From the Editor

Serbian economy produced heterogeneous results in 2013. Preliminary data shows that GDP increased by more than 2%, current account deficit is halved, and inflation reached its all-time minimum. However, the main drivers of the growth in GDP and reduction in the current account deficit are wearing out gradually, so economic growth and rise in exports slowed down in the last quarter of 2013. Besides the foregoing positive results, numerous worrying trends in Serbian economy have been detected. There is a rising illiquidity and insolvency of companies, the share or bad loans is increasing, loans to enterprises are decreasing, a number of small banks have been wound up, and tax arrears of companies are accumulating. The implemented fiscal consolidation measures have not produced the desired results because the effects of savings and tax increase were offset by new expenditures on financial support to enterprises and banks and decline in tax revenues. Low foreign investments and pressures on dinar exchange rate, stability of which has been preserved in the first quarter of 2014 only thanks to the interventions of the NBS, indicate that foreign investors place fragile trust in Serbian economy.

Prospects for Serbian economy in 2014 are quite poor. It is however possible to boost economic activity and employment in the years to come through a determined fiscal consolidation, and reforms in public sector and economic system. It is quiet certain that economic activity in 2014 will stagnate, and a mild recession cannot be ruled out. Real drop in private and public consumption will probably be sharper than it seemed two or three months ago, because additional austerity measures will be needed in the second half of the year. Investments will fall in the first half of 2014, and after the recovery expected in the second half of the year, there will be, at the best, a modest rise in total investments in 2014. Sharp drop in credit activity of banks and financial difficulties in many companies will not only cause a fall in domestic investments but also present a threat to the existing level of production. Foreign direct investments will be modest and, unless a large enterprise is privatized, their level will not exceed the last year's EUR 700 million. Real rise in exports will continue in 2014 but at a much slower rate than in 2013, so it will not be sufficient to make up the decline in other components of demand.

The official data on the employment trends in 2013 published in the October 2013 Labour Force Survey raise serious doubts about its credibility. There is a large deviation of the aggregate data from other macroeconomic indicators, such as GDP, private consumption etc. Employment growth structure is even more questionable – informal employment increased, number of supporting household members doubled over a six-month period, and the number of construction employees grew, although statistical data shows that activity in construction industry fell by 20%!? We think that the data on formal employment trends, although incomplete, reflect the trends in labour market in 2013 more accurately than the Labour Force survey. We expect a moderate fall in employment numbers in 2014 due to public sector rightsizing, and stagnation in private sector employment numbers.

Inflation in 2013 was down to its lowest level in Serbia's recent history, and we expect it to edge up in 2014 – closer to the upper boundary of the targeted interval. There has been a slight depreciation in dinar exchange rate, and it would be stronger if there were not for the NBS's frequent and decisive interventions in the forex market. The total amount of interventions made from the beginning of 2014 to mid March is EUR 820 million, or 2.5% of GDP. There are probably some pre-election motives behind keeping the exchange rate at almost fixed level. The NBS should slow down its interventions and thus allow for a moderate depreciation of dinar exchange rate, which would stimulate reduction in the current account deficit, while its negative effects on foreign currency debtors and inflation would be moderate.

Some segments of Serbia's balance of payments improved considerably in 2013, but some are deteriorating. Current account deficit has been halved, but it still stands at 5% of GDP, which is unsustainable in the long run. Increase in exports should remain one of the major priorities of economic policy in the following period. Trends in the financial account and capital account are adverse. Foreign direct investments are low, private foreign debt is going down, and public foreign borrowing is increasing, mainly for the purpose of current consumption funding.

The newly elected Government will have to get to grips with many problems arising from the decades of unfavourable conditions Serbia has been in, the world economic crisis but also from postponement of reforms and diluted effectiveness of the planned reforms over the last 3-4 years. The Government should therefore attack these problems vigorously, persistently and with a multidimensional approach. Multidimensional approach to problems means simultaneous work on fiscal consolidation, reforms in public sector and economic system and implementation of certain anti-recession measures. Vigorous response means that the Government has to adopt the necessary, often unpopular, measures rather than procrastinate or implement partial solutions. Finally, the Government should persist with the reforms, in spite of resistance or difficulties. We will see if the new Government is willing and able to carry out the necessary reforms already few months after its formation. An important test that will show whether the Government (SNS) is reform-oriented will be their readiness to enter into a binding long-term arrangement with the IMF in the second half of the year.

Although fiscal consolidation will be achieved in 3-4 years, it is necessary to make about EUR 400 million savings already in the second half of 2014. This requires reduction in public sector wages, but also reduction in or taxation on pensions. To achieve fiscal consolidation, laws and binding plans that would guarantee additional savings and more efficient tax collection in the years to come must be adopted already in 2014. This implies pension reform, plan for public sector rightsizing, plans for reduction in the republic and local administration expenditures, plans for education reform, health care reform etc. Certain reductions in fiscal deficit can be made through a more efficient tax collection, meaning that shadow economy should be curbed and that the existing tax arrears should be paid and their further accumulation prevented. Additional tax revenues must not be a substitute for austerity measures but a supplement to them.

Reforms in public sector and economic system are necessary for both a long-term sustainable economic and social development in Serbia and fiscal consolidation. Reforms in public sector should improve the quality of administrative, judicial, educational and other services of government bodies, and to bring in certain savings. Reforms in public and state-owned enterprises mean that these enterprises should be professionalized, that they should not serve social and quasi-fiscal functions, and that the process of privatization and restructuring in former public companies should be finalized. Public companies should not serve social and quasi-fiscal function, meaning that they should charge market price for their service and deliver it only to regular payers, number and structure of employees should be optimized, and buoyant sponsorship deals should be abandoned. These reforms would reduce expenditures on financial support to state-owned companies and thus help achieve fiscal consolidation.

The goal of the reform in economic system is to create a more favourable investment climate and encourage employment. This can be achieved through reduction in costs and risks involved in doing business in Serbia. Improvements in business environment mean financial discipline tightening, deregulation, labour market reform, privatization process finalization, improved competitiveness policy etc. Reforms in economic system would have positive impact on public finance because some subsidies would be abolished, rise in employment and consumption would boost public revenues, and tax collection would be more efficient (reduction in shadow economy and tax arrears).

Tax reform whereby tax burden on employment (primarily contributions) would be eased, and tax burden on consumption increased would encourage investments and employment, and indirectly improve international competitiveness of Serbian economy. However, the tax reform should be postponed until the major problems in Serbian public finance, i.e. large fiscal deficit and growing public debt, are overcome.

This issue of QM, besides the usual analysis, offers three *Highlights*. *Highlight 1* (Arsić) deals with economic policy and reforms waiting for the new Government. *Highlight 2* (Urošević) gives a review on doctoral studies in Serbia and offers suggestions on how to reach the world standard in this segment of education with modest funds. *Highlight 3* (Brčerević, Arsić) deals with certain shortcomings in statistical data and their influence on economic policy.