From the Editor

Tendencies from the beginning of the year continue in the second quarter as well. Economic activity makes slow growth, which will be between 1.5% and 2% on an annual level, the inflation is slowing down and will probably be 4-5%by the end of the year,while the current deficit is also on the decline and will be 6-7% of GDP in 2013. Most of the economy is still in recession, economic activity and employment are dropping in most industries, and the recovery is focused on a few business activities, including agriculture which is returning to its average level. Financial performance of the economy is rapidly deteriorating. Mass inability of companies to settle regularly their reprogrammed tax obligations indicates the scope of the illiquidity and insolvency problem in the economy. State of banks is deteriorating as well, because real values of loans are decreasing, and the percentage of bad loans is increasing. Unemployment is stagnating at a very high level of 25%, with half of the young generation being out of work.

Domination of negative trends in Serbia's economy is confirmed by unfavourable assessment of the economic policy by IMF and deteriorating placement of Serbia in competitiveness rankings published by the World Economic Forum. Lower placement on the list of the World Economic Forum indicates that the growing macroeconomic risks have completely neutralised the implemented reforms, such as abolishing numerous quasi-fiscal levies. EU's economic recovery, which is very much tied into Serbia's economy, is still very slow and its longevity is uncertain.

Fiscal deficit this year will be 5.5-6% of GDP (i.e. over 7% according to IMF definition) and will be the highest in Central and Eastern Europe, while the public debt in the previous year has grown by 3.6 billion euros, i.e. by 23% - growth of public debt accelerated over the past year. The structure of public spending is deteriorating, because reduction of the share of public investments is realised through it, and as a result, around 2/3 of state borrowing this year was intended for financing current spending (salaries, pensions, interests, subsidies, etc.).

Public debt will reach 63-64% of GDP by the end of the year, cost of interest is rising, so there is a risk of growth of public debt becoming self-generating, i.e. that growth of cost of interest becomes higher than the savings realised by the state in other budget lines. Unfavourable conditions in Serbia's public finances, as well as worsening conditions of borrowing on the international financial market, for now exclude the possibility of replacing expensive loans with cheaper ones with market arrangements. That possibility perhaps exists within politically motivated inter-governmental arrangements, but based on past experience, the chances of something like that being realised are very small. That is why the state will be forced in the coming period to borrow at higher interest rates than was the case over the past year.

Key measures for slowing down the growth of public debt are reduction of the fiscal deficit by 2-2.5% of GDP in 2014, limiting the growth of state guarantees, and minimisation of the fiscal effects on the issues of the banking sector. Fiscal measures from May and June this year, as well as the announced savings of the Government provide about half of the necessary savings in the next year. For the remaining savings of around 1% of GDP the Government has to accept the proposal of the Fiscal Council on taxation of above average salaries and pensions, or to come out with an alternative solution.

Acceleration of the recovery of Serbian economy cannot be expected in the following year, because the effects of investments of FIAT and NIS are diminishing, while the new investments in this year are quite low. In the first half of the year, public investments, as well as foreign direct investments, are far below the multi-year average. Decline of production and imports of investment equipment, as well as reduction of the real scope of loans indicate that private investments are declining as well.

In the next year, a real reduction of state and private spending is expected, so the potential sources of growth boil down to investments and exports. Any considerable growth of investments is highly unlikely for now, and it will happen only if some of the announced large foreign investments are realised. General, high dispersed increase of investments, as a result of improving business environment, can be expected only after a year or two after the implementation of such reforms. We expect the growth of exports to slow down, because the biggest exporters (FIAT, NIS) are gradually reaching their maximum, and new major exporters are nowhere in sight. Therefore, sources of growth for the following year are quite limited on the demand side as well as on the supply side. Additional obstacle to economic growth is bad financial situations in companies, which is decreasing borrowing activity, without which there are no investments or growth.

Unemployment rate is still on a very high level of around 25%. Statistically recorded modest growth of employment compared to the previous year is not healthy, because the employment in the private sector is growing only in the grey zone, while the registered (legal) employment is only rising in areas dominated by the state.

Strong growth of exports and reduction of deficit in the current balance of payments represent the most favourable tendency in the Serbian economy. While in the previous years the reduction of deficit was mainly a result of the reduction of domestic demand and depreciation of dinar, in this year the deficit is significantly reduced by factors on the supply side, generated by the growth of exports. Still, the deficit in the current balance of payments, although significantly reduced, is still high, so it has to be additionally reduced in the coming years. Reduction of fiscal deficit, with moderate depreciation of dinar, should be the key contributor to the reduction of current balance deficit. While the current balance deficit is being reduced at a satisfactory rate, the trends in capital balance are alarming, foreign direct investments are low, and companies and banks are deleveraging. Although similar trends have been recorded in other countries in Central and Eastern Europe, Serbia is in the group of countries where trends in the capital balance are the least favourable.

Strong reduction of inflation is another positive result of Serbia's economy. Average monthly inflation in the first seven months was 0.3%, which is 3.7% at the annual level. Reducing inflation creates a space for the reduction of restrictiveness of monetary policy, but the risks, which are the consequence of external and internal imbalances, call for a gradual and careful approach. First precondition for reducing the restrictiveness of monetary policy is adopting a credible budget for the next year, which would contain a significantly lower deficit. Depreciation of dinar during May and June reflects primarily unfavourable trends in the capital balance of Serbia, and to a lesser extent, general deterioration of capital flows in the countries of Central and Eastern Europe. Observing the wider economic picture, moderate increase of inflation, brought about by depreciation, is an acceptable price to pay for the reduction of external imbalances and growth of competitiveness of Serbia's economy.

After Government restructuring, as was the case after its formation a year ago, there were announcements of comprehensive and fundamental reforms of the economic system and public sector. Reforms of the pension system were announced, resolving of the status of companies in restructuring, liberalisation of legislation, improvement of business environment, reform of the tax system, reform of public administration, etc. and all this in a very short period of time. Some of these reforms (reform of the pension system, reform of the labour market, improvement of the business environment) have been in preparation for a relatively long time, they are pretty undisputable from an economic viewpoint, and are not excessively administratively complicated, so they should be realised quickly. However, it is uncertain whether political consensus will be reached on this issue, because parties that were blocking these reforms in the past are still in the Government. Other reforms, such as tax reform or public sector reform should be prepared more thoroughly and a more favourable economic and political moment found for their implementation. Generally speaking, a good preparation of reforms, their adoption and consistent implementation would require a relatively solid arrangement with IMF.

Recession in most of the economy requires implementation of certain short-term stimulating measures, in order to prevent mass bankruptcy of companies and banks. Although space for implementation of fiscal and monetary stimuli is quite limited in Serbia, it does not mean there should be no anti-recession measures taken. Short term anti-recession measures could include re-activating of the programme for subsidised loans, acceleration of the realisation of public investments and settling of state debts towards businesses. Additional stimuli could be created by approving loans to small and medium enterprises by international financial institutions.

This issue of Quarterly Monitor contains, aside from regular research, four Higlights as well. Higlights 1 (Arsić) analyses short-term stimuli and possible reforms, Higlights 2 (Glišić) analyses financial performance of large companies controlled by the state, Higlights 3 (Žarković-Rakić) analyses possible measures for employment of young people in EU and Serbia, while Higlights 4 (Arsić) disputes some popular proposals for jump-starting the economy and resolving the issues in public finances.