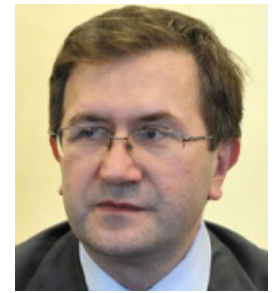

From the Editor



In the second half of the year a moderate improvement in Serbia's economic performance continues - economic activity is growing, while fiscal and external deficit are being reduced. Inflation remains low and certain improvements in the labour market probably occurred. In 2016, we expect growth of economic activity to be around 2%, inflation around 2%, while fiscal and external deficit will remain roughly at this year's level. Reforms in the state owned enterprises and the public administration reform are delayed, which may adversely affect the fiscal consolidation in the future but could also affect future economic development.

The fiscal deficit was reduced by almost 3% of GDP in 2015, which is undoubtedly a significant achievement of economic policy. However, even after the reduction the fiscal deficit is around 4% of GDP and Serbia is still among the countries with the highest fiscal deficit in Europe. The fiscal deficit of 4% of GDP is unsustainable in the long run, which makes it necessary, in a relatively short period of time, to bring it down to the level that stops the growth of public debt to GDP ratio (about 3% of GDP), and then, in the medium term, to reduce it to the level which will enable a significant reduction of public debt to GDP ratio (around 1% of GDP).

In 2016 it is planned to keep the fiscal deficit at the same level as in this year, while significant reduction is planned for 2017. However, such a plan of the fiscal deficit reduction is not credible because more difficult measures are left for the distant future, and besides, 2017 is the last year of the current arrangement with the IMF, and it is possible that this will be an election year. If the elections are held in 2018 there is a high probability that salaries and pensions will increase in 2017, which would leave out the planned deficit reduction in that year. Therefore, there is a risk that the fiscal deficit will remain at a high level of more than 3% of GDP in the next few years, which would result in a further increase in public debt to GDP ratio. To achieve a lower deficit in 2016 than the planned 4% of GDP, it would be good for the government and ministries to prepare programs of savings as well as measures to increase tax collection. These savings would represent a kind of reserve which would finance possible extraordinary expenses from financing debts of state owned enterprises.

Serbia's economy has emerged from recession in 2015, achieving growth of about 0.8%, which can be assessed as a solid performance considering that in this year, due to fiscal consolidation, domestic demand fell by around 2% of GDP. We estimate that in the next year economic growth in Serbia will amount to around 2%, which will finally allow reaching the pre-crisis level of 2008. It is estimated that the main drivers of growth in the coming year, similar as in the current, will be the growth of investment and exports.

The growth of economic activity in 2016 will also be affected by the increase of production capacity on the basis of investments that were implemented in this year. Progress in macroeconomic stabilization and reform (Labour law, building permits, inspection services,..) which affected the growth of investment and GDP in this year, are a good indicator in which direction should the Serbian economic policy take in the coming years. The growth of bank lending activity, which began in mid-2015, and the decline in real interest rates could provide additional stimulus for the growth of the Serbian economy, provided that they continue in the coming year. We expect that the growth of export will continue in 2016, which will be contributed by this year's investments as well as the moderate growth of European economies. Favorable impact on exports, and thus also on economic growth, could also be provided by a moderate real depreciation of the dinar. Finally, restoring agricultural production to the long-term average level would generate the growth of economic activity of 0.7 percentage points of GDP.

International circumstances provide moderate incentives for the growth of the Serbian economy - while on the one hand there is plenty of cheap capital that favourably impact growth of foreign direct investment and lending activities in Serbia, on the other hand there is a relatively slow recovery of European economies.

Serbia's economic growth of about 2% in the coming year will continue to be slower than expected growth in the other Central and Eastern Europe countries, but also significantly slower than the growth which would allow gradual catching up with the developed countries. So the question is what must Serbia do to increase

the average growth rate to at least 4% per year? In the short term the most powerful stimulus for growth can be generated from further strengthening of macroeconomic stability and the increase in public investments. Stronger macroeconomic stability can be achieved by keeping inflation low, with low variability of inflation and exchange rates, as well as reduction of the fiscal deficit. Increase in public investment for 1-2% of GDP would, through demand, have impact on the acceleration of economic growth in the short term, while the infrastructure, built with public investments, would increase a long-term economic growth rate.

However, the growth of private investments is crucial for the growth of the economy which, apart from macroeconomic stability and good infrastructure demands well-organized institutions and a strong financial sector. According to a variety of studies on the quality of institutions Serbia is at the very bottom among the European countries, and by some indicators at the very bottom in the world. The protection of property rights is weak, independence of the judiciary is low, and corruption level is high, while the economy is burdened by complicated, unclear and unnecessary regulations... Although the estimates of the World Economic Forum in the case of Serbia are probably biased downward, it is, however, certain that Serbian institutions are functioning poorly. Weak institutions discourage people from investing in education, innovation and entrepreneurial activities which create jobs and create additional value. Poor institutions direct people towards enrichment through corruption, which redistributes existing income and wealth, but does not increase employment nor social wealth. Weak institutions encourage people to enter the gray economy, which undermines the equality of business conditions, while the entrepreneurs who pay their taxes are being burdened with high tax rates.

Without improving the work of the institutions, a long-term sustainable economic and social development of Serbia is not possible. In order to achieve a progress in the functioning of the institutions it is essential for important areas (justice, cadastre, tax administration, statistics, other segments of the administration) to adopt annual plans of reform, as well as to define the responsibility for their implementation. In addition to sectorial plans it is necessary to conduct general reforms which would stop irregular employment (political, etc.), including the employment of people with suspicious diplomas. Instead of the current practice the public sector should systematically attract the best students from the best universities. Also, it is necessary to redefine the advancement policy in order to reverse the long trend of negative selection in the public sector. Systematic and non-selective fight against corruption is also crucial for

economic progress. Only when enrichment through corruption is disabled businessmen will turn to adoption of technological and market innovation, and bureaucrats to improving expertise and dedicated work.

In the second half of 2015 lending to the economy by the banks is increasing, but for now it is not possible to judge whether this is a longer-term trend or a temporary recovery as are the action to the credit expansion of the ECB. Given that credit growth is not driven by subsidies and that is accompanied by a decline in interest rates, reduction of non-performing loans and the recovery of the economy, it is possible that this is a long-term trend.

A good educational system is one of the crucial factors for economic growth, which has a direct impact on productivity and the ability to create and adopt innovations. In Serbia, there is an educational system which is characterized by a relatively wide comprehensiveness of the young generation, but according to research from different sources the quality of education at all levels is low, while the educational profiles created by the educational system are poorly aligned with market needs. Also, Serbia is ranked on one of a few last places in the world according to the number of patents in relation to the population or its ability to retain talent in the country. There are many educational reforms and they depend on the level of education, but some of them are common for all levels. One of these reforms is related to the gradual introduction of the measurement of the results of all educational institutions, and the conditioning, at least in part, the amount of financial resources that educational institutions receive from the State, with the quality of education and research. Another important reform relates to the concentration of scarce resources available to the state to fund education, and this includes rationalization of the network of educational institutions while maintaining access to education. In the case of university education the State, as a regulator, should tighten the criteria for accreditation, in order to prevent waste of social resources for producing low-quality degrees.

In order for educational reforms to lead to an increase in social welfare it is essential that the public and private sector use and reward knowledge and skills acquired in the educational process. The condition for this is to create an institutional environment in which the conditions for profit in the private sector would be the adoption and creation of technical, financial and market innovations, and not privileged business arrangements through political connections. Similarly, in the public sector, requirements for recruitment and promotion should be the ability and expertise, rather than political and other irregular connections.

