
From the Editor



This, dear reader, is the twentieth issue of the *Quarterly Monitor (QM)*; an anniversary, we believe, testifying to a result that is not altogether easy to achieve in a transition country such as Serbia. Speaking of challenges of transition, we still think that medium-term orientation is key; it is as early as *today* that a credible and firm plan should be adopted for cutting the budget deficit and reigning in public debt over the next five years. The moment is favorable for such a policy as there are indications that this year's depreciation of the dinar has set exports in motion, which has in turn spurred on a mild recovery in production. Obviously, structural reforms mentioned in previous issues of *QM* are yet another important medium-term factor in ensuring economic growth for Serbia.

The recently-completed round of negotiations between the Serbian Government and the International Monetary Fund also focused on fiscal policy – the key instrument of economic policy available to Serbia today. Another piece of good news for Serbian economic stability and recovery is the fact that the Government has gone back on its promise of unfreezing wages and pensions by the end of the year, bowing to dominant professional opinion (including that of *QM*), although the IMF's views are also likely to have played a role. No less important is the agreement in principle for wages and pensions to grow at a moderate pace until 2012 (an election year) – meaning an increase equal to the inflation rate plus one half of GDP growth.

Bad news, however, concerns the budget deficit: instead of 4% of GDP, as planned, it will stand at 4.8%, and perhaps even reach as much as 5%. The reason behind this is lower-than-expected tax revenue; planned expenditure is not set to rise. As tax revenue was lower due to the slower recovery of the economy, the increase in the deficit is economically justified (anti-cyclical policy); the alternative – reducing expenditure – would jeopardize the fragile recovery. Here we would do well to warn, however, of the probable beginning of a medium-term trend of a relative drop in tax revenue in relation to GDP. Due to the necessary readjustment of Serbia's economy from consumption and imports to investment and exports, the tax base (consumption, imports) is set to shrink considerably, meaning that less revenue can

be achieved using current tax rates. As *QM* has already indicated, this will make it considerably more difficult to reduce government deficit over the next five years, or, rather, will call for a major cut in current public spending. Thus an increase in some tax rates in the medium term should not be ruled out, ideally as part of comprehensive taxation reform.

Nevertheless, uncertainty remains as to whether there is a firm and credible commitment and planning for Serbia to extricate itself from high budget deficits and mounting public debt. A credible plan is required *today* to attract investors – both foreign and domestic – and thus ensure necessary economic growth. It is important to bear in mind the so-called “contagion effect”: given the widespread crisis in Southern Europe, investors are viewing countries in the region with a great deal of caution. Serbia's history of inflation, budget deficits and regular debt servicing is not a rosy one; thus the country needs to show above-average discipline when it comes to government spending, deficit and public debt to convince others it is a safe place to invest.

The bottom line is that the high government deficit, amounting to 5% this year and probably over 4% next year, needs to be cut to not more than 1% in 2015. To say that the Serbian public debt is not a problem is to be deluded. It is true that debt does not now stand at a particularly high level, but the pace of its growth is quick. In addition, as a rule, crises uncover previously concealed debts (activated government guarantees, local debts, etc); certain revised estimates put Serbia's debt at 36%, up from 32%. Finally, crises often force governments to assume a portion of private debt to prevent social disturbances and layoffs, and the Serbian private debt is very high.

In addition to all of the above, there is yet another channel that rising public debt can use to jeopardize economic stability, drive off investors and stifle economic growth and employment – its impact on an increase in foreign debt. Serbia's total foreign debt, both private and public, is already critically high, at over 70% of GDP. A comprehensive international empirical study of the impact of debt on economic growth, covering various countries and periods over the last two hundred years,

indicates that a critical level of foreign debt for developing countries is 60% of GDP. Anything exceeding that leads to a drop in economic activity by an average of two percentage points. Taking Serbia as an example, this would mean that, after the crisis is over, its economy will grow at a rate of 3%, instead of the expected 5%. Any future increase in Serbia's public debt will primarily be due to foreign borrowing, which further leads to an increase in foreign debt, already, as we have seen, exceeding critical levels. There is yet another finding of the study referred to above that is important for Serbia: critical debt levels vary from country to country, and depend on a nation's history of inflation, debt servicing and the like; for some countries, the critical level can be as low as 15% to 20% of GDP.

Fiscal adjustment – the reduction in government deficit and control of public debt that Serbia can be expected to undertake over the coming five years was attempted by many countries in many different periods. We may find it interesting to consider Ireland's experiences from the 1980s, an unsuccessful one (1982) and a successful one (1987). In the first case, fiscal adjustment was preceded by the appreciation of the national currency, and in the second, by its depreciation. Italy (in the 1990s) and Argentina (in 2001) also performed successful fiscal adjustments in tandem with a depreciation of their respective currencies.

The mechanism for achieving this is simple: cutting public spending and deficit reduces overall demand and thus stifles economic activity. On the other hand, the depreciation of a nation's currency has an expansive effect on production by boosting demand for domestic tradable goods (exports and goods that compete with imports). In Ireland in 1982 both factors – a *drop in the budget deficit* and a *rise in the value of the national currency* acted as dampeners on economic activity and so pushed the country into a deep recession. The fall in production increased the budget deficit and the public debt by adversely impacting tax revenue, resulting in the collapse of the attempted fiscal adjustment. The successful fiscal consolidation of 1987 was preceded by an 11% depreciation of the national currency; Ireland's economy was growing at a rate of 4% by as early as 1989, while the public debt began to decrease in relation to GDP.

In light of these examples, the depreciation of the dinar – initially since the start of the year, and again in May – is a welcome event for the healthy recovery of Serbia's economy. There are early indications that exports are on the increase and that they have been boosting production growth, albeit still at a very low level. If this trend continues, there are grounds to hope that Serbia will substantially reorient its economy towards exports and

thus enter a path of sustainable growth. Still, one of the preconditions for this is to begin implementing a medium-term plan of cutting government deficit and reining in public debt *now*; the Irish example also shows that *now* is a good time to do it.

The second precondition for successfully rebalancing the Serbian economy, moving it away from consumption and imports and towards investment and exports, is to preserve the current depreciation of the dinar, which seems to have brought the currency close to sustainable levels and has thus substantially improved the Serbian economy's international competitiveness. If external competitiveness is to be kept at this level the dinar needs to, on average, follow inflation – which in turn needs to substantially decrease – but it is also important that (real) wages do not grow more quickly than labor productivity does. The NBS should therefore continue to allow the dinar to follow a slight downward trend, while the Government should control the growth of public sector wages, including those at public enterprises.

To mark the jubilee, this – the twentieth – issue of *QM* devotes its Spotlight On and Highlights sections nearly exclusively to research carried out at the Foundation for the Advancement of Economics (FREN), the publisher of *QM*. This helps to establish a positive interaction between the monitoring and analysis of economic trends and policies by *QM* and empirical research into issues relevant for the economy of Serbia and the wider region. We hope that this synergy will prove fruitful and yield important results. In this issue, *Spotlight On 1* (Šestović, L.) analyzes Serbia's economic growth, stressing its regional imbalance and offering possible options open to economic policymakers. *Spotlight On 2* (Krstić, G. and Arandarenko, M.) presents the results of an analysis of the impact of the economic crisis on the relative positions of vulnerable groups in Serbia's labor market in relation to total working-age population. *Highlights 1* (Arsić, M. and Altiparmakov, N.) contrasts various proposals for taxation reform in Serbia and presents quantitative implications of individual solutions. *Highlights 2* (Avlijaš, S.) details the challenges and problems faced by the process of downsizing local administration, while *Highlights 3* (Žarković-Rakić, J.) presents SRMOD, a micro-simulation tax and benefits model for Serbia, based on EUROMOD. SRMOD is a first model in the region and is developed by FREN in cooperation with the University of Essex. The results of applying this model and its significance for economic policymakers and the academic community will be discussed in upcoming issues of *QM*.

