From the Editor

Macroeconomic trends detected in Q4 of 2012 and at the beginning of 2013 indicate certain signs of amelioration: economy is slowly recovering, inflation is brought under control swiftly, and current account deficit is shrinking. However, a more in-depth analysis indicates that only two or three sections of activity show the signs of economic recovery, while the other sections remain in recession. High unemployment, showing no sign of abating, proves that economic recovery in most sections of Serbian economy has not taken place. Economic recovery in Serbia is hampered by the return of EU recession. Although inflation has been curbed and nominal exchange rate has been stabilized at the end of 2012 and at the beginning of 2013, macroeconomic imbalances remain large. Current account deficit and fiscal deficit are large, and according to the levels of public and foreign debt the possibility of debt crisis cannot be ruled out.

In Q4 a highly expansionary fiscal policy was carried out, but at the beginning of 2013, when fiscal consolidation plan was brought into effect, implementation of a more restrictive fiscal policy began. Restrictive monetary policy followed in Q4 played a decisive role in bringing down inflation. However, macroeconomic backdrop and fiscal policy altered in the meanwhile, which allowed loosening of monetary policy. The new government lost the initial momentum gained in the first few months in power, so the reforms were held up.

In Q4 Serbian economy showed signs of recovery, which we believe is going to be lasting, but, quite slow. Seasonally adjusted GDP in Q4 increased by 0.5% relative to Q3 and the data on industrial production for January 2013 indicate continuation of an upward trend in economic recovery. However, only few sections of economic activity, namely automobile industry, pharmaceutical industry and petroleum industry, show signs of recovery, while most of other sections are stagnant or in recession. The economic growth will, therefore, lead primarily to increase in exports, and employment will not go up in the following two or three quarters. This leads to conclusion that the focus of economic policy and reforms should be on strategic measures intended to recover production in other sections of economic activity, which make up a larger share of Serbian economy, because that is the only way to increase employment. Economic activity is estimated to expand in the first quarter of 2013, and the lowest expected annual growth is 1.5%.

Analysis of the overall economic trends and their interdependence shows that Serbian labor market saw no significant change in 2012. GDP, real wages, personal spending, income taxes and social contributions decreased in the second half of the year. We therefore estimate that the data published by the SORS showing that in 2012 employment increased and unemployment dropped should be taken with a grain of salt. The data do not reflect improvements in labor market but are probably due to certain methodological changes. Euro-denominated unit labor costs grew faster than seasonally adjusted GDP, which points to a decrease in price competitiveness of Serbian economy. Because economic growth is concentrated in few capital intensive industries, employment is not expected to rise in 2013.

Having been curbed swiftly in November 2012, inflation remains low. The impact of long-term determinants (fiscal deficit and exchange rate depreciation in the first half of 2012) and short-term determinants (draught, tax increase) of rise in inflation wore off. Inflation is expected to remain low in the following months, with occasional leaps due to rise in administratively controlled prices. Nominal dinar-euro exchange rate has been quiet steady since mid-Q4. Prior to dinar exchange rate stabilization, a strong nominal and real depreciation of the dinar occurred from January to August, followed by strong appreciation from August to October. Appreciation of the dinar, driven by restrictive monetary policy and inflows of foreign currency through government's borrowing, helped reduce the inflation, but lowered price competitiveness of Serbian economy.

Current account deficit continued to shrink in Q4, but unlike the preceding quarters Q4 saw a considerable capital account surplus. While the current account deficit narrowed due to a healthy increase in exports, capital account surplus is not sustainable in the long run because it is produced through government's borrowing. The scenario from the first half of 2012, when capital inflows came to a sudden stop and consequently a strong depreciation of the dinar occurred, foreign exchange reserves of the NBS fell, and finally inflation went up, could repeat. Current account deficit, although narrowing more rapidly, is still large, so economic policy should identify its further shrinking as one of the top priorities in the years to come. At the end of 2012 foreign debt reached almost 90% of GDP. Consequently, the costs of its service will be very high and the possibility of balance of payment crisis cannot be ruled out.

In Q4 a highly expansionary fiscal policy was carried out and resulted in annual fiscal deficit to GDP ratio of 6.6%. Large fiscal deficit in Q4 was due to almost traditionally high pre-election spending. The early results indicate that fiscal consolidation has exerted favorable effects on tax revenues, though slightly below the expectations. However, a more reliable assessment of tax hike effects cannot be made before mid-2013 because, alongside with the tax hike, VAT system saw numerous changes which reduced tax revenues in the first few months of its implementation. The first effects of fiscal consolidation on budget expenditures were noted in 2013, so it will be possible to assess them in a few months. According to the data for the first two months of 2013, we estimate that fiscal deficit to GDP ratio will outrun the targeted 3.6% and according to the detected trends it will reach 4.5%. It is estimated that this high deficit would lead to further borrowing, so it is necessary to propose additional austerity measures to keep the fiscal deficit to GDP ratio under 4%.

Restrictive monetary policy followed from August to October played a key role in swift reduction of inflation. Additionally, it cushioned the effects of fiscal expansion at the end of 2012 on inflation at the beginning of 2013. However, it is estimated that a gradual loosening of monetary policy should start because inflation has been down for three to four months now, economy, exclusive of few sections of activity, is stagnant or in recession, and current account deficit remains high. The motive behind monetary loosening is to reduce current account deficit through moderate depreciation of the dinar – the depreciation would stimulate economic activity growth and employment in the long run. Depreciation would have to be moderate in order not to trigger high inflation or incur heavy losses on foreign-currency debtors. Gradual depreciation of the dinar is a precaution against an abrupt depreciation which might occur if a capital inflow came to a sudden stop. More restrictive fiscal policy implemented at the beginning of 2013 made room for loosening of monetary policy.

The new government's initial momentum towards implementation of economic reforms was soon lost. After only a few months in power, not only are the reforms blocked but there is no indication that the government is planning them. A possible reason behind this could be pre-term parliamentary elections – the issue frequently raised both by the ruling coalition and the opposition. The possibility of pre-term elections narrows the time horizon in decision-making. This means that politicians give advantage to measures producing tangible short-term results even if they incur long-term losses. Accordingly, the government holds up substantial reforms, which, as a general rule, mean some short-term sacrifice and savings for long-term gains. According to the aforementioned, major obstacles to economic reforms in Serbia are encountered in the political system which allows formation of unstable governments composed of too many coalition partners. Instead of implementing the announced reforms, the government more often resorts to measures that are effective in the short run, but discriminatory and have harmful effects on economy in the long run. Some examples of such measures are: write-off of interest and standstill of tax debt, or the announced reduction in the income taxes and social contributions in IT sector exclusively.

This issue of Quarterly Monitor offers two Highlights and one Spotlight. In Highlight 1 (Arsić) economic policies and reforms implemented in the second half of 2012 and at the beginning of 2013 are analyzed. Highlight 2 (Ranđelović) gives the analysis of corporate income tax reforms in Serbia carried out at the end of 2012 and offers recommendations for further reforms. The Spotlight (Ristić i Mijušković) gives a detailed analysis of weaknesses in competition policy in Serbia and offers clear recommendations for its enhancement.