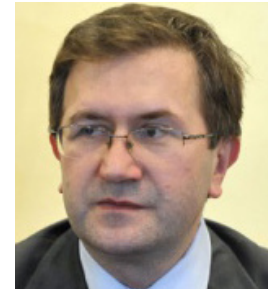

From the Editor



At the beginning of 2016 positive trends in the Serbian economy are prevailing: economic activity has accelerated growth, external and fiscal deficits have been reduced, and the labour market situation has improved slightly, while the inflation has been low and stable. Economic growth has been achieved at a desirable and long-term sustainable way, because its drivers on the demand side are investments and exports, and on the supply side industrial production, construction and services. Some negative tendencies were recorded in the capital balance where a high outflow of portfolio investments and withdrawals of credit occurred, and this resulted in a pressure on depreciation of the dinar and reduction of foreign exchange reserves. Another unfavourable tendency is a decrease in the volume of lending to the economy from the banking sector. It is possible that adverse movements in the areas of capital transactions and lending to the economy are temporary and linked to the elections, expectations on the outcome of negotiations with the IMF and developments in the global capital markets.

The elections in Serbia slowed down the reforms for several months. A progress in systematic resolving of the situation in the enterprises in the restructuring process stands out among relatively modest results in the implementation of reforms in the previous part of the year. Most analysts underestimate the importance of abolishing the protection from creditors of enterprises in the restructuring process probably because at first glance anything spectacular has not happened, nor are companies privatized nor did they immediately go bankrupt. However, from the standpoint of the economic system, it is important that these companies introduced the general legal procedures that apply to all enterprises in Serbia.

It is estimated that the Serbian economy in 2016 will achieve a growth rate of 2.5-3%, the highest growth rate since 2008 and approximately equal to the average growth rate which will be achieved in Central and Eastern Europe in this year. With the achievement of specified growth rate Serbia will finally reach the level of GDP from 2008, while other countries in Central and Eastern Europe will have for about 6% of GDP higher level of GDP than in 2008. Although the growth of the Serbian economy is not spectacular as it is similar to the average level of growth of similar countries, it is above the expected considering a relatively sharp fiscal consolidation is in progress in Serbia. Therefore, the following questions are relevant: what factors contributed to the growth of the Serbian economy in the past and in this year, what is necessary to be done in order to further

accelerate growth and maintain a high level in the long term, what are the main risks in achieving a high growth of the Serbian economy in the long run?

It is estimated that the growth of Serbian economy, in spite of the implementation of fiscal consolidation, was influenced by several factors: the reform of the economic system, consolidation of macroeconomic stability, favourable terms of trade with the world, and solid growth of the most important economic partners of Serbia. Among the reforms which most directly affected the growth of the Serbian economy are liberalization of the labour market, simplification of the approval of building permits, etc. Strengthening of the macroeconomic stability is manifested in a sharp reduction of the fiscal deficit, low and stable inflation, stable dinar exchange rate, falling interest rates, etc. After the first confirmations of the success in the fiscal consolidation in the past year, a significant growth of foreign direct investments occurred. The reaction of the economy to implementation of fiscal consolidation was quite contrary to predictions of many economists in Serbia, who argued that the reduction in domestic demand would further deepen the recession! However, that did not happen because the decline in current consumption was more than compensated by the growth of private investment and exports. The implementation of some reforms and the progress in establishing of the macroeconomic stability have led to Serbia's progress on international lists of competitiveness, as well as the improvement of its credit rating. The growth of economic activity was also favourably influenced by the fact that the terms of trade with the world during the last two years improved by 15%, mainly due to a drop in energy prices. Improved terms of trade have decreased the costs of the Serbian economy, but also mitigated the decline in private demand, which occurred during the fiscal consolidation. However, improvement in the terms of trade is by nature cyclical, and so it cannot be counted as a permanent source of growth of the Serbian economy. International conditions are relatively favourable for the Serbian economy which is primarily manifested through the solid growth of the main economic partners of Serbia. The abundance of cheap capital in the world economic market, is also a favourable factor for the recovery of the Serbian economy. Summing up the above it could be argued that there was a concurrence of favourable set of circumstances and a solid policy that led to what economists call expansionary fiscal consolidation.

Serbia's economic growth of 2.5-3% this year and expected growth of over 3% in the coming year can be evalu-

ated positively. However, to compensate for the fact that Serbia historically lags behind the countries of Central and Eastern Europe, and especially when compared to the countries of Western Europe, it is necessary to realize a high economic growth of 4-5% per year over a period of several decades. The Serbian economy was observed by the level of development in the late 80's of the last century at the average level of Central and Eastern Europe, while today this group of countries is for about 85% more developed than Serbia. In this issue of QM within Spotlight On the facts and arguments that the historical backlog of Serbia is a result of the collapse of its economy during the 90's of the last century. The backlog cannot be explained by privatization, liberalization or other measures of economic policy because Serbia applied similar policies and reforms as other countries of Central and Eastern Europe. Over the last 15 years Serbia has not significantly eliminated this backlog because up to 2008, when Serbia achieved rapid growth, other countries grew rapidly too, and after 2008, Serbia has achieved even poorer results than the other countries in Central and Eastern Europe.

Considering that the real GDP in Serbia is approximately equal to the potential GDP growth for the economy it is necessary to increase the production potential (capital and employment) of the economy, and that is possible only with high investment. The capital of the Serbian economy during the 90s was mainly physically preserved, but economically devalued and therefore largely unusable in an open market economy, which can be best seen through the inability of privatization of hundreds of former socially-owned enterprises (for more details see Spotlight On). In the case of Serbia, the economic growth is not possible to be generated by high private and public consumption as there are no significant international audience capacities, which are not used.

From the above mentioned we can conclude that the immediate requirement for long-term sustainable high growth of the Serbian economy is the increase of investment from its current level of 18-19% of GDP to around 25% of GDP. In the next few years the main contribution to the increase of investments should be provided by the public investments and by the foreign direct investments. However, to sustain investments at a high level is crucial to increase the funds for investment from private sources i.e. the funds of companies and citizens. Significant reliance on foreign loans and foreign investments, although necessary in the coming years, is not sustainable in the long run, as it would in the future result in an increasing outflow of funds from Serbia in the form of interests and dividends. Also it is not good that the Serbian economy is overly dependent on the strange fluctuations in the global capital market, which was best confirmed in 2009 when there was a sharp reduction in capital inflows, followed by a recession. The growth of domestic resources for investment requires that state and private consumption in the coming years grow slower than the growth of GDP, which will be a major challenge for

economic policy. For the growth of private, domestic and foreign investments, it is necessary to maintain low and stable inflation, low interest rates, relatively stable exchange rate, low fiscal and external deficits, etc. In addition a number of reforms are necessary, beginning with the strengthening of legal security, improvement of competition policy, reduction of administrative barriers, reduction of corruption, building of a modern infrastructure, improvement in the education system and others.

Achieving high growth rates and sustaining them in the long run is facing a number of risks and challenges. Part of these risks comes from the international environment because all major disturbances in the international economy have strong influence on a small open economy such as the Serbian. When in 2009 the GDP in 15% of the old Member States decreased by 4.4% this resulted in a drop of GDP in the countries of Central and Eastern Europe by about 5%, (if we include the Baltics decrease is close to 8%), while GDP in Serbia decreased by 3.1% (Eurostat). In contrast, the expansion of the economies of large old EU members and offer of a cheap capital before 2008 had a favourable impact on the recovery of the Serbian economy. Therefore, possible new stronger crisis in the world economy, especially in the EU, would unfavourably impact the Serbian economy. Another major challenge for the Serbian economy is to persist in the implementation of fiscal consolidation until the fiscal deficit is reduced to 0.5-1% of GDP and then to permanently maintain the deficit at a low level. Unsolved problems in state owned companies and some enterprises in the restructuring process or eventually giving in to demands to increase current consumption could in future lead to the re-growth of the fiscal deficit, which would threaten macroeconomic stability. It is therefore necessary to introduce additional legal restrictions in order to reduce the risk of weakening of fiscal discipline in the future. Long-term growth of the economy crucially depends on good institutions, and Serbia over the past decade has not yet made systematic progress in this area. Therefore, the sustainability of the achieved progress is under a big question mark. Without solid and non-selective application of the law and competent, dedicated and honest administration economic nor social progress cannot be expected.

This issue of the Quarterly Monitor contains Spotlight On (Arsic) that analyses the consequences of the economic collapse of the Serbian economy during the 90's to the present level of development and standard of living. The Spotlight On estimates movement of potential GDP, identifies the factors that have affected its trajectory, estimates the ratio of potential and actual GDP, as well as the implications for economic policy and mechanisms of growth of the Serbian economy in the future.

