Government

of the Republic of Serbia

REVISED 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

REVISED 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 given an adequate response to the crisis caused 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 in scope and structure. Fiscal policy ensured a comprehensive package of measures by which households and firms were supported and whose positive effects are reflected in macroeconomic indicators. The provided value of 2020 package of measures to support households and firms is estimated at 12.8% of the gross domestic product (hereinafter: GDP). The prolonged duration of the unfavourable epidemic situation in 2021 impelled an additional, sizable support to households and firms, aimed at providing conditions for full economic recovery and growth, along with mass vaccination of the population and bringing the epidemic under control. The support package provided in 2021 is estimated at 4.2% 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 full economic recovery and above-the-originally-projected growth are expected.

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 assumes 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 public debt share in GDP in 2020 and 2021, having in mind the projected fiscal results, goes down as of 2022 and onwards and returns 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.

Macroeconomic and fiscal risks to presented baseline scenario are significant. Uncertainties remain regarding the course and duration of the pandemic, speed of mass immunization, the way and speed of economic recovery, the need for additional economic support, 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

Global economic recovery continues despite new virus waves, with the expectation that the fight against the pandemic will still have negative effects on economic growth in the medium term. Rapid spread of Delta variant and threat of new virus mutations have led to increased uncertainty about how quickly the pandemic can be overcome. Differences in the speed of economic recovery across countries are a consequence of different availability of vaccines, as well as differences in the scope and duration of economic support packages. Timely policy-making is hampered by limited employment growth, rising inflation, the potential long-term impact of the pandemic on human capital accumulation, and the fight against climate change. The gap in the expected recovery between the economic groups has widened compared to the July forecast. The group of developed market economies is expected to reach its pre-pandemic growth trajectory in 2022, and to exceed it by 0.9% in 2024. In contrast, in developing countries (excluding China) the GDP overall level in 2024 is expected to be still below the pre-pandemic projected level, by 5.5%. Relaxation of epidemiological measures affected the strong growth of demand for goods and raw materials, while factors on the side of aggregate supply remained limited. This has led to a significant rise in commodity prices, stronger inflationary pressures and uncertainty about future economic developments. In addition to efforts to curb the health crisis and towards normalization, future challenges for decision-makers will be finding new sources of productivity and GDP growth, implementing green technology and digitalization, as well as reducing inequalities. In order to achieve this, significant international cooperation is necessary, as well as the harmonization of monetary and fiscal policy in order to combat the long-term consequences of the crisis and possible future health crises, as well as to solve the long-term problem of climate change.

Macroeconomic estimates of the International Monetary Fund

After the global shock caused by the "Great Lockdown" the economic recovery continues, but the momentum has weakened due to the appearance of new highly transmissible virus variants. This has also led to longer-than-expected disruptions in global supply chains, further feeding inflation in many countries. Under the October projections of the International Monetary Fund (hereinafter: the IMF), compared to July forecast, the global growth projection for 2021 was been revised down marginally, from 6% to 5.9%, while the outlook for 2022 is unchanged, with expected growth of 4.9%. Although expectations regarding the global economy trends are almost unchanged, the outlooks for individual countries have undergone significant changes. The main reasons for revising the projected path of economic recovery among countries relate to disparities in vaccine access, as well as in disparities in the scope of economic support measures. While almost 60 percent of the population in advanced economies are fully vaccinated, about 96 percent of the population in underdeveloped countries remain unvaccinated. Significant fiscal support continues in advanced economies, while many emerging market and developing economies are withdrawing policy support measures due to limited fiscal space.

The risks to the realization of projections are still big, thus it is increasingly difficult to make compromises in the adoption of measures and their implementation. The major source of concern is that more aggressive SARS-CoV-2 variants could emerge before widespread vaccination is reached. Rising inflation and jump in the inputs and energy prices, constitute risks whose materialization is certain if the elimination of supply-demand mismatches takes too long. Strong international cooperation remains a key factor for recovery, especially in the production and distribution of vaccines, but also in access to the global financial market and support in the fight against climate change.

Table 1. International environment – macroeconomic indicators

	2020	2021	2022	2023	2024
Real GDP growth[1], %					
World total	-3.1	5.9	4.9	3.6	3.4
Advanced economies	-4.5	5.2	4.5	2.2	1.7
USA	-3.4	6.0	5.2	2.2	1.7
Euro area	-6.3	5.0	4.3	2.0	1.6
Developing economies	-2.1	6.4	5.1	4.6	4.5
China	2.3	8.0	5.6	5.3	5.2
Russia	-3.0	4.7	2.9	2.0	1.8
World trade growth, %	-8.2	9.7	6.7	4.5	3.8
Unemployment rate, %					
Euro area	7.9	8.0	8.1	7.8	7.6
USA	8.1	5.4	3.5	3.0	3.0
Consumer prices, period average, %					
Euro area	0.3	2.2	1.7	1.4	1.5
Advanced economies	0.7	2.8	2.3	1.9	2.0
Developing economies	5.1	5.5	4.9	4.3	4.1
Exchange rate, euro/dollar, end of period	1.1	1.2	1.2	–	–
Cereal prices, in dollars, annual changes[2]	8.4	40.2	4.1	-4.9	-4.8
Metal prices, in dollars, annual changes[3]	3.5	49.7	-6.5	-0.4	-0.5
Price of iron ore, in dollars[4]	108.1	171.0	135.0	135.0	135.0
Oil prices, in dollars, annual changes, %	-32.7	59.1	-1.8	-5.0	-3.8

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

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

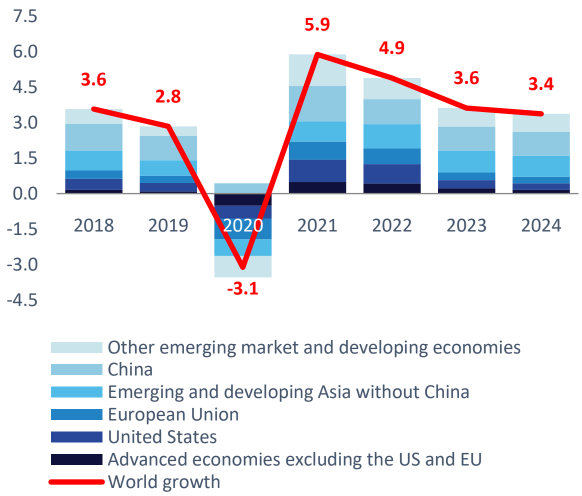
[2] The cereal price obtained as the weighted average price of wheat, corn, soya, rice and barley.

[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 October estimates, the growth of the global economy in 2021 is estimated at 5.9%, which is a downward revision by 0.1 percentage points compared to the previous estimate from July. The slight deterioration in the growth outlook is due to disruptions in supply chains in advanced economies, as well as the unfavourable development of the pandemic situation in emerging market and developing economies. Compared to the previous IMF report, the growth projections for 2022 remained unchanged, reflecting the expected positive effects of vaccination, fiscal support and the continuation of favourable financing conditions, but also the negative effects of the pandemic. Growth prospects of the advanced economy group for 2021 are revised down by 0.4 percentage points compared to the previous forecast. The reason for that relates to production sector supply disruptions in the United States and Germany, as well as the closure of the Japanese economy during the third quarter due to the new wave of the pandemic. The announced support measures in the field of infrastructure and living standards in the US and the expected EU recovery plan, together with the continuation of the vaccination process of the population, slightly pushed up advanced economies 2022 growth projection to 4.5%. On the other hand, emerging market and developing economies expected growth in 2021 has been slightly revised upwards, thanks to better results of export-oriented regions (Latin America, the Middle East and Central Asia) that have offset the consequences caused by the pandemic. However, some emerging market and developing economies such as Brazil, Mexico and Russia are facing tougher financing conditions and a higher risk of inflationary pressures, and are narrowing the space for support in the fight against the pandemic. The outlook for Asian emerging market economies has been revised downwards for both 2021 and 2022, due to an increase in the number of the infected. Also, due to the faster reduction of public investments, the estimate of China's growth for the same period was slightly reduced. Global growth is expected to stabilize at around 3.3% in the medium term, and growth will depend on the speed and number of vaccinated, as well as on the implementation of further measures to support the economy.

Global economic growth, pp



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

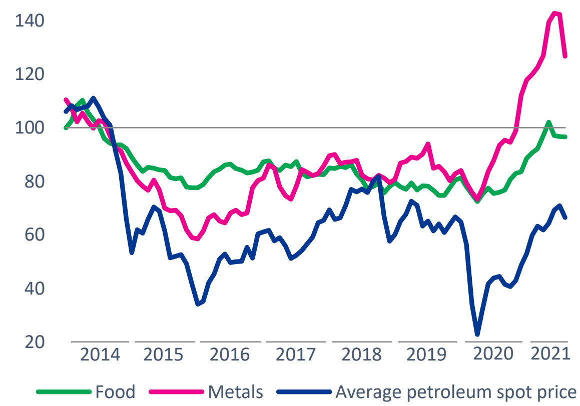
Inflation prospects mostly reflect stated growth prospects and expected movements in primary commodity prices. In advanced economies, inflation will decline slightly from 2.8% in 2021 to 1.9% in 2023, after which a largely unchanged growth rate is expected in the medium term. Emerging market and developing economies will, after the price increase of 5.5% in 2021, record a slight slowdown in inflation in the coming years. According to the IMF October projections, the price of oil in 2021 is expected to be 65.7 $/barrel, which is an increase of 59.1% compared to 2020, after which a gradual decline is expected.

Projection of oil price movements, USD per barrel

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

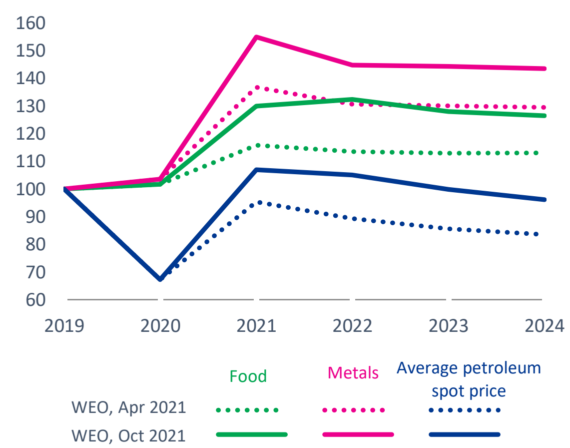
The prices of base metals are projected to record a strong growth of 49.7% in 2021, driven by the recovery of global production, while the forecast for the following period envisages their stabilization and a moderate decline. After the almost 60% growth of iron prices in 2021, their 21% decline in 2022 and stagnation in the medium term are projected. As regards cereal prices, after a sharp jump in 2021, a slight increase is expected in 2022 and then a declining trend 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 0.2% and 0.4%, respectively.

Commodity prices, indices, 2014=100



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

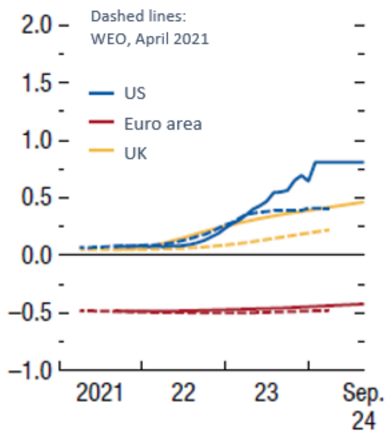
Projection of price trends, indices, 2019=100



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

The US Federal Reserve System (hereinafter: FED) maintained the target interest rate range of 0% to 0.25% in September, 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, but with indications that there will be a slight increase in 2022.

Expected movements in the key policy rate, %



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

The uncertainty regarding the evolution of the pandemic is the biggest risk to IMF's growth projection. The emergence of new highly transmissible virus variants, further mismatch of global supply and demand, inflationary pressures, tightening monetary policy, social unrests, 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 production, distribution and uptake of vaccines and a sharp increase in productivity due to a greater degree of job automation and reliance on new technologies, would contribute to accelerating global recovery and normalization of economic activity.

ECB macroeconomic projections for the euro area

According to European Central Bank's September estimates, the euro area economy is recovering swiftly despite continued uncertainty related to the coronavirus pandemic and supply bottlenecks. It rebounded more strongly than expected in the second quarter of 2021 and should continue to grow rapidly during the second half of the year, with real GDP exceeding its pre-crisis level by the end of 2021. This outlook is based on several assumptions: a rapid relaxation of containment measures during the second half of 2021, a gradual dissipation of supply bottlenecks as of early 2022, substantial fiscal and monetary support and a continued global recovery.

According to ECB projections, after a 6.5% decline in 2020, the euro area economy will grow by 5.0% and 4.6% in 2021 and 2022, respectively. GDP growth in the euro area will be driven by private consumption, which will record strong growth (3.6% and 7.0% in 2021 and 2022, respectively) and exceed the pre-crisis level in early 2022. The increased housing investment is expected to slow down over the projection horizon, while business investment is expected to recover substantially in the second half of the year, so total investments will grow by 7.2% and 5.3% in 2021 and 2022, respectively. Forecast envisages a robust export growth (8.9% and 6.7% in 2021 and 2022, respectively) related to efforts to resolve supply disruptions caused by the pandemic, i.e. shortages, high transport costs and longer delivery times of goods and services.

The unemployment rate declined in the second quarter of 2021 and is expected to remain broadly flat for the rest of the year, before falling to its pre-crisis levels by early 2023. Also, a sharp jump in labour productivity per person employed is projected in 2021, to be followed by a gradual normalization over the projection horizon.

After slightly higher inflation rates (2.2%) in 2021, inflation growth is expected to slow down in the coming years due to the gradual fading of one-off factors, such as the base effect of high energy prices and the reversal of the German VAT rate cut. The projection of headline inflation has been slightly revised upwards compared to the previous projection, which reflects the expected growth of inflationary pressures on core inflation, rise in energy prices, but also in food prices.

After the highly expansionary fiscal policy in 2020, a limited continuation of fiscal support is expected in 2021. Most of the additional measures are temporary and are expected to be repealed and reversed towards a restrictive policy during 2022. After the substantial fiscal deficit in 2020 of -7.3% of GDP, the euro area budget balance is projected to recover slightly in 2021, to -7.1% of GDP, to be followed by deficit decrease to -3.0% and -2.1% of GDP in 2022 and 2023, respectively. Euro area debt is projected to peak in 2021 (98.7% of GDP), 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 September 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 2% target.

Table 2. Macroeconomic projections for the euro area, annual percentage changes

	2020	2021	2022	2023
GDP	-6.5	5.0	4.6	2.1
Private consumption	-8.0	3.6	7.0	2.0
Government consumption	1.3	3.4	-1.2	0.9
Gross fixed capital formation	-7.,5	7.2	5.3	3.0
Exports	-9.3	8.9	6.7	4.0
Imports	-9.2	9.0	7.0	3.8
Employment	-1.5	0.5	1.2	1.0
Unemployment rate	7.9	7.9	7.7	7.3
Inflation	0.3	2.2	1.7	1.5
Unit labour costs	4.5	-1.0	-0.4	1.4
General government fiscal result (% of GDP)	-7.3	-7.1	-3.0	-2.1
General government gross debt (% of GDP)	98.0	98.7	95.1	93.6
Current account balance (% of GDP)	2.1	1.8	1.3	1.5

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

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

Current macroeconomic developments and prospects are more favourable than initially projected by the Fiscal Strategy. The package of economic measures implemented during 2021 directly contributed to increasing the liquidity of business entities and facilitating business operations, especially in those sectors that are still rather strongly impacted by the pandemic, such as tourism and passenger transport, while through support to households it has stimulated domestic demand, and thereby indirectly influenced economic activity. In parallel with economic measures, the relaxation of restrictive health measures has resulted in a more dynamic recovery of certain activities in the service sector that were hit hardest by the pandemic. In addition to these temporary factors that have positively contributed to economic activity, there have been structural improvements. They are primarily reflected in the activation of new and expansion of existing export-competitive production capacities, as well as in the further accelerated development of road and railway infrastructure, which will permanently increase the potential of the domestic economy. Structural improvements in the economy, supported by economic policy measures, materialized already in the first half of 2021, with a strong increase in GDP of 7.6%, which is a better result than initially projected and one of the main reasons for revising the expected GDP growth up.

The growth of economic activity and the package of economic support resulted in the absence of significant negative effects of the pandemic on the labour market. Jobs and wages have been preserved, both in the private and public sectors, the activity rate of the population on the labour market has increased compared to the pre-pandemic period, and the scenario of a massive increase in unemployment has been avoided. At the same time, the increase in wages and pensions did not jeopardize the established macroeconomic balance and contributed to a faster recovery of domestic demand. In addition, through active participation in socio-economic dialogue, the minimum cost of labour has been increased in a way that does not additionally 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.

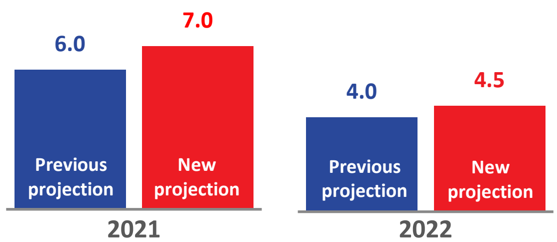
Inflation at the beginning of the year hovered at a low and stable level. Higher inflation in the second quarter of 2021 is a result of temporary factors, primarily the growth in the global energy and primary agricultural products prices, but also the disruptions in global supply chains. With the waning of their effect, inflation is expected to gradually decline and return into target tolerance band. However, such price movements were reflected in upward revision of expected inflation during this and next year, compared to the previous Fiscal Strategy.

The increased expansiveness of fiscal policy has not undermined the sustainability of public finances. Better collection of revenues, primarily tax revenues, due to faster-than-expected economic growth, was reflected in a lower level of deficit and public debt. Keeping public debt below 60% of GDP is an important result this year and the main anchor for the conduct of fiscal policy in the coming period.

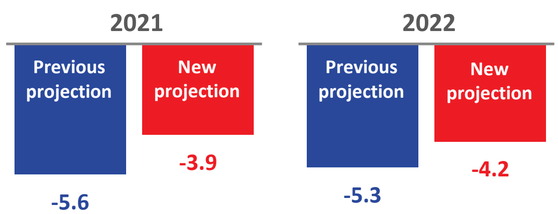
Measures that contribute to mitigating the consequences of the epidemic remain in the focus of the economic policy creators in the coming period. In addition to this, necessity of finding new sources of growth has been recognized, thus future policies shall be defined keeping innovations, research and development, and creative industries in a constant focus. 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 to green growth program, which was confirmed by the successful issue of green bonds on the international financial market in September. Efforts are also targeted at intensifying reform processes in order to ensure the continuity of economic environment improvement and enable further raising of the country's credit rating.

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

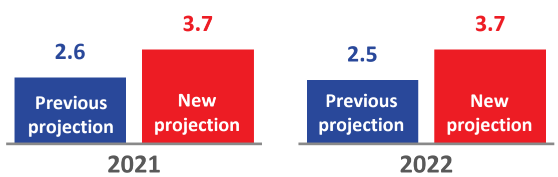
Real GDP growth, %



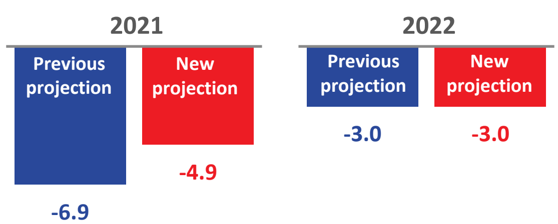
Current account balance, % of GDP



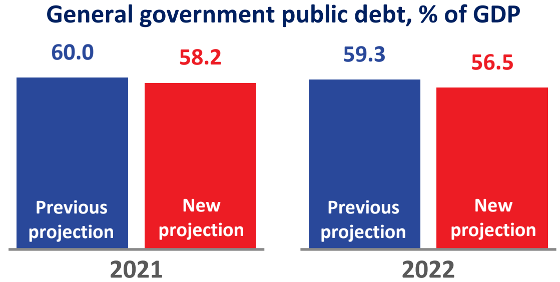
Inflation, period average, %



Fiscal result, % of GDP



General government public debt, % of GDP

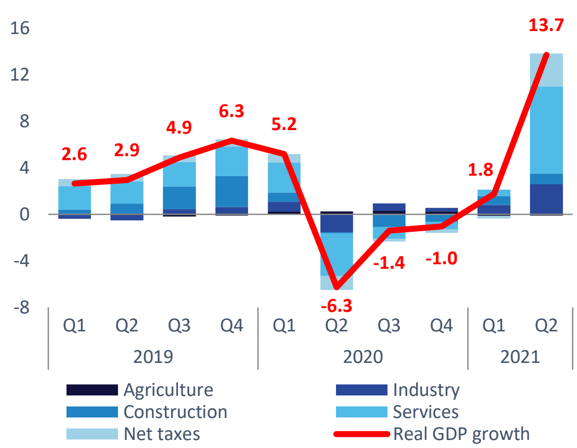


Current trends in the real sector

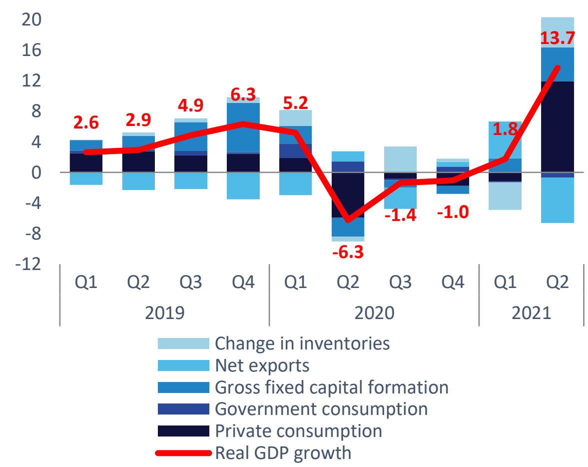
According to data of the Statistical Office of the Republic of Serbia (hereinafter: SORS), GDP growth in the first quarter of 2021 amounted to 1.8% y-o-y, which means that the domestic economy exceeded the pre-pandemic level of economic activity already in the first quarter. Observed from the production side, economic growth in this period was driven by construction sector and industrial production, which contributed to GDP growth with per 0.8 pp each. The recovery of private construction operations with the continuation of infrastructure works resulted in construction sector growth of 17.8%, while the industry maintained favourable trends and recorded a growth of 4.0%. For the first time since the outbreak of pandemic, the services sector also recorded a positive contribution of 0.6 pp, primarily owing to growth in trade, ICT and financial services. Observed by aggregates of GDP use, the effects of the pandemic during the first quarter of 2021 most strongly affected 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 recorded an increase in the first quarter of about 9% y-o-y, contributing 1.8 pp to GDP growth. Activation of new export-oriented capacities, as well as increase in exports of agricultural products, influenced the strong growth of real exports in the first quarter of 2021, while the import activity recorded a mild decrease, so that with a 4.8 pp contribution, net export was the main generator of economic growth in the first quarter of 2021.

Good economic trends continued in the second quarter as well, with a y-o-y increase in GDP of 13.7%. Observed from the production side, GDP growth in this period was driven by services sector, primarily owing to growth in trade, tourism, transport, professional and technical services. Although the service sector was hit the hardest by the pandemic in the second quarter of the previous year, so that the high growth of about 15% is partly due to the base effect, a significant number of service activities exceeded the pre-pandemic level. The industry maintained good trends and recorded a 2.6 pp contribution to GDP growth, while the recovery of private construction operations along with the continuation of infrastructure works resulted in a 17.7% construction growth. Adverse agrometeorological conditions affected agricultural production, which according to the SORS first estimates registered a decline of about 2% in the second quarter. Observed by aggregates of use, GDP growth in the second quarter was entirely driven by domestic demand as a result of growth in private consumption and investments, while the contribution of net exports was negative. The growth of real wages and employment, with increased spending propensity of the population, due to better epidemiological conditions compared to the second quarter of the previous year, was reflected in a strong increase in private consumption and its contribution to GDP growth of 11.9 percentage points. Acceleration of private investments with continued execution of infrastructure works resulted in an increase in investment activity of 22.5%. Faster real growth of imports than exports, primarily imports of intermediate goods for the needs of the economy, resulted in a negative contribution of net exports to GDP growth of 5.9 percentage points.

Contributions to real GDP growth rate, production approach, pp

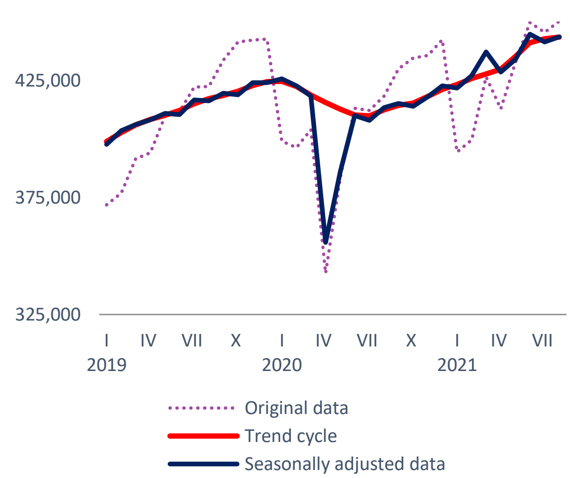


Contributions to real GDP growth rate, expenditure approach, pp



High-frequency indicators of economic activity also indicate positive macroeconomic trends in 2021. The Economic Activity Indicator (IPAS)[1], used by the Ministry of Finance to estimate monthly GDP, indicates that overall economic activity recovered very quickly from the shock caused by the lockdown, and that GDP pre-pandemic level was exceeded already in February 2021.

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

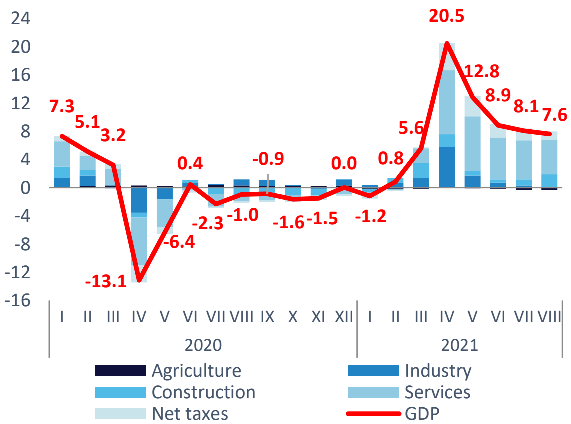


Viewed on a year-over-year basis, IPAS recorded the highest growth rate of 20.5% in April, which is partly a consequence of the low base in the same month last year, but also the result of structural improvements and the effect on the supply side. This was confirmed

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

by the high growth rates in the following months, despite the gradual disappearance of the base effect, so that in July and August 2021, a high economic growth of 8.1% y-o-y and 7.6% y-o-y, respectively, was recorded. Taking into account the dynamics from the first half of the year, according to the Ministry of Finance estimate, economic activity growth in the period January–August was 7.6%.

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

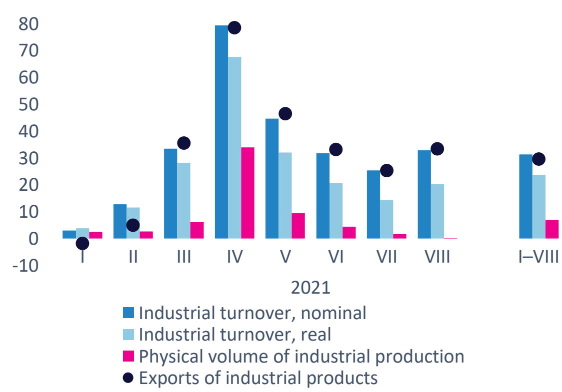


The physical volume of total industrial production in the first eight months of 2021 was higher by 6.9% y-o-y, accompanied with a growth in all three sectors, with the dominant contribution of the manufacturing industry, which recorded an increase of 7.8% y-o-y, while the volume of electricity and mining production was higher by 5.8% and 0.9% y-o-y, respectively. The good dynamics of production achieved in the manufacturing industry is largely the result of the activation of new production capacities, primarily through the materialization of foreign direct investment (hereinafter: FDI) from the previous period, but also of gradual recovery of external demand. Owing to this, under the conditions of extremely negative pandemic related effects, industrial production registered a relatively rapid recovery in the second half of the previous year, and favourable trends continued in 2021.

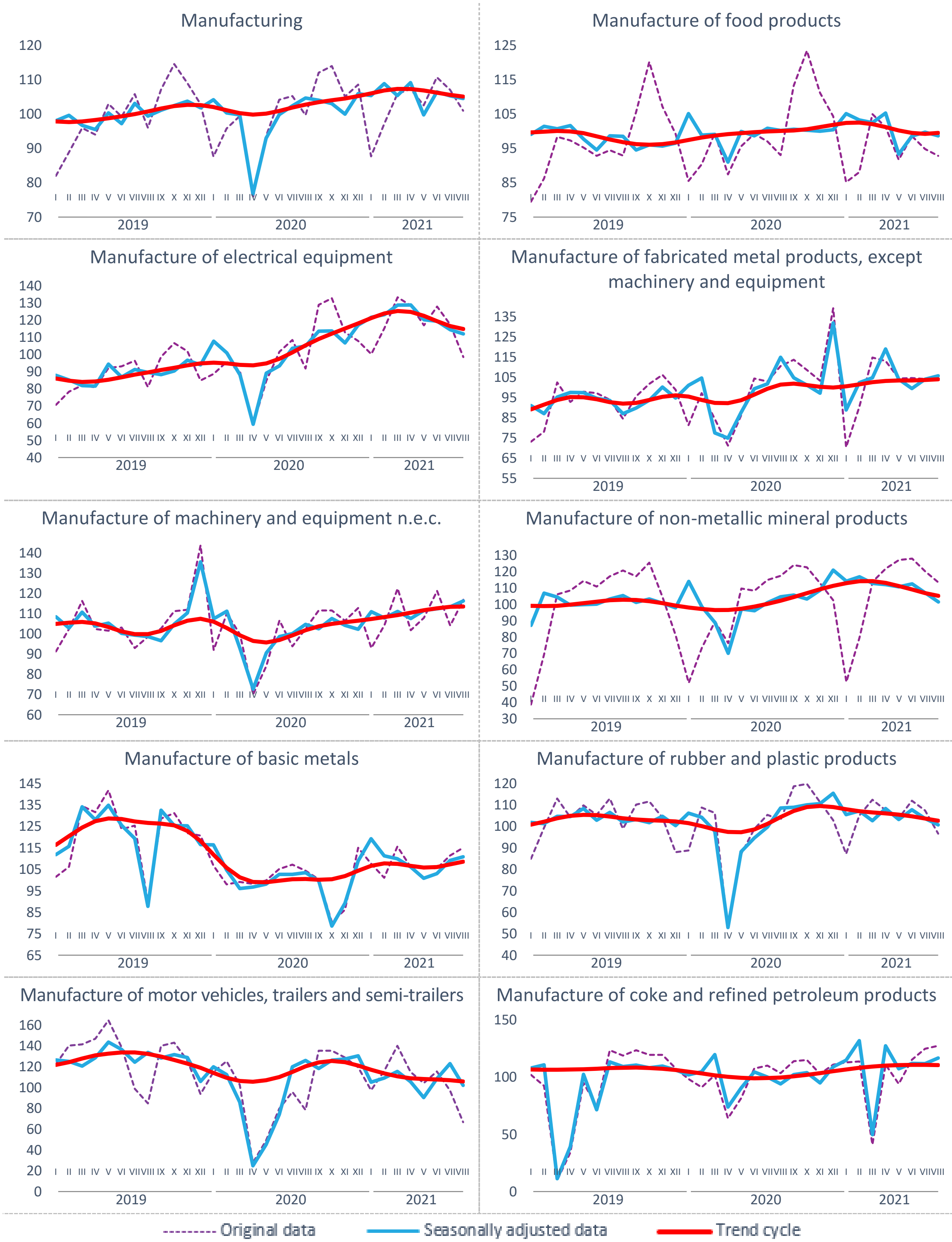
In the first eight months of 2021, more than four-fifths of industry growth was determined by the larger manufacturing industry, with diversified growth in 18 out of a total of 24 activities. The most significant positive contribution to the movement of the manufacturing industry came from export-oriented activities such as the production of electrical equipment (growth of 30.1%, y-o-y), rubber industry (11.1%), metal products (8.3%), automotive industry (25.9%) and beverage production (12.0%). Apart from the March temporary drop in production due to the overhaul of production capacities in NIS, since the beginning of the year a significant positive contribution is coming from the oil industry, which in the first eight months recorded a growth of 10.8%. In the same period, the production of other transport equipment recorded a strong increase in the physical volume of production, amounting 156.7% y-o-y, while the production of construction materials and machinery increased by 14.7% and 14.9% y-o-y, respectively. In addition, since the beginning of the year, a positive influence is coming from the metal industry, which - after the second blast furnace in the Smederevo ironworks was put back into operation - recorded 10.2% y-o-y higher production level in August, and 6.1% y-o-y in the first eight months.

However, it should be noted that the somewhat slower dynamics of the index of physical volume of industrial production from the middle of the second quarter is noticeable, as reflected in the y-o-y growth already during July and August, when it amounted to only 1.7% and 0.1%, respectively. However, despite the modest values of the physical volume of production in the last two months, good movements of other indicators in the industry are encouraging, and indicate significantly better performance of this sector. Thus, turnover in industry, i.e. sales revenue generated by producers of industrial products, continued to record strong real y-o-y growth in July and August, of 14.4% and 20.3%, respectively, with an increase in industrial products exports by about 25% and 33% y-o-y, respectively.

Indicators of industrial activity, y-o–y growth rate, in %



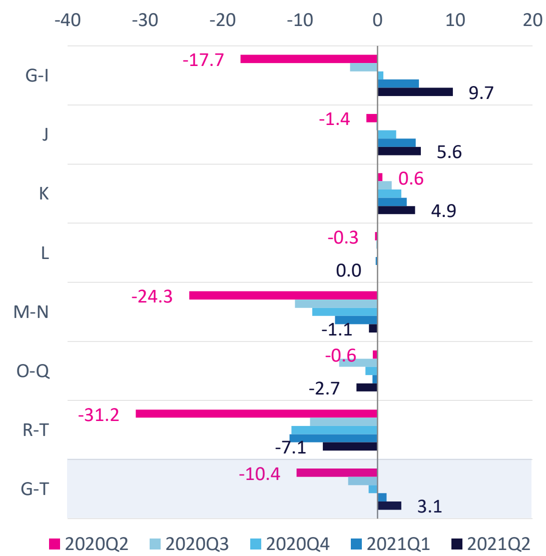
Indices of physical volume of leading activities of industrial production, 2020=100



Source: Ministry of Finance

The service sector is the part of the economy that, due to its structure, was hardest hit by the coronavirus epidemic, both in terms of impact level and its duration. According to the initial projection, the full recovery of this sector from the shock caused by the epidemic was expected only at the end of the second quarter of 2021. However, the service sector exceeded the pre-pandemic level of economic activity already in the first quarter, and strong growth continued during the second quarter. This dynamics of services has largely influenced the upward revision of GDP growth for this year.

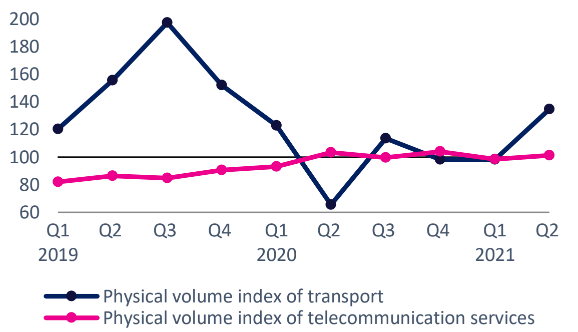
Gross value added of service sector[2] activities, seasonally adjusted growth rates (2020Q1=100), in %



Source: Eurostat

Some service activities, which, despite the pandemic, recorded growth in the previous year, such as trade, ICT and financial services, maintained positive trends in 2021. Higher disposable income of the population resulted in a real increase in retail trade turnover of 11.3% y-o-y in the first eight months, while the turnover in wholesale trade in the first six months was nominally higher by 21.7%. The physical volume of telecommunications services in the first half of 2021 was higher by 2.3%, followed by 25.5% increase in ICT services exports in the first eight months. The growth of economic activity of businesses and higher passengers and freight transport were reflected in the increase in the physical volume of transport services of 23.7% in the first half of the year, with the 30.6% growth of transport services exports in the first eight months.

Physical volume index of transport and telecommunication services (2020=100)

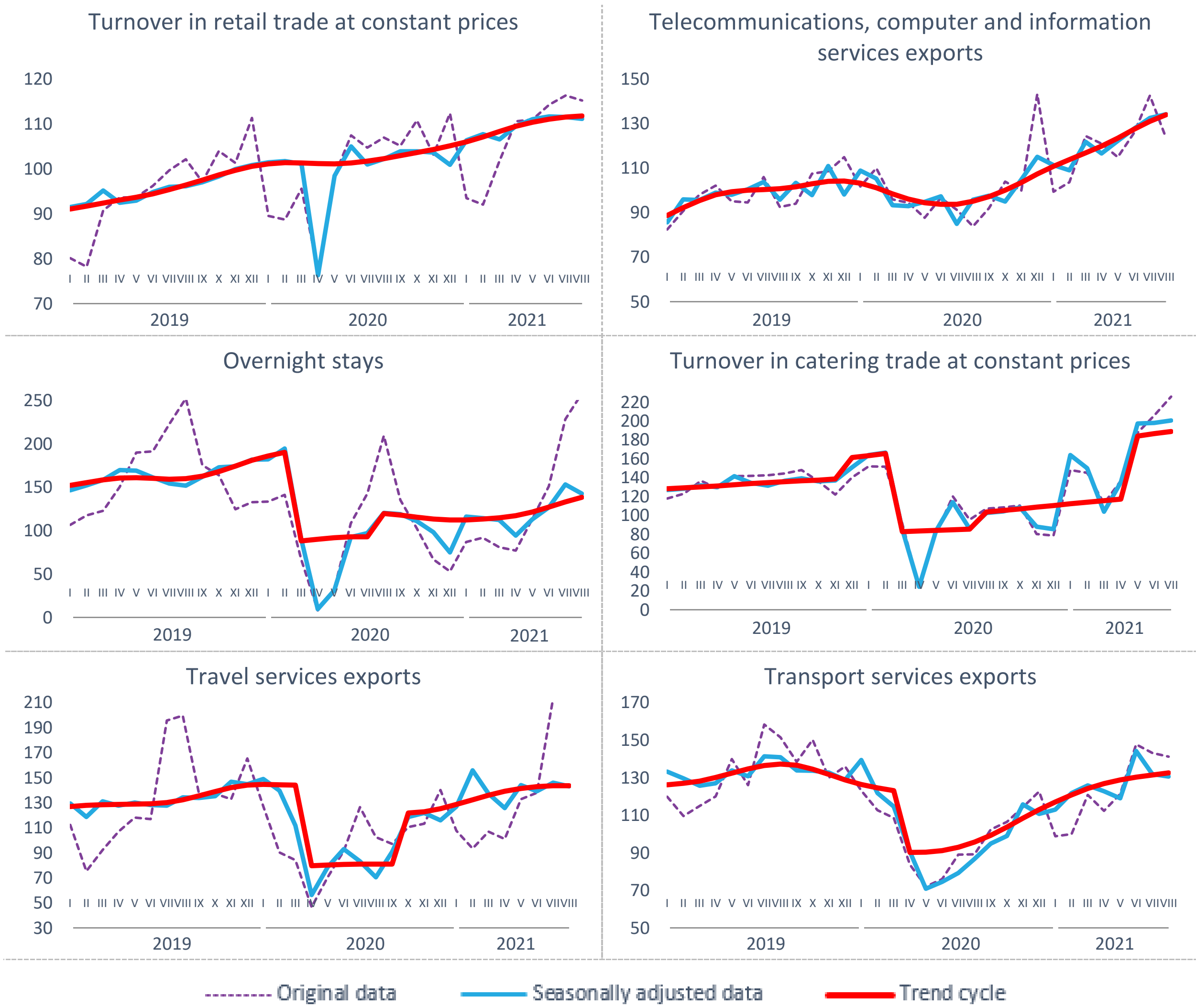


Source: SORS

Activities such as tourism, arts, entertainment and recreation, which recorded a dramatic decline, especially in the second quarter of last year and whose movements are particularly sensitive to the development of the epidemiological situation, have not as yet reached pre-crisis levels, while professional, scientific, innovative and technical activities are quite close to their pre-pandemic level. Nevertheless, a significant recovery is noticeable in these activities. Exports of tourist services in the period January–August 2021 increased by 50.4% compared to the same period last year. At the same time, the number of overnight stays of domestic tourists increased by 18.1% y-o-y compared to the first eight months of the previous year and is lower by only 5.7% compared to the same period of the pre-crisis 2019. The number of overnight stays of foreign tourists is growing strongly in 2021, primarily under the influence of the extremely low base from the same period last year, but in the first eight months it is still lower by 42.7% compared to the first eight months of pre-crisis 2019. Catering records a strong growth in 2021, with the real turnover level in the first seven months being about 63% higher than in the same period last year, or as much as 25% compared to the first seven months of the pre-crisis 2019.

[2] G-I – Wholesale and retail trade; repair of motor vehicles and motorcycles; Transportation and storage; Accommodation and food service activities | J – Information and communication | K – Financial and insurance activities | L – Real estate activities | M-N – Professional, scientific and technical activities; Administrative and support service activities | O-Q – Public administration and defence; compulsory social security; Education; Human health and social work activities | R-T – Arts, entertainment and recreation; Other service activities; Activities of households as employers

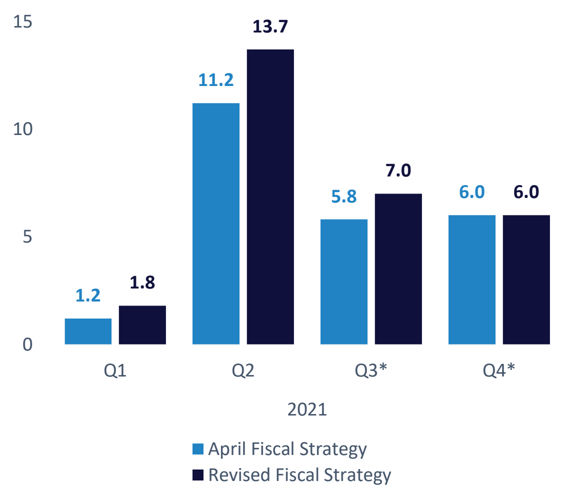
High-frequency indicators of key service industries, 2020=100



Source: Ministry of Finance

Starting from global developments, faster-than-projected growth in the first half of the year, and taking into account effects of the adopted measures to support businesses and population, the GDP projection for 2021 was revised upwards by 1.0 pp, from 6.0% to 7.0%.

Quarterly GDP growth rates in 2021, %



* 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 remain negative, although less than in the previous projection. Continuation of 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, but also increased spending propensity in the services segment, will result in more dynamic growth of personal consumption than previously projected. Accordingly, the projection of private consumption growth was revised upwards to 6.4%. In 2021, a somewhat stronger growth of investments is expected, as a result of a faster-than-expected recovery of private investments, along with the continuation of the planned dynamics of the implementation of public infrastructure projects. According to the revised projection, the increase in investment activity should amount to 15.2%, instead of the previously estimated 14.3%. As regards government consumption, no major changes are expected compared to the April estimate. A stronger recovery of external demand, along with the activation of new production capacities and the growth of exports of certain agricultural products, will result in higher growth of exports in 2021, which is estimated at 15.9%. On the other hand, higher private consumption and investments with increased export activity of domestic producers and related imports of intermediate goods will result in higher growth of imports than previously projected and will amount to 14.2%. Such dynamics of foreign trade activity will affect the smaller negative contribution of net exports to GDP growth compared to the previous projection, which is revised from -1.4 pp to currently projected -0.7 pp.

Observed from the production side, more favourable trends are expected in the service sector and construction, while the dynamics of industrial production and agriculture are generally in line with the previous projection. Increased consumption in the services segment favours stronger activity in the service sector, especially in the field of trade, tourism, catering, transport, entertainment and recreation, but also the entire segment of professional and technical services. Stable growth is also expected in ICT and financial services. As a result, service sector gross value added (hereinafter: GVA) growth in 2021 was revised upwards by about 2.5 pp and in the new projection stands at 8.4%. Favourable construction trends in the first half of the year, with a faster recovery of private construction operations and the continuation of the implementation of infrastructure projects will result in a construction growth of about 19%. As regards industrial production, good results from the beginning of the year and the activation of new production capacities, along with a gradual recovery of external demand, will result in a stable growth of 4.5%. Despite the record wheat yield, unfavourable weather conditions in summer season reflected in just average level of this year's agricultural production, which is in line with the previous projection, which envisaged a decline of about 4%.

Table 3. GDP, real growth rate, %

	2020	Q1 2021	Q2 2021	2021* (April Fiscal Strategy estimate)	2021* (current – revised estimate)
GDP	-0.9	1.8	13.7	6.0	7.0
Private consumption	-1.9	-1.8	17.4	5.8	6.4
Government consumption	2.8	-0.6	-3.8	3.0	2.8
Gross fixed capital formation	-1.9	9.0	22.5	14.3	15.2
Exports of goods and services	-4.2	8.4	36.5	13.8	15.9
Imports of goods and services	-3.6	-1.0	42.9	13.4	14.2
Agriculture	2.2	-1.9	-1.6	-4.0	-3.5
Industry	0.3	4.0	13.5	6.4	4.5
Construction	-3.6	17.8	17.7	16.1	18.5
Services	-1.2	1.1	15.1	6.0	8.4

Source: SORS, Ministry of Finance
* 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. Basic macroeconomic aggregates trends and indicators for the Republic of Serbia in the period 2022–2024 have been projected on the basis of Serbia's current economic trends and global outlooks, 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 is aimed 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 prepared, and it is described in detail in this document.

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

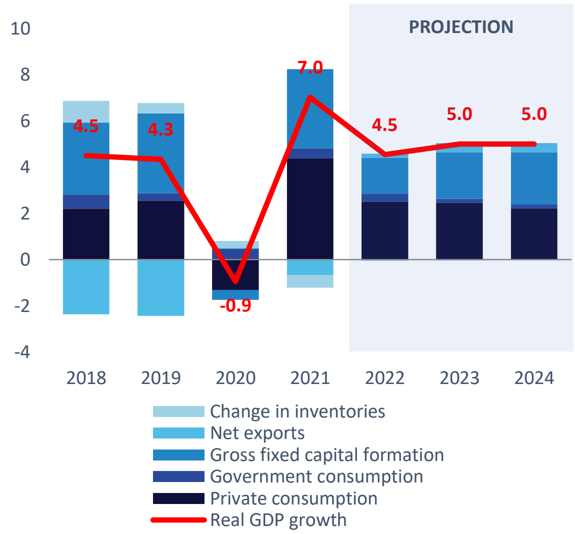
	Estimate	Projection		
	2021	2022	2023	2024
GDP, billions of dinars (current prices)	6,163.0	6,638.7	7,175.9	7,747.6
Real growth of GDP, %	7.0	4.5	5.0	5.0
GDP deflator, %	4.7	3.0	2.9	2.8
Private consumption	6.4	3.7	3.6	3.3
Government consumption	2.8	2.3	1.2	1.2
Gross fixed capital formation	15.2	6.4	8.1	8.9
Exports of goods and services	15.9	9.4	9.9	10.4
Imports of goods and services	14.2	7.6	7.9	8.5
Balance of goods and services in EUR, % GDP	-8.1	-7.7	-6.9	-6.2
Current account balance, in EUR, % GDP	-3.9	-4.2	-4.1	-3.9
Inflation, period average, %	3.7	3.7	2.6	2.5

Source: Ministry of Finance

For 2022, a real GDP increase of 4.5% is projected, whereby the initial projection from the previous Fiscal Strategy was slightly revised upwards by 0.5 pp. This revision is the result of a continuous increase in the economy potentials due to provision of new export-competitive production capacities, as well as indirect effects of accelerated construction of road and railway infrastructure, but also additional support in the implementation of green agenda projects.

Observed by aggregates of GDP use, growth will be further driven by domestic demand, which will provide a contribution of 4.3 pp, while net export 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 private consumption rise of 3.7% and consequently, as this aggregate holds the largest share in GDP, will contribute to the growth of economic activity with 2.5 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 y-o-y increase of 6.4% is expected, i.e. a contribution to GDP growth of 1.5 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 base from 2021 and record GDP share of 7.8%. In contrast to these 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, along with the activation of new production capacities as a result of materialization of FDIs from the previous period, will result in export growth of 9.4%. On the other hand, a moderate increase in private consumption as well as in investments will result in imports growth of 7.6%. Such dynamics of foreign trade will result in net exports positive contribution to GDP growth, of 0.2 percentage points.

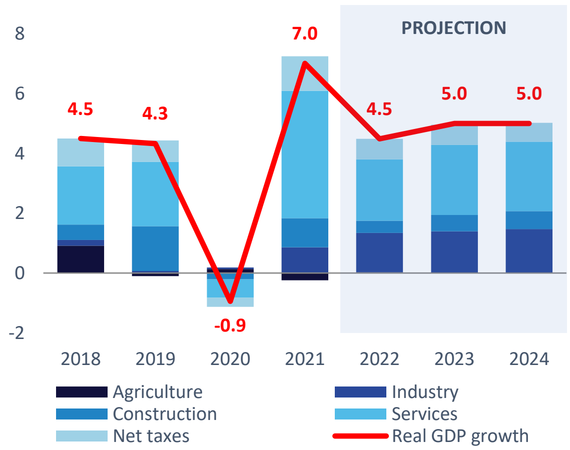
Contributions to the real GDP growth rate, expenditure approach, pp



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. 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 growth will continue in 2022 and record an increase of 6.5%. The acceleration of private construction operations, but also the continuation of the implementation of infrastructure projects, will result in construction sector solid growth of 7.4% in 2022. As for the agricultural sector, assuming average agrometeorological conditions with the continued trend of increasing productivity, a mild growth of 0.5% is projected.

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



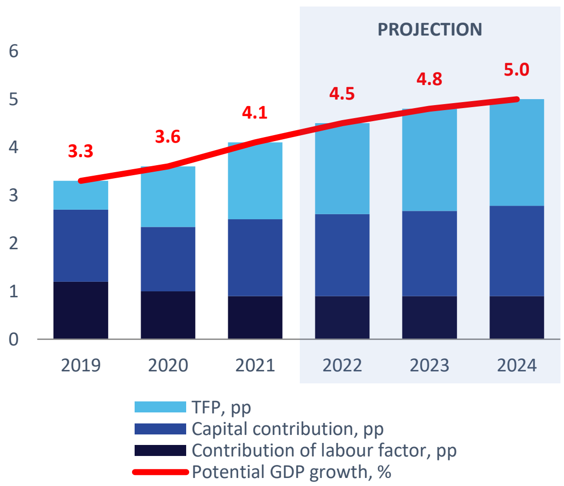
Source: Ministry of Finance

According to the medium-term macroeconomic projection, the cumulative growth rate in the period 2022–2024 will amount to 15.2% and will be driven by the growth in domestic demand and the recovery of global trade, additionally supported by a mild 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 4.8%, which is a revision upwards by 0.8 pp compared to previous expectations, primarily due to the continuous growth of the economy potential. The increase in private consumption is projected at a lower rate than the acceleration of economic activity and will average 3.5%. This increase does not include disruptive elements, it is based on sound sources, primarily on increased employment, but also on favourable influence of price and credit movements on the disposable income. A steady growth of investments is expected, on average of about 7.8% 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, materialization 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 9.9%, which is faster than the expected annual growth of imports, which will average 8.0%. Such dynamics of foreign trade flows will enable the balance of payments deficit to be maintained at the level of about 4% during the projection period. 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 4.4% and 6.9% per year, respectively. A positive contribution will be also provided by the growth of construction activity, which will average 9.4%. In agriculture, the attainment of European standards and increased competitiveness, by meeting the conditions for opening Chapter 11, and through the use of EU IPARD programs, the variability of production, caused by agrometeorological conditions, will be reduced in this sector.

With this three-year scenario, the Government remains committed to maintaining a model of economic growth based on investments and exports, backed by private consumption growth on real and sound sources. The share of gross fixed capital formation in GDP will be 24.6% 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 7.4 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, implementation of green agenda projects. 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 advanced economies. 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 4.1% in 2021, potential GDP will gradually increase and reach a rate of 5%. 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. Digitalization 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 monetary policy, synchronized with the fiscal 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 advanced economies 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

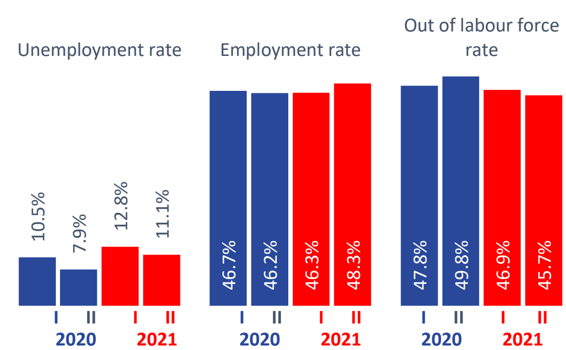
As a result of return to the path of strong economic growth and general stability of the economy, and backed by the process of vaccination of the population and the opening of the economy, 2021 is featured by better than expected trends in the labour market, especially related to wages. The success of the economic package of measures was verified by the absence of major negative impacts of the pandemic on the labour market, and jobs and wages were largely preserved, both in the private and public sectors, and the scenario of a sizable increase in unemployment was avoided.

According to the Central Register of Compulsory Social Insurance, in the period January-August, the average number of employees was higher by 3.4% compared to the same period last year, which was primarily the result of employment growth in the private sector (4.5%), while in the public sector the growth was 0.4%. At the same time, the strongest sectoral contribution to employment growth comes from manufacturing industry, trade and ICT. According to the National Employment Service data, in the related period, the number of active job seekers increased by 2.2%, but this was primarily due to a temporary increase in March and April, caused by one-off factors, and thus already in August a 0.4% y-o-y decrease in the number of unemployed was recorded.

According to the Labour Force Survey, after the unemployment rate of 12.8% in the first quarter, during the second quarter of 2021, the unemployment rate decreased to 11.1%. However, compared to the same period last year, it was higher by 3.2 percentage points. This increase in the unemployment rate was, above all, a consequence of the circumstances featuring in 2020. Namely, due to the anti-pandemic measures, a good part of the population was prevented from working or ceased seeking employment. Thus, that segment of the population, according to the methodology of the International Labour Organization (ILO), is classified in the contingent of persons outside the labour force, and they were not considered unemployed. As a consequence of this, the rate of population outside the labour force in the second quarter of 2020 was at a very high level of 49.8%, while the unemployment rate was low at 7.9%. In the second quarter of 2021, the rate of population outside the labour force was significantly reduced, by as much as 4.1 percentage points, and amounted to 45.7%. This is an indicator of recovery in the labour market, due to the return to the pre-pandemic-crisis level, despite the increase in the unemployment rate. The decrease in the population outside the labour force in Q2 2021, compared to the same period in 2020, led to an approximately equal increase in unemployment and employment, so that the unemployment rate increased from 7.9% to 11.1%, and the employment rate from 46.3% to 48.3%. A markedly positive trend was recorded among the young population, where the employment rate increased by 7.8 pp, to 25.9%. At the same time, the rate of population outside the labour force decreased by 10.1 pp, while the unemployment rate increased slightly by 0.5 pp, to 22.2%.

In the period January–July, the average net salary increased by 6.0% y-o-y in real terms, and amounted to RSD 64,358, with about four-fifths of the growth coming from the private sector. Observed by activities, more than half of the total growth of wages was determined by the growth of wages in the manufacturing industry, trade and health.

Movement of basic labour market indicators



Source: SORS

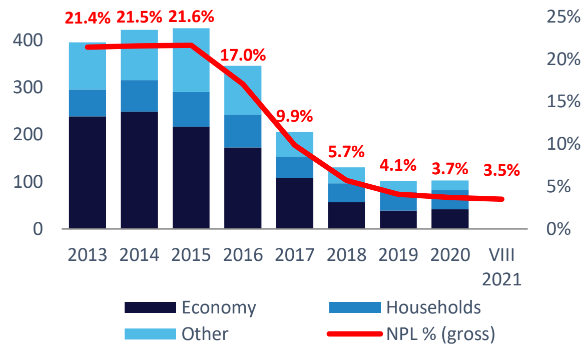
Previous favourable macroeconomic trends and economic policy makers' well-balanced measures in response to the pandemic, which were aimed primarily at maintaining economic growth and preserving employment, but also the full opening of the economy, which was enabled by the immunization process, created a strong basis for the continuation of positive trends in the labour market in the following period. Therefore, with the expected high economic growth, as well as the Government's continuous commitment to increasing the number of employees, forecast envisages continuation of positive trends in the labour market, which will result in further reduction of the unemployment rate and wage growth in the medium term. According to the Employment Strategy, in the post-crisis period, it is especially important to ensure stable financing of active employment policy measures, to ensure that unemployed remain connected to the labour market, prevent knowledge and skills loss and obsolescence, and enable training for jobs that shall be created after overcoming the crisis, which contributes to long-term economic growth. Furthermore, positive expectations are the result of continuous work on improving working conditions, improving labour market institutions, stimulating employment and inclusion of hard-to-employ persons in the labour market, as well as support to regional and local employment policy. Also, there are continuous efforts towards improving the quality of workforce, 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, 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, positive results of active measures related to training, retraining and support to social entrepreneurship are expected, which will facilitate job availability for socially vulnerable categories of society and thus add to ensuring inclusive economic growth. To ensure economic sustainability, wage growth in the medium and especially in longer term should be based on productivity growth.

Monetary developments

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 largely preserved. The good macroeconomic results during the pandemic were influenced by the previous economic growth, reduced internal and external disbalance, and on that basis increased resilience of the domestic economy. Good results were acknowledged by the rating agencies, thus in March, Moody's upgraded Serbia's credit rating to Ba2 with a stable outlook, and Fitch and S&P have not changed its credit rating. Banking stability has been preserved and further consolidated, along with credit activity growth and significantly reduced share of non-performing loans.

Lending activity recorded 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. Also, the share of dinar placements has significantly increased, which is a result of the growth of dinar loans in the corporate sector (largely under the Guarantee Scheme), i.e. fall in interest rate on dinar loans, 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. At the same time, largely as a result of encouraging housing loans, their contribution to the growth of total household loans was most significant, larger than the contribution of cash loans, by even more than 30%. At the end of August 2021, a 7.9% y-o-y nominal growth of total loans was registered, where corporate loans recorded a growth of 6.2%, while household loans were higher by 9.9%. At the same time, the growth of credit activity is accompanied by a decrease in the share of non-performing loans. 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 August 2021 amounted to 3.5%. This is a decrease of 18.7 percentage points compared to the period before the implementation of the Strategy.

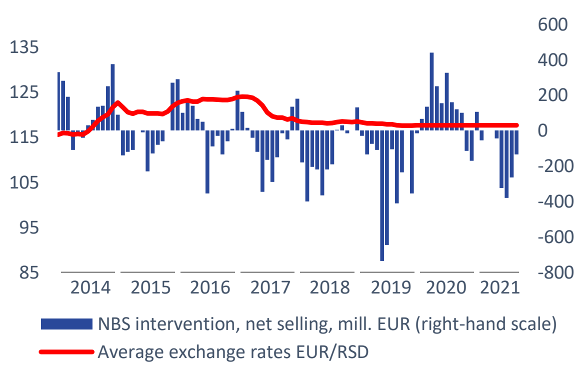
Non-performing loans, billion RSD



Source: NBS

From the middle of 2021, inflation was at a slightly higher level compared to the previous period. Such inflation movement was influenced by temporary factors, primarily the rise in global prices of oil and primary agricultural products, global supply chain disruptions, but also its low base value. Thus, in September, rise in consumer prices was above the upper bound of the target tolerance band, and amounted to 5.7% on y-o-y level. In addition to rise in the prices of oil and vegetables, also rise in the prices of meat, electricity, tobacco, vegetable oil, communal services, alcoholic beverages and restaurant and hotel services produced a significant impact on the growth of inflation in this period. The temporary character of such headline inflation growth is indicated by the inflation expectations of the financial sector and businesses, being around the target midpoint, but also the movement of core inflation, which was at the same time significantly lower and amounted to 2.6%. The still present low inflationary pressures are indicated by the relatively stable movement of core inflation, which was significantly influenced by the preserved stability of the exchange rate.

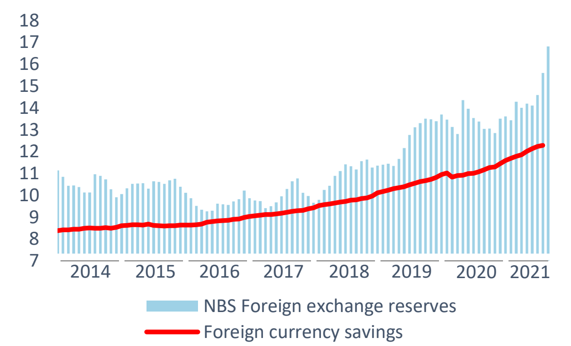
Exchange rate and NBS interventions in the foreign exchange market



Source: NBS

Owing to good macroeconomic developments, economic growth above the expected, and solid FDI inflow, 2021 is featured by continued stable trends in the foreign exchange market. As a result of the maintained stability on the foreign exchange market, the confidence of international investors has been restored and their interest in investing in dinar government bonds has increased, especially after their inclusion in the J.P. Morgan Index. The high capital inflows, starting from the second quarter of 2021, influenced the appreciation pressures to prevail. In order to alleviate these pressures, but also as an additional support to the stability of the exchange rate, the NBS intervened in the interbank foreign exchange market, starting from the second quarter, by foreign currency purchases. In the period January–September, the dinar recorded a real appreciation (1.1%) on average y-o-y, while it was nominally unchanged. In the same period, the NBS intervened in the interbank foreign exchange market with a net purchase of EUR 1.1 billion.

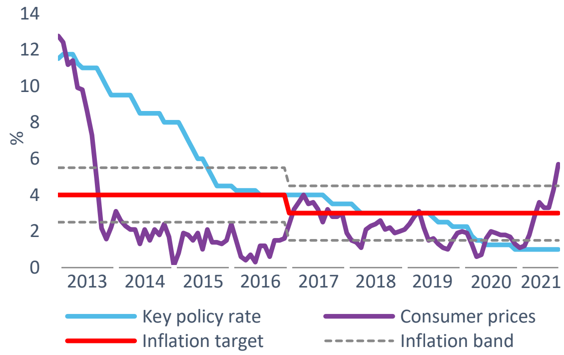
Foreign exchange reserves and foreign currency savings, billion euros



Source: NBS

At the end of September 2021, foreign exchange reserves were at a record high level, since their monitoring started, and amounted to EUR 16.8 billion. That was enough for the coverage of the money supply M1 of 149% and for about seven months of imports of goods and services. Compared to August, they increased by EUR 1.3 billion. The increase in the foreign exchange reserves of the National Bank of Serbia in September is primarily the result of inflows related to two issues of Eurobonds in euros on the international financial market in the total amount of EUR 1.7 billion. Compared to September 2020, the NBS's foreign exchange reserves increased by EUR 3.8 billion.

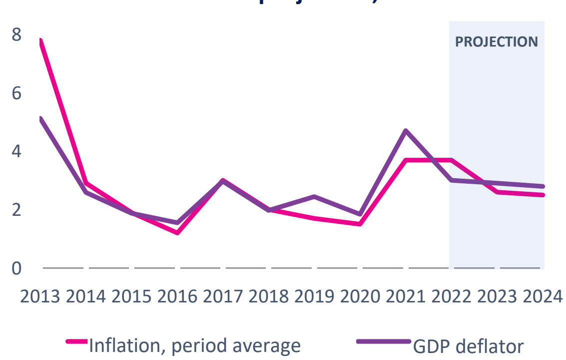
Inflation and key policy rate, %



Source: SORS and NBS

Since the middle of 2021, the movement of inflation has been strongly influenced by temporary factors, primarily the growth of global oil price and the prices of primary agricultural products, but also the global supply chain disruptions. Inflation is expected to be influenced by these factors in the short term, and will therefore continue to move above the target tolerance band in the next two quarters. With the fading of the impact of these factors, as of second quarter of 2022 inflation should return to the target tolerance band, while in the medium term, it is expected to move around midpoint. The key risks to the inflation projection relate to developments in the international environment, uncertainties regarding the movement of unprocessed food prices, global prices of primary products and energy prices, but also to the speed of recovery of the euro area and capital flows to emerging market and developing economies. 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: Ministry of Finance

External sector

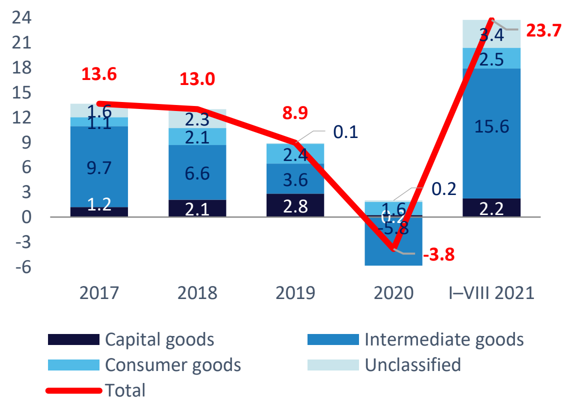
After the reduced volume of foreign trade in 2020, caused primarily by reduced external demand and introduced state of emergency, developments in the external sector are far more favourable in 2021. Several factors contributed to this, first of all the recovery of the economies of Serbia's most important trade partners and consequently increased external demand, improved structure of the domestic economy and activation of new economic capacities, as well as continued improvement of terms of trade. The total volume of foreign trade in the first eight months of the current year amounted to EUR 31.6 billion, and was 25.8% higher than in the same period last year. High y-o-y growth is primarily the result of accelerated economic activity, although it is partly a consequence of the base effect, notably a low volume of foreign trade, especially in the second quarter of the previous year. If eliminating base effect, and comparing the observed periods in the current year with the pre-pandemic 2019, the growth rate of foreign trade stands still high at 17.1%.

During the first eight months, goods worth a total of EUR 13.7 billion were exported, which is an increase compared to the same period last year of 28.5%, or 18.9% compared to 2019. The export of the manufacturing industry, which is also the main generator of export growth, is higher by as much as EUR 2.5 billion, or 26% compared to the first eight months of 2020, recording growth in 20 out of 23 areas. Main contributions to manufacturing industry export growth came from exports growth in the electronic, automotive and metal industries. In addition to the manufacturing industry, a significant contribution to export growth comes from the exploitation of metal ores, which records record high values of exports, as well as from agriculture, owing to the good agricultural season in the previous year and rising prices of cereals and primary agricultural products.

In the period January–August 2021, the import of goods amounted to EUR 17.9 billion, which is an increase of 23.7% compared to the same period last year. The high growth rate of imports is a consequence of the recovery of economic activity, gher oil prices on the global market, and is partly due to the low base from the same period last year.

Almost two thirds of imports growth is related to higher imports of intermediate goods, while the value of imports of equipment amounted to over EUR 2.5 billion, which provides for a favourable imports structure and the potential for further economic growth in the coming period.

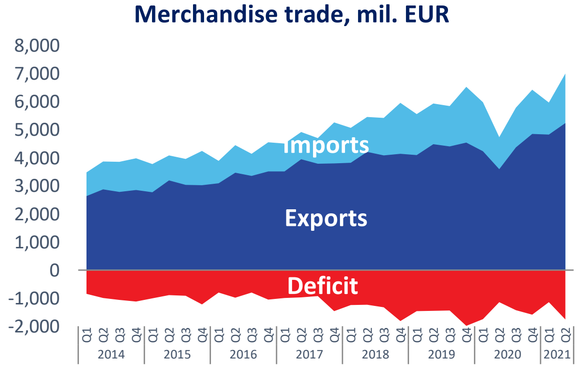
Contributions to import growth rates, economic destination, pp



Source: SORS

Such trends in foreign trade resulted in an increase in the foreign trade deficit during the first eight months of 2021 by slightly more than EUR 400 million, or 10.5%, with an increase in the coverage of imports by exports - from 73.4% to 76.3%.

Merchandise trade, mil. EUR



Source: SORS

The most important foreign trade partners during the first eight months of 2021 are still the EU countries, which accounted for 65.4% of total exports and 58.0% of total imports. The largest share of total exports (39.4%) in that period was directed to the markets of five countries: Germany, Italy, Bosnia and Herzegovina, Romania and Hungary. Imports from Germany, China, Italy, Russia and Turkey accounted for 44.1% of total imports. The foreign trade surplus in this period was realized with Bosnia and Herzegovina, Montenegro, North Macedonia, Romania, Czech Republic, United Kingdom, Bulgaria, Croatia, Slovakia, Sweden and, in a slightly lower amount, with Slovenia. The surplus with these countries amounted to EUR 1,935.9 million. The biggest deficit is recorded in trade with China, Turkey, Germany, Iraq and Russia.

Balance of payments developments in 2021 are featured by a 29.5% reduction in the current account deficit. In the first eight months of 2021, the current account of the balance of payments recorded a deficit in the amount of EUR 1,085.8 million, which is EUR 454.9 million less than in the same period last year. The reduction of the current account deficit was mostly due to the higher secondary income surplus, but also to the somewhat lower deficit on the goods and services account, which was reduced primarily due to the growth of the surplus in the trade in services with foreign countries. The trade deficit increased by 8.0%, i.e. by EUR 272.2 million, while the services account recorded a surplus that was 46.7% higher and amounted to EUR 968.8 million. Positive net exports of services are mostly the result of higher exports of ICT and tourism services in the observed period. Net inflow based on ICT services increased by 41.2% and amounted to EUR 807.1 million. The deficit of primary income increased by EUR 89.9 million (9.6%), while the secondary income surplus was higher by 23.8% y-o-y and amounted to EUR 2.6 billion, as a result of the increased inflow of foreign remittances.

The net inflow of FDIs in the first eight months of 2021 amounted to EUR 2.4 billion, while the total FDI-based inflow amounted to EUR 2.6 billion. Observed by activities, the largest net FDI inflow in the first half of the year was realized in mining, in the amount of EUR 380.7 million, owing to investment of the "Zijin mining" company in the construction of mining facilities and the execution of works for the "Čukaru Peki" copper and gold mine. The manufacturing industry, the sector that traditionally attracts the most FDI, continues to record a high net FDI inflow, amounting to EUR 352.7 million. High inflow of FDIs in this period was also realized in transport, construction and financial services. In addition to production diversity, FDIs are also geographically diversified, with a growing share of Asia-Pacific and Middle East countries. Observed by geographical origin, the

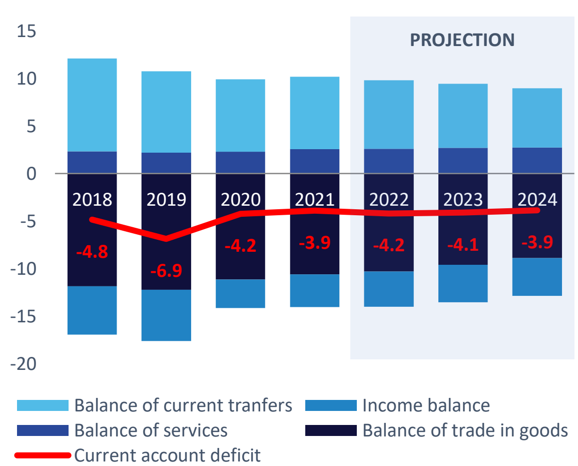
European Union is still the most important investor in Serbia, with a share of 58.0% in total investments. On the other hand, observed by country, the largest net FDI inflows come from China[3], Netherlands, Germany, Switzerland and Austria, which account for slightly less than 70% of total matured investments. The share of FDI inflows from China has increased significantly in the last six years, from 3.1% in 2015 to 15.9% last year. In the first six months of 2021, China was the single largest investor, with close to half a billion euros in investments, which account for 31.1% of the total net FDI realized in this period.

In the first eight months, an inflow of portfolio investments in the amount of EUR 649 million was registered, mostly due to the issuance of euro-denominated government bond in the amount of one billion euros on 24 February, at a yield of 1,920% and a coupon rate of 1.65%, with a 12-year maturity, which further extended the yield curve of Serbian bonds issued on the international market. By the inclusion of the Republic of Serbia bonds in the J.P. Morgan's Government Bond Index-Emerging Markets (GBI-EM Global Diversified Index) on 30 June, significant progress was made in strengthening the liquidity of the secondary market of government securities and the quality of Serbian bonds was acknowledged on the global financial market. The index includes regularly traded government bonds denominated in local currency, with fixed coupon rates that are easily accessible to foreign investors[4]. In addition to the GBI-EM Global Diversified Index, Serbia's bonds will also be included in the GBI-Aggregate Index (GBI-AGG). The joining of forces by the Belgrade (BELEX) and Athens Stock Exchanges (ATHEX), and the adoption of the Capital Market Development Strategy for the period from 2021 to 2026 have ensured further development of the capital market in Serbia and diversification of sources of long-term financing.

Serbia's external position in 2021 is featured by resilience to financial shocks from the international environment. Foreign exchange reserves at the end of September this year increased by EUR 3.3 billion since the beginning of the year, and amounted to EUR 16.8 billion. The ratio of foreign exchange reserves and short-term debt increased compared to the end of the previous year, due to the simultaneous growth of foreign exchange reserves and the reduction of short-term debt. In the same period, there was an improvement in the external solvency indicators. The share of external debt in GDP remained unchanged at 65.8%, while the share of short-term debt in GDP and the ratio of external debt and exports of goods and services decreased. The share of external debt in the export of goods and services at the end of the second quarter of 2021 was 128.8%, which is significantly below the World Bank's criterion of 220% and is a guarantee of the sustainability of its servicing.

The total current account deficit in 2021 is expected to be around EUR 2 billion, or 3.9% of GDP, and the net FDI inflow by the end of the year will be over EUR 3.5 billion, which will still be more than a sufficient amount to fully cover the current account deficit. 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 impacts of the pandemic in the external environment, and intensification of domestic investment activity.

Current account structure, % GDP



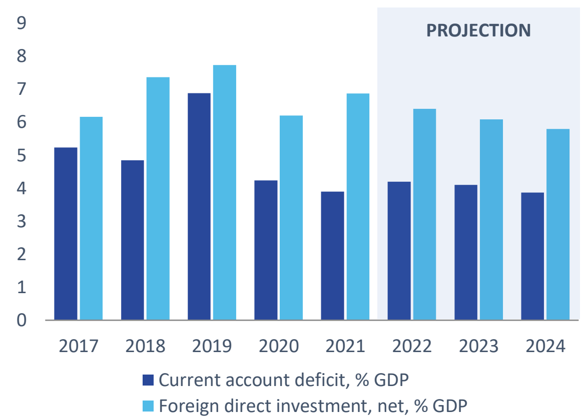
Source: Ministry of Finance, NBS, SORS

[3] Data are given aggregately for the People's Republic of China, Hong Kong and the Chinese Province of Taiwan.

[4] The index includes three dinar benchmark bonds maturing on 11 January 2026 (RSMFRSD89592), 6 February 2028 (RSMFRSD55940), and 20 August 2032 (RSMFRSD86176).

The growth of merchandise exports in euros at an average rate of 11.4% and of imports by 9.4% in the projected three-year period will reduce the deficit in foreign trade in goods to 8.9% of GDP in 2024, from this year's 10.6%. It is foreseen that the favourable developments in the services account will continue, where the surplus will average EUR 1.6 billion in the projected three-year period. The inflow from current transfers will average 6.7% 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 1.7 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 3.9% of GDP at the end of the projection horizon.

Current account deficit and FDI, % GDP



Source: NBS and Ministry of Finance

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 FDI growth, 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.

4. Risks to 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, primarily those coming from the global environment. 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, potential tightening of financial conditions and pronounced cost pressures on global inflation would lead to recessionary trends. In addition to possible new pandemic waves and related epidemiological constraints, the slowdown in economic growth may also be influenced by factors such as rising prices of intermediate inputs (primarily energy), notably accelerating global inflation. The uneven recovery of our most important trading partners is associated with the risk of further slowdown due to the spread of new virus variants. At the same time, bottlenecks in supply chains and labour market imbalances also contribute to the unfavourable medium-term growth outlooks of these economies, as they increase production costs and fuel inflation expectations.

In the short run, we assess the risks of the projection as symmetric, with downwards asymmetric based on factors from the international environment and slightly upwards based on factors from the domestic environment. 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, and the emergence of new highly transmissible virus variants, 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, rise of primary commodity prices may influence 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. Risks related to the domestic market relate to the new agricultural season, the speed of demand recovery and the movement of regulated prices.

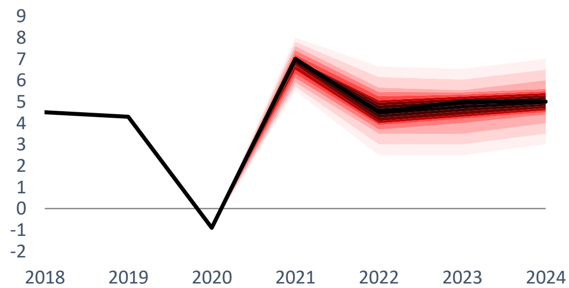
Serbia has maintained its role of a net exporter of basic metals and ores, so that faster growth in their prices would positively affect economic activity. The activation of new and expansion of existing export capacities, and more favourable trade relations will contribute to mitigating negative risks. 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. 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 featuring in the domestic environment are related 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 movements in this sector is projected. The baseline scenario assumes average agricultural production and a neutral contribution of agriculture to GDP. The growth of construction in the coming period is based on the established growth path of private construction operations, as well as on the continuation of state investment cycle. Dynamics and efficiency in the implementation of public projects, as well as activities in the segment of construction of buildings and production facilities bring along symmetrical risks. Development in the industrial production are largely determined by external factors.

Although the neutralization of internal and external imbalances in the previous period has increased the resilience 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.

Favourable macroeconomic outlook of the country, improved business environment, maintained favourable financial conditions and efficient implementation of state investment projects will reduce the uncertainty which is present in terms of the readiness for investment and expansion of production capacity.

Projection of GDP trends, y-o-y growth rates, %



Source: Ministry of Finance

II. FISCAL FRAMEWORK FOR THE PERIOD FROM 2022 TO 2024

1. Medium-terms goals of fiscal policy

Year 2021 was featured by the continuation of the fight against the coronavirus pandemic and the economic recovery. At the beginning of the year, a new package of measures to support businesses and households, in the amount of about 4.2% of GDP, was ensured. This package envisages direct assistance to businesses and citizens, and additional measures for sectors whose operations are most restrained by epidemic-control measures (hospitality, transport, hotel and tourism sectors). In addition to direct assistance, this package of measures provided additional funds for maintaining the liquidity of business entities and extended the deadline for the use of this form of assistance, and increased the amount of funds allocated to the health sector.

The package of measures additionally helped the recovery of the economy, which was reflected in better revenue collection and consequently a smaller deficit and level of public debt at the end of the year. The second rebalance envisages a general government deficit of 4.9% of GDP and public debt at the level of 58.2% of GDP, with an increase in the amount of funds allocated to infrastructure projects.

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 space for a timely response of fiscal policy in the event of crisis deepening. Possible fiscal intervention of the state in order to minimize the effects of the crisis will certainly be combined with efforts not to stop development programs and infrastructure projects financed from the budget.

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 general government debt-to-GDP ratio 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 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 benefit from planned amendments to the Budget System Law, which will, inter alia, 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 wages and pensions.

2. Fiscal trends in 2020

At the end of 2020, at the level of the general government, the fiscal deficit amounted to RSD 442.8 billion, or 8.0% of GDP, which is by 0.9% 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% of GDP was recorded. In the original budget plan, the deficit was planned at 0.5% of GDP. Debt increased by 5 percentage points, from 52.8% of GDP at the end of 2019 to 57.8% 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 considerable investments in the health system and procurement of necessary medical supplies. The total package of measures planned for 2020 amounted to RSD 704.4 billion, or 12.8% of GDP, of which RSD 564.1 billion 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 RSD 72 billion (1.3% of GDP), produces a total cost of COVID-19 response of RSD 636.1 billion, or 11.6% of GDP.

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

Public revenues were realized in the amount lower by RSD 85.8 billion (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 considerably reduced due to the pandemic (tolls, fines, court and administrative fees and charges, etc.).

Public expenditures were higher than originally planned, by 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 wage increases in the health sector. The realization of public investments in 2020 exceeded all previous years, reaching the level of 5.3% of GDP and exceeding the plan by 0.5% of GDP. Investments have been made in both transport infrastructure and new health facilities, which constitutes a major 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, funds 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 in the private sector during the state of emergency and for one additional month with subsequent repayment of liabilities in instalments (starting from January 2021 at the earliest)	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 of all donors from the obligation to pay VAT	–	–	–	–
Total	**189.0**	**3.4**	**133.3**	**2.4**
Direct support to the private sector				
Direct support to entrepreneurs who pay a flat rate tax and entrepreneurs who pay tax on actual income, and to micro, small and medium-sized enterprises in the private sector – three months payment of net minimum wage and two additional months payment of 60% net minimum wage	128.8	2.3	130.1	2.4
Direct support to large private companies – support in the amount of 50% of the net minimum wage (during the state of emergency) for 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 – EUR 350 per bed, EUR 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 (RSD 30.000)	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				
Moratorium on dividend payment until the end of the year, excluding public enterprises and loss of revenue arising from dividends	16.0	0.3	6.0	0.1
Wage increase measures and other direct financial assistance (10% increase in wages 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 EUR 100, in the 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**	**2.0**	**104.0**	**1.9**
Fiscal impact assessment of measures	**464.4**	**8.4**	**389.6**	**7.1**
Overall package of measures	**704.4**	**12.8**	**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**	**12.8**	**636.1**	**11.6**

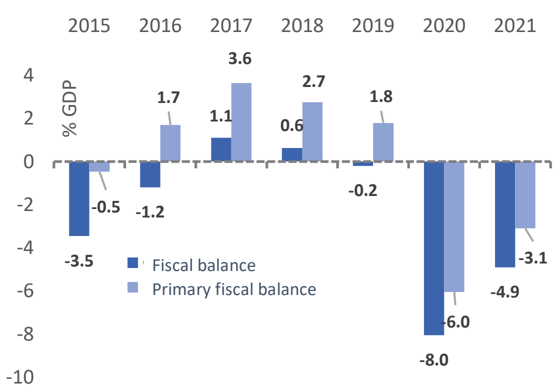
3. Current fiscal trends and the outlook for 2021

The general government fiscal deficit in 2021, according to the latest estimates, will amount to 4.9% of GDP, which is significantly less than in the April estimate when the deficit was planned at 6.9% of GDP. Compared to the balance projected in the original budget for 2021, the deficit is higher by 1.9 pp (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 support 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 and stimulate economic growth;
- substantial revision of the general government revenue projection.

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 12.8% 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 impact 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 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 assistance 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 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 hit by the extended application of epidemiological measures. Larger allocations are also planned as assistance to the most vulnerable categories of the population. Support package was modified to some extent after implementation during the first and second quarters of the current year, and the amount of direct support to households was strengthened by additional funds

The value of the 2021 package of measures is 4.2% of GDP. The effect of this package of measures on the fiscal balance in 2021 is estimated at 2.3% of GDP. Direct support to the economy aimed at preserving employment, equalling 50% of minimum wage, paid for three months, was provided to all enterprises 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 envisaged, 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	52	0.8
Direct support to hotels in urban areas	1.2	0.0
Direct sectoral support - catering, travel agencies, hotels and car rental companies	4.1	0.1
Independent artists	0.3	0.0
Direct sectoral support - sector of road passenger transport operators and bus stations - EUR 600 per bus	2.7	0.0
Total	60.3	1.0
Measures to preserve private sector liquidity		
Extension of the existing guarantee scheme to support the economy during the COVID-19 crisis	60	1.0
Establishment of a new guarantee scheme to support the most affected sectors / enterprises	60	1.0
Total	120.0	1.9
Other measures		
Fiscal incentive - stimulating domestic demand	73.1	1.2
Vaccination bonus	7.1	0.1
Total	80.2	1.3
Fiscal measures impact assessment	**140.5**	**2.3**
Overall package of measures	**260.5**	**4.2**

Along with the revision of the revenue and expenditure side and the adoption of the second rebalance of the Republic of Serbia budget, the 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 4.9% of GDP. Compared to the originally planned fiscal framework, the revenue estimate increased by RSD

254.9 billion. On the expenditures side, there was an increase of RSD 380.1 billion, with significant changes in their structure.

The revision of the real GDP growth rate for 2021 is the most important factor regarding changes in the amount of the revenue side, noting that the original projection of general government revenues was conservative, due to caution and initial uncertainty regarding overall macroeconomic developments, especially in the labour market. The negative impacts of the pandemic, and of the epidemiological measures as well, on economic and budget revenue developments are 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.

Table 7. Revenues, expenditures and balance of the government sector in 2021, in billion dinars

	budget 2021	New estimate 2021	Difference new/budget	Change %	2021 new est. % GDP
PUBLIC REVENUES	2,423.9	2,678.9	254.9	10.5	43.5
Current revenues	2,404.4	2,658.8	254.4	10.6	43.1
Tax revenues	2,171.1	2,397.3	226.2	10.4	38.9
Personal income tax	225.4	253.0	27.6	12.2	4.1
Corporate income tax	107.1	157.0	49.9	46.6	2.5
VAT	600.3	654.0	53.7	8.9	10.6
Excises	315.8	329.2	13.4	4.3	5.3
Customs duties	53.1	59.0	5.9	11.1	1.0
Other tax revenues	84.9	90.0	5.1	6.0	1.5
Contributions	784.5	855.0	70.5	9.0	13.9
Non-tax revenues	233.3	261.6	28.2	12.1	4.2
Grants	19.5	20.1	0.6	2.8	0.3
PUBLIC EXPENDITURES	2,603.3	2,983.4	380.1	14.6	48.4
Current expenditures	2,237.2	2,473.3	236.1	10.6	40.1
Expenditure for employees	602.5	628.6	26.1	4.3	10.2
Purchase of goods and services	458.5	495.3	36.9	8.0	8.0
Interest repayment	113.6	113.9	0.3	0.3	1.8
Subsidies	130.7	213.4	82.7	63.3	3.5
Social benefits and transfers	847.8	857.8	10.0	1.2	13.9
of which pensions	*621.0*	*612.0*	*-9.0*	*-1.4*	*9.9*
Other current expenditures	84.2	164.3	80.1	95.2	2.7
Capital expenditures	330.6	479.4	148.8	45.0	7.8
Net lending	23.7	22.4	-1.3	-5.4	0.4
Activated guarantees	11.7	8.2	-3.5	-29.8	0.1
Fiscal balance	-179.3	-304.5	-125.2		-4.9
Fiscal balance in % GDP	-3.0	-4.9	-1.9		

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);
- acceleration of economic activity, i.e. revision of the real GDP growth rate upwards from 6% to 7%;
- 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;
- more favourable than expected developments in the labour market;
- recovery of foreign trade;
- payment of initially unplanned non-tax revenues and donations;
- positive impact of the program of economic measures on economic activity and personal consumption.

The projection of personal income tax revenues was increased by RSD 27.6 billion 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 realization of these revenues at the end of 2020 was above expectations, and the data on employment and movement of average wages indicate maintained stability in the labour market. This trend continued during the first quarter of 2021. During the second and third quarters of the current year, the positive trends in the labour market continued, which created the conditions for another revision of this tax form upwards. The estimate of the repayment of part of the deferred taxes and contributions during 2021 was slightly adjusted based on the data on payments during the year. In a similar way, the projection of revenues from social contributions was revised upward, by RSD 70.5 billion.

The remainder of the personal 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 the beginning of the year, a strong jump in dividend tax payments was recorded, thus the projection of revenues on this basis was revised.

The projection of corporate income tax revenues was increased by about RSD 50 billion compared to the original budget plan for 2021, although it was not modified in the April revision. The main reason for the correction in this amount is caution applied in the previous estimate, bearing in mind that the data on profitability in 2020 were not known at the time of making the April projection. Despite the fact that in 2020 there was a slowdown in economic activity, the profit of companies recorded an increase, which further increased the amount of paid profit tax. As a consequence, payments based on taxes on dividends paid out by legal entities are also higher.

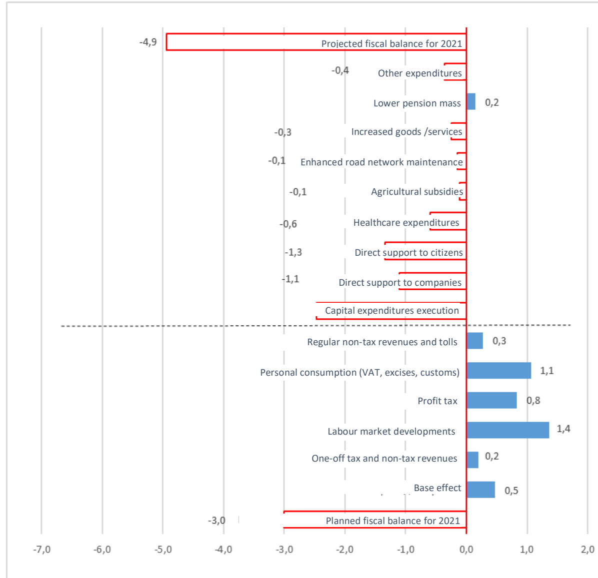
Value added tax is projected at RSD 654 billion, which is an increase of 53.7 billion compared to the original projection. During the adoption of the April rebalance, the VAT projection was not changed. During the first quarter, moderately better-than-expected growth rates were recorded, but uncertainty about the unfavourable epidemiological situation and further implementation of epidemiological measures required caution in the revision of the revenue estimate. During the second and third quarters, the growth rate of VAT collection was further accelerated, which created the conditions for a more significant revision of this form of tax upwards. The reasons for the accelerated growth of collection are a stronger recovery of personal consumption, the effects of government stimulus measures on consumption, a more favourable balance in the tourism sector and other service activities, which encouraged consumption in the domestic market, etc.

Revenues from customs duties are projected in the amount of 59 billion, which is an increase of RSD 5.9 billion compared to the original projection. Revenues from customs duties mostly follow the dynamics of import VAT, thus the projection of these revenues 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 RSD 329.2 billion, which is RSD 13.4 billion more than the original projection. Excise duties on tobacco products increased by RSD 1.6 billion, and excise duties on petroleum products by RSD 12 billion. The projection of revenues from other excise duties has not changed. Collection of excise duties on tobacco, after strong growth and payments during the most lavish summer months, has stabilized, which led to a slight correction in the estimate of these revenues, but with the positive risk of higher realization. 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. During the first quarter, a solid growth of this revenue was recorded, with additional acceleration during the second and third quarters. Despite oil and petroleum product prices rise on the domestic market, their consumption recorded increase. The level of transit transport has significantly recovered, domestic consumers are using their own transport more (partly due to habits acquired during the pandemic), and domestic tourists travelled less abroad whereby consumption in the domestic market has increased. Also, there is a realistic 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 are increased compared to the amount envisaged in the original budget, by RSD 28.2 billion. 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. Toll revenues have almost fully recovered, and the same can be said for other categories of regular non-tax revenues. Thereby conditions have been met for a more substantial correction of the estimate of these revenues upwards. 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. Extraordinary non-tax revenues were adjusted upwards due to the effected payments related to 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 are revised upward by RSD 380.1 billion in relation to the original budget. The largest part of this increase relates to the implementation of support packages for businesses and households. The remainder comprises 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 January-August period, public expenditures grew at a rate of 1.8% 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, as well as the realization of capital expenditures.

Expenditures for employees are RSD 26.1 billion higher compared to the originally planned. The largest part of this increase refers to increased 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 are increased by RSD 36.9 billion. The largest part of this increase refers to 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 routine road maintenance at the PE "Roads of Serbia". Other levels of government also recorded an increase in these expenditures, especially on the level of local self-government.

Subsidies are substantially increased compared to the original plan, by RSD 82.7 billion. The largest part of this increase relates to payment of direct assistance to companies and entrepreneurs for overcoming the pandemic-induced crisis. For these purposes, in 2021, over RSD 66.3 billion are planned. One part of the increase in subsidy expenditures relates to enhanced agricultural (about RSD 7 billion) and rail transport subsidies.

Social protection expenditures are higher by RSD 10 billion 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, National Employment Service and Pension and Disability Insurance Fund will pay the 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 RSD 9 billion. 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 increase in the number of pensioners failed to materialize. In 2021, the share of pension expenditures in GDP will stand at 9.9%.

Other current expenditures increased by RSD 80.1 billion compared to the original plan, primarily due to the payment of direct financial assistance to households (EUR 80 to all adult citizens in dinar equivalent at the official middle exchange rate of the NBS), in the total amount of RSD 58.8 billion. 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, as well as bonuses to vaccinated citizens.

It is estimated that the realization of public investments will be higher by RSD 148.8 billion than the original plan. Execution of capital expenditures in the period January–August 2021 compared to the same period last year increased by 40.1%. Capital expenditures reached currently record level of 7.8% of GDP in 2021. Higher expenditures are planned for both new and existing infrastructure projects, primarily related to 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 relates to further epidemiological protection of the population against COVID-19, and the other to future improvement of the health care system. In earlier crisis periods, capital expenditures would be most often downsized, which was not the case now, and reflects a positive change in public financial management. The rest of capital expenditures increase relates to investment in the renewal and modernization of military equipment.

The estimated fiscal deficit of 4.9% of GDP does not deviate from the average fiscal balance expected in the countries of the region and the EU. Such result is a direct consequence of the implementation of the support packages, as well as the efforts to sustain and accelerate started economic recovery in the coming period. Structural analysis of the fiscal balance showed that about 4.2% of GDP relates to one-off and temporary measures, and thus established that the sustainability of country's fiscal position has not been disturbed.

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

	I–VIII 2020	I–VIII 2021	I–VIII growth rate in %	2021/2020 growth rate in %
PUBLIC REVENUES	1,413.6	1,755.3	24.2	18.8
Current revenues	1,406.3	1,744.7	24.1	18.5
Tax revenues	1,261.8	1,575.6	24.9	20.4
Personal income tax	128.3	167.3	30.4	23.9
Corporate income tax	85.7	116.0	35.4	27.8
VAT	351.4	420.8	19.8	19.1
Excises	200.8	219.6	9.4	7.6
Customs duties	32.4	37.8	16.6	13.6
Other tax revenues	52.7	61.3	16.4	8.8
Contributions	410.6	552.7	34.6	26.9
Non-tax revenues	144.4	169.1	17.1	3.4
Grants	7.3	10.6	44.5	79.7
PUBLIC EXPENDITURES	1,753.8	1,784.5	1.8	10.6
Current expenditures	1,571.7	1,550.6	-1.3	5.2
Expenditures for employees	378.9	410.8	8.4	8.6
Purchase of goods and services	275.9	284.8	3.2	12.5
Interest repayment	76.1	85.2	12.0	3.3
Subsidies	181.0	133.0	-26.5	-15.3
Social benefits and transfers	528.8	554.9	4.9	6.4
Of which pensions	*388.7*	*406.3*	*4.5*	*4.9*
Other current expenditures	131.0	81.9	-37.5	-0.2
Capital expenditures	155.7	218.2	40.1	63.2
Net lending	21.4	11.1	-47.9	-49.5
Activated guarantees	5.0	4.7	-6.0	9.7
Fiscal balance	-340.2	-29.3		

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 September 2021 amounted to RSD 2.7 billion (about 0.04% of GDP), and has slightly increased compared to the end of 2020. Budget beneficiaries and PE "Roads of Serbia" created the arrears of RSD 1.3 billion, while the balance of arrears in the organizations of compulsory social insurance amounts to RSD 1.4 billion.

Table 9. The arrears in payments of budget beneficiaries and OCSI, end of 2020 and September 2021, in billions of dinars

	31 Dec 2020	30 Sep 2021
Budget beneficiaries and PE "Roads of Serbia"	1.2	1.3
OCSI	1.4	1.4
TOTAL	2.6	2.7

Source: Ministry of Finance

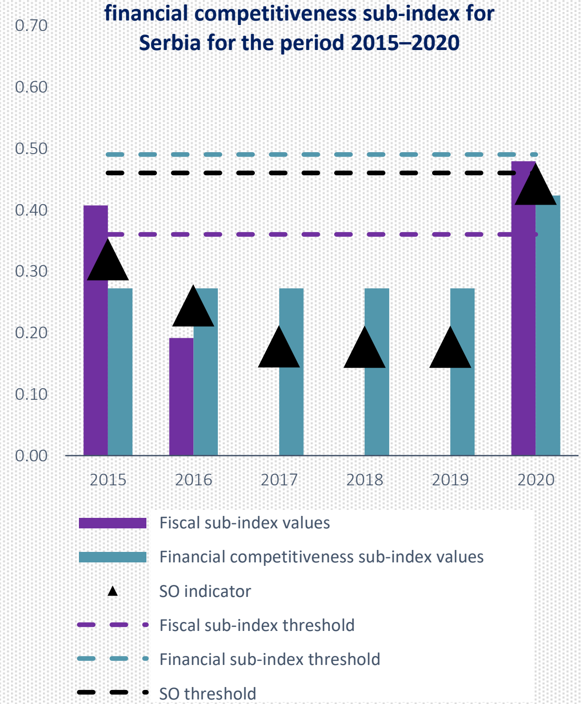
* Pursuant to the definition used in monitoring the implementation of the arrangement with the IMF.

S0 indicator of short-term fiscal sustainability

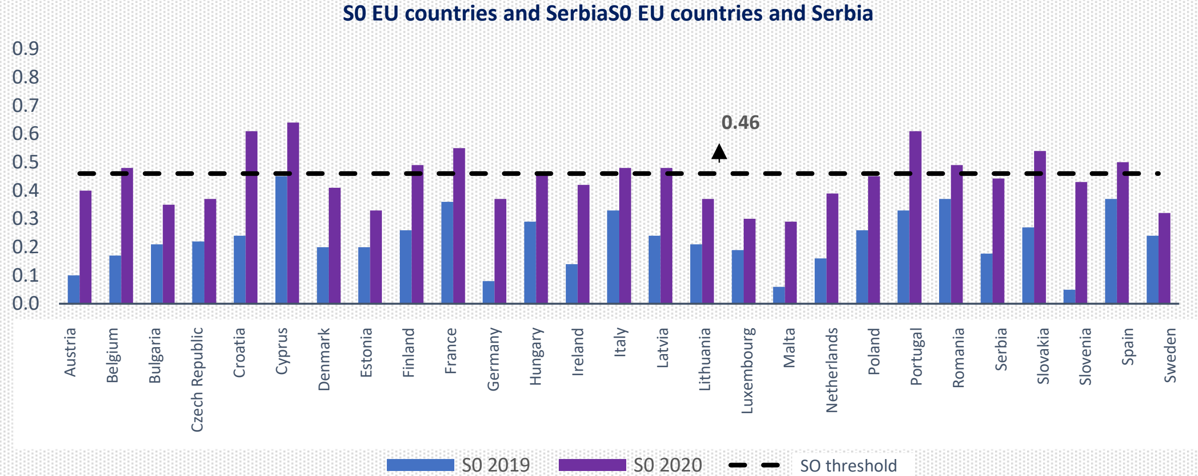
To assess short-term fiscal sustainability, the European Commission has designed a composite SO indicator which, by identifying potential short-term risks in the current year, seeks to anticipate fiscal stress in the coming year. If the S0 indicator value exceeds the defined threshold, it is considered 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 with fiscal sub-index and financial competitiveness sub-index for Serbia for the period 2015–2020



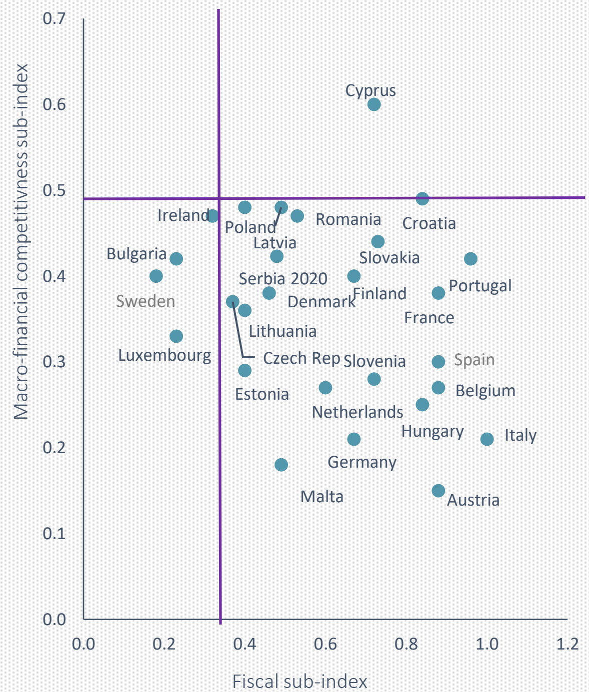
S0 EU countries and SerbiaS0 EU countries and Serbia



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 next 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 countris and Serbia in 2020



4. Fiscal projections for the period 2022–2024

Fiscal policy objectives are aimed at maintaining fiscal stability and reducing public debt share 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 public debt share to 53.8% of GDP. Projections of fiscal aggregates in the period from 2022 to 2024 are based on projections of macroeconomic indicators for that period, planned tax policy which envisages further harmonization with EU laws and directives, and fiscal and structural measures, including further restructuring of large public enterprises.

Thanks to fiscal consolidation measures in the previous period, a fiscal space was created that enabled implementation of extensive packages of measures in the framework of 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 on the revenue side - relief of tax burden on the economy 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, and to maintain the living standards of the citizens and help economic development, but also to ensure flexibility of response to any new crisis shocks.

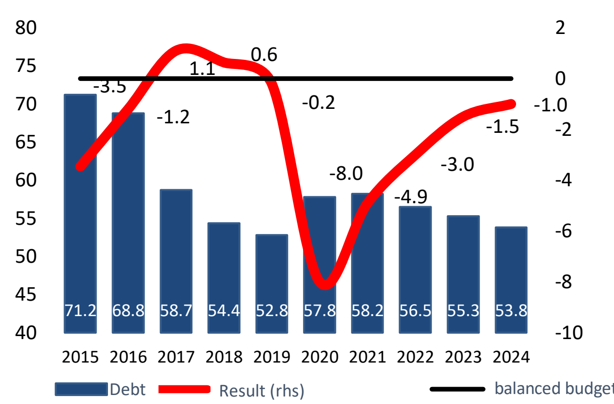
Table 10. Fiscal aggregates in the period 2020–2024, in % of GDP

Description	Realization	Estimate		Projection	
	2020	2021	2022	2023	2024
Public revenues	41.0	43.5	42.2	41.4	41.1
Public expenditures	49.0	48.4	45.3	42.9	42.1
Consolidated fiscal balance	-8.0	-4.9	-3.0	-1.5	-1.0
Primary consolidated balance	-6.0	-3.1	-1.2	0.2	0.7
General government debt	57.8	58.2	56.5	55.3	53.8
Real GDP growth rate	-0.9%	7.0%	4.5%	5.0%	5.0%

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 11. Total revenues and grants in the period 2020–2024, in % of GDP

Description	Realization	Estimate	Projection		
	2020	2021	2022	2023	2024
PUBLIC REVENUES	41.0	43.5	42.2	41.4	41.1
Current revenues	40.8	43.1	41.8	41.1	40.8
Tax revenues	36.2	38.9	38.1	37.4	37.3
Personal income tax	3.7	4.1	4.1	4.1	4.1
Corporate income tax	2.2	2.5	2.2	2.2	2.2
VAT	10.0	10.6	10.3	10.2	10.2
Excises	5.6	5.3	5.1	4.9	4.7
Customs duties	0.9	1.0	1.0	1.0	1.0
Other tax revenues	1.5	1.5	1.5	1.5	1.4
Contributions	12.2	13.9	13.9	13.6	13.7
Non-tax revenues	4.6	4.2	3.8	3.7	3.5
Grants	0.2	0.3	0.4	0.4	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 trend in 2022 as well, but will 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 most important measure of tax policy in 2022 is the increase of the non-taxable census from RSD 18,300 to RSD 19,300, with the reduction of contributions for pension and disability insurance payable by employer by 0.5 percentage points. The loss of revenues on this basis amounts to RSD 17.2 billion, of which RSD 14.2 billion are related to contributions and 3 billion to payroll taxes. On the expenditure side, there will be lower expenditures for salaries in the amount of RSD 3.5 billion, considering the decreased amount of gross salaries. The total effect of this measure on the general government balance amounts to RSD 13.7 billion.

The predominant form of personal 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 part of 2020 salary tax deferred within the anti-pandemic measures package, in the amount of about RSD 6 billion, and will be decreased by the extraordinary increase of the non-taxable census. 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 personal 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 total 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 RSD 30 billion, also in 2022, while reduced rates of pension and disability insurance contributions payable by employer will negatively affect revenues. 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 growth of the profitability of the economy in 2020, despite the slowdown in macroeconomic activities, has contributed to a significant jump in income tax revenues in 2021. Considering that a part of these revenues in 2021 relates to the carried over liabilities from 2020, in the period 2022-2024, stabilization of income tax collection is expected, in accordance with GDP movements.

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.

In 2021, several factors contributed to stronger-than expected growth of personal consumption, which contributed to an extraordinary increase in VAT revenues, such as government stimulus measures, deferred spending from the previous year and a good balance in the tourism and other service sectors.

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 EUR 1.8 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 will 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 is 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 revenue can be expected based on the expansion of its base. Increase in collection rate, through increased coverage of taxable real estates (i.e. based on expanded 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, since the inflatory component is incorporated in substantial part 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 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 balance, 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. Wages and pensions together account for over 40% 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	49.0	48.4	45.3	42.9	42.1
Current expenditures	42.8	40.1	37.5	35.7	34.9
Expenditures for employees	10.5	10.2	10.1	10.1	10.0
Purchase of goods and services	8.0	8.0	7.7	7.4	7.1
Interest repayment	2.0	1.8	1.8	1.8	1.7
Subsidies	4.6	3.5	2.5	2.1	1.9
Social assistance and transfers	14.7	13.9	13.8	12.9	12.6
of which pensions	*10.6*	*9.9*	*9.7*	*9.5*	*9.3*
Other current expenditures	3.0	2.7	1.6	1.5	1.5
Capital expenditures	5.3	7.8	7.3	6.9	6.9
Net lending	0.8	0.4	0.2	0.1	0.1
Activated guarantees	0.1	0.1	0.2	0.2	0.1

Source: Ministry of Finance

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

Increase in the expenditures for employees, which were at the level of 10.5% of GDP in 2020, was mostly due to the extraordinary increase in salaries of employees in the health system, as well as to 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.

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 8.7%. The average level of wages at the level of the general government in the EU, before the pandemic, was about 10% of GDP, while in 2020 it was raised to 10.9% of GDP. During 2020, in Serbia, as in all EU countries, the share of expenditures for employees in GDP increased.

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 wages of public sector employees. Given the effects of the pandemic on the structure of employees and wage levels in the public sector, the implementation of the new reformed wage system should begin in 2025.

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 wages, 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 1.7% of GDP.

Social assistance and social transfers constitute 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 10.6% of GDP. As of 2020, pensions have been harmonized with the so-called Swiss formula, in order to simultaneously ensure the growth of the living standard of pensioners and the sustainability of the pension system and the public finance system. The Swiss formula implies indexation, i.e. an increase in pensions equal to the sum of half the growth rate of the average wage and half the growth rate of consumer prices. It is estimated that in the coming mid-term period the indexation of pensions would be between 5 and 6%, and that in 2022 it will amount to 5.5%, while in 2021, specifically, it amounted 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 14.7% in 2020 to 12.6% in 2024. In 2022, a one-time payment is planned for all pensioners, in the amount of RSD 20,000, or about RSD 34 billion in total, which will be reflected in the social protection expenditures share in GDP.

The reduction of subsidies that serve to help inefficient segments of the public sector, enables increase in those subsidies that represent real incentives to the economy, primarily agriculture and small and medium-sized enterprises, which lead 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 for overcoming 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 share 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 5.3% 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 7.8% 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 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. As regards local level of government, this primarily refers to investments in water supply and sewerage infrastructure, waste management, local road infrastructure and others.

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 will have near 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 0.2% 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 meet 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 0.1% of GDP.

Structural measures to improve the stability and sustainability of public finances[5]

At the time of writing this document, Serbia is still confronting uncertain conditions caused by the COVID-19 pandemic, implementing the third package of measures to support the economy and the population, along with concurrent fight for the health and lives of its citizens, newly built hospital facilities and vaccine factories, and provided sufficient amounts of vaccines for all citizens, which in the foreseeable future should ensure the return of the state and society to normal flows. After the arrangement with the IMF was successfully completed at the beginning of the year, the Republic of Serbia concluded a new advisory arrangement with this institution in June. The new cooperation program - Policy Coordination Instrument (PCI) will last from June 2021 to the end of 2023, i.e. 30 months.

The new arrangement continues 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 in the medium term.

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 the next year. 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 in the coming period the same level of salaries for the same type of work in the entire public sector.

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 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

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

the level from the end of 2020. The development of “Iskra” electronic register of employees in the public sector is underway, and is planned to be implemented by the end of 2023, while a pilot project involving employees in the Ministry of Finance is already operational. The essence of this system is better planning, execution and control of expenditures for employees’ wages, greater transparency and better human resources management.

In order to reduce various forms of budget support to public and state-owned enterprises, restructuring of the largest public and state-owned enterprises continues. 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 October 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.

Solutions for the enterprises listed as strategic companies in the portfolio of the former Privatization Agency, are found either through privatization tenders or through bankruptcy. As regards transport company “Lasta” JSC Belgrade, privatization advisor was selected back in 2019, the capital evaluation procedure is about to be completed and there are parties interested in privatization. As regards Public Enterprise for Underground Coal Exploitation “Resavica”, an Action Plan has been developed, with the support of the World Bank, which includes finding solution for shutting down economically unsustainable mines and a rationalization plan, with a voluntary leave option and provision of funds for the Social Program and funds for business operation support, to prevent accumulation of arrears, especially dues to PE EPS (Electric Power Industry of Serbia). As regards petrochemical company HIP – Petrohemija, in response to the public invitation for the selection of a strategic investor, one bid was received, submitted by NIS company. The subject of this public invitation was to select a strategic investor that would become the owner of a 90% stake at the most through the recapitalization of the subject of the privatization in the amount of EUR 150 million. Should this bid be accepted, privatization is expected to take place by the end of the year. As regards nitrogen plant HIP Azotara, its bankruptcy was declared in September 2018, and after several unsuccessful auctions, the company was sold to “Promist” LLC in May this year, while for MSK Kikinda (“Methanol & Acetic Acid Complex“), 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 to investors. Public Financial Management Reform Program 2021-2025 was adopted in June this year.

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, Ministry of Labour, Employment, Veterans and Social Affairs and the Directorate for the Execution of Criminal Sanctions, which were not covered by the previous system (FMIS), which was replaced by ISIB in 2018. Only indirect beneficiaries of the Ministry of Education, Science and Technological Development are still not covered by the system, and their inclusion is expected in the forthcoming period. 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. Through the strengthening of the public investment management framework, new infrastructure projects are intensified and the quality of existing infrastructure improved. 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*), which has been established, so that the system may start functioning at the beginning of the next year, and become fully operational by the end of the year.

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 evaluate all proposals from the standpoint of cost-benefit and risk sharing analysis.

New Action plan for Tax Administration Transformation for the period 2021-2025, adopted in May 2021, defines strategic guidelines and deadlines for the implementation of activities required to build a modern tax administration, which will, using modern electronic processes, provide better and more comprehensive services to taxpayers and perform better control and collection of revenues, thus contributing to suppression of the grey economy, together with the reform and modernization of inspection supervision. The organizational separation of primary activities from those considered secondary was carried out, and now core activities are performed in a smaller number of organizational units, i.e. they have been consolidated. The analysis of business processes and required resources will enable the development of an adequate organizational structure and management, improved project management and design of an adequate structure of employees. The next phase of reforms is focused on information systems. A new fiscalization model (e-fiscalization) is being introduced, which will enable real-time control, reduce costs, increase efficiency and create a better business environment. The process of transition to the new system begins in November, and the transition period will last until the end of April next year. The state will support this process with direct subsidies to taxpayers for the purchase of new fiscal devices, in the amount of EUR 100 per location and additional EUR 100 per device, for which submission of applications has already started and will last by the end of 2022. 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 Large Taxpayer Center (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 related 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 assess liabilities under special tax accordingly. The Tax Administration played an important role in the implementation of certain 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 pre-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 Statistical Office of the Republic of Serbia (in cooperation with the Ministry of Finance and NBS) started submitting data to the Enhanced General Data Dissemination System (e-GDDS). These data are 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 reports for the general government level and by government levels and their publishing via National Summary Data Page - NSDP, which is accessible on the SORS website, as well as in the IMF's Dissemination Standards Bulletin Board (DSBB).

Comparison with the previous programme

The medium-term fiscal framework has been changed significantly compared to the last year's document,[6] in consideration of the negative effects of the pandemic on economic trends. 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 changes in the republic budget envisage 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 last year's 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[7]					
Revenues	40.4	39.3	39.1	38.0	–
Expenditures	49.3	42.2	40.7	39.0	–
Balance	-8.9	-2.9	-1.6	-1.0	–
Revised Fiscal strategy 2022–2024					
Revenues	41.0	43.5	42.2	41.4	41.1
Expenditures	49.0	48.4	45.3	42.9	42.1
Fiscal balance	-8.0	-4.9	-3.0	-1.5	-1.0
Difference					
Revenues	0.6	4.2	3.1	1.4	–
Expenditures	-0.3	6.2	4.5	1.9	–
Fiscal balance	0.9	-2.0	-1.4	-0.5	–

Source: Ministry of Finance

[6] Fiscal strategy for 2021 with projections for 2022 and 2023
[7] 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 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, solving 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 Fiscal Risks Monitoring Department, 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 result of these activities should be identification and assessment of risks and proposal of exit strategies, as support to the Government in preserving the stability of public finances, which is the key goal of fiscal policy and one of the main prerequisites for more dynamic economic growth.

In order to implement related process of fiscal risks monitoring, a Unified methodology for fiscal risks monitoring in the Republic of Serbia has been developed, which includes four basic methodologies, as follows:

1) Methodology for monitoring fiscal risks from public enterprises;

2) Methodology for monitoring fiscal risks from local self-government units;

3) Methodology for monitoring fiscal risks related to litigations;

4) Methodology for monitoring fiscal risks from natural disasters.

This very methodology, which is expected to be adopted in the fourth quarter of 2021, was developed on the basis of a draft methodology prepared by the World Bank.

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 RSD 50 billion.

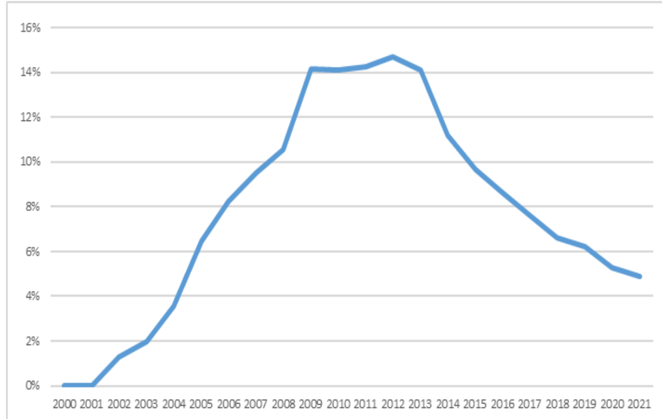
Inflation is a basic determinant of general macroeconomic stability. Due to the modification of the fiscal rules on the indexation of salaries and pensions, in the coming period, inflation will determine the movement of the total level of expenditures to a lesser extent than it was the case in the previous 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 public debt level, as well as the fiscal result, 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[8] are part of the indirect liabilities and are included in the public debt in their total amount[9]. 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 June 2021, they account for 4.9% 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 June this year, the debt balance was reduced by EUR 22.3 million, compared to the end of 2020, and amounts to EUR 1.4 billion, as at 30 June 2021.

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

Beneficiary	30 June 2021
PE “Srbijagas“	215.7
PE “Roads of Serbia”	270.9
“Serbian Railways” JSC	147.9
“Serbian Railways Infrastructure” JSC	64.1
“Srbija Voz” JSC	30.9
“Serbia Cargo” JSC	41.9
PE “EPS”	364.9
“EMS” JSC	30.6
Local self-government units (cities and municipalities)	187.6
“FIAT Automobiles Serbia” LLC	0.0
PE “Jugoimport – SDPR”	10.4
Serbia and Montenegro Air Traffic Services SMATSA LLC	0.9
“JAT Tehnika” LLC	2.3
PE “Transmitters and Communications”	6.7
PE “Ski Resorts of Serbia”	25.9
TOTAL	1,400.7

Source: Ministry of Finance, Public Debt Administration

[8] Law on Public Debt ("Official Gazette of RS", nos. 61/05, 107/09, 78/11, 68/15, 95/18, 91/19 and 149/20)

[9] 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 2020 amounted to RSD 11.4 billion, of which 7.5 billion affect the deficit. Until 2014, the accounting methodology did not include repayments based on guarantees into expenditures[10]. As of 2014, part of these expenditures is included in budget expenditures[11]. 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

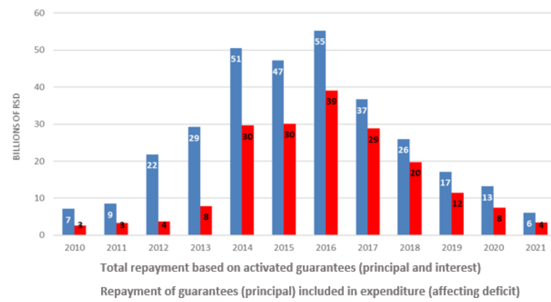


Table 15. Total paid liabilities on the basis of guarantees per beneficiaries, in billions of dinars

	2020			2021 (until 30 June)		
Beneficiary	Principal	Interest	Total	Principal	Interest	Total
PE "Srbijagas“	0.6	0.0	0.6	0.3	0.0	0.3
PE "Roads of Serbia“	3.9	1.3	5.2	1.8	0.6	2.4
"Serbian Railways“ JSC	4.2	0.5	4.6	1.6	0.2	1.8
“Galenika” JSC	-	0.0	0.0	-	-	-
PE “Transmitters and Communications”	0.3	0.0	0.3	0.1	0.0	0.1
“Serbian Railways Infrastructure” JSC	1.2	0.0	1.2	0.7	0.0	0.7
“Srbija Voz” JSC	0.1	0.0	0.1	0.1	0.0	0.2
“Serbia Cargo” JSC	1.2	0.0	1.2	0.6	0.0	0.6
PE “Ski Resorts of Serbia”	-	-	-	0.0	0.0	0.0
TOTAL	11.4	1.8	13.2	5.3	0.8	6.2

Source: Ministry of Finance, Public Debt Administration

Planned repayments under guarantees (total principal and interest) in the budget revision for 2021 amount to RSD 14.3 billion, of which RSD 3.52 billion, 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 2021 revised budget foresees the issuance of guarantees up to a maximum of RSD 133.6 billion for loans taken for the implementation of infrastructure projects.

[10] 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.

[11] 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 manoeuvrings, 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 "Djerdap 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 2,654 billion, while the final result was a net result of RSD 15.2 billion.

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

Description	2019	2020
Total assets	2,854	2,654
Equity	1,751	1,033
Total revenues	524.3	536.4
Net profit	-18.1	15.2
Subsidies	33.4	66.7
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 12.4% 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 Q2 2021

The total net result determined in the first half of 2021 is a profit of RSD 14.7 billion. 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 30 June 2021, in RSD billion

Business performance indicators	2019	2020	1 Jan–30 June 2021.
Operating income	496.7	504.5	271.9
Operating expenses	490.9	468.2	248.2
Operating profit	6	36.1	23.7
Net profit	-18.1	15.2	14.7
Cost of salaries *	111.9	110.8	49.3
Number of PE which made profit	25	25	22

* 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 half of the current year, 22 enterprises made a profit in the total amount of RSD 18.5 billion, which exceeds the plan (RSD 9.8 billion). The biggest contribution to the positive net result in the observed period came from PE “EPS”, which made a net profit of RSD 11.2 billion.

Table 19. Public enterprises which made net profit in the period 1 Jan–30 June 2021, in thousands of dinars

Enterprise	Realization 2020	Plan 1 Jan–30 June 2021	Realization 1 Jan–30 June 2021
PE “Srbijagas”	2,990,053	5,050,195	1,875,760
PE “Mreža Most”	7,863	0	5,299
PE “NP Djerdap”	9,165	5,287	6,325
PE “Ski Resorts of Serbia”	214,221	568,554	693,606
PE “Stara planina”	-900,504	3,877	5,396
“Corridors of Serbia” LLC.	0	0	87,030
Transnafta JSC	158,981	19,164	34,276
PE “Post of Serbia”	987,316	-140,423	1,660,687
“Reserve Uvac” LLC	2,639	1,278	2,830
“Prosvetni pregled” LLC	23,431	22,965	21,091
PE “NP Fruška gora”	9,048	18,810	8,473
Dipos d.o.o.	124,509	35,174	150,441
“Elektromreža Srbije” JSC	677,923	475,735	1,348,552
PE “NP Kopaonik”	18,456	28,651	59,741
PE Group “EPS”	11,704,025	762,772	11,211,021
State Lottery of Serbia LLC	112,755	14,480	101,325
PE “NP Tara”	37,699	140	6,750
PE “Nuclear facilities of Serbia” VINČA	249	528	8,955
“Serbian Railways” JSC	113,837	-159,198	16,493
PE “Srbijasume”	474,543	107,137	383,760
PWE “Srbijavode”	31,371	-2,594	19,962
PE “Roads of Serbia”	5,147,969	3,002,406	821,706

In the first half of the current year, 13 enterprises realized a net loss in the total amount of RSD 3.8 billion, which is less than planned (RSD 5.6 billion).

Table 20. Public enterprises which realized net loss in the period 1 Jan–30 June 2021, in thousands of dinars

Enterprise	Realization 2020	Plan 1 Jan–30 June 2021	Realization 1 Jan–30 June2021
PE “Transmitters and communications”	13,578	-94,729	-21,530
PE UCE “Resavica”	-2,481,390	-1,000,071	-626,401
“Serbia Cargo” JSC	-2,257,393	-851,547	-317,569
“Serbia Train” JSC	-1,054,587	-873,273	-631,813
“Metohija” LLC	562	849	-439
PE “Zavod za udžbenike”	-256,983	-243,898	-139,061
“Mokra Gora” LLC	141	29,405	-4,723
PE Skloništa	-63,226	-68,760	-27,328
PE “Official Gazette”	73,964	2,138	-61,788
“Infrastructure of Serbian railway” JSC	-1,975,348	-1,889,114	-1,169,085
“Fortress Golubacki grad” LLC	-204	-1,400	-5,971
PE “Jugoimport-SDPR”	1,286,363	-881,393	-801,456
“Park Palić” LLC	-4,891	-1,720	-614

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 (71.04%),
- *Srpska banka* JSC Belgrade (76.69%).

The reform activities concerning state-owned financial institutions, started in 2012, i.e. 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 2021-2025.

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 acts in compliance with the Law on Establishing 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. 153/20 and 40/21), and the Law on Establishing Second Guarantee Scheme as a measure of additional support to the economy due to the prolonged negative impact of the COVID-19 pandemic caused by SARS-CoV-2 virus ("Official Gazette of RS", no. 40/21).

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[12], 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

[12] 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 writeoffs 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 EUR 242 million, while on 30 September, 2019, it announced sale of the second, "large portfolio", with the nominal value of EUR 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, 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 RSD 333.0 billion, 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[13] 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

[13] 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 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 adjusted 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 2019 and 2020 show a declining profitability of banks. The banking sector of the Republic of Serbia operated profitably in 2020, with a net profit before tax in the amount of RSD 46.1 billion, which is 32% less than the result achieved at the end of 2019 when the net profit before tax amounted to RSD 67.7 billion.

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% (22.2% in June 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 EUR 1.5 billion, of the total available EUR 2 (two) billion, 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. The Republic of Serbia has recognized the need to approve an additional EUR 500 million of support for maintaining liquidity, thus the total amount of funds employed under the First guarantee scheme will come at EUR 2.5 billion. 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.

So far, 24 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 Republic of Serbia placed the planned EUR 2.5 billion with the Banks, while the Banks placed about EUR 2.1 billion with the clients. 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 support of EUR 500 million was approved. Accordingly, the projections of fiscal gross outflows in 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, EUR 21 million for 2023, and EUR 1 million for 2024. 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 EUR 14 million for 2022, EUR 16 million for 2023, and EUR 3 million for 2024. The projection of the fiscal gross outflows in the budget of the Republic of Serbia based on the second Guarantee Scheme envisages EUR 31.2 million for 2024, and the projection of the inflows for the same year envisages EUR 2 million.

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 RSD 4.8 billion. 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, Art. 300 of the Law on Enforcement and Security Interest (“Official Gazette of RS”, no. 106/15, 106/15 – authentic interpretation, 113/17 - authentic interpretation, and 54/19) 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 2020, over 50,000 Notices of Intent to Submit Motions for Enforcement were submitted to the Ministry of Finance, Treasury Administration, which were submitted by enforcement creditors in accordance with Article 300, paragraph 5 of the Law on Enforcement and Security. The debtors with the largest number of cases in 2020 were the Ministry of Defence, with a 12.24% share in the total number of Notices, and the Commercial Court in Kragujevac with a share of 9.32%.

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, while in the first eight months of 2021, RSD 8.5 billion were paid from the budget related to litigations. 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, while in the first eight months of 2021, the amount spent for these purposes was RSD 247.4 million.

As mentioned earlier, the development of the Unified Methodology for Monitoring Fiscal Risks in the Republic of Serbia is underway, which includes the Methodology for Monitoring Fiscal Risks From Natural Disasters and the Methodology for Monitoring Fiscal Risks Related to Litigations.

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[14]:

$$FB = CB + CAB$$

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 was 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.

[14] 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	Cyclically adjusted fiscal balance	Cyclically adjusted primary fiscal balance	Structural fiscal balance	Structural primary fiscal balance**	Fiscal impulse
2005	0.0	1.1	2.0	1.1	2.0	1.3	2.2	
2006	-2.7	-1.4	-0.1	-0.5	0.8	0.2	1.5	1.2
2007	0.8	-1.8	-1.2	-2.1	-1.5	-1.7	-1.2	2.3
2008	4.0	-2.5	-1.9	-3.9	-3.4	-4.0	-3.4	1.9
2009	-0.4	-4.2	-3.6	-4.0	-3.4	-4.1	-3.5	0.0
2010	-0.7	-4.3	-3.4	-4.1	-3.1	-4.2	-3.2	-0.3
2011	0.5	-4.5	-3.4	-4.7	-3.6	-4.9	-3.8	0.4
2012	-0.9	-6.4	-4.7	-6.1	-4.4	-6.1	-4.4	0.9
2013	1.2	-5.1	-3.0	-5.6	-3.4	-5.3	-3.1	-1.0
2014	-1.4	-6.2	-3.5	-5.7	-3.0	-4.8	-2.2	-0.3
2015	-1.1	-3.5	-0.5	-3.1	-0.1	-2.2	0.8	-3.0
2016	0.1	-1.2	1.7	-1.2	1.7	-1.1	1.8	-1.7
2017	-0.4	1.1	3.6	1.2	3.8	1.1	3.6	-2.1
2018	1.0	0.6	2.7	0.3	2.4	0.1	2.2	1.4
2019	1.9	-0.2	1.8	-0.9	1.1	-1.1	0.9	1.3
2020	-2.6	-8.0	-6.0	-7.1	-5.1	-0.3	1.7	6.2
2021	0.0	-4.9	-3.1	-4.9	-3.1	-0.7	1.1	-2.0
2022	0.0	-3.0	-1.2	-3.0	-1.2	-3.0	-1.3	-1.9
2023	0.2	-1.5	0.3	-1.6	0.2	-1.6	0.1	-1.4
2024	0.3	-1.0	0.7	-1.1	0.6	-1.1	0.6	-0.4

* 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.

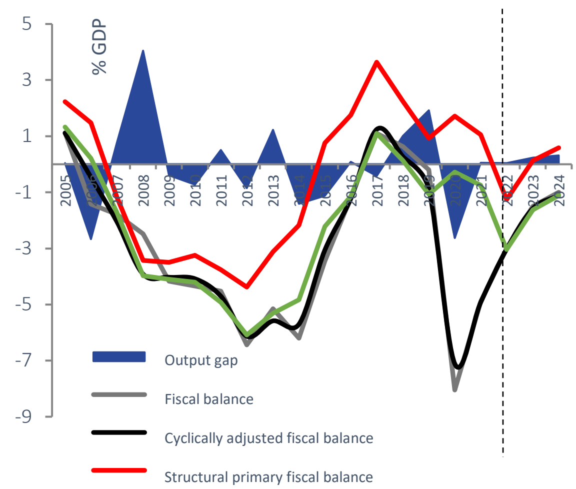
Source: Ministry of Finance

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 12.8% 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 2.6% 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 0.9% 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.

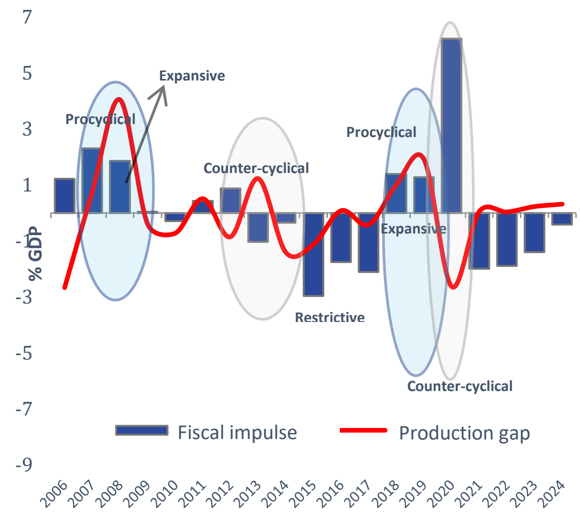
Due to the prolonged epidemiological and economic impact of the COVID-19 pandemic in 2021, it was necessary to adopt an additional package of measures of economic support to the economy and the citizens. The first and second rebalance of the budget for 2021, inter alia, envisage funds in the amount of 4.2% of GDP, as a form of support to the economy and citizens for easier overcoming of the economic consequences of the pandemic. The emphasis is 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 provide an additional stimulus to aggregate demand. The estimated effect of the third package of measures on the country's fiscal position is 2.3% of GDP.

Output gap, 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*

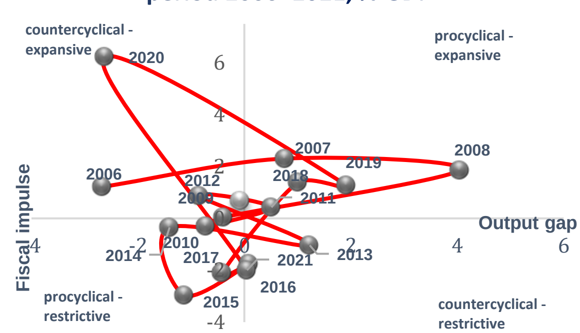


* For the period 2021–2024, the projected values are given.

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 fiscal 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 and further on, a temporary, but sustainable, deterioration of the structural fiscal position has arisen. Reduced scope of crisis measures creates room for a moderate increase in regular structural expenditures. On the other hand, increased share of public investment in GDP will have both a direct and indirect impact on accelerating economic growth in the coming period.

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 more restrictive than in the previous year, and of neutral nature. In the period from 2022 to 2024, restrictiveness still exists due to the abandonment of crisis measures and the reduction of the primary fiscal deficit. A certain countercyclical character is still present, due to the set goals of balancing and stabilizing public finances, in the conditions of a positive output gap.

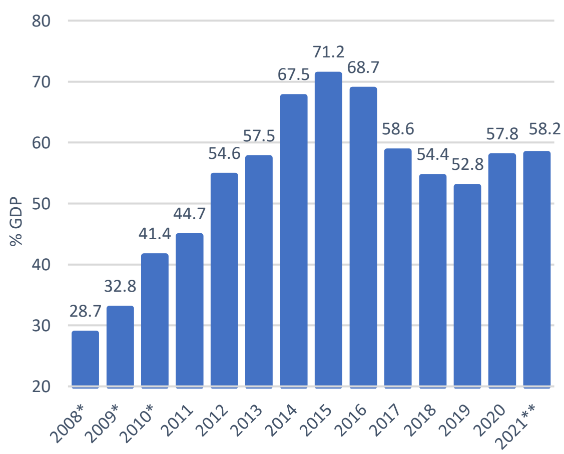
The nature and the effects of fiscal policy in the period 2006–2021, % GDP*



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[15]. 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
** 2021 estimate

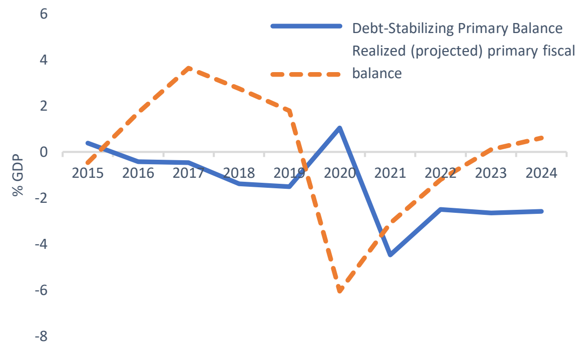
In the period from 2008 to 2014, the general government deficit increased significantly and at the same time public debt entered into the explosive growth path, with the debt-to-GDP ratio more than doubling. Fiscal consolidation measures adopted at the end of 2012 and during 2013 partially mitigated 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 1.6 pp of GDP.

Previous and the current year 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% of GDP (primary deficit of 6% of GDP) in the previous year and the estimated deficit of 4.9% 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 58.2% 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.

[15] 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 was recorded in 2020, when the highest negative value of this indicator was reached. In the period 2021-2024, 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 2028. The success of the previous program of structural fiscal adjustment enabled the reduction of the debt share by 18.4 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 and 2021, as well as the unhindered repayment of due debts. Uncertainty regarding the course and duration of the global pandemic, taken health measures as well as present global economic crisis, require fiscal policy to apply cautious in the upcoming period.

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

The assumptions in the baseline scenario are 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 2024;
- 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
Revenues	41.0	43.5	42.1	41.0	40.5	40.3	40.1	39.9	39.7
Expenditures	49.0	48.4	45.1	42.5	41.5	40.8	40.6	40.4	40.2
Decline of expenditure share		-0.6	-3.3	-2.6	-0.9	-0.7	-0.2	-0.2	-0.2
Fiscal result	-8.0	-4.9	-3.0	-1.5	-1.0	-0.5	-0.5	-0.5	-0.5
Primary fiscal result	-6.0	-3.1	-1.2	0.3	0.7	1.0	0.9	0.8	0.7
Public debt in GDP	57.8	58.2	56.5	55.3	53.8	51.4	49.0	46.8	44.8
GDP real growth rate, %	-0.9	7.0	4.5	5.0	5.0	4.0	4.0	4.0	4.0

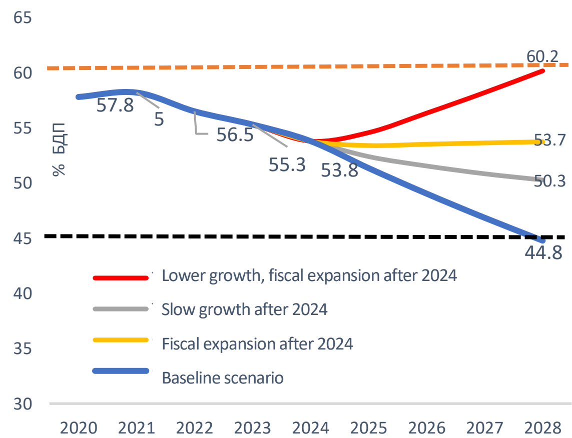
Source: Ministry of Finance

The baseline scenario envisages a reduction in public debt to around 45% of GDP in 2028. 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 2028, public debt under this scenario reaches a level of 50.3% 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 53.7% of GDP in 2028. 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.

The situation on domestic and international financial market, successful implementation of fiscal consolidation measures, along with good coordination of fiscal and monetary policy have 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 53.8% of GDP and, in accordance with the public debt management guidelines defined by the World Bank and IMF provides, in the framework of the Public Debt Management Strategy provides, a stress-scenario analysis of the effects of the foreign currency exchange rate in the domestic currency against the currencies in which the public debt of the Republic of Serbia is denominated.

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 4.59% at the end of August 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 debt-to-GDP ratio was reversed, and it 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 debt-to-GDP ratio fell to 53.6%, as at the end of 2019 when the ratio decreased to 51.9% of GDP. In order to reduce the impact of the crisis caused by the COVID-19 virus pandemic, there was a need to finance measures to support the economy and citizens, which resulted in a debt-to-GDP ratio of 57.0% at the end of 2020, and in August 2021 debt to GDP was reduced to 54.3%.

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 August 2021.

The positive fiscal results achieved by the Republic of Serbia were also confirmed through the movement of Serbia's credit rating. In 2019, *Fitch Ratings* and *Standard and Poor's* upgraded Serbia's rating to BB + from BB, while *Moody's* changed the outlook on Serbia's ratings to positive from stable. In 2020, the Republic of Serbia succeeded to maintain the unchanged credit rating it received in 2019. In March 2021, *Moody's* upgraded the credit rating of the Republic of Serbia to Ba2 from Ba3 in result of 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. Rating agency *Standard and Poor's*, in its report published on 11 June 2021, affirmed credit rating of the Republic of Serbia at BB + and kept stable outlooks for its further increase, the same as *Fitch Ratings* in its latest report from 3 September 2021.

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 aimed at minimizing 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 15 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 USD 1.2 billion, maturing in 2030. The coupon rate was 2.125%, and the final interest rate in euros, after 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 USD 900 million of Eurobonds issued in 2011 was made, out of the total of USD 1.6 billion that matured in September 2021. Bonds issued at a coupon rate of as much as 7.25% were prematurely redeemed. To lower financing costs and extend debt maturity, on 3 March 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%.

On 23 September 2021, the Republic of Serbia again moved the boundaries in the choice of financing its investments by entering the international green bond market. The green Eurobond was issued in the amount of EUR 1.0 billion with a seven-year maturity and at the lowest coupon rate ever of 1.00% an. The Republic of Serbia joined the ranks of the few European countries that have issued green Eurobonds on the international financial market, which are intended exclusively for financing environmentally friendly projects. At the same time with the issue of green Eurobond, a fifteen-year (15G) conventional Eurobond in euros in the amount of EUR 750 million was issued, at a coupon rate of 2.05% which is the longest maturity Eurobond issued by the Republic of Serbia so far, and which will additionally increase public debt maturity.

Guided by the best international practice of active public debt management, in December 2020, the Republic of Serbia realized 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 USD 1.2 billion, in euros, at a coupon rate of 1.066% on the nominal value of the issue after the conversion of EUR 1.016 billion. 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 RSD 11.6 billion 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 EUR 16.5 million. In April 2021, a new swap transaction was concluded under which the loan with Export - Import

Bank of China for the project of building a bypass around Belgrade on the E70 / E75 highway, which was initially contracted in Chinese yuan in 2018, was converted into euros with a negative interest rate. The loan, on which a fixed interest rate of 2.50% per annum in Chinese yuan was payable, was converted into euros at a fixed negative interest rate of -0.07%. As the negative interest rate has been agreed, the Republic of Serbia will not have any interest expenses in the first 5 years of the swap arrangement, which is valid until 2030, but will realize additional income from the banks with which the transaction was concluded.

During 2020, the issue of "benchmark" bonds on the domestic market continued. Bonds with a maturity of 5.5 and 12.5 years were issued in RSD with a nominal value of RSD 100 billion each, the volume of which increased to 150 billion each during 2021. On 30 June 2021, dinar benchmark bonds of the Republic of Serbia with maturities of 7, 10 and 12.5 years were included in J.P. Morgan GBI-EM Index. With the inclusion in the mentioned index, significant progress has been made in strengthening the liquidity of the secondary market of government bonds and coming of new international foreign investment funds ensured, which will result in greater competition and a further decline in borrowing costs. In October 2021, Clearstream, the international central securities depository, which performs clearing and settlement (ICSD) operations, opens a securities account in the domestic register and enables foreign investors to settle Serbian bonds, whereby another step towards further increase in investors base has been made.

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. In 2021, by mid-October, RSD 21.3 billion worth bonds with original maturity of 3 years, 3.75% coupon and maturity on 17 January 2022 were prematurely redeemed. Through these auctions, active public debt management was 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 and in the first eight months of 2021. The share of public debt in local currency in the total public debt on the central government level was only 2.6% at the end of 2008, while by the end of 2020 it surged to 30.5%, and reached 30.9% at the end of August 2021. The growth of dinar debt was primarily due to 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 realized, 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 realized by which liabilities in US dollars were converted into euros. Thanks to transactions from December 2020 and February 2021, the share of dollar debt in the total public debt decreased from 33.9% at the end of 2016 to 12.2% at the end of August 2021, while due to the repayment of the dollar Eurobond in September and new issues of Eurobonds in euros, its share is expected to fall to 10.5% by the end of September.

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, and is expected to be at 1.8% in 2021.

Thanks to the proceeds from the sale of *Komercijalna Banka*, in December 2020, the entire remaining amount of EUR 172.7 million 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 EUR 25.9 million.

At the end of August 2021, the total general government public debt amounted to RSD 3,389.2

billion, or 55.0% of GDP. Out of this, RSD 3,184.0 billion referred to direct liabilities, RSD 163.9 billion to indirect liabilities, while RSD 33.0 billion referred to the unsecured debt of local self-government units and RSD 8.3 billion to the unsecured debt of PE "Roads of Serbia" and the company "Corridors of Serbia" LLC.

General government public debt share in GDP, %

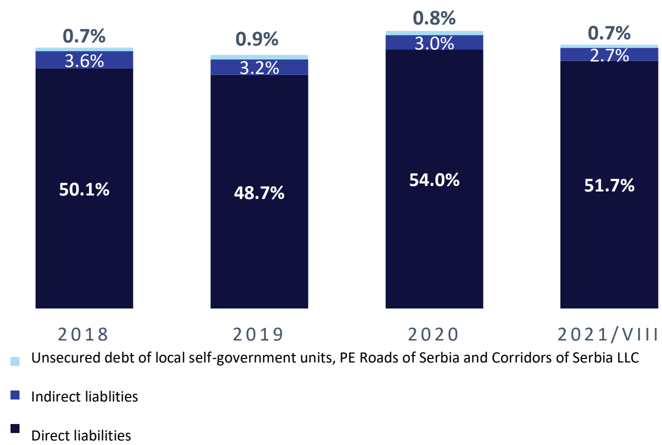


Table 23. General government public debt of the Republic of Serbia in the period from the end of 2018 to 31 August 2021

	2018	2019	2020	2021/VIII
Public debt (in billion RSD)	2,757.3	2,864.0	3,181.2	3,389.2
Public debt (in million EUR)	23,328.4	24,354.9	27,055.8	28,829.2
Public debt (in million USD)	26,669.1	27,296.9	33,254.3	34,079.0

In the first eight 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 eight months 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 USD 210.3 million 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.

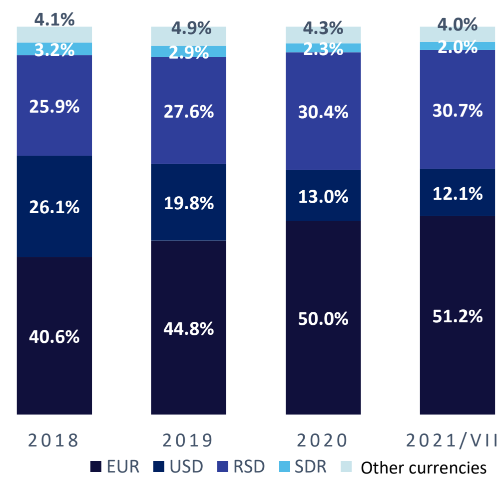
Table 24. Central government debt balance per original currencies in the period the end of 2018–31 March 2021, in millions

	2018	2019	2020	2021/VIII
EUR	9,216.7	10,582.5	13,222.5	14,450.6
USD	6,963.9	5,397.3	4,323.9	4,122.9
RSD	708,389.1	781,250.4	957,952.2	1,035,943.7
CHF	120.7	110.5	90.3	80.6
SDR	618.1	570.4	522.7	483.7
Other currencies (in RSD)	100,910.4	128,958.8	127,674.8	125,918.3

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 30.9% of the public debt of the Republic of Serbia at the end of August 2021, i.e. from RSD 708.4 billion, which was the amount of public debt in dinars at the end of 2018, to RSD 1,035.91 billion at the end of August 2021.

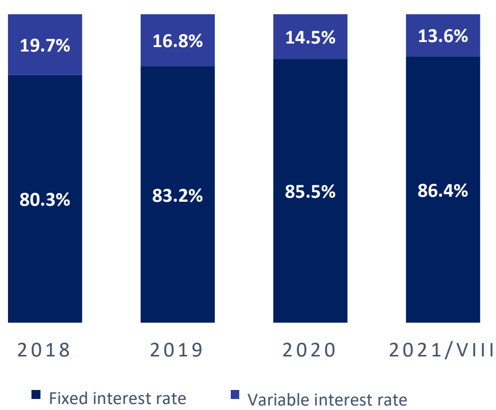
According to the data from 31 August 2021, the largest part of the general government public debt of the Republic of Serbia is still denominated in euros and amounts to 51.2%. It is followed by dinar-denominated debt in the amount of 30.7% and dollar-denominated debt in the amount of 12.1%. The remaining debt is denominated in special drawing rights (2.0%) and other currencies (4.0%). 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%.

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



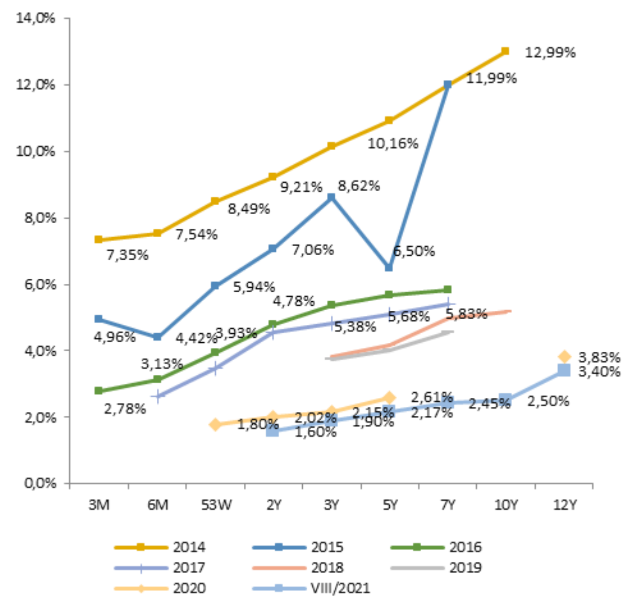
On 31 August 2021, the majority of the general government public debt of the Republic of Serbia was with the fixed interest rate – 86,4%, whereas the public debt with the floating interest rate accounted for 13,6% of the total public debt. Among the floating interest rates, the highest share hold EURIBOR and Euro LIBOR interest rates, accounting for 81,2%, then floating interest rate for special drawing rights, accounting for 11,9%, and USD LIBOR interest rate, accounting for 2,9%, while the share of liabilities with other interest rates was 4,0%.

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

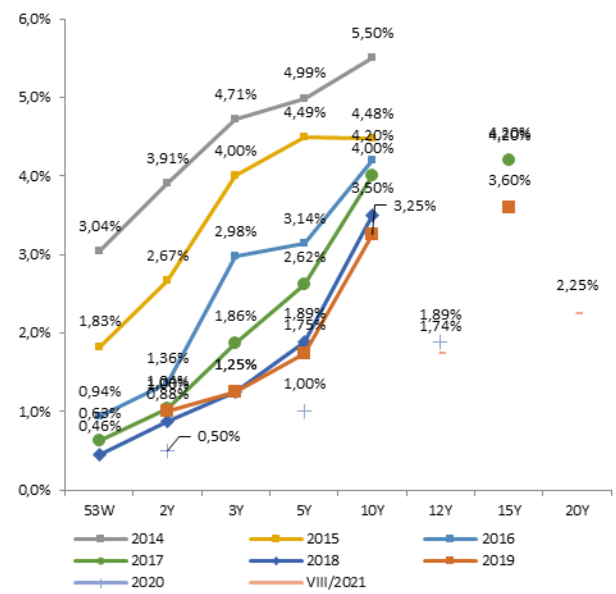


In the last few years, there has been a downward trend in borrowing costs, which is most pronounced in government securities issued on the domestic market. The decline was due to the development of the government bond capital market, the growth of the country's credit rating, i.e. the reduction of the risk premium, low inflation rate and the fall of the NBS key policy rate, which currently amounts to 1.0%, thus continuing the trend that began in the last quarter of 2012. The weighted average interest rate on public debt fell from 5.70% at the end of 2014 to 2.81% as at the end of August 2021. At the end of September, it will additionally fall to around 2.60%, thanks to new Eurobond issues and the repayment of an expensive Eurobond that was repaid during the month. The average coupon rate on dinar government securities decreased from 13.68% at the end of 2012 to 4.59% at the end of August 2021.

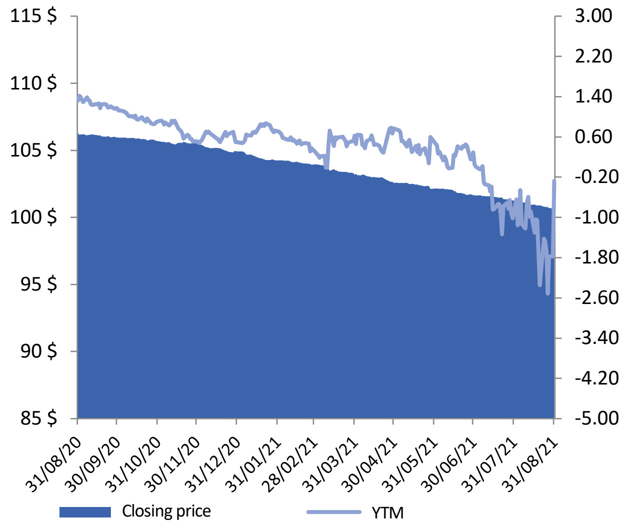
Overview of the trend of average effective interest rates in dinar-denominated securities in the period 2014–31 August 2021



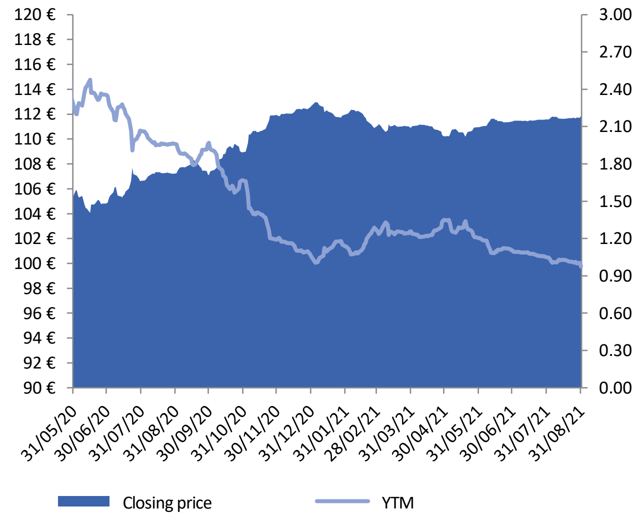
Overview of the trend of average effective interest rates in euro-denominated securities in the period 2014–31 August 2021



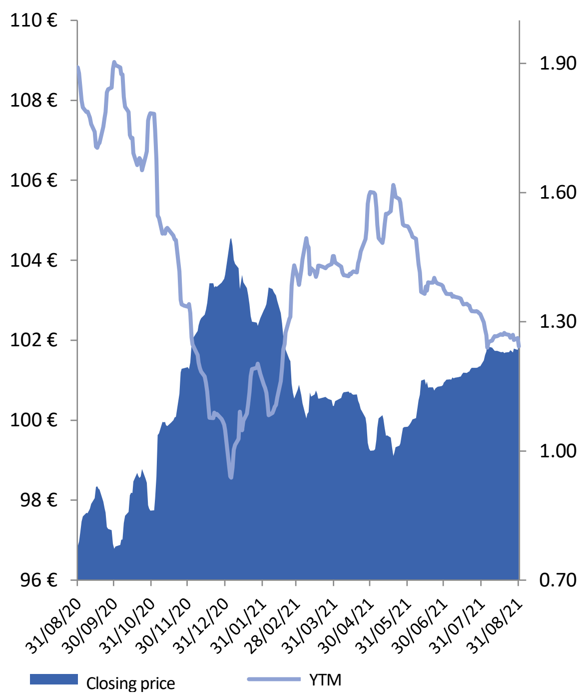
Overview of price trend and yield rates trend for Serbian Eurobond 2021



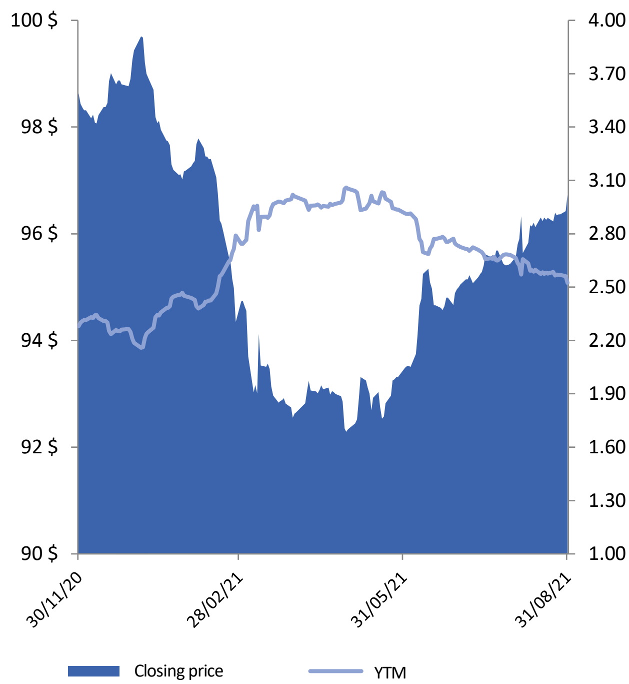
Overview of price trend and yield rates trend for Serbian Eurobond 2027



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



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



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

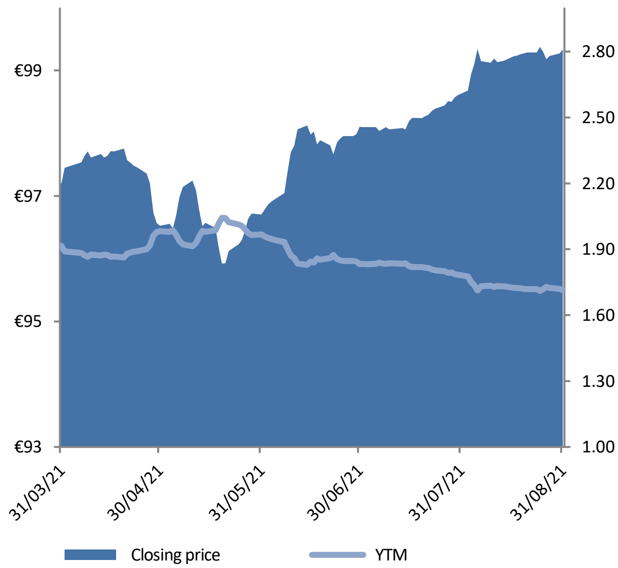


Table 25. Interests and principals repayment projections by 2024 (RSD billion)

	2021 p	2022 p	2023 p	2024 p
Principal	325.6	429.4	490.1	413.3
Interest	111.2	115.8	123.2	129.3
Total	436.8	545.2	613.4	542.6
Share in the public debt on 31 August 2021	13.0%	16.3%	18.3%	16.2%

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

	2021 p	2022 p	2023 p	2024 p
Principal	5.3%	6.5%	6.8%	5.3%
Interest	1.8%	1.7%	1.7%	1.7%
Total	7.1%	8.2%	8.5%	7.0%

Planned amounts for interests and principals repayment, 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, as well as insurance premiums on export credits

Projection of General Government public debt 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 2024 should amount to 52.7% of GDP.

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

	2021 p	2022 p	2023 p	2024 p
Public debt (central government), in RSD billion	3,529.8	3,682.3	3,893.8	4,085.8
Central government debt, as % of GDP	57.3%	55.5%	54.3%	52.7%
Non-guaranteed local self-government debt, as % of GDP	0.9%	1.0%	1.0%	1.1%
General government debt, as % of GDP	58.2%	56.5%	55.3%	53.8%

In 2021, a slight increase in the general government debt-to-GDP ratio, to 58.2% 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, as well as to provide in advance part of the funds for financing the deficit and debt that matures in the first quarter of 2022. 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 56.5%, at the end of 2023 - 55.3%, and at the end of 2024 - 53.8 %. 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. 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 and the rest of the government sector is envisaged to remain at the relatively stable level of about 0.9% 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, through the issue of government securities in the international and domestic capital market, 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. Part of the financing might be ensured also on the international financial market in the medium term. The establishment of the GMTN program in 2020 has enabled flexibility in the choice of financing and faster access to financing on the international market

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

The impact of financial and fiscal risks may lead to higher public debt growth than the baseline scenario envisages. 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 government level, the share of public debt in dinars increased from 20.9% at the end of 2016 to 30.9% at the end of August 2021. In the same time period, the share of public debt in US dollars decreased from 33.9% to 12.2%. The share of debt with a fixed interest rate increased from 73.2% to 87.1% in the period from 2013 to April 2021. In the same period, guaranteed debt fell from EUR 2.8 billion to EUR 1.4 billion and the average weighted interest rate on public debt fell from 5.64% to 2.81%.

Analyses used to create the Public Debt Management Strategy

Public Debt Management Strategy was formulated using a quantitative approach in the analysis of costs and risks that affect public debt management.

Having in mind the macroeconomic environment and market conditions, alternative sources of financing were considered in parallel.

For the purpose of analysis, 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, as well as from domestic commercial banks - 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.
- IMF allocation funds

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

After selecting the appropriate composition of financing sources (selected and comparative financing strategies), a cost-risk analysis is performed starting from the base case (most likely) scenario, followed by stress testing for additional types of scenarios - shocks, to obtain an overview of cost effects of the considered strategies.

The baseline scenario is based on the most probable market conditions for three groups of market variables: exchange rate, international market interest rates, and domestic market interest rates. 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;

Alternative borrowing strategies for the period 2022–2024

Based on the World Bank model *Medium Term Debt Strategy Model* - MTDS, the following alternative borrowing strategies were examined:

Baseline strategy (S1): under this strategy total financing needs are mostly met by using foreign currency financing sources in 2022 (60%) and 2023 (70%), while in 2024 it is planned to re-establish balanced financing from sources in domestic and foreign currency. Budget financing in 2022 is planned mostly from the issue of government bonds in domestic currency, from IMF allocation funds and a petty part from the issue of government bonds in euros. In 2023, it is planned to ensure approximately the same parts of the budget financing from the issue of government securities in dinars and the issue of Eurobonds. In 2024, budget financing from the issue of government securities in dinars is planned. As in previous years, project financing is provided mostly from loans denominated in foreign currency, from foreign creditors.

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 fifteen years.

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

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

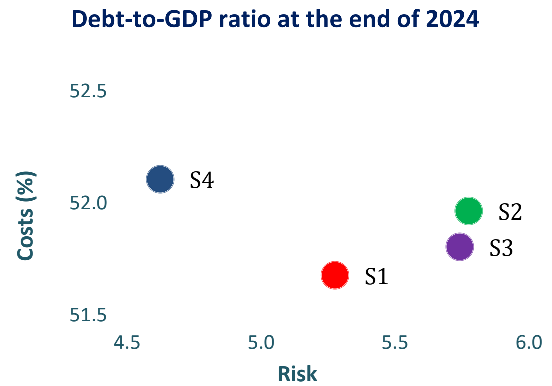
Alternative borrowing strategies were compared by applying two costs measures: the ratio of public debt to GDP and nominal interest as a percentage of GDP. The former is the status indicator, and the latter is the flow indicator. For the purpose of comparison, attention is focused on the results of the strategies examined, at the end of 2024.

Based on the chart, the costs associated with each of the considered strategies are clearly seen. The cost of alternative strategies in the baseline macroeconomic scenario is shown on the vertical axis of the cost chart, while the horizontal axis shows the potential cost of a particular borrowing strategy (the result of a stress test).

In the baseline macroeconomic scenario at the end of 2024, the S4 strategy has the highest debt-to-GDP ratio because it is based on the issuance of dinar securities, which is why it is more expensive than strategies that combine domestic and foreign currency borrowings (S1) and those based on financing only from government bonds in foreign currency (S2 and S3). Strategy S1 has the best cost position measured by debt-to-GDP ratio because it also includes concessional sources of financing (loans, allocations), unlike strategies S2 and S3 which are based exclusively on market instruments (government bonds in foreign currency). On the other hand, in case of deviation from baseline macroeconomic scenario the biggest risk to the debt-to-GDP ratio is related to changes in the exchange rate. Viewed from the aspect of exchange rate shocks, strategy S4 is best positioned because all financing is in dinars, while strategies S1, S2 and S3 have greater exposure to exchange rate risk because financing is based on sources in foreign currency. In terms of exchange rate risk, Strategy S1, which combines financing in domestic and foreign currency, has a more favourable position compared to strategy S2 and S3, where all financing is in foreign currency.

In terms of interests share in GDP, the S4 strategy is relatively more expensive and has a higher risk of increased interests share in GDP because it is exposed to fluctuations in dinar interest rates. Strategies based on sources of financing in foreign currency (S1, S3) have a lower interests share in GDP compared to strategy S2 (sources of financing in dollars) and strategy S4 which is based on domestic sources of financing which are the most expensive. The results of the stress analysis showed that the biggest risk for a change in the interests share in GDP, if the baseline scenario changes, comes from the shock of interest rate changes that is higher in the domestic than in the international market. If the above scenario of interest rate shock were realized, the interest to GDP ratio would increase the most in strategy S4, which is based on domestic sources of financing and is subject to interest rate fluctuations in the domestic market, while in strategies S1, S2 and S3 interest rate risk would be at a lower level. With the S1 strategy, the interest rate risk is the lowest because it also uses concessional borrowing instruments with a fixed rate, and not only market ones, as is the case with the S2 and S3 strategies.

Having in mind the above, it is evident that borrowings in the coming period by applying the chosen strategy S1 will have satisfactory results in terms of quantification of costs and risks arising from them.



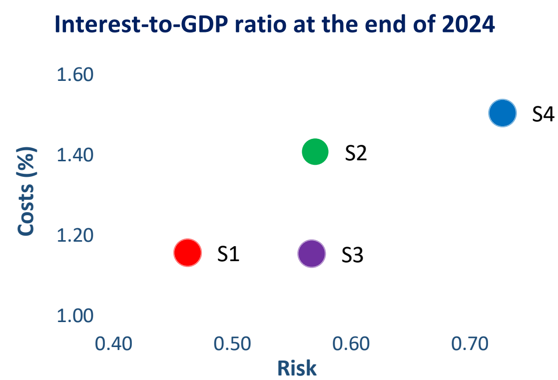


Table 28. Public debt-to-GDP ratio at the end of 2024

Scenarios	S1	S2	S3	S4
Baseline scenario	51.7	52.0	51.8	52.1
Foreign currency exchange rate shock (15% of all the currencies)	**57.0**	**57.7**	**57.5**	**56.7**
Interest shock (scenario 1)	52.1	52.6	52.4	52.7
Interest shock (scenario 2)	52.4	52.9	52.7	53.2
Combined shock (15% of USD and interest shock 1)	53.4	54.8	53.5	53.8
Maximum risk	**5.3**	**5.8**	**5.7**	**4.6**

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

Scenario	S1	S2	S3	S4
Baseline scenario	1.2	1.4	1.2	1.5
Foreign currency exchange rate shock (15% of all the currencies)	1.3	1.5	1.3	1.6
Interest shock (scenario 1)	1.4	1.8	1.5	1.9
Interest shock (scenario 2)	**1.6**	**2.0**	**1.7**	**2.2**
Combined shock (15% of USD and interest shock 1)	1.5	1.9	1.6	1.9
Maximum risk	**0.5**	**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

		S1	S2	S3	S4
Nominal debt (% GDP)		51.7	52.0	51.8	52.1
Applied interest rate (%)		2.3	2.8	2.3	3.0
Refinancing risk	ATM[16] external portfolio (in years)	8.7	8.9	8.6	6.9
	ATM domestic portfolio (in years)	6.6	3.8	3.8	8.0
	ATM total portfolio (in years)	8.1	8.2	8.0	7.5
Interest rate risk	ATR[17] (in years)	5.9	7.4	7.1	6.6
	Refinancing (% of total debt)	22.3	13.6	13.6	13.5
	Fixed rates debt (% of total debt)	84.7	92.1	92.1	92.1
Foreign currency exchange rate risk	Foreign currency debt (% of total debt)	72.5	86.4	86.4	47.8

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 57.0% of GDP, and the general government debt reached 57.8% of GDP. At the end of August 2021, the public debt-to-GDP ratio of central government and general government were 54.3% of GDP and 55.0% of GDP, respectively. By the end of 2021, a slight increase in the ratio is expected, to about 57.3% of GDP at the central level, or 58.2% 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 the high share of foreign currency-denominated debt (69.1%), 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 52.7% of GDP.

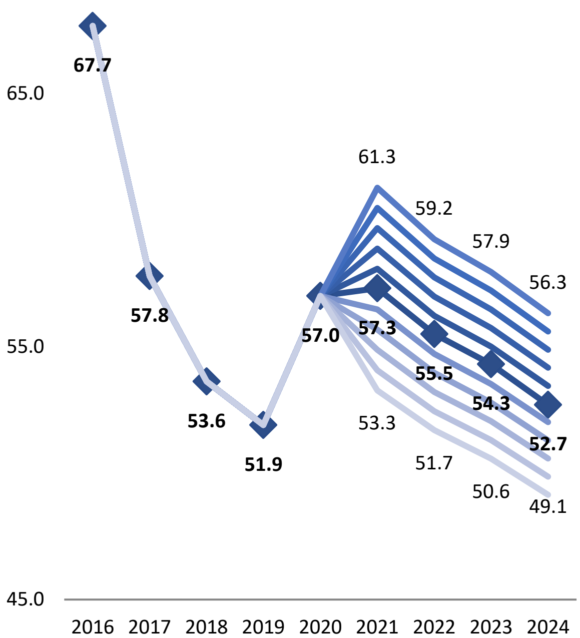
The main factors influencing the stabilization of public debt-to-GDP ratios include GDP growth, positive primary result, dinar exchange rate against foreign currencies and interest rates.

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	51.9	57.0	57.3	55.5	54.3	52.7
Changes compared to the last year, in% of GDP	-1.7	5.1	0.3	-1.8	-1.2	-1.6
Contribution of primary fiscal result	-2.2	6.4	3.1	1.4	-0.1	-0.5
Contribution of interests	2.0	2.0	1.8	1.7	1.7	1.7
Contribution of nominal GDP growth	-3.5	-0.8	-6.1	-4.1	-4.2	-4.0
Contribution of other factors	2.0	-2.5	1.5	-0.8	1.3	1.2

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

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



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 49.1% to 56.3%, while under the baseline scenario it would be at the level of 52.7%.

The main risks to 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.

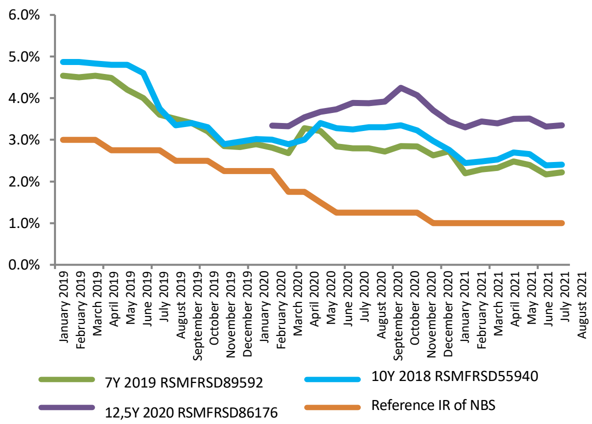
It is important to note that the reduction of public debt in relation to GDP will be enhanced by more adequate control over the issuance of guarantees and improvement of the process of prioritization of investment projects, which are financed from credit lines of multilateral and bilateral creditors. 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

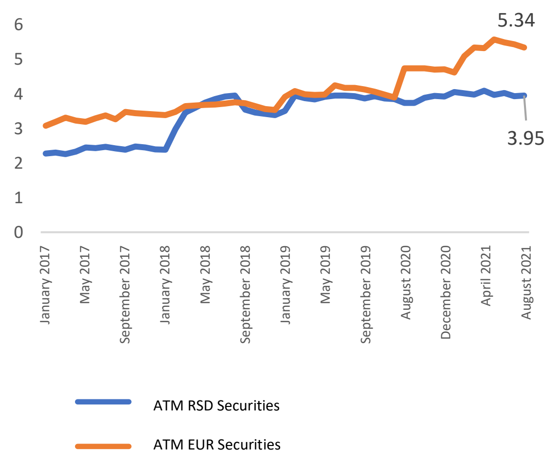
The main strategic goals that need to be pursued in the coming long-term period, in order to minimize the risks of increasing indebtedness and the cost of servicing public debt include the following:

- 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 included in the GBI-EM Global Diversified Index 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 August 2021



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

The government securities market, in the period from 2012 to August 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 August 2021 it amounted to 92.2%.

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 RSD 50 billion each. Also, an increase in the volume of the issue, in the amount of RSD 10 billion, 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. The share of foreign investors in dinar-denominated securities, at the end of August 2021 amounted to 20.9%.

On 30 June 2021, three dinar benchmark bonds were included in J.P. Morgan index of government bonds of emerging economies (GBI-EM Global Diversified Index), 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 access to Euroclear platform and 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 August 2021 it was 1.552 days (4.2 years).

The development of the domestic securities market will be supported by the following measures of the Republic of Serbia:

- Bonds of the Republic of Serbia are included in the global index which should significantly increase the investor base and additionally enhance secondary trading, which will further contribute to 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;
- 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. In October 2021 Clearstream became the first international central securities depository, which enabled foreign investors to directly settle government bonds denominated in dinars (RSD). Clearstream’s presence will contribute to a further increase in the participation of foreign investors and increase liquidity in the domestic capital market.
- During 2021 and 2022, intensive actions will be taken to harmonize legislation relevant for Central Registry connecting with Euroclear through the I-link platform.

The Republic of Serbia plans to establish iLink with Euroclear in the second half of 2022, so that at the beginning of 2023 the first government bond auctions will be settled via I-link.

The introduction of the iLink settlement system will further increase the participation of foreign investors and increase liquidity in the secondary market of government securities.

The Ministry of Finance of the Republic of Serbia expects that this step will significantly facilitate the access of foreign investors to the Serbian capital market.

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 Revised Fiscal Strategy.

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

05 No.: 400-9950/2021-1
In Belgrade, 3 November 2021

G O V E R 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, %	7.0	4.5	5.0	5.0
GDP at current market prices (in billion RSD)	6,163.0	6,638.7	7,175.9	7,747.6
Source of growth: percentage changes at constant prices				
Private consumption	6.4	3.7	3.6	3.3
Government consumption	2.8	2.3	1.2	1.2
Gross fixed capital formation	15.2	6.4	8.1	8.9
Exports of goods and services	15.9	9.4	9.9	10.4
Imports of goods and services	14.2	7.6	7.9	8.5
Contribution to GDP growth, percentage points				
Domestic demand	7.7	4.3	4.6	4.6
Private consumption	4.4	2.5	2.4	2.2
Government consumption	0.4	0.4	0.2	0.2
Investment consumption	3.4	1.5	2.0	2.3
Change in inventories	-0.5	0.0	0.0	0.0
Net export of goods and services	-0.7	0.2	0.4	0.4
GVA growth by sectors and net taxes, %				
Agriculture	-3.5	0.5	0.0	0.0
Industry	4.5	6.5	6.9	7.3
Construction	18.5	7.4	9.9	10.9
Services	8.4	4.0	4.6	4.6
Net taxes	7.1	4.0	3.9	3.7
Contribution to GDP growth, percentage points				
Agriculture	-0.2	0.0	0.0	0.0
Industry	0.9	1.3	1.4	1.5
Construction	1.0	0.4	0.5	0.6
Services	4.3	2.1	2.3	2.3
Net taxes	1.2	0.7	0.7	0.6
Price trends, %				
GDP deflator	4.7	3.0	2.9	2.8
Consumer prices (annual average)	3.7	3.7	2.6	2.5
External sector trends, % GDP				
Balance of goods and services	-8.1	-7.7	-6.9	-6.2
Current account balance	-3.9	-4.2	-4.1	-3.9
Fiscal indicator, % GDP				
General government fiscal result	-4.9	-3.0	-1.5	-1.0
Consolidated revenues	43.5	42.2	41.4	41.1
Consolidated expenditures	48.4	45.3	42.9	42.1
Gross debt of the general government sector	58.2	56.5	55.3	53.8

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 "Corridors of Serbia“ 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	**2,804.1**	**1,465.9**	**359.6**	**331.2**	**28.4**	**40.1**	**938.5**	**650.1**	**264.4**	**20.4**	**3.6**
Current revenues	2,778.1	1,442.4	357.6	329.2	28.4	40.1	938.0	650.1	264.4	19.9	3.6
Tax revenues	2,526.6	1,317.8	283.0	260.8	22.2		925.8	649.1	255.0	18.7	3.0
Personal income tax	274.5	87.7	186.8	177.6	9.1		0.0				
Social contributions	925.8		0.0				925.8	649.1	255.0	18.7	3.0
Corporate income tax	145.0	132.0	13.0		13.0		0.0				
VAT	684.1	684.1	0.0				0.0				
Excises	337.6	337.6	0.0				0.0				
Customs	63.3	63.3	0.0				0.0				
Other tax revenues	96.4	13.3	83.2	83.2			0.0				
Non-tax revenues	251.5	124.6	74.6	68.4	6.3	401	12.2	1.0	9.4	1.2	0.6
Donations	25.9	23.4	2.0	2.0		0.0	0.5			0.5	
Public expenditures	**3,004.3**	**1,346.0**	**454.5**	**385.5**	**69.0**	**58.9**	**1,144.9**	**716.7**	**400.0**	**21.5**	**6.7**
Current expenditures	2,489.9	914.5	388.8	320.8	67.9	45.0	1,141.5	715.9	398.0	21.1	6.5
Expenditures for employees	576.8	296.6	100.5	63.5	37.0	3.1	176.7	3.3	171.6	1.8	
Contributions paid by employers	96.2	52.5	16.3	9.3	7.0	0.4	27.0	0.6	26.0	0.4	
Purchase of goods and services	511.2	135.4	147.9	145.0	2.9	38.1	189.8	2.4	182.5	1.0	3.9
Interest repayment	118.6	116.2	2.3	2.0	0.3	0.1	0.0				
Subsidies	165.6	124.8	40.9	29.6	11.3		0.0				
Social assistance and transfers	914.7	120.6	49.8	49.5	0.2		744.3	708.5	15.9	17.5	2.5
Of which pensions	645.7		0.0				645.7	645.7			
Other current expenditures	106.7	68.4	31.3	21.9	9.3	3.4	3.7	1.1	2.0	0.5	0.1
Capital expenditures	485.8	403.0	65.6	64.6	1.0	13.9	3.3	0.8	2.0	0.4	0.1
Net lending	13.4	13.4	0.0				0.0				
Activated guarantees	15.2	15.2	0.0								
Fiscal result excl. transfers	**-200.2**	**119.8**	**-94.8**	**-54.3**	**-40.5**	**-18.9**	**-206.4**	**-66.6**	**-135.6**	**-1.1**	**-3.1**
Transfers from other levels of government	411.2	7.4	102.2	61.6	40.6	18.9	282.8	133.7	139.7	6.3	3.1
Republic budget	334.8	7.4	102.2	61.6	40.6	18.9	206.4	126.0	73.6	6.3	0.5
Cities and municipalities	0.0						0.0				
AP Vojvodina	0.0						0.0				
Pension & Disability Insurance Fund	67.2						67.2		64.6		2.6
National Health Insurance Fund	4.1						4.1	4.1			
National Employment Service	5.2						5.2	3.7	1.5		
Social Insurance Fund for Military Personnel	0.0						0.0				
Other levels	0.0						0.0				
Transfers to other levels of government	411.2	327.4	7.4	7.4			76.4	67.2	4.1	5.2	
Republic budget	7.4		7.4	7.4			0.0				
Cities and municipalities	61.6	61.6					0.0				
AP Vojvodina	40.6	40.6					0.0				
Pension & Disability Insurance Fund	133.7	126.0					7.8		4.1	3.7	
National Health Insurance Fund	139.7	73.6					66.1	64.6		1.5	
National Employment Service	6.3	6.3					0.0				
Social Insurance Fund for Military Personnel	3.1	0.5					2.6	2.6			
Other levels	18.9	18.9					0.0				
Net transfers to other levels of government	0.0	-320.1	94.8	54.3	40.6	18.9	206.4	66.6	135.6	1.1	3.1
Unallocated fiscal space	0.0		0.0				0.0				
Fiscal balance	**-200.2**	**-200.2**	**0.0**	**0.0**	**0.0**	**0.0**	**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 it, which are not included in the information system of budget execution.