Highlights 4. What is necessary for the sustainable growth of the Serbian economy?

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Serbia is in a small group of countries of Central and Eastern Europe[2] which have failed to reach the pre-crisis level of GDP in 2014. Serbia's economy recorded a growth in the fourth quarter of the last year, but GDP declined again in the first quarter of this year (for more details see Section 2). In the coming quarters of 2015, GDP growth is expected, largely as a result of the recovery of electricity and coal production from the last year's floods. However, flood recovery allows temporary, relatively modest growth of the economy. Therefore, a relevant question is what is needed to put the Serbian economy on the road of the long term sustainable growth. Justification of such analysis comes from the fact that the Serbian economy in recent history had several episodes of rapid growth, which were accompanied by high imbalances, and therefore growth was unsustainable in the long run. Thus, for example, in the period 2001-2008 high growth rates were achieved but with long-term unsustainable level of external deficit and a growing fiscal deficit.

The growth is sustainable in the long run[3] if it is achieved without any major internal and external imbalances, and if it is achieved with small fiscal and external deficits. Low deficits do not lead to the growth of public and foreign debt in relation to GDP and so the economic growth can last indefinitely. Sustainable growth implies a relatively high investment in physical capital, as well as a permanent improvement of knowledge and skills of the workforce. Low external deficit implies that the investments are mostly financed by domestic savings and that the country will not enter the balance of payments crisis in the future. It can be concluded that Serbia has not yet moved on the path of sustainable growth, since fiscal and external deficits remain high, while investment are low and largely financed by foreign savings. Besides the economic environment in Serbia is still not sufficiently encouraging for the development of the private sector, which should be the dominant driving force behind economic growth in the future.

1. Imbalances in the economy

With launching the fiscal consolidation in the second half of the previous year fiscal deficit was reduced to about 2% of GDP, but even after that reduction fiscal deficit in Serbia will amount to about 4.5% of GDP[4], which is unsustainable in the long run. An additional problem is that a considerable part of the deficit reduction was achieved by applying temporary, long-term unsustainable measures, such as the payment of dividends of public enterprises, taking 10% of wages from employees in the public sector, delayed payments for severances and others. Once these temporary measures cease to make effects this will cause the automatic increase in the fiscal deficit as it was the case in 2011 when measures such as excise duty on mobile phones, a reduction in transfers to local municipalities and others were abolished.

The fiscal deficit, which does not lead to the increase of the public debt in relation to GDP, with the expected growth of the economy and interest rates, is below 3% of GDP, while the long-term sustainable fiscal deficit is at 1% of GDP[5]. Therefore it is necessary to further reduce the fiscal deficit for about 2% of GDP to stop the growth of public debt in relation to GDP in a relatively short period of two years, and then to continue to reduce the fiscal deficit up to 1% of GDP over the medium term. Therefore, to continue reducing the fiscal deficit it is necessary for the Government, already in this year, to prepare measures whose implementation would lead to the fiscal deficit decline in the following years. Instead, representatives of the Government announce the abandonment or postponement of the implementation of such measures, and announce measures that would directly affect the growth of the fiscal deficit (increase in public sector wages and pensions at the end of 2015). This behaviour of the Government representatives is motivated primarily by political factors –with the increase in public spending and reduced savings the government will try to win over voter support.

However, in addition to political reasons, the intention of the Government to mitigate or postpone fiscal con-

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2 Smaller GDP in 2014 compared to 2008, with Serbia had only Croatia, Slovenia and Latvia, but Latvia will already in 2015 reach the pre-crisis level of GDP, while the pre-crisis level in Serbia could be reached in 2016. Although Slovenia, Croatia and Serbia have different starting positions and have implemented different models of transition, they all share the delayed resolution of the fundamental problems of their economies. The inability to solve basic questions in the economy and public finances in particular has become obvious from the beginning of the global economic crisis.

3 In this article we only analyze conditions for economically sustainable growth of a functionally market economy, though the sustainable growth has many other aspects, such as social or environmental sustainability.

4 It is possible that the actual fiscal deficit in this year will be smaller, but this will be achieved with temporary savings such as the postponement of the part of severances payment for the coming year, lower public investmentsthanplanned and others.

5 Reducing the fiscal deficit to 1% of GDP in the case of Serbia is also necessary to reduce the public debt from about 80% of GDP,where it would be at the end of this year, to below 60% of GDP which is the amount the Maastricht criteria, and then to below 50% which is appropriate to circumstances in which Serbia is.

solidation is partly based on optimistic and wrong assessments. Assessment of the Government that Serbia is already on the way to a rapid and long-term sustainable growth is overoptimistic and almost certainly wrong. From this wrong assessment wrong conclusion are made that so far achieved savings measures are sufficient, and perhaps exaggerated, i.e. that it is sufficient to hold consumption at the present level or even slightly to increase it, but that spending and deficit, seen as a percentage of GDP, will decline due to a strong GDP growth.

Moreover, there are suggestions that the GDP growth should be fostered by the increase in government spending or an increase in salaries and pensions. The assumption is that the increase in salaries and pensions would have more impact on GDP growth than on the increase of the fiscal deficit, so as a result the ratio of fiscal deficit to GDP would decline. In Serbia, small and open economy with a flexible exchange rate, fiscal multipliers are low, which besides econometric estimates is confirmed by the recent experience -Serbia during the previous three years had the highest fiscal deficit in Europe, which should potentially represent a strong fiscal stimulus, but its economy was in recession. In contrast, the countries of Central and Eastern Europe which have implemented fiscal consolidation in the previous years are now achieving economic growth. This year's experience, according to which the Serbian economy will stagnate or decline slightly in spite of a strong fiscal consolidation of around 2% of GDP also indicates the small impact of changes in the fiscal policy on economic growth.

Overall, it would be possible to boost economic growth in Serbia temporarily by increasing domestic consumption and increasing salaries and pensions, but such increase would not be significant because the fiscal multipliers in Serbia are low. Moreover, even that small increase in GDP would not be sustainable in the long run because the increase in wages and pensions would lead to the increase of fiscal and external deficits, and thus the public and external debt, which in the future would require spending cuts or tax increases, which would have negative impact on economic growth in the future.

The external imbalance, although much lower than in the pre-crisis period, is still high and unsustainable in the long run. Current account deficit of around 6% of GDP is not sustainable in the long-term, because it affects the growth of foreign debt or more generally deteriorates net assets position of the country[6]. Long-term sustainable current account deficit which does not generate the growth of external debt in relation to GDP, for a country like Serbia, ranges from 3-4% of GDP. This raises the question of what the Government can do to reduce the external deficit to sustainable levels. Anti-market economists often suggest the introduction of import barriers, which would in their view not only reduce the external deficit, but would encourage the growth of the economy. We estimate that measures like this are wrong for most economies, especially economies with small internal market as it is the case with Serbia. In addition it is certain that the introduction of import barriers would lead to countermeasures by other countries, which would result in a reduction of exports from Serbia[7].

Key measures to reduce the external deficit are reducing the fiscal deficit and a moderate depreciation of the real dinar exchange rate against the euro. Reducing the fiscal deficit directly reduces domestic demand[8] which has been for almost 15 years considerably higher than the GDP (domestic production), while the depreciation of the dinar will discourage imports and stimulate exports. Moderate depreciation of the real dinar exchange rate is a superior solution compared to the introduction of import barriers, which does not create an arbitrary allocation distortions, nor it creates space for lobbying of interest groups. The reduction in the external deficit will be favourably affected by reforms which improve conditions for investments and increase domestic production oriented towards exports. Serbia's export to GDP ratio is still much lower than in comparable countries of Central Europe, so there is a large space for growth in exports and a reduction of the external deficit on this basis. While in Serbia exports of goods and services in 2014 amounted to 44% of GDP, share of exports in GDP in countries of similar size (Bulgaria, Czech Republic and Hungary) is about 80%. Thus, Serbia has a large space for growth in exports and a reduction of the external deficit on this basis. In addition, growth of exports is a key driver of sustainable growth of the Serbian economy in the coming years, and so the double-digit growth rates of exports would represent a signal that Serbia is on a sustainable growth path.

6 The net assets position is the difference between the foreign exchange reserves, loans granted abroad and investments abroad on the one side and received foreign loans and foreign investment in the country on the other side. With regard to the fact that Serbia does not invest a lot in foreign countries, as well as that it does not approves loans abroad its net assets position is approximately equal to the difference between the foreign currency reserves and the sum of debts abroad and foreign investments in Serbia.

7 Paradoxically, barriers on imports of agricultural products are often suggested because Serbia is a significant net exporter of these products. The introduction of such barriers for EU countries or countries of the region would for sure lead to their countermeasures, which would result in a reduction of exports of agricultural products from Serbia.

8 The decrease in domestic demand has a direct impact on the reduction of imports, and indirectly affects the growth of exports because local producers are encouraged to compensate the drop in domestic demand with higher exports.

Investments in physical capital are a direct determinant of economic growth. Although there is no unambiguous relationship between investment and the growth of the economy, it is quite certain that with investments of about 20% of GDP, which is now the case in Serbia, rapid growth of the economy in the future cannot be expected. Based on the experience of similar countries from Central Europe it can be estimated that the rapid economic growth requires investments of around 25% of GDP. In the case of Serbia this implies an annual increase in investment of over 5% of GDP i.e. from 1.5 to 2 billion of euros. It is crucial to increase private investment reforms aimed at creating more favourable conditions for investments, but also fiscal consolidation based on reducing government spending, because it increases assets in the long-term which remain in the private sector[9].In the mid-term, the state can directly affect the increase in total investment by increasing public investments in infrastructure from the current 3% to 5% of GDP. Infrastructure construction, which reduces the costs of doing business in Serbia would favourably impact the growth of private investment in the long term. From the standpoint of the growth of the economy it is bad that the dividends of public enterprises, which would be largely used for investments, are paid to the Serbian budget, which is largely used for current spending, meaning that the payment of dividends in the budget reduces total investments. In the long term it is important that as a higher percentage of investment is financed by domestic savings.

2. Economic environment

The absence of high internal and external imbalances is a necessary but not sufficient condition for sustainable growth of the economy. In order to grow the economy in the long run numerous additional requirements are needed, such as the effective protection of property rights, financial discipline, adequate competition policy, educated workforce, efficient administration, developed financial system, low corruption, low inflation, moderate taxes and other[10]. Reforms, including those that were implemented from the middle of last year, are significant, but still insufficient for the economic environment in Serbia to be characterized as stimulating for the economy growth. According to the business conditions indicator of the World Bank Serbia is ranked 91 in the world, while in the competitiveness ranking of the World Economic Forum is ranked at 94th place. It can be expected that, as a result of the reforms that have been implemented since the middle of the last year and due to the reduction of macroeconomic risks by implementing fiscal consolidation, Serbia will progress on these lists for 15-20 places, but will still be ranked lower by 20-30 places than the countries of Central Europe. From the above mentioned it can be concluded that in Serbia a number of additional reforms are necessary in order to catch up to Central European [11]countries in terms of competitiveness and business conditions. Although in Serbia there are a number of academics (economists, sociologists, philosophers and others.) which blame "neoliberal reforms" from 2001 for all the difficulties Serbian economy is facing with, it is quite obvious that such reforms have not been implemented in Serbia. Specifically, according to the ranking of the Heritage Foundation Serbia is at the 90th place in the world according to the degree of economic freedom.

It is important to decrease state interventions in the economy to improve the business environment in Serbia,, as well as the efficiency of the state in the areas where it is indispensable, or where it has advantages over the private sector. Reduction of the role of the state in the economy would be achieved through the completion of the privatization of former socially-owned enterprises and reducing subsidies from the current level of 2.5% of GDP to a level of around 1.5% of GDP, which is suitable for European market economies.

It is necessary for the growth of market economies that the government effectively perform its core functions such as enforcement of contracts and protection of property. Progress in these areas implies the adoption of laws appropriate to the market economy and improving the work of courts and cadastre. The state has a key role in establishment of discipline in the implementation of legal and contractual obligations, whether it is about transactions in which it is directly involved, such as tax collection or settlement of obligations of the state, or those where the state performs as the guarantor of contract enforcement between private participants. By reducing the tolerance for the grey economy and orderly settlement of liabilities towards the private creditors the state directly contributes to the establishment of financial discipline. In this regard the announcement of another mass rescheduling and tax debts write-offs, as well as the delays of the state enterprises in the settlement of obligations to the private sector, are all the examples of bad signals sent by the state for all participants in the economic life.

9 The high fiscal deficit crowds out private investments with government borrowing in the country, i.e. higher taxes in the future to return loans abroad.

10 The above list of conditions is not complete, and economic science is such that it would be hard to reach an agreement on the conditions for economic growth and their relative importance.

11 We estimate that the countries of Central Europe such as Czech Republic, Hungary and Slovakia may be medium-term objective in terms of business conditions for Serbia.

Shortening the time limits for issuing building permits is an important step in removing barriers for investment, but there are still other important activities to remove the barriers for construction, such as the updated records of property rights, resolving uncertainties about the conversion of rights, the use of the property right over municipal building land, solving the restitution, updating urban plans and others.

Fair market competition represents one of the conditions for long-term sustainable growth of the market economy. According to competition policy Serbia is at the average level of the Western Balkans, but is well below the average of the countries of Central and Eastern Europe. Distortion of market competition is achieved through a variety of mechanisms ranging from the abuse of dominant and market position by economic entities, through government subsidies, the privileged position of some private companies in making business with public companies and state institutions, tolerance for the grey economy and the periodic tax debt write-offs. In order to improve competition policy in Serbia it is necessary to establish effective competition policy, abandon the policy of subsidies which distorts the equality of market participants, improve public procurement policies, but also to stop the practice of tolerating informal economy and periodical debtor rewards by writing off debts.

Economic growth requires good infrastructure and an educated work force. The state is usually dominant in the case of transport, energy and public owned infrastructure though not the only participant, while the state role as a regulator is crucial in telecommunications infrastructure. Increase of public investments in infrastructure would directly affect the economic growth in the medium term, while newly built infrastructure would have a positive impact on private investment and growth in the long term. According to the infrastructure conditions, especially transport, Serbia is significantly lagging behind other countries in the region, and the low level of public investments shows that the lag is not being reduced for now.

Educated workforce with physical capital is a direct determinant of economic growth. Based on different studies ranging from the PISA tests to the number of scientific publications and registered patents Serbia lags behind the Central Europe countries. In primary education there are non-productive costs for maintaining the extensive network of primary schools and an excessive number of employees (see Highlights 3), while investments in education of teachers and modern teaching aids is insufficient. Coverage of children with secondary education is insufficient and adaptability of education to the labour market is low. In primary and secondary education there is no adequate system of evaluating schools, as well as their rewarding depending on the results of education. State university education is characterized by an extensive network of universities and colleges that offer an average low quality of education, while the scientific work in universities is neglected. The State acting as a regulator allowed the accreditation of a large number of non-performing private universities, which further decreased the quality of overall university education in Serbia. An additional problem is that the graduates with bad quality and questionable degrees are employed in public administration and public enterprises in a growing number, which worsens the already low competence of the public sector.

The financial sector in Serbia is underdeveloped except the banking sector, and the banking sector in the past few years is in decline and stagnation. Bank lending is decreasing and without credit growth it is difficult to achieve economic growth. It is necessary to solve the problem of bad loans and establish financial discipline to start the growth of credit activity.

Conclusion

Started recovery may represent the beginning of a long-term sustainable growth of the Serbian economy, provided that it is persisted on the elimination of internal and external imbalances, as well as the reforms to improve the business environment are accelerated. In the past Serbia often dropped the reforms at this stage because the resistance to reforms strengthened and political support for them decreased and the suspension i.e. postponement or mitigation of reforms brought temporary political advantage to the ruling party.

The key role in the elimination of imbalances has a reduction of the fiscal deficit to below 3% of GDP in the next two years, and then its decrease to 1% of GDP over the medium term. Reducing the budget deficit followed by a moderate depreciation of the dinar will affect the reduction of external imbalances to sustainable levels of 3-4% of GDP. Increase of the investment rate from the current, very low, level of around 20% of GDP to around 25% of GDP can be achieved by creating a business environment that is favourable to private investments and with increasing public investments to around 5% of GDP.

In addition to the removal of internal and external imbalances for the long term sustainable economic growth it is necessary to build an enabling environment for private investment and employment. Such an environment includes effective protection of property rights, financial discipline, proper competition policy, an educated workforce, excellent infrastructure, efficient administration, developed financial system, low corruption, low inflation, moderate taxes and others.

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