# From the Editor

Adverse trends in Serbian economy prevailed in Q3 – economic activity weakened, and foreign trade deficit increased. Our estimates show that in 2014 GDP will shrink by about 2%, and current account deficit will widen to 6% of GDP. Inflation remained below the targeted level, with relatively frequent months of deflation, and dinar depreciated in nominal terms against euro by 6-7%, and the real exchange rate depreciated by 4%. Official figures show strong and continuing improvements in labor market, which is inconsistent with all other macroeconomic trends, and therefore raises reasonable doubts about their credibility. Fiscal deficit will be somewhat smaller than projected and will probably run at 7.5% of GDP by the end of year. However, Serbia will still have the largest fiscal deficit in Europe in 2014.

Laws on public sector wage cuts and pension reduction were adopted at the end of October, as one of key measures for fiscal consolidation. The amended Law on Planning and Construction adopted in Q4, which dramatically simplifies the issuing procedure and shortens the time needed to obtain building permit, is the most important reform bill. However, a number of obstacles to construction, such as outdated records of ownership of land, or the unresolved issue of restitution and conversion of building land, still remain.

In 2015, economic activity will be strongly affected by numerous factors acting in opposite directions. Fiscal consolidation, liquidation of insolvent companies, and low credit activity of banks, will weaken economic activity. However, this decrease in economic activity will be cushioned by rise in electricity and coal production back to the multiple-year average, renewal of production in some enterprises after their privatization, and expected reform-driven rise in investments. According to mid-term projections, GDP will shrink by about 1% in 2015. This decrease will be somewhat larger if the announced successful privatizations (of Železara, FAP etc.) fail, or if some over-indebted private firms stop the production. Analysis by components of demand shows that public and private consumption will suffer the sharpest drop (by -6% and -3% respectively), and investments will increase by 5%. Net export is expected to rise by 1.5 percentage point of GDP, due to drop in domestic demand and real dinar depreciation. The National Bank of Serbia should try more actively to bring the inflation back to the middle of the targeted corridor in the next year.

Government representatives and the IMF reached a three-year agreement on economic policy and reforms. This agreement is not available to the public yet, but according to what could be heard from the Government it contains a relatively comprehensive package of economic policies and reforms. The main goal of economic policy is to reduce fiscal deficit by about 4% of GDP in the following three years. Furthermore, this agreement contains crucial reforms such as completion of privatization of socially-owned enterprises, reforms in public enterprises and enhancement of business environment.

Although the measures contained in this agreement are sometimes described as draconic in public, they are actually the minimum of what Serbia needs to do to put public finance in order and prevent public debt crisis. Sustainable economic growth requires further reforms, such as reforms in judiciary, in cadastre, in tax administration, in government and municipal administration, in education system etc. However, to make progress in any of these fields, it is crucial to eliminate negative selection when hiring or promoting public sector employees.

Delays in budget approving and in signing the agreement with the IMF indicate political and social gravity of the required measures, but also suggest that the government still dithers over their implementation. This brings up the question as to whether the Government is willing and able to carry out the announced reforms. In the preceding months, the Government has embarked on some unpopular reforms and measures, such as pension reform, and wage and pension reduction, which confirms their willingness to act. Besides, there is no room for further delays and procrastination. However, it is not certain whether the Government has political will to carry out the reforms. On one hand, it is a long way to new elections and the Government has huge parliamentary majority, which should make the job easier. On the other hand, it is uncertain whether the Government will persevere with reforms in spite of the resistance from unions, bureaucratic obstruction, or a possible drop in approval rating. Limited administrative capacities are another obstacle to some complex reforms, such as reforms in judiciary, tax administration, cadastre, government administration, education etc.

Serbia is in recession and faces dinar depreciation. However, recession does not seem to have attracted much public attention, while the effects of depreciation have been overemphasized. At the same time, an extremely biased and simplified approach to both phenomena has been used.

Serbia moved into recession in the first half of 2014, and May floods deepened it. Furthermore, there is a tendency to blame the floods and unfavorable international developments for the drop in economic activity. However, economic activity started to weaken almost six months prior to the floods, which disproves the forgoing thesis. Downwards trends are detected in almost all components of aggregate demand and in almost all sectors, which indicates the impact of systemic factors on recession. In the current year, private consumption, public consumption and investments went down, and the second half of the year saw decrease in exports, as well. Almost all sectors were hit by a drop in economic activity, including those that are neither directly nor indirectly related to the floods, such as car industry or petrochemical industry. A quite reliable estimate obtained through a detailed analysis by sector shows that even if Serbia had not been hit by floods, its GDP would have shrunk by 0.8%.

Unlike the previous two, the ongoing recession was not caused by unfavorable international developments. In 2009 and 2012 Serbian economy was pushed into recession by the first and the second wave of crisis in EU. Currently, only 4 out of 28 member states are in recession, and the average growth in EU countries in 2014 is estimated at 1.3%. Drop in economic activity in Serbia cannot be attributed to Ukraine crisis either, because Eastern European economies that have closer economic ties with Russia and Ukraine than Serbia does will grow in 2014.

The foregoing leads to conclusion that the recession in Serbia was caused by internal fundamental factors, such as unfavorable business environment and growing macroeconomic risks. Economic reforms and fiscal consolidation are therefore necessary to make a sustained economic recovery.

Dinar depreciation was in line with the usual exchange rate fluctuations in countries with flexible exchange rate regime – euro and yen fell against dollar more than dinar did against euro. There are estimates of the short-term negative effects of depreciation, but its positive effects on Serbian economy are completely neglected. Short-term negative effects are direct and visible, and come down to increase in expenditures on foreign currency loans. On the other hand, favorable effects are produced in the mid and long term, and are not that apparent. In case of Serbia, deflationary tendencies that reversibly deepen recession can be eliminated through dinar depreciation. Under recession, the impact of depreciation on inflation is weakened. Somewhat deeper depreciation is therefore needed to bring the annual inflation back to the targeted corridor of 4-5%. Depreciation is needed to enhance international price competitiveness of Serbian economy and to reduce still very large trade deficit. Additionally, dinar depreciation stimulates exports and inflow of FDI, as the key generators of future economic growth. Depreciation is also a means of diversion of investments from the sector of non-tradable goods (trade and other services) to the sector of tradable goods (industrial and agricultural products). In general, devaluation of domestic currency by several percents annually through moderate depreciation is a good strategy for a small open economy such as Serbian. Systematic devaluation of domestic currency proved successful in many emerging economies. We therefore believe that it would be good to employ this strategy in Serbia, as well. Overvalued currency hinders economic growth and decreases employment. Overvaluation of dinar before the crisis is partly attributed to a large inflow of capital, and partly to a short-sighted and opportunist policy and influence of certain interest groups (importers and foreign currency debtors). To the extent to which it was caused by economic policy, whose aim was to win political favor with citizens through an unsustainable rise in the standard of living based on imports of cheap goods, and to protect the interests of importers and foreign currency debtors, overvaluation of dinar was one of the biggest mistakes made by Serbian economic policy makers after 2000.