From the Editor

In the first months of this year, Serbia's economy achieved modest positive results, but their sustainability is jeopardised by the negative trends in public finances, companies and the banking sector. GDP growth, controlling inflation and reduction of the foreign deficit are undoubtedly positive results, but it should be noted that the 2% growth is insufficient for creating new jobs, and that the current balance deficit of over 8% of GDP is unsustainable in the long term.

The most important negative trends are high fiscal deficit of around 7% of GDP, increase in the percentage of non-performing loans to over 20%, as well as the continuous growth of unemployment. In order to stop the negative trends, it is necessary to adopt over the summer additional measures of fiscal consolidation, as well as measures for improving liquidity of the economy. For long-term sustainable economic recovery, it is essential to start thorough reforms of the public sector and the economic system. Continued recession in EU and surrounding countries additionally complicates the recovery of Serbian economy. Announced reduction of monetary expansion in developed countries and possible rise of interest rates on international financial market will have a negative effect on Serbia.

Trends in public finance in the first four months have been extremely negative. In case these trends continue, the fiscal deficit in 2013 could reach 7% of GDP, which would be the highest deficit in Central and Eastern Europe and among the highest in entire Europe. Public debt is more than 60% of GDP, so the question arises as to whether investors are ready to finance such a high deficit, having in mind Serbia's low credit rating. At the end of May, a package of tax laws was adopted, which will contribute, through a better distribution of taxes among different state levels, to a reduction of the fiscal deficit this year by 0.3-0.4% of GDP. In addition, austerity measures have been announced, whose implementation by the end of the year should decrease the fiscal deficit by 1% of GDP. At the beginning of May, restrictiveness of monetary policy was reduced, which was an appropriate response to stopping the growth of inflation, decline of economic activities, and worsening financial position of the economy. After a few months' delay, reforms of the public sector and economic system are being announced again. However, statements from Government representatives on the necessity and directions of reforms are uncoordinated and contradicting, which causes confusion among the investors as to what kind of policy will be implemented in Serbia.

Growth of GDP in the first quarter was relatively modest and it was the result of a strong growth in several activities and the recession in most of the economy. Current trends confirm our estimates that the annual growth could be between 1.5% and 2%, but new risks are emerging that could jeopardise achieving even such a modest growth rate. Biggest risks for economic growth are lack of credible fiscal consolidation and increased percentage of bad loans. Growth of bad loans reflects the bad state of the economy, but if a larger number of companies and banks should crumble it would make the conditions in the economy and public finances even worse. If a credible fiscal consolidation is not adopted, a sudden stop of foreign capital inflow is possible, which would in various ways (difficulties in financing the fiscal deficit, reduction of overseas loans, sudden depreciation of dinar, etc.) worsen the situation in the economy. Finally, due to high volatility of weather conditions, it is uncertain whether the planned growth of agricultural production would be realised. As we predicted, the growth of economy is not enough to stop the growth of unemployment. According to some preliminary data, the situation at the labour market is still deteriorating. High and long-term unemployment, especially among the members of the younger generations, is becoming the biggest economic and social problem in Serbia.

Growth of economy is mainly realised in activities that are export oriented, which has a positive effect on the reduction of the foreign deficit. However, the current balance of payment deficit is 8.5% of GDP, which is less than last year, but still unsustainable in the long term. Financing of such a high deficit increases the already high foreign debt of Serbia, which has reached almost 90% of GDP. High current balance deficit makes Serbia especially dependent on foreign capital inflow, so any considerable reduction in the foreign capital inflow leads almost instantaneously to instability on foreign currency market, which due to high euroisation spreads to inflation, rising costs of economy, etc. Therefore, one of the key priorities of economic policy should be reduction of current balance deficit to a sustainable level that would probably be 3-5% of GDP.

Inflation in Serbia has been at a low level for half a year – average monthly growth rate since November last year has been 0.3%. We estimate that high growth of prices in April was a result of the influences of seasonal factors, and we predict that inflation in summer months will be low. Inflation trend during autumn will depend on the trends in dinar exchange rate and, to some extent, on the agricultural season. Considering dinar depreciation, we expect that there will be certain increase in inflation in the second half of the year, but that it will be within the targeted interval or slightly above it. In the second part of May and beginning of June, a trend of nominal and real strengthening of dinar that went on for months was interrupted. Indirect trigger for dinar depreciation was the publishing of data on negative trends in public finances in Serbia, followed by dissonant tones from the Government on what kind of policy and reforms should be implemented. It is our estimate that the positive effects of moderate depreciation of dinar (reduction of foreign deficit) outweigh the negative ones (increased inflation, increased cost of servicing loans). Besides, in conditions where most of the loans are denominated in foreign currency, approximation of dinar to the equilibrium level offers a more realistic picture of the indebtednessof the state, business sector and the citizens.

Creators of economic policy in Serbia face a complex task, as it is necessary to, almost simultaneously, considerably decrease the fiscal and foreign deficit and mitigate the recession tendencies in the economy and stop the growth of bad loans in the banks. Reduction of fiscal deficit has to be considerable in order to slow it down in a short term and then stop the growth of the public debt. It entails savings of at least 1% of GDP this year and around 2% of GDP next year. Savings of these proportions can be realised only if they include the biggest Government expenditures such as salaries, pensions, subsidies, and at all Government levels: state, local and Vojvodina. In order for the savings to become long-term, thorough reforms of the public sector are needed, i.e. of the pension, education and healthcare systems, improved efficiency of public investments and subsidies, etc. Public sector reforms are relatively complicated as they are supposed to lead to considerable savings without jeopardising the economic growth and preserving the availability and improving the quality of healthcare, education, social and other services. In addition, it is important that the burden of savings is fairly distributed between different social classes and different generations.

Savings that prevent public debt crisis are justified, because they prevent higher reductions in employment and earnings that would certainly happen in a case of crisis. Sudden deterioration of the risk premium, increased interest on Serbia's debt, reduction in the percentage of sold treasury bonds at the end of May and early June indicate that a public debt crisis in Serbia is possible and that it would be irresponsible to wait for it to happen in order to be persuaded of such a possibility.

Even though state savings are necessary, they are not sufficient for stopping the negative trends and establishing healthy foundations for economic growth. In the short term, we need monetary and fiscal incentives in order to prevent mass financial crash of companies and banks, which would then spread to public finances and additionally deepen the recession. Incentives would include reduction in the restrictiveness of the monetary policy with simultaneous approval of subsidies on liquidity loans. Subsidised loans in Serbia have proven effective unlike other monetarily fixed incentives. Funds for subsidised loans would be secured from reduced budget at the expense of savings in other expense budget lines.

Favourable conditions for long-term sustainable growth are created only by thorough reforms of the economic system. Such reforms entail establishment of financial discipline, abolition of administrative barriers on business operations, reduction of fiscal burden on labour, liberalisation of the labour market, etc. Implementation of public sector and economic system reforms is hard and perhaps even impossible within wide coalition governments, which is why a reform of election system is necessary too, which would lead to the consolidation of the political scene. Until then, some sort of guarantee for the realisation of long-term reforms could be provided by a relatively solid arrangement with IMF.

In addition to regular research, this issue of Quarterly Monitor also contains four Highlights. In Highlights 1 (Arsić) results and problems of implementing fiscal consolidation and reforms are analysed; Highlights 2 (Ranđelović) analyses the latest changes in citizen income tax; Highlights 3 (Molnar) analyses territorial economic inequalities in Serbia, while Highlights 4 (Arsić and Tanasković) analyses the causes behind the increase of bad loans and corresponding risks.

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