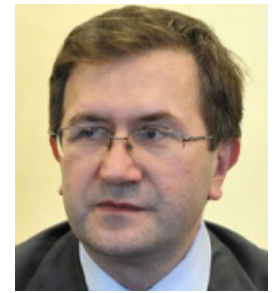

From the Editor



At the beginning of 2017 the results of Serbia's economy have deteriorated in several areas of the economy - economic activity slowed down while the external deficit and inflation increased. We estimate that the growth of the external deficit and inflation is mainly a result of cyclical factors related to the movement of prices on the world market, and therefore these deteriorations are temporary. However, the slowdown of economic growth is the result of general institutional weaknesses that have been manifested extremely in the electric power industry. At the beginning of this year Serbia also recorded good results in the field of public finances as well as certain improvements in the labour market. Significant progress in reforms was missing, among other things due to the presidential elections. Frequent elections in Serbia have significantly worse consequences than in other countries where there is a functioning market economy.

In the first quarter Serbia's economy grew by 1.2% year-on-year which is the lowest growth rate in the last twelve months and one of the lowest growth rates in Europe during that period. Although there is still possibility to accelerate growth in the remaining part of the year and reach planned 3% growth rate, the chance of higher growth than planned in this year was missed, as will be the case with many countries in Europe. Therefore, in this text, we will analyse in more details the causes of slowing economic growth at the beginning of this year.

The causes of economic growth slowdown can be trends in international environment, ineffective internal factors or weaknesses in economic policy and the economic environment. The impact of economic activity trends in large Western European economies on small open economies in Central and Eastern Europe is relatively strong. Growth in Western European economies is, almost as a rule, followed by an ever faster growth in Central and Eastern Europe, while recession in Western European economies leads to recession in Central and Eastern European countries. During the last major economic crisis which started in 2008 economic activity first declined in Western European countries by 4.4%, then the GDP fell by 5.1% in Central and Eastern Europe in 2009, and in Serbia by 3.6%. However, at the beginning of this year, European economies are expanding and the growth they have achieved is the highest since 2008. High growth is present in almost all European countries, so fifteen old and developed EU member countries recorded 2.3% growth rate in the first quarter, which is a solid result for this group of countries. The EU member states from Central and Eastern Europe recorded even stronger growth in the first quarter, which is 4.1% in average. Out of all European countries lower growth than Serbia in the first quarter was recorded by only Macedonia, Greece and Switzerland. That been said, economic trends in the international environment can in no way be the cause of the strong economic slowdown in Serbia in the first quarter of this year.

Slowdown of economic activity is also possible as a result of non-economic factors, such as natural disasters, political instability, etc. Large floods from 2014 directly affected the Serbian economy in that year, and the floods also affected negatively the economies of Bosnia and Herzegovina and Croatia. In some other years strong droughts caused a drop in agricultural production in Serbia by 10% and more, which resulted in the slowdown of economic activity in those years. However, during the first quarter of this year in Serbia, as in other countries of the region, there are no registered natural disasters of such magnitude to influence the movement of economic activity. Attempts to explain slowdown of the economy during the first quarter with cold weather during January are extremely unfounded as similar weather conditions were also in other countries in the region, and despite that they recorded a strong growth. For example, Croatia recorded a growth of 2.5%, Bulgaria 3.9%, Hungary 4.1% and Romania as much as 5.7%. The only country in the region which in the first quarter achieved poorer results than Serbia is Macedonia, but that can be explained by internal political problems, not weather.

Given that economic trends in the international environment are favourable and there were no major natural disasters and social conflicts, it remains to be examined whether the causes of economic slowdown can be found in economic policy and weaknesses of the economic environment. Looking at the causes of slowing economic growth in economic policy and the economic environment at first glance may seem surprising as Serbia has significantly reduced the fiscal deficit during the past two years, inflation is low and stable, interest rates are at a historical minimum, etc. In addition, certain reforms have been carried out, such as the labour market liberalization, more efficient approval of building permits, and some administrative procedures have been simplified, which is why Serbia made progress in the last two years of 19 places on the Doing Business list of the World Bank. Good results in establishing macroeconomic stability, particularly in fiscal consolidation, as well as some progress in reforms, received positive reviews from international financial organizations, investors and most domestic and foreign analysts. Although we could talk about some details in fiscal and monetary policy, hardly could the reasons for the slowdown of the economy be found in them. Therefore, any attempts to start growth by expanding fiscal and monetary policy would not yield lasting results.

For a long-term sustainable growth, in addition to macroeconomic stability a good economic environment is needed, i.e. a better quality of regulation of business operations, but more importantly, the consistency in their application is needed. It is important to adequately regulate the independence of the judiciary, the work of the cadastre, the public procurement procedure, the competition policy, the choice of management in public companies, the promotion policy in the administration,

etc., but it is more important that these regulations are strictly applied in practice. The economic environment also includes the quality of the infrastructure, the availability of educational workforce, political stability, good relations with the world and other.

The slowdown in economic activity during the first quarter was most directly connected to the poor management of public companies, which resulted in a high fall in coal and electricity production. Poor EPS management had a direct impact on GDP growth in Serbia in the first quarter to be 1.2% rather than 2%. And a bad management is the consequence of institutional arrangements in which party activists are promoted at key positions in public enterprises and state administration, and public companies used to perform social functions, party financing and privileged personal gains. Thus, energy production problems are the manifestation of systemic weaknesses of Serbia's economy, and not of extraordinary circumstances such as the great colds during January. The systemic problems present in EPS exist also, to a greater or lesser extent, in other public companies, therefore it would not be surprising if similar problems arise in these companies also. According to the European Bank for Reconstruction and Development estimates Serbia and Albania are at the latest place according to the progress achieved in restructuring and quality of public companies management, compared to all Central and Eastern European countries. Serbia has not made progress in this area since 2005. However, even if there were no problem in EPS Serbia would achieved growth of 2%, which is twice lower than the average of Central and Eastern European countries, indicating that there are other obstacles that hinder the growth of the economy.

Apart from the poor management of public companies in Serbia, there are other fundamental problems that fetter private entrepreneurship and thus the growth of the economy, such as the weak property and contract protection, high burden on the private sector by complicated procedures, high level of corruption, poor competition policy, etc. In such environment entrepreneurs spend a great deal of time and money on establishing links with politicians and government officials instead of dedicating themselves to adopting new technologies, gaining new markets, finding cheaper sources of finance, etc. From the standpoint of the society lobbying and corruption activities are completely useless and represent pure waste of resources. The privileged status of some businessmen is severely distorting competition, which is the main driver of economic development. The extent to which the conditions for economic growth in Serbia are unequal is seen by the fact that the state grants high-yielding investment subsidies to some businessmen, while imposing restrictions and barriers to others that can be only solved by bribery of state officials and party activists. Disruption of competition is present when concluding affairs with the state and public companies, obtaining permits and approvals, resolving disputes and others.

The aforementioned weaknesses are closely related to the low efficiency of the state administration. According to the World Bank data, Serbia was at the 119th position in the world according to the efficiency of government management in 2015, and there has been no progress in this area over the past few years. Regarding the quality of governance Serbia stands badly on all indicators of the World Bank because according to each of them Serbia is not ranked better than 110th place in the world,

and it is particularly badly placed according to the efficiency of government administration, quality of regulation and the rule of law. According to the indicator of country's quality of governance Serbia is placed one place above the last in comparison to the countries of Central and Eastern Europe, the only country below is Albania. Similar poor ratings Serbia also received from the World Economic Forum - where according to the level of competitiveness is at the 90th place in the world. The data of the World Economic Forum point to poor governance by the state, high corruption, etc., but also to the poor state of the road and rail infrastructure, inefficient competition protection, the underdeveloped financial sector, the inability to innovate etc. The inefficiency of the state administration and public companies is especially visible in the realization of public investments, which are for years below 3.5% of GDP. Delaying completion of the Corridor 10 from the end of 2015 to the end of 2016, and then to the end of 2017 and finally mid-2018, is an example of state inefficiency in the realization of public investments. And the efficiency of road construction has improved in recent years, and it is probably higher than the efficiency in other public investments.

The synthetic reflection of the weakness of the economic environment in Serbia is a low rate of total (private and state) investments which does not exceed 20% of GDP. Responsibility for this is primarily on the part of the state, which invests only little and inefficiently, and has created a business environment that is unfavourable to private entrepreneurship. And investments would be even lower without stimulation through high state subsidies. With such low investments Serbia cannot count on a rapid economic growth of 4-5%, and thus the gradual elimination of the historical lag in the level of development behind the countries of Central and Western Europe.

Achieving high growth of the economy while maintaining the fundamental weaknesses of the economic environment is only possible in a short period of time and in a relatively modest extent. Such temporary growth can be achieved by high growth in current consumption, subsidies, etc., but such growth raises fiscal and foreign trade deficits worsening macroeconomic stability and then again negatively influencing the future growth of the economy. Strong economic growth is only possible with high investments that increase the production potential of the economy, and such economic growth creates a realistic basis for a long-term sustainable increase of consumption and standard of living of citizens. However, in a market economy for high investments a good economic environment is necessary, and in its development Serbia is progressing very slowly. If in the coming year the economic environment does not improve significantly Serbia will choose between macroeconomic stability without significant growth on one side and alternating shifts in long-term unsustainable growth (generated by demand and subsidies) and crises on the other. Otherwise, Serbia, in its economic history as an independent country or as a part of Yugoslavia, repeatedly entered into periods of instability, several times after successful implementation of macroeconomic stabilization programs, because of the lack of economic environment reforms.