From the Editor

Over the previous part of the year key indicators of the Serbian economy improved compared to the situation in a couple of previous years. The economy came out of recession during the second quarter of the year, fiscal and external deficits were significantly reduced, the labour market situation is improving, and inflation is low. Although improvements are undisputed, the performance of the Serbian economy in this year, and probably also in the next, will be considerably weaker than in most Central and Eastern Europe Countries: the growth of the economy will be slower, while the unemployment rate, external and fiscal deficits will be among the largest in the above mentioned group of countries. Weaker performances of the Serbian economy in relation to its neighbouring countries are a consequence of delays in the implementation of reforms from one to one and a half decades, as well as delays in the implementation of fiscal consolidation of at least three years. Achieved results represent the first step in creating conditions for long-term sustainable growth of economic activity and employment, so it is therefore necessary to continue with fiscal consolidation, as well as to speed up the reform. There are still no grounds for complacency with the results achieved, nor a space to slow down or delay fiscal consolidation and reforms.

Serbian economy in the second quarter of 2015 came out of the recession which lasted from mid-2013. Previous recession was a consequence of weakness of the economic system and economic policy in Serbia, not the international circumstances, as almost all European countries in the mentioned period recorded economic growth. Previous recession cannot be attributed to the floods, since it started almost a year before them, which means that the floods only deepened the pre-existing recession. Serbia is one of few countries in Europe that even in 2015 has not reached the pre-crisis level of GDP and will do that only in the following year.

Exiting recession in the year when strong fiscal consolidation is being implemented, under which public spending is reduced to about 2% of GDP, is a surprise for most economists (including the authors of QM), international financial organizations, the Government, NBS and others. At the end of last year, according to most forecasts, a fall of GDP of between 0.5 and 1% was anticipated while opponents of the austerity measures argued that the fall will be higher than in the previous year, hence, over 2%. After the end of the first half of the year it is quite certain that the Serbian economy will achieve growth of 0.5-1% of GDP this year, and that without the drought in agriculture this growth would amount to over 1% of GDP. Therefore, it is reasonable to ask the question what factors influenced better than expected results of the economy in this year?

Favourable international circumstances, reforms that have improved business conditions and changes in economic policy have all contributed to exiting from the recession. Favourable international circumstances include improvements in the terms of trade, the recovery of European countries and low interest rates. More favourable terms of trade refer to the decline in oil and gas prices and base metals prices in the international market, which were in growth as a direct result, instead in the expected decline, in production of the petrochemical complex and the metal industry (MKS, processing of aluminium and copper, etc.). The decline in import gas prices influenced the increase in the purchasing power of citizens, resulting in smaller than expected decline of personal consumption. The growth of European economies at a rate of about 2% positively affects the recovery of the Serbian economy because it facilitates the growth of exports, which from the standpoint of demand contributed the most to the achieved growth. Low interest rates are for now influencing the growth of retail lending, thus reducing the drop in private consumption, while for now they are having no effect on the growth of the volume of loans to the economy, but are having a positive effect on operating costs of the economy.

Reform of the labour legislation, acceleration of the approval of construction permits and improvement of macroeconomic stability have positively influenced investments and business operations in Serbia. Improved business conditions have most directly influenced the growth of the construction industry, which was one of the drivers of economic recovery from the recession. Recovery of the construction industry was contributed by the growth of public investments in transport infrastructure, as well as the renewed growth in demand for housing due to the decrease of their prices and the fall of interest rates on housing loans. Also, better business conditions, with already low labour costs, in Serbia directly influenced the relocation of cigarette production from the EU to Serbia - production of cigarettes has been increased by almost 90%. Finally, economic growth in the year when fiscal consolidation is being implemented has confirmed what we argued in the past, and that is that the fiscal multipliers in Serbia are low, which means that an increase in government spending can't be significant to start-up the economy nor the reduction of government spending significantly impacts a drop in the economy.

Unexpected growth of the Serbian economy by 0.5 to 1% in 2015 represents a good result compared to the previous year, but it is still far below what is already achieved by other European countries and what should be a medium-term objective for the Serbian economy. Estimated growth rate in Central and Eastern Europe for the current year is about 2.5% and at the same time all countries, except Croatia, will record a growth of more than 1% while the coming year expects a growth close to 3%. Also, the rate of growth that the Serbian economy will achieve this year is far below the medium-term objective that could be between 3-4% in the next few years, and in somewhat longer term a goal could be the growth of around 5%.

Therefore, the essential question is how Serbia can stimulate economic growth from a modest 0.5% or 1% to 3%-4% per year. The growth of the Serbian economy in 2015, when state and private consumption are reduced, is another confirmation that the growth drivers in our case are not related to domestic demand but to exports and investments. The key condition for acceleration of economic growth in Serbia is to increase the investment rate from the current level of about 20% to over 25% of GDP. At the same time the state can directly contribute to the increase of total investments by increasing the public investments from 3% of GDP to 4-5% of GDP. However, the key role of the state is to create favourable conditions for the growth of private investments, and it includes primarily the improvement of business conditions and the maintenance of macroeconomic stability.

Improvement of business conditions includes reforms of judiciary, cadastre, administration, education, completion of the privatization of former state-owned enterprises, improving the work of public enterprises and others. Improvement of business conditions is not a one-time activity, but a continuous process in which the country's institutions adapt to the changing environment. For secured macroeconomic stability it is necessary to continue with the resolute fiscal consolidation as the fiscal deficit of 3.5-4% of GDP, which will be achieved in this year, still remains one of the biggest in Europe. It is therefore essential to continue reducing the fiscal deficit in the coming years in order to reduce it to around 1% of GDP in the next couple of years. Continuous reduction of the fiscal deficit, and as a result of that the reduction of the public debt to GDP ratio, is a reliable signal that the Serbian economy has avoided the public debt crisis. Therefore, for the credibility of the Government of Serbia it would be very unfavourable for the fiscal deficit to increase in the coming year compared to this year, or to remain above 3% of GDP in the next few years.

Apart from the increase of the GDP growth rate it is important that economic growth is sustainable, i.e. not to create any internal and external imbalances. Fiscal consolidation eliminates the risk of the public debt crisis, but internal risks associated with a high amount of non-performing loans in banks remain. Non-performing loans discourage growth of credit activity without which the investment growth is unlikely, and besides, bad loans are a potential risk for public finances. Removal of external imbalance with the growth of the economy means that export needs to be the main growth driver in the coming years. The condition for this is a relatively high level of investments in sectors whose products are mainly export oriented, which are primarily industry, agriculture and some services. For export growth but also to encourage domestic and foreign investments in export-oriented sectors, it is important that the exchange rate is competitive. In the globalized world, where tariff and non-tariff barriers to trade and the movement of capital are mainly eliminated, policy of moderately undervalued currency is one of the most effective ways to maintain the competitiveness of the economy and encouraging its growth. Slower growth of private and government consumption than the GDP growth in the next few years is an important element of fiscal consolidation, but at the same time in this way domestic enterprises are being directed towards production for export. After stabilizing the fiscal deficit at a low level and a start of the growth of the economy, it would be advisable to reconsider the idea of fiscal devaluation, which was rejected in Serbia in 2010. Fiscal devaluation would reduce fiscal burden on labour, while consumption taxes would be increased, which would have a positive impact on the international competitiveness of the Serbian economy, at the same not deteriorating the situation in public finances.