From the Editor

The economy of Serbia achieved significant progress in establishing macroeconomic stability in 2017, but the growth of the economy is modest, while more substantial reforms have been left out. Strengthening of the macroeconomic stability is manifested through the fiscal surplus achieved for the first time after more than a decade, low inflation stabilization, low interest rates, a decline in the percentage of bad loans, etc. Yet macroeconomic stability is still fragile as external and public debts are still high and the strengthening of the dinar influences the re-growth of the external deficit.

The growth of Serbia's economy in 2007 will be below 2%, which is twice slower than the average growth of Central and Eastern European countries. Approximately half of the lag behind the regional average can be explained by bad weather, while the other half is the consequence of the fundamental weaknesses of the economic system and failures in implementation of the fiscal policy, such as the Government's inability to realize planned investments and launch new ones. The growth of Serbia's economy this year confirms that macroeconomic stability is necessary but is not sufficient for a strong and long-term sustainable growth of the economy. Generally, the growth of 2% in 2017 was disappointing given that international circumstances were extremely favorable – a demand in European economies is growing strongly, there are many cheap capital offers, while world market prices are favorable for Serbia.

Napredak u reformama u Srbiji bio je relativno skroman, čemu je doprinelo održavanje predsedničkih izbora, a potom i rekonstrukcija Vlade. Određeni napredak je ostvaren u reformi poreske uprave i inspekcijskih službi, što se manifestuje u suzbijanju sive ekonomije i smanjenjutroškova primene pripisa, kao i u oblasti privatizacije (Galenika) i restrukturiranja državnih preduzeća (Železnica). Međutim, u oblasti nezavisnosti pravosuđa, efikasnosti državne uprave, politike konkurencije i suzbijanju korupcije nije bilo primetnijeg napretka.

Progress in reforms in Serbia was relatively modest, influenced by the presidential elections, and then by the reconstruction of the Government. Certain progress has been made in the reform of tax administration and inspection services, which is manifested in the suppression of the gray economy and in the reduction of the costs of implementing regulations, as well as in the area of privatization (Galenika) and restructuring of state-owned enterprises (Železnica). However, there was no significant progress in the area of judicial independence, efficiency of state administration, competition policy and suppression of corruption.

The results of Serbia's economy in 2018 will depend on both international economic trends and internal policies and economic environment. Movements in the world economy provide a framework for achievable results for a small economy, but it depends on economic policies and economic environment whether the results in a country are at the bottom or at the top of that framework. In 2017, the general international circumstances allowed the growth of the economies of Central and Eastern European countries by about 4%, but domestic policies determined whether that growth was 3% or 6%.

Based on the forecasts of relevant institutions, the continuation of favorable international circumstances for the growth of Serbia's economy is expected in the coming year. The most important economic partners of Serbia - EU member states, countries of the region, Russia and Turkey - will achieve high GDP growth and domestic demand growth, thus creating favorable conditions for the growth of Serbia's exports. The ECB announces that it will reduce the volume of primary emissions during next year, but interest rates increase is not expected, which creates favorable conditions for continued high inflow of foreign direct investments, loans and others in Serbia. According to most forecasts in the coming year, a moderate increase in energy prices is expected, which means that no major worsening of the conditions for the Serbian economy is expected on that side.

The announced fiscal and monetary policy for the next year supports macroeconomic stability, which will have a positive impact on the growth of Serbia's economy. The fiscal deficit is planned to be 0.7% of GDP, which is why further public debt reduction is expected in relation to the GDP. The moderate increase in fiscal policy expansion in relation to this year will have a certain impact on accelerating economic growth, particularly in the area of the growth of public investments. Nevertheless, it is not certain whether the planned increase in public investments will be realized, given that for several consecutive years public investments have significantly underperformed in relation to the plan. Continuation of a practice of taking a large share of public companies' dividends will adversely affect the growth of the economy, as the funds intended for investments, through fiscal policy, are almost completely reallocated into current consumption. From the standpoint of economic growth, it is good that there is an increase in the non-taxable portion of wage, although a relatively high salary increase in the state sector has prevented a more substantial tax relief of the economy. Monetary and credit policy is expected to keep interest rates low, which should increase the willingness of the economy to take credits. In addition, growth in credit activity will favorably be affected by the improvementsin solving the problem of bad loans during 2017.

It is of crucial importance that the announced policies are implemented even after the IMF arrangement expires, which means that it is necessary to give up the idea of stimulating the economy through a much more expansive fiscal policy. Eventual realization of such fiscal policy would have a very modest impact on the acceleration of the economy's growth, which would then be temporary because macroeconomic stability would deteriorate rapidly, thereby negatively affecting economic growth.

After a progress in fiscal consolidation, low inflation stabilization, lower interest rates and the share of bad loans, the key constraints for economic growth lie in the economic environment. During previous years, the economic environment improved in some areas such as the issuing of building permits, the work of inspection services, labor market regulations, simplification of some administrative procedures. However, general business conditions related to effective property and contract protection, financial discipline, equality of market participants, the suppression of corruption, complicated administrative procedures, quality of regulations, and others are still very unfavorable. In order to achieve progress in these areas, the key hides in a political decision to make the turnaround from a party state and a state acting in function of privileged interest groups to a state that serves general social interests. This turn is crucial to exploit the potential of societies for economic progress, or to establish the rules under which the economic position of an individual and companies would depend on their contribution to society, not from being close to the government, the ruling party and the informal power centers. Such rules of the game would encourage individuals to save, invest, innovate, take risks and other activities that generate economic growth and employ people instead of seeking links to state and party officials, informal power centers, pay bribes etc. Suspension of an influence of a party and other informal structures to economy, with the suppression of the gray economy, is a prerequisite for creating fair market competition and entrepreneurship development. Therefore, the adoption of new laws, their consistent implementation and suspension of un-institutional, "clan" (party, security-criminal and other) channels of decision-making should be the focus of the Government in the coming years. The space for un-institutional channels of decision-making would be reduced by privatization or bankruptcy of the remaining former social enterprises and by restructuring of public enterprises, as this would significantly reduce illegal leakage of public funds into private pockets, which is one of the conditions for these companies to become engines and not obstacles for Serbia's growth.

Based on expected international circumstances, announced economic policies as well as trends in 2017, we expect that the Serbian economy could achieve a growth of about 4% in 2018. In order to achieve this growth, it is necessary to accelerate the growth trend from about 2.7-2.8% this year to 3.2% in the following year, which is likely to occur due to a stronger domestic demand growth. An additional requirement for the growth of about 4% in the following year is for the agricultural season to be at the average level, which would imply a growth of agricultural production by about 10%. Thus, although 4% economic growth seems rather impressive, it will be the result of a moderate growth rate of 3.2% and a one-time agricultural recovery.

In order to accelerate the growth trend of the economy to 4-5%, the direct requirement is to increase investments from the present level of about 18% to about 25% of GDP. Increasing the investments is a condition for increasing the amount of private and public capital per worker, which is the basic determinant of the level of development of the country. In this context, Prime Minister's statement that Serbia should leave the investment-driven growth model and move on to the innovation-based growth model is quite absurd. Serbia has not yet had investment-based growth since they were among the smallest in Central and Eastern Europe and are at a level that is only slightly higher than the amount needed to replace depreciated capital. Moreover, innovations and investments are not exclusive because innovation dominantly occurs as a result of investments in research and development, including investments in human capital. Therefore, for the growth of Serbia's economy it is necessary to increase total investments, including a part aimed at research and development.

Sustainable growth of the economy implies that growth drivers are investments and exports, while private and state consumption should follow the economic growth. This means that investments in coming years would have to grow at a rate of about 10% per year, until they reach a level of about 25% of GDP. Also, for a sustainable growth, it is necessary to continue with a high exports growth of over 10% per year over a longer period of time. On the other hand, private and state consumption should also grow in real terms, but their growth should be somewhat slower than the GDP growth, until their level is aligned with the GDP level. The eventual faster growth in current consumption than the GDP growth would have the effect of re-increasing the foreign trade deficit in the coming years.

In this issue of the Quarterly Monitor, in addition to regular analyzes and projections, there is the Spotlight On section, by Sasa Randjelovic, which analyses the necessary changes of the tax policy of Serbia in the framework of the EU accession process.