Government of the Republic of Serbia
Office of the Prime Minister

THE ECONOMIC CRISIS
AND ITS IMPACT ON THE SERBIAN ECONOMY

Framework of Measures

December 2008

Introductory remarks

Several months ago the financial crisis which gripped the USA and soon spilled over to the European and other global markets, began with a sharp fall of real estate prices in the USA followed by default in mortgage payments. It turned out that the loans were inadequately insured to protect the creditors. Further developments showed that the creditors have systemically underestimated the importance of the insurance quality by issuing loans (not only mortgage loans) without sufficient guarantees. The creditors, who did not include only banks and different investment and other funds, suffered losses. This went on to have a ripple effect on small individual investors who have entrusted their assets to investment professionals as well as on other investors who have invested their funds in such a way. With the aggrivation of the financial crisis, the losses were multiplying and they began to affect an increasing number of participants on the financial market. Having transpired that the problem is of a system related nature, the crisis gradually started to spill over from the financial to the industry sector.

Initially, the crisis of the industry manifested itself through the decline of demand. Apart from the inability to collect claims which resulted in losses, in turn leading to market liqudity decrease, a further decline in market liquidity was caused by a very conservative approach when issuing new loans. Consequently, in addition to the construction business, other industry branches too were faced with the demand slump which first led to the economic growth slowdown and then to recession. At this moment it seems that the automotive industry was most hard-hid which, in regular circumstances, is the main generator of production in a string of other sectors of the economy.

In order to mitigate the crisis side effects, the developed countries have designed programs aimed at stimulating market liquidity. To that end, huge funds have been allocated and are ready to be injected into their economies. Bearing in mind the fact that the developed countries' economies are predominantely based on a concept contrary to that based on government's intervention, difficult and comprehensive debates are currently underway as to what to do next. However, it appears that a concensus on the general approach has been reached, implying that the market illiquidity, which is considered as the main cause of the demand decline (and consequently of production) can be cured only through pumping additional funds into the economy through various channels and in different forms.

The Serbian banking i.e. financial sector did not experience initial losses in a way as described above. Namely, the participants on the Serbian financial market did not take part in the financial products related transactions similar to those which were the financial crisis triggers in the developed countries, and the market itself is of such a limited scope that it had virtually no impact on the industry. At the same time, the long term macroeconomic position of Serbia is characterized by a distinct balance of payments deficit resulting from the foreign trade deficit. This indicates three basic facts:

(1) In Serbia, spending is far greater than production and the excess spending is financed by foreign sources (foreign investment – greenfield, or securing additional capital, loans – mostly private, remittances, etc.)
(2) Excessive spending is closely linked to overheated demand, i.e. ultimately to excessive liquidity on the market, and
(3) High GDP growth is closely related to high demand generated by foreign funds (of different kinds) but also by funds from local sources.

Having this in mind, it means that the beginning of the economic crisis in developed countries was evolving under different circumstances when compared to circumstances in Serbia. At the same time, the developed countries experienced the onset of the crisis through the decline of the market liquidity, while Serbia on the other hand expects the beginning of the economic crisis in the circumstances of overheated demand.

I The Expected Impact of the Finacial Crisis on Serbia's Economy

Regardless of the fact that the financial sector in Serbia suffered no losses due to inadequate investment guarantees, it is expected that in the upcoming period the global financial and economic crisis will have a spill over effect on the Serbia's economy.

Serbia's biggest problem and macroeconomic risk is the already mentioned balance of payment deficit. At the same time it is also the weakest link which is expected to be the gateway for the ripple effect of the global economic crisis. Concretely, the realistic scenario could be:

(1) A decrease in funds available to Serbia due to the developed markets' illiquidity. It is expected that the first to decline will be the loan instruments, both of those directed through banks whose founders are in developed countries as well as those taken by our companies directly from foreign banks. Furthermore, the inflow of direct foreign investments can be decreased or at least slowed down, with foreign investors being more cautious when deciding on investments.

(2) The decline in foreign funds for the above mentioned purposes will raise the question of sources of financing of balance of payment deficit. Consequently, the pressure on foreign currency reserves and dinar exchange rate will grow and ultimately the pressure will also increase on the level of current spending in the country.

(3) The spending will have to be reduced either in an organized and controlled manner or it will be done by the market itself through a considerable devaluation of the national currency and internal inflation.

(4) The reduction of spending (demand) in the country coupled by the general demand decrease abroad will directly impact the production, i.e. the growth of the Serbian economy.

(5) The pressure of foreign producers wishing to sell their products on our market will grow, while at the same time our producers will have difficulties selling their products on foreign markets. Hence, the competitiveness of our economy will be challenged more than ever before.

(6) The consequences of the aforementioned trends will result in economic growth slowdown or standstill followed by corresponding consequences in terms of employment, standard of living and the life in the country in general.

The expected effect of the economic crisis can be mitigated in different ways. First of all measures aimed at boosting liquidity in developed countries (as the crisis response measure) will also have a positive effect on our economy since they creates funds which will be available for investment on our market. In addition, the issue of increasing the economy's competitiveness is something our economy as well as the economies of other countries in the region will also be faced with. It is safe to say that in the short term, our economy has a better chance of being more competitive on the regional than on the global market. This also raises the question of the sectors of the economy that would be most hard hit as well as the sectors that are not going to be as affected by the economic crisis. According to the current analysis, the most affected will be the metal producing and processing industry while the construction industry will also be negatively affected by the economic crisis. The current trends show no signs that the food manufacturing and processing industry will be severely affected by the crisis. In any case, the regional countries will remain important foreign trade partners for us, thus this should be kept in mind when defining the economic policy objectives.

II The Principles for Defining and Implementing Measures

The basic principles for defining the measures framework, as well as for defining and implementing certain measures which are within the scope of competence of the Government and other competent institutions are as follows:

(a) Unity,
(b) Solidarity,
(c) Continuity.

A successful implementation of measures requires unity of all key institutions of the system, as well as of other relevant factors with the decision making power. This is the reason why at the first signs of global economic crisis the Government established a working group which includes representatives of the most important financial system institutions which in continuous contact with all key factors of the Serbian market. In addition, the Government prepares and adopts all measures by consensus thus additionally strengthening the unity for the implementation of those measures. The best example of this practice is the Law on the Budget of the Republic of Serbia for 2009 which has been in preparation for a longer period of time than in the previous years, precisely for the sake of the much needed unity necessary for an efficient implementation of measures included in the budget.

An efficient implementation of measures geared at mitigating effects of the economic crisis is possible only if the proposed measures are accepted by the citizens of Serbia and for this to be achieved it is necessary to distribute the burden evenly among the largest interest groups. Therefore, the principle of solidarity has been accepted as a basis for defining economic policy measures and is strictly implemented in all segments. As a result of this policy, the 2009 budget provides for the equal treatment of the employed and the retired persons and it also includes an increased level of social welfare for the most vulnerable groups.

Bearing in mind the fact that the extent of the economic crisis is not yet not known globally, even less so which segments of the Serbian economy will be most hard hit, it is necessary to monitor these effects continuously and promptly react to each and every new aspect of the crisis.

III Framework for Defining the Measures

The measures to be taken must be partially restrictive and partially stimulating. The restrictiveness of the measures comes from the need to decrease the spending in an organized way so as not to have the market do that through inflation and drastic devaluation of the national currency. At the same time, the measures must be stimulative in order to avoid the recession and maintain the GDP growth continuity, even if it means a more moderate GDP growth rate as compared to the previous couple of years.

The measures will include all segments of the economy and society, but at the same time taking care not to disrupt the market economy concept as the basis of the economic system.

In addition, the measures implemented by the Government of Serbia must be tailored to the specific needs of the Serbian market and cannot be mere cut-and-paste of measures implemented in the countries of the region or globally, because the causes of the crises differ from country to country.

The areas impacted by these measures are as follows:

- (a) The state (in the broadest sense),
- (б) The economy (industrial and financial sector),
- (в) The general population.

In the area of the economy, incentives will continue to be offered to small and medium size enterprises and entrepreneurs followed by a tighter control over the use of funds, in particular in respect of the achieved results. In addition, export oriented economy in general will receive support, especially in those segments facing fiercest competition, so as to reduce the foreign trade deficit. Particular attention will be given to foreign investments coupled by significant stimulating non-financial measures in the areas of regulations, creation of local favorable conditions and new employment incentives. The financial sector will receive government guarantees as a basis for the implementation of certain incentive measures in the industry sector, while incentives for citizens' savings accounts will also be introduced this being the main national source of investment activity.

The overall state administration sector will implement economy measures taking into consideration the overall level of public spending but also some of its individual components. The decrease of overall public spending should contribute to the competitiveness of the economy in respect of other countries in the region and it must not be a factor of macroeconomic instability in any way. In respect of particular components of the government spending the general rule will be that savings should mostly be made in the current expenditures, while the spending of a stimulating nature (both specifically and generally) must be very carefully projected. Naturally, the social character of the state will be fully affirmed (in accordance with actual capacities, of course), i.e. the most vulnerable groups of population will be provided with at least the current level of protection. The portion of subsidies (those subsidies defined by the budget as assistance, not incentives) will be restrictive while their use will be under closer scrutiny.

As for the general population sector, on average, the spending will be adjusted to the current revenues to greater a extent than before. The effects of the measures taken should provide a continuity of the GDP growth which also means the continuity in the growth of the income of the population. Generally, all the measures to be taken in the sectors of the economy and the state are designed to preserve the standard of living of the population and to weather the crisis in such a way as to perceive this crisis as a slowdown rather than a drastic drop in the standard of living and return to the years of poverty.

IV The Framework of Measures

1. Measures in the Sector of the State (restrictive)

(1) Direct Beneficiaries of the Budget

- The budget is generally restrictive with a 1,5% GDP deficit;
- The salaries of budget recipients are planned restrictively - salary growth is allowed only up to the level of the projected inflation (the stock is higher by approximately 8% as compared to the last year);
- The pensions were planned restrictively and in 2009 they remain at the same level;
- The social entitlements in the stock increase to the level of the projected inflation;
- The expenses for business trips and services (except with beneficiaries where expenses are unavoidable) have been decreased by 8% in actual amount, as compared to the last year;
- The subsidies have been limited to 84% of the nominal amount for last year. The control over the use of subsidies is introduced, i.e. a special spending regime is introduced in the institutions which are subsidies beneficiaries. In addition, control over the use of special purpose subsidies is introduced in particular the control of effects of incentive subsidies. In case of unspecified purpose spending, the contract is terminated and funds are withdrawn for reinvestment, while in case of inadequate results the subsidies model is altered.
- Introducing stimulating and punitive measures for the purpose of reducing gray economy;
- Improving the efficiency of office and renatal space utilization owned by the Republic of Serbia;
- Enabling the privatization of the communal land for development;
- A more responsible approach to state revenues (revenue agency, funds, public and utility companies) within the executive, bankrupcy and liquidation procerues (in particular in those cases where the property has already been sold off);
- Improving the system of human resources management at thel level of the whole state administration – no increase in the number of employees;
- Increasing the capacity of the budget inspection;
- More restrictive rulebooks on the use of service cars for budget beneficiaries.

(2) Companies and Organizations where the Republic of Serbia has the Majority Ownership

- Regulating and stipulating the maximum compensation for managing and monitoring board members;
- Regulating and stipulating the criteria for the salaries of managing directors – motivation scheme for increasing business efficiency;
- Introducing restrictive mechanisms for the dismissal of managers in case of deviation from business and financial plans;
- Salaries of employees are planned restrictively – the salaries increase only up to the level of projected inflation;
- No new employees;
- Improving the efficiency of office/residential space and car use. Termination of new procurements and using rent-a-car services for passenger cars over 1.500 cm^3 capacity;
- Cutting expenses for representation, business trips, fairs, professional development, part time employment and piece work contracts, etc.
- Cutting all other costs which are not directly linked to the business activities of the company;
- Decreasing subsidies – linking subsidies to increased business efficiency;
- More efficient and controlled public tender procedures.
- Quarterly planning of and reporting on business and financial results.
- Dislocation of the company's/organization's head office for the purpose of cutting costs and achieving a more even regional development, wherever possible.
- Giving recommendation to local self government units to implement a similar string of measures to companies/organizations operating at the local level.

2. Measures in the Sector of the Economy (stimulating)

(1) Increasing liquidity of the economy through:

- Issuing soverign guarantees for the amount of 40 billion dinars to the benefit of the National Bank of Serbia whcih would approve loans to banks which would then offer loans to businesses on favorable terms;
- Incentive loans from the Development Fund in the amount of 18.7 billion dinars;
- International loans for infrastructure development:
  (a) World Bank – USD 388 million
  (b) EIB - EUR 540 million
  (c) EBRD - EUR 150 million
- Favorable loans for the development of small and medium size enterprises (APEX loans) in the amount of EUR 250 million;
- In cooperation with the NBS, implement the package of measures which would cause the high liquidity in the banking sector to spill over into the economy.

(2) Increasing exports through:

- Providing working capital under favorable terms for effecting export related activities;
- A higher level of export contracts insurance;
- Eliminating customs and duties barriers;
- Financial support to product certification;
- Supporting exporters in finding new markets in countries which are not as hard hit by the crisis, i.e. those maintaining a high growth rate.

(3) Increasing domestic demand through the implementation of infrastructure projects – targeting the most vulnerable sectors: construction industry, construction materials, metal and metal products industry:

- Corridor 10;
- Corridor 7;
- Reconstruction and streamlining of infrastructure within public enterprises;
- Construction of co-op apartments;
- Development of rural infrastructure.

(4) Increasing investments by creating a favorable business climate:

- Regulatory guillotine – building permits, issuing consents, red tape;
- Reviewing the possibility of allowing free-of-charge use of land and infrastructure, as well as tax breaks for manufacturing capacities employing more than 100 people – applied to greenfield and brownfield investments (property of companies which are undergoing the restructuring process and are located outside the Greater Belgrade Area);
- Privatization – installments payment option for all methods of capital or property sale;
- Utility infrastructure – creating regulations and institutional preconditions for the modernization of public utility enterprises;
- Opening the market for the construction of new production capacities in the energy sector.

(5) Decreasing the fiscal burden :

- Interest write-off for unpaid taxes and contributions if they are now settled on regular basis.
- Past remaining obligations for health care will be frozen if the current ones are regularly paid and they will finally be written-off after five years of regular payment of the current obligations.

3. Measures in the Financial Sector

Increasing the trade in securities
- Abolishing capital gain tax when trading in securities,
- Abolishing taxes on the absolute rights transfer when trading in securities.

Other measures within the financial sector have been defined by the National Bank of Serbia and are an integral part of the Republic of Serbia Government set of measures.

4. Measures in the General Population Sector

Increasing savings accounts:
- The foreign currency savings accounts guarantee has been increased from EUR 3.000 to EUR 50.000,
- Abolishing savings tax until the end of 2009.

Employment:
- Companies which receive incentive funds are under the obligation not to reduce the number of employees,
- Increasing the effectiveness of the Employment Bureau in the area of retraining and new jobs search.

Social welfare:
- Social spending are at the same level as in 2008,
- Targeting socially vulnerable categories (amendments to the Law on Social Protection) – to assist those in need through better identification of socially vulnerable categories, to a greater extent than before.