From the Editor

The second quarter of 2012 saw some improvements in the economy of Serbia, but new problems arise. On the one side, the economic activity slightly increased, external deficit reduced considerably, but on the other side employment still decreases, while inflation accelerates. Due to a number of unfavourable factors (drought, downgraded credit rating of Serbia, stagnation in the EU), it is expected that the recovery of the economy, in the second half of 2012, will be temporarily stopped, so at the level of the whole year GDP will fall by at least 1%. Decline in economic activity will affect the fact that throughout the second half of the year decrease in employment will continue. In the second half of the year continuation of the current account deficit reduction is expected, but due to the low level of capital inflow, the financing of that reduced deficit will encounter major difficulties. Continuous acceleration of inflation and wide dispersion of products whose prices are rising, suggests that systemic factors (fiscal expansion, growth of foreign exchange rate) are dominant generators of inflation, although the influence of specific factors (increase in the prices of foodstuff and energy) is still significant. Fiscal deficit amounted to about 7% of GDP in the first half of the year, which means that, as previous times, this time a generous pre-election spending was not missing. Proposed budget rebalance, which increases the deficit, despite a substantial increase in taxes, is the result of post-election expansion, which is common in Serbia in the past decade.

The first actions of the new government, and the statements of its members on economic policy, had resulted in the reduction of the already low credit rating, as well as in increase of the risk premium on investment in Serbia. Changes in the Law on National Bank of Serbia and forced resignation of the Governor, jeopardized the independence of the NBS, While some members of the Government proposed spending of foreign exchange reserves, accused foreign investors (especially banks) for the withdrawal of capital from Serbia and exchange rate speculations, announced expansionary fiscal and monetary policy, etc. Although irresponsible assessments and suggestions can still occasionally be heard, the first decision of the new NBS management and Ministry of Finance proposals can be assessed positively. Based on that, it can be concluded that those populist statements do not reflect the firm intentions of the new government. However, these actions and statements have led to a reduction in the credit rating of Serbia, which will reduce foreign capital inflow, at least over the next few quarters, and negatively affect the economic recovery of Serbia. First actions and statements by representatives of the Government deteriorated relationship with the IMF, increased the suspicion of private investors in Serbia, and it is expected that they will be negatively assessed in EU reports that refer to the assessment of Serbia's progress in reforms.

Starting the fight against corruption is a major activity of the new government, whose success is critical to the creation of the market environment, in which creative entrepreneurs create new value and jobs, instead of, as until now, existing wealth being redistributed in favour of the privileged individuals. If this fight is to be systemic, non-selective and persistent, it could be one of the greatest contributions of the current Government to the progress of Serbia.

In early September, as a first step towards a medium-term fiscal consolidation, the budget rebalance for 2012 was proposed and a framework for fiscal policy in the coming year has been announced. Generally, the fiscal consolidation program represents a huge improvement compared to the policies announced by the representatives of the ruling coalition, but also compared to the policy the former government carried out in the period between mid 2011 and the first half of 2012. In addition to the fiscal consolidation measures, a series of regulations that significantly contribute to the improvement of the situation in the Serbian public finances, have been adopted. Such measures are inclusion of their own revenues in the budget, reform of the system of quasi-fiscal charges, *arrangement*of the wage policy in the public sector, improvement of the public procurement system, etc.

In addition to positive changes, the Budget rebalance and the elements of fiscal policy for the next year have several serious drawbacks. The first shortcoming is that the revised budget for 2012 increases rather than decreases the fiscal deficit. Increase in the fiscal deficit, even if it is temporary and extorted by extraordinary circumstances, seriously threatens the credibility of the fiscal consolidation program. Increasing fiscal deficit sends a bad message to investors, but also makes it difficult to achieve a new arrangement with the IMF. In addition, the increase in the fiscal deficit in the last quarter creates a false picture of a very high fiscal consolidation in the coming year -

maybe some citizens will accept such a picture, but it is sure that with investors and international financial organizations this will not be the case. The post-election expansion followed with the delay of the Government in the implementation of unpopular measures, such as tax increase and spending cuts, are the main reasons for the increase in deficit and spending in the fourth quarter of this year.

The second big shortcoming of the fiscal consolidation program is that it relies mainly on increase of revenue, while significant cuts on expenditure side are missing. It is estimated that increase of taxes was necessary because the systemic fiscal deficit in Serbia is very high (over 4%), so its reduction solely over reduction in expenditures is unlikely (possible only with reduction of nominal level of pensions and wages), would last for a long time, and so the risk of the debt crisis would be very high. Spending cuts in the coming year refer mainly to savings on salaries and pensions, while other current expenditures, within which there is considerable unproductive spending, are not reduced. Although on the majority of these expenses significant savings could not be realized in the short term, for long-term success of the program and its credibility, it would be important to immediately begin reducing public spending. In the short term it is possible to significantly reduce the Republic budget deficit and the deficit of the consolidated government by eliminating vertical imbalance between revenues and expenditures of the Republic and local governments. The effect of eliminating vertical imbalance would be approximately equal to the effect of the VAT increase, and would not force any costs on the citizens - only the State would effectively redistribute existing taxes and obligations.

The third shortcoming of the fiscal consolidation program, which arises from the previous, is that the reduction of the fiscal deficit is planned to be relatively slow, which means that the public debt-to-GDP ratio will increase over at least two to three years. The high amount of the funds needed to finance the fiscal deficit and principal repayment of maturing debt, under the circumstances of low credit rating, insufficiently credible fiscal consolidation program, absence of the arrangement with the IMF and uncertain progress towards the EU, seriously creates the problem of securing funds for its financing, and increases the financing costs. The amount of required funds is such that it is highly unlikely it could be secured by bilateral agreements with other countries, without a significant participation of commercial financiers. Bilateral funds can at best be used for bridging liquidity, while the conditions for re-lending of Serbia with commercial investors are not created.

Proposed budget rebalance for 2012 received a negative evaluation from the Fiscal Council and the IMF, while the measures for 2013 received a number of positive evaluations, also, the proposals, whose implementation aims to quickly reduce spending and deficits, were presented. The finance minister expressed his willingness to accept suggestions related to 2013 and subsequent years, but it is not certain whether the government is prepared to correct the 2012 rebalance. For the success of the fiscal consolidation it is crucial that the Government corrects the proposed budget rebalance, in order for the negotiations with the IMF - that would lead to the conclusion of the new arrangement – to begin by the end of the year.

Restoring Serbia's public finances on a sustainable path is not an impossible mission, for that, the political will is needed to drop some of the campaign promises, correct the bad and unsustainable programs such as fiscal decentralization, as well as to accelerate the reform of the public sector. It is necessary to reduce losses on rebalance for 7-8 billion dinars, which could be achieved by giving up on some campaign promises, elimination of certain subsidies, etc. In the budget for 2013, it is essential, in addition to the planned austerity measures, transfer obligations of at least 20 billion dinars on the local level, start with the reduction of subsidies and the number of employees in the state sector, continue pension reform, rationalize the school network, improve public procurement, etc.

Although representatives of the ruling coalition, in the period of the adoption of amendments to the Law on NBS, announced radical changes in monetary policy (spending of foreign exchange reserves, reducing interest rates, etc.), so far, decisions in the area of monetary policy, but also announced personnel decisions indicate that the policy continuity is likely. At the first meeting of the new NBS management, decisions were made to increase restrictive monetary policy, which is an adequate response to the acceleration of inflation, depreciation pressures, etc. However, it is very likely that the pressure from influential and privileged businessmen and their political representatives will continue with the aim to solve their business problems using expansive monetary policy.

This issue of Quarterly Monitor (QM) contains one text in the section Highlights (Arsić), which analyses the proposed budget rebalance for 2012, as well as the announced framework for fiscal consolidation in 2013. Spotlight On 1 (Arsić, Ranđelović, Pejić) analyzes quasi-fiscal and non-tax charges in Serbia, assessing measures of the Government to abolish many of these charges, introduce a procedural order in this area, etc. In Spotlight On 1, additional measures, for the reform of the quasi-fiscal charges, as well as measures that would compensate for the fall of state revenues due to the abolition of these charges, are proposed.