From the Editor

In Serbia, as in other countries in the region, recession trends continue – the GDP is declining for the third consecutive quarter and the unemployment increases. However, the decline in the economic activity and the unemployment growth are notably lower than during the first wave of recession and if European economies recovery in the next few months, chances are that they will be short-term. However, unlike other countries in the region, in Serbia, internal and external imbalances are increasing, which negatively affects the potential recovery of its economy.

While the other European countries are intensively decreasing their fiscal deficits and debate whether the decreasing speed is excessive, the fiscal deficit, in Serbia, is growing. In 2011, fiscal deficit in Serbia amounted to 5% of GDP, while in the first quarter of 2012 it stood at about 7% of the quarterly GDP – partly due to a one-time pre-election spending. It is estimated that with the continuation of the current policies, fiscal deficit will amount to over 6% of GDP in 2012. A high fiscal deficit and the increase in the government guarantees have directly influenced the increase of the public debt, which at the end of March reached about 50% of GDP, and it is estimated that, by the end of the year, the public debt will be about 55% of GDP. The Public debt in Serbia has entered the critical zone in which its financing costs are growing (see Section 6, Fiscal Flows and Policy), and the probability of a debt crisis is relatively high (see Highlights 1).

A greater part of Serbia's fiscal deficit is structural, i.e. systemic in nature and maintains a relatively permanent discrepancy between the tax system and public expenditure policies, while the smaller part is a consequence of the economic crisis. In 2011, the structural deficit was exceeding 4% of GDP, while the contribution of the economic crisis to the fiscal deficit amounted to less than 1% of GDP.

The most important measures of the economic policy which led to the formation of the structural fiscal deficit are: the reduction of the labor taxes and transfer of certain products to a lower VAT rate in 2007, a high wage growth in 2006-2007, pension increase by as much as 32% in 2008, as well as so called fiscal decentralization in 2011. In 2012, in the pre-election period, the fiscal deficit was increased additionally, with most of the spending being temporary, while the structural deficit rose by about 0.2% of GDP, as a consequence of the changes in the Law on Police and adoption of the Regulation on salaries at the local level. However, the outgoing government has adopted draft law for the reduction of VAT on the baby equipment and the increase of the tax-free threshold to ten thousand dinars. Implementation of such laws would lead to additional increase in structural deficit by about 0.3% of GDP.

Another worrying trend in the Serbian economy is a strong growth of the current account deficit which in 2011 amounted close to 10% of GDP, while in the first quarter of 2012 it reached 16.5% of GDP. Although a significant improvement is expected in the rest of the year, it is estimated that the current account deficit would amount to about 12% of GDP in 2012. The current account deficit in Serbia is significantly higher than in other countries of the region, in which it does not exceed 5% of GDP, with the exception of Albania and Bosnia and Herzegovina. Increase in the current account deficit throughout 2011 and at the beginning of 2012 is a consequence of the increase in a fiscal deficit, a delayed effect of last year's real appreciation of the dinar, the fall in a global demand, but also some short terms factors.

The current account deficit of 12% of GDP (about €3.5mn) is unsustainable even in the normal times, and in the times of crisis, when capital inflows are drying up (€1.5bn expected in 2012), it is a serious problem which can jeopardize macroeconomic stability. Inability to finance the current account deficit with capital inflows is the main reason for the intense depreciation of the dinar and the reduction in NBS foreign exchange reserves during the first five months of 2012. Depreciation of the dinar affects reduction of the current account deficit towards the balanced level, but with a certain lag, it affects the inflation growth and increases the cost of repayment of the foreign currency denominated loans. It is therefore essential that the deficit in a current account balance is reduced to sustainable level that under normal circumstances in the world capital market is estimated at about 6% of GDP. It is important that the reduction of the current account deficit is not done only by the depreciation of the dinar but also by the reduction of the aggregate demand, as a result of reduction of the fiscal deficit.

The unfavorable trends in the public finance and balance of payment specify the first priority of the new government and that is a fiscal consolidation. In May, the Fiscal Council published a complete proposal for the fiscal consolidation whose implementation would reduce the fiscal deficit to about 5% of GDP in the current year and about 3% in 2013 (see the original document on the website of the Fiscal Council and Spotlight On 1). Realization of the proposed fiscal consolidation aims at achieving a balanced budget over the next four years. Major part of the fiscal consolidation (about 5% of GDP) would be achieved by reducing the share of a current public spending in GDP (pensions, labor costs, subsidies, repeal of the changes to the law on decentralization, the cost of purchasing goods and services, etc.), increasing taxes by about 1% of GDP, while the public investments would increase by about 1% of GDP. A significant reduction of the fiscal deficit during the period 2012-2013 would minimize the risk of the public debt crisis and reduce the current account deficit, which would lead to the stabilization of the exchange rate and the reduction of the inflationary pressures.

The fiscal consolidation, with the real depreciation of the dinar already achieved in the first quarter of 2012, represents the key to maintaining macroeconomic stability without which the economic growth could not be achieved. To what extent the fiscal consolidation is important can be seen in the numerous examples from the world in which countries apply harsh and unpopular austerity measures and increase taxes to accomplish it. We are close to the case of Slovenia, which has a lower fiscal deficit than Serbia and about the same share of the public debt to GDP ratio, but has already resorted to the radical austerity measures such as the reduction of nominal wages. It is unlikely that the economists in almost all European countries are ignorant and their politicians irresponsible to apply such drastic austerity measures and increase taxes instead of increasing spending and reducing taxes as some politicians from Serbia suggest.

Fiscal consolidation which prevents the public debt crisis and balance-of-payments crisis, thus providing macroeconomic stability, is a necessary, but not sufficient condition for launching a long-term sustainable economic growth and reducing unemployment. To start the economic growth, a number of structural reforms are required, some of which would be implemented through a program of the fiscal consolidation. Fiscal consolidation would reduce the country risk which would result in lower interest rates for the economy and increased foreign investments. In addition to the reforms listed in the program of fiscal consolidation, a number of other reforms are necessary to promote the economic growth and employment. Among these reforms, of particular importance are the elimination of complicated and unnecessary regulations that increase the costs and risks of doing business in Serbia and are a source of corruption, development of financial discipline, improvement of competition policies, development of the financial markets, reform of the labor markets, etc.

In general, the key to the recovery of the Serbian economy is in structural reforms, which eliminate systemic barriers to economic progress, rather than fiscal incentives. Space for fiscal incentives in Serbia is very limited and their range is very small. On the other hand, potential costs and risks are high due to the public debt growth and growth of the external deficit as a result of the incentives.

This issue of the Quarterly Monitor (QM) contains one Highlights (Arsić and Ranđelović) which analyses the effects of a fiscal decentralization from the perspective of its impact on the fiscal deficit and efficiency of public spending and concludes that these results are extremely negative. It is therefore recommended to repeal changes to the law on fiscal decentralization. Spotlight On 1 (Arsić), sums up the arguments which deny the populist attitudes that only minor adjustments of the current fiscal policy are needed, which would be achieved through better tax collection, savings in the procurement of goods and services, reducing subsidies, etc., without the necessity to freeze wages and pensions and increase taxes. Also, libertarian proposals to achieve fiscal consolidation through eliminating all subsidies, dismissing the half of employees in the public sector or by reducing the cost of goods and services by 50% are challenged. While populist proposals basically mean postponement or abandonment of fiscal consolidation, which would lead to the debt crisis, libertarian proposals would provide fiscal consolidation but would lead to the collapse of some of the basic functions of the state. Spotlight On 2 (Arsić), analyses the situation in about 1300 companies that are under state control, which employ significant resources (wealth, labour), receive direct subsidies of about 2.5% of GDP, indirect subsidies of more than 1.5% of GDP but provide a modest contribution to GDP. Spotlight On 2 proposes the completion of restructuring and privatization of public companies in a relatively short time as well as measures to improve the efficiency of public enterprises, privatization of some of them and the liberalization of activities in which they operate. Reform of enterprises under state control has a broader economic impact, not only fiscal, and it is necessary for development of financial discipline and efficient use of resources.