direct support to large private companies – support in the amount of 50% of the net minimum wage (during the state of emergency) to employees who have received a decision on termination of employment (based on Articles 116 and 117 of the Labour Law).	4.5	0.1	1.6	0.0
Direct support to hospitality sector - 350€ per bed, 150€ per room, in dinar equivalent calculated at the official middle exchange rate of NBS	2.0	0.0	1.2	0.0
Direct support to caterers, travel agencies, hotels and car rental companies (30.000 RSD)	2.7	0.0	2.0	0.0
Direct support to sport clubs	1.1	0.0	1.1	0.0
Total	**139.1**	**2.5**	**136.0**	**2.5**
Measures to preserve private sector liquidity				
Financial support programme during COVID-19 crisis through the Development Fund of the Republic of Serbia	24.0	0.4	16.3	0.3
Guarantee Schemes to support the economy during the COVID-19 crisis	240.0	4.4	174.5	3.2
Total	**264.0**	**4.8**	**190.8**	**3.5**
Other measures				
Dividend moratorium until the end of the year, excluding public enterprises and loss of revenue arising from dividends	16.0	0.3	6.0	0.1
Salary increase measures and other direct financial assistance (10% increase in salaries of health workers, direct financial assistance of RSD 4,000 plus RSD 5,000 to all pensioners, support to agricultural producers, RSD 10,000 bonus to health workers)	26.3	0.5	26.0	0.5
Fiscal incentive – payment of 100€, in dinar equivalent calculated at the official middle exchange rate of NBS, to all adult citizens	70.0	1.3	72.0	1.3
Total	**112.3**	**2.1**	**104.0**	**1.9**
Fiscal impact assessment of measures	**464.4**	**8.5**	**389.6**	**7.1**
Overall package of measures	**704.4**	**12.9**	**564.1**	**10.3**
Other costs related to COVID-19 (medical equipment and medicines)	–	–	72	1.3
Overall costs related to COVID-19	**704.4**	**12.9**	**636.1**	**11.6**

3. Current fiscal trends and the outlook for 2021

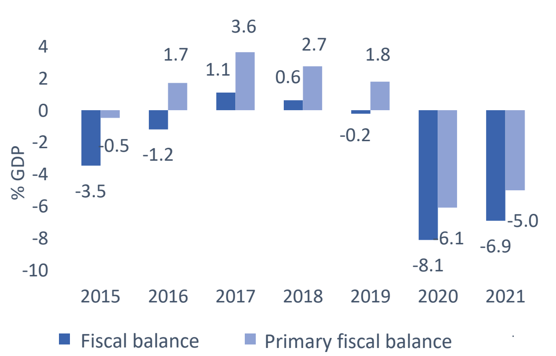
The general government fiscal deficit in 2021, according to the latest estimates, will amount to 6.9% of GDP. Compared to the balance projected in the original budget for 2021, the deficit is higher by 3.9 percentage points (the planned deficit was 3% of GDP). The following factors led to a revision of the general government fiscal balance in the current year:

- operationalization of the third economic aid package for businesses due to the extended duration of the COVID-19 pandemic;
- providing additional funds for public health protection;
- increased investment in infrastructure projects in order to support recovery of the economic growth;
- revision of the general government revenue projection.

Changes on the revenue and expenditure side necessitated 2021 budget revision, which was adopted by the National Assembly in April this year.

The downward trend in the share of public debt in GDP, present since 2016, has been temporarily suspended due to the crisis caused by the COVID-19 pandemic during 2020 and 2021. In the forthcoming period, due to the stabilization of economic trends, accelerated economic recovery and the planned movement of the fiscal balance in the medium term, the public debt trajectory is expected to decline again.

General government fiscal balance in the period from 2015 to 2021, % of GDP



Source: Ministry of Finance

Throughout 2020 the coronavirus pandemic was producing extremely negative health, economic and broader social consequences, both worldwide and in the Republic of Serbia. Since March 2020, when the first case of the disease was registered in the Republic of Serbia, epidemiological measures of varying intensity have been applied aimed at preserving citizens' health and reducing the pressure on public health system. The crisis induced by the coronavirus pandemic continued in 2021. Epidemiological measures of varying degrees of restriction are still present across the world. The Republic of Serbia has provided, despite all the difficulties in procuring vaccines, sufficient quantities for mass vaccination of the population.

During 2020, the first and second package of measures of economic support to businesses and households for overcoming the crisis caused by the pandemic were implemented. The estimated volume of these two packages was 12.9% of GDP, while, according to preliminary data, measures worth 11.6% of GDP were implemented. The economic support package for businesses and households has significantly contributed to mitigating the negative effects of the crisis and resulted in a smaller economic downturn, particularly in comparison to other European economies, and the turbulence in the labour market was avoided as well.

The fight against the pandemic continued during 2021. The application of epidemiological measures is in force along with the simultaneous mass vaccination of the population. The positive effects of the previous economic support program were carried over to the beginning of 2021, but the prolonged effect of the pandemic, with an uncertain duration, necessitated a new aid package for businesses and households. Having reviewed the economic trends in the fourth quarter of the previous year and in the first quarter of 2021, the situation on the labour market, the effects of the implemented set of measures, all in the conditions of prolonged complex epidemiological situation, the Government of the Republic of Serbia decided to adopt an additional package of measures to support the economy and population. In order to preserve the achieved results and attain the projected goals of economic recovery in 2021, it was necessary to allocate additional support funds, with stronger emphasis on those activities that have been disproportionately affected by the application of extended epidemiological measures. Larger allocations are also planned as assistance to the most vulnerable categories of the population.

An additional package of measures in 2021 is projected at 4.5% of GDP. The effect of this package of measures on the fiscal balance in 2021 is estimated at 2.5% of GDP. Direct support to the economy aimed at preserving employment, in the amount of three months payment of 50% of minimum wage is provided to all companies that have expressed interest, under the condition that they do not reduce the number of employees by more than 10% over the period of three months after having received the assistance. In addition to general assistance to the economy, additional assistance is envisaged for particularly affected sectors (hospitality, transport - bus transport, a certain segment of the hotel industry, tourism sector). In addition to direct assistance, funds for additional liquidity of the business sector in the amount of EUR 500 million have been provided, as well as a longer deadline for the use of this form of assistance. To stimulate aggregate demand and accelerate the recovery of production, but also of service activities, after the easing of epidemiological measures, provision of financial assistance to all adult citizens has been planned, the same as in the previous year. Apart of general assistance, an additional incentive is envisaged for all vaccinated citizens over the age of 16.

Table 6. Review of the package of measures to support the economy and the population in 2021

2021	Plan	
	bill. din	% GDP
Direct support to the private sector		
Direct support to the private sector - three months payment of 50% of minimum wage to all entrepreneurs, micro, small, medium-sized and large enterprises	69.8	1.2
Direct support to hotels in urban areas	1.3	0.0
Direct sectoral support - catering, travel agencies, hotels and car rental companies	4.2	0.1
Independent artists	0.2	0.0
Direct sectoral support - sector of road passenger transport operators and bus stations - 600 € per bus	2.6	0.0
Total	78.1	1.3
Measures to preserve private sector liquidity		
Extension of the existing guarantee scheme to support the economy during the COVID-19 crisis	60.0	1.0
Establishment of a new guarantee scheme to support the most affected sectors / enterprises	60.0	1.0
Total	120.0	2.0
Other measures		
Fiscal incentive - stimulating domestic demand	68.0	1.2
Total	68.0	1.2
Fiscal measures impact assessment	**146.1**	**2.5**
Overall package of measures	**266.1**	**4.5**

Along with the revision of the revenue and expenditure side and the adoption of the Republic budget rebalance, the entire fiscal framework of the general government for 2021 and the next three years was revised. The innovated fiscal framework for 2021 envisages a fiscal deficit of 6.9% of GDP. Compared to the originally planned fiscal framework, the revenue estimate increased by 56.1 billion dinars. On the expenditures side, there was an increase of 288.9 billion dinars, with significant changes in their structure.

Although the projection of the real GDP growth rate for 2021 has not been revised at this time, the original projection of general government revenues has been conservative, due to caution and uncertainty regarding overall macroeconomic developments, especially in the labour market. The current effects of the pandemic, and of the epidemiological measures, on economic and budget revenue developments are somewhat milder than originally expected. The recovery of production activities at the global level is faster and the economic support program has been successfully implemented in the country. On the other hand, uncertainties regarding the prolonged duration of the pandemic, the course of citizens' immunization, the implementation of epidemiological measures and the global economic recovery continue to call for caution when revising the revenue projection for 2021.

Table 7. Revenues, expenditures and balance of the government sector in 2020, in billion dinars

	budget 2021	New estimate 2021	Difference new/budget	Change %	2021 new est. % GDP
PUBLIC REVENUES	2,423.9	2,480.0	56.1	2.3	41.8
Current revenues	2,404.4	2,460.4	55.9	2.3	41.4
Tax revenues	2,171.1	2,225.4	54.3	2.5	37.5
Personal income tax	225.4	236.3	10.8	4.8	4.0
Corporate income tax	107.1	107.1	0.0	0.0	1.8
VAT	600.3	600.3	0.0	0.0	10.1
Excises	315.8	322.7	6.9	2.2	5.4
Customs duties	53.1	56.6	3.5	6.6	1.0
Other tax revenues	84.9	86.3	1.4	1.7	1.5
Contributions	784.5	816.1	31.6	4.0	13.7
Non-tax revenues	233.3	235.0	1.6	0.7	4.0
Grants	19.5	19.6	0.1	0.6	0.3
PUBLIC EXPENDITURES	2,603.3	2,892.1	288.9	11.1	48.7
Current expenditures	2,237.2	2,428.4	191.1	8.5	40.9
Expenditure for employees	602.5	616.0	13.5	2.2	10.4
Purchase of goods and services	458.5	483.4	25.0	5.4	8.1
Interest repayment	113.6	113.7	0.1	0.1	1.9
Subsidies	130.7	218.6	87.9	67.2	3.7
Social benefits and transfers	847.8	861.7	13.9	1.6	14.5
Of which pensions	621.0	617.0	-4.0	-0.6	10.4
Other current expenditures	84.2	135.0	50.9	60.4	2.3
Capital expenditures	330.6	429.7	99.1	30.0	7.2
Net lending	23.7	22.4	-1.3	-5.5	0.4
Activated guarantees	11.7	11.7	0.0	0.0	0.2
Balance	-179.3	-412.1	-232.8		-6.9
Balance in % GDP	-3.0	-6.9	-3.9		

Source: Ministry of Finance

The most important factors that led to the change in the amount and structure of budget revenues are:

- base effect (better performance at the end of the previous year);
- conservative planning of certain categories of tax revenues (due to uncertainty regarding the evolution and effects of a prolonged pandemic);
- collection of tax revenues during the first quarter of 2021 (especially for excise products);
- more favourable than expected developments in the labour market;
- recovery of foreign trade;
- payment of initially unplanned non-tax revenues and donations;
- anticipation of the positive impact of the program of economic measures on economic activity and personal consumption.

The projection of personal income tax revenues was increased by 10.8 billion dinars compared to the original amount. The original projection of income tax revenues took into account the projections of average wages and employment movements, estimates of prepayment of part of deferred taxes during 2020, as well as estimates of the effects of raising the non-taxable part of wages in 2021. The same assumptions have been used in the projection of revenues from social contributions, which account for the largest individual revenues at the general government level.

The results of collections at the end of 2020 were above expectations, and the data on employment and movements in the average wages are a confirmation of the maintained stability on the labour market. This trend was maintained in the first quarter of 2021, and the implementation of a new package of economic support measures provides an additional guarantee that the situation on the labour market will remain preserved in the coming period. Having in mind the above, the projection of revenues from income tax and social security contributions has been revised upwards, but with a dose of caution in the projection of these categories. The estimate of the repayment of part of the deferred taxes and contributions during 2021 was slightly adjusted based on the data on payments effected in February and March. In a similar way, the projection of revenues from social contributions was revised upward, by 31.6 billion dinars.

The remainder of the income tax covers other tax forms such as dividend tax, interest income tax, annual income tax, rental property income tax, etc. The previous program of measures, provided for a moratorium, during 2020, on the payment of dividends for companies that use state support. As most of the profitable companies did not use state support, dividends were paid out to their shareholders on a regular basis. Some of the companies that had used state support paid out dividends after the moratorium had expired, at the beginning of 2021. In January, a strong jump in dividend tax payments was recorded, so the projection of this tax category was revised on that basis.

The projection of profit tax revenues has not changed compared to the original budget plan for 2021, although the collection in the first quarter partly exceeded expectations. Although conservatively planned, most of the profit tax revenues arrive during the second quarter, so there is currently no reliable basis for their revision. Secondly, companies that decide to use funds from economic support programs will not be able to pay out dividends and pay taxes payable on that basis by legal entities.

Revenues from value added tax have also not been revised. Collection during the first quarter was in line with expectations, and an additional impetus in the coming quarters will be given by the implementation of measures under the new package of economic support. The analysis of taxable turnover for the first three months of the current year shows that the growth trend of turnover in retail trade has been maintained, while the turnover in service sector is still below the pre-pandemic level. The inability to consume certain types of services, as well as the caution of the population in uncertain epidemiological conditions, affect the slower recovery of the services sector. The structure of VAT collection was changed under the influence of a faster recovery of external trade, which led to an upward revision of import VAT and VAT refunds.

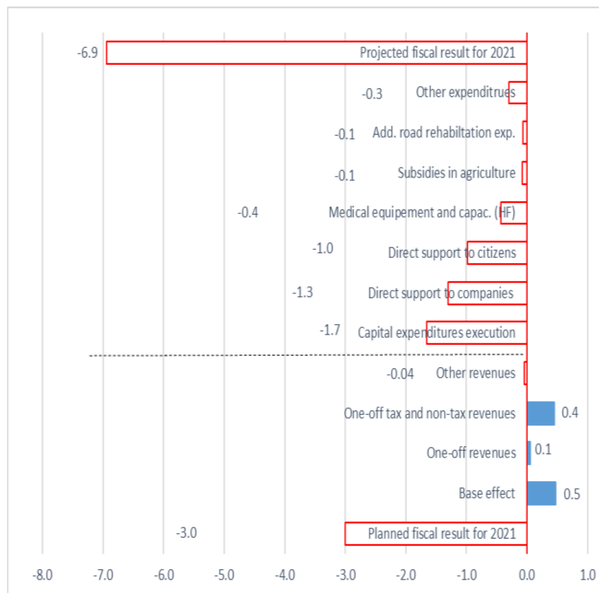
Revenues from customs duties are projected in the amount of 56.5 billion, which is an increase of 3.4 billion dinars (6.4%) compared to the original projection. Revenues from customs duties mostly follow the dynamics of import VAT, thus the projection of this revenues form was revised in accordance with the change in the structure of VAT, the volume of external trade and movements in customs duties collection in the first quarter.

Revenues from excise tax are projected in the total amount of 322.8 billion dinars, which is 7 billion dinars more than the original projection. Excise duties on tobacco products increased by 4 billion dinars, and excise duties on petroleum products by 3 billion dinars. The projection of revenues from other excise duties has not changed. The increase in revenues from excise duties on tobacco is the result of significantly better collection at the end of 2020 and the beginning of 2021. The turnover of this type of excise products was not significantly affected by the pandemic-induced crisis, so the previous year can serve as a solid basis for assessing trends in 2021. For the budget projection of revenues from excise duties on petroleum products, the reference basis is 2019, featured, unlike 2020, by the usual monthly dynamics. Movements in the collection during the first quarter of 2021 indicate a slightly higher income on an annual level than originally planned. Despite the fact that the transit traffic in the summer months may not reach the extent that is usual, the domestic traffic - due to the greater use of private vehicles - compensates for any loss on that basis. Also, the projection of the excise tax on petroleum products included the assumption that the volume of public transport, where there is a refund of part of the excise tax, will be somewhat decreased.

As regards other excise duties, somewhat lower consumption of alcoholic products and collection of excise duties on that basis is expected. This decline was offset by the expected higher collection of excise duty on electricity.

Non-tax revenues have increased slightly compared to the amount envisaged in the original budget. Non-tax revenues are a heterogeneous category of revenues presenting different movements by individual forms. Regular non-tax revenues include various fees, charges, penalties, revenues of bodies and organizations and all other revenues that are generated at a steady pace during the year, in approximately similar amounts on a monthly basis, with certain seasonal variations. Regular non-tax revenues during the previous year were significantly affected by the economic and epidemiological situation in the country. This particularly applies to toll revenues. The collection of certain revenues from this category has fully recovered, while the recovery of others requires a complete stabilization of the epidemiological situation. Extraordinary non-tax revenues include payments of profits of public enterprises and agencies, budget dividends, collected receivables of the Deposit Insurance Agency, bond issuance premiums, etc. Regular non-tax revenues of the budget of the Republic have not been revised compared to the original projection, while at other levels of government they have been slightly reduced. Extraordinary non-tax revenues were adjusted upwards due to the effected payment of revenues that were not included in the budget plan (bond issuance premium and budget dividends).

The contribution of individual factors to fiscal balance adjustment in relation to the 2021 plan, % of GDP



The estimated general government expenditures have been increased by 288.9 billion dinars in relation to the original budget. The largest part of this increase relates to the implementation of packages to support the economy and the population. The rest consists of expenditures related to the direct fight against the pandemic, improvement of the country's health capacities as well as a significant increase in capital expenditures. In the period January-March, public expenditures grew at a rate of 3.1% compared to the same period in 2020, and by the end of the year it is expected that the total growth of expenditures will accelerate due to the implementation of the program of measures in the rest of the year.

Expenditures for employees increased by 13.5 billion dinars compared to the originally planned. The largest part of this refers to the increase in the number of people engaged in the health system, increased engagement, and increased number of working hours in other sectors that participated in the control of the epidemiological situation. One part of the increase is a consequence of a slightly larger execution at the end of 2020.

Expenditures for goods and services increased by 25 billion dinars. The largest part of the increase refers to expenditures for the purchase of vaccines, other medicines, medical equipment and supplies by the National Health Insurance Fund (NHIF). The other part of the increase refers to the expenses of routine road maintenance at the PE “Roads of Serbia”. Other levels of government also recorded an increase in this category of expenditures, especially during the first quarter of the current year.

Subsidies were also significantly increased compared to the original plan, by 87.9 billion dinars. From this category of expenditures, a new package of direct assistance will be paid out to companies and entrepreneurs for overcoming the pandemic-induced crisis. For these purposes, in 2021, over 78 billion dinars are planned. One part of the increase in subsidy expenditures relates to increased subsidies in agriculture, road and rail transport.

Social protection expenditures are higher by 13.9 billion dinars compared to the original plan. In the framework of this category of expenditures, part of the assistance to households under the third package of measures will be paid out. Specifically, the NES and the Pension and Disability Insurance Fund will pay dinar equivalent of EUR 60 and 50, respectively, to their beneficiaries. This is a form of additional assistance to more vulnerable categories of the population, in addition to the one that all adult citizens receive. Expenditures for pensions have been reduced compared to the original plan by 4 billion dinars. Pensions in 2021 were indexed according to the Swiss formula, whose parameters were known during the planning of this category of expenditures, but the planned growth in the number of pensioners failed to materialize. In 2021, the share of pension expenditures in GDP is 10.4%.

Other current expenditures increased by 50.9 billion dinars compared to the original plan, primarily due to the payment of direct financial assistance to households (50 euros to all adult citizens in dinar equivalent at the official middle exchange rate of the NBS), in the total amount of 44.7 billion dinars. The remainder of the increase refers to the procurement of a part of vaccines for immunization of the population against COVID-19, which is not realized through the NHIF.

It is estimated that the realization of public investments will be higher by 99.1 billion dinars than the original plan. Execution of capital expenditures in the period January-March 2021 compared to the same period last year increased by 13.7%. Capital expenditures reached currently record level of 7.2% of GDP in 2021. Higher expenditures are planned for both new and existing infrastructure projects, primarily covering road, railway and communal infrastructure. Larger investments will contribute to accelerating economic growth in 2021 and in the medium term. Larger investments are planned in new health facilities and equipment with a longer service life. One part of the increased expenditures refers to further epidemiological protection of the population against COVID-19, and the other to the improvement of the health care system in the future. In earlier times of crisis, most often there would be a decrease in capital expenditures, but this was not the case now, which is a qualitative positive change in public financial management. The rest of the increase in capital expenditures relates to investment in the renewal and modernization of military equipment.

The estimated fiscal deficit of 6.9% of GDP does not deviate from the average fiscal balance expected in the countries of the region and the EU. Such a result is a direct consequence of the implementation of the aid packages, as well as the efforts to sustain and accelerate the economic recovery in the coming period. Structural analysis of the fiscal result identified that about 4% of GDP refers to one-off and temporary measures, and thus established that the country's fiscal position has not been disturbed.

Table 8. Revenues, expenditures and balance of the government sector, January-March, in billion dinars

	I–III 2020	I–III 2021	I–III growth/decline rate in %	2021/2020 growth/decline rate in %
PUBLIC REVENUES	537.0	594.5	10.7	10.0
Current revenues	534.0	588.7	10.2	9.7
Tax revenues	481.8	531.2	10.3	11.8
Personal income tax	49.2	55.6	12.9	15.7
Corporate income tax	24.2	28.5	17.7	-12.8
VAT	134.1	139.2	3.8	9.3
Excises	76.5	78.9	3.2	5.4
Customs duties	11.9	13.3	11.6	9.0
Other tax revenues	18.2	20.9	14.7	4.3
Contributions	167.6	194.8	16.2	21.1
Non-tax revenues	52.3	57.6	10.2	-7.1
Grants	3.0	5.7	94.7	75.8
PUBLIC EXPENDITURES	589.1	607.2	3.1	7.2
Current expenditures	530.6	542.0	2.1	3.2
Expenditure for employees	139.9	153.1	9.4	6.4
Purchase of goods and services	96.2	96.8	0.6	9.6
Interest repayment	47.3	48.2	1.8	3.1
Subsidies	25.9	25.5	-1.6	-13.1
Social benefits and transfers	194.6	202.4	4.0	6.9
Of which pensions	144.9	151.1	4.3	5.7
Other current expenditures	26.7	16.1	-39.8	-18.1
Capital expenditures	54.9	62.4	13.7	46.5
Net lending	2.0	1.0	-50.6	-49.4
Activated guarantees	1.6	1.8	7.8	57.0
Fiscal balance	-52.2	-12.7		

Source: Ministry of Finance

The balance of arrears (over 60 days of delay)* of budget beneficiaries and organizations of compulsory social insurance on the last day of March 2021 amounted to 2.1 billion dinars (about 0.05% of GDP), and decreased compared to the end of 2020 by 0.5 billion dinars. Budget beneficiaries and PE "Roads of Serbia" created the arrears of 0.7 billion dinars, while the balance of arrears in the organizations of compulsory social insurance amounts to 1.4 billion dinars.

Table 9. The arrears in payments of budget beneficiaries and OCSI in 2020 and January-March 2021, in billions of dinars

	31 Dec. 2020	31 March 2021
Budget beneficiaries and PE "Roads of Serbia"	1.2	0.7
OCSI	1.4	1.4
TOTAL	2.6	2.1

Source: Ministry of Finance

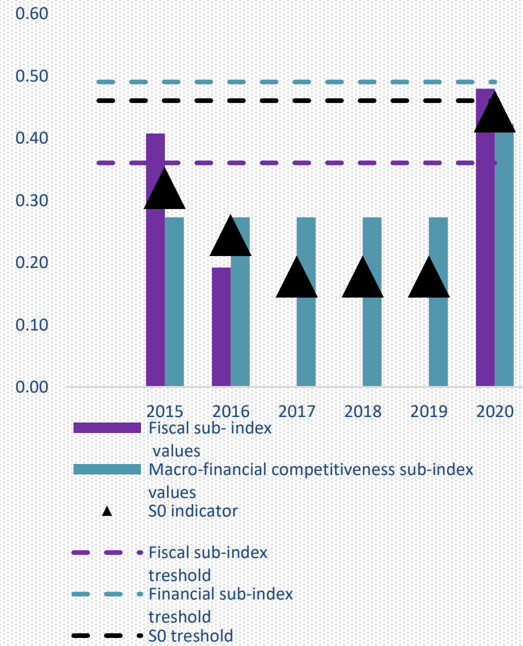
* Pursuant to the definition used to monitor the implementation of the arrangement with the IMF.

S0 indicator of short-term fiscal sustainability

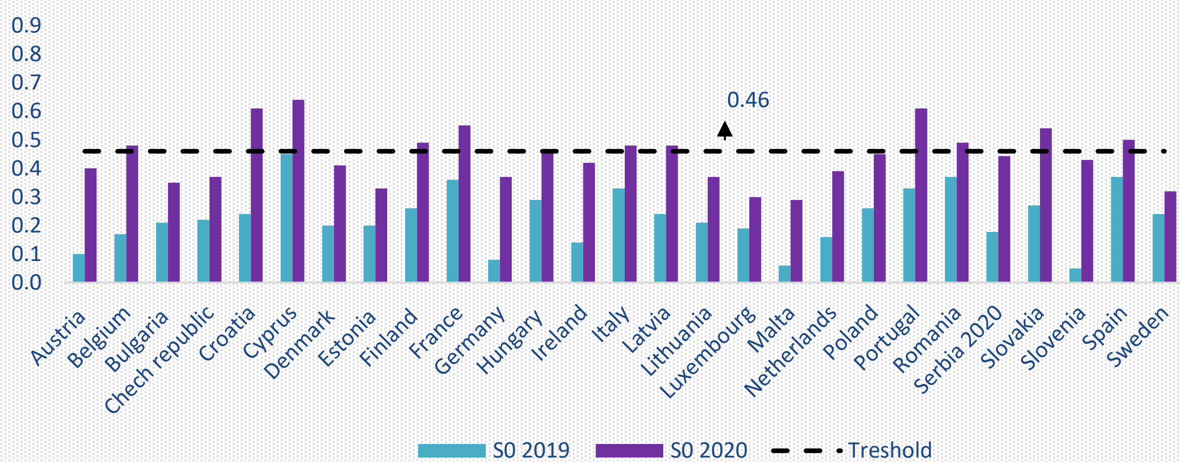
To assess short-term fiscal sustainability, the European Commission has designed a composite SO indicator which, by identifying potential short-term risks in the current year, seeks to anticipate fiscal stress in the coming year. If the S0 indicator value exceeds the defined threshold, it is considered that the country is in a short-term risk of fiscal stress. Along with the value of the entire indicator, for the purpose of locating the source of risk, the values of the sub-index and their components are considered as well. The S0 composite indicator consists of two sub-indices, which contain a number of variables of fiscal and macro-financial sustainability. The value of these sub-indices below the defined threshold indicates the absence of short-term fiscal risk.

In 2020, the value of the entire S0 indicator for the Republic of Serbia was below the defined threshold, which in principle indicates that there is no danger of macroeconomic instability in the next medium-term period. However, as a consequence of the crisis caused by the COVID-19 pandemic, the value of the fiscal sub-index (0.48) was above the related defined threshold (0.36), which indicates that challenges could arise in the fiscal sphere. The value of the financial sub-index (0.42) in 2020 is within the related defined threshold (0.49).

S0 indicator, fiscal and financial competitiveness sub indexes in Serbia for the period 2015-2020



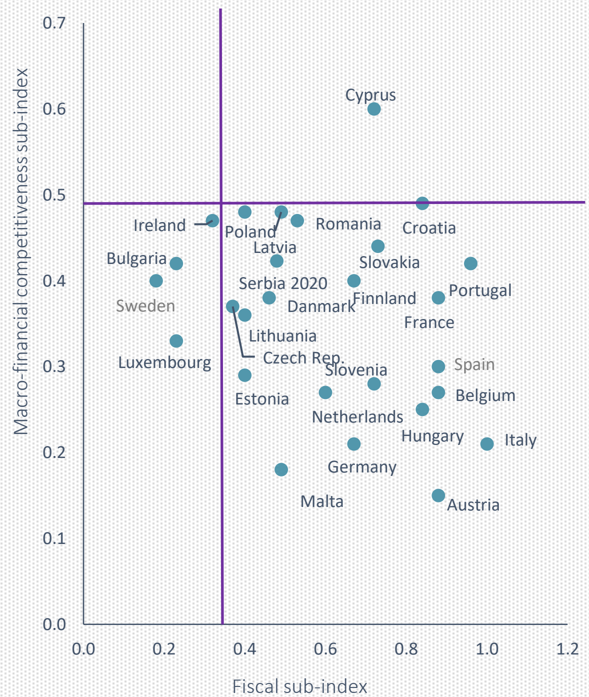
S0 EU countries and Serbia



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

Based on EC data for EU countries for 2020 and the calculation of the Ministry of Finance for the Republic of Serbia, we may conclude that most of the observed countries, including Serbia, are in a zone where they could be exposed to some kind of fiscal stress in the medium term. Minimizing the potential risks of fiscal stress in the observed countries will be necessary to create space for economic policy measures in response to the health crisis that has spilled over into all spheres of the economy.

Fiscal sub-index and financial competitiveness sub-index for EU countries and Serbia in 2020



4. Fiscal projections for the period 2022–2024

In the next medium-term period, economic and fiscal policy will depend on the development of the pandemic and success in the fight against it. Fiscal policy objectives are definitely aimed at maintaining fiscal stability and reducing the share of public debt in GDP. The medium-term fiscal framework envisages a gradual reduction of the general government deficit to 1.0% of GDP by 2024 and a decline in the share of public debt to 55.5% of GDP. Projections of fiscal aggregates in the period from 2021 to 2024 are based on projections of macroeconomic indicators for that period, planned tax policy which implies further harmonization with EU laws and directives, and fiscal and structural measures, including further reform of large public enterprises.

Thanks to fiscal consolidation measures in the previous period, a fiscal space was created enabling extensive packages of measures to be provided as part of the fight against the effects of the pandemic-induced crisis in 2020 and 2021. The same impact of the pandemic, which would require a similar package of measures, is not expected in the next year, but certain reserves will be provided in case of a new deterioration of economic trends. Continuation of capital investments and investments in health system, a moderate increase in pensions and salaries in the public sector, and possible relief of tax burden on the economy, subject to available fiscal space, are expected in 2022. These measures and their fiscal implications are designed so as not to endanger the stability of public finances and the pace of public debt reduction, then to maintain the living standards of the citizens and help economic development, but also to ensure flexibility of response to any new crisis shocks.

Table 10. Fiscal aggregates in the period 2020–2024, in % of GDP

Description	Realizations	Estimate	Projection		
	2020	2021	2022	2023	2024
Public revenues	41.3	41.8	41.8	40.8	40.6
Public expenditures	49.4	48.7	44.7	42.4	41.6
Consolidated fiscal balance	-8.1	-6.9	-3.0	-1.5	-1.0
Primary consolidated balance	-6.1	-5.0	-1.2	0.1	0.6
General government debt	58.2	60.0	59.3	57.6	55.5
Real GDP growth rate	-1.0%	6.0%	4.0%	4.0%	4.0%

Source: Ministry of Finance

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

Fiscal result and general government debt, % of GDP

Expansionary fiscal policy in 2020 and 2021 reduced the negative economic impact of the pandemic. In the next medium-term period, a moderate reduction of the general government deficit has been envisaged in order to ensure the necessary flexibility of the national economy to face potential external shocks through fiscal policy. This primarily refers to the expenditure side, in the form of an increase in public investment, as well as additional investments in the health care system. On the revenue side, the priority will remain to further reduce the tax burden on wages and to continue the fight against tax evasion and the grey economy.

The projection of revenues in the period from 2022 to 2024 was made on the basis of:

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

Table 10. Total revenues and grants in the period 2020-2024, in % of GDP

Description	Realization	Estimate	Projection		
	2020	2021	2022	2023	2024
PUBLIC REVENUES	41.3	41.8	41.8	40.8	40.6
Current revenues	41.1	41.4	41.5	40.5	40.4
Tax revenues	36.4	37.5	37.6	36.9	36.8
Personal income tax	3.7	4.0	4.0	4.0	4.0
Corporate income tax	2.2	1.8	1.9	2.0	2.1
VAT	10.1	10.1	10.1	10.1	10.0
Excises	5.6	5.4	5.3	5.1	4.9
Customs duties	1.0	1.0	1.0	1.0	1.0
Other tax revenues	1.5	1.5	1.4	1.3	1.3
Contributions	12.3	13.7	13.9	13.5	13.6
Non-tax revenues	4.6	4.0	3.8	3.7	3.5
Grants	0.2	0.3	0.3	0.3	0.3

Source: Ministry of Finance

The declining trend of revenues in terms of share in GDP is expected, taking into consideration the projected structure of medium-term growth of the Serbian economy. Collection of deferred liabilities from 2020 will increase the level of revenues above the 2021 and 2022 trend, but will also increase the effect of the decline in the share of revenues in GDP in 2023. The projection of tax revenues implies maintaining the existing level of collection.

The predominant form of income tax is the payroll tax, so the trends in the wage bill and employment are the main factors influencing the movement of this tax form. In 2022 (as well as in the current year), these revenues will be increased by the collection of the part of the deferred salary tax from 2020 as part of the package of measures in the fight against the pandemic, in the amount of about 6 billion dinars. In the coming period, the wage bill is expected to grow faster than nominal GDP as a result of continued favourable developments in the labour market, so that the salary tax revenues will grow, as well, in terms of their share in GDP. The expected increase in the minimum wage will also affect the growth of the total wage bill in the economy, and thereby also this tax category.

Other forms of income tax (dividend tax, interest income tax, annual income tax, etc.) will grow more slowly, namely in line with the movement of general economic activity, so that a stable level of income tax revenues is expected, in terms of their share in GDP. As far as the payroll taxes are concerned, the fight against the grey economy is crucial, considering the substantial number of undeclared workers and cash payment of wages. In recent years, controls have been intensified and sanctions have been tightened, which resulted in reducing the grey economy in the area of labour and employment, but it is important to proceed with continuous efforts towards resolving this issue in the following period as well.

The movement of the share of contributions in GDP has a similar trajectory as the movement of the share of the payroll tax, considering that the same assumptions on the movement of salaries and employment were used for their projection. Part of the revenue will be collected from the payment of deferred contributions from 2020, in the amount of per 30 billion dinars in 2021 and 2022. Contributions are a tax category in which the tax indiscipline is the most prominent and where the largest debt of taxpayers is recorded, so that the consequences of a possible increase in fiscal indiscipline are most visible in this form of taxation.

Revenues from corporate income tax in the period 2022-2024 will depend on the trajectory of economic growth, the relative stability of RSD exchange rate and the general profitability of the economy. Estimates of revenues on this basis may be uncertain due to economic factors, as well as due to the possibility of using a tax credit or refund, as well as differences in accounting and tax balances. The decline in 2021 reflects the expectation that the effects of the 2020 crisis will affect the profitability and income tax collection, while thereafter in the period 2022-2024 a growth in collection, in line with GDP movements, is expected.

The movement of VAT revenues is characterized by a stable share in GDP. The main determinant of VAT trends is domestic demand driven by disposable income of the population. Disposable income as the largest determinant of consumption depends on the movement of salaries in the public sector, pensions, social benefits, the movement of the wage bill in the private sector and other forms of revenues, including remittances, as well as the dynamics of banks' lending in the retail sector. As with personal income tax, the risks to the VAT projection in the coming period, in addition to uncertainty regarding the pandemic, relate to the movement of wages in the private sector, growth of economic activity, and the size of shadow economy, i.e. efficiency in reducing its scale.

The results of more efficient collection and control of taxpayers were evident in the previous period and it is expected that this trend will continue, although the effects of the fight against the grey economy have not been explicitly included in the medium-term projection of public revenues. The increase in the level of VAT collection, in terms of implementing independent anti-evasive measures in the VAT area, produced certain results in the past period. In this segment, there is room for further improvements, through strengthening and modernizing the tax administration.

The projection of excise revenues is made on the basis of the current excise policy and projected consumption of excise products. Within the excise policy for tobacco products, further gradual harmonization with EU directives is expected, in accordance with the medium-term plan of gradual increase of the excise burden. In the case of cigarettes, it will be directed through a gradual increase in excise duties, in order to reach the EU minimum of 1.8 euros per pack in dinar equivalent, calculated at the official middle exchange rate of the NBS, within a reasonable time. Applying caution in the projection of excise revenues, a further natural decline in the market of tobacco products has been envisaged in the coming period, on average of about 3% per year. Unlike tobacco products, the situation on the market of petroleum products is much less volatile. Better control and labelling effects of petroleum products have reduced the possibility and profit of illegal activities. In the coming years, for cautionary purposes, the growth of petroleum products consumption has not been envisaged to continue, although it may be expected that the acceleration of economic activity could contribute to the growth of consumption. Revenues from excise duties on alcoholic beverages, coffee and electricity have been projected in accordance with the existing consumption structure. The current nominal amounts of excise duties on alcoholic beverages and coffee are adjusted with the expected inflation rates in the medium-term period. The harmonization of excise duties on alcoholic beverages with the EU directive will not produce significant fiscal effects.

Customs revenues will stabilize at 1.0% of GDP in the coming period. The projection of the collection of customs revenues was made on the basis of the projected movement of imports, exchange rate and consumption.

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

The share of non-tax revenues in GDP is projected to decrease, from 4.6%, as recorded in 2020, to 3.5%, as expected in 2024. The reason for reducing the projected share of non-tax revenues in GDP is the exclusion from the 2020 base of all those revenues that are not considered structural, i.e. permanent, and this primarily refers to extraordinary categories of non-tax revenues. Extraordinary non-tax revenues are mostly one-off, to some extent uncertain, both in terms of their amount and in terms of the time of payment. The largest part of these revenues are extraordinary payments of profits of public enterprises and agencies, budget dividends, revenues based on collected receivables of Deposit Insurance Agency, bond issuance premiums, etc. Regular non-tax revenues include various fees, charges, penalties, revenues of agencies and organizations and all other revenues that are generated at a steady pace in the course of the year. These non-tax revenues are indexed to the inflation realized in the previous year, or follow the changes in the value of the basis to which they apply, and as a result they are adjusted to the projected inflation.

Progress in country's EU accession process increases the availability of IPA and IPARD funds, which make up the predominant part of grant revenues. The projected amounts based on donations also include funds based on EU sectoral budget support. Revenues from donations are neutral in relation to the result, since they are equal to expenditures on the same ground.

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

Table 12. Total expenditures in the period 2020–2024 in % of GDP

Description	Realization	Estimate	Projection		
	2020	2021	2022	2023	2024
PUBLIC EXPENDITURES	49.4	48.7	44.7	42.4	41.6
Current expenditures	43.1	40.9	37.3	35.9	35.0
Expenditures for employees	10.6	10.4	10.2	9.9	9.7
Purchase of goods and services	8.1	8.1	7.9	7.5	7.2
Interest repayment	2.0	1.9	1.8	1.7	1.6
Subsidies	4.6	3.7	2.0	1.8	1.7
Social assistance and transfers	14.8	14.5	14.1	13.7	13.5
of which pensions	*10.7*	*10.4*	*10.3*	*10.1*	*10.0*
Other current expenditures	3.0	2.3	1.4	1.2	1.2
Capital expenditures	5.4	7.2	7.1	6.2	6.3
Net lending	0.8	0.4	0.1	0.1	0.1
Activated guarantees	0.1	0.2	0.3	0.2	0.2

Source: Ministry of Finance

In 2020 and 2021, there was a change of trend in public expenditures, due to the need to respond to the crisis caused by the pandemic. The measures were significant on the expenditure side, which led to a high, albeit one-off, jump in the share of the expenditure side of the budget in GDP.

Such is the case with expenditures for employees, which reached the level of 10.6% of GDP in 2020, mostly due to the extraordinary increase in salaries of employees in the health system, along with the increased payments of other forms of remunerations such as for overtime work and bonuses, and increased number of employees in this sector. Given the limited fiscal space in the coming period, wages will be increased moderately, in a controlled way, taking into account their share in GDP.

Wage cuts, employment control and streamlining of public sector employment were the measures that contributed most to downsizing expenditures and attaining success in fiscal consolidation. The Law on the Budget System envisages lowering the level of wages without contributions payable by the employer to 7% of GDP, however, it seems that the targeted level of wages is set quite low. Currently, the share of thus defined wages in GDP is around 8.8%. The average level of wages at the level of the general government in the EU, before the pandemic, was around 10% of GDP, while in our country total wages are planned to be reduced to 9.7% of GDP by 2024.

In the previous period, a comprehensive reform of the public sector wage system was initiated, which aimed at ensuring fairness and reducing discrepancies between the salaries of public sector employees. The implementation of the new reformed salary system should start in the post-pandemic period.

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

Expenditures for purchase of goods and services will gradually decrease in the medium term, in terms of their share in GDP, given that their nominal growth is projected to be slower than the nominal GDP growth. The surge in 2020 and 2021 is largely the result of higher health expenditures.

The reduction of interest expenditures is one of the best indicators of a successful fiscal and monetary policy, as well as their full coordination in the previous period. Good fiscal results in the previous period reduced the need for borrowings, which, together with the easing of monetary policy, led to a fall in interest rates. In 2024, the level of interest expenditures will decrease to 1.6% of GDP.

Social assistance and social transfers represent the largest expenditure category of the general government budget. The largest single item of this group of expenditures, and at the same time the largest item of all expenditures, are pensions, which in 2020 reached the level of 10.7% of GDP. As of 2020, pensions have been harmonized with the so-called Swiss formula, in order to simultaneously ensure the growth of the living standard of pensioners and the sustainability of the pension system and the public finance system. The Swiss formula implies indexation, i.e. an increase in pensions equal to the sum of half the growth rate of the average salary and half the growth rate of consumer prices. It is estimated that in the coming period the indexation of pensions would be between 5 and 6%, and in 2021, specifically, it will amount to 5.9%. Other forms of social benefits and transfers in the coming period will be adjusted by applying the prescribed indexation, current and planned policy changes in this field and the projected number of beneficiaries. The share of expenditures for social benefits in GDP will decrease from 14.8% in 2020 to 13.5% in 2024.

The reduction of subsidies that serve to help inefficient segments of the public sector enables an increase in the portion of subsidies that represent real incentives to the economy, primarily agriculture and small and medium-sized enterprises, leading to the acceleration of economic activity. The aim is to redirect subsidized funds to development programs in the economy and agriculture. The growth of subsidies in 2020 and 2021 is the result of the implementation of measures to overcome the problems caused by the pandemic crisis.

Other current expenditures categories encompass various expenditures, such as grants to associations, political parties, religious and sports organizations, fines, damages, etc. As with subsidies, the one-time growth was caused by the fiscal response to the crisis, and a reduction in these expenditures in GDP is expected in the coming period.

Over the past three years, the efficiency of public investment has improved significantly. Capital expenditures increased to 5.4% of GDP in 2020, thanks to the commencement of a new cycle of infrastructure projects, and in 2021 they are expected to reach the level of as much as 7.2% of GDP, despite the problems caused by the pandemic. In the next medium-term period, the level of investment in public infrastructure is expected to be significantly higher than in previous years. The most significant infrastructural works include road, railway, communal and water infrastructure, which are mainly financed from international loans. In addition to transport infrastructure, funds have been provided for additional capital investments in health, environmental protection, education, culture, defence and other areas that represent the most important functions of the state. This is all part of a new investment cycle at the national level that has been made possible by the creation of fiscal space and supported by favourable borrowing conditions in the international financial market.

The general commitment of fiscal policy in the medium term is to increase investment in infrastructure at all levels of government. According to the estimates of the Fiscal Council, investments of the local self-governments in the medium term should be increase by at least 55% compared to their current level, i.e. by about 250 million euros. These are primarily investments in water supply and sewerage infrastructure, waste management, local road infrastructure, etc.

In the medium-term fiscal framework, by the end of 2024, a balanced overall fiscal position of local self-government has been projected. This means that, aggregately, all cities and municipalities have an approximately balanced budget. The projection was made on the basis of trends in the previous period, in which local self-government units, aggregately, were usually in surplus. This situation at the level of all local governments is a consequence of deleveraging in the previous period. This does not mean that individual local governments cannot go into deficit, which depends on the fiscal position of each individual municipality and city.

Projection for the next medium-term period includes reducing the level of budget loans and debt repayment on the basis of guarantees. The total share of these two categories in GDP was reduced to 0.4% of GDP in 2019, with temporary growth in 2020 and 2021. By the end of 2024, these expenditures will be minimal, with a share of up to 0.3% of GDP.

Repayments on the basis of issued guarantees and payment of guarantees on commercial transactions are liabilities based on the debt of public enterprises assumed by the state budget, since these enterprises could not perform them on their own. These expenditures have been a major burden on the budget given the long-term inefficient operation of a large number of state-owned enterprises and companies. In the previous period, these expenditures were significantly reduced, and the repayment plan envisages that by 2024 these expenditures will be at the level of 0.2% of GDP.

Structural measures to improve the stability and sustainability of public finances[2]

At the time of writing this document, the Republic of Serbia is still confronting uncertain conditions caused by the COVID-19 pandemic, while implementing the third package of measures to support the economy and the population, along with the fight for the health and lives of its citizens, by building new hospital facilities and carrying out the vaccination process, which in the foreseeable future could ensure the return of the state and society to normal flows. Serbia is also standing between two IMF arrangements: previous PCI arrangement (Policy Coordination Instrument) - was successfully completed earlier this year, and negotiations are underway on a new arrangement that would continue to support macroeconomic and fiscal stability, economic recovery and structural reforms that would support the Republic of Serbia on its European path.

The new arrangement would continue to support the preservation of macroeconomic and fiscal stability, the strengthening of the financial sector, along with further dinarization and capital market development, which in conjunction with institutional and structural reforms, should ensure high rates of green, inclusive and sustainable growth.

A functional system of fiscal rules is needed to ensure the stability and sustainability of public finances in the long run. The currently applicable fiscal rules were introduced back in 2010, but have failed to stop the growth of the deficit and public debt. Due to the pandemic, the adoption of a new set of fiscal rules has been postponed. As of 2020, the indexation of pensions has been reintroduced, where pensions are adjusted using the Swiss formula, while respecting the limit of 11% of GDP for total pension expenditures. The adoption of a fiscal rule defining the level of the deficit and ensuring that the level of public debt is set on a downward trajectory is expected. In addition to the Ministry of Finance, the IMF and the Fiscal Council will take an active part in the formulation of a new set of fiscal rules.

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

In 2016, the Law on the Public Sector Salary System was adopted, and thereafter also the relevant bylaws, which regulate this area in a systematic and transparent manner, with the aim of providing the same level of salaries for the same type of work in the entire public sector. After several years of delay, the new pay grade system for all public sector employees (including the army and police), i.e. the new Law on Salaries of Civil Servants and Employees and amendments to the Regulation on the Catalogue of Jobs in Public Services and Other Public Sector Organizations, should to be adopted during this year, so that everything may be ready for implementation in the post-pandemic period.

The existing system of recruitment, managed by the Government Commission giving approval for new employment and further hiring of employees by the beneficiaries of public funds, will be further applied in the transitional period until 2023, i.e. until the new system becomes fully operational. At the end of last year, amendments to the Law on Budget System were adopted to enable institutions, in the transition period, to hire new workers up to the level of 70% of those who leave the institution or retire, while the permission of the Commission is required if the

[2] A more detailed overview of structural reforms by priority areas is an integral part of the Economic Reform Program in the period 2021–2023.

number of new employees exceeds 70%. The purpose of this measure is to provide greater flexibility in employment at the level of the institutions themselves, in accordance with their needs for new staff. Also, a limit of 1% has been set for increasing the total number of employees engaged under indefinite-term employment contracts compared to the level from the end of 2020. The development of an electronic register of employees in the public sector is underway, which should be completed by 2023, and a pilot project involving employees in the Ministry of Finance is already operational.

In order to reduce various forms of budget support to public and state-owned enterprises, reforms of the largest public and state-owned enterprises are continuing. Reducing of budget support to these enterprises implies: a) limitation of direct and indirect subsidies, b) banning the issuance of guarantees to support liquidity, and c) strengthening accountability and transparency in the operations of these enterprises, including control and reduction of arrears, especially concerning PE "Elektroprivreda Srbija" (hereinafter: EPS) and PE "Srbijagas", and prevention of their accumulation in the future.

Status of the enterprises from the portfolio of the former Privatization Agency is resolved through bankruptcy or privatization proceedings. By March 2021, the bankruptcy was declared in more than 310 enterprises, while 68 have been privatized since the end of 2014. About 36,000 employees from 357 enterprises have accepted Social Programs. Intensive efforts are made to find solutions for 76 more enterprises with almost 28,000 employees.

The Government, with the support of the EBRD, has adopted the Strategy of State Ownership and Management of Business Entities Owned by the Republic of Serbia for the Period from 2021 to 2027, as a single act that provides a strategic vision and guidance regarding ownership management goals, goals of financial and public policies, as well as corporate governance principles and supervisory practices in line with international standards and best practices.

As for the enterprises that are strategic companies from the portfolio of the former Privatization Agency, the solution is found either through privatization tenders or through bankruptcy. Privatization advisor was appointed for the transport company "Lasta" JSC Belgrade in 2019, but the privatization process was postponed due to the pandemic. With the support of the World Bank, the Action Plan for the PE PEU "Resavica" was defined, which includes finding solutions for closing economically unsustainable mines and a rationalization plan, with the option of voluntary leave along with the funds provided for Social Programs and business support, in order to prevent the accumulation of arrears, especially concerning PE EPS. As regards HIP Petrohemija, talks with potential investors are underway, a privatization advisor has been appointed, and a tender procedure will be announced, aiming to conclude it by the end of the year. As regards HIP Azotara, after unsuccessful attempts to find a strategic partner, bankruptcy was declared, i.e. the sale through public bidding is planned, while for MSK Kikinda, a solution is being sought by looking for strategic partners or investors.

Strategic partnership or other models of privatization, or pre-pack reorganization plans (PRPs) shall be implemented in a number of state-owned companies.

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

The Budget Execution Information System - ISIB, is part of the public financial management system that includes processes and procedures carried out through electronic communication with the Treasury Department within the Ministry of Finance. The development of this system will enable tracking of all indirect beneficiaries from the central government level. The system includes direct beneficiaries of public funds, judicial authorities and indirect beneficiaries of the Ministry of Culture and Information and the Directorate for the Execution of Criminal Sanctions, which were not part of the previous system (FMIS). Since 2019, social protection institutions have also been included, so that only indirect beneficiaries of the Ministry of Education, Science and Technological Development are still not covered by the system. The system is capable of enabling the integration of new beneficiary in the future.

Public investments management is the area of public financial management to which serious attention has been paid and which is being improved. Strengthening the public investment management framework intensifies new infrastructure projects and raises the quality of existing infrastructure. In April 2018, the Law on the Planning System of the Republic of Serbia was adopted, which established the national planning framework and defined the Development Plan and the Investment Plan. The Public Investment Management System, which is being developed with the assistance of the World Bank, includes an integrated database of investment projects, which is currently under development, and a single list of priority projects (*Single Project Pipeline*) has been established, so that the system may start functioning during the current year, and become fully operational in 2022.

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

Action plan for Tax Administration Transformation for the period 2018-2023, adopted in December 2017, defines strategic guidelines and deadlines for the implementation of activities necessary for the creation of a modern tax administration, which will, using modern electronic processes, provide better and more comprehensive service to taxpayers and better control and collection of revenues, thus stepping up the fight against the grey economy, together with the reform and modernization of inspection supervision. The organizational separation of core activities from those considered as secondary was carried out, with the main activities now being performed in a smaller number of organizational units, i.e. their consolidation was performed. The analysis of business processes and necessary resources will enable the development of an adequate organizational structure and management, improvement of project management and design of an adequate structure of employees. The next phase of reforms is focused on information systems, and a tender to replace the existing system with a new one is expected in the middle of this year. The new system will enable the gradual introduction of electronic invoices, which will be issued first by public sector entities, and then by the private sector. The phased introduction of e-invoices is planned to start from the next year in the public sector, and from 2023 in the private sector. The implementation of measures aimed at reducing the average time for VAT refunds, i.e. compliance with the prescribed deadlines, continues, with the application of the precautionary principle, in order to minimize the possibility of fraud and enable refunds to low-risk taxpayers to be paid as soon as possible. The Centre for Large Taxpayers (CVPO) will expand its scope, i.e. the number of entities that settle their tax liabilities through this system will be increased, and at the same time the capacity of this very important organizational unit within the Tax Administration is being strengthened. With the adoption of the Law on Determining the Origin of Property and on the Special Tax, and the formation of a special organizational unit within the Tax Administration, conditions have been created for cross-analysis of assets and income of individuals, in order to investigate cases of unjust enrichment and determine a special tax accordingly. The procedure has been initiated for the appointment of an external consultant to review the existing business processes and manage the process of their re-engineering and modernization. The Tax Administration has played an important role in implementing some of the measures taken in response to the crisis caused by COVID-19: deferral of taxes on salaries and contributions and their payment in 24 instalments, starting from January this year, deferred advance payment of corporate income tax in the second quarter of 2020, a three-month moratorium on forced collection, and reduction of interest on tax debt.

Improving the quality and transparency of national statistics is done through the promotion of comprehensive, timely and automatic data exchange between competent institutions. In April 2018, a list of institutions that make up the general government sector, as well as other sectors, was published, in accordance with the European System of Accounts (ESA) 2010 and GFSM 2014, based on which the SORS (in cooperation with the Ministry of Finance and NBS) will start submitting data to the Extended General Data Dissemination System (e-GDDS). These data will be given in accordance with the GFSM 2014 methodology. Department for Macroeconomic and Fiscal Analysis and Projections of the Ministry of Finance, in cooperation with the IMF, was the first to initiate the process of converting public finance data from the national methodology to the GFSM 2014 methodology, and the production of consolidated data for the general government level, in order to enable a complete transition to the new methodology in terms of coverage, planning and reporting in the future.

Comparison with the previous programme

The medium-term fiscal framework has been changed significantly compared to the previous document,[3] in consideration of the negative effects of the pandemic on economic trends persisting in 2021 as well, but also of better revenues both in this and the last year. Growth in revenues, expenditures and deficits are the main differences compared to the previous document. In 2021, the biggest change was induced by the new package of measures on the expenditure side, primarily through significant investment in the health system, and then through subsidies and other fiscal stimuli aimed at mitigating the impact of the crisis on the economy and the population. In addition, the rebalance of the republic budget envisages a significant increase in capital expenditures. In the coming period, expenditures will be gradually reduced, in terms of their share in GDP, but as long as the uncertainty related to the pandemic prevails, a somewhat more expansionary fiscal policy will be pursued. The deficit reduction plan has been postponed by one year, so that the reduction to the level of 1% of GDP is foreseen for 2024 instead of 2023, as envisaged in the previous document. Planned deficits enable the reduction of the public debt share in GDP, and in the long run it is planned to go back to low deficit levels.

Table 13. Comparison of fiscal indicators of the two programs, in% of GDP

	2020	2021	2022	2023	2024
Fiscal strategy 2021–2023[4]					
Revenues	40.7	40.8	40.9	40.1	–
Expenditures	49.7	43.8	42.5	41.2	–
Balance	-9.0	-3.0	-1.7	-1.1	–
Fiscal strategy 2022–2024					
Revenues	41.3	41.8	41.8	40.8	40.6
Expenditures	49.4	48.7	44.7	42.4	41.6
Balance	-8.1	-6.9	-3.0	-1.5	-1.0
Difference					
Revenues	0.6	1.0	0.9	0.7	–
Expenditures	-0.2	4.9	2.2	1.2	–
Balance	0.8	-3.9	-1.3	-0.5	–

Source: Ministry of Finance

[3] Fiscal strategy for 2021 with projections for 2022 and 2023.

[4] The amounts were recalculated based on the revision of the GDP series data.

5. Fiscal risks

In the previous decade, the Republic of Serbia faced materialization of numerous risks which have seriously undermined its fiscal position. The financial crisis and recession negatively impacted the public finances, causing high deficits and the accelerated increase of public debt. The global financial crisis, as an external factor, had also activated internal risks, so payments on the basis of guaranteed loans, enforcement of court decisions, resolvement of state financial institutions issues and incorporation of public enterprises' liabilities into the public debt, have further deteriorated the fiscal position.

In addition to stated risks, the same as most of the countries worldwide, the Republic of Serbia has been affected by health and economic crisis caused by the SARS-CoV-2 pandemic. The pandemic can be considered a negative exogenous shock whose effects spread through the economic system, causing an economic downturn and recession. In a very short time, the economic crisis distressed global aggregate supply and demand, inter alia due to the high level of interdependence of the global economy which, due to the spillover of negative economic and social effects from one country to another, and isolation of a huge number of people, led to large-scale consequences. Measuring the effects of a pandemic is extremely complex and creates significant uncertainty about the economic outlook and the accompanying negative consequences. Some sectors, such as catering, tourism, air transport, as well as a range of various services, were forced to suspend their operation almost overnight, in order to avoid the circulation of citizens and curb the spread of the virus. For the most part, small and medium-sized enterprises, which had less reserves at their disposal to overcome the shock, suffered a severe blow. The pandemic has limited or stopped the production, either due to the disrupted supply chains and the lack of raw material, or due to impossibility to organize the production in a way that does not allow spread of virus among the employees.

In response to the economic crisis caused by the SARS-CoV-2 pandemic, the Republic of Serbia implemented strong intervention measures. With a view of eliminating harmful consequences caused by COVID-19, a comprehensive package of economic measures was adopted aimed at reducing the unemployment and preserving the liquidity of companies, maintaining investments, enabling the survival of certain sectors (tourism, agriculture etc.), providing assistance to certain categories of the population (pensioners, health workers), as well as to all adult citizens, with a view of raising aggregate demand. The purpose of these measures, which have been prepared in accordance with international practice and the proposals of relevant international financial institutions, is to help operation of the private sector and reduce the negative effects of declining business activity.

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

Identifying the biggest fiscal risks that may affect public finances in the medium term is the starting point for better fiscal risk management. There are detailed data on certain fiscal risks and it is easy to identify whether and with what probability they will affect fiscal aggregates in the medium term. As for others, however, there are no sufficiently detailed data, but their identification alone raises awareness of the possibility that in the coming period they may lead to deviations from the planned fiscal framework.

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

Macroeconomic assumptions and sensitivity of fiscal aggregates

Deviations of macroeconomic assumptions from the baseline scenario may lead to deviations of fiscal aggregates from the projected level.

A negative scenario, which in the coming period implies a decline in economic activity or a mild growth, would lead to a significant reduction in capital inflows and a decline in external trade. In that case, there would be lower revenues, and consequently a larger deficit, unless there would be additional adjustments on the expenditure side. In accordance with the assessments of the sensitivity of the fiscal balance, each change in real growth by 1 percentage point of GDP leads to a change in the fiscal result of about 0.36% of GDP. If the real GDP growth rates in the next three-year period would be lower (1 percentage point less on average per year) than planned, the cumulative increase in the fiscal deficit would amount to over 50 billion dinars.

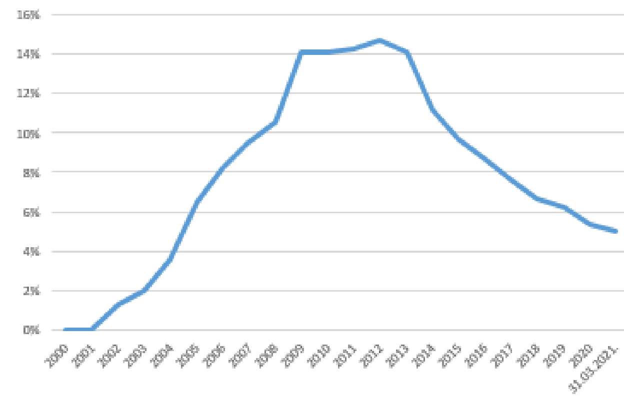
Inflation is a basic determinant of general macroeconomic stability. Due to the modification of the fiscal rules on the indexation of salaries and pensions, in the coming period, inflation will determine the movement of the total level of expenditures to a lesser extent than it was the case in the previous period. On the revenue side, the impact of inflation on indirect taxes may be favourable in the short run, but due to the inevitable adjustment of the real level of consumption, that effect is lost when the income level is limited. The exchange rate has a similar short-term effect. Some revenue items are inflation-adjusted on an annual basis (mainly non-tax revenues and the amount of individual excise rates), thus there is a certain risk related to this, but due to low projected inflation values, it is not high. Inflation, on the other hand, can indirectly affect the level of deficits and public debt. In the event that it moves significantly above the target values, during the process of adjusting the relevant interest rates, there may be an increase in interest rates on public debt. On the other hand, the consumer price index largely influences the movement of the total GDP deflator, and thus the level of nominal GDP, as the denominator of the share of deficit and public debt in gross domestic product.

Apart from the amount and structure of public debt, interest expenses are also affected by factors such as the exchange rate and interest rates on the international and domestic markets. Given the unpredictability of the movement of individual variables, increase in the required funds for interest is possible in the coming period. Interest rate policy pursued by certain international institutions (FED, ECB, etc.) may affect the general level of interest rates on the international market, which is for the Republic of Serbia, as a small open economy, an additional fiscal risk.

State guarantees

Guarantees issued by the state affect the height of public debt, as well as the height of deficit, if the state has to take over the repayment of a credit instead of the original debtor. Issued guarantees, according to the definition in the Public Debt Law[5] are part of the indirect liabilities and are included in the public debt in their total amount[6]. The limitations set for issuing new guarantees were successful, so that the share of indirect liabilities in the overall public debt is reducing. Indirect liabilities (guarantees issued by the Republic of Serbia) participated with 5.3% in the overall public debt, according to the national methodology, at the end of 2020. The share of these liabilities in the public debt is at approximately the same level in the current year, so at the end of March 2021, they account for 5.0% of the total public debt. The biggest share of these liabilities in the public debt, slightly above 14% on average, was recorded between 2009 and 2013.

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



At the end of 2020, the debt balance on the basis of issued guarantees was EUR 1,423 billion, i.e. 3.1% of GDP. The balance of debt on this basis was reduced by about EUR 65 million, compared to the end of 2019. By March this year, the debt balance was reduced by EUR 23 million, compared to the end of 2020, and amounts to EUR 1.4 billion, as at 31 March 2021.

Table 14. Debt balance based on guarantees issued, in millions of euros

Beneficiary	31 March 2021
PE "Srbijagas"	188.5
PE "Roads of Serbia"	271.2
"Serbian Railways" JSC	151.1
"Serbian Railways Infrastructure" JSC	63.1
"Srbija Voz" JSC	29.5
"Serbia Cargo" JSC	47.1
PE "EPS"	375.4
"EMS" JSC	31.3
Local self-government units (cities and municipalities)	193.0
"FIAT Automobiles Serbia" LLC	3.1
PE "Jugoimport – SDPR"	10.4
Serbia and Montenegro Air Traffic Services SMATSA LLC	0.9
"JAT Tehnika" LLC	2.5
PE "Transmitters and Communications"	7.8
PE "Ski Resorts of Serbia"	25.7
TOTAL	1,400.6

Source: Ministry of Finance, Public Debt Administration

[5] Law on Public Debt ("Official Gazette of RS", nos. 61/05, 107/09, 78/11, 68/15, 95/18, 91/19 and 149/20).
[6] The definition of debt, according to the Maastricht criteria, among other things, treats issued guarantees differently, compared to the definition of public debt provided in domestic legislation. According to the Maastricht criteria, only activated guarantees are included in the public debt (general government debt). Domestic legislation has a more conservative approach to this issue, and includes all issued guarantees in the public debt.

The total repayment of the principal on the basis of guaranteed loans in 2019 amounted to 11.4 billion dinars, of which 7.5 billion affect the deficit. Until 2014, the accounting methodology did not include repayments based on guarantees into expenditures[7]. As of 2014, part of these expenditures is included in budget expenditures[8]. Irrespective of the budgetary and accounting presentation, the debt paid by the state instead of the main debtor increases overall needs for borrowings.

Debt repayment based on activated guarantees, RSD billion

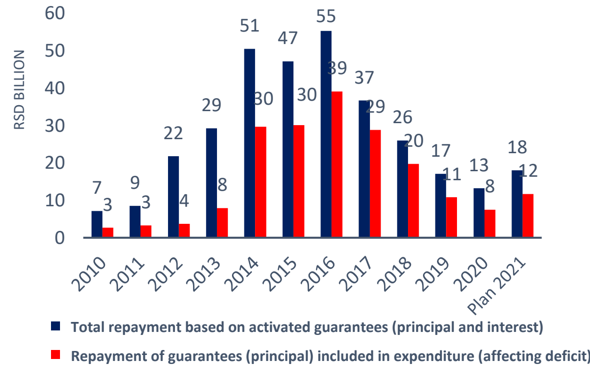


Table 15. Total paid liabilities on the basis of guarantees per beneficiaries, in billions of dinars

	2020			2021 (until 31 March)		
Beneficiary	Principal	Interest	Total	Principal	Interest	Total
PE “Srbijagas”	0.6	0.0	0.6	-	-	-
PE “Roads of Serbia”	3.9	1.3	5.2	1.8	0.6	2.4
“Serbian Railways” JSC	4.2	0.6	4.8	1.2	0.1	1.3
“Galenika” JSC	-	0.0	0.0	-	-	-
PE “Transmitters and Communications”	0.3	0.0	0.3	-	-	-
“Serbian Railways Infrastructure” JSC	1.2	0.0	1.2	0.5	0.0	0.5
“Srbija Voz” JSC	0.1	0.1	0.2	0.0	0.0	0.0
“Serbia Cargo” JSC	1.2	0.0	1.2	-	-	-
PE “Ski Resorts of Serbia”	-	-	-	0.0	0.0	0.0
TOTAL	11.5	2.0	13.5	3.5	0.7	4.2

Source: Ministry of Finance, Public Debt Administration

Planned repayments under guarantees (total principal and interest) in the budget revision for 2021 amount to 18 bill. dinars, of which 11.7 billion dinars, for the repayment of principal under guarantees, pertain to expenditures that affect the balance.

The indirect debt, the inclusion of a part of repayments on the basis of guarantees into the budget expenditures, and the ensuing increase of the deficit on that basis, have raised the awareness of growing fiscal risks arising from the issued guarantees. Therefore, actions have been taken to limit the issuance of new guarantees. Amendments to the Law on Public Debt prohibit the issuance of new guarantees for liquidity loans. Amendments to the Law on the Development Fund of the Republic of Serbia prevent further issuance of counter-guarantees for guarantees issued by the Development Fund of the Republic of Serbia.

Along with the restrictions on the issuance of state guarantees, a key step towards reducing and eliminating fiscal risks on this basis involves the reform of state-owned and public companies, which are the beneficiaries of guarantees, undertaken to make them capable of repaying their own credits. A number of enterprises, which are the leading beneficiaries of guarantees, are undergoing restructuring process, where restructuring plans, made in cooperation with international financial institutions, are implemented. The rebalance of the budget for 2021 foresees the issuance of guarantees up to a maximum of 134 billion dinars for loans taken for the implementation of infrastructure projects.

[7] Repayment based on the guarantees from the republic budget is included into the expenditures on the cash basis. International standards, which are set on the accounting basis, include the entire amount of the remaining debt in the expenditures, at the moment of activating guarantees, whereas the very repayment of debt on that basis is treated as the financial transaction.

[8] Part of the expenditures on the basis of repayment under the guarantees for PE “Roads of Serbia” is not included in budget expenditures, because this enterprise is part of the general government sector, thus the expenditures financed with guaranteed credits were part of the general government expenditures at the moment of consumption, whereas the very repayment is treated as the financial transaction (below the line).

Table 16. Issuance of guarantees plan for 2021

No.	Description	Amount in RSD	Original currency	Amount in the orig. currency
I.	European Bank for Reconstruction and Development			
1	Joint-stock company for railway passenger transportation *Srbija Voz,* Belgrade – (Reconstruction of rolling stock maintenance depot and procurement of equipment)	2,972,500,000	EUR	25,000,000
2	Joint-stock company for freight railway transport “Serbia Cargo”, Belgrade - (Procurement of diesel locomotives for freight trains hauling and for the needs of freight car maneuverings, reconstruction and modernization of existing diesel locomotives, construction of car workshop facilities with the required annexes and plants within the marshalling yard Novi Sad)	6,896,200,000	EUR	58,000,000
3	“Electricity Distribution of Serbia” Ltd.– Smart power meters project	4,756,000,000	EUR	40,000,000
	Total:	14,624,700,000	EUR	123,000,000
II.	To German Development Bank (KfW)			
1	“EMS” JSC - Regional program for energy efficiency in the transmission system II	4,756,000,000	EUR	40,000,000
	Total:	4,756,000,000	EUR	40,000,000
III.	To European Investment Bank			
1	“Electricity Distribution of Serbia” Ltd.– Smart power meters project	4,756,000,000	EUR	40,000,000
	Total:	4,756,000,000	EUR	40,000,000
IV.	To commercial banks			
1	PE “Srbijagas” – Distribution gas pipeline Leskovac - Vranje	3,329,200,000	EUR	28,000,000
2	PE “Srbijagas” - Gasification of Bor and Zajecar districts and distribution gas pipeline Paracin-Boljevac-Rgotina-Negotin-Prahovo	7,847,400,000	EUR	66,000,000
3	PE “Srbijagas” - Gasification of Kolubara district and construction of the Belgrade-Valjevo-Loznica distribution gas pipeline	8,917,500,000	EUR	75,000,000
4	PE “Srbijagas” - Strengthening the transport capacity of gas pipelines in the Republic of Serbia	21,402,000,000	EUR	180,000,000
5	PE “Electric Power Industry of Serbia” – Hydroelectric power plant Buk Bijela in the Republic of Srpska construction project through equity investment	29,725,000,000	EUR	250,000,000
6	“Electricity Distribution of Serbia” Ltd. Belgrade - Medium voltage distribution network automation project	11,551,340,459	EUR	97,151,728
	Total:	82,772,440,459	EUR	696,151,728
V.	To the Russian Federation (National Development Corp. “VEB.RF”)			
1	PE “Electric Power Industry of Serbia” - Revitalization of the hydroelectric power plant “Đerdap 2”	23,780,000,000	EUR	200,000,000
	Total:	23,780,000,000	EUR	200,000,000
VI.	To the Republic of France (Treasury)			
1	“Electricity Distribution of Serbia” Ltd. Belgrade - Medium voltage distribution network automation project	2,895,009,541	EUR	24,348,272
	Total:	2,895,009,541	EUR	24,348,272
	TOTAL:	133,584,150,000	EUR	1,123,500,000

Source: Ministry of Finance

No significant growth of this category of expenditures is planned in the coming years. The share of these expenditures in GDP will be, on average, around 0.2% of GDP in the medium term.

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

Public enterprises

Business operation of public enterprises constitutes an important source of fiscal risks, both on the side of budget revenues and on the side of expenditures. Public enterprises face numerous problems in their business operations, from the collection of claims, to the regular settlement of obligations towards creditors, the state and employees, etc. The state as the founder and their sole owner is responsible for their business operation, and is their last refuge in case of illiquidity. There are several channels through which fiscal risks related to business operation of public enterprises may be materialized. The biggest, but not the only risk involves government guarantees issued for public enterprises' borrowings. Sustainability, efficiency and profitability of public enterprises affect budget revenues, i.e. the amount of profit to be paid into the budget. The quality of products and services provided by public enterprises affect the efficiency and profitability of the private sector, and ultimately the level of tax paid into the budget.

Public enterprises constitute an important segment of Serbian economy, which employs about 81,000 people. Public enterprises are established as companies which perform activities of public interest. Their business operation is regulated by the Law on Public Enterprises, adopted in February 2016, as well as by subsector laws which define specific areas not covered by the Law on Public Enterprises (Energy Law, Company Law etc.).

Key financial indicators of public enterprises business operation

Business results of public enterprises in 2020

Total capital of Serbian public enterprises at the end of 2020 amounted to RSD 1,587 billion, whereas the net profit in the amount of RSD 16.4 billion was realized as the final result.

Table 17. Key financial indicators of business performance of public enterprises, in RSD billion

Description	2019	2020
Total assets	2,854	2,628
Equity	1,751	1,587
Total revenues	524.3	532.7
Net profit	-18.1	16.4
Subsidies	33.4	66.5
Subsidies, PE Roads of Serbia excluded	24.3	39.6

Source: Financial reports for 2019 and 2020

In 2020, the subsidies, expressed in the percentage of the total revenues, were at a higher level compared to the previous year and accounted for 12% of total revenues of public enterprises. Certain subsidies have a capital character, such as subsidies for the PE "Roads of Serbia", which are allocated for the reconstruction of the road infrastructure.

Business results of public enterprises in Q1 2021

The total net result determined in the first quarter is a profit of 16.1 billion dinars. The result of the current year is overestimated for the depreciation costs of PE "Roads of Serbia", because the enterprise records these costs only at the end of the year in the full amount for the given year.

Table 18. Key indicators of business performance of public enterprises on 31 March 2021, in RSD billion

Business performance indicators	2019	2020	1 Jan – 31 March 2021
Operating income	496.7	506.0	148.8
Operating expenses	490.9	469.2	125.4
Operating profit	6	36.7	23.4
Net profit	-18.1	16.4	16.1
Cost of salaries *	111.9	110.3	25.1
Number of PE which made profit	25	23	16

* Cost of salaries, fringe benefits and other personal expenses
Source: Financial reports for 2019 and 2020 and quarterly reports of the Ministry of Economy for 2021

In the first quarter of the current year, 16 enterprises made a profit in the total amount of 18.5 billion dinars. This result exceeds the plan for this period (2.8 billion dinars). The biggest contribution to the positive net result in the observed period came from PE "EPS", which made a net profit of 10.5 billion dinars.

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

Enterprise	Realization 2020	Plan 1/1–31/3/2021	Realization 1/1–31/3/2021
PE "Srbijagas"	2,990,053	5,263,402	2,400,416
PE "Skijališta Srbije "	279,168	799,307	857,922
"Koridori Srbije" LLC.	0	0	46,093
"Prosvetni pregled" LLC.	25,238	5,828	2,922
"Dipos" LLC	124,454	21,640	75,977
"Elektromreža Srbije" JSC	862,977	434,670	863,645
PE "NP Kopaonik"	23,651	30,503	49,712
PE "EPS"	11,581,043[9]	7,063,165	10,543,091
State Lottery of Serbia LLC	180,162	21,937	64,423
PE "National Park Tara"	35,770	40	50
PE "Nuclear Facilities of Serbia" VINČA	143	292	752
"Serbian Railways" JSC	-60,756	-86,177	24,706
PE "Roads of Serbia"	5,611,990	2,377,858	3,028,517
PE "Stara planina"	-885,910	1,000	9,901
"Metohija" LLC	704	93	2,411
PE "Post of Serbia"	877,538	-244,897	544,821
Total	21,646,225	15,688,660	18,515,359

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

In the first half of the current year, 19 enterprises realized a net loss in the total amount of 2.4 billion dinars, which is a better result than planned in this period (2.8 billion dinars).

[9] This figure includes the result of the "EPS Distribucija" LLC Belgrade. PE EPS and the Republic of Serbia concluded the Agreement on the transfer of shares in the Distribution System Operator "EPS Distribucija" LLC Belgrade, from PE EPS to the Republic of Serbia, on the basis of which the Business Registers Agency registered the Republic of Serbia as the owner of 100% of the capital of "EPS Distribucija" LLC Belgrade, on 31 December 2020.

Table 20. Public enterprises which realized net loss in the period 1 Jan –31 March 2021, in thousands of dinars

Enterprise	Realization 2020	Plan 1/1–31/3/2021	Realization 1/1–31/3/2021
PE UCE "Resavica"	-1,737,043	-543,458	-352,528
"Srbija Voz" JSC	-1,164,713	-442,636	-276,842
PWE "Srbijavode"	10,672	-114,493	-101,296
PE "Zavod za udžbenike"	-235,199	-142,953	-88,937
"Mokra gora" LLC	-9,537	27,393	-853
"Tvrđava Golubački grad" LLC	-50	-5,600	-10,543
"Serbia Cargo"JSC	-2,251,842	-561,403	-394,868
"Park Palić" LLC	-3,779	-1,310	-421
PE Skloništa	-87,001	-34,130	-29,264
PE "Jugoimport –SDPR"	194,459	-641,378	-345,630
PE Mreža most	7,215	0	-13,837
PE "NP Đerdap"	8,451	2,884	-4,006
"Transnafta" JSC	148,815	8,393	-10,826
"Rezervat Uvac" LLC	3,480	851	-1,386
PE "Official Gazette"	83,283	-915	-36,404
PE "NP Fruška gora"	13,225	5,441	-5,305
"Infrastructure of Serbian railways" JSC	-783,701	-155,185	-691,405
PE Srbijašume	485,378	-115,532	-70,568
PE "Transmitters and communications"	8,324	-41,977	-16,105
Total	-5,309,563	-2,756,007	-2,451,024

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

In order to reduce fiscal risks related to the business performance of public enterprises the restructuring processes of largest public enterprises have been undertaken (a group of companies engaged in railway transport - "Serbian Railways" JSC, "Srbija Voz" JSC, "Serbia Cargo" JSC, PE EPS and PE "Srbijagas"). The entire process is being carried out in cooperation with the world's leading financial institutions - the IMF, the World Bank and the European Bank for Reconstruction and Development (hereinafter: EBRD), in order to put these companies on a sound footing as to start operating pursuant to market principles, and to reduce potential fiscal costs that may arise from their operations.

Payment of Profits into the State Budget

Payment of profit by public enterprises and dividends of corporations in which the state holds ownership constitute an important part of non-tax revenues. The amount of budget revenues on this basis depends on the business results of these enterprises. Payments of regular profit and dividends constitute regular budget non-tax revenue, while payments from retained earnings are treated as one-off income and do not constitute a permanent source of revenue.

Public enterprises are obliged to pay not less than 50% of their profit realized in the previous year, which is also prescribed by the Budget System Law of the Republic of Serbia for 2021.

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

State-owned Financial Institutions, Banking System and Deposit Insurance

Prior to the fiscal consolidation period, the Republic of Serbia had significant fiscal expenditures related to salvation of state-owned banks. Total costs of government interventions in the banking sector in the period 2012-2015 amounted to about EUR 900 million. That is the amount set aside for the recapitalization of banks, various financial transactions involving merging unsuccessful banks with the successful ones, including the repayment of insured and uninsured deposits (for which funds from the Deposit Insurance Fund were also used).

Currently, in the country's banking sector, the Republic of Serbia has a direct share in the capital of:

- *Banka Poštanska štedionica* JSC Belgrade (79.01%),
- *Srpska banka* JSC Belgrade (76.69%).

The reform activities concerning state-owned financial institutions, started in 2012 and/or 2015, are continuing as to consistently implement the exit strategies and reduce fiscal risks on this basis

Banka Poštanska štedionica. With the support of the World Bank, the implementation of the strategy for *Banka Poštanska štedionica* will continue, with the emphasis on operations focused on retail sector, entrepreneurs, micro- and small enterprises; on the improvement of bank's internal organization, corporate governance and risk management; upgrading IT infrastructure, and business plan for the period 2020-2022.

In order to enable the mitigation of economic and financial consequences due to the pandemic of COVID-19, caused by SARS-CoV-2 virus, the bank was enabled to fully implement the Regulation on Establishing the Guarantee Scheme as a business support measure aimed at alleviating the impact of COVID-19 pandemic caused by SARS-CoV-2 virus, to employ assets in local self-government units, while the then applicable limits on exposure to an individual company were lifted in the case of *Banka Poštanska štedionica*.

Komercijalna banka. On 26 February 2020 the Republic of Serbia and *Nova Ljubljanska banka d.d*. Ljubljana signed the Share Purchase Agreement, related to 83.23% of regular shares of *Komercijalna banka a.d*. Belgrade. This transaction was closed (ownership transferred and purchase price paid) on 30 December 2020.

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

Regulatory reform governing the financial system in Serbia[10], was carried out in February 2015. One of the characteristics of that reform is the transfer of competence for monitoring the results of business performance and the work of management bodies in banks, insurance companies and other financial institutions whose shareholder is the Republic of Serbia, as well as organizing and implementation of the procedure of selling the shares in them, from the Deposit Insurance Agency to the Ministry of Finance, starting from 1 April 2015. Also, through this regulatory reform, Bank Recovery and Resolution Directive – BRRD was transposed into the domestic regulation and the bank restructuring function was entrusted to NBS. In December 2016, a set of regulations, transposing Basel III standards into the domestic regulatory framework, was adopted, whereby domestic regulations have been substantially harmonized with the relevant European Union regulations in this area, whereas in 2017 the activities aimed at improving domestic regulations governing bank operations continued, with the aim of their further harmonization with the EU regulations. The main objectives of adopted regulations are increasing the resilience of banking sector by improving capital quality and introducing capital

[10] The National Assembly adopted amendments to the Law on the NBS and the Law on Banks, as well as the new Law on Deposit Insurance Agency, the Law on Deposit Insurance, and the Law on Bankruptcy and Liquidation of Banks and Insurance Companies. Due to the amendments of the set of financial laws, also amendments to the Law on Ministries had to be adopted.

protective layers, better monitoring and control of the bank exposure to the liquidity risk, further strengthening of market discipline and operating transparency of the banks in the Republic of Serbia, by publishing all relevant information on bank operations, and adaptation of the reporting system to the new regulatory solutions.

Relatively high level of NPLs was one of the limiting factors for lending activity growth. In August 2015, the NPL Resolution Strategy was adopted, carried out through two three-year action plans, one prepared by the Government and the other by the NBS, with the aim of lowering the level of NPLs. The activities were focused on increasing bank capacities to efficiently resolve the issue of NPLs, enhancing regulations governing collateral valuation, encouraging development of the NPL market, etc.

Since the adoption of the mentioned strategy, a number of laws and by-laws have been adopted or amended, the institutional capacity has been improved, and numerous measures have been implemented to facilitate NPL write-offs or transfers through the adoption of the Law on Real Estate Appraisers (whose application started in June 2017) which, inter alia, introduced a new profession – a licenced real estate appraiser and prescribed: a mandatory appraisal to be conducted in cases related to the Law on mortgage and Law on bankruptcy, as well as when conducting valuation of real estate for the purposes of credit operations involving loans secured by mortgage; formation of an expert board (professional body that should contribute to the regulation and improvement of the profession of real estate appraiser), and adoption of National standards, code of ethics and rules of professional conduct of licensed appraisers (in July 2017) which, inter alia, define the essentials of real estate valuation, the appraisal procedure, assumptions and facts of importance that must be taken into account when preparing the appraisal report, the minimum content of the appraisal report and the rules of professional conduct of the licensed appraiser; adoption of amendments to the Law on Corporate Income Tax and the Law on Personal Income Tax, which enabled a more favourable tax treatment for loan write-offs (end of 2017); adoption of amendments to the Bankruptcy Law which shortened the bankruptcy procedure and improved the position of secured creditors (December 2017); preparation of a study on the possibilities of introducing bankruptcy of private individuals and entrepreneurs in the Republic of Serbia; and the Law on Amendments to the Law on Civil Procedure was adopted, etc. Based on the Law on Real Estate Appraisers and the Decision on the content, deadlines and manner of submitting reports on the valuation of mortgaged real estate and loans secured by mortgage, the NBS has been maintaining a database on valuation of mortgaged real estate since 2015. In accordance with the mentioned law and decision, banks and licensed appraisers have access to certain data on the valuation of mortgaged real estate. At the end of 2018, the NBS adopted a set of bylaws, responding proactively to the increasingly frequent occurrence of retail non-purpose loans with unreasonably long repayment period. These regulations aim to prevent the generation of NPLs in the banking sector and encourage banks' prudent risk-taking by directing them towards sustainable lending and avoiding excessive exposure by certain types of credit products, without disrupting growth trend of the lending activity and taking into account the rights and interests of users of services provided by banks, all with the aim to preserve and strengthen financial stability in the Republic of Serbia.

On 27 December 2018, the Government adopted the NPL Resolution Program for the period 2018-2020 (hereinafter: the Program) along with the Action Plan for the implementation of that program, whereby the reform goal within the program of cooperation with the IMF was successfully met, and a roadmap for further efficient resolving of the issue of NPLs created.

The main focus of the mentioned public policy document is resolving the issue of bad loans of bankrupt banks and loans managed in the name and for the account of the Republic of Serbia by the Deposit Insurance Agency (DIA). Accordingly, strategic and annual operational plans for DIA, and Resolution of bad loans portfolio were adopted, and internal capacities for their resolving were developed. In June 2019, DIA successfully completed the sale of the first, "pilot portfolio", with the nominal value of about 242 million euros, while on 30 September 2019, it announced sale of the second, "large portfolio", with the nominal value of 1.82 billion. Due to circumstances caused by the COVID-19 pandemic, limiting investors' ability to carry out due-diligence, the opening of binding bids was performed on 10 September 2020, and a total of five binding bids were received.

After several months of negotiations with the best bidders, in accordance with Government Conclusion 05 No. 401-1646 / 2021 of 25 February 2021, Conclusion of the Provincial Government 127 No. 422-6 / 2021 of 3 March 2021 and decisions of the Board of Creditors of all bankrupt financial institutions, whose claims are subject of assignment, the best bid was selected in the procedure of claims portfolio assignment for a fee, by the public tender method (ad. code: PPP-1/19), and the procedure of assignment of a "large" portfolio was successfully completed on 19 April 2021, by signing the Framework Agreements on the assignment of the claims portfolio and payment of assignment fee.

The implementation of other measures for resolving non-performing loans, both under the NPL Resolution Strategy and under the above-mentioned Program, continues to yield results. The reduction of non-performing loans in the period August 2015 - September 2020 amounts to 333.0 billion dinars, while the result of the NPL Resolution Strategy is reflected in the historically lowest share of non-performing loans at the end of September 2020 of 3.4%. Compared to this indicator before the implementation of the Strategy (22.25%), there is an impressive decrease of 18.82 percentage points. This is a concrete confirmation that the measures are well defined and have given excellent results.

The NBS also acted beyond the framework of the Strategy, as by the adoption of the Decision on the accounting write-off of bank balance sheet assets, which complemented the regulatory activities. Much the same, NPLs coverage with corresponding provisions in accordance with the international accounting standards, which is at the level of 62%, along with all the other indicators of the health of the financial system, unequivocally confirms the stability of our banking sector.

By creating stable business conditions, our economy entered the investment cycle in 2015, and since then investments, in terms of their volume, account for a good part of economic growth. The profitability of the economy is growing in conditions of low and stable inflation and a relatively stable exchange rate. All of these were key factors for the sustainable resolution of the issue of NPLs. This is clearly seen from the fact that sectors that are the pillars of our growth, have recorded the largest NPL decline - which is evident in the manufacturing and construction industry sectors.

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

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

Taking into account the provisions of the Law on Amendments to the Law on Deposit Insurance, starting from the collection of the premium for the first quarter of 2020, the deposit insurance premium is calculated against changed base, i.e. on the basis of the average balance of total insured amounts up to EUR 50,000 (the amount of deposit covered by insurance) in the bank in the previous quarter, instead of based on the average balance of total

[11] Protected depositors are: natural persons, entrepreneurs, micro, small and medium-sized legal entities, after the exclusions provided by the Law on Deposit Insurance.

insured deposits. With this change, the liabilities of banks under the payment of deposit insurance premiums were reduced on average by about 30%, which indirectly enabled higher investment activity of banks.

As the law introduced the possibility of calculating premiums based on the bank’s business risk level, the Agency was obliged to adopt the Methodology for calculating deposit insurance premiums based on bank’s business risk level within one year from the day this law entered into force. The Management Board of the Agency adopted the text of the Methodology on 15 October 2020, previously approved by the NBS, thus fulfilling its legal obligation within the set period, and a special decision of the Management Board of the Agency will regulate the start of application of this Methodology.

In the deposit insurance system, the Republic of Serbia is the ultimate guarantor of the payment of insured deposits. For the purpose of providing deposit insurance funds, DIA collects deposit insurance premiums from banks for the account of the Deposit Insurance Fund, manages the fund's assets and pays out deposits up to the insured amount in case of bank bankruptcy or liquidation. In addition, Fund assets may be used to finance bank restructuring in the scope and under the terms defined by the law governing banks. In case available assets in the deposit insurance fund are not sufficient, the Republic of Serbia shall ensure payment either by employing funds from the budget or by providing a guarantee for DIA borrowing.

On 24 March 2020, the Government of the Republic of Serbia passed Regulation on investing foreign currency assets managed by the Deposit Insurance Agency during the state of emergency, which stipulates that during the state of emergency due to COVID-19 disease caused by SARS-CoV-2 virus, the Agency may invest more than a quarter of the Fund's foreign currency assets in FX debt securities issued by the Republic of Serbia. Pursuant to the Regulation, the Agency is obliged to adjust the amount of foreign currency assets invested in FX debt securities issued by the Republic of Serbia with the statutory limit of 1/4 of the total foreign currency assets of the Fund, within one year from the date of termination of the state of emergency (until 6 May 2021).

The guarantee for insured deposits payment by the state, either directly from the budget, or indirectly by issuing guarantees for DIA borrowings, is a source of fiscal risks and possible fiscal costs. However, owing to the achieved stability of the banking sector, since 2015 there has been no need to use assets of the Deposit Insurance Agency, or state budget for the outpayment of insured deposit amounts.

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

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

Banking sector of the Republic of Serbia is adequately capitalized both from the viewpoint of the achieved level of capital adequacy indicators and the structure of regulatory capital. At the end of 2020, the average value of capital adequacy ratios at the level of the banking sector of the Republic of Serbia was 22.42% (22.3% in March 2021), which is significantly above the prescribed regulatory minimum of 8%, and more than enough to cover all the risks to which the sector is exposed, which is also confirmed by macroprudential stress tests that the NBS regularly conducts.

Having in mind the situation induced by declared state of emergency in the Republic of Serbia, in order to enable mitigation of economic and financial impacts of the COVID-19 pandemic caused by SARS-CoV-2 virus, economy support measures were taken, aimed at increasing liquidity. One of these measures was the adoption of the Regulation on the Establishment of Guarantee Scheme as a Measure of Support to the Economy Aimed at Mitigating the Consequences of the COVID-19 Pandemic Caused by the SARS-CoV-2 Virus). This Regulation governs the establishment of the national guarantee scheme.

Increasing businesses liquidity through the mechanism of Republic of Serbia guarantees for bank loans granted to companies to finance liquidity and working capital, instituted by concluding the Agreement on the Republic of Serbia guarantee for loans granted to companies with the aim to mitigate the negative impacts of SARS CoV-2 - is a measure that sublimates an extremely important and necessary mechanism of effects concerning all persons based in the Republic of Serbia, including agricultural holdings, which are registered in the APR of the Republic of Serbia and classified as entrepreneurs, micro, small or medium-sized enterprises in accordance with the law governing accounting, and whose liquidity is a prerequisite for the functioning of the economy of the Republic of Serbia.

Banks may invest up to two billion euros for the realization of loans, whereby the amount of one billion euros, i.e. the amount of the initial maximum secured portfolio of individual banks is determined in accordance with the bank's market share according to the NBS report as on 29 February 2020.

Given the fact that lendings, by the end of November 2020, amounted to about 1.5 billion euros, of the total available 2 (two) billion euros, and that the Regulation stipulated that the loan agreement must be concluded no later than 31 December 2020, and that the loans must be disbursed no later than 31 January 2021, it was necessary to extend the deadline by which the loan agreement must be concluded, and by which the loans must be disbursed.

In accordance with this, a proposal of the Law on the Guarantee Scheme as a Measure of Support to the Economy Aimed at Mitigating the Consequences of the COVID-19 Pandemic Caused by the SARS-CoV-2 Virus) was submitted to the National Assembly of the Republic of Serbia, which adopted related law at its session held on 17 December 2020, and it was published in the Official Gazette of the Republic of Serbia No. 153/20 of 21 December 2020.

So far, 25 banks have signed agreements on the Republic of Serbia guarantee for corporate loans aimed at mitigating the negative impacts of the COVID-19 pandemic caused by the SARS-CoV-2 virus with the Republic of Serbia and the NBS, and the Government has approved 47 requests to increase the maximum insured portfolio amounting to 1,074,759,260 euros, as well as 4 requests for reduction of the maximum insured portfolio in the amount of 74,759,260 euros.

Bearing in mind that the Republic of Serbia has invested the planned 2 billion euros by the end of April 2021, a decision was made to approve an additional 500 million euros of aid to maintain liquidity, thus the total amount of funds employed under the guarantee scheme will come at 2.5 billion euros. In reference to this, the Law on Amendments to the Law on the Guarantee Scheme as a Measure of Support to the Economy Aimed at Mitigating the Consequences of the COVID-19 Pandemic Caused by the SARS-CoV-2 Virus) ("Official Gazette of RS", No. 40/21) was adopted.

At the same time, the Republic of Serbia recognized the need for additional assistance to the most affected companies that had a decline in operating revenues of more than 20% in 2020, compared to the same period in 2019, and on 22 April 2021 the Law on the Second Guarantee Scheme as a Measure of Additional Support to the Economy due to the Extended Negative Impact of the COVID-19 Pandemic Caused by the SARS-CoV-2 Virus ("Official Gazette of RS", No. 40/21) was adopted, under which an additional aid of EUR 500 million was approved. Accordingly, the projections of fiscal gross outflows of the budget of the Republic of Serbia under the related national Guarantee Scheme amount to EUR 23 million for 2021, EUR 89 million for 2022, and EUR 21 million for 2023. Also, a projection was made regarding inflows based on the collection of problem loans under the Guarantee Scheme of the Republic of Serbia, amounting to 14 million euros for 2022, 16 million euros for 2023, and 3 million euros for 2024.

As regards other financial institutions, the Republic of Serbia has a direct share in the capital of *Dunav osiguranje a.d.o.* Belgrade (hereinafter: Danube Insurance), as well as in the National Corporation for Insurance of Housing Loans (hereinafter: the Corporation).

The Republic of Serbia currently holds a 45.29% share in the capital of Danube Insurance. However, at the end of April 2021, the Law on Amendments to the Law on Insurance (“Official Gazette of RS”, No. 44/21) was adopted, which provides the basis for changing the ownership rights over socially-owned capital in insurance companies. As the share of socially-owned capital in the total capital of the Danube Insurance currently amounts to 51.85%, after the change of ownership rights in accordance with the referred law, the direct share of the Republic of Serbia in the capital of the Danube Insurance should amount to around 76.70%. Much the same, as *Dunav Re a.d.o. Belgrade* has a share of socially-owned capital of 4.58% in the total capital, after the change of ownership rights in accordance with the referred law, the Republic of Serbia should acquire a direct share of about 5.32% in *Dunav Re*. All these changes should be implemented by the end of 2021.

Otherwise, by the end of 2014, the share of socially-owned capital in the total capital of the Danube Insurance was 94.61%, which had an adverse impact on the business operation of the Danube Insurance (primarily because of the complicated management structure), as indicated by the audit reports for 2013 and 2012, where the auditor gave a qualified opinion. Having in mind the importance of the Danube Insurance on the insurance market (the largest insurance company), in December 2014, the Republic of Serbia recapitalized Danube Insurance with 4.8 billion dinars. In recent years, business performance of the Danube Insurance has been stable, with the continuous improvement of most indicators. There is a noticeable trend of profit growth from year to year (along with regular outpayment of dividends). Danube Insurance did not suffer any negative consequences in its business operation (as reflected in the most significant indicators) due to the COVID-19 disease caused by the SARS-CoV-2 virus. In the forthcoming period, harmonization (organizational, managerial, capital, etc.) with the new regulatory standard Solvency 2 shall be the biggest challenge, which awaits all participants in the insurance market in the Republic of Serbia.

The Law on the National Corporation for Insurance of Housing Loans (“Official Gazette of RS”, No. 55/04) established the Corporation, as a legal entity specialized in the insurance of accounts receivable based on housing loans approved by banks and other financial organizations, secured by mortgages, as well as well as in performing other tasks related to that insurance. The founder of the Corporation is the Republic of Serbia, which holds a direct share of 100% in the capital of the Corporation (the Law allows that the Corporation be organized as a joint stock company, provided that the value of state-owned capital in the total capital of the Corporation is not less than 51%). The Law also stipulates that the total nominal amount of the Corporation's liabilities arising from the performance of the Corporation's activities may be up to 16 times higher than the amount of the Corporation's capital, but also that the Government may, at the reasoned request of the Corporation, give approval to increase Corporation’s liabilities arising from the performance of the Corporation's activities by over 16 times the capital of the Corporation, for a certain period of time.

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

In the previous period, the Corporation was not recapitalized from the budget of the Republic of Serbia, but the capital increase was effected from the realized profit of the Corporation. However, as the capital increase did not follow the growth of secured loans, the Government, in accordance with the law, issued an approval each year to increase the volume of Corporation liabilities arising from the activities of the Corporation by over 16 times the capital of the Corporation. This increase declines each year (for example, in 2015 the volume of liabilities of the Corporation arising from the activities of the Corporation could be up to 30 times greater than the capital of the Corporation, while in 2021 they may amount to 21 times more than the capital of Corporation).

A large number of client lawsuits against banks regarding the payment of insurance premiums to the Corporation appear as a potential risk. Although the Corporation is not a defendant, nor is the Republic of

Serbia guarantor for the Corporation's liabilities (the Corporation guarantees for its liabilities up to the amount of its capital), the potentially negative outcome of these disputes may affect the possible need for certain budget expenditures.

Other fiscal risks

In addition to the above fiscal risks, there are other circumstances that, if materialized, may lead to fiscal costs. There are no systematized data for certain risks, but having in mind that some of them have materialized in the recent past, the magnitude of their impact on public finances may be perceived. Their identification helps perceiving possible effects on the country's fiscal position in the coming period.

Business performance of local self-government units may have fiscal implications for the general government budget. Special fiscal rules for local governments set up the so-called “golden rule” which stipulates that the deficit may be allowed only for the realization of capital investments. There are also rules regarding the level of borrowings of local self-government units, which, through consistent implementation, would maintain the stability of public finances at the local level. In practice, there were cases of unrealistic planning of both revenues and expenditures which led to the accumulation of overdue and unsettled obligations that threaten the functioning of certain cities and municipalities.

In order to avoid materialization of fiscal risks on this basis, in the coming period the Ministry of Finance will significantly improve the system of control of public finances in local governments to ensure their compliance with the rules governing the process from budget planning to budget execution on the local level.

There are significant fiscal risks based on court decisions, rendered by both domestic and international courts, fines and damages paid by state authorities, especially due to the initiation of enforcement proceedings due to failure of state authorities to fulfil obligations under final judgments by the set deadlines. With a view of reducing costs in the so-called “budget” cases, in which the Republic of Serbia, autonomous province, units of local self-government, or direct and indirect budget beneficiaries appear as an enforcement debtors, Article 300 of the Law on Enforcement and Security Interest, which entered into force on 1 January 2020, has been amended. It is provided for a possibility of voluntary settlement of claims, timely fulfilment of obligations by the competent state authority due to whose actions the claim at the expense of the state was incurred, all with the view of increasing accountability, cost-effectiveness and efficiency in the operation of state authorities, to avoid unnecessary payments for public enforcement officers, which greatly increase legal costs.

In the period 2009-2018, the Republic of Serbia paid RSD 80.5 billion from its budget on the basis of court decisions. In 2019, the amount of RSD 17.6 billion was paid from the budget of the Republic of Serbia on the basis of court decisions. In 2020, the amount of RSD 22.9 billion was paid on the basis of court decisions. The Republic of Serbia was bound by the Decision of the European Court for Human Rights to settle public debt under the unpaid foreign currency savings which the citizens of the former republics of SFRY, as well as the citizens of the Republic of Serbia deposited in the banks seated on the territory of the Republic of Serbia and their branch offices on the territories former republics of SFRY. Also, possible liabilities may arise from the decisions rendered by the Constitutional Court on the basis of the filed constitutional appeals and the decisions rendered by the European Court of Human Rights on the basis of applications filed by employees of former socially-owned enterprises (for unpaid salaries, compulsory social insurance contributions, default interest, legal costs, claims based on commercial transaction).

Constantly present risk of natural disasters and catastrophes demands investments into the prevention programs in order to reduce the potential fiscal expenditures for repairing damages caused by them. Prevention implies the inclusion of a wider range of financial instruments (such as reserve funds, potential credit lines, and especially insurance) that should be available to the state. In 2014, the Republic of Serbia faced the disastrous consequences of the floods, where the total damage (with losses) was estimated at over EUR 1.7 billion. In December 2014, the Government adopted the National Program for Risk Management in case of Natural Disasters, which will be implemented in cooperation with the World Bank, United Nations and EU. Within the National

Program, in November 2018, another umbrella law was adopted, governing the problems of natural disasters and catastrophes - the Law on Disaster Risk Reduction and Emergency Management. In 2019, the Republic of Serbia paid RSD 4.22 billion from the budget for damages for injuries or damage caused by natural disasters or other natural causes. In 2020, the amount of RSD 2.8 billion was set aside for this purpose.

In order to further improve the Fiscal Risk Monitoring Division, specifically the Group for Monitoring Other Fiscal Risks, talks are underway with the World Bank regarding the development of a methodology for monitoring fiscal risks caused by natural disasters, and as of the second quarter of 2021, consultations on the development of the methodology related to monitoring the risks caused by litigations will begin.

6. Cyclically Adjusted and Structural Fiscal Balance

Cyclically-adjusted fiscal balance is the fiscal balance from which the isolated impact of the economic cycle is excluded, assuming the following starting identity[12]:

$$FB = CB + CAB$$

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

The cyclically-adjusted deficit decreases rapidly after cyclically adjusted primary deficit has been declining rapidly since 2014, along with the movement of the general fiscal result, and in 2017 it entered into the surplus zone. Structural primary balance cleared from one-off factors recorded an impressive positive value in 2017. Structural changes in tax and expenditure system during 2012 and 2013 started to give results in the following period and the process of fiscal consolidation effectively began. The next phase of fiscal consolidation, carried out during the arrangement with IMF, but this time with the focus on structural adjustment on expenditure side, significantly improved the fiscal position of the country. One-off effects on the expenditure side may be isolated through the analysis and quantification of structural primary balance, although in certain years they are not insignificant, as well as the one-off effects on the revenue side. Structural primary balance analysis evaluated the fiscal position of the country. In the period 2014-2019, the fiscal position was significantly improved, confirming the assessment of the success of the fiscal consolidation program.

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

With the outbreak of the COVID-19 pandemic at the beginning of 2020 and the introduction of measures for the health protection of the population, the global economy has entered an unprecedented crisis, which, despite the signs of gradual recovery, is still not over. The specificity of the crisis is reflected in the cause itself, which is not economic but of health nature, while the way of combat in containing the spread of the virus produces additional adverse economic effects. The impact on the fiscal position is visible through reduced budget revenues, which are a consequence of the deceleration of the economic activity due to the pandemic, and a dramatic increase of expenditure due to the increased healthcare costs and the adoption of an extensive aid package to support the economy and citizens. In such a situation, the usual analysis of economic cycle, the quantification of fiscal multiplicators and the assessment of elasticity of the fiscal balance in relation to the output gap do not provide completely correct assessments of country's fiscal position.

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

Table 21. Fiscal Balance and Cyclically Adjusted Fiscal Balance Calculation Components in the period 2005-2024, as % of GDP *

	Output gap	Fiscal balance	Primary fiscal balance	Cyclical fiscal balance component	Cyclically adjusted fiscal balance	Structural fiscal balance	Structural primary fiscal balance**	Fiscal policy nature – fiscal impulse
2005	0.0	1.1	2.0	0.0	1.1	1.3	2.2	
2006	-2.7	-1.4	-0.1	-1.0	-0.5	0.2	1.5	1.2
2007	0.7	-1.8	-1.2	0.3	-2.1	-1.7	-1.2	2.3
2008	4.1	-2.5	-1.9	1.4	-3.9	-4.0	-3.4	1.9
2009	-0.3	-4.2	-3.6	-0.1	-4.0	-4.1	-3.5	0.1
2010	-0.7	-4.3	-3.4	-0.2	-4.1	-4.2	-3.3	-0.3
2011	0.5	-4.5	-3.4	0.2	-4.7	-4.9	-3.8	0.4
2012	-0.8	-6.4	-4.7	-0.3	-6.1	-6.1	-4.4	0.9
2013	1.2	-5.1	-3.0	0.4	-5.6	-5.3	-3.1	-1.1
2014	-1.4	-6.2	-3.5	-0.5	-5.7	-4.8	-2.2	-0.3
2015	-1.2	-3.5	-0.5	-0.4	-3.0	-2.2	0.8	-3.0
2016	0.0	-1.2	1.7	0.0	-1.2	-1.1	1.8	-1.8
2017	-0.5	1.1	3.6	-0.2	1.3	1.1	3.7	-2.1
2018	0.9	0.6	2.7	0.3	0.3	0.2	2.3	1.4
2019	2.0	-0.2	1.8	0.7	-0.9	-1.1	0.9	1.3
2020	-2.2	-8.1	-6.1	-0.8	-7.3	-0.4	1.6	6.4
2021	0.0	-6.9	-5.0	0.0	-6.9	-3.1	-1.2	-0.3
2022	0.2	-3.0	-1.2	0.1	-3.1	-3.6	-1.8	-3.7
2023	0.2	-1.5	0.1	0.1	-1.6	-1.6	0.0	-1.3
2024	0.2	-1.0	0.6	0.1	-1.1	-1.1	0.5	-0.5

* The projected values are shown for the period 2021–2024.

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

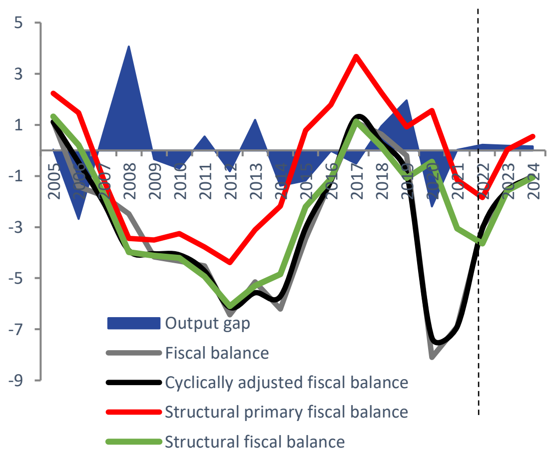
Source: Ministry of Finance

The fiscal policy response to the complex economic situation caused by the coronavirus pandemic in 2020 is represented by the large-scale package of economic measures, the value of which is planned at 12.9% of GDP (realized 11.6% of GDP). It is estimated that the direct impact of this economic package on the country's cyclical position amounted to over 7% of GDP, with a negative output gap reaching 2.2% of GDP. In the absence of measures aimed at providing support to the economy and the population, the decline of GDP in 2020 would be significantly higher, and it would amount to over 5%, due to greater economy contraction and slower recovery, and the negative output gap would be higher than 6% of GDP.

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

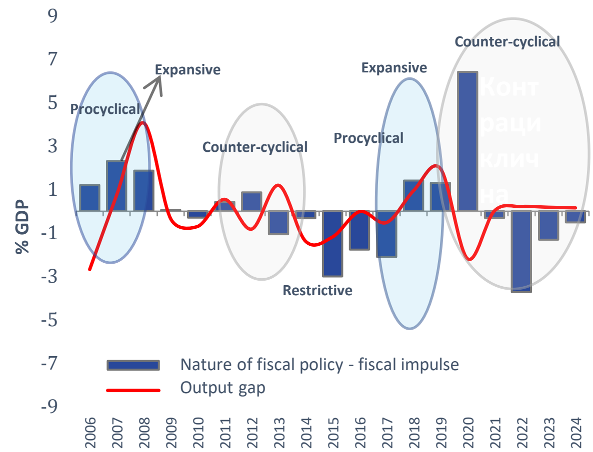
As already said in the previous part of the text, due to the prolonged epidemiological and economic impact of the COVID-19 pandemic in 2021, it was necessary to adopt an additional package of measures of economic support to the economy and the citizens. The rebalance of the budget for 2021, among other things, envisages funds in the amount of 4.5% of GDP, as a form of support to the economy and citizens for easier overcoming of the economic consequences of the pandemic. However, the emphasis is now on sectors that have been particularly affected by epidemiological protection measures. As in the previous package of measures, funds are provided to support the population, which will result in an additional stimulus to aggregate demand. The estimated effect of the third package of measures on the country's fiscal position is 2.5% of GDP.

Output gap, real cyclically adjusted and structural fiscal balance in the period 2005-2024, % GDP*



* For the period 2021–2024, the projected values are given

Nature and effects of fiscal policy in the period 2006-2024, % GDP*

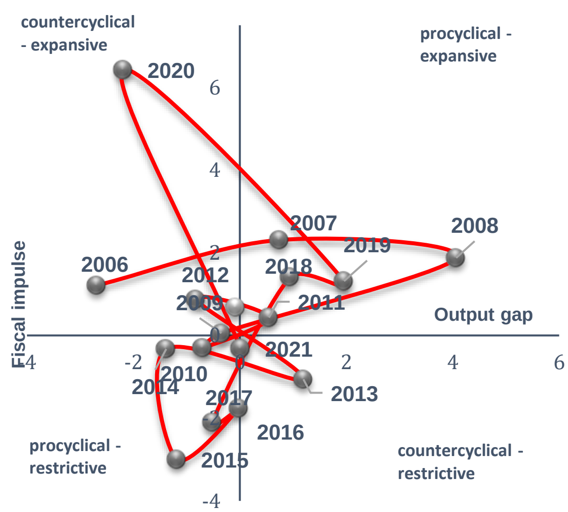


* For the period 2021–2024, the projected values are given

The structural fiscal position of the country has not been impaired because the economic aid measures have been implemented in the field of temporary fiscal policy. However, in the next medium-term period, the trend of the structural fiscal result will be influenced by tax liabilities transferred from 2020 to 2021 and 2022. The payment of revenues based on the tax and contributions deferrals from 2020 will have temporary (non-structural) effect on the structural balance in 2021 and 2022. Due to the above, as well as on the basis of a significant increase in expenditures for infrastructure in 2021, a slight deterioration of the structural fiscal position has arisen. However, increasing the share of public investment in GDP will have both a direct and indirect impact on accelerating economic growth in both the medium and long term.

Given that the fiscal impulse is defined as the difference between two successive cyclically adjusted (primary) results, it can be estimated that during 2018 and 2019, in the conditions of a positive output gap, the fiscal policy had a pro-cyclical character. On the other hand, fiscal policy during 2020 is extremely expansionary-countercyclical, aimed at mitigating the negative economic cycle. Due to the somewhat smaller scope of the package of economic support measures in 2021, fiscal policy is moderately restrictive and neutral in nature. In the period from 2022 to 2024, the countercyclical character is somewhat more pronounced, due to the set goals of balancing and stabilizing public finances, in the conditions of a positive output gap.

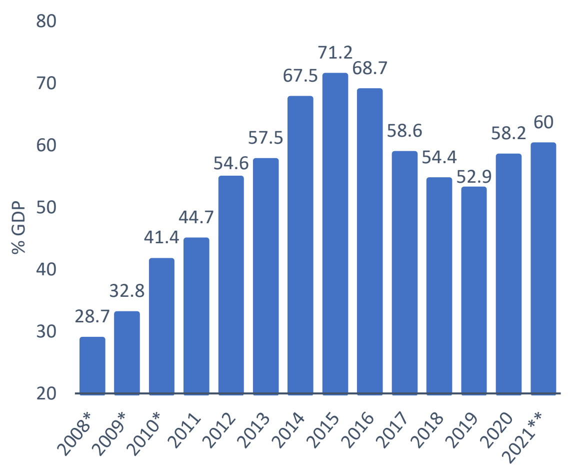
The nature and the effects of fiscal policy in the period 2006–2021, % GDP*



7. Debt reduction program

In accordance with the principle of fiscal responsibility, if the general government debt exceeds 45% of GDP, the Government is obliged to propose measures that will bring the debt closer to the target level and return it to a sustainable path[13]. At the same time, the Stability and Growth Pact defined the upper limit on the share of public debt in GDP of 60%, as well as an obligation for EU member states to present a credible plan for reaching the prescribed level at satisfactory speed, if the given limit was exceeded.

Public debt of the general government in the period 2008–2021, % GDP



* Local debt approximation
** Assessment for 2021

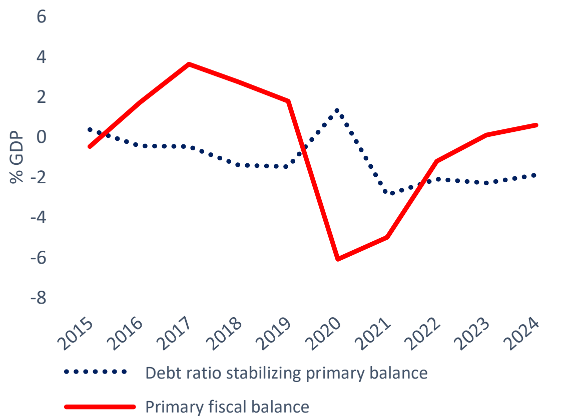
In the period from 2008 to 2014, the general government deficit increased significantly and at the same time public debt entered into the explosive growth path, with the debt-to-GDP ratio more than doubling. Fiscal consolidation measures adopted at the end of 2012 and during 2013 partially mitigated this trend, but the level of public debt continued to grow significantly. Reduction of the primary deficit in the period 2012–2014 year was not sufficient to stabilize the share of public debt in GDP. The effects of the first wave of fiscal consolidation, which referred mainly to the revenue side, were absent, due to the increased volume of the grey economy, characteristic in the period after the increase of tax rates. On the expenditure side, high interest rates and certain one-off expenditures further worsened the fiscal position.

Fiscal consolidation measures adopted at the end of 2014 lowered the primary deficit and slowed down the growth of public debt during 2015. The reduction of debt-to-GDP ratio occurred in 2016, a year earlier than envisaged by the arrangement with the IMF. In 2016, a primary surplus of 1.7% of GDP was achieved, which finally created the conditions for a decline in the share of public debt in GDP. After that, in 2017, the realized primary fiscal surplus of 3.6% of GDP led to an even more significant decline in the share of debt, by more than 10 pp of GDP, to 58.6% of GDP. During 2018, the declining trend of public debt share in GDP continued and came to 54.4% of GDP. Fiscal relaxation during 2019 did not threaten the declining trajectory of public debt. A positive primary fiscal result in 2019 of 1.8% of GDP affected the further reduction of public debt by additional 1.5 pp of GDP.

As stated in the previous part of this document, 2020 and 2021 have been marked by one of the biggest health and consequently economic crises in the last few decades, caused by the COVID-19 pandemic. The most important factors that influenced the debt trends during 2020 and 2021 are the level of the total and primary fiscal deficit, additional financing needs and repayment of the due part of the debt. The realized fiscal deficit of 8.1% of GDP (primary deficit of 6.1% of GDP) in the previous year and the estimated deficit of 6.9% of GDP in the current year, have influenced the until now declining trajectory of public debt to reverse. The share of general government public debt in GDP will reach 60% at the end of 2021. The fiscal strategy for the next medium-term period envisages the stabilization of public finances and significantly lower levels of deficit that will revert public debt to a declining trend zone. The process of stabilization of public finances will be gradual and steady so that too restrictive policies would not undermine the assumptions of accelerated economic growth.

[13] Public debt in this document does not include the debt on the basis of the restitution in compliance with the definition of the debt provided in the Budget System Law.

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



* For the period 2021–2024, the projected values are given
Source: Ministry of Finance

By analysing the primary stabilization gap, which is defined as the difference between the achieved primary result and the primary result necessary to stabilize the share of public debt in the current year, it is possible to assess the set quantitative fiscal limits. Since 2016, there has been a positive primary stabilization gap, and the debt trajectory has been reversed. During 2017 and 2018, the positive gap increased and in that period, the largest reduction in the share of debt in GDP was achieved. The opposite trend is recorded in 2020 and 2021, when the highest negative value of this indicator was reached. In the period 2022-2024, in accordance with the fiscal framework given in this document, positive values of this parameter are projected.

The dynamics of reducing the level of public debt to 45% of GDP is projected, in compliance with the applicable fiscal rules, and the baseline scenario presented by this fiscal framework, envisages a gradual reduction of the fiscal deficit to 1% of GDP at the end of 2024.

Public debt management and sustainability will be further ensured by:

- restriction on issuance of new guarantees;
- restriction on granting new project loans in cases where the previously approved loans have not been used efficiently;
- refinancing some of the expensive debts by using funds from soft loans and privatization proceeds, where possible;
- fiscal risks identification and better management.

Public debt share of 45% of GDP, envisaged by the law, will be achieved in 2029. The success of the previous program of structural fiscal adjustment enabled the reduction of the debt share by 18.3 pp of GDP in the period from 2015 to 2019. Such circumstances affected the ability of the Republic of Serbia to provide for the unhindered financing of the fiscal deficit during 2020, as well as the unhindered repayment of due debts.

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

As the fiscal rules envisage a debt limit of 45% of GDP to be reached in 2029, a simulation of the movement of the share in the case of variation of factors influencing the debt dynamics was done.

The assumptions in the baseline scenario are the following:

- After the high level of fiscal deficit in 2020 and 2021, in the period from 2022 to 2024, the level of general and primary fiscal result enables a gradual reduction of the public debt share in GDP. After that, the fiscal deficit was adjusted to 0.5% of GDP;
- slower growth of fiscal revenues in relation to nominal GDP growth due to changes in the structure of the economy, strengthening of investment activity and growth of exports. No significant changes in tax policy are envisaged, while maintaining the existing efforts in the fight against the grey economy;
- no net increase in issued guarantees after 2023;
- average real GDP growth rate of 4% in the long run;
- annual inflation rate of about 3% on average in the observed period;
- no significant proceeds from privatization in the observed 2025–2029 period. Possible higher privatization proceeds will reduce the need for financing and will further reduce the share of public debt.

Table 22. Total public debt simulation - Baseline Scenario by 2029, % GDP

Baseline scenario	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Revenues	41.3	41.8	41.8	40.8	40.6	40.4	40.2	40.0	39.7	39.5
Expenditures	49.4	48.7	44.7	42.4	41.6	40.9	40.7	40.5	40.2	40.0
Decline of expenditure share		-0.7	-4.0	-2.3	-0.8	-0.7	-0.2	-0.2	-0.2	-0.2
Fiscal result	-8.1	-6.9	-3.0	-1.5	-1.0	-0.5	-0.5	-0.5	-0.5	-0.5
Primary fiscal result	-6.1	-5.0	-1.2	0.1	0.6	1.0	0.9	0.8	0.7	0.6
Public debt in GDP	58.2	60.0	59.3	57.6	55.5	53.0	50.6	48.3	46.1	44.1
GDP real growth rate, %	-1.0	6.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0

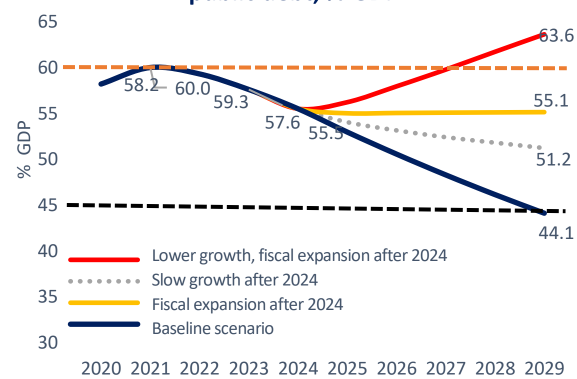
Source: Ministry of Finance

The baseline scenario envisages a reduction in public debt to around 45% of GDP in 2029. The graph shows simulations of alternative scenarios of public debt, depending on changes in certain assumptions in the baseline scenario. For a better comparison, only one variable was changed, as a risk factor affecting the debt level.

The scenario "slowed-down growth after 2024" implies an average real GDP growth of about 0.7% in the observed period, with the same level of fiscal deficit compared to the baseline scenario. This does not imply the same level of fiscal adjustment, as greater accommodation is needed on the expenditure side in situations where lower economic growth is recorded.

At the end of 2029, public debt under this scenario reaches a level of 51.2% of GDP. One of the dangers of a prolonged slowed-down growth scenario is that despite keeping the fiscal deficit level low, the level of public debt is not falling fast enough. On the other hand, slower growth, through automatic stabilizers, produces higher levels of the fiscal deficit, so larger expenditure cuts are needed to maintain the declining path of public debt share. There is a risk of entering a spiral of slow growth and the need for additional austerity measures. Despite these risks, the scenario enables a gradual reduction of the share of public debt, but not reaching the level of 45% in the observed period, under the other given assumptions

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



The scenario "fiscal expansion after 2024" implies a significant deviation from the current medium-term goal of fiscal policy and reaching a fiscal deficit of 3%. In this case, the share of public debt in GDP is largely stagnant, to reach 55.1% of GDP in 2029. Public debt does not reach the legal limit of 45% of GDP, and the level below 60% is maintained throughout the observed period. Despite the significant deterioration in fiscal performance, this scenario implies the still present primary fiscal result that allows for relative stability of the debt share at given positive GDP growth rates.

The scenario that combines lower real GDP growth and raising the level of fiscal deficit by an average of 3% of GDP has the most unfavourable public debt trajectory. In this scenario alone, debt has a markedly growing trajectory in the period after 2024, and the share of public debt is beginning to accelerate to a level significantly above 60% of GDP at the end of the observed period.

III. PUBLIC DEBT MANAGEMENT STRATEGY FOR THE PERIOD 2022 - 2024

According to the Public Debt Law, as the legal basis for the borrowing of the Republic of Serbia, the public debt shall include all the direct liabilities of the Republic, based on borrowings, as well as the guarantees issued by the Republic of Serbia for public enterprises', local governments' and other legal persons` borrowings. The Republic may borrow in domestic or foreign currency, in order to finance budget deficit, current liquidity deficit, to refinance an outstanding debt, to finance investment projects, to procure financial assets and to make payments on issued guarantees. The provisions of the Public Debt Law state that the public debt constitutes and absolute and unconditional obligation of the Republic of Serbia regarding the repayment of principal, interest and other borrowing costs.

A quantitative approach was used to formulate Public Debt Management Strategy, identifying possible constraints through macroeconomic indicators, cost-risk analysis, and market conditions which affect public debt management. The analysis involved the use of financing instruments available in the domestic and international financial markets. The Public Debt Management Strategy is based on the principles that define the need for transparent and predictable borrowing process, with the continuous development of the government securities market and acceptable level of exposure to financial risks.

Analysing possible borrowing strategies, the MTDS (Medium-Term Debt Management Strategy) model developed by the World Bank indicates that the borrowing structure based on dinar-denominated and euro-denominated securities issue is the best option in terms of costs (risks). The situation on domestic and international financial market, successful implementation of fiscal consolidation measures, along with good coordination of fiscal and monetary policy has led to a significant decline in borrowing costs on dinar and euro denominated securities in recent years, and reduction of premium risk for Serbian government securities to the historical minimum.

The fiscal strategy envisages the reduction of general government public debt by the end of 2024 to the level of 55.5.% of GDP, in which case, in accordance with the Public Debt Management Guidelines defined by the World Bank and IMF, within the Public Debt Management Strategy, the stress-scenario analysis of the effects of the foreign currency exchange rate of the domestic currency (RSD) against the currencies in which the public debt of the Republic of Serbia is denominated, is being conducted.

Significant progress has been made in the last eight years in terms of increasing the average maturity of dinar-denominated government securities and reducing financing costs based on this type of borrowing, thus reducing the exposure to refinancing risk. It is important to note that the in the mentioned period the average coupon rate of dinar-denominated government securities decreased from 13.68%, as it was at the end of 2012, to 4.65% at the end of March 2021.

The Public Debt Management Strategy defines the basic measures for further development of dinar-denominated government securities market. The development of this market is expected to increase internal debt and increase its share in total debt, as well as to reduce public debt exposure to foreign exchange risk, which will positively affect the increase in the credit rating of the Republic of Serbia.

After the successful implementation of fiscal consolidation measures in 2016, the growing path of public debt and the share of public debt in GDP was reversed, and the share fell from 70.0% of GDP, as it was at the central level of government at the end of 2015, to 67.7% at the end of 2016. During 2017, there was an even more significant decline to 57.8% of GDP. The trend continued during 2018, when the share of public debt in GDP fell to 53.6%, while at the end of 2019, the share of public debt in GDP further decreased to 52.0% of GDP. Due to the need to finance measures to support the economy and citizens in order to reduce the impact of the crisis caused by the COVID-19 virus pandemic, there has been a slight increase in public debt since April 2020, and at the end of 2020 its share in GDP was 57.4%, while at the end of March 2021 the share was reduced to 55.7%.

Due to more stringent control over the issuance of guarantees in previous years, the guaranteed public debt was halved, falling from EUR 2.8 billion at the end of 2013 to EUR 1.4 billion at the end of March 2021.

The positive fiscal results achieved by the Republic of Serbia are also confirmed by the increase in the credit rating in 2019 by the two rating agencies. *Fitch Ratings* and *Standard and Poor's* upgraded Serbia's rating to BB + from BB, while *Moody's* upgraded the outlook for raising the credit rating of the Republic of Serbia from stable to positive. During 2020, rating agencies downgraded the credit ratings of a large number of countries, while the Republic of Serbia remained in the group of countries whose credit ratings remained unchanged. Due to a very successful response to the crisis caused by the COVID-19 virus pandemic and the preservation of macroeconomic stability during a very difficult and challenging 2020, in March 2021, *Moody's* upgraded the credit rating of the Republic of Serbia from Ba3 to Ba2.

During 2020, the Republic of Serbia issued Eurobonds on two occasions in order to finance a package of measures to help the economy and households in order to minimize the impact of the crisis caused by the COVID-19 virus pandemic and prepay previously issued expensive Eurobonds. The first issue of Eurobonds was on 7 May 2020, in euros, at the most delicate moment in the first wave of the pandemic, in the total amount of EUR 2.0 billion. The coupon rate was 3.125%, with maturity in 2027 and they were listed on the London Stock Exchange, one of the largest and most representative markets in the world. The second issue of Eurobonds was on 1 December 2020, in the total amount of 1.2 billion US dollars, maturing in 2030. The coupon rate was 2.125%, and the final interest rate in euros, after effecting a hedging transaction, was 1.066%. A return to the dollar securities market, and a new dollar-denominated issue, allows Serbia to remain present in the EMBI Index, ensuring its visibility in the US capital market as well as on the wider international investment map. With the funds from December 2020 Eurobonds issue, the early repayment of 900 million dollars of Eurobonds issued in 2011 was made, out of the total of 1.6 billion dollars that matured in September 2021, so that now the remaining amount maturing on 28 September 2021 amounts to $ 700 million. Bonds issued at a coupon rate of as much as 7.25% were prematurely redeemed. On 24 February 2021, the Republic of Serbia successfully used the still favourable conditions on the international financial market and for the first time issued twelve-year government bonds denominated in euros, in the amount of one billion euros, at a coupon rate of 1.65%, thus further increasing maturity of debt.

Guided by the best international practice of active public debt management, in December 2020, the Republic of Serbia effected a hedging transaction for the first time, i.e. use of financial derivatives for the purpose of hedging against foreign exchange and interest rate risk, in accordance with internationally recognized ISDA standards (International Swaps and Derivatives Association), i.e. cross-currency swap transactions by which liabilities based on issued bonds are converted from US dollars to euros at significantly lower final interest rates. The Republic of Serbia will settle its liabilities based on the dollar-denominated issue, in the amount of 1.2 billion USD, in euros, at a coupon rate of 1.066% on the nominal value of the issue after the conversion of 1.016 billion euros. The favourable exchange rate of the euro and the US dollar at a given time was used, as well as the current divergence between dollar and euro interest rates on the international capital market, and the most favourable borrowing price was achieved, with optimization of the currency structure of public debt, all in order to ensure protection against the risk of exchange rate changes. In this way, additional savings of around 11.6 billion dinars were achieved. In February 2021, the second swap transaction was realized, by which liabilities under the Debt Rescheduling Agreement between the Republic of Serbia and the Kuwait Investment Authority were converted from US dollars to euros, at a significantly lower interest rate. Liabilities based on the said rescheduled loan, agreed in dollars at an interest rate of 1.5%, the Republic of Serbia will settle in euros at an interest rate of 0.393%, which will provide a saving of about 16.5 million euros.

During 2020, the issue of "benchmark" bonds on the domestic market continued, which led to the inclusion of bonds of the Republic of Serbia in the JP Morgan GBI-EM Index from June 2021. Bonds with a maturity of 5.5 and 12.5 years were issued in RSD with a nominal value of 100 billion dinars each, the volume of which increased to 150 billion each during 2021.

In 2019, the Republic of Serbia effected early redemption of previously issued government securities on the domestic market through regular auctions in which it repurchased government bonds denominated in dinars with high coupon rates of 4.5% on bonds with a maturity of 3 years and 10.0% on bonds with a maturity of 7 years, in the total amount of RSD 35.1 billion. The same practice continued in 2020, with the early redemption of RSD 10.2 billion worth bonds with high coupon rates. Through these auctions, active public debt management continued in order to replace debts with a shorter maturity and higher interest rates with the longer maturity debts with lower borrowing costs. At the same time, investors who actively invest in domestic securities were given the opportunity to extend the maturity of their investments and continue investing in the country, which is of great importance for further development of the capital market and government bond issues in the future.

Currency risk was further reduced during 2020. The share of public debt in local currency in the total public debt of the central government level was only 2.6% at the end of 2008, and by the end of 2020 it had risen to 30.5%. The growth of dinar debt was primarily contributed by issues of dinar government securities on the domestic securities market. During 2019 and 2020, early redemption of expensive Eurobonds issued in 2011 and 2013 in US dollars was effected, and during February 2020, regular repayment of the dollar bond issued in 2013. In December 2020, the first hedging transaction was concluded, under which Eurobond issued in US dollars was immediately converted into euros. In February 2021, another hedging transaction was effected by which liabilities in US dollars were converted into euros. Thanks to these transactions, the share of dollar debt in the total public debt decreased from 33.9% at the end of 2016 to 12.3% at the end of March 2021.

Borrowing costs were also reduced in 2020. The share of interest expenses in GDP fell from 2.9% in 2015 to just under 2.0% in 2020. This was primarily due to the fall in interest rates on the domestic securities market, which was largely caused by the growth of investor confidence, after the taken fiscal consolidation measures. The weighted average interest rate on public debt fell from 5.70% at the end of 2014 to 2.86% at the end of March 2021. The average coupon rate on dinar government securities decreased from 13.68% at the end of 2012 to 4.65% at the end of March 2021.

Thanks to the proceeds from the sale of *Komercijalna Banka*, in December 2020, the entire remaining amount of 172.7 million euros of the loan agreed with the Government of the Republic of Azerbaijan for the construction of the E-763 Ljig-Preljina highway was prepaid. The interest rate on the loan was high and amounted to 4.0%, so that this prepayment saved about 25.9 million euros.

At the end of March 2021, the total general government public debt amounted to 3,353.4 billion dinars, or 56.5% of GDP. Out of this, RSD 3,144.3 billion referred to direct liabilities, RSD 164.7 billion to indirect liabilities, while RSD 34.9 billion referred to the unsecured debt of local self-government units and RSD 9.5 billion to the unsecured debt of PE “Roads of Serbia” and the company “Corridors of Serbia” d.o.o.

General government public debt share in GDP,%

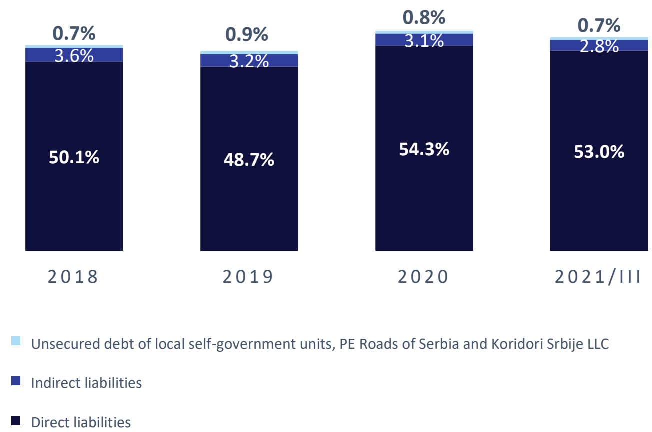


Table 23. General government public debt of the Republic of Serbia in the period from the end of 2018 to 31 March 2021

	2018	2019	2020	2021/III
Public debt (in billion RSD)	2,757.3	2,864.0	3,181.2	3,353.4
Public debt (in million EUR)	23,328.4	24,354.9	27,055.8	28,520.2
Public debt (in million USD)	26,669.1	27,296.9	33,254.3	33,391.4

In the first three months of 2021, due to the need to finance measures aimed at supporting the economy and households in the fight against the pandemic caused by the coronavirus COVID-19, there is a slight increase in central government debt in currencies with the largest share in public debt, i.e. in euros and dinars. Due to borrowing on the domestic securities market, which in 2020 and in the first quarter of 2021 was predominantly effected in dinars, there was an increase in public debt in dinars. There was also an increase in debt in euros, due to the issue of Serbian Eurobond 2027 and Eurobond 2030, in 2020, as well as of Serbian Eurobond 2033, in March 2021. In February 2020, the remaining amount of 210.3 mil. US dollars Serbian Eurobond 2020 was repaid. In the same year, Serbian Eurobond 2030, which was issued in US dollars, was immediately converted into euros, i.e. in order to reduce currency risk, the Republic of Serbia concluded a swap transaction. In February 2021, another swap transaction was concluded and the debt in US dollars was further reduced.

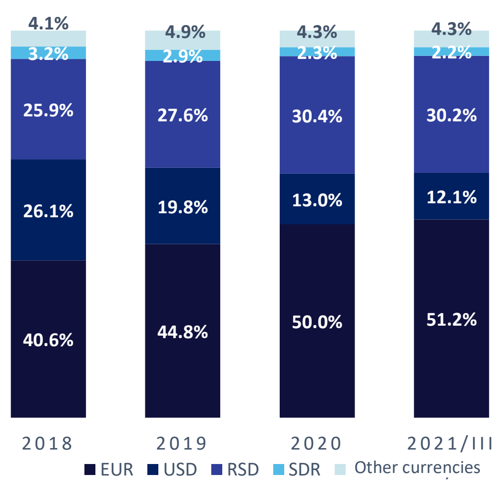
Table 24. Central government debt balance per original currencies in the period the end of 2018–31 March 2021, in millions

	2018	2019	2020	2021/III
EUR	9,216.7	10,582.5	13,222.5	14,254.7
USD	6,963.9	5,397.3	4,323.9	4,042.4
RSD	708,389.1	781,250.4	957,952.2	1,010,064.7
CHF	120.7	110.5	90.3	83.9
Special drawing rights	618.1	570.4	522.7	506.9
Other currencies (in RSD)	100,910.4	128,958.8	127,674.8	135,805.8

In line with the aspiration to reduce the exposure to currency risk, extend the maturity and continue with the development of new borrowing instruments on the domestic financial market, the main source of financing in the period 2018-2021 have been issues of dinar securities, which affected the increase in the share of the central government public debt in dinars from 26.0% at the end of 2018 to 30.5% of the public debt of the Republic of Serbia at the end of March 2021, i.e. from 708.4 billion dinars, which was the amount of public debt in dinars at the end of 2018, to 1,010.1 billion dinars at the end of March 2021.

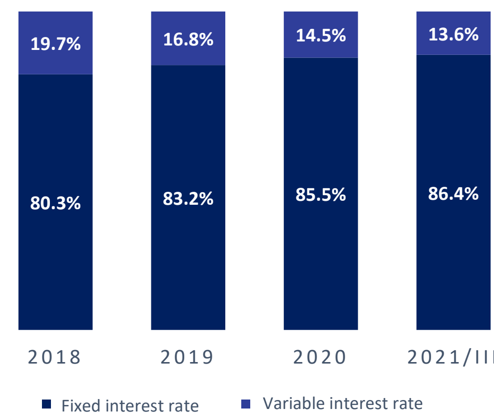
According to the data from 31 March 2021, the largest part of the general government public debt of the Republic of Serbia is still denominated in euros and amounts to 51.2%. It is followed by dinar-denominated debt in the amount of 30.2% and dollar-denominated debt in the amount of 12.1%. The remaining debt is denominated in special drawing rights (2.2%) and other currencies (4.3%). Thanks to the continuous development of the domestic securities market and the gradual increase in the volume of issues in domestic currency, there was a significant increase in the share of debt in domestic currency in previous years, which at the end of 2011 amounted to only 16.4%. Government bonds issued in dinars on the domestic market in 2020 accounted for as much as 87.2% of total sales.

Currency structure of the general government public debt in the period 2018 – 31 March 2021



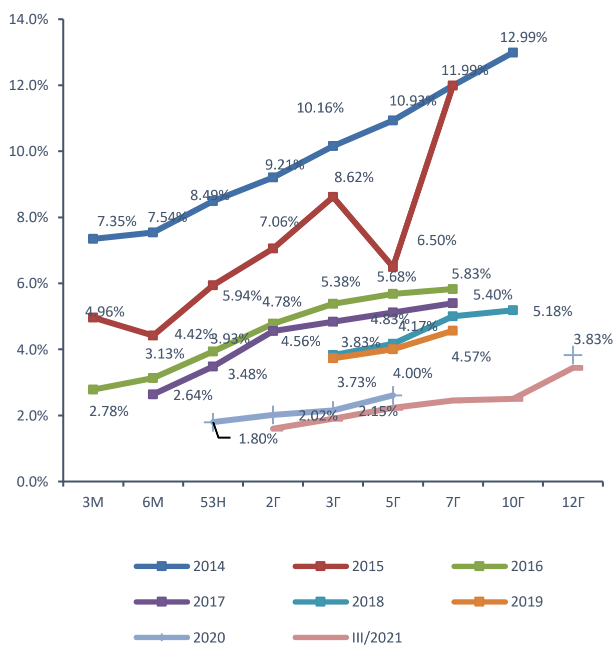
On 31 March 2021, the majority of the general government public debt of the Republic of Serbia was with the fixed interest rate – 86.4%, whereas the public debt with the floating interest rate accounted for 13.6% of the total public debt. Among the floating interest rates, the highest share hold EURIBOR and Euro LIBOR interest rates, accounting for 82.4%, then floating interest rate for special drawing rights, accounting for 12.1%, and USD LIBOR interest rate, accounting for 2.9%, while the share of liabilities with other interest rates was 2.6%.

Interest rate structure of the government public debt in the period 2018 – 31 March 2021, %

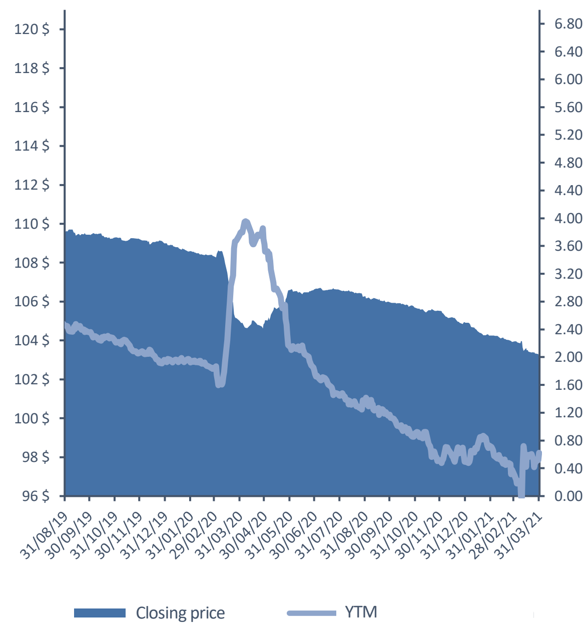


In the last few years, there has been a downward trend in borrowing costs, which is most pronounced in government securities issued on the domestic market. The decline was due to the growth of the country's credit rating, i.e. the reduction of the risk premium, low inflation rate and the fall of the NBS reference interest rate, which currently amounts to 1.0%, thus continuing the trend that began in the last quarter of 2012. During 2020, thanks to the achieved results, among which public debt management was mentioned as one of the most important, and despite the pandemic caused by the coronavirus COVID-19, all rating agencies confirmed the credit rating of the Republic of Serbia with stable prospects for further increase. In early March 2021, *Moody's* upgraded Serbia's credit rating from Ba3 to Ba2, with a stable outlook for further improvement.

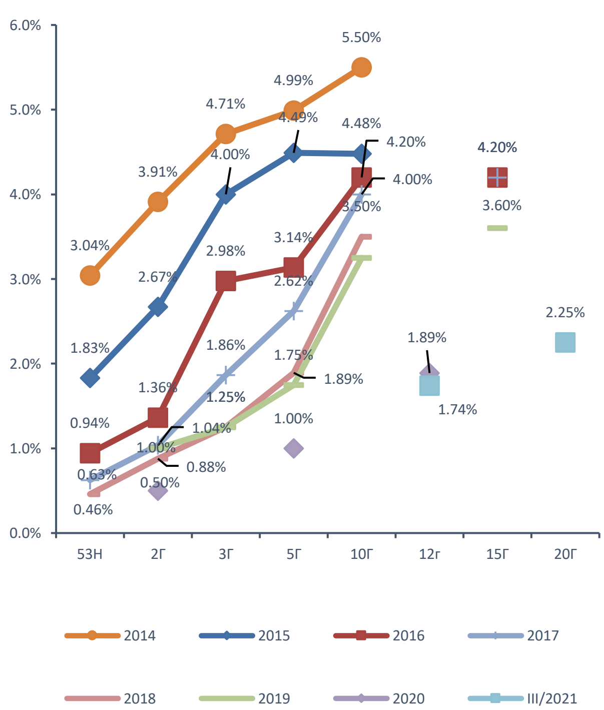
Overview of the trend of average effective interest rates in dinar-denominated securities in the period 2014–31 March 2021



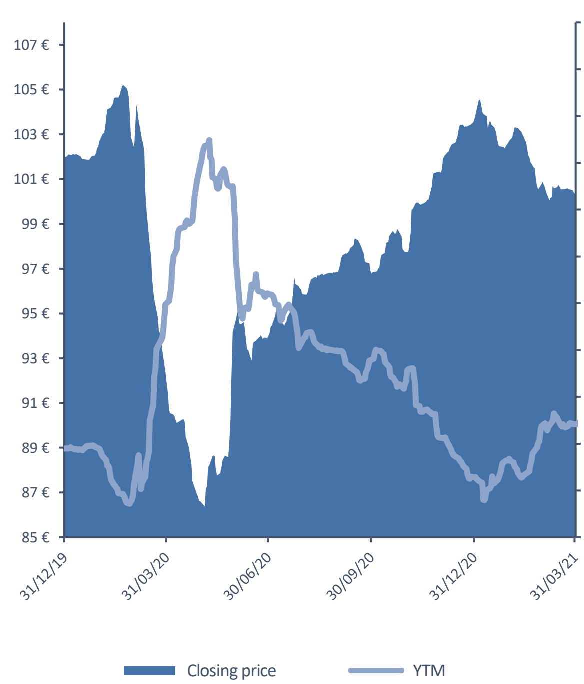
Overview of price trend and yield rates trend for Serbian Eurobond 2021



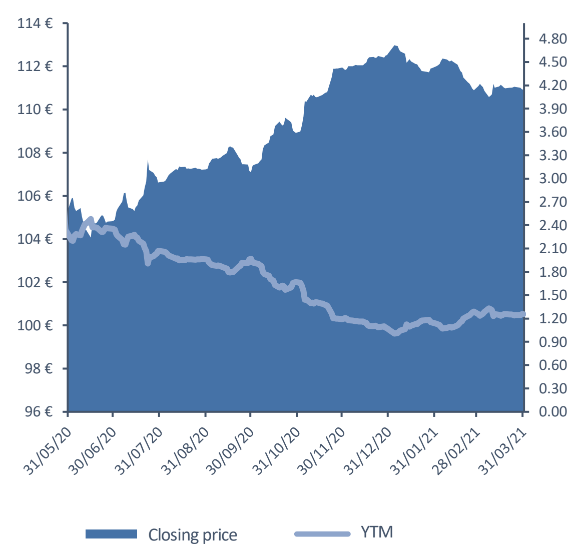
Overview of the trend of average effective interest rates in euro-denominated securities in the period 2014–31 March 2021



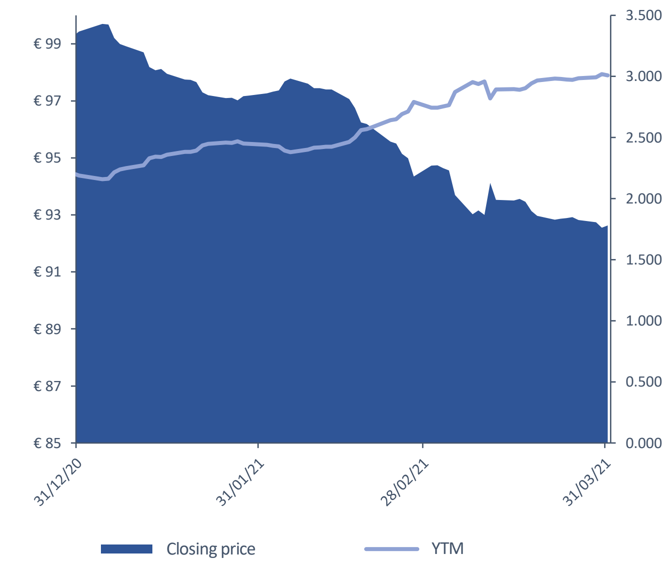
Overview of price trend and yield rates trend for Serbian Eurobond 2029



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



Overview of price trend and yield rates trend for Serbian Eurobond 2033



Overview of price trend and yield rates trend for Serbian Eurobond 2030

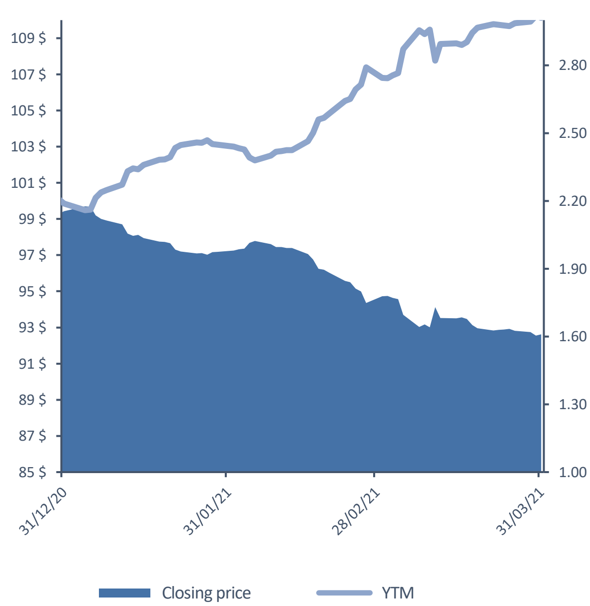


Table 25. Interests and principals repayment projections by 2024 (RSD billion)

	2021 p	2022 p	2023 p	2024 p
Principal	477.9	401.3	467.1	349.7
Interest	111.2	109.5	111.8	112.9
Total	589.1	510.8	578.9	462.6
Share in the public debt on 31 March 2021	17.8%	15.4%	17.5%	14.0%

* with planned *buy-back* operations

Table 26. Interests and principals repayment projections by 2024 (% GDP)

	2021 p	2022 p	2023 p	2024 p
Principal	8.0%	6.3%	6.9%	4.8%
Interest	1.9%	1.7%	1.6%	1.6%
Total	9.9%	8.1%	8.5%	6.4%

Planned amounts for interests and principals repayment in 2020, at the central government level, also include the funds for buy-back operations, i.e. early debt redemption, in order to replace the more expensive debt with a cheaper one.

Projection of General Government public debt balance in the period 2021–2024

Considering the projected primary budget deficit of the Republic of Serbia for the period 2020 - 2024, including the volume of drawn loan instruments for project financing of budget beneficiaries, the effects of foreign currency exchange rate of RSD against EUR and USD in the baseline macroeconomic scenario, the central government debt balance at the end of 2023 should amount to 54.4% of GDP.

Table 27. Basic projection of general government public debt balance by 2024

	2021 p	2022 p	2023 p	2024 p
Public debt (central government), in RSD billion	3,505.8	3,698.8	3,842.8	3,934.8
Central government debt, as % of GDP	59.0%	58.3%	56.5%	54.4%
Non-guaranteed local self-government debt, as % of GDP	1.0%	1.0%	1.1%	1.1%
General government debt, as % of GDP	60.0%	59.3%	57.6%	55.5%

In 2021, a slight increase in the ratio showing the share of general government debt in GDP, to 60.0% is expected, due to the need to continue financing measures to support the economy and households affected by the pandemic caused by the coronavirus COVID-19. Thereafter, in the coming years, the stabilization of the situation is expected, and the return of this ratio to the downward trajectory, so that at the end of 2022 it is expected to be 59.3%, at the end of 2023 - 57.6%, and at the end of 2024 - 55.5%. In the given period, the realization of large infrastructure projects is expected, which will be financed mainly from project loans, and their more intensive implementation compared to the previous period. If it were not for that, decrease in this ratio would be more pronounced. However, this is precisely one of the points where a clear coordination of fiscal and development goals can be seen. Account is taken of the sustainability of public debt and the gradual decline of its share in GDP, while concurrently using new borrowings to improve infrastructural conditions which lead to the growth of GDP, living standards and new investments. The non-guaranteed debt of the local self-government units is envisaged to remain at the relatively stable level of about 1.0% to 1.1% of GDP in the period from 2021 to 2024.

Public debt management principles

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

1) ensure the financing of the fiscal deficit and regular financing of liabilities based on the public debt of the Republic of Serbia;

2) set an acceptable risk level that should be defined within the targeted debt portfolio structure, in terms of debt currency structure, interest rate structure, maturity structure, and debt structure by the types of instruments;

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

4) enable transparency and predictability of the borrowing process.

The public debt management strategy must be consistent with the general medium-term macroeconomic and fiscal framework.

The Public Debt Management Strategy shall in the following medium-term period be based on the financing of the deficit and the principal of budget debt of the Republic of Serbia, mainly through the issue of government securities in the international and domestic capital market. The government securities market is still developing, and one of the principles of public debt management is the flexibility in order to secure the regular financing of liabilities. Flexibility shall be reflected in the selection of the market for borrowings, borrowing currency and financing instruments. Financing structure will be selected taking into account current state and development trends on the domestic and international financial market (interest rate level, risk premiums, yield curve, reference foreign currency exchange rates), and an acceptable level of exposure to financial risks.

The goal for the next long-term period is to effect financing primarily by issuing dinar securities on the domestic market. However, the current situation suggests that, despite a firm determination to develop the domestic government securities market, part of the financing might be ensured on the international financial market in the medium term, through the establishment of the GMTN program.

Borrowings in foreign currency, e.g. in US dollars, entail foreign exchange risk due to the changes in the euro - US dollar exchange rate, and for that reason the hedging option shall be used.

Public debt management policy must take into account the long-term perspective, but the decisions on the financing of budget expenditures must be made annually. Decisions on annual borrowing are taken within the Law on Budget for each specific fiscal year. Depending on the changes in the basic fiscal aggregates, adjustments of the borrowing plans are possible during the fiscal year.

Financial risks and financial risk management measures

Financial and fiscal risks may lead to higher public debt growth than the baseline scenario predicts. Risks that are present and that can lead to an increase in indebtedness and public debt service costs include: refinancing risk, foreign exchange risk, market risk (interest rate risk, inflation risk), liquidity risk, credit and operational risks, and risks related to the distribution of servicing costs (debt structure, liability concentration).

In order to reduce the exposure to financial risks, the following measures need to be implemented:

1. Refinancing risk

- increasing the share of medium-term and long-term financial instruments denominated in dinars on the domestic financial market;
- even annual distribution of liabilities based on public debt in the next long-term period;
- extension of the average maturity of debt issued in securities;

2. Foreign currency risk

- striving to reduce the share of debt denominated in foreign currency while taking into account the costs of new debt (debt dinarization costs);
- use of financial derivatives in order to limit the effects of changes in the exchange rates of reference currencies;
- striving to ensure that external debts are mainly in euros and opt for dollar debts only if dollar financing on the international market is cheaper, using financial derivatives to limit risks;

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

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

4. Liquidity risk

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

5. Credit and operational risks

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

6. Risks related to the distribution of servicing costs

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

Thanks to the implementation of defined measures in the past few years, there has been a significant improvement in the structure of public debt in almost all segments - improved currency structure and interest rate structure, significantly increased maturity, reduced borrowing costs, reduced guaranteed public debt, more even distribution of liabilities, maintaining an adequate level of liquidity. For example, at the central level of government, the share of public debt in dinars increased from 20.9% at the end of 2016 to 30.5% at the end of March 2021. In the same time period, the share of public debt in US dollars decreased from 33.9% to 12.3%. The share of debt with a fixed interest rate increased from 73.2% to 87.1% in the period from 2013 to March 2021. In the same period, guaranteed debt fell from 2.8 billion euros to 1.4 billion euros and the average weighted interest rate on public debt fell from 5.64% to 2.86%.

Analyses used to create the Public Debt Management Strategy

The Public Debt Administration used the quantitative approach to formulate a Public Debt Management Strategy, identifying possible constraints through macroeconomic indicators, cost-risk analysis and the analysis of market conditions affecting public debt management. In the analysis of costs and risks, alternative sources of financing are considered in parallel. The share of each instrument in the total financing needs in a given year is determined in accordance with the objectives of the Strategy.

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

Sources of financing denominated in foreign currency:

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

Sources of financing denominated in domestic currency:

- All government securities denominated in dinars are grouped into treasury bills (with maturities of up to 53 weeks) and government bonds (with maturities of 2 to 12.5 years).

Future market interest rates and analysis scenario

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

The first step is the baseline scenario based on the most probable market conditions. Next, three groups of market variables were identified: exchange rate, international market interest rates, and domestic market interest rates. The movement of the dinar exchange rate against the euro and against the US dollar was assumed in accordance with the macroeconomic framework in the observed period, and the relatively stable relationship between the euro and the US dollar was maintained in order to get a clear picture of the shock effect. The effects of changes in market interest rates were tested in shocks. The approach for dinar and euro interest rates is based on the rates realized during the previous and current year.

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

- Depreciation of the dinar in relation to all currencies of 15% in 2023. In this scenario, the ratio of the euro to the US dollar would remain stable, while only the dinar would depreciate against both currencies;

- Increase of interest rates on the domestic and international market by about 2 percentage points;

- Increase of interest rates on the international market up to 3 percentage points, and on the domestic market up to 4 percentage points;

- Combined shock related to the depreciation of the dinar against the dollar by 15% in 2023 and the growth of interest rates by about 2 percentage points;

- Each of the above stress tests or risk scenarios was used to review the cost effects of the strategies considered.

Alternative borrowing strategies for the period 2022–2024

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

Basic Strategy (S1): under this strategy financing needs are mostly (about 70%) met by using foreign currency financing sources (securities issued on both domestic and international market, loans taken from foreign creditors), and to a lesser extent (about 30%) by using financing sources in domestic currency (securities issued on the domestic market).

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

Strategy (S3): compared to S1 strategy, under this strategy financing is fully based on the issue of euro-denominated Eurobonds with a maturity of ten, twelve and twenty years.

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

Financing of budget expenditures of the Republic of Serbia under all strategies will be done mainly through issues of government securities on the international and domestic capital markets.

Comparing the alternative strategies

Quantitative analysis presents the effects of each of the four alternative borrowing strategies, where the vertical axis shows the share of debt in GDP, i.e. the cost of interest in GDP in the basic macroeconomic framework, while the horizontal axis shows the potential cost of a particular borrowing strategy (stress test result). Two cost measures were applied: the ratio of public debt to GDP and nominal interest as a percentage of GDP. The former is the status indicator, and the latter is the flow indicator. For the purpose of comparison, attention is focused on the results of the strategies examined, at the end of 2024.

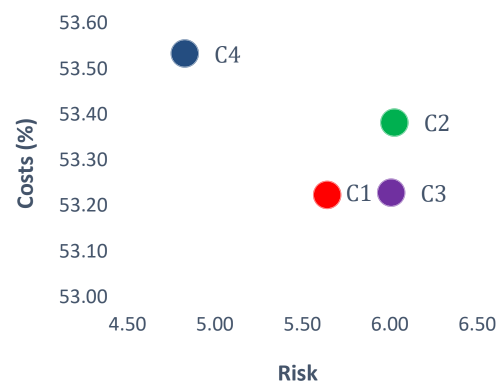
Based on the graph, the costs that each of the considered strategies carries with it are clearly visible.

The S1 strategy in the basic macroeconomic framework has the lowest debt-to-GDP ratio at the end of 2024, combined with a moderate exposure to exchange rate risk compared to other strategies. The S4 strategy has the lowest exposure to changes in the exchange rate because it is based on the issue of dinar-denominated securities, but on the other hand it is the most expensive strategy measured by the share of debt in GDP. Strategies S2 and S3 have relatively the greatest exposure to exchange rate risk, because they are completely based on sources of financing in foreign currency, but measured by the share of debt in GDP, they are more favourable than strategy S4. In terms of the share of interest in GDP, the S4 strategy is relatively more expensive and has a higher risk of increasing the share of interest in GDP because it is exposed to fluctuations in dinar interest rates. With strategies S1, S2 and S3, there is a lower risk of increasing the share of interest in GDP because the shock of changes in interest rates is smaller. Measured by the share of interest in GDP, strategies S1, S2 and S3 have lower interest costs compared to strategy S4.

The analysis of the share of public debt in GDP estimated that the S1 strategy, in the baseline scenario, has a lower ratio compared to other strategies. Also, the risk of increasing the share of debt in GDP due to changes in the exchange rate is lower in S1 than in S2 and S3. Measured by the share of interest in GDP and the possible increase in this ratio caused by the shock of interest rate growth, the S1 strategy is one of the better positioned strategies.

Having in mind the above, it is evident that in the next medium-term period, the basic borrowing operations will be based on the S1 strategy.

Debt-to-GDP ratio at the end of 2024



Interest-to-GDP ratio at the end of 2024

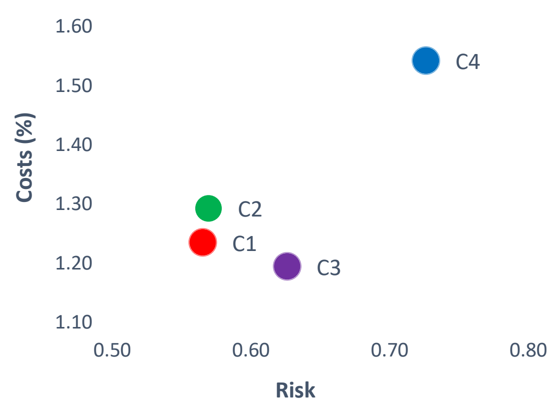


Table 28. Public debt-to-GDP ratio at the end of 2024

Scenarios	C1	C2	C3	C4
Baseline scenario	53.2	53.4	53.2	53.5
Foreign currency exchange rate shock (15% of all the currencies)	58.9	59.4	59.2	58.4
Interest shock (scenario 1)	53.8	54.0	53.8	54.1
Interest shock (scenario 2)	54.1	54.3	54.2	54.7
Combined shock (15% of USD and interest shock 1)	54.9	56.3	54.9	55.2
Maximum risk	5.6	6.0	6.0	4.8

Table 29. Payments based on interest-to-GDP ratio at the end of 2024

Scenario	C1	C2	C3	C4
Baseline scenario	1.2	1.3	1.2	1.5
Foreign currency exchange rate shock (15% of all the currencies)	1.3	1.4	1.3	1.6
Interest shock (scenario 1)	1.6	1.7	1.6	1.9
Interest shock (scenario 2)	1.8	1.9	1.8	2.3
Combined shock (15% of USD and interest shock 1)	1.6	1.8	1.6	2.0
Maximum risk	0.6	0.6	0.6	0.7

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

Table 30. Alternative strategies risk indicators at the end of 2024

		C1	C2	C3	C4
Nominal debt (% GDP)		53.2	53.4	53.2	53.5
Applied interest rate (%)		2.4	2.5	2.3	2.9
Refinancing risk	ATM[14] external portfolio (in years)	7.9	8.9	9.1	7.1
	ATM domestic portfolio (in years)	5.5	4.2	4.2	7.9
	ATM total portfolio (in years)	7.3	8.2	8.4	7.5
Interest rate risk	ATR[15] (in years)	6.7	7.9	8.0	7.2
	Refinancing (% of total debt)	14.2	10.6	10.7	10.6
	Fixed rates debt (% of total debt)	90.2	93.8	93.8	93.8
Foreign currency exchange rate risk	Foreign currency debt (% of total debt)	74.2	85.1	85.0	48.6

Stress test analysis

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

At the end of 2020, the central government debt reached 57.4% of GDP, and the general government debt reached 58.2% of GDP. At the end of March 2021, the public debt-to-GDP ratio of central government and general government were 55.7% of GDP and 56.5% of GDP, respectively. By the end of 2021, a slight increase in the ratio is expected, to about 59.0% of GDP at the central level, or 60.0% of GDP at the general government level, due to the need to further finance measures to combat the effects of the COVID-19 pandemic. Due to

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

the high share of foreign currency-denominated debt (69.5%), it is evident that foreign exchange risk will determine changes in the public debt-to-GDP ratio in the coming period, and it will significantly influence the success of fiscal policy measures designed to consolidate public finances and reduce public debt share in GDP.

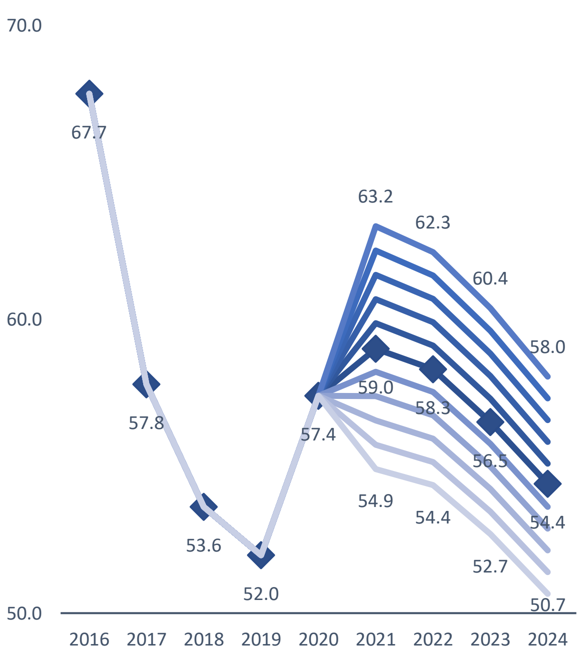
Based on the planned macroeconomic framework, and in the absence of the impact of possible risks, central government public debt in 2024 should be at the level of 54.4% of GDP.

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

Table 31. Contributions from the key macroeconomic variables to the change in the central government public debt-to-GDP ratio, in %

	2019	2020	2021 p	2022 p	2023 p	2024 p
Central government debt-to-GDP	52.0	57.4	59.0	58.3	56.5	54.4
Changes compared to the last year, in% of GDP	-1.7	5.4	1.6	-0.7	-1.8	-2.1
Contribution of primary fiscal result	-2.2	6.4	5.1	1.2	-0.1	-0.5
Contribution of interests	2.0	2.0	1.9	1.7	1.6	1.6
Contribution of nominal GDP growth	-3.4	-0.4	-4.6	-3.8	-3.9	-3.4
Contribution of other factors	2.0	-2.5	-0.8	0.1	0.6	0.3

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



The chart presents the movement of central government public debt–to GDP ratio depending on the change in the dinar exchange rate against a certain basket of currencies. The basic projection is presented with alternative scenarios depending on the appreciation or depreciation of the dinar exchange rate in the range from 10% appreciation to 10% depreciation of the dinar in relation to the currency basket. Applying the above scenarios, it can be seen that the ratio for 2024 would range from 50.7% to 58.0%, while under the baseline scenario it would be at the level of 54.4%.

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

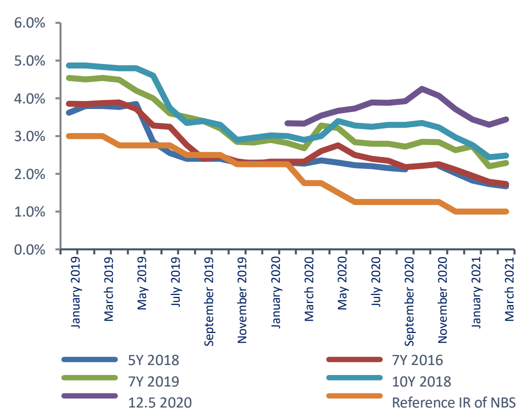
It is important to note that the reduction of public debt in relation to GDP will be enhanced by more adequate control over the issuance of guarantees and improvement of the process of prioritization of investment projects, which are financed from credit lines of multilateral and bilateral creditors. Starting from 2015, guarantees are issued only for project (investment) loans, i.e. the issuance of guarantees for loans for current liquidity to public enterprises has been suspended, which has significantly affected the reduction of the guaranteed public debt balance in the previous six years.

Long term strategic framework of public debt management

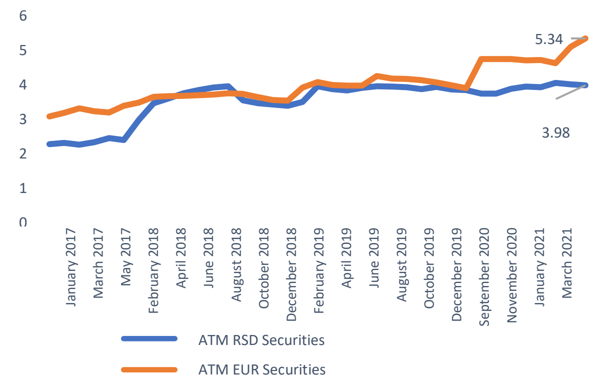
The main strategic goals that need to be pursued in the coming long-term period, in order to minimize the risks of increasing indebtedness and the cost of servicing public debt include the following:

- the share of dinar-denominated debt is at least 30% of the total public debt in the medium term;
- the share of euro-denominated debt in public debt is at least 65% of foreign currency debt, including future borrowings and transactions;
- the share of debt with a variable interest rate is below 15% in the medium term;
- the average time to refixing (ATR) is maintained at a level of at least 5.0 years, in accordance with the abovementioned measure of gradual decrease of the share of debt with variable interest rates;
- the weighted average interest rate (WAIR) for public debt in local currency does not exceed 5.00%;
- the share of short-term debt (whose maturity is up to one year) is up to 15% of the total public debt;
- the average maturity time (ATM) of internal debt is at least 5.0 years in the medium term;
- the average maturity time (ATM) of external debt is maintained at the level of 7.0 ± 0.5 years in the same time horizon.

Yield to maturity trends of dinar benchmark issues in the secondary market trading



Average time to maturity (ATM) of securities issued in the domestic financial market in the period from 1 January 2017–31 March 2021



Improvement measures for dinar-denominated securities market in the period 2022–2024

The government securities market, in the period from 2012 to March 2021, is featured by the fulfilment of the set strategic goals, primarily in terms of financing instruments, as well as in the development and maintenance of the stability of the diversified investor base. The transition from short-term financing sources featuring in the period until 2010, to medium-term and long-term financing instruments, with a constant reduction of borrowing costs, reduces refinancing risk, as one of the primary risks in the public debt management process. At the end of 2013, the share of long-term dinar-denominated instruments with an original maturity of three or more years amounted to 38.3% in the dinar-denominated securities balance, while at the end of March 2021 it amounted to 90.6%.

Transparent work and reports, as well as the presence on the international capital market, help the non-residents to be informed and therefore interested to invest their capital into debt instruments, primarily into long-term government securities, which enhances the development of a stable investor base. Due to successful realization of benchmark issues during 2014 and 2015, the same practice continued during 2016. In February and July 2016 there was an issue of a three-year and seven-year benchmark bond in the amount of RSD 110 billion each. In April 2017 there was an issue of a three-year benchmark bond in the amount of RSD 110 billion. In January and February 2018 there was an issue of a five-year and ten-year benchmark bond in the amount of RSD 110 billion each. In January 2019 there was an issue of a three-year and seven-year benchmark bond in the amount of RSD 100.0 and 150.0 billion. In January and February 2020 for the first time there was an issue of a five-and-a-half-year, i.e. twelve-and-a-half-year bond with a six-month coupon.

In 2021, amendments to the Regulation on General Conditions for Issuance and Sale of Government Securities on the Primary Market ("Official Gazette of RS", No. 100/2014, 78/2017, 66/2018, 78/2018 and 140/2020), made it possible to increase the volume of previously issued bonds, so with the five-and-a-half-year and twelve-and-a-half-year bonds, the volume of the issue was increased by 50 billion dinars each. Also, an increase in the volume of the issue, in the amount of 10 billion dinars, was effected for a ten-year bond originally issued on 6 February 2018.

These issues considerably extended the scope of secondary trading in these instruments, which has considerably contributed to the drop in effective yield rates in the re-opening of the stated issues. "Benchmark" issues also increased the share of foreign investors in dinar-denominated securities, which at the end of March 2021 amounted to 25.0%. At the beginning of 2021, it was officially confirmed that the Republic of Serbia will enter *JP Morgan's GBI-EM Global Diversified Index* in June 2021. The index will include three dinar benchmark bonds maturing on 11 January 2026 (RSMFRSD89592), 6 February 2028 (RSMFRSD55940), and 20 August 2032 (RSMFRSD86176).

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

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

At the end of 2012 the average maturity of dinar-denominated securities was 394 days (1.1 year), at the end of 2013 it was 469 days (1.3 years), at the end of 2014 it was 645 days (1.8 years), at the end of 2015, it was 749 days (2.1 years), at the end of 2016 it was 789 days (2.2 years), at the end of 2017 it was 864 days (2.4 years), at the end of 2018 it was 1,188 days (3.3 years), at the end of 2019 it was 1,403 days (3.8 years), at the end of 2020 it was 1,429 days (3.9 years), and at the end of March 2021 it was 1.452 days (4 years). The development of the domestic securities market will be supported by the following measures of the Republic of Serbia:

- Inclusion of bonds of the Republic of Serbia in the global index will significantly increase the investor base and further enhance secondary trading, which will contribute to further reduction of borrowing costs through issues of dinar-denominated government securities;
- In order to create the largest possible investor base and develop the secondary market for securities issued on the domestic market, equal tax treatment of domestic and foreign investors was created at the end of 2011, and in the coming period efforts will be made to remove any obstacles to free flow of capital;
- In the coming period, strong efforts will be made to introduce the system of primary dealers. Namely, the Law on Amendments to the Public Debt Law from December 2018 envisages the introduction of primary dealers on the domestic capital market as an incentive for the liquidity of the secondary market of government securities and a reduction of debt refinancing risk. The mentioned amendments to the Law also envisage operations with financial derivatives that would be used for conducting transactions aimed at risk

management, including reducing or eliminating the risk of changes in exchange rates, interest rates and other risks.

- Activities have been undertaken to enable the settlement of government securities on the foreign market. Amendments to the Public Debt Law from December 2019, enable the clearing and settlement of government securities issued on the domestic market, in addition to the Central Register, by another foreign legal entity that performs clearing and settlement operations.

IV. FINAL PROVISIONS

Appendix 1 – Projection of the Basic Macroeconomic Indicators and Appendix 2 – Fiscal framework of the general government in 2022, printed herewith, constitute an integral part of this Fiscal Strategy.

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

This Fiscal Strategy shall be published on the website of the Ministry of Finance.

05 No.:
In Belgrade, June 2021

G O V E R N M E N T

PRIME MINISTER

Ana Brnabić, sgd.

Appendix 1 – Projection of the Basic Macroeconomic Indicators

	2021	2022	2023	2024
GDP real growth rate, %	6.0	4.0	4.0	4.0
GDP at current market prices (in billion RSD)	5,938.1	6,342.1	6,792.2	7,287.7
Source of growth: percentage changes at constant prices				
Private consumption	5.8	3.2	3.0	2.2
Government consumption	3.0	1.1	0.3	0.3
Gross fixed capital formation	14.3	6.0	6.7	8.1
Exports of goods and services	13.8	9.5	9.9	10.0
Imports of goods and services	13.4	7.4	7.8	7.8
Contribution to GDP growth, percentage points				
Domestic demand	7.4	3.8	3.7	3.5
Private consumption	4.0	2.2	2.0	1.5
Government consumption	0.5	0.2	0.0	0.0
Investment consumption	3.2	1.4	1.6	2.0
Change in inventories	-0.3	0.0	0.0	0.0
Net export of goods and services	-1.4	0.2	0.3	0.5
GVA growth by sectors and net taxes, %				
Agriculture	-4.0	0.8	0.0	0.0
Industry	6.4	5.8	5.9	6.0
Construction	16.1	6.4	7.5	7.9
Services	6.0	3.7	3.8	3.9
Net taxes	6.3	3.2	3.0	2.6
Contribution to GDP growth, percentage points				
Agriculture	-0.3	0.1	0.0	0.0
Industry	1.3	1.1	1.2	1.2
Construction	0.8	0.3	0.4	0.4
Services	3.0	1.9	1.9	2.0
Net taxes	1.1	0.6	0.5	0.4
Price trends, %				
GDP deflator	2.6	2.7	3.0	3.2
Consumer prices (annual average)	2.6	2.5	2.9	2.9
External sector trends, % GDP				
Balance of goods	-12.0	-11.5	-10.5	-9.5
Balance of services	2.3	2.4	2.4	2.5
Current account balance	-5.6	-5.3	-4.9	-4.4
Fiscal indicator, % GDP				
General government fiscal result	-6.9	-3.0	-1.5	-1.0
Consolidated revenues	41.8	41.8	40.8	40.6
Consolidated expenditures	48.7	44.7	42.4	41.6
Gross debt of the general government sector	60.0	59.3	57.6	55.5

Appendix 2 – Fiscal framework of the general government in 2022

	General government*	Republic budget	Local self-government units	Cities and municipalities	AP Vojvodina	PE “Roads of Serbia” and “Koridori Srbije” LLC.	Compulsory Social Insurance Fund	Pension& Disability Insurance Fund	National Health Insurance Fund	National Employment Service	Soc. Insurance Fund for Military Personnel
	1=2+3+6+7	2	3=4+5	4	5	6	7=8+9+10+11	8	9	10	11
Public revenues	2,649.4	1,389.2	332.7	307.6	25.1	32.5	895.0	623.4	249.0	19.3	3.4
Current revenues	2,630.9	1,372.2	331.7	306.6	25.1	32.5	894.5	623.4	249.0	18.8	3.4
Tax revenues	2,387.6	1,248.4	256.6	238.0	18.6		882.6	622.4	239.8	17.6	2.7
Personal income tax	256.6	83.8	172.8	163.1	9.7		0.0				
Social contributions	882.6		0.0				882.6	622.4	239.8	17.6	2.7
Corporate income tax	122.5	113.5	9.0		9.0		0.0				
VAT	640.6	640.6	0.0				0.0				
Excises	335.1	335.1	0.0				0.0				
Customs	62.2	62.2	0.0				0.0				
Other tax revenues	88.1	13.3	74.8	74.8			0.0				
Non-tax revenues	243.3	123.7	75.1	68.7	6.5	32.5	11.9	1.0	9.2	1.1	0.6
Donations	18.5	17.0	1.0	1.0			0.5			0.5	
Public expenditures	2,837.5	1,249.0	419.8	356.0	63.8	65.1	1,103.6	692.2	383.6	21.3	6.5
Current expenditures	2,368.3	861.1	358.3	296.8	61.5	48.6	1,100.3	691.5	381.6	20.9	6.3
Expenditures for employees	549.5	288.2	98.2	62.1	36.1	3.0	160.0	3.2	155.0	1.7	
Contributions paid by employers	94.7	51.3	16.6	9.5	7.1	0.4	26.5	0.6	25.5	0.4	
Purchase of goods and services	500.1	134.7	132.5	130.1	2.3	42.4	190.5	2.4	183.5	1.0	3.7
Interest repayment	111.9	109.5	2.3	2.0	0.3	0.1	0.0				
Subsidies	129.7	99.2	30.5	23.1	7.5		0.0				
Social assistance and transfers	894.1	125.2	49.3	49.1	0.2	0.0	719.6	684.3	15.5	17.3	2.5
Of which pensions	655.1	0.0	0.0				655.1	655.1			
Other current expenditures	88.3	53.0	28.9	20.9	7.9	2.8	3.7	1.1	2.0	0.5	0.1
Capital expenditures	447.3	366.0	61.5	59.2	2.3	16.5	3.2	0.7	2.0	0.4	0.1
Net lending	6.0	6.0	0.0				0.0				
Activated guarantees	15.9	15.9	0.0								
Fiscal result excl. transfers	-188.1	140.2	-87.1	-48.4	-38.7	-32.6	-208.5	-68.8	-134.6	-2.0	-3.1
Transfers from other levels of government	420.1	7.7	96.1	57.0	39.1	30.5	285.8	137.0	138.7	7.1	3.1
Republic budget	342.8	7.7	96.1	57.0	39.1	30.5	208.5	129.3	71.7	7.1	0.5
Cities and municipalities	0.0						0.0				
AP Vojvodina	0.0						0.0				
Pension & Disability Insurance Fund	68.1						68.1		65.6		2.6
National Health Insurance Fund	4.1						4.1	4.1			
National Employment Service	5.1						5.1	3.6	1.5		
Social Insurance Fund for Military Personnel	0.0						0.0				
Other levels	0.0						0.0				
Transfers to other levels of government	420.1	335.1	7.7	7.7			77.3	68.1	4.1	5.1	
Republic budget	7.7	0.0	7.7	7.7			0.0				
Cities and municipalities	57.0	57.0					0.0				
AP Vojvodina	39.1	39.1					0.0				
Pension & Disability Insurance Fund	137.0	129.3					7.7		4.1	3.6	
National Health Insurance Fund	138.7	71.7					67.0	65.6		1.5	
National Employment Service	7.1	7.1					0.0				
Social Insurance Fund for Military Personnel	3.1	0.5					2.6	2.6			
Other levels	30.5	30.5					0.0				
Net transfers to other levels of government	0.0	-327.5	88.5	49.4	39.1	30.5	208.5	68.8	134.6	2.0	3.1
Unallocated fiscal space	0.0	0.0	0.0				0.0				
Fiscal result	**-188.1**	**-187.3**	**1.4**	**1.0**	**0.4**	**-2.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

The table shows the approximate amount of revenues and expenditures in 2022, which is based more on the statistical methodology of public finance accounts than on accounting. Since changes in the amount and structure of certain categories may occur during the budget process, these amounts are not legally binding.

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