From the Editor

The crisis that has struck the European Union has been adversely affecting Serbia in various ways: the halt in the growth of Europe's economies has reduced demand for Serbian products; the problems faced by the real sector and the financial markets have resulted in lower capital inflows and driven up the price of money, while, in some segments – such as banks – Serbia could yet see capital flight. In addition, the general crisis of confidence in government debt could engulf Serbia as well, although the country's indebtedness remains moderate. The substantial impact on trends in the EU on Serbia's economy is caused by the fact that some 80% of Serbian exports are sold in markets of EU member states and neighbouring countries that are yet to join the EU but are highly dependent on it. Low private and government demand means that investment in Serbia depends to a large extent on the inflows of foreign capital, the majority of which originate in the European Union.

Since the beginning of 2011, the situation in both the real and the financial sector in Serbia has been worsening, which has had an adverse effect on public finances. Serbia's economic activity has seen a downturn in Q2 and Q3, with this negative trend set to continue into Q4. This has cast doubt on the likelihood of achieving the officially forecast growth rate of 2%. An additional problem is the fact that Serbia will enter 2012 with a low level of production, meaning that substantial quarterly growth will be needed next year for the country to achieve annual growth of 1.5% (see Highlights 1). A relatively significant drop in overall employment continued throughout 2011, while the fall in formal employment has been more moderate. Exports, the main driver of economic growth for the past two years, have been decelerating since the middle of 2011. The slowing of export growth can partly be accounted for by the drop in export demand, but was also caused by deterioration in the price competitiveness of Serbia's economy due to the high real appreciation of the dinar in 2011. The rapid decline in inflation in the second half of 2011 was one of the rare positive indicators witnessed by the Serbian economy. The real value of the total sum of banking sector lending has stagnated in 2011, while the sum of lending to businesses saw a decrease in real terms. Businesses are increasingly having trouble servicing loans with national banks, at the same time being forced to repay their cross-border liabilities.

Serbia's fiscal position has worsened in Q2 and Q3. The drop in the key tax bases, personal consumption, employment and real wages, tightly linked to the drop in economic activity, has resulted in a fall in real public revenues. As envisaged under the anti-cyclical fiscal policy rule, the fiscal deficit was increased from an initially planned 4.1% of GDP to 4.5% of GDP. The rise in the fiscal deficit, coupled with the drop in the GDP growth rate in 2011, brought the public debt close to the statutory maximum of 45% of GDP. This would, even in "normal" times, be a relatively high level of indebtedness for a country with a low credit rating, and is especially so at a time of economic crisis and investor distrust. The size of the short-term public debt, amounting to more than €2bn in Treasury bills, makes Serbia very vulnerable to any possible loss of investor confidence. There is a risk that foreign investors will, at a moment that cannot be foreseen with any degree of certainty, assess Serbia as insolvent and refuse to finance the fiscal deficit and the repayment of any debts due – in which case the country would face a debt crisis. Thus, unless the Government acts in a concerted manner to limit the growth of public debt by reducing the fiscal deficit, the market will do so instead by, at some point, refusing to finance Serbia's public debt.

Economic trends in Serbia over the following several years will depend both on Serbia's economic policy and on the resolution of the crisis faced by the EU. The public debt crisis that has struck some EU member states has led to distrust and pessimism among investors, which means that debt crises may now occur in countries where they would not be likely in "normal" times. A crisis of trust can be resolved through robust, credible and coordinated action at the level of the EU and the world's leading economies. If such action is taken swiftly, a large part of the issues will be resolved, but the real problem of high indebtedness of some EU members will remain. In that case we can expect the downturn facing the real sector to be short-lived and European economies to begin to recover as early as 2012, which would mean that Serbia's economy will also have a chance to recover. If, however, the issue of EU states' government debt is not resolved quickly, a lengthy recession cannot be ruled out, with major negative implications for Serbia.

Conflicting opinions are being voiced in Serbia as to what fiscal or monetary policies should be pursued during a new wave of crisis or in case the recession continues. In a situation where the public debt has reached high levels in relation to the country's credit rating – and includes over €2bn in short-term debt – statutory provisions on debt are expected to be accorded priority, while the fiscal deficit should serve to bring the public debt to levels below the statutory limit. The Government has reached an outline agreement with the IMF to employ this principle, and is to do so by combining savings at the national level (reducing subsidies, net lending and expenditure on goods and services) with a one-off increase in revenues (see Highlights 2). However, medium-term fiscal consolidation, which entails bringing the deficit to below 1% of GDP and reducing the public debt to GDP ratio, cannot be based on one-off measures. Sustainable medium-term fiscal consolidation requires making comprehensive reforms across all main budget user sectors, shifting some functions from the central to the local level, as well as reforming the taxation system. True long-term reforms of the public sector designed to improve its efficiency and ensure financial sustainability have, in the main, been postponed for the future.

The public has also had the chance to hear proposals for the fiscal deficit to be increased above the statutory maximum, as well as for the statutory public debt limit to be raised to 60% of GDP. Proposals for increasing the fiscal deficit are mainly indirect and generally come in the form of calls for substantially reducing fiscal burdens on wages or increasing some expenditures, mainly subsidies to businesses, and employing new staff in certain sectors (health services, etc.). Reducing fiscal burdens on wages is justified, but only as part of a wider taxation reform that would not lead to an increase in the fiscal deficit. Such an increase would accelerate the growth of public debt, which would progressively increase the likelihood of a debt crisis. In addition, fiscal stimuli in an economy such as Serbia's (a small, open economy, with a flexible foreign exchange rate, low credit rating, etc.) have a relatively minor effect on the economy–which does not mean, however, that the effects would be small for interest groups that could benefit from them. Accordingly, at a time when Serbia's public debt is high, short-term indebtedness substantial, and investor confidence low, any calls for a rise in the deficit and an increase in the statutory limit for public debt are fiscally irresponsible. If they are heeded, Serbia would almost certainly slip into a debt crisis, which would, consequently, cause an economic recession.

A dip in inflation and recessionary trends seen in the economy have made room for a more expansive monetary policy. The NBS should continue cutting its prime lending rate to make investment into repo operations less attractive than lending to businesses. Inflation will be the key factor in deciding the timeframe for reductions to the prime lending rate, but any cuts will also be affected by what the banks will do with the excess liquidity – will they lend, or will they buy foreign currency and move it abroad. The NBS must thus tread very carefully to ensure that any increase in bank liquidity does not spill over into greater demand for foreign currency, as this would cause the dinar to depreciate and accelerate inflation. In addition, there is a real possibility for greater bank liquidity to be used to withdraw part of banks' investments from Serbia. Calls for monetary policy to be made more expansive by reducing the reserve requirement are quite risky at present, while proposals for foreign currency reserves to be used to lend to businesses are contrary to the basic principles of central bank operation. High banking sector liquidity, coupled with a drop in real lending to businesses, indicates that the problem lies in the low confidence of banks in the business sector rather than in any lack of funds to be lent. A cut in the reserve requirement is justified only if bank liquidity is a limitation to the growth of their lending.

This issue of the *Quarterly Monitor* (*QM*) contains three Highlights and three Spotlights On. The first Highlight (D. Brčerević) estimates and analyses GDP trends to the end of 2011 and into 2012. The principal conclusion of this Highlight is that the low level of GDP at the beginning of 2012 will make it relatively difficult – but not impossible – to achieve planned growth of 1.5%. The second Highlight (M. Arsić) analyzes the key elements of fiscal policy for 2012, as well as the impact of the new wave of the crisis on Serbia's fiscal position in the coming years. This Highlight confronts possible alternative fiscal policy responses to a lengthy recession. The third Highlight (J. Žarković Rakić) analyzes the European Commission's Opinion on the progress of Serbia in effecting political and economic reforms. The study focuses on critical points in the implementation of reforms that saw relatively modest progress throughout the past decade.

Spotlight On 1 (Ristić and Tanasković) considers potential bias in assigning Serbia's position in the World Economic Forum competitiveness rankings. The authors point out that in Serbia, unlike in other countries of the region, there is an unusually large discrepancy between measurable and objective competitiveness indicators and those indicators that reflect the subjective perceptions of business managers. If Serbia had been assessed equally by the subjective perception of its managers as it was by its measurable indicators, the country would have ranked higher on the list by some 30 places. The negative bias in assigning Serbia's ranking, and the country's indisputably poor performance in certain areas, have an unfavourable effect on attracting foreign investment. This Spotlight On examines the possible causes of the bias in managers' assessment of competitiveness and suggests measures that could be used to reduce it. Spotlight On 2 (Ranđelović) estimates the volume and structure of evasion of wage taxes and contributions. The results of this study show that the level of evasion of wage taxes and contributions is relatively high in Serbia, especially as regards the self-employed. The author estimates that reducing the scope for evasion could provide significant additional public revenues and contribute to the consolidation of public finances. Spotlight On 3 (Arsić and Altiparmakov)considers the distributional and macroeconomic effects of a taxation reform designed to reduce the fiscal burden on earnings and increase taxes on consumption, and contrast their results and conclusions with those published by Matković and Mijatović (2011). The authors conclude that the proposed taxation reform would not have any negative distributional or macroeconomic effects in the short term, while its long-term macroeconomic effects would be beneficial –a conclusion opposite to that demonstrated by Matković and Mijatović (2011).